Comments and Developments in Discharge and Dischargeability Litigation

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I. SOME BASICS

The fundamental bankruptcy bargain is full disclosure of financial condition by an honest but unfortunate debtor[1] and the commitment of the debtor's non-exempt assets to payment of creditors in exchange for a discharge and a fresh start.

A. *Two Foci: Social Justice and Individual Exceptions.*

Creditor challenges to that bargain take two distinct forms: (a) challenges to discharge of all debts generally under 11 U.S.C. §727 (objections to discharge); and (b) challenges to the discharge of individual debts (objections to dischargeability) under 11 U.S.C. §523. The first challenges the debtor's entitlement to any discharge or fresh start. The second seeks to carve out exceptions.

The two are, thus, very different. First, §727 only applies in a Chapter 7 case whereas §523 is applicable to all kinds of cases except Chapter 9. 11 U.S.C. §103(a) & (b); *Cf.*. 11 U.S.C. § 1141 (d)(2) (excepting from an individual's discharge in Chapter 11 debts listed in §523); 11 U.S.C. § 1328(a) (2) and (c)(2) (excepting from discharge in Chapter 13 some or all debts listed in §523).

Second, and critically, an objection to discharge contests whether allowing this debtor a general discharge promotes social justice whereas the adjustment of the private relations between the debtor and an individual creditor is the matter of dischargeability. A dischargeability dispute alleges that the individual creditor's debt should not be discharged and instead should be enforceable even after the bankruptcy due to some characteristic of the debt or the manner that it was incurred. For example, if it is among certain kinds of tax debt, the result of fraud, not listed on the Debtor's papers, arises from divorce, arises out of willful or malicious acts by the Debtor, is among certain kinds of fines, penalties or forfeitures, is a student loan debt, arises from an OUI

[1] *See, e.g., Lamar, Archer & Cofrin, LLP v. Appling,* 138 S. Ct. 1752, 1758 (2018) (noting the "basic policy animating the Code of affording relief only to an 'honest but unfortunate debtor.") (*citations and quotations omitted*)

incident, is an order of restitution, and certain other miscellaneous debts. 11 U.S.C. § 523(a). Dischargeability is peculiar to the claim.

In contrast, an objection to discharge is universal. It does not matter what the debts are or how they arose, all debts (and all creditors) are preserved if the debtor is denied a discharge. An objection to discharge asserts that there is some characteristic of the debtor or its conduct that makes the debtor not of the kind entitled to a discharge. The list of such characteristics or conduct includes: not being an individual, certain acts fraudulently conveying property so as to deprive creditors; concealing, destroying of failing to keep records; testifying falsely in the case; bribery in the case; failing to explain any loss of assets; refusing to obey the court; having been granted a discharge within certain time frames; failing to complete the financial management course; waiving discharge; or certain kinds of federal depository institution related crimes. 11 U.S.C. § 727(a). In shorthand, if the fundamental bankruptcy bargain is full disclosure of financial condition by an honest but unfortunate debtor and the commitment of the debtor's non-exempt assets to payment of creditors in exchange for a discharge, then the objection to discharge asserts that the debtor broke that bargain.

B. *Procedural Similarities and Differences.*

1. Both are Adversary Proceedings

Because actions under §523 deal with individual debts and actions under §727 deal with all debts, yet both deal with the fundamental bankruptcy goal of a fresh start, they are related but different. They are related in that, when litigated in the bankruptcy court,[2] they are brought as adversary proceedings, a proceeding to object to or revoke a discharge. Fed. R. Bankr. P. 7001 (4)[3] (objecting to discharge) & (6) (determining the dischargeability of certain debts).

2. Timing: the need to be brought within sixty (60) days after the first date set for the meeting of creditors.

Actions to deny discharge are required to be filed within sixty (60) days after the first date set for the meeting of creditors. Fed. R. Bankr. P. 4004(a). If no complaint (or in the case of §727(a)(8) or (9) a motion) objecting to discharge is timely filed, then the "the court shall forthwith grant the discharge…" Fed. R. Bankr. P. 4004(c)(1).

Certain actions to determine the dischargeability of individual debts are likewise governed by a sixty (60) day rule. That result arises because some kinds of dischargeability

[2] Certain §523 issues (particularly divorce related matters) can be litigated in state courts. *In re Mason*, 164 N.H. 391, 394, 58 A.3d 1153, 1155 (2012) ("As an initial matter, we find that this court has jurisdiction to determine the dischargeability of the debt at issue,… Federal district courts shall have original but not exclusive jurisdiction of all civil proceedings arising under title 11, or arising in or related to cases under title 11, …While it is true that state courts lack jurisdiction to modify or to grant relief from a bankruptcy court's discharge injunction, they retain ... concurrent jurisdiction under 28 U.S.C. § 1334(b) to construe the discharge and determine whether a particular debt is or is not within the discharge.") (quotations and citations omitted)

[3] The rule excepts from its scope, objections discharge where the debtor received discharges in certain earlier bankruptcy cases. *See,* 11 U.S.C. §727(a)(8) &(9).

complaints are statutorily required to be decided by the bankruptcy court. Those are the objections arising under §523 (a)(2), (4) and (6):

> (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.

11 U.S.C. § 523. With respect to the (2), (4) and (6) complaints, the rule requires that, like objections to discharge, the complaint be filed within sixty (60) days after the date first set for the meeting of creditors. Fed. R. Bankr. P. 4007 (c).[4]

The kinds of actions (the (a)(2), (4) or (6) actions) that are burdened by the sixty (60) day time limit to file are actions to determine that the debt was:

> (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,…
>
> (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

11 U.S.C. § 523(a).

The deadlines to file both objections to discharge and objections to dischargeability under (a)(2), (4) and (6) are strict:

> The Bankruptcy Rules apply a strict limitations period "to further the fresh start goals of bankruptcy relief by requiring creditors to promptly join their objections to discharge in order that the debtor and other participants in the proceedings may enjoy finality and certainty of relief." *Dole v. Grant (In re Summit Corp.)*, 109 B.R. 534, 537 (D. Mass. 1990). Taken together, Fed. R. Bankr. P. 4004(a) and 4007(c) require that a complaint objecting to the debtor's discharge and/or the dischargeability of certain debts be filed no later than sixty days after the first date set for the meeting of creditors under 11 U.S.C. § 341(a). Both rules permit a party in interest to seek an extension of time for cause, but expressly require that "[t]he

[4] Complaints to obtain a determination of the dischargeability of any other kind of debt "may be filed at any time. A case may be reopened without payment of an additional filing fee for the purpose of filing a complaint to obtain a determination under this rule." Fed. R. Bankr. P. 4007 (b)

> motion shall be filed *before the time has expired*." See Fed. R. Bankr. P. 4004(b)(1), 4007(c).…

In re Foistner, No. BR 17-10796 -BAH, 2018 WL 718379, at *2 (Bankr. D.N.H. Feb. 5, 2018).

3. Extensions: read the orders.

The sixty (60) day limit is short. In contested cases, extensions are often sought and granted, often with the debtor's assent. The nature of that agreement is commonly that the extension is granted only for the kinds of action contemplated (i.e., discharge or dischargeability) and often limited to the parties who are negotiating. Thus, it is common to see an agreement that the deadline to objection to discharge will be extended **for the trustee,** or **for the United States Trustee,** and not for creditors generally.

If you represent an interested creditor, then read the order and do not rely on the docket entry. The docket entry is not the order and your rights will be governed by the order and not what the Clerk's office reports.

4. Settlement – the peculiarities of acting for all creditors.

Both complaints objecting to discharge and complaints objecting to dischargeability are adversary proceedings governed by Part VII of the Federal Rules of Bankruptcy Procedure. In general, those rules follow the Rules of Civil Procedure. One of the exceptions deals with dismissal. In general Fed. R. Civ. P 41 applies to Adversary Proceedings in the Bankruptcy Court. Fed. R. Bankr. P. 7041. Rule 7041 provides:

> 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.

Fed. R. Bankr. P. 7041. Fed. R. Civ. P. 41 permits dismissal without a court order upon the filing of "a stipulation of dismissal signed by all parties who have appeared."[5]

Rule 7041 means that an objection under §523 to dischargeability can be settled with or without a court order and without any court imposed conditions.

Rule 7041 means that an objection under §727 to discharge cannot be settled except with certain notice and "on order of the court containing terms and conditions as the court deems proper." Fed. R. Bankr. P. 7041. The rationale in the New Hampshire Bankruptcy Court is:

> … a creditor who picks up the §727 torch does so for the benefit of all creditors and the bankruptcy estate. A fiduciary relationship is created,

[5] Rule 41 has exceptions relating to class action settlements, derivative suit settlements, and settlements on behalf of unincorporated associations each of which require a court order because it is by its terms subject to Rules 23(e), 23.1 (c), 23.2 and 66.

> thus imposing fiduciary duties on the plaintiff-creditor for the benefit of all other creditors and the bankruptcy estate generally.

In re Kalantzis, No. 99-12517-JMD, 2000 WL 33679401, at *3 (Bankr. D.N.H. Aug. 21, 2000).

Because the plaintiff is said to be acting for all creditors, in our District, even though the rule does not say so, and even though the Local Rules do not say so, a settlement of a Section 727 action will not be allowed without notice to the US Trustee, the Trustee, and all creditors. They will be given the opportunity to step into the plaintiff's shoes and prosecute the claim.

II. RECENT DEVELOPMENTS IN DISCHARGEABILITY - §523.

A. ***The Supreme Court: Lamar, Archer & Cofrin, LLP v. Appling*, 138 S. Ct. 1752, (June 4, 2018).**

Any time the Supreme Court decides a bankruptcy case, the bankruptcy bar takes note. When, as in *Appling,* it is about a law firm trying to collect its fee (after it "successfully settled"[6] the underlying litigation in which it was retained) it's personal.

1. The facts:

After trial, the facts were:

Lamar, Archer & Cofrin, LLP,[7] represented Appling and his company Hartwell Enterprises, Inc., in litigation. He fell behind in the payment of the fee in excess of $60,000.00. In March 2005, the firm was concerned and threatened to withdraw. Appling convinced the firm not to withdraw by telling it that he expected a tax refund in excess of $100,000 and when he received it he would pay. The firm kept on working.

In November 2005, the firm remained concerned about payment. At a November 2005 meeting, Appling "told them that he had not yet received the refund. Lamar relied on that statement and agreed to complete the pending litigation and delay collection of the outstanding fees." *Appling*, *supra.,* 138 S. Ct. at 1757.

He was lying.[8] The refund was only $59,851 and he and his wife had already received it and spent it.

In March 2006, the firm sent its final invoice of $104,179.60 which is still unpaid today.[9]

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[6] So reported in the Bankruptcy Court. *In re Appling*, 500 B.R. 246, 249 (Bankr. M.D. Ga. 2013).
[7] According to its website, the firm "has specialized in complex civil litigation of all types.…" www.laclaw.net.
[8] Ironically, the litigation was a claim that Mr. Appling, in the purchase of his company had been the victim of a misrepresentation. *Matter of Appling*, 527 B.R. 545, 547-548 (Bankr. M.D. Ga. 2015).
[9] Mr. Appling and his wife filed a voluntary petition under Chapter 7 on January 18, 2013 in the Middle District of Georgia Bankruptcy court. *In re Appling,* Bk. No. 13-30083. The Trustee filed his report of no assets on April 23, 2013. Discharge entered on May 14, 2013. The Schedules disclose $1,443,514.99 in unsecured debt and no assets available for creditors (although there are 401(k) plan funds in the amount of $535,000)

In January 2013, Mr. and Mrs. Appling filed a petition under Chapter 7 of Title 11. The firm objected to the discharge of their debt. Trial was had before Bankruptcy Judge James P. Smith in September of 2014. Judgment entered on March 10, 2015, holding that the debt to the firm was not dischargeable pursuant to 11 U.S.C. §523(a)(2)(A).[10]

Before trial, Appling, the debtor, moved to dismiss arguing the "oral representation … is not actionable under section 523(a)(2)(A) because [it] is 'a statement respecting the debtor's ... financial condition' which, pursuant to section 523(a)(2)(B), must be in writing." *In re Appling*, 500 B.R. 246, 250 (Bankr. M.D. Ga. 2013). The Supreme Court agreed.

2. The Statute:

Section 523(a) reads:

> (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**; [or]
> >
> > (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; …

[10] In a procedural parallel to *Fustolo, below,* the Bankruptcy Judge's opinion after trial recites: "As originally pled in its complaint, Plaintiff contended that when Debtor promised to use an anticipated tax refund to pay legal fees owed to Plaintiff, he committed fraud because he, in fact, never intended to do so. However, at trial, Plaintiff amended its contentions to allege that Debtor lied about when an amended tax return had been prepared and the amount of the refund, and then subsequently lied about not having received it." *Matter of Appling*, 527 B.R. 545, 547 (Bankr. M.D. Ga. 2015), *aff'd sub nom. Appling v. Lamar, Archer & Cofrin, LLP*, No. 3:15-CV-031 (CAR), 2016 WL 1183128 (M.D. Ga. Mar. 28, 2016), *rev'd and remanded sub nom. In re Appling*, 848 F.3d 953 (11th Cir. 2017), *aff'd sub nom. Lamar, Archer & Cofrin, LLP v. Appling*, 138 S. Ct. 1752 (2018) (citing Bankruptcy Rule 7015)

11 U.S.C. § 523 (emphasis added).

The statement that Mr. Appling made was that he expected to receive a tax refund in the amount of $100,000. That statement was false. On appeal, no disputes remained as to whether elements of intent, reliance or damage were satisfied. If that statement describing a single asset was a statement "respecting the debtor's …financial condition" then part (B) applies and, because there was no writing, the debt arising from that fraud is discharged. If that statement about a single asset was not a statement "respecting the debtor's … financial condition" then part (A) applies and the debt is not discharged – the law firm may collect.

3. The Decision.

The issue then is whether a statement by a prospective debtor about a single asset is a statement "respecting" the debtor's financial condition. The circuit courts were split. The Fifth and Tenth Circuits had held that a statement about a single asset was not a statement respecting the debtor's financial condition. The Eleventh and Fourth Circuits had held that it was. The First Circuit had recently noted and avoided the issue. *In re Curran*, 855 F.3d 19, 22 (1st Cir. 2017). The Supreme Court, in a unanimous opinion (at least as to all except part III-B[11]) written by Justice Sotomayor held that a statement about a single asset is a statement respecting financial condition and therefore the debtor was relieved of the obligation.

The decision turned on the meaning of "respecting." The statute makes a statement respecting the debtor's financial condition dischargeable only if in writing. The Court looked to the ordinary meaning of the words used:

> As noted, the relevant statutory text is the phrase "statement respecting the debtor's financial condition." Because the Bankruptcy Code does not define the words "statement," "financial condition," or "respecting," we look to their ordinary meanings.

Appling, supra. 138 S. Ct. at 1759. No dispute existed around the meaning of the words "statement" or "financial condition" and so the dispute turned on the definition of "respecting:"

> There is no dispute as to the meaning of the first two terms. A "statement" is "the act or process of stating, reciting, or presenting orally or on paper; something stated as a report or narrative; a single declaration or remark." Webster's Third New International Dictionary 2229 (1976) (Webster's). As

[11] Justices Thomas, Alito and Gorsuch joined in all but part III-B of the opinion. Part III-B contains a rejection of the law firm's argument that holding that the debt was discharged leaves "'fraudsters' free to 'swindle innocent victims … lying about their finances, … just so long as they do so orally.'" *Lamar, Archer & Cofrin, LLP v. Appling*, 138 S. Ct. 1752, 1763 (2018). One may wonder whether they refused to join that part because of its interpretation of *Field v. Mans,* 516 U.S. 59, 116 S.Ct. 437, 133 L.Ed.2d 351 (1995), or instead because in their view statutory language was so clear that the policy argument was unnecessary. If the latter, one wonders why they joined in part III-A dealing with and rejecting the argument that holding the debt was discharged leaves the writing requirement implausibly broad.

> to "financial condition," the parties agree, as does the United States, that the term means one's overall financial status.

Id. The Court concluded (unanimously) that a statement is "respecting" financial condition if its truth has a bearing on the value of the debtor's assets and liabilities or ability to pay:

> We agree with both Appling and the United States that, given the ordinary meaning of "respecting," Lamar's preferred statutory construction—that a "statement respecting the debtor's financial condition" means only a statement that captures the debtor's overall financial status—must be rejected, for it reads "respecting" out of the statute.…
>
> We also agree that a statement is "respecting" a debtor's financial condition if it has a direct relation to or impact on the debtor's overall financial status. A single asset has a direct relation to and impact on aggregate financial condition, so a statement about a single asset bears on a debtor's overall financial condition and can help indicate whether a debtor is solvent or insolvent, able to repay a given debt or not. Naturally, then, a statement about a single asset can be a "statement respecting the debtor's financial condition."

Id. at 1761. Thus, the Supreme Court held that a statement about a single asset is a statement "respecting" the debtor's financial condition. Such a statement, if false, may be the basis for excepting the resulting debt from discharge only if the statement is in writing.

4. Lessons for Lawyers.

The first lesson is that if you have a bankrupt client that (apparently) never paid you, complains about the fees and lack of progress, makes derogatory jokes about lawyers,[12] owes you $100,000 after you have sued them and obtained judgment and it has been years since you did the work: move on. Even if the firm had won (as they did below), the likelihood of payment means it is probably not worthwhile.

Second, despite our polarized politics, the Supreme Court is unanimous on at least one rule: the words of the statute mean what they say.

Third, it now appears to be the law that any statement about the value of an asset (something that happens frequently in workout negotiations) is not the stuff of objections to dischargeability unless: (a) the creditor has reasonably relied after due inquiry (and not merely

[12] "Prior to the [March 2005] meeting, Debtor sent an email to David Davenport, a partner at Plaintiff law firm who was handling Debtor's case, complaining about the fees and costs being incurred in the litigation, the lack of progress in the litigation and concluding with a derogatory joke about lawyers."

Matter of Appling, 527 B.R. 545, 548 (Bankr. M.D. Ga. 2015), aff'd sub nom. Appling v. Lamar, Archer & Cofrin, LLP, No. 3:15-CV-031 (CAR), 2016 WL 1183128 (M.D. Ga. Mar. 28, 2016), rev'd and remanded sub nom. In re Appling, 848 F.3d 953 (11th Cir. 2017), aff'd sub nom. Lamar, Archer & Cofrin, LLP v. Appling, 138 S. Ct. 1752 (2018)

justifiably relied); *Field v. Mans*, 516 U.S. 59, 66, 116 S. Ct. 437, 441, 133 L. Ed. 2d 351 (1995); and (b) such statement is in writing. *Appling, supra.*

B. The Supreme Court: Husky Int'l Elecs., Inc. v. Ritz, 136 S. Ct. 1581, 194 L. Ed. 2d 655 (2016)

Appling is not the only relatively recent case by the Supreme Court dealing with 11 U.S.C. §523(a)(2)(A). Consistent with the theme that the statute says what it says, Justice Sotomayor, writing for a seven member majority[13] held that when conduct that amounts to "actual fraud" gives rise to a debt, then that debt is dischargeable even though the fraud involved no statement or false representation.

1. The facts:

Ritz was the owner of and controlled Chrysalis Manufacturing Corp., which was indebted to Huskie in the amount of $160,000. Ritz caused the various assets of Chrysalis to be drained into various other entities that Ritz owned through a scheme of fraudulent conveyances. Huskie sued Ritz based on a Texas statute that makes the shareholders of a corporation personally liable to creditors in the event of such frauds.[14]

Ritz' bankruptcy followed and Hertz sought an order excluding the debt owed to it on the grounds that the debt represented money obtained by actual fraud within the ambit of 11 U.S.C. §523(a)(2)(A). The Bankruptcy Court and the District Court held that the debt was dischargeable. The Fifth Circuit affirmed holding that "holding that a necessary element of 'actual fraud' is a misrepresentation from the debtor to the creditor…"*Husky, supra*, 136 S. Ct. at 1586.

2. The Decision

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[13] The decision was handed down at a time that there was a vacancy on the Court due to Justice Scalia's death.

[14] The statute reads:

(a) A holder of shares, an owner of any beneficial interest in shares, or a subscriber for shares whose subscription has been accepted, or any affiliate of such a holder, owner, or subscriber or of the corporation, may not be held liable to the corporation or its obligees with respect to:

(1) the shares, other than the obligation to pay to the corporation the full amount of consideration, fixed in compliance with Sections 21.157-21.162, for which the shares were or are to be issued;

(2) any contractual obligation of the corporation or any matter relating to or arising from the obligation on the basis that the holder, beneficial owner, subscriber, or affiliate is or was the alter ego of the corporation or on the basis of actual or constructive fraud, a sham to perpetrate a fraud, or other similar theory; or

(3) any obligation of the corporation on the basis of the failure of the corporation to observe any corporate formality, including the failure to:

(A) comply with this code or the certificate of formation or bylaws of the corporation; or

(B) observe any requirement prescribed by this code or the certificate of formation or bylaws of the corporation for acts to be taken by the corporation or its directors or shareholders.

(b) Subsection (a)(2) does not prevent or limit the liability of a holder, beneficial owner, subscriber, or affiliate if the obligee demonstrates that the holder, beneficial owner, subscriber, or affiliate caused the corporation to be used for the purpose of perpetrating and did perpetrate an actual fraud on the obligee primarily for the direct personal benefit of the holder, beneficial owner, subscriber, or affiliate.

Tex. Bus. Orgs. Code Ann. § 21.223 (West)

Justice Sotomayor writing for the court (with Justice Thomas dissenting) reversed holding that: "[t]he term 'actual fraud' in § 523(a)(2)(A) encompasses forms of fraud, like fraudulent conveyance schemes, that can be effected without a false representation." *Husky, supra.*, 136 S. Ct. at 1586. Justice Sotomayor began by noting that Congress amended the language in 1978 to add to the list of acts that might bar discharge so that the list included "actual fraud." *Id.* When makes such changes the Court "presume[s] [Congress] intends its amendment to have real and substantial effect." *Id.*

The Court followed the lead of *Field v. Mans, supra.,* and applied the common law understanding to the words used. The common law was clear:

> from the beginning of English bankruptcy practice, courts and legislatures have used the term "fraud" to describe a debtor's transfer of assets that, like Ritz' scheme, impairs a creditor's ability to collect the debt.

Id. Since such schemes have long been considered "frauds" and yet do not rely on any statement at all (let alone a false statement) the Court concluded that a debt obtained by such a fraud is excluded from discharge by the language of Section 523.

The Supreme Court remanded for further proceedings consistent with its opinion. On remand, the Bankruptcy Court held the debt non-dischargeable finding (among other things) that the personal debt of Ritz was obtained by the fraudulent conduct. *In re Ritz*, 567 B.R. 715, 762 (Bankr. S.D. Tex. 2017)

3. Lessons for Lawyers.

Two lessons arise: first, once again, the statute means what it says (applying when appropriate the understanding of common law lawyers).

Second, if your client received a fraudulent conveyance from a corporation your client controls, the debt to pay that back may not be dischargeable. As Justice Sotomayor put it:

> It is of course true that the transferor does not "obtai[n]" debts in a fraudulent conveyance. But the recipient of the transfer—who, with the requisite intent, also commits fraud—can "obtai[n]" assets "by" his or her participation in the fraud.

Husky Supra., 136 S. Ct. at 1589.

III. RECENT DEVELOPMENTS IN DISCHARGE - §727.

A. First Circuit: In re Hannon, 839 F.3d 63 (1st Cir. 2016) – Motion for Summary Judgment Granted on Scienter.

The surprising part about *Hannon* is that the First Circuit upheld a denial of discharge for a false oath on summary judgment.

Denial of discharge is warranted when the Debtor knowingly and fraudulently swears falsely in the proceeding. The statutory language is:

> (a) The court shall grant the debtor a discharge, **unless**--
> …
> (4) the **debtor knowingly and fraudulently**, in or in connection with the case--
> (A) **made a false oath** or account;
> …

11 U.S.C. § 727 (emphasis added). The statute incorporates a requirement that the plaintiff prove the defendant's mental state at the time of the false oath. It would seem difficult to prevail in such proof on summary judgment.

Difficult, but not impossible. The facts were that Hannon filed an individual Chapter 11. In a Chapter 11 proceeding the Debtor is required to file Monthly Operating Reports. Hannon filed and signed those reports. Each report was signed with a certification that read: "I declare under penalty of perjury (28 U.S.C. Section 1746) that this report and all attachments are true and correct to the best of my knowledge and belief." *In re Hannon*, at 74. The reports, so signed, omitted (when they were required to show) over $19,000 in payments made for his benefit. *Id.* at 68.

The Court first dealt with and rejected the argument that the certification was not an oath. It rejected the argument because it was first made on appeal, but then went on to say that if it had been preserved for appeal, it most probably would not have prevailed. *Id.*at 70-71. So there was an oath and it was false.

The Court turned to whether there was a triable issue of fact as to whether the omission was knowing and fraudulent. The words "knowingly and fraudulently" mean, and the requisite scienter is established if it is shown that:

> he knows the truth and nonetheless willfully and intentionally swears to what is false.… Reckless indifference to the truth has consistently been treated as the functional equivalent of fraud for purposes of § 727(a)(4)(A).…

In re Hannon, at, 72 (citations and quotations omitted). The scienter requirement is established if the plaintiff establishes that the Debtor knew the truth and with reckless indifference swore to what is false.

The Debtor argued that he relied on counsel. The Court rejected that based on "his demonstrated knowledge of what was required to be disclosed, and his undeniable knowledge that substantial sums spent on his behalf were not disclosed." *In re Hannon,* at 73.

The final element is that the false statement must be material. A statement is material: "if the statement bears a relationship to the debtor's business transactions or estate, or concerns the discovery of assets, business dealings, or the existence and disposition of property." *In re Hannon*, at 75. No party disputed the materiality of the statements.

B. First Circuit: In re Zizza, 875 F.3d 728 (1st Cir. 2017) – Attorney Fails to List Lawsuit and Defends on Advice of Counsel.

Zizza is part of the theme of lawyers doing aggressive or unsavory things. In *Appling* the debt was a lawyer's fee and attempts to collect. In *Hannon* the creditor that objected to discharge was a corporation controlled by a lawyer who had helped the debtor acquire the relevant businesses. In *Zizza* a lawyer was the debtor.

A lawyer as debtor is not surprising nor is being a lawyer grounds for objection to discharge, but this lawyer failed to list collection actions she had against clients for fees due.

On April 8, 2011, she filed her petition under Chapter 13. At the first meeting of creditors her attorney disclosed that she had amendments to make to the papers:

> Zizza, accompanied by Attorney Rozzi, testified under oath and when asked whether there were any changes she wanted to make to her initial filings, she said "No." Attorney Rozzi stepped in and stated that "[t]here are lawsuits ... [t]hat need to be added ... both lawsuits that Ms. Zizza or Attorney Zizza has out. And, uh, and she also has a personal injury claim." Later at the meeting, Attorney Rozzi said that he was "going to add any lawsuits that are important" in an amended filing.

In re Zizza, at 730–31. She amended her papers on September 23, 2011, to disclose matters in collection but did not list two lawsuits against Sapienza and Duffy. A year later, the Chapter 13 Trustee sought to dismiss the case:

> In September of 2012, Zizza settled the Sapienza action for $20,000, but she did not seek bankruptcy court approval for the settlement. On October 5, 2012, the Chapter 13 trustee, still unaware of the two lawsuits or the settlement, filed a motion to dismiss Zizza's bankruptcy case for failure to make plan payments. In response, on October 30, 2012, Zizza again amended her filings, finally disclosing the Duffy and Sapienza actions, as well as the settlement in Sapienza.

Id. at 731.

After trial, the bankruptcy court denied her discharge for the failure to list the two lawsuits on the papers. On appeal, she argued that the requisite scienter was not established because she relied on her attorney and his negligence resulted in the omission of the lawsuits. The First Circuit was having none of it:

> It is true that "an explanation by a bankrupt that he had acted upon advice of counsel who in turn was fully aware of all the relevant facts generally rebuts an inference of fraud." *In re Mascolo*, 505 F.2d 274, 277 (1st Cir. 1974). At the same time, "even the advice of counsel is not a defense

> when it is transparently plain that the property should be scheduled." *Id.* at 277 n.4.
>
> …
>
> It should have been "transparently plain" to Zizza, an experienced attorney, that she had an obligation to disclose the two lawsuits. In re *Mascolo,* 505 F.2d at 277 n.4. The question in the initial Statement of Financial Affairs could not have been clearer; it asked her whether she was involved in any suits within one year preceding her bankruptcy filing. Similarly, at the creditors' meeting, she was asked directly whether she needed to make any changes to her initial filings, and she responded "No." Yet, only four days later, she was in state court arguing a motion to reinstate the Duffy action. As the bankruptcy judge found, the questions posed to Zizza "were in plain English, and as an attorney, Ms. Zizza knew the meaning of signing documents under oath."

In re Zizza, at 732–33.

Lawyers can take at least two lessons from *Zizza:* First, falling on one's own sword will only go so far in protecting the client from their innate untruthfulness. The client's have to understand that they bear the ultimate responsibility for the truth of that which they sign. They should understand that they cannot ignore mistakes they think they see their lawyer make.

Second, correcting the error does not cure the false oath. Once the Debtor commits the false oath, future conduct can bear on proof of scienter, but it cannot un-ring the bell. It is important to get it right the first time.

C. First Circuit: In re Simmons, 810 F.3d 852 (1st Cir. 2016)—Discharge Failure to Keep Records; Objective Standard.

A false oath is not the only way debtors lose discharges. In *Simmons* the US Trustee did not prove that the debtor lied but merely that he failed to keep records. The Mr. Simmons once held twenty-seven (27) income producing parcels of real property but virtually no records. At the time of the bankruptcy petition the debtor held only five properties, all of which he intended to surrender. He could not "provide any details about the ultimate disposition of [twenty two] properties." *Id.* at 856. The US Trustee objected to discharge under 11 U.S.C. § 727(a)(3) and (5) – failure to keep records and failure to adequately explain loss or insufficiency of assets.

The statute under which the US Trustee proceeded reads:

> (a) The court shall grant the debtor a discharge, unless--
> …
> (3) 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 transactions might be**

> **ascertained, unless such act or failure to act was justified under all of the circumstances of the case;**
> …
> (5) 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**;

11 U.S.C. § 727 (emphasis added).

The First Circuit, in a decision authored by Judge Selya for a panel that included Mr. Justice Souter, began with the fundamental statement of bankruptcy policy noting two obligations imposed on a debtor as part of his or her fresh start:

> In exchange for a fresh start, a debtor must paint a basic picture of his financial condition and satisfactorily explain the disposition of his assets during the period leading up to the filing of his bankruptcy petition.

In re Simmons, *supra.,* at 855.

i. 727(a)(3) – record keeping.

Each obligation is governed by an objective standard. The obligation to keep records is an obligation to act as a reasonably prudent person would under the circumstances:

> Record-keeping need not be precise to the point of pedantry: records can be adequate without being textbook models. The operative standard is functional: a debtor's records must sufficiently identify the transactions so that intelligent inquiry can be made of them.… The standard is an objective one. A debtor's records may be judged deficient under section 727(a)(3) even if the debtor did not intend to conceal financial information,…or harbored an honest belief that he did not need to keep records,….

Id. at. 857–58 (citations and quotations omitted). The court characterized Mr. Simmons' records as a "black hole." *Id.* at 858.

Faced with the problem of this "black hole" Mr. Simmons attempted to argue that there were extenuating circumstances. The Court treated that as a defense:

> the debtor has the burden of proving justification,…, and his ability to prevail on such a defense turns on whether his asserted justification is objectively reasonable,… The standard is that of a reasonably prudent person in the same or similar circumstances.

Id. The court reviewed the utter absence of records in the face of years in the business and concluded "we think it nose-on-the-face plain that any reasonable property owner would have kept and preserved documentation detailing income, expenses, and property dispositions." *Id.* at 859.

The Court concluded the analysis of the failure to keep records thus: "a discharge may be denied where, as here, the debtor fails, *without any objectively reasonable justification*, to keep and preserve records." *Id.* (emphasis in original)

ii. 727(a)(5) Unexplained loss of assets.

Turning to the bankruptcy court's second ground for denying discharge, the First Circuit explained that the denial of discharge for an unexplained loss of assets starts within a burden shifting framework:

> A burden-shifting framework applies: if the party seeking to thwart a discharge shows that the debtor has not accounted for previously owned assets or previously earned income, the burden shifts to the debtor to explain the deficiency…. The debtor's explanation must be supported by at least some corroboration, and it must be sufficient to eliminate the need for any speculation as to what happened to all of the assets..… Something more than vague allusions is required. …

Id. at 860. The debtor's obligation is to explain satisfactorily – an objective standard. The objection does not require proof of a fraudulent intent merely lack of reasonable explanation.

In Mr. Simmons' case, the proffered explanation was not "coherent." *Id.* The debtor's problems under (a)(5) were aggravated by, and related to, his problems under (a)(3): "The hodge-podge of records that the debtor ultimately provided were not only unlabeled and disorganized but also proved inadequate to illuminate any of the relevant issues." *Id.*

With no records Mr. Simmons had no explanation as to what happened and was denied his discharge.

iii. Lessons for lawyers.

Lessons from *Simmons* vary depending on which side your client is on. If you represent a debtor, records are important. The past is important. Making sure that your client (especially if he or she has had a complicated history) has records that support the story is important.

If you represent the creditor, remember that in an action under 727(a)(3) or (5) intent is not relevant. The standard is objective.

D. *First Circuit: In re Fustolo, 896 F.3d 76 (1st Cir. 2018); 727(a)(6) and Rule 15 (b).*

i. Facts.

Fustolo is about matters unique to the bankruptcy court but was decided by rules applicable to all federal practice relating to amendments of pleadings. *Fustolo* begins with a loan in 2007 on property in Revere Beach and a foreclosure in 2008; judgment for $20 million in

2011 and an involuntary bankruptcy petition in 2013.[15] The lender filed its action to deny discharge in 2013 alleging transfers of property intended to conceal it from the estate (§ 727 (a)(2)), concealment, destruction or failure to keep records (§727(a)(3) and false oath (§727(a)(4)). A six day trial was held.[16]

As one might expect with lots of lawyers, millions of dollars at risk, and the hostility evidenced by an involuntary bankruptcy petition, allegations of cyber-bullying and other non-bankruptcy debtor criminal misconduct,[17] there were discovery disputes.

In one such dispute, the Plaintiff sought emails. The Mr. Fustolo feigned that the emails did not exist because AOL deleted them. The Bankruptcy Court, Judge Feeney, found that argument "devoid of merit", *In re Fustolo*, 563 B.R. 85, 93 (Bankr. D. Mass. 2017), *aff'd*, No. 17-CV-10128-LTS, 2017 WL 3896667 (D. Mass. Sept. 6, 2017), *rev'd and remanded*, 896 F.3d 76 (1st Cir. 2018). Debtor further argued that the emails were protected by his Fifth Amendment privilege against self-incrimination. In response Judge Feeney established a detailed procedure of a log and in camera review with deadlines. *Id.* at 93-95. The debtor, Mr. Fustolo, failed to comply. *Id.* at 96. The Plaintiff sought sanctions. Finding an intentional non-compliance with her order Judge Feeney awarded sanctions intimating that, if Plaintiff had sought it, judgment for the Plaintiff may have been an appropriate sanction. *Id.* at 99-100.

One of the sanctions sought and allowed was expedited trial. At the start of trial, "[t]he bankruptcy court immediately asked whether Patriot had a claim under § 727(a)(6), and counsel stated that Patriot [the plaintiff] did not." *In re Fustolo*, 896 F.3d at 82. The trial was preceded by the parties Joint Pre-trial Memorandum which listed one of the fact issues at trial as "Fustolo's discovery misconduct…" *Id. at 81.* At trial, Mr. Fustolo was questioned about his failure to comply with the Court's order to produce the emails. *Id.* at 82. Trial concluded on June 23, 2016. Two months later, on August 26, 2016, the parties submitted their post-trial briefs.

"In the last pages of Patriot's brief, it moved to amend its complaint to conform to the evidence presented at trial … to include a claim under § 727(a)(6)…" *Id.* Judge Feeney granted the motion, denied discharge under §726(a)(6) and did not reach the other grounds to deny discharge. The District Court affirmed. The First Circuit reversed and remanded.

ii. Law

Fed. R. Civ. P 15 (b) provides:

(b) Amendments During and After Trial.

[15] In re Fustolo, 563 B.R. 85, 88 (Bankr. D. Mass. 2017), aff'd, No. 17-CV-10128-LTS, 2017 WL 3896667 (D. Mass. Sept. 6, 2017), rev'd and remanded, 896 F.3d 76 (1st Cir. 2018)

[16] In re Fustolo, 563 B.R. at 90.("Two months later, the Court conducted a six-day trial on the Complaint on May 23, 24 and 26 and June 14, 15, and 23, 2016.")

[17] Separate adversary and criminal proceedings existed in which the Plaintiff accused the defendant of attempting to intimidate it through, among other things, "cyber-bullying and other misconduct perpetrated against Patriot and Howe." In re Fustolo, 563 B.R. 85, 97 (Bankr. D. Mass. 2017), aff'd, No. 17-CV-10128-LTS, 2017 WL 3896667 (D. Mass. Sept. 6, 2017), rev'd and remanded, 896 F.3d 76 (1st Cir. 2018)

> **(1) Based on an Objection at Trial**. If, at trial, a party objects that evidence is not within the issues raised in the pleadings, the court may permit the pleadings to be amended. The court should freely permit an amendment when doing so will aid in presenting the merits and the objecting party fails to satisfy the court that the evidence would prejudice that party's action or defense on the merits. The court may grant a continuance to enable the objecting party to meet the evidence.
>
> **(2) For Issues Tried by Consent.** When an issue not raised by the pleadings is tried by the parties' express or implied consent, it must be treated in all respects as if raised in the pleadings. A party may move--at any time, even after judgment--to amend the pleadings to conform them to the evidence and to raise an unpleaded issue. But failure to amend does not affect the result of the trial of that issue.

In *Fustolo* trial proceeded on three issues, one of which was whether or not Mr. Fustolo, through his discovery abuses "concealed, destroyed, mutilated, falsified, or failed to keep or preserve" records. 11 U.S.C. §727(a)(3). Testimony was taken on whether he complied with the Court's order to produce emails. Such testimony was (at least arguably) relevant to whether such concealment or destruction occurred. So, Fustolo could not "object on the ground that the evidence was not within the issues raised in the pleadings.…" Fed. R. Civ. P. 15(b)(2).

The issue was whether the727(a)(6) claim was tried by consent. There was no record of express consent and so the issue turned on implied consent. *In re Fustolo*, 896 F.3d at 84.

> Implied consent occurs by either treating a claim introduced outside the complaint as having been pleaded, either through [the party's] effective engagement of the claim or through his silent acquiescence; or by acquiescing during trial in the introduction of evidence which is relevant **only** to that issue.

Id. at 84 (citations and quotations omitted emphasis added). The implied consent inquiry has due process boundaries – the defendant is entitled to adequate notice and a meaningful opportunity to mount a defense:

> It is the defendant's inalienable right to know in advance the nature of the cause of action being asserted against him…, and thus …it is not enough that an issue may be inferentially suggested by incidental evidence in the record; the record must demonstrate that the parties understood that the evidence was aimed at an unpleaded issue…
>
> Finally, while the court has the discretion to allow late amendments, it may do so only if the non-moving party will not suffer undue prejudice.…At a bare minimum ... a defendant must be afforded both adequate notice of any claims asserted against him and a meaningful

> opportunity to mount a defense.… Lack of prejudice, however, does not compel a determination that the amendment is appropriate.…

Id. at 84–85 (citations and quotations omitted).

The Court concluded that allowing the amendment by implied consent was an abuse of discretion:

> Because we find that Fustolo did not have **fair notice** of the unpleaded claim and was **prejudiced by its addition**, we hold that the bankruptcy court's allowance of Patriot's motion to conform its pleadings under Fed. R. Civ. P. 15(b)(2) was an **abuse of discretion.**

Id. at 90 (emphasis added).

iii. Lessons and questions for lawyers.

First, the lesson: clearly presenting the theory for relief at trial is as important as presenting the facts.

Rule 8 requires merely a "short plain statement of the **claim** showing that the pleader is entitled to relief." Fed. R. Civ. P. 8 (emphasis added). The word "claim" is not the same as the word "facts."

Yet on motions to dismiss, it is not the legal claim that must be pled but the facts underlying it:

> To evaluate the sufficiency of a complaint under Rule 8, we first must distinguish the complaint's factual allegations (which must be accepted as true) from its conclusory legal allegations (which need not be credited).… We then must determine whether the factual allegations are sufficient to support 'the reasonable inference that the defendant is liable...

Cardigan Mountain Sch. v. New Hampshire Ins. Co., 787 F.3d 82, 84 (1st Cir. 2015) (quotations and citations omitted).

In pleading it is the facts that matter not the statement of the legal theory. For example, the failure to note in the pleading the correct theory is not fatal. Where a civil rights complaint failed to mention 42 U.S.C. §1983 but pled the facts for such relief, the Supreme Court summarily reversed dismissal saying:

> Federal pleading rules call for "a short and plain statement of the claim showing that the pleader is entitled to relief," Fed. Rule Civ. Proc. 8(a)(2); they do not countenance dismissal of a complaint for imperfect statement of the legal theory supporting the claim asserted.

Johnson v. City of Shelby, Miss., 135 S. Ct. 346, 346, 190 L. Ed. 2d 309 (2014).

Suppose though that the same facts support two different claims for relief (as in *Fustolo*). What is a lawyer to do? Make the case plain.

Second, what is to occur on remand? Mr. Fustolo refused to obey an order of the Court after the original complaint was filed. Is that conduct outside the core nucleus of operative facts that gave rise to the initial complaint?[18] Does his refusal to obey an order of the court gives rise to a separate action and in addition would permit revocation of the discharge, 11 U.S.C. § 727(d)(3), and therefore is not barred by the usual sixty-day limit to bring actions to object to discharge. Fed. R. Bankr. P 4004 (b)(2)?

Can the Plaintiff cure the notice and opportunity to defend problem by simply filing another complaint? Is Mr. Fustolo's victory merely temporary? Can the court re-open the pleadings, permit the amendment, and then permit trial with such other evidence as the parties deem necessary? Or is the trial court forced to evaluate and opine on the six days of trial as it relates only to the theories of relief on which it did not rule?

[18] "(1) When a valid and final judgment rendered in an action extinguishes the plaintiff's claim pursuant to the rules of merger or bar (see §§ 18, 19), the claim extinguished includes all rights of the plaintiff to remedies against the defendant with respect to all or any part of the transaction, or series of connected transactions, out of which the action arose.
(2) What factual grouping constitutes a transaction', and what groupings constitute a 'series', are to be determined pragmatically, giving weight to such considerations as whether the facts are related in time, space, origin, or motivation, whether they form a convenient trial unit, and whether their treatment as a unit conforms to the parties' expectations or business understanding or usage."

Restatement (Second) of Judgments § 24 (1982)