Borrowing Against your Car to Qualify Under the Means Test

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The fact that the Supreme Court held attorneys subject to certain "gag rules" on advising bankruptcy clients has been widely discussed. That case, Milavetz, Gallop, & Milavetz, P.A. v. United States (2010), interpreted section 526(a)(4) of the Bankruptcy Code as prohibiting attorneys from advising clients to incur debt prior to bankruptcy for the purpose of getting a discharge on that debt. That is considered a manipulation of the bankruptcy system.

This limit is meant to fight what was common when I began practicing bankruptcy law in 2001. The practice was called exemption planning. For example, a debtor could sell certain non-exempt assets and purchase exempt assets several months before filing for bankruptcy. Likewise, the addition of some debt prior to bankruptcy might be a logical and even necessary step for a debtor.

The Supreme Court left much of our ability to discuss these things intact. For example, we can clearly talk about the benefits of refinancing a mortgage even though the debtor is contemplating bankruptcy. The attorney and client can discuss the wisdom of financing a new car shortly before bankruptcy. Transportation is, after all, essential. Finally, a debtor can continue to use credit to make purchases necessary for support and maintenance.

The limit, I surmise, is that debt may not be assumed for the very purpose of getting something for nothing. Obviously, a debtor cannot (or should not) charge a new home theater months before going bankrupt. This has always been the case.

Now enter the Supreme Court through Ransom v. FIA Card Services (2010). In this decision, again widely discussed, the Supreme Court stripped away $471 from many debtors trying to qualify for Chapter 7 under the Means Test. In short, there are two car "line items" in the means test. Recall that one needs to show little or negative disposable income under the means test. While the means test begins with a debtor's real gross income, it allows many "predetermined" budget items based on IRS National and Local Standards. It doesn't really matter under the means test whether it costs you $200 per month or $600 per month to maintain your car. The means test instructs you to put $388 in that slot.

Since the passage of the "reforms" of 2005, it has been customary to allow debtors to claim another car expense whether or not they financed their car. This expense was labeled "ownership costs" and allowed the entry of $471. It has now been limited to only those who have a securitized loan against their car. If you responsibly own your car free and clear, you lose out on this budget item. End of story.

The odd thing is that a debtor could have a very small car payment,

perhaps $218 per month, yet still qualify for the $471 entry. Justice Kagan, writing for the Court, stated, "the ownership category encompasses the costs of a car loan or lease and nothing more." It is triggered by a "car loan or lease." In addition, "the sum $471 is the average monthly payment for loans and leases nationwide." One's payment doesn't have to equal the average.

Consider this pre-petition planning. What if a client would qualify or not qualify for Chapter 7 based on the ability (or inability) to claim the car ownership budget item? What if that client had the wisdom to own a reasonable car free and clear? What if the equity in that car was greater than the California automobile exemption? Finally, and this is not really a question, what if that client needed money to eat and pay the rent?

Could you advise the client to do the following?

1. Go to a "money store" lender and obtain a securitized loan against the value of the car thereby encumbering the car for the means test.

2. Reducing the equity in the car at the same time to bring the value within the automobile exemption.

3. Free up cash to use for several months while preparing for bankruptcy for essentials.

The payment on such a loan might be only $100 per month. The interest would be high but the debtor could purchase the car out at a later date. That $100 payment gains the debtor $471 on the means test.

As I read it, none of this runs afoul of Milavetz, Gallop, & Milavetz, P.A. v. United States (2010). The new debt is securitized. It isn't going to be dismissed. There is no assumption of debt to get something for nothing.

Thoughts?

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