

One Minute Memo®



Restricted vs. Continuing Guaranty and the Section 727(b) Discharge

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Is your guaranty restricted or continuing? A continuing guaranty gives rise to divisible individual transactions, while a restricted guaranty—one that concerns a contemplated and specified extension of credit—arises upon execution of the guaranty. In bankruptcy, as in life, timing is everything. A debtor’s liability under a prepetition guaranty agreement for a post-petition advance of credit may depend on the distinction between restricted and continuing, and the distinction may be subtle.

In *National Lumber Company v. Reardon (In re Reardon)*, 566 B.R. 119, 122 (Bankr. D. Mass. 2017), the husband and wife joint debtors (“Debtors”) signed two separate prepetition guaranty agreements with National Lumber Company (“National”). *Id.* at 123–24. The first (“First Guaranty”) was illegible, while the second guaranteed the obligations of Beachwood Village Realty Trust (“Beachwood”) under a construction loan agreement with National for \$230,000 for a specific construction project (“Second Guaranty”). *Id.* at 123–24.

In 2009, the Debtors received a chapter 7 discharge. *Id.* at 125. In 2010, 2011, and 2012, National sold goods to Beachwood on credit. *Id.* Most such credit was paid; however, a balance of \$56,667 remained outstanding. *Id.* National demanded payment from the Debtors under their guaranties. The Debtors argued that their guaranty liability had been discharged. *Id.*

In deciding the issue, the Bankruptcy Court framed the principal issue to be “whether the [Debtors’] liability under the guaranties, if any, for postpetition advances of credit is debt that arose before the date of the filing of their bankruptcy petition.” *Id.* at 126. Recognizing that liability for the postpetition advances would have constituted a “contingent claim” as of the petition date, the Court narrowed its analysis to “whether the debt arose when the guaranty was executed or when credit was later extended to the principal obligor.” *Id.* at 127.

The “question of when the debt arose is one of federal law as informed by state law.” *Id.* Massachusetts law distinguishes between restricted guaranties and continuing guaranties, and “a continuing guaranty would be seen as giving rise to a divisible series of individual transactions, with liability for each extension of credit arising at the time of its extension. Conversely, liability under a restricted guaranty—one that concerns a contemplated and specified extension of credit—arises, for purposes of § 727(b), upon execution of the guaranty.” *Id.* at 128.

In applying this analysis, the Court noted that the Second Guaranty guaranteed “all present and future” obligations under the “Loan Documents,” which were “an Acquisition and Construction Loan Note in the principal amount of [\$230,000.00];

a Construction Loan Mortgage and Security Agreement and Assignment; and all other instruments securing or relating to any loan by Lender to Borrower or executed in connection therewith *relative to a constructive project at the property known as and/or located at Unit 58, Beechwood Village, Rockland, Massachusetts.*" *Id.* at 128 (*emphasis added*). Based on this language, the Court found that "the Second Guaranty is restricted to obligations arising under loan documents relative to the construction of Unit 58 of Beechwood Village." *Id.*

Although the Second Guaranty provided that it "shall operate as a continuing Guaranty," the Court found that such language did not extend or expand the obligations guaranteed by the Debtors. *Id.* The Second Guaranty only applied credit for the purpose of constructing Unit 58 of Beechwood Village. The Court found that "by 'continuing,' [the Second Guaranty] means only that the guaranty 'shall continue regardless of any reduction (*except by payment hereunder*) until the obligations have been paid or otherwise discharged' and regardless of certain other circumstances." *Id.* (*emphasis added*). The Court noted that the phrase "except by payment hereunder" made "clear that the payment of the Obligations would cause the guaranty to terminate." *Id.* The Court was "well satisfied that the Second Guaranty was a restricted guaranty." *Id.* at 128–29. The Debtors' liability under the Second Guaranty arose upon the execution of the Second Guaranty, and therefore was discharged in the bankruptcy. *Id.* at 128–29.

Moral of This Story

A guaranty must be read in context to determine whether it is continuing or restricted and the date the claim arises under the guaranty matters—not just for discharge, but for statutes of limitation and other date based concepts.

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