



Game Over or Game On?

Identifying Debts That Might Survive a Chapter 7 Consumer Bankruptcy

By Nicole M. Smithson

At a Glance

Michigan debtors filed 22,490 nonbusiness Chapter 7 petitions between June 30, 2018 and June 30, 2019.¹

The Bankruptcy Code identifies 21 types of debts that can be excepted from discharge in Chapter 7 cases.²

Although bankruptcy aims to aid those suffering from “oppressive indebtedness...to start afresh free from obligations and responsibilities,” this benefit is reserved for “the honest debtor.”³ In addition, some debts cannot be discharged for public policy reasons.⁴ This article highlights the exceptions to discharge that are most likely to be relevant to the nongovernmental creditor in a Chapter 7 consumer bankruptcy and provides guidance on what a creditor can do to try to protect its debt if an exception to discharge applies.

Debts potentially excepted from discharge

Domestic support obligations

Debt that is created by a separation agreement, divorce decree, property settlement agreement, or court order and owed to the debtor’s spouse, former spouse, child, or child’s caregiver for something akin to alimony, maintenance, or support is a “domestic support obligation.”⁵ A debt satisfying these requirements constitutes a domestic support obligation and is excepted from discharge.⁶

Other divorce- or separation-related debt

Debt owed to the debtor’s spouse, former spouse, or child that is incurred during a divorce or separation or in connection with a separation agreement, divorce decree, or other court order but is not a domestic support obligation is excepted from discharge.⁷

Student loans and educational debt

Debt from a qualified educational loan under the tax code, loans guaranteed or insured by the government or a non-profit, or an obligation to repay an educational benefit is nondischargeable unless the debtor shows that repayment “would impose an undue hardship on the debtor and the debtor’s dependents.”⁸ To meet this burden, the debtor must prove that:

- based on current income and expenses, the debtor cannot repay the loan and maintain a minimal standard of living for himself or herself and his or her dependents;
- additional circumstances indicate that this state of affairs is likely to continue for a significant part of the loan’s repayment period; and
- the debtor has made a good-faith effort to repay the loan.⁹

Funds used to pay tax debt

Debts incurred to pay a nondischargeable tax debt to the United States or another governmental unit are excepted from discharge.¹⁰ Although the code specifies numerous categories

of assessments that could qualify for an exception to discharge, creditors should closely scrutinize the provisions concerning taxes; the code narrows tax debts that are actually nondischargeable by imposing time limitations on many types of assessments.¹¹

Obtaining money, property, services, or credit by fraud or a fraudulent statement about financial condition

A debt for money, property, or services or an extension, renewal, or refinancing of credit is nondischargeable if the creditor can show that the debtor used false pretenses, false representation, or actual fraud to obtain the benefit.¹² The court will presume that consumer debts owed to a single creditor totaling more than \$725 for luxury goods or services incurred by an individual debtor on or within 90 days of beginning the bankruptcy action are nondischargeable.¹³ Creditors, however, should be mindful that goods or services that are reasonably necessary for maintenance or support of the debtor or the debtor’s dependents do not constitute “luxury goods or services.”¹⁴ The court will also presume that cash advances aggregating more than \$1,000 that are extensions of consumer credit under an open-end credit plan on or within 70 days of beginning the case are nondischargeable.¹⁵

A debt for money, property, or services or an extension, renewal, or refinancing of credit is also nondischargeable if the creditor can show it reasonably relied on a written statement about the debtor’s or an insider’s financial condition that is materially false and was made or published with the intent to deceive.¹⁶

Creditors contemplating an action to have a debt excepted from discharge because of fraud or a fraudulent statement about financial condition should take special care. Per statute, a court must grant the debtor a judgment for costs and reasonable attorney fees if the court concludes that the creditor’s position “was not substantially justified” unless special circumstances would make the award of costs and attorney fees unjust.¹⁷

Fraud or defalcation by a fiduciary, larceny, or embezzlement

Damages caused by fraud or defalcation while the debtor acted in a fiduciary capacity can be excepted from discharge.¹⁸ Damages from the debtor’s larceny or embezzlement can also be excepted from discharge—even if the debtor is not a fiduciary.¹⁹

Willful or malicious injury

Damages caused by the debtor’s willful and malicious injury to another’s person or property can be excepted from discharge.²⁰

Damages resulting from the debtor's operating while intoxicated

Damages for death or personal injury are excepted if they were caused by the debtor's operation of a motor vehicle, vessel, or aircraft while intoxicated.²¹

Restitution

Restitution awards in cases prosecuted under title 18 of the U.S. Code are explicitly excepted from discharge.²² Section 523(a)(7)'s exception for state court orders likely applies to criminal restitution orders from a state court.²³ Creditors with an order for restitution from a state law criminal matter can also explore whether the debtor's conduct qualifies under other exceptions. For example, exceptions for fraud, larceny, and willful and malicious injury to another's person or property may lend themselves to many state law convictions.

Omitted creditors

A debt becomes nondischargeable if the debtor fails to notify a known creditor of the bankruptcy in time for the creditor to take any required action to submit a proof of claim or pursue an action to have the debt excepted from discharge.²⁴ But an omitted creditor cannot avail itself of this exception if it had notice or actual knowledge of the bankruptcy in time to take action to protect its rights.²⁵

A word of caution about this exception: the Sixth Circuit Court of Appeals has concluded that if a case is a "no-asset" case—that is, no funds were distributed to creditors—an omitted creditor holding a debt that otherwise would have been discharged if notice had been proper is in the same position it would have been in had it received timely notice of the case.²⁶ Therefore, the debt is not excepted from discharge.²⁷

Creditors from certain prior bankruptcies

A debt that was, or could have been, listed or scheduled in a prior bankruptcy is nondischargeable if the debtor waived discharge or was denied a discharge for misconduct.²⁸ A few illustrations of qualifying misconduct include transferring or hiding assets with intent to defraud, falsifying or destroying financial records, and refusing to comply with a valid court order.²⁹

Adversary proceedings

An adversary proceeding is, among other things, an action to determine the dischargeability of a debt.³⁰ A debtor or creditor can start an adversary action by filing a complaint.³¹ Most of the Federal Rules of Civil Procedure—including those

concerning pleadings, discovery, defaults, and summary judgments—apply to adversary actions in bankruptcy court.³²

A party seeking to have a court determine the dischargeability of a debt can normally begin an adversary proceeding at any time.³³ But creditors must seek a judicial determination of nondischargeability within 60 days of the first scheduled meeting of creditors if claiming an exception to discharge based on (1) obtaining money, property, services, or credit by fraud or a fraudulent statement; (2) fraud or defalcation by a fiduciary, larceny, or embezzlement; or (3) willful or malicious injury.³⁴

The burden of proof is on the creditor to prove dischargeability by a preponderance of the evidence.³⁵ And with most exceptions, the court will narrowly construe the exception to discharge in the debtor's favor.³⁶ It should also be noted that the doctrine of collateral estoppel applies in adversary actions.³⁷ But the doctrine of res judicata does not prevent a creditor from challenging the dischargeability of a debt even though it failed to pursue a claim for fraud (or otherwise establish an exception to discharge) in a prior action.³⁸

Final thoughts

- **Consult or partner with an experienced bankruptcy attorney if you think an exception to discharge applies to your client's debt.** A bankruptcy practitioner can, among other things, expertly evaluate the dischargeability of the debt, determine whether an adversary action is necessary, provide valuable insights into the practices and preferences of your judge and trustee, and help you avoid the code's multiple opportunities for sanctions.³⁹ This person also has thorough knowledge of the rules, forms, and procedures unique to bankruptcy court.⁴⁰
- **Review all known information about the debt.** Understanding the nature of the debt is important in assessing whether it qualifies for an exception to discharge. If the debt stems from a loan, examine the application and supporting documents and any notes or records the creditor may have relating to its dealings with the debtor. Compare this information to what the debtor reports on the schedules and statement of financial affairs. Also, look at how the debtor spent the loan proceeds.
- **Attend the meeting of creditors.**⁴¹ Although called the "meeting of creditors," most creditors do not attend the debtor's first appearance before the trustee in consumer bankruptcy cases. However, creditors who believe that their debt may be nondischargeable should attend the meeting as it typically provides a *brief* opportunity to examine the debtor while he or she is under

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oath. Potential areas to explore during the meeting include when and why the debtor became insolvent, the condition and location of any collateral securing the debt, and other pertinent facts surrounding the dischargeability of the debt. Because creditors rarely appear, most debtors do not prepare for questions about specific debts in advance of the meeting. Lastly, the meetings are recorded, so a transcript of the proceeding can be prepared if requested.

- **Consider whether to conduct a 2004 exam.** Similar to a deposition, a 2004 exam is a useful tool for gathering information a creditor would need to establish that a debt is excepted from discharge. Bankruptcy Rule 2004(b) provides that interested parties can examine the debtor and other witnesses about the debtor's "acts, conduct, or property." It also allows for examination on issues relating "to the liabilities and financial condition of the debtor, or to any matter which may affect the administration of the debtor's estate, or to the debtor's right to a discharge." The subject of a 2004 exam can also be required to produce documents.⁴² If the examinee does not consent to the 2004 exam, the creditor will need to file a motion with the court.⁴³
- **Prepare and timely file the adversary action if necessary and appropriate.** Adversary actions can be expensive and difficult to win. Depending on the circumstances, sometimes a creditor's best option is to cut its losses and walk away. ■

Nicole M. Smithson is a regional manager for the Michigan Indigent Defense Commission. Before her employment with the MIDC, she spent several years representing creditors in state court litigation and Chapter 7 consumer bankruptcy proceedings. She thanks Patty Corkery and Bill DeGenaro for their assistance with this article.

ENDNOTES

1. *US Bankruptcy Courts—Business and Nonbusiness Cases Commenced by Chapter of the Bankruptcy Code*, Statistics and Reports, Table F-2 Bankruptcy Filings, United States Courts (June 30, 2019), p 2, available at <<https://www.uscourts.gov/statistics/table/f2/bankruptcy-filings/2019/06/30>> [<https://perma.cc/6j4U-HW63>] (accessed March 28, 2020).
2. 11 USC 523.
3. *Williams v US Fidelity & Guaranty Co*, 236 US 549, 554; 35 S Ct 289; 59 L Ed 713 (1915).
4. *In re Posner*, 434 BR 800, 803 (Bankr ED Mich, 2010).
5. 11 USC 101(14A).
6. 11 USC 523(a)(5).
7. 11 USC 523(a)(15).
8. 11 USC 523(a)(8).
9. *In re Oyler*, 397 F3d 382, 385 (CA 6, 2005).
10. 11 USC 523(a)(14) and 11 USC 523(a)(14A).
11. 11 USC 523(a)(1).
12. 11 USC 523(a)(2)(A).
13. 11 USC 523(a)(2)(C)(i)(I).
14. 11 USC 523(a)(2)(C)(ii)(III).
15. 11 USC 523(a)(2)(C)(i)(III) and *Revision of Certain Dollar Amounts in the Bankruptcy Code Prescribed Under Section 104(a) of the Code*, 84 Fed Reg 3488, 3489 (February 12, 2019). The \$725 and \$1,000 amounts apply to cases that began on or after April 1, 2019.
16. 11 USC 523(a)(2)(B).
17. 11 USC 523(d).
18. 11 USC 523(a)(4).
19. 11 USC 523(a)(4). See *In re Brady*, 101 F3d 1165, 1173–1174 (CA 6, 1996).
20. 11 USC 523(a)(6).
21. 11 USC 523(a)(9).
22. 11 USC 523(a)(13).
23. *In re Smith*, 547 BR 774, 779 (ED Mich, 2016) and 4 Resnick & Sommer, eds, *Collier on Bankruptcy* (16th ed), ¶ 523.19, p 523-125.
24. 11 USC 523(a)(3).
25. *Id.*
26. *In re Madaj*, 149 F3d 467, 472 (CA 6, 1998).
27. *Id.*
28. 11 USC 523(a)(10).
29. 11 USC 727(a)(2), (3), and (6)(A).
30. FR Bankr P 7001(6).
31. FR Bankr P 4007(a).
32. FR Bankr P 7008 to 7015, FR Bankr P 7026 to 7037, and FR Bankr P 7055 to 7056.
33. FR Bankr P 4007(b).
34. 11 USC 523(c)(1) and FR Bankr P 4007(c). Cf. *In re Maughan*, 340 F3d 337, 344 (CA 6, 2003) (recognizing that time limit is not jurisdictional and is subject to equitable tolling).
35. *Grogan v Garner*, 498 US 279, 287–288; 111 S Ct 654; 112 L Ed 2d 755 (1991) and FR Bankr P 4005.
36. *United States v Storey*, 640 F3d 739, 743 (CA 6, 2011). See *In re Andrus*, 338 BR 746, 752 (Bankr ED Mich, 2006) (narrow construction rule does not apply to domestic support debts).
37. *Grogan*, 498 US at 284–285.
38. *Brown v Felsen*, 442 US 127, 139; 99 S Ct 2205; 60 L Ed 2d 767 (1979).
39. See, e.g., 11 USC 362, 11 USC 523(d), and 11 USC 524.
40. Seeking guidance from an experienced bankruptcy practitioner is particularly important in Chapter 13 cases as some of the exceptions discussed in this article may not apply.
41. 11 USC 341.
42. FR Bankr P 2004(c).
43. FR Bankr P 2004(a).