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Supreme Court Expands The Definition of “Actual Fraud” by Making Fraudulent Conveyances Non-Dischargeable Under 11 U.S.C. § 523(a)(2)(A)

By **Keith C. Owens***

This article discusses a recent U.S. Supreme Court decision that expanded the types of debts that are non-dischargeable under 11 U.S.C. § 523(a)(2)(A) to include fraudulent conveyances. The Supreme Court’s ruling sends a clear message that although the purpose of a discharge is to give an honest but unfortunate debtor a fresh start, it is not intended to reward dishonest debtors who act inequitably.

Section 523(a)(2)(A) of the Bankruptcy Code exempts from discharge debts obtained by “false pretenses, a false representation or actual fraud.” The term “actual fraud” is not defined in the Bankruptcy Code, which created uncertainty amongst the bankruptcy courts and practitioners as to whether it included fraudulent conveyances even if not accompanied by a fraudulent misrepresentation to the creditor. The U.S. Court of Appeals for the Fifth Circuit held that fraudulent conveyances did not constitute “actual fraud” unless the transfer was accompanied by a misrepresentation to the creditor, whereas the U.S. Courts of Appeal for the First and Seventh Circuits held that the “actual fraud” exception to discharge applies to all intentional fraud, including receiving property that the transferee knows is intentionally fraudulent, even if no misrepresentation was made.

HUSKY INTERNATIONAL ELECTRONICS, INC. V. RITZ

In a 7-1 decision delivered by Justice Sotomayor, the U.S. Supreme Court expanded the types of debts that are non-dischargeable under 11 U.S.C. § 523(a)(2)(A) to include fraudulent conveyances.¹ In doing so, the Supreme Court has made it clear that it will not allow debtors to manipulate the court system by discharging debts that are part of a scheme to defraud creditors, but may not have otherwise been the result of fraudulent misrepresentations.

In *Husky International Electronics, Inc. v. Ritz*, Husky International sold various components used in electronic devices to Chrysalis Manufacturing

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¹ See *Husky Int’l Elecs., Inc. v. Ritz*, 136 S. Ct. 1581, 194 L. Ed. 2d 655 (2016).

Corp., causing Chrysalis to incur a debt to Husky in the amount of \$163,999.38. Daniel Lee Ritz, Jr. ("Ritz") was a director and large shareholder of Chrysalis during that time. In order to evade Chrysalis' collection efforts, Ritz caused Chrysler to transfer cash to various companies owned or controlled by Ritz. In May 2009, Husky sued Ritz personally in Texas state court, alleging that Ritz' intercompany transfers constituted "actual fraud" under Texas law. Shortly thereafter, Ritz filed a Chapter 7 bankruptcy petition in the U.S. Bankruptcy Court for the Southern District of Texas. Husky thereafter commenced an action to determine that Ritz was personally liable for Chrysalis' debt, and that the debt was non-dischargeable because the intercompany transfer scheme constituted "actual fraud" under 11 U.S.C. § 523(a)(2)(A).

The trial court held that although Ritz was personally liable for the debt under Texas law, the debt was dischargeable in bankruptcy because it was not "obtained by . . . actual fraud" under 11 U.S.C. § 523(a)(2)(A). The U.S. Court of Appeals for the Fifth Circuit affirmed, holding that, because the parties agreed that Ritz's fraudulent-transfer scheme did not involve a misrepresentation, and because a false representation by the debtor "is a necessary prerequisite for a showing of 'actual fraud' under Section 523(a)(2)(A)," Ritz's debt was dischargeable. The Fifth Circuit's holding created a circuit split with the First and Seventh Circuit Courts of Appeal, which held that the "actual fraud" exception to discharge applies to all intentional fraud, including receiving property that the transferee knows is intentionally fraudulent, even if no misrepresentation was made.² Chrysalis filed a petition for certiorari with the Supreme Court, which was granted.

THE SUPREME COURT'S DECISION

The Supreme Court reversed the Fifth Circuit Court of Appeals, holding that "[t]he term 'actual fraud' in § 523(a)(2)(A) encompasses forms of fraud, like fraudulent conveyance schemes, that can be effected without a false representation." The majority first reviewed the language of the statute, which exempts from discharge "any debt . . . for money, property, [or] services . . . to the extent obtained by . . . false pretenses, a false representation, or actual fraud."³ The majority noted that prior to the enactment of the Bankruptcy Reform Act of 1978, the Bankruptcy Code prohibited debtors from discharging debts obtained by "false pretenses or false pretenses." In 1978, Congress added the

² See *McClellan v. Cantrell*, 217 F.3d 890 (7th Cir. 2000); *In re Lawson*, 791 F.3d 214, 225 (1st Cir. 2015).

³ 11 U.S.C. § 523(a)(2)(A).

phrase, “actual fraud,” to the list of debts that are non-dischargeable under Section 523(a)(2)(A). The majority concluded that Congress did not intend the term, “actual fraud,” to mean the same thing as “a false representation,” as suggested by the Fifth Circuit. Otherwise, the term “actual fraud” would have been superfluous.

Next, the majority relied on English common law, citing the Statute of 13 Elizabeth, also known as the Fraudulent Conveyance Act of 1571, which identified as fraud “‘faigned covenous and fraudulent Feoffmentes Gytes Grauntes Alienations [and] Conveyaunces’ made with ‘Intent to delaye hinder or defraude Creditors.’”⁴ The majority concluded that this statute remains “embedded in laws related to fraud today” and “clarifies that the common-law term ‘actual fraud’ is broad enough to incorporate a fraudulent conveyance.”⁵ The majority also noted that under common law fraud, misrepresentation was not required. In addition, the majority noted that under the Statute of 13 Elizabeth and the laws that followed, “both the debtor and the recipient of the conveyed assets were liable for fraud even though the recipient of a fraudulent conveyance . . . made no representation . . . to the debtor’s creditors.”⁶ Finally, the majority rejected the debtor’s argument that a fraudulent conveyance scheme could not be nondischargeable because “the transferor does not ‘obtai[n]’ debts in a fraudulent conveyance.”⁷ The majority noted that “the recipient of the transfer—who with the requisite intent, also commits fraud—can obtain[n] assets ‘by’ his or her participation in the fraud.”⁸ Accordingly, the majority held that the term “actual fraud” in 11 U.S.C. § 523(a)(2)(A) “encompass[es] fraudulent conveyance schemes, even when those schemes do not involve a false representation.”⁹ While the Court acknowledged that “[s]uch circumstances may be rare because a person who receives fraudulently conveyed assets is not necessarily (or even likely to be) a debtor on the verge of bankruptcy,” the Court concluded that “fraudulent conveyances are not wholly incompatible with the ‘obtained by’ requirement.”¹⁰ The Court also rejected the notion that “reliance” is always required in order to establish fraud. While the Court noted that “reliance” is indeed a requirement to establish fraud perpetrated through a misrepresentation to a creditor, it was not a requirement

⁴ *Husky International Electronics, Inc. v. Ritz* (citing 13 Eliz. ch. 5).

⁵ *Id.*

⁶ *Id.*

⁷ *Id.*

⁸ Citations omitted.

⁹ *Id.*

¹⁰ *Id.*

for fraud that is “not premised on such a misrepresentation.”¹¹

THE DISSENT

In his lone dissent, Justice Thomas noted that the majority departed from the plain language of the statute. Under the statute, the debt must be “obtained by” actual fraud. He concluded that the meaning of that phrase “has an ‘inherent’ ‘element of causation,’ and refers to those debts ‘resulting from’ or ‘traceable to’ fraud.”¹² He also cited the widely used definition of “actual fraud” in bankruptcy that requires creditors to have “‘justifiably relied’ on the debtor’s ‘representation,’ which the debtor ‘knew to be false’ and made with the intent and purpose of deceiving the creditor and that the creditor ‘sustained a loss or damage as the proximate consequence.’”¹³ Justice Thomas concluded that the majority “ostensibly creates a new definition of ‘obtained by’ because it thinks that the move is necessary to avoid rendering ‘actual fraud’ superfluous.”¹⁴

IMPLICATIONS

This opinion will have important implications on bankruptcy and fraudulent conveyance law. In individual bankruptcy cases, virtually all debts are dischargeable except for certain enumerated debts as set forth in Sections 523(a), 1328(a)(2), and 727(a) of the Bankruptcy Code. Although a trustee may sue the transferee of a fraudulent conveyance under Sections 544 or 548 of the Bankruptcy Code, this statute does not give the trustee or creditors any ability to seek recovery from the debtor transferee. This is because the debtor’s assets are already property of the bankruptcy estate. The remedy against the debtor transferee would be either a determination that the debt is non-dischargeable under Section 523(a) of the Bankruptcy Code, or that the debtor is not entitled to a discharge under Section 727 of the Bankruptcy Code. In its petition for certiorari, Husky argued persuasively that the Fifth Circuit’s decision “create[d] a roadmap for dishonest debtors to cheat creditors through deliberate fraudulent-transfer schemes, and then to escape liability through discharge in bankruptcy.”

The Supreme Court’s ruling sends a clear message that although the purpose of a discharge is to give an honest but unfortunate debtor a fresh start, it is not

¹¹ *Id.*

¹² *Id.* (citation omitted).

¹³ *Id.* (quoting 4 Collier on Bankruptcy ¶ 523.08[1][3], p. 523–47 (A. Resnick & H. Sommer eds., 16th ed. 2015)).

¹⁴ *Id.*

intended to reward dishonest debtors who act inequitably. The Supreme Court’s opinion gives creditors the green light to commence litigation to determine that debts that may not have otherwise been “obtained” by “actual fraud” are nevertheless nondischargeable if they were part of a fraudulent conveyance scheme. Debtors who seek to hinder, delay, or defraud a creditor’s enforcement efforts by fraudulent transferring assets will no longer be able to discharge their obligations in bankruptcy. However, it is important to note that a judgment of nondischargeability is not automatic. Creditors must vigilantly monitor a debtor’s bankruptcy case and timely file a complaint to determine the non-dischargeability of a debt. Absent the timely commencement of an adversary proceeding, such debts will be discharged.