
CHAPTER ONE

Nature of Bankruptcy and Insolvency Proceedings

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§ 1.1 OBJECTIVES

(a) Introduction

p. 2. *Add after first full paragraph*

On April 20, 2005, President George W. Bush signed the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005^{0.1} (“2005 Act”). In many ways, the 2005 Act represents the most significant changes in the bankruptcy laws since the Bankruptcy Code replaced the Bankruptcy Act in 1978. One of the key reasons for the revisions to the Bankruptcy Code was to prevent perceived abuses in consumer bankruptcies. An important part of the basis for reducing consumer

^{0.1} Pub. L. No. 109-08, 119 Stat. 23.

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abuses was the establishment of means testing provisions. Under the means test a debtor having income above the state median may, rather than receiving a discharge of all debts, be required to make payments to creditors from future earnings. Although the primary focus of the 2005 Act was on eliminating abuses of the law by consumers, there are provisions in the bill affecting almost all participants in the bankruptcy process—businesses, creditors, landlords, and professionals involved in this field.

There was a desire, driven to a large extent by credit card companies, to make it harder for consumers to walk away from their debts. The motive underlying the 2005 Act is clear from its title, “Bankruptcy Abuse Prevention.” Some of the underlying objectives driving the changes in the law were to:

- Use a means test as a method to reduce perceived abuses of the current system by requiring some individuals to either have their petition dismissed or agree to transfer to chapter 11 or 13 and make at least some debt payments with future income.
- Eliminate perceived abuses by consumers, in addition to limiting the extent to which individuals can walk away from their debts, by adjusting amounts available for homestead exemptions, for example, and increasing amounts that may be recovered from fraud.
- Reduce the time that a business is in bankruptcy as evidenced by, among other things, a limit on the time a debtor has to decide whether to assume or reject a lease and a limit on the amount of time a debtor has the exclusive right to develop a plan.
- Provide a source of tax revenue, especially for state and local governments, by changing the tax law to provide fewer tax benefits to individuals and businesses in bankruptcy. With a significant amount of influence from state attorneys general, the drafters of the law were convinced that state and local governments were at a disadvantage when it came to the collection of taxes.
- Provide additional opportunities for creditors of businesses under certain conditions to recover all or a large percentage of their prepetition claims by, for example, increasing the

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reclamation period and providing that goods shipped within 20 days of bankruptcy are administrative expenses.

- Reinstate chapter 12 on a permanent basis and make other changes perceived as necessary to the Bankruptcy Code.
- Provide protection to certain creditors including, for example, those owed amounts for domestic support obligations and secured creditors in chapter 13.

The 2005 Act consists of over 16 different titles.

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(d) Provisions Common to All Bankruptcy Proceedings

(ii) *Priorities*

p. 8. *Replace priority list with the following:*

1. Allowed unsecured claim for domestic support obligations.
2. Administrative expenses.
3. In an involuntary case, unsecured claims arising after commencement of the proceedings but before an order of relief is granted.
- *4. Wages earned within 180 days prior to filing the petition (or to the cessation of the business) to the extent of \$10,000 (\$10,950 for petitions filed after March 31, 2007) per individual.
- *5. Unsecured claims to employee benefit plans arising within 180 days prior to filing the petition, but limited to \$10,000 (\$10,950 for petitions filed after March 31, 2007) times the number of employees less the amount paid in priority 4 above.
- *6. Unsecured claims of grain producers against grain storage facilities and claims of fishermen against product storage or processing facilities to the extent of \$4,925 (\$5,400 for petitions filed after March 31, 2007) for each such individual.
- *7. Unsecured claims of individuals to the extent of \$2,225 (\$2,425 for petitions filed after March 31, 2007) from deposits of money

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for purchase, lease, or rental of property or purchase of services not delivered or provided.

8. Unsecured tax claims of governmental units (discussed in more detail in Chapter 11).
9. Allowed unsecured claims based on any commitment by the debtor to regulation agencies of the federal government to maintain the capital of an insured depository institution.
10. Allowed claims for death or personal injury resulting from the operation of a motor vehicle or vessel under the influence of alcohol, drugs, or other substance.

The 2005 Act moved the claim for domestic support obligations from seventh priority to first priority. Prior priorities numbers 1 through 6 were changed to numbers 2 through 7. Also, the 2005 Act added the tenth priority above.

(iii) Discharge of Debts

p. 8. *Replace second paragraph with the following:*

The Bankruptcy Code contains provisions that allow an individual debtor in a chapter 7, 11, 12, or 13 proceeding to have its debts discharged. A corporation may also have its debts discharged in chapter 11 or 12; however, these debts cannot be discharged in a chapter 7 or a chapter 11 liquidation. Chapter 13 contained special provisions that dealt with the discharge of debt and allowed additional taxes to be discharged that could not be discharged in a chapter 7 or 11 proceeding. Included among debts that may not be discharged are certain types of taxes. However, the 2005 Act eliminated the special tax consideration, resulting in the same rules applying to all chapters. These taxes are discussed in Chapter 11 of the main volume and this supplement.

(iv) Preferences

p. 9. *Add at end of first full paragraph:*

There was some uncertainty as to the extent to which the third party would be protected from the preference action. The 2005 Act contained a provision that specifically provided that action may be taken against the insider only and not against the third party to recover preferences.

p. 9. *Replace second full paragraph:*

Certain exemptions apply to preferential payments. One of these is a contemporaneous exchange: An exchange (payment) for new value, such as inventory not previously received, is given to the debtor. For example, the purchase of goods or services with payment by check or cash would not be a preferential payment. The second exemption protects payments of debts that are incurred in the ordinary course of business or financial affairs of both the debtor and the transferee, when the payment is made in the ordinary course of business or made according to ordinary business terms. For example, a 30-day open account for utility service would be sheltered provided payment is made according to the normal terms (such as 30 days) or according to ordinary business terms. Prior to the change made by the 2005 Act, the payment had to be made both in ordinary course of business and according to ordinary business terms. Security interests granted in exchange for enabling loans, when the proceeds are used to finance the purchase of specific personal property, are also exempt. This exception would allow creditors to isolate from preference attack a transfer received, to the extent that the creditors replenish the estate with new value. For example, if a creditor received \$10,000 in preferential payments and subsequently sold goods with a value of \$6,000 to the debtor on unsecured credit, the preference would be only \$4,000.

(e) Chapter 7: Liquidation

p. 10. *Change (i) to (iv) and add after first full paragraph:*

If a case involving primarily the consumer debts of an individual debtor is determined to be an abuse of Bankruptcy Code provisions, chapter 7 may not be an available alternative. Section 707(b) provides that the court, on its own motion or on a motion by the U.S. trustee, or any party in interest, may dismiss a case filed by an individual debtor under this chapter whose debts are primarily consumer debts or, with the debtor's consent, may convert such a case to a case under chapter 11 or 13, if it finds that the granting of relief would be a substantial abuse of the provisions of chapter 7. This assessment is referred to as the "means test" and is made by completing form 22A, Statement of Current Monthly Income and Means Test Calculations. Appendix G contains a copy of this form. It is also available at www.usdoj.gov/ust/.

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(i) *Income (Revised)*

Section 707(b)(7) precludes any party, including the bankruptcy judge or U.S. trustee, from bringing action for substantial abuse if the debtor and the debtor's spouse's annual income (determined by multiplying the average income for the last 6 months times 12) does not exceed the median state income. Thus, if the average income does not exceed the median state income, the debtor may use the provisions of chapter 7. In section 101(39A) of the Bankruptcy Code, "median family income" for any year means the median income both calculated and reported by the Bureau of the Census in the most recent year and, if not calculated in the current year, then adjusted annually for each year since the income was reported by using the percent change in the Consumer Price Index for All Urban Consumers. For example, an individual chapter 7 debtor residing in Oregon would compare the annual income to the median income from the state of Oregon for one person. If the debtor has a household of two, three, or four, the comparison would be made with the applicable income for Oregon for the appropriate number in the household. If the debtor is a household of more than four, then a monthly allowance of \$575 would be added to the appropriate state income for each household member in excess of four in the median household.

*For example, in Oregon and New York, the median family income estimated for 2006 for various family sizes is listed as:

Household Size	Oregon	New York
1 person	\$40,161	\$41,554
2 persons	48,876	50,367
3 persons	53,380	60,850
4 persons	61,945	72,170

In some states, the spread between the lowest and highest median incomes for one-person households was over \$24,000 and for a four-person household, it was almost twice that amount. In Mississippi, the 2006 estimated median income for a one-person household was only \$28,382; in New Jersey it was \$52,000. For a four-person household, one of the largest income levels was Connecticut at \$92,205; the lowest was Mississippi at \$47,762.

Current monthly income is income from all sources that the debtor receives without regard to whether such income is taxable.

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It includes amounts received on a regular basis for the debtor's household expenses, including expense of the debtor's dependents, but excludes Social Security payments and selected payments to victims of war crimes or terrorism.

In considering whether the granting of relief would be an abuse of the provisions of this chapter in situations where the average income is greater than the median state income, the court shall presume abuse exists if the debtor's current monthly income (average of the previous six months) reduced by the average monthly deduction listed below and multiplied by 60 is not less than the lesser of:

- a. 25 percent of the debtor's nonpriority unsecured claims in the case, or \$6,575, whichever is greater; or
- b. \$10,950.

Thus, if the debtor's current monthly income (average of the previous six months) reduced by the average monthly deduction listed below (monthly net income) exceeds \$182.50 (\$10,950 divided by 60), it will be presumed that abuse exists. If the monthly net income is less than \$109.59 (\$6,575 divided by 60), the presumption of abuse does not exist. If the net income is between \$109.59 and \$182.50, abuse exists if the net income is greater than 25 percent of the debtor's nonpriority unsecured claims. Under these conditions, abuse is presumed if the monthly net income is large enough to pay at least 25 percent of the nonpriority unsecured claims. For example, if the monthly net income is \$109.59, abuse would not exist if the unsecured debt is greater than \$26,300 (60 times 109.59, or \$6,575, is less than 25 percent of \$26,300.01). If the debtor's debt is \$25,300, incurring additional debt in an amount in excess of \$1,000 prior to filing the petition for a valid need and use may avoid the presumption of abuse. If the monthly net income is \$182.50, the presumption of abuse does not exist if the nonpriority unsecured debt exceeds \$43,800 (\$182.50 times 60 divided by 25 percent).

(ii) Deductions (Revised)

The following deductions as described in Code section 707(b)(2)(A) and indicated on form 22A (see Appendix G) are allowed in determining if an abuse exists.

1. *IRS guidelines.* The monthly expenses as defined in Code section 707(b)(2)(A)(ii), including deductions allowed as living expenses specified under standards of the IRS, are allowed to be used by the debtor. The IRS guidelines include:
 - *National Standards* — Allowances for food, clothing, and other items. Allowances are nationwide except for Alaska and Hawaii, which have separate allowances. There is some uncertainty over whether debtors will be allowed the total National Standards amount for their family size and income level, without questioning amounts actually spent, or the lower of the two. For federal tax purposes, the National Standards apply, regardless of the amount actually spent.
 - *Local Standards*—Allowances for housing and utilities and transportation, known as Local Standards, vary by location. The allowances for housing and utilities are based on counties within the state and are divided into three levels: families of two or less, families of three, and families of four or more. Living allowances for housing and utilities is separated from nonmortgage expenses and mortgage and rent expense. Payments that are secured with a home are deducted from the mortgage and rent allowance and reported as a secured monthly cash outlay. Unlike the National Standards for federal tax purposes, under Local Standards the taxpayer is allowed the amount actually spent if greater than the standard. Based on the section 707(b)(2) “debtor’s monthly expenses shall be the debtor’s applicable monthly expense amounts specified under the National Standards and Local Standards.” Furthermore, section 707(b)(2)(A)(ii)(V) notes that, “[i]n addition, the debtor’s monthly expenses may include an allowance for housing and utilities, in excess of the allowance specified by the Local Standards for housing and utilities issued by the Internal Revenue Service, based on the actual expenses for home energy costs, if the debtor provides documentation of such actual expenses and demonstrates that such actual expenses are reasonable and necessary.” Line 21 of Form 22A is provided for the debtor to include cost of the allowed amount.

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- *Transportation Costs* —Transportation schedules are based on both national and regional standards. The national rate for 2007 is an allowance of \$471 per month for ownership costs for the first vehicle and \$332 for the second. The allowance for the first vehicle is reduced by the monthly secured debt payment related to that vehicle and listed as a secured debt payment. A similar reduction applies to a second vehicle. (See lines 23 and 24 of Exhibit 1-1). Operating and public transportation costs are for no car and one or two cars and are based on census regions and metropolitan statistical areas. If the taxpayer lives within one of the areas defined by city and county, the rate for that area would apply; if the taxpayer does not reside in one of these areas, the regional standard is used. For example, one of the metropolitan areas is Portland, consisting of the city of Portland, seven counties in Oregon, and one county in Washington. All other counties in Oregon would use the regional rates.
- 2. *Expenses not specified by IRS.* Section 707(b)(2)(A)(ii), paragraph (I), of the 2005 Act provides that certain categories of expenses not specified by the IRS may also be allowed:
 - Reasonably necessary health insurance, disability insurance, and health savings account expenses for the debtor, the spouse of the debtor, or the dependents of the debtor.
 - Debtor's reasonably necessary expenses incurred to maintain the safety of the debtor and the family of the debtor from family violence.
 - An additional allowance for food and clothing of up to 5 percent of the food and clothing categories as specified by the National Standards issued by the IRS, provided it is shown that such costs are reasonable and necessary.
 - However, notwithstanding any other provision, the monthly expenses of the debtor shall not include payments for debts.
- 3. *Expenses for care of family member.* These include expenses paid by the debtor that are reasonable and necessary for care and support of an elderly, chronically ill, or disabled household member or member of the debtor's immediate family who is unable to pay for such reasonable and necessary expenses.

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4. *Chapter 13 monthly expenses.* These include expenses of the debtor to administer a chapter 13 plan for the district in which the debtor resides, up to 10 percent of the projected plan payments, as determined by the Executive Office of the U.S. Trustee.
5. *Special educational expenses.* These include the actual expenses for each dependent child less than 18 years of age (not to exceed \$1,500 per year per child) to attend a private or public elementary or secondary school.
6. *Excess housing and utilities.* This is an allowance for housing and utilities expense in excess of the allowance for these expenses in the Local Standards issued by the IRS; it is to be based on the actual expenses for home energy costs, provided the debtor submits documentation of the actual expenses and demonstrates that the expenses are reasonable and necessary.
7. *Secured debt payments.* These are total secured debt due over the five years of the chapter 13 plan divided by 60 months; past-due secured payments included in the plan that are necessary for the debtor's possession of the primary residence, motor vehicle, or other property necessary for the support of the debtor and the debtor's dependents are also considered.
8. *Priority claims.* Debtor's expenses for payment of all priority claims (including priority child support and alimony claims) shall be calculated as the total amount of debts entitled to priority, divided by 60.
9. *Contributions.* Furthermore, Code section 707(b)(1) implies that the chapter 13 practice of allowing plan contributions to a tax-exempt charity is to be continued under the 2005 Act.

(iii) *Rebuttal of Presumption of Abuse (New)*

The presumption of abuse may be rebutted only by demonstrating special circumstances, such as a serious medical condition, or a call or order to active duty in the armed forces. To the extent such special circumstances justify additional expenses or adjustments of current monthly income for which there is no reasonable alternative, the additional expenses will be allowed as provided in Code section 707(b)(2)(B) as a deduction in a recalculation of the extent to which

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abuse may exist. Thus, the special circumstances does not eliminate the need for means testing, but only reduces the likelihood of an abuse.

Code section 707(b)(6) provides that only the bankruptcy judge or U.S. trustee can also assert abuse if it is determined the petition was filed in bad faith or the totality of the circumstances of the debtor's financial situation demonstrates abuse as stipulated in Code section 707(b)(3).

(f) Chapter 11: Reorganization

(iii) Disclosure Statement

p. 12. Add after second paragraph:

Section 1125(a) of the Bankruptcy Code dealing with the disclosure requirements is expanded by requiring the proponent of the plan to include full discussion of the potential material federal and state tax consequences of the plan to the debtor, any successor to the debtor, and a hypothetical investor typical of the holders of claims or interests in the case. Thus, the disclosure statement should include the impact to the debtor, to various classes of creditors, and to shareholders.

In general, the disclosure requirements for the income tax impact of the plan have not generated the desired results. Often interested parties have been told to talk with their tax specialists to find out the income tax impact of the plan. Time will tell if this requirement will result in the plan's tax impact being explained in such a manner that readers of the disclosure statement will understand tax consequences. The purpose of the amendment is not to change existing law but to make plan proponents adhere to the original intent of the law: to effectively disclose the tax ramifications of the plan on the debtor.

(h) Chapter 13: Adjustment of Debts of an Individual with Regular Income

(ii) Chapter 13 Plan

p. 18. Replace three in third line of last paragraph with four and add fourth item to the list:

4. Notwithstanding the above provisions, a plan may provide for less than full payment of domestic support obligations under

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Section 507(a)(1) provided all of the debtor's projected disposable income will be applied to a five-year plan period.⁸

p. 19. *Add to the end of the first paragraph:*

However, provisions in the 2005 Act make it more difficult to obtain a discharge. For example, many of the provisions in section 523(a) denying a discharge now apply to chapter 13 cases, including the provision that taxes for which returns were not filed, were filed late, or were filed fraudulently are now not subject to a discharge. A discharge will not be granted in chapter 13 if the debtor fails to complete an instructional course concerning personal financial management.

(i) *U.S. Trustee*

p. 19. *Add prior to last bullet on page:*

- To move for the appointment of a trustee if there are reasonable grounds to suspect that current members of the governing body of the debtor, the debtor's chief executive or chief financial officer, or members of the governing body that selected the debtor's chief executive or chief financial officer participated in actual fraud, dishonesty, or criminal conduct in the management of the debtor or the debtor's public financial reporting.

⁸ Section 1325(b)(2) defines disposable income to mean current monthly income (other than child support payments, foster care payments, or disability payments for a dependent child) less amounts reasonable and necessary for (A) the maintenance or support of the debtor or a dependent of the debtor or for a domestic support obligation that first becomes payable after the date of the filing of the petition; and selected charitable contributions and (B) for the payment of expenditures necessary for the continuation, preservation, and operation of the debtor's business.