

# **Cohen v. De La Cruz: U.S. Supreme Court Holds Treble Damage Claim Awarded Under the New Jersey Consumer Fraud Act is Nondischargeable Under 11 U.S.C. 523(a)(2)(A)**

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On March 24, 1998, the United States Supreme Court decided *Cohen v. De La Cruz*.<sup>1</sup> The Court's opinion stands as a clear determination that punitive damages awarded on account of the debtor's fraud which falls within the fraud exception to dischargeability under 11 U.S.C. §523(a)(2)(A), will not be treated any differently than compensatory damages awarded as a result of fraud.<sup>2</sup> The Supreme Court decision in *Cohen* resolved a split between the Eleventh Circuit and Third Circuit on the one hand and the Ninth Circuit on the other. In *In re St. Laurent*, the Eleventh Circuit found that punitive damages arising from fraud were nondischargeable.<sup>3</sup> The Ninth Circuit in *In re Levy*, however, had reached an entirely different result, which allowed the discharge of the penalty portion of the claims.<sup>4</sup> The Supreme Court granted *certiorari* to address the conflict between the circuits. The *Cohen* decision has now specifically abrogated the result in *Levy*.<sup>5</sup>

The unanimous decision of the Supreme Court written by Justice O'Connor held that *all* liability arising as a result of actual fraud is nondischargeable. The Court was asked to decide the issue of whether the exception to dischargeability in 11 U.S.C. 523(a)(2)(A) encompassed only the value of money, property or services obtained through fraud, or whether the statute should be read more broadly to extend beyond a restitutionary ceiling.<sup>6</sup> The Court's ruling in *Cohen* has special

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significance for New Jersey lawyers. The decision affirmed the non-dischargeability of the award against the debtor for treble damages under the New Jersey Consumer Fraud Act, as well as the award of reasonable attorney's fees and costs.<sup>7</sup> The Court analyzed the New Jersey statute and its mandatory treble damage provision requiring punitive damages in addition to a compensatory award upon a finding of consumer fraud.<sup>8</sup> Furthermore, *Cohen* originated as a decision by Chief Judge Rosemary Gambardella in *In Re Cohen*.<sup>9</sup> The case was appealed to the district court and the Third Circuit, and finally to the Supreme Court. The decision was affirmed at each intermediate appellate court, each issuing its own written opinion.

In *Cohen v. De La Cruz*, the Supreme Court noted that the issue of dischargeability of punitive damages awarded on account of fraud was raised but left unresolved in *Grogan v. Garner*, which it decided in 1991.<sup>10</sup> In footnote 2 in *Grogan v. Garner*, the Court, stated that "arguably" punitive damages claims will be more appropriately governed by 11 U.S.C. 523(a)(6) providing that willful and malicious injuries caused by a debtor to another entity or property of another entity are nondischargeable.<sup>11</sup> The *Grogan* case was the landmark Supreme Court decision that clarified the burden of proof for all exceptions to dischargeability asserted under 11 U.S.C. 523(a). In *Grogan*, the Supreme Court determined that the creditor's burden was the ordinary preponderance of the evidence standard.<sup>12</sup>

## **Background**

An adversary proceeding commenced in the Bankruptcy Court challenged the dischargeability of the claims of tenants arising from the overcharge of rent in a residential apartment building in Hoboken.<sup>13</sup> Rents in the building were governed by the Hoboken Rent Leveling Act, a comprehensive rent control ordinance.<sup>14</sup> The landlords, Edward and Nathan Cohen, charged tenants approximately double the amount that could be legally charged under the Hoboken Rent Leveling Act.<sup>15</sup> None of the tenants were born in the continental United States, nor

spoke English as their native language. None were college graduates.

In 1989, prior to the bankruptcy filing of Edward Cohen, the Hoboken Rent Control Administrator notified him that he was charging certain of his tenants rent in excess of the legal rent provided under the act.<sup>16</sup> Cohen was ordered to make refunds to tenants in the amount of \$31,382.50.<sup>17</sup> Cohen failed to make the refunds or to perfect an appeal from the administrator's determination. Thereafter, Cohen sought bankruptcy protection, attempting to discharge the claims of the individual tenants. Judge Gambardella bifurcated the hearing, deciding liability separately from the hearing on damages. After finding that the debts were not dischargeable, in a separate hearing, Judge Gambardella awarded damages to the plaintiffs.<sup>18</sup>

In reaching the conclusion that the claims against Cohen were nondischargeable, Judge Gambardella found that Cohen had demonstrated "reckless disregard for the truth," and that his intent to deceive could be derived from circumstantial evidence provided at the trial.<sup>19</sup> This finding was made despite Mr. Cohen's assertions that he was unaware of the rent control law governing what he could charge tenants in the building.<sup>20</sup> The court found that Cohen's failure to investigate the accuracy of the rents he charged to tenants demonstrated a reckless disregard for the truth. This type of reckless indifference, according to Judge Gambardella, satisfied the knowledge and intent to deceive elements of actual fraud.<sup>21</sup>

Underlying the judge's conclusions were findings that Mr. Cohen was aware of the existence of the Hoboken Rent Leveling Stabilization Board,<sup>22</sup> and thus knew or should have known that the board had authority to regulate the rents he could legally charge tenants. Although Mr. Cohen acknowledged that he knew rent increases to existing tenants could not exceed six percent, and that he investigated his ability to pass through to tenants certain increased costs such as water and taxes, he did not make any investigation as

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to whether the amount of rent he could charge to new tenants was controlled by the existing rent control ordinance. Thus, the court found Cohen acted with reckless disregard.<sup>23</sup>

In the hearing to determine damages, Judge Gambardella found that the New Jersey Consumer Fraud Act applied to the landlord/tenant legal relationship. Since the charging of excessive rents for residential apartments was an "unconscionable commercial practice" as defined in the act, the consumer fraud claims were proven.<sup>24</sup> Judge Gambardella noted that the legislative purpose of the act was to provide victimized consumers a remedy in commercial transactions, and thus should be liberally construed. Upon the finding of the existence of consumer fraud, the act requires a trebling of damages if the loss is ascertainable. Thus, the \$31,382.50 stipulated by the parties as the rent overcharges were trebled to \$94,147.59. In addition, the court awarded the tenants reasonable attorney's fees and costs.<sup>25</sup> Further, Judge Gambardella held, in agreement with the Eleventh Circuit in *St. Laurent v. Ambrose*,<sup>26</sup> that the punitive damages awarded were excepted from discharge under 11 U.S.C. 523(a)(2)(A).<sup>27</sup>

On appeal, the appellants argued that the act did not apply to the dispute, and that fraud had not been established. Further, they claimed that the punitive damages imposed were not exempted from discharge under 11 U.S.C.

523(a)(2)(A).<sup>28</sup> The district court, however, affirmed the bankruptcy court's factual findings and legal conclusions.<sup>29</sup>

The Third Circuit, in a split opinion, affirmed the district court.<sup>30</sup> Without discussion, the portion of the district court order affirming the bankruptcy judge's findings of fact under both the Bankruptcy Code and New Jersey Consumer Fraud Act was affirmed.<sup>31</sup> Since there was a split of authority in the courts of appeal regarding the dischargeability of punitive damage awards, the Third Circuit addressed that issue at length.

Looking at the plain meaning of the statute, its legislative history, and policy considerations, the Third Circuit agreed with the analysis of the Eleventh Circuit in *St. Laurent*.<sup>32</sup> Two of the three justices found that the 1984 amendment to 11 U.S.C. 523(a)(2)(A) replacing the phrase "obtaining" in the statute with "to the extent obtained by"<sup>33</sup> was intended to be merely a stylistic change and did not reflect the intent of Congress to limit dischargeability of fraud damages under 11 U.S.C. 523(a)(2)(A). Judge Greenberg disagreed with the majority opinion's statutory construction, stating that he believed that treble damages were not intended to be encompassed by 11 U.S.C. 523(a)(2)(A) because penal damages do not reflect money, property or services "obtained" by the debtor.<sup>34</sup>

### **The Supreme Court**

The Supreme Court granted *certiorari* to address the conflict in the circuits on the issue of the dischargeability of punitive damage claims. In affirming the judgment of the Third Circuit, the Supreme Court undertook a four-prong analysis reviewing the text of 523(a)(2)(A), the meaning of parallel provisions in the statute, the historical pedigree of the fraud exception, and the general policy underlying all exceptions to dischargeability. The opinion first discussed the policy of the Bankruptcy Code to grant relief only to the "honest but unfortunate debtor."<sup>35</sup> Next, the Court stated that the "most straightforward

reading of 11 U.S.C. 523(a)(2)(A) is that it prevents discharge of "any debt" respecting "money, property, services, or ... credit" that the debtor has fraudulently obtained, including treble damages assessed on account of the fraud.<sup>36</sup> In this part of the opinion, the Court cited its 1995 decision in *Field v. Manns*, where it held that debts "resulting from" or "traceable to" fraud are nondischargeable.<sup>37</sup> Thus, the Court held an obligation to pay treble damages satisfies the threshold condition that it constitutes a "debt" as defined in 11 U.S.C. 101(12) as an "enforceable obligation" of the debtor with a corresponding right to payment by a creditor.<sup>38</sup>

The Court, further analyzed the meaning of the phrase "to the extent obtained by" inserted into the statute by the 1984 amendments. Concluding that the interpretation of this phrase as argued by the debtor would impose a restitutionary ceiling on the extent to which the debtor's liability for fraud could be discharged,<sup>39</sup> the Court stated "once it has been established that specific money or property has been obtained by fraud, 'any debt' arising therefrom is excepted from discharge."<sup>40</sup>

In rejecting the limiting statutory interpretation propounded by the debtor, the Court employed a straightforward, plain meaning analysis and basic principles of statutory construction. The Court concluded that in construing the statute as a whole, all liability arising from the fraudulent acquisition of property or services by the debtor, including the debtor's liability to pay treble damages is nondischargeable under the statute.<sup>41</sup>

The Court supported its conclusion by reference to the history of the fraud exception, noting that the slight amendment to the language of 523(a)(2)(A) "to the extent obtained by" was described in the Senate Report as a "stylistic change."<sup>42</sup> The Court then found that "the change to the language of 523(a)(2)(A) in 1984 in no way signals any intention to narrow the established scope of the

fraud exception along the line suggested by petitioner."<sup>43</sup> Thus, the Court rejected the petitioner's argument that punitive damages were dischargeable, noting that Congress could not have intended a result where the damages to a creditor caused by a debtor's fraud could be discharged without fully compensating the creditor for its actual losses and for the attorney fees and costs incurred to establish the fraud.

### Conclusion

The Supreme Court holding in *Cohen* indicates the express, unambiguous rule of law that any punitive damages awarded based upon fraud will not be discharged under 11 U.S.C. 523(a)(2)(A) by debtors who argue they can only be held liable for compensatory damages. The practical effect of this decision is that attorneys must defend allegations of consumer fraud with extreme care. If consumer fraud claims are proven, and a judgment including treble damages is entered against a client, the subsequent filing of bankruptcy will not entitle the client to discharge under 11 U.S.C. 523(a)(2)(A) either the compensatory or punitive portion of the judgment. ■

### Endnotes

1. *Cohen v. De La Cruz* 118 S. Ct. 1212, (1998).
2. *Id.*, at 1215.
3. *In Re St. Laurent*, 991 F.2d 672 (11th Cir. 1993).
4. *In Re Levy*, 951 F.2d 196 (9th Cir. 1991), *cert. denied* 504 U.S. 985.
5. *Cohen v. De La Cruz*, *supra* at 1212.
6. *Cohen v. De La Cruz*, *supra* at 1215.
7. *Cohen v. De La Cruz*, *supra* at 1219.
8. The "New Jersey Consumer Fraud Act," N.J.S.A. 56:8-1, *et seq.* As to mandatory nature of punitive damage award, *see also Roberts v. Cowgill*, A-6908-96%e (App. Div. N.J. Nov. 8, 1998).
9. *In Re Cohen*, 185 B.R. 171

(Bkrtcy D.N.J. 1994), and *In re Cohen*, 185 B.R. 180 (Bkrtcy D.N.J. 1995).

10. *Cohen v. De La Cruz*, 118 S. Ct. 1212, 1216 (citing *Grogan v. Garner*, 498 U.S. 279, 111 S. Ct. 654 (1991)).
11. *Grogan v. Garner*, *supra* at 287, 111 S. Ct. at 659-660 N. 2.
12. *Grogan v. Garner*, *supra* at 659.
13. *In re Cohen*, 185 B.R. 171, 176 (Bkrtcy D.N.J. 1994).
14. *Id.*, at 173, *see Hoboken Code Section 155, et seq.*
15. *Id.*, at 173-175.
16. *Id.*, at 175.
17. *Id.*, at 175, *also In re Cohen*, 185 B.R. 180, at 182, 183.
18. *In re Cohen*, 185 B.R. 180 (Bkrtcy D.N.J. 1995).
19. *In re Cohen*, 185 B.R. 171, at 179.
20. *In re Cohen*, *supra* at 179.
21. *In re Cohen*, *supra* at 178, 179.
22. *In re Cohen*, *supra* at 178.
23. *Id.*, at 178.
24. *In re Cohen*, 185 B.R. 180, at 183-186.
25. *Id.*, at 190.
26. *Id.*, at 188, 189.
27. *Id.*, at 189.
28. *In re Cohen*, 191 B.R. 599 (D.N.J. 1996).
29. *Id.*, at 603.
30. *In re Cohen*, 106 F.3d. 52 (3rd Cir. 1997).
31. *Id.*, at 55.
32. *In re St. Laurent*, *supra*.
33. *In re Cohen*, 106 F.3d. at 58.
34. *Id.*, at 60.
35. *Cohen v. De La Cruz*, 118 S. Ct. 1212 91998), at 1216.
36. *Id.*, at 1216.
37. *Id.*, at 1216 (citing *Field v. Mans*, 516 U.S. 59, 116 S. Ct. 437 (1995)).
38. *Cohen v. De La Cruz*, *supra* at 1216.
39. *Id.* at 1217.
40. *Id.*, at 1216.
41. *Id.*, at 1217.
42. *Id.*, at 1218.
43. *Id.*, at 1218.
44. *Id.*, at 1218.

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