United States General Accounting Office

GAO

Testimony

Before the Subcommittee on Commercial and Administrative Law, Committee on the Judiciary
House of Representatives

For Release on Delivery
Expected at
10:00 a.m., EST
Thursday
March 12, 1998

PERSONAL BANKRUPTCY

The Credit Research Center and Ernst & Young Reports on Debtors' Ability to Pay

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Personal Bankruptcy: the Credit Research Center and Ernst & Young Reports on Debtors' Ability to Pay

Those who file for personal bankruptcy generally file under chapter 7 or chapter 13 of the bankruptcy code. Those who file under chapter 7 generally seek discharge of their eligible debts. Those who file under chapter 13 submit a repayment plan, which must be confirmed by the court, to pay all or part of their debts over a 3- to 5-year period. Personal bankruptcy filings have set new records in each of the past two years, although there is little agreement on the causes for such high bankruptcy filings in a period of relatively low unemployment, low inflation, and steady economic growth. Nor is there agreement on the number of debtors who seek relief through the bankruptcy process who have the ability to pay at least some of their debts and the amount of debt such debtors could repay.

Based on a sample of personal bankruptcy filings in 13 locations, principally from 2 months in 1996, a study by the Credit Research Center estimated that 5 percent of the chapter 7 debtors in the 13 locations combined would have sufficient income, after expenses, to repay all of their nonpriority, nonhousing debt over 5 years and 25 percent could repay at least 30 percent. The report estimated that about 50 percent of chapter 13 debtors in the 13 locations combined would have sufficient income, after living expenses, to repay all of their nonpriority, nonhousing debt over a 5-year period; and an additional 19 percent could pay 60 percent or more over the same period. The Center report also estimated that about 56 percent of chapter 7 debtors and about 11 percent of chapter 13 debtors were expected to have no income available to repay nonhousing debts. A February 1998 Ernst & Young study of chapter 7 personal bankruptcy petitions filed mainly in 1992 and 1993 in four locations—two of which were included in the Center report—found that under the income and expense provisions of H.R. 3150, 8 to 14 percent of these debtors would have been required to file under chapter 13, and these debtors could have repaid 63 to 85 percent of their unsecured nonpriority debt over 5 years. Both studies represent a useful first step in analyzing bankruptcy debtors' ability to pay their debts.

However, both of these studies share two fundamental assumptions that have not been validated: (1) that the information found on debtors' initial schedules of estimated income, estimated expenses, and debts is accurate; and (2) that this information can be used to satisfactorily forecast debtors' income and expenses for a 5-year period. In addition, both studies assume that 100 percent of debtors' net income after allowable expenses would be used for debt repayment, which does not reflect actual bankruptcy practice. In fiscal year 1996, 14 percent of chapter 13 debtor payments

were used for administrative costs, such as statutory trustee fees. Also, each report's estimate of potential debt repayment assumes that all repayment plans will be successfully completed. Data from the Administrative Office of the U.S. Courts shows that only about one-third of 953,180 chapter 13 repayment plans terminated between 1981 and 1993 were successfully completed.

Together, the two reports are based on data from 15 of the more than 180 different bankruptcy court locations. The samples were not designed to be representative of the nation as a whole or of each city for the year in which they were drawn. Therefore, the data on which the reports were based may not reflect all bankruptcy filings nationwide or in each of the 15 locations for the years from which the petitions were drawn. Even if a national representative sample were used, any analysis that used the same basic assumptions as these two reports would also share their limitations.

For all these reasons, we believe it is prudent to interpret the findings and conclusions of both the Center and Ernst & Young reports with caution. Although there may be a portion of chapter 7 debtors who have the ability to repay at least a portion of their debts, the actual number of debtors with an ability to repay, and the amount of debt that could be repaid, may be more or less than estimated in these two reports.

Personal Bankruptcy: the Credit Research Center and Ernst & Young Reports on Debtors' Ability to Pay

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to discuss the results of our review of the Credit Research Center (the Center) report[1] on personal bankruptcy debtors' ability to pay their debts and share with you our observations on the February 1998 Ernst & Young report[2] that also examines debtors' ability to pay. Both reports represent a useful first step in addressing a major public policy issue—whether some proportion of those debtors who file for personal bankruptcy under chapter 7 of the bankruptcy code have sufficient income, after expenses, to pay a "substantial" portion of their outstanding debts. On February 9, 1998, we reported the results of our more extensive review of the Center report and selected data to the Chairman and Ranking Minority Member of the Subcommittee on Administrative Oversight and the Courts, Senate Committee on the Judiciary.[3]

Background

Debtors who file for personal bankruptcy usually file under chapter 7 or chapter 13 of the bankruptcy code. Generally, debtors who file under chapter 7 of the bankruptcy code seek a discharge of all their eligible dischargeable debts.[4] Debtors who file under chapter 13 submit a repayment plan, which must be confirmed by the bankruptcy court, for paying all or a portion of their debts over a 3-year period unless for cause the court approves a period not to exceed 5 years.

Personal bankruptcy filings have set new records in each of the past 2 years, although there is little agreement on the causes for such high bankruptcy filings in a period of relatively low unemployment, low inflation, and steady economic growth. The National Bankruptcy Review Commission's report[5] discussed a number of factors that may affect bankruptcy filings, such as rising consumer debt relative to income, local legal cultures, the loss of medical insurance, and divorce. The Commission

[1]John M. Barron, Ph.D., and Michael E. Staten, Ph.D., Personal Bankruptcy: A Report on Petitioners' Ability-to-Pay (October 6, 1997).

[2]Ernst & Young, LLP, Chapter 7 Bankruptcy Petitioners' Ability to Repay: Additional Evidence from Bankruptcy Petition Files (February 1998).

[3]Personal Bankruptcy: The Credit Research Center Report on Debtors' Ability to Pay (GGD-98-47, Feb. 9, 1998).

[4]Eligible debts may be discharged in bankruptcy proceedings. A dischargeable debt is a debt for which the bankruptcy code allows the debtor's personal liability to be eliminated.

[5]Bankruptcy: The Next 20 Years (October 20, 1997).

report concluded, however, that no one explanation is likely to capture the variety of reasons that families fail and file for bankruptcy.

Nor is there agreement on (1) the number of debtors who seek relief through the bankruptcy process who have the ability to pay at least some of their debts and (2) the amount of debt such debtors could repay. One reason for the lack of agreement is that there is little reliable data on which to assess such important questions as the extent to which debtors have an ability to pay their eligible dischargeable debts; the amount and types of debts that debtors have voluntarily repaid under chapters 7 and 13; the characteristics of chapter 13 repayment plans that were and were not successfully completed; and the reasons for the variations among bankruptcy districts in such measures as the percentage of chapter 13 repayment plans that were successfully completed.

Several bills have been introduced in Congress that would implement some form of "needs-based" bankruptcy. These include S.1301, H.R. 2500, and H.R. 3150. All of these bills include provisions for determining when a debtor could be required to file under chapter 13, rather than chapter 7. Currently, the debtor generally determines whether to file under chapter 7 or chapter 13. Each bill would generally establish a "needs-based" test, whose specific provisions vary among the bills, that would require a debtor to file under chapter 13 if the debtor's net income after allowable expenses would be sufficient to pay about 20 percent of the debtor's unsecured nonpriority debt over a 5-year period.[6] If the debtor were determined to be unable to pay at least 20 percent of his or her unsecured nonpriority debt over 5 years, the debtor could file under chapter 7 and have his or her eligible debts discharged.[7] Another bill, H.R. 3146, focuses largely on changes to the existing "substantial abuse" provisions under section 707(b) of the bankruptcy code as the means of identifying debtors who should be required to file under chapter 13 rather than chapter 7.

The Center report and Ernst & Young reports attempted to estimate (1) how many debtors who filed for chapter 7 may have had sufficient income, after expenses, to repay at "a substantial portion" of their debts and (2) what proportion of their debts could potentially be repaid.

[6]Under the bankruptcy code, debts are classified as secured (such as mortgage and auto loans secured by property financed by the loan); unsecured priority (such as certain back taxes, child support, and alimony); or unsecured nonpriority (such as credit card debts).

[7]By statute, some types of debts and obligations, such as alimony, child support, some student loans and certain taxes, cannot generally be discharged in bankruptcy proceedings. The debtor remains financially responsible for nondischargeable debts after the close of his or her bankruptcy case.

The Center report was based on data from 3,798 personal bankruptcy petitions filed principally in May and June 1996 in 13 of the more than 180 bankruptcy court locations. The petitions included 2,441 chapter 7 and 1,357 chapter 13 petitions. On the basis of the Center report's assumptions and the formula used to determine income available for repayment of nonpriority, nonhousing debt, the report estimated that 5 percent of the chapter 7 debtors in the 13 locations combined could, after expenses, repay all of their nonpriority, nonhousing debt over 5 years; 10 percent could repay at least 78 percent; and 25 percent could repay at least 30 percent. The Center report also estimated that about 11 percent of chapter 13 debtors and about 56 percent of chapter 7 debtors were expected to have no income available to repay nonhousing debts.

Ernst & Young's report was based on a sample of 5,722 chapter 7 petitions in four cities—Los Angeles, Chicago, Boston, and Nashville—that were filed mainly in 1992 and 1993. Ernst & Young concluded that, under the needs-based provisions of H.R. 3150, from 8 to 14 percent (average 12 percent) of the chapter 7 filers in these four cities would have been required to file under chapter 13 rather than chapter 7, and could have repaid 63 to 85 percent (average 74 percent) of their unsecured nonpriority debts over a 5 year repayment period. The report concluded that its findings corroborated the Center report's findings that "a sizeable minority of chapter 7 debtors could make a significant contribution toward repayment of their non-housing debt over a 5-year period."

Scope and Methodology

In reviewing both reports, our objective was to assess the strengths and limitations, if any, of the reports' assumptions and methodology for determining debtors' ability to pay and the amount of debt that debtors could potentially repay. Our comments and observations on the Center report are based on a review of the final version of the Center report, dated October 6, 1997; some additional information we requested from the report's authors; data and analyses provided by the Federal Judicial Center on bankruptcy filings in the 13 locations used in the Center report; telephone interviews with bankruptcy judges and trustees; and our experience in research design and evaluation. The authors of the Center report declined to provide us a copy of the automated database used for their analysis, citing their interest in maintaining its proprietary value. Our observations on the Ernst & Young study are based solely on the information provided in the report regarding the report's data, methodology, and findings. We have not requested any additional data nor

discussed our observations about the report with the Ernst & Young study author.

Shared Characteristics of the Two Reports

It is important to note that the findings of both the Center report and Ernst & Young report rest on fundamental assumptions that have not been validated. Both studies share two fundamental assumptions: (1) that the information found on debtors' initial schedules of estimated income, estimated expenses, and debts was accurate; and (2) that this information could be used to satisfactorily forecast debtors' income and expenses for a 5-year period. These assumptions have been the subject of considerable debate, and the researchers did not test their validity.

With regard to the first assumption, the accuracy of the data in bankruptcy petitioners' initial schedules of estimated income, estimated expenses, and debts is unknown. Both reports assumed that the data in these schedules are accurate. However, both reports also stated that to the extent the data in the schedules were not accurate, the data would probably understate the income debtors have available for debt repayment. This reflected the researchers' shared belief that debtors have an incentive in the bankruptcy process to understate income, overstate expenses, and thereby understate their net income available for debt repayment. However, there have been no studies to validate this belief. It is plausible that, to the extent there are errors in the schedules, debtors could report information that would have the effect of either overstating or understating their capacity to repay their debts, with a net unknown bias in the aggregate data reported by all debtors. One cause of such errors could be that the schedules are not easily interpreted by debtors who proceed without legal assistance. In Los Angeles, a location whose data contributed significantly to the findings of both reports, Center data showed that about one-third of debtors reported they had not used a lawyer.

With regard to the second assumption, there is also no empirical basis for assuming that debtors' income and expenses, as stated in their initial schedules, would remain stable for a 5-year period following the filing of their bankruptcy petitions. Implicitly, the debt repayment estimates of both reports assumed that 100 percent of debtors who have the ability to repay at least a portion of their debt would complete their assumed 5-year repayment plans. These two assumptions—debtors' income and expenses remain stable and all repayment plans would be successfully completed—could result in a somewhat optimistic estimate of debt

repayment. Neither report allowed for situations in which the debtor's income decreases or expenses increase during the 5-year period.

Past experience suggest that not all future chapter 13 debtors will successfully complete their repayment plans. To the extent this occurs, it would reduce the amount of debt that future debtors repay under required chapter 13 repayment plans. A 1994 report by the Administrative Office of the U.S. Courts found that only about 36 percent of the 953,180 chapter 13 cases terminated during a 10-year period ending September 30, 1993, had been successfully completed. The remaining 64 percent were either dismissed or converted to chapter 7 liquidation, in which all eligible debts were discharged. The reasons for this low completion rate are unknown, but this illustrates the high level of discrepancy between the amount that debtors could potentially repay, based on the data and assumptions used in the two reports, and what has occurred over a 10-year period.

Another assumption made in both reports is that 100 percent of debtors' income available for debt repayment will be used to repay debt for a 5-year period. This assumption does not reflect actual bankruptcy practice. Chapter 13 repayment plans require greater administrative oversight, and thus cost more than chapter 7 cases, including periodic review of the debtors progress in implementing the plan and review of debtors' or creditors' requests to alter the plan. In fiscal year 1996, for example, creditors received about 86 percent of chapter 13 debtor payments. The remaining 14 percent of chapter 13 debtor payments were used to pay administrative costs, such as statutory trustee fees and debtor attorneys' fees. Neither study addressed the additional costs for judges and administrative support requirements that would be borne by the government should more debtors file under chapter 13.

Finally, neither study used scientific random sampling techniques in selecting personal bankruptcy petitions for review. The Center report was based on data from bankruptcy petitions in 13 locations filed principally in May and June 1996. The Ernst & Young report was based on data from bankruptcy petitions filed in four locations, principally in 1992 and 1993. Together, the two reports included data from 15 of the more than 180 bankruptcy court locations. Both reports included data from two of the same locations—Los Angeles and Chicago. The results of both reports are heavily influenced by data from these two locations, which accounted for about 41 percent of the total filings in the 13 locations in the Center study and about 85 percent of the total filings in the four locations in the Ernst & Young report. The samples were not designed to be representative of the

nation as a whole or of each location for the year from which the samples were drawn. Therefore, the data on which the reports were based may not reflect all bankruptcy filings nationally or in each of the 15 locations for the years from which the petitions were drawn.

Differences Between the Two Reports

One difference between the two reports involves the calculation of debtor expenses. The Center's estimates of debtor repayment capacity are based on the data reported in debtors' initial schedules of estimated income, estimated expenses, and debts. The Center report calculated debtor expenses using the data reported on debtors' estimated income and estimated expense schedules.

The Ernst & Young report, whose purpose was to estimate the effect of implementing the provisions of H.R. 3150, adjusted debtors' expenses using the provisions of H.R. 3150. Following these provisions, Ernst & Young used the expenses debtors reported on their schedules of estimated expenses for alimony payments, mortgage debt payments, charitable expenses, child care, and medical expenses. For all other expenses, including transportation and rent, Ernst & Young used Internal Revenue Service (IRS) standard expense allowances, based on both family size and geographic location. The impact of these adjustments on debtors' reported expenses was not discussed in the report. However, to the extent these adjustments lowered debtors expenses, they would have increased the report's estimates of debtors' repayment capacity when compared to the methodology used in the Center report. To the extent the adjustments increased debtors' reported expenses, they would have decreased the report's estimates of debtor repayment capacity. Also, to the extent that these adjustments reduced debtors' reported expenses, the adjustments would have corrected, at least in part, for what the report assumed was debtors' probable overstatement of expenses on their schedules of estimated expenses.

A second difference between the two reports involves the calculation of mortgage debt and family size. The Center gathered data from debtor bankruptcy petitions on these items. However, because Ernst & Young did not have data on mortgage debt or family size, both of these factors were estimated for its report. Based on data from the U.S. Census Bureau, Ernst & Young used an average family size of 3 for all married filers and 1.6 for single individuals or single-parent families. To the extent that the family size of those filing for bankruptcy exceeded these averages, the report understated allowable expenses, and thus overstated the debtors' ability to

pay. Conversely, to the extent that actual family size was smaller than these averages, the report overstated allowable expenses, and thus understated the debtors' ability to pay.

A third difference between the reports involves assumptions about repayment of secured, nonhousing debt. The Center report assumed that debtors would continue payments on their mortgage debt and pay their unsecured priority debt. Unlike the Center report, the Ernst & Young report appears to have assumed that debtors will repay, over a 5-year period, all of their secured nonhousing debt and all of their unsecured priority debt. The purpose of this assumption was to estimate the amount of unsecured nonpriority debt that debtors' could potentially repay after paying their secured nonhousing debt and unsecured priority debt.

March 1998 Ernst & Young Report

On March 10, 1998 we received an Ernst & Young report that used a national sample of chapter 7 petitions from calendar year 1997 to estimate debtors' ability to pay. Although we have not had an opportunity to examine this report in detail, the report appears to have addressed many of the sampling issues we raised regarding the Center report and February 1998 Ernst & Young report. However, the March 1998 Ernst & Young report shares the fundamental unvalidated assumptions of the Credit Center report and the February 1998 Ernst & Young report. These assumptions include (1) the data reported on debtors' schedules of estimated income, estimated expenses, and debts are accurate; (2) the data in these schedules can be used to satisfactorily forecast debtors' income and expenses for a 5-year period; (3) that 100 percent of debtors' net income after expenses, as determined in the report, will be used for debt repayment over a 5-year repayment period; and (4) that all debtors will satisfactorily complete their 5-year repayment plans.

Conclusion

The assumptions, data, and sampling procedures used in the Center report and February 1998 Ernst & Young report raise questions concerning the accuracy of the reports' estimates and require the reader to use caution in interpreting the types of firm conclusions stated therein. Neither report provides reliable answers to the questions of how many debtors could make some repayment and how much debt they could repay. We do not disagree that it is likely that there are some debtors who file for bankruptcy under chapter 7 who have the financial ability to repay at least a portion of their debt. However, the actual number of chapter 7 debtors who could repay at least a portion of their nonhousing debt could be more

or less than the estimates in these two studies. Similarly, the amount of debt these debtors could potentially repay could also be more or less than the reports estimated.

Finally, although the March 1998 Ernst & Young report is based on what is apparently a national representative sample of chapter 7 petitions, to the extent that the report is based on the same basic data (petitioners financial schedules) and assumptions as the Center report and the February 1998 Ernst & Young report, it shares the same limitations as these two earlier reports.

This concludes my prepared statement, Mr. Chairman. I would be pleased to answer any questions you or other members of the Subcommittee may have.

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