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# HUSKY IS NOT SO LUCKY FOR DEBTORS – THE UNITED STATES SUPREME COURT'S RECENT OPINION ON THE DENIAL OF DEBT DISCHARGEABILITY UNDER BANKRUPTCY CODE § 523(A)(2)(A)'S ACTUAL FRAUD PROVISION

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On May 16, 2016, the United States Supreme Court decided the term "actual fraud" in Bankruptcy Code § 523(a)(2)(A) encompasses forms of fraud, like fraudulent conveyance schemes, that can be effected without a false representation by a debtor. Importantly, the *Husky International Electronics, Inc. v. Ritz*, No. 15-145, 2016 WL 2842452 (U.S. May 16, 2016) opinion clears up a split among the lower courts on the question of whether the phrase "actual fraud" requires a false representation to be made to a creditor.

Husky International Electronics, Inc. ("Plaintiff"), sold its products to Chrysalis Manufacturing Corp. ("Chrysalis") and Chrysalis incurred a debt to Plaintiff. During the same period, Daniel Lee Ritz, Jr. ("Debtor"), served as a director of Chrysalis and owned at least 30% of Chrysalis' common stock. The Debtor drained Chrysalis of assets it could have used to pay its debts to creditors like Plaintiff by transferring large sums of Chrysalis' funds to other entities the Debtor controlled.

The Debtor filed for Chapter 7 bankruptcy and the Plaintiff initiated an adversary proceeding seeking to prevent the discharge of the Husky debt in bankruptcy because the Plaintiff argued, the same intercompany-transfer scheme constituted "actual fraud" under 11 U.S.C. § 523(a)(2)(A)'s exemption to discharge provision.

Both the trial court and appellate court held that the Debtor was personally liable for the debt but that the debt was not "obtained by . . . actual fraud" under § 523(a)(2)(A) and could be discharged in his bankruptcy. The appellate court held that a necessary element of "actual fraud" is a misrepresentation from the debtor to the creditor, and in transferring Chrysalis' assets, the Debtor may have hindered the Plaintiff's ability to recover its debt, but he did not make any false representations to the Plaintiff regarding those assets or the transfers and therefore did not commit "actual fraud."

The United States Supreme Court reversed. The main point of contention between the majority opinion written by Justice Sotomayor and the lone dissenter, Justice Thomas, was whether the statutory text of "obtained by" limits the provision to debts that result from fraud as a result of a misrepresentation. In other words, does a debtor have to make a false representation to a creditor in connection with the creditor's extending funds for the debt to be nondischargeable. Here, there was no indication that the Debtor made any representations to the Plaintiff inducing the Plaintiff to enter into a contract with Chrysalis. The only communication between the Debtor and the Plaintiff occurred after the Plaintiff and Chrysalis entered into the contract and after the Plaintiff had shipped the goods to Chrysalis.

The majority rejected the Debtor's argument that § 523(a)(2)(A)'s requirement that the relevant debt be "for money, property, services, or . . . credit . . . *obtained by* . . . actual fraud." *Id*. (emphasis added). The Court explained that this argument, wrongfully theorizes that fraudulent conveyances cannot ever be used to "obtai[n]" debt because they function instead to hide valuables that a debtor already possesses. Indeed, the majority held that "fraudulent conveyances are not an inducement-based fraud" but rather "[i]t is in the acts of concealment and hindrance" where the tort originates. *Husky*, at *6. The Court explained that this argument also rests on the assumption that "actual fraud" should not be interpreted to encompass forms of fraud that are incompatible with the "obtained by" requirement. "Thus, at least sometimes a debt 'obtained by' a fraudulent conveyance scheme could be nondischargeable under § 523(a)(2)(A)" although those "circumstances may be rare." *Husky*, at *8. Therefore, one can commit actual fraud by making or receiving a fraudulent transfer.

Of course, to impute the corporate debts of a company to an individual debtor the debtor must be the alter ego of his company. In Florida, it appears that orchestrating and executing a fraudulent transfer scheme may raise to an "actual fraud" level because that conduct may be deemed "improper." "Improper conduct is present only in cases in which the corporation was a mere device or sham to accomplish some ulterior purpose or where the purpose is to evade some statute or to accomplish some fraud or illegal purpose." *Johnson Enters. of Jacksonville, Inc. v. FPL Gp., Inc.,* 162 F.3d 1290, 1320 (11th Cir. 1998) (quotation marks and alterations omitted) (quoting *Dania Jai–Alai Palace, Inc. v. Sykes*, 450 So. 2d 1114, 1117 (Fla. 1984)). Conduct may also be deemed improper "where the corporation was employed . . . for fraudulent or misleading purposes, was organized or used to mislead creditors or to perpetrate a fraud upon them, or to evade existing personal liability." *Steinhardt v. Banks*, 511 So. 2d 336, 339 (Fla. 4th DCA 1987) (quoting *Tiernan v. Sheldon*, 191 So. 2d 87, 89 (Fla. 4th DCA 1966)). Thus, when a debtor orchestrates a fraudulent transfer of assets away from a company, it is likely that he has committed the requisite level of "improper conduct" to make him the alter ego of the company, and thus hold him personally liable for corporate debts.

*Husky* has serious ramifications for individual debtors who own businesses and who are attempting to discharge debts. An individual debtor who orchestrates his company's fraudulent transfer of assets away from the company may forfeit dischargeability of the corporate debt owing to a particular creditor if the fraudulent transfer scheme rises to the "actual fraud" level. This broadened reading of "actual fraud" effectively eliminates the "obtained by" language in § 523(a)(2)(A) and makes it easier for creditors to prevail on dischargeability actions. Creditors who believe that a debtor has transferred assets away from a company, thus hindering or delaying collection efforts, need to consider objecting to the debtor's discharge based on *Husky*.

*Husky* also raises several questions that the Supreme Court did not consider. First, is the entire debt nondischargeable or is the debt nondischargeable up to the value of assets fraudulently transferred. For example, the debtor owes a $1 million debt and fraudulently transfers $50,000 out of the company. Is the $1 million nondischargeable or the value of the transfer, in this example the $50,000, nondischargeable. Although this issue was not addressed or considered by the Court probably because the assets fraudulently transferred by the Debtor totaled more than the debt owed to Husky, creditors need to consider this in litigating cases.

The *Husky* opinion also raises the question of whether a fraudulent transfer of assets out of a company can be a fraud on all creditors of that company. It seems plausible that if the company had a number of debts at the time of the transfer, then according to the Court's analysis, all of the debts of that company would devolve on the debtor and be subject to nondischargeability under § 523(a). If so, then would this end-run the one-year limitation in § 727(a)(2)(A) which denies a debtor's discharge (not just a debt's dischargeability) if that debtor transfers property with actual fraudulent intent within one year of the petition date. Although the Court did address these two provisions in its opinion, this question remains unanswered.

Attorneys at Berger Singerman, LLP, especially Attorneys Lewis M. Killian and Ashley D. Bruce, have experience with both defending and prosecuting adversary proceedings and can help debtors and creditors navigate this complex area. If you are a creditor considering bringing a dischareability action or a debtor facing one, please contact the authors, Lew Killian on the firm's Business Reorganization Team or Ashley Dillman Bruce, on the firm's Dispute Resolution and Business Reorganization Teams.

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