Going for Broke

After Surge, Bankruptcy Filings Have Slowed Following New Law

By JOSEPH BEDNAR

Michael B. Katz weighs in below.

Attorney Michael Katz compared last fall's surge in bankruptcy filings to a particularly good automobile rebate – though buying a car is much more enjoyable.

Law firms braced for a rush of filers once it became known that bankruptcy laws would be overhauled last October. The most notable change of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 involves who is allowed to file under Chapter 7.

Under the new law, many filers with higher incomes will no longer be allowed the option of eliminating their debts under Chapter 7 (which eliminates credit card and other debt while allowing the filer to retain a house, car, and other assets), but will be forced to repay at least some of their debt under Chapter 13.

Partly due to media coverage of the impending change – which was passed into law on April 20 and took effect on Oct. 17 – the surge in bankruptcy filings last summer and early fall certainly lived up to expectations, said Katz, who practices bankruptcy law at Bacon & Wilson in Springfield.

"The hype basically caused people who were thinking about filing to file," he said. "It reminds me of rebates in automobile sales. If people are thinking of buying a car and General Motors has an incredible rebate offer that lasts only 30 days, many people will buy a car now because they don't want to lose the rebate.

"In the same way, the press was hyping that many people would not be able to file Chapter 7 after Oct. 17," he added. "So a lot of people who were struggling with debts and thinking about filing did so before the deadline, when they otherwise might have held out until later."

For those who did wait, the landscape is now dramatically changed – and so could be their prospects for quickly eliminating their debts.

Doing the Math

In the past, bankruptcy filers simply chose the option that seemed best to them: Chapter 7 or Chapter 13. Now, many filers are ineligible for the Chapter 7 option depending on their income and what is known as a means test – which involves some strict guidelines and plenty of math.

Under the new rules, filers must measure their current monthly income against the median income for their family size in their state (see the graphic on page 24 for a look at those income ceilings in Massachusetts). However, current monthly income is no longer defined as income at the time of filing; it is an average of monthly income over the six previous months – which can be a major obstacle for people who are filing because they recently lost a job.

If that average monthly income is equal to or lower than the median, the filer can opt for Chapter 7. If not, he or she must pass a means test. This process involves subtracting from monthly income certain unavoidable expenses (such as a mortgage or child support) and a portion of what the filer spends on basic needs such as transportation, food, and clothing.

After these calculations, if the remaining disposable income totals less than $100, the filer is allowed to use Chapter 7. If the total is between $100 and $166.66, a complex calculation involving other debts (such as student loans, medical bills, and credit cards) could still allow the person to file Chapter 7. Above $166.66, Chapter 13 is the only option.

"There is definitely an impact from the new standards on who can file Chapter 7," Katz said. "There is certainly a group of people who would not qualify because they don't pass the means test. But 85% to 90% of the people we were meeting with before the new law passed would probably still qualify to file Chapter 7."

He explained that many families are indeed struggling to the extent that the median-income regulations wouldn't affect them; for example, if one partner has been out of work for an extended period, or one wage earner brings home $30,000 annually, while the other makes $20,000. Even without children, a couple who earn $50,000 a year would slip comfortably into Chapter 7 eligibility.

"The cause of bankruptcy is not people who abuse the system," said Springfield-based attorney Eugene Berman, who focuses on that specialty. "Bankruptcy is mainly caused by medical bills, unemployment, and divorce, and a substantial portion of those who file are people who do meet the means test."

Clamoring to File

Still, news about the October law change caused a flood of last-minute filings from people who either knew they would be barred from Chapter 7, or who simply weren't sure.

"Everyone stampeded into filing before the Oct. 17 deadline," said Berman. "Some of it was probably not well-founded, but people didn't want to take a chance. Then, immediately after the deadline, the filings fell off precipitously."

His experience at Bacon & Wilson is reflected in statistics provided to *BusinessWest* by the U.S. Trustee Office in Worcester, the local office of the U.S. Department of Justice branch that oversees bankruptcy cases.

From January 2003 through February 2005, Chapter 7 filings in Western Mass. totaled between 400 and 700 each month, with one exception: 926 in November 2003. From March through August 2005, as news of the law change was reported, monthly filings hovered between 600 and 925. In September, the number rose to 1,376, followed by a whopping 3,686 in October.

Just as striking are the numbers of Western Mass. Chapter 7 filings this past November and December: 18 and 31, respectively. Chapter 13 filings have slowed as well, just not as dramatically: November and December 2005 filings for Western Mass. were about half of their typical volume during the previous three years.

It's not just the new income requirements that caused an early-fall rush to file. The new law layers several other obstacles in the way of bankruptcy filers, including mandatory credit counseling and an increase in filing fees.

"There are new complexities and more ancillary costs," Katz said. "You have to pay for credit counseling and financial planning counseling, and you have to get copies of credit reports that weren't necessary before."

These additional costs, plus the filing fee increases, might run someone between $500 and

$1,000 more than a bankruptcy filing used to cost, he explained. "That might not seem like a lot, but for a couple that is struggling to begin with, coming up with the additional money could mean the difference between filing and not filing."

Finally, under the old law, Chapter 7 filers could value their property at what they could sell it for at auction. Much property was assumed to have little value, allowing it to be exempted from being taken by creditors. The new law values property at what it would cost to replace it at retail, taking into account its age and condition – and higher-valued property is more likely to be taken and sold by the bankruptcy trustee.

Household Size	Annual Income
1	$47,176
2	$55,291
3	$71,416
4	$85,157
5	$91,457
6	$97,757
7	$104,057
8	$110,357

Maximum income to quality for Chapter 7 filing

Protection for Whom?

The changes are enough to make some wonder why the law has 'Consumer Protection' in its title, when creditors are the ones gaining most of the protection.

"The title of the bill is a major misnomer," Berman said. "It's no more consumer protection or fraud prevention than the old law. It was absolutely intended to protect credit card companies – but it could end up hurting them more than helping them." He explained that the pre-deadline rush of filings may have cost credit companies many billions of dollars, "and it didn't have to be that way."

Proponents of the bill see it differently. "As retailers, we have seen first-hand the dramatic effect bankruptcy has had on both consumers' finances and on our ability to serve the public," said Steve Pfister, the National Retail Federation's vice president for government relations, in a letter to U.S. Senators before the law was passed.

"These filings ultimately cost the tens of millions of households we serve hundreds of dollars each in unseen costs every year," he went on. "Unfortunately, many of those losses are the result of misuse of the law by irresponsible, higher-income filers."

Retailers and credit card companies hope the law gives them some relief as bankruptcy filings slowly start to increase again.

"It's starting to pick up again now that credit card bills are coming out from the holidays," Katz said. "People who charged in December are getting the bills now, and with minimum payments going up fairly substantially, and some interest rates going up, that's going to create issues with some people. We're not seeing anything close to what we saw prior to the law change, but more calls are starting to come in."❖