**March 20, 2020**

***The Alleged Liability of a Charter School's Treasurer for the School's Improper Payments Are Not an "Educational Benefit" under the Student Loan Exception to Bankruptcy Discharge***

On March 18, 2020, the U.S. District Court for the Southern District of Ohio (the "District Court"), acting as appellate court for the U.S. Bankruptcy Court for the Southern District of Ohio (the "Bankruptcy Court"), affirmed the Bankruptcy Court's decision that certain alleged liability of the Debtor, Edward Dudley, Sr., stemming from his role as treasurer for certain charter schools, was dischargeable and not exempt from bankruptcy discharge under 11 U.S.C. § 523(a)(8)(A)(ii). That is the provision which excludes student loans and similar obligations from discharge.

Mr. Dudley had served as treasurer for various charter schools. The auditor of the State of Ohio (the "State") conducted audits of the schools and concluded that funds were improperly expended, so issued findings for recovery ("FFRs") against the schools and various officers, including Mr. Dudley. FFRs assess liability, but they are not a judgment or final determination of liability. The FFRs issued in connection with the schools for which Mr. Dudley served were based on alleged insufficient documentation of transactions, payments made on account of contracts that allegedly violated certain provisions of Ohio law, or were allegedly illegal bonuses and stipends. However, the State did not allege that Mr. Dudley, directly or indirectly, either participated in the wrongdoing or received funds improperly. Indeed, Mr. Dudley served as a witness for the prosecution in several proceedings against the wrongdoers. Instead, the State's claim against him was strict liability, based solely upon his status as treasurer.

The FFRs against him exceeded $1.3 million, and so Mr. Dudley filed a personal bankruptcy case. The State filed a complaint against him seeking judgment on the FFRs and seeking to deny his discharge under § section 727 and exempt the FFRs from discharge under various subsections of § 523, including § 523(a)(8). Determining liability was going to be a time-consuming, cumbersome process, and so it was decided to seek partial summary judgment on the issue of whether any liability is dischargeable; if so, then there was no reason to incur the time and expense of determining the amount of liability that would be discharged. On cross-motions, the Bankruptcy Court granted Mr. Dudley's motion for partial summary judgment, dismissing the State's claim under § 727 and § 523(a)(8), but found that there were fact questions precluding dismissal of the State's claim under § 523(a)(4), which is the provision exempting claims for fraud or defalcation, embezzlement and larceny. *In re Dudley*, 582 B.R. 708 (Bankr. S.D. Ohio 2017). After taking Mr. Dudley's deposition, the State voluntarily dismissed its claim under § 523(a)(4), and then filed an appeal only as to its claim under § 523(a)(8), so that was the only issue before the District Court.

Section 523(a)(8) provides in relevant part:

> A discharge under section 727 … of this title does not discharge an individual debtor from any debt – …
>
> (8) unless excepting such debt from discharge under this paragraph would impose an undue hardship on the debtor and the debtor's dependents, for – …
> (A) …
> (ii) an obligation to repay funds *received as an educational benefit, scholarship, or stipend …*

(emphasis supplied). The State argued that any liability for the FFRs were non-dischargeable obligations to repay funds received as an educational benefit within the meaning of § 523(a)(8)(A)(ii).

The District Court began its analysis by reviewing the text, noting that the term "educational benefit" is not defined in the Bankruptcy Code. The State argued that the funds at issue were "educational" because they were allocated for charter schools and are "benefits" because they came from a government agency, the Ohio Department of Education. But, the Court recognized that, as argued on behalf of Mr. Dudley, the term "benefit" is subject to multiple meanings.

The District Court also agreed with Mr. Dudley's argument that the Bankruptcy Court properly applied the canon of statutory construction *noscitur a sociis* and concluded that the term must be read in context with the rest of the section as a whole. Thus, "educational benefit" should be given a similar meaning to "scholarships" and "stipends" since it is part of a list, such that the Bankruptcy Court properly concluded that "[a]n educational benefit, then must be a similar form of financial assistance that provides the same function to students." The Court also recognized that the remaining sections of 523(a) support this reading, since § 523(a)(2) covers debt for "money, property, or services" obtained by fraud and § 523(a)(4) covers debts for fraud or defalcation while acting in a fiduciary capacity. Thus, the State's proposed reading would render § 523(a)(8) superfluous if it were read broadly enough to include those debts.

Case law supported this interpretation as well: while there is no authority addressing the precise issue of whether FFRs are nondischargeable as "educational benefits," the case law generally presumes the statute applies only to student debts, where the debtor is the student (or their parent) incurring the debt in furtherance of the student's

education. However, the schools' funds at issue conferred no educational benefit on Mr. Dudley.

Since the statutory term is ambiguous, it was also proper for the Bankruptcy Court to consider the legislative history, which supports the reading that the statute does not apply to the alleged liability for FFRs because it was meant for student loans. Specifically, it was intended to encompass financial assistance provided for the purpose of pursuing higher education.

Finally, the District Court was also not persuaded by the State's argument that its interpretation would deter abuse and preserve educational funds, consistent with the purposes of enacting § 523(a)(8). The purpose of this provision was not so broad and instead, it was designed to remedy a specific abuse by students who, immediately upon graduation, sought to discharge their educational loans. Quoting Mr. Dudley's appellate brief, the District Court found that the goals of § 523(a)(8) were "to address the abuse resulting from the circumstance in which a debtor obtains the ability to increase his, her or their children's future income, but seeks to discharge the obligation to pay for the increased earning potential that the debtor or their children obtained." Imposing liability on a school treasurer for FFRs does not fall within this purpose because Mr. Dudley is not a student and he did not receive any kind of educational benefit from the funds in question. The District Court also agreed with Mr. Dudley that the goals of deterring fraud and embezzlement are already addressed by other provisions, including § 523(a)(4) (though noting that the State's claim against Mr. Dudley under that same section had been voluntarily dismissed with prejudice).

The District Court thus affirmed the Bankruptcy Court's dismissal of the State's claims against Mr. Dudley under section 523(a)(8). It appears to be the first time that these novel arguments were brought before an appellate court.

The Bankruptcy Court's decision is reported at *In re Dudley*, 582 B.R. 708 (Bankr. S.D. Ohio 2017), and the District Court's decision was issued by Chief Judge Algenon L. Marbley on March 18, 2020 in case number 2:18-cv-1327, in the United States District Court for the Southern District of Ohio.

***Takeaway:*** Courts typically read exceptions to discharge narrowly, given the policy embodied in the Bankruptcy Code of providing debtors with a fresh start. This case demonstrates that, and further emphasizes the importance of choosing the correct subsections of § 523(a) when asserting and pursuing non-dischargeability claims.

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