By Jeremy R. Fischer

Bankers Beware

Post-Discharge Guaranty Might Be an Invalid Reaffirmation Agreement that Violates Discharge Injunction

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Lenders commonly require owners of closely held companies to personally guaranty commercial loans. Requiring personal guaranties provides the lender with several benefits: Not only do they serve as a secondary source of repayment, they also ensure that the owners force the company to repay the lender, thereby eliminating the guarantors' personal liability.

If the company defaults on its loans and the lender and company seek to restructure the underlying obligations through a forbearance agreement, the guarantors are generally required to consent to the restructuring by signing the forbearance agreement. From the lender's perspective, even if the guarantors' consent is not strictly required by the terms of the guaranty agreement, the forbearance agreement is a smart and easy "belt and suspenders" move to avoid later disputes about whether the guarantors agreed to the restructured loan terms.

However, what happens if one of the guarantors files for bankruptcy and obtains a discharge of his guaranty liability, and thereafter the company defaults on its debts to the lender? What involvement should the former guarantor play in the forbearance process, and what are the rules of the road in that particular situation? A recent decision from the U.S. Bankruptcy Court for the Eastern District of North Carolina provides a road map for understanding the potential pitfalls related to post-discharge commercial guaranties.[1] Bankers should beware of obtaining new, post-discharge personal guaranties from business owners — even if the lender is providing new consideration — as it could run afoul of the reaffirmation provisions of § 524(c) and the discharge injunction under § 524(a).

Background

The factual background in the underlying case was quite simple. Dr. Karl Schwarz owned and operated a medical practice, Karl W. Schwarz, M.D., PC. In 2007 and 2008, the company entered into several equipment finance agreements with Americorp Financial LLC. Dr. Schwarz, as the sole shareholder of the corporation, was required to personally guaranty each of the commercial loans.[2]

In 2009, Dr. Schwarz and his wife, Shauna L. Schwarz, filed a joint, voluntary petition for chapter 7 relief. The liabilities to Americorp were listed on the debtors' Schedule F. In 2010, the debtors received a discharge under § 727 of the Bankruptcy Code.[3]

Before and during the personal bankruptcy case, the company continued making regular payments to Americorp. However, the company defaulted in 2012, and discussions began regarding a forbearance arrangement.[4] Ultimately, the company and Americorp entered into a forbearance agreement in 2013 whereby the company acknowledged its defaults, and Americorp agreed to lower the monthly payment amounts and extend the payment terms. The forbearance agreement also contained a provision requiring both debtors to jointly guaranty the company's obligations to Americorp.[5]

In 2015, Americorp filed a motion in the bankruptcy court seeking to reopen the debtors' bankruptcy case. After the motion was granted, Americorp initiated an adversary proceeding seeking declaratory relief that "the execution of the Forbearance Agreement did not violate the discharge injunction and ... is not an unenforceable reaffirmation agreement under § 524(c)."[6] The debtors counterclaimed, seeking a declaratory judgment that the agreement was an invalid reaffirmation agreement, as well as money damages for a violation of the discharge injunction. The parties then filed cross-motions for summary judgment.[7]

The Bankruptcy Court's Analysis

Was the Agreement Enforceable Under § 524(c)?

The bankruptcy court began its analysis by considering whether the forbearance agreement constituted an invalid reaffirmation agreement as to either or both of the debtors under § 524(c). Section 524(c) provides that "[a]n agreement between a holder of a claim and the debtor, the consideration for which, in whole or in part, is based on a debt that is dischargeable in a case under this title, is enforceable only to any extent enforceable under applicable nonbankruptcy law ... only if" the debtor and creditor comply with a list of specified requirements. However,

1 *Americorp Fin. LLC v. Schwarz (In re Schwarz)*, No. 15-00044-9-SWH-AP, 2016 WL 7413478 (Bankr. E.D.N.C. Dec. 22, 2016).
2 *Id.* at *1.
3 *Id.*
4 *Id.*
5 *Id.*
6 *Id.*
7 *Id.*

the parties stipulated "that the Forbearance Agreement did not comply with [these] requirements."[8] Thus, the bankruptcy court was presented with a clean decision about whether § 524(c) applied to the forbearance agreement.

Americorp argued that the forbearance agreement was supported by independent, post-discharge consideration in the form of its agreement to forbear, lower the company's monthly payments and extend the original repayment terms. For this reason, Americorp argued that the agreement was enforceable notwithstanding its noncompliance with § 524(c)'s requirements.[9] On the other hand, the debtors argued that applying the statute's plain language rendered the agreement unenforceable because the consideration that they provided in exchange for the agreement was based "in whole or in part" on a debt that was dischargeable in their bankruptcy case.[10]

The bankruptcy court noted that the issue of whether new consideration changed the analysis under the statute had been dividing the courts for some time.[11] After considering the competing lines of cases, the court decided that Americorp's "reasoning ... runs afoul of the plain language of the statute."[12] The court "rejects the cases [that] 'focus only on the existence of new consideration rather than whether the former discharged obligation constituted any part of the consideration.'"[13] In addition, the court found "that unless the Forbearance Agreement [was] 'not in any way supported by a promise by [the] Debtor to pay the obligation due under the original [agreements],' it cannot be found valid and enforceable."[14]

Applying this determination of the law to the facts of the case before it, the court held that the forbearance agreement was enforceable against Mrs. Schwarz, but not Dr. Schwarz. The court determined that "with respect to Mrs. Schwarz, there was no pre-petition debt or obligation to the plaintiff. Accordingly, the Forbearance Agreement was not based in whole or in part on a dischargeable debt, and it is valid as to Mrs. Schwarz."[15] As to Dr. Schwarz, "the Forbearance Agreement was based at least in part on Mr. Schwarz's original guaranty," which had been discharged in the bankruptcy case — thus, Americorp had caused him to assume a dischargeable obligation without complying with § 524(c).[16] Therefore, as to Dr. Schwarz, the agreement was invalid.[17]

Was the Discharge Injunction Violated?

Next, the bankruptcy court considered whether Americorp had violated the discharge injunction by causing the debtors to enter into the forbearance agreement as joint guarantors. As to Mrs. Schwarz, the court again determined that "there was no violation ... because ... she owed no debt to the plaintiff pre-petition, and thus there was no debt that was discharged, and no discharge injunction to violate."[18]

As to Dr. Schwarz, Americorp argued that § 524(f) provides that a debtor may voluntarily repay a discharged debt (even if the debt is not reaffirmed under § 524(c)), and thus the forbearance agreement did not run afoul of the discharge injunction.[19] The court rejected this argument because "the provisions of § 524(f) do not validate repayments of discharged debts that are *in any way induced by the acts of the creditor*."[20] In the context of § 524(f), "'Voluntary' ... is defined 'in an objective sense as referring to repayment that is free from creditor influence or inducement, regardless of whether the debtor was motivated by forces unrelated to the creditor.'"[21] The court continued, "[A]llowing a debtor to sign a note [that] places him under the same obligation [that] he was subject to pre-discharge does not constitute a voluntary repayment by the debtor nor does it leave the debtor in a position to make a voluntary repayment under § 524(f)." Moreover, the court determined that "§ 524(f) must be read in conjunction with, rather in negation of, § 524(c),"[22] thus any agreement where a dischargeable debt serves as consideration must comply with the reaffirmation provisions of § 524(c).[23]

The bankruptcy court determined that by causing Dr. Schwarz to sign a new guaranty of the company's obligations as part of the forbearance agreement, Americorp had violated the discharge injunction. However, the question of whether Dr. Schwarz was entitled to damages required a determination of whether Americorp's actions were "willful," which presented the court with disputed issues of material fact.[24] For that reason, the court scheduled an evidentiary hearing on the issue of Americorp's willfulness and any resulting damages.[25]

Practice Pointers

Banks and their counsel should beware of the *Schwarz* holding and similar cases from other courts when dealing with troubled commercial loans. If a bank obtains a new guaranty from a previously discharged guarantor as part of a forbearance arrangement, then it may find the guaranty to be unenforceable in the future. In addition, under *Schwarz*, the bank might also find itself liable for violating the discharge injunction and paying the guarantor for damages. In order to avoid these pitfalls, banks and their counsel should keep the following practice pointers in mind.

First, banks should ensure that they have established policies and procedures so that they are alerted when a personal guarantor of a commercial loan files for bankruptcy and receives a discharge. Most banks already periodically search

8 *Id.* at *2.
9 *Id.*
10 *Id.*
11 *Id.* (comparing *Liptz & Roberts v. Stevens (In re Stevens)*, 217 B.R. 757, 760 (Bankr. D. Md. 1998) (post-petition agreement supported by new and independent consideration enforceable notwithstanding § 524(c)), *with Minster State Bank v. Heirholzer (In re Heirholzer)*, 170 B.R. 938 (Bankr. N.D. Ohio 1994), and *In re Petersen*, 110 B.R. 949 (Bankr. D. Colo. 1990) (both applying plain-language approach).
12 *Id.* (citing *Sandburg Fin. Corp. v. Am. Rice Inc. (In re Am. Rice Inc.)*, 448 Fed. App'x. 415, 420 (5th Cir. 2011); *Weeks v. Isabella Bank Corp. (In re Weeks)*, 400 B.R. 117, 122 (Bankr. W.D. Mich. 2009); and *In re Arnold*, 206 B.R. 560, 566 (Bankr. N.D. Ala. 1997)).
13 *Id.* (quoting *In re Stevens*, 217 B.R. at 760).
14 *Id.*
15 *Id.*
16 *Id.* (citing *TD BankNorth NA v. Ewing (In re Ewing)*, 365 B.R. 347, 349 (Bankr. D. Mass. 2007)).
17 *Id.* at *3 (citing *Republic Bank of Calif. NA v. Getzoff (In re Getzoff)*, 180 B.R. 572, 575 (B.A.P. 9th Cir. 1995)).
18 *Id.*
19 *Id.*
20 *Id.* (quoting *Van Meter v. Am. State Bank*, 89 B.R. 32, 34 (W.D. Ark. 1988)) (emphasis added).
21 *Id.* at *2 (quoting *Venture Bank v. Lapides*, 800 F.3d 442, 447-48 (8th Cir. 2015) (quoting *Dubois v. Ford Motor Credit Co.*, 276 F.3d 1019, 1023 (8th Cir. 2002))).
22 *Id.* at *3 (citing *Cherry v. Arendall (In re Cherry)*, 247 B.R. 176, 183 (Bankr. E.D. Va. 2000)).
23 *Id.* (citing *Mickens v. Waynesboro Dupont Emps. Credit Union Inc. (In re Mickens)*, 229 B.R. 114, 117 (Bankr. W.D. Va. 1999)).
24 *Id.* (citing *Bradley v. Fina (In re Fina)*, 550 Fed. App'x. 150, 154 (4th Cir. 2014) (court must determine whether creditor willfully violated discharge injunction before awarding contempt sanctions)).
25 *Id.*

continued on page 70

from page 39

to see if their borrowers have filed, and the same practice should be instituted for personal guarantors. Banks would also be well advised to devote resources to track the progress of guarantors' cases, even if there is little or no prospect of any distribution from the estate.

Second, following a guarantor's bankruptcy, banks should think twice about seeking a new guaranty related to a discharged liability as part of any forbearance arrangement. In light of the plain-language interpretation applied in *Schwarz* and other cases, new consideration in the form of forbearance or other payment relief by the bank might be irrelevant because at least part of the consideration for the new agreement is based on a dischargeable debt. Thus, ordinary contract considerations like offer, acceptance, meeting of the minds and consideration might be of secondary importance in evaluating such post-discharge guaranties, because applicable nonbankruptcy law will yield to the reaffirmation and discharge provisions of § 524. abi

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