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High Court Bankruptcy Ruling Is a Warning to Joint Obligors

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In a unanimous decision, the U.S. Supreme Court held that Section 523(a)(2)(A) of the U.S. Bankruptcy Code precludes a debtor from discharging a debt obtained by fraud, regardless of the debtor's own culpability.

In *Bartenwerfer v. Buckley*,[1] issued Feb. 22, the court took a deep dive into the passive voice word choice in the statute and concluded that "[Section] 523(a)(2)(A) turns on how the money was obtained, not who committed fraud to obtain it."

As background, in 2005, the debtor and her then-boyfriend jointly purchased a house in San Francisco. Acting as business partners, the pair decided to remodel and flip the property.

The boyfriend took charge of the project, hiring the vendors, reviewing invoices and signing checks, while the debtor was largely uninvolved. Before selling the house, the couple filled out a required disclosure statement, attesting that they were unaware of defects and that alterations or repairs had been made with necessary permits.

Yet after the house was sold, the buyer discovered several defects that the couple had not divulged, along with permit problems. Alleging that he had overpaid in reliance on the couple's fraudulent misrepresentations, the buyer sued the couple in California state court.

The jury found in the buyer's favor, leaving the couple jointly responsible for more than $200,000 in damages.

The couple filed for Chapter 7 bankruptcy protection, in part to discharge the judgment debt. The buyer filed an adversary proceeding contesting the dischargeability of the judgment.

After a two-day bench trial, the bankruptcy court decided the couple could not discharge the debt because, based on the evidence presented, the boyfriend had knowingly concealed the house's defects from the buyer.

The court then imputed the boyfriend's fraudulent intent to the debtor — who evidently had none — because the two had formed a legal partnership to execute the renovation and resale project.

On appeal, the U.S. Court of Appeals for the Ninth Circuit's Bankruptcy Appellate Panel agreed that the boyfriend’s debt was nondischargeable due to his fraudulent intent.

However, the BAP disagreed with the bankruptcy court’s conclusion that the debtor’s debt was nondischargeable, finding that Section 523(a)(2)(A) barred her from discharging the debt only if she knew or had reason to know of the fraud.

Ultimately, the Ninth Circuit reversed, holding that a debtor who is liable for her partner’s fraud cannot discharge that debt in bankruptcy, regardless of her own culpability. The U.S. Supreme Court granted certiorari to resolve confusion in the lower courts on the meaning of Section 523(a)(2)(A).

The Supreme Court began its analysis with the statute at issue. Section 523(a)(2)(A) states:

A discharge under section 727 … 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, other than a statement respecting the debtor’s or an insider’s financial condition.

The court found that by its very terms the section precluded the debtor’s discharge of the debt.

First, she is an “individual debtor.” Second, the judgment is a “debt.” And third, because the debt [arose] from the sale proceeds obtained by [her boyfriend’s] fraudulent misrepresentations, it is a debt for money … obtained by … false pretenses, a false representation, or actual fraud.

The court rejected the debtor’s primary argument, that the statute is most naturally read to bar the discharge of debts obtained by the debtor’s fraud.

The court declined to follow such a limitation, noting Congress framed Section 523(a)(2)(A) to “focu[s] on an event that occurs without respect to a specific actor, and therefore without respect to any actor’s intent or culpability.”

The debt, the court held, must result from someone’s fraud, but Congress was “‘agnosti[c]’ about who committed it.”

The court analyzed other subsections of Section 523(a)(2) that specifically reference the culpability of the debtor. Section 523(a)(2)(B) bars the discharge of debts arising from the

use of a statement in writing—(i) that is materially false; (ii) respecting the debtor’s or an insider’s financial condition; (iii) on which the creditor to whom the debtor is liable … reasonably relied; and (iv) that the debtor caused to be made or published with intent to deceive.

Section 523(a)(2)(C) bars the discharge of recently acquired “consumer debts owed to a single creditor and aggregating more than $500 for luxury goods or services incurred by an individual debtor” and “cash advances aggregating more than $750 … obtained by an individual debtor.”

The court noted “[u]nlike subparagraph (A), the discharge exceptions in subparagraphs (B) and (C) expressly require some culpable act on the part of the debtor" and noted "'[w]hen Congress includes particular language in one section of a statute but omits it in another section of the same Act,' we generally take the choice to be deliberate."

Additionally, the court held that its precedent and Congress's response to it supported its holding.

In *Strang v. Bradner* in 1885, the court held that the fraud of one partner should be imputed to the other partners, who "received and appropriated the fruits of the fraudulent conduct." The court held this way even though the relevant 19th-century discharge exception for fraud limited disallowance to those debts that were "created by the fraud or embezzlement of the bankrupt."

When Congress next revised the bankruptcy law, it deleted the phrase "of the bankrupt" from the discharge exception for fraud. According to the court, the unmistakable implication is that Congress embraced Strang's holding.

Lastly, the debtor argued to hold her liable for the debt would run contrary to the fresh start policy of modern bankruptcy law. However, the court noted that the Bankruptcy Code is not "focused on the unadulterated pursuit of the debtor's interest."

Instead, the Bankruptcy Code seeks to balance multiple, often competing interests, including those of creditors. Moreover, while the debtor attempted to portray the situation as a liability being imposed on a hapless bystander, the court found that fraud liability generally requires a special relationship to the wrongdoer — such as a partnership — and even then, defenses to liability do exist.

And, because Section 523(a)(2)(A) takes the debt as it finds it, the court noted that if California did not extend liability to honest partners, the Bankruptcy Code would have no role to play, suggesting that any fairness-based critiques are better directed toward state law imposing liability on the honest partner.

For these reasons, the court affirmed the Ninth Circuit's judgment against the debtor.

As noted, although the Bankruptcy Code is designed to afford debtors a fresh start, that is only part of the protected interests in play.

As the Supreme Court recognized, the code is designed to protect creditor interests, to make sure similarly situated creditors are treated equally, and, as relevant here, that creditors can seek to have certain debts, including those procured by fraud, excepted from discharge.

This opinion is the latest of pro-creditor opinions issued by the court, including *City of Chicago, Illinois v. Fulton* in 2021,[2] in which the Supreme Court held that Section 362(a)(3) prohibits only affirmative acts that would change the status quo of estate property as of the time a bankruptcy petition is filed and that, therefore, an entity's mere retention of estate property after the filing of a bankruptcy petition does not violate Section 362(a)(3).

The aftermath of Fulton saw creditors successfully defend claims of automatic stay violations including whether a creditor's failure to withdraw a prepetition attachment lien on the funds in a debtor's bank account violated the automatic stay,[3] and whether a city's refusal to immediately lift a prepetition garnishment upon the debtor's commencement of a bankruptcy case violated the automatic stay.[4]

The Supreme Court's decision in Bartenwerfer opens the door to increased litigation surrounding the dischargeability of joint debts.

Business owners need to be vigilant in monitoring the activities of their partners, recognizing that they may not be able to file bankruptcy to avoid the consequences of joint liability born out of a partner's fraud.

And, although the opinion highlights the heightened risks to debtors posed as members of a partnership and other business relationships, its reach may exceed well beyond liability for the fraud of a business partner.

We can expect creditors to test the reach of the ruling in other situations that may create imputed liability, including instances where the corporate veil is pierced, and an individual becomes liable for the fraud of a business entity.

Beyond this, joint obligors need to take warning. It is not difficult to imagine a claim brought against an unknowing guarantor of the obligations of someone who deceived the lender into making the loan.

And, in community property states, where the debts of one spouse are owed by both spouses, creditors may have found a path to attribute the fraud of one spouse into the nondischargeability of the innocent spouse's obligations in bankruptcy.

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[1] https://www.consumerfinancialserviceslawmonitor.com/wp-content/uploads/sites/880/2023/02/Bartenwerfer-v.-Buckley.pdf.

[2] 141 S. Ct. 585 (2021).

[3] In re Margavitch , 2021 Bankr. LEXIS 2784 (M.D.Pa 2021).

[4] In re Stuart . 632 B.R. at 533 (9th B.A.P. 2021).

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