Creditor Acquiescence as a Defense to an Exception to Discharge in Bankruptcy

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Creditor Acquiescence as a Defense to an Exception to Discharge in Bankruptcy

The growth of the consumer credit industry has made buying on time a way of life for many. Unfortunately, bankruptcy has also become a part of this life for an increasing number of consumers. The Bankruptcy Act of 1898 was designed primarily with businesses in mind, and even as late as the major overhaul of the Act in 1938 the consumer credit industry had not yet begun to grow to the proportions it has today reached. The development of the large bank credit card industry only began in the 1960's. The Bankruptcy Reform Act was written with an awareness of the boom in consumer credit and was intended to make reforms in consumer bankruptcy. This revision provided consumer bankrupts with a more complete fresh start.

As a result of the growing use of bank credit cards in the last fifteen years, questions have arisen concerning the effect of credit card abuse on a straight consumer bankruptcy. Under section 523(a)(2)(A) of the 1978

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2 "[T]he number of bankruptcies [rose] over 2,000% [from 1938 to 1978]. The rise . . . paralleled the rise in the amount of consumer credit outstanding." See id. at 116.
4 H.R. REP. No. 595, supra note 1, at 4.
5 Id. at 3.
6 Id. at 3, 4.
7 Before the 1960's, the high operating cost due to the volume of paperwork involved kept most banks' attempts at credit card operations from succeeding. However, the development of more sophisticated computers in the 1960's made credit card operations profitable. By 1971 there were 60,000,000 bank cards in use.
Bank credit cards, such as Bankamericard, MasterCard, and Visa, are issued by local banks. Bank cards differ from merchant cards in that there are three parties involved rather than two: the creditor bank, the merchant, and the credit cardholder. The cardholder makes charges with cooperating merchants, who in turn sell these accounts receivable to the issuing bank, usually at a discount. Bank credit cards differ from company owned "transportation and entertainment" cards such as Diners Club, Carte Blanche, and American Express, in that they are available to more people, and there are no registration fees, interest, or service charges if the monthly statement is paid in full within a specified period. Transportation and entertainment cardholders are expected to pay their bills in full at the end of each month, as the company's profit is not made from interest, but from dues and merchants' fees. However, banks neither expect nor want their cardholders to pay in full as over two-thirds of the bank's profits are made from interest charged on the unpaid balance at the end of the month. The credit card operation is very lucrative for the banks, as they may charge 1.5% interest per month, or 18% per year or more. See A. GRIFFIN, THE CREDIT JUNGLE 1-42 (1971).
9 H.R. REP. No. 595, supra note 1, at 34.
10 See id. at 118.
Act, a debt created by fraud is not dischargeable. A necessary element of this type of fraud is creditor reliance. Courts have not found it easy to categorize creditor conduct as either reliance or acquiescence, especially in the area of bank credit cards.

The purpose of this note is to determine the appropriate treatment for credit card debts that the creditor claims have been fraudulently incurred although culpable conduct by the creditor is also present. The first part of the note examines the existing case law on the questions of what conduct constitutes bank acquiescence and under what circumstances this "acquiescence" has been held to be a section 523 defense. Secondly, the note explains why, in light of the policy of the Bankruptcy Reform Act and the peculiarities of the bank credit card system, creditor conduct which encourages credit card abuse should be a defense to a section 523(a)(2)(A) proceeding.

CASE LAW: WHEN IS CREDITOR CONDUCT A LEGALLY SUFFICIENT DEFENSE?

When applying for a chapter 7 straight bankruptcy liquidation, a debtor seeks to have as many of his debts as possible discharged under section 727. In addition to the requirements of section 727, which include that the bankrupt must be an individual and must not have committed any bankruptcy crimes, the debts that the bankrupt is seeking to discharge must not fall within any of the exceptions to discharge.

Under one of these exceptions, a debt will be nondischargeable if it resulted from the obtaining of "money, property, or services" by "false pretenses, a false representation, or actual fraud." There is little case law interpreting this section, but courts have applied case law interpreting the predecessor section to the present section 523(a)(2) questions, since there was little substantive change between the old and new sections. Generally, to find a debt nondischargeable under section 523(a)(2)(A), courts have required three elements: that a false pretense or representation be

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12 See In re Dolnick, 374 F. Supp. 84, 90 (N.D. Ill. 1974); In re Victorian, 8 Bankr. 196, 198 (Bankr. N.D. Ohio 1981); In re Miller, 5 Bankr. 424, 428 (Bankr. W.D. La. 1980); see also 3 COLLIER ON BANKRUPTCY § 523.08[4] (15th ed. 1981); Zaretsky, supra note 11, at 1087.
13 See infra notes 15-105 and accompanying text.
15 Id. § 727(a)(1).
16 Bankruptcy crimes include activities of the bankrupt such as destroying or concealing property or records of financial condition or business transactions, or failing to cooperate with the bankruptcy process or court. See id. § 727(a)(2)(7).
17 Id. § 523(a).
made, that it be made with fraudulent intent, and that it be relied upon by the creditor.\(^{22}\)

Recently, courts have struggled with the concept of creditor reliance, or its converse, creditor “acquiescence” in the debtor’s allegedly fraudulent conduct.\(^{23}\) This section will analyze creditor conduct that has been characterized as acquiescence, and the circumstances under which acquiescence has been held to be a legally sufficient defense to a section 523 exception in recent cases.

**Creditor Conduct: No Defense to Dischargeability**

Bankruptcy courts in the Fourth, Fifth, Sixth, and Tenth Circuits have recently held that a bank’s acquiescence in a debtor’s conduct should *not* render the debt dischargeable if the debtor’s conduct constitutes fraud, false representation, or false pretenses sufficient to invoke section 523(a)(2)(A).\(^{24}\)

When a cardholder presents his card to a merchant, he does not say, “I intend to repay this debt,” but merely implies he will pay the debt. He also implies that he is using the card in accordance with the terms of the credit contract.


However, a minority of courts still follow the decision of Davison-Paxon Co. v. Caldwell, 115 F.2d 189 (5th Cir. 1940), cert. denied, 313 U.S. 564 (1941), which required that there be an actual, overt representation in order to invoke the nondischargeability exception. See *In re Cameron*, 1 BANKR. Ct. DEC. (CRR) 53 (Bankr. M.D. Ga. July 18, 1974); *In re Newberry*, 1 BANKR. Ct. DEC. (CRR) 419 (Bankr. S.D. Ala. Nov. 25, 1974); *In re Wood*, [1970-1973 Transfer Binder] BANKR. L. REP. (CCH) ¶ 64,715 (Bankr. N.D. Ala. 1972); see also *In re Boydston*, 520 F.2d 1088 (5th Cir. 1975) (did not specifically overrule Davison-Paxon but noted that decision had been criticized). Some courts applying the Davison-Paxon rule have indicated that the continued use of a credit card after an intent not to repay develops may constitute conduct aimed at throwing the creditor off guard, thus bringing the debt within the exception to discharge. See, e.g., *In re Portz*, 1 BANKR. Ct. DEC. (CRR) 51 (Bankr. M.D. Ga. July 22, 1974).

However, the determination of a debtor’s subjective intent not to repay is very difficult. Courts are influenced by the debtor’s financial condition at the time the debt is incurred, the amount of time between the charges and the filing of bankruptcy, the number of charges made, the amount of the charges, whether an attorney had been consulted concerning filing for bankruptcy before the charges were made, and whether the charges were above the credit limit. See, e.g., *In re Stewart*, 7 Bankr. 551 (Bankr. M.D. Ga. 1980).

A smaller minority of courts have held that charging over the credit limit is *per se* obtaining property by false representations, and thus the intent of the debtor need not be determined. See *In re Curcio*, 1 Bankr. 727 (Bankr. E.D. Mich. 1979); *In re Schartner*, 7 Bankr. 885 (Bankr. N.D. Ohio 1980); see also Zaretsky, supra note 11. However, what conduct legally constitutes “intent not to repay” is beyond the scope of this note.\(^{23}\)

See Zaretsky, supra note 11, at 1087-89.


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\(^{22}\) When a cardholder presents his card to a merchant, he does not say, "I intend to repay this debt," but merely implies he will pay the debt. He also implies that he is using the card in accordance with the terms of the credit contract.

\(^{23}\) See Zaretsky, supra note 11, at 1087-89.
The seminal case in the Fourth Circuit is *In re Reinhart.* In *Reinhart*, the bankrupt had utilized both false representations and false pretenses in creating her credit card debt to the bank. The court found, nevertheless, that the bank had been "noticeably negligent in handling this account," principally by raising the bankrupt's credit limit from $300 to $1,000 when her payments were delinquent, granting two cash charges over $50 inside the bank itself, and failing to keep copies of the correspondence sent to the bankrupt concerning her account. However, after weighing the culpability of the bank's conduct against that of the bankrupt, the court held that the bank's negligence did not exonerate the bankrupt. Reinhart's fraudulently created debts were not dischargeable even though the bank had been negligent in failing to take action to prevent these debts from accumulating.

Subsequent decisions by other bankruptcy courts in the Fourth Circuit indicate that acquiescence could be a defense to a section 523(a)(2)(A) exception, but the most recent case, *In re Vegh,* relied on *Reinhart* and held that acquiescence could not be a legally sufficient defense. As in *Reinhart*, there was overwhelming evidence of fraud: the bankrupt had made approximately 600 purchases of less than $50 in one month, with virtually no income. The court did not reach the factual question of whether the bank had been negligent, because it held that "such negligence is not a legally sufficient defense." *Reinhart* and *Vegh* imply that acquiescence can never be a legally sufficient defense to a section 523(a)(2)(A) exception. On their facts, however, neither case decides the question of the legal effect of acquiescence when the bankrupt's conduct is less culpable, as for example, when the bankrupt has exceeded the credit limit but intent not to repay cannot be inferred from the situation.

In *In re Pritchard,* a bankruptcy court in the Fifth Circuit similarly held that bank acquiescence should not excuse the debtor if sufficient debtor culpability is found. The court stated in dictum that "the failure of the Bank to keep track of the status of the debtors' account would
not excuse the debtors if, in fact, they had been guilty of any false pretenses or fraudulent misrepresentations . . . .” Applying the strict standard of Davison-Paxon Co. v. Caldwell, the court held that the bankrupt had made no overt pretenses or representations even though the bankrupt owed $4,000 on a credit card account with a $300 limit, and had not made any payments in the last seven months. The debt, therefore, was discharged.

The Pritchard court also found that the bank “had established no routines whatever which would have enabled it to monitor the accounts of its Master Charge customers.” Although the court conceded that this failure was probably a factor contributing to the creation of such a large debt, this action would still not excuse the debtors had they made false representations. Under the Davison-Paxon standard, however, debtor conduct would have to be very culpable in order for a creditor to invoke a section 523(a)(2)(A) exception at all. Thus, In re Pritchard also leaves open the question of the legal effect of acquiescence when debtor conduct is less culpable.

A case from the Sixth Circuit, First National Bank v. Wright, implies that in some cases irresponsible bank conduct will not excuse the bankrupt’s fraudulent conduct. In Wright, the bankrupt went on a month-long buying spree preceding bankruptcy. The court concluded from the evidence that the bankrupt knew she could not pay for the credit card purchases. In her defense, the bankrupt claimed that she had received an extension of her credit limit before these purchases transpired and thus believed her purchases to have been properly made. Without deciding the factual question of whether or not an extension of credit had been granted, the court held that if the defendant knew or should have known that she could not pay for her purchases, the existence of a credit limit to cover them was irrelevant. Thus, even if the court in

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51 Id.
52 115 F.2d 189 (5th Cir. 1940), cert. denied, 313 U.S. 564 (1941).
53 In re Pritchard, 11 Bankr. at 620. Under Davison-Paxon only an overt representation (credit cardholder says “I will repay this debt”), not an implied representation (presenting card implies it is being used within the terms of the contract), constitutes a false pretense or representation. Davison-Paxon, 115 F.2d at 191. See generally supra note 22 (distinguishing overt from implied representations).
54 In re Pritchard, 11 Bankr. at 617.
55 Id. at 620.
56 Id. at 618.
57 Id.
58 See supra notes 22, 39-40 and accompanying text.
60 See id.
61 Id. at 626-27.
62 Id. at 628.
63 Id. at 627.
64 See id.
65 Id.
Wright had found that the bank acted negligently by raising the debtor's credit limit, the debtor's conduct would not have been excused.\textsuperscript{53}

The result in \textit{In re Wright} implies that the court began with the underlying premise that the credit card holder, and not the bank, is the party who should be responsible for determining how much credit he or she can responsibly maintain. This same premise can be seen in \textit{United Bank of Denver v. Kell}.\textsuperscript{54} In \textit{Kell}, the debtor had returned a Master Charge card due to his inability to pay the $2,000 balance,\textsuperscript{55} but had then reapplied to the same bank for new Master Charge and Visa accounts, even though he was involved in a chapter 13 bankruptcy.\textsuperscript{56} The bank, with knowledge of the bankruptcy proceedings, approved the two new accounts and allowed the debtor to exceed the new credit limit by twenty percent for the next few months.\textsuperscript{57} The bankruptcy judge in \textit{Kell} recognized that it was "astounding" that the new accounts were approved but refused to allow a discharge.\textsuperscript{58} Instead, the court ruled that the debtor had amassed the new debts while he was "hopelessly insolvent," and thus could have had no realistic expectations of paying the debts.\textsuperscript{59} This holding relieved the bank of all responsibility for the new debts and prevented discharge.\textsuperscript{60}

\textit{Creditor Conduct as a Defense to Nondischargeability}

Other bankruptcy courts have held that irresponsible bank conduct may constitute an acquiescence defense to a claimed section 523(a)(2)(A) exception.\textsuperscript{61} In \textit{In re Curcio},\textsuperscript{62} the bankrupt's conduct did not attain the level of culpability present in \textit{In re Vegh}\textsuperscript{63} or \textit{In re Wright}.\textsuperscript{64} The bankrupt in \textit{Curcio} had exceeded his credit limit of $1,400 by $712,\textsuperscript{65} but present intent not to repay the debt had not been found.\textsuperscript{66} The debt had ac-

\textsuperscript{53} See id.
\textsuperscript{54} 6 BANKR. CT. DEC. (CRR) 1193 (Bankr. D. Colo. Oct. 27, 1980).
\textsuperscript{55} Id. at 1194.
\textsuperscript{56} Id.
\textsuperscript{57} Id. at 1194-95. The evidence showed that while the bank was aware of the pending chapter 13 proceedings it failed to cross-reference the debtor's old account when it approved the new credit cards. \textit{Id.} at 1194 n.4.
\textsuperscript{58} Id. at 1194.
\textsuperscript{59} Id. at 1195.
\textsuperscript{60} Id.
\textsuperscript{65} 1 Bankr. 727, 728 (Bankr. E.D. Mich. 1979).
\textsuperscript{66} \textit{See id.} at 727; \textit{see also infra} text accompanying note 70.
cumulated over four months, but the bank had tried neither to revoke the card nor suspend its use; instead, it had merely reminded the bankrupt in his monthly statements that the credit limit had been exceeded. The court held that the bank could not rely on the credit limit agreement as a ground for nondischargeability because it had “waived” this right. Instead, the court directed that

the issuer of a credit card must make a choice. If it intends to rely upon an agreed charge limit, it must advise the holder of the card, who exceeds the limit, that he is not to incur additional charges until he has made payments to get under his charge limit.

This holding, if limited to the facts of the case, applies only to cases where intent not to repay is not found. Because the court in Curcio held that charging over the credit limit is per se obtaining property by false pretenses or representations, it did not need to determine whether there was an intent not to repay. Thus, this case does not address the issue of whether irresponsible bank action would excuse a more culpable bankrupt, who evinced an intent not to repay.

However, another case in the Sixth Circuit, In re Gibson, specifically held that bank acquiescence can be a defense to a section 523(a)(2)(A) nondischargeability claim even when the evidence shows that there was a present intent not to repay on the part of the bankrupt. In Gibson, the bank continued to bill only a percentage of the total amount due, rather than the entire amount over the credit limit. Consequently the court found that the “bank seemed more than willing to permit the charges to continue, with additions of the high finance charges typical in such transactions,” and allowed the debt to be discharged. The court appeared to rely on the rationale that banks should not be able to prevent discharge of debts which they allow to continue due to the high interest rates which they may charge.

This same reasoning is found in In re Talbot, where the court ruled that the creditor bank was “estopped” by its former conduct from seeking to prevent discharge of the credit card debt. In Talbot, the bank had been notified that the debtor was considering declaring bankruptcy,
but had allowed the debtor to exceed her credit limit, had authorized purchases by telephone, and had even renewed the credit card.29 In this case, the court again implied that the bank had been willing to allow the debt to accumulate in order to add on high finance charges.30 The court appeared to balance this conduct against the debtor's relatively less culpable conduct, and determined that estoppel should be applied.31

Creditor conduct also constituted an acquiescence defense, under a different exception to discharge, in In re Whitehead.32 The Whitehead court ruled that exceeding a credit limit amounted to "willful and malicious conversion of the property of another."33 However, since the bank had continued to bill only a percentage of the total amount rather than requiring the debtor to pay off the portion of the debt exceeding the credit limit,34 it had "impliedly ratified" an extension of the credit limit.35 Thus, there had been no conversion of the bank's line of credit,36 and the debt was dischargeable.37 The Whitehead decision may be read narrowly, as it relies on the "conversion of property" exception to dischargeability rather than the "false pretenses" exception. However, the court stated that "[t]he bank ought not to sleep on its rights and fail to diligently exercise the power of revocation and redelivery which it has."38 This implies that the bank should be responsible for promptly taking all available action in order to prevent large debts from accumulating.39 The Whitehead decision, therefore, supports the position that bank acquiescence should render section 523(a)(2)(A) exceptions dischargeable.40

Creditor Conduct in Special Situations

A third line of cases stands for the proposition that the validity of the defense of acquiescence depends upon the peculiarities of the bank credit

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77 Id. at 52.
80 See id.
81 See id.
82 2 BANKR. CT. DEC. (CRR) 1647, 1650 (Bankr. D. Utah Aug. 19, 1976). In this case an exception was claimed under a pre-1978 Act provision which provided that: "A discharge in bankruptcy shall release a bankrupt from all of his provable debts . . . except such as . . . (2) are liabilities for . . . willful and malicious conversion of the property of another." Bankruptcy Act § 17a(2), 11 U.S.C. § 35a(2) (1970) (repealed 1978). This section has been replaced in the Bankruptcy Reform Act of 1978 by § 523(a)(6), which reads: "(a) A discharge . . . does not discharge an individual debtor from any debt . . . (6) for willful and malicious injury by the debtor to another entity or to the property of another entity."
83 2 BANKR. CT. DEC. (CRR) at 1650.
84 Id. at 1649.
85 Id. at 1650. Cf. In re Gibson, 1 BANKR. CT. DEC. (CRR) 449, 450 (Bankr. S.D. Ohio Sept. 17, 1974), discussed supra notes 71-75 and accompanying text.
86 2 BANKR. CT. DEC. (CRR) at 1649-50.
87 Id. at 1649.
88 Id. at 165.
89 See id.
90 See 2 BANKR. CT. DEC. (CRR) 1646.
When a customer wishes to make a credit card purchase exceeding a specified amount, the merchant is contractually obligated to the issuer of the card to obtain approval of the purchases. If the cardholder has exceeded his credit limit or is delinquent in his payments, the approval will probably not be granted. However, no inquiry is required when the transaction is for less than the specified amount.

In section 523(a)(2)(A) cases, a problem arises because a cardholder can often run up a substantial debt over the credit limit before the bank finds out about it by making a number of purchases or obtaining cash advances under the specified amount. The bank may not know about these purchases immediately because no call for approval is required and because merchants often hold the invoices for several days before presenting them to the bank for payment.

Because the bank has no chance to protect itself from these types of purchases by early revocation of the card, it seems harsh to call the bank's conduct acquiescence, with the result that this debt is dischargeable. Courts have treated this situation differently. In In re Stewart, the court held that the bank's untimely actions would not constitute acquiescence because of the bank's lack of opportunity to protect itself by revoking the debtor's card. However, an earlier case, In re Cameron, took a different stand and held that under these facts the bank's conduct would constitute acquiescence. The court in Cameron reasoned that since the bank by its procedures "waived" its ability to protect itself by revoking the credit card, the bank could not assert that it had "relied" on any false representations utilized in making the purchases. The Cameron court believed that the bank should have exercised more responsibility because it had the record of the cardholder's account and was thus in a position to know when the credit limit had been exceeded.

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92 See In re Pritchard, 11 Bankr. 614, 618 (Bankr. N.D. Miss. 1981); In re Stewart, 7 Bankr. 551 (Bankr. M-D. Ga. 1980); In re Cameron, 1 Bankr. Ct. Dec. (CRR) 53 (Bankr. M-D. Ga. July 18, 1974). Under the contractual agreement between the bank and the merchant, the bank guarantees to pay all credit charges under the specified amount regardless of whether the cardholder can or does repay the bank.
93 See In re Schartner, 7 Bankr. 885, 888 (Bankr. N.D. Ohio 1980).
97 See, e.g., id.
98 See infra text accompanying notes 99-105.
100 See id. at 556.
102 See id. at 55.
103 Id.
104 See id.
More courts have followed In re Stewart than In re Cameron, partially because it is easy to infer an intent not to repay when the debtor has made many small purchases in a short period of time. As in the other credit card situations, the question of what a court should do in a situation where bad intent cannot be inferred is unanswered.

Key Factors Used in Determining the Sufficiency of an Acquiescence Defense

Certain key factors which courts have used to determine whether acquiescence should be a defense to a section 523(a)(2)(A) exception can be distilled from these cases. The first and most important factor appears to be the level of debtor culpability. This factor arises from the attitude that a debtor should be punished by preventing discharge of his debts if his behavior reaches a certain level of culpability. In determining the debtor's culpability, courts have looked for evidence that the debtor knew, or should have known, that he could not pay the debts he was incurring, or that he intentionally circumvented the credit approval process. The more culpable the debtor's conduct, the less likely it is that creditor conduct, no matter how irresponsible or negligent, will constitute a defense to a section 523 exception to discharge.

A second factor is the degree of influence which the creditor's conduct has upon the debtor's conduct. If the creditor does not have time to revoke the credit card, because of a bankruptcy-eve buying spree, or if the creditor does not have the notification necessary to take action because the debtor has kept his purchases under a specified amount, then creditor conduct has not influenced the debtor in any way. However, if credit charges go on for a number of months so that the bank has notice of

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106 See In re Stewart, 7 Bankr. at 555.

107 The existence of a high degree of debtor culpability appears to be the main reason why debtors are denied an acquiescence defense in a § 523(a)(2)(A) proceeding. See supra notes 24-45 and accompanying text.

108 Congress obviously intended some debtors to be denied discharge of their debts or it would have repealed § 523(a)(2)(A). It was left to the courts, however, to determine the level of culpability to be punished. See 11 U.S.C. § 523(a)(2)(A) (Supp. V 1981).


111 The bank's encouragement of the debtor's conduct appears to be the most important reason why an acquiescence defense will be upheld in a § 523(a)(2)(A) proceeding. See supra notes 56-79 and accompanying text.

112 The amount of time necessary to give the bank notice seems to be relatively short, since cases holding that bank conduct does not constitute acquiescence have required that the bank take action within one to two months of the date the charges were made. See, e.g., In re Schartner, 7 Bankr. 885 (Bankr. N.D. Ohio 1980); In re McKinzie, 3 BANKR. CT. DEC. (CRR) 1092 (Bankr. D. Or. Dec. 5, 1977); In re Cushingberry, 5 BANKR. CT. DEC. (CRR) 954 (Bankr. E.D. Mich. July 25, 1977).
the abuse, the bank is in a position to influence further action. If the bank does not take action at this point, its actions have at least been a contributing cause of the debt for which it seeks an exception to discharge.113

A third factor is the relative power of the two parties to prevent further credit card abuse.114 Banks have the requisite resources to calculate a proper credit limit, to communicate and explain the relevant terms of the contract to the cardholder, and to keep track of the debtor's account.115 A debtor may not have either the knowledge or ability to keep his credit balance manageable,116 and, in many cases, debtors do not fully understand the terms of the contract.117 To the extent the debtor lacked the knowledge or understanding to undertake an intentional and informed course of fraudulent conduct, bank conduct allowing or encouraging this conduct may be held to constitute a section 523 defense.118

A fourth and final factor is the extent to which a bank has allowed irresponsible or fraudulent debtor conduct to continue because of the bank's own interest in collecting high finance charges on the unpaid portion of the debt.119 This self-interest is found in cases where a bank has allowed debts to go totally unpaid for a number of months, or where it has allowed a cardholder to accumulate debts over the credit limit for a number of months. The rationale for considering this factor is that a bank should not be able to encourage irresponsible debtor conduct to its benefit, and then benefit again from the very behavior it encouraged if the debtor is forced into bankruptcy.120

WHEN SHOULD CREDITOR CONDUCT BE A LEGALLY SUFFICIENT DEFENSE?

Policy of the Bankruptcy Act

Relief of the honest but overburdened debtor has been a concern of the bankruptcy laws since the end of the nineteenth century.121 By the 1970's, the opportunity for a fresh start was seen as a major concern of the Bankruptcy Act.122 The new Act continues the "fresh start" policy

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113 While this factor has not been articulated very often, it appears to be an underlying equity consideration in several cases. See, e.g., In re Pritchard, 11 Bankr. at 616; In re Whitehead, 2 BANKR. Ct. Dec. (CRR) 1647, 1651 (Bankr. D. Utah Aug. 19, 1976).
114 See infra notes 133-34 and accompanying text.
115 See infra notes 134-35 and accompanying text.
116 See infra notes 136-41 and accompanying text.
118 See supra notes 61-67 and accompanying text.
120 See, e.g., Local Loan Co. v. Hunt, 292 U.S. 234 (1934); In re Dolnick, 374 F. Supp. 84, 90 (N.D. Ill. 1974).
with a particular focus on the problems of the consumer debtor.\textsuperscript{122} As noted above, new awareness of the particular circumstances of the consumer debtor was needed because of the amazing growth of the consumer credit industry over the prior thirty years, and the parallel rise in the number of bankruptcies.\textsuperscript{124}

The promulgators of the new Act were particularly concerned with the inadequacy of relief that was provided for consumer debtors under the old Act.\textsuperscript{125} The drafter's of the new Act instituted changes such as allowing consumers larger exemptions of personal goods\textsuperscript{126} and making it more difficult for consumers to reaffirm discharged debts.\textsuperscript{127} These changes helped effectuate the purpose of the new Bankruptcy Act with respect to consumers, that "bankruptcy relief should be effective, and should provide the debtor with a fresh start."\textsuperscript{128}

The discharge provisions are the heart of the Act's fresh start policy.\textsuperscript{129} The Senate Report accompanying the new Act stated that "[t]he discharge provisions require the court to grant the debtor a discharge on all of his debts except for very specific and serious infractions on his part."\textsuperscript{130} In this regard, the requirement that debts be provable in order to be dischargeable was abolished,\textsuperscript{131} thus allowing a more "complete settlement of the affairs of a bankrupt debtor . . . ."\textsuperscript{132}

The legislative intent shows that the new Act was intended to promote the general policy of providing a complete fresh start for consumer debtors. Because of this overriding policy, the exceptions to discharge sections should be construed in favor of the bankrupt.\textsuperscript{133} The addition of subsection 523(d),\textsuperscript{134} also supports the "complete fresh start" policy. Under this section, the court must award litigation costs to the debtor if the creditor brings and loses a nondischargeability claim under section 523(a)(2), unless the court finds this to be clearly inequitable.\textsuperscript{135} This award includes not only attorney's fees and court costs, but other pecuniary losses, such as the loss of a day's pay.\textsuperscript{136} By enacting this section, Congress hoped to

\textsuperscript{122} See H.R. Rep. No. 595, supra note 1, at 4.
\textsuperscript{123} Id. at 116. See supra notes 1-10 and accompanying text.
\textsuperscript{124} H.R. Rep. No. 595, supra note 1, at 4.
\textsuperscript{127} H.R. Rep. No. 595, supra note 1, at 118.
\textsuperscript{131} H.R. Rep. No. 595, supra note 1, at 180.
\textsuperscript{134} Id.
\textsuperscript{135} H.R. Rep. No. 595, supra note 1, at 365.
discourage creditors from initiating questionable exception to discharge actions with the intent of obtaining settlements from debtors who would rather settle than pay the attorney's fees. Such practices, the drafters felt, would "impair the debtor's fresh start." Thus, this section provides the debtor a better chance of having his debt discharged by removing the pressure to settle.

As the main provisions of section 523(a)(2) applicable to credit card cases are left unchanged, it is obvious that Congress still intends to punish clearly fraudulent uses of credit cards by excepting discharge of these debts. However, when faced with new issues such as the legal effect of creditor conduct, courts must keep in mind the clearly enunciated policy of the new Act: consumer debtors are to be provided with effective and complete relief in order to obtain a fresh start.

**Peculiarities of the Bank Credit Card System**

In light of the fraud prevention provisions of section 523(a)(2), and the fresh start policy of the Act as a whole, the question that must be asked is whether the creditor or the bankrupt is in a better position to bear the risk of irresponsible conduct which leads to bankruptcy.

In the factual situation presented by the typical three-party relationship in bank credit card transactions, it is likely that only the bank knows the full contract it has with each of the other two parties. Only the bank has knowledge of the details of its contract with the merchant, such as which purchases must be approved, the method of approval, and the method of payment of credit invoices; and of the details of its contract with the cardholder, such as the credit limit and monthly minimum payment computations. The bank is necessarily in the best position to devise and initiate safeguards against credit card abuse. The bank also has the necessary equipment and manpower to keep up-to-date records of accounts, enabling it to promptly respond to delinquent accounts. Most importantly, bank personnel have the requisite background and training in economic matters to establish a maximum credit limit that will enable the particular consumer to meet his payments with the income and assets available to him.

Finally, the bank has an incentive to encourage a certain amount of overextension because it collects high finance charges on the credit it extends to those debtors who do not pay their accounts in full after

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137 Id.
138 Id.
139 See supra notes 109-17 and accompanying text.
140 See generally supra note 7.
141 See id.
142 See Griffin, supra note 7, at 22.
143 See generally supra notes 62-90 and accompanying text.
receiving the monthly statement. 145 The eighty to eighty-five percent of the cardholders who do not pay their statements in full can make a credit card plan the most profitable operation a bank has. 146 Thus, the banks do not want to overly encourage prompt payment of debts, 147 as they will lose considerable profits. 148 All of this suggests that the banks should be the ones to bear the risk if a debtor miscalculates and overextends himself enough to go into bankruptcy. 149

The consumer, on the other hand, is relatively less able to prevent abuse. Consumer bankrupts are far less knowledgeable in the rudiments of credit use than are banks. 150 The average consumer bankrupt has only an eleventh grade education 151 and has a distinct lack of knowledge and ability in budgeting his money. 152

Not only does the average consumer bankrupt lack the general knowledge necessary to handle his debts, but he may also not be fully informed of or understand the terms of the credit card contract. 153 Bank credit card applications are easily obtained, either at the bank 154 or through

145 A bank may charge a rate of 1.5% per month, or 18% annually to cardholders who do not pay their monthly statement within an agreed-upon period after they receive it. There is no interest charged if the credit bill is paid monthly. This is called revolving credit. See Griffin, supra note 7, at 24-26.
146 Id. at 27. The average consumer in 1970 paid $1 in revolving credit interest for every $5 he charged on his credit card. Id. at 25.
147 "Compared to installment loan borrowers, credit card owners are only lightly pressed for payment, almost gently and tenderly." Id. at 24.
148 Id. at 24.
149 An even stronger case for the bank bearing the risk of loss by allowing dischargeability is made if bankruptcy is caused by matters outside of the bankrupt's hands, such as a job lay-off or a debilitating accident or illness. In a comprehensive study of debtors who fall into default, Professor David Caplovitz found that the single most important reason for the default was some reversal in the debtor's flow of income. This was reported to be the primary factor in 43% of the cases studied and at least a contributing factor in 48%. D. Caplovitz, Consumers In Trouble A Study Of Debtors In Default 54 (1974). The reversals in income were due to adverse changes in employment such as lay-offs, shorter shifts, strikes, illness of the chief wage earner, and loss of a secondary wage earner's income. Id. at 57-60.
151 Stanley & Girth, supra note 121, at 2 (data are from a Brookings Institute study of cases closed in 1964). Debtors who fall into default are much less likely than the general population to be high school graduates. A study of default debtors by Professor David Caplovitz found that while 52% of the general population had graduated from high school, only 39% of default debtors had. He suggests that it is "possible that poor education is a direct cause of defaults. The poorly educated may have more difficulty budgeting their incomes and may be more vulnerable to the pressures of unscrupulous salesmen urging heavy debt burdens upon them." Caplovitz, supra note 149, at 18-19.
152 "[Bankrupts] do not fully understand the meaning of four words: assets, liability, income and expense. They do not realize that income must be kept in balance with expenses, assets with liabilities." G. Sullivan, The Boom In Going Bust 103 (1968). In the Brookings Institute study, 31% of the 400 bankrupts interviewed gave poor debt management as the leading cause of their financial difficulties. See Stanley & Girth, supra note 121, at 47.
153 See supra text accompanying notes 140-43.
the mail\textsuperscript{155} and the application may be filled in and the credit card issued with no personal contact or explanation.\textsuperscript{156} The credit limit is approved by the bank, but may not always be communicated to the credit card holder.\textsuperscript{157} Further, cardholders may not understand the effect of exceeding the credit card limit\textsuperscript{158} and cardholders may believe they have received a credit extension when they have not,\textsuperscript{159} or may erringly believe a credit extension is to be added onto the present limit. Especially in cases where a cardholder has merely exceeded his credit limit, but no present intent not to repay has been shown, it is arguable that the consumer might not have been fully aware of the effects of his actions.

\textit{An Answer}

Considering the strong fresh start policy of the Bankruptcy Act and the relative abilities of the parties to prevent credit card abuse, it is apparent that the creditor banks should bear more responsibility for such abuse. Courts generally have not used this analysis, but, at best, have seemed to use a sliding-scale analysis, weighing the debtor's culpability against that of the creditor, and picking an arbitrary point at which acquiescence will become a sufficient defense.\textsuperscript{160} This approach has left the law in a confused state and has not worked to deter fraudulent transactions, contrary to the intent of section 523(a)(2)(A).\textsuperscript{161} If more responsibility were required of those who are in a position to prevent abuse, the banks,\textsuperscript{162} the intent of section 523(a)(2)(A) would be better met.

In light of this policy, there appear to be only a few situations where bank acquiescence should not be a defense to a section 523(a)(2)(A) claim of nondischargeability. If the bank has taken affirmative measures to communicate the terms of the contract to the cardholder and then revokes or suspends the card as soon as it is put on notice of an exceeded credit limit, the bank should not be held to have acquiesced in the creation of the debts. Likewise, if a debtor engages in a bankruptcy-eve spending spree, purposely keeping his purchases below a specified amount to avoid the bank's self-protection measures, the bank's conduct should not pro-

\textsuperscript{155} See Griffin, supra note 7, at 29-32.
\textsuperscript{157} Id. at 616; see also In re Kirby, 8 Bankr. 705, 708 (Bankr. S.D. Fla. 1981).
\textsuperscript{158} The cardholders in In re Kirby, 8 Bankr. at 708, testified that they thought they were free to use their credit card as long as they paid the minimum monthly charge. The credit cardholder in In re Pritchard testified that he did not know what a credit limit was. 11 Bankr. at 616.
\textsuperscript{159} See, e.g., First Nat'l Bank v. Wright, 8 Bankr. 625, 627 (Bankr. S.D. Ohio 1981) (bankrupt cardholder believed she had obtained an oral extension of her credit limit over the phone although the bank testified that a credit application was required in order to obtain an increase in a credit limit).
\textsuperscript{160} See supra notes 15-120 and accompanying text.
\textsuperscript{161} See Zaretsky, supra note 11, at 1075.
\textsuperscript{162} See supra notes 140-48 and accompanying text.
vide an acquiescence defense because the bank has not had an opportunity to prevent the debtor's action.

However, a bank should not be permitted to maintain that it has "relied" on a cardholder's representation that he is acting in accordance with the contract when the bank knows the credit limit has been exceeded and permits the situation to continue. The bank should also not be permitted to rely on a debtor's implied intent to repay when the bank has allowed the debtor to continue to use his card even though a large debt has accumulated and very little has been paid off. In these two situations, the bank's actions have encouraged or at least have been a contributing factor in the creation of the debt; such actions are, therefore, the type of conduct that is meant to be discouraged by section 523(a)(2)(A). It would be inequitable to allow the bank to benefit by invoking a section 523(a)(2)(A) exception to discharge under these circumstances.

Application of the acquiescence defense in these situations would insure more equitable results. For example, if this defense had been applied in United Bank of Denver v. Kell, the bank would not have been able to prevent discharge of debts that had been charged on credit cards which the bank had approved and issued after the debtor had already defaulted on a prior credit card account and after the debtor had entered chapter 13 proceedings. This result would encourage banks to cross-reference their credit card accounts and improve their credit application approval procedures which in turn would lead to less credit card abuse.

CONCLUSION

In light of both the policy of the Bankruptcy Reform Act of 1978 and the peculiarities of the bank credit card system, creditor conduct which encourages credit card abuse should constitute an acquiescence defense to a claim of section 523(a)(2)(A) exception to discharge. Existing caselaw is divided as to the sufficiency of an acquiescence defense. Courts have seemed to use a balancing approach, weighing the culpabilities of the debtor and the creditor. However, the fresh start policy of the new Bankruptcy Act, coupled with the fact that many consumers do not have the knowledge, economic sophistication, or power to prevent credit card abuse, indicate that the exception to discharge provisions should be construed in favor of the bankrupt and that the banks should bear more of the responsibility to prevent credit card abuse. By disallowing a bank's nondischargeability claim when bank acquiescence is present, the intent of the legislators to provide a fresh start to consumers, while at the same time discouraging fraudulent credit transactions, will be met.

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