

Bankruptcy Bar Association for the District of Maryland, Baltimore Chapter  
January 20, 2016 Lunch Meeting

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“Actual fraud” and *Husky Int’l Elecs., Inc. v. Ritz*, No. 15-145 (petition granted Nov. 6, 2015) in the Supreme Court of the United States.

I. Discharge and exceptions generally.

- a. The “basic policy” of the Bankruptcy Code is to “afford[] relief only to an ‘honest but unfortunate debtor.’” *Cohen v. de la Cruz*, 523 U.S. 213, 217 (1998) (quoting *Grogan v. Garner*, 498 U.S. 279, 287 (1991)).
- b. Bankruptcy Code provides for discharge of debts of an individual, but it disqualifies an individual’s ability to obtain a discharge of any debts whatsoever in a chapter 7 case and separately provides for more targeted exceptions for particular debts in chapter 7 and chapter 13 cases.
  - i. Section 727(a) provides that an individual is ineligible for any discharge in a chapter 7 case if the individual has committed any of the acts described in the statute. *See, e.g.*, §§ 727(a)(2) (transfer of property with the intent to defraud a creditor within 1 year before petition); (a)(3) (unjustified concealment or destruction of financial information); (a)(4) (knowing false statement); (a)(5) (failure to explain satisfactorily the loss of assets or inability to meet liabilities).
  - ii. Section 523 targets certain types of debts and provides that those debts are nondischargeable even if the debtor is otherwise eligible for a discharge of other debts. *See, e.g.*, §§ 523(a)(2)(A) (false pretenses, false representation, actual fraud); (a)(4) (embezzlement and larceny); (a)(9) (driving under the influence); (a)(19) (violations of securities laws). Section 523 applies chapter 7 and chapter 13 cases.
  - iii. The exceptions to discharge under § 523 are to be construed narrowly “to protect the purpose of providing debtors a fresh start.” *Foley & Lardner v. Biondo (In re Biondo)*, 180 F.3d 126, 130 (4th Cir.1999). However, the courts are “equally concerned with ensuring that perpetrators of fraud are not allowed to hide behind the skirts of the Bankruptcy Code.” *Id.*

II. Relevant statutory provisions and precedent

- a. 11 U.S.C. §523(a):

A discharge under section 727, 1141, 1228(a), 1228(b), or 1328(b) of this title does not discharge an individual debtor from any debt-- ... (2) for money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained by -- (A) false pretenses, a false representation, or actual fraud ....

- b. Prior to 1978 when the current version of 11 U.S.C. § 523(a) was enacted, the applicable statute at the time barred discharge of “liabilities for obtaining money or property by false pretenses or false representations.” 11 U.S.C. § 35(a)(2) (1976). In 1978, Congress added “actual fraud” as a basis for exception from discharge.
- c. *Field v. Mans*, 516 U.S. 59 (1995).
  - i. The debtor, Mans, purchased land with a promissory note secured by a second mortgage. The mortgage deed gave the sellers a right to accelerate the debt if Mans conveyed the land without first obtaining the sellers’ consent. *Id.* at 62. Mans transferred the land without telling the sellers or seeking their consent. *Id.* Instead, he sent them a letter saying that he was considering conveying the property and asking them to waive the due-on-sale clause prospectively. *Id.* The sellers refused but did not demand immediate payment on the note based on the false representation that Mans was merely considering a conveyance and his failure to disclose that he had already conveyed the land. *See id.* at 62-63. The sellers claimed that Mans’s debt on the note was nondischargeable under § 523(a)(2)(A) because he defrauded them into extending him additional credit (*i.e.*, not enforcing the due-on-sale clause immediately) based on his misrepresentation. *Id.*
  - ii. The issue for the Court was “the level of a creditor’s reliance on [the] fraudulent misrepresentation necessary to place a debt ... beyond release.” *Id.* at 61. In other words, what, if any, level of justification a creditor needs to show above mere reliance in fact in order to exempt the debt from discharge under § 523(a)(2)(A). *Id.* at 66.
  - iii. The Court analyzed the term “actual fraud” because the District Court used the term “fraud” to describe Mans’s conduct. The Court explained that the common law definition of the statutory terms should apply. It turned for guidance to Section 537 of the Restatement (Second) of Torts (1976) addressing the elements of fraudulent misrepresentation, which the Court believed was “on point.” It also analyzed treatises addressing the reliance element for a misrepresentation.
  - iv. Based on these authorities and surveying the courts of the States, the Court concluded that the prevailing standard for reliance in a “common-law

fraud action” is “justifiable reliance.” *Id.* at 73. Thus, “[f]ollowing [the] established practice of finding Congress’s meaning in the generally shared common law when common-law terms are used without further specification, [the Court held] that § 523(a)(2)(A) requires justifiable, but not reasonable, reliance.” *Id.* at 73-74.

III. Fourth Circuit and selected District of Maryland authority

- a. *Nunnery v. Rountree (In re Rountree)*, 478 F.3d 215, 219 (4th Cir. 2007) (“It is clear from the structure of the phrase that ‘to the extent obtained’ modifies the money, property, services, or credit that constitute the debt. A plain reading of [§ 523(a)(2)(A)] demonstrates that Congress excepted from discharge not simply any debt incurred as a result of fraud but only debts in which the debtor used fraudulent means to obtain money, property, services, or credit. Structurally, the subsection can have no other meaning.”).
- b. *Foley & Lardner v. Biondo (In re Biondo)*, 180 F.3d 126 (4th Cir.1999) (in a case involving an alleged misrepresentation, citing *Field v. Mans*, 516 U.S. 59 (1995), relying on the definition of fraudulent misrepresentation under Restatement (Second) of Torts § 525 (1976) to guide the court’s definition of “actual fraud,” and establishing four elements to prove an exception to discharge under §523(a)(2)(A): (1) a fraudulent misrepresentation; (2) that induces another to act or refrain from acting; (3) causing harm to the plaintiff; and (4) the plaintiff’s justifiable reliance on the misrepresentation).
- c. *Miller v. Cigna Ins. Co.*, 311 B.R. 57, 61 (D. Md. 2004) (Quarles, J.) (reciting the *Biondo* elements and holding that the insurance agent’s intentional failure to disclose a known “double financing scheme,” which the insurance company relied upon to its detriment, resulted in a loss that was nondischargeable under § 523(a)(2)(A)).
- d. *Phillip v. Reecher (In re Reecher)*, 514 B.R. 136 (Bankr. D. Md. 2014) (Rice, J.).
  - i. The Court concluded that “the damages awarded by the Circuit Court for intentional misrepresentation, civil conspiracy, and concealment and non-disclosure are claims that are nondischargeable under § 523(a)(2)(A), and that those awarded for constructive fraud and conversion are dischargeable under § 523(a)(2)(A).”
  - ii. The Court explained the exception to discharge under § 523(a)(2)(A) required a showing of “positive fraud, or fraud in fact, involving moral turpitude or intentional wrong.” Where the fraud was constructive or implied by law and did not involve bad faith or immorality, it was “not sufficient to establish as a matter of federal law” that the claim is nondischargeable under § 523(a)(2)(A).

iii. The Court also explained that the judgment for conversion did not “require any finding of a misrepresentation or reliance on the part of the plaintiff” and thus was insufficient to establish nondischargeability under § 523(a)(2)(A).

e. *Petrovic v. Vetal (In re Vetal)*, 433 B.R. 524 (Bankr. D. Md. 2010) (Catliota, J.); *Gulati v. McClendon (In re McClendon)*, 415 B.R. 170, 183 (Bankr. D. Md. 2009) (Schneider, J.); *Spinoso v. Heilman (In re Heilman)*, 241 B.R. 137, 149 (Bankr. D. Md. 1999) (Schneider, J.) (stating that, in order to sustain an action under Section 523(a)(2)(A), the plaintiffs must prove the elements described in *Biondo* and explaining that “actual fraud” is defined as “any deceit, artifice, trick or design involving direct and active operation of the mind, used to circumvent and cheat another—something said done or omitted with the design of perpetrating what is known to be cheat or deception”).

IV. *Husky Int’l Elecs., Inc. v. Ritz*, No. 15-145 (petition granted Nov. 6, 2015)

a. Relevant Factual Background

- i. The Debtor, Daniel Lee Ritz, had a 30% ownership interest in a manufacturing company in Texas. Between 2003 and 2007, the Debtor’s company had a contract with Husky International Electronics, under which Husky sold and delivered certain goods to the Debtor’s company. The Debtor’s company failed to pay for all of the goods, and it owed Husky close to \$164,000.
- ii. During the 7-months between November 2006 and May 2007, the Debtor transferred a substantial amount of the manufacturing company’s money to various other entities that were also control by the Debtor. Specifically, the Debtor transferred over \$1.1 million to seven (7) different companies in which the Debtor had an ownership interest.

b. Procedural History

- i. Creditor v. Debtor – In May 2009, Husky sued the Debtor in the U.S. District Court for the Southern District of Texas, seeking to hold the Debtor personally liable for the manufacturing company’s \$164,000 debt.
- ii. Debtor’s Voluntary Chapter 7 Petition & Creditor’s Adversary Proceeding
  1. In December 2009 – seven months after Husky sued the Debtor personally – the Debtor filed a voluntary Chapter 7 petition for bankruptcy in the U.S. Bankruptcy Court for the Southern District of Texas.

2. In March 2010, Husky filed an adversary proceeding objecting to the discharge of the Debtor's debt under 11 U.S.C. § 523(a), specifically under the "actual fraud" [(a)(2)(A)] exception and the "willful and malicious injury" exception [(a)(6)].
  3. After a trial, the bankruptcy court found that the Debtor's transfers of the manufacturing company's money were not made for reasonably equivalent value to the company. The court also found that Husky had suffered damages due to these transfers in the amount of \$164,000. Nevertheless, the court denied all of Husky's requested relief, concluding that the debt was dischargeable and that the exceptions to discharge did not apply here.
    - a. Actual fraud – the bankruptcy court concluded in order for the "actual fraud" exception to apply, Husky had to show that the Debtor made a false representation to Husky. Because no such representation was shown, the actual fraud exception did not apply.
    - b. Willful and malicious injury – the court concluded that Husky did not present sufficient evidence that the Debtor willfully and maliciously injured Husky or its property (no exhibits or testimony directly to this exception).
  - iii. Appeal to District Court. Husky appealed the bankruptcy court's decision to the district court. Like the bankruptcy court, the district court concluded that the "actual fraud" exception did not apply unless there was a misrepresentation. The district court therefore affirmed the bankruptcy court's decision.
- c. Opinion in the Fifth Circuit
- i. Just like the opinions below, the 5th Circuit appeal centered on whether the "actual fraud" exception to discharge requires a representation. The 5th Circuit agreed with the Debtor, holding that a representation is a requirement to establish "actual fraud."
  - ii. The 5th Circuit expressly considered and rejected the 7th Circuit's contrary holding on this exact issue. See *McClellan v. Cantrell*, 217 F.3d 890 (7th Cir. 2000).
    1. Facts: Creditor sold machinery to Debtor's brother for \$200,000, payable in installments. The brother defaulted, still owing more than \$100,000. Creditor sued the brother. While the suit was

pending, the brother sold the machinery to the Debtor (his sister) for \$10. The Debtor then resold the machinery for \$160,000. The Debtor eventually filed for bankruptcy, and the Creditor brought an adversary proceeding to recover the debt, arguing the debt was not dischargeable under the “actual fraud” exception.

2. Reasoning: The Seventh Circuit agreed with the Creditor, holding that fraudulent misrepresentation is not the only form that fraud can take, and therefore is not the only form of fraud that makes a debt nondischargeable.
    - a. The court distinguished the various “actual fraud” cases that simply assumed that a misrepresentation was required because in those cases, the only fraud that was alleged was a fraud based on a misrepresentation.
    - b. The court also explained that because Section 523(a)(2)(A) covers both “fraudulent representations” and “actual fraud,” the exception for actual fraud is more broad than misrepresentation.
  3. Holding: The Seventh Circuit held that actually fraudulent conveyances—that is, conveyances through which the debtor intends to hinder the creditor—constitute “actual fraud” under Section 523(a)(2)(A).
- iii. In the 5th Circuit’s view, the 7th Circuit’s decision was in conflict with the Supreme Court’s prior opinion in *Field v. Mans*.
1. Although *Field* did not directly address the issue presented here, the 5th Circuit pointed out the various places in the Supreme Court’s opinion where the Court assumed that a false representation was necessary to establish the “actual fraud” exception.
  2. The 5th Circuit also explained that *Field* made clear that the meaning of “actual fraud” depends on the common law meaning of the term in 1978, which required a false representation.
- iv. Finally, the 5th Circuit cited its own prior precedent setting forth the elements of needed to prove nondischargeability under an “actual fraud” theory. One of those elements is that “the debtor made representations” that the debtor knew were false.

- v. Accordingly, the 5th Circuit held a false representation by the Debtor “is a necessary prerequisite for a showing of ‘actual fraud’ under Section 523(a)(2)(A). This holding created a circuit split.

d. Appeal to the Supreme Court

- i. Five weeks after the 5th Circuit’s decision in this case, the First Circuit issued a decision in *In re Lawson*, in which it rejected the Fifth Circuit’s position on this issue. *See In re Lawson*, 791 F.3d 214 (1st Cir. 2015).
- ii. Aside from the circuit split, other lower federal courts are divided on this issue.
  - 1. Bankruptcy appellate panels from the 6th and 10th Circuits have followed the 7th Circuit’s analysis from *McClellan*. So too have bankruptcy courts in Kansas, Georgia, Ohio, Delaware, and Pennsylvania.
  - 2. However, bankruptcy courts in California, Texas, Massachusetts, and Virginia have followed the approach endorsed by the 5th Circuit in this case.
- iii. Husky filed a petition for certiorari to the Supreme Court in July 2015.
- iv. In November 2015 the Court granted cert to consider: Whether the “actual fraud” exception to discharge applies only where a debtor made a false representation, or whether the exception also applies to a fraudulent-transfer scheme that was actually intended to cheat a creditor.

V. Arguments of the parties

a. Husky’s arguments

- i. At common-law, the term “actual fraud” means intentional fraud and includes fraud that does not involve any misrepresentation.
  - 1. Undefined terms in the Bankruptcy Code are interpreted in accordance with their common-law meaning. The difference between actual fraud and constructive fraud hinges on the actor’s motives. It has nothing to do with whether the fraud involves a misrepresentation or takes some other form.
  - 2. The common law has long recognized many forms of fraud; some involve misrepresentations, and others do not.

3. *Neal v. Clark*, 95 U.S. 704 (1887).
    - a. Debtor who received a constructively fraudulent transfer was found liable for constructive fraud in state court. The fraud was not “actual fraud” or “positive fraud” for which wrongful intent is an element.
    - b. Because the debtor did not commit “actual fraud” (involving moral turpitude or wrong), the debt for the fraudulent conveyance was dischargeable.
    - c. According to Husky, this case demonstrates: (1) “actual fraud” is a term that is distinguishable from constructive fraud, and the difference hinges on the actor’s intent; and (2) that the common-law meaning of “actual fraud” does not depend on whether the perpetrator made a misrepresentation.
  4. Centuries of common-law jurisprudence, including in the specific context of debtor-creditor relations, recognized that conveyances that hinder creditors’ rights are a form of fraud. When a debtor obtains property with the intent to defraud creditors, he engages in “actual fraud.”
- ii. The structure, history, and purpose of § 523(a)(2)(A) confirm that actual fraud does not require a misrepresentation.
1. Before 1978, the provisions exempting the discharge of debts already applied to debts for money or property obtained by “false pretenses” and “false representations.” Congress amended the statute to extend the discharge bar to an additional type of wrongdoing that does not necessarily involve a representation. Congress did not amend § 523(a)(2)(A) merely to repeat the range of intentional misrepresentations that the statute already covered.
  2. Section 523(a)(2)(A) bars discharge of “any debt ... for money [or] property ... to the extent obtained by ... actual fraud.” A “debt” means any enforceable obligation, and the phrase “obtained by” requires that the defendant receive money or property as a result of his fraud. Because a transferee who receives property knowing of the fraudulent nature of the conveyance is himself guilty of actual fraud, he “obtain[s]” “money” or “property” “by ... actual fraud.”
  3. Congress has long sought to prevent the Bankruptcy Code from becoming an engine of fraud and corruption. That is the purpose



of § 523(a)(2)(A)’s discharge bar for debts resulting from fraud. In expanding the discharge bar to include “actual fraud,” Congress did not intend to carve out—and thereby encourage—forms of actual fraud that happen not to involve a misrepresentation.

iii. The Fifth Circuit misread *Field*.

1. The *Field* Court never considered (and had no reason to consider) whether misrepresentation is the only type of fraud that can give rise to a nondischargeable debt under § 523(a)(2)(A).
2. The *Field* Court’s methodology—looking to the common-law understanding of actual fraud against which Congress amended the statute in 1978—disproves the Fifth Circuit’s holding because common-law fraud includes an intentional fraudulent conveyance.

iv. The Fifth Circuit relied on the Code’s “fresh start” policy to support its narrow construction of § 523(a)(2)(A). But Congress has determined that protecting victims of fraud outweighs the interest in giving perpetrators of fraud a fresh start.

b. Amici curiae in support of Husky

- i. The National Association of Bankruptcy Trustees. Limiting “actual fraud” under § 523(a)(2)(A) to instances of false representation creates a dangerous loophole that dishonest debtors can exploit. Dishonest debtors can silently transfer assets to insiders and wait more than a year to file a bankruptcy case and prevent creditors and trustees from objecting to the discharge of that debt and a general discharge under § 727(a)(2)(A).
- ii. United States. Generally makes the same arguments made by Husky: common-law actual fraud is not limited to misrepresentation; Congress’s inclusion of the term “actual fraud” demonstrates intent to cover something different from misrepresentation; the purpose of the Code is undermined by allowing discharge of intentional fraudulent conveyances.
- iii. Bankruptcy Law Professors. The Bankruptcy Code enacted in 1978 codified the *Neal v. Clark* distinction between “actual fraud” as intentional fraud and “constructive fraud” as not requiring wrongful intent. The *Field* Court did not (and had no reason to) examine all types of common-law fraud. Fraud is a flexible term encompassing many different unfair ways in which humans can cheat another.

c. Ritz’s arguments

- i. The Supreme Court’s analysis in *Field* should carry the day.
  1. By utilizing the same statutory construction tools that the Court applied in *Field*, the Debtor argues that Section 523(a)(2)(A) makes a debt nondischargeable under “actual fraud” only where the fraud is the product of a misrepresentation that induced the creditor to part with money, property, services, or credit.
  2. “Actual fraud” is a term of art that carries with it a common law meaning. To determine that actual fraud means under the statute, courts must look at that concept as it was understood when Section 523(a)(2)(A).
    - a. According to the Debtor, that precise question has already been answered in *Field*. By looking to the Restatement of Torts, the Debtor argues that the Supreme Court adopted the most “widely accepted distillation” of the common law in 1978 and concluded that actual fraud requires a misrepresentation.
    - b. One of the core distinctions between actual fraud and other torts is that actual fraud injures the victim by inducing reliance. Therefore, actual fraud must necessarily first involve a statement or conduct on which the victim could have relied.
- ii. The conclusion that “actual fraud” requires a misrepresentation is confirmed by the surrounding statutory text.
  1. The language of Section 523(a)(2)(A) bars discharge of a debt “to the extent obtained by ... actual fraud.” Inherent in the language, “to the extent obtained by,” there is an element of causation, requiring some degree of reliance by the creditor.
  2. This was the question in *Field* (*i.e.*, What degree of reliance is required? “Reasonable” or “justifiable?”). According to the Debtor, if the statute could apply without any reliance at all, there would have been no need for the Supreme Court to consider this issue.
  3. Therefore, by using language in the statute that requires a creditor to have relied on the debtor’s fraudulent scheme or conduct, Congress confirmed that actual fraud requires some misrepresentation on which the creditor could have relied.

- iii. Other parts of the Bankruptcy Code protect creditors from the conduct at issue in this case.
  - 1. Section 727(a)(2)(A) provides an absolute bar to discharge for a Chapter 7 debtor who, “with the intent to hinder, delay, or defraud a creditor,” has or has permitted to be “transferred, removed, destroyed, mutilated, or concealed ... property of the debtor, within one year before the date of filing of the petition.”
  - 2. Section 523(a)(6) bars discharge of “any debt ... for willful and malicious injury by the debtor.” According to the Debtor, this provides a much more direct avenue for dealing with a situation in which a debtor has participated in an asset transfer to intentionally cheat a creditor out of money.

## VI. Predictions/Commentary

- a. Before the Supreme Court granted cert, SCOTUS Blog described this as a “petition to watch.”
- b. One legal website (Law360) describes the importance of this case: “Although the question presented to the Supreme Court involves the relatively narrow concept of ‘actual fraud’ in Section 523(a)(2)(A) for purposes of a debtor’s discharge in bankruptcy, the larger issue is the balance between the interests of debtors and creditors in bankruptcy. Although the purpose of the discharge is to give a debtor a fresh start, the bankruptcy process is meant to be equitable for the debtor as well as each of the debtor’s creditors. The Supreme Court’s decision has the potential to further solidify this equilibrium and ensure that the debtor and its creditors are on equal ground.”
- c. Argument in this case is scheduled for March 1, 2016.