Adversary Proceedings In Chapter 13

I. Introduction

Most adversary proceedings in a personal bankruptcy filed under any chapter of the Bankruptcy Code involve questions of dischargeability. Most adversary complaints are filed by creditors challenging the discharge of a specific debt or the entire discharge. A few are filed by debtors, usually to obtain a determination of the dischargeability of tax debts or student loans.

11 U.S.C. § 523(a) contains the complete list of nondischargeable debts in personal Chapter 7, 11, and 12 bankruptcies. However, the list does not apply to debtors that are not individuals, typically businesses.

Chapter 13, which is only available to individual debtors because of § 109(e), has an interesting complication because there are two ways to get a Chapter 13 discharge[1]: under § 1328(a) after plan completion, and under § 1328(b) if the debtor successfully moves the court for a hardship discharge without having completed the plan.

The list of exceptions to discharge in § 523(a) applies to the § 1328(b) hardship discharge because of § 1328(c)(1). However, the list of nondischargeable debts in a § 1328(a) discharge is found in § 1328(a), and does not include some of the § 523(a) exceptions.

For example, debts for willful and malicious harm to property are dischargeable in a § 1328(a) discharge (*cp*. § 523(a)(6) and § 1328(a)(4)). There is another important difference between the wording of § 523(a)(6) and § 1328(a)(4): § 523(a)(6) refers to "willful *and* malicious" whereas § 1328(a)(4) refers to "willful *or* malicious." Therefore, while the object of the harm is narrower in § 1328(a)(4), the burden of proof is less stringent.

Other types of debts that are dischargeable under § 1328(a) are noncriminal fines (*cp*. § 523(a)(7) and § 1328(a)(3); *e.g.*, in California parking penalties are civil rather than criminal penalties pursuant to Cal. Veh. Code § 40203.5), and the kinds of debts listed in § 523(a)(10)-(19).

In particular, debts incurred as part of a separation agreement or divorce decree that are not domestic support obligations are dischargeable in a § 1328(a) discharge. This fact alone leads to acrimonious Chapter 13 litigation — I have such a case right now — though not always in the form of an adversary proceeding.

One final note on dischargeability: if a debtor is in a Chapter 13 and then converts to Chapter 7, any debts incurred during the pendency of the Chapter 13 case are dischargeable in the Chapter 7 — subject, of course, to § 523(a) — because of § 348(b) combined with § 727(b).

[1] A Chapter 13 debtor must satisfy the debt ceilings of 11 U.S.C. § 109(e) to be eligible to file. And a Chapter 13 debtor who has had a previous relatively recent bankruptcy is not eligible for a discharge at all. *See* § 1328(f) for details.

II. <u>Debtor Initiated Adversary Proceedings</u>

Fed. R. Bankr. Proc. 4007(a) states: “A debtor or any creditor may file a complaint to obtain a determination of the dischargeability of any debt."

A. Chapter 7

Chapter 7 debtors rarely have the resources to fund an adversary proceeding, so debtor-initiated adversary proceedings are rare. Therefore, unless the case is done on a *pro bono* basis, or a wealthy friend or relative pays the costs and fees, an adversary proceeding is unlikely, even if it is warranted. It is for this reason that there are not very many student loan or tax dischargeability actions filed.

Of course, if the debtor’s debts are not primarily consumer debts — for example, they may be mostly tax debts, which are not consumer debts (*see*, *e.g.*, *In re Westberry*, 215 F.3d 589, 591 (6th Cir. 2000)) — then § 707(b) is inapplicable to the case. This is what underlies the occasional high income Chapter 7 filings. Then the debtor may have the resources to fund the litigation.

High income Chapter 7 cases usually involve high tax liabilities. As the IRS and the Franchise Tax Board (or whatever taxing authority you have in your state) may assert that the tax is nondischargeable, a debtor-initiated dischargeability action may be in order. As trust fund tax liabilities are never dischargeable, the focus of such actions is on income tax and the three-part dischargeability test that follows:

1. *Due Date Of The Return*

First, the debtor must file the bankruptcy papers more than three years after the date the tax return was due — with extensions. For example, if the tax year in question is 2007, then the date the tax return was due, with extension if the debtor took one, was October 15, 2008. Therefore, to satisfy this requirement the debtor cannot file the bankruptcy papers before October 16, 2011. Notice that this requirement does not focus on whether the debtor actually filed the return, just on when the return was due.

2. *Filing Date Of The Return*

Second, the debtor must have actually filed a legitimate, non-fraudulent return for the tax year in question at least two years before filing the bankruptcy papers. Continuing with the previous example, for the debtor to be able to file bankruptcy papers on October 16, 2011, the debtor must have filed the return no later than October 15, 2009. It should be noted that if the IRS files a "substitute for return" on behalf of the taxpayer because the taxpayer never filed a return, then this requirement cannot be satisfied.

3. *Date Of Tax Assessment*

Third, the IRS cannot have assessed the tax liability during the 240-day window immediately prior to filing the bankruptcy papers. Thus, in the previous example, for the debtor to file bankruptcy papers on October 16, 2011 the IRS cannot have assessed the tax after February 18, 2011. This particular requirement can be problematic because the 240-day clock is tolled during an offer-in-compromise, plus 30 days, and during any time in which a stay of proceedings against collections in a prior bankruptcy was in effect, plus 90 days. In applying this third requirement, one determines the applicable chronology by reviewing the tax transcript available from the IRS.

Other factors can come into play. For example, some years ago I had a client who had lived in a county in Texas that was declared a disaster area. As a result, the IRS granted a filing extension. Therefore, it is important to do a thorough analysis prior to filing the petition to ensure that a given tax is dischargeable.

B. Chapter 13

Chapter 13 debtor initiated dischargeability actions are also rare because the debtor's disposable income is usually consumed by plan payments. However, in a 100% plan where the debtor still has money left over, a dischargeability action may be warranted.

1. *Student Loan Dischargeability Actions*

A Chapter 13 debtor will almost certainly fail the so-called *Brunner* test (*see In re Brunner*, 46 B.R. 752, 753 (S.D.N.Y., 1985) (Aff'd by 831 F.2d 395 (2d Cir.1987)), and applied by the Ninth Circuit in *In re Pena*, 155 F. 3d 1108 (9th Cir. 1998)), so a Chapter 13 student loan dischargeability action will probably result in sanctions under Fed. R. Bankr. Proc. 9011.

2. *Income Tax Dischargeability Actions*

The difference in income tax dischargeability between the § 1328(a) and § 1328(b) discharges lies in the first and third requirements listed above. These requirements do not have to be met in a § 1328(a) discharge because § 1328(a)(2) does not include §523(a)(1)(A) within its ambit. This simplification in the analysis may make a debtor-initiated action worth filing, especially if the liability is large and the proof of claim asserts nondischargeability status. However, it's probably best to use an objection to the proof of claim rather than an adversary proceeding.

III. Creditor Initiated Adversary Proceedings

Most adversary proceedings in consumer cases are creditor-initiated, and are challenges, either of a specific debt under § 523, or the entire discharge under § 727. Since § 727 is part of Chapter 7, it doesn't apply to Chapter 13 cases, so we won't spend any time on it.

Section 523 actions can be divided into two categories: those with a time limit and those without one.

Fed. R. Bankr. Proc. 4007(b) states: "A complaint other than under § 523(c) may be filed at any time." These comprise the no-time-limit category.

Fed. R. Bankr. Proc. 4007(c) states: "[A] complaint to determine the dischargeability of a debt under §523(c) shall be filed no later than 60 days after the first date set for the meeting of creditors under §341(a)." And § 523(c) deals with dischargeability actions based on § 523(a)(2), (4), and (6), *i.e.*, fraud, breach of fiduciary duty[2], and willful and malicious harm to a person (remember: harm to property does not give rise to nondischargeability in a § 1328(a) discharge). These comprise the time-limit category.

Important Exception To Rule 4007(c): If a debtor applies for a § 1328(b) discharge, then the willful and malicious harm to property exception of § 523(a)(6) is implicated. Therefore, after the debtor files the hardship discharge motion, Rule 4007(d) requires the court to fix a time for creditors to file a § 523(a)(6) action. No such carve-out is given for the other § 523(a) categories not included in § 1328(a)(2) because the creditor has nothing to prove in those categories.

If you represent a debtor, and a creditor files a § 523(c) complaint after the 60-day bar date, you should file a motion for summary judgment. I have had cases that were resolved solely on that basis. It is worth considering filing a motion for sanctions pursuant to Rule 9011, but without setting it for a hearing. Rule 9011 has a 21-day safe harbor during which the party can withdraw the complaint without sanctions. If after the 21 days have elapsed the creditor still hasn't withdrawn the complaint, set the motion for hearing.

However, it is uncommon for a licensed attorney to file a § 523(c) action after the 60-day bar date. Therefore, you should prepare for combat.

The only § 523 actions I have dealt with in my practice have been § 523(c) actions (occasionally when I have gone over to the dark side of the force and represented a creditor, but most of the time as a debtor's attorney). Therefore, for the rest of this discussion I will restrict myself to § 523(c).

IV. Section 523(a)(2) Actions

I like to think of fraud as having two forms in bankruptcy.

First, a debt is incurred through fraud if at the time the debt was incurred the debtor made a material misrepresentation that induced a creditor to grant credit or issue credit or a loan, and the creditor would not have done so but for the lie. This is the classical understanding of fraud that is captured in § 523(a)(2)(A) and (B), and involves a two-party transaction.

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[2] I am imprecisely using the shorthand, "breach of fiduciary duty." There are actually three separate causes of action in § 523(a)(4): (1) fraud or defalcation while acting in a fiduciary capacity, (2) embezzlement, and (3) larceny.

Second, a debt is incurred through fraud if at the time the debt was incurred the debtor had no intention of repaying it.

Although determining a debtor's intention can be challenging, the five bankruptcy courts in the Central District of California are extremely fortunate: They each have Vulcans who do mind melds. The debtor's thoughts are then projected on a screen. The public is permitted to view the more salacious thoughts after paying an entrance fee. This paragraph is a treat for those of you who read this far.

The focus of the above analysis is on relatively recent debt, and it is the substance of § 523(a)(2)(C). It most commonly involves credit card debt, and is typically a three-party transaction: the debtor, the merchant, and the credit issuer.

One observation: when I show my debtor clients § 523(a)(2)(C), they focus solely on the time limits. I therefore emphasize the fact that we are dealing with a function of two variables: time and debt magnitude. Thus, if a debtor incurred a twenty thousand dollar debt 91 days before I meet them, I will urge them to age the debt for many months prior to filing.

A. <u>Elements Of Classical Fraud In Bankruptcy Under § 523(a)(2)(A)</u>

The creditor must plead and prove all of the following:

1. The debtor made a representation to the creditor,
2. The debtor knew that the representation was false,
3. The debtor intended to deceive the creditor,
4. The creditor justifiably relied on the representation, and
5. The creditor was harmed as a result of the representation, *i.e.*, the representation was the proximate cause of the harm.

In this type of dispute strict evidence is required (*See*, *e.g.*, *In re Slyman*, 234 F. 3d 1081, 1086 (9th Cir. 2000)(strict evidence rather than the totality of circumstances is required).

Much of the battle centers on intent, justifiable detrimental reliance, and proximate causation of the harm. If, for example, a creditor didn't exercise even a modicum of due diligence prior to the transaction, the debtor can effectively attack the reliance prong.

It is important to observe that § 523(a)(2)(A) excludes a statement regarding the debtor's or an insider's financial condition from its ambit. That factor appears in § 523(a)(2)(B).

B. <u>Elements Of Classical Fraud In Bankruptcy Under § 523(a)(2)(B)</u>

Things are a little different in a § 523(a)(2)(B) action because the focus is on a written misrepresentation that must include a misrepresentation of the debtor's (or an insider's) financial condition. Therefore, the elements that the creditor must prove focus specifically on a writing. They are:

1. The debtor made a statement in writing,
2. The statement was materially false,
3. The statement was regarding the debtor's or an insider's financial condition,
4. The creditor relied on the misrepresentation, and
5. The debtor published the statement with the intent to deceive.

As before, the battle is over intent, justifiable detrimental reliance, and proximate causation of the harm. The difference in the analysis between § 523(a)(2)(A) and §523(a)(2)(B) is on the formal writing and its application to the debtor's financial condition. The due diligence requirement is more significant here because this type of action usually involves a large loan — typically business or real estate — in which case the creditor really should investigate the debtor's financial condition.

C. <u>Elements Of Three-Party Transaction Fraud In Bankruptcy Under § 523(a)(2)(C)</u>

When a debtor uses a credit card to purchase something, the debtor has probably not made any direct representation to the creditor. Instead, the debtor interacts solely with the merchant. What then is the representation?

Courts have held that when a debtor uses a credit card, that person makes an implied representation of intent to repay the debt, but not of ability to do so. *See*, *e.g.*, *In re Anastas*, 94 F. 3d 1280, 1285 (9th Cir.1996) ("We emphasize that the representation made by the card holder in a credit card transaction is not that he has an ability to repay the debt; it is that he has an intention to repay"). The key question is: Was the intent fraudulent? Since the Ninth Circuit's holding focused solely on the debtor's intent, and not on the debtor's ability to repay, the debtor's impecuniousness at the time the debt was incurred is insufficient by itself to establish fraudulent intent.

Because of the inherent difficulty in proving intent not to repay a credit card debt, Ninth Circuit courts use a totality of circumstances approach, and look to twelve factors (*See In re Eashai*, 87 F. 3d 1082, 1087-88 (9th Cir. 1996):

1. The length of time between the charges made and the filing of bankruptcy;
2. Whether or not an attorney has been consulted concerning the filing of bankruptcy before the charges were made;
3. The number of charges made;
4. The amount of the charges;
5. The financial condition of the debtor at the time the charges are made;
6. Whether the charges were above the credit limit of the account;
7. Whether the debtor made multiple charges on the same day;
8. Whether or not the debtor was employed;
9. The debtor's prospects for employment;
10. Financial sophistication of the debtor;
11. Whether there was a sudden change in the debtor's buying habits; and
12. Whether the purchases were made for luxuries or necessities.

V. **Section 523(a)(4) Actions**

As previously stated in footnote 2, there are three separate actions under § 523(a)(4).

A. Breach Of Fiduciary Duty

Interestingly, the statute uses two words to describe the malefaction: fraud and defalcation. We have already beaten "fraud" bloody above (if you'll pardon the unsavory imagery). What is defalcation? Defalcation is a failure to produce money that was entrusted to the creditor, but does not necessarily involve fraud, embezzlement or theft. *See*, *e.g.*, *Quaif v. Johnson*, 4 F. 3d 950, 955 (11th Cir. 1993) (defalcation for purposes of this statute does not have to rise to the level of fraud, embezzlement, or even misappropriation.)

A breach of a fiduciary duty action must involve a trust, and the trust must have been a formal trust created by contract or statute. This is more than just a confidence. *See*, *e.g.*, *In re Short*, 818 F. 2d 693, 695 (9th Cir. 1987) (internal cites omitted):

> Because the broad general definition of fiduciary — a relationship involving confidence, trust, and good faith — is inapplicable in the dischargeability context, ordinary commercial relationships are excluded from the reach of section 523(a)(4). The trust must have been created before the act of wrongdoing. The debtor must have been a trustee before the wrong and not a trustee *ex maleficio*. Thus, constructive or implied trusts are excluded, but statutory trusts are not.

Therefore, proof of the absence of a formal trust antedating the malfeasance will defeat a breach of fiduciary action.

Unlike the breach of fiduciary duty action,

> Embezzlement and larceny under section 523(a)(4) does [*sic*] not require the presence of a fiduciary relationship or an express trust relationship.

In re Hofmann, 144 B.R. 459, 464 (Bankr. D. N. D. 1992).

B. Embezzlement

The courts have done a fine job of defining embezzlement and stating the burden of proof the creditor has to establish nondischargeability:

> Embezzlement is defined for purposes of § 523(a)(4) as the fraudulent appropriation of property by a person to whom such property has been entrusted, or into whose hands it has lawfully come.

Matter of Miller, 156 F. 3d 598 (5th Cir. 1998).

> A creditor proves embezzlement by showing that he entrusted his property to the debtor, the debtor appropriated the property for a use other than that for which it was entrusted, and the circumstances indicate fraud.

In re Brady, 101 F. 3d 1165, 1173 (6th Cir. 1996).

The key difference between embezzlement and larceny is that in embezzlement the original taking of the property is lawful while the larcenous taking is not.

C. <u>Larceny</u>

The word generally used for larceny in common parlance is theft. Here's how the courts define it:

> Larceny is the wrongful taking and carrying away of property of another with intent to convert said property to one's use without the consent of the owner.

In re Hofmann, 144 B.R. at 464.

Practice Tip: If you have a client who has been accused of fraud, embezzlement, or larceny, you may want to insist on payment in full, and in cash, prior to beginning any work.

V. <u>Section 523(a)(4) Actions</u>

Since a § 1328(a) discharge discharges debts incurred as the result of willful and malicious harm to property, I'll just look at willful or malicious harm to a person. That harm includes both injury and death.

Presumably the harm is self-evident, so the key elements to show are willfulness and malice. But recall that § 1328(a)(4) uses the disjunctive *or* rather than § 523(a)(6)'s conjunction *and*. Therefore, only one of these elements must be proved.

A. <u>Willfulness</u>

Willfulness requires that the tortfeasor intended the injury and not just the act that caused the injury. As the U.S. Supreme Court held:

> The word "willful" in (a)(6) modifies the word "injury," indicating that nondischargeability takes a deliberate or intentional injury, not merely a deliberate or intentional act that leads to injury. Had Congress meant to exempt debts resulting from unintentionally inflicted injuries, it might have described instead "willful acts that cause injury." Or, Congress might have selected an additional word or words, *i e.*, "reckless" or "negligent," to modify "injury." Moreover, as the Eighth Circuit

> observed, the (a)(6) formulation triggers in the lawyer's mind the category “intentional torts,” as distinguished from negligent or reckless torts. Intentional torts generally require that the actor intend “the consequences of an act,” not simply “the act itself.”

Kawaauhau v. Geiger, 523 U.S. 57, 62-63 (1998).

Therefore, the creditor must establish that the debtor intended the harm. Thus, harm that is the result of mere negligence does not meet this standard.

B. Malice

Courts frequently analyze willfulness and malice together because the dischargeability actions are primarily under § 523(a)(6) rather than § 1328(a)(4). However, we have this helpful holding from the Eighth Circuit:

> Congress tells us in § 523(a)(6) that malice and willfulness are two different characteristics. They should not be lumped together to create an amorphous standard to prevent discharge for any conduct that may be judicially considered to be deplorable. We are convinced that if malice, as it is used in § 523(a)(6), is to have any meaning independent of willful it must apply only to conduct more culpable than that which is in reckless disregard of creditors’ economic interests and expectancies, as distinguished from mere legal rights. Moreover, knowledge that legal rights are being violated is insufficient to establish malice, absent some additional “aggravated circumstances.”

In re Long, 774 F. 2d 875, 880-81 (8th Cir. 1985).

The Eleventh Circuit has added the following touch, defining malicious as: “wrongful and without just cause or excessive even in the absence of personal hatred, spite or ill-will. Malice could be implied or constructive; the specific intent to harm is not necessary.” *In re Walker*, 48 F.3d 1161, 1163 (11th Cir.1995).

Practice Tip: If you have a Chapter 13 client who has been accused of willful or malicious harm to a person, you may wish to increase your health and life insurance coverage. Better yet, rethink the client base you’re seeking to attract.

VI. Collateral Estoppel/*Res Judicata*

Given the fact that this teleconference is supposed to last about an hour, and these notes have taken considerably more than an hour to prepare, I will close with one important topic that can complicate things: the *res judicata* effect of a prior judgment in state court.

Generally, a prior judgment has *res judicata* force in the bankruptcy court. One possible exception arises when the prior judgment was a default judgment. A default judgment will be binding in an adversary proceeding if certain requirements are met. Here is the Ninth Circuit's take on the matter:

> Under California law, collateral estoppel only applies if certain threshold requirements are met:
>
> First, the issue sought to be precluded from relitigation must be identical to that decided in a former proceeding. Second, this issue must have been actually litigated in the former proceeding. Third, it must have been necessarily decided in the former proceeding. Fourth, the decision in the former proceeding must be final and on the merits. Finally, the party against whom preclusion is sought must be the same as, or in privity with, the party to the former proceeding.
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> *Harmon v. Kobrin* (*In re Harmon*), 250 F.3d 1240, 1245 (9th Cir.2001) (citation omitted).
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> The mere fact that "judgment was secured by default does not warrant the application of a special rule." *Williams v. Williams* (*In re Williams' Estate*), 36 Cal.2d 289, 223 P.2d 248, 252 (1950). California law does, however, place two limitations on this general principle. The first is that collateral estoppel applies only if the defendant "has been personally served with summons or has actual knowledge of the existence of the litigation." *In re Harmon*, 250 F.3d at 1247 (quoting *Williams*, 223 P.2d at 254). Collateral estoppel, therefore, only applies to a default judgment to the extent that the defendant had actual notice of the proceedings and a "full and fair opportunity to litigate." *Id*. at 1247 n. 6.
>
> The second limitation, in the context of a default judgment, is that a decision has a preclusive effect in later proceedings "only where the record shows an express finding upon the allegation" for which preclusion is sought. *Williams*, 223 P.2d at 254. But, as we recognized in *In re Harmon*, "the express finding requirement can be waived if the court in the prior proceeding necessarily decided the issue." 250 F.3d at 1248. In such circumstances, an express finding is not required because "if an issue was necessarily decided in a prior proceeding, it was actually litigated." *Id*.

In re Cantrell, 329 F. 3d 1119, 1123-24 (9th Cir. 2003).

VII. Topic For Another Day

The effect of *Stern v. Marshall*, 131 S. Ct. 2594 (2011)'s limitations of the authority of bankruptcy courts in litigation.

Thank you for your attention.

All the best,

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