

## **Bankruptcy Abuse Prevention and Consumer Protection Act of 2005**

The bankruptcy reform bill (S. 256) passed by Congress and signed into law by the President corrects a fundamental flaw in the current bankruptcy system – the fact that many debtors who can pay their debts avoid doing so by filing for Chapter 7 bankruptcy.

The bankruptcy reform bill creates a more objective, needs-based bankruptcy test that will be used to determine whether debtors can afford to repay some or all of their debts. This change will result in more bankruptcy filers who are capable of repaying a significant portion of their debts to do so under Chapter 13 of the bankruptcy code.

The needs test creates a presumption that debtors can repay their debts if they earn more than the median income in their state (which averages over \$54,000 nationally for a family of four) and have at least \$100 per month left over after subtracting living expenses and priority payments such as taxes, alimony and child support.

However, the new test will continue to allow those with “special circumstances,” such as a sudden loss of income or extraordinary medical expense, to continue to file for Chapter 7 bankruptcy. It will also ensure that those debtors truly in need of debt forgiveness, such as those earning less than the state’s median income and those who cannot afford to pay any of their debts, can still use Chapter 7 and have all of their debts expunged.

Those contemplating bankruptcy must receive credit counseling from an agency approved by the U.S. Trustee within the 180 day period prior to filing for bankruptcy so that they know and understand the pros and cons of going into bankruptcy and all of their options. Also, in order to complete the bankruptcy process and be “discharged,” debtors must complete a financial literacy course. These provisions will benefit consumers and should help to reduce the number of future bankruptcies.

Bankruptcy reform also puts women and children first because it gives priority to child support and alimony payments in bankruptcy proceedings and helps strengthen the enforcement of these obligations compared with current law.

In particular, a debtor’s discharge under Chapters 11, 12 and 13 is contingent upon full payment of all of these obligations. Action to establish or modify an order for domestic support is not subject to the automatic stay on legal proceedings put in place when bankruptcy is filed. Further, domestic support payments and payments to a spouse, former spouse or child in divorce or separation proceedings cannot be eliminated by filing for bankruptcy, irrespective of the debtor’s inability to pay such debts. Finally, bankruptcy trustees are required to provide notice to child support claimants and government enforcement agencies.

### **Key Provisions**

A debtor’s ability to run-up significant debt just prior to bankruptcy is limited. Debtors will find it much harder to “load up” on non-essential luxury items or cash advances just prior to declaring bankruptcy. Current law establishes a presumption that a debtor cannot eliminate charges or cash advances in excess of \$1,000 made within 60 days of filing for bankruptcy.

S. 256 changes this to \$500 within 90 days of filing for credit card charges, and \$750 within 70 days of filing for cash advances, per line of credit.

Abuses of the homestead exemption are restricted. Most states have limits on the equity in a primary residence that can be shielded from creditors. However, in some states there are no limits and some debtors have taken advantage of this by buying big, expensive homes in these states and then declaring bankruptcy. The new law places restrictions on this practice by providing that a debtor that moves from his or her state to another state is bound by the homestead exemption of his prior state until he has lived in a new state for two years. After the two years is over, the debtor is limited to a homestead exemption of \$125,000 until he has lived in the state for another 16 months. Further, the \$125,000 limit is made permanent for any debtor who violates federal or state securities laws, or for fraud or a RICO violation, or an act that caused serious injury or death. Finally, the use of an unlimited homestead exemption can be overturned if a creditor can show that the debtor attempted to hinder, delay or defraud a creditor within the 10 years prior to filing bankruptcy by changing residence to a state with a higher homestead exemption.

The rights of secured creditors to continue to receive payments on secured loans during bankruptcy are protected. Debtors in Chapter 13 are required to continue to make contract payments within 30 days after filing for bankruptcy — there is no automatic stay. The payments will be held by the bankruptcy trustee until confirmation or denial of the repayment plan. If the plan is confirmed, payments will go directly to creditors. If the plan is not confirmed, creditors are paid and administrative expenses are subtracted before the remaining amount is returned to the debtor.

Cramdown of secured debt is prohibited. The remaining balance of a loan secured by a motor vehicle for the debtor's personal use cannot be crammed down if the loan was taken out within two and one-half years before the bankruptcy filing. For loans secured by other property, no cramdown is allowed if they are incurred within one year prior to filing.

The Chapter 13 repayment period is increased. The length of Chapter 13 repayment plans is increased from three to five years for debtors with income above the state median, which increases the likelihood, and total amount, of repayment. For debtors earning less than the state's median income, the standard Chapter 13 repayment plan term of three years would remain.

Reaffirmation is strengthened. A Chapter 7 debtor must reaffirm or redeem a loan secured by personal property within 45 days of filing for bankruptcy, or the creditor can reclaim the property. However, statutory written disclosures must be given and other procedural actions must be complied with in certain situations, in particular when the debtor does not appear to have sufficient income to repay the reaffirmed loan.

Liens are protected in Chapter 13. A secured creditor of a debtor in Chapter 13 retains its lien on the collateral until the debt is repaid or the debtor receives a discharge.

There is greater certainty for netting. S. 256 contains new financial instrument netting provisions that provide greater legal certainty in situations where one of the parties in swaps, derivatives, repurchase agreements or other similar transactions becomes insolvent.

Commercial bankruptcy improvements are made. S. 256 will substantially improve the commercial bankruptcy process. For instance, it eliminates the current \$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.

### **Other Issues**

The bankruptcy reform bill is the product of difficult political compromises and negotiations stretching back over 10 years. Overall, the reforms made by S. 256 will improve the current bankruptcy system and will benefit lenders but there are a few provisions that could have negative consequences for some lenders, although the practical consequences are not entirely clear:

Consumer lenders will be required to make new disclosures to consumers such as the cost of making only minimum payments on credit card debt, introductory rates, late payment deadlines and penalties for open-end lines of credit and the tax consequences of certain home equity loans.

The provisions of Chapter 12 affecting family farm bankruptcies are made permanent. Among other changes: the current 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.

Congress focused on the use of certain trusts that it believed are being used by debtors to hide assets from creditors in the anticipation of a bankruptcy filing. Bankruptcy trustees are given new authority to void any transfer of a debtor's interest in property made within 10 years prior to a bankruptcy filing. This applies to situations in which such a transfer was made to a self-settled trust or similar device with the 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.