



AMERICAN  
BANKRUPTCY  
INSTITUTE

## 2017 Annual Spring Meeting

*Consumer*

### **Prosecuting and Defending Dischargeability Actions in Consumer Cases**

**Hon. Martin R. Barash**

*U.S. Bankruptcy Court (C.D. Cal.); Woodland Hills*

**Hon. Daniel P. Collins**

*U.S. Bankruptcy Court (D. Ariz.); Phoenix*

**Ariane Holtschlag**

*The Law Office of William J. Factor, Ltd.; Chicago*

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Prosecuting and Defending Dischargeability Actions

I. Introduction.

Bringing together the perspectives of debtors, creditors and judges, this panel will survey the universe of nondischargeability causes of action, the realistic costs of pursuing and defending these actions, effective discovery and trial strategies, the impact of issue and claim preclusion based on pre-petition judgments, the anatomy of nondischargeability settlement agreements, the challenges of collection, and the prospects for recovery of attorneys' fees.

II. Pre-filing Investigation: Identifying Causes of Action.

A. Automatic.

Some debts are excepted from discharge automatically, meaning without the need for an adversary proceeding. However, as a practical matter, in some cases it may be questionable whether a debt falls under the exception and then the burden is on the debtor to bring the adversary for a determination to obtain certainty regarding the boundaries of her discharge. Debts for taxes, student loans, and domestic support present common circumstances where a debtor may need to bring such an action.

1. Taxes.

The permanency of taxes, forever immortalized in the words of Benjamin Franklin, "Our new Constitution is now established, and has an appearance that promises permanency; but in this world nothing can be said to be certain, except death and taxes" is recognized in the exception to discharge for certain tax obligations.

- (a) A discharge under section 727, 1141, 1228(a), 1228(b), or 1328(b) of this title does not discharge an individual debtor from any debt—
  - (1) for a tax or a customs duty—

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- (A) of the kind and for the periods specified in section 507(a)(3) or 507(a)(8) of this title, whether or not a claim for such tax was filed or allowed;
- (B) with respect to which a return, or equivalent report or notice, if required—
  - (i) was not filed or given; or
  - (ii) was filed or given after the date on which such return, report, or notice was last due, under applicable law or under any extension, and after two years before the date of the filing of the petition; or
- (C) with respect to which the debtor made a fraudulent return or willfully attempted in any manner to evade or defeat such tax.

11 U.S.C. § 523(a)(1). What subsections (A) and (B) appear to have in common is timing, meaning, on a practical level, if a debtor files her returns and can ride out the collection efforts long enough, eventually the tax obligations will be dischargeable in bankruptcy. However, in light of the definition of a “return” added to § 523 as the hanging paragraph found after §523(a)(19) new questions have been raised as to whether a debt stemming from a late filed return may ever be dischargeable in bankruptcy.

- a) *Beard* test establishes four requirements for a document to serve as a return: (1) it must purport to be a return; (2) it must be executed under penalty of perjury; (3) it must contain sufficient data to allow calculation of tax; and (4) it must represent an honest and reasonable attempt to satisfy the requirements of the tax law. *See e.g. In re Payne*, 431 F.3d 1055, 1057 (7th Cir. 2005) (holding that the debtor’s “belated filing was not a reasonable effort to satisfy the requirements of the tax law,” relying significantly on the debtor’s delinquency in failing to file his tax returns until after the IRS assessment, thus “defeating the main purpose” of the self-reporting

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requirement of our tax system); *In re Moroney*, 352 F.3d 902, 906 (4th Cir. 2003); *Justice v. United States*, 817 F.3d 738 (11th Cir. 2016)(rejecting one-day-late rule and determining non-dischargeability stemming from late filed return under *Beard* test.).

- b) One-day-late Rule: Phrase “applicable filing requirements” in the hanging paragraph definition includes filing deadlines and therefore late-filed tax documents can never be “returns.” *See e.g. Fahey v. Mass. Dep’t of Revenue*, 779 F.3d 1 (1st Cir. 2015); *McCoy v. Miss. State Tax Comm’n*, 666 F.3d 924 (5th Cir. 2012); *Mallo v. IRS*, 774 F.3d 1313 (10th Cir. 2014).

#### 2. Student Loans (11 U.S.C. § 523(a)(8))

Benjamin Franklin’s quote regarding the permanency of death and taxes, should be revised to also include student loans. Another commonly recognized exception to discharge is under § 523(a)(8) and relates to student loans:

- (a) A discharge under section 727, 1141, 1228(a), 1228(b), or 1328(b) of this title does not discharge an individual debtor from any debt—
  - (8) unless excepting such debt from discharge under this paragraph would impose an undue hardship on the debtor and the debtor’s dependents, for—
    - (A)
      - (i) an educational benefit overpayment or loan made, insured, or guaranteed by a governmental unit, or made under any program funded in whole or in part by a governmental unit or nonprofit institution; or
      - (ii) an obligation to repay funds received as an educational benefit, scholarship, or stipend; or
    - (B) any other educational loan that is a qualified education loan, as defined in section 221(d)(1) of the Internal Revenue Code of 1986, incurred by a debtor who is an individual.

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11 U.S.C. § 523(a)(8).

3. Domestic Support Obligations and Property Settlements

(5) for a domestic support obligation;  
(15) to a spouse, former spouse, or child of the debtor and not of the kind described in paragraph (5) that is incurred by the debtor in the course of a divorce or separation or in connection with a separation agreement, divorce decree or other order of a court of record, or a determination made in accordance with State or territorial law by a governmental unit.

11 U.S.C. §§ 523(a)(5), (15).

B. Action Required.

1. Dischargeability.

a) False Pretenses or Representation and Actual Fraud.

(2) for money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained by—  
(A) false pretenses, a false representation, or actual fraud, other than a statement respecting the debtor's or an insider's financial condition;

11 U.S.C. § 523(a)(2)(A).

- i) Reach expanded by U.S. Supreme Court in *Husky International Electronics, Inc. v. Ritz*, 136 S. Ct. 1581 (2016). In that case, Chrysalis Manufacturing Corporation incurred a debt to Husky International Electronics prepetition. The bankruptcy debtor, Ritz, was Chrysalis' director and a part owner. Also prior to the petition date, Ritz drained Chrysalis of assets by transferring large sums of

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money to other entities controlled by Ritz. *Id.* at 1583. After Husky sued Ritz to recover on the debt, Ritz filed a Chapter 7 bankruptcy. Husky filed an adversary complaint, seeking to hold Ritz personally liable for the Chrysalis debt and seeking an order holding that the debt was not dischargeable because Ritz' intercompany-transfer scheme constituted actual fraud under § 523(a)(2)(A). *Id.* The Court agreed with Husky, noting "that the term 'fraud' has, since the beginnings of bankruptcy practice, been used to describe asset transfer that, like Ritz' scheme, impair a creditor's ability to collect a debt." *Id.* at 1584.

ii) Practical considerations: burden shifting under § 523(a)(2)(C).

b) Fiduciary Debts, Embezzlement or Larceny;

(4) for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny.

11 U.S.C. § 523(a)(4).

c) Willful and Malicious Injury;

(6) for willful and malicious injury by the debtor to another entity or to the property of another entity;

11 U.S.C. § 523(a)(6).

2. Discharge.

a) Fraudulent Transfer or Concealment of Property.

(2) the debtor, with intent to hinder, delay, or defraud a creditor or an officer of the estate charged with custody of property under this title, has transferred, removed, destroyed, mutilated, or concealed, or has permitted to be transferred, removed, destroyed, mutilated, or concealed—

(A) property of the debtor, within one year before the date of the filing of the petition; or

(B) property of the estate, after the date of the filing of the petition.

11 U.S.C. § 727(a)(2).

i) Practical Issue: Converted cases.

b) False Oath.

(4) the debtor knowingly and fraudulently, in or in connection with the case—

(A) made a false oath or account.

11 U.S.C. §727(a)(4)(A).

i) “reckless indifference to the truth” = knowing and fraudulently.

ii) fraudulent intent can be inferred from his continuing pattern of false statements

III. Pre-filing Investigation: Practical Considerations.

A. Costs. Disclosure Requirements when representing Debtors.

B. Pre-existing Judgment? Issue and claim preclusion.

IV. Complaint.



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Under Rule 8 of the Federal Rules of Civil Procedure, made applicable to adversary proceedings by Rule 7008, a complaint must contain “(1) a short and plain statement of the grounds for the court’s jurisdiction, unless the court already has jurisdiction and the claim needs no new jurisdictional support; (2) a short and plain statement of the claim showing that the pleader is entitled to relief; and (3) a demand for the relief sought, which may include relief in the alternative or different types of relief.” F.R.Civ.P. Rule 8(a).

#### V. Answer or otherwise Plead.

A. Answer. “In responding to a pleading, a party must: (A) state in short and plain terms its defenses to each claim asserted against it; and (B) admit or deny the allegations asserted against it by an opposing party.” F.R.Civ.P. Rule 8(b).

B. Dismissal. Rule 12(b) is made applicable in adversary proceedings by Rule 7012(b):

(b) How to Present Defenses. Every defense to a claim for relief in any pleading must be asserted in the responsive pleading if one is required. But a party may assert the following defenses by motion:

- (1) lack of subject-matter jurisdiction;
- (2) lack of personal jurisdiction;

- (3) improper venue;
- (4) insufficient process;
- (5) insufficient service of process;
- (6) failure to state a claim upon which relief can be granted; and
- (7) failure to join a party under Rule 19.

A motion asserting any of these defenses must be made before pleading if a responsive pleading is allowed. If a pleading sets out a claim for relief that does not require a responsive pleading, an opposing party may assert at trial any defense to that claim. No defense or objection is waived by joining it with one or more other defenses or objections in a responsive pleading or in a motion.

F.R.Civ.P. Rule 12(b).

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1. Pleading standards to withstand motion to dismiss under Rule 12(b)(6).

“To survive a motion to dismiss, a complaint must contain sufficient factual matter, accepted as true, to ‘state a claim to relief that is plausible on its face.’” *Ashcroft v. Iqbal*, 556 U.S. 662, 678 (2009) (quoting *Bell Atl. Corp. v. Twombly*, 550 U.S. 544, 570 (2007)).

“A claim has facial plausibility when the plaintiff pleads factual content that allows the court to draw the reasonable inference that the defendant is liable for the misconduct alleged.” *Id.* “The plausibility standard is not akin to a ‘probability requirement,’ but it asks for more than a sheer possibility that a defendant has acted unlawfully.” *Id.* “Where a complaint pleads facts that are ‘merely consistent with’ a defendant’s liability, it ‘stops short of the line between possibility and plausibility of ‘entitlement to relief.’”” *Id.* (quoting *Twombly*, 550 U.S. at 577). “[W]here the well-pleaded facts do not permit the court to infer more than the mere possibility of misconduct, the complaint has alleged—but it has not ‘show[n]’—‘that the pleader is entitled to relief.’” *Id.* at 679 (quoting Fed. R. Civ. P. 8(a)(2)) (latter alteration in original).

In evaluating whether a complaint states a plausible claim, a court should first identify allegations that, “because they are no more than conclusions, are not entitled to the assumption of truth.” *Id.* “When there are well-pleaded factual allegations, a court should assume their veracity and then determine whether they plausibly give rise to an entitlement to relief.” *Id.* That is, the pleader must present sufficient details about the subject-matter of its claim “to present a story that holds together.” *Swanson v. Citibank, N.A.*, 614 F.3d 400, 404 (7th Cir. 2010).

2. Heightened pleading standards for fraud claims.

Under Rule 9(b), made applicable to adversary proceedings by Rule 7009, a pleader must “state with particularity the circumstances constituting fraud.” The heightened pleading

requirements of Rule 9 govern not only claims or counts of fraud, but “averments of fraud,” which is broader than merely claims of fraud. *Borsellino v. Goldman Sachs Group, Inc.*, 477 F.3d 502, 507 (7th Cir. 2007). Therefore, a claim that “sounds in fraud”—one that is premised upon a course of fraudulent conduct—implicates Rule 9(b)’s heightened pleading requirements. *Id.*

Under Rule 9(b), a complaint alleging fraud “must provide the who, what, when, where, and how” of the fraud. *Id.* This “requires that facts such as the identity of the person making the misrepresentation, the time, place, and content of the misrepresentation, and the method by which the misrepresentation was communicated to the plaintiff be alleged in detail.” *Id.* at 509. “Allegations based on ‘information and belief’ do not comply with the specificity requirement unless accompanied by pleadings of asserted facts providing the basis of the belief.” *Lazaro v. Weichman*, 2010 Bankr. LEXIS 3354, at \*40 (U.S. Bankr. N.D. Ind. Sep. 30, 2010) (citing *Interlease Aviation Investors II (Aloha) L.L.C. v. Vanguard Airlines, Inc.*, 254 F.Supp.2d 1028, 1040 (N.D.Ill.2003)).

VI. Discovery Strategy.

VII. *Pro se* Litigants.

VIII. Settlement Strategy.

A. Special considerations in settling 727 claims.

Federal Rule of Bankruptcy Procedure 7041 specifically permits dismissal but recognizes a larger duty to the bankruptcy estate by providing that such a complaint may not be voluntarily dismissed by the plaintiff unless notice has been given “to the trustee, the United States trustee, and such other persons as the court may direct,” and then “only on order of the court containing terms and conditions which the court deems proper.” Fed. R. Bankr. P. 7041.

1. Per se Rule against settlement approach.
2. Fair and Equitable Approach.

IX. Trial

A. Practical Issues.

B. Burden of Proof.

1. Party seeking to have its debt excepted from discharge bears the burden of proof and must prove its case by a preponderance of the evidence. *See Grogan v. Garner*, 498 U.S. 279, 111 S. Ct. 654 (1991).

- a. Except student loans – there burden shifts back to debtor once status as student loan is established.

2. *Grogan v. Garner* standard also typically applied in proceedings under 727.

C. Intent/Badges of Fraud.

X. Questions.