Determining the Dischargeability of Fraudulent Claim Settlement Agreements in Bankruptcy

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DETERMINING THE DISCHARGEABILITY OF FRAUDULENT CLAIM SETTLEMENT AGREEMENTS IN BANKRUPTCY

"No one shall be permitted to profit by his own fraud, or to take advantage of his own wrong, or to found any claim upon his own iniquity, or to acquire property by his own crime."1

I. INTRODUCTION

Inherent in the Bankruptcy Code2 (the "Code") is the notion of the "fresh start," a policy whereby a debtor can obtain relief from certain debts in order to pull themselves out from under a mountain of overwhelming debt.3 Legally known as discharge, the process has endured multiple revisions of the federal bankruptcy statute first enacted in 1898.4 That is not to say, however, that a debtor can freely discharge any and all debts owed to a creditor.5 Indeed, federal bankruptcy law sets forth a specific list of nondischargeable debts that survive the bankruptcy discharge process and remain the debtor's obligation.6 Nondischargeable debts reflect the policy decision by Congress that some financial obligations should not be discharged because they are the result of the debtor's bad faith or misconduct.7

One such discharge exemption prohibits the discharge of any debt obtained by fraud, false pretenses, or misrepresentation.8 Essentially, if an individual commits fraud that results in a debt to another, that individual may not discharge the debt in a subsequent bankruptcy action.9 Congress

1 Riggs v. Palmer, 22 N.E. 188, 190 (N.Y. 1898).
6 See id.
9 See id.
included the fraud exemption to preclude a debtor from benefiting from his fraudulent actions through a bankruptcy discharge.\(^\text{10}\)

An issue arises, however, when a creditor asserts a fraud claim against a debtor, and the parties settle the dispute before trial. Stated simply, assume that two parties, creditor ("C") and debtor ("D"), have settled a fraud claim out of court through an agreement that requires C to forego any legal remedies in exchange for D's execution of a promissory note to compensate C for its loss. Under this scenario, D now owes a debt to C for the amounts due under the note. Subsequent to the entry of the settlement agreement, D encounters economic hardship and defaults on the repayment of the note to C. D then seeks bankruptcy protection, including the discharge of his debt to C. Does the debt traceable to the alleged fraudulent actions of the debtor remain intact, or does the settlement agreement supersede and replace the original fraud claim?

Currently, there is no definitive answer to this question. The Fourth, Seventh, and Ninth Circuits hold that the settlement agreement acts as a novation, replacing the original tort-based fraud claim with a contract-based claim governed solely by the terms of the agreement.\(^\text{11}\) Absent a challenge by a creditor, the Code generally permits the discharge of a debt as a matter of course.\(^\text{12}\) As a result, the debt owed under the settlement agreement is discharged, and the fraudulent debtor receives his "fresh start."\(^\text{13}\)

In contrast, the District of Columbia and Eleventh Circuits hold that the underlying nature of the debt is determinative when the debt originated from the fraudulent conduct of the debtor.\(^\text{14}\) Thus, notwithstanding the execution of the agreement settling the fraud claim, the underlying debt originating in fraud remains intact and is not dischargeable under the

\(^{10}\) See 3 NORTON, supra note 7 and accompanying text.

\(^{11}\) See Archer v. Warner (In re Warner), 283 F.3d 230, 232 (4th Cir. 2002), cert. granted, Archer v. Warner, 122 S. Ct. 2618 (2002) (holding settlement agreement in fraud dispute acts as novation replacing fraud debt with contract debt); Key Bar Investments, Inc. v. Fischer (In re Fischer), 116 F.3d 388, 389 (9th Cir. 1997) (holding same); In re West, 22 F.3d 775, 777 (7th Cir. 1994) (holding same).

\(^{12}\) See, e.g., 11 U.S.C. § 727 (2000) (providing discharge under chapter 7 liquidation proceedings); § 944 (providing discharge of debtor under chapter 9 municipality reorganization plan); § 1141 (providing discharge of debtor under chapter 11 reorganization); § 1328 (providing discharge of debtor under chapter 13 reorganization of individuals); see also FED. R. BANKR. P. 4007(c) (proscribing mechanism to determine dischargeability of debt under § 523).

\(^{13}\) See case cited supra note 11 (holding fraudulent debt settlement agreement as novation replacing fraud debt with contract debt).

\(^{14}\) See United States v. Spicer (In re Spicer), 57 F.3d 1152, 1157 (D.C. Cir. 1995) (holding underlying fraudulent nature of debt determinative for dischargeability decision); Greenberg v. Schools, 711 F.2d 152, 156 (11th Cir. 1983) (holding same).
At the time of this writing, the United States Supreme Court has yet to resolve this dispute.

The practical effect of this disconnect among the federal circuits is twofold: first, the split among the courts discourages the settlement of the underlying fraud claim as neither the creditor nor the debtor has any incentive to execute a settlement agreement. Second, this judicial disconnect places significant strain on the parties, and thus the courts, to fully litigate the underlying fraud claim. This note argues that the courts should look to the underlying nature of the debt owed and fully investigate the merits of the fraud claim in order to make the discharge determination. Such a rule more fully reflects Congress’ intent in specifying certain debts that are nondischargeable in bankruptcy due to the bad faith or misconduct of the debtor. Furthermore, given the Supreme Court’s interpretation of § 523(a)(2)(A) to encompass “all liability arising from fraud,” regardless of form, the settlement agreement establishes a liability in the debtor that is the direct progeny of the debtor’s alleged fraudulent activities, which the Code precludes from discharge in bankruptcy.

Part II of this note presents a brief history of the Bankruptcy Code and the policy rationale underlying the fraud exception to discharge. Part III describes the current disconnect among the federal circuit courts concerning the dischargeability of settlement agreements for fraudulent debts and examines the reasoning employed by those courts that have produced conflicting interpretations of § 523(a)(2)(A). Part IV argues that the courts

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15 See In re Spicer, 57 F.3d at 1157 (holding change in form from fraud claim to settlement agreement preserves debt derived through fraud); Greenberg, 711 F.2d at 156 (holding same).

16 See In re Warner, 283 F.3d at 236-37 (holding settlement agreement in fraud dispute acts as novation replacing fraud debt with contract debt); In re Fischer, 116 F.3d at 390 (holding same); In re West, 22 F.3d at 778 (holding same). But see In re Spicer, 57 F.3d at 1157 (holding underlying fraudulent nature of debt determinative for purposes of § 523(a)(2) dischargeability review); Greenberg, 711 F.2d at 156 (holding same). Depending upon the jurisdiction in which the bankruptcy proceeding is filed, the settlement agreement may either fully discharge the debt grounded in fraud, thus leaving the creditor holding nothing but an empty promise to pay, or it may create (i.e., preserve) a nondischargeable debt, a situation the debtor is seeking to avoid.

17 See Brown v. Felsen, 442 U.S. 127, 138 (1979) (posing whether creditor’s failure to pursue fraud claim betrays weakness in case). In this instance, the creditor may be compelled to plead and argue a weak fraud claim in the prior non-bankruptcy action, or conversely, withhold the fraud claim altogether to preserve it for a possible bankruptcy proceeding in the future. As a result, both parties incur greater expense by having to undergo a full trial on the fraud claim, and the courts must expend a portion of its limited resources on resolving a dispute that might otherwise lend itself to private settlement.

18 See 11 U.S.C. § 523 (2000) (relating to nondischargeable debts in bankruptcy); see also 3 NORTON, supra note 7, § 47:1 at 47-4 (discussing Congress’ intent in precluding certain debts from discharge in bankruptcy).

19 Cohen v. de la Cruz, 523 U.S. 213, 215 (1998) (holding treble damages award under state consumer statute is liability arising from debtor’s fraud).
should look to the underlying facts and circumstances of the debt to discern whether the debt arose from actual fraudulent behavior on the part of the Debtor, rather than seek to interpret the intentions of the parties in executing the subsequent settlement agreement. Part V concludes that the facts and circumstances analysis more closely comports with Congress' intent to exclude certain debts from discharge in bankruptcy.

II. BRIEF HISTORY OF THE BANKRUPTCY CODE AND THE FRAUD EXCEPTION TO DISCHARGE

A. Bankruptcy Background

The concept of bankruptcy traces its roots back nearly five hundred years to English statutes enacted under Henry VIII in 1540.20 The early English code was available only to merchants, and focused wholly on creditor's remedies which included access and seizure of a debtor's chattels, or in some instances, to the debtor himself.21 It would take another 160 years before the bankruptcy process would be made available to non-merchants, and the notion of asset seizure and sale to settle debts would come into being.22

The modern Bankruptcy Code seeks to balance competing interests: providing debtors with a "fresh start" free from burdensome debt obligations, while protecting creditors rights to fair treatment and an equitable share of the bankruptcy estate.23 American bankruptcy law finds its origins in the United States Constitution through which the framers saw fit to empower Congress, "[t]o establish ... uniform Laws on the subject of Bankruptcies throughout the United States ...",24 and "[t]o make all Laws which shall be necessary and proper for carrying into Execution the foregoing Powers ...".25 As James Madison noted in the Federalist Papers,

The power of establishing uniform laws of bankruptcy is so intimately connected with the regulation of commerce, and will prevent so many frauds where the parties or their prop-

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20 See 34 & 35 Hen. 8, c. 4 (1542-1543) (Eng.) (establishing first English statutory bankruptcy law).
21 See 1 NORTON, supra note 7, § 1:2, at 1-2 – 1-3 (discussing early English bankruptcy laws).
22 See 4 Ann., c. 17 (1705) (Eng.) (amending English bankruptcy statute to encompass non-merchant debtors).
24 U.S. CONST. art. I, § 8, cl. 4.
property may lie or be removed into the different States, that the expediency of it seems not likely to be drawn into question.26

While this represents the only mention of bankruptcy in the Federalist Papers, Norton notes that the American colonies were plagued by inconsistencies and conflicts in commercial transactions, and posits that the founders viewed bankruptcy as an important method to address such disputes.27

The early legislative history of U.S. bankruptcy law indicates that Congress wielded its bankruptcy power sparingly, enacting laws that were limited in both time and scope.28 The first comprehensive federal bankruptcy law was enacted in the wake of the Civil War, but it survived for a mere ten years before it was repealed.29 The Bankruptcy Act of 1898 represents the first permanent federal bankruptcy statute.30 Congress, while amending its provisions multiple times in the century, has never seen fit to repeal it.31

The current Bankruptcy Code, enacted in 1978, is the direct descendant of the 1898 Act, although today it holds little resemblance to its predecessor.32 The Bankruptcy Code ushered in sweeping structural and substantive revisions to federal bankruptcy law.33 The 1978 Bankruptcy Act updated and overhauled the system originally crafted in the “horse and buggy age” to reflect the modern demands placed on an antiquated and

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27 See 1 NORTON, supra note 7, § 1:3, at 1-5.
29 See Act of March 2, 1867, ch. 176, 14 Stat. 517 (1867) (repealed 1877); see also 1 NORTON, supra note 7, § 1:3, at 1-6 – 1-7 (noting 1867 Act repealed due to abuses in administration).
30 See Act of July 1, 1898, ch. 541, 30 Stat. 544 (establishing predecessor statute to current Bankruptcy Code).
Congress enacted the 1978 Code to reflect the growth of consumer credit and adoption of the Uniform Commercial Code by many states. The development of modern commercial financing, and new, more sophisticated systems of payment, strained the application of the 1898 Act to modern business and commercial activities.

In adopting the 1978 Code, Congress sought to maintain and enhance the concept of the "fresh start." Within the context of the straight bankruptcy liquidation, the "fresh start" allows the debtor to retain certain exempt assets to assist them in resurrecting themselves from bankruptcy. The Bankruptcy Code specifically lists the assets that the debtor is entitled to retain subsequent to bankruptcy via the discharge process. These exempt assets generally reflect the necessaries of life such as the family home, one automobile, certain personal and household goods, tools of the trade, life insurance policies, social health and welfare benefits, and certain tort judgments. As Congress noted, "[t]he historical purpose of these exemption laws has been to protect a debtor from his creditors, to provide him with the basic necessities of life so that even if his creditors levy on all of his nonexempt property, the debtor will not be left destitute and a public charge." Courts have recognized the importance of the discharge process, stating in one case that the "[d]ischarge is the legal embodiment of the 'fresh start.'"
The discharge aspect of bankruptcy has been an integral part of the modern Bankruptcy Code since it was first enacted in 1898.43 Multiple sections of the current code, and its far reaching effects, demonstrate the importance of the discharge process.44 The discharge generally arises as a matter of right in the debtor as the Code states that the debtor “may exempt” certain statutory property from the bankruptcy estate.45 More importantly, the discharge operates as a permanent injunction against any action or effort to collect a debt, prohibiting the creditor from contacting the debtor in any way once the discharge takes effect.46 As the Supreme Court stated, “[t]hrough discharge, the Bankruptcy Act provides ‘a new opportunity in life and a clear field for future efforts, unhampered by the pressure and discouragement of preexisting debt.’”47

While courts narrowly construe the discharge in favor of the debtor, courts also give strong consideration to satisfying a creditor’s claim against the debtor’s estate.48 Congress limited the availability of the discharge to the unfortunate debtor who otherwise acted in good faith.49 To this end, the 1978 Amendments, through § 523, preserved the policy by exempting certain debts from discharge and obligating the debtor to repay such


44 See, e.g., 11 U.S.C. § 727 (2000) (providing discharge under chapter 7 liquidation proceedings); § 944 (providing discharge of debtor under chapter 9 municipality reorganization plan); § 1141 (providing discharge of debtor under chapter 11 reorganization); § 1328 (providing discharge of debtor under chapter 13 reorganization of individuals).

45 See 11 U.S.C. § 522(b) (2000) (requiring debtor to affirmatively elect to take the federal exemptions within fifteen days of filing its petition under either 11 U.S.C. § 301 (2000) (voluntary, i.e., debtor driven petition) or 11 U.S.C. § 303 (2000) (involuntary, i.e., creditor driven petition) or the entry of the order for relief or the debtor will be deemed to have taken the exemptions set forth under relevant state bankruptcy law. See 11 U.S.C. § 522(b)(2).

46 See 11 U.S.C. § 524 (2000) (voiding any judgment and precluding creditor’s efforts to collect on the debt); see also S. Rep. No. 95-989, at 80 (1978) (noting § 524 expansion of prior bankruptcy law prohibiting creditor contact with debtor subsequent to discharge). The Senate in its legislative report stated that § 524 is “intended to ensure that once a debt is discharged, the debtor will not be pressured in any way to repay it,” and that the discharge “extinguishes the debt, and creditors may not attempt to avoid that.” Id. The Senate further noted that § 14f of the prior 1898 Act prohibited such acts as “dunning by telephone or letter, or indirectly through friends, relatives, or employers, harassment, threats of repossession, and the like.” Id.


debts.\(^{50}\) As the U.S. District Court for the Southern District of Ohio stated in *Hartford Accident & Indemnity Co. v. Flanagan*,\(^{51}\)

It is the purpose of the Bankruptcy Act, among other things, to release an honest, unfortunate, and insolvent debtor from the burden of oppressive debts and to restore him to business activity. This is done in the interest of society and it has been held that the act should be liberally construed to that end. But, too, the act should be liberally construed so as to prevent the discharge in bankruptcy of a liability which would not exist but for the fraudulent conduct of the bankrupt.\(^{52}\)

Thus, as Norton observes, the exemptions from the statutory discharge reflect the policy decision by Congress that certain debts should survive the bankruptcy process.\(^{53}\)

The fraud exemption has been the focus of debate among the federal circuit courts, specifically with respect to the dischargeability of settlement agreements that are the direct product of fraud claims against the debtor.\(^{54}\) Greater discussion of the origins and application of the fraud exemption is necessary to fully comprehend the nature of this division.

\(^{50}\) See 11 U.S.C. § 523(1)-(18) (2000) (specifying categories of nondischargeable debts). The section sets forth sixteen categories of debts that are not dischargeable in bankruptcy, including: certain tax liabilities owed; money, property, services, or credit obtained by false pretenses, misrepresentation, or fraud; fraud or defalcation while acting in fiduciary capacity, embezzlement, or larceny; alimony and child support; willful or malicious injury by debtor to another entity or property of another entity; fines, penalties, or other forfeitures payable to the government; education loans provided by the government; death or personal injury cause while debtor was operating a vehicle under the influence; and criminal fines among others. See id.


\(^{52}\) Id. at 419.

\(^{53}\) See 3 NORTON, supra note 7, § 47:1, at 47-4. Norton continues by stating that "certain debts should be excluded from discharge because of overriding public policy relating to the type of debt, the manner in which the liability was incurred, or the underlying social responsibility that the debt represents." Id.

\(^{54}\) See In re Spicer, 57 F.3d at 1157 (holding underlying fraudulent nature of debt determinative in nondischargeability determination); Greenberg v. Schools, 711 F.2d 152, 156 (11th Cir. 1983) (holding same). But see Archer v. Warner (In re Warner), 283 F.3d 230, 236-37 (4th Cir. 2002), cert. granted, Archer v. Warner, 122 S. Ct. 2618 (2002) (holding settlement agreement in fraud dispute acts as novation replacing fraud debt with contract debt); Key Bar Investments, Inc. v. Fischer (In re Fischer), 116 F.3d 388, 390 (9th Cir. 1997) (holding same); In re West, 22 F.3d 775, 778 (7th Cir. 1994) (holding same).
B. Policy Rationale of Fraudulent Debt Exception to Discharge

Congress, through the 1978 Act, preserved the policy that debts obtained through fraud or false statements are not dischargeable in bankruptcy. Specifically, the Bankruptcy Code states that bankruptcy “does not discharge any individual debtor from any debt . . . for money [or] property . . . to the extent obtained by . . . false pretenses, a false representation, or actual fraud.” This section illustrates the intention of Congress to provide the debtor with a “fresh start” provided that it does not come at the expense of defrauded third parties. The United States Supreme Court noted in *Grogan v. Garner* that, “Congress evidently concluded that the creditors’ interest in recovering full payment of debts in these categories outweighed the debtors’ interest in a complete ‘fresh start.’”

At first glance, the United States Supreme Court’s decision in *Brown v. Felsen* arguably stands for the proposition that Congress intended a full inquiry into the underlying nature of the debt for the purposes of determining dischargeability under the Bankruptcy Code. There is division among the federal circuit courts, however, as to the applicability of *Brown* to the fraud discharge exemption.

The Court in *Brown* considered whether a bankruptcy court was confined to reviewing the judgment and record of a prior state court fraud proceeding in determining the dischargeability of the disputed debt. The

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62 See In re Spicer, 57 F.3d at 1157 (holding underlying fraudulent nature of debt determinative in nondischARGEability determination); Greenberg v. Schools, 711 F.2d 152, 156 (11th Cir. 1983) (holding same). But see Archer v. Warner (In re Warner), 283 F.3d 230, 236-37 (4th Cir. 2002), cert. granted, Archer v. Warner, 122 S. Ct. 2618 (2002) (holding settlement agreement in fraud dispute acts as novation replacing fraud debt with contract debt); Key Bar Investments, Inc. v. Fischer (In re Fischer), 116 F.3d 388, 390 (9th Cir. 1997) (holding same); In re West, 22 F.3d 775, 778 (7th Cir. 1994) (holding same).

63 See Brown, 442 U.S. at 129 (holding bankruptcy court to review underlying facts of fraud claim). Brown was the guarantor for Felsen and Felsen’s luxury car dealership. Id. at 128. Brown alleged in a civil suit that Felsen induced him to guarantee several loans through fraudulent misrepresentation and non-disclosure of material facts. Id. The parties settled the suit by stipulation. Id. Soon thereafter, Felsen filed a voluntary bankruptcy
parties in that case ultimately settled the dispute by stipulation.\textsuperscript{64} Felsen, the debtor, argued that the prior stipulation and court proceeding did not result in a finding of fraud and that \textit{res judicata} barred relitigation on the issue of the nature of the debt.\textsuperscript{65} In rejecting Felsen's argument, the Court reasoned that Brown was not asserting a new ground for recovery, but rather was seeking to counter the "new defense of bankruptcy which [Felsen] has interposed between [Brown] and the sum determined to be due him."\textsuperscript{66} The Court favored the policy permitting the bankruptcy court to make an accurate determination regarding whether the debtor did, in fact, engage in deceit or fraud.\textsuperscript{67} Furthermore, the Court stated that the bankruptcy court should weigh all of the available evidence to determine whether the creditor's failure or refusal to pursue a fraud claim in an earlier action "betray a weakness in his case on the merits."\textsuperscript{68}

Creditors, however, are not automatically entitled to an order prohibiting the discharge of a debt originating in fraud. Under the Bankruptcy Code, and its accompanying rules, the creditor has the burden of pleading and proving the nondischargeability of the debt in question.\textsuperscript{69} Subsequent Supreme Court precedent requires the creditor to prove its case by a preponderance of the evidence.\textsuperscript{70} Furthermore, the creditor still must prove

\textsuperscript{64} See Brown, 442 U.S. at 128.

\textsuperscript{65} See id. at 129 (describing debtor's argument that fraud debt settled by prior agreement). \textit{Res judicata} provides that a "final judgment on the merits bars further claims by parties or their privies based on the same cause of action." \textit{Id.} (citing \textit{Montana v. United States}, 440 U.S. 147, 153 (1979)).

\textsuperscript{66} Brown, 442 U.S. at 133.

\textsuperscript{67} See id. at 138 (holding \textit{res judicata} no bar to full inquiry into fraudulent nature of disputed debt). The Court further noted that the plaintiff is master of the complaint and is entitled to selecting those causes of action which he believes are most advantageous to him. \textit{Id.} Failure in that instance to raise a claim of fraud should not serve to bar such an assertion in a later bankruptcy action to collect on a debt. \textit{Id.} at 137.

\textsuperscript{68} See id. at 138.

\textsuperscript{69} See 11 U.S.C. \textsection 523(c)(1) (2000) (permitting discharge of debt absent creditor objection and/or judicial determination of nondischargeability). \textsection 523(c)(1) states that the "debtor shall be discharged from a debt of the kind specified in paragraph (2) . . . of subsection (a) of this section, unless, on request of the creditor to whom such debt is owed, and after notice and a hearing, the court determines such debt to be excepted from discharge . . . ." \textit{Id; see also \textit{FED R. BANKR. P.} 4007(c) (relating to determination of dischargeability of a debt under \textsection 523(a)(2)). \textsection 4007(c) requires the creditor to file its complaint seeking a determination of the dischargeability of a debt under \textsection 523(c) within 60 days from the first date set for the meeting of the creditors under \textsection 341(a) (stating such meeting shall commence within a reasonable time after the entry of the order for relief). \textit{FED R. BANKR. P.} 4007(c). The court may for cause extend the deadline for filing the complaint. \textit{Id.} Taken together, \textsection 523(c) and Rule 4007(c) impose upon the creditor the obligation to file its complaint to determine the issue of dischargeability of debts under \textsection 523(a)(2) before the 60 day deadline, or the debt will be discharged as a matter of right.

each element of the fraud claim to prevail on its motion for nondischargeability of the debt.\textsuperscript{71}

The Court in \textit{Grogan} held that the preponderance of the evidence standard,\textsuperscript{72} rather than the clear and convincing standard,\textsuperscript{73} applies to all exceptions to dischargeability under § 523 of the Bankruptcy Code.\textsuperscript{74} Given that the creditor must carry the burden on the issue of dischargeability, the Court noted with concern that the clear and convincing standard poses a higher burden of proof, and thus favors the debtor, while the preponderance standard more evenly spreads the risk of error between the creditor and debtor.\textsuperscript{75} Moreover, the \textit{Grogan} Court reaffirmed its position that the exceptions from discharge evidenced Congress’ intent to preserve debt obligations obtained through fraud and doubted that Congress would favor a standard of proof (i.e., clear and convincing proof) that favors the perpetrator of fraud over the victim.\textsuperscript{76}

The Fifth Circuit Court of Appeals in \textit{In re Mercer}, applying the preponderance of the evidence standard, articulated the elements of fraud that the creditor must prove in order to obtain a nondischarge order from a bankruptcy court.\textsuperscript{77} The \textit{Mercer} court noted Congress chose to use the term “actual fraud” in drafting § 523; legislative construction that the Fifth Circuit interpreted as “positive” rather than “constructive” fraud.\textsuperscript{78} Fraud

\textsuperscript{71} See AT&T Universal Card Servs. v. Mercer (\textit{In re Mercer}), 246 F.3d 391, 403 (5th Cir. 2001) (holding creditors must prove elements of fraud to prevail on claim for nondischargeability of debt arising in fraud).

\textsuperscript{72} See \textit{BLACK'S LAW DICTIONARY} 1201 (7th ed. 1999). \textit{BLACK'S} defines the preponderance standard as being of “superior evidentiary weight that... [is] sufficient to induce a fair and impartial mind to one side of the issue rather than the other.”\textit{Id.}

\textsuperscript{73} See \textit{BLACK'S LAW DICTIONARY} 577 (7th ed. 1999). \textit{BLACK'S} defines the clear and convincing standard as requiring “the thing to be proved is highly probable or reasonably certain.”\textit{Id.}


\textsuperscript{75} See Grogan, 498 U.S. at 286-87 (recognizing policy balancing debtor and creditor interests).

\textsuperscript{76} See \textit{id.} at 287 (deducing Congress’ intent in precluding discharge of certain debts).

\textsuperscript{77} See AT&T Universal Card Servs. v. Mercer (\textit{In re Mercer}), 246 F.3d 391, 403 (5th Cir. 2001) (stating necessary elements for fraudulent debt claim).

\textsuperscript{78} See \textit{id.} at 407. The Fifth Circuit relied on the Supreme Court’s statement in \textit{Ames v. Moir}, 138 U.S. 306 (1891), that “fraud in the act... defining [nondischargeability]... means positive fraud, or fraud in fact, involving moral turpitude or intentional wrong... and not implied fraud, or fraud in law, which may exist without the imputation of bad faith or immorality.”\textit{Ames}, 138 U.S. at 311; \textit{see also} Anastas v. American Sav. Bank (\textit{In re Anastas}), 94 F.3d 1280, 1286 (9th Cir. 1996) (interpreting fraud as used in § 523(a)(2)(A).
in the most general sense is defined as a "knowing misrepresentation of the truth or concealment of a material fact to induce another to act to his or her detriment."\textsuperscript{79} The Supreme Court, in reviewing the fraud discharge exemption, stated that where Congress employs a term which has accumulated a "settled meaning" under the common law, unless otherwise stated in the statute, Congress intends to use that established meaning of the term.\textsuperscript{80} In interpreting the use of the term "actual fraud" as applied to § 523(a)(2)(A) fraudulent debts, the Court, in 1995, recognized that the most widely accepted manifestation of the common law is the Restatement (Second) of Torts, which provides that an individual may recover in an action for fraudulent misrepresentation if that individual actually and justifiably relies on the misrepresentation.\textsuperscript{81} Thus a creditor must prove by a preponderance of the evidence: "(1) [debtor] made a representation; (2) it was knowingly false; (3) it was made with the intent to deceive [the creditor]; (4) [the creditor] actually and justifiably relied on it; and (5) [the creditor] sustained a loss as a proximate result of its reliance."\textsuperscript{82} The creditor, under the fraud discharge exemption, still must prove all of the elements of fraud to carry its burden of proof.\textsuperscript{83}

Congress, more importantly, has broadened the scope of the fraud discharge exemption since passing the 1898 Bankruptcy Act.\textsuperscript{84} Specifically, the 1898 Act prohibited discharge of "judgments in actions for frauds, or obtaining property by false pretenses or false representations."\textsuperscript{85} Congress broadened this exception in 1903 to include all "liabilities for obtaining property by false pretenses or false representations."\textsuperscript{86} Finally, in enacting the Code in 1978, Congress further broadened the scope of §

\begin{itemize}
  \item as actual or positive fraud rather than fraud implied by law; RecoverEdge L.P. v. Pentecost, 44 F.3d 1284, 1292 (5th Cir. 1995) (noting fraud as used in § 523(a)(2)(A) meaning fraud involving intentional wrong rather than implied in law).
  \item BLACK'S LAW DICTIONARY 670 (7th ed. 1999).
  \item See RESTATEMENT (SECOND) OF TORTS § 537 (1977) (stating general rule of fraudulent misrepresentation as including justifiable reliance);
  \item see also Field, 516 U.S. at 70 (citing RESTATEMENT (SECOND) OF TORTS § 537 and justifiable reliance as element of fraudulent misrepresentation).
  \item In re Mercer, 246 F.3d at 403 (5th Cir. 2001).
  \item See id. (holding creditor must prove fraud elements under § 523(a)(2)(A) nondischargeability claim).
\end{itemize}
523 to encompass "any debt . . . for money, property, services . . . to the extent obtained by . . . false pretenses, a false representation, or actual fraud." 87

A recent United States Supreme Court decision in helps clarify the Court's interpretation of the term "debt" as set forth in the Bankruptcy Code. 88 The Court employed a strict reading of the statutory provisions defining debt generally within the Code, and used it specifically with respect to the fraud exemption to dischargeability. 89 The Court noted that § 523 exempts "any debt" obtained through fraud. 90 A "debt" is defined in the Code as a "liability on a claim." 91 A "claim," in turn, is defined as a "right to payment" 92 that the Court has said "is nothing more nor less than an enforceable obligation." 93 In rendering its decision that treble damages awarded under a state fraud claim are not dischargeable, the Court stated that § 523 "prevents the discharge of all liability arising from fraud" and that the treble damages award under state law falls within that scope. 94 The circuit courts, however, are divided as to whether a settlement agreement resulting from a fraud claim fits within the scope of "any debt" obtained through fraud so as to be nondischargeable under § 523. 95

88 See Cohen, 523 U.S. at 218 (holding treble damages assessed on state law fraud action not dischargeable under § 523(a)(2)(A) fraud exemption). Landlord debtor was found liable for fraud under New Jersey Consumer Fraud Act and was ordered to repay tenants for rents charged in excess of that allowed under the local rent control ordinance. Id. at 215-16. Tenant creditors obtained a judgment that debt from excess rent arose from fraud and was not dischargeable under the Bankruptcy Code, and the bankruptcy court ordered treble damages under the state consumer statute. Id. The court further held that the treble damages awarded under state law was a product of the debtor's fraudulent actions and therefore not dischargeable. Id. The United States Supreme Court affirmed. Id.
89 See Cohen, 523 U.S. at 218 (interpreting meaning of "debt" under Bankruptcy Code).
95 See United States v. Spicer (In re Spicer), 57 F.3d 1152, 1157 (D.C. Cir. 1995) (holding underlying fraudulent nature of debt determinative in nondischargeability determination); Greenberg v. Schools, 711 F.2d 152, 156 (11th Cir. 1983) (holding same). But see Archer v. Warner (In re Warner), 283 F.3d 230, 236-37 (4th Cir. 2002), cert. granted, Archer v. Warner, 122 S. Ct. 2618 (2002) (holding settlement agreement in fraud dispute acts as novation replacing fraud debt with contract debt); Key Bar Investments, Inc. v. Fischer (In re Fischer), 116 F.3d 388, 390 (9th Cir. 1997) (holding same); In re West, 22 F.3d 775, 778 (7th Cir. 1994) (holding same).
III. DISAGREEMENTS AMONG THE CIRCUITS

Several federal courts of appeals have considered the issue whether an agreement settling a fraud claim is dischargeable under § 523, but a consensus remains elusive.\(^{96}\) Holdings from the court of appeals can be placed into two categories: those holding that the settlement agreement acts as a novation\(^{97}\) substituting a new debt obligation based in contract for the original debt based on the tort claim for fraud,\(^{98}\) and those holding that the settlement agreement has no effect on the underlying tort claim because the foundation of the agreement is based on the alleged fraud.\(^{99}\)

The Fourth Circuit Court of Appeals most recently addressed the issue of nondischargeability in the context of a settlement agreement traceable to fraud.\(^{100}\) Holding that the settlement agreement constitutes a novation, the Fourth Circuit concurred with the Ninth\(^{101}\) and Seventh\(^{102}\) Cir-

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\(^{96}\) See In re Spicer, 57 F.3d at 1157 (holding underlying fraudulent nature of debt determinative in nondischargeability determination); Greenberg, 711 F.2d at 156 (holding same). \(\text{But see In re Warner, 283 F.3d at 236-37}\) (holding settlement agreement in fraud dispute acts as novation replacing fraud debt with contract debt); In re Fischer, 116 F.3d at 390 (holding same); In re West, 22 F.3d at 778 (holding same).

\(^{97}\) BLACK'S LAW DICTIONARY 1091 (7th ed. 1999) (defining novation). Black's Law Dictionary defines novation generally as the "act of substituting for an old obligation a new one that either replaces an existing obligation with a new obligation or replaces an original party with a new party." \(\text{Id.}\)

\(^{98}\) See, e.g., In re Warner, 283 F.3d at 236-37 (holding settlement agreement in fraud dispute acts as novation replacing fraud debt with contract debt); In re Fischer, 116 F.3d at 390 (holding same); In re West, 22 F.3d 778 (holding same).

\(^{99}\) See In re Spicer, 57 F.3d 1157 (holding underlying fraudulent nature of debt determinative in nondischargeability determination); Greenberg, 711 F.2d at 156 (holding same).

\(^{100}\) See In re Warner, 283 F.3d at 236-37 (describing alleged fraud claim producing debt). Archer accused Warner of fraudulent misrepresentation relating to the sale of a business. \(\text{Id.}\) at 233. As part of the pretrial settlement, Warner paid $200,000 to Archer and provided a promissory note for $100,000. \(\text{Id.}\) The parties also entered into a written agreement releasing Warner from any pending and future claims, while neither party admitted liability. \(\text{Id.}\) When the note came due, Warner failed to make the requisite payment and sought bankruptcy protection first under chapter 13, which was later converted to chapter 7. \(\text{Id.}\) Archer filed an adversary proceeding in the bankruptcy court seeking a determination that the amount due under the note was not dischargeable under section 523(a)(2)(A). \(\text{Id.}\) at 233-34.

\(^{101}\) See In re Fischer, 116 F.3d at 388 (describing circumstances producing fraudulent debt claim). In re Fischer concerned a dispute over the sale of an automobile repair shop by Key Bar Investments, Inc. to Cahn-Fischer Enterprises, Inc. \(\text{Id.}\) at 389. Cahn-Fischer asserted that Key Bar misrepresented the income generated by the shop at the time of the sale, and the parties signed a Compromise Agreement and Mutual Release settling the case. \(\text{Id.}\) By its terms, the agreement reduced Cahn-Fischer's outstanding balance on a $125,400 promissory note executed as part of the purchase and sale. \(\text{Id.}\) A few months later, Cahn-Fischer stopped making payments on the note, and Key Bar demanded payment from Cahn and Fischer individually, but both refused. \(\text{Id.}\) Fischer sought bankruptcy protection, and Key Bar filed a complaint seeking nondischargeability of the note under section
cuits’ positions that parties, by an express term of their agreement, may substitute a contractual agreement for a tort claim. Under this line of cases, an original tort claim for fraud is extinguished by a purely contractual claim, i.e., the promise to pay in exchange for the promise to forego legal claims.

Courts adopting this line of reasoning place great emphasis on the decision by the Seventh Circuit in Maryland Casualty Co. v. Cushing. The Appeals Court in Maryland Casualty noted the general rule that a promissory note is merely evidence of the debt and does not discharge the debt for which it was given. The dischargeability of the note hinges upon the express terms and conditions of the agreement. If the note was merely accepted as evidence of the debt, the original cause of action upon which it was executed remains intact. If, however, by its express terms, it is shown that the note was given and received as payment or waiver of the underlying claim, the note “operates to discharge the original obligation and substitute a new one therefor . . . .” Thus, if the note is founded upon ample consideration, then it becomes a substitute, i.e., a

523(a)(2)(A). Id. Key Bar alleged Fischer misrepresented both the value of the assets he owned at the time of the sale and the extent of his business operating experience, thus inducing Key Bar to sell the shop to Cahn-Fischer. Id. at 389-90.

103 See In re West, 22 F.3d at 777 (describing alleged fraudulent conduct producing debt). West was employed as the book keeper for John Olman. Id. Olman alleged that West embezzled more than $100,000 from her employer while serving in that capacity. Id. West executed a promissory note to Olman for $75,000, and, in consideration therefore, Olman executed a general release and covenant not to sue West for any obligation other than on the promissory note. Id. West subsequently filed for bankruptcy relief under chapter 7 and listed the promissory note as an unsecured debt. Id. Olman sought a determination that the note was not dischargeable under section 523(a)(2)(A). Id.

104 See In re Warner, 283 F.3d at 236 (adopting settlement agreement novation rule from Seventh and Ninth Circuits).

105 See In re West, 22 F.3d at 777 (citing Maryland Casualty v. Cushing, 171 F.2d 257 (7th Cir. 1948)). Maryland Casualty, 171 F.2d at 258. Maryland Casualty was the surety in favor of the Mutual National Bank which employed Cushing as a bank teller. Id. During his employment, Cushing converted $15,000 of Mutual National Bank’s money for his own use. Id. Mutual National Bank made a claim against Maryland Casualty as a result of Cushing’s actions, and Maryland Casualty was obliged to pay the bank $14,970 for the loss. Id. Cushing thereafter executed a promissory note for Maryland Casualty for that amount in exchange for Maryland Casualty foregoing tort proceedings against him. Id. Cushing soon defaulted on his payments and subsequently filed for bankruptcy protection. Id.

106 See Maryland Casualty, 171 F.2d at 258 (noting rule relating to promissory notes).

107 See id. (determining dischargeability of promissory notes).

108 See id. (describing circumstances for preserving underlying debt).

109 Id.
novation, for the original tort claim which is thereby extinguished by its acceptance.\textsuperscript{110}

In contrast, other circuit courts have held that the underlying nature of the debt is determinative when considering dischargeability under section 523(a)(2)(A).\textsuperscript{111} The lead cases following this line of reasoning are the District of Columbia Circuit’s decision in In re Spicer,\textsuperscript{112} and the Eleventh Circuit’s decision in Greenberg v. Schools.\textsuperscript{113} These circuits look primarily to Congress’ intent in drafting the Bankruptcy Code.\textsuperscript{114} Specifically, these circuits look to a trio of Supreme Court decisions; Brown,\textsuperscript{115}

\textsuperscript{110} See Maryland Casualty, 171 F.2d at 258-59 (establishing circumstance when note becomes novation for original debt).

\textsuperscript{111} See United States v. Spicer (In re Spicer), 57 F.3d 1152, 1157 (D.C. Cir. 1995) (holding underlying fraudulent nature of debt determinative under \textsection 523(a)(2)(A) fraud discharge exception); Greenberg, 711 F.2d at 156 (holding same).

\textsuperscript{112} 57 F.3d 1152 (D.C. Cir. 1995). Spicer owed a debt to the United States totaling $339,000 that arose from a settlement of civil claims relating to applications submitted to the U.S. Department of Housing and Urban Development (HUD) for mortgages insured by the Federal Housing Administration (FHA). Id. at 1154. Spicer was alleged to have intentionally overstated the down payment made by a homebuyer in order to qualify for the FHA mortgage. Id. As part of his settlement plea, Spicer admitted making similar misstatements on 81 other mortgage applications submitted to HUD. Id. The buyers on approximately half of the mortgages subsequently defaulted resulting in approximately $1.8 million in losses to HUD. Id. The District Court included a restitution order for $340,000 equal to the profits earned as a result of the misstatements. Id. Spicer reached a settlement agreement with the U.S. on the pending civil claims, executing two promissory notes totaling $339,000 in exchange for the U.S. explicitly releasing all civil claims against him. Id. Spicer subsequently filed for bankruptcy, and the U.S. filed an adversary complaint in the bankruptcy seeking a determination that Spicer’s debt is not dischargeable under the fraud exemption, section 523(a)(2)(A). Id.

\textsuperscript{113} 711 F.2d 152 (11th Cir. 1983). As an initial matter, the debt in dispute in this case arose under an analogous provision of the Bankruptcy Code that precludes discharge for any debt “for fraud or defalcation while acting in a fiduciary capacity . . . .” 11 U.S.C. \textsection 523(a)(4) (2000). Id. at 153 (quoting \textsection 523(a)(4)). Greenberg and Schools formed a corporation called the Greater Asbury Collections, Inc., but soon encountered disagreements over management. Id. Greenberg alleged that Schools in his capacity as managing director had made unauthorized use of corporate funds for his own personal benefit, engaging in fraud, misappropriation, and misuse of corporate funds while acting in a fiduciary capacity. Id. at 154. Greenberg and Schools settled the dispute prior to trial with Schools agreeing to pay Greenberg $90,000 over a period of years, and executing a promissory note on the debt. Id. Schools defaulted on the initial note, and Greenberg filed suit again on the balance due directly on the note. Id. Greenberg and Schools executed a second agreement whereby Schools promised to pay Greenberg $78,102.66 in monthly installments of $892.20. Id. Schools subsequently filed for bankruptcy, and Greenberg filed an adversary complaint in the bankruptcy action objecting to the discharge of the debt owed. Id.

\textsuperscript{114} See In re Spicer, 57 F.3d at 1155-56 (noting Congress intent in granting fresh start to good faith debtor); Greenberg v. Schools, 711 F.2d 152, 155-56 (11th Cir. 1983) (holding full inquiry into fraudulent nature of debt notwithstanding settlement agreement).

\textsuperscript{115} 442 U.S. at 139 (holding bankruptcy court not confined to review of judgment and record of prior proceeding in dischargeability determination).
Grogan,\textsuperscript{116} and Cohen\textsuperscript{117} together, stand for the proposition that the settlement agreement has no effect on the alleged fraudulent nature of the underlying debt.\textsuperscript{118}

Under the reasoning in this line of cases, the bankruptcy court should undertake the fullest possible inquiry into the underlying fraud claim to discern whether the debt originated in fraud.\textsuperscript{119} If the court so determines that the debt is based in fraud, then the provisions of § 523(a)(2)(A) preclude discharge in bankruptcy.\textsuperscript{120} The creditor still must overcome the burden of proof for each element of the fraud claim,\textsuperscript{121} and the court should analyze the claim using the preponderance of the evidence to make such determination.\textsuperscript{122} More importantly, however, is the policy permeating the discharge provisions of the Bankruptcy Code that debts originating in fraud are not to be discharged, and that only the “unfortunate debtor,” acting in good faith, should enjoy the benefits of the discharge in bankruptcy.\textsuperscript{123} Furthermore, § 523(a)(2)(A) prevents the discharge of all liability from fraud. As the District of Columbia Circuit aptly stated in \textit{In re Spicer}, “we cannot agree with a rule under which, through the alchemy of a settlement agreement, a fraudulent debtor may transform himself into a nonfraudulent one, and thereby immunize himself from the strictures of [section] 523(a)(2)(A).”\textsuperscript{124} These circuits opine that the holdings in \textit{Maryland Casualty} and \textit{West}, and thus the positions assumed by the Fourth, Seventh, and Ninth Circuits, elevate “legal form over substance.”\textsuperscript{125}

\textsuperscript{116} 498 U.S. at 283 (holding preponderance standard applies to all dischargeability determinations covered under § 523(a)).
\textsuperscript{117} 523 U.S. at 215 (holding discharge exemption for actual fraud prevents discharge of all liabilities arising from debtor’s fraud).
\textsuperscript{119} See \textit{Brown}, 442 U.S. at 138.
\textsuperscript{120} See 11 U.S.C. § 523(a)(2)(A) (prohibiting discharge of any debt obtained by fraud).
\textsuperscript{121} See \textit{AT&T Universal Card Servs. v. Mercer} (\textit{In re Mercer}), 246 F.3d 391, 403 (5th Cir. 2001) (outlining fraud elements to be proven by creditor).
\textsuperscript{122} See \textit{Grogan}, 498 U.S. at 286-87 (holding preponderance standard applies to all dischargeability determinations covered under § 523(a)).
\textsuperscript{123} See \textit{United States v. Spicer} (\textit{In re Spicer}), 57 F.3d 1152, 1156-57 (D.C. Cir. 1995) (limiting discharge to good faith debtor).
\textsuperscript{124} See \textit{id.} at 1155. The D.C. Circuit continued by stating that “[t]he purpose of the fraud exception to the general principle of dischargeability is ‘to discourage fraudulent conduct and to ensure that relief intended for honest debtors does not enure to the benefit of the dishonest.’” \textit{Id.} (citing \textit{In re Wilson}, 12 B.R. 363, 370 (Bankr. M.C. Tenn. 1981)).
\textsuperscript{125} \textit{In re Spicer}, 57 F.3d at 1155.
IV. ANALYSIS

For the purposes of this analysis, recall that C and D, have settled a fraud claim out of court through an agreement requiring C to forego any legal remedies in exchange for D’s execution of a promissory note to compensate C for its loss. D then seeks bankruptcy protection, including the discharge of his debt to C.

As an initial matter, the current unsettled state of the law has two immediate consequences for C and D above: forum shopping and exerting a burden upon the judicial system. The current disconnect among the circuits effectively sets the starting line for the race to the bankruptcy court’s door, with each party seeking to file its claim in the jurisdiction most advantageous to its respective interests. Thus D would seek to file its claim in a jurisdiction that treats the settlement agreement with release as a novation, which replaces the fraud-based debt with a contractual debt. Likewise, C would seek to file its claim in a jurisdiction that looks to the underlying nature of the debt in question. It is precisely this judicial disconnect that the framers sought to eliminate by empowering Congress to enact a uniform Bankruptcy Code for the United States.126

Second, in perpetuating this division among the circuit courts, such disconnect imposes greater strains on an already overburdened judicial system. For example, C above would more likely fully adjudicate the fraud claim, or plead and argue what might otherwise constitute a weak fraud claim, out of concern that the settlement agreement could ultimately result in a discharge of D’s debt in a subsequent bankruptcy proceeding.127 As a result, the court and the parties themselves must expend considerable time and resources to resolve an issue that is ideally suited for private settlement.

Moreover, while some courts have argued that the novation reasoning actually promotes the settlement and enforcement of agreements,128 both arguments paradoxically create situations where one party has every incentive to settle the case while the other has no incentive to commence settlement negotiations. Settlement may be the preferable avenue for the parties, however, the unsettled nature of the law in this regard essentially

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126 See THE FEDERALIST, supra note 26, at 239, and accompanying text.
127 See Brown v. Felsen, 442 U.S. at 135. The Court in Brown alluded that the rule precluding consideration of underlying fraud claim would result in creditors relentlessly pursuing fraud claim in preceding action to protect themselves against possible bankruptcy in the future.
128 See In re West, 22 F.3d 775, 778 (7th Cir. 1994) (arguing novation encourages settlement as tort-feasor likely induced to pay aggrieved party larger sum in settlement if settlement contains release from future claims based on same conduct). Note, however, that the debtor is in a better position to know the true status of its finances and may knowingly execute a settlement agreement with the full understanding that the agreement could be discharged in a subsequent bankruptcy action.
cuts off this option because neither party has an incentive to enter into a negotiated settlement.  

In a novation forum, D has every incentive to settle the fraud claim and to seek release from any and all liability arising therefrom. It is precisely this release from liability that any reasonable debtor would pursue through settlement. The debtor subsequently could file for bankruptcy protection and likely discharge the debt owed on the settlement agreement. Meanwhile, C above has no incentive to settle the fraud claim and release D from liability on the underlying claim because the settlement may be discharged in D’s subsequent bankruptcy action. Given the potential that the entire debt on the settlement agreement could be discharged, the fact that D provided greater consideration for settlement of the fraud claim is of no consequence since C will be unable to collect on the settlement agreement. Thus, the parties are at an impasse, and must fully adjudicate the underlying fraud claim.

Likewise, if the parties are in a forum that looks to the underlying nature of the debt, C above has every incentive to settle and release the fraud claim against D because the settlement agreement preserves the underlying nature of the debt in the subsequent bankruptcy action. D, however, has no incentive to negotiate a settlement because the debt obligation originating in fraud remains intact and is not dischargeable in bankruptcy.

Congress clearly intended to make certain categories of debt unavailable for discharge in bankruptcy. The discharge in bankruptcy is intended to assist the good-faith but unfortunate debtor to return to economic productivity by allowing him to escape from the burden of overwhelming debt. The bad-faith debtor, however, is not treated the same way under the Code because it precludes the discharge of debts that are the product of fraudulent conduct or statements. Additionally, the bad-faith debtor, in confronting the fraud claim, has at least raised the issue of his

129 See supra notes 100-02, 112-13.
130 See supra note 46 and accompanying text; see also cases cited supra note 11.
131 See cases cited supra note 14.
132 Indeed, a clever and unscrupulous debtor, one who may have already acted in a fraudulent manner to produce the debt, might eagerly seek to execute a settlement agreement knowing any obligation under the agreement is dischargeable in bankruptcy. Conversely, the unscrupulous debtor might forego any type of reasonable settlement offer if such agreement would establish a nondischargeable debt.
133 See cases cited supra note 14.
136 See supra notes 49-50 and accompanying text.
poor conduct or character, thereby inviting a more vigorous review by the bankruptcy court before any debts should be discharged.\(^{137}\)

The argument that the debtor bargained for the release from its liability under the fraud claim by executing the settlement agreement is unavailing because whether the claim remained unsettled, fully adjudicated, or resolved through the settlement agreement, the liability to pay the creditor under the settlement agreement originally arose from the debtor’s alleged fraudulent activities.\(^{138}\) By adopting the position of the District of Columbia and Eleventh Circuits,\(^{139}\) the Court is merely permitting the creditor to challenge the dischargeability of the settlement agreement debt by undertaking a thorough examination of the factual circumstances underlying the original fraud claim.\(^{140}\) The creditor still must prove by a preponderance of the evidence that the debtor engaged in fraudulent activities.\(^{141}\) To hold otherwise denies the creditor its claim to the debt under the settlement agreement, something which it likely did not intend to forego in executing the agreement.

V. CONCLUSION

In adopting the reasoning by the District of Columbia and Eleventh Circuits that a settlement agreement arising from the debtor’s fraudulent activities is a nondischargeable debt under § 523(a)(2)(A) of the Federal Bankruptcy Code, the Supreme Court would reaffirm Congress’s intent in preventing the dishonest debtor from benefiting from his fraudulent actions. Such a rule would permit a creditor to fully adjudicate its fraud claim against the debtor, and promote uniform application of the Federal Bankruptcy Code, a principal cornerstone of that body of law.

VI. ADDENDUM

Following the completion of this Note, but prior to publication, the United States Supreme Court, by a seven to two margin, reversed and remanded the Fourth Circuit’s decision in *In re Warner*.\(^{142}\) Justice Stevens

\(^{137}\) See *supra* notes 63-68 and accompanying text.


\(^{139}\) See *In re Spicer*, 57 F.3d at 1152 (holding underlying fraudulent nature of debt determinative for dischargeability purposes); *Greenberg*, 711 F.2d at 152 (holding same).

\(^{140}\) See *supra* notes 69-72 and accompanying text.


joined Justice Thomas in issuing a dissent.\textsuperscript{143} The majority held that while a settlement agreement may work a novation for purposes of the state law claims, it does not preclude a creditor from showing that the settlement debt arose out of the debtor’s alleged fraudulent conduct and thus survive as a nondischargeable debt.\textsuperscript{144} Specifically, the majority found that the settlement debt which the Archer’s sought to preserve was logically indistinguishable from the consent decree held nondischargeable in \textit{Brown v. Felsen}.\textsuperscript{145} The majority viewed the settlement agreement as leaving one remaining “relevant debt,” i.e., the debt represented by the agreement itself.\textsuperscript{146} The Court reasoned that if the stipulation and consent decree in \textit{Brown} did not prevent the bankruptcy court from examining the nature of the underlying debt (in order to determine whether it was obtained by fraud), then the settlement agreement in the instant case likewise does not preclude the bankruptcy court from undertaking a full inquiry into the origins of Warner’s debt to Archer.\textsuperscript{147} Moreover, the Court reiterated its opinion that Congress, in amending § 523 of the Bankruptcy Code, “‘intended the fullest possible inquiry’ to ensure that ‘all debts arising out of’ fraud are ‘excepted from discharge,’ no matter what their form.”\textsuperscript{148} This policy permits the bankruptcy court, rather than the state court, to undertake the relevant dischargeability determination.\textsuperscript{149}

Justice Thomas in his dissent argued that the majority’s decision was based on the “erroneous premise” that “the settlement agreement does not resolve the issue of fraud.”\textsuperscript{150} The dissent distinguished the “blanket release” executed by Archer and Warner from the consent decree and

\begin{footnotesize}
\begin{enumerate}
\item See Archer v. Warner, No. 01-1418, slip op. at 1 (U.S. Mar. 31, 2003) (Thomas, J., dissenting) (arguing settlement clearly demonstrates party’s intent to resolve fraud issue including dischargeability determination).
\item See Archer v Warner, No. 01-1418, slip op. at 8 (U.S. Mar. 31, 2003).
\item 422 U.S. 127, 128-29 (1979), cited in Archer v. Warner, No. 01-1418, slip op. at 5 (U.S. Mar. 31, 2003)).
\item See Archer v. Warner, No. 01-1418, slip op. at 3 (U.S. Mar. 31, 2003).
\item See \textit{id.} (applying reasoning of \textit{Brown} to context of settlement agreement).
\item See \textit{id.} at 6 (citing \textit{Brown}, 422 U.S. at 128).
\item See Archer v. Warner, No. 01-1418, slip op. at 6 (U.S. Mar. 31, 2003) (noting debt dischargeability not directly at issue before state court and implying bankruptcy court to be proper forum). The Court also addressed Warner’s alternative argument that Archer’s dismissal of the original fraud action is treated as litigated and determined in Warner’s favor under North Carolina law. \textit{Id.} at 7. Archer, therefore, would be barred on collateral estoppel grounds from claiming a nondischargeable debt originating in fraud under the Bankruptcy Code. \textit{Id.} The Court noted that the Fourth Circuit did not address the issue-preclusive effect of the settlement agreement, and stated that it was outside the scope of the question presented. \textit{Id.} The Court ultimately left the issue to “[t]he federal judges who deal regularly with questions of state law,” and remanded the case to determine whether the issue was properly raised or preserved. \textit{Id.} at 7-8. (citing Butner v. U.S., 440 U.S. 48, 58 (1979)).
\item See Archer v. Warner, No. 01-1418, slip op. at 1 (U.S. Mar. 31, 2003) (Thomas, J., dissenting).
\end{enumerate}
\end{footnotesize}
stipulation in Brown, and as such viewed the novation theory articulated in In re West as controlling. Relying on the Court’s precedent that a creditor must demonstrate the causal nexus between the debtor’s fraudulent conduct and the debt, the dissent viewed the settlement agreement as tantamount to a superceding event in a negligence action, thereby severing the causal relationship between the debtor’s action and the resulting settlement debt.

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151 See id. at 2 (citing In re West, 22 F.3d 775, 778 (7th Cir. 1994)); see also supra notes 100-10 and accompanying text (articulating novation theory as replacing tort-based debt with contract debt dischargeable in bankruptcy).

152 See id. at 5 (arguing debtor’s fraudulent conduct must proximately cause debt under § 523(a)(2)(A)); see also supra notes 74, 80-83 and accompanying text (setting forth creditor’s burden of proof in fraud exception to discharge under § 523(a)(2)(A)).

153 See id. at 4-5.