

Timing Is Everything...or Is It? *Cortez* Challenges the "Snapshot" Approach to Analyzing Abuse Pursuant to §707(b)

Written by:

Justin H. Dion

Bacon & Wilson, P.C.; Springfield, Mass.

jdion@bacon-wilson.com

Web posted and Copyright © October 1, 2006, American Bankruptcy Institute.

"You can never plan the future by the past."

-Edmund Burke

It has been said that life is all about timing. This is especially true when examining someone's financial status. Someone could be solvent today and insolvent tomorrow (or vice versa). Timing is also crucial when analyzing a prospective debtor's chapter 7 bankruptcy options. When a debtor is consulting with counsel regarding financial options and bankruptcy eligibility, the present status of the debtor's assets, liabilities and income are carefully examined. The debtor's information is then usually processed to determine if nonbankruptcy options are feasible as an alternative to bankruptcy options. The bankruptcy analysis entails determining a debtor's eligibility to discharge debts, as well as an ability to exempt assets. In addition, a debtor's current monthly income and expenses are examined to ensure that it would not be "abuse" to grant the debtor a chapter 7 discharge pursuant to 11 U.S.C. §707(b). If the chapter 7 debtor appears to have the ability to repay his or her debts based on current income and expenses, grounds for dismissal pursuant §707(b) may exist. This analysis is crucial since the enactment of the 2005 Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA), as the newly created "means test" enumerated in §707(b)(2) requires a more precise examination of the debtor's income for the six-month time period "ending on the last day of the calendar month immediately proceeding the date of the commencement of the case."

The Snapshot Approach to Analyzing §707(b)

Bankruptcy courts traditionally employed the "snapshot" approach when examining a chapter 7 debtor's eligibility pre-BAPCPA. Under the snapshot approach, the debtor is required to disclose the accuracy of his or her debts, assets, income and expenses as of the day of the filing of the petition. In essence, this gives the court and creditors a financial snapshot of the debtor's status as of the petition date. Pursuant to this approach, most post-petition changes in the debtor's finances such as incurring new debt, purchasing assets and incurring a fluctuation (either up or down) in monthly expenses and/or income are irrelevant for purposes of determining eligibility to obtain a chapter 7 discharge. Traditionally, these post-petition changes are irrelevant due to the fact that they are outside of the snapshot that was created on the day the petition was filed. Although there are some exceptions to this principle,¹ generally post-petition financial changes have little effect on chapter 7 eligibility. Despite this long-standing snapshot principle, a recent decision from the U.S. Court of Appeals for the Fifth Circuit has altered the traditional view.

Looking into the Future with *Cortez*

In *U.S. Trustee v. Cortez*, 457 F.3d 448 (5th Cir. July 20, 2006), the Fifth Circuit affirmed the decision of the U.S. District Court for the Northern District of Texas to reverse a bankruptcy court decision to exclude a post-petition increase in a debtor's income when evaluating abuse pursuant §707(b). The case was then remanded back to the bankruptcy court for further proceedings.

Procedurally, *Cortez* involved a husband and wife who filed a joint chapter 7 bankruptcy on April 8, 2004. Debtors' petition showed a secured claim for the mortgage on their house, and unsecured debt in the amount of \$85,719 (the majority of which consisted of credit card debt). In addition, as of the date of filing, on Schedule I the debtors listed their net monthly income as \$4,417, with Schedule J listing the monthly household expense payments as \$5,320. Due to Mr. Cortez's unemployment at the time of the bankruptcy filing, all of the income was attributed solely to Mrs. Cortez's employment as a registered nurse. Prior to Mr. Cortez's unemployment, the debtors reported a combined annual income of \$145,600 in 2003. The bottom of Schedule I requires the debtors to report "any increase or decrease of more than 10 percent in any of the above categories anticipated to occur within the year following the filing of this document. In response, debtors reported that Mr. Cortez "believes he will be employed this month, but he has not started working yet." In fact, four days after filing for bankruptcy, Mr. Cortez did receive a job offer as a human resource director for a large company. There is no evidence that Mr. Cortez had been extended this job offer pre-petition. Mr. Cortez accepted the position and began working on April 24, 2004. The position reportedly paid \$95,000 (or \$5,896 per month), a \$5,000 signing bonus after 60 days of employment, as well as making Mr. Cortez eligible to use a company car. After becoming employed, Mrs. Cortez voluntarily reduced her hours, and thus her net monthly income fell to \$750. These post-petition income changes resulted in the debtors' new income exceeding their monthly expenses as listed in the petition by \$1,328 per month.

Upon request of the U.S. Trustee, the debtors provided documentation evidencing Mr. Cortez's post-petition employment position, and testified accurately regarding the same at the §341 meeting of creditors. Shortly after the §341 meeting, the trustee filed a motion to dismiss pursuant to §707(b), asserting abuse. Because this was a 2004 bankruptcy filing, the court applied §707(b) prior to being amended by BAPCPA. The pre-BAPCPA provision of §707(b) stated as follows:

(1) After notice and a hearing, the court, on its own motion or on a motion by the U.S. Trustee, but not at the request or suggestion of any party in interest, may dismiss a case filed by an individual debtor under this chapter whose debts are primarily consumer debts if it finds that the granting of relief would be a substantial abuse of the provisions of this chapter. There shall be a presumption in favor of granting the relief requested by the debtor. In making a determination whether to dismiss a case under this section, the court may not take into consideration whether a debtor has made, or continues to make, charitable contributions (that meet the definition of "charitable contribution" under §548(d)(3)) to any qualified religious or charitable entity or organization (as that term is defined in §548(d)(4)).²

As expected, in response to the trustee's motion to dismiss pursuant to §707(b), the debtors invoked the snapshot defense—*i.e.*, that the petition was completely accurate as of the day of the bankruptcy filing, and that it would be error for the bankruptcy court to consider post-petition events in deciding whether or not to dismiss the case. On Nov. 5, 2004, the bankruptcy court agreed with the debtors' argument and denied the trustee's motion. Specifically, the bankruptcy court held that events that occur after the filing should not be considered when evaluating abuse under §707(b) "unless the events were clearly in prospect at the time of filing for bankruptcy." The court reasoned that analysis for abuse to be performed under §707(b) should occur at the commencement of the case because the statute utilizes the term "granting of relief," which the bankruptcy court indicated really meant granting an "order for relief," which occurs at the commencement of the case pursuant to §301. Thus, the bankruptcy court reasoned that it was required to perform the abuse analysis as of the day of filing, and therefore could not take into account Mr. Cortez's post-petition employment.

On appeal, the district court reversed the bankruptcy court, holding that the plain language of §707(b) makes it clear that post-petition events are to be taken into account because the statute specifically instructs courts not to consider whether a debtor has made, or continues to make, charitable contributions. According to the district court, this language is forward-looking and only restricts viewing the future as to charitable contributions, not changes to income.

The issue on appeal for the Fifth Circuit was whether dismissal for abuse pursuant to §707(b) includes consideration of post-petition events. The Fifth Circuit first examined the bankruptcy court's conclusion that the undefined term "granting of relief" was intended to refer to an "order for relief," thus requiring the court to conduct its abuse analysis based solely on the time the petition was filed. The Fifth Circuit disagreed, holding that although "granting of relief" is undefined, contextually it is referring to relief in the form of a discharge and not the relief afforded upon the initial filing of a petition. In addition, the Fifth Circuit found that §707(b) "does not condition dismissal on the *filing* of the bankruptcy being a 'substantial abuse' but rather on the *granting of relief*, which suggests that in determining whether to dismiss under §707(b), a court may act on the basis of any development occurring *before* the discharge is granted."

After determining that pursuant to §707(b) post-petition factors can be utilized to complete an abuse analysis, the Fifth Circuit then went on to examine other circuits' treatment of §707(b). According to the Fifth Circuit, several other circuits have ruled that a debtor's ability to repay his or her debts out of future earnings is abuse, and specifically courts can consider whether the debtor has sufficient disposable income to fund a chapter 13 plan. To bolster their position, the Fifth Circuit noted that to assist courts with bankruptcy eligibility, Congress enacted §521 in 1984, which requires a debtor to file a schedule of current income and expenditures with his or her bankruptcy schedules. In a chapter 13 case, debtors are required to amend their schedules to include subsequent income, even if it is unknown and unanticipated at the time of filing. In fact, the Fifth Circuit points out that examining post-petition income in chapter 13 cases is commonplace based on §1329, which allows the trustee to seek a subsequent modification of the plan based on an increase in the debtor's income so that ultimately more money is paid to the creditors.

In affirming the district court's ruling, the Fifth Circuit abandoned the snapshot approach as it applies to a chapter 7 debtor's income, and held that although post-petition earnings are not property of the estate under §541(a)(6), future earnings should be taken into account for purposes of determining abuse pursuant to §707.

The Impact of *Cortez* Post-BAPCPA

Although BAPCPA did make some changes to §707(b)(1) and added the complex means-test requirement pursuant to §707(b)(2), *Cortez* is still a relevant and important decision. In fact, if adopted by other circuits, *Cortez* could invoke a major change in the way chapter 7 bankruptcies are analyzed, planned and administered. *Cortez* has discredited the snapshot theory as it applies to examining a debtor's income.

Duties of the Trustee Post-*Cortez*

The *Cortez* holding now appears to require that bankruptcy trustees in the Fifth Circuit be burdened with additional investigative duties. For example, the trustees must investigate and look for post-petition improvements in income in order to determine if abuse exists up until the point at which the chapter 7 discharge is issued. In addition, if a post-petition improvement in income is discovered prior to discharge in which a debtor now fails the means test, the trustee appears obligated to file a motion to dismiss for abuse pursuant to §707. Thus, debtors who were eligible for chapter 7 relief pursuant to the means test on the day the petition was filed may suddenly find themselves ineligible for chapter 7 relief if they experience a post-petition/pre-discharge change in income. If discovered, the trustee would then be required to file a motion to dismiss. Additional questions remain pertaining to the scope of the trustee's post-*Cortez* investigation duties. For example, does the trustee's abuse inquiry require that the trustee ask about an upward change in the debtor's post-petition income at the 341 hearing? Does *Cortez* extend beyond that, and require that the trustee do a last check immediately prior to the discharge issuing? If a post-petition debtor is actively seeking employment, can the trustee extend the time to object to a debtor's dischargability solely to buy more time so that the trustee can continue to check on possible future changes in income?

Post-*Cortez* Planning for Debtors and Debtors' Counsel

If *Cortez* is widely accepted, it will also have serious repercussions for debtors and debtors' counsel. The holding seems to encourage debtors to maintain their post-petition financial status quo. For example, if an unemployed debtor is eligible and files for chapter 7 relief, it would appear that the debtor is better off to remain unemployed until the discharge issues. As discussed previously, the concern is that if the debtor improves his post-petition income by becoming employed, he may in fact improve himself out of eligibility based on the means test. In addition, do grounds for dismissal exist if an employable debtor voluntarily remains unemployed/underemployed simply in order to maintain chapter 7 eligibility? It would appear that in addition to a debtor's counsel carefully examining a debtor's current income, a hypothetical analysis may need to be performed for the debtor regarding potential future income.

Cortez is not just a concern for unemployed debtors; the holding also has repercussions for certain employed debtors. For example, debtors who receive a post-petition pay raise, commission or bonus may all be susceptible to abuse dismissal motions. Should an employed debtor now conduct post-filing financial planning, such as deferring income increases until the discharge, and what is counsel's role in recommending this evasive move?

Living in a Post-*Cortez* World

Cortez appears to be statutorily well-reasoned, despite the fact that the outcome is contrary to most practitioners' concepts of chapter 7 timing and planning. If widely adopted, discarding the snapshot theory of income will likely increase the costs and time for debtors, debtors' counsel, the trustees and the bankruptcy court. As future income always has some degree of uncertainty, for the time being debtors in the Fifth Circuit will file chapter 7 bankruptcies without knowing their discharge eligibility until the final order is issued by the bankruptcy court. Until such time, debtors will have to rely on the adage "timing is everything," and hope their timing will allow everything to turn out as anticipated.

Footnotes

1 For example, 11 USC §541(a)(5) requires that debtors must disclose information beyond the snapshot if they become the recipient of a gift, inheritance, divorce property settlement, or life insurance proceeds within 180 days following the date of the filing of the petition.

2 Although it should be noted that BAPCPA did make textual modifications to §707(b), it is the author's belief that the changes are not substantial, nor would it have changed this analysis and outcome even if this were a post-BAPCPA case.