

Bankruptcy – the New Law

By Helen Mirza

Background and Overview

New provisions under bankruptcy law became effective on October 17, 2005. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 was passed by the 109th Congress on April 14, 2005, and signed into law by President Bush on April 20, 2005.

The new legislation made sweeping changes to existing bankruptcy law, and the main result appears to be that it will now be more difficult for certain individuals to discharge all debt in Chapter 7 filings than under the old law. Individuals under the new law will have to demonstrate whether or not they have the ability to repay some or all of their debt. If the court determines that the consumer does have the ability to repay, s/he will be forced into Chapter 13, as opposed to Chapter 7. The filer as an alternative may simply withdraw the filing. There is now a “means test” to qualify for Chapter 7. Simply put, Chapter 7 results in the extinguishment of all debt, other than priority debt such as child support, taxes, and certain types of judgments. Chapter 13 does not extinguish all non-priority debt, but requires repayment of at least some debt (often including unsecured debt) over a certain time period—generally three years under the prior statute and five years under the new.

Means Testing

While the new law also included provisions affecting farming (Chapter 12), Business Reorganizations (Chapter 11), financial contracts, and ancillary foreign bankruptcy proceedings, many of which are also important in their scope, the centerpiece is the means testing required for consumers. Under the former law, the Chapter 7 filer received a presumption of eligibility to receive relief under the statute. Although it was a presumption rebuttable by the creditors or the trustee in bankruptcy, it was rarely challenged, and even more rarely challenged *successfully*, due to the inability of creditors to obtain in-depth information about the filer’s financial status.

Under the new law, no presumption of eligibility exists; the filer must prove eligibility by disclosing financial information including income documentation and tax returns. If the filer’s income is below the median income in his state (based on the prior six months), s/he is not required to show eligibility and may stay in Chapter 7. However, for those earning more than the median state income, a means test is applied.

This test, in its most simplified form, is conducted as follows:

Step 1: Subtract defined allowable expenses from monthly income, and multiply the result by 60 (the total of five years of monthly income).

Step 2: If the result of the calculation above is more than 25 percent of the filer’s unsecured (non-priority) debt or \$10,000 or more, the case must be converted to Chapter 13 or dismissed.

If ultimately, either Chapter 7 or 13 goes forward, the filer must complete an approved financial management course in order to obtain the final discharge.

Pre-filing Credit Counseling Required

For the court to begin to process a filing, the potential filer must have completed an approved credit counseling session within the prior six months.

Early predictions about the likely effects of the new provisions on debtors, prior to passage, held that the new law would make achieving total relief in Chapter 7 very difficult for the average filer. Thousands of debtors rushed into court hoping to get their case filed before the law changed. During the final two weeks before the new law took effect, over 600,000 debtors filed for bankruptcy protection,¹ compared with approximately 30,000 filings per week on average previously, and a mere 3,600 a week immediately following the effective date of the new law.²

Although predictions of difficulties in filing under the new law apparently prompted the spate of filings before it took effect, it is interesting to note that a Washington Post staff writer who spent time with a representative of Money Management International, Inc. (MMI), the "nation's largest credit-counseling organization," was told that most of the debtors they have counseled under the new requirements *will* in fact meet the test of being able to file under Chapter 7.³ Most of the debtors counseled were in very serious financial difficulty with no apparent way to repay. "In the first 13 weeks after the new law took effect October 17, only 4.5 percent of the 14,907 debtors counseled by MMI had sufficient income to be considered for a plan to pay back debts over a few years. Of those 669 debtors, only 42 have signed up so far for such a debt-management plan," stated the Washington Post reporter in the same article.⁴

Winners and Losers

The financial services industry, including banks and credit card companies, had lobbied aggressively for the passage of bankruptcy reform for over a decade. The last major reform of the bankruptcy code occurred in 1978 and was considered largely pro-debtor. Creditors had been complaining ever since about certain practices they considered unfair. In particular, they did not believe that the abruptness of the bankruptcy filing was appropriate. The creditor often only learned of the bankrupt's financial difficulties when informed of the automatic stay occasioned by the filing. Creditors felt that this lack of any notice of financial duress often lured them into continuing to extend credit in the face of the debtor knowing s/he was unlikely to be able to repay. They also felt victimized by the bankrupt's legal ability to shift assets prior to filing into asset protection trusts and into homesteads in states with extremely or even unlimited homestead exemption provisions.

Since, under the new law, the debtor must undergo counseling, creditors have an opportunity to work with the borrower and have input into any proposed repayment plans. The new law also addressed the issue of state homestead exemptions. It requires that a debtor must have lived for two years in any given state before being able to use that state's homestead exemption. In addition, if the property was acquired within 3.3 years (1,215 days) prior to filing bankruptcy, the debtor is limited to \$125,000 in homestead exemption, regardless of the state's statutory exemption limit.

Creditors were also pleased with a change to what was formerly referred to as the "cramdown" provisions of the old statute. This provision required that the secured value of a vehicle be written down to its fair market value even though the debtor may still owe substantially more than that value. Automobiles purchased new usually depreciate

rapidly; a write-down in proportion to the loan amount on a car purchased new can be significant. Under the new law, the write-down is not permitted if the vehicle was purchased within 910 days preceding the date of the filing. For other purchase money security interests on personalty, the write-down is not permitted if purchased within one year of the filing.

Debtors also received consideration in the law's new requirement for more disclosures for open-end credit under Regulation Z (Truth in Lending). The Federal Reserve is responsible for implementing these changes, and has issued an Advance Notice of Proposed Rulemaking to seek public opinion on how to craft the required disclosures. The comment period ended on December 16, 2005, and the Federal Reserve staff is in the process of evaluating these comments and drafting appropriate regulations. The principal thrust of these disclosures is to let consumers of open-end credit understand how long it will take to pay off their debt if they only make the minimum required monthly payments, and to provide a toll-free number where they can call to find out how long it would take to pay off their own balance assuming minimum payments. This provision also requires language concerning introductory interest rates (often referred to as "teaser" rates), when they will expire, what rate will apply after they expire, and under what circumstances the rate can be changed earlier (late payments for example). Some other provisions for consumers under the Truth in Lending law include:

- Barring creditors from closing open-end accounts where the consumer does not incur finance charges;
- Disclosure of the earliest date a late fee can be charged, and the fee amount; and
- Disclosure for home-secured credit wherein the amount of the loan may exceed the fair market value of the home, and the fact that interest would not be tax deductible for amounts above that fair market value.

Recent History and a Reality Check

Post enactment counseling experience at MMI indicates little change for the average consumer (who is not in a position to repay debts) seeking bankruptcy protection. The American Bankruptcy Institute is quoted as estimating that the new law will adversely affect fewer than 3 percent of all debtors.⁵ Early indications from counseling records support that estimate. However, these early filings may not be typical of future filings inasmuch as they may represent a group of filers who, for the most part, were unable to complete or attempt a filing prior to October 17, and were forced into filing relatively soon thereafter due to dire and worsening financial circumstances.

More Consumer Issues

One significant change to the priorities of obligations was to elevate child support payments or recoverable amounts to first priority, making it somewhat more likely that such debts will be paid to the custodial parent. In addition, certain penalties are provided for abusive creditor practices, particularly when a creditor refuses to negotiate a reasonable repayment schedule.

Another change prohibits disclosure of the name of minor children, unless required by the court to be kept in a non-public record, and the prohibition on the release of personal information of the debtor that may create undue risk of identity theft or "other unlawful injury to the individual or the individual's property" (Subtitle C., Section 234).

Interestingly, however, the law caps at \$1 million the value of an IRA, which the debtor may claim as exempt property, and may increase this cap "if required in the interests of justice" (Subtitle C., Section 224[e]).

Summary

It is too early to evaluate the longer-term impact on consumers and society in general of these changes to our bankruptcy laws. However, it is clear that Congress was able to put together a significant number of changes sought by various and conflicting interests and parties after an extended effort. Certainly, the financial services and banking industries were able to claim some reforms in what they perceived to be pro-consumer provisions – particularly barring some debtors with the real ability to repay some debt from Chapter 7 relief. The "means test" provides some ability to control abuse. The homestead exemption, which almost all parties other than bankrupts and their counsel felt was often abused, was successfully addressed by the new limit of \$125,000 for property held less than 3.3 years, and curtailment of use of a state's exemption until the filer has been a property owner in that state for at least two years. Certain states, notably Florida and Texas, had very high homestead exemptions, causing some wealthy individuals who contemplated bankruptcy to purchase expensive homes in these states in order to shield as much of their assets as possible under this single exemption.

Pro-consumer advocates are particularly pleased to note the new disclosures required for open-end credit – especially the requirement to let a consumer know the true cost of his borrowing if s/he makes only minimum payments. The consumer is also well served in being informed of the duration of teaser rates and how rate changes are triggered.

In February 2005, 92 law professors of bankruptcy and commercial law throughout the U.S. issued a letter to Congress to express their dissatisfaction with the then

proposed law, and to ask Congress not to pass it. They expressed the belief that abuses of the system were the exception, and that it is extremely important that an avenue remain open for consumers to make a fresh start. They particularly pointed out that consumer lending is highly profitable, and that clear abuses exist on the part of creditors as well.

No one appears to have received their entire wish list from this piece of legislation; nevertheless, most parties are happy with at least certain aspects of the new law.

What a number of people have pointed out, however, is that having obtained bankruptcy reform from Congress is just the start. Getting the legal community involved in bankruptcy filings to adapt to the changes as Congress intended may take time.

There will undoubtedly be compromises and differing interpretations of the various express changes to the law. It is too early to assess the degree of compliance with the new requirements, and the effect on the bankruptcy system as a whole.

For more information on the Truth in Lending regulatory changes, please check our Web site for updates at www.federalreserve.gov/regulations/default.htm#z.

Notes

- 1 Caroline E. Mayer, *Washington Post* staff writer, Tuesday, January 17, 2006, Page A01 located at www.washingtonpost.com.
- 2 *Ibid.*
- 3 *Ibid.*
- 4 *Ibid.*
- 5 Bankruptcy Resource Center located at www.legalhelpers.com quoting a spokesperson for the American Bankruptcy Institute.

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