BANKRUPTCY LAW NEWSLETTER

PUBLISHED BY FEDERAL BAR ASSOCIATION
WESTERN DISTRICT OF MICHIGAN CHAPTER

JANUARY, 1996

PUNITIVE DAMAGES AND ATTORNEY FEES: WHEN ARE THEY NONDISCHARGEABLE?

By: Lisa E. Gocha'[1]

Debts held to be nondischargeable under 11 U.S.C. §523 may permit a creditor to collect damages which are ancillary to those incurred as a direct result from the conduct which gave rise to the liability. Under certain conditions, a creditor may obtain punitive damages and/or attorney fees declared to be nondischargeable in conjunction with any actual damages suffered.

While courts have found that 11 U.S.C. §523(a)(2), which declares a debt to be nondischargeable "to the extent obtained by false pretenses, or actual fraud" (emphasis added), does not permit the recovery of punitive damages, most courts have taken a different view as to 11 U.S.C. §523(a)(4) and (6) basing the distinction on the language or absence thereof in each of these Code sections. 11 U.S.C. §523(a)(2) has been interpreted to require that a debt deemed to be nondischargeable must be a direct result of the debtor's bad conduct. Focusing on the specific language found in 11 U.S.C. §523(a)(2), the courts have found a debt is nondischargeable only to the "extent obtained" by the conduct proscribed. This phrase acts as a limiting component of this Code section thus prohibiting the nondischargeablity of claims beyond the scope of that language: however, 11 U.S.C. §523(a)(4) and (6) do not contain similar limiting elements. In Re: Bugna, Bugna v McArthur, 33 F.3d 1054, 1058 (9th Cir. 1994) citing In re Levy, 951 F.2d 196, 199 (9th Cir. 1991).

---

[1]Lisa E. Gocha' is an associates with Shermeta, Chimko & Kilpatrick, P.C., of Rochester Hills, Michigan and works in the Grand Rapids office.

11 U.S.C. §523(a) states, in relevant part, as follows:

"A discharge of this title does not discharge an individual debtor from any debt-

(4) for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny;

(6) for willful and malicious injury by the debtor to another entity to the property of another entity;"

While there is some split of opinion, the majority view that punitive damages may be held to be nondischargeable - focus as on the word "debt" found in 11 U.S.C. §523(a) interpreting this to mean that any act which gave rise to the liability is nondischargeable. There is no language which differentiates between whether the debt is compensatory or punitive in nature. Therefore, all liability arising from the bad conduct falls within the scope of 11 U.S.C. §523(a)(4) and (6). In Re: Benson, Brown v Benson, 180 B.R.796, 800 (W.D. Penn. 1995).

The minority position focuses on the term "injury" reasoning that if the damages bear no no direct relationship to the injury but exist merely for the purpose to punish conduct, such damages would fall outside of the scope of 11 U.S.C. §523(a)(6). Id. This view is similar to the reasoning courts have applied to 11 U.S.C. §523(a)(2).

It is of interest to note that in Bugna, the Debtor argued that, regardless of the absence of any limiting language in 11 U.S.C. §523(a)(4) and (6), failure to permit the Debtor to discharge punitive damages thwarts the fresh start policy intended by the Bankruptcy Code, and as such, the Code should be liberally interpreted in favor of the Debtor. While the Court agreed that the Code favors liberal construction toward that end, it also found that the a fresh start policy is limited to the "honest but unfortunate debtor", and that the egregious conduct on the part of the Debtor deemed him undeserving of the benefit of that policy. Bugna, 1059 citing Grogan v Garner, 498 U.S. 279 (1991).

Most of the cases on this issue deal with punitive damages and/or attorney fees previously awarded in state court and than the Debtor later filed bankruptcy. Once a judgment had been entered, the Bankruptcy Court gave full force and effect to the state court judgement refusing to relitigate the issues. Benson merits further discussion in that the creditor sought punitive damages in the Bankruptcy Court which were not ordered in the state court proceeding. The State Court judgment awarded only actual damages but allowed for the possibility of punitive damages after an evidentiary hearing was held on the matter. The Debtor filed Bankruptcy prior to any determinative hearing on the issue.

Once the Bankruptcy was filed, the creditor then brought the issue of punitive damages before the Bankruptcy Court. Upon hearing, the court found that the conduct of the Debtor was so egregious that the creditor should be allowed to recoup expenses incurred as a result of the bankruptcy and awarded the creditor such sum as to bring the creditor whole and to deter the Debtor from future conduct of this kind.

CONCLUSION

Most courts now hold that all debts including punitive damages and legal fees which flow from Debtor's wrongful conduct under 11 U.S.C. §523(a)(4) and (6) will be held to be nondischargeable. In Re: Marx: Pollock v Marx, 171 Br. 218 (N.D. Tex. 1994) citing Stokes v Ferris, 150 Br. 388, 393 (W.D. Tex. 1992). In light of the foregoing decisions on this issue, creditors are more adequately protected , and the Debtor may find it prudent to consider additional penalties which may be imposed in defending a claim of this nature.

RECENT BANKRUPTCY COURT DECISIONS

The Eastern District Court decisions are summarized by Jaye M. Bergamini. There were no Western District cases nor any Sixth Circuit and Supreme Court decisions.

In Re: Thomas Couts d/b/a American Carpet Cleaning 95-40450 (Bankr. ED Mich 1995) Meganck v Couts A/P 95-4205, filed 10/27/95. Prior to the filing of the Debtor's petition, Plaintiffs obtained a consent judgment for $3,000 against the Debtor on a state court complaint that alleged fraud and misrepresentation. On the filing of the Debtor's petition, Plaintiffs filed an adversary proceeding contesting the dischargeability of the judgment pursuant to 11 U.S.C. §523(a)(2)(A). The trustee and Debtor's counsel were served with a copy of the complaint as required under F.R.B.P. 7004, but the Debtor himself was not served.

No answer was filed and a default was entered by the court clerk. Plaintiffs then moved for entry of judgment and on the Debtor's failure to respond, judgment was entered.

Forty-nine days after entry of judgment, and 122 days after the filing of the complaint in the adversary proceeding, the Debtor appeared and filed a motion to set aside the default judgment, and to dismiss the adversary proceeding, on the basis that the summons had not been served on the Debtor within 120 days.

The court held that because a default judgment had already been entered, the proper basis for the motion to set aside would be F.R.C.P. 60(b), which allows the court to act to relieve a party from a final judgment.

Following the standards in the Sixth Circuit, set down in *United Coin v Seaboard Coastline* 705 F.2d 838 (6th Cir 1983) Judge Rhodes held that a motion to set aside the default judgment under Rule 60(b) required the establishment of a meritorious defense, as well as the defective notice.

On questioning by the court, Debtor's counsel admitted that the Debtor had notice, via his attorney, of the pendency of the adversary proceeding. Further, the attorney admitted that the decision to not answer and to not object to entry of the judgment was a deliberate tactical move, calculated to take advantage of the "expiration" of the summons after 120 days. The Debtor's motion to set aside the judgment and to dismiss the complaint was solely based on the argument that the summons had expired without proper service.

When asked why the Debtor had not attached an affidavit of meritorious defense to his motion to set aside, his counsel stated that he did not believe that *United Coin Meter* was on point, and that he did not believe that the Debtor had a meritorious defense.

A motion decided under Rule 60(b) rests on the discretion of the court. Actual knowledge of the complaint on the part of the Debtor is not a substitute for proper service and does not cure a technically defective service of process. *Friedman v Estate of Presser* 929 F.2d 1151 (6th Cir. 1991). While defective service might be sufficient to set aside entry of a default, once a judgment is entered, the Debtor had the additional burden of showing the existence of a meritorious defense. Upon the Debtor's failure to meet

that burden, the motion to set aside and dismiss was denied.

* * * * * * * *

Masters v Hamama 95-CV-72614-DT (ED Mich) issued 9/7/95. Defendant appeals from an order of the Bankruptcy Court (Judge Rhodes) finding debts owed to Plaintiff to be nondischargeable pursuant to 11 U.S.C. §523(a)(6). Plaintiff filed a motion to dismiss the appeal, claiming that the Defendant did not timely file. The District Court granted the motion and dismissed the appeal.

Trial was held in the Bankruptcy Court and on April 19, 1995 Judge Rhodes found the debt to be nondischargeable. He then sought briefs from the parties on the issue of damages. On May 30, 1995 the parties appeared and Judge Rhodes issued an oral bench opinion on the damage issue and indicated an intent to issue a corresponding judgment. A one paragraph written "Order Determining Damages" was issued by the court on June 1, 1995. Then, on June 14, 1995, Judge Rhodes issued a supplemental opinion which did not change his opinion of May 30, 1995, nor his judgment of June 1, 1995, but which was in fact the opinion which the court had read into the record as his bench opinion on May 30, 1995.

The Defendant filed a notice of appeal on June 28, 1995 from the "Order determining damages dated June 1, 1995 and the Supplemental Opinion dated June 14, 1995." Plaintiff filed a motion to dismiss, claiming that the appeal was not timely under F.R.B.P. 8002(a); the District Court lacked jurisdiction because the appeal was not filed within ten days of June 1, 1995. Defendant argued that the June 1, 1995 order must be taken in conjunction with the supplement opinion of June 14, 1995, so his June 28, 1995 appeal was timely filed. (There is no explanation in the opinion why the Defendant thinks that, even if the operative date of the entry of the final order was June 14, 1995, an appeal filed June 28, 1995 would be timely. The 10th day, June 24, 1995, was a Saturday. The next regular business day was Monday, June 26, 1995.)

The appeal turned on which opinion or order began the running of the ten day appeal period. Relying on *In re: Silva* 928 F.2d 304 (9th Cir. 1990) Judge Duggan found that a disposition is final if it contains a complete act of adjudication, a full adjudication of the issue at bar, and clearly evidences the judge's intention that it be the court's final act in the matter. Appealability turns on the effect of the ruling, not the label assigned to it by the trial court. Since the June 14, 1995 opinion was merely a formal writing of the bench opinion, it had no effect on the June 1, 1995 order. The appeal, in order to be timely, was controlled by the June 1, 1995 opinion date. The Plaintiff's motion to dismiss was granted.

* * * * * * * *

In Re: Dobbs Inc. (Bankr. ED Mich 1995) 94-CV-71689-DT Dery v Detroit Edison issued 9/20/95. Creditor Detroit Edison appeals from an order by Bankruptcy Judge Graves disallowing it's two affirmative defenses to a suit for avoidance of preferential transfers brought by Trustee Dery. The District Court, Judge Rosen, affirmed the Bankruptcy Court's finding with respect to the ordinary course of business and reversed with respect to the claim of new value.

Dobbs Furniture filed Chapter 11 in March of 1991. Trustee, Fred Dery, was appointed March of 1992. The case was converted April of 1992 to chapter 7. Dery was appointed the chapter 7 trustee as well.

Prior to the filing, Detroit Edison had supplied electrical service to the Debtor for 27 years. The Debtor had four accounts for it's retail stores as of the date of filing. The Debtor prior to 1990 generally paid on time. After 1990 and up to the date of filing, the Debtor was late with payment and incurred the 2% late payment fee. The rules of the Michigan Public Service Commission require a utility to accept a customer's late payments. The payment made within the 90 days preceding the filing covered some service provided prior to the preference period. Trustee Dery sought recovery of payments made during the preference period.

Detroit Edison stated affirmative defenses to the action of: (1) payment in the ordinary course of business, and (2) new value. The trustee brought a motion for summary disposition after obtaining answers to interrogatories and a statement of bills rendered, asserting no genuine issue of material fact. The motion was granted and the utility appealed.

The District Court noted *Street v JC Bradford & Co.* 886 F2d 1472 (6th Cir. 1989), a case which established a set of principles to be applied to motions for summary disposition. The court applied the principles to the Bankruptcy Court's decision.

On the affirmative defense of payment in the ordinary course, the issue was whether the Debtor's payments to the creditor satisfied the requirements of 11 U.S.C. §547(c)(2)(B) and (C). The substance of the ordinary course defense requires both subjective and objective analysis. The subjective subsection B element requires proof that the debt and it's payment are ordinary in relation to other business dealings between that creditor and that Debtor. The objective subsection C element requires proof that the payment is ordinary in relation to the standards prevailing in the relevant industry. *In re: Fred Hawes* 957 F2d 239 (6th Cir. 1992).

Since the record showed and the parties stipulated that the Debtor made timely payments for 27 years, and was only delinquent the five months prior to filing, the subjective subsection B analysis was clear. The late payments were not ordinary as between the creditor and the Debtor. On that point, there was no issue of material fact and the bankruptcy court properly granted the trustee's motion for summary disposition. Additionally, the court noted that the creditor presented no evidence linking the Debtor's pattern of payment to some prevailing industry practice, other than reference to MPSC rules and regulations, and hence had not met the objective subsection C burden.

As to the affirmative defense of new value, the Bankruptcy Court found that the creditor's defense was improperly presented under the abrogated "net result rule", rather than the "subsequent advance rule." The subsequent advance rule requires that the creditor must have provided new value after the transfer from the Debtor to the creditor. The net result rule used to allow the creditor to show that value was advanced either before or after the transfer, as long as, over the entire preference period, there was a net difference between the sum of the transfers and the sum of the value advanced.

The creditor conceded on appeal that it had used the wrong calculation of new value. The District Court, in analyzing the record, found that it would be possible for the creditor to establish some new value if the proper standard of review, the subsequent advance rule, were applied. (Ironically, it was the trustee and not the creditor who demonstrated that there was new value under the subsequent advance rule. The creditor did no such analysis to support it's case, even on appeal).

Even though the Bankruptcy Court did not have the duty to search the entire record to establish that it was bereft of a genuine issue

of material fact, the District Court "reluctantly concluded" that summary disposition was improperly granted. An incorrect calculation, standing alone, does not provide a basis for summary judgment where it seems clear from the record that a correct calculation will demonstrate that the creditor is entitled to claim some new value.

On remand, the Bankruptcy Court was directed to demand that the creditor provide a proposed calculation of the new value using the subsequent advance rule. Judge Rosen directed the parties attention to the good explanation and many examples of such a calculation to be found in *Boyd v Water Doctor (In re: Check Reporting Services, Inc.* 140 BR 425 (Bankr. WD Mich 1992).

STEERING COMMITTEE MINUTES

No meeting was held in December. The next meeting will be held on January 19, 1996, at noon at the Peninsula Club, Grand Rapids.

LOCAL BANKRUPTCY NOTICE

Enclosed from Mark Van Allsburg is a memo and February and March court calendars.

LOCAL BANKRUPTCY STATICS

The following is a summary of the number of bankruptcy cases commenced in the United states Bankruptcy Court for the Western District of Michigan (Lower Peninsula) during the months of December of 1995. These figures are compared to those made during the same period one year ago and two years ago.

Bankruptcy Chapter	December of 1995	December of 1994	December of 1993
Chapter 7	365	323	316
Chapter 11	4	6	11
Chapter 12	0	4	3
Chapter 13	140	113	102
Totals	509	446	432

Bankruptcy Chapter	January - December of 1995	January - December of 1994	January - December of 1993
Chapter 7	4433	3799	4067
Chapter 11	69	81	113
Chapter 12	16	18	30
Chapter 13	1710	1471	1324
§304	1	0	0
Totals	6229	5369	5534

FROM THE CLERK:

Strategic Planning Survey -- The court is now conducting a survey to find out what our customers (and this term includes you) want from us in the future. The court is faced with two very pronounced trends which will dictate radical changes in the way that court services are provided in the future: First, very rapid advances in automation technology and second, diminishing resources to pay for improved services. We are trying to find out what changes you think will be most helpful in this environment. If you do not receive a strategic planning form by the time this newsletter is mailed, give us a call and we will send you one.

Copies: The intake clerks would greatly appreciate it if you would remember to send us an original and one copy of motions, objections, orders and the like. The local rules do require these copies -- see local rule 5. Unfortunately, many people do not send them.

Payment for copies and other services: Although the Bankruptcy Court is in the business of helping people with serious credit problems, we take a much different and less charitable view of attorneys who do not pay for services when they are billed. Attorneys are permitted to set up credit accounts for copies and services which we bill on a monthly basis. However, when we do not get paid on a timely basis, we have to write and call the attorneys who fail to pay. This is a great waste of court time and resources. You should be aware that the Administrative Office of the U.S. Courts demands that we collect accounts receivable in a timely manner and that we keep a very tight rein on these billings. To ensure that we do it, they audit our records every few years. Therefore, we will terminate the credit accounts of attorneys who force us to do extra work in collecting these accounts. If we terminate the account, you have to pre-pay for all services. However, help may be on the way. For those of you who simply cannot (or simply will not) get those checks in the mail, we are in the process of making arrangements to accept payments by credit card. This may solve both of our problems once and for all.

AMENDMENT DATE: 11/20/95

COURT CALENDAR FOR 1996

	Monday	Tuesday	Wednesday	Thursday	Friday
				1	2 HL GK
FEBRUARY	5	6 SK HG	7	8	9 HK
	12 SG	13 GG	14	15 ST GK	16
	19 **PRESIDENTS DAY**	20 SM GL	21 SM	22 GT	23 GT
	26	27 GG HG	28 COURT ADMIN. MTG	29 GK	1 HK
MARCH	4	5 SG	6	7	8 HL
	11 SK	12 HG	13	14	15 HK
	18	19 GG	20 HM	21 ST GK HM	22 ST HM
	25	26 GL HG	27	28 GT	29 GT HK

This calendar is subject to change at any time.

STEERING COMMITTEE MEMBERS

Dan Casamatta	(616) 456-2002
John Grant	(616) 732-5000
Tim Hillegonds	(616) 752-2132
Mary Hamlin, Editor	(616) 345-5156
Jeff Hughes	(616) 336-6000
Pat Mears	(616) 776-7550
Hal Nelson	(616) 459-9487
Steven Rayman, Chair	(616) 345-5156
Brett Rodgers	(616) 732-9000
Tom Sarb	(616) 459-8311
Bob Sawdey	(616) 774-8121
Tom Schouten	(616) 538-6380
Peter Teholiz	(517) 886-7176
Janet Thomas	(616) 726-4823
Rob Wardrop	(616) 459-1225
Bob Wright	(616) 454-8656

ISSUE SUMMARY

NAME OF CASE: _____

_____

_____

CHAPTER: _____

RELIEF SOUGHT: _____

_____

ISSUE: _____

_____

_____

_____

_____

BENCH DECISION: _____

_____

_____

_____

_____

_____

_____

_____

_____

_____

REPORT SUBMITTED BY: _____

Grand Rapids Bar Association
200 Monroe
Suite 300
Grand Rapids, MI 49503

PETER A. TEHOLIZ
HUBBARD FOX THOMAS WHITE &
BENGTSON
P.O. BOX 80857
LANSING, MI 48908