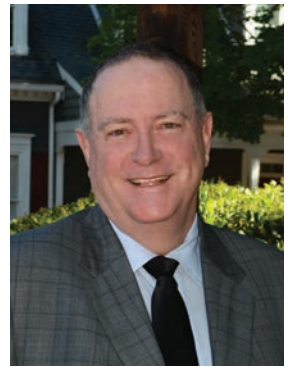
Personal Guarantees and Bankruptcy – Stay, Claim and Dischargeability Issues



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The scenario is familiar to any creditor or creditor's attorney. You have a debtor company in collections and a personal guaranty. You get a bankruptcy notice - from the company or the guarantor. This article addresses some of the issues that result - stay issues, claims questions and dischargeability.

A digression. Surprisingly often, the principal of the debtor company files a personal bankruptcy and lists the company as a d/b/a in the bankruptcy case (often with the "Inc." or "LLC" included). When the company is a separate legal entity - corporation or LLC – that d/b/a label in the bankruptcy petition does not change the status of the parties. The company's assets are not part of the bankruptcy, and the company's creditors are not creditors in the individual's bankruptcy case. Usually when the principal files and lists the company as a d/b/a, it means that the company has gone bust and caused the individual principal to file, but creditors should not presume they are stayed as to the company or its assets. Collection against the company may not be likely at this point, but don't close the file without verifying the company is uncollectible too.

THE AUTOMATIC STAY.

When the company or the guarantor files, is your claim stayed? Obviously, the stay is in place regarding the bankrupt party, but what about the non-filing party? The short answer is no. (1) There is no co-debtor stay in Chapter 7 cases - so if the case is a Chapter 7 (by either the company or the guarantor), you are not stayed from proceeding against the remaining parties. (2) If the guarantor files a Chapter 13, you are not stayed from proceeding against the company. There is a co-debtor stay in Chapter 13 but it only applies to consumer debts – "a creditor may not act ... to collect all or any part of a consumer debt of the debtor ...." 11 U.S.C. §1301(a). (3) There is no co-debtor stay included in Chapter 11 of the Bankruptcy Code, so the company's Chapter 11 does not stay litigation against the guarantor. But ...

Chapter 11 defenses. There is a line of cases where bankruptcy courts have applied a co-debtor stay in Chapter 11. In the vast majority of these cases the Court extends the stay to subsidiary or affiliated companies of the bankrupt company because the business dealings are intertwined to the point where judgments against the subsidiary or affiliate will impact the Chapter 11 case. A sharp attorney for the guarantor may make the argument that his client is so critical to the operation of the Chapter 11 company that he should not be subjected to claims of personal liability during the pendency of the company bankruptcy case. Is this BS? Yes, it is, but that has never stopped debtor's counsel in the past.

The creditor needs to argue that no one is exempt from civil action simply because of their day-time job. The best case to cite is Clinton v Jones[1], where the Supreme Court ruled that Bill Clinton's day job did not give him immunity from civil suits. If the President of the United States is not too important to be relieved from giving a deposition, how is the CEO of XYZ Corp?

The guarantor will sometimes argue as a defense that because the company is providing for payment to the creditor in the Chapter 11 plan, the creditor should not be allowed to get a judgment or collect from the guarantor. This argument is similarly bogus. First of all, the Chapter 11 plan, no matter how well it is funded, is still just another promise to pay - not actually any different than the one that led to the suit against the guarantor in the first place. Here, a creditor should argue that "going to pay" is not the same thing as "paid." While it is true that the creditor is limited to one satisfaction, the potential for payment down the road is not satisfaction of the debt. If the guaranty does not contain some requirement that the creditor exhaust its remedies against the principal (which no guaranty ever should), it is not relevant how many people might have to pay some part of the debt. Whether in the bankruptcy court, or your civil collection case, don't let the guarantor off the hook without the judge understanding precisely what she is being asked to allow - a non-existent legal right to protect someone who specifically promised to make good on the debts of the bankrupt

CLAIMS ISSUES.

When there is a civil case pending against the non-bankrupt party, it is important to make sure that the creditor's position in each case is consistent. Whatever amounts are sought in the litigation should be the same as the amounts listed in the proof of claim. The proof of claim form includes a declaration "under penalty of perjury" that the claim is true and correct. Even if there is a good explanation for the discrepancy, there is no reason to hand your defendant an argument that you will have to overcome. Better to claim the same amount.

Creditors should also remember that this need for consistency works both ways. If the guarantor in the civil suit has claimed a set off as a defense, but the creditor's claim is listed as undisputed in the bankruptcy schedules, the creditor has a solid argument that the defense has been waived by the principal obligor. Similarly, where the bankrupt guarantor is the principal of the company still in litigation, the creditor has a good argument to make if the guarantor does not list the claim as a disputed co-debtor obligation in the bankruptcy paperwork. At minimum, the guarantor is going to have to explain the inconsistency.

A couple of practice notes on filing a claim in the bankruptcy case. First, always include a copy of the guaranty agreement with the claim. Proof of the principal debt establishes the claim amount, but the guaranty agreement is the proof that there is a valid claim against the bankrupt guarantor. Additionally, the guaranty agreement should include its own, separate, agreement to pay interest at the legal rate and attorney's fees. If the only agreement to pay interest and attorney's fees is in the credit application, then the guarantor's attorney (or the trustee) can argue that the creditor is not entitled to those amounts as a claimant against the guarantor in the bankruptcy case.

DISCHARGEABILITY.

When the guarantor files bankruptcy and lists the creditor's claim, that claim will obviously be discharged. It is a common mis-conception among creditors, though, that if the claim is not listed in the bankruptcy case, then it is not discharged. It is true that the Bankruptcy Code contains an exception from the discharge for claims that were not listed in the case and creditors who did not receive notice of the bankruptcy case, but that limitation is not nearly as effective as it might seem. The exception applies to debts of creditors who did not get notice in time to file a proof of claim (when there is a distribution) or to file an objection to the discharge under §§ 523(a)(2)(4) or (6). So in a no-asset Chapter 7 where there was no proof of claim deadline, the creditor without notice is not prejudiced because she wasn't going to get any distribution anyway. Therefore, in practice, because the debtor can re-open the case, add the claim to its schedules and have it discharged, only where the claim is one which may be excepted from discharge under the code sub-sections listed above (for fraud, embezzlement, or torts) will the Court consider the lack of notice important.

Creditors need also to be aware, though, that the guaranty agreement itself is discharged in the bankruptcy case. Debt is defined as "liability on a claim;"[2] claim is then defined as a "right to payment, whether or not such right is reduced to judgment,

1 520 U.S. 681 (1997)

2 11 U.S.C. §101(12)

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Anyone addressing you should not need to use a generic greeting. Messages requiring immediate action or a sense of urgency, such as an email from your bank telling you your account is about to be closed unless you sign on and change your password immediately have become commonplace. Of course, if you fall for that and use the link included in the message to sign on to your bank, you have just given access to this cyber fraudster. Messages from an email you recognize but the tone is strange or there is an unusual sense of urgency is another way for you to bite and grant access to a fraudster. My recommendation is to pick up the old-fashioned telephone and ask if that person did or did not send you such an urgent email.

HACKING AND MALWARE

There are few people among us today who have never been "hacked". A common sign that you have been hacked is that your icons may start to disappear as the computer is starting up. You may also receive an alert that your system is infected. You probably will not be able to remove or quarantine those infected files. You may receive a pop-up message saying that the computer is now encrypted, and you must pay a ransom to recover it. Or you may spot new accounts or new programs on your device that you did not create. It is likely that your password will no longer work. Your friends and co-workers may start to receive odd messages from you that you know you never sent.

Don't try to fix this yourself. And, never give in to ransomware. Contact your IT department immediately. Trying to effectuate "self-help" may cause you to open more doors which implant more malware. Malware is commonly used to silently watch or spy on your online activities, capturing every keystroke to steal your passwords and files. A Trojan Horse could be installed and just waits for an appropriate time to become active. While your computer is open to the internet, perhaps receiving an update, that hidden trojan horse may then be able to hack into your computer, causing the serious damage.

The best defense against Cyber Fraud of all types is common sense. If something looks odd or suspicious, shut down your computer and get an IT person to look at it before the cyber-attack can take place. ■

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liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured or unsecured…."[3] Courts have uniformly held that the guaranty agreement is a contingent obligation which is discharged even though the guarantor's liability may be contingent upon the default by the principal at a later date. Courts have ruled that even where there is no pre-petition debt owed by the principal at the time of the bankruptcy filing, the guarantor is discharged from the guaranty obligation.[4]

Companies which file a Chapter 7 do not get a discharge. But companies which file a Chapter 11 case generally get a discharge of all pre-petition claims -- §1141(d)(1)(A). As a result, the creditor needs to read the Chapter 11 plan carefully, because a new tactic for debtor attorneys is to write in a provision stating that claims against the principals of the debtor company will also be discharged. The basic rule is 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. §524(e). However, an exception was carved out for a few, very limited circumstances where a non-party discharge would be appropriate. So it was only a matter of time before a debtor's counsel tried to get the exception expanded beyond any legitimate bankruptcy purpose. In the event this language is buried in a Chapter 11 plan, the creditor needs to object to the plan and make the debtor's counsel try to convince a judge that this is one of those few, very limited circumstances - in which effort they will likely fail.

It is all too easy for creditors to simply close the file when a bankruptcy is filed, particularly when the debtor is a small business and the guarantor is the principal of the company. But there are still a few options that might enable the creditor to recover something even where the business debt is going to be uncollectible, and a few steps the creditor should take to try to avoid ever being on the wrong side of a suit claiming a violation of the automatic stay or discharge injunction. ■

3 11 U.S.C. §(5)(A)

4 *Republic Bank of Calif., N.A. v Getzoff,* 180 B.R. 572 (9th Cir. BAP 1995). To this point, your author has found only one decision which does not extend the discharge to the guaranty of post-petition debt – *Weeks v. Isabella Bank Corp.*, 400 BR. 117 (Bankr. W.D.Mich. 2009).