Bankruptcy Law Letter

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The Consequences of a Chapter 7 Trustee's Rejection of an Individual Debtor's Unexpired Lease

The treatment of a debtor's executory contracts and unexpired leases in bankruptcy is plagued by considerable conceptual difficulties, especially with respect to determining the consequences of rejection of a contract or lease. *See generally* National Bankruptcy Review Commission, Bankruptcy: The Next Twenty Years 459-78 (1997); Reforming the Bankruptcy Code: The National Bankruptcy Conference's Code Review Project 191-220 (1994); Michael T. Andrew, *Executory Contracts in Bankruptcy: Understanding "Rejection,"* 59 U. Colo. L. Rev. 845 (1988); Jay Lawrence Westbrook, *A Functional Analysis of Executory Contracts*, 74 Minn. L. Rev. 227 (1989); Michael T. Andrew, *Executory Contracts Revisited: A Reply to Professor Westbrook*, 62 U. Colo. L. Rev. 1 (1991); Morris G. Shanker, *Bankruptcy Asset Theory and Its Application to Executory Contracts*, 1992 Ann. Surv. Bankr. L. 97. One area in which these uncertainties have surfaced is disposition of the contracts and leases of an individual debtor in Chapter 7. To take the most common example, a debtor may be leasing an apartment or house as a residence when they file Chapter 7. As with any other executory contract or unexpired lease, the debtor's residential real property lease is subject to the assume-or-reject decision of Code § 365, but absent unusual circumstances, the trustee will not want to assume the debtor's lease. Almost invariably, the lease will be "deemed rejected" under Code § 365(d)(1) due to the trustee's failure to affirmatively assume or reject the lease within 60 days of the petition date. The recent cases of *Miller v. Chateau Communities, Inc. (In re Miller)*, 282 F.3d 874 (6th Cir. 2002), and *Federal Realty Investment Trust v. Park (In re Park)*, 275 B.R. 253 (Bankr. E.D. Va. 2002), allow us to explore the consequences of this deemed rejection. [See Bankr. Serv., L Ed § 5E:58; Bankr. Desk Guide § 20:58; Norton Bankr. L. & Prac. 2d §§ 39:23, 39:26; West Key No. Digest References Bankruptcy 3103.2, 3115, 3115.1.]

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In This Issue

A Chapter 7 Trustee's Breach by Rejection Does Not Automatically Terminate a Debtor's Residential Real Property Lease

In the *Park* case, when the Parks filed Chapter 7, they listed on their schedules an unexpired five-year commercial lease of premises upon which they operated a business. The Parks' Chapter 7 trustee took no action with respect to the lease, which consequently was deemed rejected. The Parks were current on their lease payments on the petition date, and despite their bankruptcy filing, the Parks continued to pay all rent due post-petition. Nonetheless, the landlord asked for relief from the automatic stay in order to retake

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Editor's Note: Cases reviewed in this issue have been reported through Msy 2002. The Bankruptcy Reform Act of 1978 is referred to herein as the Code; the former Bankruptcy Act is referred to as the Act; the Bankruptcy and Federal Judgeship Act of 1984, Public Law No. 98-353, is referred to as the 1984 Amendments; the Bankruptcy Reform Act of 1994 is referred to as the 1994 Amendments.

possession of the leased premises from the Parks, contending that the trustee's deemed rejection terminated the debtors' leasehold interest.

Rejection Is Breach

Since the English case of *Copeland v. Stephens*, 106 Eng. Rep. 218 (K.B. 1818), it has been recognized that a debtor's bankruptcy estate does not automatically become a party to a debtor's unperformed contract or lease. The estate becomes a party, entitled to the non-debtor's full performance and fully subject to the debtor's performance obligations, only if the estate assumes the contract or lease. Rejection, then, is essentially the estate's decision to *not* assume the contract or lease: to forgo the benefits of the non-debtor's performance in order to escape the debtor's ongoing obligations under the contract or lease. Moreover, Code § 365(g) provides that "the rejection of an executory contract or unexpired lease of the debtor constitutes a breach of such contract or lease," and the Code's "rejection breach" is treated as if it were a pre-petition breach by the debtor, entitling the non-debtor party to assert a pre-petition (ordinarily general unsecured) claim for breach damages against the debtor's bankruptcy estate. *See* Bankruptcy Code §§ 365(g)(1), 502(g).

While these general principles dispose of the relative rights of the bankruptcy estate and the non-debtor party with respect to the contract or lease, they do not fully address the rights of the debtor, which are largely immaterial in the case of a corporate debtor. Once a corporate debtor files bankruptcy, the bankruptcy estate succeeds to *all* of the corporate debtor's assets as property of the bankruptcy estate, and the corporate debtor essentially ceases to exist and function as an entity separate and distinct from the debtor's bankruptcy estate. Of course, in the case of an individual debtor, who does continue to exist as a real live flesh-and-blood person, wholly apart from his/her bankruptcy estate, it is important to address the individual debtor's continuing rights and obligations under the rejected contract or lease.

Because the Code's "rejection breach" is treated as if it were a pre-petition breach by the debtor, the debtor's Chapter 7 discharge expressly discharges the debtor's personal liability for any damages for breach of the contract or lease. *See* Bankruptcy Code § 727(b) (providing that "a discharge under subsection (a) of this section discharges the debtor from all debts that arose before the date of the order for relief…*and any liability on a claim that is determined under section 502…as if such claim had arisen before the commencement of the case*" (emphasis added)); *id.* § 502(g) (providing that "[a] claim arising from the rejection…of an executory contract or unexpired lease of the debtor that has not been assumed shall be determined…the same as if such claim had arisen before the date of the filing of the petition"). Thus, an important element of an individual debtor's fresh start is relief from the continuing financial obligations of burdensome contracts and leases through the Code's "rejection breach."

Rejection Is Not Termination

A fundamental corollary to discharge of the individual debtor's financial responsibilities under the contract or lease is that the Code's "rejection breach" is "the equivalent of an anticipatory breach" such that the non-debtor party "has the option to treat the contract as ended, so far as further performance is concerned." *Central Trust Co. v. Chicago Auditorium Association*, 240 U.S. 581, 592, 589, 36 S.Ct. 412, 415, 414 (1916). But what about a case such as *Park*, where the individual debtors nonetheless seek to retain the benefits of the non-debtor party's continued performance by themselves performing rather than repudiating their own obligations under the contract or lease?

The courts have generally responded to this situation by resort to the terms of Code § 365(g), which again merely provides that the "rejection…constitutes a *breach* of such contract or lease." (emphasis added). And significantly, "breach and termination of leases or executory contracts are not synonymous terms under state law," and although "Congress could have chosen to depart from the state law meanings of these terms,…taken as a whole, § 365 suggests that it did not do so." *Eastover Bank for Savings v. Sowashee Venture (In re Austin Development Co.)*, 19 F.3d 1077, 1083 (5th Cir. 1994). Thus, "[w]hile rejection is

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treated as a breach, it does not completely terminate the contract" or lease, and in order to determine the full extent of the parties' rights flowing from the breach, "we must turn to state law." *Medical Malpractice Insurance Association v. Hirsch (In re Lavigne)*, 114 F.3d 379, 386-87 (2d Cir. 1997).

Differentiating breach and termination rights is a particularly important distinction in the case of an individual debtor's unexpired lease, because landlord-tenant law has largely evolved as a branch of property law, not contract law. Thus, in sharp contrast to the contractual "concept of dependency of covenants" such that a material contractual breach excuses further performance by the non-breaching party, the traditional common-law rule is that "the parties to a lease have…no general power to terminate for the other party's breach of a lease covenant." William B. Stoebuck & Dale A. Whitman, The Law of Property § 6.10, at 253 & § 6.78, at 392 (3d ed. 2000). Thus, the courts have generally concluded that a Chapter 7 trustee's "rejection breach" of an individual debtor's lease does not automatically terminate the debtor's leasehold interest and is essentially equivalent to the debtor's bankruptcy estate abandoning the lease back to the debtor. *See B.N. Realty Assocs. v. Lichtenstein*, 238 B.R. 249 (S.D.N.Y. 1999); *Couture v. Burlington Housing Authority (In re Couture)*, 225 B.R. 58 (D. Vt. 1998); *In re Bacon*, 212 B.R. 66 (Bankr. E.D. Pa. 1997); *Housing Authority v. Collins (In re Collins)*, 199 B.R. 561 (Bankr. W.D. Pa. 1996); *In re Knight*, 8 B.R. 925 (Bankr. D. Md. 1981); *cf. In re Henderson*, 245 B.R. 449 (Bankr. S.D.N.Y. 2000) (rejection of an individual debtor's lease does not automatically terminate the debtor's leasehold interest, but neither does the rejection automatically abandon the lease back to the debtor).

A Lessor's State-Law Termination Remedies (or Lack Thereof) Upon Breach by Rejection

Upon "abandonment" of the lease to the debtor by rejection, the lessor can then resort to whatever state-court termination remedies are available, based upon the nature of the debtor's breach. For example, notwithstanding the common-law rule that breach of a lease covenant provides no basis for termination of the leasehold estate, every state provides a statutory exception that permits a lessor to summarily evict a tenant for failure to pay rent. *See* Stoebuck & Whitman, *supra*, § 6.79. Discharge of the debtor's lease debts acts as a bar only to actions "to collect, recover or offset any such debt as a *personal liability* of the debtor." Bankruptcy Code § 524(a)(2) (emphasis added). Thus, "the landlord may pursue any remedy to which it is entitled under state law…*except* a remedy against the debtor pesonally to collect the money due." *In re Rush*, 9 B.R. 197, 200-01 (Bankr. E.D. Pa. 1981). So "[d]espite the discharge, a landlord can still avail itself of its statutory remedy to recover possession of premises for nonpayment of rent." *In re Hepburn*, 27 B.R. 135 (Bankr. E.D.N.Y. 1983).

Can a "Rejection Breach," Standing Alone, Provide Grounds for Termination of the Debtor's Lease? Of course, eviction for nonpayment of rent would be unavailable to the lessor in the *Park* case, because the Parks were current on all pre-petition and post-petition rent payments. The only breach of the lease in *Park*, then, was the "technical breach arising from the failure [of the trustee] to assume" the lease. 275 B.R. at 256. With respect to lease breaches other than a failure to pay rent, the lessor's ability to terminate the lease usually depends upon the existence of a forfeiture or termination clause in the lease itself, which is generally given effect by the courts because "the common law has always permitted leases to contain clauses giving one party or the other a power to terminate the leasehold and the parties' contractual obligations if certain conditions exist." Stoebuck & Whitman, *supra*, § 6.78, at 392. However, when the only breach by the tenant is a "rejection breach" in the tenant's bankruptcy case, the typical termination clause contained in most leases that would entitle the lessor to terminate the lease is rendered unenforceable by the Code's ban on *ipso facto* bankruptcy terminations. *See* Bankruptcy Code § 365(e)(1)(A)-(B) (a debtor's "lease may not be terminated or modified, at any time after the commencement of the [bankruptcy] case solely because of a provision in such…lease that is conditioned on the insolvency or financial condition of the debtor [or] the commencement of a [bankruptcy] case"). Without an enforceable lease termination provision, then, the debtor could fully preserve its rights under the lease by continuing to perform according to its terms notwithstanding the trustee's "rejection breach."

Compulsory Transformation from a Recourse to a Nonrecourse Lease? Some state courts have gone beyond the strict confines of the traditional common law of property and have adopted the approach of the Restatement (Second) of Property that makes lease termination rights more analogous to the "material breach" principles of contract law . *See* Stoebuck & Whitman, *supra*, § 6.10, at 254 & n.4. The Restatement provides that even in the absence of a termination clause in the lease, a tenant's breach

gives the lessor the power to terminate the lease if thereby "the landlord is deprived of a significant inducement to the making of the lease." Restatement (Second) of Property § 13.1(1). The *Park* court suggested that a "rejection breach," standing alone, might satisfy this termination standard:

> Of course, it could be argued that the failure affirmatively to assume the lease *has* materially affected the landlord's rights, since the debtors' contractual obligation to pay rent has been discharged. Thus, the tenants are no longer on the hook to the landlord until the expiration of the lease term but are free to stop paying rent and to turn the keys back to the landlord at any time.

275 B.R. at 257. One could also argue, though, that a landlord's termination under these circumstances would still be an impermissible *ipso facto* bankruptcy termination attributable to "a provision in…applicable law" permitting termination of the debtors' lease "solely because of a provision…conditioned on" the debtors' bankruptcy filing, within the meaning of and, thus, prohibited by Code § 365(e)(1). *But cf. Yates Development, Inc. v. Old Kings Interchange, Inc. (In re Yates Development, Inc.)*, 256 F.3d 1285 (11th Cir. 2001) (discussed in the October 2001 *Bankruptcy Law Letter*, at 1-6) (permitting exercise of a contractual modification attributable solely to the debtor's bankruptcy filing in the guise of a broad, open-ended modification standard). If the landlord were permitted to terminate the lease on this basis, the debtors could remain in possession of the leased premises only by negotiating a new lease or reaffirming their continuing personal liability on the old lease through a duly executed reaffirmation agreement under Code § 524(c).

As the *Park* court noted, permitting the debtors to retain their rights under the lease and possession of the leased premises, at the same time that their personal liability for rent payments is discharged, effects a transformation of the lease from a recourse to a nonrecourse lease. This is very similar to the recourse-to-nonrecourse transformation of a secured debt that occurs through the controversial Chapter 7 practice of permitting a Chapter 7 debtor to retain a secured creditor's collateral while maintaining the original payment schedule on the secured debt, but without having to reaffirm personal liability on the debt pursuant to Code §§ 521(2) & 524(c). *Compare In re Boodrow*, 126 F.3d 43 (2d Cir. 1997) (practice is permitted); *In re Belanger*, 962 F.2d 345 (4th Cir. 1992) (same); *In re Parker*, 139 F.3d 668 (9th Cir. 1998) (same); *Lowry Federal Credit Union v. West*, 882 F.2d 1543 (10th Cir. 1989) (same), *with In re Burr*, 160 F.3d 843 (1st Cir. 1998) (practice is *not* permitted); *In re Johnson*, 89 F.3d 249 (5th Cir. 1996) (same); *In re Edwards*, 901 F.2d 1383 (7th Cir. 1990) (same); *In re Taylor*, 3 F.3d 1512 (11th Cir. 1993) (same). The *Park* court relied upon the Fourth Circuit's approval of this Chapter 7 collateral-retention practice as validation of the propriety of a compulsory recourse-to-nonrecourse transformation in the lease context. Indeed, the converse may also be true. Since the line between leases and secured debts is, at times, an artificial one, general consistency in the bankruptcy treatment of the two seems desirable, and the fact that Code § 365(e)(1) seems to permit the recourse-to-nonrecourse transformation with respect to leases may counsel in favor of also permitting the practice in the case of secured debts, in accordance with the holdings of the Second, Fourth, Ninth, and Tenth Circuits.

Does a Chapter 7 Trustee's Breach by Rejection Automatically Terminate a Debtor's Commercial Real Property Lease?

Although the most common context in which it is necessary to determine an individual debtor's lease rights upon rejection of the lease by the debtor's Chapter 7 trustee is in the case of *residential* real property leases, the *Park* case actually involved the debtors' *commercial* real property lease, governed by the 1984 BAFJA amendments that added § 365(d)(4) to the Code:

> [I]f the trustee does not assume or reject an unexpired lease of *nonresidential* real property under which the debtor is lessee within 60 days after the date of the order for relief…then such lease is deemed rejected, *and the trustee shall immediately surrender such nonresidential real property to the lessor*.

(emphasis added). Despite the courts' general agreement that a trustee's rejection of a residential real property lease does not automatically terminate the debtor's leasehold estate, the above-quoted italicized language in Code § 365(d)(4) requiring surrender upon rejection has led many courts to conclude that rejection of a commercial real property lease does effect a termination of the debtor's leasehold estate. *See Chatlos Sys., Inc. v. Kaplan*, 147 B.R. 96 (D. Del. 1992), *aff'd,* 998 F.2d 1005 (3d Cir. 1993); *Tebo v. Elephant Bar Restaurant, Inc. (In re Elephant Bar Restaurant, Inc.)*, 195 B.R. 353 (Bankr. W.D. Pa. 1996); *In re 6177 Realty Assocs., Inc.*, 142 B.R. 1017 (Bankr. S.D. Fla. 1992); *In re Giles Assocs., Ltd.*, 92

B.R. 695 (Bankr. W.D. Tex. 1988); *In re Gillis*, 92 B.R. 461 (Bankr. D. Haw. 1988); *In re Southwest Aircraft Services, Inc.*, 53 B.R. 805 (Bankr. C.D. Cal. 1985), *rev'd on other grounds*, 831 F.2d 848 (9th Cir. 1987); *In re Hawaii Dimensions, Inc.*, 39 B.R. 606 (Bankr. D. Haw. 1984), *aff'd*, 47 B.R. 425 (D. Haw. 1985).

In *Eastover Bank for Savings v. Sowashee Venture (In re Austin Development Co.)*, 19 F.3d 1077 (5th Cir. 1994), however, the Fifth Circuit rejected this interpretation of Code § 365(d)(4), and the *Park* court adopted the Fifth Circuit's holding. Nowhere does § 365(d)(4) use the term "termination," whereas other portions of Code § 365 expressly provide that rejection of certain contracts and leases will allow the non-debtor party to "terminate" the contract or lease. *See* Bankruptcy Code § 365(h)(1)(A)(i), (h)(2)(A)(i), (i)(1) & (n)(1)(A). Moreover, "[w]hile § 365(d)(4)… expressly requires the *trustee* to surrender the property to the landlord, it is silent as to an individual debtor who is not a debtor in possession." *Park*, 275 B.R. at 258. In other words, § 365(d)(4) only purports to govern the rights of the bankruptcy estate vis-à-vis the non-debtor party and does not speak directly to the rights of an individual debtor.

Code § 365(d)(4) was enacted primarily to shorten the period within which to assume/reject commercial leases in Chapter 11 cases. *See* Bankruptcy Code § 365(d)(2) (general rule in Chapter 11 is that leases and contracts can be assumed or rejected at any time prior to confirmation of a plan of reorganization). Affirmatively mandating surrender in the case of a deemed rejection is consistent with this desire to provide commercial lessors with a more expeditious determination of their rights. For example, notwithstanding rejection of a lease by the bankruptcy estate, it is still possible to conclude that the bankruptcy estate retains a possessory or other interest in the leased premises such that the lessor must seek relief from the automatic stay in order to regain possession of the premises. *See, e.g.*, *In re Henderson*, 245 B.R. 449 (Bankr. S.D.N.Y. 2000). Thus, rather than effecting a *termination* of the lease, § 365(d)(4)'s provision for "surrender" by the trustee can more properly be interpreted as mandating an immediate *abandonment* of any interest of the estate in the leased premises. Of course, as discussed above, in the case of an individual debtor the estate's abandonment of a lease merely revives the debtor's rights and interests in the leasehold estate. The *Park* court, therefore, held that an individual Chapter 7 debtor's rights under a rejected lease are essentially the same with respect to both residential and commercial real property leases, with the only possible difference between the two being the time as of which the "abandonment" of the lease to the debtor is deemed to occur (automatically or pursuant to Code §§ 362 & 554).

"Abandonment" of a Rejected Lease to an Individual Debtor Does Not Revive the Debtor's Personal Liability for Lease Obligations

In the Sixth Circuit's *Miller* case, when Peggy Miller filed Chapter 7 on July 14, 1999, she scheduled a secured debt to Greentree Financial for a mortgage on her mobile home. The debt, however, exceeded the value of the home, and pursuant to Code § 521(2), Miller indicated her intention to surrender the mobile home to Greentree. Indeed, Miller had already moved out of the mobile home when she filed bankruptcy. The mobile home was located on a lot Miller rented from Chateau Communities under a month-to-month oral lease, and Miller's schedules also listed a debt to Chateau for unpaid pre-petition rent. The trustee filed a no-asset report, and Miller was granted a discharge on October 25, 1999.

The trustee took no action with respect to Miller's lot lease with Chateau, and therefore, the lease was deemed rejected under Code § 365(d)(1) on September 12. On October 22, after obtaining relief from the automatic stay, Greentree obtained a state-court order of foreclosure of its mortgage on Miller's mobile home. Although Chateau had likewise obtained relief from stay in order to retake possession of the lot through state-court eviction proceedings, Chateau did not retake possession. Rather, Chateau presented Miller with a bill for $1,242.80, representing rent on the lot from the petition date, July 14, until October 22, the date Greentree foreclosed Miller's equity interest in the mobile home. Thereafter, Chateau obtained a state-court judgment against Miller for this sum. Upon Miller's motion, though, the bankruptcy court held Chateau had violated Miller's discharge injunction and levied contempt sanctions against Chateau, and both the district court and the Sixth Circuit affirmed.

Chateau's argument proceeded from the view, discussed above, that rejection of an individual debtor's lease does not terminate the lease, but rather, merely "abandons" the leasehold from the estate back to the debtor. Moreover, under state law, while failure to pay rent and/or repudiation of the lease may afford the landlord a basis upon which to terminate the tenant's leasehold and retake possession of the leased premises, the landlord is under no obligation to do

so, and the landlord may opt to simply hold the tenant liable for rent accruing under the lease. *See* Restatement (Second) of Property § 12.1(2)-(3) & comments g, i, m & n. Thus, Chateau argued that rather than retake possession of the leased premises from Miller, Chateau had opted to simply hold Miller liable for post-petition rent, and since these amounts accrued post-petition rather than pre-petition, Miller's liability was unaffected by her Chapter 7 discharge. While this is certainly a creative argument with some superficial appeal, the Sixth Circuit rightly "rejected" it (bad pun intended).

One of the primary functions of Code § 365(g)'s "rejection breach" is to simultaneously both (1) afford the non-debtor party a breach claim against the debtor's bankruptcy estate, and (2) discharge the debtor's personal liability for any breach debt. The Code's "rejection breach" is not only "the equivalent of an anticipatory breach" under which the non-debtor party "*has the option* to…maintain an action at once for the damages occasioned by such anticipatory breach," *Central Trust*, 240 U.S. at 592, 589 (emphasis added), but any "claim arising from the rejection…of an executory contract or unexpired lease…*shall be determined*…the same *as if* such claim had arisen before the date of the filing of the petition." Bankruptcy Code § 502(g) (emphasis added). Thus, for purposes of the non-debtor's payment rights, the rejection is treated *as if* the debtor had anticipatorily repudiated all obligations immediately before the petition date, and the debtor's discharge extinguishes the debtor's personal liability for any and all damages arising from this hypothetical pre-petition total breach "*whether or not* a proof of claim based on any such debt or liability is filed." Bankruptcy Code § 727(b) (emphasis added).

All of this is simply an incident of the debtor's bankruptcy estate succeeding to all of the debtor's monetary obligations under pre-petition contracts and leases, and by virtue of the bankruptcy discharge, substituting the estate's liability for that of the individual debtor. Thus, even though state law may have afforded Chateau the option of (1) treating Miller's lease as continuing in order to hold Miller liable for all rent as it accrued, or (2) terminating Miller's lease and immediately claiming damages for total breach, for purposes of Chateau's payment rights against Miller's bankruptcy estate and discharge of Miller's personal liability, Chateau will be treated *as if* it had chosen option (2). For bankruptcy purposes, then, *all* of Miller's monetary liability under the lease is considered a *pre-petition* debt by virtue of Code § 365(g)(1) & 502(g). Chateau's attempt to collect *any* amounts from Miller personally, therefore, was in contravention of Miller's bankruptcy discharge and the discharge injunction of Code § 524(a)(2).

Contractual Settlement Agreements as to the Dischargeability of the Settlement Debt

Several recent court of appeals decisions address the extent to which parties can, through a pre-petition settlement, conclusively establish the dischargeability of the resulting settlement obligations in any subsequent bankruptcy filing. [See Bankr. Serv., L Ed §§ 10A:62-10A:70; Bankr. Desk Guide §§ 35:62-35:70; Norton Bankr. L. & prac. 2d § 47:14; West Digest Key No. References Bankruptcy 3341-3343.]

Does a General Release of Claims in Connection with a Settlement Also Release Claims of Nondischargeability of the Settlement Debt?

In *Archer v. Warner (In re Warner)*, 283 F.3d 230 (4th Cir. 2002), over a strong dissent, the Fourth Circuit held that a pre-petition settlement agreement in which the creditor released all claims against the debtor with respect to a particular incident prevented the creditor from asserting that the debtor's obligation to pay the settlement amount was a nondischargeable debt.

In 1992, Leonard and Arlene Warner sold their business, Warner Manufacturing, to Elliot and Carol Archer. Later that same year, though, the Archers sued the Warners in state court alleging fraud in connection with the sale. This litigation ultimately settled, with the Warners paying the Archers $200,000 in cash and promising to pay the Archers an additional $100,000 over a two-year period, but the settlement agreement expressly stated that the Warners' payments to the Archers were not to be construed as an admission of liability. In exchange for these payments, the Archers executed a broad-form release of all potential claims against the Warners:

> [The Archers] do hereby release and forever discharge the [Warners] from any and every right, claim, or demand…arising out of or relating to the matter in Guilford County Superior Court, excepting only obligations under a Note [for $100,000] executed contemporaneously herewith.

283 F.3d at 237. The Warners, though, made no payments on the $100,000 promissory note, and when the Archers sued the Warners on the note in state court, the Warners filed a Chapter 13 case that was

subsequently converted to Chapter 7. The Archers thereafter filed an adversary proceeding in the bankruptcy court for a determination that the Warners' $100,000 settlement debt was a nondischargeable "debt for money…obtained by false pretenses, a false representation, or actual fraud." Bankruptcy Code § 523(a)(2)(A). The Warners presented their settlement agreement with the Archers in defense of the nondischargeability action, contending that "the Archers may not rely upon the same alleged misconduct in the original suit in the state court as grounds for non-dischargeability because that suit was settled *in toto*." 283 F.3d at 235. The bankruptcy court agreed with this contention, and both the district court and the Fourth Circuit affirmed.

The Novation Theory

Whether a pre-petition release of fraud claims in connection with a settlement of those claims also releases claims of nondischargeability of any resulting settlement debt is a question that has divided the circuits. In *Warner*, the Fourth Circuit answered in the affirmative, adopting the reasoning and holdings of the Seventh and Ninth Circuits. *See Key Bar Investments, Inc. v. Fischer (In re Fischer)*, 116 F.3d 388 (9th Cir.), *amended*, 127 F.3d 819 (9th Cir. 1997); *In re West*, 22 F.3d 775 (7th Cir. 1994). These courts reason that a creditor's express release and discharge of fraud claims in exchange for promised payments effects a "novation" that substitutes a dischargeable contract claim for the potentially nondischargeable fraud claims. "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." *Warner*, 283 F.3d at 238 (Traxler, C.J., dissenting). This "line of cases favors the basic principle of encouraging settlements" and fostering the repose that settlements bring. *Id.* at 236 (majority opinion). The *Warner* majority, adopting this approach, thus held that the Archers' release of all claims against the Warners in exchange for the Warners' promissory note, had relinquished any claim that the note was a nondischargeable fraud debt.

Substance over Form and Effectuation of Congressional Intent

The *Warner* dissent relied upon a competing line of cases that rejects the "novation" theory in order to "elevate substance over form" and "best effectuate[] Congressional policy [of] not permitting the discharge of debts that Congress intended to survive bankruptcy." 283 F.3d at 240, 236; *see United States v. Spicer*, 57 F.3d 1152 (D.C. Cir. 1995); *Greenberg v. Schools*, 711 F.2d 152 (11th Cir. 1983); *Ed Schory & Sons, Inc. v. Francis (In re Francis)*, 226 B.R. 385 (B.A.P. 6th Cir. 1998). These cases also rely upon the spirit of the Supreme Court's opinion under the Bankruptcy Act of 1898 in *Brown v. Felsen*, 442 U.S. 127, 99 S.Ct. 2205 (1979), indicating that "'Congress intended the fullest possible inquiry' into the nature of debts for purposes of determining dischargeability." *Warner*, 283 F.3d at 237 (Traxler, C.J., dissenting) (quoting *Brown v. Felsen*, 442 U.S. at 138).

Brown v. Felsen also involved a pre-petition settlement of a creditor's fraud suit, one in which the settlement produced a stipulated judgment, but the stipulated judgment was not accompanied by any findings of fraud nor any other indication of the basis upon which the debtor was liable to the creditor. Shortly after entry of the stipulated judgment, the debtor filed bankruptcy, and when the creditor sought a declaration that the pre-petition judgment was a nondischargeable fraud debt, the debtor contended that *res judicata* barred relitigation of the nature of the debt. The Court, however, disagreed.

The debtor in *Brown v. Felsen* was making an argument very similar in form to the majority's "novation" theory in *Warner*. Under the claim preclusion principles of *res judicata*, a judgment effects a "merger" of a plaintiff's claim into the judgment, such that the plaintiff can assert a new claim on the judgment only and is thereafter precluded from asserting any cause of action arising out of the original "claim." In *Brown v. Felsen*, though, the Court essentially held that nondischargeability is a separate "claim," distinct from the claim that gave rise to the underlying judgment debt, such that the judgment does not preclude assertion of nondischargeability of the judgment.

The *Brown v. Felsen* Court's reasoning with respect to a stipulated judgment seems equally applicable to a settlement and general release:

> Here, [the judgment creditor] readily concedes that the prior decree is binding. That is the cornerstone of his claim. He does not assert a new ground for recovery, nor does he attack the validity of the prior judgment. Rather, what he is attempting to meet here is the new defense of bankruptcy which [the debtor] has interposed between [the creditor] and the sum determined to be due him. …[The debtor] has upset the repose that would justify treating the prior state-court proceeding as final, and it would hardly promote confidence in judgments to prevent [the creditor] from meeting [debtor's] new initiative.

442 U.S. at 133-34.

Transposed to the context of the *Warner* case (by substituting "settlement agreement" for the references to "decree" and "judgment" in the above-quoted passage), this reasoning also casts doubt upon the validity of the majority's formalistic, conclusory "novation" theory. That the settlement and release constituted a novation that substituted an undisputed contract debt for a disputed tort claim merely begs the question whether the resulting contract debt was, in fact, "for money…obtained by false pretenses, a false representation, or actual fraud." Bankruptcy Code § 523(a)(2)(A). Indeed, as is typical, the release in *Warner* was of all claims *except* those relating to the Warners' obligation to pay the settlement debt itself. All the Archers were attempting to do in raising nondischargeability was *enforce the settlement debt* against the Warners. They did "not assert a new ground for recovery, nor" did they "attack the validity of the prior" agreement. *Brown v. Felsen*, 442 U.S. at 133. The settlement agreement itself expressly left open any determination as to whether the resulting debt was on account of any fraudulent conduct by the Warners. As was the case in *Brown v. Felsen*, the very purpose of the prior settlement was to avoid and forestall any inquiry into whether the debtors actually engaged in fraud. It was the *debtors*, however, who necessitated the subsequent inquiry into their conduct, by failing to pay the agreed settlement debt. "By seeking discharge, [the debtors] placed the rectitude of [their] prior dealings squarely in issue, for, as the Court has noted, the Act limits that opportunity to the 'honest but unfortunate debtor.'" *Brown v. Felsen*, 442 U.S. at 128 (quoting *Local Loan Co. v. Hunt*, 292 U.S. 234, 244, 54 S.Ct. 695, 699 (1934)).

Effectuation of the Parties' Contractual Intent and/or Construction of an Appropriate Default Rule

The penultimate question in *Warner* (which the majority's formalistic "novation" theory seems to distract attention from) is discerning the intent of the contracting parties in entering into the settlement and release. If the intent to do so is expressed, there can be no doubt that a creditor can contract away the right to assert nondischargeability of a particular debt. But as the *Warner* majority acknowledged, "[t]here was no mention of bankruptcy in the settlement package." 283 F.3d at 233. The primary issue, then, is not a matter of "freedom to enter into settlement agreements" as posited by the *Warner* majority. 283 F.3d at 236. Rather, the issue is faithful interpretation of contractual intent. When the parties make no specific mention of bankruptcy or dischargeability issues in a general release of claims, is the more realistic presumption that the parties did or did not intend to release any claim of nondischargeability in the event that the debtor fails to pay the agreed settlement amount? Is the dischargeabilty issue more properly viewed as a claim that the creditor released in the general release of claims or a new defense by which the debtor seeks to challenge the enforceability of the settlement agreement itself. And given that the parties may not have even contemplated the bankruptcy ramifications when executing the settlement agreement and release, what is the bargain that the parties most likely would have struck had they actually bargained regarding release of nondischargeability claims (the so-called "majoritarian default rule" in theoretical literature)?

The *Warner* dissent makes a cogent argument that the more reasonable presumption or default rule, in the absence of specific language to the contrary, is that the parties *do not* intend to release any claims for enforcement of the settlement agreement itself, including claims of nondischargeability.

> I do not view the settlement documents as forbidding the Archers from proving in bankruptcy court the nondischargeability of the [settlement] debt because, among other things, the releases specifically excepted the Warners' obligations under the promissory note… , which I would interpret as permitting a full and fair hearing on the dischargeability of the debt in bankruptcy court.

283 F.3d at 240 n.* (Traxler, C.J., dissenting).

Can a Consent Decree Establish the Nondischargeability of the Settlement Debt?

The *Warner* case essentially involved a pre-petition agreement that a particular debt is dischargeable in bankruptcy, with the only issue being whether the parties had in fact entered into such an agreement. While a pre-petition agreement that a particular debt is *dischargeable* should be fully enforceable in a debtor's bankruptcy proceedings, a pre-petition agreement that a particular debt is *nondischargeable* is much more troublesome. Such an agreement is equivalent to a waiver by the debtor of discharge of the debt, and the Bankruptcy Code expressly authorizes waiver of discharge in only two instances. Code § 727(a)(10) authorizes a *post-petition* written waiver of discharge if approved by the bankruptcy court, and Code § 524(c) authorizes *post-petition* reaffirmation of an otherwise dischargeable debt if the reaffirmation agreement with the creditor meets specified cri-

teria. "Congress' failure to authorize prepetition waivers of discharge, while at the same time authorizing certain postpetition waivers of discharge pursuant to §§ 524(c) and 727(a)(10), must be viewed as intentional," and thus the courts have generally held that pre-petition waivers of the bankruptcy discharge are unenforceable. *Hayhoe v. Cole*, 226 B.R. 647, 654 (B.A.P. 9th Cir. 1998). As the Supreme Court recognized in *Brown v. Felsen*, though, a debtor may be precluded from asserting dischargeability issues by virtue of a pre-petition adjudication:

> If, in the course of adjudicating a state-law question, a state court should determine factual issues using standards identical to those of [1898 Act] § 17 [predecessor to Code § 523], then collateral estoppel…would bar relitigation of those issues in the bankruptcy court.

442 U.S. at 139 n.10. A consent decree is a hybrid consisting of a contractual agreement among litigants that is also embodied in a court order disposing of the litigation, and the cases of *Whitehouse v. LaRoche*, 277 F.3d 568 (1st Cir. 2002), and *Bank of China v. Huang (In re Huang)*, 275 F.3d 1173 (9th Cir. 2002), explore the extent to which a consent decree entered in a nonbankruptcy court is effective in establishing the nondischargeability of the obligations imposed by the consent decree.

Illustrative of the courts' generally chary attitude toward the enforceability of a nonbankruptcy court's stipulated nondischargeability order is the Ninth Circuit's decision in *Huang*. The Bank of China had lent money to corporations controlled by Huang, and when the corporations subsequently defaulted on the loans, the Bank sued the corporations and several individuals, including Huang, in federal district court alleging *inter alia* fraudulent manipulation of the corporations' affairs with the intent of avoiding repayment of the Bank loans. This suit settled with the defendants admitting that they jointly and severally owed the Bank over $42 million and nearly 600,000 Japanese yen, plus interest, and agreeing to entry of a stipulated judgment in this amount. The settlement agreement also contained extensive provisions by which the defendants purported to waive any conceivable rights under the Bankruptcy Code, including a promise not to file bankruptcy and an agreement that "Defendants understand, represent and promise to the Bank that the Judgment and the Debt, and all other amounts owing to the Bank, are not dischargeable in any bankruptcy or bankruptcies filed by any of the Individual Defendants." 275 F.3d at 1176.

The district court approved the settlement and entered the stipulated judgment in favor of the Bank. Fourteen months later, however, Huang filed a Chapter 7 petition, whereupon the Bank filed an adversary proceeding for a declaration that Huang's stipulated judgment debt was nondischargeable and seeking summary judgment to that effect based upon the terms of the settlement agreement, and the bankruptcy court so ruled. On appeal to the same district court that approved the settlement, though, the district court reversed because the stipulated judgment contained no factual findings whatsoever that would support a nondischargeability determination—in particular, the stipulated judgment contained no findings of actual fraud by Huang within the meaning of Code § 523(a)(2)(A). Thus, the prior judgment did not preclude relitigation of the nondischargeabilty of the judgment debt under the collateral estoppel principles of issue preclusion. The Ninth Circuit affirmed for substantially the same reasons, noting that "[t]he omission of any mention of fraud is all the more striking when it is observed that the Bank was advised by experienced counsel, who must have been aware of what was required to constitute collateral estoppel.…The Bank, which the Settlement Agreement shows to have been in a dominant position, was unable to secure the one provision that would have led to collateral estoppel, that is, Huang's admission of fraud." 275 F.3d at 1178. The Ninth Circuit also specifically noted that pre-petition contractual waivers of the bankruptcy discharge are unenforceable as against public policy. Thus, since the stipulated judgment carried no preclusive collateral estoppel effect with respect to nondischargeability, the parties' bare contractual agreement regarding nondischargeability of the judgment was of no effect whatsoever.

In sharp contrast to the *Huang* case, the First Circuit's *Whitehouse* decision illustrates a rare occasion in which a nonbankruptcy court's stipulated nondischargeability judgment was fully effective to render a settlement debt nondischargeable. In the *Whitehouse* case, the Rhode Island Attorney General, the Director of the Rhode Island Department of Environmental Management, and interested citizens sued David LaRoche in federal district court in Rhode Island for violations under the federal Clean Water Act and the Rhode Island Water Pollution Control Act. In that suit, the district court entered partial summary judgment against LaRoche, finding that LaRoche knew, prior to purchasing the property at issue, that its faulty septic system was polluting an adjacent river, leaving unresolved only the appropriate remedial award against LaRoche. Thereafter, LaRoche's creditors commenced an involuntary

Chapter 11 case against him in which an order for relief was entered and a trustee was appointed. Nonetheless, the Rhode Island district court held that its subsequent remedial orders in the litigation were excepted from the automatic stay pursuant to the police and regulatory power exception of Code § 362(b)(4). *See Friends of the Sakonnet v. Dutra*, 125 B.R. 69 (D.R.I. 1991). The parties then negotiated a settlement of all remedial issues in the district court litigation, set forth in a consent decree entered by the Rhode Island district court. Under the district court consent decree, LaRoche agreed to reimburse Rhode Island a formulaic proportion of the costs of a new waste water collection and treatment facility for the property, and LaRoche also agreed to "affirm his obligation to pay the [settlement amount], to the extent then unpaid, as a debt not discharged in any bankruptcy proceeding in which he is the bankrupt" and to obtain an order from the bankruptcy court in his pending Chapter 11 case approving his reaffirmation of the settlement debt. 277 F.3d at 571. The consent decree also provided that LaRoche agreed to imposition of a civil penalty in the amount of the settlement debt, but that the civil penalty would be assessed only in the event that the bankruptcy court did not approve LaRoche's reaffirmation of the settlement debt, and with respect to this civil penalty, the consent decree further provided:

> LaRoche specifically agrees that the civil penalty imposed hereunder constitutes a debt for a fine, penalty or forfeiture payable to and for the benefit of a governmental unit, is not compensation for actual pecuniary loss and is specifically nondischargeable under 11 U.S.C. 523(a)(7).

277 F.3d at 572. Through the consent decree, then, LaRoche purported to waive discharge of his settlement debt, either via a reaffirmation agreement or, failing that, a stipulation as to the nondischargeability of the settlement debt.

Thereafter, LaRoche's Chapter 11 case was converted to Chapter 7, and he received his Chapter 7 discharge. It was not until more than two years later, however, that LaRoche asked the bankruptcy court to approve reaffirmation of his settlement debt. The bankruptcy court, however, denied reaffirmation of the debt for failure to comply with Code § 524(c). The state then sought from the Rhode Island district court (which had retained continuing jurisdiction to oversee performance of the consent decree) a declaration that the civil penalty provisions of the consent decree were operative, including the nondischargeability stipulation. LaRoche, however, contended that his purported waiver of discharge of the settlement debt was void and unenforceable for failure to comply with the requirements of Code § 524(c). The Rhode Island district court held that the consent decree's characterization of the civil penalty as a nondischargeable debt under Code § 523(a)(7) was not conclusive, and in the absence of a nondischargeability determination by the bankruptcy court, LaRoche's settlement debt was discharged in LaRoche's Chapter 7 case. On appeal, however, the First Circuit reversed.

The First Circuit acknowledged the general policy against discharge waivers and that the reaffirmation provisions of the settlement were wholly ineffective for failure to comply with the requisites of Code § 524(c). The court also questioned whether the settlement debt was, in actuality, "*not* compensation for actual pecuniary loss" within the meaning of Code § 523(a)(7), given that it was measured by the state's remediation costs. The court, however, was willing to characterize the agreement as settlement of pending or threatened dischargeability litigation and opined that settlement of a dischargeability action is not subject to the reaffirmation requirements of Code § 524(c), expressly adopting the holding of cases such as *Saler v. Saler (In re Saler)*, 205 B.R. 737 (Bankr. E.D. Pa. 1997), *aff'd*, 217 B.R. 166 (E.D. Pa. 1998). Moreover, the court held that the consent decree constituted a binding adjudication as to the nondischargeability of LaRoche's settlement debt under Code § 523(a)(7).

The Rhode Island district court seemed to believe that the bankruptcy court had exclusive jurisdiction to determine nondischargeability of the settlement debt. Code § 523(c)(1), however, gives the bankruptcy court exclusive jurisdiction over nondischargeability determinations under only § 523(a)(2), (4), (6), or (15), and with respect to all other nondischargeability grounds, including § 523(a)(7), nonbankruptcy courts have concurrent jurisdiction. Thus, the Rhode Island district court's consent decree, by adopting the parties' stipulation as to the nondischargeability of the settlement debt, was a binding adjudication by a court of competent jurisdiction as to the nondischargeability of the debt. In the words of the First Circuit, then, "LaRoche cannot now be heard to contend that the general discharge he was granted…relieved him of liability for the civil penalty," as there is "no sound reason that LaRoche, like any other litigant who knowingly and voluntarily stipulates to judgment, should not be bound by

the obligations undertaken in the consent decree." 277 F.3d at 578-79.

As far as nonbankruptcy courts' stipulated nondischargeability judgments go, the *Whitehouse* case was fairly atypical for two reasons. First, the stipulated judgment in *Whitehouse* was entered *post-petition* rather than *pre-petition*. As the *Brown v. Felsen* case illustrates, because nondischargeability is merely a hypothetical issue before the debtor files bankruptcy, the issue is not yet ripe for adjudication in pre-petition litigation. Second, the nondischargeabilty ground at issue in *Whitehouse* was one on which the bankruptcy courts do *not* have exclusive jurisdiction, whereas the most commonly invoked discharge exceptions for fraud, defalcation, and intentional torts under Code § 523(a)(2), (4) & (6) *are* within the exclusive jurisdiction of the bankruptcy courts under Code § 523(c)(1). Thus, nonbankruptcy courts are rarely in a position to directly adjudicate nondischargeability issues, and as a result, a stipulated judgment as to nondischargeability from a nonbankruptcy court usually will be effective only to the extent that it has collateral estoppel effect based upon particularized factual findings establishing grounds for nondischargeability of the judgment debt.