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United States Supreme Court Expansively Interprets “Actual Fraud” Bankruptcy Discharge Exception

In its recently issued decision in *Husky International Electronics, Inc. v. Ritz*, a 7-1 majority of the Supreme Court has clarified that intentionally fraudulent transfers designed to hinder or defraud creditors can fall within the definition of “actual fraud” under Section 523(a)(2)(A) of the Bankruptcy Code and can sometimes result in corresponding liabilities being non-dischargeable in a personal bankruptcy proceeding.¹

The facts of the case centered around a series of transfers made by Daniel Lee Ritz, Jr., a director of Chrysalis Manufacturing Corp. The transfers in question were made to various related business entities in which Ritz held substantial equity interests, and were allegedly designed to shield the transferred assets from collection by Husky International Electronics, a creditor and the appellant in the case. Husky sought to hold Ritz personally responsible for the amounts owed to it, but Ritz successfully argued in the lower courts that all such personal liabilities could be discharged in connection with his personal bankruptcy filing.

Although Section 523(a)(2)(A) prohibits debtors from discharging certain debts “obtained by . . . false pretenses, a false representation, or actual fraud,” the Fifth Circuit held that Ritz’s liability was nonetheless dischargeable and that there can be no “actual fraud” unless a debtor makes a false representation to a creditor.

Writing for the Supreme Court majority, Justice Sonia Sotomayor rejected the Fifth Circuit’s holding in favor of a more expansive interpretation of the language of Section 523(a)(2)(A). Drawing on legal history and principles of statutory construction, the Court held that the term “actual fraud” in Section 523(a)(2)(A) was intended to encompass fraudulent conveyance schemes, even when those schemes do not involve a false representation to a creditor. In other words, the mere concealment of assets from creditors can constitute fraud, even in the absence of an untruthful statement being made to a creditor.

At the same time, the majority also recognized that the non-dischargeability provisions of Section 523(a)(2)(A) come into play only when the debt is on account of “money, property, services, or . . . credit” that are “obtained by” the fraud in question. The majority thus also appeared to signal that non-dischargeability would not necessarily apply to the liability of a fraudulent transferor unless the transferor was also in some meaningful sense the transferee. The majority hinted that Ritz’s overlapping ownership of the entities to whom the fraudulent transfers were made might qualify as a circumstance in which such non-dischargeability is triggered, but formally took no position on the matter, leaving this question to be addressed by the Fifth Circuit on remand. Thus, while the

¹ The dischargeability provisions in Section 523 of the Bankruptcy Code are applicable only to debtors liquidating under chapter 7 or to individual debtors under chapter 11, and have no applicability to corporate debtors reorganizing under chapter 11 protection.

Supreme Court has made it clear that at least some liabilities for fraudulent conveyances may be non-dischargeable, the precise parameters of this new holding will remain to be established in future cases.

Because of these unresolved questions, and because the provisions in question do not apply to debtors reorganizing or liquidating under Chapter 11, the Court's holding is in many ways a very narrow one, clarifying the potential for fraudulent transfers to give rise to non-dischargeable debts in a limited set of circumstances.

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This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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