Golden Gate University Law Review

Volume 41 | Issue 1 Article 7

December 2010

Cleaning the Mess of the Means Test: The Need For A Case-by-Case Analysis of 401(k) Loans in Chapter 7 Bankruptcy Petitions

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COMMENT

CLEANING THE MESS OF THE MEANS TEST: THE NEED FOR A CASE-BY-CASE ANALYSIS OF 401(k) LOANS IN CHAPTER 7 BANKRUPTCY PETITIONS

INTRODUCTION

How much money will you need in retirement to maintain your current lifestyle? Many financial planners suggest that you may need at least 70% to 80% of your current annual income to maintain your way of life, while others say the figure is closer to 100% or more.[1] As a result of the declining economy, balances in retirement accounts are roughly 25% lower than they were before the recession.[2] However, experts suggest that even before the recent recession most Americans were not saving enough for retirement.[3] Because Social Security alone will not provide adequate retirement income for most people, and fewer companies are offering traditional pension plans, a 401(k) plan has become an essential part of the average worker's retirement.[4] As a result, more than 40 million U.S. workers have saved for retirement through the help of 401(k) plans.[5]

Although there are numerous tax incentives to continued investing

[1] TED BENNA & BRENDA WATSON NEWMANN, 401(k)S FOR DUMMIES 18 (2003).

[2] Editorial, *About Your 401(k)*, N.Y. TIMES, Aug. 24, 2009, at A18, *available at* http://www.nytimes.com/2009/08/24/opinion/24mon1.html?scp=16&sq=&st=nyt.

[3] *Id.*

[4] TED BENNA & BRENDA WATSON NEWMANN, 401(k)S FOR DUMMIES 9 (2003).

[5] *Id*. 401(k) savings plans are a way in which employees can contribute pre-tax earnings toward retirement. This money earns interest while invested and cannot be taken out before the age of 59½ without harsh penalties. Many participants have said that the 401(k) has helped them save thousands of dollars that they otherwise would have spent carelessly. *Id*. at 15.

in a 401(k) plan, and the penalties for early withdrawal are harsh, some participants have found it necessary to access this money before retirement. One of the only ways to avoid paying a federal penalty for early withdrawal, and in some states an additional state penalty, is to borrow money through a 401(k) loan.[6] In fact, "[t]he most recent industry surveys show that about 20 to 25 percent of eligible employees have outstanding loans."[7] Unfortunately, even with 401(k) loan assistance, some borrowers have filed for bankruptcy due to overwhelming debt. Although the remaining funds in a 401(k) are protected from creditors in a bankruptcy proceeding,[8] funds that were borrowed through a 401(k) loan have not received the same treatment.[9] This discrepancy is unduly prejudicial for petitioners with 401(k) loans trying to get a fresh start in bankruptcy.

Recent changes to the Bankruptcy Code[10] have made it nearly impossible, or at least extremely difficult, for a debtor with monthly income greater than the median income in his or her state[11] to successfully petition for Chapter 7 bankruptcy.[12] Since the passage of the Bankruptcy

[6] Many 401(k) participants choose to take a 401(k) loan over a traditional unsecured loan for a number of reasons: there are minimal qualifications and credit requirements to obtain a 401(k) loan; the interest rate charged is nominal, and in most plans the interest paid is deposited back into the account; most loans allow for a five-year repayment plan through automatic deductions from the employee's paycheck; and many plan providers can have a loan funded within a matter of days. Ron Lieber, *When Credit Gets Tight, a 401(k) Loan Becomes Tempting*, N.Y. TIMES, July 5, 2008, at C1; IWASZKO, KNUTE AND BRIAN O'CONNELL, THE 401(k) MILLIONAIRE 188 (1999). According to the IRS, a participant may borrow from a 401(k) retirement plan without tax penalties or liability if three criteria are met: 1) the amount borrowed is limited to 50% of the vested account balance, or $50,000, whichever is less; 2) the loan is repaid within five years, unless the loan is used to purchase the participant's main home; and 3) the loan repayments are made in substantially level payments, at least quarterly, over the life of the loan. *401k Resource Guide – Plan Sponsors – General Distribution Rules*, IRS.GOV, http://www.irs.gov/retirement/sponsor/article/0,,id=151926,00.html (last visited Oct. 22, 2010).

[7] Ron Lieber, *When Credit Gets Tight, a 401(k) Loan Becomes Tempting*, N.Y. TIMES, July 5, 2008, at C1.

[8] 11 U.S.C.A. § 522 (Westlaw 2010).

[9] Similarly, voluntary *contributions* to 401(k) plans have received varied treatment in bankruptcy petitions. *See* James Winston Kim, *Saving Our Future: Why Voluntary Contributions to Retirement Accounts Are Reasonable Expenses*, 26 EMORY BANKR. DEV. J. 341 (2010) (arguing that voluntary contributions to retirement accounts can be reasonably necessary expenses).

[10] 11 U.S.C.A. §§ 101-1527 (Westlaw 2010). Unless otherwise noted, all references to the Bankruptcy Code, Code, or § are to Title 11 of the United States Code.

[11] 11 U.S.C.A. § 707(b)(7) (Westlaw 2010). No party in interest to the bankruptcy proceeding, nor a judge, may file a motion for dismissal under § 707(b)(2) for those petitioners with a current monthly income equal to or less than the median family income for a comparable household, thereby precluding this group of petitioners from the application of the means test.

[12] For a more detailed overview of Chapter 7 bankruptcy petitions and the means test, see Robert J. Landry, III, *The Means Test: Finding a Safe Harbor, Passing the Means Test, or Rebutting the Presumption of Abuse May Not Be Enough*, 29 N. ILL. U. L. REV. 245 (2009).

Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA),[13] courts have differed on the question whether monthly repayments to a 401(k) loan are deductible as "Other Necessary Expenses"[14] under the "means test"[15] of Chapter 7 when determining a petitioner's monthly disposable income.[16] In courts that do not recognize a deduction for 401(k) loan repayments, the means test may not accurately calculate a debtor's ability to repay creditors.[17] Thus, in those courts, a Chapter 7 petition will likely be wrongly dismissed for being presumptively abusive of the provisions of Chapter 7. As a result, courts err in not allowing a means-test deduction for 401(k) loan repayments.

This Comment examines the relevant case law regarding Chapter 7 petitions and the policy implications of not considering 401(k) loan repayment a necessary expense. Section II provides an overview of the treatment of 401(k) loans in bankruptcy, as well as a more detailed review of means testing and an analysis of Other Necessary Expenses. Section III argues that courts should look to the facts and circumstances surrounding petitions to determine whether 401(k) loan repayments can be deducted as necessary expenses, and that doing so will not affect the ability of courts to properly dismiss abusive petitions under a totality-of-the-circumstances analysis. This Comment concludes that a 401(k) loan-repayment deduction may be proper, and therefore a case-by-case analysis of a Chapter 7 petition is equitable for debtors subject to the means test.

[13] Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), Pub. L. No. 109-8, 119 Stat. 23 (2005) (codified as amended in scattered sections of Chapter 11 of the United States Code).

[14] 11 U.S.C.A. § 707(b)(2)(A)(ii)(I) (Westlaw 2010) (allowing a deduction for the "actual monthly expenses for the categories specified as Other Necessary Expenses issued by the Internal Revenue Service").

[15] The "means test" is a mechanical calculation to determine whether a presumption of abuse of the provisions of bankruptcy attaches.

[16] 11 U.S.C.A. § 707(b) (Westlaw 2010).

[17] There are two reasons those courts may misinterpret a debtor's ability to repay creditors: (1) these monthly repayment amounts are necessary expenses and should be statutorily deducted from the debtor's monthly disposable income under § 707(b)(2)(A)(ii), and therefore the courts are incorrect in their mathematical calculations of debtors' disposable income under the means test; and (2) 401(k) loan repayments are generally mandatorily deducted from an employee's paycheck, and those courts essentially require that debtors cease repayment of these loans, treating the remaining loan balances as early withdrawals, and pay the federal penalties (and in some cases additional state penalties) associated with early withdrawal, thereby imposing additional unfair penalties on debtors. Requiring an employee to pay early withdrawal penalties may leave less than 50% of what the court considers available to creditors.

I. BACKGROUND

A. THE MEANS TEST OF THE BAPCPA AND 401(k) LOAN TREATMENT

Chapter 7 bankruptcy "discharges the debtor from all debts that arose before the date of the order for relief under this chapter."[18] For decades, Congress debated reform in an attempt to prevent petitioners from completely discharging debts in favor of the repayment of creditors.[19] After a long and arduous road to reform, Congress passed the 2005 Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA).[20] The BAPCPA is meant to address abuses of the bankruptcy process and to steer debtors away from Chapter 7 into Chapter 13 plans where they will be forced to repay a portion of their debts.[21] While passing the BAPCPA was difficult,[22] the practical application of the

[18] 11 U.S.C.A. § 727(b) (Westlaw 2010). Procedurally, upon the filing of either a Chapter 7 or Chapter 13 petition, an automatic stay is triggered that prevents creditors from collecting payment from the debtor. 11 U.S.C.A. § 362(a) (Westlaw 2010). For example, the automatic stay prevents the enforcement of judgments, or the collection, assessment, or recovery of a claim against the petitioner. 11 U.S.C.A. § 362(a)(2), (6) (Westlaw 2010). While protecting the debtor from his or her creditors during bankruptcy proceedings, the automatic stay is not a complete bar of any action against the debtor. It does not protect against the commencement or continuation of criminal proceedings against the petitioner or civil proceedings and related collections with issues of paternity, child custody, marriage, or domestic violence. 11 U.S.C.A. § 362(b)(1), (2)(A)-(B) (Westlaw 2010).

[19] Congress, and creditor lobbyists, had considered means testing as an element of bankruptcy reform in every session since 1997. Eugene R. Wedoff, *Means Testing in the New §707(b)*, 79 AM. BANKR. L.J. 231, 231 (2005). For a general discussion of the political battles over bankruptcy reform in the 1990's, see Melissa B. Jacoby, *Negotiating Bankruptcy Legislation Through the News Media*, 41 HOUS. L. REV. 1091 (2004), and Robert J. Landry, III, *The Policy and Forces Behind Consumer Bankruptcy Reform: A Classic Battle over Problem Definition*, 33 U. MEM. L. REV. 509 (2003). This debate was largely due to the increased number of bankruptcy petitions as a whole, and more specifically, the significantly increased number of Chapter 7 petitions through the 1990's. Henry J. Sommer, *Trying to Make Sense Out of Nonsense: Representing Consumers Under the "Bankruptcy Abuse Prevention and Consumer Protection Act of 2005,"* 79 AM. BANKR. L.J. 191, 191-92 (2005).

[20] Pub. L. No. 109-8, 119 Stat. 23 (2005) (codified as amended in scattered sections of Chapter 11 of the United States Code).

[21] *See In re* Hardacre, 338 B.R. 718, 720 (Bankr. N.D. Tex. 2006) (stating that the intent of the BAPCPA was to prevent "easy access to chapter 7 liquidation proceedings by consumer debtors who, if required to file under chapter 13, could afford to pay some dividend to their unsecured creditors"). Chapter 7 is most commonly compared to Chapter 13 bankruptcy, in which a debtor generally projects his or her future financial circumstances for a period of three or five years, depending upon the current monthly income of the debtor as compared to the median income of a similar-size family, and submits a plan to repay creditors. 11 U.S.C.A. § 1325(b)(4) (Westlaw 2010). A Chapter 13 plan must be approved by the court, and upon completion of the repayment period, any remaining debts will be discharged. 11 U.S.C.A. § 1325 (Westlaw 2010).

[22] During remarks, proceedings and debates of Congress while attempting to pass the BAPCPA, many politicians and other individuals stood up in stark opposition to the Act. For exam-

BAPCPA's principles is proving to be even more laborious.[23] The most significant change was the addition of the means test: a mechanical calculation used to objectively determine whether a petitioner is abusing the provisions of the Bankruptcy Code.[24] The means test was purposely designed to make it more difficult to obtain a total discharge of unsecured debts in a Chapter 7 proceeding.[25]

A petition must be dismissed, or converted to a petition under Chapter 11 or Chapter 13, if the court determines that it constitutes an abuse of the Bankruptcy Code for an individual filing under Chapter 7 with primarily consumer debts.[26] The means test provides the calculation for determining whether a presumption of abuse arises.[27] For certain individuals, there are safe harbors in which the means test is not applied.[28] Safe-harbor provisions apply when (1) the petitioner is a debtor with "current monthly income" below the median household income in his or her state,[29] or (2) the petitioner is a disabled veteran.[30] However, even if

ple, The Honorable Lucille Roybal-Allard of California remarked, "This bill would negatively affect millions of hard-working Americans, particularly veterans and victims of identity theft. The [BAPCPA] is a bad bill because it favors credit card companies at the expense of hard-working Americans, veterans, and victims of identity theft. It creates a means test which would make it impossible for families to be protected even when they have suffered debt due to illness or unemployment, preventing them from being able to start over in life. While the bill makes it harder for these individuals to eliminate their debt, it unnecessarily strengthens the hands of creditors. For example, this bill does not guarantee that hard-working parents can make child support payments over credit card debt payments." 151 CONG. REC. E838-04 (daily ed. May 2, 2005) (statement of Hon. Lucille Roybal-Allard).

[23] Robert J. Landry, III, *The Means Test: Finding a Safe Harbor, Passing the Means Test, or Rebutting the Presumption of Abuse May Not Be Enough*, 29 N. ILL. U. L. REV. 245, 246 (2009).

[24] Eisen v. Thompson, 370 B.R. 762, 771 (N.D. Ohio 2007).

[25] *Id*.

[26] 11 U.S.C.A. § 707(b)(1) (Westlaw 2010).

[27] 11 U.S.C.A. § 707(b)(2)(A)(i) (Westlaw 2010) (stating "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 nonpriority unsecured claims in the case, or $7,025, whichever is greater; or (II) $11,725").

[28] 11 U.S.C.A. § 707(b)(2)(D), (b)(7) (Westlaw 2010).

[29] 11 U.S.C.A. § 707(b)(7) (Westlaw 2010). To determine whether a petitioner falls within this first safe-harbor provision, the petitioner must look to his or her income for the past 6 months, average that income, and place it onto Form 22A, the "Abuse Test" form. Robert C. Meyer, *Chapter 7 and Chapter 13 Issues* 3-4, http://www.robertcmeyer.com/PDF/Chapter7and13issuespdf.pdf (last visited Oct. 22, 2010). The average six-month income figure is called the "current monthly income" (CMI). 11 U.S.C.A. § 101(10A) (Westlaw 2010). According to the census bureau, median income varies significantly by state. *State Median Income*, http://www.census.gov/hhes/www/income/statemedfaminc.html (last visited Oct. 22, 2010). The lowest median income reported for the years 2007-2009 for three-year average medians is $36,650 in Mississippi; the highest median income reported for the years 2007-2009 for three-year average medians is $66,654 in New Hampshire. *Id*. When filing for bankruptcy and submitting the appropriate financial paperwork, income, in a factual context, is commonly difficult to determine with the loss of jobs. Robert C. Meyer, *Chapter 7 and Chapter 13 Issues* 5,

the safe-harbor provisions shield the petitioner from the means test's presumption of abuse, a court may still dismiss a petition on procedural grounds for unreasonable delay, lack of proper payment of fees, or a failure to provide the required documents.[31] The court may also dismiss a petition if it determines that under a "totality of the circumstances" the individual should not benefit from Chapter 7 bankruptcy.[32]

If the debtor's current monthly income is greater than the median income of his or her state, thereby excluding the debtor from the safe-harbor provisions, the court then uses the means test to determine the amount that the debtor can repay to his or her creditors.[33] Under the means test, the court deducts the total amount of the debtor's statutorily approved monthly expenses from the debtor's current monthly income.[34] This final figure is the debtor's monthly disposable income, i.e., the amount of money every month with which the debtor can repay his or her creditors after paying for things such as living expenses, food, and insurance.[35] The monthly disposable-income figure is then multiplied by sixty to determine how much money the debtor has to pay back to his or her creditors over a five-year period.[36] If the debtor's five-year disposable income is less than the lesser of either (1) 25% of the debtor's unsecured debts or $7,025, whichever is greater, or (2) $11,725, then the debtor may remain in Chapter 7.[37] If the debtor's five-year disposable

http://www.robertcmeyer.com/PDF/Chapter7and13issuespdf.pdf (last visited Oct. 22, 2010). This creates problems in that a petitioner who has recently been terminated from employment will have no current monthly income, yet the average of his or her income over the past 6 months may be significant. So while the petitioner has no current money to pay rent, bills, or creditors, the petitioner will likely not be able to successfully file for bankruptcy. *Id*. at 3-4. This is especially true today. In its worst economic state since the Great Depression, the unemployment rate is at 9.6%. News Release, Bureau of Labor Statistics, U.S. Dep't of Labor, The Employment Situation—September 2010 (Oct. 8, 2010), http://www.bls.gov/news.release/pdf/empsit.pdf.

[30] 11 U.S.C.A. § 707(b)(7) (Westlaw 2010).

[31] 11 U.S.C.A. § 707(a) (Westlaw 2010).

[32] 11 U.S.C.A. § 707(c) (Westlaw 2010). In determining whether to dismiss a petition or convert it to Chapter 13, the court may look to whether the totality of the circumstances of the debtor's financial situation demonstrates abuse of the provisions of Chapter 7 bankruptcy.

[33] Robert J. Landry, III, *The Means Test: Finding a Safe Harbor, Passing the Means Test, or Rebutting the Presumption of Abuse May Not Be Enough*, 29 N. ILL. U. L. REV. 245, 256-57 (2009).

[34] 11 U.S.C.A. § 707(b)(2(A)(ii) (Westlaw 2010). The deductions stated include, but are not limited to, expenses for health and disability insurance, reasonably necessary expenses to maintain the safety of the debtor and his or her family from family violence, expenses for food and clothing, and actual expenses for the care of an elderly, ill, or disabled household member.

[35] For a list of all deductions allowed, see 11 U.S.C.A. § 707(b)(2)(A)(ii) (Westlaw 2010).

[36] 11 U.S.C.A. § 707(b)(2)(A)(i) (Westlaw 2010). The court looks to the debtor's ability to repay creditors over a five-year period in order to determine whether the debtor is better suited for Chapter 13 bankruptcy. Chapter 13 petitioners are required to provide for repayments to creditors over a five-year period. 11 U.S.C.A. § 1322(a)(4) (Westlaw 2010).

[37] 11 U.S.C.A. § 707(b)(2)(A)(i) (Westlaw 2010) . The statutory amounts of $7,025 and

income does not meet this test, the presumption of abuse arises, and if it is not rebutted, the debtor must amend his or her petition to file for Chapter 13 bankruptcy, or the petition will be dismissed.[38]

In other words, if the debtor's monthly disposable income is less than approximately $120 ($7,025[39] over 60 months), the presumption of abuse does not arise.[40] If the debtor's monthly disposable income is greater than approximately $200 ($11,725[41] over 60 months), then the presumption of abuse arises.[42] Finally, if the debtor's monthly disposable income is between about $120 and $200, the presumption of abuse does not arise if this amount over 60 months is not sufficient to pay at least 25% of the debtor's "nonpriority unsecured claims."[43]

As one bankruptcy court explained, by enacting the BAPCPA Congress clearly lowered the standard for dismissal of Chapter 7 petitions; however, pre-BAPCPA case law applying these concepts is still helpful in determining whether a debtor is abusing Chapter 7 bankruptcy.[44] The means test is a statutory expansion of the concept that only a "needy" debtor is entitled to Chapter 7 liquidation relief.[45] This concept is directly related to the reduction of the standard for dismissal under § 707(b) from "substantial abuse" to "an abuse" of Chapter 7 relief.[46]

Bankruptcy scholars have noted that "[t]he mathematical formula incorporated from §707(b)(2) is unrelated to the provisions of the proposed [Chapter 13 bankruptcy] plan and bears no obvious relationship to the amount of money that will actually be available from the debtor for payments to unsecured creditors if the plan is confirmed."[47] If a debtor's

$11,725 are adjusted for inflation every three years. 11 U.S.C.A. § 104 (Westlaw 2010).

[38] 11 U.S.C.A. § 707(b)(1) (Westlaw 2010). A discussion of rebutting the presumption of abuse is beyond the scope of this Comment.

[39] 11 U.S.C.A. § 707(b)(2)(A)(i)(I) (Westlaw 2010).

[40] Eisen v. Thompson, 370 B.R. 762, 765 (N.D. Ohio 2007).

[41] 11 U.S.C.A. § 707(b)(2)(A)(i)(II) (Westlaw 2010).

[42] *Thompson*, 370 B.R. at 765.

[43] 11 U.S.C.A. § 707(b)(2)(A)(i)(I) (Westlaw 2010); *Thompson*, 370 B.R. at 765. "Nonpriority unsecured claims" is another way of saying the debtor's unsecured debt. For example, if a debtor had a monthly disposable income of $150, he or she would be able to repay $9,000 over a period of 60 months. The presumption of abuse would not arise for such a debtor if his or her unsecured debt was greater than $36,000 (25% of $36,000 is $9,000). However, if such a debtor had unsecured debt of $24,000, the presumption of abuse would arise (25% of $24,000 is $6,000, and the debtor has the ability to pay more than $6,000 over the following 60 months).

[44] *In re* Mestemaker, 359 B.R. 849 (Bankr. N.D. Ohio 2007).

[45] *In re* Behlke, 358 F.3d 429, 434 (6th Cir. 2004); *In re* Walton, 866 F.2d 981, 983 (8th Cir. 1989); *In re* Kelly, 841 F.2d 908, 914 (9th Cir. 1988).

[46] The rules for dismissal under pre-BAPCPA law, 11 U.S.C. § 707(b) (1984), allowed for dismissal of a bankruptcy petition where the granting of relief would be a "substantial abuse" of the provisions of Chapter 7. This was one of the most controversial changes in the BAPCPA.

[47] Keith M. Lundin & Henry E. Hildebrand, III, *Section by Section Analysis of Chapter 13*

Chapter 7 petition is dismissed, his or her only remedy in bankruptcy is to formulate and propose a plan under Chapter 11 or Chapter 13.[48] Courts will sometimes look to how much money will be available to creditors in a proposed bankruptcy under Chapter 13 when determining whether a debtor should be allowed to remain in Chapter 7; however, this calculation might not accurately reflect the amount of money available to creditors.[49] The most significant controversy that courts are called upon to resolve is whether a debtor's expenses are deductible from the debtor's current monthly income. Petitioners have attempted to deduct 401(k) loan repayments as payments on account of "secured debts" under § 707(b)(2)(A)(iii), but courts have gone to great lengths to explain how 401(k) loans are neither "debts" nor "secured debts."[50] Courts reason that a debtor's obligation under a 401(k) loan is "essentially a debt to himself – he has borrowed his own money."[51] Despite the valiant efforts that petitioners have put forth to argue that 401(k) loan repayments are secured debts, courts have consistently held that debtors may not deduct 401(k) loan repayments for purposes of the means test in hopes of avoiding the presumption of abuse.[52]

After BAPCPA, SL068 ALI-ABA 65, 98 (July 21-22, 2005).

[48] 11 U.S.C.A. § 707(b)(1) (Westlaw 2010).

[49] *See In re* Walker, 2006 WL 1314125 (Bankr. N.D. Ga. 2006) (recognizing that a debtor with a fully unsecured second mortgage would be entitled to deduct the full amount of the contract payments under § 707(b)(2)(A)(iii), however, the debtor would not actually be required to make the secured payments on the second mortgage while in a Chapter 13 case).

[50] *See*, *e.g.*, N.Y.C. Emps.' Ret. Sys. v. Villarie (*In re* Villarie), 648 F.2d 810, 812 (2d Cir. 1981) (an annuitant's withdrawal from the savings account of annuity fund is not a "debt"); Bolen v. Adams, 403 B.R. 396, 400-01 (N.D. Miss. 2009) (vast majority of courts have held that a debtor's obligation to repay retirement account loan is not a "debt" under the Code); Eisen v. Thompson, 370 B.R. 762, 769 (N.D. Ohio 2007) (majority view is that retirement plan loans are not secured debts); McVay v. Otero, 371 B.R. 190, 195 (W.D. Tex. 2007) ("there is a clear consensus that an individual's pre-petition borrowing from his retirement account does not give rise to a secured or unsecured 'claim,' or a 'debt' under the Bankruptcy Code"); *In re* Esquivel, 239 B.R. 146, 152 (Bankr. E.D. Mich. 1999) ("clear consensus" that borrowing from retirement account do not give rise to either secured or unsecured "claim" under the Bankruptcy Code); *In re* Fulton, 211 B.R. 247, 264 (Bankr. S.D. Ohio 1997) (funds borrowed from a debtor's pension plan do not constitute a debt, and the pension plan has no right of repayment against the debtor or the debtor's property that can be classified as a secured claim under the bankruptcy laws); *In re* Scott, 142 B.R. 126, 131-32 (Bankr. E.D. Va. 1992) (no "debt" exists between the debtor and an ERISA pension plan); *In re* Jones, 138 B.R. 536, 537-538 (Bankr. S.D. Ohio 1991) (advance is not a debt because the city's administrative code did not give the System the right to sue the debtor for the amount of the advance).

[51] *E.g.*, *In re* Egebjerg, 574 F.3d 1045, 1049 (9th Cir. 2009) ("the debtor's obligation to repay a loan from his or her retirement account is not a 'debt' under the Bankruptcy Code"); *In re* Smith, 388 B.R. 885, 887 (Bankr. C.D. Ill. 2008) (a debtor is borrowing from himself because "there is no separate entity to whom the debt is owed"); *McVay*, 371 B.R. at 195-97 (citing numerous cases following the same reasoning).

[52] *Id*.

B. OTHER NECESSARY EXPENSES UNDER THE MEANS TEST

Before the BAPCPA, former § 707(b) warranted dismissal only if the bankruptcy petition constituted a substantial abuse of Chapter 7.[53] Under the former Act, courts generally followed one of two tests: either (i) they evaluated whether an expense was reasonably necessary under a "totality of the circumstances" test,[54] or (ii) they mechanically looked to the debtor's "ability to pay" creditors *in full* over the three-year term of a Chapter 13 plan.[55] Courts that used the ability-to-pay rule were quick to adopt a per-se rule that expenses such as 401(k) loan repayments were not necessary under former § 707(b).[56] In those courts that adopted the ability-to-pay rule, the determination to dismiss a Chapter 7 petition for substantial abuse was based on the amount of disposable income available and the percentage of unsecured debts that would be discharged in a hypothetical Chapter 13 plan.[57] Some courts held that a debtor left with *any* surplus income, no matter the surrounding circumstances, justified the dismissal of the debtor's Chapter 7 petition.[58] These courts ignored whether an expense was reasonably necessary.

In contrast, the courts that adopted the totality-of-the-circumstances test for substantial abuse offer more guidance in determining whether the repayment of 401(k) loans is a necessary expense. Courts that utilized the totality-of-the-circumstances test generally looked to the facts and circumstances of the case before allowing or disallowing a deduction from a debtor's current monthly income.[59] These courts did not analyze each specific expense to determine whether it was reasonably necessary; instead, a number of factors were used to determine if a petition amounted to a substantial abuse of Chapter 7 bankruptcy in light of the

[53] *See* Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, § 312, 98 Stat. 333, 355 (1984).

[54] *See, e.g.*, *In re* Vansickel, 309 B.R. 189, 201 (Bankr. E.D. Va. 2004) (finding the appropriate standard in evaluating the deductibility of retirement account contributions and loan repayments is the totality-of-the-circumstances test).

[55] *See, e.g.*, *In re* Zaleta, 211 B.R. 178, 180-81 (Bankr. M.D. Pa. 1997) (finding that the ability-to-pay approach avoids debtors getting a "head start" rather than a "fresh start"); *In re* Edwards, 50 B.R. 933, 937 (Bankr. S.D.N.Y. 1985) (finding that a debtor who can repay principal to his or her creditors is not suffering from sufficient economic hardship to warrant use of Chapter 7).

[56] *Vansickel*, 309 B.R. at 204.

[57] *Id*.

[58] *See, e.g., In re* Behlke, 358 F.3d 429, 438 (6th Cir. 2004) (finding no bright line for dismissal under the ability-to-pay test); *In re* Walton, 866 F.2d 981, 985 (8th Cir. 1989) ("[A] finding that a debtor is able to pay his debts, standing alone, supports a conclusion of substantial abuse."); *In re* Kelly, 841 F.2d 908, 913-14 (9th Cir. 1988) (the ability-to-pay approach is fully in keeping with Congress's intent in enacting § 707(b)).

[59] *Vansickel*, 309 B.R. at 206.

totality of the circumstances.[60] For example, the Fourth Circuit enumerated some of these considerations, including the following:

> (1) Whether the bankruptcy petition was filed because of sudden illness, calamity, disability, or unemployment; (2) Whether the debtor incurred cash advances and made consumer purchases far in excess of his ability to repay; (3) Whether the debtor's proposed family budget is excessive or unreasonable; (4) Whether the debtor's schedules and statement of current income and expenses reasonably and accurately reflect the true financial condition; and (5) Whether the petition was filed in good faith.[61]

The Fourth Circuit further noted that the debtor's ability to repay creditors is the primary factor to be considered, and this determination must be made on a case-by-case basis.[62]

Likewise, the Ninth Circuit applied the totality-of-the-circumstances test and calculated a debtor's disposable income by starting with current monthly income and subtracting amounts "reasonably necessary to be expended . . . for the maintenance or support of the debtor."[63] The Ninth Circuit found that because the Code did not define the phrase "reasonably necessary" or provide examples of reasonably necessary expenses, the court had to analyze the petition based on the debtor's specific circumstances in order to decide whether a claimed expense was required for the debtor's maintenance or support.[64] According to these decisions, before the BAPCPA, courts had free rein to look to the facts and circumstances surrounding debtors' financial situations rather than applying per-se rules disallowing particular deductions. The BAPCPA, in effect, removed this power from the courts and statutorily dictates what is reasonable or necessary.[65]

By enacting the BAPCPA, Congress provided bankruptcy courts with more categorical guidance as to what constitutes a necessary expense. Under the means test, "[t]he 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

[60] Green v. Staples (*In re* Green), 934 F.2d 568, 572 (4th Cir. 1991).

[61] *Id*.

[62] *Id*.

[63] Hebbring v. U.S. Trustee, 463 F.3d 902, 906 (9th Cir. 2006) (quoting 11 U.S.C. § 1325(b)(2) (2000)), *superseded by statute*, BAPCPA, Pub. L. No. 109-8, 119 Stat. 23 (2005), *as recognized in* Egebjerg v. Anderson (*In re* Egebjerg), 574 F.3d 1045, 1052 (9th Cir. 2009).

[64] *Id*.

[65] 11 U.S.C.A. § 707(b)(2)(A)(ii)(I) (Westlaw 2010); I.R.M. § 5.15.1.10 (2009) (setting forth the statutory categorical deductions allowed as Other Necessary Expenses).

expenses for the categories specified as Other Necessary Expenses issued by the Internal Revenue Service . . . ."[66] The National Standards, promulgated by the Bureau of Labor Statistics, include categorical deductions for food, housekeeping supplies, apparel and services, personal care products and services, and miscellaneous expenses.[67] Local Standards, issued and published by the United States Trustee,[68] generally include deductions for housing, transportation, and utility expenses.[69] Other Necessary Expenses are outlined in the IRS's Internal Revenue Manual, which lists fifteen categories of expenses that may be considered necessary.[70] The IRS's list is non-exhaustive, as evidenced by Internal Revenue Manual section 5.15.1.10(1)'s "necessary expense test."[71] The test instructs that "[o]ther expenses may be considered . . . [but] they must provide for the health and welfare of the taxpayer and/or his or her family or they must be for the production of income."[72]

Bankruptcy Form 22A is the procedural form in which petitioners enter financial information to determine whether the Chapter 7 presumption of abuse arises.[73] Form 22A also lists categories of Other Necessary Expenses, which include taxes, health care, and involuntary deductions for employment.[74] Under the involuntary deductions for employment

[66] 11 U.S.C.A. § 707(b)(2)(A)(ii)(I) (Westlaw 2010).

[67] Eugene R. Wedoff, *Means Testing in the New § 707(b)*, 79 AM. BANKR. L.J. 231, 254 (2005).

[68] These amounts vary by State, County, Census Region, family size, and expense type. The allowable local expenses are published through the U.S. Trustee Program website.

[69] Eugene R. Wedoff, *Means Testing in the New § 707(b)*, 79 AM. BANKR. L.J. 231, 255 (2005).

[70] I.R.M. § 5.15.1.10. These fifteen categories include accounting and legal fees, charitable contributions (donations to tax exempt organizations), child care (babysitting, day care, nursery and preschool), court-ordered alimony payments (alimony, child support, including orders made by the state, and other court ordered payments), dependent care (for the care of the elderly, invalid, or handicapped), education, involuntary deductions, life insurance, secured or legally perfected debts, unsecured debts, taxes, optional telephones and telephone services (pager, call waiting, caller identification or long distance), student loans, internet provider/e-mail, and repayment of loans made for payment of federal taxes. Each category of deductions has different requirements to be considered "necessary," e.g., regarding expenses for unsecured debt: "If the taxpayer substantiates and justifies the expense, the minimum payment may be allowed. The necessary expense test of health and welfare and/or production of income must be met. Except for payments required for the production of income, payments on unsecured debts will not be allowed if the tax liability, including projected accruals, can be paid in full within 90 days." *Id*.

[71] I.R.M. § 5.15.1.10(1).

[72] I.R.M. § 5.15.1.10(1).

[73] Fed. R. Bankr. P. 1007 requires that the debtor file a schedule of assets and liabilities, a schedule of current income and expenditures, and a statement of financial affairs as prescribed by the appropriate Official Forms.

[74] Official Bankruptcy Form 22A, *available at* http://www.uscourts.gov/uscourts/RulesAndPolicies/rules/BK_Forms_Official_2010/B_022A_0410.

category, the Form advises petitioners to "[e]nter the total average monthly payroll deductions that are required for your employment, such as retirement contributions, union dues, and uniform costs. **Do not include discretionary amounts, such as voluntary 401(k) contributions**."[75] While Form 22A provides some guidance, there is no express mention of 401(k) loan repayments. Furthermore, although the language of the Form is helpful, the form language is not binding on the courts if it conflicts with statutory language.[76]

Even though the National Standards, Local Standards, and the IRS's Other Necessary Expenses currently provide more-concrete categories of necessary expenses, courts still find room to disagree as to what are considered "reasonably necessary" expenses.[77] While it is no longer debated that 401(k) contributions cannot be deducted from income in Chapter 7 bankruptcy petitions under the Internal Revenue Manual or Form 22A,[78] courts still disagree about whether 401(k) loan repayments are deductible.

C. JUDICIAL ANALYSIS OF 401(k) LOAN REPAYMENTS AS NECESSARY EXPENSES

Few courts have directly addressed the deductibility of 401(k) loan repayments as Other Necessary Expenses. Some courts have avoided the issue altogether by excluding the deduction on other grounds. [79] For example, multiple bankruptcy courts have held that 401(k) loan repayments

pdf; *see also* 11 NORTON BANKR. L. & PRAC. 3D Rules Form 22A (2010). Some of the other categorically necessary expenses include life insurance, court-ordered payments, education for employment or for a physically or mentally challenged child, childcare, and telecommunication services.

[75] *Id.* at *l*. 26.

[76] *In re* Barraza, 346 B.R. 724, 730 (Bankr. N.D. Tex. 2006).

[77] *Compare In re* Herbord, Nos. 07-60311, 07-60331, 2008 WL 149972 *2 (Bankr. S.D. Ill. Jan. 14, 2008) (finding that the provisions in the Internal Revenue Manual are not applicable, and denying the deduction for a vehicle ownership expense), *with In re* Buck, No. 07-31513-KRH, 2007 WL 4418145 *4 (Bankr. E.D. Va. Dec. 14, 2007) (finding that Form 22C in a Chapter 13 petition requires the court to allow a deduction for a vehicle ownership expense).

[78] The Internal Revenue Service guidelines provide, "Contributions to voluntary retirement plans are not a necessary expense." I.R.M. § 5.15.1.10. For a detailed analysis of the treatment of 401(k) and other retirement account contributions in Chapter 7 and 13 petitions, see James Winston Kim, *Saving Our Future: Why Voluntary Contributions to Retirement Accounts Are Reasonable Expenses*, 26 EMORY BANKR. DEV. J. 341 (2010).

[79] *See, e.g.*, Bolen v. Adams, 403 B.R. 396, 402 (N.D. Miss. 2009) (not addressing Other Necessary Expenses but denying a 401(k) loan-repayment deduction from Form 22A); Eisen v. Thompson, 370 B.R. 762, 768-72 (N.D. Ohio 2007) (not addressing the issue of 401(k) loan repayments as Other Necessary Expenses and dismissing the petition on other grounds); *In re* Smith, 388 B.R. 885, 888 (Bankr. C.D. Ill. 2008) (denying a petition because petitioners did not rebut the presumption under special circumstances while not addressing Other Necessary Expenses).

are not deductible under the means test because 401(k) loans do not meet the traditional definition of "secured debts."[80] The bankruptcy court in *In re Thompson* briefly addressed this issue and found that 401(k) loan repayments were deductible payments on account of "secured debts."[81] Reasoning that payments for debts are specifically excluded from deduction under the means test, the court found that 401(k) loan repayments could not otherwise have been deducted as Other Necessary Expenses.[82] The district court reversed the bankruptcy court's holding on the basis that 401(k) loans are not "secured debts," leaving unresolved the deductibility of 401(k) loan repayments as necessary expenses.[83]

In the courts that have directly addressed 401(k) loan repayments as Other Necessary Expenses, the majority have generally held that such payments are not deductible under the means test.[84] In some courts, petitioners have tried to deduct 401(k) loan repayments as Other Necessary Expenses under the "involuntary deductions for employment" section of the Internal Revenue Manual and/or Bankruptcy Form 22A.[85] For exam-

[80] In these cases, debtors attempted to deduct their monthly repayments from current monthly income under 11 U.S.C.A. § 707(b)(2)(A)(iii) (Westlaw 2010) as payments on secured debts. However, courts have consistently held that 401(k) loans do not qualify as "secured debt," and therefore any payments toward a loan from a 401(k) were not deductible. *See, e.g.*, N.Y.C. Emps.' Ret. Sys. v. Villarie (*In re* Villarie), 648 F.2d 810, 812 (2d Cir. 1981) (an annuitant's withdrawal from the savings account of the annuity fund is not a "debt"); *Bolen*, 403 B.R. at 400-01 (vast majority of courts have held that a debtor's obligation to repay retirement account loan is not a "debt" under the Code); *Thompson*, 370 B.R. at 769 (majority view is that retirement plan loans are not secured debts); McVay v. Otero, 371 B.R. 190, 195 (W.D. Tex. 2007) ("there is a clear consensus that an individual's pre-petition borrowing from his retirement account does not give rise to a secured or unsecured 'claim,' or a 'debt' under the Bankruptcy Code"); *In re* Esquivel, 239 B.R. 146, 152 (Bankr. E.D. Mich. 1999) ("clear consensus" that borrowing from retirement account do not give rise to either secured or unsecured "claim" under the Bankruptcy Code); *In re* Fulton, 211 B.R. 247, 264 (Bankr. S.D. Ohio 1997) (funds borrowed from a debtor's pension plan do not constitute a debt, and the pension plan has no right of repayment against the debtor or the debtor's property that can be classified as a secured claim under the bankruptcy laws).

[81] *In re* Thompson, 350 B.R. 770, 776 (Bankr. N.D. Ohio 2006), *rev'd sub nom.* Eisen v. Thompson, 370 B.R. 762 (N.D. Ohio 2007).

[82] *Id*.

[83] Eisen v. Thompson, 370 B.R. 762, 767 n. 9 (N.D. Ohio 2007) (finding that because the debtors did not challenge the holding that loan repayments cannot be considered Other Necessary Expenses on appeal, the district court could not consider the issue).

[84] *See, e.g.*, Egebjerg v. Anderson (*In re* Egebjerg), 574 F.3d 1045, 1051 (9th Cir. 2009) (finding that 401(k) loan repayments are not the same kind and character as deductions for the health and welfare of the debtor allowed elsewhere in the Internal Revenue Manual); *In re* Lenton, 358 B.R. 651, 655 (Bankr. E.D. Pa. 2006) (finding that 401(k) contributions are voluntary and not deductible, and therefore repayment of past voluntary contributions should receive the same treatment); *In re* Barraza, 346 B.R. 724, 730 (Bankr. N.D. Tex. 2006) (finding that 401(k) loan repayments are not *mandatory payroll deductions* in Form 22A or the Internal Revenue Manual).

[85] *See, e.g.*, *Barraza*, 346 B.R. at 730 (finding that 401(k) loan repayments are not *mandatory payroll deductions* in Form 22A or the Internal Revenue Manual).

ple, in *In re Barraza*, the bankruptcy court held that retirement account loan repayments taken from an employee's wages were not "mandatory wage deductions," and therefore could not be deducted as Other Necessary Expenses.[86] Similarly, the court in *In re Lenton* analyzed alleged "involuntary deductions" under both the Internal Revenue Manual and Bankruptcy Form 22A. The court found that the debtor's monthly 401(k) loan payment was not a condition of employment.[87] Likewise, in *In re Egebjerg*, the court explained that a debtor could treat an outstanding 401(k) loan as an early withdrawal from a 401(k) plan, thereby relieving any future repayment obligation; therefore, the court found that the loan repayments were completely voluntary.[88]

The *Egebjerg* petitioner also attempted to deduct his 401(k) loan repayments on the ground that a loan-repayment plan was necessary to preserve a debtor's "health and welfare."[89] The petitioner argued that replenishing the amount of the loan to his 401(k), which would otherwise have been out of the reach of his creditors, was necessary because he was approaching retirement and the 401(k) plan was his only significant asset.[90] The court quickly dismissed his claim because 401(k) loan repayments "are not of the same kind and character as those expenses allowed elsewhere under [Internal Revenue Manual] § 5.15.1.10."[91] The court further explained that those expense categories of the Internal Revenue Manual are allowed to be treated as deductions only if there is no alternative to paying the expense.[92] Additionally, the court noted that 401(k) contributions are not, in and of themselves, a necessary expense; therefore, the repayment of 401(k) loans should not be a necessary expense.[93]

Finally, some petitioners have argued that the disallowance of a deduction for 401(k) loan repayments causes discrepancies within the Code that lead to contradictory outcomes for deductions.[94] Accordingly, petitioners have said that Congress's intent in passing the BAPCPA was to include 401(k) loan repayments as necessary expenses in order to avoid

[86] *Barraza*, 346 B.R. at 730.

[87] *Lenton*, 358 B.R. at 657-58 (stating that a condition for employment would require that but for the expense the debtor would not be able to perform his or her job).

[88] *Egebjerg*, 574 F.3d at 1051.

[89] *Id*. at 1051-52.

[90] *Id*. at 1051.

[91] *Id*.

[92] *Id*.

[93] *Id*.

[94] *E.g.*, *In re* Lenton, 358 B.R. 651, 655-59 (Bankr. E.D. Pa. 2006) (addressing petitioner's claim that not deducting 401(k) loan repayments creates a discrepancy among 11 U.S.C. §§ 707(b), 1322(f), and 362(a)).

inconsistency.[95] The *Lenton* petitioner, for instance, argued that excluding the deduction of a 401(k) loan payment materially alters the terms of the loan in violation of § 1322(f) of the Bankruptcy Code.[96] Section 1322(f) states "[a Chapter 13] plan may not materially alter the terms of a [401(k) loan] and any amounts required to repay such loan shall not constitute 'disposable income' . . . ."[97] The court found that § 1322(a) provides for the submission of *future* earnings,[98] and channeling debtors into Chapter 13 upholds the congressional intent to protect creditors without altering the loan.[99]

In the same way, the *Lenton* petitioner argued that the automatic stay of § 362(a)[100] does not stop the continued payment of every other necessary expense; therefore, § 362(b)(19), which precludes that automatic stay from stopping the repayment of 401(k) loans, would be rendered superfluous if such repayments are not treated as necessary expenses.[101] The petitioner claimed that 401(k) loan repayments would be the "*only* expenses in which the automatic stay does not apply and which [also could not] be taken as an allowable expense in the Means Test."[102] In other words, the petitioner pointed out that creditors were barred from collecting money used to pay expenses for things such as legally perfected debts, unsecured debts, or taxes.[103] But, the petitioner would be required to continue paying his 401(k) loan repayments during the bankruptcy proceedings without any protection for those payments. The court reasoned that 401(k) loan repayments are finite and will eventually be

[95] *Id*.

[96] *Id*. at 659.

[97] 11 U.S.C.A. § 1322(f) (Westlaw 2010).

[98] 11 U.S.C.A. § 1322(a) (Westlaw 2010) (emphasis added).

[99] *Lenton*, 358 B.R. at 660.

[100] The automatic stay prevents creditors from collecting money owed by the petitioner while bankruptcy proceedings are in progress. 11 U.S.C.A. § 362(a) (Westlaw 2010). For example, the automatic stay prevents the enforcement of a judgment obtained against the petitioner where the judgment was obtained before the filing of bankruptcy. 11 U.S.C.A. § 362(a)(2) (Westlaw 2010). Similarly, it prevents any act to collect, assess, or recover a claim against the petitioner that arose before the commencement of the bankruptcy. 11 U.S.C.A. § 362(a)(6) (Westlaw 2010). While protecting the debtor from his or her creditors during bankruptcy proceedings, it is not a complete bar of any action against the debtor. The automatic stay does not protect against the commencement or continuation of criminal proceedings against the petitioner. 11 U.S.C.A. § 362(b)(1) (Westlaw 2010). Similarly, it does not protect the debtor against civil proceedings surrounding, or collections following, issues of paternity, child custody, marriage, or domestic violence. 11 U.S.C.A. § 362(b)(2)(A)-(B) (Westlaw 2010).

[101] *Lenton*, 358 B.R. at 659.

[102] *Id*.

[103] These are used as an example of generally accepted necessary expenses, set forth in I.R.M. § 5.15.1.10, which are subject to the automatic stay requirement of 11 U.S.C.A. § 362(a) (Westlaw 2010).

paid off; thus, excluding the deduction of 401(k) loans from the means test establishes a "wait and see" approach that will channel petitioners into Chapter 13.[104]

As indicated, courts have used numerous justifications to deny the deduction of 401(k) loan repayments under the means test. Until recently, no court had enunciated a per-se rule on the issue, which led to differing results. In 2009, the Ninth Circuit became the first court to adopt a rule that 401(k) loan repayments are per se an unnecessary expense.[105] Because the Ninth Circuit provided only cursory justification for the denial of deductions for 401(k) repayments, there is room for courts in other circuits to follow a different interpretation and hold that 401(k) loans can be deducted from current monthly income under the means test.

II. THE NEED FOR A CASE-BY-CASE ANALYSIS OF 401(k) LOAN REPAYMENTS UNDER THE MEANS TEST

Although several courts have disallowed the deduction of 401(k) loan repayments under the means test, their logic is flawed for two reasons. First, when courts have held that 401(k) loan repayments are not for the "health and welfare" of debtors, they have taken an extremely limited view, refusing to examine exigent circumstances that could prove the debtors' "health and welfare" contentions. Second, when courts have held that the congressional intent behind the BAPCPA was to completely exclude 401(k) loan repayments, they have overlooked the fact that this exclusion causes discrepancies within the Code, rendering portions of the Code unnecessary. Furthermore, courts that have denied the deduction for 401(k) loan repayments have not always been clear in their reasoning or have convoluted the issue in order to avoid ruling on the merits of petitioners' claims.[106] Nothing in the Code or Internal Revenue Manual limits the definition of Other Necessary Expenses as long as the neces-

[104] *Lenton*, 358 B.R. at 660.

[105] *In re* Egebjerg, 574 F.3d 1045, 1052 (9th Cir. 2009).

[106] *See, e.g.*, *id*. at 1051 (not considering that the deductions in the Internal Revenue Manual are non-exhaustive); Bolen v. Adams, 403 B.R. 396, 402 (N.D. Miss. 2009) (dismissing the petition on the grounds that 401(k) loans are not "secured debts"); Eisen v. Thompson, 370 B.R. 762, 768-72 (N.D. Ohio 2007) (not addressing the issue of 401(k) loan repayments as Other Necessary Expenses and dismissing the petition on other grounds); McVay v. Otero, 371 B.R. 190, 197 (W.D. Tex. 2007) (basing dismissal on the "secured debt" deduction and "special circumstances" while not addressing Other Necessary Expenses); *In re* Smith, 388 B.R. 885, 888 (Bankr. C.D. Ill. 2008) (denying a deduction and finding that there can be no special circumstances besides medical conditions or a call to active duty in the Armed Forces that can rebut the presumption of abuse); *In re* Mowris, 384 B.R. 235, 237-38 (Bankr. W.D. Mo. 2008) (denying a deduction where 401(k) loan repayments are not a condition of employment deductible as a mandatory payroll wage deduction).

sary expense test is met. Additionally, there may be facts and circumstances, such as a petitioner nearing retirement with no other significant assets, that support considering 401(k) loan repayments as necessary for the health and welfare of a petitioner. For those reasons, petitions should be looked at on a case-by-case basis to determine whether 401(k) loan repayments should be deducted as Other Necessary Expenses under § 707(b)(2)(A)(ii).

Even if a court determines 401(k) loan repayments are not deductible for the "health and welfare" of the debtor, other circumstances may exist that require a court to look to the facts and circumstances surrounding a petition. Therefore, a rule that 401(k) loan repayments are per se unnecessary expenses is unfair to petitioners. Prior to the BAPCPA, judges and appellate panels had the ability to look at the facts and circumstances of each Chapter 7 petition to determine whether a 401(k) loan repayment was a necessary expense based upon the petitioner's financial situation. This individualized examination of petitions should not change simply because Congress chose to provide more specific guidance as to what qualifies as a necessary expense. It is unfair for petitioners subjected to the means test to lose the ability to show other circumstances that require the repayment of 401(k) loans. However, courts continually refuse to look beyond their limited analysis to see the effect this reasoning has on a petitioner's ability to afford retirement.

This Section of this Comment argues that 401(k) loans *could* be considered Other Necessary Expenses based upon the facts and circumstances of a petitioner's financial situation. There is an inherent conflict between the current approach and public policy, creating practical problems of disallowing the deduction of 401(k) loan repayments. Because of these concerns, this Section concludes that the totality-of-the-circumstances test of § 707(b)(3) gives courts sufficient authority to dismiss abusive Chapter 7 bankruptcy petitions, and that the heavy scrutiny of 401(k) loan repayments under the means test is unnecessary and ultimately a waste of judicial resources.

A. COURTS SHOULD LOOK TO THE FACTS AND CIRCUMSTANCES SURROUNDING BANKRUPTCY PETITIONS TO DETERMINE WHETHER 401(k) LOAN REPAYMENTS COULD BE DEDUCTED AS OTHER NECESSARY EXPENSES

For more than twenty years bankruptcy courts and appellate panels looked at the facts and circumstances surrounding a debtor's financial situation before determining whether an expense would be considered necessary. Through the BAPCPA, Congress provided a more objective approach to determining which expenses should be "necessary," through the National Standards, Local Standards, and Other Necessary Expenses determined by the IRS.[107] However, Congress's inclusion of examples of deductible expenses in the legislation does not preclude a court today from determining whether an expense is necessary for any individual petitioner. Additionally, courts are instructed to look to the facts and circumstances of a petition when testing for abuse under the totality-of-the-circumstances test of § 707(b)(3).[108] Even though these two tests are distinct, the same case-by-case approach should be undertaken in analyzing deductions under the means test.

The Internal Revenue Manual's examples of "other expenses" categorically pass the necessary expense test of section 5.15.1.10(1).[109] One categorical necessary expense is the involuntary wage deduction, which is necessary as long as it is "a requirement of the job; e.g., union dues, uniforms, work shoes."[110] Courts have commonly found that the repayment of loans on a 401(k) plan is not a requirement of the job, but rather is a completely voluntary wage deduction and therefore not a necessary expense.[111] However, courts consistently neglect to acknowledge the Internal Revenue Manual's explicit necessary expense test used to evaluate whether *other* expenses could be considered necessary. The IRS's categorical standards and examples of other expenses are merely a small sample of what is a non-exhaustive list of potential necessary expenses. The Internal Revenue Manual advises that "[o]ther expenses may be allowed if they meet the necessary expense test. The amount allowed must be reasonable considering the taxpayer's individual facts and circumstances."[112] Accordingly, in order to properly evaluate an expense under the necessary expense test, a court should look to the petitioner's individual facts and circumstances.

Some bankruptcy courts have ruled that the list set forth in the Internal Revenue Manual section 5.15.1.10 *is* exhaustive for purposes of the bright-line means test because Congress expressly limited deductions to the categories specified by the IRS.[113] However, other courts have

[107] 11 U.S.C.A. § 707(b)(2)(A)(ii)(I) (Westlaw 2010).

[108] *In re* Zaporski, 366 B.R. 758, 770-71 (Bankr. E.D. Mich. 2007).

[109] *In re* Lenton, 358 B.R. 651, 657 (Bankr. E.D. Pa. 2006).

[110] I.R.M. § 5.15.1.10 (2009).

[111] *See In re* Egebjerg, 574 F.3d 1045, 1052 (9th Cir. 2009); *Lenton*, 358 B.R. at 657; *In re* Barraza, 346 B.R. 724, 730 (Bankr. N.D. Tex. 2006) (quoting I.R.M. § 5.15.1.10(1) and finding that "The Monthly Loan Payment is not a condition of Debtor's job, but rather a condition of his Loans").

[112] I.R.M. § 5.15.1.7(6) (2009).

[113] *In re* Mordis, No. 06-42590-293, 2007 WL 2962903, at *2 (Bankr. E.D. Mo. Oct. 9, 2007); *In re* Turner, 376 B.R. 370, 375 (Bankr. D.N.H. 2007); *In re* Whitaker, No. 06-33109, 2007

considered the applicability of the necessary expense test of section 5.15.1.10(1) on a case-by-case basis.[114] One district court in the Ninth Circuit went so far as to say:

> After 1984, a debtor's expenses were either "reasonably necessary" or they were not. . . . If that was true after 1984, it is *a fortiori* true after 2005, at least in the case of debtors with income above the median. For those debtors . . . the determination of disposable income is now meant to be a simple and straightforward matter of arithmetic based on sections 707(b)(2)(A) and (B). Debtors may claim applicable expenses [in the means test] under the IRS National and Local Standards, and may also claim actual Other Necessary Expenses, without any judicial consideration of whether those expenses are in fact "reasonably necessary."[115]

Under this reasoning, *any* applicable expense categorized as Other Necessary Expenses can be deducted when determining disposable income. In practice, however, what constitutes Other Necessary Expenses varies greatly among bankruptcy court opinions.[116] Because of the confusion in defining necessary expenses, courts should look to the facts and circumstances surrounding a debtor's financial situation before applying a per-se rule disallowing the deduction of 401(k) loan repayments.

In *In re Barraza*, for example, the bankruptcy court held that retirement account loan repayments from wages are not mandatory wage deductions.[117] Thus, they cannot be considered deductible as necessary expenses under either the "Other Necessary Expenses: mandatory payroll deductions" category of Form 22A or the involuntary wage deduction expense of the Internal Revenue Manual.[118] The court also found that 401(k) loan repayments are not deductible under the category of "Unse-

WL 2156397, at *4 (Bankr. N.D. Ohio July 25, 2007); *In re* Lara, 347 B.R. 198, 204 (Bankr. N.D. Tex. 2006).

[114] *In re* Mowris, 384 B.R. 235, 238-39 (Bankr. W.D. Mo. 2008); *Lenton*, 358 B.R. at 658.

[115] *In re* Chavez, No. 07-60567-13, 2007 WL 3023145, at *5 (Bankr. D. Mont. Oct. 11, 2007). Although the petitioner in that case filed under Chapter 13, the operative rules of Chapter 13 allow debtors to deduct those "[a]mounts reasonably necessary to be expended . . . in accordance with subparagraphs (A)(ii) of paragraph (2) of section 707(b)" when determining "disposable income" under section 1325(b)(2). *See* 11 U.S.C.A. § 1325(b)(3) (Westlaw 2010).

[116] *E.g.*, James Winston Kim, *Saving Our Future: Why Voluntary Contributions to Retirement Accounts Are Reasonable Expenses*, 26 EMORY BANKR. DEV. J. 341 (2010) (discussing the deductibility of retirement account contributions in Chapter 7 and Chapter 13 bankruptcy petitions).

[117] *In re* Barraza, 346 B.R. 724, 730 (Bankr. N.D. Tex. 2006); *accord In re* Turner, 376 B.R. 370, 374 (Bankr. D.N.H. 2007) (finding that because voluntary contributions to 401(k) plans are completely voluntary, the fact that the debtor took a loan against voluntary contributions does not change the nature of the funds as they are repaid).

[118] *Barraza*, 346 B.R. at 729-30.

cured Debts" in the Internal Revenue Manual.[119] The court did not consider, however, the fact that the categories of the Internal Revenue Manual are non-exhaustive. The court stated that 401(k) loan repayments are not for the "health and welfare" of the debtor, nor for the production of income; it came to this conclusion solely by evaluating the tax implications of early withdrawal, without looking to the facts and circumstances of the petition[120] as should be required under the instruction of the Internal Revenue Manual. As one author noted, "Nothing in the [Internal Revenue] Manual makes the manditoriness [sic] of the withholding be the *sine qua non* of continued employment. If ERISA[121] withholding constitutes an *assignment of wages*, then indeed it is mandatory, in the sense that the ERISA plan has a fiduciary duty to enforce the assignment mechanism."[122] The mandatory deductions from the debtor's paycheck are not what determine whether the expense is necessary; the court should look to the facts and circumstances of the individual's case.

Similarly, in *In re Thompson*, petitioners argued that 401(k) loan repayments were Other Necessary Expenses.[123] The bankruptcy court did not address the issue because it approved the deduction as a payment on account of secured debts under § 707(b)(2)(A)(iii).[124] On appeal, the bankruptcy appellate panel said that the petitioners' 401(k) loan repayments were an expense for which there was no alternative because the 401(k) loan obligation would only be terminated when one of the petitioners quit his job, which would have been financially irresponsible, or repaid the loan in full, which would have been financially impossible.[125] The panel looked to the facts and circumstances surrounding the petition and found that because the 401(k) loan was taken out nineteen months before the bankruptcy petition, in an effort to address worsening financial difficulties, deduction for 401(k) loan repayments would have been allowed as a "special circumstance" under § 707(b)(2)(B).[126] The panel

[119] *Id*. at 730.

[120] *Id*. at 730-31.

[121] The Employee Retirement Income Security Act, codified at 29 U.S.C.A. § 1001 et. seq. (Westlaw 2010). ERISA was enacted by Congress in response to the growing number of private employee retirement benefit plans. *See In re* Conroy, 110 B.R. 492, 494-95 (Bankr. D. Mont. 1990).

[122] David Gray Carlson, *Means Testing: The Failed Bankruptcy Revolution of 2005*, 15 AM. BANKR. INST. L. REV. 223, 279-80 (2007).

[123] *In re* Thompson, 350 B.R. 770, 776-77 (Bankr. N.D. Ohio 2006), *rev'd sub nom.* Eisen v. Thompson, 370 B.R. 762 (N.D. Ohio 2007).

[124] *Id*.

[125] Eisen v. Thompson, 370 B.R. 762, 773 (N.D. Ohio 2007).

[126] *Id*. at 772. The court came to this conclusion while analyzing the petitioner's claim of "special circumstances," which would have rebutted the presumption of abuse under 11 U.S.C.A. § 707(b)(2)(B) (Westlaw 2010). A discussion of rebutting the presumption of abuse is beyond the scope of this Comment.

overturned the bankruptcy court's decision on procedural grounds and dismissed the Chapter 7 petition.[127]

Because the deduction of 401(k) loan repayments as Other Necessary Expenses was not addressed by the bankruptcy court, and the issue was not preserved on appeal to the bankruptcy appellate panel, there is no guidance from the appellate panel as to whether circumstances exist upon which a 401(k) loan repayment could be a necessary expense. However, as seen in this case and its appeal, courts can come to a better conclusion only by looking to the facts and circumstances surrounding a petition. The facts and circumstances of a petitioner's financial situation can provide more information that would justify considering the expense necessary.

As in *Thompson*, the court in *In re Lenton* determined that there may be special circumstances that under § 707(b)(2)(B)(ii) justify deducting a monthly 401(k) loan payment "for which there is no reasonable alternative."[128] One example the court gave was a debtor originating a 401(k) loan for the purpose of reducing unsecured debt that would otherwise be paid off through a Chapter 13 bankruptcy.[129] Although both courts described circumstances that justify deducting 401(k) loan repayments when petitioners were attempting to rebut the presumption of abuse by showing "special circumstances" under § 707(b)(2)(B), both cases are also good examples of why a court should look to the facts and circumstances of a petition before making a determination as to the necessity of an expense.

Allowing courts the ability to look at the facts and circumstances surrounding a petition avoids a potential hardship upon the debtor. For example, a petitioner who has taken a 401(k) loan and used the proceeds to repay creditors has already repaid his debt, at least in part, and the debtor has not taken undue advantage of his creditors.[130] At least one court has advised that looking to the facts and circumstances of a petition may be a better predictor of abuse.[131] The honesty of the debtor can be seen by examining "whether the debtor made substantial eve of bankruptcy purchases, was dishonest in filing his bankruptcy schedules and

[127] *Thompson*, 370 B.R. at 773. Under § 707(b)(2)(B), petitioners are required to itemize such expenses in order to rebut the presumption of abuse by showing "special circumstances." Because the *Thompson* petitioner had not itemized these expenses in his petition, the petition was dismissed.

[128] *In re* Lenton, 358 B.R. 651, 662 (Bankr. E.D. Pa. 2006).

[129] *Id*. (dismissing the Chapter 7 petition because the debtor's 401(k) loan would end in the near future, thereby leaving the petitioner with disposable income that would have been sufficient to pay a significant amount of his or her unsecured debt).

[130] *See generally In re* Vansickel, 309 B.R. 189, 210 (Bankr. E.D. Va. 2004).

[131] *See In re* Bender, 373 B.R. 25, 28 (Bankr. E.D. Mich. 2007).

other court documents, and whether the bankruptcy was necessitated by unforeseen or catastrophic events."[132]

When analyzing 401(k) *contributions* in a Chapter 7 petition before enactment of the BAPCPA, one bankruptcy court noted that "[p]ayments into a retirement account can be an important aspect of a debtor's overall financial health and stability."[133] A number of factors can be important in determining the necessity of contributing to a 401(k) plan, including the age of the debtor, the monthly contribution amount, and the level of savings already accumulated in the account.[134] These factors are "among the aspects personal to each debtor that must be considered in determining whether payments into retirement accounts should be included in disposable income."[135] The same line of reasoning should apply to 401(k) loan repayments; there is little substantive difference between allowing money to be contributed toward retirement savings and allowing money once contributed to be repaid for the same purpose. If anything, a court has more evidence of abuse when looking at the reasons for which a petitioner borrowed from a 401(k) than it does when looking at 401(k) contributions.

Hypothetically, when a debtor takes a loan from a 401(k) he or she likely does so for one of two reasons: for personal use, such as a vacation or a large purchase, or to apply the loan proceeds to pay debts such as overdue utility bills or credit card balances. Under the per-se rule set forth in *Egebjerg*, these loan repayments would not qualify as necessary expenses regardless of the use of the loan proceeds. It is unfair for bankruptcy courts to ignore the exigent circumstances surrounding a bankruptcy petition to determine whether the 401(k) loan money was used in a fashion that is envisioned under the bankruptcy process. Had the individual not taken the loan, a bankruptcy court would not have the power to take the money from his or her 401(k) to pay off unsecured creditors during the bankruptcy process.[136] Because of this discrepancy, it is un-

[132] *Id*.

[133] *In re* Hill, 328 B.R. 490, 495 (Bankr. S.D. Tex. 2005).

[134] *Id*.; *accord In re* Taylor, 243 F.3d 124, 129-30 (2d Cir. 2001) ("[T]he bankruptcy judge may consider any factors properly before the court, including but not limited to: the age of the debtor and the amount of time until expected retirement; the amount of the monthly contributions and the total amount of pension contributions debtor will have to buy back if the payments are discontinued; the likelihood that buy-back payments will jeopardize the debtor's fresh start; the number and nature of the debtor's dependants; evidence that the debtor will suffer adverse employment conditions if the contributions are ceased; the debtor's yearly income; the debtor's overall budget; who moved for an order to discontinue payments; and any other constraints on the debtor that make it likely that the pension contributions are reasonably necessary expenses for that debtor.").

[135] *Hill*, 328 B.R. at 495.

[136] Any amount in a retirement account is not part of the bankruptcy estate and is exempt from the reach of the courts or creditors during a bankruptcy case. 11 U.S.C.A. § 541(b)(7) (Westlaw

just for a court to ignore the debtor's motive in borrowing from a 401(k) plan and refuse to exempt the money paid back in loan repayments as it would be if it had never been touched before the debtor's Chapter 7 petition.

Applying a per se disallowance of expenses under the means test, a court has no discretion to base its ruling on whether a petitioner filed for Chapter 7 bankruptcy due to inability to pay necessary expenses like health-care costs, or whether the petitioner maxed out all his or her credit cards and wasted his or her savings on frivolous spending.[137] By not taking these factors into consideration, the means test is bound to penalize a great many people who have fallen into bad circumstances through no fault of their own.[138] One court realized this moral dilemma, albeit before the enactment of the BAPCPA, and found a proper application of the bankruptcy laws that respects both the definitions and rules of bankruptcy construction as well as lending practices.[139] That court said,

> If the trustee could establish that the pension loan at issue can be collaterally attacked as a fraudulent transfer, then we might have a different case under bankruptcy law. If, for example, the debtor used the loan proceeds to pay for an expensive vacation for his family to go skiing in the Swiss Alps, to go sunning on the Cote d' Azur, to pay off a book-maker on illegal gambling debts, or to buy his spouse or significant other a five karat diamond ring or full-length sable coat, etc., then the legitimacy of the loan transaction would be readily suspect. Or if the debtor used the proceeds of the loan for the primary purpose of acquiring assets otherwise exempt from execution at state law, then we might have to face a difficult issue. Was this sort of 'debtor estate planning' subject to avoidance as a fraudulent transfer?[140]

The court's per-se ruling in *Egebjerg* suggests that people are punished if they try to make ends meet without success. If a petitioner does not take a loan from his or her 401(k), the funds remain protected in subsequent bankruptcy proceedings.[141] If the petitioner had withdrawn the entirety of his or her 401(k) to try to make ends meet unsuccessfully,

2010).

[137] *A Test of Means . . . or a Mean Test?*, CONSUMERAFFAIRS.COM, http://www.consumeraffairs.com/news04/2005/bankruptcy_act02.html (last visited Oct. 22, 2010).

[138] *Id*.

[139] *In re* Buchferer, 216 B.R. 332, 343 (Bankr. E.D.N.Y. 1997) (noting this moral issue but disallowing a deduction from current monthly income the amount of a 401(k) loan on the grounds that it is not a "loan" otherwise deductible on account of a secured debt).

[140] *Id*.

[141] 11 U.S.C.A. § 541(b)(7) (Westlaw 2010).

there would be no issue as to deducting loan repayments from current monthly income. Because the *Egebjerg* petitioner withdrew only a portion of his retirement funds, the court stuck him between a rock and a hard place with no judicial remedy available to help alleviate his financial disaster.

To ignore the facts and circumstances surrounding a petition leaves no review of other budget items such as charitable contributions or a lower-than-normal food or clothing allowance. Under a per-se rule, courts will fail to analyze important factors that may determine the necessity of the expense, including the age and health of the debtor and his or her dependents, the length of time before retirement, and the amount of the loan repayment. Refusing to look at the financial circumstances may cause inequitable results by allowing one debtor to properly deduct excessive car payments or legal expenses in the amount of thousands of dollars while denying a 401(k) loan repayment of a few hundred dollars.

B. THE TAX CONSEQUENCES OF EARLY WITHDRAWAL, THE CURRENT STATE OF THE ECONOMY, AND PUBLIC POLICY DEMAND THAT COURTS REEVALUATE THE IMPORTANCE OF 401(k) LOAN REPAYMENT

A court may hold that the total amount of 401(k) loan payments is available to creditors by disallowing a deduction, thus believing that the amount will actually be repaid to those creditors. However, if these payments are not allowed to continue, the petitioner suffers harsh financial penalties that will ultimately reduce the amount of money available to creditors. This results from federal penalties that are assessed if the loan is not repaid and the outstanding balance is treated as income for tax purposes.[142]

Hypothetically, if a debtor has a $50,000 loan from his or her 401(k) that he or she is not allowed to continue repaying, mandatory penalties and fees will be assessed that will reduce the actual amount of additional income available to creditors. From that $50,000, the debtor must pay the fees associated with the loan,[143] a federal ten-percent penalty,[144] income tax on the amount borrowed,[145] and possible state penalties and

[142] *In re* Vansickel, 309 B.R. 189, 200-01 (Bankr. E.D. Va. 2004).

[143] Generally, anywhere from 1% to 5% is charged as a processing fee. KNUTE IWASZKO & BRIAN O'CONNELL, THE 401(k) MILLIONAIRE 40, 188 (1999). Here, a 5% processing fee would be equal to an additional $2,500 taken directly out of the $50,000 loan.

[144] 26 U.S.C.A § 72(m)(5)(B) (Westlaw 2010). Here, a 10% federal penalty amounts to a $5,000 penalty.

[145] *Id*. Assuming a 28% tax bracket, the petitioner would be assessed additional taxes in the

state income tax on that same amount.[146] In a state like California, for example, this would leave the debtor with slightly more than half of the loan amount, $27,250 assuming state tax of 2.5%, to pay to his or her creditors from the $50,000 borrowed. It makes little sense to punish this debtor so severely by taking more than half of what would have been exempted from bankruptcy simply because the debtor borrowed money from a 401(k) plan. The money would have been protected had the debtor not taken the loan; the money should similarly be protected as it is paid back.

A court should evaluate the net benefit to the creditors as it compares to the lost opportunity incurred by the debtor when determining whether a 401(k) loan repayment is a necessary expense.[147] If disallowing a deduction for 401(k) loan repayment would result in substantial lost opportunity for the debtor and little benefit to the creditor, the court should use that information to determine whether an expense should be allowed.

Besides the obvious direct effect of taxes and penalties on the amount of money actually available to creditors, there is a discrepancy within the Code that remains unresolved regarding the treatment of 401(k) loan repayments. The court in *Barraza* found that because 401(k) loan repayments are not included in the automatic stay along with repayments of all other debts owed to creditors, they are treated separately.[148] The *Barraza* petitioner argued that the disallowance of a 401(k) deduction runs contrary to the exemption from the automatic stay that applies to such wage deductions.[149] In other words, the petitioner asked "why would Congress presume under section 707(b)(2)(A) that this amount of money could be used to pay unsecured creditors, and then deny unsecured creditors access to that money in chapter 13" when the disallowance would force the debtor to amend the petition to Chapter 13?[150] The court admitted that it did not know the answer, yet the court proceeded to deny the deduction.[151] This discrepancy in the Code leaves

amount of $14,000.

[146] For example, the California Franchise Board charges a 2.5% state tax on early distributions from a 401(k). Here, a 2.5% tax would deduct an additional $1,250 from the loan amount. To see how this would function on a tax return, see the Franchise Tax Board Form 3805P, *available at* http://www.ftb.ca.gov/forms/2009/09_3805p.pdf.

[147] *Vansickel*, 309 B.R. at 209. The lost opportunity referenced herein is the reduction of the future value of the 401(k) plan resulting from the discontinued repayments of a 401(k) loan, and the forgone interest that would accrue and be paid to the taxpayer on those same amounts.

[148] *In re* Barraza, 346 B.R. 724, 730-31 (Bankr. N.D. Tex. 2006).

[149] *Id*. (looking at the automatic stay of 11 U.S.C.A. § 362(a) (Westlaw 2010)).

[150] *Id*. at 731.

[151] *Id*.

uncertainty for debtors and creditors alike and could be reconciled by protecting both 401(k) plans and 401(k) loans from the reach of creditors in Chapter 7 and Chapter 13 cases.

Although the tax considerations and practicalities of repaying creditors are significant, courts should also consider the importance of condoning retirement saving for the protection of individuals and society alike. Almost two thirds of American workers are saving little or nothing for retirement.[152] With the Social Security Trust Fund projected to run a cash flow deficit of $680,000,000,000 by the year 2035, and the number of beneficiaries per 100 workers jumping from about 30 to almost 50, it is questionable whether Social Security will be able to serve as the sole support for the coming generation of retirees.[153]

Social Security's current problems are serious because the system was never intended to be the sole source of retirement income for Americans.[154] The system functions on the theory that current contributions paid by today's labor force finance the benefits taken by today's retirees.[155] Social Security and pension benefits constitute about 43% of a person's retirement income.[156] The other 57% will have to come from personal savings and retirement accounts such as 401(k)s.[157] The system worked when people only lived into their sixties, but now it cannot possibly keep up with the demand for benefits from people who will spend twenty or thirty years in retirement, rather than five or ten as originally anticipated.[158] Taxpayers cannot rely on the federal government to support them during retirement, and for this reason, the judiciary should not deny individuals the ability to continue supporting themselves. By disallowing the repayment of 401(k) loans, courts are burdening society with the added cost of supporting retirement for those petitioners who could repay their retirement loans and rely less on the Social Security Trust Fund.

Many courts have agreed on the importance of saving for retirement;[159] however, they have neglected to allow this to affect their deci-

[152] KNUTE IWASZKO & BRIAN O'CONNELL, THE 401(k) MILLIONAIRE 133 (1999).

[153] Allan Sloan, *The Next Big Bailout: Social Security*, FORTUNE, July 30, 2009, http://money.cnn.com/2009/07/29/news/economy/fixing_social_security.fortune.

[154] TED BENNA & BRENDA WATSON NEWMANN, 401(k)S FOR DUMMIES 18 (2003).

[155] SUZE ORMAN, THE MONEY BOOK FOR THE YOUNG, FABULOUS & BROKE 176 (2005).

[156] KNUTE IWASZKO & BRIAN O'CONNELL, THE 401(k) MILLIONAIRE 16 (1999).

[157] *Id*.

[158] SUZE ORMAN, THE MONEY BOOK FOR THE YOUNG, FABULOUS & BROKE 176 (2005).

[159] *E.g.*, *In re* Siler, 426 B.R. 167, 173 (Bankr. W.D.N.C. 2010) ("While saving for retirement may be prudent, it is generally unnecessary in bankruptcy . . . ."); *In re* Parada, 391 B.R. 492, 503 (Bankr. S.D. Fla. 2008) (stating that although "saving money for retirement certainly is a prudent investment . . . debtors should not be permitted to pay themselves money at the expense of credi-

sion on the deductibility of 401(k) loan repayments from a debtor's current monthly income. Prior to the enactment of the BAPCA, a bankruptcy court realized this problem and emphasized the "critical importance for every American adult to invest prudently in his or her retirement income for the duration of his or her entire working life."[160] The court went on to criticize the modern interpretation that reasonably necessary expenses are limited to current daily needs, arguing that that view "is both unrealistic and, frankly, short-sighted under the true conditions of economic life in the United States."[161]

Courts should look to the practical effect of denying deductions for the repayment of 401(k) loans. While it could be perceived that creditors will benefit in the same amount as the remaining balance of a 401(k) loan, this does not anticipate the fact that the balance is reduced by penalties and taxes associated with early withdrawal from 401(k) plans. Additionally, in this current economic state, courts should realize the effect of their decisions on debtors whose retirement savings will be needed to supplement Social Security. Therefore, allowing the deduction of 401(k) loan repayments in Chapter 7 bankruptcy is not only fair but also in accordance with the public policy of encouraging investment in retirement.

C. COURTS CAN RELY ON THE TOTALITY-OF-THE-CIRCUMSTANCES TEST TO DISMISS ABUSIVE BANKRUPTCY PETITIONS

Regardless of the outcome of the presumption of abuse under the means test, the BAPCPA created another distinct test that provides courts with a second opportunity to dismiss abusive petitions.[162] In *In re Zaporski*, the court determined that another policy reason for allowing deductions is that doing so does not mean a debtor's case will avoid dismissal.[163] It simply means that the debtor may avoid the presumption of abuse.[164] The United States Trustee can still request dismissal under § 707(b)(3) either for filing in bad faith, or because a totality-of-the-circumstances analysis evidences abuse.[165]

Prior to the BAPCPA's establishment of the means test, courts

tors").

[160] *In re* Awuku, 248 B.R. 21, 31-32 (Bankr. E.D.N.Y. 2000).

[161] *Id*.

[162] *See* Adam J. Ruttenberg, *The Totality of What Circumstances? How Courts Determine Whether Granting Bankruptcy Relief Would Be an Abuse*, 2009 ANN. SURV. OF BANKR. LAW, Part II, § 4 (2009) (examining cases where debtors face dismissal under § 707(b)(3)).

[163] *In re* Zaporski, 366 B.R. 758, 768 (Bankr. E.D. Mich. 2007).

[164] *Id*.

[165] *Id*.

looked to a number of factors for determining substantial abuse under the former totality-of-the-circumstances test, namely: (1) whether there was a likelihood of future income to fund the debtor's Chapter 11, 12, or 13 plan; (2) whether the petition was filed as a consequence of illness, disability, unemployment, or other calamity; (3) whether the schedules suggested that the debtor obtained cash advances and consumer goods without the ability to repay; (4) whether the debtor's proposed family budget was excessive or extravagant; (5) whether the debtor's papers misrepresented his or her financial condition; and (6) whether the debtor engaged in eve-of-bankruptcy purchases.[166] Similarly, after the enactment of the BAPCPA, the court in *In re Walker* provided an almost identical eight-point list of the other factors that it would consider in determining whether a debtor's financial situation demonstrated abuse.[167]

At present, even if not subject to the means test, or after debtors have successfully rebutted the presumption of abuse of § 707(b), they are still subject to the test for abuse set forth in § 707(b)(3)(B).[168] For a debtor who is subject to the means test, it is not essential for the court to determine whether payments toward a 401(k) loan are necessary expenses because the same determination is made when analyzing the petition under the totality-of-the-circumstances test for abuse. Therefore, courts can save judicial resources by avoiding this tedious process in the means test calculations and presume that payments to a 401(k) loan are necessary expenses under § 707(a). This result allows debtors subject to the means test the opportunity to fully present their financial status to the courts without affecting the courts' ultimate ability to dismiss abusive petitions.

Courts and commentators find it difficult to understand the relationship between the means test of § 707(b)(2) and the totality-of-the-circumstances test of § 707(b)(3).[169] Courts have agreed that "the Means Test is only the first step in determining whether a debtor's petition is abusive. [It] functions as an initial screen to weed out those Chapter 7

[166] *In re* Price, 353 F.3d 1135, 1139-40 (9th Cir. 2004).

[167] *In re* Walker, 383 B.R. 830, 837-38 (Bankr. N.D. Ga. 2008). This list of factors includes (1) whether the bankruptcy filing was precipitated by an unforeseen catastrophic event, such as a sudden illness or unemployment; (2) whether the debtor is eligible for Chapter 13 relief; (3) whether there are non-bankruptcy remedies available to the debtor; (4) whether the debtor can obtain relief through private negotiations; (5) whether the debtor's proposed budget is excessive or unreasonable; (6) whether the debtor has a stable source of future income; (7) whether the debtor could provide a meaningful distribution in a Chapter 13 case; and (8) whether the debtor's expenses could be reduced significantly without depriving the debtor and dependents of necessities.

[168] 11 U.S.C.A. § 707(b)(3)(B) (Westlaw 2010).

[169] *In re* Jensen, 407 B.R. 378, 383 (Bankr. C.D. Cal. 2009) (citing *In re* Johnson, 399 B.R. 72, 75 (Bankr. S.D. Cal. 2008)).

petitions that are most clearly abusive."[170] The totality-of-the-circumstances test provides a "backstop" that weighs unusual circumstances not considered under the means test.[171] However, the policies implicit in the means test must be respected by the totality-of-the-circumstances test.[172] It is the Trustee that has the power to request dismissal under the totality-of-the-circumstances test.[173] Therefore, it is judicially fair to give deference to the claims of the petitioner under the means test while relying on the "backstop" of the totality-of-the-circumstances test to determine abuse.

Some debtors have argued that if no presumption of abuse arises under the means test, then the ability to pay creditors cannot be taken into account in applying the totality-of-the-circumstances test, suggesting that Congress created the means test to be exclusive and conclusive regarding ability to pay.[174] Courts have regularly rejected this argument and reserved the right to review the surrounding facts and circumstances under the totality-of-the-circumstances test for abuse of a petition before granting relief.[175] In *In re Zaporski*, for example, the court explained that § 707(b)(3)(B) *instructs* a court to consider the totality of the circumstances of the debtor's financial situation.[176] The court stated:

> This plain language is broad enough to encompass, indeed require, consideration of those facts that are probative of a debtor's ability to repay his or her creditors. Such facts are in this Court's view a circumstance of that debtor's "financial situation" even where the debtor's petition is not filed in bad faith and even where the statutory presumption of abuse has not arisen . . . .[177]

Correspondingly, regardless of the outcome under the means test, courts are instructed to look to the facts and circumstances of a debtor's financial situation before dismissing a petition. Debtors should have the same ability to defend claims of necessary deductions under the means test to avoid prejudice before dismissal.

[170] *Id* at 384; *see also In re* Fowler, 349 B.R. 414, 420-21 (Bankr. D. Del. 2006) (explaining that Congress's intent was to create an easily applied formula to determine whether a court should presume abuse of Chapter 7).

[171] *Jensen*, 401 B.R. at 384.

[172] *Id*. at 385-86.

[173] 11 U.S.C.A. § 707(b)(3) (Westlaw 2010).

[174] Adam J. Ruttenberg, *The Totality of What Circumstances? How Courts Determine Whether Granting Bankruptcy Relief Would Be an Abuse*, ANN. SURV. OF BANKR. LAW, Part II, § 4 (2009).

[175] *Id*.

[176] *In re* Zaporski, 366 B.R. 758, 770-71 (Bankr. E.D. Mich. 2007).

[177] *Id*. at 771.

Several courts have held that voluntary *contributions* to a 401(k) plan generally should not be considered reasonably necessary expenses under the totality-of-the-circumstances analysis.[178] In *In re Parada*, the court stated that "[b]ankruptcy courts, while recognizing that saving money for retirement certainly is a prudent investment, have consistently held that debtors should not be permitted to pay themselves money at the expense of creditors."[179] Noting that the debtors in that case were "young and, hopefully, will have many years of gainful employment to work towards retirement," the court found they had an ability to pay and ordered their case dismissed.[180] This supports the conclusion that the means test is less conclusive than the totality-of-the-circumstances test. For that reason, courts should not put so much emphasis on the means test. In time, a court will look to the facts and circumstances surrounding the petition, which will give a clearer picture of whether the petitioner is abusing the relief of Chapter 7 bankruptcy.

There would be no judicial harm in considering the repayment of a 401(k) loan a necessary expense under the means test. Even if the presumption of abuse is successfully avoided under the means test, this fallback provision grants a court the power to dismiss a case regardless of whether 401(k) loan repayments are determined to be a necessary expense. Evidenced by the interplay of these two tests, the BAPCPA did not change the totality-of-the-circumstances test that courts use in Chapter 7 bankruptcy petitions. In pre-BAPCPA cases, courts did not disallow deductions from current monthly income without looking to the facts and circumstances surrounding petitions. Using similar factors in looking at the totality of the circumstances in pre- and post-BAPCPA cases, courts should not apply a per-se rule disallowing such deductions.

CONCLUSION

Understandably, courts have a delicate job balancing between protecting creditors from people not paying their debts and protecting citizens who will never truly be able to pay back their debts. This is a difficult balance, and through the BAPCPA, Congress has decidedly tipped the scale in favor of creditors by holding people responsible for their financial mistakes and broadening the circumstances that justify denial of petitions. Accordingly, courts have interpreted the means test in such a

[178] *See, e.g.*, *In re* Behlke, 358 F.3d 429 (6th Cir. 2004); *In re* Parada, 391 B.R. 492, 502 (Bankr. S.D. Fla. 2008); *In re* Zaporski, 366 B.R. 758 (Bankr. E.D. Mich. 2007); *In re* Cox, 249 B.R. 29 (Bankr. M.D. Fla. 2000).

[179] *Parada*, 391 B.R. at 503.

[180] *Id*.

way that it is nearly impossible for some debtors to obtain relief in Chapter 7 bankruptcy. By not being allowed to make deductions for 401(k) loan repayments, debtors will not only have their cases dismissed for abuse but will also suffer the financial consequences of outstanding 401(k) loans that are considered early withdrawals.

In fairness, courts should look to the facts and circumstances of a petitioner's financial situation before determining whether an expense is reasonably necessary. The categorical deductions in the Internal Revenue Manual's Other Necessary Expenses are non-exhaustive. A per-se rule disallowing *any* deduction is prejudicial and bankruptcy courts should avoid letting a blanket disallowance of a deduction to preclude an analysis of the debtor's financial situation.

Additionally, a court should look to the impact of its decision before dismissing a Chapter 7 petition on the basis of abuse. Not only is the debtor required to pay taxes and fees for an early withdrawal, but creditors will not necessarily receive the money dedicated to repayment of the loan. With Social Security expected to fall into a deeper deficit, courts should give deference to those individuals attempting to save for their own retirement and avoid future reliance on an already failing federal retirement system.

Finally, it does no harm to allow deduction for 401(k) loan repayments under the means test because the court can use the "backstop" of the totality-of-the-circumstances test to dismiss abusive petitions. Because the Trustee has the power to request dismissal under the totality-of-the-circumstances test, it would be even more prejudicial not to give deference to the petitioner under the means test. In its present state, the BAPCPA stacks the cards against a petitioner by providing multiple ways in which the court can dismiss a petition under Chapter 7.

Only a change in judicial interpretation can resolve this issue. The courts should interpret current provisions in the BAPCPA to find that 401(k) loan repayments can be a reasonably necessary expense when looking to the facts and circumstances surrounding a petition.

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[*] J.D. Candidate, May 2011, Golden Gate University School of Law, San Francisco, Cal; B.S. Business Administration: International Concentration, 2005, St. Mary's College of California, Moraga, Cal. This, my first publication, is dedicated to my loving wife, whose encouragement, love, and support have been instrumental in every part of my life. I wish to thank my parents, siblings, and family for helping me become the man I am today. Finally, thanks to my friends from the 515, the Golden Gate Law Review staff, and my fantastic fellow board members for their helpful thoughts, suggestions and guidance.