business CREDIT
NOVEMBER/DECEMBER 2021
THE PUBLICATION FOR CREDIT & FINANCE PROFESSIONALS $9.00

Does Guarantor's Bankruptcy Discharge Extinguish Future Guarantor Liability?


Bruce Nathan, Esq., is a partner in the New York office of the law firm of Lowenstein Sandler LLP, practices in the firm's Bankruptcy & Restructuring Department, and is a recognized expert on trade creditors' rights and the representation of creditors in bankruptcy and other legal matters. He is a member of NACM, a former member of the board of directors of the American Bankruptcy Institute and a former co-chair of ABI's Unsecured Trade Creditors Committee. Bruce is also the co-chair of the Avoiding Powers Advisory Committee working with ABI's commission to study the reform of Chapter 11. He can be reached at bnathan@lowenstein.com.

Michael Papandrea, Esq., is an associate in Lowenstein Sandler's Bankruptcy & Restructuring Department focused on providing practical solutions for debtors, creditors' committees, individual creditors, and other interested parties involved in bankruptcy and creditors' rights matters. Prior to joining the firm, Mike clerked for multiple bankruptcy judges in the District of New Jersey and Eastern District of Pennsylvania. He can be reached at mpapandrea@lowenstein.com.

Trade creditors extending credit to a financially distressed customer might seek a personal guaranty of a customer's indebtedness—frequently from the customer's principal. But what happens if a guarantor files for bankruptcy protection and obtains a discharge of his or her debts? Does a bankruptcy discharge extinguish a guarantor's personal liability for the creditors' post-petition (and post-discharge) extensions of credit to the customer?

The answer is yes, at least according to an August 2021 decision by the U.S. Bankruptcy Court for the Eastern District of Wisconsin (Bankruptcy Court) in *Reinhart Food Service L.L.C. v. Schlundt (Reinhart).* However, there are contrary court decisions that preserve the enforceability of a guaranty to debts arising post-bankruptcy.

Nonetheless, the *Reinhart* decision demonstrates the importance of not only "knowing your customer," but also "knowing your guarantor." That includes knowing your guarantor's financial condition and whether the guarantor has filed for bankruptcy in order to avoid the risk of having an unenforceable guaranty with respect to the customer's future obligations.

Background Regarding the *Reinhart* Case

From 2003 to 2018, David Schlundt was the owner and sole member of The Refuge, LLC (The Refuge), a restaurant in Antigo, Wisconsin. On September 11, 2003, The Refuge entered into a supply agreement (Supply Agreement) with Reinhart Foodservice, LLC (Reinhart), for Reinhart to provide food and restaurant supplies to The Refuge. Schlundt executed an absolute, continuing and irrevocable individual personal guaranty (Guaranty) pursuant to which Schlundt had agreed to be personally liable for all indebtedness that The Refuge owed to Reinhart under the Supply Agreement.

A decade later, in 2014, Schlundt and his wife (collectively, the Debtors) jointly filed a Chapter 7 bankruptcy petition. The Debtors did not list Reinhart as a creditor on their bankruptcy schedules or creditor matrix, despite the Guaranty and The Refuge's

indebtedness of $10,000 to Reinhart when the bankruptcy was filed. On April 11, 2014, the Chapter 7 trustee issued a report of no distribution (*i.e.*, it was a no asset case); and on April 21, 2014, the Debtors received a discharge of their indebtedness pursuant to section 727 of the Bankruptcy Code. Section 727(b) discharges Chapter 7 debtors from "all debts that arose before the date of the order for relief [*i.e.*, the date of the bankruptcy petition]." Section 101(12) defines a "debt" as a liability on a claim, and Section 101(5)(A) defines a claim as "a right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured or unsecured."

The Refuge continued to operate and do business with Reinhart under the Supply Agreement for several years after the Debtors' bankruptcy filing and discharge. Reinhart never sought a new personal guaranty from Schlundt because Reinhart claimed that it had not received any notice of the Debtors' bankruptcy filing and first became aware of the filing in July 2018. Schlundt refuted this assertion, arguing that all of The Refuge's suppliers were made aware of his and his wife's bankruptcy filing.

In any event, The Refuge continued ordering and receiving goods and services from Reinhart in 2018. The Refuge then closed the restaurant after having failed to pay Reinhart unpaid invoices totaling $38,839.32 for the goods and services Reinhart had provided to The Refuge from March 2018 through May 2018.

Reinhart moved to reopen the Debtors' bankruptcy case without opposition and filed a complaint seeking to enforce the Guaranty to obtain payment from the Debtors[1] of The Refuge's unpaid debt incurred in 2018. Reinhart moved for summary judgment, seeking a determination that the Debtors' 2014 discharge did not cover their post-petition and post-discharge obligations under the Guaranty with respect to Reinhart's provision of goods and services to The Refuge on credit in 2018. The Debtors-defendants moved for summary judgment, arguing that their 2014 discharge extinguished the Guaranty and all personal liability to Reinhart thereunder because any debt under the Guaranty arose in 2003—when Schlundt had executed the Guaranty.

The Bankruptcy Court's Decision

The Bankruptcy Court granted summary judgment in favor of the Debtors, holding that their 2014 bankruptcy discharge had extinguished all existing and *future* indebtedness under the Guaranty. The Bankruptcy Court considered whether the Guaranty had created a contingent prepetition claim that was discharged in the Debtors' 2014 bankruptcy case or gave rise to a post-petition claim based on the credit Reinhart had extended to The Refuge in 2018 that did not exist prior to, and was not discharged in, the Debtors' 2014 bankruptcy case.

The Bankruptcy Court relied on the 2015 decision by the U.S. Court of Appeals for the Seventh Circuit (in which the Wisconsin Bankruptcy Court sits) in *Saint Catherine Hosp. of Ind., LLC v. Ind. Family and Soc. Servs. Admin*. The Seventh Circuit held that whether a claim arises prepetition or post-petition depends on the date of the conduct that gave rise to the claim. Under this "conduct test," the conduct that gives rise to a claim under a contract is generally the act of signing the contract.

The Bankruptcy Court concluded that Reinhart's claim under the Guaranty had arisen when Schlundt signed the Guaranty in 2003. Reinhart's guaranty claim was a contingent and unliquidated prepetition claim that existed when the Debtors had filed their bankruptcy case and, therefore, was extinguished by the Debtors' 2014 discharge.

The Seventh Circuit and other courts following the conduct test have noted that the policy goals underlying Bankruptcy Code are best served by finding that a claim arises "at the earliest point possible." A broad interpretation of a "claim" and "debt" through the conduct test captures a larger number of claims (such as contingent and unliquidated claims) than the alternative "accrual approach" that other courts have followed in preserving the enforceability of a guaranty to post-bankruptcy debts.

Courts that have applied the accrual approach, such as the U.S. Court of Appeals for the Third Circuit (which covers the historically Chapter 11-heavy District of Delaware), have held that "no claim exists until a right to payment accrues under state law." However, the Bankruptcy Court in *Reinhart* applied the conduct test and rejected the accrual approach because the court held it was bound to follow the Seventh Circuit's precedent in *St. Catherine*. As the Bankruptcy Court stated, the "application of the conduct test, and not a discernment of when Wisconsin law would determine Reinhart's claim to have arisen, is the pertinent inquiry." The Bankruptcy Court, therefore, concluded that Reinhart's claim arose prepetition, in 2003, when the Guaranty was signed. At that time, Schlundt had a contingent liability to Reinhart in the event of a future default by The Refuge that was subsequently discharged as part of the Debtors' 2014 bankruptcy.[2]

The Bankruptcy Court acknowledged that certain courts had criticized the conduct test for potentially resulting in the discharge of a claim regardless of whether the creditor had reason to know the claim existed at the time of the bankruptcy filing. To avoid due process problems, courts have narrowed the conduct test to require a prepetition relationship through which the creditor would have become aware of its claim by exercising reasonable due diligence. The Bankruptcy Court determined, however, that application of this "relationship inquiry" to the *Reinhart* case would not have altered the result where the parties' relationship had clearly dated back to 2003—prior to the bankruptcy filing—in light of the parties' execution of the Supply Agreement and Guaranty at that time.

Conclusion

This story is not over, as Reinhart has appealed the Bankruptcy Court's decision to the U.S. District Court for the Eastern District of Wisconsin. But creditors—particularly those doing business within or with companies operating in Illinois, Indiana and Wisconsin (which federal districts are bound by Seventh Circuit precedent)—should be mindful of the Bankruptcy Court's ruling in *Reinhart* when extending credit to a customer on the comfort of having a personal guaranty by the customer's owner or principal. The *Reinhart* decision illustrates the risk that

a guarantor's bankruptcy filing and discharge may extinguish all claims under an existing guaranty, even with respect to post bankruptcy extensions of credit and/or where the creditor had no notice of the bankruptcy filing! Creditors should always conduct reasonable due diligence on both the customer and guarantor to protect themselves before extending new credit to their customers.

1 Though only Mr. Schlundt signed the Supply Agreement and Guaranty, Reinhart claimed that Mrs. Schlundt was also liable for the continuing post-petition debt pursuant to Wisconsin's Marital Property Act, Wis. Stat. § 766.55. The claim was ultimately rendered moot by the Bankruptcy Court's decision that the Debtors' 2014 bankruptcy discharge had extinguished the Guaranty.

2 Interestingly, the Bankruptcy Court held that there was no need to make any factual determination as to whether or when Reinhart had received notice of the Debtors' bankruptcy filing. The Bankruptcy Court concluded that such an determination was only relevant to Reinhart's potential argument that the guaranty-based debt was excepted from the Debtors' discharge pursuant to Bankruptcy Code section 523(a)(3)—and that Reinhart could not plausibly state a claim under section 523(a)(3). The Bankruptcy Court held that under the plain language of section 523(a)(3)(A), substantially all debts, other than certain debts incurred through willful and malicious conduct or by fraud, are included in the chapter 7 discharge in a no-asset, no-bar date chapter 7 case. Though Reinhart argued that Mr. Schlundt's filing chapter 7 without giving notice to Reinhart might have constituted willful or malicious conduct, the Bankruptcy Court rejected that argument. Reinhart's claim arose in 2018, after the bankruptcy filing, and therefore at the time of the bankruptcy, the claim at issue could not possibly have been considered a prepetition debt incurred by fraud or willful malicious conduct.