Chapter 7 and Chapter 13 Case Law Developments Following Recent Supreme Court and Circuit Opinions

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In the Aftermath of *Stern, Ransom, Lanning and Schwab*:

The application of the U.S. Supreme Court decisions in the lower courts

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I. Introduction

Over two years have passed since the United States Supreme Court issued several important decisions interpreting the Bankruptcy Code: *Stern v. Marshall*[1], *Hamilton v. Lanning*[2], *Ransom v. FIA Card Services*[3], and *Schwab v. Reilly*[4]. As discussed below, since these rulings, lower courts have relied on these opinions to help them understand the power of bankruptcy judges, the application of the Means Test and the ability of debtors to claim exemptions. As you will see below, as with many higher court rulings, many questions remain unanswered.

II. *Stern v. Marshall*

Since BAPCPA was passed by Congress, nothing has caused greater controversy and concern in the bankruptcy world than the U.S. Supreme Court's ruling in *Stern v. Marshall.* In *Stern,* the Court held that the bankruptcy judge, as an Article I judge, did not have constitutional authority to enter a final judgment on the Debtor's state law counterclaim based on tortious interference. Even though this type of counterclaim is defined as a "core proceeding" pursuant to 28 U.S.C. § 158, the Bankruptcy Court exceeded its authority as a non-Article III judge by entering a final judgment because the determination of the counterclaim was not dependent upon determination of the allowance of the claimant's proof of claim in the bankruptcy case.

Prior to *Stern*, bankruptcy judges entered final orders and judgments (subject to appeal) in all matters known as core proceedings pursuant to 28 U.S.C. § 158. Bankruptcy judges are prohibited from entering final orders and judgments in "non-core" proceedings related to a bankruptcy case. Instead, in noncore proceedings, bankruptcy judges submit proposed findings fact and conclusions of law to the district court, which then enters a final judgment on the matter after *de novo* review.

The ruling in *Stern* has required bankruptcy courts to redefine their authority to enter final orders and judgments. The following is a discussion of how lower courts have applied Stern.

A. Avoidance Actions

Should the ruling in *Stern* be construed narrowly? Or does *Stern* have implications for other defined core proceedings? Bankruptcy courts and District courts have struggled with this issue particularly in the context of trustee avoidance actions under 11 U.S.C. §§ 548 and 544(b). There is no clear consensus on the issue.

Some Courts have held that application of *Stern* should be expressly limited based on the language of the opinion itself: Justice Roberts stated that the *Stern* holding was "narrow" and would have limited "practical consequences." Based on this, the bankruptcy court held in *in re*

[1] 131 S. Ct. 2594, 180 L. Ed. 2d 475 (2011).

[2] 130 S. Ct. 2464, 177 L. Ed. 2d 23 (2010).

[3] 131 S. Ct. 716, 178 L. Ed. 2d 603 (2011).

[4] 130 S. Ct. 2652, 177 L. Ed. 2d 234 (2010).

American Business Financial Services[5] that it did have constitutional authority to enter final judgments on avoidance claims under the Bankruptcy Code and state law fraudulent avoidance claims. In doing so, the Court stated that *Stern* did not apply because "the action at issue stems from the bankruptcy itself." In this case, the court reasoned that because the claims arose postpetition and were matters "integral to the bankruptcy itself," the bankruptcy court retained jurisdiction to hear the adversary proceeding.

Likewise, in considering the matter in *Gugino v. Canyon County* (*in re Bujak)*[6], the Bankruptcy Court criticized those that see *Stern* as creating a "jurisdictional Armageddon" and refused to extend the holding in *Stern* to different facts. As a result, the Court held that it had constitutional authority to ultimately determine fraudulent conveyance claims brought by the trustee under § 548(a) and 544(b) because they did not involve state law claims and arose in or under the bankruptcy proceeding.

On the other hand, not all courts see the ruling in *Stern* as narrow. The Bankruptcy Court in *Heller Ehrman v. Arnold & Porter (In re Heller Ehrman LLP),*[7]which ruled that it did have constitutional authority to enter final judgments on the fraudulent conveyances under 11 U.S.C. §§ 544(b) and 548 because the claims arose from bankruptcy law itself, was overruled by the District Court. The District Court stated that the bankruptcy court did not have authority to enter a final judgment on these claims because the same reasoning applied by the Supreme Court in *Stern* regarding private rights and the right to Article III determination applied to fraudulent conveyance claims[8].

In *Kirschner v. Agoglia (In re Refco, Inc.)*[9], the District Court also held that the Bankruptcy Court did not have constitutional authority to enter a final judgment on a state law fraudulent conveyance claim. The Court reasoned that because the fraudulent conveyance action would not necessarily be resolved in ruling on the creditor's proof of claim and did not involve a "public right" arising from a federal regulatory scheme, it was the same type of "private right" claim that, under the ruling in *Stern,* must be determined by an Article III Court.

B. Core unconstitutional proceedings

According to some courts, *Stern* created a third category of bankruptcy proceedings: matters which are core matters pursuant to the statute but which the court does not have constitutional authority to hear, now known as "unconstitutional core" proceedings. How should bankruptcy courts proceed with matters that they determine they lack constitutional authority to hear?

In *Reed v. Linehan, (In re Soporex, Inc.)*, Adv. No. 11-3306-BJH, 2011 Bankr. LEXIS 4695 (Bankr. N.D. Tex. Nov. 28, 2011), the Bankruptcy Court determined that it lacked constitutional authority to enter a final judgment on a trustee's state law tort claims against

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[5] *In re American Business Financial Services*, 457 B.R. 314 (Bankr. D. Del. 2011).

[6] *In re Bujak*, Adv. No. 11-6038, 2011 Bankr. LEXIS 4291, (Bankr. D. Idaho 2011).

[7] *In re Heller Ehrman, LLP*., Adv. No. 01-32023, 2011 Bankr. LEXIS 3764 (Bankr. N.D. Cal. 2011).

[8] *Heller Ehrman*, 2011 U.S. Dist. LEXIS 143223

[9] *In re Refco, Inc*., 2012 U.S. Dist. LEXIS 65148 (S.D. N.Y. 2012).

officers of a corporation even though these matters are explicitly defined as core proceedings under the statute. The Court, however, decided that it *did* have the authority to issue proposed findings of fact and conclusions of law to the district court just as it could in "noncore" proceedings, even though there is no direct statutory authority for issuing proposed findings and conclusions in defined core proceedings.

At least one bankruptcy court found that it did not have authority to issue proposed findings of facts and conclusions of law. The Court in *in re Blixseth*[10] found that once it determined that it did not have constitutional authority under Stern to enter a final judgment in a fraudulent conveyance claim, it could not even issue proposed findings of facts and conclusions of law because there was no express statutory authority for it to do so. The District Court, however, disagreed and ruled that the bankruptcy court could issue proposed findings of facts and conclusions of law[11]. In doing so, the Court reasoned that it would make no sense for a bankruptcy court to be able to issue proposed findings in a non-core matter, as expressly authorized in 28 U.S.C. § 157(c)(1), but not in core proceedings, which are more important to a bankruptcy case.

III. *Hamilton v. Lanning* and *Ransom v. FIA Card Services*

Lanning and *Ransom* are hallmarks in consumer bankruptcy practice because they were the first and only Supreme Court decisions to interpret the Means Test implemented by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. Both *Lanning* and *Ransom* deal with the calculation of projected disposable income to be paid to unsecured creditors under Chapter 13 pursuant to 11 U.S.C. § 1325(b)(1)(B). *Lanning* dealt with the income calculation of projected disposable income, while *Ransom* dealt with the expense side.

If you recall, the debtor in *Lanning* received a one-time buyout from her employer within the six months prior to filing that caused her current monthly income to be greater than her actual income on Schedule I, such that she could not afford to pay the disposable income to her unsecured creditors as calculated on Official Form 22C. In *Lanning*, the Supreme Court held that when calculating the projected disposable income of a debtor, the court may consider changes in the debtor's income or expenses known at the time of confirmation. The Court expressly rejected a mechanical formula for determining disposable income and instead embraced the 'forward-looking" approach.

The debtor in *Ransom* attempted to deduct a vehicle ownership expense for a vehicle on official Form 22C (represented by lines 28 and 29) even though he did not have a lease or loan payment. The Supreme Court held that in calculating disposable income on the Means Test, a debtor cannot deduct expenses that he does not actually incur. An expense not incurred is not an "applicable" expense under the language of § 707(b)(2)(A)(ii)(I), which is the code section that specifies that a debtor's monthly expenses of certain categories for purposes of the Means Test are determined pursuant to the IRS National and Local Standards.

[10] *Blixseth v. Blixseth*, 2011 Bankr. LEXIS 2953 (Bankr. D. Mont. 2011).

[11] *Blixseth v. Brown*, 2012 U.S. Dist. LEXIS 28318 (D. Mont. 2012).

Since the *Lanning* and *Ransom* rulings, bankruptcy courts, district courts, and circuit courts have relied on these rulings to resolve many other issues arising from the Means Test in both Chapter 7 and 13 cases.

A. Surrendered collateral

Courts have relied upon both Lanning and Ransom to rule that a debtor cannot deduct expenses on the Means test for property that they intend to surrender. In *Morris v. Quigley*[12], the Fourth Circuit Court of Appeals recently reversed a district court ruling that affirmed a bankruptcy court ruling that a Chapter 13 debtor could claim the monthly payments for two ATVs and a truck that the debtor intended to surrender on the Means Test. The Court relied on the proposition in *Lanning* that a court may consider circumstances known at the time of confirmation when calculating projected disposable income. Because the debtor did not intend to make the secured debt payments, she could not claim the expenses for them. The Court rejected the proposition that *Lanning* only applies to changes in income and stated that changes in expenses can also be considered.

In *Darrohn v. Hildebrand*[13], the Sixth Circuit Court of Appeals also relied on *Lanning* to reverse a Bankruptcy Court's order confirming a Chapter 13 plan where debtors deducted mortgage payments for a house that they intended to surrender.

Courts have stated that *Lanning* and *Ransom,* when considered together, stand for the proposition that the Means test should not be construed as a strict formula even in the context of Chapter 7. For example, the Court in *in re Sterrenberg*[14] held that a debtor in Chapter 7 could not deduct "fictional secured expenses" for a car and home when she intended to surrender them. In doing so the court stated that the best interpretation of the phrase "scheduled as contractually due" takes into account the debtor's intention to surrender and no longer pay for the collateral.

Nevertheless, some courts have declined to apply the reasoning of *Lanning* and *Ransom* to Chapter 7 cases because the purposes of the Means Test in Chapter 7 and Chapter 13 differ. The Bankruptcy Court in the *Rivers*[15] case allowed a Chapter 7 debtor to deduct expenses for a mortgage on a house that she intended to surrender. The *Rivers* court agreed the court in the *Grinkmeyer*[16] case, which found that the Means Test in Chapter 7 is used as a screening device rather than as a calculation of projected disposable income. Accordingly, the "snapshot approach" of looking at a Chapter 7 debtor's circumstances is more appropriate. Since the debtor was contractually required to make the payments at the time the petition was filed, she could claim the deduction even though she was not actually making payments.

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[12] *In re Quigley*, 673 F.3d 269, 2012 U.S. App. LEXIS 4732 (4th Cir. 2012).

[13] *In re Darrohn*, 615 F.3d 470 (6th Cir. 2010).

[14] *In re Sterrenberg*, 2012 Bankr. LEXIS 2231 (Bankr. E.D.N.C. 2012).

[15] *In re Rivers*, 466 B.R. 558, 2012 Bankr. LEXIS 1153 (Bankr. M.D.Fla. 2012).

[16] *In re Grinkmeyer*, 456 B.R. 385 (Bankr. S.D. Ind. 2011).

B. Car Deductions

Under *Ransom*, the Supreme Court ruled that Chapter 13 debtors without car payments are unable to take a "car ownership" deduction on lines 28 and 29 of the Means Test. The result of this is that debtors who own their cars outright can only take the "car operation" expense on line 27a of the Means Test. Since older cars tend to be more expensive to maintain than newer cars, this may mean that debtors with older cars are at a disadvantage since the Means Test does not adequately account for these expenses. In an effort to remedy this, debtors with older cars older than six years and/or with mileage greater than 75,000 have attempted to deduct an extra $200 per car on line 27A for the car operating expense. Under §707(b)(2)(A)(ii)(I), debtors are required to calculate their expenses for car operation pursuant to the IRS Local Standards. The extra $200 is allowed by the IRS by virtue of the Internal Revenue Manual. The court in *in re Luban*[17] considered this issue and ruled that the Chapter 13 debtors could not take the additional $200 because the Internal Revenue Manual is not incorporated into the IRS Local Standards or §707(b)(2)(A) of the Bankruptcy Code. In the *Wilhite*[18] case, the Bankruptcy Court also ruled that this deduction is not allowed per se, though a debtor can claim an additional expense if they can provide proof of it.

What if a debtor owns more than one car? Can a debtor in a one-person household deduct operating expenses for more than one vehicle on the Means Test? The Court in the *Warden*[19] case relied on *Ransom* to rule that a debtor could claim operating expenses for two vehicles. The Court reasoned that since the debtor was actually incurring the expense to operate two vehicles, the expense was "applicable" and declined to impose a *per se* rule of "One Debtor. One Car."

C. Step plan increases

Since *Lanning*, courts have also ruled on whether post-petition income that debtors will receive during the plan after certain debt payments end is "projected disposable income" that must be paid to the unsecured creditors. In other words, are debtors required to step-up plan payments once other debt payments end? The Sixth Circuit Court of Appeals considered this issue in *Schuler v. Burden (In re Seafort)*[20] and ruled that income that becomes available to debtors after a 401k loan was paid off must be paid to the trustee for distribution to the unsecured creditors as projected disposable income. The Court would not allow the debtor to retain the funds to fund a voluntary 401k plan. The Court ruled that, while 401k loan repayments are not disposable income under 1322(f), and pre-petition existing 401k contributions are not disposable income under §541(b)(7), post-petition voluntary 401k contributions are disposable income.

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[17] *In re Luban*, 2012 Bankr. LEXIS 812, (Bankr. S.D. Fla. 2012).

[18] *In re Wilhite*, 2011 Bankr. LEXIS 4368 (Bankr. N.D.Ga. 2011).

[19] *In re Warden*, 2012 Bankr. LEXIS 1779 (Bankr. E.D.Wis. 2012).

[20] *In re Seafort*, 669 F.3d 662, 2012 U.S. App. LEXIS 2927 (6th Cir. 2012).

Likewise, the Bankruptcy Court in *in re Williams*[21] also agreed with the Chapter 13 Trustee that a debtor is required to increase his plan payments once his 401k loan is repaid. The Court held that because the loan repayment was virtually certain at confirmation, under *Lanning* the court could adjust the calculation of projected disposable income and require the debtor to make increased plan payments rather than allow the debtor to begin voluntary 401k contributions.

The Court in the *Montho*[22] case made a similar ruling based on *Lanning* and *Ransom.* Debtors making direct car payments were required to increase their plan payments to pay unsecured creditors once the car loans were paid off because the additional funds were "projected disposable income."

D. Personal injury proceeds

In the *Connor* case, the Bankruptcy Court ruled that personal injury proceeds scheduled as "unknown" on Schedule B and exempted on Schedule C are not disposable income pursuant to 11 U.S.C. § 1325(b) and do not have to be remitted to the trustee to be paid to unsecured creditors. The court held that, unlike in *Lanning*, the fact that the debtors would receive any personal injury proceeds was not "known or virtually certain." Since the recovery of any proceeds was speculative at confirmation, the Court did not find the personal injury funds to be disposable income that must be paid to unsecured creditors.

IV. *Schwab v. Reilly*

In *Schwab v. Reilly*, the Supreme Court held that a debtor's claimed exemption of $10,718 on Schedule C of equipment that she valued at $10,718 did not entitle her to exempt the full market value of the equipment when a trustee determined that the equipment was actually worth more. The trustee was allowed to retain any value above the amount exempted by the debtor even though he failed to timely object to the exemption because the debtor's exemptions were expressed in a dollar amount allowed by the statute.

A. 100% FMV

Since *Schwab*, some debtors have attempted to claim exemptions on Schedule C of the "100% of fair market value" of property. This is because, in its majority opinion, the Court pointed out that if the debtor had exempted the "100% full market value" to make it clear that she intended to exempt the whole property instead of just the dollar amount of $10,718, then the trustee would have been barred from seeking to retain the value of the property over the exemption since he failed to timely object.

[21] *In re Williams*, 2012 Bankr. LEXIS (Bankr. S.D.Ga 2012).

[22] *In re Montho*, 466 B.R. 539, 2012 Bankr. LEXIS 443 (Bankr. D. Haw. 2012).

Courts reviewing the "100% fmv" exemption issue have ruled that this is an improper exemption. In *Massey v. Pappalardo (In re Massey)*[23], the First Circuit B.A.P. affirmed the Bankruptcy Court's decision to sustain the objection of the trustee of the debtors' exemptions of "100% of fmv" of their house and car. The B.A.P. admonished the debtors for not stating their exemptions accurately by "identifying the value of the claimed exemption up to or in a specific dollar amount." The *Massey* court stated that the majority opinion in *Schwab* indicates that the time period for objecting to exemptions does not apply if the exemptions, on their face, are valid.

Similarly, in the *Stoney*[24] case, the Bankruptcy Court also sustained a trustee's objection to an exemption of "100% of Equity" of their residence stating: "it is a misreading of Schwab to conclude that the Court has blessed the use of a designation such as '100% of FMV' as a valid and unobjectionable scheduling of a claimed exemption value where the relevant exempting statute… expressly limits the exemption to a maximum cash value."

B. Unknown exemptions

In the *Hall*[25]case, the Bankruptcy Court ruled that the use of an exemption claimed as "unknown" of a cause of action (with an unknown value) under 522(d)(5) does not *per se* exempt the entire value of the asset. The Court rejected the debtor's argument that the property was no longer property of the estate because the Chapter 7 trustee failed to object to the exemption. Instead, the court agreed with the trustee that because the debtor cited a specific code section to claim the exemption, the amount of the exemption was limited to the amount allowed under the code section.

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[23] *In re Massey*, 465 B.R. 720, 2012 Bankr. LEXIS 756 (B.A.P. 1st Cir. 2012).

[24] *In re Stoney*, 445 B.R. 543 (Bankr. E. D. Va. 2011).

[25] *In re Hall*, 453 B.R. 22 (Bankr. D. Mass. July 7, 2011).