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Discharges under the New Bankruptcy Code

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Unless otherwise indicated, all section references are to the Bankruptcy Act of 1978, Title 11 of the United States Code ("Code"). "B.C.D." refers to the Bankruptcy Court Decisions; "B.R.," to West's Bankruptcy Reporter; "C.B.C.," to Collier's Bankruptcy Cases; and "UCC," to the Uniform Commercial Code.

A. Effect of a Discharge

1. A discharge protects the debtor from any further personal liability on discharged debts. It voids judgments on discharged debts and enjoins any legal action to collect the debts from the debtor or from the property of the debtor. §524(a). Extrajudicial collection acts, such as dunning letters or telephone calls to collect discharged debts, are also barred.
2. Sections 524(c) and (d) severely limit the use of any reaffirmation agreement — an agreement to pay a debt discharged in bankruptcy — by:
 - a. Requiring that the agreement be executed before the discharge is granted;
 - b. Providing a hearing at which the bankruptcy court advises the debtor of the consequences of reaffirmation and that he is not required to reaffirm discharged debts;
 - c. Giving the debtor a right to rescind the reaffirmation agreement for 30 days after the reaffirmation hearing; and
 - d. If the reaffirmed debt is a "consumer debt" not secured by real property, requiring that the bankruptcy court ap-

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prove the agreement if it finds either that the agreement does not impose undue hardship and is in the debtor's best interests or that the agreement is a good faith settlement of dischargeability litigation under section 523 or provides for a redemption under section 722.

i. Note that if a creditor can convince the court that the reaffirmation agreement meets the section 524(c)(4)(B) requirement that it be a good faith settlement of dischargeability litigation under section 523 or provide for a redemption under section 722, then the court need not find that the reaffirmation is in the best interest of the debtor, as required by section 524(c)(4)(A).

ii. What is a "redemption under section 722"? Obviously, if D owes C \$3,000, a reaffirmation agreement calling for the payment of \$2,000 plus interest is a "redemption under section 722," governed by section 524(c)(4)(B), not section 524(c)(4)(A). What about an agreement to pay C the entire \$3,000 plus interest? Does the fact that the debtor will pay significantly more than he would be required to pay by section 722 prevent the agreement from being a "redemption under section 722" and make the agreement subject to the "best interest of the debtor" test of section 524(c)(4)(A)?

iii. Section 524(c)(4)(B) also applies to any "settlement of litigation under section 523." Is a determination of the merits of the litigation necessary? If D files a Chapter 7 petition while owing C \$3,000 and C claims that D submitted a false financial statement to induce the loan, when D signs a reaffirmation agreement, does C have to file a non-dischargeability complaint to come within section 524(c)(4)(B)? Does section 524(c)(4)(B) require the bankruptcy court to examine the merit of C's section 523(a)(2)(B) assertions?

iv. *Query:* In applying the "best interests" test of section 524(c)(4)(A), can a court consider noneconomic factors, such as the fact that the debtor's mother is a cosigner on the note?

- v. *In re Avis*, 6 B.C.D. 83, 3 B.R. 205 (S.D. Ohio 1980), refused to approve the reaffirmation of a debt cosigned by personal friends of the debtor. A number of cases have disapproved reaffirmation agreements when the amount of the debt reaffirmed is much greater than the value of the property securing the debt. *In re Blount*, 6 B.C.D. 618, 4 B.R. 92 (M.D. Tenn. 1980); *In re Jenkins*, 6 B.C.D. 471, 4 B.R. 65 (E.D. Va. 1980).
- e. Requesting a reaffirmation of a prebankruptcy debt as a condition precedent to granting a new postbankruptcy loan violates section 362(a)(6), which prohibits a creditor from taking any action to recover a claim against the debtor that arose before the commencement of the case. *In re Stephens*, 5 B.C.D. 1376, 2 B.R. 365 (N.D. Ohio 1980).
- f. Reaffirmation of a consumer debt requires new Truth in Lending disclosures. *Northwest Bank & Trust Co. v. Gutschall*, 274 N.W.2d 713 (Iowa 1979), *overruled in part*, *Ipalco Employees Credit Union v. Culver*, 309 N.W.2d 484 (Iowa 1981).
3. Subject to very limited exceptions, a governmental unit may not deny the debtor a license or a franchise or otherwise discriminate against him solely because he has received a bankruptcy discharge and refuses to pay discharged debts. §525. Cf. *In re Coleman American Moving Services, Inc.*, 7 B.C.D. 142, 8 B.R. 379 (Kan. 1980).
- a. The protection afforded by section 525 is limited.
- i. The section applies only to "governmental units," not to private employers or a quasigovernmental organization such as a state bar association.
- ii. The section only prohibits actions based "solely" on bankruptcy. It does not forbid the consideration of such factors as future financial ability or responsibility.

B. What a Discharge Does Not Do

1. A bankruptcy discharge protects only the debtor. §524(d). A

bankruptcy discharge does not affect the liability of other parties such as codebtors or guarantors.

- a. For example, if an insurance company is liable to the plaintiff in a personal injury action as a matter of state tort law, the subsequent bankruptcy discharge of the insured defendant does not alter the obligation of the insurance company.
2. The Fair Credit Reporting Act authorizes consumer reporting agencies to report any bankruptcy filings of a credit applicant within the past ten years. 15 U.S.C. §1688.
 3. A debtor who has been discharged from his debts may be discharged from his nongovernmental job.
 4. Professional organizations such as bar associations regularly obtain information about an applicant's bankruptcy history.
 5. A radio station can refuse to broadcast the advertising of a Chapter 11 debtor that does not disclose the bankruptcy proceeding. *In re Coachlight Dinner Theater of Nanuet, Inc.*, 7 B.C.D. 226, 8 B.R. 657 (S.D. N.Y. 1981).
 6. A bankruptcy discharge does not protect a debtor from being prosecuted for fraudulently writing checks. *See generally* Rendleman, *The Bankruptcy Discharge: Toward a Fresher Start*, 58 N.C.L. REV. 723, 736 (1980).
 7. A bankruptcy discharge has no impact on a lien that is valid in bankruptcy. *Long v. Bullard*, 117 U.S. 617 (1886); *In re Bell*, 7 B.C.D. 219, 8 B.R. 549 (E.D. Mich. 1981). *Contra, In re Williams*, 7 B.C.D. 388, 9 B.R. 228 (Kan. 1981).
 - a. Thus, if D owes C \$5,000, secured in part by a Chrysler Cordoba worth \$3,000, and D files for relief under Chapter 7, when D receives a Chapter 7 discharge, C's security interest is not terminated. If D defaults on his payments, C can repossess the Chrysler pursuant to UCC section 9-503. The discharge does, however, wipe out C's rights against D personally. If C repossesses and sells the Chrysler, he cannot obtain a deficiency judgment against D.

C. Discharge Procedures under Chapter 7

1. Only individuals are eligible for a discharge under Chapter 7. §727(a).
2. The discharge is automatic without any application by the debtor unless the trustee or a creditor objects to the discharge under section 727(a). Cf Rule 404(d).
 - a. Under Rule 404, as amended by suggested Interim Bankruptcy Rule 4002, the bankruptcy court sets a deadline for filing complaints objecting to the debtor's discharge and notifies creditors of this date.
 - b. If any creditor files an objection to a discharge, the bankruptcy court tries the issue of the debtor's right to a discharge.
 - c. Litigation over an objection to a discharge is an adversary proceeding governed by Part VII of the Bankruptcy Rules.
 - d. The objecting party has the burden of proving the facts on which its objection is based. Rule 407. *See generally In re Ramos*, 7 B.C.D. 458, 8 B.R. 490 (W.D. Wis. 1981).
3. Section 727(a) sets out all of the grounds for objecting to a discharge in a Chapter 7 case.
 - a. The debtor is not an "individual." §727(a)(1).
 - b. The debtor has transferred property with an "intent to hinder, delay, or defraud" a creditor. §727(a)(2).
 - i. A transfer of fully encumbered property cannot be the basis of an objection under section 727(a)(2). *In re Harris*, 7 B.C.D. 437, 8 B.R. 88 (M.D. Tenn. 1980).
 - c. The debtor has unjustifiably failed to keep books and records. §727(a)(3).
 - d. The debtor has "knowingly and fraudulently":

- i. Made a false oath or account in connection with a bankruptcy case;
 - ii. Presented or used a false claim against the estate;
 - iii. Received or given consideration for action or inaction in the bankruptcy proceeding; or
 - iv. Withheld books and records from the bankruptcy trustee. §727(a)(4).
- e. The debtor has failed to explain "satisfactorily" any loss of, or deficiency in, assets. §727(a)(5).
- i. This ground focuses on the truth of the debtor's explanation, not on the wisdom of the expenditures.
- f. The debtor has refused to obey a court order or to answer questions after being granted immunity or after improperly invoking the constitutional privilege against self-incrimination. §727(a)(6).
- i. Immunity is not automatic. Section 344 provides that immunity to debtors may be granted under Part V of Title 18, which, in 18 U.S.C. section 6003, requires an application by the United States Attorney.
- g. The debtor has committed any act specified in "b" to "f" above not more than one year before the filing of the bankruptcy petition in connection with another bankruptcy case concerning an "insider." §727(a)(7).
- h. The debtor was granted a discharge in another case commenced within six years. §§727(a)(8) and (9).
- i. The six years are measured from petition to petition.
 - ii. A Chapter 13 or XIII discharge is no bar if full payment has been made to the holders of unsecured claims or at least 70 per cent payment was made to the holders of unsecured claims and this represented the debtor's "best efforts."

- iii. Sections 727(a)(8) and (9) only limit the availability of a discharge in Chapter 7; they do not affect the ability of the debtor or creditors to file Chapter 7 petitions.
 - i. The court approves a written waiver of discharge executed by the debtor after the filing of the bankruptcy petition. §727(a)(10).
4. Exceptions to the discharge of particular debts, based on sections 523(a)(2), (4), and (6), must be asserted in bankruptcy court. §523(c).
- a. The time for filing requests for exceptions will be controlled by the new bankruptcy rules, when promulgated.
 - b. Under Rule 409, as amended by suggested Interim Bankruptcy Rule 4003, the bankruptcy court sets a deadline for filing a complaint contending that a particular debt is excepted from discharge by sections 523(a)(2), (4), or (6).
 - c. Any such complaint is tried as an adversary proceeding under Part VII of the Bankruptcy Rules.
5. A creditor or the debtor may file a complaint with the bankruptcy court to determine whether a particular debt is excepted from discharge by section 523(a)(1), (3), (5), (7), or (8). Rule 409(a)(1).
- a. The issue of dischargeability under these sections may also arise in connection with the creditor's collection efforts in a nonbankruptcy forum.
 - i. To illustrate, B, while owing C \$600 under a "property settlement agreement," files a Chapter 7 petition and receives a discharge. C only receives \$100 from the bankruptcy distribution. A month later, C sues B in state court. If B asserts his bankruptcy discharge, C can counter with a claim of an exception from discharge based on section 523(a)(5).
 - b. A bankruptcy court is not limited to a review of the judgment and record in a prior nonbankruptcy proceeding

when deciding a claim for an exception from discharge. *Brown v. Felsen*, 442 U.S. 127 (1979). In *In re Lilley*, 8 B.R. 561 (E.D. Pa. 1981), a state court judgment on a contract theory did not preclude the bankruptcy court from considering additional evidence of fraud.

D. Debts Excepted from Discharge under Chapter 7

1. Section 523(a) contains an exclusive list of the debts that are excepted from discharge. The most significant exceptions are the following:
 2. *Taxes*. Bankruptcy affords very little relief to the delinquent taxpayer. Most taxes are not discharged in bankruptcy.
 - a. All excise and income taxes for the three tax years immediately preceding bankruptcy are excepted from the bankruptcy discharge. §523(a)(1).
 - i. To determine this three-year period, compare the dates on which the tax return and the bankruptcy petition were filed. If D files a Chapter 7 petition on April 14, 1981, and his income tax return is not due until April 15, 1981, his tax obligations for 1980, 1979, 1978, and 1977 are excepted from discharge.
 - b. Taxes more than three years old are nondischargeable if a return was never filed, a late return was filed within two years of the filing of the bankruptcy petition, or the return filed was "fraudulent." §§523(a)(1)(B) and (C).
 - i. Section 17(a)(1)(c) of the old Bankruptcy Act contained a similar three-year rule for taxes not reported on a return. The courts held that taxes are not "reported on a return" if the return stated the facts giving rise to the liability but not the liability. *In re Donnell*, 639 F.2d 535 (9th Cir. 1981); *Wukelic v. United States*, 544 F.2d 285 (6th Cir. 1976). There is no comparable language in the new Bankruptcy Code.
 3. *Credit card purchases*. Debts resulting from last-minute

credit card purchases are not discharged. §523(a)(2)(A). Thus, if D uses his credit card for the purchase of a color television set the day before he files a Chapter 7 bankruptcy petition, bankruptcy will not discharge this debt.

- a. Section 523(a)(2)(A) is the counterpart to section 17(a)(2) under the old Bankruptcy Act. Section 17(a)(2) was successfully invoked by creditors to except certain credit card purchasers from the operation of the discharge. *See Zaret-sky, Intent to Repay*, 23 WAYNE L. REV. 1073 (1977).
 - b. Section 523(a)(2) expressly requires a “false representation.”
 - i. A credit card user represents that he is employing the credit card in accordance with the line of credit extended, which he undertakes to repay.
 - ii. *In re Stewart*, 7 B.R. 551 (M.D. Ga. 1980), relied on section 523(a)(2)(A) and the case law under the old Bankruptcy Act to find credit card purchases nondischargeable. The debtor there used his MasterCard from September 25 to October 2 to charge goods and services totaling \$300.40, without a single charge over \$50. The debtor filed for bankruptcy relief on October 16.
 - iii. *In re Lyon*, 8 B.R. 152, 3 C.B.C. 2d 644 (Me. 1981), held that mere proof that a credit line was exceeded was not sufficient “to infer an intent not to pay.”
 - iv. Section 523(a)(2)(A) is silent as to the debtor’s intent to deceive and the creditor’s reliance, but section 523(a)(2)(B) expressly requires such deception and reliance. Deception and reliance were required by the credit card cases under old section 17(a)(2). Credit card cases under the new section 523(a)(2)(A) also require proof of the debtor’s deception and the creditor’s reliance. *In re Stewart*, 7 B.R. 551, 554-55 (M.D. Ga. 1980).
4. *False financial statements.* A debt acquired by using a materially false financial statement, made with intent to deceive, on

which the creditor reasonably relied, is not dischargeable in bankruptcy. §523(a)(2)(B).

- a. Reliance can be established even though the debtor did not obtain any "fresh cash" from the creditor. *Cf. In re Archangeli*, 7 B.C.D. 63, 6 B.R. 50 (Me. 1980).
 - b. A credit check that reveals outstanding undisclosed loans defeats reliance. *In re Schlickmann*, 7 B.C.D. 30, 6 B.R. 281 (Mass. 1980).
 - c. *In re Archangeli*, 7 B.C.D. 63, 6 B.R. 50 (Me. 1980), seems to find an intent to deceive from the nature of the false statements. On the other hand, when a creditor completes a loan application, the intent to deceive claim is weakened. *In re Schlickmann*, 7 B.C.D. 30, 6 B.R. 281 (Mass. 1980).
 - d. Section 523(d) requires a bankruptcy court to charge a creditor who files unsuccessfully an exception to discharge under section 523(a)(2) with a reasonable attorney's fee for the debtor's attorney unless "clearly inequitable."
 - i. Attorneys' fees of \$350 were awarded in *In re Majewski*, 7 B.C.D. 112, 7 B.R. 904 (Conn. 1980), even though the creditor's complaint was filed in good faith. Attorneys' fees of \$2,600 were awarded in *In re Schlickmann*, 7 B.C.D. 30, 6 B.R. 281 (Mass. 1980), even though the creditor's complaint was not filed in bad faith.
 - ii. *In re Archangeli*, 7 B.C.D. 63, 6 B.R. 50 (Me. 1980), refused to award attorneys' fees when the creditor established the debtor's intent to deceive. "No judgment for attorneys' fees . . . is warranted because there is no showing . . . that the action by the Plaintiff was frivolous and was not brought in good faith." *In re Wetmore*, 8 B.R. 629, 630 (M.D. Fla. 1981).
5. *Sale of encumbered property*. If the debtor causes "willful and malicious injury . . . to the property of another entity," the debt for which the property was encumbered is not dis-

charged. §523(a)(6). Thus, when S sells D on credit a television set in which S retains a security interest, and if D sells the set “willfully and maliciously” to neighbor N and then files a Chapter 7 petition, the debt of D to S is not discharged, even though the sale defeats S’s security interest under UCC section 9-307(2) and S remains with an unsecured claim against D.

- a. Under the old Bankruptcy Act, section 17(a)(2) excepted from discharge liabilities for “willful and malicious conversion of the property of another.” A number of cases applied this language to bankrupts who disposed of encumbered property prior to bankruptcy. *Bennett v. W.T. Grant Co.*, 481 F.2d 664 (4th Cir. 1973).
- b. Section 523(a)(6) does not mention conversion. But the phrase “willful and malicious injury” in the section covers a willful and malicious conversion. CONG. REC. 17,412 (Oct. 6, 1978) (remarks of Senator DeConcini).
- c. Both the old act and the new Code use the phrase “willful and malicious.” Legislative history indicates that a different meaning is intended for the phrase in the Code. “Under this paragraph, ‘willful’ means deliberate or intentional. To the extent that *Tinker v. Colwell*, 139 U.S. 473 (1902), held that a looser standard is intended, and to the extent that other cases have relied on *Tinker* to apply a ‘reckless disregard’ standard, they are overruled.” H.R. REP. No. 95-595, 95th Cong., 2d Sess. 365 (1978).
- d. In *In re Hodges*, 4 B.R. 513 (W.D. Va. 1980), D purchased a stereo from S on credit, with S retaining a security interest. D sold the stereo to N and filed for Chapter 7 relief. S filed a complaint asserting an exception to discharge under section 523(a)(6). The bankruptcy court found that S failed to sustain its burden:

While he may well have willfully sold the secured property, he did not appear to do so maliciously. Testimony from the Debtor indicated that he did not intend to hurt or harm Grand Piano by selling the goods; he only meant to raise money to make his monthly mortgage payment. He clearly intended to continue payments to Plaintiff if able. We cannot circumvent that direct testimony absent testimony to

the contrary. We cannot hypothesize anything further about the Debtor's intent. We must therefore find that he did not sell the property "maliciously." *Id.*, at 517.

i. *Query*: Will the debtor usually intend to harm the specific holder of the secured claim? How can the secured holder meet the test of *Hodges*?

6. *Domestic obligations*. Alimony, maintenance, and support obligations are not dischargeable in bankruptcy. §523(a)(5).

a. Section 523(a)(5) replaces section 17a(7) of the old Bankruptcy Act. Section 17a(7) excepted child support and alimony for the maintenance or support of a wife from the operation of the discharge, but not obligations generated by a property settlement agreement.

This distinction in treatment arises from the basic differences between the purposes served by a division of marital property in a settlement agreement and the purposes served by imposition of the obligation of support or alimony payments. Alimony payments are intended to provide support for the spouse who may have no marketable skills or available time for employment due to his or her past and present obligations in the home and support payments are intended to provide support for the children in that spouse's custody. . . . Public policy favors such payments as long as they are useful in furthering society's interest that families not be left destitute. . . . The alimony and child support obligations arise from the dependent relationship between a husband and wife which may be created by a marriage. . . . On the other hand, property settlements are designed to distribute at the time of divorce the property acquired by the spouses during the marriage. . . . Property settlements are based on the equities existing between the parties at the time of divorce rather than on the wife's needs and the husband's income. . . . *In re Walder*, 10 C.B.C. 236, 240-41 (N.D. Wis. 1976).

b. Legislative history indicates that "[w]hat constitutes alimony, maintenance or support will be determined under the bankruptcy laws, not State law." H.R. REP. NO. 95-595, 95th Cong., 2d Sess. 79 (1978).

c. In *In re Demkow*, 8 B.R. 554, 555 (N.D. Ohio 1981), the bankruptcy court held the debtor's obligation to pay a second mortgage on his former wife's house dischargeable.

The separation agreement separately provided for alimony and headed the provision for the payment of the second mortgage "debts." *Demkow* is inconsistent with most cases and commentary.

- d. A number of cases have held that when a divorce decree requires a debtor to pay the attorneys' fees of his former spouse, the obligation is not dischargeable. *In re Wells*, 7 B.C.D. 272, 8 B.R. 189 (N.D. Ill. 1981); *In re Knabe*, 7 B.C.D. 185, 8 B.R. 53 (S.D. N.Y. 1980).
 - i. But *In re Crawford*, 7 B.C.D. 275, 8 B.R. 552 (Kan. 1981), relied on the language in section 523(a)(5)(A) to hold an attorney's fee obligation dischargeable as "assigned to another entity."

E. Discharge Procedures under Chapter 13

1. Section 1328(a) requires the discharge of a debtor who has completed all of the payments required by his Chapter 13 plan.
2. Section 1328(b) gives the bankruptcy court discretion to grant a "hardship" discharge to a debtor who has failed to make all the payments required by the plan.
3. In a proceeding under Chapter 13, whether the debtor will receive a discharge cannot be determined until the debtor either completes the payments under the plan or completes his efforts to make payments under the plan. §1328.
4. Numerous courts have considered discharge issues in determining whether to confirm a plan under section 1325. See Note, "Good Faith" and Confirmation of Chapter 13 Composition Plans: Analysis and a Proposal, 65 MINN. L. REV. 659, 671-73 (1981).

F. Debts Excepted from Discharge under Chapter 13

1. The section 1328(a) discharge of a debtor who has made all the payments required by the plan is more comprehensive than the section 1328(b) "hardship" discharge.

- a. Except for alimony, maintenance, and support obligations, which are not dischargeable, the section 523 exceptions are inapplicable to a section 1328(a) discharge. §1328(a)-(2); *In re Seely*, 6 B.C.D. 1003, 6 B.R. 309 (E.D. Va. 1980).
 - i. Senate Bill 863, filed on April 2, 1981, would change this.
- b. A long-term debt, such as a house mortgage, upon which the payments provided by the Chapter 13 plan extend beyond the term of the plan is not discharged. §1328(a)(1).
 - i. But education loans are discharged under section 1328(a) even if the payments extend beyond the term of the plan. *In re Smith*, 8 B.R. 543 (Utah 1981).
- c. The section 523 exceptions are applicable to a section 1328(b) discharge. Long-term debts upon which the payments provided by the plan extend beyond the term of the plan also are not discharged by a section 1328(b) discharge. §1328(c).