UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF NEW YORK

In re

NANCY CAPRITTA,
CATALDO CAPRITTA, a/k/a CAL CAPRITTA,

Debtors.

Case No. 02-14301

IMPERIAL POOLS, INC.,

Plaintiff,

-against-

Adversary No. 02-90219

NANCY CAPRITTA, CAL CAPRITTA, a/k/a CAL CAPRITTA, JR., a/k/a CATALDO V. CAPRITTA,

Defendants.

APPEARANCES:

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Hon. Robert E. Littlefield, Jr., U.S. Bankruptcy Judge

MEMORANDUM-DECISION AND ORDER

Before the court is an adversary proceeding commenced by Imperial Pools, Inc. against

Cal Capritta, a/k/a Cal Capritta, Jr., a/k/a Cataldo V. Capritta, and Nancy Capritta (the "Debtors") seeking a determination that a judgment debt is nondischargeable as a debt for fraud or defalcation while acting in a fiduciary capacity pursuant to 11 U.S.C. § 523(a)(4)[1]. This is a core proceeding pursuant to 28 U.S.C. § 157(b)(2)(I), and the court has jurisdiction pursuant to 28 U.S.C. § 157(a), 157(b)(1), and 1334(b).

FACTS

At a pretrial conference, the parties advised the court that they were in a position to stipulate to the facts underlying this proceeding and wished to waive their right to a trial. As a result, no trial was conducted, and the court has taken this matter on submission. The parties filed a joint stipulation of facts which the court adopts and incorporates for purposes of this opinion.

Phoenix Pools of Upstate New York Corp. (the "Corporation") was a small, closely held corporation operated by the Debtors and engaged in the business of sales, installation, repair, and renovation of pools and spas. Nancy Capritta was an officer, director, and shareholder of the Corporation. She was responsible for receiving payments and for determining whom to pay for labor and materials. Imperial Pools is a corporation engaged in the manufacture, distribution, and sale of in-ground and above-ground pools and spas. On or about March 18, 1993, the Corporation completed an Imperial Pools' credit application and began acquiring in-ground and above-ground pools and spas, supplies, and materials for repairs and retail sales. Imperial Pools alleges that the Corporation received payment for the improvements it made to real property with

[1]Section 523(a)(4) of the Bankruptcy Code excepts from discharge "any debt ... for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny." 11 U.S.C. § 523(a)(4).

the pools, spas, supplies, and materials furnished by Imperial Pools. However, the Corporation eventually fell behind in its payments to Imperial Pools, and by February 23, 2000, it owed $61,419.75 for goods sold and delivered. On March 13, 2000, the Corporation and debtor Cal Capritta entered into a settlement, and a promissory note in an amount equal to the Corporation's outstanding indebtedness to Imperial Pools was executed. The promissory note provided for monthly payments of $1,990.53, a term of thirty-six months, and interest calculated at ten percent per annum (the "Note").

After nine payments on the Note, the Corporation defaulted. On or about March 15, 2001, Imperial Pools commenced an action against the Corporation and Mr. Capritta in New York State Supreme Court in the form of a motion for summary judgment in lieu of complaint. Imperial Pools commenced a second action in New York State Supreme Court on a second account of Phoenix Pools seeking $7,568.64 for goods sold and delivered.

Both actions were resolved by payment of $17,472.52 to Imperial Pools and execution of a promissory note in the amount of $47,148.59 by the Corporation and the Debtors in their individual capacities ("Note 2"). Note 2 provided for bi-weekly payments of $1,077.33. After fourteen payments, the Debtors defaulted under the settlement by failing to make payment on Note 2. As a result, on or about January 25, 2002, Imperial Pools commenced yet another action against the Corporation and the Debtors in New York State Supreme Court in the form of a motion for summary judgment in lieu of complaint. On or about May 10, 2002, summary judgment was granted in favor of Imperial Pools, and a judgment was entered in the amount of $39,994.44 against the Corporation and the Debtors personally (the "Judgment"). Pursuant to the terms of Note 2, the Judgment included pre-judgment interest of $2,898.70, costs and

disbursements of $615.71, and attorneys' fees of $2,200.

On or about July 2, 2002, the Debtors and the Corporation filed separate petitions seeking relief under Chapter 7 of the Bankruptcy Code. Schedule F of the Debtors' petition lists Imperial Pools as a creditor holding an unsecured claim in the amount of $39,996 for "materials purchased." Imperial Pools commenced this adversary proceeding on or about July 24, 2002.

ARGUMENTS

Imperial Pools asserts that the Supreme Court's decision *Archer v. Warner*, 538 U.S. 314 (2003), is applicable to the facts of this case, and the court may inquire beyond the contractual nature of the parties' settlement agreement and the Notes to determine whether the underlying debt should be deemed non-dischargeable. Imperial Pools contends that if you look beyond the Notes, the Debtors' underlying debt arose out of the Debtors' breach of the statutory trust created by Article 3-A of New York State Lien Law (the "Lien Law")[2] and, therefore, their debt is nondischargeable as a debt for "fraud or defalcation while acting in a fiduciary capacity." 11 U.S.C. 523(a)(4)[3]. More specifically, Imperial Pools maintains that the Debtors breached their fiduciary duty by receiving payments from the owners of real property that hired them and failing to pay Imperial Pools for the pools, spas, materials, and supplies it furnished in connection with the improvements.

The Debtors counter with the argument that the subject debt arising out of Note 2 is a

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[2]New York Lien Law §§70-71 (McKinney 1993), commonly referred to as Article 3-A, imposes a trust upon a general contractor to preserve amounts paid for materials and labor in connection with construction projects. The trust continues until all claims for services and materials in connection with the improvements have been paid.

[3]All statutory references are to Title 11 of the United States Code (the "Bankruptcy Code") unless otherwise noted.

simple contract debt and not a debt arising from the sale of pools, spas, and supplies; therefore, the debt is dischargeable. The Debtors further argue that their case is distinguishable from *Archer* because of their good faith efforts to pay the Notes, whereas the debtors in *Archer* made no payments in addition to admitting that the underlying debt arose from fraud on their part. The Debtors contend that a finding of nondischargeability would have a serious impact on small businesses due to prohibitive legal expenses and time-consuming litigation. In addition, the Debtors challenge what they claim to be Imperial Pool's first allegation of fraud, stating that it is being asserted now, rather than in its prior state court actions, because it was never "convenient" to assert it previously.

The Debtors also assert that the Corporations's business debt was transformed by the granting of consideration in the form of the Debtors' personal liability under Note 2 and, therefore, falls outside of the Lien Law. This "novation," they contend, released them from any pre-existing fiduciary obligations. Imperial Pools, however, stresses the fact that *Archer* clearly rejected this "novation" theory.

The parties stipulated that if the court finds that it may inquire beyond the contractual nature of the parties' settlement agreement and the underlying Note 2, then the court shall find and rule without further inquiry that the principal sum of $20,000, exclusive of any interest, costs, disbursements, and attorney's fees, is nondischargeable. In essence, the parties have agreed that if the court looks beyond the settlement agreement and the underlying Note 2, it would find the underlying debt would fall within the discharge exception embodied in

§ 523(a)(4).[4]

If the court determines it may inquire beyond the settlements agreement and the underlying Note 2, Imperial Pools relies upon *Cohen v. De La Cruz*, 523 U.S. 213 (1998), to argue that the language of § 523(A)(4) should be read broadly to encompass "all debt" resulting from the Debtors' fraud or defalcation, including its costs, disbursements, interest, and attorney's fees. Imperial Pools also points out that Note 2 provides for pre-judgment interest, costs, and attorney's fees supplying an independent contractual basis for such an award, and post-judgment interest is available pursuant to New York state law. Accordingly, Imperial Pools seeks a determination that the principal balance of $20,000, along with the pre-judgment interest, costs, and attorney's fees awarded in the Judgment be found to be nondischargeable for a total award of $24, 506.90[5], with interest from the entry of the Judgment. In addition, Imperial Pools seeks to recover its costs and disbursements in this proceeding, as well as additional attorney's fees of $5,810.

The Debtors, however, contend that if Imperial Pools prevails on the issue of nondischargeability only the principal sum of $20,000 would by nondischargeable and not

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[4]The Debtors, however, argue in their brief that there was no showing of fraudulent intent on their part, nor were there any allegations of fraud in the state court pleadings. It would appear the Debtors are asserting that even if the court looks beyond the Judgment and the underlying Notes, there was no fraud or defalcation on the Debtors' part. The court is somewhat confused by the Debtors' argument as the parties stipulated that there were no questions of fact for the court to decide and that if the court concludes it may look beyond the Judgment and the underlying Notes, $20,000 shall be deemed nondischargeable. As a result, the court need not reach the issue of whether the underlying obligation falls within the discharge exception of § 523(a)(4) as it was agreed to by the parties.

[5]Imperial Pools calculates the revised Judgment amount based on a principal balance of $20,000, pre-judgment interest reduced to $1,691.19, due to the reduced principal amount, costs and disbursements of $615.71, and attorney's fees of $2,200.

Imperial Pool's interest, costs, disbursements, and attorney's fees. The Debtors argue that Imperial Pools' allegation of fraud is not only untimely but also unsubstantiated.[6] They assert further that due to the frivolous nature of this action, the Debtors are equitably entitled to ancillary damages, including costs, disbursements, and attorney's fees.

DISCUSSION

The basic policy embodied in the Bankruptcy Code is to afford relief to an "honest but unfortunate debtor." *Grogan v. Garner*, 498 U.S. 279, 287 (1991) (citation omitted). In line with this, as indicated above, § 523(a)(4) excepts from discharge debts "for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny." 11 U.S.C. § 523(a)(4). The issue before the court is whether a nondischargeable debt for fraud or defalcation while acting in a fiduciary capacity becomes dischargeable if the debt is resolved prepetition, without court intervention, by the execution of a promissory note and later reduced to judgment based upon a default under the note. Based upon the Supreme Court's decision in *Archer v. Warner*, *supra*, the court holds it may look beyond the contractual nature of the parties' settlement agreement and Note 2 to determine whether the underlying debt was a debt "for fraud or defalcation while acting in a fiduciary capacity" as defined by § 523(a)(4). Because the parties stipulated that if the court reaches this conclusion the principal sum of $20,000 shall be deemed nondischargeable, the court need not address the Debtors' receipt of Article 3-A trust funds and their subsequent breach of their fiduciary duty or defalcation.

In *Archer*, *supra*, the plaintiffs sued defendants for fraud in connection with the sale of the defendants' business. Eventually, the lawsuit was settled with the execution of a promissory

[6]*See supra* note 3.

note by the defendants. When the defendants failed to make their first payment on the note, the plaintiffs commenced an action in state court for payment on the note. The defendants then filed for bankruptcy relief, and the plaintiffs commenced an adversary proceeding seeking a judgment for the amount due on the note and a determination that the debt was nondischargeable. The Supreme Court held that the nondischargeability language of § 523(a)(2)(A) can cover a debt embodied in a settlement agreement that settled a creditor's earlier claim "for money...obtained by... fraud." *Id*. at 31. Although *Archer* involved a claim of nondischargeability under § 523(a)(2)(A) and the present case involves a claim under § 523(a)(4), the Second Circuit held that the reasoning of *Archer* nonetheless controls the outcome here. *In re DeTrano*, 326 F.3d 319 (2d Cir. 2003).

The Debtors and Imperial Pools settled their claim based upon the Debtors' breach of the statutory trust created under Article 3-A of the Lien Law prior to any litigation being commenced. When the Debtors defaulted under Note 2, Imperial Pools commenced an action on Note 2, which was eventually reduced to the Judgment. Although the sequence of events *sub judice* differs slightly from *Archer*, the distinction is not determinative. The fact that Imperial Pools' fraud or defalcation claim against the Debtors was reduced to a note in settlement does not change the nature of the underlying debt for dischargeability purposes.

The Debtors raise "novation" as a defense arguing that the original debt to Imperial Pools resulting from their fraud or defalcation while acting in a fiduciary capacity was replaced with a new debt, namely money promised in a note. However, the Supreme Court granted the Archers' petition for certiorari because different circuits had come to different conclusions on the theory of novation. *Archer*, 538 U.S. at 318. Citing to its own decision in *Brown v. Felson*, 442 U.S.

127 (1979), the Supreme Court rejected the novation theory and held that the nature of a debt is not transformed for dischargeability purposes when a fraud claim is reduced to a settlement. *Archer v. Warner*, 538 U.S. at 320-321. The Supreme Court reasoned that "the mere fact that a conscientious creditor has previously reduced his claim to judgment should not bar further inquiry into the true nature of the debt." *Id.* (quoting *Brown v. Felson*, 442 U.S. at 138). A debt that originates from a debtor's fraud or defalcation should not be discharged simply because a debtor entered into a settlement or indemnification agreement, and the debt now arises from a contract rather than a tort. *See In re Peters*, 90 B.R. 588, 604 (Bankr. N.D.N.Y. 1988) (citations omitted). The Supreme Court in *Brown* explained and reiterated in *Archer* that

> "Congress [through the Bankruptcy Code] intended the fullest possible inquiry" to ensure that "all debts arising out of" fraud are "excepted from discharge," no matter what their form. Congress also intended to allow the relevant determination (whether a debt arises out of fraud) to take place in bankruptcy court, not to force it to occur earlier in state court when dischargeability concerns "are not directly in issue and neither party has a full incentive to litigate them."

Archer v. Warner, 538 U.S. at 321 (quoting *Brown v. Felson*, 442 U.S. at 134 (internal citations omitted)).

The Debtors contend that a finding of nondischargeability would have a serious impact on small businesses due to prohibitive legal expenses and time-consuming litigation. However, the converse is the more compelling argument. If the court were to find the debt dischargeable, the message sent would be for creditors not to settle fraud or defalcation claims but to litigate them to judgment on the merits, even though dischargeability concerns may not be relevant at that time.

In light of the determination that there was no novation of the debt and that the court may

inquire beyond the Judgment to determine whether the debt represented by the Notes is a debt "for fraud or defalcation while acting in a fiduciary capacity" under § 523(a)(4), the court turns to the issue of Imperial Pools' request that its ancillary expenses, including costs and disbursements, interest, and attorney's fees, also be deemed nondischargeable because they were awarded as part of the Judgment pursuant to the terms of Note 2. Section 523(d)[7] is the only statutory authority for awarding attorney's fees in connection with dischargeability actions in bankruptcy courts. Had Congress intended to award attorney's fees to prevailing creditors in dischargeability actions, the most appropriate and logical location would have been in subsection (d). *Lupin v. Ziegler*, 109 B.R. 172, 177 (Bankr. W.D.N.C. 1989). Instead, Congress chose to limit such awards to prevailing debtors under a very narrowly-defined set of circumstances in cases falling under § 523(a)(2).

This court has adhered to the policy that interest and attorney's fees are generally not recoverable in the context of a dischargeability action absent a valid and enforceable contractual right or statutory basis. *In re Snyder*, 198 B.R. 9, 16 (Bankr. N.D.N.Y. 1996) (citation omitted) (§ 523(a)(4)); *See Jordan v. Southeast Nat'l Bank*, 927 F.2d 221 (5th Cir. 1991) (§ 523(a)(2)(B)); *TransSouth Finance Corp. of Fla. v. Johnson*, 931 F.2d 1505 (11th Cir. 1991) (§ 523(a)(2)); *Martin v. Bank of Germantown*, 761 F.2d 1163 (6th Cir. 1985) (§ 523(a)(2)(B));

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[7]11 U.S.C. § 523(d) provides:

> If a creditor requests a determination of dischargeability of a consumer debt under subsection (a)(2) of this section, and such debt is discharged, the court shall grant judgment in favor of the debtor for the costs of, and a reasonable attorney's fee for, the proceeding if the court finds that the position of the creditor was not substantially justified, except that the court shall not award such costs and fees if special circumstances would make the award unjust.

Lupin v. Ziegler, *supra* (§ 523(a)(6)). This policy is consistent with the Supreme Court's decision *Cohen v. De La Cruz*, *supra*. The words "any debt" were construed by the Supreme Court to cover any debt which arises from the debtor's act in obtaining "money, property, services, or...credit" by fraud under § 523(a)(2)(A). *Id.* at 218. As a result, the Supreme Court upheld the bankruptcy court's award of treble damages, attorney's fees, and costs available to the creditor under the New Jersey Consumer Fraud Act in a § 523(a)(2) dischargeability action. The damages and fees awarded in *Cohen* were based on authorization provided for by state statute. The court does not read *Cohen* as broadly as Imperial Pools. "*Cohen* does not itself create an independent right to attorney's fees for the benefit of a party who prevails in a Section 523 dischargeability proceeding. Instead, it clarifies that attorney's fees supported by statue are included in the debt that may be determined to be nondischargeable." *Atchison v. Atchison*, 255 B.R. 790, 793 (Bankr. M.D.Fla. 2000).

Here, while Note 2 does provide for an award of attorney's fees and costs necessary for collection, as well as interest, Imperial Pools' dischargeability action is not premised on fraud or defalcation committed with respect to or under Note 2, but rather, on the Debtors' underlying debt arising out of the Debtors' breach of their fiduciary duty under the Lien Law. Neither of the parties has provided any other independent basis for an award of attorney's fees by virtue of contract or statute.

Based upon the foregoing, it is hereby ORDERED, that:

1. The sum of $20,000 due Imperial Pools pursuant to the judgment entered in its favor and against the Debtors by the New York Supreme Court for Albany County is excepted from discharge pursuant to 11 U.S.C. § 523(a)(4).

2. The parties' respective requests for ancillary costs, including attorney's fees, are denied.

Dated:

Hon. Robert E. Littlefield, Jr.
U.S. Bankruptcy Judge