THE ADVANTAGES AND LIMITATIONS OF PARENTAL GUARANTEES

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I. INTRODUCTION

As long as extension of credit has driven commerce, creditors have been wary of accepting naked promises of payment. In ancient times, the taking of hostages gave greater assurance that promises would actually be performed. In more modern times, the concept of taking hostages has evolved into practices of taking contractual enhancements to minimize the chance that the creditor will suffer the consequences of an unpaid or uncollectible receivable. One of the most popular of these contractual enhancements is the "parental guarantee" - a promise on the part of a parent corporation to be responsible for the debts of its corporate subsidiary.

II. CONCEPT AND LEGAL ISSUES

A guarantee (or "guaranty") is a promise to answer and be liable for the debt of another person or party. State Statutes of Frauds generally require guarantees to be in writing and signed in order to be enforceable against the guarantor. The original debtor remains liable for the debt, but the guarantor is a co-debtor. Guarantees may be conditional or unconditional, unlimited or limited, continuing or for a specified term. Some states regulate the form and effect of guarantees. For example, in Kentucky, a guarantee must be limited to a particular dollar amount in order to be legally enforceable.

A "guarantee of payment" is an absolute guarantee making the guarantor principally liable to the same extent as the primary debtor. A "guarantee of collection" creates a secondary liability conditional on reasonable diligence on the part of the creditor in endeavoring to collect payment from the primary debtor. See UCC 3-419(d).

Because guarantees make parties liable for the subject indebtedness who would not otherwise be legally liable, they must be supported by independent valuable consideration. This element may consist in the conferring of a benefit or the suffering of a detriment. It is good and prudent drafting practice to make the consideration express and obvious on the face of the guarantee instrument. For example, if a parent corporation owning all of the shares of stock in the debtor subsidiary corporation guarantees its subsidiary's account, debt, or contract liability, the guarantee instrument should recite the parent/subsidiary relationship and the benefit that will inure to the parent from an extension of credit to the subsidiary. Likewise, the creditor's reliance upon the creditworthiness of the parent in extending the credit should also be made explicit.

III. ENFORCEMENT

Demand and suit can be directed against the parental guarantor for non-payment of indebtedness, the same as the primary debtor. However, guarantors can defend the debt action by challenging the underlying transaction or by challenging the guarantee contract itself on the myriad grounds that any written contract might be challenged. While guarantees have the virtue of expanding the universe of potentially liable parties whose assets are available to respond to a demand, suit, or judgment, guarantors (including parent corporations) can go bankrupt or be judgment-proof, just as primary obligors can.

A. Contrasted with Article 9 (UCC) Security Interest

A well-perfected security interest, under Article 9 of the Uniform Commercial Code, in goods, equipment, accounts receivable, contract rights, *etc.,* is a commitment of specific assets to satisfaction of your claim. It is a property right in the collateral and not merely a right to expect payment. Subject to the rights of competing secured creditors in the same assets, the Article 9 lien interest is well respected in bankruptcy. You are always theoretically entitled to the property right

of realizing upon the benefit of your lien, its value, or its "indubitable equivalent." See Section 361 of the U.S. Bankruptcy Code. A parental guarantee, on the other hand, is not a specific commitment of any particular assets, but simply a right to sue and pursue recovery from another obligor with a (hopefully) larger universe of assets. If both the subsidiary debtor and the parental guarantor go into bankruptcy concurrently, as is sometimes the case, the Article 9 secured creditors of *both* will come ahead of the unsecured creditor holding only a parental guarantee.

B. Contrasted with Assignment of Accounts

An assignment of accounts receivable has many features of an Article 9 security interest, including the commitment of specific assets (*i.e.* the subject accounts) to satisfaction of your claim. Since a parental guarantee is *not* a commitment of specific assets, but simply an opportunity to "pin the tail on another donkey," its value in any given relationship is not readily liquidated or measured.

C. Contrasted with Net-Out Agreements

A net-out or set-off agreement with your primary obligor, in those relationships where you are both a buyer from and a seller to such counter-party, is analogous to holding an assignment of accounts in which the receivable that your debtor has assigned to secure its liability to you is the very receivable which is owed by your company (*i.e.* your payable). Thus, its value can be readily liquidated at any given point in time. The guarantee, by contrast, has very amorphous value (if any!) at any given point in time.

D. Contrasted with Letters of Credit

Like parental guarantees, letters of credit are obligations of a third-party committed to pay from its own assets in the event certain prescribed conditions precedent are met. However, unlike parental guarantees, letters of credit commit cash in a specific amount, providing a readily

exercisable and measurable quantum of protection. Institutional parties such as international banks issuing irrevocable letters of credit typically present less of a risk of bankruptcy or insolvency than a private parental obligor in the active energy market.

IV. IMPLICATIONS OF BANKRUPTCY, INSOLVENCY

As a "black-letter" rule, as long as the guarantor stays out of bankruptcy, a bankruptcy on the part of the primary debtor creates no obstacle to pursuing recovery under the guarantee. Although the automatic stay of Section 362 of the U.S. Bankruptcy Code precludes non-bankruptcy action to collect from your primary debtor, the liability of the parental guarantor under the guarantee is independent and not *per se* protected by the automatic stay. However, the recent opinion in *In re Lyondell Chemical Company,* 2009 WL 650598 (Bkrtcy. S.D.N.Y., February 26, 2009) demonstrates how the Bankruptcy Court can use its injunction powers to temporarily forestall demands upon and action against a parental guarantor where "each of the entities owned directly and indirectly by [the parent]... is an important part of the *integrated operations* of the Debtors and nondebtors. The Debtors and their nondebtor affiliates operate as an integrated enterprise through the worldwide coordination of their businesses and their operation as a vertically integrated group of companies." The *Lyondell* injunction against invocation of certain parental guaranties remains in place for 60 days, and thus beyond the date of this conference, but the presenter of this material will be prepared to provide an up-to-the-minute update of any holdings or analysis by the New York Bankruptcy Court that might impact the affected creditors substantively, rather than merely postponing their initiatives.

Prior to the Bankruptcy Reform Acts of 1994 and 2005, a quirk in the U.S. bankruptcy law known as the "Deprizio Rule" created a problem for creditors who took guarantees from "insiders" of the debtor (which would include the corporate parent), if the debtor filed for

bankruptcy protection. In preference actions brought under Section 547 of the U.S. Bankruptcy Code, such creditors would be subject to a one-year look-back and disgorgement period, rather than the usual 90 days. Although you could pursue recovery against your non-bankrupt parental guarantor, any payments received from your debtor during the one year before bankruptcy were subject to being characterized as a voidable preference. Fortunately, this ridiculous rule has been unambiguously abolished. Now you should be happy to take as many enforceable guarantees (from parents, affiliates, or other creditworthy "insider" parties) as you can get.

V. THE STRENGTH OF THE PARENT CORPORATION

A. Financial Statements

Since the value of the parental guarantee is your ability to rely upon the creditworthiness of the parent in extending credit, then you should assess such creditworthiness hypothetically as if the parent were the primary obligor. This means having in hand and analyzing the parent's audited financial statements as scrupulously as you would the primary debtor's. Be careful to assure yourself that the financials in question are in fact the financials of the parent and not some other entity or combination of entities. So-called "consolidated" financial statements can be very misleading. It is also prudent to require a written statement from the auditing CPAs acknowledging that the audit of the parent corporation is being provided at your express request for purposes of reliance in making the decision whether or not to extend credit, and on what terms. If it develops that the audit, under such circumstances, innocently but negligently misstates the true financial condition of the parent, then you may have a cause of action to recover from the CPAs, depending upon the nuances of local state law. For a case presenting exactly that scenario, finding the CPAs liable to the disappointed trade creditor, see *Blue Bell, Inc. vs. Peat, Marwick, Mitchell & Co.,* 715 S.W.2d 408 (Tex. App.—Dallas 1986, writ ref'd n.r.e.).

B. Credit Applications

Depending upon how extensive they are, credit applications can either enhance the information obtained from a current income statement and balance sheet, or be a substitute for such financials. For example, credit applications can verify whether or not there is any bankruptcy history, ferret out the true corporate relationships between and among the purchasing entity and the parent or any involved affiliates, require identification of individual corporate officers, directors, and decision-makers, and unearth similar relevant details which can be very useful in evaluating the benefit of a parental guarantee.

C. Due Diligence: Operating History, S&P/Moody's Ratings

The more you know, or can learn through "due diligence," about the operating history of your guarantor, including its payment patterns, and its reliability in servicing its trade debt, the better off you are. If published credit ratings exist for your potential parental obligor, then you have a greater degree of objective assurance about the degree of risk that you are taking on with any particular parent and its subsidiary. However, published ratings should only be used to establish your credit-granting guidelines and criteria; they are not a "guarantee" that the guarantor will actually perform upon the default of the subsidiary. If a "guarantee" of your guarantor is the type of certainty that you are looking for, then consider buying a credit insurance policy to insulate yourself from market effects on parental creditworthiness. Of course, such insurance often comes with a pricetag which may not be economically feasible for your routine transactions.

D. The Risk of Non-rated Parent Corporations

Non-rated parent corporations cannot provide you with the same immediate, objective assurances as to their history of credit reliability. However, such non-rated parents may be excellent candidates to provide a meaningful and valuable parental guarantee in a particular transaction. With

non-rated parents, it is all the more critical to have access to audited financial statements for the parent so that a dependable system of credit-scoring (whether in-house or out-sourced) can be applied. The Altman-Weil Z-Score (a regression-model bankruptcy predictor) is just one example of the many potential quantitative credit-granting criteria, derivable from the financial statements and credit application, that may be important to your company.

E. The Risk of Over-Committed Parent Corporations

Part of your diligence in evaluating the parent is to know the entire universe of parental guarantees to which it is obligated. Corporate financial statements (especially unaudited statements) cannot always be relied upon to candidly disclose the number of parental guarantees which the parent may have taken on for its subsidiary(ies). Your comfort level obviously increases if you are one of but a few creditors protected by a parental guarantee, as opposed to being one of many.

VI. WEAKNESSES AND LIMITATIONS OF PARENTAL GUARANTEES

If the parent is financially strong, as assessed by your diligence in marshalling the relevant base of data, your analysis of the pertinent financials, your review of ratings, and/or credit scoring, and if the universe of potential contingent liabilities of the parent is relatively small because the parent has given guarantees but sparingly, then a default, bankruptcy, or insolvency of the trading subsidiary may affect you but minimally because you can look with confidence to the parent. By the same token, if the parent is no stronger than the subsidiary, has weak financials, ratings, or scores, and has given guarantees left and right to any creditor who asks, the protection of the parental guarantee can be virtually non-existent. Prudent credit practices will involve using parental guarantees in combination with other security devices which irrevocably commit particular specified assets or funds for which your company will have a priority relative to other creditors.

VII. Example - LEGAL ANALYSIS OF PARENT GUARANTY FORM

VII. CONCLUSION

The array of security devices available to you as tools to minimize your credit risk is multi-faceted. Parental guarantees are but one option in your "bag of tricks" and must be used with awareness as to how they compare to and contrast with other potential security devices. No one strategy to minimize credit risk will make sense in every debtor/creditor or buyer/seller relationship. This is particularly true of the parental guarantee, which may be crucial to your credit decision in one transaction, but merely "gravy" in another. However, by being more aware of the possible use of parental guarantees, it is hoped that you will be able to do a better job of protecting your company's investment in supplying its customers on credit. Be aware that since parental guarantees have legal legitimacy because of state contract and creditors' rights laws, there are nuances which vary from one state to another. Consult an attorney who specializes in creditors' rights law with your unique and particular problems, circumstances, and relationships, in the states and jurisdictions in which your company operates.

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