Fashionable Trends in Consumer Fraud

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FASHIONABLE TRENDS IN CONSUMER FRAUD

Fraudulent Conveyance Litigation in Chapter 7
By: David M. Klauder, Esq.

I. Introduction

Fraudulent conveyance litigation is a fairly common occurrence in chapter 7 cases. While mostly prevalent in business cases, fraudulent conveyance litigation does play a part in consumer bankruptcies. Fraudulent conveyances traditionally are not considered "fraud" as most people understand that term, however from a legal perspective fraudulent conveyances consist of many of the characteristics of fraud that lawyers are familiar with. Terms and phrases like "intent to hinder, delay or defraud creditors" or the "badges of fraud" are common elements and characteristics of fraudulent conveyances. Without a direct admission from a transferor, proving "actual intent" to defraud one's creditors is very difficult, therefore much is left to courts to use the facts and circumstances of the case to develop whether a fraudulent conveyance has occurred. Fraudulent conveyance litigation goes back hundreds of years and has firm roots in English common law. The English courts were the first to develop the objective factors to determine if a fraudulent conveyance occurred (i.e, the precursor to what we now know as the badges of fraud). The first reported case on these factors is *Twyne's* Case, (1601) 76 Eng. Rep. 809, 810; Co. Rep. 80b, which, of all things, involved a transfer of sheep to satisfy a debt.

Now fast-forwarding hundreds of years, the standards for fraudulent conveyance litigation from *Twyne's* Case are still used today by courts, both on the state level (as virtually every state has some type of fraudulent conveyance statute on the books) and the federal level, most particularly bankruptcy courts, which interpret Bankruptcy Code section 548. We will discuss bankruptcy litigation involving both state law fraudulent conveyance causes of action and federal law fraudulent conveyance causes of action. However, we will begin with a very recent development in the law courtesy of the Supreme Court. The Supreme Court's *Husky* decision involves, at its core, a fraudulent conveyance fact pattern, but the Supreme Court assessed whether a fraudulent conveyance can be "actual fraud" such that it could cause a debt to be nondischargeable in bankruptcy.

A. **Is a fraudulent conveyance cause for nondischargeability of a debt under section 523(a)(2)(A)?** – Supreme Court decision in *Husky International Electronics Inc. v. Ritz*, ____ U.S. _____, 136 S.Ct. 1581 (Decided May 16, 2016)

1. **Issue:** Whether the dischargeability exception for "actual fraud" under Bankruptcy Code section 523(a)(2)(A) includes fraudulent conveyances, even when that fraudulent conveyance does not involve a false representation

2. **Facts of Case:** Chrysalis Manufacturing Corp. ("Chrysalis") incurred a business debt of $164,000 to Husky International Electronics, Inc. ("Husky"). Daniel Lee Ritz, Jr. ("Ritz"), the eventual debtor in chapter 7, was a director and part owner

of Chrysalis. It was alleged that Ritz drained Chrysalis of assets to pay this debt by transferring money to other Ritz-controlled entities. Husky sued Ritz; Ritz then filed chapter 7; Husky then filed a complaint objecting to the discharge of its debt contending that this inter-company transfer scheme by Ritz was "actual fraud" pursuant to section 523(a)(2)(A).

Section 523(a)(2)(A) provides:

"(a) A discharge under section 727. . .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"

(Emphasis added in bold).

District Court found that Ritz was personally liable for a fraudulent conveyance under state law, however the debt was not "obtained by. . . actual fraud" under section 523(a)(2)(A) and therefore it could be discharged. The Fifth Circuit affirmed and held that a misrepresentation from a debtor to a creditor is a necessary element for "actual fraud".

3. **Holding**: The Supreme Court overruled the Fifth Circuit and held that "actual fraud" under section 523(a)(2)(A) encompasses fraudulent conveyance schemes, even when those schemes do not involve a false representation between debtor and creditor.

4. **J. Thomas Dissent**: The lone dissenter, Justice Thomas, disagreed with the majority holding and wrote that the statutory phrase "obtained by" in section 523 is an important limitation on the reach of the provision. Therefore, he wrote that section 523(a)(2)(A) applies only when the fraudulent conduct occurs at the inception of the debt, when the debtor commits a fraudulent act to induce the creditor to give the debtor money.

5. Potential Implications:

a.) Is there an obligation by an estate representative (i.e., chapter 7 trustee or U.S. Trustee) to bring a nondischargeability action when a fraudulent conveyance has been asserted? Similarly, is section 727(a)(2)(A) now implicated as well?

b.) Will this open up the floodgates for creditors to bring nondischargeability actions?

c.) Does the Supreme Court's finding in this case that false representation between debtor/creditor is not needed have broader implications?

B. Examples of Fraudulent Conveyance Litigation in Chapter 7

1. Who brings? Chapter 7 trustees

2. Traditional Fraudulent Conveyance Actions in Bankruptcy - 11 U.S.C. § 548

a.) Actual Fraudulent Transfers - § 548(a)(1)(A)

-- *Elements*: transfer made by the debtor within 2 years of the bankruptcy filing with the actual intent to hinder, delay or defraud creditors

-- *Key Points*: Neither solvency of debtor, nor adequacy of the consideration are directly an element, although those issues factor in the analysis of intent. Actual intent based on the traditional badges of fraud

-- *Badges of Fraud*: (1) whether the transfer or obligation was to an insider; (2) whether the debtor retained possession or control of the property transferred after the transfer; (3) whether the transfer or obligation was disclosed or concealed. (4) whether before the transfer was made or obligation was incurred, the debtor had been sued or threatened with suit; (5) whether the transfer was of substantially all the debtor's assets; (6) whether the debtor absconded; (7) whether the debtor removed or concealed assets; (8) whether the value of the consideration received by the debtor was reasonably equivalent to the value of the asset transferred or the amount of the obligation incurred; (9) whether the debtor was insolvent or became insolvent shortly after the transfer was made or the obligation was incurred; (10) whether the transfer occurred shortly before or shortly after a substantial debt was incurred; (11) whether the debtor transferred the essential assets of the business to a lienholder who transferred the assets to an insider of the debtor. *See, e.g., Finkel v. Polichuk (In re Polichuk)*, 506 B.R. 405, 417 (Bank. E.D. Pa. 2014).

b.) Constructive Fraudulent Transfers - § 548(a)(1)(B)

-- *Elements*: transfer made by the debtor within 2 years of the bankruptcy filing for less than reasonably equivalent value and debtor (i) was insolvent on the date the transfer was made or became insolvent as a result of such transfer or (ii) was engagement in business or a transaction, or about to engage, for which any property remaining with debtor was an

unreasonably small capital or (iii) intend to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured or (iv) made such transfer to or for the benefit of an insider under an employment contract and not in the ordinary course of business

-- *Key Points*: Insolvency of the debtor is important but it does not matter that the transferor made the transfer with no intent to avoid paying his/her debts

3. Trustee Strong-Arm Fraudulent Conveyance Actions in Bankruptcy - 11 U.S.C. § 544(b)

   a.) State Law Fraudulent Conveyance Actions

   - Trustee may bring a state law cause of action pursuant to section 544(b) by suing to avoid a transfer that is voidable under non-bankruptcy law by an actual, existing creditor holding an allowable unsecured claim

   - Trustee stands in the shoes of the hypothetical creditor in this scenario (who must be able to assert the state law cause of action), but trustee is bound by any defenses that could be asserted against the creditor

   b.) Uniform Fraudulent Transfer Act (UFTA) – most states have adopted

   - Very similar elements to section 548(b)(1)(A) & (B)- actual fraudulent transfers and constructive fraudulent transfers

   - Typically longer look back period for transfers under state law (Delaware – 4 years after the transfer was made)

4. Recovery of Avoided Transfers - 11 U.S.C. § 550

   a.) For a transfer avoided under sections 544 and/or 548, the trustee may recover the property transferred, or the value of the property, from the initial transferee or any "immediate or mediate transferee"

   b.) Defenses include a transferee that takes "for value", in "good faith", and "without knowledge of the voidability of the transfer avoided"; and "any immediate or mediate good faith transferee"

   c.) No double recovery – trustee is only entitled "a single satisfaction"

d.) Must commence an action under section 550 upon the earlier of i.) 1 year after the avoidance of the transfer or ii.) the time the bankruptcy case is closed or dismissed

5. Relevant and Interesting Case Law

a.) Return of fraudulently transferred property provides a defense to a fraudulent transfer claim

- **Finkel v. Polichuk (In re Polichuk), 506 B.R. 405 (Bankr. E.D. Pa. 2014).** The debtor transferred real property to his brother-in-law, who transferred it back to him about one year later. The debtor later sold the property for reasonably equivalent value. Circumstances suggested that the debtor might have made the initial transfer with actual intent to hinder, delay, or defraud creditors. The trustee sued under section 544(b) to avoid the transfer to, and to recover the real property or its value from, the brother-in-law. Under section 544(b), the trustee may avoid an actual or constructive fraudulent transfer of property of the debtor under applicable nonbankruptcy fraudulent transfer law, in this case the Pennsylvania Uniform Fraudulent Transfer Act. The UFTA's and section 544(b)'s purpose is to preserve estate assets for creditors' benefit. To that end, the trustee's remedy is recovery from the transferee of fraudulently transferred property or its value. If the estate has already recovered the property's value, a judgment against the transferee would allow the estate double recovery. Therefore, where the transferee returns the property to the debtor before bankruptcy, the trustee may not recover the property or its value.

b.) Recovery under section 550 does not require actual possession of the property

- **In re Allen, 768 F.3d 274 (3d Cir. 2014)** – A pre-petition settlement between ATN, which filed a chapter 11 bankruptcy, and the Debtor, who filed a chapter 7, resulted in ATN transferring $6 million to Debtor. An Order, through proceedings in ATN's bankruptcy, was entered for ATN to recover the transferred amount, but not before Debtor transferred the amount to an offshore bank account. ATN filed an adversary case seeking a declaration that the litigation relating to the repatriation of the $6 million was not stayed as this money was property of its estate and not Debtor's. To "recover" under §§541(a)(3) and 550 does not require actual possession. ATN obtaining a judgment for recovery of the funds transferred and being prevented from obtaining actual possession because of the Debtor's actions meant that the amount was the property of ATN's estate.

c.) Stock dilution can be a form of fraudulent conveyance

- **Bank of Am., N.A. v. Veluchamy, Civil Action No. 15 CV 882, 2015 U.S. Dist. LEXIS 115013 (N.D. Ill. Aug. 27, 2015)** – Debtor and her children owned shares in a closely held corporation. Debtor, who has a controlling interest, causes a pre-petition stock dilution which raises the relative interests of her children. Court looked to UFTA handling of similar situations as it was meant to align state law with bankruptcy law. Cases reviewing such transfers typically ignore the form of the transfer through dilution and focus on the actual percentage of ownership that was transferred. The Debtor, who controlled the corporation, utilized the dilution to transfer her interest to her children, constituting a fraudulent transfer.

d.) Husband and wife/Tenancy by the Entirety transfer cases

- **In re Wettach, 489 B.R. 496 (Bankr. W.D. Pa. 2013**) - Trustee alleged that Debtor engaged in fraudulent transfers when he caused his individual compensation to be deposited into various accounts and business interests held jointly with his wife as entireties' property, some of which were then used to acquire other assets. The contention was that such deposits constituted "transfers" under the Pennsylvania Uniform Fraudulent Transfer Act (PaUFTA), 12 Pa. Cons. Stat. § 5101 et seq., and that such transfers by debtor were fraudulent, either actually or constructively so. One of the general principles the court applied was that the deposit or payment of individual debtor compensation into an entireties account or other entireties' property may constitute a fraudulent transfer for purposes of PaUFTA unless such payments or deposits were subsequently spent on "necessities" for the marital unit. The court found no suggestion of actual fraudulent intent. However, the Trustee proved by a preponderance of evidence that all necessary elements for a constructive fraudulent transfer claim under 12 Pa. Cons. Stat. § 5105 related to the entireties' account existed, allowing for the trustee to recover over $400,000.

- **Cardiello v. Arbogast (In re Arbogast), 466 B.R. 287 (Bankr. W.D. Pa. 2012)** - Where debtor had his compensation deposited directly into an account owned with non-debtor spouse as tenants by the entirety, trustee could recover against debtor and/or spouse as constructively fraudulent under 12 Pa. Cons. Stat. § 5104(a) and § 5105 disbursements from account used in connection with a home they owned as tenants by the entirety.

- **Shearer v. Oberdick (In re Oberdick), 490 B.R. 687 (Bankr. W.D. Pa. 2013)** – Trustee alleged that Debtor engaged in fraudulent transfers when, subsequent to the initiation of the creditor's litigation, he deposited his

individual earnings from a law firm into a checking account he jointly owned with his wife as tenancy by the entireties. Regarding the actual fraud count, the court found an actual intent claim had not been proven. There was no evidence to show that debtor continued to make the deposits after the litigation began out of an intent to defraud creditors. Regarding the constructive fraud counts, the trustee met his burden of proving that certain amounts were not spent on necessities by defendants, and were therefore recoverable. However, defendants were entitled to an "offset," due to a refunded expenditure, which reduced the recovery to zero, so the Trustee could recover nothing on his Pennsylvania Uniform Fraudulent Transfer Act claims.

WHEN IS A DEBTOR ENTITLED TO RECOVERY OF ATTORNEY'S FEES IN ADVERSARY PROCEEDINGS?

The Application of 11 U.S.C. 523 (a)(2)(A) and 523(d) in Dischargeability Determinations

By: Robert J. Lohr II, Esquire

I. Introduction

There appears to be a growing trend among credit card companies to initiate adversary proceedings against chapter 7 debtors challenging the dischargeability of consumer debt. In many instances the debtor is unable to afford counsel to defend the action resulting in the credit card company either receiving a default judgment or a settlement wherein the entire debt is, or at least a portion is stipulated to be, non-dischargeable.

A significant number of the dischargeability complaints are without basis since the debtors are either unable to afford counsel or lack the requisite sophistication to respond, therefore an appropriate defense is rarely entered. At least one court has found that: "Plaintiff's filing of a complaint for nondischargeability constitutes nothing more than persecuting a pair of unfortunate, honest debtors and blaming those debtors for Plaintiff's own casual and inadequate lending practices."[1] This is precisely why Congress included 11 U.S.C. § 523(d) in the

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[1] *In re Valdes*, 1995 Bankr. LEXIS 1498, (Bankr. S.D. Fla. 1995). The same Bankruptcy Judge (A. Jay Cristol, Chief Bankruptcy Judge, United States Bankruptcy Court for the Southern District of Florida), also included the following in his opinion in another case involving section 523:

> [w]hat this Court will award is the greedy lender award for January 1990. What kind of underwriting procedures were used by First Card Services, Inc. in approving an $ 8,000 cash advance to a customer with over $ 40,000 in credit card debt and no income for over a year? Where did the Debtor, a 57-year old Cuban refugee with a third grade education get this magic card in the first place? He testified that he never applied for the card. "They sent it to [him] in the mail." Is this a great country or what?

In re Cruz, 179 B.R. 975, 978 (Bankr. S.D. Fla. 1995).

Bankruptcy Code[2], as, contrary to the "American Rule"[3], this section provides for debtors to receive reimbursement of costs and reasonable attorney's fees incurred in defending adversary proceedings under certain conditions.

In order to receive an award of attorney's fees and costs under section 523(d), the debtor

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[2] This standard was not created out of whole cloth. Congress borrowed it from the Equal Access to Justice Act ("EAJA"). See *First Card v. Hunt (In re Hunt*), 238 F.3d 1098, 1103 (9th Cir. 2001) (citing *First Card v. Carolan (In re Carolan*), 204 B.R. 980, 987 (9th Cir. BAP 1996)). . . . As Congress put it:

> The original congressional intent in the drafting S. 523(d) of the existing Bankruptcy Code was to discourage frivolous objections to discharge of consumer debts, but not to discourage well-founded objections by honest creditors. The language of the subsection, however, makes the award of the debtor's costs and attorney's fees virtually mandatory in an unsuccessful challenge of a consumer debt. It has been interpreted as requiring the award of fees and costs even when the creditor acted in good faith. CF., *In re Majewski*, 7 B.R. 904 (Bankr. D. Conn. 1981). The net effect of this provision has been to preclude creditors from objecting to discharge of any consumer debt unless they are certain that the court will sustain the objection.
>
> The Committee, after due consideration, has concluded that amendment of this provision to incorporate the standard for award of attorney's fees contained in the Equal Access to Justice Act strikes the appropriate balance between protecting the debtor from unreasonable challenges to dischargeability of debts and not deterring creditors from making challenges when it is reasonable to do so. This standard provides that the court shall award attorney's fees to a prevailing debtor where the court finds that the creditor was not substantially justified in challenging the dischargeability of the debt, unless special circumstances would make such an award unjust.

S. Rep. No. 98-65, at 9-10 (1983).

Heritage Pac. Fin. LLC v. Machuca (In re Machuca), 483 B.R. 726, 733-734, (B.A.P. 9th Cir. 2012).

[3] The "American Rule" holds that a prevailing litigant may not collect reasonable attorney's fees from his or her opponent unless authorized by federal statute, an enforceable contract provision, or special circumstances, such as where the litigant has acted in bad faith, vexatiously, wantonly, or for oppressive reasons. *Alyeska Pipeline Serv. Co. v. Wilderness Society*, 421 U.S. 240 (1975).

must prove: (1) "a creditor request[ed] a determination of dischargeability of a consumer debt under section (a)(2) of this section, and (2) such debt is discharged."[4] After the debtor has established these elements, the creditor has the opportunity to avoid the imposition of costs and fees if it is able to prove: (1) "the position of the creditor was . . . substantially justified, or (2) special circumstances would make the award unjust."[5]

II. Exceptions to Discharge Under 11 U.S.C. § 523(a)(2)

Subsection (a)(2) precludes a debtor from discharging a debt "under 11 U.S.C. §§ 727, 1141, 1228(a), 1228(b) or 1328(b) for money, property, services, or an extension, renewal, or refinancing of credit to the extent obtained by false pretenses, a false representation or actual fraud . . ."[6] This section is comprised of three subparts containing the requisite elements that a creditor must prove by a preponderance of the evidence[7] in order to have a consumer debt deemed non-dischargeable. Subsection (a)(2)(A) requires a plaintiff to prove that the debtor committed a fraud at the time that the debt was incurred, subsection (a)(2)(B) is limited to representations made by the debtor in writing and specifically excludes oral and implied representations, and (a)(2)(C) sets forth a statutory presumption with specified time periods and

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[4] 11 U.S.C. §523(d).

[5] *Id.*

[6] 11 U.S.C. § 523(a)(2).

[7] Preponderance of the evidence is the standard by which a case must be proven to prevail on a claim under § 523(a)(2)(A). *In re Nelson*, 357 B.R. 508, 513 (B.A.P. 8th Cir. 2006); *see also Moen*, 238 B.R. at 791 (*citing Grogan v. Garner*, 498 U.S. 279, (1991)).

In re Falco, 2010 Bankr. LEXIS 4181, *8, (Bankr. W.D. Mo. Dec. 3, 2010).

dollar amounts.[8] This outline will only address adversary proceedings initiated under 11 U.S.C. § 523(a)(2)(A), and motions for reimbursement of attorney's fees and reasonable costs under section 523(d).

A. Claims Under 11 U.S.C. § 523(a)(2)(A)

The Supreme Court of the United States has determined that in order for a creditor to

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[8] The complete text of 11 U.S.C. § 523(a)(2) is as follows:

(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;

(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; or

(C)

(i) for purposes of subparagraph (A)—

(I) consumer debts owed to a single creditor and aggregating more than $675 for luxury goods or services incurred by an individual debtor on or within 90 days before the order for relief under this title are presumed to be nondischargeable; and

(II) cash advances aggregating more than $950 that are extensions of consumer credit under an open end credit plan obtained by an individual debtor on or within 70 days before the order for relief under this title, are presumed to be nondischargeable; and

(ii) for purposes of this subparagraph—

(I) the terms "consumer", "credit", and "open end credit plan" have the same meanings as in section 103 of the Truth in Lending Act; and

(II) the term "luxury goods or services" does not include goods or services reasonably necessary for the support or maintenance of the debtor or a dependent of the debtor;

prove that a debtor has committed a fraud pursuant to section 523(a)(2)(A) at the time he incurred a debt, the elements of fraud as found in the general common law of torts must be proven. *Field v. Mans*, 516 U.S. 59, 70 n.9 (1995).[9] It may be difficult to equate the use of a credit card as a "false representation" for purposes of satisfying this requirement under common law fraud, and therefore the author found the analysis of the Bankruptcy Court's application of section 523(a)(2)(A) to a creditor's claim in *In re Ritter*, 404 B.R. 811 (Bankr. E.D. Pa. 2009) particularly instructive.

> In order for a debt to be declared non-dischargeable under § 523(a)(2)(A), a plaintiff must prove that:
>
> 1. the debtor made a false representation;
> 2. at the time of the representation, the debtor knew it was false;
> 3. the false representation was made with the intent and purpose of deceiving the creditor;
> 4. the creditor justifiably relied upon the representation; and
> 5. the creditor sustained damage as a proximate result of the misrepresentation.

Id. at 822.

A "representation" is most commonly made verbally or in writing, which begs the question - is the **use** of a credit card to be construed as a "representation" for purposes of a section 523(a)(2)(A) analysis? In the case *In re Feld*, 203 B.R. 360 (Bankr. E.D. Pa. 1996), Bankruptcy Judge Diane Sigmund provides guidance in answering this question as follows:

> The application of § 523(a)(2)(A) to credit card debt is particularly difficult because of the nature of a typical credit card transaction which involves no face-to-face contact with a lender. The decision to extend credit to a debtor is made at the beginning of the debtor-creditor relationship when a prospective debtor is approved for a credit card. Later, when the debtor uses the card, credit is extended

[9] At the time that *Field* was decided (1995), the Supreme Court decided that the Restatement (Second) of Torts was the appropriate source for determining the elements to substantiate common law fraud. The language as it appears presently in section 523(a)(2) was added in the Bankruptcy Reform Act of 1978 (Pub. L. 95-598, 93 Stat.2549, November 6, 1978). See also *Grogan v. Garner*, 498 U.S. 279 (U.S. 1991).

> after verification of the validity of the card and the holder's pre-existing approved status by a third party merchant or bank who then looks to the credit card company for payment. Against this transactional reality, courts have attempted to measure the debtor's representations and the creditor's reliance thereon, and have fashioned various approaches to support non-dischargeability judgments in credit card cases. Clearly to give literal effect to the statute would be to except credit card transactions from the reach of § 523(a)(2)(A) since a debtor makes no actual representation to the creditor when using a card and a credit card issuer, not a direct party to the transaction whereby the credit is accessed, does not contemporaneously rely on any representation, even one implied.

Id. at 365-366.

Some courts have held that the **use** of a credit card is indeed a "representation" for purposes of establishing the first element in a common law fraud analysis. For instance, in the case *In re Anastas*, 94 F.3d 1280 (9th Cir. 1996), the Court found "[w]hen the card holder uses his credit card, he makes a representation that he intends to repay the debt." *Id. at* 1285. As evidenced by the divergent views of courts on this issue, it becomes even more complicated to determine the debtor's intention to pay the debt incurred at the time that he used the credit card.

In an effort to develop a method for determining the intention of the debtor at the time a credit card is used, some courts have adopted the position that a "debtor's intent under § 523(a)(2)(A) may be established by evaluating the totality of the circumstances."[10] Factors considered by courts in determining a debtor's intent include:

> 1. The length of time between when the charges were made and the bankruptcy filing;
> 2. Whether an attorney was consulted concerning the filing of bankruptcy before the charges were made;
> 3. The number of charges made;
> 4. The amount of the charges;
> 5. The debtor's financial condition at the time the charges were made;
> 6. Whether the charges were above the account's credit limit;
> 7. Whether the debtor made multiple charges on the same day;
> 8. Whether the debtor was employed;

[10] *In re Ritter* at 825, *citing to In re Cohn*, 54 F.3d 1108, 1118-19 (3d Cir. Pa. 1995).

9. The debtor's prospects for employment;
10. The debtor's financial sophistication;
11. Whether there was a sudden change in the debtor's buying habits; and
12. Whether the purchases were made for luxuries.

In re Ritter, at 826.

III. Burden of Proof and Defenses

"The Debtor carries the initial burden to establish three particular elements,[11] and if met, the burden shifts to the creditor that its actions were substantially justified." *In re Daecharkhom,* 505 B.R. 898, 902 (B.A.P. 9th Cir. 2013), *citing to In re Montano*, 501 B.R. 96, 114 (B.A.P. 9th Cir. 2013). The creditor also has the opportunity to demonstrate to the court that "special circumstances would make the award [of reasonable attorney's fees and costs] unjust."[12]

In an adversary proceeding captioned as *Waugh Real Estate Holdings, LLC v. Daecharkhom (In re Daecharkhom)*, 505 B.R. 898 (B.A.P. 9th Cir. 2014) , "the bankruptcy court determined that creditor Waugh Real Estate Holdings, LLC ("Waugh") was not substantially justified in pursuing a § 523(a)(2) nondischargeability action on a consumer debt and that the requested fees and costs were reasonable. It then awarded reduced fees and costs based on a determination that special circumstances justified reduction." *Id*. at 900. The Bankruptcy Appellate Panel for the Ninth Circuit reversed the Bankruptcy Court holding that a finding of

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[11] Under § 523(d)'s shifting burden of proof, a debtor must establish three elements: (1) that the creditor sought to except a debt from discharge under § 523(a), (2) that the subject debt was a consumer debt, and (3) that the subject debt ultimately was discharged. *In re Stine*, 254 B.R. 244, 249 (B.A.P. 9th Cir. 2000), affirmed in *In re Stine*, 2001 U.S. App. LEXIS 21158 (9th Cir. 2001). *See also In re Machuca*, 483 B.R. 726, 734 (B.A.P. 9th Cir. 2012), "The burden of proof then shifted to Heritage to prove that its actions were 'substantially justified.'"

In re Montano, 501 B.R. 96, 114 (B.A.P. 9th Cir. 2013).

[12] 11 U.S.C. § 523(d).

special circumstances only permits a bankruptcy court to deny an award of attorney's fees and cost, not enter an arbitrary reduction.[13]

In the case *First Deposit Nat'l Bank*, 222 B.R. 497 (Bankr. W.D.N.C. 1998), the plaintiff creditor initiated an adversary proceeding alleging that the debtor "obtained money from the Plaintiff by false pretenses, false representations or actual fraud and the debt is nondischargeable pursuant to 11 U.S.C. § 523(a)(2)(A)." *Id.* at 500. The court held "Congress had the plaintiff in mind when § 523(d) was enacted. The tactics employed herein seeking to force the debtor to enter into a Reaffirmation Agreement or settlement are totally unreasonable. The defendant should be awarded all of her reasonable attorney's fees and recovery of costs." *First Deposit Nat'l Bank*, at *26. In the court's analysis, it determined that the creditor had not exercised sufficient due diligence prior to initiating the adversary proceeding against the debtor and further that there was no substantial justification for the action, nor did special circumstances exist. The Bankruptcy Court referred to the adversary proceeding in the case *In re: Arroyo* wherein the Court, in a situation similar to the case at hand, granted the debtor's attorney a $5,000.00 fee enhancement.

Commenting on the Tactical Consumer Dischargeability Complaint, one court observed:

> AT&T's case is analogous to a gun-slinger in the wild west without ammunition. It does not survive. This Court is not closing the 523(a)(2)(A) "town gates" to credit card issuers. Just don't ride into town firing blanks and kicking up dust in the hope of rustling up a settlement. Come in armed with facts to prove fraud or you may be driven out of town with a 523(d) bullet in your tail.

In re Chinchilla, Case Number 95-15445-BKC-RAM, Adversary No. 96-0158 BKC-RAM-A, United States Bankruptcy Court, Southern District of Florida, decided December 3, 1996.

In the case *In re Robinson*, 340 B.R. 316 (Bankr. E.D. Va. 2006), creditor, a power

[13] *In re Daecharkhom* at 903.

company filed an adversary proceeding against defendant debtor alleging that the debtor had engaged in energy theft or meter tampering and that the resulting debt for the allegedly unauthorized power usage was nondischargeable pursuant to 11 U.S.C. § 523(a)(2) and (a)(6). The plaintiff argued that the debtor's "failure to disclose the fact that his bills were inaccurate constitutes fraud and a misrepresentation." *Id*. at 346. The Court held that the Plaintiff failed to meet its burden that the debtor made a false representation or engaged in fraudulent conduct. *Id*. at 347.

In the case *Universal Bank, N.A. v. Jiunn Chau Li (In re Jiunn Chau Li*), 2000 Bankr. LEXIS 2103 (Bankr. N.D. Tex. Oct. 18, 2000), a creditor filed an adversary proceeding objecting to the dischargeability of credit card debt pursuant to 11 U.S.C. §523(a)(2)(A) and (a)(2)(B). The debtor filed an answer and a motion seeking reimbursement of attorney's fees and costs pursuant to 11 U.S.C. § 523(d). The Court denied plaintiff's dischargeability complaint and debtor's motion.

In its analysis, the Court determined that the charges on the credit card did not constitute consumer debt and therefore not subject to nondischargeabilty determination pursuant to 11 U.S.C. § 523(a)(2)(A) and (a)(2)(B) and further that there was no implied representation each time the Debtor used the AT&T Universal Card, relying upon *In re Mercer* 211 F.3d 214 (5th Cir. 2000), and *In re Kuntz*, 249 B.R. 699 (Bankr. N.D. Tex. 2000). *In re Jiunn Chau Li* at *8, 9.

IV. Conclusion

Creditors should beware of the number of decisions where debtors are awarded attorney's fees in dischargeability determination actions, and should further be mindful to conduct extensive due diligence prior to commending these actions. In many instances, bankruptcy courts found that creditors had failed to adequately review their own credit card statements, serve discovery,

attend meetings of creditors and commenced adversary proceedings with the intent of forcing a debtor into a settlement with little or no justification. The majority of reported decisions interpreting claims of creditors pursuant to 11 U.S.C. § 523(a)(2) have sided with debtors and a majority of courts also have found that when a debt has been discharged, debtors who have filed motions pursuant to 11 U.S.C. § 523(d), have been awarded reasonable attorney's fees and costs incurred in defending the action. Bankruptcy courts have consistently found that it is a heavy burden for a creditor.

Submitted by:
Judge Vincent F. Papalia
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District of New Jersey
-and-
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View from the Bench - Consumer Fraud

A. Fair Debt Collection Practices Act/Truth in Lending Act

1. Claim of Exemption in Recovery versus Right to Setoff - Who Wins?

> Compare the language of:
>
> Section 522(c) -- "property exempted under this section is not liable during or after the case for any debt of the debtor that arose . . . before commencement of the case," except for (1) nondischargeable taxes; (2) domestic support obligations; (3) nondischargeable debts under § 523(a)(4) or (6); and (4) educational loans or financial assistance obtained through fraud;
>
> and
>
> Section 553(a) -- "Except as otherwise provided in this section and in sections 362 and 363 of this title, this title does not affect any right of a creditor to offset a mutual debt owing by such creditor to the debtor that arose before the commencement of the case under this title against a claim of such creditor against the debtor that arose before the commencement of the case," [subject to certain exceptions not applicable here].

2. Cases are Split on the Issue.

The majority view is that exempt property is not subject to offset. *See, e.g., In re Wilde*, 85 B.R. 147, 148-49 (Bankr. D.N.M. 1988) (recognizing that § 522(c) and § 553(a) appear to be at "cross-purposes," and noting that bankruptcy courts have generally adopted the view that setoff is not permitted against property that is exempt under the Code; setoff is allowed only as exception where policy in favor of setoff is more compelling than policy favoring debtor's rehabilitation); *In re Davies*, 27 B.R. 898, 901 (Bankr. E.D.N.Y. 1983) (setoff not allowed against exempt property because allowance would undermine the rehabilitative intent of Bankruptcy Code). *See generally,*

5 COLLIER ON BANKRUPTCY ¶ 553.03[3][e][iv] Alan N. Resnick & Henry J. Sommer eds., 16th ed. rev. 2013.

In contrast, the Court in *In re Pieri*, 86 B.R. 208 (B.A.P. 9th Cir. 1988), recognized the "appellate nightmare" that is created by the "direct conflict" between the language of § 522 and § 553 and adopted the minority view that exempt property may be subject to offset. In reconciling the conflicting provisions, the Court relied on the statutory rule of interpretation "that where there is an irreconcilable conflict between different parts of the same act, the last in order of arrangement will control." *Id*. at 212-13. Thus, even though exemptions are to be liberally construed, the *Pieri* Court adopted the minority view so as to give "preeminence [to] the right of setoff [that] appears to be in accord with the special status granted setoff under the Code." *Id*. at 213. The *Pieri* Court also noted that § 506(a) grants claims subject to offset under § 553 secured status. Thus, an offset claim may arguably fall under the exception to § 522(c)'s general rule contained in § 522(c)(2) for nonavoidable lien claims.

3. Policy Considerations

All the cases (and COLLIER) recognize that exemptions are generally determined by reference to existing law and principles of equity and do not create any new or enlarged offset rights. *See, e.g., In re Pieri*, 86 B.R. at 210. The cases also uniformly recognize that allowance of an offset is not automatic, but permissible in the bankruptcy court's discretion, applying general principles of equity. *Id*. In this regard, setoff should be limited to its defensive posture (as a shield) so as not to deprive the debtor of his or her fresh start. But by the same token, the debtor should not be able to use the discharge order as a sword that takes unfair advantage of the creditor. *Id.* at 213.

In balancing these competing policy and equitable factors, the Court should consider the nature of the underlying debts and claims. *See Riggs v. Gov't Employees Fin. Corp.*, 623 F.2d 68 (9th Cir. 1980). In *Riggs*, the Ninth Circuit upheld the denial of an offset right for the creditor's prepetition Truth-in-Lending Act ("TILA") violations against the debtor's prepetition loan obligation. There, the Court found that the strong policy considerations underlying the private attorney general enforcement provisions of the TILA, which include actual monetary damages, statutory penalties and attorneys' fees, trumped the creditor's offset rights. *Id*. at 73-74.[1] The Court reasoned that allowing the offset right would limit or eliminate the incentive for private parties to bring actions that effectuate the TILA's purposes, and also eliminate the punitive effect as to lenders, who would "suffer a lesser or no penalty for violation of the Act" if the offset is allowed. *Id.* at 74-75.

B. The Right of Rescission Under the Truth-In-Lending Act

The Truth in Lending Act (15 U.S.C. § 1601 *et seq*.) provides borrowers with certain remedies that are often sought to be invoked in bankruptcy court (but usually only after a judgment of foreclosure has been entered). One of those remedies is rescission for which the TILA provides certain strict time limitations. Further, the TILA's right of rescission applies only to certain consumer credit and mortgage transactions.

1. Application to Residential Mortgages

15 U.S.C. § 1635 *et seq.* ("Right of rescission as to certain transactions") gives a borrower a period of time after entering *certain* loan transactions to withdraw from them. 15 U.S.C. § 1635(a) states in relevant part:

[1] *Riggs* was decided under the Bankruptcy Act and did not involve a claim of exemptions, as the TILA was asserted by the Trustee of the Debtor's estate. Nonetheless, its reasoning and holding remain relevant to the exemptions/offset analysis.

> *Except as otherwise provided in this section*, in the case of any consumer credit transaction . . . in which a security interest, including any such interest arising by operation of law, is or will be retained or acquired in any property which is used as the principal dwelling of the person to whom credit is extended, the obligor shall have the right to rescind the transaction until midnight of the third business day following the consummation of the transaction or the delivery of the information and rescission forms required under this section together with a statement containing the material disclosures required under this subchapter, whichever is later, by notifying the creditor, in accordance with regulations of the Bureau, of his intention to do so.

15 U.S.C. § 1635(a) (emphasis supplied). 15 U.S.C. § 1635(e)(1) sets forth the exception for mortgage loans which are not subject to the rescission right under 15 U.S.C. § 1635(a). 15 U.S.C. § 1635(e)(1) states in relevant part:

> (e) Exempted transactions; reapplication of provisions
>
> This section does not apply to--
>
> (1) a residential mortgage transaction as defined in section 1602(w) of this title.

15 U.S.C. § 1635(e)(1).

15 U.S.C. § 1602(w), now renumbered to § 1602(x), defines "residential mortgage transaction" as follows:

> (x) The term "residential mortgage transaction" means a transaction in which a mortgage, deed of trust, purchase money security interest arising under an installment sales contract, or equivalent consensual security interest is created or retained against the consumer's dwelling to finance the acquisition or initial construction of such dwelling.

15 U.S.C. § 1602(x). *Derisme v. Hunter Leibert Jacobson P.C.*, 880 F. Supp. 2d 311, 335 (D. Conn. 2012), *appeal dismissed*, 2013 WL 1187853 (2nd Cir. Jan. 15, 2014); *Betancourt v. Countrywide Home Loans, Inc.,* 344 F. Supp. 2d 1253, 1260 (D. Colo. 2004) (confirming that 15 U.S.C. § 1635(e)(1) excepts certain residential mortgage loans, including purchase money

mortgages, from the rescission protections of 15 U.S.C. § 1635(a)). The Court in *Betancourt*, citing to *Heuer v. Forest Hill State Bank*, 728 F. Supp. 1199, 1200-01 (D. Md. 1989), *aff'd*, 984 F.2d 402 (4th Cir. 1990), explained that the rescission statute was designed (at least in part) to protect homeowners "from certain sharp practices of home improvement contractors" and their financers and specifically from "surprise and oppression stemming from mortgages unwittingly executed on homes to pay for often questionable 'home improvements,'" hence, the exception for the "residential mortgage transaction." *Betancourt*, 344 F. Supp. 2d at 1200-01. Based on this exception, the right of rescission does not apply to mortgages used to purchase or construct the debtor's residence, i.e., most first mortgages that are not refinancings.

2. Time Limitations on the Rescission Right

The time frames set forth in § 1635(a) (three days following consummation of the transaction or delivery of the required disclosures and forms, whichever is later) are further limited by § 1635(f) which provides for the absolute expiration of the rescission deadline within three years after consummation of the transaction or sale of the property, whichever occurs first:

> An obligor's right of rescission shall expire three years after the date of consummation of the transaction or upon the sale of the property, whichever occurs first, notwithstanding the fact that the information and forms required under this section or any other disclosures required under this part have not been delivered to the obligor . . . .

15 U.S.C. § 1635(f). *See Jesinoski v. Countrywide Home Loans, Inc.*, 135 S. Ct. 790 (2015).

In *Jesinoski*, a unanimous Supreme Court held that the right of rescission is properly invoked by simply giving notice of rescission within the specified time period. Relying on the plain language of the TILA, the Supreme Court reversed the Eighth Circuit, which held that the consumer was required to file a lawsuit within the three-year-period to invoke the right of rescission. As was also noted by the *Jesinoski* Court, after that three-year-period, the right to rescind expires, "[e]ven if a

lender *never* makes the required disclosures." *Jesinoski*, 135 S. Ct. at 792 (emphasis in original). *See also Beach v. Ocwen Fed. Bank*, 523 U.S. 410 (1998) (right to rescind under § 1635 expires after three years after consummation of the transaction and may not be exercised or asserted thereafter as an affirmative claim or defense).[2]

For purposes of TILA, consummation of the transaction occurs "at the time a contractual relationship is created between a creditor and a customer irrespective of the time of performance of either party." *Stevens v. Rock Springs Nat'l Bank*, 497 F.2d 307, 310 (10th Cir. 1975), *citing* 12 C.F.R. § 226.2(cc). In *Stevens,* the contractual relationship was found to be created when the bank contracted to extend credit. *Id.* In other cases, the contractual relationship has been held to occur when the borrower signed the promissory note, *Rudisell v. Fifth Third Bank*, 622 F.2d 243, 246 (6th Cir. 1980) (consummation of transaction "occurs at the time a contractual relationship is created between a creditor and customer . . . irrespective of the time of performance of either party," *citing* 12 C.F.R. § 226.2(kk)). Other courts have utilized the "date of the closing" of the loan, *Morris v. Lomas and Nettleton Co*., 708 F. Supp. 1198, 1203 (D. Kan.1989), or the date "when the debtors became contractually obligated on the transaction." *In re Vickers*, 275 B.R. 401, 407 (Bankr. M.D. Fla. 2001). Under any of these tests, the actual closing of the loan transaction would seem to be the latest date on which consummation occurs and the three-year clock starts to run.

C. Addressing "Innocent Spouse" Defense in 11 U.S.C. §§ 523(a) and 727 Actions

In a recent scenario, Debtor 1 and Debtor 2 were married. Prepetition Debtor 1 was the sole owner of a corporation (the "Entity") which was a wholesale supplier. The Entity entered into a Factoring Agreement with the Creditor to provide short-term funding to the Entity by purchasing

[2] This three-year time limitation may be further extended if an enforcement agency begins an investigative action before the three-year-period expires. 15 U.S.C. § 1635(f).

accounts receivable from the Entity at a discount. Debtor 1 and Debtor 2 each guaranteed the performance of the Entity under the Factoring Agreement. After a time, the Creditor discovered that many of the accounts receivable it had purchased were fictitious (involving counterparties and goods which did not exist or had no relation to the Entity).

Creditor sued Debtor 1, Debtor 2 and the Entity in State Court, which entered judgment against the Entity. Debtor 1, and later Debtor 2, filed separate Chapter 7 bankruptcy petitions. The Entity never filed. Creditor filed separate adversary complaints against Debtor 1 and Debtor 2 to except its debt from discharge under 11 U.S.C. § 523(a)(2), (4) or (6) and/or to deny or revoke discharge under 11 U.S.C. § 727(c), (d) and (e). The Creditor obtained a judgment excepting the debt from discharge as to Debtor 1 under 11 U.S.C. § 523(a)(2)(A) and then filed a motion for summary judgment against Debtor 2.

The challenge for the creditor is imputing intent and other conduct which generates liability under 11 U.S.C. §§ 523(a) and/or 727 to a Debtor who consistently and passively denies engagement in a fraudulent scheme. Because fraudulent intent is "nearly impossible" to establish directly, the Court may infer Debtor's intent from evidence of surrounding circumstances presented by the Creditor. *In re Van Horne*, 823 F.2d 1285, 1287-88 (8th Cir. 1987).[3] Thus, a creditor may "prove intent to deceive by showing, by a totality of circumstances, reckless indifference or reckless disregard of the accuracy of information." *In re Bocchino*, 974 F.3d 376, 381-82 (3d Cir. 2015). Additionally, Debtor's silence as to a material fact may constitute false representation under 11 U.S.C. § 523(a)(2). *In re Docteroff*, 133 F.3d 210, 216 (3d Cir. 1997). The creditor's burden may also have been lessened by the Supreme Court's recent decision in *Husky Int'l Elec.*, which is discussed elsewhere in these materials.

[3] Abrogated by *Grogan v. Garner*, 498 U.S. 279, 286-88 (1991) to the extent that *Grogan* replaced the "clear and convincing" standard of proof with "preponderance of the evidence."

Even absent actual knowledge and active participation of Debtor 2 in the fraud of Debtor 1, fraud may be imputed between spouses if they are in a partnership or an agency relationship outside of the marriage. *In re Markley*, 446 B.R. 484, 488 (Bankr. D. Kan. 2011); *In re Tsurukawa*, 258 B.R. 192, 198 (B.A.P. 9th Cir. 2001) (marriage relationship alone does not create agency relationship); *In re Oliphant*, 221 B.R. 506, 511 (Bankr. D. Ariz. 1998) (in an exception to discharge action for embezzlement, intent may be inferred in the passive spouse "where the facts and circumstances are so egregious that denial of knowledge is simply not credible"; embezzled money which injected $500,000 into household finances constituted a debt excepted from discharge under 11 U.S.C. § 523(a)(4) in the non-active spouse).

In sum, a creditor is not without tools in seeking to hold an allegedly "innocent spouse" liable in a fraudulent scheme that directly (or perhaps even indirectly) involved both parties.

Can't Have Your Cake and Eat It Too: Importance of Disclosure in Bankruptcy Proceedings

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Suppose in a chapter 7 bankruptcy case, a debtor fails to list a pending personal injury lawsuit against a third party. After relying on a debtor's bankruptcy schedules that there are no additional assets that may be liquidated to benefit creditors, the bankruptcy court enters an order discharging a debtor's debts. Should the debtor now be allowed to proceed with this pending lawsuit? Is it fair for the debtor to use the court system to discharge his or her debts, and then benefit from the lawsuit to the exclusion of creditors? If the personal injury lawsuit is not allowed to proceed, should the previous tortfeasor be allowed to escape the consequences of the previous tortious acts?

These questions lie at the heart of the doctrine of judicial estoppel, a doctrine that when invoked, precludes a party from making inconsistent statements to a court in a subsequent judicial proceeding. Like other forms of estoppel, judicial estoppel has important strategic value at trial. The doctrine also serves important and unique social policies within our judicial system: from "uphold[ing] . . . the sanctity of the oath"[1] to "prevent[ing] parties from making a mockery of justice by inconsistent pleadings."[2] The focus of this paper is to provide a brief overview of the doctrine of judicial estoppel and how it is typically used in the context of bankruptcy proceedings.

A. Overview of Judicial Estoppel

The doctrine of judicial estoppel, in its most generic form, prevents a party from asserting a position in one legal proceeding that directly contradicts a position taken by that same party in an earlier proceeding.[3] The purpose of judicial estoppel is to "protect the integrity of the judicial process by prohibiting parties from deliberately changing [their] positions according to the exigencies of the moment."[4] Judicial estoppel differs from other types of preclusion in that the doctrine focuses on a party's assertions in relation to the courts rather than in relation to other litigants.[5]

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[1] Konstantinidis v. Chen, 626 F.2d 933, 937 (D.C. Cir. 1980)

[2] American Nat'l Bank v. F.D.I.C., 710 F.2d 1528, 1536 (11th Cir. 1983).

[3] *See, e.g.,* Brandon v. Interfirst Corp., 858 F.2d 266, 268 (5th Cir. 1988).

[4] *See* New Hampshire v. Maine, 532 U.S. 742, 749–50 (2001).

[5] *See* Robert F. Dugas, *Honing a Blunt Instrument: Refining the Use of Judicial Estoppel in Bankruptcy Nondisclosure Cases,* 59 VAND. L. REV. 205, 209–10 (2006) (comparing judicial estoppel to other forms of preclusion such as equitable estoppel, res judicata, and collateral estoppel).

Although the purpose and contours of the doctrine can be sketched, it is not clear what types of legal positions, once successfully asserted, will trigger judicial estoppel. When a litigant attempts to contradict a prior statement of fact made under oath, the application of judicial estoppel is straightforward and easy to understand. In *Lowery v. Stovall*, for example, the Fourth Circuit applied judicial estoppel to a plaintiff who claimed in a civil action that a policeman had attacked him without provocation after the plaintiff had already pleaded guilty and testified in criminal proceedings to maliciously attacking another officer on the scene.[6] But should judicial estoppel apply to a litigant who in one proceeding asserts that a will provides for a residence to be held in trust, and then later argues that the will provides for the residence to be distributed outright?[7] Or a litigant who characterizes a particular action as *in personam*, then as *quasi in rem*?[8] These scenarios and others illustrate contradictory positions on matters ranging from the purely factual[9] to the purely legal.[10] In the middle ground are "combined questions of fact and law," and a category that has been described as legal positions, opinions, conclusions, assertions, theories, or contentions, in which the positions taken are ones of law applied to the specific facts of a case.

In 2001, the Supreme Court, in *New Hampshire v. Maine*, defined the doctrine of judicial estoppel, and endorsed its application for the first time.[11] The case involved a dispute regarding a river that lies on the southeastern end of New Hampshire's boundary with Maine. New Hampshire brought a cause of action against Maine, claiming that the entire Piscataqua River which runs along Maine's shore and all of Portsmouth Harbor belongs to New Hampshire. Maine moved to dismiss New Hampshire's lawsuit, claiming that New Hampshire had previously agreed to the status of the river during prior litigation in 1970 and, therefore, was prohibited from asserting a different position.

The Supreme Court agreed and held that, under the doctrine of judicial estoppel, New Hampshire was equitably barred from asserting a contrary position to the position that it had previously asserted during litigation in the 1970s. The Supreme Court explained that under the doctrine of judicial estoppel, when a party "assumes a certain position in a legal proceeding, and succeeds in maintaining that position, he may not thereafter, simply because his interests have

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[6] *See* Lowery v. Stovall, 92 F.3d 219, 220, 224 (4th Cir. 1996).

[7] *See* Helfand v. Gerson, 105 F.3d 530, 536 (9th Cir. 1997) (answering yes).

[8] *See* Jett v. Zink, 474 F.2d 149, 154–55 (5th Cir. 1973) (answering yes).

[9] The Supreme Court has given as examples of purely factual positions such as, "The light was red/green," and "I can/cannot raise my arm above my head." Cleveland v. Policy Mgmt. Sys. Corp., 526 U.S. 795, 802 (1999) (internal quotation marks omitted).

[10] In the context of interrogatories, courts have defined issues of pure law as "legal issues unrelated to the facts of the case." O'Brien v. Int'l Bhd. of Elec. Workers, 443 F. Supp. 1182, 1187 (N.D. Ga. 1977) (internal quotation omitted).

[11] New Hampshire v. Maine, 532 U.S. 742 (2001); 18–134 Lawrence B. Solum, MOORE'S FEDERAL PRACTICE – AIVIL § 134.30.

changed, assume a contrary position, especially if it be to the prejudice of the party who has acquiesced in the position formerly taken by him." The Supreme Court elaborated and said that judicial estoppel "is an equitable doctrine invoked by a court as its discretion." The purpose of the doctrine is to "protect the integrity of the judicial process" by "prohibiting parties from deliberately changing positions according to the exigencies of the moment."

While there is no strict formula for determining the applicability of judicial estoppel, the Supreme Court identified several factors that a court should consider. *First*, the court should establish whether a party's later position was clearly inconsistent with its earlier position. *Second*, the court should determine whether the party has succeeded in persuading a court to accept that party's earlier position so that acceptance of an inconsistent position would create the perception that either the first or the second court was misled. *Third*, the court should inquire "whether the party seeking to assert an inconsistent position would derive an unfair advantage or impose an unfair detriment on the opposing party if not estopped."

The Supreme Court expressly stated that it was not establishing inflexible prerequisites or an exhaustive formula for determining the applicability of judicial estoppel. Rather, the Court made it clear that other considerations may inform the court of the doctrine's application based upon the factual contexts. The Court further stated that it may be appropriate to resist applying the judicial estoppel doctrine "when a party's prior position was based on inadvertence or mistake."

B. Judicial Estoppel's Application in Bankruptcy Proceedings

In the context of bankruptcy proceedings, to understand the role that judicial estoppel often plays, it is important to understand two of the basic tenets of bankruptcy: (i) to provide a "fresh start" to individuals or entities without the burden of their old debts; and (ii) for creditors of the same priority to be treated equally. To achieve these goals, full disclosure by a debtor is critical to the functioning of the bankruptcy system.[12] Section 521(1) of the Bankruptcy Code requires a debtor to file a "schedule of assets and liabilities . . . and a statement of the debtor's financial affairs." Section 541 of the Bankruptcy Code provides that property of the estate includes "all legal or equitable interests of the debtor in property as of the commencement of the case." The language of these statutes "impose[s] upon debtors an express, affirmative duty to disclose all assets, including contingent and unliquidated claims."

If a debtor fails to list the potential cause of action, a court may estop the debtor, now a plaintiff, from asserting that cause of action and find that the unscheduled claim remains the property of the bankruptcy estate. When a court does find that an undisclosed claim remains as property of the bankruptcy estate, the debtor lacks standing to bring the cause of action after emerging from bankruptcy, and the court will either dismiss the claims or allow the trustee of a debtor's estate, assuming the case is reopened, to pursue the claim for the benefit of the estate.

[12] *See* In re Coastal Plains, Inc., 179 F.3d 197, 208 (5th Cir. 1999) (discussing importance of disclosure duty cannot be overemphasized).

1. Debtor failed to disclose a claim and the bankruptcy case was dismissed.

Although most courts agree that a debtor plaintiff cannot later assert an unscheduled claim, courts differ in holding whether a debtor-plaintiff can assert an unscheduled claim later if a judge dismisses the bankruptcy case. Ultimately, in deciding whether a debtor-plaintiff has standing, courts balance the plain meaning of section 349 of the Bankruptcy Code with equitable considerations, including the debtor's conduct during the bankruptcy.

2. Debtor received a benefit and the case was involuntarily dismissed.

In *Crawford v. Franklin Credit Management Corporation*, the plaintiff filed bankruptcy in 2006, but failed to list any of the claims against the defendants, which she subsequently sued.[13] The defendants argued that the plaintiff lacked standing and judicial estoppel should apply to prevent her from pursing claims against them. The plaintiff urged the court to find that she did have standing because the plain language in section 349 provides that once a judge dismisses a bankruptcy proceeding, the dismissal restores the previously bankruptcy-seeking party to the position that the party held before filing for bankruptcy. The defendants opposed this argument and urged the court to consider the debtor plaintiff's conduct, including that the judge had dismissed the debtor plaintiff's bankruptcy because the debtor plaintiff created unreasonable delay, she failed to appear at the confirmation hearing, and she failed to remain current in the proposed plan payments to the trustee.

The court ultimately held that the plaintiff lacked standing because the plaintiff obtained a considerable benefit by filing for bankruptcy relief as she filed two-days before a foreclosure sale began and did not attend hearings, which suggested that she had not intended to amend her bankruptcy schedules later.

3. Debtor did not benefit and the case was voluntarily dismissed.

In contrast to *Crawford*, in *Greenfield v. Kluever and Platt, LLC*, the court permitted the debtor-plaintiff to bring forth an unscheduled prepetition claim against the defendants because the debtor-plaintiff voluntarily dismissed a chapter 13 bankruptcy proceeding before pursuing the unscheduled claims.[14] In recognizing that a court had the power to dismiss the claims, the court balanced equitable considerations including that the debtor-plaintiff did not play "fast and loose" with the court, but rather exercised her statutory right to dismiss the bankruptcy case voluntarily. The court further found that debtor-plaintiff received no benefit from withholding information from the bankruptcy court.

4. Debtor disclosed the claim in his or her schedules, but the claim was undervalued.

In *Payne v. Wyeth Pharm., Inc.*, the defendants filed a motion to limit damages to $1 million since the debtor-plaintiff sought damages exceeding $1 million, and the debtor-plaintiff

[13] Crawford v. Franklin Credit Mgmt. Corp., No. 09-C-3576, 2011 WL 1118584, at *13–14 (S.D.N.Y. Feb. 16, 2010).

[14] Greenfield v. Kluever and Platt, LLC, No. 09-C-3576, 2010 WL 604830 (N.D. Ill. Feb. 16, 2010).

previously declared the value of his claim as $1 million.[15] The court applied the judicial estoppel doctrine and held that the plaintiff could not recover any more than $1 million because the plaintiff had motive to conceal the higher value of his claim. To determine whether the plaintiff had motive, the court considered the Virginia bankruptcy exemption code and found that under section 34-28.1 of the Virginia Code, proceeds from personal injury actions are exempt from creditor process unless the lienholder is secured. Because the plaintiff in *Payne* identified multiple secured creditors holding approximately $762,000 in secured debt against the plaintiff, the court found that the plaintiff intentionally misrepresented his claim to the bankruptcy court.

C. Defenses to Judicial Estoppel

Once the issue of judicial estoppel has been raised, there are a number of defenses and options that a debtor may have to overcome the imposition of judicial estoppel.

- No privity in the bankruptcy proceeding. A debtor-plaintiff may argue that a defendant was not a creditor or a party to the bankruptcy proceeding and, thus, lacks privity. However, because the purpose of the doctrine of judicial estoppel is to protect the integrity of the judicial system, not the litigants, this argument should be rejected by the court.

- Mistake or Inadvertence. The most common defense against the doctrine of judicial estoppel is that a debtor-plaintiff did not have the requisite intent to mislead the bankruptcy court so judicial estoppel should not apply. Judicial estoppel only applies in situations involving intentional contradictions not simple errors or inadvertent errors. Courts, however, have concluded that "intent" may be inferred based on the record. The Fifth Circuit in *In re Coastal Plains, Inc.*, for instance, held that a court can characterize a debtor-plaintiff's failure to disclose as "inadvertent" only if the debtor plaintiff "lacks knowledge of the undisclosed claims or has no motive for their concealment."[16]

- Right to cure. A debtor-plaintiff may ultimately argue that s/he should be allowed to reopen a bankruptcy case to amend the bankruptcy schedules to reflect a claim or the "true" value of a claim. Some courts have rejected this argument by holding that allowing this would suggest to other debtors that they only need to disclose properly if someone catches them concealing the causes of action. This remedy would only "diminish the necessary incentive to provide the bankruptcy court with a truthful disclosure of the debtor's assets."[17]

[15] Payne v. Wyeth Pharmaceuticals, Inc., 606 F. Supp. 2d 613, 616 (E.D. Va. 2008).

[16] In re Coastal Plains, Inc., 179 F.3d 197, 210 (5th Cir. 1999).

[17] Billups v. Pemco Aeroplex, Inc., 1282 F.3d 1282, 1288 (11th Cir. 2002). *See also* Traylor v. Gene Evans Ford, LLC, 185 F. Supp. 2d 1338, 1340 (N.D. Ga. 2002) (denying a debtor's request to back up and disclose a previously undisclosed claim to the bankruptcy court).

D. Conclusion

The doctrine of judicial estoppel is a powerful weapon and deterrent for nondisclosure in bankruptcy proceedings. While the doctrine will not apply in every case, counsel must remain diligent in recognizing the importance of the doctrine. Debtor's counsel must be mindful of stressing to their client the importance of disclosing all assets, and defense counsel should frequently check to see whether a plaintiff has filed for bankruptcy and, if so, whether the claim(s) was disclosed in the schedules.