No. 15-____

IN THE

Supreme Court of the United States

HUSKY INTERNATIONAL ELECTRONICS, INC.

Petitioner,

v.

DANIEL LEE RITZ, JR.,

Respondent,

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

PETITION FOR WRIT OF CERTIORARI

JEFFREY DORRELL
HANSZEN LAPORTE
11767 Katy Freeway
Suite 850
Houston, TX 77079
(713) 522-9444

SHAY DVORETZKY
Counsel of Record
CHRISTOPHER DIPOMPEO
ANTHONY J. DICK
JONES DAY
51 Louisiana Ave., NW
Washington, DC 20001-2113
(202) 879-3939
sdvoretzky@jonesday.com

Counsel for Petitioner

July 2015

QUESTION PRESENTED

The Bankruptcy Code bars the discharge of "any debt . . . for money . . . obtained by . . . [1] false pretenses, [2] a false representation, or [3] actual fraud." 11 U.S.C. § 523(a)(2)(A). The First and Seventh Circuits have held that the "actual fraud" bar applies where an individual debtor deliberately obtains money through a fraudulent-transfer scheme that is actually intended to cheat a creditor. But in an acknowledged circuit split, the Fifth Circuit held as a matter of law that there can be no "actual fraud" unless the debtor makes a false representation to the creditor. This decision creates a roadmap for dishonest debtors to cheat creditors through deliberate fraudulent-transfer schemes, and then to escape liability through discharge in bankruptcy. The question presented is:

Whether the "actual fraud" bar to discharge under Section 523(a)(2)(A) of the Bankruptcy Code applies only when the debtor has made a false representation, or whether the bar also applies when the debtor has deliberately obtained money through a fraudulent-transfer scheme that was actually intended to cheat a creditor.

LIST OF PARTIES

The parties in the court below were Husky International Electronics, Inc., and Daniel Lee Ritz, Jr.

RULE 29.6 DISCLOSURE STATEMENT

Pursuant to Supreme Court Rule 29.6, Petitioner Husky International Electronics, Inc., discloses that it is a privately held corporation that has no parent corporation and no publicly traded stock, and no publicly held company owns more than 10% of its stock.

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PETITION FOR WRIT OF CERTIORARI

Petitioner respectfully petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Fifth Circuit.

OPINIONS BELOW

The opinion of the Fifth Circuit is reported at 787 F.3d 312 and set forth at Pet. App. 1a. The opinion of the district court is reported at 513 B.R. 510 and set forth at Pet. App. 21a. The opinion of the bankruptcy court is reported at 459 B.R. 623 and set forth at Pet. App. 78a.

JURISDICTION

The judgment of the court of appeals was entered on May 22, 2015. This Court has jurisdiction under 28 U.S.C. § 1254(1).

STATUTORY PROVISIONS INVOLVED

Section 523 of the Bankruptcy Code, 11 U.S.C. § 523, provides:

> (a) A discharge under section 727, 1141, 1228(a), 1228(b), or 1328(b) of this title does not discharge an individual debtor from any debt—
>
> . . .
>
> (2) for money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained by—
>
> (A) false pretenses, a false representation, or actual fraud, other than a statement respecting the debtor's or an insider's financial condition;
>
> . . . .

STATEMENT OF THE CASE

A. Legal Background

Congress intended the Bankruptcy Code to provide a fresh start for "the honest but unfortunate debtor." *Brown v. Felsen*, 442 U.S. 127, 128 (1979) (quotation marks and citation omitted). In keeping with that purpose, the Code provides relief for individual debtors but also provides that they may not discharge debts for money obtained through dishonest or fraudulent means. Specifically, as pertinent here, "a discharge" in bankruptcy "does not discharge an individual debtor from any debt . . . for money . . . to the extent obtained by . . . false pretenses, a false representation, or actual fraud." 11 U.S.C. § 523(a)(2)(A); *see also id.* §§ 727(b), 1328(a)(2) (making the discharge exceptions of § 523 applicable to individual bankruptcies under Chapters 7 and 13).

B. Factual Background

As the Fifth Circuit explained, "[t]he facts underlying this [case] are straightforward." Pet. App. 2a.

Respondent Daniel Lee Ritz, Jr., was at all relevant times the partial owner of Chrysalis Manufacturing Corporation. Under Ritz's control, Chrysalis made a series of purchases from Petitioner Husky International Electronics, Inc., between 2003 and 2007. Husky delivered the goods, but Chrysalis never paid for them, leaving a total unpaid debt of $163,999.38. Pet. App. 2a.

While this debt was outstanding, Ritz (who had financial control of Chrysalis) fraudulently transferred over a million dollars from Chrysalis to at least seven other entities that he owned and

controlled. *See* Pet. App. 2a. Chrysalis was insolvent during this time, was not paying its debts as they became due, and did not receive reasonably equivalent value in exchange for the transfers. Pet. App. 3a.

In May 2009, Husky sued Ritz in federal district court to hold him personally liable for the debt of $163,999.38 because he orchestrated and personally benefited from the fraudulent-transfer scheme. Pet. App. 3a. Shortly thereafter, and before Husky's claim could be adjudicated, Ritz filed a voluntary petition for bankruptcy under Chapter 7. Among other things, his petition sought to discharge the personal debt that he owed to Husky as a result of his receiving funds from Chrysalis in the fraudulent-transfer scheme. Pet. App. 3a.

C. The Proceedings Below

In March 2010, Husky initiated an adversary proceeding in the bankruptcy court, arguing that Ritz's debt to Husky was non-dischargeable under the "actual fraud" exception of 11 U.S.C. § 523(a)(2)(A). Specifically, Husky contended that Ritz defrauded Husky by transferring funds from Chrysalis to his other entities in a deliberate attempt to thwart Husky's effort to collect the debt it was owed. As a result of his orchestrating and personally benefiting from this scheme, Ritz personally owed Husky a "debt . . . for money . . . obtained by . . . actual fraud." *Id.*

1. In August 2011, the bankruptcy court made findings of fact and conclusions of law. Pet. App. 78a. The court found that the transfers "orchestrat[ed]" by Ritz were not made for reasonably equivalent value,

and that Husky suffered damages in the full amount of $163,999.38. Pet. App. 82a. The court also determined that Ritz was "not a credible witness" due to his "blatantly contradictory" and "evasive[]" testimony, which was at times "disingenuous, if not downright misleading," as well as his "selective" inability to remember certain information when questioned under oath on the witness stand. Pet. App. 83a-85a.

Nevertheless, the bankruptcy court held as a matter of law that Ritz's conduct did not constitute "actual fraud" under Section 523(a)(2)(A) for the sole reason that he did not make any "false representation" to Husky in the course of his fraudulent-transfer scheme. Pet. App. 92a.[1]

2. Husky appealed to the district court. That court found that "[b]ecause . . . Ritz caused Chrysalis to be used for the purpose of perpetrating and did perpetrate an actual fraud on its creditors primarily for Ritz's direct personal benefit, i.e., he drained Chrysalis of funds and fraudulently transferred those funds to other entities under his control and/or ownership, [Texas law] applies here to impose liability on Ritz, individually." Pet. App. 68a-69a.

Nevertheless, the court went on to hold that, as a matter of federal law, Ritz's debt to Husky was dischargeable in bankruptcy notwithstanding Section 523(a)(2)(A). The dispositive legal issue, according to the district court, was that Husky failed to allege a misrepresentation by Ritz, and therefore his conduct

[1] For the same reason, the bankruptcy court held that Ritz had not committed "actual fraud" under Texas law. Pet. App. 92a.

could not constitute "actual fraud" within the meaning of Section 523(a)(2)(A). Pet. App. 73a-74a.

3. The Fifth Circuit affirmed, holding that a false representation by the debtor "is a necessary prerequisite for a showing of 'actual fraud' under Section 523(a)(2)(A)." Pet. App. 17a. The court acknowledged that the Seventh Circuit had reached the opposite conclusion in *McClellan v. Cantrell*, 217 F.3d 890 (7th Cir. 2000) (Posner, J.), which held that "'actual fraud' under [Section 523(a)(2)(A)] 'is not limited to misrepresentations and misleading omissions,'" but also includes deliberate fraudulent-transfer schemes. Pet. App. 7a (quoting 217 F.3d at 893). But the Fifth Circuit nonetheless "decline[d]" to "adopt[] the interpretation of Section 523(a)(2)(A) endorsed [in] *McClellan*." Pet. App. 9a.

To support its narrow reading of "actual fraud," the Fifth Circuit relied heavily on this Court's decision in *Field v. Mans*, 516 U.S. 59 (1995), which addressed "the level of reliance that § 523(a)(2)(A) requires a creditor to demonstrate" in order to bar discharge where the debtor has allegedly committed fraud by misrepresentation. *Id.* at 63. *Field*'s analysis began from the premise that the terms "'false pretenses, a false representation, or actual fraud,' carry the acquired meaning of terms of art" and "imply elements that the common law has defined them to include." *Id.* at 69. Thus, in determining the level of reliance necessary to trigger the discharge exception in a case of alleged fraudulent misrepresentation, *Field* "look[ed] to the concept of 'actual fraud' as it was understood in 1978 when that language was added to § 523(a)(2)(A)." *Id.* at 70. For example, the Court cited "the Restatement (Second) of Torts

(1976)," and "the edition of Prosser's Law of Torts available in 1978," both of which defined "justifiable reliance" as an essential element of fraud by misrepresentation. *Id.* at 70-71.

The Fifth Circuit acknowledged that *Field* did not "directly address[] the issue" of whether "actual fraud" requires a misrepresentation—indeed, the *Field* Court had no reason to consider other possible forms of fraud because "the facts underlying *Field* involved a misrepresentation." Pet. App. 10a-11a. But the Fifth Circuit nevertheless stated that "[the] opinion in *Field* appeared to assume that a false representation is necessary to establish 'actual fraud.'" Pet. App. 10a (citing *Field*, 516 U.S. at 68, 79).

The Fifth Circuit also cited circuit precedent and other considerations to support its interpretation of Section 523(a)(2)(A). *See infra* Part III. The court acknowledged that Section 523(a)(2)(A) refers separately to both "actual fraud" and "false representation," and that the court's reading of the statute might "render[] the latter phrase redundant." Pet. App. 14a. But the court reasoned that the canon of "giv[ing] effect, if possible, to every word Congress used" is not "inviolable." Pet. App. 14a (citation omitted). The court also suggested that the statute's separate reference to "actual fraud" may not have been "intend[ed] to create a separate basis for dischargeability," but rather "only to codify 'the limited scope of the fraud exception' as expressed in case law 'interpret[ing] "fraud" to mean actual or positive fraud rather than fraud implied by law.'" Pet. App. 15a (citation omitted).

The court further surmised that other provisions of the Bankruptcy Code "may be rendered redundant" by *McClellan*'s understanding of "actual fraud." Pet. App. 16a (citing 11 U.S.C. §§ 727(a)(2), 523(a)(4), 523(a)(6)). And at the end of its analysis, the court observed that, "to the extent Section 523(a)(2)(A) is ambiguous, '[e]xceptions to discharge should be construed in favor of debtors.'" Pet. App. 16a (quoting *Fezler v. Davis*, 194 F.3d 570, 573 (5th Cir. 1999)).

Thus, because the court concluded that "actual fraud" requires a false representation, and "the parties agree[d]" that Ritz's fraudulent-transfer scheme involved no such misrepresentation, the court held that Section 523(a)(2)(A) did not bar the discharge of Ritz's debt to Husky. Pet. App. 17a.

This petition for certiorari followed.

REASONS FOR GRANTING THE PETITION

This Court should grant certiorari for three reasons. *First*, there is a square and acknowledged circuit split on the question presented, with extensive opinions by the First and Seventh Circuits disagreeing with a thorough opinion by the Fifth Circuit. *Second*, this issue is important because it recurs throughout the lower courts, and the position espoused by the Fifth Circuit subverts the equitable purposes of the Bankruptcy Code and turns bankruptcy law into an engine for fraud. *Third*, the decision below is wrong because it misinterprets the statutory language and fails to recognize that the common-law concept of "actual fraud" codified in Section 523(a)(2)(A) encompasses deliberate fraudulent-transfer schemes that are actually intended to cheat a creditor.

I. THE CIRCUITS HAVE EXPRESSLY DIVIDED ON THE MEANING OF "ACTUAL FRAUD" UNDER SECTION 523(a)(2)(A)

Certiorari should be granted because the courts of appeals have openly acknowledged a circuit split on the question presented. *See* Sup. Ct. Rule 10(a). The Fifth Circuit has held categorically that a false representation is a necessary element of "actual fraud" under Section 523(a)(2)(A). By contrast, the First and Seventh Circuits have held that "actual fraud" occurs when a debtor participates in a deliberate fraudulent-transfer scheme with intent to cheat a creditor, even without a false representation.

1. In the decision below, the Fifth Circuit squarely held that a false representation "is a necessary prerequisite for a showing of 'actual fraud' under Section 523(a)(2)(A)." Pet. App. 17a. That holding was the sole basis for the court's decision that Section 523(a)(2)(A) does not bar the discharge of Ritz's debt to Husky. Pet. App. 17a.

At the same time, as described above, the court expressly acknowledged that the Seventh Circuit had reached the opposite conclusion on the same issue in *McClellan v. Cantrell*, 217 F.3d 890 (7th Cir. 2000), which involved allegations of a similar fraudulent-transfer scheme. The court addressed *McClellan*'s reasoning at length. *See* Pet. App. 7a-16a.

2. In *McClellan*, the Seventh Circuit confronted the same type of situation present here: The debtor's brother owed $100,000 to a creditor for the purchase of ice-making machinery. When the brother became insolvent, he "sold" the machinery to his sister, the debtor, for $10. She then sold the machinery for

$160,000, spent the money, and filed for Chapter 7 bankruptcy seeking to discharge all of her debts. The creditor sued to hold her personally liable for the debt as a result of her participation in the fraudulent-transfer scheme, and also sought to bar her from discharging the debt in bankruptcy under Section 523(a)(2)(A). *See McClellan*, 217 F.3d at 892.

Despite the lack of any false representation, the Seventh Circuit held that Section 523(a)(2)(A) bars a discharge if the debtor's participation in the fraudulent-transfer scheme "involved an *actual* fraud," in the form of a "*deliberate*[] attempt[] to thwart [the creditor's] effort to collect the debt due him." *McClellan*, 217 F.3d at 894. The court explained that when a person deliberately obtains money through a fraudulent-transfer scheme, she incurs a debt to the creditor for the transferred amount, and thus both the money and the corresponding debt are "obtained by" actual fraud. *Id.* at 894-95. The court therefore concluded that "misrepresentation . . . is not the only form that fraud can take or the only form that makes a debt nondischargeable" under Section 523(a)(2)(A). *Id.*

The court explained that "[n]o learned inquiry into the history of fraud is necessary to establish that it is not limited to misrepresentations and misleading omissions." *Id.* at 893. Although "[n]o definite and invariable rule can be laid down," "'fraud . . . includes all surprise, trick, cunning, dissembling, and any unfair way by which another is cheated.'" *Id.* (citation omitted). The court further reasoned that fraudulent transfers "may [involve] either constructive or actual" fraud: The fraud "is constructive if the only evidence of it is the inadequacy of the consideration," but "it is

actual," and thus non-dischargeable as "actual fraud" under Section 523(a)(2)(A), "if the debtor intended by the transfer to hinder his creditors." *Id.* at 894 (emphasis added, citations omitted).

Because it holds that "actual fraud" encompasses fraudulent transfers intended to cheat creditors even without any false representation, the Seventh Circuit's decision in *McClellan* squarely conflicts with the Fifth Circuit's decision below.

3. Five weeks after the Fifth Circuit issued the decision below, the First Circuit decided *Sauer, Inc., v. Lawson*, No. 14–2058, 2015 WL 3982395 (July 1, 2015), in which it rejected the Fifth Circuit's position. *Id.* at *1 n.1 (acknowledging that "the Fifth Circuit, in a post-argument decision, has disagreed with *McClellan* and our analysis here").

The First Circuit framed its holding as follows:

> We are asked to resolve this narrow but significant issue of whether a debt that is not dischargeable in Chapter 13 bankruptcy as a debt for money or property 'obtained by . . . actual fraud' extends beyond debts incurred through fraudulent misrepresentations to also include debts incurred as a result of knowingly accepting a fraudulent conveyance that the transferee knew was intended to hinder the transferor's creditors. We join the Seventh Circuit in concluding that it does.

Id. at *1 (quoting 11 U.S.C. § 523(a)(2)(A)).

Once again, the facts of *Lawson* are materially identical to those of this case and *McClellan*. The

debtor's father originally owed Sauer a debt of over $160,000. He sought to avoid paying the debt through a fraudulent-transfer scheme involving a shell company controlled by his daughter, who ultimately transferred $80,000 to herself. The daughter subsequently filed for Chapter 13 bankruptcy. Sauer sued to hold her personally liable for the debt as a result of her participation in the fraudulent-transfer scheme, and also sought to bar her from discharging the debt in bankruptcy under the "actual fraud" prong of Section 523(a)(2)(A). *See id.* at *1-2.

The First Circuit held that "'actual fraud' . . . is not limited to fraud effected by misrepresentation," but also "includes fraudulent conveyances that are 'intended . . . to hinder [the relevant] creditors.'" *Id.* at *4 (quoting *McClellan*, 217 F.3d at 894). Like the Fifth Circuit, the First Circuit followed the methodology of this Court's decision in *Field* by looking to the Restatement (Second) of Torts to discern the meaning of "actual fraud" when Congress enacted that language in 1978. *Compare id.* at *3 (citing *Field*, 516 U.S. at 70) *with* Pet. App. 10a-11a. But unlike the Fifth Circuit, the First Circuit read the Restatement to indicate that some fraudulent transfers *did* qualify as a type of "actual fraud" at common law. Specifically, the court found that deliberate participation in a fraudulent-transfer scheme was a recognized form of "fraudulent interference with [property rights]," because it involves "'intentionally depriv[ing] another of his legally protected property interest or caus[ing] injury to the interest" through "conduct [that] is generally culpable and not justifiable under the circumstances.'" *Lawson*, 2015 WL 3982395 at *3

(quoting Restatement (Second) of Torts § 871). The First Circuit's decision thus not only conflicts with the Fifth Circuit's decision in its reasoning and result, but the two courts reached their conflicting decisions based on the very same interpretive methodology that this Court set forth in *Field*.

The First Circuit also noted that Section 523(a)(2)(A) "explicitly lists both 'actual fraud' and 'false representations' as grounds for denying a discharge." *Id.* at *4 (citation omitted). "[A]gree[ing] with the Seventh Circuit," the court concluded "that this distinction must have meaning, and that the most obvious meaning is the one that comports with common law understanding: 'actual fraud is broader than misrepresentation.'" *Id.* (quoting *McClellan*, 217 F.3d. at 893).

Finally, the First Circuit found support for its conclusion by tracing the history of the "actual fraud" exception from the Bankruptcy Act of 1867 through the Bankruptcy Act of 1898 and finally to the Bankruptcy Act of 1978. *See id.* at *4-5. The court concluded that, throughout this history, "the fraud exception to discharge," which is now "codified at § 523(a)(2)(A)," has "bar[red] from discharge debts incurred through knowing and intentional receipt of fraudulent conveyances . . . since 1867." *Id.* at *5. In the absence of "'a clear indication that Congress intended . . . a departure,'" the court declined to "erode [that] past bankruptcy practice." *Id.* at *7 (citation omitted).

* * *

McClellan, *Lawson*, and the decision below create a clear and acknowledged circuit split on whether the

"actual fraud" discharge bar of Section 523(a)(2)(A) applies when a debtor deliberately participates in a fraudulent-conveyance scheme, even absent a misrepresentation. This case—in which the Fifth Circuit held that the "actual fraud" exception to discharge under Section 523(a)(2)(A) was inapplicable solely because of the undisputed lack of a misrepresentation by the debtor to the creditor—presents an ideal vehicle in which to consider the dispositive legal issue that has divided the circuits.

II. THE QUESTION PRESENTED IS IMPORTANT BECAUSE THE ISSUE RECURS THROUGHOUT THE LOWER COURTS, AND THE FIFTH CIRCUIT'S APPROACH TRANSFORMS INDIVIDUAL BANKRUPTCY INTO AN ENGINE FOR FRAUD

Certiorari should also be granted because the question presented is "an important question of federal law that has not been, but should be, settled by this Court," Sup. Ct. R. 10(c), and it recurs throughout the lower courts.

The First Circuit recognized that the scope of the "actual fraud" bar to discharge in individual bankruptcy is a "significant issue" and a "matter of public importance" that goes to the core of the equitable purposes of the Bankruptcy Code. *Lawson*, 2015 WL 3982395, at *1, *2. And the Seventh Circuit aptly summarized the stakes:

> The two-step routine [alleged]—in which Debtor A transfers valuable property to B for nothing in order to keep it out of the hands of A's creditor and B then . . .

> declares bankruptcy in an effort to shield herself from liability for having colluded with A to defeat the rights of A's creditor—is as blatant an abuse of the Bankruptcy Code as [one] can imagine. It turns bankruptcy into an engine for fraud.

217 F.3d at 893. Congress did not intend to reward such fraudulent conduct through the Bankruptcy Code. To the contrary, by the plain terms of Section 523(a)(2)(A), "Congress concluded that preventing fraud is more important than letting defrauders start over with a clean slate." *Id.* (citation and quotation marks omitted).

This issue commonly arises in individual bankruptcy cases. Even beyond the split at the circuit level, the recurrence of the issue has led to disarray in the lower courts, which generally "disagree regarding whether 'actual fraud' within the meaning of § 523(a)(2)(A) means more than, or can be established other than by proving the existence of, a 'false representation.'" *In re Ali*, 321 B.R. 685, 690 (Bankr. W.D. Pa. 2005) (collecting cases). Bankruptcy appellate panels in the Sixth and Tenth Circuits have followed *McClellan* in holding that not all forms of "actual fraud" require a showing of a misrepresentation. *See In re Vickery*, 488 B.R. 680, 691 (10th Cir. BAP 2013) (holding non-dischargeable a debt resulting from a fraudulent transfer in the absence of any misrepresentation); *In re Vitanovich*, 259 B.R. 873, 877 (6th Cir. BAP 2001). Many bankruptcy courts around the country agree.[2] But

[2] *See, e.g., In re Pollan*, 2014 WL 2756527, at *3 (Bankr. D. Kan. 2014); *In re Williams*, 2011 WL 11718019 (Bankr. N.D. Ga.

some bankruptcy courts have instead taken the approach endorsed by the Fifth Circuit here, requiring a false representation for a finding of "actual fraud."[3]

The Court should seize this opportunity to provide needed guidance to the lower courts. Due to the heavy emphasis on settlement in individual bankruptcy cases, many cases raising the question presented are resolved before they reach the courts of appeals. Unless this Court grants review now, the lower courts will continue to apply Section 523(a)(2)(A) in an inconsistent manner. And some courts will continue to aid and encourage dishonest debtors by using the Bankruptcy Code to discharge debts for money obtained through deliberate fraudulent-transfer schemes. This Court's immediate intervention is warranted.

III. THE DECISION BELOW IS WRONG

This Court should also grant certiorari because the decision below is wrong for several reasons.

(continued…)

Dec. 16, 2011); *In re Perry*, 448 B.R. 219, 225 (Bankr. N.D. Ohio 2011); *In re Hendry*, 428 B.R. 68, 81 (Bankr. D. Del. 2010); *In re Kiesewetter*, 391 B.R. 740, 748 (Bankr. W.D. Penn. 2008); *In re Draughon*, 2007 WL 7645346, at *6 (Bankr. W.D. Pa. Aug. 21, 2007); *In re Barber*, 281 B.R. 617, 624 (Bankr. W.D. Pa. 2002).

[3] *See, e.g., In re Sharma*, 2015 WL 3825887, at *5 (Bankr. N.D. Cal. 2015); *In re Lewis*, 2010 WL 1379770, at *3 (Bankr. E.D. Tex. 2010); *In re Woodford*, 403 B.R. 177, 188 (Bankr. D. Mass. 2009); *In re Hathaway*, 364 B.R. 220, 232 & n.17 (Bankr. E.D. Va. 2007); *In re McKnew*, 270 B.R. 593, 618 & n. 40 (Bankr. E.D. Va. 2001).

1. "It is . . . well established that [w]here Congress uses terms that have accumulated settled meaning under . . . the common law, a court must infer, unless the statute otherwise dictates, that Congress means to incorporate the established meaning of these terms." *Community for Creative Non–Violence v. Reid*, 490 U.S. 730, 739 (1989) (internal quotation marks and citation omitted). And since at least the early 20th century, the common law of fraudulent conveyances has used the term "actual fraud" to refer to *actual* fraudulent transfers, which are intended to hinder or delay creditors (as distinguished from mere *constructive* fraudulent transfers, which require no such ill intent). Thus, when Congress added "actual fraud" to Section 523(a)(2)(A) in 1978, that term clearly encompassed the type of fraudulent-transfer scheme at issue here.

Section 7 of the Uniform Fraudulent Conveyance Act of 1918 was entitled "Conveyance Made With Intent to Defraud," and it stated that "[e]very conveyance made and every obligation incurred with *actual intent*, as distinguished from intent presumed in law, to hinder, delay, or defraud either present or future creditors, is fraudulent as to both present and future creditors." 7A pt. 2 U.L.A. 378 (2006) (emphasis added). Based on this understanding, courts before 1978 commonly used the term "actual fraud" to refer to fraudulent-transfer schemes that were *actually intended* to hinder or delay creditors, regardless of whether there was any misrepresentation. *See id.* at 406-07 Notes 37–38 (discussing "actual fraud"). As one court put it:

> An existing creditor seeking to set aside a conveyance may do so either because of

> actual fraud or on account of what is termed constructive fraud. *Actual fraud* denotes the actual mental operation of intending to defeat or delay the rights of the creditor. Constructive fraud, on the other hand, is based on facts and circumstances which the courts have said constitute legal fraud irrespective of actual intent.

Smith v. Wilder, 120 So. 2d 871, 882 (Ala. 1960) (emphasis added).

Accordingly, it has long been recognized that "[p]roof of intent to hinder or delay creditors is proof of actual fraud" by a debtor. *Hofmann v. La Fontaine*, 16 F. Supp. 748, 752 (D. Wyo. 1936) (citing *Lovett v. Faircloth*, 10 F.2d 301, 304 (5th Cir. 1925)). The Fifth Circuit itself recognized the point in 1969. *See Ala. Credit Corp. v. Deas*, 417 F.2d 135, 139 (5th Cir. 1969) ("Actual fraud means actual intent to defeat or delay the rights of creditors. Constructive fraud is based upon facts and circumstances which the courts hold as constituting legal fraud irrespective of actual intent."). And this understanding of "actual fraud" has endured to the present day. In New York, for example, it is black-letter law that "[t]o secure summary judgment on a theory of 'actual fraud'" a bankruptcy trustee may prevail by showing that "(1) [the debtor] transferred the property with 'actual intent to hinder, delay or defraud his creditors,'" and (2) [the transferee] had "knowledge of the fraud at the time of the purchase." *In re Corcoran*, 246 B.R. 152, 161 (E.D.N.Y. 2000) (citing N.Y. Debt. & Cred. Law §§ 276, 278(1)). This type of "actual fraud" does not require any misrepresentation. *See generally*

Uniform Fraudulent Transfer Act of 1984, § 4, Note 18, *reprinted in* 7A pt. 2 U.L.A. 75 (2006) (noting that fraudulent transfers may involve "Actual or constructive fraud").

There can be no doubt that Congress understood this long-established common-law meaning of "actual fraud" when it added the term to Section 523(a)(2)(A) of the Bankruptcy Code in 1978. Indeed, "[a]s the leading treatise on bankruptcy explains, '[a]ctual fraud, by definition, consists of *any* deceit, artifice, trick, or design involving direct and active operation of the mind, used to circumvent and cheat another.'" *Lawson*, 2015 WL 3982395, at *3 (emphasis added) (quoting 4 COLLIER ON BANKRUPTCY ¶ 523.08[1][e] (A.N. Resnick & H.J. Sommer, eds., 16th ed. 2015)). The phrase "actual fraud" in Section 523(a)(2)(A) should be construed in accordance with that common-law understanding.

2. In reaching a contrary conclusion, the Fifth Circuit relied heavily on this Court's decision in *Field*, 516 U.S. 59, which addressed the level of reliance necessary to trigger the "actual fraud" bar to discharge in a case of alleged fraudulent misrepresentation. Pet. App. 9a-12a. But, as the Seventh Circuit pointed out, "*Field* has nothing to do with" whether there can be "actual fraud" without a misrepresentation, because "[t]he fraud there took the form of a misrepresentation, and the only issue was the nature of the reliance that a plaintiff must show to prove fraud *in such a case*." *McClellan*, 217 F.3d at 892 (emphasis added). "Nothing in [*Field*] suggests that misrepresentation is the only type of fraud that can give rise to a debt that is not dischargeable under section 523(a)(2)(A)," because

"[n]o other type of fraud was alleged in the case or discussed in the opinion." *Id.*

In fact, *Field*'s methodology establishes that "actual fraud" *does* include deliberate fraudulent-transfer schemes. *Field* explained that "actual fraud" should be understood by reference to the common law in 1978, when that phrase was added to the Bankruptcy Code. *See* 516 U.S. at 69. As explained above, and as both the First and Seventh Circuits recognized, the common-law understanding of "actual fraud" in 1978 easily encompassed deliberate fraudulent-transfer schemes. *See Lawson* 2015 WL 3982395, at *3-4; *McClellan*, 217 F.3d at 893.

3. The Fifth Circuit's interpretation of "actual fraud" to mean false representation creates needless surplusage because Section 523(a)(2)(A) refers separately to both "false representation" and "actual fraud" in sequence. As the Seventh Circuit explained, "by distinguishing between 'a false representation' and 'actual fraud,' the statute makes clear that actual fraud is broader than misrepresentation." *McClellan.* 217 F.3d at 893; *see also Lawson*, 2015 WL 3982395 at *4. The Fifth Circuit noted that the canon against surplusage is not absolute, and speculated that "actual fraud" may have been added to the statute "only to codify 'the limited scope of the fraud exception' as expressed in case law 'interpret[ing] "fraud" to mean actual or positive fraud rather than fraud implied by law.'" Pet. App. 15a (citation omitted). But that is a bizarre explanation: the statute *already* referred specifically to "false representation[s]" before 1978, so adding "actual fraud" could not have served to "limit[]" the

scope of Section 523(a)(2)(A) to fraudulent misrepresentations.

4. The Fifth Circuit reasoned that Section 523(a)(2)(A) must not address actual fraudulent transfers because the Bankruptcy Code contains a separate provision that specifically "excepts from discharge certain fraudulent transfers." Pet. App. 16a (citing 11 U.S.C. § 727(a)(2)(A)). But Section 727 and Section 523 serve very different purposes: While Section 727 blocks the debtor's ability to obtain a discharge *of any debts whatsoever*, Section 523 is targeted more narrowly at the discharge of *particular* debts. Thus, a debtor who violates Section 727 becomes ineligible for *any* discharge, while a debtor who violates Section 523 becomes ineligible to discharge only those debts that have been specifically tainted by fraud. "The concept of nondischargeability of a particular debt under section 523 is not to be confused with denial of discharge for all debts under section 727. It is extremely common for a debtor with nondischargeable debts to receive a discharge." 6 COLLIER ON BANKRUPTCY ¶ 727.01.

Moreover, Section 727(a)(2) applies only where the debtor diminishes the bankruptcy estate by *transferring property away*. *See* 11 U.S.C. § 727(a)(2) (denying a discharge where "the debtor, with intent to hinder, delay, or defraud a creditor . . . has *transferred, removed, destroyed, mutilated, or concealed* . . . property of the debtor . . . or . . . property of the estate") (emphasis added)). Thus, Section 727(a)(2) would not apply in a case like *McClellan*, where the debtor only *received* a fraudulent transfer. Nor would Section 727 apply in a case like *Lawson*, which arose under Chapter 13,

because "[t]he applicability of section 727 is confined to chapter 7 cases." 6 COLLIER ¶ 727.01. Section 523 therefore serves an independent purpose because it applies in Chapter 13 where Section 727 does not. *See* 11 U.S.C. §§ 723(b), 1328(a)(2).

5. The Fifth Circuit also wrongly concluded that two "other exceptions to discharge in the Bankruptcy Code may be rendered redundant" by Husky's reading of "actual fraud." Pet. App. 16a (citing 11 U.S.C. §§ 523(a)(4), (a)(6)). Both of the cited provisions have a different scope than the "actual fraud" prong of Section 523(a)(2)(A).

Section 523(a)(4) bars the discharge of a debt resulting from a debtor's "defalcation while acting in a fiduciary capacity." But defalcation reaches a broader range of fiduciary misconduct than "actual fraud." The majority of circuits have held that defalcation requires only recklessness, while three circuits have held that even "an innocent mistake can constitute a defalcation" under Section 523(a)(4). *See In re Hyman*, 502 F.3d 61, 67 (2d Cir. 2007) (citing cases). Either way, defalcation does not require a fiduciary to have actual fraudulent intent, and thus Section 523(a)(4) captures certain reckless or negligent fiduciary conduct that is not covered by the "actual fraud" prong of Section 523(a)(2)(A).

Section 523(a)(6) bars the discharge of debts incurred as the result of "willful and malicious injury by the debtor to another entity or to the property of another entity." This provision extends to "intentional torts" that do not involve any type of "fraud" at all, such as assaulting someone or setting his car on fire. *See Kawaauhau v. Geiger*, 523 U.S.

57, 61-62 (1998). Moreover, unlike Section 523(a)(2)(A), which applies in *all* Chapter 13 cases, Section 523(a)(6) does not apply in most Chapter 13 cases. *See* 11 U.S.C. § 1328(a)(2); *Lawson*, 2015 WL 3982395 at *6 & n.13. Thus, under the Fifth Circuit's interpretation, "especially clever" debtors would be able to defraud their victims through deliberate fraudulent-transfer schemes, and then avoid any discharge bar by filing for bankruptcy under Chapter 13 instead of Chapter 7. *Id.* at *7. Congress could not possibly have intended that result.

6. Finally, applying Section 523(a)(2)(A) to deliberate fraudulent-transfer schemes serves the statutory purpose of barring discharge in cases of intentional wrongdoing. When a debtor like Ritz orchestrates a deliberate scheme to cheat a creditor, the bar to discharge should apply regardless of "whether the intent to defraud was implemented by a misrepresentation or by some other improper means." *McClellan*, 217 F.3d at 894. Indeed, as this Court has recognized, "it is unlikely that Congress . . . would have favored the interest in giving perpetrators of fraud a fresh start over the interest in protecting victims of fraud." *Cohen v. de la Cruz*, 523 U.S. 213, 223 (1998) (internal quotation marks and citation omitted).

CONCLUSION

For all of these reasons, the petition for certiorari should be granted and the decision below reversed.

Respectfully submitted,

SHAY DVORETZKY
Counsel of Record
CHRISTOPHER DIPOMPEO
ANTHONY J. DICK
JONES DAY
51 Louisiana Ave., NW
Washington, DC
20001-2113
(202) 879-3939
sdvoretzky@jonesday.com

Counsel for Petitioner

July 2015

APPENDIX

APPENDIX A

UNITED STATES COURT OF APPEALS
FIFTH CIRCUIT.

IN THE MATTER OF DANIEL LEE RITZ, JR., ALSO KNOWN AS BO RITZ, DEBTOR.
HUSKY INTERNATIONAL ELECTRONICS, INCORPORATED, APPELLANT
V.
DANIEL LEE RITZ, JR., APPELLEE.

NO. 14-20526. MAY 22, 2015.

Appeal from the United States District Court for the Southern District of Texas.

Before STEWART, Chief Judge, and KING and ELROD, Circuit Judges.

Opinion

KING, Circuit Judge.

Appellant Husky International Electronics, Inc. brought this adversary proceeding against Appellee and debtor Daniel Lee Ritz, Jr., objecting to the discharge of a $163,999.38 contractual debt owed to Husky by Chrysalis Manufacturing Corp.—of which Ritz was a shareholder. Husky sought to except the debt from discharge under either 11 U.S.C. § 523(a)(2)(A) or 11 U.S.C. § 523(a)(6). The bankruptcy court denied all relief sought by Husky, determining that the debt was dischargeable. The

district court affirmed on appeal. For the following reasons, we AFFIRM.

I. Factual and Procedural Background

The facts underlying this adversary proceeding are straightforward. Appellant Husky International Electronics, Inc. ("Husky"), is a Colorado-based seller of electronic device components. From 2003 to 2007, Husky sold and delivered goods to Chrysalis Manufacturing Corp. ("Chrysalis") pursuant to a written contract. It is undisputed that Chrysalis failed to pay for all of the goods it purchased from Husky, and that Chrysalis owed a debt to Husky in the amount of $163,999.38. At all relevant times, Appellee Daniel Lee Ritz, Jr., the debtor, was in financial control of Chrysalis. Moreover, Ritz was a director of Chrysalis and owned at least 30% of Chrysalis's common stock.

Between November 2006 and May 2007, Ritz transferred a substantial amount of Chrysalis's funds to various entities controlled by Ritz. Specifically, Ritz transferred: (1) $677,622 to ComCon Manufacturing Services, Inc.; (2) $121,831 to CapNet Securities Corp. (of which Ritz held an 85% ownership interest); (3) $52,600 to CapNet Risk Management, Inc. (of which Ritz held a 100% ownership interest); (4) $172,100 to Institutional Capital Management, Inc., and Institutional Insurance Management, Inc. (of which Ritz held 40% and 100% ownership interests, respectively); (5) $99,386.90 to Dynalyst Manufacturing Corp. (of which Ritz held a 25% ownership interest); (6) $26,500 to Clean Fuel International Corp. (of which Ritz held a 20% ownership interest); and (7) $11,240 to CapNet Advisors, Inc. With respect to each of these

transfers, the bankruptcy court concluded that Chrysalis did not receive reasonably equivalent value in exchange.[1] The bankruptcy court further determined that during this time, Chrysalis was operational, but was not paying its debts as they became due. The bankruptcy court found that at all relevant times, the sum of Chrysalis's debts was greater than that of Chrysalis's assets at a fair valuation.

In May 2009, Husky sued Ritz in federal district court, seeking to hold Ritz personally liable for Chrysalis's $163,999.38 debt. In December 2009, Ritz filed a voluntary Chapter 7 petition for bankruptcy in the United States Bankruptcy Court for the Southern District of Texas. In March 2010, Husky filed a complaint in the bankruptcy court initiating the adversary proceeding underlying this appeal. In the complaint, Husky objected to the discharge of Ritz's alleged debt, relying on 11 U.S.C. §§ 523(a)(2)(A), 523(a)(4), and 523(a)(6).[2]

The bankruptcy court held a trial in February 2011. The court issued its Memorandum Opinion, including findings of fact and conclusions of law, in August

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[1] Ritz does not dispute that these transfers were made, but he challenges the bankruptcy court's conclusion regarding reasonably equivalent value—contending that these entities transferred more money into Chrysalis then was transferred out. We need not determine whether the bankruptcy court's findings as to this issue were clearly erroneous. Whether or not Chrysalis received reasonably equivalent value for the transfers, we conclude, for the reasons discussed below, that the exceptions to discharge raised by Husky are inapplicable.

[2] The bankruptcy court determined that Husky could not prevail under Section 523(a)(4), a determination Husky does not challenge on appeal.

2011. As noted above, the court found that the transfers Ritz orchestrated were not made for reasonably equivalent value. The court also found that Husky suffered damages due to these transfers—specifically, "in the amount of $163,999.38—which represents the amount owed to Husky by Chrysalis for the goods which Husky delivered to Chrysalis." In addition, the court determined that Ritz was "not a credible witness" due to his contradictory and evasive testimony, and due to his "selective" inability to recall certain information. In its conclusions of law, the bankruptcy court first addressed whether Ritz could be held liable for Chrysalis's debt under Texas veil-piercing laws. The court determined that, under Texas law, Husky had not established that Ritz perpetuated an "actual fraud" on Husky—a prerequisite for piercing the veil under Texas Business Organizations Code Section 21.223(b)—because Husky failed to show that Ritz made a false representation to Husky. The bankruptcy court found that the record was "wholly devoid of any such representation made by [Ritz]." For this same reason, the court determined that the "actual fraud" exception to discharge contained in 11 U.S.C. § 523(a)(2)(A) did not apply. Finally, the bankruptcy court rejected the applicability of the "willful and malicious injury" exception to discharge under 11 U.S.C. § 523(a)(6), concluding that Husky failed to sufficiently brief and adduce evidence on this provision, and stating that "[t]he record is wholly devoid of any proof that [Ritz] willfully and maliciously injured Husky or Husky's property." Accordingly, the bankruptcy court denied all of Husky's requested relief.

On appeal, the district court relied on a Fifth Circuit case issued after the bankruptcy court's decision, *Spring Street Partners–IV, L.P. v. Lam*, 730 F.3d 427 (5th Cir. 2013), in determining that Husky could pierce the corporate veil because there was sufficient circumstantial evidence suggesting that Ritz acted with the intent to hinder, delay, or defraud Husky. Nonetheless, the court held that Husky had not established actual fraud under 11 U.S.C. § 523(a)(2)(A), which requires a misrepresentation. Finally, the district court rejected the applicability of 11 U.S.C. § 523(a)(6), as Husky "fail[ed] to show by a preponderance of the evidence that Ritz acted willfully and maliciously." Accordingly, the district court affirmed. Husky timely appealed.

II. Standard of Review

"When a court of appeals reviews the decision of a district court, sitting as an appellate court, it applies the same standards of review to the bankruptcy court's findings of fact and conclusions of law as applied by the district court." *Jacobsen v. Moser (In re Jacobsen)*, 609 F.3d 647, 652 (5th Cir. 2010) (internal quotation marks omitted). Accordingly, we review conclusions of law de novo and findings of fact for clear error. *Bank of La. v. Bercier (In re Bercier)*, 934 F.2d 689, 691 (5th Cir. 1991). "[W]e will affirm the bankruptcy court's findings unless on the entire evidence, this court is left with the definite and firm conviction that a mistake has been committed." *Id.* (internal quotation marks and brackets omitted). Moreover, where, as here, "the district court has affirmed the bankruptcy court's findings, the clear error standard is strictly applied." *Frazin v. Haynes & Boone, L.L.P. (In re Frazin)*, 732 F.3d 313, 317 (5th

Cir. 2013) (internal quotation marks and brackets omitted).

III. Discussion

On appeal, Husky contends as a threshold matter that Ritz committed "actual fraud" under Texas Business Organizations Code Section 21.223(b) and thus can be held liable for Chrysalis's debt. Husky further argues that the debt is excepted from discharge in bankruptcy under either the "actual fraud" clause in 11 U.S.C. § 523(a)(2)(A), or as debt due to "willful and malicious injury" under 11 U.S.C. § 523(a)(6). Because we conclude—as did the bankruptcy and district courts—that neither of these exceptions to discharge applies, we need not reach the first issue.

A. "Actual Fraud" Under 11 U.S.C. § 523(a)(2)(A)

"The Bankruptcy Code has long prohibited debtors from discharging liabilities incurred on account of their fraud, embodying a basic policy animating the Code of affording relief only to an honest but unfortunate debtor." *Cohen v. de la Cruz*, 523 U.S. 213, 217 (1998) (internal quotation marks omitted). In accordance with that policy, Section 523(a)(2)(A) excepts from discharge "any debt ... for money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained by ... false pretenses, a false representation, or actual fraud." Husky asserts that the debt at issue is one for money obtained by "actual fraud." The parties vigorously dispute the meaning of this term—particularly, whether "actual fraud" can be established where, as here, the debtor made no false

representation to the creditor.[3] Guided by Supreme Court and Fifth Circuit precedent, we conclude that it cannot.[4]

Husky's argument that a false representation is unnecessary to trigger the "actual fraud" clause of Section 523(a)(2)(A) rests almost exclusively on *McClellan v. Cantrell*, 217 F.3d 890 (7th Cir. 2000). In *McClellan*, a divided panel of the Seventh Circuit held that "actual fraud" under that provision "is not limited to misrepresentations and misleading omissions." 217 F.3d at 893. The court faced a situation in which the creditor sold machinery to the debtor's brother for $200,000, payable in installments. *Id.* at 892. The brother defaulted, owing the creditor more than $100,000. *Id.* The creditor sued the brother and, with the suit pending, the brother sold the machinery to his sister, the debtor, for $10; she later resold the machinery for $160,000. *Id.* The debtor was aware of the lawsuit and "was colluding with her brother to thwart [the creditor]'s collection of the debt that her brother owed him." *Id.* The debtor ultimately filed for bankruptcy, and the creditor brought an adversary proceeding to recover the debt. *Id.* At issue in *McClellan* was whether that debt was barred from discharge under the "actual fraud" clause of Section 523(a)(2)(A)—despite the fact

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[3] Husky concedes that "Ritz made no oral or written representations to Husky inducing Husky to enter into a contract with Chrysalis." Nor does Husky point to any other false representations made by Ritz to Husky.

[4] Accordingly, we need not reach Ritz's alternative arguments that: (1) the debt at issue was not "obtained by" fraud, 11 U.S.C. § 523(a)(2)(A), and (2) Ritz did not make the transfers with the intent to deceive Husky.

that the debtor made no false representation to the creditor. Judge Posner, writing for the majority, distinguished the "[p]lenty of cases [that] ... assume that fraud equals misrepresentation," as those were "cases in which the only fraud charged was misrepresentation." *Id.* The court concluded that a fraudulent misrepresentation "is not the only form that fraud can take or the only form that makes a debt nondischargeable," *id.* at 894, relying in part on the fact that the provision covers both "false representation[s]" and "actual fraud": "[B]y distinguishing between 'a false representation' and 'actual fraud,' the statute makes clear that actual fraud is broader than misrepresentation," *id.* at 893. Accordingly, the court concluded that actually fraudulent conveyances—i.e., conveyances through which the debtor *intends* to hinder the creditor—constitute "actual fraud" under Section 523(a)(2)(A).[5] *Id.* at 894–95. The court further reasoned that the debt at issue "arose not when [the debtor's] brother borrowed money from [the creditor] but when [the debtor] prevented [the creditor] from collecting from the brother the money the brother owed him." *Id.* at 895. Accordingly, the debt was for "property ... obtained by fraud." *Id.* In a concurrence, Judge Ripple noted that the majority's interpretation was "perhaps strained," and therefore concluded that a different exception to discharge—Section 523(a)(6)—"provides a far more direct avenue for dealing with a situation such as the one" before the court. *Id.* at 896 (Ripple, J., concurring).

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[5] The court reasoned that constructively fraudulent transfers—those for which no reasonably equivalent value is received—would not constitute "actual fraud." *Id.* at 894–95.

No subsequent appellate court has adopted the interpretation of Section 523(a)(2)(A) endorsed by the *McClellan* majority,[6] and we decline to do so today. First, *McClellan* appears to be in tension with the Supreme Court's opinion in *Field v. Mans*, 516 U.S. 59 (1995), which "resolve[d] a conflict among the Circuits over the level of reliance that § 523(a)(2)(A) requires a creditor to demonstrate." *Id.* at 63. The Court reasoned that the terms " 'false pretenses, a false representation, or actual fraud,' carry the acquired meaning of terms of art" and "imply elements that the common law has defined them to include." *Id.* at 69. Because the district court treated the conduct at issue "as amounting to fraud," the Court "look[ed] to the concept of 'actual fraud' as it was understood in 1978 when the language was added to § 523(a)(2)(A)."[7] *Id.* at 70. The Court relied

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[6] Husky mistakenly asserts that both the Sixth and Tenth Circuits have followed *McClellan*. Although *bankruptcy appellate panels* in those circuits have adopted *McClellan's* reasoning, see *Mellon Bank, N.A. v. Vitanovich (In re Vitanovich)*, 259 B.R. 873, 877 (6th Cir. BAP 2001); *Diamond v. Vickery (In re Vickery)*, 488 B.R. 680, 691 (10th Cir. BAP 2013), no circuit court has done so, *cf. McCrory v. Spigel (In re Spigel)*, 260 F.3d 27, 32 n. 7 (1st Cir. 2001) ("[W]e do not decide whether we would adopt the Seventh Circuit's reasoning [in *McClellan*].") Other bankruptcy courts have explicitly rejected the *McClellan* approach. *See, e.g., Sauer Inc. v. Lawson (In re Lawson)*, 505 B.R. 117, 123 (Bankr. D.R.I. 2014); *Blacksmith Invs. v. Woodford (In re Woodford)*, 403 B.R. 177, 188 (Bankr. D.Mass. 2009); *McKnew v. KMK Factoring, L.L.C. (In re McKnew)*, 270 B.R. 593, 618 n. 40 (Bankr. E.D. Va.2001).

[7] Prior to 1978, an earlier version of the provision "provided that debts that were 'liabilities for obtaining property by false pretenses or false representations' would not be affected by any discharge granted to a bankrupt." *Id.* at 64.

primarily on the Restatement (Second) of Torts, published shortly before Congress passed the current version of Section 523(a)(2)(A). *Id.* The Court focused on "[t]he section on point dealing with fraudulent misrepresentation," which stated that "both actual and 'justifiable' reliance are required." *Id.* The Court also noted that the edition of Prosser's Law of Torts available in 1978 "states that justifiable reliance is the standard." *Id.* at 71. Accordingly, the Court concluded that the applicable standard is "one of justifiable reliance." *Id.* at 61.

Although not directly addressing the issue, the Court throughout its opinion in *Field* appeared to assume that a false representation is necessary to establish "actual fraud." *See*, *e.g.*, *id.* at 68 ("If Congress really had wished to bar discharge to a debtor who made unintentional and wholly immaterial misrepresentations having no effect on a creditor's decision, it could have provided that."); *see also id.* at 79 (Breyer, J., dissenting) ("I agree with the Court's holding that 'actual fraud' under 11 U.S.C. § 523(a)(2)(A) incorporates the common-law elements of intentional misrepresentation.").[8] The majority in

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[8] Indeed, in a separate concurrence, Justice Ginsburg strongly suggested that the debt at issue would not have been dischargeable absent a representation:

> At oral argument, the following exchange between the Court and the Fields' attorney occurred:
>
> "QUESTION: ... Suppose the debtor here had simply transferred th[e] property without saying one word to the creditor.... [W]ould [the debt] then be dischargeable? There would be no representation at all, just in violation of the agreement the debtor sells the property.... Dischargeable, right?

McClellan asserted that *Field* was inapposite because "[t]he fraud there took the form of a misrepresentation" and "[n]othing in the Supreme Court's opinion suggests that misrepresentation is the only type of fraud that can give rise to a debt that is not dischargeable under section 523(a)(2)(A)." *McClellan*, 217 F.3d at 892. Although it is true that the facts underlying *Field* involved a misrepresentation, we do not believe that the case can be so easily disregarded. Nowhere in *Field* did the Court suggest that different definitions of "actual fraud" apply depending on "the type of fraud ... alleged." *Id.* Rather, the Court looked to the Restatement (Second) of Torts and Prosser's Law of Torts in analyzing "*the* concept of 'actual fraud' as it was understood in 1978." *Field*, 516 U.S. at 70 (emphasis added). Both of those sources indicate that a representation is a necessary prerequisite. *See* Restatement (Second) of Torts § 537 (1977) ("The recipient of a fraudulent misrepresentation can recover against its maker for pecuniary loss resulting from it if, but only if ... he relies on the misrepresentation in acting or refraining from

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"MR. SEUFERT: While [those are] not the facts of this case, I would agree with you, it would be dischargeable." [Tr. Of Oral Arg.] at 8–9.

It bears consideration whether a debt that would have been dischargeable had the debtor simply transferred the property, in violation of the due-on-sale clause with never a word to the creditor, nonetheless should survive bankruptcy because the debtor wrote to the creditor of the prospect, albeit not the actuality, of the transfer.

Id. at 79 (Ginsburg, J., concurring) (alterations in original).

action...."); [9] William J. Prosser, Law of Torts § 106, p. 694 (4th ed. 1971) ("The representation which will serve as a basis for an action of deceit, as well as other forms of relief, usually consists, of course, of oral or written words; but it is not necessarily so limited." (footnote omitted)). Moreover, at bottom, the Court in *Field* made clear that the meaning of "actual fraud" depends on the 1978 common law meaning of the term. *Field*, 516 U.S. at 70. Husky has pointed to no authority, and we are not aware of any, suggesting that the common law meaning of "actual fraud" at that time encompassed fraudulent transfers of the type at issue here. Indeed, Husky's counsel conceded at oral argument that fraudulent transfers are statutory constructs, and are "not ... creature[s] of the common law."

Moreover, the reasoning in *McClellan* is at best inconsistent with, if not foreclosed by, our own Fifth

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[9] Although some may quarrel with the *Field* Court's focus on the "fraudulent misrepresentation" provision of the Restatement in interpreting the term "actual fraud," such an argument is a challenge to *Field* itself—a decision to which we are bound. In any event, Husky has not pointed to any other provision of the Restatement that it contends is applicable to the conduct at issue here. Another provision does state that one may be liable to another for *nondisclosure* where "he is under a duty of care to the other to exercise reasonable care to disclose the matter in question,"—e.g., where the parties have "a fiduciary or other similar relation of trust and confidence between them." Restatement (Second) of Torts § 551. However, such fraud is addressed in a separate provision of Section 523—11 U.S.C. § 523(a)(4)—which excepts debts "for fraud or defalcation while acting in a fiduciary capacity." In rejecting the applicability of that provision, the bankruptcy court determined that "[Ritz] owed no fiduciary duty to [Husky]"—a determination Husky has not challenged on appeal.

Circuit precedent. In cases both prior and subsequent to *Field* and *McClellan*, we have stated in no uncertain terms:

> In order to prove nondischargeability under an "actual fraud" theory, the objecting creditor *must prove* that: (1) *the debtor made representations*; (2) at the time they were made the debtor knew they were false; (3) the debtor made the representations with the intention and purpose to deceive the creditor; (4) that the creditor relied on such representations; and (5) that the creditor sustained losses as a proximate result of the representations.

RecoverEdge L.P. v. Pentecost, 44 F.3d 1284, 1293 (5th Cir. 1995) (emphasis added) (internal quotation marks and footnote omitted); *see Gen. Elec. Capital Corp. v. Acosta (In re Acosta)*, 406 F.3d 367, 372 (5th Cir. 2005) ("For a debt to be nondischargeable under section 523(a)(2)(A), the creditor must show (1) that the debtor made a representation...."). Although these cases did not directly address whether fraudulent transfers may constitute "actual fraud" under Section 523(a)(2)(A), we are at the very least hesitant to hold that a creditor need not fulfill one of the express requirements we have repeatedly delineated in our test for "actual fraud."[10]

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[10] We recognize that the Fifth Circuit, sitting en banc, noted that it was "*not* required to address" whether the elements of "actual fraud" listed in our prior cases "survived *Field*." *AT & T Universal Card Servs. v. Mercer (In re Mercer)*, 246 F.3d 391, 403 (5th Cir. 2001) (en banc). However, for the reasons discussed above, *Field* is entirely consistent with—and may even compel—the conclusion that a representation is a necessary prerequisite to a finding of "actual fraud." Furthermore, were a representation unnecessary, one of the

But even setting aside *Field* and our precedent, there are other reasons we choose not to follow *McClellan*. *McClellan* and its progeny rely heavily on the theory that because Section 523(a)(2)(A) includes the phrase "false representation," reading "actual fraud" to require such a representation renders the latter phrase redundant. *See McClellan*, 217 F.3d at 893; *see also In re Vickery*, 488 B.R. at 691. Although as a general rule we aim to "give effect, if possible, to every word Congress used" in construing statutes, *Pilgrim's Pride Corp. v. Comm'r of Internal Revenue*, 779 F.3d 311, 316 (5th Cir. 2015) (internal quotation marks omitted), that canon of construction is not a rigid, inviolable dictate. Such canons "are tools designed to help courts better determine what Congress intended, not to lead courts to interpret the law contrary to that intent." *Scheidler v. Nat'l Org. for Women, Inc.*, 547 U.S. 9, 23 (2006); *see also Chickasaw Nation v. United States*, 534 U.S. 84, 94 (2001) ("[T]hese canons do not determine how to read this statute. For one thing, canons are not mandatory rules. They are guides that need not be conclusive. They are designed to help judges determine the Legislature's intent as embodied in particular statutory language. And other circumstances evidencing congressional intent can overcome their force." (internal citation and quotation marks omitted)); Antonin Scalia & Bryan A. Garner, *Reading Law*: *The Interpretation of Legal Texts* 176

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main issues in *In re Mercer*—whether the use of a credit card constituted a "representation of intent to pay," *id.* at 404–07—would have been rendered irrelevant, *see id.* at 426 (Duhé, J., dissenting) ("If one can 'infer' a representation from use of the card, then the creditor is relieved of the obligation of proving that a false representation was made.").

(2012) ("[The canon against surplusage] cannot always be dispositive because (as with most canons) the underlying proposition is not *invariably* true."). Here, although "actual fraud" was added to the statute in 1978, some have suggested that Congress did not intend to create a separate basis for dischargeability—but rather intended only to codify "the limited scope of the fraud exception" as expressed in case law "interpret[ing] 'fraud' to mean actual or positive fraud rather than fraud implied by law." *RecoverEdge*, 44 F.3d at 1292 n. 16 (internal quotation marks omitted); Alan N. Resnick & Henry J. Sommer, Collier on Bankruptcy ¶ 523.08[01][e] (16th ed. 2014) ("Section 523(a)(2)(A) was intended to codify case law ... which interpreted 'fraud' to mean actual or positive fraud rather than fraud implied by law."); *Cohen*, 523 U.S. at 221 (stating that pre- and post-1978 versions of Section 523(a)(2)(A) are "substantially similar").[11]

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[11] Even assuming Congress intended the phrase "actual fraud" to have a meaning independent from the other phrases in that provision, this court has noted a theory under which "actual fraud" would not be redundant of those other phrases. *See In re Bercier*, 934 F.2d at 692 (reasoning that "false representations and false pretenses ... encompass statements that falsely purport to depict *current or past facts*" while "actual fraud" concerns "promises of future action which, *at the time they were made*, [the debtor] had no intention of fulfilling"). Notably, this distinction would survive even given our conclusion that "actual fraud" requires a misrepresentation. However, we need not, and do not, expressly adopt any of these theories for Congress's inclusion of "actual fraud" in Section 523(a)(2)(A). We note these theories only to suggest that, contrary to the *McClellan* majority's contention, our reading of "actual fraud" is unlikely to render the phrase meaningless or redundant.

We also note that another provision of the Bankruptcy Code, Section 727(a)(2), excepts from discharge certain fraudulent transfers. 11 U.S.C. § 727(a)(2)(A) ("The court shall grant the debtor a discharge, unless ... the debtor, with intent to hinder, delay, or defraud a creditor ... has transferred ... property of the debtor...."). It would appear odd, at the very least, for Congress to have intended that the "actual fraud" provision cover fraudulent transfers, when there is another provision directly addressing such transfers. *See United States v. $92,203.00 in U.S. Currency*, 537 F.3d 504, 509–10 (5th Cir. 2008) ("We are to read a statute as a whole, so as to give effect to each of its provisions without rendering any language superfluous." (internal citation marks omitted)). Husky did not raise this fraudulent transfer provision below. Moreover, other exceptions to discharge in the Bankruptcy Code may be rendered redundant by the *McClellan* majority's broad, omnibus construction of "actual fraud." *See* 11 U.S.C. § 523(a)(4) (excepting debts "for fraud or defalcation while acting in a fiduciary capacity"); *id.* § 523(a)(6) (excepting debts "for willful and malicious injury by the debtor to another entity or to the property of another entity").

Finally, to the extent Section 523(a)(2)(A) is ambiguous, "[e]xceptions to discharge should be construed in favor of debtors in accordance with the principle that provisions dealing with this subject are remedial in nature and are designed to give a fresh start to debtors unhampered by pre-existing financial burdens." *Fezler v. Davis (In re Davis)*, 194 F.3d 570, 573 (5th Cir. 1999); *see also Hickman v. Texas (In re Hickman)*, 260 F.3d 400, 404 (5th Cir. 2001)

("[E]xceptions to discharge are to be construed narrowly.").

For all of these reasons, we conclude that a representation is a necessary prerequisite for a showing of "actual fraud" under Section 523(a)(2)(A). Because the parties agree that the record contains no evidence of such a representation, discharge of the debt at issue is not barred under this provision.

B. "Willful and Malicious Injury" Under 11 U.S.C. § 523(a)(6)

Husky also challenges the bankruptcy court's conclusion that Section 523(a)(6) does not bar discharge of Ritz's alleged debt. Under that provision, a debt "for willful and malicious injury by the debtor to another entity or to the property of another entity" is excepted from discharge. 11 U.S.C. § 523(a)(6). The Supreme Court has interpreted this provision to require "a deliberate or intentional *injury*, not merely a deliberate or intentional act that leads to injury." *Kawaauhau v. Geiger*, 523 U.S. 57, 61 (1998). In *Kawaauhau*, the Court held that "debts arising from recklessly or negligently inflicted injuries do not fall within the compass of § 523(a)(6)." *Id.* at 64. Following *Kawaauhau*, this court has held "that an injury is 'willful and malicious' where there is either an objective substantial certainty of harm or a subjective motive to cause harm." *Miller v. J.D. Abrams, Inc. (In re Miller)*, 156 F.3d 598, 606 (5th Cir. 1998); *cf. McClendon v. Springfield (In re McClendon)*, 765 F.3d 501, 505 (5th Cir. 2014) ("[A]n individual who acts under an honest, but mistaken belief ... cannot be said to have intentionally caused injury, because absent the fact about which there has been a mistake, legally cognizable injury would not meet the

test of substantial certainty." (internal quotation marks omitted)).

In rejecting the applicability of Section 523(a)(6), the bankruptcy court stated that "[t]he record is wholly devoid of any proof that [Ritz] willfully and maliciously injured Husky or Husky's property." The court similarly concluded that Husky "failed to identify any tortious action by [Ritz] that caused a willful and malicious injury." (internal quotation marks omitted). Husky argues that these conclusions are at odds with the bankruptcy court's factual findings that Ritz "drained substantial funds out of Chrysalis[ ]" through transfers that were made without Chrysalis receiving reasonably equivalent value in return. But these findings are not incompatible with the court's rejection of Section 523(a)(6), as there appears to be scant evidence in the record indicating either that Ritz made these transfers with the intent to harm Husky, or that harm to Husky was substantially certain due to Ritz's actions. We note that it was Husky's burden to prove this exception to dischargeability by a preponderance of the evidence, *Grogan v. Garner*, 498 U.S. 279, 291 (1991), and as the bankruptcy court noted, "no exhibits were introduced" and "no testimony was adduced ... relating to § 523(a)(6)." *Cf. Williams v. Int'l Bhd. of Elec. Workers Local 520 (In re Williams)*, 337 F.3d 504, 511 (5th Cir. 2003) ("Although previous decisions by this circuit hold that injuries resulting from a knowing breach of contract may be nondischargeable under Section 523(a)(6), those decisions also require *explicit evidence* that a debtor's breach was intended or substantially certain to cause the injury to the creditor." (emphasis added)). Accordingly, the bankruptcy court did not err in

concluding that Section 523(a)(6) is inapplicable to the debt at issue.[12]

C. Equitable Considerations

Finally, Husky argues that, notwithstanding the provisions discussed above, we should direct the bankruptcy court to exercise its equitable powers to "prevent the U.S. Bankruptcy Code from becoming an engine of fraud." However, such equitable powers "must be exercised in a manner that is consistent with the Bankruptcy Code," and a bankruptcy court is not permitted "to create substantive rights that are otherwise unavailable under applicable law, or constitute a roving commission to do equity." *Perkins Coie v. Sadkin (In re Sadkin)*, 36 F.3d 473, 478 (5th Cir. 1994) (per curiam) (internal quotation marks omitted). For the reasons discussed above, the statutory exceptions to discharge raised by Husky are inapplicable, and Husky cannot rely upon general principles of equity to expand those exceptions. Indeed, as noted above, another provision of the Bankruptcy Code, Section 727(a)(2), may have applied to redress the conduct of which Husky complains—but Husky failed to raise that provision below.

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[12] We note that a portion of the bankruptcy court's analysis with respect to Section 523(a)(6) appeared to focus on Ritz's intent vis-à-vis the transaction between Husky and Chrysalis, as opposed to Ritz's intent at the time of the fraudulent transfers. In any event, the bankruptcy court's conclusions—that the record was "*wholly* devoid" of evidence that Ritz took "*any* ... action ... that caused a willful and malicious injury"—were not so limited. (emphasis added).

IV. Conclusion

For the foregoing reasons, we AFFIRM.

APPENDIX B

United States District Court
S.D. Texas
Houston Division

In re Daniel Lee RITZ, Jr., Debtor.
Husky International Electronics, Inc., Appellant
v.
Daniel Lee, Ritz, Jr., Appellee.

Civil Action No. H–11–3020. | Bankruptcy Case No. 09–39895–H4–7. | Adversary No. 10–03156. | Signed July 14, 2014.

OPINION AND ORDER

MELINDA HARMON, District Judge.

Pending before the Court is the above referenced appeal by Appellant Husky International Electronics, Inc. ("Husky"), seeking a reversal of United States Bankruptcy Judge Jeff Bohm's August 4, 2011 memorandum opinion and judgment[1] in Adversary Proceeding 10–03156, discharging a $163,999.38 contractual debt owed by Chrysalis Manufacturing Corp. ("Chrysalis") to Husky for goods Husky sold and delivered to Chrysalis from 2003 to 2007 under a

[1] Instrument # 9, Appendix A. Also available as *Husky International Electronics, Inc. v. Ritz (In re Ritz)*, 459 B.R. 623 (Bankr. S.D. Tex. 2011).

contract and for which Husky has attempted to hold Appellee/Debtor Daniel Lee Ritz, Jr. ("Ritz"), a director and shareholder of Chrysalis,[2] personally liable.[3] In this appeal Husky contends that the debt should be excepted from discharge in bankruptcy on the grounds of fraud pursuant, to 11 U.S.C. § 523(a)(2), and of willful or malicious injury to Husky or its property, pursuant to 11 U.S.C. § 523(a)(6).

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[2] Judge Bohm found, "At all relevant times, the Debtor was in financial control of Chrysalis. Moreover, he was the director and owner of at least 30% of Chrysalis common stock. [citations omitted]" *In re Ritz*, 459 B.R. at 627, ¶ 4.

[3] The opening lines of Judge Bohm's memorandum opinion summarize the dispute in the Adversary Proceeding:

> This adversary proceeding concerns an individual debtor [Daniel Lee Ritz, Jr.] who authorized transfers of funds out of one corporation [Chrysalis] into the accounts of several other companies—all of which he controlled. As a result of these transfers, the one corporation was drained of all its cash and, therefore, could not pay its creditors. One of these creditors [Husky] has filed suit against the debtor, alleging that: (a) because of the debtor's actions, [Ritz] has become personally liable for the debt owed by the corporation; and (b) this debt is nondischargeable under 11 U.S.C. §§ 523(a)(2)(A), (a)(4), & (a)(6). For the reasons set forth herein, this Court concludes that there is no debt to discharge because the plaintiff failed to establish any liability against the debtor.

Husky has not appealed the ruling under § 523(a)(4), but contests the others.

Husky does not challenge the bankruptcy judge's findings of fact or credibility determinations,[4] but only his conclusions of law. Husky raises three issues of legal error:

(1) Did the bankruptcy court err when it ignored that fraudulent transfers pursuant to Tex. Bus. &

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[4] This Court observes, "'[D]ue regard shall be given to the opportunity of the trial court to judge [ ] the credibility of witnesses.'" *Bertucci Contracting Corp. v. M/V ANTWERPEN*, 465 F.3d 254, 258 (5th Cir. 2006), *citing* Fed.R.Civ.P. 52(a) and *quoting Anderson v. City of Bessemer City, N.C.*, 470 U.S. 564, 573 (1985). "The court owes even greater deference to findings based on the credibility of witnesses and must uphold them if based on coherent, internally consistent, and facially plausible testimony that is not contradicted by external evidence." *Id.* at 259, *citing id.* at 575.

Of witnesses for Husky, Judge Bohm found the debtor, Ritz, was not a credible witness because at trial he made statements that contradicted answers that he had previously given in discovery on material issues and gave nonresponsive answers to unambiguous questions. Memorandum Op., #9, Appendix A at pp. 5–6 (examples given). He found that testimony of Nicholas C. Davis, president of Husky, very credible, as he did the testimony of several other witnesses: (1) Nancy K. Finney, comptroller for Ritz-controlled companies for approximately four years; (2) James D. Rogers, Vice President of Corporate Finance of CapNet Securities Corporation for approximately two and a half years; and (3) Richard Hollan, a shareholder of Institutional Capital Management, Inc., which was owned 40% by Ritz. *Id.* at pp. 7–8. Of Ritz's witnesses, he found Heather Cheaney to be credible, but that her testimony was not significant; he found Daniel Lee Ritz, Sr. to be credible, but gave little weight to his testimony, which was biased toward his son; he found Craig Takacs to be "a bit evasive" and gave little weight to his testimony; he found L. Andrew Well was not credible; and he found Marlin R. Williford to be "direct and forthcoming" and credible, but his testimony did not relate to the transfers of cash by Ritz out of Chrysalis and into the accounts of other entities controlled by Ritz. *Id.* at p. 8.

Com.Code § 24.005[5] are "actual fraud" within the meaning of Tex. Bus. Org.Code § 21.223(b)?[6]

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[5] The Texas Uniform Fraudulent Transfer Act ("TUFTA"), Texas Bus. & Com.Code § 24.005, "Transfers Fraudulent as to Present and Future Creditors," provides,

> (a) A transfer made or obligation incurred by a debtor is fraudulent as to a creditor, whether the creditor's claim arose before or within a reasonable time after the transfer was made or the obligation was incurred, if the debtor made the transfer or incurred the obligation:
>
> (1) with actual intent to hinder, delay, or defraud any creditor of the debtor; or
>
> (2) without receiving a reasonably equivalent value in exchange for the transfer or obligation, and the debtor:
>
> (A) was engaged or was about to engage in a business or a transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction; or
>
> (B) intended to incur, or believed or reasonably should have believed that the debtor would incur, debts beyond the debtor's ability to pay as they became due.
>
> (b) In determining actual intent under Subsection (a)(1) of this section, consideration may be given, among other factors, to whether:
>
> (1) the transfer or obligation was to an insider;
>
> (2) the debtor retained possession or control of the property transferred after the transfer;
>
> (3) the transfer or obligation was concealed;
>
> (4) before the transfer or obligation was incurred, the debtor had been sued or threatened with suit;
>
> (5) the transfer was of substantially all of the debtor's assets;

(6) the debtor absconded;

(7) the debtor removed or concealed the assets;

(8) the value of the consideration received by the debtor was reasonably equivalent to the value of the asset transferred or the amount of the obligation incurred;

(9) the debtor was insolvent or became insolvent shortly after the transfer was made or the obligation was incurred;

(10) the transfer occurred shortly before or shortly after a substantial debt was incurred; and

(11) the debtor transferred the essential assets of the business to a lienor who transferred the assets to an insider of the debtor.

[6] Section 21.223, "Limitation of Liability for Obligations," which applies only to Texas corporations and limited liability companies, recites,

(a) A holder of shares, an owner of any beneficial interest in shares, or a subscriber for shares whose subscription has been accepted, or any affiliate of such a holder, owner, or subscriber of the corporation, may not be held liable to the corporation or its obligees with respect to:

(1) the shares, other than the obligation to pay the corporation the full amount of consideration, fixed in compliance with Sections 21.157–21.162, for which the shares were or are to be issued;

(2) any contractual obligation of the corporation or any matter relating to or arising from the obligation on the basis that the holder, beneficial owner, subscriber, or affiliate is or was the alter ego of the corporation or on the basis of actual or constructive fraud, a sham to perpetrate a fraud, or other similar theory; or

(3) any obligation of the corporation on the basis of the failure of the corporation to observe any corporate formality, including the failure to:

(2) Did the bankruptcy court err when it held that Husky could not prevail under 11 U.S.C. § 523(a)(2)(A) because Husky had failed to prove a fraudulent misrepresentation by Ritz that Husky relied upon?

(3) Did the bankruptcy court err when it held that Husky could not prevail under 11 U.S.C. § 523(a)(6) because Ritz's fraudulent transfers of Chrysalis's cash were not a willful or malicious injury to Husky?

9 at p. 7 (electronic numbering).

After careful review of the record, the briefs, and the applicable law, the Court affirms the bankruptcy

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> (A) comply with this code or the certificate of formation or bylaws of the corporation; or
>
> (B) observe any requirement prescribed by this code or the certificate of formation or bylaws of the corporation for acts to be taken by the corporation or its directors or shareholders.
>
> (b) Subsection (a)(2) does not prevent or limit the liability of a holder, beneficial owner, subscriber, or affiliate if the obligee demonstrates that the holder, beneficial owner, subscriber or affiliate caused the corporation to be used for the purpose of perpetrating and did perpetrate an actual fraud on the obligee primarily for the direct personal benefit of the holder, beneficial owner, subscriber, or affiliate.

"Affiliate" means "a person who controls, is controlled by, or is under common control of another person." Tex. Bus. Org.Code § 1.002(1).

"[L]iability of the corporations's shareholder/owner is exclusive and preempts any other liability imposed for that obligation under common law or otherwise." Tex. Bus. Org.Code § 21.224.

court's memorandum and order for the reasons indicated below.

Standard of Review

This Court has jurisdiction over appeals from "final judgments, orders and decrees" of a bankruptcy court under 28 U.S.C. § 158(a)(1). *See In re Berman–Smith*, 737 F.3d 997, 1000 (5th Cir. 2013). Under 28 U.S.C. § 157(b)(1), a bankruptcy court may hear and determine "core proceedings." Actions to determine the dischargeability of a debt are core proceedings under 28 U.S.C. § 157(b)(2)(B),(I), and (O), and such determinations are exclusively within the jurisdiction of the bankruptcy court, 28 U.S.C. § 523(a)(2). In "reviewing a bankruptcy court's decision in a 'core proceeding,' a district court functions as a[n] appellate court." *Webb v. Reserve Life Ins. Co. (In re Webb)*, 954 F.2d 1102, 1103–04 (5th Cir. 1992).

Conclusions of law of the bankruptcy court are reviewed *de novo*. *In re Chesnut*, § 422 F.3d 298, 301 (5th Cir. 2005). Mixed questions of law and fact are also reviewed *de novo*. *In re San Patricio Cnty. Cmty. Action Agency*, 575 F.3d 553, 557 (5th Cir. 2009), *citing In re Seven Seas Petroleum, Inc.*, 522 F.3d 575, 583 (5th Cir. 2008).

This Court reviews findings of fact for clear error. *In re Lothian Oil, Inc.*, 650 F.3d 539, 542 (5th Cir. 2011). "A finding of fact is clearly erroneous when the appellate court, viewing the evidence in its entirety, 'is left with a firm and definite conviction that a mistake has been committed.'" *Bertucci Contracting Corp. v. M/V ANTWERPEN*, 465 F.3d 254, 258–59 (5th Cir. 2006). "If the district court's finding is plausible in light of the record viewed as a whole, the court of appeals cannot reverse even

though, if sitting as the trier of fact, it would have weighed the evidence differently." *In re San Patricio Cnty. Cmty. Action Agency*, 575 F.3d 553, 557 (5th Cir. 2009), *citing Anderson*, 470 U.S. at 573–74. "If there are two permissible views of the evidence, the factfinder's choice between them cannot be clearly erroneous." *Anderson*, 470 U.S. at 574. The appellant bears the burden of showing that a finding of fact by the bankruptcy court is clearly in error. *In re Davis*, No. 07–33986–H3–7, 2012 WL 2871662, at *3 (S.D. Tex. July 10, 2012) (*citing Perry v. Dearing*, 345 F.3d 303, 309 (5th Cir. 2003)), *aff'd,* 538 Fed.Appx. 440 (5th Cir. 2013), *cert. denied*, —— U.S. – —— (2014).

Relevant Law

A bankruptcy court has exclusive jurisdiction to decide whether a debt is nondischargeable as defined by the bankruptcy law. *Matter of Dennis*, 25 F.3d 274, 278 (5th Cir. 1994). As a creditor claiming nondischargeability, Appellant bears the burden of proving by a preponderance of the evidence that the debt is exempt from discharge. *In re Gauthier*, 349 Fed.Appx. 943, 945 (5th Cir. 2009), *citing Gen. Elec. Capital Corp. v. Acosta (In re Acosta)*, 406 F.3d 367, 372 (5th Cir. 2005). "Intertwined with this burden is the basic principle of bankruptcy that exceptions to discharge must be strictly construed against a creditor and liberally construed in favor of a debtor so that the debtor may be afforded a fresh start." *FNFS Ltd. v. Harwood (In re Harwood)*, 637 F.3d 615, 619 (5th Cir. 2011), *citing Hudson v. Raggio & Raggio (In re Hudson)*, 107 F.3d 355, 356 (5th Cir. 1997). Unless the creditor proves that an exception to discharge applies, the creditor can only collect against the

bankruptcy estate. *In re Gauthier*, 349 Fed.Appx. at 945.

11 U.S.C. § 523(a)(2)(A)

Section 523(a)(2)(A), exempting from discharge a debt obtained by false pretenses, a false representation or actual fraud, provides that

> a discharge under § 727 of this title does not discharge an individual debtor from any debt— for money, property, or services, ... to the extent obtained by—false pretenses, a false representation, or actual fraud, other than a statement respecting the debtor's or an insiders's financial condition.

Although other Courts of Appeals apply the same standard to all § 523(a)(2)(A) claims, the Fifth Circuit in the past has differentiated the elements of "actual fraud" and of "false pretenses and false representations" chronologically, based on whether the representation was made about a past or a future matter. *RecoverEdge LP v. Pentecost*, 44 F.3d 1284, 1291 (5th Cir. 1995). A false representation or false pretense under § 523(a)(2) must depict current or past facts, and the creditor must show by a preponderance of the evidence (1) a knowing and fraudulent falsehood, (2) describing past or current facts, that (3) was relied upon by the other party. *Id.* at 1292–93, *citing Allison v. Roberts (In re Allison)*, 960 F.2d 481, 483 (5th Cir. 1992). *See also Bank of La. v. Bercier (In re Bercier)*, 934 F.2d 689, 692 (5th Cir. 1991) ("'A mere promise to be executed in the future is not sufficient to make a debt nondischargeable, even though there is no excuse for a subsequent breach.'"), *citing 3 Collier on Bankruptcy* 15th Ed. ... § 523.08. A false

representation involves an express statement, while "false pretenses may be based on misleading conduct without an express statement." *Wallace v. Davis (In re Davis)*, 377 B.R. 827, 834 (E.D. Tex. 2007). Both false pretenses and false representations entail intentional conduct intended to create and develop a false impression. *Id.*, *citing Still v. Patten (In re Patten)*, 225 B.R. 211, 215 (Bankr. Or. 1998).

"'Actual fraud, by definition consists of any deceit, artifice, trick or design involving direct and active operation of the mind, used to circumvent and cheat another—something done or omitted with the design of perpetrating what is known to be a cheat or deception.'" *RecoverEdge*, 44 F.3d at 1293, *quoting 3 Collier on Bankruptcy* ¶ 523.08, at 523–57 to 523–58. For actual fraud, the creditor must prove the debtor had the intent to deceive and that the fraud proximately caused the loss by the creditor. *RecoverEdge*, 44 F.3d at 1293. To prevail on a claim that a debt is nondischargeable under 11 U.S.C. § 523(a)(2)(A) because of actual fraud, a creditor must show by a preponderance of the evidence that (1) the debtor made a misrepresentation, (2) the debtor knew the misrepresentation was false at the time he made it, (3) the representation was made with the intent to deceive the creditor, (4) the creditor actually and justifiably relied[7] on the representation, and (5) the creditor suffered a loss as a proximate result of its reliance. *In re Acosta*, 406 F.3d at 372. Moreover unlike false pretenses or false representation, actual fraud can focus on a promise of a future performance

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[7] The Fifth Circuit does not require the creditor to have "reasonably" relied on the representation. *RecoverEdge*, 44 F.3d at 1293 n. 17.

made with the intent not to perform. *Trenholm v. Ratcliff*, 646 S.W.2d 927, 930 (Tex. 1983). "Debts that satisfy the third element, the scienter requirement, are debts obtained by frauds involving 'moral turpitude or intentional wrong, and any misrepresentations must be knowingly and fraudulently made.'" *In re Acosta*, 406 F.3d at 372, *citing In re Martin*, 963 F.2d 809, 813 (5th Cir. 1992). The court may infer an intent to deceive from "'reckless disregard for the truth or falsity of a statement, combined with the sheer magnitude of the resultant misrepresentation.'" *Id.*, quoting *In re Norris*, 70 F.3d 27, 30 n. 12 (5th Cir. 1995), *citing In re Miller*, 39 F.3d 301, 305 (11th Cir. 1994). Where the speaker has an unreasonable but honest belief that a representation is true and has information justifying that it is, he does not have an intent to deceive, i.e., "a 'dumb' but honest" defendant does not have scienter. *Id.*, *citing Palmacci v. Umpierrez*, 121 F.3d 781, 788 (1st Cir. 1997). Exceptions to discharge under § 523 should be construed in favor of the debtor. *Fezler v. Davis (In re Davis)*, 194 F.3d 570, 573 (5th Cir. 1999).

As will be discussed, in the wake of *Field v. Mans*, 516 U.S. 59, 71–72 (1995) it is uncertain whether the Fifth Circuit's earlier distinction among the three terms survived *Field*. *In re Mercer*, 246 F.3d at 394–95.

"It is well settled that silence can create a false impression, providing the basis for a misrepresentation that is actionable under § 523(a)(2)(A)." *In re Demarest*, 176 B.R. 917, 920 (Bankr. W.D. Wash.1995), *aff'd*, 124 F.3d 211 (9th Cir. 1997), *cert. denied*, 525 U.S. 827 (1998). *See also In re Lau*, No. 11–40284, Adv. 11–4203, 2013 WL

5935616, at *18 (Bankr. E.D. Tex. Nov. 4, 2013) ("The failure to disclose a material fact when one has a duty to do so is sufficient grounds for nondischargeability for fraud under § 523(a)(2)(A) of the Bankruptcy Code."). Whether there is a duty to disclose is a question of law for the court. *Id.*, *citing In re Int'l Profit Assocs., Inc.*, 274 S.W.3d 672, 678 (Tex. 2009). The Fifth Circuit recognizes such a duty in fiduciary or confidential relationships and outside of a fiduciary or confidential relationship when a party voluntarily discloses some, but not all, material factors or where the speaker fails to disclose new information that makes an earlier representation misleading or untrue. *In re Lau*, 2013 WL 5935616, at *19.

In Texas to show fraud by nondisclosure, a subspecies of fraud, the creditor must prove "(1) a party conceals or fails to disclose a material fact within that party's knowledge, (2) the party had a duty to disclose the fact, (3) the party knows that the other party is ignorant of the fact and does not have an equal opportunity to discover the truth, (4) the party intends to induce the other party to take some action by concealing or failing to disclose the fact, (5) the other party justifiably relies on the nondisclosure, and (6) the other party suffers injury as a result of acting without knowledge of the undisclosed fact." *In re Edelman*, No. 13–31182–BJH, Adv. 13–03126–BJH, 2014 WL 1796217, at *34 (Bankr. N.D. Tex. May 6, 2014), *citing Bradford v. Vento*, 48 S.W.3d 749, 755–56 (Tex. 2001). Plaintiffs must prove these elements by a preponderance of the evidence. *Id.*

A fact is material if "'disclosure of the fact would likely affect the conduct of a reasonable person

concerning the transaction in question.'" *In re Lau*, 2013 WL 5935616, at *18.

Fraud by nondisclosure requires proof of a duty to disclose. *Bright v. Addison*, 171 S.W.3d 588, 599 (Tex.App.—Dallas 2005, pet. dism'd, pet. denied). Texas recognizes that a duty to disclose may arise in four circumstances: "(1) when there is a fiduciary relationship; (2) when one voluntarily discloses information, the whole truth must be disclosed; (3) when one makes a representation, new information must be disclosed when the new information makes the earlier misrepresentation misleading or untrue; and (4) when one makes a partial disclosure and conveys a false impression." *Hoggett v. Brown*, 971 S.W.2d 472 (Tex.App. —Houston [14th Dist.] 1997), citing *Formosa Plastics Corp. v. Presidio Engineers and Contractors, Inc.*, 941 S.W.2d 138, 146–47 (Tex.App.—Corpus Christi 1995), rev'd on other grounds, 960 S.W.2d 41 (1997).

Justifiable reliance requires evidence that the plaintiff actually relied on the false representations and that its reliance was justified under the circumstances. *In re Lau*, 2013 WL 5935616, at *20, *citing First Horizon Home Loan Corp. v. Apostle (In re Apostle)*, 467 B.R. 433, 443 (Bankr. W.D. Mich. 2012). Justifiable reliance is a lower standard than reasonable reliance: it does not require the plaintiff to prove reasonableness, nor does it impose a duty to investigate unless the falsity is easily apparent or there are red flags indicating that reliance is not warranted. *Id.*, *citing First Am. Title Ins. Co. v. Lett (In re Lett)*, 238 B.R. 167, 186 (Bankr. W.D. Mo. 1999); *Guion v. Sims (In re Sims)*, 479 B.R. 415, 425 (Bankr. S.D. Tex. 2012); and *Baker v. Sharpe (In re Sharpe)*, 351 B.R. 409, 423 (Bankr. N.D. Tex. 2005) (A plaintiff

"may not blindly rely upon a misrepresentation, the falsity of which would be obvious to the plaintiff had he or she used her senses to make a cursory examination or investigation. '[O]nly where, under the circumstances, the facts should be apparent to a person of the plaintiff's knowledge or intelligence from a cursory glance, or where the plaintiff has discovered something that should serve as a warning that he is being deceived, is [the plaintiff] required to make an investigation of his own.'"), *citing Field v. Mans*, 516 U.S. 59, 71–72 (1995). Justifiable reliance is not an objective standard: to determine if reliance is justified the court looks at the circumstances of an individual case and the traits of a particular plaintiff. *Id.*, *citing Manheim Automotive Financial Services, Inc. v. Hurst (In re Hurst)*, 337 B.R. 125, 133–34 (Bankr. N.D. Tex. 2005), and *Field v. Mans*, 516 U.S. 59, 70–71 (1995) (Justifiable reliance incorporates "the qualities and characteristics of the particular plaintiff and the circumstances of the particular case, rather than of the application of a community standard of conduct in all cases.").

11 U.S.C. § 523(a)(6)

Section 523(a)(6) of the Federal Bankruptcy Code bars discharge of debt incurred for "willful and malicious injury by the debtor to another entity or to the property of another entity." An injury is "willful and malicious" for purposes of § 523(a)(6) "where either (1) there is an objective substantial certainty of harm or (2) there exists a subjective motive to cause harm." *In re Edelman*, 2014 WL 1796217, at *42; *In re Miller*, 156 F.3d at 606. The statute covers physical damage and harm to personal or property rights. *In re Edelman*, 2014 WL 1796217, at *42.

Where the primary debt is nondischargeable under § 523(a)(2)(A) and/or (a)(6), related ancillary awards including attorney's fees and interest are also nondischargeable. *In re Edelman*, 2014 WL 1796217, at *43.

Liability of Owner or Shareholder of a Corporation for Breach of Contract Claims

"The corporate form normally insulates shareholders, officers and directors from liability for corporate obligations...." *Castleberry v. Branscum*, 721 S.W.2d 270, 271 (Tex. 1986), superseded in part by former Bus. Corp. Act art. 2.21, recodified at Tex. Bus. Org.Code Ann. § 21.223. Traditionally, the alter ego doctrine is relevant "when there is such unity between corporation and individual that the separateness of the corporation has ceased and holding only the corporation liable would result in injustice." *Castleberry*, 721 S.W.2d at 272. Castleberry, which required only a showing of constructive fraud to pierce the corporate veil, identified seven theories for piercing the corporate veil to hold individual shareholders liable for corporate acts: (1) the corporate fiction is used to perpetrate fraud ("a sham to perpetuate a fraud"); (2) the corporation is organized and operated as a mere tool or business conduit of another corporation (alter ego); (3) the corporate fiction is used to evade an existing legal obligation; (4) the corporate fiction is used to achieve or perpetuate monopoly; (5) the corporate fiction is used to circumvent a statute; (6) the corporate fiction is relied upon as a protection of crime or to justify wrong; and (7) where the corporation is inadequately capitalized. 721 S.W.2d at 272. Alter ego "is shown from the total dealings of the corporation and the individual, including the

degree to which corporate formalities have been followed and corporate and individual property have been kept separately, the amount of financial interest, ownership and control the individual maintains over the corporation, and whether the corporation has been used for personal purposes." *Castleberry*, 721 S.W.2d at 272.

Nevertheless, to limit Castleberry, in 1989 the Legislature placed strict restrictions on a contract claimant's ability to pierce the corporate veil; now codified at § 21.223 of the Texas Business Organizations Code, the statute states,

> (a) A holder of shares [or] owner of any beneficial interest in shares ... may not be liable to the corporation or its obligees with respect to ...
>
> > (2) any contractual obligation of the corporation or any matter relating to or arising from the obligation on the basis that the holder [or] beneficial owner is or was the alter ego of the corporation or on the basis of actual or constructive fraud, a sham to perpetrate a fraud or other similar theory....
>
> (b) Subsection (a)(2) does not prevent or limit the liability of a holder [or] beneficial owner ... if the obligee demonstrates that the ... beneficial owner ... caused the corporation to be used for the purpose of perpetrating and did perpetrate an actual fraud on the obligee primarily for the direct personal benefit of the holder [or] beneficial owner....

Any such liability for an obligation on behalf of the corporation "is exclusive and preempts any other liability imposed for that obligation under common

law or otherwise." *Id.* § 21.224; *Lone Star Air Systems, Ltd. v. Powers*, 401 S.W.3d 855, 862–63 (Tex.App.—Houston [14th Dist.] 2013). In a breach of contract case, section 21.223 requires proof of actual fraud to pierce the corporate veil on the basis of alter ego, i.e., the shareholder caused "the corporation to be used for the purpose of perpetrating and did perpetrate a fraud." *Rimade*, 388 F.3d at 143. "Actual fraud" "involves dishonesty of purpose or intent to deceive." Tex. Bus. Corp. Act Ann., art. 221(A)(2) ("[T]he ... owner ... caused the corporation to be used for the purpose of perpetrating and did perpetrate an actual fraud on the obligee primarily for the direct personal benefit of the ... owner....". Thus § 21.223 overruled *Castleberry* to the degree that a failure to observe corporate formalities is no longer a factor in proving alter ego in contract claims, and it eliminated constructive fraud as a means to pierce the corporate veil. [8] *Western Horizontal Drilling, Inc. v. Jonnet Energy Corp.*, 11 F.3d 65, 67–68 & n. 4 (5th Cir. 1994) (narrowing *Castleberry*'s list to "three broad categories in which a court may pierce a corporate veil" under Texas law: (1) the corporation was the alter ego of its owners and/or shareholders; (2) the corporation was used for illegal purposes; and

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[8] *See also Hidden Values, Inc. v. Wade*, Civ. A. No. 3:11–CV1917–L, 2012 WL 1836087, at *4 n. 4 (N.D. Tex. May 18, 2012) ("Section 21.223 is the amended, codified version of article 2.21 of the Texas Business Corporation Act and was adopted by the Texas legislature to limit a shareholder's personal liability for the contractually related obligations of a corporation and requires a showing that 'actual fraud,' rather than some lower threshold of wrongful conduct, has been perpetrated through use of the corporate form for the direct personal benefit of the corporations's shareholder that is sought to be charged with liability.").

(3) the corporation was used as a sham to perpetrate fraud); *Rimade Ltd. v. Hubbard Enters., Inc.*, 388 F.3d 138, 143 (5th Cir. 2004). "In other words, alter ego or other similar theories may be used to pierce the corporate veil only if (1) actual fraud is shown, and (2) it was perpetrated primarily for the direct personal benefit of the holder." *Ocram, Inc. v. Bartosh*, 2012 WL 4740859, *3 (Tex.App.—Houston [1st Dist.] Oct. 4, 2012).

Actual fraud is "the misrepresentation of a material fact with the intention to induce action or inaction, reliance on the misrepresentation by a person who, as a result of such reliance, suffers injury." *Trustees of Northwest Laundry and Dry Cleaners Health & Welfare Trust Fund v. Burzynski*, 27 F.3d 153, 157 (5th Cir. 1994), *cert. denied*, 513 U.S. 1155 (1995). The elements of actual fraud are "a material misrepresentation, which was false, and which was either known to be false when made or was asserted without knowledge of the truth, which was intended to be acted upon, which was relied upon, and which caused injury." *DeSantis v. Wackenhut Corp.*, 793 S.W.2d 670, 688 (Tex. 1990). If an obligee shows that the shareholder used the corporation to perpetrate fraud on the obligee for the shareholder's direct personal benefit, the shareholder is liable under § 21.223(b). *Willis v. Donnelly*, 199 S.W.3d 262, 272 (Tex. 2006) (statute precludes the use of common law veil-piercing theories).

Husky's Opening Brief (# 9)

Husky is a Colorado seller of electronic device components which sold to Chrysalis, a manufacturer of electronic circuit boards, from 2003 to 2007 certain

goods for $163,999.38, which debt Chrysalis failed to pay.

Husky sued Chrysalis in this district in May 2009, *Husky Int'l Electronics, Inc. v. Ritz*, H–09–1532, asserting that Ritz was personally liable under Texas Business Organizations Code § 21.223(b) for Chrysalis's $163,999.38 corporate debt to Husky. In December of that year Ritz filed an involuntary bankruptcy petition. # 9, Appendix A. On March 31, 2010, Husky commenced the adversary proceeding from which this appeal is taken, objecting to the discharge of that corporate debt under the exceptions set out in 11 U.S.C. § 523(a)(2), (a)(4),[9] and (a)(6). *Id.*

Regarding appellate issue one (Did the bankruptcy court err when it ignored that fraudulent transfers pursuant to Texas Business and Commerce Code § 24.005 are "actual frauds within the meaning of Texas Business Organizations Code § 21.223(b)?"), Judge Bohm found that at all relevant times, Ritz had financial control of Chrysalis, was a director of Chrysalis, owned a minimum of 30% of Chrysalis's common stock, was not paying its bills as they came due, and Chrysalis's debts were greater than all of its

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[9] Title 11 U.S.C. 523(a)(4) provides that "[a] discharge under section 727 ... does not discharge an individual from any debt for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny." Its purpose is to deal with circumstances where "debts [are] incurred through abuses of fiduciary positions and through active misconduct whereby a debtor has deprived others of their property by criminal acts; both classes of conduct involve debts arising from the debtor's acquisition or use of property that was not the debtor's." *Miller v. J.D. Abrams, Inc. (In re Miller)*, 156 F.3d 598, 602 (5th Cir. 1998), *citing In re Boyle*, 819 F.2d 583, 588 (5th Cir. 1987). As noted, Husky did not appeal the ruling denying this claim.

assets at fair valuation. Given the last two facts, Chrysalis qualified as insolvent under Texas Business & Commerce Code § 24.003(a) and (b).[10]

Judge Bohm further found that between November 2006 and May 2007, when Chrysalis stopped doing business, Ritz caused the insolvent Chrysalis to transfer the following funds to eight entities owned and controlled by Ritz, resulting in Husky's damages

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[10] Section 24.003(a) and (b) provided,

> (a) A debtor is insolvent if the sum of the debtor's debts is greater than all of the debtor's assets at a fair valuation.
>
> (b) A debtor who is generally not paying a debtor's debts as they become due is presumed to be insolvent.

A debtor is insolvent under the Uniform Fraudulent Transfer Act ("TUFTA") if it meets this definition after transfers. Corpus v. Arriaga, 294 S.W.3d 629, 637 (Tex. App.—Houston [1st Dist.] 2009). Texas Business & Commerce Code § 24.006, "Transfers Fraudulent as to Present Creditors," provides,

> (a) A transfer made or obligation incurred by a debtor is fraudulent as to a creditor whose claim arose before the transfer was made or the obligation was incurred if the debtor made the transfer or incurred the obligation without receiving a reasonably equivalent value in exchange for the transfer or obligation and the debtor was insolvent at the time or the debtor became insolvent as a result of the transfer or obligation.
>
> (b) A transfer made by a debtor is fraudulent as to a creditor whose claim arose before the transfer was made if the transfer was made to an insider for an antecedent debt, the debtor was insolvent at that time, and the insider had reasonable cause to believe that the debtor was insolvent.

of $163,999.38, i.e., that amount Chrysalis owed Husky for the goods Husky shipped to Chrysalis. Judge Bohm also ruled that Chrysalis did not receive a reasonably equivalent value in exchange for the transfers. The following transfers are identified:

> 1. $677,622.00 to Ritz's ComCon Manufacturing Services, Inc. a/k/a VirTra Merger Corporation;
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> 2. $121,831.00[11] to Ritz's CapNet Securities Corporation;
>
> 3. $52,600.00 to Ritz's CapNet Risk Management, Inc.;
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> 4. $172,100.00 to Ritz's Institutional Capital Management, Inc. and Ritz's Institutional Insurance Management, Inc.;
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> 5. $99,386.00 to Ritz's Dynalyst Manufacturing Corporation;
>
> 6. $11,240.00 to Ritz's CapNet Advisors Incorporated.
>
> Moreover Judge Bohm found,
>
> At all relevant times, the Debtor owned: (1) 30% of Chrysalis; (2) 85% of CapNet Securities Corporation; (3) 100% of CapNet Risk Management, Inc.; (4) 100% of Institutional Insurance Management, Inc.; (5) 40% of Institutional Capital Management, Inc.; (6) 25% of Dynalyst Manufacturing Corporation; and (7) 20% of Clean Fuel International Corp., a/k/a Gulf Coast Fuels. 459 B.R. at 628, ¶ 14.

Under TUFTA, Tex. Bus. & Com.Code § 24.005(a)(2)(B) (see footnote 4), if the debtor made a

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[11] The Complaint alleged $121,821.00.

transfer without receiving a reasonably equivalent value in exchange and the debtor "intended to incur, or believed or reasonably should have believed that the debtor would incur, debts beyond the debtor's ability to pay as they became due," the transfer is fraudulent as to the creditor. Judge Bohm found there was no doubt that the evidence proved that the transfers of $1.2 million were fraudulent as to Husky and possibly other creditors.

At a hearing on July 13, 2011, however, the bankruptcy court held that "actual fraud" under Texas Business Organizations Code § 21.223(b) can only be fraud by misrepresentation, the first issue challenged by Husky. Judge Bohm determined that "[n]o exhibits were introduced and no testimony was adduced indicating that the Debtor made any oral or written representations to Husky inducing Husky to enter into a contract with Chrysalis. The only communication that the Debtor ever had with Husky was a telephone conversation between Husky's founder and president, Nick Davis, and the Debtor **after** the parties had entered into a contract and Husky had already shipped the product to Chrysalis." # 2–13 at pp. 4–5. While Judge Bohm found Ritz "to be a witness with virtually no credibility" and he thought Ritz "drained Chrysalis of a lot of money," because Judge Bohm found that Ritz made no representations to Husky, Husky could not recover its damages for fraud under § 21.223(b). Doc. 20, 7:21–8:11.

In his memorandum opinion, # 2–13, Judge Bohm clearly stated that actual fraud under Texas law is defined as "the misrepresentation of a material fact with intention to induce action or inaction, reliance on the misrepresentation by a person who, as a result

of such reliance, suffers injury." *Id.* at p. 12, *citing Trustees of the N.W. Laundry & Dry Cleaners Health and Welfare Trust Fund v. Burzynski*, 27 F.3d 153, 157 (5th Cir. 1994). He identified the elements of actual fraud in Texas as "(1) the defendant made a representation to the plaintiff; (2) the representation was material; (3) the representation was false; (4) when the defendant made the representation the defendant knew it was false or made the representation recklessly and without knowledge of its truth; (5) the defendant made the representation with the intent that the plaintiff act on it; (6) the plaintiff relied on the representation; and (7) the representation caused the plaintiff injury." *Id.* at pp. 12–13, *citing Shandong Yinguang Chem. Indus. Joint Stock Co. v. Potter*, 607 F.3d 1029, 1032–33 (5th Cir. 2010). He reiterated that "the record is wholly devoid of any such representation made by the Debtor" and concluded that because "Husky's common law fraud cause of action must fail," his claims under § 21.223 and § 523(a)(2)(A) must fail. *Id.* at p. 13.

At trial Husky contended that the Ritz-directed transfers of $1.2 million from Chrysalis to other Ritz-controlled entities for Ritz's direct personal benefit were fraudulent transfers under TUFTA, Texas Bus. & Com.Code § 24.005(a). In this appeal, relying heavily on *McClellan v. Cantrell*, 217 F.3d 890, 893 (7th Cir. 2000) (opining that allowing a debtor, who fraudulently transferred valuable property in order to keep it out of the hands of a creditor, to use bankruptcy to shield herself from liability "is as blatant an abuse of the Bankruptcy Code as we can imagine," and "turns bankruptcy into an engine for

fraud,"[12]), Husky argues that the law does prohibit Ritz from defrauding Husky by the fraudulent transfers despite the absence of a representation by Ritz to Husky. In 1989 the Texas Legislature amended article 2.21 of the Texas Business Corporations Act, amended again in 2011 and now Texas Business Organizations Code § 21.223, and significantly narrowed the bases for corporate veil piercing that had been recognized in *Castleberry*, 721 S.W.2d at 271–72. Husky argues that Judge Bohm erred in holding that actual fraud is limited to fraud by misrepresentation. *Citing McCarthy v. Wani Venture, A.S.*, 251 S.W.3d 573, 591 (Tex.App.—Houston [1st Dist.] 2007, pet. denied) (actual fraud not limited to misrepresentation; affirming jury verdict of actual fraud under § 21.223(b) based on shareholder's fraudulent transfers of cash out of debtor company (applying corporate veil piercing principles to LLCs) to other companies in which the shareholder had "direct ownership and/or financial interest," i.e., using a corporation as "a sham to perpetuate a fraud").

TUFTA also makes a transfer fraudulent as to a creditor where it is made "with actual intent to hinder, delay, or defraud any creditor of the debtor." Tex. Bus. & Com.Code § 24.005(a)(1). Judge Bohm found two badges of fraud[13] in the transfers of the

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[12] Doc. 20 in Adversary Proceeding 10–3156.

[13] *See Mladenka v. Mladenka*, 130 S.W.3d 397, 405 (Tex. App.—Houston [14th Dist.] 2004, no pet.) (Because direct proof of fraud is usually not available, circumstantial evidence, i.e., "badges of fraud," may be used to determine intent under § 24.005(a)(1): whether "(1) the transfer or obligation was to an insider; (2) the debtor retained possession or control of the property transferred after the transfer; (3) the transfer or obligation was concealed;

$1.2 million, establishing actual intent under TUFTA § 24.005(a)(1): the value of consideration received by Chrysalis was not reasonably equivalent to the asset's value; and Chrysalis was insolvent when Ritz made the transfers. The evidence established two others: the transfers were made between November 2006 and May 2007 to "insiders" because Ritz was a director, officer or person in control of each of the transferee corporations; and Chrysalis was threatened with suit by Husky president Nick Davis during a conversation with Ritz on or around January 12, 2007 and Davis filed suit on January 23, 2007.

Husky also contends that it proved that Ritz perpetrated the fraudulent transfers of $1.2 million for his "direct personal benefit." Fraudulent transfer of assets to a corporation owned 100% by the individual defendant has been found to be a "direct personal benefit." *Nick Corp. v. JNS Aviation, LLC (In re JNS Aviation, LLC)*, 376 B.R. 500, 530–31 (Bkrtcy. N.D. Tex.2007) (owners of an aviation

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(4) before the transfer was made or obligation was incurred, the debtor had been sued or threatened with suit; (5) the transfer was of substantially all the debtor's assets; (6) the debtor absconded; (7) the debtor removed or concealed the assets; (8) the value of the consideration received by the debtor was reasonably equivalent to the value of the asset transferred or the amount of obligation incurred; (9) the debtor was insolvent or became insolvent shortly after the transfer was incurred; (10) the transfer occurred shortly before or shortly after a substantial debt was incurred; and (11) the debtor transferred the essential assets of the business to a lienor who transferred the assets to an insider of the debtor."). § 24.005(b). If several of the badges of fraud are found, they can give rise to an inference of fraud. *Roland v. U.S.*, 838 F.2d 1400, 1403 (5th Cir. 1988).

company against which a creditor obtained a default judgment, transferred the aviation company's assets to a newly formed entity to avoid satisfying the judgment; affirming bankruptcy court's findings of actual fraud and direct personal benefit). The same where the defendant had direct ownership and/or a financial interest in various corporate entities that received diverted sums due to another undercapitalized entity. *McCarthy*, 251 S.W.3d 573. "Any benefit" bestowed on the company is a personal benefit to the majority owner and controller. *David W. Morrison Western Builders of Amarillo, Inc. v. Morrison (In re David W. Morrison Western Builders of Amarillo, Inc.)*, 361 B.R. 107, 120 (Bkrtcy. W.D. Tex. 2007) (concluding under article 2.21(a)(2) that president and majority shareholder of an excavation company, Morrison, received direct personal benefit from misrepresenting the dire financial health of the corporation to obtain a contract for the corporation to keep the corporation in business and draw his substantial salary and maintain his lifestyle), *aff'd,* 555 F.3d 473 (5th Cir. 2009).

Husky argues that Ritz's transfer of $1.2 million of the insolvent Chrysalis's cash to entities of which Ritz owned and/or controlled substantial percentages comprised a "direct personal benefit" to Ritz within the meaning of § 21.223(b). Ritz even testified at trial that the transfers personally benefitted him. # 2–9, p. 66:19–21 (transfers to CapNet Securities); 66:23–67:6 (transfers to Clean Fuels or Gulf Coast Fuels); 67:7–10 ($96,000 transferred from Chrysalis to Dynalyst Manufacturing); 67:11–17 (all $1.2 million). Husky argues that the bankruptcy court erred as a matter of law in failing to recognize these

fraudulent transfers were "actual frauds" within the meaning of Tex. Bus. Orgs.Code § 21.223(b).

Regarding the second issue of law, (did the bankruptcy court err when it held that Husky could not prevail under 11 U.S.C. § 523(a)(2)(A) because Husky had failed to prove a fraudulent misrepresentation by Ritz that Husky relied upon?), Husky maintains that the exception to discharge in bankruptcy "for money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained by false pretenses, a false representation, or actual fraud" under 11 U.S.C. § 523(a)(2)(A) is also "not limited to 'fraudulent misrepresentation.'" *McClellan*, 217 F.3d at 892–93 (reversing bankruptcy court and holding "the statute makes clear that actual fraud is broader than misrepresentation") (citing 4 *Collier on Bankruptcy* § 523.08[1] [e], p. 523–45. (15th ed., Lawrence P. King, ed., 2000), defining actual fraud as "any deceit, artifice, trick, or design involving direct and active operation of the mind, used to circumvent and cheat another").[14] The Seventh Circuit opined, "Nothing in the Supreme Court's opinion [in *Field v. Mans*, 516 U.S. 59, 68 (1995)] suggests that misrepresentation is the only type of fraud that can give rise to a debt that is not dischargeable under section 523(a)(2)(A)." *Id.* at 892. Although misrepresentation is "the most common type of fraud," cases holding that fraud equals misrepresentation are often "cases in which the only fraud charged was misrepresentation." *Id.* In finding that the fraudulent transfers asserted in

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[14] *In accord, Mellon Bank, N.A. v. Vitanovich (In re Vitanovich)*, 259 B.R. 873, 876–78 (6th Cir. BAP 2001); *Diamond v. Vickery (In re Vickery)*, 488 B.R. 680, 691 (10th Cir. BAP 2013).

McClellan were actual frauds that would justify a denial of the debtor's discharge under § 523(a)(2)(A), the Seventh Circuit wrote,

> No learned inquiry into the history of fraud is necessary to establish that it is not limited to misrepresentations and misleading omissions. "Fraud is a generic term, which embraces all the multifarious means which human ingenuity can devise and which are resorted to by one individual to gain an advantage over another by false suggestions or by the suppression of truth. No definite and invariable rule can be laid down as a general proposition defining fraud, and it includes all surprise, trick, cunning, dissembling, and any unfair way by which another is cheated." [citation omitted]
>
> *Id.* at 893 ("here the transfer involved actual fraud" because "the debtor's brother was deliberately attempting to thwart *McClellan*'s effort to collect the debt due him"). Thus the bankruptcy court erred as a matter of law in limiting the fraud to misrepresentation, insists Husky.

Relating to Husky's final issue (Did the bankruptcy court err when it held that Husky could not prevail under 11 U.S.C. § 523(a)(6) because Ritz's fraudulent transfers of Chrysalis's cash were not a willful or malicious injury to Husky?), Husky notes that the bankruptcy judge found that the record was "wholly devoid" of evidence that Ritz willfully and maliciously injured Husky or Husky's property and therefore could not prevail under 11 U.S.C.

§ 523(a)(6). [15] Husky finds that this conclusion conflicts with the bankruptcy court's findings about Ritz's fraudulent transfers,[16] that Ritz "orchestrated" the fraudulent transfers, that Ritz "drained Chrysalis of a lot of money," [17] i.e., $163,999.38, and Judge Bohm's stated belief that "what Mr. Ritz did should not be allowed." [18] Judge Bohm criticized Husky's complaint for making only a "glancing reference" to § 523(a)(6) and Husky for failing to do any briefing on the statute. Husky states that its briefing focused on Ritz's fraudulent transfers, which it argues should except Ritz's debt from discharge under either § 523(a)(2) and § 523(a)(6). Husky further notes that a number of courts suggest that when a debtor's conduct is willful and malicious, the creditor should seek nondischargeability under both statutes. *See, e.g., Stokes v. Ferris*, 150 B.R. 388, 392 (W.D. Tex. 1992); *McClellan*, 217 F.3d at 896 (Ripple, J., concurring). A wrongful act done intentionally, which necessarily produces harm or which has a substantial certainty of causing harm and is without just cause or excuse is "willful and malicious" within the meaning of § 523(a)(6). *Miller v. J.D. Abrams, Inc.*, 156 F.3d at 601.

Husky urges that Judge Bohm's finding that there was no proof of willful and malicious injury appears to be based on his erroneous conclusion that a fraudulent transfer is not an "actual fraud" under Tex. Bus. Orgs.Code § 21.223(b). Ritz's draining

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[15] App. A, p. 16.

[16] App. A, pp. 3–4. ¶¶ 7–13.

[17] Doc. 20, 7:21–8:11.

[18] *Id.*, 11:16–19.

Chrysalis's cash and transferring it to his other companies to avoid paying Husky the $163,999.38 that Chrysalis owed Husky is an "actual fraud" under § 21.223(b), and therefore a "malicious and willful tortious conduct." Thus Ritz's debt to Husky should be excepted from discharge under § 523(a)(6).

Appellee's Brief (# 10)

Ritz objects to Husky's statement of facts first with regard to Husky's characterization that the transfers of cash from Chrysalis to seven entities, all active business operations, were made without Chrysalis's receiving equivalent value. Ritz concedes that the transfers were made, authorized by him, but argues that they were repayments of loans that these entities extended to Chrysalis on a continuous basis to finance its business operations. Ritz provides details about each. # 10 at pp. 1–6. He also claims that before 2006 there was a plan to merge two of them (ComCon a/k/a Virtra Merger and Dynalyst Manufacturing) with Chrysalis into a single business operated by ComCon, which accounted for a number of the loans and repayments, but the proposed merger failed in 2007.

Next, Ritz addresses the § 523(a)(2) claims. Acknowledging that Judge Bohm correctly stated the traditional elements of a claim for "actual fraud" under Texas common law (Mem. Op. at pp. 12–13), the Fifth Circuit has stated the same elements for a § 523(a)(2) dischargeability claim, but Ritz describes the elements slightly differently: the objecting creditor must show by preponderance of the evidence that (1) the debtor made representations (2) that the debtor knew were false when he made them, (3) the representations were made with the intention and

purpose to deceive the creditor, (4) the creditor relied on the representations, and (5) the creditor suffered losses as a proximate result of the representations. *RecoverEdge*, 44 F.3d at 1293. Observing that a claim for "actual fraud" can be based on an affirmative misrepresentation, on a failure to disclose if there is a duty to disclose, or on an affirmative concealment of material facts, Ritz maintains that there is no evidence that he made any misrepresentations or intentionally concealed any material facts from Husky. Ritz had no duty to disclose, first because he never made any partial disclosures to and he did not have a fiduciary relationship with Husky. Furthermore, such a claim must fail because Husky never pleaded a failure to disclose in the complaint or joint pretrial order. Instead the Complaint alleged that the checks signed by Ritz and given to Husky were bad, but even that claim was dropped at trial when it became apparent that Ritz's father had signed the checks. Husky waived any claim for failure to disclose by not pleading it or arguing it during trial. Second, the duty to disclose claim fails as a matter of law because such a duty arises only where there is a partial disclosure or a fiduciary duty. Ritz had no contact, dealings or miscommunications with Husky or any of its representatives until mid-January 2007, after Chrysalis had shipped all of its products to Chrysalis and Ritz attempted to resolve the dispute, so he did not make a partial disclosure that might trigger such a duty to disclose. Judge Bohm found there was no fiduciary relationship between Ritz and Husky, and Husky did not contest that ruling on appeal.

Actual fraud "'consists of any deceit, artifice, trick or design involving direct and active operation of the

mind, used to circumvent and cheat another—something said, done or omitted with the design of perpetrating what is known to be a cheat or deception.'" *RecoverEdge*, 44 F.3d at 1293, *quoting 3 Collier on Bankruptcy* ¶ 523.08 at 523–57 to 523–58 (footnote omitted). Husky's claims that Ritz engaged in an "unlawful artifice, device, or scheme to defraud" Husky fail because Ritz (1) did not make any false representations and failed to disclose or to intentionally conceal facts; (2) had no communications, interactions or dealings with Husky; and (3) had no fraudulent intent to deceive that was relied upon by Husky. Furthermore Husky's fraud claim fails as a matter of law because the property obtained by Chrysalis was not obtained because of any fraudulent conduct. Citing cases, Ritz argues that Texas common law as a matter of law shows that the facts of this case could not sustain a claim of actual fraud based on Husky's newly pleaded theory because there is no false representation, nor duty to disclose intentional concealment of a material fact, nor evidence of scienter. While Ritz agrees that "'actual fraud as used in 11 U.S.C. § 523(a)(2)(A) is not limited to intentionally engages in a scheme to deprive or cheat another of property or of a legal right, that debtor has engaged in actual fraud and is not entitled to the fresh start provided by the Bankruptcy Code.'" *In re Lewis*, No. 09–41111, ADV 09–4101, 2010 WL 1379770, at *3 (Bkrtcy. E.D. Tex. Mar. 30, 2010) (*quoting Mellon Bank, N.A. v. Vitanovich (In re Vitanovich)*, 259 B.R. 873, 877 (6th Cir. BAP 2001)), *aff'd, Lewis v. Hill*, No. 4:10cv242, 2011 WL 1299613 (E.D. Tex. Mar. 31, 2011). The Bankruptcy Code "does not permit bankruptcy courts to 'act as roving commission[s] to do equity.'" *Id.* at

*4, *citing Southmark Corp. v. Grosz*, 49 F.3d 1111, 1116 (5th Cir. 1995). Actual fraud is limited to "frauds involving 'moral turpitude or intentional wrong; fraud implied in law which may exist without imputation of bad faith or immorality, is insufficient.'" *RecoverEdge*, 44 F.3d at 1292.

Regarding claims under § 523(a)(6), Husky has the burden to prove that Ritz had either a subjective intent to harm Husky by causing Chrysalis not to pay Husky for the goods Chrysalis had received from Husky or that Ritz engaged in conduct that was substantially certain to harm Husky or its property by not receiving that payment. Ritz contends there is no evidence that he committed an act of willful and malicious injury, or that he had a subjective motive to not pay Husky. Indeed the evidence revealed that Ritz had no part in the purchase of the goods and was unaware of the unpaid debt until after Husky had already sold and delivered the goods to Chrysalis. Nor does the record contain any evidence that Ritz acted with intent to deprive Chrysalis of payment. Second there is no evidence that Husky was objectively certain not to receive payment as a result of the transfers. When the transfers were occurring, Chrysalis was open, operating, manufacturing product, paying employees, and producing income until May 2007, when it stopped.

Ritz insists that Husky's complaint never pleaded or argued any claim for relief under TUFTA, i.e., that Ritz intended to hinder, delay, or defraud creditors or that transfers lacked reasonably equivalent value,[19] but only asked to court to void "all fraudulent

[19] Tex Bus. & Com.Code §§ 24.005(a) & (b); 24.006(a).

transfers to the extent necessary to satisfy Plaintiff's claims" and in the joint pretrial order stated that "Chrysalis's fraudulent transfer ... was an actual fraud against the rights of Husky and personally benefitted Ritz." [20] Husky did state in closing argument and in its brief (# 90, 10) that Ritz violated TUFTA § 24.006(b) and that this violation automatically supports a finding of actual fraud under Texas and federal common law, but Ritz maintains that the equation is incorrect. While findings of the bankruptcy court could support the legal conclusion that Ritz violated TUFTA, the bankruptcy court rejected these facts when it decided

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[20] Husky responds that transfers are also statutorily fraudulent if made to an "insider" while the debtor was insolvent, as it has alleged under Texas Business and Commerce Code § 24.006(b), which is part of TUFTA. Section 24.006(b) provides,

> A transfer made by a debtor is fraudulent as to a creditor whose claim arose before the transfer was made if the transfer was made to an insider for an antecedent debt, the debtor was insolvent at the time, and the insider had reasonable cause to believe that the debtor was insolvent.

See Telephone Equip. Network v. TA/Westchester Place, 80 S.W.3d 601, 609 (Tex. App.—Houston [1st Dist.] 2002, no pet.) (An "'insider' is an entity whose close relationship with the debtor subjects any transactions made between the debtor and the insider to heavy scrutiny"; courts consider the closeness of the relationship between the transferee and the debtor and whether the transactions were at arm's length), *citing Matter of Holloway*, 955 F.2d 1008, 1009–11 (5th Cir. 1992). "Insider" under the statute includes "a corporation of which the debtor is a director, officer, or person in control." *Holloway*, *id.*, citing Tex. Bus. & Com.Code § 24.002(7). Judge Bohm found that Chrysalis was insolvent at all relevant times and that Ritz was a director, officer or person in control of each of the transferee entities; thus Ritz's eight transfers were fraudulent under Texas law.

that Ritz was not guilty of actual fraud. Judge Bohm properly refused to apply TUFTA concepts relating to fraudulent transfers into the actual fraud analysis under § 523(a)(2).

It is well established that scienter or fraudulent intent is a necessary element of actual fraud, e.g., as in debts obtained by frauds involving "moral turpitude or intentional wrong, and any misrepresentations must be knowingly and fraudulently made," but the bankruptcy judge did not find that Ritz acted with fraudulent intent. *Acosta*, 406 F.3d at 372. Ritz claims that he justified the transfers from Chrysalis to the seven entities by demonstrating that the inbound transfers made by the seven entities (loans to pay Chrysalis's debt and payroll obligations) exceeded the outbound by $924,000, mostly in very close timing to the outbound transfers.

Ritz observes that Husky relies on *McClellan*, 217 F.3d 890 (holding that a damage award issued as a result of a fraudulent transfer made with an actual intent to hinder, delay or defraud creditors qualifies as a type of nondischargeable "actual fraud" under § 523(a)(2)). Ritz argues that *McClellan* demonstrates that Ritz's conduct does not constitute actual fraud. In *McClellan* the Seventh Circuit has a lengthy discussion of the difference between constructive fraud, transfers for less than adequate consideration, and actual fraud, transfers made with an intent to hinder or delay creditors. Only actual fraud satisfies the fraud exception to the dischargeability of debts. *Id.* at 894. As the Seventh Circuit wrote, *id.*,

> The distinction between actual and constructive fraud is the key to this case in two distinct senses. *First*. To transfer property for less than adequate consideration may be desperate, foolish, or imprudent, and the receipt of such a transfer a pure windfall, but neither the transfer nor the receipt is in and of itself dishonest, and so neither is an appropriate ground for refusing to allow the debtor to discharge the debt arising from the transfer and thus to get on with his life without the debt hanging over his head.[21]

Ritz emphasizes that Judge Bohm found that the transfers were made without reasonably equivalent value, a finding that could support a conclusion of constructive fraud. Judge Bohm did not find that Ritz made the transfers with a specific intent to

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[21] Husky objects that Ritz has quoted this section out of context, eliminating key sentences that follow it and qualify it:

> The situation is entirely different, and the debtor's equities and argument for discharge much weaker, when the debtor is guilty of intent to defraud. The purpose of section 523(a)(2)(A) in confining nondischargeability to actual fraud is merely to recognize this difference and thus to exclude constructive fraud.

217 F.3d at 894. The allegation in *McClellan* was that "the transfer involved actual fraud; the debtor's brother was deliberately attempting to thwart McClellan's effort to collect the debt due him," i.e., the brother and sister were acting "in cahoots" and the sister was a "full and equal participant in her brother's fraud." *Id*. Husky contends that the same reasoning applies here, where Ritz was transferring Chrysalis's cash to *himself* by way of companies he owned and controlled; he and his company were "in cahoots" and full and equal participants in the scheme to defraud Husky, so Ritz should be denied a discharge under § 513(a)(2).

hinder or defraud creditors. Moreover, insists Ritz, the record does not support a finding that the transfers were made with an intent to hinder or delay creditors. Instead, the facts demonstrate at most constructive fraud in that (1) the inbound transfers exceeded the outbound by $914,000; (2) Chrysalis continued manufacturing until May 2007; (3) in February 2007 Ritz executed a personal guarantee of an unpaid $133,000 debt for parts owed to Arrow Electronic; and (4) the business operations generated gross income in excess of its ongoing payroll obligations until May 2007.

Husky also cites *McCarthy*, 251 S.W.3d 573, but, according to Ritz, misinterprets it as holding that a fraudulent transfer under Tex. Bus. & Com.Code § 24.001 automatically constitutes actual fraud as contemplated by Texas common law and Tex. Bus. Orgs.Code § 21.223(b). He insists that *McCarthy* did not involve a fraudulent conveyance under TUFTA and did not deal with allegations that the shareholder transferred assets for unfair consideration (constructive fraud) or with intent to defraud creditors (actual fraud). TUFTA addresses fraudulent transfers to third parties in order to place the assets beyond the reach of creditors trying to collect their debts. Transfers that violate the statute can be made either without "reasonable equivalent value," which does not constitute actual fraud, or with intent to hinder or delay, which may constitute actual fraud under *McClellan*. In *McCarthy*, the defendant used a corporation as a front to borrow funds and order wallboard on credit so he could divert the funds to his personal use and benefit, i.e., conversion (taking the property of another without consent for the taker's own use and benefit), not a

fraudulent conveyance (transferring property owned by the debtor to a third party to avoid satisfying the claims of creditors). Ritz could not find a Texas case holding that any fraudulent conveyance, as opposed to conversion of assets, constitutes actual fraud.

Even if Husky is correct that actual fraud includes more than affirmative misrepresentations, even if the transfers can be construed as a fraudulent artifice or device, and even if Ritz has the requisite scienter, Ritz contends that Husky's § 523(a)(2) claim still fails as a matter of law because Chrysalis did not obtain the property by means of any fraudulent conduct, and the debt incurred by Chrysalis to Husky was the result of the sale of property, not of actual fraud.[22]

Moreover the statute also requires the creditor to prove a direct nexus between the debt for the money

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[22] Husky responds that it never argued that Chrysalis fraudulently obtained any property. It suggests that Ritz's error came from his assumption that Ritz's fraud occurred at the inception of the commercial debt owed by Chrysalis to Husky. The Bankruptcy Code broadly defines "debt" as any "right to payment," liquidated or unliquidated, disputed or undisputed, legal or equitable." 11 U.S.C. § 101(12) and § 101(5); *Johnson v. Home State Bank*, 501 U.S. 78, 83–84 and n. 5 (1991). In *McClellan* the original debt was not the one in dispute: "The debt at issue here is the debt that the sister incurred to McClellan by committing a fraud against him. Because it was an actual fraud, the debt that gave rise to it is not dischargeable." 271 F.3d at 895. The McClellan court further observed, "Stated differently, the brother gave his sister McClellan's security interest, McClellan's property, which means that she was taking property from —defrauding— McClellan directly." *Id*. Here the debt rose as a matter of law when Ritz prevented Husky from collecting from Chrysalis by draining the insolvent Chrysalis of $1.1 million it had remaining and transferring it to companies owned and controlled by Ritz and used as mere conduits to himself. *Id*.

property or services and the fraudulent activity, i.e., the actual fraud must have been part of the transaction which created the debt incurred to by the parts from Husky. *Field v. Mans*, 516 U.S. at 64 (barring discharge of debts "traceable to" fraud); *Nunnery v. Rountree* (In re Rountree), 478 F.3d 215, 219 (4th Cir. 2007) ("The plain language of [§ 523(a)(2)] ... requires the debtor to have obtained money, property, services, or credit through her fraud or use of false pretenses.... 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, services, or credit."); *McCrory v. Spigel*, 260 F.3d 27, 32 (1st Cir. 2001) (although the transactions involved fraud, there was no proof of a direct link between the fraud and the debt). The sale of parts from Husky to Chrysalis was handled by Chrysalis's California sales representatives; Ritz had no part in it. Thus there was no nexus between the debt for the sale of parts and any fraud committed in connection with Ritz's transfers of the cash.

Ritz further argues that *McClellan* was wrongly decided for at least two reasons. First, before it was issued in 2000, a fraudulent conveyance, which was a matter of state statute, was never viewed as actual fraud. The Bankruptcy Code has statutes that address the avoidance and denial of discharge relating to fraudulent transfers. 11 U.S.C. §§ 548, 550, and 727. Ritz asserts that it was not likely that Congress viewed fraudulent conveyance as an element of nondischargeable fraud when the Bankruptcy Code already included statutes addressing the same subject. Second, *McClellan* in effect deletes the "for money, property or services ...

to the extent obtained by" clause out of the statute by providing an end run around the "obtained by" requirement; it helped courts to create a new debt for damages relating to the fraudulent transfer to a third party instead of a transfer of money, property or services from the creditor to the debtor. *McClellan*, 217 F.3d at 895. At the least the *McClellan* interpretation is strained; at worst it is judicial activism that should not be followed. Even if the Court finds the *McClellan* interpretation to be reasonable, Husky did not plead or try the case to collect damages for a fraudulent conveyance, Ritz argues, but only to collect the amount still due on the sale of the parts to Chrysalis.

Regarding Husky's claim under § 523(a)(6), Husky bore the burden to prove by a preponderance of evidence that Ritz acted willfully and maliciously. *Grogan v. Garner*, 498 U.S. 279, 286 (1991). A willful injury is "a deliberate or intentional injury, not merely a deliberate or intentional act that leads to injury," and does not arise from recklessly or negligently inflicted injuries. *Kawaauhau v. Geiger*, 523 U.S. 57, 61 (1998). The statute addresses intentional torts that usually require the actor to intend the consequences of an act, not just the act itself. *Restatement (Second) of Torts § 8A*, cmt. a, p. 15 (1964). An injury by the debtor to another entity is willful and malicious if there is either an objective substantial certainty of harm or a subjective motive to cause harm. *In re Matter of Miller*, 156 F.3d 598, 601 (5th Cir. 1998), *cert. denied*, 526 U.S. 1016, 119 (1999). Ritz's job was confined to the financial aspects of Chrysalis and its efforts to find more funds to keep the business operational. Ritz only learned of the debt to Husky in mid January 2007, and then he

attempted to resolve the matter with Husky's representatives. Ritz submits two tables summarizing transfers in and out of Chrysalis and the income earned during this time period. # 10 at pp. 32, 33. Chrysalis paid employees at the California plant through May 2007 and continued ordering and paying for parts purchased from Dynalyst Manufacturing Corporation. He also signed the personal guarantee for approximately $133,000 for debts to Arrow Electronic. He maintains these facts do not support Husky's imposed image of a greedy, desperate owner trying to drain the company of its assets or an objective substantial certainty that Chrysalis would be unable to pay the debt it owed to Husky.

Ritz insists there is no evidence that he had a subjective motive to cause harm, i.e., that he subjectively intended for Chrysalis to purchase material from Husky with the intent that Husky not receive payment, especially because he had no part in the purchasing of those goods. Nor is there objective substantial certainty that the transfers would result in Husky's being deprived of payment. [23] From

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[23] Husky responds that the issue is not what Ritz subjectively intended during the material purchasing process, when the debt from Chrysalis to Husky was created, but what Ritz subjectively intended when he transferred $1.1 million of Chyrsalis's cash to other companies Ritz owned and/or controlled. A transfer is fraudulent if the debtor made the transfer without receiving a reasonable equivalent value in exchange and the debtor was insolvent at the time, as Judge Bohm found here under Tex Bus. Org.Code § 24.006(b). In other words, he found that Ritz subjectively intended to commit fraud.

> As for objective substantial certainty that the transfers would result in Husky's being deprived of payment, as a matter of law transfers not supported by promissory notes

January 2006 to May 2007, more that $2.8 million were transferred in to Chrysalis to keep California manufacturing operations in business, the inbound transfers were loans, and they exceeded the outbound transfers by $924,000. Testimony by Nancy Finney showed that the transfers were intended to be loans, not capital contributions, and the company books also reflected that they were loans.

Husky's Reply (# 16)

Husky characterizes Ritz's arguments and reasoning as deeply flawed. First, relating to Husky's first point of error, Ritz's claim that the $1.1 million in transfers were loan payments is based on evidence outside the record, is contrary to Fifth Circuit authority, and was waived when he failed to raise that challenge in a cross appeal. The two tables he included to show that the funds going into Chrysalis were loan repayments are newly created and are based on at least two exhibits that were not admitted into evidence at trial. Ritz's Brief, p. 1, n. 1. Second, a district court may not set aside a bankruptcy court's findings of fact unless they are clearly erroneous." Fed. R. Bank. R. 8013. "As long as there are two permissible views of the evidence," the bankruptcy court's "choice between competing views" is not clearly erroneous. *Acosta*, 406 F.3d at 373. The bankruptcy judge's decision need only be

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reflecting interest rates and repayments are not "loans," but capital contributions. Bartley Tex. *Builders Hardware, Inc. v. Swor*, Adv. No. 07–03280, Civ. A. H–08–644, 2008 WL 5378068, at *2 (S.D. Tex. Dec. 24, 2008) ("The absence of either documentation of the loan or interest payments indicates capital rather than debt."), *rev'd on other grounds, In re Swor*, 347 Fed.Appx. 113, 116 (5th Cir. 2009).

"plausible in light of the record viewed as a whole." *Id.* Third, as a matter of law, undocumented "loans" with no repayment terms or interest rates, as is true of the transfers into Chrysalis here, are considered to be capital contributions, not loans. *Bartley Tex. Builders Hardware, Inc. v. Swor*, Adv. No. 07–03280, Civ. A. H–08–644, 2008 WL 5378068, at *2 (S.D. Tex. Dec. 24, 2008) ("The absence of either documentation of the loan or interest payments indicates capital rather than debt."), *rev'd on other grounds, In re Swor*, 347 Fed.Appx. 113, 116 (5th Cir. 2009) ("Although Mrs. Swor characterizes the funds they infused into the business as loans and the checks as repayments, the district court correctly treated money provided to the business as capital contributions: A loan is a capital contribution when payments correlate with the debtor's sense of his own financial situation and the debtor repays the money at his own discretion. The Swors had to show the court—an objective outsider—that they were debtors of their company, not just unwise investors. The Swors cannot prove debt. The absence of either documentation of the loan or interest payments indicates capital rather than debt. The Swors never had its company issue a promissory note for the loan nor did they enable the company to pay interest regularly to them. We agree with the district court that the bankruptcy court clearly erred in its conclusion that the Swors had loaned money to Swor's Glass."). *See also* 15A Charles Alan Wright, *et al.*, *Federal Practice & Procedure Juris.* § 3904 (2d ed., database updated Apr. 2014). The Court agrees.

Husky asserts that Ritz's biggest hurdle in claiming that the bankruptcy court erred in finding that Ritz's transfers were made "without Chrysalis receiving

reasonably equivalent value" is that Ritz did not raise this argument by cross-appeal. "Although an appellee may argue any ground available to support affirmance of a judgment, he may not argue for a ruling that would expand his legal rights under the judgment that was entered unless he raises it by cross-appeal." *Weaver v. Tex. Capital Bank, N.A.*, 660 F.3d 900, 905 (5th Cir. 2011), *cert. denied*, ——U.S. —— (2012); *see also Castellano v. Fragozo*, 352 F.3d 939, 960 (5th Cir. 2003) (en banc), *cert. denied*, 543 U.S. 808 (2004). Thus Ritz has waived any argument that Judge Bohm's findings that Ritz's transfers were fraudulent was erroneous.

Ritz's argument that *McClellan* was wrongly decided is not supported by any case. Instead, *McClellan* has been followed by numerous courts in several federal circuits. # 16 and nn. 6 & 7. As demonstrated in footnote 19 *supra*, Ritz's claim that *McClellan* stood for the proposition that fraudulent transfer is constructive fraud is incorrect. Moreover Husky insists that it pled and argued its fraudulent transfer claim at trial. Even if it had not, Ritz waived its complaint about the sufficiency of Husky's pleading by not challenging it in the bankruptcy court. In addition, Ritz's transfers of Chrysalis's money are "actual frauds" under TUFTA, Tex. Bus. & Com.Code §§ 24.005(a), 24.006. Husky points to the second sentence of its closing argument at trial in which Husky asserted a claim under TUFTA even though it did not use the acronym, but cited and read the entire text of Tex. Civ. Prac. & Rem.Code § 24.006(b)[24] and argued evidence of five badges of

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[24] Husky observes that this Court can take judicial notice of the fact that § 24.006(b) is part of TUFTA. Husky also notes that

fraud immediately afterward. # 12, $:11–9:3. Husky further points out that its complaint prays for relief as a result of Ritz's fraudulent transfers, details the specific amounts involved, names each transferee and the amount of the transfer it received, identifies the time period when the transfers were made, and specifies the relationship of each transferee to Ritz, all of which satisfy Rule 9(b). These fraudulent transfers make Ritz personally liable for Chrysalis's corporate debt to Husky under Tex. Bus. & Org.Code § 21.223(b). Under *McClellan* and its progeny, Husky maintains, Ritz's transfers are also "actual fraud" that warrants the bankruptcy court's denial of a discharge under § 523(a)(2)(A). *McClellan*, 217 F.3d at 893 ("'section 523(a)(2)(A) is not limited to "fraudulent misrepresentation"'"); *Mellon Bank, N.A. v. Vitanovich (In re Vitanovich)*, 259 B.R. 873, 877 (6th Cir. BAP 2001) ("[B]y distinguishing between 'a false representation' and "actual fraud," the statute makes clear that actual fraud is broader than misrepresentation.'", and quoting Collier on Bankruptcy that actual fraud encompasses "any deceit, trick or design involving direct and active operation of the mind, used to circumvent and cheat another").

Husky asserts that Ritz's debt to Husky is nondischargeable under § 523(a)(2) because Ritz obtained Husky's property by fraudulent transfer to *himself*. Husky argues that the debt at issue here is not the debt that Chrysalis owed Husky for goods sold and delivered to Chrysalis, but the debt which arose by operation of law from Ritz's fraudulent

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Ritz ultimately agreed that Husky asserted claims under TUFTA in the closing argument. Ritz's Brief, p. 15.

transfers to companies Ritz owned and controlled. In giving Chrysalis's cash to companies that Ritz owned and controlled, Ritz was taking property from, i.e., defrauding, Husky directly.

Even if Ritz's fraudulent transfers are not "actual frauds" for purposes of an exception to discharge in bankruptcy under § 523(a)(2), contends Husky, they are willful and malicious acts warranting an exception to discharge under § 523(a)(6).

In sum, Husky maintains that Judge Bohm erred in concluding that there was no "actual fraud" by Ritz. Actual fraud is not limited to misrepresentations at inception, but includes fraudulent transfers in violation of TUFTA. The bankruptcy court's other two errors of law, i.e., that exceptions to discharge in bankruptcy under § 523(a)(2)(A) and § 523(a)(6) do not apply here, arise from Judge Bohm's erroneous narrow definition of "actual fraud." The Court should find from the facts at trial that personal liability should be imposed on Ritz for Chrysalis's $163,999.48 contractual debt to Husky under Tex. Bus. Org.Code § 21.223(b) and should except Ritz's debt from discharge in bankruptcy under 11 U.S.C. §§ 523(a)(2)(A) and 523(a)(6).

Court's Decision

The Court addresses the first two points of error together: **(1) Did the bankruptcy court err when it ignored that fraudulent transfers pursuant to Tex. Bus. & Com.Code § 24.005 are "actual fraud" within the meaning of Tex. Bus. Org.Code § 21.223(b)? (2) Did the bankruptcy court err when it held that Husky could not prevail under 11 U.S.C. § 523(a)(2)(A) because Husky had failed to prove a fraudulent**

misrepresentation by Ritz that Husky relied upon?

The general rule of corporate exemption from liability in Texas is that the shareholder of a corporation

> may not be held liable to the corporation or its obligees with respect to ... any contractual obligation of the corporation or any matter relating to or arising from the obligation on the basis that the holder, beneficial owner, subscriber, or affiliate is or was the alter ego of the corporation or on the basis of actual or constructive fraud, a sham to perpetrate a fraud, or other similar theory[.]

Spring Street Partners–IV, LP v. Lam, 730 F.3d 427, 442 (5th Cir. 2013), quoting Tex. Bus. Org.Code § 21.223(a)(2). An exception is statutorily recognized "if the obligee demonstrates that the holder, beneficial owner, subscriber, or affiliate caused the corporation to be used for the purpose of perpetrating and did perpetrate an actual fraud on the obligee primarily for the direct personal benefit of the holder, beneficial owner, subscriber, or affiliate." *Id.*, quoting *id.* § 21.223(b). Within the meaning of the Business Organizations Code for piercing the corporate veil regarding a contractual obligation, "actual fraud" according to § 2.21 "involves dishonesty of purpose or intent to deceive." *Id.* at 443, citing *Tryco Enterprises, Inc. v. Robinson*, 390 S.W.3d 497, 508 (Tex.App.—Houston [1st Dist.] 2012, rev. dism'd). Because of the limitations on the liability of a corporate shareholder, when a plaintiff seeks to hold an individual shareholder liable, he must "pierce the corporate veil." *Id.* According to Texas law, "'an assertion of veil

piercing or corporate disregard does not create a substantive cause of action[;] ... such theories are purely remedial and serve to expand the scope of potential sources of relief by extending to individual shareholders or other business entities what is otherwise only a corporate liability.'" *Id.*, *quoting In re JNS Aviation, LLC*, 376 B.R. 500, 521 (Bankr. N.D. Tex. 2007), *aff'd,* 395 Fed.Appx. 127, 128 (5th Cir. 2010).

In *Castleberry*, 721 S.W.2d at 271–73, the Texas Supreme Court held that a court can ignore the corporate structure "'when the corporate form has been used as part of a basically unfair device to achieve an inequitable result.'" In *Castleberry*, the court further concluded that the corporate structure could be ignored even if the plaintiff showed only constructive fraud,[25] rather than actual fraud. *Id.* Subsequently, however, the Legislature in § 21.223(a)(2) and (b) limited that rule to require a plaintiff to prove "actual fraud" if it related to "any contractual obligation of the corporation." *Id.* at 444.

Because there was a contractual obligation between Husky and Chrysalis, and because Judge Bohm determined that Husky has shown that Ritz caused Chrysalis to be used for the purpose of

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[25] "'[C]onstructive fraud is the breach of some legal or equitable duty which, irrespective of moral guilt, the law declares fraudulent because of its tendency to deceive others, to violate confidence, or to injure public interests.'" *Spring Street*, 730 F.3d at 443, *citing Castleberry*, 721 S.W.2d at 273, *citing Archer v. Griffith*, 390 S.W.2d 735, 740 (Tex. 1965). For constructive fraud a plaintiff does not have to prove fraud nor an intent to defraud, but need only show that recognizing the corporate entity would effect an inequitable result. *Id.*, *citing Castleberry*, 721 S.W.2d at 272–73.

perpetrating and did perpetrate an actual fraud on its creditors primarily for Ritz's direct personal benefit, i.e., he drained Chrysalis of funds and fraudulently transferred those funds to other entities under his control and/or ownership, section 21.233 applies here to impose liability on Ritz, individually. Nevertheless, Judge Bohm also held that "actual fraud" under Texas law requires a material misrepresentation that was false in order to induce action or inaction, and he found that there was no misrepresentation by the debtor under the facts of this case. Thus he ruled that Husky failed to satisfy an essential element for establishing actual fraud for either § 21.223 and § 523(a)(2)(A).

This Court has found cases that do not require a misrepresentation to pierce the corporate veil to satisfy "actual fraud" under § 21.223(b) and the standard of "dishonesty of purpose and intent to deceive" for actual fraud, including the Fifth Circuit in *Spring Street*, 730 F.3d at 442. "Courts may deduce fraudulent intent from all the facts and circumstances," and the "generally look at the totality of a shareholder's actions to determine whether [a corporate director" committed actual fraud. *Id.* at 443, 445 (finding actual fraud where the defendant created an LLC to which it transferred assets and allowed the company's charter to lapse after it was sued). The Fifth Circuit concluded that Spring Street could pierce the corporate veil of DKL & DTL on the basis of fraud and impose individual liability on its owners, Long Lam and En Lam:

> We need not resolve whether the standard is invariably that of constructive fraud where fraudulent transfers have occurred, because Spring Street has offered ample evidence to

> demonstrate Long Lam and En Lam's actual fraud here. Spring Street as summarized this evidence as follows: (1) they "formed an LLC ten days after their brother Douglas Lam received notice that his debts were being accelerated"; (2) they "paid no consideration for a 25% interest each in his assets"; (3) they "personally signed a paper transferring one of those assets to another family member for no consideration"; (4) they "failed to disclosse this fact for over a year while their entity was involved in [this] litigation"; (5) they "tried to evade company liability under TUFTA by allowing the company charter to lapse"; and (6) they "then tried to evade individual liability by claiming that the charter had been reinstated." Long Lam and En Lam, along with the other DKL & DTL members, acted for their direct personal benefit, they had no other interest to serve.

730 F.3d at 445.

In *Tryco Enterprises, Inc. v. Robinson*, 390 S.W.3d 497, 508, 510 (Tex.App.—Houston [1st Dist.] 2012, pet. dism'd) (For a plaintiff to pierce the corporate veil and impose liability under an alter ego theory of liability, the plaintiff must demonstrate "(1) that the persons or entities on whom he seeks to impose liability are alter egos of the debtor and (2) that the corporate fiction was used for an illegitimate purpose."), the court of appeals held that a corporation, Tryco Enterprises, was used by its officers as a means of defrauding Robinson by transferring assets of Tryco that were subject to Robinson's judgment lien in a suit against Tryco to Crown Staffing, which the officers had previously

incorporated, leaving Tryco without assets to pay that judgment. There was no representation involved.

Therefore the remaining issue for the first and second points of error is whether such fraudulent transfers under Tex. Bus. & Commerce Code § 24.005[26] would qualify as "actual fraud" within the meaning of Texas Business Organizations Code § 21.223(b). A transfer is fraudulent under § 24.005 "if the debtor made the transfer ... with actual intent to hinder, delay, or defraud any creditor of the debtor. *Id.*, at § 24.005(a)(1). Fraudulent intent, and thus fraudulent conduct, may be inferred from "circumstantial evidence and the surrounding circumstances of the transactions." *Kaye v. Lone Star Fund v. (U.S.) LP*, 453 B.R. 645, 671 (N.D. Tex. 2011).

"[I]n the context of piercing the corporate veil, actual fraud ['dishonesty of purpose or intent to deceive'] in not equivalent to the tort of fraud." *Latham v. Burgher*, 320 S.W.3d 602, 607 (Tex.App.—Dallas 2010). To prevail on a fraudulent conveyance claim under § 24.005, a trustee must prove that the debtor made the transfers in question "with actual intent to hinder, delay, or defraud any creditor of the debtor. He may do so by circumstantial evidence, which TUFTA identifies as "badges of fraud," some of which are codified in a nonexclusive list in § 24.005(b). *In re Soza*, 542 F.3d 1060, 1066 (5th Cir. 2008). If the trustee can show four or five "badges of fraud"[27] on the part of the debtor, he can establish

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[26] The purpose of TUFTA is "to prevent debtors from defrauding creditors by placing assets beyond their reach." *Challenger Gaming Solutions, Inc. v. Earp*, 402 S.W.3d 290, 293

[27] *See* footnote 12 of this Opinion and Order.

intent to commit actual fraud by the debtor. *Ingalls v. SMTC Corp. (In re SMTC Mfg. of Tex.)*, 421 B.R. 251, 199–300 (Bankr. W.D. Tex. 2009). Judge Bohm found the trustee had proven four badges of fraud by Ritz and therefore met the requirements for fraudulent transfer under § 24.005.

Nevertheless, Husky still cannot prevail. While the fraudulent transfer without a misrepresentation may qualify as actual fraud under § 21.223(b)(1) to pierce the corporate veil, it cannot meet the requirement under 11 U.S.C. § 523(a)(2)(A) to bar the discharge of the debt, which provides that a debtor may not be discharged from any debt for money to the extent that it was obtained by "false pretenses, a false representation or actual fraud." In *Field v. Mans*, 516 U.S. 59, 69 (1995), the United States Supreme Court observed that "'It is ... well established that "[w]here Congress uses terms that have accumulated settled meaning under ... the common law, a court must infer, unless the statute otherwise dictates, that Congress means to incorporate the established meaning of these terms."'" It held *inter alia* that the terms "false pretenses, a false representation, or actual fraud" are to be given their ordinary common law meanings in 1978. It indicated, "Then, as now, the most widely accepted distillation of the common law of torts was the *Restatement (Second) of Torts* (1976), which should apply rather than a particular state's law. *Id.* at 70, n. 9. The Fifth Circuit accordingly, citing *Field*, has opined that the terms, "false pretenses," "false representation," and "actual fraud" in § 523(a)(2) are "terms of art ... [and] are common law terms." *AT & T Universal Card Services v. Mercer (In re Mercer)*, 246 F.3d 391, 402 (5th Cir. 2001). Nevertheless the

Restatement does not define "fraud," nor "actual fraud, but references only "fraudulent misrepresentation." *Id.* The *Restatement (Second) of Torts* § 525 (1976) defines fraudulent misrepresentation as follows:

> One who fraudulently makes a misrepresentation of fact, opinion, intention or law for the purpose of inducing another to act or to refrain from action in reliance upon it, is subject to liability to the other in deceit for pecuniary loss caused to him by his justifiable reliance upon the misrepresentation.

The Fifth Circuit has observed that it was unclear whether its earlier distinction among the three terms has survived *Field*, but decided it was not required in *Mercer* to address the question. *In re Mercer*, 246 F.3d at 394–95. In *General Electric Capital Corp. v. Acosta*, 406 F.3d 367, 372 (5th Cir. 2005), however, the Fifth Circuit identified the same elements for false pretenses, false representations and actual fraud.[28] Because the common law interpretation of § 523(a)(2)(A) requires a misrepresentation and there is no evidence here that Ritz made one, Husky's claim of nondischargeability under the statute fails.

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[28] Even if one assumed the Chrysalis promised to pay its debt to Husky in the future, Husky's claim under § 523(a)(2)(A) would still fail for lack of evidence of scienter. Chrysalis's promise to pay its debt to Husky in the future could be the basis of a nondischargeable debt under the actual fraud arm of § 523(a)(2)(A) if Husky had proved by a preponderance of the evidence that the debtor had no intention of fulfilling that promise at the time it was made. *In re Borschow*, 454 B.R. 374, 395 (Bkrtcy. W.D. Tex. 2011), *citing In re Roeder*, 61 B.R. 179, 181 (Bankr. W.D. Ky. 1986).

As for Husky's challenged reliance on *McClellan* v. *Cantrell*, 217 F.3d 890, 893 (7th Cir. 2000), contrary to Husky's argument, its broad interpretation of actual fraud under § 523(a)(2)(A) has not been accepted by everyone. Among appellate courts rejecting it is the First Circuit Court of Appeals. *See Palmacci v. Umpierrez*, 121 F.3d 781 (1997) (requiring false representation); *In re Spigel*, 260 F.3d 27, 32 (1st Cir. 2001). *See also Foley & Lardner v. Biondo (In re Biondo)*, 180 F.3d 126, 130 (4th Cir. 1999) (strictly examines misrepresentations); *Blacksmith Investments, LLC v. Woodford (In re Woodford)*, 403 B.R. 177, 186–87 (Bankr. D.Mass. 2009) (Feeney, J.) (*McClellan* reading was inconsistent with the Supreme Court's interpretation of actual fraud); *KMK Factoring, LLC v. McKnew* (In re McKnew), 270 B.R. 593, 618 n. 40 (Bankr. E.D. Va. 2001); *In re Kimmel*, 2006 WL 6810976, at *8 (9th Cir. BAP Cal. Dec. 29, 2006) ("Neither the Ninth Circuit nor this Panel has endorsed the approach taken to interpretation of § 523(a)(2)(A) in *McClellan* in any reported decisions," but "there is ample authority in this Circuit instructing that the provisions of the § 523(a)exceptions to discharge should be construed narrowly."), *citing Cal. Franchise Tax Bd. v. Jackson (In re Jackson)*, 184 F.3d 1046, 1051 (9th Cir. 1999). This Court has not found a decision from any court in the Fifth Circuit that has followed *McClellan*.

Therefore the Court agrees with Judge Bohm that since there is no representation involved in this Adversary Proceeding, Husky fails to prevail under § 523(a)(2)(A) to overturn the discharge of Chrysalis' debt to Husky.

(3) Did the bankruptcy court err when it held that Husky could not prevail under 11 U.S.C.

§ 523(a)(6) ("A discharge under 727 ... of this title does not discharge an individual debtor from any debt... for willful and malicious injury by the debtor to another entity or to the property of another entity") because Ritz's fraudulent transfers of Chrysalis's cash were not a willful or malicious injury to Husky?

Judge Bohm determined,

> The record is wholly devoid of any proof that the Debtor willfully and maliciously injured Husky or Husky's property. While Husky's complaint makes a glancing reference to 11 U.S.C. § 523(a)(6), that alone is not enough to preserve a claim under this provision—no exhibits were introduced, no testimony was adduced, and no briefing was done relating to § 523(a)(6) Husky provided goods to Chrysalis on an entirely unsecured basis.... Typically, complaints under § 523(a)(6) by creditors involved in a business transaction involve secured creditors who are seeking to prevent a discharge of a debt where the debtor has: (1) deliberately sold collateral out of trust and spent the sale proceeds; or (2) deliberately destroyed or damaged the collateral. *See, e.g., Friendly Fin. Serv. Mid–City, Inc. v. Modicue (In re Modicue)*, 926 F.2d 452 (5th Cir. 1991). This Court has found no case law where an unsecured creditor trade creditor *[sic]* has obtained a judgment for nondischargeability under § 523(a)(6) where the debtor simply failed to honor a contractual obligation to pay for the goods or services provided by that creditor. Accordingly, Husky may not prevail under 11 U.S.C. § 523(a)(6).

459 B.R. at 635. He noted, "'While an intentional breach of contract can be excepted from discharge under § 523(a)(6) when it is accompanied by malicious and willful tortious conduct, [Husky] ... failed to identify any tortious action by the [Debtor] that caused a willful and malicious injury.'" *Eagle Sindh, Inc. v. Desai (In re Desai)*, Adv. No. 07–04190, 2009 WL 2855735, at *6, 2009 Bankr. LEXIS 2609, at *19–20 (Bankr. E.D. Tex. Sept. 2, 2009). *Id.*, n. 11.

The Fifth Circuit has interpreted "willful" and "malicious" as one, with a single standard: "we hold that an injury is willful and malicious where there is either objective substantial certainty of harm or a subjective motive to cause harm." *Miller v. J.D. Abrams, Inc. (Matter of Miller)*, 156 F.3d 598, 606 (5th Cir. 1998).

"Secured creditors whose collateral was disposed of by the debtor often assert nondischargeability claims under § 523(a)(6)." 4 *Collier on Bankruptcy* ¶ 523.12(3) (16th ed. 2012). *See also In re Peckham*, 442 B.R. 62, 79 n. 7 (Bkrtcy. D.Mass. 2010) ("Litigation under section 523(a)(6) for willful and malicious injuries often arises in the context of conversion of collateral, resulting in courts' focusing on harm to creditors' economic interests."). Judge Bohm stated that he had "found no case law where an unsecured creditor ... has obtained a judgment for nondischargeability under § 523(a)(6) where the debtor has simply failed to honor a contractual obligation to pay for the goods or services provided by that creditor." 459 B.R. at 635. He emphasized that Husky failed to introduce any exhibits, testimony or briefing to support the 523(a)(6) dischargeability exception here, i.e., "rather than showing that Ritz deliberately sold collateral out of a trust or

deliberately destroyed or damaged collateral, Ritz merely failed to honor a contractual obligation to pay for goods or services provided by an unsecured trade creditor."

Not only did Husky fail to show by a preponderance of the evidence that Ritz acted willfully and maliciously, but this Court notes that as an unsecured creditor, Husky did not have a clearly valid claim, lien, right, interest or privilege to the monies transferred out of Chrysalis. A breach of contract suit that is an unsecured debt is dischargeable in bankruptcy. *In re Williams*, 466 B.R. 95, 106 (Bkrtcy. S.D. Tex. 2011).

Accordingly, for these reasons the Court AFFIRMS Judge Bohm's decision.

APPENDIX C

United States Bankruptcy Court
S.D. Texas
Houston Division

In re Daniel Lee RITZ, Jr., Debtor.
Husky International Electronics, Inc., Plaintiff,
v.
Daniel Lee Ritz, Jr., Defendant.

Bankruptcy No. 09-39895-H4-7.
Adversary No. 10-03156. Aug. 4, 2011.

MEMORANDUM OPINION REGARDING PLAINTIFF'S ORIGINAL COMPLAINT TO DENY DISCHARGEABILITY OF DEBT PURSUANT TO 11 U.S.C. § 523

[Adv. Docket No. 1]

JEFF BOHM, Bankruptcy Judge.

I. INTRODUCTION

This adversary proceeding concerns an individual debtor who authorized transfers of funds out of one corporation into the accounts of several other companies—all of which he controlled. As a result of these transfers, the one corporation was drained of all of its cash and, therefore, could not pay its creditors. One of these creditors has filed suit against the debtor, alleging that: (a) because of the debtor's actions, he has become personally liable for

the debt owed by the corporation; and (b) this debt is nondischargeable under 11 U.S.C. §§ 523(a)(2)(A), (a)(4) & (a)(6).[1] For the reasons set forth herein, this Court concludes that there is no debt to discharge because the plaintiff failed to establish any liability against the debtor. Therefore, the plaintiff cannot prevail under 11 U.S.C. §§ 523(a)(2)(A), (a)(4) & (a)(6).

II. STATUS OF THE MAIN CASE

Daniel Lee Ritz, Jr. (the Debtor or Ritz) filed his voluntary Chapter 7 petition on December 31, 2009. [Main Case, No. 09–39895, Docket No. 1]. The meeting of creditors was held on February 19, 2010. The case appeared to be routine with the exception of the timely filing of the pending adversary proceeding. Indeed, the Chapter 7 Trustee eventually represented that there were no assets available for distribution to pay claims; and, accordingly, on February 25, 2011, this Court signed a final decree closing the main case. [Main Case, No. 09–39895, Docket No. 34].[2] However, on June 2, 2011, the Trustee filed a Motion to Reopen the Chapter 7 Case by setting forth that the Trustee has received information that the Debtor had not disclosed all of his assets and that the case should be reopened. [Main Case, No. 09–39895, Docket No. 36]. On June 9, 2011, this Court signed the Order Granting this Motion to Reopen. [Main Case, No. 09–39895, Docket

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[1] Reference to any section (*i.e.*, §) refers to a section in 11 U.S.C., which is the United States Bankruptcy Code. Any reference herein to "the Code" refers to the United States Bankruptcy Code.

[2] The signing of the final decree with respect to the main case did not, however, resolve the pending adversary proceeding. The Court still had to hold the trial on this discrete dispute.

No. 37]. Accordingly, at this point, the Chapter 7 Trustee is conducting an investigation to determine whether there are, in fact, assets of sufficient value to make a distribution to creditors of this estate.

III. FINDINGS OF FACT[3]

1. On March 31, 2010, Husky International Electronics, Inc. (Husky) filed Plaintiff's Original Complaint to Deny Dischargeability of Debt Pursuant to 11 U.S.C. § 523 (the Complaint), which initiated this adversary proceeding. [Adv. Docket No. 1].
2. Prior to the filing of the Complaint and the filing of the bankruptcy petition, from 2003 to 2007, Husky sold and delivered goods to Chrysalis Manufacturing Corp. (Chrysalis), pursuant to a written contract. [Plaintiff's Ex. Nos. 1 & 3].
3. Chrysalis failed to pay for goods sold and delivered to Chrysalis by Husky in the amount of $163,999.38. [Plaintiff's Ex. No. 2].
4. At all relevant times, the Debtor was in financial control of Chrysalis.[4] Moreover, he was the director and owner of at least 30% of

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[3] These Findings of Fact are based on both the exhibits admitted at trial and the testimony that was adduced in open court. If there is no corresponding exhibit citation with a finding of fact, the finding of fact is nevertheless supported by testimony adduced at trial. Further, even if a finding of fact does have an exhibit citation, that does not preclude testimony adduced at trial from also supporting such a finding.

[4] It is undisputed that, for all intents and purposes, Chrysalis is the same entity as Altatron.

Chrysalis common stock. [Adv. Docket No. 1, p. 2–3, ¶ 6; Adv. Docket No. 8, p. 2, ¶ 6].

5. At all relevant times, Chrysalis was not paying its debts as they became due.

6. At all relevant times, the sum of Chrysalis' debts were greater than all of Chrysalis' assets at a fair valuation.

7. Between November 2006 and May 2007, the Debtor caused $677,622.00 of Chrysalis' funds to be transferred to ComCon Manufacturing Services, Inc., a/k/a VirTra Merger Corporation, without Chrysalis receiving reasonably equivalent value for the transfer. [Plaintiff's Ex. No. 5].

8. Between November 2006 and May 2007, the Debtor caused $121,831.00 of Chrysalis' funds to be transferred to CapNet Securities Corporation, without Chrysalis receiving reasonably equivalent value for the transfer. [Plaintiff's Ex. No. 5].

9. Between November 2006 and May 2007, the Debtor caused $52,600.00 of Chrysalis' funds to be transferred to CapNet Risk Management, Inc., without Chrysalis receiving reasonably equivalent value for the transfer. [Plaintiff's Ex. No. 5].

10. Between November 2006 and May 2007, the Debtor caused $172,100.00 of Chrysalis' funds to be transferred to Institutional Capital Management, Inc., and Institutional Insurance Management, Inc., without Chrysalis receiving reasonably equivalent value for the transfer. [Plaintiff's Ex. No. 5].

11. Between November 2006 and May 2007, the Debtor caused $99,386.90 of Chrysalis' funds to be transferred to Dynalyst Manufacturing Corporation, without Chrysalis receiving reasonably equivalent value for the transfer. [Plaintiff's Ex. No. 5].

12. Between November 2006 and May 2007, the Debtor caused $26,500.00 of Chrysalis' funds to be transferred to Clean Fuel International Corp., a/k/a Gulf Coast Fuels, Inc., without Chrysalis receiving reasonably equivalent value for the transfer.

13. Between November 2006 and May 2007, the Debtor caused $11,240.00 of Chrysalis' funds to be transferred to CapNet Advisors Incorporated, without Chrysalis receiving reasonably equivalent value for the transfer. [Plaintiff's Ex. No. 5]. During all of these transfers, Chrysalis was still operational.

14. At all relevant times, the Debtor owned: (1) 30% of Chrysalis; (2) 85% of CapNet Securities Corporation; (3) 100% of CapNet Risk Management, Inc.; (4) 100% of Institutional Insurance Management, Inc.; (5) 40% of Institutional Capital Management, Inc.; (6) 25% of Dynalyst Manufacturing Corporation; and (7) 20% of Clean Fuel International Corp., a/k/a Gulf Coast Fuels. [Adv. Docket No. 8, p. 4, ¶ 9(c)].

15. As a result of the Debtor's orchestration of the fund transfers out of Chrysalis' account, Husky suffered damages in the amount of $163,999.38—which represents the amount owed to Husky by Chrysalis for the goods

which Husky delivered to Chrysalis. [Plaintiff's Ex. No. 2].

16. No exhibits were introduced and no testimony was adduced indicating that the Debtor made any oral or written representations to Husky inducing Husky to enter into a contract with Chrysalis. The only communication that the Debtor ever had with Husky was a telephone conversation between Husky's founder and president, Nick Davis, and the Debtor **after** the parties had entered into a contract and Husky had already shipped product to Chrysalis.

IV. CREDIBILITY OF WITNESSES

A. Husky's Witnesses

1. *Daniel Lee Ritz, Jr.*

The Court finds that Ritz is not a credible witness. During his testimony at trial, he gave answers which directly contradicted answers he had previously given in discovery. These contradictory statements relate to material issues. For example, his answer to Interrogatory No. 8(i) contradicts his testimony at trial on a very important issue. Interrogatory No. 8(i) reads as follows: "[i]dentify (by name, address, and telephone number) every Person who caused any transfer of money to be made in any amount between November 2006 and May 2007 from Chrysalis to: (i) ComCon Manufacturing Services, Inc ... and state the exact Dates and amounts of each such transfer of money each such Person made to the forgoing." [Husky's Ex. No. 172]. The Debtor's answer was as follows: "Marlin Williford was the primary person who managed these accounts. Defendant did not

initiate nor authorize any of these transfers." [Plaintiff's Ex. No. 172].

The language immediately above reflects a Shermanesque statement by Ritz that he never initiated or authorized any transfers. Yet, at trial, under cross examination by Husky's counsel, Ritz unequivocally admitted that he did authorize such transfers. Moreover, he could not offer any reasonable explanation as to why his answers were blatantly contradictory. On the witness stand, he claimed that he interpreted the interrogatory to mean that Husky wanted to know whether Ritz personally transferred the funds—and Ritz testified that he did not. This explanation is weak because Ritz conceded that he authorized certain individuals to make transfers without the need for them to obtain his approval for each and every transfer. Thus, his explanation is disingenuous, if not downright misleading.

And there is plenty more. For example, at trial, Ritz testified that he disputes that Chrysalis owes any debt to Husky. Ritz then conceded he signed an affidavit on October 24, 2007 representing that Chrysalis did in fact owe a debt to Husky. [Husky's Ex. No. 167] ("I entered into good faith negotiations, on behalf of Defendant Chrysalis, to settle all claims, avoid litigation and obtain a reduction from Plaintiff for any debts Defendant Chrysalis may owe.... Unfortunately, anticipated funds to satisfy *that* debt were not received and Chrysalis was unable to make it's [sic] timely payment.") (emphasis added). He later testified that he believes the debt is a little over $100,000.00. So within a few minutes, Ritz went from completely disputing the debt, to representing that a debt is owed, to representing that the debt is

in a fairly specific amount. This shell game underscores his lack of credibility.

All in all, the record is replete with Ritz's contradictions on several very germane issues in this suit. Additionally, his frequent inability to recall certain information was not coincidental. His ability to recollect was selective.

Finally, Ritz frequently gave non-responsive answers to questions which were unambiguous. His evasiveness and obfuscation further undermines his credibility. For all of the reasons set forth above, this Court finds Ritz not to be a credible witness. The Court gives very little weight to his testimony.

2. *Nicolas C. Davis*

Nicolas C. Davis was the president of Husky. The Court finds that his testimony is very credible, and the Court gives substantial weight to this testimony.

3. *Nancy K. Finney*

Nancy K. Finney worked as a comptroller for Ritz-controlled companies for approximately four years. The Court finds that her testimony is very credible, and the Court gives substantial weight to this testimony. Of particular significance, she testified that Ritz made the decisions to transfer large sums of cash out of Chrysalis's operating account and into the accounts of other companies controlled by Ritz.

4. *James D. Rogers*

James D. Rogers (Rogers) was Vice–President of Corporate Finance of CapNet Securities Corporation for approximately 2.5 years. The Court finds that his testimony is very credible, and the Court gives substantial weight to this testimony. Of particular significance, he testified that Ritz ran all of the

operations of the various companies in which he had an interest. He also testified that he did not participate in, or have knowledge about, any transfers of funds from Chrysalis to other entities controlled by Ritz—which is contrary to the testimony given by Ritz. The Court believes that Rogers told the truth and that Ritz did not.

5. *Richard Hollan*

Richard Hollan (Hollan), at one time, owned shares of Institutional Capital Management, Inc.—which is an entity owned 40% by Ritz. The Court finds that his testimony is very credible, and the Court gives substantial weight to this testimony. Of particular significance, Hollan testified that he has known Ritz for approximately twenty-five years and does not have a high opinion of him. Indeed, he testified that Ritz is not trustworthy. Finally, he testified that he is familiar with Ritz's business practices, and that Ritz controls all of the flow of money relating to corporations which he controls.

B. The Debtor's Witnesses

1. *Heather Cheaney*

The Court finds Ms. Cheaney to be credible, but does not find her testimony to be significant on any important points. Therefore, the Court gives Ms. Cheaney's testimony little weight.

2. *Daniel Lee Ritz, Sr.*

While the Court finds Daniel Lee Ritz, Sr. to be a credible witness, the Court gives less weight to his testimony because it recognizes that many of his statements were—not unsurprisingly—aimed at helping his son's case.

3. *Craig Takacs*

The Court finds Mr. Takacs to be a bit evasive in his responses to the questions posed to him. Accordingly, the Court gives little weight to his testimony.

4. *L. Andrew Wells*

The Court does not find Mr. Wells to be a credible witness and, therefore, gives his testimony little weight.

5. *Marlin R. Williford*

The Court finds Mr. Williford to be direct and forthcoming in his testimony. Accordingly, the Court finds Mr. Williford to be a credible witness and gives his testimony significant weight. However, his testimony did not concern the transfers of cash that Ritz orchestrated out of Chrysalis's operating account into the accounts of other entities controlled by Ritz.

V. CONCLUSIONS OF LAW

A. Jurisdiction, Constitutional Authority to Enter a Final Judgment, and Venue.

The Court has jurisdiction over this adversary proceeding pursuant to 28 U.S.C. §§ 1334(b) and 157(a). This particular dispute is a core proceeding pursuant to 28 U.S.C. §§ 157(b)(2)(A), (I), and (O).

The Supreme Court's recent decision in *Stern v. Marshall* recognized significant limitations on bankruptcy courts' authority. 564 U.S. —— (2011). The undersigned bankruptcy judge therefore provides analysis of his constitutional authority to enter a final judgment in this adversary proceeding.

Stern concerned a bankruptcy court's authority over a debtor's common-law counterclaim to a proof of

claim filed against the estate. The Supreme Court held that a bankruptcy court may not constitutionally enter a final judgment over a counterclaim that would not necessarily be resolved by the resolution of the proof of claim. *Id.* at 2618. The counterclaim did not constitute a "public rights" dispute. *Id.* at 2615. Although public rights disputes may be decided by non-Article III tribunals, public rights disputes must involve rights "integrally related to a particular federal government action." *Id.* at 2611–13. Entering a final judgment with respect to the counterclaim would be an impermissible exercise of the judicial power of the United States. *Id.* at 2615.

The broader applicability of the Court's decision remains unclear. Other types of disputes frequently decided by bankruptcy courts may also require adjudication by an Article III court. *Granfinanciera, S.A. v. Nordberg*, for example, held that the adjudication of a fraudulent transfer claim against a creditor who had not filed a proof of claim did not fall within the public rights exception. 492 U.S. 33, 54–55 (1989). Following *Stern*, it is unclear whether the adjudication of a fraudulent transfer claim against a creditor who *has* filed a proof of claim falls within the public rights exception. The Court's authority over matters involving state-law causes of action is particularly questionable.

The Court concludes, however, that it may exercise authority over essential bankruptcy matters under the "public rights" exception. Under *Thomas v. Union Carbide Agric. Prods. Co.*, a right closely integrated into a public regulatory scheme may be resolved by a non-Article III tribunal. 473 U.S. 568, 593 (1985). The Bankruptcy Code is a public scheme for restructuring debtor-creditor relations,

necessarily including "the exercise of exclusive jurisdiction over all of the debtor's property, the equitable distribution of that property among the debtor's creditors, and the ultimate discharge that gives the debtor a 'fresh start' by releasing him, her, or it from further liability for old debts." *Cent. Va. Cmty. Coll. v. Katz*, 546 U.S. 356, 363–64 (2006); *see N. Pipeline Const. Co. v. Marathon Pipe Line Co.*, 458 U.S. 50, 71 (1982) (plurality opinion) (noting in dicta that the restructuring of debtor-creditor relations "may well be a 'public right' "). *But see Stern*, 131 S.Ct. at *2614 n. 7 ("We noted [in *Granfinanciera*] that we did not mean to 'suggest that the restructuring of debtor-creditor relations is in fact a public right.'").

This suit involves a dispute over the Debtor's discharge. The right to a discharge is established by the Bankruptcy Code and is central to the public bankruptcy scheme. *See Katz*, 546 U.S. at 363–64, (including a discharge among the "[c]ritical features" of a bankruptcy proceeding). A debtor, upon surrendering his or her assets for distribution in a Chapter 7 case, is entitled to a discharge. *See Tenn. Student Assistance Corp. v. Hood*, 541 U.S. 440, 447, (2004) ("A bankruptcy court is able to provide the debtor a fresh start in this manner ... because the court's jurisdiction is premised on the debtor and his estate, and not on the creditors."). Determinations of whether a debtor meets the conditions for a discharge are integral to the bankruptcy scheme, and the Bankruptcy Court has the authority to make such determinations.

Similarly, the Bankruptcy Court has the authority to determine when the statutorily established right to a discharge does *not* apply. Unless a creditor proves

the applicability of an exception to discharge, the creditor is entitled to collect only against the bankruptcy estate. *Tower Credit, Inc. v. Gauthier (In re Gauthier)*, 349 Fed.Appx. 943, 945 (5th Cir. 2009) (per curiam) ("[T]he creditor claiming nondischargeability ... has the burden of proving, by a preponderance of the evidence, that the debt is exempt from discharge."). When a bankruptcy court determines the extent of a creditor's nondischargeable claim, the court simply decides that a particular creditor is entitled to something more than the creditor would otherwise get out of the bankruptcy bargain. Such determinations are inextricably tied to the bankruptcy scheme and involve the adjudication of rights created by the Bankruptcy Code. This case therefore falls within the Bankruptcy Court's authority, and the Bankruptcy Court's judgment is final.

Venue in the suit at bar is proper pursuant to 28 U.S.C. § 1409.

B. The Debtor is not liable to Husky pursuant to Texas Business Organizations Code § 21.223(b) and, therefore, Husky cannot prevail under 11 U.S.C. § 523(a)(2)(A).

An officer, director, or shareholder of a company — *i.e.*,— "may only be held liable for the corporation's breach of contract under traditional veil piercing laws." *Kwasneski v. Williams (In re Williams)*, Adv. No. 10–05077, 2011 WL 240466, at *3, 2011 Bankr. LEXIS 266, at *7 (Bankr. W.D. Tex. Jan. 24, 2011). Previously, Texas law allowed for the corporate veil to be pierced under three expansive categories: "(1) the corporation is the alter ego of its owners and/or shareholders; (2) the corporation is used for illegal

purposes; and (3) the corporation is used as a sham to perpetrate a fraud." *Rimade Ltd. v. Hubbard Enters. Inc*, 388 F.3d 138, 143 (5th Cir. 2004) (quoting *W. Horizontal Drilling, Inc. v. Jonnet Energy Corp.*, 11 F.3d 65, 67 (5th Cir. 1994)).

However, Section 21.223(b) of the Texas Business Organizations Code (TBOC) imposes a new requirement for a litigant seeking to pierce the corporate veil for breach of contract. Unquestionably, the debt that Husky alleges is owed to it is based upon Chrysalis' breach of contract. This new provision provides that the plaintiff must also establish that the defendant shareholder "caused the corporation to be used for the purpose of perpetrating and did perpetrate an actual fraud on the obligee primarily for the direct personal benefit of the holder." Tex. Bus. Orgs. Code § 21.223(b) (West 2007); *see also Rimade*, 388 F.3d at 143; *Williams*, 2011 WL 240466, at *3, 2011 Bankr. LEXIS 266, at *8. Accordingly, for Husky to impose liability on the Debtor for the contractual debt which Chrysalis owes to Husky, Husky must prove that: (a) the Debtor's conduct amounts to actual fraud on Husky; and (b) the Debtor's conduct was primarily for his direct personal benefit. Tex. Bus. Org. Code § 21.223(b); *Rimade*, 388 F.3d at 143; *JNS Aviation, Inc. v. Nick Corp.*, 418 B.R. 898, 907 (N.D. Tex. 2009); *Williams*, 2011 WL 240466, at *3–4, 2011 Bankr. LEXIS 266, at *7–9.

Actual fraud under Texas law is defined as "the misrepresentation of a material fact with intention to induce action or inaction, reliance on the misrepresentation by a person who, as a result of such reliance, suffers injury." *Trs. of the N.W. Laundry & Dry Cleaners Health & Welfare Trust Fund v. Burzynski*, 27 F.3d 153, 157 (5th Cir. 1994)

(internal quotation marks and citation omitted). The elements of actual fraud in Texas are: (1) the defendant made a representation to the plaintiff; (2) the representation was material; (3) the representation was false; (4) when the defendant made the representation the defendant knew it was false or made the representation recklessly and without knowledge of its truth; (5) the defendant made the representation with the intent that the plaintiff act on it; (6) the plaintiff relied on the representation; and (7) the representation caused the plaintiff injury. *Shandong Yinguang Chem. Indus. Joint Stock Co. v. Potter*, 607 F.3d 1029, 1032–33 (5th Cir. 2010) (citing *Ernst & Young L.L.P. v. Pac. Mut. Life Ins. Co.*, 51 S.W.3d 573, 577 (Tex. 2001)).

The record is wholly devoid of any such representation made by the Debtor. Indeed, the record reflects that the only communication that the Debtor had with Husky was a telephone conversation between Husky's founder and president, Nick Davis, and the Debtor **after** Husky had already shipped product to Chrysalis. [Finding of Fact No. 16]. Thus, because the Debtor could not possibly have made a representation to Husky that Husky relied upon before shipping the product to Chrysalis, Husky cannot satisfy the most crucial element for establishing actual fraud. Further, the tests for fraud under section 22.223 of TBOC and the requirements of section 523(a)(2)(A) of the Code are virtually the same.[5] *See Bale v. Ryan (In re Ryan)*,

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[5] At trial, after Husky put on its case in chief, the Debtor made an oral motion for a directed verdict on all causes of action brought by Husky. This Court ruled that the Plaintiff could not go forward with its prosecution of § 523(a)(2)(A), for the Plaintiff was unable to prove that the Defendant committed actual fraud.

443 B.R. 395, 408 (Bankr. N.D. Tex. 2010). Accordingly, this Court concludes that Husky's common law fraud cause of action must fail and, therefore, Husky may not prevail under § 523(a)(2)(A).[6]

C. The Debtor does not owe a fiduciary duty to the Plaintiff and, therefore, Husky cannot prevail under 11 U.S.C. § 523(a)(4).

Husky contends that the Debtor breached a fiduciary duty to it and that damages flow from that breach. In the 1939 case of *Conway v. Bonner*, however, the Fifth Circuit held that directors of a corporation do not owe a fiduciary duty to creditors of the corporation "so long as [the corporation] continues to be a going concern, conducting its business in the ordinary way, without some positive act of insolvency, such as the filing of a bill to administer its assets....". 100 F.2d 786, 787 (5th Cir. 1939).

More recently, the Fifth Circuit has stated in dicta that "[o]fficers and directors that are aware that the corporation is insolvent, or within the 'zone of insolvency' as in this case, have expanded fiduciary duties to include the creditors of the corporation." *Carrieri v. Jobs.com, Inc.*, 393 F.3d 508, 534 n. 24

The Court denied the motion for directed verdict in all other respects.

[6] Husky's causes of action alleging equitable recovery in quantum meruit and breach of contract must also fail, as these causes of action are against Chrysalis, not Ritz in his individual capacity; the corporate form maintains Ritz's shield against any liability.

(5th Cir. 2004).[7] However, the *Carrieri* statement is not binding on this Court for two reasons: (1) the statement in *Carrieri* is dicta, and, as such, is not binding; and (2) even if *Carrieri* does contradict *Conway*, *Carrieri* has no precedential value because "[w]here two previous holdings or lines of precedent conflict, the earlier opinion controls and is the binding precedent in the circuit." *Floyd v. Hefner*, No. H–03–5693, 2006 WL 2844245, at *12 (S.D. Tex. Sept. 29, 2006) (concluding that the language in *Carrieri* is dicta because it "could have been deleted without seriously impairing the analytical foundations of the holding and, being peripheral, may not have received the full and careful consideration of the court that uttered it.") (quoting *Gochicoa v. Johnson*, 238 F.3d 278, 286 n.11 (5th Cir. 2000)); *Soc'y of Separationists, Inc. v. Herman*, 939 F.2d 1207, 1211 (5th Cir. 1991) (internal citations omitted). Accordingly, *Conway* is binding on this Court and *Carrieri* is not.

The case of *Floyd v. Hefner*, written by the Honorable Melinda Harmon, United States District Judge for the Southern District of Texas, thoroughly and extensively analyzes this very issue and reaches a conclusion which this Court is bound to follow—namely, that officers and directors do not owe a fiduciary duty to creditors when their corporation is in the zone of insolvency. *Floyd*, 2006 WL 2844245, at *10. Judge Harmon's analysis guides this Court's

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[7] Other courts have interpreted *Carrieri* to mean that when a corporation is within the zone of insolvency, creditors have the ability to bring a derivative suit for violation of fiduciary duties. *Comerica Bank v. Rajaball* (*In re Rajabali*), 365 B.R. 702, 708 (Bankr. S.D. Tex. 2007).

conclusion[8] that only the trust fund doctrine enables creditors to sue a corporation's officers and directors. *Id.* at *18–22. Understandably, "to pursue a successful trust fund claim, one must prove that a corporation is a) insolvent and b) ceased to do business at the time of the challenged transaction." *Askanase v. Fatjo*, 130 F.3d 657, 671 (5th Cir. 1997) (citing *Fagan v. La Gloria*, 494 S.W.2d 624, 628 (Tex.Civ.App.-Houston [14th Dist.] 1973, no writ)). Here, like in *Floyd*, the trust fund doctrine is inapplicable. At the time of the subject transactions, Chrysalis was still operational. [Finding of Fact No. 13]. Accordingly, the Debtor owed no fiduciary duty to the Plaintiff.

Finally, the concept that officers and directors of a corporation do **not** hold a fiduciary duty to creditors of the corporation is further reinforced by the case of *Comerica Bank v. Rajaball*, 365 B.R. 702, 708 (Bankr. S.D. Tex. 2007). In that case, the Honorable Marvin Isgur, Chief United States Bankruptcy Judge for the Southern District of Texas, held that directors do not hold fiduciary duties directly to creditors; "rather, when a corporation is insolvent, creditors have the ability to enforce such duties which continue to exist as to the corporation." *Id.* (citing *Floyd*, 2006 WL 2844245, at *10). Stated differently, even when the corporation is insolvent, a creditor may not directly

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[8] District Judge Harmon held that *Conway* remains binding precedent in the Fifth Circuit. *Id.* at *11–16. This Court believes that it is bound not only by Fifth Circuit rulings, but also by the rulings of the District Court. *In re MPF Holding U.S. LLC*, 443 B.R. 736, 753 (Bankr. S.D. Tex. 2011). Because District Judge Harmon has held that *Conway* is binding precedent, the undersigned judge will apply *Conway* to the pending dispute in this Court.

bring a lawsuit against officers and directors for breach of fiduciary duty. Instead, a creditor is able to bring a derivative lawsuit on behalf of the corporation against the directors. *Id.* And, this is what the Husky should have done in this suit. Husky should have done the following: (a) brought a derivative lawsuit against the Debtor on behalf of Chrysalis;[9] and (b) collected on that debt pursuant to applicable law.[10] This, however, Husky did not do. Therefore, Husky is out of luck and may not prevail under § 523(a)(4).

D. Husky has failed to prove that the Debtor committed willful and malicious injury to Husky or to Husky's property and, therefore, Husky cannot prevail under 11 U.S.C. § 523(a)(6).

The record is wholly devoid of any proof that the Debtor willfully and maliciously injured Husky or Husky's property. While Husky's complaint makes a glancing reference to 11 U.S.C. § 523(a)(6), that alone is not enough to preserve a claim under this provision—no exhibits were introduced, no testimony was adduced, and no briefing was done relating to § 523(a)(6). *United States v. Dunkel*, 927 F.2d 955, 956 (7th Cir. 1991) (per curiam) ("A skeletal

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[9] For a thorough discussion of this issue, see *Rajabali*, 365 B.R. at 708.

[10] In the alternative, Husky could have sued Chrysalis in state court and sought to have a receiver appointed. Then, Husky could have convinced that receiver to file suit against the Debtor on behalf of the corporation. Alternatively, Husky could have sought to put Chrysalis into an involuntary Chapter 7, and then made demand upon the Chapter 7 trustee to sue the Debtor on behalf of the corporation, including seeking a judgment of nondischargeability.

'argument,' really nothing more than an assertion, does not preserve a claim. Especially not when the brief presents a passel of other arguments.... Judges are not like pigs, hunting for truffles buried in briefs." (citation omitted)). Moreover, given the nature of the transaction between Husky and Chrysalis, even if Husky's complaint and briefing had made more substantive references to § 523(a)(6), it is highly doubtful that a different result could follow. Husky provided goods to Chrysalis on an entirely unsecured basis. [Finding of Fact No. 16]. Typically, complaints brought under § 523(a)(6) by creditors involved in a business transaction involve secured creditors who are seeking to prevent a discharge of a debt where the debtor has: (1) deliberately sold collateral out of trust and spent the sale proceeds; or (2) deliberately destroyed or damaged the collateral. *See, e.g., Friendly Fin. Serv. Mid–City, Inc. v. Modicue (In re Modicue)*, 926 F.2d 452 (5th Cir. 1991). This Court has found no case law where an unsecured creditor trade creditor has obtained a judgment for nondischargeability under § 523(a)(6) where the debtor has simply failed to honor a contractual obligation to pay for the goods or services provided by that creditor.[11] Accordingly, Husky may not prevail under 11 U.S.C. § 523(a)(6).

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[11] Husky's breach of contract claim "fails, as a matter of law, to establish that [the Debtor] caused a 'willful and malicious injury' for purposes of § 523(a)(6). While an intentional breach of contract can be excepted from discharge under § 523(a)(6) when it is accompanied by malicious and willful tortious conduct, [Husky] ... failed to identify any tortious action by the [Debtor] that caused a willful and malicious injury." *Eagle Sindh, Inc. v. Desai (In re Desai)*, Adv. No. 07–04190, 2009 WL 2855735, at *6,

VI. CONCLUSION

This Court acknowledges that the Debtor drained substantial funds out of Chrysalis's operating account and funneled these funds to other entities controlled by the Debtor. Moreover, this Court has found that the Debtor is not a credible witness. So—this Court shares Husky's view that the Debtor is not an upstanding businessman who can be trusted. The Court is therefore sympathetic to Husky's request for relief. Nevertheless, the Texas Legislature, for better or worse, has set a high bar for plaintiffs seeking to pierce the corporate veil in order to impose individual liability. Indeed, just a few years ago, Husky may have prevailed in his action against the Debtor. But, the Texas Legislature has changed the statute, and now Husky, like any plaintiff, must prove actual fraud. Actual fraud, however, is difficult to prove, and the Legislature has made clear that actions to pierce the corporate veil will be few and far between.

A judgment consistent with this Memorandum Opinion will be entered on the docket simultaneously with the entry on the docket of this opinion.

2009 Bankr. LEXIS 2609, at *19–20 (Bankr. E.D. Tex. Sept. 2, 2009).