Current Issues Regarding Objections to Discharge in Chapter 7 Cases

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Settlement of 727 Cases: A Balancing of Duties and Interests from a Trustee's Perspective

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I. Introduction

Some courts believe that as a matter of public policy a trustee may not settle claims against a debtor in an action seeking denial of discharge. The thought process is that a discharge is not property of the estate to be sold or made part of a bargain. "Selling discharges", it is said, compromises the integrity of the bankruptcy system either by rewarding an undeserving or dishonest debtor who may simply purchase, at a discount, economic freedom, or by fostering a perception that trustees abuse their authority by bringing such claims only to earn a fee. When viewed through such a prism, it appears logical to prevent both by prohibiting settlement. Other courts however view the matter differently. The "selling discharges" theme is provocative. This article suggests that a fair and objective analysis of this topic looks beyond the provocative to a more balanced and practical approach.

II. Questions Raised

Should a chapter 7 trustee, if duty-bound to bring an action for denial of discharge, be required exclusively to litigate to final judgment in satisfaction of that duty? Might such a directive have unintended consequences? What other important duties might be dishonored by such an approach? If a debtor fails to perform a court-ordered obligation, is the withholding of a discharge pending compliance an effective, and perhaps only, means of ensuring performance of that obligation? What interests might be harmed as a result of an unyielding prosecution of a debtor? Does heightened judicial scrutiny of a proposed settlement ensure fairness and help maintain integrity of the system? As a practical matter, would trustees, intrinsically restricted by limited resources, be less likely to bring discharge objections if an "all or nothing" rule applied? Would such a rule harm rather than uphold integrity of the bankruptcy system?

III. Duties and the Trustee's Role with Respect to a Debtor's Discharge

A chapter 7 bankruptcy trustee is in many respects the face of the bankruptcy system for the vast majority of debtors and others encountering a chapter 7 bankruptcy case. A trustee is, and should be, held to high standards of integrity and honesty in the workings of our bankruptcy system. Debtors, creditors, and others interacting with a trustee expect fairness and competence. Trustees are assigned several hundred or more new cases each year. Trustees are expected and required to fulfill the important duties imposed on them in each and every assignment as part of their regular administration of cases.

Primary duties include investigating a debtor's financial affairs, collecting and reducing to money property of the estate, closing the estate as expeditiously as possible as is compatible with the best interests of parties in interest, and public reporting, via court filings, of activities

and transactions. An equally important duty involves the role played by a chapter 7 trustee when facts are presented indicating that a discharge may not be warranted.

While listed in the Bankruptcy Code under the heading "Duties of a trustee-", the statutory duty to object to a discharge contains a qualifier. Importantly, section 704(a)(6) of the Code states that a trustee shall, ***"if advisable,"*** oppose the discharge of debtor.[1]

Of course a discharge should not be "sold". Bringing an action to deny discharge with the sole purpose of gaining a fee in conjunction with a settlement is an abhorrent concept. Such a practice would bring distrust to the bankruptcy system and disrepute to those who serve as trustees.

It may fairly be suggested that Congress imparted trustees with substantial discretion by using the words, "if advisable." Once a trustee decides that a case warrants the filing of a complaint objecting to discharge, should a trustee's legislatively granted discretion thereafter terminate?

IV. Objections to Discharge

The Bankruptcy Code at 11 U.S.C. §727(a) states: "The court shall grant the debtor a discharge, unless—…"[2] Section 727 thereafter describes a variety of situations where a discharge does not apply or may be opposed, such as instances of improper intentional acts or omissions, the making of false oaths or accounts, the existence of fraud in transfer of assets, the failure to provide financial information or explain a loss of assets, the failure to abide by a bankruptcy court order, and others. Generally speaking, these claims require a showing of intent or objective circumstances evidencing fraud. Revocation of discharge, a remedy found at 11

[1] 11 U.S.C. §704(a)(6)
[2] 11 U.S.C. §727

U.S.C. §727(d), refers to certain acts occurring after a discharge is granted. Most commonly, revocation of discharge is implicated where a debtor fails to comply with a court order.

In general, a trustee has approximately 90 days from the date of a bankruptcy filing to determine whether a complaint objecting to discharge should be filed. The 90 day period is in reality much shorter. If the initial case filing is skeletal, 14 days may pass after filing before the trustee may view bankruptcy schedules and statements.

A typical document submission (tax returns, bank records, real property records, vehicle titles, divorce decrees, etc.) is received just prior to or at the 341 meeting, which usually occurs about 30 days after filing. At the 341 meeting, the trustee and creditors are given a few minutes to question a debtor, as most 341 sessions involve multiple cases per hour.

After the 341 meeting, a trustee may enlist the help of a law firm or other professional to investigate. Typically many days pass before hard follow up facts are learned and a legal analysis is framed. A trustee may seek a stipulation for an extension of time to file a complaint objecting to discharge, however if a debtor resists, a motion must be filed demonstrating good cause for the requested extension.

Complaints by trustees objecting to discharge may fairly be characterized as regular occurrences, but infrequent when compared to the number of discharges granted. Once a complaint is filed, a minimum of three court appearances are required if the matter is contested. These appearances include a scheduling conference, a pre-trial conference, and trial. Experience dictates that many additional court appearances are usually involved. At least one deposition is usually conducted, and typical cases involve multiple depositions.

Though discovery may have been substantially undertaken prior to filing the complaint, during the adversary proceeding, the discovery period will necessarily encompass typical hurdles for a trustee. Debtors, like anyone being sued, are generally antagonized and many times uncooperative. Rarely will debtors admit to facts or provide the "smoking gun" supporting a trustee's claim. A debtor may blame their own counsel for false oaths and misrepresentations in an attempt to negate intent. Counsel for debtors often "fall on the sword" to save their clients. Obtaining documents and third party testimony required to carry the burden of proof is typically time consuming and expensive. Defense of dismissal motions, discovery fights, and scheduling disputes are common. Witness recalcitrance, especially when dealing with insiders, is found to be the norm.

Notwithstanding the normal push and shove involved in any litigated matter, the trustee must also be prepared to deal with a debtor's protestations that the trustee is improperly seeking to "sell" a discharge, only to gain a fee. A court may be distracted by such an inflammatory tactic.

V. Settlements – Appropriate? Under What Circumstances?

Courts have of course long encouraged the settlement of disputes. Would a proposed settlement of a 727 action, where a component of the settlement includes the debtor's payment of money, constitute an improper "selling" of a discharge to an undeserving debtor? The Code requires the trustee to close an estate "as expeditiously as is compatible with the best interests of parties in interest."[3] Often, 727 claims are brought in conjunction with other counts against the debtor (for example turnover of property) or other actions against third parties, including insider transferees (commonly relatives and close business associates). Section 727 actions based on

[3] 11 U.S.C. §704(a)(1)

fraudulent conveyances present markedly different considerations than 727 actions for failure to turnover or comply with duties imposed on debtors. If settlements could never include dismissal of a 727 count no matter what the grounds, a trustee may be handcuffed in obtaining a settlement with a fraudulent transferee, even if the estate is made whole. The incentive to settle other counts or related actions would likely be severely reduced if the trustee was compelled to take an "all or nothing" approach. Cases that contemplate settlement of 727 claims and discuss a practical approach are analyzed below.

Settlements, a necessary component to efficient operation of bankruptcy courts, are guided by Bankruptcy Rule 9019, which provides that "on motion by the trustee and after notice and a hearing, the court may approve a compromise or settlement."[4] Courts have additionally established a four factor test routinely employed for settlement approval: (a) weighing the probability of success in the litigation; (b) examination of the difficulties, if any, to be encountered in the matter of collection; (c) consideration of the complexity of the litigation involved, and the expense, inconvenience and delay necessarily attending it; and (d) deference to the paramount interest of the creditors and their reasonable views.[5]

Bankruptcy Rule 7041 provides an additional factor to be considered, and states:

> A complaint objecting to the debtor's discharge shall not be dismissed at the plaintiff's instance without notice to the trustee, the United States Trustee, and such other persons as the court may direct, and only on order of the court containing terms and conditions which the court deems proper.[6]

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[4] Fed.R.Bankr. P. 9019

[5] *Bard v. Sicherman (In re Bard),* 49 Fed. App'x 528, 530 (6th Cir. 2002); *In Re Jackson Brewing Co*., 624 F2d 605, 607 (5th Cir. 1980); *In Re American Reserve Corp*., 841 F2d 161 (7th Cir. 1987); *In Re Woodson*, 839 F2d 610, 620 (9th Cir. 1998).

[6] Fed.R.Bankr. P. 7041

As noted above, some courts prohibit 727 case settlements proposed by a trustee for either public policy reasons or perceived lack of statutory authority, while other courts employ a case by case approach to determine whether the settlement is "fair and equitable".

Courts that ban 727 settlements often hold that public policy does not allow an exchange of consideration for the grant of a discharge that a dishonest debtor is not entitled to. An Ohio Court held that compromise of a 727 claim was "tantamount to allowing [the debtor] to purchase her discharge."[7] The court in *In re Vickers* declined to approve the trustee's motion to compromise. The court stated:

> Selling discharges would be a disease that would attack the heart of the bankruptcy process, its integrity. A trustee seeking to get paid may coerce an honest debtor into paying something to get rid of a complaint that has no merit. A dishonest debtor may cover up even greater sins than those that gave rise to the complaint in the first place.[8]

Like in *Vickers,* courts that take the above approach are often (but not always) faced with settlements that may appear to degrade the spirit of the bankruptcy code.

However, a court need not be handcuffed and forced to never consider the merits of a proposed settlement. When courts are presented with a 727 settlement that is fully disclosed and deemed fair and equitable to all, there is inherently no harm to the integrity of the system, and the settlement should be approved.

Courts that allow 727 settlements consider a trustee's business judgment, and further, those courts examine other factors to determine whether or not settlement is appropriate. These courts, perhaps expanding on Bankruptcy Rule 7041, add a fifth factor to the "fair and equitable" compromise standard applied to other settlements. This fifth factor is added to address the public policy concerns commonly cited by courts that ban a 727 settlement.

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[7] *In re Wilson*, 196 BR 777, 780 (Bankr. N.D. Ohio 1996).
[8] *In re Vickers,* 176 Bankr. 287 at 290 (Bankr. N.D. Georgia 1994).

Those jurisdictions that do not to force a trustee to choose between trial or dismissal, recognize that a 727 settlement offers funds for debts that might never be paid, even without a discharge in bankruptcy.[9] The focus then is on what is good for creditors in a particular case, and not a view that the system must be saved from opprobrium otherwise.

> Under the fair and equitable standard, the court considers: (a) probability of success in the litigation; (b) collectability; (c) complexity, expense, inconvenience, and delay attendant to continued litigation; and (d) the interest of creditors. The interest of creditors is paramount, and the court must give proper deference to their reasonable views. *Woodson,* 839 F.2d at 620. A fifth factor applies under the fair and equitable test when a denial of discharge is involved: the public interest in proper administration of the bankruptcy laws must be considered.[10]

A 9th Circuit Court held that bankruptcy courts should not disapprove a settlement merely because a 727 complaint has been filed, but should use its discrete judgment in approving a settlement.[11] A New Jersey court upheld a section 727 compromise, stating that since liquidation was to be accomplished as rapidly as possible without needless or fruitless litigation, settlement of the case was appropriate where debtor's actions were not clearly fraudulent.[12]

VI. The Best Interests of Creditors

It seems unworkable and against sound reason to conclude that discharge actions should *per se* be barred from settlement or compromise. Often times a chapter 7 trustee will use section 727(a)(6) as an enforcement mechanism to compel the debtor to comply with a turnover order or the like. In cases where the Trustee is using section 727 as an enforcement mechanism, a debtor would be less likely to cooperate in a situation where the Trustee is seeking settlement of separate claims, but not the section 727 count. Ultimately, under section 704, the Trustee's duty

[9] *In re Myers*, 2015 Bankr. LEXIS 283 (Bankr. N.D. Ohio 2015).
[10] *Jacobson v Robert Speece Properties (In re Speece)*, 159 BR 314, 317 (Bankr E.D. Cal, 1993).
[11] *In re A & C Properties*, 784 F.2d 1377, 1381-82 (9th Cir. 1985), *cert. denied sub nom. Martin v. Robinson*, 479 U.S. 854, 93 L. Ed. 2d 122, 107 S. Ct. 189 (1986).
[12] *Tindall v Mavrode (In re Mavrode)*, 205 B.R. 716, 720 (Bankr. D.NJ, 1997).

is to recover and close the estate in the best interests of the creditors. Without compromises, such a recovery might never happen.

Of course it would never be appropriate for a Trustee to "sell" a discharge. But with the heightened scrutiny placed on 727 settlements, a court may discern a reasonable settlement from an inappropriate "sale" of a discharge. The United States Trustee's office likewise gives such settlements heightened scrutiny. Because of the uncertain and expensive nature of litigation, forcing a trustee to litigate a 727 claim runs opposite of the creditors' interest in an efficiently liquidated bankruptcy estate. For a trustee to honor statutory duties, room to weigh and balance sometimes divergent duties must be provided.

VII. Professional Fees

The appearance of settling an objection to discharge simply to collect a fee must be considered. Where a debtor fails to perform a duty, and where a trustee seeks compliance by use of section 727 as a last resort, inherently the debtor has caused damage to the estate. Duty, breach of duty, and damages, are necessarily present and actionable. A count for recovery of such damages is usually, and should always, be included in a trustee's complaint. In the instances of settlement, the procedure for fee requests by professionals is as transparent as can be imagined, involving prior notice and opportunity to object, scrutiny by the court, by the UST, by creditors, and even by debtors.

A chapter 7 trustee is charged with a variety of duties and often times the fulfillment of those duties can only be accomplished by skilled and dedicated professionals using resources gained in private practice. Such resources of course are not unlimited. A debtor who damages an estate, for example by failing to abide by a court order, should be made to compensate that

estate. If a debtor is finally made to "come around" by way of settlement, there should be no issue with a debtor compensating the estate for the most common form of damages, i.e. administrative expenses, and usually the trustee's attorney's fees.

VIII. A Case Example

The example below may generously be described as "unglamorous", however it nonetheless describes a common problem encountered in a consumer bankruptcy case.

Prior to the 341 meeting, the trustee surmises that a debtor is entitled to a bonus from the debtor's employer for the previous work year. The bonuses were announced publicly and could range from a few thousand to nearly twenty thousand dollars. Court rulings support the trustee's contention that such bonuses are property of the estate, even if uncertain at the time of filing. No disclosure is made in the schedules concerning the bonus, and no amendments are filed.

At the 341 meeting, the trustee makes his position known and requests turnover of bonus compensation if and when received, and seeks documents evidencing entitlement and payment of the bonus, if paid. A deadline for a response is set. The deadline expires and the debtor and counsel have ignored the trustee. A second request is made and likewise ignored. The trustee seeks to gain the information independently from the debtor's employer by subpoena.

The trustee concurrently files a motion for turnover and obtains and order by default, but has yet to learn the amount in question. Facing a rapidly approaching deadline, the trustee prepares a complaint for denial of discharge for failure to turn over documents and estate property. A draft complaint is sent to debtor's counsel but again, ignored.

The complaint is filed and the debtor answers. Belatedly documents are provided. The trustee learns the net bonus was only $1,500.00 as the debtor had been laid off for a portion of

the previous year. The trustee demands turnover again notwithstanding the already filed 727 action, and this time the debtor complies without condition. The discharge action is still pending. The estate has now incurred thousands in legal fees. The debtor has damaged the estate by causing needless administrative expenses. The debtor claims to be ill and in danger of being laid off again, and asks the trustee for dismissal. Sympathies of course lie with the debtor, yet the bankruptcy laws have been flagrantly violated and the estate damaged. What should happen next?

IX. Conclusion

Creditors, the court and the United States Trustee expect a trustee to fulfill statutorily imposed duties. A trustee may be hampered from fulfilling those duties when a debtor fails to fulfill a debtor's own duties. A section 727 action is often used as tool to delay a debtor's discharge until compliance with all duties, i.e. turnover of complete records, full disclosure of all assets, and turnover of assets. Withholding a debtor's discharge pending compliance is an effective mechanism to ensure a debtor fulfills statutory duties, which in turn, allow a trustee to fulfill a trustee's duties. If compliance is not gained, a section 727 action should proceed to its conclusion. If compliance is gained, and a financial resolution allowing the estate to be made whole should be allowed. A debtor who has not engaged in fraudulent transfers and complies with statutory duties, even belatedly, should receive a discharge if, on balance, the estate and its creditors benefit.

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Not for Sale: An Approach to the Approval of Chapter 7 Discharge Settlements by Trustees

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I. Introduction[1]

The goal of every individual chapter 7 debtor is to discharge his or her prepetition debts and obtain the "fresh start" that is the very purpose of a consumer bankruptcy law. However, the Bankruptcy Code charges a price for this fresh start, requiring that the debtor conduct itself honestly concerning his or her case. A chapter 7 trustee who believes that a debtor has failed to act honestly has a statutory duty to oppose the discharge of that debtor.

Courts view the objection to discharge as a necessary tool to preserve the integrity of the bankruptcy system, to compel other debtors to comply with their obligations and to punish those who do not. Accordingly, concern is sometimes raised when a chapter 7 trustee brings a discharge objection and thereafter seeks to settle it for consideration from the debtor. In furtherance of the public policy behind discharge objections, settlements by trustees for consideration from the debtor should not be permitted, for any price.

II. The Discharge

From an individual chapter 7 debtor's perspective, the purpose of bankruptcy is almost always to discharge outstanding debt. In *Local Loan Co. v. Hunt,*[2] the United States Supreme

[1] Portions of these materials were taken from an article of the same name published in the December, 2014 edition of the American Bankruptcy Institute Journal by Paul R. Hage, Patrick R. Mohan and Louis P. Rochkind.

Court coined the oft-cited phrase that bankruptcy laws exist to provide "the honest but unfortunate debtor who surrenders for distribution the property which he owns at the time of bankruptcy, a new opportunity in life and a clear field for future effort, unhampered by the pressure and discouragement of pre-existing debt." The legal tool that provides this fresh start is the order of discharge, the effect of which is detailed in section 524 of the Bankruptcy Code.

But a debtor is not entitled to a discharge as a matter of right. Rather, the Bankruptcy Code sets forth a number of obligations and requirements that must be satisfied for a discharge to be granted. For example, debtors are required to file a list of all assets and liabilities under penalty of perjury.[3] Debtors are also required to appear at a meeting of creditors and testify under oath as to their financial affairs.[4] Additionally, debtors are expected to cooperate with the chapter 7 trustee and, when appropriate, surrender all non-exempt property to the trustee so that it may be liquidated and the proceeds paid to creditors.

While a debtor is not entitled to the discharge as a matter of right, discharge will generally be granted unless it is challenged by the chapter 7 trustee, the Office of the United States Trustee or a creditor. Section 727 of the Bankruptcy Code sets forth certain grounds for objecting to the discharge of a debtor, most of which involve dishonest behavior such as transferring property to avoid creditors or concealing assets.[5] More specifically, the statute provides:

> (a) The court shall grant the debtor a discharge, unless—
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> * * *

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[2] *Local Loan Co. v. Hunt,* 292 U.S. 234, 244 (1934).

[3] Fed.R.Bankr.P. 1007(b).

[4] 11 U.S.C. §§ 341, 343.

[5] 11 U.S.C. § 727.

(2) the debtor, with intent to hinder, delay, or defraud a creditor or an officer of the estate charged with custody of property under this title, has transferred, removed, destroyed, mutilated, or concealed, or has permitted to be transferred, removed, destroyed, mutilated, or concealed—

(A) property of the debtor, within one year before the date of the filing of the petition; or

(B) property of the estate, after the date of the filing of the petition;

(3) the debtor has concealed, destroyed, mutilated, falsified, or failed to keep or preserve any recorded information, including books, documents, records, and papers, from which the debtor's financial condition or business transactions might be ascertained, unless such act or failure to act was justified under all of the circumstances of the case;

(4) the debtor knowingly and fraudulently, in or in connection with the case—

(A) made a false oath or account;

(B) presented or used a false claim;

(C) gave, offered, received, or attempted to obtain money, property, or advantage, or a promise of money, property, or advantage, for acting or forbearing to act; or

(D) withheld from an officer of the estate entitled to possession under this title, any recorded information, including books, documents, records, and papers, relating to the debtor's property or financial affairs;

(5) the debtor has failed to explain satisfactorily, before determination of denial of discharge under this paragraph, any loss of assets or deficiency of assets to meet the debtor's liabilities;

(6) the debtor has refused, in the case—

(A) to obey any lawful order of the court, other than an order to respond to a material question or to testify;

(B) on the ground of privilege against self-incrimination, to respond to a material question approved by the court or to testify, after the debtor has been granted immunity with respect to the matter concerning which such privilege was invoked; or

(C) on a ground other than the properly invoked privilege against self-incrimination, to respond to a material question approved by the court or to testify;

(7) the debtor has committed any act specified in paragraph (2), (3), (4), (5), or (6) of this subsection, on or within one year before the date of the

> filing of the petition, or during the case, in connection with another case, under this title or under the Bankruptcy Act, concerning an insider;
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> (8) the debtor has been granted a discharge under this section, under section 1141 of this title …, in a case commenced within 8 years before the date of the filing of the petition;[6]

Objections to discharge under section 727 are construed strictly against the plaintiff and liberally in favor of the debtor.[7] An objection to discharge is prosecuted by the filing of a complaint initiating an adversary proceeding.[8]

The premise that only the "honest but unfortunate debtor" deserves a discharge is implemented in section 704(a)(6) of the Bankruptcy Code, which delineates certain duties of a chapter 7 trustee. That section requires that every chapter 7 trustee "*shall* … if advisable, oppose the discharge of the debtor."[9] As Judge Rhodes once noted: "This obligation is clearly an institutional obligation, established to protect the bankruptcy process itself."[10] That section 704(a)(6) includes objecting to discharge amongst the statutory duties of a chapter 7 trustee evidences that Congress intended that trustees, unlike creditors of a debtor, have an affirmative obligation to bring such an objection where the facts warrant it.

III. Let's Make a Deal?

Perhaps more than any other area of the law, bankruptcy law involves compromise. Without such compromise, the already packed dockets of bankruptcy judges would become more clogged, and the business of the bankruptcy courts would slow considerably. The parties in

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[6] 11 U.S.C. 727(a).

[7] *Keeney v. Smith (In re Keeney),* 227 F.3d 679, 683 (6th Cir. 2000); *Newman v. Burnham (In re Newman),* 126 F.2d 336, 337 (6th Cir. 1942);

[8] 11 U.S.C. § 727(c)(1).

[9] 11 U.S.C. § 704(a)(6) (emphasis added).

[10] Rhodes, Hon. Steven W., *The Fiduciary and Institutional Obligations of a Chapter 7 Bankruptcy Trustee,* 80 Am. Bankr. L.J. 147 (2008).

discharge litigation, as in all bankruptcy litigation, sometimes elect to settle under Rule 9019 of the Federal Rules of Bankruptcy Procedure (the "Bankruptcy Rules"), which provides that "On motion by the trustee and after notice and a hearing, the court may approve a compromise or settlement."[11]

The decision of whether to approve a settlement is in the sound discretion of the bankruptcy court, and courts in the Sixth Circuit generally consider four factors for determining whether to approve a settlement: (a) the probability of success in the litigation; (b) the difficulties, if any, to be encountered in the matter of collection; (c) the complexity of the litigation involved, and the expense, inconvenience and delay necessarily attending it; and (d) the paramount interest of the creditors and a proper deference to their reasonable views (collectively, the "*Bard* Factors").[12]

Specific to settlements of discharge complaints, however, is Bankruptcy Rule 7041, which provides:

> A complaint objecting to the debtor's discharge shall not be dismissed at the plaintiff's instance without notice to the trustee, the United States Trustee, and such other persons as the court may direct, and only on order of the court containing terms and conditions which the court deems proper.[13]

The Advisory Committee's notes to Bankruptcy Rule 7041 explain why a voluntary dismissal of an objection to discharge is subject to more stringent rules than other dismissals:

> Dismissal of a complaint objecting to a discharge raises special concerns because the plaintiff may have been induced by an advantage given or promised by the debtor or someone acting in his interest. Some courts by local rule or order have required the debtor and his attorneys or the plaintiff to file an affidavit that nothing has been promised to the plaintiff in consideration of the withdrawal of

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[11] Fed.R.Bankr. P. 9019.

[12] *Bard v. Sicherman (In re Bard),* 49 Fed. App'x 528, 530 (6th Cir. 2002) (citations omitted).

[13] Fed.R.Bankr.P. 7041.

> the objection. By specifically authorizing the court to impose conditions in the order of dismissal this rule permits the continuation of this salutary practice.[14]

Bankruptcy Rule 7041 is based in public policy. As the Second Circuit Court of Appeals explained:

> This rule allows the bankruptcy court to tailor its order of dismissal to ensure that the dismissal was not obtained improperly. It also allows the trustee and other creditors to oppose dismissal of the original complaint. Because discharge is a statutory right undergirded by public policy considerations, it is not a proper subject for negotiation and the exchange of a *quid pro quo.*[15]

In addition to Bankruptcy Rule 7041, many jurisdictions have local rules applicable to discharge settlements. In the Eastern District of Michigan, we have Local Rule 7041-1, which provides:

> **Rule 7041-1 Dismissal of a Complaint Objecting to the Discharge of the Debtor.**
>
> When the parties to an action under § 727 propose to dismiss the action, they shall file a joint statement of the consideration received or to be received by the plaintiff. The plaintiff shall then serve the joint statement on all creditors and the trustee, with a notice stating that the deadline to file objections is 14 days after service, and file a certificate of service. If no timely objection is filed, the plaintiff shall promptly file a certificate of no response and submit the agreed proposed dismissal order. If a timely response is filed, the court will set the matter for hearing.[16]

Finally, in 2013, the chapter 7 trustees in the Eastern District of Michigan established a *Revised Protocol for Compromises of 727 Complaints and Other Proposed Compromises with Debtors,* which contemplates a level of supervision by the Office of the United States Trustee with respect to settlements of discharge actions by chapter 7 trustees.[17]

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[14] Fed.R.Bankr.P. 7041, Advisory Committee's Note.

[15] *State Bank of India v. Prasa Chalasan (In re Chalasani),* 92 F.3d 1300, 1310 (2d Cir. 1996).

[16] L.Bankr.R. 7041-1 (Bankr. E.D. Mich.).

[17] The protocol provides that the chapter 7 trustee must seek approval of all compromises of discharge objections by motion under Bankruptcy Rule 9019 regardless of the amount of the settlement. The

The effect of these rules is that court approval is required for all dismissals of discharge actions, regardless of who brought the complaint and the basis for, or the amount of, any settlement. If a discharge action is being settled or otherwise dismissed, a detailed explanation of such consideration is required, and other interested parties are given an opportunity to opine on the merits of the settlement (or, in some cases, elect to continue the litigation).

IV. Differing Approaches to Discharge Objection Settlements

Bankruptcy courts are regularly asked to approve settlements between debtors and chapter 7 trustees that call for dismissal of an objection to discharge.[18] One particular problem with discharge settlements arises when the amount of the settlement is approximately what is necessary to pay the trustee's professional fees. In such cases, where is the benefit to the estate and its creditors? Another problem arises when the trustee settles some other dispute with the debtor, like an objection to exemptions, but as part of the consideration for that settlement agrees to dismiss an objection to discharge as well. How does that square with the trustee's statutory duty to object to discharge, since if he or she filed the complaint he or she presumably thought it was "advisable" to object? And if the objection to discharge is well founded, why would it ever be permissible to reward that presumptively undeserving debtor with a discharge in bankruptcy?

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chapter 7 trustee must also "send an e-mail to his/her supervising UST Attorney" advising "of any and all pertinent details regarding the proposed settlement that are not incorporated into the motion" including: (i) the nature and extent of discovery conducted by both sides, (ii) whether the case was referred to UST for civil/criminal action, (iii) whether a written agreement has been executed, (iv) an estimate of professional fees incurred by the estate, to date, (v) current funds on hand in the estate without the proposed payment, and (vi) whether and/or how many extensions of objection deadlines have been entered by the Court; reason(s) for extensions; and current deadline." *See Revised Protocol for Compromises of 727 Complaints and Other Proposed Compromises with Debtors.*

[18] Bankruptcy courts are also asked, at times, to approve settlements of discharge objections filed by individual creditors. Although not all courts agree on this point, such settlements raise different issues. Creditors are private parties, and unlike chapter 7 trustees do not have a statutory duty to object to a discharge where advisable. In any event, the issue of whether or not individual creditors should be permitted to settle discharge actions for consideration is outside the scope of this presentation.

On the other hand, as noted above, our legal system encourages compromise. Courts generally cannot force litigants to proceed with, and incur expenses in, litigation if they elect not to do so. This problem is further exacerbated by the fact that approximately 95% of all chapter 7 cases are no-asset cases where there are limited or no funds available to pay the trustee and its professionals for bringing a discharge objection. Without question, discharge actions can be expensive to pursue.

In any event, because of the difficulty of these issues, a number of courts have labored over the issue of whether or not to approve a proposed settlement of a discharge objection by a chapter 7 trustee. Ultimately, it appears the courts have adopted three different approaches to such settlements.[19]

A. Discharge Settlements *Per Se* Prohibited As A Matter of Public Policy.

First, some courts simply prohibit settlements of discharge objections by trustees for consideration. Such courts have found that a public policy exists that a discharge is simply not for sale and dishonest debtors should not be able to negotiate discharges to which they are not entitled.[20]

For example, in *In re Vickers,* the court denied a trustee's attempt to settle a discharge objection in exchange for a payment of $24,000 to the estate. In support of the settlement, the trustee argued that there was no money in the estate to fund the discharge litigation and that the

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[19] For an excellent overview of this topic, *see* Michael, Terrence L. & Pacewicz, Michael R., *Settling Objections to Discharge in Bankruptcy Cases: An Unsettling Look at Very Unsettled Law,* TULSA LAW REVIEW, Vol. 37:637 (2002).

[20] *See e.g., State Bank of India v. Chalasani (In re Chalasani),* 92 F.3d 1300 (2d. Cir. 1996); *In re Levy,* 127 F.3d 62 (3d Cir.1942); *In re Wilson,* 196 B.R. 777 (Bankr. N.D. Ohio 1996); *Pennwell Printing Co. v. Stout (In re Stout),* 262 B.R. 862, 864 (Bankr. D. Col. 2001); *In re Sheffer,* 350 B.R. 402, 406–07 (Banla.W.D.Ky.2006).

risk of nonpayment of attorney's fees incurred by the trustee was too great to justify continuing with the litigation. In denying the settlement, the bankruptcy court stated:

> Either the discharges ought to be granted or they ought to be denied. Nothing in the Bankruptcy Code authorizes a trustee to seek funds from a debtor … as a price for giving up on a discharge complaint. Discharges are not property of the estate and are not for sale. It is against public policy to sell discharges. The reasons are obvious. Selling discharges would be a disease that would attack the heart of the bankruptcy process, its integrity. A trustee seeking to get paid may coerce an honest debtor into paying something to get rid of a complaint that has no merit. A dishonest debtor may cover up even greater sins than those that gave rise to the complaint in the first place.[21]

Similarly, in *In re Moore,*[22] both the chapter 7 trustee and a creditor brought separate objections to discharge. The parties negotiated a settlement whereby the discharge objections, as well as three adversary proceedings to avoid pre-petition transfers, would be dismissed with prejudice in exchange for a $1.3 million payment by the debtor to the bankruptcy estate. No creditors objected to the settlement. Nevertheless, the court refused to approve the compromise, stating:

> Because it involves questions of public policy previously determined by the Congress, a discharge in bankruptcy is not an appropriate element of a *quid pro quo*. Tying withdrawal of objections to discharge to settlement of other actions is contrary to public policy. Under no circumstances, not even where the intent is innocent, may a debtor purchase a repose from objections to discharge. A discharge in bankruptcy depends on the debtor's conduct; it is not an object of bargain.[23]

Right or wrong, it should be noted that the majority of the recent opinions on this issue appear to have moved away from a *per se* approach in favor of a more fact specific analysis.

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[21] *Moister v. Vickers (In re Vickers)*, 176 B.R. 287, 290 (Bankr. N.D. Ga. 1994).

[22] *In re Moore,* 50 B.R. 661 (Bankr. E.D. Tenn. 1985).

[23] *Id.* at 664.

B. Trustees Do Not Have Statutory Authority to Settle Discharge Objections.

The second approach to discharge objection settlements was articulated by Judge Hughes, while serving as a visiting Judge in the Eastern District of Michigan, in *In re Levine,*[24] wherein the court held that the process of granting and denying a bankruptcy discharge is necessarily a bankruptcy court process and, therefore, the trustee is without authority to compromise such a claim once brought.

In *Levine*, both an individual creditor and the chapter 7 trustee filed an objection to the debtor's discharge. The trustee alleged that the debtor: (i) transferred certain assets to his ex-wife within one year prior to the petition date with the intent to hinder, delay or defraud his creditors, and (ii) knowingly and fraudulently failed to disclose such transfers, and the existence of other property, in his bankruptcy schedules. Separately, the trustee sought to avoid certain transfers made to the debtor's ex-wife prior to the petition date.

Eventually, the chapter 7 trustee, the debtor and his ex-wife reached a three-party settlement that provided for the resolution of the trustee's objection to the debtor's discharge in exchange for $5,000 if paid by a specified date, or for $15,000 if paid after that date. The settlement also provided for resolution of the trustee's claims against the ex-wife in exchange for the return of the transferred assets and payment of $30,000. In support of the settlement, the trustee argued that it was no longer in the creditors' interest to expend estate assets to challenge discharge and, therefore, the money offered by the debtor, even if nominal, was justified.

Although the court found approval of the settlement between the trustee and the ex-wife to be warranted, the settlement between the trustee and the debtor was deemed ultra vires and

[24] *In re Levine,* 287 B.R. 683, 693 (Bankr. E.D. Mich. 1999).

outside the scope of a trustee's authority.[25] Rejecting the reliance of most courts on Bankruptcy Rule 9019 and the *Bard* Factors, the court held that the trustee simply did not have the authority to accept money or other consideration in lieu of proceeding with an objection to discharge, stating: "[I]t is the court which ultimately controls the discharge process, not the creditor, the Chapter 7 trustee, or the United States trustee."[26] "Once [an] objection [to discharge] is filed," the court determined, "the issue is outside of the objecting party's control."[27]

Accordingly, the court held that once a party has filed a complaint objecting to discharge, "it has only two options - the objecting party may either (a) participate in the process by prosecuting its objection to judgment (*i.e.,* an order barring the entry of the debtor's discharge), or (b) withdraw from the process by seeking the dismissal of its complaint."[28] A section 727 objection, the court reasoned, is not property of the estate which is to be reduced to money nor is it a contested claim against the estate which must be resolved. Rather, "It is part of a process

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[25] The court offered a colorful analogy:

> "if a consent decree provided that a violator could be punished by having his ear cut off, the judge could not sign it …." While a Chapter 7 trustee's decision to forego proceeding with an objection to discharge in exchange for money is not as severe as lopping off one's ear, the principle … is the same. A party simply cannot, through an agreement approved by a court, secure authority to engage in an activity which is not otherwise permitted by law.

Id. at 691.

[26] *Id.* at 692.

[27] *Id.* Using another analogy, the court stated:

> An objection to discharge is more analogous to a criminal complaint than a civil complaint. It initiates a process to determine whether a debtor is entitled to her discharge in much the same was as a criminal complaint initiates the process to determine whether a person is guilty of a crime. However, once the process is initiated, the process is out of the complainant's hands. The determination of whether the debtor is entitled to her discharge or the defendant is guilty of a crime is left to the judicial process.

[28] *Id.*

whereby the bankruptcy court itself determines whether a debtor is to receive a discharge or not."[29] Acknowledging the rigidity of its approach, the court stated:

> I recognize that it is tempting to permit Chapter 7 trustees the ability to forego proceeding with an objection to discharge in exchange for consideration…. The pragmatist in me also counsels that the estate is better off with half a loaf than no loaf at all. Even more compelling is the argument that a debtor who has stripped the bankruptcy estate of its assets through her fraud should not be able to then walk away with her discharge as well because the estate cannot afford to object to her discharge.[30]

Noting that section 727 of the Bankruptcy Code itself does not authorize settlements of discharges, the court stated:

> If Section 727 in fact required a court to defer to the best interests of creditors or some other pragmatic criterion in conjunction with its duty to grant or deny a chapter 7 debtor's discharge, or if Section 727 specifically allowed debtors to offer money or other consideration to resolve issues of whether the discharge should be granted or not, I would salute smartly and deal with these questions as best I could. However, Section 727 imposes no such criteria and I see no reason to read such criteria in to Section 727 given the problems they present.[31]

The court also relied on Bankruptcy Rule 7041, and the requisite heightened level of review with respect to dismissal of discharge objections contemplated thereby. The court concluded, stating: "Put simply, the imposition of an absolute prohibition against receiving consideration in exchange for the dismissal of an objection to discharge is necessary to prevent even the appearance that the objecting party and the debtor have engaged in the unseemly practice of buying a discharge which is otherwise not permitted under the law."[32]

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[29] *Id.* at 693.

[30] *Id.*

[31] *Id.* at 694.

[32] *Id.* at 699.

C. Discharge Objection Settlements May Be Approved Where "Fair And Equitable."

Finally, while recognizing the institutional considerations associated with discharge objections,[33] a third set of courts have held that discharge objections may be settled if such settlements are "fair and equitable."[34] Such courts generally start their analysis by focusing on the *Bard* Factors. In addition to these factors, however, such courts also consider whether the consideration paid in exchange for dismissing the complaint provides a benefit to all creditors.

For example, in *In re Bates,*[35] the chapter 7 trustee discovered various unscheduled assets after the debtor received a discharge. The trustee filed an action to revoke the debtor's discharge on a concealment theory. The debtor denied the trustee's accusations, but offered to settle the dispute by paying $250,000 into the bankruptcy estate over a three-year period. The settlement would result in a distribution to unsecured creditors of approximately 63 cents on the dollar. While the chapter 7 trustee accepted the settlement, an objection was filed by the Office of the United States Trustee.

In approving the settlement, the court found the settlement to be proper because the monies to be paid were substantial and would be available for distribution to all creditors. The court stated:

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[33] *See e.g., Lindauer v. Traxler (In re Traxler),* 277 B.R. 699 (Bankr. E.D. Tex. 2002) where the court, in denying a *per se* rule against the settlement of discharge actions, stated:

> The issue at bar raises competing policies: certainly, there should be no "taint of compromise" involved in the dismissal of a § 727 action, yet the estate should be maximized to benefit its creditors. There is a "tension between vindication of the public interest in upholding the policies behind § 727, and the public interest in fostering the peaceful, just, speedy and inexpensive resolution of disputes…."

[34] *In re Traxler,* 277 B.R. 699, 704 (Bankr. E.D. Tex. 2002); *In re Margolin,* 135 B.R. 671, 673 (Bankr. D. Col. 1992); *In re DeArmond,* 240 B.R. 51, 56 (Bankr. C.D. Cal. 1999); *In re Mavrode,* 205 B.R. 716, 720 (Bankr. D.N.Y. 1997).

[35] *In re Bates,* 211 B.R. 338 (Bankr. D. Minn. 1997).

> [T]he proposed settlement represents an attempt by the Trustee to act in the best interests of the estate by limiting the estate's exposure to the risks and expenses of trial in the face of an uncertain outcome. In light of the public policy concerns necessarily implicated by § 727 proceedings, settlements of this type are to be viewed with skepticism and are subject to especially close scrutiny by the bankruptcy court. Nevertheless, a *per se* rule against settlement in all cases is inappropriate, as such a rule would wholly deny the benefits of compromise in cases where settlement is in the best interests of the estate.[36]

Finally, the court reasoned that where the merits of a discharge action have yet to be determined, settlement of the action simply cannot be deemed a "buying of the discharge."[37]

Similarly, in *In re Maynard,*[38] a chapter 7 trustee objected to the debtors' discharge, alleging that the debtors provided false information on their bankruptcy schedules. The trustee then sought court approval of a settlement whereby the debtors would pay $5,000 into the estate in exchange for a withdrawal of the objections. No objections to the settlement were filed. The bankruptcy court adopted a *per se* rule against settlements of discharge actions, stating:

> To allow trustees to settle objections to discharge would be to endorse an unacceptable derogation of the integrity of the bankruptcy system and to encourage what could be a disturbing abuse of power by trustees. Trustees should not seek to put debtors in a position where they can defeat an adversary proceeding filed under § 727 by paying funds to the bankruptcy estate. If the debtor is entitled to a discharge, any demand for payment is improper and the complaint must be dismissed; if the debtor is not entitled to a discharge, the objection to discharge action should proceed and should not be withdrawn based upon a payment of any sum of money from the debtor to the plaintiff.[39]

On appeal, the district court reversed, rejecting the *per se* rule against discharge objection settlements. The district court reasoned:

> In addition to the important public interest in upholding the integrity of the bankruptcy system and preventing tainted compromise, there is a public interest in

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[36] *Id.* at 348.

[37] *Id.*

[38] *Wolinsky v. Maynard (In re Maynard),* 258 B.R. 91 (Bankr. D. Vt. 2001).

[39] *Id.* at 94.

> encouraging just, speedy, inexpensive and final resolution of disputes. Furthermore, a determination that a § 727 objection to discharge can never be compromised could have the practical effect of deterring plaintiffs from brining meritorious complaints, or of depriving defendant debtors of the full protection of the bankruptcy court's oversight.[40]

The district court remanded the case to the bankruptcy court with instructions to determine whether the terms of the proposed settlement were "fair and equitable" and in the best interests of the estate. Not surprisingly, given the amount of the settlement, the bankruptcy court ultimately determined that the proposed settlement was not "fair and equitable," and denied the trustee's motion.[41]

V. Discharges Should Not Be Sold At Any Price

Because of the importance of the discharge concept, settlements of discharge objections for money or other consideration by a chapter 7 trustee should not be approved. Simply put, such settlements are contrary to the policies of the bankruptcy system, serve no legitimate purpose and, unfortunately, facilitate a temptation that some may be unable to resist.

Because a discharge should be granted only to honest debtors, there is a fundamental public policy at stake in these cases; the legitimacy and integrity of the bankruptcy process.[42] Moreover, discharge objections serve to deter misconduct and motivate debtors to comply with their bankruptcy obligations. In furtherance of these important policies, section 704(a)(6) expressly charges trustees with an affirmative duty to object to a discharge when advisable based on the facts. Fulfilling this duty is part of the important role that chapter 7 trustees play in every case. Indeed, because trustees are paid a fee even in no-asset cases and a percentage of

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[40] *In re Maynard,* 269 B.R. 535, 542 (D. Vt. 2001).

[41] *In re Maynard,* 273 B.R. 369 (Bankr. D. Vt. 2002).

[42] *In re Kallstrom*, 298 B.R. 753, 758, 759 (10th Cir. BAP 2003).

recoveries in other cases, one could argue that objecting to discharges in those rare cases where it is really warranted is part of the job that a trustee signs up for.

Of course, it would not be wrong to argue that this standard creates an unfair situation for trustees in some cases. Trustees undoubtedly work hard for their compensation, sometimes too hard when much effort is put into those cases that turn out to be no-asset cases. Moreover, litigation of discharge objections can be a time consuming and expensive process. A settlement may provide funds to pay fees in a case in which the trustee has expended tremendous effort in fulfilling proper duties unrelated to discharge. Perhaps the best solution in cases where a discharge objection is warranted but sufficient monies do not exist to fund such litigation is for the chapter 7 trustee to advise the Office of the United States Trustee of the basis for the discharge objection, and for that office (which does not have the same economic pressures as a chapter 7 trustee) to take up the fight.

In any event, it should not be argued that settlements of discharge objections for money are permissible because they provide funds necessary to administer cases. A trustee who *successfully* objects to discharge cannot recover his legal fees in no-asset cases. It would be improper for a trustee who fails in an objection to discharge but settles for a nominal amount to fare better than a trustee who files a complaint and succeeds. Such an approach creates a highly effective practical deterrent to a trustee vigorously prosecuting a discharge objection to its conclusion.

As noted above, a number of courts in the "fair and equitable" camp have approved discharge settlements where creditors would receive a benefit from the settlement amount in the form of a substantially greater dividend from the estate. These cases are probably rare. In any event, for the reasons already discussed, it should make no difference whether the monetary

recovery benefits only the chapter 7 trustee or, in those cases where a large settlement is offered, the entire creditor body. Either the debtor is entitled to a discharge or not. As Judge Hughes noted in *In re Levine*:

> One has either committed the misconduct described in § 727 or not; and hence is disqualified from obtaining a discharge or not. It is my view that complaints to deny a discharge must be granted in full or denied in full; there is no middle ground.[43]

This is particularly true because there is nothing in sections 704(a)(6) or 727(a) of the Bankruptcy Code that invites a trustee or the court to defer to the best interests of creditors when misconduct by the debtor has occurred.

Of course, there may be a number of legitimate reasons for a trustee to want to dismiss a discharge objection instead of prosecuting it to conclusion. For example, in some cases the trustee may file a complaint and only through discovery learn that the section 727 action does not have merit. In other cases, the cost of prosecuting the objection may not justify the benefits that would be derived from the denial of the discharge.

In the first scenario, the adversary proceeding should simply be dismissed without any monetary payment. If there is no merit to the complaint, the chapter 7 trustee should not look to charge an honest debtor a toll to travel the road to discharge. In the second scenario, the trustee should either dismiss the complaint on the grounds that continued prosecution is no longer "advisable" pursuant to section 704(a)(6), or continue to prosecute the objection (with the fees incurred being part of its cost of doing business if the case is a no asset case). In either case, however, the trustee should not accept money or other consideration in exchange for dismissal of an objection to discharge. This approach avoids any appearance of impropriety with respect to

[43] *In re Levine,* 287 B.R. at 693.

the important work that chapter 7 trustees do in the vast majority of bankruptcy cases that are filed.

Conclusion

Discharge objections are important both to ensure the integrity of the bankruptcy system and to deter misconduct by debtors. Congress specifically provided in section 704(a)(6) that a trustee *shall* object to discharge when appropriate. Moreover, because of the policy concerns at play, Bankruptcy Rule 7041 specifically requires that the dismissal of a discharge objection be granted only after specific notice to parties and when conditioned on terms established by the court. And the local rules of the Eastern District of Michigan and other jurisdictions create additional disclosure requirements with respect to the dismissal of any discharge action. The upshot of these policies and rules is that chapter 7 trustees simply should not settle discharge actions for money or other consideration, regardless of the price.

CATCHING A TIGER BY THE TAIL: COMMENCING AND SETTLING DISCHARGE OBJECTIONS

By Scott W. Dales[1]

I. THE PROBLEM

Filing a complaint in bankruptcy court to deny or revoke a debtor's discharge is not unlike catching a tiger by the tail. In both instances, it is difficult to let go without getting hurt.

The jeopardy that attends the filing a complaint to revoke or deny a discharge is due to the nature of litigation under § 727.[2] Unlike a lawsuit under § 523, which affects only one creditor and the debtor with respect to a single claim, litigation under § 727 has a much broader impact. A creditor who initiates a lawsuit under § 727 is effectively acting as a private attorney general: successful prosecution of the complaint is a victory for the public as a whole in preventing dishonest debtors from discharging their debts. The result also has a broader pecuniary impact on all creditors: judgment for a single plaintiff under § 727 allows all creditors to pursue collection of their claims against the debtor and his non-exempt property.

In other words, if the plaintiff prevails in litigation under § 727, all creditors will benefit; if he fails or dismisses the suit, all creditors suffer.

Given the risk and expense of discharge litigation, it is conceivable, if not likely, that other creditors will be relying on the objecting creditor to advance their own interests, hoping that the plaintiff will succeed (at its own expense) in persuading the court to withhold or revoke the debtor's discharge. They are, in some sense, free-riders who are rolling the dice without placing a bet.

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[1] Chief Judge, United States Bankruptcy Court for the Western District of Michigan. Judge Dales gratefully acknowledges the assistance of Jahel H. Nolan, Esq., in preparing these materials.

[2] Unless otherwise noted, statutory citations in this text refer to title 11 of the United States Code (the "Bankruptcy Code").

Not only are other creditors relying on plaintiffs to vindicate the interests enshrined in § 727(b), but the courts, too, rely on them to police the system by bringing debtor misconduct to light. Courts recognize a broader, public interest in such litigation, viewing it as a way to preserve the integrity of the bankruptcy system.

For these reasons, some courts are exceedingly reluctant to authorize dismissal of discharge litigation without careful scrutiny, going so far as to categorically prohibit settlement of such disputes, imposing "fiduciary" duties upon plaintiffs in discharge objection litigation, or requiring the fruits of any such settlement to be shared with the estate's stakeholders generally. In somewhat hyperbolic language, many courts decry what they regard as "buying and selling discharges" under the guise of settlement. Ironically, the very outcome that courts welcome in most other litigation – settlement – raises judicial hackles in the context of discharge litigation.

We find in § 727 proceedings a profound tension between three exalted bankruptcy principles: (1) the Bankruptcy Code's bedrock of consumer bankruptcy – the fresh start; (2) the Code's important qualification that reserves discharge for "the honest but unfortunate" debtor;[3] and (3) the pervasive and salutary public policy favoring settlements --especially strong in bankruptcy proceedings where participants are highly sensitive to attorney's fees and other expenses.

Because it is frequently difficult if not impossible to reconcile these sometimes inconsistent principles in § 727 litigation, counsel must proceed carefully before filing and while settling such suits.

II. APPLICABLE STATUTES AND RULES

[3] *Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934) (discharge in bankruptcy "gives to the honest but unfortunate debtor who surrenders for distribution the property which he owns at the time of bankruptcy, a new opportunity in life and a clear field for future effort, unhampered by the pressure and discouragement of pre-existing debt.").

The problem arises most commonly[4] in chapter 7 cases involving individual debtors, and it relates to the provision that Congress enacted principally to police debtor misconduct within a bankruptcy case, as opposed to misconduct in incurring a particular debt. *Compare* 11 U.S.C. § 523 (exceptions to discharge for particular types of debts, premised on the nature of the debt) *with id.* § 727 (withholding or denying discharge based on case-related misconduct).

Section 727 is perhaps the strongest Congressional statement expressing this tension, making the discharge mandatory ("court shall grant") but simultaneously enumerating instances in which the court must withhold the relief based (in most cases) on dishonest behavior, or at least behavior that falls short of square dealing:

> (a) The court shall grant the debtor a discharge, unless—
>
> (1) the debtor is not an individual;
>
> (2) the debtor, with intent to hinder, delay, or defraud a creditor or an officer of the estate charged with custody of property under this title, has transferred, removed, destroyed, mutilated, or concealed, or has permitted to be transferred, removed, destroyed, mutilated, or concealed—
>
> (A) property of the debtor, within one year before the date of the filing of the petition; or
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> (B) property of the estate, after the date of the filing of the petition;
>
> (3) the debtor has concealed, destroyed, mutilated, falsified, or failed to keep or preserve any recorded information, including books, documents, records, and papers, from which the debtor's financial condition or business transactions might be ascertained, unless such act or failure to act was justified under all of the circumstances of the case;
>
> (4) the debtor knowingly and fraudulently, in or in connection with the case—
>
> (A) made a false oath or account;
>
> (B) presented or used a false claim;

[4] In limited circumstances, a creditor in an individual chapter 11 debtor's case may seek denial of discharge for reasons enumerated in § 727(a). *See* 11 U.S.C. §1141(d)(3).

(C) gave, offered, received, or attempted to obtain money, property, or advantage, or a promise of money, property, or advantage, for acting or forbearing to act; or

(D) withheld from an officer of the estate entitled to possession under this title, any recorded information, including books, documents, records, and papers, relating to the debtor's property or financial affairs;

(5) the debtor has failed to explain satisfactorily, before determination of denial of discharge under this paragraph, any loss of assets or deficiency of assets to meet the debtor's liabilities;

(6) the debtor has refused, in the case—

(A) to obey any lawful order of the court, other than an order to respond to a material question or to testify;

(B) on the ground of privilege against self-incrimination, to respond to a material question approved by the court or to testify, after the debtor has been granted immunity with respect to the matter concerning which such privilege was invoked; or

(C) on a ground other than the properly invoked privilege against self-incrimination, to respond to a material question approved by the court or to testify;

(7) the debtor has committed any act specified in paragraph (2), (3), (4), (5), or (6) of this subsection, on or within one year before the date of the filing of the petition, or during the case, in connection with another case, under this title or under the Bankruptcy Act, concerning an insider;

(8) the debtor has been granted a discharge under this section, under section 1141 of this title, or under section 14, 371, or 476 of the Bankruptcy Act, in a case commenced within 8 years before the date of the filing of the petition;

(9) the debtor has been granted a discharge under section 1228 or 1328 of this title, or under section 660 or 661 of the Bankruptcy Act, in a case commenced within six years before the date of the filing of the petition, unless payments under the plan in such case totaled at least—

(A) 100 percent of the allowed unsecured claims in such case; or

(B) (i) 70 percent of such claims; and

(ii) the plan was proposed by the debtor in good faith, and was the debtor's best effort;

(10) the court approves a written waiver of discharge executed by the debtor after the order for relief under this chapter;

> (11) after filing the petition, the debtor failed to complete an instructional course concerning personal financial management described in section 111, except that this paragraph shall not apply with respect to a debtor who is a person described in section 109(h)(4) or who resides in a district for which the United States trustee (or the bankruptcy administrator, if any) determines that the approved instructional courses are not adequate to service the additional individuals who would otherwise be required to complete such instructional courses under this section (The United States trustee (or the bankruptcy administrator, if any) who makes a determination described in this paragraph shall review such determination not later than 1 year after the date of such determination, and not less frequently than annually thereafter.); or
>
> (12) the court after notice and a hearing held not more than 10 days before the date of the entry of the order granting the discharge finds that there is reasonable cause to believe that—
>
> (A) section 522(q)(1) may be applicable to the debtor; and
>
> (B) there is pending any proceeding in which the debtor may be found guilty of a felony of the kind described in section 522(q)(1)(A) or liable for a debt of the kind described in section 522(q)(1)(B).

11 U.S.C. § 727(b). As is clear from the statute, the only basis for withholding a discharge that is not based on culpable conduct is the first exception, which is based on the nature of the debtor: the court may not discharge the debts of an artificial entity under § 727. 11 U.S.C. § 727(a)(1). Even the exceptions embodied in § 727(a)(8) and (a)(9) in some respects condemn the debtor's case-related conduct in seeking bankruptcy relief too frequently.

A debtor's misconduct related to the case – such as perjuring himself in connection with his schedules, at the first meeting of creditors, or in a Rule 2004 examination, or concealing estate property—hurts every interested party, given the principle of ratable distribution underlying the Code. *See* 11 U.S.C. § 726 (specifying distribution of estate property according to statutory classes and priorities). It also has implications for the public's perception of the integrity of the entire bankruptcy system.

In a chapter 7 case, for example, if a debtor were to conceal his interest in a valuable asset by fraudulently omitting it from his schedules, his trustee would be unable to administer that asset for the benefit of all claimants. Thus, all interested parties would suffer, and all would have a right to complain, provided they act quickly. The Clerk is required to enter a chapter 7 discharge "forthwith" following the passage of specified deadlines, including the 60-day deadline for objecting to discharge. *See, generally,* Fed. R. Civ. P. 4004.[5] After a debtor receives his discharge, notwithstanding relief under Fed. R. Bankr. P. 9024 (and Fed. R. Civ. P. 60), only the more limited remedy under § 727(d) of revoking a discharge is available. *See* 11 U.S.C. § 727(d) (court must revoke discharge if debtor obtains discharge or estate property through concealment or fraud, flouts court orders, or fails to cooperate with auditors under 28 U.S.C. § 586(f)).

Although debtors certainly appreciate the early entry of their discharges, the accelerated timeframe presents risks for panel trustees, the United States Trustee, and creditors considering whether to object to discharge.[6] For panel trustees, the pressure is greater because, unlike creditors who are allowed but not encouraged to object to discharge, the Bankruptcy Code imposes a qualified duty upon trustees to object "if advisable." 11 U.S.C. § 704(a)(6).[7] Moreover, a creditor or other party in interest may ask the court to direct the trustee to "examine the acts and conduct of the debtor to determine whether a ground exists for denial of discharge." *Id.* § 727(c)(2). And, of course, the court may issue such an order *sua sponte*, if it suspects abuse

[5] In a chapter 7 case, the complaint generally must be filed "no later than 60 days after the first date set for the meeting of creditors under § 341." Fed. R. Bankr. P. 4004(a).

[6] The rules do provide tools for managing this risk such as by, for example, authorizing extensions of the deadline for cause and permitting pre-suit discovery. *See* Fed. R. Civ. P. 4007 (extensions of deadline) and Fed. R. Civ. P. 2004 (pre-suit discovery).

[7] The United States Trustee, who supervises panel trustees as directed under 28 U.S.C. § 586, provides some guidance on this question: "To determine if it is advisable to oppose the debtor's discharge, the trustee must consider the cost of the litigation, the amount of estate funds available, the benefit to creditors of a denial of the discharge, and the likelihood of success." *See* Handbook for Chapter 7 Trustees, p. 4-28 (U.S. Department of Justice, Oct. 1, 2012) (available at http://www.justice.gov/ust/eo/private_trustee/library/chapter07/index.htm).

of the process. *Id.* § 105(a). These provisions put considerable pressure on a panel trustee in connection with discharge objections.

Given the compressed deadline prescribed in Rule 4004, a panel trustee or other potential plaintiff must decide, in a very short timeframe, whether to object to a debtor's discharge and, as explained below, run the risks associated with this particular type of bankruptcy litigation.

Regardless of whether a creditor, trustee, or other interested party sues to deny the discharge in the first instance or revoke it after the fact, the bankruptcy rules require judicial involvement before any dismissal order may enter.

In most federal civil litigation (including in bankruptcy court), voluntary dismissal is accomplished quite easily: a plaintiff may dismiss without a court order by filing a notice of dismissal any time before the opposing party serves either an answer or a motion for summary judgment, or the parties who have appeared may dismiss most litigation at any time without a court order by filing a stipulation to that effect. *See* Fed. R. Civ. P. 41(a)(1)(A). Generally in federal court, "[p]laintiffs are masters of their complaints . . ." at the inception of the case and throughout the litigation, even on appeal. *See Webster v. Reproductive Health Services*, 492 U.S. 490, 512 (1989) (*citing Caterpillar Inc. v. Williams*, 482 U.S. 386, 398–399 (1987)).

In discharge denial and revocation proceedings, however, the plaintiff's freedom to dismiss is circumscribed. More specifically, Rule 7041 requires the court's involvement and authorizes the court to attach conditions to any such dismissal:

> Rule 41 F.R.Civ.P. applies in adversary proceedings, except that a complaint objecting to the debtor's discharge shall not be dismissed at the plaintiff's instance without notice to the trustee, the United States trustee, and such other persons as the court may direct, and only on order of the court containing terms and conditions which the court deems proper.

Fed. R. Bankr. P. 7041. From the notes of the Advisory Committee on Rules, it is not clear whether the drafters intended to prevent creditors from overreaching against vulnerable debtors (as is generally assumed), or to prevent debtors from bribing creditors:

> Dismissal of a complaint objecting to a discharge raises special concerns because the *plaintiff may have been induced to dismiss* by an advantage given or promised by the debtor or someone acting in his interest. Some courts by local rule or order have required the debtor and his attorney or the plaintiff to file an affidavit that nothing has been promised to the plaintiff in consideration of the withdrawal of the objection. By specifically authorizing the court to impose conditions in the order of dismissal this rule permits the continuation of this salutary practice.

Id. (Notes of Advisory Committee of Rules -1983) (emphasis added). The italicized phrase in the drafters' note seems to emphasize debtor misconduct, rather than creditor overreaching.

If a bankruptcy trustee is the § 727 plaintiff who seeks to settle the dispute, Rule 9019 will probably come into play. That rule provides in relevant part as follows:

> (a) Compromise. On motion by the trustee and after notice and a hearing, the court may approve a compromise or settlement. Notice shall be given to creditors, the United States trustee, the debtor, and indenture trustees as provided in Rule 2002 and to any other entity as the court may direct. . . .

Fed. R. Bankr. P. 9019(a). Most courts will apply the familiar standards governing trustee settlements. *See Protective Comm. for Indep. Stockholders of TMT Trailer Ferry, Inc. v. Anderson*, 390 U.S. 414, 424–25 (1968). The Sixth Circuit summarized how other federal courts had implemented the Supreme Court's guidance in *TMT Trailer*—and distilled four factors for bankruptcy courts to consider:

> (a) The probability of success in the litigation; (b) the difficulties, if any, to be encountered in the matter of collection; (c) the complexity of the litigation involved, and the expense, inconvenience and delay necessarily attending it; (d) the paramount interest of the creditors and a proper deference to their reasonable views in the premises.

In In re Bard, 49 Fed. App'x 528, 530 (6th Cir. 2002) (unpublished). These standards are similar to the "if advisable" analysis described in the United States Trustee's Handbook for Chapter 7 Trustees, *supra n. 7.* Rule 9019, however, by its terms, does not apply to all settlements in bankruptcy court, only those involving a trustee.

The Committee Notes to Rule 7041, by expressing concern that a plaintiff might be "induced" by a debtor into settling, connotes some concern about debtor misconduct, but the avenue of impropriety in bankruptcy discharge litigation can certainly run in both directions, and discharge-related settlements may even be regarded as criminal. *See Bank One v. Kallstrom (In re Kallstrom),* 298 B.R. 753 (10th Cir BAP 2004) (suggesting that making settlement payment to resolve §727 action may be criminal); c*ompare* 18 U.S.C. § 152(5) (criminalizing the knowing and fraudulent post-petition receipt of property from a debtor "with intent to defeat the provisions of title 11") with *id.* § 152(6) (criminalizing bribery (on both sides of the transaction) "for acting or forbearing to act in any case under title 11"). It is certainly plausible to regard a debtor's promise of settlement payments or other consideration as inducing a plaintiff to drop a § 727 lawsuit, but of course the same may be said of most bankruptcy settlements. To commit criminal bankruptcy fraud, however, the accused must not only induce another to act or refrain from acting in connection with the case, but must do so "knowingly and fraudulently." *Id.* It is not clear why some courts single-out for special treatment discharge-related settlements as potentially criminal, when settlements of exemption disputes or avoidance actions or other matters are regarded as more routine, and in fact encouraged, without the slightest suggestion of criminal activity.[8]

[8] Admittedly, where, as in *Kallstrom*, a debtor agrees to the entry of a judgment establishing a non-dischargeable debt in a lawsuit that did not properly invoke § 523, a court may justifiably regard the settlement with skepticism.

It is also foreseeable, however, that the threat or even prospect of discharge denial or revocation may create opportunities for creditors and others to embarrass and extract undue consideration from debtors, at a particularly vulnerable time. This possibility naturally excites judicial suspicion. *See, e.g., Cadlerock Joint Venture II, L.P. v. Salinardi (In re Salinardi)*, 307 B.R. 353 (Bankr. D. Conn. 2004) (an objecting party enjoys a natural leverage in litigation which is unusually and disproportionately large in relation to the risk of adverse judgment. This leverage, if left unchecked, would routinely drive debtors to seek settlements of discharge objections, even if they are innocent of any wrongdoing.").

Courts are concerned about both sets of problems, bribery and non-criminal overreaching, and may address these issues by requiring disclosures made in accordance with Rule 9011 or under penalty of perjury. *See, e.g.*, LBR 7041-1 (E.D. Mich.) ("When the parties to an action under § 727 propose to dismiss the action, they shall file a joint statement of the consideration received or to be received by the plaintiff."). Bankruptcy judges, moreover, are not the only officials concerned about the potential for abuse: in the Eastern District of Michigan, the United States Trustee, charged with the statutory duty to supervise panel trustees, has developed a "protocol" or "directive" for panel trustees to use before settling discharge litigation. *See* Revised Protocol for Compromise of Section 727 Complaints and Other Proposed Compromises with Debtors (attached to materials as Exhibit A). Drawing inferences from this protocol, the United States Trustee is concerned, in part, about settlements designed simply to pay for administrative costs, without benefits to general unsecured creditors.

In addition to these policy concerns, courts are justifiably concerned about the reliance interests of non-parties to discharge litigation. In other words, because the relief available in a discharge proceeding affects all creditors by protecting their claims from discharge, courts

assume that non-party creditors rely on the pendency of a fellow creditor's complaint objecting to or seeking revocation of discharge. If the right to dismiss such a complaint were unfettered, creditors who refrained from filing suit in reliance on another creditor's complaint could find themselves out-of-the-money if the complaint were summarily dismissed without giving them an opportunity to intervene. In some respects, the courts endeavor to protect the free-riding creditor who did not grab the tiger by the tail, but simply sat by quietly, hoping for a successful conclusion.

The problem of creditor reliance is particularly acute given the tight limitation period prescribed in Rule 4004: if a plaintiff commences a proceeding against a debtor and if other creditors, in reliance, refrain from filing their own lawsuit, the eventual dismissal of the discharge objection will generally foreclose them from seeking similar relief, given the passage of the deadline for commencing an action under § 727.[9] In addition, it is unrealistic to suggest that non-parties to discharge litigation may commence their own proceeding after settlement by the original plaintiff. As noted above, the grounds for revoking a discharge are more limited than for withholding it in the first place, and a creditor's pre-discharge knowledge of a debtor's fraud may doom the revocation suit. *See* 11 U.S.C. § 727(d)(1).

III. JUDICIAL RESPONSE TO THE ISSUE

Courts confronting the questions arising from the proposed settlement of discharge litigation have generally taken two approaches. Some categorically prohibit settlement of discharge objection and revocation litigation, and others simply require notice, disclosure of terms, and heightened scrutiny.

[9] For a helpful discussion of the limitation period and a possible solution for cases involving the late (but understandable) discovery of the grounds for objecting to discharge, *see Lewis v Casab (In re Casab)*, 523 B.R. 543 (Bankr. E.D. Mich. 2015) (discussing Fed. R. Bankr. P. 4004(b)(2)).

For example, in a frequently-quoted passage, the Honorable Clive W. Bare flatly rejected bargained-for settlements of discharge litigation:

> During his testimony supporting the compromise, which represents a bargained for exchange, the trustee spoke of the debtor "buying his discharge." Because it involves questions of public policy previously determined by the Congress, a discharge in bankruptcy is not an appropriate element of a *quid pro quo*. Tying withdrawal of objections to discharge to the settlement of other actions is contrary to public policy. Under no circumstances, not even where the intent is innocent, may a debtor purchase a repose from objections to discharge. A discharge in bankruptcy depends on the debtor's conduct; *it is not an object of bargain*.

In re Moore, 50 B.R. 661, 664 (Bankr. E.D. Tenn. 1985) (emphasis added). Perhaps, the panel trustee's unvarnished description of the settlement as "buying [the debtor's] discharge," in addition to the court's own policy concerns, influenced the decision. The words of exchange – "bargain," "buying," "*quid pro quo*," "purchase"—suggest that the court was uncomfortable treating the settlement of this litigation as an ordinary commercial transaction. Many courts share this aversion to bargaining for a discharge. *See also State Bank of India v. Chalasani (In re Chalasani),* 92 F.3d 1300, 1310 (2d Cir. 1996) ("Because discharge is a statutory right undergirded by public policy considerations, it is not a proper subject for negotiation and the exchange of a *quid pro quo."*); *In re Kallstrom,* 298 B.R. 753 (10th Cir BAP 2004) (condemning "trafficking in discharges"); *In re Levine*, 287 B.R. 683 (Bankr.E.D.Mich. 2002) (opposing *quid pro quo*, and noting that settlement of § 727(a) action is never appropriate).

Some courts, however, take a more nuanced view, applying heightened scrutiny to dismissal requests, rather than banning them outright, while taking care to ensure that the settlement is in the best interests of the estate. *Philadelphia Indemnity Ins. Co. v. Rotert (In re Rotert)*, 530 B.R. 791 (Bankr. N.D. Okla. 2015) (noting court's discretion to approve settlement but describing concern about the judicial system's integrity as "paramount"); s*ee*, *generally*,

Bankruptcy Receivables Mgmt. v. de Armond (In re de Armond), 240 B.R. 51, 56 (Bankr. C.D. Calif. 1999) (describing this as the majority approach). In so doing, they employ familiar standards to decide whether a settlement is "fair and equitable," generally including the following:

1. Likelihood of success on the merits of the litigation;

2. Difficulties in collection of any judgment that may be obtained;

3. Complexity and expense of the litigation;

4. Interests of the creditors; and

5. Whether the settlement promotes the integrity of the judicial system.

Rotert, 530 B.R. at 798. In so doing, they seem to place more emphasis on the last factor than any other.

The courts that permit settlement of discharge litigation proceed carefully to ensure that creditors and other plaintiffs are not taking undue advantage of debtors and that the public interests involved in withholding discharges from the undeserving are not sacrificed for private gain. *See*, *e.g.*, *de Armond*, 240 B.R. at 56 (citing with approval *In re Bates*, 211 B.R. 338 (Bankr.D.Minn.1997), and the requirement that settlement of § 727 count must inure to the estate and creditors generally, rather than to the plaintiff alone). Presumably to address this concern, as noted above, the Eastern District of Michigan requires settling parties to disclose the consideration for the dismissal in a joint statement. *See* LBR 7041-1 (E.D. Mich.).

Some courts, however, go to great lengths to prevent abuse. The *de Armond* decision, for example, expressly treats the plaintiff in a § 727 action as a fiduciary, citing Chief Judge Cardozo's opinion in *Meinhard v. Salmon*, 164 N.E. 545 (N.Y. 1928), to hold a § 727 plaintiff to a standard "stricter than the morals of the market place." *de Armond*, 240 B.R. at 57. Imposing

fiduciary duties on creditors, whom we ordinarily expect to act in their own self-interests, certainly suggests that would-be § 727 plaintiffs should hesitate before objecting to discharge, at least in the Central District of California. By commencing a § 727 proceeding, a creditor in a court that treats the plaintiff as a fiduciary assumes duties to numerous, torpid creditors whose mere existence, without more, complicates the plaintiff's vindication of its own rights and hijacks the creditor's resources.

In courts that adopt this view, a creditor plaintiff subjects itself to the risk that other creditors might complain about a breach of that fiduciary duty should the plaintiff fail in its quest or settle the case. It also assumes the risk that it will be required to continue the suit well after it has exhausted its own resources and appetite for litigation. An ordinary creditor may (and frequently does) "cut and run" to avoid throwing good money after bad, but a fiduciary cannot be so nimble. If a creditor-plaintiff takes the self-interested action consistent with the morals of the marketplace, it may expose itself to unwanted expense and liability to the numerous beneficiaries of the court-imposed duty.

Indeed, the panel in *Kallstrom* specifically held that Rule 7041 expressly authorizes a bankruptcy court "to force parties to pursue litigation they have no desire or interest in pursuing." *Kallstrom*, 298 B.R. at 761. This is a remarkable construction of a rule in a court that depends so heavily on settlements in other matters.

The notion that a plaintiff could be compelled to continue litigating after reaching terms with its adversary is difficult enough to harmonize with widely-held notions of autonomy, but for a bankruptcy trustee, who must also keep in mind administrative expense, it is downright chilling. It would never be "advisable" for a trustee to commence litigation that could not be settled if the costs became prohibitive. Furthermore, a prudent trustee-plaintiff must conduct the

"if advisable" analysis described in the United States Trustee's handbook, *supra* n. 7, throughout the course of the litigation, not only before its inception. It is certainly conceivable that discovery could change a plaintiff's view of her likelihood of success, or that other demands on an estate's resources could cause her to reassess priorities. Undue limitations on a trustee-plaintiff's control of discharge litigation may interfere with her other statutory duties.

Courts must not allow the pejorative connotations of phrases such as "selling the discharge" or "trafficking in discharges" or "*quid pro quo*" to cloud their vision and lead them away from even-handedly evaluating proposed dismissals. Perversely, cases such as *de Armond, Kallstrom, Levine*, and others, that impose such onerous requirements in an effort to protect the integrity of the bankruptcy system may have precisely the opposite effect: carefully considered, these cases should discourage trustees and creditors from opposing discharge in the first place.

The fact that the public has an interest in ensuring that only honest debtors receive a discharge (and, conversely, that dishonest debtors do not) should not lead to categorical or near categorical prohibition against settling discharge litigation, or imposition of fiduciary duties upon plaintiffs in § 727 litigation. Although the analogy is not perfect, courts routinely accept – indeed encourage—plea bargaining in criminal cases where the public interest is arguably greater than in discharge litigation. Indeed, the Supreme Court has stated that "[n]inety-seven percent of federal convictions and ninety-four percent of state convictions are the result of guilty pleas," which the high court touted as "central to the administration of the criminal justice system," even while describing the practice as "horse trading" between the government and the accused. *Missouri v. Frye*, 132 S.Ct. 1399, 1407-08 (2012). Indeed, today, even restitution –the money payable to a victim on account of a criminal offense-- is regarded as part of a criminal defendant's sentence in the federal courts, and therefore a subject for plea bargaining. *See* Fed.

R. Crim. Pro. 11 (Notes of Advisory Committee on Rules – 1985). If offenses against the sovereign --the People generally-- are the proper subject of "horse trading," surely a creditor or trustee could be forgiven for attempting to settle a complaint that includes a count under § 727. Similarly, by including *qui tam* or whistle-blower provisions in other statutory schemes, Congress has no compunction in harnessing pecuniary incentives of self-serving, private plaintiffs to police the integrity of other important, public systems,[10] and Rule 41 makes no special provision for the dismissal of such litigation.

It is not uncommon for creditors to join a count under § 523 (seeking to except a particular debt from discharge) with a count under § 727 (seeking to deny the discharge altogether). As a practical matter, the efficacy of joining the claims is doubtful, at least if the § 523 count is strong: if the creditor-plaintiff is successful on the § 727 count, she will re-start the race to the courthouse with other creditors who, by virtue of the judgment withholding or revoking discharge, will be similarly licensed to dismember the debtor. Success on the § 523 count alone, however, narrows the field to only those holding non-dischargeable and post-petition claims against the debtor.

Moreover, given the judicial hostility to settling § 727 counts in exchange for consideration –the "sale of the discharge"— the creditor's supposed effort to obtain leverage may turn out to be fruitless, especially if forced to share the bounty with others. *See Rotert*, 530 B.R. at 798-99 ("Adding a § 727 action to such a complaint for the primary purpose of bringing some additional "leverage" is likely to complicate the creditor's life much more than it is worth because of the public interest and policy considerations which come into play on account of that § 727 action.").

[10] *See, e.g.*, 31 U.S.C. § 3730 (*qui* tam provision of False Claims Act specifically allowing recovery by private whistle-blower plaintiffs for false claims made against the government).

Courts generally hold, as a matter of freedom of contract, that the parties to a § 523 action may freely settle their differences subject to usual protections against overreaching. The resolution in such cases affects only the parties to the settlement. *See de Armond*, 240 B.R. at 54-55. But this freedom to contract vanishes when a § 727 count shares the stage with a § 523 count, or even where the § 727 is simply in the wings. *Id.,* 240 B.R. at 54 n.7 (asserting § 523 and § 727 counts in separate complaints will not facilitate dismissal of the § 727 complaint because "the analysis is the same as where the two kinds of claims are joined in the same complaint.").

By going to such lengths to prohibit settlement of discharge litigation, the courts may ultimately impinge upon the parties' freedom to contract, but they also run dangerously close to exceeding constitutional bounds. A recent opinion from the Eastern District of Michigan's bankruptcy court suggests the point. In *Rosenfeld v. Rosenfeld (In re Rosenfeld)*, Slip Op. Adv. Pro. No. 15-04318, 2015 WL 4623586 (Bankr. E.D. Mich. July 31, 2015), Judge Tucker dismissed a § 727 complaint filed by the debtor's ex-husband for want of subject matter jurisdiction after determining that the plaintiff-creditor in that case held non-dischargeable claim against the debtor. The court observed:

> Even if Plaintiff was authorized generally to file the adversary proceeding under § 727(c)(1) due to his status as a creditor, he must be viewed as lacking standing to prosecute the adversary proceeding as soon as the Court determines that he is owed only a nondischargeable debt. (And this Court has now made this determination as to Plaintiff).

Rosenfeld, supra, at *7. After resolving the § 523 count in the creditor's favor, the court could not award any other meaningful relief under § 727.

If the *Rosenfeld* analysis is correct, the consensual resolution of a § 523 count should render the remaining § 727 counts moot or non-justiciable as a matter of Article III

jurisprudence, or prudential limitations. Nevertheless, a visceral aversion to "selling discharges" may lead some courts to a different conclusion. *Rotert*, 530 B.R. at 799 ("The Court also rejects the argument that the Philadelphia adversary proceeding is moot because Philadelphia has decided its pursuit no longer makes economic sense."). Indeed, a footnote in *Rotert* argues that by forcing such matters to trial in the past, the court has brought facts to light proving that a debtor was undeserving of a discharge. *Id.* at n. 38. Of course, a court should satisfy itself that it has jurisdiction to decide a case before reaching, and without consideration of, the merits. *Cf. Bell v. Hood,* 327 U.S. 678, 682-83 (1946) (subject matter jurisdiction must be decided before resolving matters on the merits, and the two questions are separate). But the *Rotert* opinion shows how far bankruptcy courts go to protect the integrity of the bankruptcy process. The notion that litigants are "trading in discharges" is anathema to the courts, and they will not hesitate to use Rule 7041 to prevent such commerce, or the public perception of it, even at the risk of relaxing jurisdictional limits and compromising the efficacy of § 727(b) itself.

IV. CONCLUSION

As the case law now stands, creditors, trustees, and other interested parties must think twice before filing a complaint objecting to discharge. The public policy favoring compromise and settlement of litigation, in many courts, yields to the policy of preventing undeserving debtors from discharging their debts for lucre. Moreover, courts evidently regard settlements of discharge litigation as an affront to the integrity of the system, hinting at criminal or quasi-criminal motives, and they do not hesitate to act *sua sponte* to protect the system and the public's perception of it.

Perversely, however, in their zeal to advance these goals, the courts are probably undermining them in at least two important ways. First, the prohibition against settling discharge litigation (and the risk that a plaintiff might be forced to incur additional expense including the expense of trial against its will) unquestionably discourages trustees from objecting to discharge, making such actions less "advisable" within the meaning of § 704(a)(6). A trustee who commences such litigation which may be advisable at the outset, but who is unable to settle to mitigate the costs of obeying the command of § 704(a)(6), will almost certainly think twice before grabbing the tiger in the next case. Second, the prohibition against settlement, the imposition of fiduciary duties, and the requirement that the consideration for any settlement must be shared *pro rata*, will continue to discourage many creditors from acting as private attorneys general, contrary to the design of § 727(c)(1)). A court that insists on requiring settling creditor-plaintiffs to share their recovery with the estate essentially requires these plaintiffs to make substantial contributions without affording them administrative priority for the expenses they incurred in bringing about the recovery. *See* 11 U.S.C. § 503(b)(3)(D) (allowing administrative expense priority for creditor's expense incurred in making a substantial contribution only in cases under chapter 9 or 11). The patent unfairness of the result suggests that it does not comport with Congressional design.

These disincentives to the commencement of discharge litigation –the public and court-supervised resolution of disputes about whether the debtor is honest—will probably result in fewer instances of debtor misconduct coming to the court's attention and more undeserving debtors' receiving discharges. It will probably drive such disputes underground, making it more difficult to police creditor abuse. Given the current case law, debtors and creditors might prefer to negotiate in the shadows about what it would take to "induce" the creditor to refrain from

bringing suit, but this creates fertile ground in which abuse and bankruptcy fraud could take root. This is a very unhappy and unintended consequence of the good-intentions expressed in the cases forbidding or severely restricting settlement of discharge litigation.

It is at least plausible that these restrictions on settlement will leave the United States Trustee as the only entity willing to police case-related debtor misconduct using § 727. If so, the cases will either put an unnecessary strain on the resources of that agency, or lead to under-prosecution of discharge litigation.

It seems hollow to suggest that settlements of discharge litigation are more likely to lead to bankruptcy crimes than other settlements.[11] Every settlement to some extent induces one party, or both, to "refrain from acting or forbearing to act in a case under title 11." 18 U.S.C. § 152(a)(6). And, most settlements involving a debtor, including exemption or avoidance settlements, involve "a material amount of property from a debtor" to conclude the deal. Only when the parties strike such deals "knowingly and fraudulently," however, do they subject themselves to criminal process.

Similarly, Rule 9011, 28 U.S.C. § 1927, and professional ethics applicable to federal practitioners provide the court with tools to address many of the concerns that seem to motivate the hostility to settlement of discharge litigation. *Cf. Law v. Siegel*, 134 S. Ct. 1188, 1194-95 (2014) (the availability of Code and rule-based remedies precludes courts from creating equitable remedies to police misconduct). Stated differently, by adopting rules against settling discharge litigation, or dictating the distribution of settlement proceeds, the courts may be altering the balance that Congress struck in §§704(a)(6) and 727(c)(1) when it encouraged and authorized trustees and creditors, respectively, to litigate issues that obviously affect the entire creditor

[11] Courts and panel trustees who have concerns about the criminality of a settlement are obligated to refer the matter to the United States Attorney, at least if either has "reasonable grounds for believing" that a bankruptcy crime has been committed or that an investigation is warranted. *See* 18 U.S.C. § 3057(a).

body. The restrictions on settlement, and imposition of fiduciary duties on ordinarily self-interested creditors, may justly be criticized as unduly interfering with the balance that Congress struck, undermining the very policies that the Congress and the courts properly regard as essential to maintaining respect for, and the integrity of, the bankruptcy system.

It is time to reconsider the impact of decisions curtailing settlement of discharge litigation so that trustees and creditors, subject to appropriate supervision, will again feel free to bring debtor misconduct to the court's attention, but also free to let go of the tiger's tail "if advisable." *Cf.* 11 U.S.C. § 704(a)(6). The full disclosure of settlement agreements and consideration, coupled with the usual standards governing settlements and the opportunity for other stakeholders to intervene before dismissal, should restore the balance that Congress struck by (i) encouraging creditors and trustees to bring suit to deny or revoke discharges in appropriate cases and (ii) empowering courts to impose appropriate *conditions* on dismissal.