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## False Financial Statements and Bankruptcy Discharges

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curs whether or not the subjacent owner has violated his duty to support. It further eliminates the problem of awarding speculative damages for future subsidence that may or may not occur. Also, since each separate cave-in gives rise to a new cause of action, a recovery for new subsidence is not barred by the principle of *res judicata*. This is true even when the new subsidence results from the same act of mining that caused a previous cave-in for which the surface owner has already recovered.

LEONARD SARGEANT, III

### FALSE FINANCIAL STATEMENTS AND BANKRUPTCY DISCHARGES

A discharge has been granted in bankruptcy proceedings for more than two centuries.<sup>1</sup> Discharge provisions have varied in terms and application. The Bankruptcy Act of 1898, which is the basis of the present Act, provided for the debtor's discharge from further obligation on his debts upon meeting certain strict conditions.<sup>2</sup> Section 14(a) of the Bankruptcy Act of 1898, as now amended, shows the liberal trend in favor of discharge by providing that adjudication as a bankrupt shall be tantamount to an application for a discharge.<sup>3</sup> Section 14(c) further provides that the granting of a discharge is mandatory if the bankrupt is not guilty of any of the enumerated grounds for a denial.<sup>4</sup> Section 14(c)(3), probably the most frequently used ground for denial, was greatly liberalized in favor of the bankrupt by amendment in 1960.<sup>5</sup> Under the amended section a person may receive a dis-

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<sup>1</sup>"[A]nd be it further enacted . . . shall be discharged from all debts by him . . ." 4th Anne, ch. 17 (1705) for historical discussion see Remington, *Bankruptcy* § 5 (5th ed. 1950).

<sup>2</sup>Collier, *Bankruptcy* § 14.01 (14th ed. 1962); Remington, *Bankruptcy* § 2993 (6th ed. 1955).

<sup>3</sup>"(a) The adjudication of any person, except a corporation, shall operate as an application for a discharge." *Bankruptcy Act* § 14(a), 52 Stat. 850 (1938), 11 U.S.C. § 32(a) (1958); Remington, *Bankruptcy* § 2995 (6th ed. 1955).

<sup>4</sup>"(c) The court shall grant the discharge unless satisfied that the bankrupt has . . ." (emphasis added), *Bankruptcy Act* § 14(c), 52 Stat. 850 (1938), 11 U.S.C. § 32(c) (1958).

<sup>5</sup>(c) The court shall grant a discharge unless . . . (3) [while engaged in business as a sole proprietor, partnership, or as an executive of a corporation,] obtained [for such business] money or property on credit or as an extension or renewal of credit by making or publishing or causing to be made or published in any manner whatsoever, a materially false statement in writing respecting his financial condition [for the financial condition of such partnership or corporation;]" (language added

charge in certain instances notwithstanding that he has obtained credit or procured an extension thereof through the use of a materially false written financial statement. However, the discharge is limited since section 17(a)(2) was also amended in 1960 to provide that although a discharge is granted, a debt incurred by fraudulent means is not discharged.<sup>6</sup>

*In the Matter of Simms*<sup>7</sup> is a case of first impression involving the 1960 amendment. The bankrupt was a tenant farmer, who used his own machinery in operating a farm for another person. The owner and the bankrupt divided the profits. The bankrupt obtained a loan of \$600 from the Seaboard Finance Company, who relied on the bankrupt's materially false written financial statement. Another creditor relying on section 14(c)(3) objected to the bankrupt's discharge. The court nevertheless granted the discharge on the grounds that the 1960 amendment to this section was intended to relieve the harshness of the old provision towards a bankrupt who is engaged in a noncommercial activity, as distinguished from one who is involved in commerce.<sup>8</sup> Thus, according to this court's interpretation, a bankrupt not engaged in commercial activity will be granted his discharge to all debts except the one which, under section 17(a)(2), was fraudulently incurred.<sup>9</sup>

Prior to the 1960 amendment section 14(c)(3) was particularly harsh on the bankrupt. If a creditor could show that the bankrupt had made a materially false written financial statement, and that credit had been given in reliance thereon, a discharge was denied as to all debts.<sup>10</sup>

by amendment in brackets), Bankruptcy Act § 14(c)(3), 52 Stat. 850 (1938), amended by 74 Stat. 408 (1960), as amended, 11 U.S.C. § 32(c)(3) (Supp. II 1960); S. Rep. No. 1688, 86th Cong., 2d Sess., p. 2954 (1960).

"(a) A discharge in bankruptcy shall release a bankrupt from all of his provable debts, whether in full or in part, except such as . . .

"(2) are liabilities for obtaining money or property by false pretenses or false representations, or for obtaining money or property on credit or obtaining an extension or renewal of credit in reliance upon a materially false statement in writing respecting his financial condition made or published or caused to be made or published in any manner whatsoever with the intent to deceive . . .", Bankruptcy Act X 17(a)(2), 52 Stat. 851 (1938), amended by 74 Stat. 409 (1960), as amended, 11 U.S.C. § 35(a)(2); (Supp. II 1960); S. Rep. No. 1688, 86th Cong. 2d Sess. p. 2956 (1960).

<sup>7</sup>202 F. Supp. 911 (E.D. Va. 1962).

<sup>8</sup>For discussions of what constitutes "commerce," see, *United States v. Besser Mfg. Co.*, 96 F. Supp. 304 (E.D. Mich. 1951); *Young v. Kellex Corp.*, 82 F. Supp. 953 (E.D. Tenn. 1948); *City of Topeka v. Jones*, 74 Kan. 164, 86 Pac. 162 (1906). But see, *United States v. Oregon State Medical Soc.*, 343 U.S. 326 (1952); 7A Words & Phrases, Commerce (perm. ed. 1952).

<sup>9</sup>See note 6 supra.

<sup>10</sup>*In re Prout*, 74 F. Supp. 889 (S.D. Cal. 1947).

Thus a creditor who knew nothing about the financial statement and therefore was not deceived, benefited from the denial as well as the one who was fraudulently induced to make the loan.<sup>11</sup>

The elements outlined in section 14 (c)(3) which are requisite for a denial of discharge remain in force:<sup>12</sup> the statement must be in writing, it must be materially false, credit or an extension of credit or property must have been obtained in reliance on the false statement, and the bankrupt must have published or caused the statement to be published. The amendment, however, makes section 14(c)(3) inapplicable to the bankrupt who does not obtain money or property for commercial purposes.<sup>13</sup>

Generally the courts have strictly construed the provisions of section 14(c)(3). The requirement that the statement must be in writing has apparently presented no problem.<sup>14</sup> The other elements, however, are more complex. The determination of what is materially false<sup>15</sup> has caused some difficulty, and one court has gone so far as to hold that an understatement of a debt of less than \$250 in an application for a \$300 loan is a sufficiently material falsification to justify a denial of the discharge.<sup>16</sup> If the other requisites are met, any reliance by a creditor is sufficient to deny a discharge.<sup>17</sup> The fact that there has been an independent investigation by the creditor does not necessarily show lack of reliance.<sup>18</sup> Moreover, the statement does not need to have been made to the objecting creditor,<sup>19</sup> so long as there

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<sup>11</sup>In re Prout, 74 F. Supp. 889 (S.D. Cal. 1947); In re Henahan, 32 F. Supp. 278 (N.D. Ill. 1940); In re Easthan, 51 F.2d 287 (S.D. Tex. 1931).

<sup>12</sup>See note 5 supra.

<sup>13</sup>Bankruptcy Act 14(c)(3), 52 Stat. 850 (1938), amended by 74 Stat. 408 (1960), as amended, 11 U.S.C. § 32(c)(3) (Supp. II 1960); Collier, Bankruptcy § 14.36 (14th ed. 1962).

<sup>14</sup>Mau v. Sampsell, 185 F.2d 400 (9th Cir. 1950).

<sup>15</sup>Morimura, Arai & Co. v. Taback, 279 U.S. 24 (1929); Morris Plan Industrial Bank v. Parker, 143 F.2d 665 (D.C. Cir. 1944); In re McGillis, 40 F.2d 268 (10th Cir. 1930); Compare, Wylie v. Ward, 292 F.2d 590 (9th Cir. 1961).

<sup>16</sup>In re West, 158 F.2d 858 (7th Cir. 1946).

<sup>17</sup>Banks v. Siegel, 181 F.2d 309 (4th Cir. 1950); Yates v. Boteler, 163 F.2d 953 (9th Cir. 1947). In re Philpott, 37 F. Supp. 43 (W.D. W. Va. 1940); In re Nonsch, 18 F. Supp. 913 (E.D. Ky. 1937); In re Hochberg, 17 F. Supp. 916 (W.D. Pa. 1936); Compare, Wylie v. Ward, 292 F.2d 590 (9th Cir. 1961); In re Little, 65 F.2d 777 (2d Cir. 1933); In re Day, 11 F. Supp. 400 (D. Mass. 1935).

<sup>18</sup>In re Applebaum, 11 F.2d 685 (2d Cir. 1926); In re Muscara, 18 F.2d 606 (W.D. Pa. 1927).

<sup>19</sup>Cunningham v. Elco Distribs., 189 F.2d 87 (6th Cir. 1951); In re Haggerty, 165 F.2d 977 (2d Cir. 1948); In re Arky, 138 F.2d 669 (2d Cir. 1943) (case where loan was paid before adjudication); In re Leonard, 122 F. Supp. 214 (S.D. Cal. 1954); In re Anderson, 104 F. Supp. 599 (E.D. Wis. 1952); In re Sheridan, 34 F. Supp. 286 (D.N.J. 1940); In re Weinstein, 34 F.2d 964 (S.D. Cal. 1929).

was reliance.<sup>20</sup> However, the fact that the false statement was written and published by the bankrupt, and a creditor in fact did rely thereon is not sufficient, standing alone, to deny a discharge. In addition to the foregoing requisites the bankrupt must have intended to defraud the creditor;<sup>21</sup> however, this intent may be implied when the evidence shows that the bankrupt acted with reckless disregard as to the validity of the statement.<sup>22</sup> Upon presenting evidence of these elements the objecting creditor has presented a prima facie case thus putting the burden on the bankrupt to exonerate himself.<sup>23</sup> It follows that the bankrupt is at somewhat of a disadvantage when the false statement is introduced.

Thus the express purpose of the amendment is to limit the use of a written false financial statement as a bar to a discharge.<sup>24</sup> The intent of Congress in passing the amendment was threefold:<sup>25</sup> Firstly, to relieve the harshness of the unamended section on the noncommercial bankrupt; Secondly, to prevent creditors who had no knowledge of the false statement from benefiting by not having their claims discharged, so that they retained a possibility of full payment in the future or at least the opportunity of subjecting the debtor to harassment; Thirdly, to retain the protection of section 17(a)(2)<sup>26</sup> for the creditor who has been deceived.

While the purposes of Congress are desirable, difficulty can arise in determining the applicability of the amendment. The amended section reads in part, "(3) *while engaged in business* as a sole proprietor, partnership, or as an executive of a corporation, obtained for such

<sup>20</sup>In re Jaffee, 20 F.2d 370 (2d Cir. 1927); Bank of Monroe v. Gleeson, 9 F.2d 520 (8th Cir. 1925); Rauch v. Manchester-Smith Co., 240 Fed. 687 (4th Cir. 1917).

<sup>21</sup>In re Schwartz, 133 F.2d 216 (7th Cir. 1943); Baash-Ross Tool Co. v. Stephens, 73 F.2d 902 (9th Cir. 1934); In re Rosenfeld, 262 Fed. 876 (2d Cir. 1919); In re Cleveland, 40 F. Supp. 343 (W.D. Mich. 1940).

<sup>22</sup>Morimura, Arai & Co. v. Taback, 297 U.S. 24 (1929); In re Santos, 211 F.2d 877 (7th Cir. 1954); David v. Annapolis Banking & Trust Co., 209 F.2d 343 (4th Cir. 1953); In re Lovich, 117 F.2d 612 (2d Cir. 1941); Woolen Corp. v. Gitnig, 33 F.2d 259 (3d Cir. 1929); In re Metcalf, 48 F. Supp. 405 (N.D. Tex. 1942); In re Kellerman, 2 F. Supp. 520 (S.D.N.Y. 1932).

<sup>23</sup>Bankruptcy Act § 14(c)(7) 52 Stat. 850 (1938), 11 U.S.C. § 32 (c)(7) (1958); In re Berberich, 190 F.2d 53 (7th Cir. 1951); Morris Plan Industrial Bank v. Parker, 143 F.2d 665 (D.C. Cir. 1944); In re Finn, 119 F.2d 656 (3d Cir. 1941); In re Smatlak, 99 F.2d 687 (7th Cir. 1938); Federal Provision Co. v. Ershowsky, 94 F.2d 574 (2d Cir. 1938).

<sup>24</sup>"The purpose of the bill is to limit the use of false financial statements as a bar to discharge in bankruptcy." S. Rep. No. 1688, 86th Cong., 2d Sess., p. 2954 (1960).

<sup>25</sup>S. Rep. No. 1688, 86th Cong., 2d Sess. p. 2954 (1960).

<sup>26</sup>See note 6 supra.

*business* money . . . by making or publishing . . . in any manner whatsoever a materially false statement in writing respecting his financial condition or the financial condition of such partnership or corporation;"<sup>27</sup> Literally its applicability is limited to the situation in which the loan is obtained by a person engaged in a commercial activity, to be used for a business, i.e., for the purchase of new equipment, more merchandise, new fixtures, expansion of the business itself, or for whatever the business as such needs.

Thus in a situation which involves a wage earner, retired person, or tenant farmer,<sup>28</sup> the court would have no problem in deciding that this class of person is without the scope of the amended section 14(c)(3). By its express terms discharge is denied only to those who are engaged in commerce and have obtained a loan for a commercial purpose. Obviously this class is not engaged in commerce of any recognized type, such as buying, selling, or trading merchandise. Therefore section 14(c)(3) has no application to this class, and if such persons do publish a false financial statement the creditor who relies thereon falls within the scope of section 17(a)(2), but all other dischargeable debts are discharged.<sup>29</sup>

The more difficult problem arises in the situation in which the debtor is a businessman. The primary question is, should the amended section be applicable to the businessman who receives credit as an individual and not for commercial purposes? The amended section appears to answer this question in the affirmative by saying, "(3) while engaged in business . . . obtained for such business. . . ." Thus the discharge is denied as to all debts, only if the loan is "for" a business. However, the statement of the intent of Congress seemingly speaks in terms of individuals; "the individual noncommercial bankrupt" as distinguished from the "business bankrupt," and "the financial statement issued by a businessman is frequently for the purpose of establishing credit standing in the community."<sup>30</sup> Such statements could be interpreted to mean that if one is a businessman or engaged in the sale or purchase or trading of merchandise, and he obtains a loan either on an individual basis or for his business; he does not receive the protection of the amended section. It appears that such an inter-

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<sup>27</sup>Bankruptcy Act § 14(c)(3), 52 Stat. 850 (1938), amended by 74 Stat. 408 (1960), as amended, 11 U.S.C. § 32(c)(3) (Supp. II 1960). (Emphasis added).

<sup>28</sup>According to 7A Words & Phrases, Commerce (perm. ed. 1962) professional men are not engaged in commerce, and so may also be included.

<sup>29</sup>Bankruptcy Act § 14(c)(3), 52 Stat. 850 (1938), amended by 74 Stat. 408 (1960); as amended, 11 U.S.C. § 32(c)(3) (Supp. II 1960); 17 (a)(2), 52 Stat. 851 (1938), amended by 74 Stat. 409 (1960), as amended, 11 U.S.C. § 35(a)(2) (Supp. II 1960).

<sup>30</sup>S. Rep. No. 1688, 86th Cong., 2d Sess. p. 2954 (1960).