

## ARTICLES

### SETTLING OBJECTIONS TO DISCHARGE IN BANKRUPTCY CASES: AN UNSETTLING LOOK AT VERY UNSETTLED LAW

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#### I. INTRODUCTION<sup>1</sup>

Much has been said and written about the increase in the number of bankruptcy filings in the past decade. Since 1996, over one million bankruptcy cases have been filed each year—the vast majority of which are individual (non-business) cases.<sup>2</sup> Of those non-business cases, approximately seventy percent were Chapter 7, or straight liquidation cases.<sup>3</sup> One of the principal motivations for an individual filing a Chapter 7 bankruptcy case is to obtain a discharge.

The path to a discharge is not always smooth. Creditors and the trustee in the bankruptcy case have the right to review the debtor's conduct and contest the debtor's right to a discharge. These actions are brought as adversary proceedings, in essence separate lawsuits under the umbrella of the bankruptcy case, under § 523 or § 727 of the Bankruptcy Code.<sup>4</sup> Under § 523, a party may seek to have one or more particular

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2. *Judicial Facts and Figures*, Table 5-2 <<http://156.119.80.10/library/judfact/tables5-2htm>> (accessed Dec. 18, 2001).

3. *See id.*; *Judicial Business of the U.S. Courts 2000* 29 (Admin. Office of the U.S. Courts 2001).

4. Unless otherwise noted, all statutory references are to the United States Bankruptcy Code, 11 U.S.C.A. § 101 *et seq.* (West 2001).

debts declared non-dischargeable. This type of action deals only with the debts owed to the creditor filing the action, and has no effect upon the discharge of debts that are not the subject of the action. On the other hand, an action brought under § 727, if successful, results in a complete denial of the debtor's discharge. In that case, the debtor remains personally liable for all debts existing when the case was filed.

Litigation relating to the bankruptcy discharge shares several traits with other types of litigation. It is the subject of discovery, pre-trial practice, and trial. It is also often the subject of negotiation and settlement. The issues of whether, how, when, and on what terms these actions may be settled have been the topic of much litigation. As one might expect, court decisions vary both in result and reasoning. This Article will briefly explore the nature of the bankruptcy discharge, the various bases for objection both to the dischargeability of a particular debt and the denial of the discharge as a whole, and then take a detailed look at the differing positions taken by the courts with respect to settlement of such actions.

## II. THE BANKRUPTCY DISCHARGE

The concept of bankruptcy as a mechanism for the protection of debtors is a relatively recent phenomenon, originating in this country with the passage of the Bankruptcy Act of 1898.<sup>5</sup> The English bankruptcy laws that foreshadowed the American bankruptcy system were intended primarily to assist creditors in recovering payment from delinquent debtors.<sup>6</sup> Prior to 1898, early United States bankruptcy legislation strongly favored creditors. For example, under the Bankruptcy Act of 1800, the approval of the bankruptcy commissioners and the creditors was a prerequisite to the granting of a discharge.<sup>7</sup> Furthermore, creditors were not automatically enjoined from attempting to collect on debts that had been discharged. Instead, the debtor had to raise the discharge as an affirmative defense in the event a creditor initiated collection proceedings.<sup>8</sup>

In *Local Loan Co. v. Hunt*,<sup>9</sup> the United States Supreme Court coined the oft-cited phrase that bankruptcy laws exist to provide "the honest but

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5. As Professor Tabb noted:

[T]he 1898 law recognized formally for the first time the overriding public interest in granting a discharge to 'honest but unfortunate' debtors. The theory is that society as a whole benefits when an overburdened debtor is freed from the oppressive weight of accumulated debt. That debtor then is able to resume his or her place as a productive member of society. Furthermore, societal forgiveness of the debts of the honest unfortunate is considered to be humane.

Charles Jordan Tabb, *The Historical Evolution of the Bankruptcy Discharge*, 65 *Amer. Bankr. L.J.* 325, 364-65 (1991) (footnotes omitted).

6. *See id.* at 326-37.

7. *See id.* at 346.

8. *See id.* at 347.

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

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."<sup>10</sup> The legal tool used to "clear the field" for the bankruptcy debtor is the order of discharge. This discharge, as outlined in § 524(a) of the Bankruptcy Code, operates as an injunction against all efforts to recover debts owed prior to the filing of the bankruptcy case as a personal liability of the debtor.<sup>11</sup> Commentators have noted that the United States has one of the most liberal discharge provisions in the world today.<sup>12</sup>

The benefit of a discharge is not without its burdens. Debtors are required to file a list of all assets and liabilities, under penalty of perjury.<sup>13</sup> Debtors are required to appear at a meeting of creditors and testify under oath as to their financial affairs.<sup>14</sup> 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. Failure to perform these duties creates the prospect that the debtor's discharge may be denied.

### III. GROUNDS FOR DENIAL OF DISCHARGE

The grounds for denial of a discharge are contained in § 727(a).<sup>15</sup>

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10. *Id.* at 244 (citations omitted).

11. 11 U.S.C. § 524(a) of the Bankruptcy Code states that:

(a) A discharge in a case under this title—

(1) voids any judgment at any time obtained, to the extent that such judgment is a determination of the personal liability of the debtor with respect to any debt discharged under section 727, 944, 1141, 1228, or 1328 of this title, whether or not discharge of such debt is waived;

(2) operates as an injunction against the commencement or continuation of an action, the employment of process, or an act, to collect, recover or offset any such debt as a personal liability of the debtor, whether or not discharge of such debt is waived; and

(3) operates as an injunction against the commencement or continuation of an action, the employment of process, or an act, to collect or recover from, or offset against, property of the debtor of the kind specified in section 541(a)(2) of this title that is acquired after the commencement of the case, on account of any allowable community claim, except a community claim that is excepted from discharge under section 523, 1228(a)(1), or 1328(a)(1) of this title, or that would be so excepted, determined in accordance with the provisions of sections 523(c) and 523(d) of this title, in a case concerning the debtor's spouse commenced on the date of the filing of the petition in the case concerning the debtor, whether or not discharge of the debt based on such community claim is waived.

11 U.S.C.A. § 524(a) (West 2001).

12. See e.g. Rafael Erfat, *The Fresh-Start Policy in Bankruptcy in Modern Day Israel*, 7 *Am. Bankr. Inst. L. Rev.* 555 (1999); Tabb, *supra* n. 5; John C. McCoid, *Discharge: The Most Important Development in Bankruptcy History*, 70 *Amer. Bankr. L.J.* 163 (1996).

13. See Fed. R. Bankr. P. 1007(b) (West 2001).

14. See 11 U.S.C.A. § 343 (West 2001).

15. 11 U.S.C. § 727(a) reads as follows:

Several of these grounds relate to the conduct of the debtor during the bankruptcy case; *i.e.*, has the debtor behaved as one would expect an

§ 727. Discharge

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

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"honest but unfortunate debtor" to behave? Discharges are denied where a debtor has acted fraudulently in submitting financial information to the trustee or the court,<sup>16</sup> concealed assets with the goal of keeping them free of the claims of creditors,<sup>17</sup> or failed to cooperate with the trustee in the administration of the case.<sup>18</sup> Performance of each of these duties is essential to the integrity and proper functioning of the bankruptcy system. In the case of *In re Moore*,<sup>19</sup> Judge Clive Bare stated it thusly:

Discharge, the principal objective of a chapter 7 debtor, is a statutory right involving public policy considerations. It is not a proper subject for contractual negotiation. Discharge is refused to a dishonest bankrupt as a punishment for his fraud and to prevent its continuance in the future. In a sense the question has passed beyond the creditors and is one of public policy . . . .<sup>20</sup>

Under this analysis, which has been phrased in other ways by other courts,<sup>21</sup> creditors who decide to file objections to discharge assume duties to the other creditors, and to the bankruptcy system as a whole.

#### IV. COMPLAINTS TO DETERMINE THE DISCHARGEABILITY OF PARTICULAR DEBTS

Actions to determine the dischargeability of a particular debt, under § 523, concern conduct between the debtor and a particular creditor, rather than the conduct of the debtor during the administration of the bankruptcy case.<sup>22</sup> If a creditor prevails on its complaint to determine

16. 11 U.S.C.A. § 727(a)(4)(A) (West 2001).

17. 11 U.S.C.A. § 727(a)(2) (West 2001).

18. 11 U.S.C.A. § 727(a)(4)(D) (West 2001).

19. 50 B.R. 661, 664 (Bankr. E.D. Tenn. 1985).

20. *Id.* (citations and quotations omitted).

21. See e.g. *In re Hiller*, 179 B.R. 253, 261 (Bankr. D. Colo. 1994) ("§ 727 is the gatekeeper for allowing only honest debtors the extraordinary relief afforded by the Bankruptcy Code. It is a guardian of the bankruptcy system; it proscribes dishonest, deceptive, and disingenuous debtor conduct that is part of or related to the bankruptcy system; it upholds the integrity and stature of the bankruptcy process.").

22. The relevant portions of 11 U.S.C. § 523 provides that:

(a) A discharge under section 727, 1141, 1228(a), 1228(b), or 1328(b) of this title does not discharge an individual debtor from any debt—

(1) for a tax or a customs duty—

(A) of the kind and for the periods specified in section 507(a)(2) or 507(a)(8) of this title, whether or not a claim for such tax was filed or allowed;

(B) with respect to which a return, if required—

(i) was not filed; or

(ii) was filed after the date on which such return was last due, under applicable law or under any extension, and after two years before the date of the filing of the petition; or

(C) with respect to which the debtor made a fraudulent return or willfully attempted in any manner to evade or defeat such tax;

(2) for money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained by—

(A) false pretenses, a false representation, or actual fraud, other than a statement respecting the debtor's or an insider's financial condition;

dischargeability, only the particular debt at issue is not discharged. The debtor receives a discharge of all other debts. As such, dischargeability complaints are treated as private causes of action. Although some courts have indicated that court approval of settlements of § 523 complaints is required,<sup>23</sup> there is very little authority on the issue. It appears that most courts allow parties to settle dischargeability complaints on their own terms so long as the complaints do not also contain allegations that the debtor's discharge should (or in the alternative) be denied in its entirety under § 727.<sup>24</sup>

(B) use of a statement in writing—

- (i) that is materially false;
- (ii) respecting the debtor's or an insider's financial condition;
- (iii) on which the creditor to whom the debtor is liable for such money, property, services, or credit reasonably relied; and
- (iv) that the debtor caused to be made or published with intent to deceive; or

(C) for purposes of subparagraph (A) of this paragraph, consumer debts owed to a single creditor and aggregating more than \$1,000 for "luxury goods or services" incurred by an individual debtor on or within 60 days before the order for relief under this title, or cash advances aggregating more than \$1,000 that are extensions of consumer credit under an open end credit plan obtained by an individual debtor on or within 60 days before the order for relief under this title, are presumed to be nondischargeable; "luxury goods or services" do not include goods or services reasonably acquired for the support or maintenance of the debtor or a dependent of the debtor; an extension of consumer credit under an open end credit plan is to be defined for purposes of this subparagraph as it is defined in the Consumer Credit Protection Act;

...

(4) for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny;

...

(6) for willful and malicious injury by the debtor to another entity or to the property of another entity;

...

(15) not of the kind described in paragraph (5) that is incurred by the debtor in the course of a divorce or separation or in connection with a separation agreement, divorce decree or other order of a court of record, a determination made in accordance with State or territorial law by a governmental unit unless—

(A) the debtor does not have the ability to pay such debt from income or property of the debtor not reasonably necessary to be expended for the maintenance or support of the debtor or a dependent of the debtor and, if the debtor is engaged in a business, for the payment of expenditures necessary for the continuation, preservation, and operation of such business; or

(B) discharging such debt would result in a benefit to the debtor that outweighs the detrimental consequences to a spouse, former spouse, or child of the debtor;

11 U.S.C.A. § 523 (West 2001).

23. See *e.g.* Loc. R. 7090-1 (Bankr. N.D.N.Y.) (requiring court approval of a compromise of an action brought under § 523); Loc. R. 4007-2(a) (Bankr. S.D.N.Y.) (same).

24. See *e.g.* Loc. R. 9019(a)(3) (Bankr. W.D. Tex.) ("No application to compromise an adversary proceeding need be filed in order to settle a nondischargeability action filed pursuant to Section 523.").