# Demonstrating Fraud Exceptions to Discharge

By Craig D. Robins

When a consumer files for Chapter 7 relief, a creditor can object to the debtor's efforts to discharge a debt under several theories of fraud.

In a recent case assigned to Judge Robert E. Grossman, a debtor borrowed significant sums of money from two retirees and barely paid them back before filing for Chapter 7 relief.

The two creditors, represented by the same attorney, brought a joint adversary proceeding against the debtor, seeking to except these debts from discharge pursuant to three different legal theories contained in Bankruptcy Code §523(a)(2)(a).

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Although the two creditors alleged identical causes of action and introduced the same documentary evidence at trial, Judge Grossman, sitting in the Central Islip Bankruptcy Court, found in favor of only one of the creditors.

The judge issued a 19-page decision on February 22, which was interesting for several reasons. First, as the judge pointed out, "While the court's decision in this matter may seem harsh, the case highlights the fundamental proposition that it is the plaintiff's burden to prove each element of any cause of action set forth in the complaint."

Second, although Judge Grossman

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indicated that "much ink has been spilled over what is required to prove non-dischargeability under §523(a)(2)(a)," the he nevertheless did a nice job discussing the current state of the law for prevailing under the different legal theories of false pretenses, false representations, and/or actual fraud. *In re Cahill* (Bankr. E.D.N.Y., Case No. 15-08298-reg, Adv. Pro. No. 15-08298-reg.)

In trying to borrow money from two retirees, the debtor urged them to "invest" their life savings in a fancy restaurant in the Hamptons that was about to open. The debtor sought to cultivate a reputation as a successful businessman, formerly in a successful oil business, who was building a big, fancy home in the Hamptons, and was now focusing his energy in this new restaurant venture. He promised the retirees higher rates of interest than what they were receiving at the bank.

It did not occur to the retirees to seek out professional advice or to ask for any financial information about the restaurant, or to even visit it. They simply asked the debtor if he was honest, and he assured them that he was.

They then separately loaned the debtor $50,000 and $150,000. A year later, the debtor sought even more investments from them, and they each gave him another $50,000. The following year, the debtor persuaded the retirees that he was now starting up a solar panel business and that he had various government contracts that were about to be signed. The retirees then gave him another $25,000 each.

The debtor eventually admitted that he held no ownership interest at all in the restaurant, despite referring to himself as a "silent partner." He also admitted at trial that he did not own an oil business. In fact, he worked for his son's oil business.

It was from his employment earnings that the debtor made monthly interest payments to the retirees. The debtor initially testified that he deposited some of the money in the restaurant's supposed bank account but could not provide any evidence of that. He ultimately testified that he could not recall where the money was deposited.

The debtor did not use any of the money for the solar panel business and instead admitted that the money was used to pay back another creditor that the debtor owed, stating that he was taking money from "Peter to pay Paul." Both retirees obtained judgments before the debtor sought bankruptcy relief.

Judge Grossman began his analysis by stating some of the basics — any successful action under §523(a) results in a specific debt being deemed non-dischargeable. This is in contrast to a non-dischargeability action under §727 that denies a debtor's discharge in its entirety.

The creditor has the burden of proving the elements of a section §523(a)(2)(a) claim by a preponderance of the evidence, showing that the debtor obtained money by either of these types of fraud — false pretenses, false representations, and/or actual fraud.

The judge then discussed the recent 2016 Supreme Court opinion in *Husky International Electronics v. Ritz* which clarifies that although some types of fraud might require specific elements that overlap, "actual fraud" encompasses fraudulent acts by a debtor that can be undertaken without a false representation.

He then went on to discuss how the three types of fraud in this provision must be analyzed individually. A plaintiff, in order to be successful, need only satisfy one of the three types of fraud.

"False pretenses" means conscious, deceptive or misleading conduct calculated to obtain, or deprive another of property. The elements required to establish a debt as nondischargeable under false pretenses are: an implied misrepresentation or conduct by the debtor; promoted knowingly and willingly by the debtor; creating a contrived and misleading understanding of the transaction on the part of the creditor; which wrongfully induced the creditor to advance money, property, or credit to the debtor.

To establish "false representations, the creditor must prove that the debtor: made a false or misleading statement with the intent to deceive in order for the creditor to turn over money or property to the debtor.

Finally, a debt may be excepted from discharge where a creditor can establish elements of "actual fraud." The Supreme Court in *Husky* broadened the definition of actual fraud by defining it as "anything that counts as 'fraud' and is done with wrongful intent."

Judge Grossman also held that notwithstanding the expansive reach of *Husky*, justifiable reliance must also be shown, which is subjective.

The judge found that the debtor made false representations to both retirees. One of them, Mr. Romano, testified at trial that he relied on these misrepresentations, which misled him into believing what the debtor told him, even though he had done no investigating. The Judge Grossman found such reliance to be justified. Accordingly, he found the debtor's claim to Mr. Romano to be nondischargeable.

However, with regard to the other retiree, Ms. Argento, there was an unfortunate result since she did not testify at all because she was in a nursing home and in ill health. As such, Judge Grossman found that she failed to meet her burden of proof that she relied upon the debtor's statements. As such, she did not succeed with the same non-dischargeability claim. The judge commented, however, that she might have been successful had she submitted an affidavit or other evidence establishing that she justifiably relied on the debtor's misrepresentations, but "the record was barren of any evidence regarding reliance."

There was no doubt that the debtor made serious misrepresentations. However, that was not enough. Ms. Argento was obligated to demonstrate justifiable reliance.

The different way Judge Grossman ruled in response to the claims of these two retirees demonstrates the importance of establishing each and every one of the required elements. Just as important, since justifiable reliance is subjective in nature, the creditor must prove reliance as well. The existence of reliance is determined by the trier of facts – in this case, Judge Grossman.

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