

## Court's Diverge on What Constitutes a "Statement of Financial Condition" in Non-Dischargeability Actions

**Written by: Donald S. Maurice**

Maurice & Needleman PC; Flemington, N.J.

dsm@mnlawpc.com

An imprudent debtor whose predilection for gambling exceeded his skills sought protection from his creditors under chapter 7. One of his creditors was an old friend who, unfortunately, took a note for \$30,000 at 10 percent per annum. As "security," such as it was, the debtor had offered his friend his oral promise to repay him from his end-of-year bonus. At the time, the debtor seemed to his friend to be very earnest and convincing with his assurances that his success as an investment banker, although with only a year of experience, would bring him a windfall of several hundreds of thousands of dollars in his bonus – at least a quarter of a million in a "worst-case" scenario. Sadly, the loan repayment never materialized, thanks to the debtor's firing and resultant loss of his bonus.

Predictably, the creditor, but no longer friend, filed a non-dischargeability action pursuant to 11 U.S.C. §523(a)(2), which excepts from discharge, *inter alia*, debts incurred through false statements about the debtor's financial condition. However, the creditor's attorney believed that a problem lay in the fact that the "assurances" made by the debtor were not in writing. 11 U.S.C. §523(a)(2)(A) excepts from discharge debts obtained by fraud, except for those incurred by making false "statements respecting the debtor's . . . financial condition." Under 11 U.S.C. §523(a)(2)(B), debts incurred based on a false statement respecting the debtor's financial condition are excepted from discharge but must be in writing. A split has developed among the courts as to the scope of the communications which would constitute a "statement respecting the debtor's . . . financial condition" under this section.

Some courts have held that *any* communication which has bearing on the debtor's financial condition is a statement "respecting the debtor's . . . financial condition" and under 11 U.S.C. §523(a)(2)(B) *must be in writing*. This interpretation of the term "statement respecting the debtor's . . . financial condition" has been called the "broad view."<sup>1</sup>

Other courts have adopted a "narrow view" which finds that 11 U.S.C. §523(a)(2)(A)'s exception for statements respecting the debtor's financial condition only precludes actions based on a communication that "presents an overall picture of the debtor's financial position."<sup>2</sup> Under this view, the debtor's oral assertions regarding his bonus would be actionable under §523(a)(2)(A).

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<sup>1</sup> *Nicholson v. Nicolai* (In re Nicolai), No. 05-29876, 2007 Bankr. LEXIS 339, at \*3 (Bankr. D.N.J. Jan. 31, 2007)

<sup>2</sup> *Id.*

The creditor's Circuit had not yet ruled on the scope of "respecting the debtor's . . . financial condition." The creditor's counsel, drawing from *Weiss v. Alicea*,<sup>3</sup> explained why their Circuit should adopt the narrow view. The *Weiss* court analyzed the legislative history of 11 U.S.C. §523(a)(2) and determined that Congress intended the phrase "statement of the debtor's . . . financial condition" to have its ordinary and plain meaning, which it concluded, would be narrowly construed to mean "the typical balance sheet (assets and liabilities) and profit and loss statement in a business context."<sup>4</sup> "It may well apply to an indication of 'net worth.'"<sup>5</sup> Because here, the debtor's representation concerned only a single asset, his bonus, the creditor would argue, under narrow view, that it could not be construed as a personal financial statement, and thus was not required to be in writing to be actionable.

The pillar of the broad view is that there is nothing in 11 U.S.C. §523(a)(2) that limits the representation to a formal financial statement. In fact, under the broad view, a representation concerning even a *single asset* must be in writing to be actionable.<sup>6</sup> In *Engler v. Van Steinburg*,<sup>7</sup> a case following the broad view, the creditor made a \$5,000 loan and took back a security interest in livestock and farm implements. The debtor repeatedly stated the security interest would be first and prior to all other liens, even though the debtor knew that all other creditors had superior liens.<sup>8</sup> The Fourth Circuit reasoned that 11 U.S.C. §523(a)(2) does not limit itself to "financial statements," but to statements "respecting the debtor's . . . financial condition." Because a debtor's statement as to whether his assets are encumbered "may be the most significant information about his financial condition," the debtor's statements concerning priority were not actionable because they were not in writing.<sup>9</sup>

At the other extreme is *Cadwell v. Joelson*.<sup>10</sup> Cadwell met Joelson while she was a waitress at a cafe in Casper, Wy. Cadwell, single and retired, appears to have been smitten with Joelson's charm. Joelson said she owned a house in Scottsdale, Ariz. and needed \$50,000 to save it from foreclosure. She said her brother would later make her a loan for the same amount, which she would use to repay Cadwell. Joelson also said she owned two other residences and a motel as well as antique vehicles. She took Cadwell to one house and showed him the outside of the other home and the motel. She also took him to where the vehicles were stored, but instead of inspecting them, she gave him a list of her vehicles. She further told Cadwell she would give him collateral for the loan.<sup>11</sup>

Impressed with the asset tour, Cadwell lent Joelson \$50,000, which he obtained by mortgaging his own home. Joelson gave back a note. Joelson did not repay the debt and

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<sup>3</sup> *Weiss v. Alicea (In re Alicea)*, 230 B.R. 492, 502-03 (Bankr. S.D.N.Y. 1999).

<sup>4</sup> *Id.*

<sup>5</sup> *D. Nagin Mfg. Co. v. Pollina (In re Pollina)*, 31 B.R. 975, 978 (D.N.J. 1983)

<sup>6</sup> *Engler v. Van Steinburg (In re Van Steinburg)*, 744 F.2d 1060, 1061 (4th Cir. 1984).

<sup>7</sup> *Id.*

<sup>8</sup> *Id.*

<sup>9</sup> *Id.*, at 1061.

<sup>10</sup> *Cadwell v. Joelson (In re Joelson)*, 427 F.3d 700 (10th Cir. 2005), *cert. denied*, *Joelson v. Cadwell*, 126 S. Ct. 2321 (2006).

<sup>11</sup> *Id.*, at 703.

later filed chapter 7.<sup>12</sup> Not surprisingly, Joelson did not own any of the property she had described to Cadwell. The bankruptcy court held the debt non-dischargeable under 11 U.S.C. §523(a)(2)(A). Joelson appealed to the BAP, which affirmed; she then appealed to the Tenth Circuit.<sup>13</sup>

Under the analysis used by the *Engler* court, the oral statements concerned Joelson's ownership of assets which "may be the most significant information about financial condition" and could only be actionable under 11 U.S.C. §523(a)(2)(B). Because there was no written statement, Joelson's debt to Cadwell would be discharged.

The Tenth Circuit, however, in affirming its Bankruptcy Appellate Panel, rejected the *Engler* approach<sup>14</sup> (without citing it) and looked to the legislative history of the Code and the Supreme Court's decision in *Field v. Mans*.<sup>15</sup> Although *Field* did not address the conflict between the broad and narrow views, it addressed the different reliance standards between 11 U.S.C. §§523(a)(2)(A) and (B). In that analysis, the Supreme Court found a legislative intent to give financial statements their ordinary meaning:

The House Report on the [Bankruptcy Reform Act of 1978] suggests that Congress wanted to moderate the burden on individuals who submitted false financial statements, not because lies about financial condition are less blameworthy than others, but because the relative equities might be affected by practices of consumer finance companies, which sometimes have encouraged such falsity by their borrowers for the very purpose of insulating their own claims from discharge. The answer softens the ostensible anomaly.<sup>16</sup>

In the Tenth Circuit's reasoning, the legislative history demonstrates that 11 U.S.C. §523(a)(2)(B) was enacted to address a statement more substantial than a statement concerning a debtor's interest in a particular piece of property. It was intended to encompass "financial statements" in their traditional sense and to curb abuses surrounding them.

A statement concerning only certain assets, without regard to income, expenses or liabilities, does not purport to demonstrate the maker's creditworthiness. But, under the broad view, an oral statement, no matter how remotely it bears upon the debtor's financial condition, would have to be examined as if it purported to report the debtor's *creditworthiness*, even if the statement was not made for that purpose, as was the case in *Joelson* and *Engler*.

The flaw in the broad view is clear in the *Engler* rationale. While a debtor's statement as to whether his assets are encumbered "*may* be the most significant information about his

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<sup>12</sup> *Id.* at 704.

<sup>13</sup> *Id.*

<sup>14</sup> *Id.* at 711.

<sup>15</sup> 516 U.S. 59 (1995).

<sup>16</sup> *Id.* at 76-77.

financial condition,” it is insignificant when the debtor has negative equity in that asset. The narrow view harmonizes 11 U.S.C. §§523(A) and (B) and makes their application consistent with Congress’ intent to avoid the abusive practices surrounding false financial statements.