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An Insider's Guide To Bankruptcy Reform

Consumer credit counseling, anti-fraud measures mandated by new law

By **ELIZABETH J. AUSTIN**

I spent a year on the "inside," working as an Assistant United States Trustee, while the U.S. Trustee Program implemented the most comprehensive bankruptcy legislation passed in a generation.

It was undoubtedly the most challenging year experienced by the program since it was established in 1978, one that required lawyers in the program and in the private sector to deal with the sweeping changes intended to make it harder for individuals to file bankruptcy and for businesses to be more accountable.

In the few short months between the passage of Bankruptcy Abuse Program Prevention and Consumer Protection Act of 2005 (BAPCPA) on April 20, 2005, and the effective date of the law on Oct. 17, 2005, the program had to implement new policies, develop guidelines and forms, and select agencies to conduct the credit counseling and debtor education. It also had to train all program employees and all Chapter 7 and 13 trustees.

Stifled Creativity?

The program has also used the new law, with its strict rules for filing and working through a bankruptcy case, to install a greater degree of uniformity in procedures throughout the country. That has eliminated many of the inconsistencies of local practices, preventing program attorneys from using any discretion in bankruptcy matters. Many private sector lawyers are concerned that the uniformity has also stifled the creativity often necessary to the bankruptcy reorganization process, and that the program is trying to turn bankruptcy filings into a cookie-cutter process.

Generally, bankruptcy professionals in the private sector believe that the new law is unreasonably onerous and does nothing more than increase the time and cost of bankruptcy filings.

The program takes a different view. For the last five years, the primary focus of the program has been in criminal and civil enforcement. Much of the concern was that individuals were using the old bankruptcy rules to hide assets and routinely eliminate debt—often on credit cards—yet were not learning how to live within their means. And companies were engaging in practices that lined the pockets of those at the upper levels of management, to the detriment of the creditors and employees.

As written, the BAPCPA provides more ammunition to combat fraud and abuse. Enforcement measures will include pursuing denials of discharge, seeking a dismissal, requesting a trustee or examiner and making criminal referrals. While these are all measures that were utilized by the program pre-BAPCPA, since the inception of the new law, the filing of motions to dismiss and discharge complaints has steadily increased and the number of bankruptcy-related criminal referrals has risen by more than 20 percent.

Means Test

Means testing is the most powerful tool provided to the program through BAPCPA, and it is the most far-reaching change in the law. The objective means test replaced the former subjective "substantial abuse" standard to determine whether a case is "presumed abusive."

With few exceptions, consumer debtors must complete a means test as a part of their bankruptcy filing, which is then used to determine whether a presumption of

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abuse applies in those cases where a debtor's current monthly income exceeds the State Median Income for a household of the same size as the debtor's. Even if a debtor's current monthly income is below the State Median Income, the U.S. Trustee may challenge a case for abuse if there is suspicion of bad faith or other fraudulent conduct such as the hiding of assets.

Other major weapons are the consumer financial education requirements. Generally, individual debtors must receive credit counseling before filing, and receive debtor education prior to discharge. It was this provision that the bankruptcy courts were first called upon to interpret and the program was called upon to enforce. Under BAPCPA, an individual may not be a debtor unless the individual has, during the 180-day period preceding the date of the filing, received credit counseling from an approved agency. Only under very limited conditions may a consumer debtor obtain an exemption or an extension.

It is the U.S. Trustee's policy to demand strict adherence to this provision of the new law. Failure to obtain the required credit counseling, and produce a certificate as proof of same, results in an immediate motion to dismiss. While there have been some court decisions to the contrary, a bankruptcy court usually will grant the U.S. Trustee's motion to dismiss, if an individual has failed to obtain the required counseling.

Random Audits

The debtor audit provision did not become effective until Oct. 20, 2006. It requires the program to commence a series of debtor audits intended to verify the accuracy of the pleadings and financial documentation submitted by individual Chapters 7 and 13 debtors. An independent auditor will scrutinize the financial information filed by debtors and will utilize database searches, as well as other means to test the truthfulness of same. The purpose of the audits is to help the U.S. Trustee and creditors identify cases of fraud and abuse. The program also believes that the threat of being subjected to a debtor audit will act as a deterrent to individual creditors engaging in fraud and/or abuse of the bankruptcy system.

Random audits will be conducted in at least 1 out of every 250 Chapter 7 and Chapter 13 cases filed in a Judicial District. Additionally, the Trustee Program will target those cases for audits where a debtor's income or expenses vary greatly from the norm. It is anticipated that targeted audits will range between 1,000 and 2,000 in a one-year period. Shortly after a case is filed, the selected debtor or debtor's counsel will receive a notification of an audit. Once the independent auditor completes the audit, a process that should take no more than 70 days, a report of the audit results will be filed with the court by the independent auditor. Depending upon the result of an audit, the U.S. Trustee's Office or other creditors have an opportunity to pursue the discharge of an individual debtor either by denial or revocation, as well as take other enforcement actions, as merited.

> **The U.S. Trustee Program takes its role as a watchdog seriously and is unlikely to bend the rules in any given case.**

The new law also gave the program additional responsibilities in connection with small business Chapter 11 cases and management of accountability in large corporate reorganizations. The U.S. Trustee must conduct an initial debtor interview in every Small Business case. As part of that interview, the U.S. Trustee must investigate the debtor's viability and make an immediate determination as to whether the case should remain in a Chapter 11. If the U.S. Trustee concludes that the small business case lacks viability, the U.S. Trustee may seek to dismiss or convert the case to Chapter 7.

In the aftermath of Worldcom and Enron and with the enforcement provisions of BAPCPA, the program has developed policy that calls for closer scrutiny of management in the big business cases, which include requiring strict adherence with those provisions that were intended to limit and restrict insider retention and severance bonuses and replacement of compromised management with Chapter 11 trustees. However, the jury is still out as to whether this provision has any real teeth, since it appears that salaries and retention bonuses are still quite high in the large Chapter 11 cases.

Consistent Enforcement

With the development of the policies and procedures intended to enable the program to enforce the provisions of BAPCPA comes a mandate that U. S. Trustees in the 21 Regions across the nation implement the policies uniformly. Policy decisions are made by the Executive Office, and regional offices are expected to strictly adhere to all such policies and practices. Previously, some flexibility was permitted, particularly in complex Chapter 11 cases, but this will no longer be the case. While the inflexibility of the program often frustrates the courts and practitioners, the program takes its role as a watchdog seriously and is unlikely to bend the rules in any given case.

The challenges of implementing the new bankruptcy law continue. At this stage, it is really still too early to know whether the law will actually reduce abuse of the bankruptcy system. The playing field will change as policy and practices are adapted to deal with the statistical information that becomes available once the effect of the new law can be assessed and courts render decisions interpreting BAPCPA. ■