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Section 727 Discharge:

Why Debtors Must Be Honest

By Attorney Jeffrey Hsu

Not everyone who files bankruptcy is entitled to a discharge. For those debtors who are dishonest, or inexplicably and willfully destroyed records and documents necessary for review of the debtor's case, a 727 claim may be brought against the debtor by an adversely affected party of interest. This article reviews the different approaches in settling 727 claims in bankruptcy cases. All debtors and bankruptcy practitioners should be familiar with these approaches should a 727 claim be at issue.

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Introduction

Imagine an individual files for chapter 7 protection. This debtor is now entangled in an adversary proceeding via an objection to discharge claim under 11 U.S.C. § 727(a)(3) for intentionally and willfully destroying important records from which the debtor's financial condition might be better ascertained. If the only reason the debtor destroyed the records was to stonewall the trustee and other creditors in determining what constituted property of the estate, this could be a violation pursuant to § 727(a)(3) that would justify a denial of discharge. Assuming the trustee or a creditor of interest filed the 727 claim, should this debtor be entitled to settle the claim for money, for a partial discharge, or otherwise?

When an individual files for chapter 7 bankruptcy protection, that person's main objective is typically to obtain a discharge.[1] However a discharge is not freely granted, and a party of interest, such as a creditor or trustee, may object to a Debtor's general discharge under 11 U.S.C. § 727.[2] Unlike § 523 claims that object to the dischargeability of a particular claim against the debtor, a § 727 claim seeks to deny the debtor a discharge in the bankruptcy case, thus preserving the enforceability of all applicable debts against the debtor post-bankruptcy.

Section 727 claims all share a common thread in that "they all concern fraud or similar misbehavior against creditors."[3] However, whether the parties in interest

[1] *Marrama v. Citizens Bank*, 549 U.S. 365, 376 (U.S. 2007)(stating that the "principle purpose of the Bankruptcy Code is intended to give a 'fresh start' to the 'honest but unfortunate debtor."' citing *Grogan* v. *Garner*, 498 U.S. 279, 286, 287, (1991)).

[2] The appropriate procedure for filing an objection to discharge is through an adversary proceeding pursuant to Bankruptcy Rule 7001(4)).

[3] Thomas H. Jackson, *The Fresh Start Policy in Bankruptcy Law*, 98 Harv. L. Rev. 1393, 1440-41 (citing *Local Loan Co. v. Hunt*, 292 U.S. 234, 244 for the proposition that only an "honest but unfortunate debtor" is entitled to a discharge).

may settle 727 claims is a more unpredictable matter[4] as bankruptcy courts must balance themselves as courts of economics[5] while upholding the fundamental tenets of bankruptcy law, including the principle that only an "honest but unfortunate debtor" is entitled to discharge.[6]

While compromise is the linchpin of bankruptcy practice[7], Bankruptcy Rule 7041 requires that settlement of 727 claims may not be dismissed without proper 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.[8] Against this backdrop, it is understandable that courts have adopted three general approaches in determining the propriety of 727 settlements.[9] Accordingly, practitioners must be well-versed in the various approaches and understand the justification behind each approach in an attempt to settle such claims.

Approach #1 – Settlements are Void as against Public Policy

Some courts have found that it is never appropriate per se to settle 727 actions.[10] These courts believe that discharge is a public policy decision predicated on a whether a debtor has properly acted in compliance with the bankruptcy code.

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[4] Terrence L. Michael & Michael R. Pacewicz, *Settling Objections to Discharge in Bankruptcy Cases: An Unsettling Look at Very Unsettled Law*, 37 Tulsa L. Rev. 637, 644 (2002) ("Not surprisingly, [pursuant to Bankruptcy Rule 7041,] bankruptcy courts have often been asked to approve settlements between debtors and creditors or debtors and the bankruptcy trustee which call for dismissal of an objection to discharge. What is surprising is the range of answers given by the bankruptcy courts").

[5] *Id.* at 643.

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

[7] Terrence L. Michael & Michael R. Pacewicz, *Settling Objections to Discharge in Bankruptcy Cases: An Unsettling Look at Very Unsettled Law*, 37 Tulsa L. Rev. 637, 643 (2002).

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

[9] *In re de Armond,* 240 B.R. 51, 55 (Bankr.C.D.Cal. 1999).

[10] *See e.g. In re Moore,* 50 B.R. 661, 664 (Bankr.E.D.Tenn. 1985); *In re Vickers*, 176 B.R. 287 (Bankr. N.D. Ga.1994) (727 settlements are void as against public policy).

Under this school of thought, a fresh start is only warranted for the honest debtor; it is never a point for negotiation.

Otherwise, the notion of buying or selling a debtor's discharge would be akin to a "disease that would attack the heart of the bankruptcy process, its integrity."[11] The *Levine* court, while sensitive to the notion that half a loaf may be better than no loaf at all, opined that while it would be tempting to allow 727 settlements, it is even more important to deny a discharge to a debtor engaged in fraud rather than allowing such a debtor to strong arm an estate that is unable to prosecute a 727 claim. [12]

The Per Se approach has been attacked on ground that it fails to take into account the basic maxims of bankruptcy that a fresh start and equitable division of assets among creditors. Furthermore, the Per Se Approach assumes every 727 claim has merit, which is not always the case.

Approach #2 – Settlements Allowed Upon Proper Notice To Parties of Interest

The second approach, also called the "trustee approach"[13], recognizes that settlements are feasible after proper notice and an opportunity to assume litigation is given to all parties of interest, including the chapter 7 trustee, United States Trustee, and all creditors to the case. These courts temper the importance of settlements in a bankruptcy context against the public policy interests in preserving the integrity of the bankruptcy system.

[11] Terrence L. Michael & Michael R. Pacewicz, *Settling Objections to Discharge in Bankruptcy Cases: An Unsettling Look at Very Unsettled Law*, 37 Tulsa L. Rev. 637, 646 (2002).
[12] *In re Levine*, 287 B.R. 683, 693 (Bankr. E.D. Mich. 2002).
[13] Mandell Law Firm v. Pizzini (In re Pizzini), 2003 Bankr. LEXIS 1164, pg. 7-8 (Bankr. E.D. Va. Mar. 7, 2003)(" Since the § 727 complaint is for the benefit of all creditors, the plaintiff is, essentially, trustee for the benefit of all the creditors."). *See also* In re Margolin, 135 B.R. 671 (Bankr. D. Col. 1992); *In re Short*, 60 B.R., 951 (Bankr. M.D. La. 1986).

For example, in *Margolin*, the court determined that a bank which filed §§ 523 and 727 claims against the debtor was entitled to settle the 727 claims in part because settlement made more practical sense for the bank. In fact, the court noted that the bank would be better off settling and recovering some funds that being forced into litigating the 727 claims. The court found it unjustifiable to "put counsel in the untenable position of vigorously prosecuting an action that is detrimental to his own client and thus will not force the Bank to further prosecute the § 727 complaint" despite the chapter 7 trustee's objection.[14]

This approach is considered the minority position,[15] and it appears that no other reported cases have since agreed with *Margolin* as a stand-alone approach.[16] One concern over this approach involves whether a settlement is necessararily fair and equitable to the debtor and/or the creditors in the case simply because the trustee approves of the settlement terms and no party has objected.

Approach #3 – Cautious But Pragmatic Method Where A Court Has Final Say

Finally, for the majority of courts, settlement is appropriate for 727 claims where the terms of the settlement are fair and equitable and in the best interest of the estate.[17] There are also a line of cases following the majority position, requiring that the settlement benefit all creditors and not derive a private benefit solely to a

[14] *Id.* at 673 (noting that the trustee was given notice of the settlement and failed to intervene or assume litigation).
[15] *Absolute Fin. Servs. v. Kalantzis (In re Kalantzis)*, 2000 BNH 30 (Bankr. D.N.H. 2000)(citing *Bankruptcy Receivables Mgmt. v. De Armond (In re De Armond)*, 240 B.R. 51, 56 (Bankr. C.D. Cal. 1999).
[16] *In re de Armond,* 240 B.R. at 56; *Independence Bank v. Johnston (In re Johnston)*, 2007 Bankr. LEXIS 1415 (Bankr. W.D. Ky. Apr. 27, 2007)(finding *In re Margolin* "compelling" in comparison to the per se approach while favoring *In re Sheffer*, 350 B.R. 402, 407 (Bankr. W.D. Ky. 2006) which favors the third approach discussed infra).
[17] See, e.g., *In re Mavrode*, 205 B.R. 716 (Bankr. D. N.J. 1997); *In re Speece*, 159 B.R. 314 (Bankr. D. Colo. 1993).

particular creditor.[18] In essence, this third approach subsumes the "trustee approach" by further ensuring the merits of the settlements are just and proper.

For example, in the case of *In re Roqumore*, 393 B.R. 474 (Bankr. S.D. Tex. 2008), the court determined that the decision to approve a compromise lies "within the discretion of the trial judge" even where a trustee approves of the compromise. Ultimately the *Roqumore* court denied the approval of a compromise where a debtor's installment payments to the trustee could not be explained, and where the monetary value of the compromise was minimal, at best. *Id.*

Courts have also found that a discharge denied in a § 727 action may not be annulled via settlement post-*trial. See* Washington 1993, Inc. v. Hudson (In re Hudson), 420 B.R. 73 (Bankr. N.D.N.Y. 2009) (affirmed by Hudson v. Harris, 2011 U.S. Dist. LEXIS 24544 (N.D.N.Y Mar. 10, 2011)). In *Hudson*, the court was sensitive to the concern that allowing settlements post-trial would deter pre-trial settlements and allow a debtor to escape the policies behind the bankruptcy laws put in place. *Id.*

Conclusion

For the uninformed debtor, bankruptcy law can present overwhelming challenges. The issues regarding 727 settlements are no different. The interpretations of certain bankruptcy laws sometimes differ among states, by districts within each state, and sometimes even between judges in the same district.

[18] *See e.g. In re Smith*, 207 B.R. 177, 178 (Bankr. N.D. Ind. 1997); *In re Bates*, 211 B.R. 338, 345 (Bankr. D. Minn. 1997); *In re Traxler*, 277 B.R. 699 (Bankr. E.D. Tex. 2002); *Mandell Law Firm v. Pizzini (In re Pizzini),* 2003 Bankr. LEXIS 1164 (Bankr. E.D. Va. Mar. 7, 2003)

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The lessons for someone contemplating bankruptcy are clear: (1) keep and maintain all documents and records that may be relevant to your bankruptcy before, during, and after the bankruptcy filing; (2) be honest and completely truthful with your bankruptcy attorney at all times; and (3) be upfront and candid with all major players in the bankruptcy system including the case trustee, the bankruptcy judge, and the United States Trustee's Office.

The current case law shows a trend towards the 3rd approach, and court opinions in recent cases demonstrate the importance of the settlement provisions. Courts are concerned with the economics of the case and preservation of judicial resources. Settlements will not be approved unless it is financially sound for all involved and payouts are feasible, not imagined.

Understand that the practice of bankruptcy law is not entirely academic. Bankruptcy law is not practiced in vacuum – rather the economic impact of decisions, particularly with respect to 727 actions is an ever-present underlying factor. Courts, attorneys, trustees, and debtors must all balance the importance of a debtor's fresh start versus the equitable division of estate assets to all creditors. That is the true essence of bankruptcy law.