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**Phantom Home Mortgage Deductions on Chapter 7 Means Tests: Why Bankruptcy
Courts' Treatment of Secured Debt Payments is Contrary to Legislative Intent and Against
Public Policy**

I. Introduction

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (“BAPCPA”) requires chapter 7 debtors whose income is above the state median to complete a mathematical formula—commonly known as the “means test”—to determine whether their bankruptcy filing is abusive.¹ However, courts have inconsistently interpreted a key provision of the means test concerning expense deductions for secured debt payments. There is disagreement among courts regarding whether a debtors can deduct monthly payments for surrendered secured property on their means test.² Debtors’ most common secured debt payment, aside from an auto payment, is a mortgage.³ Thus, some courts allow debtors to deduct their monthly mortgage payment on their means test even if they intend to surrender their home to the lender holding the security interest.

Allowing debtors to deduct monthly mortgage payments that they no longer make, or intend to make, because they no longer own their homes is contrary to BAPCPA’s purpose and against public policy because it permits abusive bankruptcy filings. The home mortgage payment expense deduction allows debtors to artificially reduce their disposable income under

¹ Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8 (2005).

² Compare *In re Harris* 353 B.R. 304, 309 (Bankr.E.D.Okla.2006)(disallowing secured debt payment deductions on the means test) with *In re Gaylon*, 366 B.R. 164, 167 (Bankr.W.D.Okla.2007)(allowing secured debt payment deductions on the means test).

³ See generally, Elias Neocleous, *Restructuring and Insolvency*, MONDAQ BUS. BRIEFING, 2008 WLNR 17442433 (2008).

the means test. A court's view regarding these deductions can materially affect whether a chapter 7 debtor receives a full discharge of unsecured debts, a dismissal, or an option to convert to a chapter 13.⁴ Congress must clarify the language found in § 707(b)(2)(A)(iii)(I)⁵ of the means test to prevent abusive bankruptcy filings and the unequal treatment debtors, especially now that the number of bankruptcy filings has increased dramatically from years past due in large part to ballooning mortgages.⁶

II. Background: How the Means Test Works

BAPCPA replaced the older “substantial abuse” test of § 707(b)(2) with a new “abuse” means test.⁷ The formula for this calculation is set forth in § 707(b)(2)(A) and appears in the debtor's bankruptcy petition as Official Bankruptcy Form B22A.⁸ The means test presumes that a chapter 7 bankruptcy filing is abusive if a debtor's net Current Monthly Income (“CMI”)⁹—reduced by allowable expenses—exceeds a statutorily set amount for disposable income.¹⁰ The CMI, which is the debtor's average income for the six months prior to filing their petition,¹¹ is

⁴ See § 11 U.S.C. 702(b)(1) (2000).

⁵ § 707(b)(2)(A)(iii)(I).

⁶ See Irving Fisher, *Out of Keynes's Shadow*, THE ECONOMIST, Feb. 14, 2009, at 10; see also, Jim Puzzanghera, *House OKs Court-Approved Mortgage Relief*, L.A. TIMES, Mar. 6, 2009; see generally Dan Levy, *Foreclosure Filings in U.S. Jumped 30% in February*, Bloomberg.com, <http://www.bloomberg.com/apps/news?pid=20601103&sid=aFS4Zbll06TU&refer=us> (last visited Mar. 9, 2009).

⁷ 11 U.S.C. § 707(b)(2) (2000); see also Charles J. Tabb and Jillian K. McClelland, *Living With the Means Test*, 31 S. ILL. U. L.J. 463, 467-69 (2007).

⁸ Form 22A can be obtained at the U.S. Trustee Program website, available at <http://www.usdoj.gov/ust/eo/bapcpa/meanstesting.htm> (last visited Mar. 9, 2009).

⁹ 11 U.S.C. § 101(10A) (2000).

¹⁰ § 707(b)(2)(A)(i).

¹¹ See § 101(10A).

compared to the median income for the debtor's state.¹² Assuming a debtor's CMI is above the state's median, the court must determine if the difference between the debtor's income, after allowed expense deductions,¹³ equals or exceeds \$182.50 per month in disposable income.¹⁴

If a debtor's income exceeds the disposable income threshold, then a presumption of abuse arises, unless a debtor is able to rebut the presumption by demonstrating the existence of "special circumstances."¹⁵ When a presumption of abuse arises, § 707(b)(2) dictates that the case must be either dismissed or converted to a chapter 13.¹⁶ Under a chapter 13 plan, the debtor will be required to use his or her disposable income to pay unsecured creditors over sixty months, rather than receiving a full discharge of unsecured debts.¹⁷ Thus, chapter 7 debtors might find themselves repaying some or all of their unsecured debts in a chapter 13 plan because they exceeded the disposable income threshold.

¹² See § 707(b)(2)(A)(i); § 707(b)(7).

¹³ See § 707(b)(2)(A).

¹⁴ §§ 707(b)(2)(A)(i)(I)-(II) (If the monthly disposable income falls between \$100 and \$182.50, then disposable income is measured against the debt as a percentage, with twenty-five percent being the benchmark).

¹⁵ § 707(b)(2)(B)(i)-(iv) ("[T]he presumption of abuse may only be rebutted by demonstrating special circumstances, such as a serious medical condition or a call or order to active duty in the Armed Forces, to the extent such special circumstances that justify additional expenses or adjustments of current monthly income for which there is no reasonable alternative.").

¹⁶ § 702(b)(1).

¹⁷ § 702(b)(2)(A)(i).

III. The Problem: Courts Disparate Treatment of Secured Debt Payment Deductions for Above Median Income Earners in Chapter 7 Cases Affects Bankruptcy Discharges

Naturally, a debtor who wishes to receive a full discharge of unsecured debts, but earns income above the state median, will want to maximize expense deductions in order minimize his or her disposable income to avoid the presumption of abuse. Some courts make this task easier by allowing deductions for home mortgage payments, even if the debtor intends to surrender the home securing the debt.¹⁸

For many debtors, this difference in calculating secured debt deductions could determine whether they have sufficient disposable income to trigger the means test's presumption of abuse. In other words, without the secured debt expense deductions, a debtor's case would be either dismissed or converted to a chapter 13.¹⁹ Debtors who find themselves in courts that do not allow deductions for homes that they intend to surrender are at a disadvantage if they hope to receive a full discharge of their unsecured debts.

For example, assume a debtor has a \$4,000 monthly mortgage payment for a home that he or she intends to surrender to the bank that holds the security interest. Some courts would allow the debtor to deduct that mortgage payment on his or her means test, regardless of debtor's intention to surrender the property. However, if a court forbids the debtor to deduct that monthly mortgage payment of \$4,000, then that debtor will only be allowed to deduct a monthly rental expense pursuant to Internal Revenue Services Local Standards ("IRS Local Standards").²⁰ For a

¹⁸ See e.g. *In re Gaylon*, 366 B.R. 164, 167 (Bankr.W.D.Okla.2007).

¹⁹ § 702(b)(1).

²⁰ § 707(b)(2)(A)(ii)(I).

family of four living in Los Angeles, California, the IRS Local Standard is \$2,441.²¹ Thus, depending on a judge's interpretation of § 707(b)(2)(A)(iii), that debtor's housing expense deduction on his or her means test could vary by approximately \$1,500.

This disparate treatment of mortgage expenses can materially affect a debtor's discharge in bankruptcy. The difference between deducting the allowable IRS housing expense instead of a debtor's secured debt expense on the means test could create surplus disposable income that triggers the presumption of abuse. Accordingly, the debtor's case will either be dismissed as an abusive chapter 7 filing or the debtor will have to convert the case to a chapter 13 based on courts' interpretation of § 707(b)(2)(A)(iii).

IV. Courts' Differing Reasoning for Allowing and Disallowing the Deductions

The courts that allow secured debt payment deductions for collateral that the debtor intends to surrender argue that the plain language of § 707(b)(2)(A)(iii) permits debtors to make these deductions *regardless* of whether they actually make payments on their obligations.²² Section 707(b)(2)(A)(iii)(I) allows debtors to deduct from CMI "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."²³ Courts that apply a "plain language" reading of the section reason that the

²¹ The IRS Local Housing and Utilities Standards for California can be obtained at the U.S. Trustee Program website, *available at* http://www.usdoj.gov/ust/eo/bapcpa/20081001/bci_data/housing_charts/irs_housing_charts_CA.htm (last visited Mar. 9, 2009).

²² *See e.g.*, In re Walker, 2006 WL 1314125, *4 (Bankr. N.D. Ga. 2006); In re Linstrom 381 B.R. 303, 308 (Bankr. D. Colo. 2007); In re Benedetti, 372 B.R. 90, 97 (Bankr. S.D. Fla. 2007); In re Hayes, 376 B.R. 55, 60 (Bankr. D. Mass. 2007); In re Wilkins, 370 B.R. 815, 818 (Bankr. C.D. Cal. 2007); and In re Gaylon, 366 B.R. 164, 167 (Bankr. W.D. Okla. 2007).

²³ § 707(b)(2)(A)(iii)(I).

time of filing controls whether a debtor is entitled to deduct payments due on secured debts.²⁴ They reason that a “scheduled” future payment is not the same as an actual future payment.²⁵ Thus, a debtor’s intent to surrender or reaffirm the collateral has no bearing on whether the debtor can deduct the payments relating to secured debt.²⁶ Therefore, courts only need to determine whether a debtor owes payments on secured debt at the time of the petition was filed.²⁷

Courts that disallow secured debt payment deductions for surrendered property use a “holistic” approach when analyzing § 707(b)(2)(A)(iii)(I) and look at legislative intent to determine the statute’s purpose and policy goals, when the plain language is not clear or contrary to legislative intent.²⁸ These courts assert that the primary intent of BAPCPA’s means test is to “ensure that those who can afford to repay some portion of their unsecured debts [be] required to do so.”²⁹ These courts further argue that the term “schedule” refers to bankruptcy schedules and not the dictionary definition of schedule that a plain language reading necessitates.³⁰ Thus, courts must look to a debtor’s schedules and bankruptcy documents to

²⁴ *See supra* note 22.

²⁵ *See supra* note 22.

²⁶ *See supra* note 22.

²⁷ *See supra* note 22.

²⁸ *See e.g.*, *In re Skaggs, Richard & Connie*, 349 B.R. 594, 598 (Bankr. E.D. Mo. 2006); *In re Naut*, 2008 WL 191297, *8 (Bankr. E.D. Pa. 2008); *In re Burden*, 380 B.R. 194, 201 (Bankr. W.D. Mo. 2007); *In re Ray*, 362 B.R. 680 (Bankr. D.S.C. 2007); and *In re Harris*, 353 B.R. 304, 309 (Bankr. E.D. Okla. 2006).

²⁹ *In re Hardacre*, 338 B.R. 718 (Bankr. N.D. Tex. 2006)(*quoting* 151 CONG. REC. S2470 (daily ed. Mar. 1, 2005) (statement of Sen. Grassley)).

³⁰ *See supra* note 28.

determine whether the debtor intends to surrender or reaffirm collateral when calculating means test deductions.³¹ Accordingly, allowing debtors to deduct secured debt payments on collateral they intend to surrender is contrary to both a plain language reading of the statute and contrary to Congressional intent and should not be permitted.³²

V. The “Holistic” Approach is Correct because It Is Consistent with Legislative Intent and Public Policy

On April 20, 2005, President George W. Bush signed and enacted BAPCA.³³ At the time, he stated:

[T]oo many people have abused the bankruptcy laws . . . [by] walking away from debts even when they had the ability to repay them. The bill I sign today helps address this problem. Under the new law, Americans who have the ability to pay will be required to pay back at least a portion of their debts. Those who fall behind their state's median income will not be required to pay back their debts. This practical reform will help ensure that debtors make a good-faith effort to repay as much as they can afford.³⁴

His statement echo Congressional Reports, which state that the means test was designed to be “an objective and formulaic process to help determine which consumer debtors have the

³¹ See *supra* note 28.

³² See *supra* note 28.

³³ Press Release, President Signs Bankruptcy Abuse Prevention, Consumer Protection Act (April 20, 2005), available at <http://www.whitehouse.gov/news/releases/2005/04/20050420-5.html>.

³⁴ *Id.*

means to repay creditors at least a portion of their claims.”³⁵ BAPCPA was created to combat “the growing perception that bankruptcy relief may be too readily available and is sometimes used as a first resort, rather than a last resort.”³⁶ Moreover, BAPCPA rebuked prior bankruptcy law because prior law had “no clear mandate requiring these debtors to repay their debts.”³⁷ Thus, BAPCPA’s history signifies a break from prior law, which both Congress and President Bush felt provided too many opportunities to obtain discharges for debtors with the ability to pay at least a portion of their debts.³⁸ Allowing phantom mortgage deductions for surrendered property on the means test violates Congressional intent because the deductions disregard disposable income that could be used to pay back at least some of a debtor’s unsecured debt.

From a public policy perspective, the phantom mortgage deduction rewards real estate speculators and creates a windfall for irresponsible mortgagees. There is no limit on secured debt payment deductions.³⁹ Thus, a high income debtor with a couple of large mortgage payments can default on his or her home loans during a bankruptcy and still obtain a full discharge of debts because the large mortgage payment deductions conceal disposable income. In such a scenario, a debtor does not have to worry about being an above-median income earner and triggering the presumption of abuse because the secured debt payment deductions will cancel out any disposable income under the means test.

³⁵ H.R. Rep. No. 109-31 at 89 (2005).

³⁶ *Id.* at 4.

³⁷ *Id.* at 5.

³⁸ *Id.*

³⁹ *See* 11 U.S.C. § 707(b)(2)

Even more disturbing, if courts allow phantom mortgage deductions, debtors with interest only or negative amortization mortgages that have recently reset can deduct the newly ballooned monthly payment amounts on their mean test. Thus, the mortgage reset—which might have actually contributed to debtor’s decision to file bankruptcy—also aids the debtor in receiving a full discharge of unsecured debts under the supposedly more stringent bankruptcy laws, despite having disposable income.

Finally, the current split in authority magnifies the unfair treatment of similarly-situated debtors. In the Central District of California where there are twenty judges and number of bankruptcy filings has nearly doubled from a year ago,⁴⁰ judges’ differing interpretation of § 707(b)(2)(A)(iii)(I) can result in similarly-situated above-median debtors being treated fundamentally differently and materially impacting debtors’ ability to receive a full discharge of unsecured debts.

VI. Conclusion

Congress must amend the language of § 707(b)(2)(A)(iii)(I) so that courts no longer allow debtors to deduct monthly payments for surrendered secured property on their means test. The change will prevent this class of debtors from receiving a windfall when computing their means test and require above-median income earners with bloated home mortgages to pay back at least a portion of their unsecured debt. The change will align with Congress’s original intent, satisfy public policy concerns, and treat similarly-situated debtors fairly.

⁴⁰ M. Jonathan Hayes, Bankruptcy Professor Blog, Bankruptcy Filing Statistics for the Central District of California, http://lawprofessors.typepad.com/bankruptcyprof_blog/2008/12/bankruptcy-fi-1.html (last visited Mar. 9, 2009).