

Concurrent Session

Have You Noticed
that Your Neighbor's
in Bankruptcy?
High-Income Consumer
Debtor Cases

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High income consumer debtors – My neighbors? Who knows, maybe so.

In many respects there is no real difference between low to middle income debtors versus high-income debtors. That's because most consumer debtors suffer from not being able to live within their means or cash income. Increasingly, in recent years the difference between the middle-income debtors and the high-income debtors has become somewhat blurred at least in terms of the amount of their total debt. Both mid income and high income debtors often have substantial six-figure credit card debt, their residences generally are subject to first and junior mortgages that total more than the value of the residence and they are unable to afford the mortgage debt.

Since prior to the enactment of BAPCPA, I have advised all consumer debtors that as a general rule, Chapter 7 relief is the best form of relief available to them under the Bankruptcy Code if they qualify. However, Chapter 7 eligibility is not a certainty and it has become one of the most challenging considerations in representation of Chapter 7 debtors and particularly high-income debtors. Proper analysis and preparations of these types of cases is crucial from the onset and errors, omissions and mistakes in the preparation of schedules, SFA and other documents should be avoided. High income consumer debtors not eligible for Chapter 7 may choose to seek relief under Chapter 11 or Chapter 13 or negotiate debt settlements.

Who are high-income consumer debtors? In my practice these are debtors where income either exceeds the statutory median income and whose eligibility to file Chapter 7 is therefore subject to the Means Test (Form 22c) or whose monthly net income is significant

notwithstanding eligibility for Chapter 7 relief after successfully completing the Means Test. For purposes of our discussion I am assuming that these consumer debtors have monthly income of at least \$10-15K or more. These high-income debtors are a mixed lot: They could be doctors, lawyers, other professionals, developers, contractors, business owners, double income families, civil servants, administrators, etc.

HIGH INCOME CONSUMER DEBTORS

I. CHAPTER 7 - Qualifying to File Chapter 7 – See Flow Chart

A. Nature of Debt

1. Business Debt

- Definition of “business debt” – what included and what excluded
- Cannot be dismissed for “abuse” under 11 U.S.C. §707(b)

2. Primarily Consumer Debt

II. Avoiding Dismissal of Case for “Abuse” – 11 U.S.C §707(b)

A. Income and Expense Analysis – 11 U.S.C. §707(b)(2) Analysis

- mechanical objective test

1. Calculation of Income

- Comparison of income to IRS standards

2. Expense Allowances (Means Test Analysis)

- Only necessary if above medium income

- National and Local Allowances – Use standard IRS figures for housing, food, clothing, medical

- Other Necessary Expenses – Use actual expenses

- Secured Debt –
- Taxes, Insurance, Pension, Tuition, Charitable Contributions, Etc.

3. Passing or Failing the Means Test – What does that mean?
 - time limitation on bringing motion to dismiss - §704(b)(1) & (2)
 - UST must file a statement of presumed abuse within 10 days after 341 and motion to dismiss within 30 days thereafter

Failing – Dismissal or Conversion

Passing – No presumption of abuse, but still subject to 707(b)(3) Analysis

B. Income and Expenses Analysis – 11 U.S.C. §707(b)(3) Analysis

- More subjective equitable assessment of debtor’s circumstances
 - Review of Schedules I & J
 - Broader time limitations for bringing motion – 60 days after date set for 341. Fed. Rule of Bank. Procedure 1017(e)
- Even if debtor passes the means test, case can be dismissed for (a) bad faith (11 U.S.C. §707(b)(3)(A)) or totality of circumstances (11 U.S.C. §707(b)(3)(B))
1. Bad Faith – Misconduct on part of debtor
 2. Totality of Circumstances – not defined in 7th Circuit
 - Case by case analysis – See attached list of cases
 - Factors to be considered

NOTE: Only UST or judge can bring motion to dismiss under §707(b) for debtors under the median income. 11 U.S.C. §707(b)(6).

II. ALTERNATIVES: Chapter 13; Chapter 11 and Debt Settlement (Non-Bankruptcy)

1. Chapter 13: How to calculate monthly payment to Trustee?
 - No set standard in 7th Cir. - Depends on the judge
 - Disposable monthly income (“DMI”) from Means Test Analysis
 - Consider both DMI & monthly net income from Schedule J (majority position)

BUSINESS DEBT OR PRIMARILY CONSUMER DEBT

[11 U.S.C. § 707\(b\)\(1\)](#) provides that a court may dismiss a case “filed by an individual debtor under this chapter whose debts are primarily consumer debts ... if it finds that the granting of relief would be an abuse of the provisions of this chapter.”

11. U.S.C. §101(8) defines “consumer debt” as “debt incurred by an individual primarily for a personal, family or household purpose.” Consumer debt is distinguished from business

debt, the latter of which is incurred with a “profit motive.” *Stewart v. United States Trustee (In re Stewart)*, 175 F.3d 796, 806 (10th Cir.1999); accord *Cypher Chiropractic Center v. Runski (In re Runski)*, 102 F.3d 744, 747 (4th Cir.1996); *In re Booth*, 858 F.2d 1051, 1054-55 (10th Cir.1990); *In re Miller*, 335 B.R. 335, 339 (Bankr.E.D.Pa.2005). To determine whether a debt is a consumer debt, the Court must examine the purposes for which the debt was incurred. *Consumer United Capital Corporation v. Straughter (In re Straughter)*, 219 B.R. 672, 681-82 (Bankr.E.D.Pa.1998).

Nothing in § 101(8) suggests that a debt meeting this definition nonetheless mutates into a non-consumer debt merely because it is secured by real property. Rather, under the plain language of § 101(8), a debt incurred by an individual primarily for a Consumer Purpose is a consumer debt regardless of whether it is secured or unsecured. And the Court must follow the plain statutory language. Indeed, the majority of courts have held that a debt secured by a debtor's real property is a consumer debt if it is incurred primarily for a Consumer Purpose. See, e.g., *Price v. United States Tr. (In re Price)*, 353 F.3d 1135, 1138 (9th Cir.2004) (“[T]he statutory scheme so clearly contemplates that consumer debt include debt secured by real property that there is no room left for any other conclusion.” (internal quotation marks omitted)); *Zolg v. Kelly (In re Kelly)*, 841 F.2d 908, 912 (9th Cir.1988) (“A literal reading of the [Bankruptcy] Code's simple language leads inexorably to the conclusion that consumer debt includes secured debt.”); *Cox v. Fokkena (In re Cox)*, 315 B.R. 850, 855 (8th Cir. BAP 2004) (“With respect to debt secured by real property, if the debtor's purpose in incurring the debt is to purchase a home or make improvements to it, the debt is clearly for family or household purposes and fits squarely within the definition of a consumer debt under § 101(8).”); *Morris v. Zabu Holding Co. (In re Morris)*, 385 B.R. 823, 829 (E.D.Va.2008) (holding that a debt incurred for a personal, family, or household purpose is a consumer debt even though it is secured by the debtor's real property); *In re Naut*, 2008 WL 191297 at *5 (Bankr.E.D.Pa. Jan. 22, 2008) (same); *In re Hoffner*, 2007 WL 4868310 at * 1 (Bankr.D.N.D. Nov. 21, 2007) (same); *In re Davis*, 378 B.R. 539, 546-47 (Bankr.N.D.Ohio 2007) (same); *King v. Wells Fargo Bank, N.A. (In re King)*, 362 B.R. 226, 230 (Bankr.D.Md.2007) (same).

Courts have adopted varying approaches to defining whether debts are “primarily” consumer debts as opposed to business-related or other non-consumer debts. The majority view is that a debtor's liabilities are primarily consumer debts if the aggregate dollar amount of such debts exceeds 50% of the debtor's total liabilities. See *Hoffner*, 2007 WL 4868310 at *2 (“The majority of courts that have considered the issue have found that ‘primarily’ means more than half of the total dollar amount owed.”). See also *Stewart v. United States Tr. (In re Stewart)*, 175 F.3d 796, 808 (10th Cir.1999) (holding that a debtor has “primarily consumer debts” if the aggregate amount of consumer debt is more than 50% of the total debt); *Kelly*, 841 F.2d at 913 (holding that when “more than half ... of the dollar amount owed is consumer debt, the statutory threshold is passed”); *Naut*, 2008 WL 191297 at *7 (same); *In re Beacher*, 358 B.R. 917, 920 (Bankr.S.D.Tex.2007) (same); *In re Victoria*, 389 B.R. 250, 254 (M.D.Ala.2008) (“primarily” consumer debt means more than half). If the dollar amount of debtor's consumer debt is greater than the dollar amount of debtor's non-consumer debt, then the case is subject to the provisions of § 707(b).

The profit motive test simply involves ascertaining whether the debt was “incurred with an eye toward profit.” See [In re Davis](#), 378 B.R. 539, 547 (Bankr.N.D. Ohio 2007) (citing [In re Booth](#), 858 F.2d 1051, 1055 (5th Cir.1988); [In re Almendinger](#), 56 B.R. 97 (Bankr.N.D. Ohio 1985)). A debt incurred with a profit motive clearly is not a consumer debt. However, there are other types of debt that are not business debts, but which also fall outside the category of consumer debt. [IRS v. Westberry \(In re Westberry\)](#), 215 F.3d 589, 593 (6th Cir.2000) (income taxes are not consumer debt for the purpose of enforcing the co-debtor stay under [11 U.S.C. § 1301](#)). In that case, the court based its decision on findings that the debt was not incurred voluntarily; it was incurred for a public, rather than a personal purpose; the taxes were assessed on earning money, not spending it; and there was no extension of credit involved in the transaction. *Id.* The court pointed out that the bankruptcy code treats tax debts quite differently from consumer debts. It also noted that the language of the statute was plain, thereby eliminating the need to go beyond the language of the statute to divine meaning, or intent, from the use of the phrase “consumer debt.”

In summarizing the context in which [§ 707\(b\)\(1\)](#) was passed, and the policy rationale motivating its enactment, the Sixth Circuit has explained:

[Section 707\(b\)](#) was among the consumer credit amendments to the Bankruptcy Code enacted in 1984. These amendments were passed in response to an increasing number of Chapter 7 bankruptcies filed each year by non-needy debtors. Under prior practice, aside from potential § 523(a) exceptions, [§ 707\(a\)](#) dismissals, and § 727(a) objections to discharge, debtors enjoyed an unfettered right to a “fresh start” under Chapter 7, in exchange for liquidating their nonexempt assets for the benefit of their creditors. [Section 707\(b\)](#) introduces an additional restraint upon a debtor's ability to attain Chapter 7 relief.... Bankruptcy judges now have discretion to dismiss a consumer case when the filing is abusive.

In essence, [§ 707\(b\)](#) allows a bankruptcy court to deal equitably with the unusual situation where an unscrupulous debtor seeks to enlist the court's assistance in a scheme to take unfair advantage of his creditors; it serves notice upon those tempted by unprincipled accumulation of consumer debt that they will be held to at least a rudimentary standard of fair play and honorable dealing.

[In re Krohn](#), 886 F.2d 123, 125-26 (6th Cir.1989) (citations and internal quotation marks omitted).

BUSINESS DEBT OR NOT?

Withholding Tax Debt: Where a business operated by an individual incurs tax liability arising from the operation of that business, and the individual is held to be the responsible party, the tax liability shall be considered a non-consumer debt. [Section 6672 of the Internal Revenue Code](#), states: “Any person required to collect, truthfully account for, and pay over any tax imposed by this title who willfully fails to collect such tax, or truthfully account for and pay over such tax, or willfully attempts in any manner to evade or defeat any such tax or the payment thereof, *shall ... be liable to a penalty equal to the total amount of the tax evaded, or not collected, or not*

accounted for and paid over.” [26 U.S.C. § 6672\(a\)](#) (emphasis added). Personal liability attaches to an individual if (1) he or she is a “responsible person” under the statute (2) who willfully failed to pay taxes owed to the government. See [Ross v. United States, 949 F.Supp. 536, 541-43 \(N.D.Ohio 1996\)](#). Furthermore, “the liability imposed on responsible persons by [Section 6672](#) is distinct from the corporation's duty to pay the taxes withheld from its employees.” [Hornsby v. IRS, 588 F.2d 952, 954 \(5th Cir.1979\)](#) *In re Deloris V. Victoria, Debtor, Deloris V. Victoria, Appellant v. Greenville Hospital Corporation, Appellee*; 2007 CV 0688, Bankruptcy No. 08-31225.

Purchase Money Mortgages: Although there has been some suggestion that a debt secured by real property should not be a consumer debt, the overwhelming majority of courts consider first (purchase money) mortgages on residential property to be consumer debts, and junior mortgages to be consumer debt, to the extent that the loan proceeds are used for non-business purposes, such as consolidating other consumer debt or for home improvement. [In re Praleikas, 248 B.R. 140, 144-45 \(Bankr.W.D.Mo.2000\)](#) quoted in [In re Price, 280 B.R. at 502](#). Purchase money mortgage debt that is secured by Chapter 7 debtor's residence, along with second mortgage debt to the extent that loan proceeds are used for non-business purposes, both qualify as “consumer debt,” within meaning of bankruptcy statute providing for dismissal of Chapter 7 cases filed by debtors whose obligations are primarily consumer debt, if grant of relief would constitute “substantial abuse” of provisions of that chapter. [11 U.S.C.A. §§ 101\(7\), 707\(b\)](#). *In re Naut*, 2008 WL 191297, Bkrcty.E.D.Pa.,2008

Purchase Money Mortgage Used to Satisfy Business Debt: A loan secured by a mortgage on a home owned jointly with a non-filing spouse was used to partially satisfy consumer and business credit card debts. The Court held that the purpose of the refinancing was not to pay business debt, but for personal, household purposes; and, that even if the credit card balances paid at settlement were attributable to business expenses, the payment of these bills was incidental to a consumer transaction. The proceeds of the loan were not invested in the businesses, neither were any of the proceeds of the loan used for other investment purposes. The burden is on the debtor to demonstrate that the loan was at least partially used for business purposes. *In re Liegey*, 2009 WL 3817902, Bkrcty.M.D.Pa.,2009.

Purchase of Real Estate Investment Property: Debtors’ loan documents stated that the purpose of a loan was to purchase a piece of real property to be used as a second residence, but it was apparent that they did not have the means to finance and maintain the property without rental income. The Debtors did not have the financial means to reserve the property solely for personal use, but fully intended to use the property for investment purposes. The Debtors incurred the debt with an eye towards making a profit. *In re Swartzentruber*, 2009 WL 2873003, Bkrcty.N.D.Ohio,2009.

Purchase of Property: The debtor purchased a property for her boyfriend to “flip.” Debtor defaulted on the mortgage and the bankruptcy filing resulted from liability on the default judgment. Debtor initially filed as a consumer debtor, but later amended the voluntary petition to a business filing. The UST successfully objected to the classification of the debt as a business debt. The court focused on the fact that the debtor did not have an agreement regarding the proceeds from the sale of the property and that she was not engaged in the business of “flipping”

houses. The absence of the profit motive was fatal to debtor's position that the debt was a business debt. The Court viewed the transaction as a favor to debtor's boyfriend. [*In re Davis*, 378 B.R. 539, 547 \(Bankr.N.D.Ohio 2007\)](#).

Taxes: Income taxes are not consumer debt for the purpose of enforcing the co-debtor stay under [11 U.S.C. § 1301](#). [*IRS v. Westberry \(In re Westberry\)*, 215 F.3d 589, 593 \(6th Cir.2000\)](#)

CASE SUMMARIES – High Income Debtors and §707(b)(3)

In re Lorenca, Case No. 09-32962 (Jan 29, 2010)
Northern District of Illinois – Hon. Jack B. Schmetterer

Facts: The Debtors owned two (2) pieces of real estate –their home and a rental property. The Debtors monthly gross income is \$7,677.00 plus \$1,300 from the rental property. After withholdings, their net monthly income totals \$7,874.00. The Debtors expenses for their residence total \$5,132.79; the expenses for the rental property total \$1,782.00 (\$482.00 more than the property earns); and, with their other expenses, Schedule J reflects a monthly disposable income figure of negative \$467.51. The Debtors’ intention was to reaffirm the debt on both their residence and the rental property

The United States Trustee brought Motion to Dismiss case under §707(b)(3) arguing that these Debtors would have money available to pay their unsecured creditors if they surrender the rental property and relocate to a less costly residence. The UST’s position is that the Debtors’ expenses related to their residence greatly exceed the IRS published housing allowance for their family size and that alternate less costly housing is available. Moreover, if the Debtors surrendered the rental property, they would have an additional \$482.00 each month to repay unsecured creditors.

Ruling: The Court rejected the UST’s position that the IRS housing allowance under the means test should be the standard for determining reasonable housing costs. The IRS housing standard is a minimum standard and the means test provides for a higher allowance where a debtor pays a higher mortgage. Notwithstanding, the Court did find abuse in this case. The Court concluded that the Debtors had sufficient income to pay the mortgage debt on both their residence and the rental income and if the Debtors surrendered the rental property, they would have at least \$482.00 each month to pay to their unsecured creditors. The Court did not require that the Debtors relocate from their residence given that there was no evidence that the residence was acquired as part of any “invidious plan or gaming” and UST presented no evidence that alternative less costly housing would be available to serve the needs of the Debtors. The Debtor was given six (6) weeks to divest themselves of the rental property, convert to a Chapter 13 and file a plan. Otherwise, their case would be dismissed.

In re Brian E. Barcardi and Jean M. Bacardi, Case No. 09 -25757 (January 6, 2010) – Northern District of Illinois – Hon. A. Benjamin Goldgar

Facts: The Debtors owned three pieces of property – their residence (Deer Point property valued at \$790,000); their former residence (Squire Road property valued at \$500,000); and a condominium (Florida property valued at \$400,000). Each of the properties has mortgage debt that exceeds the current market value. The Squires Road property was vacant and while the Florida property had a renter, the monthly expenses exceeded the rental income. The Debtors' intention was to surrender the Squire Road Property and the Debtors were willing to surrender the Florida property. The Debtors income is \$18,000 per month and J reflects a negative monthly income of \$2,483.57.

The United States Trustee brought a Motion to Dismiss under §707(b)(3) arguing that these Debtors have a high income, live in a luxury house and have unreasonably high expenditures including \$500 for kids activities and \$115 for cable television. While the Debtors acknowledged that these expenditures were excessive, they argued that even after surrendering the Squires Road property and the Florida property, their monthly net income would be only \$129 which would be insufficient to fund any meaningful dividend to unsecured creditors. Because the Debtors were ineligible to file a Chapter 13 case because their debts exceeded the limits for qualifying for Chapter 13 relief, their only alternative would be to convert their case to a Chapter 11. In a Chapter 11, the Debtors questioned whether they would be able to get enough creditors to vote to confirm a Chapter 11 plan.

Ruling: The Court determined that this constituted abuse and that these Debtors had a less costly housing alternative in the Squires Road property readily available them in the close vicinity to their current residence. If the Debtors moved into the Squires Road property and surrendered the Deer Point property, which was worth almost \$200,000 less than owed on the mortgage, they would have available \$883 each month to pay unsecured creditors. In addition, if the Debtors reduced the excessive spending in their budget, they would have at least \$1,433.00 each month which, payable over 60 months, would result in a payment to unsecured creditors of \$85,980. The Court noted that this case would be an abuse even without the alternative housing because debtors are not allowed to maintain a luxury residence at the expense of unsecured creditors. Moreover, the Court rejected the Debtors concerns regarding their ability to confirm a chapter 11 plan noting that the Bankruptcy Code does not guarantee every debtor a discharge. The Court granted the Debtor 14 days to convert their case to Chapter 11 or else the case would be dismissed.

Special thanks to Monica C. O'Brien and James E. Hausler for their assistance in preparing these materials

Qualifying for Chapter 7



