DEBTS THAT CAN FOLLOW YOU TO THE GRAVE

What You Can't Get Away with in Bankruptcy

Shortly before this article was to go to press, the Senate passed S.256, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (commonly known as the Bankruptcy Reform Act, or BRA). The House of Representatives is scheduled to take up the legislation and is expected to pass it in April. Its major provisions will become effective 180 days thereafter. President Bush has indicated that he will sign it. BRA is the most comprehensive rewrite of the Bankruptcy Code since 1978. For anyone who had a passing familiarity with bankruptcy in the past, times have changed.

There is neither time nor space in this article to deal with all of the proposed changes, and we stress "proposed" because the bill ***27** still has to get through the House and the conference committee before going to the president. Instead, this article is a basic overview of section 523 and the major proposed changes regarding debts that may not be discharged in a bankruptcy. (For a redlined version of the Senate Bill S.220, 2001 Bankruptcy Reform Act, which did not pass but is similar to the current S.256 and was substantially incorporated into BRA, see www.ianb.uscourts.gov/newcode/index.html.)

There are numerous pitfalls in BRA, and any lawyer filing a bankruptcy for a client should be extremely careful. This article is a primer for the general practitioner who does an occasional bankruptcy and needs a quick checklist to help spot debts that may *not* be discharged in a bankruptcy, so that neither the client nor the attorney is surprised if the debtor does not get the "fresh start" he or she sought. Such a surprise may mean an arduous five-year Chapter 13 or no bankruptcy relief at all for the client. For the attorney it can mean sanctions, loss of fees, responsibility for paying the trustee's or creditor's attorney fees, and malpractice claims.

The Bankruptcy Code

Ideally, your client does not incur more debt than he or she can pay. Individuals should at least be able to meet their monthly expenses on a timely basis, pay their bills (even if only the "minimum payment"), and save a little money for both a rainy day and retirement. Unfortunately, that is not life in 21st-century America. The fact is that most people have substantial debt and may be just two to three paychecks away from a crisis. Divorce, illness, and/or a job loss put many people over the edge. A recent Harvard University study found that illness was a factor in nearly 50 percent of all consumer bankruptcies, even if the debtor had health insurance. These people are not able to pay their debts, are subject to collections and foreclosures, and need debt relief.

When the crisis reaches this point, it may be necessary for these people to look into bankruptcy alternatives, review the nature of their debts, and get advice on dealing with their financial problems. In a bankruptcy proceeding, at the most basic level, there are three kinds of claims/debts: debts that are dischargeable, debts that might be dischargeable, and debts that are not dischargeable. (Remember that bankruptcy speaks in terms of "claims," not debts, and claims may be liquidated, unliquidated, contingent, disputed, equitable, unmatured, etc.) The distinctions between these three types of claims are laid out in the Bankruptcy Code.

The Bankruptcy Code is divided into a number of Chapters. Chapters 1, 3, and 5 are of general application. Chapters 7, 9, 11, 12, and 13 are Chapters under which an entity might file. The bulk of our discussion will relate to Chapter 7 and, to a lesser degree, Chapter 13. (For a brief overview of Chapters 9, 11, and 12, see the sidebar "Beyond Chapters 7 and 13" on page 28.)

Chapter 7

Chapter 7 is a liquidation. With the exception of certain insurance companies, banks, trust companies, and railroads, anyone can file a Chapter 7. When the debtor files a bankruptcy, all property becomes property of the bankruptcy estate. A trustee is appointed to take control of and sell the assets. An individual debtor may exempt some property from liquidation. Those exemptions are set by state law. There are federal exemptions set forth in 11 U.S.C. §522; however, a state may opt out of the federal exemptions. The trustee is also responsible for objecting to exemptions, examining the debtor, and, in some cases, objecting to the debtor's discharge. In a Chapter 7 the trustee sells all of the non-exempt assets; the debtor gets a discharge. Corporations do not receive discharges in bankruptcy. There are basically two Code sections that affect dischargeability of claims in Chapter 7: section 727 and section 523.

Section 727: Bankruptcy Hell

Section 727 is designed to protect the integrity of the process. The types of actions that would result in a §727 denial of discharge are lying on the bankruptcy schedules, hiding assets, failing to maintain financial records, refusing to turn over records, and refusing to cooperate with the trustee in the administration of the estate. BRA imposes additional duties on attorneys for debtors. If the schedules are not accurate and the attorney did not conduct a reasonable inquiry, the attorney may be sanctioned and may have to ***28** pay the trustee's attorney fees and a civil penalty. Be very careful.

A denial of discharge under §727 denies the entire discharge. It is as if the bankruptcy was never filed and the debtor is still liable for all debts. Actually, it's even worse: The assets of the debtor are still administered by the bankruptcy trustee, and the debtor will lose non-exempt property for the payment of creditor claims. After all of the non-exempt assets are liquidated and the creditors are paid, any remaining unpaid claims are still the legal obligation of the debtor. Creditors may pursue their state law remedies to collect those unpaid claims. Loss of a §727 discharge has been described as "bankruptcy hell." All debts pass through the process unaffected, and the trustee still controls all of the assets; they cannot be used by the debtor to pay for a defense or to settle claims.

Section 523: Debts That Follow You to the Grave

Section 523 deals with particular claims. These are the debts that may "follow you to the grave." There are at least 18 specific categories of claims that currently are excepted from discharge pursuant to §523 under current law, with several more added under BRA. The §523 exceptions apply to individuals filing under Chapters 7, 11, 12, and, with certain exceptions, Chapter 13. Because Chapter 9 applies only to municipal corporations, §523 exceptions to discharge are not relevant. Section 523 does not apply to corporations. In general, corporations are not eligible to receive a discharge in bankruptcy even though there is an exception for corporations reorganized, but not liquidated, under Chapter 11.

Below is a brief checklist of §523 exceptions. If your client's debts fall into these categories, a complete "fresh start" in bankruptcy may not be possible under Chapter 7, and you may need to explore other alternatives, such as Chapter 13. What follows is a non-exclusive list; there are other non-dischargeable types of obligations, such as for security law violations, court fees, and other obligations that do not fall within the general consumer bankruptcy proceeding.

Taxes. As a quick rule of thumb, (a) income taxes less than three years old from when they first came due are not dischargeable, and (b) trust fund taxes are not dischargeable no matter when they were incurred. Trust fund taxes include an individual debtor's liability for corporate or other business employee withholding taxes (941 taxes). There is no time limit on those taxes, and they are just plain not dischargeable. Under certain state laws, some kinds of employee taxes and sales taxes are considered trust fund taxes and are equally not dischargeable. The basic question is whether the debtor collected from a third person a tax that is payable to the governmental agency. If so, it is a trust fund tax. If instead it is a direct obligation of the debtor (such as income taxes, business and occupations taxes, excise taxes, etc.), it is not considered a trust fund tax and may be discharged.

Income taxes more than three years old may be discharged as long as the debtor filed a return and an offer in compromise is not pending or has not been pending for approximately eight months prior to the filing. Further, fraudulent returns or tax obligations that arise from tax evasion schemes also may not be dischargeable and are not necessarily subject to the three-year rule.

A "substitute for return" prepared by the IRS may or may not be considered a return for these purposes. There are split decisions. ***29** In the past, these taxes could be discharged in a Chapter 13 (see page 30). BRA changes that and excludes from a Chapter 13 discharge some of these types of tax claims.

Money/services obtained by fraud. This category includes money, services, refinancing, or renewals of credit obtained by fraud, false pretenses, or false representations. The case law generally follows common law or state law fraud elements. Remember, if your client obtained money legally but attempted after the fact to hide or conceal it from a creditor or to mislead the creditor concerning what assets may be available for collection of the balances due, such a situation would *not* create a non-dischargeable obligation. Non-dischargeability arises from *originally* obtaining the money by fraudulent circumstances.

The burden of proof is based upon a preponderance of evidence. This burden is less than that in common law and state law fraud cases, where fraud generally needs to be proven by clear, cogent, and convincing evidence. Consequently, it may be possible to prove the non-dischargeability of the debt but not liability for the debt itself.

Clients need to be cautioned about using credit cards or taking out cash advances on the eve of bankruptcy. Under the old rules, any purchase of more than $1,225 worth of "luxury goods or services" or any similarly valued cash advance from an individual creditor within a period of 60 days prior to the bankruptcy filing is presumed to be fraudulent--and therefore non-dischargeable. BRA changes these amounts, lowering the presumptive threshold to $250 on luxury goods and $750 for cash advances, and it increases the look-back to 90 days (70 days for cash advances). Absent emergency circumstances (e.g., an imminent foreclosure), there is no reason to file a case during that period (be it 60, 70, or 90 days) if the client has extensive use of credit cards or cash advances. The stakes are high and the risks many.

Unlisted creditors. Creditors who are not listed or scheduled may not be discharged unless they have actual knowledge of the bankruptcy. In some circuits this is not the case, however, and the courts have held that in "no asset" consumer Chapter 7 bankruptcy, wherein creditors have not received a dividend and a creditor is not otherwise prejudiced, the failure to list a creditor does not automatically except the debt from discharge.

Defalcation/fraud in a fiduciary capacity. These kinds of debts arise when a debtor has a fiduciary duty to a creditor, such as holding funds in trust, operating under a power of attorney, and/or as an employee or other capacity entailing a fiduciary duty between the parties. Embezzlement is an example

Alimony maintenance and child support. Child support and alimony maintenance owed to a spouse, former spouse, or child are not dischargeable. Attorney fees incurred to establish maintenance, alimony, or child support are equally not dischargeable. Property settlement agreements may be dischargeable, but there is an exception if it creates a hardship on the ex-spouse (see page 30). Fees for other aspects of the divorce (property settlement litigation, etc.) are dischargeable. Remember that the decision of whether the obligation is support or property distribution is a question of federal bankruptcy law, not state divorce law. BRA now terms these debts "domestic support obligations."

Willful and malicious injury. Whether an injury to another person or to the property of another person is the result of "willful and malicious" conduct has been the subject of substantial litigation. Both elements are necessary. *Willful* means that the debtor acted purposefully. *Malicious* has been defined as knowing that the act is likely to or will cause an injury or harm. The injury or harm does not need to be substantial or severe to fall under the definition of maliciousness; the mere knowledge that the action is likely to cause an injury has generally been deemed sufficient. If the debtor knew what she was doing, did it on purpose, and knew it would probably cause some type of injury or damage, the resulting debt is non-dischargeable.

BRA changes this term in Chapter 13 (see page 30) and provides that claims for bodily injury are non-dischargeable if the injury was willful *or* malicious. This is a change only in Chapter 13.

Governmental fine, penalty, or forfeiture. This section is a little less used but essentially covers those types of debts, such as court fines, fines by governmental agencies for violating statutes (such as under EPA rules), and other types of governmental fines or penalties for violating a statute or regulation.

Student loans. Most student loans are now insured or guaranteed by a governmental unit, such as Sallie Mae or the U.S. Department of Education. Generally these student loans are not dischargeable under any circumstances. There is a provision for discharge if it would impose an "undue hardship" on the debtor or the debtor's dependants. However, the courts have generally been stingy on interpreting a hardship. As a general rule, if the debtor is not living in a cardboard box under the freeway, there is no undue hardship, and student loans have to be repaid. Furthermore, BRA adds the following, making almost all student loans non-dischargeable: "(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."

DUI-related death or personal injury. Personal injury or death claims arising from the debtor's operation of a motor vehicle while intoxicated with alcohol, drugs, or other substance are non-dischargeable. Counsel should be careful with this category: Although personal injury claims from DUIs cannot be discharged, property damage claims *can* be.

Non-dischargeable debt from a prior bankruptcy. Debt that was excepted from discharge or waived from discharge in a prior bankruptcy cannot be discharged in a subsequent bankruptcy. This prevents the debtor from being denied a discharge in bankruptcy, waiting a short period of time, and then trying it again. There currently is an exception for a subsequent Chapter 13, but that may change under BRA, which limits the ability to receive a second discharge and/or re-filing of any type of bankruptcy, Chapter 7 or 13, within certain time periods after a previous filing.

Payment of an order for restitution. Under Title 18 to the U.S. Code, such debts are not dischargeable, so counsel needs to look at any restitution obligations. This has been interpreted to include criminal restitution ***30** ordered by a state court.

Property settlement agreements in divorces. As noted earlier, property settlements may not be dischargeable under current law if the discharge would result in an *undue hardship* on the non-filing ex-spouse. The specific language provides that the discharge of these claims arising from property settlement agreements should be granted if discharging the property settlement "would result in a benefit to the debtor that outweighs the detrimental consequences to the spouse." There has been a lot of litigation under this particular section. In litigating the issue, counsel must look at the financial circumstances of the non-filing spouse to determine the comparative hardships. This litigation has been described as a *balancing of the misery*.

BRA eliminates the ability to discharge property settlement agreements in Chapter 7 and removes the hardship exception. As noted below, BRA further makes the non-dischargeability self-executing; no adversary proceeding would be required, as it is under current law.

Certain condominium dues and fees. Such debts survive the discharge and become due and owing. Again, this is a little-used section, but if the debtor has a condominium or some type of cooperative housing, counsel should review with the debtor what the fees are and whether they fall within the exception.

Pension and profit-sharing plans. BRA adds this new exception, which includes certain obligations/loans owed to a qualified pension or profit-sharing plan.

Adversary Proceedings

Other than four types of claims noted below, the exceptions to discharge contained in §523 are *self-executing:* A separate action by the creditor, called an adversary proceeding, is not necessary to determine whether the debt is discharged. The four types of claims that are *not* self-executing are those related to debts incurred (1) by fraud, (2) by defalcation in a fiduciary capacity, (3) as a result of willful and malicious conduct, or (4) as property settlement in domestic relations cases. Claims in these four categories are discharged *unless* the creditor starts a timely adversary proceeding in the bankruptcy case. Note that under BRA, property settlement agreements in domestic relations cases would now become non-dischargeable in Chapter 7, and this would be a self-executing provision, not requiring an adversary proceeding.

An adversary proceeding must be brought within 90 days of the first date set for the §341 creditor's meeting. (The clerk fixes this date at the time of the filing of the proceeding, and that date is noted on the Bankruptcy Notice sent out at the start of the case--the Section 341 Notice). Even a continuance of the §341 meeting does not extend the date for filing the action. But the time limit is not jurisdictional, and if the complaint is not timely filed and the debtor does not raise the deadline in the answer, the untimely defense may be waived. Service of process in Bankruptcy Court is made pursuant to Bankruptcy Rule 7004 and may be accomplished by first-class mail in most cases.

Chapter 13

Many debts that are not dischargeable under Chapter 7 may (under current law) be discharged under Chapter 13, formally titled an "Adjustments of Debts of an Individual with Regular Income." In common parlance, Chapter 13 is known as a "wage-earner plan."

When Congress originally enacted the Bankruptcy Code in the 1970s, it did so with the belief that debtors should be able to get out of the bankruptcy "debt free" once they complete a three- to- five-year repayment plan. Thus, many categories of debt that are not otherwise dischargeable in Chapter 7 are currently dischargeable in Chapter 13. Times have changed. BRA eliminates many of these exceptions, making the discharge in Chapter 13 not quite as attractive as currently provided. It also may require a five-year plan, rather than a three-year plan, in order to receive a discharge, depending on the debtor's median income.

There are two types of Chapter 13 discharge. The first, and most sought after, is a §1328(a) discharge, granted when the debtor completes the Chapter 13 plan. The only categories of debt currently not discharged in a §1328(a) discharge are (1) child support and maintenance, (2) criminal restitution/fines, (3) damages resulting from driving under the influence, and (4) student ***31** loans. All other §523 exceptions, including taxes and fraud, are currently dischargeable in a Chapter 13 if the debtor completes the plan. Note, again, that BRA expands the list of exceptions from discharge to include most of the Chapter 7 exceptions, but with some changes, as detailed below.

The second type of discharge is a §1328(b) or *hardship* discharge. If a debtor, despite his or her best efforts, cannot complete the plan, and if the plan cannot otherwise be modified, the debtor still is entitled to a Chapter 13 discharge so long as the payments to creditors equal or exceed the amount that the creditors otherwise would have received under a Chapter 7 liquidation. This "best-efforts" discharge has a drawback of excluding all of the categories of debt excepted from discharge under §523(a), not just the four exceptions applying to a §1328(a) listed above. Thus, the §1328(b) discharge is similar to a Chapter 7 discharge: The same debts that may not be discharged in a Chapter 7 under §532(a) are equally not dischargeable in a "best-efforts" discharge under Chapter 13.

BRA changes the "super-discharge" of Chapter 13 and would now exclude debts defined by §523(a)(1)(B) and (C) [unfiled, late-filed, and fraudulent tax returns], (a)(2) [fraud, including credit card misuse], (a)(3) [failure to notify creditors of the bankruptcy in time to allow assertion of claims], (a)(4) [embezzlement, breach of fiduciary duty], and (a)(6) [willful and malicious injury, insofar as it involves personal injury or wrongful death]. Note that where §523(a)(6) provides that "willful *and* malicious" injury gives rise to non-dischargeable debts in Chapter 7, the revised §1328(a)(4) would except these debts arising from "willful *or* malicious" injury to the extent the injury is to an individual and not to property.

Chapter 20

A "Chapter 20" is the common name for the process whereby a debtor files a Chapter 13 immediately after a discharge in a Chapter 7. If there are certain debts that survive the Chapter 7, either automatically (such as trust fund tax debts) or because a complaint was filed and a debt was found to be non-dischargeable (such as fraud debts), the debtor may attempt to shed such remaining debts through Chapter 20. A Chapter 20 is also useful for curing delinquent mortgages after a Chapter 7. It is possible to cure the arrearage over a period of time and save the house.

There are two views of Chapter 20 under BRA. To some it appears that Chapter 20 may be virtually eliminated under BRA. Section 1312 of BRA would prevent a debtor from obtaining a discharge in Chapter 13 if the debtor has received a discharge under Chapter 7 within the last four years, or received a discharge under a previous Chapter 13 within the last two years, before the filing of the new petition.

However, others think the use of Chapter 20 will increase: File the Chapter 7 to get rid of all of the debtor's dischargeable debt, then file the Chapter 13 to deal with the non-dischargeable debt. A debtor may not be able to get the second discharge under BRA, but at least a debtor will be able to term out a payment plan and avoid garnishments and executions.

Some Final Warnings

Bankruptcy proceedings are different from normal actions in state or federal courts. The procedures are set up to provide expeditious resolutions of financial problems, so time periods are telescoped inward and move at a much faster pace than a state court action. Lawyers new to the field should also be aware that, in most parts of the country, the bankruptcy bar is fairly inbred-- bankruptcy lawyers usually know one another, and because they appear before the same judges regularly, they have an advantage over non-bankruptcy lawyers in getting matters heard and determined. If they are competent, bankruptcy lawyers should know what arguments work for particular judges.

Be very careful of BRA. It adds several provisions that create personal liability to a debtor's attorney. Thus, the general practitioner who files an “occasional bankruptcy” may find that the expanded costs of malpractice insurance, and the cost to avoid potential personal liability, make practicing in the bankruptcy arena not worth the risks.

Beyond Chapters 7 and 13

Solos and general practitioners might bump into other aspects of the Bankruptcy Code beyond Chapter 7 and Chapter 13. Here’s a brief overview of the other chapters under which an entity might file.

Chapter 9. For municipal corporations. It includes cities, counties, public utility districts, and the like. States are not included.

Chapter 11. A reorganization. Technically it is open to everyone who can file a Chapter 7 except stockbrokers. In Chapter 11 the debtor acts as the trustee and becomes what is known as a debtor in possession (DIP). The DIP has the responsibility for running the business and proposing a plan to pay creditors. The process is extremely long, expensive, complex, and fraught with perils.

Chapter 12. Designed for family farmers with regular annual income. Under the proposed revisions to the bankruptcy code, it will be extended to family fishermen with regular annual income. Chapter 12 is a cross between Chapter 13 and Chapter 11. A trustee is appointed; however, the trustee’s duties are more limited than those of a Chapter 7 trustee or a Chapter 13 trustee. As in Chapter 11 and Chapter 13, the debtor proposes a plan to pay creditors, who may be paid anywhere between 100 cents on the dollar and nothing at all. Chapter 12 cases are generally unsuccessful.

Footnotes

[a1] ***Marc S. Stern and Larry B. Feinstein are currently Co-Chairs of the Bankruptcy Committee of the General Practice, Solo and Small Firm Section of the ABA, and both practice bankruptcy law in Seattle, Washington. They can be reached at*** **mstern@abanet.org** ***and*** **lbf@chutzpa.com.**