

DEBTOR/CREDITOR

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Guaranty Not Discharged

The federal bankruptcy statute does not provide a discharge for debts arising from "defalcation [misuse of funds] while acting in a fiduciary capacity." An appeals court in Richmond recently applied this to the guarantor of corporate debt.

A farm equipment dealership borrowed money to finance the purchase of inventory, giving the lender a security interest in the equipment and the personal guarantee of the dealership's owner. The security agreement required the dealership to segregate a portion of the sale proceeds from each item of equipment and pay those to the lender. Because of financial pressures, the dealership failed to do so. This is known as "selling out of trust."

After the business failed, the owner filed a bankruptcy petition in order to discharge his guarantee liability to the lender. The lender objected. The court determined that (1) the corporation had a fiduciary duty to pay sale proceeds to the lender, (2) failure to pay the proceeds was a defalcation, (3) the owner was personally responsible for the corporate conduct, and (4) the owner's conduct was a breach of fiduciary duty to the corporation. Thus, the owner's guarantee was not discharged.

Small business owners should beware of restrictions in secured loan documents on the use of funds.

KubotaTractor Corp. v. Strack (In re Strack), 524 F.3d 493 (4th Cir. 2008).

Backdoor Corporate Takeover

Mr. Nelson was a shareholder, board member and CEO of a software company. The corporation had financial difficulties, and Nelson sought to acquire the company's business while "freezing out" the other shareholders. He resigned as board member and CEO, purchased the bank's secured loan to the company, foreclosed the loan and

purchased all the corporate assets at the foreclosure sale.

The other shareholders put the company into bankruptcy and sued Nelson to recover the assets, claiming breach of fiduciary duties as an officer and director of the corporation. A Chicago judge rejected the claims of the other shareholders, reasoning that the bank had given Nelson no special treatment. Any one else could have purchased the bank's loan on the same terms. Nelson's status as a former officer and director was not relevant.

Nelson v. Repository Technologies (In re Repository Technologies), 381 B.R. 852 (N.D. Ill. 2008).

Joint Check Defeats Preference

A debtor's payment to a creditor made within 90 days prior to filing a bankruptcy petition may be recovered by a bankruptcy trustee as preferential. There is an exception where the funds paid are held in trust for the creditor.

Where a general contractor gives a subcontractor a check payable jointly to the subcontractor and one of the subcontractor's creditors, the funds represented by the check are in trust for the creditor, and the subcontractor's bankruptcy trustee will not be able to recover the payment from the creditor.

Creditors of financially shaky subcontractors should consider asking the general contractor for joint checks. *Guttman v. IMPulse NC, Inc. (In re Railworks Corp.)*, 387 B.R. 156 (Bankr. D. Md. 2008).

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This newsletter is intended to inform its readers of developments in the area of debtor/creditor relations. It is not legal advice or a legal opinion regarding any specific matter. You should consult a lawyer regarding any questions relating to your particular situation.

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