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### Insider guarantees in corporate finance

*An economic analysis of Dutch, US and German law*

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# CHAPTER 5

## US law on opportunism with the guarantee relationship

### 1 Introduction

Chapter 3 discussed the guarantee relationship from the perspective of opportunism. This chapter analyses how US law deals with the problems identified in chapter 3. The question addressed in this chapter is:

*How does US law deal with opportunism with the guarantee relationship in the context of corporate finance?*

Most legal systems contain specific rules on the internal relationship. Many of those rules are designed to protect the guarantor, who is often considered a weak party. After a short introduction of types of guarantees relevant to corporate finance, US law on the protection of weak parties, most notably the guarantor, will be discussed. The focus lies on the context of corporate finance, in which shareholders or directors often guarantee debts of their company. In the discussion of weak party protection, it will thus specifically be discussed to which extent shareholders/directors are protected as weak parties.

After discussion of the rules protecting weak parties, the regulation under US law of opportunism towards outsiders of the guarantee relationship (as identified in chapter 3) will be analyzed extensively.

### 2 Introduction to types of guarantees in US law

Under US law, a guarantee (or: personal security right<sup>771</sup>) can take many different forms, or as Alces puts it: *“The forms of commercial guaranty agreements are limited only by a counsel's*

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<sup>771</sup> This term is not common in the US, but is often used in Europe.

*imagination and the business challenges confronting his client.*<sup>772</sup> This introduction serves to set out the basic forms of personal security rights under US law. The aim is to provide a basic understanding of the most-used types of guarantees relevant to corporate finance under US law, without aiming to give a complete overview of all possible shapes a guarantee relationship can arguably take, as the focus of this book is not on all the specifics and variations of guarantee law in general, but in specific on the opportunistic use of guarantees in the context of corporate finance.

US law is discussed from a federal perspective, by discussing federal law and overarching principles of personal security rights. The rules governing personal security rights are generally based on the common law.<sup>773</sup> Variations between states do exist, but are generally not discussed. Therefore, the discussion of the general principles of the law on personal security in this chapter is mostly based on treatises and the Restatement of Suretyship, instead of the case law that may somewhat diverge between states.<sup>774</sup> The primary source for the common law on personal security rights is the Restatement of Suretyship (third) of 1996 by the American Law Institute (ALI), as updated until June 2016. Restatements of law by the ALI are meant to reflect the consensus of US law on a topic and are secondary texts that officially have no authority. However, Restatements de facto have a lot of authority and are often used and quoted by practitioners, courts and academics.<sup>775</sup> The Restatement of Suretyship (third) certainly is one of the most influential texts in the field of personal security rights in the US. It does not provide binding precedent, but does have persuasive authority.<sup>776</sup> The Restatement does not aim to do more than provide default rules ‘in the absence of agreement to the contrary by the parties affected by the rules’.<sup>777</sup> But not just the specific rules on personal security rights are relevant to their regulation. Rules in the fields of, for example, general contract law,<sup>778</sup> bankruptcy law and corporate law can be highly relevant as well. Bankruptcy law is mostly federal law, whereas states have more discretion in the field of corporate law.

In US law, a distinction is sometimes made between guarantees and suretyships, though the distinction is surrounded by confusion.<sup>779</sup> Clear is however that, if the distinction is made, a guarantee is a species of the genus suretyship. The distinction, simply put, comes down to a more subsidiary and contingent nature of a guarantee compared to suretyship in general.

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<sup>772</sup> Alces, 2016, para. 1:2; see also Lopucki *et al.*, 2006.

<sup>773</sup> Tracht, 2013b, para. 45.01.

<sup>774</sup> The law of suretyship is made somewhat more complex because Article 3 UCC, on negotiable interests, may apply to suretyship contracts in as far as the underlying obligation is signed by the surety. Or as Alces explains:

*“In a less than wholly satisfactory way, several provisions of Article 3 of the UCC, from the time the Code was first promulgated, have treated some aspects of the relationship among the creditor, debtor, and guarantor. However, at this juncture it is sufficient to note that a negotiable instrument, either draft or note, may contemplate a third party whose obligation is determined in some way by reference to the debtor-creditor relationship of two other parties. For example, a promissory note issued by the issuer and enforceable by the “holder” may be “signed” as well by a comaker, an indorser, or a guarantor. Further, a “check,” which is a form of “draft,” may be drawn by a “drawer” and signed by a codrawer, an indorser, an “acceptor,” or a guarantor.”* Alces, 2016

For the purpose of this book, the UCC is not considered further for two reasons. Firstly, this book primarily deals with suretyship, not with negotiable instruments. Furthermore, the UCC follows the common law and the Restatement on most important issues pertaining to suretyship (see also Clark, 1968, also for an extensive discussion of suretyship under the UCC).

<sup>775</sup> Hulse, 2016; some have however criticized the Restatements, see for an overview Adams, 2007.

<sup>776</sup> Tracht, 2013b, para. 45.01; Henkel, 2014, p. 334; Hulse, 2016.

<sup>777</sup> Introductory note to Chapter 1, Restatement.

<sup>778</sup> See also Restatement, § 5.

<sup>779</sup> See also Bae and McGrath, 2005, p. 786; Nation, 2002, p. 154.

However, the distinction seems mainly of technical relevance. Some states have abolished the distinction altogether by statute.<sup>780</sup> The technical differences between guarantees and suretyship, as still may exist in some states, are not directly relevant to the subject of this thesis and will be left aside. The terms 'guarantee' is generally used in this chapter, as seems to be the modern convention, and is assumed to mean the same as 'suretyship'. When referring directly to the Restatement of suretyship below, it however often seems to make more sense to use the term 'suretyship'.

The guarantee as governed by the Restatement will be discussed extensively, after which a short overview of other common types follows. This paragraph serves to provide a basic understanding of US law on personal security rights in order to be able to discuss opportunism in and with the relationship in paragraphs 3 and 4. The introduction to the types of guarantees should be read as an introduction and in no way aims to be comprehensive. A reader familiar with US law on personal security can skip this introduction.

## 2.1 Guarantees under the Restatement of suretyship

The Restatement of suretyship defines suretyship broadly. The Restatement applies when pursuant to the (suretyship) contract, a creditor has recourse against the surety or the surety's property with respect to the obligation of another person<sup>781</sup>; to the extent that performance by the surety discharges the principal debtor; and as between surety and principal debtor it is the principal debtor who ought to perform the underlying obligation (Restatement § 1). In short, we can speak of suretyship when someone has to answer for someone else's debt and the creditor is not entitled to more than one performance.<sup>782</sup> In defining suretyship, and thus awarding 'suretyship status' to the surety, the Restatement takes a substantive rather than formal approach. If the above definition is met, it is a suretyship, regardless of the wording used (see § 3 a and b of the Restatement). The principal debtor does not have to know of the existence of the suretyship for suretyship to exist (although such knowledge may be relevant for the relationship between parties).<sup>783</sup>

This definition of suretyship covers diverse commercial transactions. Suretyship is often encountered in the construction industry, often denominated as a surety bond or performance bond, in which a surety company guarantees performance by the construction company or subcontractors towards the investor that pursues the building project.<sup>784</sup> Suretyship also occurs in the example in which a relative, for example a sister, of the principal debtor guarantees the debt towards a creditor, for example a bank. Suretyship usually also applies to a relationship in

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<sup>780</sup> Tracht, 2013b, para. 45.03.

<sup>781</sup> Paragraph 2 of the Restatement specifies what having recourse against someone with respect to the obligation of another person means. In short, this is the case if either the surety has to perform the primary debtor's duties, or if the creditor has recourse against the surety in case of failure to perform of the primary debtor, or if the surety has a duty to buy the primary obligation of the creditor.

<sup>782</sup> See also Bae and McGrath, 2005, p. 785; see for some examples Hulse, 2016, para. II.

<sup>783</sup> See also Alces, 2016, para. 6:5.

<sup>784</sup> See Alces, 2016, para. 1:1 and the cases referred to there.

which a shareholder of a small corporation guarantees a line of credit extended to that corporation by a third person such as a bank.<sup>785</sup>

The relevance of the qualification of a relationship as ‘suretyship’ is that common law supplements the parties’ undertaking with certain rights, next to the rights that are defined by the terms of the contract(s) between the parties.<sup>786</sup> Parties can, in principle, derogate from these supplemented rights by contract (Restatement, paragraph 6). The most important supplemented rights are the right of the surety of recourse against the principal debtor to cause the principal debtor to perform the underlying obligation or bear the cost of performance by the surety (Restatement, par. 18)<sup>787</sup> and certain defenses of the surety against a call for performance (Restatement, par. 19)<sup>788</sup>. By default, the obligation of the surety is dependent on the obligation of the principal debtor towards the creditor.<sup>789</sup>

### 2.1.1 The relationship between creditor and surety

There are many default rules that are relevant to the guarantee relationship. These rules include the principles of subsidiarity and dependency and the suretyship defenses.

#### *Dependency and defenses from the underlying relationship*

Suretyship law offers some specific defenses to sureties (§ 19 Restatement). Firstly, the surety can invoke defenses from the underlying relationship, which relates to the dependent nature of suretyship. § 34 of the Restatement lays down the dependent nature of suretyship.<sup>790</sup> According to that paragraph, the surety may raise any defense of the principal obligor to the underlying obligation.<sup>791</sup> There are a few exceptions to this general rule. Firstly, a discharge of the underlying obligation in bankruptcy proceedings does not affect the rights of the creditor against the surety (see also § 34 Restatement). Secondly, unenforceability of the underlying obligation due to the principal obligor's lack of capacity does not affect the rights of the creditor against surety (see also § 34 Restatement). More generally, the surety cannot invoke defenses that are “personal” to the principal debtor.<sup>792</sup> For example, a claim for voidability that the principal debtor may have, is not available to the surety because only the principal debtor has the option to use his right of voidability.<sup>793</sup> Lastly, the surety usually cannot invoke an independent cause of action that the creditor may have as a defense.<sup>794</sup> The surety can however generally invoke a right of set-off that the principal debtor has against the creditor, also for an unrelated claim (§ 35 Restatement).

The creditor is generally allowed to assign the claim on the principal debtor to another party. The guarantee will follow the assignment of the underlying obligation (compare § 13 par. 5

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<sup>785</sup> See Alces, 2016, para. 1:1 and the cases referred to there.

<sup>786</sup> Restatement par. 17; see also Alces, 2016, para. 2:2.

<sup>787</sup> See also Alces, 2016, para. 2:3.

<sup>788</sup> See also Alces, 2016, para. 2:4.

<sup>789</sup> Alces, 2016, para. 2:4.

<sup>790</sup> See also Tracht, 2013b, para. 45.05.

<sup>791</sup> See also Bae and McGrath, 2005, p. 796.

<sup>792</sup> Tracht, 2013b, para. 45.05, who also states that the courts are split on the issue “whether a surety is released when the statute of limitations runs out on the creditor’s cause of action against the principal”.

<sup>793</sup> Tracht, 2013b, para. 45.05.

<sup>794</sup> Tracht, 2013b, para. 45.05.

Restatement). Such assignment of both the claim on the principal debtor and the claim on the guarantor is generally allowed (§ 13 Restatement), though some exceptions can exist, most notably when assignment would materially change the duty of the guarantor.<sup>795</sup>

### *Subsidiarity*

The liability of the surety is subsidiary in the sense that the principal debtor is primarily liable and the surety only secondarily. However, under the law of most US states, the creditor can directly pursue the surety upon mere default of the principal debtor.<sup>796</sup> In that sense, the principle of subsidiarity is not strongly incorporated in US law. The creditor does not need to pursue the principal debtor first upon default of the principal debtor. He may also choose to directly turn to the surety. Some states may however have different rules.<sup>797</sup> The contract can also implement a stronger form of subsidiarity. A guarantee with a stronger form of subsidiarity is generally known as a ‘guarantee of collection’ (as opposed to the more common ‘guarantee of payment’).<sup>798</sup> Under a guarantee of collection the creditor will first have to show that the principal debtor offers no recourse (see more extensively § 15b Restatement). Guarantees of collection are rare in practice.<sup>799</sup>

### *Suretyship defenses*

The surety has some additional defenses that are related to the dependent nature. Paragraphs 37-45 of the Restatement sum up these rights, often referred to as the suretyship defenses.<sup>800</sup> These suretyship defenses all deal with some increase in the risk due to behavior of the creditor, after the suretyship contract was concluded.<sup>801</sup> The most important include impairment of collateral, modification and extension to the principal debtor.<sup>802</sup> The Restatement groups these together under the label ‘impairment of suretyship status’ (§ 37 ff.). These are discussed below.

#### *Suretyship defenses: (i) Impairment of collateral*

If the creditor has other collateral that secures the guaranteed claim, the creditor has a duty towards the guarantor to protect that collateral and, when necessary, appropriately use it to satisfy his claim.<sup>803</sup> In other words, the creditor should not impair the collateral. The guarantor can thus, at the time of entering into the suretyship, rely on the value of the collateral being in principle available to offset against the claim of the creditor.<sup>804</sup> The creditor also has the duty to apply the value of the collateral first to the claim, and only then call on the surety.<sup>805</sup> If the creditor impairs the collateral, for example by releasing the collateral, or by not properly

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<sup>795</sup> See also Alces, 2016, para. 3:45.

<sup>796</sup> Tracht, 2013b, p. 45.07, who explains Texas and California implemented a stronger form of subsidiarity by statute; see also Henkel, 2014, p. 352.

<sup>797</sup> See Tracht, 2013b, p. 45.07; Henkel, 2014, p. 352.

<sup>798</sup> Greer and Moss, 2014, pp. 156–157.

<sup>799</sup> Lopucki *et al.*, 2006, p. 584.

<sup>800</sup> See extensively on suretyship defenses Cohen, 1993.

<sup>801</sup> Bae and McGrath, 2005, p. 798; Lewis, 1997, p. 862.

<sup>802</sup> See also Lopucki *et al.*, 2006, pp. 596–597.

<sup>803</sup> Henkel, 2014, p. 358; Tracht, 2013b, para. 45.06; Lopucki *et al.*, 2006, p. 596; Alces, 2016, para. 7.13; Bae and McGrath, 2005, pp. 804–805.

<sup>804</sup> Alces, 2016, para. 7.13.

<sup>805</sup> Henkel, 2014, p. 352+ Tracht, 2013b, para. 45.07.

perfecting or not maintaining perfection of the collateral, or by not protecting the value of the collateral, the guarantor is released up to the amount of the impairment.<sup>806</sup>

*Suretyship defenses: (ii) Other impairment: modification, extension, tender of performance, discharge*

Also other ways in which behavior of the creditor towards the principal debtor damages the surety may result in (partial) discharge of the surety, up to the amount of the damage to the surety. If for example the creditor (possibly together with the principal debtor) modifies the underlying obligation in a way that is detrimental to the surety, the surety may be partly discharged, but only in as far the change has indeed damaged the surety.<sup>807</sup> Likewise, if the creditor extends the due date towards the principal debtor, the surety may be discharged in as far as he is disadvantaged. If the creditor refuses performance offered by the principal debtor, the surety may also be discharged (see also § 46 Restatement). Slightly paradoxically, a complete discharge of the principal debtor by the creditor does traditionally not automatically release the guarantor, although discharge can clearly be disadvantageous to the guarantor.<sup>808</sup> Instead, the question whether a release of the principal debtor also leads to a release of the guarantor, is traditionally answered by focusing of the intention of the creditor, not by focusing on the interest of the guarantor.<sup>809</sup> Creditors often include a so-called reservation of rights in a discharge towards a principal debtor, reserving all rights against third parties.<sup>810</sup> This can lead to surprises for a principal debtor. He may think he is released of the burdening debt, but as long as the guarantor remains bound by the guarantee, a reimbursement claim looms. The Restatement therefore does include the rule that discharge of the principal debtor automatically leads to discharge of the guarantor (and to discharge of the principal debtor for the reimbursement claim). If the creditor does want to retain his rights against the guarantor, the terms of the discharge need to state that the creditor retains his rights against the guarantor *and* that the guarantor retains his rights against the principal debtor (§ 38 Restatement). The automatic discharge of the guarantor upon discharge of the principal debtor is routinely waived in guarantee contracts.<sup>811</sup>

*Waiver of suretyship defenses*

Although the suretyship defenses described above seem extensive, the relevance in practice is limited because the defenses can be waived (§ 48 Restatement). Such waivers are standard practice and are generally upheld.<sup>812</sup> Waivers of suretyship defenses however used to be construed narrowly (against the creditor).<sup>813</sup> Courts usually look at the plain meaning of the text rather than interpreting it against the creditor.<sup>814</sup> The Restatement, and US law generally, thus takes a liberal stand towards waivers.<sup>815</sup> It has been argued that waivers should not be

<sup>806</sup> Alces, 2016, para. 7.13; Lewis, 1997, p. 872.

<sup>807</sup> Henkel, 2014, pp. 357–358; Tracht, 2013b, para. 45.06; Lewis, 1997, p. 872.

<sup>808</sup> See also Lopucki *et al.*, 2006, pp. 597–598.

<sup>809</sup> See also Lopucki *et al.*, 2006, pp. 597–598.

<sup>810</sup> Lopucki *et al.*, 2006, pp. 597–598.

<sup>811</sup> Hulse, 2016, para. III.

<sup>812</sup> Henkel, 2014, pp. 358–359; Lopucki *et al.*, 2006, p. 598; Bae and McGrath, 2005, p. 807, who state the contract of suretyship is often ‘chock full of waivers’.

<sup>813</sup> Lopucki *et al.*, 2006, p. 598.

<sup>814</sup> Lopucki *et al.*, 2006, p. 598; see also more generally Tracht, 2013b, para. 45.04; Henkel, 2014, p. 354.

<sup>815</sup> Lewis, 1997, p. 875.

enforceable in case of uncompensated sureties, but this has not received a wide following in the law.<sup>816</sup>

## 2.1.2 The relationship surety-principal debtor

### *Performance (or: exoneration)*

The surety is liable towards the creditor when the principal debtor defaults, but in the internal relation between the surety and the principal debtor, the principal debtor is of course the one that ultimately bears the debt. Therefore, suretyship law grants the surety various rights against the principal debtor.<sup>817</sup> These rights are generally based in equity, although some US states also stipulate them by statute.<sup>818</sup> One of those rights, the right of performance by the principal debtor (also referred to as the right of exoneration), can be used to escape performance under the guarantee by influencing the principal debtor to perform. The other three, reimbursement, restitution and subrogation, can be relied on after performance by the surety.<sup>819</sup>

The surety has the right to pursue the principal debtor to perform towards the creditor (§ 21 Restatement).<sup>820</sup> In order to have this right, the principal debtor does have to have notice of the existence of the guarantee.<sup>821</sup> Such performance by the principal debtor is clearly in the interest of the guarantor as secondary obligor. Remember that the guarantor can directly be called upon when the principal debtor is in default. When the creditor turns to the guarantor, the guarantor cannot defend itself against the creditor by arguing that the principal debtor should perform, but can sue the principal debtor to make him perform, in as far as this is without prejudice to the creditor.<sup>822</sup> In practice, this right does not seem to have much relevance, because the reason why the guarantor is called upon is usually that the principal debtor has trouble performing.<sup>823</sup> Moreover, if the guarantor is some kind of insider (a close relation to the principal debtor), which is often the case, the guarantor probably has other ways of influencing the principal debtor to perform (if the principal debtor can perform at all) and thus does not need the formal right to sue.<sup>824</sup>

### *Reimbursement*

The guarantor that performs towards the creditor has the right to full reimbursement from the principal debtor (§s 22-25 Restatement), at least if the principal debtor had notice<sup>825</sup> of the guarantee and if the exceptions of § 24 Restatement do not apply.<sup>826</sup> This reimbursement claim of the surety is based on the implied promise by the principal debtor to reimburse the surety after the surety pays the principal debtor's debt.<sup>827</sup> The guarantor that partly performs, has the

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<sup>816</sup> Lewis, 1997, p. 878 ff.

<sup>817</sup> Bae and McGrath, 2005, pp. 792–793.

<sup>818</sup> Tracht, 2013b, para. 45.07.

<sup>819</sup> See also Alces, 2016, para. 6:13.

<sup>820</sup> Bae and McGrath, 2005, p. 793.

<sup>821</sup> See also Alces, 2016, para. 6:5.

<sup>822</sup> Tracht, 2013b, para. 45.07.

<sup>823</sup> Lopucki *et al.*, 2006, p. 590.

<sup>824</sup> Lopucki *et al.*, 2006, p. 590.

<sup>825</sup> See on this notice Alces, 2016, paras 6:5; 6:6.

<sup>826</sup> See extensively Alces, 2016, para. 6:17.

<sup>827</sup> Tracht, 2013b, para. 45.07.



right of reimbursement for that part.<sup>828</sup> The right arises when the guarantor pays or, if the underlying obligation was not yet due and payable at that time, at the time when the underlying obligation becomes due and payable (§ 22 par. 2 Restatement).<sup>829</sup> The right to reimbursement includes the reasonable costs to the guarantor of performance and incidental expenses (§ 23 par 1 Restatement). These include interest that the guarantor has paid as a result of default by the principal debtor, attorneys' fees for performing the guarantee obligation and expenses in determining possible defenses (but not the fees connected to the reimbursement claim).<sup>830</sup>

Often, principal debtor and surety will have made an indemnification agreement stipulating the right for reimbursement. In such a case, this contract is leading and the common law on reimbursement does not apply.<sup>831</sup>

#### *Restitution*

If the principal debtor does not have notice of the guarantee contract, the right to reimbursement does not arise. If performance by the guarantor does however enrich the principal debtor, the guarantor has a right to restitution, based on the principle of unjustified enrichment.<sup>832</sup> The right to restitution does not include the costs incurred by the guarantor.

#### *Subrogation*

When the guarantor has performed his obligation *and* the underlying obligation is fully satisfied, the right of subrogation arises (§ 27 Restatement). As long as the underlying obligation is not fully satisfied, the right of subrogation does not arise. This rule aims to prevent the guarantor's subrogation claim from conflicting with the creditor's own claim on the principal debtor.<sup>833</sup> Striking is that the rule only grants the subrogation claim when the *underlying* obligation is fully satisfied. From the purpose of the rule, preventing collision with the creditor, this can easily be appreciated. However, consider the example in which a guarantor has only guaranteed part of the obligation, for example 100 of an underlying obligation of 300. When the guarantor fully performs *his* obligation under the guarantee, the underlying obligation is not yet fully satisfied.<sup>834</sup> The guarantor then, cannot do anything to make the right of recourse arise, thus cannot benefit from the possible advantages of subrogation as compared to reimbursement. That seems harsh. Not surprisingly, courts do occasionally make exceptions to the rule that the underlying claim has to be fully satisfied for the subrogation claim to arise.<sup>835</sup>

The conceptual difference between reimbursement and subrogation is that the reimbursement claim is a new claim, whereas the subrogation claim is in essence the claim that the creditor had against the principal debtor, in which the guarantor is subrogated (the guarantor stands in the shoes of the creditor).<sup>836</sup> From the perspective of the guarantor, subrogation and reimbursement each come with up- and downsides. Firstly, as already discussed, the subrogation claim only arises when the underlying obligation is fully satisfied, whereas a reimbursement claim can also be enforced after performance in part. Secondly, the principal

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<sup>828</sup> Hulse, 2016, para. III; Bae and McGrath, 2005, p. 794; Alces, 2016, para. 6:16.

<sup>829</sup> Hulse, 2016, para. III; Alces, 2016, para. 6:15.

<sup>830</sup> Hulse, 2016, para. III; Bae and McGrath, 2005, p. 794.

<sup>831</sup> Henkel, 2014, pp. 355–356; Tracht, 2013b, para. 45.07.

<sup>832</sup> Restatement, § 26; Bae and McGrath, 2005, p. 795; Alces, 2016, para. 6:27.

<sup>833</sup> Lopucki *et al.*, 2006, p. 594; Bae and McGrath, 2005, p. 797.

<sup>834</sup> See also Hulse, 2016, para. V.

<sup>835</sup> See Hulse, 2016, para. V.

<sup>836</sup> Bae and McGrath, 2005, pp. 796–797; Henkel, 2014, p. 356; Tracht, 2013b, para. 45.07.

debtor can use all the defenses (including those based on the Statute of Limitations) that he had against the creditor against a subrogation claim, which is not the case with reimbursement.<sup>837</sup> Thirdly, subrogation by nature does not allow for the guarantor to recuperate costs made in connection to performing under the guarantee, as the claims to pay for these costs are not rights of the creditor against the principal debtor. The most important upside of subrogation is that the guarantor is also subrogated in the possible priority of the claim of the creditor against the principal debtor, including security rights.<sup>838</sup>

Subrogation and reimbursement claims can be waived in the guarantee contract.<sup>839</sup> Especially subrogation claims are often waived.<sup>840</sup>

#### *Good faith between parties*

The Restatement does not stipulate a duty of good faith between surety and principal debtor, whereas such a duty does exist between creditor and surety.<sup>841</sup> The courts are split on whether such a duty exists between surety and principal debtor, and if it exists, to which extent.<sup>842</sup> Such a duty could for example be relevant in the case where the principal debtor protests to the surety performing towards the creditor.<sup>843</sup>

### **2.1.3 Co-suretyship and sub-suretyship, contribution**

The discussion until now has focused on the three essential parties involved in suretyship: creditor, principal debtor and guarantor. More guarantors could of course be involved. These additional guarantors could be either cosureties or subsurities (§ 53 Restatement). By default, additional guarantors are assumed to be cosureties (§ 53 Restatement). In principle, each cosurety can, upon default of the principal debtor, be called upon for his full liability under the contract of suretyship. Cosureties can also be liable for contributing among themselves. If instead one is a principal surety and another a subsurety, the subsurety does not need to contribute.

The cosurety that pays more than its proportionate share of the obligation, can thus, apart from claiming reimbursement, subrogation or restitution from the principal debtor, call upon the other cosurities to contribute, also without a contract in place between cosurities. The obligation to contribute is based in equity. The surety that has paid more than his proportionate share does not need to try and take recourse from the principal debtor, but can directly pursue cosurities.<sup>844</sup> Each cosurety can be asked to contribute up to its proportionate share.<sup>845</sup>

The 'proportionate share' is determined as follows. Without any express or implied agreement between or among the cosureties, a cosurety's contributive share is the aggregate liability of the cosureties to the creditor divided by the number of cosureties (§ 57 par 1 Restatement).

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<sup>837</sup> Tracht, 2013b, para. 45.07; Alces, 2016, para. 6:29.

<sup>838</sup> Lopucki *et al.*, 2006, pp. 591–592; Bae and McGrath, 2005, p. 797.

<sup>839</sup> Tracht, 2013b, para. 45.07.

<sup>840</sup> See, regarding subrogation claims, Lopucki *et al.*, 2006, p. 594.

<sup>841</sup> See also Harris, 2002, p. 583.

<sup>842</sup> Harris, 2002, p. 586.

<sup>843</sup> Harris, 2002, p. 587.

<sup>844</sup> Tracht, 2013b, para. 45.07 [8].

<sup>845</sup> Tracht, 2013b, para. 45.07 [8].

However, if the secondary obligation of one or more of the cosureties towards the creditor is limited to an amount lower than this proportionate share, this cosurety can of course not be held to contribute more than that limit. The proportionate share of the other cosureties is increased in that case to cover the full aggregate liability (§ 57 paragraph 2a Restatement). The aggregate liability is the total amount of the underlying guaranteed obligation, minus any collateral available to the creditor.<sup>846</sup> If collection from one of the cosureties is not (or only partly) possible, for example because of insolvency, the proportionate share is recalculated leaving out this cosurety (partly or entirely), see § 57 par 2b Restatement.

## 2.2 Joint and several contractual liability

Joint and several contractual liability refers to the situation in which two or more persons promise one and the same performance.<sup>847</sup> This can be distinguished from the situation in which two or more debtors promise separate performances to a creditor. This last situation does not contain any form of suretyship. Joint and several liability however always contains some form of suretyship. As the treatise Corbin on Contracts explains, there are two alternatives under joint and several liability: “(1) one of the promisors is sole principal debtor and another his surety only, or (2) each of them is a principal debtor as to his just proportion and a surety as to the just proportions of the others.” Thus, depending on the internal relationship between the debtors, joint and several liability either amounts to a simple suretyship or to a slightly more complex form in which two or more debtors are each part surety and part principal debtor. As discussed in paragraph 2.1 above we can speak of suretyship when someone has to answer for someone else’s debt and the creditor is not entitled to more than one performance.<sup>848</sup> In defining suretyship, and thus awarding ‘suretyship status’ to the surety, the Restatement takes a substantive rather than formal approach. If the above definition is met, it is a suretyship, regardless of the wording used (see § 3 a and b of the Restatement). When the definition is not met, the relationship is not regulated by default suretyship law.

## 2.3 Independent guarantee

A suretyship or guarantee can and should be distinguished from the letter of credit and the standby letter of credit.<sup>849</sup> The main distinction between guarantee and suretyship on the one hand and (standby) letter of credit on the other hand, is the independence of the contractual relationships between the involved parties in the letter of credit situation. In a typical letter of

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<sup>846</sup> Hulse, 2016, para. IV.

<sup>847</sup> The widely used term ‘joint and several liability’ is somewhat confusing, as the reason for using both the words ‘joint’ and ‘several’ to describe the way in which two or more persons assume obligations are historical and no longer applicable, see Corbin on Contracts par 52.3; See also Monserud, 1992, pp. 257–263.

<sup>848</sup> See also Bae and McGrath, 2005, p. 785; see for some examples Hulse, 2016, para. II.

<sup>849</sup> See Dolan, 2013. The difference between a letter of credit and a standby letter of credit is that the normal letter of credit is also used as the standard payment device. Parties envision that the beneficiary will use the letter of credit in order to settle the bill. The standby letter of credit, as the name suggests, is used as a secondary payment device in case the first device (direct payment) fails. In that sense, a standby letter of credit looks more like performance insurance. See also Alces, 2016, para. 2:8.

credit transaction, three parties are involved: issuer, account party and beneficiary.<sup>850</sup> Three separate contractual relationships can be distinguished: between account party and beneficiary; between issuer and account party and between issuer and beneficiary. Each of these contractual relationships is governed by its own terms and performance is usually not directly related to performance of the other contractual relationships. Independent guarantees at first demand should, as the terminology suggests, simply be paid at first demand: pay first, argue later. Although independent guarantees may, under circumstances, look like a normal guarantee at first sight, the independence of the contractual relationship has led some to state that it is not to be confused with a guaranty.<sup>851</sup> Letters of credit are a commercial specialty, developed in practice over the last few centuries. Both the legal treatment and the use in practice can be distinguished from the dependent guarantee.

### **3 US law on opportunism towards parties inside the guarantee relationship**

Chapter 3 paragraph 2 discussed opportunism in the internal relationship. This chapter will discuss in which way and to which extent US law protects parties in the guarantee relationship.

US law on the internal relationship is not as focused on protection of weak guarantors as many continental European systems are. Below, the sparse rules protecting weak guarantors will be discussed.

#### **3.1 Specific consumer guarantor protection**

US law does not extensively protect consumer sureties and does not even categorically distinguish between the treatment of consumer and commercial guarantees.<sup>852</sup> The three only clear exceptions to this are the notice requirement of the UCCC (the Uniform Consumer Credit Code), the notice requirement of the Code of Federal Regulation (CFR)<sup>853</sup> and the stay of action against consumer guarantors of consumer debt in § 1301 Bankruptcy Code.

The UCCC contains a notice requirement for consumer sureties.<sup>854</sup> The UCCC is however only a model act, which has as of 2019 only been adopted by a small number of States.<sup>855</sup> The definition

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<sup>850</sup> Alces, 2016, para. 2:8.

<sup>851</sup> See Alces, 2016, para. 2:8, *referring to the Tenth Circuit*.

<sup>852</sup> Henkel, 2014, p. 335; Alces, 2016, para. 3:25; Tracht, 2013a, para. 44.04; *Debtor-Creditor Law* (2016), 2016, para. 4.04.

<sup>853</sup> Henkel, 2014, p. 359.

<sup>854</sup> UCCC § 3.208: "A natural person, other than the spouse of the consumer, is not obligated as a co-signer, co-maker, guarantor, indorser, surety, or similar party with respect to a consumer credit transaction, unless before or contemporaneously with signing any separate agreement of obligation or any writing setting forth the terms of the debtor's agreement, the person receives a separate written notice that contains a completed identification of the debt he may have to pay and reasonably informs him of his obligation with respect to it."

of ‘consumer’ in the UCCC is rather complicated because of cross-referencing, but it is narrow and boils down to just including natural persons, acting in the interest of a personal, family, household or agricultural purpose, while the amount financed does not exceed 25.000 USD<sup>856</sup> (UCCC par. § 1.301).

The Federal Trade Commission’s (FTC) Credit Practice Rules contained in chapter 16 of the Code of Federal Regulation (CFR) also contains a notice requirement for consumer ‘cosigners’.<sup>857</sup> These Credit Practice Rules however only apply to creditors within the FTC’s jurisdiction. Outside FTC jurisdiction are for example banks and federal credit unions.<sup>858</sup>

A consumer is defined narrowly in par. 444.1(d) CFR as “*A natural person who seeks or acquires goods, services, or money for personal, family, or household use*”. A ‘cosigner’ can include someone that issues a guarantee or suretyship, but is otherwise defined narrowly.<sup>859</sup> Par. 444.3 (c) of the CFR provides a model notice to be given to the cosigner prior to signing.<sup>860</sup> § 5 of the Federal Trade Commission Act, which par. 444.3(a)(2) of the CFR refers to, gives the FTC the power to prevent persons or corporations (but not banks, savings and loan institutions as defined in the Act) to use unfair practices.

This is public law regulation which gives a state authority the power to enforce that creditors give notice to consumer co-signors. If the creditor however fails to do so, this public law regulation does not have direct consequences for the enforceability of the guarantee or suretyship signed, the FTC Act does not contain direct private remedies.<sup>861</sup> However, if the

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<sup>855</sup> Colorado; Idaho; Indiana; Iowa; Kansas; Maine; Oklahoma; South Carolina; Utah; Wisconsin; Wyoming; Guam; see <https://www.law.cornell.edu/uniform/vol7#concc>, accessed on 3 September 2019

<sup>856</sup> This is the amount in the original code, which is to be indexed from time to time pursuant to par. 1.106 UCCC.

<sup>857</sup> Par. 444.3 (a) (2) of the CFR, title 16, stipulates that it is an “*unfair act or practice within the meaning of § 5 of that Act [the Federal Trade Commission Act] for a lender or retail installment seller, directly or indirectly, to obligate a cosigner unless the cosigner is informed prior to becoming obligated, which in the case of open end credit shall mean prior to the time that the agreement creating the cosigner's liability for future charges is executed, of the nature of his or her liability as cosigner.*”

<sup>858</sup> <https://occ.gov/news-issuances/bulletins/2014/bulletin-2014-42a.pdf>

<sup>859</sup> Par. 444.1 (k) CFR: “*Cosigner. A natural person who renders himself or herself liable for the obligation of another person without compensation. The term shall include any person whose signature is requested as a condition to granting credit to another person, or as a condition for forbearance on collection of another person's obligation that is in default. The term shall not include a spouse whose signature is required on a credit obligation to perfect a security interest pursuant to State law. A person who does not receive goods, services, or money in return for a credit obligation does not receive compensation within the meaning of this definition. A person is a cosigner within the meaning of this definition whether or not he or she is designated as such on a credit obligation.*”

<sup>860</sup> “*NOTICE TO COSIGNER. You are being asked to guarantee this debt. Think carefully before you do. If the borrower doesn't pay the debt, you will have to. Be sure you can afford to pay if you have to, and that you want to accept this responsibility. You may have to pay up to the full amount of the debt if the borrower does not pay. You may also have to pay late fees or collection costs, which increase this amount. The creditor can collect this debt from you without first trying to collect from the borrower. The creditor can use the same collection methods against you that can be used against the borrower, such as suing you, garnishing your wages, etc. If this debt is ever in default, that fact may become a part of your credit record. This notice is not the contract that makes you liable for the debt.*”

<sup>861</sup> Debtor-Creditor Law (2016), para. 4.06; All states did enact legislation granting a private course of action in case of FTC Act violations, but there may be some restrictions in some states, see Debtor-Creditor Law (2016), para. 4.06.

creditor acted contrary to the CFR rule, this may be a relevant circumstance in the context of an action to avoid the guarantee because of fraudulent or material misrepresentation.<sup>862</sup>

Another measure of consumer protection can arguably be found in par. 1301 Bankruptcy Code, which extends the automatic stay in a Chapter 13 bankruptcy to non-professional co-debtors. The object of this provision is however not to protect the consumer surety, but to protect the consumer principal debtor in a Chapter 13 procedure.<sup>863</sup> In bankruptcy of the principal debtor under Chapter 13 Bankruptcy Code, § 1301 of the Bankruptcy Code stays actions against consumer guarantors for consumer debt. This will be discussed further below in paragraph 4.2.6.

Apart from these patchy provisions of consumer protection with limited reach or force, some state courts have articulated a bias in favor of consumer sureties in the construction of suretyship contracts,<sup>864</sup> though ambiguities in suretyship contracts are also often resolved in favor of creditors.<sup>865</sup> Some states may also have specific requirements pertaining to consumer protection.<sup>866</sup> Recently, the courts have tended to be less biased in favor of the surety, and more willing to interpret against sureties, especially when the surety is independently compensated.<sup>867</sup>

US law does, in general, also not offer any particular protection to the spouse of the consumer guarantor. In some US states there may still be some remnants of the outdated idea that married women would be limited in their capacity to become sureties, but the known cases on this subject are forty years old or older and may have lost all relevance.<sup>868</sup> The Michigan State Law that one of the last cases was based on (*Nat'l Bank of Rochester v. Meadowbrook Heights, Inc*), has for example been repealed a few years later, in 1982.<sup>869</sup>

### 3.2 Protection of guarantors that are legal persons

Legal persons may enjoy some protection against themselves (or their board of directors) through the *ultra vires* doctrine, but this doctrine is hardly relevant in the context of guarantees under US law. Especially in the case of *upstream* guarantees (guarantees by a subsidiary for

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<sup>862</sup> See Restatement of suretyship, par. 12(1): “(1) If the secondary obligor's assent to the secondary obligation is induced by a fraudulent or material misrepresentation by the obligee upon which the secondary obligor is justified in relying, the secondary obligation is voidable by the secondary obligor.”  
<sup>863</sup> Kennedy, 1978.

<sup>864</sup> Especially in case of gratuitous suretyship, Tracht, 2013b, para. 45.04.

<sup>865</sup> See Alces, 2016, para. 3:25, also for references to cases.

<sup>866</sup> Tracht for example gives the example of the State of Maryland, which requires that a consumer guarantor or surety also signs the loan contract for the guarantee to be enforceable, see Tracht, 2013b, para. 45.04; New York and Illinois require notice being given to certain guarantors of retail instalment sales contracts, see Tracht, 2013a, para. 44.04; guarantors of business debt are not viewed as consumers for the purpose of the FDCPA (fair debt collection practices act), see (Nahoum, 2015). See generally on the FDCPA also Westbrook and Warren's case-book (debtor-creditor law).

<sup>867</sup> Tracht, 2013b, para. 45.04; Tracht defines a compensated surety as follows: “A compensated surety is one who receives an independent consideration for his promise to perform, and is oftentimes a business association that is organized to execute bonds or undertakings for a profit.(...)” Tracht, 2013a, paras 45B-Glossary.

<sup>868</sup> See Henkel, 2014, p. 354 with reference to case law.

<sup>869</sup> See Michigan Compiled Laws Annotated, Chapter 557: Property of Husband and Wife, 557.1, 557.2. Repealed by P.A.1981, No. 216, § 9, Eff. March 31, 1982.

debts of a parent) and *cross-stream* guarantees (guarantees by a group company to another group company that is neither a parent, nor a subsidiary) the interest of the corporation in guaranteeing can be questionable. In such a case the corporation itself may try and escape liability under the guarantee by invoking the corporate law *ultra vires* doctrine, arguing that the guarantee was not in pursuance of the guaranteeing corporation's corporate purposes.<sup>870</sup> However, the doctrine is 'of largely historical interest'.<sup>871</sup> The board is generally assumed to have the corporate power to issue guarantees and guarantees are generally assumed to support corporate objectives, even if the direct benefit to the corporation is not clear.<sup>872</sup> Courts have overwhelmingly upheld the validity of up-, down- and cross-stream guarantees in this context.<sup>873</sup>

### 3.3 Protection based on general contract law between creditor and guarantor

As discussed above, the consumer surety cannot expect much special treatment under US law. There are however general contract law rules that are relevant in any contractual relationship, and thus also apply in the contractual relationship of suretyship between creditor and guarantor.<sup>874</sup> The principal debtor does not have to be a party to this contract. The general requirements for the formation of contracts apply to the contract between guarantor and principal debtor.<sup>875</sup> The relevant general requirements are discussed below.

#### 3.3.1 Consideration

The contract of guarantee has to be supported by consideration, which generally applies to contracts.<sup>876</sup> The doctrine of consideration serves both an evidentiary purpose and a cautionary purpose.<sup>877</sup> The consideration does not need to be adequate in order for the contract to be enforceable.<sup>878</sup> The concept of consideration is however somewhat hard to apply to a contract of guarantee because the consideration given is often indirect in the sense that the guarantor often does not directly receive any pecuniary remuneration. If the guarantor does receive a direct benefit, consideration is often clear. Consideration can also exist in some detriment to the creditor or some change in the relationship between principal debtor and creditor. Often, consideration exists in a benefit to the principal debtor.<sup>879</sup> If for example the guarantee is issued because this was a condition in the contract between principal debtor and creditor, sufficient

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<sup>870</sup> Blumberg, 1987, pp. 691–692.

<sup>871</sup> Alces, 2016, para. 3:44.

<sup>872</sup> Blumberg, 1987, pp. 691–692.

<sup>873</sup> Blumberg, 1987, pp. 691–692.

<sup>874</sup> See also Bae and McGrath, 2005, p. 786.

<sup>875</sup> The Restatement of Suretyship contains in § 5: “Unless inconsistent with the rules in this Restatement, all other principles of law and equity, including the law of contracts and the law relating to capacity to contract, principal and agent, estoppel, fraud, misrepresentation, duress, coercion, and mistake, are applicable to the transactions resulting in suretyship status.”; see also extensively (Alces, 2016, para. 3:11-3:24); Tracht, 2013b, para. 45.04.

<sup>876</sup> Alces, 2016, para. 3:32.

<sup>877</sup> Alces, 2016, para. 4:2.

<sup>878</sup> Alces, 2016, para. 3:32.

<sup>879</sup> Alces, 2016, para. 3:32.

consideration may exist.<sup>880</sup> If however the guarantee contract is separate from the principal contract and the principal debtor does not receive any benefit, the guarantee itself needs to be supported by independent consideration, for compensation of the guarantor.<sup>881</sup>

### 3.3.2 Statute of Frauds

With the exception of Louisiana, all US jurisdictions follow the Statute of Frauds in requiring that certain contracts must be in writing and must be signed.<sup>882</sup> Pursuant to the Statute of Frauds, guaranty and suretyship contracts are contracts that have to be in writing, as also reiterated by the Restatement (§ 11): “(1) Pursuant to the Statute of Frauds, a contract creating a secondary obligation is unenforceable as a contract to answer for the duty of another unless there is a written memorandum satisfying the Statute of Frauds or an exception applies.” According to the explanation to the Restatement, the purpose of this requirement is not only evidentiary, but also cautionary. The promisor should be guarded against ill-considered action.<sup>883</sup> However, when the guarantor assumes the liability for his own economic benefit rather than for the benefit of the principal debtor, the writing requirement generally does not apply (§ 11(3)(c) Restatement, the so-called ‘main purpose’ or ‘leading object’ rule), because there is much less danger of an imbalance in the transaction in such a case.<sup>884</sup> However, if the benefit to the guarantor is just a fee for incurring the guarantee obligation, the contract is still within the Statute of Frauds.<sup>885</sup>

### 3.3.3 Construction

In early case law, the US courts developed the doctrine of *strictissimi juris* in relation to suretyship.<sup>886</sup> According to this doctrine, the surety would only be liable under the suretyship contract if the contract was sufficiently clear. In case the wording was not clear, the agreement would be construed in favor of the surety. The background to this rule was that suretyship was seen as a great burden. The doctrine is still applied, but has lost some of its importance. It is now mainly applied in the context of gratuitous suretyship. Most courts will not apply the doctrine when the surety receives some kind of benefit.<sup>887</sup>

## 3.4 Protection through bankruptcy law

Arguably, a surety that is liable for a large amount is somewhat protected by the protection that bankruptcy law offers against lifelong overindebtedness by discharging debts under certain

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<sup>880</sup> Tracht, 2013b, para. 45.04; see also Alces, 2016, para. 3:33.

<sup>881</sup> Alces, 2016, para. 3:32; see further extensively Alces, 2016, paras 3:32-3:42.

<sup>882</sup> Henkel, 2014, pp. 341–342; Alces, 2016, para. 3:26; see on signing Tracht, 2013b, para. 45.04.

<sup>883</sup> See also Alces, 2016, para. 4:3.

<sup>884</sup> Henkel, 2014, pp. 341–342; Tracht, 2013b, para. 45.04.

<sup>885</sup> Restatement, § 11(3)(c); Alces, 2016, para. 4:19; Alces, 2016, para. 4:25.

<sup>886</sup> See Tracht, 2013b, para. 45.04 with reference to case law.

<sup>887</sup> Tracht, 2013b, para. 45.04; Henkel, 2014, p. 354; compare also (specifically on *strictissimi juris* in relation to suretyship defense waivers) Lopucki *et al.*, 2006, p. 598; Bae and McGrath, 2005, p. 799.



conditions. US personal bankruptcy law is famed for its perceived forgivingness towards debtors by providing a liberal discharge policy. See for example David Skeel, asserting that:

*“Commentators have often marveled (or grimaced, as the case may be) at the unique attributes of American bankruptcy law. In many other nations, consumer debtors have no right to discharge their debts – or at best, the discharge is subject to strict limitations such as a requirement that the debtor continue paying her debts for an extended period of time.”*<sup>888</sup>

David Skeel refers to the indeed rather different approach in the US to personal bankruptcy compared to continental European systems. Under US law, consumer debtors have access to roughly two distinct roads to a fresh start, Chapter 7 and Chapter 13 Bankruptcy Code.<sup>889</sup> Firstly, under the Chapter 7 procedure, the individual gives up most of his or her assets and is, within a few months, granted debt relief, a fresh start.<sup>890</sup> Most European systems offer such straight liquidation procedures, but do not grant a fresh start to an individual after such a swift liquidation procedure.<sup>891</sup> Secondly, the individual also has access to Chapter 13, often called the ‘wage earners plan’. Under Chapter 13, the debtor is granted a fresh start after relinquishing his or her earnings for five years §1322(a)(4) Bankruptcy Code. The upside for the debtor under Chapter 13 is that the debtor has more ability to hold on to property under Chapter 13, most importantly the capital in their own home. To which extent holding on to a homestead under Chapter 13 is allowed, depends on the circumstances and to an important extent on state law.

Thus, US bankruptcy law seems to provide overindebted sureties a way out by providing a liberal discharge policy. Some reservations however need to be made. Firstly, with the 2005 Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCA) US law made a fresh start more remote for many.<sup>892</sup> The introduction was mostly driven by lobbyists for lenders:

*“With sometimes arrogant disregard for the facts about debt and debtors in bankruptcy, lobbyists and executives for the consumer credit industry convinced Congress that abuse was rampant in bankruptcy, that many debtors were using bankruptcy as a “first resort” to avoid paying creditors, and that courts weren’t doing enough to police the bankruptcy system.”*<sup>893</sup>

The act introduced a ‘means test’ through which courts should deny access to Chapter 7 to consumer debtors if a substantial amount of debt could be repaid under Chapter 13. Various other changes were made that made discharge less liberal, such as a standard five-year rather than a three-year repayment period under Chapter 13, a higher administrative burden for the debtor and a stronger position for certain secured lenders. The BAPCA has been a dramatic move away from a liberal fresh start policy.<sup>894</sup>

Moreover the wider backdrop of the US social system deserves some attention. The US social security system is, especially when compared to most Western-European countries, limited.<sup>895</sup>

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<sup>888</sup> Skeel, 2003.

<sup>889</sup> Individuals can also apply for Chapter 11, but this is hardly relevant in practice; moreover, Chapter 12 offers a special procedure for family farmers and fisherman.

<sup>890</sup> Ramsay, 2017.

<sup>891</sup> Compare Ramsay, 2017.

<sup>892</sup> Currie, 2009; see for an overview of the changes that BAPCA brought Wedoff, 2007.

<sup>893</sup> Lundin, 2005; see also Ramsay, 2017, also for some reservations on the ‘interest group story’.

<sup>894</sup> Ziegel, 2006, p. 302.

<sup>895</sup> See extensively Sullivan, Warren and Westbrook, 2000.

Forgiving bankruptcy laws, in as far as they indeed (still) are forgiving, can be seen as a crucial safety net in lack of much other social security in the US.<sup>896</sup> In that sense, the fact that *bankruptcy law* is forgiving in no way leads to the conclusion that overindebted individuals are well off in US society. Moreover, the US system is characterized by high student debts, which are not excused in bankruptcy, and an elaborate system of credit scoring, which both can prevent an actual fresh start even after a successful bankruptcy procedure.<sup>897</sup>

All in all, although US bankruptcy law seems generous in providing a fresh start, the system has become less debtor-friendly recently and the US comparatively does not have an extensive social security net. The analysis thus in no way leads to the conclusion that overindebted individuals are generally better off in the US system.

### 3.5 Summary of US law on the internal relations

This chapter has discussed US law on the protection of weak parties. The specific protection of consumer sureties is very scarce. General contract law and the Statute of Fraud give some, but very limited protection to weak sureties.

## 4 US law on opportunism towards parties outside the guarantee relationship

Until this point only the relations between the parties in the guarantee relationship (creditor, principal debtor and guarantor) have been discussed. Generally, in scholarly discussions on the guarantee relationship, the focus is primarily on these relations. Guarantees can however, as has been extensively described in chapter 3 paragraph 3, also influence the positions of outsiders. This chapter examines the current regulation under US law of such influence on outsiders and the protection of the interests of these outsiders against possible opportunistic use by insiders.

Chapter 3 paragraph 3 identified various types of opportunistic behavior with guarantees towards outsiders in two categories: opaque priority structures (ex ante opportunism) and covert insider dealing (ex post opportunism). Taking these types of opportunistic behavior as a starting point, or in comparative law terms as *tertium comparationis*,<sup>898</sup> US law will be discussed.

The discussion will mostly focus on the context of financing of closely held corporations, because guarantees by shareholders or group companies are by far most common in this setting. Some reference will be made to the setting of public companies, especially where indirectly relevant to the close corporation.

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<sup>896</sup> Sullivan, Warren and Westbrook, 2000.

<sup>897</sup> Compare also Ramsay, 2017, in particular also the literature referred to in fn 191.

<sup>898</sup> See extensively chapter 1.

## **4.1 Regulatory approach to opaque priority structures (ex ante opportunism)**

Guarantees can serve as a device instrumental in creating a structure in which one creditor or insider guarantor has priority over another creditor, especially in the context of corporate finance. In essence, guarantees can be used as a functional equivalent to real security rights by creating a perforated limited liability shield. This is not directly apparent, because it seems that the guaranteed creditor has recourse to an alternative source of payment with the guarantee and thus is not prioritized above other creditors of the debtor, but when one zooms out from the entity level, the priority granted by guarantees and the externalities that come with it in the context of corporate finance become apparent.

Chapter 3 paragraph 3.1 discussed whether such priority structures could as such generally be justified as efficient. Although guarantees can certainly perform efficient functions by preventing asset stripping, the analysis also showed that such piercing guarantees lead to various inefficient dynamics. It was concluded from the analysis of the literature on the efficiency of limited liability that the efficiency case for limited liability in small companies and within corporate groups is generally weak and even weaker when guarantees are used to selectively pierce the limited liability shield. Legal systems should thus be wary of such contractually perforated shields. Also the analysis of the literature on the efficiency of secured credit has shown that the efficiency case for guarantees piercing a limited liability shield is weak. Justification of secured credit based on efficiency grounds is already problematic and the efficiency case for the priority that guarantees grant is even more problematic, as such priority is often more covert and thus misleading and deceptive. This paragraph will discuss to which extent US law upholds such perforated limited liability structures.

As emerges from chapter 3 paragraph 3.1, there are roughly four regulatory approaches by which a legal system could address the inefficiencies created by pierced limited liability structures as such: (1) not upholding limited liability ('tearing down the walls'), (2) avoiding the piecing guarantees ('reinstating the walls') (3) subordinating loans guaranteed by shareholders (somewhat reinforcing the walls, though only to protect the patrimony of the debtor) and (4) disallowing double proof (again, somewhat reinforcing the walls). To which extent US law adopts these approaches is discussed below in the aforementioned order.

### **4.1.1 Annuling limited liability**

To recall, chapter 3 paragraph 3.1.2 discussed that incorporation combined with a guarantee that pierces the limited liability shield (or entity shield) that incorporation creates, is hard to justify theoretically from the policy arguments that support limited liability. In essence, such a combination of incorporation and a piercing guarantee allows the guaranteed creditor and guarantor together to use limited liability of the debtor as a shield against non-guaranteed creditors. Such a shield cannot be justified from the arguments generally supporting limited liability. This paragraph analyzes to what extent US law has any sensitivity to these dynamics or addresses the problems identified, by tearing down the limited liability walls under certain circumstances. Two measures that can be taken are relevant. Firstly, veil-piercing can be applied to hold shareholders of a corporation liable for the corporation's debts. Secondly, substantive

consolidation can be applied. The two measures somewhat overlap but there are also differences.

#### 4.1.1.1 *Veil-piercing*

Shareholders of corporations and members of Limited Liability Companies (LLC'S) enjoy limited liability.<sup>899</sup> Courts can however hold members of an LLC or shareholders of a corporation unlimitedly liable through the equitable doctrine of veil-piercing.<sup>900</sup> The empirical records for piercing in the corporation and in the LLC do not seem to differ much.<sup>901</sup> Therefore, the discussion below will just refer to the corporation. Guarantees are particularly relevant in the context of equitable veil-piercing. As extensively discussed in chapter 3 paragraph 3, the guarantee by a shareholder can be viewed as a perforation of the veil of limited liability. Such a perforation may provide an argument for a court not to pierce the already damaged veil.

Veil-piercing is probably one of the most litigated areas of US corporate law.<sup>902</sup> Bainbridge, an influential corporate law scholar, has called veil-piercing “*rare, unprincipled, and arbitrary*”<sup>903</sup>. See also Presser:

*“Scholars who have examined the piercing the veil doctrine have seemed almost in despair, remarking that the rationales for piercing the veil are “vague and illusory,” and that the jurisprudence of veil-piercing is a “legal quagmire.” As it was stated in one of the most recent attempts to impose order on the field, the law of piercing the veil “like lightning ... is rare, severe, and unprincipled. There is a consensus that the whole area of limited liability, and conversely of piercing the corporate veil, is among the most confusing in corporate law.”*<sup>904</sup>

Different State courts have different approaches (also within States), and federal veil-piercing law again differs from the States approaches, which has led Presser to state: “(...) *the federal law of veil-piercing may be in an even more confused and chaotic form than state law (...)*”. A concise discussion of veil-piercing under US law is therefore not possible.<sup>905</sup> For the purpose of the discussion of veil-piercing in the context of guarantees, it suffices to state that in general veil-piercing is available as an equitable remedy under specific circumstances that will have to be assessed on a case-by-case basis.

One such important circumstance could be a guarantee by shareholders. Some commentators have argued that courts should be “*more willing to disregard a corporate partition if the corporation’s managers or shareholders have already perforated it by issuing guarantees*”.<sup>906</sup>

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<sup>899</sup> Bainbridge, 2001, p. 480; see on LLC’s limited liability further Bainbridge, 2005; Rapp, 2006.

<sup>900</sup> Bainbridge, 2005, p. 79).

<sup>901</sup> Rapp, 2006, p. 1077; compare Bainbridge, 2005, p. 79.

<sup>902</sup> Rapp, 2006, p. 1063; Thompson, 1991.

<sup>903</sup> Bainbridge, 2005, p. 79.

<sup>904</sup> Presser, 2016, para. 1:1.

<sup>905</sup> See for a good overview of both state and Federal law on veil-piercing: Presser, 2016.

<sup>906</sup> Hansmann and Squire, 2016, para. 5; See also Leebron: “*The guarantee of the corporation’s loans thus creates a strong argument for piercing the veil, and courts have often so regarded it*” Leebron, 1991, p. 1632.

Courts have, indeed, often based veil-piercing decisions in part on the existence of guarantees by shareholders.<sup>907</sup> See for example:

*“The corporate veil should be pierced only “reluctantly and cautiously” and then only where some combination of the following factors is present: undercapitalization, failure to observe formalities of corporate existence, nonpayment or overpayment of dividends, siphoning off of funds by the dominant shareholders, where the majority shareholders have guaranteed corporate liabilities in their individual capacities, and where commingling of personal and corporate funds has occurred.”*<sup>908</sup>

See more recently also *W. Hills Farms LLC v. Classicstar*:

*“The Court turns next to whether Ferguson, Parrott, and Robinson can be, in turn, liable for those contracts. Plaintiffs have provided no evidence that Ferguson, Parrott, or Robinson disregarded the corporate formalities of ClassicStar in the sense that they raided its accounts to directly pay their own personal liabilities, for example. Nonetheless, their actions demonstrate that they treated GeoStar and - by extension - ClassicStar as instrumentalities to achieve their own ends. They made personal guarantees of financing obtained for ClassicStar from Fifth Third Bank and, ultimately, were the individuals responsible for directing the transfer of multiple millions of dollars from ClassicStar's accounts to GeoStar's accounts with the knowledge that the transfers would leave ClassicStar undercapitalized.”*<sup>909</sup>

In *Passalacqua* the Second Circuit Court enumerated an influential list of ten factors involved in determining whether the veil should be pierced.<sup>910</sup> The list includes: “(...) (9) *the payment or guarantee of debts of the dominated corporation by other corporations in the group*”. In *DeWitt Truck Brokers, Inc. v. W. Ray Flemming Fruit Co.* the court observed:

*“If the individual defendant has guaranteed the loans of the corporation or has co-signed with it, this fact is evaluated in this connection. The reason for this is obvious. The requirement that the individual defendant endorse or co-sign together with the willingness of the individual defendant to do so is evidence of the financial fragility of the corporation. Similarly, where the individual operator has used as persuasion upon the creditor that he stood personally behind the corporation and would see that its indebtedness was paid has been found in some cases to justify holding the individual defendant to his promise.”*<sup>911</sup>

#### **4.1.1.2 Substantive consolidation**

The term substantive consolidation is used to describe a measure by which a bankruptcy trustee, after court approval, consolidates the accounts of group companies and treats the assets and debts of various group companies together as essentially one bankruptcy case. This can

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<sup>907</sup> Leebron, 1991, p. 1632 refers, in this context, to: *United States v. Daugherty*, 599 F. Supp. 671, 673 (E.D. Tenn. 1984); *Mosa v. Wilson-Bates Furniture Co.*, 583 P.2d 453, 454 (Nev. 1978); *DeWitt Truck Brokers v. W. Ray Flemming Fruit Co.*, 540 F.2d 681, 686-87 (4th Cir. 1976)”.

<sup>908</sup> *White v. Winchester Land Development Corp.*, 584 S.W.2d 56, 61-62 (Ky. Ct. App. 1979).

<sup>909</sup> *W. Hills Farms, LLC v. Classicstar* (In re *Classicstar Mare Lease Litig.*), 823 F. Supp. 2d 599, United States District Court for the Eastern District of Kentucky, 30 September 2011.

<sup>910</sup> *Wm. Passalacqua Builders, Inc. v. Resnick Developers South, Inc.*, 933 F.2d 131, 32 Fed. R. Evid. Serv. 1218 (2d Cir. 1991); See also Presser, 2016, para. 3:4 at fn 41.

<sup>911</sup> *DeWitt Truck Brokers, Inc. v. W. Ray Flemming Fruit Co.*, 540 F.2d 681, 686-687 (4th Cir. 1976), citing *Financial Counsellors, Inc. v. Securities and Exchange Commission*, 339 F.2d 196, 197 (2d Cir. 1964).

make administration of the bankruptcy case much simpler, especially when the internal structures are complicated and badly administered. This measure is comparable to veil-piercing in the sense that the limited liability structures within the group are disregarded. There are also some differences. Substantive consolidation is usually only used to consolidate the accounts of various bankrupt group companies, not to hold non-bankrupt entities liable for debts of bankrupt entities, although there have been exceptional cases in which non-bankrupt entities have been included in substantive consolidation cases. In contrast, veil-piercing claims are especially interesting when the shareholder is not bankrupt, as a claim against a bankrupt entity is less valuable. Another difference is that substantive consolidation, although only applied to bankrupt entities, can have much further reaching consequences in the sense that all assets and claims of the entities are taken together, whereas veil-piercing essentially only allows the debtors of a corporation recourse to the shareholder.

The Bankruptcy Code does not explicitly allow substantive consolidation. The case law on substantive consolidation is somewhat varied. Bankruptcy Courts generally like substantive consolidation, as it makes a bankruptcy case of a complicated group much easier to handle.<sup>912</sup> Appellate courts are however much more restrained in applying substantive consolidation. In the most influential case on substantive consolidation, *In re Owens Corning* (3<sup>rd</sup> Circuit Court), the court held that substantive consolidation should be very rare and only a remedy of last resort. If applied, *“what must be proven (absent consent) concerning the entities for whom substantive consolidation is sought is 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) postpetition their assets and liabilities are so scrambled that separating them is prohibitive and hurts all creditors.”*<sup>913</sup> Both are unlikely. Creditors will often have had some idea that the group as a whole would normally not be liable for the debt and consolidation is almost invariably redistributive which will mean not all creditors will be better off because of substantive consolidation (even though there will be more to distribute because administration and litigation costs will be lower because of decreased complexity),<sup>914</sup> especially not those with guarantees.

Whereas one would, based on the economic analysis (see chapter 3, paragraph 3), expect courts to sooner allow substantive consolidation when contractual guarantees are in place, the Owens Corning case has the opposite outcome.<sup>915</sup> The court considered that the guaranteed creditors have relied on the advantage the guarantees would bring (which in this case is the advantage of double proof, see extensively chapter 3 paragraph 3.1.4). According to the court, these creditors should be granted this advantage as they have contracted for it, which means substantive consolidation is deemed less appropriate. That is unfortunate, as this advantage was received opportunistically.<sup>916</sup>

To summarize, although the law on veil-piercing is fact-oriented and hard to capture in generalizations, it can be concluded that guarantees by shareholders have often been treated as a relevant factor supporting a veil-piercing case. Of course, the existence of such guarantees is in itself certainly not enough to support a case, but the recognition as a relevant factor seems well

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<sup>912</sup> Squire, 2019

<sup>913</sup> *In re Owens Corning*, 419 F.3d 195, 208-09 (3d Cir. 2005).

<sup>914</sup> Squire, 2019

<sup>915</sup> Squire, 2019

<sup>916</sup> Squire, 2019

established. In contrast, substantive consolidation of the bankrupt estates of group companies seems less likely when guarantees are in place.

#### 4.1.2 Avoidance of the guarantee itself

Another regulatory technique to undo the priority structure created by incorporation combined with a guarantee is to annul the guarantee. The guarantee itself can under US law be attacked as a constructive fraudulent transfer under the Bankruptcy Code or under state law (usually the UFTA/UVTA - most states implemented the Uniform Fraudulent Transfer Act, UFTA or its newer version, renamed the Uniform Voidable Transfer Act, UVTA).<sup>917</sup> For a constructive fraudulent conveyance to exist, there needs to be an imbalance in value in the transaction (see §548(a)(1)(B)(i) and §4(a)(2) and §5(a) UFTA/UVTA which mention: “a reasonably equivalent value in exchange”), and the debtor needs to be insolvent at the time of the transfer (see §548(a)(1)(B)(ii)(I) and §5(a) UFTA/UVTA).<sup>918</sup> Both the application of the ‘reasonably equivalent value’ test and the ‘insolvency’ test pose some problems in the context of guarantees.

Insolvency in both the UFTA/UVTA and the Bankruptcy Code is defined as balance sheet insolvency: more debts than assets (or: ‘property’ under the Bankruptcy Code).<sup>919</sup> The problem with this test in the context of guarantees is that discussion can exist on whether to take the contingent liability under the guarantee for the full amount or whether to discount for the probability that the guarantee will be invoked.<sup>920</sup> Courts have approached the problem differently.<sup>921</sup> Listing the guarantee for the full amount, whilst counting reimbursement, subrogation or contribution claims as assets is the most followed approach according to Blumberg,<sup>922</sup> whilst other commentators more recently report that most courts discount for the probability that the guarantee is invoked from the full amount of the liability.<sup>923</sup> This approach uses the “expected value” of the guarantee: the liability discounted by the probability it will be triggered.

Moreover, whichever approach is used, establishing ‘insolvency’ is a fact-intense, time-consuming and highly speculative undertaking, which makes it hard to rely on fraudulent transfer law.<sup>924</sup> The test is not only burdensome but also does not make much sense for guarantees. As Squire explains, the background of the test is that outside troublesome times, the corporation is unlikely to give away assets.<sup>925</sup> Only when the managers are convinced the company is beyond rescue, they are likely to give value away. By guaranteeing another’s debt, the corporation does not give anything away directly, but only contingently.<sup>926</sup> What if the

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<sup>917</sup> See for example Nation, 2002, p. 159; Blumberg, 1987; Squire, 2011, p. 651.

<sup>918</sup> Or undercapitalized §548(a)(1)(B)(ii)(II) and §4(a)(2) UFTA/UVTA or illiquid (§548(a)(1)(B)(ii)(III)).

<sup>919</sup> §101(32)(A) Bankruptcy Code and §2 UFTA/UVTA.

<sup>920</sup> Blumberg, 1987, p. 698; in the past, there has also been discussion on the question whether to treat contingent reimbursement, subrogation and contribution claims as ‘assets’ or not, but both under the Bankruptcy Code and the UFTA/UVTA contingent claims are now seen as assets (or: property). See Blumberg, 1987, pp. 699–700.

<sup>921</sup> Greer and Moss, 2014, p. 195. Note that for the guarantor, the contingent guarantee claim is not an asset but a liability.

<sup>922</sup> Blumberg, 1987, pp. 699–701.

<sup>923</sup> Greer and Moss, 2014, p. 195.

<sup>924</sup> Squire, 2011, p. 657.

<sup>925</sup> Squire, 2011, p. 657.

<sup>926</sup> Squire, 2011, p. 657.

liability is only likely to be triggered when the debtor is insolvent or even bankrupt? For contingent liabilities, the financial state of the company on the moment of assuming the contingent liability should thus not be leading. Instead, the moment the contingent liability is likely to be triggered should be an important factor.<sup>927</sup> In fact, Section 548(a)(1)(B)(ii)(III) seems to open the possibility to consider this, as this allows, instead of using the insolvency test, to attack transfers that were not for reasonably equivalent value and were made while the debtor ‘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’. If the liability is only likely to be triggered when the debtor is insolvent, the debtor should have understood that he would not have been able to pay ‘as such debt matured’. Squire has argued courts should allow attack of guarantees on this ground, but case law has not yet followed.<sup>928</sup>

The problem with the ‘reasonably equivalent value’ test in the context of guarantees is that many guarantees are issued by related parties that do not bargain for any direct consideration. The debt side of the balance sheet of the guarantor goes up (with a contingent debt), whereas the assets remain the same.<sup>929</sup> The guarantor could be persuaded by personal relations to issue the guarantee, such as family relations, or by some indirect benefit, for example in the shareholder-corporation relationship. ‘Reasonably equivalent value’ must be reasonably equivalent value to the debtor itself, value given to a third person does not count as such.<sup>930</sup>

When the guarantor issues a downstream guarantee (a guarantee from shareholder to the corporation, or in the group context from parent to subsidiary), ‘reasonably equivalent value’ in the sense of §548(a)(1)(B)(i) is generally deemed to exist in the indirect benefit that the shareholder/parent receives.<sup>931</sup> Cross-stream and upstream guarantees pose more difficulty.<sup>932</sup> Establishing an indirect benefit can suffice,<sup>933</sup> but when a subsidiary company issues a guarantee for a debt of another subsidiary company or for a debt of a parent for no direct consideration, the (indirect) benefit to the subsidiary is often not immediately evident.<sup>934</sup> Some have put forward that reasonably equivalent value can exist in strengthening the financial position of the group as a whole, but in the influential *Rubin* case, the Second Circuit found such consideration too intangible.<sup>935</sup> In a more recent case in the extensive TOUSA bankruptcy proceedings, the Eleventh Circuit Court held that receiving a chance to avoid bankruptcy by issuing a guarantee did not constitute reasonably equivalent value, also because the court was of the opinion that bankruptcy would have followed anyway.<sup>936</sup> Depending on the exact circumstances of the case and the approach of the courts, downstream or upstream guarantees may also be for reasonably

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<sup>927</sup> Squire, 2011, p. 657.

<sup>928</sup> Squire, 2011, p. 658.

<sup>929</sup> See also Tabb, 2016; although, as discussed above, it could be the case that there is a (secure) contingent reimbursement or subrogation claim. A reimbursement or subrogation claim on the principal is often not very secure, because financial problems on the side of that principal are often the cause for the creditor to invoke the guarantee.

<sup>930</sup> Blumberg, 1987, p. 722.

<sup>931</sup> Nation, 2002, p. 159; Greer and Moss, 2014, pp. 193–194; Squire, 2011, pp. 653–654.

<sup>932</sup> Greer and Moss, 2014, pp. 194–195.

<sup>933</sup> See *Rubin v Manufacturers Hanover Trust Co* 661 F.2d 979 (2d Cir 1981).

<sup>934</sup> Nation, 2002, p. 159; Collier, 2016a, para. 548.05 with reference to *In re Xonics Photochemical, Inc.*, 841 F.2d 198, 201 (7th Cir. 1988) (quoting *Drabkin v. Midland-ross Corp.* (*In re Auto- Train Corp.*, Inc.), 810 F.2d 270, 277 (D.C. Cir. 1987)).

<sup>935</sup> *Rubin v Manufacturers Hanover Trust Co* 661 F.2d 979 (2d Cir 1981); see also Tabb, 2016.

<sup>936</sup> *Senior Transeastern Lenders v Official Committee of Unsecured Creditors (In re TOUSA inc)* 680 F.3d 1298, 67 C.B.C.2d 1035 (11th Cir. 2012).



equivalent value,<sup>937</sup> but there is a serious chance of disqualification as not for reasonably equivalent value when the benefit to the guarantor is too indirect or too intangible.<sup>938</sup>

Rasmussen has argued that the granting of a guarantee should not be seen as a fraudulent transfer to the creditor, but as a fraudulent transfer to the principal debtor.<sup>939</sup> Like in the context of preferences, it is indeed important to recognize the ultimate beneficiary of a transfer. Whether the creditor or the principal debtor benefits from the guarantee however depends on the circumstances; often both benefit.

More fundamentally, Squire has extensively argued that the ‘reasonably equivalent value’ test in the context of intercorporate guarantees is the wrong test to establish whether the guarantee has been detrimental to the other creditors of the guarantor.<sup>940</sup> As Squire shows, the correlation between the fate of the guarantor and the principal debtor is much more relevant in that context (see on correlation seeking extensively chapter 3 paragraph 3.1.4).<sup>941</sup> When the correlation is high (and the guarantor is thus more likely to indirectly receive reasonably equivalent value because the affairs of the guarantor are more intermingled with the principal debtor), the guarantee is actually more detrimental to the creditors of the guarantor rather than less.<sup>942</sup> The reasonably equivalent value test thus results in counterproductive outcomes.<sup>943</sup>

US law does not offer much protection against correlation seeking. The relevance of the correlation between the principal debtor’s and the guarantor’s fate in making value transfers from unsecured creditors to the guarantor is not recognized in case law. As discussed in chapter 3 paragraph 3.1.4 on correlation seeking, a perfect correlation would mean that the guarantor is de facto selling part of his insolvent estate to his creditor, incognito as a guarantee relationship. Under US law, such a guarantee would probably indeed remain incognito, because there is no case law recognizing this fact. Moreover, the Bankruptcy Code does not expressly prohibit ipso facto clauses,<sup>944</sup> although courts would likely refuse enforcement of overt ipso facto clauses.<sup>945</sup>

### 4.1.3 Subordination of claims guaranteed by shareholders

Shareholders often finance the companies they hold shares in with loans. Such shareholder loans are an alternative to providing share capital. By financing with loans instead of share capital, a shareholder may be able to substantially or even fully reduce his share capital investment in the company, whilst still providing the company with the necessary funds. Using such loans instead of share capital may have various reasons, such as tax benefits, but also simply to limit downside risks for the shareholder. An indirect way for the shareholder to provide such a loan could be to get a third person to provide the loan and to guarantee the loan towards the third person, possibly even backed by real security rights provided by the shareholder to the third person. This can be referred to as an indirect shareholder loan. Again, this can be an alternative to

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<sup>937</sup> See for example *In re Tryit Enterprises*, 121 B.R. 217 (Bankr. S.D. Tex. 1990).

<sup>938</sup> See also Tabb, 2016; Greer and Moss, 2014, p. 198; see for examples: *Senior Transeastern Lenders v Official Committee of Unsecured Creditors (In re TOUSA inc)* 680 F.3d 1298, 67 C.B.C.2d 1035 (11th Cir. 2012); *Matter of Fairchild Aircraft Corp.*, 6 F.3d 1119, (5th Cir. 1993).

<sup>939</sup> Rasmussen, 1985.

<sup>940</sup> Squire, 2011, p. 651 ff.

<sup>941</sup> Squire, 2011, pp. 655–658.

<sup>942</sup> Squire, 2011, pp. 652–653.

<sup>943</sup> Squire, 2011, pp. 652–653.

<sup>944</sup> Eisenson, 2014, n. 4.

<sup>945</sup> Squire, 2010, p. 1157.

providing share capital. If the legal system qualifies such constructions as (equivalent to) shareholder loans and subordinates the loan of the outsider creditor to other claims in the bankruptcy proceedings of the debtor, the opaque priority structure created by a combination of incorporation and the guarantee is weakened somewhat, though not completely. The creditor still has an alternative source of collection (the guarantor's patrimony), but is somewhat limited from claiming directly on the debtor in the bankruptcy of the debtor, by which the other creditors of the debtor are somewhat protected. In other words: the pierced limited liability walls would be somewhat reinforced by subordinating claims guaranteed by shareholders. Does US law take such an approach?

The Bankruptcy Code gives the Bankruptcy Court the authority to "under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim to all or part of an allowed interest to all or part of another allowed interest" (§ 510(c) Bankruptcy Code). For a Bankruptcy Court to equitably subordinate a claim of a creditor, the creditor must have behaved inequitably, which must have injured the other creditors or given the lender an unfair advantage, and subordination of the claim must not be inconsistent with the Bankruptcy Code.<sup>946</sup>

Inequitable conduct can exist in case of fraud, illegality, breach of fiduciary duties or the lender's use of the debtor as 'alter ego'. Both for a fiduciary duty to exist and for finding the lender has used the debtor as 'alter ego', a very close relationship between lender and debtor will have to be established, in which the lender was effectively in control of the day to day business of the debtor.<sup>947</sup> Guarantees can be relevant when determining whether such a close relationship existed, but will certainly not suffice.

More relevant is that inequitable conduct can also be established in a case of undercapitalization. Non-insider lenders are unlikely to be confronted by subordination because of undercapitalization, because non-insider lenders are generally not required to keep their debtor sufficiently capitalized.<sup>948</sup> Insider lenders, such as directors or shareholders, are however often confronted with equitable subordination because of undercapitalization.

Guaranteed debts present a special case because of their hybrid character. Whereas a reimbursement or subrogation claim is more likely to be equitably subordinated in case of undercapitalization (in as far as that claim is permissible in bankruptcy<sup>949</sup>), equitable subordination of the claim of the guaranteed creditor seems more remote. However a case for equitable subordination of the guaranteed claim may have a chance especially when the guarantee relationship was instrumental in continued undercapitalization in the sense that the lender would not have borrowed to the principal debtor without the guarantee and has thus artificially kept the borrower alive while the lender was assured of an alternative source of collection through the guarantee arrangement. In that sense US law has some sensitivity in uncovering covert shareholder loans, but a heavy burden of proof of inequitable conduct will rest on the bankruptcy administrator, which will be more difficult to prove in the case of indirect shareholder loans than in the case of direct loans. In short, the rules on equitable subordination

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<sup>946</sup> *Collier Lending Institutions and the Bankruptcy Code*, 2016, para. 5.05.

<sup>947</sup> *Collier Lending Institutions and the Bankruptcy Code*, 2016, para. 5.05.

<sup>948</sup> *Collier Lending Institutions and the Bankruptcy Code*, 2016, para. 5.05.

<sup>949</sup> See extensively Hulse, 2016, para. IV.

of shareholder loans do not have much effect in deterring the opaque priority structure of a limited liability shield perforated by guarantees.

#### 4.1.4 Disallowing double proof

Chapter 3 paragraph 3.1.4 discussed the opaque priority structure created by the mechanism of double proof with guarantees. Double proof occurs when a creditor is able to make more than one claim in relation to a single debt. Double proof (or: ‘double dipping’) can, especially in the context of corporate groups, have the effect of ‘squeezing down’ ordinary creditors.<sup>950</sup> The opaque priority position created by a combination of incorporation and a guarantee is thus given a further boost. This paragraph discusses to which extent US law allows double proof. Of course, the problem of double proof would not occur if either limited liability would not be upheld, or if the guarantee would be annulled (see on the possibilities, paragraphs 4.1.1 and 4.1.2 above).

US law generally allows double proof of claims with the use of guarantees.<sup>951</sup> If for example a debt of a subsidiary company is guaranteed by a parent company and both are declared insolvent, the creditor can enforce the full claim in each bankruptcy case.<sup>952</sup> If the creditor receives a payout on the claim in either bankruptcy case, for example the subsidiary’s bankruptcy case, he can probably still share in the parent’s bankruptcy case based on the full amount of the claim, although he is not entitled to more than 100% satisfaction of his claim.<sup>953</sup> This rule, which essentially allows strong-form double proof, can be traced back to a 1935 Supreme Court case, *Ivanhoe Building & Loan Association of Newark, N.J. v. Orr*,<sup>954</sup> in which case a creditor was allowed to still assert the full amount of his claim against his debtor, even after getting partial satisfaction by foreclosure on non-debtor property. *Ivanhoe* did thus not actually involve a guarantee, but it has widely been interpreted as applicable to guarantees.<sup>955</sup>

However, a more recent case before the Fourth Circuit, *In re National Energy and Gas Transmission, Inc.*, has cast some doubt on the above by considering that *Ivanhoe* only holds that *as a matter of bankruptcy law* the claim of the creditor does not need to be deducted by a sum paid to the creditor by a third party such as a guarantor. The only implication of this, according to the Fourth Circuit, is that non-bankruptcy law determines what the value of the creditor’s claim is. In the *National Energy* case, non-bankruptcy law was New York State law. According to the court, New York State law did allow the creditor not to deduct the amount paid by a surety on that claim, whereas a payment by a co-debtor would have to be deducted.<sup>956</sup> Whether this judgment will be followed remains to be seen. In short, US bankruptcy law allows double proof with guarantees and probably even strong-form double proof, but the law applicable on the claim itself could restrict the strong-form version of double proof.

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<sup>950</sup> Widen 2007, p.301 ff.; compare also Kronfeld, 2012; see extensively chapter 3 paragraph 3.1.

<sup>951</sup> See extensively on double proofing, both in general and in the context of guarantees, Widen, 2007, p. 298 ff; see also Kronfeld, 2012; see for an extensive discussion of ‘double claims’ in the *Nortel* case: Westbrook, 2015.

<sup>952</sup> Greer and Moss, 2014, p. 180 with reference to *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).

<sup>953</sup> Greer and Moss, 2014, p. 180 with reference to *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).

<sup>954</sup> *Ivanhoe Building & Loan Ass'n of Newark, N.J. v. Orr*, 295 U.S. 243, 55 S. Ct. 685, 79 L. Ed. 1419 (1935).

<sup>955</sup> Levitin and Carney, 2013, para. II.

<sup>956</sup> See further Levitin and Carney, 2013; Greer and Moss, 2014, paras 183–184.

US law does have rules to prevent ‘double claims’ from a different perspective: the guarantor’s (contingent) claim on the principal debtor and the creditor’s claim on the principal debtor can only limitedly coincide. US Bankruptcy law does not allow contingent reimbursement or contribution claims (§ 502(e)(1)(B) Bankruptcy Code). If the reimbursement or contribution claim becomes fixed after the commencement of the Bankruptcy case, it is allowed from the moment it becomes fixed (§ 502(e)(2) Bankruptcy Code). Subrogation claims are also allowed (§ 509(a) Bankruptcy Code). Claims for reimbursement, contribution or subrogation are all subordinated to the claim of the creditor until the creditor is paid in full (§ 509(c) Bankruptcy Code). This means that, unless the debtor is solvent, these claims are unlikely to produce any recovery.

## **4.2 Regulatory approaches to covert insider dealing (ex post opportunism)**

Paragraph 4.1 above discussed to which extent US law upholds opaque priority structures in which guarantees are used to create externalities for outsiders (‘ex ante opportunism’). Not unrelated, but clearly distinguishable from such opportunistic behavior is the opportunistic behavior that the guarantee incentivizes *after* (‘ex post’) concluding the guarantee. Whereas paragraph 4.1 thus discussed regulatory approaches to the selectively pierced structures as such, this paragraph discusses to which extent adverse dynamics that are created by such structures are regulated.

Chapter 3 paragraph 3.2 discussed that insider guarantees are likely to create externalities for other creditors by giving incentive for insider dealing whilst at the same time covering up such insider dealing.<sup>957</sup> This paragraph will discuss how US law deals with this. Various mechanisms under US law that may be relevant in this context are discussed below: first and foremost preference law, but also shareholder liability, director liability and lender liability.

### **4.2.1 Avoidance of payments on guaranteed loans**

#### *a) Introduction to US preference law*

US transaction avoidance law can broadly be subdivided into preference law on one side, and fraudulent conveyance law on the other side. Preference law protects the principle of equal distribution among creditors, whereas fraudulent conveyance law protects the overall value of the bankrupt estate.<sup>958</sup> Preference law deals with preferring a single unsecured creditor above other unsecured creditors. US preference law predominantly works with objective factors, whereas fraudulent conveyance law is more oriented on subjective factors. Preference law and fraudulent conveyance law are often most relevant in bankruptcy, in which the bankruptcy administrator can rely on either to attack wealth transfers. In bankruptcy, the Bankruptcy Code is the most important source of preference law and fraudulent conveyance law, but state law (most states implemented the Uniform Fraudulent Transfer Act, UFTA or its newer version,

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<sup>957</sup> See also Ayotte and Morrison, 2009; Baird, 1994a, p. 2262 ff.

<sup>958</sup> Kleinhaus and Lees, 2014.

renamed the Uniform Voidable Transfer Act, UVTA) can also play a role, as discussed further below. Outside bankruptcy, creditors of a debtor wishing to invoke preference or fraudulent conveyance law can only rely on state law (again, usually the UFTA/UVTA).

The definition of a preference given to a creditor is very broad. The Bankruptcy Code allows the administrator to avoid any transfer of an interest of the debtor in property to or for the benefit of a creditor if the transfer was made in the preference period (within a year for transfers to insiders and within 90 days for other transfers) while the debtor was insolvent<sup>959</sup> and if the transfer has enabled the creditor to receive more than he would have normally received in a liquidation (§ 547(b) Bankruptcy Code). Most transfers in the relevant period before bankruptcy (90 days, or a year for insiders) will fall within this definition.

The definition of ‘transfer’ is very broad and does not just encompass payments and the granting of security, but also other fact patterns:

Section 101 (54): *The term “transfer” means—*  
*(A) the creation of a lien;*  
*(B) the retention of title as a security interest;*  
*(C) the foreclosure of a debtor’s equity of redemption; or*  
*(D) each mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with—*  
*(i) property; or*  
*(ii) an interest in property.*

However, there are also many ‘safe harbors’ from preference law (art. 547(c) Bankruptcy Code), the most important of which are transfers that were made in payment of debts incurred in the ordinary course of business, in as far as the transfer was also made in the ordinary course of business (either ordinary in the industry at large or ordinary between this debtor and creditor) (§ 547(c)(2) Bankruptcy Code) and transfers that were a substantially contemporaneous exchange.

Preference law only allows the bankruptcy administrator to avoid preferences that were given “to or for the benefit of a creditor” (Bankruptcy Code § 547(b)(1)). Important to note is that this language covers both transfers that directly benefitted creditors, and transfers that indirectly benefitted creditors, which is crucial in the context of indirect benefits given to guarantors (see further below). However, acts of the debtor that may have diminished the estate but that have not directly or indirectly benefitted a *creditor*, for example if the debtor gives away his car to his brother just before bankruptcy whilst his brother was not a creditor of him, cannot be avoided with the use of preference law. Fraudulent conveyance law may be of use to the administrator in such a situation.<sup>960</sup> Tabb explains that this requirement makes sense given the aim of preference law of reassuring equitable treatment between creditors.<sup>961</sup>

### *b) Indirect preferences*

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<sup>959</sup> Which is presumed to be the case during the 90 days prior to the date of filing the bankruptcy petition, § 547(f) Bankruptcy case.

<sup>960</sup> Tabb, 2013, p. 494.

<sup>961</sup> Tabb, 2013, p. 494.

Important in the context of indirect preferences given to guarantors is that the US Bankruptcy Code has a very broad definition of who are considered creditors of the debtor.<sup>962</sup> The indirect benefit that a guarantor receives when a transfer is made from principal debtor to creditor can directly be attacked as a preference by the administrator because § 547(b) allows that transfers 'for the benefit of' a creditor are addressed, and § 101(5) and (10) Bankruptcy Code include in the definition of 'creditor' someone that has a contingent claim on the debtor. By default, the guarantor has a contingent claim on the principal debtor for reimbursement. In other words, the guarantor is a contingent creditor, or in the definition of the Bankruptcy Code just a 'creditor'. The contingent claim that a guarantor has against the principal debtor for reimbursement, makes him a creditor in the definition of the Bankruptcy Code, even before the guarantor has paid the creditor. If the guarantor receives any (indirect) benefit from a transfer, this can be attacked with preference law. A payment from principal debtor to creditor of course reduces exposure under the guarantee and is thus a transfer that benefits the guarantor as a creditor. The seminal case is the 1917 case *Smith v Tostevin*, in which the Second Circuit Court reasons:

*"A payment to the creditor [bank] discharges [the surety] ... precisely as though made directly to [the surety]. Hence it was inevitable that such a payment should be held a preference, whether made to the innocent creditor or to the surety; the effect was identical, whichever course was chosen."*<sup>963</sup>

The standard preference period is 90 days before the filing (§ 547(4)(A) Bankruptcy Code). In the example of a fully guaranteed debt, in which the creditor extended a loan of for example \$100.000 to the principal debtor and the guarantor guaranteed the whole loan, a payment by the principal debtor of \$40.000 on that loan within 90 days before filing is (if the other requirements are also met, see above) a preference to the guarantor as a 'creditor' who indirectly profited from such a transfer (his exposure under the guarantee relationship is diminished by \$40.000), as well as a preference to the creditor that directly profited from receiving the \$40.000. The bankruptcy administrator can now choose who he wants recover from, he '*may recover, for the benefit of the estate, the property transferred [...] from (...) the initial transferee of such transfer or the entity for whose benefit such transfer was made (...)*' (Bankruptcy Code par 550(A)(1)). If the bankruptcy administrator chooses to call on the creditor, it can be assumed that the guarantee revives for the full amount after the creditor has returned the \$40.000, though this can of course depend on the terms of the guarantee.<sup>964</sup>

By acknowledging the indirect benefit that a guarantor can have from a preferential transfer to the principal debtor, the Bankruptcy Code deters undue pressure by the guarantor on the principal debtor on the eve of bankruptcy to pay off debts guaranteed by him before paying other debts. The deterrent effect of preference law is however limited. The worst sanction that preference law can impose on the guarantor is that he has to reimburse the trustee for the benefit that he received. The trustee may not be able to prove all the elements necessary to establish a preference or the guarantor may be able to rely on a safe harbor. And even if the trustee can pursue the guarantor, he may prefer to call upon the creditor instead of the

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<sup>962</sup> Tabb, 2013, p. 494.

<sup>963</sup> *Smith v Tostevin*, 247 F. 102 (2d Cir. 1917); fragment and redaction taken from Collier, 2016b, para. 547.03.

<sup>964</sup> Westbrook, 1991, pp. 81–82; see also McCoid, 1992, p. 808.

guarantor (for example because the creditor provides more recourse).<sup>965</sup> Furthermore, the deterrent effect of preference law is dependent on the status of the guarantor as a ‘creditor’ under the Bankruptcy Code. This status can easily be contracted away by waiving the contingent reimbursement or subrogation claim, which often happens in practice.

*c) Preferences to insiders*

Preferences given to ‘insiders’ of the debtor are treated as more suspect. Such transfers are, if the other requirements have been met, presumed to be preferences if they occurred within one year before the filing for bankruptcy (§ 547(4)(B) Bankruptcy Code).<sup>966</sup> The logic behind this is that insiders may have an information advantage (and possibly an advantage in influence) compared to outsiders and could abuse that position by pressing the debtor to prefer them above outside creditors.<sup>967</sup> The relevance of this to guarantees is that guarantors are often insiders. Directors and shareholders often guarantee corporate debt. Directors, officers, persons in control of the corporation and general partners are ‘insiders’ within the meaning of § 547(4)(B) in conjunction with § 101(31)(B) Bankruptcy Code. Even relatives of such persons are insiders (§ 101(31)(B)(vi) Bankruptcy Code). Guarantees are also often found in the family setting. If the debtor is an individual, relatives of the individual are also seen as insiders, and so are corporations of which the debtor is a director, officer, or person in control (§ 101(31)(A) Bankruptcy Code). Transfers to or for the benefit of insider guarantors can thus be attacked as preferential with a look-back period of one year. As a result, within the year before insolvency, pressure of the guarantor on the principal debtor to benefit the guarantor is deterred by preference law. If for example a payment of \$40,000 was made ten months before bankruptcy to a creditor on a debt that was guaranteed by an insider of the debtor, the bankruptcy administrator can pursue the insider guarantor directly to pay back the benefit of \$40,000 (assuming the other requirements for a preference have been met, such as insolvency at the time of transfer and no safe harbors).

An interesting situation arises in the often-occurring case that the person receiving a transfer is not an insider, but the guarantor of the debt paid is, and a payment to the guaranteed creditor is made between 90 days and a year before bankruptcy. If that payment indirectly benefitted the guarantor by limiting his exposure under the guarantee relationship and the other requirements are met, the trustee can recover from the guarantor as ‘the entity for whose benefit such transfer was made’ (§ 550(a)(1) Bankruptcy Code). The trustee now however does not have the choice to recover from the initial transferee (the creditor that is not an insider). Although § 550(a)(1) Bankruptcy Code seems to allow recovery from the initial transferee, § 550(c)(1) and § 550(c)(2) stop the transferee from recovering from the non-insider in such a case.

The history of and discussion leading to introduction of § 550(c) Bankruptcy Code is rich. This provision was added by Congress in 1994 (later, in 2005, Congress added § 547(i) that is closely

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<sup>965</sup> The creditor can in turn of course pursue the guarantor after the trustee turns to him, but whether this will actually happen depends on the circumstances. Pursuing a guarantor that has little assets may make little commercial sense. Or the creditor may have other reasons, such as an ongoing business relationship with the guarantor, for being easy.

<sup>966</sup> Although, in the case a transfer occurred within 90 days and one year prior to bankruptcy, the assumption that the debtor was insolvent at that time does not apply, so this will still have to be proven by the administrator (§ 547(f)).

<sup>967</sup> McCoid, 1992, p. 807.

connected to par 550(c) Bankruptcy Code and its history, see below). In a controversial case from 1989, *Levit v. Ingersoll Rand Financial Corporation (In re V.N. Deprizio Construction Corporation)* the Seventh Circuit held that § 550(a)(1) Bankruptcy Code gives the trustee that avoided a transfer made between 90 days and one year before the filing on the basis of § 547(4)(B) Bankruptcy Code the power to choose between recovering from the insider guarantor or from the non-insider creditor. Indeed, a literal reading of the Bankruptcy Code seemed to allow this. The court did not just take a literal interpretation of the Code, but judge Easterbrook also argued convincingly that such a reading supports good policy. According to the court:

*“Loans from insiders to their firms are not the only, or even the most important, concern of outside creditors. Insiders frequently guarantee other loans. If the firm folds while these loans are outstanding, the insiders are personally liable. So insiders bent on serving their own interests (few managers hold outside lenders’ interests of equal weight with their own!) could do so by inducing the firm to pay the guaranteed loans preferentially. If the preference-recovery period for such payments were identical to the one for outside debts, this would be an attractive device for insiders. While concealing the firm’s true financial state, they would pay off (at least pay down) the debts they had guaranteed, while neglecting others. To the extent they could use private information to do this more than 90 days ahead of the filing in bankruptcy, they would make out like bandits. The guaranteed loans would be extinguished, and with them the guarantees. True, it is logically possible to recover from the insider the value of the released guarantee, even if the trustee could not reach the proceeds in the hands of the outside lender. But it is hard to determine the value of a released guarantee, and anyway insiders might think that they would be more successful resisting the claims of the trustee than the hounds of the outside creditors. So an extended recovery period for payments to outside creditors that benefit insiders could contribute to the ability of the bankruptcy process to deter last-minute grabs of assets. The outsiders who must kick into the pool when the trustee uses the avoiding powers retain their contractual entitlements; all the trustee’s recovery does is ensure that those entitlements (as modified by any statutory priorities) – rather than the efforts of insiders to protect their interests, or the cleverness of outsiders in beating the 90-day deadline – determine the ultimate distribution of the debtor’s net assets.”<sup>968</sup>*

Westbrook argues that the ruling by Judge Easterbrook in the *Deprizio* case was correct from a policy perspective.<sup>969</sup> In supporting *Deprizio*, he aims to rebut the criticism that some have had on the effects of the case. Various authors have argued that the *Deprizio* ruling of the Seventh Circuit would mean that lenders will be refrained from taking personal guarantees and will extend less credit as a result.<sup>970</sup> According to Westbrook this case is overstated. Westbrook distinguishes between ‘true value guarantees’ and ‘pure-leverage’ guarantees. True value guarantees as defined by Westbrook are those guarantees that represent true value to the creditor in the sense that the guarantor has enough assets to provide recourse for the creditor. Pure-leverage guarantees are those guarantees that do not represent such value because the guarantor does not provide recourse, and the creditor probably knows this but doesn’t care because the guarantee provides him with control over the guarantor and, if the guarantor is an

<sup>968</sup> *Deprizio* case, p. 1195.

<sup>969</sup> Westbrook, 1991; see in the same sense Ponoroff, 1995; Nussbaum, 1990; Borowitz, 1990; Dix, 1992.

<sup>970</sup> See for example Alces, 1993; Katzen, 1990; Barney, 1991.



insider of the principal debtor, thus over the principal debtor. As Westbrook argues, lenders are not really deterred in taking true value guarantees by the *Deprizio* ruling, because even if the trustee avoids a transfer and claims on the creditor, the guarantee is still intact and the creditor can simply call on the guarantor in turn.<sup>971</sup> Guarantees in practice can be a mix of true value and pure-leverage guarantees. In such a case, the *Deprizio* ruling makes sure the creditor can only be sure of the true value the guarantee grants them, and limits the control<sup>972</sup> (although it doesn't completely rule out such control). Sadly, *Deprizio* has been overruled by the abovementioned changes made by Congress in 1994 and 2005.

At first sight, it may seem that the *Deprizio* ruling relies on a rather technical point, being that the guarantor is a contingent creditor of the principal debtor, which does not have a direct relationship with the policy considerations behind insider self-dealing. If an insider indirectly benefits from a certain transaction and also happens to be a creditor of the principal debtor, the transaction may be avoidable with the use of preference law. If the insider that indirectly benefits is not a creditor of the principal debtor, preference law cannot be applied, at least not towards this insider. Indeed, the *Deprizio* case also featured a tax claim that was (partially) paid in the period between 90 days and 1 year before bankruptcy, which payments limited the exposure for insiders of the debtor towards the tax authorities. Regarding these tax claims, the insiders were not creditors of the debtor, or in other words, if the insiders would have paid the tax claims, they would not have had recourse against the debtor. The Seventh Circuit ruled that in this case, the extended preference period did not apply, because the insiders were not creditors. Why should it matter whether insiders that enrich themselves at the expense of other creditors of the debtor are themselves 'creditors' for the application of preference law?

Although this creditor requirement may seem to work randomly in these examples, Westbrook explains that the creditor requirement can be viewed as a proxy for core preference cases, to distinguish these cases from cases at the margins. As he argues, lawmakers choose between open-ended norms at one end of the spectrum, versus formulaic, mechanic rules at the other end of the spectrum. Both have their costs and benefits. Formulaic rules are easy to apply, but work mechanically with little room for the circumstances of the case, so they should only be applied to specific, core situations.<sup>973</sup> Preference law features formulaic rules that have little subjective elements in them and thus work mechanically. The objective conditions (preferences to creditors, within 90 days before bankruptcy, or within 1 year for insiders) serve to limit the application of preference law to core cases. That is not to say that each case outside those conditions should escape scrutiny altogether. It is a choice of the legislature to not apply mechanic rules to that case. Fraudulent conveyance law, with more subjective and open-ended elements, may still enable the trustee to avoid in such cases at the margins.

Because § 547(b)(1) Bankruptcy Code covers also transfers that 'benefitted' a creditor, even if that creditor was not the initial transferee, many transfers are potentially covered by preference law (see also § 550(a)(1)). It should be noted that many transfers to creditors may somehow bring an indirect benefit to an insider such as a director or controlling shareholder of the debtor. The amount of the benefit will however be hard to establish in such a case. By prescribing that this insider is also a creditor of the debtor, those unclear indirect benefit cases at the margins are excluded from preference law. Only the cases in which the guarantor limits his exposure one

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<sup>971</sup> Westbrook, 1991, pp. 81–82; see also McCoid, 1992, p. 808.

<sup>972</sup> Westbrook, 1991, pp. 81–82.

<sup>973</sup> Westbrook, 1991, p. 91.

on one by inducing the debtor to pay off the creditor are thus covered by preference law. More indirect cases of self-dealing are possibly covered by other rules, such as fraudulent conveyance law or fiduciary duties of director. In that sense, the creditor requirement works as a rough proxy for the directness of the insider benefit.<sup>974</sup>

The question remains what happens if a transfer to a creditor only partly benefits a guarantor, or at least only partly directly benefits a guarantor. There is some discussion on the question what constitutes a 'benefit' in the sense of § 547(b)(1) Bankruptcy Code.<sup>975</sup> Take for example an outstanding guaranteed debt of \$150,000 guaranteed by an insider guarantee capped at \$70,000. If the principal debtor pays \$100,000 back on the debt between 90 days and a year before insolvency, the direct benefit for the guarantor is only \$20,000, not \$100,000, although the guarantor is of course also closer to getting more benefits. Westbrook argued that this should be seen as a preferential payment of \$20,000, not as a preferential payment of \$100,000. Alces, on the other hand, argued this should be seen as a preferential payment of \$100,000.<sup>976</sup> In a slightly different example, the benefit of the guarantor is more questionable. If a payment of \$20,000 is made on a debt of \$100,000, and the guarantor guaranteed the debt up to \$60,000, such payment does not benefit the guarantor as such, but it does bring him closer to a possible benefit in the future. The First Circuit held that, in such a case where there is no direct reduction of the exposure of the guarantor, there is no benefit for the guarantor.<sup>977</sup>

The problem with establishing what the indirect benefit is to a guarantor would be by-passed if recovery was also allowed from the initial transferee. Judge Easterbrook also points this out in the *Deprizio*-judgment as a reason to allow recovery from the initial transferee that is not an insider. What for example if, as happens often, the insider guarantor only guaranteed a small amount of the claim of the creditor on the principal debtor? Consider the following example. An insider guarantor (director of the principal debtor) guarantees a line of credit extended by a bank to a principal debtor. The guarantee is capped at \$30,000. Six months before filing for bankruptcy, the bank still has a claim of \$180,000 on the principal debtor. The guarantor, knowing bankruptcy is probably unavoidable, makes sure the principal debtor pays off the bank in full six months before bankruptcy to reduce his exposure under the guarantee and hopes he can withstand any preference claims of the future trustee. If the trustee is able to prove a preference, he can, because of the amendments by Congress, only recover from the insider guarantor. What was the benefit of the guarantor in this case? Pursuant to the decision of the First Circuit *In re Erin Food*<sup>978</sup> that benefit is probably only \$30,000. However, the outsider (the creditor with guarantee) profited for \$180,000, through control obtained by the guarantee construction.

Moreover, it has been argued that it would be unfair to expose insider guarantors to preference liability in cases in which the guaranteed creditor is not exposed. The guaranteed creditor could use its often extensive control over the debtor to influence the debtor to make preferential payments that expose the insider guarantor, who probably does not understand such risks, but not the sophisticated creditor.<sup>979</sup>

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<sup>974</sup> Westbrook, 1991; 1993.

<sup>975</sup> Westbrook, 1991; 1993; Alces, 1993.

<sup>976</sup> Alces, 1993.

<sup>977</sup> *In re Erin Food Serv., Inc.*, 980 F.2d 792 (1<sup>st</sup> Cir. 1992).

<sup>978</sup> *In re Erin Food Serv., Inc.*, 980 F.2d 792 (1<sup>st</sup> Cir. 1992).

<sup>979</sup> Gordon and Landry, 2015, pp. 80–81.

d) *Waivers of reimbursement and subrogation to escape creditor status*

Another important question is whether waivers of reimbursement and subrogation should, in the context of applying preference law, be upheld by courts. The courts seem to be split on this issue. Especially just after the *Deprizio* case, lenders would request waivers of the (future) subrogation claim of the guarantor on the principal debtor. The idea was that such a waiver would mean that the guarantor is not a ‘creditor’ of the principal debtor in the sense of § 547 Bankruptcy Code, which would mean that, even if the guarantor is an insider, the extended preference period of § 547 Bankruptcy Code does not apply. After *Deprizio*, lenders tried to shield themselves from preference claims that benefitted insiders over the extended preference period. As already discussed, such shielding has been rendered superfluous by the two amendments that aimed to overrule the *Deprizio* ruling. However, waiving the subrogation right could still have some merit for both the creditor and the insider guarantor. The new section of the Bankruptcy Code that overruled *Deprizio* bars the trustee to claim on the non-insider creditor over the extended preference period. The trustee can however still claim from the insider guarantor himself, if the insider guarantor is a creditor. This may also disadvantage the creditor indirectly. As extensively discussed in chapter 3 paragraph 3.2, the guarantee gives the insider guarantor incentive to induce the principal debtor to prefer the guaranteed creditor because a payment of the principal debtor to the guaranteed creditor limits the insider guarantor’s exposure under the guarantee.<sup>980</sup> If preference law however permits the trustee to claim such a benefit back from the guarantor, this may have a deterrent effect on the guarantor. If the guarantor is indeed deterred, this hurts the creditor that would have wanted to receive preferential payments. Thus, a waiver of the subrogation right can still be relevant.

A question is however whether courts should uphold such a waiver, given the fact that the main purpose seems to be to circumvent preference law. Some commentators have argued courts should not uphold such a waiver.<sup>981</sup> Some bankruptcy courts have upheld them, especially early on just after the *Deprizio* case,<sup>982</sup> but some courts have decided not to uphold such waivers.<sup>983</sup>

The Court of Appeals for the Ninth Circuit, the only Circuit Court that has ruled on the issue, has relatively recently held that such a waiver should in principle be upheld, with a dissenting opinion by one judge.<sup>984</sup> The reasoning of the Ninth Circuit is however not convincing. The reasoning of the bankruptcy courts that had not upheld such waivers generally included that the waiver had not much other effect than circumventing preference law, because the insider could

<sup>980</sup> See also Nussbaum, 1990, pp. 614–615.

<sup>981</sup> Westbrook, 1991; Nussbaum, 1990, p. 618, although Nussbaum suggests not upholding or disregarding waivers in the context of creditor status under the Bankruptcy Code as just one solution, possibly not the best solution.

<sup>982</sup> *O’Neil v. Orix Credit Alliance, Inc. (In re Ne. Contracting Co.)*, 187 B.R. 420, 423–24 (Bankr. D. Conn. 1995); *Hostmann v. First Interstate Bank of Or., N.A. (In re XTI Xonix Techs. Inc.)*, 156 B.R. 821, 833–34 (Bankr. D. Or. 1993); *Hendon v. Assocs. Commercial Corp. (In re Fastrans)*, 142 B.R. 241, 245 (Bankr. E.D. Tenn. 1992).

<sup>983</sup> See *Miller v. Greystone Bus. Credit II, L.L.C. (In re USA Detergents, Inc.)*, 418 B.R. 533, 541–42 (Bankr. D. Del. 2009): “*The Court agrees with the Trustee that the waiver does not transform the Titan Entities’ creditor status. Even were the Titan Entities not creditors, they might be responsible for transfers to GBC as beneficiaries by way of reduction in their contingent liability on the guarantee. As such, the Trustee might recover under Bankruptcy Code § 550.*”; See also *Russell v. Jones (In re Pro Page Partners, LLC)*, 292 B.R. 622, 631–33 (Bankr. E.D. Tenn. 2003); *Telesphere Liquidating Trust v. Galesi (In re Telesphere Commc’ns, Inc.)*, 229 B.R. 173, 176 n.3 (Bankr. N.D. Ill. 1999);

<sup>984</sup> *In re Adamson Apparel, Inc.*, No. 12-57059 (9th Cir. 2015)

still obtain a claim against the principal debtor simply by purchasing the lender's note rather than paying on the guarantee.<sup>985</sup> The Ninth Circuit seems to agree in general, but also tries to establish whether, in this particular case, the waiver was a 'sham'. Based on the facts, including that the guarantor did not try to buy the creditor's claim in order to circumvent the waiver, the court decides that the waiver was not a sham and should therefore be upheld. The judgment is not convincing. It is irrelevant whether the guarantor in fact tried to circumvent the subrogation waiver. The fact is that this was possible. The waiver thus had little practical effect other than circumventing preference law. This should suffice.<sup>986</sup> Whether the guarantor indeed tries to buy the claim from the creditor, or just benefits by making sure the principal debtor pays the creditor in order to limit his exposure under the guarantee, will be decided by the guarantor depending on the circumstances. Sometimes, buying the creditor's claim is not in the interest of the guarantor, for example because the subrogation claim has little value in a possible insolvency case.

Problematic about allowing recourse waivers to affect the creditor status of the guarantor under the Bankruptcy Code is furthermore that this may give the principal debtor, through influence of the insider-guarantor, perverse incentives regarding the time of filing the insolvency case. The debtor of course often largely controls the moment that his own bankruptcy case is filed. If the guarantor benefitted from preferential payments to a guaranteed creditor somewhere in the 90-day preference period, he does well to influence the principal debtor to delay filing for bankruptcy until such a preferential payment is outside the three-month preference period.<sup>987</sup> If the reach back period was one year, the perverse incentive could still exist but is much less strong because of the long time span.

#### e) *Safe Harbors*

One of the most important safe harbors against preference attacks, and the most relevant in the context of payments on guaranteed loans, is the ordinary course of business test (§ 547(c)(2) Bankruptcy Code). Transfers that were made in payment of debts incurred in the ordinary course of business are safe in as far as the transfer was also made in the ordinary course of business (either ordinary in the industry at large or ordinary between this debtor and creditor). The defendant that relies on the safe harbor has to prove that (1) the debt was incurred in the ordinary course of business and that (2) the transfer was made in the ordinary course of business. This is often hard to argue when the transfer has been between insiders. Generally, related-party transactions are easily qualified as outside the ordinary course of business. See also Collier on bankruptcy: "*What case law there is reveals that courts generally are interested in whether the debt was incurred in a typical, arms-length commercial transaction that occurred in the marketplace or, on the other hand, whether it was incurred as an insider arrangement with a closely held entity.*"<sup>988</sup>

<sup>985</sup> See *In re Adamson Apparel, Inc.*, No. 12-57059 (9th Cir. 2015), p. 23.

<sup>986</sup> See also the dissenting opinion *In re Adamson Apparel, Inc.*, No. 12-57059 (9th Cir. 2015).

<sup>987</sup> If the guarantor is not seen as a creditor because of the waiver, a preference action cannot directly hurt the guarantor, but a preference action against the guaranteed creditor does indirectly still affect the guarantor. The guarantor therefore still has incentive to postpone bankruptcy filing.

<sup>988</sup> Collier, 2016b, para. 54.07; *Martino v. Miskowicz* (*In re Miskowicz*), 72 C.B.C.2d 197, 513 B.R. 553 (Bankr. N.D. Ill. 2014).

In the case of insider guarantees, it could both be questionable whether (1) the guarantee obligation was created in the ordinary course of business and (2) whether the payment that benefitted the guarantor was made in the ordinary course of business. The guarantee should be separated from the loan itself. The loan from the creditor could be incurred within the ordinary course of business, whilst the guarantee is often a related party transaction that is not incurred at arm's length. Often, almost by definition no other party would issue the guarantee. Taking this perspective, it will be hard for the insider guarantor to rely on the ordinary course exception of § 547(c)(2) Bankruptcy Code.<sup>989</sup> Even if the guarantor would be able to prove that the debt was incurred in the ordinary course, he would still have to prove that the transfer itself was within the ordinary course.

*f) The lender as insider*

A guarantee relationship could under circumstances also be instrumental in qualifying a lender as 'insider' of the debtor under the Bankruptcy Code.<sup>990</sup> Insider status often leads to less favorable treatment under the Bankruptcy Code.<sup>991</sup> As extensively discussed above, transfers to insiders are open to an extended period (one year) for preference attacks. Moreover, claims for equitable subordination (§ 510(c) Bankruptcy Code) have more chance against insiders.<sup>992</sup>

A lender can qualify as an insider on various grounds. § 101(31) Bankruptcy Code defines 'insider' broadly. Not only parties with a formal relationship to the debtor (such as relatives for natural persons and directors and directors, shareholders (more than 20%) and officers for corporations) qualify as insiders, but also any person 'in control' of the debtor.<sup>993</sup> The lender could of course be a person with a formal relationship to the debtor, such as the director or 20% shareholder of the corporation, in which case the qualification of insider is easily foreseeable and made. More difficult is the qualification of a lender as insider in absence of formal relations, on the ground that the lender was in control. The Bankruptcy Code does not define when someone can be qualified as 'in control'. According to *Collier on Lending Institutions*, factors relevant to establish 'control' can be: financial power over the borrower; equity interest; personal relationships; lock box arrangements<sup>994</sup> and involvement in day-to-day operations.<sup>995</sup>

Guarantees are indirectly relevant in this context because a guarantee can give the creditor a certain amount of control over the principal debtor. The mere existence of a guarantee

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<sup>989</sup> Compare *Pioneer Technology, Inc. v. Eastwood* (In re Pioneer Technology, Inc.), 107 B.R. 698, 702 (9th Cir. BAP 1988).

<sup>990</sup> Tung, 2009, p. 172 with reference to *In re Exide Techs., Inc.*, 299 B.R. 732, 743-46 (Bankr. D. Del. 2003).

<sup>991</sup> *Collier Lending Institutions and the Bankruptcy Code*, 2016, para. 5.05.

<sup>992</sup> *Collier Lending Institutions and the Bankruptcy Code*, 2016, para. 5.05.

<sup>993</sup> See § 101(31) Bankruptcy Code:

*"The term "insider" includes:*

*(A) if the debtor is an individual: (i) relative of the debtor or of a general partner of the debtor; (ii) partnership in which the debtor is a general partner; (iii) general partner of the debtor; or (iv) corporation of which the debtor is a director, officer, or person in control;*

*(B) if the debtor is a corporation: (i) director of the debtor; (ii) officer of the debtor; (iii) person in control of the debtor; (iv) partnership in which the debtor is a general partner; (v) general partner of the debtor; or (vi) relative of a general partner, director, officer, or person in control of the debtor*

*(...) (E) affiliate, or insider of an affiliate as if such affiliate were the debtor;"*

<sup>994</sup> In a lock box arrangement, clients of the debtor are asked to pay on an account controlled by the lender and the sums paid are directly used to reduce outstanding credit.

<sup>995</sup> *Collier Lending Institutions and the Bankruptcy Code*, 2016, para. 5.05.

relationship, without specific circumstances such as the creditor indeed using the guarantee relationship to put large amounts of pressure on insiders, will in itself not be enough to establish control.

*g) State preference law*

Although preference law is most suited to attack debt repayments, such repayments could possibly also be attacked with fraudulent conveyance law, either as laid down in the Bankruptcy Code (§ 548) or the UFTA/UVTA (which are mostly similar regarding fraudulent conveyances<sup>996</sup>).<sup>997</sup> The reason for the bankruptcy administrator to attack a preferential payment as a fraudulent conveyance could for example lie in the reach-back period, which can be up to four years in fraudulent conveyance law.<sup>998</sup> Moreover, especially preferential transfers to insiders can provide specific problems that are not always easily addressed by preference law itself.<sup>999</sup> Most importantly in the context of indirect preferences with guarantees, the non-insider initial transferee cannot rely on the safe harbor of § 550(c) Bankruptcy Code (the new safe harbor introduced by Congress in 1994 and improved in 2005, designed to protect non-insider lenders against preference attacks during the extended preference period for insiders) against attacks based on the UFTA/UVTA.

So-called ‘constructive’ fraudulent conveyances always need to involve an imbalance in value in the transaction, which is typically not the case with a payment of an antecedent debt.<sup>1000</sup> This also follows from § 548(d)(2)(A) Bankruptcy Code, which defines value as ‘*property, or satisfaction or securing of a present or antecedent debt of the debtor*’. There is some divergence in the case law on the question whether a preferential payment could be an intentional fraudulent conveyance (§ 548(a)(1)(A)). Some courts have held that preferences cannot be fraudulent conveyances.<sup>1001</sup> Fraudulent conveyance law, in this reading, is concerned with transfers that diminish the estate as a whole, not with transfers that prejudice one creditor above another.<sup>1002</sup> The distinction has however blurred in the case of preferences to insiders, especially indirect preferences to insiders.<sup>1003</sup> Although the Bankruptcy Code does not treat insider preferences as fraudulent conveyances,<sup>1004</sup> the case has been made that fraudulent conveyance law as laid down in the Bankruptcy Code can theoretically be applied to insider preferences.<sup>1005</sup> Intentional fraudulent conveyances do not need to involve an imbalance in value, but intent to hinder, delay, or defraud has to be shown. Apart from rare situations, such as transfers in the context of Ponzi-schemes, this is often difficult.<sup>1006</sup> Even in such rare cases, some courts have held that fraudulent conveyance law does not protect against preferential payments to creditors.<sup>1007</sup> See however

<sup>996</sup> See also Knepper *et al.*, 2016b, para. 6.03.

<sup>997</sup> See extensively Kleinhaus and Lees, 2014.

<sup>998</sup> The reach-back period is up to four years under the UFTA (see § 9 UFTA) and 2 years for constructive and intentional fraudulent conveyances under the Bankruptcy Code (§ 548(a)(1)).

<sup>999</sup> See extensively Nussbaum, 1990; Tabb, 2016.

<sup>1000</sup> McCoid, 1992, p. 816; Kleinhaus and Lees, 2014, p. 327; see however Nussbaum, 1990, who argues that, one could however take the position that a transfer to one creditor at the time that the debtor was insolvent is not a transfer for equivalent value because the creditor receives more than he would receive in case of liquidation.

<sup>1001</sup> See extensively Kleinhaus and Lees, 2014, p. 327 ff; Tabb, 2016.

<sup>1002</sup> Tabb, 2016.

<sup>1003</sup> Tabb, 2016; Nussbaum, 1990, p. 623 ff.

<sup>1004</sup> Tabb, 2016.

<sup>1005</sup> Nussbaum, 1990.

<sup>1006</sup> Compare also McCoid, 1992, pp. 813–816.

<sup>1007</sup> See extensively Kleinhaus and Lees, 2014, p. 327 ff.

Nussbaum, who argues that ‘intent to hinder, delay, or defraud’ can often easily be shown in a case in which an insider guarantor influences the corporation in paying back guaranteed debt shortly before insolvency.<sup>1008</sup> In short, although there is some discussion on the use of fraudulent conveyance law as laid down in the Bankruptcy Code to attack insider preferences, this will generally be hard to argue.<sup>1009</sup>

However, state fraudulent conveyance law goes beyond the Bankruptcy Code in this context, as state fraudulent conveyance law often includes preference-like rules.<sup>1010</sup> State law can also be used to attack fraudulent conveyances, either outside bankruptcy by creditors or inside bankruptcy by the bankruptcy administrator (§ 544b Bankruptcy Code). Most states have incorporated the Uniform Fraudulent Transfer Act (UFTA) or the newer version, renamed the Uniform Voidable Transactions Act (UVTA).<sup>1011</sup> § 5(b) UFTA/UVTA contains a preference-like rule for transfers to insiders: “A transfer made by a debtor is fraudulent as to a creditor whose claim arose before the transfer was made if the transfer was made to an insider for an antecedent debt, the debtor was insolvent at that time, and the insider had reasonable cause to believe that the debtor was insolvent.” This provision is clearly derived from 547(b)(4)(B) Bankruptcy Code.<sup>1012</sup> ‘Debt’ is defined broadly enough in § 1 UFTA/UVTA to encompass the contingent claim of a guarantor, and ‘insider’ is defined broadly as well. ‘Insolvent’ is defined in § 2 UFTA/UVTA as balance sheet insolvency, with a presumption for balance sheet insolvency in case of insufficient cash flow to pay current debts. The reach-back period under § 5b UFTA/UVTA is comparable to the reach-back period for transfers to insiders under the Bankruptcy Code.<sup>1013</sup> The Preparatory Note to the UFTA explains the insider preference provision as follows: “an insolvent debtor is obliged to pay debts to creditors not related to him before paying those who are insiders”.<sup>1014</sup>

One difficulty in applying § 5(b) UFTA/UVTA is however that it does not clearly deal with third-party transfers, whereas § 547 Bankruptcy Code does (as extensively discussed above).<sup>1015</sup> The text of §5(b) only mentions transfers *to* an insider, not transfers *for the benefit of* an insider, whereas the Bankruptcy Code does. Question is whether § 5(b) UFTA/UVTA can be interpreted to include indirect transfers to insiders.<sup>1016</sup> Blumberg extensively argues that it can and should be interpreted to include such indirect transfers, and recently Tabb also seems to agree.<sup>1017</sup>

§ 8(b)(1) UFTA/UVTA allows recovery from both the transferee as well as any indirect beneficiary of the transaction. Assuming § 5(b) UFTA/UVTA applies to indirect transfers to insiders, recovery can thus possibly both be made from the insider *and* the direct transferee. As already mentioned above, the non-insider initial transferee cannot rely on the safe harbor of § 550(c) Bankruptcy Code (the new safe harbor introduced by Congress in 1994 and improved in

<sup>1008</sup> Nussbaum, 1990, pp. 621–622.

<sup>1009</sup> See also Tabb, 2016; McCoid, 1992.

<sup>1010</sup> Tabb, 2016.

<sup>1011</sup> Some states use an older, mostly similar, version of the UFTA, the UFCA (Uniform Fraudulent Conveyance Act), including New York and Texas, whilst some others use neither. In 2014, the Uniform Law Commission introduced some changes to the UFTA and renamed it to UVTA (Uniform Voidable Transactions Act). Those changes are not directly relevant to the discussion here. Less than half of the states using the UFTA had incorporated the new UVTA as of 2017.

<sup>1012</sup> See also Blumberg, 1987, p. 712.

<sup>1013</sup> Both are one year, see 9(c) UFTA and 547(b)(4)(B) Bankruptcy Code, but with a different point of reference. Under the UFTA, the action has to be brought within a year after the transfer, whereas the Bankruptcy Code reaches back a year before filing the Bankruptcy petition.

<sup>1014</sup> See extensively on §5(b) UFTA/UVTA and guarantees: Blumberg, 1987, p. 702 ff.

<sup>1015</sup> Blumberg, 1987, p. 713.

<sup>1016</sup> Blumberg, 1987, p. 713.

<sup>1017</sup> Blumberg, 1987, p. 713 ff; Tabb, 2016.

2005, designed to protect non-insider lenders against preference attacks during the extended preference period for insiders, as extensively discussed above) against attacks based on § 5(b) UFTA/UVTA. As a result, transfers that benefit insiders indirectly can also be recovered from non-insiders with an action based on § 5b UFTA/UVTA, with a reach-back period of one year after the transfer was made (§ 9(c) UFTA/UVTA).<sup>1018</sup>

#### *h) Summary on insider preferences*

US law is characterised by a detailed statutory and judge-made regime that polices indirect preferences to insiders. US law strongly relies on objective factors, such as the period in which the payment took place and who benefitted directly or indirectly from a transfer, which objective approach is able to capture the dynamics that lead to indirect preferences well. Notable is that both the definition of ‘transfer’ and the definition of ‘insider’ are very broad. Not only transfers that benefit shareholder-guarantors are thus policed, but also transfers to other insider-guarantors, for example directors, relatives of directors and relatives of shareholders are included in the definition. Not only payment or direct granting of security is a ‘transfer’, but also other fact patterns, such as the example discussed in chapter 3 paragraph 3.2.2 in which the processing of raw materials was accelerated before filing for bankruptcy, in order to bring a benefit to the guaranteed creditor.

US law does however leave some gaps in the protection against such indirect preferences. No recourse can be had on the initial transferee, only on the indirectly profiting insider, which is especially problematic when partial guarantees lead to full satisfaction of the non-insider initial transferee. Moreover, if the insider does not provide recourse, because he or she is also declared bankrupt, the bankruptcy administrator is also left empty-handed. Especially problematic are waivers of reimbursement and subrogation to escape creditor status under the Bankruptcy Code. Under current case law it seems that if the insider-guarantor has contractually waived his recourse claim, he cannot be addressed by a preference attack. Moreover, it should be borne in mind that the reach of transaction avoidance law is limited in two respects: (1) preference law does not have a strong deterrent effect and (2) wealth transfers can remain covert, even though US law has a very broad definition of ‘transfer’.

### **4.2.2 Director liability for insider preferences**

An important deterrent force on insider dealing with guarantees in the context of corporate finance may come from director liability rules for such behavior. Roughly two situations should be distinguished in this context: (a) payment of the guaranteed debt has prejudiced other creditors but has not done damage to the balance sheet of the debtor company and (b) payment of the guaranteed debt has damaged the company, for example by leading to acute liquidity problems. This distinction is relevant in light of director liability, because, under US law, the rules on director liability towards the shareholders or the company differ from the rules on director liability towards outsiders such as creditors.

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<sup>1018</sup> Tabb, 2016; The UFTA/UVTA does provide other safe harbors, including the new value exception (UFTA 8(f)(1) (similar to § 547(c)(4) Bankruptcy Code)) and the ordinary course of business exception (UFTA 8(f)(2) (similar to § 547(c)(2) Bankruptcy Code)) and transfers made in good faith effort to rehabilitate the debtor (with additional requirements) (UFTA 8(f)(3)).



a) Liability for preferential payments that have only prejudiced creditors

Shareholders are usually not prejudiced by preferential payments to insiders, but (unpaid) creditors obviously are. Do directors also owe fiduciary duties to creditors? A second question is whether, if directors do not owe fiduciary duties to creditors, those creditors (or the bankruptcy administrator in their place) could still sue directors for breach of fiduciary duties towards the corporation, a so-called derivative action.

The answers to these questions differ between states and are, even within states, often not crystal clear, which makes formulating an answer difficult. Delaware cases are seen as by far the most influential and leading on the issue, as is often the case in corporate law.<sup>1019</sup> Therefore, Delaware law on these points is analyzed here without much reference to other states. Delaware law has developed rather a lot in the last decades on the questions whether directors owe fiduciary duties to creditors. In the past, it has been held that the fiduciary duties of directors shift from the shareholders to the creditors when the debtor comes within the ‘vicinity of insolvency’.<sup>1020</sup> However, in the more recent and much-cited *North American v. Gheewalla* case the Delaware Supreme Court held that directors owe no direct fiduciary duties to creditors, irrespective of whether the corporation is in the vicinity of insolvency.<sup>1021</sup> Creditors thus cannot sue to recover personally for the breach of a fiduciary duty. According to the Delaware Supreme Court, the fiduciary duties of directors only run towards the corporation and its shareholders, regardless of whether the corporation is solvent or insolvent.

The Delaware Supreme Court does, however, allow creditors derivative standing to sue directors for breach of fiduciary duties when the corporation is insolvent.<sup>1022</sup> A bankruptcy administrator also has standing to sue for breach of such duties towards the corporation since the corporation will presumably be insolvent while in bankruptcy. Derivative standing however implicates that creditors only have standing in as far the corporation has suffered damage because of the director’s behavior. As explained above, preferential payments or preferential treatment as such usually do not damage the corporation. This leads to the conclusion that, where it concerns damage to creditors by preferential payments or preferential treatment of other creditors, creditors usually are not substantially helped by derivative standing.

Some caution should be taken in giving too much weight to the *Gheewalla* decision of the Delaware Supreme Court and related decisions. Although Delaware is an important and influential corporate law jurisdiction, other states may and do follow different lines of reasoning and may accept direct fiduciary duties of directors towards creditors.<sup>1023</sup> Moreover, Delaware case law on this point seems somewhat unsettled.<sup>1024</sup>

A last, rather controversial, doctrine needs some discussion in the context of director liability. Creditors have often relied on a theory of ‘deepening insolvency’ to sue third parties such as directors, shareholders or lenders.<sup>1025</sup> The idea is that continuation of the corporation may in

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<sup>1019</sup> Collier on Bankruptcy par 15.02.

<sup>1020</sup> See in particular Delaware Chancery Court, 1991 Del. Ch. LEXIS 215 (Del. Ch. Dec. 30, 1991), *Credit Lyonnais v. Pathe Communications Corp* and Delaware Chancery Court, Geyer v. Ingersoll Publications Co., 621 A.2d 784 (Del. Ch. 1992); see further Knepper *et al.*, 2016b, para. 6.02.

<sup>1021</sup> *North American v. Gheewalla* 930 A.2d 92 (Del. 2007).

<sup>1022</sup> See also Knepper *et al.*, 2016b, para. 6.02.

<sup>1023</sup> *Collier Lending Institutions and the Bankruptcy Code*, 2016, para. 15.02.

<sup>1024</sup> *Collier Lending Institutions and the Bankruptcy Code*, 2016, para. 15.02.

<sup>1025</sup> *Collier Lending Institutions and the Bankruptcy Code*, 2016, para. 15.02.

some cases only cause more harm to creditors.<sup>1026</sup> The creditors (or bankruptcy administrator), when asserting such a claim, essentially claim that the corporation should have been liquidated at an earlier stage. In *Lafferty*, the Court of Appeals for the Third Circuit allowed the theory of deepening insolvency as an independent cause of action against a third person such as a director.<sup>1027</sup> However, in *Trenwick America Litigation Trust v. Ernst & Young*,<sup>1028</sup> the Delaware Chancery Court (whose decision was adopted by the Delaware Supreme Court) held that the theory of deepening insolvency does not grant an independent cause of action.<sup>1029</sup> Commentators have generally been critical of the deepening insolvency theory.<sup>1030</sup> The theory can however, probably also under Delaware law, still be relevant in calculating damages relating to the breach of another fiduciary duty.<sup>1031</sup>

The theory of deepening insolvency can, if it can indeed be relied upon either as an independent cause of action or as a theory that can be instrumental in calculating the amount of damages, be relevant in the context of loans guaranteed by insiders. As discussed in chapter 3 paragraph 3.2.2, a guarantee by directors or shareholders can, under specific circumstances, delay timely bankruptcy filing. It could be the case that the otherwise unsecured part of the guaranteed debt far outreaches the maximum amount of the guarantee, in which case the insider guarantors have incentive to gamble for resurrection instead of file for bankruptcy. It could also be the case that bankruptcy filing is delayed in order to slowly wind down the company for the benefit of the guaranteed creditor, thus prejudicing other creditors.

b) Liability for preferential payments that have prejudiced both shareholders and the creditors

Under state corporate law directors of corporations are generally held to owe the fiduciary duties of loyalty and care towards the corporation and its shareholders.<sup>1032</sup> US law has traditionally had a strong focus on conflicts of interests on the part of directors.<sup>1033</sup> This can act to deter insider dealing through guarantees. If the director himself guaranteed debt of the corporation, which is not uncommon (especially not if the director is also the sole shareholder) the director may be held liable for a breach of his fiduciary duties if he acts in his own interests as guarantor rather than in the interest of the corporation. Making the corporation pay the guaranteed creditor shortly before bankruptcy would be in his own interest. In such a case in which the director is conflicted because he is involved (albeit indirectly) on both ends of the transaction, a breach of his fiduciary duties could occur.

The roots of the doctrine of fiduciary duties of directors towards creditors can be found in trust law.<sup>1034</sup> A more contemporary explanation can be found in agency theory.<sup>1035</sup> The modern idea is that the separation of ownership and control creates an agency problem between directors and

<sup>1026</sup> *Collier Lending Institutions and the Bankruptcy Code*, 2016, para. 5.02.

<sup>1027</sup> Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 349 (3d Cir. 2001)

<sup>1028</sup> *Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P.*, 906 A.2d 168, 174 (Del. Ch. 2006)

<sup>1029</sup> See also Hu and Westbrook, 2007, p. 1323 at fn 1.

<sup>1030</sup> Willett, 2005; Hu and Westbrook, 2007, p. 1323 at fn 1; see for a defense of the theory Franklin, 2006.

<sup>1031</sup> *Collier Lending Institutions and the Bankruptcy Code*, 2016, para. 15.02.

<sup>1032</sup> See extensively Knepper *et al.*, 2016a, para. 14.01 ff.

<sup>1033</sup> Hopt, 2011, p. 38.

<sup>1034</sup> *Collier on Bankruptcy* par 15.01; McCoid, 1992.

<sup>1035</sup> *Collier on Bankruptcy* par 15.01.

shareholders. The fiduciary duties (loyalty and care) are aimed to mitigate this agency problem by assuring that the director acts in the interest of the corporation or the shareholders.

The fiduciary duties encompass the duty of loyalty and the duty of care. The duty of loyalty is understood to (inter alia) protect against self-dealing by the directors and is therefore most relevant in the context of insider dealing through guarantees.<sup>1036</sup> The duty of loyalty has for long had an important place in US law, whereas this duty is much less important on the European continent.<sup>1037</sup> It is a broad duty that is hard to define. Two common situations in the context of guarantees that could be suspect in relation to the duty of loyalty can be distinguished. Firstly, when the corporation pays a guaranteed creditor and the director himself is the guarantor, the director is obviously interested.<sup>1038</sup> In such cases the business judgement rule, which can be traced back to a 1919 case and which stipulates that the judge should stay away from assessing business judgements of directors,<sup>1039</sup> is not applied. See for example the *Lichtenstein* case, in which the Appellate Division of the New York Supreme Court held:

*"The business judgment rule, however, protects only directors who are disinterested, meaning they do not, for example, stand to gain any personal financial benefit in the sense of self-dealing "as opposed to a benefit which devolves upon the corporation or all stockholders generally" (...) The complaint in this case makes it plain that Lichtenstein was not disinterested, because his stewardship of ESI was affected by a conflict between his fiduciary duties as a director of the company and his personal exposure to \$100 million in liability on the guarantees in the event of ESI's voluntary bankruptcy."*<sup>1040</sup>

Secondly, when the director is both director of the principal debtor and director of the guarantor, both entering into the guarantee relationship and making payments on the guarantee could be suspect from the perspective of the duty of loyalty. The fact that these fact patterns are suspect, does not mean the guarantee relationship or payments on the guaranteed debts are necessarily voidable or that directors can be held liable. Most state-level statutes allow transactions by interested directors subject to disclosure and ratification requirements and some states allow as a defense against avoidance actions that the transaction was in the interest of the corporation.<sup>1041</sup> Some states also shift the burden of proof that the act was in the interest of the corporation if disinterested directors ratify the transaction.

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<sup>1036</sup> Knepper *et al.*, 2016a, para. 14.02; Collier on Bankruptcy par 15.01. The duty of care encompasses the duty to act in good faith, with the care of an ordinary prudent director and in the best interest of the company (see Collier on Bankruptcy par 15.01). This duty often has little relevance because of the so called 'business judgment rule' which directors can rely on. This rule creates a presumption that, put shortly, the director acted in the best interest of the company and in good faith (see Collier on Bankruptcy par 15.01). However, only disinterested directors can rely on the business judgment rule. In that sense, the rule refers back to the duty of loyalty.

<sup>1037</sup> Hopt, 2013, para. 1.

<sup>1038</sup> Compare Westbrook, 1991, p. 81; *Cross v. Communication Channels, Inc.*, 456 N.Y.S.2d 971, 973-74 (Sup. Ct. 1982).

<sup>1039</sup> *Dodge v. Ford Motor Co.*, Michigan Supreme Court 07/02/1919, 284 Mich. 458 (1919).

<sup>1040</sup> *Lichtenstein v Willkie Farr & Gallagher LLP*, 120 A.D.3d 1095 (New York Supreme Court appellate division, 2014). It should be noted that this was not a director liability case, but a case of a director, David Lichtenstein, against his attorney, Wilkie Farr & Gallagher, for alleged legal malpractice. One of the arguments supporting his claims was that he would have been insulated from liability by the business judgment rule had he declined to have ESI file for bankruptcy protection. In reaction to this argument, the Court held that Lichtenstein could not have relied on the business judgment rule because of the guarantees being in place.

<sup>1041</sup> Knepper *et al.*, 2016a, para. 14.05 Collier on Bankruptcy par 15.01; see for example the Delaware Code, Title 8, § 144: *No contract or transaction between a corporation and 1 or more of its directors or*

The director that is involved on both ends of a transaction, such as a director that prefers himself by paying back debt guaranteed by him, generally has the burden to show that the transaction was indeed in the best interest of the company, which can be closely scrutinized by the courts.<sup>1042</sup> If this cannot be shown convincingly, the director could be liable because of a breach of his fiduciary duty of loyalty.

US corporate law is known for its shareholder-oriented approach.<sup>1043</sup> If directors and shareholders are different constituencies, the shareholders can rely on the doctrine of fiduciary duties when a director that has guaranteed certain debts represents the company in his own interest rather than that of the shareholders. Such a situation, in which directors that are not shareholders guarantee debts of the corporation, is however rare. More common is the situation in which the guarantor is both director and controlling shareholder. In such a case, a minority shareholder could rely on the breach of fiduciary duty of loyalty of the director/controllershoulder.<sup>1044</sup> Shareholders are however rarely prejudiced by preferential payments to insiders. Such payments on debts do, in themselves, probably not change the value of the corporation. Only in rare cases, for example cases in which the payment itself pushes the corporation into bankruptcy, prejudice to shareholders may exist. The fiduciary duty of directors towards shareholders is thus not of much interest in the context of preferential payments.

### 4.2.3 Lender liability

Creditors often use guarantees to exercise control over principal debtors. Lenders that exercise too much control over the principal debtor can be confronted with certain doctrines of corporate, tort and bankruptcy law.<sup>1045</sup>

#### *a) Deepening insolvency*

The theory of deepening insolvency was discussed above. As discussed, the theory can also be relied on against a lender. The theory is however very controversial, especially as an independent cause of action. The effectiveness of the theory against a lender is even more remote than against directors. Directors can generally be expected to have knowledge of the financial state of the company and the opportunities ahead and should thus be able to make an

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*officers, or between a corporation and any other corporation, partnership, association, or other organization in which 1 or more of its directors or officers, are directors or officers, or have a financial interest, shall be void or voidable solely for this reason, or solely because the director or officer is present at or participates in the meeting of the board or committee which authorizes the contract or transaction, or solely because any such director's or officer's votes are counted for such purpose, if:*

*(1) The material facts as to the director's or officer's relationship or interest and as to the contract or transaction are disclosed or are known to the board of directors or the committee, and the board or committee in good faith authorizes the contract or transaction by the affirmative votes of a majority of the disinterested directors, even though the disinterested directors be less than a quorum; or*

*(2) The material facts as to the director's or officer's relationship or interest and as to the contract or transaction are disclosed or are known to the stockholders entitled to vote thereon, and the contract or transaction is specifically approved in good faith by vote of the stockholders; or*

*(3) The contract or transaction is fair as to the corporation as of the time it is authorized, approved or ratified, by the board of directors, a committee or the stockholders.*

<sup>1042</sup> Knepper *et al.*, 2016a, para. 4.16; McCoid, 1992, p. 837.

<sup>1043</sup> Hopt, 2011, p. 28.

<sup>1044</sup> Knepper *et al.*, 2016a, para. 4.21.

<sup>1045</sup> Tung, 2009, pp. 172–173; 'Bankruptcy Considerations (Chapter 8)', 2013, para. 8.02.

assessment whether continuing the company is justified. Lenders may have such knowledge, but often do not. Thus, for lenders to be liable based on a theory of deepening insolvency, strong lender involvement is necessary. As extensively discussed in chapter 3 paragraph 3.2, the guarantee relationship is one of the important tools through which lenders obtain control over a company and can thus be a sign of strong lender involvement, but whether it suffices depends on the circumstances of the case. Moreover, in the context of lenders, commentators recently detected a lender-friendly movement regarding deepening insolvency.<sup>1046</sup> As such, the theory of deepening insolvency does not seem to have much relevance in the context of deterring unwanted lender control.

*b) Breach of fiduciary duties*

A lender could also be liable for breach of fiduciary duties towards other creditors.<sup>1047</sup> Generally, creditors are not assumed to owe any fiduciary duties to other creditors of their debtor.<sup>1048</sup> This could however change if the lender exerts “substantial control over the borrower’s affairs”.<sup>1049</sup> The claimant (another creditor of the principal debtor or the bankruptcy administrator) would first have to show that the lender exerted substantial control and thus had a fiduciary duty, and furthermore that the duty was breached, which breach resulted in damages.<sup>1050</sup> Such a claim can only be successful in rare cases with very specific fact patterns. Moreover, the courts have, in the last two decades, become rather lender-friendly.<sup>1051</sup> Again, guarantees can however be very relevant in this context, because insider guarantees can be used to exercise control over the principal debtor. The mere existence of an insider guarantee in general, will however in itself not suffice to establish a fiduciary duty of the guaranteed creditor.<sup>1052</sup>

*c) Aiding and abetting breach of fiduciary duties*

Even if no fiduciary duty exists between lender and borrower, a claimant could, against a lender, rely on the theory of aiding and abetting breach of fiduciary duties. The idea is that a third person such as a lender that has a close connection to an insider such as a director who has a fiduciary duty and who breached that duty, can be liable towards the parties injured by such a breach. Again, there is some uncertainty and difference between states on the question whether the theory of aiding and abetting breach of fiduciary duties constitutes an independent cause of action.<sup>1053</sup> Delaware and New York seem to allow the theory as in independent cause, whereas Georgia doesn’t and Pennsylvania is unsettled.<sup>1054</sup> The elements of a claim for aiding and abetting breach of fiduciary duties can vary from state to state. Under Delaware law, which is influential, the claimant must establish:

*“(1) the existence of a fiduciary relationship; (2) proof that the fiduciary breached its duty; (3) proof that a defendant, who is not a fiduciary, knowingly participated in a breach; and*

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<sup>1046</sup> *Collier Lending Institutions and the Bankruptcy Code*, 2016, para. 5.02.

<sup>1047</sup> Tung, 2009, p. 172.

<sup>1048</sup> Tung, 2009, p. 172.

<sup>1049</sup> *Collier Lending Institutions and the Bankruptcy Code*, 2016, para. 5.02.

<sup>1050</sup> *Collier Lending Institutions and the Bankruptcy Code*, 2016, para. 5.02.

<sup>1051</sup> Baird and Rasmussen, 2006, p. 1235.

<sup>1052</sup> Compare *Collier Lending Institutions and the Bankruptcy Code*, 2016, para. 5.02; Baird and Rasmussen, 2006, p. 1235.

<sup>1053</sup> *Collier Lending Institutions* para 5.02.

<sup>1054</sup> *Collier Lending Institutions* para 5.02.

*(4) a showing that damages to the plaintiff resulted from the concerted action of the fiduciary and nonfiduciary.”*<sup>1055</sup>

This theory is relevant in the context of insider dealing through insider guarantees. If the lender uses his control to put pressure on the insider to act in a certain way, and these acts result in a breach of fiduciary duties by insiders, for example because the insider serves his own interest as guarantor rather than those of the principal debtor (breach of the fiduciary duty of loyalty), the lender can possibly be held liable for aiding and abetting breach of fiduciary duties. It should be noted that such a claim will not be allowed where the alleged breach is in essence a preferential transfer.<sup>1056</sup> However, if the complaint against the insider and the lender casts a wider net, the claimant can rely on aiding and abetting breach of fiduciary duties.<sup>1057</sup> Chapter 3 paragraph 3.2.2 gave the example of a shoe factory that is pressurized by a lender, through insider guarantees, to turn stock leather on which the lender does not have a lien into shoes on which the lender can assert a lien, all just before filing for bankruptcy. Such behavior may escape preference attacks, but could under circumstances be attacked as constituting a breach of the fiduciary duty of loyalty by the director, which was aided and abetted by a lender guaranteed by that director.

Of course, breach of the fiduciary duty of loyalty would in any case have to be shown first to be able to rely on the theory of aiding and abetting such breach. In the context of insider dealing, showing breach of fiduciary duties will often already be the bottleneck. As explained above, under (influential) Delaware law, directors are not assumed to owe any fiduciary duties towards creditors, not even in the vicinity of insolvency. Directors do owe fiduciary duties to the corporation and creditors are assumed to have derivative standing for breach of such duties, but the corporation is usually not (or only marginally) prejudiced by preferential treatment of insiders.

In short, outside extreme cases, lender liability does not provide a substantial brake on insider dealing through guarantees.

#### 4.2.4 Bad boy guarantees

A particular guarantee arrangement through which a creditor may try to gain control over a principal debtor is the so-called ‘bad boy guarantee’. A common example of such a bad boy guarantee is a guarantee by a shareholder or manager for debts of a corporation that is made contingent upon certain ‘bad’ acts by management or shareholders from the viewpoint of the lender, typically including filing for bankruptcy.<sup>1058</sup> This obviously creates, like any shareholder guarantee (though arguably even more strongly), questions in relation to for example preference law and fiduciary duties of managers, which have been extensively addressed above.

In the particular case of bad boy guarantees that aim to prevent an insider from filing for bankruptcy, guarantors have tried to escape liability by arguing that their ‘bad act’ did not

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<sup>1055</sup> See *Miller v. Greystone Bus. Credit II, L.L.C. (In re USA Detergents, Inc.)*, 418 B.R. 533, 541–42 (Bankr. D. Del. 2009).

<sup>1056</sup> See *Miller v. Greystone Bus. Credit II, L.L.C. (In re USA Detergents, Inc.)*, 418 B.R. 533, 541–42 (Bankr. D. Del. 2009).

<sup>1057</sup> See *Miller v. Greystone Bus. Credit II, L.L.C. (In re USA Detergents, Inc.)*, 418 B.R. 533, 541–42 (Bankr. D. Del. 2009).

<sup>1058</sup> Ayotte, Casey and Skeel, 2016, p. 33; Eisenson, 2014, pp. 262–263.

constitute any (or not much) damage and that they should, therefore, not be held liable for the full sum ('full recourse liability'), even though the text of the guarantee allows such full recourse.<sup>1059</sup> Guarantors have had little success with this defence.<sup>1060</sup>

Guarantors have also tried to escape liability by arguing such guarantees are unenforceable on public policy grounds, especially in the case of a guarantee by directors because such a guarantee invites breach of the fiduciary duties of the director.<sup>1061</sup> Again, guarantors have had little success escaping liability on this ground, as most courts have held bad boy guarantees to be enforceable.<sup>1062</sup> In *UBS Commercial Mortgage Trust v. Garrison Special Opportunities Fund L.P.*, the New York Supreme Court held, on the issue of enforceability of bad boy guarantees: "The court sees no distinction between this set of facts and those involving any parent corporate guaranty of debt of a subsidiary. The legitimacy of such common arrangements is not subject to question under any theory of commercial law of which the court is aware."<sup>1063</sup> However, as has been argued in this book, particularly in chapter 3 paragraph 3, such arrangements do in general deserve close scrutiny.

#### 4.2.5 Fresh start laws

Fresh start laws may influence the incentive for insider dealing. A guarantor who knows that liability under a guarantee may lead to a life of indebtedness will have a significantly different bargaining position than a business owner who knows that bankruptcy law (and society at large) will offer him a fresh start. In paragraph 3.4 of this chapter, it was already discussed that, although the US is famous for its perceived forgivingness towards debtors and although US bankruptcy law indeed seems generous in providing a fresh start, the system has become less debtor-friendly recently and the US does not have an extensive social security net. The analysis thus in no way leads to the conclusion that overindebted individuals are well off in the US system. As a result, the influence of fresh start laws on the incentive for insider dealing is likely limited.

#### 4.2.6 Specific dynamics in reorganization

§ 524(e) Bankruptcy Code 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'. In other words, guarantors of a bankrupt principal debtor remain liable under the guarantee. Moreover, the rule that creditors of the bankrupt debtor are automatically stayed from taking any action to recover (§ 362 Bankruptcy Code), does not extend to guarantors.<sup>1064</sup> As a general rule, creditors can thus still pursue guarantors, also during bankruptcy proceedings of the principal debtor.<sup>1065</sup>

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<sup>1059</sup> Eisenson, 2014, p. 263.

<sup>1060</sup> Eisenson, 2014, p. 263; Beslow and Eliason, 2014, pp. 2–3.

<sup>1061</sup> Eisenson, 2014, pp. 264–265; Adams and Kirkham, 2009, p. 7; Beslow and Eliason, 2014, pp. 2–3.

<sup>1062</sup> Eisenson, 2014, p. 265; Adams and Kirkham, 2009, p. 7; Beslow and Eliason, 2014, pp. 2–3.

<sup>1063</sup> *UBS Commercial Mortg. Trust 2007-FLI v. Garrison Special Opportunities Fund L.P.*, No. 652412/2010, 2011 WL 4552404, (N.Y. Sup. Ct. Mar. 8, 2011).

<sup>1064</sup> Greer and Moss, 2014, p. 162; Zaretsky, 1988.

<sup>1065</sup> Zaretsky, 1988.

There are two exceptions. Firstly, § 1301 Bankruptcy Code extends the automatic stay in bankruptcy to actions against guarantors.<sup>1066</sup> This only applies to guarantees for consumer debts, and only to a guarantor that is an individual who became liable on such debt outside the ordinary course of his or her corporation. Furthermore, this only applies in Chapter 13 Bankruptcy Code (simply put, the reorganization procedure for individuals, also referred to as the ‘wage earners plan’), not in Chapter 7 (liquidation) or Chapter 11 (reorganization plan procedure). The background of this rule is that many individual debtors that enter Chapter 13 have been required to furnish guarantees on their consumer loans. If collection against those guarantors is not stayed, these guarantors, who are often close relatives, may exert pressure on the individual to either pay the guaranteed debt or to repay the guarantor, in violation of the plan of reorganization.<sup>1067</sup> The reorganization and equal treatment of creditors in the reorganization is thus threatened if collection on the guarantee is not stayed. The stay is however only temporary. The creditor can request a lift of the stay in if either (1) the guarantor received consideration or (2) the plan does not propose to pay the claim or (3) the creditor’s interest would be irreparably harmed by continuation of the stay (§ 1301(c)). Often, a plan will propose not to pay creditors in full, in which case the creditor can request a lift of the stay and pursue the guarantor and thus still put pressure on the plan.

The second exception to the general rules that the guarantor remains liable when the principal debtor is declared bankrupt and that actions against guarantors are not automatically stayed, is that courts can (arguably) make temporary or permanent injunctions protecting guarantors by using their equitable powers granted in § 105 Bankruptcy Code (“The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title.”).<sup>1068</sup> Under certain circumstances, some courts have been willing to extend the automatic stay in bankruptcy to co-debtors, or to issue a temporary injunction. Some courts have even been willing to issue permanent injunctions, also referred to as ‘third-party release’ or ‘non-debtor release’. The influential ABI (American Bankruptcy Institute) report of 2014 on Chapter 11 advised against a blanket prohibition of third party release.<sup>1069</sup>

The object for such temporary or permanent injunctions is not to protect the third party, but to protect the bankrupt estate from the pressure that a guarantee can entail. Actions against guarantors could interfere with the reorganization of the principal debtor in bankruptcy, often because of a close relationship between guarantor and bankrupt.<sup>1070</sup>

Courts have generally held that temporary stays are possible under specific circumstances.<sup>1071</sup> In order to apply for a temporary stay against guarantors, the principal debtor would have to show that action against the guarantor would seriously harm or endanger the reorganization, and to show that such reorganization would be possible with a stay.<sup>1072</sup> The court will carefully balance the interests and would be very wary of damaging the interests of the creditor.<sup>1073</sup> A temporary stay may not always harm the creditor substantially whereas it can take some pressure off the reorganization process.

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<sup>1066</sup> See extensively Collier, 2016c, para. 1301.01 ff.

<sup>1067</sup> Kennedy, 1978, pp. 50–51; Collier, 2016c.

<sup>1068</sup> See also Harner, 2014, p. 252 (ABI Report 2014).

<sup>1069</sup> Harner, 2014, p. 255.

<sup>1070</sup> Zaretsky, 1988.

<sup>1071</sup> Tracht, 2000, p. 553 ff.

<sup>1072</sup> Zaretsky, 1988.

<sup>1073</sup> Zaretsky, 1988; Greer and Moss, 2014, pp. 164–165.



In rare cases such as *Twist Cap*, courts have temporarily enjoined banks from honoring a letter of credit (independent bank guarantee) in the bankruptcy of the account party.<sup>1074</sup> Such cases have however been rare and heavily criticized in the literature, also because of the function of bank guarantees in practice.<sup>1075</sup> Subsequent authority, including a decision by the same judge as the judge in *Twist Cap*, has rejected the reasoning in *Twist Cap*.<sup>1076</sup> Worries on the reliability of bank guarantees in bankruptcy were later revived by *Wysko Investment*, a case in which a district court for the first time used its equitable powers granted in § 105 Bankruptcy Code to temporarily bar a claim on a bank guarantee, on the basis of the argument that claiming on the bank guarantee by the creditor would seriously hamper the reorganization process.<sup>1077</sup>

Especially complete release of co-debtors by a bankruptcy court is controversial.<sup>1078</sup> Of course, such release would often harm the creditor substantially and is therefore usually unwarranted. Some courts refuse to do so altogether, other courts only release under very specific circumstances.<sup>1079</sup> As already stated, the ABI report of 2014 on Chapter 11 advised against a blanket prohibition of third party releases.<sup>1080</sup> In the known cases in which the court has released co-debtors, the co-debtor was not a guarantor but another type of co-debtor.<sup>1081</sup> For example, some cases have seen insurers in mass-tort litigation cases released in exchange for a contribution to a fund, because absence of such a release would have seriously endangered a reorganization process. In that sense, co-debtor release is used as a settlement device. The difference with the guarantee relationship is that liability of the guarantor is often clear and definite, whereas liability of the insurer may be a point of extensive discussion with many parties involved, in which case third-party release in exchange for some kind of contribution can be a simple (though controversial) settlement device.

The ABI report recommended using the factors established in the case *In re Master Mortgage*<sup>1082</sup> when deciding on a third-party release in a reorganization plan. Those factors, as stated by the ABI report, are:

- “(1) the identity of interest between the debtor and the third party, usually an indemnity relationship, such that a suit against the nondebtor is, in essence, a suit against the debtor or will deplete assets of the estate;*
- (2) whether the nondebtor has contributed substantial assets to the reorganization;*
- (3) whether the injunction is essential to reorganization;*
- (4) whether a substantial majority of the creditors agree to such injunction — specifically, whether the impacted class or classes have “overwhelmingly” voted to accept the proposed plan treatment; and*
- (5) whether the plan provides a mechanism for the payment of all, or substantially all, of the claims of the class or classes affected by the injunction.”<sup>1083</sup>*

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<sup>1074</sup> *Twist Cap, Inc. v. Southeast Bank (In re Twist Cap, Inc.)*, 1 B.R. 284 (Bankr. M.D. Fla. 1979).

<sup>1075</sup> See for example Gorney, 1992; see for an especially strong denunciation: Moringiello, 1994.

<sup>1076</sup> *Collier Lending Institutions and the Bankruptcy Code*, 2016, para. 2.06.

<sup>1077</sup> *Wysko Inv. Co. v. Great Am. Bank*, 131 B.R. 146 (D. Ariz. 1991); *Collier Lending Institutions and the Bankruptcy Code*, 2016, para. 2.06.

<sup>1078</sup> Kuney, 2016, p. 99; see for criticism on such discharges for example Boyle, 1992.

<sup>1079</sup> See extensively Gamble, 2011; Greer and Moss, 2014, pp. 218–221.

<sup>1080</sup> Harner, 2014, p. 255.

<sup>1081</sup> See extensively Gamble, 2011, who also argues guarantors should not be released.

<sup>1082</sup> *In re Master Mortg. Inv. Fund Inc.*, 168 B.R. 930 (Bankr. W.D. Mo. 1994).

### 4.3 Summary of US law on external relations

Guarantees can influence the positions of outsiders. This paragraph examined the current regulation under US law of such influence on outsiders and the protection of the interests of these outsiders against possible opportunistic use by insiders.

On the issue of opaque priority structures, US law is relatively well-developed, but often also unsettled. Shareholder guarantees are an often-mentioned factor supporting veil-piercing cases. For substantive subordination cases, this is however less clear. The case for equitable subordination of indirect loans through guarantees is also somewhat unclear. US law does, disappointingly, generally allow for strong-form double proofing of claims through guarantees.

US Law is well-developed on the issue of insider dealing through guarantees. Although state fraudulent transfer law is somewhat unclear on the regulation of indirect preferences, US federal bankruptcy law is clearly set up to attack indirect preferences with guarantees efficiently and has particular attention to the possible insider status of guarantors. Some particular issues remain, such as the weight given to reimbursement and subrogation waivers in this context, but the overall direction of the law is clear.

US law is less strict in regulating directors' behavior in this context, as the duty of loyalty of directors seems in many states nowadays to be assumed to run mainly towards the corporation and shareholders, not towards the creditors of the corporation, also not when the corporation is insolvent. Creditors do have derivative standing, which can generally be helpful but usually not in the case of damage because of preferential treatment of other creditors, as such behavior typically does not damage the company or shareholders.

Lenders may be held liable for 'aiding and abetting' breach of fiduciary duties, though state law differs somewhat on this point and cases are rare. Importantly also, US law has a somewhat forgiving regime for personal bankruptcy, which can deter lender control over guarantors to a certain extent, though important reservations have to be made to this statement, such as that US bankruptcy law has become less debtor-friendly recently and that the social security system in the US is generally very limited.

## 5 Conclusion

After a short introduction as to the most common types of guarantees under US law, opportunistic use of guarantees in the context of corporate finance has been discussed. Firstly, opportunism towards insiders to the guarantee relationship has been discussed, followed by a discussion of opportunistic use towards outsiders.

Regarding opportunistic use towards insiders, US law is disappointing. The specific protection of consumer sureties is very scarce. General contract law and the Statute of Fraud give some, but very limited protection to weak sureties.

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<sup>1083</sup> Harner, 2014, p. 256.

Regarding opportunistic use towards outsiders, US law offers somewhat more promising solutions. Importantly, shareholder guarantees are often considered as a factor in veil-piercing cases. US law does however generally allow double proofing of claims through guarantees.

US law is especially well-developed on the issue of insider dealing through guarantees. Indirect preference to guarantors can be attacked efficiently, though some particular issues remain, such as the impossibility to claim from the non-insider creditor for insider benefits and the weight given to reimbursement and subrogation waivers in this context, but the overall direction of the law is clear.