Non-Dischargeability of Debts Under Section 523(A)(2)(B) of the Bankruptcy Code

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The author explains the steps banks, financial institutions, and other creditors must take in order to demonstrate that a debt is non-dischargeable under Section 523(a)(2)(B) of the Bankruptcy Code.

The primary reason that individuals seek protection under the bankruptcy laws is to obtain a discharge from existing debts. Once a discharge is received, an individual has no obligation to repay any prior obligations and receives a "fresh start." However, the Bankruptcy Code does provide a mechanism for a bank, financial institution or other creditor to seek to have its debt deemed non-dischargeable. If successful, the debtor emerges with a discharge of all other debts but is still liable to the bank or financial institution.

Section 523(a)(2) of the Bankruptcy Code provides that an individual debtor will not be discharged from certain debts based upon various factors, including false pretences, false representations and fraud, other than a statement regarding the debtor's financial condition; or a materially false written statement regarding a debtor's financial condition upon which the creditor reasonably relied.[1] It is the latter provision upon which banks will more likely prevail in obtaining a non-dischargeable judgment against a debtor.

In order to demonstrate that a debt is non-dischargeable under Section

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523(a)(2)(B),[2] the movant must establish that a debtor obtained money or an extension of credit by: (i) the use of a statement in writing; (ii) that was materially false regarding the debtor's financial condition; (iii) on which the creditor reasonably relied; (iv) that the debtor caused to be made or published with intent to deceive.[3]

STATEMENT IN WRITING

A statement in writing typically involves a borrower or guarantor's financial statement or loan application presented to a lender in support of a request for a loan.[4] Although there is no requirement that the writing be signed by the debtor, more than one court has held that oral representations made over the phone to a loan representative then converted to a computer generated form is not a statement in writing.[5] On the other hand, one court has held that it is a written statement if caused to be prepared by debtor, even though the lender recorded information based upon a telephone conversation with the borrower.[6] That court concluded that the written statement requirement was met if "the existence of a written statement was caused to be prepared by the defendant."[7]

To avoid any uncertainty, it is advisable that a lender obtain a statement that has been signed by the borrower or guarantor. Most financial institutions have a form financial statement that includes a certification by the signatory. It is a good practice to have this form signed by the borrower or guarantor, both to ensure that the written statement requirement be met and for other reasons (related to reasonable reliance), as will be discussed below.

MATERIALLY FALSE REGARDING FINANCIAL CONDITION

The next element a movant needs to prove[8] is that the statement in writing was materially false regarding the debtor's financial condition. In 2007, a bankruptcy court in West Virginia, quoting the United States Court of Appeals for the Second Circuit, explained that for purposes of Section 523(a)(2)(B)(i), a statement is materially false if it paints a substantially untruthful picture of a financial condition by misrepresenting information of the type which would normally affect the decision to grant credit.[9] Other courts have noted that a relevant inquiry is whether the lender would have made the loan had he known the debtor's true situation.[10] Earlier this year, a bankruptcy court in New York concluded that a financial statement was materially false because the debtor did not actually own several properties listed on the financial statement with a purported equity value of more than $1 million.[11]

Similarly, the United States Court of Appeals for the Fifth Circuit recently upheld an appeal from a decision rendering a debt non-dischargeable, in part, because the financial statement included material misstatements.[12] Knowing that the financial statement included an $857,000 overstatement, the debtor still sent the statement in connection with a bid submitted to perform a subcontract.[13] Recently, the Bankruptcy Court for the Eastern District of Virginia concluded that a debtor's financial statement was materially false because the omission of a credit facility secured by a second mortgage on the debtor's residence meant that the equity was $95,000, not $225,000,[14] and also failed to disclose $28,000 in loans owed.

REASONABLE RELIANCE

Reasonable reliance is probably the most difficult issue for a lender. While proving reliance is usually easy, the lender must also demonstrate that the reliance was reasonable. With regard to whether a creditor reasonably relied on a statement in writing, many courts have found that Congress did not intend for creditors to perform an independent verification of statements submitted by borrowers.[15] The general view is that there is no affirmative requirement that a creditor verify from external sources the information on a financial statement. For example, in *In re Ross*, the court commented that it would not allow the debtor to escape liability by mandating that the creditor bank was under a duty to ferret out each of the debtor's intentional misstatements.[16] Similarly, the Bankruptcy Appellate Panel for the Tenth Circuit has held that requiring a creditor to affirmatively investigate numerous documents to verify the accuracy of a financial statement that it had no reason to question went beyond the reasonableness required by section 523(a)(2)(B).[17]

In *In re Davis*, a debtor intentionally misrepresented the value of a checking account, several pieces of real estate, mutual funds and a tax refund.[18] The creditor reviewed a credit report, as was the financial institution's common practice, and relied on the values as stated in the financial statements.

Determining the debt to be non-dischargeable, the court held that the creditor was under no duty to inquire further about the assets. "The reasonable reliance requirement is often satisfied by evidence that the credit would not have been extended if accurate financial information had been disclosed."[19]

In determining that a creditor's reliance was not reasonable, courts have identified the following factors:

- Where a creditor has knowledge from a prior experience that the financial statement is not accurate or is erroneous on its face;
- Where the statement contains obviously inadequate financial information;
- Where the creditor conducts an investigation which suggests the financial statement is false or incomplete;
- Where the creditor does not follow its usual and customary steps to verify the information provided.[20]

While a creditor has no duty to investigate every aspect of a credit application or financial statement that it had no reason to question, where there are noticeable inaccuracies, a creditor does have a duty to investigate further.[21] Here, there were discrepancies between the financial statement and the debtor's pay stubs. The court held that the creditor should not have ignored these differences because the documents submitted in support of the credit application should have raised a flag.[22] A lender does not have a right to ignore glaring inconsistencies or blatant falsehoods in a credit application.[23]

In *In re Broyles*,[24] the Fourth Circuit affirmed the lower court's finding that a debt owed to Citizens Bank of Maryland was dischargeable. Based upon the facts, the bankruptcy court noted that: (1) the bank did not require personal financial statements in the commitment letter; (2) even without personal guarantees, the arrangement was beneficial to the bank, and (3) the bank documents showed that the rationale for approving the loan was a long-term deposit and loan relationship and earnings performance.[25] Also, the bank's primary witness did not testify that he or the bank had relied on the understatements of the guarantors' liabilities in the personal financial statement.[26]

INTENT TO DECEIVE

Courts have pointed out that: "A debtor will rarely admit that he intended to deceive a creditor."[27] Accordingly, courts have held that an intent to deceive under § 523(a)(2)(B) can be inferred from the totality of the circumstances surrounding the debtor's acts, including the debtor's knowledge of or reckless disregard for the accuracy of his financial statements.[28]
"A creditor can establish intent to deceive by proving reckless indifference to, or reckless disregard of, the accuracy of the information in the financial statement of the debtor when the totality of the circumstances supports such an inference."[29] Other courts have noted that: "Reckless disregard for the truth or falsity of a statement combined with the sheer magnitude of the resultant misrepresentation may combine to produce the inference [sic] of intent [to deceive]."[30] Typically, a court will look at the totality of the circumstances to determine whether there was an intent to deceive.

CONCLUSION

While recovery may look bleak when a borrower files for bankruptcy, it is always prudent for a lender to review the files to determine if there is any basis to assert that its debt is non-dischargeable. Assuming that there are inconsistencies between the financial statement provided to the lender and the debtor's bankruptcy schedules, the lender may have a basis to seek a determination that other debt is non-dischargeable. To prevail, the lender will have to document that the statement in writing was materially false and that the lender reasonably relied on the written statement that was presented with intent to deceive.

NOTES

1 11 U.S.C. Section 523(a)(2).
2 11 U.S.C. Section 523(a)(2)(B).
3 11 U.S.C. Section 523(a)(2)(B). *See also In re Sapp*, 354 B.R. 618 (Bankr. N.D. W. Va. 2007); *In re Koep*, 334 B.R. 364 (Bankr. D. Md. 2005).
4 *See, e.g., In re Allen*, 65 B.R. 752 (E.D. Va. 1986) (debtor signed loan application

and personal financial statement); *In re Sapp*, 364 B.R. 618 (Bankr. N.D. W.Va. 2007) (debtor submitted loan application for purpose of purchasing mobile home); *In re Koep*, 334 B.R. 364 (Bankr. D. Md. 2005) (debtor signed various loan applications and HUD-1 settlement statements).

5 *In re Kaspar*, 125 F.2d 1358 (10th Cir. 1997) (not statement in writing where debtor had neither seen nor signed document that lender filled in); *Orsini*, 2007 WL1006919, *aff'd* 2008 WL3342017 (5th Cir., Aug. 11, 2008) (not statement in writing where one guarantor met with lender's employee who recorded her answers which she never reviewed nor signed); *In re Valdez*, 2007 WL 1160357 (Bankr. N.D. N.M., Apr. 17, 2007) (where loan officer prepared loan information that contained false information and debtor did not sign document, court found this was not statement in writing).

6 *In re Graham*, 122 B.R. 447 (Bankr. M.D. Fla. 1990).

7 *Id.* at 451.

8 The burden of proof is by a preponderance of the evidence. *See Grogan v. Garner*, 498 U.S. 279, 290 (1991); *See also In re Koep*, 334 B.R. at 371; *The Cadle Co. v. Orsini*, 2007 WL 1006919 (E.D. Tex., March 30, 2007); *In re Fisher* 2004 WL 1811264*2 (Bankr. M.D. N.C. Aug. 2, 2004) (creditor has burden of proof and standard in preponderance of evidence).

9 *In re Sapp*, 364 BR at 626. For a thorough review of the legislative history on this issue, *see In re Allen,* 65 B.R. 752 (E.D. Va. 1986).

10 *In re O'Connor*, 149 B.R. 802, 807 (Bankr. E.D. Va. 1993).

11 *In re Lavender,* 2009 WL 367493*6 (Bankr. E.D.N.Y., Feb. 9, 2009).

12 *In the matter of Morrison*, 555 F.3d 473, 476 (5th Cir. 2009).

13 *Id*. at 477.

14 *In re Orts*, 2009 WL 903259*9 (Bankr. E.D. Va. Feb. 24, 2009).

15 *In re Brevard*, 200 B.R. 836, 845 (Bankr. E.D. Va. 1996).

16 180 BR 121 (Bankr. E.D. Va. 1994).

17 *In re Watson*, 2003 WL 21241702 at * 5-6.

18 262 B.R. 573, 681 (Bankr. E.D. Va. 2001).

19 *Id.* at 680.

20 *In re Brevard* 200 B.R. at 845 (citing *In re Wingo*, 112 B.R. 141, 145 (W.D. Va. 1990). *See also In re Matter of Patch*, 24 B.R. 563, 567 (D. Md. 1982) (reliance was not reasonable where lender knew financial statement was incomplete or false).

21 *Avco Financial Services, Inc. v. Abdul'Faruq*, 175 B.R. 618 (Bankr. E.D. Va. 1994).

22 *Id.* at 623.

23 *Id.*

24 55 F.3d 980 (4th Cir. 1995).

25 *Id.* at 983.

[26] *Id.* at 984.

[27] *In re Dalton*, 205 F.3d 1332, 2000 WL 191850 (unpublished opinion) (4th Cir. 2000).

[28] *Id.* at 3. *See also In re Orts*, 2009 WL 903259 at * 9 (intent to deceive can be proven by persuasive circumstantial evidence).

[29] *In re Cohn*, 54 F.3d 1108, 1119 (3d Cir. 1995).

[30] *In re Miller*, 39 F.3d 301, 305 (11th Cir. 1994) (citations omitted).