Section 523 Nondischargeability Litigation: 
Plaintiff and Defense Strategies
Claims for Relief, Motions to Dismiss, Motions for Summary Judgment, Collateral Estoppel, Res Judicata, Attorney's Fees

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Section 523 Exceptions to Discharge Adversary Proceedings: Prosecution and Defense Strategies

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Ms. Clayson has practiced bankruptcy law for more than 10 years. She has authored articles for American Bankruptcy Institute publications and has presented authored materials at various bankruptcy related seminars sponsored by the ABI and other bankruptcy law affinity groups. Ms. Clayson’s business clients include small businesses with a focus on real estate, construction, food service and consumer products.

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Mr. Dunn has successfully turned around several small businesses and assisted hundreds of individuals fix their personal financial challenges both in and out of bankruptcy. In addition to his bankruptcy and turnaround practice, Mr. Dunn guides entrepreneurs through the purchase, sale and merger of businesses and advises small business owners.
Program Outline

1. Overview of Section 523
2. Post-petition and pre-litigation tactics
3. Pleadings and motions practice
4. Discovery issues
5. Trial strategies
6. Mediation and settlement strategies
7. Attorney's fees
8. Practical considerations
Overview of 11 U.S.C. 523

• Excepts the following debts from discharge when the debtor is an individual:

1. Debts for Taxes and Customs Duties
2. Debts Incurred Through Falsity and Fraud
3. Unlisted and Unscheduled Debts
4. Debts for Fraud or Defalcation by Fiduciary, Embezzlement, or Larceny
5. Debts for Domestic Support Obligations
6. Willful and Malicious Injury
7. Debts for Fines, Penalties, or Forfeitures
8. Debts for Educational Loans
9. Debts Caused by Intoxicated Debtor's Operation of a Motor Vehicle
10. Debts that Were or Could Have Been Listed or Scheduled in a Prior Bankruptcy in which Discharge was Waived or Denied
Overview of 11 U.S.C. 523 (cont’d)

• Excepts the following debts from discharge when the debtor is an individual:

11. Debts Provided for in a Final Judgment, Order, or Settlement Agreement Regarding Fraud or Defalcation Claims where Debtor Had Fiduciary Duties regarding a Depository Institution or Insured Credit Union
12. Debts Arising From Malicious or Reckless Failure to Fulfill Commitments to a Federal Depository Institution Regulatory Agency
13. Restitution Payments
14. Debts Incurred to Pay Taxes or other Governmental Units under Subsection (1) or Election Law Fines or Penalties
15. Debts to a Spouse, Former Spouse, or Child Incurred by the Debtor in the Course of Divorce or Separation (Not Otherwise Covered by Subsection (5))
16. Postpetition Fees or Assessments to Homeowners’ Associations
17. Court Fees Imposed Upon a Prisoner for Postpetition Filings
18. Certain Debts Owed to Pension, Profit-Sharing, Stock Bonus, or Other Incentive Plans
19. Debts for Certain Securities Law Violations
Subchapter 5 Considerations

• The exceptions in § 532(a) apply to individual debtors with a consensual plan under subchapter 5 via § 1141(d)(1)(A).
  • Section 1141(d)(1)(A) does not apply to non-individual (i.e. entity) subchapter 5 debtors.

• For subchapter 5 debtors confirming a cramdown plan, new § 1192 provides for discharge.
  • New § 1192 also incorporates § 532(a) by reference to §1141(d)(1)(A).

• Although not entirely clear from the statutory language, it appears that the § 1192 discharge exceptions may only available to individual debtors, as with 1141(d)(1)(A).
  • However, *In re Breezy Farms*, 2009 WL 1514671 (Bankr. M.D. Ga. May 29, 2009) and *In re JRB Consol. Inc.*, 188 B.R. 373 (Bankr. W.D. Tex. 1995) are cases where courts analyzed identical language under chapter 12 and found that the discharge can apply to non-individuals. Courts will likely be faced with this question under subchapter 5 in short order.
Post-petition and Pre-Litigation Tactics

• Main Issues to Consider:
  • When and how do collateral estoppel or res judicata from prior litigation impact an adversary proceeding?
  • Who Has the Burden of Proof?
  • What is the Standard of Proof?
Post-petition and Pre-Litigation Tactics – Res Judicata and Collateral Estoppel

• In *Brown v. Felsen*, the Supreme Court held that a bankruptcy court was not foreclosed by res judicata from looking beyond the state court judgment to determine whether the debt came within one of the exceptions to discharge.

• Thus, claim preclusion, or res judicata, is inapplicable in bankruptcy nondischargeability proceedings. Evidence extrinsic to the judgment and record of a prior state court suit may be considered when determining whether a debt previously reduced to judgment is dischargeable.

• In dictum, the Supreme Court stated that the case before it concerned res judicata only and then went on to say that if, in the course of adjudicating a state law question, a state court should determine factual issues using standards identical to those of the dischargeability statute, then collateral estoppel, in the absence of countervailing statutory policy, would bar relitigation of those issues in the bankruptcy court.

• Indeed it has been held that a default judgment obtained by a creditor against Chapter 7 debtors in state court, grounded in a finding of fraud and imposing punitive damages, precludes, under the state's doctrine of collateral estoppel, the relitigation in bankruptcy court of the fraudulent character of the debt, for purpose of the creditor's adversary proceeding seeking a determination that the judgment is not dischargeable in bankruptcy, where the debtors were properly served in state court, they were afforded the opportunity to contest the creditor's allegations of fraud, but they failed to appear or answer the complaint, the issue of fraud was explicitly decided by the state court, and the elements of fraud under state law and the bankruptcy code were identical.

• If prepetition tort claims asserted against a debtor would have created a nondischargeable debt under the discharge exception for fiduciary fraud or defalcation, had those claims been litigated to judgment in a creditor’s favor, then it is no defense for a debtor to state that the debtor replaced that possible liability with a dischargeable contractual obligation through the parties’ settlement agreement.
Post-petition and Pre-Litigation Tactics – Res Judicata and Collateral Estoppel (cont’d)

▪ **Observation:**
  - The bankruptcy court is required to apply the law from the state in which judgment was entered in determining whether a state court default judgment has collateral estoppel effect in a subsequent bankruptcy dischargeability proceeding under 11 U.S.C.A. § 523(a). A default judgment previously entered against a debtor in a cause of action under Massachusetts' unfair and deceptive practices law resolved the same issues as those presented in a fraud-based nondischargeability proceeding in bankruptcy court, and could be given collateral estoppel effect to except the state court judgment debt from discharge, where the state court, in assessing damages against the debtor, specifically found that the debtor had engaged in a willful and knowing scheme of unfair and deceptive practices designed to steal as much money as she could from the creditors, and the record also supported the conclusion that the creditors, debtor's mentally challenged neighbors, had relied on the debtor's fraud to their detriment.
  - An implied exception to the full faith and credit statute exists with respect to dischargeability proceedings in bankruptcy over which a bankruptcy court has exclusive jurisdiction, and therefore a bankruptcy court need not apply state collateral estoppel principles to determine whether a state-court judgment obtained by a creditor should be given collateral estoppel effect in a 11 U.S.C.A. § 523 dischargeability proceeding.

▪ **Practice Tip:**
  - To establish that collateral estoppel is applicable, a party must introduce a record sufficient to reveal the controlling facts and pinpoint the exact issues litigated in the prior action. Reasonable doubt as to what was decided by a prior judgment should be resolved against it as an estoppel.
  - Thus, in order for facts such as willfulness and malice to be established by collateral estoppel for purposes of determining nondischargeability, it must be shown that such facts were essential to the prior decision as a Matter of law and thus necessarily determine to exist by the earlier tribunal. Where neither the pleadings nor the general verdict rendered in a prior action reflect that such issues were actually litigated and necessary to the verdict, collateral estoppel will not operate to bar relitigation of the issues on a complaint for determination of the dischargeability of the state court judgment.
  - The determination that an issue was actually litigated and necessary to the judgment must be made with particular care, although an examination of the jury instructions and verdict in a tort action may suffice on that issue without a review of the full transcript if the examination clearly demonstrates that the willful and malicious nature of the debtor's actions was actually and necessarily litigated. Where a state court’s determination of fraud, involving elements congruent with fraud under bankruptcy law, is established by a stricter standard, the considerations in favor of applying collateral estoppel regarding the fraud issue to the bankruptcy proceeding are greatly enhanced.
Post-petition and Pre-Litigation Tactics – Burden of Proof

• The burden of proving that a debt falls within the statutory exception to discharge is on the party challenging the dischargeability of a debt.

• In other words, the party seeking to have the debt declared non-dischargeable has the burden of proof to show that it fits within Section 523’s exceptions.
Post-petition and Pre-Litigation Tactics – Burden of Proof (cont’d)

- A few wrinkles:
  - Non-Support Divorce-Related Debts:
    - In a proceeding to except a debt from discharge as a divorce-related debt not in the nature of support, a nondebtor spouse has the initial burden of proving that the debt was one incurred in connection with the divorce and is in the nature of a property settlement debt rather than a debt for maintenance or support. In such a proceeding brought by the debtor to obtain a discharge of the debtor's property settlement obligation to a former spouse on the theory that the benefit to the debtor of discharging the debt outweighs the detriment to the former spouse, the burden is on the debtor to establish that the requisite balance is tipped in the debtor's favor. Thus, a debtor bears the burden to prove a nonsupport divorce debt is dischargeable.
    - The party opposing discharge of a debt must prove a prima facie case of nondischargeability before the debtor is called upon to produce evidence to support discharge. Once a prima facie case is established, the debtor has the burden of going forward in defense. Thus, upon the establishment of a prima facie case under 11 U.S.C.A. § 523(a)(2)(A), the burden of coming forward with a credible explanation of the alleged facts shifts to the debtor. Under § 523(a)(2)(A), the creditor, does not have the burden of disproving all explanations and, upon a prima facie showing that a debt is nondischargeable, the burden shifts to the debtor to go forward and offer a credible explanation.
  - Luxury Goods:
    - The presumption of nondischargeability as to certain consumer debts for luxury goods or services and certain cash advances incurred or obtained shortly before a bankruptcy filing, only shifts to the debtor the initial burden of producing evidence regarding the issue of intent; it does not, by itself, shift the ultimate burden of proof or the initial burden of production of evidence regarding any other issues.
Post-petition and Pre-Litigation Tactics – Standard of Proof


- The standard of proof for all dischargeability exceptions set forth in section 523(a) is the ordinary preponderance of the evidence standard.
Pleadings and Motions Practice
Causes of action requiring the filing of an adversary proceeding

Fed. R. Bankr. P. 7001 outlines the specific actions that must be initiated by the filing of an adversary proceeding

7001(4) a proceeding to object to or revoke a discharge, other than an objection to discharge under §§727(a)(8), (a)(9), or 1328(f) [11 USCS § 727(a)(8), (a)(9), or 1328(f)];

7001 (6) a proceeding to determine the dischargeability of a debt;
Pleadings to accompany a party’s initial filings

- Statement of corporate ownership Fed. R. Bankr. P. 7007.1 where the filing party is not a person.

- Filed concurrent with filing complaint or with D’s first responsive
Jurisdictional averments required in a bankruptcy adversary proceeding

Jurisdictional pleading required under Fed. R. Civ. P. 8 and Fed. R. Bankr. P. 7008 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. 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.”
Summons

Summons Issued (Instantly issued by clerk on ECF)

Summons Service Executed

Summons and complaint must be served directly to defendant

The complaint must be mailed/served directly on the defendant even if defendant is represented by bankruptcy counsel in the 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.”
Responsive Pleadings

Responsive pleading due (30 Days after Summons Date) Fed. R. Bankr. P. 7012

Prevailing on motions to dismiss pursuant to Fed. R. Bankr. P. 7012/Fed. R. Civ. P. 12(b)(6) is rare.


Dismissal of time-barred lawsuits such as untimely non-dischargability actions*

*Take note that the deadline for nondischargability action may be extended depending on a court’s local rules for creditors who receive late notice of a bankruptcy filing
Timeliness – 523 and 727 claims

A debtor’s attorney defending a complaint to object to discharge or for nondischargability should take caution in freely consenting to amendments to the complaint to add new counts.

Debtors may prevail in opposing leave to amend a pleading if a new set of facts is alleged for a new reason to deny discharge or dischargability once the discharge deadline has passed.

The distinction may be narrow but worth considering before allowing a plaintiff to add more to the complaint.
Fed. R. Bankr. P. 7009/Fed. R. Civ. P. 9(b) sets out the particularity requirements in the context of fraud allegations and provides:

In alleging fraud or mistake, a party must state with particularity the circumstances constituting fraud or mistake. Malice, intent, knowledge, and other conditions of a person’s mind may be alleged generally.
Particularity – Bankr. R. 7009


✓ the date of the transfer;

✓ the amount of the transfer (or if the transfer was of property other than money, the property that was transferred and its value);

✓ the name of the transferor;

✓ the name of the initial transferee; and

✓ the consideration paid, if any, for the transfer
Discovery

Discovery commences upon conclusion of 26(f) conference between attorneys

Preparing discovery for service the soonest it can be served can serve the cause of defense as much as the Plaintiff’s pursuit of the action
Discovery Issues

• Nondischargeability actions are adversary proceedings governed by the Discovery Rules under Part VII of the Bankruptcy Rules
• Distinguish between 2004 Examinations and AP Discovery Rules
• Information Pertaining to Previous Bankruptcy Filings is Ripe for Discovery Requests – Be Wary of Privilege Claims
• Also, Discovery Related to Previous Lawsuits Could Also Shed Light on Non-Dischargeability Issues and Res Judicata
  • Default Judgments Can Form the Basis for Res Judicata in Non-Dischargeability Claims
Scope of Discovery

Defense counsel should first review and respond to discovery requests within the framework of the allegations raised.

If discovery in the adversary proceeding looks more like the broad reaching rules under Rule 2004, objections to discovery are warranted.

At Trial FRE 401
After Petition is Filed Fed. R. Bankr. P. 2004
Discovery of electronically stored information

Reference jurisdictional local rules about the rules for electronic discovery
Mediation and Settlement Strategies
Opportunities to settle

Mediation

Settlement
Mediation

Mediation is a great tool particularly where there is substantial gray area on both sides or where though the law is clearly in one party’s favor, the other party refuses to reach terms

Mediation is confidential, no rulings are made and a neutral third party works with each side of the dispute to identify potential terms for resolving the dispute
Settlement generally

Encouraging settlement with or without mediation has significant benefits:

• Saves in legal costs – limited resources of parties
• Reduces exposure and risks of collection (both Plaintiff and Defendant)
• Creates predictability of the outcome
Rule 7041. Dismissal of Adversary Proceedings

“Rule 41 F.R.Civ.P. applies in adversary proceedings, except 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 containing terms and conditions which the court deems proper.”
Summary Judgment

Summary judgment

• Value of drafting summary judgment
  • Narrow issues for trial
  • Litmus test for trial - what evidence may be missing
  • Translation of MSJ to a joint final pretrial statement

• Standard for summary judgment – no material issues of fact
Trial Strategies
Trial –

an adversary proceeding trial is about identical to any federal trial with the only exception of the court’s local rules governing trial, if any and that almost all adversary proceedings will be bench trials.
Joint final pretrial statement

• Identify undisputed facts

• Identify undisputed evidence for admission

• Narrow the disputed facts and legal issues for trial
Admission of evidence

Before trial →
find out how the court wants evidence supplied to the court
follow local rules to exchange evidence with opposing counsel
identify objections to admission of opposing party evidence

At start of trial →
seek admission of of undisputed evidence together with opposing counsel
evaluate when to admit evidence in dispute
OPTIONS: at the commencement of trial, at the end or during witness testimony
Order of events at trial

Opening argument

Plaintiff’s Case In Chief

Defendant’s Case In Chief

Plaintiff’s Rebuttal

Closing argument
Witness testimony

• Deposition transcripts and impeachment of witnesses – be prepared with marked transcripts for adversarial witnesses
• Identify purpose of witness testimony and the outline of what is to be accomplished – what elements will be established through this witness’s testimony?
• Anticipate a witness’s testimony
• When to take risks on witness examination
Know your hearsay rules and exceptions

Statement = person’s oral assertion, **written assertion**, or nonverbal conduct, if the person intended it as an assertion

In bankruptcy adversary proceedings consider: emails, financial statements, representations of financial condition etc.

For potential hearsay issues, keep a cheat-sheet
Hearsay – what it is and what it is not

**Hearsay** is something said outside of the trial offered in evidence to prove the truth of the matter asserted in the statement

- when trying to admit a statement – determine →
- why is evidence of the statement being used?
- to prove it is true or → to prove the statement was made?

**Not Hearsay:**

*A Declarant-Witness’s Prior Statement.* The declarant testifies and is subject to cross-examination about a prior statement

- → inconsistent testimony → for impeachment or rebuttal
- → consistent testimony → for rehabilitation of the witness

*An Opposing Party’s Statement* that is deemed a party admission
Hearsay – exceptions
the following examples are consider hearsay but are the exceptions to inadmissibility

- Present Sense Impression Excited Utterance - Then-Existing Mental, Emotional or Physical Condition.
- Recorded Recollection
- Records (but be careful, for example, MI Unemployment Insurance Agency false fraud claims)
- Statements:
  - Made for Medical Diagnosis or Treatment in Documents That Affect an Interest in Property,
  - in Ancient Documents in Learned Treatises, Periodicals, or Pamphlets
- Market Reports and Similar Commercial Publications
- Reputation
- Concerning Personal or Family History Concerning Boundaries or General History Concerning Character
- Judgment of a Previous Conviction
- Judgments Involving Personal, Family, or General History, or a Boundary
Documentary evidence/admission

• Preparation of exhibits for the court
• Identification of what exhibits will establish which elements to be proven
• Consider hearsay issues with evidence presented
• Admission of documentary evidence – stipulated admission and contested admission
Other trial considerations

Key distinctions of a bankruptcy adversary proceeding:

• Bench trial – what is persuasive to a judge compared to a jury

• Trier’s specialized knowledge of the field of law
Attorneys’ Fees – Recovery by Creditors

• There is no statutory basis for the award of costs and fees to a creditor under 11 U.S.C.A. § 523(d).

• The Bankruptcy Code provision permitting the award to a consumer debtor of costs of, and reasonable attorney's fees for, proceedings on a complaint to determine the dischargeability of a consumer debt does not prevent the award of attorney's fees and costs to creditors entitled to them as a matter of contract under state law. A contractual right to such fees is part of the debt to the creditor and is not dependent on an award of costs. Thus, where a judgment debt is nondischargeable, the award of attorney's fees to which the debtor stipulated in a consent judgment is also nondischargeable.

• Ancillary obligations such as attorney's fees and interest may attach to the primary debt; consequently, their status depends on that of the primary debt.

• There is authority which holds that when the parties have included a provision authorizing recovery of attorney's fees in a contractual agreement, and those fees are incurred in connection with the debt determined to be nondischargeable in bankruptcy, recovery of reasonable attorney's fees by a creditor may be permitted.
Attorneys’ Fees – Recovery by Debtor

• A Creditor Who Files a Non-Dischargeability Action and Does Not Prevail May Be Required to Pay the Debtor’s Attorneys’ Fees for Defending the Action Under Section 523(d)

• Under Section 523(d), the Court “Shall” Award Costs and Reasonable Attorneys’ Fees if it Finds that the Position of the Creditor Was Not “Substantially Justified,” Unless Special Circumstances Exist that would Make such an Award Unjust.

• The “Substantially Justified” Standard Arises From the Equal Access to Justice Act (24 U.S.C. § 2412(d)).
Practical Considerations