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A BROKEN PROMISE TO REPAY A DEBT IS NOT GROUNDS FOR NON-DISCHARGEABILITY

In the case of *Stevenson v. O'Herin (In re O'Herin)*, Adv. No. 08-3051 (Bankr. D. Minn. Nov. 20, 2008) (J. O'Brien), the Bankruptcy Court held that a broken promise to repay a debt in the future is not a false representation allowing a debt to be nondischargeable under 11 U.S.C. § 523(a)(2)(A).

In the *O'Herin* case, the Debtor was given substantial financial help from a friend, the Plaintiff. Over several years, the Plaintiff loaned the Debtor thousands of dollars and purchased a car for her. Before the loans were made, the Plaintiff became very close to the Debtor and learned of her financial trouble. The Debtor talked about going back to graduate school, receiving financial aid, gaining stable employment, and repaying her debts. Meanwhile, the Debtor was accepted but never enrolled in school, did not receive any financial aid, and lost a good paying job. The only formality to any of the Plaintiff's loans to the Debtor was a hand-written loan acknowledgment stating that the Debtor should make monthly payments to the Plaintiff. But the Debtor made very few payments to the Plaintiff, and the payments that were made were inconsistent and made two years after the money was loaned. The Plaintiff did not attempt to collect the debt until the friendship with the Debtor completely deteriorated, approximately four years after the loans were made. Now the Plaintiff seeks to have the Bankruptcy Court find his loans a nondischargeable debt under 11 U.S.C. § 523 (a)(2)(A).

For a debt to be nondischargeable under § 523(a)(2)(A), the debtor must make a false representation about a present or past fact that the creditor relies on when funds are loaned. A debtor's promise to repay a debt in the future is not a false representation, even if the promise is not kept, because it is a statement about future acts. In this case, the Bankruptcy Court points to several miscommunications and misunderstandings between the parties, and found that any statements made by the Debtor before the loans were given were either "truthful, not unreasonably hopeful, or simply promises," but not false representations.

Not only were the Debtor's statements not false representations, the Plaintiff did not rely on them when extending the various loans. The standard for justifiable reliance is if the facts appear to be a warning to a person of similar knowledge and intelligence, then further investigation into those facts is required. The Plaintiff had business experience and should have required some sort of documentation that the Debtor was enrolled in school if relying on her representation regarding repaying her debt with financial aid funds. Additionally, the Plaintiff knew of the Debtor's financial troubles and appeared to loan large amounts of money even after repayment of the loans seemed highly unlikely. Ultimately, the Court determined that the loans were made by a friend helping another friend in need. The Court said that the Debtor was not a "con who duped" the Plaintiff out of thousands of dollars, and ruled that the Plaintiff's debt should not be excepted from discharge under 11 U.S.C. § 523(a)(2)(A).

SECTION 108 DOES NOT TOLL STATUTE OF LIMITATIONS ON CLAIM

In the case of *Mitchell v. Bigelow (In re Bigelow)*, Case No. 08-6006 (B.A.P. 8th Cir. September 16, 2008), the B.A.P. affirmed the Bankruptcy Court's holding that 11 U.S.C. § 108(c)(1) does not independently toll or suspend the statute of

limitations on a claim which has not expired as of the bankruptcy petition date.

Plaintiff claimed to have a debt based on a prior state court action that was not identified by the Debtors during their bankruptcy case. Plaintiff had dismissed the prior state court action without prejudice in 2005, and the statute of limitations expired on October 29, 2007. On October 5, 2007, after the Debtors received their discharge and their bankruptcy case was closed, Plaintiff commenced an adversary proceeding by filing a complaint seeking a determination that his claim was nondischargeable pursuant to 11 U.S.C. § 523(a)(3) and for leave to proceed in state court on the action underlying the debt. After the expiration of the statute of limitations, the Bankruptcy Court dismissed Plaintiff's complaint because the underlying claim was time barred.

Plaintiff argued that 11 U.S.C. § 108(c) tolled the statute of limitations period for 112 days which was the length of the automatic stay in the Debtors' bankruptcy case. But because the statute of limitations on the underlying action was set to expire after the Debtors' discharge, which ends the automatic stay, the statute of limitations is only extended under § 108(c)(1) by "any suspension of such period occurring on or after the commencement of the case." The B.A.P. explained that the "suspension" referenced in § 108(c) does not independently toll the statute of limitations, but instead incorporates suspensions of deadlines that are found in other federal and state statutes. Since there was no other federal or state statutes tolling the statute of limitations for Plaintiff's underlying state court action, the period was not extended.

The B.A.P. noted that Plaintiff could have avoided this problem by asking the Bankruptcy Court for judgment on the merits of his underlying claim instead of simply seeking leave to file a suit in state court. Plaintiff also could also have filed his state court action before the statute of limitations expired on October 29, 2007.

PRE-PETITION SOCIAL SECURITY PAYMENTS NOT EXEMPT

In the case of *In re Carpenter*, No. 08-31527 (Bankr. D. Minn. Oct. 14, 2008), the Bankruptcy Court held that social security payments already received are not exempt under the federal exemptions, specifically 11 U.S.C. § 522(d)(10)(A).

The facts were undisputed. The Debtor received $17,000 in retroactive social security disability benefits. The funds were deposited into a segregated account, and then later converted to a cashier's check. The Debtor then filed for bankruptcy, electing the federal exemptions under 11 U.S.C. § 522(b)(2) and (d) and claiming the social security proceeds exempt under section 522(d)(10). The Chapter 7 Trustee objected to the claimed exemption.

The Debtor claimed that the proceeds were held in trust and thus not property of the estate under section 541. The Court disagreed, finding there was no restriction on the ability to transfer the proceeds upon receipt. The Court, however, held that the Debtor "has a protected beneficial interest in a trust under applicable nonbankruptcy law insofar as he is entitled to future Social Security disability benefits."

The Debtor next argued that the proceeds were not subject execution, levy, attachment, garnishment, or other legal process, or to the operation of bankruptcy or insolvency laws under section 407(a) of the Social Security Act. But the Court held that "[w]hile the plain meaning of § 407(a) arguably might otherwise insulate moneys already paid as Social Security disability benefits from bankruptcy law generally,

[Debtor's] choice of the federal exemptions under 11 U.S.C. §§ 522(b)(2) and (d) ruled out application of 42 U.S.C. § 407." And under section 522(d)(10), only a "debtor's right to receive" social security benefits is exempt, not benefits already received.

Finally, the Debtor argued that section 407(b) of the Social Security Act, which provides "[n]o other provision of law, enacted before, on or after April 20, 1983, may be construed to limit, supersede, or otherwise modify the provisions of this section except to the extent that it does so by express reference to this section," completely exempts the proceeds. The Court held that this provision had no application to the federal exemptions. "To conclude otherwise would require recognition that 42 U.S.C. § 407(b) as to pre-petitions payments made, is not an exemption, but, rather is a property interest exclusion from the bankruptcy estate. Nothing in 11 U.S.C. § 541 suggests that." The Court bolstered this conclusion by noting that such an interpretation would render section 522(d)(10) effectively meaningless, and the absence of any legislative history to support such a conclusion.

DISCHARGE UPHELD WHERE EVIDENCE EVENLY BALANCED AND FRAUD PRESUMPTION REBUTTED

In the case of *In re Sandiford*, 394 B.R. 487 (B.A.P. 8th Cir. 2008), the B.A.P. affirmed the bankruptcy court's denial of an objection to discharge under 11 U.S.C. 727(a)(2) when the evidence regarding the debtors intent to hinder, delay or defraud was evenly balanced.

The Debtors owned retail stores and funded operations with money they borrowed from Hibernia National Bank. The Debtors business failed, the loans became delinquent and Hibernia Bank obtained a judgment against the Debtors.

Shortly thereafter the Debtors started a real estate agency that they operated on the following model: the Debtors would create a trust; appoint their daughter as trustee and themselves as beneficiaries; their daughter would execute a promissory note or contact for the purchase of real property; the Debtors would make all payments on the note or contact; and title to the real property would transfer to the trust only after the Debtors satisfied the note or contact. In the one year preceding their Chapter 7 petition, the Debtors participated in three real estate transactions utilizing this model.

Cadlerock Joint Venture, successor-in-interest to the assignee of Hibernia's judgment, objected to the Debtors' discharge under 11 U.S.C. 727(a)(2). To prevail, Cadlerock had to show: (1) the Debtors' actions took place within twelve months prior to filing of petition; (2) the Debtors' acted with intent to hinder, delay or defraud their creditors; (3) the Debtors' themselves took the actions; and (4) the Debtors' actions consisted of transfer, concealment or other disposition of property. At trial, the only disputed issue was whether the Debtors acted with the intent to hinder, delay or defraud. The bankruptcy court found the evidence presented was evenly balanced and denied Cadlerock's objection.

Cadlerock appealed. Cadlerock argued that the bankruptcy court erred in applying the presumption of fraud that arises in a § 727(a) case when the debtor makes a gratuitous transfer. The B.A.P. disagreed.

The B.A.P noted that a presumption "imposes on the party against whom it is directed the burden to rebut or meet the presumption, but does not shift to [that] party the [ultimate] burden of proof…, which remains throughout the trial upon the

party on whom it was originally cast." In a discharge objection, the burden of proof is originally on the objecting party.

The B.A.P. recognized that in § 727(a) case there is a presumption of fraud when the debtor has made a gratuitous transfer that, once imposed, shifts the burden to the debtor to prove its intent was not to hinder, delay, or defraud.

The B.A.P. noted that although Cadlerock had created a presumption of fraud by establishing that the Debtors had made gratuitous transfers to their daughter, the Debtors had rebutted that presumption by offering a non-fraudulent reason for the transfer. Specifically, that the trusts were created to hold the property until sufficient equity existed to make a profit upon sale; a business model the Debtors learned at real estate seminars.

Presumption rebutted, the B.A.P. reasoned, the ultimate burden of proof remained with Cadlerock. Since the bankruptcy court determined that the evidence was evenly spilt, Cadlerock had failed to meet its burden of proof and the B.A.P. affirmed the bankruptcy court's denial of Cadlerock's discharge objection.

FIVE YEAR MINIMUM COMMITMENT PERIOD APPLIES TO CHAPTER 13 PLAN AND SCHEDULES USED TO DETERMINE DISPOSABLE INCOME

In the case of *In re Craig Matthew Frederickson, David D. Coop v. Craig Matthew Frederickson*, No. 07-3391 (B.A.P. 8th Cir. Oct. 27, 2008), the B.A.P. held that a debtor's "disposable income" calculation on Form 22C is a starting point for determining the debtor's "projected disposable income," but that the final calculation can take into consideration changes that have occurred in the debtor's financial circumstances as well as the debtor's actual income and expenses as reported on Schedules I & J.

Frederickson, the debtor, was an "above-median" debtor. His disposable income on Form 22C was a negative number, and as such had no projected disposable income as referenced in 11 U.S.C. § 1325(b)(1)(B). However, according to his income and expenses on Schedules I & J, the Debtor was showing a net monthly income of $606.00 a month. Based upon the surplus on I & J, the Debtor proposed a payment of $600 a month to unsecured creditors for 48 months. This plan would have paid approximately 61% of the unsecured creditors' claims. The Trustee objected to this proposed plan because it did not extend for the 60 month "applicable commitment period" in 11 U.S.C. § 1325(b)(4)(A)(ii). A five year plan would have resulted in payment of all or nearly all of his unsecured creditors' claims.

The bankruptcy court held that a trustee's objection in a case where an above the median debtor proposes a plan in which the debtor has a positive disposable income, the plan can only be confirmed unless it extends the applicable commitment period of five years pursuant to 11 U.S.C. § 1325(b)(1)(B), or the plan pays all unsecured claims in full.

The B.A.P. first decided that it had to determine the meaning of both the phrase "applicable commitment period" and the phrase "projected disposable income." The court began with the latter of the two and found an important distinction between "disposable income" calculated solely on the basis of historical numbers and regional averages, and a debtor's "projected disposable income," which is in essence a "forward-looking number." Ideally, a bankruptcy court should calculate each individual debtor's "projected disposable

income" accurately based on his or her financial situation. Essentially, the court concluded, BACPA requires that the debtor's disposable income be "projected" so that a plan does accurately reflect how much a debtor can pay back to his or her creditors.

Thus, based upon this analysis, the court held that Form 22C provides a starting point for determining the debtor's "projected disposable income," but that the debtor's income and expenses on Schedules I & J, as well as any changes in debtor's financial circumstances, must be taken into account in determining the final calculation. According to the B.A.P., this holding "realistically determines how much a debtor can afford to pay his creditors and maximizes the amount the debtor must pay to his unsecured creditors." And finally, the result of the holding is that the "applicable commitment period" of five years under BACPA is a minimum requirement and its application to all Chapter 13 Plans becomes "logical" since the debtor can now afford it under the "realistic" determination of the debtor's "disposable income" going forward.

REPLACEMENT CHECKS ISSUED AFTER DISHONOR CONSTITUTED CONTEMPORANEOUS EXCHANGE OF NEW VALUE WHERE LIENS RELEASED AFTER REPLACEMENT CHECKS CLEARED

In the companion cases of *Velde v.Kirsch*, No. 07-2017 (8th Cir. Sept. 24, 2008) and *Velde v. Reinhardt, et. al.*, No. 07-2070 and No. 07-2073 (8th Cir. Sept. 24, 2008), the Eighth Circuit held that replacement checks issued to secured creditors were not avoidable preferences because a contemporaneous exchange of value occurred when the secured creditor released its liens only after the replacement checks cleared.

The Debtor was the owner of a crop storage elevator in East Grand Forks. The trustee filed adversary proceedings against the Debtor's pre-petition creditors who had received replacement checks within 90 days of the bankruptcy case. Each of the checks were signed over to the creditors' lenders who released properly perfected liens on the Debtor's property only after the replacement checks cleared.

The Eighth Circuit noted that in the "usual case, the substitution of a bank check for a previously dishonored check from the debtor would not satisfy the new value requirement." This is because a dishonored check creates a debtor-creditor relationship; a dishonored check is the "functional equivalent of a promissory note." However, where the creditors provided new value by releasing their liens on the Debtor's property only after receipt of the replacement checks (not earlier when it received the dishonored checks), the new value requirement was satisfied. The court distinguished *In re Barefoot*, 952 F.2d 795 (4th Cir. 1991) wherein a mobile home dealer had released its security interest in a mobile home upon receipt of a check that was later dishonored. In that case, when the dishonored check was replaced by a wire transfer within the 90 day preference period, the court held that the new value defense did not apply.

The court also distinguished *In re Stewart*, 282 B.R. 871 (B.A.P. 8th Cir. 2002) wherein the trustee sought to recover the proceeds of two cashier's checks issued to an auction company to cover dishonored personal checks delivered by the debtor on the day he purchased cattle at the auction. The auction company had argued that the it would not allow the debtor to participate in a subsequent auction without replacing the dishonored checks, but the court held this was not sufficient to constitute new value.