Wis. Bankruptcy Ruling Sets Bad Policy For Debtor Liability

By **Donald Swanson** (December 14, 2022)

Every now and then, we get a bankruptcy opinion declaring a rule with broad application that may make sense in specific situations but is a terrible result for others.

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Here's an Exhibit A opinion for such a proposition: Reinhart Foodservice LLC v. Schlundt in the U.S. District Court for the Eastern District of Wisconsin on Oct. 27.[1]

The Facts

The Schlundt opinion cited these crucial facts:

- In 2003, the debtor signed a continuing guaranty;
- In 2014, the debtor received a Chapter 7 bankruptcy discharge; and
- In 2018, the guaranteed party created a new debt that is covered by the language of the debtor's 2003 guaranty.

The Question

The Schlundt opinion addresses this question: Is the debtor liable under the 2003 guaranty for the 2018 debt, notwithstanding the debtor's 2014 bankruptcy discharge?

The Practicalities

Before getting to the court's answer, let's consider the practicalities of the situation for other Chapter 7 debtors. Imagine these facts.

The debtor goes through the ordeal of a bankruptcy proceeding, receives a Chapter 7 discharge and is getting on with life under the fresh start that bankruptcy provides.

Years later, out of the blue and without the debtor's involvement or knowledge, a third person incurs a debt that, lo and behold, is covered by the language of a long-forgotten guaranty that the debtor signed before filing bankruptcy and scheduled in the bankruptcy.

Surprise, surprise. The debtor's bankruptcy fresh start is now destroyed by the actions of a third person — there is nothing good or fair or proper about such a result.

Now, back to the Schlundt opinion.

The Ruling

The U.S. Bankruptcy Court for the Eastern District of Wisconsin had ruled in 2021 that "the Schlundts' 2014 discharge order extinguished any personal liability under the Individual Personal Guaranty."

The district court reversed this, finding that the debtor was liable for the $36,839.62 post-petition debt covered by the prepetition guaranty, notwithstanding the intervening bankruptcy discharge. That's because, the district court declared, the debt is a post-bankruptcy debt under "the plain terms of Section 727(b)."

The Case

Here is how the court arrived at its holding.

Legal Standards

Under Section 727(b) of the U.S. Bankruptcy Code, the bankruptcy discharges "all debts that arose before the date of the order for relief under this chapter."

"Debt" means "liability on a claim," according to Section 101(12), and "claim" means 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," according to Section 101(5)(A).

Accordingly, the 2014 bankruptcy discharge extinguished only those debts that arose before the bankruptcy filing date.

Facts

In 2003, the debtor guaranteed his restaurant's existing and future debts — more than 10 years before filing bankruptcy.

The debt at issue arose between March and May 2018 when the debtor's restaurant, a limited liability company entity, acquired $36,839.62 worth of goods and services from the guaranteed party.

Debtor's Argument Is Without Merit

The debtor argued that the guaranteed debt must be deemed to have arisen when the debtor signed the guaranty in 2003. This argument fails for the following reasons.

The argument confuses a contractual promise with a debt, which are not the same thing. A debtor's discharge precludes enforcement of debts — not promises — that arose before the bankruptcy filing.

Nothing in the Bankruptcy Code provides that the mere filing of a bankruptcy automatically terminates all of a debtor's existing contractual obligations.

Other courts have handled debts arising post-petition from pre-petition guaranties similarly, including:

- In re: Rosenfeld in the U.S. Court of Appeals for the Fourth Circuit in 1994;
- In re: Brand in the U.S. District Court for the District of Maryland in 2017;
- In re: Shaffer in the U.S. Bankruptcy Court for the Western District of Virginia in 2018;
- In re: Jordan in the U.S. Bankruptcy Court for the Middle District of Alabama in 2006.

The debtor also tried to characterize the $36,839.62 post-petition guaranteed debt as a liability on a contingent claim under Section 101(5)(A) — but this stretches the meaning of a "contingent" claim almost beyond recognition.

Finally, neither the debtor nor the guaranteed party had any liability for the $36,839.62 at issue in 2014, as it was not even a glimmer on the horizon of anyone's imagination, so there was nothing in 2014 that could have been discharged.

A Technical Problem

The district court's analysis is technically flawed. It focuses on the debts of the wrong person, under the Section 727(b) words "debts that arose before."

Such focus must be on debts of the debtor, not on debts of the guaranteed party. While it is true that the guaranteed party's debt may have arisen after the debtor's bankruptcy filing, the debtor's obligation for that same debt actually arose back in 2003 at the signing of the guaranty.

Without the signed guaranty, the debtor has no debt. So the debtor's debt, if it exists at all, had to arise at the signing of the guaranty.

A Practical Problem

The district court's analysis is also flawed practically.

The Schlundt opinion confuses post-discharge actions by the debtor with post-discharge actions by others. This confusion is obvious from two items of rationale the Schlundt opinion provides — an example and a discussion.

Example

The opinion provides the following example.

When a debtor files bankruptcy, with a credit card, the discharge will eliminate only those credit card debts incurred before the bankruptcy filing. The same debtor is not free to go on a post-bankruptcy spending spree using that same credit card and then have the new post-petition charges declared discharged under the prior bankruptcy.

Here's the problem: In this example, it is the very same person who receives the bankruptcy discharge that is engaging in the post-bankruptcy spending spree.

Accordingly, it makes no difference, in the example, whether the debtor uses a pre-bankruptcy credit card or a post-bankruptcy credit card: That debtor will be liable for the post-bankruptcy charges, regardless of a discharge in a prior bankruptcy.

In other words, this is a bad example that does not support the opinion's conclusion.

Discussion

The opinion provides the following discussion.

At the time of the debtor's bankruptcy, the guaranty did not obligate the debtor to do

anything. It is only later, when the debtor chooses to have the debtor's restaurant obtain additional credit from the guaranteed party, that the debtor becomes exposed to liability.

There is nothing onerous or unfair about holding the debtor to that bargain based on the debtor's own post-bankruptcy conduct.

Here's the problem. In this example, it is the same debtor who incurs the new debt through an LLC that the debtor owns and controls.

This is the same point as the credit card example: The debtor takes post-bankruptcy action that incurs the new debt — it's making the debtor responsible for the debtor's own actions.

But that is a far cry from punishing a debtor for post-bankruptcy conduct by someone else.

A Bad Policy and Terrible Result

The ruling and rationale in the district court's Schlundt opinion would make all discharged debtors responsible for all post-bankruptcy transactions covered by any pre-bankruptcy guaranty — even when the debtor has no involvement in or knowledge of the incurring of the new debt.

This is a terrible result and a bad bankruptcy policy.

Conclusion

Here's hoping the U.S. Court of Appeals for the Seventh Circuit reverses on the pending appeal, and that other courts reject this opinion and refuse to follow it.

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[1] Reinhart Foodservice LLC v. Schlundt, Case No. 21-cv-1027 in the U.S. District Court for Eastern Wisconsin, (Doc. 12, issued October 27, 2022).