Interpreting 11 U.S.C. § 523(a)(2)(A) of the Bankruptcy Code: Substantive Law Approach Versus Policy-Based Arguments [*Archer v. Warner*, 538 U.S. 314 (2003)]

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The complementary concepts—that federal courts must follow state decisions on matters of substantive law . . . whereas state courts must follow federal decisions on subjects within national legislative power where Congress has so directed—seem so beautifully simple, and so simply beautiful, that we must wonder why a century and a half were needed to discover them, and must wonder even more why anyone should want to shy away once the discovery was made.[1]

I. Introduction

Bankruptcy policy raises profound moral, financial, and philosophical issues.[2] Creditors seek justice, while debtors plead for a bankruptcy court to discharge their debts.[3] The bankruptcy discharge grants relief from oppressive indebtedness, thereby providing debtors with a fresh financial start.[4] In the interest of protecting creditors and discouraging unscrupulous debtors, 11 U.S.C. § 523(a)(2)(A)[5] of the Bankruptcy Code prohibits the discharge of debts obtained by fraud.[6] When a creditor challenges the dischargeability of a debt allegedly obtained by fraud, a bankruptcy court must address numerous interrelated concerns, such as whether the debtor is honest but unfortunate, whether § 523(a)(2)(A) applies to the facts and circumstances, and whether the court is in accord with bankruptcy policies and applicable laws.[7]

Sometimes bankrupt debtors are not truly honest but unfortunate, nor are their debts clearly attributable to fraud.[8] As a result,

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1. Henry J. Friendly, *In Praise of Erie—and of the New Federal Common Law*, 39 N.Y.U. L. Rev. 383, 421-22 (1964).
2. Teresa A. Sullivan, Elizabeth Warren & Jay Lawrence Westbrook, As We Forgive Our Debtors: Bankruptcy and Consumer Credit in America (1989), *reprinted in* Bankruptcy Anthology 517, 518 (Charles J. Tabb ed., 2002).
3. Charles Jordan Tabb, *The Scope of the Fresh Start in Bankruptcy: Collateral Conversions and the Dischargeability Debate*, 59 Geo. Wash. L. Rev. 56, 113 (1990).
4. Thomas H. Jackson, *The Fresh-Start Policy in Bankruptcy*, 98 Harv. L. Rev. 1393, 1393 (1985).
5. 11 U.S.C. § 523(a) (2000).
6. 1 Collier on Bankruptcy ¶ 1.03[2][d][v], at 1-29 to 1-30 (15th ed., rev. 1996).
7. *See* Brief of Amicus Curiae G. Eric Brunstad, Jr. at 4, Archer v. Warner, 538 U.S. 314 (2003) (No. 01-1418).
8. *See id.* at 23-25.

§ 523(a)(2)(A) may not provide a definitive answer to the dischargeability question.[9] Consequently, bankruptcy courts may employ a variety of approaches to decide a case.[10] The Fourth Circuit Court of Appeals recently held that the "obtained by" language of § 523(a)(2)(A) did not apply to a debt stemming from a settled and released fraud claim because the agreements were not *obtained by* fraud, and the release barred the creditors from pursuing an adversary hearing.[11] Relying on the policies underlying the fraud exception to discharge statute, the United States Supreme Court reversed the Fourth Circuit's decision in *Archer v. Warner* (*Archer II*).[12] The Court held that a settled and released fraud claim did not prevent a creditor from proving that a debt "arose out of" a fraud claim, thereby making § 523(a)(2)(A) applicable.[13]

In *Archer II*, the Court subjectively and needlessly relied on bankruptcy policy arguments and outdated legislative history to interpret § 523(a)(2)(A).[14] The Court should have objectively followed the plain meaning of § 523(a)(2)(A) and applied substantive state laws in accord with the Erie doctrine to resolve the issue not directly addressed by the Bankruptcy Code.[15] Relevant substantive state law supported the creditors' position, harmonized with the Code, and promoted objective judicial decision making.[16]

II. Case Description

Leonard and Arlene Warner sold their company, Warner Manufacturing, to Elliot and Carol Archer (Archers) in May of 1992.[17] Months later, the Archers sued Leonard Warner in a North Carolina state court, alleging misconduct arising from the sale.[18] The Archers contended that Leonard Warner altered Warner Manufacturing financial records to portray the business as profitable, when in fact the company was losing money.[19] The Archers amended the complaint, alleging fraud and personal injury claims,[20] and added Arlene Warner

9. *See id.*
10. *Compare* Archer v. Warner, 283 F.3d 230 (4th Cir. 2002) [hereinafter *Archer I*], *with* Archer v. Warner, 538 U.S. 314 (2003) [hereinafter *Archer II*].
11. *Archer I*, 283 F.3d at 237.
12. 538 U.S. 314 (2003).
13. *Id.* at 323.
14. *See infra* Parts IV.D.1, IV.D.3.
15. *See infra* Part IV.D.4.
16. *See infra* Part IV.D.4.
17. *Archer I*, 283 F.3d 230, 233 (4th Cir. 2002), *rev'd*, 538 U.S. at 314.
18. *Id*.
19. *See* Petitioner's Brief at 5, *Archer II* (No. 01-1418).
20. *Archer I*, 283 F.3d at 233. The March 1994 amendment included allegations of misrepresentation, conspiracy, and fraudulent conveyance. *Id.* The May 1995 amendment included numerous mental, physical, and emotional injuries because of the Warners' alleged acts. *Id.*

as a defendant.[21] On the eve of trial, the parties settled the suit and executed a settlement agreement, a general release,[22] a mutual release, and a promissory note (collectively referred to as "agreements"), which resolved all the pending state-law claims.[23]

The settlement agreement specified that the Warners would pay $300,000 as compensation for infliction of mental distress: $200,000 in cash up front and $100,000 as a promissory note.[24] The parties agreed that the $300,000 served as a compromise for all the pending claims but was not intended as an admission of liability for the fraud claim.[25] Although the Archers released any present and future rights arising from the state court suit, they preserved the right to commence any collection action on the $100,000 promissory note.[26]

The Warners paid the Archers $200,000 in cash, but they defaulted on the payment of the $100,000 promissory note,[27] prompting the Archers to sue for collection in a North Carolina state court.[28] While the collection suit was pending, the Warners filed for bankruptcy.[29] Thereafter, the Archers filed for an adversary hearing in the United States Bankruptcy Court for the Middle District of North Carolina, seeking a judgment that the $100,000 was a nondischargeable debt under 11 U.S.C. § 523(a)(2)(A).[30] As grounds for showing the $100,000 was a nondischargeable debt, the Archers relied upon the same fraud claims contained in the settled North Carolina state court suit.[31]

Leonard Warner conceded that the promissory note was a nondischargeable debt and signed a consent order reaffirming the debt,

21. *Id.* The Archers added Arlene Warner to the complaint in March of 1994. Brief for Respondent Arlene L. Warner at 2, *Archer II* (No. 01-1418).

22. The general release declared that the Archers, in exchange for $300,000, agreed to "release and forever discharge [the Warners] from any and every right, claim, or demand which [the Archers] now have or might otherwise hereafter have against [the Warners] from the beginning of the world to the date of this release arising out of or relating to the matter of [the state court litigation]." Petitioner's Brief at 7, *Archer II* (No. 01-1418) (internal quotations omitted). The mutual release stated that both the general and mutual releases "are contractual in nature and not mere recitals and that each party signed the release . . . willingly and voluntarily and with full knowledge of all facts and other matters relevant to the Lawsuit." Brief for Respondent Arlene L. Warner at 4, *Archer II* (No. 01-1418) (internal quotations omitted).

23. *Archer I*, 283 F.3d at 233.

24. *Archer II*, 538 U.S. at 317. The settlement agreement expressed other reasons for agreeing to settle, such as the numerous defenses asserted by the Warners and the tax benefits associated with settling. *See Archer I*, 283 F.3d at 233.

25. *Archer II*, 538 U.S. at 317.

26. *Id*.

27. The Archers secured the promissory note with two property deeds owned by the Warners. *See* Petitioner's Brief at 6 n.4, *Archer II* (No. 01-1418).

28. *Archer II*, 538 U.S. at 317-18.

29. Petitioner's Brief at 7, *Archer II* (No. 01-1418). Originally, the Warners filed for bankruptcy under Chapter Thirteen, but the bankruptcy court converted the filings to Chapter Seven. *Id.* Filing for bankruptcy relief prevented the Archers from continuing their state court action for collection on the note. *See* 11 U.S.C. § 362(a) (2000); Brief of Amicus Curiae G. Eric Brunstad, Jr. at 2-3, *Archer II* (No. 01-1418).

30. Petitioner's Brief at 7, *Archer II* (No. 01-1418).

31. *Archer I*, 283 F.3d 230, 234 (4th Cir. 2002), *rev'd*, 538 U.S. at 314.

but Arlene Warner (Warner) asserted two defenses.[32] First, Warner argued that the promissory note debt was not *obtained by* fraud, as § 523(a)(2)(A) describes.[33] Second, Warner claimed a collateral estoppel defense that the Archers could not rely upon allegations of fraud contained in the original state court claim because the Archers settled and released the state court suit.[34] The bankruptcy court held that the $100,000 was a dischargeable debt.[35] The court stated that § 523(a)(2)(A) did not prohibit a creditor from agreeing to settle and release a fraud claim that may later arise under § 523(a)(2)(A).[36] The court reasoned that in light of the broad language of the release and the plain meaning of § 523(a)(2)(A), the Archers could not assert the very same fraud claim previously settled and released.[37]

The Archers appealed to the District Court for the Middle District of North Carolina.[38] Affirming the bankruptcy court's decision, the district court concluded that the settlement agreement and releases created a novation,[39] thereby "substituting a dischargeable contract debt for a fraud-based tort claim, which may not have been dischargeable."[40] The Fourth Circuit Court of Appeals agreed with the district court's novation theory and held that the $100,000 was not a debt obtained by fraud under § 523(a)(2)(A).[41] The United States Supreme Court reversed, concluding that a novation does not prevent creditors from pursuing an adversary hearing.[42] The Court explained that the $100,000 could very well have been a debt obtained by fraud according to § 523(a)(2)(A).[43] The Court remanded the case with instructions to allow the Archers to show that the $100,000 *arose out of* a fraud claim and, consequently, was a nondischargeable debt.[44]

III. Background

An important purpose of the Bankruptcy Code is to provide an "honest but unfortunate debtor" with a new opportunity to live debt

32. Petitioner's Brief at 8, *Archer II* (No. 01-1418). At some time between the commencement of the North Carolina state claims and the Fourth Circuit Court of Appeals decision, the Warners divorced. *Archer I*, 283 F.3d at 235 n.5.
33. Brief for Respondent Arlene L. Warner at 5, *Archer II* (No. 01-1418).
34. *Archer I*, 283 F.3d at 235.
35. Brief for Respondent Arlene L. Warner at 6, *Archer II* (No. 01-1418).
36. *Id.*
37. *Id.*
38. *Archer I*, 283 F.3d at 235.
39. While novation popularly refers to substituting one contract for another contract, a bankruptcy court may use the term novation to describe the act of parties settling and releasing a tort claim in consideration for a contractual debt. *Compare* Black's Law Dictionary 1091 (7th ed. 1999), *with Archer I*, 283 F.3d at 236 n.8.
40. *Archer I*, 283 F.3d at 235.
41. *Id.* at 237.
42. *Archer II*, 538 U.S. at 323.
43. *Id.*
44. *Id.*

free.[45] Through a bankruptcy court discharge, debtors receive a fresh start unencumbered by debt or pressure from creditors.[46] For a variety of reasons, such as public policy or preventing fraudulent debtors from exploiting the benefits of a discharge, Congress requires that debtors must repay certain debts.[47] Eleven U.S.C. § 523(a) of the Bankruptcy Code excepts nineteen categories of debts from discharge, including § 523(a)(2)(A), which prohibits the discharge of any debt "for money . . . *obtained by* . . . false pretenses, a false representation, or actual fraud."[48] In order for a bankruptcy court to apply § 523(a)(2)(A), a creditor must initiate an adversary hearing and prove by a preponderance of the evidence that a debt was obtained by fraud.[49]

Congress vested bankruptcy courts with exclusive jurisdiction to determine the dischargeability of a debt challenged under § 523(a)(2)(A).[50] When parties argue whether this section applies to an issue presented in an adversary hearing, bankruptcy courts may rule according to the policies and legislative history underlying § 523(a)(2)(A).[51] Some bankruptcy courts may apply general contract principles, such as novation, and rule accordingly.[52] Finally, bankruptcy courts may follow the principles underlying the Erie doctrine and incorporate state laws and definitions into bankruptcy cases when the Bankruptcy Code is silent on a matter.[53]

A. *The Policy-Based Approach to § 523(a)(2)(A)*

Bankruptcy courts following the policy-based approach reason that Congress intends for courts to conduct a thorough inquiry into the origin of a debt before granting a discharge of a § 523(a)(2)(A) claim.[54] This approach protects creditors and ensures that only honest

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45. Local Loan Co. v. Hunt, 292 U.S. 234, 244 (1934).
46. Honorable Bernice B. Donald & Kenneth J. Cooper, *Collateral Estoppel in Section 523(c) Dischargeability Proceedings: When Is a Default Judgment Actually Litigated?* 12 BANK. DEV. J. 321, 323 (1996).
47. *See* 1 COLLIER ON BANKRUPTCY, *supra* note 6.
48. 11 U.S.C. § 523(a)(2)(A) (2000) (emphasis added); 4 COLLIER ON BANKRUPTCY, *supra* note 6, ¶ 523.01, at 523-12.
49. 4 COLLIER ON BANKRUPTCY, *supra* note 6, ¶ 523.04, at 523-18; *see also* 28 U.S.C. § 157(b) (2000).
50. FED. R. BANKR. P. 4007 advisory committee's note (1983).
51. *See* Brown v. Felsen, 442 U.S. 127, 138 (1979).
52. *See Archer I*, 283 F.3d 230, 237 (4th Cir. 2002), *rev'd*, 538 U.S. 314 (2003).
53. *See generally* Butner v. United States, 440 U.S. 48, 55 (1979) ("Property interests are created and defined by state law. Unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding."). *But see* Erie v. Tompkins, 304 U.S. 64, 78 (1938) ("Except in matters governed by the Federal Constitution or by Acts of Congress, the law to be applied in any case is the law of the State. And whether the law of the State shall be declared by its Legislature in a statute or by its highest court in a decision is not a matter of federal concern.").
54. *Archer I*, 283 F.3d at 239 (Traxler, J., dissenting).

but unfortunate debtors have their debts discharged.[55] Courts support their opinions by applying the policy-based approach, which consists of statutory changes and congressional statements underlying § 523(a)(2)(A).[56]

In 1979, to address a gray area of the fraud exception to discharge statute, the United States Supreme Court promulgated the policy-based approach in *Brown v. Felsen*.[57] *Brown* involved 11 U.S.C. § 17a[58] from the Bankruptcy Act of 1898, the precursor to § 523(a).[59] In *Brown*, the parties settled a fraud claim and executed a consent judgment,[60] but the judgment failed to state that the settlement was for fraud and whether the debtor admitted or denied wrongdoing.[61] Subsequently, the debtor filed for bankruptcy and argued that res judicata principles barred the creditor in an adversary hearing from reasserting the same claims that could have been resolved in the state claim.[62] *Brown* held that bankruptcy policies best serve creditors by allowing them to submit additional evidence to show that the debt arose from a settled fraud claim.[63] The Court reasoned that "Congress intended the fullest possible inquiry" into any debt arising from fraud.[64] To support the "fullest possible inquiry" statement, the Court noted two demonstrative examples.[65] First, the Court remarked that when Congress amended § 17a by replacing the word "judgments" with "liabilities," the broader term suggested that Congress wanted all debts stemming from fraud to be nondischargeable.[66] Second, the Court cited the House Report accompanying the amendment, which stated that Congress only wanted "honest" debtors with liabilities not related to fraudulent "offenses" to receive a discharge.[67]

Twelve years after deciding *Brown*, the United States Supreme Court applied the policy-based reasoning in *Grogan v. Garner*[68] to

55. *See* Cohen v. de la Cruz, 523 U.S. 213, 217 (1998).
56. *See Brown*, 442 U.S. at 138.
57. *See generally* 442 U.S. 127 (1979).
58. Bankruptcy Act of 1898, ch. 541, § 17a, 30 Stat. 550 (1898) (codified as amended at 11 U.S.C. § 35(a)(2) (1976) (repealed 1979)).
59. *See Brown*, 442 U.S. at 129 n.1. The Court delivered the *Brown* opinion in June 1979, four months prior to the effective date for the Bankruptcy Act of 1978. *See id.* In light of this transition period, the Court described the soon-to-be § 523(a) as "substantially similar" to § 17a. *See id*.
60. A consent judgment is "[a] settlement that becomes a court judgment when the judge sanctions it." BLACK'S LAW DICTIONARY 846 (7th ed. 1999).
61. *Brown*, 442 U.S. at 128.
62. *Id.* at 134.
63. *Id.* at 132.
64. *Id.* at 138.
65. *See id.*
66. *See id. Compare* Bankruptcy Act of 1898, ch. 541, § 17a, 30 Stat. 550 (1898) (codified as amended at 11 U.S.C. § 35(a)(2) (1976) (repealed 1979)), *with* Bankruptcy Act of 1898, ch. 487, § 5, 32 Stat. 798 (1903) (repealed 1979).
67. *Brown*, 442 U.S. at 138 (citing H.R. Rep. No. 1698, at 3, 6 (1902)).
68. 498 U.S. 279 (1991).

resolve another gray area of the fraud exception to discharge statute.[69] In *Grogan*, the Court resolved a split among the circuit courts of appeals regarding whether a creditor in an adversary hearing must prove a § 523(a)(2)(A) fraud claim by clear and convincing evidence or by a less demanding preponderance of the evidence standard.[70] The Court unanimously agreed that the preponderance standard best effectuated congressional policy by stating, "We think it unlikely that Congress, in fashioning the standard of proof that governs the applicability of these provisions, would have favored the interest in giving perpetrators of fraud a fresh start over the interest in protecting victims of fraud."[71]

In 1998, the United States Supreme Court, in *Cohen v. de la Cruz*,[72] again applied the policy-based approach to determine whether § 523(a)(2)(A) applied to a debt for *punitive* damages stemming from a fraud judgment, or just the amount actually *obtained by* fraud.[73] The Court held that punitive damages awarded for fraudulent behavior were nondischargeable under § 523(a)(2)(A).[74] The Court based its decision on the history and general policy underlying the fraud exception to discharge.[75] In *Cohen*, Justice Sandra Day O'Connor commented on § 523(a)(2)(A), stating that "'[the Court] will not read the Bankruptcy Code to erode past bankruptcy practice absent a clear indication that Congress intended such a departure.'"[76]

Some circuit courts of appeals have reviewed cases in which a creditor challenged the dischargeability of a settled fraud claim accompanied by a mutual release.[77] For instance, in *United States v. Spicer*,[78] the D.C. Circuit found that a settlement contract debt and release for a fraud claim was nondischargeable under the policy-based approach.[79] In *Spicer*, the creditor settled a civil claim for fraud with the government.[80] The creditor denied liability but agreed to a promissory note in consideration for the government releasing its civil fraud claim against him.[81] The D.C. Circuit held that the promissory note, although not itself procured by fraud, stemmed from the settled fraud claim and, consequently, was a nondischargeable debt.[82] The

69. *See id.* at 283.
70. *Id*.
71. *Id.* at 287.
72. 523 U.S. 213 (1998).
73. *Id.* at 215.
74. *Id.* at 223.
75. *Id.*
76. *Id.* at 221 (quoting Pa. Dep't of Pub. Welfare v. Davenport, 495 U.S. 552, 563 (1990)).
77. *See* United States v. Spicer, 57 F.3d 1152 (D.C. Cir. 1995); Greenberg v. Schools, 711 F.2d 152 (11th Cir. 1983) (applying the policy-based approach).
78. 57 F.3d 1152 (D.C. Cir. 1995).
79. *See id.* at 1155-56.
80. *Id.* at 1154.
81. *Id.*
82. *Id.* at 1161.

court reasoned, "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 § 523(a)(2)(A)."[83]

B. *The Novation Theory Approach to § 523(a)(2)(A)*

While the policy-based approach relies on legislative history to interpret gray-area issues involving § 523(a)(2)(A), the novation theory approach relies on contract law principles to resolve one particular gray area of § 523(a)(2)(A): the situation in which a creditor settled and released a fraud claim in consideration for a debt.[84] Under this approach, whether parties replace or novate a fraud claim with a settlement debt and release, a bankruptcy court's only concern is the "validity and completeness" of the parties' agreements.[85] Accordingly, courts examine the terms of the settlement and release to determine if the creditor released the right to pursue an adversary hearing.[86] Because Congress declared that the adversary hearing is the creditor's choice to pursue,[87] courts applying the novation theory view the hearing as a right that is not only waivable, but also releasable by contract.[88] Courts following the novation theory think that Congress wanted to maintain the public policy that encourages parties to settle fraud claims, and consequently, the agreements should carry effect through bankruptcy.[89]

The novation theory approach only applies to debts involving settled *and released* fraud claims.[90] If a creditor settles a fraud claim for money, but does not release the fraud claim, the creditor retains the right to pursue an adversary hearing and prove that the purpose for the settlement was to resolve a fraud claim.[91] On the other hand, if a creditor settles *and releases* a fraud claim, a novation theory court would likely conclude that the agreements extinguished any right to claim fraud again in an adversary hearing.[92] A novation theory court would permit the creditor to pursue an adversary hearing for other purposes, such as for proving the debtor fraudulently, or in bad faith, induced the creditor to settle or release the fraud claim.[93]

83. *Id.* at 1155.
84. *See generally Archer I*, 283 F.3d 230 (4th Cir. 2002), *rev'd*, 538 U.S. 314 (2003).
85. *Id.* at 236.
86. *See id.*
87. *Id.*
88. *Id.*
89. *Id.*
90. Md. Casualty Co. v. Cushing, 171 F.2d 257, 258-59 (7th Cir. 1948).
91. *Archer I*, 283 F.3d at 236.
92. *Id.* at 237.
93. *Id.* at 235 n.4.

Some circuit courts have applied the novation theory in cases involving a creditor challenging the dischargeability of a settled and released tort claim.[94] In 1948, the Seventh Circuit found that a settlement contract debt and release for an embezzlement claim was dischargeable under the novation theory in *Maryland Casualty Co. v. Cushing*.[95] In *Maryland Casualty*, the defendant signed a promissory note for embezzled money in consideration for the plaintiff waiving the tort claim.[96] Thereafter, the defendant filed for bankruptcy, and the bankruptcy court discharged the promissory note debt.[97] Affirming the district court's decision, the Seventh Circuit found that the debt was reasonable consideration for releasing the embezzlement claim.[98] The Seventh Circuit reasoned that by accepting the promissory note, the creditor extinguished any related tort action that the plaintiff had prior to accepting the promissory note.[99]

C. *The Erie Doctrine and the Butner Principle*

Although Congress vested bankruptcy courts with exclusive jurisdiction over adversary hearings addressing § 523(a)(2)(A) claims, bankruptcy courts often have to incorporate laws and definitions found outside the scriptures of the Bankruptcy Code.[100] For example, to determine the meaning of "intoxication" for purposes of 11 U.S.C. § 523(a)(9), another nondischargeability statute, bankruptcy courts apply the state-law definition from its respective jurisdiction.[101] Similarly, the Bankruptcy Code does not indicate the elements required to prove fraud under § 523(a)(2)(A), so bankruptcy courts implement their governing state-law elements.[102]

The process of bankruptcy courts incorporating state laws and definitions into adversary hearings illustrates the principles underlying *Erie v. Tompkins*.[103] In *Erie*, commonly known as the Erie doctrine, the United States Supreme Court declared that federal courts should apply state law unless the Federal Constitution or federal laws govern.[104] The Court explained that state law applies in federal court be-

94. *See In re* Fischer, 116 F.3d 388 (9th Cir. 1997); *In re* West, 22 F.3d 775 (7th Cir. 1994).
95. 171 F.2d 257 (7th Cir. 1948).
96. *Id.* at 258.
97. *Id.*
98. *Id.* at 259.
99. *Id.*
100. *See* George H. Singer, *Section 523 of the Bankruptcy Code: The Fundamentals of Nondischargeability in Consumer Bankruptcy*, 71 AM. BANKR. L.J. 325, 327 (1997); *e.g.*, 11 U.S.C. § 522(b)(1) (2000) (enabling states to decide whether to enact their own list of property exempt from bankruptcy or opting for the federal exemptions provisions listed under § 522(d)).
101. Whitson v. Middleton, 898 F.2d 950, 952 (4th Cir. 1990).
102. Singer, *supra* note 100, at 332.
103. 304 U.S. 64 (1938).
104. *See id.* at 78.

cause there is no such thing as federal common law.[105] The Court disfavored federal courts creating common law when relevant state law or court decisions could apply.[106] Since the *Erie* decision in 1938, the Court has tempered the Erie doctrine by noting that creating federal common law is tolerable when state law conflicts or contradicts with a compelling federal policy or law.[107]

The United States Supreme Court integrated Erie doctrine principles into the Bankruptcy Code in *Butner v. United States.*[108] In *Butner*, the Court concluded that bankruptcy laws preempt state laws only where the laws directly conflict.[109] In particular, the Court announced that state law defines and creates property interest rights in bankruptcy proceedings.[110] The Court explained that although the Federal Constitution vests Congress with the power to enact bankruptcy laws, Congress decided not to exercise its power in certain areas of bankruptcy policy.[111] The Court noted that state law should apply even though bankruptcy case outcomes may differ from state to state.[112]

A federal statute with characteristics similar to the Erie doctrine is the full faith and credit statute.[113] Under 28 U.S.C. § 1738,[114] bankruptcy and federal courts are to apply collateral estoppel effect to state court judgments according to the adjudicating state's collateral estoppel principles.[115] Accordingly, North Carolina requires four conditions in order to assert the collateral estoppel doctrine.[116] First, the issue in the prior action must be identical to the issue in the present action.[117] Second, the parties must have actually litigated the present issue during the prior action.[118] Third, the present issues must be material and relevant in relation to the prior action's judgment.[119] Fourth, the present action issues must have been essential to deter-

105. *See id.*
106. *See* Charles Alan Wright & Mary Kay Kane, Law of Federal Courts § 55, at 379 (6th ed. 2002).
107. *See* Atherton v. FDIC, 519 U.S. 213, 218-19 (1997).
108. 440 U.S. 48 (1979).
109. *Id.* at 54 n.9.
110. *Id.* at 55; *see, e.g.*, 11 U.S.C. § 522(b)(1) (2000).
111. *Butner*, 440 U.S. at 54.
112. *Id.* at 54 n.9 (citing Stellwagen v. Clum, 245 U.S. 605, 613 (1918)).
113. *See* Vulcan Chem. Techs., Inc. v. Barker, 297 F.3d 332, 343 (4th Cir. 2002).
114. 28 U.S.C. § 1738 (2000).
115. *See* Kremer v. Chem. Constr. Corp., 456 U.S. 461, 466 (1982).
116. State v. Summers, 528 S.E.2d 17, 20 (N.C. 2000). Some North Carolina court opinions refer to the collateral estoppel doctrine as defined by the *Restatement (Second) of Judgments* section twenty-seven. *See* Thomas M. McInnis & Assocs., Inc. v. Hall, 349 S.E.2d 552, 557 (N.C. 1986). The collateral estoppel conditions declared in *Summers* are the same as stated by the *Restatement (Second) of Judgments* section twenty-seven. *See* Restatement (Second) of Judgments § 27 (1982).
117. *Summers*, 528 S.E.2d at 20.
118. *Id.*
119. *Id.*

mine the prior judgment.[120] In *Arizona v. California*,[121] the United States Supreme Court noted that collateral estoppel may apply to a settlement agreement, even though the parties did not actually litigate the claim.[122] The Court has stated that collateral estoppel may apply to a settlement if the parties *clearly* intended the settlement to carry collateral estoppel effect.[123]

IV. Analysis

In *Archer II*, the United States Supreme Court first addressed whether the $100,000 debt was money "obtained by" fraud, and consequently nondischargeable under § 523(a)(2)(A).[124] Next, the Court addressed whether the novation prevented the Archers, in an adversary hearing, from reintroducing the fraud claim previously settled and released.[125]

A. *Parties' Arguments*

1. The Archers

The Archers argued that the structure of the debt was irrelevant for purposes of an adversary hearing.[126] They stressed that § 523(a)(2)(A) prohibited "*any debt* . . . for money . . . obtained by . . . false pretenses, a false representation, or actual fraud" from discharge.[127] They explained that the phrase "any debt" meant that any causal connection established between an underlying debt and a fraudulent act rendered a debt nondischargeable.[128] Accordingly, the Archers argued that the $100,000 debt traced back to a fraud claim.[129]

Next, the Archers contended that Warner could not invoke the collateral estoppel defense because collateral estoppel applied to

120. *Id.*
121. 530 U.S. 392 (2000).
122. *Id.* at 414.
123. *Id.* The United States Supreme Court noted in *Matsushita Electric Industrial Co. v. Epstein*, 516 U.S. 367 (1996), that applying a state's collateral estoppel principles may be appropriate even if the state court judgment was not actually litigated but entered according to a settlement agreement between the parties. *See generally* 516 U.S. at 385-86 (citing 18 Charles Alan Wright et al., Federal Practice and Procedure § 4470 (2d ed. 1981) ("Settlement of state court litigation has been held to defeat a subsequent federal action if the settlement was intended to apply to claims in exclusive federal jurisdiction as well as other claims. . . . These rulings are surely correct.")).
124. *See Archer II*, 538 U.S. 314, 319 (2003).
125. *Id.* at 322.
126. Petitioner's Brief at 13, *Archer II* (No. 01-1418).
127. *Id.* (emphasis added).
128. *See id*. Any causal connection includes a "'debt as a result of,' 'debt with respect to,' 'debt by reason of,' 'debt arising from,' or 'debt on account of,'" a fraudulent act. Cohen v. de la Cruz, 523 U.S. 213, 220 (1998).
129. Petitioner's Brief at 14, *Archer II* (No. 01-1418).

claims actually litigated to a judgment.[130] The Archers pointed out that nothing in the general or mutual release indicated intent to forgo their right to establish the nondischargeability of the note in bankruptcy.[131] Instead, the Archers stated they were merely enforcing their preserved right to collect on the note.[132] They also pointed out that they did not assert any new reason for nondischargeability; instead, they simply responded to Warner's affirmative defenses.[133]

The Archers argued that *Brown* controlled the outcome in *Archer II* for numerous reasons.[134] First, the Archers asserted that in *Brown*, as well as their own situation, the debtors owed a "debt" as defined by the bankruptcy laws, and so long as the debt was traceable to fraud, the debt was nondischargeable.[135] Second, they argued that the parties in *Brown* entered into a consent judgment, which in substance was a contractual settlement agreement just like their settlement with Warner.[136] Third, the Archers contended that the consent judgment in *Brown* and their settlement with Warner generally carried res judicata effect, but not collateral estoppel effect.[137] Fourth, they argued that neither the *Brown* consent judgment nor their settlement resulted from adjudication on the issues; therefore, the only difference between *Brown* and their claim was that the consent judgment in *Brown* was subject to judicial policing.[138]

2. Arlene Warner

Warner contended that principles of federalism and collateral estoppel barred the Archers from reasserting the waived state claims in a nondischargeability hearing.[139] Warner argued that North Carolina followed section twenty-seven of the *Restatement (Second) of Judgments*[140] and claimed that North Carolina appellate courts considered a dismissal analogous to obtaining a final adjudication on the merits.[141] Although the North Carolina state court did not deliberate,

130. *See id.* at 15. Collateral estoppel must be supported by a previous judgment; otherwise, a settlement agreement serves only as a contract. 18A CHARLES ALAN WRIGHT ET AL., FEDERAL PRACTICE AND PROCEDURE § 4443, at 255-56 (2d ed. 2002).

131. Petitioner's Brief at 20, *Archer II* (No. 01-1418).

132. *See id.* at 11.

133. *See id.* at 22.

134. *See id.* at 17-18.

135. *See id.*

136. *See id.* at 17.

137. *See id.* at 19.

138. *See id.* at 18.

139. Brief for Respondent Arlene L. Warner at 10, *Archer II* (No. 01-1418).

140. *See* Thomas M. McInnis & Assocs., Inc. v. Hall, 349 S.E.2d 552, 557 (N.C. 1986) ("[A] final judgment on the merits prevents relitigation of issues actually litigated and necessary to the outcome of the prior action in a later suit involving a different cause of action between the parties.").

141. Miller Bldg. Corp. v. NBBJ N.C., Inc., 497 S.E.2d 433, 435 (N.C. Ct. App. 1998) ("Indeed a dismissal 'with prejudice' 'is said to preclude subsequent litigation to the same extent as if

Warner contended that collateral estoppel principles applied.[142] Warner distinguished her situation from *Brown* because she invoked collateral estoppel principles, while the debtor in *Brown* asserted res judicata principles.[143] Warner further distinguished *Brown* from her case, noting that the parties in *Brown* agreed to a consent judgment, whereas the Archers agreed to dismiss the suit with prejudice.[144]

Finally, Warner contended that neither bankruptcy policy nor the language of § 523(a)(2)(A) prevents a court from giving effect to a settled and released fraud claim agreed to before the debtor's petition for bankruptcy.[145] Warner pointed out that by statutory design, a creditor has the choice to pursue or forgo an adversary hearing for a debt classified under § 523(a)(2)(A).[146] Because an adversary hearing for fraud is a voluntary proceeding and the Archers agreed to release the fraud claim, Warner argued that the release applied to all proceedings, including the bankruptcy adversary hearing.[147] Furthermore, Warner asserted that the Code does not vest bankruptcy courts with the authority to override the Archers' decision to waive an adversary hearing by contract or empower courts to initiate their own inquiry and "smoke out" Warner.[148] Additionally, Warner argued that the bankruptcy laws incorporated safety provisions to weed out dishonest debtors who attempted to exploit the bankruptcy process for their own benefit.[149]

B. *Majority Opinion*

Justice Stephen G. Breyer authored the seven-justice majority opinion.[150] The Court reversed the Fourth Circuit decision, holding that the novation did not prevent the Archers from proving that the $100,000 debt traced back to a fraud claim.[151] The Court concluded that a debt captured by novation can also be "*any debt* . . . for money . . . obtained by . . . false pretenses, a false representation, or actual

the action had been prosecuted to a final adjudication adverse to the plaintiff.'" (quoting Barnes v. McGee, 204 S.E.2d 203, 205 (N.C. Ct. App. 1974))).

142. *Miller Bldg. Corp*., 497 S.E.2d at 435 (citing 18 MOORE'S FEDERAL PRACTICE § 132.03 [4][i] (3d ed. 1997)).

143. Brief for Respondent Arlene L. Warner at 20, *Archer II* (No. 01-1418). Collateral estoppel prevents a party from relitigating a previously settled or adjudicated issue from a cause of action. *See* 18 MOORE'S FEDERAL PRACTICE § 132.01[1] (3d ed. 1997). In comparison, the broader doctrine of res judicata prevents a party from alleging issues not litigated, but related to, a previously adjudicated cause of action. *See* 46 AM. JUR. 2D *Judgments* § 516 (1994).

144. Brief for Respondent Arlene L. Warner at 22, *Archer II* (No. 01-1418).

145. *Id.* at 30.

146. 11 U.S.C. § 523(c)(1) (2000).

147. Brief for Respondent Arlene L. Warner at 30, 32, *Archer II* (No. 01-1418).

148. *See id.* at 32.

149. *See id.*

150. *Archer II*, 538 U.S. at 315.

151. *Id.* at 323.

fraud,"[152] as defined by § 523(a)(2)(A).[153] Because the Fourth Circuit did not address the merits of Warner's collateral estoppel arguments, the Court remanded the case to the Fourth Circuit with instructions to determine whether Warner properly preserved her collateral estoppel arguments.[154]

The Court declared that *Brown* controlled the outcome of *Archer II*.[155] To stress the similarities between *Brown* and *Archer II*, the Court stated, "If we substitute the word 'settlement' for the word 'judgment,' the Supreme Court's statement [in *Brown*] describes this case."[156] The Court found that the novation theory was illogical.[157] In *Brown*, the reduction of the fraud claim to a consent decree functioned in the same manner as the novation at issue.[158] The Court opined that if it had applied the novation theory in *Brown*, it would have rendered the consent decree dischargeable.[159] *Brown* had instructed courts to review *all* evidence before granting a discharge; therefore, the novation theory defied the Court's instruction and prevented relevant evidence from admission into an adversary hearing.[160]

The same basic reasoning explained in *Brown* also applied in *Archer II*.[161] The Court reiterated that when Congress amended the bankruptcy laws by replacing "liabilities" with "judgments," this amendment persuaded the Court that Congress intended courts to inquire fully into the nature of all debts traceable to fraud, no matter what their form.[162] Allowing debtors and creditors to decide the dischargeability of a debt prior to filing for bankruptcy displeased the Court.[163] Because Congress intended bankruptcy courts to determine whether a debt arose from fraud, the Court explained that it does not want parties to address prematurely the nondischargeability issue when neither party directly faces the concern.[164]

The only notable difference recognized by the Court between *Brown* and *Archer II* was that *Brown* involved a consent judgment, but the Archers and Warner executed a private settlement and releases.[165] The Court indicated this difference did not affect the Archers' right to prove that the $100,000 debt traced back to a fraud

152. 11 U.S.C. § 523(a)(2)(A) (2000) (emphasis added).
153. *See Archer II*, 538 U.S. at 319.
154. *Id.* at 323.
155. *Id.* at 319.
156. *Id.* at 321.
157. *Id.* at 320.
158. *Id.*
159. *Id.*
160. *Id.* (citing Brown v. Felsen, 442 U.S. 127, 138 (1979)).
161. *Id.* at 321.
162. *Id.* (citing *Brown*, 442 U.S. at 138).
163. *Id.*
164. *Id.* (citing *Brown*, 442 U.S. at 134).
165. *Id.*

claim.[166] Stressing that § 523(a)(2)(A) applied to every debt that arose out of fraud, the Court reasoned that a debt attributed to a consent decree arose no less or more from fraud than a private settlement.[167] Overall, the Court determined that the parties created a valid novation, but the releases failed to establish whether the parties intended to resolve the issue of fraud for purposes of a potential nondischargeability claim.[168]

Although Warner's main argument involved the collateral estoppel defense, the Court only briefly addressed this defense.[169] Because the Fourth Circuit did not discuss the merits of the collateral estoppel argument, the Court explained that the argument was "outside the scope" of the issues presented.[170] In dictum, the Court responded to Warner's main point that, under North Carolina law, the releases barred the Archers from alleging the same fraud claim on collateral estoppel principles.[171] The Court quoted *Arizona v. California*,[172] which stated, "'Settlements ordinarily occasion no *issue preclusion* . . . unless it is clear . . . that the parties intend their agreement to have such an effect.'"[173] The Court stated that the Fourth Circuit remained free on remand to decide whether Warner "properly raised or preserved" the collateral estoppel defense.[174]

C. *Dissenting Opinion*

Justice Clarence Thomas wrote a dissent and reasoned that the majority opinion was supported neither by the terms of the releases nor the text of § 523(a)(2)(A).[175] Siding with the novation theory approach, Justice Thomas argued that *Brown* was not controlling because the case did not address the precise issue in *Archer II*.[176] Justice Thomas believed that the majority opinion incorrectly concluded that the parties left the fraud issue unresolved.[177] He explained that the settlement and releases clearly demonstrated that the Archers and Warner intended once and for all to resolve the fraud claim, as well as all other rights or claims associated with the state court claim, except obligations under the promissory note.[178]

166. *Id.*
167. *Id.* (citing Cohen v. de la Cruz, 523 U.S. 213, 215 (1998)).
168. *Id.* at 323.
169. *See id.* at 322.
170. *Id.*
171. *See id.*
172. 530 U.S. 392 (2000).
173. *Archer II*, 538 U.S. at 322 (quoting Arizona v. California, 530 U.S. at 414).
174. *Id*. at 323.
175. *Id.* (Thomas, J., dissenting).
176. *Id.* at 323-24 (Thomas, J., dissenting).
177. *Id.* at 327-28 (Thomas, J., dissenting).
178. *Id.* at 325 (Thomas, J., dissenting). To support this point, Justice Thomas cited *McNair v. Goodwin*, 262 N.C. 1, 7 (1964). *Id.* This case illustrated one of Warner's main points, that a

Next, Justice Thomas focused on the text of § 523(a)(2)(A), which prohibits discharging a debt *obtained by* fraud.[179] Consistently, the Court has recognized that a superseding cause will sever the causal nexus, thereby cutting off all liability.[180] According to Justice Thomas, the settlement package served as a superseding cause that severed the fraud claim, the same concept as a third party negligently intervening in a negligence tort.[181]

Finally, Justice Thomas contended that the Archers' own actions supported his superseding cause theory.[182] Because the Archers only sought to collect the promissory-note debt, which was an amount lower than the original damages allegedly attributed to the Warners' fraud, Justice Thomas believed that the Archers' claim involved the recouping of a contractual debt rather than a fraudulent debt.[183]

D. *Commentary*

In *Archer II*, the Court held that a settled and released fraud claim does not prevent a creditor from initiating an adversary hearing because of the policies underlying the Bankruptcy Code.[184] In its decision, the Court needlessly stretched the plain language of § 523(a)(2)(A) to accommodate creditors.[185] By implementing a policy-based approach, the Court subjectively interpreted the meaning of § 523(a)(2)(A) and ignored relevant facts and circumstances that benefited Warner.[186] Additionally, the Court relied on legislative history from a century ago to support its interpretation of § 523(a)(2)(A).[187] A better approach to *Archer II* would have been to leave intact the plain meaning of § 523(a)(2)(A) and apply objective substantive state laws that supported the Archers' position.[188]

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settlement is conclusive as to the issues addressed. *See* Brief for Respondent Arlene L. Warner at 23-24, *Archer II* (No. 01-1418).

179. *Archer II*, 538 U.S. at 324 (Thomas, J., dissenting); s*ee also* 11 U.S.C. § 523(a)(2)(A) (2000).

180. *Archer II*, 538 U.S. at 326 (Thomas, J., dissenting); *see also* Exxon Co., U.S.A. v. Sofec, Inc., 517 U.S. 830, 837 (1996); 57A AM. JUR. 2D *Negligence* § 790 (1989) ("The intervention, between the negligence of the defendant and the occurrence of an injury to the plaintiff, of a new, independent, and efficient cause, or of a superseding cause, of the injury renders the negligence of the defendant a remote cause of the injury, and he cannot be held liable, notwithstanding the existence of some connection between his negligence and the injury.").

181. *Archer II*, 538 U.S. at 327 (Thomas, J., dissenting).

182. *Id.* (Thomas, J., dissenting).

183. *Id*. (Thomas, J., dissenting). "[T]he nondischargeability action was brought solely in order to enforce the agreement to pay [the amount in the settlement agreement]." Petitioner's Brief at 21, *Archer II* (No. 01-1418).

184. *Archer II*, 538 U.S. at 321-22 (Thomas, J., dissenting).

185. *See infra* Part IV.D.1.

186. *See infra* Part IV.D.2.

187. *See infra* Part IV.D.3.

188. *See infra* Part IV.D.4.

1. Excluding Settlements and Novations from Discharge

If Congress had intended to preclude debtors from discharging settled fraud claims, Congress could have stated so expressly. Section 523(a) lists nineteen categories of debts excepted from discharge.[189] Three of the categories *explicitly* state that settlements connected to an ancillary debt are excepted from discharge.[190] For example, § 523(a)(19)(B)(ii) prevents the discharge of "any *settlement* agreement" stemming from a violated federal securities law.[191] The Court has stated, "Where Congress includes particular language in one section of a statute but omits it in another section of the same Act, it is generally presumed that Congress acts intentionally and purposely in the disparate inclusion or exclusion."[192] If the Court inferred that § 523(a)(2)(A) precludes settlements from discharge, then the explicit reference by Congress to "settlement" in § 523(a)(19)(B)(ii) would be superfluous.[193] Moreover, the Court has refused to interpret a subsection of § 523(a) in a manner that obviated the need for another subsection of § 523(a).[194] When considering that the Court interpreted "any debt . . . for money . . . to the extent obtained by . . . false pretenses, a false representation, or actual fraud"[195] as also meaning a "*settlement debt* [*arising*] *out of* 'false pretenses, a false representation, or actual fraud,'" it seems as though the Court amended, rather than interpreted, § 523(a)(2)(A).[196]

2. The Archers' Weak Fraud Claim and Blunders

Despite the plain meaning of § 523(a)(2)(A), weak evidence against Warner, and strategic errors committed by the Archers, the Court decided that the novation did not prevent the Archers from alleging fraud through an adversary hearing.[197] The Archers' original complaint filed in late 1992 listed only Leonard Warner as a defendant.[198] Because the Archers did not join Arlene Warner as a defendant until March of 1994,[199] one may reasonably deduce that Leonard

189. *See* 11 U.S.C. § 523(a) (2000).
190. *See id.* § 523(a)(5), (11); Act of July 30, 2002, Pub. L. No. 107-204, 116 Stat. 803 (to be codified at 11 U.S.C. § 523(a)(19)(B)(ii)).
191. *See* Act of July 30, 2002, Pub. L. No. 107-204, 116 Stat. 803 (to be codified at 11 U.S.C. § 523(a)(19)(B)(ii)) (emphasis added).
192. Gozlon-Peretz v. United States, 498 U.S. 395, 404 (1991); *accord* Russello v. United States, 464 U.S. 16, 23 (1983).
193. *See* Mackey v. Lanier Collection Agency & Serv., 486 U.S. 825, 837 (1988) (stating that the Court is "hesitant to adopt an interpretation of a congressional enactment which renders superfluous another portion of that same law").
194. *See* Kawaauhau v. Geiger, 523 U.S. 57, 62 (1998).
195. 11 U.S.C. § 523(a)(2)(A).
196. *Archer II*, 538 U.S. 314, 323 (2003) (quoting 11 U.S.C. § 523(a)(2)(A)) (emphasis added).
197. *See generally id.*
198. *Archer I*, 283 F.3d 230, 233 (4th Cir. 2002), *rev'd*, 538 U.S. at 314.
199. *See supra* note 21 and accompanying text.

was the principal person suspected of fraud. The amended complaint did not list any specific instances of fraud attributable to Arlene Warner.[200] Instead, the amended complaint adding Warner contained a paragraph of allegations that Warner described as "conclusory statements."[201] In light of the numerous claims asserted by the Archers and the completion of extensive pre-trial discovery, the parties settled the suit just prior to trial.[202] The settlement agreement stated that part of the Archers' willingness to settle stemmed from the Warners' numerous defenses asserted.[203] Because the Archers and Warners conferred with independent counsel during settlement negotiations and discovery, one may assume that each party bargained on equal footing.[204]

From a strategic standpoint, the Archers had the opportunity to better protect their interests. The Archers agreed to secure the $100,000 promissory note with "two deeds of trust," even though the property carried prior liens; consequently, the collateral did not adequately cover the indebtedness of $100,000.[205] Instead of releasing the claim at the outset of settlement, the Archers should have conditioned the release contingent upon the Warners *completely* satisfying the debt. The district court suggested that the Archers could have required the Warners to "admit to specific allegations of fraud as findings of fact in the settlement agreement."[206]

Procedural errors made by the Archers during the adversary hearing prompted the bankruptcy judge to dismiss the nondischargeability claim.[207] Even though the parties executed a settlement and release to resolve the fraud claim, the adversary hearing complaint restated the allegations previously released and settled in the state court suit.[208] Over a year after filing for the adversary hearing, the Archers filed a motion to amend the adversary hearing complaint to claim that the Warners fraudulently induced them to accept the $100,000 promissory note.[209] The proposed motion required a hearing, but when the Archers failed to appear at the motion-to-amend hearing, the bankruptcy court denied the request.[210] Thereafter, the Archers attempted again to amend the complaint, but the bankruptcy court denied the motion for reasons stated orally in court and not

200. Brief for Respondent Arlene L. Warner at 2-3, *Archer II* (No. 01-1418).
201. *Id.*
202. *Archer I*, 283 F.3d at 233.
203. *See supra* note 24.
204. *See* Brief for Respondent Arlene L. Warner at 3, *Archer II* (No. 01-1418).
205. *See* Petitioner's Brief at 6 n.4, *Archer II* (No. 01-1418).
206. *See* Brief for Respondent Arlene L. Warner at 7, *Archer II* (No. 01-1418).
207. *See supra* text accompanying notes 31, 37.
208. *Archer I*, 283 F.3d 230, 233 (4th Cir. 2002), *rev'd*, 538 U.S. at 314.
209. *Id.* at 235 n.4.
210. *Id.*

transcribed.[211] When reviewing the course of the adversary hearing, it seems as though the Archers strategically and procedurally blundered rather than Warner committed fraudulent acts.

3. Outdated Legislative History

The Court inappropriately emphasized outdated congressional statements of the fraud exception to discharge statute. The Court declared that the basic reasoning and outcome of *Brown* governed *Archer II*.[212] *Brown* involved the fraud exception to discharge statute from the Bankruptcy Act of 1898, but *Archer II* involved the Bankruptcy Reform Act of 1978 (Bankruptcy Code).[213] A main point underlying *Brown* focused on congressional statements regarding the change of "judgments" to "liabilities" in the fraud exception to discharge statute.[214] The Court reasoned that in the 1979 *Brown* decision, congressional statements and a statutory amendment, made in 1903, "*indicat*[*ed*] that Congress intended the fullest possible inquiry" into any debt suspected of arising from fraud before granting a discharge.[215] In *Archer II*, each time the Court explained congressional intent or legislative history, the Court cited *Brown*.[216] Thus, when *Archer II* referenced statutory changes and congressional intent by quoting *Brown*, the *Archer II* Court actually relied on century-old congressional statements concerning the repealed Bankruptcy Act of 1898.[217]

Although Justice Antonin Scalia joined with the *Archer II* majority, he has previously criticized the Court for relying on legislative history from repealed statutes.[218] In *Conroy v. Aniskoff*,[219] Justice Scalia expressed displeasure with the Court for taking into account the legislative history of a 1918 tolling statute for military personnel, when the statute in question was the 1940 version.[220] In a concurring opinion, Justice Scalia commented,

> [T]he Court feels compelled to demonstrate that its holding is consonant with legislative history, including some dating back to 1917—*a full quarter century* before the provision at issue was enacted. That is not merely a waste of research time and ink; it is a false and

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211. *Id.* at 235.
212. *Archer II*, 538 U.S. 314, 321 (2003).
213. *Compare* Brown v. Felsen, 442 U.S. 127, 127-28 (1979), *with Archer II*, 538 U.S. at 316.
214. *See supra* text accompanying note 66.
215. *Brown*, 442 U.S. at 138 (emphasis added).
216. *Archer II*, 538 U.S. at 320-21 (citing *Brown*, 442 U.S. at 138).
217. In comparison to the *Archer II* Court, the Fourth Circuit opined that "Congress did not intend that 11 U.S.C. § 523(a) be construed . . . to discourage the settlement of claims because they might be subject to freedom from discharge under § 523(a)." *Archer I*, 283 F.3d 230, 236 (4th Cir. 2002), *rev'd*, 538 U.S. at 314.
218. *See* Conroy v. Aniskoff, 507 U.S. 511, 518 n.12 (1993).
219. 507 U.S. 511 (1993).
220. *See id.* at 518-19 (Scalia, J., concurring).

> disruptive lesson in the law. . . . This undermines the clarity of law . . . .
>
> The greatest defect of legislative history is its illegitimacy. We are governed by laws, not by the intentions of legislators. . . . But not the least of the defects of legislative history is its indeterminacy. If one were to search for an interpretive technique that, *on the whole*, was more likely to confuse than to clarify, one could hardly find a more promising candidate than legislative history.[221]

The 1903 congressional statements referenced in *Brown* predate § 523(a)(2)(A) of the Bankruptcy Reform Act of 1978 by *three quarters of a century*.[222] It seems as though the Court valued legislative history from a century ago, concerning a repealed statute, as more controlling than the plain meaning of a current statute from a quarter of a century ago.[223]

4. Objective State Substantive Law

Instead of stretching the plain meaning of § 523(a)(2)(A) to govern a settled fraud claim, the Court could have applied substantive state law from North Carolina and found the release void. The substantive law approach follows the principles underlying the Erie doctrine:

> Except in matters governed by the Federal Constitution or by Acts of Congress, the law to be applied in any case is the law of the State. And whether the law of the State shall be declared by its Legislature in a statute or by its highest court in a decision is not a matter of federal concern.[224]

Similarly, the Court echoed the rationale underlying the Erie doctrine in the context of bankruptcy in *Butner* when it noted that "state laws are thus suspended only to the extent of actual conflict with the system provided by the Bankruptcy [Code]."[225] Although the novation theory used by the Fourth Circuit involved contract principles of law, the court was not citing to the substantive state law of North Carolina.[226] Moreover, "novation" generally refers to substituting a new

221. *Id.* (Scalia, J., concurring).

222. *Compare* H.R. Rep. No. 1698, at 3, 6 (1902), *with* the Bankruptcy Reform Act of 1978 (enacted into positive law by Act Nov. 6, 1978, P.L. 95-598, Title I, § 101, 92 Stat. 2549).

223. During a 1991 lecture, Justice Stephen G. Breyer, the author of the *Archer II* majority, expressed the importance and need for examining legislative history. *See generally* Stephen Breyer, *The 1991 Justice Lester W. Roth Lecture: On the Uses of Legislative History in Interpreting Statutes*, 65 S. CAL. L. REV. 845, 874 (1992) (advocating the use of legislative history to assist in interpreting statutes). *See also* Walter A. Effross, *Another Vote for Legislative History? New Justice Breyer's Bankruptcy Decisions*, ABI J., July 1994, *available at* 1994 ABI JNL. LEXIS 2714 (predicting that incoming United States Supreme Court Justice Stephen Breyer would abandon retiring Justice Harry Blackmun's plain meaning approach to ambiguous Bankruptcy Code provisions in favor of a legislative history approach to provisions in question).

224. Erie v. Tompkins, 304 U.S. 64, 78 (1938).

225. Butner v. United States, 440 U.S. 48, 54 n.9 (1979).

226. *See supra* notes 39-40 and accompanying text.

contract or party in place of a preexisting duty.[227] The misnomer of designating the settled fraud claim as a novation may have sidetracked the Fourth Circuit and the Court from applying the necessary substantive contracts laws.

Although bankruptcy and appellate courts have characterized a settled and released claim in consideration for a contractual debt as a novation, North Carolina courts would likely refer to the settlement agreement as a "compromise and settlement."[228] In furtherance of North Carolina's public policy of encouraging settlements, the state legislature codified the principles underlying compromise and settlement.[229] Section 1-540 of the General Statutes of North Carolina[230] provides that disputing parties can agree to an amount less than originally demanded as a compromise and settlement in consideration for the discharge of a suit.[231] In North Carolina, a compromise and settlement resolving a controversy is a contract; accordingly, the courts interpret a breach by following North Carolina state laws and binding precedent.[232] Generally, North Carolina courts consider a material breach of a contract as excusing the non-breaching party from performing its obligation any further.[233]

Warner argued that the Court should affirm the appeal because the Archers released the claim; consequently, the Archers could not allege the state fraud claim as grounds for nondischargeability.[234] In response, the Court could have followed the *Butner* principle, applied North Carolina substantive contract law, and voided the release on a breach of contract theory.[235] If the Court had voided the release, nothing would have prevented the Archers from proceeding with the adversary hearing. Thus, the Court could have reached a result favorable to the Archers without employing subjective and outdated bankruptcy policy arguments, or stretching the logic of § 523(a)(2)(A) to include settlements.

In *Torrey v. Cannon*,[236] the North Carolina Supreme Court addressed whether a debtor breaching a compromise and settlement should still benefit from the release.[237] In *Torrey*, the litigants settled a state court claim prior to trial, and the debtor agreed to a schedule

227. E. ALLAN FARNSWORTH, CONTRACTS § 4.24 (3d ed. 1999).
228. *See* 15A AM. JUR. 2D *Compromise and Settlement* § 1 (1994).
229. *See* N.C. GEN. STAT. § 1-540 cmt. (2001) ("An agreement to compromise and settle disputed matters is valid and binding.").
230. *Id.* § 1-540.
231. *See id.*
232. *See* Dobias v. White, 80 S.E.2d 23, 28 (N.C. 1954).
233. *See* Coleman v. Shirlen, 281 S.E.2d 431, 434 (N.C. Ct. App. 1981).
234. *Archer II*, 538 U.S. 314, 322 (2003).
235. *See supra* text accompanying notes 109-12, 232-33.
236. 88 S.E. 768 (N.C. 1916).
237. *Id.* at 768.

of payments in consideration for the creditor dismissing the suit.[238] The agreement stated that if the debtor defaulted, the agreement was void and should have no effect.[239] After a few payments the debtor defaulted, compelling the creditor to file suit to collect on the agreement.[240] The debtor, in defense, asserted that the repudiation rendered the agreement void; consequently, the creditor was suing to collect an agreement that was in essence void and of no effect.[241] The court rejected the debtor's defense and replied,

> Undoubtedly a party *cannot take advantage of the nonperformance* of a condition if such nonperformance has been caused by himself. . . . [Nonperformance] would enable the defendant to *profit by his own breach* of the contract, it would destroy and render of no legal effect a solemn contract entered into for the compromise and settlement of important litigation.[242]

In relation to *Archer II*, the Court could have cited *Torrey* and concluded that Warner could not take advantage of the nonperformance of the promissory note yet still benefit from the release. Because section 1-540 of the General Statutes of North Carolina describes the circumstances created between the Archers and Warner,[243] the Court in *Archer II* should have looked to substantive law remedies associated with a breach of section 1-540 or presented case law such as *Torrey* to supplement the Bankruptcy Code.

Substantive state law could also have disposed with Warner's other theory for affirming the appeal: the collateral estoppel defense.[244] The North Carolina Supreme Court has declared that collateral estoppel does not apply unless a court adjudicated the suit.[245] Because the Fourth Circuit did not address the collateral estoppel issue, the Court remanded the issue for the circuit court to decide.[246] Ironically, the Court explained that it decided to leave the collateral estoppel question with the Fourth Circuit because the federal courts consist of "'federal judges who deal regularly with *questions of state law* in their respective districts and circuits.'"[247] If the Court set a pattern of *consistently* applying substantive state law to areas not addressed by the Bankruptcy Code, lower courts and practitioners could predict that ambiguities of the Code would be resolved according to substantive state law. In the event that substantive state law would contradict bankruptcy policy or state law is inconsistent, courts could

238. *Id.*
239. *Id.*
240. *Id.*
241. *Id.*
242. *Id.* at 769 (emphasis added).
243. *Compare* N.C. GEN. STAT. § 1-540 (2001), *with supra* note 183 and accompanying text.
244. *Archer II*, 538 U.S. 314, 322 (2003).
245. *See supra* notes 116-20 and accompanying text.
246. *Archer II*, 538 U.S. at 322-23.
247. *Id.* at 322 (quoting Butner v. United States, 440 U.S. 48, 58 (1979)) (emphasis added).

then resort to policy-based arguments and employ subjective interpretations of bankruptcy policy.

V. Conclusion

The Bankruptcy Code is a bare bones set of equitable principles in constant need of interpretation.[248] In *Archer I* and *Archer II*, both the Fourth Circuit Court of Appeals and the United States Supreme Court opinions included dissents with reasonings very different than their respective majority opinions.[249] Most importantly, *Archer II* illustrated that the Bankruptcy Code is in dire need of a uniform and consistent approach to interpreting the gray areas of the Code. Policy-based arguments should be a last resort to interpreting Bankruptcy Code ambiguities because statutory and legislative history interpretations are subjective, manipulable, and susceptible to a judge's ideological values.[250] A better approach is to have bankruptcy and appellate courts first resort to substantive state law from its respective jurisdiction to fill the voids of the Bankruptcy Code. A substantive-law-first approach follows the Erie doctrine, enables parties to rely on laws from the governing jurisdiction to address gray areas of the Code, and reduces subjective policy and statutory interpretation arguments.[251] Until bankruptcy and appellate courts agree to examine Bankruptcy Code ambiguities by means of a consistent approach, judges will continue examining the same set of facts only to reach opposite holdings based on different reasonings.[252]

248. Robert L. Bayt, *Looking Back on Bankruptcy Judging*, ABI J., Nov. 2000, 2000 ABI JNL. LEXIS 121.

249. *Compare Archer I*, 283 F.3d 230 (4th Cir. 2002), *rev'd*, 538 U.S. at 314, *with Archer II*, 538 U.S. at 314.

250. *See* Ronald Dworkin, Law's Empire 87-88 (1986). For a variety of reasons, four briefs of amicus curiae supported the Archers' position. *See generally* Brief of Amicus Curiae G. Eric Brunstad, Jr., *Archer II* (No. 01-1418); Brief for the United States as Amicus Curiae Supporting Petitioners, *Archer II* (No. 01-1418); Brief for AARP as Amicus Curiae in Support of Petitioners, *Archer II* (No. 01-1418); Brief of Ohio and 29 Other States as Amicus Curiae in Support of Petitioners, *Archer II* (No. 01-1418). The Ohio brief and a United States attorney appearing during oral argument indicated that countless numbers of settlements for fraud routinely entered into by various government agencies would be susceptible to discharge if the Court affirmed *Archer II*. Brief of Ohio and 29 Other States as Amicus Curiae in Support of Petitioners at 8, *Archer II* (No. 01-1418); Tr. of Oral Argument, Jan. 13, 2003, at 23, *Archer II* (No. 01-1418). The Ohio brief warned that, if the Court upheld *Archer I*, states would fully litigate a fraud claim to ensure that a judgment on the merits was entered, which in turn would burden the court docket and drive up the states' legal costs. Brief of Ohio and 29 Other States as Amicus Curiae in Support of Petitioners at 9, *Archer II* (No. 01-1418).

251. *See* G. Marcus Cole, *The Federalist Cost of Bankruptcy Exemption Reform*, 74 Am. Bankr. L.J. 227, 236 (2000) ("If there is a bankruptcy crisis, it lies not in its expanding docket, but in the absence of an appreciation for its federalist structure and functions within a larger federalist economic and political system. In order for bankruptcy law to continue to fulfill its role, policymakers and judges alike must be sensitive to its federalist character and history.").

252. *See generally* Judith A. McKenna & Elizabeth C. Wiggins, *Alternative Structures for Bankruptcy Appeals*, 76 Am. Bankr. L.J. 625, 627-28 (2002) (discussing the shortcomings of the bankruptcy appellate system).