

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 (5th Cir.2009); In re Miller, 307 Fed. Appx. 785 (5th Cir. 2008); and In re Park, 271 Fed. Appx. 398 (5th 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 (5th 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 (5th Cir. 1997). A common scenario is where funds are advanced under a construction contract and

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