# Can a Debtor Who Files Chapter 13 in Bad Faith Survive Dismissal?

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Does a debtor's bad faith in filing his petition determine his or her eligibility for bankruptcy reorganization? This article explores how filing a chapter 13 petition in bad faith affects the debtor's eligibility to proceed in chapter 13.

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Bankruptcy courts can dismiss a chapter 13 case for cause.[1] If a debtor files a petition in bad faith, courts may consider the bad faith as cause to dismiss the petition.[2] Although the Bankruptcy Code does not specify "bad faith" as a ground for dismissal, a finding that bad faith is cause for dismissal has been recognized and accepted by courts of all levels, and affirmed by the U.S. Supreme Court.[3] Indeed, in *Marrama* the Supreme Court acknowledged that "a debtor who acts in bad faith prior to, or in the course of, filing a Chapter 13 petition...forfeits his right to obtain Chapter 13 relief."[4] But is it simply axiomatic that if the debtor files the petition in bad faith, the court has cause and therefore must dismiss the bankruptcy case? After all, the debtor cannot undo the bad faith, particularly when the bad faith is from prepetition bad acts. If the debtor cannot "cure" his past bad acts, he would be unable to remedy the cause for dismissal. Therefore once a court finds that his conduct is indeed bad faith, how can the court reasonably permit the case to proceed in a reorganization? Does this finding compel dismissal?

The question is a troubling one for bankruptcy trustees. Trustees serve a role as gatekeeper and assist the court in its gatekeeper role. As a result, trustees are confronted with the question often posed by creditors: How can this bad person who committed bad acts be permitted to file bankruptcy? Or, how can this bad person be permitted to stay in bankruptcy?[5] The creditor naturally is focusing on the prepetition conduct, but the trustee may be more interested in the postpetition conduct. The trustee may want to see if the bad person really can be a good debtor. This article concludes that if a finding that the debtor filed the petition in bad faith compels dismissal, the debtor's bad faith becomes an eligibility criterion. It is the opinion of this author that the debtor's bad faith should not be an eligibility factor if the bad faith is limited to the debtor's prepetition conduct.

**About the Author**

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## Trustee Talk

### Prepetition Transfers

Bad faith is not defined in the Code. Instead, courts have defined "bad faith" as a conclusion made after due consideration of a number of factors. Courts are virtually unanimous that the analysis for determining bad faith requires consideration of a number of factors in light of the "totality of the circumstances."[6] The debtor's prepetition conduct is one of these "bad faith" factors,[7] especially if the debtor transferred assets prior to filing for bankruptcy.[8] The prepetition transfer, if made for less than reasonably equivalent value, may permit a trustee to avoid the transfer,[9] recover the asset[10] and liquidate it for the benefit of unsecured creditors.[11] It is for this reason that debtors may attempt to hide the transfer, or fail to disclose the transfer, in the bankruptcy case. Concealment and misleading statements in the bankruptcy case are each elements of bad faith.[12]

### Petition Is Filed Intentionally to Delay and Hinder Creditors

Debtors sometimes want to pay their creditors but just do not have the means to do so timely or fully. Other times, however, debtors honestly do not want to pay their creditors, either because they do not believe they owe the debt or because they believe they should be able to have the benefit of the credit without the obligation to repay it (they do not appreciate the actual cost of the financing). In addition, divorce, business breakup or contentious litigation can lead to a desire for vengeance. The debtor may seek bankruptcy as a method to avoid repaying a debt, or to re-litigate the liability of the debt, rather than a voluntary effort to achieve financial rehabilitation. The debtor's motivation in filing the petition—or, as it is sometimes described, the debtor's sincerity in petitioning for bankruptcy relief—is one of the factors used by courts to determine whether the petition was filed in good faith or bad faith. If the debtor indeed transferred assets prepetition for less than reasonably-equivalent value and then filed the bankruptcy to hinder and avoid creditors, the court may conclude the debtor did not file the petition in good faith.

### Bankruptcy Code §1325(a)(7) vs. §1307(c)

Bankruptcy Code §1325 provides that a court shall confirm a plan if nine subsections of §1325(a) are met. Two of these subsections address good faith. In §1325(a)(3), the court shall confirm the plan if "the plan is proposed in good faith and not by any means forbidden by law." The second of these subsections, added by BAPCPA in October 2005, is §1325(a)(7), which provides that the

1 11 U.S.C . §1307(c).
2 11 U.S.C. §1307(c); *Martinez v. Arce (In re Martinez)*, 397 B.R. 158 (1st Cir. B.A.P. 2008); *In re Alt*, 305 F.3d 413, 418 (6th Cir. 2002) (and cases cites therein).
3 *In re Marrama*, 549 U.S. 365 (2007).
4 *Id.* at 367-68.
5 Whether the debtor who is found to have filed a petition in bad faith will retain all the entire protection of the automatic stay or be granted a discharge is beyond the scope of this article.
6 *In re Torres Martinez*, 397 B.R. 158, 165-66 (1st Cir. B.A.P. 2008).
7 *Id.*
8 *Marrama, supra* (debtor transferred property worth a substantial value to a trust for no consideration seven months prior to filing bankruptcy).
9 11 U.S.C. §548.
10 11 U.S.C. §550.
11 11 U.S.C. §544.
12 *See Marrama, supra.*

court shall confirm the plan if "the action of the debtor in filing the petition was in good faith."[13]

Few courts have interpreted the new subsection (a)(7), and only one has found a distinction between subsections (a)(3) and (a)(7). When considering the objection to confirmation under §1325(a)(7), the U.S. Bankruptcy Court for the Northern District of Indiana concluded that a determination that the petition is not filed in good faith requires a finding of prepetition and postpetition misconduct, such as concealment of assets or misrepresentation of material facts, whereas the determination of a plan's good faith may not.[14] Other courts have found that §1325(a)(7) provides no greater or lesser authority to dismiss a petition as a bad-faith filing than existed prior to its enactment;[15] it simply reiterates the court's authority to address whether the petition was filed in bad faith, and if so, to permit dismissal. Given that we have scant legislative history regarding §1325(a)(7), we can only speculate regarding congressional intent for its addition to the Code. The fact that Congress did not amend §1307 to add lack of good faith as a ground for dismissal nor amend §109[16] to add good faith as a condition for eligibility to be a debtor may suggest that the insertion had more to do with resolving a judicial split over whether prepetition conduct should be considered in determining good faith rather than with codifying the court's dismissal authority. While most courts did take into account a debtor's prepetition conduct when evaluating a plan's good faith, some courts excluded prepetition conduct from the pre-BAPCPA plan good-faith analysis.[17]

Notwithstanding the exclusion of "good faith" from §§1307 and 109, most courts are reluctant to find that bad faith can be remedied and therefore are unwilling to permit a chapter 13 case to proceed unless it can be shown that the debtor has filed the petition in good faith. As described by the U.S. Bankruptcy Court for the Eastern District of Pennsylvania, when considering §1325(a)(7), "if a lack of good faith in filing a chapter 13 petition mandates a denial of confirmation, it would appear that this defect would be irremediable. If so, a chapter 13 case in which the debtor is unable to confirm any plan warrants dismissal under §1307(c)."[18] Yet if a chapter 13 debtor's plan fails to comply with any of the other subsections of 1325(a), the courts do not routinely dismiss the petition; they typically deny confirmation and permit a plan modification.

For some courts the answer is in the analysis: When the court weighs the bad-faith factors, it may place less weight upon the bad conduct than upon other factors. Thus, even if egregious conduct occurred, when the debtor is nevertheless proposing a plan that represents his best efforts to satisfy his creditors, the debtor may proceed in chapter 13 and may obtain plan confirmation.[19] These courts find that after weighing the factors, the conclusion is that the petition, and plan, have been proposed in *good faith.*[20] What if the court concludes that the petition was not filed in good faith? May the debtor nonetheless amend his plan to overcome this defect?

If the *plan* is not proposed in good faith, courts may permit modification.[21] If the petition is not proposed in good faith *due to prepetition conduct,* this author believes that the same remedy should apply. The debtor's prepetition bad acts should not render the debtor ineligible for relief or rehabilitation. In other words, the debtor should be permitted to "pay for" or compensate creditors for the bad conduct prepetition through a plan of reorganization. Just what that plan will require will depend on the facts of the case and the extent of the "bad acts."[22] Postpetition bad faith or misconduct, however, should not be treated in this manner, especially if the misconduct relates to false statements in the bankruptcy. As described by one court, "a debtor cannot excise a false oath by making subsequent corrections to his bankruptcy petition...."[23] Or as another court warned, "if debtors could omit assets at will, with the only penalty that they had to file an amended claim once caught, cheating would be altogether too attractive."[24] When the debtor engages in irrational and irresponsible behavior prebankruptcy, yet is forthcoming fully during the bankruptcy, the debtor should at least have the opportunity to try to reorganize and rehabilitate. The controlling element should be a determination that the debtor is *honest* but unfortunate.[25]

## The Process

The Bankruptcy Rules provide that a request for relief be made in writing in the form of a motion,[26] or in some circumstances a complaint.[27] Generally, "adequate notice" requires advising the affected party of the relief requested sufficient to provide an opportunity to respond.[28] Therefore, it seems that if the debtor's conduct is so egregious as to merit dismissal for cause, the request should be made in writing as a motion and coupled with a notice of hearing; simply objecting to confirmation should not be enough.

One circuit court admonished bankruptcy courts to use restraint when considering whether to dismiss a petition for cause such as bad faith rather than impose the less drastic remedy of denying confirmation of a plan.[29] The Seventh Circuit suggested that "[b]ecause dismissal is harsh, we agree that the bankruptcy court should be more reluctant to dismiss a petition under §1307(c) for lack of good faith than to reject a plan for lack of good faith under §1325(a)."[30] Indeed, the Supreme Court cited the Seventh Circuit's statement in its opinion in *Marrama* as support for the bankruptcy court's discretion to consider the debtor's conduct, determine whether it qualifies as bad faith, and decide whether to deny confirmation or to order such other relief as is appropriate to prevent an abuse of process.

One cannot articulate with precision what conduct qualifies as "bad faith" sufficient to permit a bankruptcy judge to dismiss a chapter 13 case or to deny conversion from chapter 7. It suffices to emphasize that the debtor's conduct must, in fact, be atypical. Limiting dismissal or denial of conversion to extraordinary

13 11 U.S.C. §1325(a)(7).

14 *In re Jongsma,* 402 B.R. 858, 870 (Bankr. N.D. Ind. 2009) (prepetition conduct of debtor is now irrelevant in determination of good faith under 11 U.S.C. §1325(a)(3)—plan good faith).

15 *In re Shafer,* 393 B.R. 655, 659 (Bankr. W.D. Wis. 2008); *In re Bland,* 2008 WL 2006647 (Bankr. N.D. W.Va. 2008).

16 This Code section defines who may be a debtor, or who is eligible to proceed as a debtor, under each of the chapters of the Code.

17 *See generally In re Smith,* 848 F.2d 813 (7th Cir. 1988); *Jongsma, supra;* Lundin, *Chapter 13 Bankruptcy, 3d Ed,* Sec. 148.1 (2000 & Supp 2004) for a review of cases interpreting good faith.

18 *In re Manno,* 2009 WL 236844 (Bankr. E.D. Pa. Jan. 30, 2009).

19 *In re Smith,* 286 F.3d 461 (7th Cir. 2002); *In re Powell,* 403 B.R. 583 (Bankr. C.D. Ill. 2009).

20 *Banks v. Vandiver (In re Banks),* 248 B.R. 799 (B.A.P. 8th Cir. 2000); *In re Osborn,* 346 B.R. 204 (Bankr N.D. Cal. 2006); *In re Britt,* 211 B.R. 74 (Bankr. M.D. Fla. 1997), *aff'd sub non, Landis v. Britt,* No. 98-2315 (11th Cir. Oct. 20, 1998).

21 *In re Martin,* 373 B.R. 731 (Bankr. D. Utah 2007); *In re Cordes,* 147 B.R. 498 (Bankr. D. Minn. 1991).

22 The debtor must show that reorganization is not objectively futile. *Carolin Corp. v. Miller,* 886 F.2d 693 (4th Cir. 1989); *In re Mosby,* 244 B.R. 79 (Bankr. E.D. Va. 2000). The burden falls upon the debtor to show that the plan meets the requirements of confirmation in the face of a good-faith objection to confirmation. *In re Brown,* 244 B.R. 603 (Bankr. W.D. Va. 2000).

23 *Jongsma,* 402 B.R. at 874, *citing Bensenville Community Ctr. v. Union v.Bailey (In re Bailey),* 147 B.R. 157 (Bankr. N.D. Ill. 1991).

24 *Id., citing Rogers v. Boba (In re Boba),* 280 B.R. 430 (Bankr. N.D. Ill. 2002).

25 *Grogan v. Garner,* 498 U.S. 279 (1991) (emphasis added) (Bankruptcy Code is intended to give fresh start to honest but unfortunate debtors).

26 Fed. R. Bankr. P. 9013.

27 *See* Fed. R. Bankr. P. 7001.

28 *See* Fed. R. Bankr. P. 9014; 7004.

29 *In re Love,* 957 F.2d 1350 (7th Cir. 1992). *See also In re Alt,* 305 F.3d 413 (6th Cir. 2002) (same).

30 *Id.* at 1356.

*continued on page 59*

from page 53

cases is particularly appropriate in light of the fact that lack of good faith in proposing a chapter 13 plan is an express statutory ground for denying plan confirmation. 11 U.S.C. §1325(a)(3). *See also In re Love,* 957 F.2d at 1356 ("because dismissal is harsh...the bankruptcy court should be more reluctant to dismiss a petition...for lack of good faith than to reject a plan for lack of good faith under section 1325(a).").[31]

[31] *Marrama,* 549 at 1112, n. 11.

## Conclusion

Sometimes debtors do bad things. If the debtor's bad conduct relates to his honesty to the court, his compliance with orders of the court or his efforts to abuse the bankruptcy process, his conduct should result in "forfeiture of his right to proceed with a chapter 13 case."[32] Yet we should distinguish between pre- and postpetition conduct. Debtors who engage in bad conduct *prepetition* should be eligible to reorganize or rehabilitate. The test to survive in bankruptcy should be whether a debtor's conduct *postpetition* reflects a sincere effort for financial rehabilitation and does not involve false statements, concealment of assets, underreporting of income or manipulation of the Bankruptcy Code. Indeed, a bad person ultimately may be a good debtor. ■

[32] *Marrama,* 549 U.S. at 367 (Justice John Paul Stevens describes question presented to Court as whether debtor who acts in bad faith prior to or in course of filing chapter 13 petition "forfeits his right to obtain Chapter 13 relief" and goes on to acknowledge that federal courts are "virtually unanimous that prepetition bad faith conduct may cause a forfeiture of any right to proceed with a Chapter 13 case.").

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