

Determining Congressional Intent Regarding Dischargeability of Imputed Fraud Debts in Bankruptcy

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[Congress's jurisdiction] extends to all cases where the law causes to be distributed, the property of the debtor among his creditors: this is its least limit. Its greatest, is a discharge of the debtor from his contracts. And all intermediate legislation, affecting substance and form, but tending to further the great end of the subject—distribution and discharge—are in the competency and discretion of Congress. With the policy of a law, letting in all classes, others as well as traders; and permitting the bankrupt to come in voluntarily, and be discharged without the consent of his creditors, the courts have no concern; it belongs to the lawmakers.¹

Bankruptcy allows for an orderly liquidation of a debtor's assets.² In exchange for participating (either voluntarily³ or involuntarily⁴) in this orderly distribution of one's assets, a debtor is given the ability to nullify all debts remaining after the distribution concludes, known as a

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1. *Nelson v. Carland (In re Klein)*, 42 U.S. 265, 281 (1843).

2. 1 COLLIER BANKRUPTCY MANUAL ¶ 1.01 (Lawrence P. King ed., 3d ed. rev. 2002) (discussing evolution of bankruptcy law).

3. 11 U.S.C. § 301 (2000).

4. *Id.* § 303.

discharge.⁵ But a discharge is not an absolute right granted to all debtors in bankruptcy.⁶ Indeed, the instances in which a debtor will not be given a discharge have increased dramatically over the past few decades.⁷ One example of such an exception is the rule that fraud debts cannot be discharged through a bankruptcy proceeding.⁸ A debtor who incurs a debt through fraud cannot use bankruptcy to escape liability for that debt, leaving a debtor forever responsible for his own fraud.⁹ Unfortunately, responsibility for perpetrating fraud does not always lead to compensation for the victim of fraud.¹⁰ The difficulty in collection against an insolvent debtor often forces the creditor to consider alternative means of recovering the debt.¹¹ In the case of fraud incurred by a partnership, the solution may lie with collection against the partners themselves pursuant to state law, which *imputes* partner-

5. 1 COLLIER BANKRUPTCY MANUAL, *supra* note 2, at ¶ 1.01.

6. Discharge may be denied altogether, 11 U.S.C. §§ 727(a), 727(d), 1141(d)(3), 1228(b), 1228(d), 1328(b), 1328(e), or may be denied with regard to certain debts, 11 U.S.C. §§ 523(a), 1222(b), 1322(b).

7.

In 1987, just ten short years ago, there were ten grounds for excepting a debt from discharge under 11 U.S.C. [§] 523. Today, there are [eighteen] such exceptions, and the list keeps growing. Every special interest group wants Congress to carve out their particular type of debt from discharge. The result? The debtors are far from getting a fresh start—and are leaving the bankruptcy system still debt-laden. While it is understandable that certain debts incurred through willful wrongdoing should be excepted from discharge in certain situations (for moral and public policy reasons), the current growing list of authorized exceptions is certainly far afield of this objective.

Statement of D. Jean Ryan, Esq. before the Subcommittee on Administrative Oversight and the Courts, Senate Committee on the Judiciary Hearings on *The Increase in Personal Bankruptcies and the Crisis in Consumer Credit*, 1997 WL 179432 (F.D.C.H.) (April 11, 1997).

8. 11 U.S.C. § 523(a)(2) (2000).

9. “Forever” is a bit of an exaggeration. Statutes of limitation may terminate a debtor’s liability as well. However, because statutes of limitation differ among the states, this Article does not deal with when the liability of a debtor may actually terminate under them, but instead concerns whether liability can be discharged or will continue post-bankruptcy.

10. See Luther Zeigler, Note, *The Fraud Exception to Discharge in Bankruptcy: A Reappraisal*, 38 STAN. L. REV. 891, 911 (1986):

A legal rule entitling creditors to seek repayment from fraudulent debtors, however, is not the same thing as having those creditors repaid. As one commentator and former bankruptcy judge has noted, “regardless of what sanctions and penalties the law may impose upon the debtor by way of denial or limitations on discharge, it is very difficult to collect anything from one who has gone bankrupt.”

Id. (quoting D. COWANS, BANKRUPTCY LAW AND PRACTICE 374 § 6.29 (interim ed. 1983)).

11. *Id.*

ship liability to its partners. If such a collection action against the partners forces some or all of those partners into bankruptcy, can each individual partner seek the benefit of bankruptcy discharge, or will each partner forever carry the burden of fraud liability? Should this determination of liability, or at least the permanence of this liability, depend upon the identity of the partners and each partner's respective involvement in perpetrating the fraud?

Consider, for example, a situation where John, Jeff, and Joyce become partners in a business they call "Triple J." A few years later, Triple J needs funds, and John arranges for a loan from a local bank, Sunshine Bank. The bank asks John about other liabilities of Triple J. John, being somewhat inept, inadvertently fails to mention a one-million dollar liability of Triple J to another lending institution. Sunshine Bank lends Triple J the money, but Triple J, saddled with the one-million dollar debt, defaults on its loan to Sunshine Bank. Sunshine Bank made a loan to Triple J that it would not have made but for the negligent misrepresentation, and for which Triple J is liable. If Triple J cannot pay all of that debt, Sunshine Bank will likely sue John, Jeff, and Joyce for the deficiency.¹² Will Sunshine Bank recover in full? The bank will only recover if John, Jeff, and Joyce do not declare bankruptcy individually. Because they are partners of Triple J, John, Jeff, and Joyce are personally liable for Triple J's debts. However, as the debt was incurred through John's mere negligence, the debt may be discharged in bankruptcy to the extent the debt was not paid through bankruptcy proceedings.

Instead, assume that when Sunshine Bank asked John about Triple J's obligations, John intentionally failed to mention the one-million dollar liability to the other bank, knowing that the size of that liability would probably cause Sunshine Bank to forego the loan to Triple J. Sunshine Bank again loans the money on the basis of the incorrect representation. Sunshine Bank now has a different position if Triple J

12. The distinction between the partnership and its partners is, to some extent, nonexistent. Because a partnership is subject to pass-through taxation and the partners are subject to unlimited liability, the partners and the partnership are essentially the same beings. GREGORY, *infra* note 46, at 283, 334. However, the liability of one partner and the liability of the partnership are separated herein for simplicity. The liability of the partnership refers to the liability of the partnership entity that will be paid through the assets that the partners have collectively deemed to be assets of the partnership. Each partner's liability, then, comes into existence after it has been determined that the assets designated for the partnership cannot satisfy the existing debt, and the partner's personal assets may be subject to the debt instead. *But see* 11 U.S.C. § 723(c) (2000) (dealing with distribution of partner's assets in bankruptcy to partner's creditors versus partnership's creditors).

defaults. Can Sunshine Bank collect more from Triple J? No. The company is insolvent, and even Sunshine Bank cannot force Triple J, as an entity, to pay money it simply does not have. However, Sunshine Bank still has the power to sue John, Jeff, and Joyce individually. If the partners declare individual bankruptcies, the situation changes. John, as the purveyor of fraud, cannot discharge his debt in bankruptcy. Because he acted fraudulently, John will remain liable for the entire debt regardless of his bankruptcy filing. The real issue is what should become of Jeff and Joyce. Jeff and Joyce did nothing (at least nothing with regard to Sunshine Bank) in either example. For that matter, Sunshine Bank's behavior and harm were unchanged in each example. Yet, though Jeff, Joyce, and Sunshine Bank each took the same actions in the alternative scenarios, John's behavior may have altered the relationships between Jeff, Joyce, and Sunshine Bank by allowing Sunshine Bank to continue to hold Jeff and Joyce liable indefinitely.

To complicate matters further, assume that Joyce had been given the sole responsibility in the partnership to ensure that no fraud was committed and she indeed could have uncovered John's fraud had she been more diligent in performing this task. This highlights the potential need to treat partners who did not perpetrate fraud differently on the basis of whether each partner was completely without fault in creating the fraud, or was simply involved indirectly.

The real benefit in not discharging fraudulently incurred debt is a social one. From a public policy standpoint, fraud causes more concern than mere negligence—even if each causes the same damage—because the harm done results from an intentional action. Further, because fraud is an intentional tort, a fraud victim deserves a greater recovery than a victim of negligence. Yet, this rationale creates a difficult situation. Even if one agrees that a fraud victim deserves more protection than a victim of negligence because fraud can be prevented more easily than negligence, this presents a significant problem when considering imputed liability. Do we continue to protect fraud victims by making someone liable whose only mistake was an unintentional failure to prevent the fraud? Assuming that we do hold such a person liable, should that liability last indefinitely? The answer to the first

question requires an inspection of state law,¹³ the second, bankruptcy law.

Refusing discharge under 11 U.S.C. § 523(a)(2)(A)¹⁴ to a debtor who did not actually perpetrate fraud and who had no actual ability to prevent that fraud violates Congress's intent in enacting § 523(a)(2)(A), is inconsistent with early caselaw under § 523(a)(2)(A)'s predecessors,¹⁵ and fails to further an accepted goal of the Bankruptcy Code—the fresh start. Though amending § 523(a)(2)(A) to specify that imputed fraud debts will be dischargeable would be ideal, the statute, even as currently written, supports this idea because the clear expressions of Congressional intent and the policies underlying the Bankruptcy Code are sufficient to allow courts to find that imputed fraud debts should be discharged in bankruptcy.

13. Every state imputes liability to all partners for partnership debts. *See generally* Alois Valerian Gross, Annotation, *Tort Action for Personal Injury or Property Damage by Partner Against Another Partner or the Partnership*, 39 A.L.R. 4th 139 (1985) (citing section 13 of the Uniform Partnership Act); J.R. Kemper, Annotation, *Vicarious Liability of Attorney for Tort of Partner in Law Firm*, 70 A.L.R. 3d 1298 (1976) (noting that imputed liability among partners is a basic concept of partnership law). Of course, each state may limit the imputed liability of partners separate from any limitations of the Bankruptcy Code. *See, e.g., In re Bushnell*, 271 B.R. 54 (Bankr. D. Vt. 2001). “While the parties, and to some extent the case law, disagree regarding the applicability of vicarious liability principles for civil RICO violations in a partnership setting, it is well settled in this circuit that vicarious liability principles do not apply to claims of fraudulent concealment.” *Id.* at 59.

14. 11 U.S.C. § 523(a)(2)(A) (2000).

15. The current Bankruptcy Code was enacted in 1978. U.S.C. tit. 11 (1978). This Code replaced the Bankruptcy Act of 1898, 30 Stat. 544 (repealed 1978), which replaced the prior Bankruptcy Act of 1867, 14 Stat. 517 (repealed 1878). Section 33 of the 1867 Act, under which the cases of *Neal* and *Strang* were decided, *infra* text accompanying notes 68-94, is substantially identical to section 17 of the 1898 Act, except that the former lists fraud “of the bankrupt” while the later lists fraud “while acting as an officer, or in any fiduciary capacity.” *See Andy Warhol Found. For Visual Art, Inc. v. Hayes (In re Hayes)*, 183 F.3d 162 (2d Cir. 1999), which provides the text of each: “Section 33 of the Bankruptcy Act of 1867 excepted from discharge [any] debt created by the fraud or embezzlement of the bankrupt, by his defalcation as a public officer, or while acting in any fiduciary character” *Id.* at 168 n.2 (emphasis added) (quoting Bankruptcy Act of 1867, ch. 176, § 33, 14 Stat. 533).

“Section 17(a)(4) of the Bankruptcy Act of 1898 excepted from discharge any debts ‘created by . . . fraud, embezzlement, misappropriation, or defalcation while acting as an officer, or in any fiduciary capacity.’” *Id.* at 168 n.2 (emphasis added) (quoting Bankruptcy Act of 1898, ch. 541, § 17, 30 Stat. 544, 550-51). Section 523(a)(2)(A) of the now-enacted Bankruptcy Code is based upon the language of the 1898 Bankruptcy Act, with, among other items, the addition of “actual fraud” as a ground for nondischargeability. S. REP. NO. 95-989, at 5864 (1978); H.R. REP. NO. 95-595, at 6320 (1978). Despite changes to the exact language of the statutes, courts and Congress continue to use *Neal* and *Strang* as precedential authority for § 523(a)(2)(A).

I. CONGRESSIONAL INTENT

A. *Language of the Statute*

The Bankruptcy Code discharges a debtor who has completed his bankruptcy plan pursuant to the Code.¹⁶ In essence, this discharge means that a debtor will no longer face responsibility for pre-filing debt, even if the debtor has not repaid the debt in full during the bankruptcy.¹⁷ However, exceptions to this discharge occur in two ways. First, the bankruptcy court may deny a debtor's discharge altogether.¹⁸ Second, the court may grant a debtor's discharge, but except specific debts from discharge.¹⁹

16. 11 U.S.C. §§ 727(b), 1141(c), 1228(a), 1328(a).

17. *Id.* § 524.

18. *Id.* §§ 727(a), 727(d), 1141(d)(3), 1228(b), 1228(d), 1328(b), 1328(e). To some extent, the complete denial of a discharge contradicts the entire concept of the Bankruptcy Code. If the Code exists, it must be for a purpose. It must create a situation different from the one that the debtor would face in a non-Code world. Traditionally, the Bankruptcy Code creates a sense of orderly reorganization or liquidation free from the pressures of creditors and with the knowledge that, to the extent that the debtor has paid as much as reasonably possible to the creditors, he will enjoy relief from the remainder. The complete denial of discharge defeats this rationale of the Bankruptcy Code. Time becomes the only benefit for the debtor denied discharge altogether—time to relax and reorganize without having to worry about creditors. Once that relaxation time has expired, once the bankruptcy case concludes, the debtor returns to exactly the same position as before the bankruptcy filing with regard to each creditor. This severe restriction upon the debtor occurs only in extreme situations such as destroying property of the estate, falsifying debtor's financial statements, withholding important information from the court or trustee, contempt, grant of a discharge within the past six years, or lack of good faith. *Id.* § 727(a). *See also id.* §§ 727(d), 1141(d)(3), 1228(b), 1228(d), 1328(b), 1328(e).

19. *Id.* §§ 523(a), 1222(b), 1322(b). Debts excluded pursuant to § 523 include certain tax obligations, various types of debt incurred as a result of fraud, debts omitted from the bankruptcy schedules, alimony and child support, debt incurred as a result of "willful and malicious" injury, certain indebtedness owed to the government, student loans, debts arising from driving while under the influence of drugs or alcohol, previously nondischargeable debts, condominium fees, and court expenses. *Id.* § 523(a). These debts can be divided into two general categories, debts that are nondischargeable because of public policy and debts that are nondischargeable because of wrongful actions. *Cory v. Futscher (In re Futscher)*, 58 B.R. 14, 17 (Bankr. S.D. Ohio 1985), cited in Ponoroff, *Vicarious Thrills*, *infra* note 20, at 2533-34. Section 523 does not provide any discretion to the judge in determining dischargeability of these debts.

Though no one would contend that the denial of discharge of one debt equals denial of discharge altogether, the effect may be the same. At times, the amount of the fraud debt may be such that it constitutes the primary debt owed by a debtor to its creditors. In such a situation, to deny discharge of the fraud debt essentially denies the debtor's discharge

Discharge under the Bankruptcy Code provides a debtor with breathing room, commonly referred to as a “fresh start.”²⁰ This fresh start provides the primary incentive to file for bankruptcy protection by providing the debtor with the ability to escape the burdens of debt. Exceptions from discharge protect a creditor by maintaining the debtor’s liability to the creditor after bankruptcy.²¹ Courts do not take the decision to make exceptions to the fresh start, and thus to burden the debtor even after the conclusion of bankruptcy proceedings, lightly; rather, courts create exceptions only in situations where fairness to the

altogether by preventing the debtor from relieving itself of a substantial portion of its obligations.

20. Defining the legal existence of the “fresh start” concept presents its own challenges. It has been described as “neither a formal legal status nor a cognizable right in the usual sense of the terms. Instead, it represents an aspiration of the bankruptcy system.” Lawrence Ponoroff, *Vicarious Thrills: The Case for Application of Agency Rules in Bankruptcy Dischargeability Litigation*, 70 TUL. L. REV. 2515, 2519 (1996). Yet, for a mere aspiration, and one that has not been codified, society accepts it as a mainstay of the bankruptcy system. Indeed, the policy of a fresh start has been accepted by the United States Supreme Court and bankruptcy scholars alike. *BFP v. Resolution Trust Corp.*, 511 U.S. 531, 564 (1994) (Souter, J., dissenting) (noting that avoidance powers allow exceptions from state law in order to promote fresh start); *Grogan v. Garner*, 498 U.S. 279, 286-87 (1991) (reversing the court of appeals, but noting that fresh start policy remains intact); *Pa. Dep’t of Pub. Welfare v. Davenport*, 495 U.S. 552, 571 (1990) (Blackmun, J., dissenting) (citing H.R. REP. NO. 95-595, at 180 (1978), reprinted in 1978 U.S.C.C.A.N. 5963, 6141); Zachary Price, *The Bankruptcy Abuse Prevention and Consumer Protection Act*, 39 HARV. J. ON LEGIS. 237, 253 (2002) (noting that American system is unique in providing fresh start to debtors); Lawrence Ponoroff & F. Stephen Knippenberg, *The Immovable Object Versus the Irresistible Force: Rethinking the Relationship Between Secured Credit and Bankruptcy Policy*, 95 MICH. L. REV. 2234, 2235 (1997) (citing Charles G. Hallinan, *The “Fresh Start” Policy in Consumer Bankruptcy: A Historical Inventory and an Interpretive Theory*, 21 U. RICH. L. REV. 49, 85-86 (1986)).

21. *Nat’l Dev. Servs., Inc. v. Denbleyker (In re Denbleyker)*, 251 B.R. 891 (Bankr. D. Colo. 2000). “[T]he various exceptions to discharge in § 523(a) reflect a conclusion on the part of Congress ‘that the creditors’ interest in recovering full payment of debts in these categories outweigh[s] the debtors’ interest in a complete fresh start.’” *Id.* at 898 (citing *Cohen v. de la Cruz*, 523 U.S. 213, 222 (1998); *Grogan*, 498 U.S. at 287). The court in *In re Denbleyker* also discussed the creation and development of § 523(a)(2) and concluded that Congress intended a broad reading of the statute such that *all* fraud debts become nondischargeable. *Id.* at 897-98 (citing *Cohen*, 523 U.S. at 221; *Brown v. Felsen*, 442 U.S. 127, 138 (1979)). However, the court also noted that the House of Representatives Report indicates that nondischargeability of fraud debts promotes “justice and honest dealing and honest conduct [and] . . . good morals.” *Id.* at 898 (citing *Cohen*, 523 U.S. at 221; *Brown*, 442 U.S. at 138). While these reasons indicate the need to punish debtors who actually perpetrate fraud, they fail to explain why an innocent debtor should face liability for fraudulently-incurred debt.

parties warrants a deviation from accepted bankruptcy policies.²² When doubt exists about the dischargeability of a debt, the debtor should receive the benefit of the doubt, and the court should grant the discharge.²³

Fraudulently-incurred debts provide just one example of a situation in which the courts may tip the scales in favor of a creditor thus denying the debtor's complete fresh start in order to promote fairness between the parties. Section 523 specifically limits the dischargeability of a debtor for a debt incurred fraudulently:

(a) A discharge . . . does not discharge an individual debtor²⁴ 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;

(b) use of a statement in writing —

(i) that is materially false;

(ii) respecting the debtor's or an insider's financial condition;

(iii) on which the creditor to whom the debtor is liable for such money, property, services, or credit reasonably relied; and

(iv) that the debtor caused to be made or published with intent to deceive²⁵

22. See George H. Singer, *Section 523 of the Bankruptcy Code: The Fundamentals of Nondischargeability in Consumer Bankruptcy*, 71 AM. BANKR. L.J. 325 (1997). "The exceptions from discharge are set forth at § 523 of the Bankruptcy Code and are essentially the product of countervailing policy consideration in which the scales of justice tip in favor of certain creditors by allowing enumerated categories of obligations to remain virtually unscathed by the bankruptcy discharge." *Id.* at 326.

23. 2 COLLIER BANKRUPTCY MANUAL, *supra* note 2, at ¶ 523.04; *Winkler v. Winkler*, 239 F.3d 746, 751 (5th Cir. 2001) (citing *Fezler v. Davis*, 194 F.3d 570, 573 (5th Cir. 1999)); *Singer*, *supra* note 22, at 331 (citing *Brown*, 442 U.S. at 128; *Boyce v. Greenway (In re Greenway)*, 71 F.3d 1177, 1180 n.8 (5th Cir. 1996); *Hagan v. McNallen (In re McNallen)*, 62 F.3d 619, 625 (4th Cir. 1995); *Santa Fe Med. Servs., Inc. v. Segal (In re Segal)*, 57 F.3d 342, 346 (3d Cir. 1995); *Century 21 Balfour Real Estate v. Menna (In re Menna)*, 16 F.3d 7, 9 (1st Cir. 1994); *Werner v. Hoffman*, 5 F.3d 1170, 1172 (8th Cir. 1993); *Goldberg Sec., Inc. v. Scarlata (In re Scarlata)*, 979 F.2d 521, 524 (7th Cir. 1992)).

24. A "debtor" includes any "person" who is the subject of a bankruptcy proceeding. 11 U.S.C. § 101(13) (2000). The Code then defines a "person" as an "individual, partnership, [or] corporation." *Id.* § 101(41).

25. *Id.* § 523 (emphasis added).

The above statute indicates that dischargeability rests on how the indebtedness was created; however, the statute fails to mention the debtor as the party perpetrating the fraud, except in subsection 2(a)(2)(B)²⁶ regarding use of a written statement to perpetuate fraud.²⁷ Thus, a literal reading of the section²⁸ without taking into account

26. Note that § 523(a)(2)(B) is also impliedly referenced in § 523(a)(2)(A)'s exception for written statements.

27. Caselaw is also split on whether imputed liability for fraud based on a statement regarding the financial condition of the debtor may be discharged in bankruptcy. The language of § 523(a)(2)(B) seems to indicate that the fraud debt will be discharged unless the *debtor* created the financial statement and disseminated it with fraudulent intent. *Id.* § 523(a)(2)(B)(iv). Most courts have agreed, though, that the debtor must have some actual involvement in disseminating fraudulent statements in order to be denied discharge of the related fraud debt. *See, e.g.,* Modern Distribs., Inc. v. Gray (*In re Gray*), 22 B.R. 676, 680 (Bankr. Wis. 1982) (holding that debtor who saw financial statements and should have known of inaccuracies cannot discharge fraud debt); Alden State Bank v. Anderson (*In re Anderson*), 29 B.R. 184, 190 (Bankr. Iowa 1983) (requiring at least reckless or negligent indifference in order to hold debt nondischargeable); Am. Inv. Bank v. Hosking (*In re Hosking*), 89 B.R. 971, 975-76 (Bankr. S.D. Fla. 1988) (noting that debtor was reckless, therefore, his actual signature on financial statements was not required). At least one court has stated that permitting discharge of debt simply because a debtor was not actually involved in the fraud contradicts Congress's purpose in enacting § 523(a)(2)(B), regardless of the language of the statute. *Fed. Deposit Ins. Corp. v. Calhoun (In re Calhoun)*, 131 B.R. 757, 762 (Bankr. D. Colo. 1991) (noting that every case decided under the Bankruptcy Act upheld imputed liability and nondischargeability, regardless of debtor's involvement in the fraud, though finding no underlying liability in the present case). *But see* Van de Water v. Van de Water (*In re Van de Water*), 180 B.R. 283, 288 (Bankr. D. N.M. 1995) (considering dischargeability of wife for husband's fraudulent signature on behalf of wife pursuant to power of attorney and holding that cases under Bankruptcy Act required actual fraud for nondischargeability).

28. *See Winkler*, 239 F.3d at 751. "A rational legislator might conclude that an innocent debtor should be able to discharge debts in these situations, but § 523(a)(2)(A) does not permit this." *Id.* A review of the case law regarding § 523 readily demonstrates that the language of § 523 creates a great deal of confusion in the courts. Even those courts that consider the language of the statute to be clear have difficulty explaining the text of the statute clearly:

The most straightforward reading of § 523(a)(2)(A) is that it prevents discharge of "any debt" respecting "money, property, services, or . . . credit" that the debtor has fraudulently obtained, including treble damages assessed on account of the fraud Moreover, the phrase "to the extent obtained by" in § 523(a)(2)(A), as the [c]ourt of [a]ppeals recognized, does not impose any limitation on the extent to which "any debt" arising from fraud is excepted from discharge. "[T]o the extent obtained by" modifies "money, property, services, or . . . credit"—not "any debt"—so that the exception encompasses "any debt . . . for money, property, services, or . . . credit, to the extent [that the money, property, services, or . . . credit is] obtained by" fraud. The phrase thereby makes clear that the share of

bankruptcy policy or legislative history would indicate that it is the type of debt rather than the identity of the debtor that dictates the discharge-

money, property, etc., that is obtained by fraud gives rise to a nondischargeable debt.

. . . . It is clear that “debt for” in that provision means “debt arising from” or “debt on account of,” and it follows that “debt for” has the same meaning in § 523(a)(2)(A). When construed in the context of the statute as a whole, then, § 523(a)(2)(A) is best read to prohibit the discharge of any liability arising from a *debtor’s* fraudulent acquisition of money, property, etc., including an award of treble damages for the fraud.

. . . . The various exceptions to discharge in § 523(a) reflect a conclusion on the part of Congress “that the creditors’ interest in recovering full payment of debts in these categories outweigh[s] the debtors’ interest in a complete fresh start.” But if, as petitioner would have it, the fraud exception only barred discharge of the value of any money, property, etc., fraudulently obtained by the debtor, the objective of ensuring full recovery by the creditor would be ill served. Limiting the exception to the value of the money or property fraudulently obtained by the debtor could prevent even a compensatory recovery for losses occasioned by fraud.

Cohen, 523 U.S. at 218, 220-22 (citing *Field v. Mans*, 516 U.S. 59, 61, 64 (1995); *Grogan*, 498 U.S. at 287) (alterations in original) (emphasis added). Though *Cohen* dealt with a different issue, the dischargeability of debts related to the fraud debt, the Court indicated that § 523 was clear in its determination that all fraud debts are nondischargeable. 523 U.S. at 220-21.

Unlike *Cohen*, most cases have used the “to the extent by” language to limit not the types of debts which cannot be discharged, but the amount of those debts. See *Birmingham Trust Nat’l Bank v. Case*, 755 F.2d 1474, 1477 (11th Cir. 1985) (noting that courts are split over whether fraud debt is completely nondischargeable or nondischargeable only to the extent of benefit received, but chooses the former option) (comparing *Boatmen’s N. Hills Bank, Inc. v. Brewood* (*In re Brewood*), 15 B.R. 211 (Bankr. D. Kan. 1981); *Lancaster v. Easterly* (*In re Easterly*), 11 B.R. 206 (Bankr. E.D. Tenn. 1981) to *Morris Plan Co. of Iowa v. Benedict* (*In re Benedict*), 15 B.R. 671 (Bankr. W.D. Mo. 1981); *Rogers v. Swanson* (*In re Swanson*), 12 B.R. 688 (Bankr. S.D. Fla. 1981)). See also *Smith v. Young* (*In re Young*), 208 B.R. 189, 202 (Bankr. S.D. Cal. 1997) (“[A] judgment entered under § 523(a)(2)(A) cannot exceed the amount of benefits the fraudulent conduct created for a defendant.”) (citing *Palmer v. Levy* (*In re Levy*), 951 F.2d 196, 199 (9th Cir. 1991); *Birgna v. McArthur* (*In re Birgna*), 33 F.3d 1054, 1059 (9th Cir. 1994) and comparing *Cohen v. de la Cruz* (*In re Cohen*), 106 F.3d 52, 58 (3d Cir. 1997)). These cases concern direct rather than imputed fraud liability.

ability of a debt incurred fraudulently.²⁹ To the extent that the debt results from fraud,³⁰ it may not be discharged at all.³¹

Imputed liability has been discharged in cases decided under other provisions of the Bankruptcy Code. Some such discharges are not covered by § 523(a)³² or are covered, but the language of the statute limits denial of discharge specifically to a perpetrating debtor.³³

29. Luther Zeigler identifies dischargeability in terms of the party protected. To the extent that the focus is on the statement made, the creditor (relying upon that statement) receives protection. Zeigler, *supra* note 10, at 898-99. When the focus changes to who made the statement, the innocent debtor instead receives that protection. *Id.* Zeigler goes on to argue that other means of satisfying each of these objectives (protecting the creditor or protecting the debtor) exist and, thus, the objectives should not trump the fresh start policy. To the extent that bankruptcy law seeks to punish parties making fraudulent statements, criminal law can handle punishment of bad actors. *Id.* at 903. Regarding creditors, the potential losses associated with misrepresentation constitute a part of doing business. To the extent that the creditors begin to realize more risk as a result of misrepresentation, the risk can—and likely will—be passed onto consumers in the form of increased prices to obtain credit. Thus, the only real harm in allowing discharge of a fraud debt falls on the shoulders of the consumers who suffer with the resulting increase in price. *Id.* at 905-06. This, apparently, provides little reason to override the long-standing policy of allowing a debtor in bankruptcy a fresh start. *Id.* Interestingly, this theory would protect not only the innocent debtor who becomes liable for fraud simply as a result of a poor choice of partner, but also the guilty debtor who actually perpetrated the fraud. However, Zeigler oversimplifies the ability of criminal law to punish bad actors thoroughly. To the extent that criminal laws punish bad actors with a fine, that fine itself may be dischargeable in bankruptcy unless deemed to fall under § 523(a)(6) (“willful and malicious injury”) or § 523(a)(7) (“fine, penalty, or forfeiture payable to and for the benefit of a governmental unit”). Thus, a combination of criminal law and nondischargeability in bankruptcy may indeed be necessary to punish the debtor who actually perpetrates fraud.

30. Fraud is typically defined as: (1) the making of a false statement, (2) with intent to deceive, (3) that is relied upon, (4) justifiably, and (5) that results in damages to the creditor to whom the statement was made. *In re Denbleyker*, 251 B.R. at 895 (citing *Field*, 516 U.S. at 71 (1995); *Fowler Bros. v. Young (In re Young)*, 91 F.3d 1367, 1373 (10th Cir. 1996)). See also RESTATEMENT (SECOND) OF TORTS § 525 (1989).

31. See *Winkler*, 239 F.3d at 751; Zeigler, *supra* note 10, at 903 (indicating that application of § 523(a) is “purely mechanical” and does not depend at all on the type of debtor involved, but focusing on distinction between devious and desperate debtors perpetrating fraud). At least one court has held that the “history of the fraud exception” also indicates that Congress intended that the statute prevent discharge of all fraudulent debts regardless of whether the debtor actually perpetrated the fraud. *In re Denbleyker*, 251 B.R. at 898 (arguing that the “benefits approach” of determining partner liability violates § 523(a)).

32. See, e.g., *Hoyt v. Mathias (In re Mathias)*, 2001 WL 936345, at *3 n.1 (Bankr. D. Colo. 2001) (noting that partner’s imputed liability for negligence exists but can be discharged in bankruptcy).

33. Instances do exist in which imputed liability for partners will be discharged, though perpetuating debtors would remain liable, including § 523(a)(6) (“willful and malicious injury by the debtor”) (emphasis added) and § 523(a)(9) (“debtor’s operation of a motor

However, § 523(a)(2)(A), which is by definition part of § 523(a), does not specifically limit denial of discharge to a debtor who actually perpetrated fraud. To some extent, the statute or the courts must draw arbitrary lines classifying nondischargeable debts for judicial efficiency and consistency rather than merely leaving the standard when it would be fair to hold a debt nondischargeable. The question then becomes where to draw the line to best promote such fairness. Because this statute fails to mention the debtor as the perpetrator, it is impossible to determine whether Congress expected the consequences of fraud debt, i.e., refusal of discharge, to extend beyond the perpetrator of that fraud. When interpreting a vague statute, one may validly consider not only the language of the statute, but also legislative history and congressional intent.³⁴

B. Legislative History

Unfortunately, little legislative history exists on the enactment of § 523(a)(2)(A). Though limited in quantity, the existing legislative history provides a compelling basis for the conclusion that the identity of the debtor *should* be considered in determining dischargeability. In the 1978 legislative notes accompanying passage of the statute, the House of Representatives observed that “Subparagraph (A) is intended to codify *current* case law, e.g. *Neal v. Clark*,³⁵ which interprets ‘fraud’ to mean actual or positive fraud rather than fraud implied in law.”³⁶

vehicle”) (emphasis added). Steven H. Resnicoff, *Is it Morally Wrong to Depend on the Honesty of Your Partner or Spouse? Bankruptcy Dischargeability of Vicarious Debt*, 42 CASE W. RES. L. REV. 147, 181-85 (1992) (suggesting that such inconsistent treatment between these sections and (a)(2) justifies dischargeability of innocent partners under (a)(2)).

34. Though a presumption exists that the language of the statute expresses the intent of the legislature in promulgating the statute, the presumption may be overridden in extenuating circumstances when the expressed intent of the legislature indicates a different result. *Ardenstani v. INS*, 502 U.S. 129, 135 (1991); *Rubin v. United States*, 449 U.S. 424, 430 (1981). However, the negative implication of that statement suggests that, to the extent that the statute *is* ambiguous, no such presumption exists, and legislative history may not only be allowed, but may also be necessary to determine the intent of the legislature.

35. 95 U.S. 704 (1877). For a discussion of *Neal* and the subsequent case of *Strang* not mentioned by Congress see *infra* text accompanying notes 68-94.

36. Statement by the Hon. Don Edwards, Chairman of the Subcommittee on Civil and Constitutional Rights of the House Committee on the Judiciary, Upon Introducing the House Amendment to the Senate Amendment to H.R. 8200 (Sept. 28, 1978), Congressional Record H 11089, 1978 U.S.C.C.A.N. 6436, 6453 (95th Cong., 2d Sess.) (emphasis added). It is clear that, to the extent that a partner’s liability for fraud comes only as a result of state law imputing partnership liability, such fraud liability does not constitute “actual fraud.” See BLACK’S LAW DICTIONARY 661 (6th ed. 1990) (distinguishing between “fraud

Given that the Court's holding in *Neal* rejected vicarious liability of innocent persons for debts incurred by another, this statement indicates that Congress, or at least the House of Representatives, did not anticipate liability on the part of innocent partners for partnership debts. In fact, another case decided after *Neal* but before enactment of § 523(a)(2)(A) seemed to overturn the decision in *Neal*.³⁷ Therefore, the legislative history indicates a congressional intent to reinstate *Neal* as the "current" law.

As the legislative history further notes, when the debt regards the use of financial statements, Congress expressly required that the debtor seeking discharge must have made the false statement or, at the very least, "caused [it] to be made."³⁸ This requires an affirmative action on the part of the debtor. The House of Representatives failed to explain the reason for the distinction between these sections. Congress clearly stated, both in the statute and in the legislative history, that a debtor must actually be responsible for creation of a fraudulent financial statement before a court may deny discharge.³⁹ Congress neglected to include such a limitation in the text of § 523(a)(2)(A), yet according to the legislative history, it apparently intended for there to be such a limitation.⁴⁰ No significant changes to § 523(a)(2) have been made since the enactment of the statute in 1978.⁴¹

Though Congress itself has not amended § 523(a)(2)(A) regarding innocent debtors held liable for fraud under state law, legislative history is replete with congressional statements indicating the belief of its members that nondischarge of fraud debts is *already* limited to the debtor who actually committed the fraud. Most recently, the House of Representatives noted that:

in fact," also known as actual or positive fraud and "fraud in law," which exists only as a legal matter). See also RESTATEMENT (SECOND) OF TORTS § 525.

37. *Strang v. Bradner*, 114 U.S. 555 (1885).

38. H.R. REP. NO. 95-595, at 6453 (1978).

39. 11 U.S.C. § 523 (a)(2)(A).

40. S. Rep. No. 95-989, at 5684 (1978).

41. In 1984, subparagraph "C" was added to § 523, providing that:

for purposes of subparagraph (A) of this paragraph, consumer debts owed to a single creditor and aggregating more than \$500 for "luxury goods or services" incurred by an individual debtor on or within forty days before the order for relief under this title, or cash advances aggregating more than \$1,000 that are extensions of consumer credit under an open end credit plan obtained by an individual debtor on or within twenty days before the order for relief under this title, are presumed to be nondischargeable

Pub. L. No. 98-353, at § 307, 98 Stat. 353 (1984).

Allowing consumer debtors in financial distress to choose voluntarily an “unconditional discharge” has been a part of American bankruptcy law since the enactment of the Bankruptcy Act of 1898. The rationale of an unconditional discharge was explained by Congress more than 100 years ago: “[W]hen an *honest* man is hopelessly down financially, nothing is gained for the public by keeping him down, but, on the contrary, the public good will be promoted by having his assets distributed ratably as far as they will go among his creditors and letting him start anew.”⁴²

In addition, Congress has established that the purposes of the § 523 exceptions to discharge are twofold: prevention of improper behavior by debtors and repayment of important debts.⁴³ To the extent that fraud debts may not be discharged, it is the former of these rationales that warrants such an exception:

A narrow set of specified types of claims, however, are “nondischargeable” in bankruptcy, which means that they remain owing to the creditor to the full extent unpaid. These are claims for which discharge would violate the bankruptcy objective of giving a fresh start only to *honest* debtors (such as claims relating to fraud, or claims for criminal restitution obligations to victims) or which are considered to be of paramount societal importance (such as tax obligations, and alimony and child support).⁴⁴

Thus, the lack of attention paid to the plight of innocent debtors caught in the web of § 523(a)(2)(A) appears to arise not because Congress intends for innocent debtors to remain indefinitely liable for the fraud debts of their partners, but because Congress has not considered the possibility that honest debtors are indeed being denied discharge as a result of § 523(a)(2)(A).⁴⁵

42. Bankruptcy Abuse Prevention & Consumer Protection Act of 2001, H.R. REP. NO. 107-3(I), 107th Cong., at 6 (Feb. 26, 2001) (emphasis added).

43. H.R. REP. NO. 102-1085, 102nd Cong., at 50-51 (1992); H.R. REP. NO. 103-835, 103rd Cong., at 3341-42 (1994). See also Bankruptcy Abuse Prevention and Consumer Protection Act of 2001, H.R. REP. NO. 107-3(I) at 459 (Feb. 26, 2001); Bankruptcy Reform Act of 1999, H.R. REP. NO. 106-123(I), 106th Cong., at 387 (Apr. 29, 1999) (“The Bankruptcy Code does not permit the discharge of certain debts whose payments are considered to be important to society [including those] . . . incurred through the debtor’s misconduct, such as debts arising from fraud and intentional injuries.”).

44. H.R. REP. NO. 102-1085, 102nd Cong., at 50-51 (1992) (emphasis added); H.R. REP. NO. 103-835, 103rd Cong., at 3341-42 (1994).

45. Indeed, even some leading bankruptcy scholars assume that the language in § 523(a)(2)(A) applies only to defrauding debtors, despite caselaw to the contrary. See, e.g., 2 COLLIER BANKRUPTCY MANUAL, *supra* note 2, at ¶ 523.07.

II. CASELAW INTERPRETATION OF § 523(A)(2)(A)

A. *Partnership Law*

Because § 523(a)(2)(A) first requires a finding of fraud liability before determining that liability may not be discharged, it is useful to consider when an innocent partner will be responsible for the partnership's debts created by his not-so-innocent partner.

The sole proprietorship represents the most simple form of business. One person runs the business. One person takes the risks. One person makes the decisions. One person presumably knows everything that occurs in the business and takes all the responsibility.⁴⁶ With the sole proprietorship, the issue of whether an owner incurs liability for debts of the business never arises. That is, the sole proprietor is always liable for debts incurred as part of the business because, in some sense, the business simply serves as an extension of its owner.⁴⁷ However, once other owners enter the business, a sole proprietorship no longer exists, and the business owners must now choose from the myriad of organizational options available to structure the business. A partnership, though a relatively simple option with certain tax benefits, provides one major downfall. Each partner becomes liable in full for the debts of the partnership, regardless of whether that partner caused such indebtedness,⁴⁸ except for those debts incurred outside of the ordinary course of business of the partnership.⁴⁹ In fact, even a partner who knows nothing of his partner's decision and who would not have approved of the decision had he known of it remains nonetheless liable.⁵⁰ Although the disapproving partner may be guilty of nothing more than bad judgment in choosing a partner, he will remain responsible for his partner's

46. WILLIAM A. GREGORY, *THE LAW OF AGENCY AND PARTNERSHIP* 255 (3d ed. 2001).

47. ROBERT W. HAMILTON & RICHARD A. BOOTH, *BUSINESS BASICS FOR LAW STUDENTS* 241 (3d ed. 2002).

48. GREGORY, *supra* note 46, at 328.

49. *Id.* Gregory provides a detailed analysis of what actions constitute actions within the course of partnership business or outside of the course of partnership business. *Id.* at 328-32. For purposes of this Article, it is presumed that the innocent partner is properly held liable under state partnership law for the fraud perpetrated by the other partner.

50. *Zois v. Cooper*, 268 B.R. 890, 895 (Bankr. S.D.N.Y. 2001) (finding that debtor actually participated in fraud and thus debt was nondischargeable) (citing *BancBoston Mortgage Corp. v. Ledford (In re Ledford)*, 970 F.2d 1556, 1561 (6th Cir. 1992)); *Fujimoto v. Au*, 19 P.3d 699, 744 (Haw. 2001) (citing *Great Hawaiian Fin. Corp. v. Aiu*, 863 F.2d 617, 621 (9th Cir. 1988)); *Hoffend v. Villa (In re Villa)*, 261 F.3d 1148, 1153 n.8 (11th Cir. 2001) (citing *Winkler v. Winkler*, 239 F.3d 746, 751 (5th Cir. 2001); *In re Ledford*, 970 F.2d at 1561; *Luce v. First Equip. Leasing Corp. (In re Luce)*, 960 F.2d 1277, 1282 (5th Cir. 1992)).

actions to the extent the actions fall within the course of partnership business.⁵¹

The concept of partner liability stems from traditional principal/agency concepts,⁵² with a twist. Traditionally, a principal has liability for the actions of an agent as long as the agent takes those actions within the context of the agency relationship. This employment relationship provides a basis for liability even in the context of a sole proprietorship. Justification for this liability comes from the principal's *control* over the agent, even if that control only comes from the ability to fire the agent for misdeeds⁵³ and *potential to benefit*⁵⁴ from the agent's actions.⁵⁵ The same concepts are at work in a partnership. But with a partnership relationship, each partner acts as both agent and principal simultaneously.⁵⁶ Thus, each partner owes duties to the other akin to the duties of an agent, and each enjoys the benefits and responsibilities of a principal. Because a partner does not employ his partner, the partner has no capacity to "fire" the partner who fails to take his responsibilities seriously; however, the partner generally does have the ability to leave the partnership if he disapproves of the business decisions made by the partner.⁵⁷ And, because partnership asset division relies on state law or a contractual arrangement⁵⁸ rather than on the amount of money each partner makes, the "innocent" partner stands to gain (or lose, of course) based on the decisions of the other partner. These dual elements of control and potential benefit create a situation in which fairness dictates that a creditor, who arguably has little control over or benefit

51. Resnicoff, *supra* note 33, at 171.

52. GREGORY, *supra* note 46, at 271.

53. *Id.* at 14.

54. *Id.* at 13.

55. Ponoroff, *Vicarious Thrills*, *supra* note 20, at 2542-44.

56. See GREGORY, *supra* note 46, at 285. Gregory notes, however, that the adoption of Uniform Partnership Act ("UPA"), U.P.A. § 9(1) (1914) makes each partner an agent of the partnership rather than of the other partners. *Id.* In either case, a partner would be responsible for the actions taken by other partners on behalf of the partnership.

57. REV. UNIF. P'SHIP ACT [RUPA] § 601 (1992) (revised by UNIF. P'SHIP ACT (1997)). Under the Uniform Partnership Act (1914), retirement of a partner dissolved the partnership, but RUPA § 701 allows for retirement of a partner without termination of the partnership. See GREGORY, *supra* note 46, at 382. Of course, the partnership agreement can provide that leaving the partnership constitutes a violation of the agreement, thereby limiting a partner's ability to freely leave the partnership. See *id.* at 377-79. Except for Louisiana, every state, as well as Washington D.C. and the Virgin Islands, has adopted a version of the UPA or RUPA. WILLIAM A. GREGORY & THOMAS R. HURST, UNINCORPORATED BUSINESS ASSOCIATIONS 371-73 (2d ed. 2002).

58. See HAMILTON & BOOTH, *supra* note 47, at 245.

from the partner's actions, may hold the innocent partner accountable for misdeeds of his partner.⁵⁹

B. Discharge of Fraud Debt

Cases dealing with discharge in general initially focused on the idea that a discharge should only protect the so-called "honest, but unfortunate, debtor."⁶⁰ In *Cohen v. de la Cruz*,⁶¹ the United States Supreme Court confirmed that a debtor who fraudulently incurred debt could not discharge that debt.⁶² In fact, the Court went on to say that no liability related to the debt could be discharged.⁶³ The debtor in *Cohen* conceded that debt owed to his tenants due to fraudulent overcharging of rent was nondischargeable. Even so, the debtor had also been ordered to pay the tenants punitive damages under state law. The debtor argued that the punitive damages were not fraudulently incurred but tangential to the fraud debt.⁶⁴ The Court disagreed, stating that the punitive damages merge into the fraud claim and therefore may not be discharged.⁶⁵ Though the Court spoke of *all* fraud debt as being nondischargeable, the Court clearly contemplated that the debtor actually committed the fraud.⁶⁶ The Court in *Cohen* was not faced with the

59. Ponoroff, *Vicarious Thrills*, *supra* note 20, at 2542. See also Resnicoff, *supra* note 33, at 163-66 (noting that scholars justify partner liability for four reasons: the principal has more control over the agent than the victim, the principal has a better ability to absorb the cost of liability than the victim, the principal can more easily insure against loss than the victim, and the principal provides the agent's authority). While principal and agent principles have long been used to describe the liabilities of partners, these principles do not always neatly fit within the partnership model. See Deborah A. Demott, *Our Partners' Keepers? Agency Dimensions of Partnership Relationships*, 58 LAW & CONTEMP. PROBS. 109, 110 (1995) (noting that, while partnership agency may differ from traditional agency principles, agency principles allow for efficient business transactions and protect partners from completely unlimited liability).

60. *Cohen v. de la Cruz*, 523 U.S. 213, 217 (1998) ("The Bankruptcy Code has long prohibited debtors from discharging liabilities incurred on account of their fraud, embodying a basic policy animating the Code of affording relief only to an 'honest but unfortunate debtor.'") (quoting *Grogan v. Garner*, 498 U.S. 279, 287 (1991)). See also Singer, *supra* note 22, at 331 ("This liberal construction is, however, tempered by the view that such equitable considerations are only applicable to honest debtors, since, by seeking a discharge in bankruptcy, a debtor places the rectitude of his or her prior dealings with creditors directly in issue.") (citations omitted).

61. 523 U.S. 213 (1998).

62. *Id.* at 223.

63. *Id.* at 220-21.

64. *Id.* at 219.

65. *Id.* at 223.

66. *Id.* at 217 (noting protection for "honest but unfortunate debtor") (quoting *Grogan*, 498 U.S. at 287). "The most straightforward reading of § 523(a)(2)(A) is that it prevents

issue of an innocent partner and the discharge of such a partner's imputed debt responsibilities. Because that issue did not arise, the Court could focus on the type of liability present. The Court determined that fraud and related debts cannot be discharged, while prescribing a policy of protecting innocent creditors from *perpetrating* debtors.⁶⁷ While these two concepts merge neatly in the context of a debtor seeking to discharge his own fraud debt, the concepts conflict when determining imputed liability of an innocent partner.

C. Discharge of Innocent Partners

The first consideration by the United States Supreme Court of dischargeability of imputed liability came in the case of *Neal v. Clark*,⁶⁸ decided under section 33 of the Bankruptcy Act of 1867.⁶⁹ Neal found himself embroiled in a fraud controversy after reselling bonds that he had purchased from the executor of an estate. The executor lacked the power to sell the bonds to Neal, who then lacked the authority to resell the bonds.⁷⁰ Both Neal and the executor were held to have committed fraud. Though the Court failed to identify the type of fraud committed by the executor, Neal's fraud arose as "constructive fraud."⁷¹ Neal bought the bonds from the estate in good faith and did not realize that the executor could not actually sell the bonds. The Virginia Supreme Court held that Neal's liability was indeed imputed, but that the Bankruptcy Act would not permit discharge, even of imputed liability, because the debt was based in fraud.⁷²

Reversing the Virginia Supreme Court, Justice Harlan noted the Court's agreement that Neal's liability was imputed rather than

discharge of 'any debt' . . . that the *debtor* has fraudulently obtained." *Id.* at 218 (emphasis added). "As we have observed previously . . . it is 'unlikely that Congress . . . would have favored the interest in giving perpetrators of fraud a fresh start over the interest in protecting victims of fraud.' . . . fraud encompasses any liability . . . that is fraudulently obtained . . . by the debtor." *Id.* at 223 (quoting *Grogan*, 498 U.S. at 287). A number of courts have held that debtors involved in the fraud cannot discharge the fraud debt. *See, e.g.* *Bairstow v. Sullivan (In re Sullivan)*, 198 B.R. 417, 424 (Bankr. D. Mass. 1996) (concerning owner's vicarious liability for employee's malicious acts, but holding that owner's knowledge of act meant that owner also acted maliciously).

67. 523 U.S. at 223.

68. 95 U.S. 704 (1877).

69. 14 Stat. 517 (repealed 1878). "No debt created by the fraud or embezzlement of the bankrupt, or by defalcation as a public officer, or while acting in a fiduciary capacity, shall be discharged under this act." *Neal*, 95 U.S. at 706 (quoting Bankruptcy Act of 1867 § 33).

70. 95 U.S. at 704.

71. *Id.* at 705, 707.

72. *Id.* at 707.

actual.⁷³ The Court differed, however, in its interpretation of section 33 of the Bankruptcy Act.⁷⁴ Justice Harlan concentrated on the Act's linking of fraud debt to embezzlement.⁷⁵ Because embezzlement clearly requires intent, the Court found that, in enacting section 33, Congress must also have intended to deny discharge only in cases of intentional fraud.⁷⁶ Because imputed fraud, by definition, is unintentional, imputed fraud did not fall under nondischargeability provisions of section 33.⁷⁷ In addition, this statutory construction was bolstered by sound policy considerations. In particular, permitting discharge of innocent debtors promoted the overriding policy of the Bankruptcy Act "by which the *honest* citizen may be relieved from the burden of hopeless insolvency."⁷⁸

Less than a decade after the decision in *Neal*, the Supreme Court again considered an attempt to discharge imputed fraud debt by an innocent partner. *Strang v. Bradner*⁷⁹ involved a partnership of Strang and two brothers named Holland. Strang, without the knowledge of the Holland brothers, fraudulently convinced another partnership, Lowrey & Bradner, to provide the Strang partnership with wool to sell. Though clearly liable for the fraud under partnership law, the Holland brothers sought to discharge the debt in their personal bankruptcies on the ground that they had not participated in the fraud.⁸⁰ The United States Supreme Court rejected the Hollands' argument, holding that fraud debts, even debts for imputed fraud, could not be discharged in bankruptcy,⁸¹ effectively reversing the decision of the Court in *Neal*. Of course, the Supreme Court may rethink its prior decisions,⁸² even

73. *Id.*

74. *Id.* at 708.

75. *Id.* at 709.

76. *Id.*

77. *Id.*

78. *Id.* (emphasis added).

79. 114 U.S. 555 (1885).

80. *Id.* at 557-58.

81. *Id.* at 560-61. Interestingly, even the *Strang* court seems to recognize some need for the debtor to have committed fraud, stating that "the statute expressly declares that a discharge is subject, even in respect of claims provable in bankruptcy, to the limitation that no *debt created by the fraud of the bankrupt* shall be discharged by the proceedings in bankruptcy." *Id.* (emphasis added). The Court fails to rectify this language with its decision to hold imputed fraud nondischargeable.

82. The Supreme Court adheres to *stare decisis* principles, even when considering overturning its prior decisions. Specifically, the Court balances the benefits of the new rule and the difficulties in enacting it. Some considerations may include: whether the old rule has become unworkable, whether society has come to rely upon the old rule, whether changes in the law have left the old rule with no substance, or whether a change in factual

if the decisions are recent, but the Court in *Strang* did not view its decision as different from the *Neal* decision.⁸³ In fact, the Court in *Strang* apparently used *Neal* as authority for its decision:

In *Neal v. Clark*, . . . it was held that, looking to the object of Congress in enacting a general law by which the honest citizen might be relieved from the burden of hopeless insolvency, the term "fraud," in the clause defining the debts from which a bankrupt is not relieved by a discharge under the bankrupt act, should be construed to mean positive fraud, or fraud in fact, involving moral turpitude or intentional wrong, and not implied fraud or fraud in law, which may exist without the imputation of bad faith or immorality. This principle was affirmed in the recent case of *Hennequin v. Clews*, . . . where will be found a reference to the leading cases in this country and in England.⁸⁴

How, then, did the Court decide *Strang* in light of *Neal*? A number of possibilities exist. First, *Strang* and *Neal* may be factually distinguishable. At least one commentator has distinguished the cases by noting that in *Neal* no one had an intent to deceive.⁸⁵ Without an intent to deceive, even the primarily responsible party could discharge his debt and, thus, the innocent partner could do so as well.⁸⁶ However, the

circumstances create the need for a different rule. *Planned Parenthood of Southeastern Pa. v. Casey*, 505 U.S. 833, 854-55 (1992).

83. 114 U.S. at 559.

84. *Id.* The Court in *Strang* readily conceded that the liability of the Holland brothers was merely imputed. *Id.* at 561.

85. Ponoroff, *Vicarious Thrills*, *supra* note 20, at 2537.

86. *Id.* Ponoroff explains the differences between *Neal* and *Strang* as follows:

The debt for which exception from discharge was sought in *Strang* was undeniably incurred by means of a deliberate fraud. In *Neal*, there was no proof that there had ever been an intent to deceive on the part of any party to the transaction. Furthermore, the legal issue in *Strang*—recognition of vicarious liability in bankruptcy litigation—was simply not before the Court in *Neal*. Put another way, *Neal* addressed the issue of the *type* of debt that might be entitled to protection from the discharge, whereas *Strang* focused on who would be subject to that exception once a debt of the requisite type had been established. Thus, *Strang* is not in any way inconsistent with the basic holding in *Neal*, which remains good law to this day, that the fraud exception to the discharge requires proof of actual intent to deceive.

Id. There is no indication by the Court in *Neal* whether the executor escaped liability for the fraud. The party that Neal sold the bonds to, however, avoided liability. 95 U.S. at 704. Though Ponoroff suggests that the real inquiry in *Neal* is whether vicarious liability would be carried through to bankruptcy, that issue is synonymous with whether the debt can be discharged. The liability is not a matter of bankruptcy law, but of state law. Once liability exists per state law, the only authority of the bankruptcy court is to discharge the existing liability. Under both *Neal* and *Strang*, the dischargeability of debt relies on the language of the statute and whether the debt is intentional. The only difference between

court clearly spoke of intentional fraud in *Neal*, without stating whether the trustee was guilty of committing fraud, and of punishment of dishonest debtors.⁸⁷ Even if no intentional fraud existed, constructive fraud is deemed to be as reprehensible as actual fraud.⁸⁸ Nothing in section 33 of the Bankruptcy Act indicated a difference between actual and constructive fraud. The only distinction between actual and constructive fraud was created by the Court in *Neal*, which did not further distinguish between constructive fraud and implied fraud. Constructive fraud may exist without underlying actual fraud, and implied fraud cannot exist without underlying actual fraud.⁸⁹ Thus, though the Court in *Neal* spoke of “constructive” fraud, it is entirely possible that the Court was actually dealing with an implied fraud case. Furthermore, the Court seemed to ignore the trustee’s fraud, giving no basis for the conclusion that the character of the original fraud dictates the dischargeability of the subsequent fraud.

Another difference between the cases is that *Neal*, though involving imputed liability, did not involve a partnership.⁹⁰ Yet, these factual differences hardly justify different results in the cases; in each case an innocent party finds himself liable for fraud pursuant to state law after working with a party who committed fraud.

A second possibility exists that the cases can be distinguished legally. However, the Court decided each case on the basis of the Bankruptcy Act of 1867. Different state laws imputing liability are irrelevant as the Court dealt not with the fraud liability of the innocent party, but with the ability to discharge fraud liability that otherwise clearly exists. Seemingly, then, if the cases pose identical factual and legal issues, the court in *Strang* simply decreed that *Neal* was wrongly decided and changed the law. This, too, seems improbable, given that the Court in *Strang* cites the decision in *Neal* with apparent agreement.⁹¹ This

the cases is that *Strang* relies upon the intent of any party, while *Neal* focuses only on the intent of the debtor.

87. 95 U.S. at 709 (fraud requires “moral turpitude or intentional wrong”).

88. BLACK’S LAW DICTIONARY 661 (6th ed. 1990) (“constructive frauds are such acts or contracts as, though not originating in any actual evil design or contrivance to perpetrate a positive fraud or injury upon other persons, are yet, by their tendency to deceive or mislead other persons, or to violate private or public confidence, or to impair or injure the public interests, deemed equally reprehensible with actual fraud”).

89. *Neal*, 95 U.S. at 709.

90. For another example of nonpartnership imputed liability, see *Tsurukawa v. Nikon Precision, Inc. (In re Tsurukawa)*, 258 B.R. 192, 198 (9th Cir. BAP 2001), distinguishing spousal liability from other imputed fraud liability.

91. 114 U.S. at 559.

leaves the law of imputed liability and dischargeability of such liability in disarray.

Since the enactment of the current Bankruptcy Code, other cases dealing with dischargeability by innocent debtors of imputed fraud liability have followed three paths: denying discharge only if the innocent party knew or should have known of the fraud,⁹² denying discharge only if the innocent debtor benefitted from the fraud,⁹³ or denying discharge in all cases.⁹⁴ This has created continuing confusion between state law requirements for imputing fraud liability to partners and the Bankruptcy Act's requirements for refusing discharge of that liability.

D. Knowledge of the Fraud

Imputed liability is not limited to partnerships. In *Tobin v. Sans Souci Limited Partnership (In re Tobin)*,⁹⁵ the court faced the question of whether to discharge fraud liability imputed to a shareholder of a corporation.⁹⁶ The shareholder's liability was established in the state court on the basis that the shareholder was merely the "alter ego" of the corporation. Thus, the corporation's fraud liability was the shareholder's liability.⁹⁷ The court permitted discharge, holding that without direct involvement in or knowledge of the fraud, the shareholder's liability could be discharged pursuant to § 523(a)(2)(A).⁹⁸

A number of courts have likewise indicated that an "innocent" debtor will be discharged from fraud debt unless that debtor either knew or should have known of the fraud committed by his partner.⁹⁹ Consider another case involving imputed liability outside of the partnership context, *Walker v. Citizens State Bank of Maryville, Missouri (In re Walker)*.¹⁰⁰ In *In re Walker*, the husband operated a hardware store

92. See *infra* notes 95-107 and accompanying text.

93. See *infra* notes 108-35 and accompanying text.

94. See *infra* notes 136-59 and accompanying text.

95. 258 B.R. 199 (9th Cir. BAP 2001).

96. *Id.* at 202.

97. *Id.* at 201.

98. *Id.* at 206. *Cf.* *Laborers Clean-Up Contract Admin. Trust Fund v. Kay (In re Kay)*, 60 B.R. 174, 177 (Bankr. C.D. Cal. 1986) (holding imputed liability of "alter ego" of corporation absolutely nondischargeable).

99. *Green Tree Fin. Corp. v. Beasley (In re Beasley)*, 202 B.R. 979, 984 (Bankr. W.D. Mo. 1996) (concerning agency principles, not partnership); *Hamilton v. Betz (In re Betz)*, 64 B.R. 248, 251 (Bankr. N.D. Ohio 1986) (citing *Alden State Bank v. Anderson*, 29 B.R. 184 (Bankr. Iowa 1983); *Modern Distribs., Inc. v. Gray (In re Gray)*, 22 B.R. 676, 680 (Bankr. Wis. 1982)).

100. 726 F.2d 452 (8th Cir. 1984).

as a sole proprietorship. His wife ran the store while he was incapacitated and fraudulently convinced a bank to loan the store money by the creation of false accounts receivable. The wife's fraud was imputed to Walker pursuant to agency principles.¹⁰¹ The court considered whether Mr. Walker's fraud debt could be discharged, but did not consider the validity of imputing the debt to Mr. Walker.¹⁰² The court held that "[p]roof that a debtor's agent obtains money by fraud does not justify the denial of a discharge to the debtor, unless it is accompanied by proof which demonstrates or justifies an inference that the debtor knew or should have known of the fraud."¹⁰³ Though the court apparently felt that knowledge must be imputed to the debtor in order to deny discharge of fraud debt, the court was apparently confused by the distinction between liability and nondischargeability, stating:

[M]ore than the mere existence of an agent-principal relationship is required to *charge the agent's fraud* to the principal. However, as indicated, actual participation in the fraud by the principal is not always required. If the principal either knew or should have known of the agent's fraud, the agent's fraud will be imputed to the debtor-principal.¹⁰⁴

The state law did not require knowledge of Mrs. Walker's fraud to hold her principal, Mr. Walker, liable for the fraud. Further, imputation of fraud pursuant to state law was not at issue in *In re Walker*; rather, the true question before the court was the ability to discharge the imputed debt.¹⁰⁵ The court remanded *In re Walker* for a determination of whether the husband knew or should have known of the wife's fraud.¹⁰⁶ *In re Walker* has been criticized for its harsh results to creditors.¹⁰⁷

E. Development of Benefit of the Fraud

One interesting question that has arisen and received some attention since the decision in *Strang* is whether imputed fraud liability requires that the innocent partner must actually receive a benefit in order to be

101. *Id.* at 453-54.

102. *Id.* at 454.

103. *Id.*

104. *Id.* (emphasis added).

105. *Id.*

106. *Id.* at 455.

107. See *In re Calhoun*, 131 B.R. 757, 761 (Bankr. D. Colo. 1991) (citing *Walker*, 53 B.R. 174 (Bankr. W.D. Mo. 1985); *BancBoston Mortgage Corp. v. Ledford (In re Ledford)*, 970 F.2d 1556 (6th Cir. 1992); *Flucher v. Paolino (In re Paolino)*, 75 B.R. 641, 649 (Bankr. E.D. Pa. 1987). See also Ponoroff, *Vicarious Thrills*, *supra* note 20, at 2528-30.

held liable for fraud, or, more accurately, to be denied discharge. This question arises as a result of the Court's off-handed mention in *Strang* that "partners cannot escape pecuniary responsibility therefor[e] upon the ground that such misrepresentations were made without their knowledge. This is especially so when, as in the case before us, the partners, who were not themselves guilty of wrong, received and appropriated the fruits of the fraudulent conduct"¹⁰⁸ That a debtor must receive a benefit before a court withholds discharge of fraud debt to the debtor is a requirement that developed in cases involving a guilty partner seeking a discharge, but has since been considered in the context of innocent partners seeking discharge of imputed fraud debt.

The Ninth Circuit adopted the "receipt of benefits" test in *Ashley v. Church (In re Ashley)*.¹⁰⁹ The debtor fraudulently convinced his clients to invest money in a corporation. Though clearly liable for the fraud under state law, the debtor argued that the debt should be discharged because it was the corporation, not the debtor himself, that benefitted as a result of the fraud.¹¹⁰ Though the court agreed that the proper standard to be used in determining dischargeability should be "receipt of benefit," the court disagreed with Ashley's contention that he did not receive a benefit from the fraudulent misrepresentations.¹¹¹ Though this decision indicates that the Ninth Circuit has indeed adopted the "receipt of benefits" test in some circumstances, the court has not had occasion to consider whether the test would also apply to the case of an innocent debtor attempting to discharge fraud liability.¹¹²

Like the Ninth Circuit, the Eleventh Circuit has embraced the "receipt of benefits" test when dealing with "guilty" debtors. The case of *HSSM*

108. *Strang*, 114 U.S. at 561 (emphasis added). The Court in *Strang* included this language after a discussion of the nature of the liability of the Holland Brothers as imputed rather than direct liability based on agency principles. *Id.*

109. 903 F.2d 599 (9th Cir. 1990). Previous Ninth Circuit decisions concerning the issue caused confusion. In *Impulsora Del Territorio Sur, S.A. v. Cecchini (In re Cecchini)*, 780 F.2d 1440, 1444 (9th Cir. 1986), the court held that liability could be imputed to an innocent partner. The innocent partner was found liable, and that liability nondischargeable, for the actions of his partner in a complicated business transaction. However, the decision in *Cecchini* was criticized the next year by the same court. *La Trattoria, Inc. v. Lansford (In re Lansford)*, 822 F.2d 902, 905 (9th Cir. 1987) (finding no need to decide on issue because of debtor's direct involvement in fraud).

110. 903 F.2d at 602, 604.

111. *Id.* at 604.

112. The Ninth Circuit Bankruptcy Appellate Panel in 2001 decided a case involving imputed liability upon a shareholder of corporate liability. The court held that imputed liability would always be discharged. *In re Tobin*, 258 B.R. at 206. *See supra* notes 95-98 and accompanying text.

#7 *Limited Partnership v. Bilzerian (In re Bilzerian)*¹¹³ involved an appeal from the Middle District of Florida, which had reversed the decision of the bankruptcy court permitting discharge of fraud debt. The debtor, Bilzerian, owed over twenty million dollars to HSSM #7 Limited Partnership pursuant to a state court judgment finding Bilzerian and his business liable for fraud.¹¹⁴ The court held that because Bilzerian had obtained a benefit from the money obtained by the fraudulent misrepresentations to the partnership, Bilzerian could not discharge his indebtedness to the partnership.¹¹⁵ Although the court in *In re Bilzerian* considered whether a “receipt of benefits” test is appropriate, the court did so in the context of a guilty debtor.¹¹⁶ Clearly, the discharge standards for an innocent debtor should not be more stringent, preventing absolute nondischargeability for an innocent debtor. The possibility exists either that an innocent debtor in the Eleventh Circuit would be held to the same standard as a guilty partner (“receipt of benefit”) or to a lesser standard of unrestricted right to discharge.

In *Luce v. First Equipment Leasing Corp. (In re Luce)*,¹¹⁷ Luce was an innocent debtor whose partner had defrauded creditors of the partnership into believing that they were loaning money to the partnership to buy equipment and receiving the equipment as collateral for the loans. In reality, the partner was keeping the money, and the creditors were left with nothing.¹¹⁸ The court held that an innocent debtor may not discharge the debt obtained by fraud if the debtor benefitted from that fraud.¹¹⁹ However, the real issue covered in *In re Luce* was the standard by which the creditor must prove that discharge should be denied, including the element of benefit to the innocent debtor.¹²⁰ The Eighth Circuit previously held that “clear and convincing evidence” must exist to deny discharge,¹²¹ but the court in *In re Luce* held that the elements of the case must only be established by a preponderance of the evidence.¹²² Regardless of the standard used, the

113. 100 F.3d 886 (11th Cir. 1996).

114. *Id.* at 888.

115. *Id.* at 890-91.

116. Interestingly, however, the court used the Fifth and Sixth Circuits’ decisions holding an innocent partner to a “receipt of benefits” standard to bolster its argument that a guilty partner should be held to the same standard. *Id.* at 891.

117. 960 F.2d 1277 (5th Cir. 1992).

118. *Id.* at 1279-80.

119. *Id.* at 1283 (citing *Century First Nat’l Bank v. Holwerda (In re Holwerda)*, 29 B.R. 486, 489 (Bankr. M.D. Fla. 1983)).

120. *Id.* at 1281.

121. *Id.*

122. *Id.*

court clearly felt that the benefit to the debtor had been established and refused to discharge Luce's debt in bankruptcy.¹²³

Likewise, in *BancBoston Mortgage Corp. v. Ledford (In re Ledford)*,¹²⁴ the Sixth Circuit held that an innocent partner may not discharge a debt incurred fraudulently by a partner in the ordinary course of the partnership's business.¹²⁵ Ledford and Sikes were partners, but the partnership was actually managed by Ledford with little help from Sikes.¹²⁶ BancBoston loaned the partnership money to build condominiums. As a condition of the loan, the partnership was required to prove that fourteen contracts to purchase the condominiums had been entered into.¹²⁷ Without Sikes's knowledge, Ledford fraudulently created many of the fourteen contracts needed to secure the BancBoston loan. Some of the contracts were subject to undisclosed side agreements, and two of the contracts were signed as a favor to Ledford by people who never actually intended to purchase condominiums. To

123. The court in *In re Luce* clearly felt that the benefit to the innocent debtor was established:

Billye Luce did benefit from Jack Luce's fraud. As a partner, Billye Luce benefitted when the Equipment Supplier passed on funds received by it from the equipment lessors to the Luce Partnerships. Most of the money obtained from the equipment lessors went into Billye and Jack Luce's joint bank accounts. In turn, the money in the joint bank accounts was used to acquire real estate, stock, and oil and gas investments held jointly by Billye and Jack Luce, to pay business and personal expenses of the Luces, and to make payments on leases and loans, some of which Billye Luce had personally guaranteed.

Id. at 1283.

Unfortunately, such a definition of benefit leaves only one class of innocent partners protected: innocent partners whose partner absconded with the proceeds of the fraud for his own benefit. Often partnership fraud, however, involves partners trying to create a benefit for the partnership in addition to a personal benefit.

124. 970 F.2d 1556 (6th Cir. 1992). One commentator has observed that cases like *In re Ledford* should make partners more aware of the business of the partnership and each of its partners. Paul S. Davidson, *Vicarious Liability and the Traditional Law Firm Partnership: What You Should Know*, TENN. B.J., June 29, 1993, at 12, 15. Interestingly, Davidson successfully represented BancBoston in *In re Ledford*.

Arguably, however, the fact that a debt may not be discharged in bankruptcy only changes the awareness of a partner contemplating bankruptcy. Because state law creates partner liability for partnership debts regardless of the partner's knowledge, such awareness has always been advisable for partners in order to prevent or limit the fraud. However, the partner who believes that bankruptcy will compensate for ignorance may be sadly mistaken.

125. 970 F.2d at 1561-62.

126. *Id.* at 1558.

127. Interestingly, the bank had some notice that the partnership was having problems selling the condominium units. The bank had originally asked for twenty such contracts, but lowered the requirement to fourteen upon the partnership's request. *Id.*

make matters worse, construction fell behind schedule, and the valid contracts had expired by the time the condominium units were ready for occupancy. The partnership failed to make required payments on the BancBoston loan and filed for bankruptcy protection.¹²⁸ Fraud was easily established in the case as BancBoston clearly would not have loaned the partnership the funds had the contracts not been created.¹²⁹ Because the partnership lacked the funds to repay BancBoston's loan, the bank instead proceeded against Sikes as a partner.¹³⁰ The court held that, under state law, Sikes was responsible for the fraudulent debt incurred by the partnership and, under bankruptcy law, the fraud debt could not be discharged.¹³¹ In so deciding, the court cited *Luce* and *Strang* for the proposition that benefit to the innocent partner could be considered in determining dischargeability.¹³²

128. *Id.*

129. *Id.* at 1560.

130. *Id.* at 1558.

131. *Id.* at 1561-62. The Court in *Ledford* also considered whether BancBoston reasonably relied on the fraudulent contracts in making the loan to the partnership. *Id.* at 1559-60. This requirement that a creditor's reliance must be reasonable before a debt will be declared nondischargeable comes not from a statute, but has developed through case law. *Id.* at 1559 (citing *Coman v. Phillips (In re Phillips)*, 804 F.2d 930, 933 (6th Cir. 1986), *Mfrs. Hanover Trust Co. v. Ward (In re Ward)*, 857 F.2d 1082 (6th Cir. 1988)). *But see* *Recover Edge L.P. v. Pentecost*, 44 F.3d 1284, 1293 n.17 (5th Cir. 1995) (holding that the Fifth Circuit does not require reasonable reliance under § 523(a)(2)(A)). Reasonableness requires only that a creditor be on notice for obvious signs of a problem. This case law requirement creates confusion because reasonableness is *expressly* required in § 523(a)(2)(B), yet the courts have been willing to accept reasonableness as an implied element of § 523(a)(2)(A). *See also In re Calhoun*, 131 B.R. 757, 759-60 (Bankr. D. Colo. 1991) (holding that § 523(a)(2)(A) requires reliance, though that reliance need not be reasonable as in § 523(a)(2)(B)); *Fluher v. Paolino (In re Paolino)*, 89 B.R. 453, 458 (Bankr. E.D. Pa. 1988) (requiring only reasonable reliance in § 523(a)(2)(A) case).

The Supreme Court has expressly rejected the contention that § 523(a)(2)(A) requires "reasonable reliance" and instead favors the lesser standard of "justifiable reliance." *Field v. Mans*, 516 U.S. 59, 74-75 (1995). The Court reached its conclusion based on the "negative pregnant" rule of statutory construction. This rule provides that when one section of a statute includes a requirement, and another section of the statute is silent on that requirement, the general presumption is that the requirement does not apply to the silent section of the statute. *Id.* at 67, 74-75 (citing *Gozlon-Peretz v. United States*, 498 U.S. 395, 404 (1991)). However, this presumption may be rebutted when the result would be unreasonable.

The Court then stated that § 523(a)(2)(A) must require a reliance element because if there is no such element, the link between the misrepresentation and giving of value, clearly required by § 523(a)(2)(A), would disappear. *Id.* at 67-68. In addition, the Court indicated that, when a statute uses common-law terms, the Court may interpret those terms in accordance with "generally shared common law." *Id.* at 73-74.

132. 970 F.2d at 1561-62.

In re Ledford provides an unusual situation—a windfall of sorts to the bank. It was not the fraud that caused the default on the bank loan, but the delay in building the condominium units. Had the contracts not been fraudulent—had fourteen people actually signed unconditional contracts fully intending to purchase the property if completed on schedule—the default still would have occurred because the partnership did not complete the condominiums in sufficient time to comply with the contracts. The partnership would have been liable to the bank and presumably would have filed bankruptcy. If the partnership could not pay the bank, the debt would fall upon the shoulders of the partners, Ledford and Sikes. When Sikes declared a personal bankruptcy, the debt would be dischargeable because no fraud occurred. So, it actually benefitted the bank (and, of course, harmed Sikes) that the debt was incurred fraudulently. *In re Ledford* provides a real-life scenario akin to the Triple J example in the introduction because in each the fraud of the perpetrating partner alters an otherwise unchanged relationship between the innocent partner and a creditor.

Though most circuits considering the issue of fraud dischargeability have adopted a “receipt of benefits” test, it is important to note that few of the adopting circuits have actually had occasion to consider the issue with regard to innocent debtors.¹³³ To the extent that innocent debtors have been considered, the bankruptcy courts have created most of the common law.¹³⁴ The results have differed widely from the results of the circuit courts.¹³⁵

F. *The Trend Away from Receipt of Benefits*

Since deciding *In re Luce*, the Fifth Circuit has abandoned the “receipt of benefits” test. In *Winkler v. Winkler*,¹³⁶ a client of the Winkler partnership, Deodati, worked exclusively with one of Winkler’s partners, McCreight. Deodati asked that the partnership buy investments on his

133. See *Bilzerian*, 100 F.3d at 891; *Ashley*, 903 F.2d at 603-04. *But cf. Luce*, 960 F.2d at 1282.

134. See *infra* note 135.

135. The Missouri bankruptcy courts alone have been split between receipt of benefits and absolute nondischargeability. See *In re Beasley*, 202 B.R. 979, 985 (Bankr. W.D. Mo. 1996) (requiring knowledge or recklessness before imputing liability for agent’s actions); *Owens v. Miller*, 240 B.R. 566, 574 (Bankr. W.D. Mo. 1999) (requiring knowledge or recklessness for partner’s fraud liability to be nondischargeable), *rev’d*, 276 F.3d 424 (8th Cir. 2002). *But see* *W-V Enters., Inc. v. Guse (In re Guse)*, 150 B.R. 950, 954 (Bankr. E.D. Mo. 1993) (holding principal absolutely liable for agent’s actions regardless of knowledge); *Oether v. Bullington (In re Bullington)*, 167 B.R. 157, 163 (Bankr. W.D. Mo. 1994) (holding that wife may not discharge debt arising from husband-partner’s fraud under § 523(a)(6)).

136. 239 F.3d 746 (5th Cir. 2001).

behalf. McCreight agreed, but actually embezzled Deodati's money to purchase the investments. McCreight concealed the embezzlement by creating false accounting statements. The remaining partners were completely unaware of the McCreight fraud at its inception. When, however, one of the partners uncovered the fraud, he reported it to Deodati, who then sued the partnership and its partners. Eventually the innocent partners sought bankruptcy protection.¹³⁷

Because the partnership lacked the funds to pay Deodati, the partners were individually liable for the debt.¹³⁸ Deodati asked the court to deny discharge in the individual partners' bankruptcy proceedings as a fraudulently-incurred debt.¹³⁹ The Fifth Circuit complied, holding that an innocent partner cannot discharge partnership debts incurred by the fraud of another partner as long as the guilty partner acted in the ordinary course of business.¹⁴⁰ The court considered the appropriateness of the use of a "receipt of benefits" test, but determined that receipt of a benefit could only constitute an "aggravating factor and not a requirement to impute nondischargeable fraud liability."¹⁴¹ Unfortunately, the court failed to explain what an aggravating factor provides to the creditor.¹⁴² If a fraud debt exists, the creditor gets exactly what

137. *Id.* at 748.

138. *Id.*

139. *Id.*

140. *Id.* at 751.

141. *Id.* (citing *Strang*, 114 U.S. at 561). Not only does *Winkler* reject a "receipt of benefits" requirement, it also rejects an "ordinary course of business" requirement: "We conclude that if a debt arises from fraud and the debtor is liable for that debt under state partnership law, the debt is nondischargeable under § 523(a)(2)(A). Receipt of benefits and the ordinary course of business are irrelevant to this inquiry as matters of federal law." *Id.* at 751-52. To the extent that a court follows the "literal language" of § 523(a)(2)(A), the court reaches the correct conclusion. Partners held liable pursuant to state law cannot discharge that liability, regardless of factors such as receipt of benefits or ordinary course of business. However, some states only impose liability on innocent partners when they have received a benefit or the guilty partner acted in the ordinary course of business. *Kansallis Fin. Ltd. v. Fern*, 659 N.E.2d 731, 738 (Mass. 1996) (noting that guilty partner must act without apparent authority—outside of the scope of business—and no benefit be received by the other partner in order to avoid imputed liability). Thus, one of these requirements must exist in order to have nondischargeable imputed liability, but only because the imputed liability so requires.

142. *See also Moore v. Gill (In re Gill)*, 181 B.R. 666, 674 (Bankr. N.D. Ga. 1995) (noting that though receipt of benefit is not required for nondischargeability, the innocent partner benefitted because fraud allowed the business to be more competitive, but also noting that personal connection with partnership was more easily seen because the debtor commingled personal funds with partnership funds).

it wants—no discharge. If the debt is not a fraud debt, § 523(a)(2)(A) is irrelevant, regardless of receipt of benefit.¹⁴³

Likewise, in *Giacalone v. Malget (In re Malget)*,¹⁴⁴ the court held that a partner could be liable for the fraud of his partner and the resulting debt could not be discharged without consideration of benefit to the debtor.¹⁴⁵ However, the court's holding comprises dicta as the court found that the debt was dischargeable because the creditor failed to prove reliance on the misrepresentations and thus failed to show any fraud at all.¹⁴⁶ The partner misrepresented the value of collateral supporting a promissory note prior to its sale. Though the debtor had knowledge of this misrepresentation, the court held that such knowledge did not matter.¹⁴⁷ Even without the knowledge, the debtor's imputed fraud liability, had any existed, could not have been discharged.¹⁴⁸

The Colorado courts joined the list of districts refusing discharge for imputed fraud liability with decisions in 1991¹⁴⁹ and 2000.¹⁵⁰ In *In re Calhoun*, the bankruptcy court held that a debtor would automatically be held liable for fraud debt that his firm incurred when another partner took out a loan on the firm's behalf based on fraudulent representations of the firm's financial condition.¹⁵¹ Though the debtor benefitted from the fraud, the court did not base its decision on that benefit.¹⁵² In addition, the court in *In re Denbleyker* specifically rejected the "receipt of benefits" approach.¹⁵³ NDSI, a general contractor on a construction project, alleged that its subcontractor, JDB, Inc., and JDB's general manager, Denbleyker, made intentional misrepresentations about JDB's

143. Conceivably, Congress could decide that, to the extent that a partner benefits from negligence of his partner, fairness would require that the partner be denied dischargeability to the extent of the benefit. However, Congress has not made such a declaration at this time.

144. 165 B.R. 933 (Bankr. S.D. Cal. 1994).

145. *Id.* at 936.

146. *Id.* at 938.

147. *Id.* at 937-38.

148. *Id.* at 936 (citing *In re Ledford*, 970 F.2d 1556; *In re Luce*, 960 F.2d 1277; *In re Calhoun*, 131 B.R. 757; *Fed. Deposit Ins. Corp. v. Figge (In re Figge)*, 94 B.R. 654 (Bankr. C.D. Cal. 1988), *aff'd without opinion*, *FDIC v. Figge*, 928 F.2d 1136 (9th Cir. 1991)). *Cf.* *Terminal Builder Mart of Piedmont, Inc. v. Warren (In re Warren)*, 7 B.R. 571, 573 (Bankr. Ala. 1980) (focusing on "innocent" partner's knowledge of partner's misrepresentation in refusing discharge); *Owens v. Miller*, 240 B.R. 566, 574 (W.D. Mo. 1999) (requiring knowledge or recklessness to impute liability).

149. *In re Calhoun*, 131 B.R. at 762-63.

150. *In re Denbleyker*, 251 B.R. 891 (Bankr. D. Colo. 2000).

151. 131 B.R. at 760-62.

152. *Id.* at 762-63.

153. 251 B.R. at 898-99.

work. The state court found Denbleyker liable for the fraud,¹⁵⁴ and the bankruptcy court held that, given the state court's determination regarding fraud, Denbleyker could not discharge the debt.¹⁵⁵ The bankruptcy court then recognized that some cases following *Strang* require that the debtor benefit by the fraudulent misrepresentation before refusing discharge of a fraud debt.¹⁵⁶ Though the court expressly rejected this "receipt of benefits" test, *Strang* and *In re Denbleyker* differ factually because in the latter the debtor seeking the discharge, Denbleyker, was actually the person who perpetrated the fraud.¹⁵⁷ Denbleyker was not an innocent debtor. Rather, Denbleyker alleged that, even though he personally committed the fraud, he did not receive a benefit from his actions and thus could discharge the debt.¹⁵⁸ In admonishing Denbleyker's argument, the court cited *Cohen*, noting that the Supreme Court's holding indicated that a debtor could not discharge

154. *Id.* at 893-94.

155. *Id.* at 894 (noting that determination of dischargeability may depend on underlying state court litigation).

156. *Id.* at 896 (citing *Brady v. McAllister (In re Brady)*, 101 F.3d 1165 (6th Cir. 1997); *In re Bilzerian*, 100 F.3d 886 (11th Cir. 1996); *In re Luce*, 960 F.2d 1277; *In re Ashley*, 903 F.2d 599). The court noted that each circuit court and many bankruptcy courts that had considered dischargeability of fraud debt had adopted the "receipt of benefits" test. *In re Denbleyker*, 251 B.R. at 896 n.1.

157. *In re Brady* likewise involved a guilty debtor claiming an ability to discharge fraud debt on the basis of lack of benefit received. The debtor had entered into a partnership to purchase real estate. When the partnership sold the real estate, the true sale price was \$290,000. However, the debtor indicated that the sale price was \$210,000 and remitted \$105,000 to his partner. The remaining money was transferred into accounts held by debtor's businesses. 101 F.3d at 1165, 1168. After finding that the debtor clearly owed the partner \$40,000 and that the withholding of the \$40,000 constituted fraud, the court found that the debtor's fraud had provided a benefit to the debtor. *Id.* at 1172. The court did not deal with whether receipt of a benefit was necessary, but rather held that if necessary, such a benefit clearly existed. *Id.* In fact, the court expressly "reject[ed] debtor's implication that a debt is nondischargeable under section 523(a)(2)(A) only when the creditor proves that the debtor directly and personally received every dollar lost by the creditor." *Id.* See also *In re Bilzerian*, 100 F.3d at 890 (citing *In re Ledford*, 970 F.2d 1556; *In re Luce*, 960 F.2d 1277; *In re Ashley*, 903 F.2d at 604) (noting that mere potential to benefit is a benefit). The courts remain unsettled as to whether a guilty debtor may discharge a fraud debt if he did not in fact benefit from the fraud. *In re Brady*, 101 F.3d at 1171-72. While recognizing the debate in the courts, this Article assumes that fraud debts of guilty partners are never dischargeable and argues that, even if the courts find the guilty debtor unable to discharge any fraud debts, an innocent partner should not face the same standard.

158. 251 B.R. at 895.

any liability arising from his own fraud, with no mention of benefits as a prerequisite.¹⁵⁹

G. Weaknesses of the “Receipt of Benefits” Approach

The decision in *Winkler* brings out one of the problematic features of the “receipt of benefits” test.¹⁶⁰ To the extent that an innocent debtor’s ability to discharge fraud liability depends upon the debtor’s lack of benefit from the fraud, the exception (no discharge if benefit received) swallows the general rule that a debtor should be able to discharge debts.¹⁶¹ Rarely will fraud by a partnership via one of its partners not create any benefit whatsoever for the remaining partners, which forces courts to deny discharge of imputed liability in all but a few exceptional cases:

Luce, therefore, stands at least for the proposition that where a partner’s fraud benefits the *partnership*, all other partners necessarily receive a benefit from the fraud. To the extent that *Luce* does not specifically hold that a partner is deemed to benefit even absent a showing of actual benefit to the partnership, that gap is amply filled by the Supreme Court’s superseding decision in *Cohen*.¹⁶²

Thus, the “receipt of benefits” test fails to provide a middle ground between absolute refusal to discharge fraud debt and discharge of truly innocent partners because the innocent partner almost always receives some benefit from the fraud, even if only a minor one.

In addition, the concept of a “receipt of benefits” test contradicts the notions of agency law central to imputed liability. A principal, or in this case a partner, faces liability for his agent’s actions not because he receives a benefit from those actions, but because of his *potential* to benefit from those actions.¹⁶³ To create a standard based on actual

159. *Id.* at 896-98. The court in *In re Denblayker* left open the possibility of alternate tests, depending upon the status of the debtor. For a debtor who faced direct liability for fraud, either because the debtor actually perpetrated the fraud or knowingly allowed the fraud to happen, fraud-related debts cannot be discharged under any circumstances. *Id.* at 896. If state law imputes such liability to a debtor, the debtor must have received a benefit for the court to reject discharge. *Id.* at 895-96.

160. 239 F.3d at 750.

161. *Id.*

162. *Id.* (emphasis added).

163. See GREGORY, *supra* note 46, at 13.

receipt of benefits follows an unjust enrichment standard¹⁶⁴ rather than traditional agency principles.

H. Confusion in the Courts

Strang and its progeny make a fundamental mistake in analyzing discharge of fraud debt. The cases mesh concepts of state-law fraud liability and federal-law dischargeability of debt, largely because the caselaw requires that for a court to deny discharge under § 523(a)(2)(A), the perpetrator or debtor must have made a fraudulent representation upon which the creditor relied.¹⁶⁵ *Eppard v. Sestito (In re Sestito)*¹⁶⁶ demonstrates this confusion: “In comparing the elements that must be shown to sustain a claim for misrepresentation under Massachusetts law with the elements that must be established by a preponderance of the evidence to sustain a cause of action under [§] 523(a)(2)(A), the Court finds they are interchangeable.”¹⁶⁷ If one uses the elements of fraud as elements of nondischargeability, the result in *Strang* seems natural because a positive finding on one dictates a positive finding on the other. Section 523(a)(2)(A) does not actually list any elements of nondischargeability except that the debt must be one of fraud.¹⁶⁸ However, the original finding of fraud is based upon the perpetrator’s intent rather than the innocent party’s intent. To the extent that the innocent party faces liability, it is only a legal fiction; the guilty partner’s actions and intents are essentially the innocent partner’s actions and intents. Thus, *liability* itself is imputed. However, in the context of discharge, § 523(a)(2)(A) does not clearly state whether *nondischargeability* may be imputed.¹⁶⁹ Thus, though fraud may be found pursuant to state law,

164. Generally, unjust enrichment requires a benefit conferred, knowledge of the benefit, acceptance of the benefit, and circumstances such that keeping the benefit would be unfair. *Media Servs. Group, Inc. v. Bay Cities Communications, Inc.*, 237 F.3d 1326, 1330 (11th Cir. 2001); *Great Rivers Co-op. of Southeastern Iowa v. Farmland Indus., Inc.*, 198 F.3d 685, 704 (8th Cir. 1999).

165. See *In re Gill*, 181 B.R. at 673; *In re Bullington*, 167 B.R. at 160-61; *In re Tobin*, 258 B.R. at 203. Note that *Tobin* reaches the opposite result of *Strang* using similar elements to find that knowledge must be specifically found to hold debt nondischargeable. See *supra* notes 95-98.

166. 136 B.R. 602, 606 (Bankr. D. Mass. 1992) (finding a partnership by estoppel and holding innocent partner liable for partner’s misrepresentations to customers).

167. *Id.* at 605 (citing *Rubin v. West (In re Rubin)*, 875 F.2d 755 (9th Cir. 1989); *Schweig v. Hunter (In re Hunter)*, 780 F.2d 1577 (11th Cir. 1986); *First Nat’l Bank of Red Bud v. Kimzey (In re Kimzey)*, 761 F.2d 421, 423 (7th Cir. 1985); *Key Bank of Fla. v. Cifalia (In re Cifalia)*, 124 B.R. 124 (Bankr. M.D. Fla. 1991); *E. Food Serv., Inc. v. Leger (In re Leger)*, 34 B.R. 873, 876-77 (Bankr. D. Mass. 1983)).

168. 11 U.S.C. § 523(a)(2)(A) (2000).

169. *Id.*

it is conceivable that discharge would be permitted because the Bankruptcy Code may actually require that the *debtor* intentionally commit the fraud to be denied discharge in order to promote the Bankruptcy Code's fresh start objectives. This interpretation would allow for liability for debtors who, though not the perpetrators of fraud, had the ability to prevent the fraud. And because the intent rather than the entire liability may be imputed to the debtor, a direct cause of action is created for fraud under state law and for refusal of discharge under § 523(a)(2)(A).

III. POLICIES BEHIND DISCHARGE OF INNOCENT PARTNERS

The primary advantage of granting a debtor discharge is promotion of the fresh start.¹⁷⁰ It is obvious that, to the extent a debtor frees himself from the constraints of debt through discharge, the bankruptcy goal of giving the debtor a fresh start is furthered.¹⁷¹ Forcing a debtor to remain responsible for debt abandons this important policy, albeit sometimes justifiably. To abandon the fresh start requires a rationale for doing so. In the case of fraud debt, the rationale is to further state law responsibilities.

This responsibility on the part of innocent partners creates a particularly odd situation considering the fact that smart planning of a business may create a means for avoiding such liability. Every state allows the creation of a limited partnership.¹⁷² A limited partnership

170. Though dischargeability would also promote consistency of decisions among bankruptcy courts, the Supreme Court has expressly rejected consistency of decisions as a basis for statutory interpretation of the Bankruptcy Code. *Ry. Labor Executives' Ass'n v. Gibbons*, 455 U.S. 457 (1982).

Pursuant to Art. I, § 8, cl. 4, of the Constitution, Congress has power to enact bankruptcy laws that are uniform throughout the United States. Prior to today, this Court has never invalidated a bankruptcy law for lack of uniformity. The uniformity requirement is not a straightjacket that forbids Congress to distinguish among classes of debtors, nor does it prohibit Congress from recognizing that state laws do not treat commercial transactions in a uniform manner. A bankruptcy law may be uniform and yet "may recognize the laws of the State in certain particulars, although such recognition may lead to different results in different States." Thus, uniformity does not require the elimination of any differences among the States in their laws governing commercial transactions. *Id.* at 469 (citation omitted) (quoting *Stellwagen v. Clum*, 245 U.S. 605, 613 (1918)).

171. For a more extensive analysis of the fresh start policy with regard to imputed liability, see Resnicoff, *supra* note 33, at 176-77.

172. Carol J. Miller, *LLP's: How Limited is Limited Liability?*, 53 J. MO. B. 154, 154 n.2 (1997). Miller cites forty-two states and the District of Columbia as having LLP statutes in 1997, but the remaining eight states have also adopted LLP statutes. ALA. CODE § 10-8A-306 (1999); ALASKA STAT. § 32.05.100 (2000); ME. REV. STAT. ANN. tit. 31,

prevents liability for limited partners with regard to certain partnership debts.¹⁷³ By allowing such limited liability without an exception for debts incurred as a result of fraud, the states have indicated that

§ 801 (Supp. 2001); NEB. REV. STAT. § 67-344 (Supp. 2001), N.H. REV. STAT. ANN. § 304-A:44 (Supp. 2002), R.I. GEN. LAWS § 7-12-56 (1999); W. VA. CODE § 47B-10-1 (1999 & Supp. 2002), WYO. STAT. ANN. § 17-21-1101 (Michie 2001).

Many large law firms and each of the “Big Five” accounting firms have taken advantage of this business option. *One in Three Firms Seek LLP Status*, THE LAWYER (Nov. 22, 1999); Carol M. Fischer, Michael J. Fischer & Larry L. Orsini, *Accountants’ Professional Liability: What Every Student Should Know*, 14-2 NEW ACCOUNTANT, Nov. 1, 1998, at 68. *But see* Larry E. Ribstein, *Ethical Rules, Law Firm Structure and Choice of Law*, 69 U. CIN. L. REV. 1161, 1170 (2001) (noting that many states impose vicarious liability on lawyers regardless of limited liability status).

This limited liability status has become crucial today in light of the Enron Corporation and WorldCom collapses. The accounting firm for each corporation, Arthur Andersen, LLP, which allegedly aided in creating fraudulent statements for each, had hundreds of partners throughout the world. Certainly these partners had little idea of the activities of the remaining partners. Because Andersen is organized as a limited liability partnership, it will arguably be able to shield those innocent partners from imputed liability in the first place, thus making the issue of dischargeability of fraud debt moot. *See* Eric Berger, *Andersen given 20 days to send data to creditors*, HOUSTON CHRONICLE, Feb. 7, 2002, at A9 (noting possibility of shareholder fraud suit against Arthur Andersen); University of California in Enron Suit, CNN (Feb. 15, 2002), *available at* http://money.cnn.com/2002/02/15/news/enron_uofcalif/ (detailing naming of University as lead plaintiff in shareholder class action suit against Arthur Andersen); Michelle Pacelle, *Questioning the Books: Andersen Shows no Signs of Chapter 11 Filing Yet*, WALL ST. J., Apr. 24, 2002, at C13.

See, for example, 805 ILL. COMP. STAT. ANN. 205/15 (West 1917) (current version at 805 ILL. COMP. STAT. ANN. 205/15 (Supp. 2002)). This statute may be of particular importance in the case of Arthur Andersen, LLP, a limited liability partnership formed in Illinois. Subsection (b) of the statute indicates that:

Subject to subsection (c) of this Section, a partner in a registered limited liability partnership is not liable, directly or indirectly, including by way of indemnification, contribution, assessment or otherwise, for debts, obligations, and liabilities of or chargeable to the partnership, whether arising in tort, contract or otherwise, arising from negligence, *wrongful acts*, omissions, *misconduct*, or malpractice, committed while the partnership is a registered limited liability partnership and in the course of the partnership business by another partner or an employee, agent, or representative of the partnership. Nothing in this subsection shall have the effect of limiting the personal responsibility penalty that may be chargeable to any partner under Section 3-7 of the Uniform Penalty and Interest Act.

Id. (emphasis added).

173. Section 303 of the Uniform Limited Partnership Act of 1976 limits a limited partner’s liability for the debts of the partnership unless he “participates in the control of the business” and the person or entity to whom the partnership owes a debt conducted business with the partnership in reliance on a belief that the limited partner was actually a general partner of the business. REVISED UNIF. LTD. P’SHIP ACT [RULPA] § 303 (1992). A newly-revised uniform law would provide that a limited partner is not liable *even if* he “participates in the management and control” of the partnership. UNIF. LTD. P’SHIP ACT § 303 (2001) (emphasis added).

protection of the creditors from fraud debts does *not* automatically trump the partnership's ability to protect its members. Yet, the Bankruptcy Code, under the *Strang* analysis, provides that the interests of defrauded creditors *automatically* take priority over those of innocent debtors when those debtors were not savvy enough to seek limited liability status and the protections that it offers. The *Strang* interpretation of § 523(a)(2)(A) fails to serve either modern state law objectives or established policies of the Bankruptcy Code. Indeed, the American Bar Association recognized this in promulgating its proposed addition¹⁷⁴ to § 523(a)(2)-(A): "Nothing contained in [§] 523 shall preclude discharge of an individual general partner from any debt for which such general partner is liable solely as a result of imputing to the general partner the conduct or liability of a copartner."¹⁷⁵ Though the proposal has not been adopted, it provides insight into the current thinking of bankruptcy professionals. Apparently, the drafters of this proposal¹⁷⁶ felt that the statute itself fails to adequately consider discharge of imputed fraud liability and that denial of such a discharge "serves no significant public policy."¹⁷⁷

174. Like the remainder of the Bankruptcy Code, close scrutiny of § 523 has led to a number of suggestions for revision. Major revisions to the Bankruptcy Code have been proposed in the past five years, but at this time, none have been enacted into law. Note that the Bankruptcy Reform Act of 2001 has been passed by the House of Representatives and the Senate. At this point, members of each chamber of Congress have formed a committee to resolve differences between the House and Senate bills. Even if the Act becomes law, however, neither chamber's bill includes amendments to § 523(a)(2)(A). H.R. No. 107-3(I) (Feb. 26, 2001).

175. Joseph Samet, *Proposed Amendments to the Bankruptcy Code Relating to Partnerships*, 736 PLI/Comm 1063, 1087 (April-May 1996).

176. The Ad Hoc Committee on Partnerships in Bankruptcy drafted the proposal. Morris W. Macey & Frank R. Kennedy, *Partnership Bankruptcy and Reorganization: Proposals for Reform*, 50 BUS. LAW. 879 (1995).

177. *Id.* at 922. The text of the comment provided with the ABA proposal reads as follows:

The Supreme Court in *Strang v. Bradner* held that the liability of a [general] partner for fraudulent representations by a member of the partnership was not dischargeable notwithstanding the [general] partner's innocence of any responsibility for the perpetration of the fraud. *Strang v. Bradner* has been followed in a substantial number of cases that apply a doctrine of imputed fraud as a basis for denying dischargeability to an innocent [general] partner. The innocent [general] partner's sharing in the fruits of the fraudulent conduct was emphasized as a factor in the decision in *Strang v. Bradner*, but under the case law constituting the progeny of the decision the denial of discharge has not depended on a showing of receipt by the [general] partner of the benefits of the fraud. The Ad Hoc Committee on Partnerships in Bankruptcy agrees with Professor Resnicoff's conclusion that "[t]he *Strang* doctrine serves no significant public policy" and concurs in his recommendation for legislative excision of the doctrine. This

But will discharging innocent partners satisfy other functions of the Bankruptcy Code? Some commentators suggest that discharging the debts will encourage voluntary filings by a partner saddled with a fraud debt rather than encouraging the potential debtor to take risks in order to avoid bankruptcy.¹⁷⁸ If the fraud debt acts as the final straw causing the debtor to file bankruptcy, this may indeed be true. However, does society necessarily want the voluntary filing? Sometimes the risks pay off. Perhaps instead, we should encourage potential debtors to take every available means to avoid bankruptcy. All creditors have a better chance of being paid if the risk works out. There may be another compelling reason, if not a bankruptcy justification, for discharge. A partner who discovers the fraud of his partner may be unwilling to make the fraud known if he may be liable for it.¹⁷⁹ Indeed, this may provide a justification for the termination of partnership liability altogether, though beyond the scope of this Article. At least to the extent that a partner who uncovers fraud realizes that such a debt will become a substantial burden on him personally and contemplates a bankruptcy filing to discharge the fraud debt, such a discharge will encourage exposing his partner's fraud.¹⁸⁰ While policies of the Bankruptcy Code are furthered by dischargeability, it is equally important to consider the policies that underlie denial of discharge.

Nondischargeability is frequently justified as a means of punishing the dishonest debtor while protecting innocent creditors.¹⁸¹ As to punish-

proposed section would apply in Chapter 7, 11, 12, and 13 cases. It would provide no basis for a discharge of liability of a general partner for fraud or misconduct specified in [§] 523.

Id. at 922 (citation omitted).

178. Resnicoff, *supra* note 33, at 177.

179. *Id.*

180. *Id.*

181. Cohen v. de la Cruz, 523 U.S. 213 (1998) (noting that Congress would protect party deceived over party creating the deception) (citing Grogan v. Garner, 498 U.S. 279, 287 (1991)); Resnicoff, *supra* note 33, at 168-69. See also Singer, *supra* note 22, which argues that the fresh start policy often attributed to the Bankruptcy Code is defeated by imputed liability for fraud and that the only consideration in determining dischargeability should be the individual debtor's behavior. *Id.* at 355-56 (citing Resnicoff, *supra* note 33, at 147; Jones v. Whitacre (*In re Whitacre*), 93 B.R. 584, 585 (Bankr. N.D. Ohio 1988); Thatcher v. Austin (*In re Austin*), 36 B.R. 306, 311-12 (Bankr. M.D. Tenn. 1984); Ordmann v. Hoppa (*In re Hoppa*), 31 B.R. 753, 754-55 (Bankr. E.D. Wis. 1983); McIntyre v. Kavanaugh, 242 U.S. 138 (1916); Impulsora Del Territorio Sur, S.A. v. Cecchini (*In re Cecchini*), 780 F.2d 1440, 1444 (9th Cir. 1986); Bear, Stearns & Co. v. Powell (*In re Powell*), 95 B.R. 236, 240 (Bankr. S.D. Fla. 1989), *aff'd*, 108 B.R. 343 (S.D. Fla. 1989), *aff'd without opinion*, 914 F.2d 268 (11th Cir. 1990)).

What constitutes protection of a creditor may create a central issue. If protection of the creditor means simply that the creditor has the right to collect against someone, the debt

ment of a dishonest debtor, pulling in an innocent partner clearly fails to meet this objective. The innocent partner, though a debtor, is not a dishonest one. Also, to the extent that creditors are harmed, even nondischargeability of nonfraud debts would meet the goal of protecting these creditors.¹⁸² After all, a creditor can be just as damaged by a negligent misrepresentation as by a fraudulent one.¹⁸³ Protection of creditors, in and of itself, does not justify lack of discharge because it fails to provide the rationale for setting the limit of dischargeability between negligence and fraud. Indeed, outside of the bankruptcy context, the fact that a debt was incurred fraudulently is irrelevant. Harkening back to the Triple J example in the introduction, the state law liability remains the same regardless of the type of liability incurred. Jeff and Joyce are liable to Sunshine Bank whether the debt was incurred through John's negligence, recklessness, or intentional behavior. Thus, state law does not permit a change in the circumstances of innocent partners on the basis of the type of behavior exhibited by the perpetrating partner. It is bankruptcy law, as construed by *Strang* and its progeny, that creates a distinction on the basis of fraud.

Deterrence of fraud also may justify nondischargeability.¹⁸⁴ This reason focuses on the nature of the debt and fraud prevention rather than on punishing and protecting parties. However, even this reason fails to provide a basis for liability on unsuspecting innocent partners. Theoretically, a partner can prevent fraud in one of two ways: first, the partner can refuse to enter into the partnership or second, the partner can prevent fraud once in the partnership. As to the former, the fact that an innocent partner may not be able to discharge a debt in bankruptcy will likely fail to prevent that partner from entering into a partnership years earlier.¹⁸⁵ If the partner suspects that fraud may

still exists, and simply preventing the offending partner from discharge "protects" the creditor. However, if protection of the creditor actually means improving the creditor's chances of collecting on the claim, then holding additional persons liable for the claim increases the chances of payment thus supporting a rule that prohibits discharge even of innocent partners.

182. See generally Resnicoff, *supra* note 33, at 169.

183. Ponoroff's article focuses on the reliance element to justify protection of the creditor, see Ponoroff, *Vicarious Thrills*, *supra* note 20, at 2547-48, but reliance is also an element in negligent misrepresentation. See generally Gregory G. Sarno, Annotation, *Liability of Bank, to Other Than Party Whose Financial Condition is Misrepresented, For Erroneous Credit Information Furnished by Bank or its Directors, Officers, or Employees*, 77 A.L.R.3d 6 (1977) (citing 37 AM. JUR. 2d *Fraud & Deceit* § 128 (2001)).

184. Resnicoff, *supra* note 33, at 171, 176.

185. Indeed, forward-thinking partners may be able to avoid future liability by setting up the business as a partnership with two corporations as partners. The individuals could be shareholders of the corporation with liability limited even if the corporate partners are

become an issue, he will likely decline the partnership regardless of bankruptcy dischargeability because of state liabilities. As to the possibility of fraud liability changing the oversight function of the innocent partner, the same concepts apply. State law already provides the incentive to keep track of a partner's activities and, to the extent that a partner anticipates using bankruptcy as a means of avoiding his oversight responsibilities to creditors, the creditor may still be able to hold that partner liable to the extent that the partner shirks his responsibilities to the remaining partners. This final rationale, when combined with the realities of modern partnerships, justifies distinguishing one group of partners from the truly innocent partners who should be able to discharge fraud debt beyond that paid pursuant to the bankruptcy proceedings.

A. *The Strang(e) Case of Committee Members*

Often partnerships are simply too large for every partner to understand the business of every other partner.¹⁸⁶ While partners may have an incentive to keep tabs on each other, every partner cannot keep tabs on every other partner. How does an organization deal with this task? Delegation. Committees comprised of some partners take responsibility for ensuring, on the remaining partners' behalf, that each partner acts prudently and responsibly. If a large partnership commits fraud through the actions of one or more of its partners, the Bankruptcy Code clearly states that claims against the partnership for fraud will survive the bankruptcy filing and resolution of the case.¹⁸⁷ However, the true question becomes what should happen to the various partners?¹⁸⁸ Some of the partners likely perpetrated the fraud and thus, will be directly accountable for it. Such direct liability cannot be discharged in bankruptcy.¹⁸⁹ Many other partners may have no involvement in the scandal. Indeed, many could be located in other offices, other divisions, other countries. For these partners, no actual fraud exists. However, state law imputes the fraud to these partners on account of their status as partners. What wrong did these partners engage in? They made poor choices of partners or failed to uncover the fraud, perhaps. At most,

held to be liable for the fraudulently incurred debts.

186. See Resnicoff, *supra* note 33, at 174 n. 102.

187. 11 U.S.C. § 523(a)(2) (2000).

188. The partners are clearly vicariously liable for non-fraud debts, but since these debts are not automatically rendered nondischargeable in bankruptcy, they are not considered herein.

189. 11 U.S.C. § 523(a)(2).

these partners committed negligent acts.¹⁹⁰ Unending liability for such lack of awareness may be justified in the three-partner partnership in which each partner can keep an eye on the others. However, in a partnership with hundreds of partners¹⁹¹ who barely know one another or barely understand one another's business and have little decision-making power as to who may become a partner, the justification for such imputed liability becomes less clear.

Amidst the protection of an innocent debtor and punishment of a perpetrating debtor lies one group which is neither completely innocent nor completely guilty. These are the partners who, with a reasonable amount of diligence, should have uncovered the fraud—the “discovery partners.” In the context of a large partnership, these partners are the ones whom the other partners rely upon to prevent or uncover fraud. For the discovery partners, negligence is certainly an issue. However, negligence is dischargeable in bankruptcy.¹⁹² Thus, if nonperpetrating partners are permitted a discharge in bankruptcy and negligence can be discharged, the discovery partners are off the hook. But these partners can and should be distinguished from truly innocent partners.

Recall that the lack of mention of the debtor in § 523(a)(2)(A) can be overlooked when legislative history and policy dictate that the language does not truly reflect congressional intent. Though the legislative history indicates that a nonperpetrating discovery partner should be allowed to take advantage of the Bankruptcy Code's protections, the policy of preventing the fraud does not. In particular, the strong policy for preventing fraud indicates that a discovery partner should be held indefinitely liable for his failure to actually prevent the fraud, assuming that the partner actually could have done so, even if that failure is merely negligence.

Note, however, that this only applies to a partner actually able to prevent the fraud either in whole or in part. To the extent that a partner is only responsible for uncovering fraud that has already happened, that partner would share the status of a truly innocent partner despite his responsibilities to the partnership as a whole. Holding otherwise will not promote the policy of fraud prevention.

190. Resnicoff, *supra* note 33, at 171.

191. Such monstrous partnerships are the exception in the world of partnerships, but do exist. See MELVIN ARON EISENBERG, AN INTRODUCTION TO AGENCY, PARTNERSHIPS, AND LLCs 24 (3d ed. 2000) (noting that over one million general partnerships existed in the United States in 1996, but the average number of partners in each was just four).

192. 11 U.S.C. §§ 523(a), 727(a) (2000). Each of these sections prove, in reverse, the dischargeability of negligence because each establishes what is *not* dischargeable. See 1 NORTON BANKR. L. & PRAC. §§ 4:5, 47:16 (2d ed. 2002).

Fraud that has already occurred cannot be prevented. Thus, it is not the responsibility of the discovery partners that leads to denial of discharge, but the responsibility for actually preventing fraud and the ability to do so.¹⁹³ This policy of preventing fraud is strong enough to overcome the legislative history's mandate that denial of discharge should only be for perpetrating debtors.

Such a standard does not abandon the current caselaw. Some courts have required either knowledge or recklessness in order to hold an imputed fraud debt to be nondischargeable.¹⁹⁴ Because knowledge or recklessness can satisfy the intent requirement for fraud,¹⁹⁵ after finding such knowledge or recklessness, the courts can essentially impute just the *intent* of the wrongdoer onto the innocent debtor, rather than imputing all elements of the fraud onto the debtor. This differs from directly imputing the liability because, by imputing just intent, the creditor may directly establish a fraud case under state law against the discovery partners. Once a direct fraud case has been established, § 523(a)(2)(A) dictates that such a debt cannot be discharged.

IV. CONCLUSION

The text of § 523(a)(2)(A) provides little assistance in determining whether an innocent debtor may discharge an imputed debt liability in bankruptcy. Arguably, the failure to indicate that a debtor must actually perpetrate the fraud leads to the conclusion that nondischargeability applies not only to the perpetrator, but to anyone liable for the fraud. However, as noted in *Field v. Mans*,¹⁹⁶ this interpretation of statutory language may not be appropriate.¹⁹⁷ Indeed, the failure to include an express reasonableness requirement in § 523(a)(2)(A) has been overlooked despite its inclusion in § 523(a)(2)(B). This ability to look beyond the mere words of the statute exists particularly when legislative history and policy provide an alternate interpretation of the statute.

193. Arguably, this liability will discourage service of partners on committees. In return, the partnership may need to offer either extra incentives or liability insurance to such partners. If the partnership chooses the insurance path, it will only need to provide such insurance for the discovery partners rather than the entire partnership. Economically, this should translate into savings for the creditor doing business with the partnership. The creditor may then use those savings to purchase insurance for itself, in case of nonpayment of the debts (even negligence-based nonpayment of debt).

194. See *supra* note 99 and cases cited therein.

195. *Rosen v. Bd. of Med. Exam'rs of Iowa*, 539 N.W.2d 345 (Iowa 1995).

196. 516 U.S. 59 (1995).

197. See *supra* note 131.

The legislative history of § 523(a)(2)(A) indicates that Congress intended to protect innocent debtors through bankruptcy proceedings. Time and again, the courts and Congress have noted that the Bankruptcy Code protects honest debtors. The exceptions to dischargeability are limited to situations in which the debtor has not been honest or in which an overriding social policy dictates that the debtor must still be liable for the debt. Because imputed liability, by definition, requires an innocent debtor, the only justification under § 523(a)(2)(A) for denying discharge would be an overriding social policy mandating creditor protection. No such policy exists. Indeed, though the court in *Strang* focused both on the clear liability under state law¹⁹⁸ and the need to allow the states to determine such liability, even that justification has eroded in the face of state statutes allowing partners to protect themselves from such liability by seeking status as limited partners of the partnership.

Of course, the Bankruptcy Code also seeks to protect creditors. However, such protection of creditors fails to justify unending liability of innocent debtors. If merely protecting creditors from harm justified the denial of discharge, no discharge would exist. Discharge, by definition, always harms creditors. Thus, more than mere protection of creditors must exist as a reason to justify denial of a discharge.¹⁹⁹

Any justification for denial of discharge must lie in the nature of fraud itself. Perhaps the justification lies in protecting the creditor from fraud, not because the creditor was injured, but because that injury came from such a reprehensible source. Negligence is bad, but fraud is worse. Thus, if a creditor's injuries come from fraud rather than negligence, that creditor deserves additional protection. This justification contradicts congressional statements indicating that the fraud exception is

198. *Strang v. Bradner*, 114 U.S. 555, 561 (1885).

199. Though this Article advocates allowing innocent debtors the benefit of bankruptcy discharge, the use of a "receipt of benefits" test may be marginally appropriate to compensate creditors. The "receipt of benefits" test may require a debtor to release profits received as a result of the fraud, even if the debtor had nothing to do with the fraud. This is different from the traditional "receipt of benefits" test. Traditionally, receipt of benefits was merely a threshold for nondischargeability. If, for example, a one-hundred thousand dollar fraud debt existed, but the debtor had only personally benefitted by twenty-five thousand dollars, the debtor would be permanently responsible for the entire one-hundred thousand dollars. Once that receipt of benefit is found, liability exists for the entire debt. However, under the other option, if the debtor did not participate in the fraud, the nondischargeable liability would be limited to twenty-five thousand dollars, the amount of benefit received. Rather than serving as a threshold, the receipt of benefit would serve as a limitation on nondischargeable liability. However, the use of any form of a "receipt of benefit" test returns us to a consideration of the differences between fraud and negligence and whether policies of the Bankruptcy Code and state law are furthered by distinguishing between the causes of action, particularly when a creditor's harm does not differ.

designed to provide retribution.²⁰⁰ Furthermore, this justification does little to explain why an innocent debtor is refused discharge. If we are providing extra protection for the creditor because the debt was incurred fraudulently, a reason must exist to do so. Retribution? While a worthy goal, retribution implies punishment,²⁰¹ which in turn implies guilt. Thus, retribution is at odds with the notion of an innocent debtor. Protection of a creditor? As noted, this alone hardly provides a justification because a creditor may be just as harmed by actions that are discharged under the Bankruptcy Code.

Could the justification be to prevent fraud? This seems a laudable goal. However, will punishment of an innocent debtor further this goal? Not likely. Indeed, punishment of an innocent debtor may hinder the prevention of fraud by discouraging the innocent debtor who uncovers fraud from revealing it to others.²⁰² It will certainly not prevent fraud to punish a debtor who did not participate in the fraud and had little ability to prevent the fraud in the first place. Those partners who had the responsibility and the ability to prevent the fraud from occurring can be distinguished from truly innocent partners. Though their direct liability is merely for negligence and their fraud liability is imputed, that fraud liability should not be discharged. Such partners not only had some wrongdoing in the fraud, but such liability serves to encourage these partners to adequately undertake their responsibilities and, hopefully, will serve to reduce fraud. In the long run, such liability is the best possible protection for creditors. If future fraud debts are found and stopped before causing damage, the creditor may avoid the necessity of lawsuits and bankruptcy proceedings.

Policy alone is insufficient to overcome a statute's clear mandate. When that statute is not entirely clear, however, legislative history may be used to aid in determining the true interpretation of the statute.²⁰³ In this situation, § 523(a)(2)(A) is hardly clear. The statute fails to acknowledge the possibility of imputed fraud liability. But the legislative history of the statute can provide the necessary link between good bankruptcy policy and insufficient language by providing insight into congressional intent in passing the statute. Denying discharge only

200. See *supra* note 44 and accompanying text.

201. *Putman v. Head*, 268 F.3d 1223, 1234 (11th Cir. 2001) (listing retribution as a form of punishment); *Myrie v. Comm'r*, 267 F.3d 251, 256 (3d Cir. 2001) (same).

202. *Resnicoff*, *supra* note 33, at 177 (noting that innocent partner who knows that he may be liable for fraud will be less motivated to expose fraud).

203. *Sheet Metal Workers Int'l Assoc. v. Carter*, 450 U.S. 949, 952 (1981) (Rehnquist, J., dissenting); *United States v. Boren*, 278 F.3d 911, 914-15 (9th Cir. 2002) (citing *Alarcon v. Keller Indus., Inc.*, 27 F.3d 386, 389 (9th Cir. 1994)).

for the debtor who actually perpetrates fraud, or is charged with the responsibility for preventing fraud and fails to do so, is consistent with the holding in *Neal*, reinstated by the legislative history of § 523(a)(2)-(A), and the policies underlying the Bankruptcy Code. The court in *Neal* indicated a desire to protect an honest debtor. The legislative history and subsequent statements by members of Congress suggest the same.

Finally, the Bankruptcy Code serves as a protection for a debtor from unending debt, while still permitting a creditor to hold liable the debtor who actually committed wrongdoing in incurring the debt. Though ideally a solution would be provided by an express requirement in § 523(a)(2)(A) that fraud be committed *by* the debtor, or at least be preventable by the debtor, in order to be nondischargeable, such express language is not necessary in light of legislative history and bankruptcy policies. As the Court in *Neal* noted,

Such a construction of the statute is consonant with equity, and consistent with the object and intention of Congress in enacting a general law by which the honest citizen may be relieved from the burden of hopeless insolvency. A different construction would be inconsistent with the liberal spirit which pervades the entire bankrupt[cy] system.²⁰⁴

204. *Neal*, 95 U.S. at 709.