

# **DISCHARGE AND DISCHARGEABILITY LITIGATION**

**MOST COMMON CAUSES OF ACTION UNDER 523 AND 727**

**THOUGHTS ON LITIGATION STRATEGY**

**UNIVERSITY OF TEXAS SCHOOL OF LAW**

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The dual purposes of the Bankruptcy Code are to provide an honest debtor with a fresh start and to

provide for an orderly distribution of the debtor's assets. The fresh start is accomplished by allowing a debtor a discharge of his/her debts and allowing the debtor to retain at least some assets. The discharge is limited, however, as the debtor may not discharge some debts as a matter of public policy (i.e., child support, most taxes, most student loans) and may not discharge debts if they were incurred through fraud or if the debtor engaged in conduct fraudulent as to creditors generally.

As a practical matter, a creditor needs to consider the economic realities of pursuing discharge or dischargeability litigation. There is not only the cost of hiring attorneys (and/or experts), there is the loss of work time in dealing with the attorneys, attending discovery and responding to discovery requests, attending hearings, etc. Even assuming the creditor wins and its debt is not discharged, it now has to try to collect the debt from a debtor who is clearly judgment proof. (Any non-exempt assets would have been liquidated as part of the bankruptcy.)

A reasonably intelligent and diligent debtor can easily avoid directly acquiring significant assets subject to execution even while indirectly acquiring significant assets beyond the reach of creditors. (The most simple and common method is by forming a corporation owned by someone other than the debtor (i.e., spouse, other family member, family trust, best friend, etc.) Notwithstanding the fact that the debt may not be collectable in the near term, a creditor may wish to pursue these claims in the hope that the debtor will either get lazy (and/or stupid) and acquire non-exempt assets or will move to another state with much less generous exemptions where the creditor has additional collection opportunities (i.e., garnishing wages.)

### **Most common 523 and 727 causes of action.**

#### **Section 523 - *exceptions to discharge.***

The creditor's objective here is to deny the debtor of a discharge of the creditor's debt, but to allow discharge of as many of the debtor's other debts as possible. (So the creditor doesn't have to compete with other creditors to collect its debt.) The basis for an exception to discharge is misconduct directed towards an individual creditor.

#### **523(a)(A) and (B) except from a discharge a debt --**

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

- false pretenses, a false representation, or actual fraud, other than a statement respecting the debtor's or an insider's financial condition.

(2)(B) excepts from discharge a debt obtained by "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."

Remember (and this is significant) 523(a)(2)(A) and 523(a)(2)(B) are (at least somewhat) mutually exclusive. 523(a)(2)(B) requires a statement in writing. 523(a)(2)(A) does not. 523(a)(2)(B) involves a statement respecting the debtor's or an insider's financial condition. 523(a)(2)(A) involves a

statement “**other than** a statement respecting the debtor’s or an insider’s financial condition.”

523(a)(2)(B) is commonly referred to as “false financial statement fraud” as it typically involves a claim that the debtor issued a financial statement that materially misrepresented the debtor’s financial condition in order to induce the creditor to extend. (i.e., the debtor significantly inflated the value of assets, listed assets that were in fact owned by other entities, mischaracterized the nature of assets [i.e., listed exempt retirement funds as “investment accounts”], failed to disclose liabilities, or failed to disclose liabilities as secured.)

523(a)(2)(A) involves other types of false representations. A common scenario is a construction dispute where the contractor made representations (verbal or written) regarding expertise or quality of construction or materials. (These are not fun cases to try, especially if the alleged misrepresentations were verbal. It’s your classic “he said, she said” dispute. Who does the court find to be more credible? There seems to be a natural bias against the contractor - he is the “expert,” the homeowner is “unsophisticated.”)

For a discussion of the pleading issues with respect to 523(a)(2)(A) and (B), see In re Ortiz, 441 B.B. 73 (Bankr.W.D.Tex.2010), in which Judge Gargotta granted a motion for judgment on the pleadings based upon lack of specificity.

See generally, In re Gauthier, 349 Fed. Appx. 943 (5<sup>th</sup> Cir.2009); In re Miller, 307 Fed. Appx. 785 (5<sup>th</sup> Cir. 2008); and In re Park, 271 Fed. Appx. 398 (5<sup>th</sup> Cir. 2008) for recent Fifth Circuit cases on 523(a)(2).

For an analysis of representations made by a debtor when using a credit card, see In re Mercer, 246 F.3d 391 (5<sup>th</sup> Cir. 2001). (No that anyone cares, but I have a fundamental problem with that case. The court held that each time a debtor uses a credit card, there is a representation of present intent and ability to pay and that each time the creditor allows the debtor to make a charge, it is relying on that representation. This is, of course, utter nonsense in the context of how credit card companies operate. They allow the debtor to use the card based upon whether the debtor has available credit and is current on payments. Period.)

**523(a)(4)** excepts from discharge a debt for “fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny.”

For the purposes of this section, courts historically required an “express” trust - one imposed by contract or statute. Course of dealing is not enough and/or knowing each other for a long time is not enough. More recently, courts have found a fiduciary capacity to exist based upon an “informal” fiduciary relationship - One based on a “moral, social, domestic, or purely personal relationship.” In re Atkins, 2011 WL 3862009 (Bankr.W.D.Tex.2011).

Note the distinction between fraud and defalcation. Defalcation only requires only a “willful neglect of duty” - that the plaintiff prove that trust assets were expended for purposes other than those allowed for by the trustee agreement or statute - fraud is not required. In re Schwager, 121 F.3d 177 (5<sup>th</sup> Cir. 1997). A common scenario is where funds are advanced under a construction contract and the contractor fails to comply with the Texas Construction Trust Funds Act. “Misapplied” funds may

not be dischargeable, even absent fraud. See, Texas Property Code Chapter 162.

**523(a)(6)** excepts from discharge a debt “for willful and malicious injury by the debtor to another entity or to the property of another entity.”

For the purposes of this section, the injury must be willful (intentional) and malicious (without just cause). The case law requires that the debtor must not only intend the act, but the injury, as well. Kawaauhua v. Geiger, 523 U.S. 57 (1998.)

There are two typical scenarios. The first is an intentional tort. I punch you in the face and break your nose. The second is where the debtor sells the collateral of a secured creditor and does not remit the proceeds to the creditor. (A state law conversion action.)

### **Section 727 - *objections to discharge.***

The creditor’s objective here is to deny the debtor of a discharge **of any of the debtor’s debts**. The basis for an objection to discharge is misconduct directed towards the debtor’s creditors generally. (And typically involves misconduct during or in anticipation of a bankruptcy filing.)

The difference between “exceptions” to discharge and “objections” to discharge is that exceptions to discharge involve conduct between the debtor and the individual creditor (“The debtor lied to me.”), while objections to discharge generally involve fraud in the context of the bankruptcy case. (“The debtor lied about his assets in the bankruptcy.”)

**727(a)(2)** provides that the debtor will not receive a discharge if “the debtor, with intent to hinder, delay, or defraud a creditor or an officer of the estate charged with custody of property under this title, has transferred, removed, destroyed, mutilated, or concealed, or has permitted to be transferred, removed, destroyed, mutilated, or concealed –

- (A) property of the debtor, within one year before the date of the filing of the petition; or
- (B) property of the estate, after the date of filing of the petition.”

This section typically involves cases where the debtor sells non-exempt assets and simply fritters away the money prior to filing or files a bankruptcy and simply fails to disclose non-exempt assets.

A cause of action under 727(a)(2) requires a showing of actual intent. In re Reed, 700 F.2d 986 (5<sup>th</sup> Cir. 1983); In re Chastant, 873 F.2d 89 (5<sup>th</sup> Cir. 1989). Fraud may be inferred from conduct. The debtor in Reed sold non-exempt assets to friends and relatives for less than fair value and used the proceeds to pay down the debt on his exempt homestead. Transfer is broadly interpreted, but see, e.g., In re Laughlin, 602 F.3d 417 (5<sup>th</sup> Cir. 2010) where the court held that disclaimer of an inheritance was not a transfer of an interest of the debtor in property.

**727(a)(3)** provides that the debtor will not receive a discharge if “the debtor has concealed, destroyed, mutilated, falsified, or failed to keep or preserve any recorded information, including books, documents, records, and papers, from which the debtor’s financial condition or business transaction might be ascertained, unless such act or failure to act was justified under all of the circumstances of the case.”

This section typically involves cases where the debtor does not maintain sufficient records (usually bank statements) to allow the court to determine where the debtor's assets (usually cash) went. You can always get copies of the statements from the bank, but if you are going back more than six months, expect to pay for them. (I have had cases where the creditor objected because the debtor paid everything with a debit card and didn't keep the individual receipts for the charges. The bank statements showed the date, the amount, and the location, but you couldn't tell exactly what was charged, i.e., what dishes were ordered at the restaurant and who ate the meal. Judges aren't typically impressed if this is all you've got.)

See In re Duncan, 562 F.3d 688 (5<sup>th</sup> Cir. 2009) and In re Tomasek, 175 Fed. Appx. 662 (5<sup>th</sup> Cir. 2006).

**727(a)(4)** provides that a debtor will not receive a discharge if “the debtor knowingly and fraudulently, in or in connection with the case –

- (A) made a false oath or account;
- (B) presented or made a false claim;
- (C) gave, offered, received, or attempted to obtain money, property, or advantage, or a promise of money, property, or advantage, for acting or forbearing to act; or
- (D) withheld from an officer of the estate entitled to possession under this title, any recorded information, including books, documents, records, and papers, relating to the debtor's property or financial affairs.”

This section typically involves cases where there are omissions in the debtors schedules or statement of financial affairs. The misrepresentation must be intentional **and** material. 727(a)(4) can involve cases where the debtor refuses to turn over financial records to the trustee. [A 727(a)(3) claim is more common - the debtor doesn't refuse to turn over records, he simply says he doesn't have them anymore.]

If you are thinking of filing a discharge adversary, you should read the cases on objections to discharge under Section 727(a)(4). For the Fifth Circuit, see In re Mitchell, 2004 WL 1448041 (5<sup>th</sup> Cir.2004)(unpublished); In re Sholdra, 249 F.3d 380 (5<sup>th</sup> Cir.2001); In re Beaubouef, 966 F.2d 174 (5<sup>th</sup> Cir.1992); In re Pratt, 411 F.3d 561 (5<sup>th</sup> Cir.2005). See, also, Judge Lynn's opinion In re Moschella, Case No. 03-47690, and Judge Gargotta's opinions in Partners in Family Medicine v. Nolen, Adv. No. 07-01008, and In re Atkins, 2011 WL 3862009 (Bankr.W.D.Tex.2011). The key issues in these cases are typically intent to not disclose and materiality of the omissions/mistakes. Intent is commonly inferred, not admitted. The more significant the omission, the more likely that intent will be inferred. Sholdra and its progeny adopt an (alternative?) standard of “reckless disregard for the truth.”

No debtor **ever** files a flawless set of schedules. To expect otherwise demonstrates a fundamental inability to grasp reality. With that said, however, the system requires that debtors not omit material information which might lead to the discovery of assets or transfers of assets. I would suggest that failure to disclose an ownership interest in a corporation might be material by definition. By contrast, if the debtor fails to disclose that he received interest of \$5.37 last year from a checking account on SOFA#2, I cannot imagine that would be material enough to deny a discharge. Let's all exercise a little common sense.

**727(a)(5)** provides that a debtor will not receive a discharge if “the debtor has failed to explain satisfactorily, before determination of denial of discharge under this paragraph, any loss of assets or deficiency of assets to meet the debtor’s liabilities.”

This section typically involves cases where the debtor has disposed of assets and failed to explain to the satisfaction of the judge where the money went (i.e., the debtor sold a rental property a year prior to filing, netted \$50,000, the money never went into the debtor’s bank account, and the debtor can’t explain where the money was spent.) This can also involve a case where the debtor explains where the money went, but the explanation doesn’t satisfy the judge (i.e., the debtor went to Las Vegas and gambled away his savings in an attempt to win enough to pay off his debts.)

See, In re Orsini, 289 Fed. Appx. 714 (5<sup>th</sup> Cir. 2008) and In re Andrews, 98 Fed. Appx. 290 (5<sup>th</sup> Cir. 2004). These are both Cadle Company cases. Be forewarned.

**727(a)(7)** provides that a debtor will not receive a discharge if “the debtor has committed any act specified in paragraph (2), (3), (4), (5), or (6) of this subsection, on or within one year before the date of the filing of the petition, or during the case, in connection with another case, under this title or under the Bankruptcy Act, concerning an insider.”

This section applies where the debtor commits one (or more) of the acts which would result in denial of discharge in a personal case if such act occurred in a case involving an insider of the debtor. This typically involves a case of a corporation where the debtor was an officer and/or director of the corporation.

There is very little Fifth Circuit case law on this section. At the bankruptcy court level, see In re Atkins, 2011 WL 3862009 (Bankr.W.D.Tex.2011) and In re Cantu, 2011 WL 672336 (Bankr.S.D.Tex.2011).

## **Preparation**

### **Drafting**

Start drafting EVERYTHING when you start drafting the complaint (or answer)

- Complaint

- Pre-trial order (and proposed findings of fact)

- Motion(s) for summary judgment [or more likely, motion(s) for partial summary judgment]

Don’t plead it if you can’t prove it.

Don’t plead it (or try to prove it) if it isn’t material

I get a lot of adversaries filed by non-bankruptcy lawyers. They don’t follow the rules, often because they don’t know any better.

The complaint has to state jurisdiction and whether the matter is core or non-core. I get

adversaries that don't comply on a regular basis. I know the answer, but I file motions to dismiss to make the plaintiff's attorney comply (and to preview my case with the judge).

I get complaints that allege a claim under "523(a)(2)" - I file a motion to dismiss for failure to state a claim upon which relief can be granted or alternatively for more definite statement asking whether it is under 523(a)(2)(A) or (B). I am entitled to know. (The proof issues are different.) Judges pretty much always grant these motions.

## **Discovery**

The parties have to file initial disclosures under FRCP 26. The Plaintiff threw the party, so the burden is on it to go first.

FRCP 26(f) provides that a party is prohibited from sending discovery until there is a discovery conference. Plaintiff's attorneys send discovery all the time without any conference. I send a letter that demands the Plaintiff withdraw the request or I will file a motion to quash and then give the plaintiff's attorney a choice - enter into an agreed order in which they admit they violated FRCP 26(f) or we go do a hearing. Either way, I win and the plaintiff's attorney looks bad.

Avoid discovery disputes at all costs. The judges are generally inclined to believe that somebody is being unreasonable. (You do not want the judge unhappy with you at starting at the very beginning of a case.)

Plaintiff's attorneys frequently ask me to waive rules. Let me say that I routinely agree to extensions of time (to answer a complaint, to respond to discovery, etc). With that said, I am loathe to make it easier for a plaintiff to win a 523/727 adversary.

## **Anticipation**

What do you have to prove?

What evidence will you have to admit to prove it?

What do you need to get your evidence admitted?

What documents are there?

Who has to testify to prove them up?

Do you need to subpoena somebody? (Don't assume the other party will attend the trial.)

What does the other party have to prove?

What evidence will they have to admit to prove it?

What will they need to get their evidence admitted?

What documents are there?

Who has to testify to prove them up?

Do they need to subpoena somebody? (I have won several adversaries because the other side failed to subpoena my client and they needed his/her testimony. Oops.)

How do you keep their evidence out of evidence?

Relevance is valid more often than you might think. (Character evidence is not admissible to show intent. Misconduct unrelated to the transaction at issue is not admissible.)

Do you want to keep it out? (Does it confuse the issue in your favor? Does it make them look desperate? Or dishonest?)

Does it hurt your case? (If it doesn't matter and you don't object, there is no argument on appeal that important relevant evidence was excluded.)

Can you use it to your advantage?

Can you make their witnesses hurt their case? (If the case comes down to a "he said, she said" and I can make the other party out to be a dirty rotten liar, I win. It is easier to push most people's buttons than you might think.)

### **Coach your witnesses *carefully***

This does not mean tell them what to say - that is unethical.

Tell them how to behave.

Tell them to answer the question if they can.

If it is a yes or no question, they should answer with a yes or no.

I don't know and I don't remember are legitimate answers (or can be) - the problem is if the witness says it too often it looks like they are being evasive - which is a credibility issue.

If the question isn't fair, it is up to the lawyer to object - not the witness.

Clients want to answer with "yes, but...." They have to avoid doing that. The other attorney will object as non-responsive and the judge will sustain. Explain to your client that you will get a chance to ask them follow up questions and they will get to explain.

An additional benefit is that the attorney who made a big fuss will look like an idiot (or a liar.)

### **Clues (What to look for and where to look)**

A small percentage of debtors intentionally transfer assets, conceal assets, or fail to disclose assets with the intention of keeping non-exempt property while still obtaining a discharge. These people not only deserve to lose the property, but also deserve to lose their discharge and, in extreme cases, deserve to face criminal prosecution. A very large percentage of debtors are overwhelmed by the sheer volume of paperwork (or are not good with paperwork, or are just lazy, or.....) These debtors do not deserve to lose their discharge because they make what amount to clerical errors.

These clues apply to both debtors' attorneys and creditors' attorneys (and trustees).

**Look at source documents** - do not look only at the documents filed by the debtor in the bankruptcy case.

## **Tax returns**

Are there sources of income not disclosed in the schedules or SOFA?

Look at the line items on the first page of the 1040. Are there any sources of income not listed on SOFA #1 or #2?

Look for a Schedule C, K-1's, depreciation schedules

## **Bank statements**

Look for deposits that do not match the debtors' Schedule I.

This can be all kinds of things. Oil and gas royalties, other royalties, selling stuff on eBay (which might involve undisclosed inventory).

Look for expenses which do not match the debtors list of assets. Significant payments to an insurance company could be a whole life policy. Probably exempt, but failure to disclose could be a problem.

For very high income debtors (or formerly high income debtors), get copies of homeowners insurance policies, including any riders (i.e., art, jewelry, guns, collections, etc.). This could lead to objections based upon failure to disclose assets or failure to disclose transfers of assets.

## **Debtors' Schedules and SOFA**

Some of this can seem petty, but remember the cases which hold that reckless disregard for the truth is grounds to deny a discharge.

In Texas, if the debtor works for a governmental unit, they have a retirement plan and term life insurance. It's on their paystubs, it should be disclosed.

Most of the software programs used by debtors' attorneys have default settings so if no information is input, the schedules list "none."

Don't assume "none" is accurate. If the debtor has kids, there should be books and sporting goods. If the debtor lists significant pet expense, it might be a horse(s).

If the debtor does not disclose an auto, ask why not.

**Pay particular attention to SOFA #18 and Schedule B.13 and 14.** These are where the debtor discloses (or is supposed to disclose) ownership interests in corporations or partnerships. It doesn't matter if the entity is no longer operating - the question is does the debtor have an ownership interest. (I frequently have clients who have an interest in a family entity that they insist has no value, but when I start asking nosy questions we get a different answer.)

**Pay particular attention to SOFA #10.** The debtor is required to disclose transfers of any (significant) asset within the last two years. This is one of the most common omissions I see.

**Look at the debtor(s).**

I routinely have clients who leave jewelry blank on our homework package. When they sit across from me, I see that the wife is wearing a wedding ring and matching diamond stud earrings worth \$5,000 or \$10,000. When I ask, they say “I thought that was protected.” Correct statement of the law, but they still have to disclose the asset and claim it as exempt.