NON-DISCHARGE OF FRAUD DEBTS

Authored by: Josh Lewison (Barrister) - Radcliffe Chambers

"And because fraud and deceit abound in these days more than in former times, it was resolved in this case by the whole Court, that all statutes made against fraud should be liberally and beneficially expounded to suppress the fraud."

Per Lord Coke, Twyne's Case (1601) 3 Co. 80

A recent case in the Supreme Court of the United States has thrown a spotlight on fraud debts, which survive discharge from bankruptcy and invites us to consider how similar debts are treated in England and Wales.

In Bartenwerfer v. Buckley (22nd February 2023, not yet reported) the court had to consider whether a bankrupt was discharged from a fraud debt when she had not personally participated in the fraud.

Kate and David Bartenwerfer owned a house in California, which they decided to renovate and sell. They duly did so, and the sale process was handled by David. During the conveyancing, David failed to make all the requisite disclosures and the buyer sued, eventually winning a $200,000 judgment. When Kate and David filed for bankruptcy, the buyer alleged that his judgment was not discharged because it fell within the fraud exception.

11 USC 523 provides for exceptions from discharge. The relevant part of the fraud portion is as follows:

"A discharge … does not discharge an individual debtor from any debt … for money … to the extent obtained by … false pretenses, a false representation, or actual fraud, other than a statement respecting the debtor's or an insider's financial condition …"

The Bankruptcy Court agreed with the buyer, not just in respect of David, but Kate as well. Although David was the perpetrator, the Court found that Kate and David had formed a partnership for the project. Just as the debt was attributable to Kate, so too was the fraud. On the way up to the Supreme Court, it was held at one point that Kate should be discharged because she didn't know about the fraud, a view that had found favour in some Courts of Appeals.

The Supreme Court's unanimous opinion was that Kate's state of knowledge did not matter. The essential reasoning was that the text of the statute says nothing about the debtor's knowledge, or even the identity of the fraudster. The references to fraud go to the character of the debt alone. If the debtor is liable for the debt, and the debt is a fraud debt, that is enough to bring it within the exception from discharge.

Could it happen here?

Just as in the United States, England and Wales has legislated for an exception from discharge for fraud debts. The rationale is public policy: allowing debtors to enjoy the fruits of their dishonesty and then escape the consequences through bankruptcy is objectionable in a way that evading the consequences of improvidence or ill-fortune is not. The court in Bacci

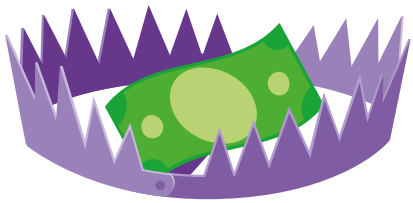
v. Green [2022] EWHC 486 (Ch) summarised it pithily: "Fraudsters should not prosper."

Section 281 of the Insolvency Act 1986 provides, in relation to fraud:

"Discharge does not release the bankrupt from any bankruptcy debt which he incurred in respect of, or forbearance in respect of which was secured by means of, any fraud or fraudulent breach of trust to which he was a party."

The central question likely to confront the court is the interaction between the words "which he incurred in respect of" and "to which he was a party" and whether those twin phrases introduce a distinction between the incurring of the debt and the participation in the fraud. There is a contrast between the English statute and the American one, in that the American text does not refer to the debtor being "party" to the fraud. That may make all the difference.

In England, there are plenty of situations in which one person can become liable for a fraud perpetrated by someone else.



In the partnership context – in which Bartenwerfer was decided – the leading English case is Dubai Aluminium Co. v. Salaam [2003] 2 A.C. 366. Under s. 10 of the Partnership Act 1890, the partners in a firm are liable for the wrongful acts and omission of their fellow partners "acting in the ordinary course of business of the firm". The question in Dubai Aluminium was the extent to which a partner committing a fraud without the authorisation of the other partners could be acting in the ordinary business of the firm. The House of Lords held that liability depended on whether the partner could "properly and fairly" be regarded as engaged in the ordinary course of business, as a matter of fact.

Another obvious situation in which an innocent party might become liable in respect of a fraud debt is under a guarantee. A borrower could obtain a loan by fraudulent misrepresentation, whether about the purpose of the loan, matters going to their creditworthiness or otherwise. Such a debt would be a fraud debt and would survive the debtor's discharge from bankruptcy. But what about a surety who did not know that the borrowing was obtained by misrepresentation and who was not induced to become a surety by misrepresentation?

There may be a distinction between a true guarantor – who incurs a secondary obligation to ensure that the principal complies with their obligations – and someone who gives an indemnity, thus incurring a primary obligation. In the former case, the guarantor's debt was not incurred in respect of a fraud, but was an independent obligation. That would be a harder argument to run where the surety had agreed to be jointly and severally liable with the borrower as a primary obligation, because there they would owe the same obligation.

The possibility that a person might, in the words of the statute, incur a debt in respect of a fraud but not know anything about the fraud throws the importance of the phrase "to which he was a party" into sharp relief. Grammatically, the phrase seems to refer to the fraud or fraudulent breach of trust rather than the incurring of the debt. If it referred only to the debt, then the phrase would be superfluous because the bankrupt would have to have incurred the debt for questions about discharge to arise.

In Templeton Insurance v. Brunswick [2012] EWHC 1522 (Ch), HHJ Simon Barker held: "The epithet 'fraudulent' added to the phrase 'breach of contract' is intended to signify that actual dishonesty on the part of the defendant is a feature of the particular breach of contract alleged." The reference to dishonesty "on the part of the defendant" was not part of the ratio; dishonesty was alleged against Mr Brunswick and it was his own discharge under consideration.

A different section of the Insolvency Act 1986 that deals with being party to fraud is s. 213. Under that section, any persons who were "knowingly parties" to fraudulent trading can be held liable. The Court of Appeal has recently reviewed the law on fraudulent trading in Tradition Financial Services v. Bilta [2023] EWCA Civ 112. The court noted an earlier case in which it was held that "party to" meant no more than "participates in", "takes part in" or "concurs in". Section 213 is not a precise comparison with s. 281, because the latter section does not explicitly mention knowledge.

Even so, I suggest that the words "to which he was party" should be understood as connoting knowing involvement with the fraud.

As discussed above, a person may suffer liability for a fraudulent transaction without knowledge that the transaction is fraudulent. But that is dealt with by "incurred". It is only when the person has knowledge that they become party to the fraud itself, beyond the underlying transaction.

Such an interpretation fits with public policy, too. The insolvency Act seeks to strike a balance between, on the one hand, giving debtors a clean slate through discharge from their debts and, on the other hand, permitting fraudsters to evade the consequences of their actions. If a person has incurred a debt as a result of a fraud, but did not themselves act dishonestly, it is hard to see what public policy purpose would be served by preserving the debt after discharge.

Thus, it can be seen through Bartenwerfer that the United States has adopted a harder line than England and Wales to discharge from bankruptcy. The different approach highlights the English policy choice that has been made to offer more extensive protection to those caught up in frauds, but who are not culpable to the same degree as the real fraudster.