UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF OHIO
EASTERN DIVISION

IN RE:	)	CHAPTER 7
WENDY KAY FEGLEY,	)	CASE NO. 01-61844
Debtor.	)	JUDGE RUSS KENDIG
	)	**MEMORANDUM OPINION**

This matter came before the court on the motion for contempt against Killbuck Savings Bank Company filed by debtor Wendy Kay Fegley (hereafter "Debtor") and the motion to dismiss filed in response by Killbuck Savings Bank Company (hereafter "Bank"). The matter came on for hearing on October 28, 2002. Present at the hearing were Debtor, Debtor's counsel, and Bank's counsel. Counsel made oral arguments. After the hearing, the court afforded both parties the opportunity to file post-hearing briefs. Debtor filed her brief on November 13, 2002, and Bank filed its brief on November 15, 2002.

Jurisdiction

The court has jurisdiction over these matters pursuant to 28 U.S.C. §§ 1334(a) and 157(a) and the general order of reference entered in this district on July 16, 1984. The following constitute the court's findings of fact and conclusions of law pursuant to Federal Rule of Bankruptcy Procedure 7052.

Facts and Arguments

Debtor commenced her Chapter 7 bankruptcy case on May 1, 2001. On July 13, 2001, she amended Schedule F to add a debt to Bank for $42,023.40 for misapplied credit card funds covering the period of 1996 to 2000.

On July 16, 2001, the trustee determined that no assets were available for distribution to creditors. On September 26, 2001, Debtor received a discharge of her debts, and on October 1,

2001, Debtor's case was closed.

During the pendency of Debtor's bankruptcy case, a criminal investigation was commenced.[1] The investigation resulted in the commencement of a state court criminal proceeding in which Debtor pleaded guilty to grand theft, a felony of the fourth degree under O.R.C. § 2913.02(A)(2). Pursuant to her plea of guilty, Debtor was sentenced and ordered to pay restitution of $40,027.43 to Bank at $400.00 per month under the provisions of O.R.C. § 2929.18(A)(1).

Subsequently, on September 3, 2003, Debtor moved to reopen her case citing the collection of the restitution by Bank as a violation of the discharge injunction. The case was reopened on September 9, 2002. Debtor filed her motion for contempt shortly after that.

In her brief, Debtor argues that restitution is not protected from discharge under 11 U.S.C. § 523(a)(7) in a Chapter 7 bankruptcy case. Debtor argues that she duly listed the debt owed Bank in Schedule F and that Bank's failure to file a complaint to determine dischargeability of the debt means that Debtor's obligation to make restitution to Bank was discharged. Debtor cites a Third Circuit Court of Appeals decision in support of her argument.

In its brief, Bank argues that two issues must be addressed to determine whether Bank should be held in contempt. First, Bank argues that the court must determine whether the ongoing criminal investigation constituted a violation of the automatic stay or discharge injunction. Bank argues that the automatic stay does not prohibit the continuation of criminal proceedings under 11 U.S.C. § 362(b)(1). Second, Bank argues that the court must determine whether the restitution obligation is nondischargeable as a matter of law. Bank argues that the restitution obligation is nondischargeable under 11 U.S.C. § 523(a)(7) and relies upon a decision of the United States Supreme Court in making that argument. Bank further argues that Debtor should pay Bank's attorney fees it incurred in responding to Debtor's motion for contempt because Debtor's motion is not well-founded under law.

Law and Analysis

I. Violation of the automatic stay

The filing of a bankruptcy petition invokes a stay of further collection efforts by a debtor's creditors. 11 U.S.C. § 362(a). Exceptions to the imposition of a stay against creditors

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[1]This was a result of Bank's discovery that Debtor had been wrongfully making double checking account deposits using a Visa credit card account issued by Bank. Under federal law, Bank had a duty to report this information to the proper authorities, including the Federal Bureau of Investigation and the Holmes County Prosecutor's Office.

are found at 11 U.S.C. § 362(b). One exception permits the "commencement or continuation of a criminal action or proceeding against the debtor." 11 U.S.C. § 362(b)(1). However, criminal proceedings that are really debt collection proceedings in disguise run afoul of § 362(b)(1). *See, e.g.,* In re Muncie, 240 B.R. 725 (Bankr. S.D. Ohio 1999); Williamson-Blackmon v. Kimbrell's of Sanford, Inc. (In re Williamson-Blackmon), 145 B.R. 18 (Bankr. N.D. Ohio 1992). For example, if the creditor indicates that the criminal action will be dropped if the debt is paid, the stay may be violated. *See, e.g.,* Muncie, 240 B.R. at 727. Actions initiated with an intent to force collection of the debt may also contravene the stay. Howard v. Allard, 122 B.R. 696, 699 (W.D. Ky. 1991). Similarly, if a creditor specifically attempts to avoid the reach of the automatic stay, the criminal action encroaches the stay's protection. Williamson-Blackmon, 145 B.R. at 21.

On the other hand, criminal actions undertaken as valid exercises of state police powers are not challenged. Section 362 encompasses both quasi-criminal actions and legitimate criminal proceedings. *See, e.g.,* Hardenberg v. Commonwealth of Virginia (In re Hardenberg), 1993 WL 1318606 (S.D. Ohio 1993) (refusing to reinstate driving privileges until debtor paid fine was a continuation of criminal action and not a violation of the stay). Courts consider the underlying intent to determine if debt collection is an ulterior motive. *See, e.g.,* Trail West, Inc. v. South Dakota (In re Trail West, Inc.), 17 B.R. 330 (Bankr. S.D. 1982) (criminal action for insufficient funds check commenced to deter writing bad checks not to collect debt); In re H. Cohen Caterers, Inc., 26 B.R. 1 (Bankr. W.D. Ky. 1981) (criminal prosecution for nonpayment of taxes excepted from stay where State Department of Revenue intended to prosecute regardless of whether overdue taxes were paid). Thus, the compelling purpose of the criminal action is important to determine whether the § 362(b)(1) exception applies.

In the case at hand, Bank did not violate the automatic stay when, after it discovered Debtor's conduct, Bank reported Debtor's activity to local authorities. Certainly Debtor's debt to Bank for the misapplied credit card funds was discharged. However, Bank's contact of and cooperation with the Federal Bureau of Investigation and the Holmes County Prosecutor's Office for the purpose of criminal prosecution cannot be found to have an impermissible underlying purpose. Bank was required to report this information pursuant to federal law.

While Bank's activities during the pendency of Debtor's bankruptcy case do not rise to the level of a violation of the automatic stay, this does not answer the question as to whether Bank's postdischarge activities violated the discharge injunction established by 11 U.S.C. § 524.[2]

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[2]Once a discharge is granted, the automatic stay is dissolved and replaced by the permanent injunctive provisions of § 524. *See* 11 U.S.C. §§ 362(a); 362(c)(2)(c); 524. One case has suggested that restitution ordered postpetition is a postpetition debt, even though based on prepetition conduct. *See* In re Moesel, 89 B.R. 895, 896 (Bankr. W.D. Okla. 1988). However, the more well-reasoned and oft-followed analysis is that the timing of the debtor's alleged criminal offense dictates whether the corresponding

Under § 524, a bankruptcy discharge "operates as an injunction against the commencement or continuation of an action, the employment of process, or an act, to collect, recover or offset any such debt as a personal liability of the debtor." 11 U.S.C. § 524. "Except as provided in section 523 of this title, a discharge . . . discharges the debtor from all debts that arose before the date of the order for relief under this chapter." 11 U.S.C. § 727(b). For a determination of this matter, the court will have to conduct an analysis of whether Debtor's obligation to make restitution is one of those enumerated exceptions to dischargeability in 11 U.S.C. § 523.

II. Violation of the discharge injunction: dischargeability of restitution

A. Jurisdiction

There are ten categories in Federal Rule of Bankruptcy Procedure 7001 denominated as adversary proceedings. Included among those is "a proceeding to determine the dischargeability of a debt." Fed. R. Bankr. P. 7001(6). Debtor commenced a contested matter by filing a motion for contempt, but implicit in Debtor's motion is a request for a determination as to whether her restitution obligation is dischargeable.

"Notwithstanding the requirements of Rule 7001, in cases where no prejudice to the parties has arisen or where no objection to the procedural defect has been lodged, certain courts allow matters to proceed by way of motion under Rule 9014 rather than as adversary proceedings." 10 Collier on Bankruptcy, ¶ 7001.01 (15th ed. 2002). *See* In re Cannonsburg Environmental Assoc., Ltd., 72 F.3d 1260 (6th Cir. 1996) (absent demonstrable prejudice, any error in conducting a contested matter rather than an adversary proceeding is harmless and therefore disregarded); In re Wilkinson, 196 B.R. 311 (Bankr. E.D. Va. 1996) (court could waive adversary proceeding requirement where creditor expressly waived requirement and where possibility existed that legal fees already equaled amount in controversy such that neither justice nor judicial economy would be served by bifurcating proceedings to require adversary); In re Command Services Corp., 102 B.R. 905 (Bankr. N.D. N.Y. 1989) (matter improperly raised as contested matter, rather than as adversary proceeding, allowed to proceed on merits as originally filed, where no objection to procedural defect lodged, and rights of affected parties adequately presented); Fed. R. Bankr. P. 9005 (harmless errors shall be disregarded).

Further, Federal Rules of Bankruptcy Procedure 9020 and 9014 provide that contempt proceedings shall be made by motion. Debtor presumably believed that this action was properly postured as a contested matter under Rules 9020 and 9014. Because Bank has not objected to the form of this proceeding and there is no apparent prejudice to either party, the court finds that

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restitution obligation is a prepetition or a postpetition obligation. *See* In re McMullen, 189 B.R. 402, 408, n.4 (Bankr. E.D. Mich. 1995) (citations omitted).

the requirement of filing an adversary proceeding to determine the dischargeability of the restitution obligation has been waived.

B. Kelly v. Robinson

The preeminent case discussing the dischargeability of a restitution order under 11 U.S.C. § 523(a)(7)[3] arising from a state court criminal proceeding is Kelly v. Robinson, 479 U.S. 36 (1986). In this case, the debtor pleaded guilty to larceny in state court based on her wrongful receipt of state welfare benefits. Id. at 38. In lieu of serving prison time, the debtor was placed on probation and ordered to make restitution through monthly payments to the probation office. Id. at 38-39. Under state law, restitution payments were to be sent to the probation office, which forwarded them to the victim. Id. at 39. Subsequently, the debtor filed a Chapter 7 bankruptcy case in which she listed the restitution obligation. Id. The victim, the state welfare department, did not file a complaint to determine dischargeability. Id. The debtor received a discharge of her debts. Id. After the probation office refused to recognize that the bankruptcy proceeding had discharged the debtor's obligation to pay restitution, the debtor commenced an adversary proceeding. Id. at 39-40.

The Court began its analysis of the dischargeability of restitution under § 523(a)(7) by examining the history of the statute, its object and the underlying policy. Id. at 43. The Court took into account the bankruptcy court's historical "deference to criminal judgments" and "the interest of the States in unfettered administration of their criminal justice systems." Id. at 44.

First, the Court examined the history of the Bankruptcy Code, beginning with its precursor, the Bankruptcy Act of 1898 (hereafter "the Act"). Id. The Court concluded that the most natural reading of the Act would have allowed the discharge of criminal penalties in bankruptcy proceedings. Id. at 44-45. However, the federal courts did not so interpret the Act. Id. at 45. The federal courts found that a discharge in bankruptcy had no effect on a state

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[3]11 U.S.C. § 523(a)(7) provides in relevant part:

(a) A discharge . . . does not discharge an individual debtor from any debt–

. . . .

(7) to the extent such debt is for a fine, penalty, or forfeiture payable to and for the benefit of a governmental unit, and is not compensation for actual pecuniary loss.

11 U.S.C. § 523(a)(7).

criminal court's judgment.[4] Id. at 46. Thus, the Court found that Congress enacted the Bankruptcy Code in 1978 against the backdrop of an established, judicially created exception to discharge for criminal penalties. Id.

Second, the Court discussed the deep set conviction that federal bankruptcy courts should not invalidate the results of state court criminal proceedings. Id. at 47. "The right to formulate and enforce penal sanctions is an important aspect of the sovereignty retained by the States. This Court has emphasized repeatedly 'the fundamental policy against federal interference with state criminal prosecutions.'" Id. (quoting Younger v. Harris, 401 U.S. 37, 46 (1971)).

Given this history, the Court held that § 523(a)(7) does not permit the discharge of any condition a state court imposes as part of a criminal sentence. Id. at 50. While the Court acknowledged that the language of § 523(a)(7) was open to interpretation, it concluded that its interpretation by the lower court of appeals was clearly incorrect. Id.

The court determined that a broad exception for all penal sanctions, whether fines, penalties, or forfeitures, had been created by Congress. Id. at 51. However, the insertion of two qualifying phrases, that the fines must be both "to and for the benefit of a governmental unit," and "not compensation for actual pecuniary loss," meant that the Court had to carefully examine whether an exception for restitution obligations had been created. Id. The Court determined that the qualifying phrases did not allow the discharge of a restitution obligation. Id. at 52. The criminal justice system is not for the benefit of victims but for the members of society. Id. Restitution resembles a judgment for the benefit of the victim but "the context in which it is imposed undermines that conclusion." Id. The decision to award restitution or the amount to be awarded is out of the victim's control. Id. The decision to award restitution depends upon

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[4]Those courts forced to decide whether restitution obligations were dischargeable applied the same reasoning. For example, the New York Supreme Court reasoned:

> A discharge in bankruptcy has no effect whatsoever upon a condition of restitution of a criminal sentence. A bankruptcy proceeding is civil in nature and is intended to relieve an honest and unfortunate debtor of his debts and to permit him to begin his financial life anew. A condition of restitution in a sentence of probation is a part of the judgment of conviction. It does not create a debt nor a debtor-creditor relationship between the persons making and receiving restitution. As with any other condition of a probationary sentence it is intended as a means to insure the defendant will lead a law-abiding life thereafter.

Id. at 46 (quoting State v. Mosesson, 218 N.Y.S.2d 483, 484 (N.Y. Sup. Ct. 1974) (citations omitted)).

the State's penal goals[5] and the defendant's financial situation. Id.

> Unlike an obligation which arises out of a contractual, statutory or common law duty, here the obligation is rooted in the traditional responsibility of a state to protect its citizens by enforcing its criminal statutes and to rehabilitate an offender by imposing a criminal sanction intended for that purpose.

Id. (quoting Pellegrino v. Division of Criminal Justice (In re Pellegrino), 42 B.R. 129, 133 (Bankr. Conn. 1984)).

The Court concluded that "the strong interests of the States, the uniform construction of the old Act over three-quarters of a century, and the absence of any significant evidence that Congress intended to change the law in this area" mandated that restitution obligations fell within the nondischargeable provisions of § 523(a)(7). Id. at 53.

C. Cases post-Kelly

In her brief in support of her motion for contempt, Debtor cited a case arising from the Third Circuit Court of Appeals, Rashid v. Powel (In re Rashid), 210 F.3d 201 (3rd Cir. 2000), for the proposition that Debtor's obligation to pay criminal restitution is dischargeable. This case is distinguishable from the case at hand. The Rashid case involved a restitution order that arose from a federal criminal court proceeding. Rashid, 210 F.3d at 203. In analyzing the dischargeability of a federal restitution order under § 523(a)(7), the Rashid court recognized that an important distinction existed between the federal criminal restitution order at issue and the state criminal restitution order at issue in Kelly: "[the federal criminal restitution order does not implicate] the federal court's longstanding 'reluctan[ce] to interpret federal bankruptcy statutes to remit state criminal judgments.'" Id. at 208, n. 3 (quoting Kelly, 479 U.S. at 44); *see also* Warfel v. Saratoga (In re Warfel), 268 B.R. 205 (9th Cir. B.A.P. 2001) (distinguishing Rashid on

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> Restitution is an effective rehabilitative penalty because it forces the defendant to confront, in concrete terms, the harm his actions have caused. Such a penalty will affect the defendant differently than a traditional fine, paid to the State as an abstract and impersonal entity, and often calculated without regard to the harm the defendant has caused. Similarly, the direct relation between the harm and the punishment gives restitution a more precise deterrent effect than a traditional fine.

Id. at 49, n. 10 (quoting Note, Victim Restitution in the Criminal Process: A Procedural Analysis, 97 Harv. L. Rev. 931, 937-41 (1984)).

this basis as well). The case at hand involves a state court criminal restitution order like the one at issue in Kelly, therefore, federal deference to the state court's order is of great importance.

Further, all the courts within the jurisdiction of the Sixth Circuit Court of Appeals, which have dealt with the issue, have strictly followed Kelly and found that the obligation to pay restitution is nondischargeable under § 523(a)(7). *See* Cummins v. Ray (In re Ray), 240 B.R. 260 (Bankr. W.D. Ky. 1999) (restitution order entered to fulfill penal goals of state nondischargeable after Kelly); North American Science Assocs., Inc. v. Clark (In re Clark), 222 B.R. 114 (Bankr. N.D. Ohio 1997) (restitutionary obligation to former employer excepted from discharge under Kelly); Fernandez v. Internal Revenue Service (In re Fernandez), 112 B.R. 888 (Bankr. N.D. Ohio 1990) (special condition of probation requiring debtor to pay all tax liabilities for particular years imposed when debtor was convicted for failing to pay income taxes for particular year constituted restitution order that was nondischargeable under Kelly where debtor failed to comply with the probation condition); Thompson v. Lewis (In re Thompson), 77 B.R. 646 (Bankr. E.D. Tenn. 1987) (finding duty to make restitution as condition of probation nondischargeable under parameters set forth in Kelly).

The court finds that Kelly sets forth the controlling law[6] in the present case. The facts in that case are on point with those in the case at hand. Debtor's criminal restitution obligation is nondischargeable under the Kelly court's interpretation of § 523(a)(7). Bank's receipt of the restitution does not constitute a violation of the discharge injunction.

III. Request for attorney fees

In its brief, Bank requests reimbursement of its attorney fees for defending against Debtor's motion for contempt. While Bank does not cite a specific code or rule section for its authority, the court presumes that Bank requests such a remedy under Federal Rule of Bankruptcy Procedure 9011(b)(2). Rule 9011(c)(1)(A) requires a party who brings a motion for sanctions under this Rule to file the motion separately from those filed in the case. Bank's request is procedurally deficient under this Rule. Additionally, the court notes that Rule 9011(b)(2) states that for pleadings to be appropriate under this Rule, the "claims, defenses, and other legal contentions therein [must be] warranted by existing law or by a nonfrivolous argument for the extension, modification, or reversal of existing law or the establishment of new law." Fed. R. Bank. P. 9011(b)(2). While the court has found that the Kelly case provides the controlling law in the within case, the court cannot find that Debtor's reliance on other case law was totally misplaced and sanctionable under this Rule.

[6]"*Kelly* is the authoritative interpretation of § 523(a)(7) regarding criminal restitution orders. It is controlling law." Warfel, 268 B.R. at 214 (concurring opinion).

Conclusion

Debtor filed a motion to hold Bank in contempt for its alleged violation of the automatic stay and discharge injunction in its pursuit and collection of a restitution obligation imposed in a state criminal court proceeding.

Bank did not violate the automatic stay when it cooperated with authorities in the prosecution of Debtor. Bank did not violate the discharge injunction in its receipt of monies pursuant to the criminal restitution order because the criminal restitution obligation is nondischargeable under the Supreme Court's interpretation of 11 U.S.C. § 523(a)(7) in Kelly v. Robinson, 479 U.S. 36 (1986).

Bank's request for attorney fees pursuant to Federal Rule of Bankruptcy Procedure 9011 was procedurally and substantively deficient.

An order in accordance with this opinion shall enter forthwith.

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RUSS KENDIG
U.S. BANKRUPTCY JUDGE

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UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF OHIO
EASTERN DIVISION

IN RE:	CHAPTER 7
WENDY KAY FEGLEY,	CASE NO. 01-61844
Debtor.	JUDGE RUSS KENDIG
	ORDER

Debtor filed a motion to hold Bank in contempt for its alleged violation of the automatic stay and discharge injunction regarding its involvement in the pursuit and collection of a restitution obligation imposed in a state court criminal proceeding. Bank responded by filing a motion to dismiss. Additionally, Bank requested the reimbursement of its attorney fees it incurred in the defense of the matter.

For the reasons set forth in the accompanying memorandum opinion, Debtor's motion for contempt is hereby **DENIED**, and Bank's motion to dismiss is hereby **GRANTED**. Bank's request for attorney fees is hereby **DENIED**.

It is so ordered.

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RUSS KENDIG
U.S. BANKRUPTCY JUDGE