Hello 13, Goodbye 7

The Bankruptcy Abuse and Consumer Protection Act of 2005

by Robert J. Kolasa

I. Introduction

After years of trying, the credit industry finally persuaded Congress to enact meaningful bankruptcy reform. The Bankruptcy Abuse and Consumer Protection Act of 2005 (Public Law No 109-8, *i.e.,* the "Act") was signed into law by President George W. Bush on April 20, 2005, and is generally effective on October 17, 2005.[1] The new legislation is the most significant revamping of the Bankruptcy Code since 1978. The Act dramatically shifts the bankruptcy paradigm, in that many debtors with consumer debts will not qualify for Chapter 7 (liquidation) bankruptcy. Instead, in order to achieve a bankruptcy discharge, such debtors will be forced into Chapter 13 proceedings, requiring five years of payments to unsecured creditors.

This is the first part of a two-part analysis of the Act. Part 1, appearing herein, outlines the new rules wrought by the Act as it relates to individual bankruptcies. Part 2, to appear in the August issue of *The Docket,* will discuss how the Act changes the rules relating to bankruptcy forum shopping, exemption planning and asset protection trusts.

II. The New "Means Test"

A. In General

In general, there are two types of bankruptcies available to individual debtors plagued with consumer debts. First, under Chapter 7 bankruptcy, debtors give up all their assets (other than "exempt" assets) and receive a general discharge of their unsecured debt. Second, under Chapter 13 bankruptcy, a debtor keeps his assets but is generally required to make payment of "excess" income to unsecured creditors over a 3 to 5 year period before such debts are discharged.

Prior to its amendment, Section 707(b) of the Bankruptcy Code invoked a presumption in favor of an individual debtor getting a bankruptcy discharge, with the bankruptcy judge having discretion to deny relief under Chapter 7 for "substantial abuse." Needless to say, in the real world the supermajority of Chapter 7 filings were not found substantially abusive and debtors received the coveted "fresh start" of an immediate bankruptcy discharge (versus the delayed bankruptcy discharge of Chapter 13).

The Act's principal sponsor, Senator Charles Grassley, in explaining the legislation voiced indignation that debtors getting off "scot-free" in easy Chapter 7 bankruptcies caused losses to the credit industry for which "hard-working, law-abiding Americans have to pay higher prices for goods and services because somebody else did not make good on their obligations to pay."[2] Accordingly, the Act amends Section 707(b) to impose a rigid testing of "abuse" for many middle class consumer debtors in lieu of the subjective judicial determination of abuse. Simply put, if a debtor with consumer debts and regular income is mathematically determined to have the means to pay unsecured creditors, a presumption of abuse arises and he is pushed from Chapter 7 into Chapter 13 bankruptcy proceedings.

Under Section 707(b), a consumer debtor's Chapter 7 bankruptcy petition is abusive and presumptively dismissed (forcing a Chapter 13 five year repayment plan) if the debtor has "current monthly income":

1. Greater than the median family income of the debtor's state (the "Median Income Test"); and
2. Greater, after defined deductions, of an amount from $100 to $166 - the amount depends on the level of unsecured debt (the "Means Test").

B. The Median Income Test

The initial step in determining a debtor's eligibility for a Chapter 7 discharge is the Median Income Test of whether the debtor's "current monthly income" is greater that the "applicable median income" of his state of residency.

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If the debtor's current monthly income exceeds the state's applicable medium income, the Median Income Test is met (and if the debtor also passes the Means Test, he is generally ineligible to file a Chapter 7 petition). However, if such income is at or below the state's applicable medium income, the debtor fails the Median Income Test and his discharge will happily be approved unless there is an unlikely judicial finding of abuse. A debtor not hitting the median income target who somehow finds himself in a Chapter 13 bankruptcy is given preferable treatment (compared to median income debtors) in that (i) payments to unsecured creditors may be made over 3 years, versus 5; and (ii) such debtor may use his actual living expenses (rather than the inflexible IRS living expenses discussed below) in setting the amount of his payment plan.

"Current monthly income" defined under Section 101(10A) is generally the debtor's monthly income (excluding Social Security benefits and certain victim payments) over the six-month period prior to the bankruptcy filing. For example, if the bankruptcy petition is filed in October, current monthly income would be the average monthly income received by the debtor during the preceding April through September. But what if the debtor lost his "good" job in June? - since the six-month lookback counts such income, effectively the debtor is expected to pay out of income he no longer has.

The "applicable medium income" of the debtor's state of residency is not exactly a precise variable at the moment, because of 2000 census results, which must be adjusted for inflation. Until the bankruptcy court publishes median income tables, Bankruptcy Judge Eugene R. Wedoff, of the Northern District of Illinois, in his "must read" article on the Act[3] calculates that the Illinois applicable median income for 2005 would be $41,231 for a 1-person household; $52,794 for a 2-person household; $61,660 for a 3-person household; and $69,742 for a 4-person household.

C. The Means Test

Under Section 707(b)(2), if a debtor passes the above "Median Income Test," the presumption of abuse for Chapter 7 bankruptcy is governed by a "Means Test" to determine the debtor's ability to repay general unsecured claims. The Means Test generally allows defined deductions from a debtor's current monthly income and compares the resulting disposable income with the following "trigger points": (See Chart 1, below.)

Accordingly, under the above table, abuse is not presumed if the debtor's disposible income (*i.e.,* current monthly income after deductions) is less than $100. On the other hand, abuse is always presumed if the debtor's disposable income is greater than $166.66. For disposable income between $100 to $166.66, abuse is presumed if the debtor can pay at least 25% of his unsecured debt over five years (for example, under the above table, $150 times 60 months equals $9,000, which is 25% of the $36,000 unsecured debt amount).

The major defined deductions from "currently monthly income" under Section 707(b) are:

1. Actual expenses of administering a Chapter 13 bankruptcy plan;
2. 1/60th of all secured debt that will become due in the five years after filing;
3. 1/60th of all priority debt;
4. Expenses for grade and high school for minor children, up to $1,500 annually, per minor child;
5. Documented energy costs in excess of the IRS expense standards (discussed below);
6. Reasonably necessary expense for health insurance, disability insurance and health savings account expense for the debtor, his spouse and dependents;
7. "National" and "Local" living expenses specified by the IRS.

D. IRS Tables Used to Determine Living Expenses for Means Testing

Yes, that is right, for bankruptcy (not tax) purposes, a debtor's allowable living expenses are generally capped at levels developed by the IRS in collecting taxes against delinquent taxpayers. In this rather strange development, it is important to realize that under the Bankruptcy Code the IRS allowable expenses are used for two distinct and separate purposes: (i) testing whether the debtor qualifies for relief under Chapter 7; and (ii) in the event of ineligibility for Chapter 7, determining the amount of the debtor's Chapter 13 payments to unsecured creditors over five years.

A sampling from the IRS website[4] of its (i) "National Standards" for food, supplies, clothes and personal care; and (ii) "Local Standards" for housing, utility and transportation costs are as follows: (See Charts 2, 3 and 4 on page 17.)

Chart 1

"Current Monthly Income" after defined deductions	Presumption of Abuse
Less than $100	Does not arise
$100	Arises unless unsecured debts exceed $24,000
$150	Arises unless unsecured debts exceed $36,000
$166.66	Arises unless unsecured debts exceed $39,998.40
More than $166.66	Always Arises

The IRS "National Standards" are generally required to be accepted by the bankruptcy court without discretion, although the food and clothing allowance may be increased by 5% if the debtor demonstrates need. Judge Wedoff in his article (see footnote 3) remarks that for purposes of the Means Test, it is unclear whether the debtor may claim the full amount specified in the IRS "Local Standards" for housing, utilities and transportation costs,

Chart 2

IRS National Standards for Food, Supplies, Clothes and Personal Care				
Living Expense Item	**$833 to $1,249 Income**	**$1,667 to $2,499 Income**	**$3,334 to $4,166 Income**	**$5,834 and over Income**
Food	$525	$527	$640	$868
Housekeeping supplies	$43	$50	$61	$110
Apparel & services	$169	$171	$189	$317
Personal care products & services	$42	$45	$53	$81
Miscellaneous	$188	$188	$188	$188

Chart 3

IRS Local Standards for Monthly Housing and Utilities Expenses			
	Family of 2 or less	Family of 3	Family of 4 or more
Lake County	$1,597	$1,879	$2,160
McHenry County	$1,427	$1,678	$1,930
Cook County	$1,327	$1,561	$1,795

Chart 4

IRS Local Standards for Car and Transportation Expenses			
	1st Car	2nd Car	No Car
Ownership Costs (National)	$475	$338	
Operating & Public Transportation Costs (Chicago Region)	$329	$422	$257

or only the amount actually expended by the debtor up to those amounts. The IRS in applying the above standards for tax collection purposes most definitely uses actual expenses if they are lower than its allowable standards and it's hard to see a different application in the bankruptcy arena.

The obvious criticism of using IRS expense standards for bankruptcy purposes is that such standards do not take into account the debtor's actual cost of living (although the Act permits the usage of actual expenses if a debtor does not meet the Median Income Test). The practical effect of excess actual expenses is that the Chapter 13 debtor may be unable to complete a 5-year payment plan unless living cuts are made. Using IRS expense standards reflect a draconian Congressional intent to bolster payments to unsecured creditors and prevent the bankruptcy "fresh start" from applying to consumer debtors who (per the IRS tables) are deemed to be living beyond their means.

To be fair, supporters of the Act contend that the equities are preserved in that under Section 707(b)(2)(B), a debtor may alter the IRS expense standards if he can prove to the court "special circumstances" (such as a serious medical condition or a call to active military service) that require additional expenses or adjustments of current monthly income. However, this would trigger additional proceedings and put the burden on the debtor to prove excess expenses, no small task in the face of creditor objections.

E. Criticisms of Means Testing

Opponents of the Act, some colorfully asserting that it "seeks to shoot a mosquito with a shotgun,"[5] harshly criticized the mechanical Means Test. A fundamental charge is that the credit industry has created the problem by aggressive marketing and a large profitable market has emerged which takes into account expected credit card defaults ("well, yeah" this author thinks as he shreds another carton of unsolicited credit card mailings). These critics contend that it is not empirically validated that "honest Americans who play by the rules have to foot the bill" of credit card defaults and that the Act does nothing to guarantee that the money the credit industry receives (by regular Chapter 13 payments) will be passed on to consumers. The Means Test is arguably overly inclusive and replaces judicial supervision with an inflexible standard which increases the costs of bankruptcy, while decreasing protections. Well-funded creditors will make bankruptcy an expensive proceeding for honest debtors and extort reaffirmation agreements to have unsecured debts survive bankruptcy. Furthermore, the Act is biased against debtors without secured debts as persons leasing apartments and cars may not be able to deduct the full amount of their living expenses, while persons with mortgages and automobile debt will be able to do so.

It appears clear that by pushing more debtors into Chapter 13, the repayment assumptions of the Means Test will make it even less likely that debtors will complete their repayment plans (under prior law, approximately 2/3 of all voluntary Chapter 13 plans were not completed). Without bankruptcy relief available to many individual debtors, creditors will rely increasingly on state law collection systems to pursue their debts.

III. Other Bankruptcy Provisions

Other major non-asset protection changes by the Act affecting individuals are as follows:

1. <u>Mandatory Credit Counseling and Financial Management Education</u>. As a condition for bankruptcy eligibility, Section 109(h) requires an individual to receive individual or group credit counseling 180 days prior to filing of the bankruptcy petition. Credit counseling must be provided by approved agencies (including telephone or internet briefings) and it is expected that this requirement will, at least

in the short term, overwhelm the debt-counseling system. In a similar vein, debtors in both Chapter 7 (Section 727(a)(11) and Chapter 13 (Section 1328(g), will generally be denied bankruptcy discharges unless they complete an instructional course concerning personal financial management. Interestingly, Judge Wedoff in his article (see footnote 3) has been widely quoted for suggesting that the credit counseling provision effectively ends involuntary bankruptcies, as creditors will never be able to force debtors to take counseling classes as a prerequisite to bankruptcy. This seems to reflect the musings of a judge frustrated by the provisions of the Act, rather than a correct or practical interpretation of the law.

2. Increased Sanctions for the Debtor's Attorney. Section 707(b)(4) beefs up civil fines and criminal penalties against bankruptcy attorneys. Attorneys must perform a reasonable investigation that their clients' bankruptcy petitions and schedules are supported by the facts and correct. In particular, sanctions may result if a debtor's Chapter 7 case is dismissed for failing the Means Test (which the attorney should have investigated in the first place). One wonders how much the increased responsibility and liability will raise the bankruptcy practitioner's fees in this practice area.

3. Limitations on Lien Stripping. For many creditors with automobile loans it is common to have the secured debt exceed the fair market value of the car. Under a practice known as "lien stripping" under Section 506, such excess was frequently converted into dischargeable unsecured debt. This practice has generally ended for Chapter 13 debtors owning newly acquired automobiles. Section 1325(a)(9) now provides that Section 506 does not apply where the creditor holds a purchase money security interest in a motor vehicle purchased within 910 days of the Chapter 13 filing, or to any other secured debt incurred within one year of bankruptcy. Furthermore, when lien stripping does apply under Chapters 13 or 7, Section 506(a)(2) make clear that the value of the secured claim is based on the collateral's replacement cost and if the collateral was acquired for personal use, the retail price for property of similar age and condition.

4. Expanded Debtor Production of Records, Including Tax Records. In addition to the bankruptcy petition and schedules, Section 521 now requires the debtor to file additional records, such as a certificate of credit counseling; evidence of payment from employers; tax returns for the most recent year (creditors can request 3 years of returns); a photo ID. Failure to provide these or other documents within 45 days after the petition has been filed results in a dismissal of the bankruptcy case.

5. Time Between Bankruptcies. Section 727(a)(8) was amended to provide that a debtor cannot receive a Chapter 7 discharge if the prior Chapter 7 discharge was received within 8 years (rather than 6) of the new filing. Section 1328(f) was also amended to limit a Chapter 13 debtor from receiving multiple Chapter 13 discharges within 2 years, or Chapter 13 discharges within 4 years of a prior Chapter 7, 11 or 12 case.

6. Miscellaneous. The Act also promulgates many other rules relating to individual bankruptcies, the most notable of which are (A) a higher priority for domestic support obligations (Section 507(a)(1)); (B) a presumption of nondischargeability for "luxury goods or services" greater than $500 incurred 90 days prior to filing, or cash advances greater than $750 incurred 70 days prior to filing (Section 523(a)(2)(C)); (C) a narrower definition of "household goods" for avoiding nonpurchase liens (Section 522(f)(4)); (D) new extensive disclosures relating to debt reaffirmations (Section 524(k)); (E) a scaling back of the Chapter 13 "superdischarge" (Section 1328)(a)) and student loan discharge (Section 523(a)(8)); and (F) a provision allowing landlords to continue eviction even after debtors have obtained an automatic stay (Section 362(b)(22)).

IV. Conclusion

The Bankruptcy Abuse and Consumer Protection Act of 2005 significantly changed the bankruptcy law by invoking a new Means Test to determine whether a debtor with primarily consumer debts will qualify for a Chapter 7 discharge. Under the new rules, many debtors with consumer debts will be pushed into Chapter 13 proceedings requiring payments to unsecured creditors over a 5-year period, or not file bankruptcy at all. The effect of the legislation will result in fewer individual bankruptcy discharges and creditors will now rely increasingly on state law collection systems to pursue individual debtors.

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1. For an excellent link to the statutory language and articles relating to the Act see http://www.bankruptcyfinder.com/bankruptcyreformnews.html. Also see http://thomas.loc.gov/ under Public Law 109-8 for links to the Committee Reports, Congressional Record and complete legislative history of the Act.
2. Explanation of the Act by its sponsor, Senator Charles Grassley, 151 Cong. Rec. S1856 (March 1, 2005), which can be accessed at http://thomas.loc.gov/.
3. Judge Wedoff's article can be accessed at http://www.bankruptcyfinder.com/bankruptcyreformnews.html.
4. http://www.irs.gov/individuals/article/0,,id=96543,00.html.
5. See the 54 page review of the "House Judiciary Democrats' dissent from bankrukptcy bill" and a February 16, 2005, letter to Senators Specter and Leahy signed by 83 bankruptcy and commercial law pro fessors. Both of these documents can be accessed at http://www.bankruptcyfinder.com/bankruptcyreformnews.html.