

High Court Holds Imputed Liability for Fraud is Non-Dischargeable Under Bankruptcy Code Section 523

By: Travis Powers

Financial Restructuring and Bankruptcy Alert

2.23.23

On February 22, 2023, the United States Supreme Court (the "Court") held that an individual chapter 7 debtor could not discharge a state court judgment arising from the fraudulent acts of her business partner even though the debtor played no part in the fraud. In *Bartenwerfer v. Buckley*,^[1] the Court affirmed a decision by the Ninth Circuit Court of Appeals (the "Ninth Circuit"), which reversed a decision of the Bankruptcy Appellate Panel for the Ninth Circuit (the "Ninth B.A.P.").

Factual Background and Procedural History

In 2005, Kate Bartenwerfer (the "Debtor") and her then-boyfriend, David, purchased a home as business partners with the intent of renovating and selling the same. David controlled renovations while the Debtor remained largely uninvolved. The pair sold the home and, in the process, attested that they had disclosed all material facts relating to the property. The purchaser soon discovered undisclosed defects with the home and sued the Debtor and David in California state court. A jury found in the purchaser's favor resulting in a judgment against the Debtor and David, jointly and severally, of more than \$200,000 (the "Judgment").

The Debtor and David subsequently filed for chapter 7 relief in the United States Bankruptcy Court for the Northern District of California (the "Bankruptcy Court"). The purchaser commenced an adversary proceeding in the chapter 7 case asserting that the Judgment was nondischargeable pursuant to Bankruptcy Code section 523(a)(2)(A), as a "debt . . . for money . . . obtained by . . . false pretenses, a false representation, or actual fraud . . ."^[2] The Bankruptcy Court: (i) found that David had knowingly committed fraud by concealing the home's defects; (ii) imputed David's fraudulent intent to the Debtor; and (iii) held that neither could discharge the Judgment. On appeal, the Ninth B.A.P. held that the Debtor could discharge the Judgment unless she knew or should have known of David's fraud. On remand, the Bankruptcy Court found that the Debtor lacked such knowledge and could discharge her liability for the Judgment, which finding was affirmed by the Ninth B.A.P. The Ninth Circuit reversed, holding that a debtor liable for a partner's fraud could not discharge a debt arising therefrom, regardless of the debtor's culpability.

The Court's Rationale

On appeal, the Court affirmed the Ninth Circuit's decision in an opinion penned by Justice Barrett. The Court, beginning with a straightforward analysis of Bankruptcy Code section 523(a)(2)(A), found that "[b]y its terms, the text precludes [the Debtor] from discharging her liability for the state-court judgment."^[3] Specifically: (i) the Debtor is an "individual debtor"; (ii) the Judgment is a "debt"; and (iii) the Judgment is a debt "for money . . . obtained by . . . false pretense, a false representation, or actual fraud," or, more succinctly, from David's fraudulent misrepresentations. The Debtor argued that even though Bankruptcy Code section 523(a)(2)(A) does not specify *whose* fraud is nondischargeable, the "relevant actor" is hidden in plain sight; "the statute is most naturally read to bar the discharge of debts for money obtained by *the debtor's* fraud."^[4] Nevertheless, the Court held that in section 523(a)(2)(A) Congress focused solely on the occurrence of an event (fraud) without reference to an actual actor or, more importantly, "to any actor's intent or culpability."^[5] Therefore, according to the Court, "[t]he debt must result from someone's fraud, but Congress was 'agnosti[c]' about who committed it."^[6] The Court further noted that its decision is supported in the context of common law fraud where courts have long held individuals liable for the frauds committed by their partners within the scope of the partnership regardless of guilt.

Additionally, though the neighboring subsections of section 523 bar discharge of liability arising explicitly from a debtor's actions (*i.e.*, sections 523(a)(2)(B) and 523(a)(2)(C)), the Court noted that "[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."^[7] The Court further noted that almost 150 years ago it held that an individual debtor could not discharge liability arising from a business partner's fraud despite the fact that the predecessor to section 523(a)(2)(A) stated, "no debt created by the fraud . . . of the bankrupt . . . shall be discharged . . ."^[8] The Court stated that the "unmistakable implication" in the drafting of section 523(a)(2)(A) was that Congress embraced the Court's holding in *Strang* by omitting reference to the "bankrupt" or "debtor."

Finally, the Debtor argued that nondischargeability of the Judgment impeded the fresh start policy of the Bankruptcy Code. Nonetheless, the Court found that the Bankruptcy Code balances competing interests of debtors and their creditors and, at times, the creditor's interest in recovering a particular debt outweighs the debtor's interest in a fresh start.

In a brief concurrence, Justice Sotomayor, joined by Justice Jackson: (i) highlighted the fact that the Debtor did not dispute that she and David acted as partners in the purchase, renovation, and sale of the home; and (ii) confirmed that the applicable legal context concerned fraud by a partner within the scope of a partnership.

If you have questions or would like additional information, please contact Travis Powers (powerst@whiteandwilliams.com; 212.868.4837).

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

[2] 11 U.S.C. § 523(a)(2)(A).

[3] 2023 U.S. LEXIS 943, at *9.

[4] 2023 U.S. LEXIS 943, at *10 (emphasis in original).

[5] 2023 U.S. LEXIS 943, at *11.

[6] 2023 U.S. LEXIS 943, at *11 (*quoting* *Watson v. U.S.*, 552 U.S. 74, 81 (2007)).

[7] 2023 U.S. LEXIS 943, at *14 (internal quotations omitted).

[8] 2023 U.S. LEXIS 943, at *16 (*quoting* Act of Mar. 2, 1887, §33, 14 Stat. 533 (emphasis added) (*citing* *Strang v. Bardner*, 114 U.S. 555 (1885)).

This correspondence should not be construed as legal advice or legal opinion on any specific facts or circumstances. The contents are intended for general informational purposes only and you are urged to consult a lawyer concerning your own situation and legal questions.

