

Summary of Bankruptcy Reform Legislation¹

Sen. Charles Grassley (R-IA) introduced bankruptcy-reform legislation, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (S. 256), in the Senate on February 1, 2005. The legislation is similar to bankruptcy-reform legislation offered in previous years, and in particular is the same as the version of S. 1920 that passed the House, by a vote of 265-99, in 2004 but stalled in the Senate. As in past legislation, it contains a “needs-based” formula that would require consumers above their state median with substantial ability to repay a significant portion of their unsecured debts to file a Chapter 13 repayment plan rather than Chapter 7 liquidation.

The Senate Judiciary Committee approved S. 256, by a vote of 12-5, on February 17, after adopting amendments related to medical costs, securities fraud, and inflation adjustments. ABA was pleased with the bipartisan Committee action and worked with Senators to oppose further changes to the legislation. The Senate passed S. 256 on March 10, 2005 by a vote of 74-25 after two weeks of debate, during which only minor, non-controversial changes were made to it.

House Judiciary Committee Chairman James Sensenbrenner (R-WI) is a strong supporter of bankruptcy reform and introduced H.R. 685, which is a companion bill to S. 256, on February 9. The House Judiciary Committee took up S. 256 on March 16, rejected all amendments offered to it, and reported the bill out by a vote of 22-13. On April 14 the full House approved S. 256 without amendment by a strong bipartisan vote of 302-126.

The President signed the bill into law on April 20, 2005. Most provisions of the bill will take effect in October 2005.

Consumer Bankruptcy

- An objective needs-based bankruptcy test for determining whether a consumer debtor is abusing Chapter 7, applicable to all filers with above-state median income levels, is established. Generally, a debtor in that category would have his Chapter 7 filing dismissed or converted to a Chapter 13 proceeding if he could repay the lesser of \$10,000 or 25 percent (but not less than \$6,000) of unsecured, non-priority debt over a five-year period. Debtors can only rebut the test’s income and expense provisions by demonstrating “special circumstances”; such circumstances include a serious medical condition or a call to active military service. Disabled veterans whose indebtedness occurred primarily during a period when the debtor was on active duty or performing a homeland defense activity are excused from the means test. This means-testing is aimed at compelling more bankruptcy filers who are capable of repaying a significant portion of their debt to do so. A number of safeguard provisions are included to ensure that low-income individuals, single parents, children, and others in need are adequately protected. Additionally, reasonably necessary expenses for health and disability insurance and health savings account for the debtor (and his spouse and dependents) are taken into account by the means test.

¹ This summary was prepared for the ABA by Philip S. Corwin, Butera & Andrews, Washington, D.C.
pcorwin@butera.andrews.com

- The Office of U.S. Trustee (UST) or the bankruptcy administrator (BA) is required to review all materials filed by the debtor and to file a motion to dismiss a Chapter 7 filing by a debtor who has an income of more than the applicable state median and who fails the needs-based test, or to file a statement declaring why such a motion would not be appropriate. This “bright-line” rule would compel trustees and bankruptcy administrators to assure that more affluent filers with the ability to pay back at least a portion of their outstanding debt in a Chapter 13 proceeding enter into one to receive the benefits of bankruptcy protection. In addition, bankruptcy trustees or parties in interest may make a motion that a debtor’s Chapter 7 case be dismissed for abuse, and creditors are permitted to bring relevant information to the attention of the UST, BA, or bankruptcy trustee.
- Increases the period prior to filing, and decreases the dollar amounts, of charges and cash advances for “luxury goods and services” that will be presumed non-dischargeable. Current law establishes a presumption for charges or cash advances in excess of \$1,000 made within 60 days prior to filing. The bill would change this to \$500/90 days for charges, and \$750/70 days for cash, per line of credit. This would expand the category of debts that a bankruptcy filer could not avoid, given that some filers “load up” on such luxury items or cash advances just prior to declaring bankruptcy. The presumption can be defeated if the debtor can document that the charges or cash were used for goods or services necessary for household maintenance, such as groceries or rent.
- Makes non-dischargeable any debt incurred to pay a state or local tax. (Federal taxes are already covered under current law.) Thus, credit card debt incurred to pay state or local taxes would not be discharged.
- Generally limits the extent to which debtors can shelter real estate assets from bankruptcy creditors by abusing unlimited homestead exemptions available in certain states. The bill establishes a general rule that a debtor is bound by the homestead exemption of his prior state of residence until he has been located in a new state for two years. In addition, a debtor may not claim a homestead exemption of more than \$125,000 until he has resided in a more generous state for 40 months. This \$125,000 cap is made permanent for any debtor who owes money as a result of violating federal or state securities law, fraud, a RICO violation, or an act that caused serious injury or death. Finally, in any case where a debtor attempts to hinder, delay, or defraud a creditor within the ten years prior to filing bankruptcy by changing residence to a more generous homestead exemption state, the debtor will not be permitted to shelter assets under that more generous exemption.
- Clarifies that any judgment, order, or settlement agreement for a violation of a securities fraud law committed after the filing of a bankruptcy case is nondischargeable.
- Increases the length of Chapter 13 repayment plans to five years for debtors with income above the state median, thereby increasing the likelihood, and total amount, of repayment. The standard Chapter 13 repayment plan term would remain three years for debtors earning less than median income.
- Requires debtors to submit federal tax returns or transcripts prior to the first meeting of creditors, and makes these documents available to any party in interest; also requires a debtor’s case to be dismissed if all required information is not filed within 45 days after the initial petition for bankruptcy relief. This provides creditors with more information on the

debtor's finances, permitting creditors to better gauge the likelihood of repayment while providing greater knowledge of potentially accessible assets.

- Requires debtor attorneys to certify that they have performed a reasonable investigation into the circumstances giving rise to a client's bankruptcy petition and that it is well-grounded in fact.
- Places restrictions on certain abusive and misleading activities of debt relief agencies.
- Generally bars the discharge of educational loans made, insured, or guaranteed by a governmental unit or funded by a non-profit institution.
- Conditions eligibility to file for bankruptcy upon a debtor's consultation with an approved credit counseling agency within the prior six months. Also requires completion of an approved financial education course as a condition of discharge from bankruptcy. Such preconditions are viewed as helpful to discourage bankruptcy filings and to encourage greater repayment activities. UST supervision of the credit counseling industry will also help consumers better identify legitimate non-profit agencies charging reasonable fees. In addition, the court is granted discretion to reduce a claim based on unsecured consumer debt by up to 20 percent if a creditor has refused to negotiate a reasonable alternative repayment schedule proposed by an approved credit counseling agency.
- Additional creditor disclosures are required to obtain a legally binding reaffirmation of unsecured consumer debt.
- Debtors must send required notices, including account numbers, to the address designated by a creditor. Creditors may not be subject to any monetary penalty for violation of the automatic stay where they have not received effective notice of the bankruptcy filing.
- Broadened categories of retirement funds (up to a \$1 million cap), as well as education IRAs and tuition program credits (capped at no more than \$5,000 in the year prior to filing), are sheltered from creditors.
- When an individual files for Chapter 11 reorganization, property acquired and earnings received between the filing of the case and discharge are included as property of the estate; subjects a Chapter 11 discharge for an individual debtor to the exceptions from discharge applicable to Chapters 7 and 13; and places other limitations on the abusive use of Chapter 11 by individual debtors.
- Provides a uniform definition of "household goods" that are exempt from nonpossessory, nonpurchase money liens.
- Domestic support obligations (alimony, maintenance, and child support) are accorded first priority among all unsecured debt. Discharge of an individual debtor in Chapters 11, 12, and 13 is made contingent upon full payment of all such obligations owing under the reorganization plan. Actions for the establishment or modification of an order for domestic support are exempt from the automatic stay. Provides that a domestic support obligation is nondischargeable; and that obligations to a spouse, former spouse, or child that are incurred in connection with a divorce or separation proceeding are nondischargeable irrespective of the debtor's inability to pay such debts. Requires bankruptcy trustees to provide certain notices to child support claimants and government enforcement agencies.

Secured Loans

- When a debtor files in Chapter 13, the legislation requires: (1) debtors to make contract payments within 30 days after filing for bankruptcy, thereby continuing the payment obligation of the debtor; and (2) payments to be held by the trustee until confirmation of the repayment plan, or denial thereof. Where the plan is confirmed, those funds would be disbursed to creditors as soon as is practical. Importantly, where the plan is not confirmed, those monies would be returned to the debtor, *minus amounts already due and owing*, plus administrative expenses. Thus, the bill would protect secured lenders by both requiring continuation of payments on any underlying debt and ensuring that past-due arrearages held by the trustee are ultimately turned over to creditors.
- Prohibits any “cramdown” of a debt secured by a purchase money security interest in a motor vehicle acquired for the debtor’s personal use if the debt was incurred within the two and one-half years preceding the filing. Prohibits “cramdown” of debts secured by other property if incurred within one year prior to filing.
- Specifies that the value of a claim secured by personal property is replacement value, without deduction for marketing or sales costs; replacement value is the price a retail merchant would charge for such property considering its age and condition.
- A Chapter 7 debtor is required to reaffirm or redeem a loan secured by personal property within 45 days of filing, or surrender the property.
- A secured creditor in Chapter 13 retains its lien on the collateral until debt payment is completed or the debtor receives a discharge.

Commercial and Agricultural Bankruptcy

- Establishes an expedited form of Chapter 11 reorganization for small businesses with less than \$2 million in aggregate debts. This includes a standard form for disclosure statements and reorganization plans, uniform national reporting requirements and rules, enumerated duties that must be performed on schedule, a general rule that reorganization plans must be filed within 180 days, and additional duties for the UST.
- Sets a strict exclusivity period of eighteen months in which only the debtor in a Chapter 11 case can propose a plan or reorganization, thereby ending current practice in which creditors may be barred from proposing a plan for years due to repeated judicial extensions of the exclusivity period.
- Requires the U.S. Trustee to move for the appointment of a trustee to replace existing Chapter 11 management if there are “reasonable grounds to suspect” that the debtor’s board, CEO, CFO, or the governing body that the selected the CEO or CFO participated in fraud, dishonesty, or criminal conduct in their management or public financial reporting.
- Generally bars retention bonuses and other payments to senior management of a company in Chapter 11, and places strict monetary limits on such payments in the narrow circumstances where they are permissible.

- Eliminates the \$4 million debt cap on single asset real estate cases in which expedited relief for creditors is available, making such relief available in large commercial realty reorganizations. The court is required to grant relief from the automatic stay within 30 days after determining that the debtor has failed to file a realistic plan of reorganization or commenced making monthly payments to secured creditors. These provisions will end abusive Chapter 11 filings that waste assets and allow property deterioration where the debtor has no feasible chance of reorganizing.
- The reclamation claims of unsecured trade creditors would be expanded, but would remain subordinate to the interests of a secured creditor. Voluntary returns of trade goods by a debtor are also made explicitly subordinate to security interests.
- Sets a deadline of no more than 210 days in which a retail debtor must assume or reject an unexpired lease of nonresidential realty, and creates a landlord's administrative expense priority of two years where such a lease is assumed and subsequently rejected. These provisions will complicate the ability of large retail operations to reorganize in Chapter 11.
- Provides that a trustee may not avoid a transfer in payment of a debt, incurred by a debtor in the ordinary course of business, where the transfer is made in the ordinary course of business or in accordance with ordinary business terms.
- Allows for the payment of expenses incurred by attorneys or accountants serving a creditors' or equity holders' committee as an administrative expense.
- The provisions of Chapter 12 affecting family farm bankruptcies are made permanent, and modified as follows:
 - The eligibility debt limit is raised from \$1.5 million to \$3.237 million, and indexed to inflation going forward.
 - The percentage of aggregate debt that must arise from farming operations is reduced from 80 percent to 50 percent.
 - The requirement that the debtor receive at least half his income from farming operations in the preceding taxable year is expanded to cover debtors who, in the alternative, met this test in both the second and third taxable years prior to filing.
 - Post-confirmation, retroactive modification of a Chapter 12 repayment plan is barred even when the debtor's income has risen substantially; increased payments may be assessed only going forward and cannot require payments to unsecured creditors greater than the debtor's disposable income unless the debtor proposes such a modification.
 - Chapter 12 protections are extended to commercial fishing operations, including aquaculture. However, the preexisting eligibility rules apply to those engaged in commercial fishing operations – that is, their aggregate debts must be less than \$1.5 million, 80 percent of those debts must arise from commercial fishing operations, and at least 50 percent of income must have been generated from such activities in the tax year prior to filing.
- Financial instrument netting provisions provide legal certainty where the issuer of, or counterparty to, swaps, derivatives, repurchase agreements, or other similar instruments

becomes insolvent. These provisions amend the Federal Deposit Insurance Act and the Federal Credit Union Act as well as the Bankruptcy Code.

- Repeals a Depression-era provision that automatically bars any investment banker (including bank securities affiliates) that has ever participated in the underwriting of an outstanding securities issue of a debtor company from acting as a financial advisor in that company's Chapter 11 reorganization. The bankruptcy court retains discretion to bar the participation of any investment banker with an interest materially adverse to the estate or to any class of creditors or equity security holders.
- New cross-border bankruptcy provisions clarify which applicable law is to be used in insolvencies that involve multiple national jurisdictions, so as to provide for fair and efficient administration and protect and maximize the value of the debtor's assets. The Model Law on Cross-Border Insolvency, promulgated by the United Nations Commission on International Trade Law (UNCITRAL) is largely incorporated within the Code, with variations reflecting U.S. law and policy. These include a general preference that the main proceeding should be brought in the home country of the debtor, with supportive ancillary proceedings in other jurisdictions where debtor assets are found.
- Excludes funds withheld or received by an employer from employee wages for contributions to employee retirement, deferred compensation, or health insurance plans, or for tax-deferred annuities, from inclusion as property of the estate.
- Establishes special rules governing the bankruptcy of health care businesses. Provides that the actual, necessary costs and expenses of closing a health care business are administrative expenses; allows for the appointment of an ombudsman to act as patient advocate; and exempts from the automatic stay an exclusion of the debtor from participation in Medicare and other specified federal health care programs brought by the Secretary of Health and Human Services.
- Purchasers of an interest in specified predatory loan assets through a bankruptcy sale would remain subject to all claims and defenses as under applicable non-bankruptcy law.
- Perfects the Code's 1994 fix of the DePrizio problem by clarifying that a trustee may not avoid a preferential lien given to a noninsider bank more than 90 days and less than one year prior to filing where the transfer benefited an insider guarantor of the debtor's debt. (The 1994 fix covered transfers to a noninsider creditor.)

Administrative Provisions

- Allows creditors to be represented by a non-attorney at the first creditors' meeting.
- Lengthens the permissible time period between a prior and new bankruptcy discharge. The minimum time period in which a debtor can receive sequential Chapter 7 discharges is increased from six to eight years. A new Chapter 13 discharge is not available for four years if the debtor previously received a discharge in Chapter 7, 11, or 12; for two years if the prior discharge was in Chapter 13.
- Allows direct appeal of bankruptcy court rulings to the Appeals Court under certain circumstances.

- The Code's provisions prohibiting fraudulent transfers and obligations are strengthened by doubling the look back period to two years, and by extending coverage to include transfers to or obligations incurred on behalf of company insiders. Additionally, the trustee is provided with new authority to avoid any transfer of a debtor's interest property made within 10 years prior to a bankruptcy filing where such transfer was made to a self-settled trust or similar device with intent to hinder, delay or defraud any creditor, or in anticipation of any judgment, settlement, civil penalty, equitable order or criminal fine arising from any violation of securities laws or due to fraud, deceit, or fiduciary manipulation in connection with the purchase or sale of any registered security.
- Limits are placed on the use of nonpublic customer information by purchasers of assets in bankruptcy. They would generally subject purchasers to the same privacy policies that the debtor had in place at the time of the bankruptcy, with the court authorized to waive such restrictions. A consumer privacy ombudsman must be appointed when a trustee seeks to sell or lease personally identifiable information.
- Provides the bankruptcy court with authority to redact information in publicly available bankruptcy records to protect filers against identity theft or other unlawful injuries. Only the last four digits of Social Security numbers would appear in publicly available bankruptcy documents; creditors would receive the debtor's full Social Security number in their initial notice of the case.
- The Attorney General is required to promulgate rules mandating the establishment of uniform forms for final reports in Chapter 7, 12, and 13 cases, and periodic reports in Chapter 11 cases, to facilitate compilation of uniform bankruptcy data to be made available to the public by both physical and electronic access.
- The Attorney General and Judicial Conference are required to randomly audit at least one of every 250 bankruptcy filings to help determine the accuracy and completeness of required filings, and to make the aggregate results of these audits available to the public.
- Numerous new permanent and temporary bankruptcy judgeship positions are established to help the courts deal with the sharp increase in bankruptcy filings.

Consumer Credit Disclosures and Regulations

- Consumer lenders are required to make new disclosures regarding: (1) minimum payments; (2) introductory rates; (3) late payment deadlines and penalties for open-end lines of credit; and (4) the tax consequences of certain home equity loans. Additional information about minimum payments must be available via a toll-free telephone number. Banks with assets of less than \$250 million are exempt from this toll-free number requirement for at least the first 24 months this provision is in effect; the Federal Reserve is required to establish such a phone line during that period, and to report to Congress 18 months after the effective date regarding the toll-free number program.
- Requires Internet-based credit card solicitations to include specified Truth in Lending Act disclosures.
- Prohibits a creditor from closing an open-end consumer loan account solely because the consumer has not incurred finance charges on the account.

- Requires the Federal Reserve to conduct studies, and report to Congress, regarding: (1) the types of information available to potential borrowers from consumer lenders regarding factors qualifying borrowers for credit, repayment requirements, and the consequences of default; (2) the adequacy of consumer protections to limit liability from unauthorized use of a debit card; and (3) the impact of credit extended to dependent college students.
- Authorizes the Federal Reserve to study consumer credit industry solicitation and credit granting policies and their effect upon consumer debt and insolvency, and to issue regulations requiring additional disclosures to consumers.

Effective Date

- Most provisions of the bill go into effect 180 days after the President signs it; however, the consumer credit disclosure provisions take effect 12 months after enactment (18 months for the minimum payment disclosure).