By Lisa Boardman Burnette

Must Debtors Contribute Exempt Assets to Pay Creditors?

Is a chapter 13 debtor required to use exempt personal-injury settlement proceeds to pay creditors in a plan that provides less than 100 percent payment to unsecured creditors? Courts remain torn on the question despite significant changes to the definition of "disposable income" brought about by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) almost 20 years ago.

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Tests for a Chapter 13 Plan

Two fundamental tests in § 1325 of the Bankruptcy Code must be met to confirm a chapter 13 plan: the best-interests-of-the-creditors test and the disposable-income test. The former analyzes assets, the latter, income. This leads to an interplay between §§ 1325(b) (establishes the debtor's obligation to commit all disposable income to their plan) and 522(c) (allows the debtor to exempt certain property). Neither Code section "is expressly limited by or subject to the other.... [I]t is difficult, if not impossible, to harmonize the two statutes."[1] Therein lies the problem.

Section 1325(a)(4) requires that unsecured creditors receive as much as they would have received if the bankruptcy estate was being liquidated in a chapter 7 case by valuing estate assets less any exemptions claimed under § 522. "[P]roperty exempted under [§ 522(c)] is not liable during or after the case for any debt of the debtor that arose, or that is determined ... as if such debt had arisen, before the commencement of the case."[2]

Section 1325(b) generally requires that a debtor commit all disposable income to the plan for the applicable commitment period (ACP) — 36 or 60 months — if the dividend to unsecured creditors is less than 100 percent.

Split in Decisions Pre-BAPCPA

Courts have been split for some time on whether the disposable-income test applies to exempt personal-injury settlement proceeds and other exempt assets that come into the debtor's possession postpetition.[3] Before 2005, the majority of courts had concluded that these assets are subject to the disposable-income analysis despite being exempt, while the minority courts had found that the exemption immunized the assets from that test. Both sides rely on the plain language of the Code sections.[4]

The Majority View

In the majority-view cases, these funds are acknowledged to be assets, and to be exempt if claimed as such without objection. However, these courts found that the funds are *also* disposable income under § 1325(b), which must be committed to paying creditors.[5] Under the pre-2005 Code, § 1325(b)(2)(A) defined "disposable income" as " income [that] is received by the debtor and [that] is not reasonably necessary to be expended ... for the maintenance and support of the debtor or a dependent of the debtor."[6] Disposable income was measured by the income disclosed on bankruptcy Schedule I, less the expenses included on Schedule J, multiplied by the length of the plan.[7]

"Income" is not defined in the Bankruptcy Code. One court reasoned that since the plain meaning of the term includes such things as gifts, it clearly would include injury settlements and the like.[8] Logically, income that is received above and beyond the originally determined disposable-income figure is income that is "disposable."

The crux of the issue was whether the *exempt* status of the funds immunized them from being considered disposable income. The majority view relied on the plain reading of §1325(b): Its language was in no way qualified by reference to § 522(c). The only limitation in § 1325(b) is the exclusion of income reasonably necessary for support.[9]

Next, the majority pointed to policy. First, exemptions are less significant in chapter 13 cases than in chapter 7 cases. In a chapter 7 case, exemptions ensure that a debtor is not left destitute if the creditors levy all his/her nonexempt assets. However, chapter 13 debtors are paying unsecured creditors with income beyond what is reasonably needed to support themselves and their

1 *In re Hunton*, 253 B.R. 580, 581 (Bankr. N.D. Ga. 2000).
2 11 U.S.C. § 522(c)(1).
3 Cases also consider life insurance proceeds, workers' compensation, inheritances and individual retirement account (IRA) distributions.
4 *See In re Launza*, 337 B.R. 286, 289-90 (Bankr. N.D. Tex. 2005).
5 *See id.* at 288.
6 11 U.S.C. § 1325(b)(2)(A) (2004).
7 *Martin*, 645 B.R. at 630.
8 *Launza*, 337 B.R. at 289.
9 *Id.* at 290. *See, e.g., Claude v. Claude*, 206 B.R. 374 (Bankr. W.D. Pa. 1997); *In re Minor*, 177 B.R. 576 (Bankr. E.D. Tenn. 1995).

dependents. Because debtors are able to "'retain nondisposable income rather than exempt assets, the importance of exemptions is diminished.'"[10]

In addition, because the discharge in a chapter 13 case is broader than in a chapter 7 case, the disposable-income reach should be broader as well.[11] There are fewer exceptions to discharge in chapter 13,[12] and a "hardship discharge" is available in certain circumstances.[13] "Allowing the Debtor to use his exempt income to attain Chapter 13's broad discharge, without the corollary requirement to use it to pay creditors as much as he is able, would contravene the express purpose of the state — namely, that the debtor makes payments under a plan."[14]

The Minority View

Alternatively, the minority-view courts have determined that based on the plain meaning of § 522(c), the exempt status of the funds immunizes them from consideration as disposable income.[15] Exempt property is protected regardless of form, and that limitation cannot be ignored.[16] The minority analysis goes no further than this.[17]

BAPCPA Changed the Disposable-Income Test

The overhaul of the disposable-income test in BAPCPA has not resolved the split. Congress enacted BAPCPA, among other things, based on the notion that more debtors should be required to pay back their debts.[18] It added limitations on which debtors could qualify for chapter 7 and generally required chapter 13 debtors to pay more to their creditors.

"Disposable income" is now defined as "current monthly income received by the debtor" ... less "amounts reasonably necessary to be expended for the maintenance or support of the debtor or a dependent of the debtor."[19] While resembling the prior definition, rather than looking merely at the snapshot of income reported in Schedule I on the petition date, BAPCPA added a look-back. Current monthly income (CMI) is "the average monthly income from all sources that the debtor receives — derived during the [six]-month [pre-petition] period."[20] In addition, rather than considering only the debtor's actual expenses on Schedule J, BAPCPA allows consideration of Internal Revenue Service national and local standards in calculating amounts reasonably necessary for support.[21] BAPCPA did not define "projected," but the U.S. Supreme Court found that the forward-looking approach implied by including that word requires an accounting for changes in income "known or virtually certain" at confirmation.[22]

10 337 B.R. at 290-91 (quoting *In re Tolliver*, 257 B.R. 98, 100 (Bankr. M.D. Fla. 2000)).
11 337 B.R. at 291.
12 11 U.S.C. § 1328(a).
13 11 U.S.C. § 1328(b).
14 *In re Schnabel*, 153 B.R. 809, 817 (Bankr. N.D. Ill. 1993)).
15 337 B.R. at 289.
16 *Id.* at 291 (citing *In re Ferreti*, 203 B.R. 796, 799 (Bankr. S.D. Fla. 1996)). *See, e.g., In re Baker*, 194 B.R. 881 (Bankr. S.D. Cal. 1996); *In re Tomasso*, 98 B.R. 513 (Bankr. S.D. Cal. 1989).
17 *See In re McGuire*, No. 20-61183, 2022 WL 2293923, at *8 (Bankr. N.D.N.Y. June 24, 2022) ("Once these minority courts determine that property is exempt, the disposable income analysis under § 1325(b) ends.").
18 Opening Statement of Sen. Chuck Grassley, Bankruptcy Reform Hearing Before the Sen. Judiciary Comm. (Feb. 10. 2005) (noting that majority of Americans believe that "it should be more difficult for people to file for bankruptcy").
19 11 U.S.C. § 1325(b)(2).
20 11 U.S.C. § 101(10A).
21 11 U.S.C. § 1325(b)(3) (referring to § 707(b)(2)).
22 *Hamilton v. Lanning*, 560 U.S. 505, 524 (2010).

Post-BAPCPA Decisions

Some courts believe that these sweeping changes resolved any questions about the treatment of exempt post-petition funds.[23] However, post-BAPCPA, minority courts continue to take the position that exempt assets cannot be disposable income, and majority courts continue to find that they are disposable income. Each side has found support in BAPCPA language for their position.[24]

Post-BAPCPA majority-view courts believe that the split was "statutorily answered by Congress" in BAPCPA.[25] These courts now reason that since Congress did not specifically exclude exempt asset income in § 101(10A), it was intended to be disposable income. Section 101(10A) includes a list of income that is excluded, including Social Security benefits, payments to victims of war crimes and terrorism, and compensation related to disability, combat injury or death of a military member.[26] "There can be no debate: [S]ince CMI does not exclude exempt assets and ... is the starting point for calculating disposable income, disposable income includes exempt assets."[27]

Nevertheless, the minority viewpoint persists.[28] Rather than focusing on the listed *exceptions* in the definition of "disposable income," the post-BAPCPA minority courts rely on the fact that Congress did not specifically *include* exempt assets in the definition.[29] A court recently also made comparisons to tax law, seemingly because BAPCPA added tax law refences in the new disposable-income test. The court noted that the categories of income derived from tax law in Form 122C-1 (the means test form) do not include personal-injury settlement proceeds.[30] Further, the Internal Revenue Code "explicitly states that personal injury proceeds are not calculated as income."[31]

Does § 1329 Make a Difference if the Issue Comes into Play on a Post-Confirmation Request to Modify a Plan?

In *In re McAllister*, the bankruptcy court concluded that since the plain language of CMI is based only on pre-petition income, generally post-petition life insurance proceeds could not constitute disposable income.[32] However, in that case, the funds were being considered for a plan modification, and the modification standard is governed by § 1329 — not by the disposable-income requirements in § 1325(b).[33] The court ultimately decided that § 1329 does not require the use of

23 *See, e.g., In re Brah*, 562 B.R. 922, 924 (Bankr. E.D. Wis. 2017).
24 *Compare Brah*, 562 B.R. at 924; *with In re Martin*, 654 B.R. 625, 633 (Bankr. W.D. Tenn. 2023).
25 *In re Waters*, 384 B.R. 432, 436 (Bankr. N.D. W.Va. 2008). *See* additional cases in *McGuire*, 2022 WL 2293923, at *8.
26 11 U.S.C. § 101(10A)(B)(ii)(I-IV). Section 1325(b)(2) includes another list of exceptions: child-support and foster-care payments, dependent disability payments, certain charitable contributions and business expenses. 11 U.S.C. § 1325(b)(2)(A), (B).
27 562 B.R. at 924. *See also In re Royal*, 397 B.R. 88, 101-02 (Bankr. N.D. Ill. 2008) ("Although both the disposable income definition and the [CMI] definition exclude certain items, exempt income is not excluded."). *In re Adamson*, 615 B.R. 303, 311 (Bankr. D. Colo. 2020).
28 *See, e.g., In re Daniels*, No. 11-08830-8-RDD, 2013 WL 365107, at *2 (Bankr. E.D.N.C. Jan. 29, 2013); *In re McCollum*, 348 B.R. 377, 388 (Bankr. E.D. La. 2006).
29 For example, in *Martin*, the court concluded that if Congress had intended for disposable income to include personal-injury proceeds, it would have explicitly said so. 654 B.R. at 633.
30 *Id.* at 632.
31 *Id.* (citing I.R.C. § 104(a); *Hawkins v. United States*, 30 F.3d 1077, 1083 (9th Cir. 1994)).
32 *In re McAllister*, 510 B.R. 409, 414 (Bankr. N.D. Ga. 2014) (J. Bonapfel).
33 *Id.* at 424-26.

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exempt assets in a modified plan because § 522(c) allows debtors to retain exempt property.[34]

Earlier this year, the U.S. District Court for the Southern District of Alabama in *Conte v. Hill* likewise distinguished how the issue is analyzed at plan modification.[35] What might not be disposable income at the time of the initial confirmation "may be considered as additional disposable income" at the time of modification.[36] Section 1325(b) does not "preclude a trustee from seeking an upward modification based on assets acquired by the debtor post-confirmation.... [M]odifications were intended to capture sources of income or assets that did not exist during the six-month look-back period which is used to calculate disposable income for purposes of confirming a Chapter 13 Plan in the first instance."[37]

Nonetheless, the district court did *not* overturn the bankruptcy court's determination that the § 1325(b) disposable-income test did not apply to the settlement proceeds, finding that the court had not abused its broad statutory discretion under § 1329 to allow modifications.[38] As ABI Editor-at-Large **Bill Rochelle** opined in *Rochelle's Daily Wire*, the district court "almost reversed the bankruptcy court," and thus sent mixed messages.[39]

The few appellate court cases considering this issue are all pre-BAPCPA and are not entirely on point. The court in *In re Hunton* sided with the minority view based on the Eleventh Circuit opinion in *In re Gamble*,[40] even though the appeals court did not consider the disposable-income test and only found that once a debtor exempted real estate, proceeds from a sale were his to use as his own.[41]

The Fourth Circuit in *In re Solomon*[42] found that potential withdrawals from an exempt IRA were purely hypothetical and thus not disposable income, without analyzing the interplay between §§ 1325(b) and 522(c). The dissent in that case argued that an IRA was disposable income because it was not needed for reasonable maintenance and support, but it was concerned with the egregious facts in that case. The majority remanded to the bankruptcy court to consider the debtor's good faith.[43]

Conclusion

On paper, the issue is ripe for consideration by the Supreme Court. In reality, it might never make its way there. Debtors' counsel and trustees with boots on the ground tend to work out compromised agreements when exempt assets come into a case. As many a bankruptcy judge has been known to say, if parties want them to hear a dispute, one of them is not going to be happy with the outcome. abi

34 *Id.* at 429-30.
35 No. BR 18-02317-HAC, 2024 WL 140247, at *1 (S.D. Ala. Jan. 12, 2024).
36 *Id.* at **14-15.
37 *Id.* at *17 (quoting *In re Peebles*, 500 B.R. 270, 275-76 (Bankr. S.D. Ga. 2013)).
38 *Id.* at *18 (affirming *In re Hill*, 652 B.R. 212 (Bankr. S.D. Ala. 2023)).
39 Bill Rochelle, "Alabama Judge Gives a Mixed Message on Who Gets Post-Petition P.I. Settlements," *Rochelle's Daily Wire* (Jan. 19, 2024), *available at* abi.org/newsroom/daily-wire.
40 168 F.3d 442 (11th Cir. 1999). Other lower courts in the Eleventh Circuit disagree about *Gamble* being precedential. *See McAllister*, 510 B.R. at 428.
41 *In re Hunton*, 235 B.R. 580 (Bankr. N.D. Ga. 2000).
42 67 F.3d 1128 (4th Cir. 1995).
43 *Cf., In re Koch*, 187 B.R. 664, 668 (Bankr. D.S.D. 1995) (finding Eighth Circuit chapter 12 opinion that exempt life insurance proceeds were disposable income to be controlling because it was "so closely analogous") (citing *In re Berger*, 61 F.3d 624 (8th Cir. 1995)).