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### Stop Right There! Assessing the Role of Collateral Estoppel in a Fraud Proceeding Against a Debtor and a Debtor-Owned Business

Brandon Dorman

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**Stop Right There! Assessing the Role of Collateral Estoppel in a Fraud Proceeding Against a Debtor and a Debtor-Owned Business**

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**Stop Right There! Assessing the Role of Collateral Estoppel in a Fraud Proceeding Against a Debtor and a Debtor-Owned Business**

**Brandon Dorman, J.D. Candidate 2019**

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**Introduction**

In an adversary proceeding, under section 523(a)(2)(A) of title 11 of the United States Code (the "Bankruptcy Code"), to determine the non-dischargeability of a debt based upon fraud, a state courts finding of fraud against a debtor-owned business may collaterally estop the debtor in the adversary proceeding from relitigating the issue of fraud. Essential to this issue is the timing at which the debtor filed for bankruptcy. Timing is critical in determining whether the prior decision against the debtor-owned business in the state court action collaterally estopped the litigation against the debtor or whether the debtor was afforded the benefits of the automatic stay.

The automatic stay is one of the essential protections afforded to a debtor. The automatic stay is granted upon the filing of a bankruptcy petition and functions as an immediate injunction,

preventing creditors from collecting debtor's assets while still preserving the creditor's rights.<sup>1</sup> Protection lasts until the debtor's petition for discharge is granted or denied.<sup>2</sup>

A debtor files for bankruptcy in order to have its debts discharged. Discharge affords the debtors a clean slate and relieves the debtor of its obligations owed to its creditors. The injunction provided by the automatic stay is pivotal to the debtor obtaining discharge. However, not all debt is dischargeable.<sup>3</sup> When debt arises from "false pretenses, a false representation, or actual fraud," debtors are denied discharge and a "fresh start."<sup>4</sup>

Collateral estoppel denies a party the opportunity to relitigate an issue when the party was provided a full and fair opportunity to litigate the issue and the elements of the issue in the lower court are identical to the elements of the issue in the subsequent court. This usually precludes an issue from being adjudicated in bankruptcy court after it has been adjudicated in state court. Depending on when the debtor files for bankruptcy in the initial litigation, all elements of fraud may have been adjudicated and, thus, the debtor may be collaterally estopped in the subsequent litigation. If so, the debtor would be unable to avail itself to the protections of the automatic stay.

This memorandum explores the relationship between the automatic stay and collateral estoppel in a section 523(a)(2)(A) bankruptcy proceeding against a debtor that stemmed from a state court finding of fraud against a debtor-owned business. Part I of the memorandum analyzes the legislative intent surrounding section 523 of the Bankruptcy Code. Part II examines how common law dictates when a debtor should file for bankruptcy. Overall, this memorandum

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<sup>1</sup> See 11 U.S.C. § 362; *Nadler v. Village (In re Triad Constr. Co.)*, 545 B.R. 597, 603 (Bankr.

<sup>2</sup> 11 U.S.C. § 362(c)(2)(C).

<sup>3</sup> See 11 U.S.C. § 523.

<sup>4</sup> *Id.* at § 523(a)(2)(A); see *Cohen v. De La Cruz*, 523 U.S. 213, 223 (1998).

illustrates how collateral estoppel prevents a debtor's subsequent filing for bankruptcy from providing the debtor the opportunity to discharge his or her debts after a debtor-owned business has been adjudicated for actual fraud.

**I. The legislature intended for collateral estoppel to apply to fraud bankruptcy proceedings.**

Section 523(a)(2)(A) of the Bankruptcy Code states that an individual is not discharged from any debt “for money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained by false pretenses, a false representation, or actual fraud.” Actual fraud is derived from the common law of torts.<sup>5</sup> In addition, the standard for actual fraud adopted by the bankruptcy courts may vary from the standard of fraud adopted by the state courts, and each state's standard may vary among each other.<sup>6</sup>

Collateral estoppel prevents a party from relitigating an issue when the identical issue had been raised, litigated, and adjudicated in the prior action and “the party to be precluded from relitigating the issue had a full and fair opportunity to litigate the issue in the prior action.”<sup>7</sup> The Supreme Court has applied the doctrine of collateral estoppel in bankruptcy proceedings.<sup>8</sup> The evidentiary standard, however, differs between state courts and the bankruptcy court in a section 523(a) proceeding.<sup>9</sup> The bankruptcy court uses a preponderance of the evidence standard, while some state courts, including New York, use the clear and convincing evidence standard.<sup>10</sup> The low evidentiary standard utilized by the bankruptcy courts makes it highly probable that a case

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<sup>5</sup> Field v. Mans, 516 U.S. 59, 70 n. 9 (1995).

<sup>6</sup> See, e.g., Evans v. Ottimo, 469 F.3d 278, 283 (2d Cir. 2006) (New York state court's fraud is made up of actual misrepresentation of material fact, knowledge by the misleading party of a false misrepresentation, justifiable reliance by the plaintiff, and a resulting injury).

<sup>7</sup> *Id.* at 281.

<sup>8</sup> See Grogan v. Garner, 498 U.S. 279, 284 (1991).

<sup>9</sup> Comparing *id.* at 291 with *Evans*, 469 F.3d at 283.

<sup>10</sup> *Id.*

for fraud that has been fully and fairly litigated in state court will be collaterally estopped since the state court applied either an equal or greater evidentiary standard.

In enacting section 523(a), the legislature intended for it to arise out of common law and be shaped by the courts.<sup>11</sup> While the statute is silent on whether collateral estoppel should be applied to section 523(a) actions, the Congressional record references estoppel in the context of a debtor's non-dischargeable taxes.<sup>12</sup> According to the Senate Report, "[t]he Tax Court decision on the merits of a tax liability would bind both the bankruptcy estate and the debtor himself for nondischargeable taxes not paid from the estate."<sup>13</sup> Thus, the Senate intended for certain non-dischargeable obligations to be collaterally estopped.

Congress, however, did not intend for estoppel to be limited to taxes. Taxes and actual fraud are both mentioned separately in section 523 as non-dischargeable.<sup>14</sup> Congress, however, specified which taxes are non-dischargeable.<sup>15</sup> According to the Senate Report, in reference to taxes, "a discharge of the trustee or the debtor which would otherwise occur under the prompt audit rule will not be granted, or will be void . . . if the return filed on behalf the estate reflects fraud."<sup>16</sup> Congress never saw fit to provide a fresh start to any obligation that resulted from fraud. While certain taxes may be afforded discharge, fraudulent taxes are not.<sup>17</sup> The fact that actual fraud is clearly stated and has its own section demonstrates Congress's intent that any debt resulting from fraud is non-dischargeable. Therefore, it does not matter that the Senate Report only mentions collateral estoppel in the context of non-dischargeable taxes. Congress fully

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<sup>11</sup> *See, e.g., Garner*, 498 U.S. at 284.

<sup>12</sup> S. REP. NO. 95-1106, at 11 (1978); *see* H.R. REP. NO. 95-595 (1978)

<sup>13</sup> *Id.*

<sup>14</sup> *See* 11 U.S.C. § 523.

<sup>15</sup> *See* S. REP. NO. 95-1106, at 11 (1978).

<sup>16</sup> *Id.* at 10.

<sup>17</sup> *See* 11 U.S.C. §523(a)(1)(C)

intended to deny fraudulent debtors a second opportunity to be heard when their issue was already fully and fairly adjudicated.

**II. The timing at which a debtor files for bankruptcy affects collateral estoppel in a subsequent proceeding.**

The moment at which a debtor triggers the automatic stay in a state court action impacts the ability of a debtor to claim estoppel in a subsequent proceeding. This principle is essential to determining whether a debtor, who was a full participant in a prior fraud proceeding against the debtor's-owned business, is estopped in a subsequent section 523(a)(2)(A) action against him or herself stemming from the same issue of fraud. Although state laws pertaining to fraud may vary, it is consistent amongst most states that collateral estoppel is not allowed in non-dischargeable debt cases where there is a default judgement since the issue was not fully litigated.<sup>18</sup> The bankruptcy court has the ultimate authority to allow a discharge and to allow for collateral estoppel to take effect.<sup>19</sup>

When a creditor seeks to have his claim declared non-dischargeable, and a state court action is pending relating to the claim, the timing of the automatic stay in relation to the state court action is vital to determining whether or not collateral estoppel applies. The automatic stay is triggered when a debtor files for bankruptcy.<sup>20</sup> The automatic stay stays “the commencement or continuation . . . of a judicial . . . action or proceeding against the debtor.”<sup>21</sup> It does not determine whether the debtor's debt is dischargeable, but it does provide the debtor with time to prevent the creditor from commencing or continuing litigation against him or her. Courts may sever the debtor in a case against the debtor and a debtor-owned business upon implementation

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<sup>18</sup> See, e.g., *In re Grainger* 20 B.R. 7, 10 (Bankr. D.S.C 1981); *Talarico v. Martel (In re Martel)*, 332 B.R. 922, 924 (Bankr. M.D. Fla. 2005).

<sup>19</sup> See *Kayes v. Klippel (In re Klippel)*, 183 B.R. 252, 258 (Bankr. D. Kan. 1995); *In re Tilbury* 74 B.R. 73, 78 (B.A.P. 9th Cir. 1987).

<sup>20</sup> 11 U.S.C. § 362(a).

<sup>21</sup> *Id.*

of the automatic stay.<sup>22</sup> Thus, the timing at which a debtor filed for bankruptcy in relation to the state court matter is imperative to whether or not collateral estoppel applies. Two cases that examine this concept are *Adler v. Ng (In re Adler)* and *In re Ottimo*, 2017 WL 2470861, No. 8-15-74712 slip op. at \*1 (Bankr. E.D.N.Y. June 7, 2017).

In *Adler*, the District Court for the Eastern District of New York found that a debtor was not collaterally estopped from relitigating a section 523(a)(2)(A) claim when the debtor had filed for bankruptcy prior to litigation commenced against his corporation.<sup>23</sup> Plaintiff had sued debtor and his company for eleven causes of action, including fraud.<sup>24</sup> The state court first removed the debtor from the action upon his filing for bankruptcy.<sup>25</sup> Following a state court verdict for the plaintiff against the debtor's corporation, the plaintiff filed a complaint under section 523(a)(2)(A) in the bankruptcy court against the debtor.<sup>26</sup> The bankruptcy court found that the state court's decision collaterally estopped the debtor from relitigating the issue of fraud.<sup>27</sup> The District Court, however, reversed the Bankruptcy Court's decision as a result of the automatic stay.<sup>28</sup> The court found that the automatic stay severed the debtor from the proceeding against his corporation.<sup>29</sup> If the debtor was not severed, continuation of the litigation would have been improper since 11 U.S.C. §362(a)(1) prohibits the continuation of litigation against a debtor who is granted a stay.<sup>30</sup> Thus, because of the automatic stay, the finding of fraud could only be held against the debtor's corporation and not him individually. The debtor was ultimately denied a

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<sup>22</sup> See *Adler v. Ng (In re Adler)*, 395 B.R. 827 (E.D.N.Y. 2008).

<sup>23</sup> *Adler*, 395 B.R. at 830.

<sup>24</sup> *Id.* at 831

<sup>25</sup> *Id.*

<sup>26</sup> *Id.* at 832.

<sup>27</sup> *Id.* at 833.

<sup>28</sup> *Id.* at 840.

<sup>29</sup> *Id.*

<sup>30</sup> *Id.* at 839.

full and fair opportunity to litigate the issue of fraud against himself since he was not a full participant in the litigation, and a finding of collateral estoppel was improper.<sup>31</sup>

In *Ottimo*, a New York State Supreme Court found debtor's owned corporation guilty of common law fraud.<sup>32</sup> Plaintiff was permitted to pierce the corporate veil and go after the debtor's assets.<sup>33</sup> The debtor subsequently filed for bankruptcy under chapter 7 of the Bankruptcy Code and the Plaintiff initiated a non-dischargeability action in bankruptcy court against the debtor.<sup>34</sup> The bankruptcy court held that since the debtor was a full participant in the state court proceeding and because the elements of common law fraud in New York are identical to the actual fraud elements in section 523(a)(2)(A) of the Bankruptcy Code, the debtor was collaterally estopped from obtaining discharge of his debts.<sup>35</sup>

Although the *Ottimo* case is silent in discussing the automatic stay, the rationale behind its holding is the relationship between timing and the automatic stay. In *Adler*, the debtor filed for bankruptcy prior to the state court fraud litigation against him and his business, leading to his severance from the law suit. The plaintiff was subsequently denied collateral estoppel on the same issue against the debtor because the debtor was not a party to the litigation against his business. The creditor was unable to pierce the corporate veil of the debtor and had to relitigate the issue. In *Ottimo*, the state court ruled in favor of plaintiff, permitted plaintiff to pierce the corporate veil, and then the debtor filed for bankruptcy. The court subsequently found that collateral estoppel prevented discharge since the debtor was a party to the prior litigated fraud issue. The key difference between the two cases is when the debtor filed for bankruptcy. Upon

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<sup>31</sup> *Id.*

<sup>32</sup> *Ottimo*, slip op. at \*2.

<sup>33</sup> *Id.*

<sup>34</sup> *Id.* at \*3.

<sup>35</sup> *Id.* at \*3, \*5.



filing for bankruptcy, debtors are afforded the benefits of the automatic stay under section 362 of the Bankruptcy Code. This prevents the commencement or continuation of the judicial action against the debtor. Thus, if the debtor files for bankruptcy prior to the completion of state court litigation, and is severed from the litigation, he or she could not be collaterally estopped; but, if the debtor waits until the completion of the litigation, the debtor, not having been severed, fully participated in the litigation, and is bound by the state court's ruling.

### **Conclusion**

The imposition of collateral estoppel in a section 523(a)(2)(A) case against the debtor is predominantly dependent on when the debtor files for bankruptcy when the debtor participates in a state court action against their owned business. The moment in the state court proceeding when the debtor files for bankruptcy affects whether or not the debtor was afforded the benefits of the stay. The automatic stay prevents the commencement or continuation of litigation against a debtor. In a suit involving a debtor and a debtor-owned business, a debtor is too late if he or she files for bankruptcy after the case has been fully litigated and adjudicated. The debtor would not be afforded the benefits of the stay and would be estopped by the state court decision. However, if the debtor filed for bankruptcy during or prior to the state court action against the debtor-owned business, the debtor would be afforded the benefits of the stay and would not be collaterally estopped. Barring a creditor's motion for relief from the stay under section 362 of the Bankruptcy Code, the debtor may be severed as a consequence of the stay, and the state court litigation will only effect the debtor-owned corporation.

The relationship between timing, the automatic stay, and collateral estoppel pertains only to the full and fair opportunity prong of collateral estoppel. When the stay is granted before or during the state court proceeding, and the debtor is a party to both proceedings, the prong is not

satisfied. When the stay is granted after the state court proceeding, and the debtor is a party to both proceedings, the prong is satisfied.

Thus, all that remains in deciding whether or not to impose collateral estoppel is whether the issues of fraud in the state court and bankruptcy court are identical. In many state courts, the elements of fraud are identical to the elements of actual fraud in the bankruptcy court. In addition, the bankruptcy court utilizes a lower evidentiary standard than the state courts making it highly likely that state court fraud will satisfy the bankruptcy court's evidentiary standard. If the elements of fraud are not identical among the two courts, timing of the stay is inconsequential since both collateral estoppel prongs must be satisfied. However, when the elements of fraud are identical among the two courts, the time at which the debtor filed for bankruptcy is pivotal in determining whether the debtor is estopped in the subsequent bankruptcy proceeding.