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NON-DISCHARGEABILITY OF BAD CHECKS

2005

A CLE Presentation

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A. Introduction

Issuance of a bad check at one time could give rise to a non-dischargeable debt without much more than issuing the instrument. As Judge Grant pointed out:

It is often advisable to periodically balance one's check book. If not, checks are apt to bounce because they have been written against insufficient funds. When this scenario is followed by a Chapter 7 bankruptcy, the result may also be a challenge to the dischargeability of the debt represented by the dishonored check. *In re Miller*, 112 B.R. 937, 939 (Bankr.N.D. Ind. 1989).

B. "Old View" of Non-Dischargeability

Miller did not suggest that all NSF checks were subject to the exemption to discharge provided by 11 U.S.C. § 523(a)(2)(A).¹ The court distinguished the situation where a debtor purchases on credit and subsequently pays the amount due with an NSF check. In such a situation, the debt would have probably been dischargeable. The reasoning was that "the original extension of credit and the subsequent attempt at payment, with an NSF check, represent[ed] two distinct transactions." *Id.* at 939. Therefore, "the creditor could not have relied upon any representations, which might accompany the presentation of a check, when it extended credit because credit was extended well before the check was presented." *Id.*

However, the court reasoned that a debt resulting from a NSF check might be non-dischargeable if the purchase and the presentation were part of the same transaction. Here, neither of the parties contemplated a credit transaction.

The only reason a debtor was given possession of the property purchased was because he had apparently paid the required price. Only later does the creditor realize that payment has not been made because the check it received [was] no good. *Id.* at 940.

In *Miller*, the court found that by issuing and delivering checks the debtor affirmatively represented that the checks would be honored by his bank when presented for payment. In addition, this representation was materially false because when the checks were written debtor's account did not contain sufficient funds to pay them and debtor had no legitimate expectation or reason to believe that his bank would honor them. Prior to issuance, debtor failed to balance his checkbook and disregarded bank statements and NSF notifications that indicated that his actual account balance was substantially lower than what his records indicated. By doing so, "the debtor acted unreasonably, with a conscious, even dangerous, disregard to the true state of affairs." *Id.* at 941.

The debtor knew or should have known that these checks would not be honored and, therefore, knew his representations were false. The court found that the debtor made these false representations with the intention and purpose of deceiving the creditor. Further, the creditor reasonably relied upon the false representations by delivering goods to the debtor, resulting in a loss equal to the value of the goods. The court concluded that this debt was therefore non-dischargeable pursuant to 11 U.S.C. § 523(a)(2)(A).

When *Miller* was decided, there was a split of authority regarding this issue.

Some courts ... held that the issuance of a check carries an implied representation by the issuer that it will be honored or that there are sufficient funds available to cover the check. See *In re Almarc Mfg., Inc.*, 62 B.R. 684, 689 (Bankr.N.D.Ill.1986); *Matter of Perkins*, 52 B.R. 355, 357 (Bankr.M.D.Fla.1985); *In re Mullin*, 51 B.R. 377, 378 (Bankr.S.D.Ind.1985); *In re Kurdoghlian*, 30 B.R. 500, 502 (9th Cir.B.A.P.1983); *In re Tabers*, 28 B.R. 679, 680

¹ Section 523 provides: (a) A discharge under section 727, 1141, 1228(a), 1228(b), or 1328(b) of this title does not discharge an individual debtor from any debt – ... (2) for money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained by – (A) false pretense, a false representation, or actual fraud, other than a statement respecting the debtor's or an insider's financial condition; ...

(Bankr.W.D.Ky.1983); *Matter of Anderson*, 10 B.R. 296, 297 (Bankr.W.D.Wis.1981); *In re Kurant*, 3 B.C.D. 832, 14 C.B.C. 783 (Bank.M.D.Fla.1977). Other courts ... held that a check is not a statement or representation as to whether it will be honored upon presentment. See *In re Jenkins*, 61 B.R. 30, 39-40 (Bankr.D.N.D.1986); *In re Hammett*, 49 B.R. 533, 534-35 (Bankr.M.D.Fla.1985); *In re Younesi*, 34 B.R. 828, 829 (Bankr.C.D.Cal.1983); *In re Hunt*, 30 B.R. 425 (M.D.Tenn. 1983); *In re Paulk*, 25 B.R. 913, 917 (Bankr.M.D.Ga.1982). *In re Miller*, 112 B.R. at 940 n.1.

C. Development of the Current Doctrine

Courts began to revisit the issue as the result of *Williams v. United States*, 458 U.S. 279. Petitioner in *Williams* was charged with violation of a criminal statute, 18 U.S.C § 1014. Section 1014 makes it a crime to:

knowingly mak[e] any false statement or report, or willfully overvalu[e] any land, property or security, for the purpose of influencing in any way the action of ... any institution the accounts of which are insured by the Federal Deposit Insurance Corporation, ... upon any application, advance, discount, purchase, purchase agreement, repurchase agreement, commitment, or loan....

To convict, the Government must prove two elements: (1) that the defendant made a "false statement or report," or "willfully overvalue[d] any land, property or security" and (2) that he did so "for the purpose of influencing in any way the action of [a described financial institution] upon any application, advance, ... commitment, or loan."

The Court reversed the petitioner's conviction because "technically speaking, a check is not a factual assertion at all, and, therefore, cannot be characterized as 'true' or 'false.' *Id.* at 279. Further, the petitioner did not "willfully overvalue property or security" because "[i]n a literal sense ... the face amounts of the checks were their 'values.'" *Id.* at 279.

The Seventh Circuit Court of Appeals relied upon *Williams* to determine if issuance of a NSF check was fraudulent. "Although *Williams* involved a criminal statute and construed the word 'statement', its reasoning governs whether [debtor's] check was a false pretense in this civil bankruptcy case." *In re Scarlata*, 979 F.2d 521, 525 (7th Cir. 1992).

The court then reiterated the three elements required to prove non-dischargeability of a debt based on fraud or false pretense. *In re Scarlata*, 979 F.2d at 525 (citing *In re Kimzey*, 761 F.2d 421, 423 (7th Cir. 1985)). These are:

- 1) That the debtor made a statement or representation either knowing it to be false or with reckless disregard for the truth.
- 2) That the debtor possessed the intent to deceive when making the misrepresentation.
- 3) That the plaintiff actually and reasonably relied on the misrepresentation.

The final element has been altered to comport with the Supreme Court decision in *Field v. Mans*, 516 U.S. 59 (1995)². Rather than proving a reasonable reliance, the complaining party need only prove the lesser standard of justifiable reliance. See *Citibank (North Dakota), N.A. v. Michel*, 220 B.R. 603, 605 n.1 (Bankr.N.D. Ill. 1998) (noting the alteration of the final element resulting from the *Williams* decision.)

² Other courts have adopted a five-part test based on *Field*. The elements are: (1) That the debtor made a representation to creditor; (2) that representation was false; (3) Debtor possessed the requisite scienter--an intent to deceive; (4) creditor relied on debtor's misrepresentation to creditor's detriment; and (5) creditor's reliance was justifiable. See *Kovilic Const. Co., Inc. v. Missbrenner*, 1997 WL 269630, *2 (N.D. Ill. 1997). This is essentially the same test, with some of the elements split in to two elements.

When oral representations are made contemporaneously with the delivery of a check, the *Williams* rule against implied representations is inapplicable. Explicit oral representations relating to the validity of a check will satisfy the requirement for a statement or representation. *In re Horwitz*, 100 B.R. 395 (Bankr. N.D. Ill. 1989). In *Horwitz*, the debtor made statements regarding the sufficiency of funds available to cover the issued check. *Id.* at 398. The court held that the presentment of the check, along with the statements made, was sufficient to satisfy the conduct requirement of the first two elements, *supra*.

The *Horwitz* court also held that the misrepresentation relied upon need not be contemporaneous with the delivery of the check. *Id.* at 401. In *Horwitz*, after having had a check returned for insufficient funds, the debtor told plaintiff that the prior check would be honored upon resubmission, in addition to the check then being issued for additional goods. *Id.* The debtor argued that the later representations regarding the first check could not be a basis for non-dischargeability under § 523(a)(2)(A) because the representations were made subsequent to the issuance of the check.

The court rejected this argument, finding the debtor's later statements to be the inducement for the plaintiff's "renewal or refinancing of credit." *Id.* The plaintiff had a right to collect on the returned check at the time of the debtor's representations. The debtor's statements, however, induced the plaintiff to forbear immediate collection. Thus, "its forbearance to do so certainly constitute[d] an extension or renewal of credit to Debtor." *Id.*

Similarly, in *In re Fine*, 1997 Bankr. LEXIS 1831 (Bankr. N.D. Ill. 1997), the court found a debtor's statement that one check would replace another, after the first had been dishonored, constituted a false representation for purposes of § 523(a)(2)(A). The court used the "extension of credit" provision of § 523 to justify its holding. Thus, the court refused to allow discharge of the debt. *See also Kovilic Construction Co., Inc. v. Missbrenner*, 1997 WL 269630 (N.D. Ill. 1997) (When creditor "further renewed its extension of credit to [debtor] when it accepted debtor's representation that the check would not bounce," conduct elements of the test were satisfied. The question in *Kovilic* was if the reliance was justifiable.).

Exceptions to discharge, like those provided in § 523, "are to be construed strictly against a creditor and liberally in favor of the debtor. The burden is on the objecting creditor to prove exception to discharge." *In re Zarzynski*, 771 F.2d 304, 306 (7th Cir. 1985). Presentment of a NSF check, with nothing more, would not qualify as fraud after *Williams* and its progeny. What actions on the part of the issuer would constitute fraud is extremely fact sensitive. When allegations are made regarding inducement beyond the mere issuance of the check are made, a court's decision will likely turn on whose story the court finds more believable.

D. Related Issues – Incomplete Instruments and State Convictions

A check that is antedated, postdated, or undated, is valid under Indiana law. *See* I.C. 26-1-3.1-113. Similarly, an incomplete instrument³ is not per se invalid. *See* I.C. § 26-1-3.1-115. Presumably an incorrect or missing date or the failure to complete the check when issued would not change the analysis of dischargeability under § 523. That is, an incomplete or misdated check can be sufficient to prove that a debt is owed. And an incomplete or misdated check, by itself, is not enough to prove intent to defraud, as "a check is not a statement." The issue still turns on what additional representations the issuer made.

However, courts may look to these facts when examining the transaction. In *In re Carter*, No. 01-07154 (Bankr. S.D. Ind. July 15, 2002) the debtor issued a check that was undated and with the amount blank. The court stated,

³ Section 26-1-3.1-115(a) defines an incomplete instrument as "a signed writing, whether or not issued by the signer, the contents of which show at the time of signing that it is incomplete but that the signer intended it to be completed by the addition of words or numbers."

It seems more likely to the Court that, when leaving a check undated and blank while experiencing financial turmoil, one would do so in order to manifest their *uncertainty* as to the date and the amount they intended to pay. In short, if [debtor] intended to lie about her ability to pay ..., she would have filled in the amount and date on the check. The fact that she left both of those items blank suggests that she did not make any false representations to [creditor]. *Id.*, slip op. at 6 (emphasis in original).

The court ultimately determined, based on this and other factors, that there was no fraud by the debtor.

Carter also involved statements made by the debtor after the check had bounced. Because the debtor never misled the creditor about her difficulty in paying him, the court saw no false representations present. As mentioned above, determinations of non-dischargeability are very fact specific.

Determinations of fraud under a state statute do not have inherently preclusive effect in bankruptcy. What constitutes “false pretense, a false representation, or actual fraud” for purposes of 11 U.S.C. § 523 is a federal, not state, question. If the state statute for fraud sufficiently mirrors the federal statute, a state determination could have preclusive effect in bankruptcy proceedings.

The doctrine of collateral estoppel bars determination of issues litigated in accordance with federal standards. Collateral estoppel will apply in a dischargeability proceeding if:

1. The issue sought to be precluded ... [was] the same as that involved in the prior action;
2. The issue ... [was] actually litigated;
3. It ... [was] determined by a valid and final judgment; and
4. the determination ... [was] essential to the final judgment. *In re Supple*, 14 B.R. 898 (Bankr. D. Conn. 1981).

Early Indiana cases indicated that a conviction under a state “bad check” statute was conclusive under § 523(a)(2)(A). *In re Mullin*, 51 B.R. 377 (Bankr. S.D. Ind. 1985). However, this was prior to the widespread adoption of the higher conduct standard of the *Williams* decision. *In re Miller*, 112 B.R. 937 (Bankr. N.D. Ind. 937) determined that violation of the Indiana statute was not preclusive.

We cannot rely upon the provisions of I.C. § 35-43-5-5(c) as a basis for concluding that Debtor knew the check would not be honored or that he intended to deceive Plaintiffs. The fraud condemned by § 523(a)(2) must be actual and may not be presumed. *Id.* at 940, n.2.

The Illinois statute also lacks preclusive effect. In the *Horwitz* decision, the court refused to grant plaintiff’s count based on collateral estoppel. 100 B.R. at 402. The court’s decision turned on the language of the Illinois statute.

The Illinois statute in question does not even use the term “fraud” or “false representation”, but rather describes what it terms a “deceptive practice.” This Court would consider that to be of limited relevance to the findings that must be made under Section 523(a)(2)(A). *Id.*

Because the state court conviction did not clearly require the same elements to be proven, the bankruptcy court required an independent showing of the requisite behavior.

E. Conclusion

To show that an NSF check is non-dischargeable under section 523(a)(2)(A), the creditor must satisfy the three elements. These are that the debtor made a statement or representation either knowing it to be false or with reckless disregard for the truth, that the debtor possessed the intent to deceive when making the misrepresentation, and that the plaintiff actually and reasonably relied on the misrepresentation. What is sufficient to prove these elements varies by case and is fact-specific.