
Nondischargeability and Default Judgments

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Generally speaking, the filing of a petition under chapter 7 of the Bankruptcy Code will relieve the petitioner of any further obligations for almost all types of debt. This is in accordance with the Federal Bankruptcy Code's underlying principle - to provide debtors with a "fresh start". But, that principle is not without its limitations.

A debtor will not be discharged from an obligation to pay debts which were created as a result of "bad acts", intentional torts, or other types of wrongdoing such as fraud and misrepresentation.

The determination of whether or not a debt is dischargeable is typically one made by the Bankruptcy Court. However, when the debt arises from a prior action wherein the issues were fully litigated and where a finding of wrongful behavior was made, that pre-bankruptcy decision may be honored by the Bankruptcy Court. This is referred to as collateral estoppel or issue preclusion.

In a client alert issued on July 22, 2019, we discussed these issues more fully. However, there have been several recent cases in which the courts discuss whether a pre-bankruptcy lawsuit which resulted in a default judgment without being fully litigated might also provide the basis for a finding of nondischargeability, precluding any defense in the bankruptcy case.

Specifically, a recent decision by the Court of Appeals for the Second Circuit, In re Snyder, Docket No.: 18-1578-bk, addresses these issues.

In Snyder the trial court had dealt with a situation where the plaintiffs had invested money with the defendants who promised to build luxury homes and give the investors an excellent return on their money. However, defendants failed to do this and plaintiffs commenced an action. Plaintiffs alleged that the defendants spent the money invested on their personal expenses. A default judgment was entered against the defendants after they failed to respond to discovery.

Agreeing with several other Courts of Appeal, but not all, the Second Circuit found that, where a default judgment had been entered as a sanction and where the defendants had ample opportunity to litigate but failed to cooperate with discovery, the Bankruptcy Court was correct in finding the resulting judgment debt to be non-dischargeable.

Curiously, it appears that the Second Circuit Court of Appeals determined the willfulness of the bad act from the facts of the case whereas the trial court had entered a judgment based only on breach of contract, which itself would not create a non-dischargeable debt. The Court of Appeals did bifurcate the causes of action and remanded part of the case for further consideration of willfulness.

The decision of the Court of Appeals appears to have been made out of a sense of equity since the plaintiffs had been put through a five year long process during which the defendants changed attorneys multiple times and repeatedly failed to cooperate with the discovery process, followed by another four years of litigation in the bankruptcy court and via multiple appeals.

Our creditor clients are advised to pay close attention when their debtors file for protection under the Bankruptcy Code seeking to discharge debts. There are exceptions to dischargeability, even when judgment has been entered by default.

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

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