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Bankruptcy Court's Stay of Litigations Against Non-Debtors: An Unusual Circumstance?

As a general rule, the automatic stay in a debtor's bankruptcy case bars creditors from taking action to collect their claims against the debtor. However, in very limited circumstances, courts have extended the stay to enjoin non-debtor third-party collection efforts, such as lawsuits against guarantors of a debtor's obligations. In a recent decision, the United States Bankruptcy Court for the Northern District of Iowa (the "Bankruptcy Court"), in *In re Bailey Ridge Partners, LLC*, took the unusual step of staying two litigations against non-debtors, one to enforce claims against guarantors of a debtor's obligations and the other to enforce a claim against a non-debtor co-obligor. The Bankruptcy Court concluded that: (a) the debtor was likely to successfully reorganize and emerge from bankruptcy; (b) the guarantors and co-obligor were critical to the success of the reorganization based on the financial and other support they had provided and committed to provide to the debtor; and (c) the creditor suing the non-debtor guarantors was fully secured by the debtor's assets.

Thus, while a creditor holding a third-party guaranty can ordinarily sue a guarantor following the customer's bankruptcy filing, there is a chance—albeit very limited—that a court could stay the creditor's lawsuit against the guarantor during the course of a customer's bankruptcy case.

Guarantees

A trade creditor can seek a guaranty as an additional source of security/payment from a financially distressed customer. There are two types of guarantees: a personal guaranty and a corporate/other entity guaranty.

A creditor might seek a personal guaranty from: (i) its corporate customer's officer, director or shareholder; (ii) its limited liability company customer's member or manager; or (iii) any other third party. Alternatively, a creditor can request a guaranty from an entity affiliated with the customer, such as a corporation or limited liability company.

A guaranty is only as useful as the guarantor's ability to pay the creditor's claim. A guarantor with little or no assets, or whose assets are fully encumbered, is likely judgment proof and unable to satisfy a guaranty. A creditor considering whether to accept a personal or corporate guaranty as a risk mitigation tool should carefully review the guarantor's financial statements to

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determine the collectability of the guaranty. The best practice is for a creditor to investigate the veracity of the information contained in a financial statement.

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A guaranty should also contain certain language that increases the chances of collection of the guaranty. A guaranty of payment is a must as this allows a creditor to collect directly from a guarantor without attempting to collect from its customer. A guaranty should also be: (a) "absolute and unconditional;" (b) "continuing" so as to be enforceable while there is any outstanding guaranteed indebtedness; (c) payable "without offset, defense or counterclaim;" and (d) appropriately witnessed and notarized upon execution. A guaranty should also provide for the waiver of guarantor defenses; the recovery of attorneys' fees and other collection costs; appropriate

notification for termination and protection for pre-termination liabilities; and for reinstatement of certain prior customer payments in the event of the customer's bankruptcy filing to protect against preference and other risks.

The Automatic Stay

The automatic stay under Bankruptcy Code section 362 halts most creditor efforts to collect their claims against a debtor that has sought bankruptcy protection. As a general rule, the automatic stay does not prohibit actions against non-debtors. However, courts have relied on two sources of authority to extend the automatic stay to protect non-debtors. Some courts have relied on section 362 to stay the assertion of claims against non-debtors. These courts have considered whether a judgment against a non-debtor is a *de facto* judgment against the debtor, whether the stay would contribute to the debtor's reorganization, as well as the relationship between the non-debtor and the debtor.

Other courts have invoked their equitable powers under Bankruptcy Code section 105 to stay actions against non-debtors. These courts have enjoined lawsuits against non-debtors where continuation of the lawsuit would "adversely affect the bankruptcy estate and pressure the debtor through a third party." Courts generally consider four factors when determining whether to enjoin a lawsuit against a non-debtor:

1. The likelihood of a successful reorganization;
2. Imminent irreparable harm to the debtor's estate if the lawsuit is not enjoined;

3. Whether the balance of harms tips in favor of the party seeking to extend the stay; and
4. If the public interest weighs in favor of a stay of the lawsuit.

The *Bailey Ridge* court, relying on the four factor test above, enjoined two separate litigations against non-debtors. The first was against the guarantors of a debtor's obligations to a creditor, and the second was against a non-debtor that was

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liable on an obligation with a debtor. The court relied on what it characterized as "unusual circumstances," including a "sufficient nexus" between the debtor, Bailey Ridge Partners, LLC ("Bailey Ridge"), and the non-debtors; the non-debtors' willingness to continue contributing to Bailey Ridge's reorganization, including injecting new money into the debtor and otherwise assisting with the reorganization, and the fully secured status of the creditor pursuing the non-debtor guarantors.

Facts and Procedural History

Bailey Ridge was engaged in a pig feeding and housing business. Bailey Ridge's primary secured lender was Dubuque

Bank (“Dubuque”). Bailey Ridge owed Dubuque approximately \$11.4 million arising from Dubuque’s loan to Bailey Ridge to refinance and pay off an earlier loan from First Dakota Bank (“First Dakota”) and to provide funding for improvements to Bailey Ridge’s facilities. Dubuque’s claim was secured by a lien on Bailey Ridge’s personal and real property, worth approximately \$11.5 million. Certain holders of Bailey Ridge’s membership interests (collectively, the “Guarantors”) guaranteed payment of Bailey Ridge’s obligations to Dubuque.

In early 2016, Bailey Ridge began having trouble servicing its indebtedness to Dubuque. As a result, in April 2016, Dubuque sent Bailey Ridge a notice of default and subsequently sued the Guarantors in Iowa state court (the “Guarantor Litigation”).

Prior to obtaining the loan from Dubuque, in 2011, Bailey Ridge had obtained a loan in the amount of \$5.6 million from First Dakota. First Dakota had simultaneously made a second loan in the amount of \$500,000 to Jerry Ruba (“the Ruba Loan”), the proceeds of which were immediately paid to Bailey Ridge. This loan was secured by Iowa farmland owned by Jerry Ruba (“Ruba”) and his wife. In exchange, Ruba received a 7.8% ownership interest in Bailey Ridge.¹ Bailey Ridge had

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also agreed to assume Ruba’s obligations under the Ruba Loan and directly make payments to First Dakota. In 2014, Bailey Ridge paid off the \$5.6 million loan to First Dakota from the proceeds of the loan from Dubuque. However, Ruba’s indebtedness to First Dakota was not paid off as part of this refinancing arrangement. While Bailey Ridge had made some interest payments on the Ruba Loan to First Dakota, Bailey Ridge was ultimately unable to make any further payments to First Dakota. In June 2015, Ruba defaulted on the Ruba Loan. First Dakota sued Ruba to recover the balance due on the Ruba Loan in the United States District Court in South Dakota (the “Ruba Litigation”). Ruba responded by suing Bailey Ridge, alleging that Bailey Ridge was the sole beneficiary of the loan and Ruba had only agreed to the Ruba Loan in reliance on Bailey Ridge’s agreement to be responsible for and to repay the Ruba Loan.

Bailey Ridge filed its Chapter 11 case on January 11, 2017. Shortly thereafter, Bailey Ridge and the Guarantors moved for a stay of the Guarantor Litigation. They argued that the Guarantor litigation would hinder Bailey Ridge’s ability to reorganize to the extent Dubuque could obtain a judgment against the Guarantors and thereafter levy on the Guarantors’ membership interests in Bailey Ridge. They also argued that Dubuque was fully secured by Bailey Ridge’s assets and was, therefore, likely to obtain full payment of its claim.

Dubuque opposed the stay of the Guarantor Litigation arguing that Dubuque had the unconditional right to collect from the Guarantors regardless of Dubuque’s fully secured status. Dubuque also asserted that the Guarantors were separate from Bailey Ridge and did not prove that they were either involved in Bailey Ridge’s business or that they would contribute any new capital to fund Bailey Ridge’s business and a Chapter 11 plan.

Likewise, Ruba moved to stay the Ruba Litigation. Ruba argued that Bailey Ridge was the sole beneficiary of the Ruba Loan. In addition, any judgment against Ruba would be a *de facto* judgment against Bailey Ridge, as Ruba had a claim against Bailey Ridge for all sums Ruba paid to First Dakota. First Dakota countered that Ruba was the only signatory on the Ruba Loan documents and First Dakota was neither a party to nor bound by any agreement between Ruba and Bailey Ridge for Bailey Ridge to repay the Ruba Loan.

On February 23, 2017, the Bankruptcy Court granted a temporary stay of the Guarantor Litigation and Ruba Litigation and set a hearing to determine whether to grant a permanent stay of the litigations. Bailey Ridge filed its Chapter 11 plan of reorganization on April 28, 2017.

The Bankruptcy Court’s Holding

The Bankruptcy Court stayed the Guarantor Litigation and Ruba Litigation pending the hearing on confirmation of Bailey Ridge’s Chapter 11 plan after applying the four factor test for determining whether to grant injunctive relief.

The Guarantor Litigation

The court first noted that Bailey Ridge was likely to successfully reorganize. Bailey Ridge was expected to generate sufficient revenue from its exclusive contract (the “Seaboard Contract”) with Seaboard Foods of Iowa, LLC (“Seaboard”) to provide funding for Bailey Ridge’s business and service its debt.

The court then found that Bailey Ridge likely faced imminent and irreparable harm if the court did not grant injunctive relief staying the Guarantor Litigation. There was a close relationship between the Guarantors and Bailey Ridge as a result of the Guarantors’ continued investment of their time, money and expertise to further Bailey Ridge’s reorganization. But for the Guarantors’ efforts, Bailey Ridge would have had significant difficulty performing under the Seaboard Contract and continuing its operations.

The Guarantors also would have likely halted their financial and other support for Bailey Ridge, if Dubuque had continued the Guarantor Litigation and obtained judgments. That would have also led to Bailey Ridge’s demise.

The balance of the harms also favored Bailey Ridge and the Guarantors. Dubuque’s claim was fully secured by Bailey Ridge’s assets, including real estate collateral that was likely to appreciate in value.

Finally, the public interest favored staying the Guarantor Litigation. Bailey Ridge was likely to pay Dubuque’s fully secured claim. That outcome was far better than the risk of protracted

litigation between the Guarantors and Bailey Ridge and between and among the individual Guarantors if the Guarantor Litigation were not stayed.

The Ruba Litigation

The Bankruptcy Court stayed the Ruba Litigation for the same reasons as the court had relied upon in staying the Guarantor Litigation. The court had already found a strong likelihood that Bailey Ridge would successfully reorganize. There was also a risk of imminent and irreparable harm if the Ruba Litigation were not stayed. The continuation of the litigation and entry of judgment against Ruba would have been costly and disruptive to his farming operation and his willingness to provide additional funds for Bailey Ridge's business. Ruba also would have likely successfully asserted a claim against Bailey Ridge for all sums Ruba was required to pay First Dakota, resulting in any judgment against Ruba being a *de facto* judgment against Bailey Ridge.

The court also found that the balance of the harms favored staying the Ruba Litigation. Bailey Ridge, not Ruba, had received the proceeds of the Ruba Loan. First Dakota was aware of and, in fact, had also orchestrated the Ruba Loan and Ruba's involvement with Bailey Ridge as part of First Dakota's larger loan arrangement with Bailey Ridge. Ruba, in turn, only agreed to the Ruba Loan in reliance on Bailey Ridge's agreement to repay the Ruba Loan.

Finally, the public interest weighed in favor of staying the Ruba Litigation. The Bankruptcy Court wanted to give Bailey Ridge the chance to repay the Ruba Loan and avoid protracted and costly litigation.

Conclusion

The *Bailey Ridge* court recognized that any stay or injunction of litigation against a non-debtor, such as a guarantor, during the pendency of a debtor's bankruptcy case should be rarely granted. The court stayed the Guarantor Litigation and Ruba Litigation during the pendency of Bailey Ridge's bankruptcy based on "unusual circumstances," such as: (i) a fully secured creditor likely to be paid by the debtor; (ii) the Guarantors and Ruba offering financial and other support for the debtor's business and reorganization, and (iii) the benefit of avoiding any further protracted litigation and damage to the non-debtors. The interesting question is whether a court will stay litigation against a non-debtor guarantor based on less "unusual circumstances?" ■

1. The Bankruptcy Court noted that it was unclear whether Ruba had retained any ownership interest in Bailey Ridge when First Dakota had commenced the Ruba Litigation.

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