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SCOTUS Rejects the "Innocent Spouse" Defense and Denies Discharge of Fraudulent Debt

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A title insurer's right of subrogation to seek recovery from third-party wrongdoers for losses incurred by its insureds is among the most important rights afforded under title policies.[1] Title insurers also have the right, but not the obligation, to act against third parties to prevent or reduce loss to insureds under a title policy's defense and prosecution of actions provisions.[2] (*Schwartz v. Stewart Title Guar. Co.*, 134 Ohio App. 3d 601, 611–12, 731 N.E.2d 1159, 1166–67 (1999) [There is no duty to prosecute actions under a title policy.])

Obtaining recovery from third-party wrongdoers can often be difficult. Wrongdoers fraudulently convey their assets to spouses and family members. They file for bankruptcy protection. Or they fall off the face of the earth.

The U.S. Supreme Court issued a significant bankruptcy decision in *Bartenwerfer v. Buckley,* 598 U.S. 69 (2023) (*Bartenwerfer*), which should aid title insurers and others seeking recovery from wrongdoers who file for bankruptcy. In *Bartenwerfer*, the Court rejected the "innocent spouse" defense and held that the wrongdoer's spouse, who was found liable on a partnership theory but was not aware of the misconduct, could not discharge a fraud judgment in bankruptcy. This article examines *Bartenwerfer* and the subsequent cases examining it.

I. The fraud exception to the bankruptcy discharge.

Chapter 7 bankruptcy allows debtors to get a "fresh start" by discharging their debts—but the fresh start is not absolute. Section 523 of the Bankruptcy Code contains several exceptions available to creditors to object to the discharge of certain debts. One of those exceptions is found in Section 523(a)(2)(A), which prohibits discharge of debt for monies obtained through fraud, but this provision does not explicitly reference the individual debtor's culpable actions as does Section 523(a)(2)(A)'s neighboring provisions. The requirement for an individual debtor's culpability was questioned in *Bartenwerfer*, which considered whether a debtor who was a passive investor can discharge debt for money obtained by fraud when the debtor was unaware of the fraud.

II. The bankruptcy court, Bankruptcy Appellate Panel, and Ninth Circuit Court of Appeals disagree whether an "innocent spouse" is subject to the fraud exception to discharge.

In *Bartenwerfer*, David and Kate Bartenwerfer (at the time unmarried) performed renovations on their California home before selling it to buyer Keiran Buckley. After the sale, the buyer discovered multiple defects and brought a state court action alleging various claims, including the Bartenwerfers' nondisclosure of material facts. The buyer prevailed and secured a judgment against the then-married David and Kate, who became jointly liable for damages in excess of $200,000.

David and Kate soon filed for chapter 7 bankruptcy seeking discharge of their debts inclusive of the state court judgment. The buyer Buckley objected and brought an adversary proceeding in the bankruptcy court arguing that the judgment

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1 For example, the 1990 CLTA Standard Coverage Loan Policy provides: "Whenever the Company shall have settled and paid a claim under this policy, all right of subrogation shall vest in the Company unaffected by any act of the insured claimant. The Company shall be subrogated to and be entitled to all rights and remedies which the insured claimant would have had against any person or property in respect to the claim had this policy not been issued. If requested by the Company, the insured claimant shall transfer to the Company all rights and remedies against any person or property necessary in order to perfect this right of subrogation. The insured claimant shall permit the Company to sue, compromise or settle in the name of the insured claimant and to use the name of the insured claimant in any transaction or litigation involving these rights or remedies."

2 For example, the 1990 CLTA Standard Coverage Loan Policy provides: "The Company shall have the right, at its own cost, to institute and prosecute any action or proceeding or to do any other act which in its opinion may be necessary or desirable to establish the title to the estate or interest or the lien of the insured mortgage, as insured, or to prevent or reduce loss or damage to an insured. The Company may take any appropriate action under the terms of this policy, whether or not it shall be liable hereunder, and shall not thereby concede liability or waive any provision of this policy. If the Company shall exercise its rights under this paragraph, it shall do so diligently."

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against the Bartenwerfers was nondischargeable under the section 523(a)(2)(A) fraud exception. The bankruptcy court agreed with Buckley and held that the funds traceable to the Bartenwerfers' nondisclosure were nondischargeable, that the husband David had actual knowledge of the false representations made to buyer, and that David's fraudulent conduct could be imputed to his wife Kate because they formed a legal partnership for the renovation and resale of the home.

The Ninth Circuit Appellate Panel ("BAP") affirmed in part, agreeing that David possessed a fraudulent intent but held that Section 523(a)(2)(A)'s exception applied to Kate only if it could be shown that she knew or had reason to know of David's fraud. the BAP remanded the case to the bankruptcy court to apply the "knew or should have known" standard, where, on remand, the bankruptcy court found that Kate lacked the requisite knowledge of her husband David's fraud such that she could discharge her liability to the buyer.

The BAP affirmed and the Ninth Circuit Court of Appeals reversed, ultimately concluding that Kate was not absolved of liability due to her husband/business partner's fraud on the grounds that she lacked knowledge.[3] And as such, the bankruptcy court applied the wrong standard for imputed liability in a partnership—a debtor who is liable for her partner's fraud cannot discharge that debt in bankruptcy, no matter her own culpability.

Confusion among the lower courts on the meaning of Section 523(a)(2)(A) prompted the Supreme Court to grant certiorari.

III. The U.S. Supreme Court rejects Kate Bartenwerfer's "innocent spouse" defense.

The Court unanimously affirmed the Ninth Circuit's ruling that Kate's debt to Buckley under the fraud judgment was not dischargeable in bankruptcy.

Justice Amy Coney Barrett began her opinion by analyzing the text of Section 523(a)(2)(A) and reasoned that the plain text of the statute applies and precludes Kate from discharging her debt because (1) she is an individual debtor, (2) the judgment is a debt, and (3) the debt arose from sale proceeds obtained by the husband's fraudulent representations: "it is a debt 'for money … obtained by … false pretenses, a false representation, or actual fraud.'"

Kate disputed the third premise in that the passive-voice statute does not specify a fraudulent actor and that the import of the statute is limited to situations where the debtor herself has committed the fraud. The Court rejected this argument and held that the text of the statute does not limit the "false pretenses, a false representation, or the actual fraud" to the debtor seeking the exception; rather, the statute only requires that somebody engaged in the fraudulent conduct and that the debt owed by the debtor follows from that conduct. Indeed, the Court stated that "[t]he passive voice in § 523(a)(2)(A) does not hide the relevant actor in plain sight, as Bartenwerfer suggests—it removes the actor altogether. Congress framed § 523(a)(2)(A) to 'focu[s] on an event that occurs without respect to a specific actor, and therefore without respect to any actor's intent or culpability."[4]

Kate also suggested that because Section 523(a)(2)(A)'s neighboring provisions (B) and (C) each require some culpable action from the debtor, and that because such requirement for culpable action is unstated in (A), Congress must have intended that the debtor herself be culpable for the fraudulent conduct to trigger the exception in (A). The Court was unmoved and deconstructed the proposition in three quick points. First, the Court pointed to precedent where one partner's fraud was rightly imputed to the other partners who "received and appropriated the fruits of the fraudulent conduct.[5] Second, the Court reached this conclusion even though the discharge exception at the time disallowed the discharge of debts "created by fraud or embezzlement *of the bankrupt*.[6] Third, Congress overhauled bankruptcy law some years later and deleted the phrase of the bankrupt" from the discharge exception for fraud.

The ultimate aim of the Bankruptcy Court, reasoned the Supreme Court, is to balance the competing interests of the creditor(s) and the debtor's ability to receive a "fresh start" by discharging certain debt. Sometimes, the Court mused, innocent people are held liable for fraud they did not personally commit, but Congress has seen fit to permit creditors to recover certain debts obtained by fraud, and Section 523(a)(2)(A) is that vehicle. From the Court's perspective, Kate could have insulated herself from liability for her husband David's actions by organizing a limited liability entity, which would insulate her from personal exposure for the debts of the business. Kate did not do so, and the special relationship existing between Kate and her husband taints her with the residue of her husband's fraud and renders her debt nondischargeable under Section 523(a)(2)(A).

IV. Dischargeability of Debt for the "innocent spouse" Post-Bartenwerfer

Post-*Bartenwerfer* Bankruptcy Court decisions illustrate that under certain circumstances, fraudulent debt of an "innocent spouse" may still be discharged under Section 523(a)(2)(A). For instance, In In re Beach, 651 B.R. 359 (Bankr. E.D. Wis. 2023) a husband signed the promissory notes on several loans obtained on behalf of the LLC.[7] The husband and the

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

4 *Bartenwerfer v. Buckley*, 598 U.S. 69 (2023) [143 S.Ct. 665, 667, 214 L.Ed.2d 434].

5 *Strang*, 561, 5 S.Ct. 1038.

6 14 Stat. 533 (emphasis added).

7 *Beach*, 651 B.R. at 365.

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LLC defaulted and the lender filed suit, securing stipulated judgment against both defendants.[8] Husband and wife filed a joint petition for relief under Chapter 7, and lender brought an adversary proceeding to except the state court judgment from discharge as to both debtors.[9] The court concluded it did not need to decide whether a wife could discharge a debt incurred by an LLC because she had no liability for debts incurred by the LLC.[10] In reaching its decision, the court noted that the wife had no ownership interest in the LLC and did not sign the any loan documents.[11] Further, Wisconsin law – as distinguished from the partnership liability in *Bartenwerfer* – provides that debts incurred by the LLC are solely owed by the LLC.

Another case distinguishable from *Bartenwerfer* is *In re Vulaj*, 651 B.R. 310 (Bankr. S.D. Cal. 2023). There, an ex-husband sent $400,000 cash to his current wife (Vulaj) despite owing his ex-wife child support pursuant to a marriage settlement.[12] The ex-wife filed suit in state court alleging the transfers violated the state fraudulent conveyance law and secured judgment of $178,861 upon a finding that the transfers were made with intent to "hinder, delay or defraud" without making any findings about whether Vulaj shared the ex-husband's intent.[13] Vulaj filed for Chapter 7, and the ex-wife filed an adversary complaint alleging Vulaj's debt was nondischargeable under 523(a)(2)(A).[14] The bankruptcy court considered the ex-wife's motion for summary judgment on whether the *Bartenwerfer* decision removed the requirement of establishing culpable intent of a transferee of an intentionally fraudulent conveyance to render it nondischargeable.[15] In denying the ex-wife's motion, the bankruptcy court determined that *Bartenwerfer* addressed the existence of a business partnership in the nondischargeability context, and because no business partnership existed between Vulaj and the ex-husband, the scope of *Bartenwerfer* was properly limited.[16]

The court in *In re Uhls*, 653 B.R. 154, 163 (Bankr. S.D. Ill. 2023) refused to extend *Bartenwerfer* to impute the fraudulent acts of a city employee to a person under contract with the city. In that case, Uhls was retained by the city as a certified public accountant to conduct annual audits of the city's financials.[17] During the timeframe Uhls was serving as auditor, the city's treasurer embezzled more than $300,000 from the city.[18] The city filed suit against Uhls and the treasurer alleging professional negligence against Uhls for failing to discover the treasurer's actions.[19] A default judgment was entered against Uhls for various discovery violations, and a judgment was later entered against both defendants in excess of $435,000.[20] Uhls filed for Chapter 7, and the city brought an adversary petition seeking to deny dischargeability of the state court judgment, and, relying on *Bartenwerfer*, argued that Uhls did not need to be an active participant in the treasurer's fraud for the court to find the debt nondischargeable.[21] In refusing to extend *Bartenwerfer*, the bankruptcy court noted that Illinois's partnership law, like California's, provides for vicarious liability of partners for debts of the partnership; however, the bankruptcy court found no basis to impute the treasurer's fraud under Illinois law because Uhls and the treasurer were not partners.[22]

Thus, it appears that the lower courts have so far declined to apply *Bartenwerfer* where state law shields an "innocent" spouse or partner from vicarious liability; however, *Bartenwerfer* may nonetheless prove to be a useful tool to title insurers in their recoupment efforts. ▪

8 *Id.* at 372.

9 *Id.*

10 *Id*. at 374.

11 *Id*.

12 *Vulaj*, 651 B.R. at 311.

13 *Id*. at 312.

14 *Id*.

15 *Id*. at 311.

16 *Id*. at 315.

17 *Uhls*, 653 B.R. at 157.

18 *Id*.

19 *Id*.

20 Id. at 158.

21 *Id*. at 158-59.

22 *Id*. at 163.

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