



Fox Rothschild Podcast

Featuring Partner John Gotaskie

We are talking today on FoxCast with John Gotaskie about a recent United States Supreme Court decision about the concept of “actual fraud” in a bankruptcy case. John is a partner and litigator with Fox Rothschild in Pittsburgh. He represents individuals, partnerships and companies in diverse legal matters, including complex commercial litigation, bankruptcy litigation and franchising issues. John also is editor of the firm’s Franchise Law Update blog. John, good morning.

John Gotaskie: Good to be here.

***Question:** John, you recently posted on the topic of “Do You Know What Actual Fraud Is?” on Fox Rothschild’s Franchise Law Update blog.*

John Gotaskie: I did and it has received a bit of attention.

***Question:** John, can you tell us more about the Supreme Court case in question?*

John Gotaskie: Yes. It is a case known as *Husky International Electronics, Inc. v. Ritz*. By a vote of seven to one – right now you might recall that the Supreme Court only has eight members – the court held for the first time that a fraudulent conveyance scheme *can* be consistent with the requirements of “actual fraud.” Now this ruling creates a potential new exception to the discharge of debts under the Bankruptcy Code. And this is a really significant development. Prior to this time, the Supreme Court had said, and other courts, in order to qualify as actual fraud under the Bankruptcy Code, a wronged party either had to have relied upon a debtor’s misrepresentations or a debt had to be directly “obtained by” the fraud.

***Question:** What was the court’s reasoning?*

John Gotaskie: In this case, a majority of the justices reasoned around the previous limitations by concluding that a recipient of a transfer in a fraudulent transfer scheme obtained the assets as a result of their “participation” in the scheme.

***Question:** What were the facts in the case?*

John Gotaskie: This is a case where, quite often, bad facts make new law. Ritz’s attorney never disputed the existence of a fraudulent transfer scheme in the entire case. What had happened was that a company called Chrysalis Manufacturing incurred a debt to Husky. And Ritz, a Chrysalis director and part owner of Chrysalis, proceeded to drain the company of all assets that could be used to pay the debt owed to Husky by transferring the assets to other entities that he controlled.

Question: So what happened?

John Gotaskie: Husky sued Ritz to recover on the debt and Ritz filed for bankruptcy. Now an adversary proceeding, which is really a mini lawsuit within the bankruptcy case, was filed within the bankruptcy seeking to hold Ritz personally liable for the debt to Husky. Now applying the previously well-established jurisprudence regarding “actual fraud,” all of the lower courts, the district court, the court of appeals for the Fifth Circuit, all held that the actual fraud requirement could not be satisfied here. So therefore, those courts reasoned the requirement was missing because the transfers came subsequent in time to the creation of the debt to Husky, and Ritz had made no false representations to Husky. So therefore Husky just didn’t qualify for having the debt not discharged.

Question: John, what does this decision mean, then, for franchisors and other businesses?

John Gotaskie: This is an important decision. I think there are two takeaways. The first is that if you are facing significant financial liabilities and considering a bankruptcy (a situation in which both franchisors and franchisees unfortunately but occasionally do find themselves), you really now need to ensure that any efforts to secure and protect assets do not run afoul of fraudulent transfer law, including the expanded definition of “obtained by” announced by the Supreme Court in the *Husky* decision. And this is important because prior to this time, you could take steps, even if they were not as egregious as Ritz’s case, which would probably be blessed by a court. Now you’ve really got to think long and hard about those steps before you make them.

Question: What’s the second takeaway?

John Gotaskie: The second takeaway is that this opinion is almost certainly going to allow creditors to pursue many more debtors for bankruptcy fraud. As such, it is likely to become a new tool for franchisors in particular seeking recovery from franchisee-debtors who have stolen trade secrets, who have violated noncompetition or nonsolicitation agreements or simply failed to pay royalties where they can establish under the new standards a scheme to fraudulently transfer assets.

Narrator: Well, thank you John. Listeners, to confidentially discuss the soundness of your organization’s policies for securing and protecting its assets, please contact John Gotaskie in Pittsburgh at 412.394.5528 or at jgotaskie – that’s J-G-O-T-A-S-K-I-E – at foxrothschild.com.

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