More Fact than Fiction: The Supreme Court Interprets the Means Test

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In 2005, Congress enacted the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) to correct perceived abuses of the bankruptcy system.[2] Some BAPCPA supporters felt that consumer bankruptcy was no longer a last resort providing a fresh start for individuals in severe financial distress, but a financial device providing a head start for individuals who could repay some or all of their debts but preferred not to.[3] As part of BAPCPA, Congress enacted the "means test" to address this perceived abuse, utilizing a formula with specified income and expense parameters and mandating amounts for calculating above median income debtors' monthly disposable income.[4]

Three primary issues soon emerged: (1) in chapter 13, whether calculation of projected disposable income under the means test requires a mechanical approach; (2) whether all debtors who possess a vehicle are eligible to deduct from their income, in addition to maintenance and operating costs, a monthly expense amount for vehicle acquisition costs regardless of loan or lease payments; and (3) whether debtors who have surrendered collateral in connection with a loan, and therefore have no obligation to continue making payments on that loan, may deduct from their monthly disposable income the payments associated with the loan.

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[2] *Milavetz, Gallop & Milavetz, P.A. v. United States*, 130 S. Ct. 1324, 1329 (2010).

[3] H.R. Rep. No. 31, 109th Cong., 1st Sess. Pt. 1, at 2 (2005).

[4] 11 U.S.C. §707(b)(2)(A).

The first issue was resolved by the United States Supreme Court in *Hamilton v. Lanning*.[5] In January, the Supreme Court decided the second issue in *Ransom v. FIA Card Services*.[6] This article examines how the means test is to be applied in accordance with *Ransom* and *Lanning*, and submits that the third issue has already been decided by *Ransom* and *Lanning* in the chapter 13 context. Early indications are that those decisions are guiding bankruptcy courts on this issue in the chapter 7 context as well.

Information about Future Income and Expenses is Relevant

In a chapter 13 case, a bankruptcy court may confirm a repayment plan only if the debtor commits either to pay unsecured creditors in full or to apply all of the debtor's "projected disposable income" during the plan period to repaying those creditors.[7] The means test is utilized in chapter 13 to calculate the amount of disposable income a debtor must devote to creditor repayment pursuant to a court-approved plan that typically lasts from three to five years.[8] "The statute defines 'disposable income' as 'current monthly income' less 'amounts reasonably necessary to be expended' for 'maintenance or support,' business expenditures, and certain charitable contributions."[9] For debtors whose income exceeds the median for their state, "the means test identifies which expenses qualify as 'amounts reasonably necessary to be expended.'"[10]

A significant issue in the chapter 13 plan confirmation process was whether the means test's disposable income calculation controlled for all purposes, or whether a bankruptcy court

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5 130 S. Ct. 2464 (2010) [hereinafter *Lanning*].

6 131 S. Ct. 716 (2011) [hereinafter *Ransom*].

7 11 U.S.C. §1325(b).

8 11 U.S.C. §§1325(b)(1)(B) and (b)(4).

9 *Ransom*, 131 S. Ct. at 721, *quoting* §1325(b)(2)(A)(i) and (ii).

could consider relevant information about a debtor's future income or expenses that varied from the income or expenses utilized in the means test. In *Lanning*, the debtor proposed a repayment plan based on her income at the time of plan confirmation. However, the income used in calculating her means test was greater because it included severance from a previous employer.[11] The chapter 13 trustee argued that the only method of projecting disposable income under her plan was to multiply disposable income under the means test by the total number of months in the plan.[12] The Supreme Court rejected the argument that the means test had to be applied rigidly and controlled the disposable income calculation without exception.[13]

The *Lanning* Court noted that in most chapter 13 cases the financial information used in calculating the means test remains constant and the means test controls.[14] The Court recognized, however, that in some cases a debtor's financial circumstances have changed significantly and financial information used in calculating the means test no longer strictly applies.[15] To determine the debtor's projected disposable income when the means test calculation of disposable income is a demonstrably unreliable predictor of the debtor's financial condition during the chapter 13 plan period, a court should account for "known or virtually certain information about the debtor's future income or expenses."[16] Hence, *Lanning* informs us that despite adoption of a uniform formula and many standardized expense amounts, the means test is not to be inflexibly applied. Instead, the factual circumstances of each individual debtor are

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[10] *Ransom*, 131 S. Ct. at 721-722.

[11] *Lanning*, 130 S. Ct. at 2470.

[12] *Id.*

[13] *Id.* at 2478.

[14] *Id.* at 2474.

[15] *Id.*

[16] *Id.* at 2478.

legally relevant.

Vehicle Expense Deductions Must Correspond with Financial Circumstances

Under the means test, a debtor whose income is above the state median calculates monthly disposable income by deducting "allowances for defined living expenses, as well as for secured and priority debt."[17] At issue in *Ransom* was the following expense-related provision of the means test:

> The debtor's monthly expenses shall be the debtor's applicable monthly expense amounts specified under the National Standards and Local Standards ... issued by the Internal Revenue Service for the area in which the debtor resides. [18]

The National and Local Standards are expense categories and amounts[19] used by the Internal Revenue Service (IRS) to calculate a taxpayer's financial capacity to make installment payments on past due income taxes.[20] The transportation expense category in the IRS Local Standards is divided into two subcategories: (1) Vehicle "Ownership Costs"[21] and (2) Vehicle "Operating Costs." Vehicle Operating Costs cover the costs associated with owning and maintaining a vehicle including "vehicle insurance, ... maintenance, fuel, state and local

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[17] *Ransom*, 131 S. Ct. at 722, *citing* §§707(b)(2)(A)(ii) – (iv).

[18] 11 U.S.C. §707(b)(2)(A)(ii)(I).

[19] *See* IRS Financial Analysis Handbook, available at http://www.irs.gov/irm/part5/irm_05-015-001.html#d0e1012 (visited Jan. 30, 2011) (hereinafter Handbook).

[20] 26 U.S.C. §7122(d)(2).

[21] The term Ownership Costs is a misnomer. By the IRS' own account, the expense category is more accurately described as one for loan or lease payments (*i.e.*, vehicle acquisition costs). *See* Handbook. Moreover, although located within the IRS Local Standards, the amount specified for Vehicle Ownership Costs is identical for vehicles in all areas of the country. *See* IRS Local Standards: Transportation, available at http://www.irs.gov/businesses/small/article/0,,id=104623,00.html (visited Jan. 30, 2011) (hereinafter Standards).

registration, required inspection, parking fees, tolls, and driver's license."[22] Vehicle Ownership Costs represent "nationwide figures for monthly loan or lease payments ... based on the five-year average of new and used car financing data compiled by the Federal Reserve Board."[23] The *Ransom* Court was called upon to interpret how the specified IRS Local Standard for Vehicle Ownership Costs should be applied under bankruptcy's means test.

The debtor in *Ransom* owned a vehicle outright and consequently made no monthly loan or lease payment.[24] Nonetheless, he claimed entitlement to a monthly expense deduction of $471[25] under the IRS Local Standard for Vehicle Ownership Costs.[26] A creditor objected to plan confirmation because the plan did not provide that all of Mr. Ransom's disposable income would be paid to unsecured creditors.[27] In particular, the creditor asserted that Mr. Ransom was not eligible for the Vehicle Ownership Costs deduction because he did not make monthly installment payments to acquire his vehicle.[28] The creditor noted that by claiming the Vehicle Ownership Costs deduction, Mr. Ransom sought to shield approximately $28,000 from unsecured creditors over the 60-month life of his plan ($471 per month x 60 months).[29]

The Supreme Court rejected Mr. Ransom's position, holding that a debtor under chapter 13 or chapter 7 who does not make vehicle loan or lease payments may not take a vehicle

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22 *See* Standards.

23 *Ransom*, 131 S. Ct. at 722 (quoting the Standards).

24 *Id.* at 723.

25 The debtor in *Ransom* filed his bankruptcy petition in July 2006. Since March 1, 2010, the Local Standard for Vehicle Ownership Costs has been $496 per month, per vehicle for up to two vehicles.

26 *Ransom*, 131 S. Ct. at 723.

27 *Id.*

28 *Id.*

29 *Id.*

ownership expense deduction under the means test.[30] To reach this result, the Supreme Court focused on the text, context and purpose of § 707(b)(2)(A)(ii)(I).[31] The *Ransom* Court noted that the key word in § 707(b)(2)(A)(ii)(I) is "applicable," and that "applicable" means "appropriate, relevant, suitable or fit."[32] The Court concluded that "rather than authorizing all debtors to take deductions in all listed categories, Congress established a filter" so that a "[d]ebtor may claim a deduction from a National or Local Standard . . . only if that deduction is appropriate for him."[33]

By using the word "applicable," Congress limited eligibility for expenses under the Local Standards to debtors for whom the expenses actually *apply*.[34] The *Ransom* Court found it "insightful and persuasive (albeit not controlling)" to consult interpretive guidance materials published by the IRS, the source of the expense Standards used in the means test.[35] The IRS guidance reinforced the *Ransom* Court's "conclusion that, under the statute, a debtor seeking to claim this deduction must make some loan or lease payments."[36] Therefore, debtors are not eligible for the Vehicle Ownership Costs deduction under the IRS Local Standards, and the deduction does not apply to them, unless their disposable income will be reduced by a monthly loan or lease payment on their vehicle.

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30 *Id.* at 721, 730.

31 *Id.*

32 *Id.* at 724.

33 *Id.*

34 *Id.* at 727.

35 *Id.* at n.7.

36 *Id.* at 726.

Interpretation of the Bankruptcy Code begins with the statutory text.[37] In *Ransom* and *Lanning*, a clear majority[38] of the Supreme Court explained, however, that statutory text should not be read in a vacuum. In the Supreme Court's first opinion authored by Justice Elena Kagan, the *Ransom* Court noted that the statutory text must be given its meaning by consulting statutory context and purpose as well.[39]

In reference to the statutory context, the *Ransom* Court stated "[b]ecause Congress intended the means test to approximate the debtor's reasonable expenditures on essential items, a debtor should be required to qualify for a deduction by actually incurring an expense in the relevant category."[40] Regarding the statutory purpose, *Ransom* is best viewed as a logical offshoot of *Lanning*. Just as *Lanning* expressed a concern that adopting a mechanical application of the means test would "deny creditors payments that the debtor could easily make,"[41] *Ransom* expresses a concern that bankruptcy's means test is meant to ensure that debtors repay creditors the maximum they can afford.[42]

Extension of *Ransom*/*Lanning* to Surrendered Property

In light of *Ransom* and *Lanning*, the issue relating to expense deductions for surrendered collateral in calculating monthly disposable income may also be resolved, at least in chapter 13 cases. The question is whether a debtor may deduct payment obligations to creditors with claims secured by collateral the debtor has surrendered or intends to surrender. As determined in *Ransom*, because Congress intended the means test to approximate the debtor's reasonable

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37 *Lanning*, 130 S. Ct. at 2471.

38 Justice Antonin Scalia is the only Justice who dissented in *Ransom* and *Lanning*.

39 *Ransom*, 131 S. Ct. at 721, 730.

40 *Id.* at 725.

41 *Lanning*, 130 S. Ct. at 2476.

expenditures on essential items, a debtor should be required to qualify for a deduction by actually incurring an expense in the relevant category.[43] Indeed, *Ransom* stated that "[e]xpenses that are wholly fictional are not easily thought of as reasonably necessary."[44] Under *Lanning*, a "court may account for changes in the debtor's income or expenses that are known or virtually certain at the time of confirmation."[45] Thus, the Supreme Court has clearly indicated, if not formally instructed, that only debtors who are making monthly payments in an expense category should be allowed an expense deduction in that category.

Two post-*Lanning* appellate decisions have been issued that make projected disposable income adjustments in chapter 13 cases because the debtor would not make monthly payments after surrendering the underlying property.[46] In *Darrohn v. Hildebrand*, the Sixth Circuit Court of Appeals reversed a bankruptcy court order confirming the debtors' proposed chapter 13 repayment plan. The Sixth Circuit held that the debtors' projected disposable income calculation should include changes to both income and expenses that are known or virtually certain at the time of confirmation, and that the debtors' claimed deductions for surrendered mortgage payments clashed with limiting payments to reasonably necessary expenses.[47]

In *Zeman v. Liehr*,[48] the bankruptcy appellate panel for the Tenth Circuit reversed a bankruptcy court order confirming the debtors' proposed chapter 13 plan. As in *Darrohn*, the plan relied upon a projected disposable income figure that did not accurately reflect the debtors'

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42 *Ransom*, 131 S. Ct. at 721, 725.

43 *Id.* at 725.

44 *Id.* at 727.

45 *Lanning*, 130 S. Ct. at 2478.

46 *Darrohn v. Hildebrand*, 615 F.3d 470 (6th Cir. 2010); *Zeman v. Liehr*, 439 B.R. 179 (B.A.P. 10th Cir. 2010).

47 *Id.* at 476.

48 439 B.R. at 179.

expenses at the time of confirmation because the debtors intended to surrender collateral associated with claimed secured debt expenses.[49] The appellate panel relied on *Lanning* and *Darrohn* to conclude that because the debtors' secured debt payment obligation was "disappearing . . . the change in circumstances should inure to the benefit of the unsecured creditors, not the [debtors]."[50]

The result in chapter 7 cases should be no different. Regardless of whether the debtor is allowed under the means test to take an expense deduction for payments associated with property being surrendered,[51] section 707(b)(3)(B) requires a bankruptcy court to consider a debtor's total financial circumstances, including future income and expense information. Consequently, "[i]ncome made available to debtors as a result of surrendering encumbered assets are [sic] properly considered as part of a totality of circumstances analysis under § 707(b)(3)(B*).*"[52]

Conclusion

The decisions in *Ransom* and *Lanning* ensure that the means test will serve its purpose in consumer bankruptcy cases. By viewing the static means test calculations through the prism of current circumstance, the Supreme Court has effectuated the overarching statutory purpose of requiring debtors to devote maximum future income to creditor repayment. By balancing the bright-line means test that produces greater uniformity in the consumer bankruptcy process with case-specific flexibility to reasonably adjust for evidence of changed financial circumstances, the Supreme Court has definitively answered two key issues under the means test, and provided

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[49] *Id.* at 181.

[50] *Id.* at 187.

[51] Only one circuit court has considered the question. It allowed the expense deduction. *See Morse v. Rudler (In re Rudler)*, 576 F.3d 37 (1st Cir. 2009); *but see In re Burden*, 380 B.R. 194 (Bankr. W.D. Mo. 2007) (collecting decisions on each side and concluding opposite of *Rudler).*

[52] *In re Perelman*, 419 B.R. 168, 178 (Bankr. E.D.N.Y. 2009).

important insight on a third.