Intra-group financing and enterprise group insolvency: problems, principles and solutions

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Part IV

Intra-Group Financing and Insolvency: Transactions and Problems

6 Cross-guarantees, Recourse Claims and "Orphan Restructurings"▪

6.1 Introduction

This chapter discusses cross-guarantees, also known as intercompany guarantees or intra-group guarantees. These transactions are common in commercial practice as they seek to improve borrowing terms by providing additional security to a guaranteed creditor, who gains access to the enlarged pool(s) of assets and in this way acquires extra protection against counterparty risk.

The purpose of this chapter is to discuss the operation and functions of guarantees in a group context and to explain the problems they cause in situations of financial distress. In many cases, cross-guarantees facilitate interdependence of group companies and weaken the protections of corporate shields, which in theory should ensure the separateness of legal entities comprising an enterprise group. Instead, cross-guarantees allow for simultaneous filing of claims against both the principal debtor and the guarantor, resulting in group-wide enforcement. While this chapter emphasises the problems, it does not offer solutions, leaving that for other chapters in this book (i.e. Chapters 10-12).

The structure of the current chapter is as follows. First, we clarify the scope of inquiry, i.e. types of transactions at issue (section 6.2.). Second, we describe the operation of a cross-guarantee relationship (section 6.3.). Third, we explain how cross-guarantees might reduce the agency cost of debt (section 6.4.1.) and how they could dilute recoveries of non-guaranteed creditors (section 6.4.2.). Fourth, we note how cross-guarantees may affect the dynamics of insolvency and restructuring. This dynamics is explored by analysing the rights and obligations of relevant parties: principal debtor, group guarantor and creditor – the "triangle of rights and liabilities" (section 6.5.). Here, two questions are examined with reference to national law.

▪ This chapter builds upon the following previously published work by the author:
- I. Kokorin, Promotion of group restructuring and cross-entity liability arrangements, Journal of Corporate Law Studies, Vol. 21, 2021, pp. 557-593.
- I. Kokorin, Third-Party Releases in Insolvency of Multinational Enterprise Groups, European Company and Financial Law Review, Vol. 18, 2021, pp. 107-140.

The first question concerns the effects of insolvency and restructuring of the principal debtor on the rights of the guaranteed creditor against the guarantor (section 6.5.2.). It is shown that while the insolvency of the principal debtor per se does not affect joint and several liability of a third party liable under a guarantee, a voluntary release granted by the creditor to the principal debtor may lead to a discharge of the guarantor. In some instances, where there are several jointly and severally liable parties (e.g. co-sureties), the release of one of them may lead to a discharge of obligations of such other parties.

The second question relates to the consequences of performance by the guarantor, specifically the rights that a paying guarantor may acquire against the principal debtor and how such rights may be exercised during or after insolvency or restructuring (section 6.5.3.). The existence and enforceability of these rights can have direct consequences for the efficiency of the insolvency and restructuring proceedings. In addition to the problems caused by the enforcement of "ricochet" claims against the principal debtor, the very fact that the creditor is entitled to proceed with a claim against other group members (i.e. guarantors or co-debtors) might lead to their financial distress or even insolvency. This can have an impact on the efficiency of the principal debtor's restructuring. These and other ex-post effects of cross-guarantees are summarised in section 6.6. Section 6.7. concludes.

6.2 Cross-guarantees and Co-debtorship Arrangements

The main focus of this chapter is on cross-guarantees – transactions creating secondary liability. It does not deal separately with cases where several group members act as co-borrowers or co-issuers (joint obligors or co-obligors). The latter are examples of primary liability. We note the differences between the cases of primary and secondary liability, for instance, with respect to the scope of potential recourse rights that may belong to a guarantor and co-debtor.[1] Yet our decision not to separately write about co-debtorship is based on the similarities between the economic and legal effects of cross-guarantee and co-debtorship arrangements, the commonality of challenges they pose in restructuring and insolvency of enterprise groups, and the uniformity of legal responses required to respond to these challenges.

1 For example, Under Dutch law, a surety has full recourse against jointly and severally liable debtors (Article 7:866 of the Dutch Civil Code (DCC), while a co-debtor may only be entitled to compensation of an amount exceeding the proportionate share of debt (Article 6:10 DCC).

First, cross-guarantees and co-debtorship arrangements perform a similar "security-granting" function, providing a creditor with access to asset pools of separate entities and purporting to satisfy his interest in receiving full performance. Insolvency of the principal debtor or co-debtor does not release the guarantor and other co-debtors, respectively, from their obligations. Thus, in both situations, the risk of default (and the incentive to control it) rests with an entity whose assets may become available to the creditor. Unless otherwise agreed, such a creditor can typically choose to enforce his claim against a single company or initiate a group-wide enforcement by filing claims against several group entities, acting as co-debtors or guarantors, at once.[2] When the creditor's interest is satisfied by one of the co-debtors or by the guarantor, other co-debtors, guarantors, or the principal debtor are discharged from their obligations to the creditor.

Second, upon satisfaction of the creditor's claim, a joint debtor and a guarantor may be entitled to request compensation from co-debtors or from the principal debtor and other guarantors, respectively. The existence and extent of this compensation in a situation where the underlying debt is restructured (e.g. decreased, postponed) or completely written down might differ and depend on applicable law, the character of discharge (voluntary vs. involuntary), as well as the nature of debt restructuring (pre-insolvency contractual vs. insolvency court-led restructuring). The complexities created by co-debtorship and guarantee relationships are similar.

Third, as will be examined in more detail in the following chapters, insolvency law often treats co-debtorship and cross-guarantee arrangements in the same way, e.g. by sanctioning third-party releases (Chapter 10) or extending an enforcement stay to group guarantors and co-debtors (Chapter 11).[3] These insolvency law tools could also be available to protect a group company acting as a provider of collateral securing performance by the principal debtor.

6.3 How Do Cross-guarantees Work?

Groups of companies are special in many respects, including in the ways group entities attract financing from within and outside the group. The cases of Lehman Brothers, Nortel Networks and Oi Brazil serve as excellent examples of how a corporate group can function as a single economic enterprise, tapping into foreign capital markets, efficiently allocating resources

2 *In re Gessin*, 668 F.2d 1105, 1107 (9th Cir. 1982), confirming that "[i]t has long been established that a creditor is entitled to pursue his claims against others liable on the same debt to the full extent of the amount owed on that debt".

3 See e.g. Dutch Bankruptcy Act, Article 372; Singapore's Insolvency, Restructuring and Dissolution Act (IRDA), Section 65; StaRUG, Section 49(3).

within the group, and seeking the most favourable terms for debt financing. One typical financial arrangement used in all three cases is corporate guarantees. These guarantees represent a risk-reduction tool and involve three parties: (i) main or principal debtor, (ii) guaranteed creditor, and (iii) guarantor.

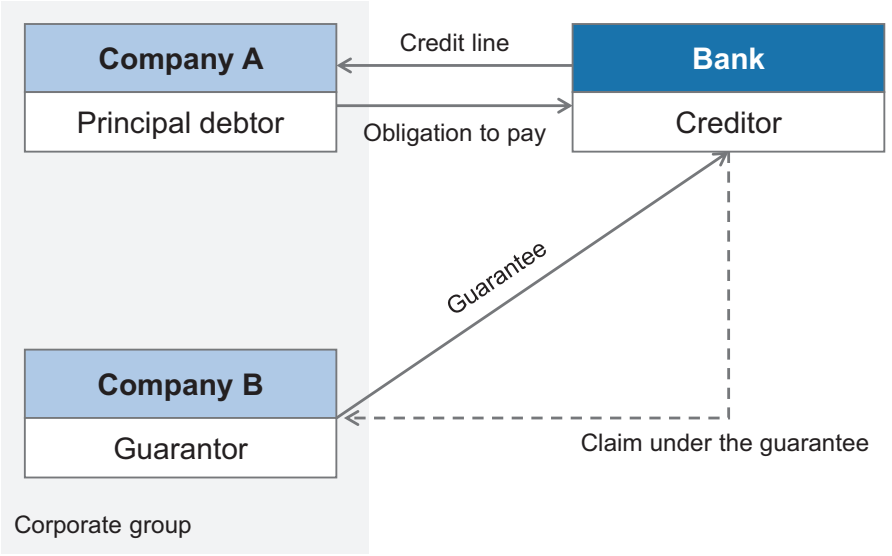

Figure 3. Schematic guarantee relationship

Reading the figure above, a creditor (Bank) has a claim against the principal debtor (Company A), while the latter's performance is guaranteed by another company, the guarantor (Company B). Thus, if the main debtor defaults (i.e. fails to perform his obligation), the creditor is entitled to request performance – usually, payment of a certain amount of money – from the guarantor. As a result, the Bank gains recourse of essentially the same debt from the estates of at least two parties (Companies A and B), depending on the number of co-guarantors involved.

Guarantees may be personal when granted by the debtor's directors or shareholders-natural persons.[4] Personal guarantees often raise specific consumer protection questions and as such fall outside the scope of this book. Corporate guarantees discussed in this book are accessory or co-extensive. They should be distinguished from an independent guarantee (in Dutch "*onafhankelijke garantie*"). Different terms may be used to refer to a type of arrangement whereby the guarantee is independent from an underlying

4 Personal guarantees are particularly common for MSME debtors. See the World Bank Report on the Treatment of MSME Insolvency, 2017 <https://openknowledge.worldbank.org/handle/10986/26709> (accessed 15 July 2023).

obligation (e.g. demand guarantee, demand bond, letter of credit).[5] In contrast, an intercompany guarantee is usually dependent on the underlying obligation and has an accessory nature.[6] This means that the guarantor's liability is contingent upon the principal obligor's continuing liability and default. The term "suretyship" also refers to this accessory agreement. It is sometimes contrasted with a "guarantee", where the latter is used to refer to an independent guarantee.[7]

In order to avoid confusion that may otherwise arise from the use of different terms in different legal systems, this book will use the terms "guarantee" and "suretyship" interchangeably, as an undertaking by the surety or guarantor to be answerable for the debt or obligation of another when that other defaults, and where liability of the surety or guarantor depends upon there being the liability of the principal or main obligor. This simplification, however, is not meant to downplay important nuances in law at the national level. Certain aspects and specifics of national laws will be discussed below.

Guarantees are common in groups, where the parent company guarantees the performance of its subsidiaries (downstream guarantee), where a subsidiary acts as a guarantor for its parent (upstream guarantee), and where one subsidiary guarantees the debt of another subsidiary (cross-stream guarantee).[8] These group guarantees, along with co-debtorship and third-party (group) collateral, are examples of intra-group support transactions.

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5 See P. Wood, International Loans, Bonds, Guarantees, Legal Opinions, Sweet & Maxwell, 2007, para. 19-016. In this case, the third party's obligation is primary and independent of that of the principal debtor. It arises whether or not a default has occurred and is usually not influenced by matters affecting the contract between the creditor and the main debtor.

6 S. Whittaker, Suretyship, in Chitty on Contracts, 33d edn, Sweet & Maxwell, 2018, para. 45-009, noting that under English law "there is a "strong presumption" that a "guarantee" concluded other than by a bank is not a demand or independent performance bond, although this presumption may be rebutted." However, see P. Ostendorf, Demand Guarantee or Suretyship Guarantee – Have corporate guarantors lost the benefit of the doubt? OBLB, 14 September 2021, discussing recent precedents that may weaken the presumption based on the guarantor's identity.

7 For a historical overview of the appearance and usages of the terms "guarantee" and "suretyship", see M. Radin, Guarantee and Suretyship, California Law Review, Vol. 17, 1929, pp. 605-622. For discussion of US law, see C. Henkel, Personal Guarantees and Sureties between Commercial Law and Consumers in the United States, The American Journal of Comparative Law, Vol. 62, 2014, pp. 333-359.

8 R. Squire, Shareholder Opportunism in a World of Risky Debt, Harvard Law Review, Vol. 123, 2010, p. 1213, noting that intragroup guarantee arrangements are extremely prevalent. See also J.F. Williams, The Fallacies of Contemporary Fraudulent Transfer Models as Applied to Intercorporate Guaranties: Fraudulent Transfer Law as a Fuzzy System, Cardozo Law Review, Vol. 15, 1994, p. 1404, observing that guarantees by companies related to a corporate borrower constitute "a common element of many financial transactions".

They enable a group of companies to be financed as one economic unit, securing beneficial conditions (e.g. lower interest rates and costs, and larger amounts) from outside lenders, like credit institutions and bondholders. Yet they promote group interdependence, as the enforcement of a guarantee or simultaneous filing of claims against multiple co-debtors may create contagion and lead to the spread of distress across corporate boundaries of enterprise group members. These and other features and functions of cross-guarantees are discussed in the following paragraphs.

6.4 Functions of Cross-guarantees

6.4.1 "Protective" function of cross-guarantees

Cross-liability arrangements, such as intercompany guarantees, serve an important "protective function".[9] They provide additional security to a guaranteed creditor by granting him access to and recourse against asset pools of two or more companies ("double dip"). Laws of many jurisdictions, including the UK, the US and the Netherlands, allow a guaranteed creditor to claim full performance from both the principal debtor and the guarantor upon default of the former.[10] This way, the guaranteed creditor acquires protection against idiosyncratic shocks affecting the borrower.

Furthermore, a guaranteed creditor can also benefit when the main debtor (e.g. the issuer of bonds) lends money (e.g. proceeds of bond issuance) to another group entity acting as a guarantor. Both the main debtor and the

9 R. Squire, Limits to Group Structures and Asset Partitioning in Insolvency: Suppressing Value and Selective Perforation by Means of Guarantees, in The 800-Pound Gorilla. Limits to Group Structures and Asset Partitioning in Insolvency, NACIIL 2018 report, Eleven International Publishing, 2019, p. 13.

10 Dutch Bankruptcy Act, Article 136; InsO §43; Italian Bankruptcy Act, Article 61. The same holds true for US and English law. See R. Squire, Limits to Group Structures and Asset Partitioning in Insolvency: Suppressing Value and Selective Perforation by Means of Guarantees, in The 800-Pound Gorilla. Limits to Group Structures and Asset Partitioning in Insolvency, NACIIL 2018 report, Eleven International Publishing, 2019, p. 12, explaining that the "standard American rule is that a lender holding a guarantee can "prove" the full amount of his claim against both the borrower and the guarantor." *Ivanhoe Building & Loan Association v. Orr*, 295 US 243, 245 (1935), where the US Supreme Court held that a creditor did not need to deduct from his claim in bankruptcy an amount received from a non-debtor third party in partial satisfaction of an obligation. Also, *In re National Energy & Gas Transmission, Inc*, 492 F3d 297, 301 (4th Cir 2007); *In re F.W.D.C., Inc.*, 158 B.R. 523 (Bankr. S.D. Fla. 1993); *In re Johnson*, 477 B.R. 879 (M.D. Fla. 2012), confirming this approach. In English law, a guaranteed creditor is entitled to claim the full amount of outstanding debt from both the primary debtor and the guarantor. G. Andrews and R. Millett, Law of Guarantees, 4th edn, Sweet & Maxwell, 2005, p. 473, noting that the "creditor can maintain [proof in the insolvency of the surety] at the same time as a proof for the full amount from the principal and any co-sureties, provided that they are each liable for the whole debt and the creditor does not receive more than 100 pence in the pound."

guaranteed creditor have separate claims against the guarantor – one pursuant to the intra-group loan and the other under the guarantee. As a result, the guaranteed creditor benefits from the direct claim against the guarantor, as well as from the payments that the guarantor makes to the main debtor on the intercompany claim. This structure was established in the Oi Brazil case (and in the Lehman Brothers case), where the bondholders had claims against the Dutch SPVs, which acted as the issuers of bonds. They could also exercise their claims directly against the Brazilian parent company, acting as a guarantor, and indirectly via the claim on intra-group loans (see Figure 4 below).

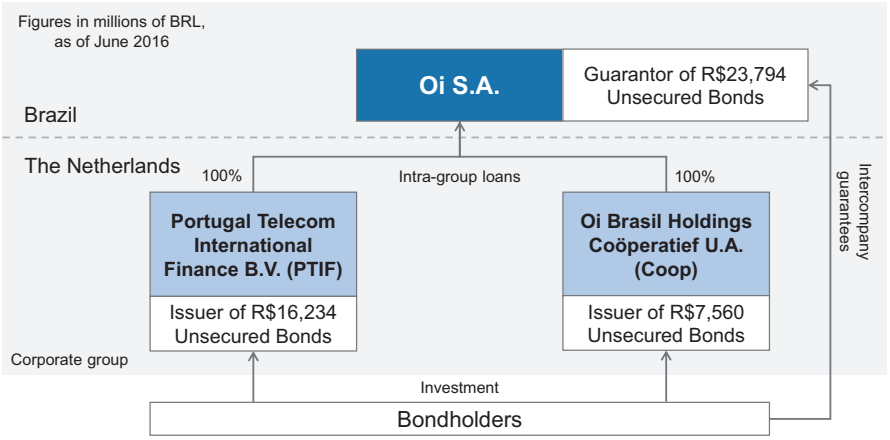

Figure 4. Oi Brazil's intra-group financing[11]

In addition to the described "double dip", a guaranteed creditor receives some protection from intra-group asset shifting or asset stripping – the transfer or taking-out of key assets from one group entity to another, which can enrich the shareholders but could be detrimental to the general body of creditors.[12] Asset stripping is a type of activity that creates what Jensen and Meckling refer to as the "agency cost of debt".[13] The agency cost of debt comprises: (i) monitoring costs, incurred by creditors to limit managerial misbehaviour (e.g. through covenants, their monitoring and enforcement),

11 This figure is based on R.J. Cooper, F.L. Cestero, J.W. Mosier, Oi S.A.: The Saga of Latin America's Largest Private Sector In-court Restructuring, Pratt's Journal of Bankruptcy Law, Vol. 14, 2018, p. 210.

12 A.W. Katz, An Economic Analysis of the Guarantee Contract, The University of Chicago Law Review, Vol. 66, 1999, pp. 73-74; H. Hansmann and R. Squire, External and Internal Asset Partitioning: Corporations and Their Subsidiaries, in J.N. Gordon and W-G. Ringe (eds), The Oxford Handbook of Corporate Law and Governance, OUP, 2018, p. 264.

13 M.C. Jensen, W.H. Meckling, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, Journal of Financial Economics, Vol. 3, 1976, p. 305.

(ii) bonding costs, incurred by the debtor to reassure creditors that he will not engage in value-destroying intra-group transfers, and (iii) costs of undeterred misconduct, arising in situation where the expected losses are borne by third parties, which may induce the debtor to overinvest.

Cross-guarantees reduce uncertainty for debtholders and therefore decrease the agency cost of debt. This reduction is attributed to their ability to curtail the negative effects of intra-group asset shifting, thereby lowering information and monitoring costs. The guaranteed creditor no longer needs to actively monitor the debtor and transactions it enters into with its affiliates-guarantors – related-party transactions, which are often particularly difficult to monitor.[14] After all, such a creditor is entitled to file a claim against the debtor and its affiliates, acting as guarantors. This additional security and cost reduction might offset anticipatory losses and lead to reduced costs of debt. A recent study analysed USD commercial and industrial loans with commitments of USD 1 million or more, issued by large bank holding companies in the USA. This study concluded that (i) over 42% of such corporate loans are guaranteed, meaning that there is recourse for full repayment of the credit obligation by a third party, (ii) guaranteed loans have lower bank estimated risk and perform better over time, and (iii) a guarantee provided by the borrower's parent or another group member generates a discount of about 9% of the cost of debt for an average borrowing company.[15]

In sum, intercompany guarantees can facilitate access to finance, improve credit supply, and be ex ante efficient for the debtor,[16] its shareholders and guaranteed creditors – typically banks and other fully or strongly adjusting creditors. However, the overall economic efficiency of intra-group guarantees is not undisputed.[17]

14 J. Dammann, Related Party Transactions and Intragroup Transactions, in L. Enriques and T.H. Tröger (eds), The Law and Finance of Related Party Transactions, CUP, 2019, p. 218, noting that "intragroup transactions frequently serve legitimate purposes. On the other hand, the frequency, volume, and depth of such transactions can make them particularly difficult to police."

15 M. Beyhaghi, Third-Party Credit Guarantees and the Cost of Debt: Evidence from Corporate Loans, Review of Finance, Vol. 26, 2022, pp. 287-317.

16 J. Armour et al., How do creditor rights matter for debt finance? A review of empirical evidence, in F. Dahan (ed), Research Handbook on Secured Financing of Commercial Transactions, Edward Elgar Publishing, 2015, pp. 3-25, more generally confirming that from an ex ante perspective, better protection of creditors' rights is associated with lower cost of credit and improved recoveries.

17 R. Squire, Strategic Liability in Corporate Groups, The University of Chicago Law Review, Vol. 78, 2011, p. 618.

6.4.2 "Opportunistic" function of cross-guarantees

While intercompany guarantees protect guaranteed creditors, they dilute the recoveries of non-guaranteed unsecured creditors.[18] This occurs because of the ability of a guaranteed creditor to submit his claim, often in the full amount, against the estates of multiple entities. These claims "compete" with the claims of creditors of those entities. Functionally, the guarantee selectively perforates the entity shields separating legal entities, effectively implementing contractual substantive consolidation for the sole benefit of the guaranteed creditor.[19] The ability of cross-guarantees to transfer value from the guarantor's pre-existing unsecured (non-guaranteed) creditors was termed by Squire as the "opportunistic" function of intragroup guarantees.[20] He argues that the perforation of the enterprise group's internal structure constitutes shareholder opportunism termed "correlation-seeking". In interconnected groups, the insolvency risks of group entities are highly correlated – they tend to thrive and fail together. Thus, in good times, cross-guarantees benefit shareholders by allowing their companies to borrow at lower interest rates, while in insolvency, the triggering of guarantees may have no impact on shareholders because their equity stake in guarantors is wiped out anyway.[21]

A part of the problem is that guarantees are opaque. Unlike some *in rem* security interests, *in personam* security rights are not subject to public registration as a precondition to their validity and effectiveness against third parties. This problem of opaqueness has been noted in academic literature,[22] but there are no generally accepted solutions to it. Usually, a creditor is unaware of the web of contractual arrangements that a debtor is

18 Ibid., p. 608.

19 W.H. Widen, Corporate Form and Substantive Consolidation, George Washington Law Review, Vol. 75, 2007, p. 265, noting that "intercompany guarantees create a type of substantive consolidation by contract." Arguably, as "contractual substantive consolidation" benefits only a guaranteed creditor, it is closer to a veil piercing.

20 R. Squire, Limits to Group Structures and Asset Partitioning in Insolvency: Suppressing Value and Selective Perforation by Means of Guarantees, in The 800-Pound Gorilla. Limits to Group Structures and Asset Partitioning in Insolvency, NACIIL 2018 report, Eleven International Publishing, 2019, p. 14.

21 R. Squire, Strategic Liability in the Corporate Group, The University of Chicago Law Review, Vol. 78, 2011, p. 607.

22 Ibid., p. 605, pointing out that the creation of subsidiaries and overuse of guarantees undermines transparency, complicates bankruptcy proceedings and introduces other distortions. See also J.L. Westbrook, Transparency in Corporate Groups, Brooklyn Journal of Corporate, Financial & Commercial Law, Vol. 13, 2018, p. 35, arguing for a regime "in which transparency is required with regard to the structure of a corporate group and the activities of each of its members" and suggesting the disclosure of intercompany guarantees, similar to that applicable to *in rem* security rights under Article 9 of the Uniform Commercial Code (UCC).

involved in. Even if he is, and even if the debtor agrees not to enter into any cross-liability arrangements (thus incurring bonding costs), creditor control over future transactions is problematic, and the monitoring costs might be excessively high, especially for unsophisticated creditors who lack the skills and incentives (e.g. due to the costs being higher than the expected benefits) to engage in it. In the end, these creditors are left in the dark and face the difficult task of calculating the risk of loss from the debtor's insolvency. Given the dilution of potential returns in insolvency, a creditor can either ask for *in rem* security or charge higher interest rates, ultimately increasing the agency cost of debt. However, these adjustments are unavailable if all or most of the debtor's assets are pledged or if the creditor cannot effectively negotiate the terms. This applies first and foremost to involuntary and poorly adjusting creditors.[23]

Another ex-ante effect attributed to cross-guarantees relates to the incentives of creditors to screen and monitor the debtor. Sophisticated lenders, who would otherwise keep track of the debtor's recordkeeping and major transactions, arguably lose impetus to do so because intra-group guarantees make them indifferent or less attentive to the issue of value allocation within the group.[24] Certainly, a guarantee does not make credit risk disappear; it simply shifts risk-monitoring to the guarantor.[25] This risk-shifting is efficient if the guarantor is a better risk bearer. This is likely not the case for group guarantors, as their ability to efficiently monitor the principal debtor is questionable due to the close bonds between such debtor and the guarantor in the group context. This is especially true for upstream guar-

23 Non-adjusting creditors are those creditors which do not adjust the size and terms of their claims to anticipate future developments and security interests encumbering borrower's assets. Among such creditors are tort creditors, tax and regulatory claims. Poorly-adjusting creditors are voluntary creditors with few incentives or possibilities to bargain for security, e.g. due to a small size of a claim or high transaction costs of negotiations. See L.A. Bebchuk and J.M. Fried, The Uneasy Case for the Priority of Secured Claims in Bankruptcy, The Yale Law Journal, Vol. 105, 1996, p. 864; L. Enriques and M. Gelter, How the Old World Encountered the New One: Regulatory Competition and Cooperation in European Corporate and Bankruptcy Law, Tulane Law Review, Vol. 81, 2007, p. 583.

24 H. Hansmann and R. Squire, External and Internal Asset Partitioning: Corporations and Their Subsidiaries, in J.N. Gordon and W-G. Ringe (eds), The Oxford Handbook of Corporate Law and Governance, OUP, 2018, p. 264, noting that intra-group guarantee leaves a guaranteed creditor largely indifferent to the division of assets between group entities. See also R. Squire, Strategic Liability in the Corporate Group, The University of Chicago Law Review, Vol. 78, 2011, p. 617, arguing that without intra-group guarantees "major lenders would pressure group managers to keep better records for each constituent entity, or to pare away extraneous subsidiary boundaries."

25 A.W. Katz, An Economic Analysis of the Guarantee Contract, The University of Chicago Law Review, Vol. 66, 1999, p. 59, observing that guarantees "help protect creditors against some of the risks of debtor misbehavior or insolvency by shifting those risks to guarantors."

antees, provided by subsidiaries with insufficient information on group performance (information asymmetry) or the ability to monitor and influence the parent company.[26] The resulting lack of efficient creditor oversight might contribute to managerial insulation. This is particularly problematic for enterprise groups with concentrated ownership, which might correlate with a higher risk of opportunistic behaviour by shareholders vis-à-vis creditors.[27]

In sum, the economic rationale of intercompany guarantees relates to risk mitigation. However, their ex ante effects on access to finance and corporate governance are not straightforward. It can be argued that they have a positive function, leading to the reduced agency cost of debt, lower interest rates, and generally advancing the group's ability to raise capital. That being said, the cost reduction is selective and concerns only guaranteed creditors, while the outcome for non-guaranteed unsecured creditors can be the opposite. This is because non-guaranteed creditors may have to incur monitoring costs and sustain potential dilution of recoveries in insolvency. Group guarantees could also influence the degree of creditor oversight, since the guaranteed creditor may be indifferent to intra-group transfers of assets, knowing that he has recourse against several or all group entities. This can worsen the moral hazard problem.

6.5 Insolvency and Triangle of Rights and Liabilities: Principal Debtor, Creditor and Guarantor

6.5.1 Cross-guarantees and insolvency: important questions

Imagine the following scenario. A group of companies consists of Company A (principal debtor and borrower) and Company B (guarantor). The creditor is the Bank that extends a credit line to Company A, with Company B guaranteeing its repayment.

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26 A. Jonkers, Insider guarantees in corporate finance: An economic analysis of Dutch, US and German law, PhD thesis, 2020, p. 267, noting that guarantees in corporate finance typically shift the risk "to inferior risk-bearers and inferior monitors, whereas the guaranteed creditors are often expert risk-bearers and expert monitors." A similar problem of the reduced incentives to monitor the debtor by sophisticated lenders has been emphasised with respect to the provision of collateral. See M. Manove, A.J. Padilla and M. Pagano, Collateral versus Project Screening: A Model of Lazy Banks, The RAND Journal of Economics, Vol. 32, 2001, pp. 726-744.

27 A. Gurrea-Martínez, Insolvency Law in Emerging Markets, Ibero-American Institute for Law and Finance, Working Paper 3/2020, 2020 <https://ssrn.com/abstract=3606395> (accessed 15 July 2023).

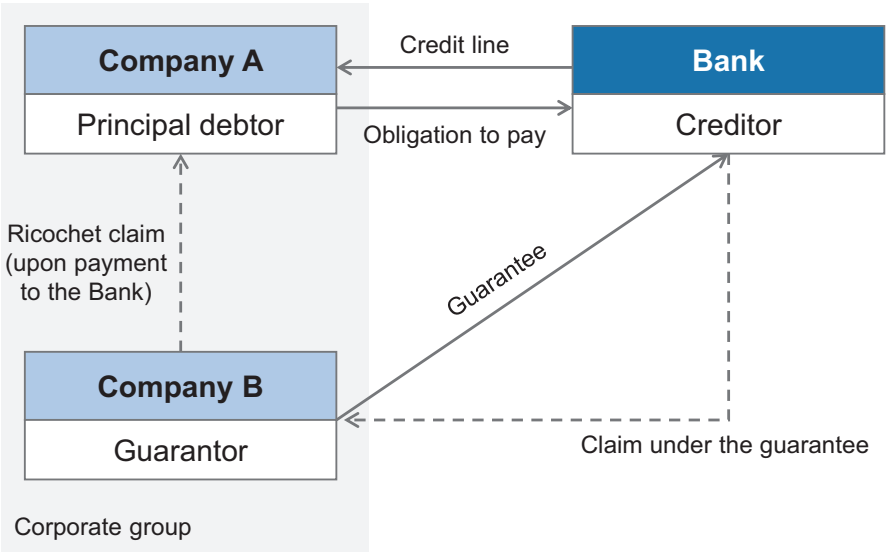

Figure 5. Triangle of rights and liabilities in group financing

Company A experiences financial distress and becomes insolvent or enters a restructuring proceeding, in which the claim of the Bank is significantly curtailed or is fully written down. In the triangle of rights and liabilities between the principal debtor, the guarantor and the creditor, the following questions arise:

(i) Does insolvency of Company A impact the claim of the Bank against Company B? Does the restructuring of the Bank's claim against Company A impact the claim of the Bank against Company B? In other words, can the Bank, despite Company A's insolvency or alteration or discharge of the Bank's claim against Company A in the restructuring proceedings, require performance from the guarantor and in what amount?

(ii) Can Company B, having performed its obligation to the Bank under the guarantee, file a "ricochet" (recourse) claim against Company A and in what amount? Here, the use of the terms "ricochet" and "recourse" is not meant to describe a particular legal qualification or relationship under which the claim arises (e.g. subrogation, indemnity). Instead, it describes a three-party situation in which there is liability for the same debt resting on two parties, and one of them (e.g. surety) has been legally compelled to pay. In these circumstances, upon the payment to the third party, the paying party may become entitled to recover from another party whose debt to the third party is discharged.[28]

28 On this three-party relationship, see C. Mitchell, The Law of Contribution and Reimbursement, OUP, 2013.

The following sections explore these questions with reference to the rules of national law, since the answers may differ depending on the law which governs the relations between the parties. As we dive into the specifics of national law and guarantee relationships, it will become clear that cross-guarantees could complicate group restructuring and impact long-term effectiveness of a restructuring plan.

6.5.2 Insolvency of the principal debtor and claim against a guarantor

6.5.2.1 The UK: co-extensiveness and discharge of guarantor's liability

There is a consensus among all three jurisdictions studied in this book that financial distress or insolvency of the principal debtor per se does not affect the creditor's rights against a guarantor. Thus, a creditor may lodge a proof in the debtor's insolvency proceedings for the full outstanding balance and simultaneously sue the guarantor and enforce his claim against it to the extent to which the creditor has not received payment from the debtor's estate and up to the limit for which the guarantor has engaged itself. This approach is taken in English law.[29] It is premised on the very purpose of a personal security right. It is precisely the insolvency of the principal debtor – a counterparty risk – that the guarantee seeks to provide a safety net against. Any other interpretation would undermine the protective function of the guarantee.

Insolvency of the principal debtor does not affect the liability of a guarantor. The question remains whether the discharge or alteration of debt in the proceedings concerning the principal debtor has any impact on the guarantor's liability. Under English law, generally, a discharge in bankruptcy of a debtor-individual does not affect the guarantor's liability. This expressly follows from the Insolvency Act 1986.[30] The same result is achieved if the principal debtor-entity is liquidated by reason of insolvency.[31] The rationale behind this position is that "the surety cannot complain of what is not the act of the creditor but […] an act arising by operation of law."[32] Insolvency of the principal debtor, therefore, falls within the risk assumed by the guarantor, unless otherwise agreed by the creditor with the guarantor.

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29 R. Goode and L. Gullifer, Goode and Gullifer on Legal Problems of Credit and Security, 6th edn, Sweet & Maxwell, 2017, para. 8-27. Note that lodging a proof of claim in insolvency proceedings may not always be needed, see e.g. Article 57 Fw.

30 Insolvency Act 1986, s. 281(7).

31 G. Moss, D. Marks, Rowlatt on Principal and Surety, 6th edn, Sweet & Maxwell, 2011, para. 12-05, clarifying that "[a]s in the case of bankruptcy, the liquidation or administration of a company will not release the surety for a company's obligations".

32 Ibid., para. 8-22.

However, what happens if the principal debtor enters into a company voluntary arrangement, a scheme of arrangement under Part 26, or a restructuring plan under Part 26A of the Companies Act? Goode points out that "it is a well-established principle of suretyship law that release of the principal debtor, an agreement not to sue him or a variation of the terms of the principal obligation discharges a surety unless the creditor reserves his rights against the surety either as a term of the guarantee or as a term of the release or other arrangement with the debtor."[33] This follows from the principle of co-extensiveness of the guarantor's liability.[34] The basis for the general rule that the release of the principal debtor, without more, discharges the guarantor is that the release of the principal debtor may interfere with the guarantor's right to sue the principal debtor for compensation.

The creditor and debtor should not be able to put the rights of the surety in danger. This is why it was held that in accepting the release subject to the reservation by the creditor of his rights against the surety, the principal debtor impliedly consents to the preservation of the surety's rights against the debtor, notwithstanding the release, so that the surety is not prejudiced.[35] Other arguments which support the discharge of the guarantor relate to the fact that: (i) the guarantor has agreed to be liable for a specific debt, and if that debt is released without the guarantor's consent, the justification for holding it liable for that same debt no longer holds, (ii) the function of a guarantee is usually to ensure the payment of a sum of money, but if that sum is no longer due, the basis of the surety's liability becomes unclear.

The release by a creditor of a surety who is jointly or jointly and severally liable can also lead to a discharge of co-sureties, unless remedies have been reserved against them.[36] The reason for this is that the release of a surety might prejudice the rights of contribution that co-sureties may be entitled to if the release were effective against co-sureties. In English law, the right of contribution is an independent right of a surety, based on the

33 K. van Zwieten, Goode on Principles of Corporate Insolvency Law, 5th edn, Sweet & Maxwell, 2018, para. 12-26. *Mahant Singh v. U Ba Yi* [1939] AC 601; *Perry v. National Provincial Bank of England* [1910] 1 Ch. 464, observing that "it is perfectly possible for a surety to contract with a creditor in the suretyship instrument that notwithstanding any composition, release, or arrangement the surety shall remain liable although the principal does not."

34 L. Smith, Security, in A. Burrows (ed), Principles of English Commercial Law, OUP, 2015, para. 8.174, noting that "the guarantor cannot be liable except to the extent that the primary debtor is liable." G. Andrews, R. Millett, Law of Guarantees, 6th edn, Sweet & Maxwell, 2011, para. 6-002, explaining that the co-extensiveness principle means that "as a general rule, the surety's liability is no greater and no less than that of the principal, in terms of amount, time for payment and the conditions under which the principal is liable."

35 *Greene King Plc v. Stanley* [2002] B.P.I.R. 491, at 80.

36 S. Whittaker, Suretyship, in Chitty on Contracts, 34th edn, Sweet & Maxwell, 2021, para. 47-122. If co-guarantors are only severally liable, the release of one of them does not discharges others fully, but only to the extent that they are prejudiced by such a release.

understanding that co-sureties have a common interest and a common burden.[37] Therefore, if the surety pays the principal debt, he should be able to claim contribution from co-sureties, because he discharged their obligations (common liability) to the creditor.[38] The idea is that since the suretyship creates a common burden that should be borne equitably by all co-sureties, no surety can be required, as between himself and co-sureties, to pay more than his due share.[39] In this regard, it is pointed out that "it is immaterial that the sureties are jointly, severally or jointly or severally liable, that they are bound by different instruments, or at different times, or that they know nothing of each other's existence as such, or that the first surety agreed to be bound before the co-surety was approached."[40]

Crucially, as the burden of paying a creditor should be ultimately borne by the principal debtor rather than (co-)sureties, "a surety who wishes to recover a contribution from a co-surety must join the principal debtor to his proceedings, or else prove that he is insolvent."[41] The purpose of this rule is to reduce the risk of multiplication of suits filed by co-sureties against the principal debtor – each for an indemnity for their ratable share.

If the creditor agrees to release the principal debtor from any liability by a valid agreement, the guarantor is discharged,[42] unless the guarantor agrees upfront that the primary obligation – or certain aspects of it – may be changed as between the principal debtor and the creditor without affecting the creditor's rights against the guarantor. Since a variation or release under a CVA is treated as consensual, it discharges the guarantor unless the guarantee provides otherwise (i.e. retaining the liability of the guarantor notwithstanding dealings between the creditor and the principal debtor).[43] In other words, a CVA is considered to be equivalent to a consen-

37 G. Andrews, R. Millett, Law of Guarantees, 4th edn, Sweet & Maxwell, 2011, para. 12-001; *Dering v. Winchelsea (Earl)* (1787) 1 Cox. Eq. Cas. 318.

38 *Ellesmere Brewery Co v. Cooper* [1896] 1 Q.B. 75. J.D. Heydon, M.J. Leeming and P.G. Turner (eds), Meagher, Gummow and Lehane's Equity Doctrines and Remedies, 5th edn, Chatswood: LexisNexis, 2015, paras. 10-040 to 10-045.

39 *Dering v. Winchelsea (Earl)* (1787) 1 Cox 318; 29 E.R. 1184; *Craythorne v. Swinburne* (1807) 14 Ves. Jun. 160 at 165; *Mahoney v. McManus* (1981) 180 C.L.R. 370 at 376; *Lavin v. Toppi* [2015] HCA 4; (2015) 254 C.L.R. 459 at 32-34.

40 G. Andrews, R. Millett, Law of Guarantees, 4th edn, Sweet & Maxwell, 2011, para. 12-001.

41 C. Mitchell, The Law of Contribution and Reimbursement, OUP, 2013, para. 5.29; *Hay v. Carter* [1935] Ch. 397, CA.

42 G. Andrews, R. Millett, Law of Guarantees, 7th edn, Sweet & Maxwell, 2015, para. 9-010.

43 *Johnson v. Davies* [1999] Ch. 117, considering the effects of an individual voluntary arrangement (IVA), made under Part VIII of the Insolvency Act 1986 and expressing the view that the general law, by which a composition or arrangement between a debtor and his creditors releases sureties, applies to an IVA. *Lombard Natwest Factors Limited v. Koutrouzas* [2002] EWHC 1084 (QB), [2003] BPIR 444 (surety was not released by an IVA of a co-surety when a guarantee expressly provided that it would not be affected by indulgence granted to a co-surety).

sual arrangement outside insolvency proceedings (workout). The case of schemes of arrangement under Part 26 and restructuring plans under Part 26A of the Companies Act 2006 is treated differently. For example, unlike CVAs, schemes of arrangement and Part 26A restructuring plans require the court sanction.[44] English courts confirm that schemes of arrangement operate to produce a discharge or variation of debtor's obligations *by operation of law* and not by virtue of an agreement between the parties, whether actual or deemed.[45] Therefore, a scheme does not discharge a guarantor or joint debtor.[46] The same applies to a Part 26A restructuring plan, as this procedure is intended to draw on practice and principles applied by courts in sanctioning schemes of arrangement.[47]

The fact that schemes of arrangement (and by analogy Part 26A plans) do not discharge the guarantor is also supported by cases in which courts approved schemes of arrangement with a third-party release, noting that in the absence of such a release, the pursuit of the guarantor by a creditor will undermine the compromise between the creditor and the debtor.[48] The same approach was taken where two companies were jointly liable as co-obligors for the same debt. Specifically, it was noted that without the release of co-obligors, they would be liable for the entire debt and may be entitled to claim a contribution from the scheme company, a form of ricochet claim discussed in the following sections of this chapter.[49] If there were a discharge of guarantors or co-debtors by operation of law, inclusion of a third-party release in schemes of arrangement would be superfluous.

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44 Companies Act 2006, Part 26, s. 899 and Part 26A, s. 901F.

45 *Oceanfill Ltd v. Nuffield Health Wellbeing Ltd & Anor* [2022] EWHC 2178 (Ch), at 25ff.

46 G. Moss, D. Marks, Rowlatt on Principal and Surety, 6th edn, Sweet & Maxwell, 2011, para. 8-22; K. van Zwieten, Goode on Principles of Corporate Insolvency Law, 5th edn, Sweet & Maxwell, 2018, para. 12-26. For authorities on the predecessors of s. 899 of the Companies Act, see *Re London Chartered Bank of Australia* [1893] 3 Ch. 540; *Dane v. Mortgage Insurance Corp Ltd* [1894] 1 Q.B. 54; *Re Garner's Motors Ltd* [1937] Ch. 594, at 599, observing that the "scheme when sanctioned by the court becomes something quite different from a mere agreement signed by the parties. It becomes a statutory scheme."

47 *Re Virgin Atlantic Airways Ltd* [2020] EWHC 2191 (Ch), at 17-18. Restructuring plans have not been widely used. Between 26 June 2020 and 30 June 2023, in England and Wales, 21 companies had a restructuring plan registered at Companies House. See Official Statistics. Monthly Insolvency Statistics, June 2023, released 18 July 2023.

48 *In the Matter of Swissport Fuelling Ltd* [2020] EWHC 1499 (Ch), at 44, pointing out that a "scheme may operate to release or modify the obligations of guarantors, as otherwise the creditors could claim against the guarantors, which would, in turn, be able to make what is called a ricochet claim against the borrower, thereby defeating the purpose of the scheme." That the scheme may be utilised to effect releases of guarantees is shown by cases such as *Re Noble Group Ltd* [2019] BCC 34 and *Re APCOA Parking Holdings GmbH* [2015] Bus LR 374.

49 *Re Lecta Paper UK Ltd* [2020] EWHC 382 (Ch).

6.5.2.2 *The USA: modification or release of primary obligation in and outside bankruptcy*

In the USA, the regulation of guarantees and suretyships has primarily evolved from common law. Additionally, all US states have enacted statutes that regulate this three-way contractual relationship, wherein one party (secondary obligor) agrees to be responsible to the creditor for an underlying obligation of another party (principal obligor).[50] While some of these statutes distinguish between suretyships and guarantees, others do not do so. The Uniform Commercial Code states that "surety" includes "a guarantor or other secondary obligor."[51] The Restatement of the Law (3rd) Suretyship and Guaranty (Restatement), influential authority in this area, observes that "[d]ifferences between these two mechanisms have been the subject of extended debate, not all of which is illuminating. A "surety" is typically jointly and severally liable with the principal obligor on an obligation to which they are both bound, while a "guarantor" typically contracts to fulfill an obligation upon the default of the principal obligor."[52] Given the lack of a uniform body of law on suretyships and guarantees and the fact that the same rules will often apply, whether a transaction is treated as a suretyship or a guarantee, technical differences are left out.[53] Instead, as before, we focus on the interplay between a guarantee and bankruptcy. The latter is regulated at the federal level.

Most US states follow the common law approach, allowing the creditor to choose whether to first sue the principal debtor, the surety, or both of them simultaneously.[54] In other words, upon the default of the principal debtor, the creditor does not have to file a claim against that debtor before turning to the surety. This rule applies to both suretyship and "guarantee of payment". Yet if the guarantee is a "guarantee of collection", the guarantor only incurs liability if the creditor has been unable to collect from the principal debtor using reasonable diligence.[55] In practice, guarantees of collection

50 C. Henkel, Personal Guarantees and Sureties between Commercial Law and Consumers in the United States, American Journal of Comparative Law, Vol. 62, 2014, p. 334.

51 UCC, § 1-201(b)(39).

52 Restatement 3d, Suretyship and Guaranty, § 1; F.S.H. Bae and M.E. McGrath, Rights of a Surety (or Secondary Obligor) under the Restatement of the Law, Third, Suretyship and Guaranty, Banking Law Journal, Vol. 122, 2005, p. 786, noting that "there is considerable dispute about the distinction between a surety and a guaranty" and pointing out that "the variations of statutory definitions among the jurisdictions do not generally affect the substantive law or the outcome of cases."

53 For discussion of differences and similarities between a guarantee and suretyship, see T. Eisenberg (ed), Debtor-Creditor Law, Matthew Bender & Company, Inc., 2022, § 44.03.

54 Ibid., § 45.07.

55 See *Chahadeh v. Jacinto Med. Group, P.A.*, 519 S.W.3d 242, 246 (Tex. App. 2017), noting that a "guaranty of collection is an undertaking of the guarantor to pay if the debt cannot be collected from the primary obligor by the use of reasonable diligence, and requires the lender to pursue the principal debtor before collecting."

are rarely used, and group guarantees are almost always unconditional "guarantees of payment".[56] If the performance of an underlying obligation is secured by collateral, the creditor may be required to proceed against the collateral first, provided that doing so does not cause any substantial injury.[57] However, if there are several secondary obligors, such as co-sureties, a creditor may proceed against any of them regardless of their relative rights, as long as the creditor does not receive double recovery.[58]

It is not uncommon for the principal debtor to enter into a settlement with a creditor. Sections 39-41 of the Restatement address the effects of a release, extension, and modification of an underlying obligation.[59] As a general rule, the "release, extension, or modification discharges the secondary obligor from its duties pursuant to the secondary obligation either completely or to the extent that the obligee's [creditor's] act would otherwise cause the secondary obligor a loss."[60] If the *modification* of an underlying obligation is material, affecting the nature, meaning, or legal effect of this obligation, and if it prejudices the surety, such surety is discharged, unless it consents to the material change.[61] The material change should impose risks on the surety fundamentally different from those imposed prior to it. If the change is not material, the surety is not discharged, but its obligation is reduced to the extent of loss due to the modification (*pro tanto*).[62] It is observed that "whether a change has been made that will discharge a surety is a question of fact, and subtle factual distinctions can lead to apparently inconsistent results."[63]

The preceding paragraph tackled the modification of an underlying obligation. Let us now turn to a *voluntary release*. Whenever a creditor releases a principal debtor, a surety is discharged. As in English law, this is based

56 A.J. Casey, The New Corporate Web: Tailored Entity Partitions and Creditors' Selective Enforcement, The Yale Law Journal, Vol. 124, 2015, p. 2680.

57 C. Henkel, Personal Guarantees and Sureties between Commercial Law and Consumers in the United States, American Journal of Comparative Law, Vol. 62, 2014, p. 352.

58 P.A. Alces, The Law of Suretyship and Guarantee, Thomson Reuters, 2021, § 5:4; Restatement 3d, Suretyship and Guaranty, § 53, comment a.

59 Restatement 3d, Suretyship and Guaranty, §§ 39-41.

60 Restatement 3d, Suretyship and Guaranty, Introductory Note to §§ 39-41. For a similar rule, see UCC, §3-605(c).

61 *Autumn Manor, Inc. v. Jones*, No. 03-4083-SAC (D. Kan. Aug. 19, 2003); *Frost Nat'l Bank v. Burge*, 29 S.W.3d 580 (Tex. App. 2000). Note that in some US states, absent consent of a surety, any change in the principal's duties that increases such duties will discharge the surety. See e.g. Cal. Civ. Code § 2819; Ga, Code § 10-7-21.

62 *National Sur. Corp. v. United States*, 118 F.3d 1542 (Fed. Cir. 1997). The rule of *pro tanto* discharge is followed in § 3-606 UCC.

63 T. Eisenberg (ed), Debtor-Creditor Law, Matthew Bender & Company, Inc., 2022, § 45.06.

on the co-extensive or accessory nature of the surety's obligation.[64] The discharge occurs unless either of the following conditions is met. First, the terms of the release preserve the surety's right of recourse against the principal debtor. If this is the case, the release does not prejudice the surety, because it maintains the reimbursement right. Second, the language or circumstances of the release confirm the creditor's intent to retain the claim against the surety.[65] "Reservation of rights" clauses are common in practice. However, a surety is nevertheless discharged to the extent it would otherwise suffer a loss due to the release.[66]

A guarantor who performs after the release of an underlying obligation generally has no recourse against the principal debtor. This is because the release of an underlying obligation discharges not only the duty of the principal debtor to the guaranteed creditor but also the duties of performance and reimbursement owed to the guarantor. Notably, the guarantor also does not acquire subrogation rights. As a consequence of this lack of recourse, the guarantor could suffer a loss to the extent that, in the absence of the release, there would have been recovery from the principal debtor. To prevent unfair outcomes, the guarantor is discharged to the extent necessary to avoid such loss.[67]

The same logic applies to the release of a co-surety or co-guarantor. State law typically provides for a right of contribution between co-sureties or co-guarantors based on a theory of implied contract. Hence, when two or more persons guarantee the debt of another, they simultaneously enter into "an implied promise on the part of each to contribute his share if necessary to meet the common obligation."[68] Co-sureties are treated as though they agreed among themselves to share the cost of their performance. Pursuant to the Restatement, a co-surety is entitled to a contribution if he pays more than his contributive share, since as "between cosureties for the same underlying obligation, each cosurety is a principal obligor to the extent of its contributive share […] and a secondary obligor as to the remainder of its

64 On this point, suretyship should be distinguished from a standby letter of credit, which creates an independent, primary obligation. P.A. Alces, The Law of Suretyship and Guarantee, Thomson Reuters, 2021, § 2.8, observing that "assurance of payment on demand, without condition, is the distinguishing feature of the standby credit." J.F. Dolan, Standby Letters of Credit and Fraud (Is the Standby Only Another Invention of the Goldsmiths in Lombard Street?), Cardozo Law Review, Vol. 7, 1985, pp. 1-45.

65 Restatement 3d, Suretyship and Guaranty, § 39(b).

66 Ibid., § 39(c)(ii).

67 Ibid., § 39, comm. f. Arguably, if the principal debtor has no assets and the recovery on the recourse claim would not lead to any payment to the guarantor, there is no loss and no discharge.

68 *Waters v. Waters*, 148 A. 326, 327 (Conn. 1930); *Lestorti v. DeLeo*, 4 A.3d 269, 275, 298 Conn. 466, 473 (Conn., 2010).

duty pursuant to its secondary obligation."[69] A right of contribution therefore arises if a surety pays in excess of the share which, as between itself and co-sureties, it ought to bear.[70] In principle, if a surety is released by an act of a creditor from its obligation, which affects the right of contribution of a co-surety, this co-surety is discharged.[71]

In sum, applying US law may lead to a similar outcome as achieved under English law. Both legal systems aim to protect the surety in the understanding that the creditor and principal debtor should not be able to put the rights of a surety in danger or to place the ultimate burden solely on the surety or one of the co-sureties. It is important to stress that in practice, the effect in the form of a discharge is often prevented or waived in a guarantee agreement.[72]

This brings us to the bankruptcy scenario. As previously noted, US law permits a guaranteed creditor to sue the principal debtor and guarantor(s) simultaneously. If they are insolvent, the creditor can assert the entire claim (as it existed on the petition date) against the estates of each obligor and recover in each proceeding on the basis of the entire amount, provided that this creditor does not collect more, in total, than the amount owed to him. Until the creditor's claim has been fully satisfied, it does not need to be reduced to reflect any partial distributions in the insolvency proceedings.[73]

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69 Restatement 3d, Suretyship and Guaranty, § 55.

70 Restatement 3d, Suretyship and Guaranty, § 57(1) ("Subject to subsection (2) and to any express or implied agreement between or among the cosureties, a cosurety's contributive share is the aggregate liability of the cosureties to the obligee divided by the number of cosureties").

71 See Restatement 3d, Suretyship and Guaranty, § 54, providing the following illustration: "To induce C to lend D $ 10,000, S[1] and S[2] guarantee D's obligation to repay the loan under circumstances such that S[1] and S[2] are cosureties with equal contributive shares. D defaults on the loan and has no assets. In exchange for $ 500, C releases S[1], who is solvent, from its guaranty and pursues S[2]. Pursuant to § 39, the release of S[1]'s duty to C also releases S[1]'s corresponding duty to S[2] and, accordingly, reduces the amount S[2] could recover from S[1] from $ 4,500 (the remainder of S[1]'s contributive share) to $ 0. Therefore, S[2] is discharged to the extent of $ 4,500 from the remaining $ 9,500 owed to C."

72 B.D. Hulse, After the Guarantor Pays: The Uncertain Equitable Doctrines of Reimbursement, Contribution, and Subrogation, Real Property, Trust and Estate Law Journal, Vol. 51, 2016, p. 51; F.S.H. Bae, M.E. McGrath, Rights of a Surety (or Secondary Obligor) under the Restatement of the Law, Third, Suretyship and Guaranty, Banking Law Journal, Vol. 122, 2005, p. 807, observing that it is common practice for a contract between a surety and a creditor "to be chock full of waivers inserted by the obligee's [creditor's] attorney."

73 B.E. Greer, J.S. Moss and N.B. Herther-Spiro, Guarantees in Bankruptcy: A Primer II, Norton Annual Survey of Bankruptcy Law, 2014 edn, p. 180. *Bd. of Comm'rs v. Hurley,* 169 F. 92, 97 (8th Cir.1909); *Reconstruction Fin. Corp. v. Denver & Rio Grande W. R.R. Co.*, 328 U.S. 495, 529 (1946); *In re Nat'l Energy & Gas Transmission, Inc.*, 492 F.3d 297, 301 (4th Cir.2007).

The question remains whether the bankruptcy discharge of the principal debtor also discharges the surety. When answering this question, we should keep in mind that one of the primary reasons for a creditor to seek a personal security right, such as a guarantee, is to protect itself in case the principal debtor becomes bankrupt and receives a discharge in a bankruptcy proceeding.[74] The US Bankruptcy Code stipulates that the discharge of the debtor's debt does not affect the liability of any other entity on, or the property of any other entity for, such debt.[75] This is logical since the bankruptcy discharge does not extinguish or cancel the debt but merely releases the debtor from personal liability.[76] Therefore, a bankruptcy discharge, including Chapter 11 discharge, does not affect the liability of a co-debtor or surety for the discharged debt unless the plan provides for a release of third parties. Consequently, a surety remains liable for the original debt and not for the partly discharged debt; and Chapter 11 confirmation does not bar litigation against third parties for the remaining amount. One court has explicitly stated that extending "the rule of equivalent liability [liability of a surety equals liability of the bankrupt principal debtor] into the bankruptcy context would destroy the value of a guarantee."[77]

To conclude, the discharge of debt through a bankruptcy route, as opposed to a settlement outside bankruptcy (i.e. workout), does not impact the obligations of persons secondarily liable inasmuch as such a discharge is effected by operation of law.[78] This argument should be familiar to the reader, as it was previously mentioned in relation to English schemes of arrangement and restructuring plans.

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74 Restatement 3d, Suretyship and Guaranty, § 34, comm. b. The term "personal security right" is not common in the USA. The terms "guarantee" and "suretyship" are used instead. In the USA, "security interest" usually refers to a form of collateral (i.e. *in rem* security right). In the UK, the term "security" has traditionally been used to describe rights over assets. Yet these days it can refer to both "proprietary" or "real" security and "personal" security. See R. Goode, L. Gullifer, Goode and Gullifer on Legal Problems of Credit and Security, 6th edn, Sweet & Maxwell, 2017, para. 1-06, noting that real security means "security in an assets, whether of the debtor or of a third party" and that real security "is to be contrasted with personal security, that is, security in the form of a personal undertaking which reinforces the debtor's primary undertaking to give payment or other performance."

75 11 US Code § 524(e).

76 *In re Hepburn*, 27 B.R. 135 (Bankr. E.D.N.Y. 1983); *In re Lembke*, 93 B.R. 701, 702 (Bankr. D.N.D.1988).

77 *In re Gentry*, 807 F.3d 1222, 1227 (10th Cir. 2015).

78 *NCNB Texas Nat. Bank v. Johnson*, 11 F.3d 1260, 1266 (5th Cir. 1994), noting that "[r]eorganization proceedings are judicial, not contractual, even where a secured creditor voluntarily participates." *Citizens Bank of Pennsylvania v. Fine Cap. Assocs.*, 2014 WL 10558250 (Pa. Super. Ct. 2014); *In re Arrowmill Dev. Corp.*, 211 B.R. 497, 506 (Bankr. D.N.J. 1997).

6.5.2.3 The Netherlands: suretyship, draagplicht and 403-statements

6.5.2.3.1 Insolvency and rights against third parties

Insolvency of the principal debtor or the adoption of a restructuring plan (*dwangakkoord*) in bankruptcy under the Dutch Bankruptcy Act does not affect creditor rights against third parties, such as sureties.[79] Furthermore, if the creditor is protected by both *in rem* (e.g. mortgage, pledge) and a personal security right (i.e. suretyship), it is generally up to the creditor to choose whether to enforce his right of pledge or mortgage or to call upon the surety.[80]

First, the above rules reflect the nature and economic function of suretyship and solidarity relationships, which serve to safeguard a creditor against the consequences of insolvency or default of the principal debtor or one of the co-debtors. Should the liberating effect of insolvency be extended to a surety, suretyship (being a personal security right) would lose its protective function at the time when it is most needed.[81] Second, Dutch law is based on the recognition that a plan (*dwangakkoord*) adopted under the Dutch Bankruptcy Act is accepted by creditors not to relinquish their rights or to make a gift, but to obtain as much as possible under the given circumstances.[82] For this reason too, sureties and co-debtors cannot invoke the plan for their release. The same rule applies, in principle, to WHOA schemes.[83] Therefore, sureties and co-debtors cannot invoke a WHOA scheme as a ground for the

79 Dutch Bankruptcy Act, Article 160. A surety is a party that has committed itself to one or more creditors to fulfil the obligations of the principal debtor towards such creditors. See Article 7:850 BW. Suretyship is a form of joint and several liability. For this reason, Article 7:850(3) BW stipulates that the provisions regarding joint and several liability apply to suretyship, insofar as this title (that is, Title 14 of Book 7 BW) does not deviate from them.

80 HR 24 April 1992, *NJ* 1992/463 (*Heidenreich/Alcredis Bank NV*) and Conclusie AG Hartkamp, nr. 6. However, if a creditor's claim is secured, it may be contrary to the standards of reasonableness and fairness if the creditor first sues the surety before attempting to enforce security rights. Therefore, in certain circumstances, a creditor may be required to first enforce his other security rights before calling on the surety. Asser/Van Schaick 7-VIII 2018/84. Also under Article 3:234(1) BW, "[i]f both the debtor's and third party's property has been pledged or mortgaged for the same claim, the third party may, when the creditor proceeds to foreclosure, demand that the debtor's assets be included in the sale and that they be sold first." A surety lacks such legal privilege of enforcement. G.J.L. Bergervoet, Borgtocht (O&R nr. 84) 2014, 6.2.2.

81 MvT, Bijlagen Handelingen II 1890/91, 100, 3, p. 61; Kortmann/Faber, Geschiedenis van de Faillissementswet, heruitgave Van der Feltz, II, Wolters Kluwer, 2016, p. 189.

82 Ibid. Note that the adoption of plans (*dwangakkoord*) in bankruptcy is rather rare in practice. In 2015, only 1.7% of declared bankruptcy cases ended by means of a plan. CBS, Faillissementen, oorzaken en schulden 2015, p. 18.

83 Dutch Bankruptcy Act, Article 370(2), stating that Article 160 applies *mutatis mutandis*, unless a plan restructures group guarantees under Article 372(1). The provision prevents guarantees from being discharged after the plan has been approved. MvT, *Kamerstukken II* 2018/19, 35249, 3, p. 35.

discharge of their obligations,[84] unless the scheme includes a third-party release (see Chapter 10). The general rule is that a surety remains liable for the payment of the original claim, in the manner stipulated and at the time agreed before the WHOA scheme has been confirmed. This outcome is not contrary to the accessory character of the surety's liability (similar to the English law principle of co-extensiveness). The principal debtor remains liable notwithstanding the plan or scheme. Only enforceability of his obligations is affected. The residual claim continues to exist in the form of a natural obligation, regardless of whether this is stipulated in a plan and whether the debtor can pay the residual claim.[85]

However, similar to the approach of US law to non-bankruptcy settlements and English law to the effects of company and individual voluntary arrangements (CVAs and IVAs), under Dutch law, the outcome is different for out-of-court agreements or workouts. Pursuant to Article 6:160 BW, an obligation ceases to exist when the debtor and creditor enter into an agreement with each other in which the creditor waives his right to performance. In view of the dependent, accessory nature of suretyship, the cancellation or release of the main obligation in principle leads to the cancellation or discharge of the secondary obligation under the guarantee. This follows directly from Articles 6:160, 3:82 and 3:7 BW. In workouts, to which the ordinary rules of contract law apply, a creditor is free to accept the composition offered by the debtor. This is why a voluntary out-of-court agreement releasing the principal debtor, discharges the surety.[86]

6.5.2.3.2 Liability and contribution claims of co-sureties

As opposed to English and US law, under Dutch law, the release of one of the sureties by the creditor may have no effect on the liability of co-sureties. The reason for this is quite complicated and specific to Dutch law. It has to do with the fact that under Dutch law, the obligations of co-debtors (including co-sureties), while being joint and several to the creditor, are not necessarily interdependent (*afhankelijk*) as between each other.[87]

Let us first consider the case where the principal debtor is not insolvent, as insolvency affects and creates rights of a surety against other co-sureties (see below). The difference with English and US law arises from the fact that under Dutch law, sureties may have no claim for contribution from

84 Asser/Van Schaick 7-VIII 2018/93.

85 HR 31 January 1992, ECLI:NL:HR:1992:ZC0492, *NJ* 1992/686, m.nt. P. van Schilfgaarde (*Van der Hoeven / Comtu*).

86 Hof Leeuwarden 7 April 2009, ECLI:NL:GHLEE:2009:BI2399, *JOR* 2009/302, refusing to apply Article 160 Fw *mutatis mutandis* to an out-of-court agreement. The court noted that for a judicial composition (*akkoord*), the unpaid part of a claim is usually treated as a natural obligation (HR 31 January 1992, *NJ* 1992/686), whereas in the event of an out-of-court agreement, this is not the case.

87 W.H. van Boom, Hoofdelijke verbintenissen. W.E.J. Tjeenk Willink, 1999, p. 133.

co-sureties. This follows from the construction of Articles 6:10 and 6:12 BW, which provide for a right to contribution (*bijdragen*) only from co-debtors that are *draagplichtig*, which is the case where the debt concerns co-debtors (co-sureties) internally. One example of this is when two persons, acting as co-obligors, buy a car for their common use (i.e. common benefit).[88] If the co-debtors are *draagplichtig*, a contribution claim of each individual debtor is limited to the amount that they owe in their internal relationship, their internal share.[89] This can be compared to a "contributive share" mentioned in the previous section on US law. In other words, the paying debtor can only sue other debtors for the amount for which the debt concerns each of them internally. Whether and to what extent there is a right to contribution from co-debtors thus depends on their internal burden-sharing, a mutual internal relationship, as distinguished from an external relationship, a relationship with the creditor.[90] If such an internal relationship is not present (and there is no general presumption of its existence in law), no right to contribution arises. This is the key difference with English and US law.

In a standard (non-group) situation, co-sureties are not considered *draagplichtig* because the debt does not concern them internally.[91] As a result, Articles 6:10 and 6:12 BW would not entitle them to claim contribution from one another. In practice, however, it might be difficult to ascertain whether there is an internal relationship that gives rise to a contribution claim between co-sureties. The first step is to check whether the parties may have expressly agreed on an internal obligation to contribute (*draagplichtovereenkomst*).[92] Particular problems arise in a group financing context, where several group members benefit, directly and/or indirectly, in their internal relationships.

Imagine a typical case where one entity within the group acts as a borrower and other group entities provide guarantees, subsequently benefitting from the loan via intra-group loans (e.g. the cases of Lehman Brothers and Oi Brazil). Based on the facts of the case, it is possible to argue that there is an obligation to contribute between group entities acting as joint and severally liable debtors to the extent or in the share that each of them benefited from group financing. For example, this could be determined by looking at which group entity used the borrowed money or at whose disposal the loan was made – a cash-flow based test. This conclusion follows from *Janssen/*

88 Asser/Sieburgh 6-I 2020/122.

89 Dutch Civil Code, Article 6:10(2). G.J.L. Bergervoet, Borgtocht (Onderneming en recht nr. 84), Deventer: Kluwer 2014, 3.2.6.

90 J. den Hoed, GS Verbintenissenrecht, commentaar op art. 6:10 BW.

91 Asser/Sieburgh 6-I 2020/122.

92 C.H.A. van Oostrum, Regres bij concernfinanciering (Serie Van der Heijden Instituut nr. 156) (diss. Leiden), Deventer: Wolters Kluwer 2019, 7.2.1.0, noting that these agreements are uncommon and arguing that even when they exist, they may not necessarily reflect the actual relations between the parties at the relevant time.

JVS Beheer.[93] Arguably, in an integrated corporate group, it is difficult to unravel financial flows between group entities to determine which specific entity derived profit and in what amount – an important step that needs to be undertaken to calculate an internal share.[94] Therefore, the existence and scope of contribution claims between group companies may be somewhat uncertain. In a more recent decision, the Dutch Supreme Court clarified that in a group context, when deciding on the internal obligation to contribute between group members, the court may also consider direct and indirect benefits of financing for the group members.[95] Hence, indirect benefits and other relevant circumstances can be part of judicial assessment. This is a step forward in the legal development. Yet it does not offer much guidance to courts regarding specific facts or patters which can assist them in carrying out such an assessment.

Outside insolvency, co-sureties and other jointly and severally liable debtors who are not liable in their internal relationship (*niet draagplichtig*), do not have to share their burden with each other.[96] This is different from English law, where co-suretyship creates a common burden that needs to be borne equitably by all co-sureties.

The situation is very different when the joint and several debtor, not liable in its internal relationship with other co-debtors, cannot recover from the principal debtor or from co-debtors with an internal obligation to contribute. This situation arises if the principal debtor is insolvent and cannot fully satisfy the surety's claim.[97] In a situation like this, Dutch law confers the right to contribution on a paying debtor against its co-debtors (Article 6:13(2) BW), and on a paying surety against co-sureties (Article 7:869 BW), even if these co-debtors and co-sureties are not internally liable.[98] The loss is

93 HR 13 July 2012, ECLI:NL:HR:2012:BW4206, *NJ* 2012/447 (*Janssen q.q./JVS Beheer*). The alternative approach argues that, in the absence of a *draagplichtovereenkomst*, the starting point should be that group entities are internally liable in equal parts, under the principle of *solidariteit*. See H.P.J. Ophof, Hoofdelijke aansprakelijkheid: solidariteit of apartheid? (Inaugurele rede Vrije Universiteit Amsterdam), Deventer: Kluwer 1987, p. 10-13. However, following *Janssen q.q./JVS Beheer*, the point of departure is different, namely the determination of which entity has used or had access to the line of credit.

94 S.M. Bartman, annotatie bij HR 13 juli 2012, ECLI:NL:HR:2012:BW4206, Ars Aequi 2012, p. 833 (*Janssen q.q./JVS Beheer*).

95 HR 24 February 2023, ECLI:NL:HR:2023:295, r.o. 3.5.

96 Asser/Sieburgh 6-I 2020/122.

97 If there are two or more joint and several debtors (co-debtors), and if the suretyship covers both their debts, the surety can claim contribution from each of them in full, and not only the part of the debt that concerns each debtor, irrespective of debtors' internal relationships (Article 7:866(3) BW). This is an explicit derogation from Article 6:10 BW, pursuant to which a joint and several debtor can only hold other debtors liable for the part of the debt that each debtor had to bear in their internal relationship.

98 For the analysis of the rules on joint and several liability and rules applicable to suretyship, see C.J.M. Klaassen, Hoofdelijkheid ofborgtocht, wat zal het wezen? WPNR 1998/6316, p. 347-351.

shared among them in proportion to the amounts for which they could have been held liable by the creditor.[99] The right of contribution under Articles 6:13(2) and 7:869 BW has a subsidiary character.[100] As a result, in practice, if the principal debtor is insolvent, cannot be traced, or if his assets cannot be recovered to satisfy the recourse claim for any other reason, Dutch law might not be that different from English or US law. As the right of contribution arises only if the debt cannot be recovered from *draagplichtige* debtor(s), a surety can be effectively forced to first go against this debtor(s), and only then seek recovery from non-*draagplichtige* co-sureties. To conclude this section, ultimately each surety bears the risk of the principal debtor's insolvency, although the risk exposure may be limited by the scope or amount for which the surety has been provided.

6.5.2.3.3 Intra-group liability and 403-statements

The discussion of intra-group liability arrangements in Dutch law would be incomplete without covering intra-group liability arising from a 403-statement (*403-verklaring*). Pursuant to Article 2:403 BW,[101] a group entity may be exempted from an obligation to prepare and publish annual accounts. There may be various reasons to opt for this special regime. It reduces the regulatory burden within the group and prevents competitors from becoming aware of the financial results and capital positions of individual group entities.[102]

However, there are a number of requirements. For example, information normally included in annual accounts (e.g. assets, liabilities, income, expenses) must be consolidated in the annual accounts of the group company, typically a parent company.[103] Crucially, this company shall declare in writing that it makes itself jointly and severally liable for debts arising from legal acts of other group entities, typically subsidiaries, whose accounts are being consolidated.[104] The statement to this effect, a 403-statement, should be deposited at the Chamber of Commerce (*handelsregister*).[105] The joint

99 Asser/Sieburgh 6-II 2021/287.

100 Asser/Van Schaick 7-VIII 2018/124.

101 This arrangement follows the Fourth Council Directive 78/660/EEC of 25 July 1978 based on Article 54 (3) (g) of the Treaty on the annual accounts of certain types of companies (Article 57), repealed by the Directive 2013/34/EU of 26 June 2013 on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings (Article 37).

102 Asser/Maeijer & Kroeze 2-I* 2015/581; J. van der Kraan, Toepassing en rechtskarakter van de groepsvrijstelling van artikel 2:403 BW (Serie Van der Heijden Instituut nr. 171), Deventer: Wolters Kluwer 2022.

103 Dutch Civil Code, Article 2:403(1)(c).

104 Dutch Civil Code, Article 2:403(1)(f). The requirement that liability must arise from legal acts (*rechtshandelingen*) excludes from the scope of 403-statement liability in tort. E.D.G. Kiersch, in: T&C Burgerlijk Wetboek, commentaar op art. 2:403 BW.

105 Dutch Civil Code, Article 2:403(1)(g).

and several liability is solely based on the 403-statement.[106] The purpose of this statement is to give protection to creditors of a group entity (e.g. a subsidiary) since such creditors – as a result of the exemption under Article 2:403 BW – cannot base their decision on whether or not to contract with the subsidiary on its annual accounts. The economic effect of a 403-statement is similar to a parent company guaranteeing debts of its subsidiaries. If the subsidiary does not pay, its creditors can go against the parent company. However, while a guarantee is commonly addressed to a specific creditor, a 403-statement is a unilateral legal act (not a contractual relationship), not addressed to any specific party, on the basis of which direct liability of the (parent) company arises.[107]

The BW does not establish specific content or consequences of a 403-claim. For example, if the claim of the creditor against the subsidiary is privileged, should it also have priority when filed against the parent? The Dutch Supreme Court clarified in this respect that any privileges attached to the original claim do not pass to the claim based on a 403-statement.[108] The court reasoned that the privileges could only arise from the law (Article 3:278(2) BW) and that neither Article 2:403 nor any other statutory provision attached a privilege to the claim based on a 403-statement. In another case, the court ruled that the subordinated status of a claim against the subsidiary did not lead to the subordination of a 403-statement-based claim against the parent company.[109] It stated that contractual subordination (Article 3:277(2) BW) was not a property of the obligation itself but constituted a deviation from the main (*pari passu*) rule, as applied to recovery from assets of a debtor that agreed to such subordination.[110] Thus, a subordination clause in the agreement between a creditor and a subsidiary has no influence on that creditor's recovery from assets of a third party (parent) that is jointly and severally liable for the obligation by virtue of a 403-statement and that is not a party to the subordination clause.

106 HR 28 June 2002, ECLI:NL:HR:2002:AE4663, *NJ* 2002/447, m.nt. J.M.M. Maeijer; *JOR* 2002/136, m.nt. S.M. Bartman (*Akzo Nobel/ING*).

107 There are other key differences between joint and several liability arising from a guarantee and a 403-statement, inter alia, regarding the consequences of a voluntary release. As noted above, a voluntary release of the principal debtor typically discharges the surety. In contrast, the release by the creditor of the subsidiary does not necessarily lead to a discharge of the parent company, liable under a 403-statement. This follows from the fact that a unilateral declaration of joint and several liability under a 403-statement does not create a dependent right in the sense of Articles 3:7 and 3:82 BW. HR 28 June 2002, ECLI:NL:HR:2002:AE4663, *NJ* 2002/447, m.nt. J.M.M. Maeijer (*Akzo Nobel/ING*).

108 HR 11 April 2014, ECLI:NL:HR:2014:898 (*X / Curatoren Econcern N.V.*) and ECLI:NL:HR:HR:2014:904 (*UWV / Curatoren Econcern N.V.*).

109 HR 20 March 2015, ECLI:NL:HR:2015:661, *NJ* 2015/361, m.nt. J.W. Winter en P. van Schilfgaarde (*Minister van Financiën / Vereniging VEB NCVB, Stichting Beheer SNS Reaal e.a.*).

110 Ibid., r.o. 4.34.4.

Liability under a 403-statement is different from a suretyship agreement when it comes to its withdrawal. The law provides that a 403-statement can be withdrawn by filing a statement to that effect with the *handelsregister*.[111] No liability can arise for legal acts after the day on which the revocation statement is filed, or from a later date if specified in the revocation statement. Nevertheless, the parent company remains liable for debts derived from legal acts predating the revocation.[112] This residual liability can be terminated if the subsidiary leaves the group, for example as a result of a sale or because there is no longer a group in the sense of Article 2:24b BW.[113] When this occurs, a creditor has a two-month period to oppose the termination of residual liability. The creditor can demand from the parent company that, "in exchange" for termination of residual liability, it is given a personal or *in rem* security.[114] Yet the creditor is not entitled to such security if his position is sufficiently protected considering the financial strength of the subsidiary.

6.5.3 Performance by a guarantor and its rights against the principal debtor

6.5.3.1 The UK: subrogation and indemnification claims in insolvency proceedings and in schemes of arrangement

Under English law, if the guarantee is provided at the request of the principal debtor, whether expressed or implied, the guarantor acquires the right to be indemnified by such a debtor for payments made under the guarantee.[115] The *indemnification claim* – a claim for the payment of debt – is "distinct from any of the creditor's rights against the debtor that it may exercise by subrogation."[116] The right to an indemnity is an independent right of the guarantor, separate from the right arising from subrogation (see below). As a result of this independent nature of an indemnity claim, any action taken by the creditor without the cooperation of the guarantor (e.g. an agreement not to sue the debtor or a compromise with the debtor) cannot prejudice the guarantor.[117] The independent nature of a right to indemnity also means

111 Dutch Civil Code, Article 2:404(1).
112 Dutch Civil Code, Article 2:404(2).
113 E. Nass, GS Rechtspersonen, commentaar op art. 2:403 BW. The rules on termination of residual liability can be found in Article 2:404(3)-(6) BW.
114 E.A. van Dooren, De aansprakelijkheid op grond van een 403-verklaring (diss.), Uitgaven vanwege het instituut voor Ondernemingsrecht nr. 122, Deventer: Wolters Kluwer, 2021, 8.9ff.
115 R. Goode, L. Gullifer, Goode and Gullifer on Legal Problems of Credit and Security, 6th edn, Sweet & Maxwell, 2017, para. 8-11.
116 J. Phillips, J. O'Donovan, W. Courtney, Philips and O'Donovan: Modern Contract of Guarantee, 4th edn, Sweet & Maxwell, 2020, para. 12-031.
117 G. Andrews, R. Millett, Law of Guarantees, 7th edn, Sweet & Maxwell, 2015, para. 10-001.

that, in the absence of an agreement to the contrary, a limitation period does not start to run against the guarantor until it has paid the creditor.[118]

Alongside the right of indemnity, there exists an equitable remedy of *subrogation*, a remedy against the party who would otherwise be unjustly enriched.[119] Subrogation arises from the relationship of a guarantor and creditor itself. When a guarantor pays the guaranteed debt in full, it becomes subrogated to the rights of the creditor, both in equity and under s. 5 of the Mercantile Law Amendment Act 1856.[120] In other words, the guarantor steps into the shoes of the creditor and assumes the latter's legal position and rights against another person, such as the principal debtor.[121] This means that: (i) the creditor is accountable to the guarantor for any further payments received from the debtor; (ii) the guarantor succeeds to security rights held by the creditor; and (iii) to the extent to which the creditor was a preferential creditor, the guarantor becomes a preferential creditor as well.[122] Additionally, unlike an indemnity claim, the enforceability of subrogation rights is governed by the limitation rules that apply to the creditor's right of action.[123]

118 *Collinge v Heywood* (1839) 9 Ad. & El. 633; *Re Mitchell* [1913] 1 Ch. 201; *Re A Debtor* [1937] Ch. 156.

119 *Banque Financière De La Cité v Parc (Battersea) Ltd* [1999] 1 A.C. 221, 236.

120 The exclusion in common law of subrogation for partial performance aims to protect the creditor (*nemo subrogat contra se*). See S. Meier, Recourse between Solidary Debtors, in N. Jansen, R. Zimmermann (eds), Commentaries on European Contract Laws, OUP, 2018, p. 1585, observing that while some civil law jurisdictions allow a partial subrogation, they provide for creditor preference. Notably, before 1992, Dutch law provided for the subordination of a subrogated party outside insolvency. However, this rule was subsequently dropped. See HR 1 February 2008, *JOR* 2008/115 (*ING/Provincie Utrecht*). Thus, the current law prescribes the subordination of a subrogated party in insolvency, whereas subordination outside insolvency was abandoned by the legislator.

121 See, however, C. Mitchell and S. Watterson, Subrogation: Law and Practice, OUP, 2007, para. 3.15, noting that under subrogation, "the claimant is given new rights which replicate the creditor's extinguished rights."

122 R. Goode, L. Gullifer, Goode and Gullifer on Legal Problems of Credit and Security, 6th edn, Sweet & Maxwell, 2017, para. 8-25; J. Phillips, J. O'Donovan, W. Courtney, Philips and O'Donovan: Modern Contract of Guarantee, 4th edn, Sweet & Maxwell, 2020, para. 12-254.

123 J. Phillips, J. O'Donovan, W. Courtney, Philips and O'Donovan: Modern Contract of Guarantee, 4th edn, Sweet & Maxwell, 2020, para. 12-280. See, however, C. Mitchell, S. Watterson, Subrogation: Law and Practice, OUP, 2007, paras. 7.137-7.162, calling this approach "parasitic", criticising it, and proposing an alternative, "autonomous" approach.

In English law, there is a long-standing rule against double-proof concerning the same debt.[124] The essence of this rule is that "the insolvent estate should not be compelled to entertain more than one proof in respect of the same debt, for to do so would unfairly distort the *pari passu* principle of distribution in insolvency."[125] This means that the surety cannot prove its right against the principal debtor (whether on the basis of indemnity or subrogation) until the creditor has received full payment, unless the guarantor is responsible for a specified part of the debt, in which case upon payment of that part, the guarantor becomes entitled to lodge a proof for the sum paid.[126] The creditor's priority under the rule against double proof is often reinforced by a non-competition clause, excluding the guarantor's right to claim, prove, or rank together or in competition with the creditor.[127] If the principal debtor is discharged upon the completion of the insolvency proceedings, and the creditor's claim has not been satisfied in full, the guarantor's claim against the principal debtor remains unenforceable.[128] Importantly, the sums received from the guarantor, before or after the debtor's insolvency, do not have to be deducted from the amount claimed by the creditor in the insolvency of the principal debtor, as long as the creditor does not receive more than the total amount of its claim (hotchpot rule).[129] The rule against double-proof does not prevent a double proof of the same debt against separate estates ("double-dip"), which happens if the creditor sues simultaneously the principal debtor and the guarantor, co-debtors or co-surety.

As mentioned earlier, restructuring of the principal debt through a scheme of arrangement or a Part 26A plan does not discharge the guarantor. The creditor can successfully proceed against the guarantor, and unless the guarantor's rights of indemnity and subrogation are expressly limited or excluded by agreement,[130] the guarantor can then recover from the principal debtor any amount the guarantor paid the creditor. This right rests on the surety's equity not to have the whole burden of debt thrown upon him. Thus, it is in the interests of the principal debtor to propose a scheme of arrangement or a restructuring plan that provide a complete release of

124 *Re Fenton* [1931] 1 Ch. 85; *Re Polly Peck International Plc, In administration (No.3)* [1996] 1 B.C.L.C. 428; *Re Kaupthing, Singer & Friedlander* [2012] 1 A.C. 804, at 11; *Re MF Global UK Ltd (In Special Administration), Heis v. Attestor Master Fund LP* [2014] 1 W.L.R. 1558, at 72-78.

125 G. Andrews, R. Millett, Law of Guarantees, 7th edn, Sweet & Maxwell, 2015, para. 13-002.

126 *Cattles Plc v. Welcome Financial Services Ltd* [2010] 2 Lloyd's Rep. 514 per Lloyd LJ at 25.

127 Ibid., where the clause also protected the principal lender from competition from intercompany debts.

128 G. Andrews, R. Millett, Law of Guarantees, 7th edn, Sweet & Maxwell, 2015, para. 13-007.

129 R. Goode, L. Gullifer, Goode and Gullifer on Legal Problems of Credit and Security, 6th edn, Sweet & Maxwell, 2017, para. 8-18; I. Fletcher, Law of Insolvency, Sweet & Maxwell, 2017, para. 9-042.

130 J. Phillips, J. O'Donovan, W. Courtney, Philips and O'Donovan: Modern Contract of Guarantee, 4th edn, Sweet & Maxwell, 2020, paras. 12-017 and 12-260. *Highbury Pension Fund Management Co v. Zirfin Investments Ltd* [2013] EWCA Civ 1283; [2014] Ch. 359 at 5-6.

liabilities, including those based on indemnity or contribution rights of a guarantor or co-debtor. Payne observes that releasing the creditor's rights against third parties (e.g. guarantors) via a scheme is "entirely sensible. She explains that if a claim is pursued under a guarantee, it would lead to a subrogation claim by the guarantor against the company as the principal debtor, thereby defeating the purpose of the compromise between the company and the creditor.[131] Yet the indemnity claim may be more problematic, because subrogation only places the guarantor in the position of the creditor. By contrast, upon payment to the creditor, the guarantor might be entitled to claim the entire amount from the principal debtor under its right of indemnity, as if no compromise of the creditor's claim was effected via the scheme.[132] This could render the success of the scheme illusory from the principal debtor's perspective.

6.5.3.2 The USA: reimbursement, subrogation and bankruptcy subordination

US law contains a number of remedies available to a surety in its relations with the principal debtor. They include exoneration, reimbursement, and subrogation. While these remedies are grounded in equity, certain US states also regulate them through statutes.[133] Additionally, it is common for a surety to require the principal debtor to agree on an indemnity, whereby the debtor commits to indemnify the surety for any losses arising from the principal debtor's failure to fulfil underlying obligations.[134]

The *right of exoneration* is the right of a surety to demand performance from the principal debtor, as long as doing so does not prejudice the creditor. It is based on the belief that it is the principal obligor, who should perform and bear the cost of performance.[135] For the right of exoneration to arise, the principal obligor needs to be aware of the secondary obligor's identity or existence. Without such notice, a surety does not have the right to insist on performance by the principal debtor.[136] If proper notice was given, the surety may ask the court to compel the principal debtor to perform when due, so that it himself does not have to perform and seek reimbursement afterwards. In equity, a surety could also file a bill of *quia timet* (from Latin "because he fears") to compel his principal to perform, when he feared that the principal was going to dissipate assets that could be used to pay the creditor.[137]

131 J. Payne, Schemes of Arrangement: Theory, Structure and Operation, CUP, 2014, p. 24.
132 *Colouroz Investment 2 LLC & Ors, Re* [2020] EWHC 1864 (Ch), 2020 WL 03964188, at 72.
133 See Cal. Civ. Code § 2846, under which a "surety may compel his principal to perform the obligation when due." See also Ohio Rev. Code § 1341.19.
134 T. Eisenberg (ed.), Debtor-Creditor Law, Matthew Bender & Company, Inc., 2022, § 45.03.
135 Restatement 3d, Suretyship and Guaranty, § 21, comm. a.
136 P.A. Alces, The Law of Suretyship and Guarantee, Thomson Reuters, 2021, § 6.5.
137 T. Eisenberg (ed), Debtor-Creditor Law, Matthew Bender & Company, Inc., 2022, § 45.07.

A surety has the *right to reimbursement* from the principal debtor upon satisfying an underlying obligation, either in part or in full. This equitable remedy arises from an implied contract and has been incorporated into the statutes of several US states.[138] This right arises when the surety makes partial or complete payment and can only be enforced after the underlying obligation becomes due.[139] Just like the right of exoneration, the right to reimbursement requires a notice of the secondary obligation. Without such notice, there is no implied contract. This does not mean that the paying surety is left without any means to protect himself. After paying the creditor, the surety is entitled to claim restitution from the principal debtor to the extent of the latter's unjust enrichment.[140] It is important to emphasise that the right to reimbursement is based on the (implied) promise by the principal debtor. When the surety pays the debt of the principal debtor, an entirely new obligation of that debtor to reimburse the surety arises.[141] This distinguishes the right to reimbursement from that of subrogation, just as English law distinguishes between indemnity and subrogation.

Once a surety has completely fulfilled the secondary obligation, he is subrogated to the rights that the creditor had pursuant to the underlying obligation. *Subrogation* is broadly defined as "the substitution of another person in the place of the creditor to whose rights he succeeds in relation to the debt."[142] US law recognises two types of subrogation: (i) conventional subrogation, which is based on an agreement, and (ii) equitable subrogation, which arises as a matter of equity and is not dependent on a contractual relationship.[143] There are several features that distinguish subrogation from reimbursement.

First, the right of equitable subrogation exists as a matter of law rather than by an (implied) consent of the parties.[144] Some US states provide for the right of subrogation by statute.[145] Second, for the right to subrogation to arise, an underlying obligation must be satisfied in full,[146] whereas the right to reimbursement can arise from partial performance. Third, as a result of

138 See e.g. La. Civ Code, Art. 3049; Ga. Code § 10-7-41; Rev. Stat. Mo. § 433.070; N.D. Cent. Code, § 22-03-10.

139 P.A. Alces, The Law of Suretyship and Guarantee, Thomson Reuters, 2021, § 6.13. La. Civ. Code, Art. 3049; Restatement 3d, Suretyship and Guaranty, § 22, comm. d.

140 Restatement 3d, Suretyship and Guaranty, § 22, comm. a, and § 26.

141 T. Eisenberg (ed), Debtor-Creditor Law, Matthew Bender & Company, Inc., 2022, § 45.07.

142 *Hanover Ins. Co. v. Corrpro Cos., Inc.*, 312 F. Supp. 2d 816, 818 (E.D. Va. 2004).

143 T. Eisenberg (ed), Debtor-Creditor Law, Matthew Bender & Company, Inc., 2022, § 45.07.

144 *In re Cone Constructors, Inc.*, 265 B.R. 302, 303 (Bankr. Ct. M.D. Fla. 2001), holding that "equitable subrogation is a legal fiction which arises by operation of law."

145 See e.g. Cal. Civ. Code § 2848; La. Civ. Code, Art. 3048 ("The surety who pays the principal obligation is subrogated by operation of law to the rights of the creditor."); Ala. Code § 8-3-11; Va. Code § 49-27; Ga. Code § 10-7-56; Minn. Stat. § 574.16.

146 Restatement 3d, Suretyship and Guaranty, § 27. *Nova Info. Sys., Inc. v. Greenwich Ins. Co.*, 365 F.3d 996 (11th Cir. 2004).

subrogation, a surety succeeds to the rights of the creditor in relation to the debt or claim, and its rights, remedies, or securities.[147] Since the underlying obligation has been fully satisfied, allowing the surety to enforce the creditor's rights does not harm the interests of the creditor.[148] By contrast, the right to reimbursement – which, as noted above, may arise from partial satisfaction – does not provide the surety with the creditor's rights concerning the underlying obligation. In other words, the right to reimbursement is a general claim with no priority over other claims except by agreement. Fourth, when enforcing the creditor's right by subrogation, the surety is subject to the statute of limitations that applies to the creditor's claim. Conversely, since the right to reimbursement is an independent cause of action, it is subject to a different statute of limitations that starts running upon the performance of the secondary obligation.[149]

The preceding paragraphs described the rights of parties outside insolvency. Reflecting on the rights and remedies of a surety in a situation where the principal debtor is insolvent, Downs observed that "[a]ny surety who has had an occasion to attempt to enforce the Bankruptcy Act [now the Bankruptcy Code] will realize why a citation of authorities would be the equivalent of entering battle with a belt filled with blank cartridges."[150] Bankruptcy law interferes with parties' contractual or equitable rights. Two sections of the US Bankruptcy Code are of relevance here, namely sections 502 and 509.

Section 502(e) in certain circumstances requires the disallowance of indemnity, reimbursement and contribution claims "of an entity that is liable with the debtor on or has secured the claim of a creditor." As in English law, the general idea is that the claims of a guarantor, surety or co-debtor should not be allowed to compete with the creditor's claim on the "limited proceeds in the estate."[151] There should only be one recovery on the basis of the same debt. Therefore, if the claim for reimbursement or contribution is contingent, it will be disallowed.[152] Collier on Bankruptcy further explains that by "disallowing the guarantor's contingent claim for reimbursement or contribution, [the law] ensures that the estate will not at the same time be liable to the primary obligor and the guarantor for the same debt."[153] However, if

147 Restatement 3d, Suretyship and Guaranty, § 28, comm. a, explaining that "by giving the secondary obligor the equivalent of an assignment of the [creditor's] rights, the law […] effectuates the goal of causing the principal obligor to bear the cost of performance."

148 Restatement 3d, Suretyship and Guaranty, § 27, comm. a. P.A. Alces, The Law of Suretyship and Guarantee, Thomson Reuters, 2021, § 6.28.

149 Restatement 3d, Suretyship and Guaranty, § 28, comm. c.

150 W. Downs, A Surety's Basic Rights and Remedies, Defense Lawyers Journal, Vol. 15, 1966, p. 172.

151 S. Rep. No. 95-989; H.R. Rep. No. 95-595, at 354.

152 11 U.S. Code § 502(e)(1)(B).

153 Collier on Bankruptcy, 16th edn, 2022, Vol. 4, ¶ 502.06[2][d].

a surety pays a portion of a claim during the case, that portion of the claim for reimbursement is no longer contingent (i.e. it becomes fixed) and may not be disallowed. In this respect, the approach of US law seems to be different from English law and its strong stance against double-proof. As noted earlier, English law does not allow the surety to prove for its claim against the principal debtor until the creditor has been paid in full. The practical effect of this difference, however, should not be overstated, because the US Bankruptcy Code contains a rule that *subordinates* the surety's claim to the claim of the creditor for the underlying obligation, until the surety fully satisfies such creditor's claim. This rule effectively grants priority to the creditor over the surety.

Section 509 provides that a surety who pays all or part of the claim post-petition is subrogated to the rights of the creditor to the extent of such payment.[154] While subrogation in common law and under state law typically requires the surety to have paid the underlying claim in full before asserting any rights, US bankruptcy law allows for subrogation to arise from partial payment of the creditor's claim.[155] Essentially, the surety steps into the creditor's shoes when the creditor is still wearing them. This peculiarly, however, is unlikely to have a significant effect on the outcome of the case, as, similar to claims for reimbursement or contribution, the subrogation claim is *subordinated* to the creditor's claim until the creditor is fully paid.

Section 509 also establishes that if the surety asserts its right of subrogation, the claims for reimbursement or contribution shall not be allowed.[156] The requirement for a surety to make a choice between these remedies seeks to avoid double recovery, one based on its own right and another by way of subrogation.[157] Logically, subrogation may be the preferred option if the creditor's claim is secured,[158] or if the payment under the guarantee is

154 11 U.S. Code § 509(a). Note that US courts refuse to extend § 509 and to grant subrogation rights to a party who is itself primarily liable on the creditor's claim. Collier on Bankruptcy, 16th edn, 2022, Vol. 4, ¶ 509.02.

155 *In re Cornmesser's Inc.*, 264 B.R. 159, 163 (Bankr. W.D. Pa. 2001); *In re LTC Holdings, Inc.*, 597 B.R. 565, 567 (Bankr. D. Del. 2019), noting that "[i]n a departure from common law, 11 U.S.C. § 509 permitted partial subrogation."

156 11 U.S. Code § 509(b)(1). *In re Fiesole Trading Corp.*, 315 B.R. 198 (Bankr. Ct. D. Mass. 2004); *In re Celotex Corp.*, 289 B.R. 460 (Bankr. M.D. Fla. 2003).

157 C.J. Tabb, Law of Bankruptcy, 4th edn, West Academic Publishing, 2016, p. 664.

158 *In re The Medicine Shoppe*, 210 B.R. 310, 313 (Bankr. N.D. Ill. 1997), holding that "Subrogation under § 509(a) allows a guarantor, who pays a debt for which a debtor is primarily liable, to assume the creditor's rights. These rights include any rights to priority distribution or secured status to which the subrogor's claim was entitled."

triggered by a post-petition breach of the principal debtor, giving rise to an administrative expense priority claim of the creditor.[159]

In sum, US law aims to achieve a fair allocation of the debtor's assets among various groups of competing claims in bankruptcy. Although a surety's claim for contribution, reimbursement, or subrogation (provided it is not contingent) may be allowed, the surety cannot partake in the distribution of the debtor's assets until the creditor's claim has been fully paid. This outcome is supported by specific rules on subordination, found in the US Bankruptcy Code. The practical effect of these rules is similar to what is accomplished under English law – the creditor goes first, without having to compete with a surety.

6.5.3.3 The Netherlands: contribution, subrogation and restructuring plans

A guarantor who has paid the creditor has a right of recourse against the principal debtor. This right can take the form of a right of contribution (*regresrecht*)[160] and a right of subrogation (*recht krachtens subrogatie*).[161]

The *right of contribution* is an independent right that is not derived from the creditor's position. It co-exists with subrogation, discussed below.[162] It aims to prevent the principal debtor from being unjustly enriched at the expense of the guarantor because the guarantor has paid the debt owed by the principal debtor to the creditor.[163] Due to the independent nature of the right to contribution, the paying guarantor does not succeed in the security and priority rights which may have been attached to the creditor's claim. This is different in case of subrogation, where – as in English and US law – a third party, such as a guarantor, takes place of the creditor and therefore benefits from the associated security and other ancillary rights and privileges.[164]

Another significant difference between a right of contribution and a right of subrogation concerns the application of the statute of limitations (*verjaring*) and, specifically, the time when it starts to run. The right of contribution is an *independent* right that only arises when a joint and several debtor makes a

159 *In re Wingspread Corp.*, 116 B.R. 915 (Bankr. S.D.N.Y. 1990). B.E. Greer, J.S. Moss and N.B. Herther-Spiro, Guarantees in Bankruptcy: A Primer II, Norton Annual Survey of Bankruptcy Law, 2014 edn, p. 171. Other types of priority may not be "assignable" to the surety's subrogation claim. See 11 U.S. Code § 507(d).

160 Dutch Civil Code, Articles 7:866 and 6:10. On *regresrechten* in general, see H.G.F.M. de Kok, Het regres (diss. Nijmegen), Deventer: Kluwer 1965.

161 Dutch Civil Code, Article 6:12.

162 J. den Hoed, GS Verbintenissenrecht, commentaar op art. 6:10 BW; Asser/Sieburgh 6-I 2020/132.

163 Castermans & Krans, in: T&C Burgerlijk Wetboek, commentaar op art. 7:866 BW.

164 Dutch Civil Code, Articles 3:7, 3:82, 6:142. Asser/Sieburgh 6-I 2020/133.

payment exceeding its share.[165] By contrast, a person with a right of *subrogation* "inherits" the rights of the creditor. Consequently, the debtor is able to raise all the defences against the subrogated party that it could have raised against the original creditor (Art. 6:145 BW), including the defence that the claim is time-barred.[166] This is also why the limitation period of the claim transferred by subrogation commences at the time the claim arose for the original creditor.[167]

In Dutch law, subrogation is understood to mean the transfer by operation of law of a claim to a person at whose expense the creditor has been paid.[168] This claim can be enforced against the debtor or several jointly and severally liable debtors.[169] A surety who pays the debt acquires a subrogation claim that can be exercised jointly and severally against co-debtors, regardless of whether such co-debtors are internally liable.[170] Subrogation is a consequence of payment. As noted above, subrogation and contribution claims are available to the paying guarantor concurrently. This means that a guarantor who has extinguished the debt is free to choose the grounds for recourse or rely on both grounds at the same time (note the difference with the US approach). At the same time, it should be noted that the guarantor's rights to contribution and subrogation are often excluded in a contract, preventing the paying guarantor from seeking recourse against the principal debtor. Such a waiver ensures that the creditor does not face competition from the guarantor's recourse claim.[171]

165 HR 6 April 2012, ECLI:NL:HR:2012:BU3784, *NJ* 2016/196, m.nt. C.E. du Perron; *JOR* 2014/172, m.nt. N.E.D. Faber & N.S.G.J. Vermunt (*ASR/Achmea*). R.J. van der Weijden, GS Verbintenissenrecht, commentaar op art. 6:150 BW, noting that before *ASR/Achmea*, some authors argued that the right of contribution existed conditionally at the time when joint and several liability was assumed. The Supreme Court in *ASR/Achmea* made it clear that this was not the case and that the right of contribution could only arise at the moment the guarantor or co-debtor paid the claim for more than the part that concerns him internally. Read further, W.H. van Boom, Het ontstaansmoment en de verjaring van de regresvordering, *Ars Aequi* 2013, p. 36-43; D.F.H. Stein, V. Tweehuysen & S.E. Bartels (red.), Verjaring, Deventer: Wolters Kluwer, 2020; D.F.H. Stein, Verjaring van wettelijke regresvorderingen en de 'afzonderlijke elementen-leer', AV&S 2020/26.

166 A.C. van Schaick, Het glibberige pad van de verjaring van de regresvordering, *NTBR* 2012/55, explaining that the subrogated party under the suretyship agreement exercises the creditor's claim and that this claim continues to be subject to the limitation period already applicable.

167 R.J. van der Weijden, GS Verbintenissenrecht, commentaar op art. 6:150 BW.

168 Asser/Sieburgh 6-I 2020/132; Asser/Sieburgh 6-II 2021/269.

169 Asser/Sieburgh 6-II 2021/284.

170 Dutch Civil Code, Article 7:866(3).

171 G.J.L. Bergervoet, Borgtocht (O&R nr. 84), Deventer: Kluwer 2014, 8.3.6. and 8.4.5. A surety can waive his right of recourse even if he is a consumer under Article 7:857 BW (*borgtocht, aangegaan buiten beroep of bedrijf*). See Article 7:866 BW.

What happens in insolvency? Under Dutch law, the guaranteed creditor can sue both the insolvent principal debtor and the guarantor for the full amount of the debt.[172] In insolvency proceedings, distributions are calculated based on the entire claim, although the creditor can never receive more than 100% of the claim. The amount of a claim is determined at the time of the insolvency order. Therefore, only payments received by the creditor prior to this point should be deducted from the claim. If partial satisfaction of a claim occurs after the initiation of insolvency proceedings (e.g. partial payment by a guarantor or co-debtor), no such deduction occurs.[173] On this latter point, Dutch law is similar to English and US law.

Dutch insolvency law adopts a position similar to English law regarding the guarantor's right of recourse. As mentioned earlier, English law does not allow double proof – a situation where two or more persons (e.g. a creditor and a guarantor) file claims in proceedings of the principal debtor for the same debt. As a general rule, a guarantor can only claim in the insolvency of the principal debtor after satisfying the creditor's claim. The same outcome is achieved in the USA, where instead of disallowing recourse claims, bankruptcy law imposes special subordination rules (see section above).

Yet, as an exception to this general rule, according to Article 136(2) Fw, a recourse claim (i.e. contribution or subrogation) of the joint and several debtor (*hoofdelijke schuldenaar*), such as a guarantor, for amounts for which he has acquired or will acquire a claim against the principal debtor, can be – if necessary conditionally[174] – admitted in insolvency proceedings of the principal debtor, but only in three specific circumstances. These include cases where: (i) the creditor himself may not submit a claim or, although he is entitled to do so, does not submit a claim in the insolvency proceedings of the principal debtor;[175] (ii) the creditor receives full payment of its claim

172 Dutch Bankruptcy Act, Article 136.

173 Article 136 Fw constitutes an exception to the basic principle of Article 6:7(2) BW, according to which a fulfilment of the joint obligation by one of the co-debtors discharges other co-debtors. See A. Jonkers, Insider guarantees in corporate finance: An economic analysis of Dutch, US and German law, PhD thesis, 2020, p. 156, explaining that the reason for this exception is simplicity. Without it, any payments on the guaranteed debt made after the date of insolvency would have to be taken into account.

174 Conditional admission appears to apply to both the claim itself and the conditions of Article 136(2)(a-c) Fw.

175 This section of the article may apply if the creditor has been paid in full before insolvency or where it has waived its claim against the insolvent debtor. J.M. Hummelen, GS Faillissementswet, commentaar op art. 136 Fw, aant. 5. Such a waiver does not preclude recourse against the insolvent principal debtor (Article 6:14 BW). The creditor can also decide not to bother filing its claim against the debtor, as it can claim the full payment from the guarantor.

in insolvency proceedings;[176] or (iii) such an admission does not adversely affect unsecured creditors by introducing a competitive claim.[177]

As previously noted, if a creditor is involved in a restructuring plan (*dwangakkoord*) under the Dutch Bankruptcy Act, and if his rights against the principal debtor are affected by such a plan – meaning the enforceability of his claim is limited by the plan – as a general rule, the creditor retains the right to sue the guarantor for the amount of the original claim (Article 160 Fw). The question remains whether a guarantor is allowed to recover from the principal debtor the sums that it has paid to the guaranteed creditor after the WHOA plan has been approved. With respect to WHOA plans, the answer can be found in Article 370(2) Fw, under which if the creditor's claim is restructured via the WHOA plan, the guarantor cannot take recourse against the principal debtor to force it to pay the original debt in full. This provision is explicitly intended to prevent the debtor, after the plan has been homologated and the debtor has restructured its debts, from becoming insolvent due to the inability to pay recourse claims that arise after the plan confirmation.[178] The question is whether the outcome would be different if a recourse claim is secured. In a recent case, the court ruled that a secured creditor cannot claim recourse against the scheme debtor after the confirmation of the WHOA plan. It pointed out that the "fact that the bank [guarantor] has security for this recourse claim does not alter this. It does not matter in what way the redress is sought against the estate, the nature of the claim precludes it."[179]

176 F.M.J. Verstijlen, in: T&C Insolventierecht, commentaar op art. 136 Fw, providing an example where the creditor, who has already had a part of his claim paid by the co-debtor, would receive such a high percentage in the bankruptcy from the insolvent joint and several debtor that he would receive more than 100% of his claim.

177 J.M. Hummelen, GS Faillissementswet, commentaar op art. 136 Fw, offering an example where the recovery of the guarantor is on the basis of a security right not vested in the creditor. Under Dutch law, insolvency does not preclude the enforcement of an *in rem* security right by a secured creditor. See further section 11.2.3. of this book.

178 R. van den Sigtenhorst, in: T&C Insolventierecht, commentaar op art. 370 Fw. A similar position is taken in German insolvency law, which recognises that an insolvency plan can be jeopardised if a third party (e.g. guarantor) could take recourse against the principal debtor. This is why German law provides that the transformation of the substantive relationship between the principal debtor and its creditor under a restructuring plan also applies to the right of recourse against the principal debtor. See § 254(2) InsO. This means that the recourse claim follows the original claim in its reduced or extinguished scope.

179 Rb. Amsterdam 1 February 2023, ECLI:NL:RBAMS:2023:569, *JOR* 2023/83, m.nt. V.G. Koolen. The court addressed the bank's (guarantor's) argument that the refusal to allow the recourse claim constituted a violation of Art. 1 Protocol 1 of the ECHR (protection of property). The court observed that the Dutch legislator had deemed the infringement of the right of (in this case) the bank, as laid down in Art. 370(2) Fw, necessary for the public interest, to prevent the debtor from becoming insolvent after the homologation due to the enforcement of a recourse claim. It noted that it is up to the bank to demonstrate that, due to the concrete circumstances of this specific case, an infringement of property rights is disproportionate. In the court's view, such concrete circumstances have not been established, nor have they become apparent. Hence, the appeal to Art. 1 Protocol 1 of the ECHR fails. However, in our opinion, it may be disputed whether the differences in the outcomes for a guaranteed creditor in a bankruptcy proceeding and in a WHOA scheme are justified.

That said, if the payment by the guarantor results in the creditor receiving the full satisfaction of its original claim, the rights granted to the creditor in the plan are transferred by operation of law (subrogation) to the guarantor.[180] This is in line with the rule that a creditor should not receive more than 100% of his claim. For example, if pursuant to the WHOA plan, the creditor can only enforce his claim against the principal debtor for 40% of the original claim, and before such a claim for 40% has been enforced, the creditor can still claim 100% from the guarantor. If the guarantor pays the entire claim (100%), creditor's rights on the basis of the WHOA plan (i.e. claim that is only enforceable for 40%) are automatically transferred to the guarantor.

The rule of Article 370(2) Fw establishes a special regulation that deviates from the general rule to the extent that it affects the right of recourse by prescribing (i.e. limiting) circumstances in which it can be exercised and the determination of value that can be claimed. Whereas this special regulation applies to WHOA plans, it does not necessarily follow that the same approach is or should be taken in law with respect to a *dwangakkoord* (plan or composition) adopted in other procedures, namely in bankruptcy (*faillissement*) and suspension of payments (*surseance van betaling*). According to Article 160 Fw, despite such a plan, a guarantor remains liable for the full amount. With this in mind, the question is whether it is possible for the guarantor to claim a contribution from the principal debtor in an amount that exceeds the amount that the creditor is entitled to under the approved *dwangakkoord*?

No problem arises if we talk about the subrogation right, as the paying guarantor steps into the shoes of the creditor, so that his claim can only be enforced to the same extent as the creditor's claim is enforceable pursuant to the *dwangakkoord*. The right of contribution (*regres*) is different. Since the right of contribution is an independent right that is not derived from the position of the creditor, it cannot be affected by the *dwangakkoord* concluded before the contribution claim arises in the first place.[181] Given the absence

180 Dutch Bankruptcy Act, Article 370(2). MvT, *Kamerstukken II* 2018/19, 35249, 3, p. 10.

181 R. van den Sigtenhorst, Herstructurering van groepen onder de WHOA, in C.M. Harmsen & M.L.H. Reumers (red.), De WHOA van wet naar recht (Recht & Praktijk, nr. InsR18), Deventer: Wolters Kluwer 2021, 8.3.4., noting that "De WHOA-regeling is bijzonder, vanwege de uitsluiting van verhaal door garantiegevers op de WHOA-schuldenaar na eventueel verhaal op hen door schuldeisers die door het akkoord zijn geraakt: dit bestaat niet in faillissement en surseance." ("the WHOA scheme is special, because it excludes recourse by guarantors from the WHOA debtor after possible recovery from them by creditors who have been affected by the plan: the same does not apply in bankruptcy and suspension of payments." (translated by the author).

of a special rule to the contrary, it does not follow from Dutch law that any future contribution rights are affected by the *dwangakkoord* concluded in bankruptcy or suspension of payments. Thus, building on the case above, if the *dwangakkoord* concluded in bankruptcy reduces the creditor's claim to 40% of the original claim, the creditor can claim 100% from the guarantor. If the guarantor satisfies the creditor's claim in full, it acquires the right to claim the full amount (100%) from the principal debtor via a contribution claim.

6.6 Insolvency and Ex-post Effects of Cross-guarantees

This section summarises the effects of cross-guarantees on debtors' and creditors' behaviour in a situation of financial distress or insolvency (ex post effects). It appears that intercompany guarantees have certain features that might contribute to debtor and creditor opportunism, potentially compromising efficient group restructuring. Creditor opportunism is understood here in broad terms as the pursuit of economic self-interest by a creditor, even if such behaviour provokes negative side-effects on third parties and is therefore Pareto-inefficient.[182] These features are observed and explored through the lens of the relationships between group members and between non-guaranteed unsecured creditors and guaranteed creditors.

First, cross-guarantees intensify interdependence between group entities. In a crisis situation, they permit a group-wide enforcement action, allowing the guaranteed creditor to foreclose on assets of the principal debtor and of the guarantor(s), or force them into insolvency. The study of English, US and Dutch law exemplifies that a guaranteed creditor has wide discretion in the pursuit of his claim against the principal debtor, guarantor, or both at the same time. The latter results in the group-wide enforcement, whereby the full amount of debt is claimed from several group companies. The threat of such enforcement may compel the debtor's management to make selective payments in favour of the guaranteed creditor.[183] An insider-guarantor could also put pressure on the principal debtor to pay the guaranteed creditor first, indirectly profiting from such payment by limiting the exposure under the guarantee. The profit is, however, indirect, as the payment goes to

182 For discussion of the negative effects of creditor opportunism on economically efficient restructurings, see D. Ehmke, Publicly Offered Debt in the Shadow of Insolvency, EBOR, Vol. 16, 2015, pp. 63-96.

183 A. Jonkers, Selective Perforation by Means of Guarantees: Dutch Law, in The 800-Pound Gorilla. Limits to Group Structures and Asset Partitioning in Insolvency, NACIIL 2018 report, Eleven International Publishing, 2019, p. 75, noting that "intergroup guarantees can be seen as promises to the lender to make preferential payments, especially on the eve of bankruptcy."

a non-insider creditor and not to the guarantor.[184] If made in the vicinity of insolvency, these payments can amount to preferential treatment and breach the principle of equal treatment of creditors.

Second, cross-guarantees strengthen the position of a guaranteed creditor compared to other (unsecured) creditors, leading to a specific form of creditor governance and control.[185] In this context, an analogy can be drawn with the interests and incentives of creditors whose claims are secured by rights *in rem*. It is pointed out in the literature that secured creditors may prefer immediate debt enforcement over restructuring since the latter is naturally more unpredictable and riskier.[186] Garcimartín and Bermejo observe that secured creditors may be more interested in foreclosing the collateral and getting paid as soon as possible, even if this entails a fire sale that frustrates other options, more beneficial to unsecured creditors. They also argue that a secured creditor can be more concerned with maximising the value of the collateral over the value of the firm.[187]

Similarly, in a situation where, because of a cross-guarantee, the lender is interested in a quick "mass enforcement" against the estates of several group entities without bearing the downside risk of reorganisation, his position becomes analogous to that of a creditor over-insured on its loan. Just like the lender protected by collateral can dominate in insolvency

184 J. Gordon and R.J. Landry III, The Risk-Shifting Effect of Business Bankruptcy: A Statutory Solution to Provide Additional Protections for Personal Guarantors of Debts by Closely-Held Business Ventures, Emory Bankruptcy Development Journal, Vol. 32, 2015, p. 76, whereby the benefit of the guarantor is termed a "phantom benefit".

185 K.M. Ayotte and E.R. Morrison, Creditor Control and Conflict in Chapter 11, Journal of Legal Analysis, Vol. 1, 2009, pp. 511-551; J.L. Westbrook, The Control of Wealth in Bankruptcy, Texas Law Review, Vol. 82, 2004, pp. 795-862.

186 C. Bergström, T. Eisenberg and S. Sundgren, Secured Debt and the Likelihood of Reorganization, International Review of Law and Economics, Vol. 21, 2002, p. 360, noting that "[s]ecured creditors receive only part of the gain if the value of the reorganized firm increases, but bear all of the costs if the value decreases." E.J. Janger, The Logic and Limits of Liens, University of Illinois Law Review, Vol. 2015, 2015, p. 592, stressing that the secured creditor control over governance in insolvency may "allow the secured creditor to capture a disproportionate share of bankruptcy-created value, or even prevent value maximizing reorganizations."

187 F. Garcimartín and N. Bermejo, Involving secured creditors in restructuring proceedings, in P.J. Omar and J.L.L. Gant (eds), Research Handbook on Corporate Restructuring, Edward Elgar Publishing, 2021, p. 122.

proceedings,[188] a guaranteed creditor might drive group-wide (pre-)insolvency dynamics. For such a creditor, the group-wide enforcement can be a way to withdraw his investment with minimal or no losses. For unsecured creditors, however, this enforcement may entail large costs, especially if it leads to a group disintegration.

Third, cross-guarantees complicate group restructurings. As demonstrated in the previous sections dealing with national law, the insolvency of the principal debtor typically has no effect on the creditor's rights against guarantors or co-debtors. Any other interpretation would result in the creditor losing its claim against both the principal debtor and guarantor, effectively undermining the essence or protective function of the guarantee relationship. The ability of a guaranteed creditor to go against the group guarantor can cause two problems:

- Under national law, a guarantor might be entitled to recover from the principal debtor the sums that he has paid to the creditor. This right of the guarantor may "survive" the approval of a restructuring plan, affecting the creditor's claim. Filing a ricochet claim by the guarantor against the restructured principal debtor in the full amount could undermine the effectiveness of the restructuring in the first place ("ricochet problem").
- The principal debtor may need the guarantor's assistance to implement the restructuring plan and to continue its business post-restructuring. The guarantor can be reluctant to contribute to the restructuring and extend assistance thereafter if it remains exposed to claims from the debtor's creditors. It might also be forced into insolvency or end up being sold to a competitor. As a result, given the group's interdependence, the restructured principal debtor can become an "orphan" with remote chances for long-term survival ("orphan restructuring problem").

188 The ever-increasing control by secured creditors over the insolvency process has been particularly emphasised in US literature. See D.G. Baird and R.K. Rasmussen, The End of Bankruptcy, Stanford Law Review, Vol. 55, 2002, pp. 751-789; D.A. Skeel, Creditors' Ball: The New Corporate Governance in Chapter 11, University of Pennsylvania Law Review, Vol. 152, 2003, p. 918, noting that "[w]hereas the debtor and its managers seemed to dominate bankruptcy only a few decades ago, Chapter 11 now has a distinctly creditor-oriented cast."; R.K. Rasmussen, The end of bankruptcy revisited, in B.A. Adler (ed), Research Handbook on Corporate Bankruptcy Law, Edward Elgar Publishing, 2020, p. 42, listing among factors strengthening the position of secured creditors in insolvency: 1998 amendments to Article 9 UCC, making it easier to obtain a blanket security interest in all debtor's assets; debtor-in-possession financing and the use of far-reaching lending covenants, giving a senior lender control over the debtor's access to cash in his accounts.

Summarising the ex-post effects of cross-guarantees, it should be emphasised that they raise a number of red flags. They perforate limited liability, increase the correlation between different group entities, and can facilitate misalignment of creditors' interests, complicating the adoption of a group solution. The default of the principal debtor may cause a guaranteed creditor to launch the group-wide enforcement by filing the same claim against separate companies. As a result, the effectiveness of the debtor's restructuring may be threatened, especially in integrated groups where group entities depend on each other, and the failure of a single entity leads to a domino-like collapse of other group entities.

6.7 Conclusion

This chapter discusses cross-guarantees – one of the most common contractual arrangements accompanying the attraction of funds from outside lenders. It examines ex ante and ex post effects of group guarantees, looking at their economic rationale and impact on the agency cost of debt and access to finance, managerial behaviour, as well as the position and rights of guaranteed and non-guaranteed unsecured creditors.

A guarantee relationship serves an important protective and risk reduction function. As neatly pointed out by Wood, "[g]uarantees are usually taken to provide a second pocket to pay if the first should be empty."[189] In addition, the existence of a claim against several or all group entities makes the lender less exposed to risks arising from intra-group asset transfers. This additional security means that the borrower and the entire group may be financed on more advantageous terms. There are other good reasons for entering into cross-guarantees from both the creditor's and debtor's perspectives, inter alia, related to the value and marketability of bonds, exercise of set-off rights by a creditor, tax optimisation inside the group, etc. These reasons can be termed as reasons of (economic) ex ante efficiency.

Yet the web of cross-guarantees, often combined with intra-group loans, can cause significant problems in insolvency (ex post). Intercompany guarantees weaken protections granted by the doctrines of limited liability and entity shielding (see Chapter 2). These protections are traded for ex ante efficiency, as noted above. In a situation of insolvency, cross-guarantees may prompt the destruction of value as a result of simultaneous group-wide enforcement of the same debt. This may complicate group restructuring and lead to a collapse of the enterprise.

189 P. Wood, International Loans, Bonds, Guarantees, Legal Opinions, Sweet & Maxwell, 2007, para. 18-002.

This chapter examined the complex relationships between various parties involved in a typical group financing arrangement – "triangle of rights and liabilities": a principal debtor-borrower, a group guarantor (or co-guarantor) and a creditor-lender (guaranteed creditor). In all three jurisdictions studied in this book – the UK, the USA and the Netherlands – insolvency of the principal debtor per se does not affect the creditor's claim against the guarantor.[190] After all, it is the very purpose of the guarantee to protect the creditor against insolvency of the debtor. However, should the guarantor play a key role within the group and be forced into insolvency itself, the efficiency of the principal debtor's own restructuring and its long-term survival might be at risk – a problem coined as the "orphan restructuring problem". But this is not the only problem. Upon payment to the creditor, the guarantor may be entitled to file a claim against the principal debtor – a recourse claim. The legal basis (e.g. subrogation, contribution), availability, and amount of this claim depend on the applicable law and the type of proceeding in which the creditor's original claim is affected. For example, sanctioning of an English scheme of arrangement with respect to the principal debtor as such does not deprive the guarantor of its right to be compensated (indemnified) by such a debtor for the payments made pursuant to a guarantee.[191] Enforcement of this recourse claim can undermine the efficiency of restructuring proceedings – the "ricochet problem".

Both the ricochet problem and the orphan restructuring problem have led to the emergence of practices and rules that permit group debt deleveraging or group debt adjustment through so-called third-party releases. Third-party releases are discussed in Chapter 10.

190 The case of restructuring is less straightforward. In some cases, a semi-voluntary or purely voluntary alteration of the terms of the underlying agreement between the principal debtor and a creditor may affect the guarantor's obligations. Thus, unless the guarantor consents to be bound by the amended terms of the underlying obligation, a CVA or IVA under English law or an out-of-court agreement or workout under Dutch and US law might result in a complete or partial discharge of the guarantor.

191 By contrast, in the Netherlands, following the explicit statutory language, if the creditor's claim is restructured in the WHOA scheme of the principal debtor, the guarantor is prevented from taking a recourse against the principal debtor to force him to pay the original debt in full. The same result is achieved under US Chapter 11.