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By STEPHEN FALANGA

No, New Jersey, There is No Creditor Fraud

Supreme Court rules creditor fraud is not viable cause of action, but other remedies exist

In its decision in the case of *Banco Popular North America v. Gandi*, 184 N.J. 161 (2005), the New Jersey Supreme Court bluntly decreed, “there is no cause of action for creditor fraud in this jurisdiction.” As the Court pointed out, traditional theories of recovery, such as conspiracy to violate the Uniform Fraudulent Transfer Act (UFTA), N.J.S.A. 25:2-20–34, already exist as remedies for a creditor who believes another party may have improperly assisted a judgment-debtor in concealing or transferring assets to avoid collection of a judgment.

The name “creditor fraud” first appeared in a published decision in 2000 with the Appellate Division decision, *Karo Marketing Corp., Inc. v. Playdrome America*, 331 N.J. Super. 430 (App. Div. 2000). In that case, Karo Marketing was seeking to collect on a prior judgment against two of several companies affiliated with the “Playdrome” name. Apparently, the two entities that Karo had obtained judgment against were judgment proof, the second (against an entity named “Playdrex”) having become judgment proof during the course of the initial litigation to enter judgment.

Falanga is a partner with Connell Foley of Roseland, where he specializes in bankruptcy, creditor's rights and commercial litigation.

Karo brought the second action against other affiliates of “Playdrome” and “Playdrex” and its individual owners and investors, contending that the defendants deliberately abandoned Playdrex and created a new company to perform essentially the same functions Playdrex had performed. Karo grounded some of its theories of recovery in fraudulent conveyance, fraud and civil conspiracy.

The Law Division granted the defendants’ motion for summary judgment on all counts and dismissed Karo’s complaint, finding, inter alia, that Karo had not proven the defendants transferred anything of value under the UFTA when it created the new company to perform the same functions as Playdrex. Significantly, the Law Division found that there could be no common law fraud claim because there had been no material misrepresentation by the defendants and, therefore, no reasonable reliance by Karo.

In reversing, the Appellate Division concluded that the trial court took “too restrictive a view” of Karo’s causes of action and held that the “creditor fraud” cause of action, if proven, was sufficient to pierce the corporate veil of the Playdrome affiliates and also reach its primary stockholders. According to the Appellate Division’s ruling, a creditor was not required to show a classic case of legal fraud to establish a cause of

action for “creditor fraud.” The creditor merely had to show that actions were taken for the purpose of “defrauding” a creditor.

The Appellate Division in *Karo* found support for its decision in the earlier case of *Jugan v. Friedman*, 275 N.J. Super. 556 (App. Div.), certif. denied, 138 N.J. 271 (1994). The phrase “creditor fraud” does not actually appear in the *Jugan* decision, but the origins of the concept are generally attributed there. As with *Karo*, the case of *Jugan* involved a creditor who had been frustrated in his efforts to collect on a judgment.

The plaintiff in *Jugan* obtained a judgment for malpractice against the defendant, Dr. Friedman, relating to back surgery. Jugan brought an action to recover the unpaid punitive damages portion of the award from Friedman’s wife and children, who were alleged to have assisted in the transfer of the doctor’s assets to avoid the claims of Jugan and others.

Although the trial court found Friedman had violated the UFTA in transferring his assets, the court dismissed Jugan’s contention that the defendants’ interference with Jugan’s attempt to collect on his judgment “was an independent tort for which he should be entitled to compensatory and punitive damages.” The Appellate Division reversed, finding that even though

Jugan could not establish a cause of action for legal fraud, Friedman's conduct in transferring his assets was "clearly unlawful" and was "closely enough analogous to common-law fraud" that it was tortious.

The *Banco Popular* case marked the first real test involving a claim of "creditor fraud" being asserted by a creditor against an attorney. The case arose in connection with Banco Popular's efforts to enforce a judgment it obtained on loan agreements the bank had entered into with an individual named Suresh Gandhi. At some time prior to Banco Popular obtaining its judgment, but after Banco Popular had some loans, Gandhi transferred two of his homes and a mutual fund to his wife in an apparent effort to avoid the claims of another creditor.

Banco Popular alleged in its complaint that the transfers violated the UFTA. When, during his deposition, Gandhi testified that he transferred the assets upon the advice of his attorney, Richard Freedman, Banco Popular amended its complaint to add Freedman as a defendant and alleged claims of common law fraud, "creditor fraud," conspiracy and negligence.

As with defendants in *Jugan*, *Karo* and *Morganroth*, Freedman successfully moved to dismiss the complaint on all counts, contending that no justifiable action for fraud could be sustained. In reversing in part, the Appellate Division, in stronger terms than before, confirmed its view that the tort of creditor fraud was firmly enconced in New Jersey's common law, recognizing that the court "had no hesitancy in permitting plaintiffs' claims to proceed" as it had in *Jugan* and *Karo*, regardless of the creditors' inability to establish a claim

of common law fraud.

While the *Banco Popular* decision was on appeal, the United States Court of Appeals for the Third Circuit handed down its decision in the case of *Morganroth & Morganroth v. Norris, McLaughlin & Marcus, P.C.*, 331 F.3d 406 (3rd Cir. 2003). Aside from the *Banco Popular* case, the *Morganroth* decision marked the only other published decision in which the tort of "creditor fraud" was used by an aggrieved judgment creditor against an attorney.

Morganroth involved a suit by creditors of the famed financier John DeLorean. The Morganroths contended that DeLorean's law firm, Norris, McLaughlin & Marcus, assisted, through the preparation and recoding of deeds and related documents, in transferring a farm owned by DeLorean to an entity controlled by him in a scheme to obstruct the Morganroths' efforts to execute on their judgment.

The District Court dismissed the Morganroths' claims, reasoning that *Karo* and *Jugan* did not support a general cause of action against a debtor's attorney when the judgment creditor did not allege reliance on the attorney's misrepresentations. Relying on the Appellate Division cases in *Kato* and *Jugan*, the Third Circuit reversed holding that "when a complaint alleges that an attorney has knowingly and intentionally participated in a client's unlawful conduct to hinder, delay, and/or fraudulently obstruct the enforcement of a judgment of a court, the plaintiff has stated a claim under New Jersey law for creditor fraud against the attorney." In rendering its decision, the Third Circuit cited to the Appellate Division decision in *Banco Popular*, while rec-

ognizing that the New Jersey Supreme Court "had not yet recognized" the tort of "creditor fraud."

Within this framework, the *Banco Popular* case made its way to the New Jersey Supreme Court, which undoubtedly surprised the Appellate Division and the District Court in quickly dispatching what the Court itself described as the "amorphous creditor fraud claim." Abrogating the Appellate Division decisions in *Karo* and *Jugan*, the Supreme Court noted that "although the word 'fraud' is used in common parlance to connote any practice involving shady or underhanded dealing, in the law it is a term of art with a clear definition." The Court reaffirmed that a fraud claim cannot be sustained if a plaintiff cannot establish all five necessary elements of fraud.

Overall, the Supreme Court's decision in *Banco Popular* provides a good framework for creditors seeking redress for improper interference by third parties, including attorneys, with a creditor's judgment enforcement actions. The Court's decision set a clear standard of proof. While it is true that creditors will need greater proofs to recover against third parties in the absence of the more liberal elements required to establish the tort of "creditor fraud," the Court has not left creditors without guidance for a remedy.

In rendering its decision, it is clear that the Court was concerned that "an unwitting party" could be held liable under a conspiracy theory. By eliminating the "amorphous" tort of "creditor fraud" but establishing a road map for future cases, it seems apparent the Court was attempting to balance the competing concerns of two justifiable policies. ■