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**IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF KANSAS**

In Re:

VILLA WEST ASSOCIATES,

DEBTOR.

**CASE NO. 88-40614-7
CHAPTER 7**

DARCY D. WILLIAMSON,

PLAINTIFF,

v.

ADV. NO. 89-7309

FRED C. KAY,

**DEFENDANT/ THIRD-PARTY
PLAINTIFF,**

v.

LESLIE M. BURNS, et al.,

THIRD-PARTY DEFENDANTS.

MEMORANDUM OF DECISION

On February 25, 1999, the last unresolved dispute in this adversary proceeding was argued and submitted to the Court for decision. The dispute concerns the attempt of MN Associates (“MN”), a partnership that is a third-party defendant and cross-claimant in this case, to recover principal, interest, attorney fees, and expenses from Doug and Ann Kay, third-party defendants and cross-claimants, based on their personal guaranty of a portion of certain debts incurred by Villa West Associates (“Villa West”), the debtor. MN is represented by counsel Robert J. Bjerg. The Kays are

represented by counsel Cindy L. Reams-Martin. The Court has considered the parties' oral and written arguments, and is prepared to decide the dispute.

FACTS

This case arose out of the Villa West partnership's financial difficulties and subsequent bankruptcy. The Kays and all the partners of MN were limited partners in the Villa West partnership. The Kays personally guaranteed a share of any loans or advances that Metro North State Bank ("Bank"), a bank located in Missouri, might make to Villa West; they signed the guaranty in their home state, California. The guaranty stated that it was "limited to and shall not exceed . . . the principal sum of" \$41,540.63, "together with interest thereon and costs of collection thereof, including reasonable attorneys' fees." Villa West thereafter gave the Bank two notes, one for a loan and one for a letter of credit, using the money and credit to help it buy a shopping center in Topeka, Kansas. A few months after Villa West had filed for bankruptcy, the letter of credit was drawn by the beneficiary and both notes immediately matured.

Sometime later, without telling the Kays or Villa West's general partner, the other Villa West limited partners formed MN, which then purchased Villa West's notes from the Bank, along with the Kays' guaranty, among other security. MN demanded that the Kays honor their guaranty, but they defaulted by failing to do so by March 29, 1989. MN now contends the Kays owe it the \$41,540.63 they guaranteed, plus 12% interest, totaling \$48,237.94 by December 3, 1998, and accruing at \$13.66 per day thereafter, plus \$21,321.45 in attorney fees, costs, and expenses. The chapter 7 trustee for the

Villa West bankruptcy estate has collected sufficient money from Villa West's general partner to pay MN the full principal owed on the notes it bought from the Bank. Due to the interaction of 11 U.S.C.A. §502(b) and §723(a),¹ the trustee could not recover from the general partner postpetition interest on MN's claim. *See Williamson v. Kay (In re Villa West Associates)*, Case No. 88-40614-7, Adv. No. 89-7309, Memorandum of Decision, slip op. at 7-11 (Bankr.D.Kan. Oct. 13, 1993), *aff'd on this point but rev'd on other grounds*, 193 B.R. 587, 594-95 (D.Kan. 1996), *point not raised but district court aff'd*, 146 F.3d 798 (10th Cir. 1998). MN lost any right to recover postpetition interest from Villa West's general partner by dismissing with prejudice a state court lawsuit in which it had sought such interest and failing to assert a claim for such interest against the general partner in this proceeding. *Id.*, slip op. at 9.

At the hearing on February 25th, MN's counsel asserted that, although the bankruptcy estate will pay all the principal the debtor owes on MN's notes, the Kays should still be required to pay the \$41,540.63 in principal that they guaranteed plus interest, fees, and costs, and that MN should be allowed to apply the Kays' principal and interest payments to the postpetition interest that it cannot collect from the bankruptcy estate or Villa West's general partner. This argument was not made in the motion MN filed that led to the February hearing, and was not supported by any case citations during or after the hearing. The Kays do not dispute the principal amount of their guaranty, MN's computation of the postpetition interest it claims is due, or the reasonableness of the fees and costs MN seeks. Instead, they contest on other grounds MN's right to obtain a judgment against them.

¹Section 723(a) was amended in 1994 for cases filed after the effective date of the amendment. The prior version of the statute applied in this case.

DISCUSSION

The Kays contend: (1) the provision in their guaranty for the recovery of attorney fees and expenses was void under Kansas law; (2) requiring them to pay interest on their guaranty would be inequitable since the bankruptcy estate will pay the entire principal owed to MN; and (3) they should not be required to pay the principal amount of their guaranty and then seek to be reimbursed from Villa West's bankruptcy estate. The Court will address these issues in order.

1. Attorney fees and expenses

The Kays' obligation to MN is based on their contract as California residents with a Missouri bank to guarantee loans to be made to a Kansas limited partnership. The loans were used to buy real property located in Kansas. Because of the connections of Villa West and the underlying transactions to Kansas, and because this Court sits in the State of Kansas, the Kays argue their guaranty contract should be governed by Kansas law. At the time all the relevant contracts were executed, K.S.A. 58-2312 (Ensley 1983) made invalid any provision for the payment of attorney fees to a creditor that was contained in various types of debt agreements, including a guaranty of a note. *Iola State Bank v. Biggs*, 233 Kan 450, 459-64 (1983). That statute was the substantive law of Kansas and rendered contract provisions for the collection of attorney fees void. *Ryco Packaging Corp. v. Chapelle Int'l, Ltd.*, 23 Kan. App. 2d 30, 42-46 (1996). Consequently, if Kansas law applies to their guaranty, the Kays are right that MN may not recover attorney fees from them. MN argues that California law applies because the Kays signed the guaranty there. The Kays do not contest MN's assertion that California law would permit the attorney fee provision to be enforced. Neither party has argued that

Missouri law would apply, but they agreed at the hearing that MN could collect attorney fees if that law applied. Missouri was certainly a significant location in all the transactions since the Bank was located there, and presumably received the limited partners' guaranties and Villa West's promissory notes there before it extended credit to the partnership from there. Still, since California and Missouri law provide the same rule on this issue, the Court need not decide which of them should apply, but only whether Kansas law controls.

A federal court exercising diversity jurisdiction must apply the choice of law rules of the state in which it sits. *Shearson Lehman Bros., Inc., v. M & L Investments*, 10 F.3d 1510, 1514 (10th Cir. 1993); *Deere & Co. v. Loy*, 872 F.Supp. 867, 869 (D. Kan. 1994). The Court believes that a bankruptcy court faces a situation analogous to diversity jurisdiction when it must decide a state law question that is before it only because the question arises in or is related to a bankruptcy case, but neither bankruptcy nor other federal law affects the decision. Consequently, the Court must follow the diversity rule here. The Kays concede that Kansas choice of law decisions declare that the law applicable to a contract is the law of the state where the contract is made, and that a contract is made when and where the last act necessary for its formation is done. *Simms v. Metropolitan Life Ins. Co.*, 9 Kan. App. 2d 640, 642-43 (1984). Under this test, the Kays argue, Kansas law should apply because Villa West is a Kansas partnership, Villa West executed the notes that allowed it to obtain credit from the Bank, the credit was extended in Kansas, the Bank filed a proof of claim in Villa West's bankruptcy case in Kansas, and the Kays' guaranty was not a binding contract when they signed but became one only after Villa West obtained the credit in Kansas. The Court cannot agree. Although it is related to Villa West's notes in a legal sense, the Kays' guaranty contract is a separate and distinct

contract. *Iola State Bank v. Biggs*, 233 Kan. at 452-53. Admittedly, if Villa West had never signed the underlying notes or had never defaulted on them, the Kays could never have been required to pay the obligation they guaranteed. Still, whether executed before or after the underlying contract, a guaranty is a separate contract and is complete when signed, without regard to the guarantor's ultimate liability on the underlying contract. The Court concludes that either California or Missouri law governs the Kays' guaranty. Consequently, MN is entitled to enforce the attorney fee provision it contains.

2. *Interest*

As this Court previously ruled, under 11 U.S.C.A. §723(a) (before its amendment in 1994), the chapter 7 trustee can recover from Villa West's general partner enough money to enable the bankruptcy estate to pay in full the principal owed on all the partnership's unsecured debts, but cannot recover money to pay postpetition interest on those debts. Because MN's claim against Villa West is unsecured, postpetition interest on the claim must be disallowed pursuant to §502(b)(2). Of course, postpetition interest continues to accrue on the notes until they are paid, even though the bankruptcy estate is not responsible for paying it. The Kays suggest this operation of the Bankruptcy Code also precludes MN from recovering interest from them because it dismissed, with prejudice, a state court lawsuit against them, and agreed instead to pursue its claims against them before this Court. Because Villa West is not an individual, however, it will not receive a discharge of its debt to MN, §727(a)(1), so the limit on MN's recovery from the bankruptcy estate does not limit its recovery from Villa West. As a practical matter, no post-bankruptcy recovery is likely, but no provision of the Bankruptcy Code precludes it. Even if Villa West would receive a discharge, §524(e) would prevent that discharge from

affecting the Kays' liability on its debts. The dismissal with prejudice of the state court lawsuit does not affect MN's right to recover interest here because MN had also asserted that right through its cross-claim against the Kays and the dismissal expressly preserved all claims that had been asserted in this proceeding. The fact that claim is based on state law does not prevent this Court from deciding the validity of the claim; bankruptcy courts routinely resolve such state law questions.

The Kays also contend it would be inequitable to require them to pay interest to MN because the bankruptcy estate will be paying the full principal amount of MN's claim. However, as guarantors, the Kays had an independent obligation, upon proper demand, to pay the principal portion of Villa West's notes that they had guaranteed. When they failed to do so, that principal amount began to bear interest, as provided in the guaranty. Even though the estate will ultimately pay the principal owed to MN, the Kays deprived MN of the use of the portion they had guaranteed from the time they should have paid it until the estate pays it. Consequently, they do owe MN the interest it is seeking from them.

3. Principal

The Kays do not dispute that they owe the \$41,540.63 identified as "principal" in their guaranty, but ask that they not be required to pay it to MN and then seek reimbursement from the trustee, who presently intends to distribute to MN the full principal owed on its notes. MN, on the other hand, belatedly argues that even if the trustee pays it the full amount of the notes, it will still be entitled to collect the \$41,540.63 from the Kays and to apply it to the unpaid interest that is accruing on Villa West's obligations. MN also contends it can collect the \$48,237.94 plus in interest that has accumulated on the \$41,540.63 principal the Kays have owed since MN made demand for it in 1989.

MN has cited no authority for this new theory, and the Court cannot agree with it. As indicated, the guaranty agreement, drafted by MN's predecessor, calls the \$41,540.63 "principal." This word is not ambiguous, and MN cannot recharacterize the obligation now. Even if it were somehow ambiguous, the Court would have to construe it against MN as the successor to the draftsman. The Court finds it significant that, although this litigation has been pending for nearly ten years, MN has not previously suggested the guaranty could be construed this way, and has not offered any authority to support doing so now.

CONCLUSION

For these reasons, the Court concludes that MN is entitled to a judgment against the Kays for \$41,540.63 in principal, \$48,237.94 plus \$13.66 per day from December 3, 1998, to the date of the judgment that will be entered at the same time as this Memorandum of Decision, and \$21,321.45 in attorney fees. This judgment will draw interest at the federal judgment rate once it is entered. However, the Court will stay MN from taking any steps to collect the \$41,540.63 principal portion of this judgment pending distribution of the bankruptcy estate by the trustee. The principal portion of this judgment will be satisfied by the trustee's distribution to MN of the full principal amount owed on its notes. The Kays will be allowed to pay the \$41,540.63 in principal along with the rest of the judgment in order to stop the running of post-judgment interest, but they will not be obliged to do so. If the Kays choose to pay MN their principal obligation before the trustee distributes the property of the bankruptcy estate, the trustee will be required to reduce the distribution to MN by that amount and

distribute the \$41,540.63 to the Kays instead to reimburse them for their payment on Villa West's debt.

The foregoing constitutes Findings of Fact and Conclusions of Law under Rule 7052 of the Federal Rules of Bankruptcy Procedure and Rule 52(a) of the Federal Rules of Civil Procedure. A judgment based on this ruling will be entered on a separate document as required by FRBP 9021 and FRCP 58.

Dated at Topeka, Kansas, this ____ day of March, 1999.

JAMES A. PUSATERI
CHIEF BANKRUPTCY JUDGE