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DISCHARGE UNDER SECTION 14
SUB. c(2) AND (3) OF THE
CHANDLER ACT

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SECTION 14 Sub. c(2) and (3) of the Chandler Act reads as follows:

"The court shall grant the discharge unless satisfied that the bankrupt has *** (2) destroyed, mutilated, falsified, concealed, or failed to keep or preserve books of account or records, from which his financial condition and business transactions might be ascertained, unless the court deems such acts or failure to have been justified under all the circumstances of the case; or (3) obtained money or property on credit, or obtained 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;***"

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1 11 U.S.C.A., Sec. 32, C(2) and (3).
The matters embraced in the foregoing provisions have received considerable attention by the Federal Courts, and there are numerous authorities construing the sections involved. It would appear that the Bar generally has not given sufficient attention to the rights afforded both the bankrupt and the creditors and also to the duties of the bankrupt under these sections. The hazards involved to the bankrupt in obtaining a discharge are great and the penalty to him, denial of his discharge, may be very severe in many instances.

I. Sub. c(2)—Failure to Keep Proper Books

Both Congress and the courts have indicated a disposition towards increasing the strictness of compelling the bankrupt to properly account for his assets under this section of the Act. The Act originally provided that it was necessary to establish that the bankrupt’s destruction or concealment of adequate records, or his failure to keep them, was with “fraudulent intent to conceal the true financial condition and in contemplation of bankruptcy.”

In 1903 the Act was amended and omitted the word “fraudulent” and also the phrase “in contemplation of bankruptcy,” and in 1926 the Act was amended to its present form to provide that books must be kept “from which his financial condition and business transactions might be ascertained; unless the court deems such failure to have been justified under the circumstances of the case.” It was realized that the former provisions made it practically impossible to prevent a discharge under this provision, in view of the fact that it was necessary to establish that the destruction of books or the failure to keep books was done with intent to conceal and in “contemplation of bankruptcy.” Both Congress and the Courts have come more and more to realize the necessity of the keeping of proper books in any business in order that the business might be successfully conducted. Many businesses have failed because of inadequate bookkeeping and bankruptcy has thereby resulted.

Under the present Act the burden of proving the intent to conceal has been taken from the objecting creditor or the trustee, and the burden of proving justification is placed upon the bankrupt. There is thus indicated on the part of Congress a purpose to lodge with the bankruptcy court a reasonably wide judicial discretion in the matter, and the cases have indicated this wide discretion on the part of the Bankruptcy Court. A finding by the trial court will not be upset unless there is an absolute abuse of discretion and the finding was clearly erroneous.

Where the creditor has shown an absolute lack of any adequate records, the burden of satisfying the Court that the failure to produce
them by the bankrupt was justified is on the bankrupt.\textsuperscript{2} Under sub-section (c) it is necessary only that the objector show to the satisfaction of the Court that there are reasonable grounds for believing that the bankrupt has committed any of the acts which would prevent his discharge, and then the burden of establishing otherwise is upon the bankrupt.

The making of false entries is of course an absolute ground for preventing the discharge of the bankrupt under this subsection. The mere neglect to keep books, or inadvertence or mistake in keeping books showing the bankrupt's financial condition, is under many circumstances not sufficient grounds for the refusal of the discharge. It is of course not necessary that the bankrupt, in every instance, keep a set of books, and this is particularly true in the case of wage earners who are not involved in any extensive financial transactions. It has been consistently held that this class of bankrupts need not establish the keeping of books in order to obtain a discharge.\textsuperscript{3} Where, however, a salaried employee has borrowed extensively or made extensive loans to his relatives or family, it has been held that his failure to properly record the transactions in an adequate manner is ample grounds to prevent the discharge.\textsuperscript{4}

The failure to keep books in the case of a clergyman receiving money from several sources and borrowing considerable sums was held to be grounds for denial of a discharge.\textsuperscript{5}

It is generally held that the nature and not the size of the bankrupt's business or enterprise determines the necessity of keeping books and records, and the facts in every case must be scrutinized closely in order to determine the necessity of a bookkeeping system. The rule is stated as follows:

"What will justify that failure depends largely upon how extensive and complicated the bankrupt's business is—a cobbler will succeed with much less than a manufacturer—but the important change is that since 1926 no moral obliquity need be shown. Honesty is not enough; the law demands as the condition of a discharge either that the bankrupt shall produce such records as are customary to be kept by a person doing the same kind of business, or that he shall satisfy the bankruptcy court with adequate reasons why he was not in duty bound to keep them."\textsuperscript{6}

A recent case arising in this district and decided January 28, 1942, is that of John Henry Marx, Bankrupt,\textsuperscript{7} in which the Circuit Court

\textsuperscript{2} White v. Schoenfeld, 117 Fed. (2d) 131 (1941).
\textsuperscript{3} In re Perkins, 40 Fed. Supp. 114 (D.C., N.J. 1941); In re Pinko, 94 Fed. (2d) 259 (C.C.A. 7th, 1938).
\textsuperscript{5} In re Northridge, 53 Fed. (2d) 858 (D.C. N.Y. 1931).
\textsuperscript{6} White case, note 2.
\textsuperscript{7} 125 Fed. (2d) 335 (C.C.A. 7th, 1942).
of Appeals held that Marx, a real estate broker, engaged in the general real estate business, was not entitled to a discharge by reason of his failure to keep books. In 1935 he was hopelessly insolvent and in 1936 he engaged in the purchase and sale of property in the name of his daughter, and to protect himself against garnishment he began to take bank accounts per himself as trustee or some similar designation. He paid no regard to the source of the moneys and deposited them all together in the same account, and actively drew on the account for every purpose. He kept no books of any kind, and the bankrupt's records were at variance with his own bank records and checks. He kept no copies of income tax returns which he had filed, and the returns of three of these years had disappeared from the assessor's office. Under this set of facts the Referee found that the bankrupt was not entitled to a discharge. In affirming the order based upon the Referee's findings, the Court stated as follows:

"What books of accounts or records satisfy the requirement of section 14c (2) are, of course, not a constant. In each case they are a function of the nature of the particular bankrupt's business transactions and financial condition. What would suffice in one, would be hopelessly unsatisfactory in another. Yet, the absence of articulated mechanics does not leave a broad area of uncertainty in which all must wander with no idea of whether they would be entitled to a discharge if economic misfortune should overtake them. Records or books of accounts are but the means to an end, the ascertainment of the bankrupt's financial condition and his business transactions, and any records which meet that end are satisfactory. They should show in some way his loss and gains, and present a satisfactory explanation of the receipts and disbursements. This condition precedent to discharge strikes at otherwise non-demonstrable fraud, for no longer does the successful objecting creditor have to prove the absence or inadequacy of the records was with intent to conceal; the bankrupt must now really have the necessary records or explain why the circumstances of his case excuse his failure. By no longer requiring proof of such intent, the statute has narrowed the bankrupt's road to the salutary discharge. * * * Now, whenever a section 14c (2) objection to the discharge is raised, the bankrupt's records must be adequate, unless excused by circumstances, or the discharge will be denied. With this considerable penalty upon inadequate books or records, perhaps the adequacy of the records kept will increase and thereby at least help remove whatever causal relation exists between inadequate bookkeeping and bankruptcy.

"The statute lodges in the bankruptcy court a reasonably wide judicial discretion in determining whether the failure to keep books of account or records was justified under all the circumstances of the case, and the determination of that question will
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not be disturbed on appeal except in case of abuse of such discretion.08

In the case of In Re Herzog,9 a set of books was kept, but transactions by a partnership and a corporation were so intermingled and the books were in such shape that not even an auditor could ascertain the financial condition of the bankrupt, who was interested in the corporate and the partnership affairs. The only excuse offered by the bankrupt was ignorance to differentiate between corporate and partnership activities. It was held that this was no excuse and that ignorance and honesty are not a sufficient justification where a bankrupt was conducting a business as extensive as the one involved in that case.

It can readily be observed, therefore, that an attorney representing a bankrupt must be careful to protect the bankrupt's rights by establishing either that the nature of the business did not necessitate the keeping of books or that the books which the bankrupt kept were adequate to determine the bankrupt's financial condition at all times.

II. SECTION 14 SUB. C(3). FALSE STATEMENTS IN WRITING

In order to establish that a bankrupt is not entitled to a discharge under this subsection, it is necessary to consider five essential elements, to-wit:

(a) Statement must be in writing.
(b) It must be materially false.
(c) Bankrupt must have knowledge of the falsity.
(d) Property must be obtained or credit extended.
(e) Creditor must have relied upon the statement.

(a) Statement in Writing Regarding Financial Condition

Statements under this section must be in writing and must involve the financial condition of the bankrupt. The most common form of statement is a financial statement given to a creditor for the purpose of obtaining property or an extension of credit. The most common form of falsity in statements is as to the concealment or overstatement of general accounts or of money borrowed, which is understated. In many cases the bankrupt will give a statement in which he disregards family obligations, and at the time of the bankruptcy the member of the family will then file a claim for the amount of the indebtedness.

It is held that the issuing of bad checks does not constitute a false statement in writing.10 A false statement means more than a mere

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09 121 Fed. (2d) 581 (C.C.A. 2d, 1941).
representation. Although the debt represented by the bad check is not dischargeable, that fact in itself is not sufficient to prevent the discharge of other obligations of the bankrupt. In the case of chattel mortgages, it has been held that a bankrupt giving a chattel mortgage on property which he does not own is not entitled to a discharge, as the chattel mortgage constitutes a false statement in writing.\textsuperscript{11}

On some rather unsound reasoning it was held in \textit{In Re Hudson}\textsuperscript{12} that a chattel mortgage does not constitute grounds for denying the discharge, it being stated in that case that the debt represented by the chattel mortgage comes under a non-dischargeable debt and is not a ground for discharge, in view of the fact that the two are inconsistent. This case was referred to in the \textit{Powell} case and the court stated that it felt the reasoning of the \textit{Hudson} case was rather unsound.

There was formerly considerable conflict in the holdings regarding the question as to whether or not commercial reports were false statements within the Act. The question seemed to turn upon whether or not the agency obtaining the statement actually represented the subscribing creditor at the time the statement was given by the debtor. There can be no question, of course, that where the agency is constituted the bankrupt's agent to circulate a false statement, which the agency obtains in making a special investigation for the subscriber, the bankrupt would not be entitled to a discharge.\textsuperscript{13} It has, however, been more recently held that statements given to credit companies do constitute false statements in writing within the meaning of the Act.\textsuperscript{14}

In the \textit{Muscara} case\textsuperscript{15} the Court states as follows:

"The test, therefore, is whether the agency to which the false statement was made was in fact the representative of the person who, receiving the statement, extended credit. From the very nature of its occupation, a mercantile agency is the representative or agent of its subscribers in the business of obtaining for them credit ratings of persons with whom they propose to have dealings, and when a false statement is made to such representative and is communicated to the subscriber with the result that the subscriber relying upon it, sells property and extends credit to one who becomes bankrupt, then the situation contemplated by the provision arises. If the amendment of 1910 did not thus enlarge the provision, then it did not change the law from what the courts had interpreted it to be before the addition of the word 'representative'."

\textsuperscript{11} In re Powell, 22 Fed. (2d) 239 (D.C. Md., 1927).
\textsuperscript{12} 262 Fed. 778 (D.C. Ala., 1920).
\textsuperscript{13} 6 Am. Jur. 796.
\textsuperscript{14} Weinberg v. American Shoe Co., 15 Fed. (2d) 557 (C.C.A. 5th, 1926).
\textsuperscript{15} In re Muscara, 18 Fed. (2d) 606 (D.C. Pa., 1927).
It would therefore seem that under the present Act statements made to credit reporting companies and circulated to their subscribers do constitute false statements in writing.

(b) *Materially False Statements*

Insignificant omissions of liabilities from a statement are not sufficient to constitute grounds for the denial of the discharge. The failure to list a contingent liability, which is doubtful, has been held not to render the statement false and it has also been held that an omission of an equal amount of assets and liabilities does not of itself make the statement materially false. However, the mere showing of a substantially correct balance of assets over liabilities was held not to excuse understating both of them.\(^6\) The question as to whether or not the falsity is material, of course must be governed by the amount involved and the circumstances in each case. Of course, if the omission of a liability which is contained in the statement would show the insolvency of the debtor, this would obviously be sufficient to render the statement materially false.

(c) *Knowledge of Falsity*

While the Act does not provide that there must be any intent on the part of the bankrupt, it would seem that the bankrupt must have knowledge of the falsity of the statement, either actual or implied, in order to bring it within this section. The rule has been stated as follows:

"In consideration of the primary and ordinary meaning of the word 'false' and of the general characteristic of personal misconduct that attaches to all but one of the other specified grounds for denying a discharge, and because there is no good reason why an incorrect statement innocently made to one creditor should bar the discharge of the bankrupt as to all his other debts, whatever be its effect as to the debt of that particular creditor, the word 'false' as here employed is not merely equivalent to 'untrue' or 'incorrect,' but it connotes a guilty scienter on the part of the bankrupt, and requires that the written statement made for the purpose of obtaining credit shall be knowingly and intentionally untrue in order to constitute a bar to the bankrupt's discharge. Ordinary negligence—as, for example, merely signing as a matter of form a blank which has been filled out incorrectly by another, under extenuating circumstances and without any intent on the bankrupt's part to deceive—does not seem to be contemplated as ground for refusing a discharge."\(^7\)

\(^6\) In re Magget, 245 Fed. 804 (D.C. N.Y., 1911).
\(^7\) 6 Am. Jur. 793-4.
As held in *Third National Bank v. Schatten*[^18^], the provision "false statement in writing" implies that the statement is knowingly false or made recklessly without the owner's belief in its truth and with purpose to mislead or deceive. It has been held that actual knowledge of the falsity and conscious intent to deceive are not essential to denying the discharge on this ground where the bankrupt makes no effort to verify the facts and does not inquire into omitted liabilities, and in conformity with this holding it has also been held that the bankrupt's failure to read a statement dictated by the manager of the creditor, where the language of the statement was unambiguous, did not relieve the bankrupt from the falsity of the statement.[^19^]

It will therefore be noted that it is not necessary to establish absolute knowledge on the part of the bankrupt of the falsity of a statement, but that any reckless indifference in making the statement is sufficient.

**Obtaining Property or Extension of Credit**

The fourth essential element to the denial of a discharge on this ground is that the bankrupt must have obtained property in some form or the extension of time to pay an existing obligation. It had been held prior to the 1926 Amendment of the Act that the extension of credit on a present indebtedness was within the Act, but this holding was probably erroneous under the former provisions. The Amendment of 1926 expressly provided for the renewal of credit and the Chandler Act so provides.

There was at one time some conflict in the authorities as to whether or not the bankrupt who gave the false statement must be the recipient of the property or credit, in order that the discharge be denied. These cases usually arise out of a stockholder giving the statement to obtain money for the corporation in which he is interested. This question was definitely settled, however, in *Levy v. Ind. Fin. Corp.*[^20^], wherein the Supreme Court affirmed the decision of the lower court to the effect that the property need not be obtained by the bankrupt, but it was sufficient that a corporation in which the bankrupt had a substantial interest obtained the property.

There was also some conflict in the cases as to whether or not a surety's obligation on a bond furnished to the bankrupt is "Property" within the meaning of the Act. It has now been definitely settled that a surety bond was "property" within the meaning of the Act.[^21^]

If after the false statement was given there never was a larger amount due the creditor than at the time the statement was given and

[^18^]: 81 Fed. (2d) 538 (C.C.A. 6th, 1936).
[^20^]: 276 U.S. 281, 72 L.Ed. 572 (1927).
in making application for new credit, the bankrupt partially reduced the indebtedness, such circumstances do not prevent the denial of a discharge on this ground.

(e) Reliance by the Creditor

A concise statement on this point is contained in Remington on Bankruptcy,\textsuperscript{22} as follows:

"The false statement must have been relied on, and if it was not relied on in parting with the property, the discharge will not be barred.

"But reliance may be proved by circumstantial evidence, and the mere facts that the statement was asked for and furnished as a basis of credit, and that the goods were supplied within a reasonable time thereafter are sufficient proof that the creditor parted with the merchandise on the strength of the representation, in the absence of adequate rebutting evidence."

"It is a sufficient 'reliance' if the decision to give the credit was induced by the false statement, or that, had the truth been stated, the credit would not have been given. If the reliance was not upon the false statement, but rather upon the fact that payments of preceding invoices had been made or dividends on the stock sold had been received, it is not a sufficient reliance to bring the case within the statute.

"It is not necessary, however, that the false written statement shall have been the sole thing relied on, nor that the credit shall have been obtained solely on the written statement; thus, a discharge will be denied where the false statement was accompanied with a deposit of securities, if the credit would not have been extended had not the statement also been given. For, usually, there are many other things also taken into account and relied upon in giving credit, as, for example, the health of the applicant, his industry, etc., etc., but such other reliance is no defense, if the statement was one of the material elements in the extending of the credit.

"Long lapse of time between the making of the statement and the extending of the credit naturally tends to weaken the likelihood of reliance being had upon the statement when the credit was granted."

There is a presumption that where credit is given, the creditor relied on the statement, this being particularly true if the credit is extended immediately following the giving of the statement. The burden of proof is then upon the bankrupt to establish that the creditor knew the truth and could not have relied on the false statement.\textsuperscript{23}

Where the creditor insists upon and obtains security before extending credit, it has been held to indicate the lack of reliance on the creditor's part, but the making of an independent investigation does not establish the lack of reliance on the false statement.\textsuperscript{24}

\textsuperscript{22} Vol. 7, Par. 3338, 5th Edition.
\textsuperscript{23} Widder v. Seiff, 94 Fed. (2d) 6 (C.C.A. 2d, 1938).
\textsuperscript{24} 73 L.Ed. 593, note.