

Two Recent Second Circuit Cases Involving “Fraudulent” Debtors.

By Bruce L. Weiner
Rosenberg Musso & Weiner, LLP; Brooklyn, New York

In November 2006, the United States Court of Appeals for the Second Circuit decided two cases involving debtors that had been found to have engaged in fraudulent activity prior to the bankruptcy case. In *Musso v. Ostashko*,¹ the Debtor, Vladimir Ostashko, and his wife, Tanya Ostashko, had been involved in a series of legal battles in state and federal courts since 1997. At the time of their separation, the Debtor told Tanya that he would prevent her from ever getting any of his assets, the most valuable of which was a house worth more than \$1 million. To further his plan, the Debtor borrowed approximately \$900,000 from a Russian bank of which he was a member of the board of directors. The Debtor defaulted in payments to the bank, and after the bank sued him to collect, the Debtor gave the bank a consent judgment for the amount owed. Tanya started a divorce proceeding and also brought an action to set aside the consent judgment as a fraudulent conveyance. Judge Allyne Ross of the United States District Court for the Eastern District of New York found that the Debtor intended to defraud Tanya when he gave the default judgment and avoided the judgment as a fraudulent conveyance.²

In the divorce action, the state court judge found that the Debtor deliberately and fraudulently attempted to prevent Tanya from sharing in any of his assets. Because of the Debtor’s fraudulent activity, the state court judge wrote a decision awarding all of the Debtor’s assets to Tanya and directing Tanya’s lawyer to submit a judgment of divorce awarding all of the Debtor’s assets to Tanya. Before the judgment was signed or entered, the successor to the Russian bank filed an

¹ 489 F.3d 99 (2d Cir. 2006). The author represented the bankruptcy trustee in the

Ostashko case.

² *Ostashko v. Ostashko*, 00-cv-7162 (E.D.N.Y. 2002).

involuntary bankruptcy petition against the Debtor.

In the bankruptcy court, the trustee brought an action asserting that 11 U.S.C. §544, the “strong arm provision,” gives a trustee the status of a fully executed judgment lien creditor as of the filing date, and therefore, the trustee’s statutory judgment comes ahead of Tanya’s unsigned judgment. The bankruptcy court agreed and found that all of the Debtor’s assets are part of the bankruptcy estate. Tanya appealed to the district court which reversed the bankruptcy court, finding that her rights to the property vested at the time of the decision awarding her the assets, and that entry of the judgment was merely “ministerial.”³

The trustee appealed to the Second Circuit, which reversed the district court finding that entry of the judgment may be immaterial as between the Debtor and Tanya, but it is critical as between Tanya and the trustee, because of the trustee’s status as a judgment lien creditor. The Second Circuit went on to state that the Debtor’s fraudulent activity and possible abuse of the bankruptcy process do not prevent the trustee from administering his assets, but should be addressed by the bankruptcy court in claim allowance and equitable subordination proceedings. In *Evans v. Ottimo*,⁴ the state court, following a default judgment and inquest, found that the Debtors committed fraud and imposed both compensatory and punitive damages. The Debtors subsequently filed for bankruptcy relief. Evans commenced an adversary proceeding under 11 U.S.C. §523 to declare the debt non-dischargeable because it was based on fraud. Evans moved for summary judgment, alleging that the findings made by the state court at the inquest collaterally estopped the Debtors from relitigating the fraud issue.

The bankruptcy court held that collateral estoppel could not be used because the judgment was

³ 333 B.R. 625 (E.D.N.Y. 2005).

⁴ 2006 WL 3354134 (2d Cir. November 20, 2006).

obtained by default. Evans appealed to the district court, which reversed and granted summary judgment to Evans. The Debtors appealed. The Second Circuit affirmed the district court, finding that collateral estoppel prevented the bankruptcy court from relitigating the issue of fraud because the Debtors had a full and fair opportunity to litigate in state court and because the state court at the inquest heard evidence of the Debtors' fraud and actually decided that issue.

CONCLUSION

These are two cases which at first glance have disparate results. In one case, the prior courts' findings of fraud did not help the wife obtain the Debtor's assets and in the other, the prior court's findings were found to be binding on the bankruptcy court. The crucial difference is the trustee's strong arm powers which give the bankruptcy court the power to bring all assets into the bankruptcy estate.