# STRUGGLING WITH THE SUPREME COURT'S APPLICATION OF SECTION 523(A)(2)(A) DISCHARGE EXCEPTIONS TO FRAUDULENT TRANSFERS IN *HUSKY V. RITZ*

## INTRODUCTION

It seems safe to predict that the Supreme Court's decision in *Husky Int'l Elecs. v. Ritz,* 136 S. Ct. 1581; 194 L. Ed. 2d 655; 2016 U.S. LEXIS 3048 (2016) will manage to make everyone unhappy – including courts and counsel for debtors, creditors and trustees. In a manner somewhat reminiscent of its 2011 ruling in *Stern v. Marshall,* 564 U.S. 462 (2011), the Court in *Husky* lets bankruptcy practitioners know they've been mistaken for years about a concept they thought they understood – in this instance, objections to discharge involving property obtained by fraud – while providing little or no practical guidance. The statute at issue, 11 U.S.C. § 523(a)(2)(A), which is commonly used by creditors to object to discharge of debts resulting from misrepresentations by debtors, creates an exception to discharge for:

> any debt . . . for money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained, by –
> (A) false pretenses, a false representation, or actual fraud, other than a statement respecting the debtor's or an insider's financial condition. . .

Stated simply, the Court's holding in *Husky* is that (1) an objection to discharge based on § 523(a)(2)(A) does not require the existence of any misrepresentation to the creditor or reliance by the creditor; and (2) "at least sometimes a debt 'obtained by' a fraudulent conveyance scheme could be nondischargeable." *Husky*, 136 S. Ct. at 1589. Unfortunately, however, the opinion does not explain when this might be true, what "debt" would be non-dischargeable, or whether such a result is even supported by facts in the Husky case, stating (in a footnote) that "we . . .leave it to the Fifth Circuit to decide on remand whether the debt to Husky was 'obtained by' . . .[the] asset-transfer scheme."

It seems likely that years of increased litigation and appeals will be the near-term consequence of the Court's ruling, as courts and counsel attempt to predict answers to many questions which were not addressed. This article briefly summarizes some of the facts and issues in *Husky* and identifies some of the unanswered questions.

## I. FACTS OF THE CASES AND THE LOWER COURT RULINGS

### A. Facts and Rulings in *Husky*

The Chapter 7 debtor in *Husky* was Daniel Lee Ritz, Jr. ("Ritz"), who was the partial owner of several companies, including one known as Chrysalis Manufacturing Corporation ("Chrysalis") that had previously filed its own bankruptcy. Under Ritz's control, between 2003 and 2007 Chrysalis made a series of purchases from Petitioner Husky International Electronics, Inc. ("Husky") but failed to make payment, leaving a debt to Husky of about $164,000. While this debt was outstanding, in 2006-7, Ritz transferred over a million dollars from Chrysalis to at least seven other entities he controlled and owned in whole or in part. Chrysalis then filed a chapter 7 case on June 12, 2008, which was closed in 2009 following a no asset report. According to its bankruptcy Schedules, Chrysalis had $5.2 million in debts, and assets consisting of accounts receivable valued at $900,000. Neither the Schedules nor Statement of Financial Affairs filed by Chrysalis and signed by Ritz mentioned the $1 million in transfers.[1]

In May 2009, Husky sued Ritz in district court to hold him personally liable for the Husky debt on the grounds Ritz orchestrated and personally benefitted (as part owner and person in

[1]These facts, and details regarding the assets and liabilities of Ritz, are not mentioned in the *Husky* opinions, but are taken from the bankruptcy Schedules and Statement of Financial Affairs found on the respective bankruptcy courts' electronic dockets.

control of Chrysalis and the transferees) from the fraudulent transfers. Shortly thereafter, and before Husky's claim could be adjudicated, Ritz filed his own Chapter 7 case, listing debts to creditors (including Husky) totaling $12.7 million, and assets of less than $500,000, mostly consisting of his residence and vehicles.

Husky then filed an adversary complaint against Ritz in his personal bankruptcy, asserting that under § 523(a)(2)(A) Ritz owed a non-dischargeable debt to Husky involving property obtained by Ritz through "actual fraud." More specifically, Husky contended that Ritz (1) orchestrated intentional fraudulent transfers from Chrysalis to his other entities; (2) was the "alter ego" of the companies; and (3) owed a non-dischargeable debt to Husky arising from "property obtained by" Ritz from Chrysalis through "actual fraud" practiced upon Husky within the meaning of § 523(a)(2)(A).

Following a trial, the bankruptcy court made findings that Ritz was not a credible witness on most issues, and that Chrysalis was insolvent when the transfers were made and did not receive reasonably equivalent value in exchange. The court did not make any findings, however, on whether the transfers were made with specific intent to defraud creditors. The bankruptcy court further held that it did not need to address the meaning of § 523(a)(2)(A) because under Texas law Ritz was not the *alter ego* of the companies receiving the transfers, and there accordingly was no basis to find that Ritz had any personal liability for the Husky debt. More specifically, the bankruptcy court determined that for contract matters, Texas law required proof of "actual fraud" involving a misrepresentation in order to reverse pierce the corporate veil, and the evidence was undisputed that Ritz never made any representations, oral or written, on which Husky relied. Interestingly, as discussed below, this issue regarding misrepresentation addressed by the bankruptcy court with regard to Texas law later became a central question considered by appellate courts with regard to the Bankruptcy Code's meaning of "actual fraud" in § 523(a)(2)(A).

When Husky appealed the bankruptcy court's ruling, it was able to convince the district court that the bankruptcy court was wrong regarding Texas law on veil-piercing, and that a fraudulent transfer without any misrepresentation "may qualify as actual fraud" for such purposes. However, the district court nonetheless affirmed the dismissal of Husky's complaint, concluding that according to Supreme Court and Fifth Circuit decisions, § 523(a)(2)(A) imposes its *own* requirement of a misrepresentation by the Debtor for purposes of excepting the debt from discharge through "actual fraud." In other words, the district court concluded that although for purposes of Texas veil-piercing law  "actual fraud" may not require a misrepresentation, the same words in § 523(a)(2)(A) with regard to "property obtained" by "actual fraud" do require a misrepresentation.

In affirming, the Fifth Circuit agreed that a false representation by the debtor "is a necessary prerequisite for a showing of 'actual fraud' under Section 523(a)(2)(A)." Husky,787 F.3d at 319. In so holding, the Fifth Circuit relied heavily on the Supreme Court's reasoning in *Field v. Mans,* 516 U.S. 59 (1995), a case involving guarantors who lied to sellers of real estate after the sale about the fact that the corporation which purchased the property (and was controlled by the guarantors) had subsequently sold the real estate to a partnership, thereby triggering a due-on-sale provision and liability on their guaranties.  The issue considered in *Field* was the degree of creditor "reliance" which might be required by 523(a)(2)(A).  The Court stated that "[n]o one, of course, doubts that some degree of reliance is required to satisfy the element of causation inherent in the phrase 'obtained by,'" but held that such the reliance need only be "justifiable" as opposed to objectively "reasonable." 516 U.S. at 66. Based on the *Field* opinion's discussion of the reliance "inherent in" the phrase "obtained by" found in 523(a)(2)(A), the Fifth Circuit concluded that some form of misrepresentation by the defendant on which the creditor relied is a prerequisite to *any* action brought under §523(a)(2)(A). In so ruling, the Fifth Circuit rejected the argument made by Husky – based on the Seventh Circuit's decision in *McClellan v. Cantrell,* 217 F.3d 890 (7th Cir. 2000) – that an exception to discharge under §523(a)(2)(A) can be based on a debt involving property which is fraudulently "obtained by" a defendant by virtue of being the recipient of a fraudulent transfer without any misrepresentations. The Fifth Circuit opinion in Husky concluded that "[n]o subsequent appellate court has adopted the interpretation of Section 523(a)(2)(A) endorsed by the *McClellan* majority, and we decline to do so today." Husky, 787 F.3d at 317. The resulting split in the circuits between *Husky* and *McClellan* was cited as grounds for Husky's petition for *certiorari*.

**B. The Seventh Circuit's Decision in *McClellan***

A brief discussion of the decision in *McClellan* is accordingly warranted. The Seventh Circuit's broad statement of the issue in that case was as follows:

> The most common type of fraud involves a deliberate misrepresentation or, what amounts to the same thing, a deliberately misleading omission. . . . The question this appeal presents is whether, as the bankruptcy court and district court ruled, this is the only type of fraud that comes within the exception for "actual fraud"[in § 523(a)(2)(A)]. We have not been able to find any reported appellate cases that deal with this question.

*McClellan*, 217 F.3d at 892. The Seventh Circuit ultimately reversed the lower courts, concluding that no misrepresentation is required by §523(a)(2)(A).

The facts of *McClellan* are at least superficially similar to those in *Husky*. A creditor (McClellan) sold machinery to a purchaser for $200,000, although unlike the situation in *Husky* the creditor also obtained a security interest which was never perfected. The purchaser defaulted and was sued by McClellan. While that suit was pending, the purchaser sold the machinery for $10 to his sister, who knew of the suit and was colluding with her purchaser brother. She then re-sold the machinery for $160,000 and, according to the opinion, "she's not telling anyone what happened to that money." *McClellan*, 217 F.3d at 892.

After McClellan amended its lawsuit to add the sister as a defendant, she filed a chapter 7 petition. McClellan in turn filed an adversary proceeding against her seeking to recover the amount owing for the machinery from her and to have the debt declared non-dischargeable under §523(a)(2)(A). Relying on *Field,* the bankruptcy court dismissed the adversary complaint for failure to state a claim because there was no reliance on a misrepresentation, and the district court affirmed.

In a majority opinion authored by Judge Posner, the Seventh Circuit reversed, concluding that *Field* "has nothing to do with this case," because "reliance is relevant only when a fraud takes the form of a misrepresentation." *McClellan,* 217 F.3d at 893. In considering the meaning of the words "actual fraud" in the statute, the opinion goes on to state "[n]o learned inquiry into the history of fraud is necessary to establish that it is not *limited* to misrepresentations and misleading omissions." *Id.* (Emphasis added). Without offering specific historical or precedential authority, the majority opinion in *McClellan* quotes Collier on Bankruptcy for the general proposition that "actual fraud" broadly includes "any deceit, artifice, trick, or design involving direct and active operation of the mind, used to circumvent and cheat another." *McClellan*, 217

F.3d at 893, *quoting* 4 Collier on Bankruptcy para. 523.08[1][e], p. 523-45 (15th ed., Lawrence P. King ed., 2000). Judge Posner then reasons that § 523(a)(2)(A) should apply to the facts in *McClellan* because the debtor-transferee participated in a fraudulent transfer scheme and thereby (1) "obtained" property through actual fraud; and (2) incurred a debt to the seller. The opinion reasoned:

> The words "obtained by" go with "money, property, [or] services," not with "debt." E.g., In re Mones, 169 B.R. 246, 251 n. 2 (Bankr. D. Colo. 1994). A debt is not something you obtain; it is something you incur as a consequence of having obtained money or something else of value from another person (the creditor).

*McClellan*, 217 F.3d at 895. Judge Posner further states:

> The brother's original debt to McClellan arose from a loan, but is not the debt at issue here. The debt at issue here is the debt that the sister incurred to McClellan by committing a fraud against him. Because it was an actual fraud, the debt that it gave rise to is not dischargeable.

*Id.*

## II. THE SUPREME COURT'S DECISION IN *HUSKY*

As noted, the majority opinion by Judge Sotomayor opted to only address the narrow issue of whether an objection to discharge under § 523(a)(2)(A) *always* requires creditor reliance on a misrepresentation. Rather predictably, the Court concluded it does not, on the grounds the statute excepts debts from discharge where the money or property was obtained not only by "false pretenses" and "false representations," but also through "actual fraud." The court reasoned that when the two words "actual fraud" were added to § 523(a)(2)(A) by Congress in 1978, it must have meant something more or different from false pretenses and misrepresentations.[2]

[2]The parties acknowledged, however, in their briefs on the issues that the legislative history provided little or no clarification of the reasons the statute was amended.

While declining to attempt to precisely define "actual fraud" except to say that it generally "connotes deception or trickery," the Court observes that "from the beginning of English bankruptcy practice, courts and legislatures have used the term 'fraud' to describe a debtor's transfer of assets that, like Ritz' scheme, impairs a creditor's ability to collect the debt." *Husky,* 136 S. Ct. at 1587.

Turning to the more troubling issue of the fact that the statute only excepts debts arising from money or property *obtained by* fraud, and the discussion of that phrase and "reliance" in *Field,* the majority opinion further states:

> Ritz' next point of resistance rests on §523(a)(2)(A)'s requirement that the relevant debt be "for money, property, services, or . . . credit . . . obtained by . . . actual fraud." (Emphasis added.) The argument, which the dissent also emphasizes, has two parts: First, it posits that fraudulent conveyances (unlike other forms of actual fraud) cannot be used to "obtai[n]" debt because they function instead to hide valuables that a debtor already possesses. Brief for Respondent 20, 31. There is, the dissent says, no debt at the end of a fraudulent conveyance that could be said to "'resul[t] from'" or be "'traceable to'" the fraud. Post, at 3 (quoting Field, 516 U. S., at 61, 64, 116 S. Ct. 437, 133 L. Ed. 2d 351). Second, it urges that "actual fraud" not be interpreted to encompass forms of fraud that are incompatible with the provision's "obtained by" requirement.
>
> It is of course true that the transferor does not "obtai[n]" debts in a fraudulent conveyance. But the recipient of the transfer—who, with the requisite intent, also commits fraud—can "obtai[n]" assets "by" his or her participation in the fraud. See, e.g., McClellan v. Cantrell, 217 F. 3d 890 (CA 7 2000); see also supra, at 6. If that recipient later files for bankruptcy, any debts "traceable to" the fraudulent conveyance, see Field, 516 U. S., at 61, 116 S. Ct. 437, 133 L. Ed. 2d 351; post, at 3, will be nondischargable under §523(a)(2)(A). *Thus, at least sometimes a debt "obtained by" a fraudulent conveyance scheme could be nondischargeable under §523(a)(2)(A).* Such circumstances may be rare because a person who receives fraudulently conveyed assets is not necessarily (or even likely to be) a debtor on the verge of bankruptcy, n3 but they make clear that fraudulent conveyances are not wholly incompatible with the "obtained by" requirement.

*Husky*, 136 S. Ct. at 1589 (emphasis added). The Court concludes that *Field* only discussed "reliance" because that case involved a misrepresentation, emphasizing "[t]he Court was not establishing a 'reliance' requirement for frauds that are not premised on such a misrepresentation." *Id.* The Court evidently concludes that *Field* did not quite mean what it said when it observed that "some degree of reliance is required to satisfy the element of causation inherent in the phrase 'obtained by.'" *Field*, 516 U.S. at 66. The *Husky* opinion instead talks about debts which are "traceable to" the fraud.

As the above excerpt from the opinion indicates, there was a dissenting opinion in *Husky*, in which Justice Thomas agreed with the majority's general conclusion that "actual fraud" may not require a misrepresentation, but emphasized that those words "must be read in context," with the rest of the statute and that:

> Section 523(a)(2) covers only situations in which "money, property, [or] services" are "obtained by . . . actual fraud," and results in a debt. See Cohen v. de la Cruz, 523 U. S. 213, 218, 118 S. Ct. 1212, 140 L. Ed. 2d 341 (1998). The statutory phrase "obtained by" is an important limitation on the reach of the provision. Section 523(a)(2)(A) applies only when the fraudulent conduct occurs at the inception of the debt, i.e., when the debtor commits a fraudulent act to induce the creditor to part with his money, property, services, or credit. The logical conclusion then is that "actual fraud"—as it is used in the statute—covers only those situations in which some sort of fraudulent conduct caused the creditor to enter into a transaction with the debtor. A fraudulent transfer generally does not fit that mold, unless, perhaps, the fraudulent transferor and the fraudulent transferee conspired to fraudulently drain the assets of the creditor. But the fraudulent transfer here, like all but the rarest fraudulent transfers, did not trick the creditor into selling his goods to the buyer, Chrysalis Manufacturing Corporation. It follows that the goods that resulted in the debt here were not "obtained by" actual fraud. §523(a)(2)(A).

Husky, 136 S. Ct. at 1591 (Thomas, J., dissenting).

## III. WHERE HUSKY LEAVES US – SOME OF THE POTENTIAL ISSUES

In one sense, the Supreme Court's ruling in *Husky* is simultaneously both broad and narrow. The Court makes it clear that the words "actual fraud" should be broadly read to include fraudulent transfers and other forms of "deception or trickery" as potential grounds for exception to discharge, but at the same time leaves for future decision any analysis of when the "debt" to be excepted from discharge should be considered "traceable" to the fraud for purposes of the limitation of § 523(a)(2)(A) to money or property that was "obtained by" fraud.

The likely result will be many more objections to discharge based on alleged fraudulent transfers, and many troublesome issues for courts to decide, some of which are summarized below.

**A. <u>Whose Discharge is Affected?</u>**

In his opinion in *McClellan,* Judge Posner noted one potentially anomalous result from applying § 523(a)(2)(A) to fraudulent transfer situations – namely, the prospect that creditors would have grounds to object to a bankruptcy discharge by the *recipient* of a fraudulent transfer – because he "obtained" property by fraud – but would have no such rights against the transferor who is at least as culpable. In *McClellan,* this anomaly was remedied by the fact that the creditor had an unperfected security interest. Judge Posner stated:

> This result would be paradoxical if it meant that while the sister could not discharge her fraud debt in bankruptcy, the brother could have discharged the same debt had he declared bankruptcy. It does not mean this. What is true is that if he had merely defaulted on his original debt to McClellan, which so far as appears was not created by a fraud, and later declared bankruptcy, that debt would have been dischargeable. *If, however, he had rendered the debt uncollectible by making an actually fraudulent conveyance of the property that secured it,* his actual fraud would give rise to a new debt, nondischargeable because created by fraud, just as in the case of the sister, his accomplice in fraud. But it would be a new debt only to the extent of the value of the security that he conveyed, for that would be the only debt created by the fraud itself. For example, if he owed McClellan $ 100,000 and defaulted after having transferred to his sister property securing the debt worth $ 10,000, he would be entitled to discharge $ 90,000 of the debt, for only the $ 10,000 was a debt created by fraud.

*McClellan*, 217 F.3d at 895 (emphasis added). While Judge Posner's analysis may be correct in *McClellan,* it seems there *would* be a "paradoxical" result from his reading of § 523(a)(2)(A) in the treatment of transferors and transferees if, as in *Husky,* the creditor does *not* have a security interest. There would be no fraudulent conveyance of property securing a debt, and accordingly no apparent basis for a non-dischargeable judgment against the transferor.[3] Indeed, even in *McClellan* where there was a security interest, the "paradoxical" result would only be avoided through operation of 11 U.S.C. § 523(a)(6) rather than § 523(a)(2)(A), because unlike his sister, the brother-transferor did not "obtain" property through any fraud. Notably, in an opinion which only concurred in the result in *McClellan*, Judge Tripple argued that although the creditor in the case based his complaint on § 523(a)(2)(A), the more appropriate basis for relief would be § 523(a)(6), excepting debts for "willful and malicious injury by the debtor . . . to property of another entity." Judge Tripple cautioned, "[u]nder the majority's approach, we are now ignoring the proper avenue of relief in favor of an awkward and ill-fitting one." *McClellan*, 217 F.3d at 896.

It is difficult to determine for certain whether the Supreme Court's reasoning in *Husky* would permit objections to discharge of both the transferor and the transferee, or just the latter. This is due, in part, to the fact that the debtor in *Husky,* Ritz, was alleged to be the *alter ego* of companies he controlled which made *and* received the transfers. More generally, however, there is some ambiguity in the Court's reasoning, because the majority opinion merely interprets *Field* to require that the debt be "traceable to" a fraudulent conveyance which "impairs a creditor's

[3] Fraudulent transfers by the debtor-transferor could be the basis for a broader denial of discharge under § 727(a)(2) and (a)(7), but it would be limited to transfers made withing a year of the filling and would bar discharge of all debts as opposed to the "creditor specific" relief of § 523.

ability to collect a debt." Is this the same thing as money or property "obtained by" fraud? As Justice Thomas observes in his dissenting opinion:

> §523(a)(2)(A) does not exempt from discharge any debts "traceable to the fraudulent conveyance." Instead, §523(a)(2)(A) exempts from discharge "any debt for" goods that are "obtained by" actual fraud.

*Husky*, 136 S. Ct. at 1592 (Thomas, J., dissenting). It may be likely that objections to discharge involving fraudulent transfers under *Husky* will be limited to actions against transferees who "obtained" property by fraud – with the resultant "paradoxical" treatment of transferors and transferees – but it is by no means certain.

**B. Is "Constructive" Fraud "Actual" Fraud?**

Another question whose answer may seem to be obvious is to some extent also left open by the majority opinion in *Husky*. Throughout the opinion, Justice Sotomayor repeatedly refers to the "scheme" or "alleged scheme" used by Ritz, clearly implying that the transfers made by Ritz were *intended* to cheat creditors like Husky. It is noteworthy, however, that the bankruptcy court hearing the claims only made findings of "constructive fraud," and that Justice Sotomayor's discussion of "actual fraud" seems to focus on the *effect* of a "fraudulent" transfer, noting that "courts and legislatures have used the term 'fraud' to describe a debtor's transfer of assets that, like Ritz' scheme, impairs a creditor's ability to collect a debt." Husky, 136 S. Ct. at 1587. We are left uncertain how to interpret the fact that the majority opinion essentially ignores the following comment in Justice Thomas' dissenting opinion:

> The Bankruptcy Court also found that there was no evidence that Ritz transferred the funds to avoid Chrysalis' obligations to pay the debt it owed to Husky—an unsecured creditor. Id., at 635. Because Husky does not contend that Ritz fraudulently induced it to sell goods to Chrysalis and cannot show that the *constructive fraudulent conveyance* had anything to do with its decision to

> contract with Chrysalis, Husky has not established that §523(a)(2)(a) covers any debt owed to it.

*Husky*, 136 S. Ct. at 1592 (Thomas, J., dissenting)(emphasis added).

### C. What "Debt" Is Excepted from Discharge?

Probably the most troublesome question left in the wake of the *Husky* ruling is not addressed at all by the Court's opinion, and was only briefly considered in *McClellan* – namely, what exactly is the amount and nature of the "debt" that would be excepted from discharge in a fraudulent transfer situation? There are really two questions here: (1) is the non-dischargeable "debt" the value of the property received by the transferee or the original debt owing to the creditor by the transferor; and (2) does the transferee in a fraudulent transfer situation owe a "debt" as that term is defined by the Bankruptcy Code?

Unsurprisingly, it was clear from Husky's contentions in its brief and at oral argument that it believes the *entire amount* of its unpaid invoices should be excepted from Ritz' discharge. This position is inconsistent, however, with the holding in *McClellan,* where Judge Posner made it clear, as noted above, that the obligation of the transferee "would be a new debt only to the extent of the value of the security" he received, because only the transferred property was "obtained by" fraud. *McClellan*, 217 F.3d at 895. Given the narrow focus of the majority opinion in *Husky,* one can only guess whether the Supreme Court would agree with Husky, *McClellan*, or neither. As Justice Thomas observes, the majority opinion talks about whether a debt is "traceable" to fraud, as opposed to property "obtained by" fraud. We again must ask whether this choice of words is significant. On this point, it is somewhat curious that throughout the majority opinion Justice Sotomayor repeatedly refers to whether the "debt" (as opposed to the transferred property) could be said to have been "obtained by" fraud. For example, her majority opinion directs the Fifth Circuit to decide on remand "whether the debt to Husky was 'obtained by' Ritz'asset-transfer scheme." Husky, 136 S. Ct. at 1589, n.3 This choice of words at least seems significant, particularly in light of the majority opinion's acknowledgment (on the same page of its opinion) that:

> It is of course true that the transferor does not "obtai[n]"debts in a fraudulent conveyance. But the recipient of the transfer—who, with the requisite intent, also commits fraud—can "obtai[n]" assets "by" his or her participation in the fraud. See, *e.g.*, *McClellan* v. *Cantrell*, 217 F. 3d 890 (CA 7 2000); see also *supra,* at 6. If that recipient later files for bankruptcy, any debts "traceable to" the fraudulent conveyance, see *Field,* 516 U. S., at 61; *post,* at 3, will be nondischargable under §523(a)(2)(A).

The second issue – how the Bankruptcy Code's definition of "debt" relates to liability of a transferee in a fraudulent transfer – is surprisingly not discussed in any detail by either the *Husky* or *McClellan*. Justice Sotomayor's opinion in *Husky* never even alludes to the Bankruptcy Code's definition of "debt." In *McClellan,* there is only a brief mention – Judge Posner's opinion makes the cursory observation that § 101(12) of the Bankruptcy Code defines "debt" as a "liability on a claim," and that "claim" is very broadly defined by § 101(5) to include a "right to payment" or a "right to an equitable remedy for breach of performance," regardless of whether either such right is matured, contingent, has been liquidated or reduced to judgment. Without further analysis, Judge Posner's opinion then states, "[t]he debt at issue here is the debt that the sister incurred to McClellan by committing a fraud against him. Because it was an actual fraud, the debt that it gave rise to is not dischargeable." *McClellan*, 217 F.3d at 895.

This brief discussion of "debt" in *McClellan* seems to imply that under the Bankruptcy Code there is a "debt" owing to anyone who holds any sort of "claim" against a transferee. But is this really true? With respect to the facts in *Husky* and fraudulent transfers in general, is it accurate to say that committing "actual fraud" by knowingly receiving property by itself gives rise to either (1) a "right to payment;" or (2) a right to an equitable remedy for breach of performance? 11 U.S.C. § 101(5). A strong argument can be made it does not.

Putting aside McClellan's unusual facts of an unperfected security interest, it would seem that the only "right" against a transferee held by a creditor harmed by the fraudulent transfer of property by a debtor-transferor would be their rights under state fraudulent transfer statutes. Certainly there is nothing in the Bankruptcy Code, including § 523, which *creates* a debt owing by a transferee to a creditor. Furthermore, the only avoidance actions and remedies addressed by the Bankruptcy Code do not belong to creditors, but to the bankruptcy trustee or debtor-in-possession under §§ 547, 548, 549 and 550. As for state statutes, two key facts must be considered: First, state fraudulent transfer statutes create equitable remedies which may – but typically do not – consist of a money judgment. More commonly, the remedy is to order surrender of the property by the transferee, which would not be a "debt" as defined by the Bankruptcy Code. Second, and most importantly, is it not true that remedies created by state fraudulent transfer statutes would be pre-empted in bankruptcy to the extent they conflict with the rights and priorities created by the Bankruptcy Code? Where the transferee is in bankruptcy, those priorities dictate that all property held by the transferee – including any property which was received through a fraudulent transfer and any proceeds thereof – become part of the debtor's bankruptcy estate. Absent a security interest in the transferred property or some claim which would defeat title to property in possession of the debtor-transferee, the bankruptcy court would not be authorized under the Bankruptcy Code to order the debtor to surrender property to one creditor of the transferor. The usual relief granted under state fraudulent transfer statutes is unavailable because of the Code.

Hence, in many, if not most fraudulent transfer circumstances, there would be no statutory "right to payment" and no "debt" to the creditor as defined by Bankruptcy Code. At the very least, the notion that a "debt" immediately arises upon a transferee's receipt of property seems simplistic if not simply wrong. As practitioners who bring fraudulent transfer actions on behalf of creditors and trustees well know, avoidance actions (under either § 548 or state fraudulent transfer statutes) involve two distinct inquiries and determinations – first, whether there are grounds which warrant avoiding the transfer, and thereafter a separate determination by the court, based on the facts and the court's discretion under § 550, regarding the remedy, which usually involves returning the property unless it has declined in value, is no longer available, or a money judgment is otherwise preferable.

In addition, consideration must be given to the "causation" connection between the debt and the fraudulent conduct which even the Petitioner, Husky, acknowledges is implicit in § 523(a)(2)(A). As noted earlier, Judge Posner makes the observation, without explicit analysis, that the "debt" in *McClellan* is the debt that "arose . . . when she [the transferee sister] prevented McClellan from collecting from the brother." *McClellan*, 217 F.3d at 895. But in a different situation, such as in *Husky*, where no security interest in specific collateral exists, would it not be necessary to make a more specific showing regarding how much the creditor bringing the action would have been paid if the transfer had not occurred? The relevant facts in Husky suggest that even if Chrysalis had never made the transfers, creditor Husky would have been paid considerably less than its original debt. As noted, Chrysalis had assets of $2 million at most (including the transferred property), and debts of $5 million.

As the above discussion suggests, careful consideration of the Bankruptcy Code's definition of "debt" and the causation elements implicit in § 523(a)(2)(A) would seem to indicate that receiving a fraudulent transfer does not create a "debt" as defined by the Bankruptcy Code which could be subject to exception from discharge, or, if it does, it would only be where (1) the creditor is entitled to bring an avoidance action – i.e., the action does not belong to a trustee in bankruptcy; (2) the transferred property or its proceeds are not estate property in an existing bankruptcy; (3) the transfer is actually avoided under state or federal law; and (4) the court hearing the avoidance action determines in its discretion that a money judgment should be entered for the value of the transferred property to the extent the transfer prevented payment to the creditor.

### D. Who and How Many May Object to Discharge?

The failure of the majority opinion in *Husky* to address the nature of the debt which might be subject to exception under § 523(a)(2)(A) in a fraudulent transfer situation also gives rise to additional questions, such as which – and how many – creditors of the transferor could bring a discharge action against the transferee. If the security interest in *McClellan* was not central to the Seventh Circuit's holding or Judge Posner's reasoning, and hence not relevant to the holding in *Husky* which was based on such reasoning, could *any* creditor of a transferor have filed a § 523 action? Would the same be true even if the trustee in the Chrysalis bankruptcy had been aware of fraudulent transfers and sought to recover them from Ritz? As noted by arguments in *Husky*, fraudulent transfer liability is not a "creditor specific" remedy, which is to say that any creditor of a transferor is ordinarily entitled to seek recovery from the fraudulent transferee. While it may be true that a transfer can only be "avoided" once – presumably by the fastest creditor to seek relief – does it necessarily follow that a non-dischargeable liability of the transferee under § 523(a)(2)(A), which is premised on the "actual fraud" of receiving the transfer, would be confined to one creditor? It seems clear that the reasoning of McClellan and the arguments of petitioner in Husky are not expressly dependent upon a creditor's actual avoidance of a transfer. Both cases involved objections to discharge in the bankruptcy court in circumstances where no avoidance of a transfer had taken place.

Needless to say, however, the results would seem to be anomalous if all creditors – not just the first – could obtain a non-dischargeable judgment against a transferee. If, for example, property worth $100,000 is transferred by a debtor who has 10 creditors who each hold claims of $100,000, would the transferee then be subject to $1 million in non-dischargeable debt by virtue of having received $100,000 in property? This result certainly seems unlikely, but one could argue that it logically follows from the idea that a transferee incurs a debt to each creditor upon receipt of fraudulently-acquired property. The issue was only tangentially considered in the *Husky* oral argument, and not at all in the opinion. When counsel for the debtor-respondent (Ritz) observed that Husky was "basically jumping the line and saying we should get all of this money," Justice Sotomayor responded, "I don't know that that moves me that much," apparently more concerned with the risk "that if you've accepted a fraudulent amount of money, you get to keep it." Interestingly, the comments by counsel for the debtor at the argument included the assertion that the trustee in the Chrysalis bankruptcy "did not see fit to try to void these transactions." It appears this was not factually correct, however. The statement of financial affairs and schedules filed by Chrysalis in its bankruptcy – which were signed by Ritz – make no mention of the over

$1 million in transfers, and there is nothing in the bankruptcy docket which suggests the trustee was ever aware of potential avoidance actions. The case presumably could be (or could have been) re-opened to administer that asset.

Justice Sotomayor's comment about whether "you get to keep" the property – and its suggestion regarding the punitive aspects of nondischargeability – brings to mind the additional question mentioned above – namely, whether any benefit ultimately received by the transferee as a result of the fraud is or should be relevant to interpretation of 523(a)(2)(A). It will be recalled, in this regard, that Judge Posner remarks in *McClellan* that the debtor was "not telling anyone what has happened to that money" she received when she re-sold the creditor's collateral.[4] In *McClellan*, Judge Posner's opinion justifies its conclusion, in part, by stating that the fraud in which the debtor-transferee participated "prevented McClellan from collecting from the brother." *McClellan*, 217 F.3d at 895. This would seemingly be true where, as in *McClellan,* the creditor has a security interest – at least where such interest is either perfected or not subject to avoidance by a bankruptcy trustee or other creditors. However, while these facts may have been true in McClellan – the opinion does not specifically say – they are certainly not present in the Husky case. In *Husky*, there not only was no security interest, but the facts also indicate that Husky and other creditors would not have received anything like full payment in the Chrysalis bankruptcy even if the fraudulent transfer had been avoided or had never occurred. The Chrysalis schedules indicated over $5 million in debt and less than $1 million in assets (not including the avoidance

[4]In such circumstances, there would certainly be grounds for her bankruptcy trustee to object to discharge of all of her debts pursuant to 11 U.S.C. § 727(a)(4) and (a)(7), which would provide remedies to all of her creditors rather than one.

claim).

One might also ask, in this regard, whether a non-dischargeable "remedy" is needed or appropriate where the property or funds received by a transferee have been disclosed, included as part of the bankruptcy estate, and paid to creditors. This would have been the case in *McClellan*, for example, if the transferee had never re-sold the machinery or had sold it but turned over the proceeds to her trustee. In either of these scenarios, the debtor would not "get to keep it," but the seller (McClellan) would nonetheless not be re-paid in full, because the unperfected security interest in the machinery and proceeds would have been avoided through the trustee's strong-arm powers. In such situations, a "debt" which would still be owing to the seller for purposes of Judge Posner's analysis, although the debt would seem to result more from the operation of bankruptcy law than from the fraudulent conduct by the debtor. It would be, after all, the same result that would occur if the purchaser, her brother, had filed a bankruptcy petition but had never transferred the machinery to her. Does it make sense to say the rights of unsecured creditors of the transferor should be enhanced beyond what they would have been if no fraudulent transfer had taken place, by being able to receive a share of the transferred property and have a non-dischargeable judgment for the balance of their debt? In effect, the creditor's position might often be improved by the fraudulent transfer.

## IV. CONCLUSION

In summary, the issues left unresolved by *Husky* include:

- Will a transferor who files bankruptcy be treated the same as a transferee who joins in his fraudulent transfer scheme, or will only the transferee be subject to objections to discharge?

- Can objections to discharge be based on constructive as well as “actual” fraud?
- Can all creditors of transferor – or just the first one – obtain a non-dischargeable judgment against the transferee?
- How much could the judgment be for – the original debt, the amount the creditor would have received in bankruptcy of the transferor, or the value of transferred property?
- Could multiple judgments collectively exceed the value of the transferred property?
- What if the transferor and transferor are both currently in bankruptcy?
- Does it affect the results if the transferee still has the property and surrenders it to trustee in his pending bankruptcy?

All of these questions, and no doubt more, will have to be sorted through further decisions by bankruptcy courts, district courts, courts of appeal, and very possibly the Supreme Court again, as was true with *Stern v. Marshall*. In the meantime, all that can be said with certainty is there will be more litigation in cases involving possible fraudulent transfers, greater expenditure of judicial resources, and substantially more legal fees incurred by creditors and debtors alike. Where potential fraudulent transfers are involved, many debtors may find that the expense of litigating the issues makes it impossible to seek bankruptcy relief, or may outweigh the potential benefits, regardless of how the litigation might ultimately have been resolved.