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JUDICIAL DISCRETION TO FIND ABUSE IN CHAPTER 13

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A CLE Presentation

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I. Introduction.

The enactment of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 resulted in numerous changes in the Bankruptcy Code. An area especially affected by the BAPCPA is that of judicial discretion to determine abuse of a debtor's proposed repayment plan.

"Under former § 707(b), a court was authorized to dismiss a case under Chapter 7 if it found that granting the debtor relief thereunder 'would be a substantial abuse of the provisions of [that] chapter.'"¹ "Former section 707(b) did not define substantial abuse, but left it to the courts to define the parameters of abusive filings."² However, under the new section 707(b) the court's discretion has been replaced with a mathematical formula.³ "New section 707(b)(2)(A) instructs the court to presume that abuse exists if the debtor passes (or, depending upon one's point of view, fails to pass) a means test."⁴

Under the new delineations of the Code, once a debtor files a chapter 13 plan, if their current monthly income is below the median as set forth in § 707 (b)(2)(A), only the income side of the means test need be completed, and Schedules I and J control the determination of the debtor's disposable income. In this circumstance, § 1325(b)(2) controls and there would be full judicial discretion to determine abuse.

Alternatively, if a chapter 13 debtor's current monthly income is above the median as set forth in § 707 (b)(2)(A), the debtor must complete the entire means test form. This renders Schedules I and J irrelevant, and § 1325(b)(3) controls. Here, there is limited judicial discretion to determine abuse of a chapter 13 plan.

The progression of this issue and the shift in case law away from judicial discretion has been marked by numerous cases, but most notable is the 2006 case *In re Hardacre*.

II. Relevant Bankruptcy Code sections.

The most relevant sections of the bankruptcy code regarding this issue fall under 11 U.S.C. §§ 707(b)(2) and 1325, and are as follows:

§ 707. Dismissal of a Case or Conversion to a Case under Chapter 11 or 13.

(b)(2)(A)(i) In considering under paragraph (1) whether the granting of relief would be an abuse of the provisions of this chapter, the court shall presume abuse exists if the debtor's current monthly income reduced by the amounts determined under clauses (ii), (iii), and (iv), and multiplied by 60 is not less than the lesser of—

(I) 25 percent of the debtor's non-priority unsecured claims in the case, or \$6,000, whichever is greater, or;

(II) \$10,000.

(ii)(I) The debtor's monthly expenses shall be the debtor's applicable monthly expense amounts specified under the National Standards and Local Standards, and the debtor's actual monthly expenses for the categories specified as Other Necessary Expenses issued by the Internal Revenue Service for the area in which the debtor resides, as in effect on the date of the order for relief, for the debtor, the dependents of the debtor, and the spouse of the debtor in a joint case, if the spouse is not otherwise a dependent. Such expenses shall include reasonably necessary health insurance, disability insurance, and health savings account expenses for the debtor, the spouse of the debtor, or the dependents of the debtor. Notwithstanding any other provision of this clause, the monthly expenses of the debtor shall not include any payments for debts. In addition, the debtor's monthly expenses shall include the debtor's reasonably necessary expenses incurred to maintain the safety of the debtor and the family of the debtor from family violence as identified under section 309 of the Family Violence Prevention and Services Act, or other

applicable Federal law. The expenses included in the debtor's monthly expenses described in the preceding sentence shall be kept confidential by the court. In addition, if it is demonstrated that it is reasonable and necessary, the debtor's monthly expenses may also include an additional allowance for food and clothing of up to 5 percent of the food and clothing categories as specified by the National Standards issued by the Internal Revenue Service.

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(iii) The debtor's average monthly payments on account of secured debts shall be calculated as the sum of—

(I) the total of all amounts scheduled as contractually due to secured creditors in each month of the 60 months following the date of the petition; and

(II) any additional payments to secured creditors necessary for the debtor, in filing a plan under chapter 13 of this title, to maintain possession of the debtor's primary residence, motor vehicle, or other property necessary for the support of the debtor and the debtor's dependents, that serves as collateral for secured debts; divided by 60.

(iv) The debtor's expenses for payment of all priority claims (including priority child support and alimony claims) shall be calculated as the total amount of debts entitled to priority, divided by 60.

(B)(i) In any proceeding brought under this subsection, the presumption of abuse may only be rebutted by demonstrating special circumstances, such as a serious medical condition or a call or order to active duty in the Armed Forces, to the extent such special circumstances that justify additional expenses or adjustments of current monthly income for which there is no reasonable alternative.

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§ 1325. Confirmation of Plan.

(b)(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.

(b)(3) Amounts reasonably necessary to be expended under 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 \$525 per month for each individual in excess of 4.

III. Current state of the law.

A. Current state of law, in general.

To curb abuses of Chapter 7 liquidation as identified by Congress, Congress substantially modified § 707(b) of the Code in the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005.⁵ “Under former § 707(b), a court was authorized to dismiss a case under Chapter 7 if it found that granting the debtor relief thereunder ‘would be a substantial abuse of the provisions of [that] chapter.’”⁶ “Former section 707(b) did not define substantial abuse, but left it to the courts to define the parameters of abusive filings.”⁷ Many courts “generally weighed substantial abuse under a ‘totality of the circumstances’ test, an important consideration of which was whether a chapter 7 debtor could make substantial payments to her creditors if her case were a case under chapter 13.”⁸

“Under new section 707(b) the court’s discretion has been replaced with a mathematical formula.”⁹ “New section 707(b)(2)(A) instructs the court to presume that abuse exists if the debtor passes (or, depending upon one’s point of view, fails to pass) a means test.”¹⁰

“Under the means test, the court is to calculate the debtor’s current monthly income, reduce that figure by certain living expenses, and then multiply the difference by 60.”¹¹ For the sake of convenience, the court refers to the product of this calculation as “income available for the debtor’s creditors.”¹² “If the income available for the debtor’s creditors is greater than \$10,000, abuse is presumed.”¹³ “If the income available for the debtor’s creditors is less than \$6,000, abuse is not presumed.”¹⁴ “If the income available for the debtor’s creditors is more than \$6,000, but less than \$10,000, abuse is presumed only if that income exceeds 25% of the debtor’s non-priority unsecured claims in the case.”¹⁵ “If the presumption of abuse arises, the court may dismiss the debtor’s case or, with the debtor’s consent, convert the case to a case under chapter 11 or 13.”¹⁶ “The debtor can overcome the presumption of abuse by demonstrating ‘special circumstances.’”¹⁷

B. Shift in discretion bestowed upon courts: *In re Hardacre*.

The 2006 case of *In re Hardacre* is instructive on the issue at hand. In *Hardacre*, the debtor filed a Chapter 13 plan which fell under the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005.¹⁸ The debtor’s plan provides no return to her unsecured creditors.¹⁹ The chapter 13 trustee urges the court not to confirm the plan, alleging that the debtor has failed to commit to the plan all of her projected disposable income as required by § 1325(b)(1)(B).²⁰ The trustee argues that in calculating her disposable income, the debtor has taken an impermissible double deduction of mortgage and car loan expenses.²¹ The effect of this “double dip” is to reduce the debtor’s projected disposable income by approximately \$1,000 per month, which, if committed to the plan, would pay the debtor’s creditors in full.²² The debtor does not deny the effect of the “double dip,” but argues that § 707(b)(2)(A)(i) expressly permits her to deduct not only her average monthly mortgage and car loan expenses, but certain standard amounts for these categories of expenses as well.²³

“In this case, no issue arises as to whether the debtor’s filing constitutes an abuse of the bankruptcy process because the debtor, as Congress intended, filed for relief under chapter 13, not chapter 7.”²⁴ However, the means test of § 707(b)(2)(A)(i) does affect confirmation of the debtor’s plan in this case.²⁵

“Under § 1325(b)(1)(B), if the trustee or an unsecured creditor objects to the debtor's plan, the court may not approve the plan unless the plan provides that all of the debtor's “projected disposable income” during the “applicable commitment period” will be applied to pay unsecured creditors.”²⁶ “Section 1325(b)(2) provides that “disposable income” means current monthly income reduced by, among other things, “amounts reasonably necessary to be expended” for the maintenance or support of the debtor or her dependents.”²⁷ “In order to determine the “amounts reasonably necessary to be expended” for maintenance or support, § 1325(b)(3) requires the debtor to compare her current monthly income multiplied by 12 (for convenience, referred to herein as “annual income”) to the “median family income” for families of a like size who live in the same state as the debtor.”²⁸

“Once the debtor has determined her applicable commitment period and whether she must calculate her expenses in accordance with the means test in section 707(b)(2), she must submit a plan that commits her “projected disposable income” during the applicable commitment period.”²⁹ “Unfortunately, the phrase “projected disposable income” is subject to conflicting interpretations.”³⁰ “Section 1325(b)(2) defines “disposable income” as “current monthly income” less various categories of expenses.”³¹ “However, “current monthly income” is defined as the debtor's average income for the six months *prior* to her petition in bankruptcy.”³²

In this case, the court interpreted the term “projected disposable income” to be “based upon the debtor's anticipated income during the term of the plan, not merely an average of her prepetition income.”³³ “This conclusion is buttressed not only by the anomalous results that could occur by strictly adhering to section 101(10A)'s definition of “current monthly income,” but because, taken as a whole, section 1325(b)(1) commands such a construction.”³⁴ “Congress's intent with respect to the means test is well known to even the most casual bankruptcy practitioner.”³⁵ “The means test was intended to ‘ensure that those who can afford to repay some portion of their unsecured debts [be] required to do so.’”³⁶

“Given this guidance on statutory construction and legislative intent, the court examines the “notwithstanding” sentence.”³⁷ “Initially, the phrase “Notwithstanding any other provision of this clause” informs the court that the “notwithstanding” sentence qualifies or modifies the first two sentences in § 707(b)(2)(A)(ii)(I).”³⁸ “In the context of the present dispute, the “notwithstanding” sentence can be paraphrased to read, ‘Notwithstanding the debtor's ability to deduct the expense amounts allowed by the Local Standards, such monthly expense allowances shall not include any payments for debts.’”³⁹

“Accordingly, the court interprets the phrase “payments for debts” to mean payments on secured debts related to mortgage and car ownership expenses.”⁴⁰ “When so construed, the “notwithstanding” sentence instructs the court to reduce the debtor's deductions for mortgage and car ownership expenses under the Local Standards by the average monthly expenses for those items under section 707(b)(2)(A)(iii).”⁴¹

“The effect of section 707(b)(2)(A)(ii)(I) is to permit the debtor to deduct the greater of her actual mortgage and car ownership payments or the amounts provided in the Local Standards.”⁴² “This is because the “notwithstanding” sentence cannot be read to require the court to reduce the allowance under the applicable Local Standard to a number that is less than zero, which the court would have to do in order for the debtor's deduction to be limited to the lesser of the amounts permitted under the Local Standards or the debtor's average monthly secured debt payments.”⁴³ “While the “shall not include” language in that sentence can be viewed as an instruction to reduce the applicable Local Standards to zero after deducting the average monthly mortgage and car ownership payments, it cannot be read to create a net negative allowance for those items under the Local Standards.”⁴⁴

“The construction adopted by the court has the salutary benefit of leading to a substantive effect that is compatible with the intent of the Act, whereas the debtor's proposed construction does not.”⁴⁵ “Under the debtor's proposed methodology, her unsecured creditors will receive nothing under her plan because, by failing to reduce her allowances under the Local Standards by her average monthly mortgage and car ownership payments, the debtor will have a projected disposable income of zero.”⁴⁶ “Under the construction adopted by the court, however, the debtor will have a projected disposable

income in excess of \$1,000 per month, which, if applied to the debtor's plan, would be more than enough to pay her creditors in full."⁴⁷

Therefore, the court in *Hardacre* ruled that Congress did not intend to permit chapter 13 debtors to take a double deduction of mortgage and car loan expenses in order to calculate projected disposable income under § 1325(b)(1)(B).⁴⁸ Therefore, the debtor's plan as originally submitted is not confirmed.⁴⁹

¹ *In re Hardacre*, 338 B.R. 718, 720 (Bankr.N.D. Tex. 2006).

² *Id.* (citing 11 U.S.C. § 707(b)).

³ *Id.*

⁴ *Id.* at 721.

⁵ *Id.* at 720.

⁶ *Id.* (citing 11 U.S.C. § 707(b)).

⁷ *Id.*

⁸ *Id.* at 721 (citing *In re Logan*, 2003 Bankr.LEXIS 600 (Bankr.N.D. Tex. 2003)).

⁹ *Id.*

¹⁰ *Id.*

¹¹ *Id.*; 11 U.S.C. § 707(b)(2)(A)(i).

¹² *Id.*

¹³ *Id.*

¹⁴ *Id.*

¹⁵ *Id.*

¹⁶ *Id.*; 11 U.S.C. § 707(b)(1).

¹⁷ *Id.*; 11 U.S.C. § 707(b)(2)(B).

¹⁸ *Id.* at 720.

¹⁹ *Id.*

²⁰ *Id.*

²¹ *Id.*

²² *Id.*

²³ *Id.*

²⁴ *Id.* at 721.

²⁵ *Id.*

²⁶ *Id.*

²⁷ *Id.*

²⁸ *Id.*

²⁹ *Id.* at 722; 11 U.S.C. § 1325(b)(1).

³⁰ *Id.*

³¹ *Id.*

³² *Id.*; 11 U.S.C. § 101(10A).

³³ *Id.*

³⁴ *Id.*

³⁵ *Id.* at 725.

³⁶ *Id.* (quoting 151 CONG. REC. S2470 (March 10, 2005)).

³⁷ *Id.*

³⁸ *Id.*

³⁹ *Id.*

⁴⁰ *Id.* at 726-27.

⁴¹ *Id.* at 727.

⁴² *Id.*

⁴³ *Id.*

⁴⁴ *Id.*

⁴⁵ *Id.* at 727-28.

⁴⁶ *Id.* at 728.

⁴⁷ *Id.*

⁴⁸ *Id.* at 720.

⁴⁹ *Id.*