

# Consumer Debts and Bankruptcy

**O**n Oct. 17, sweeping changes to the U.S. Bankruptcy Code will take effect. Consumers and businesses will both be affected; however, the more fundamental changes will occur in individual cases involving consumer debts.

## As an individual with consumer debts, will I still be able to file bankruptcy?

Bankruptcy is still available to individuals; however, many individuals with consumer debts whose income is over the median level in their home state may have more difficulty obtaining a Chapter 7 discharge.

## What is the eligibility standard?

In a case involving consumer debts, the bankruptcy trustee or any party may challenge an individual's eligibility for Chapter 7 if the debtor's current monthly income (excluding specific deductions listed in the Code) is enough to pay a certain portion of the debtor's obligations over five years. Some refer to this formula as the "means test."

If the debtor's income is equal to or below the debtor's home state's median income, however, certain presumptions under the means test would not apply, and fewer persons would have standing to try to have the bankruptcy dismissed. Thus, most debtors whose income falls below this median level should be able to stay in Chapter 7.

As a practical matter, this "median income test" may prove more important in determining eligibility than the "means test."

## What happens if I fail the means test?

A presumption of "abuse" may apply, and the Chapter 7 can be dismissed or, with the debtor's consent, it can be converted to another chapter, typically Chapter 13.

## Are there other mandatory steps to be taken? What about credit counseling?

Generally, an individual may not file bankruptcy without obtaining credit counseling from an approved nonprofit agency within 180 days before filing. Additionally, an individual debtor may not obtain a discharge until he or she has completed a personal financial management course.

## May I still reaffirm certain debts?

Reaffirmation of certain debts in Chapter 7 is still allowed; however, creditors will have to provide greater disclosure about the reaffirmed debt, and the debtor's lawyer may have to certify to the court that it does not cause an undue hardship.

## If I file Chapter 13, may I still "cram down" the amount of my car loans?

In certain cases, a Chapter 13 debtor may no longer be able to divide a creditor's claim into secured and unsecured portions. If the creditor has a purchase money security interest secured by an automobile purchased within two and a half years (910 days) before bankruptcy (or in the case of other consumer goods purchased within one year before bankruptcy), the claim must be paid in full or the collateral otherwise surrendered. The pre-bankruptcy arrearage may, however, be cured in the plan.

## May I still claim my Texas homestead?

The Texas homestead remains available for most debtors; however, a debtor generally needs to have lived in Texas for the two years (730 days) before bankruptcy in order to claim Texas exemptions. For debtors who have owned their Texas homestead for at least 1,215 days pre-bankruptcy, the homestead exemp-

tion remains unlimited; for others, however, there may be a \$125,000 cap.

## Are retirement accounts exempt?

Yes, and the new law clarifies that a qualified IRA up to \$1 million plus certain eligible rollovers is exempt and excluded from the bankruptcy estate.

## Am I more protected if my employer files bankruptcy?

Yes. The amount of a priority wage claim has been increased to up to \$10,000 earned within 180 days of the employer's bankruptcy.

## What are the major changes to business bankruptcies?

*Preferential transfers.* It should be more difficult to set aside preferential transfers that occur in the ordinary course of business. Additionally, in business cases, preferences totaling less than \$5,000 are not subject to attack. Also, smaller preference cases must now be brought in the district where the defendant resides. This should leave arms-length trade creditors less vulnerable to preference claims.

*Executive pay.* There are new restrictions on executive pay both pre- and post-bankruptcy. Retention bonuses may also be limited or at least subject to additional scrutiny.

*Reclamation.* Parties who sold goods to a debtor on credit just before bankruptcy may have more protection under expanded reclamation powers and by priority treatment in certain situations.

*Small businesses.* There are new definitions of what is considered a "small business." How this will effect smaller Chapter 11s is yet to be seen.

*Chapter 12.* Chapter 12 is now permanent, effective as of July 1, 2005.

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