

Please turn to Chapter 7: ***Still? Still.***



By Lee M. Perlman

As we pass the one-year anniversary of enactment of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 it may be worthwhile to reflect on the options still available to your clients under Chapter 7 of the Bankruptcy Code. There are three tests to determine if a debtor is eligible to file a Chapter 7 bankruptcy.

Median income test

The first is whether the debtor is above or below median income and the debtor's CMI or current monthly income. You must look to the debtor's income from all sources in the household.

"Income" is a term of art: this is the average income for the last six months, immediately preceding the filing of the petition, from all sources.

Median income in New Jersey is \$51,881 for a household of one, \$61,375 for a household of two, \$77,728 for a household of three, and \$90,261 for a household of four. You want to be sure the debtor's annualized current monthly income is not higher than the median income for New Jersey as outlined above. Note that New Jersey's median income is quite high when compared to other jurisdictions. You may be surprised to learn your client qualifies for Chapter 7 when you carefully review his income. The means test will never be an issue if your client is below median income. This is why it is critical to ensure you have explained to your client and followed up in receiving all payment advices for the applicable period. This will help defeat any possible objections under section 707.

Means test

If the debtor is above median income, the debtor still may be able to file a Chapter 7 bankruptcy depending on the outcome of the means test. If the debtor's monthly disposable income as determined by the means test is less than \$100 monthly, they are eligible to file a Chapter 7 bankruptcy. If the debtor's monthly disposable income as determined by the means test is below \$167 monthly and the debtor's aggregate non-priority unsecured debt — like credit cards — is more than \$40,000, the debtor is eligible to file a Chapter 7 bankruptcy. Note the expenses used on the means test are a combination of some of the debtor's actual monthly expenses and the IRS standard monthly expenses. Therefore, when interviewing a debtor, it is crucial to gather as much information about monthly expenses as possible.

The equity test

Assuming the debtor is eligible to file a Chapter 7 bankruptcy because they are either under the median income or they "pass" the means test, next is the equity test. If the debtor has non-exempt equity in a property they wish to retain, the debtor will be required to pay a dollar amount equal to the non-exempt equity to the debtor's unsecured creditors. The most common occurrence is a debtor with a large equity position in his or her home. For example, a married couple that jointly owns a home worth \$300,000 wishes to file a joint bankruptcy. The debtors' mortgages and home equity loans total \$200,000. To determine the amount of the non-exempt equity, deduct 10 percent from the home value for selling costs, leaving a \$270,000. Next deduct the \$200,000 in mortgages and home equity loans, leaving \$70,000. Then deduct the \$18,450 exemption each debtor is entitled to on his or her homestead. This leaves a non-exempt equity of \$33,100. The debtors will be required to file a Chapter 13 bankruptcy and pay at least \$33,100 to their unsecured creditors over no more than five years.



Totality of circumstances

The final test is the “totality of circumstances” under §707(b)(3)(B). This provision was enacted by the Bankruptcy Act. The test comes into play when either the debtor is below median income or the debtor passes the means test but has monthly disposable income reported on Schedule J. Schedule J shows the debtor’s actual monthly disposable income based on subtracting the debtor’s actual monthly expenses on Schedule J from the debtor’s actual monthly income reported on Schedule I. This issue can arise, for example, when using the debtor’s last six months of income, the debtor is below median income. However, due to starting a new job in the last month at a significantly higher salary, the debtor shows monthly disposable income of \$900 on Schedule J. The court, the U.S. Trustee, or any party in interest (i.e. creditor) could seek to have the case dismissed or, with the debtor’s consent, converted to a Chapter 13 case.

Due to poor drafting of the Bankruptcy Act, it is unclear if the debtor in the example above is subject to a potential dismissal under §707(b)(3)(B) or if — being under median income — the debtor is insulated from a §707(b)(3)(B) dismissal. This issue is working its way through the court system.

Objectors

Section 707 governs which parties can object to a client’s schedules and statements. Prior law permitted the court or the U.S. Trustee to be the objector, if it were determined that granting a discharge to the debtor would represent substantial abuse under that chapter. Under the new law, the group of potential objectors has grown to “any party in interest.” The word “substantial” has been removed. So far, few courts have interpreted cases differently.

The best way to defeat objections is to be prepared with all payment advices and client documentation, credit reports and any primary or secondary sources used to value real property in your case — such as a market analysis from a Realtor, appraisals or documents from a recent refinance or active listing agreement if the property is for sale.

Defining ‘consumer debt’

Another important but easy-to-overlook consideration involves the definition of consumer debt in the means test. Under Section 101(8) the definition is “debt incurred by an individual primarily for a personal, family or household purpose.” A careful review of your client’s debt may reveal a business or trade derivation. Maybe the debt was related to a debtor’s sole proprietorship or perhaps the nature of the original transaction changed from consumer to business.

It may not be enough here to simply review the transactions by category; it may be important to inquire how the debtor expensed or utilized specific transactions.

Also, under the definition, “primarily” may mean the total number of creditors or a higher dollar amount of charges overall. So if the debt is not primarily consumer, you may avoid the means test entirely. Do not overlook this important consideration when reviewing the facts and circumstances with your client.

Random audits

Another important consideration in accurately preparing and verifying client schedules and statements is the random audit provision built into the law. Random audits began Oct. 20, 2006. These audits will be selected by the U.S. Trustee and conducted by outside accounting firms. It is estimated there will be 6,338 random audits and 1,000 targeted audits in 2007. Auditors will determine whether the schedules, statements of financial affairs and the means test contain material misstatements. Auditors will compare and test schedules, conduct searches for unreported assets and verify market values using commercially available databases. It is not expected auditors will conduct on-site examinations of your client’s home or businesses and will not have in-person meetings with your client.

If a client is selected for an audit there is the option of permitting the auditor to communicate directly with the debtor or through you as counsel. If you reviewed the necessary documents and income with a client before filing, you do a disservice to allow communications directly from the auditor to client.

If a client’s case is selected for audit, you need to understand the timetable. An audit notification is sent within 10 days of filing. The debtor has three weeks to send the requested information. The auditor must file a report with the court and the UST no later than 63 days (nine weeks) from original audit notice. You should prepare all Chapter 7 cases as if expecting a random audit. Doing so means better-drafted schedules and a higher comfort level throughout.

Chapter 7 remains a viable option for many consumers overwhelmed by unsecured debt, collection lawsuits and any post-judgment collection actions. Counsel needs to be sensitive to qualification under the means test, possible non-exempt equity in property, the importance of accurate schedules, and the collection of all documents required to successfully handle objections and a random audit. ☉



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