

TUCKER | HESTER, LLC

**IN RE PEDIGO:
Bad Faith Filing of a Chapter 7 as Grounds for Dismissal Under §707(A)
in the Southern District of Indiana**

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A CLE Presentation

By: William J. Tucker*
Attorney at Law
bill@tucker-hester.com

Tucker | Hester, LLC
www.tucker-hester.com

Pennsylvania Center, Suite 100
429 North Pennsylvania Street
Indianapolis, IN 46204-1816

317.833.3030 | 317.833.3031 [fax]

*Also written by: Jeffrey M. Hester

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INTRODUCTION

In In re: Pedigo, 296 B.R. 485 (S.D. Ind. 2003), on the United States Trustee's motion to dismiss under §707(a), Judge Lorch held that a debtor's "bad faith" in filing for relief under Chapter 7 does not constitute "cause" for dismissal, §707(a) does not subsume §707(b)'s concept of "substantial abuse" as it applies to a debtor whose debts are primarily business debts, and Pedigo's debts were primarily business, so §707(b) is inapplicable. The motion to dismiss was denied. The United States Trustee then appealed the decision to the District Court on the issue of whether under §707(a) "cause" for dismissal includes "bad faith". At the District Court level Judge Barker reversed and remanded the matter on January 12, 2005. She held consistent with a majority of Courts that "bad faith" constitutes "cause" for purposes of §707(a). The case is currently on appeal to the Seventh Circuit Court of Appeals.

THE BANKRUPTCY COURT DECISION

The United States Trustee pursued three theories of dismissal, all address by Judge Lorch in his decision, published at In re: Roy G. Pedigo, 296 B.R. 485 (S.D. Ind. 2003). The first theory was that "cause" under §707(a) includes "bad faith" filing. According to the United States Trustee, debtor Roy G. Pedigo filed his Chapter 7 bankruptcy in bad faith because he filed in order to defeat the collection efforts of one creditor while maximizing his equity in exempt property (by continuing to pay down his mortgages), he had six vehicles, he had newly acquired property, and he had a suspect obligation claimed as a business debt to his mother-in-law for \$91,000. Because of this bad faith, the United States Trustee reasoned that Pedigo's Chapter 7 should be dismissed. Pedigo's debt was primarily business related, so §707(b), which allows dismissal for "substantial abuse" only where the debts are "primarily consumer debts" would not provide a successful basis to argue for dismissal. Thus it appears from the opinion that the United States Trustee argued that assuming Pedigo's debts are primarily business, then his bankruptcy is still a "substantial abuse" and that should be cause under §707(a). Section 707 states:

(a) The court may dismiss a case under this chapter only after notice and a hearing and only for cause, including--

- (1)** unreasonable delay by the debtor that is prejudicial to creditors;
- (2)** nonpayment of any fees or charges required under chapter 123 of title 28; and
- (3)** failure of the debtor in a voluntary case to file, within fifteen days or such additional time as the court may allow after the filing of the petition commencing such case, the information required by paragraph (1) of section 521, but only on a motion by the United States trustee.

(b) After notice and a hearing, the court, on its own motion or on a motion by the United States trustee, but not at the request or suggestion of any party in interest, 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 a substantial abuse of the provisions of this chapter. There shall be a presumption in favor of granting the relief requested by the debtor. In making a determination whether to dismiss a case under this section, the court may not take into consideration whether a debtor has made, or continues to make, charitable contributions (that meet the definition of "charitable contribution" under section 548(d)(3)) to any qualified religious or charitable entity or organization (as that term is defined in section 548(d)(4)).

Judge Lorch held that "bad faith" does not constitute "cause" for dismissal under §707(a) and §707(a) does not subsume §707(b)'s concept of substantial abuse. In reaching his conclusions, he analyses the language of the statute itself, reviews the statutory history of §707 and critically examines prior persuasive case law.

In applying rules of statutory construction, Judge Lorch reasons that §707(a)'s examples of "cause" are of a technical or procedural nature, therefore "it seems logical to conclude that Congress drafted this provision to enforce the technical and procedural requirements of Chapter 7." He also reasons that if cause under §707(a) can be "substantial abuse" then subsection (a) of §707 will subsume subsection (b), and make it superfluous—something he is unwilling to do.

When looking at the legislative history of §707, it seems pretty clear to Judge Lorch that §707(a) does not include a means test.

... These causes are not exhaustive, but merely illustrative. The section does not contemplate, however, that the ability of the debtor to repay his debts in whole or in part constitutes adequate cause for dismissal. To permit dismissal on that ground would be to enact a non-uniform mandatory chapter 13, in lieu of the remedy of bankruptcy. Senate Report No. 95-989.

It also seemed clear to Judge Lorch that §707 does not anywhere mention "good faith", which Congress knew how to do in drafting bankruptcy statutes. See §§ 1129(a)(3), 1225(a)(3), and 1325(a)(3).

Lastly, he draws fault with the Courts that conclude §707(a) "cause" includes "bad faith" filing. While noting that the majority position holds that "bad faith" filing constitutes "cause" under §707(a), he believes that Courts have overlooked the statutory history which does not include a means test and Courts draw unwarranted parallels to good faith requirements of the debtor in Chapters 11, 12 and 13. Unwarranted because debtors in those chapters will have an ongoing relationship with creditors under reorganization plans, whereas liquidation under Chapter 7 contemplates no such ongoing relationship, hence no need for the good faith.

Having found that §707(a) "cause" is not "bad faith", and having found that "cause" under §707(a) does not include "substantial abuse", the motion to dismiss under §707(a) is denied. The motion is also denied under §707(b) because Judge Lorch finds that the majority of Pedigo's debt is business debt.

THE DISTRICT COURT DECISION

The United States Trustee then appeals the bankruptcy court decision to the district court on the sole issue of whether "cause" under §707(a) is "bad faith" filing. With the majority position behind him, the United States Trustee finds a welcome ally in Judge Barker.

Judge Barker cites to numerous persuasive decisions which find that "cause" under §707(a) includes "bad faith" (or lack of good faith). *In re Tamecki*, 229 F.3d 205, 207 (3rd Cir. 2000); *In re Zick*, 931 F.2d 1124, 1127 (6th Cir. 1991); *McDow v. Smith*, 295 B.R. 69, 75 (E.D. Va. 2003); *In re American Telecom Corp.*, 304 B.R. 867, 869 (Bankr. N.D. Ill. 2004); *In re Horan*, 304 B.R. 42, 46 (Bankr.D. Conn. 2004); *In re Carbaugh*, 299 B.R. 395, 397-98 (Bankr. N.D. Tex. 2003); *In re Blumenberg*, 263 B.R. 704, 716 (Bankr. E.D.N.Y. 2001); and *In re Mastromarino*, 197 B.R. 171 (Bankr. D. Me. 1996). She then notes that although no decision exists at the Seventh Circuit Court of Appeals level on whether "cause" under §707(a) is "bad faith", she notes that it has addressed on a number of occasions a similar provision under Chapter 13.

Section 1307 is the dismissal section under Chapter 13 similar to §707 under Chapter 7. Section 1307 cites examples of cause for dismissal of a Chapter 13 and it also does not list bad faith. Despite this, the Seventh Circuit Court of Appeals has held that "bad faith" constitutes "cause" under §1307, citing *In re Smith*, 286 F.3d 461, 465 (7th Cir. 2002). And since the Seventh Circuit reads bad faith into §1307, Judge Barker reasons that it should also be read into its analogous section in §707. Judge Barker notes that, importantly, the Seventh Circuit decision finding "bad faith" constitutes "cause" was based only on §1307 and not on §1325, which requires that a plan be filed in good faith.

HOW THIS ISSUE IS EFFECTED BY THE NEW BANKRUPTCY ACT

Under the new §707(b)(3) if the debtor files his or her petition in bad faith or if the totality of the debtor's financial circumstances indicates abuse, there is grounds for dismissal. The United States Trustee, bankruptcy administrator or judge can assert this basis for finding abuse in any case; creditors and case trustees are limited to asserting it in cases where the debtor's income is above the defined state median, under the new means test (for determining whether the debtor should be in a Chapter 13). The new §707(b)(3) reads:

- (3) In considering under paragraph (1) whether the granting of relief would be an abuse of the provisions of this chapter in a case in which the presumption in subparagraph (A)(i) of such paragraph does not arise or is rebutted, the court shall consider--
 - (A) whether the debtor filed the petition in bad faith; or
 - (B) the totality of the circumstances (including whether the debtor seeks to reject a personal services contract and the financial need for such rejection as sought by the debtor) of the debtor's financial situation demonstrates abuse.

The issue in Pedigo on appeal concerns §707(a) and whether "cause" under §707(a) includes "bad faith". Presumably the legal issue of whether "cause" under §707(a) can be §707(b)'s concept of "substantial abuse" was not taken up on appeal and that issue is at least settled with Judge Lorch.

The new bankruptcy act says "substantial abuse" leading to dismissal under §707(b) is where a petition is filed in "bad faith" or when the totality of circumstances of the debtor's financial situation demonstrates abuse. However, §707(b) still only applies to consumer debtors, not business debtors.

With respect to an individual who files a chapter 7, who is a business debtor (a debtor whose debts are primarily business debts), if Judge Barker is upheld on appeal, then a motion to dismiss for "bad faith" filing can be filed under §707(a). Section 707(b) would not apply. If Judge Barker's decision is overturned, then an individual with business debts would not be subject to §707(b) "substantial abuse" or "bad faith" under §707(a).