Sweeping Changes are Here

The Bankruptcy Reform Act of 2005

By Mathew D. Laskowski

Professionals who practice in the areas of bankruptcy and creditors rights have been bracing for "sweeping reforms" of the *Bankruptcy Code* for years.

Federal legislators made such reforms a priority early in their sessions until amendment after amendment would weigh down the bill until it fell by the wayside. This time, the Republican-backed initiative was kept free of amendments, which helped it move swiftly through Congress.

Now, the bill, formally known as the *Bankruptcy Abuse Prevention and Consumer Protection Act of 2005* (S. 256, H. 685) has been approved by Congress and was signed by President Bush on April 20, 2005 (herein the *"New Code"*). The majority of the provisions will become effective in mid-October 2005.

Although this complex bill will affect many provisions of the *Bankruptcy Code*, the consumer bankruptcy sections were modified to the greatest extent, and were the subject of the most debate. Many large institutional creditors (*i.e.,* banks and credit card companies) have complained of alleged abuses of the bankruptcy system while debtors and their advocates have cried "foul" against lenders for overextending credit and contributing to their insolvency.

Following are some key areas that will affect consumers under the *New Code*.

Consumer Bankruptcy

In 2004, *Chapter 7* bankruptcy petitions accounted for slightly more than 70 percent of all consumer filings ("Non-Business Bankruptcy Filings by Chapter, 1990-2004, per Quarter" http://www.abiworld.org, 28 April 2005). *Chapter 7* of the *Bankruptcy Code* is generally relied upon as the most effective way to wipe out unsecured debt and, in many instances, provides unsecured creditors with little or no return on their claims.

Those who file their petitions under *Chapter 13* primarily do so in an effort to preserve assets (usually a home) that would otherwise be liquidated for the benefit of creditors. *Chapter 13* debtors, who make up nearly 30 percent of the remaining consumer filings, enter into a repayment plan lasting from 36 to 60 months where unsecured creditors are paid an equal percentage of their respective claims based on the debtor's disposable income. Thus, generally speaking, creditors receive a greater return on their claims, and debtors pay more to their creditors in *Chapter 13* cases than in *Chapter 7* cases.

New Code Impact

In an effort to curb the number of *Chapter 7* filings, the *New Code* purports to adopt two "means tests" to determine if a debtor may file a petition under *Chapter 7*. Furthermore, pursuant to section 707(b) of the *New Code*, the court on its own motion or by motion of the trustee may move to dismiss or convert the *Chapter 7* proceeding should the debtor's income exceed the state median income (the "Median Family Income").

The assumption behind section 707(b) is that if a debtor has income in excess of the state median, the debtor's *Chapter 7* filing is an abuse of the bankruptcy system. Such a debtor may convert the case to one under either *Chapter 11* or *Chapter 13*, with a repayment plan that provides a greater distribution to unsecured creditors.

First Means Test

The first means test is calculated using a complex formula. First, the debtor's income must be determined. Pursuant to section 101(10A) of the *New Code*, the debtor's income is determined by calculating the total of the debtor's latest six months of income (prior to the filing date) from all sources (not including Social Security payments). The total is then divided by six to determine the average monthly income.

Health expenses, disability insurance and healthcare savings accounts are deducted from the debtor's average income. Additional expenses that may be deducted include actual expense for the care and support of elderly or disabled household members, and certain expenses associated with elementary and secondary school up to $1,500 per dependant child under 18 years of age.

This final number is known as the debtor's "Adjusted Income." Once the adjusted income is calculated, it may be compared to the median family income, which is defined in sections 101(39A) and 707(b)(2)(A)(ii)-(iv), and calculated by reviewing the "Median Family Income by State and Persons in the Household" generated by the U.S. Census Bureau (1999). That number must be adjusted up to the time of filing based on the *Consumer Price Index*.

The resulting number should be reduced based upon the "IRS Standards for Allowable Living Expenses by Number of Persons in Household," then further reduced pursuant to the "IRS House and Utilities Allowable Living Expenses by State and County," and the "Allowable Living Expenses for Transportation by Region." The allowable expenses can be adjusted over the federal level if the debtor can prove their actual costs exceed the IRS allowances.

The resulting "Median Family Income" is then compared to the debtor's adjusted income. If the adjusted income is less than the median family income, the debtor will be allowed to file a petition under *Chapter 7*—provided certain additional requirements, some of which are set forth below, are met. Conversely, if the adjusted income exceeds the median family income, the debtor may not file a petition under *Chapter 7*, but may file a petition under *Chapter 11* or *13*.

Second Means Test

Those whose adjusted income is more than the median family income may still be eligible to file a *Chapter 7* petition if they meet the requirements set forth in an additional means test determined pursuant to section 707(b)(2). Under this calculation, the debtor's monthly expenses are subtracted from the debtor's current monthly income to determine an "Adjusted Monthly Income" (AMI).

The AMI is then multiplied by 60. If the result is less than 25 percent of the debtor's general unsecured claims, or $6,000 (whichever is greater), a debtor may file a *Chapter 7* petition. If it is greater than 25 percent or $6,000, the debtor may file *Chapter 11* or *13* petitions.

Credit Counseling

The *New Code* also requires mandatory credit counseling (see section 111) for all individual debtors seeking bankruptcy protection. Pursuant to section 109(h)(1), counseling must occur within 180 days prior to the filing of a petition under any section of the *New Code*. The counselor must be associated with an approved nonprofit budget and credit counseling agency as defined by section 111(c)(2), and must develop a management plan to accompany the bankruptcy petition.

There are certain exceptions for emergencies, or, if in the trustee's opinion, the agency could not provide proper counseling for the debtor's situation. These emergency exceptions do not exempt the debtor from counseling. Under section 109(h)(3)(a), the emergent debtor must complete the counseling within 30 days of the bankruptcy filing, subject to a potential court-approved additional 15 day extension to complete the counseling.

Failure to complete counseling can result in dismissal of the petition. Debtors who are incapacitated, disabled or on active military duty in a war zone are exempt from the counseling requirement.

In addition to credit counseling, debtors, under section 1328(g), will now be required to complete a course in personal financial management from a

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program approved by the U.S. Trustee's office in order to obtain a discharge of their debts. Those who do not complete the program may have their discharge (the order that absolves the debt) denied under section 727 of the *Code*.

No More 'Loading Up'

Under the current *Bankruptcy Code*, certain debts are not dischargeable and must be paid by a debtor notwithstanding a bankruptcy proceeding (see 11 USC §523). The *New Code* expands the list of items to include debts incurred 90 days prior to the filing of the petition that are owed to a single creditor and total more than $500 in "luxury goods," and cash advances of $750 or more within 70 days of the petition filing. These changes are aimed at debtors who "load up" their credit cards just before filing for bankruptcy, knowing that the debt is generally unsecured and likely to be discharged under the current *Bankruptcy Code*.

In addition, the nondischargeability of student loans is extended to for-profit and nongovernmental entities whose interest is deductible for federal income tax purposes under section 523(a)(8). Currently, only nonprofit and government backed student loans are nondischargeable.

As the code stands today, a debtor may only receive a discharge once every six years, however, once the *New Code* takes effect, the timeframe will be extended to eight years (see section 727(a)(8)).

In any consumer bankruptcy, attorneys for debtors will now be required to sign a verification, pursuant to section 707(b)(4)(C), that they conducted a "reasonable inquiry to verify that the information" contained in a petition and that the schedules are "well grounded in fact." These requirements make the attorney take on an investigative role that will undoubtedly cause an increase in fees for filing bankruptcy petitions. This "verification" requirement may also decrease the number of attorneys willing to handle these cases *pro bono*.

Calculations

There will also be changes in the way that exemptions are calculated. Exemptions are statutes that allow a debtor to retain certain property in a bankruptcy proceeding. Each state, unless it participates in the *Federal Bankruptcy Exemptions* (see 11 USC §522), has its own exemption scheme.

The court, under section 522(b)(3)(A), will now review where the debtor lived for the 730 days immediately preceding the bankruptcy filing. If the debtor has moved within the 730-day period, the court will look back an additional 180 days. The state were the debtor lived during the majority of the 180-day period will determine the exemption scheme available to the debtor.

For example, if a debtor filed for bankruptcy in Florida on April 1, 2005, he would have had to reside in Florida since April 14, 2003 to be able to use Florida's exemptions. However, if he moved to Florida after April 14, 2003 the court will look back to where the debtor lived from October 16, 2002 to April 13, 2003. If the debtor lived in New Jersey, for example, for the majority of this time period, then New Jersey's exemptions would have to be followed.

This is to avoid situations where people relocate to another state just prior to the filing of a bankruptcy petition in order to take advantage of a particular state's exemption statutes. This is significant because some debtors have purposely filed for bankruptcy in states like Florida and Texas, where they are able to exempt an entire residence, regardless of its value. Most other states limit the amount of such exemptions.

There are also new rules affecting the automatic stay for secured creditors. The automatic stay (see section 362) is what prevents creditors from collecting pre-petition debts from debtors. Once a bankruptcy petition is filed, creditors must cease collection efforts for the duration of the bankruptcy or the court may penalize them. All lawsuits pending against the debtor must also cease for the duration of the bankruptcy.

Prior to the *New Code*, a creditor was required to file a motion requesting relief from the automatic stay in order to continue collection efforts. Under the *New Code* (section 521(a)(6)), secured debt (debt secured by a particular piece of property, such as a car loan or mortgage on a home) not reassumed through agreement within 45 days after the meeting of creditors (a "section 341 meeting"), is automatically subject to the lifting of the automatic stay without a motion. Should the debtor not reassume the debt, under the same section and within the same 45-day timeframe, the trustee may file a motion to keep the secured property in the estate.

More Documents

The number of documents that must be filed with a petition has increased under the *New Code*. In addition to the petition, schedules, statement of financial affairs and creditor lists, debtors must now also include a proof of income for the 60 days preceding the bankruptcy filing and a certificate of credit counseling as previously explained.

A court will automatically dismiss a case unless these items and others listed under section 521 are filed within 45 days after filing the petition, although there is a possibility of an additional 45-day extension. Further, the debtor's most recent tax return must be turned over to the trustee seven days prior to the section 341 meeting, and must also be made available to creditors prior to the meeting.

The debtor has an ongoing duty to provide copies of tax returns filed during the course of the bankruptcy to the trustee (in both *Chapter 7* and *13* cases). In addition, under section 521(h) the trustee may require the debtor to provide photo identification.

Child/family support obligations have been given a higher priority. Child support takes first position in the creditor priority list (see the section 507 priority scheme), however a trustee's administrative costs (in

both *Chapter 7* and *13* cases) can take priority so long as the trustee is administering assets that can be used to pay the support owed. The automatic stay does not affect the duty to pay support. In fact, failure to remain current on post-petition support is grounds for dismissal of the bankruptcy or its conversion to *Chapter 7* liquidation, as per section 1307(a)(11).

The *New Code* will thwart debtors who try to hide assets in trusts. Under section 548(e), trustees will now be able to look back 10 years and seize assets if: 1) they were moved into a self-settled trust or similar device, 2) the transfer was by the debtor, 3) the debtor is the beneficiary of the trust or similar device, and 4) the debtor made such a transfer with the actual intent to hinder, delay or defraud any creditor.

Conclusion

Those who practice in the bankruptcy field should not only read the bill *(S. 256, H. 685)*, but also attend sessions sponsored by local continuing legal educators to gain further insight into these sweeping changes. The ultimate effect of these changes remains to be seen, but it is clear that filing for bankruptcy will become more expensive, more time-consuming, and less available for consumer debtors.

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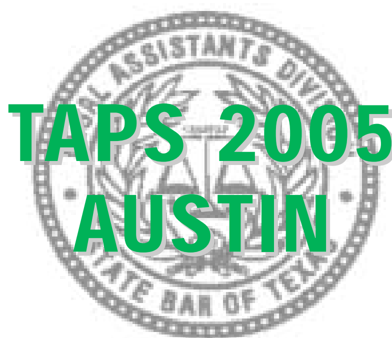

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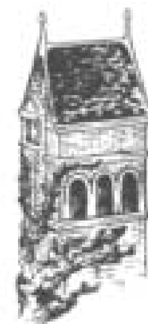

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