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A Nonspecialist's Guide to Discharge and Dischargeability in Bankruptcy

by Evan Jones



To a debtor the most important aspect of bankruptcy is its provision for a fresh start. To a creditor a most important question is whether his claim will survive the bankruptcy. These matters are governed by two critical elements of bankruptcy law: Discharge and dischargeability. These are two distinct concepts. Discharge relieves the bankrupt of liability on his "dischargeable" debts. Dischargeability governs the question of whether the discharge of a bankrupt relieves him of further liability on a particular debt.

This article focuses on individual, "straight" liquidation bankruptcies. The discharge of a corporate bankrupt is of little importance since a Chapter 7 bankruptcy results in the complete liquidation of all the assets of a corporation and

the remaining corporate shell is usually dissolved. The discharge of a corporation and the related question of what corporate liabilities are dischargeable may be important in an Arrangement proceeding under Chapter XI, which is the most common form of corporate rehabilitation proceeding. The confirmation of a Plan of Arrangement under Chapter XI operates as a discharge of all unsecured debts and liabilities provided for in the Plan except debts which are not dischargeable under Section 17 of the Act. Bankruptcy Act, § 371, 11 U.S.C. § 771.

Nature of a Discharge

The exact effect of a discharge is often misunderstood. A discharge does not extinguish a debt; rather it provides a valid defense to any future legal proceedings for the enforcement of the debt. In the language of the Bankruptcy Act, "An order of discharge shall declare that any judgment . . . obtained in any other court is null and void as a determination of personal liability of the bankrupt . . ." with respect to the debtor's dischargeable debts. Bankruptcy Act § 14f, 11 U.S.C. § 35. One of the consequences of the fact that a debt is not extinguished by a discharge is that co-debtors, endorsers, sureties and guarantors are not relieved of liability on the debt. Bankruptcy Act § 16, 11 U.S.C. § 34. Furthermore, the debtor can reaffirm or revive a

DEBTOR'S NOTE

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debt after discharge; in which case the creditor could thereafter obtain the judicial enforcement of his claim, despite the discharge. *Matter of Harris*, 28 F. Supp. 487 (E.D. Ill. 1939). State law controls the form and effect of a reaffirmation. In general, the reaffirmation must be in the form of a distinct and unequivocal new promise. However, there is no need for any new consideration or for a promise to be evidenced by a writing. The new promise must be made after the commencement of Bankruptcy Proceedings; an agreement in a Note made prior to Bankruptcy which purports to waive a right to discharge would be ineffective. See generally 1A *Collier Bankruptcy* §17.33 *et seq.* (14th ed.).

Bar to Discharge

Upon the adjudication of an individual debtor as bankrupt, the court is required to fix a time for creditors to object to the bankrupt's discharge. Bankruptcy Act § 14b, 11 U.S.C. § 32,

Bankruptcy Rules 404. Any creditor wishing to object to the discharge of a bankrupt must file a complaint in an adversary proceeding, under the Bankruptcy Rules, seeking an order that the bankrupt is not eligible for a discharge and therefore not relieved of any of his obligations. The procedures governing such adversary proceedings are discussed below in connection with complaints to determine the dischargeability of a debt.

The grounds on which discharge can be denied include the committing of an offense under 18 U.S. Code 152 by concealing assets belonging to the estate or making a false oath or account in the bankruptcy proceeding; falsification, concealment or failure to keep books of account or records; obtaining money or property on credit by a businessman on the basis of a false financial statement in writing; the transfer, concealment or destruction of assets to hinder, delay or defraud creditors; or failure to satisfactorily explain losses of assets. Bankruptcy Act § 14c, 11 U.S.C. § 32. Originally, in the case of the denial of a discharge on the basis of a false financial statement, there was no limitation to business bankrupts, but Congress found that the denial of a discharge was too Draconian a punishment of nonbusiness bankrupts. Congress concluded that a consumer was less likely to keep accurate records of finances or be aware of the importance of accurate financial records. S. Rep. No. 1688, 86th Cong. 2nd Sess., (1960) U.S. Code Cong. and Ad. News, pp. 2954 *et seq.* Although a false financial statement by a non-business bankrupt no longer bars a discharge it may nonetheless result in the particular debt incurred on the basis of a false financial statement being nondischargeable. Bankruptcy Act § 17a(2), 11 U.S.C. § 35.

The activities which would bar a discharge relate mainly to actions of the bankrupt jeopardizing the rights of creditors or obstructing the bankruptcy proceedings. One exception is the failure to pay the filing fees. Strange as it may seem, the hard pressed debtor who has no money to pay his creditors cannot take full advantage of the Bankruptcy Act and obtain a discharge if he is unable to pay the \$50 filing fee. Bankruptcy Act § 14c(8), 11 U.S.C. § 32; *U.S. v. Kras*, 40 U.S. 434 (1973). However, the Rules make liberal provisions to alleviate the burden on the bankrupt by paying these fees in up to four installments over four months and, for cause shown, up to six months. Bankruptcy Rule 107(b).

A discharge may also be denied on the basis

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Any creditor wishing to object to a bankrupt's discharge must file a written objection with the court in a proceeding under the Bankruptcy Act. The court may grant an order that the bankrupt be discharged and that all of his obligations be discharged, unless the court finds that the discharge should be denied on the basis of a false oath or account in the bankruptcy proceedings; falsification, concealment, or destruction of books or records; or the transfer, concealment, or failure to satisfactorily explain the disappearance of assets to hinder, delay, or defraud creditors. Bankruptcy Act § 14c, 11 U.S.C. § 14c. In the case of a discharge on the basis of a false oath or account, the court may also find that the bankrupt was too Draconian a punisher of his creditors and that the discharge should be denied on the basis of a false oath or account in the bankruptcy proceedings. Bankruptcy Act § 14c, 11 U.S.C. § 14c.

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Such a waiver must be made in writing and filed with the court. Bankruptcy Rule 405. There is a very important extension of this, namely, the implied waiver of discharge. A bankrupt who fails to attend and submit himself to examination by his creditors in accordance with the Bankruptcy Act may be deemed to have impliedly waived discharge. Such an implied waiver may be the basis of a complaint to object to discharge or the court, on its own initiative, may set a hearing to determine whether the bankrupt has waived his right to a discharge by his actions. Bankruptcy Rule 406.

A discharge is only available once in every six years. The obtaining of a discharge, the confirmation of an arrangement or a wage earner's plan under the Bankruptcy Act within six years prior to the commencement of the bankruptcy operates as a bar to discharge. Bankruptcy Act Section 14c(5), 11 U.S.C. § 32.

If, after the expiration of the time fixed by the court for filing objections to discharge, the court finds that no complaint has been filed, that there has been no actual or implied waiver by the bankrupt of his right to discharge and that the bankrupt has paid the prescribed filing fees in full, the court shall issue an order of discharge in the form officially prescribed. Bankruptcy Rule 404; Bankruptcy Official Form no. 104.

Dischargeability
Although it is commonly believed that a discharge in bankruptcy relieves a bankrupt of all debts, this is not the case. Discharge only affects a limited class of debts — those that are provable under § 63 of the Bankruptcy Act and those that are not otherwise excepted under § 17 of the Bankruptcy Act. As a general rule, a debtor is discharged if (a) it was in existence at the time of filing of the bankruptcy petition, (b) it is in the class of claims provable under § 63, and (c) it does not fall within one of the exceptions contained in § 17.

Provable Claims
The type of debts which may be proved and allowed against the estate of a bankrupt are set forth in the Act. Bankruptcy Act § 63, 11 U.S.C. § 63. The major class of debts which may be proved are contractual claims: a note, an open account, an express or implied contract, a contingent debt or contingent contractual liability and a claim for anticipatory breach of contract, including an unexpired lease of real or personal property. Most of the contractual provable claims are straightforward in nature. Claims for contingent debts and contingent contractual liabilities, however, have a very strange status. They are "provable," but if not allowable they become "not provable." A claim on a contingent liability would, at first blush, be provable under § 63 of the Act but because of the impossibility of liquidating the claim within a reasonable time, may not be allowable under § 57 of the Act, in which case the claim is deemed not provable. Bankruptcy Act § 63D provides, "Where any contingent or unliquidated claim has been proved, but, as provided in subdivision (d) of Section 57 of this Act, has not been allowed, such claim shall not be deemed provable under this Act." One of the important effects of this odd circularity is that a contingent claim which cannot be liquidated within a reasonable time and therefore would not be allowable, will be discharged unless the creditor has filed his proof of claim and has had it disallowed.

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In the case of claims for anticipatory breaches of contract, there is a special limitation on the damages for unexpired leases of real estate. The claim of a landlord for damages resulting from rejection of an unexpired lease of real estate may not be allowed in an amount exceeding the rent for one year succeeding the date of surrender of the premises or the date of re-entry. Bankruptcy Act § 63a(9), 11 U.S.C. § 103. In a Chapter XI proceeding the landlord's claim for rejection of an expired lease can be made for an amount up to three years. Bankruptcy Act § 353, 11 U.S.C. § 753. This limitation is only for damages from the rejection of a lease of real estate; there is no such limitation upon the

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damage claims for breach of other contracts, including the rejection of an unexpired lease of personal property

There are limited rights to prove tort claims in bankruptcy: liabilities fixed by judgment prior to the date of the filing of the petition; a workmen's compensation award for injury occurring prior to the adjudication of bankruptcy; and a claim for damages in any action for negligence provided it was instituted prior to, and pending at, the time of the petition in bankruptcy. Bankruptcy Act § 63a, 11 U.S.C. § 103.

Debts Not Affected by Discharge

Section 17 of the Bankruptcy Act carves out certain debts not affected by discharge. One of the most important classes of claims that are not affected by discharge are claims of creditors which have not been duly scheduled. Bankruptcy Act § 17a(3), 11 U.S.C. § 35. Certainly, due scheduling of claims is very important if the bankrupt is to take full advantage of the proceedings. Due scheduling means that the name of the creditor must be included, but it is not fatal if the creditor is given a misnomer as long as he is easily identifiable from the whole description given. A discharge may be effective against an unscheduled creditor if it can be proved that the creditor had notice or actual knowledge of the bankruptcy. In any event, notice or actual knowledge must be received in time to allow the creditor to prove his claim and participate equally with other creditors in the administration of the affairs of the estate. See generally 1A Collier *Bankruptcy* §17.23 (14th ed.).

Taxes owing the United States or any state or any subdivision within three years preceding the bankruptcy are not affected by discharge. The provisions governing taxes are extremely complex, with variations depending upon whether the bankrupt made a proper return,

whether taxes had been assessed, whether there was a prohibition on assessment pending exhaustion of administrative or judicial remedies, whether there was a false or fraudulent return or wilful attempt to evade taxes, whether the bankrupt had collected or withheld taxes from others as required by law but had not paid them over. The provisions of the statute should be studied with some care to determine whether a particular tax obligation is dischargeable. Bankruptcy Act § 17a(1).

Other classes of debts not affected by discharge would include liabilities created by fraud or embezzlement by the bankrupt while acting as an officer or in a fiduciary capacity, liability for priority wage and commission claims to employees, liability for alimony or maintenance or support of a wife or child, liability for willful and malicious injuries to persons or property, and liability for obtaining of money or property on credit under false pretences or in reliance on a materially false financial statement in writing. Bankruptcy Act § 17a(2)-(8), 11 U.S.C. § 35. The latter category is usually the most important in consumer bankruptcies. It commonly arises in the case of an individual bankrupt who has obtained credit through the use of a personal financial statement. The pattern of lending of small loan companies tends to encourage the debtor not to make a full statement of his liabilities on a loan application; for example, the loan application may require a statement of all outstanding debts and obligations, but leave very little space in the financial statement. In fact, there is some evidence that this is a conscious pattern of some lenders. S. Rep. No. 1660, 86th Cong. 2nd Sess., [1960] U. S. Code Cong. and Ad. News p. 2955. For a creditor to have his claim excepted from the discharge on this basis he must show that the bankrupt made the statement with intent to deceive and that, at the time the loan was made, the creditor relied

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an assessed, whether there is assessment pending executive or judicial remedies, false or fraudulent return evade taxes, whether the d or withheld taxes from y law but had not paid ions of the statute should care to determine whether ligation is dischargeable. (1).

debts not affected by liabilities created by fraud the bankrupt while acting fiduciary capacity, liability commission claims to em- limony or maintenance or child, liability for wilful s to persons or property, ning of money or property pretences or in reliance on ncial statement in writing. 'a(2)-(8), 11 U.S.C. § 35. s usually the most impor- ankrupcies. It commonly n individual bankrupt who hrough the use of a per- ent. The pattern of lend- ppanies tends to encourag- ke a full statement of his application; for example, ay require a statement of and obligations, but leave he financial statement. In idence that this is a con- : lenders. S. Rep. No. 1688, , [1960] U. S. Code Cong. 55. For a creditor to have om the discharge on this hat the bankrupt made the t to deceive and that, a s made, the creditor relied

on the financial statement and did not know that the statement was false.

Procedure to Determine Dischargeability

In most cases the Bankruptcy Act is permissive and provides that the bankrupt or any creditor may file an application with the court for a determination of dischargeability of any particular debt. Bankruptcy Act § 17c(1), 11 U.S.C. § 35. On most debts the Bankruptcy Court has concurrent jurisdiction with state courts to determine a question of dischargeability. However, in the case of debts made undischARGEABLE under clauses 2, 4 or 8 of Bankruptcy Act § 17a, relating to obtaining money or credit on the basis of a false financial statement in writing, certain other fraudulent activity or wilful and malicious injury, the Bankruptcy Court has exclusive jurisdiction. Bankruptcy Act § 17c(2), 11 U.S.C. § 35. A creditor who contends that his claim is undischARGEABLE under clauses 2, 4, or 8 of Bankruptcy Act § 17a must file a complaint for determination of dischargeability within the time fixed by the Court. Bankruptcy Act § 17c(2), 11 U.S.C. § 35; Bankruptcy Rules 409(a)(2). The court is to set the date for the filing of such complaint not less than 30 nor more than 90 days after the date set for the first meeting of creditors. Unless a complaint to determine dischargeability of claims under clauses 2, 4 or 8 of § 17a is properly brought within the time set by the court, the debt will be discharged. Bankruptcy Act § 17c(2), 11 U.S.C. § 35.

Adversary Proceedings

Complaints to determine dischargeability as well as complaints to object to discharge are governed by the Bankruptcy Rules on "Adversary Proceedings," Bankruptcy Rules 701 and following. Adversary proceedings are really a form of modified civil suit or action. The Bankruptcy Rules incorporate many of the Federal Rules of Civil Procedure, but an attempt is made to streamline the proceedings.

Once a complaint is filed to institute the adversary proceeding, under Rule 704(a) the bankruptcy judge or a delegated assistant issues a summons and notice of trial which must be served upon the other party within three days of its issuance. Rule 704(c) provides for service by mail. Under Rule 704(d)(2) service may be made by publication if the other alternatives have proven unsuccessful. If service is not made within ten days, Rule 704(e) provides that a

new summons must be issued and a new date set for trial. Rule 704(f) provides for nationwide service of process.

The defendant must file his answer on any special defense within 30 days after the issuance of a summons unless a different time is set by the court. Bankruptcy Rule 712. The parties can obtain discovery by oral deposition, written interrogatories, production of documents, requests for admissions or any of the forms of discovery permitted under the Federal Rules of Civil Procedure.

Trials are generally by the court, but either party may demand a trial by jury of any issue triable by right of jury. Bankruptcy Act § 17c(5), 11 U.S.C. § 35; Bankruptcy Rules 409(c). Demand for jury trial must be made within 10 days after service of the last pleading directed to the jury issue.

Rule 409(c) provides that an issue triable of right by a jury is placed on the calendar of jury trials to be tried by a district judge. However, the bankruptcy judge may deny the demand for a jury if he determines after hearing on notice that there is no issue triable of right by a jury.

The Bankruptcy Rules provide that the court shall require a record of all proceedings in a bankruptcy case, whenever practicable. Bankruptcy Rule 511. The Regulations issued under the Local Bankruptcy Rules for the District of Massachusetts provide that any party filing a complaint to object to discharge or a complaint to determine dischargeability of a debt must deposit \$100 with the court to pay the expenses of a court stenographer. D. Mass. Local Bankruptcy Regulation #1, dated October 13, 1972.

There is a right of appeal to the District Court from an order of judgment of the Bankruptcy Court. Notice of appeal must be filed with the Bankruptcy Judge within 10 days of the entry of the judgment or order appealed from. Bankruptcy Rule 802. Appeals are governed by Rules 801 and following of Bankruptcy Rules.

Summary

Failure to comply with the many technical provisions of the statute and rules governing discharge and dischargeability can jeopardize the main benefit of bankruptcy for a bankrupt and can prevent a creditor from pursuing what might otherwise be a non-dischargeable debt. The bankrupt need not take positive action to obtain the full benefits of a discharge other than attend the first meeting of creditors and submit himself to examination; however, if a complaint to

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object to discharge or to determine dischargeability is filed, the bankrupt must answer and actively contest the complaint in the adversary proceedings. A creditor objecting to discharge or claiming a debt to be undischageable under

clauses (2), (4) or (8) of § 17a of the Bankruptcy Act must prior to the deadline set the court file a complaint and prosecute adversary proceeding in accordance with Bankruptcy Rules.

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