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Supreme Court Holds Debtor Cannot Discharge Debt Arising From Business Partner's Fraudulent Activity

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This week, the United States Supreme Court issued its opinion in *Bartenwerfer v. Buckley*, unanimously holding that a debtor **cannot** discharge a debt obtained by fraud ***even if*** the debtor himself/herself did not personally commit the fraud.

In this case, the "innocent" debtor, Kate Bartenwerfer, had purchased a house with her then boyfriend, David. Together they acted as business partners in renovating and flipping the house. Although Kate was largely uninvolved in the remodeling projects, she jointly signed disclosure documents during the subsequent sale of the house to Kieran Buckley, which failed to disclose defects with the house. Thereafter, Buckley discovered significant issues with the house and brought suit against Kate and David under California law. Ultimately, Buckley obtained judgment jointly against Kate and David for more than $200,000 in damages on his claims of breach of contract, negligence, and nondisclosure of material facts.

Kate and David, now married, were unable to pay the judgment owed to Kieran and sought protection in a Chapter 7 bankruptcy case. The Bankruptcy Code provides debtors such as Karen and David with the ability to discharge debts except for, among other debts, debts:

> (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). Buckley filed an adversary proceeding in the bankruptcy case seeking a determination that Section 523(a)(2)(A) applied to his judgment against Kate and David, and that the judgment was therefore not dischargeable in bankruptcy.

The Bankruptcy Court determined that, under a plain reading of § 523 (a)(2)(A), the judgment against *Kate* was non-dischargeable because *David*'s knowing concealment of the house's defects were imputed to

Kate through their partnership relationship. On appeal, the Bankruptcy Appellate Panel reversed in part and remanded in part, for determination of whether Kate had independent knowledge of David's fraud. On remand, the Bankruptcy Court concluded that Kate lacked knowledge of David's fraud, and accordingly, her debt was not subject to the exception to discharge.

Buckley further appealed the decision to the Ninth Circuit Court of Appeals, which held that a debtor who is liable for a partner's fraud cannot discharge that debt in bankruptcy, *even if the debtor himself/herself had no knowledge or independent involvement in that fraud*. The United States Supreme Court's decision unanimously affirmed the Ninth Circuit, holding that § 523(a)(2)(A) precludes a debtor from discharging in bankruptcy a debt obtained by fraud, regardless of the debtor's own culpability.

The Supreme Court's decision rested upon strict statutory interpretation. The Court pointed out that Congress drafted § 523(a)(2)(A) in the passive voice, which does not "hide the relevant actor in plain sight," rather it "pulls the actor off the stage" entirely. By contrast, §§ 523(a)(2)(B) and (C) each specifically identify the debtor as the actor, further evidencing intentional Congressional intent in its use of the passive voice in § 523(a)(2)(A). The Court explained that, applying ordinary rules of statutory construction, Congress must have intended the exception of discharge to apply under § 523(a)(2)(A), regardless of whether the debtor was the actor or not, so long as the debt itself was incurred by false pretenses, a false representation, or actual fraud.

The Court also highlighted prior precedent in which the Supreme Court had previously held that business partners can be denied a discharge for debts incurred by the fraud of a business partner. Given that prior authority and Congress's failure to modify the statute, again, Congress clearly intended the culpability of the Debtor to be irrelevant.

Finally, the Court rejected Kate's arguments that the decision was unfair and was contrary to the Bankruptcy Code's interests in providing debtors with a fresh start. The Court pointed out that the debtor's idea of fairness could not override Congress's express intent, and further, that it ignored the foundation of the judgment: California law that held her liabile irrespective of her culpability.

Those who enter into "passive" partnership arrangements with others should take note: the Bankruptcy Code may not provide you or your business with the discharge of a debt incurred solely due to the fraudulent activities of your partner without your knowledge or involvement. Please reach out to your Vorys attorney with any questions or concerns as to how this Supreme Court decision might apply to your business practices.