

## 401(K) LOAN REPAYMENTS PROBLEMATIC IN CHAPTER 7 BANKRUPTCY FILING

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In this challenging economy, more employees may be requesting loans from 401(k) plans to make ends meet or to pay off outstanding loans that contain less favorable terms. If a 401(k) plan offers loans, then the plan also is required to have a written loan procedure in place, stating the limits of a loan amount and possibly a limit on the number of outstanding loans a participant may take. Such a loan procedure should always set out the loan repayment process.

Some employers who sponsor 401(k) plans have also had to learn basic information about bankruptcy law and how an outstanding plan loan figures into the bankruptcy process. May a plan participant in bankruptcy continue to repay the plan loan? Must the participant continue to pay? What if the participant cannot pay?

In an issue of first impression, the Ninth Circuit Court of Appeals, which sits in California, has held that a debtor's repayment of a 401(k) loan was not the repayment of a "secured debt," and could not be deducted as a "necessary expense" for purposes of the Chapter 7 "means test" under the federal bankruptcy law. As a result, the debtor's Chapter 7 bankruptcy petition was dismissed.

In the case, titled [In re Scott Lee Egebjerg](#), 574 F.3d 1045 (9th cir. 2009), Mr. Egebjerg had taken a loan from his 401(k) plan in 2004. As set out in the plan's loan procedure, the 401(k) plan automatically deducted \$734 from his paycheck each month to repay the loan, which was scheduled to be repaid in full by September, 2008.

On December 31, 2006, Egebjerg filed a voluntary Chapter 7 bankruptcy petition. Under a Chapter 7 filing, a debtor requests that his remaining assets be distributed among his creditors,

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thereby discharging the debtor from any further obligation to those creditors. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (“BAPCPA”) created a presumption that the granting of Chapter 7 relief would be an abuse of the Bankruptcy Code if the debtor’s current monthly income, after subtracting (a) payments on secured debt, (b) the actual monthly expenses for “other necessary expenses” as defined by the IRS and (c) monthly expense amounts specified under stated bankruptcy standards, is more than an amount provided by a specified formula. This is referred to as the “means test.”

In this case, Egebjerg deducted the 401(k) loan repayment as one of his necessary expenses in his bankruptcy filing, leaving him with a monthly disposable income of just over \$15. The U.S. Trustee in the bankruptcy matter disagreed with this characterization of the 401(k) loan, however, and argued that Egebjerg’s Chapter 7 filing should be dismissed as a result, calculating that he had greater available assets than the “means test” mandated. The bankruptcy court actually agreed with Egebjerg on the loan characterization, but ruled against him for other reasons. Egebjerg appealed to the Ninth Circuit Court of Appeals in California.

### *Secured Debt*

For purposes of the means test, the debtor may deduct the average monthly payments on account of secured debt. The Ninth Circuit pointed out that, under the Bankruptcy Code, Egebjerg’s 401(k) loan was a debt only if the plan administrator had a claim for repayment. The Ninth Circuit, disagreeing with the bankruptcy court - and joining the majority of courts on this issue - held that a debtor’s obligation to repay a 401(k) loan is not a “debt” for purposes of the Bankruptcy Code. Instead, Egebjerg essentially had borrowed his own money. Had he failed to repay the outstanding loan balance, the plan administrator would not be able to sue to recover the amount. Instead, the plan would have deemed the outstanding loan balance to be a distribution from Egebjerg’s account. Although the deemed distribution would have had income tax consequences to Egebjerg, it did not create a debtor-creditor relationship. Thus, the Ninth Circuit held that 401(k) loan repayments could not be deducted from current monthly income as payments of “secured debt” in applying the means test.

### *Other necessary expenses*

Under a separate part of the means test, debtors may deduct the actual monthly expenses for the categories specified as “other necessary expenses” issued by IRS. Examples of a “necessary

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expense” include child care, education, and court-ordered payments such as alimony and child support. Here, the court concluded that Egebjerg’s repayment of his 401(k) loan also did not qualify as a “necessary expense.” The Ninth Circuit said that 401(k) repayments are not of the same kind and character as those expenses listed by the IRS, which carefully limits necessary expenses to such situations as where the debtor had no alternative to paying the expense, or where the failure to pay the expense would result in the debtor’s loss of employment.

### *Special circumstances*

Finally, the Ninth Circuit agreed with the majority of courts that the mere obligation to repay a 401(k) loan is not itself a “special circumstance” that can rebut the presumption of abuse of the Bankruptcy Code. It is true that there might be situations in which a debtor’s underlying reason for taking out a 401(k) loan could be a special circumstance. Here, though, the Ninth Circuit noted that Egebjerg’s only explanation for the loan was to use the proceeds to pay off bills. If those bills - “unsecured consumer obligations” in bankruptcy parlance - did not represent a special circumstance in the first place, the court said, it would seem “problematic” to find special circumstances for the 401(k) loan that merely replaced that debt.

Thus, because Egebjerg did not rebut the presumption of abuse that arose from the application of the Bankruptcy Code’s means test, the Ninth Circuit held that the bankruptcy court had properly dismissed Egebjerg’s Chapter 7 petition.

What can we learn from this? An important note is that the New Hampshire’s federal district bankruptcy court is in line with the 9th Circuit’s opinion, as set out in In re Turner, 376 B.R. 370 (Bankr. N.H. 2007); the Egebjerg case, then, reflects New Hampshire rulings on the treatment of 401(k) loans in Chapter 7 bankruptcies.

Next, a couple of housekeeping tips: Confirm that your plan has a written loan procedure. Confirm that the procedure actually states what you intend. Are there dollar limits to permitted loans? Does the plan limit the number of loans a participant can have outstanding at one time? Do you administer plan loans in accordance with the procedure?

If a participant defaults on a loan, whether because of bankruptcy or otherwise, what is the plan’s process for resolving repayment? Remember, there are income tax consequences to defaulting on a 401(k) loan. The defaulted amount is taken into the participant’s income in the year of default, with income taxation and possible early withdrawal penalties assessed.



As always, from the employer's perspective, it is incumbent to administer the plan as it is written. Failure to properly manage 401(k) loans - whether due to error or an act of intended good will - can be deemed a plan operational failure, requiring a filing with the IRS and/or the DOL to set things right.

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