No. 01-1418

In the Supreme Court of the United States

A. ELLIOTT ARCHER AND CAROL A. ARCHER,
PETITIONERS

v.

ARLENE L. WARNER

*ON WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT*

**BRIEF FOR THE UNITED STATES AS AMICUS
CURIAE SUPPORTING PETITIONERS**

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QUESTION PRESENTED

Section 523(a)(2)(A) of the Bankruptcy Code provides that a debt for money obtained by means of fraud is not dischargeable in bankruptcy. 11 U.S.C. 523(a)(2)(A). The question presented is whether an otherwise non-dischargeable debt becomes dischargeable if the parties enter into a settlement agreement resolving the amount of the debt.

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INTEREST OF THE UNITED STATES

Section 523(a)(2)(A) of the Bankruptcy Code, 11 U.S.C. 523(a)(2)(A), excepts from discharge in bankruptcy all debts arising from the debtor's fraud. The question presented in this case is whether a settlement agreement precludes a creditor from proving that the debtor's obligations under the settlement agreement arise from the debtor's fraud and are, therefore, non-dischargeable under Section 523(a)(2)(A). The United States has an interest in preventing the discharge in bankruptcy of debts stemming from settlement agreements that resolve claims for fraud in connection with government programs under the False Claims Act, 31 U.S.C. 3729-3733, or under the common law. Thus, the United States, as a party, has urged courts to adopt the rule that a settlement agreement does not bar a

creditor in bankruptcy proceedings from proving fraud as the source of the settlement debt. *United States* v. *Spicer*, 57 F.3d 1152 (D.C. Cir. 1995), cert. denied, 516 U.S. 1043 (1996); *United States* v. *Turner*, 179 B.R. 273 (Bankr. D. Colo. 1995).

STATEMENT

1. On May 22, 1992, Warner Manufacturing, Inc., respondent, Arlene Warner, and her spouse, Leonard L. Warner, sold the corporate assets of Warner Manufacturing for $685,000 to a corporation formed by petitioners. In late 1992, petitioners filed a suit in Superior Court of Guilford County, North Carolina, against Leonard Warner and Warner Manufacturing alleging fraud in connection with petitioners' purchase of the business. In March 1994, petitioners amended their complaint to add respondent and two other parties as named defendants and to allege additional claims of fraud and other misconduct. On May 8, 1995, petitioners again amended their complaint to add claims of intentional and negligent infliction of emotional distress. Pet. App. 2a.

On May 11, 1995, after extensive pre-trial discovery, the parties settled the case for $300,000. Pet. App. 2a. As part of the settlement, respondent and her spouse agreed to pay $200,000 in cash and to execute a secured promissory note for $100,000 payable in two installments due on November 11, 1995, and May 11, 1996. *Id.* at 3a, 31a. Petitioners also executed releases that waived any claims arising out of the matters in the state court suit, except for the obligations of respondent and her spouse to petitioners under the promissory note. *Id.* at 3a, 9a. Neither party admitted liability, and the settlement documents did not address whether respondent committed fraud. The documents also made no mention of bankruptcy. *Id.* at 3a.

On November 11, 1995, respondent and her spouse defaulted on the first payment due under the promissory note. On December 4, 1995, petitioners filed a collection suit in Superior Court in Guilford County. On February 5, 1996, respondent and her spouse filed for bankruptcy under Chapter 13 of the Bankruptcy Code (11 U.S.C. 1301 *et seq.*) and, on October 29, 1996, the case was converted into a case for liquidation and discharge of debts under Chapter 7 of the Bankruptcy Code (11 U.S.C. 701 *et seq.*). Pet. App. 3a.

2. The instant suit arose on January 29, 1997, when petitioners brought an adversary proceeding in the United States Bankruptcy Court for the Middle District of North Carolina seeking a judgment for the amount due under the promissory note and a declaration that the debt arose from fraud and was thus excepted from discharge under 11 U.S.C. 523(a)(2)(A).[1] Pet. App. 3a-4a. On May 27, 1997, respondent's spouse agreed to the entry of a consent judgment in which the bankruptcy court ordered the promissory note non-dischargeable under Section 523(a). *Id.* at 39a-41a. Respondent contested non-dischargeability, however, asserting the settlement of the state court suit as an affirmative defense. *Id.* at 5a. The bankruptcy court upheld respondent's affirmative defense, concluding that the releases executed by petitioners "effectively

[1] Section 523(a)(2)(A) provides in relevant part that a discharge in bankruptcy "does not discharge an individual debtor from any debt * * * for money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained by * * * false pretenses, a false representation, or actual fraud." 11 U.S.C. 523(a)(2)(A).

released and extinguished the dichargeability claim which they now seek to assert." *Id.* at 35a.[2]

3. The district court affirmed. Pet. App. 17a-25a. The court reasoned that "the settlement agreement and general release created a novation, substituting a contract debt for a debt arising from tort, and that the debt was therefore dischargeable in bankruptcy." *Id.* at 21a.

4. A divided panel of the Fourth Circuit affirmed. Pet. App. 1a-15a. The majority noted that the courts of appeals have divided on the issue whether a prepetition settlement of claims for fraud extinguishes a creditor's claim that the settlement debt is excepted from discharge under Section 523(a)(2)(A) when the debtor files for bankruptcy relief before satisfying his settlement debt. *Id.* at 7a-9a. The majority observed that the District of Columbia and Eleventh Circuits have held that a settlement agreement does not extinguish a non-dischargeability claim under Section 523(a)(2)(A), because "examining the underlying fraudulent allegations leading to the settlement agreement best effectuates" the policy under the Bankruptcy Code of "not permitting the discharge of debts that Congress intended to survive bankruptcy." *Id.* at 8a (citing *United States* v. *Spicer*, 57 F.3d 1152 (D.C. Cir. 1995), cert. denied, 516 U.S. 1043 (1996); *Greenberg* v. *Schools*, 711 F.2d 152 (11th Cir. 1983)). By contrast, the court explained, the Seventh and Ninth Circuit have embraced a "novation theory," under which "parties willing to settle disputes over fraud, misrepresentation, or like tort claims may do so by way of settlement through contract, and such contractual claims are then

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[2] On June 25, 1998, petitioners twice attempted to amend their adversary complaint to allege fraud-in-the-inducement of the settlement agreement, but the bankruptcy court denied those requests. Pet. App. 4a-5a n.4.

dischargeable in bankruptcy." *Ibid.* (citing *In re Fischer*, 116 F.3d 388 (9th Cir. 1997); *In re West*, 22 F.3d 775 (7th Cir. 1994); *Maryland Cas. Co.* v. *Cushing*, 171 F.2d 257 (7th Cir. 1948)).

The majority concluded that it would follow the "novation theory" line of decisions because, in the majority's opinion, "Congress did not intend that 11 U.S.C. § 523(a) be construed * * * so as to discourage the settlement of claims because they might be subject to freedom from discharge under § 523(a)." Pet. App. 8a. The court then examined "the validity and completeness of the bargained for agreement and release," and the court concluded that petitioners had released "all pending and future related personal claims" against respondent, including petitioners' non-dischargeability claim under Section 523(a)(2)(A). *Id.* at 9a.

Judge Traxler dissented. Pet. App. 10a-15a. He observed (*id.* at 13a) that in *Brown* v. *Felsen*, 442 U.S. 127 (1979), this Court held that a consent judgment against a debtor that is silent as to the cause of action upon which the judgment is based does not bar creditor from proving in bankruptcy proceedings that the debt reflected in the consent judgment is not dischargeable. "If, as the Supreme Court has declared, '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,'" Judge Traxler saw "no reason why the mere fact that a conscientious creditor has previously reduced his claim to settlement should bar such an inquiry." Pet. App. 15a (quoting *Brown*, 442 U.S. at 138). He also noted that petitioners' releases posed no bar to petitioners' non-dischargeability claim because "the releases specifically excepted the [respondent's] obligations under the promissory note." *Id.* at 15a n.*. Judge Traxler accordingly would have

allowed petitioners "to offer such proof as they might have to show that [respondent's] debt resulted from a fraud perpetrated upon them." *Id.* at 15a.

SUMMARY OF ARGUMENT

A. The court of appeals erred in embracing a novation theory under which a settlement agreement converts an otherwise non-dischargeable debt into a dischargeable contract debt. Section 523(a)(2)(A), 11 U.S.C. 523(a)(2)(A), excepts from discharge "any debt * * * to the extent obtained by" the debtor's "fraud." The Code, therefore, treats as irrelevant the form in which a debt appears or whether there have been prior efforts to reduce a claim based on fraud to settlement or judgment. A debt reflected in a settlement agreement fits within Section 523(a)(2)(A) as long as the creditor can demonstrate in bankruptcy proceedings that the debtor's underlying actions involved obtaining money or property by fraud. This Court has underscored the breath of Section 523(a)(2)(A)'s coverage by noting that the statutory language "prevents the discharge of all liability arising from fraud." *Cohen* v. *de la Cruz*, 528 U.S. 213, 215 (1998). A novation theory conflicts with the plain language of the Code by rendering debt procured by fraud dischargeable despite the clear prohibition of Section 523(a)(2)(A).

B. This Court's decision in *Brown* v. *Felsen*, 442 U.S. 127 (1979), confirms that the bankruptcy court may examine evidence extrinsic to the form of the debt to determine whether the debtor's liability is non-dischargeable because it arises from fraud. *Brown* holds that a consent judgment against a debtor that is silent as to the cause of action on which the liability is based does "not bar further inquiry into the true nature of the debt." *Id.* at 138. There is no principled reason to confine the Court's holding to consent judgments as op-

posed to settlement agreements that are not formally reduced to judgment. In both instances, the form of the claim underlying the debt changes from an unliquidated claim for fraud into a liquidated claim reduced to contract or judgment. But in both instances, the underlying nature of the debtor's behavior is unchanged.

Moreover, in both instances, the debtor's filing of bankruptcy "place[s] the rectitude of his prior dealings squarely in issue," and therefore principles of finality and repose do not warrant barring the creditor from asserting a claim of non-dischargeability in response to the debtor's "new defense of bankruptcy." *Brown*, 442 U.S. at 128, 133. And in both instances, the bankruptcy courts have the expertise to resolve the issue of non-dischargeability, which was not definitively resolved by the parties' resolution of their state court dispute.

C. The court of appeals likewise erred in concluding that petitioners released their non-dischargeability claims under Section 523(a)(2)(A). Although the settlement agreement, like the consent judgment in *Brown*, extinguished petitioners' state law claims for fraud, petitioners expressly preserved their rights to enforce respondent's settlement obligations. After respondent defaulted on those obligations and petitioners filed a collection suit on the settlement debt, respondent sought to discharge that debt in bankruptcy. Petitioners' claim of non-dischargeability under Section 523(a)(2)(A) does not seek to resurrect the state court litigation, to assert new grounds for recovery, or to recover sums beyond that agreed to in the settlement agreement. Rather, petitioners' non-dischargeability claim simply responds to respondent's bankruptcy by asserting the enforceability of the settlement debt notwithstanding respondent's bankruptcy. Petitioners' effort to enforce the settlement agreement in this

respect is no different than the creditor's effort to enforce the consent judgment in *Brown.*

D. The court of appeals' decision is inconsistent with the long-standing tradition of the Code to limit relief to the "honest but unfortunate debtor." *Cohen* v. *de la Cruz*, 523 U.S. 213, 217 (1998) (quoting *Grogan* v. *Garner*, 498 U.S. 279, 287 (1991)). The court of appeals' decision would permit debtors who have committed fraud to render their resulting debts dischargeable by the simple expedient of settling the debt and subsequently filing for bankruptcy. That result would defeat Congress's policy choice to protect innocent victims of fraud by rendering debts on account of fraud non-dischargeable in bankruptcy.

The court of appeals also was mistaken in concluding that a novation theory has the beneficial effect of encouraging settlement. Pet. App. 8a. In the first place, the policy goal of promoting settlement provides no basis for ignoring the plain text of Section 523(a)(2)(A), which makes debts arising from fraud non-dischargeable. In any event, it is not at all clear that a policy that turns debts that are non-dischargeable if either left unliquidated or reduced to judgment into dischargeable debts, if settled, would promote settlement. The only settlements encouraged by the court of appeals' decision are those induced by a desire to ensure that the settlement debt may be discharged in bankruptcy, even where the debtor actually committed fraud. Assuming the desirability of such settlement agreements, creditors would have little incentive to reach such agreements, and, of course, it takes two sides with proper incentives to settle a case. The court of appeals' decision likely would deter settlement by encouraging creditors to litigate an otherwise resolvable claim in order to obtain a non-dischargeable judgment of fraud

against a debtor, rather than risking a settlement that is dischargeable in bankruptcy.

ARGUMENT

A SETTLEMENT AGREEMENT DOES NOT BAR THE CREDITOR FROM PROVING THAT THE SETTLEMENT DEBT IS NON-DISCHARGEABLE UNDER SECTION 523(a)(2)(A)

Section 523(a) makes, "any debt" for, *inter alia*, "money, services [or] property" non-dischargeable "to the extent obtained by * * * fraud." 11 U.S.C. 523(a)(2)(A). The plain language of the Code, therefore, makes clear that any debt—for example, a note procured by fraud —is non-dischargeable, even if the defrauded creditor makes no pre-bankruptcy effort to enforce the note in court. Likewise, the text's broad coverage of "*any* debt . . . *to the extent* obtained by" fraud provides that an unliquidated claim for damages caused by fraud is non-dischargeable, even though there was no pre-bankruptcy effort to litigate the fraud action.

At the same time, this Court's precedents make clear that such debts do not become dischargeable and do not lose their fundamental character as debts procured by fraud simply because they have been reduced to a judicially-enforceable judgment. This is true whether the judgment results from a full adjudication of the dispute, see, *e.g.*, *Cohen* v. *de la Cruz*, 523 U.S. 213 (1998), or is the product of a settlement reached by the parties and reduced to a consent judgment, see, *e.g.*, *Brown* v. *Felsen*, 422 U.S. 127 (1979). The position of respondent and the court below then is that, even though debts procured by fraud are clearly non-dischargeable in the absence of any effort to litigate the claims and are equally non-dischargeable if they have

been reduced to judgment by settlement or adjudication, those same claims somehow lose their character as non-dischargeable debts procured by fraud if they are resolved through a settlement that is not reduced to a consent judgment.

In reaching that counterintuitive conclusion by adopting a "novation theory," the court of appeals articulated two distinct but related concepts. First, the court expressed its adherence to decisions embracing the principle that "parties willing to settle disputes over fraud, misrepresentation, or like tort claims may do so by way of settlement through contract, and such contractual claims are then dischargeable in bankruptcy." Pet. App. 8a. "The basic rationale of these cases is that, having accepted a settlement and released the underlying tort action, the plaintiff voluntarily accepted a contract debt, which is dischargeable under the bankruptcy laws, in lieu of pursuing a potentially non-dischargeable tort debt." *Id.* at 11a (Traxler, J., dissenting). Second, the court of appeals concluded that by releasing all claims arising out of matters in the state court suit, petitioners "completely released [respondent] from potential non-dischargeability claims under Section 523(a)(2)(A)." *Id.* at 9a. Neither of those theories justifies precluding petitioners from proving their non-dischargeability claim under Section 523(a)(2)(A).

A. A Novation Theory Conflicts With The Text Of The Code

1. Section 523(a)(2)(A) of the Bankruptcy Code excepts from discharge "any debt * * * for money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained by * * * false pretenses, a false representation, or actual fraud." 11 U.S.C. 523(a)(2)(A). This Court has held that the plain

meaning of that statutory language "prevents the discharge of *all liability arising from fraud*." *Cohen* v. *de la Cruz*, 523 U.S. 213, 215 (1998) (emphasis added). That conclusion flows from two premises, both of which demonstrate that a creditor who reduces a disputed tort claim to a liquidated settlement debt is free to prove that the settlement debt arises from fraud and thus is non-dischargeable under Section 523(a)(2)(A).

First, Section 523(a)(2)(A) places no significance on the *form* of a debtor's liability. That provision treats as non-dischargeable "*any* debt * * * *to the extent* obtained by * * * fraud." 11 U.S.C. 523(a)(2)(A) (emphasis added). The Code defines a "debt" as "liability on a claim." 11 U.S.C. 101(12). A "claim" is defined, in turn, as a "right to payment, *whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, secured, legal, equitable, or unsecured*." 11 U.S.C. 101(5)(A) (emphasis added). The Code itself, therefore, expressly disclaims any concern whether the debt "is reduced to judgment, liquidated, [or] unliquidated." And a "right to payment" "is nothing more nor less than an enforceable obligation." *Cohen*, 523 U.S. at 218 (quoting *Pennsylvania Dep't of Pub. Welfare* v. *Davenport*, 495 U.S. 552, 559 (1990)). In sum, the relevant threshold inquiry under Section 523(a)(2)(A) is whether there is an "enforceable obligation of the debtor," and whether "the creditor has a corresponding right to payment," *ibid.*, not whether a settlement agreement was reduced to judgment.

Second, Congress intended that all debts originating in fraudulent conduct are non-dischargeable in bankruptcy. Congress employed the phrase "debt for" throughout the Code to mean "'debt as a result of,' 'debt with respect to,' 'debt by reason of' and the like,

connoting broadly any liability arising from the specified object." *Cohen*, 523 U.S. at 220 (citation omitted). In other words, Section 523(a)(2)(A) bars the discharge of debts "resulting from" or "traceable to" fraud. *Field* v. *Mans*, 516 U.S. 59, 61, 64 (1995). Accordingly, "[o]nce it is established that specific money or property has been obtained by fraud, * * * 'any debt' arising therefrom is excepted from discharge." *Cohen*, 523 U.S. at 218-219.

2. Those principles establish that a creditor must have an opportunity to show that a settlement debt arises from fraud and is, therefore, non-dischargeable under Section 523(a)(2)(A). A settlement debt satisfies the threshold condition of constituting a "debt" or "liability on a claim." 11 U.S.C. 101(12). The debtor has an enforceable obligation to pay the amount fixed in the agreement, and the creditor has a corresponding "right to payment, whether or not such right is reduced to judgment." 11 U.S.C. 101(5)(A). As the D.C. Circuit has explained, although a settlement agreement "alters the legal form" of the debtor's obligation, "it does not transmogrify its essential nature so as to immunize it from the command of § 523(a)(2)(A) that debt for money or property obtained by fraud is not dischargeable in bankruptcy." *United States* v. *Spicer*, 57 F.3d 1152, 1157 (D.C. Cir. 1995), cert. denied, 516 U.S. 1043 (1996).

Of course, the creditor has the ultimate burden of proving a connection between a settlement debt and the debtor's fraud. Settlement agreements typically will not be conclusive evidence that the debtor's settlement liability arises from fraud. For instance, respondent here did not admit liability in the settlement agreement and, therefore, the agreement is silent on whether respondent committed fraud in connection with petitioners' purchase of the assets of Warner

Manufacturing. Pet. App. 3a. Accordingly, a creditor in such instances will have the burden of proving in bankruptcy court by a preponderance of the evidence that respondent committed fraud. *Grogan* v. *Garner*, 498 U.S. 279, 287 (1991). "Once it is established that specific money or property has been obtained by fraud, however, 'any debt' arising therefrom is excepted from discharge," including debts reflected in a settlement agreement. *Cohen*, 523 U.S. at 218-219. The courts below pretermitted that inquiry and petitioners accordingly should have the opportunity to demonstrate their claim of non-dischargeability under Section 523(a)(2)(A).

B. A Novation Theory Is Inconsistent With *Brown* v. *Felsen*

1. In *Brown* v. *Felsen*, 442 U.S. 127 (1979), this Court held that a settlement stipulation and resulting consent judgment against a debtor, which was silent on the cause of action that formed the basis of liability, did not bar the creditor from establishing in subsequent bankruptcy proceedings that the debt resulted from fraud and, therefore, was non-dischargeable under Section 17 of the Code (11 U.S.C. 35 (1976)), the predecessor to Section 523(a). 442 U.S. at 128, 129 n.1. The Court explained that "all debts arising out of conduct specified in § 17 should be excepted from discharge and the mere fact that a conscientious creditor has previously reduced his claim to judgment should not bar further inquiry into the true nature of the debt." *Id.* at 138.

There is no reason for a different result when the settlement agreement has not been reduced to a consent judgment. In several fundamental respects, a settlement by private agreement is identical to a settlement by consent judgment. "A consent decree is pri-

marily a means by which parties settle their disputes without having to bear the financial and other costs of litigation." *Local No. 93, Int'l Ass'n of Firefighters* v. *City of Cleveland*, 478 U.S. 501, 528 (1986). "Consent decrees are entered into by parties to a case after careful negotiation has produced agreement on their precise terms. The parties waive their right to litigate the issues involved in the case and thus save themselves the time, expense, and inevitable risk of litigation." *United States* v. *Armour & Co.*, 402 U.S. 673, 681 (1971). Because "[t]he voluntary nature of a consent decree is its most fundamental characteristic," "it is the agreement of the parties, rather than the force of the law upon which the complaint was originally based, that creates the obligations embodied in a consent decree." *Local No. 93, Int'l Ass'n of Firefighters*, 478 U.S. at 521-522. And, like a settlement agreement, the binding effect of a consent judgment does not depend on resolution of the underlying issues in dispute. *Armour & Co.*, 402 U.S. at 681-682.

There also is nothing in the nature of a "novation" that differentiates a settlement agreement from a consent judgment for these purposes. As noted by the court of appeals (Pet. App. 9a n.8), a settlement agreement "operates as a merger" in which a contract claim is substituted for the tort claim. 15A C.J.S. *Compromise and Settlement* § 24(a), at 225 (1967). A judgment in the plaintiff's favor operates in the same respect by extinguishing the plaintiff's underlying claims and limiting him to a suit to enforce the judgment. Restatement (Second) of Judgments § 17(1) (1982) ("If the judgment is in favor of the plaintiff, the claim is extinguished and merged in the judgment."); *id.* § 18(1) ("When a valid and final personal judgment is rendered in favor of the plaintiff: * * * [t]he plaintiff cannot

thereafter maintain an action on the original claim or any part thereof, although he may be able to maintain an action upon the judgment.").

Moreover, the distinguishing features of a consent judgment provide no basis for limiting the holding of *Brown* to settlements by judicial decree rather than private contract. Because a consent decree is embodied in a judgment, the decree is subject to the court's continuing jurisdiction to enforce or modify. *Kokkonen* v. *Guardian Life Ins. Co. of America*, 511 U.S. 375, 381 (1994); *Rufo* v. *Inmates of Suffolk Co. Jail*, 502 U.S. 367, 378 (1992); *Local No. 93, Int'l Ass'n of Firefighters*, 478 U.S. at 523. A consent decree also "must spring from and serve to resolve a dispute within the court's subject-matter jurisdiction, * * * must come within the general scope of the case made by the pleadings, and must further the objectives of the law upon which the complaint was based." *Id.* at 525 (quotation marks, citations, and brackets omitted).

Although those differences may be relevant to a federal court's jurisdiction, see, *e.g.*, *Kokkonen*, *supra*, they have no bearing on the question presented in this case. The happenstance that a settlement agreement is or is not embodied in a judgment does not alter the dispositive fact that the claim that underlies the debt arises from fraud. Indeed, the Code removes all doubts on this issue, by disclaiming any concern whether a claim "is reduced to judgment." 11 U.S. 101(5)(A). Had the parties here resolved the state court suit by consent judgment, this case would be controlled by *Brown* and petitioners could attempt to show in a bankruptcy proceeding that the settlement debt is traceable to respondent's fraud. "There is no principled basis on which to conclude that [petitioners] should be barred from the opportunity to prove the true nature of the

debt just because the parties elected to keep their settlement agreement private and not to burden the state court with an unnecessary consent judgment." *In re Francis*, 226 B.R. 385, 392 (B.A.P. 6th Cir. 1998). In short, whether the parties' settlement takes the form of a consent judgment or a private contract, the relevant two-step inquiry is, first, whether the settlement creates a debt, *i.e.*, an enforceable obligation, and, second, whether the debt arises from fraud. *Cohen*, 523 U.S. at 218.

2. The Court's reasoning in *Brown* also confirms that neither principles of finality nor repose preclude bankruptcy courts from considering whether a debt embodied in a settlement agreement originates from fraud. "By seeking discharge," the Court observed, the debtor "place[s] the rectitude of his prior dealings squarely in issue," for the Code limits relief "to the 'honest but unfortunate debtor.'" 442 U.S. at 128 (quoting *Local Loan Co.* v. *Hunt*, 292 US. 234, 244 (1934)). *Brown* thus rejected the argument of the debtor that, because the litigation did not result in a finding of fraud, principles of claim preclusion or res judicata barred the creditor in bankruptcy proceedings from proving that the debtor's fraud gave rise to the consent judgment. The Court explained that, in pursuing a claim of non-dischargeability, the creditor "does not assert a new ground for recovery, nor does he attack the validity of the prior judgment." *Id.* at 133. Rather, the creditor "readily concedes that the prior decree is binding. That is the cornerstone of his claim." *Ibid.* The Court further explained that the creditor is "attempting to meet * * * the new defense of bankruptcy which [the debtor] has interposed between [the creditor] and the sum determined to be due him." *Ibid.* Noting the irony of a bankrupt relying on

principles of repose that he "has long since abandoned," the Court explained that "it would hardly promote confidence in judgments to prevent [the creditor] from meeting [the debtor's] new initiative." *Id.* at 134, 139.

As in *Brown*, petitioners hardly can be faulted for resolving their state court fraud suit and then later attempting to collect on the settlement debt. The parties' settlement had the salutary effects of avoiding the burdens, costs, and risks of litigation for both parties and the court. Those goals provided the parties with no incentive, however, to obtain a state court resolution of petitioners' underlying fraud allegations. "The object of a compromise and settlement is to compose differences and avoid litigation; it is intended, not to bring about a decision of the questions of law in dispute, but to pretermit them." 15A C.J.S., *supra*, § 1(a), at 171 (footnote omitted). Respondent, however, "upset the repose" underlying the parties settlement agreement by defaulting on her settlement debt and by filing for bankruptcy after petitioners brought suit to collect on the settlement debt. *Brown*, 442 U.S. at 133. By those actions, respondent "placed the rectitude of [her] prior dealings squarely in issue," and petitioners therefore are permitted to prove their claim of nondischargeability in response to respondent's "new defense of bankruptcy." *Id.* at 128, 133.

Similarly, the dischargeability *vel non* of respondent's settlement debt is properly resolved in the bankruptcy court that has developed expertise on the issue. *Brown*, 442 U.S. at 136. That court is well-suited "to make an accurate determination whether respondent in fact committed the * * * fraud." *Id.* at 138. That question is "now, for the first time, squarely in issue," and is "the type [that] Congress intended that the bankruptcy court would resolve." *Ibid.*

C. Petitioners Did Not Release Their Claim Of Non-Dischargeability Under Section 523(a)(2)(A)

1. The court of appeals concluded that the petitioners "completely released [respondent] from potential non-dischargeability claims under Section 523(a)(2)(A)," because petitioners executed releases that "announced the complete waiver of all pending and future related personal claims against [respondent]." Pet. App. 9a. Making a similar point, respondent argues (Br. in Opp. 10) that *Brown* has no application where the creditor "voluntarily, and expressly, released an alleged fraud claim." A creditor's release of all pending or future claims relating to a state court fraud suit, however, does not extinguish his right to assert the enforceability of the bargained-for settlement debt when the debtor defaults on that debt and seeks its discharge in bankruptcy.

A settlement agreement substitutes a plaintiff's disputed claims for a new contract right to payment under the settlement agreement; indeed, that is the principle underlying a "novation" theory. See, *e.g.*, *Village of Kaktovik* v. *Watt*, 689 F.2d 222, 230 (D.C. Cir. 1982) ("An agreement to settle a legal dispute is a contract. Each party agrees to extinguish those legal rights it sought to enforce through litigation *for those rights secured by the contract*.") (footnote omitted) (emphasis added); accord 1 Am. Jur. 2d *Accord and Satisfaction* § 3, at 471 (1994) ("novation is a mode of extinguishing one obligation by the substitution of a new one"); Pet. App. 9a n.8 (explaining that settlement agreement caused "the substitution of a contract claim for a tort claim"). Because "a novation implies the extinction of an existing debt or obligation and its transition into a new one between the same or other parties, * * * a novation may * * * be the basis of the assertion of a

substantive right arising under the new agreement." *Accord and Satisfaction*, *supra*, at 471. For those reasons, a creditor's extinguishment of fraud claims in a release does not extend to his right to payment of the settlement debt.

That principle is illustrated by the settlement agreement in this case, in which petitioners agreed to release any claims relating to the subject matter of the state court suit but not to release any claims arising from respondent's failure to comply with her obligations under the settlement agreement. In the settlement agreement, petitioners agreed to execute releases with respect to "any and all claims * * * arising out of [the state court] litigation, *except as to amounts set forth in this Settlement Agreement*." J.A. 68 (emphasis added). Similarly, in the general and mutual releases attached to the settlement agreement, petitioners explicitly excepted from the release any claims arising out of respondent's "*obligations under*" the promissory note. J.A. 72 (emphasis added).

A non-dischargeability claim under Section 523(a)(2)(A) is properly subsumed within petitioners' preserved right to enforce respondent's obligations under the settlement agreement. By pressing the non-dischargeability claim, petitioners are not re-asserting their state law causes of action; they are not asserting any new claim for recovery; and they are not seeking to collect amounts in excess of respondent's settlement debt. *Brown*, 442 U.S. at 133. Petitioners simply are asserting their rights to enforce the settlement agreement by claiming that those rights survive respondent's "new defense of bankruptcy" because respondent's settlement liability arises from fraud. *Ibid*. Thus, absent an express waiver of a creditor's claim of non-dischargeability under Section 523(a)(2)(A), a release does

not waive the creditor's right to assert non-dischargeability of a settlement debt incurred by the debtor in exchange for that release.[3]

In essence, the parties here are in the identical posture as the parties in *Brown*, who settled their dispute by agreeing to the entry of a consent judgment, which like a settlement agreement, draws its meaning and preclusive effect from the intent of the parties. *Arizona* v. *California*, 530 U.S. 392, 414 (2000); *Armour & Co.*, 402 U.S. at 681-682. Thus, in *Brown*, the debtor agreed to incur a debt to settle a fraud claim, and the form of the parties' settlement contained no finding of fraud and no disclaimer of the creditor's rights in bankruptcy. 442 U.S. at 128. The settlement here shares those same key elements. It is therefore irrelevant that respondent may have settled petitioners' fraud claims in order to "buy her peace," *i.e.*, so that she would never again have to respond to the allegations of fraud made in the state court suit. The same may be said for the debtor who settles a fraud claim by consent judgment without admitting liability, and *Brown* squarely

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[3] Because the parties' settlement made "no mention of bankruptcy" (Pet. App. 3a), this case does not present the Court with any occasion to address an instance where a settling creditor executes an express waiver of a non-dischargeability claim under Section 523(a)(2)(A) of the Code. Similarly, because the parties' settlement is silent on the question whether petitioner committed fraud, this case does not involve the application of principles of issue preclusion or collateral estoppel which might otherwise bar a creditor from proving the elements of fraud in bankruptcy proceedings. *Grogan*, 498 U.S. at 284 n.11 (noting that "collateral estoppel principles do indeed apply in discharge exception proceedings pursuant to § 523(a)"); cf. *Arizona* v. *California*, 530 U.S. at 414 (observing that although settlements have claim preclusive effect, they "ordinarily occasion no *issue preclusion* (sometimes called collateral estoppel), unless it is clear, as it is not here, that the parties intend their agreement to have such an effect.").

rejected any effort by the debtor to rest on principles of repose because it is the *debtor* who had disturbed the status quo ante by filing for bankruptcy and interposing a bankruptcy defense. *Id.* at 134, 139. Just as principles of claim preclusion or res judicata do not preclude a creditor from proving the non-dischargeability of a debt embodied in a consent judgment, petitioners' releases do not preclude them from establishing the non-dischargeability claim of a debt embodied in a settlement agreement.[4]

2. To be sure, a creditor may bargain for a specific provision in a release that explicitly preserves the ability to press a non-dischargeability claim in the event of bankruptcy. This Court should decline, however, to impose a default rule that requires creditors to take such action. At the time of the settlement, a debtor's bankruptcy is only "hypothetical." *Brown*, 442 U.S. at 135. This Court in *Brown* thus rejected the contention that the creditor "could have * * * preserved his dischargeability contentions for bankruptcy court review by bargaining for a stipulation that § 17 issues were not resolved by the consent judgment." *Id.* at 137. The Court explained that "[i]t makes little sense * * * to

[4] The court of appeals noted that petitioners, in their non-dischargeability complaint in bankruptcy court, incorporated by reference their fraud allegations in the state court suit. Pet. App. 4a n.3. Those allegations, however, are not being lodged to relitigate any new claim for recovery. Rather, the allegations in the state court proceeding are directly relevant to the question before the bankruptcy court, *i.e.*, whether the settlement debt is non-dischargeable because it arises from respondent's fraud. As the Court in *Brown* made clear, the bankruptcy court may examine the pleadings and discovery from a settled state court suit, as well as other evidence, in order to make an accurate determination of whether the debtor's liability results from fraud. 442 U.S. at 130, 138.

resolve a federal dischargeability question according to whether or not the parties in state court waived their right to engage in hypothetical litigation in an inappropriate forum." *Ibid.*

That conclusion is particularly warranted here, because the debtor presumably is the party with superior knowledge concerning the likelihood of his bankruptcy. Moreover, a default rule of dischargeability, unless the statutory policy of non-dischargeability is expressly incorporated, makes little sense as a practical matter. It is well-established that fraud claims reduced to final judgment via litigation or settlement are non-dischargeable. Accordingly, it is unclear why parties would assume that the same claims are presumptively dischargeable if settled without a consent judgment. It also is "unlikely that Congress . . . would have favored the interest in giving perpetrators of fraud a fresh start over the interest in protecting victims of fraud." *Cohen*, 523 U.S. at 223 (quoting *Grogan*, 498 U.S. at 287). There is therefore no basis for forcing innocent victims of fraud to bear the risk of loss if they settle their fraud claims without explicitly preserving a claim of non-dischargeability under Section 523(a)(2)(A).

D. The Court Of Appeals' Decision Contravenes The Purpose Of Section 523(a)(2)(A) And Does Not Encourage Settlement

1. "The Bankruptcy Code has long prohibited debtors from discharging liabilities incurred on account of their fraud, embodying a basic policy animating the Code of affording relief only to an 'honest but unfortunate debtor.'" *Cohen*, 523 U.S. at 217 (quoting *Grogan*, 498 U.S. at 287); see *Brown*, 442 U.S. at 138. Thus, the Bankruptcy Act of 1867 provided that "no debt created by the fraud or embezzlement of the bankrupt * * *

shall be discharged under this act." Act of Mar. 2, 1867, ch. 176, § 33, 14 Stat. 533. The Bankruptcy Act of 1898 similarly prohibited discharge of "judgments in actions for frauds, or obtaining property by false pretenses or false representations," Act of July 1, 1898, ch. 541, § 17, 30 Stat. 550, and the exception was broadened in 1903 to include all "liabilities for obtaining property by false pretenses or false representations." Act of Feb. 5, 1903, ch. 487, § 5, 32 Stat. 798. *Cohen*, 523 U.S. at 221; *Brown*, 442 U.S. at 138. In passing Section 523(a)(2)(A) as a "substantially similar provision," Congress carried forward the Code's long-standing tradition by "prevent[ing] the discharge of all liability arising from fraud." *Cohen*, 523 U.S. at 215, 221 (internal quotation mark omitted).

The purpose of Section 523(a)(2)(A) to limit relief to the "honest but unfortunate debtor" would be seriously undermined by the court of appeals' decision, which prevents even innocent victims of fraud from proving that a settlement debt results from fraud. The decision below "would allow a debtor to discharge a debt incurred by his own fraud by simply entering into a settlement agreement prior to declaring bankruptcy." *Greenberg* v. *Schools*, 711 F.2d 152, 154 (11th Cir. 1983). A settlement agreement, however, "makes the dishonest debtor no more honest, and no more entitled to the relief Congress intended to reserve for the honest debtor." *Spicer*, 57 F.2d at 1156. As a result, "[t]he intent of Congress to except from discharge debts incurred by means of fraud or defalcation could effectively be short-circuited by a simple execution of settlement." *In re Bobofchak*, 101 B.R. 465, 468 (Bankr. E.D. Va. 1989).

2. Those undesirable practical consequences are not outweighed by any countervailing policy to encourage

settlement. In the majority's view, allowing creditors to prove that settlement debts are non-dischargeable under Section 523(a)(2)(A) would "discourage the settlement of claims." Pet. App. 8a. As a preliminary matter, the salutary interest in promoting settlement does not justify disregarding the plain language of Section 523(a)(2)(A), which makes all debts arising from frauds non-dischargeable. In any event, it is not all clear that treating settlement agreements differently from consent judgments and adjudicated judgments would promote settlement. "[I]t would hardly promote confidence" in settlement agreements to prevent a creditor from demonstrating that settlement debts survive bankruptcy on account of the debtor's underlying fraud. *Brown*, 442 U.S. at 134.

The primary flaw in the court of appeals' analysis is that it takes two parties with proper incentives to settle a case. Although the rule embraced by the court of appeals would encourage debtors to enter settlements, it would make creditors correspondingly less apt to enter into such settlements. A rule excusing a debtor from making any payment of any debt arising from a settlement agreement likewise would clearly create incentives for debtors to settle, but it would significantly reduce any incentive for the creditor to settle. The court of appeals' settlement analysis discourages settlement by "forc[ing] an otherwise unwilling party to try [non-dischargeability] questions to the hilt in order to protect himself against the mere possibility that a debtor might take bankruptcy in the future." *Brown*, 442 U.S. at 135; see Pet. App. 24a (opinion of district court) (reasoning that a creditor concerned about risk of the debtor's bankruptcy "always has the option of going forward and seeking to secure a judgment of fraud against the debtor"). That regime, however, not only

would dissuade creditors from reducing debtors' liabilities though settlement, it would also unnecessarily waste the resources of both the parties and the judiciary. A creditor accordingly should have the opportunity to prove that a settlement debt is non-dischargeable under Section 523(a)(2)(A) because it arises from the debtor's fraud.

CONCLUSION

The judgment of the court of appeals should be reversed and the case remanded for further proceedings.

Respectfully submitted.

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