UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF OHIO

In re:	)	Case No. 03-15262
	)	
JEFFREY A. COOK,	)	Chapter 7
	)	
Debtor.	)	Judge Arthur I. Harris

MEMORANDUM OF OPINION AND DECISION

Before the Court is the motion of the United States Trustee to dismiss the instant case pursuant to 11 U.S.C. § 707 (Docket # 17) and the debtor's response thereto (Docket # 23). On January 14, 2004, the Court held an evidentiary hearing regarding these matters and, thereafter, permitted the parties to file post-trial briefing. Both the debtor and the United States Trustee timely filed such briefs (Docket ## 25, 26). After having reviewed the materials submitted by both parties and having heard testimony from relevant witnesses, this Court finds that permitting the debtor to proceed with his bankruptcy case in Chapter 7 would constitute a substantial abuse of the Bankruptcy Code and that his bankruptcy case should be dismissed pursuant to 11 U.S.C. § 707(b). Nonetheless, the Court will favorably entertain, within ten days from the date of entry of the order accompanying this memorandum, a motion by the debtor to vacate such order and to convert his bankruptcy case to one under Chapter 13.

The Court has jurisdiction in this matter pursuant to 28 U.S.C. § 1334(b) and Local General Order No. 84, entered on July 16, 1984, by the United States District Court for the Northern District of Ohio. This is a core proceeding pursuant to 28 U.S.C. § 157(b)(2)(A) and (O). This memorandum constitutes the Court's findings of fact and conclusions of law as required by Rule 52 of the Federal Rules of Civil Procedure, as made applicable to these proceedings by Bankruptcy Rules 7052 and 9014.[1]

FACTS

On April 24, 2003, the debtor filed a petition for relief under Chapter 7 of the Bankruptcy Code. After the Court granted an extension of time to file a motion to dismiss, the United States Trustee filed a motion on September 2, 2003, to dismiss the debtor's case pursuant to 11 U.S.C. § 707(a) and (b). *See* Docket # 17.

The United States Trustee argues that the debtor's case should be dismissed (i) pursuant to 11 U.S.C. § 707(a) because his petition was allegedly not filed in

[1] The findings of fact contained in this memorandum reflect the Court's weighing of the evidence and credibility. In so doing, the Court considered the witnesses' demeanor, the substance of their testimony, and the context in which the statements were made, recognizing that a transcript does not convey tone, attitude, body language, or nuance of expression. Even if not specifically mentioned in this decision, the Court has considered the testimony of all of the witnesses at the hearing, as well as all exhibits admitted into evidence and all stipulations.

good faith and the debtor acquired his debts by consistently ignoring the reality of his financial circumstances, and (ii) pursuant to 11 U.S.C. § 707(b) because the debtor's pre-petition spending patterns were arguably reckless and granting a discharge to the debtor under such circumstances would amount to a substantial abuse of the Bankruptcy Code. The debtor, on the other hand, argues that his petition was filed in good faith because he did not intend to defraud any creditors and that granting him a discharge would not result in him living–or continuing to live–a lavish lifestyle. Thus, the debtor contends that discharging his debts would not effect a substantial abuse of the Bankruptcy Code.

Since April of 2001, the debtor has been employed as a sales representative for a company named Tulsa Dental that specializes in the sale of root canal equipment to practicing dentists. *See* Hearing Transcript (Tr.) at 11 (Docket # 28). According to the Statement of Financial Affairs accompanying his petition, the debtor earned $52,495.55 in income in 2001, $85,738.93 in 2002, and $19,000 during the first four months of 2003. His monthly income, as indicated in his Bankruptcy Schedule I, is $5,792.00.

The debtor lives with his mother, who is 61 years of age, and provides all of her financial support, even though she is evidently capable of working. *See* Tr. at 9. As a way to provide financial support for his mother, the debtor purchased

his mother's residence in October of 2002 and took out a mortgage with Wells Fargo Financial America, Inc., in the amount of $104,321.16 to finance the sale. *See* Exhibit # 5, Debtor's Proposed List of Witnesses and Exhibits (Docket # 24). The monthly payment on this mortgage ($1,575.00) is relatively high because the loan is fully amortized over a period of just nine years, rather than over a more common period of between 15 and 30 years.

The debtor's residence is also encumbered by a second mortgage to Wells Fargo Financial America, Inc., for approximately $7,500.00, with a minimum monthly payment of $150.00. *See* Tr. at 34. The debtor's schedules indicate that the first mortgage exceeds the value of the residence and, therefore, leaves the second mortgage completely unsecured. The debtor has entered into reaffirmation agreements with Wells Fargo Financial America, Inc., with respect to both of these mortgages (Docket ## 5, 6).

The debtor's financial problems began in 2001 when he developed an addiction to gambling. The debtor testified that around that time he started to use credit cards and check cashing businesses to gamble increasingly larger sums of money at race tracks and with "bookies." Tr. at 18-19. The debtor also relied on friends and relatives as sources to fund his gambling addiction. Over a period of approximately three years, the debtor obtained $5,900.00 from his sister Natalie

Hayes, $11,600 from his other sister Maria Schauer, and an estimated $170,000.00 from his girlfriend Sharon Gerber for the purposes of gambling. None of these transfers of money was reduced to writing or secured by any property, and Maria Schauer and Sharon Gerber testified that they were aware of the debtor's gambling habits and did not expect the money to be repaid. *See* Tr. at 92, 99.

The debtor's schedules as initially filed did not disclose these debts. The only indirect reference to these debts appeared in the debtor's Statement of Financial Affairs which, in the section regarding losses, indicated an "unknown" amount of gambling loses dating from January 1, 2002. On August 29, 2003, the debtor amended his schedules to show the gambling debts, but he did so only after the United States Trustee had elicited the information at a Rule 2004 examination. *See* Tr. at 23-24. According to the debtor, he did not initially include the debts to his sisters and girlfriend in his bankruptcy petition because he considered those debts to be "personal" as opposed to business-type debts. *See* Tr. at 16. The debtor also stated that he never reported any gambling losses or gains on his income tax returns. *See* Tr. at 36-37.

In addition, the debtor admitted that in his original Statement of Financial Affairs he had not mentioned a potential preferential transfer of $2,000.00 to his sister Maria Schauer in December of 2002. Again, the United States Trustee

elicited this previously undisclosed information at a Rule 2004 examination, and the debtor quickly amended his Statement of Financial Affairs to reflect the transfer.

APPLICABLE LAW

Section 707 of the Bankruptcy Code addresses dismissal of a debtor's Chapter 7 case and provides:

> (a) The court may dismiss a case under this chapter only after notice and a hearing and only for cause, including—
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> (1) unreasonable delay by the debtor that is prejudicial to creditors;
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> (2) nonpayment of any fees or charges required under chapter 123 of title 28; and
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> (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.
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> (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)).

11 U.S.C. § 707.

DISMISSAL UNDER 11 U.S.C. § 707(A)

The evidence presented in this case does not persuade the Court that the debtor filed his petition in bad faith or that dismissal of the petition is otherwise appropriate under 11 U.S.C. § 707(a). On the contrary, the evidence indicates that the debtor filed this petition as part of an apparently honest effort to overcome the effects of his chronic gambling addiction.

In addition to the three enumerated criteria for dismissal under 11 U.S.C. § 707(a), a lack of good faith has been deemed "a valid basis of decision in a 'for cause' dismissal by a bankruptcy court." *Indus. Ins. Servs., Inc., v. Zick* (*In re Zick*), 931 F.2d 1124, 1127 (6th Cir. 1991). A bankruptcy court must consider the individual circumstances of a case when deciding whether the case was filed with bad faith sufficient to warrant dismissal:

> Dismissal based on a lack of good faith must be undertaken on an ad hoc basis. . . . It should be confined carefully and is generally utilized only in those egregious cases that entail concealed or misrepresented assets and/or sources of income, and excessive and continued expenditures, lavish lifestyle, and intention to avoid a large single debt based on conduct akin to fraud, misconduct, or gross negligence.

Id. at 1129 (internal citations omitted). Based on the evidence produced, this case does not contain the level of egregiousness or fraud that would warrant dismissal

for bad faith.

For example, the United States Trustee has not presented any evidence that the debtor concealed or misrepresented his assets or source of income. The only matters allegedly concealed by the debtor involved one pre-petition payment to his sister and three unsecured loans from his girlfriend and sisters. Some or all of these loans may not even qualify as repayable debts given the in-court testimony of Maria Schauer and Sharon Gerber that they provided this money to the debtor with little to no expectation of repayment. If this money was in fact given to the debtor as gifts, these creditors would not have been prejudiced by the debtor's failure to list them on his bankruptcy schedules. Moreover, the debtor's initial failure to inform two of these putative creditors (*i.e*, sisters Maria Schauer and Natalie Hayes) of his bankruptcy filing appears to have resulted more from a sense of embarrassment over his financial situation than from an intent to defraud.

In addition, dismissal under 11 U.S.C. § 707(a) is not appropriate here because there is no evidence that the debtor is continuing to make excessive expenditures or pursuing a lavish lifestyle. While the debtor's gambling losses forced him to borrow more money than his income allowed, the United States Trustee did not produce any evidence that the debtor made extravagant purchases or went on expensive vacations. Indeed, he paid virtually nothing for the one

vacation that was mentioned during the evidentiary hearing; his girlfriend won the trip for two to Mexico through her work, and she paid for the expenses that her employer did not cover. *See* Tr. at 42, 100. Moreover, the debtor lives in a relatively modest house with his mother.

The situation that led the debtor to file for bankruptcy relief does not suggest fraud, deceit, or the intent to avoid a single large debt. In his Statement of Financial Affairs, the debtor plainly identified his gambling loses as the reason he filed for bankruptcy protection. Although the debtor was culpable in the accumulation of these gambling losses, the accumulation stems more from a heavy addiction than from fraudulent behavior. The Trustee suggested at the evidentiary hearing and in his briefing that the debtor's failure to disclose his gambling winnings and losses on his tax returns is evidence of the debtor's intent to deceive others about his financial situation. However, the mere fact that the debtor's gambling winnings and losses were not disclosed to the IRS, when everyone concedes that his losses greatly exceeded his winnings in any given year, should not be a significant factor for finding bad faith. Few gamblers who finish ahead after one race, one bet, one sitting, or even one day of gaming report the income to the IRS if they have a net annual gambling loss.

Given these factors, the Court holds that the Trustee has not sufficiently

made out a case to have the debtor's bankruptcy dismissed for bad faith under 11 U.S.C. 707(a).

DISMISSAL UNDER 11 U.S.C. § 707(B)

Although the Trustee has not presented evidence sufficient for the dismissal of the debtor's case under 11 U.S.C. § 707(a), the Court finds that granting the debtor a discharge would amount to a substantial abuse of the Bankruptcy Code and that his case should be dismissed pursuant to 11 U.S.C. § 707(b). The debtor has the ability to repay, through a Chapter 13 petition or otherwise, a considerable portion of his debts out of his future earnings.

In conjunction with an appropriate motion under 11 U.S.C. § 707(b), a bankruptcy court will examine the debtor's ability to repay his debts out of his future earnings and, in general, whether the debtor qualifies as "needy." Congress added subsection (b) and its provisions for "substantial abuse" to § 707 of the Bankruptcy Code in 1984 "in response to an increasing number of Chapter 7 bankruptcies filed each year by non-needy debtors." *In re Krohn*, 886 F.2d 123, 125-26 (6th Cir. 1989). *See In re Behlke*, 358 F.3d 429, 434 (6th Cir. 2004). Prior to the enactment of subsection (b) to § 707, debtors enjoyed a virtually unfettered right to a "fresh start" through the Chapter 7 liquidation process.

The Bankruptcy Code does not define the term "substantial abuse," so

courts have been left to interpret the language. Courts have found that a debtor's substantial abuse of the Bankruptcy Code "can be predicated upon either lack of honesty or a want of need" based upon a totality of the circumstances. *Krohn*, 886 F.2d at 126. *See also Behlke*, 358 F.3d at 433. Thus, a bankruptcy court will dismiss the case of a dishonest or non-needy debtor upon appropriate motion under § 707(b).

THE DEBTOR'S HONESTY

When deciding whether a debtor has exhibited a lack of honesty in the context of a § 707(b) motion, a bankruptcy court will consider a variety of factors. Some of these factors include "the debtor's good faith and candor in filing schedules and other documents, whether he has engaged in 'eve of bankruptcy purchases,' and whether he was forced into Chapter 7 by unforseen or catastrophic events." *Krohn*, 886 F.2d at 126. Based on the evidence presented to the Court and considering the statutory presumption in favor of granting the relief requested by the debtor, the Court finds that the debtor has not exhibited a level of dishonesty that would trigger a dismissal under 11 U.S.C. § 707(b).

In arguing that the debtor has acted dishonestly, the Trustee has identified several matters that appear somewhat dishonest on their face, but likely have more innocent explanations. For instance, in failing to include his sisters and his

girlfriend as creditors in his original schedules, the debtor seems to have acted more out of a sense of embarrassment and confusion than as part of a surreptitious plan to deprive his creditors of legal rights. Also, the fact that the debtor failed to include his gambling losses and winnings on his tax returns does not suggest that the debtor sought to conceal income; rather, it looks more like a short-hand method to account for the massive net losses that the debtor suffered over a period of several years.[2]

The Trustee has not argued that the debtor has acted dishonestly by engaging in any eve-of-bankruptcy purchases. The only eve-of-bankruptcy transfer that may be subject to avoidance is a payment of approximately $2,000.00 that the debtor made to his sister Maria Schauer around Christmas in 2002. At that time, she asked him to repay some of the money she had given him so that she could afford holiday gifts for her family. Tr. at 93-94. Again, the Court does not find that this transfer indicates any sort of dishonesty on the part of the debtor.

Finally, the Trustee argues that the debtor was forced into bankruptcy as a result of his "reckless disregard for his financial circumstances" and "an egregious abuse of credit" rather than an unforseen or catastrophic event. *Motion To Dismiss*

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[2] The Internal Revenue Code provides that "losses from wagering transactions shall be allowed only to the extent of gains from such transactions." 26 U.S.C. § 165(d).

(Docket # 17) at 6. Of course, most of the debtor's financial troubles were precipitated by his gambling habits and not by circumstances that were entirely beyond his control. Even so, the debtor's conduct was not so blameworthy as to deny a discharge altogether. The debtor appears to have made sincere efforts to control his addiction, even if he did so in order to put the best light on the filing of his bankruptcy petition. The presence of a question regarding gambling losses on the Statement of Affairs (Official Bankruptcy Form 7, Question # 8) suggests that gambling might well be a valid reason for a debtor to file bankruptcy and that the presence of gambling losses would not be an automatic bar to relief under Title 11. For these reasons, the totality of the circumstances surrounding the debtor's case does not indicate that the debtor acted with the requisite level of dishonesty to trigger dismissal.

THE DEBTOR'S NEED FOR A CHAPTER 7 DISCHARGE

Although the debtor has not acted with enough dishonesty to merit dismissal, the Court finds that he does have the ability to repay a considerable portion of his debts and, therefore, his case should be dismissed under the "needy" analysis of 11 U.S.C. § 707(b). In deciding whether a debtor is needy for the purposes of a § 707(b) motion, a bankruptcy court will consider factors such as the debtor's "ability to repay his debts out of future earnings [,] . . . whether the debtor

enjoys a stable source of income, whether he is eligible for adjustment of his debts through Chapter 13 of the Bankruptcy Code, whether there are state remedies with the potential to ease his financial predicament, the degree of relief available through private negotiations, and whether his expenses can be reduced significantly without depriving him of adequate food, clothing, shelter and other necessities." *Krohn*, 886 F.2d at 126-27. One factor, the ability to repay debts out of future earnings, may be sufficient in and of itself to warrant dismissal. *See id.* (noting that court "would not be justified in concluding that a debtor is needy and worthy of discharge where his disposable income permits liquidation of his consumer debts with relative ease"). With these factors in mind, the Court turns to the debtor's current financial circumstances:

(1) As indicated by the debtor in his Schedule I, his current monthly income is $5,792.00, with $3,908.01 remaining after payroll deductions. While the debtor earns sales commissions and his income fluctuates according to his current level of sales, nothing indicates that the debtor has suffered or will suffer a dramatic decrease in income from his employment.

(2) The debtor is relatively young and healthy, and his employment at Tulsa Dental is not in jeopardy. *See* Tr. at 12, 39. Were he to fund a

Chapter 13 plan for 36 months, he would complete such a plan at age 36–still relatively young. His sole dependent, his 61 year-old mother, is in decent health and is capable of working. The Trustee asserts that "[a]lthough the debtor's [financial] commitment to his mother is laudable, it should not be funded by his creditors."[3] Post-Trial Brief of the United States Trustee at 5 (Docket # 26). The Court will not dispute the status of the debtor's mother as a valid dependent of the debtor nor attribute to her an income in view of her reputed ability to hold a job. Were the Court to do so, the debtor might owe an increased amount of taxes as a result of a change in filing status and claimed exemptions. This increased rate of taxation would presumably reduce the debtor's disposable income.

(3) The debtor pays $1,575.00 every month towards the first mortgage on his residence. This mortgage, as previously mentioned, is unusual in that it is fully amortized over a period of just nine years, rather than over a more common period of between 15 and 30 years. The

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[3] *But see* 11 U.S.C. § 1325(b)(2) (defining "disposable income" as "income which is received by the debtor and which is not reasonably necessary to be expended . . . for the maintenance or support of the debtor or a dependent of the debtor . . .").

debtor's disposable income is greatly reduced by having such a short-term mortgage: a mortgage with similar terms amortized over 15 years instead of nine would require a monthly mortgage payment of only $1,200.62–nearly $375.00 less than the debtor is currently paying each month.[4] With $375.00 paid over 36 months, the debtor could contribute as much as $13,500 towards his outstanding debts[5] while making regular mortgage installments on his residence. The debtor's decision to refinance with a nine-year mortgage, while laudable, makes it harder for him to fund a plan to pay unsecured creditors. *Cf. In re Behlke*, 358 F.3d at 436 (concurring with courts

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[4]These figures are based on mortgage calculations performed by the Court on March 1, 2004, on the web site www.bankrate.com/brm/mortgage-calculator based upon a loan of $112,173.29 at 9.93% interest over a period of 9, 15, and 30 years, and reconfirmed on several other "on-line" loan calculators. The Court takes judicial notice of these figures because they are "capable of accurate and ready determination by resort to sources whose accuracy cannot be reasonably questioned." FED. R. EVID. 201(b).

[5]According to the debtor's original schedules, the debtor has $2,406 in unsecured priority claims and $54,025 in unsecured nonpriority claims. Some of the evidence presented to the Court indicates that the debtor's unsecured gambling debts to his sisters and girlfriend may have been in the nature of gifts. Also, included within his unsecured nonpriority claims is a student loan with Sallie Mae Servicing for $15,000. Assuming that (i) the debtor's student loan debt is nondischargeable, (ii) he follows through with his reaffirmation agreements with Wells Fargo, and (iii) the unsecured gambling debts to his sisters and girlfriend are in the nature of gifts, a Chapter 7 discharge would relieve the debtor of $39,025 in unsecured debt.

which have found that debtor's "voluntary payment into pension, savings, or 401K-type plan is not a reasonably necessary expenditure"). The debtor should not be able to avoid paying unsecured creditors just because he has the financial ability to accelerate the time normally required to pay off a mortgage. The Court recognizes that the debtor now may be unable to refinance his mortgages because the amount owed exceeds the value of the residence.

(4) If the amount of the debtor's first mortgage does in fact exceed the value of his residence, the debtor may be able to treat the second mortgage to Wells Fargo Financial America, Inc., as an unsecured claim through a properly crafted Chapter 13 plan. *See generally In re Lane*, 280 F.3d 663 (6th Cir. 2002).[6] This "stripoff" would increase

[6]Although the debtor has entered into reaffirmation agreements with respect to both mortgages (Docket ## 5, 6), he remains free to rescind these agreements at any time prior to discharge. *See* 11 U.S.C. § 524(c)(2). The Court cannot force the debtor to reaffirm these debts if the Court denies the § 707(b) motion and permits the discharge to go forward. However, were the debtor to rescind the reaffirmation agreements and abandon his home, this would create a windfall for the debtor because he would become debt-free upon discharge, except for his student loans. There is no reason to believe that the debtor intends to rescind his reaffirmation agreements, and the Court will assume for the purposes of this motion that the debtor will, in fact, reaffirm his mortgage obligations.

the debtor's monthly disposable income by approximately $150.00.[7]

(5) The lending agency handling the debtor's student loans, Sallie Mae, may be willing to work out a payment schedule to reduce the amount of the debtor's monthly payments and thereby free up more disposable income to fund a Chapter 13 plan . *See* Tr. at 104.

(6) In recent years, the debtor has received significant tax refunds. In 2001, he received $7,706 and in 2002 he received $9,042. *See* Docket # 22, Exhibits 8 & 9. In his post-trial brief, the debtor essentially concedes that, based upon these tax refunds, at least $469.34 would be available to him as disposable income on a monthly basis. *See* Docket # 25 at 2. Over the course of a 36-month Chapter 13 plan, this additional disposable income would provide nearly $17,000 worth of funds for creditors.

Based on these factors, the Court finds that the debtor would be able to contribute at least $30,396 to a hypothetical 36-month Chapter 13 plan: (1) $13,500 from converting his nine-year mortgage to a 15-year mortgage and (2)$16,896.24 from adjusting his tax withholdings to eliminate the large refunds

[7]The debtor's list of current expenditures (Bankruptcy Schedule J) does not presently list payment of the second mortgage to Wells Fargo, even though that mortgage appears on the debtor's Schedule D.

that he has received for the past few years. Assuming that the monetary transfers from the debtor's sisters and girlfriend were in the nature of gifts and that the Chapter 13 Trustee would request a customary administration fee,[8] the debtor would have nearly $25,000 to apply towards $54,025 of unsecured debt (a dividend of nearly 46%), after paying off the priority claims.

Even if the debtor's excess mortgage payments are not factored into his ability to fund a Chapter 13 plan, the debtor would still have nearly $15,000 to apply towards $54,025 worth of unsecured debt (a 27% dividend) and would not meet the "needy" requirement of 11 U.S.C. § 707(b). The Court is not implying that *any* debtor who can pay unsecured creditors 27% of their claims is not needy under § 707(b), but here, at least, based upon the totality of the circumstances, where the debtor runs up large gambling expenses over a period of three years, has a steady income, is in good health, and voluntarily chooses to refinance his home with a mortgage that will be paid in full in just nine years, the debtor should be required to do more for his creditors. *Accord Behlke*, 358 F.3d at 437-38 (affirming bankruptcy court's finding of substantial abuse even though debtors would only have the ability to repay 14% of their unsecured debts over three years).

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[8] *See* 28 U.S.C. § 586(e).

CONCLUSION

For the foregoing reasons, the Court finds that he debtor is in good health and enjoys a steady income. Furthermore, he is eligible for adjustment of his debts through a Chapter 13 plan. Finally, considering his decision to pay off his home mortgage over a particularly brief period of time and his tendency to receive large tax refunds, debtor has the ability to repay a considerable portion of his debts out of his future earnings. Accordingly, the Court finds that, based upon the totality of the circumstances, granting the debtor a discharge in a Chapter 7 proceeding would constitute a substantial abuse of the Bankruptcy Code and that the debtor's case should be dismissed pursuant to 11 U.S.C. § 707(b).

/s/ Arthur I. Harris 03/15/2004
Arthur I. Harris
U.S. Bankruptcy Judge