NOTES

LIES, FILTHY LIES AND *ARCHER v. WARNER*: SHOULD WE ALLOW FRAUDULENT DEBTORS TO SIDE-STEP SECTION 523(a)(2)(A)?

The Bankruptcy Code renders debts "obtained by" fraud non-dischargeable in bankruptcy.[1] Two theories interpreting this language have emerged in recent years. One line of cases posits that a pre-petition settlement of claims involving fraud extinguishes the creditor's subsequent non-dischargeability defense under section 523(a)(2)(A) when the debtor had filed for bankruptcy without having fully satisfied the settlement obligation.[2] This approach, termed the "novation theory," permits a reviewing court to examine the terms of the pre-petition settlement agreement in order to determine the validity and completeness of the bargained for agreement and release.[3] Another line of cases subscribe to the "majority approach," arguing that a pre-petition settlement of claims involving fraud might sustain the creditor's subsequent non-dischargeability defense.[4] This would require an inquiry into the factual circumstances behind the settlement agreement to ascertain whether the debt incurred by the debtor was derived from the alleged fraudulent conduct.[5]

The Supreme Court granted certiorari to address the conflicting theories in the case of *Archer v. Warner*.[6] In this note I examine why the Supreme Court should overrule the Fourth Circuit's adoption of the novation theory based on statutory construction, Supreme Court precedent, and policy implications. Additionally, this Note examines why the majority approach should be extended to protect a creditor that executed a pre-petition specific release or waiver of subsequent non-dischargeability defense under section 523(a)(2). Several days prior to the

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[1] *See* 11 U.S.C. § 523(a)(2)(A) (2000) (rendering "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" non dischargeable in bankruptcy); Cohen v. de la Cruz, 523 U.S. 213, 218 (1998) (holding plain meaning of § 523(a)(2)(A) "prevents the discharge of all liability arising from fraud"); Local Loan v. Hunt, 292 U.S. 234, 244 (1934) (emphasizing congressional policy embodied in discharge provisions of affording relief to "honest but unfortunate debtor").

[2] *See* Key Bar Inv., Inc. v. Fischer (*In re* Fischer), 116 F.3d 388, 390 (9th Cir. 1997) ("[I]f it is shown that the note by express agreement is given and received, as a discharge of the original obligation or tort action, then the execution of the note extinguishes the tort action." (quoting *In re* Kelley, 259 F. Supp. 297, 299 (N.D. Cal. 1965))).

[3] *See* Archer v. Warner (*In re* Warner), 283 F.3d 230, 236 (4th Cir. 2002), *rev'd*, No. 01-1418, 2003 U.S. LEXIS 2498 (Mar. 31, 2003).

[4] *See* Ed Schory & Sons v. Francis (*In re* Francis), 226 B.R. 385, 390 (B.A.P. 6th Cir. 1998).

[5] *See* United States v. Spicer, 57 F.3d 1152, 1157 (D.C. Cir. 1995); Greenberg v. Schools, 711 F.2d 152, 156 (11th Cir. 1983).

[6] *In re Warner*, 283 F.3d at 235.

publication of this Note the Supreme Court rendered its decision overruling the Fourth Circuit's adoption of the novation theory.[7] Part IV of this note examines the Supreme Court's holding and rationale.

I. THE CIRCUIT SPLIT

A. Novation Theory

The novation theory is premised upon the two part holding of *Maryland Casualty Co. v. Cushing*.[8] In *Maryland Casualty*, the Seventh Circuit announced the general rule that a promissory note is but the "evidence of indebtedness and does not discharge the debt for which it was given."[9] Where a note is accepted only as evidence of a pre-existing debt, and not as satisfaction or waiver of a tort action, acceptance of such a note will not of itself waive the original cause of action.[10] However, if it is shown that the note was given and received as payment or waiver of an antecedent tort action, and the parties agreed that the note was to substitute a new obligation for the old, then the original debt is fully satisfied by the acceptance of the note.[11] Moreover, the dischargeability of the original debt does not affect the dischargeability of the obligation under the note.[12]

Therefore, a reviewing court applying the novation theory merely examines the terms of the settlement agreement to determine whether the parties released the non-dischargeability claims under section 523(a)(2)(A).[13] The court does not determine whether the underlying factual basis for the settlement agreement consisted of fraud; rather, the court only addresses the validity and completeness of the bargained for agreement and release.[14]

The circuits adopting the novation theory have argued that the approach is justifiable because it encourages and enforces settlements.[15] They have argued that

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[7] Archer v. Warner, No. 01-1418, 2003 U.S. LEXIS 2498, at *17 (March 31, 2003).

[8] 171 F.2d 257 (7th Cir. 1948).

[9] *Id*. at 258–59.

[10] *Id*.; *see In re* West, 22 F.3d 775, 777 (7th Cir. 1994) (reaffirming two part holding of *Maryland Casualty* explaining promissory note generally does not discharge debt for which it is given).

[11] *See Maryland Casualty*, 171 F.2d at 258–59; *see also In re Warner*, 283 F.3d at 236 (holding releases and settlement agreement created novation, substituting dischargeable contractual debt for fraud based tort claim which may not have been dischargeable); Key Bar Inv., Inc. v. Fischer (*In re* Fischer), 116 F.3d 388, 390 (9th Cir. 1997) (stating "if it is shown that the note by express agreement is given and received, as a discharge of the original obligation or tort action, then the execution of the note extinguishes the tort action." (quoting *In re* Kelley, 259 F. Supp 297, 299 (N.D. Cal. 1965))); *In re West*, 22 F.3d at 777 (noting if it can be shown note was given and received as payment or waiver of original obligation, and parties agreed note was to substitute new obligation for old, note fully discharges original debt).

[12] *See In re West*, 22 F.3d at 777.

[13] *See In re Warner*, 283 F.3d at 236.

[14] *Id*.; *see In re Fischer*, 116 F.3d at 390 (explaining "if the note is given and received as a discharge of the original obligation . . . [then] it would be [an] *error* for the court to look behind the note" (quoting *In re Kelley*, 259 F. Supp. at 299)) (emphasis added).

[15] *See In re West*, 22 F.3d at 778; *In re Warner*, 283 F.3d at 236 (noting § 523(a) should not be construed in manner that would discourage settlement agreements).

a tortfeasor may be inclined to pay an aggrieved party a larger sum if the settlement contains a release from future claims based on the same conduct.[16] Enforcing the note rather than the tort under such circumstances does not produce an inequitable result in bankruptcy.[17] According to these circuits, a rule that would allow a creditor to undo the discharge for which he received adequate consideration (a promissory note), would discourage debtors from entering into settlement agreements.[18]

B. The Majority Approach

Unlike the circuits that have adopted the novation theory, the circuits which have implemented the majority approach have held that a general release as part of a settlement of a tort claim does not serve as a novation, allowing a debt incurred by fraud to be discharged in bankruptcy.[19] These circuits claim that the majority approach is the better reasoned approach because it recognizes the delicate balance embodied in the Bankruptcy Code between the rights of debtors and the rights of defrauded creditors.[20] Circuits following the majority approach acknowledge that, although the Bankruptcy Code should be liberally construed to effectuate the fresh start policy of the Code,[21] a debtor's interest in obtaining a fresh start is not absolute.[22] These circuits also construe the Code to prevent the discharge in bankruptcy of a liability which would not have existed *but for* the fraudulent conduct of the bankrupt party.[23] Although debtors are entitled to an unencumbered fresh start, Congress has unmistakably mandated in section 523(a)(2)(A) that a debtor may not get a fresh start at the expense of defrauded third parties.[24] The novation theory disregards this important congressional policy determination.[25]

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[16] *See In re West*, 22 F.3d at 778.

[17] *Id*.

[18] *See id*. (stating there is no reason to adopt rule allowing creditor to undo discharge for which he received promissory note).

[19] Ed Schory & Sons v. Francis (*In re* Francis), 226 B.R. 385, 390 (B.A.P. 6th Cir. 1998) (adopting approach set forth in *United States v. Spicer*, 57 F.3d 1152 (D.C. Cir. 1995), and rejecting novation theory).

[20] *Spicer*, 57 F.3d at 1156 (quoting *In re* Pavelka, 79 B.R. 228, 232 (Bankr. E.D. Pa. 1987)).

[21] *See* Grogan v. Garner, 498 U.S. 279, 286–87 (1991) (stating "honest but unfortunate debtor" is able to get "fresh start," unencumbered by past debts (citing Local Loan v. Hunt, 292 U.S. 234, 244 (1934))); Greenberg v. Schools, 711 F.2d 152, 155 (11th Cir. 1983) (explaining purpose of Bankruptcy Code is releasing an honest, unfortunate, insolvent debtor from burden of oppressive debts and restoring him to business activity (quoting Hartford Accident & Indem. Co. v. Flanagan, 28 F. Supp. 415, 419 (S.D. Ohio 1939))).

[22] *Spicer*, 57 F.3d at 1156 (quoting *In re Pavelka*, 79 B.R. at 232); *see also In re* Detrano, 266 B.R. 282, 288 (E.D.N.Y. 2001) (explaining "fresh start" had never been intended to pertain to all debts).

[23] *Greenberg*, 711 F.2d at 155 (quoting Hartford Accident & Indem. Co. v. Flanagan, 28 F. Supp. at 419); *see* Landgraf v. Griffith, 83 N.E. 1021, 1022 (Ind. Ct. App. 1908) (explaining public policy forbids discharge of bankrupt from debt incurred through fraud, and debt so created, whether or not it is reduced to judgment is not dischargeable in bankruptcy).

[24] *Spicer*, 57 F.3d at 1155 (interpreting non-dischargeability under 11 U.S.C. § 523(a)(2)(A)).

[25] *See* Ed Schory & Sons v. Francis (*In re* Francis), 226 B.R. 385, 391 (B.A.P. 6th Cir. 1998) (arguing novation theory ignores explicit limitation in Code against discharge of debts incurred by fraud); *Spicer*, 57 F.3d at 1155 (rejecting novation theory as contrary to public policy embodied in § 523(a)(2)(A) preventing fraudulent debtors from escaping their obligations at expense of innocent defrauded creditors).

Based upon the above principles the majority approach circuits have concluded that a debt which originated from the debtor's fraud should not be discharged simply because the debtor entered into a settlement agreement.[26] Accordingly, the underlying debt is seen as ensuing from the debtor's fraudulent conduct and not from the debtor's breach of the settlement agreement.[27] Therefore, the reviewing court may inquire into the factual circumstances behind the settlement agreement to ascertain whether or not the debt incurred by the debtor was derived from the alleged fraudulent conduct.[28]

These circuits have rejected the novation theory as being overly restrictive, as contrary to the plain language of the section 523(a)(2)(A), as permitting the discharge of debts that Congress intended to survive bankruptcy,[29] and as improperly elevating legal form over substance.[30] Additionally, the proponents of the majority approach have argued that the novation theory undermines and discourages settlement agreements.[31]

The majority approach circuits have supported the theory by claiming that it effectuates congressional policy by not permitting the discharge of debts that Congress had intended to survive bankruptcy.[32] Moreover, they argue that this approach is consistent with recent Supreme Court decisions.[33]

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[26] *See Spicer*, 57 F.3d at 1155 (rejecting rule under which, through use of settlement agreement, fraudulent debtor would be able to transform himself into non-fraudulent one and thereby immunize himself from consequences of § 523(a)(2)(A)); *Greenberg*, 711 F.2d at 154–55 (interpreting meaning behind statute to preclude settlement agreement from discharging debt obtained by fraud).

[27] *Greenberg*, 711 F.2d at 156 (theorizing "underlying debt was unquestionably the result of the debtor's fraud, not his breach of the settlement agreement.").

[28] *Id*.; *see also Spicer*, 57 F.3d at 1157 (holding court must "look beyond form of settlement agreement to substance of underlying obligation").

[29] *See Greenberg*, 711 F.2d at 154 (rejecting novation theory on above grounds); s*ee also Spicer*, 57 F.3d at 1155 (refusing to adopt novation theory as contrary to public policy embodied in § 523(a)(2)(A) of preventing fraudulent debtors from escaping obligations at expense of innocent defrauded creditors).

[30] *Spicer*, 57 F.3d at 1155.

[31] *See* Ed Schory & Sons v. Francis (*In re* Francis), 226 B.R. 385, 390 (B.A.P. 6th Cir. 1998) (explaining plaintiff would be less willing to settle tort claim if aware defendant might be motivated to settle claim for any amount and then file for relief under Code in order to discharge settlement debt); *Greenberg*, 711 F.2d at 154 (noting debtor might even accept substantially adverse settlement agreement with knowledge terms and conditions would be nullified by subsequent petition in bankruptcy).

[32] *See* Archer v. Warner (*In re* Warner), 283 F.3d 230, 236 (4th Cir. 2002), *rev'd*, No. 01-1418, 2003 U.S. LEXIS 2498 (Mar. 31, 2003) (explaining rationale argued by circuits that have adopted majority approach); *In re Francis,* 226 B.R. at 391 (noting explicit limitation in Bankruptcy Code against discharge of debts incurred by fraud); *Spicer*, 57 F.3d at 1156 (justifying adoption of majority approach as best effectuating policy Congress sought to implement when it enacted § 523(a)(2)(A)).

[33] *See In re Warner*, 283 F.3d at 237 (Traxler, J., dissenting) (stating recent Supreme Court cases have held "the Bankruptcy Code has long prohibited [a] debtor 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.'" (citing Cohen v. de la Cruz, 523 U.S. 213, 217 (1998) (quoting Grogan v. Garner, 498 U.S. 279, 286–87))); *In re Francis*, 226 B.R. at 391 (noting Supreme Court, in recent decisions, has stated Congress had clearly intended that debts incurred by fraud be non-dischargeable).

II. THE SUPREME COURT SHOULD ADOPT THE MAJORITY APPROACH

A. The Novation Theory Conflicts With the Plain Language of the Code

By rendering a debt obtained by fraud dischargeable, despite the clear prohibition of section 523(a)(2)(A), the novation theory conflicts with the plain language of the Code. Section 523(a)(2)(A) of the Bankruptcy Code renders "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" non-dischargeable in Bankruptcy.[34] The Supreme Court in *Cohen v. de la Cruz*[35] held that the plain meaning of section 523(a)(2)(A) "prevents the discharge of all liability arising from fraud."[36]

In *Cohen*, a unanimous Supreme Court held that a treble damage award that was imposed as punishment for a state court defendant's fraudulent conduct was non-dischargeable in bankruptcy pursuant to section 523(a)(2)(A).[37] The Court reasoned that by using the phrase "any debt," Congress intended to except from discharge any "debt as a result of," "debt with respect to," "debt by reason of," "debt arising from," or "debt on account of," an act of fraud.[38]

The Supreme Court's result in *Cohen* is supported by the text of the Bankruptcy Code. According to bankruptcy law, a "debt" can take any number of different forms. Section 101(12) of the Bankruptcy Code[39] defines a "debt" as "liability on a claim."[40] Section 101(5) of the Code defines a "claim" as the "right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or

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[34] Brief for Petitioner at 13, Archer v. Warner (*In re* Warner), 283 F.3d 230 (4th Cir. 2002), *rev'd*, No. 01-1418, 2003 U.S. LEXIS 2498 (U.S. Mar. 31, 2003), 70 U.S.L.W. 3788 (U.S. June 24, 2002) (No. 01–1414) (No. 01–1418) (citing 11 U.S.C. § 523(a)(2)(A)).

[35] 523 U.S. 213 (1998).

[36] *Petitioner's Brief* (No. 01-1414) (No. 01-1418) at 13 (citing *Cohen*, 523 U.S. at 218).

[37] *Cohen*, 523 U.S. at 221; *see also In re Warner*, 283 F.3d at 239 (Traxler, J., dissenting) (citing Supreme Court precedent as supporting *Spicer* approach).

[38] *See Petitioner's Brief* (No. 01-1414) (No. 01-1418) at 13 (quoting *Cohen*, 523 U.S. at 220). In addition, the *Cohen* Court noted that the use of "debt for" in § 523(a) serves the identical function of introducing a category of non-dischargeable debt. The presumption that equivalent words have equivalent meaning when repeated in the same statute has particular significance here. *Cohen*, 523 U.S. at 220 (citing Ratzalaf v. United States, 510 U.S. 135, 143 (1994)). For example, "debt . . . for a tax or a customs duty . . . with respect to which a return was not filed," § 523(a)(1)(B)(i), "debt . . . for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny" § 523(a)(4), "debt . . . for willful and malicious injury by the debtor to another entity," § 523 (a)(6), and "debt . . . for death or personal injury caused by the debtor's operation of a motor vehicle if such operation was unlawful because the debtor was intoxicated," § 523(a)(9). *Id*. at 219–20.

[39] 11 U.S.C. § 101(12) (2000).

[40] *Id.*; *Petitioner's Brief* (No. 01-1414) (No. 01-1418) at 13.

unsecured."[41] And the term a "right to payment" has been defined by the Supreme Court as "nothing more nor less than an enforceable obligation."[42]

Therefore, when a creditor who was a victim of fraud settles the fraud claim with the tortfeasor, the form of the debt is converted from being "unliquidated" and "disputed" to being "liquidated" and "undisputed."[43] Although the form of the debt has changed, it is still a debt that is "traceable to" fraud.[44] This conclusion parallels the D.C. Circuit's line of reasoning in *U.S. v. Spicer,*[45] which explained that while a "settlement agreement alters the legal form [an] obligation, it does not transmogrify its essential nature so as to immunize it from the command of section523(a)(2)(A) that debt for money or property obtained by fraud is not dischargeable in bankruptcy."[46] In sum, "once it is established that specific money or property has been obtained by fraud . . . 'any debt' therefrom is excepted from discharge."[47]

Moreover, the phrase "to the extent obtained by" in section 523(a)(2)(A) does not impose any limitation on the extent to which "any debt" arising from fraud is excepted from discharge.[48] The phrase "[t]o the extent obtained by" modifies "money, property, services or . . . credit" – not any debt – so that the exception encompasses "any debt . . . for money, property, services, or . . . credit is obtained by" fraud.[49] Therefore, once it is established that specific money or property has been obtained by fraud, "any debt" arising therefrom is excepted from discharge.[50]

This interpretation of the plain language in section 523(a)(2)(A) is supported by the historical pedigree of the fraud exception and the general policy of ensuring that liabilities involving fraud do not find shelter within the bankruptcy system.[51] Following the tradition of early British common law, early American bankruptcy laws prohibited granting relief to fraudulent debtors.[52] The Bankruptcy Act of 1898 carried over this policy determination by prohibiting the discharge of "judgments in actions for frauds, or obtaining property by false pretenses or false

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[41] 11 U.S.C. § 101(5).
[42] *Cohen*, 523 U.S. at 218 (explaining definitions reflect Congress' broad view of class of obligations that qualify as claim giving rise to debt (quoting Penn. Dep't of Pub. Welfare v. Davenport, 495 U.S. 552, 558–59 (1990))); *accord In re* Richardson, 221 B.R. 956, 960 (D. Wyo. 1998) (explaining same).
[43] *See Petitioner's Brief* (No. 01-1414) (No. 01-1418) at 14.
[44] *Id*. (quoting *Cohen*, 523 U.S. at 218).
[45] 57 F.3d 1152, 1157 (D.C. Cir. 1995).
[46] *Petitioner's Brief* (No. 01-1414) (No. 01-1418) at 14 (quoting *Spicer*, 57 F.3d at 1157).
[47] *Cohen*, 523 U.S. at 218–19.
[48] *Id*. at 218.
[49] *Id*.
[50] *Id*.
[51] *See id*., 523 U.S. at 218–19.
[52] Brief of Amicus Curiae G. Eric Brunstad, Jr. at 7, Archer v. Warner (*In re* Warner), 283 F.3d 230 (4th Cir. 2002), *rev'd*, No. 01-1418, 2003 U.S. LEXIS 2498 (Mar. 31, 2003). During most of English history, a debtor who could not pay his or her debts was treated as a criminal and before the nineteenth century, incarceration for debt was common. These early English bankruptcy laws were debt-collection devices intended to repress insolvent obligors. A revised version of the first English bankruptcy statute went so far as to subject fraudulent debtors to the death penalty; other statutes authorized the mutilation of the debtor. Following common law tradition, imprisonment for debt was common in the United States up to the nineteenth century. *Id*. at 6–7.

representations."[53] This exception to discharge was broadened in 1903 to include all "liabilities for obtaining property by false pretenses or false representations."[54] The legislative history to this amendment reflects the congressional intent of making the change "in the interest of justice and honest dealing and honest conduct" and was intended "to exclude beyond peradventure certain liabilities growing out of offenses against good morals. H.R. Rep. No. 1698, 57th Cong., 1st Sess., 3, 6 (1902)."[55] And the Bankruptcy Act of 1978 enacted a "substantially similar provision"[56] to the 1903 provision, barring discharge of "any debt . . . for obtaining money, property, services, or . . . credit, by false pretenses, a false representation, or actual fraud."[57]

As a result of a slight amendment to the language in 1984, section 523(a)(2)(A) now excepts from discharge "any debt . . . for money, property, services, or . . . credit, to the extent obtained by . . . false pretenses, a false representation, or actual fraud."[58] The 1984 change to the language of section 523(a)(2)(A) in no way signals a congressional intention to narrow the scope of the fraud exception.[59] Consistent with the long established principle that courts should not erode past bankruptcy practice absent a clear indication that Congress intended such a departure, the bankruptcy courts of today should give full force and effect to the fraud discharge exception.[60] Thus the historical evolution and expansion of the fraud exception "suggests that all debts arising out of the conduct specified in [section 523] should be excepted from discharge and the mere fact that a conscientious creditor"[61] has entered into a pre-petition settlement agreement should not bar a creditor's subsequent non-dischargeability claim when the debtor has filed for bankruptcy without fulfilling the obligation under the note.

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[53] *Cohen*, 523 U.S. at 221 (citing § 17, 30 Stat. 550).

[54] *Id*. (citing § 5, 32 Stat. 798).

[55] *Brunstad Brief* at 11–12 (No. 01-1414) (No. 01-1418); s*ee also* Brown v. Felsen, 442 U.S. 127, 138 (1979) (interpreting provision as prohibiting discharge of "all debts arising out of the conduct specified therein"). Additionally, in *Local Loan v. Hunt*, the Supreme Court explained the essential purpose of the discharge provisions and emphasized the congressional policy of affording relief to the "honest but unfortunate debtor." *Brunstad Brief* at 12 (No. 01-1414) (No. 01-1418) (citing *Hunt*, 292 U.S. 244 (1934)). The Supreme Court explained:

> One of the primary purposes of the Bankruptcy Act is to relieve the honest debtor from the weight of oppressive indebtedness, and to permit him to start afresh free from the obligations and responsibilities consequent upon business misfortunes . . . . This purpose of the act has been again and again emphasized . . . in that it gives the honest but unfortunate debtor . . . a new opportunity in life . . . . The various provisions of the Bankruptcy Act were adopted in light of that view and are to be construed when reasonably possible in harmony with it so as to effectuate the general purpose of the act.

Hunt, 292 U.S. at 244–45.

[56] *Cohen*, 523 U.S. at 221 (quoting *Brown*, 442 U.S. at 129 n.1).

[57] *Id*. (citing 11 U.S.C. § 523(a)(2)(A)).

[58] *Id*. at 221 (noting change in language).

[59] *See id*. at 221–22 (rejecting petitioners argument).

[60] *See* Penn. Dep't. of Pub. Welfare v. Davenport, 495 U.S. 552, 563 (1990) (refusing to contradict Congress' plain intent).

[61] *Brown*, 442 U.S. at 138.

B. *Brown v. Felsen* Compels the Majority Approach

The majority approach, which mandates a bankruptcy court to examine the underlying fraudulent allegations leading to the settlement agreement, is consistent with the Supreme Court's decision in *Brown v. Felsen.*[62] The Supreme Court held that the bankruptcy court should not be confined to a review of the judgment and record in the prior state court proceeding when determining the dischargeability of a debtor's debt.[63] When a debtor asserts the new defense of bankruptcy, *res judicata* does not bar the creditor from offering additional evidence to meet that defense.[64] The Court explained that a contrary rule would undercut a statutory policy in favor of resolving dischargeability questions in the bankruptcy courts, forcing state courts to decide dischargeability questions at a stage when they are not directly at issue and neither party has a full incentive to litigate them.[65] The Court concluded by stating that "[a]ll debts arising out of the conduct specified in section 17 should be excepted from discharge and the mere fact that a conscientious creditor has previously reduced his claim to judgment should not bar further inquiry into the true nature of the debt."[66]

Unlike the majority approach, the novation theory merely authorizes the reviewing court to examine the terms of the settlement in order to determine whether the underlying claims were released by the agreement.[67] Therefore, the reviewing court only addresses the issues of the validity and completeness of the bargained for agreement and release.[68] This approach is inconsistent with the holding of *Brown* because it disregards the ability afforded to a bankruptcy court to inquire into the true nature of the debt.[69]

The only factual difference between *Brown* and the cases adopting the majority approach is that, in *Brown*, the parties' settlement was incorporated into a judgment, and as a result, the debtor's arguments focused on res judicata instead of release or

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[62] *See id*. at 127 (rejecting res judicata claim and allowing creditor to offer additional evidence); *see also See* Archer v. Warner (*In re* Warner), 283 F.3d 230, 238–39 (4th Cir. 2002), *rev'd*, No. 01-1418, 2003 U.S. LEXIS 2498 (Mar. 31, 2003). (Traxler, J., dissenting) (dissenting because majority approach is inconsistent with Supreme Court precedent such as *Brown*); Ed Schory & Sons v. Francis (*In re* Francis), 226 B.R. 385, 391 (B.A.P. 6th Cir. 1998) (adopting majority approach because *Brown* compels that result); *In re* Detrano, 266 B.R. 282, 289 (E.D.N.Y. 2001) (applying *Brown* reasoning).

[63] *Brown*, 442 U.S. at 138–39 (reversing lower court's holding to apply res judicata).

[64] *See id*. at 133 (contrasting case where creditor raises a new claim).

[65] *See id*. at 134.

[66] *Id.* at 138.

[67] *See* Archer v. Warner (*In re* Warner), 283 F.3d 230, 236 (4th Cir. 2002), *rev'd*, No. 01-1418, 2003 U.S. LEXIS 2498 (Mar. 31, 2003).

[68] *See id*.

[69] *See In re Detrano*, 266 B.R. 282, 289 (E.D.N.Y. 2001) (holding creditor should be given opportunity to prove to bankruptcy court that debt should not be discharged); s*ee also* United States v. Spicer, 57 F.3d 1152, 1157 (D.C. Cir. 1995) (holding court must look beyond form of settlement agreement to substance of underlying obligation). *See generally* Pepper v. Litton, 308 U.S. 295, 304–05 (stating bankruptcy court's equitable powers "have been invoked to the end that fraud will not prevail, that substance will not give way to form, that technical considerations will not prevent substantial justice from being done.").

waiver.[70] The Seventh Circuit in *In re West*, which adopted the novation theory, attempted to reconcile *Brown* by distinguishing *Brown* on the grounds that it addressed the preclusive effect of a state court judgment not a creditor's voluntary release of a debtor.[71] The court stated that "[a] judgment, however, is far removed from a release voluntarily given by a creditor."[72] This distinction is unsatisfactory for two reasons.[73] First, it ignores that the judgment in *Brown* was a consent judgment, and was thus the functional equivalent of "a release voluntarily given by the creditor."[74] Second, although the doctrines of release and *res judicata* are different in significant respects, *West* offers no explanation as to why those differences are significant in the context of a non-dischargeability claim under section 523(a).[75]

There is no reason to conclude that a creditor should be barred from the opportunity to prove the underlying nature of his debt merely because the parties elected to keep their settlement agreement private and not to burden the state court with an unnecessary consent judgment.[76] Therefore, according to *Brown*, a settlement agreement does not release a creditor's subsequent non-dischargeability claim and the bankruptcy court should afford a creditor the opportunity to prove that their claim falls within one of the exceptions from discharge found in section 523.[77] Furthermore, the *Brown* decision and the majority approach are consistent with the significant history of cases under the former Bankruptcy Acts that illustrate the extent to which courts looked through the form of a particular debt to determine if the obligation in question arose out of fraud, thereby rendering the obligation non-dischargeable.[78]

Under the Acts of 1867 and 1898, courts routinely looked through contractual obligations to determine the presence of fraud for the purpose of determining dischargeability.[79] *Strang v. Bradner*,[80] and *Gregory v. Williams*,[81] decided under the Acts of 1867 and 1898 respectively, are illustrative.[82] In *Strang* two debtors procured notes by fraud, and the injured creditors brought suit to recover their

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[70] *See* Ed Schory & Sons v. Francis (*In re* Francis), 226 B.R. 385, 392 (B.A.P. 6th Cir. 1998); *Brown*, 442 U.S. at 128–29.

[71] *In re* West, 22 F.3d 775, 778 (7th Cir. 1994).

[72] *Id*.

[73] *See In re* Francis, 226 B.R. at 392; *see also In re Detrano*, 266 B.R. at 289 (finding no meaningful distinction between voluntary release and consent judgment despite different consequences).

[74] *In re Francis*, 226 B.R. at 392 (citation omitted).

[75] *Id*.

[76] *Id*.

[77] Brown v. Felson, 442 U.S. 127, 138–39 (1979); *see In re Francis*, 226 B.R. at 392.

[78] *See* Brief of Amicus Curiae G. Eric Brunstad, Jr. at 13-17, Archer v. Warner (*In re* Warner), 283 F.3d 230 (4th Cir. 2002), *rev'd*, No. 01-1418, 2003 U.S. LEXIS 2498 (Mar. 31, 2003) (explaining under Acts of 1867 and 1898, courts routinely looked through contractual obligations to determine presence of fraud for purposes of determining dischargeability).

[79] *See id*.

[80] 114 U.S. 555 (1885).

[81] 189 P. 932 (Kan. 1920).

[82] *See Brunstad Brief* at 15-16 (No. 01-1414) (No. 01-1418).

losses.[83] In considering the dischargeability issue, the Supreme Court reasoned that it was irrelevant whether the creditors asserted claims for fraud or for contractual indemnity on the notes.[84] The Court emphasized the policy that "no debt created by the fraud of the bankrupt shall be discharged."[85] Additionally, the Court explained that "[i]t is . . . clear that, whether the claim asserted by plaintiff is regarded as one arising out of deceit or fraud by the defendants, or as a debt created by their fraud, the discharges in bankruptcy do not constitute a defense."[86]

Decisions under the Act of 1898 involving the dischargeability of promissory notes procured by fraud are consistent with the *Strang* approach.[87] For example, in *Gregory* the court held that for bankruptcy purposes the "fraud was not extinguished when the note was given."[88] The court concluded that plaintiff's act of accepting the note after discovering defendant's fraud did not take the indebtedness, which was evidenced by the note, out of the operation of section 17 of the Bankruptcy Act.[89] "The debt remained one for obtaining property by false pretenses and false representations, and the fraud was not waived, so as to discharge the defendant from his obligation to pay . . . ."[90] The majority approach is consistent with the approach taken by the courts under the Acts of 1867 and 1898. The majority approach deems the underlying debt as ensuing from the debtor's fraudulent conduct and not from the debtor's breach of the settlement agreement.[91] Accordingly, the reviewing court is allowed to inquire into the settlement agreement to ascertain whether or not the debt incurred by the debtor was derived from the alleged fraudulent conduct.[92]

Moreover, the reasoning that the Supreme Court employed in *Brown* is analogous to the majority approach's reasoning.[93] The debtor in *Brown* argued that because the creditor chose to resolve the state court action and did not press his fraud claims he should be barred from raising them again in a bankruptcy discharge proceeding.[94] The argument advanced by the debtor in *Brown* is similar to the arguments advanced by debtors who try to bar their creditors from proving the

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[83] *Id*. at 15.
[84] *Id*.
[85] *Strang*, 114 U.S. at 560–61; *see Brunstad Brief* at 15 (No. 01-1414) (No. 01-1418).
[86] *Strang*, 114 U.S. at 561; *see Brunstad Brief* at 15 (No. 01-1414) (No. 01-1418).
[87] *Brunstad Brief* at 16 (No. 01-1414) (No. 01-1418).
[88] Gregory v. Williams, 189 P. 932, 933 (Kan. 1920); *see Brunstad Brief* at 15–16 (No. 01-1414) (No. 01-1418).
[89] *Gregory*, 189 P. at 934; *see Brunstad Brief* at 15–16 (No. 01-1414) (No. 01-1418).
[90] *Gregory*, 189 P. at 934; *see Brunstad Brief* at 16 (No. 01-1414) (No. 01-1418).
[91] *See* Greenberg v. Schools, 711 F.2d 152, 156 (11th Cir. 1983) (theorizing "underlying debt was unquestionably the result of the debtor's fraud, not his breach of the settlement agreement").
[92] *Id*.; *see also* United States v. Spicer, 57 F.3d 1152, 1157 (D.C. Cir. 1995) (holding court must "look beyond form of settlement agreement to substance of underlying obligation").
[93] Brown v. Felsen, 442 U.S. 127, 138 (1979) (refusing to apply res judicata and allowing court to weigh all evidence to determine whether debtor in fact committed fraud or deceit); *see In re* Detrano, 266 B.R. 282, 289 (E.D.N.Y. 2001) (explaining Brown's reasoning).
[94] *Brown*, 442 U.S. at 134.

fraudulent allegations surrounding the parties' settlement agreement.[95] In *Brown*, the Supreme Court rejected the debtor's argument and noted that the creditor was not asserting a new ground for recovery or attacking the validity of the prior consent judgment.[96] Rather, the creditor was "attempting to meet . . . the new defense of bankruptcy which [respondent has] interposed between [creditor] and the sum determined to be due him."[97]

The creditor here, like the creditor in *Brown*, does not seek to assert any new claim against the debtor, nor does he seek to challenge the validity of the Settlement Agreement.[98] The only issue the creditor raises before the bankruptcy court is whether the debtor can avoid paying the amount he previously agreed to pay the creditor.[99] The creditor is merely seeking to get the benefit of his prior bargain with the debtor, not to alter the terms of that bargain in any way.[100] Under these circumstances, there is no reason to bar the creditor's opportunity to prove that the debtor's particular debt should not be discharged.[101] Furthermore, in reasoning that some debts are not dischargeable in bankruptcy "Congress evidently concluded that the creditors' interest in recovering full payment of debts in these categories outweighed the debtor's interest in a complete fresh start."[102]

C. The Majority Approach Parallels Other Bankruptcy Laws and Provisions

The majority approach parallels the law applicable to a situation where a creditor claims that a debtor has contractually waived the right to seek a discharge.[103] Section 727(a)(10) provides that "[t]he court shall grant the debtor a discharge, unless the court approves a written waiver of discharge executed by the debtor *after* the order of relief under this chapter."[104] Courts have interpreted section 727(a)(10) as providing that a waiver of discharge executed prior to the order of relief, such as in a state court settlement agreement, is unenforceable.[105] Therefore, agreements made in advance that waive the benefit of a discharge in bankruptcy are void as against public policy[106] and repugnant to the Bankruptcy Code.[107]

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[95] *See* Detrano, 266 B.R. at 289 (explaining how debtor in *Detrano* advances same argument as debtor in *Brown*).
[96] *Brown*, 442 U.S. at 133; *see In re Detrano*, 266 B.R. at 289.
[97] *Brown*, 442 U.S. at 133.
[98] *See id*.
[99] *See In re Detrano*, 266 B.R. at 289.
[100] *Id*.
[101] *Id*.
[102] *Id*. at 288 (quoting Grogan v. Garner, 498 U.S. 279, 287 (1991)); *see also* Cohen v. de la Cruz, 523 U.S. 213, 217 (1998).
[103] Ed Schory & Sons v. Francis (*In re* Francis), 226 B.R. 385, 390 (B.A.P. 6th Cir. 1998).
[104] *Id*. (emphasis added).
[105] WILLIAM L. NORTON, JR., NORTON BANKRUPTCY LAW AND PRACTICE, Part 12 § 74.19 (2d ed. 1997); s*ee In re* Markizer, 66 B.R. 1014, 1018 (Bankr. S.D. Fla. 1980) ("An agreement to waive the benefits of a discharge in bankruptcy is wholly void as against public policy.").
[106] *See In re* Kriger, 2 B.R. 19, 23 (Bankr. Or. 1979) (noting proposition above).
[107] *See* Fed. Nat'l Bank v. Koppel, 148 N.E. 379, 380 (Mass. 1925).

Advance agreements to waive the benefit of a discharge in bankruptcy have been held void because they go against one of the primary purposes of bankruptcy relief and of the Bankruptcy Code, that of releasing an "honest, unfortunate and insolvent debtor from the burden of oppressive debts and . . . restor[ing] him to business activity."[108] However, the protection of the honest debtor from his creditors, by means of discharge, is not the sole object of bankruptcy law.[109] "A debtor's 'fresh start' is not absolute; the Bankruptcy Code embodies a delicate balance between the rights of debtors and the rights of defrauded creditors."[110] Bankruptcy law also seeks to prevent conduct on the part of the insolvent debtor that would be detrimental to the interests of his creditors.[111]

The novation theory promotes conduct detrimental to the interests of creditors because it allows a debtor to discharge a debt procured by his own fraud merely because the debtor entered into a pre-petition settlement agreement.[112] The debtor could even accept a substantially adverse settlement with the knowledge that its terms and conditions would be nullified by the subsequent petition in bankruptcy.[113] By allowing a debtor to discharge a settlement agreement that is based upon a claim of fraud, misrepresentation, or any like tort (that would otherwise be non-dischargeable) because the settlement stipulation contained a release, the novation theory defeats a major purpose of the Bankruptcy Code — that of preventing the insolvent debtor from engaging in conduct that would be detrimental to the interests of his creditors.

On the other hand, the majority approach better effectuates the purpose of the Code by permitting the court to look beyond the mere form of the settlement agreement, considering the fraudulent allegations surrounding the settlement agreement before determining dischargeablity. It logically follows that, upon the occurrence of bankruptcy, a general release in a settlement agreement should not prevent a creditor from proving that the debt owed to him was procured by fraud. A general release "does not state or suggest any intention by either party to release bankruptcy rights and claims" which were not at issue when the settlement agreement was negotiated.[114]

Moreover, section 523(a)(2) should be read to protect creditors in the way that section 727(a)(10) protects debtors.[115] Section 523(a)(2) should be interpreted to

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[108] *In re* Wade, 26 B.R. 477, 485 (Bankr. N.D. Ill. 1983).

[109] *See generally* WARREN, WILLIAM D. & BUSSEL, BANKRUPTCY 17 (Daniel J. ed., Foundation Press 2002) [hereinafter BANKRUPTCY] (discussing general objects of bankruptcy law).

[110] United States v. Spicer, 57 F.3d 1152, 1156 (D.C. Cir. 1995); *see also In re Wade*, 26 B.R. at 485 (explaining although Bankruptcy Code has been liberally construed to effectuate primarily bankruptcy relief, that of granting "relief is to release an honest, unfortunate and insolvent debtor from the burden of oppressive debts . . ."; it also has been "liberally construed so as to prevent the discharge in bankruptcy of a liability which would not exist but for the fraudulent conduct of the debtor.").

[111] BANKRUPTCY, *supra* note 109, at 17.

[112] *See* Greenberg v. Schools, 711 F.2d 152, 154–55 (11th Cir. 1983).

[113] *Id*.

[114] *In re* Detrano, 266 B.R. 282, 290 (E.D.N.Y. 2001) (quoting Ed Schory & Sons v. Francis (*In re* Francis), 226 B.R. 385, 390 (B.A.P. 6th 1998))).

[115] *In re Francis*, 226 B.R. at 392.

prohibit the enforcement in bankruptcy of a creditor's pre-petition agreement to release its cause of action under section 523(a)(2).[116] The result would be that each section within its respective context would effectively limit to the bankruptcy process the parties' exercise of their bankruptcy rights, as well as their waiver of those rights.[117] Therefore, a settlement agreement that contained a general release of a non-dischargeability claim against the debtor would be null and void upon the filing of a bankruptcy petition. Such a rule would have a result parallel to that of section 727(a)(10)[118] and would effectuate the Bankruptcy Code's "delicate balance" between the rights of debtors and the rights of creditors.[119]

D. Policy Considerations

1. The Novation Theory Does Not Promote Settlements

The circuits that have adopted the novation theory have done so because the theory favors and encourages settlements by ensuring freedom to enter into settlement agreements, regardless of the nature of the claim.[120] These circuits have rejected the majority approach as having the effect of discouraging the settlement of claims.[121] They argue that the majority approach would cause a debtor to be tentative about entering into a settlement agreement, knowing that upon a subsequent filing for bankruptcy his bargained for settlement claim might be deemed not dischargeable.[122]

However, these circuits fail to recognize that the novation theory in fact undermines the settlement of tort claims.[123] If a pre-petition release is sufficient to extinguish a later non-dischargeability claim in bankruptcy, a defendant might be motivated to settle a tort claim for any amount and then simply file for relief under the Bankruptcy Code in order to have the settlement debt discharged.[124] Although this might encourage a tortfeasor to settle the claim, it has the opposite effect on the claimant.[125] The claimant will be concerned about the potential use of this strategy as a way to avoid the satisfaction of the settlement obligation and therefore might be

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[116] *Id.*
[117] *Id.*
[118] *Id.* at 390.
[119] United States v. Spicer, 57 F.3d 1152, 1156 (D.C. Cir. 1995).
[120] *See* Archer v. Warner (*In re* Warner), 283 F.3d 230, 236 (4th Cir. 2002), *rev'd*, No. 01-1418, 2003 U.S. LEXIS 2498 (Mar. 31, 2003) (stating § 523(a) should not be construed in manner that would discourage settlement agreements); *In re* West, 22 F.3d 775, 778 (accepting approach which encourages and enforces settlements).
[121] *See In re* West, 22 F.3d at 778 (explaining rule allowing creditor to undo discharge with adequate consideration would discourage debtors from entering into settlement agreements).
[122] *See In re Warner*, 283 F.3d at 236 (stating courts split on whether settlement claims effect dischargeability of debt).
[123] *See* Ed Schory & Sons v. Francis (*In re* Francis), 226 B.R. 385, 390 (B.A.P. 6th Cir. 1998) (holding general release as part of tort settlement does not serve as novation discharging debt).
[124] *Id.* at 390 (permitting waiver of discharge only if executed post-petition).
[125] *Id.* (illustrating benefits gained by tortsfeasor if pre-petition dischargeability held valid).

less willing to settle the tort claim.[126] The law should facilitate the settlement of tort claims, not obstruct them by adopting the novation theory.[127]

Arguably, under the novation theory, the above scenario may be resolved. Where a creditor has been coerced by exorbitant sums to enter into a settlement agreement, which, unbeknownst to the creditor, the debtor has no intention of paying, such conduct in and of itself may be an act of fraud.[128] If the creditor can subsequently prove such conduct, the settlement agreement may be voidable or offer a basis for a claim of complete non-dischargeability.[129]

However, under the novation theory, only a creditor who has been tricked into settlement will be protected. Tortfeasors who settle with the intention of eventually repaying the defrauded victim will be able to discharge their settlement obligations if they become financially incapable of doing so. Under the novation theory, the resulting defrauded creditors in these circumstances will be denied the protection of section 523(a)(2). Creditors who are aware of the possibility that their settlement may be dischargeable in bankruptcy will be more likely to litigate the issue of fraud in order to protect themselves against the possibility that a debtor might file for bankruptcy in the future. Therefore, the novation theory has the effect of deterring claimants from settlement.

2. Bankruptcy Courts as Courts of Equity Should Enforce the Provisions of the Code to Effectuate Congressional Intent

On several occasions the Supreme Court has held that the "courts of bankruptcy are essentially courts of equity, and their proceedings, inherently proceedings in equity."[130] "A bankruptcy court is a court of equity at least in the sense that in the exercise of the jurisdiction conferred upon it by the [Bankruptcy Code], it applies the principles and rules of equity jurisprudence."[131] Bankruptcy courts have exercised their equitable powers in passing on a wide range of problems arising out of the administration of bankruptcy estate.[132] These equitable powers have been invoked to insure that fraud will not prevail, that substance will not give way to form, and that technical considerations will not prevent substantial justice from being done.[133]

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[126] *Id*. (analyzing effect on tort settlements from claimants view).

[127] *Id*. (discussing public policy concerns with allowing discharge if executed pre-petition).

[128] Brief for Respondent at 37 n.12, Archer v. Warner (*In re* Warner), 283 F.3d 230 (4th Cir. 2002), *rev'd*, No. 01-1418, 2003 U.S. LEXIS 2498 (Mar. 31, 2003), 70 U.S.L.W. 3788 (U.S. June 24, 2002) (No. 01–1414) (No. 01–1418).

[129] *Id*.; s*ee In re* West, 22 F.3d 775, 776 (7th Cir. 1994) (noting court's analysis may have differed if fraudulent allegations surrounded note); Roger Rinke Cadillac, Inc. v. Castonguay (*In re* Castonguay), 77 B.R. 602, 606 (Bankr. E.D. Mich. 1987) (holding debtor's intent not to pay monthly installments on note nullified creditor's waiver of fraud claim).

[130] Local Loan v. Hunt, 292 U.S. 234, 240 (1934).

[131] Larson v. First State Bank, 21 F.2d 936, 938 (1927).

[132] Pepper v. Litton, 308 U.S. 295, 304 (1939).

[133] *Id*. at 305.

Moreover, the bankruptcy courts have been granted the exclusive jurisdiction of dischargeability determinations under section 523(a)(2).[134] The exclusive jurisdiction of dischargeability determinations, together with the equitable nature of the bankruptcy court, provides for the unique character of a bankruptcy discharge proceeding.[135] Empowered with the unique character of discharge proceedings, bankruptcy courts should not hold that a settlement agreement bars a creditor from later attempting to prove that a certain debt arises from fraud.[136] 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."[137] Section 523(a)(2)(A) continues that tradition by excepting 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."[138]

By limiting the reviewing court's examination to the terms of the settlement agreement, the novation theory prevents a bankruptcy court from exercising its equitable powers by "improperly elevat[ing] legal form over substance."[139] The novation theory has the effect of allowing a fraudulent debtor, through the execution of a settlement agreement, to transform himself into a non-fraudulent one, thereby immunizing him from the constraints of section 523(a)(2)(A).[140] This approach is contrary to the public policy embodied in section 523(a)(2)(A) of preventing fraudulent debtors from escaping their obligations at the expense of innocent defrauded creditors.[141] The equitable powers granted to the bankruptcy courts do not limit the courts' review to the terms of the settlement agreement; rather, it allows the court to "inquire into the factual circumstances behind the settlement agreement to ascertain whether . . . the debt . . . was derived from the alleged fraudulent conduct."[142] The dischargeability of a claim is determined by the substance of the liability, not its form.[143]

Under the novation theory, the intent of Congress to except from discharge debts incurred by fraud could effectively be short-circuited by a simple execution of settlement. To disregard the settlement agreement and look at the underlying nature of the claim would not hinder the overall scheme of the Bankruptcy Code of giving

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[134] 4 COLLIER ON BANKRUPTCY ¶ 523.03 at 523-17 (Lawrence P. King et al. eds., 15th ed. 2000).

[135] *See In re* Detrano, 266 B.R. 282, 288 (E.D.N.Y. 2001) (noting unique character of bankruptcy discharge proceeding); Richardson v. Hidy Honda, Inc. (*In re* Richardson), 221 B.R. 956, 961 (D. Wyo. 1998) ("In bankruptcy court there are two separate and distinct causes of action: one is on the debt and the other is on the dischargeability of the debt.").

[136] *In re Detrano*, 266 B.R. at 288.

[137] Cohen v. de la Cruz, 523 U.S. 213, 217 (1998).

[138] *Id*. at 217–18.

[139] United States v. Spicer, 57 F.3d 1152, 1155 (D.C. Cir. 1995).

[140] *Id*.

[141] *Id*.

[142] *Id*. (quoting Greenberg v. Schools, 711 F.2d 152, 156 (11th Cir. 1983).

[143] *See* S.J. Groves & Sons Co. v. Peters (*In re* Peters), 90 B.R. 588, 604 (Bankr. N.D.N.Y. 1988) (adopting majority approach).

the honest debtor a fresh start.[144] Settlement does not magically transform the dishonest debtor to an honest debtor, and therefore does not entitle him to the relief Congress intended to be reserved for the latter.[145] The equitable nature of bankruptcy courts allows the court to look beyond the mere form of the debt to the fraudulent allegations surrounding the debt, implementing the congressional policy of only affording the honest debtor a fresh start through bankruptcy relief.

3. Recent Rise In Incidents of Fraud

In recent years there has been a marked increase in the epidemic deception, fraud, and unfair practices perpetrated in a broad range of consumer transactions.[146] If the Supreme Court were to adopt the novation theory such a holding would allow perpetrators of fraud to use the Bankruptcy Code to shield themselves from having to satisfy the obligations owing to their victims. The novation theory would leave the victims of consumer fraud who settled their claims pre-petition without legal recourse upon the debtor's subsequent filing of bankruptcy.

Every year countless people become the victims of fraud in their everyday dealings with sellers of goods and services.[147] Additionally, the recent wave of accounting and corporate fraud scandals have exemplified the serious consequences that these fraudulent schemes have on consumers.[148] A defrauded purchaser of goods or securities may elect to settle with the defrauding entity. Under the novation theory, if the fraudulent debtor subsequently files for bankruptcy without fulfilling his obligation under the settlement agreement, the consumer is left without legal recourse. Such a result is daunting especially when one considers the countless number of people that were affected by recent accounting and corporate scandals. Moreover, both WorldCom and Enron declared bankruptcy after admitting they engaged in accounting fraud, bringing about the first and second largest bankruptcy filings in the nation's history.[149] Should the victims of large scale corporate and consumer fraud schemes be left unprotected merely because a cautious debtor entered into a pre-petition settlement agreement and subsequently filed for bankruptcy in order to discharge the obligation?

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[144] *See* Bobofchak v. Haynes (*In re* Bobofchak), 101 B.R. 465, 468 (Bankr. E.D. Va. 1989) (holding settlement agreement does not extinguish court's responsibility to look beyond agreement).

[145] *See Spicer*, 57 F.3d at 1156.

[146] *See* Brief of Amicus Curiae AARP at 3–6, Archer v. Warner (*In re* Warner), 283 F.3d 230 (4th Cir. 2002), *rev'd*, No. 01-1418, 2003 U.S. LEXIS 2498 (U.S. Mar. 31, 2003), 70 U.S.L.W. 3788 (U.S. June 24, 2002) (No. 01–1414) (No. 01–1418).

[147] *See* Brief of Amicus Curiae for the States at 10, Archer v. Warner (*In re* Warner), 283 F.3d 230 (4th Cir. 2002), *rev'd*, No. 01-1418, 2003 U.S. LEXIS 2498 (Mar. 31, 2003), 70 U.S.L.W. 3788 (U.S. June 24, 2002) (No. 01–1414) (No. 01–1418).

[148] N.Y. L. J., Feb. 24, 2003, vol. 229 No.35, pg. 14 col. 1 (stating massive accounting fraud kicked off nationwide corporate crisis implicating some of nation's largest companies, financial institutions and accounting firms).

[149] *Id*. (noting Enron is second largest bankruptcy in nation's history and WorldCom is biggest bankruptcy ever).

Equally chilling are recent studies which have uncovered that older Americans are disproportionately victimized by fraud.[150] Fraud against the elderly consumer is perpetrated in various forms including telemarketing scams, health care frauds, home repair swindles, insurance fraud, and predatory lending schemes.[151] "Fraud against older people inflicts especially acute harm, for the 'likelihood that an elder person's income is fixed may make it extremely difficult to recover from a financial loss.'"[152] Additionally, such frauds usually are not committed by reputable companies adverse to bankruptcy; rather, they are committed by fly-by-night operations.[153] Such entities would have little, if any, apprehension about filing for bankruptcy as a way to avoid paying settlement obligations that resulted from their illicit behavior.[154] To permit discharge of these debts would circumvent Congress' clear intention of providing relief to the honest, yet unfortunate, debtor.

III. THE SUPREME COURT SHOULD EXPAND THE NOVATION THEORY TO APPLY TO EXPRESS RELEASES

Typical settlement agreements contain a release or waiver of the underlying tort claim.[155] Although a defendant is entitled to a certain amount of repose when he settles an action alleging that he committed fraud, the finality of settlement should not mean that the defendant is relieved from the full application of the Bankruptcy Code.[156] It is a well-established principle that bankruptcy suspends the normal operation of rights and obligations between the debtor and his creditor.[157] Through section 523(a)(2)(A) Congress has expressly manifested a strong preference that debts owed as a result of fraud be paid, even in bankruptcy.[158] Therefore, a creditor should not be barred from subsequently seeking to establish that a debt is non-dischargeable because of a release or waiver in a pre-petition settlement agreement.

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[150] *See AARP Brief* at 4 (No. 01-1414) (No. 01-1418); *see also* Richard A. Starnes, *Consumer Fraud and The Elderly: The Need For A Uniform System of Enforcement and Increased Civil and Criminal Penalties*, 4 ELDER L.J. 201, 204 (1996) (stating above proposition); Nina Keilin, Note, *Client Outreach 101: Solicitation of Elderly Clients by Seminar Under the Model Rules of Professional Conduct*, 62 FORDHAM L. REV. 1547, 1547 (1994) (stating large number of elderly fall victim each year to consumer fraud).

[151] *AARP Brief* at 4 (No. 01-1414) (No. 01-1418); *see* Keilin, *supra* note 150, at 205 (explaining types of consumer fraud are widespread affecting every area of consumer life from health care to housing).

[152] *AARP Brief* at 5 (No. 01-1414) (No. 01-1418) (quoting Carolyn L. Dessin, *Financial Abuse of the Elderly*, 36 IDAHO L. REV. 203, 205 (2000)).

[153] *Id.*; *see, e.g.*, *Mortgage Lending Fraud Suit Settled for 60 Million,* CONSUMER BANKR. NEWS, April 16, 2002, vol. 11, No. 15, (stating First Alliance Mortgage Corp., predatory lender, filed for bankruptcy relief shortly after being sued).

[154] *See AARP Brief* at 5 (No. 01-1414) (No. 01-1418).

[155] United States v. Spicer, 57 F.3d 1152, 1156 (D.C. Cir. 1995); *see also In re* Pavelka, 79 B.R. 228, 232 n.15 (Bankr. E.D. Pa. 1987) ("[A] party would be foolish not to include a release in a stipulated settlement of a state court action.").

[156] *See In re* Detrano, 266 B.R. 282, 290 (E.D.N.Y. 2001).

[157] *See In re* Fountainebleu Hotel Corp., 508 F.2d 1056, 1059 (5th Cir. 1975).

[158] *In re Detrano*, 266 B.R. at 290; *see also* Grogan v. Garner, 498 U.S. 279, 287 (1991) ("Congress evidently concluded that the creditor's interest in recovering full payment of debts in these categories outweighed the debtor's interest in a complete fresh start.").

Moreover, whether or not the settlement agreement includes a general release or waiver, as opposed to an express release or waiver, should not be determinative to the court's analysis. Although a general release differs from a specific release in that a generally worded release in a tort settlement agreement does not state or suggest any intention by either party to release bankruptcy right claims,[159] this fact alone should not bar the creditor from proving the fraudulent allegations surrounding the settlement agreement. A fraudulent debtor should not be allowed to escape non-dischargeability imposed as a matter of public policy by Congress merely by altering the form of his debt through a settlement agreement. In reasoning that debts incurred by fraud are not dischargeable in bankruptcy, "Congress evidently concluded that the creditors' interest in recovering full payment of debts in these categories outweighed the debtor's interest in a complete fresh start."[160] A fraudulent debtor should not be allowed to escape the strictures of section 523(a)(2)(A) merely because he was cautious enough to insist that an express release be included into the settlement agreement.

Furthermore, the majority approach should be extended to apply to specific waivers and releases to effectuate the Bankruptcy Code's "delicate balance" between the rights of debtors and the rights of creditors.[161] Section 727(a)(10)[162] has been interpreted as providing that a waiver of discharge executed prior to the order of relief, such as in a state court settlement agreement, is unenforceable.[163] Therefore, an advance agreement to waive the benefit of a discharge in bankruptcy is entirely void as against public policy[164] and repugnant to the Bankruptcy Code.[165] Section 523(a)(2)(A) should be interpreted to afford creditors the same protection that section 727(a)(10) provides debtors.[166] Thus, when a debtor and creditor settle pre-petition and exchange mutual releases, the debtor did not give up his right to seek a discharge of his debts in bankruptcy and the creditor did not give up his right to object to discharge of debtor's debt under section 523(a)(2) in the event of such a bankruptcy.[167] Such a result would not only effectuate congressional intent of affording relief only to the honest but unfortunate debtor; but it would also further effectuate the Code's delicate balance between the rights of creditors and debtors.

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[159] *See* Ed Schory & Sons v. Francis (*In re* Francis), 226 B.R. 385, 390 (B.A.P. 6th Cir. 1998).

[160] *In re Detrano*, 266 B.R. at 288 (quoting *Grogan*, 498 U.S. at 287); *see also* Cohen v. de la Cruz, 523 U.S. 213, 217 (1998) (discussing liabilities arising out debtor's fraud are not dischargeable).

[161] United States v. Spicer, 57 F.3d 1152, 1156 (D.C. Cir. 1995) (quoting *In re* Pavelko, 79 B.R. 228, 232 (Bankr. E.D. Pa. 1987)).

[162] *See supra* notes 105–09 and accompanying text.

[163] WILLIAM L. NORTON, JR., 3 NORTON BANKRUPTCY LAW AND PRACTICE 2d. § 74:19, at 74-41–42 (1997); s*ee also In re* Markizer, 66 B.R. 1014, 1018 (Bankr. S.D. Fla. 1980) (holding "[a]n agreement to waive the benefit of a discharge in bankruptcy is wholly void, as against public policy.").

[164] *In re* Kriger, 2 B.R. 19, 23 (Bankr. Or. 1979).

[165] Fed. Nat'l Bank v. Koppel, 148 N.E 379, 380 (Mass. 1925).

[166] Ed Schory & Sons v. Francis (*In re* Francis), 226 B.R. 385, 392 (B.A.P 6th Cir. 1998).

[167] *See id*.

IV. THE SUPREME COURT'S HOLDING

Archer v. Warner arose out of the following circumstances: (1) *A* sues *B* seeking money that (*A* claims) *B* obtained through fraud; (2) the parties settle the lawsuit and release related claims; (3) the settlement agreement does not resolve the issue of fraud, but provides that *B* will pay *A* a fixed sum; (4) *B* does not pay the fixed sum; (5) *B* enters bankruptcy; and (6) *A* claims that *B's* obligation to pay the fixed settlement sum is nondischargeable because like the original debt it is for "money . . . obtained by fraud."[168] The Supreme Court held that the settlement agreement and releases may have "worked a kind of novation."[169] However, this fact alone does not bar creditors from subsequently showing that the settlement debt arose out of "false pretenses, a false representation, or actual fraud" and consequently is nondischargeable.[170]

The Supreme Court agreed with the Court of Appeal's determination that the settlement agreement and promissory note, coupled with the broad language of the release, completely released the underlying state law claims.[171] Consequently, the settlement left only one relevant debt: a debt for money promised in the settlement agreement itself.[172] This determination did not put an end to the Supreme Court's inquiry.[173] Next, the Court addressed whether that same debt could also amount to a debt for money obtained by fraud, within the terms of the non-dischargeability statute.[174] Based on the Court's precedent the Supreme Court held that it can.[175]

The Court reasoned that *Brown* v. *Felsen*[176] controlled.[177] In *Brown*, the Court held that claim preclusion did not prevent the Bankruptcy Court from looking beyond the record of the state court proceeding, the stipulation and consent judgment in order to resolve whether the debt at issue was for money obtained by fraud.[178] Hence, under *Brown*, the novation theory could not be upheld.[179] The Court noted that the reduction of Brown's state court fraud claim to a stipulation embodied in a consent decree brought about the same kind of novation as the novation in question in *Archer*.[180] Yet, in *Brown* the Supreme Court held that the bankruptcy court could look behind the stipulation to determine whether it reflected settlement of a valid claim for fraud.[181] Under the novation theory's rationale, the

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[168] Archer v. Warner, No. 01-1418, 2003 U.S. LEXIS 2498, at *6 (March 31, 2003).
[169] *Id.* at *16.
[170] *Id.* at *16–*17 (quoting 11 U.S.C. § 523(a)(2)(A) (2000)).
[171] *Id.* at *9.
[172] *Id.*
[173] *Archer*, 2003 U.S. LEXIS 2498, at *6.
[174] *Id*. at *9.
[175] *Id.*
[176] 442 U.S. 127 (1979).
[177] *Archer*, 2003 U.S. LEXIS 2498, at *9.
[178] *Brown*, 442 U.S. at 138–39.
[179] *Archer*, 2003 U.S. LEXIS 2498, at *11.
[180] *Id.* at *11–*12.
[181] *Brown*, 442 U.S. at 132.

debt in *Brown* would have been discharged,[182] thereby rendering the Court's instruction to the bankruptcy court to "weigh all the evidence" meaningless.[183]

Additionally, the Court noted that the language in *Brown* strongly favored the creditor's position.[184] In *Brown*, the Court stated that "the mere fact that a conscientious creditor has previously reduced his claim to judgment should not bar further inquiry into the true nature of the debt."[185] The *Archer* Court observed that if they substituted the word "settlement" for the word "judgment" the above statement thus describes the present circumstances.[186]

Furthermore, the Court articulated that the basic reasoning of *Brown* applied to the present case.[187] In *Brown*, the Court stated that originally the Bankruptcy Code's non-dischargeability provision applied only to "judgments sounding in fraud."[188] Congress had later amended the provision to cover all such "liabilities."[189] This change indicated that "Congress had intended the fullest possible inquiry" to ensure that "all debts arising out of" fraud are "excepted from discharge," notwithstanding their form.[190] Additionally, Congress had intended to allow the relevant determination to take place in bankruptcy court and not to force it to occur at an earlier time when non-dischargeability concerns are not directly at issue and neither party has a full incentive to litigate them.[191]

The Court observed that the only distinction between debt in *Brown* and the debt in *Archer* was that the present debt is embodied in a settlement, not in a stipulation and consent judgment; however, the distinction was not determinative.[192] The dischargeability provision applies to all debts "aris[ing] out of" fraud.[193] A debt embodied in a settlement of a fraud claim "arises out of" the underlying fraud to the same degree as a debt embodied in a stipulation and consent decree.[194] Moreover, the *Archer* Court found that the rational of *Brown*, coupled with the doctrine of res judicata, ensured a "blanket release of the underlying fraud claim."[195] The contractual releases present in *Archer* were found to be analogous.[196] Finally, similar to the parties in Brown, the parties in *Archer* had not established that they intended to resolve the issue of fraud, or more narrowly, intended to resolve the issue for the purposes of a later claim of non-dischargeability.[197] The Court

[182] *See Archer*, 2003 U.S. LEXIS 2498, at *12.
[183] *Id.*
[184] *Id.*
[185] *Brown*, 442 U.S. at 138.
[186] *Archer*, 2003 U.S. LEXIS 2498, at *13.
[187] *Id*.
[188] *Brown*, 442 U.S. at 138.
[189] *See id.*
[190] *Id.*
[191] *See id.* (citing *In re* Pigge, 539 F.2d 369, 371–72 (4th Cir. 1976)).
[192] *Archer*, 2003 U.S. LEXIS 2498, at *14.
[193] *Brown*, 442 U.S. at 138.
[194] *See Archer*, 2003 U.S. LEXIS 2498, at *14.
[195] *Id.*
[196] *See id.*
[197] *See id*. at *15.

concluded by stating that they could not find a significant difference between *Brown* and the case before it.[198]

CONCLUSION

Section 523(a)(2)(A) of the Bankruptcy Code renders "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" non dischargeable in bankruptcy.[199] Two theories interpreting this language have emerged in recent years. One line of cases has posited that a pre-petition settlement of claims involving fraud extinguishes the creditor's subsequent non-dischargeability defense under section 523(a)(2)(A) when the debtor had filed for bankruptcy without having fully satisfied the settlement obligation. This approach termed the novation theory permits a reviewing court to examine the terms of the pre-petition settlement agreement in order to determine the validity of and completeness of the bargained for agreement and release. Opponents subscribe to the majority approach, arguing that a pre-petition settlement of claims involving fraud might sustain the creditor's subsequent non-dischargeability claim. This would require an inquiry into the factual circumstances behind the settlement agreement to ascertain whether the debt incurred by the debtor was derived from the alleged fraudulent conduct. The Supreme Court's holding in *Archer v. Warner* overruled the Fourth Circuit's adoption of the novation theory. The Court held that although the settlement agreements and releases may have worked "a kind of novation," this fact should not bar a creditor from subsequently proving that the settlement debt arose out of "false pretenses, a false representation or actual fraud."

Both theories are supported by competing policy considerations, each of which has serious implications on the respective rights and obligations of debtors and creditors. The Supreme Court's approach is consistent with the majority approach, which this note contends that the Court should adopt. Under the majority approach the creditor is merely seeking to get the benefit of his prior bargain with the debtor. The creditor is not seeking to alter the terms of the bargain in any way. In this regard the settlement agreement and release may have brought about "a kind of novation." Under these circumstances there is no reason to bar the creditor the opportunity to prove that the debtor's particular debt should not be discharged. Furthermore, the majority approach should be extended to apply to specific releases and waivers of subsequent non-dischargeability defenses to effectuate the Bankruptcy Code's delicate balance between the rights of debtors and creditor. The majority approach implements the fundamental Congressional policy behind bankruptcy relief that of only affording relief to the "honest but unfortunate debtor."

Merav Biton

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[198] *Id.*
[199] 11 U.S.C. § 523(a)(2)(A) (2000).