MASSACHUSETTS LAWYERS WEEKLY

October 30, 2017

Bad faith not cause for dismissal of Chapter 7 bankruptcy case

Question has split federal circuit courts

By: Kris Olson October 26, 2017

Answering a question that has divided federal circuit courts, a Massachusetts bankruptcy judge has found that bad faith is not "cause" for dismissal of a Chapter 7 case, as defined in 11 U.S.C. §707(a).

Pursued by victims of a real estate fraud scheme in which he allegedly participated, a debtor filed for Chapter 7 bankruptcy. One of the benefits of doing so was that he could "do something he could not do under Massachusetts law [G.L.c. 188, §3(b)(6)] alone: use his homestead exemption to shelter his equity in his home … from creditors holding claims arising from his acts of fraud," Judge Frank J. Bailey noted.

Indeed, obtaining the full benefit of the homestead exemption became essentially the only benefit of filing for bankruptcy

when the debtor voluntarily waived discharge under §727(a)(10).

Two creditors moved to dismiss the debtor's bankruptcy case, arguing that, in the absence of controlling precedent from the 1st U.S. Circuit Court of Appeals, Bailey should follow the 3rd, 5th, 6th, 7th and 11th circuits in holding that lack of good faith in filing a bankruptcy petition is "cause" to warrant dismissal under §707(a).

However, Bailey noted that §707(a) offers a non-exclusive list oof three valid causes to dismiss a Chapter 7 case, two of them dealing with technical requirements such as the payment of fees and mandatory filings, along with "unreasonable delay by the debtor that is prejudicial to the creditors."

Bad faith is "so dissimilar to those enumerated items as to make it highly doubtful that the drafters intended to include it in §707(a) 'cause,'" Bailey wrote.

Finding that bad faith is "cause" under §707(a) would also render §707(b) — permitting dismissal for bad faith in consumer-debt cases — "superfluous," Bailey said.

Allowing dismissal in a "subset of chapter 7 cases … means that the drafters did not intend for bad faith to be 'cause' for dismissal in subsection (a), which applies to all chapter 7 cases," Bailey wrote.

The six-page decision is *In Re: Reinhold, Mark G.*, Lawyers Weekly No. 04-050-17. The full text of the ruling can be found here.

Policy choices in law

The debtor's Boston attorney, Richard N. Gottlieb, said *Reinhold* reinforces Congress's policy decision that, "as a living, breathing human being," a debtor — even a "bad" one — is still entitled to his homestead.

The Bankruptcy Code was designed so that debtors avoid becoming "wards of the state," Gottlieb said. That means allowing debtors to retain a certain amount of the equity in their homes, given the societal importance of the asset upon

which many people draw for their retirement, among other things.

Gottlieb said that, at oral argument, the judge told him he was "exactly right" when he argued: "If you accept the argument that you can dismiss a Chapter 7 bankruptcy for bad faith, how do you quantify that?"

The three listed causes for dismissal under §707(a) are "all mechanical, procedural, not substantive," he noted, adding that the problem with basing a dismissal on a "soft concept" like bad faith is "how bad do you have to be?"

Gottlieb said he was heartened instead to see Bailey latch onto language in his brief from *In re Miller*, in which a creditor also unsuccessfully tried to get around a Chapter 7 debtor's declaration of homestead.

"The Debtor can hardly be faulted for having done what the law permits him to do," Judge Carol J. Kenner wrote in *In re Miller*.

But to the plaintiffs' attorney, Ryan A. Ciporkin of Boston, Bailey's decision encourages debtors to shelter up to $500,000 (the full extent of the Massachusetts homestead exemption) in ill-gotten gains from participation in financial crimes.

"To me, it's an incredibly unfair result" and one contrary to Congress's intent, he said.

Of all the precedent he laid out in his 80-page memorandum in support of his motion to dismiss, Ciporkin said he was most dismayed that Bailey failed to heed the guidance of the 11th Circuit in *In re Piazza*, which cited to the U.S. Supreme Court case *Marrama v. Citizens Bank of Mass.*, for the proposition that "bad faith is pertinent in all Chapters of the Bankruptcy Code, regardless of whether a provision contains an explicit good-faith filing requirement."

"Somehow, Judge Bailey didn't think the case was binding," he said.

Ciporkin said that he and his clients had yet to decide whether to seek further review of Bailey's decision. According to Gottlieb, however, because there had been no notice of appeal filed as of Oct. 18, Bailey's determination had become final.

Boston attorney John G. Loughnane said that Ciporkin took a "valid shot" at arguing that §707(a) includes bad faith, given the conflicting precedent and the sympathetic position of his clients.

"The frustration of the plaintiffs is absolutely understandable," he said. "They were wronged by conduct that has economically harmed them, and they would like to be compensated."

But Loughnane also agreed with Gottlieb — and the judge — on the philosophy animating the decision.

The question, he said, is "how destitute do we want to make people?"

By waiving his discharge, the debtor paid a big price, he said. If the debtor comes into money in the future, his creditors could still come after him under state law, Loughnane noted.

But as to whether the debtor should be dispossessed of his house, Bailey was correct in deciding that "you can't get blood from a stone — as angry as you are at the stone," Loughnane said.

Boston attorney Richard L. Levine acknowledged that the decision "certainly would be a surprise to a layperson, but if you asked a bankruptcy expert, they would say the decision is probably correct" as dismissals under Chapter 7 are intended to be difficult to achieve.

The debtor's attorney, Richard N. Gottlieb, said Reinhold reinforces Congress's policy decision that, "as a living, breathing human being," a debtor — even a "bad" one — is still entitled to his homestead.

Victims of real estate scheme

Plaintiffs Teresa Wang and Daniel Qiu are among a group of unsecured creditors holding claims totaling $563,000 against debtor Mark G. Reinhold. The claims are related to Reinhold's alleged complicity with Michael Scott, who would be convicted of a conspiracy to defraud the creditors out of deposits paid to Reinhold's real estate brokerage company. Reinhold's other unsecured debts totaled only $11,200.

According to Wang and Qiu, Scott fraudulently induced them to deposit $199,000 with Scott for purchases of Jamaica Plain

properties under the false promise that he was working with Reinhold and that their deposit funds would be held in escrow.

Reinhold's involvement was essential to the scheme, the plaintiffs claimed, because Scott had lost his real estate license due to misdeeds that would eventually lead to a 135-month sentence for mortgage fraud. Even though he knew of Scott's legal troubles and that he had surrendered his real estate license, Reinhold had hired Scott as an "independent contractor" and allowed him unfettered access to his business bank accounts, according to the plaintiffs.

On March 20, 2014, Scott was indicted by a federal grand jury on six counts of wire fraud. He eventually pleaded guilty to one of those counts and had 12 months tacked onto his mortgage fraud sentence.

Prior to Reinhold's bankruptcy filing, two other creditors, Zainal and Reiza Mahmood, had obtained a writ of attachment for $195,000 in the home Reinhold and his wife owned as tenants by the entirety, in which they had significant equity. The home was valued at $535,000 and encumbered by two mortgages totaling approximately $45,600.

After Reinhold executed a waiver of his Chapter 7 discharge — a move supported by the U.S. trustee — the plaintiffs filed a motion to dismiss Reinhold's Chapter 7 case on Nov. 16, 2016. They alleged both pre-petition bad faith, based on his alleged participation in Scott's scheme, and post-petition bad faith, a failure to make full and candid disclosure of his assets, which Reinhold disputed.

The motion was argued before Bailey shortly thereafter, and the judge's long-awaited decision was issued Oct. 4.

"The frustration of the plaintiffs is absolutely understandable. They were wronged by conduct that has economically harmed them, and they would like to be compensated."

— John G. Loughnane, Boston

Covering his bases

Even if bad faith constitutes cause for dismissal under §707(a), Bailey said that he would hold that "the Debtor's filing of a chapter 7 petition to gain the benefits of the exemption provisions in the Bankruptcy Code is not bad faith."

Bankruptcy relief, Bailey wrote, "includes two principal features: a discharge of prepetition debt, and the ability to claim property as exempt and thereby place it beyond the reach of creditors."

Each of the forms of relief has its limitations, he added, enumerating several of those limitations and calling them "finely calibrated, limiting relief but not taking it all away."

"By taking the exemptions available to him … the Debtor is simply taking advantage of a benefit the enactors of the Bankruptcy Code knowingly chose to make available to debtors, even in the face of prepetition fraudulent and felonious conduct," Bailey wrote, following with the favorable citation to *In re Miller*.

Reinhold's Chapter 7 filing was "neither an abuse of the Code, nor bad faith," Bailey said.

The homestead exemption "is a protection that the law made available to him, and there is no bad faith in his taking advantage of it for the benefit of himself and his wife."

Bailey concluded by also noting that, given the Mahmoods' attachment, which would subsume $195,000 of Reinhold's $245,000 in equity in the property, the plaintiffs "grossly overestimate the extent that the Debtor would have equity in the homestead property, and the ability of unsecured creditors to reach that equity, were this case to be dismissed."

In Re: Reinhold, Mark G.

THE ISSUE: Is bad faith "cause" for dismissal of a Chapter 7 bankruptcy case, as defined in 11 U.S.C. §707(a)?

THE DECISION: No (U.S. Bankruptcy Court)

LAWYERS: Ryan A. Ciporkin of Lawson & Weitzen, Boston (plaintiff creditors)

Richard N. Gottlieb of Boston (defendant debtor)