

By MICHAEL J. CONNOLLY

## Discharging Duties

### Public Policy Perils of a Trustee Leveraging a § 727 Claim for Financial Gain

A chapter 7 trustee has two types of obligations.<sup>1</sup> First, a trustee has “fiduciary duties” to the parties in a case. As a fiduciary, a trustee must “collect and conserve the assets of the estate and ... maximize distribution to the creditors.”<sup>2</sup> Second, a trustee has an “institutional obligation” to protect the integrity of the bankruptcy process.<sup>3</sup> As a guardian of the bankruptcy process, a trustee, among other things, “shall, if advisable, oppose the discharge of the debtor.”<sup>4</sup>

At times, these two duties seem to clash. For example, is it appropriate for a trustee to threaten a debtor with a denial-of-discharge action simply to extract payments to increase the size of the estate?

### Relief of Biblical Proportions: The § 524 Discharge

The U.S. Supreme Court states that bankruptcy laws exist to provide “the honest but unfortunate debtor” with “a new opportunity in life and a clear field for future effort, unhampered by the pressure and discouragement of pre-existing debt.”<sup>5</sup> The mechanism to provide this “fresh start” is a discharge pursuant to § 524.<sup>6</sup> As several courts have observed, the Bankruptcy Code “offers to debtors what may well be the most extensive ‘fresh start’ since the seven year release described in the Old Testament.”<sup>7</sup> Indeed, the bankruptcy discharge is the *sine qua non* form of relief sought by individuals in chapter 7 cases.

### Denying a Discharge

Section 727 ensures that debtors seeking a discharge engage in the bankruptcy process honestly

and fairly. It also provides that a debtor could be denied a discharge for various grounds that constitute an affront to the integrity of the process. Among other things, a debtor could be denied a discharge for concealing or fraudulently transferring property, concealing or failing to maintain recorded information, making a false oath in connection with the case, failing to explain the loss of assets, and refusing orders of the court.<sup>8</sup> Thus, “[d]ischarge is refused to a dishonest bankrupt as a punishment for his fraud and to prevent its continuance in the future.”<sup>9</sup>

### Interplay of Remedies and Duties

There are many times when misconduct gives a trustee two separate remedies. For example, if a debtor transfers property with the intent to hinder, delay or defraud within the year before the bankruptcy filing, a trustee has at least two options.

First, a trustee can institute an avoidance action to recover the property.<sup>10</sup> Pursuing this remedy is consistent with a trustee’s fiduciary obligations to creditors to maximize the size and value of the estate.

Second, the trustee can institute an adversary proceeding to deny the debtor a discharge under § 727(a)(2).<sup>11</sup> Proceeding with this remedy satisfies the trustee’s institutional obligations to protect the sanctity of the bankruptcy process and bring a § 727 action when it is advisable to do so.

There are some types of debtor misconduct that might give rise to a denial-of-discharge claim, but not also give rise to an avoidance claim. For example, if a debtor unjustifiably destroyed records from which his business transactions might be ascertained, such conduct might give rise to a denial-of-discharge claim under § 727(a)(3). However, if the debtor’s destruction of records keeps the trustee from identifying avoidable transfers, there might not be a viable remedy to bring money into the estate due to the debtor’s misconduct. Similarly, if the debtor’s estate is otherwise devoid of assets, the trustee will not have money in the estate to fund the expenses of bringing a § 727 action. In some jurisdictions, the U.S. Trustee’s Office will bring § 727 actions in these instances.

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1 See Hon. Steven Rhodes, “The Fiduciary and Institutional Obligations of a Chapter 7 Bankruptcy Trustee,” 80 *Am. Bankr. L.J.* 147 (Spring 2016).

2 *In re Moon*, 258 B.R. 828, 832 (Bankr. N.D. Fla. 2001). See also *In re Luongo*, 259 F.3d 323, 340 n.3 (5th Cir. 2001) (“The trustee’s duty is to maximize the estate for the purposes of distribution to the creditors.”); *United States v. Sims (In re Feiler)*, 218 F.3d 948, 952 (9th Cir. 2000) (“[T]he trustee’s duty is to maximize the assets of the bankruptcy estate to allow maximum recovery for the debtor’s creditors.”); *McCuskey v. Central Trailer Servs. Ltd.*, 37 F.3d 1329, 1331 (8th Cir. 1994) (trustee “has the duty to pursue all actions to maximize the estate for liquidation and distribution to all creditors.”); *In re Rigden*, 795 F.2d 727, 730 (9th Cir. 1986) (“The trustee also has a fiduciary obligation to conserve the assets of the estate and to maximize distribution to creditors.”); *In re Farmer*, 786 F.2d 618, 621 (4th Cir. 1986) (“The trustee acts for all the creditors so as to maximize the distribution from the estate.”); *In re Dow Corning Corp.*, 255 B.R. 445, 523 (E.D. Mich. 2000) (“A Chapter 7 trustee’s fiduciary duty goes to both the creditors and the debtor in order to maximize the value of the estate.”).

3 Rhodes, *supra* n.1 at 202-16.

4 11 U.S.C. § 704(a)(6).

5 *Local Loan Co. v. Hunt*, 292 U.S. 234 (1934).

6 11 U.S.C. § 524(a).

7 *In re Cohen*, 47 B.R. 871, 873 (Bankr. S.D.N.Y. 1985) (citing Deuteronomy 15:1 and 2).

8 11 U.S.C. § 727(a)(1)-(12).

9 *In re Moore*, 50 B.R. 661, 664 (Bankr. E.D. Tenn. 1985).

10 See, e.g., 11 U.S.C. § 548.

11 11 U.S.C. § 727(a)(2).

## The Trustee's Quandary

Is it ever appropriate for a trustee to threaten a § 727 action solely to bring money into the estate? Consider a situation where a debtor has unjustifiably kept insufficient records for a trustee to understand the debtor's business affairs in a "no-asset" chapter 7 case. Should a trustee threaten a § 727 suit simply to coerce a payment from the debtor?

## Different Positions in the Case Law

There are numerous decisions that allow the § 727 actions to be settled, subject to various requirements. In addition to the standard requirements for settlement approval under Rule 9019,<sup>12</sup> courts certainly demand compliance with Rule 7041, which provides, in pertinent part, that "a complaint objecting to a debtor's discharge shall not be dismissed at the plaintiff's insistence 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."<sup>13</sup>

The *In re McKissack* court outlined various considerations regarding the settlement of a § 727 action. The court first acknowledged that settlements involving payment solely to a plaintiff creditor "are highly disfavored and unlikely to be approved" because they fail to account for the interests of the estate and other creditors, as well as "create the appearance that a bankruptcy discharge is a commodity that is up for sale."<sup>14</sup> In addition, the court also noted that the following factors should be considered, among others: (1) the egregiousness of the debtor's alleged conduct and the strength of the evidence against the debtor (noting that dismissal will less likely be approved in the face of strong evidence of particularly bad misconduct); (2) the objections of other parties in interest; (3) whether another qualified party seeks to take over the litigation; and (4) the degree to which the U.S. Trustee and trustee have been involved in negotiations.<sup>15</sup>

However, there are also numerous cases, under the former Bankruptcy Act and the Bankruptcy Code, that prevent the dismissal of a § 727 action in exchange for a settlement payment. One rationale for this position was expressed by the Third Circuit in a 1942 case as follows:

Persons with undesirable business ethics are not to be turned loose to prey on their fellow merchants. This general protection cannot be waived by particular creditors whose private greed outruns their community spirit.<sup>16</sup>

Similarly, the court in *In re Vickers*<sup>17</sup> ruled:

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 or to release a nondebtor entity 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. The conduct described in these hypothetical situations may be criminal bankruptcy fraud. By contrast, what appears to be happening here is that the trustee is seeking to settle two different types of claims that may be related by facts but not by the type of relief available to the estate. Public policy forbids him to offer to settle one in order to settle the other.<sup>18</sup>

The court in *In re Levine* was even more emphatic, holding that a chapter 7 trustee has no authority to settle objections to discharge in exchange for consideration.<sup>19</sup> The court found such actions to be *ultra vires* and a breach of the trustee's obligations to the bankruptcy process.<sup>20</sup> Moreover, the court in *In re Kallstrom* went so far as to suggest that the exchange of a payment for dismissal of a § 727 complaint could be a criminal offense.<sup>21</sup>

## Suggested Approaches

Perhaps the easiest way for a trustee to fulfill his/her fiduciary duties and institutional duties with regard to § 727 actions is to simply avoid practices that would lead him/her to be accused of "selling a discharge." In that regard, the following course of conduct seems appropriate.

### A Trustee Should Never Threaten Filing a § 727 Action in Exchange for a Payment to the Estate

While it is prudent and economical to demand the return of the asset prior to filing a formal turnover proceeding, a trustee should not threaten the debtor with a § 727 action during that process. Instead, the trustee should negotiate and litigate the turnover action on its own merit. In that way, the trustee cannot be accused of extorting payment for the debtor to receive a discharge.

### A Trustee Should Never Agree to Waive a § 727 Action in Connection with a Turnover Settlement

A settlement of a turnover action should be just that: resolution of a claim to recover estate assets. Including a promise to waive a potential § 727 claim creates the perception of improper leveraging.

18 See also *State Bank of India v. Chalasani (In re Chalasani)*, 92 F.3d 1300, 1310 (2d Cir. 1996) (discharge "is not the proper subject for negotiation and the exchange of a *quid pro quo*"); *In re Moore*, 50 B.R. 661 (Bankr. E.D. Tenn. 1985) ("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."); *Pennwell Printing Co. v. Stout (In re Stout)*, 262 B.R. 862, 864 (Bankr. D. Colo. 2001) ("[I]t is simply improper for a debtor and creditor to horse-trade over a discharge."); *In re Wilson*, 196 B.R. 777, 779 (Bankr. N.D. Ohio 1996); *Russo v. Nicolosi (In re Nicolosi)*, 86 B.R. 882, 888 (Bankr. W.D. La. 1988); *In re Levine*, 287 B.R. 683, 693 (Bankr. E.D. Mich. 2002) (once a party has filed complaint objecting to discharge, it has only two options: objecting party can either (1) participate in process by prosecuting its objection to judgment (*i.e.*, order barring entry of debtor's discharge); or (2) withdraw from process by seeking dismissal of its complaint).

19 *In re Levine*, 287 B.R. at 701.

20 *Id.*

21 *In re Kallstrom*, 298 B.R. 753, 759 (B.A.P. 10th Cir. 2003) (citing 18 U.S.C. § 152(5) and (6)).

12 Fed. R. Bankr. P. 9019.

13 Fed. R. Bankr. P. 7041.

14 *In re McKissack*, 320 B.R. 703, 722 (D. Colo. 2005).

15 *Id.* at 723-24.

16 *In re Levy*, 127 F.2d 62 (3d Cir. 1942).

17 *In re Vickers*, 176 B.R. 287 (Bankr. N.D. Ga. 1994).

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## **Trustee Talk: Public Policy Perils of a Trustee Leveraging a § 727 Claim**

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### **Actions to Recover Concealed or Transferred Property Should Be Instituted Prior to § 727 Action and, if Possible, Resolved Before Commencement of a § 727 Action**

A trustee should file turnover actions as promptly as possible. The trustee's pleadings can alert the U.S. Trustee, the court and other parties in interest to the trustee's belief that an asset was transferred or concealed with an intent to hinder, delay or defraud. This will alert other parties to possible § 727 claims. In some jurisdictions, the U.S. Trustee's Office will institute a § 727 action, leaving the case trustee to pursue the related avoidance claim. This division of labor helps to eliminate the appearance that the case trustee is simply leveraging the § 727 claim in order to gain an advantage in the turnover litigation.

### **A Trustee Should Advise Parties of His/Her Decisions Regarding § 727 Claims**

Sometimes, a trustee might believe a § 727 claim exists, but remain unsure as to whether it is "advisable" to bring

the claim. In such circumstances, the trustee might wish to file a motion to extend the time to object to discharge and alert the parties in the case as to the trustee's findings and thought process. Similarly, a trustee should respond to all inquiries and communications regarding the possibility of § 727 claims. Further, if a trustee elects not to bring a § 727 action where one could arguably exist, the trustee should advise the U.S. Trustee and other key creditors of the reasons for his/her conclusion.

### **If a Trustee Institutes a § 727 Action and Elects to Settle or Dismiss the Matter, the Trustee Should Provide Full Disclosure to All Parties**

Among other things, the trustee should advise parties in detail as to why he/she is terminating the litigation, demonstrate how doing so advances the interest of the estate, and afford others who could have an interest in continuing the § 727 action full access to the trustee's evidence and information about the claim. **abi**

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