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Supreme Court Takes Broad View of Fraud Exception to Discharge

In a 7-1 decision, the U.S. Supreme Court, in *Husky International Electronics, Inc. v. Ritz*, No. 15-154, resolved a split among the Courts of Appeals over the "actual fraud" exception to discharge of an individual debtor's obligations.

Section 523(a)(2)(A) of the Bankruptcy Code allows creditors to request a determination that debts owed to them cannot be discharged because of the debtor's "actual fraud." The Court held that, for purposes of the statute, actual fraud can exist even though the debtor never made a false representation to the creditor. The holding will likely open a broad avenue for creditors to prevent a debtor from being granted a "fresh start" with regard to a specific debt owed to them, based upon a debtor's involvement in a fraudulent scheme.

In *Husky*, Husky International Electronics sold goods to Chrysalis Manufacturing Company. Ritz, a 30 percent shareholder of Chrysalis, caused Chrysalis to make a number of transfers of funds to other companies that he owned or controlled, leaving Chrysalis without the ability to pay its debt to Husky. Ritz filed for protection under chapter 7 after Husky sued him for the amount of the Chrysalis debt. Husky followed Ritz to bankruptcy court and filed a lawsuit claiming that Ritz's alleged debt to Husky was incurred through "actual fraud" and was, therefore, nondischargeable under section 523(a)(2)(A) of the Bankruptcy Code. Ritz responded that he had not made a false representation to Husky, so the actual fraud exception to discharge did not apply.

The Court agreed with Husky, holding that "[t]he term 'actual fraud' in § 523(a)(2)(A) [of the Bankruptcy Code] encompasses forms of fraud, like fraudulent conveyance schemes, that can be effected without false representation." In reaching its conclusion, the Court noted that section 523 already excepted from discharge debts incurred through "false representation" and "false pretenses" when the "actual fraud" language was added to the exception. Based on that, the Court reasoned, actual fraud should not be read to require a false representation, as doing so would have rendered the actual fraud amendment superfluous.

The Court did not precisely delineate boundaries of the actual fraud exception, but it did make clear that even its broad reading of actual fraud has limits. First, the Court held that the fraud must be "actual" in that it involves moral turpitude or intentional wrong. This, the Court suggests, places constructively fraudulent transfers outside the actual fraud discharge exception. Second, there must be some type of fraud by the debtor, a condition satisfied through Ritz's collection avoidance schemes. The Court left fraud undefined, noting that the term has defied definition throughout legal history. Orchestrating fraudulent transfers is sufficiently deceitful conduct to fall within the category of fraud.

The *Husky* decision leaves a number of unanswered questions. In this case, Ritz essentially stood on both sides of the fraudulent transfers—he controlled the debtor company, Chrysalis, and owned or controlled the transferees—circumstances that made the transfers fall clearly within the Court's bounds for actual fraud. The result may well be different if the unwitting recipient of a fraudulent transfer later files for bankruptcy. Also, the level of a transferee's knowledge or participation required to trigger the actual fraud exception is an issue that needs to be resolved case by case. Ultimately, actual fraud can be established without proving that the debtor made false statements to a creditor.

The lone dissent came from Justice Thomas, who pointed out that the statute plainly states that the exception applies to debts for money *obtained by* actual fraud and that it is hard to envision a case where fraudulent activity that does not involve false statements by the debtor to a creditor could meet this standard.

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