GRABBING THE BRASS RING

A Discharge in Consumer Bankruptcies

by David H. Stein

Attorneys in the field of bankruptcy law frequently encounter individuals in their daily practice who are categorized as 'consumer debtors.' While the definition of consumer debt is set forth in the United States Bankruptcy Code, a definition for consumer debtor is not. The term 'consumer debt' is defined by statute as meaning all debt incurred by a natural person "primarily" for a personal, family, or household purpose.[1] A consumer debtor is one whose financial obligations are primarily those that do not arise from the operation of a business.[2]

Consumer debtors often seek bankruptcy protection due to a loss of income, pressing medical bills, or a combination of both, which has resulted in their inability to cover or service a home mortgage or residential lease, and which has led to imminent foreclosure or eviction proceedings. Professional guidance is often required in the backdrop of intense family strife, and may require a quick but thoughtful undertaking to achieve an objective that will result in preservation of the family homestead or the alleviation of other concerns, such as collection proceedings, wage garnishment and the like. The role of bankruptcy counsel is critical, and cannot be underestimated in these dire economic circumstances.

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Eligibility for a Consumer Chapter 7 Bankruptcy Proceeding

In order to qualify for a Chapter 7 proceeding, a consumer debtor must successfully pass the 'means test,' a requirement enacted by Congress as part of the bankruptcy code to determine eligibility for filing a Chapter 7 bankruptcy proceeding.[3] The Chapter 7 bankruptcy proceeding, often coined as a 'straight liquidation,'[4] provides the honest debtor with the means to obtain a general bankruptcy discharge, yet keep those assets that are encompassed within the bankruptcy code's exemption thresholds.[5] These statutory exemption limitations protect essential family necessities (*e.g.,* basic values of real estate, motor vehicles, tools of the trade, etc.)[6] and enable the consumer debtor to retain those assets (or their monetary equivalent) in order to achieve what is often characterized as a 'fresh start,' involving a discharge of indebtedness rather than forfeiture of assets to a trustee or creditor due to a bankruptcy filing.[7]

The requirement for the means test was first introduced through the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA),[8] and was designed to imbue the process with financial responsibility, to keep higher wage earners from filing for bankruptcy under Chapter 7, and to direct those persons exceeding the means test to file either a Chapter 13 repayment plan or a Chapter 11 reorganization proceeding under the bankruptcy code. To determine a debtor's eligibility to file Chapter 7, the means test utilizes a measure of average income generated over a six-month period of time prior to the initiation of the bankruptcy proceeding.[9]

For example, in 2018, in the state of New Jersey, an individual debtor's qualifying average personal income level was capped at $66,284, computed on an annualized basis. For a family of four persons (*i.e.*, a filer with three dependents), the qualifying average income level increased to $121,226, also computed on an annualized basis.[10] Prospective filers who exceed the means test are precluded from filing a Chapter 7 bankruptcy and, instead, must avail themselves of the relief provided for under either Chapter 13 or Chapter 11 of the bankruptcy code, each of which requires some form of debt repayment through either a 'wage earner plan' or a plan of reorganization.[11]

Dischargeability of Debt

During the initial client in-take with a prospective consumer debtor, a discussion often ensues regarding the goals and objectives of the consumer filing. Among other things, consideration should be given as to whether, by invoking bankruptcy protection, a consumer debtor hopes to achieve an overarching strategy of debt relief and a path moving forward rather than simply to obtain a temporary stop-gap or 'breathing spell' to stay a collection, eviction, or other enforcement proceeding. When first meeting with an individual debtor contemplating the filing of a personal bankruptcy proceeding, whether under Chapter 7, Chapter 11 or Chapter 13 of the bankruptcy code, often the discussion between the attorney and the prospective client centers not only on family income, the assets and liabilities to be protected, and the eligibility for one form of bankruptcy over another, but also on whether or not the prospective client has dischargeable debt.

The bankruptcy code provides for specific and unique exceptions to the granting of a discharge to an individual debtor, which are set forth in Sections 523 and 727 of the code. Generally, Section 523 involves the exception to the discharge of specific debts that are centered upon the possible fraudulent, willful or malicious conduct of the debtor with respect to an individual creditor claim.[12] Section 727 of the code involves exceptions to the entire discharge of all

debts, and typically involves reporting and compliance requirements with respect to the administration of the bankruptcy estate.[13]

Statements of Financial Condition Must Be in Writing

In order to provide some clarity with respect to the nature and type of debts that are not subject to a general discharge for an individual bankruptcy filer, the United States Supreme Court recently issued an opinion in the matter of *Lamar, Archer & Cofrin, LLP v. Appling,*[14] in which the Court determined whether certain debts are nondischargeable for money, property, services, or credit obtained by a debtor, if made in writing, by a materially false "statement…respecting the debtor's… financial condition."[15]

The facts of *Appling* are straightforward and are remarkably commonplace in virtually all law practices. At some point, R. Scott Appling hired the law firm Lamar, Archer & Cofrin, LLP to represent him in certain business-related litigation. During the course of that litigation, Appling fell behind on the payment of his legal fees, and by March 2005, Lamar was owed more than $60,000.[16] In an effort to collect the outstanding debt, Lamar notified Appling that, if he did not pay the outstanding indebtedness due and owing, the firm would discontinue its representation, withdraw from the pending litigation and place a lien on its work product until the debt was paid in full. At a subsequent, in-person meeting among the parties, Appling, in an effort to induce additional work, verbally represented that he was expecting receipt of a large tax refund of "approximately $100,000," which would be sufficient to cover the current, as well as future, legal fees and costs owing to Lamar. Lamar relied upon this representation, did not initiate collection proceedings, and continued to provide legal services to Appling.

During this time, Appling and his wife filed joint tax returns, wherein they requested a refund of approximately $60,000 and through which, in Oct. 2005, they ultimately received a refund of $59,000. Thereafter, and unbeknownst to Lamar, Appling dissipated the proceeds of the tax refund on his business. In Nov. 2005, Appling and Lamar met again, at which time Appling verbally represented that the tax refund had not yet been received, despite the fact that the tax refund had been received and spent several months earlier. Based upon that representation, Lamar continued to provide legal services and delayed the imposition of collection proceedings against Appling.

In March 2006, Lamar sent Appling its final invoices. Five years after the conclusion of the lawsuit for which Lamar had been retained, the law firm obtained a judgment against Appling in the amount of $104,179.60. Appling and his wife subsequently filed a Chapter 7 bankruptcy proceeding in which they sought to discharge the judgment obtained by Lamar.

Lamar initiated an adversary proceeding against Appling in the Chapter 7 proceeding, seeking to determine whether the debt owed for legal fees was non-dischargeable because Appling had purportedly made "fraudulent statements" about his tax refund at the March and Nov. 2005 meetings. Appling, in turn, moved to dismiss the adversary complaint, contending that the alleged misrepresentations were "statements…respecting his financial condition" and were, therefore, governed by Section 523(a)(2)(B) of the bankruptcy code. Appling argued that Lamar could not prevent the discharge of the debt because the statements were not "in writing" as required for the non-dischargeability of debt under that provision.

In resolving a split among the circuits and in affirming the decision of the 11th Circuit Court of Appeals, the Supreme Court held, in a decision authored by Associate Justice Sonia Sotomayor, that statements respecting the debtor's financial condition may include a statement about a single asset rather than a comprehensive financial picture.[17] Those statements, however, in order to be deemed non-dischargeable, must be set forth in writing pursuant to Section 523(a)(2)(B) of the bankruptcy code.[18]

The Supreme Court found that the bankruptcy code contains broad provisions for the exception of certain debts from discharge. Once such exception is found under 11 U.S.C. § 523(a)(2), which provides that a discharge under Chapters 7, 11, 12 or 13 of the code "does not discharge an individual debtor from any debt…from money, property, services or an extension, renewal or refinance in credit to the extent obtained by fraud."[19] Section 523 (a)(2) of the code excepts from discharge those debts arising from various forms of fraud, arising from conduct characterized as "false pretenses, false representation or actual fraud other than a statement respecting the debtors…financial condition." Subparagraph B of the statute bars a discharge of debts arising from a materially false "statement… respecting the debtors financial condition" if that statement is "in writing."[20]

The Supreme Court, having analyzed the language contained in the statute and considered the arguments of counsel, determined that a statement of financial condition had an expansive interpretation, and that a statement of a debtor's financial condition may merely concern one asset rather than all of the categories of assets and liabilities found in a typical financial statement.[21] A debtor making a statement "respecting" financial condition has a direct relation to or impact upon the debtor's overall financial status and could aid in the recipient's determination of whether or

not the debtor is solvent, insolvent and has an ability to repay a given debt.

In reversing the holding of the bankruptcy court, which had determined that the debt owed by Appling to Lamar was not subject to discharge under Section 523(a)(2)(A), the Supreme Court found that the debt was dischargeable, since the statements made by Appling were in the nature of a debtor's financial condition under Section 523(a)(2)(B). The Court opined, however, that such statements should be in writing, since "doing so will likely redound to a creditor's benefit as such writing can foster accuracy and facilitate the more predictable, fair and efficient resolution of any subsequent dispute."[22]

Conclusion

In the course of on-going legal representation, Lamar certainly had the ability to obtain from Appling a written statement or an amended retainer agreement regarding continued representation, the timing of any projected tax filing, the amount of the projected tax refund and the pledge of the anticipated tax refund to the law firm. In a commercial context, these types of written statements are commonplace and must be closely examined by bankruptcy counsel representing either the consumer debtor or the creditor. Often, account debtors enter into settlement agreements in which their financial condition is represented. In addition, account debtors frequently enter into forbearance agreements and provide financial statements, balance sheets, borrowing base certificates, closing statements and other such documents representing their financial condition. These are the type of written statements that, if proven false and misleading, may constitute the basis for an assertion of a claim for nondischargeability of debt.

As a matter of practice, when an account debtor or other account party provides financial information upon which a creditor is relying, it is always beneficial to obtain those representations regarding solvency, financial condition or financial ability in writing, and to have them certified by the account debtor. Such financial representations should also be accompanied by a statement by the account debtor acknowledging that the recipient of the information is basing its decision regarding whether or not to extend credit, forbear or take any other action, consistent with those representations. These types of written documents will clarify the positions of the debtor and creditor, and may be the determining factor as to whether or not a claim will be deemed dischargeable in any subsequent bankruptcy proceeding. ⚖

Endnotes

1. 11 U.S.C. § 101(8).
2. § 5:1.Introduction, 1 *Bankruptcy Practice Handbook* § 5:1 (2d ed.).
3. 11 U.S.C. § 707(b) (2).
4. *In re Poydras Manor, Inc.,* 242 B.R. 603, 607 (Bankr. E.D. La. 2000).
5. 11 U.S.C. § 522.
6. *Id.*
7. *In re Bentley*, 266 B.R. 229, 242 (B.A.P. 1st Cir. 2001); *Stellwagen v. Clum,* 245 U.S. 605, 617, 38 S.Ct. 215, 62 L.Ed. 507 (1918).
8. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, S. 256, 109th Cong. (2005).
9. 11 U.S.C. §707.
10. Census Bureau Median Family Income By Family Size https://www.justice.gov/ust/eo/bapcpa/20180401/bci_data/median_income_table.htm.
11. Global Lessons from Consumer Bankruptcy and Healthcare Reforms in the United States: A Struggling Social Safety Net, 16 *Mich. St. J. Int'l L.* 343, 351 (2007).
12. 11 U.S.C.§ 523, 11 U.S.C. §727.
13. 11 U.S.C. §727.
14. *Lamar, Archer & Cofrin, LLP v. Appling*, 138 S. Ct. 1752, 1757, 201 L. Ed. 2d 102 (2018).
15. *Id.*
16. *Id.*
17. *Lamar, Archer & Cofrin, LLP v. Appling*, 138 S. Ct. 734, 199 L. Ed. 2d 601 (2018), and *aff'd sub nom. Lamar, Archer & Cofrin, LLP v. Appling,* 138 S. Ct. 1752, 201 L. Ed. 2d 102 (2018).
18. *Lamar, Archer & Cofrin, LLP v. Appling*, 138 S. Ct. 1752, 1757, 201 L. Ed. 2d 102 (2018).
19. *Id.* at 1758.
20. *Id.* at 1762.
21. *Id.* at 1760.
22. *Id.* at 1764.