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THE BANKRUPTCY STRATEGIST

Innocent Business Partner's Fraud Liability Survives Bankruptcy

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"[S]ometimes a debtor is liable for fraud that she did not personally commit," held the U.S. Supreme Court on Feb. 22, 2023, when the debtor's business partner had deceptively obtained money by fraud, thereby making the innocent partner liable for a nondischargeable debt under Bankruptcy Code (Code) §523(a)(2)(A) ("any debt from money "obtained by … fraud" not dischargeable and survives debtor's bankruptcy). *Bartenwerfer v. Buckley*, 2023 WL 2144417 (Feb. 22, 2023). Unanimously affirming the Ninth Circuit and resolving "confusion in the lower courts," the Court explained that the common law and precedent precluded an innocent debtor from discharging a debt obtained by the fraud of the debtor's agent or partner. *Id*. at *8. The innocent debtor here thus could not use bankruptcy to avoid liability. More important, the decision has practical significance for corporate officers and others in an agency or partnership relationship. The decision also may have serious consequences for corporate Chapter 11 debtors whenever a "domestic governmental unit" is a creditor.

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Relevance

The Circuits have been split as to whether an innocent business partner's liability could be discharged in bankruptcy. *See*, *e.g.*, *In re M.M. Winkler & Assoc.*, 241 F.3d 746, 749 (5th Cir. 2001) (debts that arise from fraud cannot be discharged); *In re Villa*, 261 F.3d 1148, 1151 (11th Cir. 2001) (debt cannot be discharged when fraud is imputed to the debtor under agency principles). *But see, Sullivan v. Glenn*, 782 F.3d 378, 381 (7th Cir. 2015) (debt nondischargeable only if debtor knew or should have known of fraud); *In re Walker*, 726 F.2d 452, 454 (8th Cir. 1984) (same).

Facts

The debtor (D) and her contractor "then-boyfriend" bought a house "as business partners," intending to renovate and to resell the property. D "was largely uninvolved" in the renovation directed by her partner. When selling the house to the plaintiff (P), the debtor and her boyfriend-later-husband completed a mandatory disclosure statement, falsely claiming they knew of no leaks or other defects and that the necessary repairs on the property had been made under applicable law.

Problems with the property later arose (*e.g.*, "leaky roof, defective windows … missing fire escape …"), causing the plaintiff to sue in state court.

After a lengthy jury trial, the selling couple (D and her spouse) were held jointly liable under California law for deceptively concealing problems with the property ("breach of contract; negligence, and nondisclosure of material facts"). The state court entered a $200,000 money judgment against both of them.

Lower Courts

D and her husband then filed Chapter 7 petitions. The bankruptcy court, in response to P's non-dischargeability complaint and after an appellate remand, held that D's debt *was* dischargeable because she was unaware of her spouse's fraud. Reversing, the Ninth Circuit held that D, as a business partner, was liable for her spouse's wrongdoing even if she was innocent. *In re Bartenwerfer*, 860 Fed. Appx. 544 (2021).

Relevant Statutory Text

Code Section 523(a)(2)(A) provides as follows:

> "A discharge under section 727 … of this title does not discharge *an individual* debtor from any debt …
>
> "(2) *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."

11 U.S.C. §523(a)(2)(A) [emphasis added].

Fraud Not Limited To Wrongdoer

The court carefully rejected D's argument that §523(a)(2)(A) only bars the "discharge of debts for money obtained by *the debtor's* fraud." (emphasis in original). Because D's spouse committed the fraud, D reasoned, his fraud could not be imputed to her. Although "context can confine a passive-voice sentence to a likely set of actors," reasoned the Court, "in the fraud-discharge exception [*i.e.*, §523(a)(2)(A)], context does not single out the wrongdoer as the relevant actor." In fact, "the common law of fraud … has long maintained that fraud liability is *not* limited to the wrongdoer," 2023 WL 2144417, at *5, citing *Field v. Mans*, 516 U.S. 59, 70-75 (1995). And "courts have traditionally held principals liable for the frauds of their agents … [and held] individuals liable for the frauds committed by their partners within the scope of the partnership."

Supreme Court Precedent

The Court buttressed its "textual analysis" with its own precedent. In *Strang v. Bradner*, 114 U.S. 555 (1885), for example, the Court had imputed the fraud of one partner to the other innocent partners who "received and appropriated the fruits of the fraudulent conduct." *Id.* at 561. According to the Court in *Strang*, the fraud of one partner is the fraud of all because "[e]ach partner was the agent and representative of the firm, with reference to all business within the scope of the partnership." *Id*.

Balancing the Code's Fresh Start Policy

The Court rejected D's heavy reliance on the "fresh start policy of modern bankruptcy law." The "Code," said the Court, "like all statutes, balances multiple, often competing interests, …. Barring certain debts from discharge [in Code §523] necessarily reflects aims distinct from wiping the [debtor's] slate clean …. Regardless, if a fresh start were all that mattered, §523 would not exist … and we are not free to rewrite the statute …."

State Law Defined D's Liability for Her Partner's Fraud

California law here defined the "scope at one person's liability for another's fraud …. Section §523(a)(2)(A) takes the debt as it finds it, so if California did not extend liability to honest partners, §523(a)(2)(A) would have no role to play." D's "fairness-based" argument should have been "directed toward the state law that imposed the obligation on her in the first place," said the Court. *See,* 4 *Collier*, Bankruptcy ¶ 523.08

(16th rev. ed. 2022) (debtor's responsibility for debt obtained by fraud a state-law question; imputed liability principles in full effect). In any event, "victims have a variety of antecedent defenses … that [could] protect them from acquiring any debt to discharge in a later bankruptcy [case]." Despite D's "hardship," Congress "concluded that the creditors' interest in recovering full payment of debts" obtained by fraud "outweigh[s] the debtors' interest in a complete fresh start." *Id*. at *8, quoting *Grogan v. Garner*, 498 U.S. 279, 287 (1991). As the concurring opinion stressed, the "Court correctly holds that [Code] §523(a)(2)(A) bars debtors from discharging a debt obtained by fraud of the debtor's agent or partner." *Id*. D conceded here that "she and her husband acted as partners."

Comment

Innocent Agents and Partners May Be Liable. *Bartenwerfer* provides a warning to any person in an agency or partnership relationship. If, for example, an innocent corporate agent (*e.g.*, officer) is held jointly liable for fraud with its corporate principal, the agent cannot use a bankruptcy discharge to be released from liability. Similarly, an innocent partner in a general partnership cannot be insulated from a state law fraud judgment against the firm.

Suggested Defenses or Advance Protections. Aside from knowing your partner or principal, the Supreme Court suggested the following "defenses to liability":

- Any innocent employer "can escape liability" for an employee's wrongdoing by proving "that the employee's action was committed outside the scope of employment";
- An innocent partner can avoid liability by proving that the wrongdoing partner acted "without authority or outside the [firm's] ordinary course of business";
- "Partnerships and other businesses can also organize as limited liability entities, which insulate individuals from personal exposure to the business's debts"; and
- Individual fraud victims "are also likely to have defenses to liability" (*e.g.*, duped guarantor or duped purchaser of "fraudulently obtained property").

Bartenwerfer, at *8.

Claims of A Domestic Governmental Unit Against a Corporate Chapter 11 Debtor May Not Be Dischargeable. Federal or state agencies are often creditors and can oppose a corporate debtor's fraud in a Chapter 11 case. Code §1146(d), enacted by Congress in 2005, extended Code §523(a)(2)(A) to corporate Chapter 11 debtors. *In re Fusion Connect, Inc.*, 634 B.R. 22, 24, 27-29 (S.D.N.Y. 2021) ("Congress has imported the relevant content of §523(a)(2)(A) into Chapter 11 [cases] via §1146(d) [but] added only one limitation on the reach of §523(a)(2)(A): that the creditor whose debt is excepted from discharge must be a "domestic governmental unit.""; *held* Chapter 11 corporate debtor's monetary penalty obligation owed to the Federal Communications Commission, resulting from "fraud on consumers," survived reorganization plan discharge, even when the commission "was not a victim of the fraud""; reversed bankruptcy court). *See also*, *In re Hawker Beechcraft, Inc.*, 515 B.R. 416, 419, 424-25 (S.D.N.Y. 2014) ("… the exception to discharge for corporate debtors" is "self-executing.").