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Is filing bankruptcy an out for wrongdoers with penalties to pay?

By Brian J. Hunt, J.D.



Filing for bankruptcy typically results in a bankruptcy discharge, which relieves debt obligations. The Bankruptcy Code, however, stipulates that not all types of debt are dischargeable—particularly when it comes to the presence of fraud.

The case of *Catrambone v. Adams*, 498 B.R. 839 (September 10, 2013) addressed two of these debt discharge exceptions, specifically Section 523(a)(4) and Section 523(a)(6).

Under Section 523(a)(4), debts resulting from fraud or defalcation (the misappropriation of money or funds) while acting in a fiduciary

capacity are non-dischargeable. Section 523(a)(6) establishes an exception for willful and malicious injury by the debtor.

In *Catrambone*, Richard Catrambone and Thomas Adams were equal partners in Great Lakes Building Materials, a materials distribution company. At prior proceedings, Adams testified that Catrambone retained sole access to the company computer, meaning that he wasn't able to access even basic information about day-to-day business activities, much less financial records about the company. Catrambone also owned or controlled several other companies, including RDM Distribution, through which he improperly overcharged Great Lakes for wallboard, without Adams' disclosure or approval. What's more, through other entities that he controlled, Catrambone diverted additional profits belonging to Great Lakes and Adams. Then, in September 2002, he terminated Adams as a Great Lakes shareholder, officer and employee.

Adams ultimately brought suit against Catrambone and Great Lakes, alleging a violation of the Illinois Wage Payment and Collection Act, breach of fiduciary duty, and tortious interference with prospective economic advantage. Adams further alleged that his damages were caused by insider trading, diversion of money and profit, and wrongful termination.

A fiduciary duty is an obligation to act in the best interest of another party. In general, a fiduciary relationship occurs whenever the principal places a special trust and confidence in, and relies upon, the fiduciary. The defining feature of a fiduciary relationship is a difference in knowledge or power, which gives the fiduciary a position of ascendancy or control over the other party.

Ultimately, a jury found in favor of Adams, and determined that punitive damages were

appropriate since Catrambone's misconduct was willful and wanton. A bench trial later held on the issue of damages, with Adams being awarded more than \$575K.

Catrambone responded by filing a voluntary petition seeking relief of his debts under Chapter 7 of the Bankruptcy Code. Adams filed an adversary complaint, alleging that the judgment against Catrambone was non-dischargeable under Sections 523(a)(2)(A), (a)(4) and (a)(6) of the Code. The bankruptcy court ultimately held that Adams had properly established an exception, and that Catrambone could not discharge the judgment he owed.

In affirming the bankruptcy court's judgment, the District Court began by discussing whether Section 523(a)(4) was applicable in this case. More specifically, the Court focused on whether there was sufficient evidence at trial and at the bankruptcy proceeding to establish that Catrambone owed Adams a fiduciary duty, and that Catrambone acted with the requisite state of mind for defalcation.

Turning to the fiduciary relationship, the Court concluded that Adams had indeed proved that Catrambone had superior knowledge or power, which gave him a position of ascendancy. The Court noted that the ascendancy test looks to economic realities rather than labels, which means that even though Catrambone and Adams each held a 50 percent interest in Great Lakes, they were not equals with respect to their knowledge and control of the business. The Court reasoned that this inequality placed Catrambone in a position of ascendancy and imposed a fiduciary obligation to Adams.

The Court also concluded that Catrambone acted with the requisite state of mind for defalcation, explaining that the debtor, as a fiduciary, performed with knowledge of, or gross recklessness with respect to, the improper nature of his behavior. The Court went on to state that defalcation, like fraud, requires a deliberate and intentional wrong. Being instructed that willful and wanton conduct is "a course of action which shows actual or deliberate intention to harm," the Court reasoned that the jury's punitive damages finding was sufficient.

Next, the Court discussed the applicability of Section 532(a)(6) in this case, noting that this exception requires a deliberate or intentional injury, not merely a deliberate or intentional act that leads to the injury. The Court further explained that a willful and malicious injury is one that the injurer desired to inflict while knowing he didn't have a legal justification for his actions. It concluded that the jury's finding that Catrambone's actions were willful and wanton plainly satisfied the requirements under this discharge exception.

While filing for bankruptcy can help a debtor reduce his debts, it's important to note the exceptions. As we see in *Catrambone*, if a debt occurred because of a debtor's wrongdoing, he can't simply file for bankruptcy to erase the debt. Courts have a strong interest in holding debtors responsible for their wrongful actions, and are unwilling to reward bad actors who come to court with unclean hands. □

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