Luxurious Lifestyles Alone May Not Constitute a Lack of Good Faith under the Bankruptcy Code

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Introduction

Luxurious lifestyles implicate a debtor’s good faith when applying for the protections provided under title 11 of the United States Code (the “Bankruptcy Code”). Typically, bankruptcy courts avoid making the debtor’s luxurious lifestyle, on its own, a determinative factor because the good faith (or bad faith) analysis is determined under a totality of the circumstances approach. A debtor with continuing expenses typically indicative of bad faith can maintain such expenses if the debtor has made other concerted efforts to repay creditors or can otherwise justify those expenses. What is required depends on whether the debtor is applying for protections under Chapter 7 or under Chapters 11 or 13. This memorandum examines the good faith standard under section 707 of the Bankruptcy Code, the standard used for confirmation of reorganization plans under Chapters 11 and 13, and the implications of both standards for debtors with lavish lifestyles.

1. Good Faith Standard under Chapter 7

The purpose of the Bankruptcy Code is to provide honest debtors with a fresh start.1 To protect this purpose, the Bankruptcy Code and the courts have explicitly and implicitly required

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1 See In re DeTrano, 326 F.3d 319, 322 (2d Cir. 2003).
a debtor’s good faith at several points throughout a bankruptcy case. Good faith is defined by common law. Thus, there are multiple standards for good faith inquires, depending on the jurisdiction, case type, and phase of the case.

Under Chapter 7, the court can dismiss a case, on its own motion or on the motion of an interested party, when the court finds that the debtor “filed the plan in bad faith” or “the totality of the circumstances . . . of the debtor’s financial situation demonstrates abuse.” Under a section 707 bad faith analysis, courts have weighed up to sixteen different factors in a totality of the circumstances approach, including: “[t]he absence of an attempt to pay creditors;” “[t]he debtor's failure to make significant lifestyle changes;” “[w]hether the debtor has sufficient resources to pay a substantial portion of debts;” and “whether the debtor failed to make lifestyle adjustments or continued living an expansive or lavish lifestyle.” Many of these factors are common across all good faith analyses under the Bankruptcy Code. However, under the majority rule, these factors are of little consequence under section 707 without additional “egregious circumstances.” Egregious circumstances “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.”

In In re Zick, the Sixth Circuit found egregious circumstances where the debtor scheduled almost $150,000 in legal fees and obligations to family members without further explanation, transferred assets just prior to filing, and the primary debt was a judgment against the debtor for violating a non-compete contract, in addition to the debtor’s lavish lifestyle. The court found

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3 See In re Madison Hotel Assocs., 749 F.2d 410, 424–25 (7th Cir. 1984).
4 See id.
6 Id. at 951–952.
7 See McDow v. Smith, at 81.
8 See In re Zick, 931 F.2d 1124, 1129 (6th Cir. 1991).
9 See id. at 1129.
that the combination of the factors was sufficient to dismiss the plan as filed with bad faith. In contrast, in *McDow v. Smith*, the court found that despite the debtor’s continued spending on a lavish lifestyle at a rate of $32,000 per month, his high monthly income of $30,000 per month, and millions of dollars in tax debt, the plan was not filed in bad faith because these factors were insufficient to constitute egregious circumstances.\(^\text{10}\) The court pointed to a lack of “fraud, misconduct, or gross negligence” or other behavior indicating an attempted abuse of the code.\(^\text{11}\)

Thus, under section 707, a lavish lifestyle alone is insufficient to indicate a lack of good faith because of the egregious circumstances requirement. While this standard represents the majority rule, it is not uniformly followed.\(^\text{12}\) *In re Griffieth* illustrates a variation of the minority rule.\(^\text{13}\) In *In re Griffieth*, the United States Bankruptcy Court for the Northern District of New York did not require egregious circumstances in addition to the usual good faith factors. The factors the court weighed included the debtor’s lavish lifestyle, the failure to repay or attempt to repay creditors despite the debtor’s ability to do so, and additionally, a discharge principally against a single creditor. The court held that these factors were enough to dismiss the case under section 707 for not being filed in good faith.\(^\text{14}\)

II. **Good Faith and Lavish Lifestyles under Chapters 11 and 13**

The good faith analysis for confirmation of a plan of reorganization under Chapters 11 and 13 does not contain the egregious circumstances requirement of a dismissal of a Chapter 7 case. Confirmation of a Chapter 11 plan requires that, “[t]he plan has been proposed in good faith. . . .”\(^\text{15}\) An analysis of good faith under section 1129(a)(3) typically asks whether, under the totality of the circumstances, “there is a reasonable likelihood that the plan will achieve a

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\(^{10}\) See *McDow v. Smith* at 82, 83.

\(^{11}\) Id.

\(^{12}\) See id. at nn. 24–26; *In re Snyder* at 949 - 950.


\(^{14}\) See id.

result consistent with the objectives and purposes of the Bankruptcy Code.”\textsuperscript{16} This standard encompasses many of the same factors as the Chapter 7 standard previously discussed including: attempts to abuse the Bankruptcy Code by using it for improper purposes, ability to pay, lavish lifestyles, and underpayment of creditors.\textsuperscript{17}

The good faith standard under Chapter 13 is essentially the same as Chapter 11. Confirmation of a Chapter 13 plan requires that, “the action of the debtor in filing the petition was in good faith” and that “the plan has been proposed in good faith.”\textsuperscript{18} This has been interpreted to include the same factors and totality of the circumstances test as used in Chapter 11 cases.\textsuperscript{19}

One of the primary factors in determining a debtor’s good faith is a debtor’s ability to pay as compared to the pro rata distribution to unsecured creditors. For example, in \textit{In re Osborne}, the debtor’s lavish lifestyle combined with the lack of substantial repayment of creditors was sufficient to constitute a lack of good faith under Chapter 11. In that case, the debtors’ proposed plan retained a Lexus automobile, a vacation home, and a $140,000.00 “rainy day fund.”\textsuperscript{20} The year prior to filing, the husband-debtor earned $314,000.00.\textsuperscript{21} The debtors had “over $500,000 in unsecured debt, [but] . . . only propose[d] to pay $20,000 to the unsecured class.”\textsuperscript{22} The court

\begin{itemize}
\item \textsuperscript{16} \textit{In re Hamilton-Gaertner}, No. 17-00271-5-DMW, 2019 Bankr. LEXIS 1401, at *11 (Bankr. E.D.N.C. May 1, 2019); see \textit{In re Osborne}, No. 12-00230-8-SWH, 2013 WL 2385136, at *5 (Bankr. E.D.N.C. May 30, 2013) (reviewing cases).
\item \textsuperscript{19} See \textit{In re O’Neill Miranda}, 449 B.R. 182, 194, 195 (Bankr. D. P.R. 2011) (good faith factors include the debtor’s ability to pay, proposed payment amounts, attempts to mislead the court, and attempts to abuse the “spirit” of the Bankruptcy Code).
\item \textsuperscript{20} \textit{In re Osborne}, 2013 WL 2385136, at *2–3.
\item \textsuperscript{21} Id.
\item \textsuperscript{22} Id. at *5.
\end{itemize}
described the proposed distribution as “tossing the unsecured creditors a bit of spare change.” The court held that the plan was not proposed in good faith and refused to confirm the plan.

When a debtor continuously attempts to work with creditors and proposes a substantial repayment to its creditors in their Chapter 11 plan, good faith may be found despite a lavish lifestyle. For example, in In re Hamilton-Gaertner, the court found that the debtor’s proposed Chapter 11 plan satisfied the good faith requirement of section 1129(a)(3), despite a lavish lifestyle because the debtor offered substantial repayment to creditors. In that case, the debtor had an income of about $400,000 per year, with annual expenses amounting to nearly $200,000. Those expenses included: private school tuition for her three children, two vacation timeshare mortgages, a mortgage on her primary residence, and liens on multiple vehicles. The court weighed the debtor’s lavish lifestyle against the debtor’s continual attempts to work with creditors, and the debtor’s reorganization plan setting forth substantial repayment of creditors. The court also noted that the debt owed to the objecting creditor was business-related, and not due to the debtor’s personal or familial expenses. The court held that under the totality of the circumstances, the debtor’s lavish lifestyle did not constitute a lack of good faith, and ultimately confirmed the plan. The court specifically distinguished In re Hamilton-Gaertner from In re Osborne on the basis of the factor of the debtor’s proposed distribution to creditors.

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23 Id. at 10.
24 Id.; see also In re Harman, 141 B.R 878, 879 (Bankr. E.D.Pa. 1992) ("[A] debtor's failure to make anything close to the best offer of payment to the creditors violates . . . 11 U.S.C. § 1129(a)(3).”).
26 Id. at *2, *9.
27 Id. at *2, *16–19.
28 Id. at *15–16.
29 Id. at *6, *7, *28.
Thus, the combination of the factors of the debtor’s lavish lifestyle and failure to, despite ability to, propose a significant distribution to creditors is enough to constitute a lack of good faith under Chapters 11 and 13.31

Conclusion

Despite their similarities, the good faith requirements of Chapter 7 and Chapters 11 and 13 can have different results for debtors with extravagant lifestyles. Under Chapter 7, a plan with extravagant expenses will not by itself trigger a finding of bad faith, while under Chapters 11 and 13, extravagant expenses are enough to indicate bad faith if the proposed plan does not substantially repay creditors.

31 See In re Weber, 209 B.R. 793, 800 (Bankr. D. Mass. 1997) (“A plan in which the Debtor retains 100 percent of the expenditure necessary to support a lavish lifestyle, while proposing to pay a 5 percent dividend to creditors is not proposed in good faith.”).