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Working for a Fresh Start: Labor Issues Facing Consumer Debtors

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Overview of Section 525: Protection against Discrimination Based on Bankruptcy[1]

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1. Types of Discrimination Prohibited by Section 525

A. Discrimination by governmental units - § 525(a)

In addition to the discharge protections in section 524, the Code contains a specific provision barring some types of discrimination based upon a debtor's bankruptcy or a debt discharged in bankruptcy. Section 525(a) provides that a governmental unit:

> … may not deny, revoke, suspend, or refuse to renew a license, permit, charter, franchise, or other similar grant to, condition such a grant to, discriminate with respect to such a grant against, deny employment to, terminate the employment of, or discriminate with respect to employment against, a person that is or has been a debtor under this title or a bankrupt or a debtor under the Bankruptcy Act, or another person with whom such bankrupt or debtor is or has been associated, solely because such bankrupt or debtor is or has been a debtor under this title or a bankrupt or a debtor under the Bankruptcy Act, has been insolvent before the commencement of the case under this title, or during the case but before the debtor is granted or denied a discharge, or has not paid a debt that is dischargeable in the case under this title or that was discharged under the Bankruptcy Act.

It is clear that this provision is directed at governmental units[2] and that it does not cover private entities. But the legislative history suggests that the Code is not intended to authorize discrimination by private entities, and gave strong intimations that discrimination not specifically within the terms of section 525 that greatly impedes a debtor's fresh start might be prohibited.[3]

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[1] This is derived from National Consumer Law Center, *Consumer Bankruptcy Law and Practice* (11th ed. 2016), *updated at* www.nclc.org/library, and is reprinted with permission from NCLC.

[2] "Governmental unit" is defined in 11 U.S.C. § 101(27). *See In re* Trusko, 212 B.R. 819 (Bankr. D. Md. 1997) (credit union a governmental unit for purposes of a different Code section).

[3] S. Rep. No. 95-989, at 81 (1978); H.R. Rep. No. 95-595, at 367 (1977). *See In re* Holmes, 309 B.R. 824 (M.D. Ga. 2004) (IRS ordered to consider debtor's offer in compromise under section 105 even though not required by section 525); *In re* Macher, 303 B.R. 798 (W.D. Va. 2003) (IRS ordered to consider debtor's offer in compromise under section 105 based on fresh start policy); *In re* Peterson, 321 B.R. 259 (Bankr. D. Neb. 2004) (following *Holmes*); *In re* Blackwelder Furniture Co., 7 B.R. 328 (Bankr. W.D.N.C. 1980) (preliminary injunction issued requiring private company to continue dealing with corporate debtor according to previous business relationship); *In re* Golliday, 216 B.R. 407 (Bankr. W.D.

The strongest arguments for extending the scope of section 525 have been made in cases against quasi-governmental entities, such as state bar associations, which are specifically mentioned in the legislative history.[4]

b. Discrimination by private employers - § 525(b)

Congress took another legislative step in this direction in 1984 with the addition of section 525(b), prohibiting private employers from employment discrimination based on bankruptcy, insolvency before a bankruptcy, or nonpayment of a debt discharged or dischargeable in a bankruptcy case.[5] This subsection provides:

> (b) No private employer may terminate the employment of, or discriminate with respect to employment against, an individual who is or has been a debtor under this title, a debtor or bankrupt under the Bankruptcy Act, or an individual associated with such debtor or bankrupt, solely because such debtor or bankrupt—
>
> (1) is or has been a debtor under this title or a debtor or bankrupt under the Bankruptcy Act;
> (2) has been insolvent before the commencement of a case under this title or during the case but before the grant or denial of a discharge; or
> (3) has not paid a debt that is dischargeable in a case under this title or that was discharged under the Bankruptcy Act.

This section is helpful when employers resist court orders to deduct chapter 13 payments

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Mich. 1998) (although city's termination of debtor's right to sit as rent commissioner found not to violate section 525, it did violate fresh start principles enunciated by Supreme Court and was therefore enjoined). *But see* Wilson v. Harris Trust & Sav. Bank, 777 F.2d 1246 (7th Cir. 1985) (section 525 did not apply to private employer prior to 1984 Amendments).

[4] *See In re* Oksentowicz, 314 B.R. 638 (Bankr. E.D. Mich. 2004) (privately owned apartment complex participating in Section 8 housing program and subject to extensive regulation by the Dep't of Housing and Urban Development was governmental unit); *In re* Marcano, 288 B.R. 324 (Bankr. S.D.N.Y. 2003) (pervasive entwinement of the city in the workings and composition of a nominally private tenant's association justified conclusion that association should be considered an instrumentality of the city and a governmental unit).

[5] *See* Robinette v. WESTconsin Credit Union, 686 F. Supp. 2d 1206 (W.D. Wis. 2010) (protection extended to employee terminated because she said she intended to file bankruptcy case); Leary v. Warnaco, 251 B.R. 656 (S.D.N.Y. 2000) (provision applied both the current employees and to hiring of new employees). *But see In re* Majewski, 310 F.3d 653 (9th Cir. 2002) (section 525(b) inapplicable when debtor fired before bankruptcy case was filed, even if cause was debtor's intention to file bankruptcy case); *In re* Mayo, 322 B.R. 712 (Bankr. D. Vt. 2005) (although supervisor told debtor she would be fired if she filed bankruptcy case, section was inapplicable when debtor resigned before case was filed); Kepple v. Miller, 257 Ga. App. 784, 572 S.E.2d 687 (2002) (section 525(b) inapplicable to real estate agent who was independent contractor).

from a debtor's paycheck and forward them to the chapter 13 trustee. It also helps in cases in which debtors owe debts to their employers or to persons or institutions closely affiliated with their employers.[6] However, as in any employment discrimination case, there may still be difficult problems of proof as to motivation, particularly when the employer presents alternative reasons for its actions adverse to the debtor. The court may have to evaluate whether the reasons presented are the true motivations for the employer's actions and, if so, whether those reasons are valid.[7]

Because the statutory language states that an employer shall not "terminate the

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[6] *See* Simms-Wilson v. Linebarger Goggan Blair & Sampson L.L.P. (*In re* Simms-Wilson), 434 B.R. 452 (Bankr. S.D. Tex. 2010) (firing attorney who had filed bankruptcy case because she owed dischargeable taxes to law firm's client violated § 525(b)); *In re* Patterson, 125 B.R. 40 (Bankr. N.D. Ala. 1990) (antidiscrimination provision applied to employer's credit union which denied services to the debtor), *aff'd*, 967 F.2d 505 (11th Cir. 1992); *In re* McNeely, 82 B.R. 628 (Bankr. S.D. Ga. 1987) (antidiscrimination provision applied to entity which refused to do business with independent contractor after claim of that entity's sister corporation was discharged in bankruptcy). *Cf.* Mangan v. Cullen, 870 F.2d 1396 (8th Cir. 1989) (district administrator in state court system has qualified official immunity against damage suit for discrimination brought by court reporter who was not given a raise after she discharged state's claim in bankruptcy). *But see* Asquino v. Fed. Deposit Ins. Corp., 196 B.R. 25 (D. Md. 1996) (provision of Federal Deposit Insurance Act precluded review of termination of employment of debtor by F.D.I.C.).

[7] *See, e.g.*, White v. Kentuckiana Livestock Mkt., Inc., 397 F.3d 420 (6th Cir. 2005) (employer showed that bankruptcy was not sole reason for discharge from position); Laracuente v. Chase Manhattan Bank, 891 F.2d 17 (1st Cir. 1989) (debtor must show bankruptcy is sole reason for dismissal, bank had valid basis to dismiss bank employee who improperly processed loans for family and friends); Mangan v. Cullen, 870 F.2d 1396 (8th Cir. 1989) (state official had valid nondiscriminatory basis for treating employee differently after she discharged state's claim in bankruptcy); Bell v. Stanford-Corbitt-Bruker, Inc., Bankr. L. Rep. (CCH) ¶ 72,114 (S.D. Ga. 1987) (termination of employment is unlawful if it would not have occurred "but for" the debtor's bankruptcy); *In re* McKibben, 233 B.R. 378 (Bankr. E.D. Tex. 1999) (debtor awarded almost $90,000 in lost wages when circumstances belied employer's stated reason for termination); *In re* Sweeney, 113 B.R. 359 (Bankr. N.D. Ohio 1990) (termination from employment, though couched in terms of concern for financial imprudence, was based solely on employee's insolvency and was thus discriminatory); *In re* Vaughter, 109 B.R. 229 (Bankr. W.D. Tex. 1989) (employer's failure to allow bankruptcy debtor to participate in advancement program was discriminatory); *In re* Hopkins, 81 B.R. 491 (Bankr. W.D. Ark. 1987) (debtor reinstated with full back pay after she was fired solely for filing bankruptcy); *In re* Hicks, 65 B.R. 980 (Bankr. W.D. Ark. 1986) (bank not permitted to transfer teller due to alleged fear of customer relations problem stemming from teller's bankruptcy when bank had no valid concern about teller's honesty); *In re* Hopkins, 66 B.R. 828 (Bankr. W.D. Ark. 1986) (bank employee could not be terminated on basis of fear of public reaction to employee's bankruptcy when there was no doubt of employee's honesty). *See also* Comeaux v. Brown & Williamson Tobacco Co., 915 F.2d 1264 (9th Cir. 1990) (prospective employer did not discriminate when debtor's bankruptcy status was not sole reason for decision not to hire; employer had told debtor, before learning of chapter 13 filing, that it would not hire him because of credit history). *Cf. In re* Arentson, 126 B.R. 236 (Bankr. N.D. Miss. 1991) (bankruptcy court could decide issue of bankruptcy discrimination despite arbitration provision in employment contract).

employment of, or discriminate with respect to employment," and does not specifically include the phrase "deny employment to," many courts have held that section 525(b) does not extend to hiring decisions with respect to debtors who were not yet employees of the employer on the date of the bankruptcy petition.[8]

c. Discrimination against a debtor seeking a student loan or grant - § 523(c)

Section 525 was amended again in 1994 with the addition of section 525(c). This amendment prohibits discrimination against a debtor seeking a student loan or grant. Section 525(c) prohibits a governmental unit or private entity involved in a student loan program from discriminating based upon a bankruptcy case, insolvency prior to a bankruptcy case, or an unpaid debt that was discharged in a bankruptcy case.

2. Scope of Section 525(a)

In addition to the question of who may or may not discriminate, there is also a good deal of uncertainty about the scope of section 525(a). What is covered by the phrase "license, permit, charter, franchise, or other similar grant"? Clearly covered are such matters as issuance of drivers' licenses.[9] Courts are more divided on various public benefits, such as welfare or Social Security when the agency has been denied recoupment by the discharge.[10] Several courts have

[8] Burnett v. Stewart Title, Inc. (*In re* Burnett), 635 F.3d 169 (5th Cir. 2011) (section 525(b) does not extend to hiring); Myers v. TooJay's Mgmt. Corp., 640 F.3d 1278 (11th Cir. 2011) (same); Rea v. Federated Investors, 627 F.3d 937 (3d Cir. 2010) (same); Fiorani v. Caci, 192 B.R. 401 (E.D. Va. 1996) (section 525(b) did not extend to hiring); Pastore v. Medford Sav. Bank, 186 B.R. 553 (D. Mass. 1995) (omission of words "deny employment to" in section 525(b) means that hiring decisions are not covered by that section, because those words do appear in section 525(a)).

[9] *See In re* Kish, 238 B.R. 271 (Bankr. D.N.J. 1999) (license could not be denied due to nonpayment of discharged insurance "surcharges"); *In re* Brown, 244 B.R. 62 (Bankr. D.N.J. 2000) (denial of driver's license to chapter 13 debtor who was paying dischargeable traffic fines through plan violated section 525); *In re* Colon, 102 B.R. 421 (Bankr. E.D. Pa. 1989) (prepetition traffic fines are dischargeable in chapter 13; attempts to collect them by postpetition license suspension violate the automatic stay and nondiscrimination provision); *In re* Young, 10 B.R. 17 (Bankr. S.D. Cal. 1980) (state could not deny driver's license due to fine which would be discharged in chapter 13).

[10] *See In re* Lech, 80 B.R. 1001 (Bankr. D. Neb. 1987) (government loan agreement with right to extend annually comes within governmental antidiscrimination provision); *In re* Latchaw, 24 B.R. 457 (Bankr. N.D. Ohio 1982) (quasi-governmental transit authority could not take disciplinary action against an employee under policy which prohibited wage garnishment when court ordered employer to pay debtor's wages to chapter 13 trustee); *In re* Rose, 23 B.R. 662 (Bankr. D. Conn. 1982) (home mortgage financing program within scope of section 525); Parker v. Contractors State License Bd., 231 Cal. Rptr. 577 (Ct. App. 1986) (contractor's license could not be suspended solely for failure to pay debt to union). *See also In re* Harris, 85 B.R. 858 (Bankr. D. Colo. 1988) (provision of state law which provides that bankruptcy

concluded that in some contexts it is not discriminatory for a governmental entity to deny benefits to a debtor who has discharged a debt, based on the fact that the debtor's need for government assistance is less as a result of the discharge.[11]

The legislative history[12] for section 525 states that it is intended to codify the result of *Perez v. Campbell.*[13] In that case, the Supreme Court held that a state could not deny a driver's license due to a debt after that debt had been discharged in bankruptcy, because that denial would impair the debtor's fresh start. Although *Perez* dealt with a driver's license, the "fresh start" principle is equally applicable to virtually any type of public benefit or government action. Section 525(a) has been interpreted to bar eviction of public housing tenants who discharged rent arrearages through bankruptcy.[14] Denial of various other governmental benefits, services or privileges has also been found discriminatory.[15] It is also clear that the section extends not just to

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discharge cannot relieve debtor of real estate license suspension violates supremacy clause). *But see* Ayes v. United States Dep't of Veterans Affairs, 473 F.3d 104 (4th Cir. 2006) (VA loan guaranty entitlement was not an "other similar grant"); Toth v. Mich. State Hous. Dev. Auth., 136 F.3d 477 (6th Cir. 1998) (section 525 did not extend to denial of credit in state home improvement loan program); Dixon v. United States, 68 F.3d 1253 (10th Cir. 1995) (debtor who did not discharge indemnity obligation to government on VA mortgage could have future eligibility for government guaranteed loans reduced; court held that denial of benefits was not attempt to collect discharged debt and did not discuss section 525(a)); *In re* Watts, 876 F.2d 1090 (3d Cir. 1989) (state mortgage assistance loans not within the scope of section 525); *In re* Goldrich, 771 F.2d 28 (2d Cir. 1985) (student loan not a license, charter or grant within meaning of statute); *In re* Begley, 46 B.R. 707 (E.D. Pa. 1984) (right to have state public utility commission mediate dispute with utility was not license, charter or grant within meaning of section 525), *aff'd*, 760 F.2d 46 (3d Cir. 1985). This holding in *Goodrich* was legislatively overruled by the passage of 11 U.S.C. § 525(c) in 1994.

[11] Lee v. Yeutter, 106 B.R. 588 (D. Minn. 1989) (debt restructuring under the Agricultural Credit Act denied), *aff'd*, 917 F.2d 1104 (8th Cir. 1990). *See also In re* Watts, 876 F.2d 1090 (3d Cir. 1989) (state mortgage assistance can be denied on the basis of bankruptcy filing, because the bankruptcy protects the debtor against foreclosure of the mortgage on which assistance is sought).

[12] S. Rep. No. 95-989, at 81 (1978); H.R. Rep. No. 95-595, at 366 (1977).

[13] 402 U.S. 637, 91 S. Ct. 1704, 29 L. Ed. 2d 233 (1971).

[14] *In re* Stolz, 315 F.3d 80 (2d Cir. 2002) (section 525 trumps any contrary language in section 365); In re Curry, 148 B.R. 966 (S.D. Fla. 1992); *In re* Biggs, 2007 WL 654247 (W.D. Pa. Feb. 28, 2007), appeal vacated as moot, 271 Fed. Appx. 286 (3d Cir. 2008); Gibbs v. Hous. Auth., 76 B.R. 257 (D. Conn. 1983), aff'g 9 B.R. 758 (Bankr. D. Conn. 1981); *In re* Carpenter, 2015 WL 1956272 (Bankr. D. Vt. Apr. 29, 2015) (2005 amendments to section 362 did not change result of Stolz); *In re* Aikens, 503 B.R. 603 (Bankr. S.D.N.Y. 2014) (same).

[15] *See, e.g.*, *In re* Bradley, 989 F.2d 802 (5th Cir. 1993) (denial of insurance license would be in violation of section 525 if retention of license was conditioned on payment of discharged debt); *In re* Mead, 2013 WL 64758 (Bankr. E.D.N.C. Jan. 4, 2013) (IRS attempt to revoke accepted offer in compromise after bankruptcy was filed was discriminatory); *In re* Ray, 355 B.R. 253 (Bankr. D. Or. 2006) (contractor's license could not be denied to debtor based on debts of corporation of which he had been principal when debtor's liability on those debts had been discharged); *In re* Jessamey, 330 B.R. 80 (Bankr. D. Mass. 2005) (section 525 violated when town denied motor vehicle registration based on nonpayment of

discrimination based upon the bankruptcy, but also discrimination based upon an unpaid debt that was discharged in bankruptcy.[16] Under section 525, except insofar as creditworthiness is being considered, the debtor should be treated the same as if the discharged debt never existed.[17]

The Supreme Court has interpreted section 525(a) broadly, holding that a court must look behind the alternative alleged motives of a government agency that denies a license.[18] It is not sufficient for the government to say that a license was denied for a "regulatory" purpose if the proximate cause for the denial was the failure to pay a dischargeable debt.[19] The Court made clear that the fact that licenses were also revoked for nonbankruptcy debtors who failed to pay similar debts did not change this fact.[20] The Court specifically rejected the argument, raised by the dissent, that there must be discrimination based upon the debtor's filing bankruptcy, rather than simply nonpayment of a dischargeable debt, as contrary to the clear meaning of the statutory language.[21]

One important limitation which should be noted, however, is that the section bars discrimination only when it is solely based upon the bankruptcy or upon nonpayment of a dischargeable debt. When other factors are involved, unless they can be shown to be pretextual, the debtor will have a difficult case, especially because the legislative history specifically states

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dischargeable excise tax); *In re* Berkelhammer, 279 B.R. 660 (Bankr. S.D.N.Y. 2002) (state could not remove debtor from list of Medicaid-eligible physicians based on nonpayment of prepetition debt); *In re* Jacobs, 149 B.R. 983 (Bankr. N.D. Okla. 1993) (revocation of insurance agent license violated discharge injunction and section 525(a)); *In re* Walker, 927 F.2d 1138 (10th Cir. 1991) (denial of real estate license because of payment by real estate recovery fund to debtor's creditor would violate section 525(a)). *See also* Fed. Communications Comm'n v. NextWave Personal Communications, 537 U.S. 293, 123 S. Ct. 832, 839, 154 L. Ed. 2d 863, 874 (2003); *In re* Exquisito Servs., 823 F.2d 151 (5th Cir. 1987) (refusal to renew food service contract violated section 525); *In re* William Tell II, 38 B.R. 327 (N.D. Ill. 1983) (liquor license restored); *In re* Mills, 240 B.R. 689 (Bankr. S.D. W. Va. 1999) (Congress intended broad interpretation to assist debtor's fresh start and therefore IRS refusal to consider offers in compromise from bankruptcy debtors violated section 525); *In re* Coleman Am. Moving Servs., 8 B.R. 379 (Bankr. D. Kan. 1980) (Air Force enjoined from discriminating against chapter 11 debtor in contract bidding; term "employment" construed broadly).

[16] 11 U.S.C. § 525; Henry v. Heyison, 4 B.R. 437 (E.D. Pa. 1980); *In re* Goldrich, 45 B.R. 514 (Bankr. E.D.N.Y. 1984) (barring application of statute denying student loan to any student who had defaulted on previous loan), *rev'd on other grounds*, 771 F.2d 28 (2d Cir. 1985) (scope of section 525 does not include future extensions of credit such as student loans).

[17] H.R. Rep. No. 103-835, at 58 (1994), *reprinted in* 1994 U.S.C.C.A.N. 3340.

[18] Fed. Communications Comm'n v. NextWave Personal Communications, 537 U.S. 293, 123 S. Ct. 832, 839, 154 L. Ed. 2d 863, 874 (2003).

[19] 537 U.S. 293, 123 S. Ct. 832, 839, 154 L. Ed. 2d 863, 874, 875 (2003).

[20] 123 S. Ct. at 841, 842.

[21] *Id.*

that factors such as future financial ability may be considered, if applied in a nondiscriminatory fashion.[22] Thus, a financial responsibility law cannot require only debtors who have filed bankruptcies to obtain insurance. However, if all persons who do not have assets sufficient to pay a judgment are required to obtain insurance, then debtors who filed bankruptcies would not be excepted under section 525(a).[23] And if a debt is not discharged in a bankruptcy, discrimination based upon that debt is not prohibited by this section.[24]

3. Issues related to the SAFE Act.

The federal Secure and Fair Enforcement for Mortgage Licensing Act of 2008 (S.A.F.E. Act) requires all individual mortgage loan originators to be licensed or registered and sets minimum standards for state licensing regimes.[25] The Act required all states to adopt compliant licensing regimes or be subject to a federally administered regime. All jurisdictions now comply with the federal S.A.F.E. Act.

Under the Act, a loan originator must be registered with the Nationwide Mortgage Licensing System and Registry (NMLSR).[26] Registration refers to the requirement to have a record in the Nationwide Mortgage Licensing System and Registry. The registry is a database mandated by the Act that facilitates the sharing of licensing and registration information. Consumers can look up loan originators and their employers and obtain their registration information for free on the Internet at www.nmlsconsumeraccess.org. This database is operated by a partnership of the Conference of State Bank Supervisors and the American Association of Residential Mortgage Regulators.

Licensing refers to the state process for authorizing individuals to act as loan originators.

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[22] S. Rep. No. 95-989, at 81 (1978); H.R. Rep. No. 95-595, at 367 (1977). *See In re* Smith, 259 B.R. 901 (B.A.P. 2001) (section 525 not applicable because debtor's public housing lease terminated due to fraud; dictum that there would be no protection under section 525 even if nonpayment of rent was only reason); Brookman v. State Bar of Cal., 46 Cal. 3d 1004, 760 P.2d 1023, 251 Cal. Rptr. 495 (1988) (order that suspended attorney make restitution was not solely because debt was discharged in bankruptcy or because debt not paid; purpose of order was to protect the public from professional misconduct); *In re* Anonymous, 74 N.Y.2d 938, 549 N.E.2d 472 (1989) (denial of application for admission to bar not based solely on applicant's bankruptcy filing).

[23] *In re* Norton, 867 F.2d 313 (6th Cir. 1989) (no discrimination found when financial responsibility law is applied equally to every financially irresponsible driver); Henry v. Heyison, 4 B.R. 437 (E.D. Pa. 1980). The *Norton* holding is probably no longer good law after the Supreme Court's decision in *NextWave*.

[24] Johnson v. Edinboro State College, 728 F.2d 163 (3d Cir. 1984).

[25] 12 U.S.C. §§ 5101–5116.

[26] 12 U.S.C. § 5103.

In addition to registering, loan originators must obtain a state license unless they are employed by one of several types of exempt entities: a depository institution, an entity regulated by the Farm Credit Administration, or a subsidiary of a depository institution that is regulated by the Federal Reserve Board, the Office of the Comptroller of the Currency, the National Credit Union Administration, or the Federal Deposit Insurance Corp. Therefore, some loan originators need only be registered while others must be both state licensed and registered. In practice, licensing usually includes registration. State licensing standards vary, but the S.A.F.E. Act sets minimum requirements. Loan originators may be licensed in multiple jurisdictions.

The S.A.F.E. Act is implemented through two sets of federal regulations administered by the Consumer Financial Protection Bureau (CFPB) and through state law. Federal Regulation H sets minimum standards for the state licensing of loan originators.[27] It also includes several appendices that are important when interpreting the Act. Regulation H does not apply directly to state-regulated loan originators. Instead, it sets standards for determining whether a state licensing system complies with the federal Act. It also sets standards for the national registry, and establishes procedures for the CFPB to use when a state is deemed non-compliant. The appendices to Regulation H, however, may be useful when interpreting state laws. Federal Regulation G applies to loan originators who must be registered but who are exempt from state licensing requirements.

Each state has adopted its own regulatory system for loan originators subject to the SAFE Act's licensing requirement. As a result there is no single definition of mortgage loan originator. The SAFE Act requires each state to determine that the loan originator has never had a loan originator license revoked; has not been convicted of certain felonies within specified timeframes; has shown financial responsibility, character, and fitness; has completed 20 hours of pre-licensing classes; has passed a written test; and has met net worth or surety bond requirements. Licensed loan originators must take eight hours of continuing education classes and must renew their licenses annually. As part of the financial responsibility requirement, some states consider originators' past credit history and whether they have filed bankruptcy.

[27] 12 C.F.R. pt. 1008.

Bankruptcy Code Section 525 and Security Clearances

Honorable Brian F. Kenney,
U.S. Bankruptcy Court for the Eastern District of Virginia·

I. Security Clearances and Section 525.

There are very few reported decisions on the intersection of Section 525 and security clearances. In the case of *In re Ellis*, the debtor was employed as an armed security guard with a contactor (DECO) that provided security services to the Department of Homeland Security (DHS). 493 B.R. 818 (Bankr. D. Colo. 2013). The debtor, who had filed under Chapter 13, was required to have a positive "suitability determination" in order to maintain his position with the company. *Id*. at 821. The bankruptcy court focused on the "solely because" language of Section 525(a), and held:

> in evaluating whether a violation of Section 525(a) has occurred, the Court should examine whether the bankruptcy filing and/or failure to pay a debt was the proximate cause of the government's action—the determination that Plaintiff was unsuitable for clearance—against Plaintiff. In evaluating Defendant's actions, the Court must look to the objective evidence and draw reasonable inferences as to the subjective intent of the parties involved.

Id. at 828.[28]

The Court evaluated the employer's "bad debt" policy, holding that "if the employee can only satisfactorily resolve a debt concern by a showing that the debt is completely satisfied, then the Policy likely stands in violation of Section 525(a)." *Id*. at 831. On the other hand, if the policy simply required the debtor to demonstrate that he was in compliance with his pending Chapter 13 plan, then the policy would not violate Section 525. *Id.* In the end, the court found

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· Judge Kenney gratefully acknowledges the assistance of his law clerk, Eric Roberson, in the preparation of these materials.

[28] The court might have focused on Section 525(b) here, but the error if any is harmless. The debtor was already employed by DECO, and both Sections 525(a) and (b) contain the same "solely because" language.

that the debtor's employment was not terminated solely because he had filed for bankruptcy protection; rather, the court found that the debtor was terminated for his lack of diligence in responding to the Government's request for information concerning his financial condition. *Id*. at 833 ("it was a culmination of events that led to Plaintiff's unfavorable suitability adjudication, including Plaintiff's failure to provide documents [to DHS] that the debt concerns were included in his Chapter 13 bankruptcy.")

In the case of *Fiorani v. CACI,* 192 B.R. 401 (E.D. Va. 1996), the plaintiff was employed by Woodside Employment Consultants, which in turn had arranged for him to work for CACI on a government contract. The plaintiff claimed both that he was terminated from his employment with Woodside, a private employer, because of his bankruptcy filing and that he was not hired by CACI for another position for the same reason. The court dismissed the second claim, that CACI had refused to hire him, on the basis stated in Part I above – Section 525(b) does not extend to private employer hiring decisions.

With respect to Woodside's decision to terminate the debtor, the court held that the plaintiff's complaint stated a claim against the plaintiff's employer for discrimination under Section 525(b). *Id*. at 407.

II. The Applicable Regulations.

Suitability for government employment is generally governed by the Office of Personnel Management's Regulations, which provide in part:

> (a) *General*. OPM, or an agency to which OPM has delegated authority, must base its suitability determination on the presence or absence of one or more of the specific factors (charges) in paragraph (b) of this section.
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> (b) *Specific factors*. In determining whether a person is suitable for Federal employment, only the following factors will be considered a basis for finding a person unsuitable and taking a suitability action:
>
> (1) Misconduct or negligence in employment;

(2) Criminal or dishonest conduct;

(3) Material, intentional false statement, or deception or fraud in examination or appointment;

(4) Refusal to furnish testimony as required by § 5.4 of this title;

(5) Alcohol abuse, without evidence of substantial rehabilitation, of a nature and duration that suggests that the applicant or appointee would be prevented from performing the duties of the position in question, or would constitute a direct threat to the property or safety of the applicant or appointee or others;

(6) Illegal use of narcotics, drugs, or other controlled substances without evidence of substantial rehabilitation;

(7) Knowing and willful engagement in acts or activities designed to overthrow the U.S. Government by force;

(8) Any statutory or regulatory bar which prevents the lawful employment of the person involved in the position in question.

(c) *Additional considerations*. OPM and agencies must consider any of the following additional considerations to the extent OPM or the relevant agency, in its sole discretion, deems any of them pertinent to the individual case:

(1) The nature of the position for which the person is applying or in which the person is employed;

(2) The nature and seriousness of the conduct;

(3) The circumstances surrounding the conduct;

(4) The recency of the conduct;

(5) The age of the person involved at the time of the conduct;

(6) Contributing societal conditions; and

(7) The absence or presence of rehabilitation or efforts toward rehabilitation.

5 C.F.R. § 731.202 (2016).

Similarly, the Department of Defense has Adjudicative Guidelines (AG) implementing the Department of Defense Directive 5220.6, *Defense Industrial Personnel Security Review*

Program (Jan. 2, 1992), as amended (Directive). Guideline F provides, with respect to the criteria for financial responsibility:

> Failure or inability to live within one's means, satisfy debts, and meet financial obligations may indicate poor self-control, lack of judgment, or unwillingness to abide by rules and regulations, all of which can raise questions about an individual's reliability, trustworthiness, and ability to protect [sensitive] information.

AG F.[29]

The Department of Defense Appeal Board has provided the following guidance:

> … an applicant is not required, as a matter of law, to establish that he has paid off each and every debt listed in the SOR. All that is required is that an applicant demonstrate that he has established a plan to resolve his financial problems and taken significant actions to implement that plan. The Judge can reasonably consider the entirety of an applicant's financial situation and his actions in evaluating the extent to which that applicant's plan for the reduction of his outstanding indebtedness is credible and realistic. There is no requirement that a plan provide for payments on all outstanding debts simultaneously. Rather, a reasonable plan (and concomitant conduct) may provide for the payments of such debts one at a time. Likewise, there is no requirement that the first debts actually paid in furtherance of a reasonable debt plan be the ones listed in the SOR.

ISCR Case No. 07-06482 at *3 (App. Bd. May 21, 2008).[30]

The Board reviews these matters (financial and non-financial) under the "whole person" concept, under which it will take into consideration: (1) the nature, extent, and seriousness of the conduct; (2) the circumstances surrounding the conduct, to include knowledgeable participation;

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[29] This DOD Directive and Guidance may found at http://www.dod.mil/dodgc/doha/DoD_Directive_5220_6.pdf, which is current through December 2, 2003 and contains the Revised Adjudicative Guidelines as of August 30, 2006 and made effective for any adjudication in which a Statement of Reasons issued on or after September 1, 2006. The Department of State maintains nearly identical guidelines. *See* Dep't of State, Undersecretary of Management, Bureau of Diplomatic Security, *Adjudicative Guidelines for Determining Eligibility for Access to Classified Information* (Feb. 3, 2006), https://www.state.gov/m/ds/clearances/60321.htm.

[30] Decisions of the Department of Defense Appeals Board are available on the Defense Office of Hearings & Appeals (DOHA) website, located at http://www.dod.gov/dodgc/doha, which contains cases for the years 1996 to the present. Some DOHA decisions are also available on Westlaw's Defense Office of Hearings & Appeals database.

(3) the frequency and recency of the conduct; (4) the individual's age and maturity at the time of the conduct; (5) the extent to which participation is voluntary; (6) the presence or absence of rehabilitation and other permanent behavioral changes; (7) the motivation for the conduct; (8) the potential for pressure, coercion, exploitation, or duress; and (9) the likelihood of continuation or recurrence. AG 2(a).

The Board has addressed Section 525 of the Bankruptcy Code in a few of its adjudication decisions. In a 2004 case, the Board highlighted that a "decision to grant or deny a security clearance is a matter of executive discretion," however, it must be supported by substantial evidence. *See* ISCR Case No. 02-22474, at *3, n.3 (App. Bd. Feb. 13, 2004) (citing *Dep't of the Navy v. Egan*, 484 U.S. 518, 527-29 (1988)). The Board, in noting the applicability of Section 525, emphasized that security clearance applicants are not denied because they file for bankruptcy; instead, it is the "underlying financial situation that is the basis for denials." *Id*. ("The bankruptcies are merely evidence of how [an] Applicant's financial situation has changed, or not, as a result of [the] exercise of [filing bankruptcy].") Thus, under the "substantial evidence" standard, the Government appears to at least to need to put forth some evidence other than the mere filing of a bankruptcy petition to successfully defend a negative adjudication.

In another case, the Board explained that filing bankruptcy may in fact show good financial judgment worthy of a favorable security clearance adjudication. ISCR Case No. 99-0326, at *5 (App. Bd. Oct. 4, 1999) ("Although a court-issued discharge order has yet to be issued in their case, it is clear that 'the problem is being resolved or is under control.' . . . [T]he Applicant had "initiated" a good-faith effort to resolve his debts [and] [t]he family has taken positive, nay drastic, steps to curtail their living expenses, e.g., going bankrupt with only the most modest of exempt personalty.")

A few other bankruptcy-related examples of security clearance determinations are:

- ISCR Case No. 09-06683: applicant granted a security clearance where he discharged debts in a Chapter 7 case, and had no post-discharge history of accumulating unpaid debts.
- ISCR Case No. 09-05254: applicant denied a security clearance where he accumulated substantial financial delinquencies (mortgage payments, unsecured consumer loan payments) after receiving a discharge in Chapter 7.
- ISCR Case No. 08-11264: security clearance denied where applicant filed for Chapter 13, but the applicant's submissions "do not indicate any plan approval from the presiding court."
- ISCR Case No. 10-00228: applicant denied security clearance where he engaged a bankruptcy attorney, but did not follow through – "His efforts in regard to bankruptcy have been intermittent and unconvincing. Though the record remained open after the hearing, he submitted only a cancelled check, with no further confirmation that the process had was underway."
- ISCR Case No. 09-02454: applicant granted security clearance where he filed for Chapter 13, had a plan approved and was current in his plan payments.
- ISCR Case No. 10-00893: applicant denied a security clearance where he was in his second Chapter 13, the first having been discharged ("At some point in 2007 it should have been obvious to Applicant that his efforts were fruitless and he should have cut his losses by selling the house.")

Other Bankruptcy Issues Related to Employer/Employee Controversies

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1. When can an employee be held personally liable for a corporate credit card?

Determining a consumer debtor's personal liability for corporate credit cards can present unique challenges to Bankruptcy Courts. There is no hard and fast rule to apply for whether a debtor will be able to discharge personal liability on a corporate credit card. Ultimately dischargeability is determined on a case by case basis after an analysis of all relevant facts. That being said, a survey of caselaw on the issue does reveal some trends. Typically, where a creditor contests the matter, a debtor can only discharge personal liability on a corporate credit card if the use of the card was authorized.[31] Authorized use will be determined by an examination of matters such as the underlying agreement and the actual transactions on the card. On the other hand, bad behavior by a debtor typically results in a determination of non-dischargeability for corporate credit cards.[32] Additionally, regardless of the debtor's behavior, liability may exist from the underlying agreement on a corporate credit card.[33] A full inquiry into the facts is a necessity before a determination of dischargeability of corporate credit cards can be made.

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[31] *Atkisson v. Roberts (In re Roberts)*, 453 B.R. 819 (Bankr. W.D. Ky. 2011) (debtor discharged a corporate credit card because there was no evidence of debtor obtaining the debt through a material misrepresentation that he knew was false or made with gross recklessness and the debtor's use of a corporate credit card was authorized by the creditor.)

[32] *Hathaway v. OSB Mfg., Inc. (In re Hathaway)*, 364 B.R. 220 (Bankr. E.D. Va. 2007) (facts support finding of nondischargeability where debtor used card for personal expenses instead of for emergency purposes only as agreed upon with employer)

[33] *In re Fairfield*, 455 B.R. 849 (Bankr. E.D. Pa. 2011) (Claim objection for a Chapter 13 debtor against corporate credit cards denied, although debtor had cards issued to him for his official capacity as a corporate officer, unsigned revised cardholder agreements sent to debtor extended personal liability to him, and these updated agreements were found valid under controlling state law of Utah.)

2. Post-*Wellness* jurisdiction of Bankruptcy Courts for Employer/Employee Controversies.

The Supreme Court holding in *Wellness*[34] allows Bankruptcy Courts to enter final judgments on core matters and non-core matters with the consent of all parties. Accordingly, Bankruptcy Courts now can be relied on with confidence to resolve disputes between employers and employees. In *Holden v. Hansen*[35], an entrepreneur (Holden) who fell on tough times sued the Hansens, his former accountant and the accountant's wife, who was also a former employee. The plaintiff filed an adversary proceeding alleging large debts related to the debtor's time as accountant for the failed business, and the employer sought to collect these debts in the former employee's Chapter 13.

Taking guidance from the Supreme Court's *Wellness* decision, the Eastern District of Wisconsin obtained the consent of all parties and entered final judgments on the core matter of determining dischargeablility. In this specific circumstance after a thorough examination of the facts over a two day trial, the Court determined that the debtors did not commit a violation of any state law and the employer had no valid causes of action under state law theories of fraud and breach of fiduciary duty.

Since there was mutual consent to the jurisdiction of the bankruptcy court, the disgruntled former employer is barred by res judicata from hauling the debtor into state court to try his luck again. So, in a post – *Wellness* world, Bankruptcy Courts may have a larger role in wading into

[34] *Wellness Int'l Network, Ltd. v. Sharif*, U.S. , 135 S. Ct. 1932 (2015) (decided May 26, 2015)
[35] *Holden v. Hansen (In re Hansen)*, Nos. 15-28166-beh, 15-2485, 2016 Bankr. LEXIS 3810 (U.S. Bankr. E.D. Wis. Oct. 24, 2016)

these thorny issues of where employers may or may not have valid causes of action under state law.

3. Does Section 525 create a private right of action?

The statutory language of section 525 does not plainly create a private right of action, and there is nothing in the legislative history to indicate that congress intended on creating this right.[36] Other sections of the Bankruptcy Code do create a private right of action.[37] In *Taylor v. United States*, the District Court also ruled that a Bankruptcy Court cannot create a private right of action through Section 105 of the Bankruptcy Code if one doesn't already exist under 525. "As the Supreme Court has repeatedly emphasized, the 'fact that a federal statute has been violated and some person harmed does not automatically give rise to a private cause of action in favor of that person.'"[38]

So, what recourse is there for a debtor whose rights under 525 have been violated? Some Courts have held that Debtors may be able to bring a claim under 42 USCS 1983 due to a violation of 525.[39] In *Potter*, the court held that section 525 "creates a 'right' in a debtor or former debtor, a right not to be discriminated against by public actors in employment and other economic transactions 'solely because' of the bankruptcy."[40] The court found further support in allowing a private right of action under Section 1983 since, "no specific remedy or procedural

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[36] See *Taylor v. United States (In re Taylor)*, 263 B.R. 139 (N.D. Ala. 2001) (finding the bankruptcy court erred as a matter of law when it found a private right of action under 525)
[37] See 11 U.S.C.S. § 362 (LexisNexis, Lexis Advance through PL 114-329, approved 1/6/17)) (statutory language provides a private right of action in 362(h))
[38] *Taylor,* quoting *Walls v. Wells Fargo Bank N.A.*, 255 B.R. 38, 2000 WL 1584576, at 6 (E.D. Calif. 2000)
[39] See *Potter v. City of Hanceville (In re Potter)*, 354 B.R. 301 (Bankr. N.D. Ala. 2006)
[40] *Potter* at 316

requirements for enforcement set out in § 525 itself that foreclose use of the 42 U.S.C.S. § 1983 remedy."[41]

Since Courts are likely to find that Section 525 itself will not allow debtors to obtain the full amount of damages, it is important for debtors' attorneys to be creative and look outside of the Bankruptcy Code and determine if their clients may seek enforcement of their rights using different areas of the law.

[41] Id.