

DISCHARGE, EXCEPTIONS TO DISCHARGE, AND OBJECTIONS TO DISCHARGE

Consumer bankruptcy principally is designed to permit debtor rehabilitation through the discharge of debts. The Bankruptcy Code authorizes a broad discharge, which provides a fresh start to “honest but unfortunate debtors,” to fulfill one of its most fundamental purposes.⁴⁰¹

Notwithstanding the general availability of the discharge, section 523 of the Bankruptcy Code specifically enumerates certain debts that are not discharged. A debtor may discharge all other debts in bankruptcy, but those exceptions remain postbankruptcy charges against the debtor. The exceptions are to be construed narrowly,⁴⁰² and a creditor bears the burden to prove each element of an exception to discharge by a preponderance of the evidence.⁴⁰³

Debts excepted from the bankruptcy discharge obtain distinctive treatment for public policy reasons. Many nondischargeable debts involve “moral turpitude” or intentional wrongdoing.⁴⁰⁴ Other debts are excepted from discharge because of the inherent nature of the obligation, without regard to any culpability of the debtor. Regardless of the debtor’s good faith, for example, support obligations and many tax

⁴⁰¹ *Local Loan Co. v. Hunt*, 292 U.S. 234 (1934); *Goldberg Sec. Inc. v. Scarlata*, 979 F.2d 521 (7th Cir. 1992). Creditors therefore are expected to prove each element of an exception to discharge by a preponderance of the evidence. *Grogan v. Garner*, 498 U.S. 279 (1991). See generally Margaret Howard, *A Theory of Discharge in Consumer Bankruptcy*, 48 OHIO ST. L.J. 1047, 1085-87 (1987).

⁴⁰² See, e.g., *Schweig v. Hunter*, 780 F.2d 1577, 1579 (11th Cir. 1986); *In re Christensen*, 193 B.R. 963, 967 (N.D. Ill. 1996).

⁴⁰³ *Grogan v. Garner*, 498 U.S. 279 (1991).

⁴⁰⁴ See *Thul v. Ophaug*, 827 F.2d 340 (8th Cir. 1987).

claims remain nondischargeable. Society's interest in excepting those debts from discharge outweighs the debtor's need for a fresh economic start.

When the Bankruptcy Code initially was enacted, section 523 contained a short list of exceptions for certain types of wrongdoing, such as fraud, defalcation, and intentional torts. The list of exceptions has grown to nearly twenty, in addition to those exceptions contained in other portions of the United States Code.⁴⁰⁵ Some of these exceptions provide overlapping grounds for dischargeability and are the result of special interest amendments. While the Commission did not whittle down the list to its original form, as some commentators have advocated, the Commission recommends certain specific clarifications and amendments to enhance fairness to all parties and to alleviate litigation, confusion, and nonuniformity.

While section 523 deals with individual debts, section 727 governs a debtor's eligibility for an overall Chapter 7 discharge. As was discussed in the first portion of this chapter, only the honest debtor is entitled to the extraordinary relief that a bankruptcy discharge provides. Section 727 forecloses the availability of the Chapter 7 discharge to debtors who engage in fraudulent behavior. The Commission makes several moderate recommendations to section 727 to help ensure the proper use of this important provision.

1.4.1 Credit Card Debt

Except for credit card debts that are excepted from discharge under section 523(a)(2)(B) (for materially false written statements respecting the debtor's financial condition) and section 523(a)(14), (debts incurred to pay nondischargeable taxes to the United States), debts incurred on a credit card issued to the debtor that did not exceed the debtor's credit limit should be dischargeable unless they were incurred within 30 days before the order for relief under title 11.

A debtor who has engaged in fraudulent activity should not be rewarded with a discharge of a debt that was obtained through that fraud. For this reason, section 523(a)(2)(A) of the Bankruptcy Code excepts from discharge a debt for money, property, or an extension of credit to the extent it was obtained by false pretenses, a false representation, or actual fraud. This provision bears great similarity to its predecessor, section 17 of the Bankruptcy Act of 1898. In addition, if debtors make

⁴⁰⁵ See William C. Whitford, *Changing Definitions of Fresh Start in U.S. Bankruptcy Law*, 20 J. CONSUMER POLICY 179, 185-85 (1997); Letter from Hon. Samuel L. Bufford, Bankruptcy Judge - C.D. Cal. (April 15, 1997) (section 523 has lost its coherence and should be reworked).

false statements in credit card applications that mislead a lender to extend credit, the resulting debts may be nondischargeable under section 523(a)(2)(B).⁴⁰⁶

However, with increasing frequency, section 523(a)(2)(A) is used to challenge the dischargeability of debt arising from the routine use of credit cards even in the absence of actual fraud.⁴⁰⁷

The Commission received numerous comments indicating that the current version of section 523(a)(2)(A) is ill-suited to sort dischargeable credit card debt from nondischargeable credit card debt. The courts seem to concur that application of this exception to credit card debt “has been fraught with doctrinal difficulty.”⁴⁰⁸ Even direction from the circuit courts has not been a panacea for the confusion; within a year’s time, the Court of Appeals for the Ninth Circuit issued four opinions analyzing section 523(a)(2)(A), three of which involve credit card debt and employ somewhat different methods of interpretation.⁴⁰⁹ The lack of clear guidance is especially

⁴⁰⁶ See 11 U.S.C. § 523(a)(2)(B) (1994).

⁴⁰⁷ Another nondischargeability provision, section 523(a)(2)(C), deals specifically with luxury goods purchased on credit cards on the eve of bankruptcy. This section provides:

(C) for purposes of subparagraph (A) of this paragraph, consumer debts owed to a single creditor and aggregating more than \$1,000 for “luxury goods or services” incurred by an individual debtor on or within 60 days before the order for relief under this title, or cash advances aggregating more than \$1,000 that are extensions of consumer credit under an open end credit plan obtained by an individual debtor on or with 60 days before the order for relief under this title, are presumed to be nondischargeable: “luxury goods or services” do not include goods or services reasonably acquired for the support or maintenance of the debtor or a dependent of the debtor; an extension of consumer credit under an open end credit plan is to be defined for purposes of this subparagraph as it is defined in the Consumer Credit Protection Act[.]

11 U.S.C. § 523(a)(2)(C) (1994).

⁴⁰⁸ See, e.g., *AT&T Universal Card Servs. Corp. v. Feld*, 203 B.R. 360 (Bankr. E.D. Pa. 1996); *AT&T Universal Card Serv. Corp. v. Akdogan*, 204 B.R. 90 (Bankr. E.D.N.Y. 1997) (“Misrepresentation and reliance in the fraud context are anchored on a direct nexus or relationship between a debtor and a creditor. Here, as in so many other credit card nondischargeability actions, there was little, if anything, in the nature of direct, purposeful contact between the credit card issuer (AT&T) and the credit card holder (the debtor) either at the inception or over the course of the relationship between the parties”). See also *Citibank (S. Dakota), N.A. v. Eashai*, 87 F.3d 1082 (9th Cir. 1996) (credit card debts different than those arising from traditional two-party credit transactions).

⁴⁰⁹ See *American Express Travel Related Servs. Co. v. Hashemi*, 104 F.3d 1122 (9th Cir. 1996), *cert. denied*, 117 S.Ct. 1824 (1997); *Anastas v. American Servs. Bank*, 94 F.3d 1280 (9th Cir.

problematic considering the continuing growth in the availability and use of credit cards, the number of consumer bankruptcy filings, and the number of adversary proceedings threatened or brought regarding credit card debt on questionable grounds.

A troubling consequence of this confusion is that ordinary credit card debt that was incurred honestly is declared nondischargeable -- while all other debts are discharged -- in the absence of any fraudulent action or intention. A creditor's allegation of nondischargeability can lead to quick settlement because the debtor cannot afford to contest the charge, so the debtor agrees to repay the debt postpetition without any judicial evaluation of whether the debtor committed fraud. When this occurs, both fundamental principles of bankruptcy are violated: the financial rehabilitation of the debtor is undermined by continuing obligations on ordinary prepetition credit card debt that continues to accrue interest at high rates. At the same time, the credit card issuer has received preferential treatment over all other unsecured creditors of the same debtor. With the recommended change to reaffirmation procedures, it is necessary to address this side of the issue as well.

For these reasons, the Commission recommends that credit card debts incurred within 30 days of bankruptcy be automatically nondischargeable and credit card debts not exceeding the debtor's credit limit incurred outside of 30 days be automatically dischargeable. To the extent that debts exceeded the debtor's credit limit, they would continue to be governed by the current law, and thus the creditor would have to prove fraud, false pretenses, or false representation.

Background on the Dischargeability of Credit Card Debt. A creditor that challenges the dischargeability of a debt under section 523(a)(2)(A) currently has the burden to show:

- the debtor knowingly made misrepresentations;
- the debtor intended to deceive the creditor when making these misrepresentations; and
- the creditor justifiably relied on the representation, which proximately caused the creditor's damages.⁴¹⁰

This test has been applied to actions under this provision regardless of whether the creditor alleges actual fraud, false pretenses, or false representation as the specific

1996); *Eashai*, 87 F.3d at 1082.

⁴¹⁰ See, e.g., *Hashemi*, 104 F.3d at 1125.

grounds for nondischargeability.⁴¹¹ The interpretation and application of these standards has been highly variable. Courts have taken disparate approaches to assess implicit “representations” made by the use of a credit card, to determine when a person had an “intent to deceive,” and to identify “justifiable reliance” by the credit card issuer when the debtor made purchases on a valid credit card within the established credit limits for the card.

The following discussion illustrates the disparity in application of the various elements of section 523(a)(2)(A) that lead to conflicting results.

Use of a Credit Card as a Representation. When a customer has used a credit card and subsequently seeks to discharge that debt in bankruptcy, some courts have determined that the customer misrepresented that she was able to repay the resulting debt when she made the charge.⁴¹² Simply using a credit card, under this theory, represents both an intent and present ability to pay;⁴¹³ if repayment later becomes impossible, the original charge retroactively is deemed fraudulent. This may be the case even if the lender had no expectation when the debts were incurred that the debtor had the present ability to repay the charges.⁴¹⁴

Other courts are critical of that approach, noting that “[t]he availability of credit during financially difficult times is a very good reason to maintain credit. ‘The test for nondischargeability is not whether the credit was used in difficult times.’”⁴¹⁵ Rather than making every consumer a guarantor of her future solvency, they find that

⁴¹¹ See *Field v. Mans*, 116 S. Ct. 437, 444 (1995); *Mayer v. Spanel Int’l, Ltd.*, 51 F.3d 670 (7th Cir.), *cert. denied*, 116 S. Ct. 563 (1995).

⁴¹² See, e.g., *Mercantile Bank v. Hoyle*, 183 B.R. 635 (Bankr. D. Kan. 1995); *Chase Manhattan Bank v. Weiss*, 139 B.R. 928 (Bankr. D.S.D. 1992).

⁴¹³ “The purchase of goods with a credit card constitutes an implied representation by the purchaser that he has both the means and intent to repay for the goods purchased.” *AT&T Universal Card Servs. v. Ramirez*, 184 B.R. 859, 861 (Bankr. S.D. Fla. 1995); *Household Credit Servs. v. Walters*, 208 B.R. 651, 653 (Bankr. W.D. La. 1997) (use of card is representation that consumer has intent and present ability to make payment); see also *Norwest Bank (Des Moines, N.A.) Card Servs. Div. v. Stewart*, 91 B.R. 489 (Bankr. S.D. Iowa 1988), *citing Comerica Bank Midwest v. Kouloumbiris*, 69 B.R. 229 (N.D. Ill. 1986); *In re Buford*, 25 B.R. 477 (Bankr. S.D.N.Y. 1982).

⁴¹⁴ “Seldom do the courts concern themselves with the debtors’ ability to make the *minimum monthly payment*.” *GM Card v. Cox*, 182 B.R. 626, 633 (Bankr. D. Mass. 1995) (emphasis added).

⁴¹⁵ *First U.S.A. Bank v. Hunter (In re Hunter)*, 210 B.R. 212 (Bankr. M.D. Fla. 1997), *citing Barnett Bank of Pinellas County v. Tinney*, 188 B.R. 1015, 1020 (Bankr. M.D. Fla. 1995).

a customer's use of a credit card constituted an express or implied representation of an intent to repay.⁴¹⁶

A few courts have declined to equate a credit card charge with a representation of intent or ability to pay.⁴¹⁷ The court in *In re Cox* concluded that Congress did not intend section 523(a)(2)(A) to cover "implied representations," nor do policy and jurisprudential justifications support the provision's use in this regard. The court said instead that most credit card fraud cases belong in the purview of section 523(a)(2)(C), under which debts incurred on the eve of bankruptcy for luxury goods are nondischargeable.⁴¹⁸ *Cox* "has its origins in nineteenth-century cases holding that a borrower's predictions regarding his future ability to pay his debts are not actionable as false pretenses."⁴¹⁹ Another court has suggested that the use of a credit card is not a "representation" because it is not a statement that is capable of being true or false. This conclusion was extrapolated from a Supreme Court decision that held that signing and submitting a check is not a factual assertion and is not

⁴¹⁶ "To hold, as some courts have, that objective inability to pay, coupled with an implicit representation to the contrary at the time the card is used, establishes the deceit element of the nondischargeability cause of action would be to make the debtor a guarantor of his own financial condition. Such a burden is not imposed by the statute." *F.C.C. Nat'l Bank v. Cacciatore*, 209 B.R. 609, 617 (Bankr. E.D.N.Y. 1997); *Anastas*, 94 F.3d at 1285; *American Express Travel Related Servs. v. Christensen*, 193 B.R. 863, 866 (N.D. Ill. 1996); *Feld*, 203 B.R. at 366 ("each use of the card, accompanied by the cardholder's signed acknowledgment of additional indebtedness incurred pursuant to the card agreement, is a reaffirmation of the intent to repay"); *AT&T Universal Card Servs. Corp. v. Chinchilla*, 202 B.R. 1010 (Bankr. S.D. Fla. 1996) (intent-not ability-to repay, is relevant inquiry); *Mercantile Bank of Illinois v. Williamson*, 181 B.R. 403, 406 (Bankr. W.D. Mo. 1995); *Citicorp Credit Serv. v. Hinman*, 120 B.R. 1018 (Bankr. D.N.D. 1990); *Sears Roebuck & Co. v. Faulk*, 69 B.R. 743 (Bankr. N.D. Ind. 1986); *Chase Manhattan Bank v. Carpenter*, 53 B.R. 724 (Bankr. N.D. Ga. 1985).

⁴¹⁷ *Cox*, 182 B.R. at 634; *see also Comerica Bank Midwest v. Kouloumbri*, 69 B.R. 229, 231 (N.D. Ill. 1986) (because debtor may have intended to pay for purchases when charged, court cannot presume that use of credit card constituted misrepresentation); *AT&T Universal Card Servs. Corp. v. Alvi*, 191 B.R. 724 (Bankr. N.D. Ill. 1996).

⁴¹⁸ *Cox*, 182 B.R. at 634-36.

⁴¹⁹ *AT&T Universal Card Serv. Corp. v. Nguyen*, 208 B.R. 258, 260 (D. Mass. 1997), *citing Commonwealth v. Drew*, 36 Mass. 178, 185 (1837). However, the *Cox* analysis has been met with disfavor by the district courts in the district where this decision was issued. *See AT&T Universal Card Servs. Corp. v. Pakdaman*, 210 B.R. 886 (D. Mass. 1997) (rejecting *Cox* analysis; while recognizing that the application of traditional elements of misrepresentation to the credit card area is tricky, this court must conclude that *Cox* strikes the balance too harshly against the creditor"); *Nguyen*, 208 B.R. at 261 (rejecting *Cox* approach as being fundamentally unfair to creditors and contrary to section 523(a)(2)).

capable of being true or false.⁴²⁰ A far cry from the implied misrepresentation approach, these theories can make it difficult, if not impossible, for credit card lenders to bring nondischargeability actions under section 523(a)(2)(A) unless the circumstances of the use of the credit card were unique, *e.g.*, there was some additional affirmative misrepresentation accompanying the use of the card.⁴²¹

Intent to Deceive Using a Credit Card. Ill intent traditionally has been a crucial factor of fraud or false representation.⁴²² Although not central to the holding of the Supreme Court's *Field v. Mans* decision, the Court noted that Congress could have barred discharge on the basis of unintentional misrepresentations if it had wished, "but it would, however, take a very clear provision to convince anyone of anything so odd."⁴²³

While actual intent should be critical to the inquiry, intent is a particularly difficult element to prove, especially in connection with regular credit card use. Quite a few courts use objective factors to "infer" an intent to deceive the credit card issuer.⁴²⁴ The most widely-utilized set of factors includes the following:

- the length of time between making the charges and the bankruptcy filing;
- whether the debtor consulted an attorney about bankruptcy before making the charges;
- the number and amount of charges;
- whether the charges exceeded the debtor's credit limit;
- whether the debtor made multiple charges on the same day;
- whether the debtor was employed when making the charges;

⁴²⁰ *Alvi*, 191 B.R. at 732, *citing* *Williams v. United States*, 458 U.S. 279 (1982). *See* *Goldberg Sec. Inc. v. Scarlata*, 979 F.2d 521 (7th Cir. 1992) (applying *Williams* analysis to bankruptcy nondischargeability action); *In re Horwitz*, 100 B.R. 395, 398 (Bankr. N.D. Ill.1989) (same); *see also* *Bank One Columbus, N.A. v. McDaniel* 202 B.R. 74, 78 (Bankr. N.D. Tex. 1996) (agreeing with conclusion in *Alvi* regarding representations).

⁴²¹ *See Alvi*, 191 B.R. at 732, n.14.

⁴²² *See* *Neal v. Clark*, 95 U.S. 704, 709 (1877) (fraud means actual or positive fraud, not fraud implied in law); *In re Welch*, 208 B.R. 107 (S.D.N.Y. 1997) (regardless of what method courts apply to determine nondischargeability of credit card debt, creditor must establish that debtor intended to deceive creditor at time charges were incurred).

⁴²³ *Field v. Mans*, 116 S. Ct. 437, 442 (1995).

⁴²⁴ *See, e.g., Hashemi*, 104 F.3d at 1126, n.2; *see also Eashai*, 87 F.3d at 1087-88 (court adopted the twelve factor test set forth in *Citibank S. Dakota v. Dougherty*, 84 B.R. 653, 657 (B.A.P. 9th Cir. 1988)).

- whether the debtor had prospects for employment;
- whether the debtor suddenly changed her buying habits;
- whether the debtor was financially sophisticated;
- whether the debtor purchased luxury items or necessary items; and
- the debtor's financial condition at the time the charges were made.⁴²⁵

Yet, courts again diverge on the extent to which objective factors such as these should be used to impute intent. Some courts carefully examine most or all of the aforementioned elements to determine whether or not the debtor demonstrated intent to repay.⁴²⁶ Thus, if the collective evidence shows that the debtor was “loading up” on goods shortly before filing, the court may conclude that the debtor did not intend to repay and was acting deceitfully.⁴²⁷

Other courts believe that the consideration of one or two objective factors may suffice to produce an inference that the debtor intended to deceive the creditor when making a credit card purchase.⁴²⁸ Using this approach, fraud might be inferred if a reasonable person would have questioned her ability to repay the debt: “If evidence indicated that the cardholder should have known that the charges cannot be paid, the creditor has established a claim of nondischargeability.”⁴²⁹ This approach enables a credit card lender plaintiff to “prove” fraud merely by indicating the pattern

⁴²⁵ See *Dougherty*, 84 B.R. at 657.

⁴²⁶ See *Mercantile Bank of Illinois v. Williamson*, 181 B.R. 403, 406 (Bankr. W.D. Mo. 1995) (finding that debt was dischargeable); *General Elec. Capital Corp. v. Janecek*, 183 B.R. 571, 575 (Bankr. D. Neb. 1995) (insolvency can be considered, but is not determinative in assessing debtor's intent to deceive).

⁴²⁷ See, e.g., *American Express Travel Related Servs. Co. v. Hashemi*, 104 F.3d 1112, 1126 (9th Cir. 1996) (using factors to determine that \$60,000 worth of credit card charges on six week European vacation on eve of bankruptcy was not dischargeable), *cert. denied*, 117 S. Ct. 1824 (1997).

⁴²⁸ See, e.g., *FCC Nat'l Bank v. Berz*, 173 B.R. 159 (Bankr. N.D. Ill. 1994).

⁴²⁹ *AT & T Universal Card Servs. v. Ramirez*, 184 B.R. 859, 861 (Bankr. S.D. Fla. 1995); *Southtrust Bank of Alabama v. Moody*, 203 B.R. 771 (Bankr. M.D. Fla. 1996) (“It should not take a rocket scientist to figure out that even if [debtor] lived 1000 years she would still not be able to repay the charges she ran up on her credit cards”), *citing American Express Travel Related Servs., Inc. v. Dorsey (In re Dorsey)*, 120 B.R. 592, 594 (Bankr. M.D. Fla. 1990); *Mercantile Bank v. Hoyle*, 183 B.R. 635, 638 (Bankr. D. Kan. 1995); *Household Card Servs./VISA v. Vermillion*, 136 B.R. 225, 226 (Bankr. W.D. Mo. 1992). *Cf. Stewart*, 91 B.R. at 495 (insolvency alone does not establish intent to deceive); *AT & T Universal Card Servs. v. Alvi (In re Alvi)*, 191 B.R. 724, 733 (Bankr. N.D. Ill. 1996); *AT & T Universal Card Servs. Corp. v. Chinchilla*, 202 B.R. 1010, 1016 (Bankr. S.D. Fla. 1996) (lack of ability to pay is insufficient basis on which to infer intent to deceive).

of credit card charges, the proximity of the charges to the bankruptcy filing, and the debtor's inability to repay the debts.⁴³⁰ There is an inherent tautology in this approach; because families find themselves in bankruptcy on account of financial problems, unsecured credit card debts can become dischargeable almost automatically.

Some courts reject the notion that a debtor's inability to repay evidences fraudulent intent, and instead try to determine the debtor's subjective intent.⁴³¹ The "hopeless state" of the debtor's financial affairs is no substitute for an actual finding of bad faith, according to this approach. "[A]lthough the reasonableness of the debtors' belief as to the truth of their representations may be circumstantial evidence of their intent, ultimately the issue is their actual intent and not the objective reasonableness of it."⁴³² The Ninth Circuit stated in the *Anastas* case that "the focus should not be on whether the debtor was hopelessly insolvent at the time he made the credit card charges . . . if ability to repay were the focus of the fraud inquiry, too often would there be an unfounded judgment of nondischargeability of credit card debt."⁴³³ Thus, under this approach, objective factors are relevant only to assist the court in determining whether the debtor actually and subjectively intended to deceive the creditor.⁴³⁴ In courts taking this approach, creditors may have to prove that the

⁴³⁰ A closely related approach is to use objective factors to find "constructive fraud." See *Strawbridge & Clothier v. Caivarelli*, 16 B.R. 369 (Bankr. E.D. Pa. 1982); *Mercantile Trust Co. Nat'l Assoc. v. Pozucek*, 73 B.R. 110 (Bankr. N.D. Ill. 1987).

⁴³¹ See, e.g., *Sears, Roebuck & Co. v. Taylor (In re Taylor)*, 211 B.R. 1006 (Bankr. M.D. 1997) (although court can review litany of factors, ultimate determination turns on subjective intent); *AT & T Universal Card Servs. Corp. v. Feld (In re Feld)*, 203 B.R. 360, 367 (Bankr. E.D. Pa. 1996) (dischargeability will not turn on reasonableness of debtor's expectations of ability to repay); *AT&T Universal Servs. v. Totina*, 198 B.R. 673, 679 (Bankr. E.D. La. 1996); *Chase Manhattan Bank v. Murphy*, 190 B.R. 327, 333 (Bankr. N.D. Ill. 1995).

⁴³² *Chevy Chase Bank, FSB v. Briese*, 196 B.R. 440, 451 (Bankr. W.D. Wis. 1996).

⁴³³ See *Anastas v. American Sav. Bank (In re Anastas)*, 94 F.3d 1280, 1285 (9th Cir. 1996), citing 124 CONG. REC. H11089 (Sept. 28, 1978) (Statement of Rep. Edwards) ("subparagraph (A) is intended to codify current case law . . . which interprets 'fraud' to mean actual rather than fraud implied in law"); *Alvi*, 191 B.R. at 733; *First Fed. of Jacksonville v. Landen*, 95 B.R. 826 (Bankr. M.D. Fla. 1989) (debtor's honest but questionable relief that he would be successful at gambling and be able to repay his debts defeats finding of intent to deceive).

⁴³⁴ See *Anastas v. American Sav. Bank (In re Anastas)*, 94 F.3d at 1285; *Feld*, 203 B.R. at 367 (factors may be helpful, but not controlling, in determining whether debtor had subjective intent to repay). See also *Comerica Bank Midwest v. Kouloumbri*, 69 B.R. 229, 231 (N.D. Ill. 1986).

debtor incurred credit card debt in bad faith with the intention of filing for bankruptcy and avoiding the debt.⁴³⁵

Credit Card Lender's Reliance on Borrower's Representation by Use of a Credit Card. Even more difficult is the question of reliance, another essential component to the common law definition of fraud on which courts have been divided. In a section 523(a)(2)(A) case involving a land sale, the Supreme Court in *Field v. Mans* held that a creditor must prove that his reliance was *justifiable*; if the falsity of the representation should have been readily apparent to that particular creditor, the creditor will not prevail.⁴³⁶ This resolved a split in the circuits over whether reliance had to be "reasonable," but did not minimize the difficulties in credit card debt nondischargeability cases. It is unclear whether a credit card lender relies on each charge made by a consumer as an expression of solvency or intent.⁴³⁷

Some courts do not require a credit card issuer to prove reliance at all. They simply presume that a credit card issuer is entitled to rely on each use of a credit card as a manifestation of an intent to repay.⁴³⁸ "The credit card issuer justifiably relies on a representation of intent to repay as long as the account is not in default and any initial investigations into a credit report do not raise red flags that would make reliance unjustifiable."⁴³⁹ The fact that many courts presume justifiable reliance may explain why it is not uncommon for credit card plaintiffs to refrain from offering any specific evidence of reliance, which may hurt their cases in other courts.⁴⁴⁰

Other courts treat reliance in the traditional sense as a discrete and independent element of fraud that must be proven by a preponderance of the

⁴³⁵ See *Chinchilla*, 202 B.R. at 1015.

⁴³⁶ *Field v. Mans*, 116 S. Ct. 437, 444 (1995); *P&S X-Ray Co. v. Dawes*, 189 B.R. 714 (Bankr. N.D. Ill. 1995); *Irwin v. O'Bryan*, 190 B.R. 290 (Bankr. E.D. Ky. 1995).

⁴³⁷ The courts do not agree on whether each credit card transaction should be considered a separate contract or whether they are part of a continuing contract, a distinction that may have implications on the outcome of the case. Cf. *Anastas*, 94 F.3d at 1285 (each transaction is separate contract), with *Cox*, 182 B.R. at 636 (continuing contract), and *Feld*, 203 B.R. at 367, n.7 (same).

⁴³⁸ See, e.g., *AT&T Universal Card Servs. Corp. v. Burdge*, 198 B.R. 773 (Bankr. 9th Cir. 1996); *Colonial Nat'l Bank U.S.A. v. Levinthal*, 194 B.R. 26, 28 (Bankr. S.D.N.Y. 1996).

⁴³⁹ *Anastas*, 94 F.3d at 1286, quoted in *Hashemi*, 104 F.3d at 1126.

⁴⁴⁰ See, e.g., *Feld*, 203 B.R. at 368-369; *In re Christensen*, 193 B.R. 963, 967 (N.D. Ill. 1996); *F.C.C. Nat'l Bank v. Willis*, 190 B.R. 866 (Bankr. W.D. Mo. 1996), *aff'd*, 200 B.R. 868 (W.D. Mo. 1996).

evidence.⁴⁴¹ At a minimum, these courts may require a creditor to show that it did not continuously extend credit passively or blindly.⁴⁴² If a creditor conducts a financial analysis that raises a “red flag” and extends credit nonetheless, this also may defeat a finding of justifiable reliance.⁴⁴³

Some of these courts are especially troubled by the fact that creditors send an increasing number of unsolicited credit card applications and make minimal inquiries into the status of the consumer’s income and existing debt obligations when originally extending credit to the debtor.⁴⁴⁴ If a creditor never conducted a meaningful initial credit check, some courts will find that the creditor could not have relied justifiably on any representation made by the subsequent use of a credit card.⁴⁴⁵ Following an Eleventh Circuit case decided under the Bankruptcy Act of 1898, other courts hold that a credit card company “assumes the risk” of nonpayment once a debtor exceeds her credit limit until the lender attempts to revoke the borrower’s credit privileges.⁴⁴⁶

⁴⁴¹ See, e.g., *Christensen*, 193 B.R. at 867; F.C.C. Nat’l Bank v. Cacciatore (*In re Cacciatore*), 209 B.R. 609, 614 (Bankr. E.D.N.Y. 1997) (court “will not ignore the element of reliance simply because it may be difficult for credit card companies to prove”); *Sears, Roebuck & Co. v. Hernandez*, 208 B.R. 872, 880 (Bankr. W.D. Tex. 1997) (rejecting implied reliance); *AT&T Universal Card Servs. v. Richards*, 196 B.R. 181, 182 (Bankr. E.D. Ark. 1996). *Alvi*, 191 B.R. at 731; F.C.C. Nat’l Bank v. Willis (*In re Willis*), 190 B.R. 866, 869 (Bankr. W.D. Mo. 1996).

⁴⁴² *AT & T Universal Card Servs. Corp. v Akdogan*, 204 B.R. 90, 98 (Bankr. E.D.N.Y. 1997) (granting debtor’s motion for summary judgment on nondischargeability complaint due to lack of proof of justifiable reliance). The court in *Akdogan* cited *Alvi*, *Manufacturer’s Hanover Trust Co. v. Ward*, 857 F.2d 1082 (6th Cir. 1988), and *First Card v. Leonard*, 158 B.R. 839 (Bankr. D. Colo. 1993), in support of its decision. The *Akdogan* court found it noteworthy that the creditor “did not request any information relating to the debtor’s expenses, assets, nature of employment or business, health, home ownership, credit references or general financial condition,” nor did the creditor require the debtor to supply the basic requested information before issuing the debtor the credit card. *Id.* at 92.

⁴⁴³ *Briese*, 196 B.R. at 453.

⁴⁴⁴ See, e.g., *Household Credit Servs., Inc. v. Walters*, 208 B.R. 651, 654 (Bankr. W.D. La. 1997) (looking first at whether lender justifiably relied on any credit information when originally issuing card; pre-approved, unsolicited cards do not indicate justifiable reliance); *Bank One Columbus v. McDaniel (In re McDaniel)*, 202 B.R. 74, 79 (Bankr. N.D. Tex. 1996) (referring to credit issuer’s practice as “commercial entrapment”), citing *Mercantile Bank v. Hiemer*, 184 B.R. 345 (Bankr. D. Neb. 1995).

⁴⁴⁵ See, e.g., *Cacciatore*, 209 B.R. at 616 (lender did not justifiably rely when it granted \$5,000 line of credit to 21 year old student that listed no employer or place of business); *Akdogan*, 204 B.R. at 97.

⁴⁴⁶ *First Nat’l Bank of Mobile v. Roddenberry*, 701 F.2d 927 (11th Cir. 1983), cited in *Cox*, 182 B.R. at 631. Cf. *Feld*, 203 B.R. at 367, n.6 (“fact that creditors anticipate loss does not mean

Some courts in the Eleventh Circuit have considered themselves bound by this approach,⁴⁴⁷ which will preclude a finding of reliance in many instances absent evidence of actual fraud when the debtor did not exceed the credit limit.

The element of reliance becomes even more elusive to some courts when applied to another modern credit device, the “live check.” With this credit product, a creditor sends an unsolicited check to a consumer; by endorsing the check, the consumer becomes subject to the fine print in the credit agreement. At least one court questioned how reliance could be proven in this context: “Absent proof of [lender]’s clairvoyant abilities, this Court is hard pressed to find that [lender] relied upon a representation which occurred subsequent in time to Beneficial’s action of issuing the check.”⁴⁴⁸ Reliance on the use of the check as a representation of solvency or intent would not suffice.

Benefits to All Parties of a Bright-Line Rule for Credit Card Debt. As has been illustrated, courts are searching for a way to apply a traditional test to a novel transaction but are reaching vastly different results.⁴⁴⁹ One court described the problem in the following manner:

Each of the . . . approaches [presently used by courts] has been criticized by courts that adhere to one of the other approaches or to one of the many other divergent views that do not fit neatly into the above categories. It seems likely that until Congress takes action to establish clear cut guidelines in credit card nondischargeability cases

that they should be saddled with losses resulting from fraud”), *citing Briese*, 186 B.R. at 449.

⁴⁴⁷ *See, e.g.,* Sears, Roebuck & Co. v. Taylor, 211 B.R. 1006 (Bankr. M.D. Fla. 1997) (stating that *Roddenberry* remains good law); AT&T Universal Card Servs. Corp. v. Harris (*In re Harris*), 210 B.R. 617 (Bankr. M.D. Fla. 1997) (under *Roddenberry*, creditor can only prevail on allegations of actual fraud, not false pretenses or false representation if creditor failed to revoke privileges); First Card Servs., Inc. v. Herndon, 193 B.R. 595 (M.D. Fla. 1996) (upholding summary judgment to dismiss); AT&T Universal Card Services Corp. v. Stansel, 203 B.R. 339 (Bankr M.D. Fla. 1996) (under *Roddenberry*, court cannot hold debts nondischargeable when debtor exceeded credit limit but creditor failed to revoke credit privileges); AT&T Universal Card Servs. Corp. v. Berry, 197 B.R. 382, 383 (Bankr. M.D. Fla. 1996). *See also* Manufacturer’s Hanover Trust Co. v. Ward (*In re Ward*), 857 F.2d 1082 (6th Cir. 1988); Comerica Bank-Midwest v. Kouloumbri, 69 B.R. 229, 231 (N.D. Ill. 1986).

⁴⁴⁸ *Beneficial of Missouri, Inc. v. Shurbier*, 134 B.R. 922 (Bankr. W.D. Mo. 1991) (noting that reliance may be part and parcel to ongoing relationship between credit card issuer and user in open-ended credit relationship, but this is distinguishable from discrete loan transaction).

⁴⁴⁹ The present provisions of section 523(a)(2) work fine in the context of fraud in an *application* for a credit card or instances of actual fraud that happen to involve a credit card, such as using some one else’s card.

under Code section 523(a)(2)(A), divergent views among the courts will continue to proliferate. Unabated, the current situation will result in increased inconsistency of outcomes among cases resting on similar facts. That such lack of consistency is harmful to the system, should be obvious to all concerned.⁴⁵⁰

A bright-line test would minimize unnecessary costs and burdens for credit card lenders who currently have to keep track of the vastly disparate approaches being employed by various courts, many within the same district. Although nondischargeability actions are brought by some lenders with great regularity, pursuing nondischargeability complaints under the current system simply is not cost effective for many other lenders, whether or not they have colorable claims. A bright-line rule would permit all credit card lenders to look to the same comprehensible test to determine whether a debt is nondischargeable and to proceed accordingly.

Clarifying the law also would have a significant effect in the cases involving the poorest debtors who cannot afford to defend these actions. The current uncertainty leaves ample room for some creditors to threaten to bring nondischargeability actions even when they have no evidence of borrower misbehavior. This forces some innocent debtors to settle and agree to repay otherwise dischargeable unsecured debts.⁴⁵¹ Courts around the country report that they are receiving increasing numbers of motions for extensions for time to file nondischargeability complaints, shortly followed by settlements and/or reaffirmations. “[T]oo often in a case where a creditor alleges fraudulent use of a credit card, debtor’s counsel advises them to agree to judgments which saddle them with obligations they are unable to pay.”⁴⁵² This situation creates a predicament for both debtors and their counsel. On the one hand, some debtors are represented by attorneys “who work for a flat fee and thus may be inclined to agree to an easy

⁴⁵⁰ AT&T Universal Card Servs. v. Wong, 207 B.R. 822, 828, n.4 (Bankr. E.D. Pa. 1997).

⁴⁵¹ See Hon. Leif M. Clark, Taking Responsibility: A Creditor’s Duty, AM. BANKR. INST. J. 35 (Feb. 1996) (reporting on growing practice of creditors threatening to file nondischargeability actions); Statement of Charles A. Docter to National Bankruptcy Review Commission, “Attacking Credit Card Industry Abuse of Nondischargeability Provisions of the Bankruptcy Code” (May 16, 1996). The ability to settle these matters before filing an adversary proceeding may lead to low actual percentages of dischargeability proceedings filed.

⁴⁵² *In re Bermingham*, 201 B.R. 808 (Bankr. W.D. Mo. 1996) (court refusing to enter consent judgment of nondischargeability); see also Letter from Hon. James F. Queenan, Bankruptcy Judge - D. Mass. (May 7, 1997) (“for most debtors, the mere threat of a trial, with its attendant expense, is enough to pressure a settlement”). See generally Marc Galanter, *Why the “Haves” Come out Ahead: Speculations on the Limits of Legal Change*, 9 L. & SOC’Y REV. 95 (1974).

settlement.”⁴⁵³ On the other hand, if the debtor’s lawyer charges an hourly fee, the rising legal costs of defending an action might lead the debtor to settle.⁴⁵⁴

Creditors have identified changes in their practices in bringing nondischargeability charges and seeking settlements that amount to reaffirmations.⁴⁵⁵ A credit industry trade publication reported that about 30% of Visa’s members challenged the discharge of credit card debt in the early 1990s, while 99% of its members now challenge the dischargeability of those debts.⁴⁵⁶ According to a senior vice president and counsel for one lender, about 98% of the company’s alleged fraud cases are settled out of court, with 80-90% in the credit card company’s favor.⁴⁵⁷

An increasing number of courts are expressing concern and outrage about these practices, particularly when the creditor has made no efforts to investigate the underlying facts.⁴⁵⁸ However, courts cannot monitor all activities in all cases that take

⁴⁵³ See Albert B. Crenshaw, *Creditors Take Harder Line on Personal Bankruptcies*, WASH. POST, Feb. 16, 1997, H01.

⁴⁵⁴ *Id.*, citing David Lynn, Docter, Docter & Lynn, Washington D.C. (stating that the debtor might “easily burn through several thousand dollars in attorneys’ fees” disputing a debt for a \$100 television set).

⁴⁵⁵ See Albert B. Crenshaw, *Creditors Take Harder Line on Personal Bankruptcies*, WASH. POST, Feb. 16, 1997, H01 (quoting representative of Visa USA, Inc. stating that it is VISA’s objective to encourage issuers to pursue debtors who can pay). One bank representative has calculated that the actual percentage of dischargeability proceedings filed in Chapters 7 and 11 cases was 3.76% in 1993 and 4.05% in 1996. See Letter from Raymond Bell, Bankruptcy Manager, NationsBank Card Services Recovery Department (December 13, 1996). However, the numbers may be increasing. According to some sources, AT&T Universal Card Services had filed only 3 adversaries in 1995, which increased to 47 in the same district in 1996. Reportedly, “AT&T sued 2,700 debtors for fraud [in 1996] and expects to sue an additional 3,300 this year [1997].” Apparently, 98% of AT&T’s credit card cases are settled out of court, with 80-90% in the lender’s favor. Prof. Marianne B. Culhane & Prof. Michaela M. White, Preliminary Results of the Bankruptcy Reaffirmation Project 18 (Sept. 25, 1997), citing Memorandum to Charles Smith from Bankruptcy Court - S.D. Iowa on Adversary Information on AT&T (Dec. 31, 1996).

⁴⁵⁶ Lisa Fickenscher, *Banks Heavy-Handed in Attacks on Bankruptcy Claims, Critics Say*, AM. BANKER 1 (Jan. 10, 1997). Not all creditors file a high number of nondischargeability actions. For example, NationsBank reports that its nondischargeability adversary proceeding filing rate breaks down to approximately 10 nondischargeability actions per month. See Letter from Raymond Bell, Bankruptcy Manager, NationsBank Card Services Recovery Department (Dec. 13, 1996).

⁴⁵⁷ Debra Sparks, *Got an AT&T Credit Card? Don’t Go Bankrupt; The Company Is Quick To Charge Down-and-Out Debtors with Fraud. Too Quick?* BUS. WEEK (Sept. 15, 1997).

⁴⁵⁸ See, e.g., *In re Chinchilla*, 202 B.R. 1010 (Bankr. S.D. Fl. 1996) (sanctioning creditor that dismissed case during trial for failure to conduct even minimal investigation of cause of action

place beyond the courthouse doors. While some districts have local rules that require hearings for settlements for pro se debtors and impose standards parallel to the reaffirmation requirements,⁴⁵⁹ many courts do not review settlements of nondischargeability actions at all.

Although the Bankruptcy Code contains a fee-shifting provision to encourage debtors to defend actions that are not substantially justified,⁴⁶⁰ the wide spectrum of interpretations of section 523(a)(2)(A) makes it is nearly impossible to show that a credit card debt nondischargeability action was wholly unjustified. One court recently noted this when rejecting a prevailing debtor's request for attorneys' fees and costs:

[A] variety of overlapping theories have emerged in respect of the elements required of a credit card plaintiff to obtain a judgment of nondischargeability as well as the manner in which those elements may be satisfied. The papers submitted by [creditor]'s motion in opposition to [debtor]'s motion cite authority tending to support some of its arguments. In the absence of prior rulings on point by this court, or binding Second Circuit authority, the Court cannot conclude that [creditor]'s position lacked substantial justification within the meaning of section 523(d).⁴⁶¹

As a consequence, debtors cannot be certain that they will be reimbursed for attorneys' fees even if they successfully defend against a completely nonmeritorious claim of nondischargeability. Under the current system, economics force some honest debtors to settle nondischargeability actions, regardless of the merits. Putting aside the question of fee-shifting, an honest debtor cannot be certain that she will be able to defeat a finding of "implied fraud" that is constructed out of various objective factors.

before bringing adversary proceeding); *In re Williamson*, 181 B.R. 403 (Bankr. W.D. Mo. 1995); *In re Ramirez*, 184 B.R. 859 (Bankr. S.D. Fla. 1995). See also Lisa Fickenscher, *Don't Come to Court Without a Solid Case, Judge Warns Card Issuers*, AM. BANKER (January 10, 1997) (reporting on Judge Robert Mark's ruling in Chinchilla case).

⁴⁵⁹ See, e.g., U.S. Bankr. Court S.D. Fla. Local Rule 788. According to Chief Judge Jay Cristol of the Southern District of Florida, the rule was established to ensure that lenders filed colorable claims. Lisa Fickenscher, *Banks Heavy-Handed in Attacks on Bankruptcy Claims, Critics Say*, AM. BANKER (January 10, 1997) (reporting that Eastern District of Michigan has adopted similar local rule).

⁴⁶⁰ 11 U.S.C. § 523(d) (1994).

⁴⁶¹ *Cacciatore*, 209 B.R. at 618.

Thus, even when debtors incurred debt honestly, the confusion on the credit card nondischargeability standard serves as a collection device for the most aggressive creditors while the debts of other less aggressive creditors are discharged. A clearer bright-line rule for nondischargeability is needed.

The Bankruptcy Code already contains several bright-line provisions that establish lookback periods for activities occurring directly prepetition, such as the 90-day period to void preferential transfers.⁴⁶² A lookback period for credit card debt may be superior to a detailed factual inquiry, which already has proven to be an inadequate legal sorting device. As the current case law demonstrates, the elements of fraud are handled in a disparate fashion, with some elements ignored or others conflated because they are so difficult to prove in the credit card usage context. Moral issues surrounding the proliferation and use of credit cards provide an additional overlay onto an already-difficult analysis, and conflicting value judgments may be playing a large role in the determination of these disputes. In addition, judicial time and resources in the bankruptcy system are at a premium, and case-by-case analyses may be too costly and require other sacrifices. All things considered, a “rough justice” standard that does not require litigation of the underlying principle in each case may be the fairest method to identify debts that should be excepted from discharge.

The 30-Day Bright-Line Test. The Commission recommends that debts incurred within 30 days of bankruptcy be excepted from discharge. If Congress adopts this Recommendation, section 523(a)(2)(C) would be repealed and section 523(a)(2)(A) no longer would be available for routine credit card use pursuant to a valid credit card agreement.⁴⁶³ The proposed approach reaches the debts most likely incurred when the borrower knew she would not repay because she was contemplating bankruptcy.

The Commission settled specifically on the 30-day period after considering and debating proposals for both shorter periods and longer periods. The original Recommendation contained a 15-day lookback period, which some Commissioners

⁴⁶² See 11 U.S.C. § 547(b) (1994).

⁴⁶³ The provision would be similar in method—but broader in scope and more definitive—to section 523(a)(2)(C) dealing with luxury goods. *Sears, Roebuck & Co. v. Hernandez (In re Hernandez)*, 208 B.R. 872, 881 (Bankr. W.D. Tex. 1997) *citing* S. REP. NO. 98-65, at 58 (1985), Senate Report Accompanying section 445, Omnibus Bankruptcy Improvements Act of 1983. “[O]pinions dealing with the term “luxury” as used in this statute have “considered whether under circumstances of each particular case the purchases or transactions were ‘extravagant,’ ‘indulgent,’ or ‘nonessential.’” *Hernandez*, 208 B.R. at 880, *citing* *Carroll & Sain v. Vernon*, 192 B.R. 165, 170 (Bankr. N.D. Ill. 1996), *General Motors Acceptance Corp. v. McDonald*, 129 B.R. 279 (Bankr. M.D. Fla. 1991); *Sears Roebuck & Co. v. Faulk*, 69 B.R. 743 (Bankr. N.D. Ind. 1986).

and creditors believed was too narrow a window.⁴⁶⁴ The Recommendation on which the Commissioners ultimately voted contained the 30-day nondischargeability period. Others recommended longer periods such as 60 days. However, the justification for a time-cleavage approach breaks down as the nondischargeability period is enlarged. Timing creates a sufficiently strong inference that certain credit card debts incurred shortly before a bankruptcy filing were incurred in contemplation of the filing and should be nondischargeable. The Proposal reflects the view that 30 days is the outside edge for the length of time that this inference may be supported. Every day that the nondischargeability period is extended, it becomes less probable that the debts were incurred in contemplation of bankruptcy and increasingly difficult to rationalize the preferential treatment of credit card debts over other unsecured debts. A 60-day lookback period would have had to be presumptive, which would provoke the same litigation problems facing the current system. Even with a 30-day rule, some debtors who have used their credit cards within the month before bankruptcy will not have done so in contemplation of bankruptcy.

This Proposal does not affirmatively disrupt credit granting practices; unlike the approaches taken by some courts, it does not condition creditors' relief on the rigor of their initial scrutiny of borrowers. However, as a consequence of the Proposal's design, the bankruptcy system would not provide an additional safeguard for all improvident lending decisions that lenders might have addressed themselves. As such, while credit card lenders would receive preferential treatment over other creditors for the last 30 days of credit extended before bankruptcy, the preference would not extend further to the creditors' earlier lending decisions.

Competing Considerations. Excepting debts from discharge based on bright-line tests, such as the recommended 30 days, does not isolate only those debts incurred with ill-intent. Therefore, this approach arguably conflicts with discharge policy. The bright-line test may capture the credit card debts of only innocent individuals, including those with no legal representation or those dealing with emergency situations. However, the proposed 30-day rule would be less prejudicial to honest debtors than many of the rules currently used to determine the dischargeability of credit card debt. Honest debtors would be at less risk of being forced to settle nondischargeability actions of questionable merit. Even if the proposed test would encompass some debts not culpably incurred and currently dischargeable, the penalty is limited to the last month's worth of charges. The

⁴⁶⁴ Letter from Karen S. Williams, Senior Counsel, NationsBank Corp. to Brady C. Williamson, Consumer Bankruptcy Proposal #7 - Alternative Recommendation (August 25, 1997) (Noting that originally proposed 15 day lookback period is too short and recommending lookback period of 60 days, and also recommending that creditors should be able to rebut presumption when clear and convincing evidence exists to show that the debtor incurred debts in specific contemplation of bankruptcy); Letter from Theresa C. Scardino to Brady C. Williamson, Proposal #7: Dischargeability of Credit Card Debt, (August 20, 1997) (opposing 15 day lookback period).

Proposal represents a compromise: some debts that were innocently incurred before bankruptcy will be nondischargeable, but the lookback period is clearly limited. The solution is not perfect, but no single approach will be wholly satisfactory, either in theory or in practice.

At the same time, a bright-line nondischargeability rule might be perceived as too permissive towards sophisticated debtors who carefully plan the timing of their bankruptcy filings. An individual who can wait 30 days to file will avert the potential nondischargeable status of these debts.⁴⁶⁵ To put this consequence in perspective, however, that month's worth of credit card debt merely would be treated like all other unsecured debts. Credit card lenders are in a superior position to expand or limit their risks when they determine their standards for lending unsecured debt. Bankruptcy cannot guarantee across the board protection against losses for one type of creditor after the fact.

According to some people, all credit card debts incurred during financial distress should be excepted from discharge, even if the debtor was making the minimum monthly payments and the charges were incurred within the terms of the credit card agreement.⁴⁶⁶ This approach would give preferential treatment to credit card lenders over all other unsecured lenders. The credit card lender who permits the debtor to spend \$20 on a credit card should not get better treatment in bankruptcy than a neighbor who lends the debtor \$20, particularly because credit card lenders already determined the amount of credit they were willing to risk.

1.4.2 *Debts Incurred to Pay Nondischargeable Federal Tax Obligations*

Section 523(a)(14) should remain unchanged to except from discharge debts incurred for federal taxes that would be nondischargeable under section 523(a)(1).

Credit card debts incurred to pay nondischargeable taxes raise slightly different concerns because Congress already has carved out these debts for special treatment. Since the Bankruptcy Reform Act of 1994, the Bankruptcy Code has excepted from discharge debts incurred to pay federal taxes "that would be nondischargeable pursuant to paragraph (1) of section 523(a)."⁴⁶⁷ Currently, this

⁴⁶⁵ See Electronic Mail from Dani Robinson, Commonwealth Central Credit Union (September 17, 1997) (debtors' counsel "would simply wait the 30 day period before filing the case")

⁴⁶⁶ See Letter from Mark A. Cronin to Hon Edith Hollan Jones, Re: Proposed Draft on Credit Card Nondischargeability (July 17, 1997) (referring to rejection of previous proposal on credit card nondischargeability and endorsing codification of "implied representation" approach).

⁴⁶⁷ 11 U.S.C. § 523(a)(14) (1994) (excepting from discharge "debts incurred to pay a tax to the United States that would be nondischargeable pursuant to paragraph (1)").

exception to discharge can be used whenever an individual borrows to pay taxes, which would include taking a cash advance on a credit card or using a check issued by a credit card company. With this limited application, the published case law indicates that section 523(a)(14) seldom has been used; an on-line search of the published case law reveals that this provision has been cited in only a few reported decisions and has provided the basis for nondischargeability in one case.⁴⁶⁸

The use of credit cards for paying tax liabilities is about to change and this provision will take on newfound importance: Congress recently amended the laws to permit the Internal Revenue Service to accept payment of taxes by credit card and other commercially acceptable means.⁴⁶⁹ Thus, the provision would except from discharge any credit card debt directly incurred to pay nondischargeable federal taxes. A lender must establish that the funds were used to pay a nondischargeable federal tax liability,⁴⁷⁰ but need not prove intent not to repay. Any tracing problems that might have resulted in the context of cash advances will be minimized whenever consumers pay the Internal Revenue Service directly with credit cards.⁴⁷¹ It is reasonable to expect an increased use of this exception to discharge when the IRS accepts credit card payment directly. To put this provision in the context of the proposed change to section 523(a)(2)(A), section 523(a)(14) would provide an exception to the proposed general rule governing nondischargeability of credit card debt.

The beneficiaries of this exception are credit card lenders, not the government. If a consumer paid taxes with a credit card and subsequently filed for bankruptcy, the government would not experience a loss even if the credit card debt were discharged. Like any entity that accepts credit cards, the IRS is not required to give the money back to the credit card company if the debtor defaults on a credit card obligation. The debtors' failure to pay—whether through bankruptcy or otherwise—is the loss borne by the credit card issuer, just as the interest a debtor pays on the obligation inures to the benefit of the credit card lender, not the government. Because the tax obligation already has been satisfied, this exception to discharge allows a credit card lender to collect an unsecured, nonpriority credit card debt postbankruptcy, without showing

⁴⁶⁸ *In re Chrusz*, 196 B.R. 221 (Bankr. D.N.H. 1996). See *MNBA America v. Parkhurst*, 202 B.R. 816 (Bankr. N.D.N.Y. 1996), in which section 523(a)(14) provided additional grounds for nondischargeability to a credit card issuer already pursuing a section 523(a)(2) claim against a pro se debtor.

⁴⁶⁹ Taxpayer Relief Act, Pub. L. No. 105-34, 105th Cong. (August 5, 1997).

⁴⁷⁰ See *In re Chrusz*, 196 B.R. 221 (Bankr. D.N.H. 1996) (access check that was first deposited into account and then used as part of funds to pay IRS was nondischargeable debt).

⁴⁷¹ Tracing problems will not be eliminated because questions may arise regarding the application of payments to a credit card account on which a borrower charged taxes and other expenses as well.

any proof of fraudulent intent, merely because the debtor happened to use that credit card to pay for taxes instead of groceries. Consumers paying taxes on credit cards who pay the debt off over time will be paying a very high interest rate on their tax payments, which presumably is nondischargeable as well.

However, the provision reinforces the principle that citizens must bear responsibility for certain tax obligations, regardless of their methods of payment. The exception to discharge for tax debts paid by credit card emphasizes the important message that payment of taxes is an obligation shared by all. In light of the recent change to permit the IRS to accept credit card payment, it would have been premature for the Commission to recommend a change.

1.4.3 Criminal Restitution Orders

Section 523(a)(13) should be expanded to apply to all criminal restitution orders.

Federal criminal restitution orders cannot be discharged in bankruptcy, according to section 523(a)(13).⁴⁷² Congress added this provision through The Violent Crime Control and Law Enforcement Act of 1994.⁴⁷³ This provision applies to only federal criminal restitution orders and excludes restitution orders issued under state law. According to the United States Supreme Court's decision in *Kelly v. Robinson*, state criminal restitution orders are nondischargeable under section 523(a)(7).⁴⁷⁴

While state restitution orders already are protected under section 523(a)(7), there is no reason to distinguish among restitution orders in section 523(a)(13). Provisions that arbitrarily distinguish between similar debts run counter to a policy-

⁴⁷² 11 U.S.C. § 523(a)(13) (1994) (excepting from discharge "any payment of an order of restitution issued under title 18, United States Code"). See also 11 U.S.C. § 1328(a)(3) (excepting restitution or criminal fine from Chapter 13 superdischarge).

⁴⁷³ Violent Crime Control and Law Enforcement Act of 1994, Pub. L. No. 103-322, 108 Stat. 1796, 2135 (1994).

⁴⁷⁴ *Kelly v. Robinson*, 479 U.S. 36, 50 (1986) (section "523(a)(7) preserves from discharge any condition a state criminal court imposes as part of a criminal sentence"); *In re Gelb*, 187 B.R. 87 (Bankr. E.D.N.Y. 1995) (restitution order nondischargeable under section 523(a)(7)). Section 523(a)(7) excepts from discharge a debt "to the extent such debt is for a fine, penalty, or forfeiture payable to and for the benefit of a governmental unit, and is not compensation for actual pecuniary loss, other than a tax penalty-(A) relating to a tax of a kind not specified in paragraph (1) of this subsection; or (B) imposed with respect to a transaction or event that occurred before three years before the date of the filing of the petition."

based approach to nondischargeability. Whether federal or nonfederal, criminal restitution orders are part of criminal convictions that reflect the penal and rehabilitative interests of government entities. Therefore, the Commission recommends this change that is wholly consistent with current law and policy.⁴⁷⁵

Some have argued that section 523(a)(13) is unnecessary to make restitution orders nondischargeable and should be deleted because subsequent courts uniformly have applied the holding and reasoning of *Kelly v. Robinson* to make federal and state restitution orders nondischargeable under section 523(a)(7),⁴⁷⁶ providing two bases for nondischargeability for criminal restitution obligations. Also, because many restitution orders involve conduct that gives rise to a nondischargeable debt under section 523(a)(6) for willful and malicious injury or section 523(a)(2) for fraud, section 523(a)(13) provision duplicates the results of another statutory section as well.

1.4.4 *Family Support Obligations*

Sections 523(a)(5), (a)(15), and (a)(18) should be combined. The revised 523(a)(5) should provide that all debts actually in the nature of support, whether they have been denominated in a prior court order as alimony, maintenance, support, property settlements, or otherwise, are nondischargeable. In addition, debts owed under state law to a state or municipality in the nature of support would be nondischargeable in all chapters.

Many state and federal laws reflect the importance of upholding family support obligations. In bankruptcy, obligations owed to support children and former spouses receive extra protection for important policy reasons. Unlike many other creditors, children and former spouses requiring support are involuntary creditors who have no opportunities to offset their credit risks or diversify a loan portfolio to protect themselves.⁴⁷⁷ They are relying on one person who is obligated to pay an amount deemed necessary for their support. Without those payments, they may suffer serious consequences. Ultimately, they may need governmental assistance to compensate for the lack of support, or they may be forced into bankruptcy themselves.

⁴⁷⁵ A conforming change to section 1328(a) might be necessary as well.

⁴⁷⁶ See *In re Gelb*, 187 B.R. 87, 90 (Bankr. E.D.N.Y. 1995) (collecting citations).

⁴⁷⁷ See *Shine v. Shine*, 802 F.2d 583, 585-88 (1st Cir. 1986) (there is strong policy interest in protecting ex-spouses and children from the loss of alimony, support and maintenance owed by debtor who has filed for bankruptcy).

The bankruptcy laws reflect the critical importance of family support obligations through the priority and exception to discharge provisions.⁴⁷⁸ However, there may be ways to strengthen and clarify the laws to ensure that the policy goals are met with less confusion and with less burden on the parties and the courts. Three separate sections currently govern the nondischargeability of family support obligations.

Section 523(a)(5). The primary nondischargeability provision to protect recipients of support obligations is section 523(a)(5). Under this provision, maintenance and alimony obligations are nondischargeable in all chapters.⁴⁷⁹ Federal law governs whether a debt is in the nature of a family support obligation, even if a state domestic relations court did not label the obligation as support.⁴⁸⁰ In determining nondischargeability, courts sometimes must look beyond the language of the decree, particularly in a community property state, to determine whether the obligation is actually in the nature of support.⁴⁸¹ Bankruptcy courts and state courts have concurrent jurisdiction to make this determination, but, regardless of what court is resolving the question, it is clear that federal law governs the determination of

⁴⁷⁸ 11 U.S.C. §§ 523(a)(5), (a)(15), (a)(18), § 1328(a) (1994) (excepting family support obligations from Chapter 13 superdischarge. The Bankruptcy Reform Act of 1994 further advanced the policy of requiring payment of support obligations by according them priority in payment over other unsecured claims. 11 U.S.C. § 507(a)(7) (1994).

⁴⁷⁹ Section 523(a)(5) provides as follows:

A discharge . . . does not discharge an individual debtor from any debt -

(5) to a spouse, former spouse, or child of the debtor, for alimony to, maintenance for, or support of such spouse or child, in connection with a separation agreement, divorce decree or other order of a court of record, determination made in accordance with State or territorial law by a governmental unit, or property settlement agreement, but not to the extent that -

(A) such debt is assigned to another entity, voluntarily, by operation of law, or otherwise (other than debts assigned pursuant to section 408(a)(3) of the Social Security Act, or any such debt which has been assigned to the Federal Government or to a State or any political subdivision of such state); or

(B) such debt includes a liability designated as alimony, maintenance, or support, unless such liability is actually in the nature of alimony, maintenance, or support.

11 U.S.C. § 523 (a)(5) (1994).

⁴⁸⁰ H.R. REP. NO. 95-595, at 364 (1977) (“What constitutes alimony, maintenance, or support, will be determined under the bankruptcy laws, not State law.”); S. REP. NO. 95-989, at 79 (1978) (same). In fact, this is true even if the obligation was denominated as part of a property division by the nonbankruptcy court. See *In re Swate*, 99 F.3d 1282 (5th Cir. 1996); *Shaver v. Shaver*, 736 F.2d 1314 (9th Cir. 1984). See generally HENRY SOMMER AND HON. DEE MCGARITY, *COLLIER FAMILY LAW AND THE BANKRUPTCY CODE*, Ch. 6 (1991).

⁴⁸¹ See, e.g., *In re Brody*, 3 F.3d 35 (2d Cir. 1993); *In re Goin*, 808 F.2d 1391 (10th Cir. 1987).

nondischargeability.⁴⁸² Thus, if the obligation actually is a support obligation, it should be excepted from discharge under section 523(a)(5) even if it previously has been characterized as a property settlement.⁴⁸³

Courts have considered a variety of factors in determining whether an obligation is actually in the nature of support, including the intent of the parties and whether the provision functioned as support at the time of the divorce.⁴⁸⁴ Looking at whether a given debt functions as support enables the court to except from discharge a wide range of debts that are not labeled as alimony or child support, such as credit card debts,⁴⁸⁵ or “hold harmless” arrangements to pay other debts incurred during the marriage.⁴⁸⁶

Because both state and federal courts are required to assess whether an obligation is actually in the nature of support for purposes of federal nondischargeability, regardless of what the obligation is labeled in the divorce decree or property settlement, the fact that a community property state may not have “alimony” per se does not preclude a finding of nondischargeability under section 523(a)(5).⁴⁸⁷ The circuit courts of appeals have reinforced this point in their opinions

⁴⁸² *Shaver v. Shaver*, 736 F.2d 1314 (9th Cir. 1984).

⁴⁸³ *See, e.g., Williams v. Williams*, 703 F.2d 1055, 1057 (8th Cir. 1983).

⁴⁸⁴ *See In re Young*, 35 F.3d 499 (10th Cir. 1994) (intent and function tests); *In re Gianakas*, 917 F.2d 759 (3d Cir. 1990) (considering substance as well as language of decree, parties’ financial condition when agreement was made, and function served by obligation).

⁴⁸⁵ *See, e.g., Martin v. Martin*, 832 P.2d 390 (Nev. 1992) (assumption of credit card debts was in exchange for lowering amount expressly provided as child support and thus was nondischargeable); *In re Borzillo*, 130 B.R. 438 (Bankr. E.D. Pa. 1991).

⁴⁸⁶ *In re Coil*, 680 F.2d 1170 (7th Cir. 1982) (hold harmless agreement for marital debts nondischargeable); *In re Haas*, 129 B.R. 531 (Bankr. N.D. Ill. 1989) (obligation to pay marital debts awarded in place of maintenance, thus nondischargeable);

⁴⁸⁷ *See, e.g., In re Swate*, 99 F.3d 1282, 1285 (5th Cir. 1996) (“Whether a particular obligation constitutes alimony, maintenance, or support within the meaning of this section is a matter of federal bankruptcy law, not state law”) *citing In re Joseph*, 16 F.3d 86, 87 (5th Cir. 1994) (citation omitted); *In re Dennis*, 25 F.3d 274, 277-79 (5th Cir. 1994) (“dischargeability of a debt is determined by the substance of the liability rather than its form”); *Jones v. Jones*, 9 F.3d 878 (10th Cir. 1993) *citing Yeates v. Yeates (In re Yeates)*, 807 F.2d 874, 878 (10th Cir. 1986) (“a debt could be in the ‘nature of support under section 523(a)(5) even though it would not legally qualify as alimony or support under state law”); *Friedkin v. Sternberg*, 85 F.3d 1400 (9th Cir. 1996); *Kritt v. Kritt*, 190 B.R. 382, 387 (B.A.P. 9th Cir. 1995) (community property division was in nature of support and thus nondischargeable under section 523(a)(5)); *Johnson v. Arcelus*, 162 B.R. 130 (Bankr. S.D. Tex. 1993) (because federal law determines whether divorce related claims are “support

interpreting the statute in the context of community property law. Although published case law suggests that lower courts are in accord with these standards, it is possible that not all courts are in line with this directive. Therefore, the Commission recommends an amendment to section 523(a)(5) to provide express statutory language that any debt actually in the nature of support is not dischargeable in any chapter of the Bankruptcy Code in both community property and common law property states.

Section 523(a)(18). Section 523(a)(18) sets forth an additional exception to discharge governing support obligations owed to certain government entities.⁴⁸⁸ As part of the Personal Responsibility and Work Opportunity Reconciliation Act of 1996, Congress added this provision to ensure that a debt in the nature of support owed to a state cannot be discharged in bankruptcy cases. Section 523(a)(5)(A) already exempts from discharge support obligations that were assigned to a state or political subdivision of a state, and according to Collier on Bankruptcy, there is no legislative history to explain what appears to be redundant legislation.⁴⁸⁹ However, unlike debts covered by section 523(a)(5), section 523(a)(18) is included in the superdischarge for debtors who complete Chapter 13 plans.⁴⁹⁰ So long as section 523(a)(5) clearly provides that the debts delineated in section 523(a)(18) are nondischargeable, subsection (18) should be deleted.⁴⁹¹ This approach ensured that those debts are nondischargeable in all chapters.

Section 523(a)(15). The Bankruptcy Reform Act of 1994 introduced a new exception to discharge for debts arising out of divorce decrees or separation

obligations," community property division was support obligation for nondischargeability purposes); *and Semrow v. Robinson*, 122 B.R. 502 (Bankr. W.D. Tex. (1990) (same).

⁴⁸⁸ Section 523(a)(18) provides as follows: A discharge . . . does not discharge an individual debtor from any debt - owed under State law to a State or municipality that is -
(A) in the nature of support, and
(B) enforceable under part D of title IV of the Social Security Act (42 U.S.C. 601 et seq.).
11 U.S.C. § 523 (a)(18) (1994).

⁴⁸⁹ 4 COLLIER ON BANKRUPTCY ¶ 523.24, 523-109 (Lawrence P. King et al. eds., 15th ed. 1996).

⁴⁹⁰ 11 U.S.C. § 1328(a) (1994).

⁴⁹¹ See Memorandum from Karen Cordry, Bankruptcy Counsel, National Association of Attorneys General, Comments on May 30 Draft of Dischargeability Proposal, at 8 (June 17, 1997) (speaking for herself and not on behalf of N.A.A.G., agreeing with Memorandum of Professor Morris et al regarding the elimination of section 523(a)(18)).

agreements under certain circumstances.⁴⁹² This provision apparently was enacted to ensure that some of the aforementioned “hold harmless” and property settlement obligations that are not labeled as “support” are nonetheless nondischargeable when the debtor can afford to pay the debt.⁴⁹³ However, the procedures and requisite tests are cumbersome and can impose significant burdens and litigation costs on the nondebtor spouse. To take advantage of section 523(a)(15), a former spouse must file an adversary proceeding seeking to except such obligations from discharge. In most cases, this must occur no later than 60 days after the first date set for the section 341 meeting of creditors.⁴⁹⁴ If the former spouse misses the deadline, an obligation to divide property will be discharged.⁴⁹⁵

Section 523(a)(15) further requires the bankruptcy court to assess the present financial capabilities and needs of both the debtor and nondebtor parties, and to balance the hardship to the nondebtor against the benefit to the debtor of discharging the debt. The provision permits the discharge of these debts if it is shown that the

⁴⁹² Section 523(a)(15) provides as follows: A discharge . . . does not discharge an individual debtor from any debt -

(15) 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 or record, a determination made in accordance with State or territorial law by a governmental unit unless -

(A) the debtor does not have the ability to pay such debt from income or property of the debtor not reasonably necessary to be expended for the maintenance or support of the debtor or a dependent of the debtor and, if the debtor is engaged in a business, for the payment of expenditures necessary for the continuation, preservation, and operation of such business; or

(B) discharging such debt would result in a benefit to the debtor that outweighs the detrimental consequences to a spouse, former spouse, or child of the debtor.

11 U.S.C. §523(a)(15) (1994).

⁴⁹³ “In some instances, divorcing spouses have agreed to make payments of marital debts, holding the other spouse harmless from those debts, in exchange for a reduction in alimony payments. In other cases, spouses have agreed to lower alimony payments based on a larger property settlement. If such “hold harmless” and property settlement obligations are not found to be in the nature of alimony, maintenance, or support, they are dischargeable under current law. The nondebtor spouse may be saddled with substantial debt and little or no alimony or support. This subsection will make such obligations nondischargeable in cases where the debtor has the ability to pay them and the detriment to the nondebtor spouse from their nonpayment outweighs the benefit to the debtor of discharging such debts.” 140 CONG. REC. H10,752-01 (daily ed. Oct. 4, 1994).

⁴⁹⁴ See 11 U.S.C. § 523(c) (1994). Fed. R. Bankr. P. 4007 (1995).

⁴⁹⁵ See, e.g., *In re Cannon*, 203 B.R. 768 (Bankr. M.D. Fla. 1996). Because this provision is not cross-referenced in section 523(a)(3), a lack of notice to an ex-spouse can be fatal to any attempt to render the debt nondischargeable.

debtor cannot pay the debt,⁴⁹⁶ bringing into play the same “disposable income” analysis that creates disparate results in the required payments to unsecured creditors in Chapter 13.⁴⁹⁷ In addition, the debt might be discharged if the benefit to the debtor of the discharge outweighs the detriment caused by discharge to the nondebtor spouse.⁴⁹⁸ The application of this test is not an easy task.⁴⁹⁹ The provision is silent on presumptions and burdens of proof.⁵⁰⁰ Also unclear is whether the court should assess the debtor’s financial condition at the time of the bankruptcy filing,⁵⁰¹ the time of the filing of the adversary proceeding,⁵⁰² or the time of the hearing.⁵⁰³ Any of these choices entails a set of circumstances distinct from those at the time of the divorce decree.

⁴⁹⁶ See, e.g., *In re Slover*, 191 B.R. 886 (Bankr. E.D. Okla. 1996); *In re Florio*, 187 B.R. 654 (Bankr. W.D. Mo. 1995); *In re Wiley*, 198 B.R. 1007 (Bankr. S.D. Fla. 1996).

⁴⁹⁷ See 11 U.S.C. § 1325(b) (1994). Because of the inconsistencies and subjective analyses inherent in the Chapter 13 disposable income test, the Commission’s Chapter 13 discussion contains a Recommendation to replace the Chapter 13 disposable income test.

⁴⁹⁸ Whether there is a presumption built into this discharge is subject to some dispute. Compare *In re Woodworth*, 187 B.R. 174 (Bankr. N.D. Ohio 1995) (balancing test favors discharge) with *In re Marquis*, 203 B.R. 844 (Bankr. D. Me. 1997) (balancing test favors nondischargeability).

⁴⁹⁹ See, e.g., *In re Schmitt*, 197 B.R. 312, 317 (Bankr. W.D. Ark. 1996) (balancing test imposes “impossibly amorphous standard”).

⁵⁰⁰ “The opinions of the majority of reported cases--approximately twenty-eight (Majority Group)--reveal that this group of courts allocate to the debtor the burdens of proof for section 523(a)(15)(A) and (B) for Ability to Pay and Detriment. The second group (the Bifurcated Group), based on reported decisions consists of only three courts, allocates the burden of proof for Detriment to the former spouse/spouse and for the Ability to Pay to the debtor. The third category of courts (Minority Group)--five reported cases-- places the burden of proof for all of section 523(a)(15), including Ability to Pay and Detriment, on the former spouse/spouse.” *Stone v. Stone*, 199 B.R. 753 (Bankr. N.D. Ala. 1996) (citing authorities allocating burden of proving “ability to pay” and “detriment” under section 523(a)(15)(A)). See also *Jodoin v. Samayoa*, 209 B.R. 132 (B.A.P. 9th Cir. 1997) (debtor had burdens of proof as to both inability to pay” and “detriment” tests).

⁵⁰¹ See, e.g., *Gamble v. Gamble*, 196 B.R. 54 (Bankr. N.D. Tex. 1996).

⁵⁰² See, e.g., *In re Hill*, 184 B.R. 750 (Bankr. N.D. Ill. 1995).

⁵⁰³ See, e.g., *In re Campbell*, 198 B.R. 467 (Bankr. D.S.C. 1996); *In re Dressler*, 194 B.R. 290 (Bankr. D. R.I. 1996); *In re Gantz*, 192 B.R. 932 (Bankr. N.D. Ill. 1996).

Although there is no indication that Congress intended to affect the broad interpretation of support obligations of section 523(a)(5),⁵⁰⁴ the present set of procedures in section 523(a)(15) for obligations that are not labeled as support potentially weaken the protection of ex-spouses and children that Congress afforded them under section 523(a)(5). Section 523(a)(15) is operative only with respect to debts “not of a kind described in section 523(a)(5).” Where previously a court looked to the nature of obligations that were not labeled as support under section 523(a)(5) to determine if they actually function as support, a court now might proceed under section 523(a)(15) for obligations now labeled as support, such as the assumption of certain debts in exchange for lower support payments.⁵⁰⁵ Not only does this entail the cumbersome balancing and consideration of the relative needs of the parties, but it also necessitates quick action on the part of the nondebtor ex-spouse: missing the 60 day filing deadline for obligations that are not obviously support obligations might foreclose all possibility of preserving nondischargeability.⁵⁰⁶ The resulting nondischargeable debt may be smaller than what could have been protected under section 523(a)(5). Furthermore, any debts that might be excepted from Chapter 7 discharge under section 523(a)(15) are dischargeable in Chapter 13 if the debtor completes a payment plan.⁵⁰⁷ Thus, while well-intentioned, the new section 523(a)(15) in practice has introduced uncertainty into the protective scheme, thereby undermining the protection for family support obligations.

With the recommended change to section 523(a)(5), section 523(a)(15) would become largely superfluous. As the sole provision governing nondischargeability of family obligations, an amended and clarified section 523(a)(5) would provide explicit direction for all parties on the nondischargeability of support obligations and would make them uniformly nondischargeable in all chapters. Obligations handled through property settlements that truly are not for support, such as business debts that were not assumed in exchange for lower support payments, would be dischargeable like

⁵⁰⁴ See, e.g., *Macy v. Macy*, 114 F.3d 1, 2 (1st Cir. 1997) (Congress did not intend to apply section 523(a)(15) to debts that were, prior to the Bankruptcy Reform Act, considered to be nondischargeable under section 523(a)(5)).

⁵⁰⁵ “A judge, facing a close question about whether a particular debt really is in the nature of support, may have a tendency to err in favor of finding nonsupport, since this finding still allows the judge to consider the relative needs of the parties under § 523(a)(15).” Memorandum from Hon. Samuel L. Bufford, Prof. Margaret Howard, Prof. Jeffery W. Morris, Hon. Eugene R. Wedoff, Discharge and Dischargeability in Consumer Bankruptcy (May 30, 1997).

⁵⁰⁶ “[I]t behooves a creditor who is owed a debt that arises out of a divorce decree or separation agreement to seek a determination of nondischargeability under section 523(a)(15), as well as a determination of nondischargeability under section 523(a)(5), in case there is any question about the nature of the debt.” COLLIER FAMILY LAW ¶ 6/07A[2] (1997).

⁵⁰⁷ See 11 U.S.C. § 1328 (1994).

other debts. This consolidation of related provisions would limit the extent to which bankruptcy courts must intrude into family law issues. Under section 523(a)(5), the bankruptcy court simply must characterize the prior state court judgment but should not adjudicate support entitlements. Thus, while some litigation remains necessary, court intrusion is kept to its minimum.⁵⁰⁸ Moreover, because state courts have concurrent jurisdiction over proceedings under section 523(a)(5), this litigation can proceed in a state court.

Competing Considerations. Some might prefer that the implementation problems with section 523(a)(15) be repaired by clarifying the standards and providing more details, rather than omitting it, so that debtors will remain responsible for nonsupport property settlements in some instances. Others would go several steps further and would provide that all property settlements in connection with a divorce decree, regardless of their content, should be nondischargeable, which would relieve the nondebtor spouse from having to litigate the nondischargeability of an obligation in the bankruptcy court or state court, and correspondingly would relieve the courts from having to undertake any investigation into whether the debt actually was in the nature of support.⁵⁰⁹ An inherent assumption of this approach is that the vast majority of property settlements involve some element of support, although this may not account for situations in which the nondebtor spouse is far better off financially than the debtor.⁵¹⁰ The American Academy of Matrimonial Lawyers advocates that property settlements be nondischargeable for five years, while it also endorses a specific provision to protect attorneys' fees.⁵¹¹ The notion of eliminating all litigation on family obligations is appealing, but the question of nondischargeability under federal bankruptcy law is one that can be determined only after an individual files for bankruptcy. The Commission's Recommendation reflects a policy choice that support obligations deserve very special protection which should be spelled out clearly in the

⁵⁰⁸ *In re Harrell*, 754 F.2d 902, 906 (11th Cir.1985) ("The statutory language suggests a simple inquiry as to whether the obligation can legitimately be characterized as support, that is, whether it is in the nature of support.").

⁵⁰⁹ See Memorandum from Hon. Edith H. Jones and Prof. Richard E. Flint (August 20, 1997) (recommending that the section 523(a)(5) exception to discharge apply to all debts to a spouse, former spouse, or child of the debtor for any debt in connection with or incurred by the debtor in the course of a separation agreement, divorce decree, any modifications thereof, including property settlement agreements and hold harmless agreements).

⁵¹⁰ See, e.g., *Taylor v. Taylor*, 199 B.R. 37 (N.D. Ill. 1996) (nondebtor spouse had income of almost three million dollars in three years preceding bankruptcy case).

⁵¹¹ See Letter from W. J. Giles, III, Chair, Bankruptcy Committee of the American Academy of Matrimonial Lawyers, Sioux City, IA to Brady C. Williamson (May 20, 1997) (proposing amendment to make property settlements, in addition to attorneys' fees, absolutely nondischargeable for five years after entry of settlements).

statute. Whether every obligation that might exist between once-married people should become a nondischargeable debt is a different question.

1.4.5 Dischargeability of Student Loans

Section 523(a)(8) should be repealed.

Until the middle of the 1970s, student loans were not treated differently in bankruptcy than other debts. Since then, the dischargeability of government- and nonprofit- insured educational loans increasingly has been restricted. Student loans initially were nondischargeable only within the first five years after payment became due and could be discharged in Chapter 13 if the debtor completed a three to five year payment plan. Now, bankruptcy law excepts from discharge student loans within their first seven years of repayment, and, unlike most other nondischargeable debts, current law makes these loans nondischargeable in all chapters.⁵¹² While the Code provides an exception to the rule of nondischargeability if a debtor can affirmatively prove that repayment of the loans would cause the debtor “undue hardship,” this exception is narrowly construed such that the debtors most in need are least likely to be able to litigate the issue convincingly or at all. The Commission reviewed the principles behind declaring such loans nondischargeable and recommends to Congress that the provision be overturned.

The question at issue in this Proposal is not whether anyone wants individuals to discharge their debts, educational loans or otherwise. The question is whether a debtor overloaded with consumer debts incurred to buy a car, a vacation, or a pizza can resort to bankruptcy but a debtor who borrows to pay for tuition and books cannot. Unlike a home mortgage, a credit card debt, a small business loan, or almost any other type of consumer credit, an educational loan remains the debtor’s obligation until it is paid in full:

Congress placed guaranteed loans in a class with debts for taxes, debts induced by fraud, and debts for compensation of injuries by drunk drivers. The government guarantees the loans and makes laws that treat its guaranteed loans as more obligatory than other loans, defining them to be as compelling as debts arising from turpitude. Students are not criminals, however, and debts owed to the United States should be no more sacred than other personal obligations. Today young people are induced to indenture themselves by a system that ignores the capacity of the debtor to bear the burden. This system is, moreover, exploited by proprietary schools, colleges, and universities,

⁵¹² 11 U.S.C. § 1328(a)(2) (1994). For more information on the dischargeability of debts in Chapter 13, please *see* the subsection on the “superdischarge” in this chapter.

as well as by bankers and other lenders, through contracts of adhesion that most students must accept lest they give up the idea of learning.⁵¹³

The educational loan burden can be even more overwhelming for those who try to pay their debts. While the debtor is in Chapter 13, interest continues to compound. If a debtor does not find a way to make all student loan payments in addition to other Chapter 13 obligations, the debtor will face an even more overwhelming loan obligation at the end of the Chapter 13.⁵¹⁴ Yet, this consequence often is unavoidable when most courts interpret the Code to require that all unsecured debts, including nondischargeable debts, must be paid pro rata.⁵¹⁵ Even if courts permit separate classification or the debtor otherwise pays the principal in full, the debtor may emerge from a Chapter 13 plan only to be liable for compounded interest that will take years to repay.⁵¹⁶ The Commission has received letters recounting the details of cases in which a debtor has completed a five year payment plan and paid the principal on educational loans in full, only to face tens of thousands in accrued interest at the end that the debtor was not able or not allowed to pay through the plan.⁵¹⁷ The bankruptcy system, through its network of exceptions to discharge, seems to penalize

⁵¹³ Arthur Ryman, *Contract Obligation: A Discussion of Morality, Bankruptcy, and Student Debt*, 42 *DRAKE L. REV.* 205, 219 (1993); Margaret Howard, *A Theory of Discharge in Consumer Bankruptcy*, 48 *OHIO ST. L.J.* 1047, 1085-87 (1987) (it is inconsistent with fresh start policy to have exception to discharge for student loans).

⁵¹⁴ See *Leeper v. Penna. Higher Education Assistance Agency*, 49 F.3d 98 (3d Cir. 1995) (creditors can accrue postpetition interest on nondischargeable debt while bankruptcy is pending); Electronic Mail Memorandum from Hon. Leif M. Clark, (October 18, 1996) (explaining problem of interest buildup on nondischargeable student loans throughout Chapter 13 case); *Leeper v. Penna. Higher Educ. Assistance*, 49 F.3d 98 (3d Cir. 1995) (interest continues to accrue during Chapter 13 and is nondischargeable); *In re Sullivan*, 195 B.R. 649 (Bankr. W.D. Tex. 1996); *In re Ridder*, 171 B.R. 345 (Bankr. W.D. Wis. 1994); *In re Shelbyyah*, 165 B.R. 332 (Bankr. N.D. Ga. 1994).

⁵¹⁵ Compare *Groves v. LaBarge*, 39 F.3d 212 (8th Cir. 1994) (nondischargeability, in itself, of student loan debt is insufficient to warrant separate classification under section 1322(b)(1)); *In re Sperna*, 173 B.R. 654 (B.A.P. 9th Cir. 1994); *McCullough v. Brown*, 162 B.R. 506 (N.D. Ill. 1994); with *In re Tucker*, 159 B.R. 325 (Bankr. D. Mont. 1993) (separate classification permitted); *In re Foreman*, 136 B.R. 532 (Bankr. S.D. Iowa 1992). See generally William Houston Brown & Katherine L. Evans, *A Comparison of Classification and Treatment of Family Support Obligations and Student Loans: A Case Analysis*, 24 *MEMPHIS ST. UNIV. L. REV.* 623, 650 (1994) (advocating case by case totality of circumstances, rather than "ironclad," approach to student loan classification in chapter 13 plans).

⁵¹⁶ See *In re Wagner*, 200 B.R. 160 (Bankr. N.D. Ohio 1996); *In re Jordan*, 146 B.R. 31 (D. Colo. 1992).

⁵¹⁷ See, e.g., Electronic Mail from David L. Gibbs, Student Loan Dischargeability (June 26, 1997) (noting that vast array of decisions on treatment of student loan interest provided basis for judge and trustee position to preclude collection of interest during plan but to permit it to accrue).

individuals who seek to educate and improve themselves while it liberates other individuals from overwhelming debt incurred for other purposes or through different means. At the same time, the exception may be perceived as unfair to other lenders who do not lend money for education or make educational loans that are not insured by the government or nonprofit agencies.

When Congress singled out student loans for different treatment in the mid-1970s, several issues were crucial to the policy discussions. Some people worried that borrowers too easily would discard educational debts if permitted. Stories in the popular press focused on individuals who sought bankruptcy relief to discharge student loans in spite of their promising prospects for significant future income.⁵¹⁸ These borrowers purportedly would cost the federal government millions of dollars. Concerned that the perception of abuse, however small in reality, would “discredit the system and cause disrespect for the law and those charged with its administration,” the 1973 Report of the Commission on the Bankruptcy Laws of the United States recommended that student loans be nondischargeable for five years after repayment commenced. However, the 1970 Commission acknowledged that student loan abuse was more perception than reality. A sweeping recommendation might prove too burdensome for debtors in serious trouble. Therefore, the 1970 Commission recommended an exception: if the debtor could show that the student loans caused undue hardship for the debtor and dependents, those loans should be discharged.⁵¹⁹ Congress enacted such a provision in the Education Amendments Act of 1976,⁵²⁰ which later became section 523(a)(8) of the Bankruptcy Code.

While the debates were haunted by the image of the about-to-be wealthy graduate of medical school or law school, this image was not accepted universally. Many questioned whether there was sufficient evidence of abuse to warrant an exception to discharge for student loans at all.⁵²¹ In the House debates, for example,

⁵¹⁸ See *Hearings on H.R. REP. NO. 95-595*, 95th Cong. 159 (1977) (statement of Ronald J. Iverson, Executive Director, Vt. Student Assistance Corp. reporting on several cases where student loans comprised majority of debt discharged in bankruptcy). But see Kurt Wiese, *Discharging Student Loans in Bankruptcy: The Bankruptcy Court Tests of ‘Undue Hardship,’* 26 ARIZ. L. REV. 445, 449 (1984) (alleged student loan discharge problem was created by media).

⁵¹⁹ COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. Doc. No. 137, Part II, 140 (1973).

⁵²⁰ Education Amendments of 1976, Pub. L. No. 94-482, § 127(a), *codified at* 20 U.S.C. § 1087-3 (1976) (repealed 1978).

⁵²¹ See *Hearings on H.R. 31 and H.R. 32 Before the Subcomm. on Civil and Constitutional Rights of the Comm. on the Judiciary*, 94th Cong., pt. 2, at 1096 (1976) (Rep. Don Edwards expressing concern over lack of evidence of significant abuse in light of legitimate purposes of

Representative O'Hara stated that excepting student loans from discharge was a "discriminatory remedy for a 'scandal' which exists primarily in the imagination."⁵²² The House Judiciary Committee did not endorse these restrictions.⁵²³ In taking this position, the House Judiciary Committee cited General Accounting Office data finding that only a fraction of 1% of all matured student loans were discharged in bankruptcy and that bankruptcy filings constituted only three to four percent of student-loan losses, a rate that compared favorably to the consumer credit industry overall.⁵²⁴ When student loans were discharged in bankruptcy, that GAO study found that debtors also had other significant indebtedness, leading to the conclusion that those filings represented genuine financial need, not from attempts to find an easy avenue to student debt relief.

Groups such as the American Bankers Association and Consumer Bankers Association Task Forces on Bankruptcy opposed the 1970s student loan nondischargeability legislation that gave government agencies privileged treatment to collect debts postbankruptcy: "If the social utility of what is exchanged for the debt is to be determinative of dischargeability then the question can be raised of whether it is proper to discharge medical bills, food bills, etc. This proposed [legislation] simply suggests that if sufficient political pressure can be generated, a special interest group can obtain special treatment under the bankruptcy law."⁵²⁵

Student loans were dischargeable in Chapter 13 cases under the Bankruptcy Code until legislation in 1990.⁵²⁶ Particularly in courts that permit three-year low percentage plans, a limitless number of individuals arguably could have attempted to use Chapter 13 to unburden themselves of student debt. However, no empirical evidence has been discovered showing that students systematically were able to take advantage of Chapter 13 to discharge their student debts. According to empirical data on cases in 1981, less than 7/10 of 1% of total debt for wage earners in all consumer cases was for educational loans.⁵²⁷ Perhaps more significantly, that debt was

bankruptcy law).

⁵²² H.R. REP. NO. 95-595, at 148 (1977).

⁵²³ See H.R. REP. NO. 595, at 132 (1977).

⁵²⁴ *Id.*

⁵²⁵ H.R. REP. NO. 95-595, at 150 (1978).

⁵²⁶ See GENERAL ACCOUNTING OFFICE, STUDENT LOANS: CHARACTERISTICS OF DEFAULTED BORROWERS IN THE STAFFORD STUDENT LOAN PROGRAM 7 (April 1991).

⁵²⁷ TERESA A. SULLIVAN, ELIZABETH WARREN, AND JAY LAWRENCE WESTBROOK, AS WE FORGIVE OUR DEBTORS BANKRUPTCY AND CONSUMER CREDIT IN AMERICA 275, Table 14.1

equally likely to be reported in Chapter 7 (where it was nondischargeable) as in Chapter 13 (where it was dischargeable).⁵²⁸ When debtors attempted to use Chapter 13 solely to discharge significant educational loans, some courts denied confirmation under the bad faith doctrine if the facts so required.⁵²⁹

Although the drafters of the nondischargeability provision may have intended that those who truly cannot pay should be relieved of the debt under the undue hardship provision, in practice, nondischargeability has become the broad rule with only a narrowly construed undue hardship discharge.⁵³⁰ Many commentators have recounted the vagaries of the undue hardship exception.⁵³¹ In many courts, undue

Amounts of Debt Owed to Creditors, by Secured and Unsecured Status, for Total Sample, Pure Wage Earners and Ever Self-Employed (1989).

⁵²⁸ *Id.*, at 265, n.11.

⁵²⁹ *See, e.g., In re Doersam*, 849 F.2d 237, 240 (6th Cir. 1988) (denying confirmation for bad faith of debtor when 81% of unsecured debt was student loan debt, and debtor filed for bankruptcy six weeks before graduation); *In re Stewart*, 109 B.R. 998 (D. Kan. 1990) (reversing for bankruptcy court to determine whether confirmation should have been denied for bad faith attempt to discharge student loans through de minimus Chapter 13 payment plan, and also when debtors expenses increased in amount roughly coinciding with income increase). *See also* letter from Hon. Samuel L. Bufford, Bankruptcy Judge, C.D. Cal., NBRC Student Loans (Oct. 3, 1997). In Judge Bufford's experience with approximately 60,000 consumer cases, of which 22,000 were Chapter 13s, he has seen only about five involving unneeded debtors attempting to use bankruptcy only to discharge student loans. Judge Bufford denied confirmation of their Chapter 13 plans for bad faith. *Id.*

⁵³⁰ *See In re Pelkowski*, 990 F.2d 737 (3rd Cir. 1993) (purpose of exception was to protect loan program and prevent abuse, and "Congress has revealed an intent to limit the dischargeability of educational loan debt, and we can construe the provision no more narrowly than the language and legislative history allow"). *Brunner v. New York State Higher Education Services Corp.*, 831 F.2d 395 (2d Cir. 1987) (applying 3 part test: 1) in light of debtor's current level of income and expenses, whether minimal standard of living could be maintained for debtor and dependents if debtor had to repay student loans; 2) additional circumstances that might suggest that debtor's current financial condition would likely continue for significant portion of repayment period; 3) whether debtor had made good faith attempt to repay the student loans). Although debtor in *Brunner* could not find job in field, had been on welfare for 4 months, and greatest annual income in preceding decade was \$9,000, the educational loans were nondischargeable because she was healthy, intelligent and had no dependents, so she would be able to pay if she found work). *See also Pennsylvania Higher Educ. Assistance Agency v. Faish*, 72 F.3d 298(3rd Cir. 1995)(using Brunner test,\$33,000 debt not dischargeable for debtor earning \$27,000 who could not find job in her field, did not own car, had health problems, and was supporting 11 year old son with no child support, and had been making payments for two years); *In re Roberson*, 999 F.2d 1132 (7th Cir. 1993) (using Brunner test, debt discharged where debtor had no income, apartment with no toilet or kitchen, debts exceeding \$34,000, and \$7000 liquid assets).

⁵³¹ *See Jeffrey L. Zackerman, Discharging Student Loans in Bankruptcy: The Need for a Uniform 'Undue Hardship' Test*, 65 U. CIN. L. REV. 1997) (parties have no certainty as to meaning

hardship requires more than severe financial difficulty; debtors sometimes are expected to provide affirmative proof of truly extraordinary circumstances beyond financial inability.⁵³² It hardly is surprising that some courts see few requests for hardship discharges of educational loans given the pitfalls of the undue hardship standard.⁵³³ The borrowers most likely to prevail in many courts are those with the least possibility of being able to litigate the question. The risk of losing is also high. Failure to meet the burden of proof leaves the debtor with the student loan debts and substantial litigation expenses.⁵³⁴

Moreover, even the seven-year nondischargeability period is the subject of much litigation due to the variety of deferral and forbearance options that many student loan grantors provide.⁵³⁵ The seven-year period is tolled if the borrower

of undue hardship test; recommending nationwide adoption of Second Circuit Brunner test so that debts will be dischargeable if debtor unable to maintain minimal standard of living while paying loans, if debtor made good faith attempt to repay, and consideration of additional circumstances); Robert F. Salvin, *Student Loans, Bankruptcy, and the Fresh Start Policy: Must Debtors be Impoverished to Discharge Educational Loans?*, 71 TULANE L. REV. 139 (1996) (reviewing disputes in the case law and concluding undue hardship should be found to exist for any debtor who will not be able to maintain a middle-class lifestyle and while simultaneously repaying student-loan debt); Thad Collins *Forging Middle Ground: Revision of Student Loan Debts in Bankruptcy as an Impetus to Amend 11 U.S.C. § 523(a)(8)*, 75 IOWA L. REV. 733, 738 (1990); Darrell Dunham & Ronald A. Buch, "Educational Debts under the Bankruptcy Code," 22 MEMPHIS ST. U. L. REV. 679 (1992); Jerome M. Organ, "Good Faith" and the Discharge of Educational Loans in Chapter 13: Forging a Judicial Consensus, 38 VAND. L. REV. 1087, 1088-92 (1985); Kurt Wiese, *Discharging Student Loans in Bankruptcy: The Bankruptcy Court Tests of 'Undue Hardship'*, 26 ARIZ. L. REV. 445, 449 (1984); Lawrence Kalevitch, *Educational Loans in Bankruptcy*, 1982 N. ILL. U. L. REV. 325; Ted D. Ayres & Dianne R. Sanger, *The Bankruptcy Reform Act and Student Loans: Unraveling New Knots*, 9 J.C. & U.L. 361, 368 (1982-83) Janice E. Kosel, *Running the Gauntlet of 'Undue Hardship' - The Discharge of Student Loans in Bankruptcy*, 11 GOLDEN GATE U. L. REV. 457, 464 (1981); Alan M. Ahart, *Discharging Student Loans in Bankruptcy*, 52 AM. BANKR. L.J. 201, 206 (1978).

⁵³² See, e.g., *In re Koch*, 144 B.R. 959 (Bankr. W.D. Pa. 1992) (debtor must show that he suffers from truly severe and uniquely difficult circumstances and that he can pay none of loan); *In re Stebbins-Hopf*, 176 B.R. 784 (Bankr. W.D. Tex. 1994) (student loans nondischargeable where debtor chose to provide financial help to family members since moral obligations do not take priority over legal obligations, debtor could work, and her financial problems were not permanent).

⁵³³ See *Pennsylvania Higher Educ. Assistance Agency v. Faish*, 72 F.3d 298 (3rd Cir. 1995) (acknowledging difficulty for debtor to present evidence of undue hardship since courts do not take unified approach and litigants don't know applicable standards).

⁵³⁴ See, e.g., Electronic Mail from David L. Gibbs, Student Loan Dischargeability, (June 26, 1997) (client spent \$2,000 to seek hardship discharge and failed).

⁵³⁵ The nondischargeability period was extended from five to seven years in 1988, bringing more debtors potentially in the purview of this test.

requests the deferral, but lenders sometimes argue that a period of nonpayment retroactively can be deemed a deferral, yielding a longer nondischargeability period.⁵³⁶ In addition, a loan consolidation may start the seven-year period anew.⁵³⁷

It frequently is argued that student loans must remain presumptively nondischargeable to ensure that those with promising future income streams remain liable to preserve student loan funding in the future.⁵³⁸ This view is premised on the notion that if student loans are dischargeable, professional students will flock in droves to the bankruptcy system. As stated previously, the available evidence does not support the notion that the bankruptcy system was systematically abused when student loans were more easily dischargeable. Furthermore, empirical evidence does not support the oft-cited allegation that changes in bankruptcy law entitlements—exemptions, dischargeability, or otherwise—affect the rate of filing for bankruptcy to obtain those benefits.⁵³⁹ The fear that soon-to-be rich professionals would line up for bankruptcy to do away with their student loans remains a questionable proposition judging by earlier experiences when student loans were dischargeable and by long-term data on influences on bankruptcy filings.⁵⁴⁰ Defaults

⁵³⁶ See, e.g., *In re Huber*, 169 B.R. 82 (Bankr. W.D.N.Y. 1994) (lender cannot buy itself longer dischargeability period by unilateral or retroactive “suspension” of payments); *In re Flynn*, 190 B.R. 139 (Bankr. D.N.H. 1995); *In re Chisari*, 183 B.R. 963 (Bankr. M.D. Fla. 1995).

⁵³⁷ *In re Hesselgrave*, 177 B.R. 681 (Bankr. D. Or. 1995); *Hiatt v. Indiana State Student Assistance Comm’n*, 36 F.3d 21 (7th Cir 1994). See Letter from Laura J. Walker, Cable, Benedict, & Haagensen, Portland OR (May 9, 1997) (citing cases holding that refinancing triggers new seven year nondischargeability period and suggesting that this may be contrary to Congressional intent).

⁵³⁸ See Letter from Marshall S. Smith, Acting Deputy Secretary, United States Department of Education (July 29, 1997) (opposing Proposal to eliminate section 523(a)(8)). “Congress’ primary legislative intent in enacting section 523(a)(8) was to maintain the solvency of education lending programs in order to achieve the goal of promoting access to higher education.” Letter from Ernest T. Freeman, President and Chief Executive Officer, The Education Resources Institute (September 18, 1997).

⁵³⁹ See, e.g., Ian Domowitz & Thomas L. Eovaldi, THE IMPACT OF THE BANKRUPTCY REFORM ACT OF 1978 ON CONSUMER BANKRUPTCY,” 2 J. L. & ECON. 803, 805 (1993) (“Code cannot be established as the cause of any major increase in the number of nonbusiness bankruptcies”); KIM J. KOWALEWSKI, PERSONAL BANKRUPTCY: THEORY AND EVIDENCE, FEDERAL RESERVE BANK OF CLEVELAND ECONOMIC REVIEW 1-29 (1982); CHARLES A. LUCKETT, PERSONAL BANKRUPTCY (1988); TERESA A. SULLIVAN, ELIZABETH WARREN, JAY L. WESTBROOK, AS WE FORGIVE OUR DEBTORS; BANKRUPTCY AND CONSUMER CREDIT IN AMERICA (1989). See also Ian Domowitz & Elie Tamer, Two Hundred Years of Bankruptcy: A Tale of Legislation and Economic Fluctuations, 37 (Unpublished Manuscript) (May 1997) (changes in law to restrict consumer options would have no substantial effect on consumer filings).

⁵⁴⁰ *Id.* See also Electronic mail from Wendell Sherk to the National Bankruptcy Review Commission (July 2, 1997) (noting that he rarely sees anyone trying to dispose of student loans who

may rise or fall as the number of borrowers and size of tuition bills change at all types of institutions beyond the ability of students to repay, but this happens to a large extent irrespective of dischargeability in bankruptcy.

No one questions the fact that insured student loan programs further federal policy supporting vocational and higher education. They are significant in helping students obtain access to higher education or technical training. Such programs are funded on the assumption, in part, that many students simply will be unable to repay these loans, whether or not they discharge them in bankruptcy:

Consideration of various reform proposals during the 1980s centered on the recognition that there is a 'subsidy element' to a government loan guarantee program. If all loans were repaid, there would be no cost to the government apart from administrative expenses. Were this the case, however, there would probably have been no need for the program to begin with. Since the objective of a loan guarantee program is to enhance the availability of credit which the private lending market alone cannot or will not provide, it is reasonable to expect that there will be defaults, most likely at a higher rate than the private lending market experiences.⁵⁴¹

The government does not refuse to guarantee loans that may be hard to collect. The potential difficulty in collection often is what necessitates government insured programs. The government inherently has enhanced collection tools, such as access to social security information, ability to offset against tax refunds, and heightened wage garnishment ability, but may be less vigilant in its collection efforts than private insurers. Although they bear significant distinctions from the G.I. Bill and grant programs that formerly were prevalent in helping to educate the American population,

was successful because of his or her education, and concluding that the change should not create any real public relations backlash but will help a lot of people who were never given any real benefits). In fact, law school graduates who file for bankruptcy to discharge their student loans run a significant risk of being denied admission to the bar, a significant nonbankruptcy law deterrent to filing for bankruptcy and discharging educational loans. *See, e.g., In re Anonymous*, 549 N.E.2d 472 (N.Y. (1989) (application for admission to bar properly denied when applicant lacked financial responsibility that bar thought was necessary for attorneys); *In re Application of Taylor*, 647 P.2d 462 (Or. 1982) (applicant for bar admission lacked good moral character where applicant had discharged student loans, among other allegations). *But see Board of Law Examiners of the State of Texas v. Stevens*, 850 S.W.2d 558 (Tex. App. 1992) (application for bar admission should not have been denied for lack of moral character where his actions would not hurt future clients; applicant had severe financial difficulties arising partly from his failure to pay taxes).

⁵⁴¹ UNITED STATES GENERAL ACCOUNTING OFFICE, OFFICE OF THE GENERAL COUNSEL, PRINCIPLES OF FEDERAL APPROPRIATIONS LAW, 1992 WL 700432, 11 GAO-RB pt. B. sec. 2 (2d Ed. 1992) (discussing Federal Credit Reform Act of 1990).

government-guaranteed student loans are the closest approximation to those types of subsidies. They serve the same functions to help Americans receive an education, a goal that Congress continues to embrace strongly.

The fact that student loans may sometimes be uncollectible does not mean that the bankruptcy system should encourage any increase in the level of defaults. However, whether or not borrowers can discharge their student loans in bankruptcy, many will continue to default and be unable to repay. In 1991, the GAO reviewed numerous empirical studies to isolate characteristics of the average student loan defaulter.⁵⁴² The GAO reported the following defaulter characteristics: they had attended vocational or trade school;⁵⁴³ they had low incomes, with five studies finding that the majority of defaulters had incomes of \$10,000 or less;⁵⁴⁴ the borrowers were unemployed at the time of default;⁵⁴⁵ they had borrowed small amounts; they had little or no financial support from others; many had minority backgrounds; some lacked high school diplomas; many did not complete the program for which they obtained the student loans, often attending for one year or less.

The GAO provided an additional explanation of student loan collection:

Several other problems associated with student loans also make it difficult to collect. Our February 1997 high-risk series report, for example, noted that many student borrowers have little or no means to repay their loans because they attended poor quality proprietary schools that failed to provide them with marketable skills. In addition, we have also reported that, in the past, many student loans were initiated absent important controls critical to mitigating risks up front, including checks to identify prior defaults on the part of applicants.⁵⁴⁶

⁵⁴² GENERAL ACCOUNTING OFFICE, STUDENT LOANS; CHARACTERISTICS OF DEFAULTED BORROWERS IN THE STAFFORD STUDENT LOAN PROGRAM (April 1991).

⁵⁴³ Default rate by students at vocational or trade schools ranged from 29-62%. *Id.* at 13.

⁵⁴⁴ *Id.* at 14. Three studies found that 75% had incomes of \$15,000 or less.

⁵⁴⁵ In the two studies that identified this factor, 37% and 51% of defaulters were unemployed at time of default. *Id.* at 21.

⁵⁴⁶ UNITED STATES GENERAL ACCOUNTING OFFICE, DEBT COLLECTION - IMPROVED REPORTING NEEDED ON BILLIONS OF DOLLARS IN DELINQUENT DEBT AND AGENCY COLLECTION PERFORMANCE, Report to the Chairman, Committee on the Budget, House of Representatives, 1997 WL 358072 GAO/AIMD 97-48 (Fed. Doc. Clearing House June 2, 1997) *citing* High-Risk Series: Student Financial Aid (GAO/HR-97-20SET, Feb. 1997). Delinquent student loans are harder to collect than the other types of loans discussed in this report for several reasons. First, unlike the

The GAO report indirectly illustrates a different kind of abuse that has complicated the issues surrounding student loans. Because the loans are guaranteed, some trade or technical schools enroll people for government guaranteed student loans with little explanation of the obligation undertaken and take the tuition dollars without providing any real training of value that leads to employability. Others note another type of misuse: the heightened debt burden of students is exacerbated significantly when schools are able to raise their tuition to take advantage of the money that will flow in from government-guaranteed loans; for example, one author has noted tuition at public law schools jumped over 171% between 1978 and 1988.⁵⁴⁷

If student loans could be discharged once again, the government and the lenders would not be powerless to protect themselves. If lenders request family co-signors, there is a significant disincentive to bankruptcy filing unless both the student and the co-signors are in financial trouble. If a child in a wealthy family seeks to borrow money and discharge it in bankruptcy, that child's family will remain liable on the obligation unless the family is willing to liquidate all property in excess of exemptions and subject itself to the bankruptcy process as well. Families with meager means may discharge the debt in bankruptcy, but these are the families most likely to have defaulted on the student loan even if the debt were not dischargeable. Making more student loans nondischargeable does not alter the defaulters' inability to repay the loans.

The Commission recommends that Congress eliminate section 523(a)(8) so that most student loans are treated like all other unsecured debts. In so doing, the dischargeability provisions would be consistent with federal policy to encourage educational endeavors. The Recommendation would also address the numerous application problems that have resulted from the current nondischargeability provision. No longer would Chapter 13 debtors who made diligent efforts to repay be penalized after completing a plan with thousands and thousands in compounded back due interest. Litigation over "undue hardship" would be eliminated, so that the discharge of student loans no longer would be denied to those who need it most.

This Recommendation would not change the treatment of Health Education Assistance Loans. Such loans are available in a specialized profession, with a

housing loans, student loans are unsecured, leaving the government and private lender with no collateral. Second, for the loans on which Education itself is trying to collect, delinquent cases are not received until both lenders and the guaranty agencies have attempted collection, a process which typically lasts at least 4 years after the debt became delinquent. Third, it is more difficult to locate and contact borrowers who frequently relocate after attending post secondary schools, experience name changes in the event of marriage, and, in general, tend to have more frequent changes in residences." *Id.*

⁵⁴⁷ Arthur Ryman, *Contract Obligation: A Discussion of Morality, Bankruptcy, and Student Debt*, 42 DRAKE L. REV. 205, 221 n.100 (1993).

significant proportion of the funding devoted to physician training. The presumption of adequate income to repay such loans is stronger in these cases.⁵⁴⁸ Under the Commission's Recommendation, loans for medical education governed by special federal legislation, such as the HEAL program, should remain nondischargeable under the terms provided by that special legislation. Congress could, however, set forth those provisions in section 523(a)(8) in place of the current text, to counter any trend to scatter bankruptcy legislation outside Title 11.

1.4.6 *Issue Preclusive Effect of True Defaults*

For complaints to establish nondischargeability on grounds set forth in section 523(c), the Bankruptcy Code should clarify that issues that were not actually litigated and necessary to a prior judgment shall not be given preclusive effect.

Discharge is a unique feature of the bankruptcy laws. Whether a particular debt is dischargeable has been a federal question governed by bankruptcy law since Congress amended the Bankruptcy Act of 1898 in 1970.⁵⁴⁹ As a general matter, Congress delegated to the federal courts the exclusive right to determine the dischargeability of certain debts in bankruptcy, particularly for allegations of fraud, defalcation, or intentional tort.⁵⁵⁰ When parties seek the application of an exception to discharge under section 523 of the Bankruptcy Code, courts are obligated to construe those sections narrowly,⁵⁵¹ and for good reason: debts excepted from discharge are treated differently than all other debts for overriding policy reasons, not mere fiat.⁵⁵²

⁵⁴⁸ Even HEAL loans are dischargeable seven years after the first date that repayment of loan is required, excluding any suspension period, and earlier if continued liability would be "unconscionable." See 42 U.S.C. § 292f(g) (1994). Nothing in this Recommendation would change that provision. *But see In re Tanksi*, 195 B.R. 408 (Bankr. E.D. Wis. 1996) (HEAL loans under second filing are governed by section 523(a)(8)). See Letter from Thomas P. Schneider, United States Attorney, Eastern District of Wisconsin to Brady C. Williamson, (April 2, 1997) (advocating deletion of reference to HEAL loans in section 523(b)).

⁵⁴⁹ *Grogan v. Garner*, 498 U.S. 279, 284 (1991), citing S.REP. NO. 91-1173, at 2-3 (1970); H.R. REP. NO. 91-1502, at 1 (1970), reprinted in U.S.C.C.A.N. 4156.

⁵⁵⁰ *Brown v. Felsen*, 442 U.S. 127, 138 (1979).

⁵⁵¹ See, e.g., *Schweig v. Hunter*, 780 F.2d 1577, 1579 (11th Cir. 1986); *Manufacturer's Hanover Trust Co. v. Ward*, 857 F.2d 1082, 1083 (6th Cir. 1988).

⁵⁵² See *Thul v. Ophaug*, 827 F.2d 340 (8th Cir. 1987). Some exceptions to discharge, such as those for certain taxes and alimony, are justified by other public policy reasons, e.g., to protect the public fisc. Because these exceptions do not expressly require litigation in the bankruptcy court and

Although determination of discharge status is a federal question, some factors that give rise to a determination of nondischargeability may have been established prior to the bankruptcy case. In some cases, creditors and debtors have already been involved in legal actions that may have a bearing on issues that overlap with elements in a nondischargeability determination. The question of this Recommendation is whether a prebankruptcy default judgment can make a debt conclusively nondischargeable in bankruptcy without any presentation of evidence of the debtor's wrongdoing.

A hypothetical fact pattern will help illustrate the problem. A creditor sues an individual to collect a debt. The defendant does not appear at the state court hearing because her employer will not excuse her from work or because she cannot afford an attorney. In the defendant's absence, the judge enters a default judgment. The creditor included a charge of fraud in the order submitted to the court. Later, the defendant files for bankruptcy. The creditor in the prior lawsuit alleges that the debt is nondischargeable because the default judgment includes a claim of fraud. While the debtor asserts that she did not commit fraud, and that the debt should not be treated differently from her other debts that are being discharged, the creditor states that she cannot make that claim because the default judgment refers to fraud and therefore the issue has been established conclusively.

Under federal issue preclusion doctrine, the debtor would have an opportunity to contest the charge of fraud in the context of nondischargeability because the issue was never actually litigated in state court.⁵⁵³ This is consistent with the general rule on issue preclusion set forth in the Restatement (Second) of Judgments:

When an issue of fact or law is actually litigated and determined by a valid and final judgment, and the determination is essential to the judgment, the determination is conclusive in a subsequent action between the parties, whether on the same or a different claim.⁵⁵⁴

The federal rule and Restatement rule are based on sound policy considerations. When parties have actually litigated the issue that triggers nondischargeability, the judicial doctrine of issue preclusion prevents needless

are of a different nature, they are not amenable to being the subject of issue preclusion problems.

⁵⁵³ See, e.g., *Allen v. McCurry*, 449 U.S. 90, 94 (1980), citing *Montana v. United States*, 440 U.S. 147, 153 (1979); *Klingman v. Levinson* 831 F.2d 1292, 1295 (7th Cir. 1987).

⁵⁵⁴ RESTATEMENT (SECOND) OF JUDGMENTS § 27 (1982).

litigation.⁵⁵⁵ Issue preclusion relieves parties of the cost and vexation of multiple lawsuits, conserves judicial resources, and, by preventing inconsistent decisions, encourages reliance on adjudication.⁵⁵⁶

However, not all courts use the same test for issue preclusion. In some state courts, actual litigation is not a prerequisite to issue preclusion, so that a default judgment can preclude subsequent challenges in a different forum. The issue arises in bankruptcy because not all bankruptcy courts automatically apply federal issue preclusion doctrine. Rather, courts give prior judgments the same “full faith and credit” as the state courts from which they were taken.⁵⁵⁷ Although this rule has its limits and is inapplicable if the prior action had woefully deficient procedures⁵⁵⁸ or if Congress provides a statutory exception,⁵⁵⁹ bankruptcy courts are generally free to apply state issue preclusion rules—including preclusion based on a default judgment—to dischargeability proceedings.

If a state court were to consider its judgment’s effect on a subsequent federal proceeding invoking unique federal issues, the state court might well determine that the federal, not the state, issue preclusion doctrine should apply. However, this possibility rarely enters into the analysis. Rather, courts consider only the issue preclusion doctrine of the state court in which the judgment was rendered. In so doing, the Sixth and Ninth Circuit Courts of Appeals have determined that the issues

⁵⁵⁵ *Grogan v. Garner*, 498 U.S. 279, 285, n.11 (1991); *Parklane Hosiery Co. v. Shore*, 439 U.S. 322, 326 (1979).

⁵⁵⁶ *Montana v. United States*, 440 U.S. 147 (1979).

⁵⁵⁷ 28 U.S.C. § 1738 (1994). *Matsushita Elec. Indus. Co., Ltd. v. Epstein*, 116 S. Ct. 873, 877 (1996). The Full Faith and Credit Clause of the United States Constitution, Article IV, section 1, applies only to state recognition of other states’ judgments.

⁵⁵⁸ It ordinarily is a violation of due process for a judgment to be binding on a litigant who was not a party or a privy and therefore has never had an opportunity to be heard. *Parklane Hosiery Co. v. Shore*, 439 U.S. 322, 327 n.7 (1979), *citing* *Blonder-Tongue Laboratories, Inc. v. University of Illinois Foundation*, 402 U.S. 313, 329 (1971). Applying a slightly broader exception than the due process standard, the Supreme Court also has “previously recognized that the judicially created doctrine of collateral estoppel does not apply when the party against whom the earlier decision is asserted did not have a ‘full and fair’ opportunity to litigate.” *Kremer v. Chemical Construction*, 456 U.S. 461, 480-481 (1982). “Redetermination is warranted if there is reason to doubt the quality, extensiveness, or fairness of procedures followed in prior litigation.” *Id.*, *citing* *Montana v. United States*, 440 U.S. 147, 164 (1979).

⁵⁵⁹ For example, the first habeas corpus statute rendered state court proceedings null and void that were inconsistent with the decision of a federal habeas court. *Allen v. McCurry*, 449 U.S. 90, 98 n.12 (1980), *quoting* Act of Feb. 5, 1867, ch. 28., s 1, 14 Stat. 385, 386, *codified as amended* at 28 U.S.C. § 2254 (1994).

of fraud and defalcation were decided conclusively in prior state court default judgments because Florida and California law, which governed the prior proceedings in those cases, did not require issues to be actually litigated for issue preclusion purposes.⁵⁶⁰ Therefore, although no evidence on fraud or defalcation was presented in the state court hearings on fraud or defalcation, these debts were deemed to be nondischargeable in subsequent bankruptcy cases without any litigation on the merits.

The result reached by the Sixth and Ninth Circuits is troubling for several reasons. It is inconsistent with Congressional intent to except from discharge a narrow class of debt for public policy reasons and generally to treat all creditors equally. While a bankruptcy court defers to prior state court judgments when the issues relevant to dischargeability have been litigated fully, an issue that was never litigated at all provides an insufficient basis on which to make a debt nondischargeable. In instances of true default judgments, completely forgoing litigation of the grounds for nondischargeability is inconsistent with the exclusive jurisdiction of the federal district and bankruptcy courts over dischargeability actions. Issue preclusion in this context should bar *re*-litigation—not initial litigation—of issues that were actually litigated and decided in a previous action, as federal issue preclusion doctrine generally demands.⁵⁶¹

In addition, permitting default judgments to be preclusive in discharge litigation yields substantial disparities. This problem is illustrated by comparing three appellate cases in the Ninth Circuit: As mentioned previously, in *In re Nourbakhsh*, the Ninth Circuit held a debt nondischargeable based on a Florida court default judgment. However, in *In re Davis*, after a district court gave preclusive effect to an Arizona default judgment, the Ninth Circuit reversed the district court because Arizona law required actual litigation as a prerequisite to issue preclusion.⁵⁶² In a third case, *Silva v. Smith's Pacific Shrimp*, the prior judgment at issue came from a federal court based on diversity jurisdiction. Because the judgment was based on an unopposed motion for summary judgment, the Ninth Circuit held that it did not satisfy

⁵⁶⁰ See, e.g., *Bay Area Factors v. Calvert*, 105 F.3d 315 (6th Cir. 1997) (precluding relitigation of fraud after California court default judgment that contained no specific findings of fraud); *Gayden v. Nourbakhsh*, 67 F.3d 798 (9th Cir. 1995) (precluding relitigation of fraud after Florida court default judgment that contained finding of fraud). *But see* Stephen J. Burbank, *Interjurisdictional Preclusion, Full Faith and Credit and Federal Common Law: A General Approach*, 71 CORNELL L. REV. 733, 737 (1986) (“Once one recognizes that the full faith and credit statute states or chooses only a domestic referent and not domestic state preclusion law, it is not apparent why a general approach to federal common law should not also accommodate problems concerning the preclusive effects of state judicial proceedings”).

⁵⁶¹ *Gober v. Terra + Corp.*, 100 F.3d 1195, 1199 n.2 (5th Cir. 1996), *citing* RESTATEMENT (SECOND) OF JUDGMENTS, Introductory Note to ch. 1 (1982).

⁵⁶² *Feltor v. Davis (In re Davis)*, 108 F.3d 337 (9th Cir. 1994).

the requirements for issue preclusion.⁵⁶³ The rules in the Ninth Circuit alone differ for default judgments from state courts versus federal courts and from one state to another. In other words, the geographic location of a prior default judgment has become determinative of whether the debtor will have the opportunity to litigate a federal cause of action, the nondischargeability of an otherwise dischargeable claim.

Permitting default judgments to constitute the basis of nondischargeability also encourages some questionable practices that Congress expressly has sought to avoid. Longstanding concerns about debtor-creditor relations justify the apprehension of judges, scholars, and practitioners about the problem of reliance on default judgments. Until 1970, under the Bankruptcy Act of 1898, the discharge of debt was not self executing, but rather it was an affirmative defense in subsequent proceedings. Creditors would bring state court actions postbankruptcy that included allegations of fraud on prepetition debts based on claimed mistakes on financial statements. Debtors failed to defend themselves in these actions because of “an inability to retain an attorney due to lack of funds” or because of a mistaken reliance on their bankruptcy discharge.⁵⁶⁴ This practice significantly undermined the bankruptcy process and the scope of the discharge.⁵⁶⁵ In response, in 1970, Congress amended the Bankruptcy Act of 1898 to make the discharge automatic and to require creditors to file and litigate certain nondischargeability actions in the context of the bankruptcy itself if they intended to assert them at all.⁵⁶⁶ Congress also sought to further the bankruptcy judges’ expertise in analyzing exceptions to discharge.⁵⁶⁷

The current situation presents the opportunity for a new twist on the problem that occurred under the Bankruptcy Act. Now, state court actions, which almost invariably include a fraud count, are begun before the debtor has filed a bankruptcy petition. If the debtor fails to respond, either because of a misunderstanding or

⁵⁶³ 190 B.R. 889 (B.A.P. 9th Cir. 1995) (unopposed motion for summary judgment in Washington case does not prevent subsequent litigation).

⁵⁶⁴ H.R. REP. NO. 91-1502, at 1 (1970).

⁵⁶⁵ *Id.* at 3.

⁵⁶⁶ “The 1970 amendments took jurisdiction over certain dischargeability exceptions, including the exception for fraud, away from the state courts and vested jurisdiction exclusively in the bankruptcy courts.” *Grogan v. Garner*, 498 U.S. 279 284, n. 10 (1991), *citing* *Brown v. Felsen*, 442 U.S. at 135-136; S. REP. NO. 91-1173, at 2-3 (1970); H.R. REP. NO. 91-1502, at 1 (1970), 1970 U.S.C.C.A.N. 4156.

⁵⁶⁷ H.R. REP. NO. 91-1502, at 2 (1970). *See generally* Jon T. Alexander, Comment, *Issue Preclusion, Full Faith and Credit, and Default Judgments: A Dilemma For the Bankruptcy Courts*, 44 UCLA L. REV. 159, 173 (1996).

because the debtor lacks the financial resources to hire an attorney,⁵⁶⁸ a default judgment will be entered against the debtor that will have the effect of making the debt nondischargeable. This has a particularly harsh effect on *pro se* debtors.⁵⁶⁹

The Bankruptcy Code already recognizes that prior judgments do not always provide the information necessary to make determinations about dischargeability because dischargeability raises different questions that necessitate independent decisions about the nature or character of those judgments. For example, courts must make independent determinations of whether a domestic relations obligation is actually a support obligation, regardless of how the parties or a state court have denominated the legal obligation.⁵⁷⁰

The writings of Professor Stephen Burbank, a noted federal courts scholar, suggest that this Recommendation would not be inconsistent with the full faith and credit statute: “There is a federal interest in ensuring that legal rules used in the process by which rights under federal substantive law are recognized and enforced are not inimical to a particular scheme of federal substantive rights. This interest exists whether federal or state law provides the process and however the rules are characterized. In the case of litigation in the federal courts, the existence of the interests suffices, under traditional federal common law analysis, to trigger the conclusion that federal law governs.”⁵⁷¹ The rule proposed here is consistent with other federal policies.

The primary concern of this Proposal is “true” or “ordinary” defaults, not situations where a debtor may have participated substantially and extensively in a prior

⁵⁶⁸ “I cannot help but believe that the broad reading of the ‘actually litigated’ requirement is a trap for unwary and innocent debtors that cannot afford counsel. I suspect that many of these debtors do not contest liability because they admit that they owe the money (albeit not because of any fraud).” Letter from Hon. Edward D. Jellen, Chief Bankruptcy Judge, N.D. Cal. to Elizabeth Warren, 2 (February 5, 1997).

⁵⁶⁹ See Memorandum from Wayne Johnson, Consumer Bankruptcy Issues, 3 (July 25, 1996).

⁵⁷⁰ 11 U.S.C. §523(a)(5) (1994).

⁵⁷¹ Stephen J. Burbank, *Interjurisdictional Preclusion, Full Faith and Credit and Federal Common Law: A General Approach*, 71 CORNELL L. REV. 733, 737 (1986) (concluding that contrary to Supreme Court’s interpretation, Full Faith and Credit statute does not choose domestic preclusion law of rendering state, but rather it requires application in interjurisdictional cases of law that courts of rendering state should apply). “Under traditional federal common law analysis a court must still be alert to the possibility that application of state law, borrowed as federal law, will thwart the purposes of, or otherwise interfere with, federal substantive law. In that event, the offending state law rule is displaced, because federal sources require otherwise than that it apply.” *Id.*, at 765.

adversary proceeding but then managed to force entry of a default rather than a litigated judgment. As such, this Proposal is not intended to affect courts' determinations of what is "actually litigated" for issue preclusion purposes.⁵⁷² A court may hear evidence and make its own determination of when a default judgment is or is not a true default judgment.

Competing Considerations. For those who believe that bankruptcy law must incorporate as much state law as possible, failure to apply state law preclusion standards, even in actions that are exclusively federal bankruptcy actions, may seem inappropriate. This concern does not address the possibility that state courts might have applied federal preclusion standards in some circumstances.

Others do not think this Proposal goes far enough because it does not specifically require the application of the federal issue preclusion standards.⁵⁷³ This means that liberal interpretations of actual litigation still could prevent an actual determination of fraud or other bases for making a debt nondischargeable.

1.4.7 *Vicarious Liability*

Section 523(c) should be amended such that intentional action by a wrongdoer who is not the debtor cannot be imputed to the debtor.

Some sources of law impose liability without individual culpability. Under partnership law, partners are liable for partnership debts incurred by any of them in the ordinary course of business;⁵⁷⁴ liability is not premised on the intent of the

⁵⁷² *Pahlavi v. Ansari*, 113 F.3d 17 (4th Cir. 1997) (although default judgment ultimately entered, issue of defalcation actually litigated); *Gober v. Terra + Corp.*, 100 F.3d 1195, 1199-1200 (5th Cir. 1996) (parties actively litigated for two years before debtor failed to attend hearing that yielded default judgment, which satisfied Texas' requirement that issue be actually litigated and essential to judgment); *Bush v. Balfour Beatty Bahamas, Ltd.*, 62 F.3d 1319 (11th Cir. 1995); *In re Daily*, 47 F.3d 365, 368-69 (9th Cir. 1995) (party who deliberately precludes resolution of factual issues through normal adjudicative procedures may be bound, in subsequent, related proceedings involving same parties and issues, by prior judicial determination reached without completion of usual process of adjudication).

⁵⁷³ See Letter from Christopher S. Moffitt, NBRC Recommendations Concerning Issue Preclusion (September 11, 1997) (noting that Fourth Circuit law has weakened "actual litigation" standard and uses elastic standard as to what constitutes valid binding judgment of court, thus advocating use of federal issue preclusion standards, per se prohibition of default judgment, summary judgment, or consent judgment).

⁵⁷⁴ UNIFORM PARTNERSHIP ACT § 15 (1992).

partners.⁵⁷⁵ Likewise, tort law imposes vicarious liability under the doctrine of respondeat superior, again without a showing of intent on the party of the debtor.⁵⁷⁶ Similarly, some state laws make parents responsible for the offenses of their children.⁵⁷⁷

By contrast, a nondischargeability finding is based principally on the debtor's individual culpable conduct.⁵⁷⁸ This is especially true of the more frequently-litigated categories of nondischargeable debts in section 523(a) that contain an express or inherent intent requirement, *e.g.*, those for fraud, defalcation, and willful and malicious injury. Debts are excepted from discharge for public policy reasons to deter intentional conduct and to eliminate the benefits of the debtor's inappropriate actions. The plain language of the nondischargeability provisions indicates Congressional intention that many nondischargeability provisions are triggered specifically by the intention and activity of the debtor, not some other party. For example, section 523(a)(6) excepts from discharge those debts "for *willful and malicious* injury by the debtor to another entity or to property of another entity." If a husband is ignorant of his wife's intentional tort, he may be liable on the underlying debt, but he has not acted with any ill intent that would make that debt nondischargeable as to him. Because spouses have no formal agency relationship, it is inappropriate to permit one spouse's intent to be imputed to another for purposes of nondischargeability.⁵⁷⁹ For this reason, some courts have rejected vicarious liability as a basis for

⁵⁷⁵ *Id.* §13.

⁵⁷⁶ *In re Rex*, 150 B.R. 505 (Bankr. D. Mass. 1993) (no vicarious liability for section 523(a)(6) action).

⁵⁷⁷ *See, e.g.*, *Deroche v. Miller*, 196 B.R. 334, 336 (Bankr. E.D. La. 1996) (refusing to impute liability even though Louisiana Civil Code made parents answerable for offenses or quasi-offenses committed by their children); *Jones v. Whiteacre*, 93 B.R. 584, 585 (Bankr. N.D. Ohio 1988) (refusing to impute child's intent to parents).

⁵⁷⁸ *Neal v. Clark*, 95 U.S. 704 (1877).

⁵⁷⁹ Steven H. Resnicoff, *Is it Morally Wrong to Depend on the Honesty of Your Partner or Spouse? Bankruptcy Dischargeability of Vicarious Debt*, 42 CASE W. RES. L. REV. 147 (1992).

nondischargeability under section 523(a)(6).⁵⁸⁰ Likewise, some courts have refused to impute liability for actions under section 523(a)(2)(A).⁵⁸¹

However, courts have not always fully embraced this view. The Supreme Court held in 1885 that an obligation of an individual partner could be imputed to other partners who benefitted from the fraud.⁵⁸² Others have followed this line of reasoning and have determined that debts are nondischargeable on account of the

⁵⁸⁰ *Columbia Farms Distribution, Inc. v. Maltais*, 202 B.R. 807 (Bankr. D. Mass. 1996) (nondischargeability of debt under section 523(a)(6) cannot be grounded on imputation to debtor of acts of another); *Deroche v. Miller*, 196 B.R. 334, 336 (Bankr. E.D. La. 1996) (“plain meaning test requires that the debtor must have been the one who caused the willful and malicious injury. Imputed liability is insufficient [for section 523(a)(6)],” thus not applying vicarious liability to debtor for act of her child), *citing* *United States v. Ron Pair Enterprises, Inc.*, 489 U.S. 235, 241 (1989). “The statute is not concerned with liability which, as here, is vicariously imposed upon a debtor under the doctrine of respondeat superior solely by reason of the intentional and malicious conduct of the debtor’s agent or servant.” *In re Rex*, 150 B.R. 505, 506 (Bankr. D. Mass. 1993) (debt not dischargeable under section 523(a)(6) for acts of debtor’s agent, and finding decisions on point to be consistent with this holding); *Giuliano v. Albano*, 143 B.R. 323 (Bankr. D. Conn. 1992) (rejecting vicarious liability for willful and malicious injury based on actions of bouncer at debtor’s restaurant because nothing in language or legislative history of section 523(a)(6) suggests that common law notions of vicarious or imputed liability on agency theory are appended to statutory exceptions to discharge).

⁵⁸¹ *See* *Neal v. Clark*, 95 U.S. 704 (1877) (debt is dischargeable, even if dishonestly incurred, if the debtor did not participate in the dishonest actions); *Aetna Casualty and Surety Co. v. Markarian*, 208 B.R. 249 (Bankr. 1st Cir. 1997) (portions of judgment debt attributable to codefendants’ wrongdoing not included in nondischargeable debt under section 523(a)(2)(A)). *See also* *Walker v. Citizens State Bank*, 726 F.2d 452, 454 (8th Cir.1984) (fraud not imputed to debtor/principal spouse unless debtor knew or should have known of fraud, or was recklessly indifferent to agent’s act).

⁵⁸² *Strang v. Bradner*, 114 U.S. 555, 561 (1885) (partners legally obligated for each others’ misrepresentations, and thus resulting debts nondischargeable for all partners, especially benefitting from “fruits of the fraudulent conduct”).

innocent debtor's partner or agent's action and intent.⁵⁸³ This disparity creates confusion and more litigation in the courts.

In the context of its deliberation on partners as debtors, the Commission first proposed that partners should not be vicariously liable for intentional acts of other partners.⁵⁸⁴ Whether the partnership is large and diffuse or small, partners may be wholly unaware of their co-partners' ill-intended activities. The "innocent" debtor does not necessarily gain from the inappropriate activity of a partner, when, for example, one partner steals goods entrusted to the partnership.

The Commission voted to extend this preclusion of vicarious liability to other contexts. Vicarious liability is particularly troubling if implemented to transfer liability between spouses or other social relations because the predicate assumptions for applying vicarious liability are not present at all between non-agent spouses. Debtors' involvement in a non-profit-seeking social relationship should not be the sole basis for punishing a debtor for the ill-intentioned act of another. This Proposal seeks to minimize uncertainty and to adopt the trend in more recent bankruptcy court decisions that the creditor bringing a nondischargeability action must prove that the debtor had the requisite intent, whether the debtor is the spouse, the employer, or the principal of a wrongdoing agent. Of course, the fact of partnership or marriage may be factually relevant in litigation over an exception to discharge. To the extent that the debtor's own actions are sufficient to meet the applicable standard of nondischargeability, then the debt caused by those actions may be excepted from discharge. This Proposal merely seeks to eliminate an automatic imputation of liability based on the debtor's status as a spouse or partner.

⁵⁸³ See *McIntyre v. Kavanaugh*, 242 U.S. 138, 139 (1916) (interpreting predecessor to section 523(a) that did not include the words "by the debtor"); *BancBoston Mortgage Corp. v. Ledford*, 970 F.2d 1556 (6th Cir. 1992), (fraud can be imputed to innocent partner for purposes of section 523(a)(2)(A) because debtor is liable under Tennessee agency law for actions taken by other partners in ordinary course of business), *cert. denied*, 507 U.S. 916 (1993); *Luce v. First Equip. Leasing Corp.*, 960 F.2d 1277, 1282 (5th Cir. 1992) (imputing liability under section 523(a)(2)(A), following *Strang v. Bradner* and prior lower court decisions); *Impulsora Del Territorio Sur v. Cecchini*, 780 F.2d 1440 (9th Cir. 1986) (imputing knowledge and intent of blameworthy partner to innocent debtor-partner on account of partnership law under section 523(a)(6)); *Moore v. Gill*, 181 B.R. 666 (Bankr. N.D. Ga. 1995); *Eppard v. Sestito*, 136 B.R. 602 (Bankr. D. Mass. 1992) (excepting from discharge under section 523(a)(2)(A) debt where misrepresentation was made by the debtor's partner); *Lail v. Weaver*, 174 B.R. 85 (Bankr. E.D. Tenn. 1994) (under Tennessee law, false representation of joint venturers should be imputed to debtor); *Oetker v. Bullington*, 167 B.R. 157 (Bankr. W.D. Mo. 1994) (nondischargeability for section 523(a)(6) can be based on imputed intent from other partners).

⁵⁸⁴ See Recommendation 2.3.25 on the vicarious liability of partners.

Competing Considerations. Some might argue that the discharge exceptions reflect competing social policy choices based on the nature of the debt itself, not just protecting the “honest but unfortunate” debtor, thus there may be justifiable reasons to acknowledge vicarious liability in bankruptcy dischargeability litigation for true agency relationships.⁵⁸⁵ However, even under this approach, spouses in typical consumer nondischargeability cases would not be vicariously liable because spouses do not have a formal agency or partnership relationship.

In imputing a partner’s fraud to the debtor, some courts have emphasized that partners have a duty to ensure that partnership affairs are conducted with integrity and the partners accept these obligations by participating in the partnership. In effect, partners are made guarantors for the fraudulent activities of other partners. When the Commission considered this question directly in the context of dealing with partnerships in bankruptcy, it rejected this policy conclusion.

1.4.8 Effect of Lack of Notice on Time to Bring Objection to Discharge

Creditors that did not receive notice of a bankruptcy should get an extension of time to file an objection to or seek revocation of a discharge.

If a creditor does not receive notice of a bankruptcy case until after the applicable deadline for filing a nondischargeability action, the Bankruptcy Code may except that debt from discharge.⁵⁸⁶ Creditors should not be prejudiced by a lack of notice. Likewise, debtors should not have incentives to omit certain creditors from the bankruptcy schedules. The Bankruptcy Code does not provide creditors with parallel protection with respect to objections to the debtor’s general discharge under section 727(c).⁵⁸⁷ If notice is not provided to a creditor with information that may provide grounds for the denial of the debtor’s discharge, that creditor may be time-barred in pursuing the objection. The Federal Rules of Bankruptcy Procedure authorize extensions of the time to object to discharge only if the creditor makes an

⁵⁸⁵ See, e.g., Lawrence Ponoroff, *Vicarious Thrills: The Case for Application of Agency Rules in Bankruptcy Dischargeability Litigation*, 70 TUL. L. REV. 2515 (1996).

⁵⁸⁶ 11 U.S.C. § 523(a)(3) (1994). *Judd v. Wolfe*, 78 F.3d 110 (3rd Cir. 1996) (debtor loses the benefit of 60 day time bar to nondischargeability actions, but provision does not provide independent basis for nondischargeability); *cf.* *Faden v. Insurance Company of North America*, 96 F.3d 792 (5th Cir. 1996) (failure to schedule debt provides independent basis for excepting obligation from discharge, but debtor should be allowed to amend schedules to add and discharge debt, absent bad faith or prejudice).

⁵⁸⁷ Complaints objecting to a Chapter 7 debtor’s discharge must be filed no later than 60 days after the first date set for the section 341 meeting. FED. R. BANKR. P. 4004(a) (1994). Lack of notice does not provide an exception, under current law, from the deadline to file an objection to discharge. *Id.*

extension motion within the allotted time,⁵⁸⁸ thus a creditor omitted from the schedules and unapprised of the bankruptcy until afterwards is unable to object to the discharge. Parties can seek revocation within a year after the discharge, but the grounds for revocation are somewhat more circumscribed, and again, the Code contains no extensions for lack of notice.⁵⁸⁹

One of the key policies underlying the Bankruptcy Code is that only debtors who have acted honestly will be entitled to a discharge under section 727.⁵⁹⁰ To this end, the statute expressly authorizes parties in interest to bring relevant information to the court's attention that might indicate that the debtor's discharge should be denied. Although their debts may be excepted from discharge if they did not receive notice of the bankruptcy, creditors with pertinent information cannot perform this broader monitoring function if they are not aware of the bankruptcy proceeding. A creditor omitted from the schedules should have a reasonable period of time after receiving notice of bankruptcy to file an objection to discharge or a motion to revoke discharge.

Some people might argue that this amendment is unnecessary. The objection-filing deadline (60 days after the first date scheduled for the section 341 meeting) surpasses the average tenure of Chapter 7 individual bankruptcy cases. In addition, the statute already affords a one-year post-discharge period to seek revocation, which provides an adequate time frame in most cases. The legitimacy of the bankruptcy process is premised on adequate notice and disclosure. This Recommendation should encourage debtors and their attorneys to be as forthright as possible in listing creditors and in providing accurate information.

1.4.9 *Settlement and Dismissal of Objections to Discharge*

Section 727 should be amended to provide that (a) any complaint objecting to discharge may be dismissed on motion of the plaintiff only after giving notice to the United States trustee, the case trustee, and all creditors entitled to notice, advising them of an opportunity to substitute as plaintiff in the action; (b) any motion to dismiss a complaint objecting to discharge must be accompanied by an affidavit of the moving party disclosing all consideration given or promised to be given by the debtor in connection with dismissal of the complaint; and (c) if the debtor has

⁵⁸⁸ FED. R. BANKR. P. 4004(b) (1994).

⁵⁸⁹ 11 U.S.C. § 727(e) (1994).

⁵⁹⁰ *See In re Yonikus*, 974 F.2d 901, 904 (7th Cir. 1992) (affirming revocation of discharge under 11 U.S.C. S 727(d)(2) because “[d]ebtors have an absolute duty to report whatever interests they hold in property.”).

given or promised to give consideration in connection with dismissal of the complaint, the complaint may not be dismissed unless the consideration benefits the estate generally.

Debtors are presumptively eligible for a general discharge of debt under section 727 of the Bankruptcy Code. The Code authorizes creditors, as well as the U.S. trustee and case trustees, to file adversary complaints objecting to a debtor's discharge.⁵⁹¹ This serves a legitimate function to help ensure that only honest debtors discharge their debts. However, a troubling situation arises if a creditor brings an objection to discharge and then settles or dismisses the complaint in exchange for the debtor's agreement to reaffirm a debt or to concede the nondischargeability of the debt on other grounds. This may indicate that the original objection was meritless and was brought only to yield a benefit to the creditor, or it may mean that a dishonest and undeserving debtor will get a general discharge by making a deal with the one creditor who discovered the dishonesty.⁵⁹²

The effect of an objection to the debtor's discharge goes beyond the plaintiff and the debtor; the ability of the complaining creditor to prove that the debtor is unworthy of a bankruptcy discharge significantly affects the rights of other creditors to pursue collection of their debts. For this reason, several courts have characterized a complaining creditor as a "trustee" of that action for the benefit of all creditors.⁵⁹³ As such, the creditor "may not abdicate that responsibility or use that position to its own advantage by settling the litigation on terms which will allow it to receive a private benefit solely for itself."⁵⁹⁴

The Proposal would build upon the basic concept already set forth in the Bankruptcy Rules that "a complaint objecting to the debtor's discharge shall not be dismissed at the plaintiff's instance without notice to the trustee, the United States trustee, and such other persons as the court may direct, and only on order of the court

⁵⁹¹ "The trustee, a creditor, or the United States trustee may object to the granting of a discharge under subsection (a) of this section." 11 U.S.C. § 727(c)(1) (1994).

⁵⁹² *But see* 18 U.S.C. § 152 (criminalizing concealment of assets, false oaths and claims, and bribery).

⁵⁹³ *In re Lindsey* 208 B.R. 169 (Bankr. E.D. Ark. 1997), *citing In re Taylor*, 190 B.R. 413, 416 (Bankr. D. Colo.1995) *and Hage v. Joseph (In re Joseph)*, 121 B.R. 679, 682 (Bankr. N.D.N.Y. 1990).

⁵⁹⁴ *In re Smith*, 207 B.R. 177, 178 (Bankr. N.D. Ind. 1997) (regardless of lack of objections of other parties, if successful prosecution of section 727 proceeding will benefit entire creditor body, action may not be settled in return for private benefit).

containing terms and conditions which the court deems proper.”⁵⁹⁵ The 1983 Advisory Committee Note explains that the rule-makers intended to authorize the court to impose conditions on dismissal of a complaint objecting to a discharge, which “raises special concerns because the plaintiff may have been induced to dismiss by an advantage given or promised by the debtor or someone acting in his interest.”⁵⁹⁶ This rule works in conjunction with some courts’ local rules or orders that already require parties to file affidavits that nothing has been promised to the plaintiffs in consideration of the withdrawal of the objection.⁵⁹⁷

A legitimate objection to discharge should not be dismissed on the basis of consideration flowing only to the creditor who filed the action, notwithstanding the interests of other creditors. Moreover, debtors should not be able to “purchase a repose from objections to discharge” given the severity of the charges that would support such an objection.⁵⁹⁸ This Recommendation would permit creditors who did not institute a section 727 action within the 60-day limit to continue the timely-brought action when the original plaintiff declines to go further.⁵⁹⁹ Of course, not all settlements or dismissals of objections to discharge are problematic;⁶⁰⁰ this Recommendation simply would help the court obtain the relevant facts to determine whether the settlement or dismissal should be approved and to allow other creditors to become substitute plaintiffs.

⁵⁹⁵ FED. R. BANKR. P. 7041 (1995).

⁵⁹⁶ FED. R. BANKR. P. 7041, Advisory Committee Note (1983).

⁵⁹⁷ *In re Smith*, 207 B.R. 177, 179 (Bankr. N.D. Ind. 1997).

⁵⁹⁸ *In re Moore*, 50 B.R. 661 (Bankr. E.D. Tenn.1985).

⁵⁹⁹ *See In re Lindsey*, 208 B.R. 169 (Bankr. E.D. Ark. 1997); *In re Nicolosi*, 86 B.R. 882, 888 (Bankr. W.D. La. 1988) (questioning whether “there can ever be a compromise of an objection to discharge that would involve receipt of compensation or remuneration by a creditor”).

⁶⁰⁰ *In re Mavrode*, 205 B.R. 716, 719 (Bankr. D.N.J. 1997) (citing “majority view” that settlements of section 727 complaints are not prohibited per se, but should be settled in limited circumstances where there is no impropriety and there is no harm to other creditors).

If the Commission's Recommendation to limit the availability of reaffirmations were adopted, fewer reaffirmation agreements could be extracted using section 727, leading some to conclude that the instant Proposal is less necessary. However, this Proposal strengthens the integrity of the system both in structure and in practice. It prevents less scrupulous creditors from using section 727 allegations as an avenue to obtain preferential payments.