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President Bush Signs The Bankruptcy Abuse Prevention And Consumer Protection Act of 2005

On April 20, 2005, President Bush signed The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the "Act") into law. After years of failed efforts to reform the bankruptcy laws, the Act was passed by the Senate (on March 10, 2005, by a 74-25 margin) and the House (on April 14, 2005 by a 302-126 margin) in rapid succession, and signed by President Bush only six days later. The Act represents the most significant change to the bankruptcy laws in the last 27 years. Although the Bankruptcy Code has been amended numerous times since its enactment in 1978, no prior legislation has effected such sweeping changes, especially in the area of personal bankruptcy.

One of the principal reasons why the Act's supporters were able to secure its passage was their ability to fend off potentially controversial amendments. In 2002, for example, Democrat Senator Charles Schumer of New York succeeded in attaching an amendment to proposed bankruptcy reform legislation to prohibit individuals from filing bankruptcy to avoid paying fines imposed for illegal anti-abortion protests. Senator Schumer's efforts to amend the Act in a similar fashion this year failed (by a 53-46 margin), as did others' efforts to amend the Act to cap interest rates as a matter of federal law, limit the use of asset protection trusts, exempt debtors from the Act's means test if their financial difficulties were caused by identity theft or serious medical problems, and bar claims by creditors who had violated the Truth in Lending Act in connection with residential mortgage lending.

CONSUMER BANKRUPTCY PROVISIONS

The Act's passage was in large part the result of a massive lobbying effort by the credit card industry, the U.S. Chamber of Commerce, and other business groups. Not surprisingly, then, the principal focus of the Act is in the area of personal bankruptcy. The most important changes in this area include the following:

- ♦ **Means Test for Chapter 7 Eligibility** - This new test is designed to measure the debtor's ability to repay his or her debts. If the combined gross income of the debtor's family is greater than the median family income in the debtor's state, the court, the trustee or any party in interest may seek to have the debtor's Chapter 7 (liquidation) case dismissed or, with the

debtor's consent, to convert the debtor's Chapter 7 case to one under Chapter 11 (reorganization) or Chapter 13 (individual debt adjustment), if the amount of the debtor's income left after deducting allowed expenses over 60 months is greater than \$6,000. If the debtor's monthly income minus all allowed expenses multiplied by 60 is between \$6,000 and \$10,000, conversion is required only if that amount is more than 25 percent of the total amount of nonpriority unsecured claims. In most cases, conversion would result in the debtor being forced into a Chapter 13 case and thus being required to repay a percentage of his or her debts over a 3 to 5-year period.

- ♦ **Mandatory Credit Counseling and Debtor Education** - Within 180 days prior to filing a Chapter 7, 11, or 13 case, an individual must receive credit counseling from a non-profit budget and credit counseling agency approved by the United States Trustee. In addition, an individual debtor must complete a United States Trustee-approved debtor education course before he or she may receive a discharge under Chapter 7 or Chapter 13.
- ♦ **Homestead Exemption** - In order to invoke a state's homestead exemption, an individual debtor must have lived in the state for at least 730 days (two years) immediately prior to the filing. If this is not the case, the exemption law of the state in which the debtor lived for the majority of the time for the 180 days prior to the 730-day period will apply. In addition, unless the debtor acquired the homestead more than 1,215 days (40 months) prior to filing, the debtor may only exempt up to \$125,000 of his or her interest in a homestead, even if the state's exemption level is higher.
- ♦ **Domestic Support** - Domestic support obligations are now given first priority among creditors' claims in bankruptcy. However, if a trustee is appointed under Chapter 7, 11, 12, or 13, the trustee's expenses may be paid ahead of the support obligations.
- ♦ **Retirement Benefits** - An individual debtor may exempt assets in an individual retirement account having an aggregate value not exceeding \$1 million. With this amendment, the Bankruptcy Code for the first time deals

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explicitly with the question whether IRA's may be claimed as exempt property.

- ♦ **Scope of Discharge and Serial Filings** - Debts owed to a single creditor totaling more than \$500 for luxury goods or services incurred by an individual within 90 days of filing and cash advances aggregating more than \$750 within 70 days of filing are presumed to be non-dischargeable. A discharge will not be granted in a Chapter 13 case if the debtor obtained a discharge in a Chapter 7, 11, or 12 case within the four years prior to the pending case, or in a Chapter 13 case filed within the two years prior to the pending case.
- ♦ **Time Between Discharge** - An individual Chapter 7 debtor cannot receive a discharge if he or she previously received a discharge within eight years of the subsequent bankruptcy filing. Previously, the time within which an individual could not obtain a second discharge under Chapter 7 was six years.
- ♦ **Asset Protection Trusts** - A trustee can avoid the debtor's transfer of an interest in property made within 10 years of the bankruptcy filing if the transfer was made to a self-settled trust or similar device, and the transfer was made with the actual intent to hinder, delay or defraud any creditor.

Supporters of the Act contend that it will prevent abusive bankruptcy filings by individuals who would otherwise be able to repay their debts. Critics of the Act disagree, arguing that it will unduly limit the availability of bankruptcy relief to those who truly need it—that is, people in financial distress on account of job loss, medical expenses, divorce, or a combination of these causes. At the same time, critics argue, the Act fails to close the very loopholes that permit a small number of individuals to use the bankruptcy system to erase their debts while sheltering significant assets through the use of unlimited homestead exemptions (in certain states) and asset protection trusts.

BUSINESS BANKRUPTCY PROVISIONS

Although more attention has been paid to its personal bankruptcy provisions (the number of personal bankruptcy filings having risen from approximately 875,000 in 1995 to nearly 1.6 million in 2004), the Act also brings about some important changes in the area of business bankruptcy. Among bankruptcy professionals, the Act's elimination of a provision that automatically disqualifies a corporate debtor's pre-bankruptcy investment bankers from representing the debtor during the bankruptcy case

has attracted the most attention. Corporate debtors, particularly those in the retail sector, will be required to make certain decisions sooner; for example, the 60-day window for a debtor to decide whether to assume or reject a non-residential real estate lease, while increased to 120 days, may only be extended over the landlord's objection by one additional 90-day period. In the same vein, where Chapter 11 debtors previously could obtain serial extensions of the exclusivity period for filing a plan, they now will face a firm deadline of 180 days from the commencement of the case. Finally, vendors who are later sued by or on behalf of a corporate debtor to recover preferential payments will benefit from the provision amending Section 547 of the Bankruptcy Code to make it easier to prove that a preferential payment was made in the "ordinary course of business."

THE ACT'S EFFECTIVE DATE

The Act has a general effective date of 180 days from that date of enactment, or October 17, 2005, and applies to cases filed on or after that date. The Act creates a number of exceptions to the general effective date, however, including with respect to the homestead provisions, which become effective immediately upon enactment. The impact of the Act is expected to be felt immediately, however, as individuals rush to obtain bankruptcy relief before the limitations on personal bankruptcy filings take effect.

AVAILABILITY OF EXTRANET

Lord, Bissell & Brook has established an extranet (private website) to track the Act and other federal law developments of interest to the insurance and financial services industry (*e.g.*, TRIA extension, SMART Act, tort and class action reform). The Act is posted on the extranet. For password access to this extranet, please contact lali@lordbissell.com.

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