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Judgment debt excepted from discharge

Debtor fraudulently induced creditor's investment

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An out-of-state judgment obtained by an individual who lost a substantial sum investing in a Chapter 7 debtor's failed business venture was excepted from discharge as money obtained by false representation, a U.S. Bankruptcy Court judge has ruled in an adversary proceeding.

Plaintiff Bob Weiss invested $150,000 in a bar that defendant Robert Fautz was opening in Manhattan. Weiss allegedly did so with the understanding that Fautz would be investing $450,000 of his own money and that the two would be the only shareholders in the corporation.

Fautz never contributed the full $450,000, claiming a big part of his own investment was to come in the form of his "sweat equity" and by seeking other investors, a point Weiss disputed.

The bar shut down within months, and Weiss sued Fautz in New York state court for breach of contract and fraud, obtaining a default judgment for $150,000 plus interest.

When Fautz filed for Chapter 7 protection in Massachusetts, Weiss domesticated his judgment and initiated an adversary proceeding in U.S. Bankruptcy Court, asserting that the debt was excepted from discharge under §523(a)(2)(A) of the U.S. Bankruptcy Code as a debt for money obtained by false representation.

Judge Frank J. Bailey agreed.

"[Weiss credibly testified that he] would not have made any of his investment … had he not thought that Fautz also had 'skin in the game,'" Bailey wrote. "Moreover, Weiss's reliance was reasonable. Weiss had no reason not to take Fautz's representations at face value; his deceit was not readily apparent. The standard of justifiable reliance placed Weiss under no obligation to investigate, but it is unclear how he might have investigated had he wanted to. Only Fautz knew and could have known that he did not intend to honor his promise."

The judge did, however, reject Weiss' alternate theory that the judgment debt was nondischargeable under §523(a)(4) as one obtained by fraud or defalcation while acting in a fiduciary capacity. Bailey found that that provision did not apply because the parties had not yet entered a fiduciary relationship at the time Fautz made his false representations.

The 24-page decision is In Re: Fautz, Robert R., Lawyers Weekly No. 04-002-22.

'Good guidepost'

Plaintiff's counsel David A. Conti of Newton called the ruling "a good guidepost" for assessing whether a creditor might prevail on a §523 claim.

"The court really took great pains to go step by step through each element and suss out the facts and evidence," he said.

Conti also said the §523(a)(4) ruling would be an interesting issue for appeal, which he would explore should Fautz seek further review of the §523(a)(2)(A) decision.

"Since we prevailed on §523(a)(2)(A), there's no intent on our side to appeal the ruling, but it's a cautionary tale at a minimum for investors, particularly in industries they really don't know anything about, relying on representations from somebody they really have no history with," Conti said.

Thomas H. Curran of Boston, who represents creditors, said the ruling draws an important distinction between fraud at the inception of a relationship between the parties, which is addressed by §523(a)(2)(A), and fraud that occurs

In Re: Fautz, Robert R.

THE ISSUE: Was an out-of-state judgment obtained by an individual who lost a substantial sum investing in a Chapter 7 debtor's failed business venture excepted from discharge as money obtained by false representation?
DECISION: Yes (U.S. Bankruptcy Court)
LAWYERS: David A. Conti of Dwyer, Spino & Goncalves, Newton (plaintiff) Dmitry Lev of Watertown (defense)

once the relationship is in place, as addressed by §523(a)(4).

"When you're approached with a fact pattern like this, you need to determine if it fits under both provisions or just one and how to proceed," he said.

Medway bankruptcy attorney Christine E. Devine said the decision is helpful in that it expands on what is required to prove an intent to deceive.

"Discharge actions are fact-specific. People have to get on the stand and there's conflicting testimony," Devine said. "But there were good examples in this decision of documents that could support the plaintiff on the §523(a)(2)(A) count. There were also undisputed circumstances like the investor not being invited to [the bar's] opening night. These are good illustrations of what helps when you have 'he said/she said' testimony, which is definitely going to happen."

Fautz's attorney, Dmitry Lev of Watertown declined to be interviewed.

Misplaced reliance

Weiss and Fautz met in 2006 through a mutual acquaintance.

Before they were introduced, Fautz got an opportunity to purchase a bar on Manhattan's Lower East Side.

He planned to take over the space, renovate it, and open a bar called "Revolver." In August 2006, he set up Silver Revolver, Inc., the corporation through which he planned to operate the bar.

Weiss, an investment trader with no prior experience investing in bars or restaurants, was interested in the venture.

Fautz, who previously owned a "burger joint" and had been involved in the operation of at least one other bar, apparently represented to Weiss that he had experience and success in the industry. Because they met through a mutual friend, Weiss conducted no due diligence into Fautz.

Despite concerns that other establishments had failed at the location in question, Weiss — apparently relying on Fautz's experience and enthusiasm — initially agreed to invest $100,000 in return for a 10-percent stake in Revolver. He also indicated that he would be interested in investing more if he could have his name on the liquor license as protection for his investment.

On July 31, 2006, the parties executed their "Schedule A" shareholder agreement giving Fautz a 90-percent interest with a $600,000 capital contribution, and a 10-percent interest for Weiss with his $100,000 contribution.

The agreement was amended about a month later to reduce Fautz's capital contribution to $550,000 for an 85-percent stake and increase Weiss' contribution to $150,000 for a 15-percent stake. Meanwhile, Fautz told Weiss he received a temporary liquor license listing Weiss as co-owner.

A final amended Schedule A, executed in November, decreased Fautz's contribution to $450,000.

Fautz never contributed the full $450,000, claiming he did not intend for it to be strictly in cash; instead, he said he contemplated contributing up to $150,000 with the rest coming in "sweat equity" and through other investors. Weiss, for his part, claimed he would not have invested had he known Fautz was not going to contribute his investment in cash.

In any event, Fautz commenced renovations of the space and hired Joseph John Giampa to do the build-out work.

Giampa allegedly did $200,000 in work without compensation, believing it was part of his own investment in the bar.

Fautz claimed he planned to give Giampa 25 percent of his own shares and that the $200,000 in renovations would count toward his own capital contribution, though none of that was formalized in writing.

According to Weiss, he knew none of this until after the bar's opening, and when he questioned Giampa's role in the venture, Fautz allegedly responded that Weiss' role was limited to that of a silent investor, not a co-operator, and told him that the corporation still had not received full approval of a liquor license.

The company never turned a profit, and the bar soon ceased operations. At that point, Fautz turned the keys over to the principal of Silver Revolver's sub-lessor and moved to Florida.

In September 2007, Weiss sued Fautz in New York state court for breach of contract, fraud in the inducement, and unjust enrichment and secured a default judgment for $150,000 plus interest and fees.

Weiss initially domesticated the judgment in Florida but seven years later domesticated it in Massachusetts, which issued a new judgment for $285,000. He then filed an adversary action in Bankruptcy Court under §523(a)(2)(A) and §523(a)(4).

Excepted from discharge

Bailey found that the debt indeed was exempt from discharge under §523(a)(2)(A).

Specifically, he found that Fautz induced Weiss to invest his $150,000 in the venture by falsely representing that he planned to invest at least $450,000 himself, that Weiss actually relied on his representations, and that such reliance was justifiable.

Additionally, Bailey said, Weiss proved that his reliance caused harm — namely $150,000 of his funds.

"Weiss having thus satisfied each of the … requirements, I conclude that Fautz's representation concerning the extent of his intended investment was a false representation within the meaning of § 523(a)(2)(A)," the judge said.

At the same time, Bailey found that Weiss did not prove his §523(a)(4) claim, emphasizing that Fautz made the false representations while trying to secure Weiss' initial investment, which was before he became a fiduciary of Weiss.

"It makes no difference that, as a consequence of the alleged fraud and defalcation, the monies at issue became assets of the corporation and from that point forward were held by Fautz as a fiduciary," Bailey said. "The statute expressly requires that the fraud and defalcation have been committed while acting in a fiduciary capacity."

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