

Will My Judgment Get Discharged in Bankruptcy?

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Bankruptcy is meant to provide a fresh start for the honest but unfortunate debtor.

A debtor who files Chapter 7 does so with the presumption that all his or her debts will be forgiven or "discharged." But what about the dishonest debtor? How dishonest can a debtor be before their discharge is denied? And what can or should a creditor do – before and during bankruptcy – to

protect a debt from discharge? In *In re Jacobs*, the United States Bankruptcy Court for the Western District of North Carolina considered the dischargeability of a state-court judgment for multiple torts and a punitive damages award. In doing so, the Court provided guidance for creditors seeking to except a judgment from discharge.

A Death, an Estate, a Struggling Business, and a Long Fight

Eddie Wallace owned Ed Wallace Construction, Inc. when he died in a motorcycle accident in 2007. His two teenage children inherited his Estate, which consisted of his home and the company. His will named his sister, Susan Jacobs, as his personal representative. Jacobs became the executrix of the Estate and president of the company.

The children and Jacobs soon were locked in a contentious and lengthy dispute over whether Jacobs was breaching her fiduciary duties to the Estate and the company through self-dealing, mismanagement, and other improper conduct. Eventually, a Lincoln County Clerk of Court removed Jacobs as executrix. Later, the children sued Jacobs for breach of fiduciary duty, negligence, unjust enrichment, misrepresentation, and fraud. The children dismissed their claims of improper conduct by Jacobs to the Estate. The case went to trial on the claims of improper conduct by Jacobs against the company. A jury ruled for the company, awarding it \$222,689 in compensatory damages and \$40,000 in punitive damages. The verdict lumped all the compensatory awards into a single judgment. It did not differentiate between the claims for negligence and fraud.

After trial, Jacobs filed Chapter 7. The plaintiff, the assignee of the judgment, filed an adversary proceeding (a lawsuit inside a bankruptcy case) to deny Jacobs her discharge and to have the jury award declared non-dischargeable.

The Bankruptcy Court Decides Discharge Issues

The Court began by considering the weight given to the proceedings in state court and the jury's verdict. Dischargeability is a matter of federal law. Section 523 of the Bankruptcy Code lists the exceptions to discharge. They generally involve intentional, fraud-like conduct. The Court cannot automatically defer to a state-court judgment – even one based on intentional torts like fraud – but must independently compare the state law claims with Section 523. If the issues are identical, then findings by the state court may preclude re-litigation of identical issues in bankruptcy court under the doctrine of collateral estoppel. To make this decision, the Court considers the Verdict Sheet, Judgment, Jury Instructions, Pleadings, Briefs, Transcripts, and Exhibits from the state court.

The thrust of the Court's inquiry is (1) whether the state court made specific factual findings material to the discharge issues and (2) the extent to which the elements of the claims on which judgment was entered match the elements of the Section 523 non-dischargeability claim. In In re Jacobs, the Bankruptcy Court looked at everything (including a 2,200-page transcript) but still could not decide the issue without further evidence. As a result, the Court set the case for a second trial on the dischargeability issues.

At trial, the plaintiff has the burden of proof. The party seeking to establish an exception to the discharge of a debt must prove the requisite elements by a preponderance of the evidence.

False Pretenses, False Representations, or Actual Fraud

One exception to discharge is for debts obtained by false pretenses, false representations, or actual fraud. These claims have four elements: (1) a fraudulent misrepresentation; (2) that induces another to act or refrain from acting; (3) causing harm to the plaintiff; and (4) the plaintiff's justifiable reliance on the misrepresentation. The fraudulent misrepresentation element “is satisfied if the debtor's representation was known to be false or recklessly made without knowing whether it was true or false.” A debt may be non-dischargeable even absent a false representation if the debt was obtained through actual fraud.

Fraud While Acting in a Fiduciary Capacity

Another exception to discharge is for debts due to fraud or defalcation while acting in a fiduciary capacity. Defalcation refers to a failure to produce funds entrusted to a fiduciary. It requires proof of an intentional wrong. Intentional includes not only conduct that the fiduciary knows is improper but also reckless conduct of the kind that the criminal law often treats as the equivalent. The Bankruptcy Court noted that intra-family disputes generally cannot support a defalcation claim.

Willful and Malicious Injury

Another exception to discharge is for a willful and malicious injury to another entity or the property of another entity. The plaintiff must show that the defendant's acts leading to the debt were done with the actual intent to cause injury.

What about Punitive Damages?

The Bankruptcy Court concluded that a state-court punitive damages award is not automatically non-dischargeable in bankruptcy because, at least in North Carolina, courts can allow punitive damages for conduct that does not always lead to a non-dischargeable debt in bankruptcy.

In In re Jacobs, the plaintiff could not meet the burden of proof on any exception to discharge. A crucial issue was that the plaintiff had to prove the elements of a discharge exception as to the company since the company was the judgment creditor. Because the claims against Jacobs as to the Estate had been dismissed, conduct related to the Estate that qualified as an exception to discharge was irrelevant. As a result, their judgment was discharged.

Conclusion

Bad conduct by a debtor that culminates in a state-court judgment does not automatically lead to a non-dischargeable debt. A judgment sounding in negligence likely will be discharged. Exceptions to discharge are generally limited to intentional torts sounding in fraud. If you are suing a party and believe they will file bankruptcy to avoid a judgment, strive to obtain a pre-bankruptcy judgment that specifically describes the damages flowing from each claim and mirrors, to the maximum extent possible, the elements of a discharge exception. The more material factual findings in state court, the better your odds in Bankruptcy Court. Ultimately, however, discharge is in the hands of the Bankruptcy Court, and there may be no way to avoid a second trial of your case to determine dischargeability.

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