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HIGHLIGHTS OF CONSUMER BANKRUPTCY CHANGES UNDER THE BANKRUPTCY ABUSE PREVENTION AND CONSUMER PROTECTION ACT OF 2005

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On April 20, 2005, President Bush signed into law the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the "2005 Act"), which effects numerous broad and sweeping changes to the Bankruptcy Code (the "Code"). Most changes become effective on October 17, 2005. This memorandum briefly summarizes some of the more significant changes relating to consumer bankruptcy filings that may affect creditors.

The 2005 Act includes the following changes, which are of special import to creditors:

- Changes to who may file and under what chapter of the Bankruptcy Code they may file, including a "means test" for debtors filing Chapter 7, changes affecting individual Chapter 11 filings, and an expansion of eligibility for Chapter 12 filings.
- Changes to the treatment of debtors who file multiple bankruptcies, including increases in the time between discharges and limits on the automatic stay.
- Changes to the treatment of secured creditors in Chapter 13 cases, including limitations on the ability to "stripdown" the value of collateral.
- Changes to the homestead exemption.
- Changes to the bankruptcy discharge, including restrictions to the Chapter 13 discharge and expanded provisions for the nondischargability of luxury goods.

I. Who May File Under What Chapter?

A. Who may file a Chapter 7: The "Means Test"

The most significant change in the 2005 Act is the so-called "means test" to determine the eligibility of individuals to file a Chapter 7. Congress was concerned that too many debtors who could afford to repay at least a portion of their debts were filing Chapter 7, which allows debtors to discharge their debts with a few exceptions, rather than filing Chapter 13, which requires debtors to repay secured debts and a portion of unsecured debts over time according to a plan. The means test restricts the eligibility of individual debtors to file a Chapter 7, in an effort to force more individual debtors to file Chapter 13 and repay a portion of their debts according to a Chapter 13 plan.

Under the means test, a debtor's income and expenses are examined to determine whether there is a presumption of abuse, i.e., that the individual debtor's Chapter 7 filing is an abuse of the Code. The current law presumes that a Chapter 7 filing is not an abuse of the Code. In contrast, under the 2005 Act, if the debtor "fails" the means test, a presumption of abuse arises, and the debtor's case will be dismissed or converted to a Chapter 13, unless the debtor successfully rebuts the presumption. The means test consists of two steps. First, a debtor's income is compared to the state's median income to determine whether the means test applies at all. Second, the debtor's expenses are evaluated to determine whether the debtor has or should have some income available to pay unsecured creditors through a Chapter 13 plan.

Step 1: Compare the Debtor's Income to the Applicable Median Family Income

The first step is to determine whether the debtor's current monthly income is greater than the applicable "median family income." The debtor's current monthly income is the debtor's average income for the six months preceding the filing of the bankruptcy petition. The debtor's applicable median family income depends on the debtor's state of residence and family size. Median family income is defined as the median family income reported by the Bureau of the Census for the most recent year, and then adjusted for inflation. The applicable median income is the highest median income in the debtor's state for a family of the same size or smaller.

For example, according to tables published by the Bureau of the Census, the 2005 median incomes for North Carolina as reported by the Bureau of the Census are shown in Table 1. In North Carolina, the applicable median income for a family of three or fewer people is $45,540, for 4 people is $58,000, and for more than 4 people is $58,000 plus $6,300 per person in excess of 4. This number is divided by 12 and compared to the debtor's current monthly income. If the debtor's current monthly income exceeds the applicable median income, then the second step is applied; if not, the debtor is eligible to file a Chapter 7.

TABLE 1

	1 Person	2 People	3 People	4 People	More than 4 People
Median Income	$45,540	$41,184	$45,310	$58,000	Add $6,300 for each additional person over 4

Step 2: Apply the Means Test

The second step is to determine whether the debtor has or should have sufficient income to repay a portion of his or her unsecured debts. In this step, certain allowed expenses are subtracted from the debtor's current monthly income. There are several categories of allowed expenses, including payment of secured debts, and continued contributions to tax-exempt charities. In addition, living expenses are allowed as determined by the standards developed by the Internal Revenue Service. The IRS living expenses standards were developed by the IRS for use in negotiation with taxpayers for the payment of overdue taxes. The standards set monthly amounts, on a county-by-county basis, for housing and utilities, as well as regional and national standards for food, clothing, and transportation expenses. The IRS standards are very stringent.

Subject to certain exceptions, if after subtracting allowable expenses from the debtor's current monthly income, the debtor's remaining monthly income is at least $100 and would be sufficient to pay at least 25% of the debtor's unsecured debts over a five-year period, or if the debtors remaining monthly income is more than $166.66 per month ($10,000 over a five-year period), then the presumption of abuse arises. This scheme is summarized in Table 2.

Enforcement and Effect of the Means Test

A debtor may rebut the presumption of abuse by showing special circumstances that decrease income and/or increase expenses. If the presumption is not rebutted, the bankruptcy court will grant a motion either to dismiss an individual's bankruptcy case or, with the debtor's consent, to convert the case to a Chapter 13. Under previous law, motions to dismiss or convert a Chapter 7 could only be brought by the United States Trustee or the Bankruptcy Administrator. However, under the 2005 Act, any "party in interest," which includes creditors, may bring a motion to dismiss or convert.

At the commencement of a Chapter 7 case, a debtor must file a statement of current monthly income as well as the calculations to determine whether the presumption of abuse arises with his or her petition. Filing a Chapter 7

Table 2

Current Monthly Income Less Allowed Expenses	Presumption of Abuse
Less than $100	No Presumption of Abuse
$100	Arises unless unsecured debt exceeds $24,000
$166.66	Arises unless unsecured debt exceeds $39,998.40
More than $166.66	Always arises

that does not qualify under the means test could subject both the debtor and the debtor's attorney to penalties. Therefore, the net result of the means test should be fewer Chapter 7 filings, and possibly fewer bankruptcy filings overall, if a debtor who is ineligible for Chapter 7 elects to forego filing a Chapter 13.

B. Individual Chapter 11 Filings

Under the 2005 Act, it is possible that certain high-income, high-debt individuals will be precluded from filing either a Chapter 7 or a Chapter 13. This is because these individuals would likely "fail" the means test under Chapter 7, but would be unable to file Chapter 13 because their debts exceed the debt ceilings for Chapter 13. (In 2005, a debtor may not file Chapter 13 unless his or her unsecured debts are less than $307,675 and secured debts are less than $922,975.)

As a result, some of these individuals will be forced to file a Chapter 11 bankruptcy, the chapter most often associated with business reorganizations. Consequently, Congress enacted several changes to Chapter 11 to make it similar to a Chapter 13 for individual debtors.

C. Family Farmers

The 2005 Act also changes Chapter 12 of the Code, which currently deals with family farmers. In general, Chapter 12 is analogous to a Chapter 13 with special provisions applicable to farmers. Previously, Chapter 12 had included sunset provisions requiring it to be periodically reenacted. The 2005 Act makes Chapter 12 a permanent chapter of the Code.

In addition, the definition of "family farmer" is amended to raise the debt ceilings for eligibility. To file under Chapter 12 of the current Code, a farmer must have aggregate debts not exceeding $1.5 million, at least 80 percent of which must have arisen from a farming operation. Under the 2005 Act, a farmer is eligible for a Chapter 12 if his debts do not exceed $3,237,000, and at least 50 percent of that debt arises from the farming operation. The increase in debt limits is likely to make Chapter 12 a more attractive option for small family farmers.

Finally, Chapter 12 is expanded to include "family fisherman." To be eligible to file Chapter 12, a fisherman must have aggregate debts not exceeding $1.5 million, at least 80 percent of which must have arisen from a commercial fishing operation.

II. Multiple Bankruptcies

The 2005 Act changes the treatment of debtors who file multiple bankruptcies. First, the time between discharges has been extended. The time that a debtor must wait between discharges is summarized in Table 3.

In addition, the 2005 Act limits the application of the automatic stay for serial bankruptcy filings. In general, if an individual debtor files a second bankruptcy within one year of the dismissal of the first bankruptcy, the automatic stay in the second case terminates 30 days after the filing unless the debtor or a party-in-interest shows that the second filing is made in good faith. If there is a third filing, the automatic stay does not go into effect at all unless, after a hearing, the court determines that the filing is in good faith

TABLE 3

Prior Case	Current Case		
	Chapter 7	Chapter 11	Chapter 13
Chapter 7	8 years	None	4 years
Chapter 11	8 years	None	4 years
Chapter 13	6 years	None	2 years

and orders the stay to take effect. This change should deter debtors from filing multiple bankruptcies simply to delay the repossession of collateral or foreclosure of a home, and will allow creditors to avoid filing relief from stay motions in repeat cases.

III. Secured Debts

A. Retention of Collateral Option Abolished

Prior to the 2005 Act, the courts were divided over whether a debtor, who was current on a secured debt, could retain the collateral and continue making payments without redeeming or reaffirming the debt. The Fourth Circuit, where North Carolina is located, had ruled that as long as the debtor was not in default on its credit agreement, the debtor could retain the collateral and continue to make payments. This option has often been referred to as the "ride-through" option. Other circuits ruled that the only way the debtor could retain the collateral was to redeem it or reaffirm the debt.

The 2005 Act expressly abolishes the ride-through option. All debtors will be required to either surrender the non-exempt collateral to the secured creditor, redeem it by paying the creditor the value of the collateral, or sign a reaffirmation agreement with the secured creditor which excepts the debt from the discharge.

B. Debtor's Statement of Intention

Under the current Code, if a debtor has debts secured by property, the debtor is required to file a statement of intention stating what the debtor intends to do with that property, i.e., surrender the property, retain it as exempt, redeem the property, or reaffirm the obligation. The current Code requires the debtor to perform the stated intention within 45 days of filing the statement of intention. Because there is no penalty for a debtor who does not timely perform the stated intention to repossess property, secured creditors often incurred the expense of filing motions for relief from stay despite the debtor's stated intent to surrender the property.

Under the 2005 Act, a debtor still must file a statement of intention. However, the debtor is only allowed 30 days to perform the stated intention. If the debtor fails to perform the intention within that time, the stay is automatically lifted with respect to the property in question.

C. Changes to the Treatment of Secured Claims in Chapter 13 Cases

The 2005 Act makes significant changes to the debtor's ability to "stripdown" the value of creditors' liens in Chapter 13. Under the current Code, a debtor can reduce a secured creditor's claim down to the value of the collateral, giving the creditor an unsecured claim for the difference. This is commonly referred to as a "stripdown" and is most effective when the debtor files a Chapter 13 bankruptcy early in the term of a secured loan, when the amount of the debt often exceeds the value of the collateral.

Under the revised Code, a debtor may not stripdown the value of purchase money security interests in automobiles purchased with 2 ½ years of the bankruptcy filing. If the debt is secured by any other thing of value and is incurred within 1 year of the bankruptcy filing, it may not be stripped, regardless of whether or not it is a purchase money security interest.

When stripdown is permitted, the secured creditor's claim may only be reduced to the "replacement value" of the collateral, which in general is the price a retail merchant

would charge for like property of similar age and condition. In addition, the debtor's Chapter 13 plan may no longer provide that the lien be released upon payment of the stripped-down value. Rather, secured creditors retain their liens until their claims are paid in full or until the plans are completed. In other words, if a debtor pays the full amount of the stripped down lien, but does not complete payments under the plan and the case is dismissed prior to discharge, the secured creditor would still retain its lien on the collateral that could be enforced against the debtor.

D. Reaffirmations

Reaffirmation agreements are agreements between a debtor and a creditor signed after the debtor's bankruptcy whereby the debtor agrees to repay a debt incurred prior to the date of the bankruptcy filing, subject to bankruptcy court approval. The 2005 Act requires that the debtor sign specific and extensive disclosures before signing a reaffirmation agreement. The debtor must state the amount of his or her monthly income and expenses. If the difference between income and expenses is not sufficient to cover the payment set forth in the reaffirmation agreement, then the agreement is presumed to create an undue hardship on the debtor. The debtor may rebut this presumption by explaining how the payment can be afforded. Unless the presumption is rebutted, the bankruptcy court will not approve the reaffirmation agreement.

In the event that the presumption of undue hardship arises, the debtor's attorney must make the additional certification "that in the opinion of the attorney, the debtor is able to make the payment." Attorneys will understandably be reluctant to sign any such certification. As a consequence, reaffirmation agreements are likely to be extremely rare if the undue hardship presumption applies.

E. Household Goods

The 2005 Act also restricts what household goods a debtor can claim as exempt to avoid nonpossessory, non-purchase money security interests in such goods. The term "household goods" is now restricted to limit the amount of electronic equipment (1 radio, 1 television, 1 VCR, 1 personal computer) and to exclude all art, antiques, and jewelry other than wedding rings.

IV. Changes to the Homestead Exemption

The 2005 Act adds several new limits to the ability of a debtor to claim a homestead exemption, the amount of equity in a home that a debtor may exempt from his or her creditors. To prevent a rush to bankruptcy for debtors with larger homestead exemptions, these changes became effective immediately upon the enactment of the 2005 Act.

First, a state's exemptions will only apply to debtors who have lived in the state for the 730 days (2 years) prior to the bankruptcy petition. If the debtor has not lived in the state for the full 730 days, then the exemptions from the previous state of residence apply. The purpose of this change is to avoid debtors moving to take advantage of more favorable state exemptions.

Second, the amount of the homestead is exemption is reduced to the extent that it was obtained through the conversion of nonexempt assets within the 10 years preceding the filing of the petition with the intent to hinder, delay or defraud a creditor. Third, any amount in excess of $125,000 added to the homestead within 1215 days (3 years, 4 months) prior the filing of the bankruptcy petition may not be included in the debtor's exemption regardless of the debtor's intent. Finally, the $125,000 cap will also apply if the debtor was convicted of a felony that shows that the bankruptcy filing was an abuse of the Bankruptcy Code, or if the debtor owes money for violations of federal or state securities laws, for fiduciary fraud, for racketeering, or for crimes or intentional torts that caused death or serious physical injury in the previous 5 years.

These changes, while significant nationally, will likely make little difference in North Carolina, because its homestead exemption is currently only $10,000. Therefore, the new limits listed above will only be relevant in North Carolina for debtors who have recently moved into, or out of, the state and for creditors dealing with out of state residents.

TABLE 4

	Current Code	2005 Act
Debt Incurred to Obtain Luxury Goods or Services	Not dischargeable if greater than $1,225 and incurred within 60 days of bankruptcy filing.	Not dischargeable if greater than $500 and incurred within 90 days of bankruptcy filing.
Cash Advance	Not dischargeable if greater than $1,225 and incurred within 60 days of bankruptcy filing.	Not dischargeable if greater than $750 and incurred within 70 days of bankruptcy filing.

V. Discharge

A. Chapter 13 "Superdischarge"

Under the current Code, the discharge granted under Chapter 13 is broader than the Chapter 7 discharge, leading to it sometimes being referred to as the "superdischarge." The 2005 Act limits the scope of the Chapter 13 discharge to be similar in scope to the Chapter 7 discharge. For example, debts for willful and malicious torts, as well as certain fines and penalties, are all dischargeable in a Chapter 13 and not in a Chapter 7 under the current Code. Under the 2005 Act, none of these will be dischargeable.

Certain debts are still dischargeable in a Chapter 13 and not in a Chapter 7, including debts incurred to pay nondischargeable taxes and debts arising from property settlements in divorce cases. However, in a Chapter 13, debts for "willful *or* malicious" torts will be nondischargeable, while under a Chapter 7, only debts for "willful *and* malicious" torts are nondischargeable. Therefore, under the 2005 Act, a Chapter 13 discharge may in some cases be more limited than in a Chapter 7.

B. Credit Obtained for Luxury Goods and Cash Advances

The 2005 Act also increases the restrictions on dischargeability of debts for luxury goods and cash advances incurred shortly before a bankruptcy filing. These changes are summarized in Table 4.

We would be happy to discuss any of the changes instituted by the 2005 Act with you. Please contact one of the following Brooks Pierce advisors if you would like to discuss these issues.

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