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Vol. 96, No. 20  
IN THE UNITED STATES BANKRUPTCY COURT  
FOR THE DISTRICT OF IDAHO  
**Cite as: 96.1 IBCR 37**

IN RE

LARRY G. HOSELEY, SR., dba L.G. HOSELEY AND  
ASSOCIATES, J. ANNE M. HOSELEY, JODY HOSELEY, dba  
JODY'S ALL BREED GROOMING,  
Debtors.

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DREW S. FORNEY, MANAGER OF THE IDAHO STATE  
INSURANCE FUND,  
Plaintiff,

vs.

LARRY G. HOSELEY and JODY HOSELEY, dba L.G.  
HOSELEY AND ASSOCIATES, and JODY'S ALL BREED  
GROOMING,  
Defendants.

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Case No. 95-00283

Adv. No. 95-6120

MEMORANDUM OF DECISION

Jed W. Manwaring, EVANS, KEANE, Boise, Idaho, for  
Plaintiff.

Gordon S. Nielson, NIELSON LAW OFFICES, Boise,  
Idaho, for Defendants.

HON. JIM D. PAPPAS, CHIEF U.S. BANKRUPTCY JUDGE.

Background.

Creditor Idaho State Insurance Fund (hereinafter "Plaintiff") filed this adversary proceeding against Debtors Larry Hoseley, d/b/a L.G. Hoseley and Associates, and Jody Hoseley, d/b/a Jody's All Breed Grooming (hereinafter "Defendants") seeking a determination that a state court judgment entered in Plaintiff's favor against Defendants is excepted from discharge under 11 U.S.C. § 523(a)(7). The

matter is before the Court on Plaintiff's Motion for Summary Judgment and Defendants' response after a hearing. There is no dispute as to the material facts. This Memorandum sets forth the Court's conclusions of law. F.R.B.P. 7052.

#### Facts.

Defendants operated as a subcontractor in the housing construction industry. They also operated a dog grooming business. Beginning in March, 1993, Plaintiff provided Defendants a policy and insurance contract for workers compensation coverage. The policy was canceled effective April 6, 1994, based upon Defendants' nonpayment of premiums.

In May of 1994, Plaintiff conducted an audit of Defendants' payroll records. Through the audit, Plaintiff discovered that Defendants had misrepresented the payroll amounts used as the basis for calculating the policy premiums charged by Plaintiff. Defendants had also falsely classified some of their employees as contract laborers. Defendants' conduct resulted in a significant underpayment of insurance premiums.

On September 14, 1994, Plaintiff filed suit in state court against Defendants for non-payment of premiums and for falsification of payroll records. Plaintiff's Complaint alleged fraud and breach of contract. Plaintiff sought recovery of statutory penalties under Idaho Code § 72-919 for Defendants' non-payment of premiums, and under Idaho Code § 72-923 for falsification of payroll records.

On January 12, 1995, the state court entered a default judgment in Plaintiff's favor against the Defendants. The judgment was composed of: (1) \$200,654.20 which represented the amount of the unpaid premium of \$20,065.42 multiplied by ten as provided by Idaho Code 72-923 for falsification of payroll records; (2) \$3,050.00 as a penalty for the non-payment of premiums pursuant to Idaho Code § 72-919; (3) \$75.00 in costs, and (4) \$1,000.00 in attorney fees, for a total judgment of \$204,779.60.<sup>1</sup>

On February 3, 1995, Defendants filed for bankruptcy relief under Chapter 7.

#### Arguments.

Both parties acknowledge, and the Court finds and concludes, that the \$3,050.00 penalty in the state court judgment awarded to Plaintiff pursuant to Idaho Code § 72-919 for non-payment of premiums is excepted from discharge under Section 523(a)(7). In addition, both parties agree, and the Court finds and concludes, that the \$20,065.42 in unpaid premiums included in the judgment is neither a fine nor a penalty because it represent compensation for the loss of unpaid premiums, and therefore, is dischargeable.

Plaintiff argues, however, that the Court should deny Defendants a discharge for that portion of the state court judgment awarded to Plaintiff under Idaho Code § 72-923. This amounts to \$180,588.87 (i.e., the \$200,654.20 for the unpaid premium times ten, less the \$20,065.42 for the actual

unpaid premium). Plaintiff contends that this portion of the liability imposed by Idaho Code § 72-923 is a civil penalty, and thus, is excepted from discharge pursuant to Section 523(a)(7).

Defendants assert that this component of the judgment is not a penalty as required by Section 523(a)(7). In addition, Defendants claim that the \$75.00 in costs and \$1,000.00 in attorney fees contained within the judgment are dischargeable.

The Court finds for Plaintiff.

#### Discussion.

Plaintiff's position is based upon Section 523(a)(7). This provision excepts from discharge certain debts, "to the extent that such debt is for a fine, penalty or forfeiture to and for the benefit of a governmental unit, and is not compensation for actual pecuniary loss . . ." 11 U.S.C. § 523(a)(7). In order for a debt to be excepted from discharge under Section 523(a)(7), three requirements must be met. First, the debt must be a debt for a fine, penalty, or forfeiture; second, it must be payable to and for the benefit of a governmental unit; and third, the debt cannot constitute compensation for actual pecuniary loss. *See* 11 U.S.C. § 523(a)(7).

The Bankruptcy Code does not define the terms "fine", "penalty", or "forfeiture". As a result, the courts, in addressing the issue of whether a civil liability is a "fine, penalty, or forfeiture" within Section 523(a)(7), review the statutory scheme creating or imposing the liability, and the function or nature of the liability in question. *See In re Williams*, 93 I.B.C.R. 97, *aff'd*, 95 I.B.C.R. 12; *see also United States v. WRW Corp.*, 986 F.2d 138 (6th Cir. 1993); *In the Matter of Kent*, 1995 WL 726997 (Bankr. D.N.J. Dec. 5, 1995); *In re Lueking*, 125 B.R. 513 (E.D. Tenn. 1990); *In re Renfrow*, 112 B.R. 22 (Bankr. W.D.Ky. 1989); *In re Taite*, 76 B.R. 764 (Bankr. C.D.Cal. 1987).

Idaho Code § 72-923 provides:

72-923. Falsification of payroll. — An employer who shall misrepresent the amount of the payroll upon which the premiums chargeable by the state insurance fund are to be based shall be liable to the manager 10 times the amount of the difference between the premiums paid and the amount the employer should have paid had his payroll been correctly computed; and the liability to the manager under this Section shall be enforced in a civil action by the manager, and any amount so collected shall become a part of the state insurance fund.

Although the word "penalty" is neither included within the provision's title nor its text, such is not determinative.

According to the Idaho Session Laws, when the Idaho Legislature enacted the "Workman's Compensation Act" ("Act"), of which Idaho Code § 72-923 is a part, the preamble to the legislation stated that this statute was intended as a means of

prescribing penalties for employers in default for the payment of premiums, for falsification of pay-rolls and wilful misrepresentation;

1917 Idaho Session Laws, ch.81, p.253. In the preamble, the phrase "for falsification of pay-rolls," which is the focus of

<sup>1</sup>. The amount of the default judgment entered in state court was \$205,779.60. However, this amount is incorrect. The correct total of the various components listed above is \$204,779.60. This Court will use the correct figure.

Idaho Code § 72-923, is the direct object of the verb “prescribing penalties.” Therefore, despite the absence of the word “penalty” in the actual title or text of Idaho Code § 72-923, the Legislature clearly articulated its intent to penalize the act of falsifying payroll records.

Moreover, the only conduct which triggers the application of Idaho Code § 72-923 is an employer’s fraud or misrepresentation. The statute plainly punishes wrongful conduct. Thus, the application of the statute appears to be punitive in nature.

Further, the amount of liability imposed by the statute is considerably more than the amount of any actual loss: 10 times the amount of the unpaid premium. This potential liability operates to deter employers from fraudulently misrepresenting their payrolls. Likewise, there is no evidence in the statutes that Idaho Code § 72-923 serves as a revenue generating provision.

Thus, the \$180,588.87 imposed by Idaho Code § 72-923 is sufficiently penal in nature to characterize it as a “penalty”.

To come within the terms of subsection (a)(7), the debt must also be “payable to and for the benefit of a governmental unit.” 11 U.S.C. § 523(a)(7). Section 101(27) of the Code defines “governmental unit” to include a “department, agency, or instrumentality” of a state. 11 U.S.C. § 101(27).

The legislative history of Section 101(27) states that:

department, agency, or instrumentality does not include entities that owe their existence to state action, such as the granting of a charter or a license but that have no other connection with a state or local government or the federal government. The relationship must be an active one in which the department, agency, or instrumentality is actually carrying out some governmental function.

H.R. Rep. No. 595, 95th Cong., 1st Sess. 311, *reprinted in* 1978 U.S.C.A.N. 5787, 6268. Further, the legislative history to this provision indicates that the definition of a governmental unit is intended to be construed in the “broadest sense.” *Id.*; *see also In re Williams*, 93 I.B.C.R. 97, 98 n.2, *aff’d*, 95 I.B.C.R. 12.

A legislative commission, a governmental purpose, and an active interaction between the entity and the State are some of the characteristics of a governmental unit. In this case, Plaintiff is an instrumentality created and administered by the State of Idaho under the Act for the purpose, in part, of insuring employers against liability and providing compensation to employees for personal injuries sustained in the course of employment. 1917 Idaho Session Laws, ch.81, p.253. Thus, Plaintiff, as an instrumentality of the State of Idaho which performs functions associated with the government, satisfies the Bankruptcy Code’s definition of a governmental unit under Section 101(27).

Accordingly, the Court finds that Plaintiff is a governmental unit under Section 523(a)(7). In addition, because the penalties at issue are assessed by a state instrumentality and payable to that instrumentality, this Court also finds that such penalties are “payable to and for the benefit of a governmental unit” as required by Section 523(a)(7).

Under the third element of Section 523(a)(7), that the debt cannot constitute compensation for actual pecuniary loss,

the focal point is whether the civil penalty is penal or pecuniary in nature. *See United States v. WRW Corp.*, 986 F.2d 138 (6th Cir. 1993); *In re Sokol*, 170 B.R. 556, 561 (Bankr. S.D.N.Y. 1994), *aff’d*, 181 B.R. 27 (S.D.N.Y. 1995); *Commonwealth of Kentucky v. Seals*, 161 B.R. 615, 619-21 (W.D.Va. 1993); *In re Lueking*, 125 B.R. 513, 516 (E.D. Tenn. 1990); *In re Renfrow*, 112 B.R. 22, 23 (Bankr. W.D.Ky. 1989). This third element need not be heavily debated. The determination above as to whether the debt is a fine or penalty somewhat overlaps the analysis of whether the debt constitutes compensation for actual pecuniary loss.

To the extent that the liability imposed by Idaho Code § 72-923 constitutes compensation for actual pecuniary loss, i.e., to the extent that a percentage of the amount collected is used to compensate Plaintiff for the loss of unpaid premiums, that amount is dischargeable. Here, the Court concluded above, that the \$20,065.42 in unpaid premiums included in the judgment was neither a fine nor a penalty because it represented compensation for the loss of the unpaid premiums.

In addition, although the remaining liability assessed by Idaho Code § 72-923 is based solely on a violation of the statute, it cannot be said that the \$180,588.87 pertains to an actual pecuniary loss or to compensation for a monetary injury actually incurred. Moreover, no evidence has been presented, other than the \$20,065.42 in unpaid premium, which illustrates that Defendants have suffered any actual loss during the time for which civil penalties were assessed. The Court concludes that, except for the \$20,065.42 representing the unpaid premium, the liability under Idaho Code § 72-923 is not based upon compensation for actual losses incurred from a violation.

Accordingly, the \$180,588.87 awarded Plaintiff by the state court in the judgment under this statute is a penalty payable to and for the benefit of a governmental unit which does not constitute compensation for actual pecuniary loss, and thus, is excepted from discharge pursuant to Section 523(a)(7).

Attorney fees and costs were imposed against Defendants by the state court as part of its judgment. Thus, there is the question as to whether the attorney fees and costs are excepted from discharge.

The issue of whether attorney fees and costs awarded in a state court judgment are dischargeable, if the underlying debt is held nondischargeable under Section 523(a)(7), appears to be one of first impression in this District. However, in *In re Florida*, 164 B.R. 636, 639 (9th Cir. B.A.P. 1994), the Ninth Circuit Bankruptcy Appellate Panel applied the “status dependent doctrine” in holding that “[a]ncillary obligations such as attorneys’ fees and interest may attach to the primary debt; consequently, their status depends on that of the primary debt.” The *Florida* Court concluded that those portions of the claim based on attorney fees and costs which were ancillary to the underlying debt partook of its character. *Id.* Thus, because the underlying debt was held nondischargeable under Section 523(a)(6), the attorney fees and costs were also excepted from discharge. *Id.*

This Court believes that the reasoning behind the application of the status dependent doctrine by the Ninth Circuit Bankruptcy Appellate Panel to debts which were ancillary to an underlying debt held nondischargeable under Section 523(a)(6) applies equally to Section 523(a)(7). Under this approach, ancillary obligations such as costs and attorney

fees incurred in a proceeding to enforce the primary obligation are to be characterized in the same manner as the primary debt. Consequently, the discharge-ability of such charges depends on that of the primary debt.

The Court finds no principled reason why this doctrine cannot be applied to a case, like the one at bar, involving a nondischargeable debt under Section 523(a)(7) for Defendants' act of fraudulently misrepresenting payroll records. The existence of the ancillary debt entirely depended upon Defendants' improper conduct and Plaintiff would not have incurred its costs and attorney fees but for such conduct. To discharge an ancillary debt which would not exist but for a nondischargeable debt seems erroneous. Further, Plaintiff's fees and costs are within the realm of debts that were caused by Defendants' own conduct.

This approach is consistent with fundamental precepts of Bankruptcy law. This approach furthers the Code purpose of discharging only the "honest but unfortunate debtor." See *Grogan v. Garner*, 498 U.S. 279, 286-87, 111 S.Ct. 654, 659 (1991). A contrary rule sanctioning the discharge of attorney fees and costs incurred in a proceeding to enforce a debt otherwise nondischargeable would leave dishonest debtors better off under the Code than under state law without furthering a Bankruptcy policy. Accordingly, this Court concludes that the principle applies with equal force to Section 523(a)(7).

#### Conclusion.

The Court concludes that the \$20,065.42 in unpaid premiums owed by Defendants to Plaintiff is neither a fine nor a penalty as used in Section 523(a)(7) and is dischargeable. In addition, the Court finds that the \$3,050.00 penalty awarded to Plaintiff pursuant to Idaho Code § 72-919 for non-payment of premiums, and the \$180,588.87 penalty imposed upon Defendants by the state court under Idaho Code § 72-923 for falsification of payroll records, are excepted from discharge pursuant to Section 523(a)(7). Finally, the costs and attorney fees incurred by Plaintiff in obtaining the underlying judgment, which is predominantly nondischargeable, are likewise excepted from discharge under Section 523(a)(7).

Plaintiff's Motion for Summary Judgment will be granted in part. Of the amounts awarded to Plaintiff in the state court judgment, \$184,713.87 is excepted from discharge under Section 523(a)(7). However, that portion of the judgment representing the unpaid premiums, \$20,065.42, is dischargeable. Counsel for Plaintiff shall submit an appropriate form of order and judgment to the Court for entry, which form has been approved by counsel for Defendants.

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