



**A Showing of Gross Recklessness Satisfies Section 523(a)(2)(A): Denying Deceivers the Ability to Discharge Debts Related to Fraudulently Obtained Funds**

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**Introduction**

11 U.S.C. Section 523(a) lists certain debts that may not be discharged through a debtor's bankruptcy.<sup>1</sup> In particular, section 523(a)(2)(A) provides that a debtor who files bankruptcy will not be discharged of debts that were obtained by "false pretenses, a false representation, or actual fraud, other than a statement respecting the debtor's or an insider's financial condition."<sup>2</sup> False representations, such as those described in section 523(a)(2)(A), carry a scienter requirement which requires that it be shown that an individual knowingly made false statements or representations.<sup>3</sup> This requirement carries a heavy burden, as trying to prove that a person had actual knowledge that his or her statements were false is not an easy feat. To overcome this burden, courts have found that a showing of gross recklessness is enough to satisfy the scienter requirement of section 523(a)(2)(A).

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<sup>1</sup> 11 U.S.C. § 523(a)(2)(A).

<sup>2</sup> 11 U.S.C. § 523(a)(2)(A) is cited as Section 523(a)(2)(A) for the remainder of the document.

<sup>3</sup> *In re Bocchino*, 504 B.R. 403, 405 (Bankr.M.D.Pa. 2013).

This article will discuss the scienter requirement of section 523(a)(2)(A) and will address the standard and burden of proof used when examining and applying exceptions. Part I will discuss the scienter requirement and how it is applied in other areas of the law other than bankruptcy. Part II discusses the Supreme Court’s treatment of section 523(a)(2)(A) when faced with questions regarding the standard of proof required in analyzing it. Finally, Part III concludes by discussing how the same reasoning used by the Supreme Court in finding that a showing of gross recklessness satisfies the scienter requirement of 11 U.S.C. section 523(a)(4) can be utilized in showing that the same burden of proof applies to the scienter requirement of section 523(a)(2)(A).

## **I. Origin of the Scienter Requirement**

Section 523(a) lists exceptions to discharge from debt. The statute reads: “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. . . .”<sup>4</sup> The statute makes no actual mention of a scienter requirement. Black’s Law Dictionary defines “scienter” as “a degree of knowledge that makes a person legally responsible for the consequences of his or her act or omission” or “a mental state consisting in an intent to deceive, manipulate, or defraud.”<sup>5</sup> The principle of the scienter requirement derives from the law of torts. The Second Restatement of Torts states:

A misrepresentation is fraudulent if the maker  
(a) knows or believes that the matter is not as he represents it to be,  
(b) does not have the confidence in the accuracy of his representation that he states or implies, or

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<sup>4</sup> 11 U.S.C. § 523(a)(2)(A).

<sup>5</sup> Black’s Law Dictionary 1463 (9th ed. 2009).

(c) knows that he does not have the basis for his representation that he states or implies.

Restatement (Second) of Torts § 526 (1977) (Comment (a): “The word ‘fraudulent’ is here used as referring solely to the maker’s knowledge of the untrue character of his representation. This element of the defendant’s conduct frequently is called ‘scienter’ by the courts.”)

A strict reading of the Restatement seems to inherently require the need for some sort of actual knowledge on the defendant’s part as to the false nature of his or her statements. Yet courts presented with tort cases involving fraudulent misrepresentation have held that a showing of gross recklessness satisfies this requirement. The Supreme Court of Texas in *Oilwell Division, U.S. Steel Corp. v. Fryer* lays out the elements for establishing fraud enumerated by the court in *Wilson v. Jones*.<sup>6</sup> One of these elements is “that, when the speaker made [the statement], he knew it was false *or made it recklessly without any knowledge of its truth* and as a positive assertion.”<sup>7</sup> Though the Restatement does not expressly mention a showing of recklessness as being sufficient to fulfill the scienter requirement, civil judicial interpretation has consistently allowed for it.<sup>8</sup>

## **II. Supreme Court favors the interests of the victims**

As stated earlier, requiring a showing of actual knowledge of fraud in order to satisfy the scienter requirement is a very difficult burden to meet. If proof of actual knowledge was required, then those who wish to defraud others could simply not make any inquiries and would truthfully be able to claim that they did not know their statements were false. In order to deter this type of behavior, the Supreme Court has consistently been more lenient with the burden of proof required in bankruptcy cases dealing with exceptions to dischargeability of debts incurred

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<sup>6</sup> *Oilwell Division, U.S. Steel Corp. v. Fryer*, 49 S.W.2d 487, 491 (Sup. Ct. Tex. 1973); *Wilson v. Jones*, 45 S.W.2d 572 (Tex.Com.App. 1932).

<sup>7</sup> 49 S.W.2d 487 at 491 (quoting *Wilson* at 573)(emphasis added).

<sup>8</sup> *See Oilwell Division, U.S. Steel Corp. v. Fryer*, 49 S.W.2d 487 (Sup. Ct. Tex. 1973); *see also Wilson v. Jones*, 45 S.W.2d 572 (Tex.Com.App. 1932).

by fraud.<sup>9</sup> In *Grogan v. Garner*, the Supreme Court held that “preponderance of the evidence standard, rather than clear and convincing evidence standard, applies to all exceptions from dischargeability of debts contained in 11 USC § 523(a), including nondischargeability for fraud provision.”<sup>10</sup> The Supreme Court supported this holding by reasoning that it is unlikely that Congress would want to make a more difficult standard of proof, one that would favor those who committed fraud, rather than trying to fashion the statute to work in favor of the victims of fraud.<sup>11</sup>

The Supreme Court used similar reasoning in reaching its decision in *Field v. Mans*.<sup>12</sup> In that decision, which dealt directly with section 523(a)(2)(A), the Court held that “[t]he standard for excepting a debt from discharge as a fraudulent representation within the meaning of § 523(a)(2)(A) is not reasonable reliance but the less demanding one of justifiable reliance on the representation.”<sup>13</sup> The Court supports this holding by stating that arguments against this line of reasoning are the same type of arguments that would effectively lead to the negation of the scienter requirement from section 523(a)(2)(A).<sup>14</sup> Additionally, the Court returns to the idea

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<sup>9</sup> See *Grogan v. Garner*, 498 U.S. 279 (1991); see also *Field v. Mans* 516 U.S. 59 (1995).

<sup>10</sup> *Grogan v. Garner*, 498 U.S. 279, 288 (1991) (The nondischargeability for fraud provision is § 523(a)(2)(A).)

<sup>11</sup> *Id.* at 287 (“We think it unlikely that Congress, in fashioning the standard of proof that governs the applicability of these provisions, would have favored the interest in giving perpetrators of fraud a fresh start over the interest in protecting victims of fraud. Requiring the creditor to establish by a preponderance of the evidence that his claim is not dischargeable reflects a fair balance between these conflicting interests.”)

<sup>12</sup> 516 U.S. 59 (1995).

<sup>13</sup> *Id.* at 59.

<sup>14</sup> *Id.* at 60 (“[T]his reasoning would also strip § 523(a)(2)(A) of any requirement to establish causation and scienter, an odd result that defies common sense.”)

that, because the principles of section 523(a)(2)(A) come from the principles of torts,<sup>15</sup> those principles should be taken into account.<sup>16</sup>

### III. The Supreme Court's holding gives weight to the Third Circuit's holding

Though the Supreme Court has not dealt directly with the scienter requirement with respect to section 523(a)(2)(A), it has discussed what satisfies the scienter requirement of a different provision of section 523(a), specifically section 523(a)(4).<sup>17</sup> In *Bullock v. BankChampaign, N.A.*, a creditor filed a complaint seeking to be discharged of debts that he incurred when he was found liable for breach of fiduciary duty while acting as the trustee of his father's trust.<sup>18</sup> The lower courts all consistently found that the debts could not be discharged under section 523(a)(4), and, on appeal, the Supreme Court granted *certiorari*.<sup>19</sup> The main issue discussed was the scope of the word "defalcation"<sup>20</sup> which Black's Law Dictionary defines as "the fraudulent misappropriation of money held in trust."<sup>21</sup> The Supreme Court held that the culpable mental state applied to the term "defalcation" is applied in the same way it is applied to the other terms in the statutory phrase.<sup>22</sup> The Court further stated, "[w]e describe that state of

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<sup>15</sup> *Id.* ("§ 523(a)(2)(A) refers to common law torts . . . [t]he terms used in paragraph (a) imply elements that the common law has defined them to include.")

<sup>16</sup> *Id.* ("The Restatement (Second) of Torts states that justifiable, rather than reasonable, reliance is the applicable standard.")

<sup>17</sup> 11 U.S.C. § 523(a)(4) states that "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 -- (4) for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny."

<sup>18</sup> *Bullock v. BankChampaign, N.A.*, 133 S.Ct 1754, 1755 (2013).

<sup>19</sup> *Id.*

<sup>20</sup> *Id.* at 1757.

<sup>21</sup> Black's Law Dictionary 506 (9th ed. 2009).

<sup>22</sup> 133 S.Ct. 1754 at 1757. The phrase the Court is referring to from § 523(a)(4) reads in its entirety: "for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny." The culpable mental state required for fraud is laid out in § 526 of the Second Restatement of Torts, see *infra* note 6.

mind as one involving knowledge of, or gross recklessness in respect to, the improper nature of the relevant fiduciary behavior.”<sup>23</sup>

The Supreme Court supports this statutory interpretation with a discussion of how, in other areas of the law, a showing of gross recklessness is sufficient in circumstances where actual knowledge is too burdensome a standard to prove. The Court cites the Model Penal Code, stating that “the Model Penal Code’s definition of ‘knowledge’ was designed to include ‘wilful blindness’” in circumstances where proof of actual knowledge of wrongdoing is lacking.<sup>24</sup> The Court reasons that the term “defalcation” generally encompasses behavior that is similar to behavior described as “fraud.”<sup>25</sup> Concluding by stating that it is important to have a “uniform interpretation of federal law,”<sup>26</sup> the Court held that, because in other areas of the law, statutes concerning behavior similar to the types of behavior section 523(a)(4) is meant to deter have a scienter requirement and this requirement can be satisfied by a showing of gross recklessness, section 523(a)(4) should be interpreted in the same way.<sup>27</sup>

While the Supreme Court’s decision in *Bullock* opened the door for using gross recklessness as a way to satisfy a scienter requirement in Bankruptcy Code provisions, section 523(a)(4) discussed in *Bullock* deals specifically with debtors who committed fraud while in a fiduciary capacity. Section 523(a)(2)(A) applies to debts “for money . . . obtained by -- false pretenses, a false representation, or actual fraud”<sup>28</sup> and does not make any mention of fiduciary duties. However, the United States Court of Appeals for the Third Circuit did not address this

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<sup>23</sup> *Id.*

<sup>24</sup> *Id.* at 1759-1760.

<sup>25</sup> *Id.* at 1760.

<sup>26</sup> *Id.* at 1761 (“[I]t is important to have a uniform interpretation of federal law. . . .”)

<sup>27</sup> *Id.*

<sup>28</sup> 11 U.S.C. § 523(a)(2)(A).

difference, and used the *Bullock* decision and the Supreme Court’s reasoning therein as a basis for its holding in *In re Bocchino*.<sup>29</sup>

*In re Bocchino* concerned a debtor, Bocchino, who was found civilly liable for “inducing investors via high pressure sales tactics and material misrepresentations” and had a judgment entered against him.<sup>30</sup> When thereafter Bocchino filed for chapter 13 bankruptcy protection, the SEC petitioned the bankruptcy court for a judgment declaring the judgments against Bocchino nondischargeable under section 523(a)(2)(A).<sup>31</sup> Bocchino had sought investors for two ventures without doing any independent research into them, despite there being cause for suspicion.<sup>32</sup> These ventures turned out to be fraudulent.<sup>33</sup> The bankruptcy court concluded that the portions of the judgment relating to the debts incurred due to Bocchino’s fraudulent statements were nondischargeable and found that, although “Bocchino did not knowingly make any false statements,” the scienter requirement of section 523(a)(2)(A) “may be satisfied by grossly reckless behavior.”<sup>34</sup> On appeal, the Third Circuit affirmed the bankruptcy court’s decision.<sup>35</sup> The Third Circuit relied on the Supreme Court’s decision in *Bullock* in its reasoning in *Bocchino*. The court stated, “[t]o read § 523(a)(2)(A) so restrictively as to sanction Bocchino’s gross recklessness would be at odds with the general principles of the act.”<sup>36</sup> This is directly aligned with the Supreme Court’s statement in *Bullock* that “it is important to have a uniform interpretation of federal law.”<sup>37</sup>

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<sup>29</sup> *In re Bocchino*, 794 F.3d 376 (3d. Cir. 2015).

<sup>30</sup> *Id.* at 378.

<sup>31</sup> *Id.*

<sup>32</sup> 794 F.3d at 378.

<sup>33</sup> *Id.*

<sup>34</sup> *Id.* at 379.

<sup>35</sup> *Id.* at 380.

<sup>36</sup> *In re Bocchino*, 794 F.3d at 382.

<sup>37</sup> *See infra* note 19.

The Supreme Court's decisions in *Field v. Mans* and *Grogan v. Garner* serve as examples of how the Supreme Court has interpreted section 523(a)(2)(A) of the Bankruptcy Code in such a way that it favors the interests of victims of fraudulent acts by being more lenient in the level of evidence that is required to prove scienter. This, coupled with the Court's treatment of the scienter requirement in section 523(a)(4), lends support to the Third Circuit's decision in *In re Bocchino* that requiring a showing of actual knowledge is too strict a burden to adhere to. Because the Supreme Court has ruled that less strict burdens of proof should be applied to section 523(a)(2)(A), it follows that this reasoning would also apply to the burden of proof required to satisfy the scienter requirement of section 523(a)(2)(A).

### **Conclusion**

Section 523(a)(2)(A) is very specific and strictly construed because the Bankruptcy Code is supposed to help those who are "honest but unfortunate." But courts have consistently found that this does not include those who act recklessly and make representations without making the proper inquiries. Not allowing a showing of gross recklessness to fulfill the scienter requirement would effectively allow thieves to deceive others, and then when caught, to declare bankruptcy protection and never have to pay for their crime.