DePaul University
University Libraries

DePaul Business and Commercial Law Journal

Volume 1
Issue 3 *Spring 2003*

Article 5

Can Ipso Facto Clauses Resolve the Discharge Debate? An Economic Approach to Novated Fraud Debt in Bankruptcy

Michael J. Di Gennaro

Harley J. Goldstein

Follow this and additional works at: https://via.library.depaul.edu/bclj

Recommended Citation

Michael J. Di Gennaro & Harley J. Goldstein, *Can Ipso Facto Clauses Resolve the Discharge Debate? An Economic Approach to Novated Fraud Debt in Bankruptcy*, 1 DePaul Bus. & Com. L.J. 417 (2003)
Available at: https://via.library.depaul.edu/bclj/vol1/iss3/5

This Article is brought to you for free and open access by the College of Law at Via Sapientiae. It has been accepted for inclusion in DePaul Business and Commercial Law Journal by an authorized editor of Via Sapientiae. For more information, please contact digitalservices@depaul.edu.

Can Ipso Facto Clauses Resolve the Discharge Debate?: An Economic Approach to Novated Fraud Debt in Bankruptcy

*Michael J. Di Gennaro**
*and Harley J. Goldstein***

I. Introduction

The United States Supreme Court is on the verge of resolving an issue that has divided lower courts for more than fifty years:[1] whether fraud-related claims, ordinarily excepted from discharge under section

* Candidate for J.D., New York University School of Law, 2004; M.A., Columbia University, 1997; B.S., Cornell University, 1994. This Article is based on a work presented by Mr. Di Gennaro as his thesis for the New York University School of Law's Galgay Fellowship in Bankruptcy and Reorganization Law. Mr. Di Gennaro would like to thank Professor Barry E. Adler for his patience and constructive guidance throughout the development of this Article, as well as Judge Cornelius Blackshear and Professors Sanford Ikeda, Dean R. Lillard, and Alan Mathios.

** Senior Associate, Katten Muchin Zavis Rosenman. J.D., Benjamin N. Cardozo School of Law, 1997; B.A., Arizona State University, 1994. Mr. Goldstein is a member of the Bar of both Illinois and New York. Mr. Goldstein would like to thank David L. Kane, an associate at his firm, for his invaluable research assistance.

1. As this Article was going to press, the United States Supreme Court decided Archer v. Warner (In re Archer), No. 01-1418, slip op. 1 (U.S. Mar. 31, 2003), reversing the United States Court of Appeals for the Fourth Circuit, Archer v. Warner (In re Archer), 283 F.3d 230 (4th Cir. 2002). Although the Supreme Court held that despite any novation of the fraud-based debt in that case, such debt could nevertheless be excepted from discharge in bankruptcy, the Court explicitly declined to decide whether the parties to the novation meant "to resolve th[e] issue [of fraud] for purposes of a later claim of nondischargeability in bankruptcy [,]" finding that the Court of Appeals did not address (and permitting the Court of Appeals, on remand, to consider) this argument. Archer v. Warner (In re Archer), No. 01-1418, slip op. at 7-8 (U.S. Mar. 31, 2003). The Supreme Court's opinion therefore buttresses this Article's conclusion that parties to a novation should explicitly provide for the consequences of bankruptcy in settlements of tort-based claims. See supra Part V. Indeed, the approach recommended in this Article resolves the debate between Archer's majority and dissenting opinions. In his dissent, Justice Thomas (joined by Justice Stevens) believed that the intent of the parties was to release the fraud-based claim in any subsequent proceeding, as evidenced by the "sweeping language" of the release contained in the novation. Archer v. Warner (In re Archer), No. 01-1418, slip op. 1 (U.S. Mar. 31, 2003) (Thomas, J. and Stevens, J., dissenting). Justice Thomas (joined by Justice Stevens) also recognized that the parties could contract for whichever result they sought fit. See id. at 5 n.2. ("Indeed, petitioners have failed to point to any provision of the Bankruptcy Code that specifically bars a creditor from entering into an agreement that impairs its right to contest dischargeability."). If the parties succinctly memorialized their intent regarding the effect of a subsequent bankruptcy on the debt, the Court would not have been forced to attempt to infer the parties' implicit motive from the language of the settlement agreement.

523(a)(2)(A) of the Bankruptcy Code,[2] are dischargeable in bankruptcy where such claims have been transformed into contract debt prior to the tortfeasor's bankruptcy filing.[3]

Where a tort claim is converted into an agreement to pay monetary damages (in exchange for a release of the tort claim), a "novation" occurs.[4] Although the Bankruptcy Code provides an exception, to the debt discharge an individual may obtain in bankruptcy, for "any debt for money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained by false pretenses, a false representation, or actual fraud, other than a statement respecting the debtor's or an insider's financial condition,"[5] no explicit provision for the dischargeability of novated fraud debt is included. Under Seventh, Ninth, and, more recently, Fourth Circuit precedent, as a result of its novation, non-dischargeable fraud debt may metamorphose into dischargeable contract debt upon settlement.[6] However, the Courts of Appeal for the District of Columbia and Eleventh Circuits (as well as a Bankruptcy Appellate Panel in the Sixth Circuit)[7] disagree, and hold that courts should examine the underlying cause (in contrast to the present form) of the creditor's claim. Accordingly, in certain circuits, fraud claims remain non-dischargeable regardless of their ultimate form.[8]

Although there has been copious debate regarding the respective rationales for each of these approaches, this Article analyzes the issue

---

2. Title 11 of the United States Code is hereinafter referred to as the "Bankruptcy Code."

3. *Bankruptcy: Settlement of Fraud Claims Creates Contract Debt Dischargeable in Bankruptcy*, U.S. L. WK. DAILY EDITION (BNA), at 1547 (Mar. 20, 2002).

4. Novation is sometimes interpreted to mean the act of substituting for an old obligation a new one that replaces an original party with a new party. *See* BLACK'S LAW DICTIONARY 1091 (7th ed. 1999). A good example of this exists in the payments system context, where X's check to Y: 1) transforms X's bank's liability to X into 2) X's bank's debt to Y's bank, which in turn is changed into 3) Y's bank's debt to Y. Thus, the check allows X's liability to Y to become Y's bank's debt to Y. *See* Joseph H. Sommer, *Where is a Bank Account?*, 57 MD. L. REV. 1, 10 (1998). However, like the Fourth, Seventh, and Ninth Circuits, the term in the context of section 523(a)(2)(A) of the Bankruptcy Code is hereinafter used to express the substitution of a contract claim for a tort claim through a settlement agreement. *See In re Warner*, 283 F.3d at 236 n.8.

5. 11 U.S.C. § 523(a)(2)(A) (2002).

6. *See In re* West, 22 F.3d 775, 777 (7th Cir. 1994); Key Bar Invs., Inc. v. Fischer (*In re* Fischer), 116 F.3d 388, 391 (9th Cir. 1997) (per curiam); *In re Warner*, 283 F.3d at 237.

7. In certain circuits and under certain circumstances, Bankruptcy Appellate Panels hear appeals from bankruptcy court decisions, and are comprised of specially-appointed bankruptcy judges. *See* 28 U.S.C. § 158(b) (2002). In essence, the Bankruptcy Appellate Panels hear these appeals in lieu of being heard by United States District Courts, and their decisions are reviewable by the appropriate Court of Appeals. *See* 28 U.S.C. § 158(c), (d).

8. *See* Greenberg v. Schools, 711 F.2d 152, 156 (11th Cir. 1983) (per curiam); United States v. Spicer, 57 F.3d 1152, 1157 (D.C. Cir. 1995); Ed Schory & Sons, Inc. v. Francis (*In re* Francis), 226 B.R. 385, 391 (B.A.P. 6th Cir. 1998) (electing to follow *Spicer*).

from an economic perspective, and offers a recommendation based on the analysis. This analysis yields the conclusion that where the risk of bankruptcy cannot be priced into a novation, or where a creditor can assess the risk of a debtor's insolvency (but chooses not to accept it), the implementation of an *ipso facto* clause — a "contract clause that specifies the consequences of a party's bankruptcy"[9] — may resolve this dilemma by shielding a plaintiff-creditor's[10] novation from a defendant-debtor's[11] bankruptcy risk, while at the same time allowing the parties to derive the benefits of the novation.

Part II of this Article clarifies the doctrines of the divided circuit courts. Part II.A identifies the case history and reasoning of the Fourth, Seventh, and Ninth Circuits that support the "novation theory," while Part II.B presents the case history and reasoning of the Eleventh and District of Columbia Circuits (and the Sixth Circuit Bankruptcy Appellate Panel) that reject this theory.

Part III of this Article briefly comments on the technicalities of the debate. Part III.A discusses the logic underlying the promotion of settlement, while Part III.B questions whether the goals of each approach are being fulfilled.

Part IV of this Article proposes the ipso facto clause as a potential solution to the problems inherent in both approaches. Part IV.A describes how an ipso facto clause would operate in terms of the dischargeability provisions of the Bankruptcy Code. It provides an analysis of how an ipso facto clause furthers the objectives of courts on both sides of the debate. Part III.B gives attention to the obstacles inherent in implementing such an approach. These obstacles include the fact that the Bankruptcy Code explicitly forbids ipso facto clauses in certain instances, and where not outright forbidden, certain bankruptcy courts frown upon the clauses for equitable reasons. In addition, Part IV of the Article examines the enforceability of ipso facto clauses in various other scenarios.

However, the general arguments against ipso facto clauses are weak, and in the novation context, especially debile.

9. BLACK'S LAW DICTIONARY 834 (7th ed. 1999). Literally, "ipso facto" means "by the fact itself." *Id.* at 833.

10. This term is used throughout this Article to signify the potential plaintiff to a fraud claim who subsequently novates it.

11. This term is used throughout this Article to signify the potential defendant of a fraud claim who subsequently becomes the debtor-party to a novation.

II. THE DEBATE

The debate has emerged from two distinct lines of cases. The Seventh Circuit first approached the problem of the dischargeability of a novated fraud claim in the late 1940s, decidedly favoring the discharge, and establishing what is more commonly referred to as the *Maryland Casualty* approach to dischargeability.[12] The Ninth Circuit was next to weigh in when, in its 1967 decision in *Gonder v. Kelley*, it adopted the *Maryland Casualty* approach.[13]

However, when faced with the same issue in the early 1980s, the Eleventh Circuit, in *Greenberg v. Schools*, adopted the dissenting view of *Gonder v. Kelly*, rejecting the *Maryland Casualty* approach and holding that "a debt which originates from the debtor's fraud should not be discharged simply because the debtor entered into a settlement agreement."[14] Subsequently, that approach gained the support of the District of Columbia and Sixth Circuits.[15] Since "[m]any bankruptcy courts have followed the *Greenberg* approach," it was considered at that time to be the majority approach.[16] However, despite the fact that many of those cases have been deemed consistent with the *Maryland Casualty* approach by those circuit courts favoring it,[17] numerous bankruptcy courts adopting the approach have not been explicitly in its accord.[18]

Regardless of the situation at the time, the recently decided case of *Archer v. Warner* squarely placed the Fourth Circuit in the *Maryland Casualty* camp, pitting the Fourth, Seventh, and Ninth Circuits against courts in the Sixth, Eleventh, and District of Columbia circuits.[19] With *Maryland Casualty* and its progeny on one side, and *Greenberg*

12. Md. Cas. Co. v. Cushing, 171 F.2d 257 (7th Cir. 1948).

13. Gonder v. Kelly, 372 F.2d 94, 94 (9th Cir. 1967)(affirmed for the reasons stated in the district court's opinion); *In re* Kelley, 259 F. Supp. 297, 299 (N.D. Cal. 1965).

14. Greenberg v. Schools, 711 F.2d 152, 156 (11th Cir. 1983) (affirming on the basis of the district court opinion, 21 B.R. 1011 (S.D. Fla. 1982), for the reasons articulated by the dissent in Gonder v. Kelley, 372 F.2d at 94-95 (Koelsch, J., dissenting)).

15. *See supra* note 7.

16. David Zelikoff, *Fraud By Any Other Name Is Still Fraud: Settling a Potential Fraud Claim Under the Bankruptcy Code*, 64 GEO. WASH. L. REV. 866, 869 (1996).

17. *See infra* note 28.

18. *See, e.g., In re* Kovacs, 42 B.R. 1 (Bankr. D. Mass. 1982). *See also In re* Carnahan, 115 B.R. 697 (Bankr. D. Colo. 1990) (holding that the component of a debtor's settlement agreement attributable to fraudulent conduct cannot be discharged); 43 E. 74th St. Assocs. v. Marceca (*In re* Marceca), 129 B.R. 371 (Bankr. S.D.N.Y. 1991) (holding that despite debtor having signed a note to pay back money allegedly misappropriated, the nondischargeable alleged debt did not become a dischargeable contract claim). *But see, e.g.,* Blackhawk B.M.X., Inc. v. Anderson (*In re* Anderson), 64 B.R. 331 (Bankr. N.D. Ill.1986).

19. *See supra* note 7.

v. Schools and its descendants on the other, the battle lines in the discharge debate are clearly demarcated.

A. *The Maryland Casualty Approach*

In *Maryland Casualty*, a defendant embezzled funds from a bank that agreed to waive a tort action in exchange for execution of a promissory note.[20] Subsequently, the defendant filed for protection under the Bankruptcy Code, and the plaintiff sued upon the note.[21] The court described the rule that it would use to determine whether the plaintiff was entitled to prevent the discharge of the debt:

> The general rule is that a promissory note is but the evidence of indebtedness and does not discharge the debt for which it was given. And, of course, where a note is accepted only as evidence of a pre-existing debt and not as satisfaction or waiver of a tort action, acceptance of such a note will not of itself waive the original cause of action. But if it is shown that the note, by express agreement, is given and received, as payment or waiver of the antecedent tort action, and if the agreement is that the note operates to discharge the original obligation and substitute a new one therefor — in other words, that it is taken in payment of the debt — then the original debt is fully satisfied by acceptance of the note.[22]

The court ultimately agreed with the district court's determination that due to an express agreement, "the tort liability had been satisfied and discharged by the execution of the note and that the indebtedness upon the note, in turn, was barred by the discharge in bankruptcy."[23]

More recently, the Seventh Circuit rearticulated the holding of *Maryland Casualty* in *In re West,* describing it as a two-part approach.[24] The first part of the holding is that a promissory note generally does not discharge the debt for which it is given.[25] The second part is that if, however:

> [I]t is shown that the note 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.[26]

---

20. *See* Md. Cas. Co. v. Cushing, 171 F.2d 257, 259 (7th Cir. 1948).
21. *Id.* at 258.
22. *Id.* at 258-59 (citations omitted).
23. *Id.* at 259.
24. *In re* West, 22 F.3d 775, 778 (7th Cir. 1994).
25. *Id.*
26. *Id.*

Given the two-part dynamic of the approach, the Seventh Circuit contends that there is no tension regarding the dischargeability of novated fraud-type debt between circuits; that the *Maryland Casualty* approach is entirely consistent with the *Greenberg v. Schools* approach.[27] The *West* court asserts that, when considering *Greenberg v. Schools*, attention must be given to the fact that the bankruptcy court in *Greenberg* found that the parties never agreed that the note was to substitute a new obligation for the old, failing the second prong of *Maryland Casualty,* and thus not creating a dischargeable novation.[28] Similarly, when confronted with a myriad of cases intended to convince the court of the weight of case law favoring the abandonment of the *Maryland Casualty* approach, the court insisted that those "cases, *which held that settlements did not change the nature of the underlying obligation*, are entirely consistent with *Maryland Casualty* because none involved a release."[29] However, those opposing the *Maryland Casualty* approach claim that the *West* court misread these cases; *despite* an express release from liability, the debt was not dischargeable.[30] For example, the *Spicer* court quoted a bankruptcy court decision stating that "debt that originates from the debtor's fraud should not be discharged simply because the debtor has entered into a settlement. . . agreement, *and the debt now arises from a contract*

27. *Id.*

28. *In re West*, 22 F.3d at 777 (citing *In re* Schools, 14 B.R. 953, 955 (Bankr. S.D. Fla. 1981), *vacated on other grounds and remanded sub nom.* Greenberg v. Schools, 21 B.R. 1011 (D.C. Fla. 1982), *aff'd*, 711 F.2d 152 (11th Cir. 1983)). *But see* United States v. Spicer, 57 F.3d 1152, 1156 (D.C. Cir. 1995) (pointing out that while the Eleventh Circuit's opinion in *Greenberg* indeed offered no details of what was offered in the settlement agreement, the prior history of the case suggests that "settlement agreement may well have included a release of the underlying fraud claim").

29. *In re West*, 22 F.3d at 777 (emphasis added). The court considered the following cases: *In re* Bobofchak, 101 B.R. 465 (Bankr. E.D. Va. 1989); *In re* Pavelka, 79 B.R. 228, 232 n.15 (Bankr. E.D. Pa. 1987); *In re* Castonguay, 77 B.R. 602, 606 (Bankr. E.D. Mich. 1987); *In re* Rush, 33 B.R. 97 (Bankr. D. Me. 1983); Firemen's Fund Ins. Co. v. Covino (*In re* Covino), 12 B.R. 876 (Bankr. M.D. Fla. 1981); Hartford Accident & Indem. Co. v. Flanagan, 28 F. Supp. 415 (S.D. Ohio 1939); Wilmington Trust Co. v. Behr (In re Behr), 42 B.R. 922, 926 (Bankr. E.D. Pa. 1984) (release from criminal charges only). *But see* United States v. Spicer, 57 F.3d 1152, 1156 (D.C. Cir. 1995) ("On our reading of those cases, however, they cannot be reconciled with *Maryland Casualty*.").

30. The *Spicer* court provided *In re Bobofchak*, 101 B.R. at 467-68, as an example, which "expressly rejected the theory that novation extinguishes nondischargeability, saying that contrary to the debtor's contention that the settlement extinguished the underlying tort claim against him," and that regardless of the structure of the settlement it was the bankruptcy court's responsibility to look at the character of the debtor's original claim. *Spicer*, 57 F.3d at 1156. Similarly, the *Spicer* court thought *In re Pavelka*, 79 B.R. at 232, illustrative, showing that while the settlement agreement in that case purported to release the debtor from liability, the court would look at the underlying nature of the debt for a determination of dischargeability. *See Spicer*, 57 F.3d at 1156-57.

rather than a tort."[31] There are numerous examples of this "parry and jab" dialogue between the supporters and opponents of the *Maryland Casualty* approach, whose dissection would not be instructive at this point.[32]

The encouragement and enforcement of settlements is the primary reason that courts give for adopting or obeying the *Maryland Casualty* approach.[33] These courts assert that this is achieved through their respect for the contractual freedom of the parties by supporting the contract law principle of ensuring parties receive their respective "benefit of the bargain."[34] The Fourth Circuit cogently spelled these principles out in a recent decision:

> The [Maryland Casualty approach] 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. 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.[35]

While the circuit courts neglect to expand on their determination that the *Maryland Casualty* rule effectively encourages and enforces settlements, they opine that Congress never intended section 523(a) of the Bankruptcy Code to be construed in such a way as to discourage the settlement of claims because they may be non-dischargeable.[36] Nor do they believe that enforcing the contractual obligation, rather than the underlying tort, produces an inequitable result in the bank-

31. *Spicer*, 57 F.3d at 1156-57 (citing *In re* Peters, 90 B.R. 588, 604 (Bankr. N.D.N.Y. 1988)) (emphasis added). *But see In re West*, 22 F.3d at 778 (distinguishing *Peters* as considering "the matters of a subrogor's rights with respect to non-dischargeable debts, and not the continuing vitality of a creditor's release of a nondischargeable debt").

32. *See, e.g., In re West*, 22 F.3d at 778 (confronted with *In re* Schmidt, 70 B.R. 634 (Bankr. N.D. Ind. 1986), the *West* court distinguished it as a case where debtor allegedly engaged in fraud in obtaining the release of liability, a consideration absent in *Maryland Casualty*).

33. *See Md. Cas. Co.*, 171 F.2d at 259 (stating: "Hence, if the agreement between the parties . . . was that plaintiff accepted the note in substitution of the tort action, a contract thus made would be binding. *This is so because compromise, accord and satisfaction are open to one claiming to have a tort action.*") (emphasis added). *See also In re West*, 22 F.3d at 778 ("The *Maryland Casualty* approach *encourages and enforces settlements.* A tort-feasor may well be inclined to pay an aggrieved party a larger sum in settlement if the settlement contains a release from future claims based on the same conduct.") (emphasis added).

34. *See* Gonder v. Kelley, 372 F.2d 94, 94 (9th Cir. 1967)(affirmed for the reasons stated in the district court's opinion, *In re* Kelley, 259 F. Supp. 297, 300 (N.D. Cal. 1965) ("To allow the respondents to now go behind the note to establish the nondischargeable character of the original indebtedness would destroy the very essence of what the bankrupt bargained for in the agreement . . . .")).

35. Archer v. Warner (*In re* Warner), 283 F.3d 230, 236 (4th Cir. 2002).

36. *Id.*

ruptcy context since, following the "agreement between parties" requirement of the second prong of *Maryland Casualty*,[37] the creditor — not the debtor — discharges the obligation.[38]

B. *The Greenberg v. Schools Approach*

Greenberg emerged from a corporate managerial dispute, where the plaintiff (Greenberg), in a New Jersey action, alleged that the defendant (Schools) engaged in fraud, misappropriation, and misuse of corporate funds while acting in a fiduciary capacity in managing the corporation.[39] Prior to trial, the parties entered into a settlement agreement whereby Schools executed a $90,000 promissory note upon which he made $50,000 payments in principal and interest before defaulting.[40] A second New Jersey action on the promissory note resulted in the execution of a new settlement agreement whereby Schools agreed to pay Greenberg $78,102.66, in monthly installments of $892.20.[41] However, Schools then moved to Florida and filed for bankruptcy protection. *Greenberg* was the subsequent appeal from an adversary proceeding initiated by the plaintiff objecting to any discharge of the debt, and contending that the exceptions to the Bankruptcy Code's discharge provisions covered his claim.[42]

Examining two district court cases dealing with similar factual circumstances,[43] the Eleventh Circuit rejected the bankruptcy court's determination that the debt was dischargeable.[44] It vacated the final judgment and remanded the decision to the bankruptcy court, ordering it to:

> [I]nquire into the factual circumstances behind the settlement agreement to ascertain whether or not the debt incurred by appellee Schools was derived from the alleged fraudulent conduct while managing the. . . corporation. If the court is satisfied that Schools' conduct was fraudulent and did result in the debt that Greenberg claims against him, the debt should not be discharged by the bankruptcy proceeding.[45]

---

37. *See In re West*, 22 F.3d at 778.
38. *Id.*
39. *See* Greenberg v. Schools, 711 F.2d 152, 153-54 (11th Cir. 1983).
40. *Id.* at 154.
41. *Id.*
42. *Id.*
43. *See* Hartford Accident & Indem. Co. v. Flanagan, 28 F. Supp. 415 (S.D. Ohio 1939); *see also* Firemen's Fund Ins. Co. v. Covino (*In re* Covino), 12 B.R. 876 (Bankr. M.D. Fla. 1981). *But see supra* note 28. These cases were deemed consistent with the *Maryland Casualty* approach by the *West* court.
44. *See Greenberg*, 711 F.2d at 156.
45. *Id.*

As discussed *supra*, while courts supporting the *Maryland Casualty* approach argue that it is consistent with the *Greenberg* approach,[46] they acknowledge that at least one bankruptcy court decision sympathetic to, and claiming to have adopted, *Greenberg*, directly contravenes it.[47]

Despite the Seventh Circuit's professed inability to identify tension between *Maryland Casualty* and *Greenberg*, given the *Greenberg* approach's adherent's reasoning, it seems probable that courts adopting *Greenberg* would look behind settlement agreements, *even if the agreement contains an express waiver of the antecedent tort action* for a determination of dischargeability.[48] First, they contend that following the *Maryland Casualty* approach circumvents the Congressional policy of Bankruptcy Code section 523(a)(2)(A), by providing all debtors with a "fresh start" (rather than just those debtors who have not defrauded third parties).[49] Moreover, the Eleventh Circuit in *Greenberg* was receptive to the admonition that, by looking at the technical nature of a claim (contract versus tort) over the claim's underlying substance, the Ninth Circuit was ignoring the United States Supreme Court's instruction that equitable principles are to govern in bankruptcy jurisdiction.[50] Those courts adopting the *Greenberg* approach agree.[51]

Greenberg proponents invoke several United States Supreme Court decisions that lend credence to their position.[52] Judge Traxler, the dissenting voice in *Archer v. Warner*, reviewed *Brown v. Felsen*,[53] *Grogan v. Garner*,[54] and *Cohen v. de la Cruz*,[55] and pointed out that, in *Brown*, after reviewing the legislative history of the Bankruptcy Act, the United States Supreme Court unanimously held that Congress required the fullest possible inquiry into the true nature of debts for

46. *See supra* note 28.

47. *See In re* West, 22 F.3d 775, 778 (7th Cir. 1994) (acknowledging that *In re* Spicer, 155 B.R. 795 (Bankr. D.D.C. 1993), *aff'd*, 57 F.3d 1152 (D.C. Cir. 1995), explicitly rejected the holding of *Maryland Casualty*).

48. *See supra* note 29.

49. *See* United States v. Spicer, 57 F.3d at 1156; *see also In re* Pavelka, 79 B.R. 228, 232 (Bankr. E.D. Pa. 1987); *In re* Rush, 33 B.R. 97, 98 (Bankr. D. Me. 1983); *In re* Bobofchak, 101 B.R. 465, 468 (Bankr. E.D. Va. 1989); *In re* Wilson, 12 B.R. 363, 370 (Bankr. M.D. Tenn. 1981).

50. *Greenberg*, 711 F.2d at 156 (affirming on the basis of the district court opinion, 21 B.R. 1011 (D.C. Fla. 1982), for the reasons articulated by the dissent in Gonder v. Kelley, 372 F.2d 94, 94-95 (9th Cir. 1967) (Koelsch, J., dissenting)). *But see*, *In re* West, 22 F.3d at 778.

51. *See, e.g.*, *Spicer*, 57 F.3d at 1155.

52. *See, e.g.*, Archer v. Warner (*In re* Warner), 283 F.3d 230, 237 (4th Cir. 2002) (Traxler, J., dissenting).

53. 442 U.S. 127 (1979).

54. 498 U.S. 279 (1991).

55. 523 U.S. 213 (1998).

purposes of determining dischargeability.[56] Similarly, a Bankruptcy Appellate Panel in the Sixth Circuit concluded that *Brown v. Felsen* required adoption of the *Greenberg* approach.[57]

Twelve years after *Brown*, the United States Supreme Court held, in *Grogan,* that a creditor need only prove by a low evidentiary threshold (a preponderance of the evidence rather than clear and convincing evidence) that its claim was dischargeable, finding it doubtful "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."[58] Finally, in 1998, in support of its decision in *Cohen* to uphold the non-dischargeability of a state-court imposed treble damages award for defendants' fraudulent conduct, the Court cited "the historical pedigree of the fraud exception, and the general policy underlying the exceptions to discharge."[59] Circuit Judge Traxler felt that under this weighty authority, "[i]n 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."[60]

III. A BRIEF COMMENT ON THE APPROACHES

An analysis of the discharge debate yields the conclusion that those courts following the *Maryland Casualty* approach are concerned about issues of judicial economy focusing on the likelihood of effectuating settlement,[61] while those opposed to it are more concerned with the possibility of dishonest debtors' strategic bankruptcy.[62] More opaque is whether either rule produces its desired objective.

56. *See In re Warner*, 283 F.3d at 239 (Traxler, J., dissenting). *But see In re West*, 22 F.3d at 778 (dismissing *Brown*, finding that: "The holding in Brown is immaterial . . . Brown addressed the preclusive effect of a state court judgment, not a creditor's voluntary release of a debtor."); *accord* Key Bar Invs., Inc. v. Fischer (*In re* Fischer), 116 F.3d 388, 391 (9th Cir. 1997) ("'res judicata' cases do not control our case, which involves a voluntary agreement between two parties that created a novation, releasing either side from liability arising from the original contract").

57. 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").

58. *See In re Warner*, 283 F.3d at 239 (Traxler, J., dissenting) (citing *Grogan*, 498 U.S. at 287).

59. *Id.* (citing *Cohen*, 523 U.S. at 223).

60. *Id.*

61. *See supra* note 32.

62. *See supra* note 58.

A. *A Word on Settlements*

A settlement is a compromise reflecting the reality that completing a trial puts the plaintiff's case at risk, subjects the defendant to an uncertain outcome, and generates litigation costs (such as attorneys' fees).[63] Where transaction costs are low enough, parties will transact to their mutual benefit by effecting a settlement.[64] In the context of civil litigation, the benefits of settlement are well recognized[65] - the benefits are both private and social.[66]

1. Private Benefits

There are generally two private benefits to a settlement: the elimination of transaction costs and the reduction of the risks inherent in a trial outcome.

a. Elimination of Transaction Costs

Settlements eliminate or reduce transaction costs to the parties in terms of time and money.[67] For example:

> [I]f the two parties to a case were to agree, for example, that after trial the court will definitely award the plaintiff $20,000, but it will cost each side $4000 to bring the case to trial, then the parties could save time and money by settling for somewhere between $16,000 (what the plaintiff would net from trial) and $24,000 (what the defendant would spend in damages plus litigation costs). This simple example illustrates the general principle that where the parties agree on the likely trial outcome, the aggregate of their litigation costs (here $8000) creates the settlement "surplus" that constitutes the parties' settlement range.[68]

Of course, this economic model is simplistic, as it assumes that the parties have the same estimate of the likely outcome at trial, are risk-

63. ROBERT W. HAHN, UNITED STATES v. MICROSOFT: THE BENEFITS OF SETTLEMENT 1 (American Enterprise Institute-Brookings Joint Center for Regulatory Studies, Related Publication 02-2, 2002).

64. *See, e.g.*, RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 554 (4th ed., Little, Brown & Co. 1992).

65. *See generally* Robert D. Cooter & Daniel L. Rubinfeld, *Economic Analysis of Legal Disputes and Their Resolution*, 27 J. ECON. LITERATURE 1067, 1067-97 (1989).

66. *See* HAHN, *supra* note 63, at 3.

67. A. MITCHELL POLINSKY & STEVEN SHAVELL, THE ECONOMIC THEORY OF PUBLIC ENFORCEMENT OF LAW 32 (Harvard Law School: Olin Center, Working Paper No. 235, 1998), *available at* http://www.law.harvard.edu/programs/olin_center/papers/pdf/235.pdf; *see* BRIAN G. M. MAIN & ANDREW PARK, PRE-TRIAL SETTLMENT: WHO'S FOR TWO-WAY OFFERS? (Univ. of Edinburgh 1999), *available at* http://www.econ.ed.ac.uk/pdf/gaz2.pdf (providing numerical examples and empirical evidence of transaction costs, bargaining ranges and the likelihood of settlement).

68. Leandra Lederman, *Precedent Lost: Why Encourage Settlement, and Why Permit Non-Party Involvement in Settlements?*, 75 NOTRE DAME L. REV. 221, 229 (1999).

neutral,[69] do not engage in strategic behavior in dividing the settlement surplus, have no stakes in the litigation other than the economic outcome of the particular case, and that settlement costs do not exist (or at least that litigation costs exceed settlement costs).[70]

b. Elimination of Uncertainty in Trial Outcome

The violation of the assumption of risk-neutrality leads to the second recognized private advantage of settlements: they eliminate the risks inherent in a trial outcome — a benefit for any risk-averse[71] party.[72]

> Risk aversion increases the likelihood of settlement because a risk-averse party will prefer a sure outcome, such as a $12,000 payment, even if it is less than the statistically predicted (but uncertain) award at trial, such as a 70% likelihood of a $20,000 award (accompanied by a 30% likelihood of no award at all).[73]

2. Social Benefits

The social benefits of settlement include the reduction of court costs and the reduction of congestion of the court system.[74] One author

---

69. A risk neutral individual is one who is indifferent among alternatives with the same expected value. *See* MICHAEL L. KATZ & HARVEY S. ROSEN, MICROECONOMICS 186 (1991).

70. Lederman, *supra* note 68, at 229-30.

71. "A person is risk-averse if he prefers a 100 percent chance of a $10 loss to a 10 percent chance of losing $100." Jeffrey A. Greenblatt, Comment, *Insurance and Subrogation: When the Pie Isn't Big Enough, Who Eats Last?*, 64 U. CHI. L. REV. 1337, 1356 n.79 (1997). *See also* A. MITCHELL POLINSKY, AN INTRODUCTION TO LAW AND ECONOMICS 53 (2d ed., Little, Brown & Co. 1989) (A risk-averse person cares "not only about the expected value" of an accident, "but also about the absolute magnitude of the risk.").

72. ROBERT COOTER & THOMAS ULEN, LAW AND ECONOMICS 44-48 (2d ed. 1997). Note also that, in the corporate context, reduction of uncertainty would necessarily lower the cost of capital. *See, e.g*, CARL SHAPIRO, ANTITRUST LIMITS TO PATENT SETTLEMENTS 7 (Univ. of Cal., Working Paper No. 501, 2001).

73. Lederman, *supra* note 68, at 230 n.60. In this context, an additional example may prove illustrative. Setting the transactions costs argument mentioned above aside for the moment, assume the probability of winning (pW) and losing (pL) at trial are equivalent (pW = pL = .05). Furthermore, assume that accurately calculated damages amount to $D, where D is greater than zero (D > 0 (also note that another risk of trial is that damages, due to less than perfect information, are calculated incorrectly in an amount greater or less than $D). The expected value of judgment on the tort claim would be 0.5($0) + 0.5($D) = $D / 2. A risk-neutral plaintiff would be indifferent between going to trial and receiving a promissory note in the amount of $D / 2 (this assumes that there is no risk that the note could later be discharged in bankruptcy). However, empirically, most individuals are risk averse — not risk neutral. *See* KATZ & ROSEN, *supra* note 69, at 189-90. A risk-averse plaintiff may be as well off with ($D / 2 - x) novated dollars, where (D / 2) > x > 0 (this again assumes that there is no risk of the defendant's bankruptcy). Similarly, where y > 0, a risk averse defendant may be indifferent between paying ($D / 2 + y) novated dollars and proceeding to trial. The dollar amount represented by (y + x) > 0 is "surplus" that creates a bargaining range where both parties can achieve gains.

74. *See, e.g.*, SHAPIRO, *supra* note 72, at 7.

points out that courts encourage settlement because "parties do not internalize the costs to the public of continuing to litigate."[75] Moreover, empirical studies suggest that, in the corporate context, the elimination of an industry member's uncertainty may have positive economic "spillover" effects on an industry-wide basis.[76]

3. Undesirable Consequences of Settlement

It merits mentioning that despite both these benefits and society's mores encouraging freedom to contract, there are socially disadvantageous consequences of settlements.[77] For example, settlements dilute deterrence since the settlement lowers the injurer's disutility of the sanctions.[78] Additionally, settlement may result in sanctions that are not as appropriately designed as adjudicated sanctions for certain harmful acts.[79] That is, in the presence of information asymmetries,[80] low-harm victims may be able to obtain settlements in excess of harm, whereas trial outcomes may more accurately capture the actual harm.[81] This may result in certain injurers taking an excessive (socially sub-optimal) degree of protection since injurers who cause below-average harms may be over-deterred.[82] Third, settlements squelch the adaptively efficient qualities of common law systems, hindering the broadening and deepening of the law through the setting of precedents.[83]

Importantly, some commentators focus on this third effect concerned that since "precedent is path-dependent, interest groups can manipulate the substance of a body of case law by choosing to bring and not to settle cases with favorable facts, and by engineering settlements in unfavorable cases."[84] While the private benefits that parties may gain from settlement should be respected, settlement detracts from the public benefit of precedent, so one may question whether legal rules favoring settlement should be encouraged.[85] However, it may be concluded that "despite the high percentage of settlements, and the fact that economic models predict such a high settlement per-

75. Lederman, *supra* note 68, at 259.

76. *See* George Bittlingmayer and Thomas W. Hazlett, *DOS Kapital: Has Antitrust Action Against Microsoft Created Value in the Computer Industry?*, 55 J. FIN. ECON. 329 (2000).

77. *See* POLINSKY & SHAVELL, *supra* note 67, at 33.

78. *Id.*

79. *Id.*

80. See *infra* note 95 and accompanying text.

81. *See* POLINSKY & SHAVELL, *supra* note 67, at 33.

82. *Id.*

83. *Id.*

84. Lederman, *supra* note 68, at 268.

85. *Id.* at 257.

centage even without third-party intervention, legal rules favor settlement."[86]

4. Conclusion Regarding Utility of Settlement

One may certainly question whether the law should encourage settlement, rather than neutrally respecting the contractual freedom of litigants.[87] Nonetheless, given the extent of economic literature supporting settlements, as well as the support that many courts and commentators express for the settlement of lawsuits,[88] it is difficult to attack those circuits following the *Maryland Casualty* approach for their support of settlements. Moreover, "[f]ederal policy seems to favor settlement and disfavor litigation, as reflected in the Civil Justice Reform Act, Federal Rule of Civil Procedure 68, Federal Rule of Evidence 408's exclusion from evidence of settlements and settlement offers, and statutory support for private contractual agreements to arbitrate rather than litigate."[89] One cannot criticize the circuits following *Maryland Casualty* for executing federal policy. The merits of that policy may more appropriately be the subject of future legislative debate.

B. *The Appropriate Rule?*

The troublesome question is whether the *Maryland Casualty* rule actually fulfills its goal of encouraging and enforcing settlement. To determine this, one needs to examine the effect the rule has on both plaintiff-creditors and defendant-debtors.

1. Effect of the *Maryland Casualty Rule* on Parties

The phenomena of risk-aversion, asymmetrical information, and moral hazard shape the incentives of both the plaintiff-creditor and defendant-debtor.

a. Risk Aversion

Empirically, most individuals are risk averse, meaning that an individual prefers to bear a given cost with certainty rather than an uncertain prospect of a greater cost that has the same expected value.[90]

86. *Id.*

87. *See, e.g.*, Marc Galanter & Mia Cahill, *"Most Cases Settle": Judicial Promotion and Regulation of Settlements*, 46 STAN. L. REV. 1339, 1341 (1994).

88. *Id.*

89. *Id.; see also* Civil Justice Reform Act of 1990, 28 U.S.C. § § 471-482 (Supp. IV 1992).

90. EDGAR K. BROWNING & JACQUELENE M. BROWNING, MICROECONOMIC THEORY AND APPLICATIONS 451 (4th ed. 1992).

Ceteris paribus,[91] a risk-averse defendant will be prone to settle, "preferring the certainty of a settlement to a gamble on the outcome of a trial, even if the expected cost of going to trial is somewhat lower than the cost of the settlement."[92] If the risk of a trial outcome were forever eliminated through the formulation of a novation with the plaintiff, this would encourage risk-averse defendants to settle. However, although a settlement agreement typically involves the release or waiver of the underlying fraud claim,[93] courts following the *Maryland Casualty* rule claim that any plaintiff who does not wish to risk discharge of a tort claim in bankruptcy can simply avoid including an express discharge of tort liability in a settlement agreement.[94] Without such a release, a defendant's settlement incentive is greatly diminished, as the plaintiff retains the ability to resurrect the fraud claim, again leaving the defendant-debtor exposed to a risky trial outcome. Unless a plaintiff-creditor is willing to include an express discharge of liability in the novation (and hence accept the risk of a bankruptcy filing by a defendant-debtor), the goal of encouraging and enforcing settlements is hampered (since defendants would be denied a substantial benefit of a settlement agreement).

While the *Maryland Casualty* rule may actually discourage defendants from settling, the effect on risk-averse plaintiffs is unclear. Again, given the assumption that a plaintiff is able to accurately and costlessly assess risk and does not suffer from any cognitive bias, a risk-averse plaintiff, like a risk-averse defendant, prefers the certainty of settlement to a risky trial outcome, even where the expected value of the trial outcome is somewhat higher (lower in the case of the defendant) than that of the settlement.

The risks that such a plaintiff-creditor faces are two-fold under the *Maryland Casualty* rule. On the one hand, the novation in and of itself will reduce the risk of losing a lawsuit and, thus, should have the effect of inducing a risk-averse plaintiff to enter into a settlement agreement. On the other hand, the *Maryland Casualty* rule will increase the risk that a formerly non-dischargeable tort claim will now be discharged at some point in the future. Given the unknown magnitude of each of these countervailing risks, it is difficult to determine

---

91. Other things being equal. *See* BLACK'S LAW DICTIONARY 222 (7th ed. 1999). An assumption that both parties have perfect information and that there are no transaction costs.

92. Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497, 530 (1991).

93. United States v. Spicer, 57 F.3d 1152, 1156 (D.C. Cir. 1995). *See also In re* Pavelka, 79 B.R. 228, 232 n.15 (Bankr. E.D. Pa. 1987) ("a party would be foolish not to include a release in a stipulated settlement of a state court action").

94. *See supra*, note 28.

their effect on a risk-averse plaintiff. Assuming no transaction costs (as well as perfect information), where the riskiness of an uncertain trial outcome dwarfs that of a defendant-debtor's bankruptcy risk, a risk-averse plaintiff-creditor will be more likely to enter into a settlement. However, under these assumptions, where the bankruptcy risk exceeds that of an uncertain trial outcome, a plaintiff-creditor will not be inclined to settle.

b. Information Asymmetry

Wherever one party to an economic relationship has more perfect information than the other, the situation is one of asymmetric information.[95] In the present context, even with the empirically implausible assumption of risk-neutral parties, a plaintiff-creditor and a defendant-debtor do not possess symmetrical information about defendant-debtor's bankruptcy risk. A defendant-debtor is in a far better position than a plaintiff-creditor to assess his own default risk. Unsophisticated plaintiff-creditors are incapable of obtaining the private information needed to assess a defendant-debtor's likelihood of default. Even if this information could be obtained, the costs of such an assessment could be prohibitive.

To further exacerbate this problem, a creditor cannot assess a debtor's probability of bankruptcy solely by increasing its information, as a debtor typically controls the decision of whether and when to file for protection under the Bankruptcy Code,[96] as well as whether to incur debt to the point of insolvency (as discussed in the next section of this Article regarding "moral hazard").[97]

c. Moral Hazard

Arising from the difficulty of asymmetric information is the problem of hidden actions whereby the informed side may take the "wrong" action (that is, not do enough to prevent the action), also known as "moral hazard."[98] Moral hazard is a phenomenon whereby,

---

95. *See* KATZ & ROSEN, *supra* note 69, at 595.

96. *See* 11 U.S.C. § 301 (2002). Of course, under certain circumstances, a debtor's creditors may elect to file an involuntary bankruptcy protection against a debtor, and the debtor retains the right to contest such a petition on certain grounds. *See* 11 U.S.C. § 303 (2002).

97. Insolvency is not a requirement of an individual's bankruptcy filing. 2 COLLIER ON BANKRUPTCY ¶ 301.04[1], at 301-06 (15th ed. rev. 2002) ("While debtors frequently are insolvent, insolvency itself, as defined in section 101 of the Code, is not a requirement for protection under chapters 7, 11, 12, or 13 of the Code."). However, where a debtor is not insolvent (and assuming insolvency is not caused by the expenses of bankruptcy administration), debt claims may, in any event, be paid in full, rendering a discharge worthless to a debtor.

98. KATZ & Rosen, *supra* note 69, at 621.

for example, as a result of having insurance, an individual's behavior changes in such a way that the probability of the unfavorable outcome increases or its cost is greater upon occurrence.[99] This may apply in the present context, since a defendant-debtor may be more likely to engage in risky behavior if the debtor knows the debt is dischargeable in bankruptcy; "[I]t is generally recognized that firms and individuals on the edge of insolvency have an incentive to behave in a risk-preferring[100] fashion, since they capture the upside gains of a gamble while being protected from the downside losses by limited liability."[101]

2. Effect of the *Greenberg Rule* on the Parties

Acknowledging the aforementioned phenomena seems to suggest that the *Greenberg* approach is more appropriate than the *Maryland Casualty* approach. Given that, under the *Greenberg* approach, courts look at the nature of the underlying tort claim and may decline to discharge the novation, risk-averse plaintiffs who face default risk that exceeds the risk of an uncertain trial outcome will be more inclined to settle (since they will no longer face the risk of default). Since plaintiffs will be free to release a defendant from liability without fearing the loss of the benefit-of-the-bargain if the debtor files for bankruptcy protection, a risk-averse defendant-debtor will be able to receive the benefit of eliminating trial uncertainty. The problem of information asymmetry is then eliminated because the plaintiff need not assess the defendant's risk of default. Finally, because the novated debt will not be discharged upon bankruptcy, the defendant will not behave in a fashion that is more likely to increase his bankruptcy risk. However, the *Greenberg* approach may not be favorable in all instances.

3. Are All Parties Created Equal?

There are at least two other types of plaintiffs that may be undeterred from entering into settlement arrangements. One class would be risk-preferring plaintiffs seeking to enter settlement arrangements because they enjoy the risk of a debtor's default.[102]

---

99. *See* BROWNING & BROWNING, *supra* note 90, at 453.

100. A risk preferring individual is one who prefers an uncertain prospect with a particular expected value to a certainty with the same expected value. *See* KATZ & ROSEN, *supra* note 69, at 186.

101. Avery Katz, *When Should an Offer Stick? The Economics of Promissory Estoppel in Preliminary Negotiations*, 105 YALE L.J. 1249, 1300 (1996).

102. While this is theoretically plausible, it is not empirically supported. *See* KATZ & ROSEN, *supra* note 69, at 189-90.

a. Plaintiffs with Superior Ability to Assess Risk (Reduction of Information Asymmetries)

The second type of plaintiff that may not be deterred from creating a settlement arrangement expressly releasing a debtor from tort liability would be one that could: (a) easily assess the likelihood of a debtor's default; (b) accurately price that risk of default into the novation; and (c) accept the risk because of a superior capacity of risk diversification. For example, a plaintiff-creditor may be able to determine a defendant-debtor's need for access to credit, or the value that the debtor attributes to her reputation, as potential constraints inhibiting a defendant's filing for bankruptcy protection. Perhaps certain governmental, corporate, and financial entities would qualify as such a plaintiff-creditor.

b. Entities that are Less Risk-Averse

Some analysts claim that in addition to the superior ability to price risk, entities such as corporations are less risk-averse than individuals because they have a greater ability to diversify their risk portfolios.[103] In reality, however, a firm's diversification capabilities do not make it less risk-averse than an individual — simply more capable of minimizing risk.[104] Despite the diversification capacity of these entities, they may, at best, behave as if they are risk-neutral.

c. Effect on These Plaintiffs

Assuming that these hypothetical plaintiff-creditors accurately price into the novation the risk of a debtor's default, and choose to accept this risk because of their superior capacity to diversify the risk, courts following the *Greenberg* approach would potentially overcompensate this plaintiff-creditor in the event of a defendant-debtor's default. In order to avoid such a result, each section 523(a)(2)(A) novation inquiry would then require a bankruptcy court to assess whether default risk was priced into the novation. This could entail an inquiry into the sophistication of the plaintiff, and an examination both of the provisions of the settlement agreement and, potentially, parole evidence. Despite the sophistication of bankruptcy courts, this introduces, in addition to expenditure of additional resources, the possibility of error.

Given that neither the *Maryland Casualty* approach nor the *Greenberg* approach entirely addresses the problems surrounding the dis-

---

103. *See* Alexander, *supra* note 92, at 531.

104. *See* Barry E. Adler, *Bankruptcy and Risk Allocation*, 77 CORNELL L. REV. 439, 482 (1992).

charge of novated fraud debt, other alternatives should be examined, aimed at better accomplishing the desired goals of the circuit courts supporting each of the presently existing solutions.

IV. IPSO FACTO CLAUSES AS A POTENTIAL SOLUTION

Ipso facto clauses are also commonly referred to as "bankruptcy clauses" or "default upon filing clauses."[105] They typically provide that a loan or contract is either terminated or automatically accelerated upon the filing of a bankruptcy petition, or that a bankruptcy filing constitutes an event of default, entitling a lender or contract-holder to terminate or accelerate the terms of the contract or lease.[106] Ipso facto clauses are similar to "financial covenant" or "restrictive covenant" clauses in contracts and loan agreements, designed to deter a debtor from unilaterally engaging in certain behavior, such as modifying investment behavior to include riskier choices, that increases the risk to the other party to the loan or contract.[107] These covenants are designed so that the creditor can police this misbehavior by allowing it to "call" the loan upon the occurance of opportunistic behavior.[108]

The ipso facto clause, which terminates a loan or contract upon a debtor's bankruptcy filing, plays an analogous role.[109] It serves as a sweeping *in terrorem*[110] clause designed to deter certain misbehavior, imposing a cost on a debtor who resorts to bankruptcy — therefore making activities that increase the likelihood of bankruptcy more costly.[111] Unlike financial covenants, which narrowly define measures of increased risk, the ipso facto clause uses a bankruptcy filing as a rough proxy for evidence of increased risk.[112]

A. *Ipso Facto Clauses in the Section 523(a)(2)(A) Context*

In the context of the Bankruptcy Code's dischargeability provisions, the parties may choose to construct a settlement agreement that allows the novation, upon bankruptcy, to revert to a non-dischargeable

105. Aaron C. von Staats, Note, *Ipso Facto Clauses and Chapter 7 Bankruptcies: Superfluous Contract Provisions, Enforceable Prenuptials, or Contrary to the Fresh Start?*, 32 B.C. L. REV. 703, 704 (1991).

106. Thomas H. Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain*, 91 YALE L.J. 857, 887 (1982).

107. *Id.* at 888. *See supra* Part III.B.1.c of this Article (regarding moral hazard).

108. Jackson, *supra* note 106, at 888.

109. *Id.* at 889.

110. "A provision designed to threaten one into action or inaction; esp., a testamentary provision that threatens to dispossess any beneficiary who challenges the terms of the will." BLACK'S LAW DICTIONARY 825 (7th ed. 1999).

111. *See* Jackson, *supra* note 106, at 889.

112. *Id.*

intentional tort action for fraud, with liquidated damages remaining for the amount unpaid under the promissory note.[113] Upon filing for bankruptcy protection, a debtor may be prevented from discharging this liquidated amount.

Again, plaintiffs may choose not to accept the risk of bankruptcy for several reasons. The plaintiff may be risk-averse, and therefore would assign too much weight to events that have low probability of occurrence (where the consequences of such events are extremely adverse).[114] On the other hand, the plaintiff may experience difficulty, at a reasonable cost, in accurately assessing the defendant's default risk. Finally, a plaintiff may be incapable of diversifying the risk of default. Thus, in those situations where the plaintiff chooses not to accept the risk of the defendant's insolvency, the novation could contain an ipso facto clause. Under the ipso facto clause regime, the assumption would be that, absent an ipso facto clause, the parties have priced the risk of default into their settlement. Therefore, pursuant to *Maryland Casualty*, the debt would be rendered dischargeable.

In this fashion, since ipso facto clauses reveal the defendant's private information to the plaintiff, they might provide a means of eliminating information asymmetries. This may, in turn, encourage parties to settle. A tort-feasor may offer a plaintiff the benefit of an ipso facto clause where the *ex ante* gain from this barter exceeds the gain from strategically filing for bankruptcy protection, thus revealing a credible commitment to the settlement.[115] Since the plaintiff does not charge a risk premium, and the defendant is denied the private benefit of discharging the debt if upon bankruptcy, the defendant has a greater incentive to avoid strategic behavior where an enforceable ipso facto clause exists.[116] The clause functions as a commitment device that the debtor can use to credibly signal the creditor that she will behave appropriately.[117]

This approach may resolve the concerns of both the *Maryland Casualty* adherents, as well as the *Greenberg* followers. Creditors who accept the risk of default will receive no more than the benefit of their bargain in the event of a default. Those creditors who do not accept

113. *See* discussion *infra* Part IV regarding the enforceability of stipulations as to the nondischargeability of debt. Importantly, any contract providing for resurrection of a tort claim should include a provision tolling the applicable statute of limitations.

114. *See* Alexander, *supra* note 92, at 531.

115. *C.f.* Yeon-Koo Che & Alan Schwartz, *Section 365, Mandatory Bankruptcy Rules and Inefficient Continuance*, 15 J.L. ECON. & ORG. 441, 445 (1999).

116. *Id* at 448.

117. *Id.; see also* ANTHONY T. KRONMAN & RICHARD A. POSNER, THE ECONOMICS OF CONTRACT LAW 224 (1979) (discussing the signaling function of penalty clauses).

the risk of default have a device that they can use to settle claims without being adversely affected by an erroneous discharge. Defendants remain encouraged to settle, as the tort claims against them are waived in the absence of bankruptcy, and, furthermore, defendants' strategic bankruptcies are deterred.

B. *Obstacles to an Ipso Facto Clause Solution*

There are at least two identifiable obstacles to successfully employing an ipso facto clause strategy in the context of the Bankruptcy Code's dischargeability provisions. Most importantly, the Bankruptcy Code generally prohibits the enforcement of ipso facto clauses.[118] Moreover, even where they are permitted, courts selectively enforce them.[119]

1. Enforceability of Ipso Facto Clauses Under Section 365 of the Bankruptcy Code

Prior to the Bankruptcy Code of 1978, parties to contracts and leases could use ipso facto clauses to opt out of related bankruptcy statutory provisions.[120] Section 365(e)(1) of the Bankruptcy Code promulgated in 1978,[121] however, generally[122] renders ipso facto

---

118. Sections "365(e)(1), 541(c)(1) and 545(1), deal respectively with executory contracts and leases, property of the estate and statutory liens, and limit the enforcement of ipso facto clauses in bankruptcy." Jerry M. Markowitz, *Contracting To Avoid Assumption: A Review of the Availability of Certain Contractual Provisions That May Be Employed to Assist Landlords in Asserting and Enforcing Bargained—For Rights*, 11 J. BANKR. L. & PRAC. 155, 168 n.5 (2002).

119. Thomas J. Cunningham, *Postpetition Payments on Secured Debt: Ipso Facto Clauses and Their Relationship to Reaffirmation Agreements*, 20 CAL. BANKR. J. 213, 229 (1992).

120. *See* 3 COLLIER ON BANKRUPTCY ¶ 365.05[4], at 365-52 (15th ed. rev. 2002).

121. 11 U.S.C. § 365(e)(1) (1978). COLLIER ON BANKRUPTCY explains § 365(e), stating:

> Section 365(e) expressly invalidates ipso facto and other bankruptcy termination clauses that might otherwise prevent the estate from receiving the benefit of an executory contract or lease. Under § 365(e), a clause providing for the termination or modification of an executory contract or lease conditioned on the debtor's insolvency or financial condition, the commencement of a bankruptcy case, or the appointment of a receiver or custodian, is inoperative in a bankruptcy case. Section 365(e) has also been held to preempt contrary provisions of state law which purport to release the non-debtor from a contract upon bankruptcy filing. Consequently, the trustee or debtor-in-possession may assume such a contract or lease notwithstanding a clause triggered by these events.
>
> The broad language of § 365(e) is intended to address provisions in contracts or leases that lead to the same effect as a clause triggered by bankruptcy, without mentioning bankruptcy. Thus, a provision conditioned on the debtor's insolvency or financial condition, or on the appointment of a trustee or receiver, is invalid because it is most likely to operate in the vicinity of a bankruptcy case.

3 COLLIER ON BANKRUPTCY ¶ 365.07, at 565-67 (15th ed. 2000) (footnotes omitted).

122. Subject to certain limited exceptions pursuant to 11 U.S.C. § 365(e)(2).

clauses contained in executory contracts and unexpired leases unenforceable.[123] According to section 365(e)(1):

> Notwithstanding a provision in an executory contract or unexpired lease, or in applicable law, an executory contract or unexpired lease of the debtor may not be terminated or modified, and any right or obligation under such contract or lease may not be terminated or modified at any time after the commencement of the case solely because of a provision in such contract or lease that is conditioned on:
>
> (A) the insolvency or financial condition of the debtor at any time before the closing of the case;
>
> (B) the commencement of a case under this title; or
>
> (C) the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement.[124]

As a corollary to section 365(e)(1), section 365(b)(2) of the Bankruptcy Code permits a debtor to "assume" (in essence, ratify) an executory contract or unexpired lease in bankruptcy without curing defaults related to ipso facto clauses.[125]

---

123. *See* Che & Schwartz, *supra* note 115, at 442. *See also* Mims v. Fid. Funding, Inc. (*In re* Auto Int'l Refrigeration), 275 B.R. 789, 811 (Bankr. N.D. Tex. 2002) ("whether the lender or the debtor is using 365(e)(1) as a defense, the Code clearly states that ipso facto clauses are unenforceable and thus can not be considered as an event of default"); *In re* Metrobility Optical Sys., Inc., 268 B.R. 326, 329 (Bankr. D.N.H. 2001) ("Section 365(e) invalidates ipso facto clauses in executory contracts and unexpired leases."); *In re* Nat'l Hydro-Vac Indus. Servs., L.L.C., 262 B.R. 781, 786 (Bankr. E.D. Ark. 2001) ("That section [365(e)(1)] 'expressly invalidates ipso facto and other bankruptcy termination clauses' predicated on the financial condition of the debtor, the debtor's bankruptcy filing or the appointment of a trustee in bankruptcy."); *In re* Pak, 252 B.R. 215, 217 n.1 (Bankr. M.D. Fla. 2000) ("A creditor cannot force a default upon a debtor by the use of the ipso facto clause of a contract solely because of a bankruptcy filing."); Lyons Sav. & Loan Ass'n v. Westside Bancorporation, Inc., 828 F.2d 387, 393 n.6 (7th Cir. 1987) ("Section 365(e) of the Bankruptcy Code invalidates ipso facto or bankruptcy termination clauses which permit one contracting party to terminate or even modify an executory contract or unexpired lease in the event of the bankruptcy of the other contracting party."); *In re* Monica Scott, Inc., 123 B.R. 990, 992 n.6 (Bankr. D. Minn. 1991) ("Insolvency and bankruptcy clauses typically define default to include insolvency or the filing for bankruptcy protection. The clauses are not enforceable in bankruptcy."); *In re* Texaco Inc., 73 B.R. 960, 965 (Bankr. S.D.N.Y. 1987) ("A termination or modification clause in a contract which is triggered by the filing of a bankruptcy case is expressly denounced and is unenforceable . . . .").

124. 11 U.S.C. § 365(e)(1).

125. In relevant part section 365(b) provides:

> (1) If there has been a default in an executory contract or unexpired lease of the debtor, the trustee may not assume such contract or lease unless, at the time of assumption of such contract of such contract or lease, the trustee —
>
> (A) cures, or provides adequate assurance that the trustee will promptly cure, such default;
>
> (B) compensates, or provides adequate assurance that the trustee will promptly compensate, a party other than the debtor to such contract or lease, for any actual pecuniary loss to such party resulting from such default;

a. The Definition of Executory Contract[126]

Contracts are generally considered executory where they are partially performed.[127] While the Bankruptcy Code contains no express definition of an executory contract, the legislative history of section 365(a) indicates that Congress's intent was for the term to mean a contract "on which performance [is] due to some extent on both sides."[128] The Black's Law Dictionary definition of an executory contract in the bankruptcy context is a contract "under which the debtor and non-debtor each have unperformed obligations and the debtor, if it ceased further performance, would have no right to the other party's continued performance."[129] That is, the obligations of both the debtor and non-bankrupt party to the contract are as yet unperformed and that failure of either party to perform would cause a material breach.[130]

> (C) provides adequate assurance of future performance under such contract or lease.
>
> (2) Paragraph (1) of this subsection does not apply to a default that is a breach of a provision relating to —
>
> (A) the insolvency or financial condition of the debtor at any time before the closing of the case;
>
> (B) the commencement of a case under [the Bankruptcy Code];
>
> (C) the appointment of or taking possession by a trustee in a case under [the Bankruptcy Code] or a custodian before such commencement; or
>
> (D) the satisfaction of any penalty rate or provision relating to a default arising from any failure by the debtor to perform nonmonetary obligations under the executory contract or unexpired lease . . . .

11 U.S.C. § 365(b).

126. Generally, the definition of executory contract employed and adopted by most courts (*i.e.*, material performance required by both sides) was engendered by scholar Vern Countryman. *See* DOUGLAS G. BAIRD ET. AL., CASES, PROBLEMS, AND MATERIALS ON BANKRUPTCY 200 (3d ed. rev. 2001).

127. Che & Schwartz provide the example:

> [I]f the contract required a seller to deliver goods to the firm and the seller had delivered them before insolvency, the contract is not executory: the seller fully performed her obligation, thereby maturing the buyer's duty to pay. If instead the contract required the seller to deliver goods and the firm became insolvent before the seller delivered or was paid, the contract is executory: the seller has still to perform and the buyer's obligation is contingent on performance.

Che & Schwartz, *supra* note 115, at 441-42.

128. H.R. REP. NO. 95-595, at 347 (1977), 1978 U.S.C.C.A.N. 5963, 6303; *see* S. REP. NO. 95-989, at 58 (1978), 1978 U.S.C.C.A.N. 5787, 5844.

129. BLACK'S LAW DICTIONARY 321 (7th ed. 1999).

130. *See* Sable v. Morgan Sangamon P'ship, 280 B.R. 217, 220 n.1 (N.D. Ill. 2002); *see also* Unsecured Creditors' Comm. of Robert L. Helms Constr. & Dev. Co. v. Southmark Corp. (*In re* Robert L. Helms Constr. & Dev. Co.), 139 F.3d 702, 705 (9th Cir. 1998) (en banc) ("[A] contract is executory if the obligations of both parties are so unperformed that the failure of either party to complete performance would constitute a material breach and thus excuse the performance of the other.") (citation and internal quotation marks omitted); Marre v. United States, 117 F.3d 297, 308 n.19 (5th Cir. 1997) ("'[A]n executory contract "is one that is still unperformed by both

Significantly, several courts suggest that where the debtor's only remaining performance is the payment of money, there can be no executory contract (even where the other side's performance is not yet completed).[131] This reasoning originates from the courts' reliance on a legislative history comment that an obligation on a note is not usually an executory contract.[132] However, certain commentators disagree:

> [T]his reliance seems misplaced, as the statement was not of a general proposition. Close examination of the statement reveals an assumption that the obligee on the note had no duties left to perform. Thus the statement's disqualification of the note as an executory contract may have had nothing to do with the remaining one-sided obligation being to pay money and everything to do with the remaining obligation being one-sided.[133]

b. The Economics of Enforcement

The Congressional intent behind section 365(e)(1) of the Bankruptcy Code was to protect debtors from the enforcement of unfavorable insolvency-triggered termination clauses in executory contracts and unexpired leases.[134] The invalidation of such clauses for section 365 purposes attempts to promote the goal of rehabilitating a debtor by enabling assumption (and hence, continuation of) beneficial contracts that would otherwise have terminated.[135] Bankruptcy courts additionally credit the desire to enhance a debtor's bankruptcy estate as a justification for the non-enforcement of ipso facto clauses.[136] However, recent economic analysis has cast doubt that restricting the enforcement of ipso facto clauses effectively accomplishes either of these goals.[137]

Nevertheless, at least one market-based reason exists for not enforcing ipso facto clauses: they may generate externalities.[138] Imagine the hypothetical creditor possessing a contract containing an ipso facto clause, entitling the creditor to repossession of goods that the debtor purchases in the event of bankruptcy. If the ipso facto clause is

---

parties or one with respect to which something still remains to be done on both sides'") (quoting Lee v. Cherry, 812 S.W.2d 361, 363 (Tex. App. 1991), *reh'g of writ overruled* (Jan. 8, 1992)).

131. Baird, *supra* note 126, at 200.

132. *Id.*

133. *Id.*

134. *See In re* S. Pac. Funding Corp., 268 F.3d 712, 716 (9th Cir. 2001).

135. *Id.* (citing H.R. Rep. No. 95-595, at 348-49, *reprinted in* 1978 U.S.C.C.A.N. 5963, 6304-05 (noting that enforcement of ipso facto clauses "frequently hampers rehabilitation efforts")).

136. Che & Schwartz, *supra* note 115, at 462.

137. *Id.*

138. *See* Jackson, *supra* note 106, at 890.

enforceable in bankruptcy, under certain circumstances an element of moral hazard is introduced where the creditor may have an incentive to promote the debtor's bankruptcy filing.[139] This would occur because the creditor, by possessing the rights of an "ipso facto" clause, is better off when the debtor goes into bankruptcy whenever the market rate of the goods exceeds the contract price.[140] Therefore, the creditor has an incentive to force a debtor into bankruptcy,[141] even if this is not in the debtor's other creditors' collective interest.[142] Alternatively, a debtor may forego bankruptcy because of the effect of bankruptcy on a single creditor relationship, even where bankruptcy would benefit the debtor's creditor body as a whole.

Under these circumstances, the creditor possessing the ipso facto clause could bargain with other creditors, but there would be high transaction costs in negotiation since there might be multiple creditors who possess dissimilar contractual entitlements.[143]

One may argue for non-enforcement of ipso facto clauses because they unfairly prioritize creditors who possess them. However, as with a secured creditor, those who possess ipso facto clauses have already "paid" for this entitlement, a higher probability of being repaid, by receiving of a lower return than had they priced in default risk (at least in theory).[144] Conversely, those creditors who do not possess such clauses have already been "paid" for allowing this prior entitlement since they receive a higher rate of return because of their lower

139. *Id.*

140. *Id.*

141. This issue may be weakened in this example in the section 523(a)(2)(A) context given the contract is a novation where the underlying "good" is the tort claim whose market price is not existent or at least not readily quantifiable. Moreover, the presence of transaction costs and uncertainty in actually pursuing a legal remedy may deter holders of a novation from behaving strategically. Furthermore, even in the goods contract context, an externality problem is not inevitable. First, the costs introduced by the presence of the ipso facto clause may be "priced out." The debtor could be affected directly by the costs the clause imposes on his other creditors in the form of higher credit charges by them. Second, there are rules that regulate the creditor-initiated implementation of the bankruptcy process, such as those that require that the debtor is not paying debts as they become due, and those that require, under certain circumstances, initiation by a minimum of three or more creditors with unsecured claims. *See* Jackson, *supra* note 106, at 891-92; discussion *infra* note 142.

142. Jackson, *supra* note 106, at 890. To the extent a creditor is able to either exert influence over a debtor to compel bankruptcy, or to file an involuntary bankruptcy proceeding under section 303 of the Bankruptcy Code, there may be remedies for improper action, whether under non-bankruptcy law, or under the provisions of the Bankruptcy Code. *See* 11 U.S.C. § 303(i) (2002). Perhaps a contract may contain restrictions on certain of the creditor's rights to propel the debtor into bankruptcy.

143. Jackson, *supra* note 106, at 890-891.

144. *Cf. id.* at 871.

priority position.[145] Besides, in the context of the section 523(a)(2)(A) fraud debate, the creditor who possesses a novation would have been entitled to non-dischargeability had she not novated the former tort claim.

Perhaps the strongest reason, however, for enforcing ipso facto clauses in the section 523(a)(2)(A) context is that, by definition, a novation is not generally executory.[146] Where the only remaining performance in a contract is the debtor's payment (such as in an installment sales contract), it is not executory and instead outside the section 365 framework.[147]

2. Enforceability of Ipso Facto Clauses Under Section 541 of the Bankruptcy Code

Although section 365 of the Bankruptcy Code is solely applicable to unexpired leases and executory contracts, the enforceability of ipso facto clauses must be examined in a broader context, on the ground that these clauses may nevertheless be subject to bankruptcy court approval and review.[148] In relevant part, section 541(c)(1) of the Bankruptcy Code provides:

> Except as provided in paragraph (2) of this subsection, an interest of the debtor in property becomes property of the estate under subsection (a)(1), (a)(2), or (a)(5) of this section notwithstanding any provision in an agreement, transfer instrument, or applicable nonbankruptcy law:
>
> * * *
>
> (B) that is conditioned on the insolvency or financial condition of the debtor, on the commencement of a case under this title, or on the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement, and that effects or gives an option to effect a forfeiture, modification, or termination of the debtor's interest in property.[149]

Under section 541(c)(1), bankruptcy courts may potentially be granted the discretion in bankruptcy cases to void ipso facto clauses–even where the clause is contained in an agreement that is neither an executory contract nor unexpired lease.[150] Indeed, this may very well

145. *Id.*

146. *See* Unsecured Creditors' Comm. of Robert L. Helms Constr. & Dev. Co. v. Southmark Corp. (*In re* Robert L. Helms Constr. & Dev. Co.), 139 F.3d 702, 705 (9th Cir. 1998) (en banc).

147. *See* Cunnigham, *supra* note 119, at 214 n.7.

148. William L. Medford & Bruce H. White, *Ipso Facto Clauses and Reality: I Don't Care What the Documents Provide*, 21-APR AM. BANKR. INST. J. 28, 51 (2002) (citing Farm Credit of Cent. Fla. ACA v. Polk, 160 B.R. 870 (Bankr. M.D. Fla. 1993), *In re* Randall Enters. Inc., 115 B.R. 292 (Bankr. D. Colo. 1990); *In re* Powers, 170 B.R. 480 (Bankr. D. Mass. 1994)).

149. 11 U.S.C. § 541(c)(1) (2002).

150. *See* Bank of Am., N.A. v. Garcia (*In re* Garcia), 276 B.R. 627, 639 (Bankr. D. Ariz. 2002).

have been the Bankruptcy Commission's intent in assembling the initial draft of the Bankruptcy Code, which "invalidated" ipso facto clauses and restraints on alienation.[151]

Although certain courts have opined that the eventually-adopted Bankruptcy Code voids ipso facto clauses altogether, there exists contrary authority to the effect that section 541(c)(1) only thwarts ipso facto clauses to the limited extent necessary to permit property to reach the debtor's bankruptcy estate.[152] Generally courts that universally invalidate ipso facto clauses, argue that the clauses run contrary to the bankruptcy law's policy of granting debtors a "fresh start."[153]

Furthermore, the legislative history of the Bankruptcy Code, as promulgated, indicates that sweeping invalidation of ipso facto clauses in bankruptcy was not Congress's intention.[154] Congress was apparently concerned with the inequity of validating ipso facto clauses in all circumstances under the Bankruptcy Act (the Bankruptcy Code's predecessor), as well as the arbitrariness which would be engendered if bankruptcy courts were required to evaluate ipso facto clauses on a piecemeal, equitable basis. As a result, in crafting section 365 of the Bankruptcy Code, Congress specifically forbade enforcement in bankruptcy of ipso facto clauses contained in executory contracts and unexpired leases, but implicitly left ipso facto provisions valid in other

151. *Id.* (citing Report of the Commission on the Bankruptcy Laws of the United States Pt. II, § 4-601(b), at 147-48, H.Doc. 93-137, 93d Cong., 1st Sess. (1973) ("Invalidity of Certain Restrictions and Forfeitures. Any prohibition on the transfer of property by the debtor and any provision for forfeiture or termination conditioned on the filing of a petition are unenforceable as to property of the estate . . . .").

152. *Id.* at 639-40. *Compare* Riggs Nat'l Bank of Washington, D.C. v. Perry (*In re* Perry), 729 F.2d 982, 985 (4th Cir. 1984) (finding ipso facto clauses unenforceable as a matter of law), *and* First & Merchs. Nat'l Bank v. Ballance (*In re* Ballance), 33 B.R. 89, 91 (Bankr. E.D. Va. 1983) (finding ipso facto clauses invalid under all circumstances) (citing *In re* N. Am. Dealer Group, Inc., 16 B.R. 996 (Bankr. E.D.N.Y. 1982)), *and* Brock v. Am. Sec. Bank (*In re* Brock), 23 B.R. 998 (Bankr. D.C. 1982)), *with* Gen. Motors Acceptance Corp. v. Bell (*In re* Bell), 700 F.2d 1053, 1058 (6th Cir. 1983) (holding that ipso fact clauses are to be initially held inoperative under section 541(c)(1), but that once the property was abandoned by the trustee, the section 541(c) prohibition was inoperative, and the ipso facto was once again effective) (citing *In re* Schweitzer, 19 B.R. 860, 865 (Bankr. E.D.N.Y. 1982)).

153. *See* Cunnigham, *supra* note 119, at 219.

154. Cunnigham cites as evidence:

> The Report of the Commission on the Bankruptcy Laws of the United States . . . , recommended rendering ipso facto clauses 'unenforceable as to property of the estate.' . . . The drafters apparently took this advice: 'Section 365(e) does not limit the application of an ipso facto or bankruptcy clause to a new insolvency or receivership after the bankruptcy case is closed. That is, the clause is not invalidated in toto, but merely made inapplicable during the case for the purposes of disposition of the executory contract or unexpired lease.' (citations omitted).

See Cunnigham, *supra* note 119, at 217 n.25.

contexts.[155] While this solution resolved some of the inequities of the Bankruptcy Act, courts continued to decide the propriety of ipso facto clause enforcement outside of the section 365 environment.[156]

3. Ipso-Facto Clauses in Other Contexts

There has been significant debate and indecision regarding the enforceability of ipso facto clauses in other specific bankruptcy and non-bankruptcy contexts. As a result of the existence of section 365's explicit provisions regarding the irrelevance of ipso facto clauses, these other contexts may be most useful in our analysis.

For example, courts have reached varying conclusions regarding the enforceability of pre-petition waivers of the automatic stay of (among other things) debt collection that the debtor's bankruptcy filing imposes, under section 362 of the Bankruptcy Code,[157] upon a debtor's creditors. Certain courts enforce these waivers against debtors,[158] many courts consider the waivers as factors in determining whether relief should be granted,[159] and some courts categorically refuse enforcement.[160] The courts ground their decisions on a variety of justifications. The policies of holding debtors to their contracts[161] and encouraging out-of-court restructuring[162] buttress the argument in favor of enforceability. In contrast, courts cite, among other things, protection of other creditors[163] and deprivation of a debtor's opportunity to reorganize[164] as reasons to deny enforcement of pre-petition waivers of the automatic stay.

Although provisions accelerating the maturity of debt upon a bankruptcy filing are generally enforceable,[165] similar debate exists in and

---

155. *Id.* at 229.

156. *Id.*

157. 11 U.S.C. § 362 (2002).

158. *See, e.g., In re* Cheeks, 167 B.R. 817 (Bankr. D.S.C. 1994).

159. *See, e.g., In re* Powers, 170 B.R. 480 (Bankr. D. Mass. 1994).

160. *See, e.g., In re* Pease, 195 B.R. 431 (Bankr. D. Neb. 1996).

161. *See In re* Gulf Beach Dev. Corp., 48 B.R. 40, 43 (Bankr. M.D. Fla. 1985).

162. *See In re Cheeks*, 167 B.R. at 819.

163. *See In re* Sky Group Int'l, Inc., 108 B.R. 86, 89 (Bankr. W.D. Pa. 1989).

164. *See In re* Jenkins Court Assocs. Ltd. P'ship, 181 B.R. 33, 36-37 (Bankr. E.D. Pa. 1995).

165. *See, e.g.,* Chrysler Credit Corp. v. Schweitzer (*In re* Schweitzer), 19 B.R. 860, 867-68 (Bankr. E.D.N.Y. 1982) ("[T]he contract provision which accelerated the debt upon the filing of the petition in reality did no more, at least in regard to the outstanding principal, than what the Code does automatically. In other words, inasmuch as 'bankruptcy operates as the acceleration of the principal amount of all claims against the debtor,' . . . one can hardly brand the clause as against public policy.") (citation omitted); *see also* 11 U.S.C. § 365(e)(2)(B) (1978) (Section 365(e)(1) of the Bankruptcy Code "does not apply to an executory contract . . . , if . . . such contract is a contract to make a loan, or extend other debt financing or financial accommodations, to or for the benefit of the debtor, or to issue a security of the debtor."). Of course, even

out of bankruptcy. These areas of debate include the enforceability of pre-petition waivers of the discharge which would otherwise be obtainable in bankruptcy,[166] stipulated findings that a bankruptcy filing was made in bad faith,[167] and usury "savings" clauses (stipulations preventing the amount of interest upon a loan from constituting a usurious rate).[168]

In these contexts, an important distinction must be made between ipso facto clauses which include a defendant-debtor's agreement that the debt in question will be excepted from the debtor's discharge upon a bankruptcy filing, and ipso facto clauses which simply permit a creditor-plaintiff's tort action to be automatically reinstated upon a bankruptcy filing. While ipso facto clauses extending to findings of nondischargeability (based upon an agreement as to the existence of fraud) may be subject to all of the policy concerns discussed in the contexts of, for example, automatic stay waivers, discharge waivers, and bad faith findings, these concerns may be both alleviated where the claim is simply resurrected and will be subject to adjudication, and outweighed by the competing policy concerns in favor of enforcement of the clauses.

4. Bankruptcy Courts Should Enforce Ipso Facto Clauses in the Section 523(a)(2)(A) Context

Accepting the conclusion that ipso facto clauses may be enforced outside the context of section 365 of the Bankruptcy Code, ipso facto clauses embedded in novations should be favored on equitable grounds. Since courts subscribing to *Greenberg's* reasoning attribute weight to providing honest debtors with a "fresh start" in bank-

---

though the maturity of debt may be accelerated, it still remains uncollectable absent relief from the automatic stay.

166. *Compare* Saler v. Saler (*In re* Saler), 205 B.R. 737, 743-48 (Bankr. E.D. Pa. 1997) (holding that a bankruptcy court approved stipulation of nondischargeability in nondischargeability litigation is enforceable in a subsequent bankruptcy proceeding), *aff'd*, 217 B.R. 166 (E.D. Pa. 1998), *with* Hayhoe v. Cole (*In re* Cole), 226 B.R. 647, 651-54 (B.A.P. 9th Cir. 1998) (holding pre-petition waiver of discharge void as against public policy).

167. *Compare In re* Aurora Invs., Inc., 134 B.R. 982, 986 (Bankr. M.D. Fla. 1991) (pre-petition stipulation of bad faith in filing bankruptcy petition held enforceable), *with* Colloquy, *Good Faith: A Roundtable Discussion*, 1 AM. BANKR. INST. L. REV. 11, 39-40 (1993) (in which certain sitting bankruptcy judges indicated their belief that pre-petition stipulations of bad faith are not *per se* enforceable, but do provide evidence of bad faith).

168. *Compare* 5636 Alpha Rd. v. NCNB Tex. Nat'l Bank, 879 F. Supp. 655, 658-59 (N.D. Tex. 1995) (usury savings clause held enforceable because it negated intent required for usury), *with* Swindell v. Fed. Nat'l Mortgage Ass'n, 409 S.E.2d 892, 896 (N.C. 1991) (usury savings clause held invalid as against public policy).

ruptcy,[169] these courts should uphold ipso facto clauses where enforcement will prohibit a debtor from discharging debt incurred as a result of the debtor's own dishonesty. In contrast, courts following the *Maryland Casualty* approach strongly support contractual freedom.[170] As both the creditor and debtor have explicitly expressed their intentions by fashioning the ipso facto clause included in the novation, these courts should also favor their enforcement in bankruptcy.

V. CONCLUSION

While courts presently disagree on the dischargeability of novated fraud debt under section 523(a)(2)(A) of the Bankruptcy Code, a pragmatic resolution may exist.

The Fourth, Seventh, and Ninth Circuits take the position that nondischargeable fraud debt may be transformed into dischargeable contract debt upon the debt's novation. These courts reason that their approach encourages and enforces settlements. To the contrary, the District of Columbia and Eleventh Circuits (as well as a Bankruptcy Appellate Panel in the Sixth Circuit) disagree, arguing that discharging novated fraud debt encourages strategic bankruptcies by dishonest debtors.

While the concerns that these courts raise are grounded in logic, dogmatic attachment to either of the favored rules does not appear to provide an adequate resolution. It is not at all clear that the *Maryland Casualty* approach achieves its goal of encouraging settlements. Moreover, the *Greenberg* approach may prove flawed where sophisticated creditors are capable of assessing a debtor's default risk, and pricing this risk into the novation.

However, despite some court's disinclination to enforce ipso facto clauses in bankruptcy, encouraging ipso facto clauses may provide a solution that better fulfills the courts' objectives. Where a novation contains an ipso facto clause providing that the contract-based claim reverts to a tort cause of action upon the tortfeasor's bankruptcy filing, that clause should be enforced in bankruptcy. Where the ipso facto clause is more daring, and provides for a stipulated finding of nondischargeability, the clause may still be enforceable, depending on the bankruptcy court's evaluation of competing policy rationales.[171] Alternatively, where the novation explicitly provides that the debt

169. *See* Archer v. Warner (*In re* Warner), 283 F.3d 230, 239 (4th Cir. 2002) (Traxler, J., dissenting).

170. *See supra* note 34.

171. In this circumstance, at the very least, the bankruptcy court should allow the claim to revert to a tort-based cause of action.

shall remain contract-based despite the bankruptcy, with no reinstatement of the tort-based claim, the debt in question should be discharged upon bankruptcy. Finally, where the contract lacks an ipso facto clause, the intent of the parties is ambiguous and should remain subject to the bankruptcy court's assessment and findings of fact.

Where sophisticated creditors have already priced into a novation a debtor's default risk, this approach does not provide them with a windfall. Less sophisticated creditors, or sophisticated creditors which opt not to accept bankruptcy risk, will not be threatened by the prospect of a debtor's default, and will therefore be encouraged to release a debtor from tort claims. Finally, because strategic defaults are no longer in their interest, debtors are armed with the means to signal creditors of their credible commitment to abide by the novation's repayment terms.