

Non Dischargeable Debts

July 22, 2019

Michael Traison- 312.860.4230

Jocelyn Lupetin- 516.296.9109

A recent decision out of the United States District Court for the Southern District of California provides an opportunity to address three issues related to debt dischargeability in the Bankruptcy process.

In the case of In re Wlodarczyk, Case No.: 3:19-cv-00062-H-MDD (Bankr. S.D.N.Y. July 15, 2019), the Debtor filed a personal Chapter 7 case seeking to be discharged from any further liability resulting from a personal guarantee he had executed prior to filing his bankruptcy petition. In seeking to be relieved from the debt, the Debtor was relying upon the general rule that a Chapter 7 filing provides an individual debtor an opportunity for a fresh start, discharging him/her from liability related to most prepetition obligations.

However, excepted from the general rule that allows for prepetition debt to be discharged, are certain kinds of debts enumerated in 11 U.S.C. § 523. Included among those debts for which liability cannot be terminated are debts arising from torts including bad acts such as committing fraud. Thus, creditors may respond to a debtor's petition by asking the Bankruptcy Court to find a specific debt to be non dischargeable.

In Wlodarczyk, long before the Bankruptcy, the Debtor had defaulted on a \$300,000 guarantee he had executed in favor of a film producer. The film producer then sued him in State Court asserting that the Debtor committed fraud by offering to guarantee a borrower's debt when he should have known he would not be able to honor his guarantee. The parties eventually settled the matter prior to trial and a Stipulated Judgment was entered against the Debtor and in favor of the film producer.

Given the film producer's concern that the guarantor might file bankruptcy following settlement of their dispute, he required the inclusion of a term in the settlement agreement which provided that the specific debt would be excepted from discharge in the event that the guarantor filed Bankruptcy.

Subsequently, the guarantor defaulted on the settlement agreement and filed a Chapter 7 case seeking, *inter alia*, to avoid the liability resulting from the guarantee. The film producer sued in Bankruptcy Court, asserting that the guarantee debt should not be dischargeable, as the parties had explicitly contracted to preserve the enforceability of the debt. Additionally, the film producer argued that the debt was non dischargeable insofar as it was based on the Debtor's fraud.

In evaluating this case, the Court was faced with three distinct questions: (A) Was the negotiated term contained in the Settlement Agreement which stipulated to the non dischargeability of the debt enforceable?; (B) Was the State Court litigation dispositive of the issue of the debt being procured through fraud, therefore making the debt not dischargeable?; and (C) If the prior two questions are answered in the negative, can the Bankruptcy Court now find that the debt was procured through fraud and hold the debt to be non dischargeable?

The District Court answered all three questions in the negative, affirming the lower court holding that the guarantor debt is dischargeable.

First, the Court reminded us that prepetition agreements which purport to overrule a benefit of the Bankruptcy Code are unenforceable as a matter of public policy. Additionally, it was made clear that here, where the issue of fraud was not fully litigated in State Court, the Stipulated Judgment has no preclusive or *res judicata* effect. Finally, the Bankruptcy Court held that a conclusion that a fraud had been committed by the guarantor could not be found in the absence of an actual misrepresentation or omission on his part.

In this case the film producer, in his role as lender, might have considered asking the Debtor to provide financial statements as well as requiring an unambiguous written statement from the Debtor reflecting his ability to honor his promise to pay. Additionally, the Stipulation Judgment might also have included specific findings of fraud and misrepresentation in lieu of trivial language providing asserting that the subject debt be non dischargeable in the event of a bankruptcy filing.

In light of this recent holding, it is important that creditors closely examine § 523 exceptions to discharge when a debtor is seeking to escape his obligations. Moreover, best practice encourages consideration of the possibility of such a scenario at the inception of a debtor/creditor relationship.

Please note that this is a general overview of developments in the law and does not constitute legal advice. Nothing herein creates an attorney-client relationship between the sender and recipient. If you have questions regarding these provisions, or any other aspect of bankruptcy law, please contact Michael Traison at [312.860.4230](tel:312.860.4230)

Practices

- Bankruptcy and Creditors' Rights

Industries

- Financial Institutions

Attorneys

- Michael H. Traison
- Jocelyn E. Lupetin