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Determining When the Granting of Relief is Deemed Abuse of the Bankruptcy Code under Section 707

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Introduction

There is no constitutional right for an individual to have their debts discharged.[1] A discharge is a privilege offered to the honest but unfortunate debtor pursuant to title 11 of the United States Code (the "Bankruptcy Code"). A bankruptcy court considers different standards and/or tests to determine when a debtor may be abusing the relief provided under the Bankruptcy Code.[2] The specific provision that restricts relief because of abuse was originally enacted in 1984, and then amended in 2005 under the Bankruptcy Abuse Prevention and Consumer Protection Act ("BAPCPA").[3] A main purpose of the BAPCPA was to deter abuses within the bankruptcy process, specifically targeting individual debtors with consumer debts.[4] Under the Bankruptcy Code, after a hearing and notice, the bankruptcy court, the United States Trustee ("UST"), or any interested party may dismiss a case filed under chapter 7 of the Bankruptcy

[1] *See* U.S. v. Kraus, 409 U.S. 434, 445 (1973).
[2] *Id*.
[3] *See In re* Smith, 585 B.R. 168, 174 (Bankr. W.D. Okla. 2018); 11 U.S.C. §707 (2012).
[4] *See* Kings v. Wells Fargo, N.A., 362 B.R. 226, 231 (Bankr. D.MD. 2007).

Code by an individual debtor "whose debts are primarily consumer debts".[5] "Primarily consumer debts" are defined as debts for personal, family or household purposes.[6]

This memorandum examines the application of 11 U.S.C. §707(a) and (b) (1)-(3), and the evaluation a court makes before finding that granting relief would be an abuse of provisions of chapter 7. Part I analyzes the application of the "for cause" dismissal under 11 U.S.C. §707(a). Part II examines section 707(b)(1)-(3) and the different tests or standards that apply when presumption of abuse arises vs. when it does not, or when it is rebutted by the debtor.

I. Dismissal "For Cause"

A court may dismiss a case under section §707(a) "for cause".[7] "For cause" is not specifically defined within this section of the Bankruptcy Code.[8] Section 707(a) provides three non-exclusive but illustrative examples of cause: (1) unreasonable delay; (2) nonpayment of fees; and (3) failure to timely file certain required information, but only on motion by the UST.[9] The court has discretion to decide what else may constitute cause.[10]

In deciding whether to dismiss "for cause" under 11 U.S.C. §707(a), a court is guided by equitable principles and performs a case-by-case analysis evaluating whether dismissal of the chapter 7 case would be in the best interest of all the parties involved.[11] For example, in *In re Chovev*, a dentist had been sued for malpractice by a patient who was awarded judgment of approximately $260,000.[12] The dentist and his wife had been served information subpoenas regarding the malpractice judgment and filed a chapter 7 case in order to stay all collection

[5] 11 U.S.C. §707(b).
[6] *Id.*; *see* 11 U.S.C. §101(8).
[7] *See id*. §707(a).
[8] *Id*.
[9] *See id*.
[10] *See In re* Atlas Supply Corp., 857 F.2d 1061, 1064 (5th Cir. 1988).
[11] *See In re* Murray, 900 F.3d 53, 58 (2d Cir. 2018).
[12] 559 B.R. 339, 341–342 (Bankr. E.D.N.Y 2016).

efforts on the judgment.[13] The creditor (patient) moved to dismiss the debtor's chapter 7 case pursuant to section 707(a) claiming that filing to avoid payment of the malpractice judgment was bad faith, and additionally that the debtor inflated his expenses on a schedule within his chapter 7 petition.[14] The debtor opposed the motion arguing that bad faith does not constitute cause under 11 U.S.C §707(a).[15]

The court denied the dismissal of the chapter 7 case holding that the alleged "bad faith" by debtor was not egregious enough to constitute "cause" and that other Bankruptcy Code provisions covered false statements by the debtor.[16] First, the court emphasized that the creditor's list of factors that suggested bad faith were not egregious enough; just because there were multiple pieces of evidence presented by the creditor, does not mean that the evidence was probative.[17] The creditor also argued that filing a chapter 7 case to avoid payment of the judgment was considered bad faith; the court agreed that this was the reason that the debtor filed, however, in of itself, it was not sufficient to prove "cause" to dismiss a chapter 7 case.[18]

Moreover, for a court to determine that a case should be dismissed "for cause", the basis for cause must not be covered under another section of the Bankruptcy Code.[19] For example, if information within the Schedule made by debtor had been falsely made, that information would be considered "false oaths" and would fall under 11 US.C. §727(a)(4)(A).[20] Dismissal "for cause" under 11 U.S.C. §707(a) is limited to conduct that falls outside of specific Bankruptcy Code provisions where the court needs to make a case-by-case analysis based on the facts.[21]

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[13] *Id*.
[14] *Id*. at 344.
[15] *Id*.
[16] *Id*. at 349.
[17] *Id*. at 347–348.
[18] *Id*. at 347; *see In re* McVicker, 546 B.R. 46, 51 (Bankr. N.D. Ohio 2016).
[19] *Id*. at 349.
[20] *Id*.
[21] *Id*.; *see In re* Aiello, 428 B.R. 296, 303 (Bankr. E.D.N.Y 2010).

II. Dismissal for Reason of "Abuse"

Alternatively, the court can dismiss or convert a chapter 7 case when the filing is deemed an "abuse" of the Bankruptcy Code.[22] Abuse can be presumed by the "Means Test" calculation formulaically or, if no presumption arises or the debtor rebuts the presumption, the court can find abuse of the provisions of a chapter 7 case through "bad faith" or based on a "totality of the circumstances".[23]

A. Presumption of Abuse

The "Means Test" is an objective and mechanical formula used by the bankruptcy court to determine if a presumption of abuse exists.[24] Abuse of relief is presumed, after the Means Test calculation is applied, when an "ability to pay" threshold has been exceeded.[25] Specifically, debtors are required to complete schedules where they report income and are permitted to deduct certain expenses from their income amount based on section 707(b)(ii)–(iv).[26] From there, the presumption of abuse arises if the debtor's current monthly income, reduced by the expenses delineated, and multiplied by 60, is not less than either (1) "25 percent of the debtor's nonpriority unsecured claims in the case, or $7,700, whichever is greater," or (2) "$12,850."[27] The Means Test is described as "backward-looking," meaning that the financial information that comes out of the form is a "snap-shot" of the chapter 7 debtor's financial state as of the petition date.[28]

In calculating current monthly income, certain expenses are deducted in the calculation, such as household expenses and dependents' tuition, while others, like non-debtor's spouse's

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[22] *See* 11 U.S.C. §707(b).
[23] *Id*.
[24] *See In re* Lopez, 574 B.R. 159, 164 (Bankr. E.D. Cal. 2017); *In re* Rivers, 466 B.R. 558, 568 (Bankr. M.D. Fla. 2012).
[25] *See* U.S.C. §707(b)(2).
[26] *See id*. §707(b)(ii)–(iv).
[27] *Id*.
[28] *See* Fokkena v. Hartwick, 373 B.R. 645, 655 (D. Minn. 2007); *In re* Castillo, No. 08-10878-PGH, 2008 Bankr. LEXIS 2740, at *13 (Bankr. S.D. Fla. 2008).

personal expenses, are not.[29] In *In re Persuad*, the debtor filed a petition for relief under chapter 7 of the Bankruptcy Code and the UST moved to dismiss the case under section 707(b) (1–3).[30] In her Statement of Current Monthly Income, the debtor reported her monthly income correctly, but incorrectly deducted her non-debtor husband's personal expenses as household expenses under the marital adjustment.[31] The UST contended that the husband's withholding of taxes, 401(k) contributions, automobile loans, and insurance did not constitute household expenses and the debtor's children's tuition should have been counted in the debtor's income as household expenses.[32] Under the UST's calculations, the debtor would have had an amount of disposable income large enough to presume abuse and pay all unsecured claims through a chapter 13 plan had she used the correct numbers in her calculations.[33] The court granted the UST's motion to dismiss the chapter 7 case for presumption of abuse.[34] The court found it sufficient to only review the tuition inquiry and held that the children's tuition was a household expense, even if solely paid out of one spouse's account, and therefore, the debtor's chapter 7 case was dismissed.[35]

B. Presumption of Abuse Does Not Arise or is Rebutted by the Debtor

If there is no presumption of abuse or the debtor rebuts that presumption, then the court will either evaluate whether the debtor filed in bad faith, or will apply a "totality of the circumstances" test, where factors are weighed in deciding if the debtor's financial situation warrants relief.[36] Both evaluations are made on a case-by-case basis of the debtor's financial situation, meaning that both avenues of dismissal need clarification when being applied by the

[29] *In re* Persuad, 486 B.R. 25, 253 (Bankr. E.D.N.Y. 2013).
[30] *Id*. at 253.
[31] *Id*. at 253–254.
[32] *Id*.
[33] *Id*. at 254.
[34] *Id*. at 264.
[35] *Id*.
[36] *See* U.S.C. §707(b)(3).

court.[37] Certain aspects of a debtor's lifestyle can apply in some circumstances, but not in others.[38]

1. Bad Faith Filing

Under section 707(b)(3), the court first considers whether the chapter 7 case was filed in bad faith.[39] Prior to the 2005 amendments, some, but not all, courts used bad faith as a justification for dismissal "for cause" under section 707(a), even though the words "bad faith" were not included in the statute.[40] In 2005, the Bankruptcy Code was amended to include "bad faith" as a justification for dismissal for abuse.[41] However, some circuits still disagree that bad faith should be considered when deciding a dismissal "for cause" or abuse.[42]

A "bad faith filing" is specifically defined as "[t]he act of submitting a bankruptcy petition that is inconsistent with the purposes of the Bankruptcy Code or is an abuse of the bankruptcy system (that is, by not being filed in good faith)."[43] When determining bad faith, the court focuses on the debtor's conduct and intent when the chapter 7 case was filed.[44] An analysis of bad faith can be unrelated to the debtor's financial situation, such as "eve-of-bankruptcy purchases, filing incomplete or false schedules, or failure to cooperate with the bankruptcy

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[37] *See In re* Jensen, 407 B.R. 378, 384 (Bankr. C.D. Cal. 2008).
[38] *Id*.
[39] *See* 11 U.S.C. §707(b)(3)(A).
[40] *See id*. §707(a).
[41] *See id*. §707(b)(3)(A); Pub. L. No. 109-8, § 102(a) (2005); *In re* Padilla, 222 F.3d 1184, 1191 (9th Cir. 2000) (holding that "cause" rather than "bad faith" is the proper inquiry under § 707(a)); *In re* Zick, 931 F.2d 1124, 1127 (6th Cir. 1991) (holding that debtor's lack of good faith in filing a chapter 7 petition was proper "cause" for dismissal under §707(a)).
[42] *See In re* Grullon, No. 13-11716 (ALG), 2014 Bankr. LEXIS 2238, at *5 (Bankr. S.D.N.Y. May 20, 2014) (noting that the Third and Eleventh circuits include "bad faith" in a "for cause" justification, while the Eighth and Ninth circuits held to the contrary).
[43] BLACK'S LAW DICTIONARY 149 (8th ed. 2004).
[44] *See In re* Honkomp, 416 B.R. 647, 649 (Bankr. N.D. Iowa 2009); *In re* Hornung, 425 B.R. 242, 249 (Bankr. M.D.N.C. 2010).

trustee."[45] Under section 707(b)(3), "bad faith" is a forward-looking analysis that takes future expenses into consideration.[46]

The purchase and retention of luxury items are analyzed on a case-by case basis, specifically with respect to the value and character of the item, when determining bad faith under section 707(b)(3)(A). In *In re Boyle*, debtors had purchased a 28-foot boat when they had no significant debt and kept up-to-date on their boat payments.[47] About a year later, the Boyles accumulated unpaid balances on eight separate credit cards in the aggregate amount of approximately $67,600.[48] In October 2008, the couple filed a petition for relief under chapter 7.[49] The court found that the debtors had filed the petition in bad faith because the boating expenses amounted to more than twenty per cent of the debtors' monthly income, meaning that they could have utilized repayment through chapter 13.[50] The UST's motion for dismissal was granted because the debtors were using their resources on the boat, a luxury and recreational item, instead of paying off outstanding debt.[51]

In contrast, in *In re Gomez*, the bankruptcy court used its discretion to deny the UST's motion to dismiss a chapter 7 case for abuse because the court found no sign of bad faith.[52] In *Gomez*, the debtors purchased two new vehicles, through a loan secured by the two vehicles, one month prior to filing a chapter 7 petition.[53] The UST argued that the purchase of the two new vehicles which necessitated a new secured debt, compared to purchasing used vehicles,

[45] *In re* Parada, 391 B.R. 492, 499 (Bankr. S.D. Fla. 2008).
[46] *See In re* Haman, 366 B.R. 307, 317 (Bankr. D. Del. 2007).
[47] 412 B.R. 108, 109 (Bankr. W.D.N.Y. 2009).
[48] *Id.*
[49] *Id.*
[50] *Id.*
[51] *See id.* at 113.
[52] No. 13-32210, 2014 Bankr. LEXIS 1117, at *1 (Bankr. N.D. Ohio Mar. 21, 2014).
[53] *Id.* at 2.

demonstrated bad faith.[54] The court found that the debtors purchased two new vehicles out of necessity and that they could only secure a loan if they purchased new vehicles, because the creditor wanted to protect his interest in case of default.[55] Looking to multiple factors such as job location, job hours, and testimony at the hearing, the court found that the purchase was reasonable and was not carried out to take advantage of creditors.[56]

2. "Totality of the Circumstances" Test

Compared to the backward-looking, mechanical Means Test used in section 707(b)(2), the "totality of the circumstances" test is a forward-looking and more flexible approach to determine if a debtor is entitled to seek relief under chapter 7.[57] Pre- and post-petition events, such as future income and expenses, are better suited to be taken into consideration by the court under the "totality of the circumstances" test.[58] Bankruptcy courts use pre-BAPCPA case law to give meaning to the phrase "totality of the circumstances" because the Bankruptcy Code did not define the term.[59] Various courts use slightly different "totality of the circumstances" factors, but all tests only differ by matter of degree.[60]

The Second Circuit has consistently used the "*Kornfield*" factor test, which is a bifurcated approach that first focuses on the debtor's ability to pay the debts and then weighs aggravating and mitigating factors.[61]

Courts have considered the following under the "*Kornfield*" factor test:

> (1) whether the filing was forced or happened as a result of sudden illness, calamity, disability, unemployment or catastrophic events; (2) whether

[54] *See id*. at 7.
[55] *See id*. at 8–9.
[56] *See id*. at 8–10.
[57] *See In re* Lindstrom, 381 B.R. 303, 309 (Bankr. D. Colo. 2007).
[58] *See id*.
[59] *See In re* Smith, 585 B.R. 168, 175 (Bankr. W.D. Okla. 2018); *In re* Masella, 373 B.R. 514, 518 (Bankr. N.D. Ohio 2007).
[60] *See In re* Vesnesky, 115 B.R. 843, 848 (Bankr. W.D. Pa. 1990).
[61] *See In re* Colgate, 370 B.R. 50, 55–56 (Bankr. E.D.N.Y. 2007).

> schedules were filed in good faith, whether the petition was filed in good faith; (3) whether debtor's disposable income permits liquidation, whether debtor has engaged in "eve of bankruptcy purchases"; (4) whether the debtor enjoys a stable source of future income; (5) whether the debtor is eligible for adjustment through chapter 13 or relief under chapter 11; (6) whether there are state remedies to ease debtor's financial issues; whether there is relief obtainable through private negotiations; (7) whether the debtor's expenses can be reduced significantly without depriving him of necessities; (8) whether the debtor has significant retirement funds, which could be devoted to payment of creditors; and (9) whether chapter 7 is debtor's only choice and he has explored other alternatives.[62]

Because the "totality of the circumstances" test is based on individual facts, the court must look to past cases to determine how specific factors or lifestyle/financial choices can affect the determination of abuse.[63] For example, in *In re Wise*, the UST filed a motion to dismiss a debtors' chapter 7 case for abuse under the "totality of the circumstances" standard.[64] The court held that the there was no abuse of chapter 7 provisions for relief in this case based on the weighing of the factors.[65] Under the bifurcated *Kornfield* approach, the court first analyzed the debtors' ability to pay and found that the debtors did have some ability to pay dividend to their creditors, based on their monthly income.[66] Next, the court looked at any other aggravating and mitigating factors, from the *Kornfield* test, to come to a conclusion on abuse.[67]

On the first factor, the court found that the debtors' initial filing resulted from debts that began after one of the debtors lost their job so the filing could be attributed to sudden unemployment.[68] Pertaining to the third group of factors, these potentially aggravating factors were inapplicable in this case because the debtors had no new debt after filing.[69] The fourth, fifth and eighth factors were also not implicated because, even though debtors had a stable stream of

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[62] *See In re* Carlton, 211 B.R. 468 (Bankr. W.D.N.Y. 1997), *aff'd sub nom.*, Kornfield v. Schwartz (*In re* Kornfield), 214 B.R. 705 (W.D.N.Y. 1997), *aff'd*, *In re* Kornfield, 164 F.3d 778 (2d Cir. 1999).
[63] *See In re* Masella, 373 B.R. 51, 518 (Bankr. N.D. Ohio 2007).
[64] 453 B.R. 220 (Bankr. D. Vt. 2011).
[65] *Id*. at 235.
[66] *Id*. at 232.
[67] *See In re* Fitzgerald, 418 B.R. 778, 782 (Bankr. D. Conn. 2009).
[68] *Wise*, 453 B.R. at 232–233.
[69] *Id*. at 233.

income, they did not have enough disposable income to pay creditors in a chapter 13 case and the debtors' retirement savings were of an insignificant amount.[70] Taking factor two, seven and nine together, the court held that the debtors filed in good faith by completing a change in their lifestyles that included moving from California to Vermont and trading in luxury cars, and that no other aggravating factors would weigh in favor of granting the UST's motion.[71] In this instance, the court found that there were more mitigating factors than aggravating factors.[72]

Conversely, in *In re Colgate*, the bankruptcy court granted the UST's motion to dismiss the chapter 7 petition for abuse after analysis under "totality of the circumstances".[73] Under *Kornfield*, the court analyzed the debtor's ability to pay and found that he would have been able to pay a substantial amount to unsecured creditors.[74] The court then looked to the factor test to either mitigate or aggravate the debtor's initial ability to pay. Here, the court found that the first factor was implicated because the debtor filed for overspending on luxury items such as a computer and new furniture, and not because of a sudden catastrophe.[75] The court also pointed out that the debtor lacked good faith and candor while filing schedules and providing explanations for certain expenses.[76] Because of the aggravating factors found by the court, and the lack of mitigating factors, the court granted the UST's motion for dismissal and gave the debtor the option to convert to a chapter 13 case.[77]

III. Conclusion

[70] *Id.*
[71] *Id.* at 234.
[72] *Id.* at 235.
[73] 370 B.R. 50, 52 (Bankr. E.D.N.Y. 2007).
[74] *Id.* at 57.
[75] *Id.*
[76] *Id.*
[77] *Id.*

Bankruptcy courts, as courts of equity, use discretion in balancing competing interests for dismissal.[78] Bankruptcy courts tend to stray from making judgment calls with respect to how a person spends their free time, however, they have the discretion to consider certain financial decisions when that decision implicates the privilege of having debts discharged.[79] Under sections 707(a) and (b)(3), the bankruptcy court has flexibility in considering what constitutes abuse "for cause" and abuse based on "bad faith" or "totality of the circumstances".[80] In contrast, under section 707(b)(2), the bankruptcy court follows a more rigid formula in the Means Test calculation when evaluating if abuse exists, regardless of the circumstances.[81]

[78] *See In re* Marra, 179 B.R. 782, 785 (M.D. Pa. 1995).
[79] *See In re* Smith, 585 B.R. 168, 177 (Bankr. W.D. Okla. 2018).
[80] *See Lindstrom*, 381 B.R. at 309; *Atlas Supply Corp.*, 857 F.2d at 1061.
[81] *See In re* Kogler, 368 B.R. 785, 790 (Bankr. W.D. Wis. 2007).