

## THE DISCHARGE OF DEBTS

By

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Generally, one of the primary purposes of the United States Bankruptcy Code (Title 11 of the United States Code of Laws) is to provide individual debtors with a "fresh start." The fresh start is provided by (1) allowing the debtor to keep certain minimal assets and (2) discharging the debtor from his obligations to pay his debts. Generally, courts construe objections to the debtor's discharge against the objector and liberally in favor of the debtor. *See, e.g., In re Scarlata*, 979 F.2d 521 (7th Cir.1992); *In re Hunter*, 780 F.2d 1577 (11th Cir. Fla. 1986); *Rosen v. Bezner*, 996 F.2d 1527 (3d Cir. 1993) (Section 727 is construed liberally in favor of the debtor); *Insurance Co. of N. Am. v. Cohn (In re Cohn)*, 54 F.3d 1108 (3d Cir. 1995) (same).

However, discharge is a privilege granted to the honest debtor and not a right accorded to all bankrupts and as the Supreme Court once said discharge is only for the "honest but unfortunate debtor." *Grogan v. Garner*, 498 U.S. 279, 112 L. Ed. 2d 755, 111 S. Ct. 654 (1991); *In re Burgess*, 955 F.2d 134 (1st Cir. Mass. 1992); *see also In re Horridge*, 127 B.R. 798 (S.D. Tex. 1991) (discharge not a matter of right); *In re Pimpinella*, 133 B.R. 694 (Bankr. E.D.N.Y. 1991) (same). While some have suggested that the debtor should use pre-exemption planning to "go as far as you can," this attitude does not comport well with the idea of the honest but unfortunate debtor. Cristol, A., Cassidy, W. and Walden, A. Exemption Planning: How Far May You Go?, 48 S.C.Law. R. 715, 742 (1997). With the recent change relating to the Individual Retirement Account (an "IRA"), providing for an unlimited exemption for IRA's under South Carolina law, we may see an increase in pre-petition planning by debtor. *See In re Outen*, 97-08675-W, (March 18, 1998) (IRA is included as exempt under South Carolina homestead exemptions); *but see Rowland v. Strickland*, 362 S.E.2d 892 (Ct App. 1987) (judgment creditor may attach IRA account as not exempt from alienation). With this increase in pre-petition planning, we may see an increase in complaints objecting to the discharge of the debtor's obligations.

Section 727 provides for the denial of the debtor's discharge in Chapter 7 cases. Section 1328 provides for the denial of the debtor's discharge in Chapter 13 cases. Section 523 provides for the non-discharge of certain obligations under certain conditions. In the materials that follow, Richard R. Gleissner discusses the denial of discharge of certain obligations and gives certain practice pointers for practitioners to keep in mind. Dana Wilkenson discusses the denial of discharge under Chapter 7 and Chapter 13.

### Objections to Discharge under Section 523

Section 523 provides that certain specific obligations of the debtor may be excepted from discharge under two conditions. The first condition is that the debt must be determined to be not subject to a discharge. The second condition is that the obligation must meet certain criteria. This paper will first discuss the practical aspects of the trial of issues

relating to the discharge and then will discuss the substantive criteria used to determine whether the debt will be discharged.

## **I. The Practical Aspects of Objecting to Discharge**

### **1. Bring a Law Suit.**

Under Section 523(a), a creditor, or someone standing in the creditor's shoes, must object to the discharge of a particular debt through an adversary proceeding. Rule 7001, Fed.R. Bankr. P. See also *In re Kennerley*, 995 F.2d 145, 146-47 (9th Cir. Cal. 1993) (A motion to lift the automatic stay is not either a valid complaint to determine dischargeability or a motion to extend the deadline under Bankr. R. 4007(c)).

#### **1.1 Standing.**

To obtain standing to bring a complaint objecting to discharge, the plaintiff must show (1) it is a creditor, (2) it is the assignee of a creditor, (See *Westbank v. Grossman (In re Grossman)*, 174 B.R. 972 (Bankr. N.D. Ill. 1994) (assignment of judgment rights)) or (3) it is subrogated to the claims of a creditor. Subrogation may occur in relation to nondischargeable taxes, as discussed below and when the debts ordinarily would not be dischargeable but they are paid by some insurance company or surety. *Old Republic Sur. Co. v. Richardson (In re Richardson)*, 178 B.R. 19 (Bankr. D.D.C. 1995) (public policy behind exceptions to discharge for breach of fiduciary duty is punitive in nature and intended to discourage improper conduct; public policy would be frustrated if debtor could avoid liability by allowing surety to cover a debt and then discharge the debt to the surety in bankruptcy; whether plaintiff had fiduciary relationship with the debtor irrelevant). See *In re Snellgrove*, 15 B.R. 149 (Bankr. S.D. Fla. 1981) (debt to surety nondischargeable to extent of debtor's embezzlement of creditor's funds).

#### **1.2 Class Actions.**

>Although not seen in the District of South Carolina, Bankruptcy Courts have permitted class action suits to challenge the dischargeability of similarly situated debts. *Santa v. Lebner (In re Lebner)*, 197 B.R. 180 (Bankr. D. Mass. 1996). In so finding, the Bankruptcy Court for the District of Massachusetts indicated that a majority of the bankruptcy courts addressing the issue agreed to allowing the suits through class actions.

#### **1.3 Jurisdiction.**

Objections to discharge are core proceedings. 28 USC §158(b)(2)(I) and (J). In South Carolina, these core proceedings have been referred to the Bankruptcy Court for determination. 28 USC §157 (on allowing referrals). Under Code § 523(c), the Bankruptcy Court has exclusive jurisdiction to determine the dischargeability of debts for: (1) Section 523(a)(2) (debts created by false pretenses, false representation, actual fraud, or by use of a false financial statement); (2) Section 523(a)(4) (debts for fraud or defalcation while acting in a fiduciary capacity, or for embezzlement, or larceny); (3)

Section 523(a)(6) (debts for willful and malicious injury by the debtor to another entity or to the property of another entity); and (4) Section 523(a)(15) (certain debts arising from divorce or separation which are not excepted under Code § 523(a)(5)). Other courts are given concurrent jurisdiction for the remaining objections to discharge.

#### **1.4. Abstention.**

In those situations where another court has jurisdiction, the Bankruptcy Court could abstain from hearing a dischargeability issue. *See* 28 USC § 1334 (discussing both discretionary and mandatory abstention). In a practical sense this abstention is most often used in questions dealing with the dischargeability of claims involving multiple personal injury suits (see *In re Robbins*, 964 F.2d 342 (4th Cir. N.C. 1992); *Wood v. Fiedler*, 548 F.2d 216 (8th Cir. Minn. 1977); *Austin v. Wendell-West Co.*, 539 F.2d 71 (9th Cir. Wash. 1976)) or in family support obligations where state courts are more familiar with the criteria for measuring support requirements. *Brothers v. Tremaine (In re Tremaine)*, 188 B.R. 380 (Bankr. S.D. Ohio 1995) (abstaining from dischargeability proceeding under Code § 523(a)(5) with respect to alleged alimony). Sometimes it is used relating to tax claims but the abstention in tax claims seems to be limited to situations involving no asset chapter 7 cases. *See In re Gossman*, 206 B.R. 264 (Bankr. N.D. Ga. 1997); *Shapiro v. United States (In re Shapiro)*, 188 B.R. 140 (Bankr. E.D. Pa. 1995) (Court abstained from hearing debtor's adversary proceeding to determine amount of nondischargeable debt where such determination would have no effect on creditors in the no-asset bankruptcy case which had been fully administered). If another court renders a determination on dischargeability, that determination is given preclusive effect in the bankruptcy court. *E.g., In re Galbreath*, 83 B.R. 549 (Bankr. S.D. Ill. 1988).

#### **2. Bring the Suit Timely.**

##### **2.1 Within 60 days after the first date set for the meeting of creditors.**

For causes of action within the exclusive jurisdiction of the bankruptcy court, the complaint objecting to discharge must be filed "not later than 60 days following the first date set for the meeting of creditors held pursuant to § 341(a)." Fed.R. Bankr. P. 4007(c). A motion to extend the 60-day period must be made prior to the end of the period and must be made by the creditor. Fed. R. Bankr. P. 9006(b)(3) permits an enlargement of time. If you don't bring the complaint, no amount of excusable neglect will save the creditor and unless the creditor relies upon an incorrect bar date being provided by the court, the bankruptcy court will not allow the late filing of a claim objecting to discharge. *Neeley v. Murchison*, 815 F.2d 345 (5th Cir. 1987); *In re Alton*, 837 F.2d 457 (11th Cir. 1988); *In re Anwiler*, 958 F.2d 925 (9th Cir. 1992), *cert. denied*, 121 L. Ed. 2d 171, 113 S. Ct. 236 (1992) (court has equitable power to permit untimely filing where the clerk gave an incorrect bar date); *Themy v. Yu (In re Themy)*, 6 F.3d 688 (10th Cir. 1993) (courts have "almost uniformly allowed an out-of-time filing when the creditor relies upon a bankruptcy court notice setting an incorrect deadline"). Some courts have held that a late filed complaint denies the court of jurisdiction and the case is dismissed even if the defense of failure to timely file is not raised by the debtor. *Dollinger v. Poskanzer*,

146 B.R. 125 (D.N.J. 1992) (bar date for filing dischargeability complaint is jurisdictional, and thus debtor's failure to plead untimeliness in answer is not a waiver of time bar); *But see In re Santos*, 112 B.R. 1001 (Bankr. 9th Cir. 1990) (dischargeability complaint bar date is not jurisdictional, and thus debtor can waive defense of untimeliness). Still other courts have found other exceptional circumstances to allow them to accept late-filed objections to discharge. *See In re Dewalt*, 961 F.2d 848 (9th Cir. 1992) (unscheduled creditor's late-filed complaint acceptable because notice of bankruptcy filing only 7 days before the bar date was insufficient under Code § 523(a)(3)(B), the court required at least 30 days' notice or knowledge of the bankruptcy to satisfy Section 523(a)(3)(B)); *In re Crumley*, 73 B.R. 996 (Bankr. E.D. Tenn. 1987) (due process required acceptance of creditor's late filed Section 523(a)(2), (4) or (6) objection because creditor was without notice of bar date); *Shaheen v. Penrose (In re Shaheen)*, 174 B.R. 424 (E.D. Va. 1994) (30-day notice required by Bankruptcy Rule applied to objections to discharge and thus late filed complaint was timely where creditor received notice of bankruptcy only 12 days before bar date).

For dischargeability issues not within the exclusive jurisdiction of the bankruptcy court, under Rule 4007(b), these complaints may be filed at any time. There is no bar date for filing complaints based on alimony and child support, driving while intoxicated, student loans, and taxes. These types of debts are not automatically discharged. Thus, in these instances, a debtor may have an incentive to bring the complaint in the form of a declaratory judgment action.

Under Bankruptcy Rule 1019(2), if a Chapter 11 case is converted to Chapter 7, a new filing period commences. If the Chapter 11 case partially concluded by way of a confirmed plan, that confirmed plan discharged the debt and the new time period can be used only for post confirmation issues of discharge. *In re Pavlovich*, 952 F.2d 114 (5th Cir. La. 1992) (conversion to Chapter 7 after confirmation of individual debtor's Chapter 11 plan precludes creditors whose claims were dealt with under the plan from challenging discharge or dischargeability; however, creditor may challenge discharge based on post-confirmation conduct). Further, if a case started as a Chapter 7, converts to a Chapter 11 and then is converted back to a Chapter 7, there is some authority that the reconversion will not start a new period. *See, e.g., F & M Marquette Nat. Bank v. Richards*, 780 F.2d 24 (8th Cir. Minn. 1985) (reconversion did not start new period); *In re Jones*, 966 F.2d 169 (5th Cir. Tex. 1992) (reconversion did start a new period for filing objections to discharge pursuant to Fed. R. Bankr. P. 1019(2) and 4004).

## **2.2. If you don't know the bar date, find it out.**

A creditor with actual notice of the bankruptcy but not the bar date must take reasonable steps to ascertain the bar date or lose the right to object. *In re Sam*, 894 F.2d 778 (5th Cir. 1990); *In re Rhodes*, 61 B.R. 626 (Bankr. 9th Cir. Cal. 1986).

## **2.2 File the Complaint or File the Extension.**

On the bar date, the creditor must file the complaint or the extension. Some courts have held that the motion is made upon filing. *See In re Miller*, 188 B.R. 1021 (Bankr. S.D. Fla. 1995) (motion to extend bar date pursuant to Bankruptcy Rule 4007(c) is "made" when filed with court, not when served on debtor). However other courts hold that a motion is "made" when it is served on the debtor as long as the motion is filed within a reasonable time after service. *E.g., In re Friscia*, 123 B.R. 9 (Bankr. E.D.N.Y. 1991). The Eleventh Circuit has adopted the former approach and requires the filing of the motion. *Coggin v. Coggin (In re Coggin)*, 30 F.3d 1443 (11th Cir. Ala. 1994).

### **2.3. Others can't obtain an extension for the creditor.**

The Chapter 7 panel trustee and the Chapter 13 panel trustee doesn't have the ability to get an extension on behalf of creditors to object to discharge. *In re Farmer*, 786 F.2d 618 (4th Cir. 1986); *Vaccariello v. Lagrotteria*, 43 B.R. 1007 (N.D. Ill. 1984); *but see Marshall v. Demos (In re Demos)*, 57 F.3d 1037 (11th Cir. 1995) (the court "validly entered" order granting motion by Chapter 7 trustee to extend the time for all creditors to file objections to discharge).

### **3. Allege the entire factual basis for the creditor's claim.**

An amendment to a complaint objecting to discharge that changes the legal theory or adds another claim arising out of the same transaction or occurrence relates back to the original complaint. *In re Tester*, 56 B.R. 208 (W.D. Va. 1985) (Code § 523(a)(4) complaint permitted to be amended to add § 523(a)(6) claim). Thus, if the creditor has alleged all of the factual basis for asserting an objection to discharge, the creditor stands a better chance of the court determining in its favor that "the amended pleading arose out of the conduct, transaction, or occurrence set forth or attempted to be set forth in the original pleading." Fed. R. Civ. P. 15(c)(2). For a discussion of the application of Bankruptcy Rule 7015 (which incorporates Fed. R. Civ. P. 15); see also *Flexi-Van v. Perez (In re Perez)*, 172 B.R. 284 (Bankr. E.D.N.Y. 1994) (amendment in discharge context); *In re Gunn*, 111 B.R. 291 (Bankr. 9th Cir. Cal. 1990) (complaint alleging §§ 523(a)(2)(A) and (B) and 727(a)(5) causes of action amended after two years of discovery to allege § 727(a)(3) and (4) because all claims arose out of same transaction); *CIT Group/Factoring Mfrs. Hanover, Inc. v. Srour*, 138 B.R. 413 (Bankr. S.D.N.Y. 1992) (action under Code § 727(a)(2) and (4) amended to seek relief under § 523(a)(4), because claims arose out of the same conduct, transaction or occurrence); *Bank of Chester County v. Cohen*, 139 B.R. 327 (Bankr. E.D. Pa. 1992) (complaint originally filed under § 523(a)(2)(A) amended to assert Section 523(a)(2)(B) and 727(a)(2)(A) where actions in the amended complaint were based on the same conduct, transaction and occurrence as the original); *but see In re Union Bank of Middle East, Ltd.*, 127 B.R. 514 (E.D.N.Y. 1991) (amendment of Code § 523(a)(2)(A) complaint to include § 523(a)(4) claim not allowed); *In re Harrison*, 71 B.R. 457 (Bankr. D. Minn. 1987) (§ 727(a) claim was not sufficiently similar to § 523(a)(6)); *Rufenacht, Bromagen, & Hertz, Inc. v. Russell*, 69 B.R. 394 (D. Kan. 1987) (§ 727 complaints may be timely amended to assert a § 523 claim); *In re McClellan*, 60 B.R. 719 (Bankr. E.D. Va. 1986) (amendment from § 727(a)(2) relief to action under § 523(a)(2) was not allowed); *In re Grant*, 45 B.R. 262 (Bankr. D. Me. 1984) (§ 727

complaint could not be amended to allege § 523 cause of action because of "insufficient identity" between claims).

#### **4. Don't ask for a jury trial**

Discharge proceedings are equitable actions tried without juries. *In re Hallahan*, 936 F.2d 1496 (7th Cir. 1991); *In re Johnson*, 110 B.R. 433 (Bankr. W.D. Mo. 1990); *but see In re Jensen*, 946 F.2d 369 (5th Cir. 1991) (in dicta suggesting that debtor did not waive the right to a jury trial but denying debtor jury trial because creditor filed a proof of claim regarding the debt); *Longo v. McLaren (In re McLaren)*, 3 F.3d 958 (6th Cir. Ohio 1993). Even when the creditor seeks a money judgment, the bankruptcy court gets to make the determination. *In re McLaren*, 3 F.3d 958 (6th Cir. 1993); *In re Hallahan*, 936 F.2d 1496 (7th Cir. 1991); *Harris v. U.S. Fire Ins. Co.*, 162 B.R. 466 (E.D. Va. 1994); *Citibank (South Dakota) N.A. v. Fisher (In re Fisher)*, 186 B.R. 70 (Bankr. W.D. Ky. 1995).

In situations involving personal injury torts, the claim must be determined by the District Court and the parties are still entitled to a jury trial on the claim itself. See 28 U.S.C. §1411. Nevertheless, the question of discharge is determined by the court. *See In re Thompson*, 140 B.R. 979 (N.D. Ill. 1992).

#### **5. The Creditor has the burden of proof.**

The creditor has the burden to prove that the claim is not subject to discharge by a preponderance of the evidence. *Grogan v. Garner*, 498 U.S. 279, 111 S.Ct. 654, 112 L. Ed. 2d 755 (1991).

##### **5.1. Collateral Estoppel.**

If a state court has already made a determination, the Creditor may be benefitted by the doctrine of collateral estoppel or issue preclusion. *Grogan v. Garner*, 498 U.S. 279, 111 S. Ct. 654, 112 L. Ed. 2d 755 (1991). But you still need to show that the elements of the claim made in state court are the same elements associated with the Bankruptcy Court's determination of dischargeability. *In re Tsamasfyros*, 940 F.2d 605 (6th Cir. Ohio 1981). The elements of issue preclusion are (1) the issue to be decided by the bankruptcy court is identical to that involved in the prior litigation, (2) the issue was actually litigated, (3) the issue was determined by a valid and final judgment, (4) the determination of the issue was essential to the judgment, and (5) the standard of proof in the prior litigation was at least as high as the standard in the present litigation. *Spilman v. Harley*, 656 F.2d 224 (6th Cir. Ohio 1981). The application of issue preclusion will be discussed with the substantive aspects of the suit below.

#### **6. Use caution when settling nondischargeable obligations.**

It has been held that where an obligation was created from embezzlement and this obligation is settled through a promissory note to repay and release, the debt has been held to be dischargeable absent fraud surrounding the note. *In re West*, 22 F.3d 775 (7th

Cir. 1994); *but see United States v. Spicer*, 57 F.3d 1152 (D.C. Cir. 1995), *cert. denied*, 116 S.Ct. 701, 133 L. Ed. 2d 658 (1996) (type of debt is not altered through settlement agreement as settlement "makes the dishonest debtor no more honest, and no more entitled to relief").

## **II. The Substantive Aspects of Objecting to Discharge**

Section 523(a) provides that the following debts are not discharged: (1) certain kinds of taxes, (2) claims created by certain wrongful acts of the debtor, (3) unlisted and unsecured claims; (4) claims resulting from the fraud or defalcation by a fiduciary, (5) alimony, maintenance and support for a spouse or child, (6) willful and malicious injury, (7) fines, penalties and forfeitures to a governmental unit, (8) student loans, (9) claims of wrongful death or personal injury resulting from the operation of a motor vehicle while intoxicated, (10) claims surviving prior bankruptcies, (11 and 12) claims relating to federally insured depository institutions, (13) restitution orders, (14) debts incurred to pay a tax that wasn't dischargeable, (15) claims associated with a divorce decree or settlement agreement not provide for in Section 523(5), (16) post petition fees or assessments by homeowners associations, (17) fees for filing cases, motions, complaints or appeals, and (18) funds owed to a state or state agency for support. This paper will discuss each of these sections in turn.

### **1. Certain taxes.**

The following taxes and customs duty are excepted discharge:

(A) Taxes and duties entitled to priority;

(B) Taxes for which a return was never filed or was late-filed less than two years before the bankruptcy case commenced; and

(C) Taxes associated with the debtor's filing of a fraudulent return or willful attempt to evade or defeat a tax.

11 U.S.C. §523(a)(1). Other than these specifically enumerated exceptions, taxes are generally discharged in bankruptcy. If the underlying tax obligation is not dischargeable, pre-petition interest, post petition interest and penalties on these taxes are not dischargeable. *In re Larson*, 862 F.2d 112 (7th Cir. 1988) (pre-petition interest); *In re Hanna*, 872 F.2d 829 (8th Cir. 1989)(post petition interest); *In re Burns*, 887 F.2d 1541 (11th Cir. 1989) (post petition interest); 11 USC § 523(a)(7) (fines, penalties, and forfeitures payable to a governmental unit are exempt from discharge); *but see In re Woodward*, 113 B.R. 680 (Bankr. D. Or. 1990) (citing cases holding that post-petition interest is dischargeable). Non compensatory tax penalties are generally dischargeable.

#### **1.1 Priority Taxes.**

Section 523(a)(1)(A) excepts from discharge the debtor's obligation to pay: (1) withholding taxes, (2) recently incurred taxes, and (3) taxes incurred during the period of time between an involuntary petition and the court's appointment of a trustee or order for relief. 11 USC § 507(a)(2), incorporating 11 USC § 502(f). This section incorporates Sections 507(a)(2) and 507(a)(8) in determining the dischargeability of the taxes. Both secured tax claims and unsecured tax claims are not discharged. *See In re Latulippe*, 13 B.R. 526 (Bankr. D. Vt. 1981) (the legislative history expresses an intent to make secured, as well as unsecured, tax claims nondischargeable).

To get the bankruptcy court to make a determination of whether certain taxes are dischargeable, the debtor may desire to bring the action. *See* §523(c). Further, the provision in this section that provides for the continuing of the debt beyond bankruptcy "whether or not a claim" has been filed appears to be quite ominous. Specifically, the Tenth Circuit has found that the Internal Revenue Service may make a claim for taxes for a particular year, accept the distribution provided by the Bankruptcy Court, and then audit the records to make additional claims for that same year. *DePaolo v. United States ex rel. IRS (In re DePaolo)*, 45 F.3d 373 (10th Cir. Wyo. 1995).

Generally, the taxes and customs duties excepted from discharge fall within the following categories:

(1) taxes on or measured by income or gross receipts; 11 USC §507(a)(8)(A)

(2) assessed property taxes; 11 USC § 507(a)(8)(B). *See also In re Davis*, 11 B.R. 621 (Bankr. N.D. Tex. 1981) (the term "assessed" includes the procedure by which the property is listed, valued, and the pro rata tax claim determined).

(3) taxes required to be collected or withheld and for which the debtor is liable in any capacity ("trust fund taxes"); 11 USC § 507(a)(8)(C). *See In re King*, 117 B.R. 339 (Bankr. W.D. Tenn. 1990) (state sales taxes are nondischargeable trust fund taxes); *In re Fernandez*, 130 B.R. 757 (Bankr. W.D. Mich. 1991) (100% penalty for failure of responsible party to pay withholding taxes is included in this section rather than Section 523(a)(7) on penalties); *United States v. Sotelo*, 436 U.S. 268, 98 S. Ct. 1795, 56 L. Ed. 2d 275 (1978) (under Bankruptcy Act 100% penalty on this section and not under penalty section).

(4) certain employment taxes; 11 USC § 507(a)(8)(D).

(5) certain excise taxes; 11 USC § 507(a)(8)(E). *See In re Payne*, 27 B.R. 809 (Bankr. D. Kan. 1983) (excise tax is a tax "imposed on the performance of an act, the engaging in an occupation or the enjoyment of a privilege"); *In re Grynberg*, 986 F.2d 367 (10th Cir. Colo. 1993), *cert. denied*, 114 S.Ct. 57, 126 L. Ed. 2d 27 (1993) (excise taxes include gift taxes); *In re Beaman*, 9 B.R. 539 (Bankr. D. Or. 1980) (excise tax includes amount to be paid to State in repayment for uninsured debtor's employee's injuries); *Yoder v. Ohio Bureau of Workers' Compensation (In re Suburban Motor Freight)*, 998 F.2d 338 (6th Cir. 1993) (unpaid workers' compensation premiums are excise taxes).

(6) customs duties on certain imported merchandise; 11 U.S.C. §507(a)(8)(F).

>(7) any penalty in compensation for actual pecuniary loss. 11 U.S.C. §507(a)(8)(G).

The only type these taxes that aren't limited to a specific period of time (either two years pre-petition or three years prepetition) are "trust fund taxes". *Rosenow v. Illinois, Dept. of Revenue*, 715 F.2d 277 (7th Cir. Ill. 1983). Most of the taxes are given priority only for a limited time. This temporal aspect also affects the payment of the tax claims. If necessary for an effective reorganization, the court may instruct the taxing authority to apply payments to non-dischargeable taxes prior to applying payments to dischargeable taxes claims. *United States v. Energy Resources Co.*, 495 U.S. 545, 110 S.Ct. 2139, 109 L. Ed. 2d 580(1990). However, courts have rejected the debtor's request to instruct the taxing authority as to the application of the payments in a Chapter 7 or liquidating Chapter 11 setting. *See In re Schilling*, 177 B.R. 862 (Bankr. N.D. Ohio 1995) (declining to instruct Internal Revenue Service as to allocation of tax payments between dischargeable and nondischargeable tax obligations in a Chapter 7 case); *In re Suburban Motor Freight*, 161 B.R. 640 (S.D. Ohio 1993) (not applicable to Chapter 7 corporate debtor); *but see In re Deer Park*, 136 B.R. 815 (Bankr. 9th Cir. Cal. 1992) (debtor can direct application in liquidating Chapter 11 plan), *aff'd*, 10 F.3d 1478 (9th Cir. 1993).

If a surety pays the claim, under some cases, that surety is subrogated to the rights of the taxing authority to the extent that the surety's claim is rendered not dischargeable. *In re Fields*, 926 F.2d 501 (5th Cir. 1991), *cert. denied*, 112 S.Ct. 371, 116 L. Ed. 2d 323 (1991); *In re Waite*, 698 F.2d 1177 (11th Cir. 1983), *reh'g denied*, 703 F.2d 582 (11th Cir. 1983), *reh'g denied*, 703 F.2d 582 (11th Cir. Ga. 1983) *but see National Collection Agency, Inc. v. Trahan*, 624 F.2d 906 (9th Cir. 1980) (decided under the bankruptcy act).

## **1.2 Late Filed Taxes.**

If the Debtor fails to file a return or filed a late return within the two years immediately preceeding the bankruptcy case, Section 523(a)(1)(B) excepts from discharge debts the debts relating to the return. The debtor's intent or lack of knowledge concerning the requirement to pay the tax is not a defense to an objection to discharge under this section. *Spain v. United States (In re Spain)*, 182 B.R. 233 (Bankr. S.D. Ill. 1995). Similarly, even though 26 U.S.C. §602(b)(1) allows the Secretary of the Treasury to prepare a substitute return, this substitute return is not equivalent to the tax payer filing a return. *In re Bergstrom*, 949 F.2d 341 (10th Cir. Wyo. 1991); *In re Pruitt*, 107 B.R. 764 (Bankr. D. Wyo. 1989); *In re Hofmann*, 76 B.R. 853 (Bankr. S.D. Fla. 1987); *Delaney v. United States (In re Delaney)*, 177 B.R. 251 (Bankr. E.D. La. 1994); *but see Gless v. USA/IRS (In re Gless)*, 181 B.R. 414 (Bankr. D. Neb. 1993) (where debtor cooperated with the Secretary of the Treasury in preparing and filing the return).

If the return is filed but the filing is late the government is afforded at least two years to effect collection before the debtor can discharge the debt. At the same time, if the debtor completely fails to file a tax return, taxes for years ending within three years are also excepted from discharge. 11 USC § 507(a)(8)(A)(i) (incorporated into 11 USC § 523 by

subsection (a)(1)(A)). The three-year period begins on the date the return is originally due. *Pan American Van Lines v. United States*, 607 F.2d 1299 (9th Cir. Cal. 1979); *In re Wood*, 866 F.2d 1367 (11th Cir. Fla. 1989).

### **1.3 Fraudulent Return or Willful Attempt to Evade Tax.**

Section 523(a)(1)(C) provides that debts for taxes relating to fraudulent returns or for which the debtor "willfully attempted in any manner to evade or defeat such tax" are nondischargeable. *Cassidy v. Commissioner*, 814 F.2d 477 (7th Cir. 1987). Acts such as (1) claiming an imaginary child as a dependent have been determined to fall within this exception to discharge (*In re Harris*, 59 B.R. 545 (Bankr. W.D. Va. 1986)); (2) using false W-2 Forms (*In re Gilder*, 122 B.R. 593 (Bankr. M.D. Fla. 1990); *Ketchum v. United States*, 177 B.R. 628 (E.D. Mo. 1995); and (3) titling real property in the names of others to evade the taxes (*In re Jones*, 116 B.R. 810 (Bankr. D. Kan. 1990).

The Internal Revenue Service has the burden of proof to establish: (1) debtor's knowledge of the falsehood; (2) debtor's intent to evade the taxes; and (3) an underpayment of taxes. *Brackin v. United States, IRS*, 148 B.R. 953 (N.D. Ala. 1992); *In re Kirk*, 98 B.R. 51 (Bankr. M.D. Fla. 1989); *In re Hopkins*, 133 B.R. 102 (Bankr. N.D. Ohio 1991). The court applies a the totality of circumstances test in determining each of these three elements. *Berzon v. United States*, 145 B.R. 247 (Bankr. N.D. Ill. 1992); *In re Kirk*, 98 B.R. 51 (Bankr. M.D. Fla. 1989). Intent is inferred from such factors as significant understatements, failure to file returns, habitual late filings, failure to cooperate with the IRS, and implausible or inconsistent behavior. *Toti v. United States*, 149 B.R. 829 (E.D. Mich. 1993), *aff'd*, 24 F.3d 806 (6th Cir. Mich. 1994), *cert. denied*, 115 S.Ct. 482, 130 L. Ed. 2d 395 (1994); *In re Jones*, 116 B.R. 810 (Bankr. D. Kan. 1990).

The courts hold that any attempt to evade or defeat a tax, including omissions and commissions, and any willful attempt to avoid paying a tax fall within this provision. *Toti v. United States (In re Toti)*, 24 F.3d 806 (6th Cir. Mich. 1994), *cert. denied*, 115 S.Ct. 482, 130 L. Ed. 2d 395 (1994) (acts of omission and commission fall within Section 523(a)(1)(C)); *Bruner v. United States (In re Bruner)*, 55 F.3d 195 (5th Cir. La. 1995) (following Toti); *but see Internal Revenue Code. Haas v. IRS (In re Haas)*, 48 F.3d 1153 (11th Cir. Ala. 1995) (Congress, which knew how to distinguish between evasion of tax and evasion of payment and this section does not apply to evasion of payment); *see generally, Ketchum v. United States*, 177 B.R. 628 (E.D. Mo. 1995) (a good discussion of the case law).

## **2. For Claims When the Debtor made False Representations.**

The dischargeability of claims based upon false representations made by the debtor fall within two categories (1) false representations other than a statement respecting financial condition and (2) false statements relating to financial conditions.

### **2.1. Not relating to financial condition.**

The distinction between "false pretenses, a false representation, or actual fraud" appears to be the level of intentional conduct. "The 'fraud' referred to . . . means positive fraud, or fraud in fact, involving moral turpitude or intentional wrong . . .". *Neal v. Clark*, 95 U.S. 704, 24 L. Ed. 586 (1878); *In re Black*, 787 F.2d 503 (10th Cir. 1986); *Stanley H. Silverblatt Electrical Contractor, Inc. v. Marino*, 139 B.R. 380 (Bankr. D. Md. 1992). Actual fraud may also form the basis for an objection to discharge under Section 523(a)(6) for willful and malicious injury. *See Printy v. Dean Witter Reynolds, Inc.*, 110 F.3d 853 (1st Cir. 1997) (surveying circuit court opinions from the Third, Fourth, Fifth, Sixth, Eighth, Ninth, and Eleventh circuits interpreting "malicious").

The elements of a cause of action under this portion Section 523(a)(1)(A), appear to be:

1. A present material misrepresentation, either oral or in writing. *See In re Buttendorf*, 11 B.R. 558 (Bankr. D. Vt. 1981) (promises of future performance are insufficient); *In re Bogstad*, 779 F.2d 370 (7th Cir. 1985) (an important or substantial misrepresentation is needed); *Engler v. Van Steinburg*, 744 F.2d 1060 (4th Cir. 1984) (representation may be made orally or in writing); *In re Van Horne*, 823 F.2d 1285 (8th Cir. Iowa 1987) (silence or concealment may constitute the false representation).
2. Knowledge that the representation is false. *In re Colvin*, 117 B.R. 484 (Bankr. E.D. Mo. 1990) (discharge granted where mentally challenged debtor did not know the falsity of her statements); see also *Morimura, Arai & Co. v. Taback*, 279 U.S. 24, 73 L. Ed. 586, 49 S. Ct. 212 (1929) ("reckless indifference to actual facts" is equivalent to intentional misrepresentation).
3. Intent to defraud or deceive. *In re Devers*, 759 F.2d 751 (9th Cir. 1985); *FDIC v. Reisman*, 149 B.R. 31 (Bankr. S.D.N.Y. 1993) (intent to deceive may be inferred from surrounding circumstances). This intention is usually determined by the totality of the circumstances surrounding the representation. *Sinclair Oil Corp. v. Jones (In re Jones)*, 31 F.3d 659, (8th Cir. 1994).
4. Justifiable Reliance by the creditor. *Field v. Mans*, 133 L. Ed. 2d 351, 116 S. Ct. 437 (1995); *See Greenfield State Bank v. Copeland*, 330 F.2d 767 (9th Cir. Cal. 1964) (no reliance in fact because the loan was granted before the representation); *In re Geyen*, 11 B.R. 70 (Bankr. W.D. La. 1981) (after the fact representations were not relied upon); *City Bank & Trust Co. v. Vann (In re Vann)*, 67 F.3d 277 (11th Cir. 1995) (justifiable reliance means a creditor's conduct should be determined by the creditor's own capacity and knowledge); *In re Kirsh*, 973 F.2d 1454 (9th Cir. Cal. 1992) ("justifiable reliance" is required not "actual reliance" or "reasonable reliance").
5. Damage. *In re Collins*, 946 F.2d 815 (11th Cir. 1991); *In re Siriani*, 967 F.2d 302 (9th Cir. 1992).

As to these elements it should be understood that the courts are continually developing the concept of common law fraud and this area will incorporate that development. *Wingate v. Attalla (In re Attalla)*, 176 B.R. 650 (Bankr. D.N.H. 1994) (Section

523(a)(2)(A) "has always been understood to incorporate common law development" of the concept).

## **2.2. Relating to Financial Conditions.**

Section 523(a)(2)(B) requires that these representations be: (1) in writing, (2) material, (3) reasonably relied upon, and (4) made with the intention to deceive. The second and fourth elements are the same as the elements provided for under Section 523(a)(2)(A).

The first element is that representations relating to financial condition must be in writing. Oral statements relating to financial condition do not form the basis for an objection to discharge. *Engler v. Van Steinburg*, 744 F.2d 1060 (4th Cir. 1984) (oral statement that property not subject to liens insufficient).

The third element, reasonable reliance, is a higher burden and requires more than just "justifiable reliance." Some courts require the creditor to show that it engaged in further investigation of the written financial statement of the debtor. *Kentile Floors, Inc. v. Winham*, 440 F.2d 1128 (9th Cir. Ariz. 1971) (creditor "acted unreasonably if it acted upon the . . . statement in extending credit without any further investigation."); *see also In re Smith*, 424 F. Supp. 858 (M.D. La. 1976); *Sweet v. Ritter Finance Co.*, 263 F. Supp. 540 (W.D. Va. 1967). The further investigation requirement appears to require the creditor to merely follow industry practices in relying upon the financial statement. *See In re Patch*, 24 B.R. 563 (D. Md. 1982); *In re Ardelean*, 28 B.R. 299 (Bankr. N.D. Ill. 1983).

In renewal situations, when the false documentation is only part of the renewal, the courts are split on whether a creditor must provide "new money" as a necessary element. *In re Gerlach*, 897 F.2d 1048 (10th Cir. Colo. 1990) (new money not required); *Cho Hung Bank v. Kim (In re Kim)*, 62 F.3d 1511 (9th Cir. Cal. 1995) (although no additional money was provided, the court required an extension of repayment due date to form consideration associated with nondischargeability under Code § 523(a)(2)). For the courts requiring consideration, some hold that only the amount of the "new money" is except from discharge. *In re Barnacle*, 44 B.R. 50 (Bankr. D. Minn. 1984); *In re Wright*, 52 B.R. 27 (Bankr. W.D. Pa. 1985); *In re Curl*, 64 B.R. 14 (Bankr. W.D. Mo. 1986). Other courts except the debt represented by both the previous obligation and new money. *In re Carter*, 11 B.R. 992 (Bankr. M.D. Tenn. 1981); *In re Greenidge*, 75 B.R. 245 (Bankr. M.D. Ga. 1987); *In re Duncan*, 123 B.R. 383 (Bankr. C.D. Cal. 1991).

When the documentation is part of the original loan procedure, the debt arising from a renewal of the loan is should also be nondischargeable. *In re Liming*, 797 F.2d 895 (10th Cir. Okla. 1986) (creditor should not be forced to call loan after discovering falsity of financial statement in order to maintain rights). The idea is that a debtor shouldn't be able to benefit from a renewal because the renewal "makes the dishonest debtor no more honest, and no more entitled to relief Congress intended to reserve for the honest debtor." *United States v. Spicer*, 57 F.3d 1152 (D.C. Cir. 1995), *cert. denied*, 116 S.Ct. 701, 133 L. Ed. 2d 658 (1996); *see also Fuller v. Johannessen (In re Johannessen)*, 76 F.3d 347

(11th Cir. Fla. 1996) ("the debtor's fraud should not be discharged simply because the debtor entered into a settlement agreement.").

### **2.3 Purchasing of luxury goods on the eve of bankruptcy**

It is generally thought that when a debtor makes a purchase using a credit card, the debtor is impliedly representing that he intends to pay the credit card company for that purchase. *American Express Travel Related Servs. Co. v. Mc Kinnon (In re Mc Kinnon)*, 192 B.R. 768 (Bankr. N.D. Ala. 1996) (majority of courts have adopted the implied representation theory); *Colonial Nat'l Bank USA v. Leventhal (In re Leventhal)*, 194 B.R. 26 (Bankr. S.D.N.Y. 1996) (same). Because of this general theory, in the Bankruptcy Amendments and Federal Judgship Act of 1984, Congress adopted an subsection (C) to Section 523(a)(2). Basically, Section 523(a)(2)(C) excepts from discharge luxury purchases.

The Bankruptcy Reform Act of 1994 amended Section 523(a)(2)(C) by increasing the monetary values associated with luxury purchases. Specifically, consumer debts of more than \$1,000 owing to a single creditor for luxury goods or services which are incurred within 60 days of the bankruptcy petition are now presumed to be excepted from discharge. In addition, if the debtor received aggregate cash advances during the 60 days immediately preceding the bankruptcy of more than \$1,000, these advances are presumed to be excepted from discharge. Advances for goods and services reasonably necessary to support the debtor or the debtor's dependents are not "luxury goods and services." *In re Koch*, 83 B.R. 898 (Bankr. E.D. Pa. 1988); *In re Claar*, 72 B.R. 319 (Bankr. M.D. Fla. 1987); *In re Smith*, 54 B.R. 299 (Bankr. S.D. Iowa 1985).

### **3. Unscheduled and Unlisted Creditors.**

Section 523(a)(3) divides creditors into two categories: (1) those creditors that have claims against the debtor because of the debtor's wrongful acts under Section 523(a)(2), Section 523(a)(4) and Section 523(a)(6), and (2) all other creditors.

#### **3.1 Creditors having claims "of the kind" specified under 523(a)(2), (4) and (6).**

If the creditor is not scheduled and doesn't have knowledge of the bankruptcy in time to file a dischargeability complaint, the creditor's claim is not discharged under this section. Courts have not yet determined the extent to which a creditor must show that his claim is "of the kind" specified under Section 523(a)(2), (4) and (6). Some require a full trial of the claim others require a lesser degree of proof. See *Fidelity Nat'l Title Ins. Co. v. Franklin (In re Franklin)*, 179 B.R. 913 (Bankr. E.D. Cal. 1995) (full trial with applicable substantive law and proof for unscheduled fraud claim); *In re Haga*, 131 B.R. 320 (Bankr. W.D. Tex. 1991) (creditor need only show it has "a viable or colorable claim"); *In re Thompson*, 177 B.R. 443 (Bankr. E.D.N.Y. 1995) (debtor has burden of proof to show not a claim under Section 523(a)(2), (4) or (6)).

#### **3.2 For creditors with claims not "of the kind" specified under 523(a)(2), (4) and (6).**

For the second set of creditors, if the debtor knows of the creditor and fails to list and schedule the creditor, the claim is not discharged by the bankruptcy proceeding, unless the creditor receives notice or has actual knowledge of the filing of the bankruptcy in time to file a proof of claim. If the debtor knows of the creditor and knows the correct address of the creditor, the claim is similarly not discharged if the debtor fails to correctly list the creditor. *In re Gelman*, 5 B.R. 230 (Bankr. S.D. Fla. 1980) (exception applies where, knowing correct address, debtor gave wrong address and creditor had no actual knowledge of case); *Beverly Lumber Co. v. Nicholson (In re Nicholson)*, 170 B.R. 153 (Bankr. W.D. Mo. 1994) (proper list includes viable addresses); *In re Faden*, 170 B.R. 304 (Bankr. S.D. Tex. 1994) (notice to subsidiary of creditor insufficient).

### **3.3 Notice of Knowledge requirement.**

If the creditor has notice or knowledge of the bankruptcy, even though unscheduled and unlist, the creditor bears the burden of finding out the bar dates and filing a proof of claim. *In re Price*, 79 B.R. 888 (Bankr. 9th Cir. 1987), *aff'd*, 871 F.2d 97 (9th Cir. 1989). However, the creditor must receive the information by more than rumor. *In re Stratton*, 29 B.R. 93 (Bankr. W.D. Ky. 1983) (unsubstantiated rumor of bankruptcy is not sufficient); *In re Bosse*, 122 B.R. 410 (Bankr. C.D. Cal. 1990) (mere statement of intent to file made by debtor insufficient). The knowledge has to be (1) that the case was actually filed and (2) the location of the bankruptcy. *In re Layman*, 131 B.R. 495 (M.D. Fla. 1991).

If no bar debt for filing proofs of claims is set, such as a no-asset Chapter 7 case, the Bankruptcy Court for the District of South Carolina has held that it is technically never too late to file a timely proof of claim. Thus, the Bankruptcy Court for the District of South Carolina has concluded that an unscheduled creditor in a no-asset Chapter 7 case cannot take advantage of the exception provided by Code § 523(a)(3)(A) and the claim is discharged. *In re Gardner*, 194 B.R. 576 (Bankr. D.S.C. 1996). The Bankruptcy Court for the District of South Carolina has not addressed the issue of whether the Court should reopen a bankruptcy case where an unscheduled debt was the result of an intentional design, fraud, or improper motive rather than due solely to negligence or inadvertence. *Stone v. Caplan (In re Stone)*, 10 F.3d 285, 291 (5th Cir. 1994) (if part of an intentional design, fraud or improper motive, failure to include claim in no asset bankruptcy would render claim not subject to discharge).

## **4. Fraud and defalcation by a Fiduciary, embezzlement or larceny.**

If the debtor acted in a fiduciary capacity, Section 523(a)(4) provides that the claims of fraud and defalcation against the fiduciary are not subject to discharge. In addition, all acts of embezzlement and larceny are exempted from discharge whether or not the debtor was acting in a fiduciary capacity.

### **4.1 Fraud by a fiduciary.**

The fraud associated with a fiduciary's actions appears to be similar to the fraud found in Section 523(a)(2), however, the burden upon the creditor is lessened by the fiduciary's duty of good faith, loyalty and full disclosure. In addition, the creditor appears to have the right to rely upon the fiduciary as a matter of law.

The definition of "fiduciary" includes persons acting under an objectively manifested, pre-existing, and binding relationship. *Davis v. Aetna Acceptance Co.*, 293 U.S. 328, 55 S.Ct. 151, 79 L. Ed. 393 (1934); *LSP Investment v. Bennett*, 989 F.2d 779 (5th Cir. Tex. 1993); *Lewis v. Scott (In re Lewis)*, 97 F.3d 1182 (9th Cir. 1996). The express trust may arise from contract, from statute, or may be inferred from conduct but some courts have required an identifiable trust corpus. *Evans v. Pollard (In re Evans)*, 161 B.R. 474 (9th Cir. 1992) (breach of general fiduciary obligations are insufficient and claim must involve money or property entrusted to the fiduciary). Even though the trust may be inferred, this exception has been held not to apply to equitable, implied or constructive trusts. *In re Stone*, 91 B.R. 589 (D. Utah 1988); *In re Freeman*, 101 B.R. 698 (Bankr. E.D. Okla. 1989).

#### **4.2 Defalcation by a fiduciary.**

Defalcation is the "misappropriation of trust funds or money held in a fiduciary capacity; failure to properly account for such funds." Black's Law Dictionary, (5th Ed. 1961); *see also In re Matheson*, 10 B.R. 652 (Bankr. S.D. Ala. 1981) (using trust fund for any purpose other than the intended purpose constitutes defalcation); *In re Duttenhofer*, 12 B.R. 926 (Bankr. C.D. Cal. 1981) (inability to account for use of trust funds is defalcation); *In re Beach*, 13 B.R. 759 (Bankr. M.D. Ala. 1981) (failure to account for and turn over money collected is defalcation); *In re Gonzales*, 22 B.R. 58 (Bankr. 9th Cir. Cal. 1982) (misapplying construction funds is defalcation). Defalcation does not require an intentional conduct and may simply be a willful neglect of duty. *See In re Moreno*, 892 F.2d 417 (5th Cir. 1990).

Upon insolvency, corporate officers and directors are fiduciaries of the creditors of the corporation. *In re Bernard*, 87 F.2d 705 (2d Cir. N.Y. 1937) (based on common law and statute, the Honorable Learned Hand found a fiduciary relationship between corporate officers and creditors); *See also In re Long*, 774 F.2d 875 (8th Cir. 1985) (upon insolvency, director has a fiduciary duty owing to creditors); *In re Chavez*, 140 B.R. 413 (Bankr. W.D. Tex. 1992) (complaint filed against former president and chief executive officer of bank for defalcation); *Berres v. Bruning*, 143 B.R. 253 (D. Colo. 1992) (common law creates a fiduciary relationship upon insolvency). In this context, defalcation occurs when "a payment by an officer of his own claim, or that of another officer, . . . when he knew that the corporation was insolvent and that the interests of other creditors would be sacrificed for the benefit of its fiduciaries." *In re Bernard*, 87 F.2d 705 (2d Cir. N.Y. 1937). Defalcation may also occur when the director or officer transfers property to himself or herself. *Lawrence T. Lasagna, Inc. v. Foster*, 609 F.2d 392 (9th Cir. 1979), *cert. denied*, 446 U.S. 919, 100 S.Ct. 1853, 64 L. Ed. 2d 273 (1980); *In re Metz*, 6 F.2d 962 (2d Cir. N.Y. 1925).

Also, general partners of a limited partnership and managing partners are often found to be fiduciaries of the partnership. *Bennett v. Bennett (In re Bennett)*, 989 F.2d 779 (5th Cir. 1993), *reh'g, en banc, denied*, 993 F.2d 1545 (5th Cir. 1993) (managing partner of limited partnership is a fiduciary); *In re Short*, 818 F.2d 693 (9th Cir. 1987) (managing joint venturer was a fiduciary); *Cundy v. Woods (In re Woods)*, 175 B.R. 78 (Bankr. D. Colo. 1994) (joint venturers and management committee members have fiduciary obligations). The law is less clear on general partners of a general partnership. *See LSP Investment v. Bennett*, 989 F.2d 779 (5th Cir. Tex. 1993), *reh'g, en banc, denied*, 993 F.2d 1545 (5th Cir. Tex. 1993) (citing cases finding the general partner is a fiduciary in footnote 6 and citing cases finding that the general partner is not a fiduciary in footnote 7).

### **4.3 Embezzlement.**

"Embezzlement" is defined as "the fraudulent appropriation of property by a person to whom such property has been entrusted or into whose hands it has lawfully come." *Chrysler First Commercial Corp. v. Nobel (In re Nobel)*, 179 B.R. 313 (Bankr. M.D. Fla. 1995); *In re Jardula*, 122 B.R. 649 (Bankr. E.D.N.Y. 1990) (quoting *Moore v. United States*, 160 U.S. 268, 16 S.Ct. 294, 40 L. Ed. 422 (1895)). To establish embezzlement the creditor must show: (1) the appropriation of money or property; (2) for the debtor's use or benefit; and (3) done with fraudulent intent. *In re Patton*, 129 B.R. 113 (Bankr. W.D. Tex. 1991). For embezzlement, the fraudulent intent is established by a showing of dishonesty in fact. *In re Black*, 787 F.2d 503 (10th Cir. Utah 1986). This section has been applied to a wide variety of property, not just the embezzlement of money. *E.g., In re Mastrangelo*, 34 B.R. 399 (Bankr. D. Mass. 1983) (diamonds); *In re Berkemeier*, 51 B.R. 5 (Bankr. S.D. Ind. 1983) (fertilizer). As with fraud, the intent is usually inferred from the debtor's actions and the totality of circumstances. *Hall v. Blanton*, 149 B.R. 393 (Bankr. E.D. Va. 1992); *In re Beasley*, 62 B.R. 653 (Bankr. W.D. Mo. 1986); *Savonarola v. Beran*, 79 B.R. 493 (Bankr. N.D. Fla. 1987); *In re Bevilacqua*, 53 B.R. 331 (Bankr. S.D.N.Y. 1985).

### **4.4 Larceny.**

"Larceny" is defined as the wrongful taking of the property of another with fraudulent intent. *In re Rose*, 934 F.2d 901 (7th Cir. Ill. 1991). The fraudulent intent in larceny is merely the intent to convert the property to one's own use without consent. *In re Shinew*, 33 B.R. 588 (Bankr. N.D. Ohio 1983). With Larceny, the wrongful conduct is in the initial taking of the property. With embezzlement, the wrongful conduct is after the property comes into the possession of the debtor. *In re Weber*, 892 F.2d 534 (7th Cir. Wis. 1989).

In this regard, embezzlement and larceny are similar to the South Carolina criminal acts of breach of trust and larceny at common law. Breach of trust is part of the criminal statutes found at S. C. Code Ann. §16-13-230(1997) ("S.C. Code"). Basically, breach of trust is larceny after trust, which includes all of the elements of larceny (stealing), except the unlawful taking in the beginning. *See State v. Owings*, 205 S.C. 314, 31 S.E.2d 906

(1944). In the case of *State v. Jordan*, 255 S.C. 86, 177 S.E.2d 464 (1970), the defendant was given money to purchase stock for the victim. The defendant used some of the money to purchase groceries for himself, rather than to purchase the stock. Thus, he breached the trust and was guilty of the crime of breach of trust. Larceny occurs when the possession of the property is obtained through artifice, trick, or other fraud. *State v. McCann*, 167 S.C. 393, 166 S.E. 411 (1932).

## 5. Alimony, Maintenance and Support

Under Section 523(a)(5), to be exempt from discharge, the obligation to pay support must have some legal basis, such as the obligation of one spouse to pay another. *Audubon v. Shufeldt*, 181 U.S. 575, 21 S.Ct. 735, 45 L. Ed. 1009 (1901) ("on the natural and legal duty of a husband to support the wife" ); *Wetmore v. Markoe*, 196 U.S. 68, 25 S.Ct. 172, 49 L. Ed. 390 (1904). If there is no legal duty to support, the obligation may be found to be dischargeable. *Norris v. Norris*, 324 F.2d 826 (9th Cir. Cal. 1963) (annulled marriage does not form legal basis for support); *In re Doyle*, 70 B.R. 106 (Bankr. 9th Cir. 1986) (payments to non-spouse companion may be discharge). The obligation of a parent to support the child is always found to be non-dischargeable. *In re Magee*, 111 B.R. 359 (M.D. Fla. 1990); *Mullally v. Carter*, 67 B.R. 535 (N.D. Ill. 1986) (obligation from paternity action); *In re Seibert*, 914 F.2d 102 (7th Cir. 1990) (paternity can be determined as part of the dischargeability process).

The issue of whether the obligation is nondischargeable support is determined by federal law. *Sylvester v. Sylvester*, 865 F.2d 1164 (10th Cir. 1989); *In re Harrell*, 754 F.2d 902 (11th Cir. 1985); *In re Calhoun*, 715 F.2d 1103 (6th Cir. 1983); *In re Williams*, 703 F.2d 1055 (8th Cir. 1983); *In re Spong*, 661 F.2d 6 (2d Cir. N.Y. 1981); *In re Long*, 794 F.2d 928 (4th Cir. 1986); *Shaver v. Shaver*, 736 F.2d 1314 (9th Cir. 1984). Even if state law does not provide for alimony and support, some obligation may still be found non-dischargeable under this provision. See *In re Nunnally*, 506 F.2d 1024 (5th Cir. 1975), *reh'g denied*, 509 F.2d 576 (5th Cir. Tex. 1975), *reh'g denied*, 509 F.2d 576 (5th Cir. Tex. 1975) (Texas law does not allow alimony or support, nevertheless obligation held to be non-dischargeable under this provision); *In re Biggs*, 907 F.2d 503 (5th Cir. 1990) (although no alimony allowed, there are alimony substitutes for dischargeability issues).

The Honorable Learned Hand suggested that the courts are to examine the underlying duty that created the obligation and not the written terms of the obligation in determining whether an obligation is for support. *In re Adams*, 25 F.2d 640 (2d Cir. N.Y. 1928). Since that opinion, the federal courts have generally examined whether there is an underlying obligation to support and whether the intent of the parties was to fulfill that obligation through the mechanism at issue. However, some courts ignore the underlying obligation and focus on the form or mechanism in an effort to determine whether the mechanism provides for support. See *In re Fox*, 5 B.R. 317 (Bankr. N.D. Tex. 1980) (if obligation terminates on death or remarriage, it is alimony or support); see also *In re Maitlen*, 658 F.2d 466 (7th Cir. Ind. 1981); *In re Taff*, 10 B.R. 101 (Bankr. D. Conn. 1981); *In re Snyder*, 7 B.R. 147 (W.D. Va. 1980).

The primary objective in examining either the nature of the obligation or the mechanism used to provide for the obligation is to determine the true intent of the parties. In the absence of clear intent as manifested in some writing, the courts examine various factors present at the time the debt was incurred. The factors examined are usually the same as those that a divorce court might consider in deciding whether to award support or alimony. Under this test, even obligations to pay third parties may be nondischargeable. *See In re Stranathan*, 15 B.R. 223 (Bankr. D. Neb. 1981); *In re Harrell*, 754 F.2d 902 (11th Cir. 1985) (educational expense for 19-year-old child); *In re Crawford*, 8 B.R. 552 (Bankr. D. Kan. 1981) (moving expenses are non-dischargeable when intended for support); *In re Maitlen*, 658 F.2d 466 (7th Cir. Ind. 1981) (mortgage payments are non-dischargeable when intended for support).

Different courts use a different list of factors in determining the intent of the obligation. *See, In re Singer*, 787 F.2d 1033 (6th Cir. Ohio 1986) (eleven factors); *In re Stone*, 79 B.R. 633 (Bankr. D. Md. 1987) (the eighteen factors); *In re Goin*, 808 F.2d 1391 (10th Cir. Kan. 1987) (four factors). These factors usually include:

(1) whether the obligation terminates on the death or remarriage; (2) the written characterization of the payment; (3) whether the payments appear to balance disparate income; (4) whether the payments are to be made directly to the spouse or to a third party; (5) whether the obligation is payable in lump sum or installments; (6) whether an assumption of a debt has the effect of providing the support necessary to insure that the daily needs of the former spouse and children; and (7) whether an assumption of debt has the effect of providing the support necessary to insure a home for the spouse and children.

*Friedman v. Silberfein*, 138 B.R. 778 (Bankr. S.D.N.Y. 1992). Some courts also examine such things as whether the spouse has declared the obligation as a support obligation for tax purposes as indicia of the intent of the parties. *Robb-Fulton v. Robb (In re Robb)*, 23 F.3d 895 (4th Cir. 1994); *See Nowak v. Nowak (In re Nowak)*, 183 B.R. 568 (Bankr. D. Neb. 1995) (debtor's income taxes that claimed past payments as alimony used to support finding).

As previously discussed, claims for support are not discharged and under Section 523(c), the creditor is not required to bring a suit to make this determination. The determination of dischargeability can be made at any time and in other courts. However, if the claim has been assigned to another entity or includes a liability designated as alimony, maintenance or support, then the claim may be non-dischargeable under Section 523(a)(15). As previously discussed, the creditor does have to bring a suit for a determination of whether the claim is dischargeable under Section 523(a)(15).

## **6. Willful and malicious injury.**

Section 523(a)(6) has received recent attention in the case of *Kawaauhau v. Geiger*, 118 S. Ct. 974; 140 L. Ed. 2d 90; 66 U.S.L.W. 4167 (March 3, 1998). *Kawaauhau* dealt with a medical malpractice action and whether the malpractice claim was a willful and

malicious injury. The Supreme Court held that it was not willful and malicious and therefore it was subject to being discharged. The facts of this case are a bit different than the ordinary malpractice case. The case didn't involve an honest negligent mistake by a physician, instead, the case involved an intentional act of providing a lesser degree of care. In this case,

The Kawaauhaus urge that the malpractice award fits within this exception because Dr. Geiger intentionally rendered inadequate medical care to Margaret Kawaauhau that necessarily led to her injury. According to the Kawaauhaus, Geiger deliberately chose less effective treatment because he wanted to cut costs, all the while knowing that he was providing substandard care. Such conduct, the Kawaauhaus assert, meets the "willful and malicious" specification of § 523(a)(6).

The Supreme Court held that:

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."

The Court went further in also describing the claims covered by Section 523(a)(6) as follows:

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." Restatement (Second) of Torts § 8A, comment a, p. 15 (1964) (emphasis omitted).

Thus, it appears that the Supreme Court has defined "willful and malicious" as "intentional." A copy of this opinion is attached to this outline for your viewing pleasure.

### **6.1 Willful means intentional**

Prior to this Supreme Court ruling, several courts found that "willful" meant intentional and that the intent required under the willful element was the intent to do the act which resulted in harm, not the intent to injure the creditor. *In re Britton*, 950 F.2d 602 (9th Cir. 1991); *In re Posta*, 866 F.2d 364 (10th Cir. 1989). Under *Kawaauhau*, the debtor must intend not just the act but the consequences of the act.

### **6.2 Malicious means done without just cause.**

Prior to *Kawaauhau*, most courts examined Section 523(a)(6) as requiring a showing both intentional and malicious. Malicious required a showing that the act was done without just cause or excuse. *See, e.g., Seven Elves, Inc. v. Eskenazi*, 704 F.2d 241 (5th

Cir. Tex. 1983). The malicious action did not require a showing of hatred or ill will. *In re Wooten*, 30 B.R. 357 (Bankr. N.D. Ala. 1983); *In re Chambers*, 23 B.R. 206 (Bankr. W.D. Wis. 1982); *First Nat'l Bank v. Stanley (In re Stanley)*, 66 F.3d 664 (4th Cir. Md. 1995). Although not stated, it could be suspected that the *Kawaauhau* court did not want to get into the question of whether saving money by providing substandard care was "just cause or excuse."

Prior to *Kawaauhau*, some secured creditors attempted to use this section to object to the discharge of debtors that sold the collateral and then used the proceeds of the sale for purposes other than payment to the secured creditors. Even prior to *Kawaauhau*, the rule appeared to be that the mere conversion of collateral and diverting of funds for other uses did not constitute a willful and malicious injury required under Section 523(a)(6). *In re Long*, 774 F.2d 875 (8th Cir. 1985); *but see First Nat'l Bank v. Zinke (In re Zinke)*, 174 B.R. 1017 (Bankr. D.N.D. 1994) (finding willful and malicious injury resulting from repeated and unauthorized disposition of collateral in contravention of the security agreement). Other courts have required a showing that the debtor made personal use of the diverted funds. *E.g., Taubert v. Walsh*, 143 B.R. 691 (Bankr. N.D. Ohio 1992); *See also C.J. Tabb, The Scope of Fresh Start in Bankruptcy: Collateral Conversions and the Dischargeability Debate*, 59 *George Washington L. Rev.* 56 (1990).

### **6.3 Punitive Damages.**

Kaawauhau also places into question the issue of punitive damages. Prior to Kaawauhau, applied Section 523(a)(6) in deciding whether punitive damages were non-dischargeable. *E.g., In re Miera*, 926 F.2d 741 (8th Cir. 1991); *In re Levy*, 951 F.2d 196 (9th Cir. 1991), *cert. denied*, 112 S.Ct. 2965, 119 L. Ed. 2d 586 (1992); *Gober v. Terra+Corp. (In re Gober)*, 100 F.3d 1195 (5th Cir. Tex. 1996); *see also, Grogan v. Garner*, 498 U.S. 279, 111 S.Ct. 654, 112 L. Ed. 2d 755 (1991) ("Arguably, fraud judgments in cases in which the defendant did not obtain money, property, or services from the plaintiffs and those judgments that include punitive damages awards are more properly governed by § 523(a)(6)."); *Brown v. Benson (In re Benson)*, 180 B.R. 796 (Bankr. W.D. Pa. 1995) ("The vast majority of courts to address the issue have held that punitive damages are nondischargeable under § 523(a)(6).") Punitive damages may be awarded in cases where the conduct is far less culpable than the intentional standard set in *Kawaauhau*.

At least one circuit has taken the position that if the underlying actual damages are non-dischargeable, the punitive damages associated with the claim are non-dischargeable. *See St. Laurent v. Ambrose (In re St. Laurent)*, 991 F.2d 672 (11th Cir. 1993) (under Section 523(a)(2)(A), punitive damages are nondischargeable because they flow from the same course of conduct). It is unclear the extent to which punitive damages will continue to be exempt from discharge.

### **7. Fines, penalties and forfeitures.**

Section 523(a)(7) which excepts from discharge penalties:

Other than a tax penalty

(A) relating to a tax of a kind not specified in paragraph (1) of this subsection; or

(B) imposed with respect to a transaction or event that occurred before three years before the date of the filing of the petition.

Both subsections (A) and (B) must exist before the tax penalty is excepted from discharge. *McKay v. United States*, 957 F.2d 689 (9th Cir. Cal. 1992); *In re Roberts*, 906 F.2d 1440 (10th Cir. Okla. 1990); *In re Burns*, 887 F.2d 1541 (11th Cir. Ga. 1989).

It should be noted that in Chapter 13 the result is different. Taxes are dischargeable under a Chapter 13 plan if the plan is fully consummated. 11 U.S.C. §1328(a). Only priority taxes must be paid in full in Chapter 13. 11 U.S.C. §1322(a)(2). Thus, a tax penalty whose nondischargeability is based on 11 USC § 523(a)(7)(A) and (B) is discharged under 11 USC § 1328(a) and need not be paid in full in a Chapter 13 case.

Section 101(27) defines a "governmental unit" to include all departments, agencies, and instrumentalities of states and the United States. The term is construed in the broadest sense. See *In re Haberman*, 137 B.R. 292 (Bankr. E.D. Wis. 1992) (extending application to state attorney disciplinary boards created by a state supreme court); *Attorney Registration & Disciplinary Comm'n v. Betts*, 149 B.R. 891 (Bankr. N.D. Ill. 1993) (same). The fines, penalties, and forfeitures imposed by these various entities are nondischargeable to the extent they do not represent "compensation for actual pecuniary loss." These fines would include traffic fines and parking tickets. *E.g.*, *In re Young*, 10 B.R. 17, (Bankr. S.D. Cal. 1980) (traffic citations are criminal fines which are nondischargeable); *In re Marini*, 28 B.R. 262 (Bankr. E.D.N.Y. 1983) (contempt fine is nondischargeable). Some penalties issued by administrative agencies such as environmental agencies are also held to fall within this section's scope. See *In re Daugherty*, 25 B.R. 158 (Bankr. E.D. Tenn. 1982) (monetary penalty for environmental damage nondischargeable); *In re Tauscher*, 7 B.R. 918 (Bankr. E.D. Wis. 1981) (civil money penalties for violations of Fair Labor Standards Act). Lastly, court sanctions, such as Rule 9011, are not dischargeable. *In re McIntyre*, 96 B.R. 70 (Bankr. S.D. Miss. 1989) (nondischargeable under either Code § 523(a)(7) and Code § 523(a)(6)).

In South Carolina, the SC Department of Transportation requires the payment of certain funds in order to reinstate a debtor's driver's license. These required payments may be dischargeable. See *Williams v. Motley*, 925 F.2d 741 (4th Cir. Va. 1991) (service fees to reinstate vehicle registration and driving privileges are compensatory and not excepted from discharge).

Because of certain limiting language in Section 523(a)(13) (declaring federally ordered restitution orders non-dischargeable), State Court-ordered restitution may still be found nondischargeable under Section 523(a)(7) and court-ordered restitution imposed as a condition of probation is nondischargeable because it is viewed as part of the state's interest in rehabilitation and punishment. *Kelly v. Robinson*, 479 U.S. 36, 107 S.Ct. 353,

93 L. Ed. 2d 216 (1986) (State Court ordered restitution excepted from discharge under Section 523(a)(7)). If the purpose of the restitution order is to compensate, the obligation may be discharged. *In re Car Renovators*, 946 F.2d 780 (11th Cir. 1991), *cert. denied*, 112 S.Ct. 1949, 118 L. Ed. 2d 553 (1992).

The Fourth Circuit distinguishes between restitution orders that seek to compensate the government from restitution orders that seek to compensate the victim. The Fourth Circuit held that the government's purpose was penal when it required the criminal to compensate the victims and therefore, found the obligations to the victims to be non-dischargeable. *United States Dep't of Hous. & Urban Dev. v. Cost Control Mktg. & Sales Management*, 64 F.3d 920 (4th Cir. Va. 1995).

It should be noted that in the Crime Control Act of 1990, Congress amended the discharge provisions of Chapter 13. Section 1328 no longer discharges restitution orders. The restitution order mentioned in Section 1328 does not distinguish between federal restitution orders and state restitution orders. Thus, if state restitution orders are not found to be included under Section 527(a)(7), debtors could face the anomalous situation where a state court restitution order is not dischargeable in a Chapter 13, but is dischargeable in a Chapter 7 and Chapter 11.

## **8. Student Loans.**

Section 523(8) provides that student loans are not dischargeable if (1) made, insured, or guaranteed by a governmental unit or (2) made under any program funded in whole or part by a governmental unit or a nonprofit institution. This section does not require the creditor to bring a complaint objecting to the discharge, thus the burden is on the debtor if he seeks a determination from the bankruptcy court. *Buford v. Higher Education Assistance Foundation*, 85 B.R. 579 (D. Kan. 1988); *United States v. Bradburn*, 75 B.R. 108 (S.D. Ind. 1987); *In re Frech*, 62 B.R. 235 (Bankr. D. Minn. 1986). Nevertheless, the creditor bears the burden of establishing the existence of the debt and its qualification for the debt under Code § 523(a)(8). *In re Webb*, 132 B.R. 199 (Bankr. M.D. Fla. 1991).

This exception to discharge contains two exceptions (1) an exception for loans that first came due more than seven years before bankruptcy and (2) cases where not discharging the loan would work an "undue hardship" upon the debtor. In 1990, the discharge provided under Chapter 13, Section 1328, was amended to prevent the discharge of otherwise non-dischargeable student loans under Section 523(a)(8). The debtor should also be aware that outside of Section 523(a)(8) there are other statutes that relate to specific types of student loans.

### **8.1 Made, insured or guaranteed by a governmental unit**

Section 101(27) defines "governmental unit," to include the United States, states, municipalities, foreign states, and their departments, agencies and instrumentalities. An educational loan is "made" by a governmental unit regardless of the immediate source of the money for the loan. *See In re Shore*, 707 F.2d 1337 (11th Cir. 1983) (immediate

source was a trust with the beneficiary as the educational institution); *In re Hammarstrom*, 95 B.R. 160 (Bankr. N.D. Cal. 1989) (loan made with the intention of selling it to a nonprofit institution with the debtor's knowledge). While not considering the source of the money for the loan, the courts will consider the source of repayment and if that source is specifically identified, the court may determine the obligation to be something other than a student loan. *See In re Shipman*, 33 B.R. 80 (Bankr. W.D. Mo. 1983) (when obligation was to be paid back by labor in work-study program, court determined the obligation was not a loan); *but see In re Merchant*, 958 F.2d 738, (6th Cir. 1992) (even though creditor had recourse against educational institution, loan was still excepted from discharge).

## **8.2. Made pursuant to a program funded by a governmental unit or nonprofit institution**

Unlike governmental unit, the term "nonprofit institution" is not defined. Thus, even though some institutions are clearly nonprofit, the case law is split on whether these nonprofit institutions are allowed to claim the benefit of Section 523(a)(8). *In re Sinclair-Ganos*, 133 B.R. 382 (Bankr. W.D. Mich. 1991) (credit unions do not deserve to claim benefit of exception); *but see In re Roberts*, 149 B.R. 547 (C.D. Ill. 1993) (credit unions are nonprofit institutions); *see also, T I Fed. Credit Union v. DelBonis*, 72 F.3d 921 (1st Cir. Mass. 1995) (federal credit unions are governmental units). In deciding whether the nonprofit institution is allowed standing to object to a discharge the court will examine the corporate structure, whether dividends are paid and whether the institution competes with "for profit" institutions. *Navy Fed. Credit Union v. Simmons (In re Simmons)*, 175 B.R. 624 (Bankr. E.D. Va. 1994).

## **8.3 First became due more than seven years before the bankruptcy petition.**

The first exception to the exception provided under Section 523(a)(8) relates to loans that first became due more than seven years before the filing of the bankruptcy petition. The burden of proof is on the creditor to show that the loan first became due within the seven years. *See In re Webb*, 132 B.R. 199 (Bankr. M.D. Fla. 1991); *In re Norman*, 25 B.R. 545 (Bankr. S.D. Cal. 1982). The date on which the loan "first became due" is the date on which the first installment is due under the promissory note as interpreted under state law. *Woodcock v. Chemical Bank, NYSHESC (In re Woodcock)*, 45 F.3d 363, (10th Cir. Colo. 1995), *petition for cert. filed*, 45 F.3d 363 (1995); *In re Nunn*, 788 F.2d 617 (9th Cir. Wash. 1986). The date the loan "first became due" is extended by any suspension period in the creditors ability to seek collection, such as a forbearance in whole or in part or a prior bankruptcy. *In re Eckles*, 52 B.R. 433 (E.D. Wis. 1985) (forebearance agreement); *In re Shryock*, 102 B.R. 217 (Bankr. D. Kan. 1989) (forebearance agreement); *In re Saburah*, 136 B.R. 246 (Bankr. C.D. Cal. 1992) (automatic stay); *State Educ. Assistance Auth. v. Gibson (In re Gibson)*, 184 B.R. 716 (E.D. Va. 1995) (automatic stay). The forbearance has to be agreed upon by the debtor and cannot be unilaterally decided by the creditor. *In re Crumley*, 21 B.R. 170 (Bankr. E.D. Tenn. 1982) (deferment beyond requested time did not suspend); *In re Keenan*, 53 B.R. 913 (Bankr. D. Conn. 1985) (unilateral suspension was invalid).

If student loans are consolidated, the new loan may restart the seven-year period. *United States v. McGrath*, 143 B.R. 820 (D. Md. 1992); *In re Saburah*, 136 B.R. 246 (Bankr. C.D. Cal. 1992); *Martin v. Great Lakes Higher Educ. Corp.*, 137 B.R. 770 (Bankr. W.D. Mo. 1992); *but see, In re Brown*, 4 B.R. 745 (Bankr. E.D. Va. 1980) (consolidation does not restart running of statutory period); *Hiatt v. Indiana State Student Assistance Comm'n*, 36 F.3d 21 (7th Cir. Ind. 1994), *cert. denied*, 115 S.Ct. 1109, 130 L. Ed. 2d 1074 (1995) (same). In situations involving consolidated loans, the courts examine the current creditor to determine whether the loan is still a student loan. *See Santa Fe Medical Servs. v. Segal (In re Segal)*, 57 F.3d 342 (3d Cir. Pa. 1995) (money loan by prospective employer to repay National Health Services Corp. service obligation was not a student loan) (in dicta, the court suggests that consolidated loans are educational loans).

#### **8.4. Undue Hardship.**

Section 523(a)(8) provides for an exception to the exception to discharge if the continuation of the obligation would result in an undue hardship. "Undue hardship" is not defined in the bankruptcy code. Nevertheless, some courts have found this issue to be a question of law, reviewable de novo on appeal. *Cheesman v. Tennessee Student Assistance Corp. (In re Cheesman)*, 25 F.3d 356 (6th Cir. 1994); *In re Roberson*, 999 F.2d 1132 (7th Cir. Ill. 1993). Undue hardship is more than current financial difficulties and must include a long-term detriment. *In re Berthiaume*, 138 B.R. 516 (Bankr. W.D. Ky. 1992). In one instance, undue hardship was described "as a result of unique factors" which make the "expectation of repayment . . . virtually non-existent unless by the effort the bankrupt strips himself of all that makes life worth living." *United States v. Russo*, 708 F.2d 209 (6th Cir. 1983), *cert. denied*, 464 U.S. 993, 104 S.Ct. 487, 78 L. Ed. 2d 682 (1983).

The debtor has the burden to show undue hardship by a preponderance of the evidence and each case involving a student loan must be examined on the facts and circumstances surrounding that particular bankruptcy. *In re Betz*, 31 B.R. 565 (Bankr. W.D.N.Y. 1983) (debtor has burden); *In re Keenan*, 53 B.R. 913 (Bankr. D. Conn. 1985) (debtor has burden); *In re Garneau*, 122 B.R. 178 (Bankr. W.D.N.Y. 1990) (debtor has burden by the preponderance of the evidence); *In re Connolly*, 29 B.R. 978 (Bankr. M.D. Fla. 1983) (facts and circumstance of particular case); *In re Ford*, 22 B.R. 442 (Bankr. W.D.N.Y. 1982) (court must examine facts and circumstance of particular case); *See also In re Diaz*, 5 B.R. 253 (Bankr. W.D.N.Y. 1980) (good factual discussion of hardship).

In determining undue hardship, the courts generally examine three factors that were first discussed in the case of *In re Johnson*, 5 Bankr. Ct. Dec. (CRR) 532 (Bankr. E.D. Pa. 1979). The first factor is known as the "mechanical" test. The court examines whether the debtor's financial resources will be insufficient to enable the debtor (and any dependents of the debtor) to live at or above a subsistence level. The court examines numerous indicia including: the number of the debtor's dependents, and their ages and needs; health of the debtor and his or her dependents; access to transportation; level of education attained by the debtor; the reasonable and necessary day-to-day living expenses; marketability of the debtor's job skills; current income; and other sources of wealth. *In re*

*Andrews*, 661 F.2d 702 (8th Cir. S.D. 1981); *Koch v. Pennsylvania Higher Educ. Assistance Agency*, 144 B.R. 959 (Bankr. W.D. Pa. 1992); *In re Armijo*, 13 B.R. 175 (Bankr. D.N.M. 1981); *In re Rice*, 13 B.R. 614 (Bankr. D.S.D. 1981); *In re Clay*, 12 B.R. 251 (Bankr. N.D. Iowa 1981); *In re Perkins*, 11 B.R. 160 (Bankr. D. Vt. 1980); *In re Conard*, 6 B.R. 151 (Bankr. W.D. Ky. 1980); but see *In re Fischer*, 23 B.R. 432 (Bankr. W.D. Ky. 1982) (motherhood is not an "undue hardship" but voluntarily assumed). If the debtor fails to establish that his financial resources are insufficient to live at or above a subsistence level, the court denies the discharge. If the debtor meets this test, the court proceeds to the second factor. *Woodcock v. Chemical Bank, NYSHESC (In re Woodcock)*, 45 F.3d 363 (10th Cir. Colo. 1995), cert. denied, 116 S.Ct. 97, 133 L. Ed. 2d 52 (1995); *In re Johnson*, 5 Bankr. Ct. Dec. (CRR) 532 (Bankr. E.D. Pa. 1979).

The second factor is the "good faith" test. The debtor must demonstrate that he or she has made a good faith attempt to make payments on the loan. *Koch v. Pennsylvania Higher Educ. Assistance Agency*, 144 B.R. 959 (Bankr. W.D. Pa. 1992); *In re Love*, 28 B.R. 475 (Bankr. S.D. Ind. 1983); *In re Lezer*, 21 B.R. 783 (Bankr. N.D.N.Y. 1982); *In re Armijo*, 13 B.R. 175 (Bankr. D.N.M. 1981); *In re Rice*, 13 B.R. 614 (Bankr. D.S.D. 1981); *In re Clay*, 12 B.R. 251 (Bankr. N.D. Iowa 1981); *In re Archie*, 7 B.R. 715 (Bankr. E.D. Va. 1980). In addition to examining the payment history of the loan, the court will examine such factors as: efforts to get and keep a job; present employment; job history; whether the debtor's education and skills are being used to the best advantage; and attempts by the debtor to live within his or her means. If the debtor fails to meet his burden on this factor, the debt is excepted from discharge. If the debtor meets his burden, the court examines the third factor.

The third factor is referred to as the "policy test" and appears to be a category for the court to examine an any other potential reason not to allow the debtor to discharge the student loan. Some Circuit Courts have abandoned the "policy test" but employ a modified version of the remaining factors. See *Brunner v. New York State Higher Education Services Corp.*, 831 F.2d 395 (2d Cir. 1987); *In re Roberson*, 999 F.2d 1132, 1137 (7th Cir. Ill. 1993). These courts require the debtor to prove:

- (1) that the debtor cannot maintain, based on current income and expenses, a "minimal" standard of living for [himself] and [his] dependents if forced to repay the loans;
- (2) that additional circumstances exist indicating that this state of affairs is likely to persist for a significant portion of the repayment period of the student loans; and
- (3) that the debtor has made good faith efforts to repay the loans.

999 F.2d at 1137.

Except for the Johnson test and the modified Johnson test, the courts seem to provide a divergent group of tests to determine whether the debtor has met his burden of showing an undue hardship. See *In re Craig*, 64 B.R. 854 (Bankr. W.D. Pa. 1986), appeal dismissed, 64 B.R. 857 (W.D. Pa. 1986) (debtor must rebut presumption on

nondischargeability with a showing of severe and uniquely difficult circumstances); *Mathews v. Higher Educ. Assistance Found.* (In re *Mathews*), 166 B.R. 940 (Bankr. D. Kan.1994) (presumption must be rebutted); *In re Ford*, 151 B.R. 135, 139 (Bankr. M.D. Tenn.1993) (same); *In re Bryant*, 72 B.R. 913 (Bankr. E.D. Pa. 1987) (Federal Poverty Income Guidelines established by the Department of Health and Human Services).

In addition to determining whether a debt is dischargeable, some courts have examined the issue of undue hardship and revised payment schedule or to reduced the amount of the nondischargeable debt. *In re Webb*, 132 B.R. 199 (Bankr. M.D. Fla. 1991) (revised payment schedule); *In re Littell*, 6 B.R. 85 (Bankr. D. Or. 1980) (reduced amount); *Silliman v. Nebraska Higher Educ. Loan Program*, 144 B.R. 748 (Bankr. N.D. Ohio 1992) (reduced amount); *Raimondo v. New York State Higher Educ. Servs. Corp.* (In re *Raimondo*), 183 B.R. 677 (Bankr. W.D.N.Y. 1995) (finding debtor could repay \$5,000 of student loan obligations (20% of total outstanding) over ten years without undue hardship). *But see Rice v. United States* (In re *Rice*), 78 F.3d 1144 (6th Cir. Ohio 1996) (Bankruptcy Court may not reduce an otherwise nondischargeable debt on the basis of perceived undue hardship). In South Carolina, the amount of the obligation may be reduced. *See Ammirati v. Nellie Mae, Inc.* (In re *Ammirati*), 187 B.R. 902 (D.S.C. 1995), *aff'd without op.*, 85 F.3d 615 (4th Cir. S.C. 1996).

### **8.5. Non Bankruptcy Exceptions to Discharge of Student Loans.**

Outside of Section 523(a)(8), the debtor should be aware of the following possible exceptions, depending upon the student loan itself.

1. 42 U.S.C. §254o(d)(3). Under the National Health Service Corps ("NHSC") medical training is funded as part of a program to redistribute physicians to areas in need of medical care providers. Discharge is permitted only if (1) five years has passed since the first date that payment of damages for breach of the scholarship contract is required and (2) the Bankruptcy Court finds that failure to discharge the obligation would be unconscionable. *In re Hines*, 63 B.R. 731 (Bankr. D.S.D. 1986); Pub. L. 100-177, 101 Stat. 992 (1987) (adding unconscionable requirement); *Matthews v. United States, Nat. Health Service Corps.*, 150 B.R. 11 (Bankr. W.D. Pa. 1992);

2. 42 U.S.C. §292f(g). Under the Health Education Assistance Loan ("HEAL") obligations cannot be discharged unless (1) the passage of seven years from the first date repayment was to begin; (2) a finding that nondischarge of the debt be "unconscionable"; and (3) the Secretary of Health and Human Services has not waived certain rights. *Matthews v. Pineo*, 19 F.3d 121, 124 (3d Cir. 1994), *cert. denied*, 130 L. Ed. 2d 35, 115 S. Ct. 82 (1994) (defining unconscionable as "excessive, exorbitant," "lying outside the limits of what is reasonable or acceptable," "shocking, unfair, harsh, or unjust," or "outrageous."); *Barrows v. Illinois Student Assistance Comm'n* (In re *Bush Barrows*), 182 B.R. 640 (Bankr. D.N.H. 1994) (to determine "unconscionability" the court should examine the totality of the circumstances including the debtor's age, health, educational background, employment history, financial condition, earning ability and current income).

3. 37 U.S.C. §301d(c)(3). This section provides for an exception to discharge for the obligation of a medical officer in the military to pay back the retention bonus if the discharge is entered less than five years after the termination of the officer's agreement to complete a term of active duty. Pub. L. 101-510, § 611, Nov. 5, 1990.

This list is not meant to be exhaustive. If the debtor has a particular type of student loan, funded under a particular legislative program, it is recommended that the legislation associated with that particular loan is examined for any possible discharge issues.

### **9. For death and personal injury caused while driving under the influence.**

Section 523(a)(9) has three objectives: (1) deter drunk driving; (2) ensure that those who caused injury by driving drunk do not escape liability; and (3) protect victims of drunk driving. *Lugo v. Paulsen*, 886 F.2d 602 (3d Cir. N.J. 1989); *In re Hudson*, 859 F.2d 1418 (9th Cir. Wash. 1988)). Under Section 523(a)(9), the creditor must show: (1) the debtor was legally intoxicated under state (or other applicable) law and (2) liability resulted from the operation of a motor vehicle. *Whitson v. Middleton*, 898 F.2d 950 (4th Cir. Va. 1990); *In re Phalen*, 145 B.R. 551 (Bankr. N.D. Ohio 1992). The definition of motor vehicle may be broad enough to include boats. *See Willison v. Race*, 192 B.R. 949 (W.D. Mo. 1995) (term "motor vehicle" is broad enough to include motorboats); *In re Williams*, 101 B.R. 356 (Bankr. S.D. Fla. 1989), *aff'd*, 111 B.R. 361 (S.D. Fla. 1989) (motorboat is a motor vehicle); *Schwartz v. Dunn (In re Dunn)*, 203 B.R. 414 (E.D. Mich. 1996) (snowmobile a "motor vehicle"); *but see Boyce v. Greenway (In re Greenway)*, 71 F.3d (5th Cir. 1996), *cert. denied*, 116 S. Ct. 2499, 135 L. Ed. 2d 191 (1996) (boat not a motor vehicle); *Schachter v. Fall (In re Fall)*, 192 B.R. 16 (Bankr. D.N.H. 1995) (boat not a motor vehicle).

### **10. Debts from a prior case**

If the debtor was previously involved in a Chapter 7 proceeding and the debtor either waived his discharge or was denied his discharge, Section 523(a)(10) excepts these same claims from discharge. Debts existing at the commencement of a case in which the debtor is denied discharge can never be discharged in a subsequent bankruptcy.

Four subsections of Section 727(a) are not listed in 523(a)(10), including subsection (a)(1) (debtor not an individual), subsection (a)(8) (discharge barred where debtor received a discharge in a previous Chapter 7 or Chapter 11 case within six years), and subsection (a)(9) (Chapter 7 discharge denied where debtor received discharge in a Chapter 12 or 13 case within six years before a subsequent Chapter 7 case and debtor failed to pay specified percentages of unsecured claims in the Chapter 12 or 13). Of these (a)(8) provides an exception to the general rule relating to prior bankruptcy debts. If the debtor didn't receive a discharge because of (a)(8), then those claims do not fall within the exception of Section 523(a)(10).

Reaffirmation of a debt is not waiver of discharge. *In re Lones*, 50 B.R. 801 (Bankr. W.D. Ky. 1985). Dismissal of a case is not a bar to discharge in a subsequent case. 11 U.S.C. § 349(a). *Britt v. Logan*, 145 B.R. 324 (Bankr. D. Kan. 1992).

As to previous determinations under Section 523(a), if a debt is determined to be non-dischargeable in one bankruptcy, this determination is res judicata in subsequent cases. *Royal American Oil & Gas Co. v. Szafranski*, 147 B.R. 976 (Bankr. N.D. Okla. 1992); *but see In re Sobh*, 61 B.R. 576 (E.D. Mich. 1986) (debtor reopened bankruptcy to relitigate student loans based on new circumstances to show undue hardship). A subsequent Chapter 13 filing could get a different result. *In re Lilley*, 185 B.R. 489 (E.D. Pa. 1995) ("Congress did not intend to foreclose categorically the benefit of Chapter 13 reorganization to a debtor who previously has filed unsuccessfully for Chapter 7 relief"); *In re Harlan*, 179 B.R. 133 (Bankr. W.D. Ark. 1995) (requiring Chapter 13 plan be proposed in good faith); *In re Chaffin*, 816 F.2d 1070 (5th Cir. 1987) (debtor converted case to Chapter 13 from Chapter 7 after a debt was found nondischargeable).

### **11. and 12. Insiders of Federal Depository Institutions**

Sections 523(a)(11) and (a)(12) affect insiders within bank and thrift institutions who were involved in wrongful acts. These provisions do not overrule previous case law regarding honest debtors but does attempt to punish those who were in charge of failed insured depository institutions. 136 Cong Rec H13,289 (daily ed. Oct. 27, 1990).

Section 523(a)(11) excepts from discharge any final judgment, order or consent decree issued by a federal depository institutions regulatory agency or any obligation contained in any settlement agreement to which the debtor was a party that arose from any act of fraud or defalcation by the debtor while acting in a fiduciary capacity with respect to any insured depository institution or insured credit union. *In re Harris*, 135 B.R. 434 (Bankr. S.D. Fla. 1992) (creditor may choose to seek judgment in forum other than bankruptcy court).

Section 523(a)(12) excepts from discharge those claims arising from malicious or reckless actions or omissions by a debtor in fulfilling any commitment to maintain minimum capital at an insured depository institution. The act need only be reckless and as we have seen under Section 523(a)(6), this standard is lower than the intentional standard found in Section 523(a)(6).

The regulatory agency seeking a determination of dischargeability must bring suit by the bar date unless it was not appointed in time to reasonably comply with the deadlines. 11 USC § 523(c)(2).

### **13. Federal Court Ordered Restitution.**

In the Violent Crime Control and Law Enforcement Act of 1994, Pub. L. 103-322, § 320934 (Sept. 13, 1994), Section 523(a)(13) was added to address federal restitution orders. This Section excepts from discharge restitution ordered in cases arising under

Title 18 of the United States Code. No provision is made to except restitution ordered by state courts. As previously discussed, the exception to the discharge in Chapter 13 cases under Section 1328(a), however, applies to all restitution orders. Thus, if Section 523(a)(6) or (7) is not applied for restitution orders of a state court the debtor could receive a discharge in Chapter 7 or 11 but not in Chapter 13.

Sometimes, an award of costs is included in a restitution order to compensate for "a pecuniary loss." These awards are not included in Section 523(a)(7). However, this type of award may be viewed as nondischargeable under Section 523(a)(13).

#### **14. Loans to pay a tax**

The Bankruptcy Reform Act of 1994 added Section 523(a)(14). This section excepts from discharge loans made to pay a tax "to the United States that would be nondischargeable" under Code § 523(a)(1). According to the House Report accompanying the bill, the purpose of this section is to encourage the use of credit cards in paying federal taxes. H.R. Rep. No. 103-835, 103d Cong., 2d Sess. (1994). The idea of subrogation for tax claims has been previously discussed. This section merely codified previous case law on subrogation.

#### **15. Support Obligations not included in 523(a)(5)**

In the Bankruptcy Reform Act of 1994, Section 523(a)(15) was added to address concerns over certain limiting rulings relating to Section 523(a)(5) and its requirement that the obligation be "to a spouse, former spouse or child." Section 523(a)(15) applies to all obligations found in a divorce or separation decree and is limited in only two respects. First, the exception does not apply when the debtor does not have an ability to pay the debt. Second, the exception does not apply when "discharging such debt would result in a benefit to the debtor that outweighs the detrimental consequences to a spouse, former spouse, or child of the debtor."

Courts have taken different approaches to the burden of proof: (1) debtor has burden of proof after creditor establishes the debt arose from divorce proceeding; (2) creditor has burden of proof but debtor has burden of going forward once creditor has established the debt arose from divorce proceeding; (3) once established that debt arose from divorce proceeding, burden is on debtor under Section 523(a)(15)(A) but remains on creditor under Section 523(a)(15)(B); and (4) creditor has burden throughout the proceeding. *Willey v. Willey (In re Willey)*, 198 B.R. 1007 (Bankr. S.D. Fla. 1996) (citing cases for each approach).

In the first limitation, courts generally examine the debtor's "ability to pay" based upon the "disposable income test." *Hill v. Hill (In re Hill)*, 184 B.R. 750 (Bankr. N.D. Ill. 1995) (discussing different approaches to determining when expenses are "reasonably necessary"); *Carroll v. Carroll (In re Carroll)*, 187 B.R. 197 (Bankr. S.D. Ohio 1995) (using disposable income test); *McGinnis v. McGinnis (In re McGinnis)*, 194 B.R. 917 (Bankr. N.D. Ala. 1996) (citing cases) (reviewing debtor's current status); *Belcher v.*

*Owens (In re Owens)*, 191 B.R. 669 (Bankr. E.D. Ky. 1996) (adopting "disposable income test" of Code § 1325(b)); *Taylor v. Taylor (In re Taylor)*, 191 B.R. 760 (Bankr. N.D. Ill. 1996).

In reviewing the second limitation, the Courts apply a totality of the circumstances test including consideration of (1) the income and expenses of both parties, (2) the nature of the debt, and (3) the former spouse's ability to pay the debt. *See Florio v. Florio (In re Florio)*, 187 B.R. 654 (Bankr. W.D. Mo. 1995); *Phillips v. Phillips (In re Phillips)*, 187 B.R. 363 (Bankr. M.D. Fla. 1995) (the court exercises its equitable powers to make a value judgment).

## **16. Condominium and Homeowners Association Fees**

The Bankruptcy Reform Act of 1994 added Section 523(a)(16) which excepts from the discharge condominium and cooperative housing corporation fees and assessments which are due and payable after the order for relief. Section 523(a)(16) has two limitations. First, the exception does not affect the dischargeability of fees and assessments arising before the order for relief. Second, the exception applies only to fees and assessments payable during the period the debtor physically occupies the dwelling or the period during which the debtor rents the dwelling and receives rental payments. Section 523(a)(16) specifically references condominium associations and cooperative housing corporation fees and assessments. The legislative history of Section 523(a)(16) suggests that the exception is intended to affect "condominiums, cooperatives, or similar membership associations." H.R. Rep. No. 103-835, 103d Cong., 2d Sess. (1994). I haven't found any case law on this section.

## **17. Court Costs.**

Section 523(a)(17) excepts from discharge a debt "for a fee imposed by a court for the filing of a case, motion, complaint, or appeal, or for other costs and expenses assessed with respect to such filing" regardless of an assertion of poverty by the debtor under 28 U.S.C. § 1915(b) or (f) or the debtor's status as a prisoner as defined in 28 U.S.C. § 1915(h). Section 523(a)(17) applies to all "fees . . . others costs and expenses" imposed or assessed by the court irrespective of the status of the debtor as a prisoner. Code § 523(a)(17) could also be read to render non-dischargeable fines and sanctions imposed in civil matters under Rule 11, Fed. R. Civ.P., Rule 9011, Fed. R. Bankr. P. or even the related state court sanction.

## **18. Support Enforceable Under the Social Security Act.**

The "Personal Responsibility and Work Opportunity Reconciliation Act of 1996" added Section 523(a)(18). This Section excepts from discharge an obligation owed to a state or municipality that is in the nature of support and enforceable under Part D of title IV of the Social Security Act. The Act also amended the Social Security Act to provide that a debt owed under state law to the state or a municipality "that is in the nature of support and that is enforceable under this part is not released by a discharge in bankruptcy under

title 11 of the United States Code." The amendments apply to bankruptcy cases filed only after August 22, 1996. P.L. 104-193, 110 Stat. 2105 (1996).