Guarantors Take Note: Debt Remains for Pre-Petition Guaranty Resulting in Post-Petition Debt

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Savvy creditors will obtain a personal guaranty from a financially distressed customer's principal before extending credit. And those same savvy creditors should anticipate that sometime later—even years later—the guarantor may file for bankruptcy and receive a discharge. If that happens, does the bankruptcy discharge prevent the creditor from collecting under the guaranty if debts arise therefrom after the discharge? In other words, if the creditor continues to extend credit to the guarantor even after the discharge—does the guarantor remain liable?

Bankruptcy courts have split over this issue and most circuits lack binding precedent. However, very recently, the United States District Court for the Eastern District of Wisconsin reversed a bankruptcy court's decision and held that a debtor's obligations arising from his personal guaranty of an LLC's debt executed prior to debtor's chapter 7 petition were not extinguished for debts arising post-discharge.1 According to the District Court, the bankruptcy court's conclusion was based on "an overbroad reading of Saint Catherine and is contrary to the plain terms of the Bankruptcy Code."2

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Background

The facts of this case are relatively straightforward and relatable for almost all of the business clients in our practice. Pursuant to a supply agreement, David Schlundt engaged Reinhart Foodservice, LLC (Reinhart), to be a provider of food services to his restaurant called "The Refuge." Within that same supply agreement, David, as sole member of The Refuge, also signed an "Individual Personal Guaranty" whereby he personally guaranteed prompt payment to Reinhart of The Refuge's obligations. Both of these agreements were formalized years before financial difficulties began.

In 2014, ten years after executing the agreements, David and his wife filed a joint petition for personal bankruptcy under Chapter 7. The Schlundt's did not list Reinhart as a creditor on their bankruptcy filing, nor did they schedule any debt to Reinhart in Schedule F. As a result, Reinhart did not even receive official notice of the bankruptcy filing. On April 11, 2014 the Trustee's Report of No Distribution confirmed it was a no assets case and the debtor received discharge 10 days later.3

Over the next four years, The Refuge continued to operate and incur debt with Reinhart. And when The Refuge finally closed in the summer of 2018, Reinhart was owed approximately $37,000.00. Reinhard demanded payment from David under the personal guaranty, but David refused to pay, citing the 2014 bankruptcy discharge.

As a savvy creditor, Reinhart avoided sanction risk by returning to the bankruptcy court with theirconcerns, rather than trying to collection on potentially discharged debt. The bankruptcy court, concluding it was bound by a Seventh Circuit decision, held that the liability was discharged as pre-petition debt in the 2014 bankruptcy. Reinhart appealed.

Law and Analysis

As the Court noted, pursuant to the Bankruptcy Code, 11 U.S.C. §727(b), the Schlundts' bankruptcy discharge effectuated a discharge of "all debts that arose before the date of the order for relief under this chapter." The Court followed with clarifications that: (1) a debt is a liability on a claim of a creditor;4 (2) a claim is 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;"5 and (3) the terms "date of the order for relief" is the bankruptcy filing date of the debtor.6 Read together, the Court maintained that these definitions applied to the Schlundt's bankruptcy case such that their discharge order eliminated all debt that arose before the filing date—but not debt arising after the filing date of the bankruptcy.

While the Schlundts' insisted that debts associated with the personal guaranty, "whether from credit extended before or after their bankruptcy filing, must be deemed to have arisen when Schlundt signed the Personal Guaranty in 2003," the Court emphasized that a "promise" and a "debt" are not the same thing.7 The Court elaborated, stating:

> Most debtors enter bankruptcy having made many promises and signed many contracts. But the mere existence of a promise or a contract does not necessarily create a legal liability. Nor does a bankruptcy discharge automatically wipe away all of a debtor's pre-bankruptcy contracts or contractual promises. A debtor's discharge precludes enforcement of "debts"—not promises—that arose before the bankruptcy petition was filed."8

Significantly, in 2017, the District of Maryland heard a case with similar facts to those in Reinhart and also concluded that "unpaid amounts arising from [contractor's] post-petition purchase orders, even if owed by [Guarantor] pursuant to her unrevoked pre-petition guaranty, were not pre-petition debts discharged through [Guarantor's] bankruptcy."9

Conclusion

Again, bankruptcy courts are still split in cases like this, and most circuits lack binding precedent. Until a circuit split captures the Supreme Court's attention, the back and forth is projected to continue. Interestingly, some courts' rulings in these cases, including Reinhart here, appear to suggest that if any pre-petition debt was listed and the guaranty was revoked by the party, the results may have been different. Thus, it is very important to have counsel that understands the importance of notifying everyone and actually listing the guaranty as being cancelled or revoked in the bankruptcy schedules. Contact our team today at (410) 983-6536 or you can SCHEDULE AN CONFIDENTIAL CONSULTATION.

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