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In re Kagenvaema: An End-Run Around the "Applicable Commitment Period"

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Imagine a debtor who lives in New York State, where the median household income for 2007 was approximately $53,000. The debtor is a doctor and receives $80,000 of income from the hospital where she works. The good doctor, however, has gotten in over her head. She purchased a gigantic home she could not afford, has too many student loans to pay back, and regrets buying that expensive car. Her credit card debt is staggering, and she incurs thousands of dollars each month in interest and fees. She decides she can no longer handle the financial pressure and wants to file for Chapter 13 bankruptcy. However, because her income exceeds the median income in New York, the doctor is classified as an above-median income debtor, which requires a debtor to propose a repayment plan that lasts five years. The doctor is not thrilled about the prospect of subjecting herself to the five-year bankruptcy period, particularly because she has been offered a lucrative position as a partner in a prestigious medical practice. She decides to defer the offer because she does not want to increase her income during the time she is in bankruptcy and therefore have to pay more to her unsecured creditors.

After filing for bankruptcy, she determines that, due to the amount of debt held by her secured creditors, her projected disposable income amounts to zero or a negative number. As a result, she is not subject to the five-year commitment period and proposes a plan to repay her unsecured creditors for 2 years. The plan is confirmed, although it guarantees the unsecured

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creditors recover only a fraction of the debt owed to them. After the two years has ended, she accepts a position with the medical practice and now receives $200,000 per year in compensation. The unsecured creditors, however, would not enjoy in her increased income because the bankruptcy period has ended. Is this a fair result? According to the Ninth Circuit, there is nothing wrong with increasing secured debt or deferring income as a means of cheating unsecured creditors out of their money.

Section 1325 of the Bankruptcy Code (the "Code") requires that an above-median income debtor who files for Chapter 13 bankruptcy be subject to a five-year "applicable commitment period." 11 U.S.C. § 1325 (2006). Generally, courts have interpreted the "applicable commitment period" to be a temporal requirement for above-median income debtors (as opposed to a monetary multiplier, which would be useful in calculating the amount owed to unsecured creditors during the bankruptcy but would not impose a minimum length of time for the bankruptcy). By ruling that the "applicable commitment period" is a temporal requirement, most courts afford unsecured creditors a specific period of five years within which to be paid.

Recently, the Ninth Circuit Court of Appeals agreed that the five-year "applicable commitment period" mandates a temporal requirement, but carved out an exception for above-median income debtors with no "projected disposable income." *In re* Kagenvaema, 541 F.3d 868 (9th Cir. 2008). Although it based its decision on a contextual analysis of the statutory text, the court's construction of the Code conflicts with the plain language of section 1325 and Congress' intent to allow creditors a sufficient period of time to be repaid. *See* 11 U.S.C. § 1325(b)(4)(B) (establishing "applicable commitment period" may only be less than three or five years "if the plan provides for *payment in full* of all allowed unsecured claims over a shorter period") (emphasis added). Therefore, the court should have required the "applicable

commitment period" to apply to all above-median income debtors who voluntarily file for Chapter 13 bankruptcy.

Case Background

In 2005, Laura Kagenvaema filed a petition for Chapter 13 protection in the United States Bankruptcy Court for the District of Arizona. Kagenvaema filed the required paperwork, including Schedules A through J and a Form B22C Statement of Current Monthly Income and Calculation of Commitment Period and Disposable Income. Her schedule I listed a monthly gross income of $6,168.21, with a monthly net income of $4,096.26. Her schedule J listed a monthly expenses totaling $2,572.37. After subtracting her expenses from her net income, Kagenvaema was left with $1,523.89 in disposable income to pay her creditors. Kagenvaema then filed an amended Form B22C, which listed her annual income as $74,018.52 for the six months prior to her bankruptcy, which qualified Kagenvaema as an above-median income debtor. Because she was considered an above-median income debtor, Kagenvaema was required by § 1325(b)(3) to recalculate her expenses pursuant to § 707(b)(2). After the recalculation, Kagenvaema's disposable income was listed on the Form B22C as -$4.04.

Kagenvaema argued that she was not subject to the five-year "applicable commitment period" because her "projected disposable income" was a negative number. Therefore, she proposed a plan to repay her unsecured creditors $1,000 per month for 36 months, or three years. Edward Maney, the Trustee acting on behalf of the unsecured creditors, objected to the repayment plan because it was shorter than the five-year "applicable commitment period." The bankruptcy court held that the five-year period did not apply because Kagenvaema's "projected disposable income" was a negative number. The Trustee appealed, and the case was certified for

direct appeal to a Ninth Circuit panel. The divided panel affirmed the bankruptcy court's decision, holding that the five-year "applicable commitment period" did not apply because Kagenvaema did not have any "projected disposable income."

Ruling

The majority agreed with the Trustee that the "applicable commitment period" mandates a specific period of time. The court held that the "applicable commitment period" requires above-median income debtors to repay their creditors for a five-year period. *See* 11 U.S.C. 1325(b)(4(A)(ii); *see also In re* Grant 364 B.R. 656 (Bankr. E.D. Tenn. 2007); *In re* Alexander, 344 B.R. 742 (Bankr. E.D.N.C. 2006). The court rejected Kagenvaema's argument that the "applicable commitment period" was a monetary multiplier, that is, a time reference by which the debtor computes the monetary amount owed to unsecured debtors. *See, e.g.*, *In re* Mathis, 367 B.R. 629 (Bankr. N.D.Ill. 2007); *In re* Fugar, 347 B.R. 94 (Bankr. D. Utah 2006). The court's analysis of the "applicable commitment period" as mandating a temporal measurement is arguably correct, and it is undoubtedly consistent with a majority of courts that have addressed the issue. *See In re* Heyward, 386 B.R. 919, 922 (Bankr. S.D. Ga. 2008) (citing cases).

However, the majority then held that the "applicable commitment period" is inapplicable when an above-median income debtor has no "projected disposable income," even though the shorter plan would not result in 100% repayment to the unsecured creditors. It reasoned that the "applicable commitment period" is not a requirement for a minimum duration; rather, it represents the time during which a debtor must devote her "projected disposable income" to repayment of unsecured creditors. Therefore, the majority concluded that she was not subject to

the "applicable commitment period" because she had no "projected disposable income" to devote to her unsecured creditors. The majority offered two central arguments in support of its decision.

First, the majority reasoned that the plain meaning of the Code does not require all repayment plans to be held open for the "applicable commitment period." It noted that section 1325(b)(4) does not automatically subject above-median income debtors to a five-year bankruptcy. Rather, when read in context of the entire section, particularly subsection (b)(1)(B), which references calculation of "projected disposable income," the above-median income debtor is only subjected to the five-year "applicable commitment period" when there is "projected disposable income" to repay unsecured creditors. This is consistent, the majority observed, with the definitions of "applicable commitment period" and "projected disposable income" in subsections (b)(2) and (b)(4), which support the court's holding that the former is only applicable to repayment plans that include the latter.

Second, the majority found support in a recent Eighth Circuit Bankruptcy Appellate Panel ("BAP") case addressing the issue of whether the five-year "applicable commitment period" is required for above-median income debtors with no "projected disposable income." In *In re* Frederickson, 375 B.R. 829 (B.A.P. 8th Cir. 2007), an above-median income debtor proposed a repayment plan of 48 months, arguing that the 60-month "applicable commitment period" was irrelevant because the debtor had no "projected disposable income." The trustee objected, but the Eighth Circuit BAP overruled the objection, holding that the "applicable commitment period" is the time during which debtors must pay the trustee their disposable income. If debtors have no disposable income to pay their creditors, then the "applicable commitment period" is irrelevant for determining the length of the bankruptcy. The BAP further noted that section 1322(d) governs the length of time a repayment plan must be in effect for

above-median income debtors in bankruptcy. The BAP concluded, and the majority in *Kagenvaema* agreed, that this provision would be rendered superfluous if the "applicable commitment period" represented a minimum durational requirement. Consequently, the majority held the five-year "applicable commitment period" is not required when an above-median income debtor has no "projected disposable income."

The consequences of the majority's holding are aptly highlighted by the forceful dissent in the case. The dissent argued that the majority's test would allow above-median income debtors to escape repayment of unsecured creditors by increasing their expenses prior to filing for bankruptcy or deferring income until after the expiration of their proposed repayment period. As a result, an above-median income debtor who can show no "projected disposable income" is free to choose a period of time for repayment that is shorter than five years, thereby circumventing the requirements of section 1325. While this protects the debtor from being subjected to examination by unsecured creditors for the five-year period, it also may prevent the unsecured creditors from receiving payment.

First, the dissent argued that a "plain meaning" analysis of the Code requires that the "applicable commitment period" apply to all above-median income debtors regardless of their "projected disposable income." Beginning with section 1325(b)(4)(B), the dissent argued that the "applicable commitment period" can be shortened "only if the plan provides for payment in full of all allowed unsecured claims over a shorter period." Furthermore, section 1325(b)(1)(B) requires debtors to pay their creditors "all of the . . . projected disposable income *to be received* in the applicable commitment period . . . ." 11 U.S.C. § 1325(b)(1)(B) (emphasis added). Therefore, even where a debtor's "projected disposable income" at the time of filing for bankruptcy is zero or a negative number, the Code specifically requires debtors to pay *all*

disposable income they *receive* during the "applicable commitment period." As the dissent noted, the temporal requirement ensures that a debtor will "commit to pay such disposable income as he receives it-should he receive it-during the applicable commitment period."

Second, the dissent argued that the majority's rule disserves the legislative intent of section 1325. The legislative intent behind section 1325 allows creditors the opportunity to "keep an eye on" debtors to recover their money for the entire five-year period prescribed by the statute. As an above-median income debtor, it is at least possible to conceive of an increase in disposable income during a five-year period, even if the "projected disposable income" at the time of filing is zero or a negative number. The dissent correctly argued that allowing debtors to propose repayment plans that are shorter in length than the five-year "applicable commitment period" deprives unsecured creditors the opportunity to recover disposable income received by the debtor after the shortened plan has expired. Moreover, the dissent highlighted a fundamental flaw in the majority's reasoning: now, the debtor can "propose as short a time period as he wants: a day, a week or a month" because the debtor is no longer subject to the mandatory five-year period. This, the dissent argued, would encourage debtors to fiddle with their expenses prior to filing for bankruptcy and avoid the "applicable commitment period" by calculating their "projected disposable income" as zero or a negative number.

For example, it may encourage debtors, before bankruptcy, to take on more secured debt or defer their income so as to give the appearance of zero or negative "projected disposable income." Therefore, an above-median income debtor could avoid repaying unsecured creditors simply by incurring *more* secured debt or deferring income to a later date after the shortened bankruptcy period has ended. This could not, the dissent concluded, have been Congress' intent

when it included the requirement for a five-year "applicable commitment period" for above-median income debtors.

The dissent concluded by articulating an alternative test that requires all above-median income debtors to be subject to the five-year period, regardless of their "projected disposable income" at the time of filing for bankruptcy. Debtors can escape this requirement and propose a shorter repayment plan only if the plan would result in full 100% repayment to all unsecured creditors. However, where debtors do not propose to repay their unsecured creditors in full, the dissent argues that the creditors should be afforded every opportunity permitted to them by statute to recover any and all of the debtor's disposable income for the five-year "applicable commitment period."

Analysis and Proposal

Essentially, the Ninth Circuit's ruling has created a loop-hole which allows an above-median income debtor to propose a repayment plan that, as the dissent notes, may be "as short a period as he wants: a day, a week or a month." Such a policy, however, is contrary to the purpose of the BAPCPA amendments and contravenes Congress' intent to provide creditors with a five-year window during which they can share in any good fortune or increased income the debtor may receive. While Ninth Circuit's ruling may encourage some debtors to choose Chapter 13 and voluntarily pay more to their creditors rather than little or nothing under Chapter 7, it also creates an intolerable scheme whereby above-median income debtors can hide or defer their "projected disposable income" or acquire more secured debt as a means of avoiding the five year "applicable commitment period."

The majority's rule presents four troublesome issues that cast doubt on the validity of its holding. First, the exemption from the five-year "applicable commitment period" is not expressly permitted by statute. Section 1325(b)(4)(B) allows an above-median income debtor to be exempted from the full five-year period only if the repayment plan will fully repay unsecured creditors. The fact that the majority's exemption is not included in the statute creates a presumption against its validity. Moreover, the statute expressly requires debtors to remit all disposable income received during the "applicable commitment period." 11 U.S.C. § 1325(b)(1)(B). Therefore, a plain reading of this provision indicates that the existence, or lack thereof, of disposable income at the outset of the bankruptcy is irrelevant; rather, debtors are required to pay all disposable income received during the "applicable commitment period," even if that could not be calculated on the filing date.

Second, as the dissent noted, the majority's rule would encourage debtors to manipulate their income and expenses, resulting in zero or negative "projected disposable income" on their Form B22C. In so doing, debtors could then propose a shorter repayment plan and defer their income until after the plan has expired, leaving unsecured creditors without payment and without remedy. Or, debtors thinking about filing for bankruptcy could acquire *more* secured debt, thereby driving up expenses and giving the appearance of zero or negative disposable income.

Third, the policy reasons for enacting the Code are not served by the majority's rule. Although the purpose of bankruptcy generally is to "provide debtors with a second chance, it is not a pardon of debt or, at least, a pardon right away." 541 F.3d at 878 (Bea, J. dissenting). The fundamental reason for imposing a five-year "applicable commitment period" for above-median income debtors is to allow creditors to enjoy a longer period of time during which they may receive repayment. The majority's rule undercuts this purpose by allowing debtors to

circumvent the requirement by increasing their expenses or deferring their income during the shortened bankruptcy period.

Finally, the majority's argument that section 1322(d) would be rendered superfluous is without merit. Section 1322(d) establishes the maximum length for a repayment plan proposed by an above-median income debtor; it makes no mention of a minimum length requirement. Section 1325(b)(4)(A)(ii), however, creates a minimum requirement for above-median income debtors who propose a plan that will not repay fully the unsecured creditors. Moreover, section 1322(d)(1) only requires that repayment plans for above-median income debtors not exceed five years. Because there is no minimum time period specified in section 1322, the minimum time period specified in section 1325(b) is controlling, and *all* above-median income debtors should be subject to the full five-year period. The majority's finding that the "applicable commitment period" is a temporal requirement supports the dissent's argument that the five-year period establishes a minimum length of time for a Chapter 13 bankruptcy filed by an above-median income debtor. Moreover, section 1325(b)(4)(B) allows a shorter repayment plan, but only if the plan provides for payment in full to all unsecured creditors.

The majority purports to provide a safety valve for unsecured creditors in section 1329. Section 1329(a) allows a creditor to request modification of the repayment plan to increase repayments from the debtor. *See* 11 U.S.C. § 1329(a)(1) (2006). However, plan modification can only occur "after confirmation of the plan but before the completion of payments under such plan . . . ." *Id*. As the dissent noted, this remedy is useless to unsecured creditors after the repayment plan has elapsed. If the repayment period is less than the five-year "applicable commitment period," section 1329(a) will not help unsecured creditors who wish to recover from any increased disposable income received by a debtor after the plan has expired, but before the

full five years has elapsed. Therefore, section 1329(a) is a useless remedy for unsecured creditors once the repayment plan has expired. This section, however, has no bearing on the debtor's ability to circumvent the "applicable commitment period" and propose a significantly shorter period of time, at the expense of the creditors.

The consequences of the majority's rule are significant because the rule provides above-median income debtors with a loop-hole to avoid the five-year "applicable commitment period." Two examples may prove illustrative. First, if an above-median income debtor, prior to filing for bankruptcy, arranged to defer a portion of his monthly income and acquired secured debt, such as a car loan, he could successfully eliminate his "projected disposable income." As a result, the debtor could propose a shorter period of time for repayment, even as short as one or two years. After the one or two years has elapsed, the discharged debtor could then receive his additional income, but the unsecured creditors would be unable to access that additional disposable income because the repayment plan has ended.

Second, even if the above-median income debtor is not attempting to conceal assets or defraud creditors and truly does not have "projected disposable income," the unsecured creditors, under the majority's rule, would still receive less repayment. It is important to note that "projected disposable income" is merely a calculated, educated guess about the debtor's future disposable income based on the status quo at the time of the filing for bankruptcy. For example, assume a debtor proposes a repayment plan of four years. She makes her required payments to her creditors, but has only repaid 15% of her debt to the unsecured creditors at the conclusion of the four years. Upon completion of the plan, she receives a discharge from bankruptcy. One month later, the debtor wins the lottery, a cash award, or some other accession to wealth occurs, and the debtor suddenly acquires a huge sum of money. Once again, the unsecured creditors

would be unable to share in the debtor's good fortune because the majority's rule exempted her from the mandatory five-year "applicable commitment period."

To be sure, unsecured creditors should not have an indefinite amount of time to "keep an eye on debtors." In fact, they are limited to five years by section 1322(d)(2). On the other hand, unsecured creditors should not be deprived of the opportunity to share in any new wealth acquired by the debtor. The Code should not tolerate a situation in which an above-median income debtor with negative or zero "projected disposable income" can escape the five-year "applicable commitment period," but an above-median income debtor with $5.00 of "projected disposable income" is subject to the full five-year period. Such an absurd result was not contemplated by Congress and does not fulfill the balancing purpose of the Code.

Conclusion

The Ninth Circuit's ruling has created a loop-hole that allows above-median income debtors to escape the five-year "applicable commitment period" at the expense of their creditors. The tangible benefits for allowing the exemption are significantly outweighed by the harm imposed upon unsecured creditors, many of whom will never receive repayment because debtors will be permitted to propose and receive a repayment plan of *ANY* length, regardless of how much they repay their creditors and regardless of whether they attempted to manipulate their income and expenses to achieve the desired result of receiving a discharge from bankruptcy as quickly and as cheaply as possible. The result of the majority's rule will only encourage debtors to minimize their income and drive up their expenses so as to avoid being subjected to the full five-year period. The test proposed by the majority does not comport with the statutory text and does not fulfill clear Congressional intent to allow unsecured creditors five years to monitor the

income of their above-median income debtors. The proper test is that proposed by the dissent and would require all above-median income debtors to be subject to the full five-year period. The dissent's test is not only more feasible to implement, but adequately protects unsecured creditors and ensures an increased likelihood that they will be repaid, at the insignificant cost to debtors that their finances will be monitored for a little while longer.