

What We Know

ARTICLES & INSIGHTS

ABOUT THE AUTHOR



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Don't Proceed Against that Guarantor Just Yet

December 3, 2002 | by

A good credit policy should be designed to protect your business in the event that a customer fails to pay his or her bills. One proven method to accomplish this is to have a guaranty agreement signed, especially if the customer has a poor credit history or is a new customer with no prior relationship with you or your company. The assumption is, of course, that if your customer defaults and is unable to pay his or her debts, you have the option to pursue the guarantor for the debt. Your right to proceed against the guarantor is severely restricted, however, in certain bankruptcy settings as a result of the co-debtor stay provided by the United States Bankruptcy Code in Chapter 13 bankruptcy cases.

Dealing with individual customers, in contrast to business customers, usually means that your guarantor will be a friend, parent or other relative of your customer. The Bankruptcy Code provides that if an individual files a Chapter 13 bankruptcy containing a debt that is guaranteed or secured by someone else, the creditor is prohibited not only from pursuing the debtor for payment of the debt, but also from pursuing the guarantor as well. Before you may exercise your collection rights against the guarantor, you must first obtain permission from the Bankruptcy Court. There are certain requirements that must be met before the Court will grant such relief.

The co-debtor stay does not apply to all Chapter 13 debts. The debt must be a "consumer" debt, which is defined as a debt incurred for personal, family or household purposes. Therefore, if your customer incurred the debt for business rather than for personal use, it may not be considered a "consumer" debt, in which case the co-debtor stay would not be applicable. In addition, the co-debtor stay does not protect a guarantor who becomes liable on the debt as a result of the guarantor's business – for example, a surety or bonding company.

It should be remembered that the co-debtor stay does not relieve the guarantor of liability on the debt, but rather postpones his obligation to pay, and your right to collect, until your customer's bankruptcy is completed. The guarantor remains liable for any amount unpaid by your customer during the bankruptcy plan. Once the bankruptcy case is closed, dismissed, or converted to a Chapter 7 or Chapter 11, you may proceed

against the guarantor as if the bankruptcy had not been filed.

The Bankruptcy Code does not distinguish a guarantor from a co-signer, so the co-debtor stay applies equally to both. In addition, for those businesses that deal with agricultural customers, there is a co-debtor stay that applies to individuals that seek to reorganize family farms under Chapter 12 of the Bankruptcy Code.

A guaranty agreement can be a useful tool for today's business and is highly recommended, especially for new customers or if the credit requested by the customer is more than you feel comfortable extending. However, remember that if your customer files for bankruptcy protection, there are certain provisions of the United States Bankruptcy Code that may affect your ability to pursue the guarantor. To be safe, we recommend that you refer all questions to your attorney or call our firm for assistance.

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