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ANATOMY OF A § 523(a) ACTION

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Pre-Litigation Considerations:

- a. Creditors:
 - i. Collection:
 - (1) What are the prospects for payment on your client's claim? Does the Debtor have the ability to obtain funds to resolve your client's claim?
 - (2) Does Debtor have multiple creditors or are you the only real creditor in the bankruptcy case?
 - ii. §727 Action:
 - (1) Advantage:
 - (a) Easier: Sometimes a § 727 might be easier than a § 523.
 - (i) Example - §727(a) (4), debtor knowingly, fraudulently, and in connection with the case made a false oath. If Debtor lied at the § 341 hearing or Rule 2004 examination, a § 727 might be easier to prove than a § 523 action.
 - (b) Assistance: The Trustee and U.S. Trustee are more likely to join this action or bring it on their own.
 - (2) Disadvantage:
 - (a) Coattails: Other creditors benefit from your prosecution of a § 727. If all creditors are able to pursue Debtor for their debts, it reduces potential recovery to your client.
 - (b) Lack of Settlement: As a §727 implicates the integrity of the court and the bankruptcy system, debtors are often not allowed to "buy a discharge."
- b. Debtor:
 - i. Non-bankruptcy options:
 - (1) Total & Permanent Disability Administrative Discharge
 - (2) Income Driven Repayment Plan
 - ii. Settlement: Does the debtor have a source, whether from exempt funds or a third party, to settle the debt?



Procedure for Nondischargeability Actions:

1. Rules:
 - a. Adversary Proceedings governed by Part VII of Federal Rules of Bankruptcy Procedures.
 - b. Remember to review local rules and forms.
 - c. Requesting a Jury Trial:
 - i. Timing – FRCP Rule 38(b) – "no later than 14 days after the last pleading"
 - ii. Special Designation of Bankruptcy Judge to conduct the jury trial
 - iii. Consent of adverse party
 - iv. Withholding consent is deemed an objection (cure by Requesting withdrawal of the reference back to the district court).
2. Timing and Deadlines
 - a. Rule 4007
 - i. Creditors: 60 days from Meeting of Creditors to file complaints against debtor under Section 523(c):
 - (1) 523(a) (2) – false pretenses, false representation, or actual fraud;
 - (2) 523(a) (4) fraud or defalcation;
 - (3) 523(a) (6) willful and malicious injury.
 - (4) Chapter 13:
 - (a) 30 days to file 523(a) (6) action in chapter 13 if debtor receives hardship discharge.
 - (b) Any time prior to discharge for §1328(a) (4) objection for willful or malicious injury.
 - ii. Debtors: Pursuant to Rule 4007(b), a debtor may file a complaint at any time seeking a determination of the discharge ability of any debt.
 - (1) A debtor cannot seek a determination of the dischargeability of debts under §523(a)(2), (a)(4), or (a)(6) more than 60 days after the Meeting of Creditors, but those would automatically have become dischargeable at that point.



iii. May seek an extension "for cause" if filed before time expires.

b. Untimely Objection:

i. *Anwar v. Johnson*, 2013 WL 3306327 (9th Cir. July 2, 2013) ("[A]bsent unique and exceptional circumstances . . ., we do not inquire into the reasons a party failed to file on time in assessing whether she is entitled to an equitable exception from FRBP 4007(c)'s filing deadline . . .").

ii. *Willms v. Sanderson*, 723 F.3d 1094 (9th Cir. July 25, 2013) (Rule 4007(c) deadline cannot be retroactively extended). PUERTO RICO CASE

iii. *Five Star Laser, Inc. v. Height (In re Height)*, 2011 WL 1480265 (E.D. Michigan Apr. 19, 2011) (Stipulation between debtor and trustee to extend deadline to file complaint did not apply to creditors).

iv. Creditor without Notice of Bankruptcy

(1) Amendment of Schedules: Rule 1009 allows amendment of schedules to list additional creditors any time before the case is closed.

(2) Local Rules may then allow additional time to commence nondischargeability actions. See, for example, Eastern District of Michigan Local Bankruptcy Rule 1009-1(d).

3. Complaint:

a. Jurisdictional averments required in a bankruptcy adversary proceeding:

i. In addition to the jurisdictional pleading required under Fed. R. Civ. P. 8, in an adversary proceeding, Fed. R. Bankr. P. 7008 provides that the jurisdictional statements "shall also contain a reference to the name, number, and chapter of the case under the Code to which the adversary proceeding relates and to the district and division where the case under the Code is pending.

ii. In an adversary proceeding before a bankruptcy court, the complaint, counterclaim, cross-claim, or third-party complaint shall contain a statement that the pleader does or does not consent to entry of final orders or judgment by the bankruptcy court."

b. Allegations

c. Prayer for Relief

4. Service of Summons

a. Rule 7004

i. First Class Mail: Rule 7004(b) permits service of the summons and complaint within the United States by first class mail rather than by personal service.



ii. To the defendant:

(1) An Adversary Proceeding is a new proceeding even though it stems from a bankruptcy filing. The complaint therefore must be mailed/served directly on the defendant even if defendant is represented by bankruptcy counsel in the main bankruptcy proceeding. See *Tex-Link Communs., Inc. v. Lopez (In re Lopez)*, 2008 Bankr. LEXIS 3146, 61 Collier Bankr. Cas. 2d (MB) 205.

(2) Must be served by first class mail to the individual's "dwelling house or usual place of abode" or place where individual "regularly conducts a business or profession."

(a) Mailing to an individual at a P.O. Box is not sufficient because it is not the debtor's home or business.

(3) Incompetent and Infant Debtors: If the plaintiff has knowledge or belief that the individual he is serving is an infant or incompetent, Rule 7004(b) (2) covers how to properly serve them.

(a) Affidavit of Service may aver that the Plaintiff does not believe the defendant is incompetent or an infant.

iii. To the Debtor's Attorney:

(1) Rule 7004(g) requires service to the Debtor's attorney.

(2) Even if defendant is represented by bankruptcy counsel in the main bankruptcy proceeding. See *Tex-Link Communs., Inc. v. Lopez (In re Lopez)*, 2008 Bankr. LEXIS 3146, 61 Collier Bankr. Cas. 2d (MB) 205. "Plaintiff relied on Debtor's Attorney's ECF agreement, service upon Debtor's Attorney through ECF is effective only to the extent of his written consent. There is nothing in the record to indicate that Debtor's Attorney consented in writing to service of the Complaint by electronic means."

iv. Service on Corporations:

(1) 7004(b) (3) requires service to the attention of "an officer, a managing or general agent, or to any other agent authorized by appointment or by law to receive service of process."

(a) Some courts require naming the actual agent or officer

(b) Others hold "Attn: Officer, Managing Agent or General Agent" to be sufficient

(2) Correct Address:

(a) Use the address from a Proof of Claim



of State (b) Use the address for the registered agent from the Secretary

(3) FDIC Insured Depository:
(a) Rule 7004(h) requires service to FDIC Insured Depositories
by certified mail

(b) Check at:
<http://banks.data.fdic.gov/bankfind-suite/bankfind>
(c) For Adversary Proceedings (but not objections to claims)
this does not apply to NCUA insured credit unions.

v. Service on the United States: Rule 7004(b)(5)
(1) To the U.S. Attorney for the district
(2) To the U.S. Attorney General in Washington, D.C.
(3) To the Agent or Officer of the United State implicated in the
Adversary Proceeding, for example the Secretary of Education

b. Answer:

i. Time:
(1) Rule 7012 requires an answer be filed within 30 days after the
issuance of the Summons

(2) The United States is allowed 35 days after the issuance of the
Summons to file an answer

ii. Representation: While most bankruptcy courts allow debtor's counsel to
exclude in writing the representation in an Adversary Proceeding from their retainer agreement,
debtor's counsel does have an obligation to advise clients of deadlines to answer

iii. Content:

(1) Affirmative Defenses:

c. Motion to Dismiss: Outright dismissal under Fed. R. Bankr. P. 7012/Fed. R. Civ.
P. 12(b) (6) is rare. Courts are within their discretion to grant plaintiffs an opportunity to file an
amended complaint pursuant to Fed. R. Bankr. P. 7015/Fed. R. Civ. 15(a) if the complaint fails to
meet the standards of specificity set forth by Fed. R. Bankr. P. 7009/Fed. R. Civ. P. 9.

i. Dismissal of time barred lawsuits:



(1) *In Wahrman v. Bajas (In re Bajas)*, 443 B.R. 768, 773 (E.D. Mich.), the dismissal pursuant to Fed. R. Civ. P. 12(b) (6) was granted primarily because of the creditor's untimely filed nondischargeability complaint. The plaintiff made no argument for equitable tolling of the complaint deadline nor had the court found there was any basis to rule in plaintiff's favor on equitable tolling.

ii. Failure to state a claim with particularity:

(1) Allegations of Fraud: Rule 7009 requires that "[i]n alleging fraud or mistake, a party must state with particularity the circumstances constituting fraud or mistake."

(2) This can include:

- (a) The date of the transfer;
- (b) The amount of the transfer (or if the transfer was of property other than money, the property that was transferred and its value);
- (c) The name of the transferor;
- (d) The name of the initial transferee; and
- (e) The consideration paid, if any, for the transfer.

(3) Allegations of Malice: Rule 7009 requires that "[m]alice, intent, knowledge, and other conditions of a person's mind may be alleged generally."

- d. Status Conference
- e. Mediation
- f. Discovery
- g. Settlement
- h. Summary Judgment
- i. Pre-Trial
- j. Trial



Elements of Nondischargeable Claims:

1. **False Pretenses or Fraud under §523(a)(2)(A):**
 - a. The creditor
 - b. provided money, property, services, or an extension, renewal, or refinancing of credit
 - c. due to an intentionally and materially false statement,
 - d. not about the debtor's financial condition,
 - e. by the debtor
 - f. upon which the creditor justifiably relied.
 - g. This standard is basically the standard for fraud at common law
 - h. However, the fraud must be actual, and not constructive or implied by law.
 - i. Reversal of Presumption: The debtor is presumed to have incurred debts under false pretenses if:
 - i. Consumer debts;
 - ii. To a single creditor;
 - iii. For luxury goods or services:
 - (1) In excess of \$725; and
 - (2) Within ninety days prior to filing a bankruptcy, or
 - iv. Cash advances:
 - (1) On an open-end credit plan;
 - (2) In excess of \$1000; and
 - (3) Within seventy days prior to a filing.



2. **False Financial Statements under §523(a)(2)(B):**

- a. The Debtor
 - i. It remains unclear whether debt is nondischargeable when the money, property, and so forth, was obtained by the debtor for another or to what extent a debtor can be held responsible for actions of a spouse or an agent that were fraudulent. 4 Collier on Bankruptcy ¶ 523.08[1] (16th ed.).
- b. Obtained money, property, services or an extension, renewal or refinancing of credit
- c. Through the use of a materially false statement:
 - i. Small omissions are usually insufficient to meet this materiality test.
 - ii. Similarly, a false statement that is irrelevant to the decision about whether to grant credit is not material.
 - iii. Usually, the creditor is relying on the debtor's credit history.
 - iv. Thus, a debtor contesting this element should be entitled to conduct discovery into the creditor's application evaluation process and credit scoring systems and methods to determine what effect the falsehood actually had.
- d. In writing. *Lamar, Archer & Cofrin, L.L.P. v. Appling*, ___ U.S. ___, 138 S. Ct. 1752, 201 L. Ed. 2d 102 (2018) (debtor's false statement about anticipated tax refund was statement about financial condition and was not in writing, so debt was dischargeable).
- e. Concerning the financial condition of the debtor or an insider
- f. From the creditor asserting the debt is nondischargeable
- g. Upon which the creditor reasonably relied; and
- h. The debtor had an intent to deceive



3. **Defalcation under §523(a)(4):**

- a. The failure by a trustee to properly account for funds placed in their trust.
Bullock v. BankChampaign, 569 U.S. 267, 133 S. Ct. 1754, 1759–60, 185 L. Ed. 2d 922 (2013).
- b. Express or Technical Trust (not Constructive Trust)
- c. The conduct at issue involves:
 - i. Bad faith;
 - ii. Moral turpitude;
 - iii. Immoral conduct; or
 - iv. An intentional wrong, including:
 - (1) Conduct that the fiduciary knows is improper;
 - (2) Reckless conduct of the kind that the criminal law often treats as the equivalent; or
 - (3) Conscious disregard of a substantial and unjustifiable risk

4. **Larceny under §523(a)(4): As a matter of federal common law larceny is:**

- a. The taking property;
- b. From its rightful owner;
- c. Willfully; and
- d. With fraudulent intent.
- e. This may be narrower than under state law, See *In re Shreve*, 386 B.R. 602 (Bankr. W.D. Va. 2008).

5. **Embezzlement under §523(a)(4):**

- a. The fraudulent appropriation;
- b. Of property belonging to another;
- c. By a person in lawful possession of that property.



6. **Willful and/or Malicious Injury:**

a. **Under §523(a)(6):**

- i. To an entity;
- ii. By the debtor;
- iii. For injury to person or property; and
- iv. That was willful AND malicious.

b. **Under §1328(a)(4):**

- i. To an individual or the estate of an individual;
- ii. By the debtor
- iii. For personal injury or death;
- iv. That was willful OR malicious
- v. Adjudicated by prior civil award for restitution or damages.
- vi. Not subject to the same deadlines as 523(a) actions.

Comparison of Willful and/or Malice Nondischargeability in Chapter 7 and Chapter 13		
	§523(a)(6)	§1328(a)(4)
To:	An entity	An individual or the Estate of an individual
For:	Injury to Person or Property	Personal Injury or Death
By:	The Debtor	The Debtor
Intent:	Willful AND Malicious	Willful OR Malicious
Adjudication:	No restriction	Prior Civil Award for restitution or damages



Defenses:

- a. Collateral Estoppel
- b. Claim Preclusion
- c. Res Judicata
- d. ADVICE OF COUNSEL DEFENSE

i. At its heart, the advice of counsel defense is not so much an affirmative defense as it is a way for a debtor to negate the element of intent. To meet his burden on the advice of counsel defense, [the debtor] must show (1) that all facts were fully and fairly communicated to counsel; (2) that counsel gave legal advice; (3) that the debtor relied on the legal advice; and (4) that [the debtor's] reliance was in good faith. *Rupp v. Biorge (In re Biorge)*, 536 B.R. 24, 30 (Bankr. D. Utah 2015). See also *In re Richmond*, No. 1:19CV667, 2021 WL 1195737 (M.D.N.C. Mar. 30, 2021).

ii. In the case of *United Orient Bank v. Green*, that likewise involved a § 523(a)(6) action, the court rejected the debtor's attempt to defend a very aggressive business strategy based on the advice of counsel: "[the debtor] knew that there was, at a minimum, a substantial risk that his actions were improper and elected to run that risk . . . [and the debtor] knew that his actions were 'contrary to commonly accepted duties in the ordinary relationships among people, and injurious to' plaintiffs."

- e. JUSTIFICATION/EXCUSE

i. *State Farm Fire & Cas. Co. v. Edie (In re Edie)*, 314 B.R. 6, 15 (Bankr. D. Utah 2004) (citation omitted) ("in order for an act to be willful and malicious it must be a deliberate or intentional injury (willful) that is performed without justification or excuse (malicious).") (Quoting *Am. First Credit Union v. Gagle (In re Gagle)*, 230 B.R. 174, 181 (Bankr. D. Utah 1999)). See also *Tinker v. Colwell*, 193 U.S. 473, 485–86 (1904) ("Malice, in common will against a person, but in its legal sense it means a wrongful act, done intentionally, without just cause or excuse.") (Citation omitted).

f. Refinancing: If a refinancing was intended to eliminate the liability on the preexisting note, the debtor may be able to argue that all claims arising from that note are also extinguished. See *In re Fischer*, 116 F.3d 388 (9th Cir. 1997) (agreement that was novation of prior contract eliminated any nondischargeability claims arising out of prior contract); *In re West*, 22 F.3d 775 (7th Cir. 1994) (general release included a release of a nondischargeability claim in bankruptcy, stating, because even if the obligation arising from debtor's embezzlement would have been nondischargeable due to its fraudulent nature, no allegations of fraud surround the note, and the note substituted a contractual obligation for a tortious one). But see *United States v. Spicer*, 57



F.3d 1152 (D.C. Cir. 1995) (settlement agreement on fraud claim did not extinguish nondischargeability claims grounded in underlying debt).

i. Settlement of a fraud case that substitutes a new contractual obligation does not eliminate the ability to claim that the underlying debt is nondischargeable due to fraud. *Archer v. Warner*, 538 U.S. 314, 123 S. Ct. 1462, 155 L. Ed. 2d 454 (2003).

2. Attorney's Fees for the Debtor if a Debt is Discharged §523(d)



Sources and Other Resources

- 11U.S.C §523(a)(2) and (4):
 - Dreher, Nancy C. and Roy, Matthew E. (1993) *Bankruptcy Fraud and Nondischargeability under Section 523 of the Bankruptcy Code*, North Dakota Law Review: Vol. 69: No. 1, Article 4.
 - Morgan Green, *No Misrepresentation Needed: Excepting Discharge for Actual Fraud Under 11 U.S.C. § 523 Without Misrepresentation*, 84 Fordham L. Rev. 2919 (2016).
- 11U.S.C §523(a)(6):
 - Matthew Harte, *A Critical Analysis of the Bankruptcy Code's Exception to Discharge for Debts Arising From Wrongful Conduct*, 4 Brook. J. Corp. Fin. & Com. L. (2009).
- 11U.S.C §523(a)(7):
 - Abbye Atkinson, *Consumer Bankruptcy, Nondischargeability, and Penal Debt*, 70 Vanderbilt Law Review 917 (2017).
- 11U.S.C §523(a)(8)
 - National Consumer Law Center, *Training Manual for Pro Bono Bankruptcy Training Program- REPRESENTING DEBTORS IN STUDENT LOAN HARDSHIP DISCHARGE CASES* (2017).
- General:
 - Norman, Jeffrey P., U.S. Bankruptcy Judge (SDTX), *Trial Handbook: Exceptions to Discharge in Chapters 7 and 13* (2019).
 - Tucker, Thomas, Clayson, Kimberly, Kochis, Anthony, and Turner Lewis, Wendy, *Prosecuting and Defending § 523 Adversary Proceedings*, 2018 Hon. Steven W. Rhodes Consumer Bankruptcy Conference, American Bankruptcy Institute (2018).
 - Bankr. M.D.N.C.: Service Pursuant to Federal Rule of Bankruptcy Procedure 7004.