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## **Hot Topics in Discharge and Dischargeability**

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## **HOT TOPICS IN DISCHARGE AND DISCHARGEABILITY**

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The *raison d'être* of most bankruptcy cases is the discharge: after all, that is the very reason most individual bankruptcy cases are filed. For that reason, case law expanding exceptions to discharge threatens the fresh start bankruptcy has historically provided to the unfortunate debtor.

Discharge issues fall into two major categories: (1) issues relating to the discharge of the debtor from all his debts; and (2) issues relating to the discharge of the debtor from particular debts. The primary Code section that addresses the former—discharge in general—is Code section 727. That section applies in Chapter 7 cases (providing for the liquidation of assets of individuals and entities such as corporations and LLCs), and, through other sections, to Chapter 12 (family farmer debt adjustment plans), Chapter 13 (repayment plans for individuals with debt below particular thresholds) and Chapter 11 (reorganization plans for individuals) cases. Similarly, issues relating to the discharge of the debtor from particular debts—referred to as “dischargeability”—are set forth primarily in Code section 523 and apply in Chapter 7 cases, Chapter 12 cases, Chapter 13 cases, and Chapter 11 cases of individuals.

### **HUSKY**

Without doubt, the most important dischargeability case of the previous year was the Supreme Court’s decision in *Husky Int’l Elecs., Inc. v. Ritz*.<sup>1</sup> In that case, the Supreme Court construed Code section 523(a)(2)(A) and overturned a Fifth Circuit Court of Appeals decision. The *Husky* holding is that the term “actual fraud” in Code section 523(a)(2)(A), which excepts from discharge debts “obtained by . . . actual fraud,” includes actions that do not involve a misrepresentation. Although the holding a first blush may seem to have broad implications, in fact a close reading of the decision suggests that it may have very limited reach depending on the resolution of the case on remand. Let me explain why I read the case that way.

Bankruptcy Code section 523(a)(2)(A) provides,

- (a) A discharge under section 727, 1141, 1228(a), 1228(b), or 1328(b) of this title does not discharge an individual debtor from any debt—

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<sup>1</sup> *Husky Int’l Elecs., Inc. v. Ritz*, No. 15-145, 2016 U.S. LEXIS 3048 (May 16, 2016)

\* \* \*

(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 . . . .

The key phrase, then, that explains what type of debt is nondischargeable, is that it is a debt “obtained by . . . actual fraud.” The statute raises two issues: (1) what does the phrase “obtained by” require; and (2) what is “actual fraud”?

Both the Fifth Circuit Court of Appeals and the Supreme Court focused for the most part on the term “actual fraud,” but, at the end of the day, the Supreme Court's reasoning regarding “obtained by” may have the most practical effect.

Here are the facts:

Chrysalis Manufacturing Corp. (“Chrysalis”) incurred a debt of nearly \$164,000 to Husky International Electronics, Inc. (Husky”), which debt arose from the purchase of goods over time. Daniel Ritz (“Ritz”) was a Chrysalis director and part owner of the company at that time. Afterwards, Ritz caused Chrysalis to make a number of fraudulent transfers to entities he controlled and, for that reason, Chrysalis could not pay its obligations to Husky. Husky then sued Ritz under Tex. Bus. Orgs. Code § 21.223(b), seeking to obtain a judgment, under which Ritz was liable for Chrysalis' debt to Husky. Husky contended that Ritz having caused the fraudulent transfers to have been made constituted “actual fraud” under the Texas statute.<sup>2</sup> Under Tex. Bus. Orgs. Code § 21.223(b), the corporate veil can be pierced and a principal can be liable for the debt of an affiliated company if he has engaged in “actual fraud” primarily for his direct personal benefit.<sup>3</sup>

Thereafter, Ritz filed for Chapter 7 bankruptcy. Husky then commenced an adversary proceeding, alleging that Ritz was liable to it under the Texas law and that the debt arising under that law was non-dischargeable under Code section 523(a)(2)(A).<sup>4</sup>

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<sup>2</sup> *Id.* slip. op. at 4-5.

<sup>3</sup> See *Spring St. Partners-IV, L.P. v. Lam*, 730 F.3d 427 (2013)(actual fraud in connection with a fraudulent transfer had been proven and thus under Tex. Bus. Org. Code § 21.223(b) the veil could be pierced and the principals become liable for the entities' debts).

<sup>4</sup> *Husky*, slip. op. at 5-6.

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