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Crooked Path to Nondischargeability of Restitution Obligations

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The U.S. Supreme Court has stated that bankruptcy is intended to grant relief to the "honest but unfortunate" debtor.[1] The exceptions to dischargeability of specific debts reinforce this policy. Criminal-restitution obligations — similar to debts for fraud, embezzlement and larceny — should be excluded from discharge based on policy grounds, and consistently have been. However, the route that Congress and the courts have taken to achieve this goal has been circuitous, which is why a clean exception to dischargeability would be desirable.

The Supreme Court Addresses Restitution Under the Code

The Bankruptcy Code of 1978[2] did not provide for an explicit exception to dischargeability for criminal-restitution obligations. However, an early Supreme Court decision found that the exception for "a fine, penalty, or forfeiture payable to and for the benefit of a governmental entity, and ... not compensation for actual pecuniary loss"[3] applied to criminal-restitution debts imposed by a state.[4] To reach this result, the Court had to address the statute's requirement that the nondischargeable debt be payable to a governmental entity and not be compensation for actual pecuniary loss. The Court did not have difficulty with the first requirement, since the restitution obligation was owed to the state of Connecticut.[5] However, the Court found ambiguity in the statutory text as to the second element:

> This language is subject to interpretation. On its face, § 523(a)(7) certainly does not compel the conclusion reached by the Court of Appeals, that a discharge in bankruptcy voids restitution orders imposed as conditions of probation by state courts. Nowhere in the House and Senate Reports is there any indication that this language should be read so intrusively.[6]

The Supreme Court relied heavily on the canon of statutory interpretation that Congress will not be presumed to have changed prior law unless it expressly states this intention. Under the Bankruptcy Act,[7] criminal fines were not subject to discharge, even though there was not an express exception for them. However, some courts have extended this exception to criminal-restitution obligations.[8] The Court ultimately concluded that criminal-restitution obligations were included in sentencing to further the state's interest in rehabilitation of the prisoner:

> The criminal justice system is not operated primarily for the benefit of victims, but for the benefit of society as a whole. Thus, it is concerned not only with punishing the offender, but also with rehabilitating him. Although restitution does resemble a judgment "for the benefit of" the victim, the context in which it is imposed undermines that conclusion. The victim has no control over the amount of restitution awarded or over the decision to award restitution. Moreover, the decision to impose restitution generally does not turn on the victim's injury, but on the penal goals of the State and the situation of the defendant.[9]

Thus, although the amount of the restitution obligation was equal to the amount that the debtor had improperly received, the Supreme Court found that the debt was not compensation for actual pecuniary loss. The majority opinion was not without controversy, however. Justices Thurgood Marshall and John Paul Stevens dissented, arguing that the Court was merely substituting its preference for what Congress had legislated:

> While I am wholly in sympathy with the policy interests underlying the Court's opinion, in our constitutional system the commitment to the separation of powers is too fundamental for us to pre-empt congressional action by judicially decreeing what accords with "common sense and the public weal."[10]

The opinion also appeared to rely on contortions of reasoning to square 11 U.S.C. § 523(a)(7) with restitution. While the Court in *Kelly v. Robinson* concluded that restitution was *not* compensation for actual pecuniary loss, the Court later characterized restitution as such. In *Hughey v. United States*, the Court, speaking through Justice Marshall, stated that "the ordinary meaning of 'restitution' is restoring someone to a position he occupied before a

1 *Grogan v. Garner*, 498 U.S. 279, 287 (1991).
2 Bankruptcy Reform Act of 1978, Title 1, Pub. L. No. 95-598 , 92 Stat. 2549 (1978).
3 11 U.S.C. § 523(a)(7).
4 *Kelly v. Robinson*, 479 U.S. 36 (1986).
5 *Id.* at 38.
6 *Id.* at 50.
7 Bankruptcy Act of 1898, former title 11 of the U.S. Code, *as repealed by* Pub. L. No. 95-598.
8 479 U.S. at 45-46.
9 *Id.* at 52.
10 *Id.* at 58.

particular event."[11] If restitution is restorative, this holding would strongly suggest finding that it is compensation for loss, and therefore excluded from § 523(a)(7).

Further, the Supreme Court's historical analysis was forced at best. The Court relied on a district court decision, which stated that "[t]he provisions of the bankrupt act have reference alone to civil liabilities, as demands between debtor and creditors, as such, and not to punishment inflicted *pro bono* public for crimes committed."[12] The Court also relied on a statement in *Collier on Bankruptcy* that "fines and penalties are not affected by a discharge."[13]

However, these sources support an exception for fines and penalties, which Congress had expressly included in § 523(a)(7). When it came to restitution, the Court stated that "those few courts faced with restitution obligations imposed as part of criminal sentences applied the same reasoning to prevent a discharge in bankruptcy from affecting such a condition of a criminal sentence."[14] The sole authority it cited for this proposition was a New York Supreme Court case (in New York, trial courts are denominated as Supreme Courts).[15] Thus, the Court's historical analysis on the dischargeability of restitution obligations appeared to rely on a single decision from a state trial court, as well as general principles concerning federalism and noninterference with state criminal courts.

Subsequent Developments

Kelly v. Robinson was not the last time that the courts faced issues regarding the dischargeability of restitution obligations. In 1990, the Supreme Court considered criminal restitution obligations in chapter 13 cases.[16] Since § 523(a)(7) is not incorporated as an exception to the chapter 13 "super-discharge," it could not provide a rationale for nondischargeability in chapter 13. Instead, the state argued that criminal-restitution obligations were not "debts" and therefore could not be discharged. The Court rejected this contention and found that restitution obligations were dischargeable in chapter 13 cases.

However, this result was "speedily undone."[17] In response, Congress enacted § 1328(a)(3), which included debts "for restitution, or a criminal fine, included in a sentence on the debtor's conviction of a crime" as a nondischargeable debt in chapter 13.[18] This amendment demonstrated that when Congress wanted to refer to restitution, it was capable of doing so explicitly. However, the legislative history to this section indicated that Congress did not intend to overrule *Kelly v. Robinson*.[19]

Several subsequent courts of appeals found specific instances in which restitution obligations could be discharged. *In re Towers*[20] involved a debtor who defrauded customers and, as a result, a state court ordered civil restitution. Neither the state nor the defrauded customers filed a timely request to exclude the debt from discharge based on fraud.[21] The state argued that the debt was a nondischargeable restitution obligation, but the Seventh Circuit rejected this contention:

> Civil restitution under the Illinois Consumer Fraud and Deceptive Business Practices Act is payable to, but not for the benefit of, the Attorney General of Illinois. It is therefore not protected from discharge by 11 U.S.C. § 523(a)(7).[22]

Other courts have followed suit in finding that *civil* restitution obligations owing to a nongovernmental party are dischargeable.[23] In *Rashid v. Powel (In re Rashid)*,[24] the Court also found a restitution obligation to be dischargeable. In that case, a federal court found a defendant guilty of mail fraud, wire fraud and money laundering, and the court ordered the defendant to pay $1.6 million in restitution to the victims. Relying on the *Towers* case, the Third Circuit found that restitution "ultimately payable to the victims"[25] was not a "fine, penalty, or forfeiture payable to and for the benefit of a governmental unit" and could not be excluded from discharge under § 523(a)(7).

However, this hole in the restitution-protection scheme had already been plugged by Congress — just not in time for the creditors in *Rashid*. Congress adopted § 523(a)(13) in 1994, which expressly stated that "any payment of an order of restitution issued under title 18, United States Code" could not be discharged. This language was part of the Violent Crime Control and Law Enforcement Act of 1994,[26] a substantial bill that addressed many different criminal-justice topics. This legislation was both broader and narrower than *Kelly v. Robinson*'s interpretation of § 523(a)(7).

On the one hand, § 523(a)(13) only applied to *federal* restitution obligations, while *Kelly v. Robinson* also addressed state law debts. Section 523(a)(13) applied to any obligation created under title 18, which meant that it would apply to amounts payable to and for the benefit of victims of a crime. Although the Third Circuit decided *Rashid* in 2000, the underlying bankruptcy case was filed in 1994, prior to the effective date of the Violent Crime Control and Law Enforcement Act of 1994.[27]

On the other hand, most courts to consider the issue have found that state criminal-restitution orders payable to a victim are nondischargeable under § 523(a)(7).[28] While *Kelly v. Robinson* involved restitution payable to a state, these cases have found that the Supreme Court's rationale would also apply to obligations payable to a victim.

The Current State of the Law

The treatment of restitution obligations under the Bankruptcy Code has steadily moved toward nondischarge-

11 495 U.S. 411, 416 (1990).
12 *In re Moore*, 111 F. 145, 148-49 (W.D. Ky. 1901).
13 1A *Collier on Bankruptcy* ¶ 17.13, pp. 1609-10, and n.10 (14th ed. 1978).
14 479 U.S. at 45.
15 *State v. Mosesson*, 78 Misc. 2d 217, 218, 356 N. Y. S. 2d 483, 484 (1974).
16 *Pennsylvania Dep't of Public Welfare v. Davenport*, 495 U.S. 552 (1990).
17 *In re Towers*, 162 F.3d 952, 954 (7th Cir. 1998).
18 *Hardenberg v. Va. Dep't of Motor Vehicles (In re Hardenberg)*, 42 F.3d 986, n.1 (6th Cir. 1994).
19 H.R. Rep. No. 681(I), 101 Cong., 2d Sess. 165 (1990), *reprinted in* 1990 U.S.C.C.A.N. 6472, 6571; *In re Hardenberg*, 42 F.3d at 992 n.6.
20 162 F.3d 952 (7th Cir. 1998).
21 Objections to discharge under § 523(a)(2), which encompasses fraud, must be filed within 60 days after the first date set for the first meeting of creditors, or they are waived. 11 U.S.C. § 523(c).
22 162 F.3d at 956.
23 *Scheer v. State Bar (In re Scheer)*, 819 F.3d 1206 (9th Cir. 2016); *Hughes v. Sanders*, 469 F.3d 475 (6th Cir. 2006); *Schaffer v. La. State Bd. of Dentistry (In re Schaffer)*, 515 F.3d 424 (5th Cir. 2008).
24 210 F.3d 201 (3d Cir. 2000).
25 *Id.* at 208.
26 H.R. 3355, Public Law No. 103-322.
27 210 F.3d at 204.
28 *Troff v. Utah (In re Troff)*, 488 F.3d 1237 (10th Cir. 2007); *Colton v. Verola (In re Verola)*, 446 F.3d 1206 (11th Cir. 2006); *In re Thompson*, 418 F.3d 362 (3d Cir. 2005)

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ability. As previously discussed, there are three statutory provisions that prevent the discharge of restitution obligations: §§ 523(a)(7), 523(a)(13) and 1328(a)(3).

Even after 30 years and two amendments to the Bankruptcy Code, there are still questions about how the Code should be interpreted. Although there are many issues that could be discussed, two of the most obvious ones include civil restitution obligations and state-restitution debts payable directly to a victim.

Civil restitution obligations is one particularly ill-defined area. Sections 523(a)(13) and 1328(a)(3) both speak directly to restitution obligations, but they are limited to criminal cases. Similarly, *Kelly v. Robinson* was predicated on concerns that federal courts should not interfere with state criminal proceedings. Where a debt arises in a civil context, such as an attorney being ordered to return funds wrongfully withheld from a client, the debt might be nondischargeable, but § 523(a)(7) will not apply. Instead, an action must be brought under §§ 523(a)(2), (a)(4) or (a)(6), each of which requires that a timely adversary proceeding be filed.

This might be a problem that does not need fixing. Since the existing statutory exceptions will cover most civil restitution debts, it is not unreasonable to require creditors owed civil restitution debts based on fraud or similar claims to file a timely adversary proceeding.

Restitution obligations awarded in state law criminal proceedings and payable directly to a victim are still problematic. Section 523(a)(13) prevents all restitution obligations awarded under federal law — that is, restitution under title 18 — from being discharged. However, state restitution obligations are governed by § 523(a)(7), which does not actually mention restitution. However, what it does refer to is debts that are "payable to and for the benefit of a governmental entity" and are not "compensation for actual pecuniary loss." *Kelly v. Robinson* was able to find that restitution served a penal purpose in the criminal justice system, which overcame the compensation-for-actual-pecuniary-loss requirement. However, it did not address debts owed to non-state actors because the specific debt involved in the case was owed to a state.

Numerous cases have applied § 523(a)(7) to cases involving restitution owing to private parties.[29] However, these decisions stretch the statutory language to the breaking point. It does violence to the statutory language to say that amounts payable to a private party are "payable to and for the benefit of a governmental entity." As the *Tower* and *Rashid* cases point out, some courts will not say that the statute says something it does not. Even if the courts are collectively willing to say that black is white, such results-based jurisprudence harms the integrity of the system.

One way to avoid this particular statutory gap is to uncouple restitution from § 523(a)(7), a provision that is ill-suited for this purpose. A simple fix would be to amend § 523(a)(13) to read as follows: "for any payment of an order of restitution issued under title 18, United States Code, *or a state criminal statute*."

While this amendment would not address civil restitution obligations, it would achieve parity between state and federal restitution obligations under both chapters 7 and 13. Another solution would be to replace § 523(a)(13) with the language of § 1328(a)(3). In this case, § 523(a)(13) would except from discharge a debt "for restitution, or a criminal fine, included in a sentence on the debtor's conviction of a crime." If this language was imported into § 523(a)(13), then § 1328(a)(2) could simply reference § 523(a)(13) and there would not be a need for § 1328(a)(3).

Either one of these amendments would ensure that bankruptcy would not provide relief from restitution obligations, whether issued by a state or federal court, whether awarded to a governmental entity or directly to a crime victim, and whether the debtor seeks relief under chapter 7 or 13. This would align the language of the Bankruptcy Code with the policy goals articulated by the Supreme Court. abi

29 *See* n.26 *supra*.