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## POLICING DEBTOR'S LIFESTYLE: JUDICIAL DISCRETION OR REQUIREMENT?

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A CLE Presentation

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### **§ 707. Dismissal of a case or conversion to a case under chapter 11 or 13**

(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, but only on a motion by the United States trustee.

(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. In making a determination whether to dismiss a case under this section, the court may not take into consideration whether a debtor has made, or continues to make, charitable contributions (that meet the definition of "charitable contribution" under section 548(d)(3)) to any qualified religious or charitable entity or organization (as that term is defined in section 548(d)(4)).

(3) In considering under paragraph (1) whether the granting of relief would be an abuse of the provisions of this chapter in a case in which the presumption in subparagraph (A)(i) of such paragraph does not arise or is rebutted, the court shall consider--

- (A) whether the debtor filed the petition in bad faith; or
- (B) the totality of the circumstances (including whether the debtor seeks to reject a personal services contract and the financial need for such rejection as sought by the debtor) of the debtor's financial situation demonstrates abuse.

### **§ 1325. Confirmation of plan**

(b)(1) If the trustee or the holder of an allowed unsecured claim objects to the confirmation of the plan, then the court may not approve the plan unless, as of the effective date of the plan--

- (A) the value of the property to be distributed under the plan on account of such claim is not less than the amount of such claim; or
- (B) the plan provides that all of the debtor's projected disposable income to be received in the applicable commitment period beginning on the date that the first payment is due under the plan will be applied to make payments to unsecured creditors under the plan.

(2) For purposes of this subsection, the term "disposable income" means current monthly income received by the debtor (other than child support payments, foster care payments, or disability payments for a dependent child made in accordance with applicable nonbankruptcy law to the extent reasonably necessary to be expended for such child) less amounts reasonably necessary to be expended--

(A)(i) for the maintenance or support of the debtor or a dependent of the debtor, or for a domestic support obligation, that first becomes payable after the date the petition is filed; and

(ii) for charitable contributions (that meet the definition of “charitable contribution” under section 548(d)(3) to a qualified religious or charitable entity or organization (as defined in section 548(d)(4)) in an amount not to exceed 15 percent of gross income of the debtor for the year in which the contributions are made; and

(B) if the debtor is engaged in business, for the payment of expenditures necessary for the continuation, preservation, and operation of such business.

(3) Amounts reasonably necessary to be expended under paragraph (2), other than subparagraph (A)(ii) of paragraph (2), shall be determined in accordance with subparagraphs (A) and (B) of section 707(b)(2), if the debtor has current monthly income, when multiplied by 12, greater than--

(A) in the case of a debtor in a household of 1 person, the median family income of the applicable State for 1 earner;

(B) in the case of a debtor in a household of 2, 3, or 4 individuals, the highest median family income of the applicable State for a family of the same number or fewer individuals; or

(C) in the case of a debtor in a household exceeding 4 individuals, the highest median family income of the applicable State for a family of 4 or fewer individuals, plus \$575 per month for each individual in excess of 4.

(4) For purposes of this subsection, the “applicable commitment period”--

(A) subject to subparagraph (B), shall be--

(i) 3 years; or

(ii) not less than 5 years, if the current monthly income of the debtor and the debtor's spouse combined, when multiplied by 12, is not less than--

(I) in the case of a debtor in a household of 1 person, the median family income of the applicable State for 1 earner;

(II) in the case of a debtor in a household of 2, 3, or 4 individuals, the highest median family income of the applicable State for a family of the same number or fewer individuals; or

(III) in the case of a debtor in a household exceeding 4 individuals, the highest median family income of the applicable State for a family of 4 or fewer individuals, plus \$575 per month for each individual in excess of 4; and

(B) may be less than 3 or 5 years, whichever is applicable under subparagraph (A), but only if the plan provides for payment in full of all allowed unsecured claims over a shorter period.

## **Introduction**

The degree to which Chapter 13 debtors are required to sacrifice to benefit from bankruptcy's "fresh start" policy is governed by a determination of what are debtors' reasonable and necessary expenses. *5A Bankr. Service L.Ed. § 50:443 (2008)*. The types of expenditures which are considered "reasonable and necessary" are not defined by the Bankruptcy Code, so some type of judicial "policing" of debtor lifestyle is required to ensure appropriate payment to creditors. It is well-established that although bankruptcy courts should not squeeze every last dollar from a debtor, the debtor may not maintain an excessive life-style at the expense of his creditors. *In re Stein*, 91 B.R. 796 (Bankr. S.D. Ohio 1988). In many cases, it is appropriate for the courts to determine that some changes in lifestyle are necessary to prevent the debtor from continuing the lifestyle that drove him or her into bankruptcy at the creditors' expense. *In re Tibbs*, 242 B.R. 511 (Bankr. N.D. Ala. 1999).

## **Chapter 13 "Disposable Income" Test**

A bankruptcy court's analysis of debtor lifestyle will generally begin with the application of Chapter 13's "disposable income" test. *Tibbs*, 242 B.R. at 511. The disposable income test should allow debtors to live adequately, but not first class. *In re Woodman*, 379 F.3d 1 (1<sup>st</sup> Cir. 2004). "Modification of his pre-petition lifestyle is often the price that the Chapter 13 debtor must pay to satisfy the 'disposable income' test and to obtain discharge of his pre-petition debt in Chapter 13." *In re McGilberry*, 298 B.R. 258 (Bankr. M.D. Pa. 2003). The general consensus among courts is that debtors who cannot pay their unsecured creditors in full are expected to undergo a moderate amount of belt-tightening in order to ensure the integrity of their Chapter 13 plan. 11 U.S.C. § 1325(b); *In re Loper*, 367 B.R. 660 (Bankr. D. Colo. 2007).

Therefore, an appropriate level of judicial discretion is a necessity where debtor's lifestyle is at issue. Chapter 13 debtors do not have unbridled discretion under the "disposable income" test to carve out for themselves and their families whatever lifestyle they may choose. *In re McNichols*, 249 B.R. 160 (Bankr. N.D. Ill. 2000); *In re Zaleski*, 216 B.R. 425 (Bankr. D. N.D. 1997). However, courts do not have a warrant "to mandate dramatic changes in debtor's lifestyle,

in order to fit some preconceived norm for Chapter 13 debtors.” *5A Bankr. Service L.Ed.* § 50:443; *Woodman*, 379 B.R. at 1.

In Chapter 7 cases , “[f]or § 707(b) purposes, a debtor’s ability to pay creditors is measured by evaluating the debtor’s financial condition in a hypothetical Chapter 13 proceeding.” *In re Burger*, 280 B.R. 444, 448 (Bankr.S.D.Ind.2002). Under Chapter 13, the debtor’s plan must provide for all disposable income to be applied to plan payments for a minimum of three years. 11 U.S.C. § 1325(b)(1)(B). “Disposable income” is defined by § 1325(b)(2) as a debtor’s current monthly income which is not reasonable or necessary to be expended for the maintenance or support of the debtor or his dependents. 11 U.S.C. § 1325(b)(2).

#### “Reasonably Necessary” Expenses

A determination of what is a “reasonably necessary” expense for the purpose of the “disposable income” test is unrelated to a debtor’s former lifestyle. *In re McNichols*, 249 B.R. 160 (Bankr. N.D. Ill. 2000); *In re Butler*, 277 B.R. 917 (Bankr. N.D. Iowa 2002). Therefore, debtors generally may not maintain their pre-petition standard of living at the expense of their creditors. *McNichols*, 249 B.R. at 160.

Courts are divided as to what constitutes “reasonably necessary” expenses for the maintenance and support of debtors. Most have taken an approach that the “Bankruptcy Code requires a meaningful and realistic budget, accompanied by the devotion of most of the debtor’s surplus income to repay creditors.” *In re Downin*, 284 B.R. 909, 912 (Bankr. N.D. Iowa 2002). To satisfy the “disposable income” requirement in § 1325(b) for confirmation of a proposed Chapter 13 plan, debtors are not required to live as paupers, but neither are they allowed to continue to live an extravagant lifestyle at the creditors’ expense. *In re Stout*, 336 B.R. 138 (Bankr. N.D. Iowa 2006). This requirement is to be applied to allow debtors to maintain a reasonable lifestyle while simultaneously ensuring that they make a serious effort to pay creditors by eliminating unnecessary and unreasonable expenses. *Id.* Otherwise stated, “while bankruptcy does not require that the debtor adopt a completely Spartan existence, debtors will not be permitted to continue, at the expense of their creditors, to maintain the lifestyle that drove them to bankruptcy. *In re Osborne*, 383 B.R. 423 (Bankr. N.D. Ohio 2008).

“Some expenditures are clearly essential, or non-discretionary, such as reasonable amounts budgeted for food, clothing and shelter.” *Stout*, 336 B.R. at 142. Courts may also allow debtors some leeway for discretionary spending on items like clubs, recreation, newspapers, entertainment, charitable contributions, and other expenses. *Id.* However, excessive expenditure on non-discretionary items such as food, utilities, housing, and health expenses may be found by the courts to be not reasonably necessary. *Id.*

Courts often scrutinize expenses such as gifts, recreation, charitable contributions, boat payments, private school tuition, and health and country club dues. *In re Butler*, 277 B.R. 917, 921 (Bkrtcy.N.D. Iowa 2002). Also scrutinized by courts are cell phone expenses, television services, veterinary expenses, and unspecified home repairs. *Stout*, 336 B.R. at 142. Expenses for golf and music lessons have been found not reasonably necessary. *In re Falke*, 284 B.R. 133, 139 (Bankr.D.Or. 2002). And a parental preference to sustain an expenditure of \$900 per month on private school tuition for their four children, with a total annual education expense of \$53,640, was found by a court to be “excessive and possibly even extravagant.” *In re Kornfield*, 164 F.3d 778, 784 (2<sup>nd</sup> Cir. 1999).

In determining whether a Chapter 13 debtor is devoting all of his disposable income to payments under the plan, lifestyle issues most frequently arise where a debtor has a high level of income. In cases where debtor has a fairly high income, courts must generally engage in greater scrutiny of a debtor’s proposed lifestyle and budget, especially where the debtor is advancing a three-year plan that offers only a niggling return to pre-petition creditors. *McNichols*, 249 B.R. at 160. Debtor’s expenses should be scrutinized for luxuries which are not enjoyed by the average American family.” *Woodman*, 379 B.R. at 1; *In re Dunn*, 225 B.R. 393 (Bankr. S.D. Ohio 1998)(maintenance of luxury items definitely excluded for debtor’s adequate standard of living).

#### Dismissal for Bad Faith: Section 707(a)

At least one case has dismissed a debtor’s Chapter 13 bankruptcy for “bad faith” under § 707(a) for failure to make lifestyle changes. Several cases have generally held that “bad faith” may constitute a cause for dismissal under § 707(a). *In re Zick*, 931 F.2d 1124 (6th Cir.1991); *In re Tamecki*, 229 F.3d 205 (3d Cir.2000); *In re American Telecom Corp.*, 304 B.R. 867

(Bankr.N.D.Ill.2004). The bad faith inquiry under § 707(a) looks at the totality of circumstances. *In re Collins*, 250 B.R. 645, 653-54 (Bankr. N.D. Ill.2000). At least one of the factors required to mandate a dismissal of a case for bad faith includes whether the debtor is willing to make lifestyle changes to pay his debts. *Zick*, 931 F.2d at 1129. The court in the case of *In re Sekendur* took that factor in to consideration, and ultimately dismissed the debtor's Chapter 13 case in part because he was unwilling to make a lifestyle change to pay his debts. *In re Sekendur*, 334 B.R. 609, 619 (Bankr. N.D. Ill. 2005).

#### Dismissal for Substantial Abuse: Section 707(b)

Section 707(b) of the bankruptcy code provides the Court may dismiss a case filed by a Chapter 7 debtor whose debts are primarily consumer debts if it finds that the granting of relief would be a substantial abuse of the provisions of Chapter 7. *In re Taylor*, 212 F.3d 395, 396 (8<sup>th</sup> Cir. 2000); 11 U.S.C. § 707(b). "Substantial abuse" is not a defined term within the bankruptcy code, and courts are split as to its meaning. The circuit courts have developed three main approaches. The 8<sup>th</sup> and 9<sup>th</sup> Circuits have adopted a "per se" approach in which a debtor's ability to repay his debts may be the sole justification of a § 707(b) dismissal. See *In re Koch*, 109 F.3d 1285, 1288 (8<sup>th</sup> Cir.1997); *In re Kelly*, 841 F.2d 908, 914-15 (9<sup>th</sup> Cir. 1988). The 4<sup>th</sup> Circuit has rejected this approach, and has instead adopted a "totality of the circumstances" test which requires several factors to be considered. *In re Green*, 934 F.2d 568 (4<sup>th</sup> Cir. 1991).

The 6<sup>th</sup> Circuit has devised a hybrid test between these two approaches. "Under this test, the court must first examine the debtor's ability to repay his creditors out of future earnings," and this may be the sole justification for a § 707(b) dismissal. *In re Burger*, 280 B.R. 444, 447 (Bankr.S.D. Ind. 2002)(citing *In re Krohn*, 886 F.2d 123, 126 (6<sup>th</sup> Cir. 1989)). However, the court should also consider other factors under this "hybrid" approach, such as state remedies available to the debtor, and "whether the debtor's expenses can be significantly reduced without depriving him of adequate food, clothing, shelter and other necessities." *Id.* Under this approach, courts should also consider the "good faith and candor" of the debtor in filing the petition and schedules, whether or not the debtor engaged in "eve of bankruptcy purchases," and whether the debtor was forced into bankruptcy by unforeseen or catastrophic events. *Id.*

The “hybrid” approach of the 6<sup>th</sup> Circuit was adopted in the Southern District of Indiana in the case of *In re Burger*. *In re Burger*, 280 B.R. 444 (Bankr.S.D. Ind. 2002). The court in that case held debtors’ petition was subject to being dismissed as “substantial abuse” under the provisions of § 707(b). *Id.* The holding was based, in part, on the debtors’ apparent ability to repay creditors through a Chapter 13 plan. The court determined that many of debtors’ expenses were “discretionary,” therefore not reasonable and necessary to maintain the debtors and their dependents, and that the debtors’ financial difficulties were due largely to mismanagement and overspending. *Id.* at 448-49. These “discretionary” expenses included \$500 per month for their children’s parochial school tuition, ballet and swim lessons, and \$200 per month for a vacation fund. *In re Burger*, 280 B.R. 444, 448-49 (Bankr.S.D. Ind. 2002). The court was persuaded that the debtors possessed significant “disposable income, and these “discretionary” expenses could be used to fund a Chapter 13 plan. *Id.* at 449. Therefore, the court found that the debtors’ Chapter 7 filing constituted a “substantial abuse” under § 707(b). *Id.*

A similar holding was entered by the bankruptcy court for the Northern District of Iowa in the case *In re Stout*. In that case, the court dismissed a debtor’s Chapter 7 case as a “substantial abuse” pursuant to § 707(b), with the opportunity to voluntarily convert to Chapter 13 prior to the entry of dismissal. *In re Stout*, 336 B.R. 138, 142 (Bankr. N.D. Iowa 2006). In reaching its conclusion, the court made findings that the debtor’s preference to keep his young daughter in home schooling, so that her school schedule would be flexible with her ice skating responsibilities, was a luxury. *Id.* at 143. The court also found that debtor’s expenses for his daughter’s ice skating items, skating rink and lesson fees, and expenses for out of state travel for competitions was substantial and extravagant. *Id.* Accordingly, the court held that debtor had substantial discretionary income which could be used to pay unsecured creditors in a Chapter 13, and the Chapter 7 case was dismissed pursuant to § 707(b) with the opportunity to voluntarily convert to Chapter 13 prior to the entry of dismissal. *Id.*

#### Dismissal under Totality of the Circumstances: Section 707(b)(3)

The bankruptcy court for the Northern District of Ohio recently determined that the debtors had the ability to repay their debts based upon totality of circumstances pursuant to §

707(b)(3). *In re Osborne*, 383 B.R. 423, 429 (Bankr. N.D. Ohio 2008). Accordingly, since granting relief to the debtors under Chapter 7 would constitute an abuse pursuant to § 707(b)(1), the court dismissed the debtors' case. *Id.* The court based its decision, in part, on the theory that "while bankruptcy does not require a debtor to adopt a completely Spartan existence, debtors will not be permitted to continue, at the expense of their creditors, to maintain the lifestyle that drove them in to bankruptcy." *Id.* at 428(citing *In re Webb*, 262 B.R. 685, 692 (Bankr. E.D. Tex. 2001).

In this case, both debtors were retired, with no dependents. They had a \$500 monthly expense for transportation, which did not include car payments. Debtors also had allocated \$151 for cable television and \$128 for telephone service. In the court's opinion, these expenses fell "outside the orbit of what one would expect of persons who are making a good faith effort to put their financial situation back in order." *Id.* The court determined, by looking at the whole picture of debtors' financial situation, that by tightening their financial belt they would "have more than ample leeway in their monthly budget to allow for a meaningful remuneration to their unsecured creditors." *Id.*

The bankruptcy court for the Southern District of Ohio similarly dismissed a Chapter 7 case based on abuse under the totality of circumstances test in *In re Schubert*. In that case, the court found abuse pursuant to § 707(b)(3) since the debtors "would like to be able to earn less than their full earning capacity, keep their expensive home, generously replace their cars, and pay their creditors nothing." *In re Schubert*, 2008 WL 857466, 3 (Bankr. S.D. Ohio 2008).

The court looked to several factors to consider the totality of the circumstances in this case. The debtors in *In re Schubert* both had excellent jobs, and a combined gross annual income of \$102,122. *Id.* This would have given the debtors "the ability to pay their unsecured creditor a meaningful percentage without depriving themselves or their children of adequate necessities." *Id.* A "meaningful percentage" of payout to unsecured creditors in this case refers to a \$250 monthly payment, which the court observed to be far less than the debtor's previous monthly boat payment of \$444. *Id.*

The court also observed that the bankruptcy was not caused by a catastrophic or unforeseen event, but the debtors' desire to have jobs with more predictable hours and less pay.

*Id.* The court stressed that “it is elemental that a reduced income for an extended period of time requires a change in lifestyle.” *Id.* The debtors here did not surrender their boat or third vehicle at the points in time their income was reduced, and took out a second mortgage that they later refinanced “to pay bills.” *Id.* These facts were indicative to the court that for an extended period of time, the debtors had been living beyond their means. *Id.* Therefore, a finding of abuse pursuant to § 707(b)(3) was appropriate. *Id.*