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Problems in the Code

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Why the Chapter 7 Eligibility Guidelines Are Counterproductive

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The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA)[2] was highly controversial and driven primarily by a variety of political considerations and creditor lobbying efforts. It was triggered in part by a misconception that chapter 7 eligibility, which gave insolvent individuals the ability to discharge most of their debt with minimal consequences, also benefited individuals otherwise able to repay their debt to avoid doing so. Efforts to revise the Bankruptcy Code had been ongoing for many years but were vetoed by President Bill Clinton in 2000, and were waylaid at the eleventh hour by Sept. 11, 2001. When bankruptcy reform became effective in 2005, it was wholeheartedly applauded by the credit industry while being roundly criticized by bankruptcy pundits and bankruptcy judges. Because of the perception, and to some extent the reality, that it would and could impact chapter 7 eligibility, a record number of bankruptcies were filed shortly before its effective date, ironically leaving ineligible for chapter 7 many individuals who were facing dire financial straits following the economic collapse of 2008.

The fundamental premise behind BAPCPA was to make it more difficult for high-income individuals to file for chapter 7, instead forcing them to reorganize under the Bankruptcy Code and supposedly generating repayment for creditors. So what were the Code changes that Congress enacted?

Changes to Chapter 7 Eligibility

The unequivocal goal of BAPCPA was to prevent individuals who otherwise could pay a percentage of their debt from seeking chapter 7 relief. Before BAPCPA, there was a perception that filers were taking advantage of the bankruptcy system because there was no consideration of a filer's debt-to-income ratio, and consumer debt could be discharged quickly. As Sen. Charles Grassley (R-Iowa) noted in his opening statement at the bankruptcy reform hearing, it should be "more difficult for people to file for bankruptcy," and the prior rules allowed "high rollers who game the current system and its loopholes to get out of paying their fair share."[3] To accomplish this goal, Congress introduced what is known as the "means test" into the chapter 7 process.[4]

A somewhat arbitrary number was selected based on demographics that permitted individuals earning less than that amount to be automatically eligible for chapter 7. Individuals earning more than the statutory amount would have to find other alternatives to proceed with a chapter 7. To eliminate the possibility that an individual could simply stop working the month before seeking chapter 7 relief to become eligible, the means test calculates one's income based on a six-month lookback period[5] from the date of the filing.

Because the Bankruptcy Code changes focused on individuals who had incurred consumer-type debt, BAPCPA still allowed individuals holding primarily nonconsumer debt to seek chapter 7 relief.[6] This was no different than in the past, but in light of the means test, it became an even more important option.

1 The author thanks **James Samuelson** and Michael Galen for their assistance.
2 Pub. L. 109-08.
3 Bankruptcy Reform: Hearing on S. 256 Before the Senate Judiciary Committee, 109th Cong. (2005) (statement of Sen. Grassley).
4 Statement of Sen. Grassley, March 1, 2005, 151 Cong. Rec. S1856 ("The Bankruptcy Reform Act of 2005 asks the very fundamental question of whether repayment is possible by an individual. It is this simple: If repayment is possible, then he or she will be channeled into chapter 13 of the Bankruptcy Code, which requires people to repay a portion of their debt as a precondition for limited debt cancellation.... This bill does this by providing for a means-tested way of steering people ... who can repay a portion of their debts away from chapter 7 bankruptcy.").
5 11 U.S.C. § 101(10A).
6 11 U.S.C. § 707(b).

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Finally, in recognition that certain individuals who incurred consumer debt were still deserving of chapter 7 relief because of special circumstances, individuals could still proceed under chapter 7 if they could demonstrate that they could not effectively fund a chapter 13 or 11 plan because their reasonable and necessary expenses either exceeded or were very close to their judicially defined take-home income.[7]

Before BAPCPA was passed, many experts criticized the pending eligibility requirements because of the high likelihood that they would not serve their intended purpose.[8] Nevertheless, based on a variety of rather strong marketing efforts by the creditor lobby,[9] the primarily conservative and Republican Congress enthusiastically passed the legislation.

What Went Wrong?

Most bankruptcy practitioners agree it is fundamentally unfair that certain creditworthy debtors may qualify for chapter 7 more easily than a debtor with low income. In many pre-BAPCPA cases, even conscientious creditors that conducted their due diligence found their debts being discharged by debtors who were able to maintain a relatively high standard of living by seeking bankruptcy relief.[10] If BAPCPA reforms had ultimately achieved that goal, criticizing that the outcome would be difficult.

Although some individuals were prevented from seeking chapter 7 relief because of the 2005 Code changes, in most cases that was not what occurred. Instead, the radical changes in chapter 7 eligibility often had the opposite effect.

By introducing a six-month lookback period for chapter 7 eligibility, an unfortunate individual who had lost his job for uncontrollable reasons, including a medical emergency, might be precluded from seeking chapter 7 relief if his income slightly exceeded the means test. Because little consideration is given to the debtor's financial condition on the actual filing date under BAPCPA, a deserving individual's eligibility would be challenged if that person had been financially stable in the months preceding the bankruptcy filing. In most instances, BAPCPA is indifferent to a debtor's financial insolvency, inability to work and lack of prospects for a reversal if that condition was not long-term. Pre-BAPCPA, such a deserving person would have been able to qualify for chapter 7.

The COVID-19 pandemic has demonstrated how draconian the six-month lookback period can be to an individual desperately in need of chapter 7 relief. An untold number of citizens have lost their jobs because of this tragedy. Individuals whose job loss was recent and whose prior income rendered them ineligible for chapter 7 may still be precluded from chapter 7 protection if the courts strictly enforce the definition of income for purposes of chapter 7 eligibility.[11]

On the other hand, if the individual seeking chapter 7 relief had incurred large amounts of nonconsumer debt regardless of why, chapter 7 would be available for that person. This has led to the rather incongruous result that if a high-income earner had speculated on business ventures, chapter 7 eligibility would be within that person's grasp, but if a citizen had taken on debt in paying necessary hospital bills and expenses, that person could face either outright dismissal of a chapter 7 case, or conversion to a chapter 13 or 11. Because bankruptcy courts typically do not consider why and how the debt was incurred (except for dischargeability issues), the system may actually reward those who overextended themselves for business purposes while unduly punishing individuals who incurred debt for personal necessities, such as health care.

This scenario was even worse in instances in which struggling individuals took on multiple jobs to stay afloat, only to find themselves ineligible for chapter 7 because of their efforts to pay their bills. If that same person had simply stayed employed at one job and continued to incur additional debt to stay afloat, chapter 7 eligibility would have been readily available.

Individuals could also avoid the ramifications of chapter 13 or 11 by demonstrating that, despite their income exceeding the statutory limit, their legitimate expenses were so high that they could not fund a reorganization plan.[12] In many cases, authorized expenses were based on certain IRS guidelines, whereas in other scenarios, depending on the individual debtor's financial situation, much higher expenses than the IRS guidelines were allowed.[13] Not surprisingly, this resulted in certain individuals proceeding in chapter 7 because they had taken on certain debt, such as large mortgage payments. Because the mortgage industry did not want to dissuade individuals from maintaining mortgage debt in hopes of retaining chapter 7 eligibility, the legislation protected lenders in that situation by allowing their borrowers to continue making those payments, even if they far exceeded what the IRS considered to be reasonable for similar expenditures.

What happens in cases in which an individual is not eligible for chapter 7, but cannot fund a reorganization? Probably the most tragic consequence of barring certain individuals from proceeding in chapter 7 is that they are left in financial limbo. Whereas in the past creditors would have been inclined to settle with debtors if they recognized that the alternative was chapter 7, leaving little chance of recovery, the 2005 amendments disincentivized creditors from considering any type of discount to their borrowers. If such individuals cannot afford payments in a reorganization but still try to proceed in that manner, their cases can be dismissed rather than converted to chapter 7, because they would not be eligible. The ultimate result is that individuals unable to repay their debts are facing the injustice of having a percentage of their meager wages garnished upon their creditors obtaining judgments against them.

Not surprisingly, many of the individuals in this situation had been earning slightly more than the maximum

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7 *See* 11 U.S.C. § 707(b)(2)(A)(ii)(I-V) (high-income debtors are able to rebut presumption of abuse if they can demonstrate to court that the allowed deductions are reasonable and necessary).

8 *See* Henry J. Sommer, "Trying to Make Sense Out of Nonsense: Representing Consumers Under the 'Bankruptcy Abuse Prevention and Consumer Protection Act of 2005,'" 79 *Am. Bankr. L. J.* 191, 192 (2005).

9 *Id.*; *see also* Peter G. Gosselin, "Judges Say Overhaul Would Weaken Bankruptcy System," *L.A. Times* (March 29, 2005) ("[J]udges say the effect of the overhaul would be to discourage most forms of personal bankruptcy, which for nearly two centuries has served as a safety net for people in economic trouble.").

10 *See* H.R. Rep. No. 109-31, pt. 1 (2005).

11 Thankfully, stimulus benefits received under the Coronavirus Aid, Relief, and Economic Security Act are excluded from current monthly income under the means test.

12 11 U.S.C. § 707(b)(2)(A)(ii)(I-V).

13 *Id.*

amount permitted under the means test. It is difficult to comprehend how most creditors really benefit from forcing these debtors into a reorganization rather than a chapter 7 liquidation, since the potential recovery from such individuals is minimal at best.

Circumventing the Changes

Bankruptcy reform was supposed to stop high-income earners from seeking chapter 7 protection, but in actuality, many of these individuals are the exact people who are able to still proceed in chapter 7, because their financial wherewithal allows them to organize their financial affairs so that they can avail themselves of chapter 7.

First, individuals taking on primarily nonconsumer debt are still eligible for chapter 7. In many instances, individuals who are involved in major business ventures and who took on large amounts of debt are often high-income earners. Many of these debtors are doctors and other professionals who are able to keep earning large sums of money even in the face of their substantial obligations. If the legislation had really been designed to prevent these individuals from filing for chapter 7, that result could have been achieved by legislation that was more carefully drafted.

In other instances, individuals realize that if their approved monthly expenditures are high enough, their income could far exceed the means test amount, but they could still receive a discharge in chapter 7. Although this outcome could potentially be avoided by restricting the amount that individuals could spend on secured debt, such as mortgages, the mortgage industry would likely lobby against such a restriction. As a result, those individuals find themselves still eligible for chapter 7. On the other hand, if a person earning a high income saved money by renting inexpensively, doing so would render that person unable to file for chapter 7 relief. In the end, many consumer lawyers representing more affluent individuals have quickly discovered that those who had wildly speculated on business enterprises or had taken on inappropriate secured debt can easily file for chapter 7, while their more responsible clients cannot.[14]

So, do creditors have any recourse against individuals who are able to continue living an expensive lifestyle but can easily discharge their debts in a chapter 7?

Creditor Recourse

A creditor does have recourse when a high-income individual proceeds under chapter 7. Section 707 previously provided for dismissal of a chapter 7 case after a finding of "substantial abuse." Under BAPCPA, the Bankruptcy Code provides for dismissal or conversion after a finding of "abuse" by a debtor with "primarily consumer debt."[15] Courts may find the presence of "abuse" where the debtor fails the means test set forth in § 707(b)(2), since that individual could ostensibly pay back his debt. Additionally, a creditor could attempt to convert a debtor's chapter 7 case under § 706(b), though compelling an individual to reorganize in certain instances may raise due-process concerns and some courts have been reluctant to grant this relief, although more recently, courts have been willing to convert chapter 7 cases to chapter 11.[16] Nevertheless, because of the cost involved in mounting such a challenge, most creditors will not bother to go through the exercise.

Finally, the U.S. Trustee and creditors have the power to seek relief from the court on the basis that a debtor is not entitled to relief under chapter 7, but conscientious debtors and their attorneys can take prophylactic steps to frustrate any such efforts, such as incorporating unusual expenses that are reasonable and necessary for the family's well-being.

What Does the Future Hold?

Sen. Elizabeth Warren, who is sensitive about this issue because of her background as a bankruptcy professor, has recognized the inequities that exist and has recommended changes in the Bankruptcy Code, including chapter 7 eligibility criteria. Relief is needed because a large number of individuals who need chapter 7 relief are ineligible for it, whereas many high-income earners meet no obstacles at all. Reform may be coming, especially if such changes are left in the hands of individuals well-versed and experienced in bankruptcy and mindful of the perils of allowing special interests to craft deceptively complicated legislation. abi

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14 11 U.S.C. § 707(b)(2)(a)(iii).
15 11 U.S.C. § 707(b)(1).

16 *See In re Brophy*, 49 B.R. 483, 484 (Bankr. D. Haw. 1985) ("Section 706(b) was not intended to be a vehicle by which individual debtors would be forced to submit to a plan of repayment against their wills."); *In re Freunscht*, 53 B.R. 110, 111-112 (Bankr. D. Vt. 1985) (citing *Brophy*); *In re Graham*, 21 B.R. 235, 238 (Bankr. N.D. Iowa 1982) (forced conversion of chapter 7 case to chapter 11 would be akin to "a mandatory [c]hapter 13 proceeding."); *but see In re Decker*, 535 B.R. 828, 836-837 (Bankr. D. Alaska 2015), *aff'd sub nom.*, *Decker v. Office of the United States Tr.*, 548 B.R. 813 (D. Alaska 2015) (rejecting rationale in *Graham* post-BAPCPA); *In re Karlinger-Smith*, 544 B.R. 126, 132 (Bankr. W.D. Tex. 2016) (same); *In re Gordon*, 465 B.R. 683, 702 (Bankr. N.D. Ga. 2012) (same).