

Consumer Track
Discharge Issues

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Dischargeability Issues and Litigation

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I. STUDENT LOAN DISCHARGE

There is more than \$1.2 trillion in outstanding student loan debt, which now accounts for more debt than home mortgages. Thus, student loan discharge issues are a continuing concern for many debtors. It may be that the judicial perspectives are changing on student loan discharge. It is rather amazing to read the concurrence of Judge Pappas in *In re Roth*, 490 B.R. 908 (9th Cir. BAP 2013) and hear his call for the rethinking of the standards for discharge. He calls for a consideration of existing law in light of the changed economic conditions in the country today compared to the early years of the Bankruptcy Code, when the law was forged.

Current Ninth Circuit Law

In determining whether student loan debt should be discharged pursuant to Section 523(a)(8), the Ninth Circuit applies the three factor *Brunner* test under which a debtor must prove: (1) she cannot maintain, based on current income and expenses, a “minimal” standard of living for herself and her dependents if required to repay the loans; (2) additional circumstances exist indicating that this state of affairs is likely to persist for a significant portion of the repayment period; and (3) the debtor has made a good faith effort to repay the loans. *Educ. Credit Mgmt. Corp. v. Mason (In re Mason)*, 464 F.3d 878, 882 (9th Cir. 2006). The application of this test may result in zero discharge, partial discharge or full discharge of the debtor’s student loan debt.

The most recent Ninth Circuit Court of Appeals opinion on this issue is *Hedlund v. Educ. Res. Inst. Inc.*, 718 F.3d 848, 855 (9th Cir. 2013). This case focused on the standard of review for the good faith prong of the *Brunner* test.

The debtor was a graduate of Willamette Law School who had failed the bar multiple times and was employed as a juvenile counselor. The Bankruptcy Court applied the *Brunner* test and determined that the debtor was entitled to a partial discharge of more than \$50,000 of his student debt.

The lender appealed and the District Court reversed the Bankruptcy Court's good faith ruling after *de novo* review, disregarding the Bankruptcy Court's weighing of the evidence of good faith.

The Ninth Circuit clarified that the standard of appeal for good faith prong of the *Brunner* test is clear error, not *de novo* review. The Ninth Circuit made clear that an appeals court's role is to apply and review under the correct legal standard, not to second guess fact finding done by the Bankruptcy Court. Thus, Ninth Circuit reversed the District Court.

Other recent appellate cases in the Ninth Circuit include *In re Roth*, 490 B.R. 908 (B.A.P. 9th Cir. 2013) and *In re Jorgensen*, 479 B.R. 79 (B.A.P. 9th Cir. 2012).

In *Roth*, the Ninth Circuit determined that a sixty-four-year-old debtor who had not made a single voluntary payment on her student loan debt and had declined to enter into an income contingent repayment plan, nonetheless exhibited good faith for purposes of the *Brunner* test. The debtor suffered from a variety of ailments, had made good faith efforts to obtain employment, maximize her income, and minimize her expenses, and had did not come to the bankruptcy court seeking an undue hardship discharge until many years after her loans entered repayment. The debtor's failure to make voluntary payments was mitigated somewhat by her good faith belief that loans were being paid through garnishments and tax offsets. The debtor's payments on loans under the Income Contingent Repayment Program ("ICRP") or other program would have been minimal at best and participation in the ICRP could have adverse tax consequences on the elderly debtor.

In *Jorgensen*, the Ninth Circuit affirmed a partial student loan discharge because it found the Bankruptcy Court did not clearly err in determining that Chapter 7 debtor had made good faith efforts to repay her student loans. The record supported the Bankruptcy Court's determinations that the debtor had unsuccessfully applied for higher-paying federal jobs, debtor was optimally employed and maximized her income, and debtor made timely payments on her loans for nearly eight years. The Bankruptcy Court had factored into its decision debtor's rejection of income based repayment plans and debtor's purchase of a new car. The Ninth Circuit refused to second guess the Bankruptcy Court's weighing of evidence regarding good faith.

Various Factors in Evaluating Student Loan Discharge.

Remaining Work Life

What is the appropriate retirement age? There are Social Security Administration statistics on retirement age. See Retirement Planner: Full Retirement Age, <http://www.ssa.gov/retire2/retirechart.htm> (last visited Feb. 24, 2014). This source was also used in *Morrison v. Sallie Mae, Inc. (In re Morrison)*, 2014 Bankr. LEXIS 751, at *26 (Bankr. E.D. Wash. Feb. 26, 2014) ("[A]ccording to the Social Security Administration, [debtor] will reach full retirement age on his 67th birthday.").

Reasonable Expenses

Reasonable *expenses* are determined by the following standards. While the undue hardship test is strict, it does not require that debtors live at or below the poverty line to obtain relief under 11 U.S.C. § 523(a)(8). *In re Howe*, 319 B.R. 886 (9th Cir BAP 2005). In fact, cable television, tanning and a new car were affirmed as part of the minimal standard of living in *In re Rifino*, 245 F.3d 1083, 1088 (9th Cir. 2001), and retirement contributions may also be included in this standard,

see *Craig v. Educ. Credit Mgmt. Corp. (In re Craig)*, 579 F.3d 1040 (9th Cir. 2009). Various donations to charity, dining out, and books for book clubs have not been considered reasonable expenses in other contexts. *In re Birrane*, 287 B.R. 490 (9th Cir. BAP 2002).

There is the housing and utilities figure permitted in Chapter 13 bankruptcy proceedings as reflected in the IRS Necessary Expense Guidelines. See *Educ. Credit Mgmt. Corp. v. Howe (In re Howe)*, 319 B.R. 886, 893 (B.A.P. 9th Cir. 2005) (explaining that debtor is not required to relocate to reduce their housing expense to the lowest amount possible and holding that these guidelines are a permissible indication of reasonable housing and other expenses in regard to student loan discharge cases).

Settlement Offers and Efforts

Sometimes the debtor is offered an income based repayment plan ("IBR") The IBR was explained in *Hedlund v. Educ. Res. Inst., Inc.*, 718 F.3d 848, 850 n.2 (9th Cir. 2013) "Under the ICRP, the debtor pays the lesser of: (1) payments based on a 12-year amortization derived by application of an annually adjusted percentage of the debtor's adjusted gross income; or (2) 20% of the debtor's annually adjusted discretionary income, defined as adjusted gross income less applicable federal poverty guidelines." The court should not fault a debtor for failing to accept the IBR. See *Roth v. Educ. Credit Mgmt. Corp. (In re Roth)*, 490 B.R. 908, 917 (B.A.P. 9th Cir. 2013) ("Any offered repayment plan's terms, duration, and consequences need to be examined. These consequences include future tax liability and negative credit ratings.").

Jurisdiction

A bankruptcy court has jurisdiction under 28 U.S.C. §§ 157 and 1334(b), and constitutional authority to enter a final judgment. *Deitz v. Ford (In re Deitz)*, 469 B.R. 11, 24 (B.A.P. 9th Cir. 2012) (citing *Sasson v. Sokoloff (In re Sasson)*, 424 F.3d 864, 867 (9th Cir. 2005)). A dischargeability matter is identified as statutorily core.

Partial discharge

The Court also the "authority to partially discharge" the student loan debt pursuant to its equitable authority under 11 U.S.C. § 105(a). *Saxman v. Educ. Credit Mgmt. BJR Corp. (In re Saxman)*, 325 F.3d 1168, 1173 (9th Cir. 2003); *Educ. Credit. Mgmt. Corp. v. Jorgensen (In re Jorgensen)*, 479 B.R. 79, 86 (B.A.P 9th Cir. 2012) (student loan discharged to the extent each element of the *Brunner* test was met). The amount and terms of payment of a partial discharge are left to the discretion of the bankruptcy court, and a debtor will remain obligated to repay any portion of a student loan debt that does not impose an undue hardship. *Saxman*, 325 F.3d at 1173.

To grant a partial discharge, the Court must find all three parts of the *Brunner* test are met as to the portion of the loan being discharged. "[T]he first prong of the *Brunner* test allows the bankruptcy court to determine the amount of student loan debt that prevents the debtor from maintaining a minimal standard of living and discharge only that amount." *Jorgensen*, 479 B.R. at 86. As to the second prong, "the bankruptcy court has the power to grant a partial discharge of student loans even when the debtor's earning capacity is expected to improve, if that improvement will be insufficient for the debtor to pay the full balance due without an undue hardship." *Carnduff*, 367 B.R. 120 (9th Cir. BAP 2007); *see also Mason*, 464 F.3d 878 (9th Cir. 2006) (citing *Saxman*, 325 F.3d at 1174 and affirming the bankruptcy court's holding that the debtor "had satisfied the second prong of the *Brunner* test only with respect to a portion of his student loans"). As to the third prong, the Ninth Circuit has held that only that portion of the student loan that the debtor cannot repay in good faith will be discharged. *Hedlund*, 718 F.3d at 856.

Persistence of Problem

The second prong of the *Brunner* test requires the Court to determine whether additional circumstances exist indicating that the impoverished state of affairs is likely to persist for a significant portion of the repayment period of the student loans. For this issue, the Court can look to whether the debtor has "psychiatric problems, lack of usable job skills and severely limited education." *Birrane*, 287 B.R. at 497. A more detailed test was later adopted in *In re Nys*, 446 F.3d 938 (9th Cir. 2006), to determine whether the debtor will be able to make student loan payments in

the future: (1) whether the debtor or a dependent has a serious mental or physical disability which prevents employment or advancement; (2) the debtor's obligation to care for dependents; (3) a lack of, or severely limited, education; (4) poor quality of education; (5) lack of marketable job skills; (6) underemployment; (7) maximized income potential in the chosen field and no other more lucrative job skills; (8) limited number of work years remaining; (9) age or other factors that prevent retraining or relocation; (10) lack of assets which could be used to pay the loan; (11) potentially increasing expenses; and (12) lack of better financial options elsewhere.

Good Faith

"Good faith is measured by the debtor's efforts to obtain employment, maximize income, and minimize expenses. Courts will also consider a debtor's effort -- or lack thereof -- to negotiate a repayment plan, although a history of making or not making payments is, by itself, not dispositive." *Hedlund*, 718 F.3d at 852; *see also Mason*, 464 F.3d at 884 (same);

Efforts to Repay, History of Payments; and Timing of the Bankruptcy

Timing is important. When the debtor took out the loans and efforts to pay even with difficult financial situations matter greatly. A debtor can exhibit good faith by paying when able. The effect of timing is demonstrated in a comparison of *Hedlund*, 718 F.3d at 853 (weighing in debtor's favor that he waited four years from the beginning of his repayment obligations to file bankruptcy), *with Brunner*, 831 F.2d at 397 (finding bad faith in part because debtor filed for discharge one month after first payment date).

During the time period that there are no payments, it is a valid excuse that the debtor did not have the "financial wherewithal to make them." *Roth*, 490 B.R. at 917. During these times, even a small windfall, such as an inheritance, may not have to go to the student loan if there are other expenses to pay. *See Hamilton v. United States Dep't of Educ. (In re Hamilton)*, 361 B.R. 532, 544 (Bankr. D. Mont. 2007) (discharging the student loan and noting that the inheritance received by the debtors was used to pay expenses); *Myhre v. U.S. Dep't of Educ. (In re Myhre)*, 503 B.R. 698, 704 (Bankr. W.D. Wis. 2013) (finding an undue hardship despite using the \$30,000 inheritance to pay expenses and to invest in his house and vehicle).

Determination of Amount of Partial Discharge

A reasonable method to determine the amount of a partial discharge is to project what the debtor can earn in her remaining work life less payroll deductions and reasonable expenses. This useful approach was also used in *Carnduff*, 367 B.R. at 133 ("If the bankruptcy court had no other concerns then it might have used Debtors' evidence to project their future income, deduct future expenses, calculate how much student loan debt Debtors could pay without undue hardship, and discharge the excess"). This formula is basically net income less reasonable expenses equaling the amount that can be paid annually for the remaining work life of the debtor.

II. ISSUE AND CLAIM PRECLUSION

THE IMPACT OF PREBANKRUPTCY LIGATION

(Materials primarily prepared by Hon. Margaret Mann, US Bankruptcy Judge, So. Dist. CA)

Res judicata/Claim Preclusion Does Not Apply to Nondischargeability Claims

Under *Brown v. Felsen*, 442 U.S. 127, 131 (1979), claim preclusion does not apply because its application in dischargeability proceedings would inspire needless litigation by an otherwise unwilling party to try bankruptcy issues to protect against the mere possibility that a debtor may file bankruptcy in the future.

Issue preclusion can be applicable in dischargeability cases. *Grogan v. Garner*, 498 U.S. 279, 284 (1991); *Collins v. D.R. Horton, Inc.*, 505 F.3d 874, 880 (9th Cir. 2007).

As a matter of full faith and credit, 28 U.S.C.S. § 1738 requires courts apply the collateral estoppel principles of the state from which the judgment was entered. *Grogan v. Garner*, 498 U.S. 279, 284 (1991); *In re Honkanen*, 446 B.R. 373, 382 (B.A.P. 9th Cir. 2011) (citing *Grogan* and holding that in "determining the preclusive effect of a state court judgment, federal courts must, as a matter of full faith and credit, apply that state's collateral estoppel principles").

Should the Court raise the Issue Sua Sponte?

The Court may raise it when appraised of an earlier decision. *McClain v. Apodaca*, 793 F.2d 1031, 1033 (9th Cir. 1986) (finding it consistent with the principles of collateral estoppel to permit a bankruptcy "court which has been apprised by the plaintiff of an earlier decision arising out of the same contract upon which the action before the court is based, to examine the res judicata effect of that prior judgment *sua sponte*"). *Clodfelter v. Republic of Sudan*, 720 F.3d 199, 208 (4th Cir. 2013) ("Similarly, the Supreme Court's holding in *Arizona v. California*, 530 U.S. 392, 412, 120 S. Ct. 2304, 147 L. Ed. 2d 374 (2000), that *sua sponte* consideration of a preclusion defense 'might be appropriate in special circumstances,' suggests an inherently discretionary judgment. This language indicates that whether to consider res judicata *sua sponte* amounts to a situation where "there is no single right or wrong answer."

If raised, the Court must allow the parties to be heard on the issue. If the prior judgment was a default judgment, the court "must be cautious about raising a preclusion bar *sua sponte*." See *Headwaters Inc. v. United States Forest Serv.*, 399 F.3d 1047, 1054-1055 (9th Cir. 2005) ("As a general matter, a court may, *sua sponte*, dismiss a case on preclusion grounds where the records of that court show that a previous action covering the same subject matter and parties had been dismissed. However, where no judicial resources have been spent on the resolution of a question, trial courts must be cautious about raising a preclusion bar *sua sponte*, thereby eroding the principle of party presentation so basic to our system of adjudication. Our research failed to find a single case in which this court has upheld a dismissal for claim or issue preclusion where the parties were not given any opportunity to be heard on the issue."); see also *Nevada Employees Ass'n v. Keating*, 903 F.2d 1223 (9th Cir. 1990) (reversing because "the trial court did not subject its res judicata decision to the rigors of the adversarial process").

If Not Raised, Preclusion is Waived.

The advantage of estoppel can be lost. *Hansen v. Moore (In re Hansen)*, 368 B.R. 868, 878 (B.A.P. 9th Cir. 2007): Both claim and issue preclusion are waived if not pled as affirmative defenses. *George v. City of Morro Bay (In re George)*, 318 B.R. 729, 736 (B.A.P. 9th Cir. 2004). Res judicata doctrines are neither mandatory, nor jurisdictional. Claim and issue preclusion must be raised affirmatively and, if not raised, may be treated as waived.

How do Preclusion Issues Affect Case Management?

Factors in Applying Issue Preclusion

Federal collateral estoppel law applies to a federal question judgment. *Marlee Elecs. Corp. v. Antonakis (In re Antonakis)*, 207 B.R. 201, 204 (Bankr. E.D. Cal. 1997). Under federal law, "[i]n order for a prior judgment to be entitled to collateral estoppel effect, five elements must be met: 1) The issue sought to be precluded from relitigation must be identical to that decided in a former proceeding; 2) The issue must have been actually litigated in the former proceeding; 3) It must have been necessarily decided in the former proceeding; 4) The decision in the former proceeding must be final and on the merits; and 5) The party against whom preclusion is sought must be the same as,

or in privity with, the party to the former proceeding." *Silva v. Smith's Pac. Shrimp (In re Silva)*, 190 B.R. 889, 892 (B.A.P. 9th Cir. 1995).

State collateral estoppel law applies to a prior federal diversity judgment. *Bates v. Union Oil Co. of California*, 944 F.2d 647, 649 (9th Cir. 1991); *see also Silva v. Smith's Pac. Shrimp (In re Silva)*, 190 B.R. 889, 892 n.1 (B.A.P. 9th Cir. 1995).

State collateral estoppel law applies to state judgments. *Gayden v. Nourbakhsh (In re Nourbakhsh)*, 67 F.3d 798, 800 (9th Cir. 1995).

Under California law, collateral estoppel requires that:

(1) the issue to be precluded from relitigation be identical to that decided in the prior proceeding;

(2) the issue have been actually litigated;

(3) the issue have been necessarily decided;

(4) the decision on the issue be final and on the merits; and

(5) the party be the same as, or in privity with, the party in the prior proceeding. *Younie v. Gonya (In re Younie)*, 211 B.R. 367, 373 (B.A.P. 9th Cir. Cal. 1997).

The sixth element is a mandatory "additional" inquiry into whether imposition of issue preclusion in the particular setting would be fair and consistent with sound public policy. *In re Summerville*, 361 B.R. 133, 143 (B.A.P. 9th Cir. 2007).

Under Arizona law, the follow elements govern issue preclusion:

(1) the issue or fact to be litigated was actually litigated in a previous suit,

(2) a final judgment was entered, and

(3) the party against whom the doctrine is to be invoked had a full opportunity to litigate the matter,

(4) and actually did litigate it, [and]

(5) such issue or fact was essential to the prior judgment.

In re Child, 486 B.R. 168 (9th Cir BAP 2013) citing *Chaney Building Co. V. City of Tucson*, 148. Airz.571 (1986)

In Nevada, the issue preclusion can be invoked if:

(1) the issue decided in prior litigation is identical to the issue presented in the current litigation;

(2) the initial ruling was on the merits and is final; and

(3) the party against whom the judgment is asserted was a party or in privity with a party to the prior litigation. *LaForge v. State ex rel. Univ. & Cmty. Coll. Sys.*, 116 Nev. 415, 997 P.2d 130, 133 (2000).

Dias v Elique, 436 F.3d 1125 (9th Cir. 2006).

Identical Factors

In determining whether the issues in a prior proceeding are identical to those in the subsequent proceeding, the Ninth Circuit has developed a list of four factors to be considered: (1) is there a substantial overlap between the evidence or argument to be advanced in the second proceeding and that advanced in the first? (2) does the new evidence or argument involve the application of the same rule of law as that involved in the prior proceeding? (3) could pretrial preparation and discovery related to the matter presented in the first action reasonably be expected to have embraced the matter sought to be presented in the second? (4) how closely related are the claims involved in the two proceedings? *Resolution Trust Corp. v. Keating*, 186 F.3d 1110, 1116 (9th Cir. 1999).

Slander: a state court judgment for slander or intentional infliction of emotion distress does not determine privilege, i.e., whether there was "just cause or excuse" under § 523(a)(6). *People v. Carter*, 36 Cal. 4th 1215, 1240 (Cal. 2005); *Peck v. Maaskant (In re Peck)*, 295 B.R. 353, 362 (B.A.P. 9th Cir. 2003)

Negligence: finding does not establish willfulness under § 523(a)(6). *See Robinson v. Louie (In re Louie)*, 213 B.R. 754, 757 n.1 (Bankr. N.D. Cal. 1997)

Fraud: identical elements *In re Younie*, 211 B.R. 367 (B.A.P. 9th Cir. 1997)

Necessarily Decided

There is no estoppel without a finding of specific elements of claim if elements would have necessarily been found by the state court to enter its judgment. *In re Younie*, 211 B.R. at 374-75. Breach of Contract: Fraud not necessarily decided. *In re Harmon*, 250 F.3d 1240, 1248-49 (9th Cir. 2001) (judgment for constructive fraud not tantamount to a determination of actual fraud).

Findings must be detailed and unambiguous for preclusion to apply. *See Genesis V J, Inc. v. Nguyen (In re Nguyen)*, 2012 Bankr. LEXIS 683, at *21-22 (B.A.P. 9th Cir. Feb. 17, 2012) (unpublished) ("Given the ambiguity of the record and the lack of specific findings of fact by the state court that would support a determination that an agency relationship existed, it is far from clear that the bankruptcy court would have abused its discretion in declining to apply issue preclusion to the agency issue. As a matter of fairness, when faced with serious questions about the scope of a ruling, the bankruptcy court should err on the side of caution and avoid applying issue preclusion when a state court's exact determination is ambiguous. In this case, the state court's determination was simply not sufficiently firm to be given preclusive effect."); *see also Honkanen v. Hopper (In re Honkanen)*, 446 B.R. 373, 384 (B.A.P. 9th Cir. 2011) ("[A]ll doubts about what was decided in the state court action are to be construed against the party seeking preclusion."); *Phan v. Nguyen (In re Phan)*, 2014 Bankr. LEXIS 727, *21-22 (B.A.P. 9th Cir. Feb. 24, 2014) (no preclusive effect when alternative dischargeable grounds for a judgment are included).

Sound Public Policy:

Three factors are germane to the public policy issue: "preservation of the integrity of the judicial system, promotion of judicial economy, and protection of litigants from harassment by vexatious litigation." *Lucido v. Superior Ct.*, 51 Cal. 3d 335, 341-43 (1990).

Creditor may seek to prove nondischargeability of state court judgment for a dischargeable claim. *See Banks v. Gill Distrib. Ctrs., Inc. (In re Banks)*, 263 F.3d 862, 868-69 (9th Cir. 2001) (previous state court contract judgment does not prevent creditor from raising discharge issues that were not raised early); *Mandalay Resort Group v. Miller (In re Miller)* 292 B.R. 409, 412 (B.A.P. 9th Cir. 2003) ("[T]he Ninth Circuit Court of Appeals has held that the running of a state statute of

limitations for a fraud claim 'does not foreclose a later determination by the bankruptcy court that what occurred was fraudulent and therefore nondischargeable' under § 523(a)(2).").

The Status of the State Court Judgment Matters

State Court Judgment on Appeal

California courts have consistently determined that appealed judgments are not final, and thus prevent the judgment from becoming res judicata on the issues. *Woods v. Herson*, 39 Cal.App.3d 737, 747 (1974). However, an appealed judgment may be determined as final, if the circumstances of the case show the appeal is effectively abandoned, the issue of res judicata is not raised, and no miscarriage of justice will occur by doing so. *Id.* at 747-48.

In Arizona, a judgment is final even if an appeal is pending from that judgment. *Downs v Superior Court*, 623 P.2d 1229 (Ariz. 1981). The same rule applies in Nevada. *Edwards v. Ghandour*, 123 Nev. 105, 117, 159 P.3d 1086 (Nev (2007)

State Court Default Judgment

Defendants are estopped from contesting facts found in a default judgment because the Defendant "is presumed to admit all the facts which are well pleaded in the complaint " subject to two limitations: (1) "Where there is a complete lack of knowledge on the part of a defendant of the action [in which a default was obtained], it would be unreasonable to hold that the judgment" has preclusive effect and (2)"only where the record shows an express finding upon the allegation for which preclusion is sought." *Harmon v. Kobrin (In re Harmon)*, 250 F.3d 1240, 1247 (9th Cir. 2001). A default judgment is as conclusive on the allegations in the complaint as would be a trial on the issues. *See In re Moore*, 186 B.R. 962, 972 (Bankr. N.D. Cal. 1995); *see also In re Jung Sup Lee*, 335 B.R. 130 (9th Cir. BAP 2005). In *Harmon*, however, the Ninth Circuit Court of Appeals found that estoppel did not apply because the state court made no express finding concerning Debtor's allegedly fraudulent actions. *Id.* at 1247-48.

Federal Court Default Judgment

Federal collateral estoppel law does not find a default judgment to meet the "actually litigated" standard. *In re Silva*, 190 B.R. 889, 894 (B.A.P. 9th Cir. 1995).

Settlement

Settlements ordinarily occasion no collateral estoppel unless it is clear that the parties intend their agreement to have such an effect. *Arizona v. California*, 530 U.S. 392, 414 (2000). The U. S. Supreme Court has held that claim preclusion did not prevent the Bankruptcy Court from looking beyond the record of the state-court proceeding and the documents that terminated that proceeding (the stipulation and consent judgement) in order to decide whether the debt at issue (namely, the debt embodied in the consent decree and stipulation) was a debt for money obtained by fraud." *Archer v Warner*, 538 U.S. 314, 320 (2003)

State Court Arbitration Ruling

In the arbitration context, the sixth element of the collateral estoppel test (fairness) evaluates "whether adjudicatory standards for administrative tribunals were satisfied." *Khaligh v. Hadaegh (In re Khaligh)*, 338 B.R. 817, 829-30 (9th Cir. BAP 2006). "[W]hile confirmation of an arbitration award under California law does not turn on whether the arbitration proceeding was conducted in an adjudicatory manner, California makes the adjudicatory nature of the underlying arbitration a prerequisite for using the award as a basis to impose issue preclusion in other litigation." *Id.* at 829. "The essential elements of adjudication include the following elements: (a) Adequate notice to persons who are to be bound by the adjudication . . . ; (b) The right on behalf of a party to present evidence and legal argument in support of the party's contentions and fair opportunity to rebut evidence and argument by opposing parties; (c) A formulation of issues of law and fact in terms of the application of rules with respect to specified parties concerning a specific transaction, situation, or status, or a specific series thereof; (d) A rule of finality, specifying a point in the proceeding when presentations are terminated and a final decision is rendered; and (e) Such other procedural elements as may be necessary to constitute the proceeding a sufficient means of conclusively determining the matter in question, having regard for the magnitude and complexity of the matter in question, the urgency with which the matter must be resolved, and the opportunity of the parties to obtain evidence and formulate legal contentions." *Khaligh*, 338 B.R. at 830 (*quoting* Restatement (Second) Judgments § 83(2)).

Criminal Plea

"Collateral estoppel does not bar relitigation of an issue necessarily decided in a prior criminal case where, as here, that issue was determined by a plea of guilty or nolo contendere rather than by trial." *20th Century Ins. Co. v. Schurtz*, 92 Cal. App. 4th 1188, 1196 (Cal. Ct. App. 2001). "A plea of guilty is admissible [, however] in a subsequent civil action on the independent ground that it is an admission. It would not serve the policy underlying collateral estoppel, however, to make such a plea conclusive. 'The rule is based upon the sound public policy of limiting litigation by preventing a party who has had one fair trial on an issue from again drawing it into controversy.'" *Teitelbaum Furs, Inc. v. Dominion Ins. Co.*, 58 Cal. 2d 601, 605, 375 P.2d 439, 441 (1962).

State Judgment Obtained by Fraud

"To establish a case for vacating a California state court judgment based upon extrinsic fraud, the movant must plead and prove that he has a meritorious case. In addition, if the party is seeking relief from a default judgment, as in the instant case, he must also present a satisfactory excuse for not defending against the original action. Finally, the moving party must prove diligence in setting aside the default once it was discovered. For each of these requirements, the party seeking to set aside a judgment pursuant to a court's equity powers must make a substantially higher showing than is necessary to obtain relief under statute." *Lake v. Capps (In re Lake)*, 202 B.R. 751, 759 (B.A.P. 9th Cir. 1996) (internal citations omitted).

Issue Preclusion And The Amount of the Claim

The amount of the nondischargeable debt includes "any debt for money, property, services, or credit, to the extent obtained by' fraud encompasses any liability arising from money, property, etc., that is fraudulently obtained, including treble damages, attorney's fees, and other relief that may exceed the value obtained by the debtor." *Cohen v. De La Cruz*, 523 U.S. 213, 223 (1998) (internal quotations omitted).

Damages: "The classic example of the proper use of issue preclusion in discharge proceeding is when the amount of the debt has been determined by the state court and reduced to judgment. In that event, if there are no new issues, the bankruptcy court should ordinarily decline to allow the

parties to relitigate the debt amount and should give the state court judgment as to the amount of preclusive effect." *Sasson v. Sokoloff (In re Sasson)*, 424 F.3d 864,872 (9th Cir. 2005).

Can The State Court Revise Its Ruling?

Within six months of the order being entered, Cal. Civ. Code § 473 allows a state court to relieve a party of a judgment or order due to a party's mistake, inadvertence, surprise or excusable neglect. At any time, state courts have the inherent authority to correct judgment by nunc pro tunc order so as to make judgment as entered to conform to judicial decision actually made. *Estate of Eckstrom*, 54 Cal. 2d 540, 547 (Cal. 1960) ("[T]here is both an inherent and a statutory right for a court to cause its acts and proceedings to be correctly set forth in its records, where such records fail to indicate the order or direction in fact made. By its very nature, however, the right is exercisable only for the purpose of ascertaining and reflecting the truth. In most instances, as in the present case, the truth must be ascertained from the intention of the trial judge in making his original order.").

III. INTENT AFTER *BULLOCK V. BANKCHAMPAIGN*

The Supreme Court issued an influential ruling on the scope of the term “defalcation” in Section 523(a)(4) that may have ramifications in all intentional tort nondischargeability areas. The case is *Bullock v Bankchampaign NA*, __ U.S. __, 133 S.Ct. 1310 (2013).

In *Bullock*, the debtor’s father established a trust for the benefit of his five children. Debtor was the trustee of the trust. The trust’s sole asset was a life insurance policy for the debtor’s father. The trust instrument allowed the trustee to borrow funds from the insurer against the policy’s value. On three occasions, the debtor borrowed money from the trust. Each time, the debtor caused the borrowed funds to be repaid with interest.

Later, the debtor’s siblings sued him in state court for breach of fiduciary duty. The state court determined the debtor did not have a malicious motive in borrowing the funds from the trust, but found him liable for breach of fiduciary duty based on self-dealing. The state court imposed a constructive trust on the property obtained by the debtor with the borrowed funds and appointed BankChampaign as trustee.

The debtor filed for bankruptcy. The bankruptcy court determined that the debtor’s debts were nondischargeable as a debt for defalcation in a fiduciary capacity under Section 523(a)(4). The District Court and Court of Appeals affirmed.

The Supreme Court reversed. It determined that defalcation in a fiduciary capacity under Section 523(a)(4) requires some sort of bad intent. It is a fascinating case in that Justice Breyer says early on that legal authorities have disagreed about the meaning of defalcation almost since it was added as an exception to discharge in 1867. In order to interpret “defalcation as a fiduciary”, the court looked to the other types of acts listed in Section 523(a)(4), which all require a bad intent and concluded defalcation should be interpreted similarly. It rejected the idea that some sort of strict liability applied. In *Bullock*, all the funds were repaid to the estate and some of the self-dealing was encouraged by the trustor while alive.

The case squarely overrules Ninth Circuit precedent that “even innocent acts of failure to fully account for money received in trust will be held as non-dischargeable defalcations.” *In re Sherman*, 658 F.3d 1009, 1017 (9th Cir. 2011).

Although *Bullock* was only recently decided, there appears to be a trend by some courts to interpret its reasoning broadly. For example, the Ninth Circuit Bankruptcy Appellate Panel recently cited *Bullock* to support its holding that under Section 523(a)(2)(A) debts incurred as the result of the debtor's agent's fraud should not be excepted from discharge unless the debtor is culpable. *In re Huh*, 506 B.R. 257 (B.A.P. 9th Cir. 2014)(en banc) This was an *en banc* decision with a detailed analysis covering over 100 years of law. Similarly a Bankruptcy Court cited *Bullock* to support its holding that fraud under Section 523(a)(2)(A) should not be imputed to an innocent spouse. *In re Shart*, 505 B.R. 13, 16 (Bankr. C.D. Cal. 2014).

IV. DOMESTIC SUPPORT OBLIGATIONS

A County's Claim for Jail Fees can be a DSO.

The debtor's minor son was jailed. By law, the debtor was liable to Orange County for the costs of support of her son while in jail. The debtor filed bankruptcy and listed the County. After the case closed and the discharge had been issued, the County renewed collection efforts. The trial court and the Bankruptcy Appellate Panel held that the County's debt fell under Section 523(a)(5) under a plain language interpretation. *In re Rivera*, 511 B.R. 643 (9th Cir BAP 2014). The court held that the debt:

- (1) accrued before the order of relief;
- (2) was owed to a governmental unit;
- (3) was incurred for the support of Debtor's child as "assistance provided by a governmental unit;"
- (4) was established before Debtor's bankruptcy by an order of the state court; and
- (5) had not been assigned to a nongovernmental entity for collection.

Id. at 653.

This case serves as a warning to us all that it is the language of the statute, not its title, that holds the meaning. There is nothing in this debt that ties it to a Family Court case. There are no divorcing spouses. It seems per the general rubric of discharge that this is not a domestic support obligation.

The breadth of this case's application is unclear. In very general terms, it appears that where a governmental entity provides "assistance" that becomes the monetary responsibility of the debtor, that debt may be of the *Rivera* type. Historically it was not a major advantage in bankruptcy to be a governmental entity for nondischargeability purposes, this ruling erodes that fact.

A Hold Harmless Agreement can be Enforced as to Discharged Debt.

Here, the debtor, as commonly happens, gave his ex-spouse his promise to hold her harmless from various community debts. The promise was approved by the Family Court. But the debtor did not pay the debts, instead he filed bankruptcy and apparently discharged his personal liability for them. His former spouse ultimately paid the debts. She sought a ruling that his promise to pay them and keep her safe from this liability was nondischargeable. The Bankruptcy Appellate Panel agreed that the debt was not discharged. *In re Francis*, 505 B.R. 914 (9th Cir. BAP 2014).

Where the debtor files bankruptcy before divorce and lists and discharges the loan from his former in-laws, the family court cannot oblige the debtor to pay this debt or indemnify the former wife. *In re Heilman*, 430 B. R. 212 (9th Cir. BAP 2010). The dissent argues that the duty to equitable adjust the liabilities of the divorcing partes was not discharged in bankruptcy and thus it might be that the debtor could not discharge the debt. Substantial statutory support is provided.

Bankruptcy practitioners need to warn the family law bar that the common and mindless practice of having one spouse, usually the high income or the one getting a disproportionate amount of the assets will give a hold harmless agreement to the other spouse creates a potentially long term problem. Better to make no promise in this regard to one another or to agree to use bankruptcy to wipe out the debts, possibly before finalizing the divorce.

Who Holds a Domestic Support Claim?

Not all family court orders to pay money are domestic support obligations. In *In re Gunness*, 505 B.R. 1 (9th Cir. BAP 2014), the BAP held that a debt owed by family court order to the former spouse of the former spouse was not nondischargeable as a domestic support obligation. The debtor owed money to her former husband's former wife based on fraudulent conveyances she participated in with her former husband. The BAP held that since the debt holder was not a spouse, former spouse or child of the debtor, she did not fall under the explicit language of Sections 523(a)(5) and (a)(15). The court concluded its opinion by stating that it could not liberally interpret those statutes to render the debts of a non-spouse nondischargeable.