By Constance L. Young

To Release or Not to Release That Guaranty, That Is the Question

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Guarantors often request a return or release of a guaranty when the creditor has received payment in full on the guaranteed debt. However, is a creditor giving up any rights if it executes a release or returns a guaranty upon payment in full? What happens if the creditor is subsequently sued in a bankruptcy for a fraudulent conveyance or a preference related to the obligation covered by the guaranty that the creditor may have returned or released? Is that creditor prevented from recovering from its guarantor in this situation? And how long may the exposure period be for potential liability for an alleged fraudulent conveyance? This article examines these issues.

In *In re RedFMarketing LLC*,[1] a lender sought to enforce its guaranty against a guarantor after payments that released the guarantor were subsequently disgorged by a trustee. Here, the debtor's affiliate sought to purchase real estate from sellers that owed a debt to the lender. The debtor, who was not a party to this transaction, directly paid the seller's obligations to the lender as a condition of the purchase of the real estate.

Almost four years later, after the guarantied debt was paid off and the lender returned the guaranty and signed a release, the liquidating agent for the debtor brought fraudulent-transfer claims against the lender alleging that the debtor transferred more than $1.2 million of funds directly to the lender in order to satisfy an obligation for an affiliate of the debtor to purchase real estate from which the debtor received no benefit. Furthermore, the liquidating agent alleged that the transfers substantially depleted (1) the debtor's assets, and (2) its ability to pay its creditors. As a result, the lender then looked to the guaranty to recover the disgorged payments that it had to pay back to the liquidating agent. The guaranty in *In re RedFMarketing LLC*[2] contained the following language:

> In the event any payment by [the] Borrower or any other Person to [the] Lender is held to constitute a preference, fraudulent transfer or other voidable payment under any bankruptcy, insolvency or similar law, or if for any other reason [the] Lender is required to refund such payment or pay the amount thereof to any other party, such payment by [the] Borrower or any other party to [the] Lender shall not constitute a release of [the] Guaranty from any liability hereunder, and this Guaranty shall continue to be effective or shall be reinstated (notwithstanding any prior release, surrender or discharge by [the] Lender of this Guaranty or of [the] Guarantor), as the case may be, with respect to, and this Guaranty shall apply to, any and all amounts so refunded by [the] Lender or paid by [the] Lender to another Person (which amounts shall constitute part of the Guaranteed Obligations), and any interest paid by [the] Lender and any attorneys' fees, costs and expenses paid or incurred by [the] Lender in connection with any such event. It is the intent of the Guarantor and Lender that the obligations and liabilities of [the] Guarantor hereunder are absolute and unconditional under any and all circumstances and that until the Guaranteed Obligations are fully and finally paid and performed, and not subject to refund or disgorgement, the obligations and liabilities of [the] Guarantor hereunder shall not be discharged or released in whole or in part by any act or occurrence that might, but for the provisions of this Guaranty, be deemed a legal or equitable discharge or release of a guarantor.

So, could the lender rely on this language in any attempt to recover from the guarantor despite having returned the guaranty? What would happen if that language had not been in the guaranty? Again, how long does a lender need to be concerned about disgorgement of a payment on a fraudulent-conveyance theory?

With respect to timing, the time period a creditor could be at risk of suit by a trustee for a fraudulent transfer or conveyance is based on both federal and state law. However, trustees generally look to state laws to recover preferences or fraudulent transfers from creditors because the "clawback" period under state law is likely longer than under federal law. Although the Bankruptcy Code has a two-year limitations period,[3] the trustee might be able to use the state law statutory period if she can point to an unsecured creditor that existed at the time of the transfer.[4] State

1 Case No. 12-32462 from the U.S. Bankruptcy Court of the Western District of North Carolina is the base case. The adversary proceedings are 14-03254, 14-03259, 14-03260, 14-03261, 14-03262 and 14-03263.

2 *Id.*

3 *See* 11 U.S.C. § 546(a)(1)(A).

4 *See* 11 U.S.C. § 544(b).

statutes of limitations vary on the length of the limitations period and the date from which the limitations period is calculated. For example, in some states, the calculation of the limitations period does not begin until the fraudulent conveyance was, or reasonably could have been, discovered.[5] In other jurisdictions, the limitations period can be extended if the fraud was not discovered during the limitations period.[6] Also, if it is determined that the debtor took steps to actively conceal the transaction, the limitations period can be tolled until the fraud is discovered.[7] Thus, the time period after which a creditor can breathe a sigh of relief can vary on a case-by-case basis, according to state law and the particular facts of the case.

With respect to continuing liability under a released guaranty, case law generally favors a lender's right to recover from the guarantor a payment that is subsequently disgorged, even if the guarantor had been discharged by the payment. In *In re Southco Inc.*,[8] the bankruptcy court held that the specific language of the guaranty protected the lender and allowed it to recover from its guarantor. The guarantor argued that the debt was discharged by payment, and he was thus released from liability when the debt was paid. However, the lender never cancelled the guaranty or executed any written release. The guaranty contained the following language:

> The obligation of the Undersigned to the Bank hereunder is primary, absolute and unconditional.... The Undersigned ... agree[s] that ... this agreement is a continuing Guaranty and shall remain in force at all times hereafter, whether there are any liabilities outstanding or not, until all originals hereof are returned to the Undersigned by the Bank or until written notice from the Undersigned terminating this Guaranty has been received and acknowledged by the Bank ... but such termination shall not release the Undersigned from liability for payment of ... any damages, losses costs, interest, charges, attorneys' fees or expenses then or thereafter incurred in connection with said liabilities or any renewals or extensions thereof.

The bankruptcy court held that the language of the guaranty controlled and reflected the parties' intent. The court found "that the full payment of the loan to the Bank did not release [the guarantor] from liability to the Bank."[9] The bankruptcy court did not discuss surety law and strictly relied on the language of the guaranty to reach its decision.

In *In re SNTL*,[10] the Ninth Circuit was faced with a situation in which a creditor settled a claim brought against it for a preference, then sought to recover the money from the guarantor. The guarantor, SNTL Corp., filed for bankruptcy after the settlement on the preference claim was reached. The trustee objected to the proof of claim filed by the creditor for the amount of the settlement, alleging: (1) since the creditor paid the $110 million (the "preference payment") pursuant to a settlement rather than a court order, it did not trigger the creditor's ability to pursue its guarantor under the settlement agreement; and (2) the debtor's liability had been extinguished pre-petition under the release that was part of the settlement agreement and could not be revived post-petition.

The Ninth Circuit ruled that the court order approving the settlement agreement was sufficient to trigger the creditor's rights under the settlement agreement. It noted that there was no Ninth Circuit authority regarding whether the guarantor remained liable in these situations, so it analyzed decisions where guarantor liability had been found without special language in the guaranty agreement. The Ninth Circuit, citing *In re Robinson Bros. Drilling Inc.*,[11] a Tenth Circuit decision that held guarantors must make good on their guaranties regarding the avoidance of payments previously made by their principal,[12] and stated that a preferential payment is deemed by law to be no payment at all.[13] Further, the Ninth Circuit cited the *Restatement of Suretyship and Guaranty*, which states:

> When a secondary obligation is discharged in whole or part by performance by the principal obligor or another secondary obligor, or by realization upon collateral securing such performance, the secondary obligation revives to the extent that the oblige under a legal duty to do so, later surrenders that performance or collateral, or the value thereof, as a preference or otherwise.[14]

Thus, in *In re SNTL*, the Ninth Circuit found that specific language in a document triggered the creditor's right to seek recovery and the general principles of surety law entitled the creditor to recover from the guarantor. However, a Tennessee court seems to add two conditions to a creditor's ability to recover from a guarantor after a payment has been disgorged.

In *In re Quality Takes Time Inc.*,[15] the lender returned a guaranty with a letter stating, "I believe this now completely closes are *[sic]* collateral account."[16] Subsequently, the creditor was sued by the trustee to recover a preference payment made to the creditor. In turn, the creditor brought a third-party action against the guarantor seeking to recover from the guarantor any amounts that it had to pay as a result of the preference. The guarantor argued that she had been released when the guaranty was returned returned to her.

However, the guaranty stated that it was "unconditional and continuing" and that it could only be released in writing by the lender.[17] The bankruptcy court relied on prior Tennessee authority that stated that a bank could recover from an "accommodation maker because it accepted the payment in good faith and was legally obligated to accept the payment or lose its right to claim against the accommodation maker."[18] The court concluded that the lender met both requirements.[19] However, in *In re Herman Cantor Corp.*,[20] the bankruptcy court made the following statement regarding a guarantor's continued liability after the creditor is forced to disgorge part of the payment:

5 *See, e.g., New Amsterdam Cas. Co. v. Waller*, 323 F.2d 20, 26 (4th Cir. 1963); *In re Sea Horse Realty & Const. Inc.*, 2013 WL 412928 (Bankr. E.D.N.C. 2013), *aff'd sub nom.*, *CitiMortgage Inc. v. Sea Horse Realty & Constr. Inc.*, No. 2:13-CV-44-FL, 2013 WL 12110096 (E.D.N.C. 2013).
6 *In re Werner*, 386 B.R. 684 (Bankr. N.D. Ill. 2008).
7 *See In re Dreilling*, 233 B.R. 848 (Bankr. D. Colo. 1999).
8 168 B.R. 95 (Bankr. D.S.C. 1994).
9 *Id.* at 100.
10 380 B.R. 204 (9th Cir. 2007).
11 6 F.3d 701 (10th Cir. 1993).
12 *In re SNTL Corp.*, 380 B.R. 204, 213 (9th Cir. 2008).
13 *Id.* (quoting *In re Herman Cantor Corp.*, 15 B.R. 747, 750 (Bankr. E.D. Va. 1981)).
14 *Restatement (Third) of Suretyship & Guaranty* § 70 (1996).
15 96 B.R. 818 (M.D. Tenn. 1989).
16 *Id.* at 819.
17 *Id.*
18 *Id.* at 820.
19 *Id.*
20 15 B.R. 747 (Bankr. E.D. Va. 1981).

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Although a surety usually is discharged by payment of the debt, he continues to be liable if the payment constitutes a preference under bankruptcy law. A preferential payment is deemed by law to be no payment at all.[21] In *Horner*, the Virginia high court described the plight banks would face if preferential payments could discharge sureties:

> They would in fear and trembling receive payment from harassed debtors striving to maintain their credit. When to take and when to refuse would be beyond the wisdom of man, for not all who are financially embarrassed fail, and not all who fail do so within the magic period of four months. Must a bank say to a customer, 'You seem to be in trouble, and I cannot permit you to pay me; I might perchance have to refund to some trustee in bankruptcy and so lose the security of your indorsers.[22]

Conclusion

The majority of courts agree that payment from a debtor that is later set aside as a preference does not discharge a surety.[23] Thus, the best advice for creditors is to have a continuing and unlimited guaranty with language as cited in the cases mentioned above. With aptly crafted language, even if the guaranty is ultimately returned and releases are signed, the plain language of the guaranty and common law provide the creditor the opportunity to recover from the guarantor. abi

21 *Horner v. First Nat'l Bank*, 149 Va. 854, 141 S.E. 767, 770 (1928).

22 *Horner*, 141 S.E. at 770.

23 *See Annot.*, 56 A.L.R. 1363 (1928).