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NO HARM, NO FOUL: CALCULATION OF NONDISCHARGEABLE DAMAGES IN TRANSACTIONS TAINTED BY FRAUD

Theresa J. Pulley Radwan*

I. INTRODUCTION AND HYPOTHETICAL

A. THE PROBLEM OF RENEWED DEBT AND SECTION 523(A)(2)(B)¹

STEPHEN and Sarah Dawson are a young married couple. Together, they have a gross income of about \$50,000 per year.² When Stephen and Sarah needed to purchase a new car a few years ago, they obtained a \$20,000 loan from the local bank (“Bank”). In connection with the loan application, the Dawsons were required to submit a number of forms and financial statements. They filled out the documents completely and honestly. The Bank granted them the loan, secured by the car, with payment due over the next five years. As part of the loan agreement, the Bank required the Dawsons to provide new financial

* ©2005, Theresa J. Pulley Radwan—Associate Dean of Academics and Associate Professor of Law, Stetson University College of Law. This research was supported by a generous research grant from the Stetson University College of Law. The author wishes to thank her research assistants—Tiffany Dilorio, Esq. and Patricia Neubacher, Esq. for their assistance in preparing this article. In addition, she is grateful for the support and encouragement of her colleagues, particularly Dean Darby Dickerson, Professors Kristen Adams, Michael Allen, Brooke Bowman, James Fox, Royal C. Gardner, Cynthia Hawkins-Leon, and James Underwood.

1. Though the majority of cases considering this issue deal with honest debt later tainted by fraud, cases have considered the issue in reverse. In *Jennen v. Hunter (In re Hunter)*, 771 F.2d 1126 (8th Cir. 1985), the debtor fraudulently convinced Jennen to invest in property. *Id.* at 1131. Though the money was actually invested in property, the debtor did not reveal the nature of the property to Jennen. *Id.* at 1128. The debtor then convinced Jennen to send more money to pay property taxes; Jennen did so, and the debtor actually used the money to pay the taxes as promised. *Id.* at 1127. Thus, debtor incurred the first debt fraudulently but the second debt honestly. *Id.* at 1129-30. The Eighth Circuit did not reconsider the issue of dischargeability already decided by the bankruptcy court—the first debt was deemed nondischargeable, but the second dischargeable. *Id.* at 1127. Rather, the circuit court only considered how to divide the proceeds from the sale of the property in bankruptcy between the dischargeable and nondischargeable debts. *Id.* at 1128. Ultimately, the court opted for a pro-rata distribution between the debts. *Id.* at 1130. The court also held that attorneys’ fees incurred in collecting on the fraud debt were part of the fraud claim and, thus, nondischargeable. *Id.* at 1131. See also *Central National Bank & Trust Co. v. Liming (In re Liming)*, 797 F.2d 895 (10th Cir. 1986), in which the court held that the original, fraudulently incurred, loan later renewed honestly could be nondischargeable.

2. The average household income in the United States from 2001 through 2003 was \$43,527. U.S. Census Bureau, Income 2003, <http://www.census.gov/hhes/www/income/income03/statemhi.html> (last visited Sept. 20, 2005).

statements every year. If the financial statements indicated a problem with the Dawsons' financial condition, the Bank could call the loan forcing the Dawsons to pay the remainder due immediately or face repossession of the car under state law.³ In addition, the Dawsons were required to verify annually that they had insurance covering the replacement value of the car and that they had no significant new debt.

One year after borrowing the money, Sarah and Stephen were ready to submit their first annual financial statements. Unfortunately, due to Sarah's poor driving record and excessive number of speeding tickets, the Dawsons' insurance provider recently cancelled their automobile insurance. Consider the different outcomes resulting from the Dawsons' potentially reporting the insurance cancellation to the Bank. If the Dawsons fraudulently failed to report the lack of insurance, the Bank would not cancel the Dawsons' loan or take action to otherwise protect itself. Conversely, if the Dawsons *did* report the cancellation of insurance, the Bank could protect itself by purchasing insurance on the car (at the Dawsons' expense, of course) or calling the loan.

Six months after the Dawsons submitted their first statements, Sarah caused a devastating accident. The Dawsons' car sustained significant damage and, though still driveable, was basically worthless. Sarah was also personally responsible for many of the debts caused by the accident. In addition, though Sarah had medical insurance, the Dawsons were left with thousands of dollars in deductibles and other expenses not covered by the health insurer.

When the time came for the Dawsons to submit their second annual financial statements to the Bank, they neglected to mention the accident, though the statements required them to verify the value of the automobile. The financial statements also required them to disclose potential and actual liabilities, but the Dawsons failed to mention the debts incurred as a result of the accident. The Bank employee in charge of the Dawsons' loan received the documents, quickly looked through them, and placed them in the Dawsons' file.

Before long, the Dawsons realized that Sarah's accident had changed them forever, personally and financially. They tried to pay the debts, but they simply could not afford to pay hospital bills, car payments, and all of their other obligations. On top of that, the insurers for the others involved in the accident filed a lawsuit against the Dawsons to pay the automobile and medical claims of the others involved in the accident. Under significant financial pressure, Sarah and Stephen filed for chapter 7 bank-

3. See UCC § 9-601(a)(1) (2000) (allowing secured party to foreclose on collateral after a default); *id.* § 9-601 cmt. 3 (noting that parties may contract as to when a default occurs). Revised Article 9 of the Uniform Commercial Code has been substantially adopted by every state. Uniform Law Commissioners, Facts About the Revised UCC Article 9, http://www.nccusl.org/Update/uniformact_factsheets/uniformacts-fs-ucca9.asp (last visited Sept. 20, 2005).

ruptcy protection.⁴ When the Bank officer received copies of Sarah and Stephen's financial statements filed with the bankruptcy court, he was stunned to find out about the accident and the lawsuits against Sarah and Stephen. The Bank knows that, as a secured creditor in a bankruptcy, it receives the value of the car,⁵ but the Dawsons, only two years into a five-year loan, still owe nearly \$15,000 to the Bank, and the car's value vanished after the accident. The Dawsons' other assets will, for the most part, be exempt⁶ from creditors or of little value. If the Dawsons had notified the Bank of the insurance cancellation and the Bank purchased replacement insurance, the Bank may be able to obtain some money from the insurance company (though likely less than the value of the loan because the debt likely exceeds the value of the car) but will lose the remainder of its claim. If the Dawsons did not make the Bank aware of the insurance cancellations, there will be no insurance money to collect. The Bank faces the possibility that most of the money owed by the Dawsons will be discharged⁷ in bankruptcy and will never be repaid.

Though the Bank's situation looks bleak, it may find salvation in section 523(a) of the Bankruptcy Code ("Code"), which provides for exceptions to discharge of the debts of a debtor. Section 523(a)(2) provides:

(a) A discharge under section 727, 1141, 1228(a), 1228(b), or 1328(b) of this title does not discharge an individual debtor from any debt—

(2) for money, property, services, or an extension, renewal, or refinancing of credit, *to the extent obtained by* –

(B) use of a statement in writing –

(i) that is materially false;

(ii) respecting the debtor's or an insider's financial condition;

(iii) on which the creditor to whom the debtor is liable for such money, property, services, or credit reasonably relied; and

(iv) that the debtor cause to be made or published with intent to deceive[.]⁸

Though section 523(a)(2) provides for other "fraud" exceptions to dis-

4. Unforeseen medical expenses constitute one of the primary reasons for bankruptcy filings. H.R. REP. NO. 108-40, at 561 (2003); *but cf.* Edith H. Jones & Todd J. Zywicki, *It's Time for Means-Testing*, 1999 BYU L. REV. 177, 242 (1999) (arguing that medical expenses are not necessarily a substantial cause of bankruptcy filings and do not explain the rapid increase in the number of bankruptcy filings), *cited in* Todd J. Zywicki, *Bankruptcy Law as Social Legislation*, 5 TEX. REV. L. & POL. 393, 399 n.30 (2001).

5. 11 U.S.C. § 506 (2005).

6. *See* 11 U.S.C. § 522(b), (c) (providing that debtors in bankruptcy may take some types of property out of the bankruptcy estate, based either on federal or state law, making it unavailable to satisfy claims of creditors).

7. Sections 727(a), 1141(d), 1228(a), and 1328(a) of the Code provide that debts not paid through the bankruptcy proceeding will be discharged after the conclusion of the bankruptcy. A creditor may not collect on a discharged debt. 11 U.S.C. § 524(a).

8. 11 U.S.C. § 523 (2005) (emphasis added).

chargeability, those sections apply to unwritten fraud⁹ and to certain forms of implied fraud.¹⁰ Thus, in most situations involving loans incurred honestly but renewed fraudulently, a written financial statement will render the nondischargeability of the loan debt a section 523(a)(2)(B) question.¹¹

B. THE DELICATE BALANCE OF DISCHARGE

Congress designed section 523 of the Bankruptcy Code to protect creditors.¹² However, Congress designed the Bankruptcy Code as a whole to balance protection for both debtors and creditors.¹³ These policies compete throughout the Code. On the one hand, bankruptcy protects debtors by providing them with a “fresh start” unencumbered by obligations

9. 11 U.S.C. § 523(a)(2)(A) (prohibiting discharge for debts incurred through “false pretenses, a false representation, or actual fraud, *other than a statement respecting the debtor’s or an insider’s financial condition*”) (emphasis added).

10. 11 U.S.C. § 523(a)(2)(C) (prohibiting discharge for significant amounts of “luxury” purchases).

11. Some cases involve both written financial statements and oral statements. For one case with an interesting factual background, see *European American Bank v. Gitelman (In re Gitelman)*, 74 B.R. 492 (Bankr. S.D. Fla. 1987). Richard and Barbara Gitelman ran multiple businesses, which borrowed money from the bank under a revolving credit line. *Id.* at 493. The debtors were required to provide financial statements to the bank each year. *Id.* The decision does not clearly indicate whether the loan was originally taken out honestly, but it clearly presents a picture of “continuing fraud” on the bank, in which “the debtors’ actions and interim financial statements created an artificial facade which concealed an empty shell, a facade which gave [the bank] a false sense of security and induced [the bank] to renew and increase [debtors’] line of credit.” *Id.* For example, Mr. Gitelman provided loans to the company that could be reflected on the financial statements as assets of the company, only to take the money out of the company one month later. *Id.* at 493-94. The debtors listed assets that they did not actually have, and borrowed money for the company without so disclosing to the bank. *Id.* at 494. Finally, the debtors moved, selling the house that guaranteed the Debtors’ loan, without informing the bank. *Id.* at 495. The Bank renewed and increased the line of credit twice on the basis of these fraudulent statements. *Id.* at 494. Citing section 523(a)(2)(A) of the Code, the court found fraud and denied discharge of the entire debt. *Id.* at 497. The court did not, however, expressly consider whether to imply a damages requirement under section 523(a)(2).

Takeuchi v. Fields (In re Fields), 44 B.R. 322 (Bankr. S.D. Fla. 1984), provides an equally interesting example. The Fields’ company purchased six backhoes from Takeuchi; the backhoes could not be sold without Takeuchi’s permission. *Id.* at 324-25. Of course, Fields sold some of the backhoes. *Id.* at 325-26. When warned that a Takeuchi representative would be visiting the Fields’ company, Fields contacted the purchasers of the backhoes and induced them to return the backhoes by falsely claiming a problem with the equipment. *Id.* at 326. No one informed the Takeuchi representative visiting of the sales. *Id.* at 324-26. The court held that the Fields’ silence constituted a fraudulent misrepresentation under section 523(a)(2)(A), which rendered the debt nondischargeable. *Id.* at 329. The court noted, however, that Takeuchi might have had a remedy available to it at the time of the fraudulent sales that was no longer available when the bankruptcy was filed, and that “Takeuchi suffered damage and loss” as a result. *Id.*

12. Merav Biton, *Lies, Filthy Lies and Archer v. Warner: Should We Allow Fraudulent Debtors to Side-step Section 523(a)(2)(A)?*, 11 AM. BANKR. INST. L. REV. 267, 278 (2003); Robert C. Yan, Note, *The Sign Says “Help Wanted, Inquire Within”—But It May Not Matter if You Have Ever Filed (or Plan to File) for Bankruptcy*, 10 AM. BANKR. INST. L. REV. 429, 432 (2002).

13. Yan, *supra* note 12, at 432.

of the past.¹⁴ The fresh start¹⁵ relies on the ability to discharge debts.¹⁶ The Code also ensures that a debtor cannot abuse that fresh start to the detriment of creditors.¹⁷ Exceptions to discharge help ensure that debtors cannot unduly harm creditors via bankruptcy.¹⁸

Exceptions to discharge occur in one of two ways: either a general denial of discharge altogether¹⁹ or the denial of discharge of specific debts.²⁰ Section 727 of the Code provides grounds for which a debtor will be denied discharge altogether.²¹ Because of the severity of section 727, which completely denies a debtor's fresh start, the grounds for section 727 are equally extreme.²²

Section 523 provides a less-severe remedy for creditors. The grounds for nondischargeability in section 523 lead to a denial of discharge only for those creditors who have been wronged,²³ or who are owed debts that, for policy reasons, should not be discharged.²⁴ Section 523 epitom-

14. See Theresa J. Pulley Radwan, *Domino Effect: The Continued Existence of Liability for Fraud in Bankruptcy Despite Good-Faith Settlement by the Honestly Unfortunate Settlor*, 53 CATH. U. L. REV. 81, 84 (2003) (citing *FCC v. NextWave Pers. Comm., Inc.*, 527 U.S. 293 (2000)); *Grogan v. Garner*, 498 U.S. 279, 286-87 (1991); *Boston Univ. v. Mehta (In re Mehta)*, 310 F.3d 308 (3d Cir. 2002).

15. H.R. REP. NO. 95-595, at 125 (1977) ("The two most important aspects of the fresh start available under the Bankruptcy laws are the provision of adequate property for a return to normal life, and the discharge, with the release from creditor collection attempts. Current law is deficient in both of these areas.")

16. The discharge of debt in bankruptcy essentially renders the debt nonexistent. It can no longer be collected or adjudicated. 11 U.S.C. § 524(a) (2005).

17. See *Grogan*, 298 U.S. at 286-87 (noting that Code gives debtors ability to start anew, but only "honest but unfortunate debtor[s]"); see also Honorable Nancy C. Dreher & Matthew E. Roy, *Bankruptcy Fraud and Nondischargeability Under Section 523 of the Bankruptcy Code*, 69 N.D. L. REV. 57, 58 (1993) (noting that discharge only allows honest persons to avoid debt).

18. Craig A. Bruens, *Melting the Plastic Theories: Advocating the Common Law of Fraud in Credit Card Nondischargeability Actions Under 11 U.S.C. § 523(A)(2)(A)*, 50 VAND. L. REV. 1257, 1262 (1997) (indicating that section 523 balances concerns of debtors and creditors).

19. 11 U.S.C. §§ 727(a), 1141(d)(3) (2005).

20. 11 U.S.C. § 523(a).

21. These grounds include that "debtor is not an individual," debtor fraudulently concealed property, debtor destroyed or falsified information, debtor defrauded the court, debtor cannot explain the loss of property, debtor fails to obey a court order, debtor has received a discharge recently, or debtor voluntarily waives discharge. 11 U.S.C. § 727(a).

22. *Id.*

23. See 11 U.S.C. §§ 523(a)(1) (2005) (unfiled or fraudulent tax obligations); (2) (fraud debts); (3) (unscheduled debts); (4) (fiduciary fraud); (6) ("willful or malicious injury"); (7) (fines owed to government); (9) (DUI); (11) (bank fiduciary); (19) (securities fraud).

24. See 11 U.S.C. §§ 523(a)(5) (alimony, maintenance, or child support); (8) (student loans); (10) (previously denied discharge); (18) (federal restitution); (14) (loan to pay tax debt); (15) (divorce property settlement), (16) (condo association fees); (17) (court fees); (18) (support owed under Social Security Act). Some of these categories of debt could invoke repayment obligations both because the creditor was wronged and because society views the debt as significant. *But see* NATHALIE MARTIN, *THE GLANNON GUIDE TO BANKRUPTCY: LEARNING BANKRUPTCY THROUGH MULTIPLE-CHOICE QUESTIONS AND ANALYSIS* 135 (2005), which distinguishes the reasons for nondischargeability of debts based on which are granted discharge in the various bankruptcy chapters (noting that [n]on-dischargeable debts include debts incurred by fraud, debts for luxury goods purchased within 60 days of the filing, certain property settlement debts owed to spouses, debts neither listed nor scheduled in the bankruptcy

mizes balance. The debtor still, for the most part, starts fresh after bankruptcy, but the truly harmed creditors are protected. However, before determining how much of an honestly-incurred debt that is later tainted by fraud can be discharged, one must determine whether the fraudulent statement provided after incurrence of the debt can invoke the provisions of section 523(a)(2).

C. THE THRESHOLD ISSUE: WHETHER EXTENSION OR RENEWAL OF A DEBT CONSTITUTES OBTAINING MONEY

With fraudulently incurred debt, courts have little problem determining that the debtor received money via fraud, and thus, the debt cannot be discharged. A more complicated issue arises when the debtor did not actually receive additional cash²⁵ as a result of the fraud. In other words, the debtor provided the fraudulent statements, and in exchange, the lender did not collect on an already-outstanding and honestly incurred loan. Almost every court that has considered the issue has determined that fraud in such a situation invokes section 523(a)(2) because the plain language of the Code prohibits discharge for "money, property, services, or an extension, renewal, or refinancing" if incurred as a result of fraud.²⁶ Thus, courts have determined that the willingness of the lender to continue to loan money to the debtor, rather than calling the loan, consti-

paperwork, debts for fraud or defalcation while acting in a fiduciary capacity, and debts arising from embezzlement or larceny [may be discharged in a chapter 13 bankruptcy and] [s]ome . . . debts are excepted from discharge because society has decided that these are the types of debts that people should be obligated to pay no matter what . . . [and] include alimony and child support, debts for recent taxes and some other taxes regardless of age, debts resulting from criminal restitution claims, debts arising while driving under the influence of alcohol, and student loans".)

However, this distinction is less clear now that Chapter 13 discharges have become more limited. See Bankruptcy Fraud Prevention & Consumer Protection Act of 2005 (Pub. L. 109-08).

25. Actually, in many cases, the debtor receives additional cash as a result of the fraud, but also continues to owe money under an original debt incurred before the fraud. Many early cases, and even some more recent cases, considering this issue dealt with this dichotomy under the "new cash" doctrine, limiting the nondischargeable debt to the amount of "new cash" obtained as a result of the fraud, and discharging the renewed debt. *Beneficial Mortgage Co. of Ohio v. Rollman* (*In re Rollman*), 223 B.R. 111 (Bankr. N.D. Ohio 1998); *Family Fed. Credit Union v. Schuster* (*In re Schuster*), 69 B.R. 352 (Bankr. Conn. 1987); *In re Gadberry*, 37 B.R. 752 (Bankr. Ill. 1984); *Regency Nat'l Bank v. Blatz* (*In re Blatz*), 37 B.R. 401 (Bankr. Wis. 1984).

26. 11 U.S.C. § 523(a)(2) (emphasis added); see, e.g., *First Commercial Bank v. Robinson* (*In re Robinson*), 192 B.R. 569 (Bankr. N.D. Ala. 1996) (bank's forbearance from collection on debt qualifies as an extension of credit to the debtor); *First Fed. Sav. & Loan Ass'n of Largo v. Mancini* (*In re Mancini*), 77 B.R. 913 (Bankr. M.D. Fla. 1987 (same); but see *Fleming v. Preston* (*In re Preston*), 47 B.R. 354 (E.D. Va. 1983) (holding that payment of a debt with a bounced check does not create fraud nondischargeability, even if payment temporarily caused bank not to call loan immediately); *Drinker Biddle & Reath v. Bacher* (*In re Bacher*), 47 B.R. 825 (Bankr. E.D. Pa. 1985) (finding that forbearance does not invoke section 523(a)(2)(A) without significant analysis); *Ballard v. Grubbs* (*In re Grubbs*), 9 B.R. 499 (Bankr. M.D. Ga. 1981) (finding that forbearance does not create claim of nondischargeability under 523(a)(2)(A) unless it involves a new extension of credit).

tutes a grant of credit sufficient to invoke the protections of section 523(a)(2).²⁷ Assuming that the creditor's willingness to extend a loan or not to collect on a loan as a result of fraudulent statements provided after origination of the loan invokes section 523(a)(2), the next question becomes how much of the loan qualifies for nondischargeability. Is the entire loan or only the actual damages caused by the fraud nondischargeable, and if the latter, how will the actual damages be calculated?

II. THE CAUSATION AND DAMAGES ISSUE: DOES AND SHOULD SECTION 523(A)(2)(B) REQUIRE A DAMAGE CALCULATION?

What options are available under section 523(a)(2)(B) in a case such as the Dawson bankruptcy? First, the entire debt can be deemed nondischargeable as a grant of credit to the debtor on the basis of a fraudulent financial statement.²⁸ Alternatively, only those damages actually caused by the false financial statement can be discharged. The issue of whether to discharge any of the debt incurred honestly but renewed fraudulently comes down to whether section 523(a)(2)(B) includes a requirement that the creditor was damaged.²⁹ The statute itself provides the obvious starting point for such a determination.³⁰ To the extent that the statute does not answer the question, one can consider the legislative history behind the statute, the case law interpreting the statute, and the policies inherent in the Code.³¹

A. THE LANGUAGE OF SECTION 523(A)(2)

1. *Damages v. Causation*

Most cases dealing with this issue arise under section 523(a)(2)(B), which specifically lists the elements required to establish nondischargeability of debt resulting from a fraudulent written financial statement.³² Clearly, none of these requirements expressly includes an element of damages. Though reliance by the creditor requires a causal relationship, causation does not equate to damages. Looking beyond

27. Though the author believes that this determination should be based on a case-by-case determination of the lender's use of the fraudulent statements, for purposes of this article, it will be assumed that, indeed, the lender would have called the loan had no financial statements or correct financial statements been given. In other words, but for the fraudulent financial statements, the lender would have initiated proceedings to repossess collateral and/or collect against the debtor.

28. See *infra* Part II(C)(2)(a).

29. See *Wolf v. Campbell (In re Campbell)*, 159 F.3d 963, 964 (6th Cir. 1998).

30. *United States v. Ron Pair Enters., Inc.*, 489 U.S. 235, 240-41 (1989).

31. *Chickasaw Nation v. United States*, 534 U.S. 84, 85 (2001) (considering text of the statute, legislative history, and policy before turning to principles of "statutory construction").

32. Those elements include: reasonable reliance by a creditor on a "materially false" written statement about the debtor's "financial condition" that the debtor was responsible for. 11 U.S.C. § 523(a)(2)(B) (2005).

subsection (B)'s elements, section 523(a)(2) itself has a requirement that the granting of credit be "obtained by" the fraud.³³ Many courts have considered this language and concluded that this requirement implies a causation requirement,³⁴ which, as noted, may already be implicit in subsection (B)'s elements.

2. "To the Extent"

The courts seemingly forget that another phrase precedes the "obtained by" phrase—"to the extent." The statute does not need this phrase to establish a causation requirement. Section 523 could read just as easily without it: "A discharge . . . does not discharge an individual debtor from any debt . . . for . . . an extension, renewal, or refinancing of credit, . . . obtained by . . . use of a [fraudulent] statement in writing . . ." Given that every phrase in a statute should be included for a reason,³⁵ one must consider the effect of including "to the extent" within section 523(a)(2).

The idea of extent necessarily implies a calculation.³⁶ But does it imply a calculation of damages?³⁷ In section 523(a)(2), "to the extent" modifies

33. *Id.*

34. See, e.g., *Field v. Mans*, 516 U.S. 59, 66 (1995); *Campbell*, 159 F.3d at 966; *In re McFarland*, 84 F.3d 943, 946 (7th Cir. 1996) (citing *Shawmut Bank v. Goodrich (In re Goodrich)*, 999 F.2d 22, 24 (1st Cir. 1993)).

35. *Bailey v. United States*, 516 U.S. 137, 145 (1995).

36. *Black's Law Dictionary* defined "obtain" as "[t]o get hold of by effort; to get possession of; to procure; to acquire, any way." BLACK'S LAW DICTIONARY 1078 (6th ed. 1990), while defining "extent" as "[a]mount; scope, range; magnitude." *Id.* at 553.

37. This ability to discharge a portion of the debt, while only retaining the fraudulently-incurred debt post-bankruptcy was recently noted by Judge Richard Posner in *McClellan v. Cantrell*, 217 F.3d 890 (7th Cir. 2000). The debtor's brother owed money to McClellan, taking an unperfected security interest in equipment owned by the brother. *Id.* at 892. When McClellan sued for payment, the brother sold the equipment to his sister for the stated price of \$10. *Id.* at 897. The sister in turn sold the equipment for \$160,000 and declared personal bankruptcy after being named a defendant in the original lawsuit between McClellan and her brother. *Id.* at 892. McClellan sought a nondischargeable claim against the sister in the bankruptcy proceeding. *Id.* The primary issue in the case involved the ability to rely on section 523(a)(2)(A)'s false statement provisions when neither the sister nor the brother had ever actually made a statement to McClellan regarding transfer of the equipment. *Id.* After deciding that the "actual fraud" provisions of section 523 sufficed to create nondischargeability, the court turned, in dicta, to the calculation of the nondischargeable claims:

What is true is that if he had merely defaulted on his original debt to McClellan, which so far as appears was not created by a fraud, and later declared bankruptcy, that debt would have been dischargeable. If, however, he had rendered the debt uncollectible by making an actually fraudulent conveyance of the property that secured it, his actual fraud would give rise to a new debt, nondischargeable because created by fraud, just as in the case of the sister, his accomplice in fraud. But it would be a new debt only to the extent of the value of the security that he conveyed, for that would be the only debt created by the fraud itself. For example, if he owed McClellan \$100,000 and defaulted after having transferred to his sister property securing the debt worth \$10,000, he would be entitled to discharge \$90,000 of the debt, for only the \$10,000 was a debt created by fraud.

Id. at 895. Thus, though a different factual situation, Judge Posner considers the same question: does the later fraud taint the entire debt? In answering "no" to that question, Judge Posner requires a consideration of the true loss to the Bank as a result of the fraud. The court, however, goes on to note that, in the case at hand, the sister obtained all of her

“obtained by.” Thus, it implies a calculation of the amount of money or credit actually *obtained* as a result of the fraud (recalling that refinancing may be obtained fraudulently). The phrase “to the extent” recognizes that a creditor, even given the true financial picture, may extend some credit to a debtor. Assume, for example, a borrower incurred an unsecured debt of \$10,000 based on false financial statements. Had correct financial statements been provided, the lender would still have permitted the borrower to borrow \$3,000. To what extent was the credit “obtained by” fraud? Only to the extent of \$7,000—the difference between what the borrower would have received if it had been truthful and what it actually received by the fraud. This phrase limits causation, rather than providing a calculation of damages actually incurred by the bank, in that it simply forces the bank to prove what the fraud actually caused. Yet, it also serves as a calculation of the loss to the bank, which gave an additional \$7,000 as a result of the fraud.

To highlight how this differs from a true damages calculation, reconsider the Dawsons’ situation. In so doing, one must consider what would have happened had the Dawsons been completely truthful at all times versus what happened with the fraudulent misstatements. When the Bank was told of the loss of insurance coverage, the Bank purchased replacement insurance. When told about the accident and the potential lawsuits, though, the Bank likely would have called the loan. Assume further that had the Bank called the loan, the Dawsons would have been forced to file bankruptcy at that time. What would the Bank have received in the Dawson bankruptcy? It would have received the car, or the value of it, and an unsecured claim for any remaining debt. Recall that Dawsons owed the Bank \$15,000 at the time of the bankruptcy filing; assume that the value of a car originally purchased for \$20,000 two years ago has decreased to about \$10,000. The Bank then holds a \$5,000 unsecured claim.

Compare that with what would have happened had the Dawsons told the Bank about the insurance coverage, but not about the accident. In such a situation, the Bank would have purchased insurance coverage for the car. When the accident occurred, about \$10,000 would be recovered from the insurance carrier. Because the Bank does not know about the accident, the loan would remain outstanding until the bankruptcy filing. In the bankruptcy, the Bank would receive the \$10,000 in proceeds, assuming that they are traceable, leaving it with a \$5,000 unsecured claim. To what extent did their fraud *cause* the Bank to give credit? Conceivably, to the extent of the entire outstanding amount of the loan, as without the fraud, the Bank would not have continued to loan the money. But what were the Bank’s actual damages? Really, it had none. Whether the Bank knows of the accident or not, it receives the \$10,000 in proceeds

money by fraud without deciding what the damages would actually be in the case. *Id.* at 896.

from the insurer and a \$5,000 unsecured claim in the bankruptcy proceeding.

Contrast that scenario with what would have happened if the Bank was not made aware of the cancellation of the insurance coverage or the accident. After the accident, the car has no value, so Bank could not have collected its debt by repossessing the car. There are no insurance proceeds to give to the Bank either. The Bank enters bankruptcy with a \$15,000 unsecured claim, likely to be paid only pennies on the dollar. The Bank suffers a significant loss. The Bank lent \$15,000 on account of the fraud, but lost \$10,000 in payments. The entire "extent" of the debt was renewed as a result of the fraud, but the loss resulting from the fraud was only \$10,000.

In either scenario, the entire amount of the loan was "reloaned" to the Dawsons as a result of the fraudulent statements because, had the truth been known, the Bank would have called the loan in its entirety. However, the damages differ significantly in the various scenarios. The fraud regarding the insurance causes the Bank to lose the value of the car. Though the car accident causes loss to the Bank, the accident itself, *not the failure to disclose the accident*, actually causes the loss to the Bank. Put another way, the Bank's *right* to collect does not create an *ability* to collect. The Bank, in either event, cannot collect the unsecured portion of its claim against Sarah and Steven unless the Code *creates* a continuing right of the Bank to collect post-bankruptcy.

The analysis could stop here. Nothing in section 523(a)(2) expressly requires that the lender be damaged in order to render a debt nondischargeable. The only language that hints at a damage requirement can be explained as a limitation on causation instead. However, policy considerations may dictate a different result. Further, this debate has continued through revisions to section 523(a)(2) and its predecessor, section 17a(2) of the Bankruptcy Act. Thus, a consideration of legislative history, case law, and policy assists in determining whether the current statute could be considered differently or, if not, whether it should be changed.

B. THE HISTORY BEHIND SECTION 523

Section 523(a)(2)(B) has a long history of development that begins with the passage of the Bankruptcy Act of 1798. Under the Bankruptcy Act, defrauded creditors had two options available—seek denial of discharge of the individual debt or seek denial of discharge of all of the debtor's debts.³⁸ Of course, the current Bankruptcy Code allows the same choice in certain situations. However, the grounds for denial of *all* debts are more strict and no longer include fraud in the actual incurrance of debt.³⁹ Even under the Bankruptcy Act, courts are divided over the issue

38. Household Fin. Corp. v. Danns (*In re Danns*), 558 F.2d 114, 115 (2d Cir. 1977) (citing Bankruptcy Act § 14c(3) and § 17a(2)).

39. The grounds for total denial of a debtor's discharge include an institutional debtor, a debtor who destroyed property, a debtor who falsified information in connection with the

of whether to discharge debt incurred honestly but renewed fraudulently.⁴⁰

Congress amended the discharge exceptions, sections 14 and 17, of the Bankruptcy Act in 1960.⁴¹ Courts interpreting the amended provisions routinely agreed that the new provisions were designed to strike a balance between debtors and creditors. The new provisions prohibited creditors from seeking a complete denial of debtor's discharge on the basis of a fraudulently-incurred debt; most courts felt that, in return, they strengthened the creditor's ability to seek denial of discharge of an individual debt.⁴² However, the effect of the changes in 1960 were not entirely clear.⁴³ The legislative history, as noted in case law, provided little guidance:

[t]he legislative history of this amendment contains the following statement of the reason for these changes: "The committee believes that complete denial of a discharge is too severe a penalty in the case

bankruptcy, a debtor who refuses to cooperate with the bankruptcy court, or a debtor granted prior discharges in bankruptcy. 11 U.S.C. § 727(a) (2005). The only references to fraud in section 727 are found in section 727(a)(2), which denies discharge for a debtor who "with intent to hinder, delay, or defraud a creditor or an officer of the estate charged with custody of property under this title, has transferred, removed, destroyed, mutilated, or concealed . . . property", and section 727(a)(4), which prohibits discharge if "the debtor knowingly and fraudulently, in or in connection with the case . . . made a false oath or account; presented or used a false claim; gave, offered, received, or attempted to obtain money, . . . or withheld from an officer of the estate." Other chapters of the Bankruptcy Code make section 727 applicable by reference. See 11 U.S.C. § 1141(d)(3)(c). But nothing in chapter 13 refers to section 727. Rather, limitations on discharge in Chapter 13 are dictated by reference to section 523 or other sections of the bankruptcy code and include: payments for which the plan provides post-discharge payment, certain tax claims, fraud claims, unscheduled claims, fiduciary fraud claims, alimony and other support claims, student loan payments, debt due as a result of certain DUI or similar claims, amounts due as a result of criminal actions, and liability due as a result of a personal injury. 11 U.S.C. § 1328(a). Many categories of nondischargeable debt, including the fraud debt, were added to the list of nondischargeable debt under Chapter 13 as a result of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005; previously, fraud had been dischargeable in a Chapter 13 if the debtor successfully completed the bankruptcy plan. 11 U.S.C. § 1328(a) (pre-2005 version). It is unclear what prompted the change. Cf. 11 U.S.C. § 1328(b), (c) (providing that an uncompleted plan may still permit discharge if failure to complete plan occurred in good faith and plan cannot reasonably be amended, but discharge will be limited); § 1328(e) (allowing court to revoke discharge during year after grant of discharge if the discharge itself resulted from fraud).

40. See *Danns*, 558 F.2d at 115 ("Under the old § 17a(2) where the debtor obtained an additional loan and signed a new note covering the old balance as well, state courts were split over whether discharge should be barred for the entire loan or only for the 'fresh cash.'") (citing R. Lewis Townsend, "Fresh Cash"—Another Element of the Bankrupt's "Fresh Start"?, 31 U. MIAMI L. REV. 275, 281 n.39 (1977)).

41. *Danns*, 558 F.2d at 115.

42. *Id.* ("State courts interpreted this as a compromise whereby the defrauded lender lost the right to bar the bankrupt's entire discharge, but was still to be entitled to a complete bar of discharge on his own claim.")

43. Not all courts agree that the 1960 amendment and its effects were unclear. See *Local Indus. Fin. Co. v. McDougale*, 404 S.W.2d 789, 791 (Ky. Ct. App. 1966) (stating "The language of section 17a(2) is clear and unambiguous. There are no complexities in its terminology. It may well be that we could find the conclusion of the whole matter in the language of the section itself, and that no precedents or illustrations are necessary to make its exemptions applicable to the transaction in controversy. But "the world must have emphatic warrant.)

of the individual noncommercial bankrupt. It is also a penalty which experience has shown to be subject to abuse. . . . unscrupulous lenders have frequently condoned, or even encouraged, the issuance of statements omitting debts with the deliberate intention of obtaining a false agreement for use in the event that the borrower subsequently goes into bankruptcy."⁴⁴

While this section clearly indicates a need to protect debtors from problematic creditors, it does nothing to indicate whether damages are necessary to render a debt nondischargeable. Indeed, courts have used the language of the 1960 amendments to bolster both sides of the argument.⁴⁵ The problem that it references—creditors requesting written financial statements in the hope that those statements would be inaccurate and able to serve as the basis for a nondischargeability determination—is not resolved by changing fraud from the general denial of discharge category to the individual creditor denial of discharge category. Further, the concern is adequately resolved by the reliance requirement of section 17a of the Bankruptcy Act and its successor, 11 U.S.C. § 523(a)(2).

The legislative history also provides that "any obligation incurred as a result of such a statement is to be nondischargeable."⁴⁶ This statement provides the closest indication of congressional intent regarding damages. While it clearly indicates that Congress intends to expand the fraud provisions of the Code beyond just the actual incurrence of debt, the statement merely indicates the need for a causal relationship between the fraud and nondischargeability without expressly considering the need, or lack of need, for damages. Further, it neglects to define an "obligation," though taken with current section 523(a)(2)'s statement that nondischargeability applies to more than just the original granting of credit, that definition may now be supplied.

44. *First Am. Nat'l Bank v. Carter (In re Carter)*, 11 B.R. 992, 993 (Bankr. M.D. Tenn. 1981) (citing Act of June 24, 1960, Pub. L. No. 86-621 (74 Stat. 409)).

45. *See Beneficial Fin. Co. v. Ellis (In re Ellis)*, 400 F. Supp. 1112, 1117 (S.D.N.Y. 1975) (recognizing that most courts have held entire debt nondischargeable, but finding nondischargeable only debt "given in reliance upon the false statement," without discussing damages per se); *In re Fuhrman*, 385 F. Supp. 1185, 1186 (W.D.N.Y. 1973) (stating "to except from discharge that portion of the preexisting debt untainted by fraud would be to render the form rather than the substance of the transaction controlling . . . such a result would fly in the face of the legislative history of the 1960 amendment"); *In re Soika*, 365 F. Supp. 555, 555 (W.D.N.Y. 1973) (same); *Seaboard Fin. Co. v. Barnes*, 148 N.W.2d 756, 760 (Mich. 1967) (same); *Household Fin. Corp. v. Walters*, 443 P.2d 929, 933 (Ariz. Ct. App. 1968) (same); *Budget Fin. Plan v. Haner*, 436 P.2d 722, 725-26 (Idaho 1968) (reading amendments to allow full amount of debt nondischargeable); *Liberal Fin. Corp. v. Holley*, 157 So. 2d 376, 379-80 (La. Ct. App. 1963) (finding reliance necessary, but without discussing damages); *Fed. Fin. Co. v. Merkel*, 397 P.2d 436, 439-40 (Wash. 1964) (same); *First Credit Corp. v. Wellnitz*, 123 N.W.2d 519, 521-22 (Wis. 1963) (same); based on inclusion of "renewal of credit" language in statute). Many of the cases, however, did not actually consider whether a damages requirement should be included; rather, they merely considered whether a renewal of credit could be considered under section 523(a)(2). *See, e.g., Advance Loan Co. v. Bell*, 402 P.2d 944 (N.M. 1965); *Family Fin. Corp. v. Lyons*, 310 N.Y.S.2d 514, 514 (N.Y. App. Div. 1970) (both considering only whether to limit nondischargeability to "fresh cash"); cases cited above.

46. *Carter*, 11 B.R. at 995 (citing S. REP. NO. 86-1688, at 2954 (1960)).

Other changes to the Bankruptcy Act in 1970 and a complete revision of the Bankruptcy Code in 1978⁴⁷ have affected these precedents.⁴⁸ Interestingly, the court in *In re Schuerman*⁴⁹ recognized that the 1960 amendments to the Bankruptcy Act made changes that most courts determined made the entire debt nondischargeable. While recognizing these precedents, the court both questioned the validity of this conclusion and noted that the 1970 amendments made the precedents irrelevant.⁵⁰ In so doing, the *Schuerman* court stressed the policy of uniformity among bankruptcy courts in dealing with fraud dischargeability.⁵¹ Despite numerous years of tinkering with the fraud nondischargeability provisions and numerous precedents concerning section 523(a)(2), “the law in this area still seems to be unclear.”⁵²

The current section 523(a)(2) arose as part of the 1978 creation of the Bankruptcy Code. Distrust of creditors, a theme shared by the 1960 legislative history, prompted the Bankruptcy Commission to recommend eliminating section 523(a)(2)(B) altogether.⁵³ Yet, Congress retained this exception to dischargeability.⁵⁴ Congress made the change to 523(a), noting that a false financial statement does not *automatically* render the en-

47. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 became effective Oct. 17, 2005. For purposes of this article, the most significant change under the Reform Act is the addition of fraud debt to the list of nondischargeable debts under Chapter 13. However, the language of § 523(a) did not change to resolve the issue presented within.

48. *Household Fin. Corp. v. Danns (In re Danns)*, 558 F.2d 114, 115-16 (2d Cir. 1997) (stating “However, since Congress gave the federal courts exclusive jurisdiction over dischargeability questions in 1970, see 11 U.S.C. § 35(c)(1), a large majority of federal courts and bankruptcy referees have concluded that only that portion of the credit obtained as a result of a fraudulent statement should be barred from discharge.”).

49. 367 F. Supp. 1347 (E.D. Ky. 1973).

50. *Id.* at 1349 (“the advent in 1970 of provisions granting the federal courts exclusive authority to ascertain the dischargeability of debts ends the necessity for reference to state laws and institutes another standard of inquiry.”) (citing 11 U.S.C. § 35(c) (2005)).

51. *Id.* (citing 9 AM. JUR. 2D *Bankruptcy* § 38 (2005)).

52. *Norwest Fin. N.M., Inc. v. Ojeda (In re Ojeda)*, 51 B.R. 91, 92 (Bankr. N.M. 1985) (citing cases that have determined that only new loans actually incurred as a result of fraud can be discharged as well as cases that prohibit discharge of the entire debt, but ultimately determining that a creditor must prove that it suffered loss as a result of the fraud).

53. H.R. REP. NO. 95-595, at n.84 (1979) and surrounding text (citing COMMISSION REPORT, pt. I, at 176 & pt. II, at 136):

The threat of litigation over this exception to discharge and its attendant costs are often enough to induce the debtor to settle for a reduced sum, in order to avoid the costs of litigation. Thus, creditors with marginal cases are usually able to have at least part of their claim excepted from discharge (or reaffirmed), even though the merits of the case are weak. Statistics from a recent year, for example, show that approximately 8,000 cases were filed under this exception to discharge. Of those, over 5,000 were settled without trial. Of the remaining 3,000, creditors won just half. If those 3,000 are representative, then it is likely that in 2,500 cases, debtors settled by agreeing to repay part of the debt, even though they would have won the case had it gone to trial.

54. H.R. REP. NO. 95-595, H.R. 8200 (1979) (“Most of the grounds for denial of discharge concern misconduct by the debtor in the events leading up to the bankruptcy or during the conduct of the case.”).

tire debt nondischargeable.⁵⁵ What the legislative history did not completely answer was the question of how to calculate the amount of the nondischargeable debt when the debtor clearly engaged in some wrongdoing:

The amount of the debt made nondischargeable on account of a false financial statement is not limited to "new value" extended when a loan is rolled over. If an initial loan is made subject to a false financial statement and new money is advanced under a subsequent loan that is not made under conditions of fraud or false pretenses, then only the initial amount of the loan made on the original financial statement is invalidated and excepted from discharge. On the other hand, where the original financial statement is made under non-fraudulent conditions and the entire loan in addition to new money is advanced under a subsequent false financial statement, the entire loan is made under fraudulent conditions. This rule is sound as a matter of policy because the creditor relies to *his detriment* with respect to the entire amount advanced under the false financial statement. Legal rights with respect to the amount previously advanced *may be* altered; interest rates *may be* changed, maturity dates *may be* extended, and legal remedies *may be* foregone in reliance on the new false financial statement. *However, if the terms of the new agreement are identical to the old agreement with respect to the old money, then no new money was obtained by a false statement on which the creditor relied since the creditor's rights were unchanged; therefore, only that portion of the false financial statement that applied to new money would be nondischargeable.*⁵⁶

The congressional statement is, at best, unclear and, at worst, contradictory. It begins by presuming that a creditor's renewal of a loan based on fraudulent financial statements causes *detriment* to the creditor. It then goes on to recognize that the many factors creating that detriment to the creditor *may* occur. Further, it ends with a situation in which a creditor will rely on a financial statement but not actually be damaged by it and not be entitled to nondischargeability. Some congressional intent evinces from the legislative history. Nondischargeability applies to more than just an advance of cash and should include renewals of credit or forbearance from collecting a debt. A creditor damaged by the fraud should be entitled to a nondischargeable debt. A creditor not relying on the false statement should not be entitled to use that false statement to create nondischargeability. But the question of whether damages are presumed or must be proven remains open, and to the extent presumed, the question of rebuttal of that presumption remains unanswered.

Citing the legislative history surrounding the enactment of section 523(a)(2) in the case of *North Shore Savings & Loan Ass'n v. Jones* (*In re*

55. 124 CONG. REC. H. 32383 (statements of Congressman Edwards of California, chairman of the Subcommittee on Civil and Constitutional Rights of the House Committee on the Judiciary) ("Under section 523(a)(2)(B)(1) a discharge is barred only as to that portion of the loan with respect to which a false financial statement is materially false.").

56. H.R. REP. NO. 95-595 (1979).

Jones),⁵⁷ the court considered how damages play into nondischargeability. The debtor borrowed money from North Shore to purchase a boat.⁵⁸ Without notifying North Shore, the debtor permanently relocated the boat to Florida.⁵⁹ Once in Florida, the debtor also borrowed money from other lenders, secured by the boat, without notifying the other lenders of North Shore's security interest in the boat.⁶⁰ Indeed, North Shore eventually lost its security interest in the boat for failing to refile its security interest against the boat in Florida.⁶¹ After determining that the debtor had defrauded North Shore by failing to disclose the relocation of the boat,⁶² the court decided that part of the debt owed to North Shore could not be discharged in bankruptcy.⁶³ The court considered precedent, determining that, though they reached different conclusions, each "applied a consistent analysis in that they required the creditor to show *detrimental* reliance as to both new cash advanced at renewal and the foregoing of remedies to collect the original loan for the entire debt to be found nondischargeable."⁶⁴ Beyond simply case precedent, however, the court focused on legislative history surrounding the enactment of section 523(a)(2), which provided that:

In many cases, a creditor is required by state law to refinance existing credit on which there has been no default. If the creditor does not forfeit remedies or otherwise rely *to his detriment* on a false financial statement with respect to existing credit, then an extension, renewal, or refinancing of credit is nondischargeable only to the extent of the new money advanced; on the other hand, if an existing loan is in default or the creditor otherwise relies *to his detriment* on a

57. 88 B.R. 899 (Bank. E.D. Wisc. 1988).

58. *Id.* at 900.

59. *Id.*

60. *Id.* at 900-01.

61. Article 9 of the Uniform Commercial Code, as then written, required refiling a financing statement in the new state within four months of permanently relocating the collateral. U.C.C. § 9-103 (2005) (pre-revision).

62. *N. Shore Savs.*, 88 B.R. at 902-03. Not every court has agreed that silence can constitute fraudulent misrepresentation. *See, e.g.*, *Bombardier Capital, Inc. v. Baietti*, 189 B.R. 549, 556 (Bankr. D. Maine 1995) (finding that debtor misappropriated creditor's property, but refusing to find that debtor's failure to reveal sales of inventory, even if such revelations would have led creditor to foreclose on loan, constitute fraud under section 523(a)(2)(A)). *Bombardier* provides an interesting example. The court acknowledged that, had the creditor been made aware that the first boat had been sold without turning over the proceeds to Bombardier, the subsequent sales might have been avoided because Bombardier would have taken measures to prevent the unauthorized transactions. *Id.* at 558. And, since other boats existed for Bombardier to repossess at the time of the misrepresentation, that were no longer available by the time that Bombardier actually realized what had happened, those misrepresentations clearly damaged Bombardier's ability to collect upon its loan. *Id.* Nonetheless, the court refused to utilize section 523(a)(2) as the creditor's remedy.

63. *N. Shore Savs.*, 88 B.R. at 905-06. In making its determination, the court presumed that, had North Shore Savings been made aware of the move to Florida, it would have filed a lien in Florida on the boat and become the second lienholder. *Id.* After paying off the first lienholder, North Shore Savings would have received almost \$30,000 on its debt of nearly \$45,000. *Id.* Thus, the \$30,000 could not be discharged, but the \$15,000 remaining could be. *Id.* at 906.

64. *Id.* at 905 (emphasis added).

false financial statement with regard to an existing loan, then the *entire debt* is nondischargeable under section 523(a)(2)(B). This codifies the reasoning expressed by the second circuit in *In re Danns*, 558 F.2d 114 (2d Cir. 1977).⁶⁵

The references highlighted, however, create further uncertainty. The legislative statement indicates that reliance (causation) alone does not suffice. The creditor must suffer a *detriment* as a result of the statement *or* forfeit remedies. The statement then goes on to conclude that the entire debt is nondischargeable in such a circumstance. Is Congress indicating that the damage—the *detriment*—may not be discharged or saying that if there was *any* detriment, the entire amount due may not be discharged? Further, if there exists reliance on a financial statement that causes the creditor to “forfeit remedies,” must detriment even exist? In other words, what constitutes a *detriment*—the damages resulting from the fraud or waiver, or simply the waiver of an ability to foreclose upon a loan as a result of the fraud even if no damage results?⁶⁶ Did the legislature truly intend to provide nondischargeability *in toto*, even if the creditor’s damages were something less than the amount of the debt, or did Congress simply not consider that the amount of the damages might be something less than the entirety of the debt? The answers to these questions do not appear in the statements given, and reasonable persons can certainly differ in their interpretations of these statements.

The *Household Finance Corp. v. Danns* case referred to by the legislative history was one of the first circuit-court decisions in the area.⁶⁷ *Danns* involved a loan of \$2,000, obtained honestly, which was later renewed by a fraudulent statement that omitted \$14,000 of liabilities.⁶⁸ The *Danns* court, interpreting section 523(a)(2)’s predecessor, section 17a(2) of the Bankruptcy Act, held that only “‘liabilities for obtaining’ extensions or renewals of credit” could be denied discharge.⁶⁹ Though the court spoke of discharge for loans “obtained fraudulently,”⁷⁰ the court did not expand on the definition of “obtained.” Thus, it left open the possibility that a loan initially incurred honestly could be tainted by fraud if the extension was “obtained” dishonestly.⁷¹ The court did not discuss

65. *Id.* (emphasis added) (quoting Statement by the Hon. Don Edwards, September 28, 1978).

66. *Black’s Law Dictionary* defines “detriment” in terms of the “loss or harm suffered” or “relinquishment of some legal right that a promisee would have otherwise been entitled to exercise.” *BLACK’S LAW DICTIONARY* (8th ed. 2004). Thus, even the legal definition of detriment wavers between a need for a mere waiver of a right and the need for damages resulting from that waiver.

67. *Danns*, 558 F.2d 114, 114 (2d Cir. 1977).

68. *Id.* at 115.

69. *Id.* at 116.

70. *Id.*

71. At least one court has recognized that, though *Danns* did not absolutely prohibit nondischargeability of renewed debt, many courts have interpreted *Danns* in such a manner. *N. Shore Sav. & Loan Ass’n v. Jones (In re Jones)*, 88 B.R. 899, 905 (Bankr. E.D. Wis. 1988) (citing *Minn. Small Loan Co. v. Wright (In re Wright)*, 52 B.R. 27, 29 (Bankr. W.D. Pa. 1985); *Northwest Card Servs. v. Barnacle (In re Barnacle)*, 44 B.R. 50, 54 (Bankr. D. Minn. 1984)).

how to calculate the damages, if such a calculation was necessary at all, except to note that the creditor carries the burden of proving that it relied *to its detriment* on the misstatement.⁷² Interestingly, the Bankruptcy Code, passed one year after the *Danns* decision held that section 17a(2) created nondischargeability “*to the extent* that the creditor could actually have relied upon the debtor’s misrepresentation,” mirrors the language from the *Danns* decision.⁷³ From this statement, one cannot determine whether the court intended only that the creditor prove reliance on the statement⁷⁴ or that the creditor show the extent of the reliance and the damages inherent therefrom.

Before enactment of the amendment, courts often followed what came to be known as the “new cash” rule.⁷⁵ Essentially, the “new cash” rule provided that when (1) a debtor borrows additional money from a lender with which the debtor has an existing relationship; (2) that lender both grants the new loan and, essentially, renews the former loan; and (3) the lender does so after the debtor provides fraudulent financial statements, the new cash loan cannot be discharged, but the original loan will be discharged because it was given to the debtor without any fraud.⁷⁶ The initial statement of the legislative history provided above indicates that the change to the statute deals with this multiple-loan situation. Thus, Congress may have considered only the issue of whether to extend the “new cash” rule under the revised section 523(a)(2) or to allow the original debt to be included in nondischargeability, without considering whether the *entirety* of the original debt or simply some portion of it could be denied discharge.

C. CASE LAW INTERPRETATIONS OF SECTION 523(A)(2) AND ITS PREDECESSOR

1. Supreme Court

The only statement provided by the United States Supreme Court regarding the “to the extent obtained by” language of section 523(a)(2) came in the 1995 case of *Cohen v. de la Cruz*.⁷⁷ In *Cohen*, the Supreme Court unanimously determined that punitive damages for nondischarge-

72. *Danns*, 558 F.2d at 116.

73. *Id.*

74. The court expressed obvious concern that creditors would manipulate debtors if later fraud could render an honestly incurred debt nondischargeable:

The rule urged by HFC would encourage unscrupulous lenders making extensions on consumer loans to play down the importance of outstanding debts or even to suggest to the applicant that he write on the application form that he has no other debts. By inducing the naive debtor to make a false statement, the finance company might hope to protect itself against extinguishment of the debt in bankruptcy.

Id.

75. See *In re Peterson*, 437 F. Supp. 1068, 1070 (D.C. Minn. 1977) (finding that most courts before 1977 followed the “new cash” rule, prohibiting discharge only on new loans extended as a result of the fraud).

76. *Id.*

77. 523 U.S. 213 (1998).

able fraud could not be discharged.⁷⁸ The *Cohen* case considered the dischargeability of treble damages assessed against a landlord for defrauding his tenants.⁷⁹ In finding that those treble damages were not dischargeable, the Court focused on the language in section 523(a)(2), finding that “[t]he most straightforward reading of § 523(a)(2)(A) is that it prevents discharge of ‘any debt’ respecting ‘money, property, services, or . . . credit’ that the debtor has fraudulently obtained, including treble damages assessed on account of the fraud.”⁸⁰ The court continued:

the phrase “to the extent obtained by” in § 523(a)(2)(A), as the Court of Appeals recognized, does not impose any limitation on the extent to which “any debt” arising from fraud is excepted from discharge. “[T]o the extent obtained by” modifies “money, property, services, or . . . credit”—not “any debt”—so that the exception encompasses “any debt . . . for money, property, services, or . . . credit, to the extent [that the money, property, services, or . . . credit is] obtained by” fraud. The phrase thereby makes clear that *the share of* money, property, etc., that is obtained by fraud gives rise to a nondischargeable debt. Once it is established that specific money or property has been obtained by fraud, however, “any debt” arising therefrom is excepted from discharge.⁸¹

Under the *Cohen* Court’s analysis, whether the debt itself was incurred fraudulently does not matter. Rather, whether the debt *resulted* from money or other value (including, of course, renewal) incurred by fraud becomes the relevant question.⁸² The opinion holds that even damages not actually constituting the money received through fraud, if those damages are related to money obtained fraudulently, are nondischargeable.⁸³

The passage quoted above indicates that the fraud must not cause the debt itself, but the credit that then leads to the debt. In the case of loan renewal, however, those two inquiries are the same, as the amount of the

78. *Id.* at 218.

79. *Id.* at 215.

80. *Id.* at 218.

81. *Id.* (emphasis added). Though the Supreme Court did not expressly address the issue at hand here, the question of how to handle fraud after granting of an initial loan has arisen. In *Field v. Mans*, 516 U.S. 59 (1995), the court considered the appropriate level of reliance—reasonable or justifiable—that a creditor must have had to claim nondischargeable fraud. Ultimately, the Court required only justifiable reliance. *Id.* at 61. Justice Ginsburg concurred, but added:

I concur in the Court’s opinion and write separately to highlight a causation issue still open for determination on remand: Was the debt in question, as the statute expressly requires, “obtained by” the alleged fraud? . . . Mans ultimately urges that the promissory note to the Fields is, in any event, a dischargeable debt because it was not “obtained by” the allegedly fraudulent letters Mans’s attorney wrote to the Fields’ attorney months *after* the debt was incurred. The Fields maintain that they relied on the letters to their detriment, in effect according Mans an extension of credit instead of invoking the due-on-sale clause.

Id. at 78-79. Justice Ginsberg declined to share her thoughts on how to decide the question that she raised. *Id.* at 79.

82. *Cohen*, 523 U.S. at 219-20.

83. *Id.* at 220.

loan/renewal equals the debt sought by the creditor. The *Cohen* analysis, indicating that all damages resulting from that fraud, even if not fraudulently incurred, are nondischargeable, does not clearly apply to the fraudulent-renewal situation. Treble damages clearly could have been prevented in *Cohen*, if the landlord had not defrauded his tenants, the treble damages would never have been assessed, even though treble damages were not the direct damages of the fraud.⁸⁴ The current situation differs, though, because the damages would have existed *even without the fraud*. The *Cohen* court even notes that nondischargeability requires a debt that somehow “results” from the fraud:

Section 523(a) defines several categories of liabilities that are excepted from discharge, and the words “debt for” introduce many of them None of these use “debt for” in the restitutionary sense of “liability on a claim to obtain”; Instead, “debt for” is used throughout to mean “debt as a result of,” “debt with respect to,” “debt by reason of,” and the like, the presumption that equivalent words have equivalent meaning when repeated in the same statute, . . . has particular resonance here. . . . When construed in the context of the statute as a whole, then, § 523(a)(2)(A) is best read to prohibit the discharge of any liability arising from a debtor’s fraudulent acquisition of money, property, etc. . . .⁸⁵

This still does not answer the question posed. If one rewrites section 523(a)(2) in *Cohen*’s terms, stating that “debt resulting from fraudulent renewal of a loan” may not be nondischarged, the statement only provides a *causation* requirement that if the damages sought by the creditor are linked to the fraud, they are nondischargeable.⁸⁶ Courts both before and after *Cohen* have disagreed regarding how to handle a renewal caused by fraud that does not actually cause any damage to the creditor.

2. Cases Expressly Considering Issue of Dischargeability of Fraudulently Renewed Debt

- a. Fraud in the transaction renders the entire debt nondischargeable, even if the fraud did not cause any damage

In *Shawmut Bank v. Goodrich (In re Goodrich)*,⁸⁷ the First Circuit Court of Appeals considered a fraudulent incurrence and renewal of a loan.⁸⁸ The debtor originally obtained a \$100,000 line of credit from the bank.⁸⁹ No fraud infected the original loan.⁹⁰ The bank then renewed the debtor’s line of credit and increased it to \$150,000, again without any

84. *Id.* at 220-21.

85. *Id.* at 219-21.

86. *Id.* at 222-23.

87. 999 F.2d 22 (1st Cir. 1993).

88. *Id.* at 23.

89. *Id.*

90. *Id.*

fraud involved.⁹¹ However, when the debtor twice more requested renewal of the line of credit, the Bank required financial statements.⁹² The debtor provided fraudulent financial statements, understating liabilities by \$9 million, and the bank granted the debtor's requests.⁹³ When the debtor filed for bankruptcy protection, the bank alleged that the entire \$109,000 actually borrowed against the line of credit should be deemed nondischargeable.⁹⁴ The debtor disagreed, asking that only the \$10,000 actually borrowed after submission of the fraudulent financial statements be denied discharge.⁹⁵ In reversing the bankruptcy and district court opinions, the First Circuit denied discharge of the entire debt.⁹⁶ Clearly, the fraud caused the bank to renew the line of credit,⁹⁷ and thus, the renewal was obtained fraudulently. The bank did not demonstrate any damages caused by that fraud.⁹⁸ However, the First Circuit held that no damages needed to be shown, because the explicit language of section 523(a)(2)(B) lacks a damage requirement.⁹⁹ The language of section 523(a)(2)(B) instead prohibits discharge so long as a causal link exists between the fraudulent statement and the money obtained.¹⁰⁰

Likewise, the Sixth Circuit's Bankruptcy Appellate Panel dismissed the argument that "to the extent obtained by" creates a damages requirement.¹⁰¹ In *National City Bank v. Plechaty*, the debtor obtained loans from the bank for his company.¹⁰² The bank did not originally ask for financial statements but later reconsidered and requested financial statements.¹⁰³ The debtor provided the requested statements and a personal guaranty, but the financial statements misrepresented the debtor's financial situation.¹⁰⁴ The loan agreement provided that the bank could call the loan at any time.¹⁰⁵ Thus, the court initially considered whether the

91. *Id.*

92. *Id.*

93. *Id.* at 23-24.

94. *Id.* at 23.

95. *Id.* at 24.

96. *Id.*

97. *Id.* Though the court accepted that the bank would not have renewed but for the fraudulent financial statements, the bank originally made the loan without asking the debtor for any financial statements. *Id.* at 23. If the bank would have renewed (as opposed to increasing the line of credit) without any financial statements, it is unclear how the court would have responded. Providing financial statements that are not necessary could affect the bank's reliance on those financial statements, a factor that the court clearly felt necessary to establish fraud, or the bank's damages as a result of the financial statements, a factor that the court clearly felt unnecessary. *Id.* at 24-25.

98. *Id.* at 25.

99. *Id.* ("Had Congress wished to add 'damage' as an element, it could easily have done so, especially since some of the decisions favoring this requirement were issued before the elaboration and reenactment of section 523(a)(2)(B) in 1978."); *see also* Wolf v. Campbell, 211 B.R. 14, 16 (Bankr. E.D. Mich. 1997) (quoting *Goodrich*, 999 F.2d at 25).

100. 11 U.S.C. § 523(a)(2)(B) (2005).

101. 213 B.R. 119, 127-28 (6th Cir. B.A.P. 1997).

102. *Id.* at 121.

103. *Id.* at 121-22.

104. *Id.* at 122.

105. *Id.* at 121.

bank had “extended” credit under section 523(a)(2).¹⁰⁶ Because the debtor’s misrepresentations led the bank to forego its option to call the loan, the court held that an extension of credit did indeed occur.¹⁰⁷ The court then turned to a consideration of whether the Bank needed to show damages.¹⁰⁸ Noting the “to the extent obtained by” language of section 523(a)(2), the court nonetheless declined to require such a showing under section 523(a)(2)(B).¹⁰⁹

The language of the statute was considered in more detail by the Fifth Circuit in *Norris v. First National Bank (In re Norris)*.¹¹⁰ In *Norris*, the debtors, who incurred the loan as husband and wife but separated by the time of the bankruptcy filing, purchased land with a loan from the bank.¹¹¹ When the debtors sought a renewal of the loan, the husband provided false financial statements.¹¹² Because the wife had not committed the fraud, her debt was discharged.¹¹³ Thus, the only issue before the courts was that of the husband’s dischargeability.¹¹⁴ The court held that the husband could not discharge any of his debt to the bank:

Unlike *Norris*, we do not read these cases as grafting onto section 523(a)(2) a proximate causation requirement; rather, we read them as applying the statutory mandate that qualifying debts are nondischargeable “to the extent obtained by” the fraudulent documentation. In this case, because the renewal of the entire note was “obtained by” *Norris*’s false documentation, it is the entire note which is excepted from discharge.¹¹⁵

In 1990, the issue was decided similarly by the Tenth Circuit in *John Deere Co. v. Gerlach (In re Gerlachs)*.¹¹⁶ The Gerlachs purchased equipment from John Deere on credit with an agreement that, as the Gerlachs resold the equipment, Deere would lower the outstanding balance on the loan, even before receiving the proceeds of the sale, and extend additional credit to the Gerlachs.¹¹⁷ The Gerlachs created false sales of the equipment in order to receive additional credit.¹¹⁸ The court found the entire debt owed to John Deere to be nondischargeable.¹¹⁹ Looking at the language of the statute, the court held that:

106. *Id.* at 123.

107. *Id.* at 124.

108. *Id.* at 127-28.

109. *Id.*

110. 70 F.3d 27 (5th Cir. 1995).

111. *Id.* at 28.

112. *Id.* at 29.

113. *Id.*

114. *Id.* at 28-29.

115. *Id.* at 29 n.6. Though the court in *Norris* spoke of a debt “obtained by” fraud, the actual inquiry should consider whether the money (or in this case, renewal) was obtained by fraud. See *Cohen*, 523 U.S. at 219-20. However, though the renewal in *Norris* clearly occurred as a result of the fraud, that does not answer the issue of whether the “to the extent obtained by” language of section 523(a)(2) implies a damages requirement.

116. 897 F.2d 1048 (10th Cir. 1990).

117. *Id.* at 1049.

118. *Id.* at 1049-50.

119. *Id.* at 1050.

Several courts go beyond the plain meaning of the statute and preclude discharge only to the extent an objecting creditor can prove damages—reduction in the ultimate recovery on the debt caused by forbearance. . . . But we will not adopt such a requirement, because “the plain language of the statute suggests that dischargeability is an ‘all or nothing’ proposition.”¹²⁰

The *Gerlach* court recognized arguments that (1) the language “to the extent obtained by” created a damage requirement in section 523(a)(2) and (2) state-law fraud requires damages and thus impliedly applies to 523(a)(2).¹²¹ The court dismissed each of these concerns.¹²² As to state law, the court noted that the existence of fraud and the damages underlying the fraud are entirely separate concerns from the dischargeability of that debt once discovered.¹²³ Thus, state law determines the existence of fraud, but it is the province of federal law to determine dis-

120. *Id.* at 1051 (partially quoting *Birmingham Trust Nat'l Bank v. Case*, 755 F.2d 1474, 1477 (11th Cir. 1985)). The *Case* decision did, indeed, consider dischargeability to be an “all or nothing” proposition, but in a slightly different manner. *Case* dealt with fraud in the initial incurrence of the debt. *Case*, 755 F.2d at 1475. The issue presented to the court was whether debt owed to a severely undersecured creditor (that is—a creditor whose collateral was worth significantly less than the outstanding loan amount) was nondischargeable in the entire amount of the debt, or only in the amount of the collateral. *Id.* at 1476-77. The argument proposed by the debtor was that the creditor was only harmed by the fraud to the extent of the collateral’s value because the creditor would only have been able to foreclose upon the collateral and would not have received anything on the unsecured portion of its debt. *Id.* The court correctly disagreed. The fraud in that case did not just cause the creditor to forebear from foreclosing—the fraud actually *caused* the creditor to make the loan in the first place. *Id.* at 1477. But for the fraud, the creditor would never have given up the money. Thus, the *Case* court’s decision to hold the entire debt nondischargeable does not indicate a refusal to read a damage element into section 523(a)(2)(B). Indeed, the court did not discuss the existence or non-existence of a damage element. Instead, its discussion of damages was of the extent of the damage. *Id.* The opinion can just as easily be read to include a damage requirement, but find that damages do, indeed, exist:

We realize that the dischargeability of a fraudulently incurred debt and the measure of damages for the underlying fraud are separate and distinct questions. Nonetheless, the Debtor argues, and we agree, that the appropriate measure of damages for fraud does shed some light on the dischargeability question. In the instant case, however, we cannot agree that holding the debt nondischargeable only to the extent of the value of the collateral is sufficient to make BTNB “whole.”

Id. Thus, the “all or nothing” of dischargeability refers to whether a portion of the damages can be discharged, while another portion cannot. The court requires a determination of the damages, but once determined, all of the damages must be treated in a like manner. *Id.* This differs from the question at hand, where the entire debt can be ascertained, but the damages attributable to fraud have not yet been ascertained. Once calculated, however, all of the damages must be treated equally, regardless of the value of the collateral underlying.

It has been noted “that the *Birmingham Trust* decision is not in complete accord with the 1984 amendments to the Code and that the phrase ‘to the extent obtained by’ is limiting language.” *Dodson v. Church (In re Church)*, 69 B.R. 425, 434-35 (Bankr. N.D. Tex. 1987) (concluding that “to the extent obtained by” requires a showing of damages, but in the context of whether attorneys’ fees are included in nondischargeable debt) (citing 3 COLIER ON BANKRUPTCY ¶ 523.08 (1986)).

121. *Gerlach*, 897 F.2d at 1051.

122. *Id.*

123. *Id.*

chargeability.¹²⁴ As to the language of section 523(a)(2), the court found that the 1984 amendment to section 523(a)(2), which changed the language of the code from a “debt ‘for obtaining’ an extension of credit by fraud” to a “debt for extension of credit . . . ‘to the extent obtained by’ fraud,” actually indicated an intent to allow *more* debt to be nondischargeable.¹²⁵ The *Gerlach* court did define when a debt is “obtained by” fraud, holding that “a debt is ‘obtained by’ fraud if the fraud is a substantial factor in the creditor’s decision.”¹²⁶

While the reasoning of these cases seems compelling in light of the lack of reference to damages in section 523(a)(2)(B), the cases ignore the potential windfall to the bank in such a situation. Take, for example, *Marquette National Bank v. Richards (In re Richards)*.¹²⁷ The debtors borrowed money from the bank through a line of credit and renewed the loan multiple times based on incorrect financial statements.¹²⁸ Had the debtors correctly represented their financial status to the bank, the bank would not have renewed the loans.¹²⁹ Finding that “[a] nondischargeability action under § 523(a)(2)(B) is not an action for damages,” the court held the entire debt to be nondischargeable.¹³⁰ The court held so, even though it recognized that “fraudulent conduct which produces *no adverse consequences* to the victim, should not result in a judgment of nondischargeability” and that “[t]he nondischargeability provisions of § 523 are *remedial*, not *punitive*.”¹³¹ In essence, the court ignored the effect of its decision on these policies because section 523(a)(2)(B) does not expressly require a determination of the damages attributable to the fraud or false financial statement.¹³² Interestingly, the court also indicated that the debtors might be able to use the lack of damages as an affirmative defense but did not consider it any further because the debtors had not actually shown a lack of damages.¹³³

124. *Id.* (citing *Case*, 755 F.2d at 1477).

125. *Id.* at 1051 n.2. Interestingly, though the court used this change in the legislation to advance its point, it later noted that “there is no reason to conclude that the 1984 amendments were anything but technical and cosmetic. We have found no legislative history reflecting that Congress intended to significantly alter the rights and obligations of creditors and debtors governed by this section.” *Id.*

126. *Id.* at 1052. More recently, the Seventh Circuit, in *In re McFarland*, 84 F.3d 943 (7th Cir. 1996), also interpreted the language of section 523(a)(2)(B) as requiring no damage calculation. *Id.* at 947 (citing *Norris v. First Nat’l Bank (In re Norris)*, 70 F.3d 27, 29 n.6 (5th Cir. 1995)). Though the court considered the phrase “to the extent obtained by,” it found that phrase to require causation, despite the fact that it felt that section 523(a)(2)(B) already expressly required causation. *Id.* at 946 (citing *Goodrich*, 999 F.2d at 24).

127. 81 B.R. 527 (Bankr. D. Minn. 1987).

128. *Id.* at 528.

129. *Id.* at 530.

130. *Id.*

131. *Id.* at 531, 531 n.3 (emphasis added).

132. The court spent a significant portion of the opinion discussing the element of “detrimental reliance” in section 523(a)(2)(B), ultimately concluding that detrimental reliance did not require a showing of damages. *Id.* at 531.

133. *Id.*

b. Determine the effect that the fraud had on the transaction

In the 1992 case of *Siriani v. Northwestern National Insurance Co. (In re Siriani)*, the debtors borrowed money from a lender to purchase an apartment building; Northwestern guaranteed the loan.¹³⁴ When the debtors renewed the loan, they also sought a renewal of the Northwestern guaranty.¹³⁵ Northwestern required financial statements from the debtors in connection with the renewal; the debtors provided false financial statements.¹³⁶ When the debtors defaulted on the original loan, Northwestern paid pursuant to the guaranty.¹³⁷ It sought nondischargeability of its claim in the debtors' bankruptcy based on the fraudulent financial representations.¹³⁸ After determining that a debt renewal could create a nondischargeability claim under section 523(a)(2)(B), the court determined that Northwestern must prove that it could have collected more from the debtors at the time of the misrepresentation than it could in the bankruptcy.¹³⁹ In essence, the court required that a creditor show that, had it not been defrauded, it could have sought and received recovery from the debtor in excess of the recovery in bankruptcy.¹⁴⁰

134. 967 F.2d 302, 303 (9th Cir. 1992).

135. *Id.*

136. *Id.*

137. *Id.*

138. *Id.*

139. *Id.* at 304-05.

140. *Id.* at 305-06. Though the court required that the creditor show that it could have collected against the debtor, it stopped short of requiring a showing that the creditor would have promptly done so:

a creditor seeking nondischargeability under section 523(a)(2)(B) must show that it had valuable collection remedies at the time it agreed to renew its commitment to the debtor, and that those remedies later became worthless. . . . a creditor is not required to show that had it not renewed its commitment in reliance on the debtor's fraudulent statements, it would have exercised its collection remedies in a sufficiently timely fashion to collect the debt; the bankruptcy court should not have imposed a "creditor's diligence" requirement.

Id. at 305 (citing *N. Shore Sav. Ass'n v. Jones (In re Jones)*, 88 B.R. 899, 905 (Bankr. E.D. Wis. 1988); *Household Fin. Corp. v. Greenidge (In re Greenidge)*, 75 B.R. 245, 247 (Bankr. M.D. 1987); *In re Gadberry*, 37 B.R. 752, 754 (Bankr. C.D. Ill. 1984)); *Lincoln First Bank v. Tomei (In re Tomei)*, 24 B.R. 204, 207 (W.D.N.Y. 1982)). Thus, the damage was not the actual lost money to be collected, but the lost ability to collect the money. The Eighth Circuit reached a similar conclusion in *Caspers v. Van Horne (In re Horne)*, 823 F.2d 1285 (8th Cir. 1987), a case involving a loan from the debtor's mother-in-law. When he defaulted on the loan, his mother-in-law renewed the loan rather than suing to collect. *Id.* at 1286. During the renewal, the debtor neglected to mention his intent to file for divorce from his wife. Shortly thereafter, the debtor filed for divorce and filed for bankruptcy. *Id.* at 1286-87. The mother-in-law claimed fraud as a result of the Debtor's failure to disclose the impending divorce. *Id.* at 1287. The court found fraud and held that the mother-in-law's forbearance sufficiently demonstrated damages, without the need for the mother-in-law to show that she actually would have sued her son-in-law, or could have recovered any money from him. *Id.* at 1289 ("In renewing Van Horne's entire debt, Caspers necessarily waived any right to foreclose on the original loan when it came due. In addition, Caspers postponed the date of maturity and altered the interest terms contained in the original note. We are not faced with a situation in which the creditor stands to receive a windfall under the Bankruptcy Code.")

Interestingly, the end result in the case does not always demonstrate the leaning of the court. For example, in the case of *Norwest Financial New Mexico, Inc. v. Ojeda*,¹⁴¹ the typical situation occurred when the debtor borrowed from the creditor and then borrowed additional funds while renewing the original debt; fraud existed only in the context of the second loan and renewal.¹⁴² The court ultimately found that the first loan could be discharged in its entirety, reminiscent of the “new cash” era.¹⁴³ The court recognized that a creditor can be harmed in connection with the first loan as a result of the fraudulent statements provided with the second loan and renewal.¹⁴⁴ The *Norwest* court also insisted that the creditor must *prove* the amount of that damage to take advantage of section 523(a)(2)’s nondischargeability protections.¹⁴⁵ Ultimately, *Norwest* failed in its burden of proving this damage.¹⁴⁶ The court briefly mentioned prior cases and legislative history in reaching its conclusion but provided little explanation or analysis of either.¹⁴⁷

In *Howard & Sons v. Schmidt (In re Schmidt)*, the debtor agreed to purchase inventory from Howard but defaulted on his payments for the inventory.¹⁴⁸ In settling Howard’s claims against the debtor, the debtor misrepresented the value of inventory to be returned to Howard and paid with checks on which he placed a stop-payment order.¹⁴⁹ The court primarily considered whether the fraud regarding the inventory value and validity of the checks sufficed to invoke section 523(a)(2)’s nondischargeability.¹⁵⁰ The court then held that only the results from the fraud could be discharged.¹⁵¹ In this case, that meant that only the damages resulting from the release of the original claim executed by Howard in connection with the settlement would be denied discharge:

where a Debtor, such as Schmidt, by his conduct fraudulently induces a settlement agreement, the consideration received by the Debtor must have been the receipt of actual money or tangible property or services or the release of an underlying claim which is itself non-dischargeable, as a direct result of the fraud, and if all that was obtained by the Debtor was the release of a general unsecured claim for monies due and owing *which could have been discharged in bankruptcy notwithstanding the mutual release*, then the debtor has not received any property of the creditor.¹⁵²

141. 51 B.R. 91 (Bankr. D.N.M. 1985).

142. *Id.* at 91.

143. *Id.* at 92.

144. *Id.*

145. *Id.*

146. *Id.*

147. *Id.*

148. 70 B.R. 634, 656 (Bankr. N.D. Ind. 1986).

149. *Id.* at 636-37.

150. *Id.* at 641.

151. *Id.* at 643-44.

152. *Id.* at 642.

In essence, the court assumed that, to the extent that the original claim was dischargeable, had the fraud not occurred, the debtor would have discharged the original claim for lack of payment on the inventory anyway. Thus, Howard lost nothing by the fraud. Yet, the court neglects the very reality that, even with a dischargeable claim, the creditor may lose something. Perhaps the debtor would not have filed bankruptcy; perhaps it had another means of making the payment. Perhaps the debtor had collateral that could have been used to secure payment of the claim. To assume that Howard lost nothing because the claim *could* have been discharged really assumes that the claim *would* have been discharged which, in turn, presumes that a bankruptcy *would* have been filed immediately had the creditor been told the truth and that the payout on unsecured claims at the time of that bankruptcy filing would have equalled the payout on unsecured claims at the time of the actual bankruptcy filing.¹⁵³

D. POLICY CONSIDERATIONS

The lack of a damages element in section 523(a)(2)(B) weighs in favor of not requiring damages. Indeed, most cases considering the issue have felt that way. The legislative history provides little guidance in determining congressional intent in enacting and revising section 523(a)(2)(B). The section clearly resolved the "new cash" problem—cases in which a mere renewal of credit can never suffice for nondischargeability. That result should occur. A creditor can be just as damaged by a fraudulent renewal of a loan as a fraudulent giving of a loan. However, Congress failed to indicate whether it even considered whether a calculation of the extent of damages as a result of the renewal should be included in the nondischargeability determination, warranting at least a consideration of

153. Though this article and many of the cases focus on what the creditor would have received had the fraud not occurred or had it been true, some courts have used a different basis for permitting discharge of fraudulently renewed debt. In *Beneficial Finance Co. of New York, Inc. v. McNee (In re McNee)*, 390 F. Supp. 271 (S.D.N.Y. 1975), the debtor applied for a loan from Beneficial honestly and applied for a second loan dishonestly. Beneficial granted the second loan and consolidated the two loans. *Id.* at 272. Doing so essentially constituted a renewal of the second loan on the basis of the fraudulent financial statements. *Id.* While conceivably, the court could have decided that Beneficial did not truly rely on the fraud in renewing the original loan since it was not at the end of its term and no financials would have been required but for the second loan application to continue its existence, the court focused on state law, which *required* Beneficial to consolidate the loans, noting that:

It is important to note that the only reason the original loan had to be rewritten was to permit Beneficial to get the additional business and comply with Section 352(b) of the banking Law which provides that: "(b) No licensee shall permit any loan to be split up or divided."

Id. (quoting N.Y. BANKING LAW § 352(b)). In essence, the consolidation of the loans was not for the convenience of or at the request of the debtor. As far as the debtor was concerned, he would have been equally happy (although one can assume that having the consolidated loans eases administrative burdens on the debtor as well as the bank) to have two loans—one fraudulent and one not. The debtor should not be punished because of a technicality forced upon the bank by state law (or, if not required by state law, done for the convenience of the bank). *Id.*

whether section 523(a)(2)(B), as currently written and interpreted, properly supports bankruptcy policies.

a. Windfall to the creditor

One can safely assume that in most cases involving fraudulent financial statements the lender would not have renewed if truthful financial statements had been given. If the lender would have lent money with the correct financial statements (even if the lender would have renewed a part of the loan), the phrase “to the extent *obtained* by” makes it clear that the debt should be discharged for lack of a causal relationship between the fraud and the extension of credit.

Now reconsider the situation of Sarah and Steve. When the false financial statement was provided incorrectly stating that they had insurance on the car, what might have happened if a correct financial statement had been given? The Bank might have required them to obtain insurance or obtained it for them. Conversely, it might have taken the most extreme action by calling the loan, repossessing the car, and seeking a judgment for any amount of debt still due after the car was sold. What are the damages to the Bank of receiving the fraudulent statement? It, in reliance on the statement, gave up its right to repossess the car or to ensure that the car was properly insured. By the time the bankruptcy occurred, the car was practically worthless without any insurance proceeds to show for it. Thus, the Bank incurred damage in the lost value of the car as a result of the fraudulent misstatement. If section 523(a)(2)(B) does not require damages, the Bank will be made whole because the lost car will be replaced by a nondischargeable damages claim for the value of outstanding loan debt. Indeed, the Bank would be made more than whole, as its entire claim, even that exceeding the value of the car, would be nondischargeable. Even if damages are required, the Bank will have a nondischargeable claim in the value of the car that it would otherwise have had because by not having the opportunity to seek replacement insurance, the Bank lost the ability to secure the value of the car. Unlike the “new cash” rule, either interpretation of current section 523(a)(2)(B) would allow the Bank to have a nondischargeable claim on the basis of a renewal of a loan.

Consider the difference in the second fraudulent financial statements. What damage happened to the Bank when Sarah and Steve only failed to disclose the car accident and pending litigation against them? In order to determine the damages, consider what would have happened if Sarah and Steve had told the truth. If they confessed to the Bank that Sarah had caused an accident and that lawsuits were pending against them, almost undoubtedly, the Bank would have called the loan immediately. What would it have gotten then? Sarah and Steve, saddled with debt, filed bankruptcy even when the Bank did not call the loan. The Bank calling the loan might simply have caused an earlier bankruptcy filing, and without nonexempt assets, the creditors face the unfortunate truth of having

to write those debts off. Further, because there would not have been a fraud (taking out of the equation for a moment the initial fraudulent statement regarding the loss of insurance), the Bank would have had no possibility of nondischargeability. Unfortunately for the Bank, that is the risk of being in the business of giving loans.

Thus, in considering the two frauds perpetrated by Sarah and Steve, the first fraud caused loss to the Bank, for the Bank could have either obtained insurance or repossessed its car while the car still had value. However, the Bank likely lost nothing, except perhaps time, by Sarah and Steve's failure to disclose the car accident. Under case law refusing to add a damage component to section 523(a)(2), the Bank stands to receive an extra benefit because it happened to be defrauded—payment on an otherwise unsecured claim that the Bank would not have otherwise received. Without any fraud, the Bank would only have received the \$10,000 from the insurance company (plus an unsecured claim for the remainder, most or all of which would be discharged in the bankruptcy); with nondischargeability, the Bank receives the money from the insurer and a *nondischargeable* claim for the remainder.

Perhaps this extra benefit to the creditor should occur. After all, the debtor committed fraud. However, the bankruptcy system exists for multiple purposes—both to protect creditors and to help a debtor. While not designed to help a debtor get away with fraud, the Code balances competing interests of debtors and creditors. Even to the extent that the system protects a creditor, it should not allow a creditor to receive more than it would otherwise have received simply by having the good fortune of having been defrauded. Note how this differs from fraud which induces a creditor to loan money in the first place. Say, for example, that Sarah and Stephen had misstated their income when originally borrowing money from the Bank. The entire loan would be nondischargeable, because it would never have been given *but for* the fraud. What does the Bank receive by nondischargeability? The Bank returns to the position it would have been in had no fraud occurred—it becomes whole, but not better off, as a result of the fraud. When no damage requirement exists, however, you open up the possibility of a Bank actually *benefiting* by the fraud, rather than simply *not suffering loss* as a result of the fraud.

b. Discourage fraud

Of course, the Bankruptcy Code also seeks to discourage fraud. Indeed, the Supreme Court recently recognized the need to discourage fraud in *Archer v. Warner*.¹⁵⁴ Certainly, prohibiting discharge whenever fraud taints a transaction will serve such a purpose.

The debtor in this situation is not particularly sympathetic. The debtor lied. Scholars have noted that to permit discharge simply because the debt had already been incurred and would not have been paid even if no

154. 538 U.S. 314, 321 (2003).

fraud had occurred encourages debtors to be dishonest with creditors. After all, what's the risk?¹⁵⁵ In Stephen and Sarah's situation, once the car was destroyed, they had no incentive to tell the Bank. By not disclosing to the Bank, they continued to have a loan. Disclosing to the Bank would likely push them into a bankruptcy proceeding. Without the threat of a nondischargeable debt, they have nothing to encourage them to be completely honest. Thus, in considering policy, it becomes readily apparent that each party to the loan contract has a policy argument: preventing a windfall to the creditor versus discouraging fraud.

c. 523(a)(2)(A) vs. 523(a)(2)(B)

The no-damages approach has the potential to treat different types of fraud differently. Section 523(a)(2) provides for three types of fraud that will prevent discharge of a debt: subsection (A) deals with oral fraud or fraud not regarding financial condition, and subsection (C) deals with implied fraud in the purchase of luxury items shortly before a bankruptcy filing. Though the elements of a 523(a)(2)(B) nondischargeability claim are expressly included in the Code, subsection (A) prohibits discharge of debts "for money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained by . . . false pretenses, a false representation, or actual fraud, other than a statement respecting the debtor's or an insider's financial condition."¹⁵⁶ Section 523(a)(2)(A) would include an *unwritten* statement of financial condition that constitutes fraud, since such a statement could not be included in section 523(a)(2)(B). Even if the "to the extent obtained by" language that applies to both section 523(a)(2)(A) and section 523(a)(2)(B) does not include a damage component, section 523(a)(2)(A)'s reference to fraud (state-law fraud) implies a damage component. Nondischargeability under 523(a)(2)(A) requires proving the existence of a statement made by the debtor knowing that it was incorrect in order to defraud a creditor who, in reliance on the falsehood, suffered damage.¹⁵⁷ Thus, with an unwritten fraud regarding the financial condition, section 523(a)(2)(A) requires a showing of damage, but section 523(a)(2)(B), which deals with written fraud, does not require showing of damage. However, this distinction may be acceptable. Congress created a different section for written fraud debts because a written fraud has more inherent potential to create reliance and damage. Thus, putting a lower burden on the affected creditor may be fair.

155. Hon. Arthur J. Spector, *Bankruptcy*, 1999 L. REV. M.S.U.—D.C.L. 317, 337 (1999) ("A debtor in financial straits otherwise would have no incentive to tell the truth to his creditors.").

156. 11 U.S.C. § 523(a)(2)(A) (2005).

157. *Id.*; *Diamond v. Kolcum (In re Diamond)*, 285 F.3d 822, 827 (9th Cir. 2002) (citing *Household Credit Servs. v. Ettell (In re Ettell)*, 188 F.3d 1141 (9th Cir. 1999)); *Citibank v. Eashai (In re Eashai)*, 87 F.3d 1082 (9th Cir. 1996); see also Nancy C. Dreher & Matthew E. Roy, *Bankruptcy Fraud and Nondischargeability under Section 523 of the Bankruptcy Code*, 69 N.D. L. REV. 57, 65 (1993) (listing the elements of a cause of action under 523(a)(2)(A)).

In *Field v. Mans*, the Supreme Court recognized that section 523(a)(2)(A) and section 523(a)(2)(B) have different standards.¹⁵⁸ In *Field*, the Court refused to apply the "reasonable reliance" standard in (B) to (A), requiring only "justifiable reliance."¹⁵⁹ *Field* provides an interesting exercise in statutory interpretation, however. One unsuccessful argument in the *Field* case involved the principle of statutory interpretation that if, in one statute, the legislature included a standard in one section of the statute, but not in another section, the lack of that standard in the latter section is presumed to be intentional. The Court found that applying such a presumption in section 523(a)(2)(A) would mean that *no* reliance was necessary because such a standard had not been included. The Court was unwilling to use this "negative pregnant" presumption to find no requirement of reliance in section 523(a)(2)(A). In so doing, the Court indicated that reliance *must* be a part of a fraud determination, even if not expressly included in the statute.¹⁶⁰ Though not dealing with

158. 516 U.S. 59, 68 (1995).

159. *Id.* at 61.

160. *Id.* at 66-67. The Court stated that:

They contend that the addition to § 523(a)(2)(B) alone supports an inference that, in § 523(a)(2)(A), Congress did not intend to require reasonable reliance, over and above actual reliance. But this argument is unsound. The argument relies on the apparent negative pregnant, under the rule of construction that an express statutory requirement here, contrasted with statutory silence there, shows an intent to confine the requirement to the specified instance. . . . Thus the failure of § 523(a)(2)(A) to require the reasonableness of reliance demanded by § 523(a)(2)(B) shows that (A) lacks such a requirement. Without more, the inference might be a helpful one. But there is more here, showing why the negative pregnant argument should not be elevated to the level of interpretive trump card. First, assuming the argument to be sound, the most it would prove is that the reasonableness standard was not intended. But our job does not end with rejecting reasonableness as the standard. We have to discover the correct standard, and where there are multiple contenders remaining (as there are here), the inference from the negative pregnant does not finish the job.

Though the court rejected the "negative pregnant" presumption, the case differs from the situation herein in that the consequences of the assumption would create more integral problems with the statute. The comparison of the general language of section 523(a)(2)(A) to the specific requirements of section 523(a)(2)(B) creates a number of "negative pregnant" assumptions which, essentially, do away with any requirements in section 523(a)(2)(A), a problem not found when the implied requirements of section 523(a)(2)(A) are used to invalidate an implied requirement in section 523(a)(2)(B):

If the negative pregnant is the reason that § 523(a)(2)(A) has no reasonableness requirement, then the same reasoning will strip paragraph (A) of any requirement to establish a causal connection between the misrepresentation and the transfer of value or extension of credit, and it will eliminate scienter from the very notion of fraud. Section 523(a)(2)(B) expressly requires not only reasonable reliance but also reliance itself; and not only a representation but also one that is material; and not only one that is material but also one that is meant to deceive. Section 523(a)(2)(A) speaks in the language neither of reliance nor of materiality nor of intentionality. If the contrast is enough to preclude a reasonableness requirement, it will do as well to show that the debtor need not have misrepresented intentionally, the statement need not have been material, and the creditor need not have relied. But common sense would balk. If Congress really had wished to bar discharge to a debtor who made unintentional and wholly immaterial misrepresentations having no effect on a creditor's decision, it could have provided that. It

the requirement of damages, the same argument could apply with regard to damages. In other words, though the presumption would indicate that, because Congress did not include a damages component to the statute, damages are not required, the *Field* decision reminds us that the statutory presumptions are not absolute.

So how should the court or the legislature balance these competing policy interests in either interpreting or redrafting section 523(a)(2)(B)? First, focus on the reason for the exception to discharge.¹⁶¹ As noted, some discharge exceptions are designed to ensure payment of a particular type of debt despite bankruptcy, even if the debtor did nothing wrong (for example, child support or taxes). In these situations, the Bankruptcy Code aims to put the creditor in the same position that the creditor would have been but for the bankruptcy filing. The remaining exceptions are designed to ensure payment to a creditor who has been wronged by the debtor. In these situations, the goal of the Bankruptcy Code should be to put the creditor in the same position that the creditor would have been *but for the wrongdoing*. Creditors with these types of debt (for example, contract debt) run the risk of not being paid in a bankruptcy. Society does not place on them the burden of the wrongdoing, in this case, the fraud. To allow the creditor to be in the position that the creditor would have been in but for the fraud *and* but for the bankruptcy does more than make the creditor whole. It actually rewards a creditor for having been the victim of the bad act and becomes punitive rather than remedial.¹⁶²

III. CALCULATING DAMAGES

Even if one agrees that damages must be calculated, the actual calculation of those damages creates another area of uncertainty. Damages may be calculated in a number of ways, but one of two options are traditionally used. The court may use a “benefit of the bargain” analysis, in which the creditor enjoys the same position that the creditor would have been in had the false statement been true.¹⁶³ Contract-based actions favor such an approach.¹⁶⁴ The “benefit of the bargain” analysis has support in tort law, even as applied in the bankruptcy courts. In *Castner Knott Co. v. Wilson (In re Wilson)*,¹⁶⁵ the court considered how to calculate damages on fraudulently-incurred credit card debt. Though not dealing with the

would, however, take a very clear provision to convince anyone of anything so odd, and nothing so odd has ever been apparent to the courts that have previously construed this statute, routinely requiring intent, reliance, and materiality before applying § 523(a)(2)(A).

Id. at 67-68.

161. See *supra*, notes 23-24.

162. See *supra*, note 107.

163. COMMERCIAL DAMAGES: A GUIDE TO REMEDIES IN BUSINESS LITIGATION ¶1.03 (2004).

164. J.F. Rydstrom, Comment Note, “*Out of Pocket*” or “*Benefit of Bargain*” as Proper Rule of Damages for Fraudulent Representations Inducing Contract for the Transfer of Property, 13 A.L.R. 3D 875, § 2(a) (2004).

165. 12 B.R. 363 (Bankr. M.D. Tenn. 1981).

question of an honestly incurred debt fraudulently renewed, the court considered many similar issues. The court started with the basic premise that “a creditor’s recovery is governed by the appropriate measure of damages in tort actions.”¹⁶⁶ The debtor argued for limiting damages to only the value of the goods that the debtor had received, less than half of the actual debt incurred.¹⁶⁷ The court agreed with the creditor that damages should represent the benefit of the bargain, defining that phrase to mean what the creditor would have received had the debtor lived up to his or her representations.¹⁶⁸ The debtor borrowed over \$2,300 on credit, promising to pay it back, and should be bound by that promise.¹⁶⁹ In the fraudulent renewal context, this approach often eliminates the calculation of damages. The creditor loaned money on the basis that the fraudulent statement was true. Presumably, the financial statements indicated that the debtor could repay the obligations in full. Thus, any money loaned out (or any renewal of credit) would constitute damages under such an approach, leaving no need to “calculate” damages at all. Essentially, such an approach would equate to a standard whereby once fraud exists, the entire loan becomes nondischargeable.¹⁷⁰

Alternatively, the court may opt for an “out-of-pocket” analysis, in which the creditor returns to the same position that the creditor would have been had the fraudulent statement not been made.¹⁷¹ Though fraud actions typically invoke an “out-of-pocket” analysis,¹⁷² courts frequently waiver from this standard when a contract action serves as the basis for the fraud claim.¹⁷³ The *Castner Knott* court looked at this approach for

166. *Id.* at 365.

167. *Id.*

168. *Id.* at 366, 369.

169. *Id.* at 366 (citing 37 AM. JUR. 2d § 353 (“Essentially (t)his rule compels the party guilty of fraud to make good his representations, and under its operation the parties are placed in the same position as if the contract and representations had been fully performed”)); *cf.* *Howenstein v. Freeman (In re Freeman)*, 142 B.R. 758 (Bankr. E.D. Va. 1991) (limiting nondischargeability to damages).

170. Consider, however, the situation in *Goodnow v. Adelman (In re Adelman)*, 90 B.R. 1012 (Bankr. D.S.D. 1988), in which the Debtor purchased inventory on credit from Goodnow. When Debtor failed to pay for the inventory, he promised a lien on all of the inventory, and promised to file a financing statement reflecting Goodnow’s security interest in the inventory with the state. The Debtor never filed the financing statement. A bank had properly perfected its security interest against Debtor’s inventory, and took all of it through the bankruptcy proceeding, leaving Goodnow unsecured. *Goodnow*, 90 B.R. at 1016. Though the court found fraud, and thus nondischargeability, the court held that Goodnow was not entitled to any damages as a result of the fraud claim. In so deciding, the court focused on what Goodnow would have received had the fraudulent statement been true. Because the Bank’s security interest in the inventory was perfected *before* Debtor made the fraudulent statement, Goodnow was not harmed by the fraud. Goodnow would have been second to the Bank in priority and would have received nothing anyway. *Id.* at 1022-23.

171. COMMERCIAL DAMAGES: A GUIDE TO REMEDIES IN BUSINESS LITIGATION ¶ 1.03 (2004).

172. Rydstrom, *supra* note 164, 13 A.L.R. 3d 875, § 2(a).

173. *Id.* §§ 2(a), 3(a). The Rydstrom article gives case citations from across the country indicating how various states treat such questions of fraud in contract. *Id.* § 2(a). States clearly disagree on how to treat this issue. Though one concern would be that, to the extent that bankruptcy courts borrow from state damage calculations and states are not consis-

calculating tort damages.¹⁷⁴ In rejecting the rule, the court recognized that the “out-of-pocket” rule, which typically yields lower damages than the “benefit-of-the-bargain” rule, does not provide an incentive for a debtor not to commit fraud.¹⁷⁵

State law regarding how to handle fraud-in-contract claims varies widely.¹⁷⁶ Even if one assumes that *most* states apply a “benefit of the bargain” analysis to such claims, there are a number of reasons why bankruptcy courts should not do so. First, it undermines the very essence of bankruptcy law—a balance between protection of creditors and the fresh start of debtors. Indeed, the Supreme Court has noted that the bankruptcy court has jurisdiction to deal with dischargeability—not state law. In other words, state law determines the existence of fraud, but the bankruptcy court determines the effect that the fraud would have on the debt.¹⁷⁷ Second, states have a number of reasons why they may favor “benefit of the bargain,” including favoring the victim of the fraud over the perpetrator, providing that a perpetrator of fraud pay at least as much in damages as one who does not, and preventing fraud by ensuring that the perpetrator actually suffers as a result of the fraud.¹⁷⁸ However, these reasons are less compelling in bankruptcy court. Bankruptcy enables the debtor to recover from financial distress. The idea that a debtor would be better off committing fraud than honestly breaching a contract is quite compelling in state court. After all, an honest party to a contract who breaches pays damages under a “benefit of the bargain” analysis; but by including some fraud, the party could potentially pay only under “out-of-pocket” ideas. But such a distinction does not apply in bankruptcy because an honest debtor receives a discharge and does not pay out expectancy damages on a contract. Finally, the action in question involves nondischargeability completely based *in tort*. If the action were just a breach of contract, all of the damages would be dischargeable (absent another exception to discharge under the Bankruptcy Code). The creditor uses fraud to create a nondischargeable debt and should be bound by the damages applicable to such fraud. The creditor should not be able to

tent, bankruptcy courts will likewise not be consistent. However, the Supreme Court has recognized that bankruptcy courts must only apply consistent standards (such as following state law), not necessarily be consistent as to which law they apply. *Hanover Nat'l Bank v. Moyses*, 186 U.S. 181, 188-89 (1902).

174. *Castner Knott Co. v. Wilson (In re Wilson)*, 12 B.R. 366 (Bankr. Tenn. 1981).

175. Citing to 37 AM. JUR. 2D § 356, the court stated that the out-of-pocket damage calculation:

does not discourage fraud, since the fraudulent party takes no chance of losing anything because of his fraud: if he is not called to account, he enjoys his plunder; if he is called to account, he merely gives back what was not rightfully his, and thus is no worse for the fraud. It has been said in this respect that if active fraud is to carry no greater penalty than to make price and value agree, honesty will not be much encouraged.

Id.

176. Rydstrom, *supra* note 164, 13 A.L.R. 3d 875, § 2(a).

177. *Grogan v. Garner*, 498 U.S. 279, 283-84 (1991).

178. Rydstrom, *supra* note 164, 13 A.L.R. 3d 875, § 2(a) (citing *United States v. Ben Grunstein & Sons Co.*, 137 F. Supp. 197 (N.J. 1955)).

use tort principles to create nondischargeability and contract principles to determine the amount of the nondischargeable claim. The nondischargeable claim is either a tort or a contract.

IV. CONCLUSIONS

Bankruptcy law presumes that a debtor receives a fresh start, including the discharge of debts. Indeed, a strong presumption against nondischargeability exists.¹⁷⁹ The inclusion of a damage component is central to create a balance between this strong presumption and the Code's desire to protect creditors who have been wronged. Given that fraud nondischargeability intends to make the creditor "whole," rather than to protect a particular type of creditor, the damages permitted should be only those needed to make the creditor "whole." Including a requirement that damages be shown and that those damages be calculated on the basis of what the creditor actually lost better ensures this needed balance. Creditors actually harmed by fraud should be protected by nondischargeability. Conversely, those creditors not actually harmed by the fraud should not enjoy the benefits of nondischargeability just by happenstance of being a fraud "victim." Such a rule does, in some cases, allow the most desperate of debtors to "get away with" fraud by failing to provide an incentive *not* to commit the fraud. But in the balance between desperate debtors and creditors, desperate debtors should win absent compelling reasons to favor the creditor. No one wants fraud, but the bankruptcy system's primary goal is an equitable distribution of assets. Allowing nondischargeability only for the true harm done to the creditor strikes a balance needed to protect the creditor while still allowing the debtor the fundamental fresh start inherent in a bankruptcy proceeding. In so doing, the Code ensures that the creditors are neither burdened nor blessed by the existence of a bankruptcy proceeding.

179. *Boston Univ. v. Mehta (In re Mehta)*, 310 F.3d 308, 311 (3d Cir. 2002).