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The Approval of Retirement Contributions in Chapter 13 Payment Plans

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Introduction

In the United States, employees often contribute a portion of their annual income to their 401(k) retirement plans. These contributions may fluctuate based on age, income, or additional contributions by employers. At the same time, chapter 13 debtors are often required to pay at least a portion of what is owed to creditors as part of their court-approved payment plans. A court will only approve a debtor’s chapter 13 payment plan if a debtor contributes all of his “projected disposable income” to pay creditors over the “applicable commitment period.”1 While disposable income is defined as the “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,” projected disposable income is not actually defined in the Bankruptcy Code.2 An issue arises for chapter 13 debtors regarding whether they may contribute to their retirement funds while paying back creditors through their chapter 13 plans. If a debtor’s retirement contributions are considered part of his disposable income, then it appears that income

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must be put toward his chapter 13 plan; but if not, perhaps a portion of it may still be put towards the debtor’s 401(k).

Prior to 2005, courts held that voluntary contributions to a 401(k) were part of a debtor’s disposable income.\(^3\) Chapter 13 debtors were required to cease retirement contributions and instead use all disposable income to pay creditors for the duration of their chapter 13 payment plans. In 2005, Congress amended section 541 of the Bankruptcy Code in the Bankruptcy Abuse and Consumer Protection Act (“BAPCPA”), providing that “property of the estate does not include any amount withheld by an employer from the wages of employees for payment as contributions to [a 401(k) retirement plan] except that such amount under this subparagraph shall not constitute disposable income as defined in section 1325(b)(2).”\(^4\) Known as “the hanging paragraph,” this section has caused disagreement among bankruptcy courts regarding whether contributions to retirement plans are excepted from a debtor’s estate in chapter 13 calculations—if so, creditors would not be entitled to funds that a debtor has already contributed to his retirement plan. This memorandum first discusses the differing post-BAPCPA interpretations regarding retirement funds as disposable income, as well as the permissibility of post-petition retirement contributions. The next section will highlight the impact of the good faith requirement on the feasibility of retirement plan contributions throughout the chapter 13 bankruptcy process.

Discussion

I. Diverging Interpretations of the Hanging Paragraph

The phraseology of the hanging paragraph has created such ambiguity and disagreement among courts across the country that payment plan decisions have been anything but uniform.


Three main interpretations have become most prevalent since the passing of BAPCPA: the
Prigge view, the Davis/Seafort view, and the Johnson view.5

A. The Prigge Approach

The most restrictive interpretation of section 541(b)(7) dictates that a debtor cannot make
any post-petition 401(k) contributions, and that all of a debtor’s pre-petition retirement
contributions are included in his or her disposable income. This interpretation is premised on the
textual language of the Bankruptcy Code. “[T]he absence of any exclusion of voluntary 401(k)
contributions from the Code simply reinforces the Court’s conclusion that . . . contributions to
voluntary retirement plans are not a necessary expense.”6

Courts that follow this view hold that “Congress would have placed a provision within
chapter 13 if it had intended to exclude voluntary 401(k) contributions from disposable income,
as it did for retirement loan repayments in 1322(f).”7 They find that the phrase “such amount” in
§ 541(b)(7)(A) applies only to pre-petition, not post-petition, retirement contributions, and that
“nowhere in chapter 13 are voluntary retirement contributions excluded from disposable
income.”8 This interpretation of section 541(b)(7) is consistent with pre-BAPCPA case law.9

Courts distinguishing this interpretation have argued that it does not give any meaning to the
hanging paragraph; in fact, other than in a brief footnote, the Prigge court does not mention
section 541(b)(7) at all.10 Distinguishing cases have found that the Prigge interpretation places
an “unwarranted emphasis” on the placement of § 541(b)(7) outside of Chapter 13.11 They argue

5 In re Prigge, 441 B.R. 667 (Bankr. D. Mont. 2010). In re Davis, 960 F.3d 346 (6th Cir. 2020). In re Seafort, 437
6 In re Prigge, 441 B.R. at 677.
7 Id.
8 Id. at 708. See also In re Parks, 475 B.R. 703, 708 (Bankr. App. 9th Cir. 2012); In re McCullers, 451 B.R. 498,
503–04 (Bankr. N.D. Cal. 2011).
9 See In re Anderson, 21 F.3d 55, 357 (9th Cir. 1994).
that “because § 541(b)(7) expressly excludes voluntary retirement contributions from the bankruptcy estate, there is no need for [section 13] to contain a duplicative provision excepting such contributions.”

B. The Davis/Seafort Approach

A more moderate interpretation is found in Davis, in which the United States Court of Appeals for the Sixth Circuit read § 541(b)(7) to exclude monthly 401(k) contributions prior to bankruptcy from a debtor’s disposable income. Courts that abide by this view find that § 541(b)(7) excludes from disposable income “a debtor’s post-petition monthly 401(k) contributions so long as those contributions were regularly withheld from the debtor’s wages prior to her bankruptcy.” The Davis interpretation highlights the textual ambiguity of the hanging paragraph but ultimately determines, unlike the court in Prigge, that Congress intended to change existing law with the enactment of BAPCPA; the exclusion of retirement contributions from a debtor’s disposable income is what gives the hanging paragraph its meaning.

Other courts have put a twist on the Davis interpretation, acknowledging that continuing 401(k) contributions by a chapter 13 debtor is allowable, but that a debtor cannot increase or begin for the first time to make those payments in his chapter 13 plan. The court in Seafort explains that § 541 defines “property of the estate” at the commencement of the bankruptcy case; thus, “only 401(k) contributions [that] are being made at the commencement of the case are excluded from the property of the estate under § 541(b)(7).” Because the property of the estate includes “earnings from services performed by the debtor after the commencement of the case,”

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13 In re Davis, 960 F.3d 355.
14 Id. at 357.
15 Id. at 354.
16 In re Seafort, 437 B.R. 209.
17 Id.
without an exclusion like the one found in the hanging paragraph, a debtor “was not allowed to
divert income from creditors by beginning to make 401(k) contributions.”18 Like the Davis
approach, this interpretation rationalizes its leniency by explaining that Congress “intended to
strike a balance between protecting debtors’ ability to save for their retirement and requiring that
debtors pay their creditors the maximum amount they can afford to pay.”19 Critics of this
approach find that, like the Prigge approach, this interpretation “misplaces the focus of its
analysis on § 541(b)(7)’s location outside of Chapter 13,” which leads courts following this
approach to conclude that the hanging paragraph only applies to pre-petition retirement
contributions.20

C. The Johnson Approach

The most expansive approach is the Johnson view, which finds that the hanging paragraph
excludes all 401(k) contributions, so long as the debtor’s chapter 13 payment plan is made in
good faith. Courts that abide by this view emphasize that the hanging paragraph “place[s]
retirement contributions outside the purview of a chapter 13 plan,” and thus debtors may fund
401(k) plans “in good faith, so long as their contributions do not exceed the limits legally
permitted by their 401(k) plans.”21 Contribution to employee benefit plans (EPBs) or 401(k)
plans do not constitute disposable income so long as the debtor’s contributions are within the
legal limits permitted by the EBP.22 Unlike the Prigge and Davis/Seafort approaches, the
Johnson view finds that § 1306 incorporates the exclusions found in § 541(b)(7), and that
voluntary retirement contributions are part of these exclusions from the § 1325(b) disposable

18 Id. at 210.
19 Id.
21 In re Johnson, 346 B.R. 263.
22 Id.
income calculation. This view is the most expansive because it allows debtors not only to contribute to their retirement plans through their chapter 13 repayment plans, but to increase the amount of their contributions so long as they are made in good faith and within the legal limit of their 401(k) plans.

II. Post-Petition Retirement Contributions

The hanging paragraph only discusses disposable income, not whether a 401(k) contribution is a factor in the debtor’s projected disposable income or whether a debtor can make 401(k) contributions during the three-to-five-year life of its chapter 13 plan.

A majority of courts follow the Johnson view in allowing post-petition retirement contributions, finding that “because debtors are not required to contribute income withheld for qualified retirement contributions to their chapter 13 plans under § 541(b)(7), they may commence or increase those contributions postpetition.” This is largely due to the finding that § 541(b)(7) does not distinguish between pre-petition and post-petition retirement contributions; it simply excludes retirement contributions in general from disposable income. Further, exclusion from the property of the estate refers to “any amount withheld,” which again does not distinguish between pre- and post-petition income withheld for 401(k) contributions. The court in Vanlandingham finds that “nothing in either § 541(b)(7) or § 1325(b) expressly conditions these exclusions on the debtor having begun to contribute before filing,” and that “limiting the effect of the § 541(b)(7) exclusion to prepetition contributions or conditioning the exclusion of

23 See In re Drapeau, 485 B.R. at 36–37.
25 Id. at 635.
26 Id. at 635.
postpetition contributions upon the existence of prepetition contributions would effectively nullify the exclusion in chapter 13 cases.”

A minority of courts have found that § 541(b)(7) does not permit post-petition voluntary retirement contributions regardless of whether the debtor was making pre-petition contributions. More moderately, courts that have adopted the Davis/Seafort view have allowed debtors to contribute to their retirement funds after filing for bankruptcy, but only in the same amount which they were contributing pre-petition.

III. Good Faith Requirement

Section 1325(a)(3) of the Code states that “except as provided in subsection (b), the court shall confirm a plan if the plan has been proposed in good faith and not by any means forbidden by law.” While the term “good faith” is not defined in the Code, courts may consider a number of factors in its analysis, including the percentage of repayment creditors will receive, the financial situation of the debtor, the employment history of the debtor, and the nature of the debtor’s pre-petition conduct giving rise to the case. This is known as the “totality of circumstances test.” While the Johnson court ignores the debtor’s retirement plan contributions in its good faith analysis, other courts that follow the Johnson approach consider a debtor’s retirement plan contributions in its analysis of the debtor’s financial situation at the time of the petition and of the percentage of his proposed plan’s repayment to unsecured creditors. The Court in Edmunds explains that nothing in Congress’ legislative history indicates that it intended

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27 Id.
28 In re Seafort, 669 F.3d 662, 677 (6th Cir. 2012).
29 In re Seafort, 437 B.R. at 209.
31 See In re Johnson, 346 B.R. at 261; In re Kitchens, 702 F.2d 885, 888–89 (11th Cir. 1983).
to change the court’s practice of considering a debtor’s 401(k) contributions as part of the debtor’s financial situation in its good faith analysis.\textsuperscript{33}

The court in \textit{Miners v. Johns} elaborates on the consideration of post-petition retirement contributions in the good faith analysis, stating that the good faith inquiry “requires the Bankruptcy Court to evaluate a proposed plan in its entirety, which would include a debtor’s retirement contributions as set forth within the plan.”\textsuperscript{34} While the court must ensure that the debtor’s contributions are within the legal limits established by the IRS, it must also certify that the debtor is not attempting to “abuse the spirit of the Bankruptcy Code through his retirement contributions.”\textsuperscript{35} However, a debtor’s payment plan must not be denied for bad faith solely because his 401(k) contributions resulted in the reduced availability of funds to repay creditors.\textsuperscript{36} The court must consider all relevant factors under the totality of circumstances test.

\textbf{Conclusion}

Ultimately, depending on which approach the court takes, a debtor might be allowed to continue and increase his retirement fund contributions for the duration of his chapter 13 payment plan, or he might not be permitted to contribute to his retirement plan at all. Regardless of a court’s approach to the permissibility of post-petition retirement contributions, the chapter 13 payment plan must be proposed in good faith, whether or not the debtor hopes to contribute to a retirement plan.

\textsuperscript{33} \textit{Id.} at 648–49.
\textsuperscript{35} \textit{Id.}
\textsuperscript{36} \textit{Id.}