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Dischargeable Debt? Not So Fast! – The Requirement To "Look Behind" Debts To Determine Their True Nature

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Section 523 of the Bankruptcy Code (the "Code") governs the discharge of certain debts of a debtor seeking a fresh start (this is not to be confused with an *individual debtor receiving a discharge*, which is governed by Section 727 of the Code). Notably, however, not all debts are created equal. *See* Non Dischargeable Debts; *see also* Debtors Behaving Badly: Non-Dischargeabillty of Debt Based on Debtor's "Bad Acts".

Section 523 of the Code provides a list of 19 kinds of debts that can survive a bankruptcy case allowing creditors to continue to seek collection of those types of debts. These nondischargeable debts include those arising from fraud, willful and malicious actions, family support, tax debts, and bad acts. *See* The Continuing Saga of Amber Heard and Johnny Depp: Is Bankruptcy the Next Stop and Is a "Fresh Start" Available for Amber Heard?

But what if there's a debt arising from a breach of a settlement agreement resolving a debt which would have been nondischargeable? Is that a dischargeable breach of contract debt or does it retain its original nondischargeable character?

In a recent case, *Hilgartner v. Yagi (In re Hilgartner)*, 22-1762 (4th Cir. Jan. 18, 2024), a debtor entered into a settlement agreement resolving a tort based on the debtor's willful and malicious conduct. The debtor then breached the settlement agreement and argued that the debt arising from the breach was dischargeable as a breach of contract.

The Fourth Circuit Court of Appeals disagreed with the debtor and found that the non-performance of the settlement agreement was also nondischargeable. The Court explained that since the breached contract relates back to the underlying dispute (*i.e.* – based on the debtor's willful and malicious conduct), the breach of contract is also nondischargeable. *Hilgartner v. Yagi (In re Hilgartner)*, 22-1762 (4th Cir. Jan. 18, 2024).

This is not the first time this issue has been presented to the court. As referenced and relied upon in the opinion in *Hilgartner*, the Supreme Court addressed this issue in *Archer v. Warner*, 538 U.S. 314 (2003).

In *Archer*, after the debtors sold a company to creditors, the creditors sued the debtors in state court for fraud in connection with the sale. The lawsuit was ultimately settled, resulting in the debtors executing a promissory note for part of the settlement payment. However, the debtors failed to make the first payment and then filed for

bankruptcy. *Archer*, at 317-18.

The Bankruptcy Court, the District Court, and the Court of Appeals for the Fourth Circuit all held that the settlement agreement, releases, and promissory note all acted as a novation. *Id.* at 318. In making this determination, these courts concluded that the novation replaced the original debt for money obtained by fraud, with a new debt for money promised in a settlement agreement, and was thus dischargeable. *Id.*

However, the Supreme Court, in reviewing the *Archer* case, reversed and remanded the lower courts' decisions reasoning that, although the "settlement agreement and releases may have worked a kind of novation, that fact did not bar the [creditors] from showing that the settlement debt arose out of 'false pretenses, a false representation, or actual fraud' and consequently is nondischargeable, 11 U.S.C. § 523(a)(2)(A)." *Id.* at 323.

Thus, if a debt from breach of settlement agreement arises from an original debt that was, itself, nondischargeable, then that settlement agreement debt is also nondischargeable. In other words, "the true nature of the debt, rather than the formal mechanism imposing it, controls." *Hilgartner*, *supra.* at *6 (internal quotations omitted). Banking institution clients and trade creditors should be mindful of this principle and consult with counsel.

Please note this is a general overview of developments in the law and does not constitute legal advice. Nothing herein creates an attorney-client relationship between the sender and the recipient. If you have any questions regarding the provisions discussed above, or any other aspect of bankruptcy law, please contact Michael H. Traison (mtraison@cullenllp.com) at 312.860.4230 or Jocelyn E. Lupetin (jlupetin@cullenllp.com) at 513.296.9109.

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