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SCOTUS: Bankruptcy Doesn't Erase Debts Incurred by the Fraud of Another

Insight — April 2023

This article was originally published in the April 2023 issue of Bench & Bar of Minnesota, Minnesota State Bar Association. Republished with permission.

The United States Supreme Court recently answered the question of whether a debtor in bankruptcy can discharge a debt resulting from another person's fraud, even if the debtor is not aware of the fraud. On February 22, 2023, the high court decided *Bartenwerfer v. Buckley*,[1] ruling unanimously that a debtor could not use the protection of bankruptcy to avoid paying a debt that resulted from the fraud of a partner. The debt is nondischargeable in bankruptcy even though the debtor had no culpability—she did not know and could not have known about the fraud.

A cornerstone of modern bankruptcy law is the discharge. The discharge is the statutory forgiveness of liability for debts not otherwise addressed in a bankruptcy case. It facilitates the “fresh start” policy of the bankruptcy laws by freeing the honest, but unfortunate, debtor from the financial burdens of debt. Bankruptcy, however, strikes a balance between the interests of debtors and creditors. Congress enacted §523 of the Bankruptcy Code to reflect a policy that certain debts should be excepted from the discharge when the creditor's interest in recovering a particular debt outweighs the debtor's interest in a fresh start. One such exception is set forth in §523(a)(2)(A), which precludes a debtor from discharging any debt for money to the extent “obtained by… fraud.”

Factual background

Kieran Buckley sued Kate and David Bartenwerfer after discovering defects in a San Francisco house that he purchased from the couple in 2007. The Bartenwerfers remodeled the home after purchasing it to resell it at a profit. They subsequently sold the property for more than $2 million to Buckley, a real estate developer. The couple made disclosures in connection with the sale and attested that they had disclosed all material facts relating to the property. Buckley later discovered several undisclosed defects with the home.

Buckley sued the Bartenwerfers in state court for misrepresentation, arguing that the couple were partners in the remodeling project and sale transaction. He secured a judgment against both Kate and David Bartenwerfer as partners of more than $200,000 for breach of contract, negligence, and nondisclosure of material facts.[2]

The Bartenwerfers filed for protection under Chapter 7 of the Bankruptcy Code. Buckley commenced an adversary proceeding seeking to have the amount awarded declared nondischargeable under the fraud exception set forth in 11 U.S.C. §523(a)(2)(A)—which excepts from the bankruptcy discharge "any debt… for money… to the extent obtained by… false pretenses, a false representation, or actual fraud."

Lower courts reach opposite conclusions

The bankruptcy court found that David committed fraud and imputed his fraudulent intent to Kate. The court reasoned that the two had effectively formed a legal partnership to renovate and sell the property. The bankruptcy court therefore found the debt to be nondischargeable.

Kate appealed to the bankruptcy appellate panel, which found that §523(a)(2)(A) barred her from discharging the debt only if she knew or had reason to know of David's fraud. On remand, the bankruptcy court determined that Kate lacked such knowledge and permitted the discharge of the debt. The Ninth Circuit Court of Appeals reversed on further appeal, finding that a debtor who is liable for the fraud of a partner is not able to discharge that debt in bankruptcy, regardless of the individual's own culpability.

The Supreme Court's decision

The Supreme Court affirmed the decision of the Ninth Circuit, resolving a circuit split over the dischargeability of such debts in bankruptcy.[3] In an opinion authored by Justice Barrett, the Court found that the Bankruptcy Code, "[b]y its terms" precludes the discharge of the debt. The Court rejected the debtor's argument that an ordinary English speaker would understand that "money obtained by fraud" as used in §523(a)(2)(A) of the Bankruptcy Code means money obtained by the individual debtor's fraud.[4] The Court found that the text of the statute is written in a passive voice and does not specify a fraudulent actor. The Court disagreed with the contention that the passive voice "hides the relevant actor in plain sight."[5] Rather, the passive voice used by Congress "pulls the actor off the stage."[6]

Section 523(a)(2)(A) is framed by Congress to be agnostic with respect to who committed the fraud. What is important is not the identity of the actor, but the event that occurred. The intent or culpability of the actor is, unlike neighboring provisions of §523(a)(2)(B) and (a)(2)(C) of the Bankruptcy Code, not a focus. The Court pointed out that in the relevant context of common law fraud, fraud liability is not confined to the wrongdoer. Courts, for example, have long held principals liable for the fraud of their agents[7] and held partners jointly liable.[8]

The Court also considered its textual analysis of the fraud exception to discharge in the context of the statute's history. Congress reenacted the statute when it overhauled the Bankruptcy Code in 1978 and deleted "of the bankrupt" from the exception for fraud that was in place under the predecessor statute. By doing so, Congress excised the actor from the statute. In addition, the Court underscored a Supreme Court decision from 1885 which found that two partners were liable for a debt attributable to the claims of a third partner even though they were not "guilty of wrong."[9]

The debtor invoked the "fresh start" policy of modern bankruptcy law to support the argument that precluding faultless debtors from discharging debts for frauds they did not commit is inconsistent with that policy. The Court emphasized that §523's aim of barring certain debts from discharge is a reflection of countervailing policies distinct from wiping the slate clean. In any event, the discharge exception embodied in §523(a)(2)(A) addresses the debt as it is. It does not define the scope of a debtor's liability for the fraud of another—that is the function of underlying nonbankruptcy law.[10]

The statute turns on how the money subject to the debt was obtained, not on who committed the fraud to obtain it or any actor's intent or culpability. The Court adopted a nationwide rule in favor of victims of fraud to seek compensation for losses by precluding those who are liable, even if not culpable, from discharging that debt in bankruptcy. Congress has concluded that a creditor's interest in recovery of full payment of debts resulting from fraud outweighs a debtor's interest in a complete fresh start.[11]

The concern over the consequences of the Supreme Court's decision in *Bartenwerfer v. Buckley* will be with respect to the imputation of liability. As the debtor argued in her petition for *certiorari*, an adverse ruling on the issue "potentially impacts every joint transaction or endeavor that may be construed as a partnership, including transactions involving married persons and couples, even the sale of a family home." The Court, however, pointed out that the law of fraud does not impose liability "willy-nilly on hapless bystanders" and an ordinarily faultless individual is responsible for another's debt only when there is a special relationship between the parties.

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Notes

[1] __ U.S. __, No. 21-908, 2023 U.S. LEXIS 943 (2/22/2023).

[2] The debt has, as a function of interest and time, ballooned to over $1 million.

[3] *Compare In re M.M. Winkler & Assoc.*, 239 F.3d 746, 749 (5th Cir. 2001) (finding that any debts that arise from fraud are nondischargeable) with *In re Walker*, 726 F.2d 452, 454 (8th Cir. 1984) (finding a debt to be

nondischargeable only if the debtor knew or should have known of the fraud).

[4] As positioned by the debtor, any other interpretation would bar the liability perpetrated by another from the discharge in bankruptcy without any act, omission, intent, or knowledge on the part of the debtor.

[5] *Bartenwerfer v. Buckley*, __ U.S. __, 2023 U.S. LEXIS 943 *10 (2/22/2023).

[6] *Id.*

[7] *Id.* at *11 (citing *McCord v. Western Union Telegraph Co.*, 39 N.W. 315, 317 (Minn. 1888).

[8] *Id.* at *12 (citing *Tucker v. Cole*, 11 N.W. 703, 703-04 (Wis. 1882)). “Understanding 523(a)(2)(A) to reflect the passive voice's 'antagonism' is this consistent with the age-old rule that individual debtors can be liable for fraudulent schemes they did not devise.” *Id.*

[9] *See Strang v. Bradner*, 114 U.S. 555 (1885) (rejecting the contention that a lack of knowledge or intent serves as a basis to discharge a debt incurred by a partner under predecessor statute).

[10] *Buckley*, __ U.S. __, 2023 U.S. LEXIS 943 *19.

[11] *Id.* at *20. Justices Sotomayor, with whom Justice Jackson joined, authored a concurrence and indicated that §523(a)(2)(A) incorporates the common-law principles of fraud and bars debts obtained by fraud of a debtor's agent or partner. Justice Sotomayor found noteworthy that the Court was not confronting a situation involving a fraud by a person bearing no agency or partner relationship to the debtor. *Id.* at *22. It involved two people who acted together in a partnership. *Id.*
