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The U.S. Trustee's Perspective in Consumer Cases; Means Test, Motions Filed under §707(b)(2) and (3); §727 Complaints; Debtor Audits; §329 Motions and Actions Against Creditors

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UNITED STATES TRUSTEE'S PERSPECTIVE IN CONSUMER CASES

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UNITED STATES TRUSTEE'S PERSPECTIVE IN CONSUMER CASES

I. INTRODUCTION

The United States Trustee Program (the "Program") is the component of the Department of Justice that seeks to promote the efficiency and protect the integrity of the federal bankruptcy system. To further the public interest in the just, speedy and economical resolution of cases filed under the Bankruptcy Code, the Program monitors the conduct of bankruptcy parties and private estate trustees, oversees related administrative functions, and acts to ensure compliance with applicable laws and procedures. It also identifies and helps investigate bankruptcy fraud and abuse in coordination with United States Attorneys, the Federal Bureau of Investigation, and other law enforcement agencies. United States Trustees assist in faithfully executing the law by carrying out a broad range of enforcement, litigation, regulatory, and administrative responsibilities under titles 11 and 28 of the United States Code. This paper addresses some of the Program's perspectives on certain types of consumer cases.

II. CONSUMER PROTECTION ISSUES

A top priority of the Program's civil enforcement efforts has been to protect consumer debtors. In FY 2009, for example, United States Trustees initiated approximately 5,000 actions and inquiries to address conduct by creditors and bankruptcy petition preparers. These include over 1,000 actions and inquiries involving mortgage-related fraud and abuse. The Program has, for some time, focused its efforts on combating mortgage-related fraud and abuse in both a civil and criminal context. The Program's enforcement effort has three prongs: (1) combating fraud and abuse committed by debtors; (2) combating mortgage servicer violations of the Bankruptcy Code; and (3) addressing mortgage-related fraud and foreclosure rescue fraud. The Program's enforcement efforts on behalf of consumers are further enhanced by its participation on a wide range of inter-agency and multi-state task forces.

A. FRAUD AND ABUSE COMMITTED BY DEBTORS

United States Trustees are required by law to refer cases of suspected criminal conduct to United States Attorneys and to assist in the prosecution of these cases. Three experienced career prosecutors within the Program's Criminal Enforcement Unit, in addition to twenty-five attorneys in the field offices, are cross-designated to serve as Special Assistant United States Attorneys who directly prosecute bankruptcy crimes.

The Program is dedicated to combating fraud and abuse committed by debtors. By way of example, in 2009, the Assistant United States Trustee in the Program's Alexandria, Virginia, office, serving as a Special Assistant United States Attorney, criminally prosecuted a noteworthy fraudulent debtor case. The debtor had conspired with his attorney and others to perpetrate a sham sale of his house so he could siphon money out of the property while continuing to live there rent free. The debtor was found guilty on three counts of conspiracy to commit bankruptcy fraud, bankruptcy fraud, and bank fraud. He was sentenced to 42 months in prison followed by three years of supervised release, and was ordered to pay $1.1 million in restitution.

Additionally, the Program's Chattanooga office recently obtained a judgment denying a debtor's chapter 7 discharge of nearly $31 million in unsecured debt. The debtor operated a multi-state Ponzi scheme that claimed over 300 victims. After the scheme was discovered, an involuntary chapter 7 case was filed against the debtor. The Program's Chattanooga office sought denial of the debtor's discharge, and assisted with the criminal prosecution of the debtor. To date, the chapter 7 trustee has recovered $3.5 million in assets, and the debtor was recently sentenced to 293 months in prison and ordered to pay roughly $18 million in restitution.

B. MORTGAGE SERVICER VIOLATIONS OF THE BANKRUPTCY CODE

The Program prioritizes identifying and remedying violations of the Bankruptcy Code by national mortgage servicers to protect consumers. The Program is involved in significant litigation involving national mortgage servicers who have filed inaccurate proofs of claim or motions for relief from stay or who have attempted to assess costs, fees, and other charges that are not allowable under the terms of a contract or other applicable law. The principal enforcement focus in mortgage servicer litigation is on creditor filings of inaccurate information or unreasonable or impermissible fees and charges in proofs of claim and motions for relief from stay. United States Trustees have and will continue to take action to remedy systemic errors and abuse identified in inaccurate and inflated proofs of claim and motions for relief from the automatic stay.

Although the United States Trustee has authority to raise, appear, and be heard on any issue in any case or proceeding under the Bankruptcy Code, in many instances the case trustee and the debtor's attorney are in the best position to address creditor misconduct. Accordingly, the Program generally focuses its attention on cases in which the integrity of the bankruptcy system as a whole is at stake.

United States Trustees rely heavily on referrals to help identify cases for action to protect homeowners. Debtors' counsel have the primary responsibility to prevent mortgage servicer overreaching. But chapter 13 trustees also are on the front lines. That is why the Program issued Minimum Standards for Chapter 13 Trustee Review of Mortgage Proofs of Claim. Trustees usually lack information to verify every proof of claim. But these minimum standards put mortgage companies on notice that their proofs of claim will be scrutinized. Improper claims will be subject to action by either the chapter 13 trustee or the United States Trustee.

Thus far, United States Trustees have reviewed hundreds of complaints about improper mortgage servicer activity and are currently litigating multiple cases through the prosecution of complaints, orders to show cause, motions to obtain discovery, or other active case participation. Many more cases have been the subject of informal actions by United States Trustees.

Litigation is not an option of first resort. United States Trustees continue to talk to lenders and counsel about their practices. Practical and mutually beneficial results can be obtained without the need for protracted litigation. The goal is to obtain a result that makes debtors whole and ensures that past violations are not repeated.

The following are some recent court rulings addressing misconduct by mortgage servicing companies in cases where the Program has participated and continues to participate on appeal.

In re Stewart, Civil Nos. 08-3225, 08-3669, 08-3852, 08-3853 and 08-4805, slip op., 2009 WL 2448054 (E.D. La. Aug. 7, 2009). The district court upheld the bankruptcy court's authority to require Well Fargo to audit and amend proofs of claim in certain cases within the Eastern District of Louisiana. The United States Trustee participated as *amicus* in support of affirmance.

The bankruptcy court held that, due to systemic inaccuracies, Wells Fargo's claims no longer merited *prima facie* validity under Rule 3001(c) of the Federal Rules of Bankruptcy Procedure (the "Bankruptcy Rules"). The bankruptcy court ordered Wells Fargo to audit every proof of claim in a case pending in the district on or filed after April 13, 2007, to provide a complete loan history on every account, and to amend such claims when necessary. For closed cases, the court required Wells Fargo to provide a copy of the accounting to the debtor, debtor's counsel and the trustee.

On appeal, the district court rejected Wells Fargo's argument that the order to prospectively audit and amend claims unlawfully shifted the burden of proof because the Bankruptcy Code and Bankruptcy Rules create an entitlement of *prima facie* validity upon filing. The court concluded that it is the supporting documentation, and not the filing of the proof of claim in and of itself, that provides *prima facie* status. *Id*. at *7. Because the burden of proof ultimately rests with the claimant, and the claimant's inaccurate and inappropriate filings created a systemic threat, the district court determined that the bankruptcy court's remedy was "well within its authority, inherent and under section 105, to protect and manage its docket." *Id*. at *12.

The district court also ruled that the prospective remedy was a permissible exercise of the bankruptcy court's authority and that it was not necessary to find fraud or bad faith under section 105. *Id*. at *13. Distinguishing between the bankruptcy court's discretionary authority to enforce provisions of the Bankruptcy Code and its exercise of contempt powers under section 105, the district court found that the bankruptcy court was exercising its enforcement authority when it mandated that Wells Fargo comply with (1) the specified procedural and evidentiary requirements in order for a claim to receive *prima facie* status and (2) the existing, continuing, and affirmative duty to correct erroneous proofs of claims. *Id*. The district court also found that the authority for such a prophylactic remedy could be based in a bankruptcy court's inherent authority, statutory authority under section 105, or as civil contempt under section 105 and Rule 9011. *Id*. Alternatively, it held, even if the remedy were to be construed as injunctive relief, the systemic nature of the problem and the burden on both the court and other debtors satisfied the traditional four-part test for injunctive relief. *Id*. at *15.

Wells Fargo has appealed to the Court of Appeals for the Fifth Circuit. *In re Stewart*, No. 09-30832 (5th Cir. Sept. 14, 2009). The Program is participating in the appeal as *amicus*.

In re O'Neal, No. 08-5031, slip op. (Bankr. N.D. Ohio July 31, 2009). In one of the United States Trustees' adversary proceedings against Countrywide Home Loans, Inc. ("Countrywide"), the bankruptcy court imposed injunctive relief requiring Countrywide to file supplemental information for proofs of claim filed in the district. In ruling on the liability phase of the trial, the court found that Countrywide's conduct in filing a factually inaccurate proof of claim and objections to confirmation in the case "was not reasonable, was reckless and sanctionable pursuant to [11 U.S.C.] § 105 and Rule 9011." *Id*. at 22 (Bankr. N.D. Ohio May 1, 2009). The court concluded that Countrywide's voluntary efforts to improve its procedures were insufficient, and that the minimum sanction necessary to deter future misconduct was an injunction that requires Countrywide and its assigns to complete a four-page addendum providing additional explanation for the amounts claimed as due. In fashioning its remedy, the court concurred with the United States Trustee's argument that bankruptcy courts possess broad power to redress creditor abuse through equitable remedies. Countrywide has appealed this decision to the district court. *In re O'Neal*, No. 09-2106 (N.D. Ohio Sept. 11, 2009).

In re McKain, No. 08-10411, slip op., 2009 WL 2848988 (Bankr. E.D. La. May 1, 2009). The Program is participating as *amicus* before the district court in support of affirmance of the bankruptcy court's order imposing certain accounting procedures against Ocwen. The bankruptcy court documented six cases in which Ocwen had engaged in a pattern of abuse, and found that this pattern reflected an error rate of approximately 17%, or one in six files. The court found that Ocwen had engaged in a pattern of attempting to collect improper fees and charges in a proof of claim; attempted to collect fees and costs assessed post-discharge but not disclosed; and/or attempted to foreclose on debts that had been disallowed or discharged.

The bankruptcy court ruled that Ocwen's practice was in bad faith and its ongoing pattern imposed a burden on debtors and the court to monitor Ocwen's pleadings and claims. The court also found that Ocwen's continuing disregard for bankruptcy law and procedure clearly indicated that monetary sanctions were ineffective, and imposed certain accounting procedures. Among other things, the court required that Ocwen establish two new accounts upon the filing of a chapter 13 case: (a) the first contains the prepetition past due amounts, including interest, costs, charges and fees, to be paid under the debtor's plan by the chapter 13 trustee; and (b) the second reflects the principal amount due as of the petition date, plus postpetition interest, insurance, taxes or other court authorized charges, to be paid from the debtor's regular monthly note payments. The court also directed that Ocwen accrue but not assess or collect postpetition charges, fees or costs, except postpetition property insurance and taxes, which it may collect upon ten days' written notice to the debtor, debtor's attorney and the trustee; if Ocwen fails to comply with such notice for any given year of the case's administration, it will be prohibited from collecting or assessing any charges against the debtor for that year and shall treat the debtor as fully current at the time of discharge. Finally, the court required that upon the debtor's discharge, Ocwen must adjust its permanent records to reflect that the debtor is current. Ocwen has appealed this decision to the district court. *In re McKain*, No. 09-3662 (E.D. La. May 22, 2009).

C. MORTGAGE-RELATED FRAUD AND FORECLOSURE RESCUE FRAUD

As part of its civil enforcement efforts, the Program uses a variety of approaches to identify and go after mortgage-related fraud and foreclosure rescue fraud schemes that abuse the bankruptcy system at the expense of consumers. Through internal screening protocols, trustee referrals and other third-party contacts, possible schemes are identified and evaluated for appropriate civil enforcement action. Detection often involves heightened inquisitiveness and alertness. For example, bankruptcy documents that present an incomplete or confusing financial picture, debtors' statements suggesting they may be victims of a scheme, or creditors' claims that they were victimized by the debtor all may warrant further inquiry. Experience has shown that asking a few additional questions, requesting more information or investigating complaints can lead to finding and potentially stopping a mortgage-related fraud or mortgage rescue fraud scheme.

When apparent abuse is detected, the Program has a variety of civil enforcement options that may be appropriate to pursue. Motions and adversary proceedings pursuant to Bankruptcy Code sections 110, 526, 527 and 528 are brought against both disclosed and undisclosed petition preparers, seeking return of fees, damages, fines and injunctive relief. Civil contempt actions are pursued for violations of court orders or injunctions. Denial or revocation of discharge complaints under section 727 are filed against straw purchasers and scheme perpetrators based on concealment, false statements and inability to satisfactorily explain loss of assets. Actions such as section 329 motions relating to attorney compensation or requests for sanctions under Bankruptcy Rule 9011 are brought against lawyers who fail to disclose their relationships with petition preparers or are otherwise participants in a scheme. When the Program believes criminal conduct is involved, it makes a criminal referral to its law enforcement partners.

To aid in combating mortgage-related fraud, the Program has been working with the Federal Bureau of Investigation on an "intelligence assessment" entitled, *Mortgage Fraud: U.S. Bankruptcy Court System Exploited To Perpetrate Foreclosure Rescue Schemes*. A classified version of the intelligence assessment will be disseminated throughout the law enforcement and intelligence community. Additionally, an unclassified version will be available for sharing in the public domain via the Program and Federal Bureau of Investigation web sites, press releases, Congress, and industry and regulatory channels.

D. INTER-AGENCY AND MULTI-STATE COOPERATION ON BEHALF OF CONSUMERS

As part of its civil and criminal enforcement efforts, the Program also serves on several inter-agency working groups of national task forces such as the Financial Fraud Enforcement task force established by President Obama in November 2009. Led by Attorney General Eric Holder, the Task Force brings together civil and criminal resources at all levels of government to hold perpetrators of financial fraud accountable. The Program's participation on various national and local working groups further enhances the Program's ability to detect and fight schemes that utilize a federal court system as a tool in victimizing those in financial distress.

In 2009, the Department of Justice, Federal Trade Commission, the U.S. Treasury, and the Department of Housing and Urban Development pledged coordination of resources and efforts to maximize targeting and efficiency in fraud investigations, and to alert financial institutions to emerging schemes, step up enforcement actions, and educate consumers to help those in financial trouble avoid becoming the victims of a loan modification or foreclosure rescue scam.

In follow up to this initial pledge, the Department of Justice became part of a newly formed Joint State and Federal Mortgage Fraud Task Force, whose participants include the Federal Trade Commission, the United States Treasury, the Department of Housing and Urban Development, the Federal Bureau of Investigation, and attorneys general from fourteen different states. This task force will comprise three working groups: civil enforcement, criminal enforcement efforts, and data-sharing. The groups are in their nascent stages, but are convening to develop mission statements and objectives.

III. PRESUMED ABUSE UNDER SECTION 707(b)

Bankruptcy Code section 707(b)(1) provides that, after notice and a hearing, the court may dismiss a case filed by an individual whose debts are primarily consumer debts if it finds that granting relief would be an abuse of the provisions of chapter 7.

A. THE MEANS TEST

Bankruptcy Code section 707(b) provides a formula for the court to objectively assess the debtor's ability to pay his debts. "The means test is the embodiment of Congress' intent 'that there be an easily applied formula for determining when the Court should presume that a debtor is abusing the system by filing a Chapter 7 petition.'" *In re Henebury*, 361 B.R. 595, 603 (Bankr. S.D. Fla. 2007) (*citing In re Fowler*, 349 B.R. 414, 419 (Bankr. D. Del. 2006)).

The debtor's annualized "current monthly income" is compared to the "median family income" of a similarly sized family in the debtor's state. If the debtor's current monthly income is below the median, then the presumption of abuse does not arise. 11 U.S.C. § 707(b)(7); *see* H.R. Rep. 109-31(I) (2005), at 15, as reprinted in 2005 U.S.C.C.A.N. 88. Where the debtor's current monthly income exceeds the median family income, the means test is used to calculate the debtor's monthly disposable income. Under the means test, the debtor's current monthly income, reduced by certain prescribed living expenses, is multiplied by sixty. If that figure is greater than $10,950 (or $182.50 per month), the debtor's case is presumed abusive.[2]

Bankruptcy Code section 101(10A) defines "current monthly income" as the "average monthly income form all sources that the debtor receives . . . derived during the 6-month period" preceding the date of filing. 11 U.S.C. § 101(10A). Bankruptcy Code section 101(10A)(B) further defines current monthly income as "including any amount paid by an entity other than the debtor . . . on a regular basis for the household expenses of the debtor" but excludes, among other things, benefits received under the Social Security Act. 11 U.S.C. § 101(10A)(B). Bankruptcy courts disagree about whether unemployment compensation and veterans benefits are benefits received under the Social Security Act. In addition, courts have come to differing

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2 Bankruptcy Code section 104(a) provides for an automatic three year adjustment of dollar amounts. As of April 1, 2010, a debtor's case will be presumptively abusive if the difference between monthly income and living expenses, multiplied by sixty, is greater than $11,725 (or $195.42 per month).

results on income issues raised by retirement distributions, amounts paid by persons other than the debtor for household expenses, income tax withheld from paychecks, and funds returned as tax refunds.

In FY 2009, about 12 percent of all chapter 7 debtors were above their state median income, and about 10 percent of those were presumed abusive under the means test. United States Trustees declined to file motions to dismiss in about 55 percent of all presumed abuse cases that did not voluntarily convert or dismiss. This means that, in more than half of their presumed abuse cases, United States Trustees exercised their discretion and did not file an enforcement action. These declinations were often based on such factors as job loss, other economic calamity, or other changed circumstances.

The Program devotes substantial resources to collecting as much relevant information as possible before deciding whether to file a motion under Bankruptcy Code section 707(b). It does not seek to file improvident motions or to face surprises in bankruptcy court. It is therefore important for members of the consumer bar to promptly provide special circumstances information to United States Trustees. The provision of such information, if it is available, might justify a chapter 7 discharge, despite a finding of "presumed abuse."

United States Trustees have litigated and sought appellate review in several cases that will have a profound effect on the future of the means test. The circuits are now split on three key issues: (1) the definition of "projected disposable income;" (2) whether debtors may deduct phantom expenses for vehicles for which they have no lease or loan payment; and (3) whether debtors may deduct secured debt payments on property they surrender. On March 22, 2010, the Supreme Court will hear oral argument in *Hamilton v. Lanning*, in which the government, acting as *amicus*, will argue that courts may take into account the future financial circumstances of debtors in calculating projected disposable income in chapter 13. *Hamilton v. Lanning,* 545 F.3d 1269 (10th Cir. 2008), *cert. granted*, 130 S.Ct. 487 (U.S. Nov. 2, 2009) (No. 08-998). The Program worked with the Solicitor General on the case.

Three noteworthy means testing issues – the widely litigated vehicle ownership expenses issue, the secured debt expense issue, and the new National Guard and Reservists Debt Relief Act of 2008 – are highlighted below.

1. Vehicle Ownership Expenses

The IRS Transportation Standards divide transportation expenses into two components: a nationwide allowance for ownership costs and an allowance to cover the costs of operating one or two vehicles. The Operating Expense Standard provokes little debate, and very few cases directly address it. The Ownership Expense Standard generates new cases on an almost weekly basis. The issue of a debtor's entitlement to an ownership expense when a debtor has no loan or lease payment has been addressed by several circuits. The Court of Appeals for the Ninth Circuit prohibits debtors from claiming the standardized expense amount when debtors have no associated expense. *Ransom v. MBNA America Bank, N.A. (In re Ransom)*, 577 F.3d 1026 (9th Cir. 2009). However, the Court of Appeals for the Fifth, Seventh, and Eighth Circuits allow this expense. *In re Tate*, 571 F.3d 423 (5th Cir. 2009); *In re Ross-Tousey*, 549 F.3d 1148 (7th Cir. 2008); *Babin v. Washburn (In re Washburn)*, 579 F.3d 934 (8th Cir. 2009).

2. Secured Debt Expenses

Bankruptcy Code section 707(b)(2)(A)(iii) contemplates that only future expenses will be used to determine whether a debtor will have sufficient income going forward. In relevant part, the statute provides: "[t]he debtor's average monthly payments on account of secured debts shall be calculated as the sum of . . . the total of all amounts scheduled as contractually due to secured creditors in each month of the 60 months following the date of the petition." 11 U.S.C. § 707(b)(2)(A)(iii). The Program has set forth the position that Bankruptcy Code section 707(b)(2)(A)(iii) independently prohibits debtors from subtracting payments for collateral they are surrendering in calculating the means test. Specifically, the Program has litigated that Bankruptcy Code section 707(b)(2)(A)(iii) is best interpreted as prohibiting debtors from claiming secured debt expenses they will never pay. This reading is consistent with the plain language of the statute, which contemplates that only future expenses will be used to determine whether a debtor's case is presumptively abusive. This reading is also consistent with Congress' stated intent, in enacting the 2005 Act, that debtors "repay creditors the maximum they can afford." H.R. Rep. No. 109-31(I), at 1. Thus far, at the circuit level, the Court of Appeals for the First Circuit has ruled chapter 7 debtors can claim secured debt expenses when payments on the debt remain contractually due and owing at the time the petition is filed – even if they intend to surrender the collateral. *See Morse v. Rudler (In re Rudler)*, 576 F.3d 37 (1st Cir. 2009). In comparison, the Court of Appeals for the Seventh Circuit has ruled chapter 13 debtors may not claim the expense if they are surrendering the collateral. *In re Turner*, 574 F.3d 349 (7th Cir. 2009).

3. National Guard and Reservists Debt Relief Act of 2008

A new exception to the means test is the National Guard and Reservists Debt Relief Act of 2008, which amends section 707(b)(2)(D) of the Bankruptcy Code, and took effect on December 19, 2008. *See* Pub. L. No. 110-438. It exempts qualifying reservists of the Armed Forces and members of the National Guard who are called to active duty for at least 90 days, or who perform homeland defense activity for at least 90 days, from all forms of means testing during the time of active duty or homeland defense activity, and for a 540-day period thereafter. The new exclusion is temporary and applies only to cases commenced during the three year period beginning on December 19, 2008. Interim Rule 1007-I and Official Form 22A implement this amendment to Bankruptcy Code section 707(b). According to Program records, the exemption has been invoked approximately 200 times since enactment of the new exclusion.

IV. DISMISSAL UNDER 707(b) WITHOUT PRESUMPTION OF ABUSE

Bankruptcy Code section 707(b)(3) provides that, in considering whether granting relief would be an abuse in a case in which the presumption of abuse does not arise or is rebutted, the court shall consider whether the debtor filed the petition in bad faith or whether the totality of the circumstances of the debtor's financial situation demonstrates abuse.

It is important to recognize that BAPCPA lowered the standard for dismissal under Bankruptcy Code section 707(b) from "substantial abuse" to "abuse." *See* 11 U.S.C. §§ 707(b)(1) and 707(b)(3)(B) (each referencing "abuse" as the threshold, not "substantial abuse"). *See also Rudler*, 576 F. 3d at 40.

A. BAD FAITH

BAPCPA created a new basis for dismissal under Bankruptcy Code section 707(b)(3)(A) when it created the "bad faith" provision. It required a finding that a chapter 7 petition was filed in "bad faith." Whle few published decisions have addressed this alternative basis for dismissal under Bankruptcy Code section 707(b)(3), the following represents a selection of those courts that have addressed the issue:

In re Hageney**,** – B.R. –, 2009 WL 5217674, at *4 (Bankr. E.D. Wash. Dec. 31, 2009) ("Bad faith may involve a dishonest debtor or nefarious acts, but such motivation or intent is not necessary. Bad faith exists if the filing of the bankruptcy was for a purpose not consistent with the Bankruptcy Code or policy even though the purpose may otherwise be lawful.").

In re Victoria, 389 B.R. 250, 257 (Bankr. M.D.Ala. 2008) ("We have got the debtor who is a doctor, who has income of nearly two hundred thousand a year, who is married, who shares a home and a household with her husband who is also a doctor who also makes approximately two hundred thousand dollars per year. So we have got a debtor household here with household annual income of between three hundred and fifty and four hundred thousand dollars per year. It would appear to be a poster-child case for substantial abuse . . . I have gotten a real sense that the debtor is playing hide-the-ball and being uncooperative, and that's certainly a factor in my view.").

In re Adams, No. 06-16027, 2007 WL 3091583, at *5 (Bankr. D. Md. Oct. 19, 2007) ("The Court holds that residing in a $1.3 million dollar residence, driving a luxury car with lease payments of $1,225 a month, and otherwise not conforming to a reasonable budget while filing a Chapter 7 bankruptcy case to support such a lavish lifestyle on the backs of creditors amounts to bad faith.").

In re Richie, 353 B.R. 569, 580 (Bankr. E.D. Wis. 2006) ("The Court finds that a debtor's failure to seek any but very limited – possibly non-existent – employment, and thus her failure to make a real attempt to pay something to her creditors before seeking discharge of her debts, is not behavior that treats her creditors fairly. It is not behavior that indicates that the debtor has tried her best to repay her debts before throwing in the towel and seeking Chapter 7 discharge as a last resort . . . it smacks a bit of bad faith for a debtor to seek full discharge of all of her debts without making some effort to find employment that would enable her to repay a portion of those debts.").

B. ABILITY TO PAY

As discussed, BAPCPA created a two-step financial analysis for determining if a chapter 7 petition should be dismissed. The first is the objective calculation under Bankruptcy Code section 707(b)(2), known as the "means test." The second is a subjective analysis under Bankruptcy Code section 707(b)(3). The plain language of the statute demonstrates that these subsections perform two distinct functions in determining whether a debtor is eligible for a discharge.

The means test, namely the calculations mandated by Bankruptcy Code 707(b)(2)(A)(i)-(iv), reflects congressional intent that there be an "easily applied formula" to create a presumption of abuse. *In re Henebury*, 361 B.R. 595, 602-603 (Bankr. S.D. Fla. 2007). "Passing the means test" merely means that the court will not "presume abuse exists;" it is not a determination that the debtor is entitled to relief under chapter 7. 11 U.S.C. § 707(b)(2)(A)(i); *In re Lenton*, 358 B.R. 651, 660-61 (Bankr. E.D. Pa. 2006); *In re Booker*, 399 B.R. 662, 666 (Bankr. W.D. Mo. 2009) (stating that the results of the "means test" are "not dispositive").

The means test does more than identify abusive chapter 7 debtors. *In re Fowler*, 349 B.R. 414, 420 (Bankr. D. Del. 2006). It also establishes the burden of proof between the debtor and the moving party, usually the United States Trustee. *Lenton*, 358 B.R. at 660. If the debtor passes the means test, then the United States Trustee has the burden of proof to show abuse. *In re Parada*, 391 B.R. at 496. In contrast, debtors who fail the means test must show that a special circumstance exists that would make them eligible for chapter 7 relief. 11 U.S.C. § 707(b)(2)(B)(I). Any argument that the means test and Bankruptcy Code section 707(b)(3) duplicate each other is therefore incorrect.

Instead, the "developing body of case law" confirms a relationship between the means test and Bankruptcy Code section 707(b)(3)(B) that amounts to an objective evaluation of a debtor's financial circumstances followed by a more subjective, flexible consideration of whether discharge is appropriate considering those financial circumstances. *In re McGillis*, 370 B.R. 720, 747 (Bankr. W.D. Mich. 2007). The means test is an objective application to determine only whether there is a presumption of abuse. *In re Rudler*, 576 F.3d at 51. It is not meant to be conclusive or comprehensive analysis of whether granting the debtor relief would be an abuse of chapter 7. Toward that end, Congress formulated Bankruptcy Code section 707(b)(3)(B) to be a subjective look at the totality of the debtor's financial circumstances. *In re Krohn*, 886 F.2d 123, 126-27 (6th Cir. 1989) (broad-ranging analysis).[1]

The majority of courts have rejected the argument that the means test replaces the ability-to-pay analysis mandated in Bankruptcy Code section 707(b)(3)(B). *In re Ross-Tousey*, 549 F.3d 1148, 1161-62 (7th Cir. 2008) (post-2005 ruling that passing the means test does not foreclose a

[1] Similarly, section 707(b)(3)(A) permits the court to look into whether the debtor filed the petition in bad faith.

Bankruptcy Code 707)(b)(3)(B) analysis); *In re Crink*, 402 B.R. 159, 168-69 (M.D.N.C. 2009) (citing 13 cases). First, the statute mandates that the court "shall" consider a debtor's financial condition and circumstances if the presumption of abuse does not arise from the means test. 11 U.S.C. § 707(b)(3); *Reed v. Anderson (In re Reed)*, – B.R. –, 2009 WL 5227840, at *21 (C.D. Cal. Nov. 24, 2009). If Congress had intended that the means test foreclose further consideration of ability to pay, it would not have required further analysis of petitions which passed that test. Instead, "a court must consider a debtor's actual debt-paying ability in ruling on a motion to dismiss based on abuse where the presumption does not arise or is rebutted." *In re Mestemaker*, 359 B.R. 849, 854-55 (Bankr. N.D. Ohio 2007); *Parada*, 391 B.R. at 498, n.4 (stating that analysis under Bankruptcy Code 707(b)(3)(B) "unambiguously presupposes that the debtor has 'passed' the means test"); *Lenton,* 358 B.R. at 663 (stating that if Congress had intended to eliminate consideration of ability to pay, "it would have done so expressly or by explicit references to § 707(b)(2)(A)"). Notably, in 2007, the Court of Appeals for the Seventh Circuit ruled that Bankruptcy Code section 707(b)(3)(B) applies to debtors who pass the means test. *Ross-Tousey*, 549 F.3d at 1161-62. Also, "there is overwhelming support for consideration of this factor [ability to pay] within an analysis of the totality of the circumstances." *In re Hoffman*, 413 F.191, 194 (M.D. Pa. 2008) (citing cases).

"Under a subjective approach, the Court is not required to accept, at face value, the financial figures put forth by [debtors] when assessing their ability to re pay their debts." *In re Kaminski*, 387 B.R. 190, 195 (Bankr. N.D. Ohio 2008). "Rather, 'in its role as the trier-of -fact, the Court is under a duty to scrutinize a debtor's expenses, and make downward adjustments where necessary, so as to ensure that the debtor's expenses are reasonable.'" *In re Felske*, 385 B.R. 649, 655 (Bankr. N.D. Ohio 2008) (*citing In re Gonzalez*, 378 B.R. 168, 173 (Bankr. N.D. Ohio 2007)). "Similarly, when determining a debtor's 'disposable income, a court may impute income to the debtor when it would be equitable to do so- *e.g.,* when the debtor is voluntarily underemployed." *Gonzalez* at 173.

The Program is currently litigating the scope of Bankruptcy Code section 707(b)(3)(B) before the Court of Appeals for the Fourth Circuit. *See In re Calhoun*, No. 09-1646 (4th Cir. Aug. 8, 2009).

1. Postpetition Increase in Income

In a decision interpreting pre-BAPCPA Bankruptcy Code section 707(b), the Court of Appeals for the Fifth Circuit concluded that Bankruptcy Code section 707(b) is forward looking and that, in considering a debtor's ability to pay for purposes of a substantial abuse analysis, post-petition improvements in income should be taken into account up until the date of discharge. *In re Cortez*, 457 F.3d 448 (5th Cir. 2006). The Fifth Circuit found support for its decision in statutory language in Bankruptcy Code section 707(b), case law decided under Bankruptcy Code section 707(b), and the official forms of the bankruptcy court.

2. Excessive Housing

"In assessing a debtor's ability to pay, all debtors are entitled to expense against their income those costs associated with maintaining adequate shelter." *In re Kaminski*, 387 B.R. at 195. The difference between a reasonable and an excessive housing expense includes consideration of such factors as a debtor's family size, income level, location and any special needs of the debtor. *Id.*

3. Excessive Spending Practices

Spending on normal household expenses must be considered in an analysis under Bankruptcy Code section 707(b)(3). For instance, the court may consider whether the debtor has made any efforts to moderate family spending. *In re Wolf*, 390 B.R. 825, 832 (Bankr. D.S.C. 2008) ("The family has engaged in no effort to moderate spending or to tighten the family financial belt. This factor weighs against Debtor."); *In re Schubert*, 384 B.R. 777, 781 (Bankr. S.D. Ohio 2008) ("[I]t is elemental that a reduced income for an extended period of time requires a change in lifestyle.").

4. Support of Adult Children

"The Court is not implying that supporting college-age children is not admirable when parents have the means to do so. However, the Court agrees with its learned colleagues that supporting adult children at the expense of unsecured creditors is not permissible." *In re Walker*, 383 B.R. 830, 838 (Bankr. N.D. Ga. 2008).

5. 401K Contributions and Loan Payments

Although BAPCPA amended Bankruptcy Code section 1322(f) to permit chapter 13 debtors to exclude retirement loan repayments from disposable income, Congress declined to extend this protection to chapter 7 debtors. The Bankruptcy Code contains no language permitting debtors to exclude 401(k) loan repayments from their disposable income. *Eisen v. Thompson*, 370 B.R. 762 (N.D. Ohio 2007). To the contrary, the plain language of Bankruptcy Code section 707(b)(3)(B) mandates that courts evaluate the totality of a debtor's financial situation when determining whether to dismiss the case under Bankruptcy Code section 707(b)(3)(B). Voluntary 401(k) contributions that are not necessary for the maintenance and support of the debtors or their dependents – as determined by the facts specific to a particular case – should be included as disposable income for purposes of determining their ability to pay their creditors out of future earnings. *In re Behlke,* 358 F.3d 429 (6th Cir. 2004); s*ee also Egebjerg v. Anderson (In re Egebjerg)*, 574 F.3d 1045, 1051-52 (9th Cir. 2009) (disallowing claimed 401(k) expenses under Bankruptcy Code section 707(b)(2)(a)(3)).

V. OBJECTIONS TO DISCHARGE

A. SECTION 727(a)(2)

"Section 727(a)(2) prevents the discharge of a debtor 'who attempts to avoid payment to creditors by concealing or otherwise disposing of assets.'" *In re Coady*, No. 05-38130, 2008 WL 2995162, at 3 (Bankr. S.D. Fla. Aug. 1, 2008) (*citing Menotte v. Davis*, 363 B.R. 614 (Bankr. M.D. Fla. 2006)). A cause of action arising under Bankruptcy Code section 727(a)(2) has two elements: (1) a transfer or concealment of property of the debtor or property of the estate, and (2) a subjective intent to hinder, delay, or defraud a creditor or the trustee. 11 U.S.C. § 707(a)(2). The plaintiff bears the burden of establishing the debtor's actual intent to defraud at the time of the transfer of concealment.

Actual intent may be inferred from the circumstances surrounding the transfer or concealment. *In re Dulock*, 250 B.R. 147 (Bankr. N.D. Ga. 2000). "Badges of fraud" include: (1) lack or inadequacy of consideration; (2) family, friendship, or other close association or relationship between the parties; (3) the debtor's retention of possession, benefit, or use of the property in question; (4) the financial condition of the debtor before and after the transaction; (5) the existence or cumulative effect of any pattern or series of transactions or course of conduct after the incurring of debt, onset of financial difficulties, or pendency or threat of suits by creditors; and (6) the general chronology of the events and transactions under inquiry. *In re Cutts*, 233 B.R. 563, 570 (Bankr. M.D. Ga. 1999).

Some courts have found that Bankruptcy Code section 521(4) places an affirmative duty on debtors to surrender to the trustee all property of the estate. For example, in *In re Letlow*, 385 B.R. 782, 798 (Bankr. N.D. Ga. 2007), the plaintiff, a former business partner of the debtor, proved that the debtor delayed turning over funds to the trustee that the debtor unequivocally knew belonged to the estate. The debtor used property of the estate that he had not claimed as exempt to pay personal expenses and liquidated estate property without court approval. The debtor's conduct evidenced his intent to hinder and delay the case trustee in collecting and liquidating property of the estate. The court found that the debtor's delay in turning over estate property to the case trustee based on the debtor's false theories of ownership or based on what may have been nothing more than a hope that the trustee would lose interest supported the denial of discharge.

B. SECTION 727(a)(3)

Bankruptcy Code section 727(a)(3) does not require a showing of fraudulent intent. Instead, a debtor may be denied a discharge, pursuant to 727(a)(3), merely for failure to keep or preserve books and records from which the debtor's financial situation may be ascertained, unless the failure is justified under all the circumstances of the case. *In re Ghere*, 393 B.R. 209, 319 (Bankr. W.D. Mo. 2008). The chapter 7 trustee and United States Trustee are not required to speculate as to the debtor's financial history or condition, nor are they required to reconstruct the debtor's financial records and affairs. *Matter of Juzwiak*, 89 F.3d 424, 428 (7th Cir. 1996).

Bankruptcy Code section 727(a)(3) requires the debtor to produce, when called upon, written information concerning his business and financial affairs that helps trace the accurate and useful financial history of the debtor during the period preceding his bankruptcy. "Records are adequate when they are kept 'so as to reflect, with a fair degree of accuracy, the debtor's financial condition and in a manner appropriate to his business.'" *In the Matter of Watson*, 122 B.R. 476, 480 (Bankr. M.D. Ga. 1990) (*citing* 4 Collier on Bankruptcy, ¶727.03[3] (15th Ed. 1983)). "Documents produced by a debtor must be more than merely voluminous. '[The documents] must assist the Court and the creditors in determining what the Debtor's financial condition was as of the Petition Date, and for the recent period prior to the Petition Date.'" *In re Ghere*, 393 B.R. at 220 (*citing In re Shah*, 388 B.R. 23, 35 (Bankr. E.D.N.Y. 2008)). In determining whether the debtor failed to maintain adequate records, the court considers the sophistication of the debtor, his business experience, and other relevant factors. *In the Matter of Watson*, 122 B.R. at 480.

In considering the loss of computer records, one court has stated: "While it is a common occurrence for computers to crash and records to be lost, that fact does not excuse the Defendant from retaining backup files and/or hard copies, nor does it provide him with a convenient excuse from providing those records." *In re Debusk*, No. 07-32718, 2008 WL 3904448, *6 (Bankr. E.D. Tenn. Aug. 19, 2008).

C. SECTION 727(a)(4)

"The veracity of the bankrupt's statements is essential to the successful administration of the Bankruptcy Act." *In re Chalik*, 748 F.2d 616 (11th Cir. 1984) (citing *Diorio v. Kreisler-Borg Const. Co.*, 407 F.2d 1330, 1331 (2d 1969). Moreover, debtors have a duty to disclose changes in their financial situation. *Burnes v. Pemco Aeroplex, Inc.*, 291 F.3d 1282, 1286 (11th Cir. 2002). Accordingly, when a debtor knowingly or with reckless disregard for the truth files statements or schedules containing incomplete or false information, the court should deny his discharge pursuant to Bankruptcy Code section 727(a)(4).

A debtor seeking shelter under the bankruptcy must disclose all assets, or potential assets, to the court. 11 U.S.C. §§ 521(1) and 541(a)(7). The duty to disclose is a continuing one that does not end once the forms are submitted to the court; rather, a debtor must amend his financial statements if circumstances change. *See In re Coastal Plains*, 179 F.3d 197, 208 (5th Cir. 1999). Full and honest disclosure in a bankruptcy case is "crucial to the effective functioning of the federal bankruptcy system." *Ryan Operations G.P. v. Santiam-Midwest Lumber Co. et al.*, 81 F.3d 355, 362 (3d Cir. 1996).

To justify denial of discharge under Bankruptcy Code section 727(a)(4), the false oath must be fraudulent and material. *Swicegood v. Ginn*, 924 F.2d 230, 232 (11th Cir. 1991). As stated by one court:

> The subject matter of a false oath is "material," and thus sufficient to bar discharge, if it bears a relationship to the bankrupt's business transactions or estate, or concerns the discovery of assets, business dealings, or the existence and disposition of his property...The recalcitrant debtor may not escape a section 727(a)(4) denial of discharge by asserting that the admittedly omitted or falsely stated information concerned a worthless business relationship or

> holding; such a defense is specious...It makes no difference that he does not intend to injure his creditors when he makes a false statement. Creditors are entitled to judge for themselves what will benefit, and what will prejudice, them.

In re Chalik, 748 F.2d at 618 (citations omitted).

"[A] demonstration that a misstatement is material is insufficient in and of itself to deny a discharge. The misstatement or omission much be made with the requisite fraudulent intent, and the size of the error may bear on whether intent exists." *In re Parnes*, 200 B.R. 710, 714 (Bankr. N.D. Ga. 1996). The filing of an amendment to include an omitted asset in response to a creditor's objection will support a finding that the asset was deliberately omitted. However, the court may consider the debtor's explanation when deciding whether the debtor made a *bona fide* effort to value his assets when preparing the original schedules. *Id*.

Most cases turn on the court's observation of the debtor's demeanor, consideration of her testimony regarding her knowledge and understanding of the matters under inquiry, and assessment of her credibility. *Compare In re Cutts*, 233 B.R. at 563, *with In re Horton*, 252 B.R. 245 (Bankr. S.D. Ga. 2000).

D. SECTION 727(a)(5)

Bankruptcy Code section 727(a)(5) provides the basis for denying a discharge to a debtor who has failed to explain satisfactorily any loss of assets or deficiency of assets to meet the debtor's liabilities. "By penalizing a debtor who is insufficiently forthcoming about what happened to his assets, [section 727(a)(5)] is one of several Code provisions meant to 'relieve [ ] creditors and courts of the full burden of reconstructing the debtor's financial history and condition, placing it instead upon the debtor.'" *In re Debusk*, 2008 WL 3904448, at *8, n.4 (citing *In re Cohen v. Olbur*, 314 B.R. 732, 740 (Bankr. N.D. Ill. 2004) (quoting *First Commercial Fin. Group, Inc. v. Hermanson*, 273 B.R. 538, 545 (Bankr. N.D. Ill. 2002)).

Bankruptcy Code section 727(a)(5) does not contain an intent element, and what constitutes a "satisfactory" explanation is left to the discretion of the court. *In re Huynh*, 392 B.R. 802, 813 (Bankr. D. N.D. 2008). "For a debtor's explanation to be satisfactory, it must 'convince the judge that the debtor has not hidden or improperly shielded assets . . . . General assertions that money was spent on living expenses or lost through gambling, without documentation, are unacceptable.'" *Id.* (citing *Carter Eng'g Co. v. Carter*, 236 B.R. 173, 180 (Bankr. E.D. Pa. 1999)).

It is worth noting that uncorroborated gambling losses will not fend off denial of discharge under Bankruptcy Code section 727(a)(5). *See, e.g.*, *In re Huynh*, 379 B.R. 865 (Bankr. D. Minn. 2008) ("[T]he defendant has not presented any significant corroborating evidence to her claims in this preceding either. We know that the defendant gambled in the summer of 2005. Credit card statements reveal a number of modest ATM cash withdrawals in or near casinos, and two witnesses testified that they saw her occasionally at one or another casino. But, these facts fall far short of an explanation of losses of more than $300,000 to addictive gambling. In the end, we are essentially asked to take the defendant's word and nothing more as an adequate explanation. That is not sufficient.").

VI. ATTORNEY ISSUES

Bankruptcy Code section 329(a) provides that an attorney representing a debtor submit to the court a statement of compensation paid or agreed to be paid during the year prior to the commencement of the bankruptcy case for services rendered or to be rendered in contemplation or in connection with the case. Under Bankruptcy Code section 329(b), if a court determines that the compensation exceeds the reasonable value of services rendered, the court can cancel the agreement or order the return of funds paid in excess of services rendered.

In one recent illustrative case in which the United States Trustee was a party, the Bankruptcy Appellate Panel for the Ninth Circuit Court of Appeals affirmed the bankruptcy court's order that the debtor's attorney disgorge $8,850 in attorney's fees for services in two sequentially-filed chapter 11 bankruptcies. *Lawrence v. United States Trustee (In re Windman)*, No. 08-1080 (B.A.P. 9th Cir. Nov. 18, 2009). The first bankruptcy case was dismissed because the debtors did not obtain credit counseling. After the bankruptcy court dismissed for failure to comply with credit counseling requirements of the Bankruptcy Code and for bad faith, the United States Trustee brought and won a motion for disgorgement pursuant to 11 U.S.C. § 329.

On appeal, the appellate panel held that the record supported the bankruptcy court's findings regarding the value of the attorney's services and that the disgorgement order was not rendered moot because the debtors had paid the entirety of the sanctions fee, noting that the disgorgement order was based on the value of the attorney's services. The appellate panel rejected the appellant's argument that the bankruptcy court lacked "arising under" jurisdiction when ordering the disgorgement relating to the first, closed bankruptcy case during a hearing held in the second bankruptcy case. The appellate panel stated that the bankruptcy court's "arising under" jurisdiction depends on the existence of a proceeding arising under title 11, not the status of a case, and was therefore proper because the United States Trustee had sought sanctions under § 329. The appellate panel held that the bankruptcy court did not commit reversible error by ordering disgorgement in the first case without formally re-opening that case, reasoning that even if it were required, any error was harmless because (1) the parties, judge, creditors, and attorney were all the same and (2) that no rights of any party in interest were materially infringed by not reopening the case with notice to all creditors.

VII. CONCLUSION

The discussion presented here highlights only some of the many consumer-related areas the Program prioritizes in its local and national efforts fulfill its mission to enhance the integrity and efficiency of the bankruptcy system.