Washington and Lee Law Review

Volume 37 | Issue 1 Article 16

Winter 1-1-1980

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Recommended Citation

Res Judicata and Collateral Estoppel in Bankruptcy Discharge Proceedings, 37 Wash. & Lee L. Rev. 281 (1980).

Available at: https://scholarlycommons.law.wlu.edu/wlulr/vol37/iss1/16

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RES JUDICATA AND COLLATERAL ESTOPPEL IN BANKRUPTCY DISCHARGE PROCEEDINGS

A debtor who files a petition for bankruptcy seeks to have his debts adjudicated discharged.[1] Bankruptcy courts, in determining whether a debt is dischargeable,[2] occasionally consider whether res judicata or collateral estoppel effect should be given to a prior state court judgment on the debt.[3] The doctrines of res judicata and collateral estoppel are fundamental precepts of common law.[4] The doctrines require that a right, question, or fact put in issue and specifically determined by a court of competent jurisdiction cannot be relitigated by the same parties in a subsequent suit.[5]

Res judicata makes a valid, final judgment on the merits conclusive as to all matters that should or could have been litigated in reference to the

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[1] "Discharge" is the release of a bankrupt debtor from all his debts except such debts which are excepted by the Bankruptcy Act. 11 U.S.C. § 1(15) (1976).

[2] In a bankruptcy proceeding, the debtor first is granted a general discharge for all his debts. After the general discharge, a creditor can have a particular debt, which falls under one of the the exceptions to discharge, declared nondischargeable. D. EPSTEIN & J. LANDERS, DEBTOR AND CREDITORS CASES AND MATERIALS 386-87 (1978) [hereinafter cited as EPSTEIN]. Both the Bankruptcy Act of 1898 ("Bankruptcy Act"), 11 U.S.C. §§ 1-1086 (1976), and the Bankruptcy Reform Act of 1978 ("Reform Act"), 11 U.S.C.A. §§ 101-151326 (1979), allow exceptions to discharge. The Bankruptcy Act provides both a federal remedy for creditors and a federal relief for debtors. EPSTEIN, *supra* at 380. The Bankruptcy Act is designed to relieve the honest debtor from his debts and to give him a fresh start in the business world. Local Loan Co. v. Hunt, 292 U.S. 234, 245 (1934). The Reform Act is designed to modernize the bankruptcy laws to reflect the changes in modern society. *See* H.R. REP. No. 595, 95th Cong., 1st Sess. 3, 4, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 5963, 5965.

The specific types of debts excepted from the general discharge are listed in § 17a of the Bankruptcy Act and in § 523a of the Reform Act. 11 U.S.C. § 35a (1976); 11 U.S.C.A. § 523a (1979). Examples of these exceptions are debts for taxes, debts induced by fraud, and debts for willful and malicious injury. 11 U.S.C. § 35a(1), (2), (4) & (8) (1976); 11 U.S.C.A. § 523a(1), (2), (4) & (6) (1979).

[3] Occasionally a creditor, who files a complaint in the bankruptcy court to determine dischargeability of a debt, has previously obtained judgment on the debt against the bankrupt in a state court. The bankruptcy court must decide to what extent the prior decison binds the bankruptcy court by the doctrines of res judicata and collateral estoppel. Lasarow, *Debts Not Affected by Discharge*, in 232 CORPORATE LAW AND PRACTICE 198 (PLI 1977).

The problem of whether res judicata or collateral estoppel effect should be given to a prior judgment also arises when the debt has been reduced to judgment by a federal court. *See* Heiser v. Woodruff, 327 U.S. 726, 732-33 (1946) (prior judgment by federal court with diversity jurisdiction); *In re* Ross, 602 F.2d 604, 607 (3d Cir. 1979) (prior judgment by federal court applying federal securities laws). *See* text accompanying notes 78-90 *infra*.

[4] *See* Montana v. United States, 440 U.S. 147, 153 (1979).

[5] *See id.* The theory behind the doctrines of res judicata and collateral estoppel is that an issue should be judicially determined only once between the same parties and their privies. *Id.* By barring a party from contesting matters which he had a full and fair opportunity to litigate, the other party is protected from the expense and vexation attending multiple lawsuits. Also, res judicata and collateral estoppel promotes conservation of judicial resources and an increased reliance on judicial action since the possibility of inconsistent decisions is minimized. *Id.* at 153-54.

same cause of action.[6] Application of res judicata necessitates identifying the causes of action in two different suits involving the same parties. If the causes of action are the same, the judgment in the first suit constitutes an absolute bar to the second suit.[7]

Although the doctrine of res judicata is concerned with "causes of action" in different suits between the same parties, the doctrine of collateral estoppel is concerned with "issues" raised in different suits between the same parties.[8] If an issue is litigated in the first suit, collateral estoppel bars relitigation of that issue in a second suit.[9] The decision of the first court on the common issue is binding and conclusive on the second court.[10]

In order for the doctrine of collateral estoppel to apply, four requirements must be met. First, the issue presented in the second action must be identical to that involved in the prior action.[11] The first court, in determining factual issues, must have used standards identical to those standards which would be used by the second court in determining the same issue.[12] Second, the issue must actually have been litigated and adjudicated in the prior action.[13] In order for there to be an actual litigation, there

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[6] *See id.*; Cromwell v. County of Sac, 94 U.S. 351, 352 (1876). Res judicata does not operate as a bar in a suit on a different cause of action. *See* 1B MOORE'S FEDERAL PRACTICE ¶ 0.401 (2d ed. 1974) [hereinafter cited as 1B MOORE'S].

[7] *See* 1B MOORE'S, *supra* note 6, ¶ 0.410[1].

[8] In a bankruptcy discharge proceeding, only the creditor to whom a particular debt is owed by the bankrupt has standing to claim that the particular debt should be excepted from the general discharge. 11 U.S.C. § 35c(2) (1976); 11 U.S.C.A. § 523c (1979). *See also* note 2 *supra*.

[9] *See* Montana v. United States, 440 U.S. 147, 153 (1979). Collateral estoppel bars relitigation of an issue even though the second suit is so different from the first that the second suit is not barred by res judicata. *See* 1B MOORE'S, *supra* note 6, ¶ 0.441[2].

[10] *See* Montana v. United States, 440 U.S. 147, 153 (1979); 1B MOORE'S, *supra* note 6, ¶ 0.441[2]. To illustrate the difference between res judicata and collateral estoppel, consider the following hypothetical. A sues B for injuries incurred in an automobile accident and alleges B is liable because of negligence. A judgment is rendered on the merits in favor of A. The judgment is a final judicial settlement of A's claim against B concerning the accident. Even though A may have been able to recover more money through punitive damages based on a theory that B willfully and maliciously caused the accident, A is barred by res judicata from doing so in a subsequent suit because the cause of action in the second suit would be the same as the first. *See id.* ¶ 0.405.

Suppose, however, A subsequently sues B on a different cause of action, such as placing a judgment lien on B's property to enforce the judgment above. The first suit would not have res judicata effect on this second suit. Nevertheless, collateral estoppel would bar the relitigation of B's liability to A regarding the accident. The second court must accept the issue of B's liability as conclusive. *See id.*

[11] *See In re* Ross, 602 F.2d 604, 608 (3d Cir. 1979); *In re* Merrill, 594 F.2d 1064, 1067 (5th Cir. 1979); 1B MOORE'S, *supra* note 6, ¶ 0.443[1].

[12] *See* Brown v. Felsen, 99 S. Ct. 2205 (1979). The Supreme Court noted in *Brown* that a prior state court decision may have collateral estoppel effect if the state court determined factual issues using standards identical to those of § 17 of the Bankruptcy Act, 11 U.S.C. § 35 (1976). *Id.* at 2213 n.10.

[13] *See In re* Ross, 602 F.2d 604, 608 (3d Cir. 1979); *In re* Merrill, 594 F.2d 1064, 1067 (5th Cir. 1979); 1B MOORE'S, *supra* note 6, ¶ 0.443[1].

must be a trial on the merits. Collateral estoppel effect will not be given to default or consent judgments, or to stipulated judgments unless the record is clear that the parties intended the decision to be binding in future suits.[14] An issue also must have been fully adjudicated. Full adjudication requires that the court make specific findings concerning the issue.[15] Third, the issue must have been material and relevant to the disposition of the first action.[16] If the first court decided a matter related to the facts at issue, but the determination of the related matter was not material to the disposition of the first action, the determination of the related matter has no collateral estoppel effect on any subsequent action.[17] The fourth requirement for application of the collateral estoppel doctrine mandates that the determination of the issue was essential and necessary to the prior judgment.[18]

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[14] *See* 1B MOORE'S, *supra* note 6, ¶ 0.444[1]; *In re* McMillan, 579 F.2d 289, 293 (3d Cir. 1978) (prior state court default judgment not given collateral estoppel effect because issue not actually litigated); *In re* Garland, 401 F. Supp. 608, 610 n.3 (E.D. Pa. 1975) (default judgment has no collateral estoppel effect in later suits involving different matters); *In re* Wong, 5 BANKR. CT. DEC. 222, 225 (D. Ore. 1979) (default judgment does not give rise to rebuttable prima facie case of fraud); *In re* Conway, 3 BANKR. CT. DEC. 365, 366 (N.D. Tex. 1977) (issues not litigated in default judgment); *In re* Garrard, 3 BANKR. CT. DEC. 223, 225 (N.D. Ga. 1977) (debtor should not be compelled to defend and litigate merely to establish precise ground of liability). *But see In re* Nadler, 424 F. Supp. 1106, 1108 (E.D. Mo. 1976) (consent judgment equivalent to admission by defendant that facts existed on which decree rests).

[15] The situation where a creditor sues a debtor based on breach of contract and fraud illustrates the requirement of actual adjudication for collateral estoppel. If in awarding judgment for the creditor the court addresses only the breach issue and does not address the fraud issue, there is collateral estoppel only with respect to the breach. The fraud issue was not adjudicated. *See* Russell v. Place, 94 U.S. 606, 609-10 (1876); 1B MOORE'S, *supra* note 6, ¶ 0.443[4].

[16] *See* 1B MOORE'S, *supra* note 6, ¶ 0.443[1]; note 17 *infra.*

[17] Landon v. Clark, 221 F. 841 (2d Cir. 1915), illustrates the application of the material and relevant requirement of collateral estoppel. In the first suit, Clark sued Landon's predecessor in title for trespassing on Wickham Pond, claiming he owned the entire pond. *Id.* at 842. Landon's predecessor admitted trespassing but claimed ownership of a substantial portion of the pond, including the areas upon which he had entered. The court ruled in favor of Landon's predecessor stating that the predecessor was the owner of that portion of the pond to which he claimed title. *Id.* at 846. The first court expressly found that several tracts belonged to Landon's predecessor and that one of these tracts, consisting of 8.7 acres, was the tract on which the alleged trespass had been committed. *Id.*

Subsequently, Landon sued Clark to quiet title to tracts of Wickham Pond which Landon's predecessor claimed and which had been decreed to belong to Landon's predecessor by the prior suit. Clark did not question Landon's ownership of the 8.7 acre tract but contended that the prior suit had no collateral estoppel effect as to the other tracts. The court agreed with Clark reasoning that title to the other tracts was not material to the prior suit since the prior judgment had not depended upon findings of title, except as to the 8.7 acre tract. *Id.* at 847.

[18] *See In re* Ross, 602 F.2d 604, 608 (3d Cir. 1979); *In re* Merrill, 594 F.2d 1064, 1067 (5th Cir. 1979); 1B MOORE'S, *supra* note 6, ¶ 0.443[1]. The collateral estoppel requirement that the determination of the issue must have been essential and necessary presents a problem when a plaintiff bases his claim in the first suit on independently adequate grounds. *Id.* ¶

A bankruptcy judge occasionally considers the doctrines of res judicata and collateral estoppel[19] when, prior to the debtor's petition for bankruptcy, a state court has reduced to judgment specific contractual debts of the debtor. The creditor usually based his state court claim to recover the debt on contract theory and not on fraud.[20] Even if the creditor also alleged fraud, the state court usually awarded judgment based on contract theory alone and did not make any findings on the fraud claim.[21] Often judgment was awarded by default or stipulation which also results in reduction of the debt to judgment without a specific finding of fraud.[22] Since the debt is reduced to judgment before the debtor files for bankruptcy, the bankruptcy court faces a res judicata problem when a creditor claims that

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0.443[5]. The situation where the creditor sues to recover a debt and bases his claim on breach of contract and fraud illustrates the essential and necessary requirement. If the first court renders a general verdict in favor of the creditor but is silent as to whether the creditor prevailed on the contract issue or the fraud issue, there is no collateral estoppel effect given to either the contract issue or the fraud issue. On the other hand, if the court makes specific findings that there was fraud and a breach of contract, there is collateral estoppel effect given to both even though the court ruled in favor of the creditor alternatively on the two grounds. *See id.*; United States v. Title Ins. & Trust Co., 265 U.S. 472, 486 (1924) (when trial court bases decision on two grounds, either of which supports judgment, and appellate court adopts both grounds, there is collateral estoppel on both grounds); Irving Nat. Bank v. Law, 10 F.2d 721, 724 (2d Cir. 1926) (if court decides case on two independent grounds, each has collateral estoppel effect); RESTATEMENT OF JUDGMENTS § 68, comment n (1942) (judgment based on alternative grounds has collateral estoppel effect on both grounds). *But see* Halpern v. Schwartz, 426 F.2d 102, 105 (2d Cir. 1970) (no collateral estoppel effect to either alternative ground since losing party might not appeal because of likelihood at least one ground would be upheld); RESTATEMENT (SECOND) OF JUDGMENTS, Explanatory Notes § 68, comments i, o (Tent. Draft No. 4, 1977) (adopting position of *Halpern v. Schwartz* unless appellate court upholds both grounds as sufficient).

The problem presented by the essential and necessary requirement becomes more acute if the first court specifically determines that there was a breach of contract but not fraud. Although collateral estoppel effect will be given to the contract issue, the majority rule does not give collateral estoppel effect to the fraud issue. *See* 1B MOORE'S, *supra* note 6, ¶ 0.443[5]. The rational behind the majority rule is that the creditor, as the winning litigant, cannot appeal the first court's decision. *See id. But cf.* Equitable Life Assur. Soc. v. Gillan, 70 F. Supp. 640, 650 (D. Neb. 1945) (suggesting that a rule which denies collateral estoppel effect to issues decided against winning litigant should be limited to situations in which losing litigant does not appeal).

[19] *See* note 3 *supra.*

[20] *See In re* Nicholas, 510 F.2d 160, 162 (10th Cir.), *cert. denied,* 421 U.S. 1012 (1975). In *Nicholas,* the creditor instituted an action in state court to recover a debt and only alleged breach of contract. After creditor was awarded judgment, the debtor filed for bankruptcy. The circuit court held the debt was dischargeable. *Id.* at 163. The court reasoned that since the creditor could have raised a fraud claim in the state court, the doctrine of res judicata barred the bankruptcy court from deciding whether the debt was induced by fraud. Thus, the debt was excepted from discharge under 11 U.S.C. § 35a(2) (1976). 510 F.2d at 163-64. *But see* text accompanying notes 26-44 *infra.*

[21] The state court will not make any findings on the fraud claim since the court has already found there was a breach of contract and the debtor owes the creditor money. *See, e.g., In re* Pigge, 539 F.2d 369, 372 (4th Cir. 1976) (creditor sued on both breach and fraud, but state court only made findings on breach).

[22] *See* text accompanying notes 28-30 *infra.*

the same debt is not dischargeable under section 523a(2)[23] of the Bankruptcy Reform Act of 1978[24] (Reform Act) because of fraud perpetrated by the debtor on the creditor.[25] The bankrupt debtor will claim that there was no finding of fraud in the prior state court decision. Therefore, res judicata arguably would bar litigation of the fraud issue, even though the application of section 523a(2) was not an issue in the state court proceedings.

The fraud claim sometimes is fully litigated in the prior state court proceedings, and the state court makes specific findings of fraud by the debtor. In this situation, the creditor claims that the bankruptcy court is barred from relitigating the fraud issue. By the doctrine of collateral estoppel, the bankruptcy court arguably must accept the state court findings of fraud and, therefore, must declare the debt nondischargeable.

In *Brown v. Felsen,*[26] the Supreme Court determined whether a state court proceeding which reduced a debt to judgment prior to bankruptcy would have res judicata effect on a bankruptcy court proceeding, when the bankruptcy court subsequently considers the dischargeability of the same debt under section 17a(2) of the Bankruptcy Act.[27] Brown, the plaintiff,

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[23] 11 U.S.C.A. § 523a(2) (1979). Section 523a lists types of debts excepted from the general discharge given to a bankrupt. *See* note 2 *supra* & note 25 *infra.*

[24] 11 U.S.C.A. § 101-151326 (1979).

[25] Under § 17a(2) of the Bankruptcy Act, there must be actual fraud perpetrated by the debtor on the creditor. Fraud implied by law, which may exist without imputation of bad faith or immorality, is insufficient. 1A COLLIER ON BANKRUPTCY ¶ 17.16[3] (14th ed. 1978) [hereinafter cited as 1A COLLIER 1978]. Early interpretations of § 17a(2) required that in order for there to be actual fraud under § 17a(2), the creditor must show that the debtor knowingly made false representations with the intent to deceive the creditor. *See id.* Presently, the debtor need not have actual knowledge that the representations were false, but he only needs have had a reckless disregard for the truth. *See* Carini v. Matera, 592 F.2d 378, 380 (7th Cir. 1979); *In re* Houtman, 568 F.2d 651, 656 (9th Cir. 1978); *In re* Butler, 425 F.2d 47, 50 (3d Cir. 1970); *In re* Blessings, 442 F. Supp. 68, 70 (S.D. Ind. 1977); *In re* Smith, 424 F. Supp. 858, 861 (M.D. La. 1976); *In re* Bowler, 208 F. Supp. 879, 880 (W.D. Va. 1962). In addition, the creditor reasonably must have relied on these representations and sustained the alleged damage as the proximate result of the representations. *See In re* McMillan, 579 F.2d 289, 292 n.5 (3d Cir. 1978); *In re* Houtman, 568 F.2d at 655; *In re* Burton, 4 BANKR. CT. DEC. 569, 570 (S.D.N.Y. 1978).

Section 523a(2) of the Reform Act is the replacement provisions for § 17a(2) and only slightly modifies § 17a(2). *See* 3 COLLIER ON BANKRUPTCY ¶ 523.07 (15th ed. 1979) [hereinafter cited as BANKRUPTCY 1979]. "Actual fraud" has been added as a ground for exception from discharge. The creditor's reliance on the false representations also must have been reasonable. These modifications codify case law construing § 17a(2) of the Bankruptcy Act. *See, e.g., In re* McMillan, 579 F.2d at 292 n.5; *In re* Houtman, 568 F.2d at 655; *In re* Burton, 4 BANKR. CT. DEC. at 570. Third, Congress deleted as unnecessary the phrase "in any manner whatsoever" that appears in § 17a(2) after "made or published." S. REP. No. 989, 95th Cong., 2d Sess. 78, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 5787, 5864; H.R. REP. No. 595, 95th Cong., 1st Sess. 364, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 5963, 6320; *accord,* BANKRUPTCY 1979, *supra,* ¶ 523.07. Therefore, although the discussion which follows in the text will be based on cases and writings on § 17a(2) of the Bankruptcy Act, the discussion should apply equally to § 523a(2) of the Reform Act.

[26] 99 S. Ct. 2205 (1979).

[27] *Id.* at 2207. In addition to claiming that the debt could not be discharged by § 17a(2) of the Bankruptcy Act, the creditor in *Brown* claimed that the debt could not be discharged

had guaranteed certain loans made by Felsen, the defendant. Before the defendant filed for bankruptcy, the creditor-bank brought a collection suit against the defendant-debtor and against the plaintiff, as the guarantor of the loan. The plaintiff-guarantor filed a cross-claim against the defendant alleging that the defendant induced the plaintiff to sign the guaranty through misrepresentation and nondisclosure of material facts.[28] The collection suit was settled by stipulation which granted joint and several recovery to the creditor-bank against both the plaintiff-guarantor and the defendant-debtor. The stipulation also provided that the plaintiff should prevail against the defendant on the cross-claim. Neither the stipulation nor the resulting judgment, however, indicated the cause of action on which defendant's liability to the plaintiff was based.[29] Subsequently, the defendant filed for bankruptcy. The plaintiff sought to establish that defendant's debt was not dischargeable because of defendant's fraud in the inducement of the guarantee. The defendant claimed that there was no finding of fraud in the prior state court proceedings and that res judicata barred the bankruptcy court from litigating the issue. The bankruptcy court agreed with the defendant and held the debt dischargeable.[30]

The Supreme Court reversed the decisions below and rejected defendant's contention that res judicata should apply.[31] The Supreme Court held that a bankruptcy court is not limited to the judgment and record of a prior state court proceeding when considering the dischargeability of a debt.[32] Further, the Court reasoned that in an ordinary collection proceeding, considerations material to discharge are irrelevant. The creditor in a collection proceeding is suing on the instrument which created the debt, and the cause of action is for non-payment of the debt.[33] In the subsequent bankruptcy proceeding, the cause of action is based on the allegation that the debt is not dischargeable. Thus, the dischargeability cause of action does not arise until the debtor is declared bankrupt.[34]

The *Brown* Court further reasoned that when a fraud issue is presented in the state court proceeding, the state law concept of fraud is likely to differ from that of section 17a(2) of the Bankruptcy Act.[35] If res judicata

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by § 17a(4) of the Bankruptcy Act. *Id.* at 2208. The Court narrowed its discussion to fraud which is an element of both §§ 17a(2) and 17a(4). *Id.* at 2208-09.

[28] *Id.* at 2207.

[29] *Id.*

[30] *Id.* at 2207-09. Both the district court and the court of appeals affirmed the bankruptcy court in *Brown. Id.* at 2209.

[31] *Id.* at 2213.

[32] *Id.*

[33] *Id.* at 2211.

[34] *See* 1A COLLIER 1978, *supra* note 25, ¶ 17.16[6] n.50; *In re* Conway, 3 BANKR. CT. DEC. 365, 365 n.4 (N.D. Tex. 1977) (causes of action are different); Fidelity & Casualty Co. v. Golombosky, 133 Conn. 317, 50 A.2d 817, 820 (1946) (cause of action in discharge hearing is extraneous to cause of action in prior suit on debt).

[35] 99 S. Ct. at 2211. The Bankruptcy Act requires actual fraud perpetrated by the debtor on the creditor. Fraud implied by law is insufficient. *See* 1A COLLIER 1978, *supra* note 25, ¶ 17.16[3].

applies, a creditor would be forced to litigate every possible exception to discharge in order to protect himself against the possibility that the debtor may later be adjudicated bankrupt, thus creating unnecessary litigation.[36] Even if the state law fraud concept was identical to that required by section 17a(2), the creditor may not consider claiming fraud to be advantageous to him in a prebankruptcy collection suit.[37] So long as a debtor is solvent, a contract suit is preferable to an inherently more complex fraud suit.[38] A fraud action may result in increased legal fees for both parties and may force the debtor into bankruptcy,[39] thus decreasing the creditor's chances of full payment.[40]

As an additional reason for not allowing a prior state court proceeding to have res judicata effect on a subsequent bankruptcy proceeding, the *Brown* Court held that adoption of a policy of res judicata would undercut congressional intent to commit section 17a(2) issues to the jurisdiction of the bankruptcy court.[41] The 1970 amendments to the Bankruptcy Act eliminated post-bankruptcy state court collection suits as a means of resolving section 17a(2) dischargeability questions.[42] The 1970 amendments gave the bankruptcy court "exclusive" jurisdiction to determine the dischargeability of certain debts, including those falling under section 17a(2).[43] While Congress did not specifically confront the problems created by prebankruptcy state court judgments, the Supreme Court reasoned that to give res judicata effect to prior state court proceedings, which forces section 17a questions back into state courts, would be inconsistent with the philosophy of the 1970 amendments.[44]

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[36] 99 S. Ct. at 2211; *accord, In re* Lovitt, 4 BANKR. CT. DEC. 14, 17 (D.R.I. 1978) (no res judicata since creditor would have to anticipate debtor's bankruptcy); *cf.* Pioneer Finance and Thrift Co. v. Powell, 21 Utah 2d 201, 443 P.2d 389, 391 (1968) (when not necessary to determine whether debt was induced by fraud, court should not determine fraud issue merely because debtor may go bankrupt).

[37] 99 S. Ct. at 2212.

[38] *Id.* at 2212 n.8.

[39] In a fraud action the creditor may be awarded punitive damages, but the advantages of these additional damages may be offset by the prospect of driving the debtor into bankruptcy. *Id.*

[40] *Id.*

[41] *Id.* at 2211.

[42] 11 U.S.C. § 35c (1976). The 1970 amendments to the Bankruptcy Act vested the bankruptcy courts with exclusive jurisdiction on questions of exceptions to discharge under Bankruptcy Act § 17a(2), (4) & (8). 11 U.S.C. § 35a(2), (4), & (8) (1976). *See, e.g., In re* McMillan, 579 F.2d 289, 291 (3d Cir. 1978); *In re* Houtman, 568 F.2d 651, 653 (9th Cir. 1978); Countryman, *The New Dischargeability Law,* 45 AM. BANKR. L.J. 1, 25-28 (1971) [hereinafter cited as Countryman]. Other courts have concurrent jurisdiction on discharge questions falling under other paragraphs of Bankruptcy Act § 17. *See, e.g., In re* Houtman, 568 F.2d at 653; Countryman, *supra* at 29. *See also* text accompanying notes 56-65 & 70-75 *infra.*

[43] 99 S. Ct. at 2211-12. *See* note 42 *supra.*

[44] 99 S. Ct. at 2212. *Brown v. Felsen* is in accord with the majority of previous decisions which have addressed the res judicata issue in connection with fraud. *See, e.g., In re* Pigge, 539 F.2d 369, 372 (4th Cir. 1976) (unnecessary for state court to consider fraud issue when state court found debtor owed money); *In re* Burns, 357 F. Supp. 176, 178 (D. Kan. 1972) (no res judicata because of 1970 amendments granting exclusive jurisdiction to bankruptcy

Brown v. Felsen apparently settled the res judicata question faced by bankruptcy courts when determining whether a debt is nondischargeable because of fraud. Specifically, when a prebankruptcy state court proceeding has reduced a debt to judgment without commenting on whether the debtor is liable for fraud, the bankruptcy court will not be limited to the state court record to determine whether the debt is nondischargeable because of fraud. However, in a footnote to *Brown v. Felsen,*[45] the Supreme Court conspicuously left the collateral estoppel question unresolved. The *Brown* Court stated that "[t]his case concerns res judicata only, and not the narrower principle of collateral estoppel."[46] The Court noted, however, that absent countervailing statutory policy of the Bankruptcy Act, collateral estoppel effect would be given to a prior state court decision if the state law standards for fraud are identical to the Bankruptcy Act standards.[47]

Based on the *Brown* footnote, a bankruptcy court, while barred from giving a prior state court decision res judicata effect, would not be barred from giving the prior decision collateral estoppel effect unless there is a statutory policy of the Bankruptcy Act against collateral estoppel. The statutory policy of the Bankruptcy Act is twofold. The primary purpose of the Act is to collect and distribute the bankrupt's estate to his creditors.[48] The discharge of the bankrupt from his debts is a secondary purpose.[49] Discharge is only granted to the honest debtor.[50] Consequently, there should be no counterveiling statutory policy against collateral estoppel when the bankrupt previously has been adjudicated a defrauder by a state court applying standards of fraud identical to the standards of section 17a(2) of the Bankruptcy Act or section 523a(2) of the Reform Act. A bankruptcy judge seemingly is no more qualified to decide a case involving

courts. *See also* notes 34 & 36 *supra.*

The few courts which have held that res judicata should apply have done so based on the doctrine of res judicata in general and have failed to consider the purpose of the 1970 amendments. *See In re* Nicholas, 510 F.2d 160, 163 (10th Cir.), *cert. denied,* 421 U.S. 1012 (1975) (since entire record of state court established liability based on breach of contract and did not mention fraud, res judicata bars bankruptcy court from looking behind state court record); *In re* Matthews, 2 BANKR. CT. DEC. 492, 496 (N.D. Ala. 1976); *cf.* William McDonald LTD. v. Miller, 4 BANKR. CT. DEC. 954, 957 (N.D. Tex. 1978) (court noted parties knew bankruptcy was contemplated when consent judgment in state court was entered); *In re* Cervone, 2 BANKR. CT. DEC. 872, 874-75 (W.D. Pa. 1976) (prior state court decision had res judicata effect on nondischargeability claim for willful and malicious injury under Bankruptcy Act section 17a(8) because creditor could have brought action on this cause in state court).

[45] 99 S. Ct. at 2213 n.10.

[46] *Id.*

[47] *Id.*

[48] *See* 1A COLLIER 1978, *supra* note 25, ¶ 14.02[1]; Kokoszka v. Belford, 417 U.S. 642, 645-46 (1974) (bankrupt's estate first is distributed to creditors, then bankrupt is given fresh start with such rights as statute left untouched).

[49] *See* note 48 *supra.*

[50] *Id.; accord,* Local Loan Co. v. Hunt, 292 U.S. 234, 245 (1934) (discharge is to relieve honest debtor); Countryman, *Consumers in Bankruptcy Cases,* 18 WASHBURN L. REV. 1, 5 (1978) (discharge should only be accorded honest debtor).

actual fraud[51] than is a state court judge.[52]

In addition, the Supreme Court previously held in *Heiser v. Woodruff*[53] that a bankruptcy court should give collateral estoppel effect to a prebankruptcy decision.[54] Although *Heiser* would probably be decided differently today since the prebankruptcy decision given collateral estoppel effect was a default judgment,[55] *Heiser* suggests that the Supreme Court did not believe there was a counterveiling statutory policy against the application of collateral estoppel. Since the *Heiser* decision, however, Congress passed the 1970 amendments to the Bankruptcy Act.[56] In *Brown v. Felsen*,[57] the Supreme Court acknowledged that the amendments have been interpreted to mean that collateral estoppel effect should not be given to a prior state court decision.[58] In fact, the 1970 amendments provide the only rationale against giving collateral estoppel effect to a prior state court decision. The 1970 amendments vested the bankruptcy courts with exclusive jurisdiction to decide whether a particular debt is nondischargeable under certain sections of the Bankruptcy Act, including section 17a(2).[59] According to those opposed to giving collateral estoppel effect to prior state court decisions, the ability of the 1970 amendments to strengthen the discharge in bankruptcy would be greatly reduced, if the bankrupt were barred from relitigating the fraud issue in bankruptcy courts.[60] This objection to allowing collateral estoppel, however, misinterprets the true congressional intent behind the 1970 amendments.

The major purpose of the 1970 amendments was to render discharges in bankruptcy less vulnerable to post-bankruptcy abuses by harassing creditors.[61] Before the 1970 amendments, creditors were permitted to bring

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[51] *See* note 25 *supra*.

[52] A bankruptcy judge seemingly is no more qualified to decide a case involving actual fraud than a state court judge since actual fraud is one of the oldest civil causes of action.

[53] 327 U.S. 726 (1946).

[54] *Id.* at 736.

[55] The lower federal courts generally agree that collateral estoppel effect should not be given to any default judgment. *See* note 14 *supra*. A debtor should not be compelled to defend and litigate merely to establish the precise ground of liability. *See* 1B MOORE'S, *supra* note 6, ¶ 0.444[2]. Also, collateral estoppel requires that the issue actually be litigated. *See* text accompanying notes 13 & 14 *supra*. Since in a default judgment the losing party fails to defend himself in court, the issues are not actually litigated..

[56] 11 U.S.C. §§ 32f, 35c (1976).

[57] 99 S. Ct. 2213 n.10.

[58] *See* 1A COLLIER 1978, *supra* note 25, ¶ 17.16[6]; Countryman, *supra* note 42, at 49-50.

[59] *See* note 42 *supra* & note 93 *infra*.

[60] *In re* McMillan, 579 F.2d 289, 294 (3d Cir. 1978) (Gibbons, J., concurring) (stating 1970 amendments designed to make bankruptcy court sole forum for discharge determination); *In re* Houtman, 568 F.2d 651, 653 (9th Cir. 1978) (1970 amendments allow no room for technical doctrine of collateral estoppel); *In re* Blessings, 442 F. Supp. 68, 70-71 (S.D. Ind. 1977); *In re* Burns, 357 F. Supp. 176, 178 (D. Kan. 1972) (stating since bankruptcy court has exclusive jurisdiction there can be no collateral estoppel); *See* 1A COLLIER 1978, *supra* note 25, ¶ 17.16[6] (discharge in bankruptcy court would be dissipated).

[61] H.R. REP. No. 1502, 91st Cong., 2d Sess. 1, 2, *reprinted in* [1970] U.S. CODE CONG. &

suit in state courts in order to determine whether a particular debt was excepted from the general discharge given the bankrupt debtor.[62] Many creditors went into state court hoping that the bankrupt would fail to appear in the post-bankruptcy action.[63] As a result of the bankrupt's failure to appear, the creditor received a default judgment. The bankrupt's debt was excepted from the general discharge when, in fact, the debt may not have fallen under one of the specific discharge exceptions.[64]

If collateral estoppel effect were given by a bankruptcy court to a prebankruptcy decision, the debtor would not be susceptible to harassment by creditors similar to the post-bankruptcy abuses. In order for the prebankruptcy decision to be given collateral estoppel effect, the issue of fraud actually must have been litigated.[65] If the bankrupt debtor failed to litigate the fraud issue in the prebankruptcy decision, by the rules of collateral estoppel, the prebankruptcy decision is not binding on the bankruptcy court. Therefore, giving collateral estoppel effect to a prebankruptcy decision does not dissipate the effect of the 1970 amendments since the debtor took advantage of the opportunity to show in state court that the debt was not induced by fraud.

In addition, the Supreme Court addressed itself in another context to the collateral estoppel effect which should be given by a federal court vested with exclusive jurisdiction to a prior state court decision. In *Becher v. Contoure Laboratories, Inc.*,[66] the Court held that the grant of exclusive jurisdiction to the federal courts does not give the federal courts exclusive

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AD. NEWS 4156, 4156; *see In re* Mountjoy, 368 F. Supp. 1087, 1094 (W.D. Mo. 1973) (1970 amendments added to cure abuse of creditors procuring post-bankruptcy default judgments); Brody, *The So-Called Dischargeability Bill—Public Law 91-467. A Milestone in Bankruptcy Legislation,* 76 COM. L.J. 9, 9 (1971) [hereinafter cited as Brody]; Note, *1970 Amendments to the Bankruptcy Act—An Attempt to Remedy Discharge Abuses,* 69 MICH. L. REV. 1347, 1353 (1971) [hereinafter cited as *Discharge Abuses*].

[62] *See* note 2 *supra.*

[63] The bankrupt often failed to appear in the post-bankruptcy action because he did not realize the general discharge by the bankruptcy court was an affirmative defense which was waived if not pleaded. The bankrupt also may have failed to appear because he was unable to afford an attorney or because he was not properly served. H.R. REP. No. 1502, 91st Cong., 2d Sess. 1, 2, *reprinted in* [1970] U.S. CODE CONG. & AD. NEWS 4156, 4156; *see* Brody, *supra* note 61, at 9; *Discharge Abuses, supra* note 61, at 1353.

[64] H.R. REP. No. 1502, 91st Cong., 2d Sess. 1, 2, *reprinted in* [1970] U.S. CODE CONG. & AD. NEWS 4156, 4156; *see* Brody, *supra* note 61, at 9; *Discharge Abuses, supra* note 61, at 1353.

[65] *See* text accompanying notes 13 & 14 *supra.*

[66] 279 U.S. 388 (1929). In *Becher,* the plaintiff was employed as a machinist to construct an invention. The employment agreement provided that anything the plaintiff discovered while working for his employer would be kept confidential and could not be used by the plaintiff for his personal benefit. Contrary to the agreement, the plaintiff patented the invention himself. The employer then sued the plaintiff in state court for breach of contract and fiduciary duty. After the employer won in state court, the plaintiff brought suit in federal court against the employer for patent infringement. *Id.* at 388-89. Finding the issues of fact and law in the two suits to be similar, the Supreme Court affirmed the appellate court's ruling that the state court's findings had collateral estoppel effect on the federal court. *Id.* at 392.

power to determine facts which might be conclusive upon a federal claim.[67] Even though the state court decision may be dispositive of a federal claim, the state court merely establishes a fact. The federal court must then accept that finding of fact and give specific effect to the fact in connection with the federal claim.[68]

In a bankruptcy situation, prior state court decisions establish fraud, which is a finding of fact.[69] Therefore, if the state law standards of fraud are identical to the bankruptcy standards, the bankruptcy court should accept the state court's finding of fact and give specific effect to that finding when the dischargeability of the bankrupt's debt is decided.

Another reason that the 1970 amendments have been interpreted to foreclose the doctrine of collateral estoppel is section 14f[70] of the Bankruptcy Act.[71] Section 14f provides that an order of general discharge shall declare any prior judgment in any other court null and void with respect to the liability of the debtor.[72] Since the bankruptcy courts have the power

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[67] *Id.* at 391.

[68] *Id.* at 391-92. *But see* Lyons v. Westinghouse Elec. Corp., 222 F.2d 184 (2d Cir.), *cert. denied,* 350 U.S. 825 (1955). Westinghouse sued Lyons in state court for breach of contract, and Lyons interposed restraint of trade as a defense. Westinghouse won the state suit, and the state court held that Lyons defense had not been established. Lyons appealed the state court decision and sued Westinghouse in federal court, alleging violations of federal antitrust laws, while the state court appeal was pending. The district court stayed the federal proceedings pending resolution of the state appeal, and Lyons appealed the stay. *Id.* at 185.

The circuit court ordered the district court to vacate the stay. *Id.* at 190. Judge Learned Hand, writing for the majority, noted that the state court finding against Lyons' antitrust defense would not have collateral estoppel effect on the district court. Hand tried to differentiate Becher v. Contoure Laboratories,Inc., 279 U.S. 388 (1929), by distinguishing "between the finding of one of the constituent facts that together make up a claim and the entire congeries of such facts taken as a unit." 222 F.2d at 188. The former creates an estoppel while the latter does not. *Id.* The distinction between "constitutent" facts and "congeries" of such facts have generally been equated with the difference between findings of fact and application of law to fact. *See* Note, *The Collateral Estoppel Effect of Prior State Court Findings in Cases Within Exclusive Federal Jurisdiction,* 91 HARV. L. REV. 1281, 1284 (1978) (specifically excluding bankruptcy because of unique nature of bankruptcy proceedings and remedies). However, in other areas of exclusive federal jurisdiction, federal courts arguably should give collateral estoppel effect to state court decisions which involve common law questions using standards identical to the federal standards. *Id.* at 1286-87.

The situation in a bankruptcy proceeding, however, is more analogous to the *Becher* case than the *Lyons* case. Unlike *Lyons* where the state court ruled on an issue based solely on federal law, the state courts in *Becher* and in the bankruptcy situation ruled on an issue based on state common law. *Id.* at 1285.

[69] Trice v. Commercial Union Assurance Co., 334 F.2d 673, 677 (6th Cir. 1964), *cert. denied,* 380 U.S. 915 (1965) (trial judge erred in granting judgment n.o.v. because fraud is issue of fact for jury).

[70] 11 U.S.C. § 32f (1976). An order of general discharge shall declare any judgment in any other court null and void with respect to the bankrupt's debts which were not excepted from discharge under § 17a or debts specifically discharged under § 17c, 11 U.S.C. § 35a & c (1976).

[71] *See* 1A COLLIER 1978, *supra* note 25, ¶ 17.16[6]; Countryman, *supra* note 42, at 49-50.

[72] *See* note 70 *supra.*

to declare a prior state court judgment against the bankrupt null and void, section 14f has been interpreted as requiring the bankruptcy court to make an independent determination of fraud.[73] Requiring such independent determination, however, is premature. Section 14f only allows the bankruptcy court to make a null and void declaration once a determination has been made that a debt is not excepted by section 17 of the Bankruptcy Act.[74] The bankruptcy court cannot make a determination of an exception to discharge until the court considers the effect of the prior court's finding of fraud.[75]

Nevertheless, most courts have noted that collateral estoppel effect should be given to a prior state court decision if the required elements for bankruptcy fraud had been litigated and fraud was clearly found by the state court.[76] The few cases which actually decided the collateral estoppel issue before *Brown v. Felsen* differed in results.[77] Since the *Brown v. Felsen*

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[73] *See* 1A COLLIER 1978, *supra* note 25, ¶ 17.16[6]; Countryman, *supra* note 42, at 49-50.

[74] *See* note 70 *supra*.

[75] Brody, *The New Dischargeability Bill*, in INSTITUTE OF CONTINUING LEGAL EDUCATION, BASIC BANKRUPTCY 50 (L. Abramson ed. 1971).

[76] *See In re* McMillan, 579 F.2d 289, 292-93 (3d Cir. 1978); *In re* Pigge, 539 F.2d 369, 373 (4th Cir. 1976); *In re* Conway, 3 BANKR. CT. DEC. 365, 366 (N.D. Tex. 1977); *In re* Garrard, 3 BANKR. CT. DEC. 223, 224 (N.D. Ga. 1977); *In re* Matthews, 2 BANKR. CT. DEC. 492, 496 (N.D. Ala. 1976). Unfortunately, these cases are void of analysis as to why collateral estoppel effect should be given. *Cf.* Coen v. Zick, 458 F.2d 326, 330 (9th Cir. 1972); National Homes Corp. v. Lester, Indus., 336 F. Supp. 644, 648 (W.D. Va. 1972) (collateral estoppel effect given to prior decisions based on exception of willful and malicious injuries under 17a(2) of the Bankruptcy Act, presently codified at 11 U.S.C. § 35a(8) (1976)).

[77] *See* In *In re* Herman, [1979] 2 BANKR. L. REP. (CCH) ¶ 67,087 (S.D.N.Y. 1979), the Southern District of New York held that a prior state court decision operated as collateral estoppel. Without discussion or analysis, the court ruled that since the state standards and the bankruptcy standards were virtually identical and since the state jury possibly could have found fraud, collateral estoppel effect must be given to the prior decision and the debt was nondischargeable. *Id.*; accord, *In re* Walshak, 3 BANKR. CT. DEC. 118, 119 (W.D. Pa. 1977) (no reason to relitigate issue when state court made specific findings of fraud based on bankruptcy standards).

The Ninth Circuit, however, has held that a bankruptcy court should not give collateral estoppel effect to a prior state court decision. *In re* Houtman, 568 F.2d 651, 653 (9th Cir. 1978). The *Houtman* court reasoned that the 1970 amendments to the Bankruptcy Act allowed no room for the application of collateral estoppel. *Id.* The court stated that the expertise of the bankruptcy court would be impaired if the bankruptcy court gave collateral estoppel effect to a prior state court's factual findings. *Id.* at 654 n.2. The expertise rationale, however, neglects the fact that consideration of actual fraud is not unique to bankruptcy courts.

Even though the *Houtman* court refused to give collateral estoppel effect to the state court decision, the court held that the state court judgment based on fraud was sufficient to establish a prima facie case that the debt was nondischargeable under § 17a(2). *Id.* at 654. Since the bankrupt debtor was unable to rebut the state court record, the *Houtman* court held that the debt was nondischargeable. *Id.* at 655-56. Consequently, the Ninth Circuit seems to say that even though technically there may not be collateral estoppel, in effect there is collateral estoppel. If the issue of fraud is fully litigated in the prior state court proceedings and if the state court specifically determines the existence of fraud based on the bankruptcy standard for fraud, the bankrupt debtor will have difficulty rebutting the evidence. In addi-

decision, only the Third Circuit has faced the collateral estoppel issue. In *In re Ross*,[78] Ross was indebted to Metro-Goldwyn-Mayer (MGM) because of a violation by Ross of Rule 10b-5[79] of the Federal Securities Regulations.[80] After Ross filed for bankruptcy, MGM claimed that the debt was not dischargeable under section 17a(2) of the Bankruptcy Act and that collateral estoppel effect should be given to the Second Circuit's decision (*MGM*) which held Ross had violated Rule 10b-5.[81] The bankruptcy court refused to give collateral estoppel effect to the *MGM* decision. The district court reversed the bankruptcy court,[82] and concluded that the fraud standard for a Rule 10b-5 violation in the circuit where the *MGM* decision was decided was the same as under section 17a(2) of the Bankruptcy Act.[83] The Third Circuit reversed the district court and remanded the case to the bankruptcy court to review the *MGM* record and determine, in light of *Brown v. Felsen*, whether the *MGM* record supports the application of

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tion, the debtor could also benefit from the doctrine of collateral estoppel. If the prior state court record clearly shows that an element of fraud is missing and the creditor was able to appeal the prior decision, the debt must be discharged. *See In re* Burns, 357 F. Supp. 176, 178 (D. Kan. 1972) (since state court record revealed no intent to deceive and no reliance by creditor, debt is discharged); *In re* Newman, [1975-76 Transfer Binder] BANKR. L. REP. (CCH) ¶ 65,906 (E.D. Tenn. 1976) (since state court found no fraud, debt is discharged).

[78] 602 F.2d 604 (3d Cir. 1979). *See also In re* Tessman, 5 BANKR. CT. DEC. 435 (W.D. Mich. 1979). Relying on *Brown v. Felsen*, the Western District of Michigan held that there should be no collateral estoppel effect given to a prior state court decision when the bankruptcy court determines whether a debt is excepted from discharge by § 17a(8) of the Bankruptcy Act which excepts willful and malicious injuries. *Id.* at 438. However, whether the *Tessman* court's reliance on *Brown* was proper is doubtful. The *Tessman* court's conclusion relied solely on the language in *Brown* where the Supreme Court said that "res judicata" would be inconsistent with the philosophy of the 1970 amendments to the Bankruptcy Act. No mention was made of footnote 10 of the *Brown* decision, where the Supreme Court addressed collateral estoppel.

[79] 17 C.F.R. § 240.10b-5 (1979). Rule 10b-5 makes it unlawful for any person to defraud, to make any untrue statement of material fact, or to omit material facts in connection with the purchase or sale of any security.

[80] *See* Metro-Goldwyn-Mayer, Inc. v. Ross, 509 F.2d 930, 932-33 (2d Cir. 1975), *rev'g* 363 F. Supp. 23 (S.D.N.Y. 1973). In *MGM*, Ross had misrepresented material facts to MGM when MGM entered into a contract with Ross to buy a company. The Second Circuit held that Ross had violated Rule 10b-5 and awarded MGM $303,000. In ruling on Ross' Rule 10b-5 violation, the circuit court did not make a specific finding of fraud by Ross. *Id.* at 933. However, there must be actual fraud involved in order to have a private cause of action for damages under Rule 10b-5. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193, 215 (1976). *See also* note 86 *infra.*

[81] *See* Metro-Goldwyn-Mayer, Inc. v. Ross, 509 F.2d 903, 932-33 (2d Cir. 1975); note 80 *supra.*

[82] *In re* Ross, 602 F.2d 604, 607 (3d Cir. 1979).

[83] *Id.* The district court judge in *Ross* relied on Lanza v. Drexel & Co., 479 F.2d 1277, 1305 (2d Cir. 1973), when he concluded the bankruptcy standards and Rule 10b-5 standards for fraud were identical. *In re* Ross, 602 F.2d 604, 605 n.2 (3d Cir. 1979). In *Lanza*, the Second Circuit held that in order for there to be a Rule 10b-5 violation, the defendant either must have actually known his representations were false or had a reckless disregard for the truth. Lanza v. Drexel & Co., 279 F.2d at 1306. *See* text accompanying notes 88-90 *infra.*

collateral estoppel.[84]

On its face, *In re Ross* seems to contradict itself. The case appears to say collateral estoppel effect should be given to prior judgments if the standards of fraud are the same.[85] However, since Rule 10b-5 of the Securities Regulations and section 17a(2) of the Bankruptcy Act both require fraud,[86] the Third Circuit's decision to remand indicates that collateral estoppel effect should not be given. One possible explanation for the apparent contradiction in the *Ross* decision may be the lack of a specific finding of fraud in the *MGM* decision. This explanation fails, however, because the Second Circuit's finding that Ross had violated the Securities Regulations required an implicit finding of fraud. The only possible explanation for this apparent contradiction can be seen from closely examining the positions of the judges involved in the *MGM* decision and the *Lanza v. Drexel & Co.*[87] decision relied on by the district court in *Ross.*

In *Lanza,* Judges Hays and Smith dissented stating that under certain circumstances, negligent conduct establishes liability for a Rule 10b-5 violation.[88] These two judges were two of the three judges who held that Ross had violated Rule 10b-5 in the *MGM* decision. Since the *MGM* decision made no specific finding of actual knowledge or recklessness by Ross, the *MGM* court possibly found a Rule 10b-5 violation because Ross only negligently disregarded the truth.[89] If negligence was the standard used in the *MGM* decision, then the *MGM* decision should not be given collateral estoppel effect since the knowledge standard was not the same knowledge standard required for fraud under section 17a(2).[90] Consequently, although the Third Circuit in *In re Ross* apparently held that collateral estoppel effect should be given, the case was remanded to the bankruptcy court to examine the *MGM* records to see if the required knowledge standard was used. If the required knowledge standard was not used or if the bankruptcy court is unable to determine what standard was used, the Third Circuit

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[84] *In re* Ross, 602 F.2d 604, 605-06 (3d Cir. 1979).

[85] *Id.* at 607-08. The *Ross* court stated that *Brown v. Felsen* indicates that collateral estoppel should be allowed and sets out requirements for collateral estoppel. *Id.*

[86] In Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976), the Supreme Court held that absent an allegation of "scienter," no private cause of action for damages will lie under Rule 10b-5. *Id.* at 193. Courts have interpreted this "scienter" requirement to mean that the defendant either knowingly made false representations or had a reckless disregard for the truth. *See* Nelson v. Serwold, 576 F.2d 1332, 1336-38 (9th Cir.), *cert. denied,* 439 U.S. 970 (1978). *See also* note 80 *supra.*

[87] 479 F.2d 1277 (2d Cir. 1973). *See* note 83 *supra.*

[88] Lanza v. Drexel & Co., 479 F.2d 1277, 1317 (2d Cir. 1973) (Hays, J., concurring in part and dissenting in part). *See* note 83 *supra.*

[89] The Supreme Court has held that a defendant is not liable for a Rule 10b-5 violation if the defendant only had a negligent disregard for the truth. Ernst & Ernst v. Hockfelder, 425 U.S. 185, 193 (1976). However, *Ernst & Ernst* was decided after the *Lanza* and *MGM* decisions. Therefore, Judges Hays and Smith in the *MGM* decision may have still applied the negligence standard for a Rule 10b-5 violation since at the time only their fellow judges in the Second Circuit and not the Supreme Court disagreed with them.

[90] *See* note 25 *supra.*

apparently stated that the fraud issue must be relitigated.

There are several reasons why a bankruptcy court should give collateral estoppel effect to a prior state court decision, provided that the standards for fraud used by the state court are identical to the standards of the Bankruptcy Act[91] and that the requirements for collateral estoppel are satisfied.[92] The objection that the exclusive jurisdiction[93] of the bankruptcy court to determine whether certain debts are excepted from discharge precludes giving collateral estoppel effect is unfounded. The bankruptcy court was vested with exclusive jurisdiction to prevent post-bankruptcy harassment by creditors. In a collateral estoppel situation there is no such harassment since the bankrupt actually must have litigated the fraud issue before collateral estoppel is allowed.[94] Fraud is an issue of fact, and the federal courts do not have exclusive jurisdiction over questions of fact which might be conclusive upon a federal cause of action.[95] The state courts are as competent as bankruptcy courts to determine if actual fraud existed. Since the statutory policy for discharge is to protect the honest debtor,[96] a bankrupt debtor deserves no protection if he has been previously adjudicated a fraud.[97]

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[91] *Id.*

[92] *See* text accompanying notes 11-18 *supra.*

[93] Under the Reform Act the bankruptcy court will enjoy expanded jurisdiction. 28 U.S.C.A. § 1471 (Supp. 1979); Klien, *The Bankruptcy Reform Act of 1978,* 53 AM. BANKR. L.J. 1, 5 (1979). The bankruptcy court will be given exclusive jurisdiction of all cases under the Reform Act but only will have original jurisdiction of all civil proceedings arising under the Reform Act. 28 U.S.C.A. § 1471(a), (b) & (c) (Supp. 1979). Since the determination of whether a particular debt is excepted from the general discharge is considered a civil proceeding arising under the Reform Act, the bankruptcy court only will have original jurisdiction to determine exceptions to the general discharge. *See* BANKRUPTCY 1979, *supra* note 25, ¶ 523.06[13]; H.R. REP. No. 595, 95th Cong., 1st Sess. 49, *reprinted in* [1978] U.S. CODE & CONG. AD. NEWS 5963, 6010; S. REP. No. 989, 95th Cong., 2d Sess. 153, *reprinted in* [1978] U.S. CODE & CONG. AD. NEWS, 5787, 5939. The one exception to the grant of original jurisdiction only to determine exceptions to the general discharge is in 11 U.S.C.A. § 523c, which grants exclusive jurisdiction for determination of dischargeability under 11 U.S.C.A. § 523a(2), (4) & (6) (1979). BANKRUPTCY 1979, *supra* note 25, ¶ 523.06[13]. Since under the Bankruptcy Act of 1898 the bankruptcy court had exclusive jurisdiction in determining dischargeability only for the equivalent provisions to 11 U.S.C.A. § 523a(2), (4) & (6) (1979), the Reform Act does not change or increase the bankruptcy court's jurisdiction with respect to dischargeability. *See* note 42 *supra;* BANKRUPTCY 1979, *supra* note 25, ¶ 523.07, 523.13, 523.16. Therefore, nothing discussed in the article would be different because of the expanded jurisdiction of the bankruptcy court under the Reform Act.

[94] *See* text accompanying notes 61-65 *supra.*

[95] *See* text accompanying notes 66-69 *supra.*

[96] *See* text accompanying notes 48-52 *supra.*

[97] As shown by the Third Circuit in *In re Ross,* a bankruptcy court may not give collateral estoppel effect because of a technicality. Therefore, a creditor who sues a debtor for fraud should have the presiding judge make specific findings in his opinion or in his order which conform with the bankruptcy standard of fraud. Given these findings, the creditor should not lose in a discharge proceeding if the debtor subsequently files for bankruptcy.