

Too Much Secured Debt Can Constitute an Abuse under §707(b)(3)

Written by:

J. Ellsworth Summers Jr.¹
Rogers Towers PA; Jacksonville, Fla.
jes@rtlaw.com

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) was intended to restore “integrity to the bankruptcy process” by assuring that “Americans who have the ability to pay will be required to pay back at least a portion of their debts.”² The means test, which focuses on a debtor’s disposable income, is the centerpiece of the consumer bankruptcy reforms found in BAPCPA, and is a multi-step objective test aimed at determining whether a debtor with primarily consumer debts has the disposable income available to pay to his or her creditors.

If a debtor fails the means test, a presumption of abuse arises, and if un rebutted, the chapter 7 case must be dismissed or converted to chapter 13 with the debtor’s consent. In calculating disposable income, Congress has allowed a debtor to deduct his or her average monthly payments on secured debt, including “the total of all amounts scheduled as contractually due to secured creditors in each month of the 60 months following the date of the petition.”³ Nothing in BAPCPA requires these secured-debt payments to be reasonable or necessary, and many courts suggest that BAPCPA removed all judicial discretion in making that determination.⁴

The means test’s mechanical formula, combined with the removal of judicial discretion in considering the reasonableness of secured debt, creates a potential loophole permitting further abuse of the bankruptcy process. The current statutory scheme allows debtors to purchase prepetition luxury items—such as extravagant vehicles⁵ and recreational

About the Author

J. Ellsworth Summers is a shareholder at Rogers Towers PA in Jacksonville, Fla.

boats⁶—and deduct loan payments for these items to minimize disposable income and pass the means test.

An informed debtor can use prebankruptcy strategies to manipulate a means test, such as incurring additional secured debt, letting payments on secured property lapse in order to deduct the arrearages or by paying more on unsecured debts, leaving the debtor with more secured debt when the means test is calculated.⁷ This “secured-debt loophole” in the means test runs contrary to BAPCPA’s intent by allowing bankruptcy abuse to continue, rather than restricting it.

Fortunately, whether a person qualifies to be a chapter 7 debtor does not end

Wedoff.⁹ As Judge Wedoff persuasively asserts, judicial discretion to grant §707(b)(3)(B) motions on the basis of excessive secured debt is crucial to preserving the integrity of BAPCPA and the bankruptcy process as a whole.¹⁰ “Nothing in the text of §707(b)(3) suggests an intent to eliminate any aspect of the debtor’s finances from consideration in determining whether a case constitutes an ‘abuse’ of Chapter 7.”¹¹ As one court noted, “bankruptcy is meant to afford an honest debtor a fresh start... [but] is not meant to be used as a means by which a debtor can perpetuate bad financial decisions.”¹² Unlike the means test, which is inherently objective, analysis under §707(b)(3)(B) is subjective, requiring a case-by-case examination of the debtor’s financial situation and conduct.¹³

Granting §707(b)(3) motions has proven effective in preventing debtors from abusing the bankruptcy system by

Consumer Point

with the means test. Anticipating such situations, Congress enacted §707(b)(3) as an additional obstacle for chapter 7 debtors. Section 707(b)(3) permits a court to dismiss a bankruptcy petition for abuse absent the statutory presumption in two instances. First, §707(b)(3)(A) instructs the court to consider whether the debtor filed his or her petition “in bad faith.” This section is intended primarily for debtors who have engaged in misconduct or filed a petition for improper purposes.

Second, §707(b)(3)(B) permits courts to consider the totality of the circumstances of the debtor’s financial situation. It is this provision that allows courts to consider the reasonableness of secured debt and dismiss or convert a bankruptcy petition if it appears the debtor is abusing the bankruptcy process.⁸

The degree of judicial discretion to find abuse when a debtor has passed the means test is highly controversial, as demonstrated by the ongoing debate between Profs. **Marianne Culhane** and **Michaela White**, and Judge **Eugene R.**

using secured debt to pass the means test. For example, in *In re Oot*, the court dismissed a debtor’s bankruptcy petition under §707(b)(3)(B) based on the debtor’s extravagant secured debt, which included deductions for a \$430,000 home that cost more than \$4,000 per month to maintain and three vehicles including a nearly new Mercedes Benz and Volvo.¹⁴

Similar results can be seen in numerous post-BAPCPA cases, such as in *In re Kaminski*, where the court dismissed a bankruptcy petition due to the debtor’s secured-debt deduction of \$1,800 per month for a home (more than twice the Internal Revenue Service’s allowance for that region) and a \$40,000 truck purchased on the eve of bankruptcy.¹⁵ Outcomes such as these are certainly far more in line with BAPCPA goals than if judges did not have such discretion. ■

¹ The author gratefully acknowledges the contribution of Susan Novak, a third-year law student at the University of Florida Levin College of Law, for her assistance in the research and drafting of his portion of this article.

² “President Signs Bankruptcy Abuse Prevention, Consumer Protection Act,” www.whitehouse.gov/news/releases/2005/04/20050420-5.html (April 20, 2005).

³ 11 U.S.C. §707(b) (2006).

⁴ See *In re Austin*, 372 B.R. 668, 680-81 (D. Vt. 2007) (stating that BAPCPA has removed bankruptcy courts’ discretion to consider reasonableness of secured debt); *In re Martin*, 373 B.R. 731, 734 (Bankr. D. Utah 2007) (finding that courts must deduct secured-debt payments in calculating the means test so long as the payments are owing and regardless of whether those payments are considered reasonably necessary for the debtor’s maintenance and support). In a chapter 13 case, if a debtor has income above the median family income for similarly-sized households, “the amount of disposable income is determined by using the means test provided for in §707(b)(2).” *In re Hylton*, 274 B.R. 579, 582 (W.D. Va. 2007) (citation omitted).

⁵ *In re Carlton*, 362 B.R. 402, 411 (C.D. Ill. 2007) (permitting debtors to deduct secured debt under §707(b)(2) on three vehicles, including new Honda and three-year-old Cadillac Escalade).

⁶ See *Martin*, 373 B.R. at 734, and *Hylton*, 374 B.R. at 586 (both cases permitting debtors to deduct secured-debt payments on recreational boats).

⁷ Charles Tabb, “Living with the Means Test,” 31 S. Ill. U. L. J. 463, 492-93 (2007).

⁸ Hon. Eugene R. Wedoff, “Judicial Discretion to Find Abuse under §707(b)(3),” 71 Mo. L. Rev. 1035, 1042 (2006).

⁹ See *id.* Marianne B. Culhane and Michaela M. White, “Catching Can-Pay Debtors,” 13 Am. Bankr. Inst. L. Rev. 665, 667 (2005).

¹⁰ Wedoff, *supra* note 8 at 1035-51.

¹¹ *In re Schoen*, No. 06-20865-7, 2007 WL 643295 at *3 (Bankr. D. Kan. March 2, 2007).

¹² *In re Kaminski*, 387 B.R. 190, 196 (D. Del. 2008) (citation omitted).

¹³ *In re Wilson*, 356 B.R. 114, 121 (D. Del. 2006).

¹⁴ 368 B.R. 662, 668-70 (N.D. Ohio 2007).

¹⁵ 387 B.R. at 197-99 (D. Del. 2008). See also *In re Short*, No. BK08-80155, 2008 WL 2020200 at *3 (Bankr. D. Neb. May 8, 2008) (dismissing chapter 7 petition under §707(b)(3)(B), citing debtor’s excessive secured debt of \$5,500 per month for home and two new vehicles); *In re Hoffner*, No. 07-30461, 2007 WL 4868310 *5 (Bankr. D. N.D. Nov. 21, 2007) (dismissing chapter 7 case under §707(b)(3), finding debtor’s secured-debt payments on new model recreation boat to be unreasonable).