By David R. Kuney[1]

Supreme Court's Vicarious Liability Approach to Discharge Needs Congressional Reform

David R. Kuney
Georgetown University Law Center
Washington, D.C.

David Kuney is an adjunct professor at the Georgetown University Law Center and teaches the Bankruptcy Advocacy Practicum. He is also a past member of ABI's Board of Directors.

On Feb. 22, 2023, the U.S. Supreme Court handed down its unanimous decision in *Bartenwerfer v. Buckley*.[2] For those interested in protecting the core notion that an honest debtor is entitled to a discharge, the decision is disappointing, with far-reaching consequences. For Kate Bartenwerfer, it is devastating. The decision seems to be part of a recent pattern in which the Court adopts a more pro-creditor stance and is less attentive to the financial distress of the individual debtor.

The question presented arose under the Bankruptcy Code's section setting forth an exception to debts that may be discharged. Section 523(a)(2)(A) states that a "discharge ... does not discharge an individual debtor from any debt ... for money, property [or] services ... to the extent obtained by ... actual fraud." Bartenwerfer did not commit actual fraud herself, but the court found that her husband did in connection with the renovation and sale of their home (which they jointly owned) to the respondent. The question was whether Bartenwerfer could lose her discharge for "actual fraud" on the grounds that she was "vicariously liable" for the fraud of her husband/partner. The *amici* argued that the answer is "no," because § 523(a)(2)(A) requires "actual fraud," which includes *scienter* or intent, and the requirement for intent precludes reliance on vicarious liability.

Oral argument focused on the statutory issues and revealed the need for a congressional amendment. Justice Elena Kagan asked whether Congress had been careless in drafting § 523(a)(2)(A).[3] Justice Amy Coney Barrett asked whether the section was an "anomaly," meaning that it seemed oddly different from the rest of § 523 — where vicarious liability does *not* apply.[4] Justice Sonia Sotomayor wanted to know whether an ancient case, *Strang v. Bradner*,[5] controlled.[6] Justice Clarence Thomas asked just how far one could take vicarious liability; if there was a family partnership, would an infant or a minor child also lose its discharge if a family member had engaged in fraud?[7]

Despite the anomaly, the unanimous court held that vicarious liability would apply to block a discharge of an individual debtor, even an honest debtor. The Court held that the statute was written in the passive voice, and that the "[p]assive voice pulls the actor off the stage ... [the Code] conveys only that *someone's* [fraud blocks the discharge]."[8] Further, the common law has "long maintained that fraud liability is not limited to the wrongdoer,"[9] and that courts "have traditionally held principals liable for the frauds of their agents."[10]

A significant part of the decision was based on the somewhat anomalous notion that spouses are "partners" in the legal sense, even where they may have no idea what the term signifies. The Court stated that "the two had formed a legal partnership to execute the renovations and resale [of their home]."[11] However, from the proceedings before the Court it is hard to fathom what that meant; they had no formal partnership agreement, had no lawyer arrange the "partnership" and seemingly were speaking in a colloquial fashion. How exactly did they "form" a partnership? Bartenwerfer acknowledged that she and her husband were "partners" in the sale of the house, but did she even understand the basic legal concept of what a "partnership" is? Are spouses always acting as "agents" for one another when they conduct family transactions? Nevertheless, the Court found that the couple was "[a]cting as business partners,"[12] and from this it was willing to impose vicarious liability. This is mostly because of *Strang*, a 19th century case involving true commercial partners, and despite an abundance of case law that requires intent for "actual fraud" to have occurred — a notion that is counter to assigning liability to one without such intent.

The Supreme Court's decision could force thousands of individual debtors into "permanent or at

1 Mr. Kuney was the author of an *amicus* brief submitted on behalf of Hon. **Judith K. Fitzgerald** (ret.) of Tucker Arensberg PC, Hon. **Robert E. Gerber** (ret.) of Joseph Hage Aaronson LLC and Hon. **Eugene R. Wedoff** (ret.), along with a group of law professors in support of the petitioner (Bartenwerfer). The *amicus* brief can be found at bankruptcyadvocacy.net/briefs-filed (last visited Feb. 27, 2023).
2 Case No. 21-908.
3 Transcript of Oral Argument of Dec. 6, 2022, at 4 and 75.
4 Trans. Oral Arg. at 45.
5 114 U.S. 555 (1885).
6 Trans. Oral Arg. 74.
7 Trans. Oral Arg. 40.
8 *Slip op.* at 5.
9 *Id.*
10 *Id.*
11 *Slip op.* at 3.
12 *Slip op.* at 1.

least indefinite pauperism," and could do so in the context of a marital relationship where an innocent spouse loses a discharge because of the wrongdoing of the other spouse.[13] Bartenwerfer now faces a claim of more than $1.3 million for a wrong committed by her husband. A ruling that a spouse can lose his/her discharge through a spouse's misconduct runs deeply counter to notions of protection for the honest debtor and would be injurious to marital relationships. Whether the concurrence by Justice Sotomayor will ameliorate this outcome in future cases remains to be seen.

Actual Fraud Is Not Constructive Fraud nor Implied Fraud

The Court began with a close look at the language in § 523(a)(2)(A). It states that "any debt" obtained by "actual fraud" is not discharged. What language suggested that there was an exception for vicarious liability from the broad notion of "any debt"? The question suggested that it might not matter "whose debt" was involved, as long as the debt was obtained by fraud. Justice Thomas noted that § 523(a)(6) states that the exception to the discharge pertains to willful misconduct "by the debtor," but that this phrase was not in § 523(a)(2)(A) and that this worked against the petitioner.[14] Justice Kagan asked, "Why is that we should essentially insert the words 'the debtor's own fraud'?"[15]

The question of whose debt it is is answered in part by looking at the meaning of "actual fraud" as interpreted by the Supreme Court. As its precedent instructs, "actual fraud" requires "intent," and once intent is required, then the proper focus is only on the debtor's fraud — and not on someone else.[16] Intent cannot be transferred. That is why in the surrounding sections of § 523 where intent is expressly required (*e.g.*, willful), there is broad agreement that vicarious liability is not sufficient to deny a discharge.[17]

The Court stated that the "linchpin" of its decision was when Congress revised the Bankruptcy Code "post-*Strang*."[18] We might agree, if only the Court had looked more closely at what the legislative history said following *Strang*. Significantly, no mention was made of *Strang*, which has become a highly criticized case.

The more pertinent post-*Strang* legislation makes it doubtful that Congress wanted to carry *Strang* forward. Instead of looking to *Strang*, the Court looked to the meaning of "actual fraud" as applied in the very context of dischargeability. In *Neal v. Clark*,[19] the question presented was whether actual fraud included "constructive fraud." *Neal* held that a debtor could not lose his discharge on the basis of "constructive fraud," but the Court concluded that the term "fraud" means "positive fraud" and not fraud implied in law. The key notion was that loss of a discharge had to be based on "intentional wrong" and not on a theory of implied liability. The language of the Code "imperatively require[s] the conclusion that 'fraud' referred to in that section means positive fraud, or fraud in fact, involving moral turpitude or intentional wrong, as does embezzlement, and not implied fraud in law, which may exist without the imputation of bad faith or immorality."[20]

If constructive fraud cannot be the basis to deny a discharge, then neither can vicarious liability. They are both legal fictions. Prof. **Ralph Brubaker** of the University of Illinois College of Law has written that "a debtor's vicarious liability for the fraud of another could also be characterized as 'implied or constructive fraud, as the legal fiction of vicarious liability attributes the conduct of one person to another such that the debtor is treated as if he/she had perpetrated the fraud for purposes of the debtor's liability therefor[e].'"[21] Accordingly, this rejection of implied fraud as a bar to a discharge means that vicarious liability is likewise not a valid basis for denial of a discharge.[22] *Neal v. Clark* is controlling.

Neal v. Clark should have been controlling because Congress said it looked to *Neal* when it was drafting the Bankruptcy Code. The legislative history to § 523(a)(2)(A) stated that it was intended to "codify current case law, *e.g.*, *Neal v. Clark*, which interpreted 'fraud' to mean actual or positive fraud rather than fraud implied in law."[23] The legislative history makes no mention of *Strang*;[24] maybe Congress should have said it was overruling *Strang*, but it said enough to make its thoughts known. The rule that Congress adopted was that a discharge could only be lost through actual fraud and not implied fraud, and vicarious liability is a species of implied fraud.

Counsel for Bartenwerfer repeatedly urged the Court to consider its prior ruling in *Bullock v. Bankchampaign NA*,[25] which emphasized the importance of *Neal v. Clark*. The question presented was whether the term "defalcation" in § 523(a)(4) requires a "culpable state of mind." Justice Stephen G. Breyer, writing for a unanimous Court, relied predominantly on the *Neal v. Clark* holding that debts created by fraud or embezzlement "mean positive fraud or fraud in fact involving moral turpitude."[26] This view was consistent, said the Court, with the surrounding provisions and "consistent with the long-standing principle that 'exceptions to discharge' should be confined to those plainly expressed."[27]

These principles go hand in glove, as constructive fraud cannot be a basis to deny a discharge. Vicarious liability is a form of constructive fraud, and § 523(a)(2)(A) requires "actual fraud," not "constructive fraud." This means that

13 Prof. Steven H. Resnicoff, "Is It Morally Wrong to Depend on the Honesty of Your Partner or Spouse: Bankruptcy Dischargeability of Vicarious Debt," 42 *Case W. Rsrv. L. Rev.* 147 (1992).
14 Trans. Oral Arg. 6.
15 Trans. Oral Arg. 24.
16 "Buckley agrees that these common-law torts require wrongful intent; he merely disputes whose intent qualifies." (Pet. Br. at 21) (citing Br. in Opp. 15).
17 *See, e.g., Kronk v. Anthony (In re Anthony)*, Case No. 8:13-bk-00922-RCT, 2019 WL 10734097 at *7 (Bankr. M.D. Fla. 2019) ("[C]ourts uniformly do not recognize vicarious liability to satisfy the willful requirement for a § 523(a)(6) claim because it is one party's liability for the conduct of another.").
18 *Slip op.* at 9.
19 95 U.S. 704 (1877).
20 95 U.S. at 709.
21 Prof. Ralph Brubaker, "The Dischargeability of 'Control Persons' Liability for Federal Securities Fraud: Actual Fraud, Vicarious Nondischargeability and the Vacillating Objects of the § 523(a)(2)(A) Discharge Exception," *Bankruptcy Law Letter* No. 5 (May 2002).
22 Prof. Brubaker nevertheless argues that *Strang* and *Neal*, both authored by Justice John Marshall Harlan, can be reconciled, even though he acknowledges that "at first blush ... *Strang v. Bradner* and *Neal v. Clark* seem hopelessly inconsistent and irreconcilable." *Id.* at *9.
23 124 Cong. Rec. H. 11-095-96 (Sept. 28, 1978).
24 Justice Kagan suggested that after *Strang*, Congress amend "the statute so that the text of the statute actually reflects better the *Strang* holding." Oral Arg. at 33. We respectfully disagree, as the omission of *Strang* and the focus on *Neal* is consequential and reflects a decision not to follow *Strang*.
25 569 U.S 267, 269 (2013).
26 *Id.* at 273.
27 *Id.* at 275 (internal quote mark omitted).

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denial of a discharge is based on the individual culpability of the debtor; the honest debtor still receives a discharge. Despite this, the Court found that the absence of any reference to fraud by the debtor was dispositive.

The Anomaly of § 523(a)(2)(A)

Perhaps Congress needs to amend the Bankruptcy Code. During oral argument, Justice Barrett wondered about the "anomaly" arising from the fact that the surrounding sections in § 523 seemed to exclude vicarious liability. Justice Barrett asked the respondent why it made sense that there was a different rule in § 523(a)(2). Section 523(a)(6) excepts from discharge "willful and malicious injury by the debtor" and thus, all agreed, would exclude vicarious liability. Did the absence of the phrase "by the debtor" in § 523(a)(2)(A) mean that a nearly identical form of conduct in a nearby section would require the opposite result and that a discharge could be based on vicarious liability? As previously noted, case law under § 523(a)(2)(6) expressly rejects the notion of vicarious liability.

The respondent asked the Court to disregard the surrounding provisions and relied instead on the "negative pregnant" rule to argue that because "by the debtor" appears in one part of § 523, but not in (a)(2)(A), Congress did not mean for the fraud to be "by the debtor." Justice Thomas said the absence of this phrase in § 523(a)(2)(A) cut against Bartenwerfer.

However, the reliance on surrounding provisions in the same section is a time-honored principle in bankruptcy jurisprudence. The Court has rejected a nearly identical argument concerning so-called missing language. In *Field*, the question presented was the level of a creditor's reliance on a fraudulent misrepresentation necessary to justify denying a discharge under § 523(a)(2)(A). Section 523(a)(2)(A) does not use the phrase "reasonable reliance," but here the Court refused to apply the "negative pregnant" argument in the same Code section, stating, "If the negative pregnant is the reason that § 523(a)(2)(A) has no reasonable requirement, then the same reasoning will eliminate *scienter* from the very notion of fraud."[28] Just as the absence of the phrase "reasonable" did not preclude it from being implied with respect to the creditor's conduct, so, too, does the phrase "actual fraud" require intent or *scienter* with regard to the debtor's conduct.

The Pernicious Effect of *Strang*

The Court held that *Strang* was controlling, stating that "[t]he unmistakable implication is that Congress embraced *Strang*'s holding — so do we."[29] We think not.

Strang involved a commercial partnership engaged in the business of purchasing wool. One partner, Peter O. Strang, made a fraudulent misrepresentation to a buyer in connection with a sale and was denied a discharge on the basis of actual fraud. Two other partners were found to have had no knowledge of the fraud, yet the Court found that the partners could not escape liability "upon the ground that such misrepresentations were made without their knowledge." Strang looked to the law of general partnerships, although in today's world this form is rarely used, and commercial partners typically adopt legal forms that protect them from vicarious liability — even if the partnership's assets may be exposed to the claim.

Leading scholars reject the application of *Strang* in the marital context. Prof. Steven Resnicoff of DePaul College of Law wrote that *Strang*'s use of vicarious liability to deny a discharge in the context of a marital relationship is "pernicious." He added that "social 'partners' are less able to dissolve their 'partnership' or protect themselves against wrongful 'agents. *Strang* ... punishes those debtors for wrongs they did not commit. Thus, application of *Strang* condemns those innocent debtors to permanent or indefinite pauperism."[30]

The Court was reminded that circuits have frequently refused to apply *Strang* and have predicted its demise. Its continuing vitality is anachronistic, if not "pernicious." The legislative history makes no mention of it, and instead points to *Neal* as the basis for the Code's rule. "Finally, if *Strang*'s reasoning lives on, then much of the modern Bankruptcy Code imputes responsibility. Fresh start would become the exception and not the rule."[31]

Justice Sotomayor concurred and was joined by Justice Ketanji Brown Jackson. Perhaps they meant to signal that they would not extend this case to the normal spousal relationship where there was something short of a true commercial-like partnership. The Court stated that it "does not confront a situation involving fraud by a person bearing no agency or partnership relationship to the debtor. Instead, '[t]he relevant legal context' concerns only fraud by 'agents' and 'partners' within the scope of the partnership. With that understanding, I join the Court's opinion."

Only time will tell whether this caveat by Justice Sotomayor will effectively serve to limit future decisions. If not, the effect may well be "pernicious" in both spousal relationships and other activities by two or more persons where an informal type "partnership" is deemed to have occurred, even without the express knowledge of either so-called "partner." abi

28 *Field*, 67-68. Justice Jackson said, "I'm relying on *Field v. Mans*, which suggested and, in fact, I think held that fraud in the Bankruptcy Code is defined by common law principles. And we do have in common law this notion that people are held responsible for the fraud of agents." Trans. Oral Arg. 10-11.

29 *Slip op.* at 10.

30 Resnicoff, *supra* n.13, at 156.

31 Pet. Br. 15.