UNITED STATES BANKRUPTCY COURT
DISTRICT OF MINNESOTA

In re:

WILLIAM N. GALLAGHER and
MORIA M. GALLAGHER,

BKY 99-34686

Debtors.

Chapter 7

VILLAGE BANK, a Minnesota Corporation,

Plaintiff,

ADV 99-3339

v.

WILLIAM N. GALLAGHER and
MORIA M. GALLAGHER,

MEMORANDUM ORDER

Defendants.

This matter came before the Court on October 30, 2000, on the complaint of Village Bank under 11 U.S.C. § 727(a)(4)(A) seeking denial of the Debtors' discharge, and on the Court's motion under 11 U.S.C. § 707(b) to consider dismissing the case for substantial abuse of the provisions of Chapter 7. Barbara J. May appeared on behalf of the Debtors, William N. Gallagher and Moria M. Gallagher; and Steven L. Mackey appeared on behalf of Village Bank. The case was tried and the Court took the matter under advisement.

The Court has jurisdiction over this matter under 28 U.S.C. § 157(b)(1), as a core proceeding under § 157(b)(2)(J), and under § 1334. Based upon the proceedings and upon all the relevant files and records herein, the Court now makes this ORDER pursuant to the Federal and Local Rules of Bankruptcy Procedure.

I. Introduction

The Debtors substantially overstated their debt in the original schedules filed with their bankruptcy petition. It is undisputed that the total debt owed to Village Bank by the Debtors at the time of filing their Chapter 7 bankruptcy petition on September 17, 1999, was $132,673.03; and, that the Debtors overstated the debt to the Bank on Schedule D by listing three separate debts owing to Village Bank in the amounts of $136,000.00, $133,315.00, and $43,414.82. It is also undisputed that the Debtors owed State Capital Credit Union approximately $5,177.33, on a car loan; and, that the same debt was listed on their Schedule D in the amount of $12,116.25. Village Bank claims that the Debtors knew that their schedules overstated their debt, made the misrepresentations with the intent to deceive creditors and the Court, and should therefore be denied a discharge, pursuant to § 727(a)(4)(A).

The Debtors also substantially understated both their monthly combined income and their expenses. Debtor Moria Gallagher initially failed to disclose in Schedule I a postpetition monthly services contract that would pay her in excess of $3,000 a month through the end of the year, 1999.[1] The Debtors' family living expenses, initially scheduled at $3,845.36, were later increased to $6,131.02 in an amended Schedule J. The Court, on its own motion, raised the § 707(b) inquiry into whether the Debtors' petition was a substantial abuse of Chapter 7 due to the apparent possibility, reflected from the Debtors' uncertain income and expense

[1] The Debtors filed an amended Schedule I on November 8, 1999, which disclosed Moria's postpetition, temporary employment contract.

schedules, that the Debtors could in fact fund a Chapter 13 plan.

The Debtors in this case, William and Moria Gallagher, are highly educated and accomplished individuals. William holds a bachelor of fine arts degree, a master's degree in occupational therapy, a teaching license, and certification as an occupational therapist. He has held positions as a case manager for locked psychiatric care units, including serving more than two years in that position at Fairview Riverside Hospital. William is presently employed by the Minnesota Department of Human Services as the special review board coordinator on mentally ill and dangerous psychopathic personalities and sexually dangerous persons. His responsibilities include management of 500 inmates or patients and necessitates communication with lawyers, judges, court administrators and county officials. William's net monthly income is $3,000.00.

Moria holds a bachelor's degree in occupational therapy from the College of St. Catherine, obtained with extensive special accommodations, such as oral tests and individual instruction, for her adult attention deficit disorder (ADD), and she is also a certified occupational therapist. She was part owner of a 25 employee business, which she subsequently successfully negotiated to buy out. Her business, Renew Rehabilitation/Shooting Star, was an integrated daycare center, providing care on an inclusive basis to children with and without special needs. In obtaining the financing to purchase and fund the operations of Renew/Shooting Star, Moria independently prepared financial statements for Village Bank. She obtained a Minnesota daycare provider license and successfully applied for FCHA rehabilitation agency certification. She also obtained a respite grant from Dakota County and in connection therewith prepared and submitted monthly reports and timesheets.

Renew/Shooting Star began to fail financially. As Moria's attention was increasingly focused on an attempt to keep the daycare center operating, unstable personal and family relationships became increasingly dysfunctional. William also suffers from ADD, as well as chronic depression, and a severe inability with numbers.[2] Moria has suffered clinical depression all of her life. In addition to ADD, she has dyslexia which causes her to mix up words when reading. She claims to have great difficulty with details.

Both William and Moria take medications for depression and were taking those medications at the time prior to filing and during the preparation of schedules. William also takes medication for his ADD. He testified that the medications he was taking around the time of filing were not effective, that he was starting a third drug, and that he could not make it through a day without being exhausted and agitated.

The Debtors have two children at home, 10 and 15 years old, who are also mentally disabled. Their daughter has ADD and suffers from a sensory disorder. Their son has attention deficit hyperactivity disorder (ADHD). The entire Gallagher family was, at the time of Renew/Shooting Star's decline and through the early process of bankruptcy, a household of discord. William testified that the family was "essentially dysfunctional," not working as a team, and not communicating. The Debtors fought regularly and separated from time to time. The children experienced their parents' anxiety and conflict, and "acted out" often. Moria's

[2] William testified that he could not complete a basic statistics course in college, avoided any activity that required mathematical computation, relied on calculators and finger-counting, and could not add numbers 2 digits or higher by thought. He disclosed his problem with numbers to his employer and claims that there is no aspect of his position that involves math or accounting, such as a budget.

testimony offered a similar picture of stress and bedlam.

For the two years prior to filing for bankruptcy relief, the Debtors did not live under any sort of a budget. They did not discuss their debts; they did not talk about paying bills; and eventually they did not pay the bills. Renew/Shooting Star operated continuously at a loss in spite of Moria devoting herself completely to the center. Debt statements accumulated in a box over a long period of time and William only occasionally balanced the Debtors' checkbook.

When the Debtors realized the need for bankruptcy relief, they obtained counsel and completed the questionnaire provided to them by their attorney. The information contained in the law firm questionnaire was collected by Moria from months of accumulated records. She prepared the questionnaire and the attorney prepared the Debtors' petition and schedules. Both William and Moria testified that at the time appointed for them to sign the schedules, they went to their attorney's law office and were directed to an empty conference room. They were given the schedules to review and sign without any discussion or guidance from their attorney.

Village Bank contends that the overstated debts and underestimated income on the Debtors' schedules constitute false oaths made in connection with the bankruptcy case and that therefore the Debtors should be denied a discharge pursuant to 11 U.S.C. § 727(a)(4)(A). The Debtors claim that the errors were made inadvertently, as a result of their own failure to more carefully verify information due to the combination of their mental and learning disabilities, due to the high level of stress and family dysfunction at the time, and due to the carelessness of their first attorney in preparing the schedules.

Regarding their income and expenses, the Debtors explained that Moria's postpetition monthly services contract income was not disclosed due to a misunderstanding. According to the Debtors, the contract had not yet been finalized at filing, and her lawyer told Moria that she need not list prospective income to which she was not entitled at filing. In any event, the Debtors claim, their real monthly expenses were substantially understated in the original schedules, and as reflected in the amended schedules, more than offset any undisclosed income.

II. Analysis

Denial of Discharge Under § 727(a)(4)(A)

Section 727(a)(4)(A) of the Bankruptcy Code provides:

(a) The court shall grant the debtor a discharge, unless —

> (4) the debtor knowingly and fraudulently, in or in connection with the case —
>
> > (A) made a false oath or account;

See 11 U.S.C. § 727(a)(4)(A).

There are essentially three elements that must be present to deny a debtor's discharge under § 727(a)(4)(A). The representation made must first constitute an oath, as is the case here in which the misinformation at issue was contained in the official schedules which the Debtors verified under penalty of perjury. See Cepelak v. Sears (In re Sears), 246 B.R. 341, 347 (8th Cir. B.A.P. 2000). Second, the misrepresentation or omission in the schedules must be material. Id., citing In re Olson, 916 F.2d 481, 484 (8th Cir. 1990). Finally, there is the statutory intent element of § 727(a)(4)(A), requiring that the debtor must have made the misrepresentation both knowingly and fraudulently. <u>See</u> <u>Sears</u>, 246 B.R. at 349.

In order for § 727(a)(4)(A) to bar discharge of the Debtors in this case, it must be shown that they knew that their schedules materially overstated their debt, and that they intended to fraudulently overstate the debt. The standard of proof required to sustain an objection to discharge under § 727 is a preponderance of the evidence. <u>See</u> <u>Miller v. Boles (In re Boles)</u>, 150 B.R. 733, 736 (Bankr. W.D. Mo. 1993).

Most cases challenged under § 727(a)(4)(A) involving inaccurate schedules are about assets or interests that have been omitted from schedules and otherwise concealed from the trustee, creditors, and the court. Nevertheless, an overstatement of debt, especially a great overstatement as in this case, is also material. <u>Id</u>. at 736-37. The test for materiality of a false oath under § 727(a)(4)(A) is whether the misrepresentation "bears a relationship to the [debtor's] business transactions or estate, or concerns the discovery of assets, business dealings, or the existence and disposition of his property." See <u>Sears</u>, 246 B.R. at 347; <u>United Mortgage Corp. v. Mathern (In re Mathern)</u>, 137 B.R. 311, 320 (Bankr. D. Minn. 1992). The amounts of debts and to which creditors specific debts are owed is information core and basic to an adequate analysis and management of a bankruptcy estate. These considerations are also relevant to determining the propriety or eligibility of a particular debtor filing under Chapter 7. <u>See</u> <u>Boles</u>, 150 B.R. at 736 (intentional inflation of indebtedness to avoid creditor objections to discharge and to avoid possible § 707(b) dismissal).

In this case, however, the Court need not determine the materiality of the Debtors' misrepresentations because the Court is persuaded that the Debtors did not have the requisite fraudulent intent to overstate their debts. "The fraudulent state of mind contemplated by § 727(a)(4)(A) is an intent to mislead the court and the debtor's creditors." See Mathern, 137 B.R. at 321. Both William and Moria offered credible testimony at the trial: that their intentions were honest; that they relied completely and in good faith on their attorney; and, that they could do no better under the circumstances of severe individual and family dysfunction.

Both Debtors testified sincerely, and emotionally, about the troubled relationship between them and with their children and the practical effect those problems had on their respective abilities to manage their financial affairs even basically, much less with careful attention. Both Debtors admitted that their review of the schedules was cursory. While Moria admitted that she saw that the schedules listed the debt to Village Bank more than once, and that she knew there was just one debt to Village Bank, she assumed that the lawyer had listed it that way for a reason, and apparently even pointed it out to someone at the law firm on the day that she and William signed the schedules.

Unlike the debtor in Boles, 150 B.R. at 739, William and Moria Gallagher have never, since first becoming aware of the inaccuracies on the schedules, denied the true accounting of their debts to the credit union and to Village Bank or otherwise compounded the situation by attempting to further conceal the scheduled inflated debts. At the § 341 meeting, neither Debtor denied the overstatement of the debt. Moreover, the client worksheet that Moria completed, the substance of which was apparently used by the Debtors' attorney in preparing the schedules, listed the debt to Village Bank only once, in the amount of $136,000.00, which is only slightly overstated.

With respect to the overstatement of the debt to the State Capital Credit Union for the car installment loan, William explained that the payments were made by automatic deduction from his paycheck, and that at some point the payments were doubled, apparently in error, but he neglected to notice either the greater deduction or the rapidly declining balance on the loan until at least January of 2000. The Credit Union apparently suspended payments through May and then corrected the withdrawal amount. The statement that Moria used to schedule the debt was from January of 1999, for which she had no explanation.

Ordinarily, a carelessness explanation for materially inaccurate schedules, such as failing to adequately review personal and corporate financial records in preparation for filing, being disorganized and distracted, reviewing the wrong statements, or failing to notice double debits, is insufficient to avoid § 727(a)(4)(A) consequences. However, it is clear to the Court that the distractions in this case were not ordinary, but severe.

After careful consideration, the Court concludes that the evidence is insufficient to support, by a preponderance, a finding that the Debtors intended to mislead the Court or creditors. The sophistication, education and accomplishments of the Debtors do not overcome the demonstrated level of dysfunction and confusion reigning in their lives prior to and at the time of filing. The overstatements of debt in the schedules are more likely innocent errors, not the product of deceit. There is, accordingly, no basis under § 727(a)(4)(A) to deny the Debtors a discharge in this case.

Dismissal Under § 707(b)

Moria's postpetition income under the Dakota County contract combined with William's income appeared to the Court more than sufficient to meet the expenses of the Debtors and their dependents, and adequate to also fund a Chapter 13 plan, at least as the Debtors' budget was originally scheduled. The Court therefore raised the question of whether the

Debtors' case was ripe for dismissal as a substantial abuse of the provisions of Chapter 7 pursuant to § 707(b).

Section 707(b) of the Bankruptcy Code provides:

> (b) 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.

See 11 U.S.C. § 707(b).

Dismissal under § 707(b) is appropriate in cases in which the debts to be discharged are primarily consumer debts and if granting a discharge under Chapter 7 would amount to substantial abuse.

Section 101(8) of the Bankruptcy Code defines consumer debt as "debt incurred by an individual primarily for a personal, family, or household purpose." See 11 U.S.C. § 101(8); In re Shirley, 2000 WL 150835 (Bankr. N.D. Iowa 2000). William testified that he believed most of the credit card debt scheduled was incurred to fund family expenses such as clothing and food. Moria, on the other hand, testified that the same debt was virtually all incurred to fund operation of Renew/Shooting Star. Specifically, she claimed that more than $50,000 of the credit card and credit line debt listed on the schedules actually was spent only for Renew/Shooting Star. Moria simply stated that William was not knowledgeable about the nature of any of that debt. Although he testified to the contrary, William also stated that he did not, in fact, have much knowledge of their finances, and moreover that they did not communicate with each other about their debts or spending, and indeed that he had no knowledge of Renew/Shooting Star debt.

Most of the rest of the debt was clearly incurred in furtherance of Renew/Shooting Star and is scheduled specifically as such. Accordingly, it is questionable whether most of the debt in this case is consumer debt. Some of the debt is surely not even debt of the Debtors, as Moria patently demonstrated at the trial that she does not understand the distinction between a legally binding personal guaranty of a corporate debt and her word of honor, the former of which she may not have actually executed in the instances of the smaller debts identified in the schedules as associated with the Renew/Shooting Star business.

However, even if the Debtors' debts are primarily consumer debts and § 707(b) applies, the case is not, in fact, a substantial abuse of those provisions. Substantial abuse is not defined by the Bankruptcy Code. The Eighth Circuit Court of Appeals has held that the substantial abuse inquiry focuses on a debtor's ability to pay the debtor's debts. See Taylor v. United States (In re Taylor), 212 F.3d 395, 396 (8th Cir. 2000); Stuart v. Koch (In re Koch), 109 F.3d 1285, 1288 (8th Cir. 1997); In re Makinen, 239 B.R. 532, 534 (Bankr. D. Minn. 1999); In re Walton, 866 F.2d 981, 982 (8th Cir. 1989).

"Section 707(b) was intended to promote fairness to creditors, and thereby increase the flow of consumer credit, by stemming the use of Chapter 7 relief by unneedy debtors." See Koch, 109 F.3d at 1288. "[I]ndeed, substantial ability to pay creditors standing alone warrants dismissal of a Chapter 7 petition for substantial abuse." Id. "Ability to pay, however, is a determination necessarily subject to an infinite variety of circumstantial factors depending on a given debtor and the debtor's particular financial condition." See Makinen, 239 B.R. at 535. "Egregious conduct is not a required element of substantial abuse dismissal." See In re Harris, 960 F.2d 74, 76 (8th Cir. 1992).

"[A]bility to pay for § 707(b) purposes is measured by evaluating Debtors' financial condition in a hypothetical Chapter 13 proceeding." See Koch, 109 F.3d at 1288. The test for a debtor's ability to fund a Chapter 13 plan requires a determination of the debtor's disposable income, which is "income received by the debtor that is not reasonably necessary to support the debtor, the debtor's dependents, or the debtor's business." Id. at 1289.

Village Bank contends that Moria intentionally understated her income in the petition and schedules. While there is disagreement as to whether Moria started working for Dakota County pre- or post-petition, that employment was for only a few months, lasted just through the end of 1999, and is not a present source of income. Moria is presently employed by Resources for Child Caring approximately 30 hours per week, by which she earns approximately $800.00 net monthly. However, her hours will be reduced to 20 hours a week certain after this December. In any event, Moria was forthright in describing at the meeting of creditors her anticipated employment with Dakota County and the Court finds that she did not intentionally understate her income.

Nevertheless, the Court was concerned, especially in light of the Debtors' originally scheduled expenses, that the Debtors may have a fair ability to fund a Chapter 13 plan. Based on the Debtors' amended schedule of expenses and having before it the proper and present incomes of the Debtors, however, the Court can only conclude that the Debtors have no disposable income whatsoever, regardless of the amount of debt. In fact, the budget, prepared in August, 2000, is still underestimated and running a monthly deficit of more than $2,300.00. The Debtors' combined monthly net income is approximately $3,800.00, and their scheduled monthly expenses are $6,131.02. The Debtors are funding this budget by cashing in soon-to-be-exhausted IRAs, for which they will face a tax liability of more than $20,000 in April, 2001.

Some of the Debtor's expenses may be unreasonable, including school tuition ($190), cable television ($40), internet access ($20), community center dues ($35), allowances for the children ($100), and gifts and family entertainment ($400), especially in light of their financial circumstances. But, even were the monthly expenses for these things substantially reduced or eliminated from the schedule of expenses, the Debtors' monthly deficit would not be offset, nor would any disposable income result. Even by reducing expenses several hundreds of dollars, there is no disposable income in this case to fund even a modest Chapter 13 plan.

The accurate amount and nature of the debts finally before the Court, and being finally fully advised of the Debtor's true income and expenses, the Court finds that the case is not a substantial abuse of Chapter 7 and need not be dismissed therefor.

III. Disposition

Based on the foregoing, it is hereby ordered:

1. The Debtors did not knowingly and fraudulently make a false oath or account in connection with this case, and accordingly the Debtors shall not be denied a discharge pursuant to 11 U.S.C. 727(a)(4)(A).

2. The Debtor's bankruptcy case does not constitute a substantial abuse of Chapter 7 pursuant to 11 U.S.C. 707(b) and will not be thereby dismissed.

LET JUDGMENT BE ENTERED ACCORDINGLY.

Dated: December 28, 2000.

By the Court:
/e/ Dennis D. O'Brien
Hon. Dennis D. O'Brien
United States Bankruptcy Court