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## WILL EXPLODING GUARANTIES BOMB?

MARSHALL E. TRACHT

*Springing and exploding guaranties – insider guaranties that will become due if and when a borrower files for bankruptcy – have become popular as “bankruptcy-proofing” devices, yet there is little case law or literature on their enforceability. This article reviews the limited existing law on these bankruptcy-contingent guaranties and examines some of the arguments against their enforceability that can be expected to be made in the future.*

Over the past decade, we have seen the development and spread of a number of “bankruptcy-proofing” techniques, many of which have not yet been extensively tested in the courts. Among these devices are “springing” and “exploding” guaranties, devices which have become common, yet have so far elicited relatively little analysis or critical scrutiny. The enforceability of these instruments is an open question, and one that is likely to be hotly contested come the next recession.

A springing guaranty is a guaranty of an enterprise’s debt, given by an insider, which will become effective only upon specified conditions.<sup>1</sup> Typically, those conditions include the filing of a bankruptcy case by the borrower or failure to have any involuntary bankruptcy case quickly dismissed. An exploding guaranty is the mirror image, a guaranty that is in effect but will become void if the borrower cooperates with the lender after any default. The effect is the same: The insider will be personally liable for the debt if the borrower contests the lender’s rights or remedies, or files a bankruptcy proceeding, after default. The insider will be free from liability if the borrower “rolls over” and lets the lender enforce its remedies without a contest.<sup>2</sup>

These devices (hereinafter referred to as “bankruptcy-contingent guaranties”) were developed in the early 1990s and have rapidly become commonplace.<sup>3</sup> Although they raise difficult legal and policy issues, the strength of the economy

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through the 1990s has generally prevented lenders from having to enforce them, and so there is, as of yet, little case law on their enforceability.

Bankruptcy-contingent guaranties are the clearest example of “pure-leverage guaranties.”<sup>4</sup> Their function is not to assure an additional means of repayment of the debt should the borrower default. Rather, they ensure that the borrower will make every effort to live up to its contractual promises and will not hamper the creditor in its efforts to enforce its rights and recover its debt. Bankruptcy-contingent guaranties are most widely used in three contexts. First, they may be used in financing for closely-held businesses, where a single or small number of shareholders, members, or partners own and control the borrower. Second, they are used in commercial real estate lending.<sup>5</sup> Third, they are increasingly common as an adjunct to creating “bankruptcy remote” entities in securitized financing transactions.<sup>6</sup>

The challenges to bankruptcy-contingent guaranties are likely to come from several different directions. There will be arguments that they are unenforceable as a matter of state law because they violate public policy. They will be challenged in bankruptcy cases, where debtors and guarantors will seek temporary and permanent injunctions against their enforcement. These attacks will go beyond contesting the guarantor’s liability, as debtors seek to have lenders’ claims equitably subordinated on account of the leverage created by the guaranty. Although a comprehensive examination of all possible objections is impossible in one article, this article reviews the sparse case law on springing and exploding guaranties, then examines two of the more significant arguments against their enforcement: that these instruments breach the guarantor’s fiduciary duties, and that they violate bankruptcy policy.

## THE CASE LAW

Only two reported cases address bankruptcy-contingent guaranties, each involving a bankruptcy carve-out in a nonrecourse mortgage. In each case, the guaranty was found to be enforceable. Even so, there are substantial reasons to wonder if these precedents will carry the day in future cases.

Consider first the Fourth Circuit’s decision in *FDIC v. Prince George Corp.*<sup>7</sup> After foreclosure, the FDIC sued a joint venturer for a deficiency judgment on the joint venture’s nonrecourse mortgage note. The nonrecourse clause had a carve-out providing that the note would become recourse “to the extent that Holder’s rights of recourse to the property which is then subject to the Mortgage are suspended, reduced, or impaired by or as a result of any act, omission or misrepresentation...or by or as a result of any case, action, suit or proceeding to which [the borrower or any other liable party] voluntarily becomes a party.”<sup>8</sup> In essence, the carve-out was a

springing guaranty by the joint venturers.

The district court held that the borrower's bankruptcy filing was an "act" triggering liability under this provision, but for "policy reasons", the court declined to hold that the borrower's actions in resisting the foreclosure itself gave rise to liability.<sup>9</sup> The court stated that if the "lender intended to use the threat of a deficiency judgment as an incentive to induce PGC to give up its right to defend against foreclosure, such an extreme position should have been more clearly stated."<sup>10</sup> The district court thus awarded damages based on the sixty-three days by which foreclosure had been delayed by the borrower's bankruptcy filing.<sup>11</sup>

On appeal, the guarantor argued that the borrower had a statutory right to bankruptcy protection and that any waiver of that right was void on public policy grounds.<sup>12</sup> The Fourth Circuit rejected that argument, noting that the contract "did not prohibit PGC from resorting to bankruptcy; it merely provided that if PGC took certain actions it would forfeit its exemption from liability for any deficiency."<sup>13</sup> Moreover, the court held that the unambiguous language imposed deficiency liability for "any act" that impaired the lender's recourse rights, language that includes the borrower's defense of the foreclosure proceeding.<sup>14</sup> The Fourth Circuit therefore remanded for a determination of liability based on the delays caused by both the bankruptcy case and the borrower's defense of the foreclosure action.

The second case that considers springing guaranties is similar. In *First Nationwide Bank v. Brookhaven Realty Assocs.*,<sup>15</sup> the debtor real estate partnership had entered into a nonrecourse mortgage with a carve-out providing that the partners would be individually liable should the partnership ever file for bankruptcy. After default, the partnership filed for bankruptcy, although the case was later dismissed. The lender then sued the partners, who argued that the bankruptcy-contingent liability was unenforceable under the Bankruptcy Code's prohibition of *ipso facto* clauses.<sup>16</sup> The court rejected this argument on numerous grounds, including the facts that the *ipso facto* prohibition applies only to executory contracts, not mortgages, and that once the bankruptcy cases had been dismissed, the enforceability of the agreement was a matter of state law rather than bankruptcy law.<sup>17</sup>

While both of these cases enforced bankruptcy-contingent liabilities, they should provide little comfort to lenders. In each case, the bankruptcy proceeding had been dismissed prior to the initiation of the guaranty suit, making these poor candidates to test the robustness of springing guaranties in the face of a strong bankruptcy policy argument. Moreover, both decisions involved single-asset realty cases, meaning that the borrowers had few, if any, creditors other than the mortgagee. As a result, state law fiduciary duties that might have been owed to creditors were not relevant either. In other words, these were the easy cases, to which the arguments against bankruptcy-contingent guaranties do not readily apply.

## FIDUCIARY DUTIES

Perhaps the most obvious argument against springing and exploding guaranties — on appropriate facts<sup>18</sup> — is that they are intended to create a conflict between the guarantor's self-interest and the fiduciary duties owed to all of the borrower's creditors as the borrower becomes insolvent.<sup>19</sup> From this observation, it would seem only a small step to the conclusion that bankruptcy-contingent guaranties are unenforceable. Breach of fiduciary duty is a tort, and it is elementary contract law that an agreement intended to induce the commission of a tort violates public policy and is not enforceable.<sup>20</sup> This argument does not rely on the Bankruptcy Code or bankruptcy policy. It simply asserts that a springing or exploding guaranty is not enforceable as a matter of state law.

This argument builds on the traditional view of the duties of corporate directors. Courts have routinely held that contracts limiting the ability of corporate directors to exercise their independent judgment are unenforceable.<sup>21</sup> While this argument is likely to prevail in some jurisdictions and with some types of debtors, in others the case will be more difficult given the trend toward flexible or waivable fiduciary duties. In New York, for example, the duty of loyalty does not prohibit self-dealing by corporate directors if the personal interest is disclosed and approved by the disinterested directors.<sup>22</sup> Delaware has a similar provision.<sup>23</sup>

In the context of close corporations, courts have applied somewhat higher standards of loyalty as between majority and minority shareholders, given the position of dependence that minority shareholders find themselves in.<sup>24</sup> However, it is far from clear that these higher standards will apply when courts consider the fiduciary duties owed to the firm's creditors. And in some jurisdictions, such as Delaware, the discretion of board members or managing shareholders in a close corporation may be modified or controlled by written agreement of a majority of the shareholders.<sup>25</sup>

This trend toward waivable fiduciary duties is also apparent in recent statutory enactments governing noncorporate business entities. For example, under the Uniform Limited Liability Company Act (1995) and the Revised Uniform Partnership Act (1994), a partner's or manager's duty of loyalty may not be waived; however, the partnership or operating agreement may "identify specific types or categories of activities that do not violate the duty of loyalty, if not manifestly unreasonable."<sup>26</sup> The Uniform Acts, of course, are not binding on the states, and some states, most notably Delaware, have loosened the restrictions even further.<sup>27</sup>

The defense of contingent guaranties under this contractarian approach is simple enough. The question is whether the potential conflict is to be viewed from an *ex ante* perspective, from which the "conflict" is a deliberate decision by the firm to bind its managers to a particular approach to insolvency, or from an *ex post* per-

spective, which examines the situation as a conflict of interest arising at the point of insolvency. Viewed *ex post*, the decision to stay out of bankruptcy may be a breach of the duty of loyalty — unless it was permissible for the parties to enter into a defined modification of the duty of loyalty in specified future circumstances, where that modification was in the firm's interest at the time it was executed. What looks like a conflict of interest at the time of insolvency is really a process for bonding the firm's decision makers to ensure that they will carry out those acts to which the entity has agreed, at the time of financing, in order to best advance its goals.

As a matter of corporate law (but not necessarily bankruptcy law), this argument has considerable merit. While some early cases held that a director could not enter into a contract that could create a personal interest in conflict with the director's fiduciary duty to the corporation,<sup>28</sup> this is no longer the prevailing law. In most states today, a corporation may enter into a contract with a director if a disinterested quorum and voting majority of directors supports the transaction, or if the director shows the fairness of the transaction. Conflicts are not *per se* impermissible, and if appropriate disinterested parties (directors or a judge) ratify the transaction, there is no violation.

Put in this light, bankruptcy-contingent guaranties seem unobjectionable. It is hard to argue that an insider is taking advantage of the firm when he assumes the risk of liability for the firm's debt in order to secure financing for the firm.<sup>29</sup> As one court has said in a different context, the fiduciary duty of a controlling shareholder "does not require self-sacrifice."<sup>30</sup> Thus, under modern standards of fiduciary duty, it seems that a springing or exploding guaranty can be validated by vote of the board (or members or partners, as the case may be) or by subsequent judicial ratification. In some contexts, such as the LLC or partnership setting, the validation may occur through provisions in the organizing documents.

There is a potent counter-argument, however. The fact that a manager's fiduciary duties to other equity holders are contractually defined, modified, or waived does not necessarily settle the extent of the fiduciary duties owed to creditors upon insolvency. After all, the creditors were not parties to the modification provision, nor are the equity holders or directors who ratified it the creditors' representatives. Indeed, statutory provisions governing the modification of fiduciary duties in the LLC and partnership contexts explicitly state that "the partnership [operating] agreement may not... (10) restrict rights of third parties under this [Act]."<sup>31</sup> Even under a contractarian approach to fiduciary duties, the manager may not be able to enter into a bankruptcy-contingent guaranty, which attempts to modify the incentives that will be faced by the manager *at a future time when he or she will owe fiduciary duties to creditors*.<sup>32</sup>

At the very least, an insider subject to a springing guaranty faces a basic conflict

of interest, and should therefore have to excuse herself from voting on whether the borrower should file for bankruptcy. If the insider does not abstain, then the insider could be held liable for breach of fiduciary duty absent a showing of the fairness of the decision made.

## BANKRUPTCY POLICY

Insider guaranties can help create appropriate incentives to keep firms from filing unwarranted bankruptcy cases.<sup>33</sup> This is also the purpose of a bankruptcy-contingent guaranty. It might even seem that the contingent guaranty, through its tailored structure, would be superior to an unconditional guaranty. The bankruptcy-contingent guaranty, however, is less accurate in its incentives than an unconditional guaranty, creating an inappropriate overdeterrence. For this reason, bankruptcy-contingent guaranties violate fundamental bankruptcy policies, and should be held unenforceable.

Consider a hypothetical firm, with a liquidation value of \$70 and a reorganization value of \$80. The firm has \$100 in unsecured debt, \$50 of which has been protected with a springing guaranty and \$50 of which is not guaranteed. Clearly the firm should be reorganized, in which case creditors will lose only \$20 rather than \$30. From the insider's perspective, however, the choice is between nonbankruptcy liquidation with no personal liability, and bankruptcy reorganization with a personal liability of \$10.<sup>34</sup> In other words, the incentives created by a bankruptcy-contingent guaranty may prevent efficient bankruptcy filings.<sup>35</sup>

Moreover, there is reason to be concerned that waivers of post-default rights may be entered into even when they are not, *ex ante*, efficient. Particularly where these waivers are used to signal creditworthiness, as insider guaranties are, it is possible that borrowers will decline to ask for efficient terms for fear of labeling themselves as unworthy borrowers.<sup>36</sup> While this risk exists with bankruptcy waivers and insider guaranties in general, the problem is exacerbated in the case of springing or exploding guaranties: At least in the case of an outright waiver<sup>37</sup> or unconditional guaranty, the insider has efficient incentives regarding the bankruptcy case. Once the firm is in financial trouble the insider can be expected to negotiate with the waiver holder to relinquish the waiver for some reasonable *quid pro quo*.<sup>38</sup> In the case of a springing guaranty, however, the insider's conflict usually means that there is no one in a position to act on behalf of the creditor body in negotiating for a release of the anti-bankruptcy provision. For this reason, bankruptcy-contingent guaranties are more inimical to the goals of bankruptcy than a simple waiver of bankruptcy rights which the debtor could seek to renegotiate without the *in terrorem* effect of

the springing liability.

If springing guaranties violate fundamental bankruptcy policies — preventing firms that would benefit from reorganization from filing and defeating the Bankruptcy Code’s ability to cure the collective action problem faced by creditors — there is still the question of what legal doctrine, if any, a bankruptcy court could use to bar enforcement of the contract. As shown above, it may be difficult to argue that the guaranty is unenforceable under state law, and obligations that are binding under state law are normally enforceable in bankruptcy.

However, a bankruptcy court could enjoin suit on a bankruptcy-contingent guaranty using its general equitable powers under section 105.<sup>39</sup> These powers are limited to actions “necessary or appropriate to carry out the provisions of” the Bankruptcy Code, so injunctive relief of this sort is not possible except insofar as it is in aid of other specific bankruptcy provisions.<sup>40</sup> In the case of bankruptcy-contingent guaranties, however, equitable relief is consistent with the policies and provisions of the Code. For example, section 362 of the Code, the automatic stay, enjoins creditor actions against the debtor or its property, but does not enjoin suits against third parties.<sup>41</sup> Nonetheless, courts have repeatedly entered temporary injunctions protecting third parties (such as insider guarantors) to carry out the intent of the automatic stay.<sup>42</sup> Similarly, Section 365(e) of the Bankruptcy Code generally invalidates *ipso facto* clauses, provisions that grant rights against the debtor upon the filing of bankruptcy.<sup>43</sup> This provision applies only to “an executory contract or unexpired lease of the debtor,” and thus would not invalidate a bankruptcy-contingent guaranty.<sup>44</sup> However, where a contract against a third party has the effect of creating additional leverage over the debtor upon the filing of the bankruptcy case, as a bankruptcy-contingent guaranty does, such a contract would seem to fall within the intended functions of section 365(e).

In short, bankruptcy courts should be willing to invoke their authority under section 105 to further the policies effectuated by sections 362 and 365(e)(1) by temporarily enjoining suits on bankruptcy-contingent guaranties. The reasoning is consistent with, but more persuasive than, cases in which bankruptcy courts have granted temporary injunctions against the enforcement of insider guaranties because enforcement threatened the bankruptcy proceedings.<sup>45</sup> The argument is more persuasive because of the inappropriate incentives created by the bankruptcy-contingent nature of the liability.

A more difficult question will arise when the court must consider whether to permit the bankruptcy-contingent liability not just to be temporarily stayed during the bankruptcy case, but to be discharged pursuant to a bankruptcy plan.<sup>46</sup> Assuming that such injunctions are not barred by Bankruptcy Code section 524(e), a matter on which courts are split,<sup>47</sup> should a permanent injunction be permitted



over the objection of a creditor holding a bankruptcy contingent guaranty? Even in those courts that permit them, permanent injunctions protecting third parties are viewed as extraordinary relief requiring unusually powerful justifications.<sup>48</sup> However, a bankruptcy-contingent guaranty is not, at its core, an obligation of a third party or a contract of financial assurance; it is a bonding device used to control the business decisions of the debtor, with financial liability imposed on the principals as a penalty for breach.<sup>49</sup> As such, it is appropriate for a bankruptcy court to enjoin enforcement as part of a reorganization plan.

Although the springing guaranties were enforced in *Prince George* and *Brookhaven Realty*, these cases are consistent with the arguments advanced here. In each case, the debtor had no real prospect of reorganizing and the bankruptcy case had been quickly dismissed prior to the state law suit seeking to impose personal liability. As the court noted in *Brookhaven Realty*, "The policies of providing a debtor with a fresh start and an opportunity to reorganize its finances are not present in a foreclosure proceeding."<sup>50</sup>

## CONCLUSION

Springing and exploding guaranties are clever devices, attempting to do by indirection what has been forbidden by direct means — if the right to file for bankruptcy cannot be waived, at least the exercise of that right can be made painful. And what little case law exists seems to support the effectiveness of these instruments. However, we have not yet seen a case where a bankruptcy court, rather than a state court, has been asked to rule on the enforceability of a springing guaranty or to grant an injunction barring its enforcement in order to protect the bankruptcy proceeding. Nor have we seen a case where a viable business is threatened by the effects of a bankruptcy-contingent guaranty, or the interests of legitimate third-party creditors have been put at risk. It remains to be seen whether, given a viable debtor or harm to third-parties, a court would permit a springing or exploding guaranty to stand.

## NOTES

<sup>1</sup> For sample documents, see William L. Norton, Jr., *Bankruptcy L. & Prac.* (2d ed.), Form § 1111:2 (non-recourse provision with carve-out for bankruptcy proceedings); Lester M. Bliwise, *Mortgage Lending Documentation, Attachment C* ("Model Springing Guaranty"), in *Commercial Real Estate Financing* 9, 61 (PLI Real Est. Law & Practice Course Handbook Series No. N4-4603, 1997) (although entitled a "Springing Guaranty," this is actually a terminable or "exploding" guaranty); Sidney A. Keyles, *Counseling the Client on Springing and Exploding Guaranties (with Forms)*, 12 *Prac. Real Est. Law* 29 (Nov. 1996); Michael T. Madison and Jeffrey R. Dwyer, *The Law of Real Estate Financing* (rev. ed. 1996), Forms 14.2 ("Guaranty: Springing") and 14.3 ("Guaranty Agreement: Exploding"); Joshua Stein, *Lender's Model State-of-the-Art Nonrecourse Clause (with Carveouts)*, 43 *Prac. Law* 31 (1997).

<sup>2</sup> The same effect can be created in nonrecourse loans by creating a "carve-out" from the nonrecourse provisions. See, e.g., Alan Wayne, Non-Recourse Clause, *reprinted in* Modern Real Estate Transactions 1575, 1585-86 (ALI-ABA Resource Materials, 11 ed. 1996) which provides in relevant part:

(d) Notwithstanding the limitation of liability in subsection (a) above, Borrower shall be fully personally liable for all of Borrower's obligations under the Loan Documents, and Lender's recourse to the personal assets of Borrower and its constituent partners shall not be limited in any way by this Section X, if Borrower (A) attempts to prevent or delay the foreclosure of the Mortgage or any other collateral for the Loan or the exercise of any of lender's other remedies under any Loan Document, or (B) claims that any Loan Document is invalid or unenforceable and such a claim [sic] will have the effect of preventing or delaying such foreclosure or any other exercise of remedies. Without limitation, Borrower shall be deemed to have attempted to prevent or delay such foreclosure or other exercise of remedies if (i) Borrower files a petition under the Bankruptcy Reform Act of 1978, 11 U.S.C. § 101 *et seq.* (the "Bankruptcy Code), as amended, (ii) Borrower opposes a motion by Lender to lift an automatic stay imposed pursuant to 11 U.S.C. § 362 and for leave to foreclose the Mortgage and any other collateral for the Loan, or (iii) Borrower files a proposed plan of reorganization under the Bankruptcy Code under which Lender would receive (x) less than all of the Property or (y) a lien encumbering less than all of the Property or (z) a lien having a lower priority or terms less favorable to Lender than the Mortgage as it existed immediately prior to the filing of a petition under the Bankruptcy Code....

<sup>3</sup> While conversations with practitioners confirm that bankruptcy-contingent guaranties are now a standard part of commercial transactions, there is no real data on the prevalence of these devices. Indeed, to the extent a bankruptcy-contingent guaranty serves its purpose, there never will be a judicial record of its existence. Some indication of the growth of the bankruptcy-contingent guaranty may be found in the secondary literature. There are no references to springing or exploding guaranties in the WESTLAW TP-ALL database (all texts and periodicals) prior to 1996; four in 1996; six in 1997; eleven in 1998; thirteen in 1999; and ten in the first half of 2000. Only in the last three or four years have form books started including bankruptcy-contingent guaranties. See sources cited *supra* note 1.

<sup>4</sup> The term is borrowed from Professor Jay Westbrook, but note an important difference from the context in which he used it B to refer to any insider guarantee from a guarantor who is "not likely to be able to offset any shortfall in the debtor's performance." See Jay Lawrence Westbrook, *Two Thoughts About Insider Preferences*, 76 Minn. L. Rev. 73, 80 (1991). Here, the point is that, regardless of whether the guarantor is solvent, the entire purpose of the guaranty is to control behavior rather than to provide additional financial resources.

<sup>5</sup> See, e.g., Joshua Stein, *Nonrecourse Carveouts: How Far is Far Enough?*, Real Est. Rev. (Summer 1997); Russell L. Munsch, et al., *The Changing Commercial Real Estate Environment - Are Commercial Real Estate Workouts Dead?*, (Dallas Bar Ass'n, Nov. 5, 1997), ("The standardization of commercial real estate loan documentation nationwide, as well as structured impediments to the commencement of insolvency proceedings and bankruptcy cases (including the proliferation of 'springing guaranties'), may adversely impact upon the willingness or ability of commercial real estate owners to seek the protection of these forums."); Kenneth M. Block & Jeffery B. Steiner, *Stays of Springing Guaranties: How Creditor Can Enforce Rights Against Non-Debtor Guarantor*, N.Y.L.J., July 17, 1996, at 5 (stating that springing guaranties "are common in real estate loans and financings").

<sup>6</sup> See, e.g., Frederick Z. Lodge, et al., *Bankruptcy Remote Structures in Mortgage Loans*, *Prob. & Prop.*, June 10, 1996, 49.

<sup>7</sup> 58 F.3d 1041 (4th Cir. 1995).

<sup>8</sup> *Id.* at 1044.

<sup>9</sup> See *id.* at 1045.

<sup>10</sup> *Id.* at 1047.

<sup>11</sup> See *id.*

<sup>12</sup> See *id.* at 1046.

<sup>13</sup> *Id.*

<sup>14</sup> See *id.* at 1048.

<sup>15</sup> 637 N.Y.S.2d 418 (N.Y. App. Div. 1996).

<sup>16</sup> See 11 U.S.C. § 365(e), which invalidates lease or contract clauses under which "a right or obligation [is] terminated or modified...solely because of " insolvency or bankruptcy.

<sup>17</sup> See *Brookhaven Realty* 637 N.Y.S.2d at 421.

<sup>18</sup> This argument is factually inapposite in single asset real estate cases like *Prince George Corp.* and *Brookhaven Realty*, where there are few, if any, creditors other than the mortgage lender asserting the guaranty liability.

<sup>19</sup> The directors of a solvent corporation owe their fiduciary duties (duties of loyalty and of care) to the corporation's

shareholders, and owe creditors only the contractual duties that have been agreed to by the parties. However, as a company approaches insolvency, the directors may come to owe a fiduciary duty to creditors as well. See, e.g., *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*, No. 12150, 1991 Del. Ch. LEXIS 215, at \*108 (Del. Ch. Dec. 30, 1991) (“[w]here a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residue [sic] risk bearers, but owes its duty to the corporate enterprise” as a whole, rather than any single group of stakeholders.). And those duties may shift entirely to creditors once the firm is insolvent. See, e.g., *Geyer v. Ingersoll Publications Co.*, 621 A.2d 784, 787 (Del. Ch. 1992); *Collie v. Becknell*, 762 P.2d 727 (Colo. App. 1988); *Middlesex Ins. Co. v. Mann*, 124 Cal. App. 3d 558, 177 Cal. Rptr. 495 (506) (4th Dist. 1981); *Official Comm. of Unsecured Creditors of Buckhead Am. Corp. v. Reliance Capital Group, Inc. (In re Buckhead A. Corp.)*, 178 B.R. 956 (Bankr. D. Del. 1994); *Miramar Resources, Inc. v. Shultz (In re Shultz)*, 208 B.R. 723 (Bankr. M.D. Fla. 1997); *FDIC v. Sea Pines Co.*, 692 F.2d 973, 976-77 (4th Cir. 1982), cert. denied, 461 U.S. 928 (1983). Once a company becomes a debtor in possession in a bankruptcy reorganization case, management owes its fiduciary duties to the estate, rather than to any particular constituency. See, e.g., *Commodity Futures Trading Comm’n v. Weintraub*, 471 U.S. 343, 355 (1985) (“[t]he fiduciary duty of a trustee runs to shareholders as well as to creditors.”); *In re Central Ice Cream Co.*, 836 F.2d 1068, 1072 (7th Cir. 1987) (arguing that debtor-in-possession has duty “to maximize the value of the estate, not of a particular group of claimants.”).

This pattern is commonly explained by considering who holds the “residual interest” in the firm. See, e.g., *Steven L. Schwarcz, Rethinking a Corporation’s Obligations to Creditors*, 17 *Cardozo L. Rev.* 647, 667-68 (1996); Frank H. Easterbrook & Daniel R. Fischel, *The Economic Structure of Corporate Law* 67-70 (1991); Christopher W. Frost, *Running The Asylum: Governance Problems in Bankruptcy Reorganizations*, 34 *Ariz. L. Rev.* 89, 114-15 (1992); Jonathan R. Macey, *An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties*, 21 *Stetson L. Rev.* 23 (1991). In other words, fiduciary duties are owed to the parties who will be affected by a marginal profit or loss, thereby creating an incentive to make economically efficient decisions. If the firm is solvent, creditors will receive their contractually fixed payments, and additional profits or losses will accrue to the shareholders. Once the firm becomes insolvent, creditors will receive only part of their claims, and additional profits or losses will increase or decrease the payments to these creditors. Thus, the directors’ fiduciary duties run to the creditors upon insolvency because they become the residual claimants, the parties who stand to gain or lose based on the decisions made by management.

<sup>20</sup> See Restatement (Second) of Contracts § 192 (“A promise to commit a tort or to induce the commission of a tort is unenforceable on grounds of public policy.”). A related argument that could be made, yet would likely fail, is that the threat to exercise a springing guaranty violates a fiduciary duty owed by the lender. While it is generally true that a lender owes no fiduciary duties to its borrowers, to the extent that a creditor is able to exercise control over a particular decision made by a debtor’s board of directors, the creditor may be found to have fiduciary duties with regard to that decision. See, e.g., *Anaconda-Ericsson, Inc. v. Hessen (In re Teltronics)*, 29 B.R. 139, 170-71 (Bankr. E.D.N.Y. 1983) (“The general rule that a creditor is not a fiduciary of his debtor is not without exception. In the rare circumstance where a creditor exercises such control over the decisionmaking processes of the debtor as amounts to a domination of its will, he may be held accountable for his actions under a fiduciary standard.”).

<sup>21</sup> See, e.g., 18B *Am. Jur. 2d Corporation* § 1487 (“A contract by a director of a corporation that limits or restricts him in the free exercise of his judgment or discretion, or that places him under direct and powerful inducements to disregard his duties to the corporation, its creditors, and other stockholders in the management of corporate affairs, is against public policy and void.”) (Citing cases); William E. Knepper & Dan A. Bailey, *Liability of Corporate Officers and Directors* § 4-20 (5th ed. 1993) (citing cases).

<sup>22</sup> See N.Y. Bus. Corp. Law § 713(b) (McKinney 1986).

<sup>23</sup> See Del. Code Ann. tit. 8, § 144 (1991).

<sup>24</sup> See Kathleen D. Fuentes, Comment, *Limited Liability Companies and Opting-Out of Liability: A New Standard for Fiduciary Duties?*, 27 *Seton Hall L. Rev.* 1023, 1043-46 (1997).

<sup>25</sup> See Del. Code Ann. tit. 8, §§ 350-354.

<sup>26</sup> § 103(b)(2)(i) (1995); Revised Uniform Partnership Act (R.U.P.A.) § 103(b)(3)(i) (1997). Similarly, the acts provide that the operating agreement may not “unreasonably reduce the duty of care”, § 103(b)(3) (1995) and 10(b)(4) (1997), nor “eliminate the obligation of good faith and fair dealing...but the [operating agreement or partnership agreement] may determine the standards by which the performance of the obligation is to be measured, if the standards are not manifestly unreasonable.” ULLCA § 103(b)(4)(1975); R.U.P.A. § 103(b)(5)(1997).

<sup>27</sup> See Del. Code § 18-1101(c) (“To the extent that, at law or in equity, a member or manager or other person has duties (including fiduciary duties) and liabilities relating thereto to a limited liability company or to another member or manager...(2) the member’s or manager’s or other person’s duties and liabilities may be expanded or restricted by

provisions in a limited liability company agreement.”).

<sup>24</sup> See James D. Cox, et al., *Corporations*, § 10.12-14.

<sup>25</sup> Most cases addressing conflict of interest situations involve a fiduciary dealing with the corporation in a manner that results in a personal benefit for the fiduciary. Thus, cases on the corporate opportunity doctrine or excess compensation or self-dealing are commonplace. In the bankruptcy-contingent guaranty context, however, the insider does not gain at the expense of the corporation by entering into the guaranty; thus, most of the existing case law seems inapposite. The closest analogy is to cases that address whether it is a breach of fiduciary duty for an insider to cause an insolvent corporation to make payments on a debt owed to, or guaranteed by, the insider. See John C. McCoid, *Corporate Preferences to Insiders*, 43 S.C. L. Rev. 805, at 816-21 (1992) (discussing cases that have addressed whether such payments are constructively fraudulent or reversible on “equity” grounds). At least these cases present situations where an insider entered into a contract from which the insider could only lose in order to benefit the corporation. Courts have held that later actions taken to mitigate the insider’s loss, at the expense of other creditors, could be a breach of fiduciary duties. Bankruptcy-contingent guaranties would seem to pose an even stronger case for condemnation. The insider preference cases concern a question that is purely distributional (which creditors will be paid from a given pool of assets), while the bankruptcy-contingent guaranty may prevent the firm from maximizing its assets, distributional questions aside.

<sup>26</sup> *Getty Oil v. Skelly Oil Co.*, 267 A.2d 883, 888 (Del. 1970).

<sup>27</sup> R.U.P.A. § 103(b)(10) (1996); U.L.L.C.A. § 103(b)(7) (1996).

<sup>28</sup> I am not addressing the fiduciary duties of the manager of the debtor in possession *after* a bankruptcy filing, which are a matter of bankruptcy law, and presumably cannot be modified by a pre-bankruptcy contractual arrangement. Moreover, the argument against springing and exploding guaranties is not that they subvert the management of the bankruptcy case because once the guarantor has “bitten the bullet” and caused the borrower to file for bankruptcy, the guaranty, if enforceable, is indistinguishable from an ordinary insider guaranty. The threat from contingent guaranties exists before any bankruptcy filing — the threat is that the bankruptcy case will never be initiated.

<sup>29</sup> An insider who has guaranteed the firm’s debt will be less likely to file a hopeless bankruptcy case because the losses sustained during the proceeding will increase the liability on the guaranty.

<sup>30</sup> One half of the \$80 reorganization value, or \$40, will be applied to the \$50 in guaranteed debt.

<sup>31</sup> Note that this same disincentive does not exist when the insider has entered into an unconditional guaranty. The choice would then be between nonbankruptcy liquidation, which would result in personal liability for a \$15 deficiency (\$50 owed to the guaranteed creditor, less \$35 share of liquidation value), and a bankruptcy reorganization with personal liability of just \$10 (\$50 guaranteed debt less \$40 share of the reorganized firm). Note as well that the provision at issue in *Prince George Corp.* avoided the perverse incentives attendant on many springing guaranties, because it imposed deficiency liability only “to the extent” that prohibited acts impaired the FDIC’s recourse to its collateral. 58 F.3d at 1044. Thus, the damages were measured by the interest lost and expenses incurred directly from the borrower’s acts. *Id.* This is dramatically different — and far more defensible — in its effects from a provision that would make the borrower’s principals liable for the entire deficiency, regardless of the actual harm caused by the borrower’s resistance.

<sup>32</sup> See Marshall E. Tracht, *Renegotiation and Secured Credit: Explaining the Equity of Redemption*, 52 Vand. L. Rev. 599, 636-41 (1999).

<sup>33</sup> Although I have argued for the enforceability of bankruptcy waivers, I am not optimistic that courts will adopt this position. See Marshall E. Tracht, *Contractual Bankruptcy Waivers: Reconciling Theory, Practice, and Law*, 92 Cornell L. Rev. 301 (1997). Accordingly, throughout this analysis I assume that waivers of the right to file for bankruptcy are void on “public policy” grounds. Nonetheless, even if courts determine that bankruptcy waivers are enforceable, for the reasons expressed in this paragraph I believe that springing and exploding guaranties are suspect.

<sup>34</sup> See *id.* at 330.

<sup>35</sup> 11 U.S.C. § 105(a) provides, in relevant part: “The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title.”

<sup>36</sup> See *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 206 (1988) (stating that authority under section 105 is limited because “whatever equitable powers remain in the bankruptcy courts must and can only be exercised within the confines of the Bankruptcy Code.”).

<sup>37</sup> See, e.g., *Credit Alliance Corp. v. Williams*, 851 F.2d 119 (4th Cir. 1988).

<sup>38</sup> It generally has been held that bankruptcy courts have the power to temporarily enjoin suits against third parties, such as guarantors, where the injunction is necessary to facilitate the reorganization. Cases in which such injunctions have been granted to protect insider guarantors include: *In re Third Eighty-Ninth Assocs.*, 138 B.R. 144 (S.D.N.Y. 1992); *Litchfield Co. of S.C. L.P. v. Anchor Bank (In re Litchfield Co. of S.C. Ltd. Partnership)*, 135 B.R. 797

(W.D.N.C. 1992); *In re Lomas Fin Corp.*, 117 B.R. 64 (S.D.N.Y. 1990); *First Federal Sav. & Loan Ass'n. of Little Rock v. Pettit*, 12 B.R. 147 (E.D. Ark. 1981); *In re F.T.L., Inc.*, 152 B.R. 61 (Bankr. E.D.Va. 1993); *Codfish Corp. v. FDIC (In re Codfish Corp.)*, 97 B.R. 132 (Bankr. D. P.R. 1988); *In re Kasual Kreations*, 54 B.R. 915 (Bankr. S.D. Fla. 1985); *In re Northlake Blag Partners*, 41 B.R. 231 (Bankr. N.D. Ill. 1984). For discussions of the temporary injunction issue, see Paul H. Deutch, Note, *Expanding the Automatic Stay: Protecting Nondebtors in Single Asset Bankruptcy Cases*, 2 Am. Bankr. Inst. L. Rev. 453 (1994); G.H. Ishii-Chang, *Litigation and Bankruptcy: The Dilemma of the Codefendant Stay*, 63 Am. Bankr. L.J. 257 (1989); Elizabeth H. Winchester, Note, *Expanding the Bankruptcy Code: The Use of Section 362 and Section 105 to Protect Solvent Executives of Debtor Corporations*, 58 Brooklyn L. Rev. 929 (1992).

<sup>41</sup> See 11 U.S.C. § 365(e)(1)(1986).

<sup>42</sup> 11 U.S.C. § 362 (1986).

<sup>43</sup> See *supra* cases cited at note 42.

<sup>44</sup> A related question is whether a permanent injunction should be granted if the bankruptcy of the borrower does not result in a confirmed plan of reorganization. If the bankruptcy case is converted to Chapter 7 or dismissed, that is a strong indication that the filing was inefficient, and it does not seem to threaten B and indeed may support B bankruptcy policy to enforce personal liability triggered by the inappropriate recourse to bankruptcy. (This is consistent with the decisions in *Prince George* and *Brookhaven*.) However, conversion or dismissal does not prove the case should not have been filed or even that the case did not benefit creditors. Moreover, given the uncertainty of any bankruptcy case, the risk of such liability would deter some efficient cases. The distorted incentive created by the bankruptcy-contingent liability argues for their outright prohibition, and so relief should be available to the guarantor even absent confirmation of a reorganization plan. The appropriate limitation on release of a bankruptcy-contingent liability should not be whether or not a plan is confirmed, but whether the case was filed in good faith. Courts have properly held that a bankruptcy case filed simply in order to protect guarantors is filed in bad faith. See, e.g., *In re Humble Place Joint Venture*, 836 F.2d 814 (5th Cir. 1991); *In re North Vermont Associates, L.P.*, 165 B.R. 340 (Bankr. D.D.C. 1994). Again, this appears largely consistent with *Prince George* and *Brookhaven*, situations in which the bankruptcy cases were quickly dismissed. It seems appropriate for state courts to leave discharge of the liability up to the bankruptcy court, which is in a much better position to determine whether the petition was filed in good faith.

<sup>45</sup> The Ninth and Tenth Circuits have rejected the authority of the bankruptcy courts to permanently enjoin actions against third parties (effectively discharging the third parties' obligations), relying largely on section 524(e), which provides: "Except as provided in subsection (a)(3) of this section, discharge of a debt of the debtor does not affect the liability of any other entity on, or the property of any other entity for, such debt." 11 U.S.C. § 524(e). See *Resorts Int'l v. Lowenschuss (In re Lowenschuss)*, 67 F.3d 1394 (9th Cir. 1995); *American Hardwoods, Inc. v. Deutsche Credit Corp. (In re American Hardwoods, Inc.)*, 885 F.2d 621 (9th Cir. 1989); *Underhill v. Royal*, 769 F.2d 1426 (9th Cir. 1985); see also *Landing Diversified Properties-II v. First Nat'l Bank & Trust Co. (In re Western Real Estate Fund)*, 922 F.2d 592, 601-02 (10th Cir. 1990) (holding that section 524(e) prohibits discharge of third party). Most courts and commentators disagree. See, e.g., *Feld v. Zale Corp. (In re Zale Corp.)*, 62 F.3d 746 (5th Cir. 1995) (bankruptcy court has "related to" jurisdiction over creditors' suits against debtor's insurer, but lacks power to permanently enjoin such suits); *In re Specialty Equip. Inc.* 3 F.3d 1043 (7th Cir. 1993) (stating, *in dicta*, that while section 524(e) provides that the discharge does not release third parties, it "does not purport to limit or restrain the power of the bankruptcy court to otherwise grant a release to a third party."); *SEC v. Drexel Burnham Lambert Group, Inc. (In re Drexel Burnham Lambert Group, Inc.)*, 960 F.2d 285, 293 (2d Cir. 1992) ("In bankruptcy cases, a court may enjoin a creditor from suing a third party, provided the injunction plays an important part in the debtor's reorganization plan." (*citing A.H. Robins*)); *MacArthur Co. v. Johns-Manville Corp. (In re Johns-Manville Corp.)*, 837 F.2d 89 (2d Cir. 1988); *Menard Sanford v. Mabey (In re A.H. Robins Co., Inc.)*, 880 F.2d 694 (4th Cir. 1986), *cert. denied*, 493 U.S. 959 (1989); *In re AOV Indus., Inc.* 792 F.2d 1140 (D.C. Cir. 1986); *Monarch Life Ins. Co. v. Ropes & Gray (In re Monarch Capital Corp.)*, 173 B.R. 31 (D. Mass. 1994), *aff'd*, 65 F.3d 973 (1st Cir. 1995); *In re Heron, Burchette, Ruckert and Rothwell*, 148 B.R. 660 (Bankr. D.D.C. 1992); see generally Hyde Feldstein, *Reinterpreting Bankruptcy Code § 524(e)* 22 Cal. Bankr. J. 25 (1994); Peter E. Meltzer, *Getting Out of Jail Free: Can the Bankruptcy Plan Process Be Used to Release Nondebtor Parties?*, 71 Am. Bankr. L.J. 1 (1997) (arguing that section 105 does not authorize bankruptcy courts to enjoin actions against third parties).

Even if such permanent injunctions are within the power of the bankruptcy court, this power is seldom if ever used to protect guarantors. Cases decline to confirm reorganization plans on the grounds that they impermissibly purported to release the liability of third party guarantors or codebtors. See *American Hardwoods Inc. v. Deutsche Credit Corp. (In re American Hardwoods)*, 885 F.2d 621 (9th Cir. 1989); *In re Rohnert Park Auto Parts, Inc.*, 113 B.R. 610 (9th Cir. BAP 1990); *In re Boston Harbor Marina Co.*, 157 B.R. 726 (Bankr. D. Mass. 1993); *In re Bennett Paper Corp.*, 65 B.R. 518 (Bankr. E.D. Mo. 1986); *Bill Roderick Distrib. Inc. v. A.J. Mackay Co. (In re A.J. Mackay Co.)*, 50

B.R. 756 (D. Utah 1985). In the only case I have been able to find in which the bankruptcy court may (the published appellate decision is unclear) have confirmed such a plan over the timely objection of a creditor, the order was reversed on appeal. See *Mellon Bank v. M.K. Siegel*, 96 B.R. 505 (E.D. Pa. 1989).

For analysis of the propriety of permanently enjoining actions against third parties, see Ralph Brubaker, *Bankruptcy Injunctions and Complex Litigation: A Critical Reappraisal of Non-Debtor Releases in Chapter 11 Reorganizations*, 1997 U. Ill. L. Rev. 959; Meltzer, *supra*; Hydee Feldstein, *Reinterpreting Bankruptcy Code § 524(e)* 22 Cal. Bankr. J. 25 (1994); Kenneth M. Lewis, *When are Nondebtors Really Entitled to a Discharge: Setting the Record Straight on Johns-Manville and A.H. Robins*, 3 J. Bankr. L. & Prac. 163 (1994); Judith R. Starr, *Bankruptcy Court Jurisdiction to Release Insiders from Creditor Claim in Corporate Reorganizations*, 9 Bankr. Dev. J. 485 (1993); Howard C. Buschmann III & Sean P. Madden, *The Power and Propriety of Bankruptcy Court Intervention in Actions Between Nondebtors*, 47 Bus. Law. 913 (1992).

<sup>48</sup> Such injunctions have been permitted primarily when the injunction was necessary to the reorganization. In those cases, the creditor(s) being enjoined were to receive payment in full under the plan of reorganization, and the vast majority of creditor(s) being enjoined consented to the injunction. See *In re Master Mortgage Inv. Fund, Inc.*, 168 B.R. 930 (Bankr. W.D. Mo. 1994) (gathering and discussing cases).

<sup>49</sup> I use the word "penalty" carefully here to distinguish from "damages." The principal objection to the bankruptcy-contingent guaranty is that the liability is not measured by the loss occasioned by the bankruptcy filing itself.

<sup>50</sup> 637 N.Y.S.2d 418, 421 (N.Y.App.Div. 1996)