Bankruptcy’s Potential Impact on Guaranties: A Cautionary Tale

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A December 2015 opinion by the 10th U.S. Circuit Court of Appeals reminds us of the importance of the language contained in a guaranty agreement and why these documents should be carefully drafted. In In re Gentry, 807 F.3d 1222 (10th Cir. 2015), the court allowed a lender to enforce a guaranty as to the full amount of the debt, even though the primary borrower’s liability for the guaranteed debt had been modified in bankruptcy.1 To appreciate the Gentry ruling, a general overview of the law surrounding guaranties is helpful.

WHAT IS A GUARANTY?

Lenders extending commercial loans frequently require guaranties from third parties, typically from those who receive some benefit from the loan transactions, such as principals or affiliates of the borrower. The borrower is the “maker” of a note. Under the common law, that person is considered the “primary” obligor. A guarantor of the note is a “secondary” obligor.

“A guaranty is a collateral agreement to pay a debt or perform a duty for another in case of default which may be enforced separately from the primary obligation,” and it may be unconditional (also referred to as absolute) or conditional.2 There are key differences between a conditional and unconditional guaranty. An unconditional guaranty does not require notice to the guarantor; nor does the creditor have an obligation to seek payment from the primary obligor first.3

Guaranties can also be limited; for example, the amount of the guaranty obligation may be capped at some amount less than the borrower’s full debt or may be limited to some stated percentage of the borrower’s debt.

DEFENSES OF GUARANTOR

Not only do guarantors have the same defenses as the borrower, they also have an arsenal of other defenses under both the Uniform Commercial Code and the common law. Guarantor defenses are discussed in “Revisiting The 24 Defenses of the Guarantor – 24 Years Later,” where it is emphasized that these defenses should be considered when drafting a guaranty.4 Guaranties tend to be lengthy because they seek to protect lenders against a guarantor’s potential unique defenses.

In addition, co-signers of a loan who are not direct beneficiaries of the loan are “accommodation makers” and, as such, are treated as sureties who have available to them all of the defenses of a guarantor.5 Many lenders prefer to reduce the available defenses by having such parties sign a separate guaranty agreement containing waivers of many, if not all, of the available defenses.

THE GENTRY CASE

In Gentry, the maker of the note, a corporate entity, modified its loan under a Chapter 11 plan of reorganization that was approved by the bankruptcy court. The approved modification provided that
the loan, which was secured by real property, would be paid in full over 25 years. The lender sued
the individual guarantors of the note, Larry and Susan Gentry.

The Gentrys then filed their own Chapter 11 bankruptcy case. Their plan of reorganization provided
that their obligations under the guaranties would be satisfied by the corporate borrower’s
payment pursuant to its confirmed Chapter 11 plan.

The U.S. Bankruptcy Court for the District of Colorado and the U.S. District Court for the District
of Colorado both held that the Gentrys owed no more than was owed by the corporate borrower,
relying in part on the language of the guaranties.

Relying on the specific language of the guaranties, the Gentry guarantors argued that their
liability was expressly limited to match the borrower’s liability on the loan. Since the loan had
been modified and was current under the modified loan terms, the Gentrys asserted they were not
in default on their guaranties. In effect, they argued that the obligations under their guaranties
were altered to match those of the primary obligor. As noted above, the two lower courts agreed
with their position. But the 10th Circuit did not.

The 10th Circuit noted that “under Colorado law, the extent of a guarantor’s liability is determined
by the language of the guaranty, and ‘absent language to the contrary,’ a guarantor’s liability
matches that of the borrower.”

However, the court pointed out that Section 524(e) of the Bankruptcy Code provides that the
discharge of a borrower’s debt in bankruptcy does not affect the liability of the guarantors. The
10th Circuit then reviewed the guaranties to glean the intent of the parties.

The court relied on three provisions in the guaranties to conclude that the Gentrys’ obligation was
not modified to match that of the borrower. The guarantors

- Had agreed “to pay all of the principal amount outstanding.”
- “Expressly waived any defenses arising because of the ‘cessation of Borrower’s liability from
  any cause whatsoever.’”
- “Agreed not to assert any deductions to the amount guaranteed.”

Most importantly, the 10th Circuit explained that the bankruptcy court’s power to grant
discharges results in a change to the debtor’s liability but that a discharge does not extinguish
the underlying debt.

This case illustrates the importance of understanding the effect of a borrower’s bankruptcy plan
on the liability of guarantors (and of the proposed modification of the underlying debt in the
borrower’s Chapter 11 case). Gentry also shows the importance of using a written and carefully
drafted guaranty agreement, and of understanding and reviewing the boilerplate language in a
guaranty agreement.

During negotiations with a guarantor, lenders should be mindful that the modification or removal
of provisions in the guaranty should be carefully considered and undertaken only with a full
understanding of the consequences of such changes because guaranties are strictly construed by
the courts. Generally, each of the provisions of a carefully drafted guaranty are designed to limit
potential defenses that the guarantor may raise when a lender seeks to enforce the guaranty.

Ultimately, the lender’s goal is to obtain a guaranty wherein the guarantor has waived many
of these defenses, so the lender has full access to the guarantor and the guarantors’ assets to
assure repayment of the underlying obligation.

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NOTES

1. The 10th Circuit’s decision reversed rulings by both the bankruptcy court and the district court, which had held that the corporate borrower’s confirmed plan of reorganization had effectively modified the guarantors’ liability under their guaranties, preventing the lender from enforcing the guaranties outside a default by the corporate borrower under its confirmed plan of reorganization.


3. Id.


6. Gentry, 807 F.3d at 1227 (citations omitted).

7. Id.; see also Highlands Ranch Univ. Park LLC v. Uno of Highlands Ranch LLC, 129 P.3d 1020, 1024-1025 (Colo. Ct. App. 2005). (Interpretation of a guaranty is a question of law and, like contracts in general, the parties’ intent is to be understood from a review of the entire agreement).

8. Gentry, 807 F.3d at 1227 (citations and internal quotation marks omitted).

9. Id. at 1228.


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