SCOTUS Clarifies ‘Actual Fraud’ in Bankruptcy Code

BNA Snapshot

Husky Int'l Elecs., Inc. v. Ritz, U.S., No. 15-145, 5/16/16

Development: U.S. Supreme Court resolves a circuit split by holding that the term “actual fraud” encompasses fraudulent conveyance schemes that don’t involve a false representation.

Takeaway: Bankruptcy experts disagree with the majority's broad reading of the statute, favoring Justice Thomas's dissent.

By Diane Davis

May 16 — “Actual fraud” includes fraudulent conveyance schemes even when those schemes don’t involve a false representation, the U.S. Supreme Court held May 16 in its first bankruptcy decision of the term ( Husky Int'l Elecs., Inc. v. Ritz, U.S., No. 15-145, 5/16/16).

Justice Sonia Sotomayor wrote the opinion for the 7-1 majority, reversing the U.S. Court of Appeals for the Fifth Circuit and remanding the case. The court resolved a circuit split on whether “actual fraud,” as used in Bankruptcy Code Section 523(a)(2)(A), requires a false representation. That provision prohibits debtors from discharging debts “obtained by … false pretenses, a false representation, or actual fraud.”

Practitioners and scholars who reacted to the decision were more or less united in their skepticism of the majority's reading of the law. They also cautioned that a close reading of the opinion would be advisable.

“This case must be read carefully and completely to avoid being misled,” one professor told Bloomberg BNA. It can appear quite broad at first glance, but ultimately the court limits the universe of debtors subject to the actual fraud language by focusing on the requirement that the debtor used the fraud to obtain something, he said.

Another practitioner—who filed a brief on behalf of the debtor—suggested that on remand, the lower court may use the fact that the debtor didn’t obtain anything to find the debt in this case dischargeable.

The court’s decision “further eviscerates the [Bankruptcy Code’s] fresh start policy,” Prof. Charles J. Tabb, of counsel, Foley & Lardner LLP and Mildred Van Voorhis Jones Chair in Law, University of Illinois, Champaign, Ill., told Bloomberg BNA May 16. It “undermines the fresh start policy, greatly expanding the fraud exception far beyond its historical origins, to the detriment of individual debtors,” according to Tabb. “There is no basis for thinking that Congress intended such a dramatic exception to the fraud exception when it added the words ‘actual fraud.’”

Justice Clarence Thomas wrote a dissenting opinion, concluding that “actual fraud” doesn’t encompass fraudulent transfer schemes.

‘Sensible Presumption’ of Additional Term

It is “sensible to presume” that when Congress amended the Bankruptcy Code in 1978 and added to debts obtained by “false pretenses or false representations” an additional bankruptcy discharge exception for debts obtained by “actual fraud,” it didn’t intend the term “actual fraud” to “mean the same thing as the already-existing term ‘false representations,’” the majority said.

The court found even stronger evidence that “actual fraud” encompasses the kind of conduct alleged to have occurred in this
case in the phrase's historical meaning because at common law, “actual fraud” meant “fraud committed with wrongful intent.”

Since the “beginning of bankruptcy practice,” fraud has been “used to describe asset transfers that, like Ritz’ scheme, impair a creditor's ability to collect a debt,” the court said.

Justice Thomas Dissents

In his dissenting opinion, Thomas said, “[s]tatutory language must be read in context and a phrase gathers meaning from the words around it.”

In his view, context “dictates that 'actual fraud' ordinarily does not include fraudulent transfers because ‘that meaning does not fit' with the rest of § 523(a)(2),” Thomas said.

‘Opinion Is Misguided.’

“The opinion is misguided and inexplicably conflates discharge denial under Section 727(a)(2) with the discharge exception under 523(a)(2),” Tabb, who is an editor of Bloomberg Law: Bankruptcy Treatise, told Bloomberg BNA.

According to Tabb, it’s “hard to square the Court's decision with Field v. Mans,” 516 U.S. 59 (1995), which held that the terms in Section 523(a)(2)(A) should be interpreted in light of “elements that the common law has defined them to include” as of 1978, when the current Bankruptcy Code was adopted.

“It's also difficult to see how the debtor himself in this case 'obtained' anything by the fraud, since it went to his company,” Tabb said.

Not Duplicative

The majority said that interpreting “actual fraud” in Section 523(a)(2)(A) to encompass fraudulent conveyances wouldn't render duplicative two of Section 523’s other discharge exceptions because “actual fraud” captures much conduct not covered by those other provisions. The court also didn't find a redundancy in Section 727(a)(2), which it said was broader in scope than Section 523(a)(2)(A), but narrower in timing.

Section 727(a)(2), the court explained, prevents a debtor from discharging all of his debts if, within the year preceding the bankruptcy petition, he “transferred, removed, destroyed, mutilated, or concealed” property “with intent to hinder, delay, or defraud a creditor or an officer of the estate charged with custody of property.” The two provisions are “meaningfully different,” the court said.

‘Obtained by’ Actual Fraud?

G. Eric Brunstad, partner at Dechert LLP, Hartford, Conn., and adjunct professor of law at Georgetown University Law Center, Washington, D.C., told Bloomberg BNA that he agrees with Justice Thomas' dissent.

“By its plain terms, Section 523(a)(2)(A) applies only to a debt ‘obtained by’ actual fraud,” Brunstad said.

“On remand, I believe the Fifth Circuit should find that the debt does not fall within the scope of Section 523(a)(2)(A) and that it is fully dischargeable in Ritz’ bankruptcy case,” Brunstad said. He filed an amicus curiae brief in support of the respondent/debtor Ritz.

“Most of the majority's opinion focuses on the meaning of the term ‘actual fraud' and whether a fraudulent conveyance may constitute an example of 'actual fraud,'” Brunstad said. “But as Justice Thomas explained, Section 523(a)(2)(A) applies only to debts for property ‘obtained by’ actual fraud, and, he noted, the relevant debt for $166,999.38 was not ‘obtained by' fraud,” he said.

“Critically, the majority does not disagree,” Brunstad said, noting that the court in footnote 3, states that it is not deciding whether the debt in question was “obtained by” actual fraud: "We take no position on that contention here and leave it to the Fifth Circuit to decide on remand whether the debt to Husky was ‘obtained by’ Ritz’ asset-transfer scheme."

“Given the Court's clear statement that it was not deciding whether the particular debt in the Husky case was ‘obtained by' fraud, it seems fair to conclude that all the Court actually decided today was that a fraudulent transfer could be an example of actual fraud, not whether Ritz’ particular obligation was actually non-dischargeable,” Brunstad said.
Read Decision Cautiously

“This is the latest in a series of recent consumer bankruptcy cases that the Supreme Court should never have taken,” G. Ray Warner, Professor of Law at St. John's University School of Law, Jamaica, N.Y., told Bloomberg BNA.

“Both the majority and dissent agree that the fraudulent conveyance issue that the Court resolves will almost never arise because the ruling only applies when the debtor is the recipient of a fraudulent transfer and acted in collusion with the transferor,” he said.

Imploring practitioners to read the opinion carefully, Warner said that “this case must be read carefully and completely to avoid being misled.” “The first part of the majority opinion appears to create a very expansive ‘fraud’ exception to discharge that extends well beyond representational fraud to cover all sorts of actions designed to cheat or circumvent the rights of another,” he said.

“But, the final section of the opinion eliminates almost all non-representational fraud from the exception by focusing on the requirement that the debtor must have used fraud to obtain something. Thus, only the recipient of fraudulently transferred property faces a discharge exception,” Warner said.

“The majority opinion misunderstands the nature of fraudulent transfer liability,” according to Warner. “It is liability owed to the creditor group as a whole for the value of the property transferred,” he said. “That is more appropriately addressed as an objection to discharge under Section 727. A fraudulent transfer does not create the debt owed to the particular creditor, and thus does not fit into the Section 523 exception to discharge structure,” Warner said.

What's Next?

Following today's decision, “creditors will likely argue that bankruptcy courts can take into consideration conduct of the debtor that occurs after a debt is incurred in making a decision as to whether a particular debt should be dischargeable,” Kate Toomey, partner with Lewis Baach, Washington, D.C., told Bloomberg BNA.

“Up to this point, the inquiry was largely limited to what was done or said at the time the debt was incurred,” Toomey said.

“The issue that the Supreme Court was faced with was whether ‘actual fraud’ requires that Ritz made some false statement to Husky,” Toomey said. “Judge Sotomayor, writing for all of the Justices (except Justice Thomas), said that ‘actual fraud’ does not require proof that the bankrupt made a false statement to the creditor, but can be satisfied by fraudulent conduct, like fraudulent transfers made for the purpose of keeping the money out of the hands of creditors.”

Toomey noted that Justice Thomas, in his dissent, “is actually addressing a slightly different question (and a different part of the relevant statute) — not whether the scope of ‘actual fraud’ requires a false statement — but whether, in this particular case, Husky's debt was ‘obtained by’ fraud.” “Justice Thomas' point is that Ritz' conduct, even though it was wrong, was not related to Chrysalis’ debt to Husky — which seemed entirely legal. So the debt was not ‘obtained by actual fraud’ which is what is required to exempt it from discharge,” she said.

Background of Transactions

The case arose out of a Chapter 7 bankruptcy filed by Ritz in which his nonexempt assets were liquidated and the proceeds were distributed to creditors. Before filing for bankruptcy, Ritz was a director and partial owner of Chrysalis Manufacturing Corp., a circuit board manufacturer.

For four years, the petitioner sold and delivered electronic device components to Chrysalis. Chrysalis failed to pay Husky for some of the goods delivered. While some of that debt was outstanding, Ritz transferred a substantial amount of funds from Chrysalis to several other entities that he controlled.

Husky sued Ritz in Texas state court to hold him personally liable for the company's debt. After Ritz filed for bankruptcy protection, Husky initiated an adversarial proceeding to have Ritz's debt declared non-dischargeable because Chrysalis had not received any reasonably equivalent value for the funds transferred to Ritz's companies.

The district court held that Ritz was personally liable for the debt under Texas law, but the debt wasn't "obtained by ... actual fraud," and could be discharged in bankruptcy.
The Fifth Circuit affirmed, holding that the “actual fraud” exception to a bankruptcy discharge under Section 523(a)(2)(A) requires that the debtor make some kind of false representation to the creditor (Husky Intl Elecs., Inc. v. Ritz (In re Ritz), 787 F.3d 312 (5th Cir. 2015)(27 BBLR 809, 6/4/15)). Because respondent/debtor Daniel Lee Ritz, Jr.’s fraudulent transfer scheme didn’t involve a misrepresentation, he wasn't barred from discharging $163,999 in debt to petitioner Husky International Electronics, Inc.

The petition for certiorari was granted Nov. 6, 2015 (27 BBLR 1512, 11/12/15).


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