Student Loan Obligations
Consumer or Non-Consumer Debt for 707(b)(1) Dismissal?

Erika D. Hart
The Taunt Law Firm
700 E. Maple Road, Second Floor
Birmingham, MI 48009
(248) 644-7800

I. Introduction

Several bankruptcy courts have recently addressed the issue of whether student loan obligations are to be classified as consumer debts or non-consumer debts for purposes of §707(b). Under this section, the United States Trustee may file a motion to dismiss a Chapter 7 bankruptcy for abuse – but only where the debtor has primarily consumer debts.

The cases center primarily around student loans incurred for professional degrees where the debtor subsequently filed Chapter 7. These cases do not include those debtors who have extensive other obligations stemming from their failed businesses, otherwise the debtors would have primarily non-consumer debt and §707(b) would not apply.

II. Section 707(b) Dismissal

This issue arises in the context of a motion to dismiss by the United States Trustee (UST) under 11 U.S.C. §707(b)(1), which provides (in pertinent part) as follows:

> (b)(1) After notice and a hearing, the court, on its own motion or on a motion by the United States trustee, trustee (or bankruptcy administrator, if any), or any party in interest, may dismiss a case filed by an individual debtor under this chapter whose debts are primarily consumer debts, or, with the debtor's consent, convert such a case to a case under chapter 11 or 13 of this title, if it finds that the granting of relief would be an abuse of the provisions of this chapter.

"There are two prerequisites to dismissal under § 707(b)(1): 1) the debtor has primarily consumer debt; and 2) the bankruptcy court finds that granting the debtor's petition would be an abuse of chapter 7." *Aspen Skiing Co. v. Cherrett (In re Cherrett)*, 523 B.R. 660, 668 (B.A.P. 9th Cir. 2014)

III. Definition of Consumer Debt: A consumer debt is defined in 11 U.S.C. §101(8) as a "debt incurred by an individual primarily for a personal, family or household purpose."

One of the earliest courts to address this issue was the United States Bankruptcy Court for the Northern District of Oklahoma in *In re Stewart (Stewart I),* 201 B.R. 996 (1996). In *Stewart I,* the debtor had incurred extensive educational expenses to attend medical school. Some of the expenses were obligations to individuals or other lending institutions which were not a typical

"student loan" and were found to be given for the purpose of "keeping the debtor in a comfortable lifestyle" while he was attending school, as opposed to institutional purposes such as books or tuition.

There is no per se rule that student loans are consumer debt. *Stewart II,* 215 B.R. 456 (10th Cir. BAP, 1997). See also *In re Ferreira,* 549 B.R. 232, 237 (Bkrcy E.D.Ca. 2016), citing *In re Rucker,* 454 B.R. 554 (Bankr. M.D.Ga. 2011). However the court in *Stewart I, supra,* held that "student loans in general should be treated as 'consumer debt' at least absent unusual facts or factors of which this Court is not presently aware". *Stewart I,* at 1005.

But non-consumer debt doesn't necessarily mean business debt. Tax debts are incurred for a public purpose. (*IRS v. Westerberry*, 215 F.3d 589, 590 (6th Cir.2000)(deciding whether debts were non-consumer debts for the purpose of enforcement of the co-debtor stay under 11 U.S.C. §1301). "[U]nlike taxes, consumer debt normally involves the extension of credit." *IRS v. Westerberry*, 215 at 591.

IV. Burden of Proof

Generally, the moving party – the United States Trustee in this instance - would have the burden of supporting its motion by a preponderance of the evidence. *In re Weixel*, 494 B.R. 895, 901 (B.A.P. 6th Cir. 2013).

The *Ferreira* court is unclear on the burden. The court states early in its opinion that "if the debtor is correct, the [UST] will have failed to satisfy its burden of demonstrating the debts in this case are 'primarily consumer debts' . . ." *In re Ferreira,* 549 at 235. But the opinion later states that "the debtor, however, bears the burden of demonstrating that a debt is nonconsumer or a business debt." *In re Ferreira,* 549 at 237. Which is it? Based upon the language, does the UST have the obligation to prove that the dollar amount at issue is more than 50% (relying on the use of the word "primarily" in the opinion) and the debtor the burden of proof regarding the classification of each debt as consumer or non-consumer? Such an approach would shift the burden to the debtor.

V. The Profit Motive Test

The 6th Circuit Court of Appeals has adopted – like many courts – the profit motive test as a partial test for determining whether the debt was a consumer debt. *IRS v. Westerberry*, 215 at 593. The profit motive test determines that debt is not consumer debt if the debt was "incurred with an eye toward profit." *Id*., citing *In re Booth*, 858 F.2d 1051, 1055 (5th Cir. 1988).

To determine whether to dismiss a case under Section 707(b), the court must look to the totality of the circumstances. *In re Krohn,* 886 F.2d 123, 126 (6th Cir. 1989).

But even in *Westerberry, supra,* the 6th Circuit held that the profit motive test was not determinative of the issue. *Id.,* at 593. The Court of Appeals held that the profit motive test does not define the only category of non-consumer debt. *Id.*

Other courts have required that the debt be "motivated for ongoing business requirements." *In re Cherrett*, *supra*. In addition, the debtor must "demonstrate a tangible benefit to an existing business, or show some requirement for advancement or greater compensation in a current job or organization." *In re Palmer,* 542 B.R. 289, 297 (Bankr. D. Colo. 2015), see also *Ferreira,* at 240 (stating that a "narrow standard that looks to an 'existing' business or 'current' employment also places debtors on equal footing").

The evidence required to establish a "profit motive" seems to stem from the debtor's own intentions, which has led some courts to question whether such evidence can be relied on at all. In *In re Millikan,* 2007 Bankr. LEXIS 4696 at *16 (Bankr. S.D. Ind. 2007), the court noted that "[t]he difficulty with the profit motive test is that it places in the hands of the debtor the means to characterize the debt. If a debtor testified that he or she had attended school for humanitarian reasons or just for the personal satisfaction of learning, the student loan could be considered a consumer debt. If the debtor testified that he or she had attended school primarily to earn a large income, the same loan could now become a non consumer debt. The result of applying the "profit motive test" allows a debtor to tailor his or her testimony to determine if a debt is to be considered a consumer or non consumer debt." *Id.*

The "profit motive test" should be interpreted narrowly. *In re Palmer,* 542 at 295. A narrow standard "tied to an existing business, or to some requirement for advancement in a current job or organization is necessary to avoid a student's aspirational goal, or a wished-for 'hope and dream' being the focus, as opposed to the advancement of a tangible opportunity." *Id.,* at 297.

Not all courts agree. At least one bankruptcy court has held that certain student loans satisfied the profit motive test and are non-consumer debts. In *In re De Cunae,* 2013 Bankr. LEXIS 5128 at *9-10, the United States Bankruptcy Court for the Southern District of Texas stated as follows:

> The evidence presented in this case is that the Debtor set out on a course of action to obtain a skill that would improve his ability to earn future income. The Court can think of no better example of incurring a debt with an eye toward profit. With respect to the UST's argument that the Debtor's personal benefit creates a consumer debt, the Court finds that the collateral self-enrichment is not the type of "consumption" that is the trademark of a consumer debt.
>
> The Court finds that student loan proceeds that are used for direct educational expenses with the intent that the education received will enhance the borrower's ability to earn a future living are not consumer debts.

VI. Bifurcation of the Loan Amount (Living Expenses v. Tuition)

The student loan obligation may be subject to apportionment into a consumer and non-consumer component, with only the consumer portion counted as consumer debt for purposes of 707(b)(1).

A least one court has declined to apportion student loan debt. In *Hopkins v. Marble (In re Kempkers),* 2012 Bankr. LEXIS 4878, at *2 (Bankr. D. Idaho 2012), the court held that the language of §101(8) in defining "consumer debt" was clear that a debt is either entirely consumer or not. The *Kempkers* court held that a debt should be considered consumer debt even if a portion of it was incurred for a business purpose. *Id.*

Many other courts have been willing to apportion the debt or have agreed to allow the parties' stipulated apportionment control. *In the Matter of Booth, supra*, the Fifth Circuit split the debt where a portion was used by the debtor for a business venture.

Where the debtor is unable to document how the student loan funds were used, the court relied on debtor's "estimate" of what portion was used for "direct education expenses" and which portion was used for "travel and child care expenses". *In re Ferreira,* 549 B.R. at 236.

VII. Types of Student Loans

Does the type of degree or education the debtor was seeking effect the Court's decision? There are no reported cases regarding a general bachelor's degree or an associate's degree. The cases center mostly on professional degrees as follows:

Nursing Degree: *In re Ferreira,* 549 B.R. 232; 2016 Bankr. LEXIS 622 (Bkrcy E.D.California, February 29, 2016). The court found that the debtor "did not meet her burden of demonstrating that she incurred her student loans for an existing business or for current job advancement." *Id.,* at 240.

Medical Degree: *In re Grenardo,* 2012 Bankr. Lexis 6302 (Bankr. D. Colo., 2012). The Court held that a student loan debt incurred in order to attend medical school was consumer debt. "[w]here student loans result in tangible benefits that are assimilated to the debtor's person, thereby enhancing the debtor's personal qualities, the Court concludes that the loans are properly characterized as consumer debts." *Id,* at *29.

See also *In re Stewart (Stewart I),* 201 B.R. 996 (Bankr. N.D. Okla., 1996), which also held that medical school debts were consumer debts. Note that there were egregious and peculiar facts in this case – even as noted by the court in its opinion – which may limit this opinion's applicability.

Doctorate in Business Administration: *In re Palmer,* 542 B.R. 289 (Bankr. Colo. 2015). The Court held that a student loan incurred to obtain a doctorate in business administration was a consumer debt even though the debtor and his wife "always wanted to be business owners" and the debtor began his failed business (a sports bar) while he was pursuing his education.

Dental School: *In re Millikan,* 2007 Bankr. LEXIS 4696 (Bankr. S.D. Ind. 2007). The Court held that student loan debt for attending dental school was consumer debt, and that the "'profit motive test' works to the benefit of those who are most likely to have the ability to pay their creditors and to the disadvantage of those who are least able to pay their creditors. Those with a large amount of student loan debt and the greatest amount of education and, who, in turn, have the greatest earning potential can invoke the profit motive test and essentially fly under the §707(b) radar screen while the factory worker with an extra $ 100 a month and little or no student loan debt is forced to pay his creditors in a chapter 13 plan." *Id.,* at *16-17.

But the United States Bankruptcy Court for the Southern District of Texas held that a student debt incurred for dental school did qualify as a non-consumer debt and denied the UST's motion to dismiss under 707(b)(1). *In re De Cunae,* 2013 Bankr. LEXIS 5128 (2013).

VIII. Practical Effect

If the Court determines that the debts are primarily consumer debts, the case may be dismissed if the income and expense elements of §707(b) are satisfied – finding that the Debtor could make meaningful payments to creditors over time.

However, a case with primarily non-consumer debts is not the subject of a §707(b) dismissal according to the terms of the statute. *In re Bell*, 65 B.R. 575, 578 (Bankr. E.D. Mich. 1986). Courts rely instead on the provisions of §707(a):

> (a) The court may dismiss a case under this chapter only after notice and a hearing and only for cause, including—
> (1) unreasonable delay by the debtor that is prejudicial to creditors;
> (2) nonpayment of any fees or charges required under chapter 123 of title 28; and
> (3) failure of the debtor in a voluntary case to file, within fifteen days or such additional time as the court may allow after the filing of the petition commencing such case, the information required by paragraph (1) of section 521(a), but only on a motion by the United States trustee.

The 6th Circuit Court of Appeals has read the word "including" in §707(a) broadly, so as not to be a limiting word. *In re Zick*, 931 F.2d 1124, 1126 (6th Cir. 1991)(holding that a Chapter 7 petition can be dismissed for lack of good faith under 707(a)).

Other courts have followed this approach, allowing §707(a) to be utilized for dismissal of Chapter 7 petitions where the court finds a lack of good faith.

A debtor's ability to pay is an appropriate factor to consider when determining whether a debtor lacks good faith in applying for Chapter 7 relief of its non-consumer debts. *Rahim v. Pacifica Loan Four, LLC (In re Rahim)*, 2011 U.S. Dist. LEXIS 55369, at *18 (E.D. Mich. 2011), citing *Perlin v. Hitachi Capital Am. Corp. (In re Perlin)*, 497 F.3d 364, 371 (3d Cir. 2007).

Section 707(a) is not an exhaustive list of "for cause" reasons to dismiss a Chapter 7 case. *In re Rahim*, at *18, citing *In re Zick, supra.*

If the debtor's income and expenses support filing a Chapter 7 – if they are truly needy - the debtor is unlikely to face dismissal under §707(b). If the non-consumer debtor faces a §707(b) challenge because they would fail the Means Test if their debts were primarily consumer debts, then the non-consumer debtor would likely fail to meet the Court's requirement for a "needy" debtor and face dismissal pursuant to §707(a).

The Debtor's debt burden of being pushed into a Chapter 13 actually increases over time. The student loans cannot be separately classified in a Chapter 13, yet are non-dischargeable and continue to accrue interest during the life of the plan.

However some debtors may not qualify for a Chapter 13 given the debt cap in Section 109(e). These debtors would be left with Chapter 11 as the only option.