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Husky International Electronics, Inc. v. Ritz: "Actual Fraud" According to the SCOTUS

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On May 16, 2016, the Supreme Court of the United States delivered another in a long string of recent bankruptcy opinions with *Husky Int'l Electronics, Inc. v. Ritz*, Case No. 15-145. In *Husky*, Justice Sotomayor delivered a 7-1 majority opinion holding that the term "actual fraud" contained in the Bankruptcy Code's §523(a)(2)(A) exception to discharge applies where the debtor evades creditors through a fraudulent transfer, even without a false representation. The Court's ruling reverses a 5th Circuit decision and resolves a split among circuits, the 4th Circuit among those being reversed.

Husky International Electronics ("Husky") supplied goods to Chrysalis Manufacturing Corp. ("Chrysalis"), a company partially owned and directed by Daniel Lee Ritz, Jr. When Chrysalis failed to pay a debt of approximately $164,000, Husky sought to hold Ritz personally liable, alleging that Ritz bled Chrysalis of assets it could have used to pay debts by transferring such assets to other entities Ritz controlled. When Ritz filed for Chapter 7 bankruptcy, Husky filed a complaint seeking a determination that the debt owed to Husky was non-dischargeable because the intercompany transfers constituted "actual fraud" under the discharge exception in codified §523(a)(2)(A). The District Court held that though Ritz could be held personally liable for Chrysalis' debt under applicable Texas law, the debt was not "obtained by … actual fraud" under §523(a)(2)(A) and could be discharged by Ritz. The 5th Circuit affirmed, holding that a misrepresentation from the debtor to the creditor is a necessary element of "actual fraud," and in this case, Ritz made no false representation to Husky.

The Supreme Court agreed to review the matter, and after oral arguments conducted on March 1, 2016, concluded that the term "actual fraud," as it is used in §523(a)(2)(A), includes forms of fraud, such as fraudulent conveyances,

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which may occur without a false representation. The term "actual fraud" was added to §523(a)(2)(A) in 1978, the statute already excepting from discharge any debts "obtained by … false pretenses or false representations." In reaching its conclusion, the Court reasoned that if actual fraud required a false representation, then the terms essentially had the same meaning and Congress' specific addition of the term "actual fraud" would have been superfluous. The Court found further support in historical bankruptcy and common law usage of the terms "actual" and "fraud," noting that "anything that counts as "fraud" and is done with wrongful intent is "actual fraud."" Going back even further in history – to 1571 and the principals of the Statute of 13 Elizabeth – the Court recognized that the phrase "actual fraud" has long encompassed the type of scheme alleged to have occurred when Ritz transferred assets to his other companies and avoided paying debt owed to Husky.

Addressing Ritz's assertion that interpreting "actual fraud" to include fraudulent transfers would be duplicative of other exceptions to discharge enumerated by §523(a) (specifically, §523(a)(4), which excepts debts for fraud while acting as a fiduciary, and §523(a)(6), which excepts debt for willful and malicious injury), the Court conceded that there was some overlap in the conduct covered, but that the provisions each had meaningful distinctions and were therefore not redundant. The Court also found §523(a)(2)(A) to be "meaningfully different" from §727(a)(2), as the former renders non-dischargeable a specific debt where the latter prevents a debtor who engaged in fraudulent transfers in the year preceding bankruptcy from obtaining any discharge in Chapter 7.

Justice Thomas was the lone dissenter, writing that while he agreed with the majority that the common law meaning of "actual fraud" encompassed the type of fraudulent conveyance at issue in the case, the term "obtained by" prevents the reach of §523(a)(2)(A) to such conduct. Specifically, he concluded that in order for debt to be "obtained by" actual fraud, it must occur at the inception of the transaction and noted that the majority ignored its own precedent in *Field v. Mans*, 516 U.S. 59 (1995), which found that actual fraud requires reliance on a false statement, misrepresentation or omission.

The 4th Circuit, having analyzed §523(a)(2)(A) many times in recent history, has focused its inquiry strictly on whether a misrepresentation occurred. Specifically, courts in the 4th Circuit have detailed that in order to make debt non-dischargeable under §523(a)(2)(A), a plaintiff must prove the following elements:

"(1) that a debtor made a representation;
(2) that at the time the representation was made, the debtor knew the representation was false;
(3) That the debtor made the false representation with the intention of deceiving a creditor;
(4) That the creditor relied on such representation; and
(5) That the creditor sustained the alleged loss and damage as the proximate result of the false representation."

See e.g., *In re Hathaway*, 364 B.R. 220, 232 (Bankr. E.D.Va. 2007), *citing In re Biondo*, 180 F.3d 123, 130 (4th Cir. 1999); *In re McKnew*, 270 B.R. 593, 617 (E.D.Va. 2001). In many such decisions, the court has acknowledged that the 7th Circuit Court of Appeals and the 6th Circuit Bankruptcy Appellate Panel have adopted a broader definition of "actual fraud" for the purposes of §523(a)(2)(A), which encompasses "general tricks and deceit" without the need for a misrepresentation. *Id. See McClellan v. Cantrell*, 217 F.3d 890, 893 (7th Cir.); *In re Vitanovich*, 259 B.R. 873, 877 (B.A.P. 6th Cir. 2001). The Supreme Court has now made clear that it agrees.

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