Evans v. Otimo: Revisiting Issue Preclusion in the Second Circuit

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Creditors contemplating an objection to discharge proceeding pursuant to Bankruptcy Code § 523(a)(2)(A)'s fraud provision often think that a judgment in a prior state court action will automatically entitle them to judgment in bankruptcy court. Prior to reaching such conclusions, however, creditors should be mindful of several potential pitfalls.

Section 523(a)(2)(A) excepts from discharge debts obtained by "false pretenses, a false representation, or actual fraud...." Often, creditors will obtain a default judgment in state court based on a complaint that included a count of fraud. When the debtor subsequently files for bankruptcy, a creditor may be tempted to think the principle of *res judicata* will bar a debtor from defending himself in a subsequent adversary proceeding. In such a scenario, the creditor would file the summons and complaint in bankruptcy court and then simply move for summary judgment. Since the creditor was already successful in state court, *res judicata* would bar the debtor from setting forth a defense on the merits, and the creditor's motion would be granted. In fact, although the holding of *Evans v. Ottimo* [1] applies collateral estoppel to default judgments where there were allegations of fraud in a prior action, *Evans* has important limits of which practitioners should be mindful.

Evans, the seminal Second Circuit case dealing with issue preclusion in the context of an adversary proceeding, involved joint debtors that filed for bankruptcy five years after a default judgment had been taken against them in a prior New York state court proceeding. *Evans* began its discussion of issue preclusion by citing to the Supreme Court precedent of *Grogan v. Garner*. [2] While *Grogan* primarily dealt with the distinction regarding the burden of proof by which fraud must be demonstrated to sustain a nondischargeability claim, the takeaway point is that if fraud is properly proved in a prior action, the debtor will be collaterally estopped from defending a subsequent nondischargeability proceeding. [3] *Grogan*, however, involved a jury verdict after trial and did not address the applicability of collateral estoppel to default judgments. This was the issue presented to the *Evans* court.

Before delving into the *Evans* preclusion analysis, it is important to clarify the elements necessary to maintain a § 523(a)(2)(A) claim of actual fraud. The elements of actual fraud under the Bankruptcy Code require that "the debtor made representations which the debtor knew were false; (2) the debtor made the representations with the intent to deceive; (3) the creditor relied on the false representation; and (4) the creditor suffered a loss as a result of this reliance." [4] Thus, any preclusion analysis must begin by examining whether the state court made a finding of any of these elements. This is the analysis employed by *Evans*.

Evans began by first asking whether the litigant was afforded a full and fair opportunity to litigate the issue. If so, the bankruptcy court would then be bound by the liability determination of the state court. The full range of what is considered a full and fair opportunity to litigate, though, is beyond

the scope of this article. The focus of this article is on the often-overlooked second prong of the *Evans* analysis: "whether the issue of fraud under § 523(a) of the Bankruptcy Code was identical to an issue that necessarily was decided by the state court." [5]

In addressing whether issues raised in bankruptcy court were identical to those decided by the state court, *Evans* presented a detailed discussion of collateral estoppel under New York law. The crux of the discussion centered on the following principle: In order for an issue to have actually been litigated, it not only must have been properly raised, more importantly it has to have actually been determined in the prior proceeding. [6] In *Evans,* following a default judgment and inquest, the state court specifically found "a very definite element of fraud and deceit in this matter" and imposed substantial compensatory and punitive damages. [7] In making numerous factual findings regarding the debtors' fraudulent conduct, the state court specifically ruled that "[t]he evidence established that the [defendants], in their capacities as the principle executive officers of J-Ran Carriers, Inc., over a number of months improperly diverted hundreds of thousands of dollars through the use of a secret account and checks signed by them and made payable to a check cashing company." [8] Based on these specific findings of fraud, *Evans* ultimately held that the state court resolved all issues necessary to establish fraud under § 523(a)(2), and was, therefore, decisive of the present action. [9] The debtors were thus collaterally estopped from re-litigating these issues, and judgment was rendered in favor of the creditor. [10]

It is, however, important to understand the limits of *Evans*. The *Evans* ruling regarding collateral estoppel was based on a clear finding of actual fraud in the state court proceeding. However, very often fraud is used as nothing more than a throwaway cause of action in state court. In such a case, the Second Circuit appears to be of the view that, barring a clear finding of actual fraud by the state court, a general judgment on liability with no specific finding of actual fraud is not sufficient to collaterally estop a debtor from defending a subsequent nondischargeability action on the merits brought under § 523(a)(2)(A).

Such a proposition is supported by *A.M. Hochstadt v. Lew (In re Lew)*. [11] In *A.M. Hochstadt*, the creditor, just as in *Evans,* argued that a state court judgment against a debtor was preclusive and automatically entitled him to a determination of nondischargeability. The only twist was that the state court judgment was from an out-of-state court. Regardless, the bankruptcy court held that the relevant analysis still remains whether or not the state court made a finding of actual fraud consistent with § 523(a)(2)(A). In *A.M. Hochstadt,* the court expressly held that the "Florida court did not give the question of 'actual fraud' any deliberation or analysis in rendering its decision...." [12] Thus, without establishing findings of actual fraud in the state court, a creditor is unlikely to be successful on a claim for estoppel.

There is one additional caveat of which creditors should be aware. Even if a state court did in some fashion issue a finding of fraud, the ele fraud, as well as the burden of proof by which such elements must be established, may vary between a given state law and the Bankruptc Thus, the mere fact that a state court issued a finding of fraud does not by itself mean the debtor committed actual fraud under the meani Bankruptcy Code. So, before jumping into an adversary proceeding, creditors' attorneys would be wise to carefully research both the state elements of fraud as well as the burden of proof necessary to establish such a claim in the relevant jurisdiction where the judgment was entered.

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[1] 469 F.3d 278, 281 (2d Cir. N.Y. 2006).

[2] 111 S. Ct. 654 (1991).

[3] *Id.*

[4] *DeRosa v. Jacone*, 156 B.R. 740, 743 (Bankr. S.D.N.Y. 1993).

[5] *Evans,* 469 F.3d at 282.

[6] *Id.*

[7] *Id.* at 283.

[8] *Id.* at 280.

[9] *Id.* at 283.

[10] *Id.*

[11] Nos. 11-10346 (ALG), 11-02404 (ALG), 2011 Bankr. LEXIS 4608 (Bankr. S.D.N.Y. Nov. 21, 2011).

[12] *A.M. Hochstadt,* 2011 Bankr. LEXIS 4608.

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