APPENDIX A

UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

IN RE LEONARD L. WARNER AND ARLENE L. WARNER,
Debtors.

A. ELLIOTT ARCHER; CAROL A. ARCHER,
Plaintiffs-Appellants,
v.

ARLENE L. WARNER,
Defendant-Appellee,
AND

LEONARD L. WARNER,
Defendant.

No. 00-2525.

Argued Sept. 27, 2001
Decided March 8, 2002

[--- F.3d ---, 2002 WL 369926]

OPINION

WIDENER, Circuit Judge.

Elliot and Carol Archer appeal from the district court's order affirming the bankruptcy court. The district court held that Arlene Warner's affirmative defense of settlement in a state suit, involving the same facts upon which rest the non-dischargeability claim at issue here, created a novation substituting a contract debt which was dischargeable for the tort claims which arguably were not. For the following reasons, we affirm.

I.

On May 22, 1992, Warner Manufacturing, Inc. and Leonard L. and Arlene Warner, his wife, the owners thereof, sold the corporate assets of Warner Manufacturing to a corporation formed by the Archers for a total of $685,000.[1] In late 1992, the Archers filed suit in Superior Court of Guilford County, North Carolina against Leonard Warner and Warner Manufacturing for fraudulent misrepresentation and like misconduct arising out of the sale. An amended complaint, filed in the state court in March 1994, asserted fraud, misrepresentation, conspiracy, and fraudulent conveyance, among other claims, and added Arlene Warner and two other parties as named defendants. On May 8, 1995, the Archers again amended their complaint to include intentional and negligent infliction of emotional distress, and asserted that they had suffered mental and emotional distress, pain and suffering, and loss of enjoyment of life as a consequence of the Warners' alleged acts. Three days later, on May 11, after extensive pre-trial discovery, the parties settled the state court litigation.

The settlement consisted of an agreement, an addendum to the agreement, two releases, a promissory note, and two deeds of trust. The settlement agreement provided that the Archers would receive $300,000, consisting of a $200,000 cash payment which was paid, and a $100,000 promissory note to be paid in two installments over the next year. The agreement stated that the willingness of the Archers to resolve the case stemmed from both the non-taxable nature of a part of the consideration for the settlement and the

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1 The assets of Warner Manufacturing sold for $610,000; there was included in the transaction a $70,000 consulting fee to Leonard Warner and a $5000 non-competition agreement.

numerous defenses asserted by the Warners. An addendum to the settlement agreement specified that the agreement would be declared null and void if the criminal charges pending against Leonard Warner were not dismissed by the State of North Carolina. The promissory note, from Leonard and Arlene Warner and Hosiery Industries, Inc., was secured by two deeds of trust--one on the Warners' home and another on business property owned by Hosiery Industries, Inc. The Warners received both a general and mutual release of all pending and future claims by the Archers. Specifically, the general release stated the Archers "do hereby release and forever discharge the ... [Warners] from the beginning of the world to the date of this release arising out of or relating to the matter of the litigation in Guilford County Superior Court, File No. 92-CVS-7777...." In both releases, neither party admitted liability or wrongdoing; moreover, specific clauses stated that the payment of money should not be construed as an admission of liability. There was no mention of bankruptcy in the settlement package.

On November 11, 1995, the first payment on the $100,000 promissory note became due. When the Warners defaulted on this payment, the Archers sued in Superior Court in Guilford County on December 4, 1995.[2] The suit was for collection on the note. On February 5, 1996, while this collection suit was still pending, Leonard and Arlene Warner filed for relief under Chapter 13 of the Bankruptcy Code, which was converted to a case under Chapter 7 on October 29, 1996. The present dispute originated on January 29, 1997 when the Archers filed an adversary proceeding in the United States Bankruptcy Court for the Middle District of North Carolina, seeking a judgment for the amount due under the promissory note and a determination that such indebtedness was non- dischargeable under Section 523(a) of

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2 The second payment was due on May 11, 1996. The Warners defaulted on this payment as well, being in bankruptcy.

the Bankruptcy Code, 11 U.S.C. §523(a). As grounds for asserting the non-dischargeability of this indebtedness, the Archers incorporated by reference in the bankruptcy adversary complaint the multiple allegations contained in their suit in the state court.[3] These were the only grounds there stated for asserting non-dischargeability.[4] Defendant

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[3] In the Archers' adversary complaint to determine dischargeability of debt, Section 13 of the complaint states:

> Plaintiffs expressly incorporate by reference the terms and conditions of the Amended Complaint plaintiffs filed against defendants in Guilford County Superior Court, case no. 92-CVS-7777, setting forth causes of action for, among other matters, fraud, misrepresentation, conspiracy to defraud, conspiracy to take plaintiffs' property by false pretenses in violation of criminal statute G.S. § 14-100, and, in general, for deliberate, intentional, willful, wanton, malicious, and wrongful acts of defendants in an elaborate scheme by which defendants took hundreds of thousands of dollars from plaintiffs by false pretenses.

[4] The Archers attempted later to claim fraud-in-the-inducement of the settlement as well. On June 25, 1998 the Archers moved to amend their adversary complaint to show, among other things, that Mrs. Warner had committed fraud when she and her husband induced the Archers to accept the $100,000.00 note. The proposed amended complaint was filed with the motion, but, when the motion came on for hearing, no attorney appeared for either side and the bankruptcy court justifiably denied the motion to amend the complaint, a plaintiff's motion for discovery, and a motion by Arlene Warner for summary judgment. This order was filed October 6, 1998.

On February 2, 1999 the court set the adversary proceeding for trial on June 1, 1999, and on May 27, 1999 the Archers renewed their motion to amend the complaint. The trial having been continued at the instance of the Archers, the pending motions to amend the complaint came on before the bankruptcy court for hearing on June 1, 1999, along with other motions and objections by both the Archers and Mrs. Warner, all of whom were represented by their attorneys at that hearing. The court denied all of the motions and its order filed June 2, 1999 provided as the reasons: "For the reasons stated in open court." Among the motions denied was the renewed motion to amend the complaint. Although the reasons were stated in open court, they are not included in the record in

Arlene Warner denied any misconduct on her part and asserted an affirmative defense of settlement of the original state court suit.[5] She argued that the Archers may not rely

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this case, and we are left to speculate as to what they were. We are asked to decide, in effect, that the bankruptcy court abused its discretion when it did not permit the amendment of the complaint in the adversary proceeding.

A reading of the amended complaint presented to the bankruptcy court on May 27, 1999 does not charge any fact that Mrs. Warner misrepresented to the Archers, unless it be that she and her husband could only borrow or otherwise come up with $200,000.00 of the agreed $300,000.00 settlement, leaving $100,000.00 to be paid under the note, as has been mentioned before. While the Archers now argue that the reason the note is not dischargeable in bankruptcy is because Mrs. Archer intended at the outset not to pay it, that reason was not presented to the bankruptcy judge in the amended complaint at the hearing on June 1, 1999 resulting in the June 2, 1999 order.

While the amended complaint contains many conclusions charging fraudulent or like conduct against Mrs. Warner, a reading of that paper does not contain sufficient factual allegations for us to conclude that the bankruptcy court abused its discretion when it did not permit the amendment. In that respect, we note that the prayer of the amended complaint includes the following:

> 5. That in the alternative, if defendant Arlene Warner's obligation to plaintiffs is determined to be discharged in Bankruptcy, that plaintiffs be declared released from any agreement and obligation to take no action to cause criminal proceedings to be brought against Arlene Warner or her son, Stuart Warner.

That aspect of the prayer alone would seem to be sufficient reason to justify the action of the bankruptcy court in denying the sought for amendment of the complaint, but, again, since the record does not disclose the reasons, we decline to find the bankruptcy court abused its discretion in its denial of the motion to amend the complaint, and do not speculate as to its reasons.

5 Arlene Warner contested this issue of non-dischargeability in the bankruptcy court. We are told her husband, Leonard Warner, did not. No issue with respect to the liability of Leonard Warner is before this court on appeal, and, again, we are told that the Warners are divorced.

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*.

On August 24, 1999 the bankruptcy court had ordered the trial bifurcated, first hearing issues on what it called the affirmative defense.[6] On August 26, 1999 the case was tried on the affirmative defense of the dischargeability action. The bankruptcy court decided in favor of Mrs. Warner, upholding her affirmative defense. The Archers appealed this decision contending that the bankruptcy court misinterpreted the exception to dischargeability under 11 U.S.C. § 523(a)(2)(A). The district court affirmed the bankruptcy court's decision. It concluded that the releases and settlement agreement created a novation, substituting a dischargeable contract debt for a fraud-based tort claim which may not have been dischargeable. The district court continued by holding that the argument of fraud-in-the-inducement of the settlement agreement was not properly before the court because such claim was not presented to or decided by the bankruptcy court. Nevertheless, the district court commented that any successful fraud-in-the-inducement contention must establish that Mrs. Warner planned all along to file bankruptcy to escape her contractual settlement commitments with the Archers. The district court doubted such a plan because the Warners had ready paid $200,000 in cash pursuant to the settlement agreement, and had given deeds of trust on real estate to secure the payment of the note as well. In any event, because of the novation which we affirm, see *infra*, and our

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[6] As previously noted, the Archers' motion to amend their complaint was last denied by the bankruptcy court on June 2, 1999. Whether the bankruptcy court has foreclosed such a claim is a question we do not decide. The bankruptcy court called for trial the issue presented here, which was whether the settlement agreement effected a novation of the dischargeability claim which might have existed into a claim upon the settlement which does exist. No evidence was offered in the bankruptcy court as to fraudulently inducing the settlement.

opinion that the Archers have not shown an abuse of discretion by the bankruptcy court in its refusal to permit the amendment to the adversary complaint, that is a contention upon which we express no opinion.

II.

We have jurisdiction to hear this case under 28 U.S.C. § 158(d). This court "reviews the judgment of a district court sitting in review of a bankruptcy court de novo, applying the same standards of review that were applied in the district court." *In Re Biondo*, 180 F.3d 126, 130 (4th Cir.1999).[7] Specifically, we review the factual findings of the bankruptcy court for clear error, while we review questions of law de novo. *In Re Biondo*, 180 F.3d at 130.

The pertinent bankruptcy code, 11 U.S.C. § 523, provides:

> § 523. Exceptions to discharge
>
> (a) A discharge under section 727, 1141, 1228(a), 1228(b) or 1328(b) of this title does not discharge an individual debtor from any debt....
>
> (2) for money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained by--
>
> (A) false pretenses, a false representation, or actual fraud, other than a statement respecting debtor's or an insider's financial condition; ...
>
> (6) for willful and malicious injury by the debtor to another entity or to the property of another entity....

The issue we address is whether the district court erred in determining that a prepetition settlement of claims involving the same claims pursued here, alleged fraud or intentional tort, extinguished the Archers' subsequent non-

[7] We note in passing that the Archers do not depend on *Biondo*.

dischargeability claims under Section 523(a)(2)(A) when Mrs. Warner filed for bankruptcy relief without having paid the settlement promissory note. As noted by the district court, there is a split among the circuits concerning this issue. Under one line of cases, a settlement agreement does not distinguish a dischargeability claim under Section 523(a). See *United States v. Spicer*, 57 F.3d 1152 (D.C.Cir.1995); *Greenberg v. Schools*, 711 F.2d 152 (11th Cir.1983). According to this line of cases, examining the underlying fraudulent allegations leading to the settlement agreement best effectuates Congressional policy by its construction of the statutes as not permitting the discharge of debts that Congress intended to survive bankruptcy. *Greenberg v. Schools*, 711 F.2d 152 (11th Cir.1983). The opposing line of cases favors the basic principle of encouraging settlements by way of freedom to enter into settlement agreements, regardless of the nature of the claim subject to the settlement agreement. See *In re Fischer*, 116 F.3d 388 (9th Cir.1997); *In re West*, 22 F.3d 775 (7th Cir.1994); *Maryland Casualty Co. v. Cushing*, 171 F.2d 257 (7th Cir.1948). Under this theory, parties willing to settle disputes over fraud, misrepresentation, or like tort claims may do so by way of settlement through contract, and such contractual claims are then dischargeable in bankruptcy. Otherwise, the incentive to settle is gone.

We agree with the district court and the bankruptcy court that the better reasoned decisions are those of the Seventh and Ninth Circuits rather than those of the District of Columbia and Eleventh Circuits. So we follow *West*, *Md. Casualty*, and *Fischer*. We are of opinion that Congress did not intend that 11 U.S.C. § 523(a) be construed, as a reversal here would require, so as to discourage the settlement of claims because they might be subject to freedom from discharge under § 523(a).

When following the novation theory,[8] the terms of the settlement should be examined to determine whether the non-dischargeability claims under Section 523(a)(2)(A) were released. The Archers would have us hold that courts must determine whether the underlying factual basis for the settlement agreement consisted of fraud; however, under the novation theory, courts need only address the validity and completeness of the bargained for agreement and release. We review these factual issues for clear error.

The settlement package, consisting of the settlement agreement with addendum, two releases, a promissory note, and two deeds of trust, completely released Arlene Warner from potential non-dischargeability claims under Section 523(a)(2)(A). The settlement agreement referred explicitly to the general and mutual releases. The general release further announced the complete waiver of all pending and future related personal claims against Arlene Warner. It provides that 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 and deeds of trust executed contemporaneously herewith.

This release continued by specifying the claims released:

> The payment of the sum of $300,000 ... is paid to [the Archers] in settlement of their personal claims for emotional distress/personal-injury-type damages they claim to have suffered for the torts of fraud, intentional misrepresentation, intentional infliction

[8] While novation is sometimes interpreted to mean the replacement of a third party to an existing contract, see *Black's Law Dictionary*, 7th Ed., 1999, p. 1091, we, like the Ninth Circuit, use the term in the context of § 523(a)(2)(A) to express the substitution of a contract claim for a tort claim through a settlement agreement, the Seventh Circuit use.

> of emotional distress, and negligent infliction of emotional distress. The parties further acknowledge that all sums set forth above constitute payment for claims of damages resulting from personal injuries or sickness or mental and emotional distress in a case involving prosecution of a legal suit or action based upon tort or torttype rights....

As noted in *West*, "A promissory note does not discharge the underlying obligation unless the parties expressly release the old and substitute the new." *West*, 22 F.3d at 778. The settlement agreement and promissory note here, coupled with the broad language of the release, completely addressed and released each and every underlying state law claim.

We therefore follow *Fischer*, *West*, and *Md. Casualty* and affirm the judgment of the district court that the prepetition settlement of claims involving alleged fraud and intentional tort extinguished the Archers' subsequent non-dischargeability claim under Section 523(a) when Mrs. Warner filed for bankruptcy relief without having paid the entire amount of the settlement.

The judgment of the district court is accordingly

AFFIRMED.

TRAXLER, Circuit Judge, dissenting.

A unanimous Supreme Court reminded us as recently as four years ago that "[t]he Bankruptcy Code has long prohibited debtors from discharging liabilities incurred on account of their fraud, embodying a basic policy animating the Code of affording relief only to an 'honest but unfortunate debtor.' " *Cohen v. de la Cruz*, 523 U.S. 213, 217, 118 S.Ct. 1212, 140 L.Ed.2d 341 (1998) (quoting *Grogan v. Garner*, 498 U.S. 279, 287, 111 S.Ct. 654, 112 L.Ed.2d 755 (1991)). To this end, "Congress intended the fullest possible inquiry" into the nature of debts for purposes of determining dischargeability. *Brown v. Felsen*, 442 U.S. 127, 138, 99 S.Ct. 2205, 60 L.Ed.2d 767 (1979). Because I believe the approach employed by the D.C. and Eleventh Circuits in *United States v. Spicer*, 57 F.3d 1152 (D.C.Cir.1995), and *Greenberg v. Schools*, 711 F.2d 152 (11th Cir .1983) (per curiam), ultimately accomplishes the congressionally enacted policy objective embodied in the nondischargeability provisions, I respectfully dissent.

I.

There are two competing views to the main issue in this case and both have much to commend them. The bankruptcy court adopted the approach of the Ninth and Seventh Circuits reflected in *In re West*, 22 F.3d 775 (7th Cir.1994), and *Key Bar Invs., Inc. v. Fischer* (*In re Fischer*), 116 F.3d 388 (9th Cir.1997) (per curiam). The analysis employed in those cases is best illustrated by the test articulated by the Ninth Circuit in *Fischer*: "[I]f it is shown that the [promissory] note, by express agreement is given and received, as a discharge of the original obligation or tort action, then the execution of the note extinguishes the tort action and it would be error for the court to look behind the note." *Fischer*, 116 F.3d at 390 (internal quotation marks omitted); *accord West*, 22 F.3d at 778 ("[I]f it is shown that the [promissory] note [that was executed pursuant to the settlement] was given and received as payment or waiver of the original debt and the parties agreed that the note was to substitute a new obligation for the old, the note fully discharges the original debt, and the nondischargeability of the original debt does not affect the dischargeability of the obligation under the note."). 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.

The competing approach adopted by the D.C. and Eleventh Circuits in *Spicer* and *Greenberg* can be quickly illustrated by examining *Spicer*. In that case, John Spicer had been convicted of one count of interstate transportation of money obtained by fraud from the United States Department of Housing and Urban Development and had thereafter settled the government's multiple civil claims against him. In accord with the civil settlement agreement, Spicer executed two promissory notes and the government expressly released its civil claims against him. Spicer later filed for bankruptcy protection and, relying on *West*, sought to have the promissory notes discharged. Addressing *West* directly, the D.C. Circuit declared that it could not "agree with a rule under which, 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)(A)." *Spicer*, 57 F.3d at 1155. The court found the government's release of the underlying tort action immaterial, declaring that "a fraudulent debtor may not escape nondischargeability, imposed as a matter of public policy by Congress ..., merely by altering the *form* of his debt through a settlement agreement." *Id.* at 1156. Accordingly, the court affirmed the bankruptcy court's holding that the promissory notes executed by Spicer were not dischargeable. *Id.* at 1157. Thus, simply stated, the *Spicer* approach is a policy-based approach intended to effectuate the considered judgment of Congress.

II.

The Archers urge us to adopt the *Spicer* approach and allow them the opportunity to prove in bankruptcy court that Arlene Warner committed fraud against them and that the promissory note executed as part of the settlement of the state-court tort action is therefore nondischargeable under § 523(a)(2)(A). In my judgment, Supreme Court precedent strongly suggests that the *Spicer* approach is the correct one.

In 1979, for example, the Supreme Court decided *Brown*. In that case, G. Garvin Brown had been guarantor of a loan that financed Mark Paul Felsen's business. When the creditor instituted a collection action against Brown and Felsen, Brown filed a counterclaim against Felsen alleging that Felsen had induced Brown to sign the guarantee "by misrepresentations and non-disclosures of material facts." *Brown*, 442 U.S. at 128 (internal quotation marks omitted). The suit settled and was reduced to a consent judgment indicating that Brown should have judgment against Felsen but not indicating the cause of action upon which the liability was based or whether Felsen had in fact engaged in fraud. Felsen subsequently filed for bankruptcy, and Brown sought to challenge in bankruptcy court the dischargeability of Felsen's debt to him. Felsen argued that because the state-court suit had been reduced to a consent judgment and the documents evidencing that judgment did not result in a finding that he had in fact committed fraud, res judicata barred further inquiry into the nature of the debts. Gleaning from the legislative history of the Bankruptcy Act "[s]ome indication that Congress intended the fullest possible inquiry" into the true nature of debts for purposes of determining dischargeability, the Supreme Court unanimously rejected that argument. *Id.* at 138. After "careful inquiry," the Court concluded that "the policies of the Bankruptcy Act" would best be served by allowing Brown to "submit[ ] additional evidence to prove his case." *Id.* at 132.

Twelve years after *Brown*, the Supreme Court was asked in *Grogan* to resolve a circuit split on the question of whether, in bankruptcy court, a creditor was required to prove the nondischargeability of his claim by a preponderance of the evidence or by clear and convincing evidence. The Court unanimously found that the preponderance standard best reflected the "congressional decision to exclude from the general policy of discharge certain categories of debts--such as ... liabilities for fraud," and the Court therefore held that a creditor need only prove that his claim was nondischargeable under the preponderance standard. *Grogan*, 498 U.S. at 287. "We think it unlikely," the Court declared, "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." *Id.*

And finally, in 1998, in *Cohen*, a unanimous Supreme Court yet again stressed the importance of reinforcing the congressional policy objective underlying the nondischargeability provisions. In *Cohen*, the Court decided that a treble damages award that was imposed as punishment for a state-court defendant's fraudulent conduct was non-dischargeable under the fraud exception to dischargeability, rejecting the debtor's argument that only an amount equal to the actual value obtained by fraud should be nondischargeable. *Cohen*, 523 U.S. at 219. In support of its decision, the Court cited "the historical pedigree of the fraud exception, and the general policy underlying the exceptions to discharge." *Id.* at 223.

Thus, the message delivered by a unanimous Supreme Court on three separate occasions has been clear. In deciding cases dealing with the fraud exceptions to dischargeability, courts should effectuate congressional policy objectives by conducting the fullest possible inquiry into the nature of the debt and limiting relief to the honest but unfortunate debtor. The *Spicer* approach is squarely grounded in these policy interests.

Under any other approach, a defendant can completely immunize himself from § 523 by simply settling any fraud claims against him with a promise to pay, having the plaintiff release the underlying tort action as part of the settlement, and then filing for bankruptcy. The acceptance of the defendant's promise to make payment should not prevent the plaintiff, upon a default by the defendant and subsequent filing of bankruptcy, from showing the bankruptcy court that the debt had its genesis in fraud. If, as the Supreme Court has declared, "the mere fact that a conscientious creditor has previously reduced his claim to judgment should not bar further inquiry into the true nature of the debt," *Brown*, 442 U .S. at 138, then I see no reason why the mere fact that a conscientious creditor has previously reduced his claim to settlement should bar such an inquiry. *See Ed Schory & Sons, Inc. v. Francis* (*In re Francis*), 226 B.R. 385, 391 (B.A.P. 6th Cir.1998) (choosing to "follow [ ] *Spicer* because *Brown v. Felsen* compels the *Spicer* result"); *see also Giaimo v. Detrano* (*In re Detrano*), 266 B.R. 282, 288 (E.D.N.Y.2001) (finding *Brown* "[i]nstructive"). Moreover, because the nondischargeability provisions of the Bankruptcy Code evidence a considered congressional policy to favor "the interest in protecting victims of fraud" over "the interest in giving perpetrators of fraud a fresh start," *Grogan*, 498 U.S. at 287, and because the Supreme Court has so strongly and unwaveringly signalled through three uninamimous opinions over the course of twenty years that that policy objective is to be jealously protected, I would adopt the *Spicer* approach.* *Cf. Foley & Lardner v. Biondo* (*In re Biondo*), 180 F.3d 126, 130 (4th Cir.1999) (noting the importance of "ensuring that perpetrators of fraud are not allowed to hide behind the skirts of the Bankruptcy Code").

III.

For these reasons, I would elevate substance over form and allow the Archers to offer such proof as they might have to show that Arlene Warner's debt resulted from a fraud perpetrated upon them. Therefore, I respectfully dissent.

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* I do not view the settlement documents as forbidding the Archers from proving in bankruptcy court the nondischargeability of the debt because, among other things, the releases specifically excepted the Warners' obligations under the promissory note and deeds of trust, (J.A. 45, 48), which I would interpret as permitting a full and fair hearing on the dischargeability of the debt in bankruptcy court.

APPENDIX B

UNITED STATES DISTRICT COURT
MIDDLE DISTRICT OF NORTH CAROLINA
GREENSBORO DIVISION

IN RE:

LEONARD L. WARNER and ARLENE L. WARNER,
Debtors.

Adversary Proceeding No. A-97-2003
Bankruptcy Proceeding No. B-96-10373 C-7G

A. ELLIOTT ARCHER and CAROL A. ARCHER,
Appellants,

v.

ARLENE L. WARNER,
Appellee.

Civil Action No. 1:99CV00924

[FILED: Sept. 27, 2000]

MEMORANDUM OPINION

BULLOCK, District Judge

This case comes before the court on appeal, pursuant to 28 U.S.C. § 158(a), from an order of the United States Bankruptcy Court for the Middle District of North Carolina. Appellants, A. Elliott Archer and Carol A. Archer (the "Archers"), appeal an order of the bankruptcy court entering judgment in favor of Appellee, Arlene L. Warner ("Warner"), on the Archers' **[Page 2]** non-dischargeability action under Section 523(a)(2) of the Bankruptcy Code. For the following reasons, the court will affirm the order of the bankruptcy court.

FACTS

Because the facts are fully set out in the bankruptcy court's memorandum opinion, a brief summary will suffice.

On May 22, 1992, a corporation formed by the Archers purchased the assets of a company known as Warner Manufacturing, Inc., for the price of $610,000.00 plus payment of a consulting fee to Leonard L Warner in the amount of $70,000.00 and the sum of $5,000.00 for a related non-compete agreement. In late 1992, the Archers instituted a suit in the General Court of Justice, Superior Court Division, Guilford County, North Carolina, against Warner Manufacturing, Inc., and Leonard Warner alleging fraudulent misrepresentation arising out of the asset-purchase agreement. Thereafter, in March 1994, the Archers filed an amended complaint, adding Arlene Warner and two other parties as named defendants and asserting claims for breach of contract, fraud and misrepresentation, conspiracy, fraudulent conveyance, and unfair and deceptive trade practices. The Archers also sought to pierce the corporate veil of Warner Manufacturing, **[Page 3]** Inc., and to establish a constructive trust. The amended complaint specifically alleges that Arlene Warner was involved in the fraud and other misconduct. On May 8, 1995, the Archers amended their complaint again to designate their second claim as being one for fraud, misrepresentation, and intentional and negligent infliction of emotional distress.

On or about May 11, 1995, after extensive pre-trial discovery, the parties were able to reach a settlement. Pursuant to the written settlement agreement, the Archers were to receive the sum of $300,000.00, consisting of a cash payment of $200,000.00 and a promissory note for the principal sum of $100,000.00. The Archers were paid the

$200,000.00 in cash and the remainder as a $100,000.00 promissory note from Leonard L. Warner, Arlene Warner, and Hosiery Industries, Inc. The Archers also received two deeds of trust securing the promissory note. Pursuant to the settlement agreement, the Archers executed and delivered to Arlene Warner a general release and a mutual release which Arlene Warner similarly executed. On May 15, 1995, the Archers dismissed with prejudice the state court suit against Arlene Warner.

The $100,000.00 promissory note which the Archers received in the settlement was payable in two payments, the first due on November 11, 1995, and the second due on May 11, 1996. When the **[Page 4]** November payment was not made, the Archers brought suit on the promissory note in the General Court of Justice, Superior Court Division, Guilford County, North Carolina, on December 4, 1995. This suit for collection on the promissory note was still pending when Arlene Warner filed for relief under Chapter 13 of the Bankruptcy Code on February 5, 1996. Several months later, Arlene Warner's Chapter 13 case was converted to Chapter 7. Thereafter, the Archers filed this proceeding in United States Bankruptcy Court for the Middle District of North Carolina on January 29, 1997, seeking a judgment for the amount due under the promissory note and a determination that such indebtedness is non-dischargeable under Section 523(a) of the Bankruptcy Code.

In their complaint in the bankruptcy proceeding, the Archers incorporated by reference the allegations of fraud, misrepresentation, conspiracy and the like from their original state court action against the Warners as grounds for asserting that the indebtedness due under the promissory note was non-dischargeable. Arlene Warner answered these allegations by denying any misconduct on her part and asserting an affirmative defense that the settlement of the original suit was a settlement of a disputed claim and did not constitute an admission of fraud or of liability.

[Page 5] Prior to trial, the bankruptcy court ordered that the trial be bifurcated and that the issues involved in the affirmative defense be tried first. On August 26, 1999, the dischargeability action was called for trial and the bankruptcy court received evidence and heard arguments of the parties. The bankruptcy court concluded that the affirmative defense raised by Arlene Warner should be upheld and that judgment should be entered in her favor. The Archers appeal, contending that the bankruptcy court misinterpreted the exception to dischargeability under Section 523(a)(2)(A) and did not allow them an adequate opportunity to present evidence of fraud in the underlying business transaction or fraud in the inducement of the settlement agreement.

DISCUSSION

The district court "review[s] the bankruptcy court's factual findings for clear error, while . . . review[ing] questions of law de novo." In re K&L Lakeland, Inc., 128 F.3d 203, 206 (4th Cir. 1997). When addressing exceptions to discharge, a district court should "interpret the exceptions narrowly to protect the purpose of providing debtors a fresh start." In re Biondo, 180 F.3d 126, 130 (4th Cir. 1999) (citing Century 21 Balfour Real **[Page 6]** Estate v. Meanna, 16 F.3d 7, 9 (1st Cir. 1994). However, district courts should be "equally concerned with ensuring that perpetrators of fraud are not allowed to hide behind the skirts of the Bankruptcy Code." Id. (citing Cohen v. Cruz, 523 U.S. 213 (1998)).

The issue raised on appeal, as correctly framed by the bankruptcy court, is "whether a prepetition settlement of claims involving alleged fraud and intentional infliction of injury can extinguish the plaintiff's subsequent nondischargeability claim under § 523(a) when the defendant files for bankruptcy relief without having paid the entire amount of the settlement." (Mem. Op. at 6). Section 523(a)(2)(A) of the Bankruptcy Code, excepts from discharge any debt obtained by fraud, false pretenses, or a false representation in writing, other than a false representation concerning the financial condition of the debtor or an insider. See 11 U.S.C. § 523(a)(2)(A). To establish that a debtor engaged in actual fraud making the obligation non-dischargeable under Section 523(a)(2)(A), the creditor must prove four elements: (1) a fraudulent misrepresentation; (2) that induces another to act or refrain from acting; (3) causing harm to the creditor; and (4) the creditor's justifiable reliance on the misrepresentation. See In re Biondo, 180 F.3d at 135.

[Page 7] In the context of a non-dischargeability proceeding brought pursuant to Section 523(a)(2)(A), there presently exists a split of authority as to whether a subsequent promissory note accompanied by a settlement agreement containing a general release executed by the creditor makes an otherwise non-dischargeable debt a dischargeable one. The case law is sharply split on this issue, and the Fourth Circuit offers little guidance. However, an examination of these various non-binding authorities reveals that the bankruptcy court correctly concluded that the settlement agreement and general release created a novation, substituting a contract debt for a debt arising from tort, and that the debt was therefore dischargeable in bankruptcy.

In the Seventh and Ninth Circuits, a debt that otherwise would have been non-dischargeable becomes fully dischargeable when an instrument such as a note, release, or waiver substitutes a contractual obligation for the obligation arising from tortious acts. In re Fisher, 116 F.3d 388 (9th Cir. 1997); In re West, 22 F.3d 775 (7th Cir. 1994). Courts in other jurisdictions have arrived at different conclusions on this issue. The Eleventh Circuit held under Section 523(a)(4) that "a debt which originates from the debtor's fraud should not be discharged simply because the debtor entered into a settlement agreement." **[Page 8]** Greenberg v. Schools, 711 F.2d 152, 156 (11th Cir. 1983). The District of Columbia

Circuit followed Greenberg in a Section 523(a)(2)(A) context, noting that such an approach effectuates congressional policy by denying the nefarious debtor a fresh start at the expense of innocent third parties. United States v. Spicer, 57 F.3d 1152, 1156 (D.C. Cir. 1995). Similarly, the bankruptcy appellate panel of the Sixth Circuit has recently held that, for bankruptcy purposes, a novation does not extinguish the underlying fraud or debt. See In re Francis, 226 B.R. 385, 389-91 (6th Cir. 1998).

As an initial matter, this case involves facts markedly similar to West and it is readily distinguishable factually from Greenberg, Spicer, and Francis. The settlement agreement in Greenberg did not include a waiver and release of the underlying fraud claim, while the settlement agreement in the instant case contains such a release from further liability. As the bankruptcy court noted, the settlement documents in this case make it clear that the claims which were being settled by the parties included claims based on fraud, misrepresentation, and other alleged intentional misconduct on the part of Arlene Warner. The general release provided that the Archers would release and forever discharge Arlene Warner from "any and every right, claim, or demand which [the Archers] now have or might **[Page 9]** otherwise hereafter have against [Arlene Warner] arising out of or related to the matter of the litigation in Guilford County Superior Court . . . excepting only obligations under a Note and Deeds of Trust executed contemporaneously herewith." (Mem. Op. at 9). Spicer was a post-conviction settlement while the present case involved a pre-litigation settlement. Here, there had been no determination of fraud or even a presentation of evidence on the issue at the time of settlement. In re Francis contained an admission of fraud on the part of the debtor while this case contains no such acknowledgment of wrongdoing. In the present case, as in West, the settlement agreement contained a complete release, it was a pre-litigation settlement, and there was no admission of fraud on the part of the debtor. Accordingly, the factual setting in which the disputed legal issue is presented strongly suggests the application of In re West and In re Fisher rather than Greenberg, Spicer, and In re Francis.

A recent district court case, In re Detrano, 222 B.R. 685 (Bankr. E.D.N.Y. 1998), involves facts quite similar to this case and addresses the legal issue in a persuasive manner. In Detrano, the court held that the debtor's execution of a promissory note in settlement of pending fraud litigation replaced the fraud claim with a contract debt dischargeable in **[Page 10]** bankruptcy. The bankruptcy court elected to follow West rather than Spicer, explaining its reasoning as follows:

> This court is not at all persuaded that Spicer's medieval imagery of alchemy is particularly helpful in determining this issue. Indeed, the line of decisions reflected in Spicer begs the fundamental question and, worse, undermines the entire structure of incentives for settling tort claims in state court. What Spicer ignores is that there is usually a tremendous distance between pleading and proving intentional torts. Until the allegations are proven by clear preponderance of the evidence (or admitted to), there is no basis for presuming the defendant is an intentional tortfeasor for purposes of either state law or federal bankruptcy law. A settlement in which both parties are represented by competent counsel, and which is approved by a court of competent jurisdiction, should render those allegations entirely moot--not because the defendant is or is not a bad man, but because the parties have mutually agreed that issue will not be litigated. There is absolutely nothing about federal bankruptcy law that should disturb that state law outcome.

222 B.R. at 688.

The result reached in the West line of cases is bolstered by the fact that there are several reliable ways to ensure that a debt for fraud does not become dischargeable in bankruptcy after the parties settle the claim: (1) the creditor can make the debtor admit to specific allegations of fraud as findings of fact in the settlement agreement, Detrano, 222 B.R. at 689; (2) the creditor can make the debtor acknowledge that any release of liability is conditional until full payment is made, id.; and (3) the settlement agreement can be subject to plaintiff's right **[Page 11]** to assert non-dischargeability in a bankruptcy proceeding. If the risk associated with the potential for bankruptcy is greater than the risk associated with the uncertain outcome at trial, the creditor always has the option of going forward and seeking to secure a judgment of fraud against the debtor. The Archers contend that a pre-petition settlement of a fraud claim cannot alter the nature of the obligation so as to extinguish a subsequent dischargeability claim under Section 523(a)(2)(A). However, this argument merely begs the question of why parties cannot bargain to account for the contingencies of liability in any given case. As Judge Lundin, the dissenter in Francis, observed,

> [T]here is no analogous provision of federal law that conditions or prohibits enforcement in bankruptcy of a creditor's prepetition agreement to release its cause of action under § 523(a)(2). Put another way, nothing in the Bankruptcy Code interrupts the ordinary capacity of creditors under nonbankruptcy law to contract for the release of claims that are or might be nondischargeable in bankruptcy. As recognized by the Seventh and Ninth Circuits, if enforceable under state law, a creditor's prepetition release of a potential cause of action under § 523 of the Bankruptcy Code precludes that creditor's § 523 complaint without regard to the merits of the underlying dispute.

226 B.R. at 393. In dismissing the Francis majority's reliance on public policy as a basis for its decision, Judge Lundin responded that the majority actually did the public a disservice by remov[ing] a major incentive for debtors to settle with **[Page 12]** creditors before bankruptcy and [thereby] impos[ing] a previously unrecognized 'bankruptcy penalty.' A debtor willing to give valuable collateral to a prebankruptcy victim in exchange for release of potentially nondischargeable personal liability bargains for a worthless promise under the Panel's rule." 226 B.R. at 395.

The Archers' procedural argument also fails in that they did not object to the bankruptcy court's severance of the case and ruling first on the affirmative defense raised by Arlene Warner. Therefore, only the bankruptcy court's determination on that issue is before this court. Regardless, the Archers' fraud-in-the-inducement argument would have to overcome the substantial hurdle of showing that the Warners planned all along to file bankruptcy to extinguish their debt, despite the fact that $200,000.00 of the $300,000.00 settlement amount was paid in cash at the time of settlement.

The decision of the bankruptcy court will be affirmed. An order and judgment in accordance with this memorandum opinion shall be entered contemporaneously herewith.

September 27, 2000 /s/ Frank W. Bullock, Jr.
United States District Judge

APPENDIX C

UNITED STATES BANKRUPTCY COURT
MIDDLE DISTRICT OF NORTH CAROLINA
GREENSBORO DIVISION

IN RE:

LEONARD L. WARNER and ARLENE L. WARNER,
Debtors.

Adversary Proceeding No. A-97-2003
Bankruptcy Proceeding No. B-96-10373 C-7G

A. ELLIOTT ARCHER and CAROL A. ARCHER,
Appellants,
v.

ARLENE L. WARNER,
Appellee.

Civil Action No. 1:99CV00924

[FILED: Sept. 27, 2000]

ORDER and JUDGMENT

BULLOCK, District Judge

For the reasons set forth in the memorandum opinion filed contemporaneously herewith,

IT IS ORDERED AND ADJUDGED that the judgment of the Bankruptcy Court is **AFFIRMED**, and this appeal is **DISMISSED**.

September 27, 2000 /s/ Frank W. Bullock, Jr.
United States District Judge

APPENDIX D

UNITED STATES BANKRUPTCY COURT
MIDDLE DISTRICT OF NORTH CAROLINA
GREENSBORO DIVISION

IN RE:

Leonard L. Warner and Arlene L. Warner,
Debtors.

Case No. 96-10373C-7G

A. Elliott Archer and Carol Archer,
Plaintiffs,
v.
Leonard L. Warner and Arlene L. Warner,
Defendants,

Adversary No. 97-2003

[Entered: Aug. 30, 1999]

MEMORANDUM OPINION

This dischargeability action came before the court for trial on August 26, 1999. Harry G. Gordon appeared on behalf of the plaintiffs and Rayford K. Adams, III appeared on behalf of defendant Arlene L. Warner. Having considered the evidence offered by the parties, the findings and conclusions of the court pursuant to Rule 7052 of the Federal Rules of Bankruptcy Procedure are hereinafter set forth.

JURISDICTION

The court has jurisdiction over the subject matter of this **[Page 2]** proceeding pursuant to 28 U.S.C. §§ 151, 157 and 1334, and the General Order of Reference entered by the United States District Court for the Middle District of North Carolina on August 15, 1984. This dischargeability action is a core proceeding within the meaning of 28 U.S.C. § 157(b)(2)(I) which this court may hear and determine.

FACTS

This litigation arose out of a business transaction which occurred in 1992 in which a corporation formed by the plaintiffs agreed to purchase the assets of a company known as Warner Manufacturing, Inc. for a price of $610,000.00, plus payment to Leonard Warner of a consulting fee of $70,000.00 and the sum of $5,000.00 for a non-compete agreement. The closing on the purchase occurred on May 22, 1992. The plaintiffs contend that numerous fraudulent misrepresentations were made by Leonard Warner during the negotiations which they relied upon in entering into the asset purchase agreement.

During the latter part of 1992 plaintiffs instituted a suit in the Superior Court of Guilford Count against Warner Manufacturing, Inc. and Leonard Warner. In March of 1994 the plaintiffs filed an amended complaint in which Arlene Warner and two other parties were **[Page 3]** added as defendants. The amended complaint contained claims for breach of contract, fraud and misrepresentation, conspiracy, a claim to pierce corporate veil, fraudulent conveyance, unfair and deceptive trade practices and constructive trust. The amended complaint alleges that both Leonard Warner and Arlene Warner were involved in the fraud and other misconduct alleged in the amended complaint. On May 8, 1995, shortly before the state court litigation was settled, the plaintiffs amended their complaint again to designate their second claim as being one for fraud, misrepresentation and intentional and negligent infliction of emotional distress, and to add a paragraph asserting that plaintiffs had suffered mental and emotional distress, pain and suffering and loss of enjoyment of life as a consequence of the intentional and negligent acts of the defendants.

On or about May 11, 1995, after extensive pre-trial discovery, the parties to the state court litigation reached a settlement. Pursuant to this settlement the plaintiffs were to receive the sum of $300,000.00, consisting of a cash payment of $200,000.00 and a promissory note for the principal sum of $100,000.00. The parties entered into a written settlement agreement and consummated the settlement on or about May 11, 1995. The plaintiffs were paid the **[Page 4]** $200,000.00 cash payment and a $100,000.00 promissory note from Leonard L. Warner, Arlene Warner and Hosiery Industries, Inc. was delivered to the plaintiffs. The plaintiffs also received two deeds of trust securing the promissory note. Pursuant to the settlement agreement the plaintiffs executed and delivered to defendants a general release and a mutual release which also was executed by the defendants. On May 15, 1995, the plaintiffs dismissed the state court suit against the defendants with prejudice.

The $100,000.00 promissory note which the plaintiffs received in the settlement was payable in two payments, one due on November 11, 1995, and the other due on May 11, 1996. When the November payment was not made, plaintiffs brought suit on the promissory note in the Superior Court of Guilford County on December 4, 1995. This suit on the promissory note was still pending when Leonard Warner and Arlene Warner filed for relief under Chapter 13 of the Bankruptcy Code on February 5, 1996. After several months defendants' Chapter 13 case was converted to Chapter 7. Thereafter, this adversary proceeding was filed on January 29, 1997, seeking a judgment for the amount due under the promissory note and a determination that such indebtedness is **[Page 5]** under § 523(a) of the Bankruptcy

Code. In the complaint in this adversary proceeding the plaintiffs incorporate by reference the allegations of fraud, misrepresentation, etc., contained in the complaint in their original suit against the defendants as the grounds for asserting that the indebtedness due under the promissory is nondischargeable. Defendant Arlene Warner answered these allegations with a denial of any misconduct on her part and an affirmative defense in which she asserted that, based upon the settlement of the original suit, the plaintiffs may not rely upon the misconduct alleged in the original suit as grounds for asserting that defendant's obligation under the promissory note is nondischargeable under § 523 of the Bankruptcy Code.

Prior to trial, the court ordered that the issues involved in the affirmative defense be severed and tried first. When this action was called for trial on August 26, 1999, the court received the evidence and arguments of the parties regarding the issues involved in the defendant's affirmative defense. For the reasons hereinafter discussed, the court has concluded that the defense raised by the defendant should be upheld and that judgment should be entered in favor of defendant Arlene Warner.

DISCUSSION

Plaintiffs' original action against the defendants **[Page 6]** unquestionably involved claims alleging fraud, misrepresentation, intentional infliction of emotional distress and other acts of misconduct on the part of the defendants. It is evident from the settlement documents that these claims were included in the settlement which was made in May of 1995. For example, the general release which was signed by the plaintiffs specifically provides that the payment by the defendants is "in settlement of [plaintiffs'] personal claims for emotional distress/personal-injury-type damages they claimed to have suffered for the torts of fraud, intentional misrepresentation, intentional infliction of emotional distress, and negligent infliction of emotional distress." The issue raised by defendant's affirmative defense is whether a prepetition settlement of claims involving alleged fraud and intentional infliction of injury can extinguish the plaintiff's subsequent nondischargeability claim under § 523(a) when the defendant files for bankruptcy relief without having paid the entire amount of the settlement. The case law is sharply split on this issue.

Under one line of cases, a prepetition settlement does not extinguish a subsequent dischargeability claim. These cases reason that a settlement of a fraud claim cannot alter the nature of the **[Page 7]** defendant's obligation and, therefore, even if the settlement includes a general release, the court may inquire into the factual circumstances behind the settlement agreement to ascertain whether the debt was originally derived from fraudulent conduct and should be treated as nondischargeable. According to this line of cases, such a result is necessary in order to effectuate the congressional policy underlying the enactment of exceptions to discharge such as § 523(a)(2)(A). E.g., United States v. Spicer, 57 F.3d 1152 (D.C. Cir. 1995); In re Francis, 226 B.R. 385 (6th Cir. BAP 1998); Greenberg v. Schools, 711 F.2d 152 (11th Cir. 1983).

Another line of cases recognizes that under some circumstances, a prepetition settlement may have the effect of extinguishing a later dischargeability claim. Under these cases, the general rule is that a promissory note accepted from a party charged with fraud does not discharge the debt for which it was given and does not bar a later dischargeability claim. However, if it is shown that there is a settlement agreement under which the promissory note was given and received as a discharge of the original obligation or tort action then the execution of the note and settlement agreement extinguishes the tort action and the plaintiff is precluded from thereafter going behind the settlement **[Page 8]** in order to assert nondischargeability. E.g., In re

Fischer, 116 F.3d 388 (9th Cir. 1997); In re West, 22 F.3d 775 (7th Cir. 1994); Maryland Casualty Co. v. Cushing, 171 F.2d 257 (7th Cir. 1948). These cases rely upon the terms of the settlement between the parties in deciding whether a prepetition settlement will have the effect of extinguishing a subsequent dischargeability claim. To the extent that this line of cases represents the view that there is no overriding policy underlying § 523 which prevents the bankruptcy court from giving effect to a valid settlement agreement or release which is broad enough to release and extinguish claims under § 523(a), this court concludes that these cases reflect the better reasoned approach, and will adopt this approach in the present case. There is nothing in § 523(a) which can be read as making it unlawful or illegal for a party alleging fraud to enter into a settlement under which that party agrees to release any claim which might arise in the future under § 523. If such a settlement is made by competent parties and there is no fraud or other vitiating circumstances associated with the settlement, then there is no reason why the settlement should not be enforced and upheld according to its terms. Accordingly, the court will look to the terms of the settlement documents which were signed by the **[Page 9]** plaintiffs in the present case in determining whether the settlement precludes the plaintiffs from now asserting that defendant's obligation under the promissory note is non-dischargeable under § 523(a) of the Bankruptcy Code.

As previously observed, the settlement documents make it clear that the claims which were being settled by the parties included claims based upon fraud, misrepresentation and other alleged intentional misconduct on the part of the defendants. The general release which was executed by the plaintiffs describes the claims which the plaintiffs were releasing and extinguishing. Under this document, the plaintiffs agreed to "release and forever discharge" the defendants "from any and every right, claim, or demand which [the plaintiffs] now have or might otherwise hereafter have" against the defendants "arising out of or relating to the matter of the litigation in Guilford County Superior Court . . . excepting only obligations under a Note and Deeds of Trust executed contemporaneously herewith." It is significant that this broad language includes the release of any claims which the plaintiffs "might otherwise hereafter have" against the defendants. The plaintiffs thus not only were releasing the claims which existed at the time of the settlement, but also released any claims which they **[Page 10]** might have in the future arising out of or relating to the matters alleged in the complaint in their original action.

By including in the release future claims, the court concludes that the plaintiffs effectively released and extinguished the dischargeability claim which they now seek to assert against the defendant under § 523(a)(2)(A) and § 523(a)(4). The plaintiffs were willing to release and extinguish all of their claims, past, present and future, arising out of the matters alleged in the original law suit in exchange for cash of $200,00.00, a $100,000.00 promissory note and two deeds of trust, which they evidently deemed a satisfactory exchange at the time of the settlement. This settlement was made after the plaintiffs and their counsel had the benefit of extensive information developed through prolonged discovery. Having agreed to the settlement and the broad release granted to the defendants, and having received the cash payment of $200,000.00 as well as the promissory note and deeds of trust, the plaintiffs may not now raise the dischargeability claim they now assert based upon the same allegations and claims contained in the complaint in their original action. The dischargeability claim against defendant Arlene Warner therefore must be decided in her favor of the defendant since the only misconduct alleged in this **[Page 11]** action is the same misconduct described in the original complaint which plaintiffs dismissed with prejudice pursuant to the settlement. Accordingly, a judgment will be entered contemporaneously with the filing of this memorandum opinion dismissing this action as to Arlene Warner.

This 30th day of August, 1999.

/s/ William L. Stocks
WILLIAM L. STOCKS
United States Bankruptcy Judge

APPENDIX E

UNITED STATES BANKRUPTCY COURT
MIDDLE DISTRICT OF NORTH CAROLINA
GREENSBORO DIVISION

IN RE:

Leonard L. Warner and Arlene L. Warner,
Debtors.

Case No. 96-10373C-7G

A. Elliott Archer and Carol Archer,
Plaintiffs,

v.

Leonard L. Warner and Arlene L. Warner,
Defendants,

Adversary No. 97-2003

[Entered: Aug. 30, 1999]

JUDGMENT

In accordance with the memorandum opinion filed contemporaneously herewith, it is ORDERED, ADJUDGED AND DECREED that this action is hereby dismissed with prejudice as to Arlene L. Warner.

This 30th day of August, 1999.

/s/ William L. Stocks
WILLIAM L. STOCKS
United States Bankruptcy Judge

APPENDIX F

UNITED STATES BANKRUPTCY COURT
MIDDLE DISTRICT OF NORTH CAROLINA

IN RE:

LEONARD L. WARNER AND ARLENE L. WARNER,
Debtors.

SS# 075-30-7046

Case No. 96-10373

A. ELLIOTT ARCHER AND CAROL A. ARCHER,
Plaintiffs,

v.

LEONARD L. WARNER AND ARLENE L. WARNER,
Defendants,

Adversarial Proceeding Number 97-2003

[Entered: June 20, 1997]

CONSENT ORDER

Pursuant to the Consent of the parties and from a review of the Complaint to Determine Dischargeability of Debt and other documents files in this matter, the Court finds as follows:

1. This Adversary Proceeding is a Core Proceeding over which the Bankruptcy Court has jurisdiction pursuant to 28 U.S.C. Section 157 and 11 U.S.C. Section 523(a)(2) and (4).

2. Plaintiffs are citizens and residents of Indiana.

3. Defendants are citizens and residents of Guilford County, North Carolina. **[Page 2]**

4. On February 5, 1996, defendants filed for protection under Chapter 13 of the United States Bankruptcy Code.

5. On October 29, 1996, defendants' Chapter 13 case was converted to a case under Chapter 7 of the United States Bankruptcy Code.

6. On May 11, 1995, defendants signed a promissory note secured by deeds of trust in the amount of $100,000.00 to plaintiffs.

7. On December 4, 1995, plaintiffs filed suit against defendants in Guilford County Superior Court to enforce the Note signed by defendants.

8. The first payment of $54,500.00 on the Note was due and payable November 11, 1995, and defendants failed to pay the amount due on that date.

9. Defendants were in default under the Note for failure to pay the principal and interest due on the Note.

10. Defendants received due notice of such default and did not cure the default.

11. Plaintiffs declared the entire balance under the Note due and payable.

12. Defendants were indebted to the plaintiffs in the sum of $100,000.00 plus accrued interest at nine percent (9%) per annum, for a total debt of $104,500.00 as of November 11, 1995, and additional interest since that date.

13. The Note provided that defendants "agree to pay to the holder reasonable attorneys fees not exceeding a sum equal to fifteen percent (15%) of the outstanding balance owing on said Note, plus all other reasonable expenses incurred by the holder in exercising any of the holder's rights and remedies upon default." **[Page 3]**

14. On November 22, 1995, plaintiffs sent to defendants a letter in accordance with NCGS § 6-21.2 demanding

payment within five (5) days or, in lieu thereof, the payment of 15% attorneys fees. Defendants made no payment.

15. On January 29, 1997, plaintiffs filed a Complaint to Determine Dischargeability of Debt, which set forth the reasons that the debt to plaintiffs as represented by the Note is not dischargeable in Bankruptcy.

16. Defendant Leonard L. Warner has agreed that defendant Leonard L. Warner's debt is not dischargeable in Bankruptcy but is excepted from discharge under 11 U.S.C. Section 523(c).

17. Defendant Leonard L. Warner has authorized the entry of an Order by the United States Bankruptcy Court declaring that defendant Leonard L. Warner's debt to plaintiffs is nondischargeable.

18. The Court has jurisdiction over the subject matter and the parties to this action.

NOW, THEREFORE, IT IS HEREBY ORDERED, ADJUDGED AND DECREED that the debt of owed by defendant Leonard L. Warner to plaintiffs as represented by the Promissory Note attached hereto as **Exhibit A** is excepted from discharge under 11 U.S.C. Section 523(c).

This 18th day of June, 1997.

/s/ William L. Stocks

Judge Presiding

[Page 4] I consent to the foregoing Consent Judgment.

/s/ Leonard L. Warner

Leonard L. Warner

Date: 5-27-97

[Exhibit A not reproduced here]

APPENDIX G

STATUTORY PROVISION

[11 U.S.C. § 523(a)]

§ 523. Exceptions to Discharge

(a) A discharge under section 727, 1141, 1228(a), 1228(b), or 1328(b) of this title does not discharge an individual debtor from any debt--

(1) for a tax or a customs duty--

(A) of the kind and for the periods specified in section 507(a)(2) or 507(a)(8) of this title, whether or not a claim for such tax was filed or allowed;

(B) with respect to which a return, if required--

(i) was not filed; or

(ii) was filed after the date on which such return was last due, under applicable law or under any extension, and after two years before the date of the filing of the petition; or

(C) with respect to which the debtor made a fraudulent return or willfully attempted in any manner to evade or defeat such tax;

(2) for money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained by--

(A) false pretenses, a false representation, or actual fraud, other than a statement respecting the debtor's or an insider's financial condition;

(B) use of a statement in writing--

(i) that is materially false;

(ii) respecting the debtor's or an insider's financial condition;

(iii) on which the creditor to whom the debtor is liable for such money, property, services, or credit reasonably relied; and

(iv) that the debtor caused to be made or published with intent to deceive; or

(C) for purposes of subparagraph (A) of this paragraph, consumer debts owed to a single creditor and aggregating more than $1,150 for "luxury goods or services" incurred by an individual debtor on or within 60 days before the order for relief under this title, or cash advances aggregating more than $1,150 that are extensions of consumer credit under an open end credit plan obtained by an individual debtor on or within 60 days before the order for relief under this title, are presumed to be nondischargeable; "luxury goods or services" do not include goods or services reasonably acquired for the support or maintenance of the debtor or a dependent of the debtor; an extension of consumer credit under an open end credit plan is to be defined for purposes of this subparagraph as it is defined in the Consumer Credit Protection Act;

(3) neither listed nor scheduled under section 521(1) of this title, with the name, if known to the debtor, of the creditor to whom such debt is owed, in time to permit--

(A) if such debt is not of a kind specified in paragraph (2), (4), or (6) of this subsection, timely filing of a proof of claim, unless such creditor had notice or actual knowledge of the case in time for such timely filing; or

(B) if such debt is of a kind specified in paragraph (2), (4), or (6) of this subsection, timely filing of a proof of claim and timely request for a determination of dischargeability of such debt under one of such paragraphs, unless such creditor had notice or actual knowledge of the case in time for such timely filing and request;

(4) for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny;

(5) to a spouse, former spouse, or child of the debtor, for alimony to, maintenance for, or support of such spouse or child, in connection with a separation agreement, divorce decree or other order of a court of record, determination made in accordance with State or territorial law by a governmental unit or property settlement agreement, but not to the extent that--

(A) such debt is assigned to another entity, voluntarily, by operation of law, or otherwise (other than debts assigned pursuant to section 408(a)(3) of the Social Security Act, or any such debt which has been assigned to the Federal Government or to a State or any political subdivision of such State); or

(B) such debt includes a liability designated as alimony, maintenance, or support, unless such liability is actually in the nature of alimony, maintenance, or support;

(6) for willful and malicious injury by the debtor to another entity or to the property of another entity;

(7) to the extent such debt is for a fine, penalty, or forfeiture payable to and for the benefit of a governmental unit, and is not compensation for actual pecuniary loss, other than a tax penalty--

(A) relating to a tax of a kind not specified in paragraph (1) of this subsection; or

(B) imposed with respect to a transaction or event that occurred before three years before the date of the filing of the petition;

(8) for an educational benefit overpayment or loan made, insured or guaranteed by a governmental unit, or made under any program funded in whole or in part by a

governmental unit or nonprofit institution, or for an obligation to repay funds received as an educational benefit, scholarship or stipend, unless excepting such debt from discharge under this paragraph will impose an undue hardship on the debtor and the debtor's dependents;

(9) for death or personal injury caused by the debtor's operation of a motor vehicle if such operation was unlawful because the debtor was intoxicated from using alcohol, a drug, or another substance;

(10) that was or could have been listed or scheduled by the debtor in a prior case concerning the debtor under this title or under the Bankruptcy Act in which the debtor waived discharge, or was denied a discharge under section 727(a)(2), (3), (4), (5), (6), or (7) of this title, or under section 14c(1), (2), (3), (4), (6), or (7) of such Act;

(11) provided in any final judgment, unreviewable order, or consent order or decree entered in any court of the United States or of any State, issued by a Federal depository institutions regulatory agency, or contained in any settlement agreement entered into by the debtor, arising from any act of fraud or defalcation while acting in a fiduciary capacity committed with respect to any depository institution or insured credit union;

(12) for malicious or reckless failure to fulfill any commitment by the debtor to a Federal depository institutions regulatory agency to maintain the capital of an insured depository institution, except that this paragraph shall not extend any such commitment which would otherwise be terminated due to any act of such agency.

(13) for any payment of an order of restitution issued under title 18, United States Code;

(14) incurred to pay a tax to the United States that would be nondischargeable pursuant to paragraph (1);

(15) not of the kind described in paragraph (5) that is incurred by the debtor in the course of a divorce or separation or in connection with a separation agreement, divorce decree or other order of a court of record, a determination made in accordance with State or territorial law by a governmental unit unless--

(A) the debtor does not have the ability to pay such debt from income or property of the debtor not reasonably necessary to be expended for the maintenance or support of the debtor or a dependent of the debtor and, if the debtor is engaged in a business, for the payment of expenditures necessary for the continuation, preservation, and operation of such business; or

(B) discharging such debt would result in a benefit to the debtor that outweighs the detrimental consequences to a spouse, former spouse, or child of the debtor;

(16) for a fee or assessment that becomes due and payable after the order for relief to a membership association with respect to the debtor's interest in a dwelling unit that has condominium ownership or in a share of a cooperative housing corporation, but only if such fee or assessment is payable for a period during which--

(A) the debtor physically occupied a dwelling unit in the condominium or cooperative project; or

(B) the debtor rented the dwelling unit to a tenant and received payments from the tenant for such period,

but nothing in this paragraph shall except from discharge the debt of a debtor for a membership association fee or assessment for a period arising before entry of the order for relief in a pending or subsequent bankruptcy case;

(17) for a fee imposed by a court for the filing of a case, motion, complaint, or appeal, or for other costs and

expenses assessed with respect to such filing, regardless of an assertion of poverty by the debtor under section 1915(b) or (f) of title 28, or the debtor's status as a prisoner, as defined in section 1915(h) of title 28; or

(18) owed under State law to a State or municipality that is--

(A) in the nature of support, and

(B) enforceable under part D of title IV of the Social Security Act (42 U.S.C. 601 et seq.).

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