The default judgment is the second act in American lives

State court default judgments trump the bankruptcy discharge

By David Cook

Facing civil litigation, the defendant defaults because the defendant intends to file bankruptcy and escape the costs of defense. Ever so helpful, the defendant advises trial counsel of the bankruptcy case number. The trial counsel even relishes a bankruptcy that likewise ends futile litigation. Are we done?

What happens if the defendant defaults, but default judgment is entered and, thereafter, the defendant files for bankruptcy?

Alchemy under Title 11

Is the "paper judgment" worth anything when the defendant files bankruptcy? Does bankruptcy transform the paper judgment into paper money? "There are no second acts in American lives," wrote F. Scott Fitzgerald. Some former presidents defied this quote. Default judgments in ensuing bankruptcy proceedings might defy this quote as well. Let's see…

What if the claim can support the non-dischargeability of the debt?

Bankruptcy Code (11 U.S.C.)section 523(a) enables a creditor to file suit in bankruptcy court and exempt the debt from the discharge. This note highlights the relief available under 11 U.S.C. sections 523(a)(2) [fraud], 523(a)(4) [breach of fiduciary duty], and 523(a)(6) [willful and malicious].[1]

Non-dischargeability litigation is costly because the cases are fact-specific. These cases are not necessarily impossible, improbable or even difficult to prosecute, but they do require counsel to prove up each element of the claim for relief. Juries render verdicts on inferences while bankruptcy judges make findings from the stone-cold record. The standard of proof is a preponderance of the evidence. (See *Grogan v. Garner* (1991) 498 U.S. 279, 285.)

To mitigate the burden of non-dischargeability case, the trial counsel can invoke collateral estoppel arising from the state court litigation in proving up the elements of non-dischargeability. (See *Grogan, supra,* 28 U.S.C. § 1738; see also, *Marrese v. American Acad. Of Orth. Surgeons* (1985) 470 U.S. 373, 380; *In re*

Copyright © 2012 by the author.
For reprint permission, contact the publisher: **www.plaintiffmagazine.com**

Nourbakhsh (9th Cir.1995) 67 F.3d 798; *In re Randolph C. Bugna* (9th Cir.1994) 33 F.3d 1054, 1057-58.) A state court default judgment might support collateral estoppel. (See *In re Naemi* (Bankr.S.D.Cal. 1991) 128 B.R. 273, 278 (citing *O'Brien v. Appling* (1955) 133 Cal.App.2d 40, 42).); also *In Re Richard N. Green* (B.A.P. 9th Cir. 1996) 198 B.R. 564, 566; *Four Star Elec. Inc. v. F.&H Constr.* (1992) 7 Cal.App.4th 1375, 1380; *Mitchell v. Jones* (1959) 172 Cal.App.2d 580.) A default judgment in federal court might not support collateral estoppel. (See *Bush v. Balfour Beatty Bahamas, Ltd.* (11th Cir. 1995) 62 F.3d 1319, 1323.)[2].

The starting point, of course, is that counsel needs to recycle this task back to the state court complaint, the default process, the hearing on the default judgment, and to the form of default judgment itself.[3] Call this movie *Back to the Bankruptcy Future*.

In litigating the state court case, the language of the default judgment should necessarily track the text of section 523(a) and replicate every element. Collateral estoppel applies if threshold requirements are met. (See *In Re Harmon* (9th Cir. 2001) 250 F.3d 1240, 1245.) Counsel should literally draft, file, and prosecute state court litigation as if it is being heard by a bankruptcy judge, except for the final closing claim of non-dischargeability. Litigate the state court case under the aegis of the bankruptcy court.

For example section 523(a)(2) renders a common law fraud non-dischargeable. Section 523(a)(4) renders a debt non-dischargeable for funds embezzled by a state law fiduciary. Section 523(a)(6) renders non-dischargeable an intentional tort lacking any justifiable excuse or cause. "Willful and malicious" are treated separately and not lumped together. (See *In Re Barboza* (9th Cir. 2008) 545 F.3d 702, 706; also *In re George Jercich* (9th Cir. 2001) 238 F.3d 1202, 1204-1205.)

Here is a roadmap for litigating these potential non-dischargable claims in state court:

1. Plead each state law cause of action separately, discretely and accurately. Incorporate key documents and provide a fact-specific history. Name the names, date the dates, frame the facts, repeat the representations and detail the damages. The pleading style: Blow-by-blow. Eschew daisy-chain pleadings. Eschew notice pleadings. Swap out inference, and swap in facts. Employ the *Dragnet* school of pleadings: "Just the facts, ma'am." Leave nothing to the imagination. Call this "detail-driven pleading."

2. The prayer for relief in the complaint should segregate compensatory and punitive damages for each separate and distinct cause of action, as opposed to a single-dollar aggregate summary prayer. The damage calculus must dovetail with the individual claims and provide a clear, common sense connection. The amounts must be both reasonable and based on findings in the record, lest counsel discover that pigs get fed and hogs become artisanal bacon.

3. The prove-up hearing is a fact-driven trial, not a "walk-through." Counsel should try each independent cause of action and seek specific, detailed findings of fact on the record for each individual claim. The supporting declaration must parse out each claim. Most default hearings are summary in nature. Judges will typically render the default judgment without any great detail. No good. The court should recite separate and discrete relief and findings on the record that replicate the fact-driven causes of action. Be prepared to actually "try" the case even though there is a default judgment. Don't be shy: Counsel should tell the court why this level of detail is required and why a specific finding is necessary. In the non-dischargeability action, the record must show that the pertinent issue was litigated and decided, even if by default. (See *In Re King* (5th Cir. 1997) 103 F.3d 17.)

4. The form of judgment must segregate each cause of action and the damages attributable to each cause of action. This is an absolute necessity. Even better, incorporate findings of fact into the judgment (or have separate findings) that replicate 11 U.S.C. section 523(a). The judgment should incorporate findings, relief and damages mirroring the complaint.

The default judgment is the key that unlocks section 523(a) relief

The bankruptcy court will invoke collateral estoppel and incorporate the state court findings into the ensuing non-dischargeability action. If the state court litigation replicates relief under section 523(a), *et seq.*, counsel can convert an otherwise uncollectible default judgment into a non-dischargeable debt that survives the bankruptcy discharge. This can be done. Better yet, the debtor is freed of the other dischargeable debts, and this non-dischargeable debt exits the bankruptcy unscratched. The creditor crowd thins to one – you. For example, collateral estoppel rendered non-dischargeable a default judgment against a bookkeeper who browbeat her employer, attorney, while other debts were discharged. (See *In re Brown* (Bkrtcy.N.D Cal. 1995) 186 B.R. 962.)

Most tort claims aggregate around section 523(a)(6) relief [willful and malicious]. Section 523(a)(6) requires a specific textual finding that "willful injury requirement is only met when the debtor has a subjective motive to inflict injury or when the debtor believes that injury is substantially certain to result from his [or her] own conduct," (See *In re Ormsby* (9th Cir. 2010) 591 F.3d 1199, 1206), and might be inferred from the record. (*Id.* at 1207). Malice is separately proven. "[A] malicious injury involves (1) a wrongful act, (2) done intentionally, (3) which necessarily causes injury, and (4) is done without just cause or excuse. (*Ibid.*; also, e.g., *In re Barboza, supra*.)

The battleground here is whether the default judgment contains a finding that the defendant acted "maliciously" under section 523(a)(6) and predicated upon "state of mind." (See *In Re Su* (9th Cir. 2002) 290 F.3d 1140, 1146-1147 ["subjective state of mind"]). In invoking collateral estoppel arising from the state court

Copyright © 2012 by the author.
For reprint permission, contact the publisher: **www.plaintiffmagazine.com**

default judgment, the focal point is the *twin* findings of "willful" and "malicious," which necessarily are found separately and distinctly for each cause of action. Clarity is king, and anything less is mush. The default judgment must incorporate precision including subjective state of mind proof supporting actual malice. "Whether the issue of intent was litigated and resolved in the state court action, as required for application of collateral estoppel, is a question of law." (See *E.B. Harper & Co v. Nortek, Inc.* (7th Cir. 1997) 104 F.3d 913, 922.) Let Colonel Jessup draft a "crystal clear" default judgment.

The punchline

Section 523(a) claims have excessive moving parts. The default judgment blossoms in value by reducing the number of moving parts and the burdens of the Section 523(a) action. Settlement shows up at the bankruptcy courthouse steps accompanied by a Section 523(a) action that opens the courthouse door and is free of other claims.

In *Local Loan v. Hunt* (1934) 292 U.S. 234, the Supreme Court hailed the bankruptcy discharge a "fresh start." The state court proceeding tracking Section 523(a) is a better start. Collateral estoppel applied by the bankruptcy court is the head start. The summary judgment in bankruptcy court is the start to finish. We are done.

There are no second acts in American lives – except in bankruptcy court.

Cook

As the senior attorney of Cook Collection Attorneys PLC*, located in San Francisco, David J. Cook specializes in the enforcement of judgments and collection of debts for the last 36 years. David Cook represents Fred Goldman in his historic quest to recover from OJ Simpson. Contact him at* Cook@SqueezeBloodFromTurnip.com.

Endnotes

[1] 11 U.S.C. § 523 reads, in pertinent part, as follows:
"§ 523. Exceptions to discharge –

(a) A discharge under section 727, 1141, 1228 (a), 1228 (b), or 1328 (b) of this title does not discharge an individual debtor from any debt—

***

(2) for money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained by—
(A) false pretenses, a false representation, or actual fraud, other than a statement respecting the debtor's or an insider's financial condition;
(B) use of a statement in writing—
(i) that is materially false;
(ii) respecting the debtor's or an insider's financial condition;
on which the creditor to whom the debtor is liable for such money, property, services, or credit reasonably relied; and
that the debtor caused to be made or published with intent to deceive; or

***

(4) for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny;

***

(6) for willful and malicious injury by the debtor to another entity or to the property of another entity;

[2] This article is limited in scope to collateral estoppel effect of a state court default judgment, and not federal court.
[3] While this article is limited to default judgments, after a litigated state court case, plaintiff can ensure bankruptcy court viability (the "Second Act") by tailoring the statement of decision to mirror Section 523(a).

Copyright © 2012 by the author.
For reprint permission, contact the publisher: **www.plaintiffmagazine.com**