No. 01-1418

In The Supreme Court Of The United States

A. ELLIOTT ARCHER AND CAROL A. ARCHER,

Petitioners,

v.

ARLENE L. WARNER,

Respondent.

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

BRIEF OF OHIO AND 29 OTHER STATES AS *AMICUS CURIAE* IN SUPPORT OF PETITIONERS

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INTEREST OF THE AMICI STATES

Ohio and 29 other amici States and Commonwealths write to urge the Court to reverse the judgment of the court of appeals. State and local governments are routinely required to don the mantle of "creditor" and aggressively pursue funds that are owed to the public. In many instances, the debts owed to these governmental entities result from the debtors' fraudulent misconduct involving health care services, consumer sales, and other activities regulated by the government. The Court's decision in this case will affect the States in our role as creditors when we confront debtors who have committed fraud. For the reasons explained below, we believe that the court of appeals erred in siding with the debtor in this case.

As is true in the business world, where many commercial disputes are resolved through settlements, we States often negotiate and settle with companies or individuals who owe money to us. Particularly when the underlying debt is tied to some fraudulent activity on the debtor's part, our ability to seek full recovery of all funds owed to us is critically important for both fiscal and public policy reasons. When we settle with such a debtor and he agrees to pay a set amount to resolve a fraud-related claim, we rightly expect that the debtor will remain obligated to pay that full amount, even if he later files bankruptcy. Congress has said exactly that in the Bankruptcy Code, and unless those provisions are enforced without exception, dishonest debtors who have already fleeced us or our citizens once may well be tempted to try to dodge their obligations again by settling their debts and then seeking to discharge them in bankruptcy. The amici States have a strong interest in protecting our citizens and our own treasuries from that outcome.

In holding otherwise, the court of appeals has established an environment that discourages creditors from settling fraud-related claims, for those creditors may well fear that the agreed-upon amount owed by the debtor will be discharged in a later bankruptcy filing. When fewer cases settle in this area, litigation expenses for the States and other creditors naturally increase. And the Fourth Circuit's reading of the Bankruptcy Code forces the States and other creditors who negotiate settlements involving fraud-related debts to do so with an eye toward each debtor's future financial wherewithal and possible plans to file bankruptcy, even though Congress surely intended to eliminate that concern for creditors.

SUMMARY OF ARGUMENT

The statutory rights afforded to victims of fraud trump those available to dishonest debtors seeking discharge through bankruptcy. By reversing the judgment below, this Court will confirm the validity of out-of-court settlements as efficient instruments that fully protect the rights of defrauded creditors, even when those debtors who owe money to the creditors file bankruptcy. States and other creditors who have settled claims involving frauds committed by debtors have long relied on the Bankruptcy Code's promise that those fraud-related debts are not dischargeable in bankruptcy. That reliance deserves respect, not only because it rightly rests on the words of the Code itself, but also because the public policy concerns that underlie those words are important. Congress has sensibly said that one who defrauds his creditors must remain liable for paying them back – even if the debtor later files bankruptcy – and those words and that policy deserve the teeth that Congress intended.

In light of Congress's policy judgment in this area, courts should eliminate that special treatment for defrauded creditors only upon a clear showing that the creditor-victim has knowingly and intentionally waived that right. Where a settlement does not reflect such a waiver on its face, bankruptcy courts should permit creditors to show that the debtor's fraudulent conduct gave rise to the original debt, and then the agreed-upon amount of that debt reflected in the parties' settlement agreement should be treated as non-dischargeable obligation of the debtor in the bankruptcy court. The Fourth Circuit's approach short-circuits that process, improperly allowing a debtor to erase any connection between his past fraud and the related obligation to his creditor without any showing that the creditor knowingly agreed to waive the special protections that Congress has created for fraud victims.

Both in our role as bill collectors for the States and in our role as advocates for consumers, we Attorneys General rely on those Bankruptcy Code protections that treat as non-dischargeable any fraud-related debts. By reversing the circuit court's judgment, this Court will promote an environment that encourages parties to seek private settlements for debts owed, while still preserving the kind of bankruptcy-court protections for defrauded creditors that Congress intended.

ARGUMENT

I. The Decision Below Conflicts With The Letter And Spirit Of The Bankruptcy Code.

Because 11 U.S.C. 523(a)(2)(A) in the Bankruptcy Code says that a debt obtained by false pretenses or fraud is not dischargeable, bankruptcy courts must examine each debt to make certain that only the "honest but unfortunate debtor," is given the "fresh start" that the Bankruptcy Code allows. *Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934). Yet the court below said that a debt tied to fraudulent conduct *is* dischargeable if (1) the debtor and the creditor have settled on a new amount that the debtor should pay to resolve his obligation, and then (2) the debtor files bankruptcy.

If that approach is correct, then "through the alchemy of a settlement agreement, a fraudulent debtor may transform himself into a non-fraudulent one, and thereby immunize himself from the strictures of § 523(a)(2)." *United States v. Spicer*, 57 F.3d 1152, 1155 (D.C. Cir. 1995) (criticizing the approach that has now been adopted by the court below), *cert. denied*, 516 U.S. 1043 (1996). Congress has said no such thing, and that outcome improperly rewards the very debtors whom Congress has sensibly chosen to distinguish from the "honest but unfortunate" few whose debts can be forgiven in bankruptcy.

As this Court has said, the Bankruptcy Code's "central purpose . . . is to provide a procedure by which certain insolvent debtors can reorder their affairs, make peace with their creditors, and 'enjoy a new opportunity in life and a clear field for future efforts, unhampered by the pressure and discouragement of preexisting debt.'" *Grogan v. Garner*, 498 U.S. 279, 286 (1991) (quoting *Local Loan Co.*, 292 U.S. at 244). But not all debtors are treated alike in the Code, and Congress has appropriately chosen to exempt some debts from discharge based on the circumstances that gave rise to the debt. Debts that cannot be avoided in bankruptcy include student loans, taxes and child support obligations, along with the kind of fraud-related debt that is at issue in this case. See 11 U.S.C. 523(a).

When analyzing Section 523(a), this Court has consistently taken a position that sharply contrasts with the approach adopted by the court below. The Court has explained that the Bankruptcy Code "has long prohibited debtors from discharging liabilities incurred on account of their fraud, embodying a basic policy animating the Code of affording relief to only an honest but unfortunate debtor."

Cohen v. De La Cruz, 523 U.S. 213, 217 (1998) (citation and quotations omitted). And the Court has said that "it is unlikely that Congress . . . would have favored the interest in giving a perpetrator of fraud a fresh start over the interest of protecting victims of fraud." *Grogan*, 498 U.S. at 287.

Congress has also reserved to the bankruptcy courts the power to determine whether a particular debt fits within the discharge exception for fraud. As Professor Charles Seligson, speaking for the National Bankruptcy Conference, said when key provisions of the Code were before the Congress for adoption:

> [O]ne of the strongest arguments in support of the bill is that . . . a single court; to wit, the bankruptcy court, will be able to pass upon the question of dischargeability of a particular claim and it will be able to develop an expertise in resolving the problem in particular cases.

H.R. Rep. No. 91-1502 (1970), reprinted in 1970 U.S.C.C.A.N. 4156, 4160.

The Fourth Circuit's analysis, however, turns the whole process of careful bankruptcy-court scrutiny on its head. The court of appeals allowed the debtor in this case to argue that a settlement agreement conclusively demonstrates the creditor's abandonment of the Code's protections for the victims of fraud, even in the absence of any showing that the parties actually considered or agreed on the effect that the settlement would have on a later bankruptcy proceeding. That approach is not consistent with Congress's intent or with the approach followed by this Court in past cases.

In *Brown v. Felsen*, 442 U.S. 127 (1979), the Court examined the impact on a bankruptcy filing of an earlier state-court case in which the creditor had filed a complaint alleging fraud against the debtor. The parties settled the case, but the state-court consent order reflecting their agreement did not include any findings regarding the fraud allegations. Even so, this Court held that the state-court judgment did not bar a bankruptcy court from later taking the necessary evidence to determine whether the debt was fraud-related (and therefore non-dischargeable). The Court explained that forcing the bankruptcy courts to give res judicata effect to such a prior state-court judgment (and the limited record on which it was based) "would undercut a statutory policy in favor of resolving Section 17[1] questions in bankruptcy court, and would force state courts to decide these questions at a stage when they are not directly in issue and neither party has full incentive to litigate them." *Brown*, 442 U.S. at 134.

The only notable difference between this case and *Brown* is that the agreement in that case was made part of a consent judgment in the state court. That distinction is not one that should lead to a different outcome for the debtor in this case. Just as the Court said in *Brown* that the state-court judgment in that case did not prevent a bankruptcy court from later considering bankruptcy discharge issues and exceptions left unmentioned in the parties' state-court settlement, so the Court should hold in this case that a bankruptcy court may still examine the role that fraud may have played in the original dealings between the debtor and the creditor, even though the parties' settlement agreement does not mention fraud.

Congress has established the bankruptcy courts as the expert venues for resolving the often-complex questions that arise when creditors hold competing claims to a limited asset pool. And Congress has spelled out for those courts the

[1] Section 17 has been replaced and is analogous to Section 523(a) of the Bankruptcy Code.

types of debts that may be discharged and those that may not. The judgment below undercuts the entire thrust of Congress's handiwork in this area.

Just as a number of lower courts have held that creditors are not allowed to convince debtors to sign advance agreements waiving the *benefits* of bankruptcy, see, e.g., *Klingman v. Levinson*, 831 F.2d 1292, 1296 n.3 (7th Cir. 1987) (while "a debtor may stipulate to the underlying facts that the bankruptcy court must examine to determine whether a debt is dischargeable," the debtor "may not contract away the right to a discharge in bankruptcy"); *In re Madison*, 184 B.R. 686, 690 (Bankr. E.D. Pa. 1995) ("an agreement not to file bankruptcy is unenforceable"), so debtors who have committed fraud ought not be permitted to evade so easily the *costs* of their conduct either. Congress has attached a particular cost to that conduct by taking away the debtor's option of avoiding the debt in bankruptcy. That congressional intent ought to be carried out in this case and others where the debtor's own fraud gave rise to the debt initially.

At a minimum, courts should not lightly presume that a victimized creditor who has settled a case has willingly agreed to give away his right to be protected against the effect of a debtor's bankruptcy. Instead, the burden should be left on the debtor to prove that the parties actually agreed to that result. If the debtor cannot meet that burden, then, just as in *Brown*, the bankruptcy court should be free to uncover the actual facts surrounding the original debt.

II. The Fourth Circuit's Decision Improperly Eliminates A Key Statutory Protection For Victims Of Fraud.

Governmental entities, businesses and private citizens alike routinely resolve disputes through out-of-court settlements. Those settlements typically cut litigation expenses for all parties involved, and also eliminate the need for trial or appellate judges to spend their time and energies on disputes that would otherwise end up before them.

And settlements play an important role in the resolution of the particular kind of claim at issue in this case: a claim that a debtor owes a creditor money because of the debtor's fraudulent conduct. Private individuals – like the petitioners here – as well as corporations may be the victims of fraud in a wide range of transactions, including those involving securities or contracts or consumer sales. State and local governments are surely not exempt from similar scams, and state Attorneys General in particular frequently pursue claims on behalf of their States or on behalf of residents who have been victimized by fraud and who are owed money as a result. Many times those individual fraud victims are unaware of their rights as creditors and may not be represented by counsel, while the debtors who have defrauded them may well be quite familiar with any available legal loopholes open to them.

The States have two key concerns that this case will affect. First, the States – like other creditors – are currently protected by a number of provisions in Section 523 of the Bankruptcy Code. A win for the respondent debtor in this case will undermine those protections across-the-board in ways that Congress did not intend, adversely affecting state and local governments in a variety of situations.

We may enter out-of-court settlements for tax payments, child support obligations, student loan repayments and other claims. All of these are currently non-dischargeable debts if the debtor later files for bankruptcy, and that status should be preserved for those debts, just as Congress intended.

The fraud exception at issue in this case, in particular, is a critical one for the States. We routinely investigate fraud in a wide range of settings, including Medicaid fraud, workers' compensation fraud, consumer fraud, or fraud involving government contracts. When we settle any of those cases with the defrauding debtor, we rely on the Code's language describing fraud-related debts as non-dischargeable, and the assurance we take from the Code – that any settlement amount that we agree to accept from such a debtor will not be wiped out if the debtor later files bankruptcy – is an important factor in our decision to settle those cases. If that assurance is eliminated, the value of settlement plunges for us and other creditors, for then clearly we would be much better off to steer clear of settlements in any cases involving debts linked to fraud. That outcome will drive up litigation expenses and will further burden our state court systems as we pursue ordinary collection remedies for the full amount of the original debts.

To be sure, even if the respondent debtor wins this case, governments and other creditors may be able to include language in future settlement agreements that will reserve the creditor's right to present in each bankruptcy case any relevant evidence pointing to the fraud-related origin of the debt, all in the hope that a bankruptcy court will then treat the settlement amount as a non-dischargeable debt if the debtor later files bankruptcy. But the exact wording of such a clause would be subject to negotiation and then subject to judicial scrutiny by the bankruptcy court in order to make sure that the creditor had not overreached by asking the debtor to waive its right to discharge debts. And given the large number of state and local agencies that act as creditors in this country – many of which have scarce resources available to cover legal expenses – the odds are good that particular magic words necessary to protect us will be omitted or misstated in at least some settlement agreements if we are forced to operate in the kind of legal regime advocated by the respondent in this case.

Placing on creditors the obligation to include in each settlement agreement the kind of airtight language that will preserve non-dischargeable status for fraud-related debts will undermine the value of settlements as a low-cost alternative to litigation. The essence of *Brown v. Felsen* is that parties should not be required to focus on future bankruptcy issues before they actually arise. The same principle applies here as well.

Our second key concern in this case focuses on our obligation to protect resident citizens in their role as consumers. Each year, many of them are the victims of fraud in their day-to-day dealings with the sellers of goods and services. While many of those victims turn to state Attorneys General for help in resolving claims of shoddy workmanship or misleading promises in advertising materials or in contracts, surely many more victims try to cope with their fraud-related dilemmas on their own.

Just as we States do, a consumer who has been defrauded may settle with the defrauder for repayment of lost money. If the debtor then declares bankruptcy, however, and the debt owed to the consumer becomes dischargeable, the consumer comes out the loser. That outcome is not what Congress intended when it designated certain kinds of debts as non-dischargeable in bankruptcy.

And certainly the average consumer who does settle a fraud-related claim is unlikely to include language in the settlement agreement protecting his ability to later present evidence about the underlying fraudulent nature of the debt to a bankruptcy court should the defrauder file bankruptcy. Congress's words in Section 523 evidence an intent to help the victims of fraud by designating debts owed to them as non-dischargeable, yet the approach adopted by the court of appeals will give to the perpetrators of fraud a tantalizing incentive to settle any of their fraud-related debts just before filing bankruptcy. Many unsuspecting fraud victims will then be stripped of the special protection that Congress intended to give them, just as they were first stripped of their assets by the perpetrator of the original fraud. That result is inconsistent with Congress's effort in Section 523(a) to penalize – not reward – the clever or slipshod debtor who falsely represents his goods or services to unsuspecting consumers.

CONCLUSION

The judgment of the court of appeals should be reversed.

Respectfully submitted,

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