Means Testing Bankruptcy

[Destroying the Social Safety Net in Trying Times?]

By Bruce D. Fisher

Fast Facts:

- A means test now exists for Chapter 7 filings.
- Debtor access to Chapter 7 is denied if the debtor is "abusing"—not "substantially abusing"—Chapter 7.
- One way of analyzing the means test is to consider it as consisting of three parts: current monthly income, allowable expenses, and the residual available to the debtor to service his or her debts.

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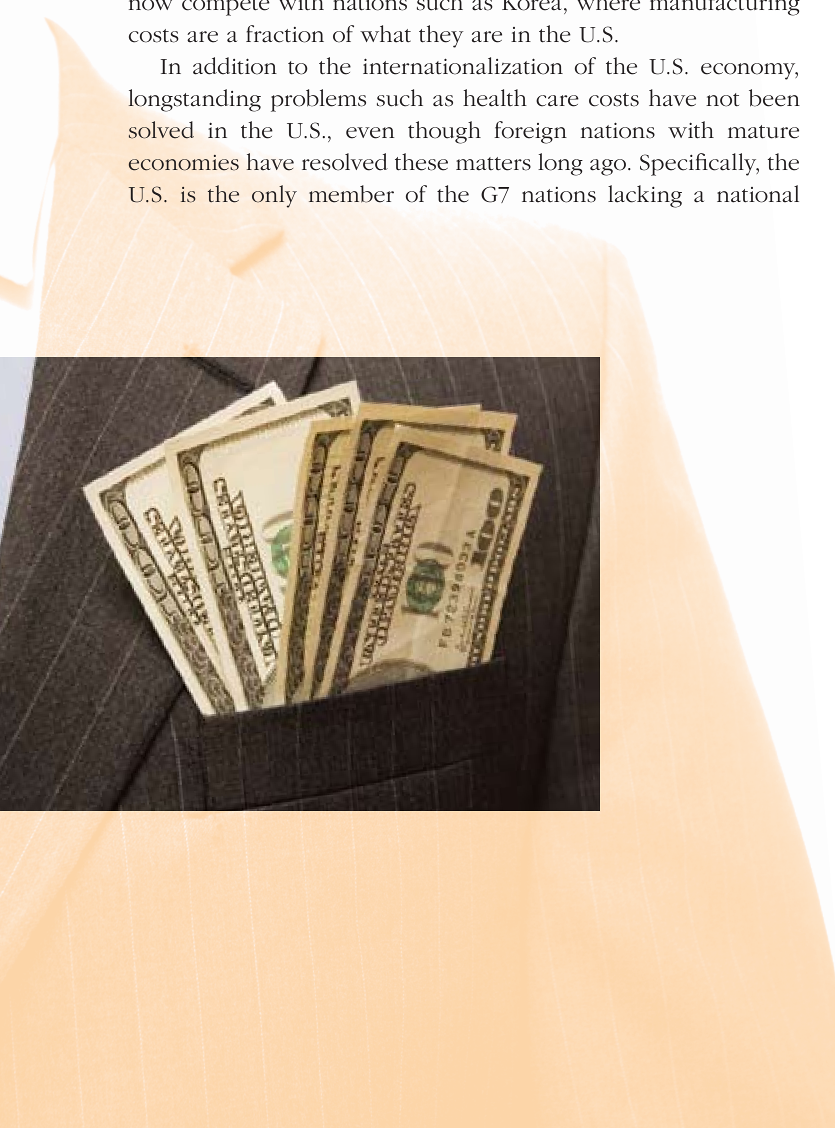
Before October 17, 2005, the effective date of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the act), a high income level did not necessarily prevent one from obtaining a Chapter 7 "straight bankruptcy." Under the act, however, individuals will be "means tested" when attempting to file a Chapter 7 bankruptcy petition and possibly will be denied a Chapter 7 straight bankruptcy or diverted to another chapter of the Bankruptcy Code.

This article focuses on the new means test for those attempting to file under Chapter 7. The test arguably works a hardship on persons in states such as Michigan, where macroeconomic forces far beyond the control of individuals have resulted in many needing the Chapter 7 "safety net" to give them a fresh start.

Macroeconomic Factors Often Explain Resort to Chapter 7

Many consumer-debtors in the state of Michigan are in a unique economic position. There have been numerous accounts of downsizings in the Michigan automobile industry. States heavily involved in manufacturing, such as Michigan, have borne more than their share of the pain resulting from the internationalization of the U.S. economy. Michigan automobile manufacturers now compete with nations such as Korea, where manufacturing costs are a fraction of what they are in the U.S.

In addition to the internationalization of the U.S. economy, longstanding problems such as health care costs have not been solved in the U.S., even though foreign nations with mature economies have resolved these matters long ago. Specifically, the U.S. is the only member of the G7 nations lacking a national health care system. As a result, individual businesses find themselves having to deal with (not necessarily provide) health care protection for their workers. The anomaly is that while about 15 percent of the U.S. population finds itself without health insurance protection, the U.S. spends a higher percentage of its gross domestic product on health costs than do other G7 nations. Further, at least one recent federal court decision has held that the Employee Retirement Income Security Act does *not* preclude employers from cutting retired employee health care benefits in certain instances.[1] Thus, businesses could well leave it to individual workers to provide for their own health care by taking out private insurance or by "self-insuring." In the case of the latter event, this often means facing crippling hospital and doctor bills, which eventually could lead to bankruptcy. In fact, one of the leading causes of personal bankruptcies is insurmountable medical debts.[2] Such debts are often not the result of personal mismanagement but, rather, an event such as an unexpected diagnosis of a dreaded disease resulting in overwhelming, often uninsured or underinsured, medical bills.



While total bankruptcies have doubled nationally over the past eight years, the state of Michigan has seen the total number of bankruptcies triple in the same period. In February 2008, Michigan was first in seasonally adjusted unemployment at 7.2 percent (ahead of Mississippi at 5.9 percent and Alaska at 6.6 percent).[3] Thus, without exaggeration, Michigan could be described as being in a "three-state recession," given the relatively high state unemployment rate coupled with the high level of bankruptcies.

Means Testing Debtors Who Can File for Chapter 7

One of the problems animating passage of the act was the perception that too many people were using Chapter 7 as a debt management tool. Statistics supported the idea that many file under Chapter 7, although the reasons for such filings vary. In 1990, there were 505,337 Chapter 7 filings.[4] By 2000, that number had grown to 885,447, and in the most recently reported year, 2006, the number had grown to 1,142, 958 Chapter 7 filings.[5]

One of the biggest changes in the act was its abandonment of the idea that straight bankruptcies are available to any debtor irrespective of the size of his or her current income. Before October 17, 2005, the size of one's income was generally no impediment to filing for a straight bankruptcy given the fact that there had to be "substantial abuse" to deny a Chapter 7 filing—a threshold that was not prohibitive. Following passage of the act, access to Chapter 7 is denied if the debtor is "abusing" Chapter 7, not "substantially abusing," as under the Code in its former incarnation.[6]

"Abuse" can occur in one of two ways: (1) failing a "means test"[7] or (2) failing a "totality of circumstances test."[8]

Means Test

In essence, if a debtor has sufficient means to service his or her unsecured debts, he or she has sufficient means to repay those

debts and therefore should be denied access to Chapter 7 because he or she will be presumed to be "abusing" Chapter 7. Also, the act removes the presumption in favor of granting Chapter 7 relief requested by the debtor.[9]

But when is the debtor committing an abuse of Chapter 7? The act limits Chapter 7 filings by creating a presumption of abuse of Chapter 7 on the basis of a rather complex means test.[10] Specifically, Chapter 7 abuse is presumed if the debtor's current monthly income, reduced by allowable statutorily determined expenses and multiplied by 60, is not less than the lesser of 25 percent of the debtor's nonpriority unsecured claims in the case, or $6,000, whichever is greater; or, alternatively, $10,000.[11]

Another way of analyzing the means test is to consider it as consisting of three parts: current monthly income, allowable monthly expenses, and the remainder or residual available to the debtor to service his or her debts. If the residual is too large, there is a presumption of abuse. Examples that follow provide an idea of the size of the monthly residuals and when they would establish the presumption of abuse.

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Means Test: Current Monthly Income

"Current monthly income" is defined as the average monthly income that the debtor receives from all sources, without regard to whether such income is taxable income derived during the six months before filing the petition.[12] If it is a joint case, the income is that of the debtor and his or her spouse. It includes any amount paid by any entity other than the debtor on a regular basis for the household expenses of the debtor or debtor's dependents.[13] It excludes Social Security benefits, payments to victims of war crimes or crimes against humanity, and payments to victims of international or domestic terrorism.[14]

Means Test: Allowable Expenses

After considering current monthly income, one then deducts certain allowable expenses. The matter of determining allowable monthly expenses is important in determining Chapter 7 abuse. The greater the debtor's allowable expenses, the less the residual amount used to determine abuse. The act devotes considerable language in determining "debtor's monthly expenses." The expense amounts are specified under the National Standards and Local Standards, and the debtor's actual monthly expenses for the categories specified as "other necessary expenses" issued by the Internal Revenue Service for the area in which the debtor resides.[15] The date of these standards is the date of the order for relief (initial Chapter 7 filing).[16]

The expenses that may be taken into account are not only those of the debtor, but the debtor's dependents and the debtor's spouse (if a joint filing or if the spouse is not otherwise a dependent).[17] The expenses allowed include reasonably necessary health insurance, disability insurance, and health savings account expenses for the debtor, the debtor's spouse, or debtor's dependents.[18] However, one notable item *not* included in debtor's monthly expenses are debt payments.[19] Also allowed in the debtor's monthly expenses are the debtor's reasonably necessary expenses incurred to maintain the debtor and his or her family's safety from family violence under Section 309 of the Family Violence Prevention and Services Act (or other applicable federal law).[20] The debtor's expenses for food and clothing may be increased up to 5 percent of the food and clothing allowances for the National Standards issued by the IRS if they are reasonable and necessary.[21]

Beyond the above, other debtor expense items may be included in monthly expenses before arriving at the net monthly figure against which abuse occurs if they apply. First allowed are the actual expenses associated with the reasonable and necessary care and support of an elderly, chronically ill, or disabled household member or member of the debtor's immediate family.[22] Immediate family includes the debtor's parents, grandparents, siblings, children, grandchildren, and dependents. In addition, the act allows actual expenses up to $1,500 per year per child to attend a private or public elementary or secondary school.[23] At a time of escalating energy costs for home heating, another allowance for debtors should prove helpful. Debtors may deduct from their gross income an allowance for housing and utilities in excess of the allowance specified by the Local Standards for housing and utilities issued by the IRS, based on actual expenses for home energy costs if they can be documented and are reasonable and necessary.[24]

Means Test: Residual Debtor Income After Deducting Allowable Expenses from Current Monthly Income

The act lays out certain "trip wires" or boundaries that determine if the debtor's residual income is high enough to infer abuse or low enough to reject the notion debtor is abusing Chapter 7. On the low end of the scale is the amount of less than $6,000 over a five-year period (less than $100 residual income per month for 60 months). This is a very low residual, and in such case a debtor is presumed not to be abusing Chapter 7. At the high end of the range, if the debtor has $10,000 residual income for a five-year period ($166.67 per month for 60 months), the debtor is presumed to be abusing Chapter 7. Between the residuals set by the act, the debtor's total unsecured debt comes into play in calculating whether the presumption of abuse exists.

It is possible to rebut the presumption of abuse arising from the debtor's income level. This can be done if the additional expenses

or adjustments to income noted above cause the product of the debtor's current monthly income reduced by adjustments noted above when multiplied by 60 to be less than the lesser of 25 percent of the debtor's nonpriority unsecured claims, or $6,000, whichever is greater, or $10,000. In other words, if the debtor's residual monthly income falls below the "trip wires," the presumption would be rebutted.

Totality of Circumstances Test

The act creates one other way to establish abuse of Chapter 7 if the presumption of abuse does not apply or has been rebutted: a "totality of circumstances" test. If the bankruptcy court, administrator, or trustee finds under the totality of circumstances that the debtor is filing in bad faith, it has the authority to deny a Chapter 7 filing in any case. As can be seen from these means tests, the act arms the bankruptcy court, administrator, and trustee with heavy weapons to stop debtor abuse of Chapter 7.

Standing to Challenge a Chapter 7 Filing

One other factor should be mentioned in connection with challenging a debtor's Chapter 7 filing as an abuse: the matter of who can raise the abuse issue. The act confers standing to challenge a Chapter 7 filing on the bankruptcy court, the bankruptcy trustee, or any party in interest (creditors, for example).[25] Another type of means testing, however, in some respects narrows who has standing to challenge a debtor's Chapter 7 filing. The situation is when a state's median income comes into play. Median family income for the debtor's particular state is relevant in determining who has standing to challenge if a debtor is abusing Chapter 7. If the debtor's current monthly income times 12 is greater than the median family income of a family of the same or smaller size for the debtor's state, the bankruptcy court, trustee, or any party in interest has standing to challenge the debtor's Chapter 7 filing.[26] The agency that determines the median family income is the Bureau of the Census for the most recent year.[27] In Michigan, the median income for a family of one is $41,877; for two people, $49,052; for three people, $62,480; and for four people, $70,887.

If the family income is of equal or smaller size than the state median income, only the bankruptcy court has standing to assert the debtor is abusing Chapter 7.[28] The act imposes other rules that limit the ability of even a judge or bankruptcy trustee to challenge Chapter 7 filings in the certain cases involving below median state incomes, such as those involving certain disabled veterans.[29]

Note that standing to challenge a Chapter 7 filing as abusive should not be confused with whether an actual abuse of Chapter 7 has occurred.

Conclusion

In industrial states such as Michigan facing high unemployment with fragile local economies trying to restructure in the face of strong foreign competitors, the act represents a threat to the social safety net that Chapter 7 represents, especially for workers facing layoffs, early retirements, and mounting medical bills. Recent court interpretations of ERISA refusing to hold that vesting applies to post-retirement employee health insurance will do nothing to improve matters for debtors.

There are economic factors in the U.S. legal environment and Michigan's economic environment in particular that justify a reconsideration of some of the bankruptcy provisions, especially concerning the length between Chapter 7 filings or a softening of its impact by sympathetic bankruptcy judges. The fact that health care costs continue to escalate and that a national health insurance solution remains unlikely, coupled with the fact that medical bills are often the most significant factor driving persons into bankruptcy filings in the first place, all question the wisdom of the act's tightening access to Chapter 7. ■

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FOOTNOTES

1. *Cherry v Auburn Gear, Inc,* 441 F3d 476 (CA 7, 2006).
2. ConsumerAffairs.com, *Long View for a Long Road* <http://www.consumeraffairs.com/news04/2005/bankruptcy_act04.html> (accessed June 19, 2008).
3. U.S. Dept. of Labor, *Local Area Unemployment Statistics* <http://www.bls.gov/LAU> (accessed June 19, 2008).
4. U.S. Dept. of Commerce, *Statistical Abstract of the U.S.: 2008* (127th ed, 2007), p 506.
5. *Id.*
6. Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, PL 109-8, §102(a)(2)(B)(3), 119 Stat 23, 27.
7. *Id.* at §102(a)–(d).
8. *Id.*
9. *Id.* at §102(a)(2)(B)(2).
10. *Id.* at §102(a)(2)(C).
11. *Id.*
12. *Id.* at §102(b).
13. *Id.*
14. *Id.*
15. *Id.*
16. *Id.*
17. *Id.*
18. *Id.*
19. *Id.*
20. *Id.*
21. *Id.*
22. *Id.*
23. *Id.*
24. *Id.*
25. *Id.* at §102(a)(2)(B)(i)(1).
26. *Id.* at §102(a)(2)(A)(i).
27. *Id.* at §102(k).
28. *Id.* at §102(a)(6).
29. *Id.* at §102(a)(7).