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US Supreme Court Enhances Creditor Protections by Prohibiting Discharge of Fraudulently Incurred Debt of Innocent Partner

Client Advisories

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On February 22, 2023, the Supreme Court of the United States gave a win for lender and creditor protections over a debtor's fresh start and ruled that debt incurred by a partner's fraud cannot be discharged through bankruptcy, even the bankruptcy of the innocent partner. In *Bartenwerfer v. Buckley*, No. 21-908, the debtor argued that she should not be held liable for the fraud committed by her husband and house-flipping business partner because she was not the one who was found to have committed the fraud. In a unanimous opinion authored by Justice Amy Coney Barrett, the Supreme Court determined that Section 523(a)(2)(A) turns on how the money that is subject to a creditor claim was obtained, not on who committed the fraud to obtain it, within the bounds of legal partnership.

Relying on its opinion in *Strang v. Bradner*, 114 U.S. 555 (1885), the Supreme Court reiterated that the fraud of one partner should be imputed to the other partners who "received and appropriated the fruits of the fraudulent conduct." *Id.* at 561. The Supreme Court stressed, however, that fraud liability generally requires a special relationship to the wrongdoer. For instance, the relevant legal context — the common law of fraud — has long maintained that fraud liability is not limited to the wrongdoing, and that courts traditionally hold principals liable for the fraud of their agents within the scope of their agency, and partners liable for the fraud of their partner within the scope of their partnership.

The Supreme Court combines the common law concept of fraud liability with the passive-voice of Section 523(a)(2)(A) to arrive to the conclusion that the wrongdoer is not the focus of the non-dischargeability but rather the focus is on the fraudulent event itself. Thus, the fraud of one partner, or agent, is the fraud of all because it was committed within the scope of the partnership or agency, and everyone profited from the fraud.

The Supreme Court rejected the debtor's argument regarding modern bankruptcy's "fresh start" policy, noting that the Bankruptcy Code balances multiple, often competing interests, Section 523 being the case in point since barring certain debts from discharge is an aim distinct from wiping a debtor's slate clean. Finally, the Supreme Court reiterated that Congress has "evidently concluded that the creditors' interest in recovering full payment of debts" obtained by fraud "outweigh[s] the debtors' interest in a complete fresh start," citing *Grogan v. Garner*, 498 U.S. 279, 287 (1991).

In a one-page concurring opinion, Justice Sonia Sotomayor, joined by Justice Ketanji Brown Jackson, concurred with the majority. However, they indicated that they only concurred based on the understanding that the relevant text of the Bankruptcy Code would bar debtors for fraudulent debts if the fraud were committed by the debtors' "agents" or the debtors' "partners within the scope of the partnership."

Some commentators note the construction of the text of the statute as the driver here, for good or bad, some criticize going back to an 1880's case for precedent over modern application of the "fresh start" theory of the Bankruptcy Code. For lenders and the business community, this is a win, as the implication of this decision is that fraudulent acts committed by agents or partners will be imputed to the principal or otherwise-innocent partner such that debts arising from the fraud will not be discharged under the Bankruptcy Code, regardless of the lack of culpability of the debtor.

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