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Is Chapter 11 Painless Solution For Guarantors?

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Owners of small business entities are frequently required to guaranty the debts of such entities. Those business entities might later file for ***Chapter 11***, and may be able to achieve confirmation of a plan to restructure their indebtedness. The question then presented is whether this confirmation event affects the separate guaranty obligations of the owners? The *Tenth Circuit* Court of Appeals recently explored this issue in *In re: Larry Ralph Gentry*, No. 14-1441 (10th Cir. Dec. 8, 2015).

Background

Susan and Larry Gentry are the sole shareholders, officers, and directors of Ball Four Inc., which in turn owns a sports complex in Colorado. In 2005, Ball Four received a loan from a bank to expand its sporting facilities. The loan was secured by the sports complex. The Gentrys each personally guaranteed the loan.

Ball Four filed a Chapter 11 case in 2010. The bank's assignee (the "Lender") filed a proof of claim in the amount of $3,572,158. Ball Four proposed a plan of reorganization that provided the Lender's allowed claim would be repaid in full, plus 6 percent interest, over twenty-five years with a five-year balloon payment, and that Lender would retain its lien on Ball Four's property until the claim was paid. The bankruptcy court confirmed Ball Four's plan in August 2011.

In response to a lawsuit filed by the Lender to collect on the guaranties, the Gentrys filed their own Chapter 11 case in November 2011. The Lender initially claimed the Gentrys owed $3,204,868, but later amended its calculation of default interest, and claimed the Gentrys actually owed $4,628,127.

The Gentrys' proposed plan of reorganization provided that their liability to the Lender would be satisfied by the stream of payments offered by Ball Four under its separate plan. In other words, so long as Ball Four performed the payment obligations specified in its plan, the Gentrys would not be required to pay the Lender from their personal assets or from their future salaries. Over the Lender's objection, the bankruptcy court confirmed the Gentrys' plan.

Tenth Circuit Opinion

On appeal to the Tenth Circuit, the Lender first challenged the feasibility of the Gentrys' plan. The Tenth Circuit rejected this contention, noting the bankruptcy judge considered the status of Ball

Four's Chapter 11 plan, and found that the Ball Four was not in default under its confirmed plan. The Tenth Circuit also noted that the bankruptcy court had found the Gentrys' obligations will not be discharged until Ball Four's loan indebtedness is paid in full and that the Lender retains state law remedies against the Gentrys in that event. The Tenth Circuit found the bankruptcy court's feasibility findings sufficient – albeit barely – to survive a "clearly erroneous" standard of review.

At first blush, it might seem that the Gentrys managed to escape responsibility for their separate obligations. However, the Tenth Circuit's opinion then takes a surprising turn.

Ball Four's obligation under its separate plan had been capped at $3,572,158. The bankruptcy court had found Ball Four capable of repaying this amount under its plan.

Later, in their separate plan, the Gentrys' contended that their liability to the Lender was no greater than Ball Four's liability. The bankruptcy judge accepted this contention. However, on appeal, the Tenth Circuit rejected this contention as a matter of law.

The bankruptcy judge had looked to Colorado law on guarantors, and relied upon two state law cases that held a guarantor's liability matched that of the borrower, described as the rule of "equivalent liability". However the Tenth Circuit concluded the state law cases establishing the rule of "equivalent liability" did not consider the effect of bankruptcy, and that "[w]ith its unique code of rules, protections, and purposes, bankruptcy necessarily changes the calculation."

The Tenth Circuit cited section 524(e) of the Bankruptcy Code for the proposition that discharge of a borrower's debt in bankruptcy does not affect a guarantor's liability, and observed that extending the "rule of equivalent liability into the bankruptcy context would destroy the value of a guaranty."

Because the Gentry's liability on their guaranty could be as high as $4,628,127, and Ball Four's plan only proposed to pay approximately $3.5 million, the Tenth Circuit remanded the matter to the bankruptcy court to reassess the feasibility of the Gentry plan.

Conclusion

The Tenth Circuit's opinion may be of assistance to both guarantors and their creditors. First, guarantors may be able to demonstrate feasibility of their Chapter 11 plans based upon the performance of the primary obligor. Second, if the guarantors' liability amount exceeds the amount to be satisfied under the primary obligors' plan, the guarantors may be required to contribute additional assets or future wages and salary toward the satisfaction of the shortfall. While a guarantor may be able to utilize its primary obligors' Chapter 11 plan to satisfy a portion of the guarantor's obligations, the Tenth Circuit's opinion can be construed to hold Chapter 11 does not provide a "painless" solution for the guarantor if a shortfall in debt coverage remains.

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