American College of Bankruptcy Seventh Circuit Education Seminar

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"Year in Review"

- What is a "valid reorganization purpose" anyway?
- The present status of the solvent debtor exception
- Reconciling conflicts between federal/state law, jurisdiction, soverign immunity, and contracts
- Exculation, release, and dicharge issues

Panelists:

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Is Chapter 11 No Longer a Route to Resolving Mass Tort Liabilities?
In re Aearo Technologies LLC* and *In re LTL Management, LLC

Catherine Steege

Three recent decisions—*In re Aearo Technologies LLC,* 2023 Bankr. LEXIS 1519 (Bankr. S.D. Ind. June 9, 2023)*, In re LTL Management, LLC,* 64 F.4th 84 (3d Cir. 2023) ***("LTL I")****, and In re LTL Management, LLC,* 2023 Bankr. LEXIS 1884 (Bankr. D.N.J. July 28, 2023) ***("LTL II")***—reign in the use of chapter 11 to resolve mass tort liabilities. In each of these cases, the courts found that, notwithstanding the significant number of tort claims pending against these debtors, the debtors' bankruptcies lacked a reorganization purpose because the debtors were not facing *imminent* financial distress. As a result, the courts concluded that the debtors had not filed their bankruptcy petitions in good faith and dismissed their cases for cause pursuant to 11 U.S.C. §1112(b)(1). The courts dismissed these cases even though in the case of *LTL II* (filed two hours after *LTL I* was dismissed on remand from the Third Circuit), the debtor had negotiated plan support agreements with 58,392 tort claimants and with the private lien holders holding approximately 85% to 90% of the medical liens, 2023 Bankr. Lexis 1884, at *10-13, and in Aearo's case, the debtor was a "named defendant in the biggest MDL in United States history," consisting of 255,500 actions. 2023 Bankr. LEXIS 1519, at *10, 50. In all three cases, the determinative factor was a "funding agreement" between the debtor's solvent corporate parent and the debtor that backstopped the debtors' liabilities to tort claimants. As a result of these funding agreements (and in Aearo's case, potential insurance coverage as well), the courts concluded that the chapter 11 cases were filed as a "litigation management tactic" and not as a part of a "rehabilitative effort." 2023 Bankr. LEXIS 1519, at *56.

The facts of the cases are as follows:

LTL I: In 2019, the Food & Drug Administration found traces of asbestos in Johnson & Johnson's baby powder. In 2021, Health Canada confirmed a finding of a significant association between exposure to talc and ovarian cancer. As a result, over 38,000 ovarian cancer lawsuits were filed along with approximately 400 mesothelioma actions against Johnson & Johnson Consumer Inc. ("Old Consumer") and its parent Johnson & Johnson ("J&J"). Although J&J and Old Consumer had a good track record in either defeating these claims or obtaining reversals on appeal, in 2020, a Missouri jury awarded $4.69 billion to 22 ovarian cancer plaintiffs, which was later reduced on appeal to $2.24 billion. 64 F.4th at 93-95.

As a means of addressing the ever-growing number of lawsuits and the associated defense costs (running at between $10 to $20 million per month), J&J restructured Old Consumer using Texas's divisional merger statute. Old Consumer transferred $6 million in cash, its equity interests in a subsidiary that received

certain royalty payments, and all of its talc-related liabilities to LTL. Old Consumer transferred its profitable operating business to New Consumer. When the dust settled, New Consumer was LTL's parent and New Consumer and J&J both agreed to back stop LTL's talc liabilities up to the value of New Consumer. Two days after the merger was complete, LTL filed for bankruptcy. 64 F.4th at 95-97.

The bankruptcy court declined to dismiss, concluding that LTL filed its petition in good faith because Old Consumer faced significant liabilities when it entered into the divisional merger and that bankruptcy was a preferable means of resolving mass tort liability. 64 F.4th at 98-99. The Third Circuit reversed. Although it acknowledged that a debtor need not be insolvent to file for bankruptcy, its petition must serve a valid reorganization purpose and cannot be filed merely to obtain a tactical litigation advantage. According to the Third Circuit, a valid bankruptcy purpose assumes the debtor is in financial distress and needs bankruptcy to preserve going concern value or to maximize the value of its estate for creditors. *Id*. at 100-104.

Unlike the bankruptcy court, the Third Circuit focused its financial analysis on LTL, concluding that the Bankruptcy Code is designed to address the financial distress of *the entity* that is actually in bankruptcy. 64 F.4th at 105-06. It concluded that LTL was not in financial distress because LTL had access through the funding agreement to New Consumer's $61.5 billion in assets and LTL itself had told the bankruptcy court that it could pay the talc claims in full. *Id*. at 106-10. Because LTL was not in immediate financial distress, the Third Circuit held that LTL did not file its petition in good faith. In a footnote, the court also noted that a filing to change the forum of litigation where there is no financial distress raises "the specter of 'abuse which must be guarded against to protect the integrity of the bankruptcy system.'" 64 F.4th at 110 n.19.

LTL II: Two hours after the bankruptcy court dismissed the first LTL case following its remand from the Third Circuit, LTL filed for bankruptcy a second time. 2023 Bankr. LEXIS 1519, at *10. While the appeal in its first case was pending, LTL reached agreement with a significant number of its creditors to settle all present and future talc claims by establishing a trust for their benefit with a present value of $8.9 billion. LTL also ripped up its old funding agreement; under the new agreements J&J only backstopped LTL's talc liabilities if LTL was able to confirm a plan of reorganization and New Consumer's backstop was also limited in amount. *Id*. at *9-15.

Notwithstanding the significant steps that LTL had taken to resolve its talc liabilities, the bankruptcy court dismissed its second case. Although the bankruptcy court expressed its disagreements with the Third Circuit's conclusions,[1] it dismissed

[1] For example, the bankruptcy court noted: "One can view the Third Circuit's ruling as being somewhat at odds with a pro-active approach to trouble. When one smells smoke, the wise course of action is to get out

the second case because the "emphasis on certainty and immediacy of financial distress closes the door of chapter 11 to LTL at this juncture." *Id*. at *36. It also concluded this time around that it could not consider whether an alternative to dismissal would be in the best interests of creditors because that option under §1112(b)(2) is "reserved only for those who properly belong in bankruptcy" in the first place. Id. at *49.

***Aearo*:** Unlike LTL, Aearo was an operating company with a business and employees. Aearo was not created for the purpose of filing a bankruptcy case. Nonetheless, the bankruptcy court still dismissed its case in a decision which tracks the reasoning of the Third Circuit's *LTL I* decision. Aearo, like LTL, faced significant liabilities related to Combat earplugs and a smaller number of claims related to its mask and respirator products. Its parent, 3M, defended the earplug claims on Aearo's behalf, and was found jointly and severally liable with Aearo in those cases where liability was found. In the respirator cases, Aearo had an agreement with another co-defendant for indemnification. Finally, Aearo had two insurance programs, in the amounts of $1.05 billion and $550 million that could potentially provide coverage for these claims. 2023 Bankr. LEXIS 1519, at *6-21.

Both 3M in public filings and Aearo in argument to the bankruptcy court acknowledged that Aearo filed chapter 11 to resolve its tort liabilities. 2023 Bankr. LEXIS 1519, at *13, 15. Before filing, Aearo negotiated a funding agreement with 3M pursuant to which 3M agreed to fund Aearo's tort liabilities whether Aearo was in bankruptcy or not. Based on that agreement, the bankruptcy court concluded that Aearo was not in imminent financial distress and thus did not file its chapter 11 petition in good faith. *Id*. at 56. The bankruptcy court further supported its conclusion by noting that "[t]here is also nothing before the Court to suggest that the Aearo Entities' filings serve creditors, as the cases will not necessarily augment their recovery." *Id*. In other words, bankruptcy served only to give Aearo a tactical advantage by moving its litigation to another forum.

What is the upshot of these three decisions? Can these cases be explained by the fact that the courts simply did not like a subsidiary using its bankruptcy to protect the parent? Is bankruptcy foreclosed whenever there is a third party that backstops the debtors' liabilities? What if the debtor has significant insurance coverage—does that fact alone preclude a bankruptcy filing? What if there is a non-recourse guaranty? How imminent does financial distress have to be to justify a chapter 11 filing? And is the moral of the story, do not negotiate too rich of a funding agreement before you file for bankruptcy?

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of the house and call for help. However, as it stands now, in gauging financial distress, observing smoke may not be enough—one must see flames." 2023 Bankr. LEXIS 1519, at *23.

The Status of the Solvent Debtor Exception

Professor Douglas G. Baird

It may be a rare day when a Chapter 11 debtor turns out to be able to pay all its creditors in full, but such cases have long been a part of our bankruptcy law and it is decidedly odd that they raise as many problems as they do.

It is worth starting at the beginning. The issue arose for the first time during the prolonged bankruptcy of Stephen Evance. Evance was born in New Haven in 1654, shortly after his father died. He was sent to England to apprentice for the Goldsmiths' Company. Evance flourished there, eventually serving as its Prime Warden. He was knighted and was, for many years, one of London's leading merchant bankers. Then Evance's fortunes took a sudden and spectacular turn for the worse. In late 1711, Evance embarked on a speculative venture in insurance. The business failed catastrophically, and his associates deserted him. In early March, while visiting his cousin, Evance hanged himself from an attic window and left others to make sense of his financial affairs. Evance had substantial assets along with his enormous debts, and his bankruptcy lasted many decades. The Lord Chancellor finally finished sorting things out in 1743. Bromley v. Goodere (1743) 26 Eng. Rep. 49; 1 Atk. 75.

The Lord Chancellor first confronted whether interest ran during the bankruptcy case. He found that it did not, reasoning that when bankruptcy was filed, everything came to a halt. A bankruptcy was like a shipwreck. In admiralty law, those with cargo aboard have a pro rata share of whatever is salvaged. Bankruptcy is the same. The relative rights of all the creditors are measured at the time that the petition is filed. Each creditor's contractual rights are transformed into a fixed pro rata share of the estate. If each creditor could enjoy interest at whatever rate their contracts provided, some creditors would enjoy more than others merely because of the length of the bankruptcy proceeding. Holmes embraced this conception of claims in Sexton v. Dreyfus, 219 U.S. 339 (1911). The sound idea that claims for unmatured interest should not be allowed was imported into §502(b)(2) of the Bankruptcy Code. Not all good ideas are new ideas.

But this did not end matters for the Lord Chancellor. Evance had been forced to throw in the towel too quickly. Eventually, his assets turned out to be much greater than the liabilities of the estate. Indeed, the bankruptcy estate could pay all the interest owed to Evance's creditors and still leave something for his heirs. The Lord Chancellor therefore had to ask whether the presence of a solvent debtor required departing from the principle that interest did not run during the case. He found that it did. The rationale for denying interest—protecting the relative rights among creditors—did not apply when every creditor could be paid in full. Indeed, he did not think the question particularly hard. As the Lord Chancellor put it, "it would be an extraordinary thing that the delay of payment should prevent the creditors from having an interest out of an estate able to pay it."

This idea that unsecured creditors had a right to interest when the debtor proved solvent also became part of American bankruptcy law. This right is unambiguously incorporated into Chapter 7. Section §726(a)(5) requires that interest be paid before any dividend is returned to the debtor. There was no reason that the debtor should receive more and the creditors less merely by the happenstance of bankruptcy. The Bankruptcy Code does depart from *Bromley v. Goodere* in one respect, however. Section 726(a)(5) provides for the "legal rate," and the conventional wisdom is that the legal rate means the federal government rate. The federal government rate is typically lower than the contractual rate. Hence, a solvent debtor may still receive a recovery even when the nonbankruptcy rights of creditors are not fully respected. It may not make sense to depart from ancient wisdom, but the interpretative task of deciding what counts as the "legal rate" is conceptually straightforward.

The treatment of the solvent debtor in Chapter 11, however, is not at all straightforward. To be sure, impaired creditors can invoke §1129(a)(7) and demand treatment at least as good as they would have received under Chapter 7. Because §726(a)(5) gives them a right to interest at the legal rate, they are entitled to it in Chapter 11 as well. But trouble begins when the plan leaves unsecured creditors unimpaired.

An unimpaired creditor cannot invoke §1129(a)(7), and there is no other explicit recognition of the unimpaired creditor's right to interest against a solvent debtor. Section 1124(1) does require that the plan leaves the legal, equitable, and contractual rights unaltered, but it is not obvious that this requires respecting claims that are disallowed.

Assume, for example, that a solvent debtor has a lawyer who has charged twice as much as was reasonable. The lawyer's allowed claim is hence only for half of what he charged. One can argue that a plan that pays this allowed claim in full leaves the lawyer unimpaired. By this account, §1124(1) focuses only on claims that the plan impairs, not on claims that the Bankruptcy Code itself impairs. Section 1124(1) demands only that a plan not impair an allowed claim. Once a claim is disallowed under §502(b), it ceases to exist. That the lawyer could collect an excessive fee outside of bankruptcy is neither here nor there. The Bankruptcy Code refuses to recognize such claims, and §1124(1) should not be read to bring them back to life.

This argument is not ironclad, at least as it applies to postcontractual interest. Section 502(b)(2) stands on a different footing than other parts of §502(b). Disallowance of unmatured interest is needed only to vindicate the principle of equality among creditors. It should not be read to provide a windfall to the solvent debtor. Moreover, as originally enacted, §1124 contained an additional subsection. Section 1124(3) rendered a creditor paid its entire claim in cash unimpaired. Congress eliminated this section after a court invoked this provision to hold that an unimpaired creditor was not entitled to postpetition interest. In re New Valley

Corp., 168 Bankr. 73 (Bankr. D.N.J. 1994). One might infer from this deletion Congress's intent to allow postpetition interest to unimpaired creditors of solvent debtors. On the other hand, it is also possible to argue that the text of one part of a law should not change merely because a later Congress chose to delete another part.

In any event, the question of whether unimpaired creditors are entitled to postpetition interest has reached the circuit courts late last year. See Ultra Petroleum v. Ad Hoc Committee, 51 F.4th 138 (5th Cir. 2022); Ad Hoc Committee v. P.G.&E., 46 F.4th 1047 (9th Cir. 2022). In both these cases, the majority found that unsecured creditors who are not impaired are entitled to interest at the contract rate. In *Hertz*, Judge Walrath did not go quite so far. She allowed unimpaired creditors to recover interest, but only at the federal judgment rate. Wells Fargo Bank v. Hertz Corp., 637 Bankr. 781 (Bankr. D. Del. 2021). Judge Shannon reached the same result in In re RGN-Group Holdings, LLC, 2022 WL 494154 (Bankr. D. Del. 2022). In dictum, the Second Circuit has signaled its agreement with the general idea that creditors of solvent debtors are entitled to interest in an opinion in which it found that the debtor before it was insolvent. See In re LATAM Airlines Group S.A., 55 F.4th 377 (2d Cir. 2022).

The Supreme Court denied certiorari in both *Ultra* and *PG&E* earlier this year, but one should not regard the matter as settled. There were strong dissents in both cases that underscored the lack of a clear path in the text of the Bankruptcy Code that gives unimpaired general creditors interest when the debtor is solvent. Given a Supreme Court committed to narrow textualist readings of the Bankruptcy Code, one cannot be confident that courts outside of the Fifth and Ninth Circuits will follow their lead. The Third Circuit accepted *Hertz* on direct appeal, and oral argument is scheduled for October 25.

Warsco v. CreditMax Collection Agency, Inc.: The Seventh Circuit Changes Course

John Hauber

On January 6, 2023, the Seventh Circuit Court of Appeals issued its opinion in the case *Mark A. Warsco v. CreditMax Collection Agency, Inc.*, No 22-1733 (7th Cir. 2023), which reversed its own 1984 holding in the case, *In re Coppie*, 728 F.2d 951 (7th Cir. 1984). Both Coppie and Warsco center around the issue of whether and to what extend garnished wages may be considered avoidable preferential transfers; and more specifically, when the transfer occurred.

In the *Coppie* case, the state court had previously ordered that the judgment was a continuing lien on the defendant's future, non-exempt wages. As the lien was continuous, the defendant retained no interest in 10% of future wages following entry of the garnishment order. In so ruling, the Seventh Circuit held that transfers must be based upon non-bankruptcy state law, and that under Indiana law, a transfer occurs when the garnishment order is issued and not when the money is paid from the garnishee defendant to the judgment creditor. The *Coppie* court reasoned, "Section 547(e)(3) does not come into play in this case simply because after a garnishment order providing for a continuing lien is created in Indiana, a debtor will never acquire rights in the portion of his or her wages to be garnished in the future." *Coppie* at 952.

Likely, the Seventh Circuit would have reversed the *Coppie* holding as far back as 1992, when the United States Supreme Court made its ruling in *Barnhill v. Johnson*, 503 U.S. 393 (1992). That case centered around the transfer date of a check issued to a creditor for payment. Specifically, the debtor delivered a check on November 18 (92 days prior to a bankruptcy filing), which was dated November 19, and the bank did not honor the check until November 20. The trustee, Johnson, argued that the transfer occurred on November 20 within the preference period, while the creditor, Barnhill, argued that the transfer occurred on November 18 (following the "date of delivery" rule). Under state law, the U.C.C. is clear that a check is simply an order to the drawee bank to pay the sum stated, signed by the maker and payable on demand [UCC § 3-104(1)]. The *Barnhill* Court was clear that there was no transfer under state law when a check is presented as "myriad events can intervene between delivery and presentment of the check that would result in the check being dishonored. … The import of the preceding discussion for the instant case is that no transfer of any part of the debtor's claim against the bank occurred until the bank honored the check on November 20." *Barnhill* at 399.

What constitutes a transfer in bankruptcy cases are determined by federal law [Quoting *McKenzie v. Irving Trust Co.*, 323 U. S. 365, 369-370]. The Bankruptcy Code defines "transfer" as "each mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with (i) property; or (ii) an interest in property." See 11 U.S.C. § 101(54)(D). While the Court ultimately ruled that the transfer was not made until the bank honored the check (and thus it was an avoidable preference), the Court was clear that transfers under bankruptcy law must be determined in accordance with the Code's definition. In other words, the date written on the check does not constitute a transfer under federal law.

In fact, the Seventh Circuit appeared to reverse course on the *Coppie* holding in 1995 when it followed *Barnhill* holding and decided *Freedom Group, Inc. v. Lapham-Hickey Steel Corp.*, 50 F.3d 408 (7th Cir.1995). The facts of that case were simple: The debtor, Freedom Group, filed an adversary proceeding against Lapham-Hickey, seeking to undo what it claimed had been a preferential transfer resulting from a judicial seizure of Freedom Group's bank account in an amount of $7,335.49. The judgment was obtained on June 2; the notice of garnishment was issued on June 12; the bank was served on June 15 (when the balance was $108.25); Freedom Group deposited $18,000 into the account the next day on June 16; and the state court issued the final order of attachment on June 17. Freedom Group filed bankruptcy on September 14. Quick math demonstrates that the notice of garnishment was served on the bank ninety-one days prior to the bankruptcy filing (June 15). Accordingly, if the Court determined that the transfer occurred any time after June 15, that transfer would be an avoidable preference.

Judge Posner, writing for the Seventh Circuit stated, "under Indiana law a notice of garnishment not only prevents the debtor from withdrawing the funds in his bank account but also gives the judgment creditor who procured the notice a lien against the funds up to the amount of the judgment. [Citations omitted.] A lien is a property interest, and it was acquired by Lapham-Hickey. The funds themselves were not transferred to Lapham-Hickey. They were merely frozen, until the final order of attachment was issued and complied with — and if the transfer did not occur until then, it came too late for Lapham-Hickey to avert a finding of preferential transfer" Id. at 410. Lapham-Hickey argued that the Bankruptcy Code definition of "transfer" includes any means of disposing of an interest in property, and the right to satisfy a judgment out of specific property means the interest has been "disposed of" to Lapham-Hickey. The Seventh Circuit disagreed stating,

> Freedom Group did not have to deposit $18,000 — or 1¢ — in its bank account after the notice of garnishment was issued. That was a decision made (or effectuated) by Freedom Group within ninety days of declaring bankruptcy, and thus during the period of avoidable preferences. The effect was to put one of its creditors, the one that had

> succeeded in garnishing its bank account, ahead of the others — and that is just the sort of thing that the preferential-transfer statute is intended to prevent.

Id. at 411.

When *Warsco v. CreditMax Collection Agency, Inc*. finally reached the Seventh Circuit thirty years after *Barnhill*, Judge Easterbrook stated, "*Coppie* is indeed wrongly decided. The reason is simple: *Barnhill v. Johnson*."

In the *Warsco* case, Chapter 7 trustee, Mark Warsco, calculated that CreditMax had garnished approximately $3,700 during the preference period, but the garnishment order was issued more than 90-days prior to the bankruptcy filing. The Seventh Circuit acknowledged that the *Coppie* decision was wrongly decided and relied on the *Barnhill* ruling. Like *Barnhill* the garnishment order provided to the employer was nothing more than instructions to the employer to make a transfer of funds once the funds were available. However, the transfer was not made until the employer sent the funds to the judgment creditor. The date of transfer follows both the *Barnhill* ruling as well as Section 101(54) definition of transfer. CreditMax argued that a wage garnishment can be distinguished from the facts of *Barnhill*; specifically, that *Barnhill* dealt with the date that a bank learned of a transfer order versus when the garnishment order was actually entered. The Seventh Circuit was not convinced stating that all dates are irrelevant under Sections 101(54) and 547. Only the date of payment matters when determining what constitutes a transfer.

This reversal creates equity among unsecured creditors in a bankruptcy when a trustee has limited funds to equitably divide among the class. And, theoretically at least, this ruling may delay a creditor from rushing to court to obtain a garnishment order and give the debtor additional opportunities to make payments delaying a bankruptcy filing outside the preference period.

As a final thought, the *Warsco* ruling only gets trustees past the section 547(b) element of transfer by relying on the Bankruptcy Code definition as opposed to state law consideration. However, that only takes the analysis to section 547(c) and a determination as to whether there are any exceptions to the preference. The only potential exception is found in section 547(c)(2), which reads:

> The trustee may not avoid under this section a transfer—
>
> to the extent that such transfer was in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee, and such transfer was—

(A) made in the ordinary course of business or financial affairs of the debtor and the transferee; or
(B) made according to ordinary business terms.

So, the required elements to be determined are:

1. Was the transfer of wages from the debtor to the creditor payment of a debt?
2. Was the debt incurred by the debtor in the ordinary course of the debtor's financial affairs?
3. Was the transfer of wages made *EITHER*
   a. Made in the ordinary course of the debtor's financial affairs, *OR*
   b. Made according to ordinary business terms.

As Judge Posner wrote in the case, *In re Tolona Pizza Products Co.*, [3 F.3d 1029, 1032 (7th Cir. 1993)], "the purpose of the preference statute is to prevent the debtor during his slide toward bankruptcy from trying to stave off the evil day by giving preferential treatment to his most importunate creditors, who may sometimes be those who have been waiting longest to be paid. Unless the favoring of particular creditors is outlawed, the mass of creditors of a shaky firm will be nervous, fearing that one or a few of their number are going to walk away with all the firm's assets; and this fear may precipitate debtors into bankruptcy earlier than is socially desirable." That reasoning raises the question regarding whether an ongoing and continued wage garnishment (which may have continued for months or years prior to a bankruptcy filing) are preferential or out of the ordinary course of financial affairs.

Element two asks whether the debt was incurred by the debtor in the ordinary course of the debtor's financial affairs. Clearly, this element would be fact specific. There might be a difference, for example, regarding repayment of a credit card debt used to purchase household related items versus repayment of a single and substantial tort claim. Is repayment of a credit-card on the fifteenth of each month any different than a regularly occurring wage garnishment? If the purpose of the preference is to stave off the "importunate" creditor, is a wage garnishment that has continued for more than ninety-days the cause of the bankruptcy filing?

The final element is the OCB defense which looks to the timing of the payments and allows a creditor to demonstrate either that payments made during the preference period were similar to payments made outside the preference period. Or, if the payment history is not long enough to establish, a creditor may prove that the payment or other transfer was made according to "ordinary business terms."

The Bankruptcy Code does not define the phrase "ordinary business terms," but courts have reasoned this element is met if the creditor can demonstrate that the transfer was consistent with payments made in the creditor's industry, the debtor's industry, or some combination of both industries. In this case, if the creditor is a collection agency who purchased a charged off account (such as CreditMax), it might be able to demonstrate that wage garnishment is the industry standard for repayment of delinquent accounts.

In *Tolona Pizza Products*, the Seventh Circuit, held that when deciding on "ordinary business terms," courts should focus on the creditor's industry. With that said, the Seventh Circuit acknowledged that it may be difficult to identify the industry as a whole. Judge Posner wrote:

> Not only is it difficult to identify the industry whose norm shall govern (is it, here, the sale of sausages to makers of pizza? The sale of sausages to anyone? The sale of anything to makers of pizza?), but there can be great variance in billing practices within an industry. Apparently, there is in this industry, whatever exactly "this industry" is; for while it is plain that neither [creditor] nor its competitors enforce payment within seven days, it is unclear that there is a standard outer limit of forbearance. .... The law should not push businessmen to agree upon a single set of billing practices; antitrust objections to one side, the relevant business and financial considerations vary widely among firms on both the buying and the selling side of the market.

Where a debtor has incurred debt in the ordinary course of the debtor's financial affairs and is repaying that debt through a regular wage assignment, to a collection company whose industry standard is collection through wage garnishment, it may be necessary for a trustee or court to determine whether and to what extent this particular garnishment is what caused (or at least sped up) the debtor's slide into bankruptcy. The interested parties may want to consider whether there is a difference between a debtor who quickly filed bankruptcy to stop a garnishment versus a debtor who has had several garnishments lined up, has paying for many years, and only elected to file bankruptcy when other assets were at risk of seizure. Could it be argued successfully that the second case demonstrates garnishment payments have been made in the debtor's ordinary course of financial affairs and immune from an avoidable preference action?

Lac du Flambeau Band of Lake Superior Chippewa Indians v. Coughlin
No 22-327, 599 U.S. ____ (2023)

John Hauber

Debtor, Brian Coughlin, borrowed $1,100.00 from Lendgreen, a wholly owned subsidiary of Lac du Flambeau Band of Lake Superior Chippewa Indians ("the Band"). Coughlin filed Chapter 13 bankruptcy prior to repaying the loan and listed the debt to Lendgreen as an unsecured and nonpriority debt. Lendgreen continued to collect on the debt, in apparent violation of the automatic stay. Coughlin alleged that the collection attempts were so aggressive that he suffered emotional distress and even contemplated ending his own life. Coughlin initiated an action in the Bankruptcy Court for a violation of the stay seeking damages under §362(k). The Band moved to dismiss for lack of subject matter jurisdiction due to tribal sovereign immunity. The Bankruptcy Court dismissed the complaint holding that the Bankruptcy Code did not clearly express Congress's intent to revoke tribal sovereign immunity in §106(a). The First Circuit reversed the Bankruptcy Court in holding that the Bankruptcy Code "unequivocally" divests tribes of a sovereign immunity defense. The ruling created a split with other Circuits and the Supreme Court granted certiorari.

The relevant Code provisions are §§106(a) and 101(27). Section 106(a) reads: "Notwithstanding an assertion of sovereign immunity, sovereign immunity is abrogated as to a governmental unit to the extent set forth in this section with respect to the following: (1) Sections … 362 …" In other words, government units may not claim sovereign immunity regarding actions that may violate the §362 automatic stay. The question, then, is whether federally recognized tribes are considered a governmental unit. That definition is found in §101(27) which defines governmental unit as "United States; State; Commonwealth; District; Territory; municipality; foreign state; department, agency, or instrumentality of the United States (but not a United States trustee while serving as a trustee in a case under this title), a State, a Commonwealth, a District, a Territory, a municipality, or a foreign state; or other foreign or domestic government." Through this definition, did Congress make its intent to abrogate tribal sovereign immunity unmistakably clear? In an 8-1 decision the Supreme Court held in the affirmative.

While the definition does not specifically abrogate tribal sovereign immunity, there is no requirement that it must. The definition itself "exudes comprehensiveness from beginning to end. Congress has rattled off a long list of governments that vary in geographic location, size, and nature." Additionally, Congress ended the definition with the broad catch-all phrase "foreign or domestic." The phrase would cover all governments. When Congress takes an oath to support

and defend the Constitution from all enemies, foreign or domestic, the intent was broad enough to encompass all enemies without limitation.

From an equitable perspective, the purpose of the Bankruptcy Code is to allow debtors to obtain a fresh start in an orderly and centralized manner. The automatic stay and discharge provisions apply to all creditors. Carving out an exception for certain governmental units and not others would create risks and would contradict the purposes and policies contained within the Code.

Justice Jackson, writing for the majority, found the Band argument that it is neither foreign nor domestic "far-fetched." Specifically, the Band argued that the definition of governmental unit could exclude federally recognized tribes as they have characteristics that are both foreign and domestic. The dissent posed hypothetical statements including a pet that is "small or a dog" and ice cream that is "chocolate or vanilla." An item which includes both characteristics would be excluded. However, that is not the case in this definition as the Bankruptcy Code also states "in this title 'or' is not exclusive" [see §102(5) Rules of Construction].

MOAC Mall Holdings LLC v. Transform Holdco LLC
598 U.S. ____, 143 S.Ct. 927 (2023)

John Hauber

MOAC leases space to tenants at the Minnesota Mall of America, and Sears, Roebuck and Co. was one such tenant. After filing Chapter 11 bankruptcy in 2018, Sears sold most of its pre-petition assets including its lease assignment rights which were sold to Transform. Specifically, the agreement required Sears to assign the lease to any assignee designated by Transform. Transform assigned the lease to one of its wholly owned subsidiaries, and MOAC filed an objection claiming that Sears had not demonstrated adequate assurance of future assignee performance as required by §365(f)(2)(B). Adequate assurance is required even if there has not been a default in the lease and includes assurance that the assignee lease will not disrupt any tenant mix or balance within the shopping center. However, the Bankruptcy Court authorized the lease assignment through an Assignment Order over the MOAC objection.

The Assignment Order was an appealable order subject to §363(m) which provides that "the reversal or modification on appeal of an authorization … of a sale or lease of property does not affect the validity of a sale or lease under such authorization to an entity that purchased or leased such property in good faith … unless such authorization and such sale or lease were stayed pending appeal" (emphasis added). Accordingly, MOAC sought to stay the Assignment Order. However, the Bankruptcy Court also denied the stay request believing that the Assignment Order was not an appeal of an authorization and based upon Transform's explicit representation that it would not invoke §363(m) as a defense. MOAC appealed the adequate assurance issue to District Court and was successful in getting the Assignment Order vacated. Transform filed for rehearing claiming that the District Court lack jurisdiction due to §363(m), and the lack of jurisdiction was not subject to waiver or judicial estoppel. The District Court agreed and dismissed the appeal and the Second Circuit affirmed.

The Supreme Court granted certiorari and in a 9-0 opinion written by Justice Jackson reversed the Second Circuit. The Court held that the issue before District Court was not moot as §363(m) is not a jurisdictional provision. A jurisdictional provision carries unique and severe consequences, and Courts should only treat a provision as jurisdictional if Congress "clearly states" that intent. A clear statement does not require any "magic words," but the statement must be clear and not merely plausible. The language of §363(m) is there to protect a certain class of good-faith purchasers or lessees from losing newly acquired assets. As a final point, Congress lists jurisdiction over bankruptcy matters in 28 U.S.C. §§1334(a)-(b), (e), 157, and 158, and not in §363(m).

Coinbase, Inc. v. Bielski
No. 22-105, 599 U.S. ____ (2023)

John Hauber

The sole question before the Supreme Court was whether a district court must stay its pre-trial and trial proceedings while the interlocutory appeal is ongoing. In a 5-4 opinion written by Justice Kavanaugh, the answer is yes.

Abraham Bielski was the class plaintiff in an action brought by Coinbase users against Coinbase alleging that Coinbase failed to replace funds fraudulently taken from users' accounts. When creating the accounts, users were required to sign a user agreement which contained a provision requiring all disputes to be settled through binding arbitration. The District Court denied the Coinbase motion to compel arbitration and Coinbase filed an interlocutory appeal to the Ninth Circuit. Coinbase also moved to stay proceedings pending resolution of the appeal, but both the District Court and the Ninth Circuit denied that request.

The United States Supreme Court granted certiorari and reversed the Ninth Circuit. The relevant statute is a provision of the Federal Arbitration Act located at 9 U.S.C. § 16(a) which simply states that "an appeal be taken from an interlocutory order granting, continuing, or modifying an injunction against an arbitration that is subject to this title." There is nothing in the statute which suggests that the underlying pretrial or trial must be stayed. However, Congress created that statute knowing full well the Supreme Court precedent that an interlocutory appeal "divests the district court of its control over those aspects of the case involved in the appeal." *See Griggs v. Provident Consumer Discount Co*., 459 U.S. ____, ___ (2019). The *Griggs* principal resolves this case. And from a practical perspective, if the purpose of arbitration is to create more judicial efficiency, it makes little sense to continue to utilize resources on a trial just to have a Circuit Court later order binding arbitration. Because of the *Griggs* principal, there is an implication that all District Court proceedings related to the interlocutory appeal will be stayed unless Congress adds language to a statute that an interlocutory appeal does not stay the proceeding.

Justice Jackson wrote the dissenting opinion which states that the majority created thus rule "out of nowhere." There is no language in the statute which creates a stay of proceeding, and this holding will stay every proceeding even when there is no good reason for one. Additionally, other statutes make it clear that Congress does not follow the *Griggs* requirement. Specifically, 28 U.S.C. §1292(d)(4) states that the U.S. Court of Appeals for the Circuit shall have exclusive jurisdiction of an appeal from an interlocutory appeal of a district court. The

statute further reads that "proceedings shall be further stayed until the appeal has been decided by the Court of Appeals for the Federal Circuit. [See 28 U.S.C. §1292(d)(4)(B).] Even in the Federal Arbitration Act itself in §3 states that proceeding will be stayed when an issue is referred to arbitration. "At the end of the day, the best the majority can do is point to a smattering of provisions that do not contain the rule that the majority adopts." The Griggs rule simply stands for the proposition that the two courts should avoid exercising control over the same issues simultaneously.

YEAR IN REVIEW – EXCULPATIONS, RELEASES AND DISCHARGE

By: Jay Jaffe
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American College of Bankruptcy

Seventh Circuit Continuing Legal Education

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The past year has seen developments in exculpation provisions, third-party release provisions, and discharge issues. With respect to exculpations, the Supreme Court of the United States has before it a petition for certiorari that, if granted, will lead to a Supreme Court decision in 2024. The Supreme Court just recently granted certiorari to hear at least one aspect of a circuit split on whether a plan can contain a release that extinguishes claims by nondebtors against nondebtor third parties without the claimants' consent, to be argued in the December, 2023 argument session of the Court. The Supreme Court issued a decision this past term addressing the scope of individual discharge. And there have been some other interesting discharge decisions.

We will turn first to exculpation provisions.

EXCULPATION

Exculpation provisions are intended to protect certain parties from claims that are based on actions that relate to restructuring and the Chapter 11 process. The subjects of an exculpation provision typically includes the debtor, its officers and directors, members of an unsecured creditors committee, lenders, asset purchasers, and professionals retained by the foregoing, including financial advisors and attorneys. Related to exculpation are so called "injunction" and "gatekeeper" provisions. Injunction provisions are complimentary of the discharge granted under a Chapter 11 plan. They are essentially a policing mechanism to deter parties from taking

actions in violation of a Chapter 11 discharge or otherwise inconsistent with the plan of reorganization. Gatekeeper provisions are intended as a tool for the enforcement of the injunction provisions. That is, before a party can bring an action against a protected party that might conceivably violate the injunction provisions, the party must seek permission from the gatekeeper (usually the Bankruptcy Court). The Bankruptcy Court would then determine whether the claim or cause of action presents a colorable claim against a protected party and authorize, or refuse to authorize, the putative plaintiff from bringing the claim. Exculpation provisions have not historically been terribly controversial, and rarely drew objection. When objections were filed, it was usually because the released parties have been defined too broadly, the scope of the exculpation went beyond activities that occurred during the pendency of the case or were not sufficiently related to case activities. That is, until the Fifth Circuit issued its opinion in Nexpoint Advisors, L.P. vs. Highland Capital Management, L.P. (In re Highland Capital Management, L.P.), 48 F.4th 419 (5th Cir. 2022).

Highland Capital Management, L.P. ("Highland") was a Dallas based investment firm operated by its co-founder, James Dondero ("Dondero"). Early in the case, and in order to avoid the possible appointment of a Chapter 11 trustee, the Highland Unsecured Creditors Committee ("Committee") reached a corporate governance settlement agreement under which Dondero stepped down as director and officer of Highland, and agreed not to cause any Highland related or affiliated entities to terminate any agreement with Highland. However, notwithstanding the settlement, Dondero soon turned the Highland case into a litigation case on steroids. Dondero proposed several plans, each of which was objected to by the Committee and Highland's board of directors (the "Independent Directors"). Dondero, along with certain other creditors, then began objecting to settlements, appealing orders, seeking writs of mandamus, interfering with

Highland management, threatening employees and cancelling trade between Highland and its clients, all in frustration of the Chapter 11 case. Against this backdrop, the Independent Directors filed a Fifth Amended Plan of Reorganization (the "Plan"), which included a broad exculpation clause that extended to nearly all bankruptcy participants: Highland, its employees and CEO; Strand Advisors, Inc.; the Independent Directors; the Committee; successor entities and a postpetition oversight board; professionals retained in the case; and all "related persons" (the "Exculpation Parties"). The plan also contained injunction and gatekeeper provisions to enjoin certain defined parties (the "Enjoined Parties") from taking any actions to interfere with the implementation or consummation of the Plan and provided that the Bankruptcy Court would be the gatekeeper, with sole and exclusive jurisdiction to determine whether a proposed claim or cause of action could be brought against a large laundry list of parties (the "Protected Parties"). Dondero and others appealed the confirmation order, seeking a direct appeal to the Fifth Circuit. The Fifth Circuit accepted the direct appeal, and with the exception of the exculpation of non-debtor parties, affirmed the confirmation order. The Fifth Circuit sided with Dondero and restricted the Exculpation Parties to only mean Highland, the Independent Directors, the Committee, and members of the Committee (in their official capacities). However, the Fifth Circuit left undisturbed the injunction and gatekeeper provisions, under which no claims could be brought against the Protected Parties without first seeking the permission of the Bankruptcy Court. Notably, the Protected Parties under the Plan were not the same as the Exculpation Parties. The Protected Parties' list was far broader, and included several parties that were not even in existence prior to plan confirmation, such as a claimant trustee, a claimant oversight board, and litigation trustee, all of which were created under the plan for the furtherance of the plan's administration. The Fifth Circuit ruling, restricting the exculpation provisions, is

consistent with Fifth Circuit precedent. It leads to a circuit split, under which Section 524(e) of the Bankruptcy Code is found by the Second, Third, Fourth, Sixth, Seventh, Ninth and Eleventh Circuits to permit bankruptcy courts to confirm plans containing non-debtor exculpations. In contrast, only the Fifth and Tenth Circuits hold that Section 524(e) prohibits confirmation of a plan that exculpates non-debtors. Both Highland and Nexpoint filed petitions for a writ of certiorari, asking the Supreme Court to resolve the conflict among the circuits concerning the effect and reach of 524(e) of the Bankruptcy Court as it relates to exculpation provisions. Notably, neither group sought review of the Supreme Court with respect to non-consensual third-party releases, even though the release related issues are very similar to the issues raised in the exculpation provision at issue in the Highland case. Nexpoint is urging the Supreme Court to restrict who may be Protected Parties under the injunction and gatekeeper provisions, so that the Protected Parties are no more broad than the Exculpation Parties under the Plan, as revised consistent with the Fifth Circuit decision. Highland seeks review to reinstate the broader exculpation provisions under the original plan. Both sides have fully briefed their positions. The most recent activity in the case is an invitation extended to the Solicitor General to file a brief in the case expressing the views of the United States.

<u>NON-CONSENSUAL THIRD-PARTY RELEASES</u>

For those who might have bemoaned the fact that the Highland case specifically avoided teeing up before the Supreme Court the issue of the availability of non-consensual third-party releases under a Chapter 11 plan of reorganization, do not despair. There is brewing an independent case under which the Supreme Court of the United States has agreed to consider the issue of non-consensual third-party releases. That opportunity is presented by the Supreme

Court grant of a petition for a writ of certiorari from the Second Circuit decision in In re Purdue Pharma L.P., 69 F.4th 45 (2nd Cir. 2023).

The travails and saga of the Purdue Pharma L.P. ("Purdue") case are well known. Purdue was the manufacturer of Oxycontin, and primary target of governmental units and individuals asserting claims for the opioid epidemic that has roiled through this country for years. The founders and principals of Purdue, the Sackler family, agreed to contribute $5.5 billion to $6.0 billon to the settlement of opioid related claims, in return for being granted non-consensual third-party releases under the Purdue Chapter 11 plan of reorganization. The Bankruptcy Court, by Judge Drain, confirmed the Purdue plan. The District Court, through Judge McMahon, overturned the Bankruptcy Court's confirmation of the Purdue Chapter 11 plan. On May 30, 2023, the Second Circuit reversed the District Court and reinstated the Bankruptcy Court's confirmation of the Purdue Chapter 11 plan, including the inclusion of the non-consensual releases of creditors' direct claims against non-debtor's including the Sacklers. The Second Circuit's opinion in Purdue is consistent with earlier precedent (In re Drexel Burnham Lambert Grp. Inc., 960 F.2d 285 (2nd Cir. 1992)). And, is consistent with the majority of circuits that have examined the availability of non-consensual releases under a bankruptcy Chapter 11 plan. As with exculpation provisions noted in the previous section, the Second, Third, Fourth, Sixth, Seventh and Eleventh Circuits have ruled that third party releases may be permissible in rare or unusual circumstances. Only the Fifth and Tenth Circuits have gone the other direction.

In Purdue, consistent with Second Circuit precedent, the Second Circuit found that the third-party releases were statutorily authorized by the Bankruptcy Code under Sections 105(a) and 1123(b)(6). Section 105(a) codifies a Bankruptcy Court's equitable authority to "issue any

order, process or judgment that is necessary or appropriate to carryout the provisions" of the Bankruptcy Code. Section 1123(b)(6) allows a Chapter 11 plan to "include any other appropriate provision not inconsistent with the applicable provisions" of the Bankruptcy Code. The Second Circuit opinion furthered the analysis beyond existing precedent in two specific ways. First, the Second Circuit agreed with Judge McMahon that a bankruptcy court lacks constitutional power to enter a final judgment containing non-consensual third-party releases because the releases are the type of claims proscribed by Stern v. Marshall. So, in the Second Circuit, a bankruptcy court could only issue proposed findings of fact and conclusions of law in a confirmation order containing non-consensual third-party releases, for entry by the District Court. This creates a new circuit split on the constitutional authority of a bankruptcy court to grant non-consensual third-party releases. The Third Circuit came out the other way and has ruled that a bankruptcy court does have constitutional authority to enter an order granting non-consensual third-party releases. In re Millenium Lab Holdings, II, LLC, 945 F.3d 126 (3rd Cir. 2019).

Second, in an attempt to provide guidance as to when circumstances are rare or unusual to support non-consensual third-party releases, the Second Circuit laid out seven non-exclusive factors for courts to consider:

1. Is there an identity of interest between the debtor and the to be released party such that a suit against the non-debtor is effectively the same as a suit against the bankruptcy estate;

2. Are the claims against the debtor and non-debtor "factually and legally intertwined";

3. Is the scope of the release appropriate (that is, is it too broad);

4. Are the releases essential to the reorganization, as opposed to an attempt by a third party to manipulate the process for its own advantage;

5. Is the non-debtor beneficiary contributing substantial assets to the reorganization process;

6. Is the plan "overwhelmingly" supported by the class of creditors impacted by the third-party release; and

7. Does the plan provide for the fair payment of enjoined claims.

In a concurring opinion (that reads more like a dissent), Circuit Judge Wesley urges the Supreme Court to grant certiorari to resolve the split among Circuit Courts.

The US Trustee sought a stay of the implementation of the Chapter 11 plan, while the US Trustee worked to prepare its petition for a writ of certiorari. The stay request was directed to the Supreme Court. The stay request was opposed by Purdue, who urged the Supreme Court to treat the stay request as a petition for a writ of certiorari, and initiate a briefing schedule. Purdue further urged the Supreme Court to deny the petition for writ of certiorari, whether filed separately or treating the stay request as a petition for writ of certiorari. On August 10, the Supreme Court issued a brief ruling on the US Trustee stay request:

CERTIORARI GRANTED

> Harrington, William K. v. Purdue Pharma, L.P., et al.
>
> The application for stay presented to Justice Sotomayor and by her referred to the Court is granted. The mandate of the United States Court of Appeals for the Second Circuit in case No. 22-110 and the consolidated cases is recalled and stayed. Applicant suggested this Court treat the application as a petition for a writ of certiorari; doing so, the petition is granted. The parties are directed to brief and argue the following question: Whether the Bankruptcy Code authorizes a court to approve, as part of a plan of reorganization under Chapter 11 of the Bankruptcy Code, a release that extinguishes claims held by nondebtors against nondebtor third parties, without the claimants' consent.
>
> The Clerk is directed to establish a briefing schedule that will allow the case to be argued in the December 2023 argument session. The stay shall terminate upon the sending down of the judgment of this Court. **(Emphasis added)**

The direction from the Supreme Court does not specifically invite the parties to brief the Stern v. Marshall constitutional authority issue that now also divides the Second and Third Circuits. Although, the direction is broad enough that the parties may yet brief and argue the constitutional authority issue. Pursuant to the Supreme Court direction, the case will be scheduled for argument during the December 2023 argument session.

DISCHARGE

In this section we will take a look at guidance from the Supreme Court of the United States, a Circuit split on a Subchapter V discharge issue, and an interesting discharge development in the Seventh Circuit.

1. Bartenwerfer v. Buckley.

This year, the Supreme Court offered some guidance on the reach of Section 523(a)(2) of the Bankruptcy Code where discharge is sought to be denied for money, property, services or an

extension, renewal or refinancing of credit to the extent "obtained by . . . fraud." Specifically, the Supreme Court was asked to consider who the "obtained by fraud" provision applies to. Is it the fraudster him or herself? Or, does the provision apply to a broader community of persons, including partners or agents. Stated differently, is it possible for a person to be denied a discharge due to another person's fraud? The Supreme Court resolved a split among circuits and held that a debtor can be held liable for a fraud in which that debtor did not participate, including where the fraud was the action or inaction of a partner or agent.

Please refer to Appendix 1 of these materials, which is a summary of the case prepared by Annie Kastanek, a partner at Jenner & Block LLP, that is kindly reprinted by her permission.

2. Are Subchapter V corporate debtors subject to the Section 523(a) exceptions to discharge?

Prior to the adoption of the newly created Subchapter V under the Small Business Reorganization Act of 2019 (the "SBRA Act"), there did not appear to be much of an issue as to whether corporate debtors in a Chapter 11 case were subject to the Section 523(a) exceptions to discharge. Section 1141(d)(1) provides, without exception[1], that confirmation of a plan discharges a Chapter 11 debtor. Then, in Section 1141(d)(2), an exception is created. A discharge under Chapter 11 does not discharge a debtor **who is an individual** from any debt excepted from discharge under Section 523 of this title. So, did the SBRA Act in its creation of Subchapter V change that result? Are Subchapter V corporate debtors subject to the exceptions

[1] Section 1141(d)(6) does create a very narrow and specific exception to corporate debtor discharge for fraud (a) upon a governmental unit or (b) in connection with a tax return or nonpayment of taxes.

to discharge contained in Section 523(a)? The Fourth Circuit has answered that in the affirmative. In Cantwell-Cleary Co., Inc. v. Cleary Packaging, LLC (In re Cleary Packaging, LLC), 36 F.4th 509 (4th Cir. 2022), the Fourth Circuit Court of Appeals held that the exceptions to discharge listed in Section 523(a) may apply to both individual and corporate debtors in Subchapter V cases where discharge is sought pursuant to Section 1192(2) of the Bankruptcy Code.

Other courts disagree with the Fourth Circuit. In Avion Funding, LLC v. GFS Indus., LLC (In re GFS Indus., LLC), 647 B.R. 337 (Bankr. W.D. Tex. 2022), the Bankruptcy Court for the Western District of Texas held that only individual debtors in Subchapter V cases are subject to the discharge exceptions listed in Section 523(a). That holding is also supported by a Ninth Circuit bankruptcy appellate panel in Lafferty v. Off-Spec Solutions, LLC, et al., 2023 WL4360311 (9th Cir. BAP July 6, 2023). There, the Ninth Circuit BAP held that the non-dischargeability provisions in Section 523(a) do not apply to a corporate debtor in Subchapter V. Attached as Appendix 2 to these materials is an excellent article authored by Kayla Britton of Taft Stettinius & Hollister LLP examining this issue in detail. Those materials are reprinted with the kind permission of its author.

3. Reinhardt Food Service LLC v. David S. Schlundt, et al., case number 21-CV-1027-BHL (D. Ct. E. D. Wis. October 27, 2022).

The District Court for the Eastern District of Wisconsin recently entered an order reversing and remanding a decision of the bankruptcy judge in Reinhart Foodservice LLC v. Schlundt (In re Schlundt), 20-02091, 2021 BL 314402, 2021 Bankr. Lexis 2265 (Bankr. E.D. Wis. August 19, 2021) to determine that an individual debtor's discharge in a prior bankruptcy

did not discharge liability on a personal guarantee for debts incurred after the bankruptcy. A copy of the District Court decision is attached as Appendix 3 to these materials.

The facts are fairly simple. The debtors filed a Chapter 7 bankruptcy petition which was found to be a no asset case. Debtors received a discharge in 2014. The debtors had personally guaranteed debts that might be owing to a certain supplier ("Supplier") by a restaurant that debtors operated. The guarantee was "absolute, continuing and irrevocable." The debtors failed to schedule a $10,000 liability to the Supplier on the guarantee at the time of their Chapter 7 filing. However, the Supplier was aware of the debtors' bankruptcy case. Later, in 2018, well after the discharge granted in the prior no asset Chapter 7 case, the restaurant incurred a $40,000 debt to the Supplier that was not paid. The Supplier moved to reopen the debtor's Chapter 7 case and filed in adversary proceeding to declare that the $40,000 debt on the guarantee was not discharged. The Supplier conceded that the $10,000 debt was discharged.

The bankruptcy judge held that a prepetition guarantee is a contingent claim that is discharged by a bankruptcy filed after the execution of the guaranty. The Bankruptcy Court applied the "conduct test" to determine whether a claim arose prepetition or postpetition. The Bankruptcy Court concluded that the relevant conduct was the signing of the guaranty prior to the 2014 bankruptcy, and therefore the subsequent debts were discharged, citing Saint Catherine Hospital of Indiana LLC v. Indiana Family and Social Services Administration, 800 F.3d 312 (Seventh Circuit 2015).

On appeal, the District Court reversed, finding that the $40,000 debt on the guarantee arose in 2018, because "[t]here was no debt, claim, or right to payment of any kind for this [$40,000 debt] prior to 2018," and "[b]ecause the liability did not arise until four years *after* the

debtors] file their bankruptcy petition." In the District Court's view, the guarantee was a contractual promise, which was not the same thing as a debt. The District Court view is that a bankruptcy discharges debts, not promises that arose before the bankruptcy petition was filed.

The case reminds us that a rejection of an executory contract is not a termination of a contract. Mission Product Holdings, Inc. v Tempnology, LLC, 139 S.Ct. 1652 (2019). Under Section 365(d)(1) of the Bankruptcy Code, if a trustee does not assume or reject an executory contract within 60 days after the order for relief, then such contract or lease is deemed rejected. However, the rejection of that contract does not terminate the contract. This is the circumstance that the debtors in Reinhart found themselves in. The guarantee, assuming that it was executory, was a contract rejected in their 2014 bankruptcy case. However, the contract did not terminate. Therefore, when the liability under a new transaction arose in 2018, it arguably was not subject to the discharge granted to the debtors in 2014.

If practitioners are representing individuals with guarantee obligations, perhaps the individual debtors should terminate or revoke their guarantee contract prior to the filing of their bankruptcy petitions. Termination or revocation would not relieve the debtors of guaranteed obligations that arose prior to termination/revocation, but, those obligations would be dischargeable in the individual debtors' bankruptcy case. Termination or revocation of the guarantee contract would then cut off any potential post-discharge obligation or liability.

APPENDIX 1

Bartenwerfer v. Buckley Analysis

Annie Kastanek, Partner, Appellate and Supreme Court Practice, Jenner & Block LLP

Overview

On February 22, 2023, the Supreme Court issued a unanimous opinion in Bartenwerfer v. Buckley, which interprets the provision in Title 11 that precludes discharge of a debt where the debt was "obtained by fraud."

The question posed by this case, and that culminated in a circuit split and in the Court taking this case, is who the "obtained by fraud" provision applies to.

- It obviously applies to one's own malfeasance—if the debtor was him or herself the fraudster.
- But does it also extend to partners or agents, such that one can be deprived of discharge due to responsibility for another person's fraud.

The Supreme Court answered that question in the affirmative—it held, in short, that a debtor can be held liable for a fraud in which they did not personally participate, including where the fraud was the doing of a partner or agent.

As I'll discuss, this affects the status of case law in the Seventh Circuit, which prior to this case had held the opposite, and has the potential to affect commercial finance activities.

Statutory Background

Specifically, § 523(a)(2) provides a discharge exception for "money, property, services, or an extension, renewal, or refinancing of credit," but only "to the extent obtained by" certain forms of misconduct – described in subparagraphs (A) and (B) and (C).

The provision at issue here, 523(a)(2)(A), states that a debtor should not be discharged from an individual debt for

(2) for money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained by—
(A) false pretenses, a false representation, or actual fraud, other than a statement respecting the debtor's or an insider's financial condition;

In other words, it prohibits the discharge of "any debt… for money, property, [or] services… obtained by… false pretenses, a false representation, or actual fraud."

Subsection (B) applies where the "debtor caused" a materially false statement regarding his or her financial condition to be made with intent to deceive. Subsection (C) applies to certain consumer debts "incurred by an individual debtor" and cash advances "obtained by an individual debtor."

Factual Background

Kate Bartenwerfer and her boyfriend and later husband David purchased a home to flip. Her boyfriend was in charge of the flip, whereas Kate was uninvolved.

After the flip, they resold the property for a profit to Buckley. At the time of the sale, David made representations regarding not being aware of material defects in the property on a standard-form Transfer Disclosure Statement.

Buckley, however, over time discovered numerous defects and filed a lawsuit against the Bartenwerfers. She obtained a 200k judgment against the Bartenwerfers for non-disclosure of the defects.

Procedural History

The Bartenwerfers jointly filed for Ch. 7 protection, as spouses, but sought to discharge the debts as to Kate due to her purported innocence with respect to the construction debt. Buckley, in turn, invoked 523(a)(2)(A) in an adversary proceeding to argue that the judgment was nondischargeable.

The Bartenwerfers argued that bankruptcy laws and discharge exception in § 523(a)(2)(A) should be interpreted to protect the honest but unfortunate debtor—a phrase from the Depression-era ***Local Loan Co. v. Hunt*** and frequently appears in the Supreme Court's bankruptcy caselaw.

The procedural history gets a complicated due to a series of appeals but in short:

- After a trial, the bankruptcy court held that (a) the husband knowingly concealed the house's defects from Buckley; and (b) the fraud could be imputed to Kate because she was part of a legal partnership with David, even though she was largely uninvolved in the renovation and sale.
- A Ninth Circuit Bankruptcy appellate panel held, consistent with the rule of the Eighth Circuit I'll discuss in a few minutes, that Kate could be held liable only if she knew or could have known of the fraud and remanded for findings regarding her mental state.
- On remand, bankruptcy court found that Kate did not have the requisite mental state and that the fraud therefore could not be imputed to her.
- The Bankruptcy appellate panel affirmed.

The case was then appealed to the Ninth Circuit, which reversed on grounds that the debt was nondischargeable. According to the Ninth Circuit, Section 523(a)(2)(A) means that a debtor is liable for her partner's fraud, even if she did not knowingly participate in the fraud, and that this liability precludes discharge.

Circuit Split

This created a split with numerous other circuits, including the Seventh Circuit and Eighth Circuit. Most pertinent here, given our location in Chicago, Judge Posner of the Seventh Circuit in Sullivan v. Glenn, 782 F.3d 378, 381 (7th Cir. 2015), held that 523(a)(2)(A)'s discharge limit applies only to cases where an uninvolved partner knew or should have known of the fraud.

Supreme Court Opinion

The Court granted cert.—a somewhat unusual step given that the case turns on only 200k but prompted obviously by the need to resolve the circuit split.

After a spirited argument regarding textual interpretation, the Court held, 9-0, that an honest debtor, unaware that there was fraud used to procure the debt, can be denied a discharge.

According to the Court, this holds true-

- Even if the debtor did not commit the fraud, or even participate in the fraud.
- And even if the debtor knew nothing of the fraud.

The opinion is written by Justice Barrett, who is quickly distinguishing herself as one of the Court's fastest writers. The oral argument was in December; the opinion was released Feb. 22, which is record timing at the Supreme Court level.

Some commentators have characterized the Bartenwerfer opinion as a "joy to read"—something that you ordinarily don't think when you read a pretty dense bankruptcy opinion. But I agree. It's got a lot of word play in it, so if you're interested in these types of things, I'd recommend you read it!

Central to the Court's analysis was an examination of the text of the statute itself.

- ***Passive language***: Because the statutory phrase is passive, it does not identify the person who actually committed the fraud. If the debt is the result of *someone*'s fraud, it would be subject to the provision.
  - The example that the petitioner in the Supreme Court gave was "Jane's **clerkship was obtained through hard work**." She argued that the ordinary meaning of this sentence is that Jane worked hard—while phrased passively, the actor is implied. Barrett disagreed—if other people contributed to her success through their own hard work (e.g., a prof who worked hard at a good letter of rec), then the ordinary meaning of the sentence suggests that they also could be credited with the clerkship.
  - The opinion contrasts the use of passive language in § 523(a)(2)(A) with § 523(a)(2)(B) and (C), both of which use active rather than passive voice,

- ***Precedent from 1885***: Also central to the Court's opinion was the 1885 opinion in Strang v. Bradner—and no, 1885 is not a typo.

- The predecessor statute to 523(a)(2)(A)—which was part of the Federal Bankruptcy Act of 1867, provided, "no debt created by the fraud or embezzlement *of the bankrupt*… shall be discharged under this act."
- The italicized language suggested that it applied only to fraud of the debtor herself. Yet, in Strang, the Supreme Court held that all three partners were barred from discharging a debt caused by only one of the partners.
- Following Strang, Congress amended 523 to specifically remove the "of the bankrupt" language, replacing it with the current-day formulation, making the statute even more focused on the occurrence of fraud rather than the responsible individual than it was at the time Strang was decided.

Is it limited to partnerships and agency relationships?

Sotomayor and Jackson concurred, specifically to clarify that the opinion is limited to partnerships and agency relationships, and that it does not address when a debtor was not a fraudster's agent or partner.

- This is consistent with questions at oral argument from these Justices, who focused on common-law principles of vicarious liability.
- Sotomayor: "The debtor's fraud is what's at issue, but it includes the alter ego of the debtor, such as partners and agents of the debtor."
- It's interesting, of course, that this clarification does not appear in the majority opinion itself, perhaps leaving for another day the scope of the ruling.

Significance?

Will this opinion make big waves? Probably not. But the implications broader than simply this particular house-flipping gone wrong:

It changes the law in the Seventh Circuit, by effectively overturning the Sullivan case that I referred to.

In general, the ruling is highly favorable to fraud victims, which could include a bank like BMO in certain scenarios.

A basic misrepresentation of financial condition on, for example, a loan app wouldn't be implicated here. But 523(a)(2)(A) applies to other types of fraud in the course of obtaining a loan, including (a) submitting false information other than about financial condition to obtain a loan; (b) misrepresentations regarding the intended use of loan proceeds; or (c) false documents that might be prepared and submitted to the bank to facilitate a loan.

In those situations, a bank is better positioned after Bartenwerfer to receive just compensation for its losses.

The decision, however, underscores the need to conduct due diligence before forming a legal partnership, or entering into agency relationships; and to monitor the partnerships' liabilities throughout the course of the legal relationship.

APPENDIX 2

Are Subchapter V Corporate Debtors Subject to the §523(a) Exceptions to Discharge? – The Fourth Circuit Stands Alone

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The Small Business Reorganization Act of 2019 enacted a new subchapter V of title 11 of the Bankruptcy Code, codified at 11 U.S.C. §§ 1181 – 1195. Qualifying debtors, including individuals and entities, may elect the application of subchapter V to its case. Ambiguity in the language of subchapter V has resulted in litigation as to whether a corporate debtor may discharge certain kinds of debts in its subchapter V plan. The reported opinions on both sides of this issue rely primarily on a textualist or plain language approach. At its core, each view rests on a single term. Courts holding that the exceptions to discharge apply only to individual debtors focus on the phrase "individual debtor" in the introductory clause of section 523(a). Conversely, courts holding that the exceptions to discharge apply to individual and corporate debtors in subchapter V focus on the word "debt" in section 1192(2).

1. ***Cantwell-Cleary Co., Inc. v. Cleary Packaging, LLC (In re Cleary Packaging, LLC)*, 36 F.4th 509 (4th Cir. 2022).**

Vincent Cleary, one of the principals of Cantwell-Cleary Co., Inc. (Creditor), left the Creditor to form his own company in the same industry, Cleary Packaging, LLC (Debtor). Mr. Cleary solicited various employees to join his new company, in violation of their non-compete clauses, and he took with him Debtor's customer lists and other sensitive or proprietary information. Creditor obtained a $4.7 million state court judgment against Debtor for intentional interference with contracts and tortious interference with business

relations. Debtor subsequently commenced a bankruptcy case under subchapter V. Debtor's plan proposed to pay Creditor 2.98% of the total debt ($140,489.77) over five years, with the remainder of the debt discharged. Creditor filed a complaint seeking a declaratory judgment that the $4.7 million was not dischargeable under sections 523(a)(2) and (a)(6).

The U.S. Bankruptcy Court for the District of Maryland dismissed Creditor's complaint, holding that the section 523(a) exceptions to discharge do not apply to subchapter V corporate debtors. Among other reasons, the Bankruptcy Court found that Congress would not need to include section 1192 in section 523(a) if Congress intended the phrase "of a kind specified in section 523(a)" to apply to debts of all debtors, individual and corporate, under subchapter V. While Judge Ruark's opinion ended with a plain language analysis, the Court also analyzed historical context and legislative history. The Court found that Congress has once considered and rejected applying discharge exceptions to corporate debtors. The ongoing judicial protection of a corporate debtor's discharge was "all encompassing," with the exception of section 1141(d)(6), which took eight years to be enacted. Judge Ruark concluded that finding that Congress incorporated new exceptions to discharge for small business corporate debtors would contradict the history of bankruptcy law and policy.

The Court also addressed the importance of consistency between subchapter V and traditional chapter 11 cases. In chapter 11 cases, individuals have operated large corporations, and such entities were still entitled to a complete discharge upon plan confirmation. This rationale should thus continue to apply to smaller businesses that are likewise run by individuals. The Court reasoned that it would be inconsistent to apply the

discharge exceptions to non-consensual plans when they are not applied to consensual plans.

On appeal, the Fourth Circuit Court of Appeals reached the opposite conclusion and held that the exceptions to discharge listed in section 523(a) may apply to both individual and corporate debtors in subchapter V cases where discharge is sought pursuant to section 1192(2). The Court first looked to the text of section 1192(2). Although section 1192(2) applies to both individual and corporate debtors, it is less clear whether the exception to discharge applies to both individuals and corporations or only to individuals. This question arises because the introductory language in section 523(a) limits its discharge exceptions to individual debtors. Nevertheless, section 1192(2) does not incorporate section 523(a) in its entirety. Rather, section 1192(2) only excepts from discharge "any debt . . . of the kind specified in section 523(a)." Use of the phrase "debt of the kind" in section 1192(2) indicates legislative intent to incorporate only the *list* of non-dischargeable debts found in section 523(a), not the introductory language.

To the extent that tension exists between the language of section 523(a) addressing individual debtors and the language of section 1192(2) addressing both individual and corporate debtors, the Court stated, "the more specific provision [section 1192(2)] should govern over the more general."

In its contextual analysis, the Court noted that, for all chapters of the Bankruptcy Code, Congress identified the types of debtors covered by each discharge provision. Congress purposefully addressed both individual and corporate debtors when defining the right of discharge in subchapter V proceedings. Excluding corporate debtors from

section 1192(2), the Court reasoned, would be irreconcilable and inconsistent with section 1141(d)(6). Section 523(a) includes in its introductory language section 1141, just as it includes section 1192 and several other sections. Under the debtor's interpretation, the list of exceptions to discharge in a traditional chapter 11 proceeding would govern only individuals by reason of such introductory limiting language. Yet, section 1141 itself incorporates specified debts listed in section 523(a) to apply to corporate debtors.

The Court also noted that the chapter 12 discharge provision, section 1228, contains nearly identical language as that used in section 1192(2). Courts have construed the scope of section 1228(a) to apply to both individual and corporate debtors. To give different interpretations to the same language in the same statute would ignore the rationality of using previously used language, as was done when subchapter V was drafted.

Lastly, from an equity perspective, the fact that subchapter V permits a debtor to confirm a non-consensual plan without complying with the absolute priority rule requires that Congress limit the discharge of debts in order to provide fairness and balance to creditors. To make a distinction between individuals and corporations for how subchapter V is applied would undermine that balance.

2. ***Avion Funding, LLC v. GFS Indus., LLC (In re GFS Indus., LLC)*, 647 B.R. 337 (Bankr. W.D. Tex. 2022).**

GFS Industries, LLC (GFS) provided cleaning and environmental services to commercial tenants. GFS attempted to expand its business to meet the anticipated increased demand for sanitation and cleaning services resulting from the COVID-19 pandemic. GFS resorted to seeking funding through merchant cash advances to fund its expansion efforts. GFS was unable to service its operations with the reduced cash flow

caused, at lease in large part, by the purchase discount under the merchant cash advances.

Avion Funding, LLC (Avion) was one of GFS's merchant cash advance lenders. After GFS filed its subchapter V case, Avion commenced an adversary proceeding, alleging that GFS made material misrepresentations concerning whether a bankruptcy filing was imminent and GFS failed to disclose the existence of senior merchant cash advance lenders. Avion sought a determination that that the debt that GFS owed to it was nondischargeable under section 523(a)(2). GFS filed a motion to dismiss the complaint, asserting in part that the exceptions to discharge were not applicable to subchapter V corporate debtors.

The Bankruptcy Court for the Western District of Texas held that only individual debtors are subject to the discharge exceptions listed in section 523(a) in subchapter V cases.

The Court began its analysis by examining the statutory language of sections 1192 and 523(a). While the Court noted that section 1192 on its face seeks to incorporate the list of non-dischargeable debts in section 523(a), the Court also highlighted the limiting language of 523(a) stating that "a discharge under . . . 1141, 1192 . . . does not discharge an *individual* debtor" from the debts. Because section 523(a) only applies to individuals, and section 1192(2) does not "empower 523(a) to cast a wider net" than the text permits, those exceptions do not apply to corporate debtors.

The Court explained that if Congress had intended for the exceptions to apply to all types of debtors in a subchapter V proceeding, Congress would have unambiguously done so, as explicitly done in section 1141(d)(6). That section specifies that confirmation

does not discharge "a debtor that is a corporation" from certain debts. Further, in considering the language of section 1141(d)(2), if Congress intended corporate debtors be covered by section 523(a), then the clarification that section 523(a) only applies to individuals would be futile. The Court deduced that Congress chose not to insert such instructive language in drafting section 1192(2), and thus, it must remain limited to individual debtors as stated in section 523(a).

Overall, the Court explained that it is well-settled that section 523 exceptions apply only to individual debtors, and not corporate debtors. As such, Congress likely "intended to expand, not discontinue, the principle that chapter 11 corporate debtors are not subject to section 523(a) complaints to determine dischargeability." This conclusion is supported by the canon of statutory construction against surplusage, under which courts should "lean in favor of a construction which will render every word operative."

Further, the Court rejected the view that the earlier chapter 12 decision by the same district supported the view that the section 523 exceptions applied to corporate debtors under subchapter V. *See In re JRB Consolidated, Inc.,* 188 B.R. 373 (Bankr. W.D. Tex. 1995). Although section 1192(2) and section 1228(a)(2) (governing the chapter 12 discharge) have similar language, the operation of a corporate discharge in the two chapters is different. In general, the provisions of chapter 11 are narrower, excepting only a liquidating corporate debtor that would be denied discharge under section 727(a) and an individual chapter 11 debtor with the kinds of debts enumerated in section 523(a). The Court also noted that chapter 12 is only available to small, family-owned corporate debtors and therefore such proceedings have "unique considerations" not present in

chapter 11. These critical differences permit different statutory interpretations, notwithstanding the provisions' textual similarities.

The Court rejected the Fourth Circuit's use of the generic/specific canon of interpretation in *In re Cleary Packaging, LLC*, noting that the canon only applies when conflicting provisions cannot be reconciled. Also rejected was the Fourth Circuit's focus on the scope of discharge found in other chapters of the Bankruptcy Code. The Court found the history of chapter 11 "supports the opposite conclusion" since corporations "have not been subject to section 523(a) exceptions to discharge since the inception of the Code." Finally, the Court found that any potential conflicts between sections 1141(d)(6) and 1192(2) are resolved by the contexts in which they operate. While 1141(d)(6) excepts only debts that fall under section 523(a)(2) as to governmental entities, section 1192(2) applies section 523(a) more broadly.

The Court found that Congress intentionally chose to incorporate subchapter V into the larger statutory scheme of Chapter 11, rather than its own chapter. The practical effect of applying section 523(a) to corporate debtors would "disincentivize corporations from availing themselves of the benefits of subchapter V." As for principles of fairness and equity, the Court noted that general unsecured creditors in a subchapter V case benefit by excluding corporate debtors from the section 523(a) discharge exceptions. As it pertains to creditors with dischargeable debts, "every dollar paid on the non-dischargeable debt in excess of a pro rata share of disposable income is a dollar that is not paid to unsecured creditors generally."

3. ***Lafferty v. Off-Spec Solutions, LLC et al. (In re Off-Spec Solutions, LLC)*, 2023 WL 4360311 (9th Cir. BAP July 6, 2023).**

Kristina Lafferty filed a claim in the subchapter V bankruptcy case filed by Off-Spec Solutions, LLC (Debtor), asserting that she was sexually harassed and discriminated against by her manager and was ultimately fired in retaliation for her complaint to management. Lafferty commenced an adversary proceeding, seeking a determination that her claim was nondischargeable under section 523(a).

The U.S. Bankruptcy Court for the District of Idaho granted the Debtor's motion to dismiss the complaint, holding that section 523(a) does not apply to corporate debtors in subchapter V. Lafferty appealed to the Ninth Circuit Bankruptcy Appellate Panel. **The Ninth Circuit BAP held that the nondischargeability provisions in section 523(a) were not applicable to a corporate debtor in subchapter V.**

The Court first focused on the statutory construction of sections 523(a) and 1192. It concluded, "[T]he better interpretation is that § 1192 reiterates § 523(a)'s application to debtors under subchapter V, and § 523(a) limits its applicability to individuals.'" Nothing in the language of section 1192 suggested that the preamble of section 523(a) should be ignored.

As in the *GFS* decision, the Court disagreed with the Fourth Circuit's application of the general/specific canon for two reasons. First, the Court found that the two provisions could be reconciled. Namely, "Section 1192 incorporates the types of debts that are nondischargeable under a nonconsensual subchapter V plan, and § 523(a) limits the scope of nondischargeability to individual debtors." Second, if the provisions were irreconcilable, the Court concluded that section 523(a) is more specific than section 1192, as the relevant inquiry is the scope of the provisions, not the nature of the provisions.

The Court also found that Lafferty's interpretation (and the *Cleary* decision) would render the amendment of 523(a) under SBRA adding a reference to section 1192 a surplusage.

The Court next looked to the context of sections 523(a) and 1192. "[S]ubchapter V remains a part of chapter 11, and its discharge provisions should be interpreted consistent with the overall statutory scheme in chapter 11." In establishing chapter 11 in 1978, Congress intentionally eliminated exceptions to discharge for corporate debtors. "Congress has limited the corporate discharge in chapter 11 once, by enacting 1141(d)(6), and it did so by expressly stating that certain debts are excepted from discharge of corporate debtors." The Court also looked to the context of other discharge provisions within the overall Bankruptcy Code and again concluded that section 1192 restates section 523(a)'s application without changing it. "Section 523(a) applies to discharges granted under §§ 727, 1141, 1192, 1228(a), 1228(b), and 1328(b), yet each of these discharge provisions contains a similar reference to § 523." And each such reference "merely reiterates that the debts listed in § 523(a) are not dischargeable for individual debtors under the specified discharge provisions."

Finally, the Court looked at policy considerations. It acknowledged that the Bankruptcy Court's interpretation results in a broader discharge for subchapter V debtors under nonconsensual plans than under consensual plans, but it determined that was a more plausible outcome than Congress intending to expand 523(a)'s application to corporate debtors "through an opaque reference rather than an express statement." The Court noted its agreement with Judge Bonapfel in the *Guide to the Small Business Reorganization Act of 2019*:

> [I]t is difficult to conclude that, in enacting a statute universally proclaimed to have the purpose of facilitating reorganization of small businesses, by among other things eliminating the absolute priority rule in a cramdown situation, Congress in 2019 intended to re-introduce all the problems with exceptions to the discharge of a corporation that it eliminated over 50 years earlier.

4. Discussion Points

a) Which position has the better policy argument?

b) To the extent there is tension between 1192 and 523(a), would the rule of construction for elevating the "specific over the general" apply?

c) Does the majority approach incentivize corporate debtors to pursue non-consensual plans?

d) If Congress intended the discharge exceptions in section 523 to apply to corporate debtors receiving a discharge under section 1192, what was the purpose of the amendment to section 523 under SBRA? Why would Congress intend this result?

APPENDIX 3

UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF WISCONSIN

REINHART FOODSERVICE LLC,

Appellant,

v. Case No. 21-cv-1027-bhl

DAVID S SCHLUNDT, et al,

Appellee.

ORDER REVERSING AND REMANDING CASE

Under Bankruptcy Code Section 727(b), a Chapter 7 debtor's bankruptcy discharge eliminates the debtor's liability for "all debts that arose *before* the date of the order for relief." 11 U.S.C. §727(b) (emphasis added). This appeal concerns the application of that provision to liabilities arising *after* the bankruptcy but based on the debtor's *pre*-bankruptcy promise to guarantee the obligations of a third party. The bankruptcy court concluded it was bound by the Seventh Circuit's decision in *Saint Catherine Hospital of Indiana, LLC v. Indiana Family and Social Services Administration*, 800 F.3d 312 (7th Cir. 2015) to hold the debts in this case were discharged even though it is undisputed that the transactions that gave rise to the debts did not occur until four years *after* the debtor filed his joint bankruptcy petition. *In re Schlundt*, No. 14-20454-beh, 2021 WL 3700401, at *2 (Bankr. E.D. Wis. Aug. 19, 2021). Because that conclusion rests on an overbroad reading of *Saint Catherine* and is contrary to the plain terms of the Bankruptcy Code, this Court will reverse and direct the bankruptcy court to enter declaratory judgment in favor of Reinhart.

BACKGROUND

From 2003 through 2018, David Schlundt was the owner and sole member of The Refuge, LLC, a restaurant in Antigo, Wisconsin. (ECF No. 2-2 at 29; ECF No. 2-3 at 56.) In that capacity, on September 11, 2003, Schlundt signed a supply agreement (Agreement) with Reinhart FoodService LLC (Reinhart). (ECF No. 2-3 at 56.) Under the Agreement, Reinhart agreed to provide Schlundt's restaurant with goods and services subject to enumerated conditions, including payment terms to be set by Reinhart's credit department. (*Id.* at 34-35.) Among other things,

payments not made in accordance with those terms would be subject to a delinquency charge. (*Id.* at 35.)

Within the same document, Schlundt also signed an "Individual Personal Guaranty." (*Id.*) Under this provision, Schlundt agreed that in exchange for Reinhart's extension of credit to his restaurant, he would "personally guarantee prompt payment of any obligation" of The Refuge to Reinhart "whether now existing or hereinafter incurred." (*Id.*) He further promised "to pay on demand any sum which is due . . . whenever [The Refuge] fails to pay same." (*Id.*) And he confirmed that the guaranty was "absolute, continuing, and irrevocable." (*Id.*)

Ten years after making this commitment, Schlundt and his wife Jennifer filed a joint petition for personal bankruptcy under Chapter 7. (ECF No. 2-2 at 6-8.) In the filings that accompanied their petition, the Schlundts did not identify Reinhart as a creditor. (*Id.* at 9-61.) They did not list Reinhart on their Schedule F "List of Creditors Holding Unsecured Nonpriority Claims," and they similarly omitted it from the required list or "matrix" of creditors, which serves as the basis for identifying who receives notice of filings in the bankruptcy case. (*Id.* at 22-26; ECF No. 2-3 at 42.) As a result, Reinhart did not receive official notice of the bankruptcy. (ECF No. 2-3 at 58.)

At the time of the bankruptcy filing, The Refuge owed Reinhart approximately $10,000 for sales of goods and services under the Agreement. (*Id.* at 40.) The record is unclear whether that amount was overdue as of the petition date. It is also unclear whether The Refuge had "'fail[ed] to pay'" the debt sufficient to trigger Schlundt's liability under the Personal Guaranty.[1] (ECF No. 9 at 9-10.) In any event, on April 11, 2014, the Chapter 7 trustee administering the bankruptcy issued a Report of No Distribution, confirming that the trustee had completed his administration of the debtors' estate and determined there were no non-exempt assets available to make distributions to creditors. (ECF No. 2-2 at 3-4.) Ten days later, on April 21, 2014, the Schlundts received their bankruptcy discharge, and their case was then closed. (*Id.* at 4.)

Schlundt continued to operate The Refuge throughout the bankruptcy proceeding and indeed for several years thereafter. (ECF No. 2-3 at 40.) He also continued to purchase supplies for the restaurant from Reinhart under the Agreement. (*Id.*) Then, in the summer of 2018, he closed the restaurant. (*Id.*) At the time of its closure, The Refuge owed Reinhart $36,839.62 for

[1] The record confirms that, at some point, The Refuge itself satisfied the $10,000 debt, and it is not at issue in this appeal. (ECF No. 9 at 10.)

goods and services purchased earlier that Spring, from March to May 2018. (*Id.*) When The Refuge failed to pay this outstanding sum, Reinhart demanded payment from Schlundt under his Personal Guaranty. (*Id.*) He refused to pay, citing his 2014 bankruptcy discharge. (ECF No. 4 at 6.)

Rather than risk sanctions for trying to collect a potentially discharged debt, Reinhart (prudently) returned to the bankruptcy court to obtain clarity on the parties' rights and obligations. (ECF No. 2-3 at 10.) Reinhart first moved to reopen the Schlundts' bankruptcy case and then filed an adversary complaint in which it sought a declaratory judgment that the roughly $37,000 in debt arising from unpaid sales in 2018 was not subject to the Schlundts' 2014 bankruptcy discharge. (*Id.* at 2, 10.)

Reinhart moved for summary judgment, and, on March 10, 2021, the bankruptcy court heard oral argument on the motion. (ECF No. 2-5 at 1.) Reinhart's primary argument was that because Schlundt's liability for the $36,839.62 did not arise until 2018—four years after he and his wife filed their joint bankruptcy petition—the debt was not discharged under the plain terms of Section 727(b). (ECF No. 2-3 at 28-30.) Reinhart also argued in the alternative that the debt was excepted from discharge under 11 U.S.C. §523(a)(3) because the debt was not scheduled in time for Reinhart to file a proof of claim. (*Id.* at 30-31.) In opposition, Schlundt argued that because he signed the Personal Guaranty in 2003, ten years before he filed for bankruptcy, the debt should be deemed to have arisen prior to the petition date, regardless of when the unpaid sales occurred and the corresponding liability arose. (*Id.* at 46-51.) He also argued that because his was a "no-asset" case, it did not matter that he had failed to include Reinhart on his schedules for Section 523(a)(3) purposes. (*Id.* at 51-52.)

In an August 19, 2021 Decision and Order, the bankruptcy court ruled that Reinhart's claim was covered by the Schlundts' 2014 discharge. *In re Schlundt*, 2021 WL 3700401, at *7. The court noted the division of authority in the bankruptcy courts over the effect of a debtor's discharge on liabilities arising post-petition under a pre-petition personal guaranty. *Id.* at *3-4. But it concluded it was bound by the Seventh Circuit's decision in *Saint Catherine* to hold that the liability Reinhart sought to enforce was a pre-petition debt discharged in the Schlundts' 2014 bankruptcy. *Id.* at *5. Citing *In re Guseck*, 310 B.R. 400, 402-03 (Bankr. E.D. Wis. 2004), the bankruptcy court also rejected Reinhart's Section 523(a)(3) argument. *Id.* at *5-7. The bankruptcy court concluded that Reinhart's "garden variety" debt was discharged notwithstanding any

scheduling failures by the Schlundts because Reinhart had not alleged pre-petition fraud related to Schlundt's entry into the personal guaranty sufficient to take the debt outside the *Guseck* rule. (*Id.* at *5.)

Reinhart then appealed to this Court. (ECF No. 1.)

LEGAL STANDARD

Bankruptcy court decisions are reviewed according to the same standards that govern other appeals. *In re Midway Airlines, Inc.*, 383 F.3d 663, 668 (7th Cir. 2004). Thus, a bankruptcy court's findings of fact are reviewed for clear error, and its conclusions of law are reviewed de novo. *See Stamat v. Neary*, 635 F.3d 974, 979 (7th Cir. 2011). "As a conclusion of law, a grant of summary judgment by the bankruptcy court is therefore reviewed de novo" and "will be affirmed 'if there is no genuine issue as to any material fact and . . . the moving party is entitled to judgment as a matter of law.'" *In re Midway*, 383 F.3d at 668 (quoting Fed. R. Civ. P. 56(c)). This Court "may affirm . . . on any grounds supported by the underlying record." *In re Winters*, No. 96-c-7117, 1999 WL 281083, at *11 (N.D. Ill. Mar. 31, 1999) (citing *McCarthy v. Kemper Life Ins. Cos.*, 924 F.2d 683, 686 n.1 (7th Cir. 1991)) (other citations omitted).

ANALYSIS

In its appeal, Reinhart offers two challenges to the bankruptcy court's decision. First, Reinhart claims the bankruptcy court incorrectly concluded that Reinhart's $36,839.62 claim was a pre-petition debt subject to the Schlundts' 2014 discharge. Second, Reinhart contests the bankruptcy court's determination that the Schlundts' failure to schedule Reinhart as a creditor and provide it notice of their bankruptcy petition did not preclude discharge under 11 U.S.C. Section 523(a)(3). Because the first argument necessitates reversal and remand, the Court will limit its discussion to that argument.[2]

[2] The bankruptcy court's application of *In re Guseck* to resolve the Section 523(a)(3) argument is not without question. *Guseck* held that under "the plain language of §523(a)(3)(A), in a no-asset, no-bar-date bankruptcy case" all "garden variety debts" fall within the scope of the Section 727 discharge even if a debtor fails to schedule and provide notice to creditors. 310 B.R. 400, 402-03. While *Guseck*'s rule may be sensible as a policy matter, a more faithful reading and simpler application of the text of the Bankruptcy Code and Rules appears to require a different result. *See In re Jakubiak*, 591 B.R. 364, 380-382 (Bankr. E.D. Wis. 2018) (explaining inconsistency between *Guseck* ruling, text of Section 523(a)(3), and Bankruptcy Rules.) Because the Court concludes Schlundt's debt to Reinhart arose post-petition and was thus not discharged under Section 727(b) in any event, it need not weigh into the interpretive differences between *Guseck* and *Jakubiak*.

I. **Under the Plain Terms of the Bankruptcy Code, Schlundt's 2018 Liability Under the Personal Guaranty Is a Post-Petition Liability Not Discharged in the Schlundts' 2014 Bankruptcy.**

The dispositive question is whether a 2014 bankruptcy discharge order can extinguish a debt from the sale of goods and services in 2018 based solely on the fact that the promise to guarantee such a debt was made in 2003, prior to the bankruptcy. As with most bankruptcy issues, the analysis begins with the plain terms of the Bankruptcy Code.

Under Section 727(b), the Schlundts' bankruptcy discharge served to discharge "all debts that arose before the date of the order for relief under this chapter." 11 U.S.C. §727(b). "'[D]ebt' means liability on a claim." *Id.* §101(12). "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." *Id.* §101(5)(A). And "the date of the order for relief" is the date on which the debtors filed their bankruptcy petition. *Id.* §§727(b); 302(a). Taken together and applied to this case, that means the Schlundts' 2014 bankruptcy discharge order extinguished all debts, but only those debts, that arose *before* January 17, 2014, the date they filed their joint bankruptcy petition.

Under the undisputed facts, the $36,839.62 debt at issue is a post-petition debt not subject to the Schlundts' 2014 discharge. Schlundt promised to personally guarantee his restaurant business' existing and future debts to Reinhart in 2003, more than ten years before the Schlundts' bankruptcy petition. (ECF No. 2-3 at 56-57.) At the time he signed the Personal Guaranty, neither Schlundt nor The Refuge owed any debt or had any liability to Reinhart; specific debts arose only when The Refuge later acquired actual goods or services under the Agreement. (*Id.* at 35.) The debt and liability at issue here arose between March and May 2018 when The Refuge acquired $36,839.62 worth of specific goods and services from Reinhart. (*Id.* at 37.) At that point, but no earlier, Reinhart had both a $36,839.62 claim against The Refuge for those goods and services and a contingent claim against Schlundt, subject to the contingency that Schlundt's liability would be triggered only if The Refuge "failed to pay." There was no debt, claim or right to payment of any kind for this $36,839.62 prior to 2018. Because the liability did not arise until four years *after* the Schlundts filed their bankruptcy petition, the debt was not subject to the Schlundts' earlier bankruptcy discharge, consistent with the plain terms of Section 727(b).

The Schlundts insist, however, that any debts associated with the 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. This argument confuses a contractual "promise" with a "debt," and they are not the same thing. 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. 11 U.S.C. §727(b). And, under Section 101(12), a debt exists only when there is liability on a claim. The mere existence of a promise or contractual provision does not, in and of itself, create legal liability or, accordingly, a debt. Thus, for example, a debtor who contracts for a credit card or line of credit and then files for bankruptcy will receive a discharge for any debts relating to purchases or credit draws made before the bankruptcy filing. But that same debtor is not free to go on a post-bankruptcy spending spree using that credit card or drawing on that line of credit and then have these new post-petition liabilities declared discharged. The same result applies here, where the bankrupt debtor is a guarantor of future extensions of credit, just as it would if he was the primary obligor obtaining that credit.

The $36,839.62 debt at issue stands in contrast to the $10,000 debt that existed at the time the Schlundts filed for bankruptcy. Leaving to one side the effect of the Schlundts' failure to include this debt in their bankruptcy schedules, it was an existing liability as of the petition date and thus would have been subject to their discharge. While the record is unclear whether The Refuge had already failed to pay that debt sufficient to trigger Schlundt's immediate liability under the Personal Guaranty, even if that contingency had not yet occurred, the debt would have been discharged because the Bankruptcy Code expressly recognizes that claims may be contingent. *See* 11 U.S.C. §101(5)(A).

It is also worth noting that a claim could have arisen with respect to Schlundt's Personal Guaranty if he had terminated it prior to filing for bankruptcy. Because the Personal Guaranty was "irrevocable," any termination would have been a breach. But if Schlundt had notified Reinhart he was terminating the guaranty, any liabilities arising from that breach would have been discharged as a pre-petition debt under Section 727(b). Schlundt does not suggest he made any effort to do so, (ECF No. 2-3 at 51-52), and nothing in the Bankruptcy Code provides that the mere

filing of a bankruptcy petition automatically terminates all of a debtor's existing contractual obligations.[3]

This analysis is also consistent with state law concerning continuing guaranties. Wisconsin law treats each extension of credit under a continuing guaranty as a separate liability. "A guaranty of payment for future purchases is considered a continuing offer to guarantee payment of each purchase as a separate transaction." *John Deere Co. v. Babcock*, 278 N.W.2d 885, 886 (Wis. 1979). "The offer is accepted on each successive sale." *Id.* And a party is subject to separate liabilities for breaches of those discrete transactions. *See Associates Fin. Servs. Co. v. Eisenberg*, 186 N.W.2d 272, 275 (Wis. 1971). Other courts have handled debts arising post-petition from pre-petition continuing guaranties in a similar manner. *See In re Rosenfeld*, 23 F.3d 833, 837 (4th Cir. 1994); *In re Brand*, 578 B.R. 729, 733-34 (D. Md. Sept. 19, 2017); *In re Shaffer*, 585 B.R. 224, 228-29 (Bankr. W.D. Va. 2018); *In re Jordan*, No. 04-11372-DHW, 2006 WL 1999117, at *3 (Bankr. M.D. Ala. June 15, 2006).

The Schlundts try to justify their position by characterizing the $36,839.62 debt as a liability on a "contingent" claim within the meaning of Section 101(5)(A). But this stretches the meaning of a contingent claim almost beyond recognition. As one philosophically inclined bankruptcy court has noted, every future event is contingent on a past state of affairs. *See In re CD Realty Partners*, 205 B.R. 651, 656 (Bankr. D. Mass. 1997). The election of Herbert Hoover depended on the Big Bang. Would it be fair to say that his election "arose" with the end of the primordial singularity? The real question (in bankruptcy, not cosmological physics) is at what point a right to payment, contingent though it may be, is identifiable as a legal liability. Neither the Schlundts nor The Refuge had any liability for this $36,839.62 in 2014; it was not even a glimmer on the horizon of anyone's imagination. It is likely the goods purchased had not even been manufactured yet. Accordingly, in 2014 there was no claim for this amount, contingent or otherwise, and the future debt could not have been discharged.

[3] Moreover, had Schlundt notified Reinhart that he was terminating the guaranty, Reinhart would have been in a position to request that he sign a new one as a condition of it continuing to supply Schlundt's restaurant. It is a standard requirement for suppliers to require such guaranties from the owners of small, wholly owned business entities. Mark A. Tanner, *Food for Thought—The Matter of Personal Liability for Restaurant Debt*, BACON WILSON P.C. (Sept. 29, 2008), https://www.baconwilson.com/articles/food-for-thought-the-matter-of-personal-liability-for-restaurant-debt/ ("Unless the restaurant is well-financed, or the principals have a proven track record of success in the industry, it is likely that lending institutions such as banks and institutional suppliers will seek personal guarantees from the restaurant's principals.").

II. The Holding in *Saint Catherine* Does Not Compel a Different Result.

The Bankruptcy Court accepted the Schlundts' position based largely on what it concluded was the holding in *Saint Catherine Hospital of Indiana, LLC v. Indiana Family and Social Services Administration*, 800 F.3d 312 (7th Cir. 2015). But the actual holding of *Saint Catherine* does not compel the result the Schlundts argue for here.

Saint Catherine involved an Indiana hospital that filed a Chapter 11 bankruptcy petition after receiving fee assessments under a new state scheme intended to increase Medicaid reimbursements. 800 F.3d at 313-14. The scheme was created by the Indiana legislature in April 2011 and required eligible hospitals to pay a Hospital Assessment Fee (HAF) based on their historic costs into a common fund to be used to reimburse hospitals for treating Medicaid patients. *Id.* Under the law, the Indiana Family and Social Services Administration (FSSA) assessed each hospital its HAF during a "fee period" running from July 1, 2011 to June 30, 2013, and the hospitals would then be required to pay the fee in two installments, covering the 2012 and 2013 fiscal years. *Id.* at 314. The FSSA assessed St. Catherine Hospital in Charlestown, Indiana a HAF of just over $1.1 million for fiscal year 2012 and roughly the same amount for 2013. *Id.* After billing St. Catherine for the 2012 portion of the assessment, the FSSA began collecting the amount due by withholding Medicaid reimbursements from the hospital. *Id.* Less than a month later, on June 19, 2012, the hospital filed for bankruptcy. *Id.* The FSSA continued its withholdings, notwithstanding the bankruptcy filing, and, after billing St. Catherine for the 2013 assessment, began withholding Medicaid reimbursements to satisfy that obligation too. *Id.* The hospital then filed an adversary proceeding in the bankruptcy court to enjoin the FSSA from continuing its withholding of Medicaid reimbursements, arguing that doing so violated the automatic stay under Bankruptcy Code Section 362. *Id.* at 314-15. It also sought recovery of the amounts previously withheld on grounds they were preference payments under Section 547. *Id.* at 314. The bankruptcy court agreed with the hospital on both points. *Id.* at 313. The district court affirmed these rulings, but reversed with respect to the 2013 HAF assessment, which it concluded was a post-petition debt and therefore not subject to the automatic stay. *Id.*

On appeal, the Seventh Circuit reversed, concluding that the hospital's debts to the FSSA for both the 2012 and 2013 HAF were pre-petition debts. *Id.* In reaching this conclusion, the Court of Appeals adopted the "conduct test" under which "the date of a claim is determined by the date of the conduct giving rise to the claim." *Id.* at 315. It further explained that "[t]he

determination of what conduct gives rise to a claim will vary depending on the nature of the liability, be it tort, contract, or tax." *Id.* at 316. After noting that St. Catherine's HAF liabilities did not fit neatly into any of these categories, the Seventh Circuit engaged in a lengthy discussion of the particular circumstances and nature of the debt at issue and ultimately held that the conduct giving rise to the HAF for both 2012 and 2013 took place *before* the hospital's bankruptcy petition. *Id.* at 317. The assessment was calculated according to the hospital's pre-petition cost reports and only enforceable via the pre-petition passage of a new law. *Id.* It did not matter that payment of the HAF was contingent on the hospital's post-petition continued operations; the creditor "was aware of [the exact amount of] its claims against [the debtor] . . . well before it filed for bankruptcy." *Id.* at 318. Accordingly, the FSSA's claim for the HAF was a pre-petition debt and subject to the automatic stay. *Id.* at 316-17.

Nothing in the holding of *Saint Catherine* necessitates categorizing Schlundt's debt to Reinhart as pre-petition. That case involved a unique Medicaid-reimbursement scheme, nothing like a pre-petition personal guaranty, and there was no application of the Bankruptcy Code or the conduct test to facts similar to those present here. While *Saint Catherine* required application of Section 105(a)'s definition of "claim," it did not involve the Chapter 7 discharge provision in Section 727(b) or its application in the particular setting of debts created via post-petition transactions subject to a pre-petition guaranty that the debtor had never sought to terminate. Even more fundamentally, unlike the creditor and debtor in *Saint Catherine*, neither Reinhart nor the Schlundts had any idea of the amount that would be owed to Reinhart in 2018, prior to the Schlundts' bankruptcy filing in 2014. Indeed, they could not have known because the legal liability did not exist.

In concluding that *Saint Catherine* required holding that the $36,839.62 debt owed Reinhart was a pre-petition debt, the bankruptcy court cited a number of general statements made by the Seventh Circuit in explaining its adoption of the conduct test. For example, the Court of Appeals observed that "contractual liability is *generally* thought to arise on the date a contract is signed." *Saint Catherine*, 800 F.3d at 316 (emphasis added). The bankruptcy court also cited the Seventh Circuit's instruction that "'*under most circumstances*, finding that a claim arose "at the earliest point possible" will best serve the policy goals underlying the bankruptcy process.'" *In re Schlundt*, 2021 WL 3700401, at *4 (quoting *Saint Catherine*, 800 F.3d at 317) (emphasis added). While the bankruptcy court understandably deferred to these general observations, they are not

part of the holding and do not necessitate the conclusion that Reinhart's claim, based on sales transactions four years after the petition date, was a pre-petition debt under the conduct test. It is true as a general matter that most liabilities arising under a contract will exist immediately when the contract is signed. Similarly, it will usually be the case that the Bankruptcy Code's goals will be best served by determining that a claim arose "at the earliest point possible." But neither precept compels the result reached by the bankruptcy court here.

Applying the plain text of the Bankruptcy Code and the conduct test adopted in *Saint Catherine* makes clear that the debt at issue here is a post-petition debt. Reinhart's claim depends almost entirely on post-petition conduct. At the time of the Schlundts' 2014 bankruptcy petition, the $36,839.62 legal liability to Reinhart was still years away from existing. While the Agreement and Personal Guaranty were both signed, the actual conduct giving rise to the liability had yet to occur. Schlundt's restaurant made the purchases giving rise to this liability four years later, in March through May of 2018. And similar to the debtor in *In re Rosenfeld*, 23 F.3d at 837-38, Schlundt's $36,839.62 debt arose from his restaurant's post-petition exercise of an agreement, subject to a personal guaranty that he could have "terminated at any time." *In re Brand*, 578 B.R. at 733 (citing *In re Rosenfeld*, 23 F.3d at 838); *John Deere Co.*, 278 N.W.2d at 886 (holding that each loan subject to a guaranty is a separate transaction, comprising a new offer to guarantee payment).

Legal principles aside, it also makes little sense as a policy matter to apply the conduct test in the manner the Schlundts suggest. Courts typically find that claims arise at the earliest possible moment because "there is 'little benefit' to be 'gained by allowing a person who knows it has a claim to pursue the claim outside of bankruptcy or to sit on the claim until after bankruptcy.'" *Saint Catherine*, 800 F.3d at 317-18 (quoting *In re Chicago*, 974 F.2d 775, 782 (7th Cir. 1992)). But this is not a case where Reinhart lay in wait, determined to pursue its claim at a more advantageous time. It had no right to payment to enforce. A nebulous promise (that the debtor declined to revoke or terminate before, during, or after his bankruptcy) for a sum then completely unknowable is hardly a "right to payment" that a court can account for in administering the debtor's estate. Moreover, the continued existence of the guaranty did not deny the Schlundts a "'fresh start.'" *Id.* at 317 (quoting *In re Chicago*, 974 F.2d at 782) When the Schlundts received their discharge under Section 727(b), they owed no liabilities to Reinhart. At that time, the guaranty did not obligate Schlundt to do anything. It was only later, when he affirmatively chose to have

his restaurant obtain additional credit from Reinhart that he exposed himself to liability. By choosing to purchase additional goods and services under the Agreement, he subjected himself to the promises contained therein, including his Personal Guaranty. There is nothing onerous or unfair about holding him to that bargain based on his own post-bankruptcy conduct.

CONCLUSION

Accordingly,

IT IS HEREBY ORDERED that the Order and Judgment of the Bankruptcy Court Granting summary judgment in favor of David and Jennifer Schlundt and denying Reinhart FoodService, LLC's motion for summary judgment is **REVERSED and REMANDED** with instructions to enter declaratory judgment in favor of Reinhart as to the enforceability of the Personal Guaranty and conduct any necessary further proceedings consistent with this Order.

Dated at Milwaukee, Wisconsin on October 27, 2022.

s/ *Brett H. Ludwig*
BRETT H. LUDWIG
United States District Judge