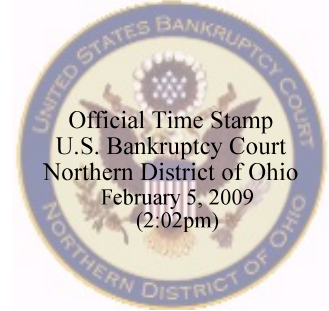


NOT FOR COMMERCIAL PUBLICATION

UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF OHIO
EASTERN DIVISION



In re:) Case No. 08-15538
)
CONSTANCE LEE BLAKE,) Chapter 7
)
Debtor.) Judge Pat E. Morgenstern-Clarren
)
) **MEMORANDUM OF OPINION**¹

The United States trustee moves to dismiss this chapter 7 case under bankruptcy code §§ 707(b)(1) and (b)(3), which provide for dismissal if the debtor has primarily consumer debts and granting the debtor a discharge would, under the totality of the debtor’s financial circumstances, be an abuse of chapter 7. The debtor denies that her debts are primarily consumer debts and, alternatively, denies that her case involves abuse. For the reasons stated below, the court finds that the United States trustee did not meet his burden of proof and the motion is denied.

JURISDICTION

Jurisdiction exists under 28 U.S.C. § 1334 and General Order No. 84 entered by the United States District Court for the Northern District of Ohio. This is a core proceeding under 28 U.S.C. § 157(b)(2)(A), (J), and (O).

¹ In the court’s view, the value of this opinion is to resolve the dispute between the parties and not as an addition to the general jurisprudence. For that reason, the opinion is not intended for commercial publication.

THE EVIDENTIARY HEARING

The court held an evidentiary hearing on January 9, 2009. The United States trustee (UST) presented his case through cross-examination of the debtor, the testimony of Philip Lamos (chief counsel to the standing chapter 13 trustee in Cleveland), and David Kozlowski (a bankruptcy analyst with the UST). The debtor presented her case through her own testimony and cross-examination of the other witnesses. Each side supported its case with exhibits.

ISSUES

Did the UST meet his burden of proving:

- (1) that the debtor's debts are primarily consumer debts, rather than business debts; and if so,
- (2) that granting the debtor a discharge would be an abuse of chapter 7?

FACTS

A. The Scheduled Secured Debt

In 1991, the debtor and her non-debtor husband Kevin Blake borrowed \$153,450.00 from Lorain National Bank to build a three bedroom house at 13409 South Durkee Road, Grafton, Ohio (the property). They signed a note secured by a mortgage on the property. In 1993, the debtor and her husband refinanced the then-principal amount of \$149,466.36 owed on the note to obtain a lower interest rate. The parties agree that these were both consumer transactions.

The dispute over how to characterize the debt begins in 1996. At that time, the Blakes borrowed an additional \$85,395.00 from Lorain National Bank (LNB), secured by a second mortgage on the property. They used the proceeds from that loan to finance a business run by Kevin Blake.

In October 2001, the Blakes refinanced the notes secured by both the first and second mortgages, again with LNB. They signed a promissory note in the principal amount of \$340,000.00, secured by the property. The disbursements listed on the settlement statement for the loan total \$338,902.07, including settlement charges of \$2,035.25, which is less than the loan amount. The evidence did not address this discrepancy. The proceeds were disbursed as follows:²

line 1501	\$117,470.89	Pay off the LNB first mortgage note
line 1502	\$ 22,541.34	Pay off business loan from LNB
line 1503	\$ 53,748.62	Pay off "CLA" business loan from LNB
line 1504	\$ 48,275.97	Pay off "Better Way" business loan from LNB
line 1505	\$ 50,601.94 ³	Pay off "CLA" business loan from LNB
line 1604	\$ 44,228.06	Disbursed to the borrowers

Of the total amount disbursed, the slight majority of funds (\$175,167.87) were used to pay business debt, or approximately 51.7% of the proceeds. Therefore, the remainder of the funds (\$163,734.20) consisted of consumer debt.

In December 2006, the debtors refinanced the note with Wells Fargo Bank, NA in the principal amount of \$396,900.00. The proceeds were disbursed as follows:

line 1501	\$328,899.6[x] ⁴	Pay off the LNB October 2001 note
line 1502	\$ 25,000.00	Pay off LNB lien on the property

² The line number refers to the corresponding line on the October 24, 2001 settlement statement for the loan, submitted into evidence as debtor's exhibit D-2. The pay off descriptions are taken verbatim from the document.

³ Although the testimony indicated that line 1505 appeared to be a pay off of approximately \$80,000, to comport with the "disbursements to others" amount on line 1603 (\$293,738.68), this figure must be \$50,601.94.

⁴ An "[x]" is used where the figure was not legible. For calculation purposes, the figure represented by the [x] was assumed to be "0." Therefore, the totals are approximate.

line 1503	\$ 10,222.00	Pay U.S. Treasury for federal business trust fund taxes owed by Kevin Blake
line 1504	\$ 6,490.8[x]	Pay off Chase business credit card
line 1505	\$ 4,246.00	Pay off Capital One auto loan ⁵
line 1506	\$ 5,034.00	Pay off Discover business credit card
line 1507	\$ 3,101.00	Pay off Capital One business credit card
line 1508	\$ 2,685.6[x]	Pay off Sam's Club credit card
line 1602	\$ 10,047.3[x]	Settlement Charges
line 1604	\$ 1,183.4[x]	Disbursed to the borrowers

The debtor testified that the debts paid on lines 1502, 1503, 1504, 1506, and 1507 were business debts. Assuming the consumer debt portion of the October 2001 transaction (\$163,734.20) remained static, the portion of the line 1501 pay off of the October 2001 note representing business debt would be \$165,165.40. Adding that figure to the amounts on lines 1502, 1503, 1504, 1506, and 1507 yields a total of \$215,013.20 in business debt, or 54% of the loan proceeds.

Conversely, adding the additional consumer debt from the December 2006 transaction (Capital One auto loan, Sam's Club credit card payoff, and the disbursement to the borrowers) to the amount of consumer debt from the October 2001 transaction (\$163,734.20), and assuming that the settlement charge number was consumer debt, yields total consumer debt of \$181,896.50, or 46% of the loan.

The debtor scheduled Wells Fargo as a secured creditor with a claim amount of \$392,925.00.

B. The Debtor's Other Debts

In addition to the Wells Fargo debt, the debtor scheduled other liabilities totaling \$111,284.76, for total scheduled debt of \$504,209.76. Some portion of this other debt was also

⁵ The debtor testified that the automobile securing the Capital One loan was used for both business and household purposes.

incurred in the operation of Kevin Blake's business. The debtor's initial bankruptcy filing stated that her debts are primarily consumer debts. After the UST filed this motion, the debtor amended her filing to state that her debts are primarily business debts. She changed the debt designation after talking with her husband and friends about the reason why she incurred the debt; those discussions led her to believe that the majority of debt was business rather than consumer. The court believed the debtor's testimony as to why she changed the designation. That does not, however, resolve the issue of whether the debt is, in fact, consumer debt or business debt.

C. The Debtor's Financial Situation

The debtor and her husband have three children, ages 13, 16, and 19. She is a registered nurse who has been employed at the same facility for 18 years and has an annual income of about \$89,000.00. Her husband is a self-employed construction worker who has a gross annual income of about \$24,000.00. The debtor contributes \$134.00 a month to her 401(k) retirement account and pays \$557.03 monthly to repay a loan from that account. A year from now, the loan repayment will decrease to about \$150.00.

As a result of the last refinancing transaction, the debtor's monthly mortgage payment is \$3,600.00 (including real estate taxes). This is more than three times the amount allotted by the Internal Revenue Service for housing expenses in Lorain County, Ohio under its Local Standards.⁶ The debtor cannot refinance the debt yet again because she does not have any equity in the house, she has bad credit, and the general lending market is closed to her. As stated in her petition, she intends to stay in the home without reaffirming the debt owed to the lender.⁷ The

⁶ See IRS Housing and Utility Standards available at www.usdoj.gov.

⁷ See 11 U.S.C. § 524(c).

lender obtained relief from stay to proceed with a state court foreclosure, but to date has continued to accept payments from the debtor. As a result, the family has been permitted to remain in the property. The debtor has not made the December 2008 or January 2009 payment, although she hopes to be able to make one payment by the end of January. She estimated the house's market value at \$400,000.00 when she filed her petition in July 2008. She does not know how much it is worth now, other than that it is probably worth less in this falling market. She is not able to sell the house due to market conditions. She has not investigated the cost of rental housing in the area.

Aside from the housing cost, the debtor's monthly expenses for a family of five are quite modest. These include \$800.00 for food, \$85.00 for clothes, \$50.00 for medical and dental expenses, and \$20.00 for items such as hair care and toiletries. The family spends nothing on recreation and charitable contributions, and they have no emergency fund. They cannot afford to change the oil in their car. They sold everything that they had, other than the house. They have been "pinching pennies" for some time and are at a point where they do not, in the debtor's view, "go anywhere or do anything." According to the schedules, the family's monthly expenses exceed their income by \$855.19.

David Kozlowski from the UST's office testified that he looked on the internet to investigate the cost of rental housing in Lorain County. He found generally that three bedroom apartments in the Grafton area rent for \$600.00 to \$900.00 a month. If the debtor reduces her housing expense to \$1,047.00 by abandoning her house and moving, he believes that she will be able to pay about 50% of her unsecured debt in a chapter 13 filing. The debtor then testified that if she reduced her housing expense, she would have other reasonable expenses that she could

attend to, including such items as spending more money on food and clothing, and maintaining their car.

THE POSITIONS OF THE PARTIES

The UST moves to dismiss under § 707(b)(3), arguing first that the debts are primarily consumer debt because the business debt was paid off with the last refinancing. He then moves to the second point he must prove—abuse—and argues that the totality of the circumstances shows that the debtor is able to repay her unsecured debts through a chapter 13 plan if she and her family reduce their housing costs by refinancing or finding less expensive housing.

The debtor's position is that the UST did not meet his burden of proof because (1) the majority of her debts were initially incurred to support a business, thus establishing them as business debt; and (2) in the current economic market, she cannot refinance her house to reduce her housing expense. If she reduces her housing costs by moving, she argues, she would still not be able to fund a chapter 13 plan because she would be entitled to increase spending on food, clothes, and other items that are reasonable expenses in a chapter 13 case. She also argues that requiring her to abandon the house would hurt her secured creditor (Wells Fargo, who is currently being paid on its secured debt) to benefit her unsecured creditors, where the bankruptcy code does not require or support such a reallocation of financial loss.

DISCUSSION

A. 11 U.S.C. § 707(b)

The court may dismiss a chapter 7 case filed by a debtor whose debts are primarily consumer debts if it finds that granting relief would be an abuse of chapter 7. 11 U.S.C.

§ 707(b)(1). In a case such as this where there is no presumption of abuse,⁸ the UST must prove that (a) the debtor filed in bad faith, or (b) the totality of the circumstances shows abuse. 11 U.S.C. § 707(b)(3). The UST must prove his case by a preponderance of the evidence. *See Grogan v. Garner*, 498 U.S. 279 (1991); *In re Wright*, 364 B.R. 640, 643 (Bankr. N.D. Ohio 2007).

1. The Nature of the Wells Fargo Secured Debt

The initial point of disagreement between the parties is whether the debtor's secured debt to Wells Fargo is consumer debt. The bankruptcy code defines consumer debt as "debt incurred by an individual primarily for a personal, family, or household purpose." 11 U.S.C. § 101(8). To determine whether a particular debt is a consumer debt within the meaning of § 101(8), the court must consider the debtor's purpose in incurring it. Consumer debt generally: (1) is incurred voluntarily; (2) for personal or household purposes; (3) results from consumption rather than earning money; and (4) involves the extension of credit. *Internal Revenue Servs. v. Westberry (In re Westberry)*, 215 F.3d 589, 591 (6th Cir. 2000). If a debt was incurred for more than one purpose, the primary purpose for which most of the funds were obtained will determine its character. *Swartz v. Strausbaugh (In re Strausbaugh)*, 376 B.R. 631, 639 (Bankr. S.D. Ohio 2007); *Monroe Bank & Trust v. Nowatzke (In re Nowatzke)*, 318 B.R. 400, 402–03 (Bankr. E.D. Mich. 2004).

Business or commercial debts are not consumer debts, and a profit motive test may be applied to determine whether a debt is a business debt. *In re Westberry*, 215 F.3d at 593. Under this test, a debt "is not consumer debt if the debt was 'incurred with an eye toward profit.'" *Id.*

⁸ *See* 11 U.S.C. § 707(b)(2)(A)(i).

(quoting *In re Booth*, 858 F.2d 1051, 1055 (5th Cir. 1988)). The profit motive analysis does not, however, “define[] the *only* category of non-consumer debt. Therefore, while [the analysis] may assist in the determination of which debts are not consumer debt, it does not prohibit other debts from falling outside the category of consumer debt.” *Id.* (emphasis in original).

Debts which are secured by real property may qualify as consumer debt.⁹ And in the majority of cases, debt secured by the debtor’s residence *is* consumer debt. *See Zolg v. Kelly (In re Kelly)*, 841 F.2d 908, 913 (9th Cir. 1988) (“It is difficult to conceive of any expenditure that serves a ‘family . . . or household purpose’ more directly than does the purchase of a home and the making of improvements thereon.”). That is not always the case, however, and if mortgage loan proceeds were used for a business or commercial purpose, the debt may be classified as business debt. *In re Booth*, 858 F.2d at 1055 (determining home mortgage loan debt related to a debtor’s business ventures to be non-consumer debt); *In re Praliekas*, 248 B.R. 140, 144-45 (Bankr. W.D. Mo. 2000) (noting that mortgage loan debt is consumer debt, except to the extent loan proceeds are used for business purposes). The debtor’s purpose at the time the mortgage debt was incurred, rather than at some later date, controls on this issue. *See In re Naut*, No. 07-20280, 2008 WL 191297, at *6 (Bankr. E.D. Pa. Jan. 22, 2008) (determining that the debtor’s original purpose in incurring home mortgage debt could not be recharacterized as business debt

⁹ This proposition was not disputed by the parties, is consistent with the bankruptcy code’s language and design, and has been adopted by the majority of courts. *See, for example, In re Booth*, 858 F.2d 1051, 1054 (5th Cir. 1988); *Zolg v. Kelly (In re Kelly)*, 841 F.2d 908, 912 (9th Cir. 1988); *In re Hlavin*, 394 B.R. 441,444-45 (Bankr. S.D. Ohio 2008) (discussing cases reaching this result). Cases to the contrary improperly rely on legislative history to reach the opposite conclusion. *See, for example, In re Restea*, 76 B.R. 728, 734 (Bankr. D. S.D. 1987) (citing congressional statements in support of the bill which “indicate[] that, ‘[A] consumer debt does not include a debt to any extent that the debt is secured by real property.’”); *see also* 6 Alan N. Resnick, *et al.*, COLLIER ON BANKRUPTCY ¶ 707.04[3][b] (15th ed. revised 2008).

based on the fact that the debtor had vacated the home and presently regarded the property as an investment); *In re Nicolas*, No. 02-00211, 2002 WL 32332461, at *2 (Bankr. D. Haw. Mar. 22, 2002) (“The determination of whether a debt relates to a personal, family, or household purpose or is motivated by profit-seeking is made at the time the debt is incurred.”); *In re Bertolami*, 235 B.R. 493, 497 (Bankr. S.D. Fla. 1999) (same).

When the debtor in this case refinanced her home mortgage loan through Wells Fargo in 2006, she used the loan proceeds to pay off (1) the portion of the prior loan attributable to her purchase of the property; (2) the portion of the prior loan attributable to old business debt; and (3) additional debts, some of which were incurred in running the business. The UST argues that the Wells Fargo debt is a consumer debt because the business had ceased operating by 2006, the debtor did not have a profit motive at that time for borrowing the funds, and the debtor did not use the funds to generate a profit. In effect, the UST argues that the debtor extinguished most of her business debt through the Wells Fargo transaction and replaced it with consumer debt. The debtor, on the other hand, argues that the Wells Fargo loan was used primarily to satisfy debt which she had incurred to run a business and is, therefore, properly characterized as business debt. Each takes an all or nothing approach to the issue, with the UST saying that the refinanced debt replaced the business debt in its entirety and the debtor saying that the refinanced debt was essentially business debt. The court finds a slightly different approach to be useful in resolving this issue.

Neither party cited any case in the bankruptcy context which specifically addresses whether debt which is incurred to pay off existing business debt can continue to be characterized as business debt for purposes of §§ 101(8) and 707(b). The court has not found any either.

There are, however, cases which address a comparable issue under the Truth in Lending Act (TILA),¹⁰ which applies to consumer credit transactions and exempts transactions which are primarily business or commercial.¹¹ In that context, courts have concluded that debt which is incurred for the primary purpose of refinancing existing business debt is properly characterized as business debt. *See Sherlock v. Herdelin*, No. 04-cv-3438, 2008 WL 732146, at * 7 (E.D. Pa. Mar. 17, 2008) (concluding that a mortgage loan obtained by a chapter 7 debtor to refinance his residence and to pay off his existing debts was primarily a business debt not governed by TILA, because it was taken out primarily for a business purpose); *Gombosi v. Carteret Mortgage Corp.*, 894 F. Supp. 176, 180 (E.D. Pa. 1995) (holding that a transaction for refinancing a residential mortgage loan was appropriately characterized as a business transaction, because the borrower's primary purpose was not to refinance their home but to refinance existing business debts). Adopting the reasoning of those cases, the court finds that the debt at issue here did not necessarily lose its characterization as business debt when the debtor refinanced with Wells Fargo.

The court turns then to the applicable standard: what was the debtor's primary reason for refinancing her home loan with Wells Fargo? There was no direct testimony as to the debtor's reasons for refinancing with Wells Fargo. However, based on the evidence as a whole, the court concludes that the 2001 refinancing was primarily to pay business debt (51.7% of the amount

¹⁰ 15 U.S.C. §§ 1601-1667(f).

¹¹ *See* 15 U.S.C. § 1602(h) (defining a consumer credit transaction as one in which "the money, property, or services which are the subject of the transaction are primarily for personal, family, or household purposes"); and 15 U.S.C. § 1603(1) (providing that the act's provisions do not apply to "[c]redit transactions involving extensions of credit primarily for business, commercial, or agricultural purposes," among others).

borrowed). In 2006, the debtor refinanced that business debt, as well as an additional \$49,847.80 in business debt. As a result, 54% of the proceeds of the Wells Fargo loan was incurred to resolve debts related to the business. The evidence showed, therefore, that the majority of the 2006 debt was incurred for business purposes. The court, therefore, concludes based on the evidence that the Wells Fargo debt is not consumer debt.

2. Primarily Consumer Debts

Having concluded that the Wells Fargo debt is not a consumer debt, the court also concludes that the debtor's debts collectively are not primarily consumer debts. Courts have used a number of different approaches to determine whether a debtor's debts are primarily consumer debts for purposes of § 707(b). *See In re Hlavin*, 394 B.R. 441, 446-47 (Bankr. S.D. Ohio 2008) (discussing the different approaches used). "The majority view is that a debtor's liabilities are primarily consumer debts if the aggregate amount of such debts exceeds 50% of the debtor's total liabilities." *Id.* at 446. This court adopts that view for the reasons stated in the *Hlavin* opinion. As the Wells Fargo debt was scheduled in the amount of \$392,925.00, almost 80% of the debtor's total scheduled debt, it is clear that her debts are not primarily consumer debts.

3. The Totality of the Circumstances

Alternatively, even assuming that the debts are primarily consumer debt, the court finds that the UST did not prove that the debtor's filing is an abuse of chapter 7.

Before Congress enacted the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), a chapter 7 case could be dismissed as a substantial abuse of the system if the debtor was not needy or was dishonest. *In re Krohn*, 886 F.2d 123, 126-27 (6th Cir. 1989).

BAPCPA reduced the standard from “substantial abuse” to “abuse,” but the factors used to determine if a debtor was needy before BAPCPA are relevant to determining whether the totality of the circumstances show abuse under BAPCPA. *In re Mestemaker*, 359 B.R. 849, 856 (Bankr. N.D. Ohio 2007). These factors include:

1. the debtor’s ability to repay debts out of future earnings, based upon a hypothetical chapter 13 plan;
2. whether the debtor has a stable source of future income;
3. whether the debtor is eligible for chapter 13;
4. whether there are state remedies available to the debtor;
5. whether the debtor can obtain relief through private negotiations; and
6. whether the debtor can reduce expenses significantly without being deprived of necessities such as food, clothing, and shelter.

Behlke v. Eisen (In re Behlke), 358 F.3d 429, 434 (6th Cir. 2004).

In this case, the debtor has a stable source of income and she is eligible for chapter 13 relief. She cannot obtain relief from her mortgage debt by refinancing or otherwise renegotiating the terms of her note. There was no testimony as to state remedies. The relevant testimony really comes down to whether the debtor can significantly reduce her expenses without being deprived of necessities, which reduction would permit her to fund a chapter 13 plan.

The debtor agrees with the UST that there are four ways in which she could theoretically reduce her housing expenses: (1) sell her house and move to rental property; (2) abandon her house and move to rental property; (3) refinance the mortgage note at a rate that would result in lower monthly payments over the life of the new note; or (4) refinance to reduce the monthly

payments in the short term, with a balloon payment. The testimony did not show that the debtor can sell or refinance her house. The remaining scenario, then, is one in which the debtor would abandon the house, move to rental property, and fund a chapter 13 plan.

The UST's argument focuses solely on the debtor's housing expense. He contends that if the current monthly mortgage expense (\$3,600.00) is reduced to the amount provided for in the IRS housing allowance for Lorain County, Ohio (\$1,047.00), that would change the calculation in the debtor's Form 6J (schedule J) to have a positive amount of \$1,700.00 in line 20c. That amount, multiplied by a 36 month payment, would result in \$61,200.00 being available to pay to unsecured creditors over the life of a chapter 13 plan. The debtor rightly responds, however, that she would not necessarily be required to pay that amount each month in a chapter 13 plan. The bankruptcy code permits her to keep enough money to pay reasonable expenses for items such as food, clothing, recreation, transportation, health care, insurance, and personal toiletries. At the moment, the family is sacrificing in these areas to pay the mortgage note, as reflected in the very modest non-housing expenses listed in the debtor's schedule J. Mr. Lamos, chief counsel to the chapter 13 trustee acknowledged, for example, that the debtor's current clothing budget of \$85.00 for a family of five is below average for a chapter 13 debtor. So, too, with the debtor's current budget for laundry and dry cleaning, medical and dental expenses, recreation, charitable contributions, and payroll taxes. On the other hand, the debtor would not be entitled to continue to contribute to her 401(k) plan in a chapter 13 plan.

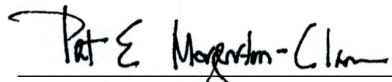
While the reduction in housing expenses is a starting point for determining whether the debtor can fund a chapter 13 plan, it is only the starting point. There are, as discussed above, many other factors that would go into whether such a plan can be formulated and the amount that

any such plan would provide for unsecured creditors. Based on these uncertainties, there simply is not enough information in the record for the court to conclude that if the debtor abandoned the house and moved to rental property, she would be able to fund a chapter 13 plan that would pay a dividend to her unsecured creditors. The UST did not, therefore, meet his burden of proving that the debtor's filing is an abuse of chapter 7.

CONCLUSION

The UST did not meet his burden of proving that the debts are primarily consumer debts or that, if consumer debts, the debtor is abusing chapter 7 of the bankruptcy code. The motion to dismiss is, therefore, denied.

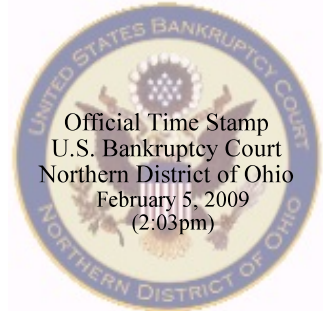
A separate order will be entered reflecting this decision.



Pat E. Morgenstern-Clarren
United States Bankruptcy Judge

NOT FOR COMMERCIAL PUBLICATION

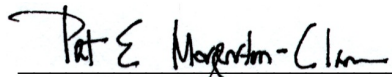
UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF OHIO
EASTERN DIVISION



In re:) Case No. 08-15538
)
CONSTANCE LEE BLAKE,) Chapter 7
)
Debtor.) Judge Pat E. Morgenstern-Clarren
)
) **ORDER**

For the reasons stated in the memorandum of opinion entered this same date, the motion of the United States trustee to dismiss this chapter 7 case under bankruptcy code §§ 707(b)(1) and (b)(3) is denied. (Docket 16).

IT IS SO ORDERED.



Pat E. Morgenstern-Clarren
United States Bankruptcy Judge