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From the Bankruptcy Courts

Benjamin Weintraub* and Alan N. Resnick**

ELIGIBILITY FOR CHAPTER 13 AS A REQUIREMENT FOR DISMISSAL OF CHAPTER 7 CASE BASED ON "SUBSTANTIAL ABUSE": *IN RE* *MASTROENI*

In an attempt to avoid misuse of the bankruptcy laws by consumer debtors, Congress added to the Bankruptcy Code another ground for dismissal applicable in liquidation cases commenced on or after October 8, 1984.¹ The court, on its own motion "and not at the request or suggestion of any party in interest," and after notice and a hearing, may dismiss the case if it finds that the granting of relief "would be a substantial abuse" of the provisions of chapter 7. This new ground applies only if the debtor is an individual whose liabilities are primarily consumer debts. The amendment also makes it clear that the debtor is aided by a presumption in favor of

granting the relief requested by the debtor.

There is no doubt that this ground will result in litigation requiring an interpretation of "substantial abuse." For example, is it a substantial abuse of chapter 7 for an insolvent consumer to file a petition if future income would be sufficient to fund a chapter 13 plan paying creditors a greater percentage of their claims? A comparison of statements made by legislators renders the answer to this question unclear. Representative Peter Rodino chairman of the Judiciary Committee of the House of Representatives, stated that the 1984 amendments "contain no threshold or future income tests."² However, Representative Anderson indicated that it is a "substantial abuse" of chapter 7 if "the debtor is found capable of fulfilling the terms of a chapter 13 repayment agreement."³ In one of the first decisions on this issue, the court in *In re Edwards*⁴ inter-

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¹ See 11 U.S.C. § 707(b), added by the Bankruptcy Amendments and Federal Judgeship Act of 1984, § 312.

² 130 Cong. Rec. H7489 (June 29, 1984).

³ 130 Cong. Rec. H7499 (June 29, 1984).

⁴ 13 Bankr. Ct. Dec. 250 (S.D.N.Y. 1985). Compare *In re Bryant*, 47 Bankr. 21 (D.N.C. 1984) (debtor's concealment of credit card debts, inflated expenses, and ability to fund a plan to pay a significant portion of debts was a substantial abuse of chapter 7). See

puted substantial abuse to mean that the debtor's future income and expenses would permit the funding of a chapter 13 plan that would pay 100 percent of the principal amount of unsecured claims in a three-year period.

In Re Mastroeni

A recent decision by the bankruptcy court in *In re Mastroeni*⁵ could, if followed, have a limiting effect on the application of Section 707(b) in consumer cases involving sizable indebtedness. During a hearing on a request for relief from the automatic stay initiated by a bank asserting the right to set off the debtor's obligation against several individual retirement accounts (IRAs), certain facts came to the judge's attention causing the court on its own motion to issue a notice to the debtor to show cause why his liquidation petition should not be dismissed pursuant to Section 707(b) and the "substantial abuse" of chapter 7.

The debtor's schedules reflect \$110,850 in unsecured debts, which arose from loans from six banks to finance stock market trading and for the debtor's per-

sonal needs.⁶ The debtor earns \$73,000 per year as an officer of an international oil trading company. His assets, including \$9,500 in IRA accounts, are worth \$14,485.

The debtor's financial problems resulted from speculative stock market trading and the loss of his former job in 1983. Between 1979 and 1985, he paid an average of \$17,000 per year in interest to bank creditors. He promptly spent a \$10,000 tax refund within months before filing the chapter 7 petition in July 1985, using the funds for automobile repairs, furniture, air conditioners, and other personal needs.

The debtor's schedule of current income and expenditures reflected a net monthly take-home pay of \$4,000 and monthly expenses of \$3,980.

Evidence of Abuse

The court focused on several factors that are usually relevant in determining whether a petition is a substantial abuse of chapter 7.

First, the court noted that the debtor's \$73,000 salary rendered him financially capable of partially repaying his consumer creditors over a period of years. "Indeed,

also *In re Grant*, 13 Bankr. Ct. Dec. 303 (N.D. Ohio 1985) (petition dismissed where debtor could fund a chapter 13 plan paying 68 percent of debts over five years instead of only 2 percent distribution in liquidation).

⁵ 13 Bankr. Ct. Dec. 1129 (S.D.N.Y. 1985).

⁶ Although the court's reasoning and decision are sound, it is questionable whether the loans constituted consumer debts within the definition of § 101(7): "Consumer debt" means debt incurred by an individual primarily for a personal, family, or household purpose."

he managed to repay approximately \$90,000 over approximately five years until reaching a point where he felt that he was emotionally drained by the debt burden and he decided to seek financial relief and the potential fresh start afforded under Chapter 7 of the Bankruptcy Code."⁷

Second, the debtor's monthly estimated expenses as stated in his schedule "are obviously inflated."⁸ His estimated monthly electric bill of \$150 for a three-room apartment "does not appear to be realistic."⁹ Food and household supplies of \$600 and recreation expenses of \$700 per month for one person "do not appear to be in line."¹⁰ The court referred to *In re Bryant*,¹¹ where the bankruptcy court mentioned inflated expenses as a reason for dismissal under Section 707(b). As stated in *Bryant*, "While Congress intended to give the debtors relief in such cases, it was not the design of the Bankruptcy laws to allow the Debtor to lead the life of Riley while his creditors suffer on his behalf."¹² Relevant to this factor, the court emphasized that the debtor disposed of a \$10,000 income tax refund shortly before bankruptcy by paying \$1,700 to repair his 1981 Audi automobile

and by spending the remainder to acquire furniture and other items for his apartment and personal needs.

Ineligible for Chapter 13

Regardless of the debtor's high income, ability to pay at least a significant portion of his debts over time, and inflated expenses, the court would not dismiss the chapter 7 petition under Section 707(b) because the debtor's unsecured debts exceeded \$100,000, which rendered him ineligible for chapter 13 relief.¹³

The court reasoned that a partial repayment of consumer obligations is feasible only under a chapter 13 plan. Section 1306(a)(2) provides that property of the estate includes postpetition earnings of a chapter 13 debtor. In contrast, postpetition earnings from services performed by an individual debtor in either chapter 7 or chapter 11 are not included in the estate pursuant to Section 541(a)(6). Thus, postpetition salary is "not required to be available for repayment purposes under either Chapter 7 or Chapter 11."¹⁴ The court pointed out that chapter 11 would not be an acceptable alternative to relief under chapter 7. "An individual consumer debtor with minimal assets could not be compelled to consummate a

⁷ 13 Bankr. Ct. Dec. at 1130-1131.

⁸ *Id.* at 1131.

⁹ *Id.*

¹⁰ *Id.*

¹¹ 47 Bankr. 21 (D.N.C. 1984).

¹² *Id.* at 26; see also *In re Grant*, 51 Bankr. 385 (N.D. Ohio 1985).

¹³ See 11 U.S.C. § 109(e); see also *In re White*, 49 Bankr. 869 (W.D.N.C. 1985).

¹⁴ 13 Bankr. Ct. Dec. at 1130.

Chapter 11 plan because the debtor's postpetition income may not be treated as property of the estate . . . and as such the debtor cannot be compelled to fund a Chapter 11 plan with such income. Therefore, an individual consumer's Chapter 11 plan would not much differ from a Chapter 7 liquidation."¹⁵

In reaching its conclusion, the court was careful to note that the availability of chapter 13 relief does not necessarily mean that consumer debtors must forego chapter 7. The court points out several sections of the Code that reflect Congress's intention to allow chapter 7 relief despite the availability of chapter 13. Under Section 706(c), the court may not order conversion of a chapter 7 case to a chapter 13 case unless it is requested by the debtor. The 1984 amendments to the Code stopped short of requiring consumer debtors with prospects for substantial future income to make some effort to repay creditors under chapter 13. Section 707(b) contains an express presumption in favor of granting chapter 7 relief when the debtor requests it. Moreover, only the court may raise the issue as to the appropri-

ateness of chapter 7—others have no standing to do so. Finally, the court may find that "an honest debtor's economic picture may not support a continuing obligation to repay partially or fully all of the prepetition creditors without jeopardizing the fresh start contemplated by the discharge available under 11 U.S.C. § 727 (a)."¹⁶

Although it was not necessary for the court to hypothesize or decide whether Mastroeni's chapter 7 petition would have been dismissed if his unsecured debts did not exceed \$100,000, the court did arrive at a sound resolution in emphasizing the hardship to the debtor of a dismissal:

A dismissal of a Chapter 7 consumer debtor's petition pursuant to 11 U.S.C. § 707(b), when the debtor is ineligible for Chapter 13 relief and where Chapter 11 is not a meaningful alternative, would not be consistent with the legislative intent to encourage repayment in those instances where a debtor has sufficient income to repay creditors fully or partially. Indeed, a dismissal in such circumstances would be tantamount to a denial of a discharge under 11 U.S.C. § 727, without establishing any of the statutory grounds for barring such discharge.¹⁷

The court concluded with a critical attack on the drafters of Section 707(b), who "failed to take into account the fact that if re-

¹⁵ *Id.* at 1131. *Contra In re Bell*, 56 Bankr. 637, 642 (Bankr. E.D. Mich. 1986) ("Although the debtor is not eligible to file a Chapter 13 petition because his unsecured debt exceeds \$100,000, 11 U.S.C. § 109(e) . . . he is nevertheless eligible to file a Chapter 11 petition 11 U.S.C. § 109(d).").

¹⁶ 13 Bankr. at 1131.

¹⁷ *Id.*

payment is the desired goal under this section there should be no limitations placed on the eligibility of debtors for relief under Chapter 13."¹⁸ The court's comment that this oversight, as well as the omission of specific standards to be used in determining what consti-

¹⁸ *Id.* at 1131-1132.

tutes a substantial abuse, "highlights the inherent weakness in the efficacy of the statute."¹⁹

¹⁹ *Id.* at 1132; see Breiturtz, "New Developments in Consumer Bankruptcies: Chapter 7 Dismissal on the Basis of 'Substantial Abuse,'" (pts. 1 & 2) 59 *Am. Bankr. L.J.* 327 (1985), 60 *Am. Bankr. L.J.* 33 (1986).