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When Is a Debt "Obtained by" Fraud?: Reconsideration of the Fraud Nondischargeability Exception under Section 523(A)(2) of the Bankruptcy Code

Theresa J. Pulley Radwan
Stetson University College of Law

WHEN IS A DEBT "OBTAINED BY" FRAUD?: RECONSIDERATION OF THE FRAUD NONDISCHARGEABILITY EXCEPTION UNDER SECTION 523(A)(2) OF THE BANKRUPTCY CODE

Theresa J. Pulley Radwan[*]

I. INTRODUCTION

An individual debtor who successfully completes a bankruptcy case receives a discharge of the debtor's unpaid debts at the conclusion of bankruptcy

* Professor, Stetson University College of Law.

or upon confirmation of the debtor's bankruptcy plan.[1] However, the Bankruptcy Code limits the ability of the debtor to receive a discharge of certain debts. Section 523 of the Bankruptcy Code outlines most of those exceptions to discharge,[2] and those exceptions limit discharge in order to protect special populations of creditors[3] or punish a debtor for poor behavior in incurring the debt.[4]

Section 523(a)(2) of the Bankruptcy Code denies discharge of pre-petition debt "to the extent obtained by" fraud.[5] This provision suggests that the mere existence of fraud does not render debt nondischargeable. Instead, the inquiry requires a determination of the extent to which the debt resulted from pre-petition fraud committed by the debtor.[6] The Bankruptcy Code does not define the elements of fraud; instead, it leaves the question of what constitutes fraud to various state laws.[7] The courts interpreting this provision generally require several elements to be met to render debt nondischargeable fraud debt, including the existence of a debt resulting from fraud that benefits the debtor.[8] Section 523 makes clear that the existence of fraud alone does not make a debt nondischargeable. Rather, the existence of state-law fraud, *combined with a causal element between how the debt arises and the resulting benefit to the debtor*, creates fraud nondischargeability in a bankruptcy case. Unfortunately, the causal connections and the interpretation of the phrase "to the extent obtained by" provide significant challenges for the courts in determining when a debtor's fraud leads to nondischargeability of a debt. This article seeks to consider several situations in which the causal connection poses such difficulty in order to develop a uniform application of § 523(a)(2)'s nondischargeability for fraud

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1 *See* 11 U.S.C.A. §§ 727(a), 1141(d)(1)(A), 1192, 1228(a), 1328(a) (West 2021).

2 In addition to specific discharge exceptions outlined in § 523, the Code denies all discharge to debtors who have engaged in particularly egregious behaviors that impact the ability to carry forth the bankruptcy case. *See, e.g.*, 11 U.S.C.A. §§ 727 (2)–(7) (denying discharge for, *inter alia*, concealment of assets, being untruthful in the case, and refusal to obey court orders).

3 *See, e.g.*, *id.* § 523(a)(1) (nondischargeability of certain tax obligations, even if return was filed); *id.* § 523(a)(5) (nondischargeability of domestic support obligations, including alimony, child support, and maintenance); *id.* § 523(a)(15) (nondischargeability of property settlements in divorce proceedings).

4 *See, e.g.*, *id.* § 523(a)(4) (nondischargeability for defalcation in a fiduciary capacity); *id.* § 523(a)(6) (nondischargeability for willful and malicious injury); *id.* § 523(a)(9) (nondischargeability for injuries associated with driving under the influence).

5 *Id.* § 523(a)(2).

6 *Id.*

7 *See, e.g.*, Husky Int'l Elecs., Inc. v. Ritz, 832 F.3d 560, 569 (5th Cir. 2016) (noting that whether fraud exists falls within Texas state law). The Code also includes "false pretenses" and "false representation[s]" as part of the fraud nondischargeability provision. 11 U.S.C.A. § 523(a)(2)(A).

8 *In re* Torres-Montoya, 580 B.R. 556, 563 (Bankr. D.N.M. 2017).

claims in light of the Supreme Court's 2016 opinion in *Husky International Electronics, Inc. v. Ritz*.[9]

II. EXCEPTIONS TO DISCHARGE IN BANKRUPTCY CODE SECTION 523(A)(2)

An individual debtor who successfully completes a bankruptcy case receives a discharge of most of the debtor's unpaid debts at the conclusion of bankruptcy. Section 523 provides for exceptions to the debtor's discharge, including nondischargeability for debts resulting from fraud: "(a) A discharge . . . does not discharge an individual debtor from any debt . . . (2) for money, property, services, or an extension, renewal, or refinancing of credit, *to the extent obtained by* . . . (A) false pretenses, a false representation, or actual fraud."[10]

Congress enacted § 523 as part of the 1978 Bankruptcy Code, but the concept of nondischargeability for fraud debt existed in the Code's predecessor, Bankruptcy Act § 17a(2).[11] The Code modified the Act provision, adding "actual fraud" as a basis for nondischargeability.[12] The legislative history notes the purpose of the changes implemented in the Code:

> Section 523(a)(2) likewise represents a compromise between the position taken in the House bill and the Senate amendment with respect to the false financial statement exception to discharge. In order to clarify that a "renewal of credit" includes a "refinancing of credit," explicit reference to a refinancing of credit is made in the preamble to section 523(a)(2). A renewal of credit or refinancing of credit that was obtained by a false financial statement within the terms of section 523(a)(2) is nondischargeable. However, each of the provisions of section 523(a)(2) must be proved. Thus, under section 523(a)(2)(A) a creditor must prove that the debt was obtained by false pretenses, a false representation, or actual fraud, other than a statement respecting the debtor's or an insider's financial condition. Subparagraph (A) is intended to codify current case law e.g., *Neal v. Clark*, 95 U.S. 704 (1887) [24 L. Ed. 586],

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9 578 U.S. 356 (2016).

10 11 U.S.C.A § 523(a)(2) (emphasis added).

11 For more discussion of the legislative history of 11 U.S.C.A. § 523(a)(2)(A) before the Bankruptcy Act, see David Koha, *When Fraud Results in a Nondischargeable Debt: The Scope of 11 U.S.C.A. § 523(a)(2)(A) After* Husky International Electronics v. Ritz, 2017 ANN. SURV. BANKR. L. 13 (2017).

12 *See* S. REP. NO. 95-989; *see also* H.R REP. NO. 95-595.

> which interprets "fraud" to mean actual or positive fraud rather than fraud implied in law.[13]

The legislative statement indicates several things: (1) even without fraud in the initial incurrence of debt, fraud in refinancing suffices for nondischargeability when it involves false financial statements, (2) actual fraud does not include implied fraud situations, and (3) to render a debt nondischargeable under this section, the impacted creditor must show both fraud and that the fraud caused the indebtedness.[14] The third element—that the debt was "obtained by" fraud—leads to much debate among the courts considering that causal requirement.

While the language of the statute currently provides for nondischargeability of debt "to the extent obtained by" fraud, when first adopted in 1978, the language denied discharge "for obtaining money, property, services or an extension, renewal, or refinance of credit, by—(A) false pretenses, a false representation, or actual fraud."[15] Part of this change appears to be relatively minor—changing "obtaining" money or property by fraud to money or property "obtained by" fraud. But that change from the active tense to the passive tense allows the courts to deny discharge even for parties who did not promulgate the fraud or receive the benefits of that fraud by no longer suggesting that the party being denied discharge must actively engage in the action of obtaining something through fraud. The change also added the modifier "to the extent" to qualify what was obtained, suggesting a limitation on the nondischargeability provision. Simply having something obtained through someone's fraud alone may not necessarily create nondischargeability. But the reasons for the change in language from the affirmative act of "obtaining money . . . by . . . fraud" to the passive "to the extent obtained by . . . fraud" and the impact of those changes creates more uncertainty given the wide variety of situations falling into the category of fraud.

III. THE SUPREME COURT DECISIONS ON WHAT CONSTITUTES NON-DISCHARGEABLE FRAUD

This section will examine the major Supreme Court decisions on the topic of what constitutes non-dischargeable fraud. First, this section will examine *Husky International Electronics Inc., v. Ritz,* a case in which the Supreme Court considered what constitutes non-dischargeable fraud under § 523(a)(2)'s exception to dischargeability. Second, this section will examine *Cohen v. de la Cruz*, a case in which the Supreme Court applied a broad construction to § 523(a)(2), concluding that it prevents the discharge of *any* debt respecting

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13 *See* Bankruptcy Code, Pub. L. No. 95-598, 92 Stat. 2549 (1978).

14 *Id.*

15 The language was amended to its current version in 1984. Pub. L. No. 98-353, § 454, 98 Stat. 333 (1984).

money, property, or services, or credit. Finally, this section will discuss *Archer v. Warner*, in which the Court also adopted a broad construction of the "obtained by" language in § 523(a)(2).

A. Husky International Electronics, Inc. v. Ritz

In 2016, the Supreme Court considered what constitutes non-dischargeable fraud under § 523(a)(2) in *Husky International Electronics, Inc. v. Ritz*.[16] The debtor, Ritz, served as a director and partial owner of Chrysalis Manufacturing Corporation, which purchased electronics from Husky International on credit.[17] While indebted to Husky International, Ritz used his control of Chrysalis to deplete company resources that could have paid the company's debts.[18] Husky International sued Ritz, arguing that Ritz's control of the company made him liable for the company's debts,[19] and then asked the bankruptcy court to declare the resulting liability nondischargeable as fraudulently incurred debt.[20] The primary issue considered by the Court involved whether § 523(a)(2)(A)'s fraud nondischargeability exception includes "forms of fraud, like fraudulent conveyance schemes, that can be effected without a false representation."[21] Focusing on the language of the nondischargeability statute[22] and common law definitions of fraud,[23] the Court refused to require a false statement to find nondischargeable fraud.[24]

The Court then addressed the impact of section (a)(2)'s "obtained by" language. The debtor clearly committed a fraudulent act by transferring assets out of Chrysalis that could have been used to pay creditors, a form of fraudulent

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16 *See* Husky Int'l Elecs., Inc. v. Ritz, 578 U.S. 356 (2016).

17 *Id.* at 357–58.

18 *Id.*

19 After being remanded by the Supreme Court and eventually making its way back to the bankruptcy court, the debtor was found to be liable for Chrysalis's debt by piercing the corporate veil. *In re* Ritz, 567 B.R. 715 (Bankr. S.D. Tex. 2017).

20 *Husky*, 578 U.S. at 357–58.

21 *Id.* at 359–60.

22 *Id.* (citing Bankruptcy Code, 11 U.S.C.A. § 35(a)(2) (Supp. II 1976)); Bankruptcy Reform Act, Pub. L. No. 95-598, 92 Stat. 2590 (1978); 11 U.S.C.A. § 523(a)(2)(A) (West 2021)). Under the Bankruptcy Act, debtors could not discharge debts based on "false pretenses or false representations." Bankruptcy Code, enacted in 1978, included "actual fraud," suggesting that actual fraud means something other than simply false pretenses or false representations by the debtor.

23 The Court had previously defined "actual" fraud to "denote any fraud that 'involv[es] moral turpitude or intentional wrong.'" *Id.* at 360–61 (citing Field v. Mans, 516 U.S. 59, 69 (1995); Neal v. Clark, 95 U.S. 704, 709 (1878)) (noting that "from the beginning of English bankruptcy practice, courts and legislatures have used the term 'fraud' to describe a debtor's transfer of assets that, like Ritz's scheme, impairs a creditor's ability to collect the debt").

24 *Id.* at 362–63.

conveyance.[25] The debtor argued that he did not "obtain" anything by the fraudulent conveyances. The Court rejected that argument and held that "any debts 'traceable to' the fraudulent conveyance . . . will be nondischargeable."[26] This provides a relatively low threshold of causality—simply requiring a connection between the existence of fraud and the debt owed to the creditor. The Court likewise rejected the debtor's argument that the initial obligation—the debt owed by Chrysalis to Husky International—must result from fraud, instead favoring an interpretation that allowed later fraud to serve as the basis for nondischargeability even though the debt existed regardless of the fraud.[27] In short, the majority opinion provides a broad construction of the phrase "obtained by," indicating that the phrase does not require that the initial debt be obtained by fraud and requiring a minimal link between the existence of fraud and the debt owed to the victim of that fraud.

In his dissent, Justice Clarence Thomas focused on the "obtained by" language and suggested a more narrow reading of the term.[28] Justice Thomas found that the "obtained by" language of § 523(a)(2) mandates that the fraud *lead* to the payment obligation—the section only provides for nondischargeability if the fraud "caused the creditor to enter into a transaction with the debtor."[29] In the case at hand, the initial debt occurred because Husky International sold electronics on credit and did not involve any fraud on Chrysalis's (or even Ritz's) part.[30] The majority dismissed the dissent's conclusion, noting that:

> It is of course true that the transferor does not "obtai[n]" debts in a fraudulent conveyance. But the recipient of the transfer—who, with the requisite intent, also commits fraud—can "obtai[n]" assets "by" his or her participation in the fraud.[31]

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25 *Id.* at 359.

26 *Id.* at 365.

27 *Id.* at 365–66.

28 *Id.* at 368–69 (Thomas, J., dissenting) (quoting Archer v. Warner, 538 U.S. 314, 325 (2003) (citing *Field*, 516 U.S. at 61, 64) (requiring "a causal nexus between the fraud and the debt")).

29 *Id.* ("Section 523(a)(2)(A) applies only when the fraudulent conduct occurs at the *inception of the debt, i.e.,* when the debtor commits a fraudulent act to induce the creditor to part with his money, property, services, or credit.") (emphasis in original).

30 *Id.* at 364–65 (majority opinion).

31 *Id.* (citing McClellan v. Cantrell, 217 F.3d 890 (7th Cir. 2000)). At least one commentator has noted that this language poses the risk that recipient of a fraudulent transfer, whose debt exists only because of the fraud, may face nondischargeability of its repayment obligation while the transferor, whose debt predates the fraud, would be allowed to discharge any obligation to the same creditor. *See* Koha, *supra* note 11, at Part IV.B.1 ("If the Fourth Circuit's decision in *Rountree* is correct, the debtor must obtain money, property, services or credit as a result of the fraud. Transferring money or property to someone else does not seem to meet this requirement" and "transferee becomes subject to § 523(a)(2)(A), but absent the unique type of situation found in *Husky*, the transferor will not incur a nondischargeable debt"). This presents a problem because in a fraudulent transfer based on intent to "hinder, delay, or defraud," it is the transferor's intent that

The majority also dismissed Justice Thomas's causal link between the fraud and incurrence of the debt as being based in caselaw on a different issue because the cases used to interpret the requirement of reliance required when fraud occurs through the making of a false statement.[32] The Supreme Court did, indeed, require reliance on the part of the creditor for fraud nondischargeability in *Field v. Mans*,[33] but that case involved a false statement made by the debtor to the creditor.[34]

B. Cohen v. de la Cruz

Even before the *Husky* decision, the Supreme Court gave a broad construction of § 523(a)(2)'s "obtained by" language in several other cases. In *Cohen v. de la Cruz*, the local government ordered Cohen, a landlord, to refund excess rents paid by tenants; Cohen instead filed for bankruptcy protection. [35] The tenants sought nondischargeability, arguing that the excessive rents constituted payments obtained by Cohen through fraud.[36] The primary issue before the Supreme Court involved the punitive damages awarded by the Bankruptcy Court for the fraudulent behavior and whether those punitive damages constitute an obligation "obtained by" the debtor's fraud.[37] Previously, some courts held that "[p]unitive damages do not constitute a benefit to a debtor who has engaged in fraud nor do they represent a loss to a creditor. Rather, punitive damages are 'awarded as an example to others or as a penalty or by way

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makes the situation fraudulent. 11 U.S.C.A. § 548(a)(1)(A) (West 2021). Thus, while the transferee *might* be aware of or complicit in the fraud, the transferee could be relatively innocent. But the transferor will never lack intent. *See also* 11 U.S.C.A. § 550(b) (allowing subsequent good-faith transferees to avoid liability for the transfer, but not allowing same for initial transferee regardless of good faith).

32 *See Husky*, 578 U.S. at 364–66. *See also* Hon. Deborah L. Thorne & Brett Newman, *What's Next After* Husky v. Ritz*: Has Pandora's Box Been Opened?*, AM. BANKR. INST. J. 20, 21 (2016) (discussing "obtained by" requirement as an "unresolved question[ ]").

33 516 U.S. 59, 66 (1995) ("[S]ome degree of reliance is required to satisfy the element of causation.").

34 *See* 11 U.S.C.A. § 523(a)(2)(A). Section 523(a) provides for nondischargeability "for money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained by . . . a false representation." In such a case, it is clear that the money or credit had to be obtained through the false representation. *See also* Bankruptcy Reform Act, Pub. L. No. 95-598, 92 Stat. 2549 (1978) ("Subparagraph (A) is mutually exclusive from subparagraph (B). Subparagraph (B) pertains to the so-called false financial statement. In order for the debt to be nondischargeable, the creditor must prove that the debt was obtained by the 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 obtaining money, property, services, or credit *reasonably relied*; (iv) that the debtor caused to be made or published with intent to deceive.") (emphasis added).

35 *See* Cohen v. de la Cruz, 523 U.S. 213, 215 (1998).

36 *Id.*

37 *Id.* at 216.

of punishment.'"[38] As a result, a debtor did not "obtain" an obligation to pay punitive damages through the fraud, and those damages could be discharged even if nondischargeability applied to the related compensatory damages. The *Cohen* Court disagreed, concluding instead that "[t]he 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."[39] As the Court noted, the treble damages qualify as a debt,[40] and the debt arose as a result of money "obtained by" fraud—"[t]he phrase thereby makes clear that the share of money, property, etc., that is obtained by fraud gives rise to a nondischargeable debt. Once it is established that specific money or property has been obtained by fraud, however, 'any debt' arising therefrom is excepted from discharge."[41] While *Husky* and *Cohen* both provide broad interpretations of the "obtained by" language, they can be distinguished. In *Cohen*, the debtor's initial obligation existed as a result of fraud; in *Husky*, the fraud occurred after the initial debt arose. Applying the *Cohen* standard that looks first to whether "it is established that specific money or property has been obtained by fraud" would not necessarily create nondischargeability in the *Husky* case because the debtor did not obtain anything as a result of fraud. Thus, these two cases suggest broad constructions of the obtained by language in two different ways: (1) per *Cohen*, once the creditor proves the existence of fraud to incur debt, any other debts resulting from that fraud face nondischargeability, and (2) per *Husky*, a creditor must only demonstrate a link between the debt and fraud, even if that link post-dates the debt being incurred because the debtor engages in fraud to prevent the collection of that debt by the creditor.

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[38] Star Bank, N.A. v. Reveal (*In re* Reveal), 148 B.R. 288, 293 (Bankr. S.D. Ohio 1992) (citing Palmer v. Levy (*In re* Levy), 951 F.2d 196, 198 (9th Cir. 1991), *cert. denied*, 504 U.S. 985 (1992); Haile v. McDonald (*In re* McDonald), 73 B.R. 877, 882 (Bankr. N.D. Tex. 1987)).

[39] *Cohen*, 523 U.S. at 218 (citing 11 U.S.C.A. § 523(a)(2)(A)).

[40] *Id.* ("A 'debt' is defined in the Code as 'liability on a claim,' § 101(12), a 'claim' is defined in turn as a 'right to payment,' § 101(5)(A), and a 'right to payment,' we have said, 'is nothing more nor less than an enforceable obligation.'") (citing Pa. Dep't. of Pub. Welfare v. Davenport, 495 U.S. 552 (1990)).

[41] *Id.* Twelve years before the *Cohen* decision, a bankruptcy court considered a similar issue in a case involving treble damages awarded to the government due to a violation of the Racketeer Influenced and Corrupt Organizations (RICO) Act, 18 U.S.C.A. § 1962 (West 2021). *See* McCullough v. Suter (*In re* Suter), 59 B.R. 944 (Bankr. N.D. Ill. 1986). The Court held that the punitive damages could be discharged, even though the compensatory damages clearly qualified as nondischargeable fraud. While *Cohen* seems to overrule that result, the *Suter* court relied in part on § 523(a)(7), which permitted discharge of non-compensatory damages owed *to the government. Id.* at 947. Despite the *Suter* court's limitation on government-owed damages, other post-*Cohen* courts have interpreted the *Cohen* decision as permitting nondischargeability of punitive damages owed to a governmental entity. *See, e.g.*, Colorado v. Wine (*In re* Wine), 558 B.R. 438 (Bankr. D. Colo. 2016); Mouhtadi v. Shaikh (*In re* Shaikh), No. 16-02765-5-JNC, 2017 WL 4838746, at *8–9 (Bankr. E.D.N.C. Oct. 24, 2017).

C. Archer v. Warner

The Court also provided a broad construction of "obtained by" in its 2003 case, *Archer v. Warner*.[42] The *Archer* case involved the settlement of a potential fraud claim before the alleged tortfeasor filed for bankruptcy protection.[43] The debtor argued that the debt owed to the plaintiff constituted a dischargeable contract claim, as settlement agreements constitute a contract, and the debtor did not engage in any fraud in entering into the settlement contract.[44] The Court disagreed, holding that but for the initial fraud—if the existence of fraud could be shown by the plaintiff—the settlement obligation would not have existed.[45] Thus, though the settlement did not arise out of fraud, fraud led to the initial claim, which, in turn, led to the settlement.[46] In so deciding, the Court considered changes to the Bankruptcy Code that modified the language of §523(a)(2)(A) to expand from "judgments" of fraud to "liabilities" resulting from fraud.[47] That modification "indicated that 'Congress intended the fullest possible inquiry' to ensure that 'all debts arising out of' fraud 'are excepted from discharge,' no matter what their form."[48] The *Archer* Court interpretation mirrors the *Cohen* court interpretation—if the initial obligation existed because of fraud, any further obligations that exist only as a result of that initial fraud also face nondischargeability.

The combination of these cases provides a broad construction of the "obtained by" language, one in which a causal connection[49] between the debtor's

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42 *See* Archer v. Warner, 538 U.S. 314 (2003).

43 *Id.* at 316–17.

44 *Id.* at 318.

45 *Id.* at 322–23.

46 *Id.* at 320–21.

47 *Id.* at 321.

48 *Id.* at 321 (citing Brown v. Felsen, 422 U.S. 127, 138 (1979)).

49 *See* Field v. Mans, 516 U.S. 59, 67 (1995) (rejecting an interpretation of § 523(a)(2) that would eliminate "any requirement to establish a causal connection between the misrepresentation and the transfer of value or extension of credit"). *Field* involved the debtor's guaranty of debt owed by his corporation and the giving of a mortgage to secure that debt. *Id.* at 61. The agreement required the creditors' consent to sell the mortgaged property, but the debtor transferred the property without noticing the creditors. Instead, the debtor asked the creditors to waive some of their rights under the agreement (via a written letter) without disclosing the transfer. *Id.* at 62. The § 523(a)(2) nondischargeability issue arose when the creditors claimed fraud because the debtor wrote about the property without disclosing the transfer. This essentially repeats the common law requirement that the fraud caused damages. *Id.* at 62–63. The primary issue involved the standard required to show reliance by the creditors on the debtor's statements in the letter. The reliance element is implicit in the phrase "obtained by" as establishing a causal element. *Id.* at 66. The Court determined that § 523(a)(2) requires a showing of justifiable reliance on the statements by the creditors to establish nondischargeability. *See id.* at 74.

perpetration of fraud and the existence of the debt[50] suffices to create nondischargeability. One can reconcile the differing broad interpretations of *Husky* versus *Cohen* and *Archer*. While, in *Husky*, Chrysalis's debt did not arise from the fraudulent conveyance, Ritz's debt *did* arise from that fraud. Ritz's fraudulent conveyance actions led to piercing the corporate veil of his personal liability to Husky.[51] Thus, in each of the three cases, but for the debtor's fraud, the debtor would not owe an obligation to the creditor. In *Husky*, Ritz's fraud allowed piercing liability against him.[52] In *Cohen*, a clear link exists between the fraud and the incurrence of punitive liabilities—but for the fraud, the debtor would not owe punitive damages.[53] In *Archer*, the potential fraud by the debtors led to the initial claim against them and, ultimately, the settlement of that claim.[54] The Supreme Court's opinions taken together clearly provide that when the debtor's fraud leads to the debtor's liability, that liability cannot be discharged.

IV. OTHER FACTUAL SCENARIOS WHICH EVOKE "OBTAINED BY" FRAUD LANGUAGE UNDER § 523(A)(2)

Several other factual scenarios evoke consideration of the "obtained by" language in § 523(a)(2). Some of the scenarios pre-date the *Husky* and *Cohen* cases; others continue to arise after those decisions. This section considers those scenarios in light of the Supreme Court cases and considers whether the decisions rendered in those cases comport with the Supreme Court's rulings that link the debtor's nondischargeable liability to the fraudulent actions of the debtor.

This section will examine these scenarios in three main categories. First, this section considers cases in which fraud occurs after the initial debt is incurred. Second, it will examine cases where the debtor does not benefit from the fraud, and it is instead committed in the interest of a third party. Finally, this section will examine scenarios where the debtor did not perpetrate the fraud but benefits from the fraud.

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50 Cohen v. de la Cruz, 523 U.S. 213, 218 (1998). The Court noted that, structurally, § 523(a)(2) requires not that *debt* be "obtained by" fraud, but that the "money, property, services, or . . . renewal . . . of credit" be obtained by fraud, and that property obtained by fraud lead to the indebtedness.

51 Fraud is an element of piercing the corporate veil. *See* Husky Int'l Elecs., Inc. v. Ritz (*In re* Ritz), 513 B.R. 510 (S.D. Tex. 2014), *aff'd*, Husky Int'l Elecs., Inc. v. Ritz (*In re* Ritz), 787 F.3d 312 (5th Cir. 2015), *rev'd and remanded*, Husky Int'l Elecs., Inc. v. Ritz, 136 S. Ct. 1581 (2016). Even so, the District Court found that fraud different than fraud required for nondischargeability: "While the fraudulent transfer without a misrepresentation may qualify as actual fraud . . . to pierce the corporate veil, it cannot meet the requirement . . . to bar the discharge of the debt." *Id.* at 538.

52 *See id.*

53 *Cohen*, 523 U.S. at 218.

54 Archer v. Warner, 538 U.S. 314, 317 (2003).

A. *Fraud Which Occurs After Incurring Debt*

In the classic fraud nondischargeability case, the debtor defrauds the creditor in their initial interaction, such that the debt itself would never exist but for the debtor's fraud. The creditor proves the elements for a judgment of fraud under state law[55] or can clearly demonstrate false "pretenses" or "representation"[56] that led the creditor to part with services or value and created the debtor's payment obligation to the creditor. However, not all fraud causes the creditor to part with value. Frequently, fraud occurs after the initial incurrence of the debt, as occurred in *Husky*, and courts must tackle the question of how to handle post-incurrence fraud under § 523(a)(2). Though *Husky* involved fraud after the incurrence of debt, the decision still required a causal link that must be explored in the context of other cases.

1. Fraud Which Causes Additional Extension of Credit or Forbearance

One of the most common scenarios invoking § 523(a)(2)'s "obtained by" provision involves an initial extension of credit, with fraud coming later during the transaction in order to entice the creditor not to terminate the relationship or call the loan. For example, *In re Plechaty*,[57] a case from the Sixth Circuit Bankruptcy Appellate Panel, involved a loan made by a syndicate of banks, and false financial statements and a personal guaranty by the principal of the debtor provided several years later, which led to a delay in the banks demanding repayment of the loan.[58] The Code provides for nondischargeability for "an *extension*, renewal, or refinancing . . . obtained by" fraud.[59] The *Plechaty* case focused on what constitutes an "extension of credit" and, more particularly, whether the banks' delay in calling the loan due qualified as an extension of credit sufficient to support § 523(a)(2) nondischargeability.[60] The court found that "[a] majority of courts have concluded that a debtor who has caused a creditor to grant a delay in receiving or collecting payment that is due has received an extension of credit within the meaning of § 523(a)(2)"[61] while also

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55 Grogan v. Garner, 498 U.S. 279, 290 (1991) (finding that fraud must be shown by a preponderance of the evidence for nondischargeability purposes and, as a result, any state-court judgment of fraud necessarily renders the debt nondischargeable in bankruptcy).

56 11 U.S.C.A. § 523(a)(2)(A) (West 2021).

57 *See* Nat'l City Bank v. Plechaty (*In re* Plechaty), 213 B.R. 119 (B.A.P. 6th Cir. 1997).

58 *Id.* at 122.

59 11 U.S.C.A. § 523(a)(2) (emphasis added).

60 *In re Plechaty*, 213 B.R. at 124–25.

61 *Id.* at 124 (citing John Deere Co. v. Gerlach (*In re* Gerlach), 897 F.2d 1048 (10th Cir. 1990); First Comm. Bank v. Robinson (*In re* Robinson), 192 B.R. 569 (Bankr. N.D. Ala. 1996); FDIC v. Cerar (*In re* Cerar), 84 B.R. 524 (Bankr. C.D. Ill. 1988); First Bank v. Eaton (*In re* Eaton), 41 B.R. 800 (Bankr. E.D. Wis. 1984)).

recognizing that several courts hold just the opposite.[62] In agreeing with the majority of courts, the court noted that a forbearance constitutes just one type of extension; an extension includes any increased time to pay back debt.[63] The debtor provided the false financial statements with the intent to cause a delay in repayment, sufficing for nondischargeability.[64] The court then turned to the issue of damages, the primary issue involving the "obtained by" language. The debtor argued for limiting nondischargeable damages to those shown to result from the fraud.[65] The court held that, upon a showing of an extension of credit received through fraud, *all* amounts due qualify as nondischargeable.[66] Thus, while the debtor argued that the causal link "to the extent obtained by language" applied to the calculation of which damages would be nondischargeable, the court instead interpreted the language to apply to whether the fraud creates nondischargeability of the debt as a whole.[67]

In a case remanded by the Supreme Court[68] that made its way back up to the Circuit Court,[69] the First Circuit likewise rejected a requirement that the creditor prove that fraud led specifically to damages. The debtor's business purchased property from the Fields, granting the Fields a mortgage on the

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62 *Id.* at 125 (citing Howard & Sons, Inc. v. Schmidt (*In re* Schmidt), 70 B.R. 634 (Bankr. N.D. Ind. 1986); Drinker, Biddle & Reath v. Bacher (*In re* Bacher), 47 B.R. 825, 829 (Bankr. E.D. Pa. 1985); Cement Nat'l Bank v. Colasante (*In re* Colasante), 12 B.R. 635 (E.D. Pa. 1981)).

63 *Id.* (citing *Extension*, BLACK'S LAW DICTIONARY (6th ed. 1990)).

64 *Id.*

65 *Id.* at 127.

66 *Id.* at 128 (citing *In re* McFarland, 84 F.3d 943 (7th Cir. 1996); Shawmut Bank, N.A. v. Goodrich (*In re* Goodrich), 999 F.2d 22 (1st Cir. 1993); *In re Gerlach*, 897 F.2d 1048; Wolf v. Campbell, 211 B.R. 14 (E.D. Mich. 1997); Siriani v. Northwestern Nat'l Ins. Co. (*In re* Siriani), 967 F.2d 302 (9th Cir. 1992)). *See also In re Goodrich*, 999 F.2d at 22 (declining to require showing of harm from renewal of line of credit obtained through false financial statements, even though "it is possible that the bank would have called the loan if accurate information had been furnished on renewal and yet been unable to collect a penny before bankruptcy"); *In re Gerlach*, 897 F.2d at 1048 (debtor's falsification of sales caused John Deere not to call credit and satisfied nondischargeability requirements); *In re McFarland*, 84 F.3d at 943 (refusing to require proof of damages after debtor obtained extension of credit through fraudulent means); Norris v. First Nat'l Bank in Luling (*In re* Norris), 70 F.3d 27 (5th Cir. 1995) (finding that "renewal of the entire note was 'obtained by' [debtor's] false documentation" in obtaining renewal of credit). *Cf.* Bombardier Capital, Inc. v. Baietti (*In re* Baietti), 189 B.R. 549 (Bankr. D. Me. 1995) (looking at the phrase "to the extent" as creating a requirement that debtor prove damages were caused by the fraud), *with* Field v. Mans, 157 F.3d 35 (1st Cir. 1998).

67 *In re Plechaty*, 213 B.R. at 127.

68 Field v. Mans, 516 U.S. 59 (1995) (indicating that creditors need only establish justifiable, not reasonable, reliance on fraudulent statement for nondischargeability). Justice Ginsburg's concurrence specifically noted that the "causation issue" had not been determined by the Court's opinion. *Id.* at 78 (Ginsburg, J., concurring).

69 *In re* Mans, 200 B.R. 293 (Bankr. D.N.H. 1996), *motion to reconsider denied*, 203 B.R. 355 (1996), *rev'd*, 210 B.R. 1 (1st Cir. BAP 1997), *rev'd sub nom.* Field v. Mans, 157 F.3d 35 (1st Cir. 1998).

property. The debtor also issued a personal guaranty of the business's debt obligation to the Fields.[70] The terms of the sale agreement obligated the debtor to notify Fields of the sale of the property.[71] The debtor asked the Fields' permission to sell the property but did so one day *after* actually selling the property and without notifying Fields of the sale.[72] The Court first determined that the lack of acceleration of the debt by the Fields sufficed as an extension of credit.[73] In so doing, the Court declined to require that the Fields demonstrate that they would have called the loan had they been aware of the sale or that, after calling the loan, they could have recovered the obligations owed to them:

> [W]e disagree with the BAP that—in order for failure to accelerate to be equivalent to an extension of credit—"there would have to be virtual certainty that acceleration would have taken place." We think it enough, *see* below, that the Fields were in a position to have accelerated effectively and might well have done so.[74]

In rendering its decision, the Court focused on the "fresh start" policies and the availability of a discharge only for honest debtors.[75]

This issue arises even outside of traditional lending. The Fourth Circuit Court of Appeals case of *In re Biondo*[76] arose after the debtors hired Foley & Lardner and failed to pay most of the lawyers' fees. After Foley & Lardner filed suit to collect its fees, the debtors created limited partnerships and transferred significant assets into those partnerships.[77] Eventually, the debtors and Foley & Lardner entered into a settlement agreement by which Foley & Lardner agreed to hold on collections and reduce the total debt owed in exchange for a security interest in the limited partnerships and an assignment of the debtors' distributions from the partnerships.[78] The fraud arose because the debtors "represented that they maintained and could transfer interests in the Partnerships when, in fact, those interests already had been placed into [another limited partnership]."[79] The timing of the fraud compared to the incurrence of the debt presented an issue because the fraud occurred *after* the firm provided the initial services causing the outstanding obligation.[80] The debtors argued that they did not commit fraud but,

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70 *Id.*

71 *Mans*, 157 F.3d at 37.

72 *Id.* at 38.

73 *Id.* at 39.

74 *Id.* at 44.

75 *Id.*

76 Foley & Lardner v. Biondo (*In re* Biondo), 180 F.3d 126 (4th Cir. 1999).

77 *Id.* at 129.

78 *Id.* at 129–30.

79 *Id.* at 130.

80 *Id.* at 133.

even if they did so, the debt for the legal services did not accrue because of that fraud.[81] The court recognized the clear language of § 523(a)(2) requiring a connection between the receipt of money or benefit and the fraud.[82] It found, however, that "secondary debt transactions—extensions, renewals, and refinancings" procured through fraud also qualify for nondischargeability.[83] The debtors' fraud "result[ed] in the substitution of one debt for another."[84] The court focused on the fraud directly leading to the settlement, thus causing the firm to relinquish its rights to collect on the initial fees at a time when it might have been able to collect. The fraudulent statements *caused* the firm to give up those rights, and the court held that the causal connection sufficed to create nondischargeability.[85] The court required no showing that, absent the misstatements and the resulting settlement, the firm could have recovered the fees owed.

Each of these cases involves two questions, one answered easily and the other presenting more of a challenge. The first question involves whether the debtor received an extension or refinancing of credit. In each case, the court found such an extension because the debtor continued to receive the ability to use the credit given without an enforcement action by the creditor. The second question involves the extent to which the debtor "obtained" that extension or refinancing of credit through the fraud. While often phrased as a question of damages, every creditor seeking nondischargeability incurred damages because each failed to receive payment from the debtor. The real issue, according to each of these courts, entails whether the fraud *caused* the extension rather than whether the extension led to damages, as further noted by the court in *Wolf v. Campbell*.[86] *Wolf* involved a fraudulent representation made by the debtor after the initial incurrence of the loan and in order to induce forbearance by the creditor—a form of further extension of credit.[87] The bankruptcy court allowed discharge because the creditor failed to demonstrate that the misrepresentations led to additional damages that would not have otherwise occurred:[88]

> In common parlance, the bankruptcy court said that Campbell was broke when he made financial representations to Wolf, and

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81 *Id.* at 131, 133.

82 *Id.* at 131–33.

83 *Id.* at 131.

84 *Id.* at 132–33 (citing *In re* McFarland, 84 F.3d 943 (7th Cir. 1996)); *see also* Dominion Bank v. Nuckolls, 780 F.2d 408 (4th Cir. 1985).

85 *In re Biondo*, 180 F.3d at 135.

86 211 B.R. 14 (E.D. Mich. 1997).

87 *Id.*

88 *Id.* at 15.

> therefore since Wolf lost nothing by the misrepresentation, Campbell is entitled to the discharge of his debt.[89]

The district court disagreed, and in so doing, considered cases focused on the need to prove damages while discussing proximate causation.[90] Ultimately, the court determined that it would "not . . . engage in a statutory exegesis focusing on the words 'for money, property, services, or an extension, renewal, or refinancing of credit, *to the extent obtained by,*' 11 U.S.C.A. § 523(a) . . . ."[91] In so doing, it also stated that the "[d]ischarge of debts is for honest debtors. That a debtor does not profit by a misdeed is no occasion to ignore the misdeed."[92]

Not all courts make the entire debt nondischargeable simply because the debtor made a misrepresentation that caused the creditor not to call the loan. In *In re Baietti*,[93] the bankruptcy court limited damages to the amount that the creditor could prove an ability to collect absent the fraudulent extension of credit. The debtor's business included the sale of boats financed by the creditor and secured by the boats themselves and the debtor's personal guaranty.[94] As the debtor sold boats, the agreement required that the business use the value received for the boats to repay the creditor.[95] The creditor's manager regularly visited the business to check that the boats had not been sold without payment to the creditor.[96] The debtor sold several boats that secured the creditor's loan without using the proceeds of sale to pay the creditor; the creditor did not discover the sales because the boats were still on the premises during the manager's periodic checks of the inventory, and the debtor did not inform the creditor of the sales.[97] The creditor argued that relinquishing its right to call the loan and liquidate the collateral constituted an extension of credit and the entire loan balance would thus be nondischargeable; the debtor argued that nondischargeability requires proof of damages caused by the fraud, and without the extension of new credit to the debtor that causation does not exist.[98] Though declining to hold that any fraud leading to an "involuntary" extension of credit by preventing the creditor from discovering a situation that might have allowed the creditor to recover

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89 *Id.* at 16.

90 *Id.* (discussing "the abundant precedential authority holding that the proximate cause element is an impermissible addition to the statute" in the same discussion as a case indicating that "[h]ad Congress wished to add 'damage' as an element, it could easily have done so") (quoting Shawmut Bank, N.A. v. Goodrich (*In re* Goodrich), 999 F.2d 22 (1st Cir. 1993)).

91 *Id.* at 16 (emphasis in original).

92 *Id.*

93 Bombardier Capital, Inc. v. Baietti (*In re* Baietti), 189 B.R. 549 (Bankr. D. Me. 1995).

94 *Id.* at 551.

95 *Id.*

96 *Id.* at 551–52.

97 *Id.* at 552.

98 *Id.* at 556.

sufficed as an extension of credit, the court found a clear causal connection between the debtor's dishonesty and the creditor's affirmative choice not to call the loan,[99] bolstered in large part by the creditor's history of requiring strict compliance with the requirement to use the sale proceeds to repay the loan.[100] Even so, the court noted that the discharge exception applies only to the portion of the debt that continued to exist because of the fraud. [101] In the case at hand, that applied only to the boats sold *after* the misrepresentation and that, absent the misrepresentation, the creditor could have repossessed and sold the property.[102]

In enacting the Code, Congress discussed refinancing debt:

> In many cases, a creditor is required by state law to refinance existing credit on which there has been no default. If the creditor does not forfeit remedies or otherwise rely to his detriment on a false financial statement with respect to existing credit, then an extension, renewal, or refinancing of such credit is nondischargeable only to the extent of the new money advanced; on the other hand, if an existing loan is in default or the creditor otherwise reasonably relies *to his detriment* on a false financial statement with regard to an existing loan, then the entire debt is nondischargeable under section 523(a)(2)(B). This codifies the reasoning expressed by the second circuit in *In re Danns*, 558 F.2d 114 (2nd [C]ir. 1977).[103]

The quoted language suggests that none of the debt can be discharged *if the creditor relinquishes rights* because of the fraud (and, specifically, a false

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99 *Id.* at 557.

100 *Id.* at 552.

101 *Id.*

102 *Id.* at 558.

103 Shawmut Bank, N.A. v. Goodrich (*In re* Goodrich), 999 F.2d 22, 26–27 (1st Cir. 1993) (emphasis added) (quoting 124 CONG. REC. 32399, 33998 (1978) (statements of Rep. Edwards and DeConcini)). Before adoption of the Bankruptcy Code, the Bankruptcy Act provided for nondischargeability of fraud debts. S. REP. NO. 95-989, 1978 U.S.C.C.A.N. 5787, 5864 ("As under the Bankruptcy Act Sec. 17A(2), a debt for obtaining money, property, services, or a refinancing extension or renewal of credit by . . . fraud, . . . is excepted from discharge. This provision is modified only slightly from current Section 17A(2)."). Shortly before adoption of the Code, the Second Circuit dealt with the Act's provision. Household Finance Corporation v. Danns (*In re* Danns), 558 F.2d 114 (2d Cir. 1977), *superseded by statute* 11 U.S.C.A. § 523(a)(2)(B) (West 2021). The *In re Danns* case dealt with two loans—one made and renewed before the debtor's fraudulent statement and one made after the debtor's fraudulent statement. *Id.* at 115. The Court allowed the debtor to discharge the initial loan because, to the extent that the bank renewed the initial loan, it did so unrelated to the fraudulent statements made in connection with the second loan. Thus, no causation existed between the fraudulent statements and the *renewal* of the first loan. *Id.* at 116 ("There was no evidence that the original loan was renewed in reliance on the false representation" and noting that "[t]his was not a true extension of the original loan" because "the original loan was renewed only because state law required that it be consolidated with the new loan."). *Id.*

financial statement).[104] In other words, once the creditor establishes reliance, an element specifically listed for false financial statements, the *entire* debt faces nondischargeability. While it mentions the creditor's detriment, it does so in establishing that none of the debt can be discharged—an indication that there must be a causal link but no affirmative showing of the amount of damage caused by the misstatement. Thus, the creditor need not establish that the creditor would have succeeded in recovering on the debt if the fraud had not occurred and the loan had not been extended.

The legislative history cites to *In re Danns*,[105] noting that the new provision referring to the refinancing of credit codifies the holding in that case. *In re Danns* involved a debtor who engaged in fraud when simultaneously obtaining a second loan and renewing a first loan from Household Finance Corporation ("HFC").[106] At the time, the Bankruptcy Act—the predecessor to today's Bankruptcy Code—provided for nondischargeability for "liabilities for obtaining money or property by false pretenses or false representations, or for obtaining money or property on credit or obtaining an extension or renewal of credit in reliance upon a materially false statement in writing respecting his financial condition . . . ."[107] Thus, the issue involved modern-day § 523(a)(2)(B),[108] not the "false pretenses," "false representation," and "actual fraud" provisions under (a)(2)(A). In determining that "the creditor should be entitled to bar discharge only of that portion of his loan as was obtained fraudulently,"[109] the *In re Danns* court focused on the lack of connection between the renewal of the initial loan and the making of the false representation—a lack of justifiable reliance rather than a lack of damages. The creditor relied on the false statement in extending the new loan but not in renewing the initial loan; as a result, the court allowed discharge of the initial debt.[110] Interestingly, the *In re Danns* court did not, as the legislative history suggests, clearly indicate that "if an existing loan is in default or the creditor otherwise reasonably relies *to his detriment* on a false financial statement with regard to an existing loan, then the entire debt is nondischargeable under section 523(a)(2)(B)."[111] Rather, the *In re Danns* Court indicated that, absent a showing of reasonable reliance on a financial statement in the renewal or refinancing of a loan, the initial loan amount

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104 *See infra* note 119 (discussing other legislative history indicating the same idea).

105 *In re Danns*, 558 F.2d at 114.

106 The initial loan had to be refinanced in order to take out the second loan under state law. *Id.* at 115 n.1.

107 11 U.S.C.A. § 35(a).

108 That section provides for nondischargeability for "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 . . . reasonably relied; and (iv) that the debtor caused to be made or published with intent to deceive." 11 U.S.C.A. § 523(a)(2)(B).

109 *In re Danns*, 558 F.2d at 116.

110 *Id.*

111 124 Cong. Rec. 32399 (1978) (statement of Rep. Edwards).

could be discharged. Further, *In re Danns* focused on the question of whether damages must be shown within the § 523(a)(2)(B) "financial statement" exception, rather than the § 523(a)(2)(A) fraud or false representation nondischargeability test. As a result, the legislative history and circuit court cases provide little concrete guidance as to the appropriate standard to apply in determining whether to discharge all debt resulting from fraud.

While the *In re Danns* case and the legislative history focus on § 523(a)(2)(B), the Supreme Court's decision in *Field v. Mans* focused on actual fraud under § 523(a)(2)(A).[112] But, like *In re Danns*, the *Field* Court looked at reliance by the creditor upon the fraudulent misstatement to establish nondischargeability.[113] The cases differ in that the *Field* Court bases that requirement of reliance on the phrase "to the extent obtained by" in § 523(a)(2)(A) rather than on the express reliance element provided for in § 523(a)(2)(B).[114] On remand, the bankruptcy court and ultimately circuit court both found the basis for nondischargeability under § 523(a)(2)(A) due to the creditor's justifiable reliance on the debtor's false representations.[115] Notably, the First Circuit focused on how the false representations led the creditor to give up rights it could have exercised had it known the true scenario, holding that "[b]ut for the fraud they *could* have withdrawn the credit they had previously extended"[116] and specifically rejecting a requirement that the creditor demonstrate that it would have taken such action.[117]

At this point, each of the circuit courts considering the "obtained by" language rejects a requirement that a creditor demonstrate damages resulting from the debtor's fraud. Instead, each focuses on the creditor relinquishing rights, without the stricter showing that the creditor would have exercised those rights or even more strict showing that the creditor would have been successful in recovering had it sought to exercise those rights. This result comports with the Supreme Court's broad reading of "obtained by" in *Husky* and other cases because it suggests that when the creditor continues to extend credit following fraud, that continued extension occurs because of the fraud and is thus "obtained by" the fraud.[118] All of the credit that continues to exist can be traced to the

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112 516 U.S. 59 (1995).

113 *Id.* at 61.

114 *Id.* at 66 ("No one, of course, doubts that some degree of reliance is required to satisfy the element of causation inherent in the phrase 'obtained by.'").

115 *Id.* at 64–65.

116 Field v. Mans, 157 F.3d 35, 43 (1st Cir. 1998) (emphasis added) (discussing whether the lack of acceleration constituted an extension of credit).

117 *Id.* at 44.

118 It is possible that in such a scenario, a creditor actually benefits from the debtor's fraud. For example, in the *Foley* case, the firm might have sought recovery had it not been enticed to enter into a settlement agreement through the debtor's fraud. And it is entirely possible that the firm would have been unsuccessful in recovering any of the debt before the debtor filed for bankruptcy protection. To the extent that the debt was not paid in the bankruptcy case, the debt owed to the

fraudulent statement and is, thus, nondischargeable.[119] The Code does not require that the debt itself exist because of the fraud, but rather that the *extension of credit* be obtained by the fraud.[120] Put in the context of the Supreme Court standards outlined earlier, but for[121] the fraud, the creditor would not have extended the credit and, thus, the credit extended falls within the nondischargeability provisions. Even if the creditor would have suffered the same damages regardless of the fraud, such a result comports with the policy of § 523(a)(2)(A), which seeks to protect victims of fraud and not allow the perpetrators to enter the bankruptcy system with unclean hands and abuse its provisions to the detriment of its victims.[122]

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firm would have been discharged. But, because of the debtor's later fraud, the firm now enjoys the benefit of nondischargeability and a greater likelihood of payment in the future.

119 With the exception of the *In re Biondo* case, each of the circuit court cases considered in this section involved a false financial statement. Under § 523(a)(2)(B), the creditor must "reasonably rely" on the statement to render the debt nondischargeable. 11 U.S.C.A. § 523(a)(2)(B)(iii) (West 2021). The legislative history for § 523(a)(2) provides that:

> The amount of the debt made nondischargeable on account of a false financial statement is not limited to the 'New Value' extended when a loan is rolled over. If an initial loan is made subject to a false financial statement and new money is advanced under a subsequent loan that is not made under conditions of fraud or false pretenses, then only the initial amount of the loan made on the original financial statement is invalidated and excepted from discharge. On the other hand, where the original financial statement is made under nonfraudulent conditions and the entire loan in addition to new money is advanced under a subsequent false financial statement, the entire loan is made under fraudulent conditions. This rule is sound as a matter of policy because the creditor relies to his detriment with respect to the entire amount advanced under the false financial statement. Legal rights with respect to the amount previously advanced may be altered; interest rates may be changed, maturity dates may be extended, and legal remedies may be forgone in reliance on the new false financial statement. However, if the terms of the new agreement are identical to the old agreement with respect to the old money, then no new money was obtained by a false statement on which the creditor relied since the creditor's rights were unchanged; therefore, only that portion of the false financial statement that applied to new money would be nondischargeable.

H.R. REP. NO. 95-595, 1978 U.S.C.C.A.N. 5963, 6090–91. Thus, while the courts in those cases each held the debt nondischargeable, each presumed that the creditor reasonably relied to its detriment on the financial statement in opting to continue to extend the initial credit. No such reliance element appears in the general fraud nondischargeability provision. 11 U.S.C.A. § 523(a)(2)(A).

120 *See* Koha, *supra* note 11, at Part IV.A.1 ("The most sensible reading—and the reading that accords with prior precedent—is that one does not 'obtain' debts, but rather one 'obtains' money, property, or services.") (arguing that Supreme Court's *Husky* decision actually provides for nondischargeability for "debts" obtained by fraud by eliminating the causal connection between money obtained by debtor and nondischargeability).

121 *See supra* notes 49–54 and accompanying text.

122 St. Laurent v. Ambrose (*In re* St. Laurent), 991 F.2d 672, 680 (11th Cir. 1993).

2. Fraudulent Conveyances

The *Husky* case involved a fraudulent conveyance by the debtor after the inception of the loan. The Supreme Court held that a fraudulent conveyance qualifies as the basis for nondischargeability, as long as the conveyance relates to the indebtedness.[123] Like the extension of credit scenario, the debtor-creditor relationship in a fraudulent conveyance system begins without fraud, but the debtor engages in fraudulent activity that prevents the creditor from collecting its debt. The Ninth Circuit Court of Appeals, considering a similar situation, followed the *Husky* Court's lead the following year in *DZ Bank AG Deutsche Zentral-Genossenschaft Bank v. Meyer*.[124] Meyer owned and managed Choice Cash Advance L.L.C, which borrowed money from Brooke Credit Corporation, granting Brooke a security interest in its assets. Meyer and his wife personally guaranteed the debt obligation.[125] Eventually, DZ Bank purchased the obligation from Brooke Credit Corporation and provided several forbearances and modifications of the loan. The Meyers then transferred $385,000 of assets to prevent creditors from reaching those assets shortly before Choice defaulted on its loan.[126] DZ Bank successfully argued that the transfers constituted fraudulent transfers under state law and then argued for nondischargeability of the debt.[127] While the bankruptcy court limited nondischargeability to the amount "traceable to DZ Bank's security interest in the assets,"[128] the Ninth Circuit found the entire $385,000 in transferred assets to be nondischargeable fraud. The Ninth Circuit's ruling focused on causation. To the extent that the Meyers transferred assets, a direct causal link existed between the fraudulent transfer and the inability of creditors to reach those assets. As a result, the Meyers enjoyed that amount of assets that otherwise could have gone to DZ Bank to satisfy the guaranty, even if the creditor did not hold a lien on any assets.[129] A similar situation arose in *In re Bloemendaal*,[130] in which the debtor allegedly transferred his residential property into a trust in order to protect it from creditors when it appeared he would face liability on a guaranty of business debt. Neither the business debt nor the guaranty arose from fraud, but an allegedly fraudulent act prevented the creditor (or the trustee on behalf of the estate) from reaching assets that could

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123 *See supra* notes 21–24 and accompanying text.

124 869 F.3d 839 (9th Cir. 2017).

125 *Id.* at 840–41.

126 *Id.* at 841.

127 *Id.* at 842 (indicating that bankruptcy court found that transfer met fraudulent transfer requirements).

128 *Id.*

129 *Id.* at 843.

130 Foster v. Bloemendaal (*In re* Bloemendaal), Case No. 16-600059-7, Adv. No. 16-00047, 2016 WL 7852312 (Bankr. D. Mont. Dec. 22, 2016).

pay the debt.[131] The court, relying on *Husky*, denied the debtor's motion to dismiss, noting that a fraudulent conveyance *may* serve as the basis for nondischargeability if the creditor establishes all elements of nondischargeability.[132] Notably, each of the cases involved the debtor transferring assets from the debtor's business to the debtor personally (or to another business owned by the debtor) and, thus, the debtor personally benefitted by the fraudulent transfer.

However, not all cases embrace *Husky* as a decision allowing nondischargeability for any fraud that results in the debtor's receipt of property that could have been used to repay creditors. *In re Wilson* involved entry of a judgment against the debtor under a construction contract shortly before the debtor fraudulently transferred his residential property to an L.L.C., presumably to avoid it being taken in satisfaction of the judgment.[133] The plaintiff argued that the debtor's fraud in transferring the residential property sufficed for nondischargeability status under § 523(a)(2)(A).[134] The court disagreed, noting that even in light of *Husky*, a connection must exist between the fraud and the *incurrence* of the debt in order to render the debt nondischargeable.[135]

These three cases differ from *Husky* in one important facet—each involves a liability voluntarily incurred by the debtor personally that served as the basis for liability to the creditor. In *Husky*, the debtor's liability arose through piercing the corporate veil—a liability that existed only as a result of the debtor's fraudulent actions. But in *DZ Bank*, *In re Bloemendaal*, and *In re Wilson*, the debtor agreed to take on liability outside of the fraudulent action. The mere existence of a guaranty does not create nondischargeability. The issue, then, becomes whether the fraudulent transfer occurring after the guaranty comes into existence and after the business owes money suffices for nondischargeability. The liability does not arise *because* of the fraud; rather, the fraud makes payment to the creditor less likely because the fraud left the obligor without assets to pay. The obligation of the debtor arose when the initial payment couldn't be made due to the lack of assets, and the creditor either invoked a guaranty by the debtor or sought recovery under fraudulent transfer laws. In essence, the fact that the creditor needed to use the guaranty or fraudulent transfer provisions to recover from the debtor arose *because of* the debtor's fraud and should create the causal nexus necessary to create liability.

But that liability should have limits. The language of § 523(a)(2) prohibits nondischargeability on "debt . . . for property . . . obtained by . . . actual

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131 *Id.* at *1.

132 *Id.* at *6–7 (rejecting the debtor's argument that the *Ritz* holding is dicta).

133 Norton v. Wilson (*In re* Wilson), Case No. 16-30782, Adv. No. 16-3068, 2017 WL 1628878, slip op. at *4 (Bankr. N.D. Ohio May 1, 2017).

134 *Id.* at *1.

135 *Id.* at *7 (distinguishing *Husky* because the *Husky* debtor's "liability to the creditor arose if at all through a scheme of fraudulent transfers he caused the original corporate obligor to make" whereas this creditor received a judgment of liability against the debtor before any fraud occurred).

fraud."[136] In each case, the debtor owes a debt, and the debtor obtained property (either directly or through another receiving entity) from the initial obligor through fraud. But the debt is not for that property transfer. For example, in *DZ Bank*, the amount due to the creditor exceeded $1.7 million, and the debtor guaranteed that full amount.[137] But only $385,000 of that obligation could be attributed to the fraudulent transfer.[138] If the debtor had not transferred $385,000 out of the company, it would have been available to pay the creditor, and the debtor would not owe that portion under the guaranty. For that reason, the creditor cannot claim the entire $1.7 million owed under the guaranty as nondischargeable, but only the amount that would not have been due as a result of the fraud—$385,000.[139] At first glance, this concept of limiting the nondischargeable portion of the loan to that directly linked to the fraudulent action seems inconsistent with the prior section, where the *entire* loan amount could be nondischargeable. It appears to be a calculation of the damages resulting from the fraud, which the courts routinely reject in the extension of credit cases. However, in such cases, the fraud led to an extension of the *entire* amount of the initial credit, but the credit might not have been given at all but for the fraud. In the situation of *DZ Bank*, without the fraud, the debtor would have owed $385,000 less on the guaranty because, presumably, the $385,000 would have been available to pay the creditor. But the debtor would still face liability under

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136 11 U.S.C.A. § 523(a)(2) (West 2021). The original language of § 523(a)(2) denied discharge "for obtaining money, property, services, or an extension, renewal, or refinance of credit, by—(A) false pretenses, a false representation, or actual fraud." It was amended to its current version in 1984. Pub. L. No. 98-353 § 454, 98 Stat. 354 (1984).

137 DZ Bank AG Deutsche Zentral-Genossenschaft Bank v. Meyer, 869 F.3d 839, 841 (9th Cir. 2017).

138 *Id.* at 842.

139 This is the exact result reached by the court in holding the $385,000 claim as nondischargeable. *See supra* note 128. *See also* Baytree Nat'l Bank & Trust Co. v. Christensen (*In re* Christensen), Bankr. No. 04 B 17486, Adv. No. 04 A 3646, 2005 WL 1941231 (Bankr. N.D. Ill. Aug. 12, 2005). Per the facts deemed to be admitted, the creditor, Baytree, loaned the debtor's company almost $1 million, secured by mortgages on the lots to be developed with the loan money. The debtor and his wife guaranteed payment on the loans. The debtor submitted monthly statements indicating the work completed on the project; Baytree released the loan money based on the statements. *Id.* at *1. Of course, the debtor misstated the amount of work completed, fraudulently inducing the creditor to release roughly $150,000 more than it would have done with correct information. Baytree eventually foreclosed upon the lots and spent just over $125,000 to finish construction of the lots. Shortly thereafter, the debtor filed for bankruptcy protection, and Baytree sought nondischargeability on its entire $275,000 claim. *Id.* at *2. After determining that all elements of fraud existed, the court moved to a determination on the amount of Baytree's claim that qualified for fraud nondischargeability. Focusing on the "to the extent obtained by" language of § 523(a)(2), the court confined nondischargeability "to that portion of the debt directly attributable to fraudulent acts." *Id.* at *4 (citing F.T.C. v. Austin (*In re* Austin), 138 B.R. 898 (Bankr. N.D. Ill. 1992); McCullough v. Suter (*In re* Suter), 59 B.R. 944 (Bankr. N.D. Ill. 1986)). The court noted that if the debtor failed to complete construction but without fraud, Baytree would still have spent the additional $125,000 to finish the project and, thus, that amount did not result from fraud but from the need to complete an unfinished project. *Id.* at *5.

the guaranty for the remaining $1.315 million regardless of the fraud. In both cases, the causal link suggested by the *Husky* and other Supreme Court cases exists when—but for the fraud—the liability could have been satisfied.

B. Cases Where Fraud Benefits a Third Party Rather than the Debtor

While debtors generally benefit from the fraud they promote, situations do arise in which fraud benefits a third party rather than the debtor. Several Circuit Courts have considered whether a debtor's fraud from which the debtor receives no direct benefit qualifies for nondischargeability.

The *In re Bilzerian*[140] case out of the Eleventh Circuit considered misrepresentations by the debtor that caused HSSM to make investments. At trial, the jury and the court found the debtor guilty of fraud.[141] However, the trial court did not make a finding that the debtor benefitted directly from the fraud.[142] The Eleventh Circuit considered "whether a debtor, who did not individually receive the fruits of his or her fraud, but nevertheless received some benefit, has *obtained* 'money, property, services, or an extension, renewal or refinancing of credit'" under § (a)(2).[143] The court began by noting three possibilities in answering this question: (1) a narrow construction whereby nondischargeability requires that "the debtor personally receive the fruits of the fraud," (2) a broad construction providing that nondischargeability requires fraud, regardless of benefit received, or (3) a middle construction requiring that the debtor receive some benefit[144] to find nondischargeability. The court noted agreement among all circuits considering the issue and sided with the other circuits in selecting the middle option and requiring some benefit to accrue to the debtor for a finding of nondischargeability.[145] Courts commonly refer to this position as the "receipt of benefits" theory because it requires that the debtor benefit from the fraud, even if the debtor does not directly "obtain" the value defrauded from the victim.[146] In so doing, the court noted that requiring that the debtor *directly* receive the "fruits"

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140 HSSM #7 Ltd. P'ship v. Bilzerian (*In re* Bilzerian), 100 F.3d 886 (11th Cir. 1996).

141 *Id.* at 888.

142 *Id.* at 889.

143 *Id.*

144 Even if some benefit must be shown, the connection may be relatively limited. For example, in *S.P. Investments Ltd. P'ship v. O'Connor* (*In re O'Connor*), 145 B.R. 883 (Bankr. W.D. Mich. 1992), the debtor and his wife fraudulently caused a bank to loan money to the debtor's business. The court held that the receipt of money by the company inured to the benefit of the debtor-owner *and* necessarily benefitted the debtor's wife as well (but allowed the discharge of the wife's obligation for failure to meet another requirement of nondischargeability) *Id.* at 895.

145 *In re Bilzerian*, 100 F.3d at 890 (citing BancBoston Mortgage Corp. v. Ledford (*In re* Ledford), 970 F.2d 1556 (6th Cir. 1992); Luce v. First Equip. Leasing Corp. (*In re* Luce), 960 F.2d 1277 (5th Cir. 1992); Ashley v. Church (*In re* Ashley), 903 F.2d 599 (9th Cir. 1990)). *See also* Arm v. Morrison (*In re* Arm), 87 F.3d 1046 (9th Cir. 1996).

146 *In re Bilzerian*, 100 F.3d at 890.

of the fraud goes beyond the express language of the Code.[147] While at the time of *In re Bilzerian*, all circuits considering the issue agreed to a "receipt of benefits" requirement, a Circuit Split now exists on that issue. That split arises, in part, from the Supreme Court's 1998 decision in *Cohen v. de la Cruz*.[148]

Two years after the *Cohen* decision, the Fourth Circuit seemingly abandoned the receipt of benefits test. The debtor in *Pleasants v. Kendricks*[149] misrepresented his qualifications to the Kendricks when working with them on a home addition. After learning of Pleasants' misrepresentations, the Kendricks agreed to continue under the contract[150] pursuant to an agreement that Pleasants' company would meet certain construction milestones. Ultimately, the company failed to meet those requirements, and the Kendricks obtained a judgment against Pleasants, who then filed for bankruptcy protection.[151] The Kendricks argued for nondischargeability of the judgment under § (a)(2)(A); Pleasants responded that the "obtained by" requirement mandates that the debtor directly receive the transfer from the creditor.[152] In the case at hand, the funds paid by the Kendricks went to subcontractors hired by Pleasants rather than to Pleasants himself. The court disagreed, noting that the *Cohen* case determined that nondischargeability includes any debt existing because of the fraud regardless of whether the debtor actually received the funds.[153] To hold otherwise would allow some debtors who defraud to escape nondischargeability despite their wrongful action.[154] Since the *Pleasants* decision, two other circuit courts have abandoned the receipt of benefits test.[155]

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147 *Id.* at 891.

148 Cohen v. de la Cruz, 523 U.S. 213 (1998). *See also supra* note 10, at Part B.

149 219 F.3d 372 (4th Cir. 2000).

150 Pleasants also argued that the intervening agreement, entered into *after* the Kendricks learned of the fraud, meant that the debt no longer existed because of the fraud. The court disagreed. *Id.* at 375–76. While the court did not discuss this argument at length, the court focused on causation because the debt would not have existed but for the fraud since the forbearance agreement merely served "to salvage what they could from the situation at hand," and that situation occurred because of the fraud. *Id.* The fraud caused the Kendricks to enter into the contract and suffer damages, even if they continued under the contract without any additional fraud. This result accords with the causal link promoted by the Supreme Court, and with its decision in *Archer v. Warner*, 538 U.S. 314 (2003), which rejected an argument by the debtor that a subsequent contract serves as a novation and replaces what could otherwise be a nondischargeable fraud claim with a dischargeable contract claim.

151 *In re Pleasants*, 219 F.3d at 374.

152 *Id.* at 375.

153 *Id.*

154 *Id.*

155 Muegler v. Bening, 413 F.3d 980, 983–84 (9th Cir. 2005) (citing the *Cohen* case as favoring a broad interpretation of § 523(a)(2) in order to protect victims of fraud); Ghomeshi v. Sabban (*In re* Sabban), 600 F.3d 1219 (9th Cir. 2010) (rejecting receipt of benefits test, but also finding lack of causation between contractor's fraud and liability to homeowner).

The Tenth Circuit Bankruptcy Appellate Panel also considered whether the debtor must personally receive the property obtained by fraud in *In re Thompson*.[156] Thompson operated nursing homes and made several misrepresentations to the state health department in obtaining the certificate to operate the nursing homes.[157] One of those misrepresentations indicated that he would remain actively involved in the operation of the nursing homes when, in fact, he did not participate in—and arguably never intended to participate in—management of the homes. Ultimately, one of the residents died as a result of inadequate care, and her estate obtained a judgment against the home. When Thompson filed for bankruptcy protection, the estate argued that Thompson should be held personally liable for the home's obligations via piercing of the corporate veil. The estate also argued that Thompson's fraudulent statements to the state led to the inadequate care and, thus, he could not discharge the debt resulting from those statements.[158] The court began by considering whether a debt that arose under a veil-piercing theory could qualify for fraud nondischargeability. It rejected the debtor's argument that the state court must find fraud as the basis for liability for the bankruptcy court to find nondischargeability.[159] Rather, it held that "[c]laims established under state law on grounds other than fraud are not automatically precluded from qualifying for the exception to discharge under § 523(a)(2)(A)."[160] Instead, if the creditor establishes all elements of section (a)(2)—including that "the debtor obtained money, property, services, or credit by the actual fraud"—the debt qualifies for nondischargeability.[161] Discussing the "obtained by" requirement, the court noted that "there is no requirement that the debt be for something the debtor obtains from the creditor."[162] Ultimately, the court remanded for further factual

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156 Hatfield v. Thompson (*In re* Thompson), 555 B.R. 1 (B.A.P. 10th Cir. 2016).

157 *Id.* at 4.

158 *Id.* at 5–6.

159 *Id.* at 8–9.

160 *Id.* at 9.

161 *Id.* at 10.

162 *Id.* at 12.

determinations.[163] The *Thompson* court recognized the receipt of benefit issue but specifically declined to render a decision on that issue.[164]

Nunnery v. Rountree distinguished the result in the *Pleasants* case and declined to extend § 523(a)(2)'s nondischargeability provision.[165] Nunnery filed an insurance claim following an automobile accident; the insurer hired Rountree to investigate Nunnery's claim. In the investigation, Rountree "befriended Nunnery and convinced her to attempt activities in which Nunnery was reluctant to participate because of her injuries."[166] Rountree then videotaped Nunnery participating in the activities, and the insurer used those tapes against Nunnery in ensuing litigation over the insurance claim.[167] Nunnery sued Rountree and received an award in arbitration before Rountree filed for bankruptcy protection; Nunnery then received an award of damages following trial post-bankruptcy. Nunnery sought a declaration of nondischargeability on that award in Rountree's bankruptcy case. The bankruptcy court held the debt nondischargeable, but the district court reversed on the basis of the phrase "obtained by" in § 523(a)(2).[168] The Court of Appeals agreed with the district court, holding that the debtor must benefit by the fraud for a finding of nondischargeability:

> The plain language of the subsection under which Nunnery seeks relief requires the debtor to have obtained money, property, services, or credit through her fraud or use of false pretenses. It is clear from the structure of the phrase that "to the extent obtained" modifies the money, property, services, or credit that constitute the debt. A plain reading of this subsection demonstrates that Congress excepted from discharge not simply any debt incurred as a result of fraud but only debts in which the debtor used fraudulent means to obtain money, property,

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163 *Id.* at 14. Interestingly, one court within the Tenth Circuit impliedly interpreted the *Thompson* decision as *requiring* that the debtor receive a benefit from the fraud, even though the *Thompson* court suggested otherwise:

> The Tenth Circuit has not ruled on the "receipt of benefits" issue. The Tenth Circuit Bankruptcy Appellate Panel recently held, however, that to prevail in a § 523(a)(2)(A) actual fraud claim, a creditor must provide that "the debtor obtained money, property, services, or credit by the actual fraud." . . . It did not address whether the benefit must come from the creditor.

Torres-Montoya v. Montoya (*In re* Torres-Montoya), 580 B.R. 556, 563 (Bankr. D.N.M. 2017). The Court focused primarily on the Fourth Circuit's decision in *Rountree*, however, as the basis for its determination that a debtor must receive a benefit and that benefit must come from the creditor to establish nondischargeability.

164 *Thompson*, 555 B.R. at 13 n.73.

165 478 F.3d 215, 222 (4th Cir. 2007).

166 *Id.* at 217.

167 *Id.* at 217–18.

168 *Id.* at 218.

> services, or credit. Structurally, the subsection can have no other meaning.[169]

The court recognized that Rountree committed fraud and that fraud injured Nunnery but declined to find nondischargeability when Rountree did not personally benefit from that fraud.[170] In so doing, the court considered prior Supreme Court decisions regarding fraud nondischargeability, particularly noting that the Supreme Court's decisions regularly provide nondischargeability for any debt arising from the fraud. Those cases, however, involved situations in which the debtor clearly received value from the creditor through the debtor's fraud, and thus cannot extend to the facts presented by *Rountree*.[171] It also recognized its own precedent, particularly distinguishing *Pleasants* as a case in which the debtor received an indirect benefit through his fraud.[172] In its decision, the *Rountree* court essentially returns to the idea promoted in *Bilzerian*—a middle ground in which the debtor must receive some benefit in order to declare the debt nondischargeable. While a direct receipt of the benefits of the fraud is not required, there must at least be some indirect benefit received by the debtor. Notably, the *Rountree* Court suggests that the earlier decision by the same court was also a receipt of benefits decision because it indicated that Pleasants did benefit by the payments made to his subcontractors, even if he did not directly receive the payments himself.[173]

The middle ground proposed by *Bilzerian* and the majority of circuit courts works well in a common situation—one in which the owner of a business commits the fraud on the business's behalf and, thus, receives an indirect benefit from the fraud.[174] At first glance, the requirement of a benefit received by the debtor seems inconsistent with the Supreme Court's very broad interpretation of the "obtained by" requirement as merely requiring a "but for" causal connection between the fraud perpetrated by the debtor and the resulting debt owed by the

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169 *Id.* at 219.

170 *Id.* at 220.

171 *Id.* at 220, 222 (citing Archer v. Warner, 538 U.S. 314, 321 (2003); Cohen v. De La Cruz, 523 U.S. 213, 215 (1998); Brown v. Felsen, 442 U.S. 127, 138 (1979)).

172 *Id.* at 222.

173 *Id.* The *Pleasants* Court never discusses the receipt of benefits test and focuses on the issue raised by Pleasants regarding whether "§ 523(a)(2)(A)'s 'obtained by' language requires that some portion of a creditor's claim must have been directly transferred from the creditor to the debtor." Pleasants v. Kendrick (*In re* Pleasants), 219 F.3d 372, 375 (2000). This does, indeed, raise the possibility that *Pleasants* does not truly abandon the receipt of benefits test but instead only requires an indirect benefit to the defrauding debtor to suffice for nondischargeability.

174 *See, e.g.*, Bombardier Capital, Inc. v. Baietti (*In re* Baietti), 189 B.R. 549 (Bankr. D. Me. 1995). *In re Baietti* involved a fraudulent scheme in connection with a loan given to the corporation owned by the debtor. The court found the debtor's guaranty of debt nondischargeable on account of the fraud because the debtor received an "attenuated" benefit from the fraud. It specifically declined to determine whether a benefit was required under the factual circumstances at hand. *In re Baietti*, 189 B.R. at 556–57.

debtor to the creditor. Indeed, as courts note, the Code does not include any requirement of benefit—direct or indirect—to the debtor by the harm.[175] However, each Supreme Court case dealing with the "obtained by" requirement involved situations in which the debtor *actually benefited* from the fraud.[176] As a result, the Supreme Court has not yet dealt with the receipt of benefits issue.[177]

Situations rarely occur in which the debtor truly receives *no* benefit, either direct or indirect, from the debtor's fraud. People naturally engage in risk-benefit analysis,[178] and engaging in fraud with no potential benefit seems unlikely. Such an unusual situation arose in *Kovens v. Goodwich*.[179] Kovens received a judgment against Goodwich prior to Goodwich's bankruptcy filing.[180] A third party, Glorioso, convinced Goodwich to invest in a series of concerts; Glorioso eventually served three years in prison for his fraudulent schemes. Goodwich, in turn, convinced some of his clients—including Kovens—to invest in the concerts. Goodwich even personally guaranteed loans taken out by his clients to participate in the investment opportunities.[181] While the concerts really occurred, Glorioso lacked any part in them and fraudulently took the funds invested in them. In convincing Kovens to invest in the concerts, Goodwich presented Kovens with post-dated checks from Glorioso payable to others who

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175 Bilzerian v. Bilzerian (*In re* Bilzerian), 100 F.3d 886, 891 (11th Cir. 1996).

176 In *Husky*, Ritz's fraudulent conveyance benefitted his other companies, thereby indirectly benefitting him as the owner of those companies. Husky Intern. Elecs., Inc. v. Ritz, 578 U.S. 356, 357–58 (2016). In *Cohen*, the debtor-landlord received a direct benefit by overcharging rent to tenants. *Cohen*, 523 U.S. at 215.

177 One very early Supreme Court case may provide some basis for the receipt of benefits test. In *Strang v. Bradner*, 114 U.S. 555 (1885), the Court considered imputed fraud liability in a partnership context. The non-defrauding partners found themselves liable for the fraudulent actions of one of their partners, even though they neither participated in nor had knowledge of the partner's fraud. They sought discharge of the liability for the partner's fraud in bankruptcy. *Id.* at 557–58. The Supreme Court held that fraud nondischargeability extended to the debtors' liabilities because "partners cannot escape pecuniary responsibility . . . upon the ground that such misrepresentations were made without their knowledge. This is especially so when, as in the case before us, the partners . . . received and appropriated the fruits of the fraudulent conduct." *Id.* at 561. However, this decision did not require a receipt of benefits but instead noted that in the case at hand, the debtors had received a benefit from their partner's fraudulent conduct. *Id.*

178 *See* Daniel Romer, Valerie F. Reyna, & Theodore D. Satterthwaite, *Beyond Stereotypes of Adolescent Risk Taking: Placing the Adolescent Brain in Developmental Context*, 27 DEV. COGNITIVE NEUROSCIENCE 19, 23 (2017) (comparing "rational" risk taking of adolescents and adults, while noting that both age groups engage in risk-benefit analysis).

179 Kovens v. Goodwich (*In re* Goodwich), 517 B.R. 572 (Bankr. D. Md. 2014). *See also* Berman v. Leary (*In re* Leary), 601 B.R. 307 (Bankr. D. Conn. 2019) (judgment owed by debtor attorney who convinced others to participate in Ponzi scheme through knowingly fraudulent statements regarding existence of company in good standing with the state and falsified information about the investment nondischargeable because judgment could be traced to fraud, even if debtor did not directly receive the fraudulent investment).

180 *Goodwich*, 517 B.R. at 576.

181 *Id.* at 577–79.

invested in prior concerts.[182] The court also believed testimony that Goodwich "bragged to Kovens" about profits received from prior concerts, even providing financial statements on the profits from those shows.[183] Goodwich's fraud did not personally benefit him, either directly or indirectly;[184] rather, it benefitted Glorioso's fraudulent scheme. Nonetheless, Goodwich's false statements constituted a fraud that led to Kovens' investment in that fraudulent scheme.[185] But for Goodwich's fraud, Kovens would not have invested, and Goodwich would not have faced liability. Accordingly, the court denied discharge of the debt, holding that § 523(a)(2) requires only that the debtor's fraud caused the creditor to part with value that in turn led to the creditor's damages, not that the debtor benefitted personally from that fraud. It focused on protecting the creditors deceived by the fraud, not just punishing those who benefit from it.[186] Thus, the debt owed constituted non-dischargeable fraud debt.[187]

The broad construction of the "obtained by" language from the Supreme Court and the lack of a Code requirement of benefit by the debtor justifies the result in *Kovens*, *Rountree*, and *Thompson*. While it is unlikely that a debtor will engage in fraud without the hope of receiving any direct or indirect benefit, if the debtor does so, each nondischargeability element exists. The debtor's fraud caused the loss of creditor value and, thus, the damages and should be nondischargeable. Such a result comports with the goals of § 523(a)(2)(A) because it punishes debtors who engage in wrongful acts and protects the victims of the debtor's fraud.

C. Cases in Which the Debtor Does Not Perpetrate the Fraud but Is

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182 *Id.* at 578.

183 *Id.* at 579.

184 The court noted, however, that Goodwich did not benefit because Glorioso committed fraud against Goodwich. Goodwich believed that he would also financially benefit from the investments because he expected to receive 20% of the profits from the concert in which he convinced Kovens to invest. The court decided that

> It is possible that Goodwich . . . was unaware that he was being defrauded by Glorioso. Goodwich's state of mind . . . is not relevant to the outcome here. . . . He was eager to induce his friend to invest . . . Goodwich presented what was either unverified information or definitively false information . . . in an effort to induce him . . . ."

Id. at 589.

185 *Id.* at 588.

186 *Id.* at 586 (citing Nunnery v. Rountree (*In re* Rountree), 478 F.3d 215, 219–20 (4th Cir. 2007)).

187 *Id.* at 592. The court also determined that the debt qualified for nondischargeability under § 523(a)(2)(B) as a written fraudulent misrepresentation. *Id.* at 590–92.

Subject to Vicarious Liability

1. Partnership and Agency

A debtor is more likely to face liability for fraud without receiving any benefit from that fraud when the debtor's liability arises from vicarious liability for another's fraud, such as occurs in the partnership context. Every Circuit Court case involving a partner seeking discharge of imputed fraud liability based on his or her partner's actual fraud held that the liability cannot be discharged. Though, in most cases, the court did not need to consider the receipt of benefits issue.[188]

In *BancBoston Mortgage Corporation v. Ledford*,[189] the bank loaned funds to a partnership relying on fraudulent misrepresentations by Ledford. Ledford's partner, Sikes, did not participate in or know of the fraud.[190] Agency and partnership laws hold even a non-defrauding general partner responsible for the partnership's liabilities. As a result, Sikes faced liability for the fraudulent actions of his partner and the resulting debt owed to the bank. The court phrased this inquiry as a question of whether "fraud of one partner can be imputed to another partner who had no actual knowledge of it."[191] Noting a Fifth Circuit decision on a similar case,[192] and specifically noting that "Sikes shared in the monetary benefits of the fraud" because the money obtained "[was] used for partnership purposes," the court held Sikes' debt to the bank nondischargeable.[193]

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[188] *In re* Luce, 960 F.2d 1277 (5th Cir. 1992) (specifically noting that debtor received an indirect benefit through the partnership); BancBoston Mortg. Corp. v. Ledford (*In re* Ledford), 970 F.2d 1556 (6th Cir.1992) (specifically noting that debtor received an indirect benefit through the partnership); Deodati v. M.M. Winkler & Assocs. (*In re* MM. Wrinkler & Assocs.), 239 F.3d 746 (5th Cir. 2001) (specifically rejecting the receipt of benefits test in imputed fraud nondischargeability case). The court in *In re M.M. Winkler & Assocs.* noted that in most partnership imputed liability cases, the debtor will indirectly benefit from the partner's fraud, thus rendering the issue of whether receipt of benefits must occur moot: "*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." *In re M.M. Winkler & Assocs.*, 239 F.3d at 750. 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.

[189] *In re Ledford*, 970 F.2d at 1556. This case, and others cited in this section, were the basis for the court's findings in the *In re Bilzerian* case. See *supra* note 145. The factual scenarios were different, but *Bilzerian* cited them as the basis of the receipt of benefits test.

[190] *In re Ledford*, 970 F.2d at 1558.

[191] *Id.* at 1561.

[192] *In re Luce*, 960 F.2d at 1282 (finding that debtor "shared in the monetary benefits" of her partner's fraudulent behavior). *But see In re M.M. Winkler & Assocs.*, 239 F.3d at 750 (arguing that *In re Luce* Court did not address the issue of whether receipt of benefits was required because debtor clearly benefitted from spouse's fraud).

[193] *In re Ledford*, 970 F.2d at 1561. The court also cited an 1885 Supreme Court opinion in which the non-defrauding partner faced liability for the fraud and "received the fruits of the

As one court noted, "a majority of courts have adopted the reasoning . . . to impute the wrongful conduct of one party to an innocent debtor for purposes of nondischargeability."[194]

While the *Ledford* case noted that the partner benefitted personally from the fraud, at least one Circuit Court specifically declined to require personal benefit to the debtor as a result of fraud.[195] In *In re M.M. Winkler & Assocs.*, three parties formed a partnership, and Deodati contracted with the partnership to engage in business dealings.[196] Unfortunately, one of the partners fraudulently stole Deodati's funds; the other partners neither participated in nor benefitted from the fraud. Under state law, all partners faced liability for the fraud. The non-defrauding partners filed for bankruptcy protection and argued for discharge of the fraud debt because of their lack of role in and benefit from the fraud.[197] In making its determination, the Fifth Circuit Court of Appeals[198] focused on the statutory language of § 523(a)(2)(A), which merely requires that a debt be for money or value "obtained by" fraud, not that the debtor benefitted from that fraud.[199] It further looked to two Supreme Court cases to justify its holding. The first, which considered a similar issue under the Bankruptcy Act, referenced the benefit received by the debtor but found that under that case, "benefit to an innocent partner is an aggravating factor and not a requirement."[200] The second

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fraudulent conduct," thus allowing nondischargeability. *Id.* at 1561–62 (citing Strang v. Bradner, 114 U.S. 555 (1885)).

194 Palilla v. Palilla (*In re* Palilla), 493 B.R. 248, 254 (Bankr. D. Colo. 2013). For a more thorough discussion of discharge of imputed fraud liability, see Theresa J. Pulley Radwan, *Determining Congressional Intent Regarding Dischargeability of Imputed Fraud Debts in Bankruptcy*, 54 MERCER L. REV. 987 (2003) (arguing for Congressional intent to allow discharge for debtors whose fraud liability comes only as a result of imputed liability within partnership context).

195 *See, e.g.*, *In re Palilla*, 493 B.R. at 256 (citing *In re M.M. Winkler & Assocs.*, 239 F.3d at 749; Nat'l Dev. Servs., Inc. v. Denbleyker (*In re* Denbleyker), 251 B.R. 891 (Bankr. D. Colo. 2000)).

196 *In re M.M. Winkler & Assocs.*, 239 F.3d at 748.

197 *Id.*

198 The Fifth Circuit later extended its holding to cover a situation in which an agent defrauded a third party, and a principal could not discharge his liability for the agent's fraud. Tummel & Carroll v. Quinlivan (*In re* Quinlivan), 434 F.3d 314 (5th Cir. 2005) (remanding for a determination of the extent of the principal-agency relationship). *See also* Villa v. Villa (*In re* Villa), 261 F.3d 1148, 1151 (11th Cir. 2001) (noting that "a debt may be excepted from discharge when . . . such actual fraud is imputed to the debtor under agency principles" but declining to extend outside of agency relationship).

199 *In re M.M. Winkler & Assocs.*, 239 F.3d at 748–49.

200 *Id.* at 749 (citing Strang v. Bradner, 114 U.S. 555 (1885)). As one Court noted, that seemingly violates the idea of providing a fresh start to an honest debtor:

> The Court acknowledges the unfairness of this result. It is often said the discharge is reserved for the honest-but-unfortunate debtor, thus implying that the purpose of § 523 is to punish only the less-than-honest debtor. . . . While the Court sympathizes with Debtor's unfortunate position, granting a discharge is not solely about an honest debtor's fresh start. . . . § 523 also has

was the more recent *Cohen* case, where the court discussed the case as filling "that gap" in which the debtor does not actually benefit from the partner's fraudulent act.[201] Importantly, the court phrases the issue as one of whether to require a "receipt of benefit" in order to find nondischargeability of the fraud debt.[202]

These cases involve debt directly caused by the fraud, and the cases generally agree with the Supreme Court's broad interpretation that nondischargeability simply requires a causal connection between fraudulent activity and the existence or continuation of the debt. However, it is difficult to reconcile the broad causal analysis and lack of benefit requirement in these imputed-liability cases with the requirement of some benefit to the debtor from the debtor's own fraud. The Supreme Court's jurisprudence answers neither scenario because those cases only establish the "but for" causal link requirement between the fraud and the harm but do not clearly indicate whether the *debtor* must engage in the fraud or whether the debtor must *benefit* from that harm.

Outside of the partnership context, imputed fraud liability has a less consistent result. *In re Huh*[203] involved a debtor facing liability for his employee's fraudulent actions.[204] The bankruptcy court did not find fraud sufficient to hold Huh directly liable for the fraud; rather, his liability arose as the principal operating through his employee-agent. As a result, "the bankruptcy court declined to impute [the employee's] fraud to Huh."[205] On appeal, the Ninth Circuit Bankruptcy Appellate Panel ("BAP") outlined five elements to be met to establish fraud nondischargeability, including "knowledge of the falsity or deceptiveness of such representation(s) or omission(s)" and "intent to deceive."[206] The BAP ultimately adopted a knowledge-based approach, requiring that for a debtor to be denied discharge based on imputed fraud liability, the debtor must have known or should have known of the fraud.[207] The case focused less on the causation and more on the basic elements of fraud.

> compensatory objectives which aim to protect certain types of creditors regardless of the debtor's culpability.

In re Palilla, 493 B.R. at 257 (citing Lawrence Ponoroff, *Vicarious Thrills: The Case for Application of Agency Rules in Bankruptcy Dischargeability Litigation*, 70 TUL. L. REV. 2515 (1996)).

201 *In re M.M. Winkler & Assocs.*, 239 F.3d at 750.

202 *Id.* at 749.

203 Sachan v. Huh (*In re* Huh), 506 B.R. 257 (B.A.P. 9th Cir. 2015).

204 *Id.* at 259–61.

205 *Id.* at 261.

206 *Id.* at 262 (also including misrepresentation, justifiable reliance, and damage "proximately caused" by reliance on the misrepresentation).

207 *Id.* at 265–66 (citing Walker v. Citizens State Bank (*In re* Walker), 726 F.2d 452 (8th Cir. 1984)).

Another situation in which the debtor might not be the one engaging in fraud comes in the constructive fraud context. In *McClellan v. Cantrell*,[208] the primary issue presented to the court involved whether a participant in constructive fraud can discharge the amount due as a result of that fraud. Cantrell, the debtor, purchased machinery from her brother for a fraction of the machinery's value.[209] Unfortunately, the brother defaulted on a loan to McClellan secured by the machinery.[210] The sale occurred shortly after McClellan sought an injunction on the machinery's sale and with the debtor's knowledge of McClellan's injunction motion. The bankruptcy court determined that nondischargeability required an affirmative misrepresentation *by the debtor*.[211] The *McClellan* Court disagreed, holding that because the debtor's brother engaged in actual fraud, and the debtor knowingly received the benefit of that fraud, nondischargeability applied to the debt.[212] In so holding, the court focused on the purpose of the nondischargeability provision—preventing fraud and providing a remedy to defrauded creditors.[213] The court also distinguished actual fraud from constructive fraud, in which the recipient takes property for less than reasonably equivalent value but does so honestly. Such a situation would not serve as the basis for nondischargeability, both due to the lack of culpability of the debtor and the lack of connection between any fraud *by the debtor* and receipt of money that creates a repayment obligation.[214]

Both constructive fraud and imputed fraud liability in the partnership context involve a debtor who did not engage in fraudulent behavior with any malintent, but in the constructive fraud situation, the debtor always benefits by receipt of something for which the debtor did not pay full value.[215] By contrast,

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208 McClellan v. Cantrell, 217 F.3d 890 (7th Cir. 2000).

209 *Id.* at 892. The debtor purchased the machinery for the stated price of $10 and sold it for $160,000. *Id.*

210 *Id.* McClellan attached on the security interest but failed to perfect the interest before the debtor purchased the machinery. *Id.* Under the Uniform Commercial Code, the buyer of machinery takes priority over an unperfected security interest in machinery as long as the buyer lacks knowledge of the existence of the creditor's interest in the property. U.C.C. § 9-317(b) (AM. L. INST. 2001). Whether the debtor purchased the machines from her brother knowing of the existence of McClellan's security interest then dictated whether the debtor took the property subject to McClellan's interest in it. *See McClellan*, 217 F.3d at 897–98 (J. Ripple, concurring) (considering whether debtor's actions constituted willful and malicious injury for nondischargeability under § 523(a)(6)).

211 *McClellan*, 217 F.3d at 892.

212 *Id.* at 894.

213 *Id.* at 893.

214 *Id.* at 894.

215 *See* 11 U.S.C.A. §§ 548(a)(1)(B)(i)–(ii) (West 2021) (constructive fraud occurs when debtor transfers property to another for "less than reasonably equivalent value" while insolvent); UNIF. VOIDABLE TRANSFERS ACT § 4(a)(2) (2014) (providing for recovery by a creditor of transfers made by debtor for less than reasonably equivalent value while insolvent).

no such guaranty of benefit exists in the imputed-fraud context.[216] Thus, to the extent that a partner's imputed fraud liability can be declared nondischargeable, even if the partner did not benefit from the fraud, no justification exists for allowing discharge in the constructive fraud context simply because the transferee acted in good faith.

The fact that partners who did not engage in fraud are *more* likely to face nondischargeability of their imputed fraud liability contravenes the clear bankruptcy policy of providing discharge to the "honest but unfortunate" debtor.[217] It seems impossible that a debtor who *actually* engages in fraud might be allowed to discharge that debt if the debtor did not actually benefit from the fraud[218] or that a debtor who perpetuates or the benefactor who receives property as a result of constructive fraud might be entitled to discharge absent knowledge of the fraud,[219] while denying discharge to the innocent partner who might incidentally benefit from the partner's fraud[220] (and, in cases like *In re M.M. Winkler & Assocs.*,[221] even if the partner received *no* benefit from the fraud).

A close reading of § 523(a)(2)(A) suggests that a debtor need not benefit from the fraud, nor even know of the fraud, in order to be liable. The language prevents the discharge of "any debt . . . for money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained by" fraud. In both the situation in which the debtor engaged in fraud but received no benefit from the fraud and the situation in which fraud liability is imputed to a partner or a principal, property was obtained by the perpetrator of the fraud through that fraud and the debtor's liability ensued as a result of that fraudulent action. In short, but for the fraud, the debtor's debt would not exist. Nothing in the Code requires that the debtor benefit from that fraud—directly or indirectly. And nothing in the Code requires that the debtor perpetrate that fraud, or even that the debtor knew or should have known of the fraud. As noted by the Supreme Court,[222] it merely requires that the debt be tied to fraud that caused the creditor to relinquish

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216 Deodati v. M.M. Winkler & Assocs. (*In re* M.M. Wrinkler & Assocs.), 239 F.3d 746 (5th Cir. 2001).

217 Marrama v. Citizens Bank of Mass., 549 U.S. 365 (2007) ("The principal purpose of the Bankruptcy Code is to grant a 'fresh start' to the 'honest but unfortunate debtor.'" (quoting Grogan v. Garner, 489 U.S. 279 (1991)).

218 HSSM #7 Ltd. P'ship v. Bilzerian *(In re* Bilzerian), 100 F.3d 886 (11th Cir. 1996); Nunnery v. Rountree (*In re* Rountree), 478 F.3d 215 (4th Cir. 2007).

219 *McClellan*, 217 F.3d at 894 (noting the possibility that recipient of a constructively fraudulent transfer would be able to discharge resulting debt) (dictum).

220 *See supra* note 188 (noting consensus among Circuit Courts dealing with discharge of imputed fraud liability of partners).

221 Deodati v. M.M. Winkler & Assocs. (*In re* M.M. Winkler & Assocs.), 239 F.3d 746 (5th Cir. 2001).

222 *See supra* Part III.

value.[223] At the very least, consistency would suggest that if debtors cannot discharge imputed fraud liability, they should not be allowed to discharge liability for fraud that they actually perpetrated simply because they did not personally benefit from that fraud. Such a result would be consistent with the Supreme Court's broad interpretation of the phrase "to the extent obtained by," and with the policy of punishing dishonest debtors. If any persons should be able to discharge debt that resulted because of fraud, it would only be the truly honest debtors, such as the partner whose liability comes solely from imputed liability.

V. CONCLUSION: GOING BEYOND THE SUPREME COURT'S DECISIONS TO PROMOTE DISCHARGE FOR AN INNOCENT PERSON LIABLE FOR ANOTHER PARTY'S FRAUD IF THE DEBTOR DID NOT BENEFIT FROM THE FRAUD

Most cases considering § 523(a)(2)(A)'s "obtained by" language predate the Supreme Court's decision in *Husky*, and many predate the Supreme Court's decisions in *Cohen* and *Archer*. Cases coming after some or all of those Supreme Court decisions have recognized the broadening impact of each case.[224] The Supreme Court cases discussing the "obtained by" requirement merely create the causal link required for nondischargeability—the debt would not be owed but for the fraudulent activity. Each of the cases considered by the Supreme Court involved situations in which the debtor was seeking to discharge debt perpetrated and benefitted from the fraud. That guidance translates easily to other situations in which the debtor engaged in fraud, such as the post-incurrence extension of the debt. The Court's rulings, the language of the Code, and the subsequent cases all support a finding that the continued extension of credit harms the creditor directly as a result of the fraud and creates nondischargeability. But the Court's decisions should also provide guidance for less clear situations in which the debtor's fraud does not benefit the debtor, or the debtor did not actually perpetuate the fraud for which the debtor suffers liability. Most courts considering the Supreme Court's relatively broad interpretation of the phrase "to the extent obtained by" have moved toward a standard that does not require that the debtor benefit from, or even engage in, the fraud for a debt to be nondischargeable.

Perhaps the most challenging issue involves situations in which the debtor did not benefit at all from the fraud. In situations where the debtor perpetrated the fraud, courts differ as to whether nondischargeability requires

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223 *But see* Theresa J. Pulley Radwan, *Determining Congressional Intent Regarding Dischargeability of Imputed Fraud Debts in Bankruptcy*, 54 MERCER L. REV. 987 (2003) (arguing that, despite the language of the statute, imputed fraud liability should be dischargeable based on policy and legislative history of § 523(a)(2)(A)). *See also supra* note 10 (noting that if fraudulent transfer did not cause creditor to give value to transferor, the transferor's debt lacks the causal connection to the fraud and, arguably, could be discharged, while the transferee's liability exists only because of the fraud and would not be dischargeable under a broad reading of *Husky*).

224 *See, e.g.*, *supra* notes 154, 201 and accompanying text.

that the debtor receive some, at least indirect, benefit from the debtor's fraudulent actions. The Supreme Court's broad holdings suggest that any time that a debtor's fraud leads to the debtor's liability, the debtor cannot discharge that liability. Benefit need not be shown, though admittedly, the issue did not arise in any of the Supreme Court cases.

Despite the lack of a requirement that the debtor perpetuate the fraud in the Code's language, and the Supreme Court's broad interpretation of § 523(a)(2)(A), courts should be cautious in finding nondischargeable an innocent debtor's liability for fraud perpetuated by another.[225] Holding the debt of the innocent transferee, innocent partner, or innocent principal nondischargeable undermines one of the goals of nondischargeability—to punish the dishonest debtor but protect the honest one. The Supreme Court repeatedly recognizes this goal when punishing a dishonest debtor with nondischargeability. Of course, protecting the victim of the fraud must also be considered, but courts' discharge exceptions should be construed narrowly to offer the "honest but unfortunate" debtor the maximum discharge available.[226] The Code, while silent, may suggest that Congress assumed that the debtor would be the person perpetrating the fraud upon that creditor, providing some basis for allowing an innocent debtor to discharge debt for fraud perpetrated by another person.[227]

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225 *See also* Koha, *supra* note 11, at Part IV.B.1 (arguing that "the best reading of the plain language . . . is that the debtor must have obtained money, property, services or credit by fraud").

226 *See, e.g.*, Grogan v. Garner, 498 U.S. 279, 286–87 (1991) (citing Local Loan Co. v. Hunt, 292 U.S. 234 (1934)); Marrama v. Citizens Bank of Massachusetts, 549 U.S. 365, 367 (2007) (considering ability of a Chapter 7 debtor who engaged in bad faith activities to convert to a Chapter 13 case); Cohen v. de la Cruz, 523 U.S. 213, 217, 223 (1998).

227 *See supra* Section II.