THE BANKRUPTCY ABUSE PREVENTION AND CONSUMER PROTECTION ACT OF 2005

HIGHLIGHTING ASSET PROTECTION ISSUES

Prepared and Presented by:

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I. Introduction:

On April 20, 2005 President Bush signed into law The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the "Act"). The Act makes several major changes to existing bankruptcy law, as well as changes to other areas of the law. These changes impact the practices of financial planners, CPAs, non-bankruptcy attorneys and bankers, as well as bankruptcy attorneys. Since its signing, some early cases and commentary have identified some of the more important issues with respect to the Act's drafting and interpretation.

II. Brief Overview of Bankruptcy System

A. The Bankruptcy Estate: Generally, all property that the debtor owns prior to bankruptcy, whether later determined to be exempt or non-exempt property, becomes part of the bankruptcy estate. Whether post-filing property is a part of the bankruptcy estate depends on which Chapter the debtor's bankruptcy is administered under (discussed below).

B. The Automatic Stay: The automatic stay stops collection activities from the date of filing of the petition for bankruptcy. If a creditor knowingly violates the automatic stay, the creditor may be subject to damages and attorney's fees.

C. Voluntary and Involuntary Bankruptcy: Bankruptcy can be voluntary (such as a Chapter 13 filing) or forced upon a debtor by a certain number of creditors holding a minimum amount of debt (such as an involuntary Chapter 7 filing).

D. Trustee: In a Chapter 7 or 13 bankruptcy, a trustee must be appointed to administer the bankruptcy estate. The trustee is given broad powers to deal with estate assets and recover assets either fraudulently or preferentially transferred prior to the filing of the petition for bankruptcy. The trustee holds the same position as a judicial lien holder.

E. Chapters: Each Chapter of the Bankruptcy Code maps out a distinct framework for the resolution and redistribution of the bankruptcy estate. Generally, each

Chapter focuses on the best interests of the creditors as the guiding principal for the court and the bankruptcy trustee, but the objective is also to give the debtor a fresh start or at least an opportunity to emerge from bankruptcy with a good chance of not returning.

1. Chapter 7: The primary characteristic of a Chapter 7 bankruptcy is the liquidation of the debtor's non-exempt assets. The assets are sold by the trustee, creditors are paid in accordance with a predetermined priority schedule, and the remaining debts (with several exceptions) of the debtor are discharged. The bankruptcy can be voluntary or involuntary. For an involuntary Chapter 7 bankruptcy, if a debtor has 12 or more unsecured creditors, three or more of them may get together to file the petition if they have a minimum amount of claims. If a debtor has fewer than 12 unsecured creditors, only one is required to file an involuntary petition.

2. Chapter 13: Chapter 13 is generally a voluntary bankruptcy by an individual who would like to repay his or her debt, or at least part of it, over time. The primary difference between a Chapter 7 and a Chapter 13 bankruptcy for an individual is that the debtor generally gets to keep his or her assets in a Chapter 13 bankruptcy. Nevertheless, many debtors prefer a Chapter 7 bankruptcy because they would like their debts completely discharged. The new changes to the Bankruptcy Code discussed below make a Chapter 7 bankruptcy more difficult to attain.

3. Chapter 11: A business or an individual may file (voluntarily or involuntarily) for a Chapter 11 bankruptcy, but Chapter 11 is most commonly associated with the reorganization of a large business. Individuals more often file under Chapter 13 unless they have a very large amount of debt, sometimes associated with a small business. In a Chapter 11 bankruptcy, the creditors must approve the plan for reorganization, so there are often protracted negotiations. There is no requirement that a trustee be appointed in a Chapter 11 bankruptcy. Unless there is cause such as fraud, dishonesty, or incompetence, the debtor continues to operate the business and conducts the reorganization as a "debtor in possession."

F. **Preferences:** The trustee may avoid payments to some creditors (and not others) made within a certain amount of time prior to filing of the bankruptcy petition. Thus, the trustee can get back the preference and redistribute it among all of the creditors in accordance with the priorities specified in the Bankruptcy Code. This time period is generally 90 days. The new changes add some exceptions to this rule.

G. **Fraudulent Transfers:** The trustee can avoid transfers that are deemed fraudulent under the bankruptcy statute if made within a year of the filing of the petition, and may avoid transfers deemed fraudulent under state law if made within the statute of limitations for that state (Texas has a four-year statute of limitations.). Changes are made to this rule under the Act. Under the Bankruptcy Code, a fraudulent transfer was previously defined as a transfer made with the actual intent to hinder, delay, or defraud

any entity to which the debtor was or became indebted, or a transfer for less than reasonably equivalent value if (1) the debtor was insolvent at the time or become insolvent as a result of the transfer, (2) the debtor was engaged or was about to be engaged in an inadequately capitalized business, or (3) the debtor intended to incur debts he knew he would be unable to pay.

H. Exemptions: Federal and state law each provide a list of exemptions. These exemptions represent the assets that the debtor gets to keep except to the extent the creditor has a security interest as to a particular asset. They are designed to provide the debtor with a minimum amount of property to sustain the debtor during the bankruptcy process. In Texas, the state law exemptions are much more favorable than the federal exemptions. The debtor has the right to elect the most favorable of the Federal or state law exemptions in Texas. The new Act makes important changes that affect the state law exemptions.

III. The New Act - Changes

A. Individuals: The most dramatic and important changes made by the Act affect individual debtors.

1. Choice of Law – New Two Year Rule:

a. Prior Law: As noted above, a Texas debtor can choose between state law and federal law exemptions. Prior law provided that the debtor had to live in a state for at least 180 days to choose that state's exemptions.

b. New Law: Under the Act, the debtor must have lived in a state for the previous 730 days (two years) to gain the ability to choose that state's exemptions. If the debtor has not lived in a state for the previous two years, the state that the debtor lived in during the 180 days prior to moving to the new state is the one that the debtor may choose if he does not want the federal exemptions. (Section 522(b)(3)(A))

2. Means Testing: Much of the publicity surrounding the Act concerns the new procedure for determining whether a debtor qualifies for Chapter 7 or Chapter 13.

a. Prior Law: Former Section 707 of the Bankruptcy Code specifically provided a presumption "in favor of granting the relief requested by the debtor." Section 707 addressed dismissal only (not conversion from one Chapter to another), and such a dismissal could only be granted upon the motion of the court or the United States trustee. Also, a debtor's expenses (used to determine how much income the debtor needed to keep in a Chapter 13 bankruptcy) were determined on a case-by-case basis.

b. New Law: Section 707 has been extensively revised to provide a mechanism for forcing a debtor who has requested a discharge under Chapter 7 into a Chapter 13 repayment plan. Under this mechanism, any debtor earning more than the state median income will not be eligible for Chapter 7 relief absent special circumstances such as a serious medical condition or a call to active duty.

Rather than a presumption "in favor of the relief the debtor requests," a presumption of abuse of the bankruptcy system is established when the debtor's monthly income, minus expenses, multiplied by 60, is not less than the lesser of (1) 25% of the debtor's non-priority unsecured claims or $6,000 (whichever is greater), or (2) $10,000. In short, this formula is meant to determine whether the debtor is realistically going to be able to pay back a significant amount of the debt over a five-year period.

The debtor's expenses, instead of being determined on a case-by-case basis, are calculated using the applicable monthly expense amounts under the National Standards and Local Standards, as well as several specific expense items listed in the statute such as expenses for administering the Chapter 13 plan, actual expenses for a dependent's education (but not to exceed $1,500 per child), expenses for care of the elderly, payments on account of secured debt, child support and alimony.

Penalties and costs can be imposed against the attorney representing the debtor if the court grants a motion that the petition for bankruptcy was an abuse of the bankruptcy process. Given the presumption in favor of abuse in certain circumstances, this is an important consideration for bankruptcy attorneys and could result in difficulty for debtors trying to find counsel.

3. Exemptions: Several provisions of the Act affect and supersede the state law exemptions. The federal exemptions remain largely unchanged, except that a specific definition of "household goods" has been created.

a. Homestead: As discussed above, under prior law, a debtor in a bankruptcy proceeding could choose certain exemptions from the bankruptcy estate afforded to him under federal law or he could choose the exemptions afforded to him under the law of his domicile. The exemptions for federal law are listed in the Bankruptcy Act statute. Often the debtor would elect the state law exemptions, especially in states such as Texas that allow an unlimited exemption for the homestead, whereas the federal exemption for real property is only $18,450.

Under the new Bankruptcy Act §522, a debtor in Texas would still choose state law exemptions over the federal exemptions, but for some the

advantage will not be nearly as great. Under the new law, a $125,000 limitation is applied to the homestead exemption where the debtor purchased the homestead within the 1215 day (40 month) period prior to the filing of the bankruptcy petition.

In calculating the new $125,000 limitation for newly-acquired homestead residences, any interest transferred from a previously owned homestead (acquired prior to the 1215 day period) would not be counted. For example, if a debtor owned a $1 million dollar homestead, of which $500,000 represented equity of the debtor, and later the debtor moved to a new $2 million homestead prior to filing bankruptcy, then $625,000 would be exempted from the bankruptcy estate under the new federal limitation on the Texas unlimited homestead exemption rules ($500,000 equity transferred from old homestead plus $125,000 limitation imposed by new Bankruptcy Act).

A new subjective ten-year look-back provision for homesteads has also been added to the Bankruptcy Act. Under new §522(o), the value of an interest in the homestead will be reduced to the extent (1) that the debtor converted property to a homestead to hinder, delay, or defraud a creditor, and (2) if the property had not been converted to a homestead it would not be exempt property. Therefore, the court can look back over the previous ten years and determine whether any property was invested in the homestead with the intention of keeping that property away from creditors. There was previously no fraudulent transfer provision as to a Texas homestead.

Another new provision strictly limits the homestead exemption to $125,000 (with no add-on for transferred equity) in certain fact situations where crimes have been committed by the debtor. Those situations are:

(1) Where the court determines that the debtor has been convicted of a felony, which under the circumstances, demonstrates that the filing of the case was an abuse of the provisions of the Bankruptcy Code; and

(2) The debtor owes a debt arising from:

(a) any violation of federal securities laws;
(b) fraud, deceit, or manipulation in a fiduciary capacity in connection with the purchase or sale of securities;
(c) racketeering;
(d) any criminal act, intentional tort, or willful or reckless misconduct that caused serious physical injury or death within the previous five years.

This new section (522(o)) will not apply to the extent that amounts are reasonably necessary for the support of the debtor or a dependent of the debtor.

Overlay of the New Two Year Rule: Keep in mind that the general two-year rule regarding the selection of state law exemptions also applies in the homestead context. Therefore, a person moving from another state into Texas may only receive the benefit of his prior state's homestead laws, which could be less favorable than Texas's "unlimited prior residence value plus $125,000" new rule.

Early Interpretations:

(1) Occupancy: The court in *In Re Grady*, 327 B.R. 807 (Bankr. S.D. Tex. 2005) decided that in order to be entitled to the bankruptcy homestead exemption, the debtor must actually occupy the property at some point prior to his ro her bankruptcy filing. This decision is somewhat at odds with Texas law, which provides that homestead protection may be created without actual occupancy as long as there is intent to occupy the premises as a residence coupled with some overt act of preparation.

(2) Interest "Acquired": For purposes of interpreting the 1215 day rule, the court in *In Re Blair*, 334 B.R. 374 (Bank. N.D. Tex. Nov. 2005) decided that the equity gained within the prior 1215 days was not subject to the $125,000 cap. The interest in the home is "acquired" when title in the home is acquired, when the home is actually purchased.

Contrast *Blair* with *In Re Greene*, 346 B.R. 835 (Bank. D. Nev. 2006) where the debtor had owned the home for ten years, but had not made it his residence until he was within the 1215 day period. The court found that the "homestead" exemption is an interest unto itself and was not acquired until the debtor was within the 1215 day period, so the $125,000 cap applied.

(3) Marital Transfers: *In Re Leung*, 356 B.R. 317 (Bank. D. Mass. 2006). The court in Leung was asked to interpret the new Act in terms of inter-spousal transfers. The debtor and his wife had lived in their home for many years as tenants by the entirety. Four years before filing for bankruptcy, the debtor transferred his interest in the homestead to his wife. Seven months before the debtor filed for bankruptcy, his wife transferred the debtor's original interest back to him, so that the debtor and his wife again held the home as tenants by the entirety.

The court found that the debtor could not avoid the 1215 day rule and was limited to an exemption of $125,000. He acquired his interest only seven months before filing the petition. The court rejected arguments that (1) a gift should not fall within the statute, (2) that he nonetheless had held an equitable interest in the home the whole time, and (3) that he should be able to roll over the equity from his previous residence (which here would be the same residence).

The decision in Leung has estate planning as well as asset protection implications. Transfers between spouses are commonly made in order to equalize estates, and of course, in states like Texas, the marital home is an excellent asset for the spouse who is likely to be sued or have creditor issues.

b. Retirement Benefits:

(1) Prior Law: Under former law, the rules concerning the exemption of retirement assets were not entirely clear. Specifically, it was unclear whether and to what extent interests in IRAs and other non-qualified plans were exempt.

(2) New Law: The Act makes clear that any plan exempt from taxation under Sections 401, 403, 408, 408A, 414, 457, or 501(a) of the Internal Revenue Code are exempted. For IRAs and similar plans, the amount exempted is limited to $1 million. However, recent case law indicates that the $1 million exemption imposed by the Act may not be exclusive, and may be increased by a court if the interests of justice so require. (*Gould*, 2005-1 USTC ¶ 50,318, *Rousey v. Jacoway*, 125 S. Ct. 1561). In *Rousey*, the court sent back the case to the lower court to determine how much of the IRA was necessary for the debtor to live on.

The Act also makes clear that exempted retirement benefits include amounts that have been properly rolled over, even if the amount rolled over results in an exemption greater than the $1 million limit. (Section 522(b)(4)) It does not appear that qualified plans are limited in any way.

c. Insurance Benefits:

While there is no change in the Federal or Texas state law with regard to insurance benefits, it is worth noting that the Texas state law exemption with respect to insurance benefits (the proceeds and cash value, so long as it is in the policy) is unlimited. Section 1108.051 of the Texas Insurance Code provides the

blanket exemption. This exemption is subject to the state law four year statute of limitations for fraud. (Section 1108.053).

However, if a policy is cancelled and as a result the former policy holder receives a check for the cash value, that check does not constitute proceeds of the policy and is therefore not protected. See *In Re Trautman*, 340 B.R. 773 (Bank. W.D. Tex. Mar. 2006).

d. Education Plans:

To a very limited extent, certain education plans are excluded from the bankruptcy estate and thus are protected in bankruptcy. Section 541 of the Act excludes from the bankruptcy estate Education Individual Retirement Accounts qualified under Section 530(b)(1) of the Code and "529 Plans."

Specific limitations include: (1) the beneficiary must be a child or step-child of the debtor for the year in which funds were place in the account, (2) the funds cannot be pledged in connection with credit, (3) the funds must have been in the account for more than 1 year; (4) the amount contributed between 1 and 2 years before filing the petition are only protected to the extent of $5,000 beneficiary. Funds beyond these limitations or within 1 year of filing the petition for bankruptcy are not automatically brought into the estate. Rather, they are subject to attack by the bankruptcy trustee as fraudulent conveyances.

4. Fraudulent Transfers:

a. New Look-Back Period: The one-year look-back period for fraudulent transfers has been increased by the Act to two years. This new look-back period will only apply to bankruptcy cases filed one year or more after enactment.

b. Transfers to Insiders: Added to the list of transfers that are considered fraudulent are transfers to insiders under an employment contract and not in the ordinary course of business where the debtor received less than reasonably equivalent value in return. In enacting this provision, Congress is trying to prevent large bonuses to insiders as the debtor is headed into bankruptcy.

c. Self Settled Trusts – 10 Year Rule : Under the Act, the look-back period for fraudulent transfers has been increased to two years. However, a special ten-year look-back period has been added for self-settled trusts "or similar devices." If the transfer to the trust was made with the intent to hinder, delay, or defraud creditors, the trustee may avoid the transfer. The Act specifically includes transfers that are made in

anticipation of any money judgment, settlement, civil penalty, equitable order, or criminal fine incurred by, or the debtor believed would be incurred by any violation of securities laws. Whether actual intent to hinder or delay creditors can be established by proving the anticipation of violating non-securities laws is not clear.

Given the power associated with a ten-year look-back, anticipate significant time, energy, and litigation involving the interpretation of the phrase "similar devices" used in this new version of Section 548, specifically with respect to offshore life insurance arrangements and annuity contracts. Commentators have criticized the general wording of the statute as well. Several questions are raised such as whether Congress intended to cover any creditor to whom the debtor became indebted in the ten years following the creation of the trust, or whether they only meant to cover a certain kind of creditor. Another outstanding question is whether the creation of a self-settled trust by itself is evidence of intent to hinder creditors.

5. Credit Counseling: The Act requires that individual debtors obtain credit counseling prior to filing for bankruptcy protection. The debtor is required to submit a plan developed during the credit counseling process, if any, for paying back creditors. The automatic stay does not start until filing of the bankruptcy petition, so creditors can continue collection efforts and take action against the debtor's assets while this counseling is occurring. The counseling must occur within 180 days prior to filing the petition.

6. Valuation: Under prior law, the value of personal property that secured a claim was determined "in light of the purpose of the valuation and of the proposed disposition or use of such property." The Act changes the valuation standard to the replacement value as of the date of the filing for Chapter 7 and 13 filings. (Section 506)

7. Other Provisions Affecting Individual Debtors:

a. The Act extends the period between discharges of debt under Chapter 7 from six years to eight years.

b. If a debtor files a bankruptcy case within one year of a prior case, the automatic stay for the second case will expire after thirty days unless the court extends the stay. If the debtor has filed two or more cases within a one-year period, there will be no automatic stay unless the court imposes one.

c. Debts owed to a retirement plan or stock bonus plan are not dischargeable. Other new non-dischargeable debts include consumer

debts owed to a single creditor for luxury goods in excess of $500 incurred within 90 days of bankruptcy filing.

d. Debts covered by purchase money security interests that are not reaffirmed by the debtor within 45 days of the bankruptcy filing, or where the debtor does not redeem the property, will not thereafter be subject to the automatic stay. In a Chapter 13 case, the secured claimant will retain its lien until the underlying debt is paid or the debtor receives a discharge.

e. New provisions (Section 362) are aimed to prevent the filing of a bankruptcy petition for the sole purpose of preventing an eviction involving a residential lease. There is an exception if non-bankruptcy law would allow the debtor to cure the default, in which the debtor is given 30 days to make such cure. (Compare to new commercial lease rule, discussed below)

f. The Act extends the time to perfect a purchase money security interest (so as to prevent an avoidance by the trustee) from 20 days to 30 days.

g. The Act requires Chapter 13 debtors to remain current on personal property leases and provide proof of adequate insurance.

h. The Act specifies that child support claimants receive the highest payment priority and requires that these claimants receive notices regarding the bankruptcy case.

B. Businesses: Although the new Act provides for several changes to laws listed under a general heading of "Small Businesses," many of the new provisions are applicable to all debtors. A Small Business bankruptcy is one where the total debt is less than $2 million, and no creditors committee is formed or is inactive. (Section 101(51C)).

1. Information Requirements:

In a Small Business bankruptcy, the debtor is required to report periodically on its progress toward meeting its post-petition obligations, its current financial position and projected financial position.

Within 7 days of filing a bankruptcy petition, the small business debtor is required to file a myriad of financial disclosures including balance sheets, tax returns, cash-flow statements and statement of operations.

2. Status Conferences: Status conferences are required to be held to facilitate the quick and economical resolution of the case. It appears that this provision applies to all debtors, not just small businesses.

3. Wage Priorities: Section 507 now creates priority claims for wages and benefits earned within 180 days of filing the bankruptcy petition. The limitation on the priority is $10,000 per employee. Under prior law, the limitation was $4,925 for the period of 90 days prior to filing the bankruptcy petition.

4. Retirement Plans: If a debtor changes its pension plan within 180 days of filing for bankruptcy and at that time the debtor was insolvent, the court will reinstate the old plan unless the court finds that the new plan is better. (Section 1114)

5. Leases:

A non-residential real property lease is automatically rejected if the debtor fails to assume the lease within 120 days of the bankruptcy filing. This changes the old rule which only allowed for a 60 day period.

Personal property leases rejected by the debtor are eliminated from the bankruptcy estate and the automatic stay as to that property is lifted. (Section 365(p))

6. Reclamations for Vendors:

If a vendor delivers goods to the debtor within 45 days of the bankruptcy petition being filed, the vendor can assert a reclamation claim (Section 546)

New Section 503 states that all goods delivered to the debtor within 20 days of the filing of the petition for bankruptcy are entitled to administrative expense priority. Since all administrative expense priority items must be paid prior to a plan being confirmed by the court, this adds some assurance to certain creditors and possibly adds to the costs associated with getting a plan confirmed.

7. Filing of Returns:

A new rule provides that if the debtor misses the filing of a return after the petition for bankruptcy has been filed, the court has the authority to dismiss the case. (Section 521(j)).

8. Defense to Preference Actions:

a. Ordinary Course of Business

(1) Prior Law: This defense to a preference action required that the creditor to prove that (1) the payment was incurred in the ordinary course of business of the debtor and transferee, (2) the payment was made in the ordinary course of business of the debtor and transferee, and (3) the payment was made according to

ordinary business terms. This three-part test was often difficult to prove and required expensive expert testimony.

(2) New Law: The Act now only requires that to prove the "ordinary course of business" defense, the transferee need only establish that the transfer was made in the ordinary course of business or that it was made according to ordinary business terms, if the transfer was made within 90 days of the debtor's bankruptcy.

b. Limitation on Amount

(1) Prior Law: If a transfer to a creditor was less than $600, it could not be voided as a preferential transfer.

(2) New Law: If a transfer to a creditor is less than $5,000, it cannot be voided as a preferential transfer. Note that this only applies to businesses (non-consumer debts). In the individual context, the limit remains at $600. There is uncertainty regarding what should be included in a "transfer" in this context. The Act uses the phrase "aggregate value of all property that constitutes or is affected by such transfer." Therefore, one would presume that the sale of several items, all under $5,000, to a particular vendor would constitute separate transfers that could not be avoided, while the sale of an item worth more than $5,000, but where installment payments were made, would be a voidable transfer.

9. Single Asset Real Estate Filings:

Where the debtor is a single asset entity and that asset is real estate, new rules under Section 362 require that the debtor either file a confirmable plan or commence making payments to the secured creditor within 90 days of the filing of the petition. If the entity fails to do so, the automatic stay will be lifted.

IV. TILA Changes:

The Act changes several provisions related to or contained in the Truth in Lending Act which will change the look of many common billing statements. Specifically, the new rules require that companies provide warnings and examples regarding how long it will take to pay off a debt if only minimum payments are made. The rules also require clear explanations of the amount and due dates for late charges, and it prevents companies from closing an account merely because finance charges are not incurred by the debtor.

V. Effective Dates:

Most of the provisions of the Act became effective 180 days from enactment. However, some important exceptions are:

(1) The homestead rules, wage priority rules, transfers to insiders rules, and the reinstatement of retirement plans rules were effective immediately.
(2) The new small business reporting rules became effective 60 days from enactment.
(3) The new two-year look-back rule for fraudulent transfers became effective for filings made one year or more after enactment.

Pursuant to new IRS rules which became effective June 20, 2005, we are required to inform you that any U.S. federal tax advice contained in this communication, including any attachments, is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding any penalties under U.S. federal tax law or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein.