Spring 2004

Game of Hide and Seek in Bankruptcy: The Supreme Court Levels the Playing Field, The

Jennifer A. Davis Foster

Follow this and additional works at: http://scholarship.law.missouri.edu/mlr

Part of the Law Commons

Recommended Citation

This Note is brought to you for free and open access by the Law Journals at University of Missouri School of Law Scholarship Repository. It has been accepted for inclusion in Missouri Law Review by an authorized administrator of University of Missouri School of Law Scholarship Repository.
The Game of Hide and Seek in Bankruptcy: The Supreme Court Levels the Playing Field

Archer v. Warner

I. INTRODUCTION

Since its inception, the Bankruptcy Code has provided relief to debtors who have overextended their financial resources. Under the Code, the “honest, but unfortunate” debtor is allowed to discharge certain debts in bankruptcy to protect future earnings and other exempt property from creditors. However, in enacting the Code, Congress determined that certain types of debt should not be dischargeable in bankruptcy, either because the “debt arose out of bad conduct... or the debt in question is thought to be particularly important.” As discussed in this Note, a debt for money obtained by fraud is one of those fundamental debts that is not dischargeable in bankruptcy, as it stems from improper conduct by the debtor.

In Archer v. Warner, the United States Supreme Court addressed the issue of whether a voluntary settlement agreement between the parties that generally released underlying fraud claims so changed the nature of the debt as to render it dischargeable in bankruptcy. In rendering its decision, the Court sought to resolve a split among the circuits. The Courts of Appeals for the Fourth, Seventh and Ninth Circuits argued that such settlements create a novation, substituting a voluntary contractual debt for a preexisting debt procured by fraud. Accordingly, these circuits held that the new contractual debt should be dischargeable in bankruptcy.

4. See id. at 15-16.
5. Id. at 51.
8. Id. at 318-19.
9. Id. at 318.
10. See In re Warner, 283 F.3d 230, 237 (4th Cir. 2002), rev’d sub nom. Archer v. Warner, 538 U.S. 314 (2003); In re Fisher, 116 F.3d 388, 390 (9th Cir. 1997); In re West, 22 F.3d 775, 778 (7th Cir. 1994); Md. Cas. Co. v. Cushing, 171 F.2d 257, 258-59 (7th Cir. 1948).
dischargeable in bankruptcy, as no nondischargeability provision applies. Conversely, the Courts of Appeals for the Eleventh and D.C. Circuits argued that such debts should not be dischargeable in bankruptcy merely because the parties entered into a settlement agreement, thereby changing only the form of the debt.

Adopting the latter view, the Supreme Court held that, given the language of the Code and Congress's intent in enacting the nondischargeability provisions, defrauded creditors should not be barred from establishing the nature of the underlying debt. In so holding, the Supreme Court clarified the effect that voluntary settlement agreements have on underlying claims of fraud for dischargeability purposes. This Note explores the analysis employed by the Court and argues that, in light of the Court's precedent in this area and the underlying purpose of the Code, the Court in Archer reached the correct conclusion.

II. FACTS AND HOLDING

In 1991, Leonard and Arlene Warner (the "Warners") purchased the Warner Manufacturing Company for $250,000. The Warners sold the corporate assets of the company in 1992 to Elliot and Carol Archer (the "Archers") for $610,000. In conducting the sale, the Warners affirmatively misrepresented the profitability of the company, inducing the Archers to pay more than the company was actually worth. Shortly thereafter, the Archers discovered that the company was losing money, and that the Warners had lied to them about the company's profitability. The Archers filed suit in North Carolina state court alleging, among other things, that the Warners had committed acts of fraud and material misrepresentation in selling the company.

11. See Warner, 283 F.3d at 236-37.
12. 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).
13. Archer, 538 U.S. at 323.
14. Id.
15. Id. at 317.
16. Id. The total purchase price was $685,000, which included $410,000 for the corporate assets, a $70,000 consultation fee, and a $5,000 non-competition agreement. Warner, 283 F.3d at 233 n.1.
17. Petitioners' Brief at 5, Archer v. Warner, 538 U.S. 314 (2003) (No. 01-1418). The false representations included altered financial records of the company that suggested the company was making money when it was actually losing massive sums of money. Id.
18. Id. at 6.
19. Archer, 538 U.S. at 317. The Archers subsequently amended their complaint on two different occasions to include conspiracy, fraudulent conveyance, intentional and
In 1995, before this lawsuit went to trial, the parties agreed to settle the underlying claims. The settlement agreement specified that the Warners would pay "$300,000 ... as compensation for emotional distress/personal injury type damages." At the time of the settlement, the Warners paid the Archers $200,000 in cash and issued a promissory note for the remaining $100,000, which was to be paid in two later installments of $50,000 each. In the settlement agreement, the parties specifically stated that "the Archers would 'execute releases to any and all claims ... except as to amounts set forth in [the] Settlement Agreement.'" Based on the settlement agreement, the Archers voluntarily dismissed the lawsuit with prejudice.

The Warners failed to pay the first $50,000 due under the settlement agreement in November, 1995. This prompted the Archers to again file suit in North Carolina state court seeking collection on the promissory note. Prior to the claim's litigation at trial, the Warners filed for bankruptcy. In response, the Archers filed an adversary proceeding in the United States Bankruptcy Court for the Middle District of North Carolina, seeking a determination that the $100,000 promissory note was nondischargeable under the Code. The Code excepts from discharge debts "for money ... to the extent obtained by false pretenses, a false representation, or actual fraud." The Archers argued that the settlement did not extinguish the underlying fraud debt, and that the settlement agreement


20. *Warner*, 283 F.3d at 233. As a result of the settlement agreement, the Archers voluntarily dismissed their claim with prejudice in the state court. *Id.*


23. *Archer*, 538 U.S. at 317 (quoting Record at 63).

24. *Id.*

25. *Id.*

26. *Id.* at 317-18.

27. *Id.* at 318. The Warners filed for relief under Chapter 13 of the Bankruptcy Code, which the bankruptcy court converted to a case under Chapter 7. *Warner*, 283 F.3d at 233.


specifically excepted the promissory note from discharge. Specifically, the Archers requested that the bankruptcy court look behind the settlement agreement to discover the fraudulent nature of the underlying debt. In response, Arlene Warner asserted an affirmative defense of settlement of the underlying claim. She claimed that the settlement agreement effected a novation, and argued "that the Archers may not rely upon the same alleged misconduct in the original suit in the state court as grounds for non-dischargeability because that suit was settled in toto."

The bankruptcy court agreed with Arlene Warner, upholding her affirmative defense of dischargeability of the settlement debt. The Archers appealed to the District Court for the Middle District of North Carolina, which affirmed the decision. The district court reasoned that the "settlement agreement created a novation, substituting a dischargeable contract debt for a fraud-based tort claim which may not have been dischargeable." The Archers again appealed the decision, and a divided panel of the Court of Appeals for the Fourth Circuit affirmed. Recognizing a split of opinion among the circuits on this issue, the majority reasoned that the better approach was to uphold the parties' voluntary settlement as a novation rather than to look behind that settlement to uncover the source of the underlying debt. In this manner, the court argued, parties will be more willing to reduce their claims to settlement. The dissenting judge argued that the novation theory should fail, as Supreme Court precedent required bankruptcy courts to look behind the settlement agreement to determine if the

30. Warner, 283 F.3d at 234. The Archers later attempted to amend their adversary complaint to include, among other things, a claim of fraud in the inducement of settlement, but the bankruptcy court denied leave to amend. Id. at 235 n.4; see also Petitioners' Brief at 20-21, Archer v. Warner, 538 U.S. 314 (2003) (No. 01-1418).
31. See Petitioners' Brief at 19, Archer (No. 01-1418).
32. Warner, 283 F.3d at 235.
33. A "novation" is "[t]he act of substituting for an old obligation a new one that replaces an existing obligation with a new obligation." BLACK'S LAW DICTIONARY 1091 (7th ed. 1999).
34. Warner, 283 F.3d at 235; see also Archer, 538 U.S. at 322.
35. Warner, 283 F.3d at 235.
36. Id.
37. Id.
38. Id. at 237.
39. Id. at 236.
40. Id.

http://scholarship.law.missouri.edu/mlr/vol69/iss2/4
underlying debt was fraudulent in nature. If so, he argued, the debtor should not be allowed to discharge the debt under the Code.

The Archers appealed to the United States Supreme Court, which granted certiorari to resolve the split of opinion on this issue among the circuits. A majority of the Court reversed, rejecting the novation theory advanced by the Warners and the lower court as inconsistent with congressional intent. The Court held that, where the parties specifically excepted the promissory note from discharge, the debt under the settlement agreement could amount to a debt for money obtained by fraud within the meaning of the Code's nondischargeability provisions. Consequently, the Court remanded the case, holding that the Archers should have an opportunity to present such claims to the bankruptcy court.

III. LEGAL BACKGROUND

In enacting the Bankruptcy Code, Congress recognized that many debtors are honest, but simply have overextended their financial resources, leading them to bankruptcy. Accordingly, the Code provides relief to the "honest, but unfortunate" debtor by allowing a discharge of certain debts. Under the discharge provisions of the Code, an individual debtor is allowed to make a "fresh start" without worrying about future repercussions of past debts. Although Congress provided for this fresh start policy, it also recognized that certain debts should not be dischargeable in bankruptcy, prompting the enactment of Section 523 of the Code. Generally, debts are not dischargeable to the extent that they result from bad actions by the debtor or are viewed as particularly important from a policy or social standpoint. Although the Code

41. Id. at 238-39 (Traxler, J., dissenting). In his dissent, Judge Traxler relied on Brown v. Felsen, 443 U.S. 127 (1979), and Cohen v. de la Cruz, 523 U.S. 213 (1998), arguing that these cases supported his argument that the Supreme Court did not intend a settlement debt to be automatically dischargeable in bankruptcy. Warner, 283 F.3d at 238-39 (Traxler, J., dissenting).
42. See id. at 238 (Traxler, J., dissenting).
44. Id. at 323.
45. Id. at 322-23.
46. See BAIRD, supra note 3, at 33.
48. BAIRD, supra note 3, at 33-34.
50. BAIRD, supra note 3, at 51. Debts that arise as a result of "bad actions" on the part of the debtor include debts for willful conversions of property, drunk driving, and certain fines and penalties payable to the government as a result of tortious conduct. Id. at 52. Socially important debts include payments owed for child support, alimony, and various tax obligations. Id. at 51.
contains clear provisions concerning dischargeability of debts, courts have consistently grappled with the issue of whether a particular debt truly falls within the Code's nondischargeability provisions.

A. The General Fresh Start Theory of Bankruptcy

Through the procedures detailed in Chapter 7 of the Bankruptcy Code, a debtor is allowed to discharge all pre-petition debts in bankruptcy so long as a nondischargeability provision does not apply to one or more of his debts. In this manner, the Code provides a procedure by which the debtor's future earnings become exempt as payment for past debts. In enacting this procedure, Congress recognized that protection of the debtor's future earnings is crucial to allowing the debtor a fresh start. As the Supreme Court has interpreted these provisions, "a central purpose of the Code is to provide a procedure by which certain insolvent debtors can reorder their affairs, make peace with their creditors, and enjoy 'a new opportunity in life with a clear field for future effort, unhampered by the pressure and discouragement of preexisting debt.'" Furthermore, regardless of the dischargeability provisions, it is unlikely that these future earnings would be adequate to pay off all of the debtor's debts in bankruptcy.

Under the general dischargeability provisions of the Code, individual debtors "must disclose the whereabouts of all their assets and submit to

51. An individual debtor with regular income may instead choose to file for bankruptcy under Chapter 13 of the Code. See 11 U.S.C. §§ 109(e), 1305 (2000). Once the debtor submits a Chapter 13 bankruptcy plan, she is allowed to keep all pre-petition earnings, and creditors are paid through post-petition earnings in excess of the debtor's dispensable income. Id. §§ 1321-22. Unlike Chapter 7, the Chapter 13 debtor is allowed to discharge fraud debts in bankruptcy. See id. § 1328(a). As this Note focuses on the nondischargeability of fraud debts generally, discussion is limited to Chapter 7 of the Code.

52. 11 U.S.C. § 727(b) (2000). See also 11 U.S.C. § 524(a) (2000), which provides:

A discharge . . .
(1) voids any judgment at any time obtained, to the extent that such judgment is a determination of the personal liability of the debtor with respect to any debt discharged under 727 . . . whether or not discharge of such debt is waived;
(2) operates as an injunction against the commencement or continuation of an action . . . to collect, recover or offset any such debt as a personal liability of the debtor, whether or not discharge of such debt is waived.


55. Id. (quoting Local Loan Co. v. Hunt, 292 U.S. 234, 244 (1934)).

56. See BAIRD, supra note 3, at 33.
questioning from creditors" when bankruptcy proceedings are initiated. If the debtor does not fulfill this obligation, she is not afforded the protection of debt dischargeability. Creditors can also submit any claims that they have against the debtor for repayment of incurred debts at this time. If the debtor files under Chapter 7, the debtor’s nonexempt property is then liquidated and placed in a bankruptcy estate, and the trustee dispenses the proceeds among creditors to pay off the debtor’s debts. These are generally the only assets that can be used to repay debts owed to creditors, who cannot thereafter attempt to collect further payment from the debtor. As the debtor’s future earnings are thereby protected, this procedure effectuates congressional intent in providing the honest but unfortunate debtor the right to a fresh start after bankruptcy.

B. The Fraud Exception to Debt Dischargeability

Although the Bankruptcy Code provides fundamental protection to the bankrupt debtor, Congress also chose to except certain debts from discharge. As discussed above, these debts predominantly fall into one of two categories: either Congress thought the debt particularly important or the debtor engaged in bad conduct giving rise to the debt. A debt procured by fraud is one of those debts arising from the debtor’s bad conduct, making such debt nondischargeable in bankruptcy. For the fraud provision to apply, the creditor must assert nondischargeability of the debt in adversary proceedings before the bankruptcy court.

Though the categorization of nondischargeable debts has fluctuated throughout the history of the Code, Congress has always excepted from

57. Id. at 34.
58. Id.
60. See 11 U.S.C. § 541 (2000) (describing the distinction between exempt and nonexempt property for bankruptcy purposes and the procedure by which assets are placed in the estate).
61. See BAIRD, supra note 3, at 38.
62. See id. at 42-43.
64. BAIRD, supra note 3, at 51.
65. Id. at 52.
66. See id. at 28 (analyzing Bankruptcy Rule 7001 with respect to adversary proceedings). Once adversary proceedings have been initiated, the bankruptcy court is to determine whether the debt is dischargeable according to a "preponderance of the evidence" standard of proof. Grogan v. Garner, 498 U.S. 279, 287 (1991); see also Brown v. Felsen, 442 U.S. 127, 134 (1979) (stating that the relevant nondischargeability inquiry must take place in bankruptcy court rather than state court where such issues "are not directly in issue and neither party has a full incentive to litigate them").
Specifically, "[a] discharge under section 727 . . . does not discharge an individual debtor from any debt . . . (2) for money, property, services, or an extension, renewal or refinancing of credit, to the extent obtained by (A) false pretenses, a false representation, or actual fraud . . . ." Congress has continually expanded the scope of this nondischargeability provision, changing the language of the provision from "judgments sounding in fraud" to "liabilities" to "all debts arising out of fraud . . . no matter what their form." Essentially, Congress has determined that such debts are "morally distinguishable from usual debt," as they carry with them "a moral opprobrium," rendering them nondischargeable in bankruptcy.

If the bankruptcy court determines that a debt is nondischargeable in bankruptcy, that debt survives bankruptcy and becomes a claim against the debtor's assets and income. Thus, the fraudulent debtor cannot hide behind the fresh start policy of bankruptcy to protect future earnings against debts procured by fraud.

C. The Pre-Archer Dispute: The Effect of Settlement on Debts Procured by Fraud

Prior to the Supreme Court's decision in Archer v. Warner, the lower courts struggled with the issue of whether a voluntary settlement agreement so changed the nature of an underlying fraud debt as to render it dischargeable in bankruptcy. Some courts held that a settlement agreement effects a novation, whereby a dischargeable contractual debt is substituted for a nondischargeable debt based in fraud. Other courts held that, given the broad language and public policy inherent in the Code, a creditor should not be barred from establishing that the underlying debt was procured by fraud, even where the parties had voluntarily settled their claims. The fundamental tension between

---

67. See 2 Epstein et al., supra note 59, § 7-26, at 340. "Subsection 523 (a)(2) is based on section 17(a)(2) of the Bankruptcy Act of 1898." Id.
70. 2 Epstein et al., supra note 59, § 7-24, at 326-27. "Opprobrium" means a "harsh criticism or censure" and "the public disgrace arising from one's shameful conduct." The Oxford American College Dictionary 958 (2002).
71. 2 Epstein et al., supra note 59, § 7-17, at 313.
73. See, e.g., In re Fischer, 116 F.3d 388, 390-91 (9th Cir. 1997), amended by 127 F.3d 819 (9th Cir. 1997); In re West, 22 F.3d 775, 778 (7th Cir. 1994); Md. Cas. Co. v. Cushing, 171 F.2d 257, 259 (7th Cir. 1948).
74. See, e.g., Brown, 442 U.S. at 138; In re Spicer, 57 F.3d 1152, 1157 (D.C. Cir. 1995); Greenberg v. Schools, 711 F.2d 152, 156 (11th Cir. 1983).
the courts' desire to encourage voluntary settlement of claims and the competing desire to effectuate public policy inherent in the nondischargeability provisions of the Code lies at the heart of this dispute.

Since *Maryland Casualty Co. v. Cushing* was decided in 1948, the Courts of Appeals for the Seventh and Ninth Circuits have focused on the voluntary nature of settlement agreements in holding that, given the expressed intent of the parties, such agreements create a novation. Specifically, these courts analyzed whether the parties had included a mutual release of claims within the body of their settlement agreements. As stated in *Maryland Casualty*, "The general rule is that a promissory note is but the evidence of indebtedness and does not discharge the debt for which it was given." As such, a settlement agreement or promissory note does not, in and of itself, create a novation. Rather, the settlement or note must include a release of underlying claims or other language that expresses an intent by the parties to substitute a new contractual debt for the underlying nondischargeable debt. According to this line of cases, if such language is included in the settlement agreement, "the note fully discharges the original debt, and the nondischargeability of the original debt does not affect the dischargeability of the obligation under the note."

Those courts endorsing the novation theory have predominantly focused on the desire to effectuate the parties' expressed intent in voluntarily settling their claims. Inherent in their analysis is the policy goal of encouraging and enforcing settlement agreements as written. As noted in *In re West*, it is the creditor, not the debtor, that originally agrees to discharge the underlying debt by entering into a settlement agreement. Accordingly, the courts following this approach have seen "no reason to adopt a rule that would allow the creditor to undo the discharge for which he received a promissory note."

This was the approach taken by the Court of Appeals for the Fourth Circuit in originally deciding *Archer v. Warner*. In analyzing the settlement agreement, the court found that the "agreement and promissory note . . . coupled

---

75. 171 F.2d 257 (7th Cir. 1948).
76. See Fischer, 116 F.3d at 391; West, 22 F.3d at 777.
77. See West, 22 F.3d at 777.
78. *Md. Cas.*, 171 F.2d at 258.
79. See id.
80. Id.
81. Id.
82. See *In re* Fischer, 116 F.3d 388, 390 (9th Cir. 1997), amended by 127 F.3d 819 (9th Cir. 1997); *West*, 22 F.3d at 778.
83. *West*, 22 F.3d at 778.
84. Id.
85. Id.
with the broad language of the release, completely addressed and released each and every underlying state law claim." The court not only focused on the intent of the parties and the need to encourage voluntary settlements, but also suggested that the novation theory is easier to apply, as courts need only look at the validity and nature of the agreement, rather than undertake an in-depth analysis of underlying fraud claims. 

Conversely, the Courts of Appeals for the Eleventh and D.C. Circuits have focused on the language and policy of the Code in holding that a creditor should not be barred from establishing that the underlying debt was for fraud simply because the parties have entered into a voluntary settlement agreement. The courts following this approach have required only that the creditor show a proximate causal connection between the underlying fraud debt and the subsequent contractual debt.

As a matter of statutory construction, these courts have argued that the novation theory "would permit the discharge of debts that Congress intended to survive bankruptcy." Specifically, the courts have looked to the legislative history of the nondischargeability provisions in determining that Congress intended a complete inquiry into the nature of the underlying debt. Since 1898, when the nondischargeability provisions were first enacted, Congress has significantly expanded the scope of such provisions to include many more debts fundamentally based in fraud. Noting the significant change in the language of the Code's fraud provision over time, the Court in Brown v. Felsen argued 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.

As a fundamental policy matter, the courts employing this rationale also argue that the novation theory encourages debtors to settle their fraud claims

87. Id. at 237.
88. Id.
89. See Brown v. Felsen, 442 U.S. 128 (1979); In re Spicer, 57 F.3d 1152 (D.C. Cir. 1995); Greenberg v. Schools, 711 F.2d 152 (11th Cir. 1983).
90. See Spicer, 57 F.3d at 1157.
91. Greenberg, 711 F.2d at 154.
92. Brown, 442 U.S. at 138. When the Bankruptcy Act was originally enacted, only "judgments sounding in fraud" were excepted from discharge. Id. In 1903, Congress expanded the scope of the provision by substituting the term "liabilities" for "judgments." Id. As it currently reads, the Code includes "any debt . . . for money . . . to the extent obtained by . . . fraud." 11 U.S.C. § 523(a)(2)(A) (2000).
95. Id. Although the parties in Brown had reduced their claims to a consent judgment, the Court's analysis of the language and policy underlying the Code is fundamental to understanding congressional intent concerning the nondischargeability provisions. See also Greenberg, 711 F.2d at 154-55.
with full knowledge that they can immediately discharge such debts in bankruptcy. As such, these courts argue that this approach directly conflicts with the underlying purpose of the fresh start theory of bankruptcy, as the fundamental purpose is to discourage fraud and “ensure that relief intended for honest debtors does not inure to the benefit of the dishonest.” Thus, these courts reason, “[s]ettlement makes the dishonest debtor no more honest, and no more entitled to the relief Congress intended to reserve for the honest debtor.”

Finally, in response to the argument that this approach discourages individuals from voluntarily settling their claims, these courts argue that creditors will become increasingly unwilling to settle underlying fraud claims if they know that the debtor can then immediately discharge such debts by filing for bankruptcy. Accordingly, so long as there is a causal connection between the underlying fraud claim and the subsequent settlement debt, these courts reason that the creditor should be allowed to establish the underlying nature of the debt as fraudulent. Fundamental to this theory is the premise that “a fraudulent debtor remains a fraudulent debtor, and debt originating in fraud remains nondischargeable even if its legal form changes under a settlement agreement.”

Against this backdrop of confusion and competing policy concerns, the Supreme Court granted certiorari in Archer v. Warner to clarify the effect that voluntary settlement agreements have on underlying claims for fraud in adversary bankruptcy proceedings.

IV. INSTANT DECISION

In Archer v. Warner, the Supreme Court settled the conflict among the circuits regarding the effect of settlement on underlying debts procured by fraud where the debtor subsequently files for bankruptcy. The issue before the Court was whether a voluntary settlement agreement between the parties created a novation, substituting a dischargeable contractual debt for an underlying debt for fraud, the latter of which is nondischargeable under the Code. In an opinion written by Justice Breyer, the Court held that although a settlement agreement may create a novation, a litigant should not be barred from

96. See Greenberg, 711 F.2d at 155.
97. Id. (quoting In re Wilson, 12 B.R. 363, 380 (Bankr. M.D. Tenn. 1981)).
98. In re Spicer, 57 F.3d 1152, 1156 (D.C. Cir. 1995).
99. See Brown, 442 U.S. at 135.
100. See Spicer, 57 F.3d at 1156-57.
101. Id. at 1157.
103. Id. at 320.
104. Id. at 321-22.
establishing that the underlying debt was procured by fraud within the meaning of Section 523 of the Code.105

The Court began its discussion by analyzing the effect of the settlement agreement on the underlying claim for fraud.106 The Court agreed with the Court of Appeals for the Fourth Circuit that "'[t]he settlement agreement . . . completely addressed and released each and every underlying state law claim.'"107 The only remaining debt, the Court noted, was the debt for money promised in the settlement agreement and accompanying promissory note.108 However, unlike the lower courts, the Court also noted that it had to "decide whether that same debt [could] also amount to a debt for money obtained by fraud, within the terms of the nondischargeability statute."109

The Court analyzed this issue under the precedent established in Brown v. Felsen.110 In Brown, the Court stated that a consent judgment, silent on its face with respect to the underlying fraud claim, "did not prevent the Bankruptcy Court from looking beyond the . . . record and the documents [that terminated] the . . . proceeding to decide whether the debt was a debt for money obtained by fraud."111 The Court held that the creditor must be allowed to present evidence to the bankruptcy court to determine whether the underlying debt was procured by fraud, and therefore nondischargeable.112

Applying Brown's holding to the present facts, the Court argued that the novation theory advanced by the lower courts and Arlene Warner must be incorrect.113 Specifically, the Court stated, "If the Fourth Circuit's view[s] were correct—if reducing a fraud claim to settlement definitively changed the nature of the debt for dischargeability purposes—the nature of the debt . . . in Brown would have changed similarly, thereby rendering the debt dischargeable."114 Thus, the Court held that even if the settlement agreement effected a novation, the bankruptcy court still must examine the underlying nature of the debt to determine whether it was for money obtained by fraud.115

Next, the Court examined congressional intent in enacting the nondischargeability provisions of the Code.116 In analyzing the history of these

105. Id. at 323 (citing 11 U.S.C. § 523(a)(2)(A) (2000)).
106. Id. at 318.
108. Id. at 319.
109. Id.
111. Archer, 538 U.S. at 320.
112. Id.
113. Id.
114. Id.
115. Id. at 323.
116. Id. at 321-22.
provisions, the Court stated that Congress intended that debts be investigated to ensure that they did not spring from fraud. In the instant case, the Court analyzed the parties' mutual release of pending claims, but noted that this language did not conclusively resolve the issue of whether they intended the settlement to be dischargeable in bankruptcy. This prompted the Court to hold that the Archers should be allowed to present such evidence of intent to the bankruptcy court on remand, thus fulfilling the investigatory requirement that Congress intended in enacting the nondischargeability provisions of the Code.

Finally, the Court noted Arlene Warner's alternative defense that the settlement agreement "included a promise that the Archers would not make the present claim of nondischargeability for fraud." She argued that, under North Carolina state law, the doctrine of collateral estoppel barred the Archers from raising the nondischargeability issue in bankruptcy. The Court did not analyze this issue as it was not properly presented to the Court or fully litigated in the lower courts. The Court remanded the issue to the court of appeals for further argument and determination.

In his dissent, Justice Thomas primarily argued that the majority's reliance on Brown was misplaced. Unlike in Brown, the parties to the present dispute had executed a voluntary release of the underlying claims without the participation of the state court. Based on this release, Justice Thomas found a clear intention by the parties to conclusively resolve "not only the issue of fraud, but also any other 'right[s], claim[s], or demand[s]' related to the state-court litigation." Thus, he argued, the settlement agreement extinguished the underlying fraud claim, and the Archers should not be allowed to re-litigate the issue before the bankruptcy court.

Justice Thomas also argued that the settlement agreement broke any causal connection between the fraud and the present debt. He noted that the "language of [Section] 523(a)(2) requires a creditor to prove that a debtor's fraud is the proximate cause of the debt." He argued that the voluntary settlement...
agreement between the parties was similar to a "superseding cause" that broke the necessary causation between the initial fraud and the subsequent debt.\textsuperscript{131} Thus, Justice Thomas concluded that the only remaining debt after the settlement agreement was "obtained by voluntary agreement of the parties, not by fraud," and the debt was therefore dischargeable in bankruptcy.\textsuperscript{132}

V. COMMENT

The Supreme Court's holding in Archer v. Warner clarifies the effect that voluntary settlement agreements have on underlying debts procured by fraud in adversary bankruptcy proceedings. As long as there is a causal connection between the two debts, the creditor is allowed to establish before the bankruptcy court that the underlying debt was for money obtained by fraud.\textsuperscript{133} The Court's decision is consistent with the fresh start theory of bankruptcy that Congress intended in enacting the nondischargeability provisions of the Code and with previous Supreme Court precedent on this issue. Accordingly, the Supreme Court came to the correct decision in applying general principles of federal bankruptcy law, and has consequently established a fundamental precedent with respect to future disputes in this area of the law.

As the Bankruptcy Code is currently written, Congress clearly intended all debts arising from fraud to be excepted from dischargeability in bankruptcy.\textsuperscript{134} Consequently, the mere fact that the parties have chosen to settle their claims should not bar the bankruptcy courts from examining the underlying nature of the debt where the creditor can establish that the debt is based in fraud. As the nondischargeability provisions of the Code have only grown broader in scope over time, this is consistent with both congressional intent and the general policy inherent in limiting discharge to the "honest, but unfortunate" debtor.

While it is tempting to argue that the Court's holding in Archer will discourage the voluntary settlement of claims by the debtor, this argument has a fundamental fallacy. In general, when the debtor has engaged in fraudulent activity and fears that litigation will result in liability, there is a strong incentive to voluntarily settle such claims. Typically, a voluntary settlement agreement by the parties will result in a lower overall debt that the debtor owes to the creditor. In fact, this was the case in Archer, as the Warners settled their claims for $300,000, but litigating the fraud claim would have resulted in at least a $400,000 debt, plus court costs and attorneys' fees.\textsuperscript{135}

\textsuperscript{131} Id. at 326-27 (Thomas, J., dissenting).
\textsuperscript{132} Id. at 327 (Thomas, J., dissenting).
\textsuperscript{133} Id. at 323.
\textsuperscript{135} See Archer, 538 U.S. at 317. This amount is determined by subtracting the actual worth of the corporation upon purchase from the amount that the Warners
Although there would be an added incentive for the debtor to settle a claim if such debts could then be discharged in bankruptcy, this would not only violate the fresh start policy inherent in the Code, but would also result in a decreased incentive for the creditor to settle. As the debtor has already engaged in an act of fraud when the parties begin contemplating settlement, any conscientious creditor would be very hesitant to settle fraud claims for fear that the debtor would immediately claim dischargeability in bankruptcy. As a result, more fraud would likely occur and more innocent creditors, whom the Code intends to protect, would be harmed. This is clearly inconsistent with both congressional intent underlying the Code and fundamental public policy concerns in discouraging fraudulent behavior.

VI. CONCLUSION

In Archer v. Warner, the United States Supreme Court held that creditors who have voluntarily settled their fraud claims against debtors should not be barred from establishing that the underlying debt was based in fraud.\textsuperscript{136} Thus, the mere fact that the parties have agreed to settle their claims does not necessarily result in a novation, substituting a dischargeable debt for a nondischargeable one in bankruptcy. In this manner, the Code’s dischargeability provisions truly are limited to the “honest, but unfortunate” debtor, as the bankruptcy court is forced to look behind the settlement agreement in determining the true nature of the original debt. The Court not only clarified the rule with respect to dischargeability, but also provided strong incentives for parties to willingly settle their fraud claims without fear that such settlements will be discharged in bankruptcy. Finally, the Court’s holding and discussion of fundamental bankruptcy theory in Archer gave needed credence both to its prior decisions in this area and to congressional intent underlying the Code.

JENNIFER A. DAVIS FOSTER

\textsuperscript{136} Id. at 323.