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BANKRUPTCY LAW

Section 707(b) of the Bankruptcy Code, 11 U.S.C. § 707(b) (1990), (section 707(b)), allows the United States trustee in a bankruptcy proceeding to file a motion to dismiss the case if granting relief would contradict the import of the provisions of the Bankruptcy Code. One court has interpreted this statute to allow the trustee to raise a motion to dismiss even when a creditor initially has proposed the idea to the trustee.[62] However, at least one court and one treatise writer have concluded that section 707(b) precludes the trustee from raising the motion to dismiss a bankruptcy action when an interested party's suggestion initially prompts the trustee's action.[63]

Additionally, the courts are divided on whether a trustee has standing to appeal the denial of a section 707(b) motion considering that the Bankruptcy Code does not expressly give the trustee the power to appeal. Courts generally determine if a party has standing in bankruptcy cases by applying the "person aggrieved" test.[64] To achieve "person aggrieved" status a party must be directly injured pecuniarily.[65] United States trustees cannot meet this standard because they never have a pecuniary interest in the bankruptcy proceeding. However, other standards may apply to a party such as a trustee.[66] In In re *Clark*, 927 F.2d 793 (4th Cir. 1991), the United States Court of Appeals for the Fourth Circuit confronted the issues of whether a trustee may raise a section 707(b) motion when an interested party originally proposes the motion to the trustee, and whether a trustee has standing to appeal a court's denial of a section 707(b) motion.

After Cleatus Clark filed a voluntary petition for relief pursuant to Chapter 7 of the Bankruptcy Code, one of Clark's creditors sent the trustee a letter informing the trustee that Clark's statements about his income and expenses might be inaccurate. The letter asked the trustee to consider filing a section 707(b) motion to dismiss Clark's petition for "substantial abuse." After an investigation of Clark, the trustee filed a section 707(b) motion to dismiss. The bankruptcy court issued a Memorandum Opinion and Order dismissing the trustee's motion because the motion appeared to originate with Great Western, one of Clark's creditors. The court interpreted section 707(b) as barring the trustee from instituting a "substantial abuse" motion at the suggestion of a creditor, who is a party in interest. The trustee then

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62. *See In re* Busbin, 95 B.R. 240, 242 (Bankr. N.D. Ga. 1989) (holding that trustee can bring § 707(b) motion to dismiss at suggestion of creditor).

63. *See In re* Restea, 76 B.R. 728, 733 (Bankr. D.S.D 1987) (holding that trustee cannot enter motion to dismiss when action was originally suggested by party in interest); 4 COLLIER ON BANKRUPTCY § 707.05 at 707-16 (15th ed. 1990).

64. *In re* Clark, 927 F.2d 793, 795 (4th Cir. 1991).

65. *In re* Fondiller, 707 F.2d 441, 442 (9th Cir. 1983).

66. *See* SEC v. United States Realty & Improvement Co., 310 U.S. 434, 460 (1940) (holding that "party aggrieved" standard could be satisfied when party had official duty to enforce bankruptcy law in public interest); *In re* Revco D.S., Inc., 898 F.2d 498, 499-500 (6th Cir. 1990) (holding that U.S. trustee had standing because of his official duty to enforce bankruptcy law in public interest).

appealed the bankruptcy court's ruling to the Western District Court of Virginia. The district court dismissed the appeal, holding that the trustee did not have standing to appeal the bankruptcy court's denial of a section 707(b) motion.

In *In re Revco D.S., Inc.*, 898 F.2d 498 (6th Cir. 1990), the Sixth Circuit had used the official duty standard to hold that a United States trustee had appellate standing. The district court had distinguished *SEC v. United States Realty & Improvement Co.*, 310 U.S. 434 (1940), from the case at bar, reasoning that in *U.S. Realty* the SEC had a right to intervene under Federal Rule of Civil Procedure 24. Therefore, the SEC had appellate standing where an adverse ruling affected a public interest which the SEC had a duty to protect. The district court then concluded that because the trustee had no similar right of intervention, the trustee could not appeal the bankruptcy court's ruling.

On appeal, the Fourth Circuit first addressed the trustee's standing to appeal the bankruptcy court's dismissal of the section 707(b) motion. The *Clark* court, relying on *In re Fondiller*, 707 F.2d 441 (9th Cir. 1983), acknowledged that a trustee could not satisfy the normal aggrieved person appellate standing test because the trustee could not be directly and pecuniarily injured. The court then noted that in *United States Realty & Improvement Co.*, the United States Supreme Court had held that standing to appeal could also arise out of a party's official duty to enforce the bankruptcy law in the public interest. The Fourth Circuit held that the absence of a right of intervention was not crucial. Instead, the court compared the trustee's and the SEC's respective duties to enforce the law in the public interest. The court reasoned that because the trustee had a statutory right to bring a section 707(b) motion, he did not need a right of intervention. The court then stated that if a trustee alleges that the bankruptcy court's ruling has interfered with the trustee's statutory duty then the trustee has standing to appeal that ruling under the *United States Realty* rationale.

The court further opined that section 307, 11 U.S.C. § 307 (1990), gives the trustee appellate standing because section 307 grants the trustee the right to appear and be heard in any Title 11 case or proceeding. Even though the trustee had no pecuniary interest in the suit, the House of Representatives report on section 307 noted that the section granted the trustee standing.[67] Finally, the court reasoned that if Congress had intended to limit the trustee's appellate standing it would have explicitly excluded the right as Congress had done with certain agencies in numerous sections of the Bankruptcy Code. Thus, the court held that the trustee had standing to appeal the bankruptcy court's decision.

After dispensing with the district court's refusal to allow the trustee to appeal, the court turned to the trustee's right to bring a section 707(b) motion to dismiss. Section 707(b) states:

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67. H.R. REP. No. 764, 99th Cong., 2d Sess. 27, *reprinted in* 1986 U.S.C.C.A.N. 5227, 5240.

> 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.

11 U.S.C. § 707(b). The bankruptcy court held that the trustee could not make a motion to dismiss under section 707(b) if a party in interest had previously suggested that the trustee do so. The Fourth Circuit, however, interpreted the phrase "but not at the request or suggestion of any party in interest" to modify what the court itself can do, because "the court" is the subject of the sentence. Therefore, the court held that section 707(b) bars the court from dismissing a debtor's Chapter 7 petition only if a party in interest suggests to the court as opposed to the trustee that a section 707(b) motion should be made. The court stated that section 707(b) does not bar the trustee from making a motion at the suggestion of a creditor and does not bar the court from considering such a motion.

The court contended that this reading of section 707(b) will avoid creditor harassment of debtors because the trustee must make an independent judgment about filing a 707(b) motion to dismiss after receiving the suggestion from an interested party. Thus, the Fourth Circuit overruled the bankruptcy court, holding that the trustee could make a section 707(b) motion to dismiss even though an interested party had previously suggested the action to the trustee.

Section 707(b) of the Bankruptcy Code (the Code), 11 U.S.C. § 707(b) (1990), permits a court to dismiss a debtor's Chapter 7 bankruptcy suit, on the court's or the United States trustee's motion, if it finds that granting relief would constitute "substantial abuse" of the Code. Courts have been struggling to define "substantial abuse" since 1984, when Congress amended the 1978 Bankruptcy Code to include section 707(b). Congress intended the amendment to address the conflicting interests of debtors who desire a fresh financial start, and creditors who complain of abuses of the bankruptcy proceeding by non-needy debtors. Congress, however, did not define the phrase "substantial abuse," and courts have applied either a per se rule or a totality of the circumstances analysis to the dismissal question.[68] Under

68. *Compare In re* Kelly, 841 F.2d 908, 914 (9th Cir. 1988) (holding debtor's ability to pay debts, standing alone is sufficient justification to deny Chapter 7 petition under § 707(b)) *and In re* Edwards, 50 B.R. 933, 936 (Bankr. S.D.N.Y. 1985) (holding that ability to pay 100% of debts in three years constitutes substantial abuse under § 707(b)) *and In re* Struggs, 71 B.R. 96, 97 (Bankr. E.D. Mich. 1987) (holding that debtor who can repay debt under Chapter 13 plan should have Chapter 7 petition dismissed) *with In re* Shands, 63 B.R. 121, 124 (Bankr. E.D. Mich. 1985) (holding ability to pay 100% within three years, when combined with other egregious circumstances, sufficient to deny Chapter 7 relief) *and In re* Peluso, 72

the per se rule, a substantial abuse exists if a debtor's income exceeds his necessary expenses. The totality of the circumstances approach requires a court to consider additional factors such as illness, unemployment and the debtor's good faith, in determining whether the bankruptcy petition constitutes a substantial abuse of the bankruptcy proceedings.

In *In re Green*, 934 F.2d 568 (4th Cir. 1991), the United States Court of Appeals for the Fourth Circuit considered which approach was more appropriate for a court's consideration of dismissal under section 707(b). In *Green*, the debtor filed a petition for Chapter 7 bankruptcy relief with the United States Bankruptcy Court for the District of Maryland. The bankruptcy court held a hearing at which Green testified that he had $40,000 in unsecured debt, consisting mostly of a credit union loan and department store and consumer loan debts. He also had an income of at least $638 a month in excess of his necessary expenses. Having held the same job as a bus driver for 13 years, Green's 1988 income was $46,000. A substantial amount of that income was attributable to overtime pay. Green, however, had injured his leg and would not be able to earn overtime pay in the future. He estimated that his income in 1989 would be only $26,000.

The United States trustee moved for dismissal of Green's petition and the bankruptcy court granted the motion. Applying the per se rule, the bankruptcy court reasoned that the income in excess of necessary expenses was, by itself, sufficient to constitute a substantial abuse of Chapter 7. The district court affirmed, holding that excessive monthly income could serve as the sole basis for finding substantial abuse. Green appealed this decision to the Fourth Circuit Court of Appeals.

On appeal, the United States trustee argued that the *per se* rule that the lower courts had applied was the proper method of interpreting "substantial abuse" under section 707(b). In applying the per se rule, the lower courts had relied on *In re Kelly*, 841 F.2d 908 (9th Cir. 1988). In *Kelly*, the debtor had an excess of income over expenditures of $440 per month, and the court found that they could repay ninety-nine percent of their unsecured debt out of disposable income in three years. The United States Court of Appeals for the Ninth Circuit noted that the principal factor for several courts considering dismissal of a Chapter 7 petition under the substantial abuse standard was the debtor's ability to repay his debts. Using these cases, the *Kelly* court announced, as a general rule, the proposition that this ability to pay, standing alone, can justify a dismissal under section 707(b).

The Fourth Circuit agreed that a debtor's ability to repay his creditors is the primary factor to be considered in a motion to dismiss a Chapter 7 petition, but criticized the *Kelly* court's holding that ability to repay could

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B.R. 732, 738 (Bankr. N.D.N.Y 1987) (considering injuries and debtor's financial statements as relevant factors) *and In re* Deaton, 65 B.R. 663, 664 (Bankr. S.D. Ohio 1986) (holding that factors other than debtor's ability to repay debt under Chapter 13 plan needed to find substantial abuse under § 707(b)).

serve as the sole factor used in making a determination to dismiss a petition. The Fourth Circuit looked to the legislative history of the amendment that established section 707(b) for insight into the appropriate definition of "substantial abuse," but found that the history was not helpful. The court then noted that the legislative history of section 707(a), which enumerates causes for dismissal of debtor's bankruptcy petition, showed that Congress had not contemplated whether a debtor's ability to repay constituted grounds for dismissal.[69] The *Green* court held that the lack of any legislative preference for the per se rule required a case-by-case analysis which would take into consideration the totality of the circumstances.

The totality of the circumstances approach involves considering other relevant factors, five of which the court enumerated: (1) sudden illness, disability or unemployment; (2) cash advances and consumer purchases in excess of the debtor's ability to repay; (3) excessiveness or unreasonableness of the debtor's family budget; (4) accuracy of the debtor's income and expense schedule; and (5) the debtor's good faith in petitioning for bankruptcy relief. The *Green* court stated that this approach allows a court to determine with greater accuracy whether a creditor is abusing the Bankruptcy Code by unfairly taking advantage of his creditors, which is the concern that section 707(b) was intended to address.

The court's opinion also noted that section 707(b) contains a statutory presumption in favor of granting a debtor's petition for Chapter 7 relief, implying that solvency alone cannot constitute substantial abuse. Under the *per se* rule an insolvent debtor would qualify for Chapter 7 protection and a solvent debtor would not. The court would not consider other factors, and a statutory presumption would serve no purpose. The *Green* court found that this was not consistent with Congress' intent in enacting section 707(b). Furthermore, the court noted that the Bankruptcy Code does not require that a debtor be insolvent in order to file for bankruptcy. Consequently, the Fourth Circuit's opinion emphasizes that the totality of the circumstances analysis is preferable to the *per se* rule because it serves as a better test for determining whether a debtor is attempting to abuse the bankruptcy process, and is also consistent with the statutory presumption in favor of granting a debtor's petition for Chapter 7 relief. As a result, the court reversed the district court's opinion and remanded the case with instructions that it be returned to the bankruptcy court to apply the five enumerated factors.

One Illinois district court, in *In re Fortune*, 130 B.R. 525 (Bankr. C.D. Ill. 1991), has cited the *Green* court's holding with approval, and rejected the *per se* rule in favor of the totality of the circumstances test. The *Green* court's adoption of the totality of the circumstances test, instead of the *Kelly* court's *per se* rule, creates a split between the Fourth and the Ninth Circuits. Although the court in *Green* agreed that the debtor's ability to

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69. S. Rep. No. 95-989, 95th Cong., 2d Sess. 94 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5880.

repay is the primary factor for a court to consider in deciding a motion to dismiss a Chapter 7 petition, the court refused to make it the sole, dispositive factor. Such a standard, in the *Green* court's opinion, is inconsistent with the statute's legislative history and its presumption in favor of granting Chapter 7 relief. Both the *per se* rule and totality of circumstances approaches find support in bankruptcy court opinions, but neither test is dominant.

The doctrine of collateral estoppel or issue preclusion prevents the relitigation of an issue or issues actually litigated and necessarily decided in a prior action before a court of competent jurisdiction.[70] Issue preclusion will bar a party from relitigating an issue previously decided if that party had "a full and fair opportunity" to litigate the issue in a prior suit.[71] The doctrine of issue preclusion applies in a bankruptcy context, but before a party may assert issue preclusion the bankruptcy court must determine whether the issue was actually litigated "with particular care."[72]

In a bankruptcy proceeding, prior judgments against a debtor for fraud, defalcation, embezzlement, and larceny are not dischargeable.[73] With these principles in mind, the United States Court of Appeals for the Fourth Circuit, in *In re Raynor*, 922 F.2d 1146 (4th Cir. 1991), considered the issue of whether a prior default judgment for fraud, adverse to a bankruptcy petitioner, will operate as issue preclusive and bar the discharge of the judgment debt.

In *Raynor*, the creditor, M & M Transmissions, Inc. (M & M), contracted with AAA Distributors and Associates, Inc. (AAA) to purchase automobile repair equipment. Subsequently, M & M brought suit in state court in North Carolina against AAA and Charles G. Raynor, Sr. (Raynor), as AAA's agent, alleging breach of contract, breach of express and implied warranties, fraud, and unfair or deceptive trade practices. After being served with process, Raynor retained an attorney, Donald E. Britt, Jr., to represent him in the suit. Because settlement negotiations were in process, Britt did not enter a formal appearance nor did Britt file an answer on behalf of Raynor. Although a settlement agreement was reached and signed by Raynor, Raynor refused to abide by the agreement and the case was set for trial on October 2, 1986. From the date of the agreement until the trial, there was no communication between Britt and Raynor. After failing in his attempts to contact Raynor, Britt moved, on the day of the trial, to withdraw from the case. The trial court granted Britt's motion, and thus, Raynor had neither notice of the trial and nor representation. The trial court, finding AAA and Raynor liable on all counts alleged and granting punitive damages, entered a default judgment against AAA and Raynor jointly and

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70. RESTATEMENT (SECOND) OF JUDGMENTS § 27 (1982).
71. Allen v. McCurry, 449 U.S. 90, 95 (1980).
72. Combs v. Richardson, 838 F.2d 112, 113 (4th Cir. 1988).
73. 11 U.S.C. § 523(a)(4) (1988).

severally in the amount of $226,000. In addition, the trial court awarded M & M $15,000 in attorney's fees.

Raynor did not learn of the default judgment or of the withdrawal of his attorney until M & M attempted to claim exempt property belonging to Raynor. After learning of M & M's claim, Raynor, represented by new counsel, moved for relief from the judgment, but the trial court denied his motion. Raynor appealed to the North Carolina Court of Appeals. Finding no abuse of discretion on the part of the trial court, the appeals court affirmed the judgment in part and remanded with directions that M & M elect a remedy under either the fraud claim or the unfair trade practices claim. M & M elected the fraud remedy and the trial court entered judgment for breach of contract, fraud, and punitive damages in the amount of $144,000.

Next, Raynor voluntarily petitioned for bankruptcy and M & M initiated an adversary proceeding to determine whether Raynor should be discharged from the judgment debt. Raynor filed an answer stating that he had not had an opportunity to present his defense before the trial court entered the default judgment against him. M & M moved for summary judgment on the grounds of issue preclusion. The bankruptcy court, finding that bankruptcy law and North Carolina law were similar with respect to the elements of fraud and the standard of proof, applied the doctrine of issue preclusion to the fraud issue and granted M & M motion for summary judgment. The bankruptcy court entered judgment for M & M in the amount of $226,000 and denied dischargeability.

Raynor appealed to the United District Court for the Eastern District of North Carolina. The district court affirmed the finding of the bankruptcy court that the default judgment was *res judicata* on the issue of fraud and that the debt was not dischargeable. But the district court corrected the judgment entered by the bankruptcy court, reducing it to $144,000. Raynor appealed the district court decision to the Fourth Circuit arguing that the doctrine of issue preclusion does not apply to a default judgment for fraud when dischargeability in a bankruptcy proceeding is at issue.

Initially, the Fourth Circuit recognized that Congress did not intend the fresh start of a bankruptcy discharge to discharge an individual debtor from any debt to the extent obtained by false pretenses, a false representation, or actual fraud. However, the Fourth Circuit ruled that a default judgment, even when rendered upon a claim of fraud, will not have preclusive effect in the determination of dischargeability. The Fourth Circuit based its ruling on *Combs v. Richardson*, 838 F.2d 112 (4th Cir. 1988), which required that the determination of whether an issue had been actually litigated and necessarily decided be made with "particular care," and upon *In re Myers*, 52 B.R. 901 (Bankr. E.D. Va. 1985) and the Restatement (Second) of Judgments, both of which refuse to apply the doctrine of issue preclusion to a default judgment.

In arriving at its conclusion, the Fourth Circuit paid special attention to the fact that at no time was the issue of fraud actually litigated. The issue of fraud was not litigated in state trial court because Raynor was

unaware of the proceedings. When Raynor petitioned for relief from the default judgment, the trial court did not address the issue of fraud, but merely exercised its discretion to deny relief. There was no cross-examination of M & M's witnesses, and the state trial court placed the burden of showing a defense of fraud on Raynor. The Fourth Circuit found this burden allocation to be contrary to the rule in bankruptcy which requires the party who challenges discharge to bear the burden of proof. In the state appellate court, the parties did not litigate and merely addressed the issue of whether the state trial court had abused its discretion in denying relief from the default judgment. Thus under the rule of *In re Myers* and the Restatement (Second) of Judgments section 27 comment e, the Fourth Circuit held that a default judgment could not support issue preclusion and reversed the judgment of the Federal District Court. The Fourth Circuit remanded the case and directed the bankruptcy court to conduct evidentiary hearings on the issue of fraud to determine whether Raynor should be discharged.

Judge Niemeyer, in a very strong dissent, disagreed with the majority's conclusion that issue preclusion could not be applied to the facts of this case. Instead, Judge Niemeyer believed the state court default judgment to be a proper judgment and entitled to recognition by a bankruptcy court. Feeling that Raynor had had his "full and fair opportunity" to litigate the fraud issue in either the initial state court proceeding, in the motion for relief from judgment, or in the state court of appeals, Judge Niemeyer would have applied issue preclusion to the default judgment and denied dischargeability. In reaching this conclusion, Judge Niemeyer placed special emphasis on the fact that Raynor was no stranger to lawsuits. In fact Raynor had been involved in at least eleven prior suits, each resulting in a judgment adverse to Raynor. Thus, Judge Niemeyer voted to affirm the Federal District Court's determination that issue preclusion did indeed apply to the facts of this case.

The Fourth Circuit's decision in *Raynor* is in accord with the holding of a majority of the other circuits that have addressed this issue.[74] Additionally, the *Raynor* holding is in line with the view of several commentators.[75] Even though Judge Niemeyer recognizes the injustice which will occur in this particular case, his view appears to be shared by only the United States Court of Appeals for the Second Circuit.[76] Given the fact that the

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74. *See*, *In re* McMillan, 579 F.2d 289 (3d Cir. 1978). The Third Circuit in *McMillan* held that a default judgment had no collateral estoppel effect even as to facts which were necessary to the default judgment; thus, the bankrupts were not collaterally estopped from relitigating the same issues in a bankruptcy case where a creditor sought to have a claim and default judgment for fraud and misrepresentation declared non-dischargeable. *See also In re* Poston, 735 F.2d 866 (5th Cir. 1984) (holding that debt incurred through false representations and fraud did not have conclusive collateral estoppel effect as to subsequent determination of nondischargeability of debt in bankruptcy case).

75. *See, e.g.*, 1B J. MOORE ET AL., MOORE'S FEDERAL PRACTICE ¶ 0.401 (2d ed. 1985); 1A COLLIER'S ON BANKRUPTCY ¶ 17.16 (14th ed. 1973).

76. *See* Kelleran v. Andrijevic, 825 F.2d 692, 694 (2d Cir. 1987) (holding that bankruptcy