

The U.S. Supreme Court Speaks to Suppliers on Documenting a Customer and Guarantor's Assets Who Later Files Bankruptcy

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On the new account stage where an applicant is scored as a high credit risk, the credit team may consider credit enhancements to offset the risk while offering terms. Likewise, when a customer is rescored at a higher credit risk because of risk flags, the credit team may consider credit enhancements to limit risk with the existing customer. With the small to mid-sized corporate customer, the credit team may request personal guaranty. With the sole proprietor, the credit team may request disclosure of personal assets.

The U.S. Supreme Court recently considered whether a debtor can discharge through bankruptcy a common form of debt through fraudulent conduct. The Court's ruling highlights the need for due diligence by the credit team in documenting credit risk. The following narrative discusses the Court's ruling and best practice for the credit team in documenting a debtor's asset.

The U.S. Supreme Court Considers Whether Debtor Can Discharge Creditor's Debt

In the case considered by the Supreme Court, a creditor demanded payment on past due invoices from the debtor. The debtor promised to repay the past due debt by paying the debt through a tax refund. The debtor received the refund but did not pay the creditor. In response to the debtor's failure to use tax refund proceeds to pay off past due debt, the creditor filed suit and obtained a judgment. The debtor filed a Chapter 7 bankruptcy petition to discharge the creditor's debt. The creditor filed an adversary proceeding alleging that their debt was nondischargeable pursuant to Bankruptcy Code section 523(a)(2)(A) as it was obtained through fraud. This section provides:

- (a)** A discharge under section 272, 1141, 1228(a), 1129(b) of this title 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, other than a statement**

respecting the debtor's or an insider's financing condition;

Bankruptcy Code section 523(a)(2)(A) (emphasis added).

Based on this provision of the Bankruptcy Code, the debtor moved to dismiss the adversary claim because his false statements were made with respect to his financial condition. The bankruptcy court denied the debtor's motion to dismiss, finding the creditor's debt was nondischargeable. The bankruptcy court found the debtor made a false representation regarding the tax return and the creditor was harmed.

The U.S. District Court affirmed. The Court of Appeals for the 11th Circuit reversed. The creditor appealed to the U.S. Supreme Court.

Elements of A Nondischargeable Action

When a debtor that files bankruptcy defrauds a supplier, the supplier may be able to have its claim "ride through" bankruptcy. A supplier may also seek to have its particular debt to be ordered non-dischargeable, or object to the debtor's discharge, wherein all of the debtor's debts are ordered nondischargeable.

The nondischargeable provisions of the Bankruptcy Code provide that the debtor must be an individual. Thus, if the supplier sold to a sole proprietorship, or holds a personal guarantee on a sale to a corporation, LLC or partnership, the supplier has a claim against an individual. There are no nondischargeable claims against a corporation, as the corporation is not entitled to a discharge in bankruptcy. If the supplier sold to a corporation, and the insider of the corporation filed bankruptcy, the supplier may still have a nondischargeable claim against the individual, but must establish an alter ego claim against the insider. (An alter ego claim is a legal doctrine by which a court of law holds individual shareholders liable for a corporation's debts if the corporation is deemed to be nothing more than an "alter ego" of the corporation's owners.)

Where property is obtained by the debtor's false pretense, false representation or actual fraud, such a claim may be excepted from discharge. Under the fraud nondischargeable provision, the supplier may establish either oral or written fraud by the debtor. With the oral fraud, the supplier must establish fraud and its reasonable reliance on the debtor's representation. If the fraud is in writing, the supplier must establish that the false financial statement is materially misleading, and the supplier reasonably relied on the false financial statement.

The Supreme Court's Reasoning

The Bankruptcy Court found that a statement about a *single asset* is not a "statement respecting the debtor's financial condition." The Eleventh Circuit reversed. They interpreted the term "respecting" to be broad and encompass a single false statement about a single asset.

The Supreme Court agreed with this reasoning, stating that a "statement about a single asset can be a 'statement respecting the debtor's financial condition'" and affirmed the Eleventh Circuit ruling. Section 523(a)(2)(A) only renders false representations nondischargeable where the debtor is making a statement *other than* respecting his financial condition. Thus, in this situation § 523(a)(2)(B) would apply, which requires that a false statement be made *in writing*. The holding is that an individual debtor may make an oral false statement about a single asset to a creditor and discharge the creditor's claim in his or her bankruptcy.

What it Means for the Credit Team?

What this means for the credit team is that any statement or representation about a debtor's financial condition should be obtained in writing—regardless of whether it is a statement about a single asset or a financial statement—if this statement is being relied upon to extend credit or services. For example, if the credit team insists on a personal guaranty as a condition for extending credit, the credit team should insist on a personal financial statement from the guarantor. By contrast, if the credit or sales team were to rely on a guarantor's oral representations as to ability to honor the credit sale, such oral representations may fall short based on the Supreme Court's decision if the debtor files bankruptcy.

The Supreme Court stated that creditors are not left "powerless" by this opinion and are still afforded the protection of Bankruptcy Code section 523(a)(2)(B), so long as they get the representation in writing. While the Supreme Court did not find that every statement regarding a single asset is equal to a statement respecting the debtor's financial condition, the reasoning in this case points towards this being the rule and not the exception. The takeaway from this case: credit teams should receive debtor representations in writing to be on the safe side.

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