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Implications Of In Re Rahim

Law360, New York (February 7, 2011) -- On Dec. 16, 2010, the Bankruptcy Court for the Eastern District of Michigan weighed in on an issue plaguing bankruptcy practitioners since the inception of the Bankruptcy Abuse Prevention and Consumer Protection Act in 2005 and the implementation of the means test: Can the court dismiss a bankruptcy petition of a debtor whose debts are primarily nonconsumer (and therefore not subject to the means test) under 11 U.S.C. §707(a)[1] for cause?[2]

Prior to this decision, it was clear that a debtor's bankruptcy could be dismissed for not "passing" the means test, but the means test only applied to a debtor whose debts were consumer debts. Therefore, it was unclear what recourse a creditor would have against a Chapter 7 debtor who had filed in bad faith but whose debts were primarily nonconsumer. Could the debtor's case be dismissed for "cause" under §707(a)? This court answered "yes."

In this case, the court made it clear that the "egregious" facts present clearly warranted dismissal. Id. at *3. Two of the debtors' largest creditors filed motions to dismiss their bankruptcy for cause under §707(a).[3] The Chapter 7 debtors, who were both doctors, sought to discharge debts from their failed business ventures while maintaining an extravagant lifestyle.

The court ordered an evidentiary hearing and ultimately held that, even though the debtors' debts were primarily nonconsumer, the debtors' bankruptcy could be dismissed under §707(a) because it had not been filed in good faith. The debtors had both income[4] and expenses[5] beyond what had been disclosed in their schedules, including irregular but significant withdrawals from their medical business and personal expenses paid by their business. The court held that the debtors had not tightened their belts, continued to pay for three luxury vehicles, sent their children to an expensive private school, and continued to pay for three homes, including their primary residence at the expense of $15,714 per month.

The court stated that "the debtors ha[d] made no effort whatsoever to reduce their expenses." Id. at *3. In further support of dismissal, the court also noted that "the present case brings considerations of ability to pay and continuing lavish lifestyle to a new order of magnitude that simply cannot be condoned." Id. at *2. The court explicitly held that the debtors had sufficient resources to pay their debts, indicating that the debtors could comfortably fund a Chapter 11 plan by merely reducing their expenses, which would pay their creditors between $1 million and $1.8 million.
The court further supported dismissal by looking at the Supreme Court's requirement that a bankruptcy debtor must be "honest but unfortunate."[6] The court reasoned that "[t]here is nothing either honest or unfortunate about a debtor who, though able, chooses not to pay a meaningful dividend to his creditors through Chapter 11, Chapter 13, or otherwise. And that is so whether a debtor's debts are business debts or consumer debts." Id. at *4.

The court rejected the debtors' argument that "ability to pay" should only be considered in dismissal of a bankruptcy under §707(b), chastising an opinion out of the Third Circuit[7] that held that ability to pay should not be considered in dismissing a bankruptcy under §707(a), ultimately holding that "[a] bankruptcy court may dismiss any Chapter 7 case for cause." Id. at *4.

Therefore, the Eastern District of Michigan has taken the position that debtors whose debts are primarily nonconsumer are not insulated from dismissal just because they are not subject to the means test. If a debtor is acting in bad faith by filing his or her Chapter 7 petition when clearly he or she is living an extravagant lifestyle, a creditor does have recourse. It should be noted that on Dec. 23, 2010, the debtors filed a notice of appeal with the U.S. District Court for the Eastern District of Michigan, case number 10-15123.

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Foley & Lardner LLP is counsel for Pacifica Loan Four LLC, one of the moving parties in this case.

[1] Section 707(a) states "[t]he 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."

[2] In re Rahim, Case No. --- B.R. --- ¬, 2010 WL 5128944 (Bankr. E.D. Mich. December 15, 2010).

[3] It is interesting to note that the creditors, not the United States Trustee or Chapter 7 Trustee, filed these motions. As the court noted, the Chapter 7 Trustee's counsel did not support dismissal because she believed that there could be a large distribution to creditors. Id. at *5.

[4] The court actually imputed income to the debtors above the $39,400 disclosed in the debtors' schedules, holding that the debtors earned $42,446 per month.

[5] The debtors' schedules showed monthly expenses of $39,480, but the court determined that the evidence showed that their expenses were actually $42,426 per month.

[6] See Local Loan Co. v. Hunt, 292 U.S. 234, 244 (1934).

[7] Perlin v. Hitachi Capital Am. Corp., 497 F.3d 364 (3d Cir. 2007).