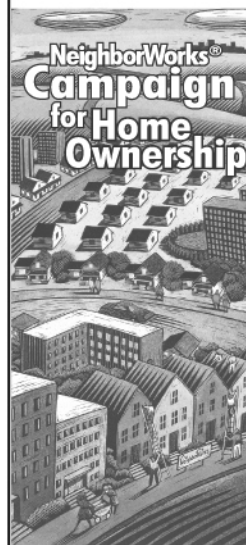


Changes in Bankruptcy Laws: Implications for Homebuyer Programs

A NeighborWorks America Briefing Paper

December 12, 2005



*Creditors have better memories than debtors.
~ Benjamin Franklin*

*At the end of the day, it is law-abiding, bill-paying citizens
who pay for the bankruptcy of others.
~ Senator Orrin Hatch*

Synopsis:

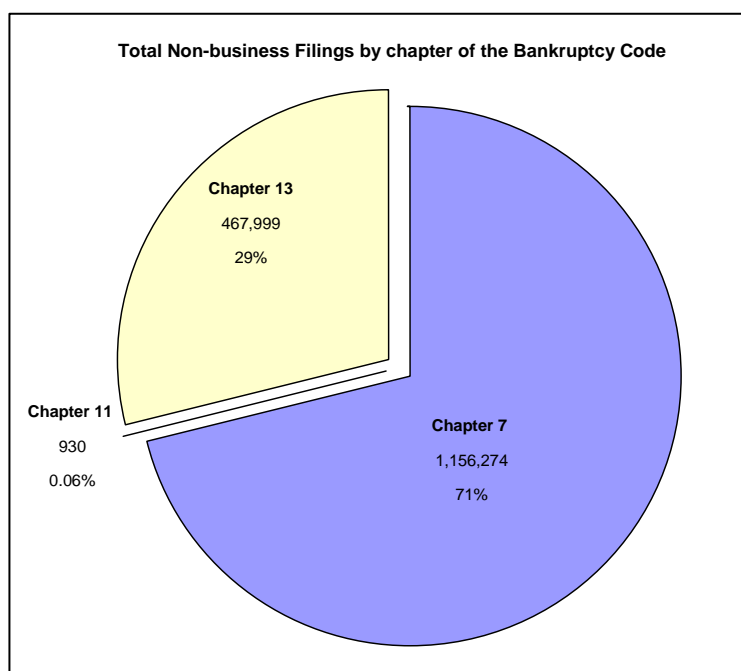
Changes in bankruptcy laws have two impacts on NeighborWorks organization and similar housing counseling agencies. First, clients in financial crisis seeking assistance may have more difficulty filing bankruptcy than under previous regulations. Second, the new law requires credit counseling and debtor education, services which some nonprofit organizations may decide to provide. Organizations need to understand the new provisions of the law to guide existing counseling programs, and should thoroughly analyze the requirements for providing counseling or education services before considering entering the bankruptcy counseling field.

Background:

On April 20, 2005 President Bush signed into law the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, which will take effect on October 17, 2005. This is the most significant change in U.S. bankruptcy laws since the late 1970s. Of course, the financial markets have changed dramatically since that time. Supporters suggest the new provisions have updated bankruptcy provisions for the current environment. Detractors counter the law is punitive towards borrowers and will create generous profits for credit providers. While the long-standing controversy about bankruptcy “reform” continues, practitioners working with clients on financial issues should take this opportunity to re-familiarize themselves with the bankruptcy process and the implications of the new law.

Types of Bankruptcy:

In 2004, 1.6 million personal (non-business) bankruptcies were filed in U.S. bankruptcy courts. This is up from 900,000 filings in 1995—a nearly 80 percent increase over a decade. Each petition to the federal court may be filed by a couple or individual seeking protection from creditors. The court assigns a “trustee” to oversee the bankruptcy proceedings who takes control of the debtor’s assets and liabilities. The federal bankruptcy system consists of 21 regional U.S.



Trustee Offices nationwide and an Executive Office for U.S. Trustees (EOUST) in Washington, DC.

After a debtor files for bankruptcy, any credit seeking to collect debts must now work through the trustee. The trustee will document all of the debtor's financial obligations, savings, investments and other assets in order to establish a repayment plan.

The chapter of the bankruptcy code under which the debtor files determines how the trustee will proceed. If the filing is under chapter 7, as were nearly three-quarters of filings in 2004, then all non-exempt assets will be sold to pay off debts. Remaining unpaid debts are discharged and the debtor gets a "fresh start."

In chapter 13, the debtor develops a plan for repaying their liabilities, over a period as long as five years. As long as the debtor's plan is approved and maintained, they will not be forced to sell assets by the trustee. Some debts may be discharged under chapter 13, but most creditors will be paid in full, unlike under chapter 7.

Chapter 11 is used by a small number of sole proprietors who file personal bankruptcy instead of business bankruptcy (35,000 total business bankruptcies were filed in 2004). Chapter 11 allows the sole proprietor to continue after a reorganization and repayment plan.

Alimony, child support, taxes and student loans are exempt from bankruptcy relief; these obligations must be paid in full regardless of bankruptcy proceedings. In many cases debtors will negotiate directly for modifications of these payments, however. Any secured loan, such as a home mortgage or car loan, is also not protected by bankruptcy. Debtors must maintain these payments, or default and risk the lender foreclosing or repossessing the property. Filing bankruptcy will force these creditors to work through the trustee, which may delay payments or foreclosure proceedings, but bankruptcy will not stop repossession or foreclosure.

New Provisions of the Bankruptcy Law

In general, the new and amended provisions of bankruptcy law make filing bankruptcy more difficult. The most significant change is that debtors who want to file for chapter 7 (liquidation and clean slate) bankruptcy will be forced file under chapter 13 (debt repayment plans) if their income is above the area median and meet certain expense benchmarks set by the IRS. Instead of wiping out debts under chapter 7, many debtors will have to establish up to five-year repayment plans under chapter 13. Also, the new law requires most people to get credit counseling from a nonprofit agency before filing for bankruptcy. The following are some of the more critical changes in the new law:

- If the debtor's current income exceeds the state median income, adjusted for a family size, they will usually need to file under chapter 13. Income is reduced by "allowable" expenses to determine the amount left for repayment to unsecured creditors. Debtors who apply for chapter 7 but fail to meet income and expense tests will be forced to withdraw their petition or convert the case to chapter 13. Special expenses such as health care costs and tuition for dependent children will be reviewed and could allow debtors to file for chapter 7 instead of chapter 13.

- The federal exemption for home equity debt is limited to \$100,000 if the home equity mortgage was originated within two years of filing for bankruptcy.
- To claim a state's homestead exemption (which are more generous in some states than others), the debtor must establish residency in that state at least two years prior to filing for bankruptcy protection. State homestead exemptions for a home acquired less than 3 years and 4 months (1,215 days) before the filing date are limited to \$125,000, unless the current home was purchased with the proceeds from a previous home or is the principal residence of a family farmer. Also, investments in the value of a home, such as an addition, completed less than 10 years before the bankruptcy petition was filed may be examined by the trustee and exempted from state homestead protections.
- The new law applies more scrutiny to the conduct of bankruptcy attorneys. Civil damages may be assessed on any attorney who is shown to abuse bankruptcy provisions on behalf of their clients.
- The automatic stay—which buys debtors time from the collections process—is less generous. The stay will terminate 60 days after the request is filed, or 30 days if the debtor filed another case in the past year.
- Credit card debt, cash advances, and other forms of consumer debt borrowed within 70 days of filing for bankruptcy may not be discharged under the new law.
- The new law reinforces that child support and other forms of domestic assistance may not be discharged. It specifies that domestic support obligation may not be avoided and should be first in line for repayment.
- A debtor cannot file for another chapter 7 bankruptcy for eight years (increased from six currently) and may not receive a discharge in a chapter 13 case if they had debt discharged in a chapter 7 case in the last four years. Also, debtors may not receive a discharge in a chapter 13 case if they received a discharge under chapter 13 in the last two years.
- The law has clarified which assets are exempt from liquidation, including limited quantities of clothing, furniture, appliances, medical supplies, personal effects and even one personal computer. Works of art, entertainment equipment, high-value antiques and jewelry, and boats are not exempt and generally will be considered for liquidation to pay off debts. The law reinforces that contributions to education savings plans, individual retirement accounts and health insurance plans are also exempt from liquidation, up to certain maximum amounts.

Credit Counseling

The new law describes “counseling” in several forms. One form is pre-petition counseling, which must be completed at least 180 days *before* filing for bankruptcy. This has been labeled “debtor education” by the U.S. Trustee. The course is required to last at least two hours and cover a series of topics, including budget development, money management, wise use of credit and consumer protections. Instructors are required to be certified, such as a teacher’s certificate, professional credential or specific qualifications.¹ Sessions may be provided in person, on the telephone or over the internet. However counseling must provide actual assistance in budgeting and it is unlikely a self-study workbook would be sufficient.

A second form of counseling is required as part of the process of filing and approving repayment plans. This has been labeled “credit counseling.” Debtors must file a certificate with the court from an approved nonprofit counseling agency describing the services provided. The law requires counseling agencies to provide help in developing a budget, understanding the causes of the client’s financial problems, and a creating a plan for financial recovery. The exact “financial management” course is not detailed in the law, however, many U.S. bankruptcy court trustees currently use financial education programs as part of their regional processes. The law requires the U.S. Trustee’s office to conduct an 18-month test of financial management curricula in six bankruptcy court districts by July 2006. After evaluating programs, the Trustee may issue standardized materials and details regarding how counseling should be delivered.² While an exact fee limitation is not specified, the Trustee’s office as suggested \$1-\$50 is considered a reasonable fee. Sessions are expected to average 90 minutes in length.

Approved Counseling Agencies

Each counseling agency and its courses must be approved by the U.S. Trustee and listed by the clerk of the Bankruptcy Court. The clerk of the Bankruptcy Court will post a list of approved providers in all districts by October 17, 2005, when the new law becomes effective. The Executive Office for United States Trustees (EOUST) is required under section 111 of the new law to oversee the process of approving counseling agencies.³ Approval means that the counseling agency meets the minimum standards for operational integrity established by the United States Trustees, but will not warrant the services provided in any way.

Counseling agencies are required to be 501(c)(3) nonprofit entities. Each agency must provide evidence of the qualification of its counselors and quality of its services. The

¹ At a minimum, providers must have at least one individual with credentials from the National Foundation for Consumer Credit, Association of Independent Credit Counseling Agencies, Accredited Financial Counselors, American Association of Family and Consumer Sciences, or be a Certified Financial Planner, Registered Financial Consultant or a Certified Public Accountant.

² See: <http://www.doney.net/bkcode/11usc0111.htm>

agency also must be audited, carry bonding for counseling staff, and have an independent board of directors. Counseling is required to be provided in adequate facilities located in convenient locations, although telephone and Internet counseling is permitted. Counselors must have at least six months experience and be trained by programs offered by the National Foundation for Consumer Credit or the Association of Independent Credit Counseling Agencies.

The law requires counseling agencies to disclose their funding sources to potential clients, as well as the qualifications of counselors. The counseling agency is prohibited from reporting to credit bureaus if a debtor is receiving services. Although reasonable fees are allowable, services must be provided “without regard for the ability to pay the fee.” The law also stipulates counselors may not receive commissions or bonuses based on the outcome of counseling.

A counseling agency not approved for the initial October 17, 2005 list issued by clerk of Bankruptcy Court may later be provisionally approved with a six month probationary period. The approved agencies list is intended to be revised each year, with all agencies up for renewal annually. There is an appeal process for agencies not approved by the court, and also the Trustee can remove an agency from the approved list for violating the minimum requirements.

The law is explicit about the distinction between counseling and the actual bankruptcy filing process. Any agency advertising bankruptcy counseling services must make clear they will only provide advice and information, but not bankruptcy petition preparation services. Debt relief agencies—for-profit entities that provide bankruptcy filing assistance—are required to state clearly they do not provide counseling and only prepare petitions. These agencies may not suggest they provide advice about credit problems, foreclosures, evictions or collections. An agency that does not make the required disclosures or fails to follow the federal rules of bankruptcy procedures can be held liable for civil damages.

It seems clear the new bankruptcy law was designed for primarily for Consumer Credit Counseling Services (CCCS) agencies. These agencies already provide counseling to debtors near or in bankruptcy. Also, because the new law encourages participation in debt management plans (DMPs) as an alternative to bankruptcy, CCCS agencies may be well-suited to provide counseling. Most CCCS agencies offer DMPs, which provide the agency establishing the plan with a fee based on a proportion of the outstanding debt. Under the new law, if an individual files for bankruptcy after a creditor refuses a DMP, the court may reduce that creditor’s claims by up to 20 percent as a penalty.

³ See: <http://www.usdoj.gov/ust/press/articles/credit-01.htm>

Recent IRS reports indicate that hundreds of new organizations have been incorporated in the last few months requesting 501(c)(3) nonprofit status in order to capitalize on the presumed growth of demand for counseling services for these consumers.⁴

Conclusion

In Colonial America, bankruptcy was considered a crime. Debtors were flogged or branded with a “T” marking them as a thief. The creation of bankruptcy laws allows consumers and businesses to take risks, which on the whole spurs innovation and economic growth. But, modern bankruptcy laws must balance providing debtors a “clean slate” with discouraging abuse of bankruptcy provisions. The extent to which bankruptcy was being abused is controversial. While bankruptcy filings have grown dramatically in recent years, so has the availability of credit. A recent study by Harvard Professor Elizabeth Warren reported that 55 percent of bankruptcy filers are homeowners and 54 percent have at least some college education. The average filer is 41 years old and has a median income of \$25,000. The same study suggests half of all bankruptcies are triggered by medical expenses.⁵ Very few debtors appear to be serial filers abusing the law.

The debate over the new law will continue. Many argue reform has actually moved too far towards penalizing debtors and will stifle borrowing. Others suggest creditors will worry less over losses due to discharges and expand the availability of aggressive loan products. Whether the key features of the new law—means testing and counseling—will reduce abuse of bankruptcy laws or simply create a barrier to relief is yet to be seen. While few homeownership programs are set up to provide bankruptcy counseling, community based organizations will benefit from understanding the new law, and deepening partnerships with local entities in their market providing bankruptcy counseling and legal services.

More information:

The Department of Justice created a working group after the law was passed to develop a process for approving agencies. Agencies interested in becoming approved nonprofit counseling agencies should check the United States Trustee Program website (<http://www.usdoj.gov/ust/bapcpa/ccde.htm>) for information, instructions and application. There is a rolling deadline for applications. Once approved in one district, agencies may seek approval in additional districts by submitting a new application noting the district in which approval has already been granted.

For a list of regional trustee offices, see: <http://www.usdoj.gov/ust/ustofc.htm>

To learn more about NeighborWorks America and the NeighborWorks Network, see <http://www.nw.org>

⁴ Deibel, Mary "New law would require pre-bankruptcy counseling" Scripps Howard News Service, April 08, 2005.

⁵ <http://content.healthaffairs.org/cgi/content/full/hlthaff.w5.63/DC1>