UNITED STATES BANKRUPTCY COURT
DISTRICT OF NEW HAMPSHIRE

In re: Bk. No. 99-12517-JMD
Chapter 7

Charles Kalantzis,
Debtor

Absolute Financial Services, LP,
Plaintiff

v. Adv. No. 99-1173-JMD

Charles Kalantzis,
Defendant

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MEMORANDUM OPINION

I. BACKGROUND

Although this matter raises controversial legal issues, its factual underpinnings are straightforward and not in dispute. On November 12, 1999, Absolute Financial Services, LP (the "Plaintiff") filed a complaint objecting to a discharge being entered in the Chapter 7 case initiated by Charles Kalantzis (the "Debtor"). The Plaintiff, a creditor in the above-captioned bankruptcy case, later amended its complaint for clarification reasons. In its amended complaint, the Plaintiff argues that the Debtor should be denied a discharge for having violated the following Bankruptcy Code sections: (1) 11

U.S.C. § 727(a)(2)(A);[1] (2) § 727(a)(3); (3) § 727(a)(4); and (4) § 727(a)(5). Because all of the Plaintiff's grounds originate in § 727(a), they all allege certain fraudulent acts by the Debtor in connection with his bankruptcy case. On June 8, 2000, a trial was held concerning the Plaintiff's complaint, at which time considerable testimonial evidence was presented. During a break in the trial, the parties reached a settlement agreement (the "Settlement"), which was filed with this Court in the form of a motion to approve settlement on June 16, 2000 (the "Motion"). The terms of the Settlement are simple: in exchange for the Plaintiff agreeing to terminate its adversary proceeding, the Debtor agrees to pay the Plaintiff $5,000 and release any claim he may have to $1,500 being held by the Chapter 7 Trustee.

Pursuant to Fed. R. Bankr. P. 7041, the parties served a copy of the Motion on the United States Trustee (the "UST") and all creditors.[2] In response to such, the UST, Kristen Bowman ("Bowman"), and Katherine Porter ("Porter") filed objections to the Motion. Bowman and Porter (collectively, the "Creditors") are creditors in the Debtor's bankruptcy case. The UST and the Creditors based their objections on similar grounds. Both argue that, pursuant to existing case law, a § 727 objection to discharge cannot be settled when the settlement proceeds inure to the exclusive benefit of a creditor. Moreover, counsel for the UST indicated that she may be willing to step into the shoes of the Plaintiff for the purpose of further pursuing its § 727 complaint.

As the above-stated facts indicate, the issue before the Court is straightforward: under what circumstances, if any, may a § 727 objection to discharge action be settled? Although facially simple, this question is not easily answered. The courts are in disagreement as to the proper resolution of the issue. Accordingly, this Court must decide which legal standard it will follow and how such a standard resolves the instant controversy.

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[1] Unless otherwise noted, all section references hereinafter are to Title 11 of the United States Code.

[2] Fed. R. Bankr. P. 7041 provides that a complaint objecting to a debtor's discharge shall not be dismissed absent "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.

The Court has jurisdiction of the subject matter and the parties pursuant to 28 U.S.C. §§ 1334 and 157(a) and the "Standing Order of Referral of Title 11 Proceedings to the United States Bankruptcy Court for the District of New Hampshire," dated January 18, 1994 (DiClerico, C.J.). This is a core proceeding in accordance with 28 U.S.C. § 157(b).

II. DISCUSSION

As noted above, controversy exists regarding whether § 727 objections to discharge may be settled and under what circumstances. There are currently three views on the matter: (1) a per se ban against settlement of § 727 actions; (2) the allowance of settlement so long as the United States Trustee and other creditors are given the opportunity to be substituted as plaintiffs; and (3) the allowance of settlement so long as it is fair and equitable and in the best interests of the bankruptcy estate.

A. A Per Se Ban Against Settlement

Some courts hold that a § 727 action can never be settled as a matter of law. See In re Levy, 127 F.2d 62, 63 (3rd Cir. 1942); Moister v. Vickers (In re Vickers), 176 B.R. 287, 290 (Bankr. N.D. Ga. 1994); In re Moore, 50 B.R. 661, 664 (Bankr. E.D. Tenn. 1985). The rationale behind such a strict view is that settling § 727 actions is against public policy since such actions are not "a proper subject for contractual negotiation." Moore, 50 B.R. at 664 (citing Levy, 127 F.2d at 62). In other words, courts following this view reason that allowing § 727 actions to be settled may pave the way for dishonest debtors to effectively "buy" a discharge, notwithstanding the fundamental bankruptcy policy that discharge be limited to the honest but unfortunate debtor. See In re Bates, 211 B.R. 338, 345 (Bankr. D. Minn. 1997). Other courts, however, take a more flexible approach.

B. Settlement Allowed Upon Notice and Opportunity for Substitution

At least one court has allowed the settlement of a § 727 action upon satisfaction of the following two requirements: (1) notice of the settlement being served on all parties in interest; and (2) allowing other creditors and/or the trustee to intervene or be substituted as the plaintiff in the § 727 action. See In re Margolin, 135 B.R. 671, 673 (Bankr. D. Colo. 1992). This approach appears to be a minority position. See Bankruptcy Receivables Mgmt. v. De Armond (In re De Armond), 240 B.R. 51, 56 (Bankr. C.D. Cal. 1999). The majority of courts follows a different standard.

C. The Majority Approach

The majority approach with respect to the instant issue allows the settlement of § 727 actions so long as the terms of the settlement are fair and equitable and in the best interests of the estate. See De Armond, 240 B.R. at 56 (stating that this is the majority approach); Bates, 211 B.R. at 343; Tindall v. Mavrode (In re Mavrode), 205 B.R. 716, 719-20 (Bankr. D.N.J. 1997). Although the standard is phrased broadly, the majority approach is quite strict. The majority approach puts great stock in the view that a creditor who initiates a § 727 action does so as a fiduciary with respect to the bankruptcy estate. It is generally agreed that once a party initiates a § 727 action, the party becomes, in effect, a fiduciary on behalf of all creditors. See State Bank v. Chalasani (In re Chalasani), 92 F.3d 1300, 1310-11 (2nd Cir. 1996); De Armond, 240 B.R. at 57; In re Bates, 211 B.R. 338, 343 (Bankr. D. Minn. 1997) ("A private creditor who commences a § 727 proceeding on behalf of the estate assumes a duty to act in the best interests of the general creditor body."). This conclusion flows from the fact that a successful § 727 action results in a benefit to all creditors. Once a creditor dons a fiduciary hat, significant duties attach. Even where a creditor pursues a § 523 claim and a § 727 claim in the same complaint, it is wearing two hats: a fiduciary hat for the § 727 claim and an individual hat for the § 523 claim. See De Armond, 240 B.R. at 57.

In Meinhard v. Salmon, 249 N.Y. 458 (1928), the seminal fiduciary duty case, Chief Judge Cardozo explained:

> Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A [fiduciary] is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the 'disintegrating erosion' of particular exceptions. Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd.

Meinhard, 249 N.Y. at 464. A fiduciary relationship is not one to be taken lightly.

Many courts following the majority approach conclude that a § 727 settlement agreement between a debtor and creditor is not in the best interests of the estate, and therefore cannot be approved, when it results in the creditor receiving benefits solely for itself. See De Armond, 240 B.R. at 58 ("The settlement of such a claim belongs to all creditors."); Bank One v. Smith (In re Smith), 207 B.R. 177, 178 (Bankr. N.D. Ind. 1997) ("[A creditor may not settle a § 727 action] on terms which will allow it to receive a private benefit solely for itself."); Bates, 211 B.R. at 346 ("This Court holds that it is per se inappropriate to approve a proposed settlement of a § 727 proceeding where the consideration offered in exchange for the dismissal of the plaintiff's complaint will inure for the benefit of a private creditor rather than for the benefit of the bankruptcy estate as a whole"); Mavrode, 205 B.R. at 721. This view is frequently presented as a corollary to the majority approach, and is followed by many courts within the majority camp.

D. Adoption of the Fair and Equitable Standard and its Application to the Instant Case

This Court finds a per se ban against settlement of a § 727 action too extreme. Although allowing such a settlement may enable a dishonest debtor to "buy" a discharge, certain procedural and substantive safeguards may be used to minimize such a danger. The law favors compromise. See Lindquist v. First Northtown Nat'l Bank (In re Lakeland Dev. Corp.), 48 B.R. 85, 90 (Bankr. D. Minn. 1985). From a systemic perspective, compromise is preferable to controversy. Accordingly, if a standard may be established so that compromise is possible while the danger of allowing a dishonest debtor to "buy" a discharge is minimized, it should be preferred to a standard that only generates controversy.

This Court finds the majority approach persuasive insofar that it holds that a § 727 settlement must be fair and equitable and in the best interests of the bankruptcy estate before it may be approved. Moreover, the Court agrees with the majority view that a creditor who picks up the § 727 torch does so for the benefit of all creditors and the bankruptcy estate. A fiduciary relationship is created, thus imposing fiduciary duties on the plaintiff-creditor for the benefit of all other creditors and the bankruptcy estate generally. Although this view is often articulated in the case law, it is not an invention of the judiciary; it has roots in the Federal Rules of Bankruptcy Procedure. The Advisory Committee Note to Fed. R. Bankr. P. 7041, the rule governing dismissal of adversary proceedings, expresses a concern that allowing a creditor to dismiss a § 727 complaint in exchange for consideration that solely benefits itself may create a prohibited conflict. See Fed. R. Bankr. P. 7041 Advisory Committee Note.[3] Accordingly, a § 727 settlement should be viewed with suspicion when the consideration for the settlement goes only to the plaintiff-creditor and does not benefit the estate generally. Such a settlement carries a presumption of not being in the best interests of the estate and therefore a presumption against approval. However, there may be instances when a § 727 settlement may be fair and equitable and in the best interests of the estate despite the fact that there exists a private benefit flowing to the settling-creditor.[4] See Mavrode, 205 B.R. at 720-22 (approving a § 727 settlement even though the benefits went only to the plaintiff-creditor when the funds were not estate

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[3] The Advisory Committee Note to Fed. R. Bankr. P. 7041 provides:

> 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.

Fed. R. Bankr. P. 7041 Advisory Committee Note.

[4] The Court notes, however, that such a "private benefit" does not necessarily include a plaintiff-creditor in a § 727 action recovering reasonable attorneys' fees and costs incurred in pursuing the § 727 complaint. Accordingly, a § 727 settlement could potentially pass muster notwithstanding the fact that the plaintiff-creditor receives reimbursement of its reasonable attorneys' fees and costs. Otherwise, a disincentive would be created regarding the initiation of § 727 actions.

property and no other party, including the trustee, requested to be substituted as the plaintiff). The Court specifically observes, however, that it is not speculating as to the form of such circumstances since settlements may reflect an almost infinite variety of facts and circumstances.

The Court notes its view that a portion of the Margolin standard is inherent in the majority position. More specifically, the Court finds merit in Margolin's position that the United States Trustee or other creditors be given the opportunity to be substituted as the plaintiff in the underlying § 727 action. Such an opportunity guards against the danger that a dishonest debtor may be able to "buy" a discharge by settling a § 727 action. In fact, the Court views the allowance of substitution as implicit in the majority's fair and equitable standard. In other words, the Court holds that to be fair and equitable, a motion to approve settlement or the terms of the § 727 settlement itself must at least give the United States Trustee and other creditors the opportunity to be substituted as plaintiffs in the underlying action.

The Court limits its adoption of the majority approach to holding that, to be approved, a § 727 settlement must be fair and equitable and in the best interests of the estate, and to be fair and equitable it must at least give the United States Trustee and other creditors the opportunity to be substituted as plaintiffs in the underlying action. It does not accept the proposition that a § 727 settlement can never be approved when the consideration for the settlement inures to the benefit of the plaintiff-creditor. Because of the many nuances often reflected in settlement agreements, the Court is hesitant to adopt such a sweeping standard. Admittedly, however, a settlement that can be approved, but still grant benefits to the settling creditor is likely a rare breed. The instant settlement, however, is not of such a breed. It envisions the Plaintiff receiving a private benefit of $5,000 from the Debtor in exchange for its agreement to dismiss its § 727 action, and fails to give the UST and other creditors the opportunity to be substituted as plaintiffs in the § 727 action. The Court holds that a § 727 settlement cannot be deemed fair and equitable and in the best interests of the estate, and therefore approved, when it results in benefits inuring only to the settling creditor, and the United States Trustee and other parties are not given the opportunity to be substituted as plaintiffs. Accordingly, the Settlement cannot be approved.

The Court can only act upon the Settlement in its current form. It will not speculate as to what form it must take before it may be approved under the fair and equitable standard. That, of course, is up to the parties.

III. CONCLUSION

For the reasons stated above, the Motion is denied. The Court shall issue a separate order for the purpose of allowing the parties to propose an amended settlement, if any, or to determine whether a further trial, motion for substitution of plaintiff, or dismissal is necessary.

This opinion constitutes the Court's findings of fact and conclusions of law in accordance with Federal Rule of Bankruptcy Procedure 7052.

DONE and ORDERED this 21st day of August, 2000, at Manchester, New Hampshire.

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J. Michael Deasy
Bankruptcy Judge