

Debtors Behaving Badly: Non-Dischargeability of Debt Based on Debtor’s “Bad Acts”

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It is said that the word bankruptcy originated in the middle ages from the term “breaking the bench.” At that time, rupturing a craftsman’s bench was the punishment for defaulting. Later, debtors were punished for their failure to pay their debts through imprisonment. Neither approach helped the creditor. Rather, it punished those dependent upon the debtor for support. In the late 19th Century, the American system of bankruptcy was created to break from these policies and provide debtors a fresh start.

This “fresh start” is engrafted in the Bankruptcy Code (hereinafter, the “Code”). It may allow debtors to be forgiven for some, or all, of their debts.

In an earlier client alert, we discussed the nondischargeability of debt: [Non Dischargeable Debts - Cullen and Dykman LLP \(cullenllp.com\)](#). Section 523 of the Code creates exceptions to the discharge of certain types of debts. Section 727 of the Code permits the bankruptcy court to deny discharge of a debtor. Creditors may either object to the debtor’s overall discharge or discharge of a specific debt.

Creditors may ask the court to declare a debt nondischargeable. Examples include debts arising from (i) money, property or services provided to the debtor obtained by false pretenses, false representation or actual fraud (section 523(a)(2)(A)); (ii) debtor’s fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny (section 523(a)(4)); or (iii) debtor’s willful and malicious injury to another entity or property of another entity (section 523(a)(6)).

Our recent legal alerts discuss student loan debt, which is another type of debt that can be nondischargeable pursuant to section 523(a)(8) of the Code: [Student Loan Debt Discharged in Recent Bankruptcy Court Opinion - Cullen and Dykman LLP \(cullenllp.com\)](#); [Student Loan Debt Discharged in Recent Illinois Bankruptcy Court Opinion](#)

- Cullen and Dykman LLP (cullenllp.com); Another Bankruptcy Court Rules in Favor of Discharging Student Loan Debt. - Cullen and Dykman LLP (cullenllp.com); An Update on Student Loan Debt: Interpretation of the Statute is Critical - Cullen and Dykman LLP (cullenllp.com).

A recent case in Illinois, *McGee v. Reed (In re Reed)*, No. 18bk19801, 2021 WL 4028730 (Bankr. N.D. Ill. Sept. 3, 2021), illustrates the court's ability to deny discharge of a debt due to bad acts. Here, the debtor falsely altered a power of attorney using it to deceptively withdraw funds from a bank account without the holders' permission. The court determined section 523(a)(2)(A) precluded discharge of the debt as actual fraud. The court found the creditor established that (1) fraud occurred; (2) with debtor's intent to defraud; and (3) the fraud created the debt. The debtor was required to repay the money she fraudulently obtained.

In another case, the Second Circuit Court of Appeals in *In re Snyder*, 939 F.3d 92 (2d Cir. 2019) found a debtor's bad acts weighty enough to deny dischargeability. The debtor here agreed to invest his friend's money in a building project. Instead, the debtor used these funds for his own personal and business expenses. Considering the defalcation exception, the court found a fiduciary relationship between the parties and the debtor acted with gross recklessness by improperly using his friend's money for himself. Due to these bad acts, the debts were not discharged under sections 523 (a)(4) and (6) of the Code.

Creditors confronted with bankruptcy of their debtor should be aware that although the fresh start is available as to most debt, some debts may be nondischargeable. As such, creditors may hold the power to object to the debtor's discharge or dischargeability of its particular debt.

However, a debt falling within one of the exceptions does not automatically except it from discharge. It is the burden of the creditor to act. Consulting insolvency counsel to evaluate whether a debt may be excepted from discharge is advisable.

Please note that this is a general overview of developments in the law and does not constitute legal advice. Nothing herein creates an attorney-client relationship between the sender and recipient. If you have questions regarding these provisions, or any other aspect of bankruptcy law, please contact Michael Traison at 312.860.4230 and/or Amanda Tersigni at 516.357.3738.

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