

First Circuit Bucks Majority on Discharge of Unlisted Debt in No-Asset Case

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Under §523 of the Bankruptcy Code, a debtor is required to give all of his or her creditors notice of the bankruptcy. Doing so allows the creditors ample time to file proofs of claim and participate in the distribution of assets. The section prohibits the discharge of debt that was “neither listed nor scheduled...in time to permit...timely filing of a proof of claim, unless [the] creditor had notice or actual knowledge of the case in time for timely filing.”² In the process of filing for bankruptcy, a debtor may innocently forget to list a creditor. The debtor may be unaware that a debt will be due, or a debtor may believe he or she is not responsible for the debt.

In a case where the debtor had nonexempt assets that were distributed to his or her creditors in the bankruptcy process, the debt owed to an unlisted creditor, who otherwise had no notice of the debtor’s bankruptcy, will not be discharged because the creditor was unable to receive his or her share of the distribution in the bankruptcy.³ That unlisted creditor may, even after the discharge is granted, seek to bring a collection action against the debtor.

In no-asset cases, where the listed creditors have no chance to file proofs of claim and no claims process is initiated, the majority rule regarding §523 is the “no harm, no foul” rule first recognized by Bankruptcy Judge **Robert Kressel** in the District of Minnesota.⁴ Judge Kressel noted that the purpose of §523 is to “remedy the harm to creditors that results from not being able to participate in the bankruptcy case.”⁵ However, where there are no assets to distribute, the claims deadline never starts to run and the time to file a

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proof of claim does not expire. Where there is no deadline to file a claim, the notice to a creditor, even a notice given years after discharge, cannot be untimely and no harm is suffered by the creditor. Therefore, the creditor’s debt is discharged, absent a showing of fraud or intentional omission, as though notice had been previously given.⁶

The First Circuit, in breaking with the plethora of cases that followed Judge Kressel’s lead, recently held in *Colonial Surety Co. v. Weizman (Colonial)*⁷ that under 11 U.S.C. §523(a)(3), a creditor must be listed, or have actual notice or knowledge of the debtor’s

or actual knowledge of the proceedings in bankruptcy.⁹ Section 523(a)(3) of the current U.S. Bankruptcy Code provides:

(a) A discharge under §727, 1141, 1228(a), 1228(b) or 1328(b) of this title does not discharge an individual debtor from any debt—

(3) neither listed nor scheduled under §521(1) of this title, with the name, if known to the debtor, of the creditor to whom such debt is owed, in time to permit—

(A) if such debt is not of a kind specified in paragraph (2), (4) or (6) of this subsection, timely filing of a proof of claim, unless such creditor had notice or actual knowledge of the case

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bankruptcy filing, for the underlying debt to be discharged. The First Circuit construed §523(a)(3)(A) narrowly when it concluded that “if the debtor fails to list a supposed creditor’s claim—meaning that the creditor will not be notified of the opportunity to participate in the proceeding (and the creditor does not otherwise happen to know of the bankruptcy), the debt is not discharged.”⁸ This article will examine the history of §523(a)(3)(A)’s rationale and the divergent rules in the various courts, and opines that the majority rule is the correct interpretation of the law.

Early Interpretations

Section 17 of the Bankruptcy Act of 1898 provided:

A discharge in bankruptcy shall release a bankrupt from all of his provable debts, except such... have not been duly scheduled in time for proof and allowance, with the name of the creditor, if known to the bankrupt, unless such creditor had notice

in time for such timely filing; or

(B) if such debt is of a kind specified in paragraph (2), (4) or (6) of this subsection, timely filing of a proof of claim and timely request for a determination of dischargeability of such debt under one of such paragraphs, unless such creditor had notice or actual knowledge of the case in time for such timely filing and request.¹⁰

The Supreme Court addressed the issue of an unlisted creditor in its decision in *Birkett v. Columbia Bank*¹¹ in 1904. In analyzing §17 of the Bankruptcy Act, the Court construed the language regarding notice by requiring actual notice to be given to all creditors. The creditor in *Birkett* had notice of the bankruptcy after the

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² 11 U.S.C. §523(a)(3)(A) (2008).

³ *Id.*

⁴ *In re Anderson*, 72 B.R. 783, 787 (Bankr. D. Minn. 1987). Judge Stewart of the District of Missouri previously recognized this principle in *Matter of Abernathy*, 38 B.R. 768 (W.D. Mo. 1983); however Judge Kressel first advanced the theory that reopening the chapter 7 case to add the unlisted creditor was not necessary (in fact was immaterial) to determine the dischargeability of the debt of that creditor.

⁵ *Id.* at 786.

⁶ *Id.* at 787.

⁷ *Colonial Surety Co. v. Weizman*, 564 F.3d 526 (1st Cir. 2009).

⁸ *Colonial*, 564 F.3d at 530.

⁹ 30 Stat. at L. 578, 550, Chap. 541, U.S. Comp. Stat. 1901, p. 3424, 3428, quoted in *Birkett v. Columbia Bank*, 195 U.S. 345, 349 (1904), later codified at 11 U.S.C. 35(a)(3).

¹⁰ 11 U.S.C. §523(a)(3) (2008).

¹¹ 195 U.S. 345 (1904).

discharge was entered; however it still would have had time under the Act to seek to revoke the discharge and add its name to the list of creditors receiving a dividend.¹² The Court held that this knowledge and especially the timing of the receipt of the knowledge was not sufficient for the debtor to receive a discharge of the particular debt under the Act.¹³ The Court further held that the excuse offered for failing to list the creditor (inadvertent neglect) was irrelevant because the Code required that a debtor give notice to his known creditors.¹⁴ Thus, the debt in *Birkett* was not dischargeable under the precursor to §523(a)(3).

The Second Circuit, in *Milando v. Perrone*,¹⁵ addressed this again 40 years later and strictly applied §17(a)(3) of the Bankruptcy Act, holding that there were no exceptions to the *Birkett* doctrine. The *Milando* court held that §17(a)(3) prevented the discharge of a creditor's claim, even though the debtor sought the right to amend the schedule and it was a no-asset case where no creditor had received any dividend.¹⁶

In the 1978 Bankruptcy Code, former §17(a)(3) was recodified as §523(a)(3). The "failure to list" provision is very similar to the language of the 1898 Act and in relevant part, prohibits the discharge of debt that was "neither listed nor scheduled...in time to permit...timely filing of a proof of claim, unless [the] creditor had notice or actual knowledge of the case in time for timely filing."¹⁷

At least two courts, however, have reviewed the legislative history to the changes of §17(a)(3)¹⁸ and cited statements in the legislative history that the formulation of §523(a)(3) was in response to the contradictory interpretations surrounding the *Birkett* rule, including a Fifth Circuit decision, *Robinson v. Mann*, where the court held that *Milando's* absolute bar to amending the bankruptcy schedule was inequitable.¹⁹ The legislative intent of the reform, as evidenced in judicial-hearing committees, reflects

Congress' desire to overrule the harsh results of *Birkett*.²⁰ The House Judiciary Committee explained the purpose of the notice provision by stating that "§523(a)(3)(A) of the House amendment is derived from the Senate Amendment. The provision is intended to overrule *Birkett v. Columbia Bank*."²¹

Majority Approach

A majority of courts have determined that a debt is discharged in a no-asset case, even when the creditor is unlisted at the time of the discharge, if the creditor is later informed of the bankruptcy discharge.²² Courts following this rule recognize that no harm has been suffered by an unlisted creditor in a no-asset case because the creditor did not miss out on the distribution of assets.

The "no harm, no foul" rule has been used in situations where a debtor innocently forgot to list a creditor and where there is no deadline to file claims.²³ The exception for courts following the majority approach is where the creditor can establish that it was fraudulently omitted from the bankruptcy schedule.²⁴

Typical of these decisions is the Ninth Circuit's opinion in *In re Beezley*.²⁵ The focus for the *Beezley* court was not on the language of the section denying discharge, but instead on the definition of a no-asset proceeding. In recognition of the fact that a debtor in this type of case has no assets that qualify for distribution among the creditors, the Ninth Circuit held that creditors are not prejudiced by not being listed.²⁶

Courts following the majority approach rely on the fact that there is no harm to an unlisted creditor in no-asset cases. There are also remedies available to a creditor if a debtor fraudulently did not

give notice to a creditor. These protections for creditors were sufficient in cases holding that the "no harm, no foul" rule should be applied to an unlisted creditor in a no-asset bankruptcy proceeding.²⁷

The Fifth Circuit in *Stone v. Caplan*, following the majority approach, enunciated a three-factor test to determine whether a debtor's failure to list a creditor would prevent discharge of an unsecured debt.²⁸ The court held that if the discharge in a no-asset case is challenged through a §523 dischargeability proceeding, the court must examine (1) the reasons the debtor failed to list the creditor, (2) the amount of disruption that would likely occur if the creditors were added to the discharge and (3) any prejudice suffered by the listed creditors and the unlisted creditor in question.²⁹

In *Stone*, the Fifth Circuit reasoned that the debtor in that case innocently—not fraudulently—omitted the creditor. Therefore, there was very little disruption to allow the debtor to amend the schedule and discharge the debt. The only way that a creditor would be prejudiced is if it was unable to receive its share of the dividends, which the court held was not relevant to a no-asset case.³⁰

Stark (1983) and Colonial (2009)

The First Circuit's decision in *Colonial* represents an anomaly to the majority approach to unlisted creditors, with the Seventh Circuit following a similar rule. In *Stark v. St. Mary's Hospital*, the Seventh Circuit concluded that the decision of whether to discharge the debt of an omitted creditor is based on equity.³¹

The *Stark* court concluded that the burden is on the debtor to show that law and equitable principles allow the reopening of the case to include the omitted creditor.³² Without such a showing by the debtor, the debt will not be discharged and the creditor will have a claim against the debtor, despite the previous order for discharge of debts.

²⁷ See, e.g., *Anderson*, 72 B.R. at 788-789.

²⁸ *Stone v. Caplan*, 10 F.3d 285, 291 (5th Cir. 1994).

²⁹ *Id.*

³⁰ *Id.* at 290-92.

³¹ *Stark v. St. Mary's Hospital*, 717 F.2d 322 (7th Cir. 1983).

³² *Id.* at 324. This case has been criticized for suggesting that adding a creditor to a schedule has an effect on the dischargeability of the underlying debt. See, e.g., *In re Anderson*, 72 B.R. 783 (Bankr. D. Minn. 1987). The general rule in most jurisdictions is that a debt is either dischargeable or not based on the nature of the debt, and the nature of the status of the claims proceeding, and that reopening the case is unnecessary. See generally, Helbling, "The Emerging Harmless Innocent Omission Defense to Nondischargeability Under Bankruptcy Code §523(a)(3)(A): Making Sense of the Confusion Over Reopening Cases and Amending Schedules to Add Omitted Debts," 69 *Am. Bankr. L.J.* 33, 37-39 (1995).

²⁰ H.R. Rep. No. 595, 95th Cong., 2d Sess. (1977), 1978 U.S.C.A.N. 5963.

²¹ *Id.* at 6453. See also *Id.* at 6522.

²² See *Beezley v. California Land Title Co.* (*In re Beezley*), 994 F.2d 1433 (9th Cir. 1993); *Stone v. Caplan*, 10 F.3d 285 (5th Cir. 1994); *Judd v. Wolfe*, 78 F.3d 110 (3d Cir. 1996); *In re Madaj*, 149 F.3d 467 (6th Cir. 1998); *Matter of Abernathy*, 38 B.R. 768 (W.D. Mo. 1983); *In re Anderson*, 72 B.R. 783 (Bankr. D. Minn. 1987); *In re Padilla*, 84 B.R. 194 (Bankr. D. Colo. 1987); *In re Karamitsos*, 88 B.R. 122 (Bankr. S.D. Tex. 1988); *In re Crull*, 101 B.R. 60 (Bankr. W.D. Ark. 1989); *In re Mendiola*, 99 B.R. 864 (Bankr. N.D. Ill. 1989); *In re Hunter*, 116 B.R. 3 (Bankr. D.C. 1990); *In re Moon*, 116 B.R. 75 (Bankr. E.D. Mich. 1990); *In re Guzman*, 130 B.R. 489 (Bankr. W.D. Tex. 1991); *In re Jongquist*, 125 B.R. 558 (Bankr. D. Minn. 1991) (by implication); *In re Musgraves*, 129 B.R. 119 (Bankr. W.D. Tex. 1991); *In re Shipman*, 137 B.R. 524 (Bankr. N.D. Fla. 1991); *American Credit Servs. Inc. v. Tucker* (*In re Tucker*), 143 B.R. 330 (Bankr. W.D.N.Y. 1992); *American Standard Ins. Co. v. Bakhorn*, 147 B.R. 480 (N.D. Ind. 1992); *Keever v. Tyler* (*In re Tyler*), 139 B.R. 733 (D. Colo. 1992); *Peacock v. State Farm Mut. Auto Ins. Co.* (*In re Peacock*), 139 B.R. 421 (Bankr. E.D. Mich. 1992); *In re Thibodeau*, 136 B.R. 7 (Bankr. D. Mass. 1992); *In re Humar*, 163 B.R. 296 (Bankr. N.D. Ohio 1993); *In re Hauge*, 232 B.R. 141 (Bankr. D. Minn. 1999); *cf.*, *Stark v. St. Mary's Hospital*, 717 F.2d 322 (7th Cir. 1983), discussed *infra*.

²³ *Anderson*, 72 B.R. at 787.

²⁴ 11 U.S.C. §523(a)(4).

²⁵ *Beezley v. California Land Title Co.* (*In re Beezley*), 994 F.2d 1433 (9th Cir. 1993).

²⁶ *Id.* at 1436.

¹² *Id.* at 350.

¹³ *Id.*

¹⁴ *Id.*

¹⁵ 157 F.2d 1002, 1004 (2d Cir. 1946).

¹⁶ *Id.*

¹⁷ 11 U.S.C. §523(a)(3)(A).

¹⁸ See *Beezley v. California Land Title Co.* (*In re Beezley*), 994 F.2d 1433, 1439, n. 4 (9th Cir. 1993); *Stone v. Caplan*, 10 F.3d 285, 290 (5th Cir. 1994). Neither court (nor the legislative history cited by them) is clear on how the language of the new statute (which is remarkably similar to the old statute) is supposed to change the meaning of §17(a)(3) of the Act; however, in coming to the conclusion that a post-discharge notice to a creditor in a no-asset case is discharged, these courts assume that the harsh effects of the interpretation of the old law were somehow meant to be overcome in the new statute, because Congress said so.

¹⁹ *Robinson v. Mann*, 339 F.2d 547 (5th Cir. 1964).

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Discharge of Unlisted Debt in a No-Asset Case

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The First Circuit in *Colonial* extended the analysis of the Seventh Circuit in *Stark*.³³ In *Colonial*, Colonial Surety Company signed a contract with Uni-Con Floors Inc., obligating Uni-Con to reimburse Colonial for losses incurred by Colonial's bonding of certain construction contracts.³⁴ Uni-Con's obligations were personally guaranteed by Uni-Con's president, Avi Weizman. Uni-Con later defaulted on the bonds, and Colonial incurred expenses related to the completion of the work.³⁵ Weizman went through a no-asset chapter 7 proceeding in October 2005 and received a discharge order in April 2006,³⁶ but he failed to list Colonial as a creditor in his no-asset chapter 7 case.

In the 2007 proceedings on the Uni-Con bonds, Weizman argued that his bankruptcy discharge protected him from liability to Colonial. He further argued that he innocently omitted Colonial Surety Company because at the time of his bankruptcy filing, the debt to Colonial had not come due.³⁷

The issue in *Colonial* was whether the language in the Code intended to carve out an exception for no-asset bankruptcy proceedings that debts to unlisted creditors were discharged at the close of bankruptcy, regardless of whether the creditors were notified. The First Circuit held that the Code did not create a loophole for debtors who did not give notice to a creditor, no matter what

assets they owned at the time they filed for bankruptcy.³⁸

The First Circuit relied on the plain language of 11 U.S.C. §523(a)(3) in explaining that if a debtor fails to list a creditor's claim, then that claim is not discharged. The court found that this is especially relevant in light of the fact that the debtor is privy to more information than the creditor.³⁹

[T]he Colonial court's decision is an attack on ratable distribution and on full disclosure, both of which are the heart and soul of the bankruptcy process.

The First Circuit agreed with the creditor's argument that without notice, a creditor does not have an opportunity to argue the status of a no-asset case. If given notice, a creditor may be able to demonstrate that there are assets available, even if the debtor argues otherwise. The *Colonial* court ruled that this possible harm was enough for a court to deny a discharge for the unlisted creditor.⁴⁰ The holding in *Colonial* recognized that Weizman had the opportunity to seek the type of relief requested in *Stark*: to reopen the bankruptcy to add Colonial as a creditor.⁴¹ The debtor had not made a

decision concerning whether to file a *writ of certiorari* with the U.S. Supreme Court at the time this article was written.

Conclusion

In reviewing the First Circuit's decision, it seems clear that the court got it wrong. The *Colonial* court failed to acknowledge that in enacting §523, Congress meant to eliminate the strictest interpretations of the statute under *Birkett*. The strict reading of §523, without reference to the other Code sections that allow differing treatment for no-asset cases, puts the courts back into examining the circumstances of each debtor's motives in leaving out each creditor, as was the case in *Birkett* and its progeny. The *Colonial* court further bolstered its decision by describing the harm that mandates the result; that is, the possibility that an unlisted creditor might be able to tell a trustee that in fact there are assets to be distributed.

However, if in fact a nonlisted creditor knows of assets of the debtor, rather than rewarding that creditor by allowing only them to obtain that asset after a discharge of other debts, a creditor with knowledge of an unlisted asset should be forced to contact the trustee who can reopen the case and obtain the asset for the benefit of all creditors. To do otherwise is to encourage fraud and collusion between favored creditors and debtors by "forgetting" to list that creditor on a bankruptcy petition. Therefore, the *Colonial* court's decision is an attack on ratable distribution and on full disclosure, both of which are the heart and soul of the bankruptcy process. ■

³³ 564 F.3d 526.

³⁴ *Id.* at 528.

³⁵ *Id.*

³⁶ *Id.*

³⁷ *Id.*

³⁸ *Colonial*, 564 F.3d at 530.

³⁹ *Id.* at 532.

⁴⁰ *Beezley*, 994 F.2d 1433.

⁴¹ *Colonial*, 564 F.3d at 532. The efficacy of this potential remedy has been questioned by other courts. See n. 28.

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