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Bankruptcy Fraud and Nondischargeability under Section 523 of the Bankruptcy Code

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BANKRUPTCY FRAUD AND NONDISCHARGEABILITY UNDER SECTION 523 OF THE BANKRUPTCY CODE

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I. INTRODUCTION

The most sweeping remedy available to a debtor in bankruptcy is the discharge of the debtor's personal liability to his or her creditors. A fundamental tenet of the Bankruptcy Code[1] is that the discharge of debts in bankruptcy is a remedy for the honest but unfortunate debtor. Thus, a bankruptcy discharge is a form of relief available only to those debtors who conduct themselves with candor and honesty, both in their dealings with the Bankruptcy Court, and with their creditors. Debtor fraud can take many different forms and the Bankruptcy Code is endowed with several provisions for dealing with such fraud.

The discharge of debts in bankruptcy envisions a trade-off; a financially troubled debtor is relieved of his or her debt burden through a discharge, and in return, the debtor is required to surrender certain assets to the control of the bankruptcy court. In order to ensure that such assets are fully and fairly turned over for the benefit of creditors, the Bankruptcy Code requires full disclosure of the nature, location and disposition of all assets. Improper efforts to conceal or destroy assets which might otherwise be available to creditors are repugnant to the very nature of the trade-off. Typical remedies for such fraud are denial or revocation of the discharge.[2]

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1. 11 U.S.C. §§ 101-1330 (1988 & Supp. III 1991).

2. *See* 11 U.S.C. § 727(a) (1988), 11 U.S.C. § 727(d) (1988), 11 U.S.C. § 1141(d)(3) (1988), 11 U.S.C. § 1228(d) (1988), 11 U.S.C. § 1328(e) (1988).

Similarly, improper efforts to transfer assets to other entities in order to avoid administration of such assets for the benefit of creditors would be repugnant to the nature of the bankruptcy trade-off. Such transfers often can be recovered and administered for the benefit of creditors,[3] or can result in denial of discharge.

The discharge should not be used as a sword for dishonest debtors to evade responsibility for debts incurred through fraud, deceit or misrepresentation. While such fraudulently incurred debts are not so severe as to merit a denial of the discharge altogether, the debts themselves are generally nondischargeable notwithstanding the fact that the debtor still receives a discharge of his or her other debts.[4]

This article focuses on the treatment of fraudulently incurred debts and the provisions of § 523 of the Bankruptcy Code[5] as remedies for such fraud. It will familiarize the reader with all aspects of § 523 dischargeability proceedings, discuss the elements and burdens of proof, set forth the distinctions between the various subsections, highlight commonly seen cases, point out mistakes which are often made and should be avoided, and provide suggestions that should prove to be invaluable to presenting a winning case. For reference purposes, the relevant Bankruptcy Code sections and Bankruptcy Rules are reproduced as an appendix to this article.

II. APPLICABILITY OF § 523 TO THE VARIOUS CHAPTERS OF THE BANKRUPTCY CODE

Section 523(a) of the Bankruptcy Code excepts a number of debts from the effect of the discharge where debtor fraud is involved. Such "nondischargeable" debts include: (1) debts obtained by false pretenses, representations, or actual fraud; (2) debts obtained through the use of falsely written financial statements; (3) debts for fraud or defalcation where the debtor is a fiduciary; and (4) debts for embezzlement or larceny.[6]

Since the remedy provided by § 523 excepts certain debts from the bankruptcy discharge, it is axiomatic that the remedy only applies in cases where a discharge of debts is available. Chapters 7, 9, 11, 12, and 13 all contain provisions for discharging debts.

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3. *See* 11 U.S.C. § 548 (1988 & Supp. III 1991).
4. *See* 11 U.S.C. § 523(a)(2) (1988), 11 U.S.C. § 523(a)(4) (1988), 11 U.S.C. § 523(a)(6) (1988).
5. 11 U.S.C. § 523 (1988 & Supp. III 1991).
6. *See* 11 U.S.C. § 523(a)(2)(A) (1988), 11 U.S.C. § 523(a)(2)(B) (1988), 11 U.S.C. § 523(a)(4) (1988).

However, each chapter contains its own limitations on the types of debtors entitled to the discharge, and the types of debts which are dischargeable.

Section 727(a)(1) limits a discharge under Chapter 7 to *individual* debtors; therefore, a corporation that files for protection under Chapter 7 cannot receive a discharge. The Chapter 7 discharge is expressly subject to all of the exceptions enumerated in § 523, thus debts for all of the aforementioned types of fraud are nondischargeable.

The discharge granted to municipalities under § 944 of the Code contains no exceptions for debts based on fraud.[7] Thus, a § 523 action cannot be maintained against a municipality discharged under Chapter 9 of the Bankruptcy Code.

In a Chapter 11 bankruptcy, a corporate debtor can receive a discharge of all pre-confirmation debts, including debts for fraud,[8] but an individual debtor's discharge does not extend to debts for fraud.[9] Therefore, a § 523 fraud action can be maintained against an individual Chapter 11 debtor, but not a corporate Chapter 11 debtor.

In Chapter 12 and 13 cases, the debtor is granted a discharge upon completion of plan payments. Under Chapter 12, an individual's discharge does not extend to debts for fraud, but in Chapter 13 cases, and corporate Chapter 12 cases, the discharge encompasses such debts.[10] The debtor is also entitled to a "hardship discharge" under either Chapter 12 or 13 in certain cases where the debtor's inability to complete the plan is due to circumstances beyond the debtor's control.[11] Debts for fraud are excepted from an individual's hardship discharge under both chapters.[12] Thus, a fraud dischargeability action can always be maintained against an individual Chapter 12 debtor, but can only be maintained against a Chapter 13 debtor where the discharge was granted based on hardship rather than completion of a confirmed plan.

Counsel for both debtors and creditors must remain cognizant of the chapter under which the debtor is proceeding, and the precise extent of the discharge afforded under that chapter. The costs incurred in connection with commencing a dischargeability proceeding for fraud will be difficult to justify if the debtor is not enti-

7. *See* 11 U.S.C. § 944(b) (1988), 11 U.S.C. § 944(c) (1988).
8. *See* 11 U.S.C. § 1141(d)(1) (1988), 11 U.S.C. § 1141(d)(2) (1988).
9. *See* 11 U.S.C. § 1141(d)(2).
10. *See* 11 U.S.C. § 1228(a) (1988), 11 U.S.C. § 1328(a) (1988); 11 U.S.C. § 523(a).
11. *See* 11 U.S.C. § 1228(b) (1988), 11 U.S.C. § 1328(b) (1988 & Supp. III 1991).
12. 11 U.S.C. § 1228(c)(2) (1988), 11 U.S.C. § 1328(c)(2) (1988 & Supp. III 1991).

tled to a discharge or if debts for fraud are expressly included within the discharge.

III. BASICS OF CONDUCTING A § 523 ACTION

Once the determination has been made that the debtor has filed under a chapter of the Code that entitles it to a discharge, and that such discharge does not extend to debts for fraud, counsel for both debtors and creditors will need a full understanding of the nature of dischargeability proceedings under § 523. Such proceedings are similar in nature to any federal civil proceedings governed by the Federal Rules of Civil Procedure. However, the specific legal issues being litigated as well as many of the procedural aspects of the proceedings are unique to bankruptcy; consequently, a working knowledge of how to conduct dischargeability proceedings is essential to success.

A. APPLICABILITY OF THE FEDERAL RULES OF CIVIL PROCEDURE

Dischargeability proceedings are governed by Part VII of the Bankruptcy Rules which incorporates most provisions of the Federal Rules of Civil Procedure.[13] A proceeding to determine the dischargeability of a debt is commenced by the filing of an adversary complaint.[14] The complaint is similar in nature to a civil complaint filed in federal district court, and must be served upon the defendant along with a summons.[15] As in federal district court, all allegations of fraud must be pled with particularity; general averments are insufficient.[16] An answer to the complaint is required, and counterclaims, cross-claims and third-party pleadings are allowed.[17] As in other federal civil proceedings, scheduling conferences are routinely held; liberal discovery is allowed; relief can be granted on default, on the pleadings, and on summary judgment; and ultimately the matter is tried to judgment by the bankruptcy court under the Federal Rules of Evidence.[18]

Familiarity with the Bankruptcy Rules, Federal Rules of Civil

13. *See* FED. R. BANKR. P. 4007(a), (e).
14. FED. R. BANKR. P. 4007, 7003.
15. *See* FED. R. BANKR. P. 7004.
16. *See* FED. R. BANKR. P. 7009.
17. *See* FED. R. BANKR. P. 7007, 7012, 7013, 7014.
18. *See* FED. R. BANKR. P. 7016 (scheduling and pretrial conferences), 7026-37 (discovery rules), 7055 (default judgment), 7012 (judgment on the pleadings), 7056 (summary judgment), 9017 (applicability of the Federal Rules of Evidence), 7052 (entry of factual findings and legal conclusions), 7054 (entry of judgment).

Procedure, and Federal Rules of Evidence is fundamental to conducting a dischargeability proceeding.

B. BURDEN OF COMMENCING THE ADVERSARY PROCEEDING

Section 523(c)(1) provides that debts incurred through fraud are discharged unless the creditor files a dischargeability complaint with the bankruptcy court. This provision places the burden of filing a § 523 complaint alleging fraud on the creditor.[19]

However, § 523(c)(1) does not apply if the creditor had no notice or actual knowledge of the bankruptcy case in time to file its complaint.[20] Therefore, if the creditor has no notice or actual knowledge of the bankruptcy case, a debt for fraud is not discharged merely because the creditor fails to file a complaint with the bankruptcy court. This means that if a creditor without notice or actual knowledge files a subsequent suit on the debt in state court, it will not be prejudiced by its failure to file a dischargeability complaint. Thus, in cases in which a creditor fails to receive notice or actual knowledge of a bankruptcy case, the burden of filing a dischargeability complaint for fraud is effectively shifted onto the debtor since the debtor will need a determination of dischargeability in order to avoid liability in the state court proceeding.

This result clearly places a premium upon listing all creditors with accurate addresses in the debtor's schedules. If the debtor does so, he or she can rest assured that all creditors will receive notice of the bankruptcy and that all § 523(c)(1) debts will be discharged unless a creditor specifically objects to the discharge of its debt. If the debtor fails to list all creditors, he or she runs the risk of having such debts determined to be nondischargeable in subsequent proceedings.

C. TIMELINESS OF THE COMPLAINT

The adversary complaint must be filed within sixty days of the *first date* set for the § 341 creditors' meeting.[21] Thus, if the creditors' meeting is continued or if the date of the meeting is changed,

19. *See* 11 U.S.C. § 523(c)(1) (Supp. III 1991).
20. 11 U.S.C. § 523(c)(1).
21. FED. R. BANKR. P. 4007(c). This rule only applies in Chapter 7 and Chapter 11 cases. No such deadline is normally set in Chapter 13 cases, since the Chapter 13 discharge includes debts for fraud. However, if a debtor receives a Chapter 13 *hardship* discharge, the court then sets a deadline for filing § 523 fraud complaints.

the sixty-day deadline *does not change*. The deadline can only be extended "for cause," and a motion requesting such an extension must also be filed within the sixty-day period.[22]

Failure to timely file either a complaint or a motion to extend the deadline can be fatal to a plaintiff's case. If the debt is properly listed in the debtor's schedules in time to permit the creditor to file a proof of claim and complaint within the sixty-day period, the debt is discharged unless the creditor acts within such period.[23] Even if the debt is not properly listed, the debt will be discharged if the creditor had notice or actual knowledge of the bankruptcy case in time to file a proof of claim and a dischargeability complaint.[24]

D. JOINDER OF NONDISCHARGEABILITY COUNTS FOR WILLFUL AND MALICIOUS INJURIES

Section 523 contains a number of dischargeability provisions which do not deal with fraud. Since the focus of this article is the fraud remedies of § 523, discussion of non-fraud dischargeability provisions might seem to be irrelevant. However, mention of the willful and malicious injury provisions of § 523(a)(6) is warranted because counts under subsection (a)(6) are frequently joined in fraud dischargeability complaints. The elements of proof for these types of counts are very different than those for fraud counts, but counsel should be prepared to deal with both types of nondischargeability counts since they are so often joined in one complaint.[25]

E. JOINDER OF COUNTS RELATED TO DISCHARGEABILITY

By its very nature, a proceeding under § 523 is simply one to determine whether a particular debt is dischargeable. However, two questions closely related to the dischargeability of a debt can arise in dischargeability proceedings: (1) whether the debtor should be denied the protection of the discharge altogether; and (2) what is the amount of the debt alleged to be nondischargeable? Once again, understanding these related issues and knowing when

22. FED. R. BANKR. P. 4007(c).

23. Bowen v. Residential Fin. Corp. (*In re* Bowen), 89 B.R. 800, 804-05 (Bankr. D. Minn. 1988); *see also* 11 U.S.C. § 523(c)(1) (1988), 11 U.S.C. § 523(a)(3)(B) (1988).

24. *Bowen*, 89 B.R. at 804-05; *see also* 11 U.S.C. § 523(c)(1) (1988), 11 U.S.C. § 523(a)(3)(B) (1988).

25. Given the high frequency of subsection (a)(6) counts being joined with subsection (a)(2) and (a)(4) counts, the major issues arising in willful and malicious injury cases are discussed in section VIII, *infra*.

they should be coupled with a dischargeability count will be instrumental in planning and conducting the dischargeability case.

In cases where a creditor wishes to object to the debtor's discharge altogether under § 727 of the Code, rather than contesting the dischargeability of a particular debt, the creditor should file an adversary complaint similar to that filed in a dischargeability proceeding.[26] Section 727 complaints are often combined with § 523 complaints, so that both the question of denial of the discharge and the question of dischargeability of a debt can be before the court in the same proceeding. The decision to combine such complaints is not one that should be entered into lightly. Where a count objecting to discharge is coupled with a count contesting the dischargeability of a particular debt, the debtor will be under significant pressure to settle with the complaining creditor, stipulating to nondischargeability of the debt in order to avoid the possibility of being denied a discharge altogether. In order to frustrate the assertion of such leverage by creditors, Rule 7041 conditions voluntary dismissal of § 727 complaints on notice to the trustee and United States Trustee. Additionally, many bankruptcy courts have enacted local rules which further assure that voluntary dismissals are not a result of undue leverage.[27]

An additional consideration is whether denial of discharge is more relief than any single creditor wants. Since a denial of discharge allows all debts to survive bankruptcy, it may result in the complaining creditor having to compete with other creditors for the debtor's assets. Therefore, if a creditor has a strong case under § 523, joining a count under § 727 is often not in the creditor's best interest.

Liquidation of the actual amount of the debtor's liability is similarly a matter that creditors often join with their complaint to determine the dischargeability of a debt. Given the large volume of cases handled by bankruptcy courts, they are usually reluctant to liquidate such debts. If the parties are already before the bankruptcy court, however, it may be in the interest of judicial economy to liquidate the debt if the creditor has not yet obtained a judgment elsewhere. Thus, while the issue of liquidation of debts is usually referred back to the state courts, the bankruptcy court will be more willing to liquidate claims where the facts necessary to prove the debt are also necessary to determine its

26. *See* FED. R. BANKR. P. 4004.

27. *See, e.g.*, LOCAL R. BANKR. P., D. Minn. 1110 (appended to this article).

dischargeability.[28]

Although the question litigated in dischargeability proceedings is normally limited to the dischargeability of a debt, counsel should be prepared to deal with the issues of denial of discharge and debt liquidation. Properly identifying and distinguishing the substantive issues that are—and are not—before the court saves both time and money, and facilitates orderly disposition of the case.

F. STANDARD OF PROOF

The standard of proof in dischargeability proceedings for fraud[29] is the preponderance of the evidence standard. However, counsel should be prepared to face different standards of proof in cases where any of the matters discussed in sections D and E above are joined with the fraud issues. The standard of proof, both with respect to counts alleging nondischargeability based on willful and malicious injuries and counts objecting to the discharge altogether, are currently unresolved.[30]

IV. DEBTS INCURRED THROUGH FALSE PRETENSES, FALSE REPRESENTATIONS OR ACTUAL FRAUD—§ 523(a)(2)(A)

Section 523(a)(2)(A) excepts from discharge any debt "for money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained by—(A) false pretenses, a false representation, or actual fraud, other than a statement respecting the debtor's or an insider's financial condition . . . ."[31]

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28. *See In re* Borbridge, 81 B.R. 332, 334-36 (Bankr. E.D. Pa. 1988).

29. Grogan v. Garner, 111 S. Ct. 654, 659 (1991).

30. In objections to discharge, a number of courts apply the clear and convincing standard in § 727(a)(2) cases, and the preponderance standard in § 727(a)(4) cases based on pre-*Grogan* law. *See, e.g., In re* Sanders, 128 B.R. 963, 967 & n.2 (Bankr. W.D. La. 1991). The legislative history of the Code plainly states that the preponderance standard applies to § 727(a)(4), but it is silent regarding the other subsections. H.R. REP. NO. 595, 95th Cong., 1st Sess. 384 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6340. S. REP. NO. 989, 95th Cong., 2d Sess. 98 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5884. Subsequent to *Grogan*, many courts are applying the preponderance standard to objections brought under the other subsections as well, and are doing so based on reasoning analogous to that in *Grogan*. *See, e.g., In re* Cook, 126 B.R. 261, 265 (Bankr. E.D. Tex. 1991).

For a discussion of the standard of proof in willful and malicious injury dischargeability cases, see section VIII(A), *infra*.

31. 11 U.S.C. § 523(a)(2)(A) (1988).

A. ELEMENTS OF PROOF

The elements of proof for a case under § 523(a)(2)(A) are as follows:

1. A false representation or pretense by the debtor;
2. The debtor knew the representation to be false at the time, or acted with reckless disregard as to its veracity;
3. The debtor intended to deceive the creditor or to induce him to act upon the representation;
4. Actual reliance by the creditor;[32] and
5. The creditor sustained the alleged loss and damage as a proximate result of the representation.[33]

B. BURDEN OF PROOF AND PRESUMPTIONS

The creditor normally bears the burden of proving its case by a preponderance of the evidence.[34] However, § 523(a)(2)(C) creates a presumption of nondischargeability in the cases of "luxury goods" and "cash advances." The presumption arises in connection with two types of debts: (1) consumer debts incurred by an individual debtor within forty days of the order for relief that are owed to a single creditor and add up to more than $500 for "luxury goods or services;" and (2) cash advances obtained by an individual debtor within twenty days of the order for relief that aggregate more than $1,000 and are "extensions of consumer credit under an open ended credit plan."[35] The presumption is a rebuttable one, and if the creditor establishes its applicability,[36]

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32. *Id.* As discussed in section IV(E), *infra*, some courts require proof of *reasonable* reliance, but this element of proof is not universally required.

33. *In re* Rubin, 875 F.2d 755, 759 (9th Cir. 1989); Thul v. Ophaug (*In re* Ophaug), 827 F.2d 340, 342 n.1 (8th Cir. 1987); Alexander & Alexander of Washington, Inc. v. Hultquist (*In re* Hultquist), 101 B.R. 180, 183 (Bankr. 9th Cir. 1989); Interfinancial Corp. v. White (*In re* White), 130 B.R. 979, 985 (Bankr. D. Mont. 1991); Citicorp Credit Serv., Inc. v. Hinman (*In re* Hinman), 120 B.R. 1018, 1021 (Bankr. D.N.D. 1990); First Baptist Church v. Maurer (*In re* Maurer), 112 B.R. 710, 712-13 (Bankr. E.D. Pa. 1990); City Fed. Sav. Bank v. Seaborne (*In re* Seaborne), 106 B.R. 711, 714 (Bankr. M.D. Fla. 1989); Rowe v. Showalter (*In re* Showalter), 86 B.R. 877, 880 (Bankr. W.D. Va. 1988); Scwalbe v. Gans (*In re* Gans), 75 B.R. 474, 482-83 (Bankr. S.D.N.Y. 1987); Thorp Credit & Thrift Co. v. Pommerer (*In re* Pommerer), 10 B.R. 935, 939 (Bankr. D. Minn. 1981); Fournet v. Miller (*In re* Miller), 5 B.R. 424, 428 (Bankr. W.D. La. 1980).

34. Grogan v. Garner, 111 S. Ct. 654, 659 (1991); *see also* Page v. Racila (*In re* Racila), 138 B.R. 303, 305 (Bankr. M.D. Fla. 1992); Norwest Bank Iowa v. Larson (*In re* Larson), 136 B.R. 540, 543 (Bankr. D.N.D. 1992); Key Bank v. Cifalia (*In re* Cifalia), 124 B.R. 124, 126 (Bankr. M.D. Fla. 1991); FDIC v. Smith (*In re* Smith), 133 B.R. 800, 805 (N.D. Tex. 1991); Farina v. Balzano (*In re* Balzano), 127 B.R. 524, 530 (Bankr. E.D.N.Y. 1991).

35. *See* 11 U.S.C. § 523(a)(2)(C) (1988).

36. The elements of proof to establish the presumption have been outlined as follows: (1) a consumer debt, (2) owed to a single creditor, (3) aggregating more than $500, (4) for

the burden of going forward then shifts to the debtor to produce evidence that the debt was not incurred through false pretenses, false representations, or actual fraud.[37] The ultimate burden of persuasion, however, remains on the creditor.[38]

Subsection (a)(2)(C) provides no definition of luxury goods, but does provide that luxury goods do *not* include "goods or services reasonably acquired for the support or maintenance of the debtor or a dependent of the debtor."[39] In determining whether purchases constitute luxury goods, the courts universally hold that the facts and circumstances surrounding the debtor's purchase must be considered.[40] Thus, one court considered an automobile to be a luxury good in a case in which the debtor owned two other cars, had incurred the debt to purchase the third one after meeting with counsel to discuss bankruptcy, filed the bankruptcy petition ten days after incurring the debt, and made only one payment on the loan.[41] Other courts, however, have found that automobiles are not luxury items when weight is given to the following factors: (1) the automobile is moderately priced[42] or used;[43] (2) the automobile is necessary for the debtor's livelihood[44] or family travel needs;[45] (3) the automobile is the debtor's only car;[46] and (4) the debtor traded in an old automobile for a new one.[47]

The "cash advance" presumption is applicable to debtor's who "load up" their credit cards by taking cash advances shortly before filing for bankruptcy. In explaining the presumption, § 523(a)(2)(C) refers to the Consumer Credit Protection Act.[48] "Consumer" credit under that Act refers to credit that is extended

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luxury goods or services, (5) incurred by an individual debtor, (6) on or within 40 days before the order for relief. Lorain County Bank v. Triplett (*In re* Triplett), 139 B.R. 687, 689-90 (Bankr. N.D. Ohio 1992) (citing authorities); J.C. Penny Co. v. Leaird (*In re* Leaird), 106 B.R. 177, 179 (Bankr. W.D. Wis. 1989).

37. *Triplett*, 139 B.R. at 689-90; Sears Roebuck & Co. v. Faulk (*In re* Faulk), 69 B.R. 743, 751 (Bankr. N.D. Ind. 1986). *See* First Security Bank v. Davis (*In re* Davis), 56 B.R. 120, 121 (Bankr. D. Mont. 1985).

38. *Faulk*, 69 B.R. at 752; *Leaird*, 106 B.R. at 179; Norwest Fin. Consumer Discount Co. v. Koch (*In re* Koch), 83 B.R. 898, 902 (Bankr. E.D. Pa. 1988).

39. 11 U.S.C. § 523(a)(2)(C) (1988).

40. GMAC v. McDonald (*In re* McDonald), 129 B.R. 279, 282-83 (Bankr. M.D. Fla. 1991); *Faulk*, 69 B.R. at 751; *Davis*, 56 B.R. at 121-22.

41. *See Triplett*, 139 B.R. at 690.

42. *McDonald*, 129 B.R. at 283.

43. *Davis*, 56 B.R. at 122.

44. *McDonald*, 129 B.R. at 283.

45. *Davis*, 56 B.R. at 121-22.

46. *Id.*

47. *Id.*

48. 15 U.S.C. §§ 1601-1693(r) (1988 & Supp. III 1991).

"primarily for personal, family, or household purposes."[49] An "open end credit plan" is one "under which the creditor reasonably contemplates repeated transactions, which prescribes the terms of such transactions, and which provides for a finance charge which may be computed from time to time on the outstanding unpaid balance."[50]

Thus, while the creditor normally bears the burden of proof, the initial burden of going forward can be shifted to the debtor in cases involving consumer debtors that incur substantial debt immediately prior to filing the petition. Counsel should be prepared for such a shift in the burden, but should remain cognizant that the ultimate burden of persuasion remains on the creditor.

C. OMISSIONS

The first element of proof under § 523(a)(2)(A) requires a false representation or pretense by the debtor. Whether an omission, as opposed to an overt representation, can constitute a representation for purposes of nondischargeability under § 523(a)(2)(A) is an unresolved issue.

The courts holding that an omission is not sufficient under § 523(a)(2)(A) reason that the requirement of "actual or positive fraud"[51] requires overt fraudulent representations.[52] This rationale follows from the common law principle that omissions do not constitute fraudulent representations.[53] However, where the debtor is under a duty to disclose, these courts may be more willing to find a debt nondischargeable.[54] In *Trizna & Lepri v. Malcolm* (*In re Malcolm*),[55] the court went so far as to find that such a duty exists where the debtor knows that the circumstances imply an incorrect material fact.[56]

The courts holding that omissions can be sufficient to result in nondischargeability hold that such omissions can constitute false

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49. 15 U.S.C. § 1602(h) (1988).
50. 15 U.S.C. § 1602(i) (1988).
51. *See* discussion at section IV(D), *infra*.
52. *See* Schweig v. Hunter (*In re* Hunter), 780 F.2d 1577, 1580 (11th Cir. 1986); Trizna & Lepri v. Malcolm (*In re* Malcolm), 145 B.R. 259, 262-63 (Bankr. N.D. Ill. 1992); Key Bank v. Cifalia (*In re* Cifalia), 124 B.R. 124, 126-27 (Bankr. M.D. Fla. 1991); Flint Area Sch. Employee Credit Union v. Nogami (*In re* Nogami), 118 B.R. 846, 848 (Bankr. M.D. Fla. 1990); Oppenheimer v. Reder (*In re* Reder), 60 B.R. 529, 535 (Bankr. D. Minn. 1986); Mercer v. Bailey (*In re* Bailey), 35 B.R. 224, 227 (Bankr. E.D. Va. 1983); Boatmen's North Hills Bank, Inc. v. Brewood (*In re* Brewood), 15 B.R. 211, 214 (Bankr. D. Kan. 1981).
53. *Malcolm*, 145 B.R. at 262-63; *Cifalia*, 124 B.R. at 126.
54. *See Cifalia*, 124 B.R. at 126; *Bailey*, 35 B.R. at 227.
55. 145 B.R. 259 (Bankr. N.D. Ill. 1992).
56. *See* Trizna & Lepri v. Malcolm (*In re* Malcolm), 145 B.R. 259, 263 (Bankr. N.D. Ill. 1992).

pretenses. While a number of courts boldly state that omissions are sufficient under § 523(a)(2)(A) with little or no analysis,[57] the courts that have analyzed the issue generally hold that the omission can constitute a false pretense if the circumstances of the case create a false impression, the true nature of which is known to the debtor.[58] When comparing the holdings of these cases to that described in the *Malcolm* case above, it can be seen that the line between these two seemingly divergent positions is significantly obscured.

The upshot of this conflicting case law is that counsel must be familiar with the prevailing law in the forum where the case is venued. Counsel should know whether the court recognizes omissions under § 523(a)(2)(A) before a complaint is ever filed. If the court does allow omissions, counsel should be prepared to prove that the particular circumstances of the case created a false impression of which the debtor was aware.

D. INTENT

The second and third elements of proof require a showing that the debtor made the representation or pretense knowing it to be false and intending to deceive the creditor or induce reliance. These elements require a showing of actual or positive fraud by the debtor in order to support a finding of nondischargeability under § 523(a)(2)(A). Such fraud involves moral turpitude or intentional wrongful acts. Constructive fraud, or fraud implied in law, which can exist without any imputation of bad faith or immorality, is insufficient.[59] Rather, § 523(a)(2)(A) requires positive fraud which encompasses deceit, artifice, trick, or design involving active operation of the intellect to mislead, circumvent or cheat a

57. *See* Caspers v. Van Horne (*In re* Van Horne), 823 F.2d 1285, 1288 (8th Cir. 1987); Interfinancial Corp. v. White (*In re* White), 130 B.R. 979, 985 (Bankr. D. Mont. 1991); McHenry v. Ward (*In re* Ward), 115 B.R. 532, 539 (W.D. Mich. 1990); Wheeling Wholesale Grocery Co. v. Piccolomini (*In re* Piccolomini), 87 B.R. 385, 387 (Bankr. W.D. Pa. 1988); Thorp Credit & Thrift Co. v. Pommerer (*In re* Pommerer), 10 B.R. 935, 939 (Bankr. D. Minn. 1981).

58. *See* Germain Lincoln Mercury, Inc. v. Begun (*In re* Begun), 136 B.R. 490, 494-95 (Bankr. S.D. Ohio 1992); Evans v. Dunston (*In re* Dunston), 117 B.R. 632, 640-41 (Bankr. D. Colo. 1990); Cooke v. Howarter (*In re* Howarter), 95 B.R. 180, 187-88 (Bankr. S.D. Cal. 1989).

59. Schweig v. Hunter (*In re* Hunter), 780 F.2d 1577, 1579 (11th Cir. 1986); Driggs v. Black (*In re* Black), 787 F.2d 503, 505 (10th Cir. 1986); Thul v. Ophaug (*In re* Ophaug), 827 F.2d 340, 342 n.1 (8th Cir. 1987); Cladakis v. Triggiano (*In re* Triggiano), 132 B.R. 486, 490 (Bankr. M.D. Fla. 1991); Custer v. Dobbs (*In re* Dobbs), 115 B.R. 258, 265-66 (Bankr. D. Idaho 1990); First Baptist Church v. Maurer (*In re* Maurer), 112 B.R. 710, 713 (Bankr. E.D. Pa. 1990); Leeb v. Guy (*In re* Guy), 101 B.R. 961, 978 (Bankr. N.D. Ind. 1988); Thorp Credit & Thrift Co. v. Pommerer (*In re* Pommerer), 10 B.R. 935, 939 (Bankr. D. Minn. 1981); Fournet v. Miller (*In re* Miller), 5 B.R. 424, 427 (Bankr. W.D. La. 1980).

creditor.[60]

The following cases are exemplary of the type of fraud contemplated by § 523(a)(2)(A). In *Thorp Credit & Thrift Co. v. Pommerer (In re Pommerer)*,[61] a loan debt was found to be nondischargeable because the debtor led the creditor to believe that he owned certain livestock, intending to induce the creditor to grant the loan in reliance on the false pretense.[62] In *Fournet v. Miller (In re Miller)*,[63] a debt owed by a remodelling contractor to a homeowner was found to be nondischargeable because the contractor induced payment by submitting invoices for amounts due to suppliers with no intention of paying the amounts received to such suppliers.[64] In *City Federal Savings Bank v. Seaborne (In re Seaborne)*,[65] the court found a loan debt to be nondischargeable because the debtor assigned leases to the creditor in order to induce the creditor to make the loan, knowing that the parties to the leases had no intention of making payments under the leases.[66] In *Caspers v. Van Horne (In re Van Horne)*,[67] an extension of credit was nondischargeable because the debtor failed to disclose his intentions to divorce the creditor's daughter, intending to deceive the creditor into extending the credit.[68]

Although positive fraud is required, courts recognize that direct evidence of positive fraud is seldom forthcoming since few debtors will admit to intentionally deceiving their creditors. Accordingly, the courts universally allow fraud to be proven by circumstantial evidence.[69] Positive fraud is difficult to prove, and circumstantial indicia are crucial. Witness credibility is a key factor in proving intent, so counsel should objectively weigh the credibility of his or her own witnesses against the opponent's.

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60. *Dobbs*, 115 B.R. at 265-66; *Guy*, 101 B.R. at 978; *Pommerer*, 10 B.R. at 939.

61. 10 B.R. 935 (Bankr. D. Minn. 1981).

62. Thorp Credit & Thrift Co. v. Pommerer (*In re* Pommerer), 10 B.R. 935, 939-40 (Bankr. D. Minn. 1981).

63. 5 B.R. 424 (Bankr. W.D. La. 1980).

64. Fournet v. Miller (*In re* Miller), 5 B.R. 424, 428 (Bankr. W.D. La. 1980).

65. 106 B.R. 711 (Bankr. M.D. Fla. 1989).

66. City Fed. Sav. Bank v. Seaborne (*In re* Seaborne), 106 B.R. 711, 714 (Bankr. M.D. Fla. 1989).

67. 823 F.2d 1285 (8th Cir. 1987).

68. Caspers v. Van Horne (*In re* Van Horne), 823 F.2d 1285, 1288 (8th Cir. 1987).

69. *See id.* at 1287; Trizna & Lepri v. Malcolm (*In re* Malcolm), 145 B.R. 259, 263-64 (Bankr. N.D. Ill. 1992); Interfinancial Corp. v. White (*In re* White), 130 B.R. 979, 985 (Bankr. D. Mont. 1991); First Baptist Church v. Maurer (*In re* Maurer), 112 B.R. 710, 713 (Bankr. E.D. Pa. 1990); Leeb v. Guy (*In re* Guy), 101 B.R. 961, 978 (Bankr. N.D. Ind. 1988); Wollman v. Gessler (*In re* Gessler), 11 B.R. 489, 492 (Bankr. W.D. Wis. 1981); *In re* Pommerer, 10 B.R. at 940.

E. RELIANCE

The fourth element of proof requires a showing of reliance by the creditor. Although courts universally hold that actual reliance must be shown, there is a split of authority as to whether the creditor must prove the additional element that its reliance upon the representation was reasonable.[70] This split is widened by the fact that the courts requiring reasonable reliance are not in accord as to the level of creditor reasonableness required.[71]

The courts finding that there is no requirement of reasonableness generally cite the Eighth Circuit precedent of *Thul v. Ophaug (In re Ophaug)*,[72] in which the court based its holding in part on the reasoning of the Bankruptcy Court for the District of Connecticut in *Mechanics & Farmers Savings Bank v. Fosco (In re Fosco)*.[73] This line of cases relies first on the "plain language rule" of statutory construction. The courts hold that § 523(a)(2)(A) is unambiguous and contains no express reasonableness requirement, and therefore one should not be judicially imposed absent a clear expression of legislative intent to the contrary.[74] Examining the legislative history, the courts find no such expression of intent.

Upon close examination of the legislative history, the courts following *Ophaug* and *Fosco* garnish more support for their view that § 523(a)(2)(A) lacks a reasonableness requirement.[75] Subsection (a)(2)(B) contains an express requirement of reasonableness, and the legislative history expresses clear policy reasons for requiring reasonable reliance in (a)(2)(B) cases. The courts conclude that these policy concerns are not present in subsection (a)(2)(A) cases, justifying the lack of a reasonableness requirement therein.[76]

In addition to the Eighth Circuit, the Fifth Circuit Court of Appeals has recently weighed-in on this side of the dispute in *Allison v. Roberts (In re Allison)*.[77] In *Allison*, the Fifth Circuit held that reasonableness was not a requirement under

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70. *See infra* notes 72-82.

71. *See infra* notes 83-85.

72. 827 F.2d 340 (8th Cir. 1987).

73. 14 B.R. 918 (Bankr. D. Conn. 1981). *Accord* Allison v. Roberts (*In re* Allison), 960 F.2d 481, 484-85 (5th Cir. 1992); Weeden v. Monahan (*In re* Monahan), 125 B.R. 697, 699 n.5 (Bankr. D. R.I. 1991); City Fed. Sav. Bank v. Seaborne (*In re* Seaborne), 106 B.R. 711, 714 (Bankr. M.D. Fla. 1989); Rowe v. Showalter (*In re* Showalter), 86 B.R. 877, 881 (Bankr. W.D. Va. 1988).

74. *See* Thul v. Ophaug (*In re* Ophaug), 827 F.2d 340, 342 (8th Cir. 1987); *Showalter*, 86 B.R. at 881; *Seaborne*, 106 B.R. at 714.

75. *See* note 73, *infra*.

76. *See Ophaug*, 827 F.2d at 343; Mechanics & Farmers Sav. Bank v. Fosco (*In re* Fosco), 14 B.R. 918, 921-22 (Bankr. D. Conn. 1981); *Showalter*, 86 B.R. at 881-82.

77. 960 F.2d 481 (5th Cir. 1992).

§ 523(a)(2)(A), but added that reasonableness of reliance can be strong circumstantial evidence of actual reliance.[78]

The courts on the other side of the split argue that a judicial gloss requiring reasonable reliance had been placed on the precursor to § 523(a)(2), and that such gloss survived enactment of the Bankruptcy Code.[79] These courts rely on the principle of statutory construction that Congress is deemed to enact legislation cognizant of existing common law and should not be deemed to have repealed such law absent a clear expression of intent to that effect.[80] The courts find further support for their position in arguments of policy, reasoning that the requirement of reasonable reliance places a measure of responsibility upon creditors.[81] The Courts of Appeals for the Sixth, Seventh, Tenth, and Eleventh Circuits, as well as the Ninth Circuit Bankruptcy Appellate Panel, all require a creditor's reliance to be reasonable.[82]

The Sixth Circuit Court of Appeals holds that the reasonableness requirement is not a rigorous one requiring a searching inquiry into a creditor's lending policies and practices.[83] Rather, it is a means of assuring that dischargeability is not denied in instances where the creditor's reliance is "so unreasonable as to negate any actual reliance."[84] Whether the reliance element is similarly restricted in the Seventh, Tenth and Eleventh Circuits, and by the Ninth Circuit Bankruptcy Appellate Panel, is currently unclear, although at least one bankruptcy court in the Tenth Circuit has held that reliance is so restricted.[85]

The practical implication of the split in case law is that counsel must become familiar with the prevailing law in the district in

78. Allison v. Roberts (*In re* Allison), 960 F.2d 481, 485 (5th Cir. 1992).

79. *See* Coman v. Phillips (*In re* Phillips), 804 F.2d 930, 933 (6th Cir. 1986); BancBoston Mortgage Corp. v. Ledford (*In re* Ledford), 970 F.2d 1556, 1559-60 (6th Cir. 1992); First Bank v. Mullet (*In re* Mullet), 817 F.2d 677, 679 (10th Cir. 1987); Cooke v. Howarter (*In re* Howarter), 114 B.R. 682, 685-86 (Bankr. 9th Cir. 1990). *See also* First Nat'l Bank v. Kimzey (*In re* Kimzey), 761 F.2d 421, 423 (7th Cir. 1985) (citing the pre-Code case of Carini v. Matera, 592 F.2d 378, 380 (7th Cir. 1979)).

80. *Supra*, note 79.

81. *See Ledford*, 970 F.2d at 1559-60; *Mullet*, 817 F.2d at 679.

82. *See supra* note 79. Given the Supreme Court's clear espousal of the "plain meaning" rule in a litany of recent bankruptcy cases, the reasoning of the courts finding a reasonableness requirement in subsection (a)(2)(A) is questionable. *See* Patterson v. Shumate, 112 S. Ct. 2242, 2248 (1992); Connecticut Nat'l Bank v. Germain, 112 S. Ct. 1146, 1149-50 (1992); United States v. Nordic Village, Inc., 112 S. Ct. 1011, 1015 (1992); Union Bank v. Wolas, 112 S. Ct. 527, 530 (1991); Board of Governors v. MCorp Fin., Inc., 112 S. Ct. 459, 466 (1991); United States v. Ron Pair Enter., 489 U.S. 235, 240-42 (1989). *But see* Dewsnup v. Timm, 112 S. Ct. 773, 778-79 (1992) (finding the plain meaning rule inapplicable based on a supposed ambiguity in the term "allowed secured claim").

83. *Ledford*, 970 F.2d at 1560.

84. *Id.*

85. Newsome v. Culp (*In re* Culp), 140 B.R. 1005, 1013 (Bankr. N.D. Okla. 1992).

which the dischargeability case is venued. In circuits where the law is clear, counsel should be familiar with exactly what must be proven, and in circuits where the requirement is either unclear or unresolved, counsel must be prepared to argue the merits of the reasonableness requirement as well.

F. CREDIT CARD CASES

Probably the most typical nondischargeability case brought under subsection (a)(2)(A) is the so-called "credit card case." An apparent majority of courts now hold that the purchase of goods through use of a credit card constitutes an implied representation that the debtor has both the means and intention to satisfy the debt created thereby.[86] Therefore, a debtor, who at the time a credit card purchase is made, either knows that he is unable to repay the debt or has no intention of doing so, obtains property through a false representation. Certain factors have been identified as being indicative of the debtor's subjective intent: (1) the length of time between the charges and the filing of the petition; (2) whether an attorney was consulted regarding bankruptcy before the charges were made; (3) the number of charges made; (4) the amount of the charges; (5) the debtor's financial condition at the time the charges were made; (6) whether the charges were above the credit limit; (7) whether multiple charges were made on the same day; (8) whether the debtor was employed at the time; (9) the debtor's prospects for employment; (10) the financial sophistication of the debtor; (11) whether there was a sudden change in buying habits; and (12) whether purchases were for luxuries or necessities.[87] These criteria are not exhaustive and not all of them are adhered to by all courts. A lack or presence of particular factors does not conclusively establish fraudulent intent. Rather, they are merely indicia of the debtor's subjective state of mind which should be determined in light of all the relevant circumstances of

86. *See* Household Card Servs./Visa v. Vermillion (*In re* Vermillion), 136 B.R. 225, 226-27 (Bankr. W.D. Mo. 1992); Firsttier Bank v. Rush (*In re* Rush), 136 B.R. 999, 999 (Bankr. W.D. Tex. 1992); Signet Bank v. Borror (*In re* Borror), 132 B.R. 194, 196 (Bankr. M.D. Fla. 1991); Household Bank v. Touchard (*In re* Touchard), 121 B.R. 397, 401 (Bankr. D. Utah 1990); Citicorp Credit Servs., Inc. v. Hinman (*In re* Hinman), 120 B.R. 1018, 1021 (Bankr. D.N.D. 1990); The May Co. v. Chech (*In re* Chech), 96 B.R. 781, 783 (Bankr. N.D. Ohio 1988).

87. *See* Chevy Chase Fed. Sav. Bank v. Cacho (*In re* Cacho), 137 B.R. 864, 866 (Bankr. N.D. Fla. 1991); *Touchard*, 121 B.R. at 401-02; *Hinman*, 120 B.R. at 1021; Notre Dame Fed. Credit Union v. Tondreau (*In re* Tondreau), 117 B.R. 397, 401 (Bankr. N.D. Ind. 1989); Williamsport Nat'l Bank v. Sutliff (*In re* Sutliff), 112 B.R. 680, 682-83 (Bankr. M.D. Pa. 1990).

the case.[88]

The courts that eschew the "implied representation" doctrine argue that it runs afoul of the requirement of actual fraud, and would in essence allow a debt to be held nondischargeable based on implied or constructive fraud. These courts reason that fraud is not proven merely by showing a debtor's inability to repay. Rather, the debtor must have the subjective intent not to repay at the time the charge was made in order to sustain a finding of nondischargeability.[89]

G. NSF CHECK CASES

Another common fact pattern seen in § 523(a)(2)(A) dischargeability cases is the situation where a debt results from payment with an NSF check. Once again, the courts are divided as to the circumstances under which such debts are nondischargeable.

One line of cases holds that debts incurred through the issuance of NSF checks are *per se* nondischargeable if the debtor knew it did not have sufficient funds in its account to cover the check.[90] Courts espousing this position take the view that the delivery of a check constitutes a representation that there are sufficient funds in the account to cover the check.[91]

A somewhat more lenient rule is taken by courts that reason that a debtor who issues a check knowing that his account has insufficient funds but intending to deposit sufficient funds into his account to cover the check is not acting with fraudulent intent.[92] Absent additional circumstantial evidence establishing that the debtor did not intend to cover the check, these courts hold that the mere issuance of the check at a time when the account balance was insufficient to cover the check does not result in nondischargeability.[93] While these courts agree that the issuance of a check carries an implied representation, the representation is that

88. Manufacturers Hanover Trust Co. v. Cirineo (*In re* Cirineo), 110 B.R. 754, 759 (Bankr. E.D. Pa. 1990).

89. Citibank South Dakota v. Dougherty (*In re* Dougherty), 84 B.R. 653, 655-57 (Bankr. 9th Cir. 1988); Montgomery Ward & Co. v. Blackburn (*In re* Blackburn), 68 B.R. 870, 876-77 (Bankr. N.D. Ind. 1987); Chase Manhattan Bank v. Carpenter (*In re* Carpenter), 53 B.R. 724, 731-32 (Bankr. N.D. Ga. 1985).

90. *See* Monarch Tile Mfg., Inc. v. Anderson (*In re* Anderson), 10 B.R. 296, 297-98 (Bankr. W.D. Wis. 1981); Altus Bank v. Stacey (*In re* Stacey), 105 B.R. 672, 675 (Bankr. S.D. Ala. 1989).

91. *Anderson*, 10 B.R. at 297; *Stacey*, 105 B.R. at 675.

92. P & W Foreign Car Serv., Inc. v. Edwards (*In re* Edwards), 143 B.R. 51, 54 (Bankr. W.D. Pa. 1992); Jarboe Sales Co. v. Degraffenreid (*In re* Degraffenreid), 131 B.R. 178, 180 (Bankr. N.D. Okla. 1991).

93. *Edwards*, 143 B.R. at 54-55.

the debtor will cover the check, not that the account currently has sufficient funds to pay for the purchase.[94]

A third position is taken by courts holding that the issuance of an NSF check, without more, contains no implied representation at all. These courts require an express representation by the debtor that the check will be honored in order for the debt to be nondischargeable.[95]

Once again, counsel must find out which position the forum court espouses, and if the court has not ruled on the issue, counsel should be prepared to argue the propriety of a particular approach.

H. RECOVERY OF COSTS

A common problem in dischargeability proceedings is that creditors may be tempted to file complaints in hopes of recouping some of their losses through settlement with consumer debtors who wish to avoid litigation costs. To discourage such filings, § 523(d) allows the consumer debtor to recover his or her attorney's fees if the creditor's complaint in a § 523(a)(2) case was not substantially justified. The burden of establishing that the case was substantially justified is on the creditor.[96]

The court's inquiry in this instance generally focuses on whether the creditor's action was substantially justified as of the time the complaint was filed, as opposed to whether the creditor would have succeeded on the merits.[97] This inquiry requires an analysis of the creditor's review of its case prior to filing the complaint, including the basis in truth for the facts alleged, the basis in law for the theory advanced, and the connection between the facts and law.[98]

While the focus is generally on the commencement of the case, it has been held that the burden of establishing substantial justification is essentially a "moving target." In other words, even

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94. *Id.*

95. *See* Goldberg Sec., Inc. v. Scarlata (*In re* Scarlata), 127 B.R. 1004, 1009 (N.D. Ill. 1991), *aff'd*, 979 F.2d 521 (7th Cir. 1992); Microtech Int'l, Inc. v. Horwitz (*In re* Horwitz), 100 B.R. 395, 398-99 (Bankr. N.D. Ill. 1989).

96. Huntington Nat'l Bank v. Smith (*In re* Smith), 107 B.R. 133, 134 (Bankr. N.D. Ohio 1989); Chrysler First Fin. Serv. Corp. v. Rhodes (*In re* Rhodes), 93 B.R. 622, 624-25 (Bankr. S.D. Ill. 1988).

97. Chevy Chase Fed. Sav. Bank v. Kullgren (*In re* Kullgren), 109 B.R. 949, 953 (Bankr. C.D. Cal. 1990); First Nat'l Bank v. Cloud (*In re* Cloud), 107 B.R. 156, 159 (N.D. Ill. 1989); *Smith*, 107 B.R. at 134; Household Fin. Co. v. Beam (*In re* Beam), 73 B.R. 434, 438 (Bankr. S.D. Ohio 1987).

98. America First Credit Union v. Shaw (*In re* Shaw), 114 B.R. 291, 295 (Bankr. D. Utah 1990); *Cloud*, 107 B.R. at 159; *Rhodes*, 93 B.R. at 624-25; *Beam*, 73 B.R. at 438.

if the original complaint can be substantially justified, an award of fees against the creditor will still be proper if the creditor continues to pursue the case after learning that its position is no longer justified.[99]

Section 523(d) places a premium on weighing the merits of the case before a complaint is filed. Furthermore, creditor's counsel should be aware that the court may impose an ongoing duty to dismiss the case if it becomes apparent that the case is meritless.

V. DEBTS INCURRED THROUGH USE OF FALSE FINANCIAL STATEMENTS—§ 523(a)(2)(B)

Section 523(a)(2)(A) expressly excludes false representations regarding a debtor's or insider's financial condition. Such debts are dealt with instead by subsection (a)(2)(B) which excepts from discharge debts that are obtained through the use of false written financial statements.

A. ELEMENTS AND BURDEN OF PROOF

The elements of proof for a case under § 523(a)(2)(B) are as follows:

1. A debt was obtained by the use of a statement in writing;
2. The financial statement was materially false;
3. The falsity concerns the debtor's financial condition;
4. The debtor made the statement with the intent to deceive;
5. The creditor relied on the statement; and
6. The creditor's reliance was reasonable.[100]

As is the case under § 523(a)(2)(A), the standard of proof is the preponderance of the evidence standard, and the burden of proof is on the complaining creditor.[101]

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99. *See* Beneficial of Missouri, Inc. v. Shurbier (*In re* Shurbier), 134 B.R. 922, 928 (Bankr. W.D. Mo. 1991); Manufacturer's Hanover Trust Co. v. Hudgins, 72 B.R. 214, 221 (N.D. Ill. 1987).

100. 11 U.S.C. § 523(a)(2)(B) (1988). ITT Commercial Fin. Corp. v. Walz, 115 B.R. 353, 357 (Bankr. N.D. Fla. 1990); Chrysler Credit Corp. v. Ruwart (*In re* Ruwart), 114 B.R. 725, 728 (D. Colo. 1990); NCNB Nat'l Bank v. Sofro (*In re* Rental Journal, Inc.), 111 B.R. 1012, 1015 (Bankr. S.D. Fla. 1989); First Seneca Bank v. Galizia (*In re* Galizia), 108 B.R. 63, 67 (Bankr. W.D. Pa. 1989); Whitney Nat'l Bank v. Delano (*In re* Delano), 50 B.R. 613, 617 (Bankr. D. Mass. 1985); Lambrakis v. Jones (*In re* Jones), 49 B.R. 431, 435 (Bankr. D.C. 1985).

101. Southwest Fin. Bank & Trust Co. v. Stratton (*In re* Stratton), 140 B.R. 720, 722 (Bankr. N.D. Ill. 1992); Codisco, Inc. v. Marx (*In re* Marx), 138 B.R. 633, 636 (Bankr. M.D. Fla. 1992); Groth v. Masegian (*In re* Masegian), 134 B.R. 402, 405 (Bankr. E.D. Cal. 1991); Fifth Third Bank v. Frugh (*In re* Frugh), 133 B.R. 870, 874 (Bankr. N.D. Ohio 1991); Texas Am. Bank v. Barron (*In re* Barron), 126 B.R. 255, 258 (Bankr. E.D. Tex. 1991).

B. THE WRITING REQUIREMENT

The first element of proof requires that a false financial statement be in writing in order to give rise to nondischargeability. A creditor who relies on a debtor's oral misrepresentation of its financial wherewithal will not be entitled to a determination of nondischargeability.

C. MATERIALITY

The second element of proof requires the misrepresentation to be material in order to result in nondischargeability. The concept of materiality in the context of § 523(a)(2)(B) has both objective and subjective elements, as observed by the Fifth Circuit Court of Appeals in *Jordan v. Southeast National Bank (In re Jordan)*.[102] Objectively, a materially false statement is one that contains substantial and important untruths regarding information of the type which would normally affect the decision to grant credit.[103] Although not dispositive, a relevant subjective inquiry used by courts in determining whether a statement is material is whether the creditor would have extended credit had it known the debtor's true situation.[104]

D. OMISSIONS

Unlike case law under § 523(a)(2)(A), there is no dispute that omissions from written financial statements are sufficient to sustain a finding of nondischargeability under § 523(a)(2)(B) if such omissions are material.[105] Thus, a failure to fully disclose assets or liabilities can result in nondischargeability.

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102. 927 F.2d 221, 224 (5th Cir. 1991).

103. Jordan v. Southeast Nat'l Bank (*In re* Jordan), 927 F.2d 221, 224 (5th Cir. 1991); First Interstate Bank v. Greene (*In re* Greene), 96 B.R. 279, 283 (Bankr. 9th Cir. 1989); Groth v. Masegian (*In re* Masegian), 134 B.R. 402, 405 (Bankr. E.D. Cal. 1991); First Seneca Bank v. Galizia (*In re* Galizia), 108 B.R. 63, 67 (Bankr. W.D. Pa. 1989).

104. *Jordan*, 927 F.2d at 224; *Masegian*, 134 B.R. at 405; *Galizia*, 108 B.R. at 67.

105. *See Jordan*, 927 F.2d at 224; *Stratton*, 140 B.R. at 722; Fifth Third Bank of Toledo v. Frugh (*In re* Frugh), 133 B.R. 870, 874 (Bankr. N.D. Ohio 1991); NCNB Nat'l Bank v. Sofro (*In re* Rental Journal, Inc.), 111 B.R. 1012, 1015 (Bankr. S.D. Fla. 1989); *Galizia*, 108 B.R. at 67. *But see* Lambrakis v. Jones (*In re* Jones), 49 B.R. 431, 436 (Bankr. D.C. 1985). The portion of the *Jones* holding stating that omissions are insufficient under § 523(a)(2)(B) appears to be an aberration and was not followed by the only court citing that part of the holding. *See* North Shore Sav. & Loan Ass'n v. Jones (*In re* Jones), 88 B.R. 899, 903-04 (Bankr. E.D. Wis. 1988). The holding is flawed because the only authority cited by the *Jones* court is *Mercer v. Bailey*, which was a § 523(a)(2)(A) case. Mercer v. Bailey (*In re* Bailey), 35 B.R. 224 (Bankr. E.D. Va. 1983). As noted in section IV(c) above, there is a split of opinion under subsection (a)(2)(A).

E. INTENT

As is the case under § 523(a)(2)(A), the debtor must have made the statement with an intention of deceiving the creditor.[106] Although actual knowledge that the statement was false will satisfy the intent requirement, it is sufficient to show that the creditor acted with recklessness as to the truth or falsity of the statement.[107] Thus, courts have found debts nondischargeable in cases where the debtor has signed a loan application without reading it.[108]

Given the difficulty of proving the debtor's state of mind through direct evidence, circumstantial evidence is sufficient to establish intent.[109] Debtor credibility is essential to override persuasive circumstantial evidence; therefore, debtor's counsel should objectively determine his or her client's credibility.

F. RELIANCE

For a debt to be nondischargeable under § 523(a)(2)(B), the creditor's reliance on the false financial statement must be both actual and reasonable.[110] To establish actual reliance, the creditor need only show that it did in fact subjectively rely on the financial statement in extending credit to the debtor.[111] Even partial reliance on the false statement is sufficient to find the debt nondischargeable,[112] but the actual reliance element is missing if the creditor relied solely on the debtor's past payment history, estab-

106. Signet Bank v. Wingo (*In re* Wingo), 113 B.R. 249, 251 (W.D. Va. 1989).

107. Southwest Fin. Bank & Trust Co. v. Stratton (*In re* Stratton), 140 B.R. 720, 723 (Bankr. N.D. Ill. 1992); Groth v. Masegian (*In re* Masegian), 134 B.R. 402, 406 (Bankr. E.D. Cal. 1991); Fifth Third Bank of Toledo v. Frugh (*In re* Frugh), 133 B.R. 870, 875 (Bankr. N.D. Ohio 1991); Texas Am. Bank v. Barron (*In re* Barron), 126 B.R. 255, 260 (Bankr. E.D. Tex. 1991); Roster Corp. v. Fisackerly (*In re* Fisackerly), 114 B.R. 145, 150 (Bankr. W.D. Tenn. 1990); *Galizia*, 108 B.R. at 68.

108. *See, e.g.*, *In re* Coughlin, 27 B.R. 632, 636 (Bankr. 1st Cir. 1983).

109. *Stratton*, 140 B.R. at 723-24; Codisco, Inc. v. Marx (*In re* Marx), 138 B.R. 633, 636 (Bankr. M.D. Fla. 1992); *Masegian*, 134 B.R. at 406; *Frugh*, 133 B.R. at 875; *Wingo*, 113 B.R. at 251; *Galizia*, 108 B.R. at 68.

110. First Am. Bank v. Schraw (*In re* Schraw), 136 B.R. 301, 304 (Bankr. S.D. Fla. 1992); John Deere Co. v. Meyers (*In re* Meyers), 124 B.R. 735, 742 (Bankr. S.D. Ohio 1991); Founders Bank v. Moore (*In re* Moore), 118 B.R. 64, 65-66 (Bankr. N.D. Tex. 1990); Household Fin. Corp. v. Schoeff (*In re* Schoeff), 116 B.R. 119, 121 (Bankr. N.D. Ind. 1990); *Wingo*, 112 B.R. at 145; Horowitz Fin. Corp. v. Hall (*In re* Hall), 109 B.R. 149, 154 (Bankr. W.D. Pa. 1990); IFG Leasing Co. v. Vavra (*In re* Harms), 53 B.R. 134, 140-41 (Bankr. D. Minn. 1985).

111. FDIC v. Lafeve (*In re* Lafeve), 131 B.R. 604, 609 (Bankr. S.D. Miss. 1991); Southeast Assoc. v. Jacobe (*In re* Jacobe), 121 B.R. 299, 305 (Bankr. E.D. Va. 1990); *Moore*, 118 B.R. at 65-66; *Wingo*, 112 B.R. at 145; *Hall*, 109 B.R. at 154.

112. Arkansas Aluminum Alloys, Inc. v. Joyner (*In re* Joyner), 132 B.R. 436, 441 (D. Kan. 1991); Texas Am. Bank v. Barron (*In re* Barron), 126 B.R. 255, 259 (Bankr. E.D. Tex. 1991); Teachers Credit Union v. Johnson, 131 B.R. 848, 854-55 (W.D. Mo. 1991); *Meyers*, 124 B.R. at 742; *Hall*, 109 B.R. at 154.

lished credit rating, or pledged collateral.[113]

To establish reasonableness, the creditor must show that its reliance was objectively reasonable as compared to the degree of care that would be exercised by a reasonably cautious person in a similar business transaction given (a) the particular circumstances of the case, (b) the creditor's own business practices, and (c) the standards and customs of the industry.[114] Certain creditor practices such as indicating that the debtor need not list all of its current loan obligations, using truncated financial statements, failing to follow the creditor's normal procedures, or ignoring independent knowledge of debtor's credit history may lead to a conclusion that reliance on such statement was unreasonable.[115] A creditor normally has no duty to conduct an independent investigation of the debtor's credit history,[116] but where the financial statement contains certain "red flags" which put the creditor on notice that the statement is inaccurate, the creditor's reliance may be unreasonable if the creditor fails to investigate further.[117]

G. RECOVERY OF COSTS

Section 523(d), which allows for the recovery of costs where the complaint is not substantially justified, is applicable to cases under § 523(a)(2)(B) as well as under subsection (a)(2)(A). Therefore, a successful debtor can recover its costs if the complaint was not substantially justified, and there may be a continuing burden on the creditor to dismiss the case if it becomes apparent that its position lacks merit.

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113. *See* Household Fin. Corp. v. Howard (*In re* Howard), 73 B.R. 694, 705-06 (Bankr. N.D. Ind. 1987) (citing numerous authorities); Standard Fed. Bank v. Compton (*In re* Compton), 97 B.R. 970, 978 (Bankr. N.D. Ind. 1989) (quoting *Howard*, 73 B.R. 694); *Coughlin*, 27 B.R. 632, 636 (Bankr. 1st Cir. 1983).

114. *Schraw*, 136 B.R. at 304; *Barron*, 126 B.R. at 259; Jaress Truck Centers, Inc. v. Hodges (*In re* Hodges), 116 B.R. 558, 561-62 (Bankr. N.D. Ohio 1990); *Schoeff*, 116 B.R. at 121; Horowitz Fin. Corp. v. Hall (*In re* Hall), 109 B.R. 149, 154 (Bankr. W.D. Pa. 1990); *Harms*, 53 B.R. at 140-41.

115. *See Howard*, 73 B.R. at 705-06; *Compton*, 97 B.R. at 978; Pacific Fin. Discount Co. v. Whiting (*In re* Whiting), 10 B.R. 687, 689-90 (Bankr. E.D. Pa. 1981).

116. Arkansas Aluminum Alloys, Inc. v. Joyner, (*In re* Joyner), 132 B.R. 436, 440-41 (Bankr. D. Kan. 1991); *Lafeve*, 131 B.R. at 609; *Meyers*, 124 B.R. at 743; *Hall*, 109 B.R. at 154-55.

117. Teates v. Kuranda (*In re* Kuranda), 122 B.R. 264, 269 (Bankr. E.D. Va. 1990); *Moore*, 118 B.R. at 66-67; Franklin State Bank v. Lippert (*In re* Lippert), 84 B.R. 612, 617 (Bankr. D. Minn. 1988); Beneficial of New York, Inc. v. Bossard (*In re* Bossard), 74 B.R. 730, 735 (Bankr. N.D.N.Y. 1987); Oppenheimer v. Reder (*In re* Reder), 60 B.R. 529, 538 (Bankr. D. Minn. 1986).

VI. DEBTS FOR FRAUD OR DEFALCATION BY FIDUCIARIES—§ 523(A)(4)

Section 523(a)(4) excepts from discharge debts for "fraud or defalcation while [the debtor is] acting in a fiduciary capacity, embezzlement or larceny."[118] By its own terms, this section makes debts for fraud or defalcation nondischargeable only if the debtor was acting as a fiduciary. Debts for larceny and embezzlement, in contrast, are nondischargeable regardless of the debtor's fiduciary status.

This section will be limited to analysis of the so-called "fiduciary debts," while the nonfiduciary debts will be discussed in section VII below.

A. FIDUCIARY CAPACITY

The type of fiduciary relationship contemplated by § 523(a)(4) is strictly that of an express or technical trustee; *i.e.* the trust relationship must be created either by an express agreement between the parties, or by the operation of state or federal law. Constructive and implied trusts, and trusts *ex maleficio*, which arise based on equitable principles are insufficient under § 523(a)(4). Since trusts *ex maleficio* are not sufficient, the trust must be one which arises independently of, and without reference to, the act which gives rise to the debt.[119]

Normal commercial relationships such as debtor/creditor, principal/agent, bailor/bailee, and broker/client do not by themselves give rise to the type of fiduciary duty contemplated by § 523(a)(4).[120] However, through operation of state or federal law, the duties of a technical trustee can be imposed upon a party based on such party's relationship with others. If such fiduciary capacity exists between the debtor and a creditor, the fiduciary

118. 11 U.S.C. § 523(a)(4) (1988).

119. LSP Inv. Partnership v. Bennett (*In re* Bennett), 970 F.2d 138, 142-43 (5th Cir. 1992); Woodworking Enter., Inc. v. Baird (*In re* Baird), 114 B.R. 198, 202 (Bankr. 9th Cir. 1990); Farina v. Balzano (*In re* Balzano), 127 B.R. 524, 532 (Bankr. E.D.N.Y. 1991); Beebe v. Schwenn (*In re* Schwenn), 126 B.R. 351, 352 (D. Colo. 1991); San Saba Pecan, Inc. v. Failing (*In re* Failing), 124 B.R. 340, 344 (W.D. Okla. 1989); Fox v. Shervin (*In re* Shervin), 112 B.R. 724, 730-31 (Bankr. E.D. Pa. 1990); Coronet Ins. Co. v. Blumberg (*In re* Blumberg), 112 B.R. 236, 240 (Bankr. N.D. Ill. 1990); Hayton v. Eichelberger (*In re* Eichelberger), 100 B.R. 861, 863-64 (Bankr. S.D. Tex. 1989); American Sav. & Loan Ass'n v. Weber (*In re* Weber), 99 B.R. 1001, 1008-09 (Bankr. D. Utah 1989); United Am. Ins. Co. v. Koelfgen (*In re* Koelfgen), 87 B.R. 993, 996 (Bankr. D. Minn. 1988).

120. Byber v. Geer (*In re* Geer), 137 B.R. 37, 40-41 (Bankr. W.D. Mo. 1991); Moore v. McQueen (*In re* McQueen), 102 B.R. 120, 124 (Bankr. S.D. Ohio 1989); Leeb v. Guy (*In re* Guy), 101 B.R. 961, 983 (Bankr. N.D. Ind. 1988); Sager v. Lewis (*In re* Lewis), 94 B.R. 406, 410 (Bankr. E.D. Va. 1988).

requirement of § 523(a)(4) is satisfied.[121] The types of parties upon whom such fiduciary duties are imposed will therefore vary from state to state. The following commercial entities have been found to carry fiduciary obligations sufficient to satisfy § 523(a)(4) based on state or federal law: bank directors;[122] securities and commodities brokers;[123] escrowees;[124] insurance agents;[125] real estate licensees;[126] and public treasurers.[127] Corporate officers' duties to their corporations are generally held to satisfy the fiduciary capacity requirement,[128] but their duties to creditors probably are not sufficient to satisfy § 523(a)(4) unless the corporation is either insolvent or in bankruptcy.[129]

The question of whether the state law duties imposed on partners rise to the level contemplated by § 523(a)(4) is one that has caused courts much difficulty. The courts are fairly evenly split on the issue of whether partners in a general partnership owe a sufficient duty to each other to render debts for fraud or defalcation nondischargeable.[130] A stronger case for imposing fiduciary duties

121. *Bennett*, 970 F.2d at 143; *Baird*, 114 B.R. at 202; *Schwenn*, 126 B.R. at 352-53; Blashke v. Standard (*In re* Standard), 123 B.R. 444, 453 (Bankr. N.D. Ga. 1991); *Blumberg*, 112 B.R. at 240-41; *Guy*, 101 B.R. at 983. *See also* Bakis v. Snyder (*In re* Snyder), 101 B.R. 822, 835 (Bankr. D. Mass. 1989); *Weber*, 99 B.R. at 1009.

122. *See* First Nat'l Bank v. Thurman (*In re* Thurman), 121 B.R. 888, 889-90 (Bankr. N.D. Fla. 1990); FDIC v. Sax (*In re* Sax), 106 B.R. 534, 538-39 (Bankr. N.D. Ill. 1989).

123. *See* Prudential-Bache Sec., Inc. v. Sawyer (*In re* Sawyer), 112 B.R. 386, 389-91 (D. Colo. 1990); Lock v. Scheuer (*In re* Scheuer), 125 B.R. 584, 592-93 (Bankr. C.D. Cal. 1991).

124. *See, e.g.*, Stone v. Feldman (*In re* Feldman), 111 B.R. 481, 486 (Bankr. E.D. Pa. 1990).

125. *See Blumberg*, 112 B.R. at 241-42; Graves v. James (*In re* James), 94 B.R. 350, 352-53 (Bankr. E.D. Pa. 1988). *But see* Rocky Mountain Gen. Agency v. Rustad (*In re* Rustad), 110 B.R. 928, 931 (Bankr. D. Mont. 1987).

126. *See, e.g.*, Woosley v. Edwards (*In re* Woosley), 117 B.R. 524, 529 (Bankr. 9th Cir. 1990).

127. *See, e.g.*, Crooksville Exempted Village School Dist. v. Curth (*In re* Curth), 98 B.R. 324, 327 (Bankr. S.D. Ohio 1989).

128. *See* Bell v. Collins (*In re* Collins), 137 B.R. 754, 756 (Bankr. E.D. Ark. 1992); LaPointe v. Brown (*In re* Brown), 131 B.R. 900, 904 (Bankr. D. Me. 1991); *Thurman*, 121 B.R. at 889; Cutter Realty Group, Inc. v. Schiraldi (*In re* Schiraldi), 116 B.R. 359, 361-62 (Bankr. D. Conn. 1990); Pan-Western Life Ins. Co. v. Galbreath (*In re* Galbreath), 112 B.R. 892, 898-900 (Bankr. S.D. Ohio 1990); *Snyder*, 101 B.R. at 835.

129. *See* Krug, Inc. v. Nayee (*In re* Nayee), 99 B.R. 90, 92 (Bankr. M.D. Fla. 1989); American Sav. & Loan Ass'n v. Weber (*In re* Weber), 99 B.R. 1001, 1009 (Bankr. D. Utah 1989); Bay 511 Corp. v. Thorsen (*In re* Thorsen), 98 B.R. 527, 529 (Bankr. D. Colo. 1989).

130. *Compare* Roy v. Gravel, 143 B.R. 825, 828-29 (W.D. La. 1992) (finding that a partnership relationship is sufficient under § 523(a)(4)); Longo v. McLaren (*In re* McLaren), 136 B.R. 705, 714 (Bankr. N.D. Ohio 1992) (finding that a partnership relationship is sufficient under § 523(a)(4)); Walters v. Sawyer (*In re* Sawyer), 130 B.R. 384, 396-97 (Bankr. E.D.N.Y. 1991) (finding that a partnership relationship is sufficient under § 523(a)(4)); Beebe v. Schwenn (*In re* Schwenn), 126 B.R. 351, 353 (D. Colo. 1991) (finding that a partnership relationship is sufficient under § 523(a)(4)); Getaz v. Stewart (*In re* Stewart), 123 B.R. 817, 820 (Bankr. W.D. Tenn. 1991) (finding that a partnership relationship is sufficient under § 523(a)(4)); Tindale v. Blatnik (*In re* Blatnik), 101 B.R. 718 (Bankr. E.D. Okla. 1989) (finding that partnership relationship is sufficient under § 523(a)(4)); *with* Rolley v. Spector (*In re* Spector), 133 B.R. 733, 740 (Bankr. E.D. Pa. 1991) (finding that a partnership relationship is insufficient under § 523(a)(4)); Blashke v. Standard (*In re* Standard), 123 B.R. 444, 451-52

in this context can be made with respect to a managing partner of a limited partnership, who has complete control of the financial operations of the partnership, since such a partner has a heightened fiduciary duty. However, there is not complete consensus on this issue.[131] Ultimately, these are questions of interpreting the standards imposed by state partnership law.

An interesting question is posed when the managing partner of a limited partnership is either a corporation or another partnership. Clearly the fiduciary duties of the individual controlling the managing partner extend only to that partnership or corporation. Such an individual has no fiduciary obligations with respect to the limited partners.[132] However, at least one court has signalled a willingness to pierce the veil of the corporate managing partner to reach the individual ultimately responsible for operating the business if such individual is virtually indistinguishable from the managing partner, and he or she operated the corporate managing partner for his or her sole benefit.[133]

The issue of fiduciary capacity is largely determined on a case-by-case basis. Counsel should usually be prepared to argue the issue of whether fiduciary capacity exists, especially in partnership cases. It is important, however, to bear in mind the fundamental requirement that counsel must be able to point to a specific agreement or statute that gives rise to the fiduciary relationship.

B. INTENT

In addition to fiduciary capacity, the creditor must also prove fraud or defalcation in a § 523(a)(4) claim. The intent elements for fraud and defalcation are very different.

1. *Fraud*

As is the case under § 523(a)(2), the type of fraud that the

(Bankr. N.D. Ga. 1991) (finding that a partnership relationship is insufficient under § 523(a)(4)); Sulphur Partnership v. Piscioneri, 108 B.R. 595, 601-02 (Bankr. N.D. Ohio 1989) (finding that a partnership relationship is insufficient under § 523(a)(4)); Kunzler v. Bundy (*In re* Bundy), 95 B.R. 1004, 1012-13 (Bankr. W.D. Mo. 1989) (finding that a partnership relationship is insufficient under § 523(a)(4)); Sager v. Lewis (*In re* Lewis), 94 B.R. 406, 410 (Bankr. E.D. Va. 1988) (finding that partnership relationship is insufficient under § 523(a)(4)).

131. *Compare* LSP Inv. Partnership v. Bennett (*In re* Bennett), 970 F.2d 138, 149 (5th Cir. 1992); Selenske v. Selenske (*In re* Selenske), 103 B.R. 200, 202-04 (Bankr. E.D. Wis. 1989); Leeb v. Guy (*In re* Guy), 101 B.R. 961, 990-91 (Bankr. N.D. Ind. 1988); Arnett v. Weiner (*In re* Weiner), 95 B.R. 204, 206-07 (Bankr. D. Kan. 1989); *with* Hardesty v. Johnson, 126 B.R. 343, 346 (E.D. Mo. 1991).

132. *Bennett*, 970 F.2d at 149; Medved v. Novak (*In re* Novak), 97 B.R. 47, 59 (Bankr. D. Kan. 1987).

133. *See* Park v. Moorad (*In re* Moorad), 132 B.R. 58, 62 (Bankr. N.D. Okla. 1991).

creditor must establish is actual or positive fraud. Such fraud involves moral turpitude or intentional wrongdoing. Once again, implied or constructive fraud that exists without any bad faith or immorality is insufficient.[134]

The evidentiary problems in connection with proving intent, discussed with respect to § 523(a)(2) arise with equal force in § 523(a)(4) fiduciary fraud cases. Circumstantial evidence and witness credibility will be the deciding factors in the case.

2. *Defalcation*

To prove defalcation is a far simpler matter than proving fraud. Defalcation is a broader concept than fraud, subsuming even embezzlement and misappropriation. To establish defalcation, all the plaintiff must show is that the fiduciary failed to account for money entrusted to him or her.[135] Even negligent or innocent defaults where the fiduciary acted in good faith can constitute defalcation.[136] Furthermore, it is not even necessary that the fiduciary be fully aware of its duties as such.[137] Nor is it necessary that the fiduciary personally benefit from its acts.[138]

Given the ease of proving defalcation as opposed to fraud, counsel should be very explicit regarding which type of fiduciary debt he or she is pursuing and which state of mind he or she intends to prove. If counsel is attempting to prove fraud, it is advisable to take an objective look at the client's credibility and the implications that can be drawn from the circumstances of the

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134. Lawrence Steel Erection Co. v. Piercy (*In re* Piercy), 140 B.R. 108, 114 (Bankr. D. Md. 1992); American Home Assurance Co. v. Katzen (*In re* Katzen), 47 B.R. 738, 742 (Bankr. D. Mass. 1985); Allentown Supply Co. v. McCurdy (*In re* McCurdy), 45 B.R. 728, 731 (Bankr. M.D. Pa. 1985); REL Commercial Corp. v. Materetsky (*In re* Materetsky), 28 B.R. 499, 502 (Bankr. S.D.N.Y. 1983).

135. Woodworking Enter., Inc. v. Baird (*In re* Baird), 114 B.R. 198, 204 (Bankr. 9th Cir. 1990); Hoff v. Carroll (*In re* Carroll), 140 B.R. 313, 316 (Bankr. D. Mass. 1992); Boudakian v. Boudakian (*In re* Boudakian), 137 B.R. 89, 94 (Bankr. D.R.I. 1992); Hall v. Johann (*In re* Johann), 125 B.R. 679, 681 (Bankr. M.D. Fla. 1991); Bamco 18 v. Reeves (*In re* Reeves), 124 B.R. 5, 6, 8-9 (Bankr. D.N.H. 1990); San Saba Pecan, Inc. v. Failing (*In re* Failing), 124 B.R. 340, 344 (W.D. Okla. 1989); Pisoni v. Hodges (*In re* Hodges), 115 B.R. 152, 155 (Bankr. S.D. Ill. 1990); Chicago Title Ins. Co. v. Manzo (*In re* Manzo), 106 B.R. 69, 72 (Bankr. E.D. Pa. 1989); FDIC v. Sax (*In re* Sax), 106 B.R. 534, 539 (Bankr. N.D. Ill. 1989); American Sav. & Loan Ass'n v. Weber (*In re* Weber), 99 B.R. 1001, 1012-13 (Bankr. D. Utah 1989).

136. *Baird*, 114 B.R. at 204; *Carroll*, 140 B.R. at 316; LaPointe v. Brown (*In re* Brown), 131 B.R. 900, 904 (Bankr. D. Me. 1991); Reliance Ins. Co. v. Wilson (*In re* Wilson), 127 B.R. 440, 443 (Bankr. E.D. Mo. 1991); *Reeves*, 124 B.R. at 6, 8-9; *Failing*, 124 B.R. at 344; *Hodges*, 115 B.R. at 155; *Manzo*, 106 B.R. at 72; Hayton v. Eichelberger (*In re* Eichelberger), 100 B.R. 861, 866 (Bankr. S.D. Tex. 1989); Ohio Casualty Ins. Co. v. Kern (*In re* Kern), 98 B.R. 321, 324 (Bankr. S.D. Ohio 1989).

137. *Kern*, 98 B.R. at 323.

138. *Boudakian*, 137 B.R. at 94; *Failing*, 124 B.R. at 344; *Manzo*, 106 B.R. at 72; *Eichelberger*, 100 B.R. at 866.

case. Debtor credibility will be less of an issue in proving defalcation since even innocent defaults are sufficient.

C. STANDARD OF PROOF

The standard of proof for all debts under § 523(a)(4), including embezzlement and larceny discussed below, appears to be the preponderance standard, based on the Supreme Court's holding in *Grogan v. Garner.*[139]

VII. DEBTS FOR EMBEZZLEMENT AND LARCENY

In addition to the fiduciary debts, § 523(a)(4) also excludes debts for embezzlement and larceny. No fiduciary duty need be shown to sustain a finding of nondischargeability for larceny or embezzlement.[140]

The elements of proof for nondischargeability based on embezzlement are:

1. The creditor's property was entrusted to the debtor;
2. The debtor appropriated the property or used it for a purpose other than that for which it was entrusted; and
3. The debtor acted with fraudulent intent.[141]

The elements of proof for nondischargeability based on larceny are:

1. The debtor fraudulently and wrongfully took property from its rightful owner;
2. The debtor intended to convert the property to his or her own use; and

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139. 111 S. Ct. 654, 659 (1991). *See also* Kaye v. Rose (*In re* Rose), 934 F.2d 901, 904 (7th Cir. 1991); Cincinnati Ins. Co. v. Butts (*In re* Butts), 142 B.R. 1011, 1012 (Bankr. M.D. Fla. 1992); Cavalier Ins. Agency, Inc. v. Rico (*In re* Rico), 133 B.R. 880, 881 (Bankr. N.D. Ohio 1991); Gravel v. Roy, (*In re* Roy), 130 B.R. 214, 217 (Bankr. W.D. La. 1991). However, as discussed in section VIII, *infra*, the Supreme Court's holding in *Grogan* is dicta as it applies to sections other than subsection (a)(2)(A), so courts could entertain arguments that a clear and convincing standard should apply in subsection (a)(4) cases.

140. First Nat'l Bank v. Henson (*In re* Henson), 135 B.R. 346, 349 (Bankr. E.D. Ark. 1991); Farina v. Balzano (*In re* Balzano), 127 B.R. 524, 532 (Bankr. E.D.N.Y. 1991); American Nat'l Bank v. Cooper (*In re* Cooper), 125 B.R. 777, 780 (Bankr. N.D. Ill. 1991); Fox v. Shervin (*In re* Shervin), 112 B.R. 724, 735 (Bankr. E.D. Pa. 1990); Rech v. Burgess (*In re* Burgess), 106 B.R. 612, 621 (Bankr. D. Neb. 1989).

141. *See* Transamerica Commercial Fin. Corp. v. Littleton (*In re* Littleton), 942 F.2d 551, 555 (9th Cir. 1991); *Rico*, 133 B.R. at 881; RAI Credit Corp. v. Patton (*In re* Patton), 129 B.R. 113, 116 (Bankr. W.D. Tex. 1991); *Balzano*, 127 B.R. at 532-33; *Burgess*, 106 B.R. at 621; Coleman v. Choisnard (*In re* Choisnard), 98 B.R. 37, 41 (Bankr. N.D. Okla. 1989); United Am. Ins. Co. v. Koelfgen (*In re* Koelfgen), 87 B.R. 993, 997 (Bankr. D. Minn. 1988).

3. The owner did not consent to such conversion.[142]

The elements of proof for both embezzlement and larceny have their roots in common law, and are similar to the definitions used by most state statutes.[143] However, if there is any conflict, the elements listed above prevail in proceedings under § 523(a)(4).[144]

Fraudulent intent is a necessary element to the establishment of both embezzlement and larceny. Once again, the plaintiff must prove actual or positive fraud involving moral turpitude or intentional wrong.[145]

VIII. DEBTS FOR WILLFUL AND MALICIOUS INJURIES—§ 523(a)(6)

Section 523(a)(6) excludes from discharge debts for "willful and malicious" injury to the creditor or its property.[146] Proof of fraud is not necessary to establish grounds for relief under § 523(a)(6), but a thorough understanding of this section is necessary since requests for relief under § 523(a)(6) are often coupled with requests for relief for fraud under subsections 523(a)(2) and (a)(4).

A. STANDARD OF PROOF

Several courts hold that the Supreme Court's holding in *Grogan v. Garner*[147] is broad enough to establish the preponderance of the evidence standard of proof as the proper standard in all dischargeability cases under § 523(a), including subsection (a)(6).[148] However, the precise issue before the Supreme Court in *Grogan* was which standard should be applied in § 523(a)(2)(A) cases; therefore, the Court's holding is dicta regarding the standard of proof to be applied to the other subsections. At least one court

142. *See Balzano*, 127 B.R. at 532; Weinreich v. Langworthy (*In re* Langworthy), 121 B.R. 903, 907 (Bankr. M.D. Fla. 1990); *Burgess*, 106 B.R. at 622; *Choisnard*, 98 B.R. at 41.

143. Kaye v. Rose (*In re* Rose), 934 F.2d 901, 903 n.2 (7th Cir. 1991); *Langworthy*, 121 B.R. at 907; Doran Services, Inc. v. Valentine (*In re* Valentine), 104 B.R. 67, 71 (Bankr. S.D. Ind. 1988).

144. Gillespi v. Jenkins (*In re* Jenkins), 110 B.R. 74, 76 (Bankr. M.D. Fla. 1990).

145. Tague & Beem, P.C. v. Tague (*In re* Tague), 137 B.R. 495, 500 (Bankr. D. Colo. 1991); Bernstein v. Moran (*In re* Moran), 107 B.R. 359, 361 (Bankr. M.D. Fla. 1989).

146. 11 U.S.C. § 523(a)(6) (1988).

147. 111 S. Ct. 654 (1991).

148. *See* Transamerica Commercial Fin. Corp. v. Littleton (*In re* Littleton), 942 F.2d 551, 554 (9th Cir. 1991); Hoskins v. Yanks (*In re* Yanks), 931 F.2d 42, 43 (11th Cir. 1991); Johnson v. Miera (*In re* Miera), 926 F.2d 741, 745 (8th Cir. 1991); Night Kitchen Music v. Pineau (*In re* Pineau), 141 B.R. 522, 526 & n.17 (Bankr. D. Me. 1992); Wood Peak v. Mazander (*In re* Mazander), 130 B.R. 534, 536 (Bankr. E.D. Mo. 1991); Bartlett Futures, Inc. v. Davis (*In re* Davis), 124 B.R. 831, 833 (Bankr. D. Kan. 1991).

recently has applied the clear and convincing standard of proof in § 523(a)(6) cases, finding the Supreme Court's reasoning in *Grogan* to be inapplicable to dischargeability cases not dealing with fraud.[149]

Counsel therefore should be prepared to argue the appropriate standard of proof if the forum court has not ruled on the issue, and to face differing standards of proof in some fraud dischargeability proceedings.

B. INTENT

In order to prove a case under subsection (a)(6), the creditor must establish that its injury was proximately caused by acts of the debtor, and that the debtor's acts were both willful and malicious. The term "willful" merely means that the debtor's act was deliberate or intentional.[150] Negligent or reckless acts will not support a finding of nondischargeability under § 523(a)(6).[151] The term "malicious" means that the debtor acted with knowledge that its actions were certain, or substantially certain, to cause injury without just cause.[152] Actual hatred, spite, or ill will are not necessary to establish maliciousness.[153]

C. NATURE OF INJURY TO CREDITOR

Section 523(a)(6) applies to many types of injuries, most of which are irrelevant to a discussion of dischargeability as a remedy for fraud. However, in connection with fraud cases under subsections 523(a)(2) and (a)(4), allegations that a creditor was injured by the conversion or disposition of its collateral are not uncommon.

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149. *Tague*, 137 B.R. at 504-05. The Bankruptcy Court for the Middle District of Florida has also applied the clear and convincing standard in *Sjostedt v. Salmon*, reasoning that it was bound to do so by an earlier Eleventh Circuit opinion. Sjostedt v. Salmon (*In re* Salmon), 128 B.R. 313, 315 (Bankr. M.D. Fla. 1991). However, *Salmon* appears to be in conflict with Hoskins v. Yanks (*In re* Yanks), 931 F.2d 42 (11th Cir. 1991), not cited by the *Salmon* court, and decided by the Eleventh Circuit only one month earlier.

150. C.I.T. Fin. Serv., Inc. v. Posta (*In re* Posta), 866 F.2d 364, 367 (10th Cir. 1989); *Tague*, 137 B.R. at 502; Sun Bank v. Moore (*In re* Moore), 136 B.R. 570, 572 (Bankr. S.D. Fla. 1991); Sylvester v. Martin (*In re* Martin), 130 B.R. 930, 947 (Bankr. N.D. Ill. 1991); Blashke v. Standard (*In re* Standard), 123 B.R. 444, 449 (Bankr. N.D. Ga. 1991).

151. *Moore*, 136 B.R. at 572; *Martin*, 130 B.R. at 947; McGee v. McCown (*In re* McCown), 129 B.R. 432, 438 (Bankr. D. Md. 1991); *Standard*, 123 B.R. at 449; Chemical Bank v. Neman (*In re* Neman), 119 B.R. 547, 550 (Bankr. N.D. Ohio 1990).

152. Britton v. Price (*In re* Britton), 950 F.2d 602, 605 (9th Cir. 1991); Vulcan Coals, Inc. v. Howard, 946 F.2d 1226, 1228-29 (6th Cir. 1991); *Posta*, 866 F.2d at 367; Tague & Beem v. Tague (*In re* Tague), 137 B.R. 495, 502 (Bankr. D. Colo. 1991); *Moore*, 136 B.R. at 572; Edgman v. Farfalla (*In re* Farfalla), 132 B.R. 628, 630 (Bankr. D. Neb. 1991); *Martin*, 130 B.R. at 947; *Standard*, 123 B.R. at 449.

153. *Howard*, 946 F.2d at 1228-29; *Moore*, 136 B.R. at 572; *Martin*, 130 B.R. at 947; *Standard*, 123 B.R. at 449; Rolland v. Johnson (*In re* Johnson), 109 B.R. 885, 892 (Bankr. N.D. Ind. 1989).

Such injuries have been found to be eligible for redress under § 523(a)(6) in cases in which the conversion or disposition was willful and malicious.[154]

IX. PRACTICAL SUGGESTIONS

A. Do not commence a case for fraud under § 523 or § 727 lightheartedly; § 523 cases are difficult to prove, and § 727 cases are even harder.

B. Consider the economics of the case. A dischargeability case is full-fledged litigation. Consider the chances of collecting on any judgment obtained.

C. Do not couple a § 523 action with a § 727 action if the only desired relief is a declaration of nondischargeability of a particular debt. Consider the client's goals and interests. If a successful challenge to dischargeability of a specific debt can be made, there is probably little interest in allowing other creditors to pursue the debtor for collection of their debts.

D. Remember that actual or positive fraud must be proven in most cases. Be prepared for the debtor's defense: "I did it, but it was an honest mistake and I didn't mean to mislead the creditor" or "I sold the collateral, but I did it to save the business, not to injure the creditor." Circumstantial evidence is almost always necessary to prove intent, and the best kind of circumstantial evidence is documentary.

E. Reassess the case as it progresses. If it appears that there is a good chance the creditor will lose, the creditor could wind up being responsible for the debtor's costs and expenses under § 523(d).

F. Recognize the very factual nature of dischargeability proceedings. A decision regarding fraud almost always turns on the weight given to the evidence presented by each side, so reversals on appeal are rare.

G. Understand that court files in adversary proceedings are separate files from those maintained in the main bankruptcy case. Thus, any evidence from the main case file that a party wishes the court to consider must be introduced into evidence at the trial of the adversary proceeding. Judicial notice of the main case file will not get the substantive content of documents from that file into

154. *See* Friendly Fin. Serv. Mid-City, Inc. v. Modicue (*In re* Modicue), 926 F.2d 452, 453 (5th Cir. 1991); Transamerica Commercial Fin. Corp. v. James (*In re* James), 124 B.R. 614, 616 (Bankr. M.D. Fla. 1991); St. Luke's Hosps. of Fargo, Inc. v. Smith (*In re* Smith), 119 B.R. 714, 721 n.2 (Bankr. D.N.D. 1990).

evidence because the only facts that are subject to judicial notice are facts that are "not subject to reasonable dispute" or that are "capable of accurate and ready determination by resort to sources whose accuracy cannot reasonably be questioned."[155] Thus, only facts such as *when* a document was filed, or *whether* it was filed at all, are subject to judicial notice.

H. Have all evidentiary objections in mind prior to the trial. Factual stipulations, stipulations as to admissibility of evidence, and clearly stated objections to admissibility make dischargeability trials proceed much more smoothly. The bankruptcy courts use and apply the Federal Rules of Evidence.

I. Know the judge and the court. Do not assume that trying a case in bankruptcy court is just like trying a case in state court. Most bankruptcy courts have detailed local rules because of the volume of litigation they process. Tripping-up on a particular local rule can be fatal to the case. Also, different judges have distinctly different "smell tests" when it comes to judging fraud. If counsel has not appeared in bankruptcy court before a particular judge, ask around—a lot could be learned.

J. Remember that bankruptcy judges try many dischargeability cases and quite a few discharge cases. They have heard most anything the creditor can say about reliance or the debtor can say about intent to defraud. It is important, therefore, to realistically assess the believability of witnesses vis-a-vis the opposing party's witness. If counsel doesn't find his or her witness convincing, the strength of counsel's case should be reconsidered.

K. Be prepared to conduct discovery on a shorter deadline than usual. Bankruptcy judges often want to move dischargeability cases to trial very quickly to accommodate the public policy of providing a discharge swiftly. It is not at all unusual to try the case within five to six months of filing.

L. Debtor's counsel should be wary of bringing counterclaims against the plaintiff. Often such counterclaims are estate property because they arise from pre-petition events and must therefore be commenced by the trustee.

X. CONCLUSION

The Bankruptcy Code abhors debtor fraud, and thus the creditor is given powerful remedies to redress such fraud through the denial of the fundamental elements of debtor relief afforded by

155. FED. R. EVID. 201.

the Code. However, these remedies are provided in light of the Bankruptcy Code's central purpose of providing a "procedure by which certain insolvent debtors can reorder their affairs, make peace with their creditors, and enjoy 'a new opportunity in life with a clear field for future effort, unhampered by the pressure and discouragement of preexisting debt.' "[156] Therefore, bankruptcy courts require strict creditor compliance with both the procedural and substantive requirements for obtaining a determination of nondischargeability. Familiarity with such requirements is thus fundamental to effective representation of both creditors and debtors where allegations of debtor fraud arise.

156. Grogan v. Garner, 111 S. Ct. 654, 659 (1991) (quoting Local Loan Co. v. Hunt, 292 U.S. 234, 244 (1934)).

APPENDIX

11 U.S.C. § 523(a) (1988 & Supp. III 1991)

§ 523. Exceptions to discharge

(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—

(A) false pretenses, a false representation, or actual fraud, other than a statement respecting the debtor's or an insider's financial condition;

(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 caused to be made or published with intent to deceive; or

(C) for purposes of subparagraph (A) of this paragraph, consumer debts owed to a single creditor and aggregating more than $500 for "luxury goods or services" incurred by an individual debtor on or within forty days before the order for relief under this title, or cash advances aggregating more than $1,000 that are extensions of consumer credit under an open end credit plan obtained by an individual debtor on or within twenty days before the order for relief under this title, are presumed to be nondischargeable; "luxury goods or services" do not include goods or services reasonably acquired for the support or maintenance of the debtor or a dependent of the debtor; an extension of consumer credit under an open end credit plan is to be defined for purposes of this subparagraph as it is defined in the Consumer Credit Protection Act (15 U.S.C. § 1601 et seq.);

(3) neither listed nor scheduled under section 521(1) of this title, with the name, if known to the debtor, of the creditor to whom such debt is owed, in time to permit—

* * *

(B) if such debt is of a kind specified in paragraph (2), (4), or (6) of this subsection, timely filing of a proof of claim and timely request for a determination of dischargeability of such debt under one of such paragraphs, unless such creditor had notice or actual knowledge of the case in time for such timely filing and request;

(4) for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny;

* * *

(6) for willful and malicious injury by the debtor to another entity or to the property of another entity;

* * *

(c)(1) Except as provided in subsection (a)(3)(B) of this section, the debtor shall be discharged from a debt of a kind specified in paragraph (2), (4), or (6) of subsection (a) of this section, unless, on request of the creditor to whom such debt is owed, and after notice and a hearing, the court determines such debt to be excepted from discharge under paragraph (2), (4), or (6), as the case may be, of subsection (a) of this section.

* * *

(d) If a creditor requests a determination of dischargeability of a consumer debt under subsection (a)(2) of this section, and such debt is discharged, the court shall grant judgment in favor of the debtor for the costs of, and a reasonable attorney's fee for, the proceeding if the court finds that the position of the creditor was not substantially justified, except that the court shall not award such costs and fees if special circumstances would make the award unjust.

Federal Rules of Bankruptcy Procedure 4007

(c) Time for Filing Complaint Under § 523(c) in Chapter 7 Liquidation, Chapter 11 Reorganization, and Chapter 12 Family Farmer's Debt Adjustment Cases; Notice of Time Fixed.

A complaint to determine the dischargeability of any debt pursuant to § 523(c) of the Code shall be filed not later than 60 days following the first date set for the meeting of creditors held pursuant to § 341(a). The court shall give all creditors not less than 30 days notice of the time so fixed in the manner provided in Rule 2002. On motion of any party in interest, after hearing on notice,

the court may for cause extend the time fixed under this subdivision. The motion shall be made before the time has expired.

(d) Time for Filing Complaint Under § 523(c) in Chapter 13 Individual's Debt Adjustment Cases; Notice of Time Fixed.

On motion by a debtor for a discharge under § 1328(b), the court shall enter an order fixing a time for the filing of a complaint to determine the dischargeability of any debt pursuant to § 523(c) and shall give not less than 30 days notice of the time fixed to all creditors in the manner provided in Rule 2002. On motion of any party in interest after hearing on notice the court may for cause extend the time fixed under this subdivision. The motion shall be made before the time has expired.

Federal Rules of Bankruptcy Procedure 7041

Rule 41 F.R.Civ. P. applies in adversary proceedings, except that a complaint objecting to the debtor's discharge shall not be dismissed at the plaintiff's instance without notice to the trustee, the United States trustee, and such other persons as the court may direct, and only on order of the court containing terms and conditions which the court deems proper.

District of Minnesota Local Bankruptcy Rule 1110

A complaint objecting to discharge or seeking revocation of discharge shall not be dismissed at the plaintiff's instance except by order of the court after hearing on motion made in the adversary proceeding. The plaintiff shall serve the motion on all creditors and other parties in interest. The plaintiff also shall file an affidavit stating that nothing has been received by or promised to the plaintiff in consideration of the request for dismissal.