

Chapter 7 Eligibility

A Chapter 7 bankruptcy also known as a “straight liquidation”, liquidates a debtor’s non-exempt assets and pays back creditors the proceeds from liquidation, and the rest of the debt is forgiven. Almost all Chapter 7 filings are no asset cases; meaning no assets are liquidated and the debtor keeps all the property they owned at the time of filing. Whether or not assets are liquidated, a successful Chapter 7 filing will result in elimination of almost all of the debtor’s pre-petition liabilities (credit cards, contractual liabilities, mortgages, medical bills, etc). The bankruptcy process can be difficult and confusing. One of the first obstacles debtors must overcome is qualifying for a Chapter 7. A debtor’s Chapter 7 eligibility is highly dependent on one factor: income. The Bankruptcy Code is very complex to say the least. Congress decided to complicate matters to prevent bankruptcy abuse through the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the “Act”). The Act made qualifying for a Chapter 7 a confusing and daunting task. The Act implemented 11 USC §707(b)(2)(A)(i) which is also known as the “means test” to encourage debtors to reorganize their debts in a Chapter 13 rather than eliminating them in a Chapter 7. Pursuant to 11 USC §707(b)(2)(A)(i) a debtor’s Chapter 7 case may be dismissed if the presumption of abuse arises. The presumption of abuse arises if the debtor has disposable income after their necessary expenses are deducted.

The first question that needs to be addressed when determining whether a debtor is eligible for a Chapter 7 is whether they are above or below the median income for their applicable household size. For example, a household of 5 for a family in Cook County has a median income of \$87,288. If a debtor within the same county and household size is under the median, then the “means test” is not applicable and there is no presumption of abuse of the

bankruptcy code and they are presumably eligible. If a debtor is over the median income for the applicable household size, then there is a presumption of abuse and the debtor must overcome the presumption by passing the “means test”.

The “means test” is a Congressional invention that determines whether a debtor is presumably abusing the system. The “means test” only applies to debtors with “primarily consumer debt”. It is “supposed” to determine whether a debtor is living beyond their means. In a nutshell, if the debtor’s necessary expenses as defined by the means test are close to or outweigh their current monthly income then they pass the test. The nuisance of the “means test” is that debtor’s cannot deduct their actual expenses for most deductions. Conversely, the debtor must use IRS standard deductions to determine whether they have disposable monthly income after all their necessary expenses are deducted. However, a debtor can deduct all “contractually obligated” expenses, regardless of how high they are. For example, a \$5000 mortgage can be used as a deduction whether or not the debtor wants to keep or surrender the home. Other necessary expenses are determined by IRS standards. For example, a family of 5 can only deduct \$1427 for housing expenses (excludes utilities) if they rent. Keep in mind, if you own then you are “contractually obligated” to make that payment and can use the actual expense opposed to the IRS standard for the applicable household size. Once a debtor deducts all the necessary expenses from their income (average of 6 months prior to bankruptcy is used as the current income under the “means test), they will pass the “means test” if the number is around \$200 or less. The “means test” was implemented to encourage some repayment to creditors if the debtor has disposable monthly income after all necessary deductions. Therefore, if a debtor has \$500 left over each month, then they would have money left over each month to pay creditors in a Chapter 13.

The “means test” has caused confusion and hysteria in the bankruptcy community. Many believe that it does not reflect a debtor’s actual circumstance. The Bankruptcy Court is aware of the complex issues produced by the “means test”. It is common knowledge that the “means test” has its share of ambiguities. As a result, the Courts are having great difficulty interpreting Congress’s intent. Courts are divided on how portions of the “means test” should be interpreted. Consequently, one district may allow an expense where another does not. It has been around 5 years since the “means test” has been implemented and the issues that have spawned from the ambiguities are still far from settled. Therefore, it is of utmost importance that a debtor consult with a competent bankruptcy attorney before even considering filing a Chapter 7.

Passing the “means test” presumably qualifies a debtor for a Chapter 7. However, other major considerations still need to be addressed. As you recall, a Chapter 7 is a liquidation; meaning all non-exempt assets are subject to liquidation. So, just because a debtor qualifies for a Chapter 7 does not mean that debtor should file. For example, if a debtor has \$40,000 in credit card debt and has unexempt personal property assets worth \$80,000, then the assets will be liquidated. In the example, it would make more sense for a debtor to file a Chapter 13 and protect his assets.

Although income is the most important variable in qualifying for a Chapter 7, the debtor must meet some other qualifications. A debtor who has received a Chapter 7 discharge within the last 8 years does not qualify for a Chapter 7. Furthermore, a debtor who has filed and successfully completed a Chapter 13 in the last 6 years does not qualify for a Chapter 7 unless the debtor paid more than 70% of their unsecured debt in the Chapter 13. There is no debt limit for a Chapter 7. Therefore, whether your debt is \$2 or \$20 million, you can discharge the debt in a Chapter 7 bankruptcy.

In today's economic climate, most debtors, whether above or below median income, do not have any assets and have considerable debt. A Chapter 7 bankruptcy assures the debtor a fresh start allowing them to proceed with their lives without the stress of creditors. Many high-income debtors assume they are not eligible for a Chapter 7 bankruptcy. Nothing can be further from truth. Although income is the most vital factor, there are numerous other considerations that need to be addressed. The Bankruptcy Code's complexity is not to be taken lightly. The only way to determine your eligibility is to consult with a competent bankruptcy attorney.

Common Scenarios

Scenario 1:

Client owns a home and has fallen back on his mortgage payments. The house is worth \$350,000 and Client owes \$550,000 between his first and second mortgage. Client has decided that the house is a bad investment and wants to walk away. Client is worried that the house will sell for less than it is worth at sale and the bank will go after him for the difference. Client makes about \$90,000 between him and his wife and they have 2 kids. Client's mortgage payments are \$5000 a month, \$6,000 if taxes and insurance are included. Client wants to file a Chapter 7 bankruptcy to ensure the bank will not come after him for the deficiency? Is he eligible?

A: The client will most likely qualify for a Chapter 7 even though his income for a family of 4 is above the median, thus triggering the "means test". His \$5,000 "contractually obligated" expense is the main qualifier in this scenario. A salary of \$90,000 translates to \$7500 a month before taxes are deducted. The necessary expense of \$5000 eats up so much of the Client's salary that he would not have any money left over each month to pay creditors after other

necessary expenses are deducted (utilities, car payments, food, health care, transportation costs, etc). If the Client's mortgage payment was \$1200 a month, he most likely would not qualify for a Chapter 7 assuming he does not have any other mortgages on any other properties.

Scenario 2:

Client owns 4 properties, 1 primary residence and 3 investment properties. The investment properties are underwater (worth less than Client owes). Client is having trouble finding renters and has maxed out his credit cards (owes \$80,000). Client is married with 1 child. Client's income is \$180,000. The mortgages on the investment properties are \$12,000 combined and he is not receiving rent on any of the properties. Client wants to surrender the properties to the bank but is worried they will come after him for the deficiencies. Client wants to keep his primary residence and the house is worth equivalent to what he owes. Is he eligible?

A: Once again, the answer is probably yes. For one, the debtors' debts are primarily "non-consumer" and therefore the "means test" does not apply since most of his debt arose from investments. Even if the "means test" applied, he mostly likely would qualify. Since his "contractually obligated" expenses (all 4 mortgages) are so high, it will eat up his income in the means test leaving no money to pay back creditors in a Chapter 13.