Reinhart

Lenders Beware: The Effect of Bankruptcy on Personal Guaranties

A well-drafted personal guaranty of payment and performance provides peace of mind for the diligent lender. It is not only irrevocable, but also covers future extensions of credit and includes broad waivers of defenses. Even when a lender is faced with a bankruptcy proceeding, the guarantor's promise to pay the full amount of a debt is inviolate: a claim against the guarantor need not be reduced to account for recoveries from other sources unless and until the creditor is paid in full. As long as the creditor does not collect more than it is owed, it may prosecute its bankruptcy claim for the full amount of a guaranty obligation, regardless of the current balance on the debt. *See, e.g., Reconstruction Finance Corp. v. Denver & R.G.W.R. Co.*, 328 U.S. 495, 529 (1946) ("The rule is settled in bankruptcy proceedings that a creditor secured by the property of others need not deduct the value of that collateral or its proceeds in proving his debt.") (citing *Ivanhoe Bldg. & Loan Assoc. v. Orr*, 295 U.S. 243 (1935)).

In general, a claim against a personal guarantor is just that: a cause of action against one who promised to pay; an unsecured claim. And like most unsecured debts, a guaranty obligation can be discharged in a bankruptcy proceeding. But what about new extensions of credit—advances made to the primary obligor after the guarantor's discharge in bankruptcy? The answer resides in a recent decision from Judge Beth E. Hanan, in the U.S. Bankruptcy Court for the Eastern District of Wisconsin, confirming what lenders may have feared all along—those debts, too, are discharged.

In *Reinhart Food Service L.L.C. v. Schlundt (In re Schlundt)*, Adv. No. 20-2091-beh (Bankr. E.D. Wis. August 19, 2021), Judge Hanan used the "conduct test" to determine whether the personal guaranty signed by Mr. Schlundt in 2003 created a pre-petition debt that was discharged in the Schlundts' 2014 chapter 7 bankruptcy, or "set the stage" for a post-bankruptcy debt incurred when Reinhart Food Service extended credit in 2018. Under the conduct test, "the date of a claim is determined by the date of the conduct giving rise to the claim." *Id.* (citing *Saint Catherine Hosp. of Ind., LLC v. Ind. Family and Soc. Servs. Admin.*, 800 F.3d 312, 315 (7th Cir. 2015)). The test can be contrasted with the "accrual theory," by which the date of a claim was determined with reference to state law that dictates when liability for the claim arose.

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The conduct giving rise to a contract claim is usually the signing of the contract, so liability generally arises on the date a contract is signed. This is true even though the contractual obligation may be contingent or unmatured at the time the contract is signed (a "claim" in bankruptcy is broadly defined 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." 11 U.S.C. § 101(5)(A)). This is a clear expression of congressional intent to discharge as many claims as possible in a bankruptcy proceeding, to ensure a debtor's "fresh start."

Any concerns that the conduct test is too broad—potentially resulting in the discharge of a claim before a creditor has reason to know it exists—were mitigated, Judge Hanan found, by the pre-petition contractual relationship between Reinhart Food Service and Mr. Schlundt. The guaranty expressly contemplated future indebtedness, and Mr. Schlundt assumed a contingent liability when he signed the guaranty. Therefore, Schlundt's guaranty was discharged in the 2014 bankruptcy, and did not extend to Reinhart Food's new credit in 2018.

The *Reinhart Food* decision serves as a reminder that lenders should not assume that personal guaranty liabilities will "ride through" a bankruptcy, even for new, post-bankruptcy extensions of credit. The advice here would appear simple: get a new personal guaranty. But lenders should exercise caution when obtaining a new guaranty that is arguably connected to a discharged debt. Some courts have found new, post-discharge guaranties unenforceable as unlawful reaffirmations of debt in violation of Bankruptcy Code § 524(c) and have even held that lenders violate the discharge injunction by obtaining such guaranties, subjecting them to liability. *See, e.g., Americorp Fin. LLC v. Schwarz (In re Schwarz)*, No. 15-00044, 2016 WL 7413478 (Bankr. E.D.N.C. Dec. 22, 2016). Lenders should work with legal counsel to avoid this liability.

If you have questions about personal guaranties in bankruptcy, or other insolvency issues, please contact Frank DiCastri or your Reinhart attorney.