LANDLORD CONSIDERATIONS WHEN NAVIGATING PERSONAL GUARANTIES IN BANKRUPTCY

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When a business leases commercial space, it is common practice for the landlord to request that the company provide a personal guaranty, a protective measure taken to ensure landlords have recourse against a commercial lessee if there is a default under the lease. In this way, landlords mitigate financial losses.

A personal guaranty gives the landlord the ability to recover any losses from the personal guarantor if the commercial lessee breaches its lease agreement by failing to pay rent. In that instance, the landlord can seek to recover the unpaid rent from the personal guarantor. The personal guarantor is often the principal or manager of the business.

Although personal guaranties are a good safety mechanism, with the recent surge of businesses filing for bankruptcy, it is important to understand the ramifications of a commercial lessee or personal guarantor filing for bankruptcy and the limitations of personal guaranties.

An individual debtor's primary intention when filing for bankruptcy is to be released from past financial obligations such as a guaranty. Bankruptcy prevents creditors from seeking payment on obligations that have been discharged in bankruptcy. Bankruptcy can protect a debtor from creditors seeking repayment of debts incurred before the debtor filed for bankruptcy; however, bankruptcy is not a complete shield for guarantors and not all guaranties can be discharged, although many can be.

DOES A BANKRUPTCY DISCHARGE A GUARANTY THAT HAS NOT YET BEEN TRIGGERED?

If a personal guarantor files for bankruptcy, the lessee is still expected to continue to fulfill its obligations under the lease, as the guarantor's bankruptcy filing should not affect the commercial lessee's performance under the lease. If the personal guarantor receives a discharge in the bankruptcy case, however, the landlord may not be able to recover against the personal guarantor if the commercial lessee breaches the lease agreement.

In fact, some courts have discharged personal guaranties that have yet to be triggered, e.g., the commercial lessee has not breached the lease and therefore there is no reason to seek recourse under the personal guaranty.

For example, the Bankruptcy Appellate Panel for the Sixth Circuit held that a personal guaranty may be discharged even though it has not been triggered. In *In re Orlandi*, 612 B.R. 372 (B.A.P. 6th Cir. 2020) the debtor (also the personal guarantor) owned a company that owned a salon. The salon (the commercial lessee) had previously entered into a commercial lease, and the debtor personally guaranteed the lessee's performance under the lease. At the time the guarantor filed for bankruptcy, there was no breach by the lessee.

After the individual debtor obtained his bankruptcy discharge, the commercial lessee exercised an option to extend the lease for five years. The tenant later defaulted, and the landlord thereafter sought to enforce the guaranty against the discharged guarantor, but the court held that the personal guaranty was discharged, and therefore, the landlord could not seek to recover against the personal guarantor.

If a landlord is aware that a personal guarantor has filed for bankruptcy, the landlord should be proactive in mitigating their financial losses. Besides filing a claim in the bankruptcy case, two measures are available to landlords.

Depending on the circumstances, if the personal guarantor has filed for bankruptcy, the landlord may request that the personal guarantor "reaffirm" the debt. This means that the personal guarantor agrees that even if they receive a discharge in the bankruptcy proceeding, the personal guaranty will not be discharged and will still be enforceable after the bankruptcy case. In that case, the guaranty will not be included in the discharge because it is a debt entered into after the bankruptcy filing.

Another option for the landlord is to request a letter of credit when the lease is executed, which can offer a landlord financial protection in the event a lessee or guarantor files for bankruptcy, since the letter of credit is an independent obligation of the obligor (often a financial institution) to pay in the event of a default by the lessee.

It is important to note that not all courts have held that personal guaranties can be discharged. Again, these are all based on different circumstances, but some courts have enforced guaranties after the debtor has been discharged if the creditor extends credit post-petition.

For example, the Bankruptcy Court for the Middle District of Alabama held that a debtor's obligation arising from the personal guaranty was not subject to a discharge. In *McClure-Johnston Co. Inc. v. Jordan* (*In re Jordan*), 2006 Bankr. Lexis 1460 (Bankr. M.D. Ala. 2006) the court found that despite the guarantor's Chapter 7 bankruptcy filing, the guaranty was not included in the debtor's discharge because there was a continued borrowing relationship after the debtor filed for bankruptcy since the creditor continued to loan money to the debtor's company.

There is a split among courts regarding the enforceability of guaranties. The outcome will depend on the type of bankruptcy that is filed, and the circumstances surrounding each case. Even if the personal guaranty is not discharged, the landlord is likely to incur legal fees in defending its claim and participating in the bankruptcy case.

IS A GUARANTY DISCHARGED IF THE COMMERCIAL LESSEE FILES FOR BANKRUPTCY BUT THE PERSONAL GUARANTOR DOES NOT?

Generally, bankruptcy protections are afforded only to those who file for bankruptcy.

In the case of *In Mich Nat'l Bank v. Laskowski*, 228 Mich. App 580 NW2d (1998), the court held that the bankruptcy of a corporate debtor did not extend to the corporation's president, who had signed a personal guaranty.

A commercial lessee's bankruptcy filing does not impact the obligations of the personal guarantor. However, if a commercial lessee files for bankruptcy and is discharged, the landlord's recovery against the commercial lessee may be limited.

It is also worth noting that whether the commercial lessee or personal guarantor files for bankruptcy, the Bankruptcy Code caps claims against the debtor.

Calculating rejection claims can be complex because of the different interpretations and approaches adopted by courts. There are two approaches when calculating damages under this section, the "rent approach" and "time approach." Regardless of the approach adopted, a landlord will not be made whole.

When a debtor files for bankruptcy, it can assume (i.e., continue) or reject (i.e., breach) unexpired leases and executory contracts – contracts for which performance remains due or full performance under the contract has not been completed. When a debtor rejects a lease, the landlord can assert a claim against the debtor in the bankruptcy case. Bankruptcy Code § 502(b)(6) does not expressly address whether the cap on lease rejection damages applies to personal guaranties. However, courts have applied the statutory cap to lease rejection claims that involve guaranties.

Guaranties are good protection but not a complete safeguard because a bankruptcy filing can hinder a landlord's ability to recover from a guarantor. Landlords should be proactive and explore alternative options. As mentioned, a landlord can request that the debtor reaffirm the debt or execute a new guaranty. The debtor is not obligated to fulfill the landlord's request, but it should ensure some repayment if the debtor agrees. The landlord can also request a letter of credit before executing the lease, which provides the landlord an additional level of repayment security.

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