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Satisfaction Not Guaranteed – Claims Against Guarantors in Bankruptcy

BY JOEL H. LEVITIN AND MICHAEL R. CARNEY

I. Introduction

Many finance lawyers believe that a creditor is entitled to assert the full face amount of its claim against a guarantor in bankruptcy, without having to reduce such claim to reflect any partial payments by the primary obligor on the underlying debt.[1] Thus, there is a traditional notion in bankruptcy practice that a creditor is entitled to receive a distribution from the guarantor based on the full face amount of its debt, potentially obtaining a recovery in excess of those received by other holders of claims with the same priority of payment that have received partial payments from the debtor.

Consider two creditors of a debtor that will pay 50% of amounts owed to its creditors, one with a $100 guaranty claim and the other with a $100 non-guaranty claim, where the holder of the guaranty claim received a partial payment of $50 from the primary obligor, and the other claimholder was paid $50 on its claim by the debtor, prior to bankruptcy. Under the conventional view, the holder of the guaranty claim would be allowed to assert a claim of $100, despite the $50 payment, entitling it to recover an additional $50 from the debtor's estate for a total of $100 in full satisfaction of its claim. In contrast, the other creditor, whose claim has the same priority, would be required to reduce its claim by the $50 payment, recovering only $25 on its remaining claim of $50, for a total of $75. If the claim against the guarantor were limited to the $50 remaining amount unpaid, however, it would receive only an additional $25 distribution from the debtor's estate, like other similarly-situated creditors with net unpaid claims of $50.

The U.S. Supreme Court's 1935 decision in *Ivanhoe Building & Loan Association of Newark, N.J. v. Orr*[2] is cited in support of the accepted position. However, *Ivanhoe* is not necessarily definitive on the issue, and other decisions offer a potential departure from the traditional view. As explained in greater detail below, it is at least arguable that a creditor should not be required to reduce its claim for guaranteed debt by the amount paid by the primary obligor.

II. The Traditional View of Guaranty Claims in Bankruptcy

In *Ivanhoe*, the Supreme Court held that a creditor was entitled to an allowed claim for the full amount of a mortgage bond under which the debtor was obligated, notwithstanding that such creditor's claim already had been satisfied in part by a recovery through foreclosure on the mortgaged property then owned by a third party.[3] The *Ivanhoe* decision rests upon an interpretation of the defined term ''secured creditor'' under Bankruptcy Act § 1(23) and makes no reference to applicable non-bankruptcy law.[4]

Bankruptcy Act § 1(23) (as in effect in 1935) provided that a

> [s]ecured creditor shall include a creditor who has security for his debt upon the property of the bankrupt of a nature to be assignable under this Act . . . or who

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[1] A creditor cannot, of course, collect a total of more than 100% of its claim in the aggregate from all contributing parties. *See, e.g., Nuveen Mun. Trust v. Withumsmith Brown, P.C.*, 629 F.3d 283, 295 (3d Cir. 2012) (''a creditor cannot collect more, in total, than the amount it is owed.''); *In re Sacred Heart Hosp. of Norristown*, 182 B.R. 413, 417 (Bankr. E.D. Pa. 1995).

[2] 295 U.S. 243 (1935).

[3] *Id.* at 245.

[4] *Id.* at 245-46 (''Decision must be governed by relevant provisions of the Bankruptcy Act.'').

Mr. Levitin is a partner in the business restructuring and bankruptcy practice group at Cahill Gordon & Reindel LLP, and Mr. Carney is an attorney in the bankruptcy litigation practice group at McKool Smith, P.C.

> owns such a debt for which some indorser, surety, or other persons secondarily liable for the bankrupt has such security upon the bankrupt's assets.[5]

Further, Bankruptcy Act § 57e provided that ''claims of secured creditors'' were to be allowed only for sums owing ''over and above'' the value of their collateral. According to the Court, the creditor in *Ivanhoe* did not fit within the definition of ''secured creditor'' under Bankruptcy Act § 1(23) because the debtor no longer owned the collateral at issue at the time of foreclosure, so such creditor's claim was not subject to mandatory reduction by the value of such collateral under Bankruptcy Act § 57e.[6]

Although *Ivanhoe* did not involve a guaranty claim, it has been interpreted to apply to such claims, at least in the context of a foreclosure on collateral. For example, in *In re F.W.D.C., Inc.*,[7] a Florida bankrutpcy case, Chase Manhattan Bank received a payment on outstanding debt from certain primary obligors by foreclosing on collateral in a state-law foreclosure proceeding.[8] The debt owed to Chase was guaranteed by affiliates of those obligors, and Chase asserted the full amount of the underlying debt as an unsecured claim in the guarantors' bankruptcy cases, without reducing such claim for the value received as a result of the foreclosure.[9]

Certain creditors moved for substantive consolidation of the bankruptcy cases of the obligors and their affiliated guarantors, with the primary purpose of reducing Chase's claims by the value previously received through the foreclosure.[10] The movants—noting that Bankruptcy Code § 506(a) emphasizes secured ''claims,'' as opposed to its predecessor's reference to ''secured creditors''—argued that *Ivanhoe's* analysis of the meaning of ''secured creditor'' under the Bankruptcy Act, and how such creditors' claims were treated thereunder, should be inapplicable to cases filed under the Bankruptcy Code.[11]

The *F.W.D.C.* court rejected the movants' argument, without significant analysis, finding that *Ivanhoe* was controlling because Bankruptcy Code § 506(a) has the same effect as Bankruptcy Act §§ 1(23) and 57e, and because the movants cited no case law in support of their position.[12] Consequently, the *F.W.D.C.* court concluded that, as a general proposition of bankruptcy law under *Ivanhoe*, ''a claim against a debtor-guarantor . . . need not be reduced to reflect a creditor's receipt of a third party's collateral securing the third party's indebtedness guaranteed by the debtor.''[13]

III. Potential Contrary Authority Regarding Guaranty Claims in Bankruptcy

In *National Energy & Gas Transmission, Inc. v. Liberty Electric Power, LLC (In re National Energy & Gas Transmission, Inc.)*,[14] ET Power entered into an agreement to purchase energy from Liberty.[15] ET Power's corporate parent, NGET, and a non-debtor subsidiary, GTN, guaranteed ET Power's performance under the agreement up to $140 million.[16] After both ET Power and NGET filed for bankruptcy protection, ET Power rejected the agreement, and Liberty claimed it was owed approximately $140 million in rejection damages, plus additional amounts, including $17 million in postpetition interest.[17] GTN subsequently paid Liberty $140 million, but Liberty continued to assert claims for $140 million in bankruptcy against NGET and ET Power in an attempt to recover the additional $17 million.[18]

NGET and ET Power objected to Liberty's claims, arguing, among other things, that Liberty should not be permitted to assert claims against both for $140 million when the actual amount required to make it whole was, at most, $17 million.[19] The bankruptcy court held that the claims could proceed for $140 million (capping any recovery at $17 million).[20]

On appeal, the United States Court of Appeals for the Fourth Circuit looked first to *Ivanhoe* to determine whether the full amount of the claim could be asserted, as a bankruptcy matter, and then turned to state law to determine the amount of such claim.[21] The court characterized the issue before it as follows:

> Because Liberty is currently owed only approximately $17 million, the debtors argue its claim should be limited to this amount. The debtors' argument is foreclosed by the combination of *Ivanhoe Building & Loan Ass'n of Newark v. Orr*, 295 U.S. 243, 55 S. Ct. 685, 79 L. Ed. 1419 (1935), ***and New York law, which governs*** pursuant to the Agreement. In *Ivanhoe,* the Supreme Court held that a creditor need not deduct from his claim in bankruptcy an amount received from a non-debtor third party in partial satisfaction of an obligation. Thus, as a matter of bankruptcy law, ET Power's debt to Liberty is not reduced by the amount which Liberty received from GTN. However, ***this merely leads to the question of what the value of ET Power's debt is, and New York law provides the answer to this question.***[22]

Specifically, Section 15-103 of New York's General Obligations Law (codified as N.Y. Gen. Oblig. L. § 15-

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[5] That section of the Bankruptcy Act became section 1(28) of the version in effect at the time the Bankruptcy Code superseded it in October 1979.

[6] *Ivanhoe*, 295 U.S. at 245-47.

[7] 158 B.R. 523 (Bankr. S.D. Fla. 1993).

[8] *Id.* at 524 (bankruptcy court granted relief from stay to permit proceeding to go forward).

[9] *Id.*

[10] Although the debtors in *F.W.D.C.* supported substantive consolidation (and claims reduction), a previous agreement with Chase precluded them from seeking such relief. *Id.* at 524 n.1.

[11] *Id.* at 527.

[12] *Id.* at 528.

[13] *Id.* at 527. Recently, another bankruptcy court in Florida has also followed the traditional view, *see In re Johnson*, 477 B.R. 879 (M.D. Fla. 2012), and the United States Court of Appeals for the Third Circuit endorsed this view in the context of deciding a jurisdictional issue. *See Nuveen,* 629 F.3d at 295-98.

[14] 492 F.3d 297 (4th Cir. 2007).

[15] *Id.* at 299.

[16] *Id.*

[17] *Id.*

[18] *Id.* at 300. Only that $17 million was at issue in the appeal.

[19] *Id.*

[20] *Id*

[21] Courts have long held that the validity and amount of claims is generally determined in accordance with applicable nonbankruptcy law. *See Butner v. United States*, 440 U.S. 48, 55 (1979) (''Property interests are created and defined by state law,'' and ''[u]nless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding.'').

[22] *Id.* at 300-01(emphasis added), *citing Travelers Cas. & Sur. Co. of Am. v. Pac. Gas & Elec. Co.*, 549 U.S. 443, 450-51 (2007) (''[W]e have long recognized that the basic federal rule in bankruptcy is that state law governs the substance of claims[.]'').

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103), which incorporates section 3 of the Model Joint Obligations Act,[23] provides:

> The amount or value of any consideration received by the obligee from one or more of several obligors, or from one or more of joint, or of joint and several obligors, in whole or in partial satisfaction of their obligations, shall be credited to the extent of the amount received on the obligations of all co-obligors to whom the obligor or obligors giving the consideration did not stand in the relation of a surety.[24]

The Court found that ''whether GTN's payment to Liberty must be deducted from ET Power's obligation turns on whether GTN was a surety or a co-obligor.''[25] Because the Court determined that GTN was a surety, the authority set forth above did not require that the claims be reduced: ''[W]e conclude that . . . GTN was a surety for ET Power's obligations to Liberty. Accordingly, the value of ET Power's debt to Liberty under state law is not reduced by the $140 million received from GTN.''[26]

By implication, however, had GTN not been a surety, but either an obligor or a co-obligor, Liberty's claims in the bankruptcy cases would have been reduced, under the ''combination of *Ivanhoe* . . . and New York law.''[27] Thus, at least according to the analysis in *National Energy & Gas*, the provision of consideration by a co-obligor, which is a denomination of borrower affiliate guarantors in sophisticated financing arrangements more common than surety, reduces the obligation of other obligors (whether primary or secondary obligors or sureties) to the extent of the amount or value of consideration received,[28] and once that obligation is so reduced, claims against such other obligors in bankruptcy arguably should be reduced as well.[29]

IV. Conclusion on Reducing Guaranty Claims in Bankruptcy

Although certain courts have interpreted Ivanhoe as standing for the proposition that, as a matter of general bankruptcy law—and without regard to state law principles governing the amount of debt for which a guarantor was liable—a creditor is entitled to assert claims against a guarantor in bankruptcy without reducing such claims by the amount paid by the primary obligor, there are arguments to the contrary that practitioners should be aware of and consider. Indeed, it is not entirely clear (and it is certainly not ''guaranteed'') that a creditor is entitled to assert the full amount of its guaranty claims against a guarantor in bankruptcy, and it may well be required to reduce such claims by the amount or value of any of the primary obligor's payments on the underlying debt.

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[23] The Model Joint Obligations Act, which was proposed by the Uniform Law Commissioners in 1925, has been adopted in six states: Hawaii (Haw. Rev. Stat. §§ 483-1 to 483-6), Maine (Me. Rev. Stat. tit. 14 §§ 11 to 17), Nevada (Nev. Rev. Stat. §§ 101.010 to 101.90), New York (N.Y. Gen. Oblig. L. §§ 15-101 to 15-110), Utah (Utah Code Ann. §§ 15-4-1 to 15-4-7), and Wisconsin (Wis. Stat. §§ 113.01 to 113.11).

[24] Section 3 of the Model Joint Obligations act essentially codifies a widely-accepted principle under the common law of contracts that the ''[f]ull or partial performance or other satisfaction of the contractual duty of a promisor discharges the duty to the obligee of each other promisor of the same performance to the extent of the amount or value applied to the discharge of the duty of the promisor who renders it.'' *See* Restatement (Second) of Contracts § 293.

[25] *Nat'l Energy & Gas*, 492 F.3d at 301. The definition of ''obligations'' under N.Y. Gen. Oblig. L. 15-101 expressly concerns contractual, as opposed to tort, liability, and ''obligor'' under New York's General Obligations law also includes both primary and secondary obligors. *See Maine Trust Co. of Buffalo v. Richardson*, 15 Misc. 556, 558-59 (N.Y. Sup. Ct. 1939) (collateral agreement guaranteeing money advanced for building of school constituted a joint obligation). Other state that have adopted the Model Joint Obligations Act do not make such a distinction. *See, e.g.*, *W. Techs., Inc. v. All-Am. Golf Ctr., Inc.*, 139 P.3d 858, 861 (Nev. 2006) (section governing payments credited to co-obligors applies to contract actions, as well as actions in torts, and permits offsets between co-obligors).

[26] *Nat'l Energy & Gas*, 492 F.3d at 301. Notwithstanding that finding, the Court ultimately held that Liberty was not entitled to any additional recovery beyond the $140 million paid by GTN, since the $17 million was a claim for unmatured interest not recoverable under Bankruptcy Code § 502(b)(2). *Id.* at 302-03.

[27] *See also Greenhalch v. Shell Oil Co.*, 78 F.2d 942, 943 (10th Cir. 1935) (interpreting identical provision of Utah law to mean that ''payments made by an obligor *not a surety* shall be credited to the obligation of co-obligors'') (emphasis added).

[28] Consistent with that analysis, if a guarantor were sued by a creditor outside of bankruptcy on a guaranty, any judgment against the guarantor would generally be reduced by the value of any consideration provided by the primary obligor. *See, e.g.*, *Fundex Capital Corp. v. Rochelle*, No. 05-civ-2972, 2006 BL 150207, at *3 (S.D.N.Y. Mar. 7, 2006) (damages award against guarantor was equal to face amount of primary obligor's debt *less* all prior payments primary obligor made on such debt).

[29] The distinction between payments by co-obligors that *are* sureties (which payments are not credited against the underlying debt) and payments by co-obligors that *are not* sureties (which payments are credited against the underlying debt) is based on the fact that a surety has subrogation rights, and a co-obligor does not. *See City Trust, Safe Deposit & Surety Co. of Philadelphia v. Haaslocher*, 91 N.Y.S. 1022, 1026 (N.Y. App. Div. 1905) (''[T]he surety, by the mere payment of the debt . . . is in equity subrogated to all the rights and remedies of the creditor for the recovery of his debt against the principal debtor or his property, or against the co-sureties or their property, to the extent of what they are equitably bound to contribute.''); *Winkelmann v. Excelsior Ins. Co.*, 650 N.E.2d 841, 844 (N.Y. 1995) (''[T]he surety acquires no subrogation rights to pursue the debtor until the creditor . . . is made whole. Any rule permitting the surety to recover its losses from the defaulting debtor *pro tanto* would interfere with the creditor's right to be made whole''). Thus, if a surety paid $75 on a debt of $100, and a primary obligor paid $25, the debt would be satisfied in full and the creditor would have no further claims against the primary obligor or the surety, and the surety's right of subrogation would ripen. If the underlying debt were reduced by the $75 paid by the surety in addition to the $25 paid by a primary obligor (as the statute provides), the surety—which has rights no greater than the creditor—would not have any subrogation claim to assert against the primary obligor. The statute avoids that unfair result by not reducing the underlying debt by payments the surety made, thereby permitting the surety to be subrogated to the creditor's rights and to assert a claim of $75 against the primary obligor.