Evidence on Bankrupt Debtors' Ability to Pay

Testimony Given by:

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March 17, 1999

UNITED STATES HOUSE OF REPRESENTATIVES

Committee on the Judiciary

Subcommittee on Commercial and Administrative Law

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Summary

During the 1998 debate over bankruptcy reform, two studies (one conducted by the Credit Research Center at Georgetown University and the other by Ernst and Young, LLP) found that a sizeable minority of Chapter 7 debtors appeared able to fund meaningful Chapter 13 repayment plans. After the 105th Congress adjourned a third study conducted at Creighton University was released. All three studies are relevant to the debate regarding whether eligibility for a Chapter 7 discharge should be subject to a means-testing formula. This testimony offers an assessment of what we know from these studies taken as a group.

Despite differences in sampled courts, time periods and methods of calculating repayment potential, five key points emerge.

1. All three studies demonstrate that there are thousands of households asking the courts for discharge under Chapter 7 who could support meaningful Chapter 13 repayment plans.

2. Both the ABI/Creighton and Ernst and Young studies demonstrate that it is technically feasible to implement a means-testing formula. However, differences in interpretation of the legislative language accounted for some of the differences between the two studies in their estimates of ability to repay.

3. Means-testing as proposed in H.R. 833 only impacts petitioners who are in the upper half of the U.S. income distribution for their given household size. The means test will not impact the poor (by definition), force impoverished debtors into repayment plans, or create a class of debtors "too rich for Chapter 7 and too poor for Chapter 13."

4. The fact that the study which sampled the most recent petitions (Ernst and Young) found the highest repayment capacity raises the disturbing possibility that repayment capacity among Chapter 7 debtors may be growing with each passing year.

5. As a resource for simulating the impact of changes in federal bankruptcy policy, the Ernst and Young sample of Chapter 7 petitioners who filed in 1997 is the superior database.

I. Introduction

Good afternoon Mr. Chairman, and members of the Committee. My name is Michael Staten and I am a Professor of Management and Director of the Credit Research Center at the McDonough School of Business at Georgetown University. As you may know, over its 25-year history the Credit Research Center has generated over 100 research papers, most of which examine the impact of public policy toward consumer and mortgage credit markets. During the past quarter-century the Center's research program has been supported by a mix of grants and contracts from both the public sector (e.g., National Science Foundation; Federal Trade Commission) and private sector foundation and corporate grants.

I'm pleased to be invited to join you again to discuss bankruptcy reform. As you may recall, I appeared before this committee in March, 1998 to share with you the results of our research on the repayment capacity of debtors who file for personal bankruptcy. Today I would like to re-visit the issue of repayment capacity as it is especially relevant to the means-testing mechanism that I believe is an integral component of serious bankruptcy reform. H.R. 833 proposes a similar mechanism to the need-based formula of its predecessor in the 105th Congress, H.R. 3150.

As we sit here today we know more about the likely impact of such a formula than we did a year ago. Three independent studies in the past two years have built a substantial body of research from which to draw conclusions about whether and how a means-test for Chapter 7 eligibility should be implemented. Two studies you heard about during last year's hearings. Late in 1998 a new study sponsored by the American Bankruptcy Institute was added to the literature on repayment ability. In this panel today you will hear directly about the ABI study from one of its authors. In my testimony I would like to offer an assessment of what we now know from these studies taken as a group.

II. Three Studies of Repayment Capacity

During the 1998 debate over bankruptcy reform, two studies (one conducted by the Credit Research Center at Georgetown University and the other by Ernst and Young, LLP) were presented during Congressional hearings. Both studies were funded by Visa and MasterCard. Both found that a sizeable minority of Chapter 7 debtors appeared to have the economic capacity to repay a significant portion of their debts within a Chapter 13 repayment plan.

The CRC study (John M. Barron and Michael E. Staten, "Personal Bankruptcy: A Report on Petitioners Ability to Pay," Credit Research Center Monograph #33, October, 1997) was conducted prior to the development of the needs-based formula in HR 3150 and so could not simulate its impact. Instead, we used the debtor's own statement of monthly living expenses and calculated the amount of debt repayable by 3,800 Chapter 7 debtors (regardless of income) in 13 U.S. cities within a five-year repayment plan. The result:

about 25 percent of Chapter 7 debtors could have repaid at least 30 percent of their non-housing debts over a 5-year repayment plan, after accounting for monthly expenses and housing payments. About 5 percent of Chapter 7 filers appeared capable of repaying all of their non-housing debt over a 5-year plan. All calculations assumed income would remain unchanged relative to expenses over the five years. For a more detailed discussion of the CRC study, a subsequent review by the U.S. General Accounting Office (GAO), and our response, I refer you to my written testimony from one year ago (testimony by Michael Staten, "The Empirical Case for Needs-Based Bankruptcy," U.S. House of Representatives, Committee on the Judiciary, Subcommittee on Commercial and Administrative Law, March 12, 1998).

The Ernst and Young study ("Chapter 7 Bankruptcy Petitioners' Ability to Repay: the National Perspective, 1997", T. Neubig, F. Scheuren, G.Jaggi and R. Lee, March, 1998) was specifically designed to simulate the impact of H.R. 3150 with a sample that met the GAO's statistical criteria for a nationally representative sample. Using a sample of over 2,100 Chapter 7 bankruptcy petitions filed in 90 bankruptcy districts, the Ernst and Young researchers simulated the impact of the needs-based formula in H.R. 3150. They found that about 15% of Chapter 7 debtors in 1997 would have been shifted to Chapter 13 based on the formula in the February, 1998 version of H.R. 3150. The results of these two studies were cited by both Republicans and Democrats as reason to establish a needs-based approach to determining who qualifies for bankruptcy relief.

After the 105th Congress adjourned, the results of a third study of repayment capacity were released in December, 1998. This latest effort to measure whether Chapter 7 debtors can actually repay their debts was funded by the American Bankruptcy Institute (data collection was funded by the National Council of Bankruptcy Judges). Authors Marianne Culhane and Michaela White, law professors at Creighton University, applied their interpretation of the means-testing formula from last year's HR 3150 to a sample of Chapter 7 petitioners who filed in 1995. Their goal was to determine how many would qualify for Chapter 13 repayment plans. Their conclusion: 3 percent of Chapter 7 debtors in their sample would have been shifted to Chapter 13 had H.R. 3150 been in effect in 1995. The remaining 97 percent of the Chapter 7 debtors in their sample either had incomes below the minimum required by H.R.3150, or had too little income after subtracting monthly expenses and various secured and priority debt payments to repay at least 20 percent of their unsecured debts over five years.

III. What Have We Learned?

What have we learned from these three separate and independent studies of repayment capacity among debtors using the bankruptcy courts? Despite differences in sampled courts, time periods and methods of calculating repayment potential five key points emerge.

1. **All three studies demonstrate that there are thousands of households asking the courts for discharge under Chapter 7 who could support meaningful Chapter 13 repayment plans.** The lowest of the estimates (Creighton/ABI), if applied to 1998

filing volumes, indicates that over 30,000 households who filed for a Chapter 7 discharge actually had incomes that were above the national median and were also sufficient to support meaningful Chapter 13 repayment plans. Keep in mind that in its proposed legislation, Congress has defined a meaningful repayment plan to be one in which the debtor maintains payments on all secured debts (home mortgage, auto loans, etc) for up to five years, and also makes a significant payment to unsecured creditors. The Ernst and Young study presented to Congress (March, 1998) indicates that the number of Chapter 7s who should be in Chapter 13 ranges from 100,000 to 150,000 households (10 - 15% of Chapter 7 petitioners), depending upon whether the legislation sets the minimum income hurdle at 75% or 100% of the national median. ***Clearly, the fact that tens of thousands of debtors are able to file for more bankruptcy relief than they need is now well established.***

2. **Both the ABI/Creighton and Ernst and Young studies demonstrate that it is technically feasible to implement a means-testing formula.** Some critics have complained that means-testing is an abstract and impractical concept that would impose too much complexity on judges and attorneys. In the hearing before this committee on March 11, 1999 Harvard Professor Elizabeth Warren asserted that the means test proposed in H.R. 833 "is impossible to administer." Yet, in the ABI/Creighton study, two law professors applied the exact criteria of the means-testing formula in last year's H.R. 3150, made several clarifying assumptions, and were able to classify debtors with the information supplied on the petition. The research team at Ernst and Young did the same thing with an earlier version of the means-testing formula.

   A useful outcome of having two independent simulations of the means-testing formula is that Congress can now see where the formula criteria need to be clarified. Indeed, the assumptions that each research team adopted in making the calculations are responsible for at least some of the differences in their estimates of the size of the groups affected by the test. Based on information provided in the ABI/Creighton press release ("Means Testing For Chapter 7 Debtors: Repayment Capacity Untapped? December, 1998) there appear to be three significant areas where the procedures used to calculate repayment capacity differ from the assumptions used by the Ernst and Young researchers.

   A. **Minimum income.** Because it was conducted early in the legislative development of H.R. 3150, the Ernst and Young study incorporates a restriction that petitioners must have an income greater than 75 percent of the national median (adjusted for family size) to be subject to the means-testing formula. The ABI/Creighton study simulates a later version of H.R. 3150 that raises the income required for means-testing to 100 percent of the national median. The higher income requirement exempts more debtors from means testing, so fewer are impacted.

   B. **Trustees' Fees.** The ABI/Creighton researchers assumed H.R.3150 intended the court to treat the Chapter 13 trustee's administrative fee as a monthly expense and subtracted it from the debtor's income ***prior to computing eligibility for a***

plan. Accordingly, they assumed an administrative fee equal to 5.6 percent of each monthly debt payment and subtracted this as a monthly expense. In fact, H.R. 3150 did not specify how trustee fees were to be handled, and such fees were not incorporated into the Ernst and Young calculations. It does make a difference. Debtors who are "close" to the eligibility cutoff but who do not qualify for a Chapter 13 plan under the ABI/Creighton treatment receive a Chapter 7 discharge and, presumably, pay little or nothing to unsecured creditors. If the trustee's fee was not incorporated into the means test but subtracted from actual debt payments, those same debtors would be placed in Chapter 13 plans and make payments to their creditors, minus a 5-6% fee to the trustee.

C. **Automobile Expenses.** The two studies sharply disagree on the proper treatment of automobile expenses in order to determine a debtor's allowance for living expenses. Their different interpretations of what is permissible under the IRS Collection Standards appears to account for as much as $200-300 per month in allowable expenses for many debtors. The ABI/Creighton study gives debtors a larger allowance, thereby lowering the percent of debtors who would qualify for Chapter 13 repayment plans.

Clarification of these elements of the means-testing formula within H.R. 833 would remove the technical obstacles to steering petitioners into the proper bankruptcy chapter. A needs-based formula that utilizes well-defined criteria to clearly signal how the court will treat a given debtor would streamline the administration of the system, promote consistent treatment and reduce costly litigation.

3. **Means-testing as proposed in H.R. 833 only impacts those bankrupt petitioners in the upper half of the income distribution.** Actually, we didn't need three studies to tell us this. The formula itself dictates this result, since the needs-based test applies only to households at or above the national *median* income, adjusted for family size. To illustrate, the national median income for a family of four in 1997 was $53,165. No petitioner in a family of four with an income less than $53,165 that year would have been subject to the means test. Still, opponents of means-testing continue to cite the low *mean* after-tax income of Chapter 7 petitioners (about $19,620 for the CRC sample in 1996) as evidence that H.R. 833 (and H.R. 3150 before it) would somehow force impoverished debtors into repayment plans. In her testimony last week, Professor Elizabeth Warren said "bankruptcy law is the last safety net of the middle class . . . Bankruptcy is the last hope for the small businessman, the divorced woman, the African-American homeowner, the displaced executive, and the elderly couple facing a sharp slide out of the middle class into the lower class." True enough, and there is nothing in the means-testing formula that weakens the safety net for those who truly need it.

4. **The fact that the study which sampled the most recent petitions (Ernst and Young) found a higher repayment potential raises the disturbing possibility that the repayment capacity among Chapter 7 debtors may be growing with each passing year.** The ABI/Creighton study was based on petitions filed in 1995, but the Ernst and Young

study analyzed petitions filed in 1997. This key point significantly affects the interpretation of the results. We know that 875,000 personal bankruptcy petitions were filed during 1995. We also know that filings soared over the next two years to reach a total of 1,350,000 in 1997, an increase of 54 percent. Some fundamental change in the factors that contribute to a bankruptcy decision clearly occurred during the intervening period to trigger such a dramatic increase. Under these conditions, it is inappropriate to extrapolate the results from a study of petitioners in 1995 and assume they describe petitioners filing in 1997-98.

Indeed, the fact that the Creighton study found that only 3% of debtors in 1995 would be impacted by H.R. 3150 in no way precludes a larger percent of debtors being impacted by 1997. Given the remarkable escalation in petitions over the same time period, and under stellar economic conditions, one explanation for the greater repayment capacity found by Ernst and Young could certainly be that ***a declining stigma to filing for bankruptcy has encouraged a growing proportion of debtors to opt for the Chapter 7 discharge,*** despite having significant capacity to repay their debts. This alarming possibility reinforces the need for Congress to develop a workable means testing formula that will make bankruptcy relief available only to those who truly need it.

5. **As a resource for simulating the impact of changes in federal bankruptcy policy, the Ernst and Young sample of Chapter 7 petitioners who filed in 1997 is the superior database.** Both the CRC and ABI/Creighton studies sampled from a relatively small number of bankruptcy districts (13 and 7, respectively, out of 90 in the continental U.S.). Neither study was designed to be nationally representative. In contrast, the Ernst and Young researchers designed their study to address every sampling criticism that the GAO raised in its review of the CRC study. Those members of Congress who spoke out strongly last year for a database suitable for guiding national policy now have one in the Ernst and Young database.

Thank you for the opportunity to appear before the committee today. I will be happy to answer any questions.