

## **Dramatic Changes for Consumer and Business Debtors, and for Bankruptcy Attorneys**

By Elliott D. Levin & John M. Rogers  
Rubin & Levin, P.C.

Those of us who regularly practice insolvency law were not surprised by an August 21, 2005 headline in *The New York Times*, declaring “Debtors in Rush to Bankruptcy as Change Nears.”<sup>1</sup> Throughout 2005, bankruptcy filings have perceptibly jumped in anticipation of the October 17, 2005 effective date of the Bankruptcy Abuse Prevention and Consumer Protection Act (“BAPCPA”), signed into law by President Bush on April 20, 2005. According to the *Times* article, after leveling off or even starting to decline last year, in 2005 bankruptcy filings nationwide for April, May and June were up 12 percent over the same period in 2004, with even larger increases in “heartland” states such as Indiana. *Id.* Indeed, the Clerk of the Bankruptcy Court for the Southern District of Indiana reports there were 23,418 filings in the Southern District through July of this year, approximately 3,300 per month,<sup>2</sup> compared to 19,680 or 2,800 per month for the same period in 2004 – an increase of approximately 19%.

The rise in filings is neither surprising nor, it seems, unwarranted. Regardless of whether one is an advocate or critic of BAPCPA, anyone familiar with the legislation acknowledges that the changes in the law are substantial and – with few exceptions – make it more difficult (and less beneficial) for debtors to obtain bankruptcy relief. Less commonly known is that the changes will drastically affect business as well as consumer debtors (and the relief available to

creditors of either) and will broadly change the day-to-day practices *and risks* for attorneys who practice in the bankruptcy area.

This article highlights some of the key changes imposed by BAPCPA, including the new limitations placed on the relief available to business debtors, which has not received quite the same attention in the popular press as consumer-related changes.

### **Issues Giving Rise to the New Law**

A quick review of the bankruptcy landscape in recent years, and the heated debate over its alleged need for reform is appropriate, because many of the modifications in statutory language are most easily understood with reference to the perceived issues which, in theory at least, gave rise to the ultimate changes. These issues appear to include not only perceived bankruptcy “abuse,” but also (1) a surge in the number of filings and apparent decline in associated bankruptcy stigma; and (2) disparate results in individual cases, caused by differing state exemption laws and variations in judicial interpretation of the Code. Many of the changes implemented by BAPCPA appear to be as much in reaction to the way some Bankruptcy Courts have applied and interpreted the law, as to “abuse” practiced by individual debtors.

Pursuant to the Bankruptcy Code enacted in 1978<sup>3</sup>, consumer debtors would typically file under either Chapter 7, which involves liquidation by a trustee of the debtor’s non-exempt assets (if any) and distribution of proceeds to creditors; or under Chapter 13, in which debtors with regular income such as

wages pay their “disposable” income to creditors for three or five years under a simple reorganization plan, following a more streamlined procedure for reorganization than the elaborate reorganization plans and voting procedures typically used by businesses under Chapter 11.

Although the Bankruptcy Code governs all filings through the country, the results in individual cases under the 1978 Code have been by no means uniform. Disparities arose because of flexibility inherent in the Bankruptcy Code, with regard to the assets included or excluded from the bankruptcy “estate,” and by virtue of a complex interplay between the Bankruptcy Code and state law “exemptions,” provisions designed to exempt from the bankruptcy estate the property deemed necessary to provide to debtors with a “fresh start” after their bankruptcy discharge.

Although the 1970 Bankruptcy Commission urged adoption of a uniform set of federal bankruptcy exemptions,<sup>4</sup> in 1978 Congress opted instead to allow an election between state and federal exemption law – an election which produces extremely different results depending upon a debtor’s state of residence, due to wide variations in the exemption laws of individual states. Additional disparities arose because under pre-BAPCPA law governing Chapter 13 “wage earner” plans, the disposable income payable to creditors by debtors would fluctuate considerably from debtor to debtor, depending upon the individual’s financial circumstances at the time of filing. Someone living in a nice home with a new car may have considerably less “disposable” income<sup>5</sup> to be allocated for payments to

unsecured creditors under a Chapter 13 plan than another debtor, earning the same income, who lives in an apartment and drives an older car that is paid for.

While such disparities are cited as one rationale for the passage of BAPCPA – which attempts to achieve more uniformity – the general consensus is that the relatively high volume of consumer bankruptcy filings during the 1990s was also a significant – perhaps the key -- factor in creating a climate for reform.<sup>6</sup> Although real economic hardship arising from layoffs, uninsured medical expenses, and divorce may have actually precipitated the vast majority of filings, anecdotal evidence also suggests that to the dismay of creditors, in recent years there has also been a weakening of the “stigma” traditionally associated with bankruptcy relief, a development which itself may arise from the same lenders’ seeming willingness to quickly extend credit to the recently-discharged debtor.

For these reasons, and no doubt others, “reform” legislation was repeatedly proposed beginning in 1998. In each instance, the proposed changes included a relatively complicated “means” test for prospective consumer bankruptcy debtors, intended to screen out “abusive” filings, and to make debtors ineligible for Chapter 7 (liquidation) filings if they could make meaningful payments on their debts under Chapter 13 (wage-earner reorganization), an approach which survived in the passage of BAPCPA.

Proponents of such reform legislation – who were nearly successful in the 106<sup>th</sup> and 107<sup>th</sup> Congresses before passage of BAPCPA this year – contended, in part, that reform was needed not only to stem the tide of “abusive” bankruptcies,

by reviving the social stigma of filing, and to prevent alleged “convenience” bankruptcies, but also to provide more uniform and rigorous tests to insure that those who file pay what they are able to pay to creditors.<sup>7</sup> The result, it has been argued, would not only reduce “abusive” filings and maximize distribution to secured and unsecured creditors, but would broadly benefit society by, for example, lowering consumer interest rates. *Id.*

Opponents of bankruptcy reform have responded that the alleged “abuses” are overstated, and that the vast majority of filings arise involuntarily from job loss, medical bills and divorce, a conclusion borne out by a number of studies. It was further argued, unsuccessfully, that the proposed means tests would unfairly impact less sophisticated debtors, and would ultimately burden the system without clear evidence that there would even be a meaningful benefit to creditors. *Id.*

Regardless of one’s view on these debates – the relative merits of which will ultimately be tested by experience under the new law – it is undeniable that the sweeping changes of BAPCPA will radically alter the entirety of bankruptcy practice, not just consumer cases. In many instances, these changes have little or no connection with the hotly debated issues stressed by politicians and the media. As discussed below, the desire for reform triggered by alleged abuse has wrought much broader changes in the law, both substantive and procedural.

### **A. Consumer Bankruptcy Changes**

BAPCPA imposes profound changes on consumer bankruptcy law, the

general effect of which is to (1) create “objective” income and expense criteria and other standards which reduce regional and individual disparities, and limit court discretion; (2) curtail debtor relief while expanding creditor rights; and (3) impose substantial new procedural and administrative burdens, which will likely increase the cost of filing and create pitfalls -- and significant potential liability – for attorneys practicing in the consumer bankruptcy area.

**1. “Objective” Means Testing for Chapters 7 and 13, and Other Uniformity Changes**

Perhaps the most dramatic change involves the so-called “means” test, which seeks to reduce disparity and prevent abuse by using “objective” income and expense criteria founded on IRS guidelines (1) to identify bankruptcy “abuse,” requiring either dismissal of Chapter 7 cases or (with the debtor’s consent) conversion to a Chapter 13; and (2) as a basis for the amount of required payments under a Chapter 13 repayment plan.

Under the law prior to BAPCPA, courts applied §707(b) to prevent abusive Chapter 7 filings through an open-ended, discretionary standard – judicial determination that the case would be a “substantial abuse” of the provisions of the Code. The 1978 Code version of §707(b) also included a “presumption in favor of the relief requested by the debtor.”<sup>8</sup> By contrast, BAPCPA creates an objective *presumption of abuse* requiring dismissal or conversion to Chapter 13 if unrebutted whenever (1) the debtor has at least \$166.67 in “current monthly income” (\$10,000 for five years) available after certain allowed deductions from total income; or (2) at least \$100 of such “current monthly income” (\$6,000 for

five years) if it is sufficient to pay at least 25% over five years of the debtor's general unsecured debt at the time of filing. To rebut the presumption, a debtor must demonstrate and justify "special circumstances" to adjust the income determination. BAPCPA also continues to allow a finding of abuse on general grounds, such as bad faith, determined under the "totality of the circumstances."

Under BAPCPA, "current monthly income" is a key defined term, which is used to create an objective standard, sometimes irrespective of the debtors' actual circumstances, for (1) applying the presumptions of §707(b) to identify Chapter 7 abuse, *and* (2) to determine the amounts which must be paid to creditors under a Chapter 13 "wage earner" plan to satisfy the "best efforts" test of Chapter 13.<sup>9</sup> Generally speaking, "currently monthly income" consists of a monthly average of all the income received by the debtor during a defined six-month period, less defined living expenses, following standards developed by the Internal Revenue Service. The specified expense allowances include the IRS's "National Standards" for food, clothing, personal care and entertainment, depending on the taxpayer's family size, on a national basis, and "Local Standards" for transportation and housing.

Although many aspects of the means test remain unclear and will require interpretation by the courts and the office of the United States Trustee, it is clear that the general effect – because of the presumptive nature of the test and the reliance on IRS standards rather than the individual's actual expenses in many instances -- will be to reduce the number of Chapter 7 cases, and to increase the

cost of bankruptcy relief and the difficulty of successfully completing a Chapter 13 reorganization. In addition to utilizing the objective “currently monthly income” standard, Chapter 13 as amended by BAPCPA will also require debtors to make payments of disposable income to creditors for *five* years, in contrast to the 1978 Code, which states that a Chapter 13 plan “may not provide for payments over a period that is longer than three years, unless the court, for cause, approves a longer period, but the court may not approve a period that is longer than five years.”<sup>10</sup>

While the means test and its objective definition of “currently monthly income” are the broadest changes of BAPCPA consistent with promoting uniformity and reduction of bankruptcy court discretion, other specific provisions appear designed to have a similar effect of limiting disparate results in consumer cases, and of generally reducing the benefits of filing a bankruptcy petition. For example, a new §522(b)(3) specifies the state or local law governing the debtors’ exemption as the law of the place where the debtor’s domicile was located for 730 days before filing, or if the debtor did not maintain a domicile in a single state for that time, to the place of the debtor’s domicile for the majority of the 180-day period preceding the 730 days. The apparent purpose of these changes is to reduce debtor “forum-shopping” in the form of re-location to states with liberal exemption laws.

A number of changes also limit homestead exemptions – another source of disparities under pre-BAPCPA law -- in certain situations. Under a new §522(p),

any value in excess of \$125,000 that is added to a homestead during the 1,215 days preceding a filing may not be included in a state homestead exemption unless it was transferred from another homestead in the same state or the homestead is the principal residence of a family farmer. The exemption is also effectively reduced if the debtor uses non-exempt property to add to the value of the homestead within 10 years of filing, if done with intent to hinder, delay or defraud creditors,<sup>11</sup> and is absolutely limited to \$125,000 for debtors guilty of certain crimes or torts.

Finally, BAPCPA modifies substantive law to limit the frequency with which consumer bankruptcies may be filed. Prior to BAPCPA, under §727 a Chapter 7 debtor cannot obtain a discharge if he has previously been granted a discharge under Chapter 7 or Chapter 11 within six years of the filing of the current petition, or was granted a Chapter 13 discharge within six years through a plan which did not pay at least 70 percent of allowed unsecured claims.<sup>12</sup> Under BAPCPA, amendments to 727(a)(8) deny a discharge if the debtor received a Chapter 7 or 11 discharge within *eight* years of filing the pending case; in addition, §1328 is also amended to include a new subsection (f), denying a discharge to a Chapter 13 debtor if the debtor previously received a discharge under Chapter 13 within two years, or under Chapters 7, 11 or 12 during the four-year period preceding the current Chapter 13 filing.

## **2. New Burdens and Risks for Attorneys – and Higher Costs for Bankruptcy**

BAPCPA also imposes substantial new administrative and procedural requirements, which will likely significantly affect the cost and availability of bankruptcy assistance, and will also create a worrisome source of potential liability for attorneys. Many practitioners and commentators predict that fewer attorneys will be willing to practice consumer bankruptcy law, and that the cost to debtors will be much greater – because of the new procedures, and because many cases that previously would have been filed under Chapter 7 (for perhaps \$500 to \$1,000 in attorney’s fees) will now, of necessity, be filed as Chapter 13s, which typically involve substantially higher attorney’s fees.

Of particular interest and concern to attorneys are provisions of §707(b) imposing additional responsibility and potential liability on counsel in connection with Chapter 7 cases, and for violations of Bankruptcy Rule 9011. Specifically, subparagraphs (4)(C) and (D) of §707(b) provide that the signature of the debtor’s attorney constitutes a certification that the signed documents are well grounded in fact, that any Chapter 7 petition is not an abuse under §707(b), and that the attorney has no knowledge after an inquiry that the information in the schedules filed with the petition is correct. The potential liability for attorneys is daunting: subparagraph (4)(A) allows the court to award costs and fees to a trustee who successfully pursues a §707(b) motion, payable by the debtor’s counsel, if the Chapter 7 petition violated Bankruptcy Rule 9011; and a general provision in subparagraph (4)(B) specifies that if the court finds any violation of Bankruptcy

Rule 9011 by the debtor's attorney in a Chapter 7 case<sup>13</sup>, it may award a civil penalty against the attorney, payable to the trustee, U.S. trustee, or bankruptcy administrator.

Other additional new procedures and pitfalls include: required filing of detailed income statements and income verification documents with the bankruptcy Schedules, along with an attorney certification stating the debtor has been provided with certain general bankruptcy information, with provisions for automatic dismissal after 45 days if not completed;<sup>14</sup> filing of all tax returns prior to the first meeting of creditors under §341 due within four years of the filing;<sup>15</sup> required credit counseling with an approved counseling agency; a requirement that Chapter 13 debtors file, on request of a party in interest or the judge, a detailed annual financial statement, under penalty of perjury, showing income, source of income and expenditures, and the identity of any person who is responsible with the debtor for support of dependents or who contributed to the household of the debtor and the amount contributed<sup>16</sup> during the year.

### **3. Provisions Benefitting Certain Creditors**

In addition to the broad limitations on debt relief discussed thus far, a number of changes to the consumer bankruptcy chapters under BAPCPA specifically expand the rights of certain creditors -- particularly banks, car dealers, finance companies, and taxing authorities.

For example, the presumption of nondischargeability for fraud in use of a credit card is expanded by reducing the amounts which trigger the presumption

(from \$1,225 to \$500 for “luxury goods” and from \$1,225 to \$750 for cash advances) and increasing the relevant period of time prior to the filing for computing the amounts (from 60 days to 90 for luxury goods and from 60 to 70 days for cash advances). An amendment to §1325 precludes a Chapter 13 plan from providing for release of lien upon payment of a stripped-down secured claim, and requires that the creditor be allowed to retain the lien until the full amount of the claim is paid or the plan is completed.

Under §724(b) as amended, property tax liens are no longer subordinated to family support claims. If property subject to such a tax lien is sold, the proceeds will now be used to pay the taxes before the support obligations. While the language is not clearly drafted, §1325(a) appears intended to limit the ability of Chapter 13 debtors to purchase cars and other items in the months before bankruptcy, and to then pay only the depreciated value (“stripdown”) under a Chapter 13 plan: it appears no stripdown would be allowed for cars purchased within 910 days of the filing, or for other items within one year of filing. If a debtor under Chapter 7 or Chapter 13 chooses to retain a secured creditor’s collateral by paying a lump sum, or making installment payments under a Chapter 13 plan, the relevant amount is the cost to the debtor of replacing the collateral, without deduction for costs of sale or marketing.<sup>17</sup> The list of debts *excepted* from a Chapter 13 discharge under pre-BAPCPA §1325(a) is expanded, to include fraud such as mis-use of credit cards, unfiled or fraudulent tax returns, and creditors who are not timely advised of the bankruptcy so as to permit them to file

claims.

### **B. Changes Relating to Business Bankruptcies**

Although not so widely publicized as the consumer bankruptcy issues, there are also sweeping changes in the law relating to Chapter 11 reorganizations, typically used by businesses. As with consumer bankruptcies, most of BAPCPA's changes for Chapter 11 tend to (1) limit the discretion of Bankruptcy Courts; (2) constrain the relief given to the debtor company which files for reorganization; and (3) expand the rights of at least some individual creditors.

Although there are many more significant modifications than can be discussed here, some of the key changes include:

#### **1. Curtailment of Bankruptcy Court Discretion.**

Several very significant changes place absolute limits on the discretion given to the Bankruptcy Court to extend the time for a chapter 11 debtor to take action. A key such change concerns the debtor's "exclusive" right to file a plan of reorganization. Under the 1978 Code, a Chapter 11 debtor could often control the bankruptcy case for extended periods of time, by obtaining extensions of the exclusive right to propose a reorganization plan, effectively precluding creditors' committees of other interested parties from offering alternatives. Pursuant to pre-BAPCPA §1121(b), the debtor had the exclusive right to file a plan during the first four months of the case, after which extensions could be sought, and were often granted, pursuant to §1121(d), which – except in the case of a "small business" debtor<sup>18</sup> -- places no restrictions on the court's discretion to grant

extensions.

Apparently in response to criticisms that bankruptcy courts were too lenient in extending the debtor's exclusive right to file a plan, BAPCPA amends §1121 of the Code to prohibit any extensions of exclusivity beyond 18 months from the petition date, and to provide that solicitation of votes for a plan may not be extended beyond 20 months. As a result, creditors, creditors' committees and others may file competing plans more quickly, placing greater pressure on chapter 11 debtors.

Another significant change, of particular importance to retail debtor businesses, limits the Bankruptcy Court's discretion to extend the time for a debtor to assume or reject a lease of non-residential real property. The 1978 Code requires a debtor to assume or reject the lease within 60 days, but the court could broadly grant additional time for "cause."<sup>19</sup> As a result, although a debtor was required to continue performing under a lease which had not been rejected, the debtor could defer a decision to formally assume or reject the lease, by obtaining extensions with the Court's approval. By contrast, BAPCPA requires the debtor to make its final decision more quickly; while it extends the "automatic" deferral period from 60 to 120 days, BAPCPA expressly prohibits any further extension in excess of 90 additional days, without the landlord's written consent. Thus, debtors have a maximum of 210 days to decide whether to affirm or reject, absent the cooperation of a landlord.

## **2. Limitations on Debtor Rights and Relief.**

Where limitations on the Bankruptcy Court's discretion may indirectly affect the relief available to business debtors, other provisions of BAPCPA more directly reduce the debtor's "rights" as they previously existed in bankruptcy.

Two of the more important changes relate to lawsuits brought by debtors (both consumers and businesses). The venue statute, 28 U.S.C. §1409, is amended to generally provide that any action brought to recover money on a consumer debt for less than \$15,000, or a debt excluding a consumer debt against a non-insider for less than \$10,000, must be brought in the district in which the *defendant* resides. Previously, the limitation applied only where the amount sought was \$1,000 or less. Thus, debtors will more often be required to weigh the cost and inconvenience of litigation in a different venue against the benefits of the litigation.

In addition, changes to the substantive law governing actions by the debtor to recover some payments made to creditors within 90 days – so-called "preferences"-- will make it easier for the creditor, and more difficult for the debtor, to prevail. The theory of preference litigation is that creditors who were fortunate enough to receive payments on "antecedent" debts in the months before bankruptcy should be required to refund the payments, to permit an equitable allocation of the funds among all creditors. In many cases, preference litigation accounts for a large part of the litigation undertaken by business debtors, and is often used, to the dismay of creditor defendants, to help fund the cost of the reorganization. Under the 1978 Code, the debtor could

recover the payments unless the creditor affirmatively showed that the payments were in the ordinary course of the parties, *and* according to business terms in the industry. It is commonly believed that many preference defendants choose to settle such cases, rather than undertaking the cost of defense, which includes, among other things, the cost of offering evidence of industry practice.

BAPCPA changes the law by (1) providing that a non-consumer debtor may *not* avoid preferences where the aggregate amount is less than \$5,000; and (2) considerably lessening the defendant's burden of showing the "ordinary course" defense, by allowing a creditor to prevail by showing *either* that the payments were in the parties' ordinary course *or* were according to ordinary business terms in the industry. Presumably, the number of preference actions (and the dollar amounts of many settlements) will be much smaller.

BAPCPA also clamps down in a variety of ways on the compensation (including severance packages) that business debtors may offer to executives and others in the course of the reorganization.<sup>20</sup>

### **3. Additional Creditor Benefits.**

Numerous other provisions in BAPCPA directly benefit creditors, particularly those who provide service after the bankruptcy filing. For example, the "administrative" claim provisions of §503 are expanded to include such administrative treatment of claims for sellers of goods received by the debtor in the ordinary course within 20 days of the commencement of the case, and for actual and necessary expenses of closing a debtor health care facility. In addition,

utility companies will be able to routinely demand cash or a similar deposit with regard to post-petition service. While §366 of the 1978 Code already required “adequate assurance” of payment, BAPCPA expressly states that prior payment history, proof of post-petition financing or allowance of an “administrative” claim (commonly used to show adequate assurance under the 1978 Code) *cannot* constitute such adequate assurance.

1. “Debtors in Rush to Bankruptcy as Change Nears,” *The New York Times*, August 21, 2005. The Article cites LexisNexis as its source for nationwide bankruptcy filing statistics.
2. The Clerk reports monthly filings for 2005 as follows: January - 2,705; February - 2,633; March - 3,979; April - 3,800; May - 3,629; June - 3,076, and July - 3,596. Filings during the same months of 2004 were: January - 1909; February - 2,535; March - 3,535; April - 3,260; May, 2,876; June - 2,832; and July - 2,733.
3. 11 U.S.C. §101 *et seq.* enacted pursuant to the Bankruptcy Reform Act of 1978, P.L. 95-598, replaced and repealed the pre-existing Bankruptcy Act of 1898.
4. Report of the Commission on Bankruptcy Laws, H.R. Doc. No. 137, Part I, 93<sup>rd</sup> Congress, 1<sup>st</sup> Session 170-173 (1973).
5. In broad terms, disposable income consists of the debtor’s excess monthly income after payment of fixed living expenses and after payment of secured obligations such as mortgage and car payments, where the home or car is being retained by the debtor.
6. Jeweler, “Consumer Bankruptcy Reform in the 109<sup>th</sup> Congress: Background and Issues,” Congressional Research Service (CRS), CRS Report RL 32741, at CRS-10. The Congressional Research Service does not provide direct public access to its reports, requiring citizens to request them from their Member of Congress. Some Members, as well as several non-profit groups, have posted the reports on their Web sites. The referenced report may be viewed, for example, at the American Bankruptcy Institute website at <http://www.abiworld.org/pdfs/s256/CRS-background.pdf>
7. Jeweler, CRS Report RL 32741, at CRS-10.
8. 11 U.S.C. §707(b) (1978 Code).
9. 11 U.S.C. §1325(b).

10. 11 U.S.C. §1322(d) (1978 Code).

11. *See* new 11 U.S.C. §522(o).

12. The 1978 Code version of §727(a)(9)(A) and (B) prohibit a Chapter 7 discharge where there has been a discharge under Chapter 13 within six years unless the Chapter 13 plan paid 100 percent of allowed unsecured claims, or at least 70 percent of such claims and “the plan was proposed by the debtor in good faith, and was the debtor’s best effort.”

13. *See* §103(b) (1978 Code).

14. *See* new §521(a)(1)(B), §521(i).

15. *See* new §521(f).

16. *See* new §521(f)(4).

17. *See* new 11 U.S.C. §506(a)(2)

18. *See* 11 U.S.C. §1121(e)(3) (1978 Code).

19. 11 U.S.C. §365(d)(4) (1978 Code).

20. For example, it prohibits payments to an insider such as an officer or director to remain in the business unless their services are truly essential, the individual has a bona fide offer from another business at the same or greater compensation, *and* the amount does not exceed 10 times the mean of similar payments to non-management employees or if there were no such payments, 25 percent of any similar transfer made to the insider in the prior year.