SPEAKERS CONTENTS INSERTS Tables

Page 1 TOP OF DOC

BANKRUPTCY REFORM ACT OF 1998; RESPONSIBLE BORROWER PROTECTION ACT; AND CONSUMER LENDERS AND BORROWERS BANKRUPTCY ACCOUNTABILITY ACT OF 1998
PART II

Thursday, March 12, 1998
U.S. House of Representatives,
Committee on the Judiciary,
Subcommittee on Commercial and
Administrative Law,
Washington, DC.

The subcommittee met, pursuant to notice, at 10:00 a.m., in room 2226, Rayburn House Office Building, Hon. George W. Gekas (chairman of the subcommittee) presiding.

Present: Representatives Steve Chabot, Bob Inglis, Ed Bryant, Lamar S. Smith, Jerrold Nadler, Sheila Jackson Lee, Martin T. Meehan, and William D. Delahunt.

Also present: Raymond V. Smietanka, chief subcommittee counsel; Susan A. Jensen-Conklin, subcommittee counsel; Audray Clement, subcommittee staff assistant; David Lachmann, subcommittee professional staff member; and Peter Levinson, committee counsel.

OPENING STATEMENT OF CHAIRMAN GEKAS

Mr. **GEKAS.** The subcommittee will come to order. Noting the presence of two members of the subcommittee, the Chair and the Ranking Member, the gentleman from New York, we are in a position to begin our set of witnesses and the testimony they will offer. I will have a brief opening statement and yield to the gentleman from New York.

Page 2 PREV PAGE TOP OF DOC

One of the concerns that led us to look at bankruptcy for the purposes of possible reform was the explosion of filings in 1997, which we thought at that time was 1.3 million. Now the latest numbers escalate that to 1.4 million. That, of course, is not the only reason that we have tried to conduct a comprehensive look at the Bankruptcy Code and all its ramifications, but it is a compelling one.

The thesis that the Chair wants to propound time and time again is to those that look at the proposals we have made as an attack on the helpless is that there is nothing in H.R. 3150 or H.R. 2500 that prevents an individual who has become so engulfed by debt that there is no way out except to seek and gain a fresh start through the bankruptcy courts. Nothing in our legislation prevents that. And that is a good starting point.

But at the same time, we provide for a mechanism whereby in those cases—and we acknowledge that it is a minority of cases—where the debtor could, with some diligence and with monitoring and with guidance will be able to pay some or all of the debt back over a period of time, then we ought to accommodate that as we look at Chapters 7 and 13 to see what opportunities there are for doing justice to all concerned.

So with those thoughts—which the Chair in his own way will repeat time and time again—I yield to the gentleman from New York.

[The prepared statement of Mr. Gekas follows:]

PREPARED STATEMENT OF HON. GEORGE W. GEKAS, A REPRESENTATIVE IN CONGRESS FROM THE

STATE OF PENNSYLVANIA

Page 3 PREV PAGE TOP OF DOC

More than 120 years ago, Mr. Justice Miller of the United States Supreme Court prophetically observed, "[N]owhere has the Federal Constitution shown its expansive possibilities more frequently and more forcibly than in that clause that vests in Congress the power to pass 'uniform laws on the subject of bankruptcies.' "

Indeed, Congress has always viewed the subject of bankruptcy law as a priority matter. For example, the learned historian Charles Warren, in his book, *Bankruptcy in United States History,* notes that the very first session of the first Congress, during which only the most necessary subjects of legislation were considered, devoted part of its time to the subject of bankruptcy. However, while Congress has always been aware of its special responsibility over bankruptcy, major reforms have tended to come in response to some form of economic upheaval.

I think we are now in the middle of a special kind of economic crisis—although the Nation is enjoying relative economic prosperity, the Administrative Office of the United States Courts just announced last month that a record number of Americans—1.4 million—filed for bankruptcy in 1997. We will hear testimony today that the losses attributable to these filings exceeded $44 billion. Not surprisingly, you and I as well as and every American family will have to somehow bear the cost of these tremendous losses, now estimated to be about $400 for the average household.

To add insult to injury, some of these people who are filing for bankruptcy relief are not poor or destitute. Some of these so-called debtors actually have the means to repay all or a significant portion of their debts. But our current laws do not require them to do this. These "bankruptcies of convenience" allow people who do not want to repay their debts to get away with doing just that. This leaves us all—in effect—"holding the bag."

Page 4 PREV PAGE TOP OF DOC

I introduced legislation last month, which we will hear testimony on today, that will fix this problem by instituting a major overhaul of the current consumer bankruptcy laws and system. H.R. 3150 is designed to ensure that dishonest and undeserving debtors will be quickly and efficiently removed from the bankruptcy system. Just as importantly, debtors who have the means to repay their creditors will be required to do so where they can.

More than 20 years ago, the United States Supreme Court held that bankruptcy was not a right, but a privilege. I think now is the time to restore balance and integrity to the consumer bankruptcy system. By cutting back on "bankruptcies of convenience," H.R. 3150 will reduce losses suffered by creditors caused by profligate bankruptcy filings and, as a result, spare Americans from having to bear the costs of those losses.

I am particularly pleased to have with us today on the first witness panel several of my distinguished colleagues, two of which took the initiative to introduce H.R. 2500 last fall. As you know, one of the prime components of H.R. 2500 is its provision for needs-based consumer bankruptcy reform. Bipartisan Congressional support for H.R. 2500 is overwhelming. At last count, 180 House members have signed on to this bill.

H.R. 3150 incorporates much of H.R. 2500's consumer bankruptcy reforms, including, most importantly, its needs-based reforms. As we will hear today and in the upcoming hearings, the need for needs-based reform is absolute, it is needed immediately, and it will work.

Mr. **NADLER.** Thank you, Mr. Chairman.

Page 5 PREV PAGE TOP OF DOC

Mr. Chairman, I would simply observe that from my point of view that I disagree with everything the Chairman said a moment ago. I think that H.R. 3150 presents many, many obstacles to debtors who are in way over their heads from discharging their debts. I think it presents many opportunities for increased litigation against debtors' for the parties in

interest to initiate 707(b) motions on their own initiative, not just the court or the U.S. trustee, which will cost debtors and the system a lot of extra time and money and will weigh down debtors. I think that there are a lot of problems with this and I don't think that the need for so-called "needs-based bankruptcy" has been shown.

In addition, I would simply say that there are problems with the current system. It does need reform. But the kind of radical change for the first time in a couple of centuries curtailing access to chapter 7 or its equivalent—the need for that has not been shown. We need a balanced reform of the system that reflects the real evidence.

I also want to say that we're having this panel today reflecting various studies on the ability to pay. One of the fundamental arguments used to support the needs-based bankruptcy system enshrined in H.R. 3150 is that a significant number of debtors allegedly have an ability to repay a portion of their debts which they now discharge. We are going to hear from the authors of various studies on that question today.

Mr. Kim Kowalewski of the Congressional Budget Office did an analysis of one of the studies for the National Bankruptcy Review Commission. At the request of the Minority, he has been reviewing these studies. And although he was invited to testify today because his testimony could not be cleared in time by CBO, the Minority has objected to the haste and the speed of the schedule of these hearings. And this is a perfect example of why.

Page 6 PREV PAGE TOP OF DOC

We ought to have at this hearing the CBO analysis of the reviews of these studies and the authors of the studies who could rebut whatever the CBO person said if they thought it was unfair or not properly balanced so that we could have the different views here. But in the short time space available, CBO was unable to clear that.

The Minority will request that his testimony either be presented at another time or be made part of the record. But of course, being made part of the record is not the equivalent of testifying at this hearing.

Mr. **GEKAS.** Would the gentleman offer the statement for the record?

Mr. **NADLER.** We don't have the statement.

Mr. **GEKAS.** When it appears?

Mr. **NADLER.** We will probably ask that he have an opportunity to testify at a subsequent hearing.

Mr. **GEKAS.** Do you want the Chair to wait until that time?

Mr. **NADLER.** We're not making any requests now. I am saying that in the future we will request that either—depending on when the hearings are and when CBO can clear that testimony—preferably that he testify at a subsequent hearing—although it would have been preferable if he were here with the people whose studies he was reviewing so that they could comment on his review and back-and-forth—but preferably he can testify at a future hearing. But failing that, that it be made a part of the record.

Page 7 PREV PAGE TOP OF DOC

In any event, I am pleased to be present at this hearing along with Mr. Delahunt. We look forward to an interesting dialogue.

Thank you, Mr. Chairman.

Mr. **GEKAS.** Let the record show that the gentleman from Massachusetts, Mr. Delahunt, indeed is present. Working quorum and hearing quorum being present, we will proceed.

We will call the first set of witnesses to the witness table.

Dr. Michael Staten is a professor at Georgetown University's School of Business where he also serves as Director of the Credit Research Center. Dr. Staten received his Ph.D. in economics from Purdue University in 1980. He taught at the University of Delaware from 1980 to 1988 where he received the Outstanding Faculty Instructor Award in 1984. He became Director of the Credit Research Center in 1990 while it was located at Purdue University's Krannert Graduate School of Management. The Center and Dr. Staten moved to Georgetown University in the summer of 1997.

Since its founding in 1974, the Credit Research Center has built a national reputation as the only academic research center in the United States devoted to the study of consumer credit market economics. The Center's research product is used by regulatory agencies, legislatures, the credit industry, consumer groups, and the court system. As Director of the Credit Research Center, Dr. Staten has designed and conducted projects on a wide range of policy-oriented issues involving consumer credit markets.

Page 8 PREV PAGE TOP OF DOC

Dr. Staten co-authors "Consumer Trends," a monthly newsletter on consumer financial services published by the International Credit Association. He has written numerous papers on a broad range of economic issues. He serves on the Board of Trustees for the National Foundation of Consumer Credit and is a trustee for the Consumer Credit Education Foundation of the American Financial Services Association.

After obtaining his bachelor of arts degree in economics at the University of Texas, Dr. Staten went to obtain his master of science and Ph.D. degrees both in economics at Purdue University.

Joining him at the table will be Richard M. Stana, Associate Director, Administration of Justice Issues, General Government Division of the General Accounting Office. Mr. Stana has been with the General Accounting Office for more than 21 years. He has served in a number of capacities in the GAO's headquarters, its field offices, and overseas. He has worked in a range of Administration of Justice Issues for more than 4 years.

Dr. Thomas Neubig, National Director, Policy Economics and Quantitative Analysis for Ernst & Young, based in Washington, DC, is the next witness. As National Director of Policy Economics and Quantitative Analysis at Ernst & Young, Dr. Neubig serves as a consultant to numerous public and private clients on a broad range of subjects. These include tax and regulatory policy issues as well as risk management quantification.

Prior to joining Ernst & Young in 1994, Dr. Neubig was previously associated with Price Waterhouse, where he was a director of financial sector economics in the Tax Economics Department.

Page 9 PREV PAGE TOP OF DOC

Before coming to Price Waterhouse, Dr. Neubig was the Director and Chief Economist in the Office of Tax Analysis at the United States Treasury Department.

Dr. Neubig has testified before the House Ways and Means Committee as well as before several State Legislatures. He has also served as an expert witness in several legal cases. He has offered numerous articles on various aspects of economics.

He holds a master of arts degree and Ph.D. both in economics from the University of Michigan. He received his B.A. cum laude from Kalamazoo College.

The fourth witness is Dr. Fritz Scheuren, the Association National Technical Director of Statistical Sampling at Ernst & Young based in Washington, DC. Dr. Scheuren is a mathematical statistician and internationally known sampling expert. He has worked for more than 25 years as a statistician.

As Association National Technical Director of Statistical Sampling, Dr. Scheuren has managed large audit sampling engagements, designed major inventory sampling efforts, and negotiated statistical matters with the Internal Revenue Service, among other responsibilities.

His industry experience includes banking and finance, consumer products, health care, mining, retail and wholesale trade, telecommunications, and transportation. Prior to joining Ernst & Young, he was a professor of statistics at George Washington University. From 1980 to 1994, Dr. Scheuren was with the Internal Revenue Service, where he was the director of the Statistics of Income Division.

Page 10 PREV PAGE TOP OF DOC

Dr. Scheuren is a fellow of the American Statistical Association and the American Association for the Advancement of Science. He is also a member of the International Statistical Institute and the American Society for Quality. He is currently the scientific secretary of the International Association of Survey Statisticians as well as a member of the committee for Applied and Theoretical Statistics at the National Academy of Sciences.

As a well-known sampling expert, Dr. Scheuren has published nearly 100 books, monographs, and papers on survey design and other statistical problems. In 1995, he won the Shiskin Award for contributions to the United States economic statistics.

We welcome the panel and will lay down two or three ground rules that we always apply.

First, your written statement will be automatically made a part of the record. So you can feel safe that that has been accomplished. Also, because of the number of witnesses and number of panels and the schedule of the day, we must restrict the testimony orally to be presented to 5 minutes. There will be some leeway, depending on the reach of the chairman toward the gavel.

We will begin, then, with the testimony in the order in which they were introduced.

Excuse me. We note the presence of the other gentleman from Massachusetts, Mr. Meehan.

Page 11 PREV PAGE TOP OF DOC

Mr. **DELAHUNT.** Mr. Chairman, before you begin, if I could ask the indulgence of the Chair for a moment, I have to go to another meeting.

Mr. **GEKAS.** The Chair recognizes the gentleman.

Mr. **DELAHUNT.** Thank you, Mr. Chairman.

I just want to comment on some of the observations made by Mr. Nadler, the Ranking Member.

Again, the number of panels, the speed with which this train is going with regard to this particular issue concerns me. Again, I say this—and I want to be very clear—with great respect for the Chair. I enjoy working with him and I enjoy working with his staff on this subcommittee. But I think the matter is of such import that we ought to attempt to slow this train down somewhat because the amount of material, both by way of testimony and by written statement, is so voluminous that I would like to see these hearings spaced somewhat differently with smaller panels.

I just want to make that a matter of record. And I will return after about an hour or so.

Mr. **GEKAS.** The Chair thanks the gentleman and we will proceed with the panel.

Page 12 PREV PAGE TOP OF DOC

Did you want to make a statement? I thought you might.

Mr. **MEEHAN.** Mr. Chairman, just to follow up on my colleague's from Massachusetts comments, I was unable to make Tuesday's hearing. On Tuesday morning I had meetings in my district that were scheduled long in advance. Unlike some of my subcommittee colleagues in the Minority, I was unable to reschedule those appointments.

This is a very important matter and I happen to think that we ought to try to pass some kind of bankruptcy legislation, but in terms of the means testing involved in this, studies in the ability to repay, interest rates—it is a very complicated subject. To have this sort of series of meetings come up this quickly makes it difficult to deal with this issue. Tuesday was a great example of that.

But in any event, I yield back the balance of my time. Thank you, Mr. Chairman.

Mr. **GEKAS.** We thank the gentleman.

We will proceed with the opening statement and testimony from Dr. Staten.

STATEMENT OF MICHAEL E. STATEN, CREDIT RESEARCH CENTER, GEORGETOWN SCHOOL OF BUSINESS, GEORGETOWN UNIVERSITY

Mr. **STATEN.** Thank you very much and good morning, Mr. Chairman and members of the committee.

Page 13 PREV PAGE TOP OF DOC

I am Michael Staten, professor of management and director of the Credit Research Center at the Georgetown University School of Business.

I know that at least three bills have been introduced to this Congress that would amend the Federal bankruptcy statutes. My testimony today is especially relevant to the concept of needs-based bankruptcy embedded in those bills.

Needs-based bankruptcy is a generic term that refers to proposals that would guide debtors into a Chapter 13 repayment plan when they have income sufficient to repay a substantial portion of their debts. These proposals are based on the premise that the current code affords some debtors more bankruptcy relief than they actually need.

The concept of reserving the Chapter 7 discharge only for those consumers who truly can't repay sounds fair and reasonable. Bankruptcy, after all, is social insurance in its purest form. When a bankruptcy court awards a Chapter 7 discharge, the losses associated with one debtor's financial catastrophe are spread across millions of other borrowers as creditors adjust their prices and credit availability.

If bankruptcy were a free-market insurance program, we wouldn't be debating the merits of a needs-based approach. It would already exist. Like the consumer whose house has suffered storm damage, debtors would be required to show that they had suffered a loss. A court would measure the extent of the damage prior to awarding relief.

No free-market insurance program would pay out a claim without assessing the size of the loss, yet that is exactly how our current bankruptcy code operates when it permits debtors to file for a Chapter 7 discharge without requiring the court to evaluate the debtor's capacity to repay those debts.

Page 14 PREV PAGE TOP OF DOC

Two years ago, the Credit Research Center began a study of nearly 4,000 consumers who filed for bankruptcy during 1996 in 13 major U.S. cities. One of the project's objectives was to determine how well the current bankruptcy law calibrates bankruptcy relief to debtor need. That is, we attempted to measure petitioner repayment capacity using the same materials available to the court when the debtor requested a Chapter 7 discharge.

We issued our first report last October. We found that 25 percent of Chapter 7 petitioners told the court they had income net of living expenses at the time they filed that was sufficient to repay at least 30 percent of their non-housing debt over a 5-year repayment period and 5 percent of Chapter 7 filers could pay all their non-housing debts over 5 years.

Following publication of our report in October, the GAO evaluated our methods and procedures. You will hear more about their findings later in the panel. We believe that our analysis was strengthened as we responded to the GAO's questions and concerns. As you will see in my written statement, we resolved a number of issues by refining our calculations. In particular, we recalculated our repayment estimates to simulate full reaffirmation of secured debts and full repayment of student loans.

In the past 2 months, two additional studies of petitioner capacity to repay have been released. Both were conducted by the accounting firm of Ernst & Young. Again, you will hear more detail about those studies later in the panel. However, in each case, the results strongly corroborate our findings. The second study, in particular, was especially designed to satisfy the GAO's statistical criteria for a national representative sample.

Page 15 PREV PAGE TOP OF DOC

I believe that the body of empirical research supported by these three distinct databases has established that debtors with the means to repay are filing for Chapter 7 in sufficient numbers to be worrisome.

Of course, while creditors may initially bear the cost of debt that could have been repaid, we know from long experience with competitive markets that these costs are ultimately passed along to all consumers in the form of higher prices or reduced availability of credit products.

I reject the argument by some opponents of H.R. 3150 that its need-based criteria would place an excessive administrative burden on the courts. It seems to me that a viable needs-based approach would utilize well-defined criteria to clearly signal how the court will treat a given debtor. Well-defined eligibility standards streamline the administration, promote consistent treatment, and reduce costly litigation.

Our estimates of the impacts of H.R. 3150, corroborated by both Ernst & Young studies, is that 12 to 15 percent of current Chapter 7 debtors would be directed into Chapter 13 repayment plans. Presumably, only a fraction of these would generate appeals for exceptions due to special circumstances. Consequently, the straightforward, up-front screening criteria embedded in H.R. 3150 would allow the court to focus its attention on the subset of the 12 to 15 percent of cases which warrant closer scrutiny.

Some critics have argued that bankruptcy reform should penalize creditors for making bad lending decisions. I would simply point out that the needs-based proposal will not rescue creditors from making those bad decisions because it reserves bankruptcy relief for those debtors who truly can't pay. A needs-based system would preserve the industry's incentive to make credit available, but also to lend prudently by differentiating between consumers who can pay and those who can't.

Page 16 PREV PAGE TOP OF DOC

Perhaps most importantly, a needs-based approach bolsters consumer incentives to use credit cautiously by removing the temptation of a free ride for those who can pay but would choose not to. In contrast, by offering the lure of a Chapter 7 discharge without demonstration of need, the current bankruptcy does little to encourage the responsible use of credit.

In closing, I would simply point out that bankruptcy is a complex phenomenon with many causes, only a few of which can be addressed by the bankruptcy statutes themselves. Incorporating the needs-based eligibility requirement into the existing system will probably not reduce the number of filings to the levels we experienced a decade ago.

However, if Congress desires to curb the growth in bankruptcies, at the same time preserving access to credit for those financially-vulnerable households who need it the most, I believe that incorporating a needs-based approach is the single most effective step that can be taken toward that goal.

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

[The prepared statement of Dr. Staten follows:]

PREPARED STATEMENT OF MICHAEL E. STATEN, CREDIT RESEARCH CENTER, GEORGETOWN SCHOOL OF BUSINESS, GEORGETOWN UNIVERSITY

The Empirical Case for Needs-Based Bankruptcy

Page 17 PREV PAGE TOP OF DOC

SUMMARY

Needs-based bankruptcy is a generic term which refers to proposals that would guide debtors into Chapter 13 repayment plans if they have a significant capacity to repay their debts. Current bankruptcy law allows debtors the freedom to choose the chapter under which they file for relief, but does not require the Bankruptcy Court to assess a Chapter 7 petitioner's ability to repay debt out of future income as a condition to awarding a discharge. The possibility exists that some, perhaps many, debtors in Chapter 7 could actually fund meaningful Chapter 13 repayment plans.

In October, 1997 the Credit Research Center published a report which provided a snapshot of the ability of 3,800 bankrupt debtors to repay their debts in 13 major U.S. cities. The report found concluded that 25 percent of Chapter 7 filers could have repaid at least 30 percent of their non-housing debt over a 5-year repayment period. Five percent of Chapter 7 filers could have repaid *all* of their non-housing debts over five years.

The U.S. General Accounting Office evaluated the CRC methodology. It concluded that "overall, the Center report represents a useful first step in analyzing the ability of bankrupt debtors to pay their debts," but advised caution in the interpretation of the results based on five areas of concern, which involved sampling issues, methods of calculating repayable debt, and the reliability of assumptions underlying the calculations. CRC responded with subsequent analysis and commentary.

The Center continues to believe that the uniformity of repayment results across such a diverse group of cities strongly suggests a nationwide pattern. Even under the extreme assumption that all secured debt was reaffirmed and after accounting for payment of all non-dischargeable student loans, we found that one quarter of all Chapter 7 debtors could pay, on average, 24.6 percent of their unsecured debts over a 5-year payment period. Five percent of all Chapter 7 debtors could pay all of their unsecured balances.

Page 18 PREV PAGE TOP OF DOC

These results have been corroborated by two separate studies conducted by Ernst and Young. The more powerful of the two found that 150,000 Chapter 7 filers during 1997 (about 15 percent of the U.S. total) had the capacity to repay over $4 billion on their unsecured debts had they been required to enter a 5-year Chapter 13 repayment plan.

Empirical research has now established that large numbers of debtors are filing under Chapter 7 who could fund significant repayment plans. A needs-based approach that utilizes well-defined criteria to clearly signal how the court will treat a given debtor would promote consistent treatment, streamline administration and reduce costly litigation. It would preserve access to credit for financially vulnerable households but still encourage creditors to lend prudently. It would preserve bankruptcy relief for those debtors who truly can't pay, but also bolster consumer incentives to use credit responsibly by removing the temptation of the free ride for those who can pay but would choose not to.

I. INTRODUCTION

Good morning Mr. Chairman, and members of the Committee. My name is Michael Staten and I am a Professor of Management and the Director of the Credit Research Center at the Georgetown University School of Business. As you may know, over its 24-year history (the first 23 years located at Purdue University) 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.

In 1996 the Credit Research Center undertook a large study of nearly 4,000 consumers who filed for bankruptcy during 1996. The project was partially funded through a joint grant from Visa, U.S.A. and MasterCard International. I am pleased to join you today to discuss our analysis of the petitions filed, and what they reveal about the apparent repayment capacity of those debtors. I will also compare our results with two additional studies of bankrupt debtors that were conducted during the past year.

Page 19 PREV PAGE TOP OF DOC

I am aware that at least 3 bills have been introduced to this Congress that would amend the federal bankruptcy statutes. My testimony today is especially relevant to the concept of "needs-based" bankruptcy imbedded in those bills. Needs-based bankruptcy is a generic term which I believe was coined this past year to refer to proposals that would guide debtors into Chapter 13 repayment plans who have a significant capacity to repay their debts. These proposals are based on the premise that the current code affords some debtors more bankruptcy relief than they need, where "need" is measured in terms of the debtor's ability or inability to fund a repayment plan out of future income. Current bankruptcy law allows debtors the freedom to choose the chapter under which they file for relief. In particular, the law does not require the Bankruptcy Court to assess a Chapter 7 petitioner's ability to repay debt out of future income as a condition to awarding a discharge. Given that Chapter 7 petitions can be approved without such an assessment, it would not be surprising to find that some debtors do have capacity to repay, but opt for the "fresh start" discharge obtainable through Chapter 7.

The concept of reserving the Chapter 7 discharge only for those consumers who truly can't repay sounds fair and reasonable. However, opponents of the needs-based approach have argued that such an evaluation would be impractical due to high administrative costs. They also dispute the observation that there are significant numbers of consumers currently filing under Chapter 7 who could fund meaningful repayment plans. The latter issue is an empirical question which I shall address for you today.

II. CONTEMPORARY EVIDENCE ON REPAYMENT ABILITY

A. Credit Research Center, 1997 report

Page 20 PREV PAGE TOP OF DOC

In October, 1997 the Credit Research Center at Georgetown University published the first in a series of reports on its ongoing study of Americans who file for personal bankruptcy (Barron and Staten, *Personal Bankruptcy: A Report on Petitioners' Ability-to-Pay)*. The initial report provided a snapshot of filers' ability to repay their debts in 13 major U.S. cities. We found in all 13 cities that a sizeable percentage of Chapter 7 filers had enough income to repay at least some of their non-housing debts that would otherwise be discharged through bankruptcy.

Study parameters included:

—Approximately 3,800 usable bankruptcy petitions from a geographically diverse group of 13 major cities

—Selected cities represented about 18 percent of the nation's total filings in 1996

—All calculations were based on debtor statements filed with the bankruptcy court

—Calculations assume finance charges accrue on mortgage debt during the repayment period; no finance charge accrual on non-mortgage debt

Highlights of the results:

—25 percent of Chapter 7 filers could have repaid at least 30 percent of their non-housing debt over a 5-year repayment period (see Figure 1).

Page 21 PREV PAGE TOP OF DOC

—5 percent of Chapter 7 filers could have repaid *all* of their non-housing debt.

B. GAO Evaluation of CRC Report and Subsequent Analysis

At the request of Senators Grassley and Durbin, the U.S. General Accounting Office undertook an evaluation of our research methodology and formula for calculating the amount of petitioner income available to repay debts. In its evaluation (*Personal Bankruptcy: The Credit Research Center Report on Debtors' Ability to Repay,* GAO/GGD–98–47, February, 1998) the GAO concluded that *"overall, the Center report represents a useful first step in analyzing the ability of bankrupt debtors to pay their debts."* However, the agency advised caution in the interpretation of the results based on five areas of concern.

A detailed discussion of our responses to the GAO's concerns is contained in the GAO report as Appendix 1. In several instances, we were able to supply additional evidence or analysis that was not available to the GAO from our original report. For the committee's benefit I have briefly summarized our response to each of the GAO's concerns below.

1. GAO: *A scientific, random sampling technique was not used to select the courts so the conclusions cannot be projected to the entire nation.*

CRC Response: We did not draw a nationally representative probability sample. Instead, the study focused on samples of 300 bankruptcies filed in each of 13 major cities across 11 states. Selection of cities/courts was not random. Cities were picked to achieve variation in a number of factors believed to affect filing patterns (e.g., geographic location, unemployment rate, asset exemption rules in Chapter 7; see Table 1). This was the same approach used in the prominent and influential studies of bankruptcy petitions conducted over the past two decades, including Sullivan, Warren and Westbrook (*As We Forgive Our Debtors,* 1989) and the GAO's own study in 1983 (*Bankruptcy Reform Act of 1978—A Before and After Look,* GAO/GGD–83–54, July, 1983).

Page 22 PREV PAGE TOP OF DOC

Our sample revealed that a significant percentage of Chapter 7 filers had the capacity to repay some of what they owed in each of the 13 cities. *We continue to believe that the uniformity of results across such a diverse group of cities strongly suggests a nationwide pattern.*

2. GAO: *In determining how much income a debtor had available to repay creditors, the study did not subtract payments on debts that petitioners had agreed to reaffirm.*

CRC Response: In many bankruptcy cases, debtors agree to "reaffirm" a debt, i.e., repay a creditor on a set schedule outside the bankruptcy process, in exchange for keeping the asset on which the debt is owed (e.g., an automobile). The crux of the GAO's concern is how much *extra* could debtors pay toward their *unsecured* debts after accounting for such reaffirmations. We recalculated our payment percentages under two assumptions: 1) debtors reaffirmed none of their secured, non-housing debts and 2) debtors reaffirmed all of their secured, non-housing debts. Their actual experience falls somewhere in between.

Even under the more extreme assumption that ALL secured debt was reaffirmed, we found that 31.6% of Chapter 7 debtors had enough income to repay, on average, 31.4% of their unsecured debt over five years (See Table 2 and Table 3).

3. GAO: *The report did not clearly define the universe of debts for which it estimated debtors' ability to repay.*

CRC Response: In fact, our original report specifically defines this universe to include all debt not secured by real estate ("non-housing debt"), making no distinctions between secured vs. unsecured debts, or dischargeable vs. non-dischargeable debts. However, the GAO correctly pointed out that non-dischargeable debts impose a drain on the debtor's future income and should be incorporated into the calculations of a debtor's ability to repay *unsecured creditors.*

Page 23 PREV PAGE TOP OF DOC

Table 2 reflects the recalculation of payment potential to incorporate *reaffirmation of all secured debt* and *repayment of all student loans.* Payments for unsecured priority debts (e.g., back taxes and child support) were already incorporated into the repayment calculations. Consequently, we believe Table 2 accounts for all debts which the GAO argued were repayable inside of bankruptcy ahead of unsecured creditors.

We consider the remaining dollars that could be repaid to unsecured creditors to be substantial. Even assuming full reaffirmation of all secured debts and repayment of all student loans, about 25 percent of all Chapter 7 debtors could repay something toward their unsecured creditors. On average, this group could pay 24.6 percent of their unsecured balances over a 5-year repayment period, but keep in mind that five percent of all Chapter 7 debtors could pay *all* of their unsecured balances.

4. GAO: *The report combined the results for all 13 cities sampled, with little discussion of the differences between individual cities.*

CRC Response: At least a quarter of the Chapter 7 petitioners *in every city* had the ability to repay at least some of their unsecured debt, even if we assume they reaffirm *all* of their secured debts (See Table 4).

5. GAO: *The report's findings are based on information provided by debtors, including estimates about their income and expenses in the future, which may not be accurate.*

CRC Response: This is true, but there is little practical alternative. Because there is no formal audit process conducted by the courts, there is no way to know whether the information reported by a debtor on the petition is accurate. The GAO conceded this point. Consequently, *any* empirical analysis of how much bankruptcy relief a debtor truly needs becomes problematic. Like all social scientists we necessarily made some assumptions (clearly stated in the report) upon which subsequent calculations were based. One assumption was to accept without adjustment the debtor's own sworn statement to the court regarding monthly living expenses. *What the GAO seems to be recommending is for the bankruptcy court (or anyone else using the petition data) to compare the expense schedules with benchmarks of actual household expenses derived independently, such as those compiled by the U.S. Bureau of Labor Statistics. We would agree with that approach.*

Page 24 PREV PAGE TOP OF DOC

As for future income, nobody (including the debtor) can know with certainty what will happen to the debtor's income over the 5 years subsequent to filing a petition. Certainly, a practical repayment plan ought to incorporate an income cushion to buffer the plan against unexpected expenses. Repayment plans should also contain re-write contingencies to adjust for potential income interruptions. In pointing out the need for both contingencies when implementing a repayment plan the GAO belabors the obvious. Nevertheless, until such time as the debtor's income does change from the level stated on the petition, our calculations reflect the best estimate available to the court of

each debtor's ongoing payment capacity.

C. Ernst and Young/Visa Petition Analyses

In its final commentary, the GAO stated that "We continue to believe that the concerns we found strongly suggest that additional research and clarification are needed to determine the accuracy of the Center report's conclusions . . ." (p. 19). In recent weeks two additional studies of petitioner capacity to repay have been released. Both were commissioned by Visa, U.S.A and both were conducted by the accounting firm of Ernst and Young. *In each case the results strongly corroborate our findings.*

The first study (February, 1998) focused on a sample of 5,722 Chapter 7 bankruptcy petitions filed in four bankruptcy courts (Boston, Chicago, Los Angeles, and Nashville), primarily during 1992 and 1993. The Ernst and Young research team replicated the calculations we used in the CRC study and found that repayment ability was somewhat higher in their own sample. For example, where we had found that 25 percent of Chapter 7 debtors could repay 30 percent or more of their non-housing debts over a 5-year period, Ernst and Young found that the top 25 percent could pay, on average, 45 percent of their non-housing debts over a 5-year period (See Figure 2).

Page 25 PREV PAGE TOP OF DOC

The second study (March, 1998) was specifically designed to satisfy the GAO's statistical criteria for a nationally representative sample. Ernst and Young obtained a national sample of over 2,100 bankruptcy petitions filed throughout 1997 in 90 bankruptcy districts. Because that report was released just in the past few days, we have not yet had an opportunity (or the data) to conduct detailed comparisons with our own work.

However, because both Ernst and Young studies conducted a simulation of the impact of the "Bankruptcy Reform Act of 1998" (H.R. 3150), the results offer a basis for comparison if we conduct the same simulation with our own data. Table 6 displays results that are strikingly similar across the three data bases. Using the criteria for needs-based bankruptcy as set forth in H.R. 3150, between 12 and 15 percent of Chapter 7 debtors *in each of the three samples* would be impacted by the needs-based provision of H.R. 3150 (See Figure 3). Of course, only the most recent Ernst and Young results was designed to make statistically valid national projections of the proportion of Chapter 7 debtors with repayment capacity. However, the similarity across the three data bases in outcomes triggered by the specific set of "needs-based" criteria set forth in H.R. 3150 suggests that many of the *hypothetical* sources of sample bias in the CRC data (i.e., city location, time of the year, day of the month) about which the GAO speculated in fact did not distort our calculations of repayment capacity.

CONCLUSIONS

At the outset of my statement I noted that opponents to needs-based reform doubt that there are more than a trivial number of debtors in Chapter 7 who could fund meaningful repayment plans. I believe that empirical research has established that debtors with the means to repay are filing for Chapter 7 in sufficient numbers to be worrisome. Each of three distinct and independent data bases found that many debtors who filed under Chapter 7 had income to repay a significant portion of their debts over a 5-year period. *The nationally representative Ernst and Young sample indicates that 150,000 Chapter 7 filers during 1997 had the capacity to pay over $4 billion on their unsecured debts had they been required to enter a 5-year Chapter 13 repayment plan.* Of course, these costs are ultimately passed along to the vast majority of consumers who handle credit responsibly.

Page 26 PREV PAGE TOP OF DOC

Whether referred to as "needs-based-bankruptcy" or by some other label, the concept of limiting the Chapter 7 discharge to those who truly need it is an idea whose time has clearly arrived. By offering the lure of a Chapter 7 discharge without a demonstration of need, the present bankruptcy system does little to encourage the responsible use of credit.

We are all worried about the dramatic and continued rise in the number of bankruptcy filings. Bankruptcy is a complex phenomenon with many causes, only a few of which can be addressed through the bankruptcy statutes themselves. Incorporating a needs-based eligibility requirement into the existing bankruptcy system will probably not reduce the annual number of filings to the levels we experienced a decade ago. However, if Congress desires to curb the growth in bankruptcies at the same time preserving access to credit for those financially vulnerable households who need it most, I believe that incorporating a needs-based approach is the single most effective step that can be taken toward that goal.

A needs-based approach that utilizes well-defined criteria to clearly signal how the court will treat a given debtor has much to commend it. Well-defined eligibility standards streamline the administration, promote consistent treatment, and reduce costly litigation. A needs-based system would preserve the industry's incentive to make credit available, but also to lend prudently by differentiating between consumers who can pay and those who can't. It preserves bankruptcy relief for those debtors who truly can't pay. And, it bolsters consumer incentives to use credit cautiously by removing the temptation of a free ride for those who can pay but would choose not to.

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

Page 27 PREV PAGE TOP OF DOC

INSERT OFFSET RING FOLIOS 1 TO 4 **HERE**

Mr. **GEKAS.** We thank the gentleman.

We also welcome to the witness table the phantom witness, Mr. Jenkins, who I suppose is here with Mr. Stana.

STATEMENT OF RICHARD M. STANA, ASSOCIATE DIRECTOR, ADMINISTRATION OF JUSTICE ISSUES, U.S. GENERAL ACCOUNTING OFFICE

Mr. **STANA.** Good morning, Mr. Chairman and members of the subcommittee.

My name is Rich Stana. I am the Associate Director for Administration of Justice Issues at the GAO. As you noted, Mr. Chairman, with me today is Dr. Bill Jenkins, who was a primary contributor to our analysis of the Credit Research Center study, a report on which we just issued to the Senate Judiciary Committee last month.

I am pleased to be here today to discuss the results of our review of the Credit Research Center's report on personal bankruptcy debtors' ability to pay their debts and share with your our observations on the recent Ernst & Young reports that also examine debtors' ability to pay. These reports are a useful first step in addressing a major public policy issue, that is, 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.

Page 28 PREV PAGE TOP OF DOC

Specifically, we were requested to evaluate each report's research methodology and formula for estimating the income that debtors have available to pay debts. Our February 9, 1998 report provided the results of our more extensive review of the Center report Dr. Staten mentioned. Our observations on the Ernst & Young studies are based solely on our analysis of the published reports, the last of which we just received the day before yesterday.

Our overall conclusion is that the assumptions and data used in these reports raise questions concerning the accuracy of the reports' estimates and require the reader to use caution in interpreting the reports' conclusions. None of the reports provide reliable answers to the questions: How many debtors could make summary payments? And how much debt they could pay over a 5-year period? The actual number of Chapter 7 debtors who could repay at least a portion of their non-housing debt could be more or less than the estimates reported in these studies. Similarly, the amount of debt these debtors could potentially repay could also be more or less than the reports estimated.

Let me turn now to our major observations. It is important to note that the findings of both the Center report and the Ernst & Young reports rest on fundamental assumptions that have not been validated. These studies share two fundamental assumptions: first, that the information found on debtors' initial schedules of estimated income, estimated expenses, and debts was accurate; and second, 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, these reports use the same type of data, that is, bankruptcy petitioners' initial schedules of estimated income, estimated expenses, and debts. The accuracy of this data is unknown. However, the reports assume that the data in these schedules are accurate.

Page 29 PREV PAGE TOP OF DOC

These reports also state that to the extent the data in the schedules were not accurate, the data would probably understate the income debtors have available for repayment. This reflected the researcher's 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 the extent to which this happens. 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 debt with a net unknown bias in the aggregate data reported by all debtors.

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 relative to one another for a 5-year period following the filing of their bankruptcy petition. None of the reports allowed for situations in which the debtor's income decreases or expenses increase during the 5-year period. In either case, a debtor's ability to repay debt could significantly be affected.

Two other assumptions are made in these reports that could result in an overestimation of debt repayment. Implicitly, the debt repayment estimates of these reports assume 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 plan. Past experience suggests that not all future Chapter 13 debtors will successfully complete their repayment plan.

Page 30 PREV PAGE TOP OF DOC

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 Chapter 13 cases terminated over a 10-year period had been successfully completed. The remaining 64 percent were dismissed or converted to Chapter 7 liquidation in which all eligible debts were discharged. The reasons for the low completion rate are unknown, but this illustrates the high level of discrepancy between the amount the debtors could potentially repay based on assumptions used in these reports, and what has occurred over a 10-year period.

Another assumption made in these reports is that 100 percent of debtors' net 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 debtor's progress in implementing the plan and review of the debtor's or creditor's request 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 repay administrative costs such as statutory fees and debtor attorney fees. In addition, none of the studies addressed the additional cost to the Government for judges and administrative support requirements that would be incurred should more debtors file under Chapter 13.

In our prepared statement and our report on the Center study, we discuss other factors that, taken together, would suggest caution in interpreting the results of these studies.

Page 31 PREV PAGE TOP OF DOC

To conclude my oral statement, let me say that we agree that there are likely some debtors who file for bankruptcy under Chapter 7 who have the financial ability to repay at least a portion of their debt, and that those who are able to repay their debts should do so. But we believe that more research is needed to verify and refine the estimates of debtors' repayment capacity to better inform policy makers.

Mr. Chairman, Bill and I would be happy to answer any questions you or other members of the subcommittee may have.

[The prepared statement of Mr. Stana follows:]

PREPARED STATEMENT OF RICHARD M. STANA, ASSOCIATE DIRECTOR, ADMINISTRATION OF JUSTICE ISSUES, U.S. GENERAL ACCOUNTING OFFICE

PERSONAL BANKRUPTCY: THE CREDIT RESEARCH CENTER AND ERNST & YOUNG REPORTS ON DEBTORS' ABILITY TO PAY

Summary

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.

Page 32 PREV PAGE TOP OF DOC

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.

Page 33 PREV PAGE TOP OF DOC

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.

Introduction

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(see footnote 1) on personal bankruptcy debtors' ability to pay their debts and share with you our observations on the February 1998 Ernst & Young report(see footnote 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.(see footnote 3)

Page 34 PREV PAGE TOP OF DOC

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.(see footnote 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(see footnote 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 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.

Page 35 PREV PAGE TOP OF DOC

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.(see footnote 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.(see footnote 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.

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.

Page 36 PREV PAGE TOP OF DOC

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.

Page 37 PREV PAGE TOP OF DOC

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.

Page 38 PREV PAGE TOP OF DOC

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.

Page 39 PREV PAGE TOP OF DOC

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.

Page 40 PREV PAGE TOP OF DOC

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.

Page 41 PREV PAGE TOP OF DOC

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.

Mr. **GEKAS.** We thank the gentleman and will turn to Dr. Neubig.

Page 42 PREV PAGE TOP OF DOC

STATEMENT OF THOMAS S. NEUBIG, PARTNER AND NATIONAL DIRECTOR, POLICY ECONOMICS AND QUANTITATIVE ANALYSIS, ERNST & YOUNG, LLP, WASHINGTON, DC

Mr. **NEUBIG.** Mr. Chairman and members of the subcommittee, I am the National Director of Ernst & Young's Policy Economics and Quantitative Analysis Group. I appreciate the opportunity to present our findings on a new Ernst & Young study on Chapter 7 filers' ability to repay.

The personal bankruptcy reform legislation you are considering is very similar to prior reforms in the tax law, which are often influenced by personal anecdotes, but where detailed distributional data and policy simulation analysis is critical to sound policy. The lack of a nationally representative study has been characterized as a limitation to prior policy analyses of personal bankruptcy. That limitation has now been removed.

Thus, we are able to evaluate what effect the needs-based provision of H.R. 3150 would have had on Chapter 7 filers in 1997. We did not quantify the effects of other provisions of H.R. 3150, which are also designed to reduce bankruptcy losses.

I would like to highlight the study findings and if I could refer to the graph on my left. This shows that if H.R. 3150's needs-based provision had been applied to the bankruptcy information supplied by the petitioners in 1997, we found that 53 percent of Chapter 7 filers had gross income below 75 percent of the national median income. Another 32 percent did not meet the net income and repayment test. Thus, 85 percent of Chapter 7 filers would not have been affected at all by H.R. 3150's needs-based provision, and therefore would have continued to have been eligible for debt relief under Chapter 7 in 1997.

Page 43 PREV PAGE TOP OF DOC

Based on the nationally representative study, we can confidently predict that if the needs-based provision test had been in effect in 1997 and applied to the petitioners' information supplied, 15 percent of Chapter 7 filers, with a margin of error of plus or minus 2 percent, would have been required to file a Chapter 13 repayment plan. That represents 150,000 individuals who would meet the income and repayment test.

These 150,000 filers, with enough income and enough ability to repay, could potentially repay over $4 billion of their unsecured non-priority debt under a 5-year repayment plan based on their current income. Actual repayments, of course, would depend on their circumstances during the next 5 years. Based on their current income, these impacted filers could repay an average 64 percent of their unsecured non-priority debts. This is after paying all secured debt payments such as a mortgage and auto loans, after paying priority debts such as alimony, child support, and back taxes, and after a living expense allowance currently used by the Federal Government.

The median amount of unsecured non-priority debt that these impacted filers could repay over 5 years would be as much as $21,700, which represents $360 per month. That represents on average less than 10 percent of these impacted filers' gross monthly income.

H.R. 3150's needs-based provision would impact principally higher income filers. Let me repeat. H.R. 3150's needs-based provision would impact principally higher income filers. As you can see on this chart, the median gross income of impacted filers was $45,000. That is 26 percent higher than the 1996 U.S. national median income for all families of $35,500.

Page 44 PREV PAGE TOP OF DOC

This new national study finds similar results to an Ernst & Young study of repayment ability of Chapter 7 filers during 1992 and 1993, and also the Georgetown Credit Research Center study of filers in 13 cities during 1996. The GAO, from their auditor perspective, has noted some "unvalidated assumptions" included in these calculations.

Dr. Scheuren will comment on this issue in more detail, but let me stress that the 15 percent figure of Chapter 7 filers who would have been impacted in 1997 is based on information available to the bankruptcy courts, and then simply applying the math involved in the needs-based calculation formula. The potential amount of debt repayments, of course, would depend on the filers' financial circumstances during the 5 years after bankruptcy.

Making assumptions in policy analysis is unavoidable, and it must be based on available information. Using debtors' current income provides policymakers with an estimate of potential debt repayments of over $4 billion annually, which can then be subject to sensitivity analysis. In my 18 years of doing policy analysis, I found it is more helpful to have estimates based on how a proposal would have applied in the past, or estimates of the future based on reasonable assumptions, rather than waiting to validate every assumption or shying away from making projections that are common in most policy decisions.

This new national study provides a sound basis for action on bankruptcy reform.

That concludes my testimony. I would be happy to answer any questions.

[The prepared statement of Drs. Neubig and Scheuren follows:]

Page 45 PREV PAGE TOP OF DOC

PREPARED STATEMENT OF THOMAS S. NEUBIG, PARTNER AND NATIONAL DIRECTOR, POLICY ECONOMICS AND QUANTITATIVE ANALYSIS, ERNST & YOUNG LLP, WASHINGTON, DC

Chapter 7 Bankruptcy Petitioners' Ability to Repay: the National Perspective, 1997(see footnote 8)

EXECUTIVE SUMMARY

This study analyzes the effects of the needs-based bankruptcy provision of the "Bankruptcy Reform Act of 1998" (H.R. 3150) on Chapter 7 filers. It is the first study to evaluate repayment capacity on a *national basis.*

The analysis is based on a stratified random sample that is statistically valid on a national basis for calendar year 1997. This sample is comprised of over 2,000 Chapter 7 bankruptcy petitions, which were selected from each of the 90 bankruptcy districts in the nation.

Key study findings are:

15 percent of 1997 Chapter 7 filers would have been impacted by the needs-based provision of H.R. 3150 and required to file Chapter 13. (See Chart 1).

These filers would have had the ability to repay 64 percent of their unsecured non-priority debts, which represents over $4 billion. These filers could have repaid $9 billion of total Chapter 7 debt. This assumes that income remained unchanged relative to expenses and liabilities during the 60 month repayment period.

Page 46 PREV PAGE TOP OF DOC

H.R. 3150 would impact higher income filers:

The median gross income of impacted filers was over two times that of Chapter 7 filers not impacted ($44,738 vs. $20,417), and was 26 percent higher than the 1996 U.S. national median income for all families ($35,492).

The needs-based bankruptcy provision in H.R. 3150 impacts petitioners with demonstrated ability to repay their debts. Petitioners with incomes above 75 percent of the national median (adjusted for family size) must enter a Chapter 13 repayment plan, if they can repay their secured and priority debt payments, living expenses calculated from the IRS Collection Financial Standards, plus at least $50 monthly and 20 percent of their unsecured non-priority debts within five years.

"The Official Committee record contains additional material here."

Strip offset folio 5 here

It is important to emphasize that this analysis only measures the needs-based provision of H.R. 3150. This pending House legislation contains numerous other provisions which will reduce bankruptcy losses. Quantifying the impact of these other provisions is beyond the scope of this study.

1. INTRODUCTION

Page 47 PREV PAGE TOP OF DOC

In 1997, personal bankruptcy filings were almost 1.4 million, an increase of about 20 percent from the previous year.(see footnote 9) The record levels of filings in recent years contrast sharply with the state of the overall economy, which has grown steadily and experienced low levels of unemployment and high consumer confidence. The dichotomy between the healthy economy and the number of filings has focused attention on current bankruptcy laws. Reform proposals are being considered by Congress, and their impact on the number of bankruptcy filers and debt repayment in the bankruptcy system are important factors to consider in the public policy debate.

While several previous research studies have investigated petitioner repayment capacity, this is the first study that evaluates repayment capacity comprehensively on a *national basis.* The new national database of 1997 bankruptcy petitions, herein referred to as the "1997 Visa national bankruptcy database" includes more than 2,000 Chapter 7 filers. The study calculates the effects of the needs-based bankruptcy provision of H.R. 3150, the "Bankruptcy Reform Act of

1998." The analysis also replicates our own earlier work in four bankruptcy courts (Ernst & Young, 1998)(see footnote 10) using petitions filed mainly during 1992 and 1993.

The needs-based provision of H.R. 3150 requires Chapter 7 petitioners with incomes above 75 percent of the national median adjusted for family size(see footnote 11) to file under Chapter 13, if they can repay at least $50 monthly and 20 percent of their unsecured non-priority debts within 5 years, after making secured and priority debt payments and paying for living expenses. If the law had been in effect in 1997, 15 percent of U.S. Chapter 7 filers would have been impacted by the needs-based provision and required to file Chapter 13.(see footnote 12)

Page 48 PREV PAGE TOP OF DOC

This study is divided into four sections, beginning with this introduction (Section 1), plus three appendices. Section 2 gives a general description of the 1997 Visa national bankruptcy database. Section 3 presents key findings about the impact of the needs-based provision. This is followed by concluding comments in Section 4. Appendix 1 summarizes important consumer bankruptcy provisions of H.R. 3150. Appendix 2 provides a detailed description of the data collection methods employed and discusses data limitations. Calculation details on repayment ability under the needs-based provision of H.R. 3150 are presented in Appendix 3.

2. DESCRIPTION OF THE 1997 VISA NATIONAL BANKRUPTCY DATABASE

Since 1995, as a service to its member financial institutions, Visa has maintained a national bankruptcy notification service (BNS) which records virtually all non-business bankruptcy filings. Chart 2 shows the number of filings from this source over the period 1995–97. As can be seen, the number of bankruptcies has grown rapidly for the last three years.

This study began by taking a sample from the 1997 BNS, which included all 11 federal court circuits and 90 districts. The sample was drawn in two stages: the first stage sample was extracted into a computer file by Visa, based on Ernst & Young's specifications; the second stage sample was randomly selected from this file by Ernst & Young statisticians.(see footnote 13)

The first stage sample was designed to have sample sizes of approximately 500 Chapter 7 petitioners for each of the 90 districts in the United States.(see footnote 14) This sample of 43,730 cases was drawn randomly in each district to ensure that the monthly sample was proportionate to the actual monthly volume in that district. The second stage sample consisted of about 2,200 petitions, 200 of which were Chapter 7 asset cases.(see footnote 15)

Page 49 PREV PAGE TOP OF DOC

In the second stage sample, the district sample sizes were determined by allocating the total sample in proportion to each district's volume within each month of filing. This was supplemented by sampling additional observations from the smallest districts, so that each had a minimum of about a dozen cases.(see footnote 16) Table 1 shows the distribution of petitions by chapter that were finally selected in the first and second stages of sampling.

INSERT OFFSET RING FOLIO 6 **HERE**

Table 1

The U.S. bankruptcy courts were the source for all of the petitions obtained for the 1997 sample database. A listing of the cases to be included in the final sample was sent to an outside vendor who obtained the designated petitions from the applicable court. The petitions obtained were then copied and transmitted for data entry at Visa, where virtually all of the information on the petitions was captured. During the data gathering process, Ernst & Young monitored all steps—including selecting a subsample of cases for independent reprocessing.

The sampling was highly successful. One indication of this is shown in Table 2, which connects the sample to the population about which inferences are to be made. Columns 1 and 2 show the total number of 1997 Chapter 7 petitions by circuit, first as obtained from BNS (Column 1), and then as obtained from official sources (Column 2).(see footnote 17) Column 3 shows the universe of 1997 petition filings after eliminating cases estimated to be dismissed.(see footnote 18) Column 4, designated "Final Selected Sample," corresponds to the "second stage sample" discussed earlier and summarized in Table 1. The last column of the table, Column 5, consists of the sample determined usable.(see footnote 19) The differences between Column 4 and 5 are quite small; on an overall basis, the usable sample was about 97 percent of the size of that selected.

Page 50 PREV PAGE TOP OF DOC

Table 2

3. KEY FINDINGS

The analysis in this section focuses only on the needs-based provision of H.R. 3150, which requires petitioners with monthly income of at least 75 percent of the national median for families of comparable size to file under Chapter 13, if they have "monthly net income" of at least $50 and the capacity to repay 20 percent or more of their unsecured non-priority debts within 5 years, after paying living expenses and making secured and priority debt payments.(see footnote 20)

Share of Filers Impacted

The share of 1997 Chapter 7 filers impacted by the needs-based provision of H.R. 3150 is shown in Table 3. As shown, 15 percent of 1997 Chapter 7 filers would have been required to file under Chapter 13, if H.R 3150's needs-based bankruptcy provision had been in effect in 1997.

H.R. 3150 requires that petitioners filing for bankruptcy calculate several tests to determine under which chapter of the bankruptcy code they will be able to file. Chart 3 shows the cumulative percentage of filers impacted by each of the criteria used to determine a petitioner's need for relief under the proposed legislation. As shown:

47 percent of 1997 Chapter 7 filers would have had income above 75 percent of the national median;

Page 51 PREV PAGE TOP OF DOC

17 percent of filers would have had income above 75 percent of the national median and net monthly income in excess of $50.

15 percent of 1997 Chapter 7 filers would have met both these income tests and could have repaid 20 percent or more of their unsecured non-priority debt over five years.

INSERT OFFSET RING FOLIOS 7 **HERE**

Debt Repayment Capacity

The 1997 Chapter 7 filers impacted by H.R. 3150 would have had the ability to repay 60 percent of their total debts, if income remained unchanged relative to expenses and liabilities during the 60 month repayment period.(see footnote 21) When broken down by type, the corresponding repayment figures are 56 percent for secured and priority debt owed and 64 percent for unsecured non-priority debt owed. These figures are shown in Table 3.

In dollar terms, the amounts of debt repayable by filers impacted by the needs-based provision in 1997 are $5 billion in secured and priority debt repaid, and $4 billion in unsecured non-priority debt repaid. In other words, the 15 percent

of Chapter 7 filers impacted could repay about $9 billion of the $74 billion (or 12 percent) of total Chapter 7 debt at risk. More details on the distribution of repayment ability across debtors are provided in Table 4.

Table 3

Table 4

Debt and Income Profiles of Filers Impacted and Not Impacted Under H.R. 3150

Page 52 PREV PAGE TOP OF DOC

Filers impacted in 1997 under H.R. 3150 had median incomes ($44,738) considerably above the 1996 national median income ($35,492) for all households (U.S. Bureau of the Census, 1997). Filers not impacted by the provision earned less than half at the median ($20,417) of that earned by filers impacted. In addition, filers impacted had more unsecured non-priority debt ($30,813 at the median) than filers not impacted ($23,570 at the median). Chart 4 displays these results. Not surprisingly, impacted filers also had higher repayment capacity than the typical Chapter 7 filer: the median amount of unsecured non-priority debt that impacted filers could repay over five years was $21,679; the comparable figure for all Chapter 7 filers was zero.

"The Official Committee record contains additional material here."

Strip offset folio 8 here

Comparison with Other Studies

The results of this study are consistent with several recently released studies, for example the finding of an earlier Ernst & Young analysis that 12 percent of 1992/93 Chapter 7 filers in four court districts would have been impacted by the needs-based provision had it been in effect at the time.(see footnote 22) Both also corroborate the Georgetown study's conclusion that "a sizable minority of Chapter 7 debtors could make a significant contribution toward repayment of their non-housing debt over a five year period."(see footnote 23) The cumulative weight of all three studies supports a consistent finding: that a significant share of Chapter 7 filers have the ability to repay a substantial portion of their debts.

Page 53 PREV PAGE TOP OF DOC

The 1997 nationally representative sample was used to estimate the total amount of Chapter 7 debt in the bankruptcy system. These estimates, along with similar estimates from another study (WEFA, 1998) are presented in Chart 5. The new estimates appear similar to the WEFA estimates. If anything, the new data suggests that the WEFA estimates may have understated the amount of debt in the system, and consequently, may have underestimated the financial costs of the personal bankruptcy system. Our study estimates that the total amount of Chapter 7 debt in the bankruptcy system from 1997 filings is $74 billion.

"The Official Committee record contains additional material here."

Strip offset folio 9 here

Issues of Interpretation

The following points about the analysis of the impact of the needs-based provision contained in H.R. 3150 should be noted:(see footnote 24)

(1) As defined by H.R. 3150, the repayment calculations assume all secured and priority debt(see footnote 25) is paid

first, whether reaffirmed or not. The remaining repayment ability of the debtor is stated as a share of total unsecured non-priority debt.

(2) The calculations use petition data submitted by petitioners—that is, all data were taken from the actual petitions, as filed by debtors. While submitted under oath, these data are unaudited, unless the petition is challenged by a creditor or trustee. Chapter 7 filers may have an incentive to exaggerate their financial distress by overstating expenses and understating income.

Page 54 PREV PAGE TOP OF DOC

(3) H.R. 3150 provides that Chapter 13 plans can be adjusted over the repayment period to reflect changes in circumstances. However, to "score" the proposed legislation, the repayment calculations assume that the petitioners' future income relative to expenses and liabilities during the five year period is the same as their current income as reported on the bankruptcy petition. For petitioners whose income relative to expenses and liabilities increases over the five year period, this assumption would underestimate repayment ability. Conversely, the assumption would overestimate the repayment ability of petitioners whose income relative to expenses and liabilities declines during the five year period.(see footnote 26)

(4) The repayment calculations do not include potential administrative costs incurred in repaying debt. While these costs could somewhat reduce repayment ability, many administrative costs (i.e., filing and attorney fees) are incurred before the petitioner files for bankruptcy protection. Furthermore, if H.R. 3150 were implemented, some debtors may likely choose not to file for bankruptcy at all (thus reducing administrative expenses) because repayment is required for debtors with an ability to repay debts. On balance, therefore, net administrative costs might not increase materially. This issue is discussed more fully in Appendix 2.

4. CONCLUDING COMMENTS

The results presented in this report indicate that a significant share of 1997 U.S. Chapter 7 filers had the ability to repay large portions of their debts. In particular, this study shows that:

Page 55 PREV PAGE TOP OF DOC

About 15 percent of 1997 Chapter 7 filers would have been impacted by the needs-based provision of H.R. 3150, had it been in effect in 1997.

These filers could have repaid 60 percent of their total debts over five years. When broken down by type of debt for filers impacted, the corresponding repayment figures are 56 percent for secured and priority debt owed, and 64 percent for unsecured non-priority debt.

An estimated $9 billion of Chapter 7 debt could have been repaid within five years by the filers impacted.

Filers who would have been impacted by H.R. 3150's needs-based provision had relatively higher incomes:

Impacted filers had median gross annual income of $44,738, compared to $20,417 for those unaffected.

Impacted filers also had more unsecured non-priority debt ($30,813 at the median) than those not impacted ($23,570 at the median).

The 1997 findings corroborate several earlier studies using different databases and different methodologies. Taken together with this earlier work, the new 1997 Visa national bankruptcy database should be a sound basis for action on bankruptcy reform.

APPENDIX 1: MAIN CONSUMER BANKRUPTCY PROVISIONS OF H.R. 3150

Page 56 PREV PAGE TOP OF DOC

This report was limited to analyzing the impact of the needs-based provision of H.R. 3150. Quantifying the impact of other provisions is beyond the scope of this study. For informational purposes, however, a summary of some of the provisions of H.R. 3150 designed to reduce losses due to bankruptcy is provided in Table 5.

Table 5

APPENDIX 2. PROCESS MANAGEMENT AND DATA LIMITATIONS

The database used in this study was constructed with considerable care. As in virtually all empirical investigations, there are potential sampling and nonsampling issues.(see footnote 27) This appendix presents the approach to the management of these issues. Where possible, the impact of our approach has been quantified.

Management of the data capture and related analyses consisted of a number of interlocking steps that began with error prevention activities. These were followed up (as needed) with a quick response when problems arose, and "fail-safe" analysis methods(see footnote 28) that recognized a few errors would remain despite all reasonable efforts to eliminate them. Wherever possible, measurements were made to guide in the management of the process and to quantify remaining limitations.

Process Management

Space does not permit a full discussion of all the management steps taken. However, two examples are reflective of the degree to which care was taken: the process of obtaining petitions, and controls over the quality of the data entry operation.

Page 57 PREV PAGE TOP OF DOC

(1) Obtaining Petitions

The vendor who secured copies of the selected petitions was given financial incentives to obtain them on a very tight schedule. Vendor performance was also monitored closely throughout processing. As it turned out, all but a handful of the over 2,000 second stage sample cases contracted for were obtained.(see footnote 29)

Unavoidably, some petitions could not be found. To the extent possible in these cases, random selections were substituted from the larger first stage sample.(see footnote 30) To keep tight control on substitutions, the vendor who was securing the petitions had to come back and request each substitute, one by one, providing a reason why it was not available. There were 90 such cases in all, or only four percent of the final sample, for which substitutes were needed. The biggest group of cases needing substitutes were petitions that had been sent to be archived but which had not yet been shelved (39). Some petitions (11) simply could not be found at the court,(see footnote 31) while the rest were not available for various other reasons.(see footnote 32)

It should noted that using substitutions is not entirely desirable. Ironically, it can cause some reduction in quality, if the effort to obtain the original is lessened—something we are virtually certain did not occur here (because of the incentive structure, among other reasons). Still, the substitute can only, at best, reduce the variance impact of not being able to use the original case.(see footnote 33) A bias impact remains. In this instance, the low rate of substitution suggests that such a bias is not important at the national level. For some districts, though, it may be a factor. This is why our impact analyses are confined to the national level.

Page 58 PREV PAGE TOP OF DOC

(2) Data Entry Process

Petition data entry was performed in Paradox.(see footnote 34) The Paradox data entry form included built-in field checks for each item, using the following methods: reasonable range checks for each entry, table-driven valid responses for each entry, and the checking of summation fields(see footnote 35) against the individual items entered for expenses, income, assets, secured debt, and unsecured debt.

A daily regimen for the data processing was constructed that incorporated checks and balances at each step. Each day, as petitions were received for data entry, they were manually counted and stamped with a control number, then entered into a control file containing the information that was used to select the original sample cases. Data on the completeness of the received petitions were recorded at this stage. All petitions with the exception of the "Face Sheet Only" petitions were then assigned to a keyer in sequential order.(see footnote 36) Keyers would work through their assigned petitions, averaging about 15 per day.

Since editing was built directly into data entry, inconsistencies could be reviewed by the keyers as they proceeded. When an inconsistency occurred, the keyer was instructed to review the entered data and make sure that what he or she had captured was what appeared on the petition. *Inconsistencies in the petitions, as filed, were not changed.* (See (2) in "Data Limitations" section below).

An ongoing management review of petitions took place during data entry—including additional reviews conducted to address problems of interpretation. At the end of each day, a second validity check was performed that identified each petition for which any of the 40 logical (or "cross-foot") tests failed. For failed tests, the data were reviewed and any data entry mistakes corrected. In addition, between five and ten percent of all petitions were reviewed for errors on a keystroke by keystroke basis. After this additional checking was completed, the cases for that day were transmitted electronically to Ernst & Young where an independent daily quality sample was selected for reprocessing. This sample was designed to measure the quality achieved, but it also provided insights that aided the ongoing operation. Any additional errors uncovered in this independent quality review were also corrected.

Page 59 PREV PAGE TOP OF DOC

Data Limitations

Despite the care(see footnote 37) taken in developing the 1997 Visa national bankruptcy database, potential issues with the data should be noted. These include: (1) errors arising due to undercoverage and unavailable or unusable petitions; (2) missing information and reporting errors; (3) undetected data entry errors; and (4) sampling errors. Each of these is addressed below and, where possible, their importance is quantified.

(1) Errors due to undercoverage and unavailable or unusable petitions

Table 2, presented earlier, provides a summary of the net undercoverage believed to exist in the Visa bankruptcy notification service (BNS) database from which the selections were drawn. This difference is estimated at under three percent and, in our view, is not a serious limitation. There is, however, some unevenness across the country, which has partially been addressed in the sample weighting.

To weight the sample, selection rates, r_f, were calculated for each case. These first stage rates were obtained basically as the ratio of the first stage sample (usually about 500), divided by the total number of Chapter 7 bankruptcy petitions in each of the 90 districts in the study. To get the second stage sample, subsampling rates, r_s, were applied initially, so as to obtain a self-weighting sample of petitions, stratified by district. The no-asset sample obtained at this point was judged too small and its selection rate for the second stage was doubled, thus obtaining more asset cases. The district-by-district samples were examined and also increased (to get at least 12 cases in the smaller districts). Finally, because the overall sample was judged too large, it was thinned slightly by systematically subsampling the cases chosen at this point to arrive at the 2,220 cases for which petitions were sought. To obtain the overall probability of a case, denoted p_i, it is necessary to recognize each of the sampling rates involved. Algebraically, this meant calculating

the p**i** as p**i** = (r**f** * r**s** * r**t**), where the r**f** or first stage rates were defined by district, the r**s** or subsampling rates depended again on the district and also on whether the case was an asset or no-asset case. To complete the calculation, the rate at which the sample thinning took place, r**t**, was applied. Knowing these probabilities, it is possible to properly account for the appropriate role each case in the sample should have in making the national estimate.

Page 60 PREV PAGE TOP OF DOC

Our handling of dismissed petitions is presented in Table 2. At just over one percent, dismissals also appear to be unimportant. We will have to wait for the official numbers to be available to be sure, but they are almost certain to have little or no effect on the broad conclusions in this report.(see footnote 38)

Unavailable petitions were replaced for the most part to minimize the variance impact that their omission would otherwise represent. The remaining shortfall in petitions, after allowing for substitutions, was very small (at under three percent); hence, one can feel comfortable in asserting that, even though not all the original selections were obtained, this should have no material effect on the national results presented in this study.

Only a very few petitions (27) proved too incomplete to be used in the analysis of the proposed legislation. Most of these were "face sheet only" cases; the few others did not have usable debt or income information. While more research might be done here, it is our belief is that such cases have no material impact on the conclusions of this study.

In any case, for this study, we took the usable sample, shown in column 5 of Table 2, and first a weight for each case was given, w**i**, determined by the inverse of the probability, p**i**, of its selection that is, the initial case weight was w**i** = 1/p**i**. The second step was to take the weighted sample and aggregate it by circuit. To handle missing petitions, and to reduce coverage and nonresponse bias and variance effects, the weighted sample totals were then ratio adjusted to the population totals for all 1997 Chapter 7 bankruptcies, as shown in column 3 of Table 2. The ratio adjustment factors, f**i**, calculated in this way, were then used in deriving the final weights, W**i** = f**i** * w**i**.(see footnote 39)

Page 61 PREV PAGE TOP OF DOC

(2) Missing information and reporting errors on the petitions used

The petitions are complex legal documents sworn to under oath. During processing, they were found to be generally complete. Most of the needed income information was available, for example.(see footnote 40) Very few petitions had to be discarded as unusable, as noted above. Sometimes petitions, though, were internally inconsistent, due to issues such as summary schedules that did not agree with detailed schedules. When inconsistencies arose, we relied on the detailed schedules believing these to be generally more accurate. However, such internal inconsistencies occurred infrequently, and there were very few cases with internal inconsistencies in the sections of the petition used for the analysis of the needs-based provision.(see footnote 41)

All amendments that had been filed at the time of petition retrieval were obtained and entered. Overall, filed amendments occurred in very few petitions and were not significantly different than the original schedules filed. There were two types of amendments: (1) amendments that supplemented information on the petitions, such as additional pages about unsecured non-priority debts on Schedule F; and (2) amendments that replaced information originally provided on the petitions. In some cases, the amendments caused validity check failures since the summary of schedules was not always changed. As explained above, we relied on information on the revised individual schedules.

The repayment ability measures calculated for H.R. 3150 rest on a number of assumptions. These assumptions include taking reported information from the petitioners' statements at face value. These data are unaudited, unless the petition is challenged. As noted earlier, Chapter 7 filers may have an incentive to make themselves appear insolvent.

Page 62 PREV PAGE TOP OF DOC

An important omission, due to the nature of the petition filings, is that they do not contain any information on the

court's administrative expenses connected with the bankruptcy filing. However, except for the small fraction of Chapter 7 petitions that are asset cases, most significant administrative expenses are incurred before filing, and hence do not affect ability to repay debt after filing. In addition, expenses for no-asset cases tend to be minimal. For example, "Generally, Chapter 7 no-asset cases do not generate professional fees, trustee compensation, or expenses, and they do not take much of the judges' time. Trustees in no-asset cases receive $45 per case, which comes from the filing fee, which is paid by the debtor." (GAO, 1994)

For Chapter 7 asset cases, additional expenses are incurred that are not reflected here; however, only 5 percent of all Chapter 7 cases are of this type. For the vast majority of cases, therefore, not including administrative expenses seems to be a reasonable assumption. Because H.R. 3150 envisions the conversion of some Chapter 7 cases to Chapter 13, administrative expenses would necessarily rise for the petitions that are converted to Chapter 13. As noted earlier, the total net impact on administrative expenses may not be significant, however, as some petitioners may decide not to file for bankruptcy protection when repayment is required.

(3) Undetected data entry errors

As part of the due diligence that Ernst & Young carried out in this study, a daily quality sample was selected, based on the previous day's petition data entry.(see footnote 42) Copies of the selected petitions were then expressed to Ernst & Young, where two kinds of review were carried out. For most items involved in the calculation of the repayability ratio, Ernst & Young independently re-entered the applicable fields. A computer match was then done and if there happened to be a discrepancy between the two variables, the actual petition would be consulted to determine who was in error. Inconsistencies were counted on a petition, variable, and keystroke level and three separate run charts were produced regularly which displayed error rates by day.(see footnote 43) Chart 6 provides an example of a typical run chart for variable inconsistencies.

Page 63 PREV PAGE TOP OF DOC

"The Official Committee record contains additional material here."

Strip offset folio 10 here

Chart 6 shows that the variable inconsistency rate hovered around one percent, except on January 26, when it shot up to 9 percent—an anomaly that was immediately resolved. Variable inconsistencies fluctuated the least because keystroke errors tended to occur within one variable, thus the inconsistency rate was not inflated if there was an abundance of keystroke errors. Petition level inconsistency rates were also less useful, because any given petition had numerous chances to have at least one inconsistency. In any case, over the whole data entry process, the estimated undetected data entry inconsistency rate was found to be 1.3 percent on a per-variable basis. The inconsistencies exhibited no systematic pattern; in fact, because the inconsistencies tended to cancel each other out, the mistakes are likely to have little, if any, discernible effect on the repayability calculations (beyond that, as later discussed, already being measured by sampling error).

A second review of the sample of petitions was also conducted. This broader review looked at other parts of the data entry process, rather than focusing as directly on repayability. The idea was to spot check potential errors on the petition without going through the laborious process of re-entering every variable. For each day's sample, each of the schedules on the petition was reviewed twice at random. The hard copy of the petition was pulled and the analyst would compare the petition values to the selected keyed entries. Except for an instance when the data transmission was partially garbled (since resolved), the error rate measured in this process was quite small—less than one percent on a per variable basis.

Page 64 PREV PAGE TOP OF DOC

For both types of quality review, all detected data entry errors were corrected on the computer file used for this analysis.

While technically not an undetected error, it may be worth noting that the rate at which cross-foot data entry errors arose was just over one percent per cross-foot. These, of course, were all corrected. The bottom line here is that the data entry process was of very high quality and the resulting data and interpretations can be used safely for the analysis described in this report.

(4) Sampling errors

The sample of 1997 petitions is reasonably large and hence one would expect statistically stable results, especially for statistics like proportions and medians. For some other statistics, totals and means for instance, the results may be less stable, since the sample was not stratified by debt amount, so as to oversample petitions with very large debts.

To estimate the sampling error, we divided the sample into eleven random subsamples or "replicates," each structured as much as possible like the overall sample. This gives a ready way of seeing the variability in any statistic of interest. In particular, the margin of error calculations developed showed that the 95% confidence bounds for the fraction of debtors impacted was plus/minus 1.9%. As noted already that means we can be 95% sure that the true fraction (15%) of impacted debtors will lie in the interval from 13.1% to 16.9%. For the estimated total debt (60%) repayable under H.R. 3150, we can be 95% sure that the true percentage repayable for 1997 would lie between 55.7% and 64.3%. Similarly for secured and priority debt repayable the 95% confidence interval is between 49.9% and 62.1%; for unsecured non-priority debt repayable, between 57.9% and 70.1%.

Page 65 PREV PAGE TOP OF DOC

(5) Summary

In this section, sampling and nonsampling errors have been discussed at length. Most have been quantified in some way. Coverage issues were found to be small (see also Table 2); the same was true for missing or incomplete petitions and for data entry errors. The sampling margin of error measures, which are extremely important, are estimated to be small. Still remaining, however, is the question of the combined impact of all these errors. In our view, this overall impact is minor as well—probably not much larger, for technical reasons,(see footnote 44) than the sampling margin of error. We are quite satisfied, therefore, that the results presented in this report are sound.(see footnote 45)

APPENDIX 3. METHODOLOGY USED TO CALCULATE ABILITY TO REPAY DEBT UNDER H.R. 3150'S NEEDS-BASED BANKRUPTCY PROVISION

This appendix describes the methodology used to calculate repayment ability under the needs-based provision of H.R. 3150, as implemented given the data available.(see footnote 46)

Basic Calculation

The needs-based repayment measure is based on the following formulas:

1. Repayment Rate = Projected Monthly Net Income * 60/Unsecured Non-priority Debt

Page 66 PREV PAGE TOP OF DOC

2. Projected Monthly Net Income = Current Monthly Total Income– Monthly Expenses

3. Current Monthly Total Income(see footnote 47) = Current monthly income on Schedule I. For joint filers, income and deductions included spousal income and deductions.

4. Monthly Expenses = Transportation Expenses + Housing and Utility Expenses (for non-homeowners) + Mortgage Debt Service, Utility and Home Maintenance Payments (for homeowners) + Other Living Expenses + Other Necessary

Expenses + Secured Non-mortgage Debt Service Payments + Priority Debt Payments

The repayment ability as described above was calculated for households meeting the minimum income requirements specified by H.R. 3150, i.e., only households whose income exceeded 75 percent of 1996 median national income for families of comparable size as reported by the Census Bureau, and whose monthly income less expenses exceeded $50. While family size data is not currently required on bankruptcy petitions, family size was estimated and included in the database. For individual petitions, family size was determined by adding one to the number of dependents listed on Schedule I. For joint petitions, two was added to the number of dependents listed.

Unsecured non-priority debt includes finance company and personal loans, credit card loans, student loans, and other miscellaneous debts.

Expense Items

Page 67 PREV PAGE TOP OF DOC

The monthly expense items are described in detail below. The 1997 IRS National Collection Standards were used for food, housekeeping supplies, apparel & services, personal care products and services and miscellaneous expenses. Local IRS collection standards were used for housing, utilities and transportation expenses. (Internal Revenue Service, 1997).

(1) Housing and utility expenses

IRS standard expenses for housing and utilities are determined according to the county and family size. Since H.R. 3150's needs-based bankruptcy provision would allow the IRS standard expense in the absence of mortgage payments, non-homeowners(see footnote 48) were allowed the IRS standard housing and utility expense for the relevant county and estimated family size. Conversely, homeowners were allowed to deduct their mortgage payments (discussed below) home maintenance expenses, and utility expenses for electricity and heating, water, sewer and telephone, as reported on Schedule J.

(2) Transportation expenses

IRS standards for automobile operating costs and public transportation are determined by census region; there are also IRS standards for a number of large US cities. The reported county was used to assign petitioners' transportation expenses. If the county was in a metropolitan statistical area that contained one of the cities with separate IRS transportation expense, then the transportation expense for that city was used. Otherwise, the petitioner was assigned the transportation expense for the appropriate region. IRS transportation expenses also depend on the number of vehicles.(see footnote 49) IRS standards generally make allowance for necessary or income producing expenses. There is no information on the bankruptcy petitions indicating whether a petitioner's vehicle meets this test. Therefore, transportation expenses were assigned to petitioners based on the number of vehicles reported on the petition, regardless of whether or not all of the vehicles were necessary. The only exception made was for debtors with a family size of one who had more than one vehicle. In this case, it seems reasonable to allow transportation expenses based on one vehicle.

Page 68 PREV PAGE TOP OF DOC

(3) Other living expenses

The IRS national standards for living expenses include allowances for housekeeping supplies, apparel and services, personal care products and services, food, and miscellaneous items. These expenses are determined according to household gross monthly income and the number of individuals in the household. Accordingly, all petitioners were assigned these expenses based on their gross income and estimated family size.

(4) Other necessary expenses

The H.R. 3150 provision also allows filers to claim "other necessary expenses" based on IRS guidelines. Consistent with the needs-based bankruptcy provision, the following reported monthly expenses were deducted from monthly income: alimony, charity, child care, health insurance, medical expenses, taxes and payroll deductions (payroll taxes, social security, insurance, union dues, and other taxes not deducted from wages or included in home mortgage payments). All of these items were taken as reported *by the petitioner* on Schedules I and J. As a conservative approach, all charitable expenses were used, even though the IRS limits the type of charitable contributions which are allowed. Similarly, all taxes were used as listed on Schedule J. It is likely that some petitioners listed their monthly payments for back taxes on Schedule J. Such filers would have been allowed to deduct their monthly back tax payments twice: once as shown on Schedule J, and once on the basis of calculated monthly back tax payments based on amortization of priority debt (see section on "Priority and Secured Non–Mortgage Debt Payments" below). All of these conservative approaches tend to underestimate the amount of debt repayable under the needs-based provision.

Page 69 PREV PAGE TOP OF DOC

(5) Mortgage Debt Service, Utility and Home Maintenance Payments

As discussed in the section on housing and utility expenses above, mortgage debt payments were only allowed for homeowners. Two adjustments were made to the reported mortgage debt payment amount: (a) if income after non-debt-payment expenses was insufficient to make the entire mortgage payment reported, then the available income was used instead, and (b) if 85 percent of reported current monthly mortgage payments multiplied by 60 was greater than 110 percent of the outstanding mortgage debt, then the outstanding mortgage debt was repayable in less than 60 months, and the average monthly mortgage payment was calculated by dividing 110 percent of the outstanding balance by 60.(see footnote 50) In addition, homeowners were allowed utility expenses for electricity and heating, water, sewer and telephone, and home maintenance expenses for repairs and upkeep, as reported on Schedule J.

(6) Priority and Secured Non–Mortgage Debt Service Payments

Secured and priority debt was amortized over 60 months by dividing the total secured and priority debt by 60 (ten percent was added to outstanding amounts of secured non-mortgage debt and back taxes to allow for interest).(see footnote 51) H.R. 3150 allows for amortization of priority debt by dividing the outstanding priority debt by 60. Allowing for interest on back taxes is a conservative approach which underestimates the ability to repay debt under H.R. 3150.

References

Page 70 PREV PAGE TOP OF DOC

Administrative Office of the U.S. Courts (1998), "Calendar Year 1997 Shows Bankruptcy Filings Up 19 Percent Over 1996." (February 27).

Barron, J. and M. Staten. (1997) "Personal Bankruptcy: A Report on Petitioners' Ability-to-Pay," mimeo. Credit Research Center, Georgetown University. (October).

Chapman, D. (1983) "The Impact of Substitution on Survey Response" in *Incomplete Data in Sample Surveys,* Volume 2.

Ernst & Young. (1998) "Chapter 7 Bankruptcy Petitioners' Ability to Repay: Additional Evidence from Bankruptcy Petition Files." T. Neubig, F. Scheuren, G. Jaggi, and R. Lee. (February).

Falk, E., G. Jaggi, R. Lee, C. Lundquist, D. Lundquist, F. Scheuren, R. Towne, and L. Woodburn. "Methodology for Developing the 1997 Visa National Bankruptcy Database." To be presented at the 1998 Joint Statistical Society Meetings in Dallas.

Federal Reserve Board. (1997) *Federal Reserve Bulletin.* (December).

Hansen, M., W. Hurwitz, W, and W. Madow. (1953) *Sample Survey Methods and Theory* (Vol 1).

Internal Revenue Service. (1997) "Collection Financial Standards." *http://www.irs.ustreas.gov/prod/ind_info/coll_stds/*

United States Bureau of the Census. (1997). "Table H–11. Size of Household—Households by Median and Mean Income: 1967 to 1996." *http://www.census.gov/hhes/income/histinc/h11.html*

Page 71 PREV PAGE TOP OF DOC

United States Government Accounting Office (1998), "Personal Bankruptcy: The Credit Research Center Report on Debtors 'Ability to Pay." (February).

United States Government Accounting Office, "Bankruptcy Administration: Case Receipts Paid to Creditors and Professionals." (1994) GAO/GGD–94–173. (July).

Visa (1997). "Bankruptcy Petition Study," Visa Consumer Bankruptcy Reports, (June).

WEFA (1996). "Consumer Bankruptcy: Causes and Implications," Visa Consumer Bankruptcy Reports. (July).

WEFA (1998). "The Financial Costs of Bankruptcy" (February).

Mr. **GEKAS.** Thank you.

We will turn to Dr. Scheuren.

STATEMENT OF FRITZ J. SCHEUREN, ASSOCIATE NATIONAL TECHNICAL DIRECTOR, STATISTICAL SAMPLING, ERNST & YOUNG, LLP, WASHINGTON, DC

Mr. **SCHEUREN.** Mr. Chairman and members of the subcommittee, I am the head of Statistical Sampling at Ernst & Young. I also continue to teach statistics at George Washington University and have for over 10 years. Most of my experience, though, has been in the government, including 14 years as the Director of the Statistics Division at the IRS.

Page 72 PREV PAGE TOP OF DOC

You just heard from Dr. Neubig about the main results of our study. I want to highlight how our work has attempted to deal with the issues GAO raised about the methodology of previous bankruptcy petition studies.

GAO has raised the issue of projectability of previous petition studies because they were not national in scope or could be subject to seasonal effects. We completely addressed this by obtaining a statistically valid national sample of 1997 petitions filed throughout the entire calendar year.

The final Chapter 7 sample was large, comprising over 2,100 cases, stratified to obtain petitions from each of the 180 bankruptcy courts in the nation, spread out over each of the 12 months of 1997. As expected, given the large sample, the results are statistically reliable and may be used with confidence.

GAO has previously raised concerns about the quality and extent of data available from the petitions and how this limitation should be dealt with in policy analyses. We adequately addressed these concerns as far as possible. Nearly all the items on the petitions from all the schedules were captured for potential analysis. This makes our 1997 study not only the first ever national study, but also the most complete study ever done.

GAO did not explicitly raise concerns about the data capture quality of previous studies, but this, too, was an area in which we made extraordinary effort to achieve excellence. Ernst & Young monitored all data gathering steps, including selecting a subsample of cases for independent reprocessing. Several of us went to California to conduct on-site validation. Real-time feedback from our quality control was used to improve the operation and to quantify remaining limitations.

Page 73 PREV PAGE TOP OF DOC

GAO raised some concerns not only about how previous studies were constructed, but also about the quality of the underlying reporting by debtors on the petitions themselves. Naturally, when carrying out the 1997 study, we paid special attention to this. Frankly, we were surprised about how good the quality was, nothing like we were led to expect. Prior to our study, conventional wisdom seems to be largely based on anecdotal evidence. Our careful examination refutes that wisdom. Almost all the petitions were complete enough to use and were internally consistent. Any inaccuracies that may remain in the data on the petitions are unlikely to be an issue in the computation of ability to repay.

Three components determine the repayment calculation. Inaccurate expense data is likely to be of minor importance since so many of the components are determined by preset reasonable standards. If income numbers are inaccurate at all, it is plausible to conjecture that the inaccuracy is caused by debtors understating income on their petition so as to appear insolvent. To the extent that such inaccuracies exist, they would lead us to understate repayability. Finally, data about debts are likely to be accurate since debtors are seeking to discharge them. Thus, none of the components cause real concern.

As to GAO's remaining criticism about "unvalidated assumptions"—methinks they doth protest too much. As Dr. Neubig states in his testimony, assumptions are inherent in the policy process, especially assumptions about the future.

As for the data itself, the quality we found is comparable to what we used to obtain when I directed the statistical processing of tax returns for the Federal government—data that were extensively later for tax policy analysis.

Page 74 PREV PAGE TOP OF DOC

To summarize, the 1997 database used in our report was constructed with considerable care. In my professional opinion, moreover, we have more than adequately addressed GAO concerns with past studies and I am quite satisfied with the soundness of our own conclusions. Finally, as Dr. Neubig has just said, the new 1997 database should form a firm basis for action on bankruptcy reform.

Thank you for your time and attention.

Mr. **GEKAS.** We thank the gentleman and now will turn to a round of questions from the members of the subcommittee.

Joining us at the subcommittee bench is the gentleman from Tennessee, Mr. Bryant.

We will proceed with allotting to the Chair the customary 5 minutes for examination of the witnesses.

Dr. Staten, you said that the study on which you are reporting was of a mere 4,000 consumers who filed for bankruptcy in 1996. Is that correct?

Mr. **STATEN.** That's correct.

Mr. **GEKAS.** So you took the results from that and found X percentage could repay some portion of the debt of those 4,000. Is that correct?

Page 75 PREV PAGE TOP OF DOC

Mr. **STATEN.** Yes.

Mr. **GEKAS.** Mr. Stana, do you dispute the fact that he found in those 4,000 X number who were able under the H.R. 3150 test to repay some of their debt? Do you dispute that that occurred in that study of the 4,000?

Mr. **STANA.** I want to be real clear about this because I think it will help explain our objections and observations.

These studies are useful first steps. The studies that have been done in the last couple of years are unlike any that have been done before.

Our objection or our note of caution comes from this: yes, I think Dr. Staten and the gentlemen to my left have found that within the universe of debtors who can pay, applying some assumptions you come up with a point—a rifle shot—that shows this was how many can pay, this percent, and this is how much they can pay.

If you apply different assumptions, you're going to come up with a different point in this range of possibilities.

Mr. **GEKAS.** They used that assumption. Did you use an assumption?

Mr. **STANA.** We were asked by Senators Grassley and Durbin to evaluate their methodology.

Page 76 PREV PAGE TOP OF DOC

So what we are saying is that you could use a sensitivity analysis, like the kind that Dr. Scheuren was suggesting, to do some what-if assumptions. What if income went down relative to expenses, or up? What if one-third of debtors completed a Chapter 13 repayment plan and two-thirds did not? How much money are you going to recapture? What if administrative costs rose because this is a more labor-intensive—if you will—situation and you get maybe 80 cents on the dollar instead of 100 cents on the dollar? What if?

What we are saying is that as these studies are being done, these kind of refinements are really needed so that you are better informed on how many debtors could potentially repay and how much money could be repaid with these kind of changes to bankruptcy law.

Mr. **GEKAS.** Dr. Neubig, you came up with a 15 percent figure as contemplating those who had some ability to repay. Is there a margin of error raised in that 15 percent up or down 1 or 2 percent that you incorporate in your final figure, or not?

Mr. **NEUBIG.** When you are working with a sample, there is a margin of error in terms of sampling. We would estimate that the true percentage would range between 13 and 17 percent. But I think it is real important to note that when you're talking about policy—and clearly policy is going to apply in the future—it is very difficult to have everything you would need in order to do a perfect prediction of the future—in fact, you can't. So what we do in other policy situations—and we did at the Treasury Department—is to apply the rules that are being proposed to information that you have from the past as a good proxy.

Page 77 PREV PAGE TOP OF DOC

And that is what we did with the 1997 petitions. We have information for 1997 petitioners. We literally did the math of the H.R. 3150 and in this sample—which we believe is projectable nationally—15 percent of the 1997 Chapter 7 petitioners would have been required to file a Chapter 13 repayment plan. We feel very comfortable with that. Again, it is based upon historical information, so it is not involving the projection of the future that I think GAO has expressed some concerns about. But again, doing policy analysis, you have to make those projections of the future.

Mr. **GEKAS.** Dr. Scheuren, isn't the projection made in these studies for future application much the same as in IRS or in Congress' attempt to determine the estimates of tax revenues for the next 2 years, 5 years, and so forth? Aren't they based on the same kind of analysis and projection?

Mr. **SCHEUREN.** You are correct, Mr. Chairman. Dr. Neubig has already made this point. Dr. Neubig's view accords with my own experience, both at the IRS and in earlier experiences when working on welfare reform.

You cannot, of course, really see the future until it has occurred; instead, you construct scenarios within which you look at the policy alternatives.

Mr. **GEKAS.** So it is has been that the Congress has relied on estimates of tax revenue of next year to formulate the budget for this year, for instance?

Mr. **SCHEUREN.** That's correct.

Page 78 PREV PAGE TOP OF DOC

Mr. **GEKAS.** What about Mr. Stana's criticism of the analysis that would lead to that kind of assumption?

Mr. **SCHEUREN.** I think he is right that all data needs to be used with caution. I always teach my students that. But that doesn't mean that the caution should be so great that you don't use the data at all—especially not data as good as these.

Mr. **GEKAS.** Thank you very much.

The time of the Chair has expired. We turn to the gentleman from New York and extend to him the customary 5 minutes. Knowing him, it might be over 5 minutes.

Mr. **NADLER.** I appreciate your indulgence, Mr. Chairman.

First of all, let me simply observe—since the chairman, Dr. Scheuren, and Dr. Neubig were talking about the estimates of future revenues—in November of 1996, most of us in Congress patted ourselves on the back for finally passing a fiscal year 1997 budget. A month late, but we passed it. It was the budget for October 1, 1996 through September 30, 1997.

We also patted ourselves on the back for reducing the projected deficit to $160 billion.

Eleven months later, the deficit turned out not to be $160 billion, but to be $20 billion. An error of 90 percent on an 11-month projection. So I think these projections have to be taken with a great deal of caution, even when made on the basis of best data available. And on that one, CBO and the Office of Management and Budget were all off—I forget which was off less—but they were all off by several orders of magnitude. If this is off by an order of magnitude, you get very different conclusions, period.

Page 79 PREV PAGE TOP OF DOC

Mr. **GEKAS.** If the gentleman would yield for a moment——

Mr. **NADLER.** Yes, Mr. Chairman.

Mr. **GEKAS.** Doesn't Congress have standard ways of using this which are accepted in the field and accepted over years of experience? The fact that it might be wrong doesn't mean that the standards are not correct.

Mr. **NADLER.** Reclaiming my time, we use the best we can. My point is that we don't know how to do it very well.

I don't mean that Republicans don't know how to do it or Democrats. All of us are subject to huge margins of error and we have to treat the conclusions with an appropriate degree of humility. If we are dealing with the budget deficit and how much it is going to be 12 months from now, knowing how reliable or unreliable your data is from your projections you might want to be cautious, depending. But here when you are talking about the number of debtors who can repay and the extent to which they can repay, I think it is even more difficult to ascertain.

Mr. Chairman, one further observation. Yesterday and today we have received a flurry of industry-funded studies. These studies may be correct in their conclusions and they may not be. But I believe very strongly that we need an independent review of them. We wouldn't accept a cancer study from the tobacco industry at face value, and we shouldn't accept industry-funded studies at face value here either.

Page 80 PREV PAGE TOP OF DOC

No one has even tried to assess administrative costs of H.R. 3150, and they ought to be assessed. We need these answers.

So I ask you again to join in a bipartisan request, as was done in the Senate to GAO, to assess all of these studies and to assess them in the time that GAO needs to do it. I know that there is a concern that asking GAO—which is non-partisan and independent and reports to Congress—to do that would upset the timetable for this legislation and we wouldn't be able to have it on the Floor in April or May. But I would again submit that it is more important to get it right than to get it done on an arbitrarily-imposed timetable.

So I ask you again to join me, as was done in the Senate, in a bipartisan request and to slow down the hearings so that we have time to assess the results of that request to GAO to adequately all of these studies.

Mr. **GEKAS.** The Chair will not slow down the process of the pending legislation. The schedule was announced back in February. But it will join with the gentleman in sitting down to discuss the request the gentleman has made.

It is ironic that the gentleman is now requesting a governmental analysis which he just criticized on the part of the estimates of the 1996 or 1997 budget and now wants to rely on the same governmental entities to apply to these.

That is exactly the point. These are all estimates. A lot of it is professional guesswork and a lot of it is conjecture. But it is all funnelled into a standard professional state-of-the-art accepted way of estimating numbers, particularly in this type of grid that would be used for the first time.

Page 81 PREV PAGE TOP OF DOC

So I will sit down with the gentleman to discuss his problems with all of this, but I will not agree at this juncture to anything of that type.

Would the gentleman like some more time?

Mr. **NADLER.** Yes, please.

Mr. **GEKAS.** That is surprising. [Laughter.]

Mr. **NADLER.** Well, I used up the time.

Mr. **GEKAS.** Why would you use the time for this argument?

Mr. **NADLER.** Because I thought it was important.

Mr. **GEKAS.** The gentleman is granted an additional 2 minutes.

Mr. **NADLER.** Thank you.

Mr. Stana, let me ask you quickly, is it correct that you believe, based on your analysis of these studies, that they simply do not give us adequate information on which to make the policy decisions we are asked to make based on them?

Mr. **STANA.** Oftentimes Congress has to make decisions without perfect information. I think we all recognize that. But there are some things that can be done with the data they have to increase the certainty—or at least increase the reliability of the study. These include sensitivity analyses, which frankly are considered part of a routine——

Page 82 PREV PAGE TOP OF DOC

Mr. **NADLER.** And they also include validating the two key assumptions you talked about?

Mr. **STANA.** The key ones, yes, in particular the one about the 5-year projection. Again, you can do a what-if analysis to get a better idea of where within this range is the likely number of debtors who could repay debt and how much could be repaid.

Mr. **NADLER.** How long would it take to do this? Are we talking about 2 years, 2 months, 2 weeks?

Mr. **STANA.** It would not be 2 years. I have not seen the database. Mr. Scheuren has experience with big databases.

I want to add one more thing very quickly.

They made a point that we looked at this issue from an auditor perspective—emphasizing "auditor." We had social scientists, statisticians—and they're aware of this—examine the different industry studies. It was not our accountant-auditors who did this work.

Mr. **NADLER.** Let me ask Dr. Neubig and Dr. Staten, would you be willing to give to GAO the background on which you relied so that the GAO can properly assess these studies? Knowing that you may assert that some of this is proprietary, GAO can keep that for itself.

Page 83 PREV PAGE TOP OF DOC

Mr. **NEUBIG.** Congressman, we tried to lay out in our written report all of the information about the data and also about the exact calculation of the needs-based provision. I think the report really stands on its own.

Mr. **NADLER.** You have no background data that might be helpful in assessing all of this?

Mr. **NEUBIG.** This unique 1997 database has a lot of information, but in terms of assessing the effects of the needs-based provision——

Mr. **NADLER.** You won't let the GAO assess the validity of your conclusions and let them decide how much that background data——

Mr. **NEUBIG.** Again, I do not have the authority to commit to provide you this information. We clearly have provided——

Mr. **NADLER.** Could you report back to us when you talk to someone who does?

Mr. **NEUBIG.** I will be happy to.

Dr. Staten.

Mr. **STATEN.** I would be happy to take a crack at that.

Page 84 PREV PAGE TOP OF DOC

If the GAO is committed to delivering a report in less than 2 years, let me suggest that they will not be able to validate the most important assumption that they are criticizing here, and that is the stability of income over a 5-year repayment period. If they choose to wait the remaining 3 years on our petition database to see what happened to those individuals, then perhaps they could.

Mr. **NADLER.** But are you willing to——

Mr. **STATEN.** I would be willing to let them look at it in 3 years when the information is available.

Mr. **NADLER.** Are you willing to let them look and let them decide what they can and can't do based on the background data that you have?

Mr. **STATEN.** I would be happy to talk to them about it.

Mr. **NADLER.** But you're not willing to agree to do that?

Mr. **GEKAS.** The time of the gentleman has expired.

Mr. **NADLER.** I have one more question, if I may have unanimous consent.

Mr. **GEKAS.** I will consent.

Page 85 PREV PAGE TOP OF DOC

Mr. **NADLER.** Thank you.

I am not sure who I should ask this of, so whoever wants to take a crack at this—I gather that in these studies no differentiation is made for regional variations and the cost of living is not taken into account so that someone with an income of, say, $30,000 in one area may have a better ability to repay debt than someone with the same income in a different area based on the cost of living. How would you comment on the validity—assuming everything else is valid—of these studies not taking into account regional variations of cost of living.

Mr. **NEUBIG.** H.R. 3150's needs-based provision does not apply a regional income approach. In terms of applying regional differences, clearly both income and expenses and probably debts are all influenced in roughly the same direction. So again, what we're talking about—the relationships I would expect would be relatively constant across the regions whereas the absolute levels may differ slightly.

Mr. **GEKAS.** Although it does apply regional expenses.

Mr. **SCHEUREN.** We applied the bill fully. There are county by county adjustments for expenses. And we learned a lot about how to spell different counties. We applied all the bill's provisions.

Mr. **GEKAS.** The time of the gentleman has expired.

We turn to the gentleman from Tennessee, Mr. Bryant, who will examine the witnesses for 5 minutes. Then we will recess for the purpose of a vote.

Page 86 PREV PAGE TOP OF DOC

Mr. **BRYANT.** Thank you.

Mr. Stana, very quickly since we are pushed for time here, policy considerations aside on the so-called needs-based testing, just looking at it from the numbers, I understand you to say that perhaps one drawback to this is what you might recover might not offset the expenses that might be incurred in this additional monitoring of cases.

Aside from that, is there any other reason this system wouldn't work? Or we wouldn't see an improvement?

Mr. **STANA.** Well, we haven't been asked to take a position on the bills. Nor have we studied them in terms of the data. But what we do know is that policymakers often make decisions based on the amount of money you're likely to get back versus the cost it's going to take you to get it back. What we don't know is what that cost-benefit ratio is.

Mr. **BRYANT.** Dr. Neubig, given the current economic impact of the present consumer bankruptcy system, what is the likely future economic impact of the system if reforms such as this are not made?

Mr. **NEUBIG.** Our repayment study did not address that issue specifically. We do know that if this change were made in terms of the needs-based provision that clearly there would be fewer Chapter 7 filings, more Chapter 13 repayment plans, more payments back to the credit card and other secured and unsecured lenders as a result of these rules—where people who have the ability to repay actually do repay rather than walking away from these debts.

Page 87 PREV PAGE TOP OF DOC

Mr. **BRYANT.** One final question.

Dr. Scheuren, in what respects do the two studies prepared by Ernst & Young respond to GAO's review of Dr. Staten's study?

Mr. **SCHEUREN.** I think we've responded fully on the sampling, totally responded. There are concerns with data always. And we share those concerns with GAO, but we think we have adequately dealt with that. I think we have responded fully. We are satisfied.

Mr. **BRYANT.** Thank you, Mr. Chairman. That is all I have.

Mr. **GEKAS.** The Chair acknowledges the attendance now of the lady from Texas, Ms. Jackson Lee, but we will be recessing now to conduct the votes on the Floor. We excuse this panel. I see relief on their forehead.

Ms. **LEE.** Mr. Chairman, I would certainly like to ask questions of them. It is only one vote, isn't it?

Mr. **GEKAS.** Two votes. You may proceed.

Ms. **LEE.** Thank you very much.

Mr. **GEKAS.** The Chair recognizes the lady from Texas.

Page 88 PREV PAGE TOP OF DOC

Ms. **LEE.** Do you have something, Mr. Nadler?

Mr. **NADLER.** I just wanted to say that there a number of members who were unable to be here and I would ask unanimous consent that we have the normal 7 legislative days for people to insert comments or questions into the record.

Mr. **GEKAS.** Without objection.

Are you prepared to ask questions now?

Ms. **LEE.** I certainly am, unless you're going to hold them over.

Mr. **GEKAS.** No, I will wait.

Ms. **LEE.** Whether it sounds prepared or not, I am prepared. [Laughter.]

Ms. **LEE.** I have been living this issue for a long time. I thank the chairman very much. I thank the presence of the gentlemen here and those who are present in the room.

I understand and apologize. I was dealing with bail bondsmen and whether or not individuals appear before courts and whether or not we should have forfeiture of bail bonds or bonds. I appreciate the chairman allowing me to raise these questions.

Page 89 PREV PAGE TOP OF DOC

You've done a series of studies about these issues and I would appreciate the gentlemen responding. The key element that I have that concerns me is the means testing and what that does to the whole system of bankruptcy. I would just like for your to answer for me this whole concern that I have that means testing in fact does not and cannot work. We heard testimony from an actual practitioner, a bankruptcy court judge, who indicated it could not work. And I would like to hear from you gentlemen on that end as well, to refute the argument that in fact it will burden the lower income individuals who are filing or would seek to file a bankruptcy.

Dr. Staten.

Mr. **STATEN.** It is not clear to me why it would burden anybody filing in the system as long as means testing is incorporated with well-defined criteria up front, much as is contained in H.R. 3150. That criteria spells out which direction debtors would be guided. The direction they follow—it falls right out of the filing of the petition. Estimates of the impact of H.R. 3150 suggest that only 15 percent of filers would be directed into Chapter 13 repayment programs. And those are not low-income filers. Hurdles imbedded in H.R. 3150 provide that they would be filers with incomes above 75 percent of median national income.

Fifteen percent of cases then directed into Chapter 13—and presumably there might be some special circumstances among that 15 percent—but it allows the court to focus its attention just on those 15 percent and the other 85 percent continue with Chapter 7.

Mr. **STANA.** GAO does not have a position on the needs-based provision.

Page 90 PREV PAGE TOP OF DOC

Ms. **LEE.** What did your study say?

Mr. **STANA.** We reviewed the results of the studies from Ernst & Young and the Center on how many debtors could repay a portion of their debt and how much they could repay. The results of our analysis are in our report. But that report doesn't really get to the issue you're raising here.

Ms. **LEE.** Then repeat for me what you have in your study briefly—your conclusion.

Mr. **STANA.** Our conclusion is that one needs to read these studies with caution, that they don't give you an absolutely reliable estimate of how many people can afford to repay and how much they can afford to repay, owing to

the assumptions used in the reports. I might add that all of them essentially used the same assumptions with some variations, so it's not surprising that they all have roughly the same results.

Mr. **NEUBIG.** Congresswoman, this chart summarizes our findings for a new national sample of 1997 bankruptcy petitions and it applies the needs-based provisions of H.R. 3150. We found that 53 percent of the Chapter 7 petitioners in 1997—so it is not making projections—would not be affected by H.R. 3150 needs-based provision as a result of their low gross income. Another 32 percent would not be affected at all by the needs-based provision because they don't meet the other tests in terms of net income and repayment ability. The needs-based provision would impact just 15 percent of the Chapter 7 filers in 1997.

Page 91 PREV PAGE TOP OF DOC

Ms. **LEE.** Do we have a copy of that chart in our materials?

Mr. **NEUBIG.** It is included in my written testimony, which is the report. It does not depend upon the assumption about projecting income forward. It is literally applying the math of the needs-based provision to the information that the bankruptcy courts currently have.

Ms. **LEE.** Thank you.

Dr. Scheuren.

Mr. **SCHEUREN.** I can't add anything to what Dr. Neubig already said.

Ms. **LEE.** Let me just say in closing, I am still stuck on the idea that it seems to be that only 4 percent of filings of bankruptcies generate problems and concerns. I said earlier that I am concerned about fixing something that may not be broken.

Lastly, whether or not where there is an increase in bankruptcy filings—which I saw in a statement made here—that it is not a result of bad economic times, which happen across the Nation.

I thank the gentlemen for their comments.

Mr. **GEKAS.** The time of the lady has expired.

Page 92 PREV PAGE TOP OF DOC

We relieve the witnesses from any further attendance. We thank them for their participation.

The subcommittee stands in recess until 11:20.

[Recess.]

Mr. **GEKAS.** The hour of 11:20 has now passed and pursuant to custom and usage, we shall await the arrival of another member of the subcommittee so that a hearing quorum might be established. Until then, we again recess.

Mr. **GEKAS.** This is my way of keeping faith in hitting the gavel at the appointed time.

[Recess.]

Mr. **GEKAS.** A hearing quorum having been established, we will begin with the next panel and invite them to take their places at the witness table.

George J. Wallace of Eckert Seamons Cherin & Mellott of Washington, DC, on behalf of the American Financial Services Association. Mr. Wallace is a member of the Washington, D.C. office of the law firm of Eckert Seamons Cherin and Mellott. His practice includes the representation of debtors and creditors. He has also specialized in consumer and mortgage credit.

Page 93 PREV PAGE TOP OF DOC

He was previously general counsel for the Travellers Mortgage Services, Inc., a subsidiary of the Travellers Corporation. Before beginning to practice law, Mr. Wallace was a professor of law for 15 years. He taught at Tulane University, the University of Iowa College of Law, the University of Virginia, Stanford, and Rutgers. He served as a faculty advisor to a low-income legal clinic that he started in Iowa. He also has served as trustee and debtors counsel.

Mr. Wallace received his law degree from the University of Virginia Law School where he was a member of the Order of the Coif and the Law Review. He received his bachelor of arts from Yale University cum laude.

Joining him at the witness table is Robert F. Mitsch of Mitsch and Crutchfield of St. Paul, on behalf of the National Retail Federation. He has been in-house bankruptcy counsel for national creditors as well as general counsel for a mortgage servicing company. He was formerly vice president of ITT Consumer Financial Corporation and general counsel for Northwest Mortgage Services.

Mr. Mitsch is a member of the American Bankruptcy Institute, the National Association of Chapter 13 Trustees, and the National Association of Bankruptcy Trustees. As a member of these organizations, Mr. Mitsch generally participates in national continuing legal education seminars.

Mr. Mitsch received his undergraduate degrees with honors from the University of Minnesota and his law degree magna cum laude from William Mitchell College of Law.

Page 94 PREV PAGE TOP OF DOC

Mr. William Brewer, Jr. of Raleigh, North Carolina, on behalf of the National Association of Consumer Bankruptcy Attorneys, where he serves as Director. Certified as a specialist in consumer bankruptcy law by the North Carolina State Bar, he is a bankruptcy practitioner with more than 20 years of experience. Mr. Brewer primarily represents consumer bankruptcy debtors in Chapter 7 and Chapter 13 cases.

Mr. Brewer graduated from the University of North Carolina with an undergraduate degree in economics, as well as his jurist doctor degree with honors in 1976.

Robert H. Waldschmidt joins the panel of Howell and Fisher of Nashville, Tennessee. Mr. Waldschmidt practices there and regularly represents creditors, debtors, creditors' committees, and trustees under Chapter 7, Chapter 11, and Chapter 13 of the Bankruptcy Code.

Mr. Waldschmidt has served as a bankruptcy trustee since 1976 and has been a member of the Chapter 7 Trustee Panel for the middle district of Tennessee since 1979. He administers 800 to 1,200 bankruptcy cases a year. In addition to the National Association of Bankruptcy Trustees on whose behalf he appears, Mr. Waldschmidt is a member of the American Bar Association, the Commercial Law League of America, and the Nashville Bar Association.

A graduate of Vanderbilt Law School where he received his J.D., Mr. Waldschmidt previously attended Hillsdale College where he received his B.S. in mathematics summa cum laude.

They are joined by Norma L. Hammes of Gold and Hammes in San Jose, California on behalf of the National Association of Consumer Bankruptcy Attorneys. She has served as its treasurer from 1992 to 1996 and is currently the association's president.

Page 95 PREV PAGE TOP OF DOC

Ms. Hammes has represented consumer bankruptcy debtors since 1978. She has participated in significant cases and their appeals. Ms. Hammes received her undergraduate degree from the University of California at Berkeley and her J.D. from Santa Clara University Law School in 1977.

We welcome the panel.

We now note the attendance and presence of the gentleman from Ohio, Mr. Chabot. And with that, we will begin with the testimony in the order in which they were introduced with the same set of rules in which the written statement will be accepted for the record and the time limited to 5 minutes for the oral presentation.

Mr. Wallace.

STATEMENT OF GEORGE J. WALLACE, ESQ., ECKERT SEAMONS CHERIN & MELLOTT, LLC, WASHINGTON, DC, REPRESENTING AMERICAN FINANCIAL SERVICES ASSOCIATION

Mr. **WALLACE.** Thank you very much, Mr. Chairman.

I appreciate this opportunity to address the subcommittee with respect to H.R. 2500, H.R. 3150, and H.R. 3146, specifically with regard to the needs-based bankruptcy provisions in those bills.

Page 96 PREV PAGE TOP OF DOC

I represent today the American Financial Services Association. That is an association of market-funded consumer credit lenders ranging across the full range of available consumer credit.

My remarks today, in focusing upon needs-based bankruptcy, are going to begin by discussion of H.R. 3150 and H.R. 2500. The provisions—as I think most of you know—in both of those bills are very close, particularly with regard to needs-based bankruptcy. In addressing those provisions, I think I should first focus upon the need for reform. Considerable bankruptcy reform is critical this year. There are many more Americans each year filing for bankruptcy and there are too many to continue to allow the inefficiencies and unfortunate failures of the present system to continue.

As you all know, approximately 1.4 million Americans in 1997 filed for consumer bankruptcy. That was up from 1.1 million in the previous year. And the effect of that upon the consumer bankruptcy system is to magnify its present inefficiencies and failures. The bill-paying American consumers are being required to pay, because of those inefficiencies and failures, for others who run up debts and then use bankruptcy irresponsibly when they have some ability to pay those debts and without regard for the original purpose of the Bankruptcy Code, which was to take care of those people who were really in need.

Without legislative intervention this year, that situation can only worsen. As more Americans recognize that their neighbors are using bankruptcy successfully, they too are tempted to file bankruptcy and take the easy way out. Congress needs to send a clear message and back it up with effective legislation.

Page 97 PREV PAGE TOP OF DOC

Bankruptcy is there for those who need it, but if you have the ability to pay a substantial part of the debt, you will have to do so. That is the simple message which H.R. 3150 and H.R. 2500 send. It is an important message. It is a timely message. It is a message which needs to be sent today.

On the other hand, H.R. 3150 and H.R. 2500 send another message. If you are in need, you will get breathing room, even if you have ability to pay. You will be able to file Chapter 13 and get the automatic stay. But you won't get a free ride.

It has been the bipartisan policy for over 20 years in this country to make available to as many Americans as possible the advantages of consumer credit. Those benefits cannot stand for long the personal irresponsibility of growing numbers of those who use bankruptcy to discharge debts when they have the ability to pay a significant portion of them. The reason is simple: when debts are discharged in bankruptcy Americans who pay their bills must pay for the resulting losses in increased credit costs and the cost of what they buy. Americans now needlessly pay for those things when other credit users act irresponsibly.

Others today have already addressed these statistics demonstrating this problem. I will simply observe that the evidence is there for all to see whether you are willing to do so or not. It should not be ignored and it makes bankruptcy reform this year urgent.

Turning now to the specific needs-based bankruptcy provisions of H.R. 3150 and 2500, they adopt a sensible approach to trying to make what needs to be done effective. Mr. Mitsch is going to address the simple and direct system that is proposed by that bill. We have worked with many people and others have worked with many other people to try to design this system to make it as simple as possible, to make it as effective as possible, and as low-cost as possible.

Page 98 PREV PAGE TOP OF DOC

Of course, it may cost something to do it, but isn't that cost worth it when, based upon the testimony just given, in 1997 130,000 people apparently went through Chapter 7 bankruptcy with the ability to pay some part of their debts. What is that doing to the fabric of American society? What is that doing to the consumer credit system in this country?

Turning for a brief moment to H.R. 3146, that bill does not address what H.R. 3150 does or what H.R. 2500 does. It actually cuts back on the available protections today that are intended to require some consumers to use Chapter 13 when they have the ability to pay. It imposes a $60,000 gross income limit for a floor upon any needs-based bankruptcy test, a $60,000 floor. And that floor is only for an individual. $5,000 of gross income is added for each additional member. In other words, for a family of four, $80,000 would have to be their gross income before the needs-based bankruptcy provisions of H.R. 3146 kick in. In addition, it requires in the net income test that you have the ability to pay all of your debts and that the judge decides that there is substantial abuse before the needs-based bankruptcy provisions would require anyone to move from Chapter 7 to Chapter 13. That is a major change from current law.

Mr. Chairman and members of the committee, I appreciate this opportunity to address you today and I look forward to taking questions at the appropriate time.

[The prepared statement of Mr. Wallace follows:]

PREPARED STATEMENT OF GEORGE J. WALLACE, ESQ., ECKERT SEAMONS CHERIN & MELLOTT, LLC, WASHINGTON, DC, REPRESENTING AMERICAN FINANCIAL SERVICES ASSOCIATION

Page 99 PREV PAGE TOP OF DOC

I appreciate this opportunity to express my views on consumer bankruptcy and the various bills which have been introduced in the House addressing consumer bankruptcy (H.R. 3150, "Bankruptcy Reform Act of 1998," H.R. 2500, "Responsible Borrower Protection Act," and H.R. 3146, "Consumer Lenders and Borrowers Bankruptcy Accountability Act of 1998."

I am a member of the law firm of Eckert Seamans Cherin & Mellott LLC and am resident in the Washington, DC, office. My practice includes bankruptcy representation of debtors and creditors, and I have another specialty in consumer and mortgage credit.

I represent the American Financial Services Association. My remarks today reflect its views on the various bills now before you affecting consumer bankruptcy.

For fifteen years before I began practice full time, I was a professor of law, the longest period of time at the University of Iowa College of Law from 1968 to 1978. During this time I taught bankruptcy law and also learned about the day to day realities of bankruptcy practice in my role as the faculty advisor to the low income legal clinic I started in Davenport Iowa, as well as in serving as a trustee or debtor's attorney in a few cases. I also learned something about what a bankruptcy judge faces as the faculty advisor to student bankruptcy law clerks for the bankruptcy judge in the Northern District of Iowa during the 1970s, reviewing and editing the draft opinions the students prepared for the judge.

Since then, I have practiced law full time for fifteen years, first with Archer & Greiner in New Jersey, then as General Counsel of The Travelers Mortgage Services, Inc., and finally with my present firm.

Page 100 PREV PAGE TOP OF DOC

First of all, I believe that the Bankruptcy Code is long overdue for substantial changes in the consumer bankruptcy area. Consumer bankruptcy has become a hot topic, partly because of the startling increase in the number of individual bankruptcies filed, suggesting that the stigma of bankruptcy has so far eroded that people are too easily seeking the extraordinary relief bankruptcy provides. The rate of increase in consumer bankruptcy filings is staggering. The 1.33 million consumer bankruptcy filings expected for 1997 will be up from under 300,000 in 1980 and sharply up from approximately 780,000 in 1994. As the number of filings increase, the impact bankruptcies have on the cost of extending credit and therefore on bill paying consumers also increases, magnifying the adverse effect of poorly constructed bankruptcy policies.

Preceding and following the report of the National Bankruptcy Review Commission on October 20, 1997, four bills have been introduced in Congress, three in the House and one in the Senate, that propose reforms to the consumer bankruptcy provisions of the Bankruptcy Code ("Code"). Significantly, two—maybe even three, depending on how you look at it—of the House bills and S. 1301 adopt a version of "needs based bankruptcy", which would means test the availability of complete discharge under Chapter 7. Those who do not qualify for Chapter 7 relief could get relief in Chapter 13, which requires a payment plan (or not file at all).

Before directly addressing some of the policies involved in the bill, a brief summary of our position follows on bankruptcy in general as well as comments on several issues that continually come up when bankruptcy reform is discussed.

Overview of the Bankruptcy Problem and the Industry Response

Page 101 PREV PAGE TOP OF DOC

Bankruptcy is an extremely complex problem. The consumer credit industry has focused on three main solutions:

1. Consumer Education

2. Underwriting and Causation

3. Bankruptcy Code Reform

CONSUMER EDUCATION

None of the bills introduced in the House or the Senate deal with the fundamental problem of insolvency, nor is it reasonable to expect them to. By insolvency, I mean those debtors who, for whatever reason, simply have no capacity to repay and appropriately end up in a Chapter 7 liquidation. This is where consumer education and credit counseling

can play a major role, although results will not occur overnight. To this end, the American Financial Services Association (AFSA), along with the Federal Reserve and many other non-profit consumer education groups, is a founding member of the *Jump Start Coalition,* which is an unprecedented private/public partnership designed to promote, on a state by state basis, financial literacy training starting in kindergarten and extending through the 12th grade. Education, however, will do little to solve the most difficult part of the bankruptcy problem—bankruptcies of convenience or bankruptcies where the debtor has a meaningful ability to repay. The Coalition's activities are in addition to ongoing consumer education efforts through the AFSA Education Foundation—the Foundation materials are distributed through a wide range of channels, including the government's Consumer Information Center.

Page 102 PREV PAGE TOP OF DOC

While consumer education is the best way to help prevent problems, consumer credit counseling is the most effective way to deal with problems once they start. No doubt, the best known is the National Foundation for Consumer Credit Counseling, which has over 1,300 counseling facilities in the United States. These services have produced great results for the 998,805 debtors who sought help in 1997. Unfortunately, not all debtors seek this type of assistance—those debtors that first turn to bankruptcy lawyers almost never come to consumer credit counseling for assistance.

Lawyer advertising for consumer bankruptcy services is unfortunately very effective in drawing in individuals with financial problems with promises of a quick fix. Often these advertisements are blatantly misleading (e.g. Chapter 13 is often referred to as a "Federal Debt Consolidation Plan"). Again, consumer education is the answer here. However, much more can and should be done to ensure that individuals are properly informed about all aspects and alternatives of dealing with severe financial problems. H.R. 3150 would mandate that bankruptcy attorneys and petition preparers be much more active in informing potential debtors of the consequences of bankruptcy. The "Debtor's Bill of Rights" (Section 115) will provide much more useful information to potential debtors at the initial point of contact with any "debt relief counseling agency". The law should be designed to ensure that as many information channels are available to people in financial distress. Just as creditors are required to provide extensive disclosures at the time credit is granted, anyone involved in the bankruptcy infrastructure should be required to exercise their duties to properly advise and inform in a responsible fashion.

UNDERWRITING

Page 103 PREV PAGE TOP OF DOC

Underwriting is the second area where the industry is concentrating its efforts. Throughout the industry, everything that has been learned about bankruptcy has been applied to underwriting practices with the goal of maximizing loss prevention without having to adopt the crude expedient of indiscriminately restricting credit—especially to those debtors who are on the margin in a particular risk category. Artificial intelligence, studies of both bankruptcy demographics and the behavior of debtors prior to filing bankruptcy are a few of the techniques currently employed and constantly updated to combat bankruptcy losses. Despite these efforts, the causes of bankruptcy are extremely complex. A significant portion of bankruptcies—those of convenience—remain beyond the reach of even the most advanced underwriting techniques. It is these bankruptcies which require reform of the bankruptcy code.

CAUSATION—IS IT AS SIMPLE AS TOO MANY CREDIT CARDS?

Opponents of bankruptcy reform claim that the industry has created the problem by indiscriminately extending too much credit in the form of credit cards and simply wants to "turn the government into a bill collector". Nothing is further from the truth on a both a statistical and qualitative basis. First of all, if bankruptcy was simply a matter of too much credit, bankruptcy rates would be uniform across the country. In fact, they are not—they show wild variations across the nation and within the individual states. For example, Shelby County, Tennessee has a bankruptcy rate that is 32 times the national average—does Shelby County get 32 times the amount of credit that the rest of the country does? No, of course not. Well, then, if not too much credit, what does cause bankruptcy? The causes are very complex and frequently a number of factors are present. Some of the main causative correlations include divorce, lack of health

insurance, lack of mandatory automobile insurance laws (7 states) and so on. Unemployment in and of itself is not a big factor. Urban areas have the highest bankruptcy rates—they also have the highest divorce rates. Young adults between the ages of 21 and 25 have low rates of bankruptcy filing as do adults over the age of 41. The age group most likely to file are those in their early 30s, particularly age 32. Poor people and minorities have relatively low rates of overall filing while filings take off as you approach a total annual household income of between $32–36,000. There is no way to really screen for most of these types of events and characteristics during the underwriting process. Should we not lend to 32 year olds? Should we ask applicants if they are happily married?

Page 104 PREV PAGE TOP OF DOC

What about credit cards? Bank credit cards account for approximately between 5 and 6 percent of total consumer debt. If you include other types of credit cards, you might get to 9 percent, depending on how you account for convenience users who pay off their balance every month. Is this 9 percent of consumer debt causing all of the problems while the other 91 percent maintains a benign budgetary impact? This is counterintuitive—as all of us know, our big obligations are our housing, car, student loans etc. Do credit cards play any role in bankruptcy? Of course, but *they are in no way the* principal *cause.* In general, the role that credit cards play is that they are the last form of credit available for use before filing for bankruptcy. When a debtor gets into financial trouble for whatever reason, they will frequently try to float themselves using their credit cards, or if a debtor is planning to file a bankruptcy of convenience, they will frequently use their cards to acquire certain goods or make certain payments prior to filing. We have learned to identify some of this behavior and can sometimes reduce our losses, but particularly in case of planned or non-insolvent bankruptcies, this is virtually impossible.

BANKRUPTCY CODE REFORM

While AFSA and its members can carry out consumer education and underwriting initiatives, only Congress can undertake the necessary reforms to the bankruptcy code. AFSA believes that the Code must make provisions for bankruptcies where the debtor is not only *not* insolvent, but has some substantial capacity to repay—in other words, the Code should provide for a needs-based system as opposed to one that provides relief on demand. We believe that approximately 25 percent of all bankruptcies potentially fall into the category where meaningful recovery is possible. The majority of bankruptcies—roughly the other 75 percent—belong in Chapter 7 and should be dealt with as quickly and effectively as possible by the Code. It is these bankruptcies where we feel consumer education and underwriting initiatives can play a role over the long run. The other 25 percent are difficult to deal with because they are not insolvencies. If there is substantial capacity to repay, then by definition, it is certainly not a case of extending too much credit. As the Code now stands, there is no effective "gatekeeper" other than "moral stigma" to prevent debtors from obtaining full relief when they clearly don't need it.

Page 105 PREV PAGE TOP OF DOC

Out of the three bills being considered, only two, H.R. 2500 and H.R. 3150 realistically have any likelihood of substantially curbing the rate of unjustified bankruptcies, and restore fairness and integrity into the bankruptcy system.

H.R. 2500, The Responsible Borrower Protection Bankruptcy Act, introduced in the House September 17, 1997 by Representatives Bill McCollum and Rick Boucher is intended to reinforce personal responsibility by removing windfalls available under the present Code and tailoring bankruptcy relief to the actual welfare needs of those who file. Doing so should lower unnecessary credit losses and reduce the cost of credit for those who pay their bills. Consumers who need bankruptcy relief will still be able to get essentially the same relief available today.

"Needs based bankruptcy"

There will be eligibility requirements for Chapter 7 relief.

Debtors Unable to Pay Even Some Part of Their Debts. Debtors who earn less than 75% of national median family income *for a family of equal size* continue to have the choice to file under Chapter 7 (discharge of unsecured debt

without payment), Chapter 13 (payment of creditors over 3 years), or Chapter 11 (reorganization plan for those with complicated financial affairs). In other words, the basics of consumer bankruptcy as we know it today is still available to people who need it, although some of the windfalls and abuses will be regulated as described below.

Debtors With Ability to Pay Some Part of Their Debts. Debtors who earn more than 75% of national median income *for a family of equal size* can use Chapter 7 only if their monthly "net income", as calculated and disclosed by the debtor under federal standards set in the bill ,(see footnote 52) is less than $50 or not enough to pay 20% of their unsecured, non-priority debt over five years.

Page 106 PREV PAGE TOP OF DOC

In addition, when it becomes apparent during the case that the debtor is not eligible for Chapter 7 under the needs based bankruptcy provisions or where the totality of circumstances demonstrate substantial abuse, the Chapter 7 case can be dismissed on motion of any party in interest.

Changes to Consumer Bankruptcy Administration

Each debtor must be given an improved "notice of alternatives" before the petition is filed which lists the addresses and telephone numbers of available credit counseling.

Non-attorney representatives can attend and participate in the first meeting of creditors.

Proofs of claim need not be filed in a Chapter 7 or 13 case if the claim is listed in the schedules unless the claim is listed as disputed.

Significantly better notice of proceedings and information about the debtor and about cases is made available.

There will be automatic dismissal of a Chapter 7 or 13 bankruptcy case for failure to file schedules and other information required under section 521(1) as amended within forty-five days after filing the petition.

Page 107 PREV PAGE TOP OF DOC

Random audits will be conducted of the accuracy of the information debtors tell the court when seeking relief.

To be effective, notices to creditors from the bankruptcy court and service by a debtor on a creditor must use an address which the creditor specifies in a filing with the court. The filing can specify that the notice address be used in all bankruptcy matters filed in that court.

The debtor will include in any notice to the creditor the creditor's account number if it is reasonably available, and will send any notices to an address which the creditor has previously specified.

The debtor will provide financial information about income and expenses, such as copies of his or her tax returns for the three most recent tax years, current pay stubs, and other proof of income.

A conformed copy of the petition, schedules and statement of financial affairs and any corresponding amendments of any Chapter 13 plan must be provided upon request.

The clerks of the various bankruptcy courts will compile statistics on bankruptcy cases involving individual debtors, and report these statistics annually to Congress.

An eight member Bankruptcy Exemption Study Commission is created to study whether the Code's use of exemptions should be revised.

Bankruptcy Relief Less Frequently Available for Repeat Filers

Page 108 PREV PAGE TOP OF DOC

Chapter 7 discharge will be available only once every ten years, compared to the present six. Chapter 13 discharge will be available only once every five years.

Provisions Affecting Secured Creditors

Secured credit is usually the only "deep pocket" in a consumer bankruptcy case. Since 1978, debtors' advocates have been moderately successful in "unlocking" the secured creditor's pocket through cram downs, "ride throughs", nonpayment while a plan is being confirmed, Chapter 13 conversions to Chapter 7 after cramdown or cure, and the like.

Chapter 7 and 13 Cases

Multiple Filings. The Bill regulates abusive multiple filings by restricting availability of the stay on the second filing within one year, backed up by a national filing system keeping track of all debtors who file for bankruptcy relief.

The phrase "household goods" as it now appears in section 522(f) of the Code is defined by using the definition already used in a similar context by the Federal Trade Commission in the Trade Regulations Rule on Credit Practices, 16 C.F.R. §444.1(I).

Chapter 7 Cases

Chapter 7 cases should quickly resolve themselves into reaffirmation or return of the collateral. Debtors are required to fill out a statement of intention with regard to any secured property, and they must either perform their stated intention or return secured property within a short period of time. The need for lift stay litigation is significantly decreased.

Page 109 PREV PAGE TOP OF DOC

The "ride through" is effectively barred. It is now established law in the Second, Fourth and Tenth Circuits, while three other circuits have ruled against it.

Lift stay litigation should be more rapid. There is a sixty day maximum period for the court's decision to be rendered.

Serial or installment redemptions are barred.

Chapter 13 Cases

Clarifies that the inclusion of incidental property in a mortgage on the debtor's principal residence will not disqualify that mortgage from protection under section 1322(b)(2). It also makes clear that if the debtor resided in the house during the six months previous to filing and still owns it, or if the residence is a mobile home, condominium or cooperative apartment, technically treated as personalty in a number of states, the protection of section 1322(2)(b) applies.

Cram downs of consumer goods are limited to retail value, and not available at all for filings within the first 180 days.

Failed chapter 13 cases cannot be converted to 7 if a convenience user is involved, and even when converted, the cram down is lost.

Interim interest and principal payments must be maintained so that the cash flow stream will not be interrupted by a filing.

Page 110 PREV PAGE TOP OF DOC

When the creditor is crammed down, the unsecured portion is more likely to be paid because of the disincentives to dismiss or convert and the five year plan requirement for those with more than 75% of median national income.

The automatic stay will not be violated if a prepetition foreclosure proceeding is postponed during the pendency of a Chapter 13 proceeding so long as any prepetition default remains uncured by actual payment in full according to the plan.

Creditors are given better opportunity to get notice of chapter 13 proceedings, the contents of the plan, the hearing upon confirmation, and the like so that rush plans will not be confirmed without creditor participation. At the same time, long delays during Chapter 13 cases, particularly long delayed confirmation, are limited.

Provisions Affecting Lessors

The bill gives debtors the ability to keep leased personal property by assuming the lease.

The debtor must continue interim periodic lease payments during the "gap" between the time the debtor files a Chapter 13 case and the stay goes into effect, and the time the debtor resumes making payments under the plan.

Provisions Affecting Unsecured Creditors

Page 111 PREV PAGE TOP OF DOC

The needs based bankruptcy provisions are expected to increase the amount available to pay unsecured creditors both by including more debtors with ability to pay in Chapter 13 and increasing the period of payment for those debtors to five years.

To be confirmed, a Chapter 13 plan must pay at least the debtor's "net income", generally determined in the same way as for eligibility, and never less than $50 per month, to unsecured, non-priority creditors.

Any debt is nondischargeable if incurred to pay a prior debt that otherwise would be nondischargeable.

Consumer debts incurred within 90 days of bankruptcy are presumptively non-dischargeable.

Debts which were fraudulently incurred will not be dischargeable in Chapter 13, as they now are.

The co-debtor stay would continue to be available when the debtor who borrowed the money sought Chapter 13 relief, but if a guarantor or other co-debtor who did not receive the consideration for the creditor's claim filed for relief, the debtor who borrowed the money would not be protected by a stay unless he or she also filed for bankruptcy protection.

H.R. 3150, introduced by Representatives Gekas and Moran, contains many of the provisions of H.R. 2500 which are essential to any meaningful changes to the current bankruptcy system. Additionally, Subtitle B of the bill contains several provisions which will institute practical consumer information and protection mechanisms in the process.

Page 112 PREV PAGE TOP OF DOC

H.R. 3146, introduced by Representatives Conyers and Nadler, is clearly premised on a different view of the

underlying problems with the bankruptcy system in this country than that of the other bills. The premise of H.R. 3146 is that creditors are as much to blame for bankruptcies, if not more to blame, than individual borrowers. Simply put, H.R. 3146 is basically premised on a "blame-game." Based on that premise, creditors should be punished for "reckless lending activities" and prohibited from using the "taxpayer-funded bankruptcy system to support those activities."

Unless one accepts the fundamental premise of H.R. 3146, it is difficult to compare the relative merits of the bill with H.R. 2500 and H.R. 3150. While the latter two bills are intended to deter the relatively small percentage of more affluent individuals who unjustifiably avail themselves of the extraordinary remedy of bankruptcy relief, H.R. 3146 essentially demonizes the credit industry and would do little, if anything, to encourage personal responsibility.

For Americans to have confidence in the "safety net" mechanisms which exist in this country today such as the Bankruptcy system, it is necessary that such institutions be perceived as fair. H.R. 3146 does little to restore fairness and integrity into the Bankruptcy system. Instead, it attempts to legislate a rough justice between creditors and individuals. This is a function which is best left to the marketplace. If some creditors are indeed extending credit recklessly, they will not survive. The market will, in the end, dictate their demise.

Bankruptcy is an extraordinary remedy, and it should continue to be perceived as such by all Americans. Individuals who are currently availing themselves of the Bankruptcy remedy without adequate justification bring discredit to the system, and cause the honest borrower to pay more for credit. In her statement before the Subcommittee on Commercial and Administrative Law of the House Committee on the Judiciary on November 13, 1997, Circuit Court of Appeals Judge Edith R. Jones, a member of the National Bankruptcy Review Commission said:

Page 113 PREV PAGE TOP OF DOC

. . . I cannot overemphasize that the time has come for Congress to consider whether the bankruptcy discharge and "fresh start" are widely being made available to individuals who could afford to repay some of their unsecured, non priority debts. From my experience on the Commission, I believe the discharge is being unjustifiably granted in a significant number of cases. Proportionately, these may not be a large share of overall bankruptcy filings, but taken together, they case disrespect on the system and impose large losses that ultimately must be borne by non-bankrupt consumers. Statement of the Hon. Edith Hollan Jones, pp. 11–12 (1997).

I have confidence that this Congress will restore balance and fairness in the Bankruptcy Code. I believe that this is what most Americans want. I look forward to working with you in the effort to achieve this important goal.

Mr. **GEKAS.** Thank you, Mr. Wallace.

We turn to Mr. Mitsch.

STATEMENT OF ROBERT F. MITSCH, ESQ., MITSCH & CRUTCHFIELD, ST. PAUL, MN, REPRESENTING NATIONAL RETAIL ASSOCIATION

Mr. **MITSCH.** Thank you.

I want to thank the subcommittee for this opportunity to address the issue of needs-based bankruptcy in the context of H.R. 3150.

Page 114 PREV PAGE TOP OF DOC

My name is Robert Mitsch. I am a partner of the law firm Mitsch and Crutchfield, a Minnesota law firm specializing in the representation of creditors in bankruptcy. I am speaking today on behalf of the National Retail Federation.

I want to make my comments brief and to the point and to indicate how I believe that H.R. 3150, if it were enacted,

would in fact be easily implemented. I believe that the formula and the needs-based process in H.R. 3150 is something which, for three reasons, commends itself for enactment.

Number one, I think it is going to be a fairly simple and straightforward formula, which I believe can be easily implemented. Secondly, I believe it is more objective because it is based on statistical rather than interpretive criteria. And thirdly, I believe it is important because it protects the people at low incomes and targets people at higher incomes who can indeed afford to pay back some or all of their debts.

I think it is best to look over the horizon and ask ourselves, What would happen if H.R. 3150 were enacted? I think I can predict with some confidence that the first thing you would see is that a number of the software companies that produce programs for the debtor bankruptcy attorneys would issue upgrades immediately to their software. What would be happening is that the same information which is being garnered today in the process of an interview with a debtor would be garnered as it is right now with some additional database calculations put in to qualify for the three-part test under H.R. 3150.

You would have the same information as to debts and assets, breaking out debts as secured and unsecured, priority and non-priority as you do now. However, you have a three-part test—which is a simple worksheet, I believe—that would be applied during the course of the interview with a debtor. What would happen is that you would probably be looking at filling in the debtor's income, which would then refer to the database of the national median income to see whether or not the debtor is over or above the 75 percent mark. If they are under the 75 percent mark, they can file a Chapter 7 if they so choose, or Chapter 13 if they so choose.

Page 115 PREV PAGE TOP OF DOC

The next hurdle to be met in the three-part test would be when the debtor and the debtor's attorney would look at the expenses. If the expenses indeed are over the IRS guidelines, flags would go up, there would be questions, and probably a new screen would pop up on the computer that would simply say, "This is in excess of the IRS standards." Then the debtor and counsel would have to look at why that is. If it is something that is reasonable and something that is an extraordinary expense, the extraordinary expense affidavit would be completed and then you would go down to the bottom line. The bottom line of total debtor's expenses then would be subtracted from the income and it would be a question of whether or not there is or is not over $50 a month left over after the expenses.

If they are under $50, again, they can choose Chapter 7 or Chapter 13 as they so choose. If they are over, then the computer would simply have to calculate what a Chapter 13 plan would pay out and would it indeed retire 20 percent of the unsecured, non-priority debt.

This is the way you would look at whether or not the person would be directed to a Chapter 13. In addition, the debtor would have to submit the proof of income, pay stubs, and prior tax returns. But I believe that this helps to validate and provide the trustee—who probably would also have an upgrade to their computer system—to check this out based on the same statistics. These statistics give you benchmarks which are objective, benchmarks which mean there is less uncertainty in this system. Under the current system, it is a vauge definition of what is "reasonably necessary" for an individual debtor to exist on. It may vary indeed from court to court.

So we believe that this would be a far more efficient system because it would be far more objective.

Page 116 PREV PAGE TOP OF DOC

And finally, if you look at what 3150 targets, it says that if you are in the lower income bracket you indeed have a system which protects you and allows you to file Chapter 7 or Chapter 13. And if you are in the higher income area, that is where the capacity to repay is examined. That is where the capacity to repay makes a difference and that is where I believe we should look and say, "If this person has the capacity to repay, they should be asked to do so."

There should be real need. There should be real relief for real need. And I believe that this system would be one

which could easily be implemented with, I believe, a great deal of consistency.

In conclusion, I believe that the question before Congress and the American people is whether or not debtors who can pay a significant portion of their income should be asked to do so. If bankruptcy is indeed debt relief, it obviously constitutes a form of either welfare or tax amnesty. And I believe that those who are asking for this relief should have to qualify in some shape, manner, or form.

I appreciate the opportunity to address the subcommittee and would be happy to answer questions.

Thank you.

[The prepared statement of Mr. Mitsch follows:]

Page 117 PREV PAGE TOP OF DOC

PREPARED STATEMENT OF ROBERT F. MITSCH, ESQ., MITSCH & CRUTCHFIELD, ST. PAUL, MINNESOTA, REPRESENTING NATIONAL RETAIL ASSOCIATION

Executive Summary

The issue of Needs-Based bankruptcy was raised in recent months in response to public concern over the huge increases in bankruptcy filings during a period of economic optimism and low unemployment.

A Needs-Based bankruptcy system changes some of the preliminary bankruptcy procedures but makes ultimate legal and common sense for several reasons.

First, the proposed system in H.R. 3150 is one that is geared to simple and efficient installation. The procedures envisioned for implementing H.R. 3150 involve filling out forms that would clearly indicate whether a person qualifies for Chapter 7 under a three-part test. It is made easier to enforce due to the additional income verifications that have to be filed with the petition.

Second, the H.R. 3150 approach has a more objective basis since it relies on government statistics such as the median household income and the IRS household expenses by category. This replaces the current less certain framework of trying to evaluate "reasonable living expenses."

Third, the Needs-Based procedures and criteria under H.R. 3150 are targeted to avoid denying bankruptcy relief to those who are truly honest but unfortunate debtors who need a fresh start.

Page 118 PREV PAGE TOP OF DOC

Introduction

My name is Robert Mitsch. I am an attorney with the Minnesota law firm of Mitsch and Crutchfield; this firm specializes in representing creditors in bankruptcy. I am speaking today on behalf of the National Bankruptcy Reform Coalition and the National Retail Federation.

I will try to make my comments brief and to the point today. Needs-Based bankruptcy is the topic that has come to the fore due to a number of reasons. In part it is due to the public concern over the huge increases in bankruptcy filings during a period of economic optimism and low unemployment. Bankruptcy filing increases in the context of high unemployment of recession are seen as understandable results of the larger economic forces. However, in today's economy the popularity of bankruptcy filings seems out of place.

Creditors have been as shocked as anyone at this phenomenon. There has been a growing anomaly of customers

with current credit suddenly filing for bankruptcy. This leaves the creditor with no warning and no way to see if there is any negotiated work out that could have prevented the bankruptcy and its negative credit history that will follow the customer for years.

Implementing a Needs-Based Bankruptcy System

A Needs-Based bankruptcy system changes some of the preliminary bankruptcy procedures but makes ultimate legal and common sense for several reasons.

Page 119 PREV PAGE TOP OF DOC

First, the proposed system in H.R. 3150 is one that is geared to simple and efficient installation. The procedures envisioned for implementing H.R. 3150 involve filling out forms that would clearly indicate whether a person qualifies for Chapter 7 under a three-part test.

The debtor already has to fill in most of this information today. What is added to the standard filing package is the additional requirement of previous years' tax returns, pay stubs to verify income and a worksheet that would show how the debtor qualifies under the three-part test.

One portion of the worksheet would compare the debtor's household income to the national median income for a household of comparable size. A second portion of the worksheet would show whether the debtor has $50 or more disposable income after living expenses and secured debt service. The third portion of the worksheet would show whether the extra income could retire 20% or more of the unsecured debt in a Chapter 13 plan.

This is not a very difficult procedure. It could be easily and quickly reviewed by a Chapter 7 trustee. In addition, should the debtor have extraordinary expenses such as medical expenses that exceed the standard expenses, the debtor need merely append an affidavit explaining the reasons for the additional expense.

This type of a system is made easier to enforce due to the additional income verifications that have to be filed with the petition. The use of tax returns and pay stubs will help the trustee to immediately spot problems or to quickly see the rationale for variances in the worksheet and schedules.

Page 120 PREV PAGE TOP OF DOC

Second, the H.R. 3150 approach has a more objective basis since it relies on government statistics such as the median household income and the IRS household expenses by category. This replaces the current less certain framework of trying to evaluate "reasonable living expenses."

Some have voiced concern over whether there will be a flood of litigation over the standards imposed. This must be seen in the current context in which litigation already exists as to what items might constitute a reasonable living expense. The use of a more objective, statistical basis should help reduce, not increase litigation in this regard.

Third, the Needs-Based procedures and criteria under H.R. 3150 are targeted to avoid denying bankruptcy relief to those who are truly honest but unfortunate debtors who need a fresh start. The vast majority of those who are filing for Chapter 7 now would not be denied that relief. The recent study by the WEFA group shows that the implementation of the H.R. 1350 Needs-Based approach would only require about 12% of the Chapter 7 filers to go into a Chapter 13. This is based on the debtor's own schedules that show that the debtor can pay from 20% or 100%.

In short, the impact is not a wholesale denial of Chapter 7 relief to most of the current debtors.

Conclusion

The question which Congress and the American public now have before them is whether the debtors who can pay a

significant portion back to creditors should be asked to do so. As a member of the American public who has to pay for the credit losses and uncollected taxes of others, I believe this is a fair request.

Page 121 PREV PAGE TOP OF DOC

If we are using bankruptcy as debt relief, it constitutes a form of welfare or tax amnesty. We would certainly want to have some form of qualification for this benefit if the rest of the public eventually pay for it.

The bankruptcy system is part of the judicial system supported by the entire citizenry. In order for this system to command the respect of the public it must be seen as providing real relief for real needs. The minute that personal responsibility is no longer required we are confronted with the potential for abuse.

Needs-Based bankruptcy merely seeks to prevent this abuse by providing a mechanism that deters those who do not need the extraordinary benefits of bankruptcy from gaming the system and from getting a free ride instead of a needed fresh start.

I appreciate the opportunity of discussing the issues presented by H.R. 1350 and would welcome any questions that the Subcommittee might have.

Mr. **GEKAS.** We thank the gentleman.

We turn to Mr. Brewer.

STATEMENT OF WILLIAM E. BREWER, JR., ESQ., NATIONAL ASSOCIATION OF CONSUMER BANKRUPTCY ATTORNEYS, RALEIGH, NC

Page 122 PREV PAGE TOP OF DOC

Mr. **BREWER.** Thank you, Mr. Chairman.

I want to cover three major points in my brief remarks this morning. One is on needs-based testing; the other is on the issue of repeat filers; and finally, the revised fraud standard proposed in H.R. 3150.

I have listened to this debate about debtors who are filing Chapter 7 who can file Chapter 13 and it resonates as untrue, based on my personal experience. Let me tell you a little bit about that experience so you can gauge my remarks.

I have been practicing bankruptcy primarily for about 10 years. In my district, the eastern district of North Carolina, the bankruptcy filings last year broke down to about 48 percent Chapter 7, 52 percent Chapter 13. I filed approximately 440 cases last year and they broke down roughly 60 percent Chapter 7, 40 percent Chapter 13.

I know from my experience that I don't have clients who are filing Chapter 7 that could file Chapter 13. But I listen to Mr. Staten and his study, and I listen to these other studies and it confuses me. So I had a conversation with Mr. Staten during the recess. I said, "When you did your study and you looked at the debtors' budgets, did you take the numbers they had on there as being a complete listing of all their expenses?" He said, "Why certainly."

That is where the study falls on its face. That assumption is not accurate. Debtors don't overestimate their expenses, they underestimate. Even when they file bankruptcy they don't include all their expenses because that's—let me give you an example. Mr. Waldschmidt gives some examples in footnote one of his testimony, but you have a debtor who has a 1988 Chevrolet car. It's paid for. No payments. He does a budget and he doesn't show putting money aside for a new car. But he had better be doing that because that car is not going to last for a 3-to 5-year Chapter 13 plan.

Page 123 PREV PAGE TOP OF DOC

Mr. Staten's analysis says that he can afford to put money into a Chapter 13 plan in which that debtor is going to get to work and continue to feed his family—you stick him in a Chapter 13, what is going to happen? His car is going to break down, his plan is going to fail, and he either converts it to a Chapter 7 or dismisses.

So the underlying premise on which these studies are made is inaccurate. The money is just not there. There are other expenses that debtors have that sometimes don't show up on their budgets. There is nothing fraudulent about underestimating your expenses. If you inflate them, that's bad and I don't allow—I have never filed a bankruptcy when my clients have inflated their expenses, but they very often underestimate them.

That is one reason they get into debt trouble in the first place. When you're doing their budget and you say, "How about health insurance?" They say, "I let my health insurance drop. I couldn't afford it." The first thing they better do after they file bankruptcy is go get health insurance. Or if they get sick, then they're really going to have debt problems. There are a number of expenses that are there that don't show up in their budgets when they file their Chapter 7 petitions.

The real purpose behind needs-based bankruptcy is to force people from Chapter 7 into Chapter 13. I submit to you that the dismissal rate of Chapter 13 throughout the country is probably about two-thirds. I think maybe one-third are successful. These dismissals of cases are filed by debtors who elect to file Chapter 13 voluntarily, most of whom do so upon the motivation to save a house from foreclosure or to save a car, maybe to stop an IRS garnishment so they can afford to have a living wage.

Page 124 PREV PAGE TOP OF DOC

One can safely assume that the dismissal rate will go much higher if debtors are forced into a Chapter 13 as their only means of debt relief. This failure rate will be increased if you impose these IRS guidelines onto debtors.

As a North Carolinian, I don't think that I want some Washington bureaucrat to decide what it costs my clients to live in a particular circumstance in North Carolina. It is a tremendously diverse State. We have the Research Triangle Park with as much technology as there can be, when at the same time within a mule you have very rural areas. The cost of living is tremendously diverse even within that small region.

I have two other quick points.

With respect to repeat filers, when a debtor files Chapter 13, he is not engulfed in a protective envelope that prevents him from getting laid off, from getting sick, from having his car break down. When these things happen, the Chapter 13 often fails. But debtors are tremendously resilient. They get well. They get a new job. But these still need debt relief. The debt relief they need in order to save their house is perhaps to file another Chapter 13. This absolute bar or 30-day stay and then it evaporates basically slams effective bankruptcy relief in the face of these people.

Now there are abusive filers out there. There are repeat filers out there. And we need to get at those folks. But those are the people that are filing the third, the fourth, the fifth bankruptcy. They are being represented by bankruptcy mills. I would strongly recommend consideration of the repeat filing provisions in H.R. 3146 as the better approach to repeat filers that get at the real abusers, but that leaves the honest debtor—I wish I could bring every one of the repeat filers I have represented over the last several years and line them up here and have someone look them in the eye and tell them that they are abusive filers. They are not.

Page 125 PREV PAGE TOP OF DOC

Finally, the fraud exception. There will be the unintended result of actually punishing the person who in the last days prior to filing bankruptcy has taken steps to pay their debts rather than not pay. It is very common, when I have a client that has $20,000 worth of credit card debt on 18 percent cards to get a letter from one of these teaser rates that say, "Convert your balances to 6.9 percent," and they do so. But it is not enough and they still have to seek debt relief.

If I understand this provision, if you could show when you converted those balances to the 6.9 percent rate and you didn't have the ability to pay at the time you did it, even though it is an obvious attempt to pay debts, not to not pay them—if you're not going to pay them, you don't care what your rate is—that is a step someone takes in order to pay debts—it would have the unintended consequence of punishing people for taking the very steps to try to stay out of bankruptcy.

Please, take that provision out.

[The prepared statement of Mr. Brewer follows:]

PREPARED STATEMENT OF WILLIAM E. BREWER, JR., ESQ., NATIONAL ASSOCIATION OF CONSUMER BANKRUPTCY ATTORNEYS, RALEIGH, NC

I. PERSONAL BACKGROUND

Good morning Mr. Chairman and Honorable Senators, I am William E. Brewer, Jr., of Raleigh, North Carolina. I am honored to be here today as a Director of the National Association of Consumer Bankruptcy Attorneys (NACBA) and as a bankruptcy practitioner win over 20 years experience in private practice. I have been a NACBA member since 1993, and was elected a Director in May 1997. I also serve on the Executive Council of the Bankruptcy Section of the North Carolina Bar Association.

Page 126 PREV PAGE TOP OF DOC

I graduated from the University of North Carolina—Chapel Hill with an A.B. in Economics in 1973, and received my J.D. with honors in 1976. I served as law clerk to Judge R.A. Hedrick of the North Carolina Court of Appeals before beginning private practice in 1977.

Certified as a specialist in consumer bankruptcy law by the North Carolina State Bar, I represent primarily consumer bankruptcy debtors in Chapter 7 and Chapter 13 cases. In that role, I represented the debtors in a series of well-known cases against Sears in the Eastern District of North Carolina, dealing with the validity and effect of purchase money security interests in bankruptcy cases. I have litigated numerous consumer bankruptcy issues and have over 15 reported cases.

II. BANK CONSUMER LENDING PRACTICES CONTROL THE NUMBER OF CONSUMER BANKRUPTCY FILINGS

1. The Increase in Bankruptcy Filings Has Been Caused by Increasing Numbers of Over-Extended Debtors

In the ten years from 1986 to 1996, outstanding revolving consumer credit increased 238% (from $136 billion to $460 billion). Over the same period, total bankruptcy filings increased just 122% (from 530,436 to 1,178,555). Therefore, although the fact that bankruptcy filings exceeded one million cases in 1996 attracted substantial media attention, the rate of increase in bankruptcy filings during that ten-year period was only about half the rate of increase in outstanding revolving consumer credit. In fact, the increase in bankruptcy filings actually slowed substantially over the last five years. While bankruptcy filings increased 78% from 1986 to 1991, they increased only 25% from 1991 to 1996. [Administrative Office of the U.S. Courts, Federal Reserve Board & Department of Commerce]

Page 127 PREV PAGE TOP OF DOC

Disposable household income, however, has not experienced anywhere near such an increase over the last ten years. Consequently, household debt-service payments have risen as a share of disposable income. It should not be surprising that non-business bankruptcy filings closely track the debt-to-income ratio over the period of 1962 to 1995. As the debt-to-income ratio increases, so do bankruptcy filings. [Kim Kowalewski, Congressional Budget Office]

Similarly, personal bankruptcy filing rates track credit card delinquency rates, as documented in the work of my fellow panelist, Professor Lawrence Ausubel.

2. Credit Card Delinquency Rates and Debt-To-Income Ratios Have Increased Because Banks Have Pursued More Marginal Borrowers

As the cost of funds to banks decreased, credit card lending at high rates became increasingly attractive for banks. In order to expand their credit card market-base, banks loosened credit standards significantly. Higher-quality borrowers relied less on credit card borrowing and more on lower-interest forms of borrowing, leaving credit card lenders to pursue more marginally qualified borrowers.

The marketing of credit cards by banks increased drastically in the last few years. Credit card mail solicitations approached and exceeded 2.5 billion solicitations per year in the last several years. Banks also purchased increasing numbers of telemarketing hours to solicit credit card usage. Old-fashioned advertising of credit cards also increased. As evidence of this mass marketing, everyone knows of children and even pets who have received credit card offers in the last few years.

Page 128 PREV PAGE TOP OF DOC

As a result of the heavy marketing of credit cards to increasingly marginal borrowers, it is understandable that credit card delinquency rates have increased, along win the debt-to-income ratio.

3. Banks Have Pursued More Marginal Borrowers Because Even With the Associated Losses Their Net Profits Greatly Increase

While net profits earned by banks on their credit card portfolios have decreased over the last few years, those profits remain substantially higher than other forms of bank lending. In 1993–94, credit card lending was 135% more profitable, as a percent of assets, than all forms of bank lending taken together. In 1995, credit card lending was 54% more profitable; and in 1996, credit card lending was about 35% more profitable. So, although credit card net profits have decreased somewhat, it is still substantially more profitable than other forms of bank lending [Economic Report of the President, 1997]

4. Bankruptcy Filings Make Up Only a Portion of All Bank Charge-Offs

Charge-offs on credit card lending have increased in the last few years, now approximating 5%, bringing the rate back to the previous 1991 peak. Charge-offs due to bankruptcy filings account for only about half of those charge-offs, according to the credit card industry. In general, charge-offs result when borrowers simply cannot repay their debts. Whether the borrower files a bankruptcy to resolve the financial dysfunction legally, or merely allows the debt to be charged-off outside of bankruptcy, does not change the underlying cause of charge-offs. In either case, the debtor does not have enough money to pay his/her debts.

Page 129 PREV PAGE TOP OF DOC

5. Banks Can Control Their Charge-Off Rates by Changing Lending Practices

Charge-off rates vary greatly among banks, depending on their lending practices. Low charge-off rates reflect more responsible lending practices [e.g., MBNA (Wilmington)—2.1% and Peoples (Bridgeport)—2.48%]. On the other hand, higher charge-off rates result from riskier lending practices [Mellon (Wilmington)—9.0% and Hurley State (Sioux Falls)—9.0%]. [Veribanc, as cited by Stephen Brobeck, *Expanding Credit Card Debt: The Role of Creditors and the Impact on Consumers,* December 16, 1997]

Common sense indicates that banks can reduce high charge-off rates by instituting more responsible lending

practices. Evidence shows that banks do just that, in many cases. Jonathan McCarthy, *Debt, Delinquencies, and Consumer Spending,* Current Issues in Economics and Finance—Federal Reserve Bank of New York, February 1997.

6. Therefore, Bank Consumer Lending Practices in Large Part Control the Numbers of Consumer Bankruptcy Filings

As banks pursue riskier borrowers in order to earn high interest from increasing numbers of issued credit cards, the debt-to-income ratio of borrowers increases, and particularly that ratio of more marginal borrowers. With more borrowers, and more marginal borrowers, on the brink of financial disaster which can be brought on by illness, divorce or unemployment, the possibility of financial dysfunction looms. An increase in bankruptcy filings is a natural consequence of the banks' riskier lending practices.

Page 130 PREV PAGE TOP OF DOC

Some bank lobbyists claim that purportedly "lax" U.S. bankruptcy laws (dating back to 1978) have caused the number of bankruptcy filing to increase. If this were true, bankruptcy filings should have decreased in the mid-1980s when "means-testing" was incorporated in the Bankruptcy Code. No such decrease in filings occurred then, and no increase in filings occurred in 1979 when the 1978 Bankruptcy Code went into effect. In fact, rates of bankruptcy filings in the U.S. track bankruptcy filings in Canada. Clearly, U.S. bankruptcy laws have no effect on bankruptcy filing rates in Canada; what is much more likely is that similar economic forces and lending practices have caused the similar bankruptcy filing rates.

III. CONSUMERS WHO PAY THEIR CREDIT CARD BILLS IN FULL DO NOT PAY FOR THE DEBTS DISCHARGED IN BANKRUPTCY

Bank lobbyist claim that consumers who pay their credit cards in full also pay for debts discharged by others in bankruptcy—that those losses are passed directly through to other consumers. If this were true, when bankruptcy filings are up interest rates would increase; and when bankruptcy filings decrease interest rates would likewise decrease.

On the contrary, just the opposite seems true. With bankruptcy filing rates at an all-time high, credit card interest rates are actually somewhat lower than they were earlier in the 1990s when bankruptcy filing rates were substantially lower. In addition, if banks passed through to their customers their losses and profits, during the 1991–92 record profit years one would have expected rebates or lower interest rates to have been passed through to the customers. Of course, that did not happen.

While credit card interest rates have fallen slightly in the last few years, the cost of funds to banks has fallen even more. This spread in interest rates (between interest charged and the cost of funds) has increased from 6.1 percentage points in 1982 to 11 percentage points in 1996. [Donald Morgan and Ian Toll, *Bad Debt Rising,* Current Issues in Economics and Finance—Federal Reserve Bank of New York, March 1997]. With this significant increase in the spread, banks could easily have passed their profits through to consumers in the form of even lower interest rates. They chose not to, however; but rather chose to assume additional risks of marketing credit cards to more marginal borrowers in hopes of further increasing their net profits.

Page 131 PREV PAGE TOP OF DOC

IV. FIVE MYTHS ABOUT CONSUMER BANKRUPTCY FILINGS

1. Myth #1: The Cost of Discharging $40 Billion in Debts in Bankruptcy Every Year Is Passed Directly on to the Average Consumer in the Amount of $400 Per Year

There are no statistics which support the bank lobbyists' claim that $40 billion is discharged in consumer debt each year. Neither the U.S. Trustee Program nor the Administrative Office of the U.S. Courts maintain any statistics on this subject. Nor does the Staten Study provide any information about the total amount of discharged consumer debt; the

Study does not even clarify whether business bankruptcies were excluded from the sample.

Although obviously a substantial amount of debt is being discharged in consumer cases each year, and the discharged debt is a charge against the credit system as a whole, it is misleading to state that this charge is passed directly on the average consumer. When bankruptcy rates declined, in 1993 and 1994, at a time when credit card profits peaked—consumers received no rebates from the banks.

However, banks have increased fees associated with credit card lending recently. The fees have not been charged to all credit card users across the board, however. Banks have reduced grace periods and in some cases imposed nominal annual fees for users who carry no balances and therefore pay no interest. But, the bulk of the fee increases have targeted marginal borrowers. Most notably, banks will now increase a borrowers' interest without notice if the borrower's credit report shows vulnerability—with the result of pushing a marginal debtor even closer to filing bankruptcy.

Page 132 PREV PAGE TOP OF DOC

These increased fees may be seen as ways in which the cost of consumer bankruptcies is distributed among consumers, with a heavy emphasis on consumers most likely to need bankruptcy relief in the fixture. But, these increases in fees to consumers could just as easily be tied to debt discharged by large businesses that file bankruptcy, or other inherent costs in our economic system such as environmental protections or highway repairs.

2. Myth #2: A Substantial Number of Debtors Can Pay the Debts They Discharge in Bankruptcy

The only support for this myth is in the unfounded conclusions of a bank industry-funded Credit Research Center study done by Professor Michael Staten ("Staten Study"). After being criticized by Kim Kowalewski, Economist for the Congressional Budget Office, in a report which is attached as an Appendix to the Report of the National Bankruptcy Review Commission, the Staten Study was again criticized by the GAO, in its own draft report completed in January. The GAO report charged that, among other important failures in methodology, the Staten Study did not use scientific random sampling techniques.

Putting aside for the moment its serious deficiencies, the Staten Study stated that:

1. 50% of Chapter 13 debtors could pay all nonpriority, nonhousing debt over five years;

2. 69% of [Chapter 13 debtors could pay 60%+ of all nonpriority, nonhousing debt over five years;

Page 133 PREV PAGE TOP OF DOC

3. 5% of Chapter 7 debtors could pay all nonpriority, nonhousing debt over five years;

4. 10% or 15% of Chapter 7 debtors could pay 78%+ of nonpriority, nonhousing debt over five years;

The initial Staten Study did not take into consideration that the debtor would be repaying certain debts that would be reaffirmed or debts that would not be discharged but were also not priority debts, such as assigned child support and most student loans.

The Staten Study reported widely varying average dollar amounts which the debtors stated their intention to reaffirm in Chapter 7 cases: $1,310 in Dallas to $6,706 in Memphis; and wide variations in percentages of debtors who stated their intention to reaffirm debts: 11% in Dallas, 57% in Houston, and 73% in Indianapolis. The initial Staten Study did not reduce the amount it estimated the debtors could pay on nonhousing debt by the amount the debtors indicated they would reaffirm. In a subsequent revision of his Study, Staten claimed to have accounted for monthly payments on reaffirmed secured debt. This is extremely hard to believe because it is only *rarely* that expected monthly payments on reaffirmed debts are disclosed *anywhere* in the debtors' bankruptcy schedules.

Accordingly, a major problem with the Staten Study's conclusion is that it did not seriously purport to determine the amount of *discharged and unreaffirmed* nonhousing debt the debtor could afford to repay. Staten does not address the fact that nonpriority nondischargeable debts are rarely identified as such in the schedules. A conclusion that a debtor can afford to repay a certain percent of nonhousing debt is without any import whatsoever, if the debtor will indeed be repaying an equivalent amount because it is nondischargeable or reaffirmed. Because the Staten Study has not calculated how much of the debtors purported ability to pay will be consumed by reaffirmed and nondischarged debt, the Study completely fails to prove that *any* debtors, much less a substantial number of bankruptcy debtors, can repay their discharged debts.

Page 134 PREV PAGE TOP OF DOC

Using my twenty years of experience, I can conclude that the vast majority of consumer bankruptcy debtors are honest and conscientious. As such, rather than strategically hiding or undervaluing assets and projected income, they often err in the opposite direction. They are, really, much like the rest of us in terms of being generally unable to accurately estimate their financial situation—and, if anything, they are more optimistic than they should be:

They tend to underestimate the amount of their total outstanding debt;

They tend to overestimate their ability to pay off their outstanding debt by assuming that paying the minimum payments will substantially pay down those debts over a reasonable period of time;

They tend to overestimate the value of their assets;

They tend to overestimate their past and future average income; and

They tend to underestimate their living expenses.

These characteristics of bankruptcy debtors are reflected in statistics regarding the outcome of Chapter 13 cases, according to the Administrative Office of the U.S. Courts:

Only 36% of Chapter 13 cases are actually completed;

Page 135 PREV PAGE TOP OF DOC

14% of Chapter 13 cases are ultimately converted to Chapter 7; and

49% of Chapter 13 cases are ultimately dismissed as incomplete.

As a practitioner, I can say that my clients are indeed anxious to repay their debts to the full extent of their perceived ability—and their perception of their ability sometimes results in their embarking on a Chapter 13 plan which I fear may not ultimately be successful.

3. Myth #3: The Stigma of Filing Bankruptcy Is Gone and Debtors File Bankruptcy as a Financial Planning Tool Rather Than as a Last Resort

In the perception of most of my clients, the stigma of filing bankruptcy remains very strong. I am very often asked questions such as, "Will my employer or family have to know about this?" and "Will it be published in the newspaper? " In fact, most of my clients (75%) contact me through my telephone directory advertisement. Unlike other areas of the law in which people inquire of friends, family or coworkers about attorneys, when it comes to financial difficulties and the need to consider bankruptcy, people are so embarrassed and ashamed of their situation that they retain their anonymity by finding an attorney through the telephone directory.

Most of my clients file bankruptcy only as a last resort. Many have unsuccessfully tried consumer credit counseling. Many are working two jobs and are at the point of near-exhaustion, in an attempt to pay their debts. some even forego medical insurance in the misguided notion that it is more important to pay the VISA bill than to cover themselves and their children with medical insurance. To the vast majority of my clients, and consumer bankruptcy debtors in general, being forced to file bankruptcy is a truly humiliating experience.

Page 136 PREV PAGE TOP OF DOC

4. Myth #4: The Increase in Bankruptcy Filings Is Due to Increased Attorney Advertising

My personal experience contradicts the notion that attorney advertising plays a significant role in creating the increase in bankruptcy filings. The numbers of cases I have filed in the past years are as follows:

Table 6

The increase in the number of my case filings during this time period has occurred with *no change* in my advertising, which consists primarily of a three-quarter page advertisement in the telephone directory. My increase in filings is reflective of the increases in the Eastern and Middle Districts of North Carolina over this period of time. There have not been any significant changes by other bankruptcy attorneys in their advertising practices either. Therefore, the increases in filings cannot be tied to attorney advertising.

5. Myth #5: If Substantial Numbers of Americans Were Prevented From Filing, They Would Be Able To Pay Their Bills

Bank lobbyists and professor Staten state or imply that if a significant number of debtors who now file bankruptcy were prevented from doing so, they would be able to pay their bills. They claim that with a little more pressure and fewer alternatives, debtors could refocus their priorities and pay their bills. Nothing could be further from the truth.

It is perhaps difficult for middle and upper-income Americans to perceive of one million families being unable to pay their bills—each year. But, that is in fact the case. It is also difficult, as members of the general public, to comprehend the real distance between stars or the size of an atom. But, our difficulty in imagining these things does not prevent them from being true. Similarly, there really are a million families who have suffered tremendous pain and guilt over their financial problems, and they deserve our respect and assistance rather than disbelief.

Page 137 PREV PAGE TOP OF DOC

V. PENDING BANKRUPTCY LEGISLATION

1. H.R. 2500 (McCollum-Boucher) & H.R. 3140 (Gekas-McCollum-Boucher-Moran)

These two bills propose a radical restructuring of the consumer bankruptcy system. They would prevent many honest, hard-working Americans from obtaining relief from the incessant hounding of collection agencies, the garnishment of wages, the foreclosure of homes, and the repossession of vehicles. Bankruptcy relief affords a way of comprehensively and fairly managing a convergence of financial demands upon the debtor, demands which the debtor has no way of paying.

Under either of these two bills, many homes would be foreclosed, cars repossessed, and many hard-working Americans would lose or abandon their jobs because of the hopelessness of their situation. Although banks claim that they would recover more money from financially-distressed debtors under the systems proposed by these two bills, the huge increases in administrative and legal costs which would be required would likely consume any nominal increases in funds extracted from the debtors.

2. S. 1301 (Grassley-Durbin)

While not quite as radical as H.R. 2500 and H.R. 3150, S. 1301, would still shift the bankruptcy balance too far in favor of creditors, and would also impose substantial additional costs on the system.

Page 138 PREV PAGE TOP OF DOC

For example, S. 1301 would, like H.R. 3150, require debtors to redo their budgets each year they are in a Chapter 13 payment plan and would also require Chapter 13 trustees to do a detailed review of these budgets. The increased cost of such a review in both attorneys' fees and trustees' administrative expenses would, like H.R. 3150, almost certainly far outweigh any small revenues realized.

Also, S. 1301 would require debtors to file their tax returns in the open files of the Bankruptcy Court Clerk, thus creating enormous potential for violations of the debtors' privacy rights.

3. H.R. 3146 (Nadler-Conyers-Hilliard)

This bill is a balanced approach which will address abuses by creditors as well as debtors. This bill would retain and improve the "needs-based" approach to bankruptcy currently in the Code, and will require debtors and creditors to share the responsibility to make the bankruptcy system work fairly.

INSERT OFFSET RING FOLIOS 11 TO 25 **HERE**

Mr. **GEKAS.** We thank the gentleman for his testimony.

We turn to Mr. Waldschmidt.

STATEMENT OF ROBERT H. WALDSCHMIDT, ESQ., HOWELL & FISHER, NASHVILLE, TN, REPRESENTING NATIONAL ASSOCIATION OF BANKRUPTCY TRUSTEES

Page 139 PREV PAGE TOP OF DOC

Mr. **WALDSCHMIDT.** Mr. Chairman and members of the committee, I would like to thank you for asking me here today.

The panel of Chapter 7 trustees are in a unique position to weigh the balance between debtors' rights and creditors' remedies. In a recent poll, our membership had an average of over 13 years of experience on the panel and each handled an average of over 740 cases each year.

Trustees have numerous concerns about reform including preserving the preference and fraudulent conveyance statutes to discourage pre-bankruptcy planning, and striking any reference to a "deemed filed" rule, which is in H.R. 3150 at this time, which if enacted would become a nightmare in Chapter 7 and Chapter 13 cases. My materials refer to that further.

However, the principal focus of this debate has centered on the perceived debtor abuses in Chapter 7. It is the experience of Chapter 7 trustees, that even though we encounter *potential* repayment possibilities in perhaps 10 to 15 percent of all our cases, a further inquiry only reveals 1 to 2 percent of these debtors who could *actually* confirm a Chapter 13 plan. The statistics are merely a compilation of numbers and don't look at the human realities that debtors face when they encounter insolvency.

But regardless of the extent of the problem, the solution lies not with any "front end" eligibility requirement in bankruptcy. The jurisdictional and procedural problems of such a change will burden the courts for decades to come and the costs of administration are exorbitant. The whole bankruptcy system will slow to a crawl if this system is

enacted on the front end. However, an alternate solution—portions of which are already contained in both H.R. 3150 and H.R. 3146—may be an appropriate remedy.

Page 140 PREV PAGE TOP OF DOC

NABT feels that there are four areas which need to be amended to address the problems that face this subcommittee at this time. First, Section 707(b) already contains the framework to prevent debtor abuse. Unfortunately, it has been ineffective because of the language of the statute. Both H.R. 3150 and H.R. 3146 have suggested changes to this section and I believe both of those are headed in the right direction. We like the use of the words "inappropriate use" rather than "substantial abuse". And the percentage distribution test may be appropriate. The percentages could be worked out and there could be compromises reached, but this is headed in the right direction, *if* you can have a disposable income test which works—and there is a lot of argument about different expenses in different parts of the country.

However, we would also encourage another test, which is the solvency test. We often encounter debtors who hide behind their exemptions when they have the capacity to pay 100 percent of their debt from those assets. These debtors may not have disposable income and may not fit the other portions of 707(b), but they do have the ability to repay their debt.

The second problem that needs to be addressed is discussed in both of these bills is the problem of serial filings. We think that is headed in the right direction. We think that a change to Section 362 is appropriate. We have suggested the third filing invoke a stay upon request only, not the second filing, and H.R. 3146 suggests that it be a 30-day termination the third time and then a stay upon request the fourth time. All those suggestions are headed in the right direction, but we think the issue of serial filings can be addressed in that manner.

Third, Chapter 13 was originally enacted with a super discharge in order to attract debtors to a repayment plan. Since that time, the discharge provisions have been narrowed to where the filing of Chapter 7 provides almost the same relief as Chapter 13 but the debtors don't have to go through a 5-year repayment plan. The relief available under Chapter 13 should be much more attractive to debtors to encourage them into that section and the limitations on discharge in that section should be reconsidered.

Page 141 PREV PAGE TOP OF DOC

Here is where H.R. 3150 actually further discourages Chapter 13 and makes it more difficult and puts more restraints on it. H.R. 3146 gives debtors much more relief but perhaps goes too far, particularly as those sections relate to Chapter 7. However, I think Chapter 13 needs to be more attractive than Chapter 7 instead of going the other direction.

Finally, an area that is not addressed in either of the bills and needs to be discussed in order to prevent abuse involves conversions to and from Chapter 7. These are often not considered, but a debtor who has been in Chapter 13 for a year and has incurred additional liabilities while they are in Chapter 13 can discharge those liabilities by converting to Chapter 7. However, if during that same period of time they acquire assets, they can keep those assets because they are not property of the estate under Section 541. So the debtor keeps the assets they obtain post-petition, but discharges the debts they have incurred post-petition, which is an extremely unfair result.

On the other hand, going the other direction, when Chapter 7 trustees do their job well and convince debtors, by the filing of motions or complaints or just administering assets, that they need to go into Chapter 13—if anything else, to get rid of the Chapter 7 trustee—if they accomplish that, the Chapter 7 trustees are punished because they can't receive a trustee's fee. Under Section 326, trustees are not entitled to a fee if no money has run through their hands.

So even if we do our job well and accomplish a good result, we aren't entitled to any kind of a fee. We think the compensation for trustees who do their job well needs to be considered.

Page 142 PREV PAGE TOP OF DOC

In conclusion, the issues facing bankruptcy reform do not require a complete redrafting of the Bankruptcy Code. We think the structure and framework for an effective system is already in place. If the amendments are made to these few sections, as we have indicated in our materials, the blueprint will be in place to prevent debtor abuse to the bankruptcy system.

Thank you for inviting me here today.

[The prepared statement of Mr. Waldschmidt follows:]

PREPARED STATEMENT OF ROBERT H. WALDSCHMIDT, ESQ., HOWELL & FISHER, NASHVILLE, TN, REPRESENTING NATIONAL ASSOCIATION OF BANKRUPTCY TRUSTEES

The National Association of Bankruptcy Trustees (NABT) represents the interests of most of the trustees appointed under Chapter 7 of the Bankruptcy Code. Although trustees are facilitators of the system and are responsible for enforcing the provisions of the bankruptcy laws enacted by Congress, they also have the unique opportunity to observe the delicate balance between creditors' rights and debtors' remedies.

NABT was actively involved in the work of the Bankruptcy Review Commission. Several members of the Association provided input and testified before the Commission on various issues relating to bankruptcy reform. The Association is very concerned with improving the integrity of the system, which serves to grant debtors an appropriate remedy for their financial problems while protecting the rights of creditors to avoid an abuse of the system.

Page 143 PREV PAGE TOP OF DOC

The "needs-based" concept reflected in H.R. 3150 is a dramatic change from prior law. Bankruptcy statutes have historically been based on a "balance sheet" approach, where assets versus liabilities (not income) are the primary basis for relief. However, since the enactment of the Bankruptcy Reform Act of 1978 the economy of this country has shifted to a system where credit is often granted based on income alone, with minimal consideration given to the debtor's balance sheet. Thus, the credit industry is now asking Congress to modify the bankruptcy laws to mirror this shift in credit policies.

Chapter 7 trustees are placed in a positions which enable them to observe the socioeconomic difficulties encountered by debtors and to recognize those debtors who are in dire need of a fresh financial start through the bankruptcy process. The vast majority of all Chapter 7 debtors do not have any viable option. Not only do they suffer from insolvency (with few assets to apply to their liabilities) but also from a lack of sufficient cash flow to meet a tight budget.

However, there are debtors who do not belong in Chapter 7. These debtors have a capacity to generate a meaningful income in excess of their expenses, usually business or professional people. Despite reports from the credit industry, Chapter 7 trustees encounter these situations in less than 1–2% of all cases. (Appendix 1 expands on the reasons for the discrepancy in the statistics.)

NABT perceives that the current bankruptcy system is structured to encourage Chapter 7 and discourage Chapter 13. Except for 11 U.S.C. §707(b) (which is too vague with its current language), there are few incentives for a debtor to choose Chapter 13. An initial aim of the Bankruptcy Reform Act of 1978 was to make Chapter 13 attractive. Unfortunately, subsequent amendments to the statute have diluted the relief available to Chapter 13 debtors.

Page 144 PREV PAGE TOP OF DOC

NABT does not believe that drastic reform to the bankruptcy laws is necessary to prevent abuse of the system. Overall, encouraging debtors to choose Chapter 13 over Chapter 7 would be preferable, rather than to enact statutes which *force* debtors into a particular chapter. To prevent abuse and to encourage debtors to choose the "income-based"

approach of Chapter 13 over the "asset-based" approach of Chapter 7, NABT suggests consideration of the following four proposals:

1. Redraft §707(b) to provide a meaningful procedure to prevent "un-needy" debtors from continuing under Chapter 7. An amendment to §707(b) needs to address five areas: (Appendix 2 outlines a proposed §707(b))

A. Modify the language in the statute by deleting reference to the words "substantial abuse." This phrase is too severe and results in a negative response from debtors and their counsel, instead of a conciliatory approach by which debtors could reevaluate their choice of Chapter. NABT has previously suggested the words "improper use" although similar language could be equally effective.

B. There must be concrete tests for the "improper use" of Chapter 7. A court presented with certain factors must dismiss or convert a case—unless extraordinary circumstances exist. Tests which NABT has suggested include:

(1) The ability to make a 30% distribution to unsecured creditors from disposable income.

Page 145 PREV PAGE TOP OF DOC

(2) The solvency of the debtor—assets vs. liabilities (without regard to exemptions).

(3) If the debtor's annual income exceeds four times the debt being discharged within the bankruptcy proceeding.

[The percent distribution test which is reflected in the bill is one area where the improper use of Chapter 7 can be determined. However, sometimes debtors have assets (rather than income) from which to pay their liabilities. However, they often elect to shield those assets (through exemption laws) instead of using their assets to satisfy their debt. Therefore, a solvency test using all assets available to the debtor is appropriate. The third test is a unique bright line test which would be extremely effective in the clearly abusive cases. If the debtor earns $100,000 per year but is only attempting to discharge $25,000, Chapter 7 relief is unnecessary. It is possible that a factor of less than four times would involve an abusive filing but this test would be an easy solution for the grossly abusive filings. In addition, all parties in interest could pursue actions under §707(a) to dismiss a Chapter 7 proceeding if filed in bad faith. NABT perceives that this section is adequate to cover any remaining situations which may be deemed an abusive Chapter 7.]

C. The improper use provisions should be available to Chapter 7 trustees and to larger creditors in the case. (Perhaps to unsecured creditors with claims of at least 25% of the total debt to be discharged). If Congress provides this remedy to *all* creditors there is the chance of abuse by small credit companies electing to file motions in every case. However, larger creditors have more at stake and would not abuse their rights.

Page 146 PREV PAGE TOP OF DOC

D. Recovery of costs by panel trustees—NABT has suggested that trustee's costs and attorney's fees be recovered directly from the debtor and any claim incurred by a Chapter 7 trustee (or his counsel) would become an administrative expense in the bankruptcy proceeding (if converted to Chapter 13) or any subsequent bankruptcy filed in the future. Such a claim by the trustee would also constitute a non-dischargeable debt against the debtor in any subsequent bankruptcy. Although this remedy would not ensure trustees of recovery in every case, it would increase the likelihood that trustees would pursue these motions.

E. Limit liability of trustees—If panel trustees are given the authority to pursue actions under §707(b), their exposure for taking such actions should be defined. If a trustee unsuccessfully pursues an action to dismiss a Chapter 7 case, that trustee should not be held liable for any costs or attorney's fees incurred by the debtor (otherwise, panel trustees would seldom risk the pursuit of these actions.) In addition, if a Chapter 7 trustee elects *not* to file a motion, a creditor may accuse the trustee of neglecting his or her duties by failing to pursue the motion. (Although creditors and the U.S. Trustee have the right to file the same motion.) Trustees need protection from this type of collateral attack, particularly such actions that other parties can pursue.

2. The stay provisions of §362 should be modified to eliminate the *automatic* stay for any bankruptcy filing if the debtor has filed two prior bankruptcies within the last six (6) years. Although there would be no automatic stay, the debtor could file a motion for a stay and the court could impose such stay if there was a showing of just cause. Modification to the stay provisions would prevent serial filings, particularly those under Chapter 13. However, it would also provide relief to debtors if extraordinary circumstances arise.

Page 147 PREV PAGE TOP OF DOC

3. Chapter 13 provisions should be enhanced to make this remedy more attractive for debtors. In particular, the "super-discharge" should be reinstated and the "cram-down" provisions should be re-evaluated. Recent efforts to add claims to the list of nondischargeable debts in Chapter 13 is counter-productive. Debtors with obligations which are non-dischargeable under Chapter 7 (and who may never have the capacity to repay those claims during their lifetime) should have the ability to address those issues within the Chapter 13 proceeding. After committing their disposable income to the payment of their obligations for a reasonable period of time these debtors should be given a fresh start. If the dischargeability section of Chapter 13 resembles that in Chapter 7 then there is little incentive to choose Chapter 13 over Chapter 7.

4. The effect of a conversion from Chapter 13 to Chapter 7 should be modified to prevent debtor abuse. More than 65% of all Chapter 13 proceedings result in a dismissal or conversion of that case to Chapter 7. In converted cases any assets that the debtor acquires after the filing of the Chapter 13 petition are *not* property of the estate under §541. However, any debts incurred by the Chapter 13 debtor prior to the conversion can be discharged. This has resulted in debtors accumulating assets after the filing of a Chapter 13, and then converting their case to Chapter 7, while retaining their new property. Modifying §541 could avoid this problem (property of the estate) to include all property that the debtor acquired after the commencement of the bankruptcy proceeding but before conversion to Chapter 7. This will discourage debtors from obtaining a windfall or advantage by converting from Chapter 13 to Chapter 7. Conversely, conversion from Chapter 7 to Chapter 13 should be supplemented to allow a Chapter 7 trustee to receive compensation for pre-conversion services to the estate. Under current law a trustee is denied compensation under §326 if the debtor converts before any funds flow through the trustee's accounts. Chapter 7 trustees should be rewarded for assisting conversion of a case to a repayment plan. An amendment to §326 could provide incentive to Chapter 7 trustees to encourage conversions to Chapter 13 (either through §707(b) or by the threatened administration of assets.)

Page 148 PREV PAGE TOP OF DOC

NABT believes that focusing on these four areas can best address the "needs-based" concerns of creditors. The approach taken by the creditor groups and reflected in H.R. 3150 have parallel goals as those stated above. The clear intent of these bills is to discourage debtors from filing Chapter 7 if they do not need a Chapter 7 discharge.

However, this bill proposes a more dramatic approach at the commencement of a bankruptcy proceeding. An immediate determination must be made regarding the debtor's eligibility for relief under Chapters 7 or 13 at the time the case is filed with the clerk of the court. NABT was presented with this concept by several creditor groups during the BRC, and has raised several concerns about the application of such an approach. A "front-end" determination of Chapter, although attractive in a perfect world, would encounter several obstacles in practice.

1. Jurisdictional—if a case is filed under Chapter 7 and is not accepted by the clerk, does the debtor have any ability to challenge the decision of the clerk? In the alternative, if a case is filed under Chapter 7 and accepted by the clerk (although it should have been filed under Chapter 13) does the bankruptcy court have jurisdiction to administer the case? If a Chapter 7 or 13 trustee is appointed in a case which has been designated with the wrong chapter, does that trustee have authority to act? If the court enters orders in a case under Chapter 7, and it is later determined that the case should have been filed under Chapter 13, are those orders still valid?

2. Procedural—most bankruptcy court clerks do not have the capacity to administer a procedure which would require a quasi-judicial determination about whether a petition can be filed under a particular chapter. Most clerks are required

to *receive* all papers and pleadings filed in a case (within guidelines dictated by local rules) and requiring the clerk to make such decisions may be beyond their authority. Is a decision by the clerk of the court appealable?

Page 149 PREV PAGE TOP OF DOC

3. Debtor reactions—if a 20% disposable income test is applied to all Chapter 7/13 petitions, debtors might be forced into unique and innovative ways to "beat the system." A debtor might buy a new car shortly before bankruptcy, so that the monthly expenses could be increased by $500 to eliminate his disposable income. Or the debtor on the borderline of the 20% test could decide to incur $10,000 of unsecured debt on the verge of bankruptcy, merely to meet the requirements of Chapter 7. Or the debtors could quit their jobs or allow themselves to be fired, so that they could represent to the court that they did not have any income. These strategies violate the public policy they are designed to protect.

4. Anticipated backlogs of cases—Many court dockets are already full with contested matters and the addition of contested eligibility hearings (where debtors may or may not be eligible for relief under Chapter 7) would have a drastic effect on the entire court system. In Nashville it is estimated (using the creditors' data) that 2500 cases per year would become involved in some type of eligibility hearing. If these cases required one hour per hearing, that would require one judge to devote every working hour of every working day to hear only those cases. Additional judges would have to be appointed or the administration of all other cases would be delayed. Also, the disbursement of funds to creditors in both Chapter 7 and Chapter 13 cases would have to wait in line for rulings from the court.

NABT does not object to the concept of a "needs-based" bankruptcy system, but prefers that the approach focus on a major modification to §707(b). The jurisdictional and procedural process is already in place, and Chapter 7 trustees have expressed their willingness to pursue motions for "improper use."

Page 150 PREV PAGE TOP OF DOC

The bill currently before the House would also require trustees to investigate and report on the debtor's income in each Chapter 7 case. This new investigation would substantially add to the work of trustees in no asset cases. In particular, a "verification" is supposed to be filed within 30 days after the filing of the petition. This will be nearly impossible for most panel trustees, who could not verify any information from the debtors before the meeting of creditors (which normally occurs after the first 30 days of the case). In addition, this extra work will require trustees to spend considerably more time in all no-asset cases. Trustees may need to hire additional staff yet this concept does not provide for any supplement to the trustee's compensation or payment of these expenses. The issue of trustee liability also surfaces with respect to the "verification" process, and provisions would need to be included which protect trustees from collateral attack from creditors.

One other area of the bill which is of extreme concern to trustees is the proposed "deemed-filed" provision. This provision would eliminate the necessity for creditors to file proofs of claim and deems the inclusion of the debt on the schedules as an allowable claim. Such a proposal would complicate Chapter 7 and 13 proceedings and would produce drastic unforseen consequences.

The experience of Chapter 7 trustees suggests that consumer debtors never accurately list the amount of their liabilities on Schedules D, E, and F. The accrual of interest prior to the filing of the petition makes it virtually impossible to accurately determine the amount of a claim from the debtor. In addition, some claims may be subject to dispute although the debtors have not listed it as such.

The statutory duty of §704 requires trustees to review and make recommendations for all claims. Trustees cannot rely on the debtor's representation to fulfill this duty and usually need to review the backup documentation for each claim.

Page 151 PREV PAGE TOP OF DOC

This change would require the filing of a "motion to determine the amount, priority status, and secured status of claim," or the filing of an "objection to claim" for virtually every debt listed on the debtor's schedules. This procedure would not only increase the costs of administration of a bankruptcy estate (attorney's fees) but would also force the creditors to incur additional attorney's fees and expenses in responding to and/or defending the motion/objections filed by the trustees. This would not simplify the process, but would merely create one more layer of contested matters and litigation in every asset case before funds could be distributed to creditors. A "deemed-filed" rule is not functional in Chapter 7 or Chapter 13.

NABT is encouraged by the attention given to bankruptcy reform, but the Association believes that House Bill 3150 attempts to "force" debtors away from Chapter 7 rather than "attract" them to a repayment Chapter. The abuse is not as widespread as suggested by creditor groups and §707(b) is an adequate tool to prevent an improper use of Chapter 7. The current structure of the court can handle the case load since the jurisdiction, procedure, and enforcement mechanisms for such an amendment are already in place. Therefore, additional judges, clerks, magistrates or trustees would not be needed.

The original concept of the Bankruptcy Code did not create this problem. However, the subsequent attractiveness of Chapter 7 over Chapter 13 and the ineffectiveness of §707(b) have allowed (and encouraged) many debtors to discharge their debts and obtain a fresh start. NABT believes that the small changes referenced herein will provide the necessary framework to eliminate perceived abuses in the future.

Thank you for inviting me to participate in this hearing. NABT welcomes the opportunity to assist the subcommittee in the future.

Page 152 PREV PAGE TOP OF DOC

APPENDIX 1

Statistical studies which report that 8% to 22% of all Chapter 7 debtors can repay a substantial portion of their debt, do not reflect the reality of each case. These studies focus on the cumulative totals listed on Schedules D, E, and F (liabilities), and Schedules I and J (income and expenses). Using these numbers does not provide reliable results.

A debtor's financial situation involves more than the schedules usually show and can be materially misleading. Some reasons that these schedules do not tell the whole story may be (these situations are regular occurrences in Chapter 7):

1. Schedule I—

(A) the income includes 10 to 20 hours of overtime, which is not always reliable or available to the debtor.

(B) the income includes alimony or child support which is never timely paid.

(C) the debtor has recently changed jobs, or his job security is uncertain.

2. Schedule J—

(A) expenses are routinely too low, sometimes reflecting a $100–$200 per month food expense for a family of five.

Page 153 PREV PAGE TOP OF DOC

(B) the debtor has no health insurance and could not handle even a minor medical problem.

(C) debtors may have recently had an addition to their family or the debtor may be pregnant.

3. Schedule F—Unsecured claims often include contingent/unliquidated claims. These often involve large "claims," yet the debtor states that the claim amount is "0" or "unknown" because the claim is disputed. This claim does not appear in the totals and the debtor is actually more insolvent than the schedules reflect

4. Schedule D—It is usually presumed that secured creditors are not included as unsecured claimants. However, most secured claims in personal property are under-secured and deficiency claims can be significant, thereby decreasing any proposed percentage distribution to unsecured creditors.

Debtors with any of the circumstances mentioned above would probably not be realistic candidates for Chapter 13. However, a statistical study would place them in the category as an "abusive" filer. Thus, each case needs to be reviewed separately and any "compilation of numbers" for statistical purposes does not justify the conclusions reached in those studies.

APPENDIX 2

Page 154 PREV PAGE TOP OF DOC

Possible Draft of "Improper Use" provision to replace the current 11 U.S.C. §707(b)

§707(b)(1)—For purposes of this section the phrase "inappropriate use of Chapter 7" shall mean: the filing of a Chapter 7 proceeding by an individual debtor, whose household income exceeds 75% of the national median family income for a family of equal size, and the debtor:

(A) Has sufficient disposable income, after providing for a reasonable standard of living for the debtor and the debtor's dependents, that would allow the debtor to propose a confirmable three year plan under Chapter 13, which would treat all secured and priority claims and provide for a distribution to unsecured claims of more than 30% of the amount of said unsecured claims; or,

(B) Has assets with a value (without deduction for exemptions) equal to or greater than the total amount of all non-contingent, liquidated claims in the case; or,

(C) Has gross income equal to or greater than four (4) times the amount of unsecured debt to be discharged in the Chapter 7 proceeding.

(2) The court, upon motion filed by the U.S. Trustee, the Chapter 7 trustee, or any creditor (or group of creditors) holding claims of more than 25% of the total debt to be discharged in the proceeding, shall dismiss a case (or permit the conversion of said case to Chapter 11, 12, or 13), if the continuation of the proceeding under Chapter 7 would constitute an inappropriate use of Chapter 7, unless the court after notice and a hearing determines that the dismissal or conversion of the case would create an undue hardship on the debtor.

Page 155 PREV PAGE TOP OF DOC

(3) If the Chapter 7 trustee or a creditor files a motion under subsection (b)(2) and the case is subsequently dismissed or converted to another chapter, then said trustee or creditor shall be entitled to an award of all reasonable costs, expenses, and attorney fees incurred by the moving party against the debtor, and the trustee shall be entitled to a reasonable trustee's fee (which shall not be limited by the maximum percentage test established in §326.)

(4) Any award of costs, expenses, or attorney fees under subsection (b)(3) shall be:

(A) an administrative expense under §503, in the converted case, or in any subsequent case filed by the debtor under any chapter; and,

(B) a non-dischargeable debt under §523 in the converted case, or in any subsequent case filed by the debtor under

any chapter.

(5) If a Chapter 7 trustee pursues an action under this section and the case is not dismissed or converted, or if the Chapter 7 trustee elects not to pursue an action under this section, neither the Chapter 7 trustee nor the bankruptcy estate shall incur any liability as a result thereof.

Mr. **GEKAS.** We thank the gentleman.

We turn to Ms. Hammes.

Page 156 PREV PAGE TOP OF DOC

STATEMENT OF NORMA L. HAMMES, ESQ., GOLD AND HAMMES, SAN JOSE, CA, REPRESENTING NATIONAL ASSOCIATION OF CONSUMER BANKRUPTCY ATTORNEYS

Ms. **HAMMES.** Thank you, Mr. Chairman and members of the subcommittee.

The hearing held by the subcommittee on Tuesday brought out some of the problematic aspects of the qualification tests for Chapter 7 and Chapter 13 debtors contained in H.R. 3150. To help clarify the issue, I would like to share with you the actual income levels at which H.R. 3150's means testing would apply.

On this chart over here to the left are the actual numbers. They are 75 percent of the national median family income based on the 1996 census data. And you can see a puzzling result of means testing in H.R. 3150. As family size increases over four members, the income level at which means testing occurs actually decreases. A family of seven, for example, would be means tested at about $8,300 lower than a family of four. The effect of this means testing system would be to deny relief to or to set up prohibitive barriers to relief for poorer, larger families.

This is just one example of how inequitable the results of H.R. 3150 would be. And without a doubt, this inequity was not intended by its sponsors. But it does reveal the complexity of the issues the subcommittee is attempting to address. And it points to the inadvisability of taking quick action on H.R. 3150 without fully investigating all of its many consequences.

Page 157 PREV PAGE TOP OF DOC

Another inequity that would be caused by H.R. 3150 is the calculation of the debtor's income based upon the average of the 6 months preceding the bankruptcy. Here is an example of the problem, based on a husband who was laid off from a reasonably good-paying job for months three and four. So you can see the first 2 months—and this information is in your written materials also—the husband is making $4,500 a month for month one and month two. He is unemployed in months three and four, receiving unemployment benefits and assistance from family at $1,000 per month. So the income drops drastically during months three and four. Month five, the husband gets a job again.

But as is true for most of our debtors, he is reemployed at a considerably lower level of pay, $2,500. That added to the $1,000 a month that the wife is making brings the actual income of the household up to $3,500. But under the test of H.R. 3150, the family would be deemed to have income of $3,999 per month rather than $3,500, which is the actual income of the family.

So they have phantom income. This is what we were talking about on Tuesday. Phantom income of almost $500 per month that they do not have, but would be deemed to have under H.R. 3150.

The tests which a debtor must meet in order to qualify for relief under Chapter 7 or Chapter 13 under H.R. 3150 produced irreconcilable results. We have a few examples of typical families who seek bankruptcy relief and the result of H.R. 3150's qualification tests in their cases.

Page 158 PREV PAGE TOP OF DOC

This first example here is an example where the family would be entitled to relief under Chapter 7. As you can see at the bottom, the amount available to unsecured is zero and therefore they would be entitled to relief. The reality in this family's case is that Chapter 7 relief is not what they need. They really need Chapter 13 relief and they are not qualified for it because there is not $50 left to go to the unsecured creditors. They need Chapter 13 relief because they have non-dischargeable taxes that are owed and they have a car loan together with the non-dischargeable taxes that make what comes out of the bankruptcy at the end of a Chapter 7 something that they cannot afford.

As I mentioned before, it is very often the case that income levels drop for our debtors before they file bankruptcy. It would be exactly consistent with this scenario.

In the next example, we have a family facing home foreclosure. They need to file a Chapter 13 case also. This family is not entitled to Chapter 7 relief, and that is okay. From our standpoint, they need to file a Chapter 13. The problem is that under H.R. 3150 the calculation of their budget shows that they must pay $676 per month to unsecured creditors in order to file a Chapter 13 plan.

You can see that the second column shows that instead of $676, because they have a mortgage, they only have $384 a month left over to pay to unsecured creditors. So because of that difference, they are not qualified under H.R. 3150 to file a Chapter 13. Under current law, they could. Under current law, they could save their home from foreclosure and they could also pay $384 a month to the unsecured creditors, which would be a total of $23,000. Currently, $23,000 could go to unsecured creditors under current law and be a 77 percent repayment plan. But unfortunately, under H.R. 3150, they would not be able to do that. They would not be qualified for a Chapter 13.

Page 159 PREV PAGE TOP OF DOC

The third example is a family that makes considerably more money. They do not have a house. They are what you would call an upper income family. In this situation, they are actually able to file a Chapter 7. They are able to file a Chapter 7 because 20 percent of their debts they could not afford to pay through their repayment plan.

[The prepared statement of Ms. Hammes follows:]

PREPARED STATEMENT OF NORMA L. HAMMES, ESQ., GOLD AND HAMMES, SAN JOSE, CA, REPRESENTING NATIONAL ASSOCIATION OF CONSUMER BANKRUPTCY ATTORNEYS

SUMMARY OF TESTIMONY

I. Personal Background

I am honored to be here today as the president of the National Association of Consumer Bankruptcy Attorneys (NACBA), formed in 1992 in order to provide consumer debtors with an effective voice in the legislative process. I served as NACBA's first treasurer from 1992 to 1996, and I am currently its president.

I have represented consumer bankruptcy debtors in Chapter 7 and Chapter 13 cases, in San Jose, California, since 1978.

II. Incomes of Families Subject to Means-Testing Under H.R. 3150

Page 160 PREV PAGE TOP OF DOC

Larger families would be subject to H.R. 3150's means-testing at a considerably lower income level than smaller families. Virtually all moderate income families would be subject to the means-tests of H.R. 3150.

The means-test assumes that the debtor will be able to continue to receive all sources of income received in the six

months prior to bankruptcy, whether or not that income is still available to the debtor. This would result in unfairly assessing the debtor's ability to pay based upon income that will not be received in the future.

III. Qualification for Consumer Bankruptcy Relief Under H.R. 3150

Several examples are offered of debtors' situations in which the debtors would not be qualified to obtain the type of bankruptcy relief they need under H.R. 3150.

IV. Even If A Debtor Qualifies to File Chapter 7 She Will Not Get the Relief She Needs Under H.R. 3150

Even if a debtor qualifies for bankruptcy relief, essential bankruptcy relief needed by that debtor would be eliminated or severely restricted by H.R. 3150.

V. H.R. 3146 Creates None of These Inequities and Provides Balanced Solutions to the Abuses Which Exist

In contrast, H.R. 3146 does not penalize honest debtors, but rather offers balanced solutions to the abuses of the bankruptcy system by creditors as well as debtors.

Page 161 PREV PAGE TOP OF DOC

I. PERSONAL BACKGROUND

Good morning Mr. Chairman and Honorable Members of the Subcommittee. I am Norma Hammes, and I am honored to be here today as the president of the National Association of Consumer Bankruptcy Attorneys (NACBA). I co-founded NACBA with Ike Shulman in 1992 in order to provide consumer debtors with an effective voice in the legislative process. I served as NACBA's first treasurer from 1992 to 1996, and I am currently its president. Today NACBA has approximately 1,150 members across the nation.

I received an A.B. in Communications and Public Policy from the University of California (Berkeley) in 1972, and a J.D. from Santa Clara University Law School in 1977. I am certified as a Specialist in Consumer and Small Business Bankruptcy Law by the State Bar of California Board of Legal Specialization.

I have represented consumer bankruptcy debtors in San Jose, California, with my husband and partner, James Gold, since 1978. As such, I practiced under the Bankruptcy Act, before the Bankruptcy Code went into effect in late 1979. I am admitted to the California State Bar, U.S. District Court—Northern District of California; Fifth Circuit Court of Appeals, Seventh Circuit Court of Appeals, Ninth Circuit Court of Appeals, and U.S. Supreme Court. I am a member of the Bankruptcy & Commercial Law Executive Committee of the Santa Clara County Bar Association, and its Chapter 13 Subcommittee (Chair, 1991).

Published cases of interest (with James Gold) are *General Motors Acceptance Corp.* v. *Mitchell,* 954 F.2d 557 (9th Cir. 1992), cert. denied, 113 S.Ct.303 (1992), regarding Sec. 506(a) valuation of secured claims in Chapter 13 cases; and *In re Galvan,* 110 B.R. 446 (9th Cir. BAP 1990) regarding Sec. 522(f) & 506(d) judicial lien avoidances in Chapter 13 cases.

Page 162 PREV PAGE TOP OF DOC

On behalf of NACBA, I filed amicus briefs in the Seventh Circuit, *In re Hoskins,* 102 F.3d 311 (1996); the Fifth Circuit, *In re Rash,* 90 F.3d 1036, *en banc* 1996); and the U.S. Supreme Court, *Associates* v. *Rash,* 117 S.Ct. 1879 (1997), regarding the valuation of secured claims in Chapter 13 cases.

Neither I nor NACBA has received any federal grant, contract, or subcontract in the current or preceding two fiscal years.

II. INCOMES OF FAMILIES SUBJECT TO MEANS-TESTING UNDER H.R. 3150

The hearing held by this Subcommittee on Tuesday brought out some of the problematic aspects of the qualification tests for Chapter 7 and 13 debtors contained in H.R. 3150. To help clarify the issue, I would like to share with you the income levels at which H.R. 3150's means-testing would apply. These numbers are 75% of the national median family incomes, based upon 1996 U.S. Census Data:

Table 7

You can see a puzzling result of means-testing in H.R. 3150—as family size increases over four members, the income level at which means-testing occurs actually *decreases.* A family of seven would be means-tested at about an $8,300 lower level than a family of four. The reason for this incongruous result is that larger families tend to be one-income families since the cost of child care for several children, which would be required if the second parent worked, becomes exorbitant. The effect of this means-testing system would be to deny relief to—or sets up prohibitive barriers to relief—for poorer large families. Prior to acting on H.R. 3150, I propose that it would be prudent for this Subcommittee to carefully review the effect of this bill's means-testing system on the various demographic groups which exist across the country.

Page 163 PREV PAGE TOP OF DOC

This is just one example of how inequitable the results of H.R. 3150 would be, and without a doubt this inequity was *not* intended by its sponsors. But, it does reveal the complexity of the issues this Subcommittee is attempting to address—and it points to the inadvisability of taking quick action on H.R. 3150 without fully investigating all of its many consequences.

Another inequity that would be caused by H.R. 3150 is the calculation of the debtors' income, based upon the average of the six months preceding the bankruptcy. Here is an example of the problem, based on a husband who is laid off for months 3 and 4. during which he receives unemployment and temporary support from relatives. The husband is reemployed in months 5 and 6, but at a job that pays considerably less than his former job. This is a very common scenario faced by debtors needing to file for bankruptcy relief.

Table 8

The current monthly total income per H.R. 3150 would be $3,999, averaging the income received from all sources during the six months preceding the bankruptcy ($23,994).

Under H.R. 3150, the debtors would be deemed to have income of $3,999. Actually, the debtors' real projectable monthly income is only $3,500. Therefore, under H.R. 3150, the debtors' budges would show $499 per month in "phantom income" which would be used both to determine their qualification for Chapter 7 relief and the amount they would have to pay unsecured creditors each month in a Chapter 13 case.

III. QUALIFICATION FOR CONSUMER BANKRUPTCY RELIEF UNDER H.R. 3150

Page 164 PREV PAGE TOP OF DOC

The tests which a debtor must meet in order to qualify for relief under Chapter 7 or Chapter 13 under H.R. 3150 produce irreconcilable results. Below are a few examples of typical families who seek bankruptcy relief, and the results of H.R. 3150's qualification tests as applied to them. The IRS standards used are those which would apply to my clients in San Jose, California.

Example 1

Table 9

Table 10

This family would be subject to the H.R. 3150 means test for Chapter 7, and would be qualified for Chapter 7 relief. However, this family would *not* be qualified for Chapter 13 relief because they do not have $50 per month available to pay to unsecured creditors according to the qualification test. Unfortunately, these debtors would receive little benefit from discharging $5,000 of unsecured debt in Chapter 7, while being left with a $300 per month car payment and nondischargeable tax debts. Under current law, these debtors would likely be able to obtain relief for all their debts under Chapter 13.

Example 2

Table 11

Table 12

This family is facing home foreclosure and needs to file a Chapter 13 case. However, under H.R. 3150, they must be able to pay the unsecured creditors at least $677 per month in order to qualify for Chapter 13 relief. Since their *actual* expenses would not allow that payment, they would not qualify and would be forced to lose their home. In contrast, under current law they could both save their home and afford to pay their unsecured creditors $384 per month—$23,040 total over the life of a five year plan—which would be a 77% repayment plan. These debtors would fail to qualify for Chapter 7 under the H.R. 3150 means-test.

Page 165 PREV PAGE TOP OF DOC

Example 3

Table 13

Table 14

Since the amount available to unsecured creditors ($23,100) is less than 20% of the total unsecured debt ($25,000), these debtors would qualify for Chapter 7 relief. Compare this inequitable result with the debtors in Example 2 (same size family but substantially *lower* income) who failed to qualify for Chapter 7 under H.R. 3150. This comparison illustrates the same result found by Judge Randall Newsome, and reported by him at the Tuesday hearing of this Subcommittee.

IV. EVEN IF A DEBTOR QUALIFIES TO FILE CHAPTER 7 SHE WILL NOT GET THE RELIEF SHE NEEDS UNDER H.R. 3150

After reviewing the results of the qualification tests on various sample debtor fact situations, I am convinced that many honest, financially-distressed debtors would not be qualified to file for relief under either or both chapters.

Today, however, I also want to address the nature and extent of the relief which a debtor who would qualify for a Chapter 7 or 13 would actually receive under H.R. 3150. In many ways, H.R. 3150 would eliminate or drastically reduce the relief needed by honest consumer bankruptcy debtors, and which is available under existing law.

Some basic types of relief currently granted in bankruptcy are:

Page 166 PREV PAGE TOP OF DOC

1. The discharge of most general unsecured debts except those incurred by wrongdoing of the debtor, or those debts whose collection protects important governmental and policy interests such as recent income taxes and family support;

2. The ability to refile a case if circumstances intervened to cause a prior case to be unsuccessful, or even after a discharge in a successful prior case;

3. In a Chapter 13, the ability to stop foreclosures or car repossessions while those claims are being paid; and

4. The ability to strip-down partially secured debts to the actual value of the item securing the debt in order to prevent these creditors from receiving a disproportionate share of the debtor's meager funds.

All of these important protections under current law would be seriously eroded by H.R. 3150.

1. H.R. 3150 would prohibit any effective strip-down of partially-secured debts;

2. H.R. 3150 would seriously limit the ability of debtors to stop foreclosures or car repossessions while paying those claims in Chapter 13 cases;

3. H.R. 3150 would seriously limit the ability of honest debtors to refile cases regardless of whether a prior case has been successful or not;

Page 167 PREV PAGE TOP OF DOC

4. And finally—and most importantly—H.R. 3150 would prevent honest debtors from discharging most credit card debt.

The critical increase in outstanding consumer credit—and credit card debt in particularly—in the last few years was reflected in the case data cited by Judge Randall Newsome to this Subcommittee on Tuesday. Nearly every family I see now has significant amounts of credit card debt.

Under H.R. 3150, most of this credit card debt would not be discharged, however. Without any governmental or public policy justification for this result, a debtor who incurred the credit card debt, wholly in good faith, would be unable to discharge much of that debt. Section 145 of H.R. 3150 would make dischargeable all credit extensions made while the debtor did not have a reasonable expectation of repayment. This change would be a revolutionary departure from the historic bases for denial of discharge in bankruptcy—fraudulent or intentionally harmful conduct by the debtor.

Most debtors, even outside of bankruptcy, are not capable of analyzing their ability to repay their credit card debt. Credit card users usually believe that if they can pay their minimum monthly payments they are using their credit cards responsibly. However, since minimum monthly payments are almost always much less than would be required to actually pay off the debt over a reasonable period of time, most of these debtors would not meet H.R. 3150's test for discharging credit card debt.

Therefore, even an honest, financially-distressed debtor who happens to meet the qualification test for filing a bankruptcy case—either a Chapter 7 or a Chapter 13, in most cases *will not get the relief they need,* under H.R. 3150.

Instead, they will continue to be burdened with nondischargeable credit card debt that will survive the bankruptcy. They will submit themselves to the humiliation—and the serious increase in the invasion of the most private details of their personal lives—and at the end of this painful process, they will receive almost no benefit from the bankruptcy process.

Page 168 PREV PAGE TOP OF DOC

This is precisely the result intended by the banking lobby—to make personal bankruptcy so painful and of such little assistance that debtors will choose *not* to file bankruptcy. The banking lobby thinks that if debtors are deterred from filing bankruptcy they will somehow magically produce the money necessary to pay their bills. We, the consumer bankruptcy debtors' attorneys, know differently, however. Just as there is no blood to be found in turnips, there is also no additional money to be found in our clients' budgets.

V. H.R. 3146 CREATES NONE OF THESE INEQUITIES AND PROVIDES BALANCED SOLUTIONS TO THE ABUSES WHICH EXIST

On the other hand, H.R. 3146 would create none of the inequities which would result from the implementation of H.R. 3150. H.R. 3146:

1. Would not penalize larger families by requiring them to meet stricter income tests than smaller families;

2. Would not judge financially-distressed families based upon income they will no longer receive;

3. Would not unfairly prevent honest debtors from filing Chapter 7;

4. Would not unfairly prevent honest debtors from filing Chapter 13 to save homes from foreclosure;

Page 169 PREV PAGE TOP OF DOC

5. Would not eliminate the discharge of substantial portions of debtors' credit card debt;

6. Would not unfairly prohibit most honest debtors from obtaining relief from foreclosure in a second filing where the debtors were temporarily unemployed in a prior Chapter 13 case and were unable to keep up those plan payments; and

7. Would not allow partially-secured creditors to extract more than their fair share of the debtors' meager funds available to all creditors.

H.R. 3146 would, however, correct the few abuses which currently exist in the bankruptcy system—abuses by creditors as well as debtors. In contrast, H.R. 3150 addresses none of the well-publicized abuses by creditors, and is extremely punitive to honest debtors.

NACBA strongly recommends the balanced approach of H.R. 3146. Thank you for the opportunity of presenting these views today.

Mr. **GEKAS.** We thank the lady and she will be subjected to some cross examination.

Ms. **HAMMES.** Thank you.

Mr. **GEKAS.** The Chair yields itself the customary 5 minutes for a round of questions.

Page 170 PREV PAGE TOP OF DOC

I think it was Mr. Waldschmidt who said that under your criticism of H.R. 3150 you would retain the power of the

trustee to apply a test to prevent an unfair result, like in the hypothetical where they could keep an asset while their debt mounts.

So my point is, at some point you're saying a test has to be applied. We are saying that test should happen at the front end and you are saying it should happen in the middle. So that is a philosophical difference, is it not, as to where the test should be applied?

Mr. **WALDSCHMIDT.** Yes, it is. However, as I pointed out in my materials, the procedural and jurisdictional problems—the practical problems—of doing an eligibility test on the front end make it untenable. We have estimated in Nashville that if the statistics are correct, that 10 to 15 percent of the debtors might fall into that area who should not be in Chapter 7 but in Chapter 13, and—if my estimates are correct—that really only 1 or 2 percent of them should be in that "group," we have 13 percent of the debtors filing approximately 2,500 case per year that would have to go through a contested eligibility hearing.

One judge handling cases 40 hours a week would take the entire year doing nothing but handling contested eligibility hearings. It would clog the court's docket and it would not be functional unless the Congress wanted to hire 33 percent more judges in the country.

Mr. **GEKAS.** Mr. Brewer, you are aware in H.R. 3150 of the fall back position we have on extraordinary or emergency expenses?

Mr. **BREWER.** Yes.

Page 171 PREV PAGE TOP OF DOC

Mr. **GEKAS.** Wouldn't your hypothetical about that car expense that you put forth be covered by that?

Mr. **BREWER.** Yes. And I could put that person in Chapter 7. Here is my point. The statistics that are saying that we have 15 percent that could be paying are terribly inflated. It is almost nothing. And when you consider, as Mr. Waldschmidt just said, the cost of administering the system, we're going to have to hire a lot more judges. We're going to interject the Federal Government into a lot of people's lives for very little, if any, benefit to the creditors.

Mr. **GEKAS.** Mr. Wallace, can you comment on what Mr. Brewer said about repeat filers? He invoked your name at the outset, so you have the right to rebut.

Mr. **WALLACE.** Thank you very much, sir.

If you look at H.R. 3150's provision on multiple filers, you will see that Mr. Brewer doesn't quite get it the way it is drafted.

What H.R. 3150 says is that when you file the second time, if you file within a year, you're going to have the automatic stay—it's going to be there just as it is now and it will be there for you for 30 days. If you have had a problem—for example, your Chapter 13 plan has failed and has been dismissed—during those 30 days you're going to apply to the court and ask for an extension of the stay because you show that you're not an abuser. That seems to me to take care of the problem for Mr. Brewer and it seems to me it takes care of the problem he has discussed.

Page 172 PREV PAGE TOP OF DOC

We need to deal with the problem of multiple filing. Multiple filing is becoming a real game that is being played by debtors' counsel on behalf of their clients in order to allow them to stay in the house or keep the car for an indefinite period. My firm has been involved in a case in which someone was able to keep a house by juggling back and forth between State court and Bankruptcy Court for 9 years without paying a nickel on that particular debt.

That can happen. That's an odd case. The debtor was both clever and lucky. But nonetheless, this is a situation which is a national problem that needs to be dealt with. And if you don't adopt something like H.R. 3150, you're not going to be able to reach the problem.

Mr. **GEKAS.** The efficacy of requiring tax returns as a part of the evidentiary portion of the first stage of entering into a bankruptcy was mentioned. Do you have any objection to that, Ms. Hammes?

Ms. **HAMMES.** Absolutely. Requiring tax returns to be filed as H.R. 3150 does, 6 years' worth with the U.S. trustee to be on display for anybody to go in and look at is a terrible invasion of privacy. And it is the kind of thing, let me say, that the creditors will latch onto immediately. The banks will latch onto that immediately and threaten debtors who are considering bankruptcy. They will say, "You had better not file bankruptcy because I'm going to go down there and I will look at your tax returns and will find out every personal detail about you." Creditors do that.

Mr. **GEKAS.** Do you have any objection to that, Mr. Waldschmidt?

Page 173 PREV PAGE TOP OF DOC

Mr. **WALDSCHMIDT.** I think it would burden the courts with a lot more paperwork.

Mr. **GEKAS.** Mr. Brewer.

Mr. **BREWER.** Yes, I do.

Mr. **GEKAS.** Thank you.

The time of the Chair has run out. We will——

Mr. **DELAHUNT.** Why don't you finish with the panel? I would be interested in Mr. Mitsch's and Mr. Wallace's ——

Mr. **GEKAS.** Mr. Mitsch already said he was in favor of it.

All right, we will do a poll. [Laughter.]

Mr. **MITSCH.** I think if there is a privacy issue that could easily be dealt with by sealing a part of the record as far as the tax returns and having it accessed or access authorized by primarily the trustee. I think the benefit obviously is that the trustee, if they are looking at the case, would now have more information than they have in the system as it stands now. They would have a pay stub to verify income, tax returns to look back and see if certain expenses are indeed continuing extraordinary expenses, and they would also have detailed affidavits on extraordinary expenses explaining why they are there, which they don't have under the current system. And they could easily make more informed and quicker judgments with just the information being submitted in the bankruptcy petition papers.

Page 174 PREV PAGE TOP OF DOC

Mr. **GEKAS.** Mr. Wallace, you are next on the poll.

Mr. **WALLACE.** First of all, you have to have tax returns in order to keep the system honest. People have pointed out that sometimes the information on Schedules I and J about income and expense are allegedly not entirely accurate. You must have the tax returns in there in order to keep the system honest. And tax returns are the universal device. When you apply for a loan, you have to give your tax returns if you are self-employed and most other folks have to give pay stubs.

This is not a particularly burdensome thing. Ms. Hammes mentioned that it was for 6 years, but it is actually for 3

years in the bill. There are already protections in H.R. 3150 with respect to the privacy issue. The tax returns would only be available to the trustee. A creditor could only get them through the trustee on request. And then the trustee would enforce and make sure that the creditor was not abusing the privacy issues.

Mr. **GEKAS.** The time of the Chair has expired. I must say that the last 2 minutes are chargeable to Mr. Delahunt.

Mr. **DELAHUNT.** Well, I'm going to be asking for second and third rounds of questions, Mr. Chairman.

Mr. **GEKAS.** That might not be feasible.

At this juncture we yield 5 minutes to the gentlelady from Texas, Ms. Jackson Lee.

Page 175 PREV PAGE TOP OF DOC

Ms. **LEE.** Thank you very much, Mr. Chairman.

Mr. Chairman, I have a statement for the record and I would appreciate asking unanimous consent to allow the statement to be included in the record.

Mr. **GEKAS.** Without objection, your prepared statement will appear in the record.

Ms. **LEE.** Thank you very much.

[The prepared statement of Ms. Lee follows:]

PREPARED STATEMENT OF SHEILA JACKSON LEE, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF TEXAS

Before entering into my remarks, let me acknowledge the Chairman of this Subcommittee for his zeal and dedication to finding a solution to the many troubling issues currently swirling around the world of consumer bankruptcy. Nevertheless, my previous comment notwithstanding, I must question his schedule of a total five hearings on this subject over the next two weeks, as my colleagues Mr. Nadler and Mr. Delahunt already noted in our Tuesday session. In sum, the Chairman's brisk "drive-by" approach to the complexities presented to us by bankruptcy reform, is a bit hurried to say the least.

Consumer bankruptcy reform, must not be taken lightly. Simply stated, the Congress should not attempt to pass untested legislative policy without first reviewing every reasonable option, possibility, and alternative to radical structural reform. If not, the American people are the ones that will have to pay the consequences for our hasty choices. I need not remind anyone that we have not been elected to act as social scientists empowered by the Constitution of this great country to test our ideological theories on this nation's millions of unexpecting human subjects. Rather, we are the chosen Representatives of the People of the United States charged to protect and serve their interests to the fullest extent of our powers. But how can we fulfill this sacred responsibility to our constituents if we do not take the necessary time to contemplate serious matters?

Page 176 PREV PAGE TOP OF DOC

I know that there are legitimate merits to all three of these legislative proposals, but I am sure that there are also yet undetected deficiencies in them as well. We must take the time to analyze, criticize, contest, debate, consider and then review these measures before taking action. This is why the Congress took five (5) years to pass reforms after the last report by the National Bankruptcy Review Commission; because these weighty matters truly deserve our lasting and full attention. As distinguished as our witnesses are on this matter, hearings do not make up the totality of the process of legislative review; in the end, every member must have the necessary time to make up their own mind.

As for the substantive components of this issue, I must state that I am particularly concerned about the financial impact that the abuses of our present bankruptcy system could have on the American taxpayer, and how we, in the Congress, can take action to minimize them. However, I am not yet sure what is the best means to accomplish this goal without unnecessarily burdening the rights of the bankrupt debtor. I believe that our reforms must be balanced in their treatment of both debtor and creditor. Some debtors probably do abuse the current bankruptcy system, but let us not pretend that creditors do not do so also.

Many financial institutions just seem to be too loose in their extension of credit to consumers, and it would seem that they continue this practice because it is profitable for them. Mr. Lloyd Cutler of Wilmer, Cutler and Pickering, shared with us in our last hearing that only 4% of all credit card debt is actually defaulted upon, and that is not the source of the problem. If this is the case, why are we being urged by the credit industry to change the current bankruptcy laws? Either way you look at this issue, it is definitely a questionable move for Congress to seek to insulate the credit industry from their own questionable lending policies.

Page 177 PREV PAGE TOP OF DOC

In spite of my criticisms, I am glad to be continuing this bankruptcy review process, and hope that a greater sense of clarity and understanding will be the result of these exhaustive hearings. At present, I am extremely unmoved by the arguments that I have heard in favor of needs-based testing, and hope that some compelling reasons for its addition to the law will be aired today. On the other hand, I am very sympathetic to the approaches of the Nadler Conyers Bill, and only differ with it on a few minor matters of substance. However, I am still open minded about all three of these legislative initiatives and look forward to the opportunity to study them further in light of the testimony today. Thank you.

Ms. **LEE.** I do want to raise what has probably been said. It may not have been answered, but this is a massive undertaking. I am certainly impressed with the chairperson's leadership, but I think moving so quickly in times when many of our members are scattered about the Congress with respective responsibilities—I'm just very concerned at how fast this is going because it has such absolute overwhelming impact.

With that, Mr. Chairman, I want to proceed and offer a comment from Mr. Brewer, I believe, and whether he said it quite as he printed it—I want to read it so that it is part of the record. He refers to H.R. 2500 and H.R. 3150 and he says, "These bills will prevent many honest, hard-working Americans from obtaining relief from the incessant hounding of collection agencies, the garnishment of wages, the foreclosure of homes, and the repossession of vehicles. Bankruptcy relief affords a way of comprehensively and fairly managing a convergence of financial demands upon the debtor, demands which the debtor has no way of paying."

I might add an addendum to that—it preserves families. And it allows hard-working people to—rather than crumble under the burden of financial devastation—it allows them to gain the ability of standing again and responding legitimately to the responsibilities of adulthood.

Page 178 PREV PAGE TOP OF DOC

Let me make one other comment.

Let me clarify the point I used earlier in the first panel with the 4 percent question. The 4 percent responds or is in reference to our credit card friends when one of their witnesses indicated that only 4 percent of all credit card debt is actually defaulted. That is the point I was making because they are certainly one of the chief advocates.

The house is not on fire, so why are we calling the fire engines and disrupting the town's tranquility at 3:00 in the morning?

With that, Mr. Brewer, if I can, we would like to make sure that we have friends on both sides of the aisle—but also both sides of the issue—to correct this problem. We would like to see the bankruptcy proponents of this legislation

who represent large corporations, credit cards, et cetera be with us. In your perspective, however, let's look at H.R. 3150 that wants to use IRS guidelines to determine a debtor's necessary expenses instead of actual expenses. It looks like you were egging to make a comment.

Does this reflect reality? And you had a point to make.

Mr. Brewer, is that the right kind of vehicle to deal with this issue?

Mr. **BREWER.** It is not. There is a provision for extraordinary circumstances. That doesn't answer the problem because it just adds a level of intervention into the situation by the courts that is simply going to bog the system down.

Page 179 PREV PAGE TOP OF DOC

The point that I wanted to also make was on your comment about preserving families. It is a vicious cycle. But if I were to look at the main cause of bankruptcies, it is to break up families. If I were to look at one of the reasons for the break up of families, it is financial stress. I will have clients come in to the office and I almost have to separate them. They are so mad with each other because they are in debt trouble.

It is not necessarily either one of them's fault, but financial stress breaks up families. The ability to get them into bankruptcy can heal families. I have seen them come in to my office ready to fight and walk out of my office hand in hand. It does preserve families. It is a real issue. These are real people with real problems. And I am afraid to get at the very few that are abusing the system—and there are some out there. We are painting with too broad a brush and we are going to hurt a lot of good people.

Ms. **LEE.** Thank you, Mr. Brewer.

Let me open to Ms. Hammes with a comment that Mr. Brewer made earlier that repeat filers are not abusers. They are not addicted substance abusers that we should condemn. I hope we don't condemn substance abusers but that we get them treatment.

But let me follow up to protest that this determination that the IRS may make—and it is interesting my good friends on the other side of the aisle have put the worst hat on the IRS and now all of a sudden they are riding on the white horse coming in and saving us all by making determinations.

Page 180 PREV PAGE TOP OF DOC

But can a family protest themselves? Do they have to get a lawyer? Can that even happen in reality with these people suffering from financial problems?

Ms. **HAMMES.** Theoretically, it is possible, but in reality it is going to be very, very difficult. It is going to be very expensive. The sponsors of the bill point out, of course, that you can claim extraordinary expenses. But I will tell you what—the judges are not going to find extraordinary expenses in every single case.

And there are going to be expenses like that in every single case. Child care, for example, is an extraordinary expense. You wouldn't think that was extraordinary. That is pretty common in this country. But every time there is a child care expense, you have to go through the complicated and expensive procedure to establish it as an allowable extraordinary expense.

Ms. **LEE.** And you would need a lawyer to establish that?

Ms. **HAMMES.** Absolutely.

Ms. **LEE.** Thank you.

I have a plate of questions, Mr. Chairman. Thank you very much.

Mr. **GEKAS.** The time of the lady has expired.

The gentleman from Tennessee is recognized for 5 minutes.

Page 181 PREV PAGE TOP OF DOC

Mr. **BRYANT.** Thank you, Mr. Chairman.

I apologize to this panel. We were shifted between committees this morning. But I have had a chance to look through some of this material and I know I questioned one of the earlier panels about the means testing arrangement that is proposed under this bill. We did not talk policy there and I get a sense that we have been talking policy here about whether that is or is not a good idea.

Let me ask, if I might start with Mr. Mitsch—this concern that it might make it tougher for debtors to file for bankruptcy relief, therefore it would encourage lenders to be less willing to negotiate with the borrowers—in a short answer, what do you think of that?

Mr. **MITSCH.** One of the things I noticed in H.R. 3150 is that, amongst other things, there are certain disclosures that have to be made, including disclosures touching on other consumer credit counselling availability. Therefore, I believe that many of the people would be helped, I hope, in terms of these disclosures so that if they can settle or negotiate with creditors—either themselves or through a consumer credit counselling agency. They would be able to avoid bankruptcy and restructure their own finances and learn budgeting, therefore being able to negotiate their own workout plans without having to either hire an attorney or go through bankruptcy.

Mr. **BRYANT.** Ms. Hammes, in your statement you indicate that H.R. 3150 will hurt poor people. This statement I think reflects a misunderstanding of H.R. 3150 in two major areas. First, the focus of H.R. 3150's needs-based reforms is on those who can afford to repay the debts, not the poor. You know, you have a ceiling there.

Page 182 PREV PAGE TOP OF DOC

Second, absent some type of reform in this area the credit industry will have no other choice but to limit the availability of unsecured credit to the poor and charge higher interest rates to borrowers who present the greater risk, such as the poor.

How do you respond? I guess the nature of that question is that poor people are not going to be hurt by the means testing because they're going to be below the level, other than that they will have a harder time getting credit made available to them.

Ms. **HAMMES.** I am sorry that you were unable to be here earlier because I have a chart up there—and it is in the materials—that in fact larger families will be means tested at about an $8,300 lower figure, a seven-member family rather than a four-member family. So it is not true that the poor families are protected. They are subjected to the means test at an even lower level than smaller families.

Once subjected to the means test, as Representative Jackson Lee pointed out, it is an extremely complicated and expensive process to establish your qualification for bankruptcy relief. There is nothing simple about it, nor nothing inexpensive about it.

Mr. **BRYANT.** Mr. Waldschmidt, welcome. You're not one of my constituents, but you are close to it in Nashville.

As the representative of the Trustee's Office, we had a comment earlier from one of the gentleman that what we

might gain from this process might not be enough to offset the additional administrative costs. Do you have any views on that?

Page 183 PREV PAGE TOP OF DOC

Mr. **WALDSCHMIDT.** Yes. This bill, as it is currently structured—and again, trustees don't object to the concept of looking at a needs-based idea. We do not think, though, it is appropriate to do it as an eligibility requirement on the front end. We think it can all be incorporated within Section 707(b). Let these debtors get into bankruptcy and deal with them at that point in time. It resolves the jurisdictional and procedural problems.

But the needs-based system on a "front end" eligibility requirement will probably make the legal profession rich. Lawyers are going to have to increase their fees 50 to 100 percent because every time they file a petition for a debtor they are going to have to contemplate the problems of the eligibility issues and contemplate the possibility that they will be thrown into a contested eligibility hearing within the first month of the case.

It puts trustees in a very awkward position because we are required under this bill to do a complete study of the debtor and give a verification that their income is accurate and give a verification that they are eligible for relief under Chapter 7 within the first 30 days. We haven't even met the debtor. We do not meet the debtors until the 341 hearing, which normally takes place about 40 days later.

I'm going to have to hire additional staff. I can't afford to do that and cover that particular provision. Or else the fees to the trustees are going to have to go up, which is going to increase the cost of the system, which it cannot handle right now. The creditors are going to hire additional people, et cetera, to monitor these eligibility requirements.

Page 184 PREV PAGE TOP OF DOC

And there is another area of this bill which is apart from the needs-based area but is more troublesome for the administrative costs, and that is the deemed filed rule. This is contained somewhere else in H.R. 3150 and indicates that creditors in Chapter 7 or Chapter 13 no longer have to file claims. If the debtor lists them on their schedules, it is deemed allowed.

I, as a trustee, have an obligation under Section 704 to review and make a recommendation to the allowance or disallowance of every claim. What is going to happen—I would have no way of reviewing their underlying documentation. I am going to have to file a motion or an objection to every creditor listed on the petition. They are all going to have to hire attorneys. We will all go to court and all make lots of money contesting these issues.

It is a nightmare. It does not work. And the court cannot take away my requirement to review claims. It is one of the trustee's functions. But if that deemed filed rule is in there we are just going to have a great deal more litigation to clog up the courts even more than they are already clogged now.

Mr. **BRYANT.** Thank you.

Mr. **GEKAS.** The time of the gentleman has expired.

The gentleman from Massachusetts is recognized.

Mr. **DELAHUNT.** Mr. Waldschmidt, let me assure you that if you need one-third more personnel, you can be absolutely sure that you are not going to get it. So understand that up front.

Page 185 PREV PAGE TOP OF DOC

Mr. **WALDSCHMIDT.** I understand.

Mr. **DELAHUNT.** We all talk about the prosperity of the past 5 years, 10 years, whatever. Can anybody here tell me which quintiles of our population have benefited from that prosperity?

Mr. Wallace.

Mr. **WALLACE.** I don't have an answer to that question, sir. You are asking me a demographics question to which I have no answer.

Mr. **BREWER.** Do I understand your question to be, Why are we having an increase in bankruptcies with a good economy?

Mr. **DELAHUNT.** Right.

Mr. **BREWER.** Let me tell you a story about a lady I filed a bankruptcy for.

Mr. **DELAHUNT.** Can you make it a really brief story? Because I have probably 15 minutes worth of questions.

Mr. **BREWER.** Yes.

Page 186 PREV PAGE TOP OF DOC

This lady worked for IBM. She moved from New York to North Carolina to keep her job. She bought a house and about 6 months after buying a house she was told by IBM, "You are going to have to take a 25 percent cut in pay or you can take early retirement."

Mr. **DELAHUNT.** Are you suggesting that not every American is benefiting from this prosperity?

Mr. **BREWER.** I am suggesting——

Mr. **DELAHUNT.** Are you suggesting that maybe 10 or 15 percent are getting most of the benefits of the prosperous economy?

Mr. **BREWER.** That's it. She has a job. She doesn't show up in the unemployment statistics. IBM stock has risen. The economy is going up. That hot air balloon called our economy is rising. This lady was part of the ballast that got thrown out of the gondola so it could continue to rise.

We need a safety net, a parachute—use your own metaphor—to keep her from hitting splat on the ground.

Mr. **DELAHUNT.** I have heard some statistics that say that the top 20 percent of the American population has clearly and dramatically benefited from the enhanced prosperity of the last 10 years. But in fact, the other 80 percent seem to be stagnating. Have you seen those figures? If not, is that your experience in the real world?

Page 187 PREV PAGE TOP OF DOC

Mr. **BREWER.** I don't study statistics. I take them as they walk through the doors——

Mr. **DELAHUNT.** Those real people.

Mr. **BREWER.** Those real people that if you cut them they bleed. Voters, you know? [Laughter.]

Mr. **BREWER.** Those are the people——

Mr. **DELAHUNT.** Are you reminding us of something, Mr. Brewer? [Laughter.]

Mr. **DELAHUNT.** I think it was you, Mr. Wallace, sending the message. Do you believe—I mean, clearly there are two different perspectives here, one from the creditor and one from the debtor side. Do you think that the 1.4 million bankruptcies that are now being filed are a result of debtor misconduct or behavior?

Mr. **WALLACE.** The 1.4 million, no. The statistics that were mentioned earlier by the gentleman from Ernst & Young was that the results of his study were approximately 130,000 people.

Mr. **DELAHUNT.** Are the gamers the ones scamming the system?

Mr. **WALLACE.** The statistics suggest some bankruptcy users have the ability to pay. I am not saying that they are gamers. I am saying that the statistics indicate that they have the ability to pay some significant part of their debts.

Page 188 PREV PAGE TOP OF DOC

Mr. **DELAHUNT.** So out of that 1.3 million is about——

Mr. **WALLACE.** About 15 percent.

Mr. **DELAHUNT.** And you think that if we pass H.R. 3150, we're going to see a decline in the number of bankruptcies that are filed?

Mr. **WALLACE.** You're either going to see a slowing of the increase in the number of bankruptcies—and we are all projecting here—or you are going to see a decline. One or the other. I do not know how large that decline will be. We are talking about the future.

Mr. **DELAHUNT.** That's just it. We all want to be sure here that when we craft public policy we are going to see the results that I think everybody in the room—clearly every Member of Congress wants to see—which is a reduction in the number of filings. You can't give me that guarantee, Mr. Wallace.

Mr. **WALLACE.** No, I am not in the business of guaranteeing the business, sir.

Mr. **DELAHUNT.** Neither am I.

Mr. **WALLACE.** If I were, I would be in the stock market and be very rich. I wouldn't be here.

Page 189 PREV PAGE TOP OF DOC

Mr. **DELAHUNT.** Right.

Do you see any responsibility on the part of creditors for what some have described as excessive solicitation of credit? Do they bear some responsibility for the rise in the number of bankruptcy filings?

Mr. **WALLACE.** Creditors are always responsible when their debtors go bankrupt because they have to collect the losses that they experienced. And the market takes care of that. I think that there is a market system. If creditors are extending credit unwisely, the market system works really quite well. And it's already working very well.

Mr. **DELAHUNT.** Maybe if this system isn't changed sooner or later, the credit card, those who have—shall I say—loose underwriting standards will get a message that they had better tighten up.

I am going to quote to you a story that appeared in my hometown paper, the Boston Globe. There is a quote there that I found somewhat interesting.

This is from Mark Zamby, the chief economist for the Pennsylvania-based Regional Financial Associates, a consulting firm with credit card companies as clients. He suggests that the real change between the 1980s and the 1990s is the aggressiveness of credit card companies. It is only partly due to a loosening of morality—and I presume he is referring there to those who would feel free to abuse credit.

Page 190 PREV PAGE TOP OF DOC

The process of soliciting is a phenomenon of the 1990s and has really begun over the last 5 years. About 3 billion solicitations were made last year, an average of 30 for every household in the country. I just find that extraordinary.

Mr. **GEKAS.** The time of the gentleman has expired.

Ms. **LEE.** Mr. Chairman, could I ask for a second round? There are such important issues here.

Mr. **GEKAS.** I would suggest that we submit those in writing and submit them to the witnesses, all of whom would be available to respond by memorandum, I would suggest.

Ms. **LEE.** Do we not have the time, Mr. Chairman, to at least allow us, in a compromise—I just think the open dialogue is certainly a much better approach than the questioning. I know my colleague, Mr. Delahunt—both of us have some additional questions.

Mr. **GEKAS.** The Chair will relent. We will allow a second round of 2 minutes.

Ms. **LEE.** I thank the chairman very much and we will put the other in the records.

Mr. **GEKAS.** Does the gentleman from Tennessee require 2 minutes at this juncture?

Page 191 PREV PAGE TOP OF DOC

Mr. **BRYANT.** I probably will, but I would yield at this point.

Mr. **GEKAS.** The lady from Texas is recognized for 2 minutes.

Ms. **LEE.** Thank you very much.

Let me quickly say that bankruptcy, for all those who may not be aware of it, helps both the creditors and the debtors. It did not seem like we had that information.

Ms. Hammes, let me get right to you. Please explain how the tests that we have in the Gekas bill would operate to force families into Chapter 13 even though their real income and expenses should really place them in Chapter 7? I know you had some charts, but can you help us get that down concisely as to what would happen to those individuals that face that?

Ms. **HAMMES.** Yes.

As shown before, the phantom income problem is a serious problem in H.R.——

Ms. **LEE.** Would you also add the question of unsophisticated debtors? Because scammers can get out of anything.

Ms. **HAMMES.** That is true.

Page 192 PREV PAGE TOP OF DOC

But the type of debtors that Billy and I see every day that come in to our office are people who have very marginal forms of employment frequently. They are frequently going through periods of unemployment or underemployment. What is consistent is the inconsistency. And what we see in H.R. 3150 is a requirement to take into consideration phantom income, income which no longer exists and basically cause the debtor to have less protection as a result of income that no longer exists.

Another thing that is a problem with H.R. 3150 is that it projects that you're going to continue to have that income for 5 years, 3 years if you are 75 percent or below the median income. But for many of the people, it would be a 5-year projection of consistent income.

As it was pointed out by Billy, you have cars that are going to break down, you have periods of unemployment that will happen almost every year. There is the rare Chapter 13 that gets through to completion without substantial modification and suspension of payments.

Mr. **GEKAS.** The time of the lady has expired.

The gentleman from Massachusetts.

Mr. **MEEHAN.** I would defer to my colleague from Tennessee.

Mr. **GEKAS.** The gentleman from Tennessee is recognized for 2 minutes.

Page 193 PREV PAGE TOP OF DOC

Mr. **BRYANT.** Thank you, Mr. Chairman, and I thank my friend from Massachusetts.

Mr. Wallace, I have two questions, please. I think these are legitimate questions.

How do you respond to those who blame the credit card industry for the increase in consumer bankruptcy filings? I think in essence Mr. Delahunt was referring to that.

Secondly, Mr. Waldschmidt's assertion that the cost as a trustee of implementing H.R. 3150—particularly the screening mechanism, even though he talked about some other things—but the initial screening mechanism would be too costly.

Mr. **WALLACE.** Well, 2 minutes is short, so I'm going to give brief answers.

With respect to the involvement of increasing consumer credit volume to increasing bankruptcy, whether that is related or not as I understand it is a hot dispute amongst academics. I am not going to participate in that dispute. We are not talking about that particular issue here today. H.R. 3150 is not going to affect that particular question. The market is going to deal with that. If there is too much credit out there, the market will take care of the problem. That is how we have dealt with the volume of consumer credit virtually for the whole period we have had consumer credit in this economy.

Page 194 PREV PAGE TOP OF DOC

With respect to Mr. Waldschmidt's question, could you repeat, please?

Mr. **BRYANT.** In essence, it would be too costly to implement the screening process.

Mr. **WALLACE.** The bill was designed to keep the cost as low as possible. I understand Mr. Waldschmidt has some figures. I have not had the opportunity to look at them closely. I will and I will be glad to give you a written answer, if you like.

Mr. **BRYANT.** Thank you.

Mr. **GEKAS.** The gentleman yields back the balance of his time.

We recognize the gentleman from Massachusetts, Mr. Meehan for 5 minutes.

Mr. **MEEHAN.** Thank you very much, Mr. Chairman.

Mr. Waldschmidt, first of all I want to compliment you on the alternative means test proposal that you included in footnote two of your testimony. I think this proposal reflects a balanced and sensible approach to channelling those who have the ability to pay a significant portion of their unsecured debts to Chapter 13.

I have a question. I was wondering how under this approach you would stop savvy debtors from gaming the system by amassing so much debt on the eve of filing for bankruptcy that they would fall outside the ability to pay standards that you proposed.

Page 195 PREV PAGE TOP OF DOC

Mr. **WALDSCHMIDT.** That's a problem that exists both in the needs-based system on a front end eligibility and Section 707(b). If someone goes out and says that they can pay 21 cents on the dollar now and they're not going to meet the eligibility requirements so I will go out and borrow $5,000 and spend it tomorrow and then file bankruptcy the next day so that they can get the 19 percent. That problem exists one way or the other.

I think there are some suggestions being made that certain debts incurred within 90 days become non-dischargeable. I don't know whether 90 days is the right number or whether it is 30 days or perhaps some other test needs to be done. But I think that issue needs to be taken care of in the dischargeability sections, not in Section 707(b) or in any eligibility requirement.

I also understand the debtors' counsel's concern that some people do incur debt on the eve of bankruptcy which is justifiable. If anything, that should only be a presumption perhaps against the debtors, that they could overcome on a dischargeability issue.

Mr. **MEEHAN.** Mr. Wallace, obviously there are a number of proposals we are looking at. What is your opinion of the Grassley-Durbin consumer bankruptcy bill that was introduced in the Senate?

Mr. **WALLACE.** We generally support the philosophy and goals of that bill. It does adopt a needs-based bankruptcy system. The approach taken there we think is a commendable first step in the right direction. We are concerned, however, that it will not be effective—we take a different view than some other folks here. We are concerned about the case-by-case litigation approach. We think that is going to be quite expensive. We do not think it is going to be effective. The reason we do not think it will be effective is that it is so open-secret that the results in bankruptcy court after bankruptcy court vary widely. Bankruptcy judges have strong views as to whether or not people should be in Chapter 7 or Chapter 13.

Page 196 PREV PAGE TOP OF DOC

Mr. Brewer practices in a court that prefers a high level of Chapter 13s. Perhaps his experience is not representative, therefore. I practice in a court which prefers a low level of Chapter 13s. And I do debtor work and know about which I am speaking here.

I think you are going to find—at least in my jurisdictions where I practice around here—if you adopt a bill and you take it into the judges and the trustee goes in to the judge with a case, the judge is going to find a reason why there is no need for that person to go into Chapter 13, even though it may be extremely clear that they should be under the

standards that we are talking about here.

So what you need is a clear bright line test. That is why H.R. 3150 is going to work and why we are concerned that S. 1301 will not.

Mr. **MEEHAN.** You state in your written testimony that H.R. 3146, the consumer bankruptcy bill assembled by the subcommittee's Ranking Member and the full Judiciary Committee's Ranking Member, is premised on a blame game. Is it your opinion that the proponents of H.R. 3150 have not engaged in any blaming of their own?

Mr. **WALLACE.** I am not sure quite what we are talking about here in blaming. I think what we are trying to do here is make bankruptcy policy work for the American people. The American people pay if people are going through bankruptcy who have the ability to pay. If they don't have the ability to pay, then we don't need to have a bill. But there is a demonstrated problem here in which people are going through bankruptcy and they do have the ability to pay. The American people pay for that. That is not a blame game. That is just saying that we need to have a policy change.

Page 197 PREV PAGE TOP OF DOC

We have a bill here, we have a statute that doesn't work right now. Problems are getting bigger as it is getting used by more and more Americans. That needs to be addressed.

Mr. **MEEHAN.** When I say a blame game—who are the winners and who are the losers when we are done at the end of the day?

In your written testimony, you state that if some creditors are indeed extended credit recklessly, then they are not going to survive. Do you have any statistical evidence to support this claim that those who are extended credit recklessly do not survive? Is there any statistical basis for that statement?

Mr. **WALLACE.** I am a practical man and I have Advanta, if you would like to know. Advanta is a situation—I'm not going to say that they were reckless, but they did get into a situation, large credit card extender, where their defaults got out of hand and they were sold. That's the discipline of the market and is really quite effective. The manager simply goes and looks for another job. I think that is pretty effective, generally. It certainly incensed me.

Mr. **MEEHAN.** My additional 2 minutes I would like to give to Congressman Jackson Lee, if I could.

Mr. **GEKAS.** I have to be home by 8:00. [Laughter.]

Page 198 PREV PAGE TOP OF DOC

Mr. **GEKAS.** The lady is recognized for 2 minutes.

Ms. **LEE.** I appreciate it very much, Mr. Chairman

I wanted to get to Mr. Wallace and try to focus again on my friends with the credit cards.

Can you tell me whether our credit card companies check pay stubs or other proof of income before extending credit? Do credit card lenders perform the sort of audits required of the courts under this bill to determine whether an individual is filing in good faith of Chapter 7?

It seems that if this is something very important, it is worth the expense by the credit card companies. They acknowledge themselves that only 4 percent actually default, but yet you want the Government to do it. Why don't you all do your due diligence that more appropriately should be in your hands?

Mr. **WALLACE.** In general, you can't predict which of your customers are going to go into Chapter 7 or Chapter 13. That is the difficulty.

Ms. **LEE.** But you can explore their income more thoroughly than you actually do.

Mr. **WALLACE.** Of course. Let me explain something about the way creditors work.

Page 199 PREV PAGE TOP OF DOC

They know if they are going to give money to somebody on a loan and not get it paid back that there is no bankruptcy law in the land that will make them whole. They are just going to lose that money. They have a very strong market incentive—or just common sense incentive—to avoid giving money to somebody who is going to go into bankruptcy.

They are going to do whatever they can do to do that. As the technology develops, they are trying to predict as much as possible. Billions of dollars have been spent on developing underwriting standards so as to sift the wheat from the chaff.

Ms. **LEE.** Do they spend extensive dollars on educating credit card applicants as well in the use of credit and how credit may ultimately be abused? I do know there are some positive uses of credit because from my community, the minority community, when banks do not loan them any money—only to get the shiniest new car when they want to start up new businesses—potentially use credit cards. Those are the hard-working folks down in the trenches that use credit cards for good and viable reasons and many times create a very successful business.

Since I suffer from not getting credit in my community, I am very sensitive to what credit cards can do, but I think you have the burden as well as being responsible in your usage and educate your potential applicants as well.

Mr. **WALLACE.** May I respond?

The American Financial Services Association is a charter member of the Jump Start Coalition, which has developed a whole program of consumer credit education to be used in our Nation's schools and public fora. We are strongly interested in educating our customers. We have spent a lot of money in doing so and we will continue to do so.

Page 200 PREV PAGE TOP OF DOC

Ms. **LEE.** I would like to get a packet of that and may offer it into the record, if you would direct it to my attention.

Thank you.

Thank you, Mr. Chairman.

Mr. **GEKAS.** Do you have 2 minutes coming?

Mr. **DELAHUNT.** I have 5 minutes coming. [Laughter.]

Mr. **GEKAS.** Do you have 2 minutes coming?

Mr. **DELAHUNT.** I have 2 minutes, Mr. Chairman.

Mr. **GEKAS.** The gentleman is recognized for 2 minutes.

Mr. **DELAHUNT.** Mr. Wallace, I thought your comments were interesting. I think you see the issue differently than I do. I think your focus is on that 100,000 that have the ability to pay that presently go into bankruptcy and leave

bankruptcy and continue to have the ability to pay. I think that is how you see this proposal before us now. Is that a fair statement?

Mr. **WALLACE.** The needs-based provisions are designed to deal specifically with that problem, yes.

Page 201 PREV PAGE TOP OF DOC

Mr. **DELAHUNT.** So what we're talking about in terms of the needs-based proposal—accepting your data and the policy—we are really talking about 100,000 or 130,000.

What I am talking about is something different. I am talking about 1.4 million people because the problem has been framed as an explosion in terms of the filing of personal bankruptcies. We have gone from about 300,000 in 1985 to approximately 1.4 million today. What I am suggesting is that I believe it is the responsibility of the Congress to address that larger problem and reflect and craft a social policy that would return that number of 1.4 million back to 300,000 of 1985.

I am suggesting that this is why I think we are here today. You are correct when you said that there is great dispute among economists as to the cause of this explosion of bankruptcy.

Let me just read into the record another quote, again from that same economist for a Pennsylvania-based company called Regional Financial Associates, a consulting firm, again, with credit card companies as clients.

He states, "The principal factor in the increase in bankruptcies has been the dramatic lowering of loan standards during the most recent 5 years."

Again, I think your testimony and this additional time has been important. I would suggest that we have to understand what we are focusing on as far as this legislation is concerned.

Page 202 PREV PAGE TOP OF DOC

Thank you, Mr. Chairman.

Mr. **GEKAS.** The Chair yields itself 2 minutes, which it has not done before.

The dialogue back and forth—the lady from Texas, the gentleman from Massachusetts—on the credit card companies sending out all these applications—isn't it a simple fact that all a potential debtor has to do is reject it? To say no and not be tempted? Are we blaming the tempter for this explosion in credit card debt?

Mr. Wallace, in your first statement you said what I think is the important part of H.R. 3150, that it protects the individual who is inundated by debt and has no recourse but to ask the courts for a fresh start through bankruptcy while at the same time making sure that those who are able to repay some or all the debt be accorded the opportunity and indeed the requirement to try to pay back. After all, they have accumulated goods and services at the business level of other people and they should have a requirement to repay when they can.

Isn't that the thrust of what you have been attempting to portray?

Mr. **WALLACE.** Yes, exactly. This is about personal responsibility. People who use credit have personal responsibility and that is a very important point.

Ms. **LEE.** Mr. Chairman, would you just simply yield?

Page 203 PREV PAGE TOP OF DOC

Mr. **GEKAS.** Would you like the gavel?

Ms. **LEE.** Only if it is in my hand and not thrown at me. [Laughter.]

Mr. **GEKAS.** What is it now?

Ms. **LEE.** This is too important, Mr. Chairman, because you made a point and I have a letter here that was addressed to a staff member in this room that says, "You became eligible to receive up to $50,000 cash advance." What you have here is something that looks like a $50,000 check. Mr. Chairman, the vulnerable will remain vulnerable, and while they are sinking down and out, you have people pushing credit and you need to help the addicted. That is what I think we are not doing with this bankruptcy reform.

Mr. **GEKAS.** I thank the lady for the final statement of this particular panel.

We thank you. It has been an engaging dialogue. Thank you very much.

We call the next panel to the witness table.

The next panel is comprised of those who have joined us at the witness table.

Page 204 PREV PAGE TOP OF DOC

Professor Karen Gross of New York Law School os. who we might add, a constituent of the gentleman from New York, Mr. Nadler. Prior to that she was an associate in the Bankruptcy Department of the New York law firm of Weil, Gotshal & Manges. Among Professor Gross' many writings is her book on rebalancing the bankruptcy system, which was published last year, as well as numerous articles on various aspects of bankruptcy.

Professor Gross received her B.A. degree *cum laude* from Smith College. She thereafter obtained her J.D. degree *cum laude* from Temple University School of Law. She is active in various professional organizations including the American Bar Association, the Association of the Bar of the City of New York, and the Coalition for Consumer Bankruptcy Debtor Education.

Seated with her is Dean Lewis Mandell from the College of Business Administration of Marquette University. Before becoming Dean of the College of Business Administration at Marquette, he was Associate Dean of the School of Business Administration at the University of Connecticut. He has directed various research programs at centers and institutes at three universities. In addition, Dean Mandell was the Director of Research for the United States Comptroller of the Currency.

The author of 16 books and more than 30 journal articles, Dean Mandell also has extensive business experience. He was the founder of a high-technology manufacturing company and has served on the board of directors for two publicly-traded companies. He has also served as a consultant to many large corporations in the United States.

Seated with them is Marion A. Olson, Jr., who is a standing Chapter 13 trustee for the Western District of Texas and has so served since 1976. He also serves as a Chapter 12 trustee. In addition to being an attorney, Mr. Olson is a certified public accountant.

Page 205 PREV PAGE TOP OF DOC

Mr. Olson is one of the leading pioneers in the area of Chapter 13 debtor education programs. He started his program in 1979 in San Antonio.

Mr. Olson has many professional affiliations including the American Society of Certified Public Accountants, the National Association of Chapter 13 Trustees, and the San Antonio Bankruptcy Bar.

Mr. Olson received his J.D. degree in 1973 from St. Mary's University. Before that he received his undergraduate degree from the University of Texas at Austin.

We welcome the panel, and as heretofore your written statements will be accepted for placement in the record and your statements should be attempted to be restricted to 5 minutes.

Proceed, Professor Gross.

STATEMENT OF KAREN GROSS, PROFESSOR, NEW YORK LAW SCHOOL, NEW YORK, NY

Ms. **GROSS.** Thank you, Mr. Chairman and members of the committee.

My name is Karen Gross and I am a law professor at New York Law School. I welcome this opportunity to share with you my ideas about a very important topic, namely post-filing debtor education. But, I do want to note, in light of this morning, that I do have a variety of thoughts and views on some of the other issues that have been raised today—needs-based bankruptcy, bankruptcy filing rates, the use of credit—and I would be more than happy to respond to those issues in the question and answer period.

Page 206 PREV PAGE TOP OF DOC

Debtor education is a central issue because it is really through debtor education that we can help debtors and their families, current and prospective creditors, and society as a whole. Everyone talks about the large number of filings, 1.3 million. It is actually higher if you count joint filers as additional filers. And, we provide debtors with a legal fresh start. But we do not provide the vast majority of debtors in Chapter 7 and Chapter 13 cases with the tools to re-enter the credit marketplace as more knowledgeable and thoughtful participants in our credit community.

Debtors leave largely as they entered, and we can do better than that. I have seen the need for this personally when I worked with debtors. I have heard about it from debtor lawyers, creditor lawyers, and numerous judges. Indeed, the Canadian experience should give us some insight into this; Canada is the only nation in the world with debtor education in place and up and running.

So, in the time allotted to me, I would like to briefly summarize what I mean by debtor education and then make a few remarks about the specific provisions within H.R. 3150 with respect to debtor education.

Let me say about that, H.R. 3150 is the only pending bill with a post-filing debtor education provision. As such, it should be commended for introducing the topic; it is a very good first step in the right direction.

Post-filing debtor education is intended for Chapter 7 and Chapter 13 debtors. It is very important to realize that it is for both groups. To the extent that there is any education currently in the system, it is for Chapter 13 debtors, some of whom get it through existing education programs such as those run by Al Olson and several others. Some get it through the budgeting process and plan confirmation process. But, there is virtually no education for Chapter 7 debtors.

Page 207 PREV PAGE TOP OF DOC

Post-filing debtor education is not intended to supplant lawyer counselling. It is not intended to address chapter choice. It is not intended to impair or impede pre-bankruptcy debtor education or counselling. It is not like drunk driving school. It is not intended to be punitive. It is not intended to create another Federal bureaucracy. As I conceptualize post-filing debtor education, it is a way of giving debtors tools so that they can re-enter a credit marketplace better able to become knowledgeable citizens.

Many people say it is too little too late. The horse is already out of the barn. Shouldn't we focus on educating debtors sooner rather than later? I have several answers to that.

First, as an academic, it is never too late to teach anyone. Also, think about it in terms of a medical analogy. Even the best system of preventative medicine does not do away with the need for an emergency room. Debtors are in that emergency room, and they need help. They are a captive audience, and we are wasting an opportunity if we do not do something to help the debtors within the system.

There are lots of features that would actually be in a debtor education program, and I would be happy to enumerate them. But, I think it would be more useful if I turned to those aspects of H.R. 3150 which are most troubling to me. Let me repeat, the bill is a commendable and important first step. It provides for a pilot debtor education program. It provides for a study mechanism of that program. But, I think there are three key ways in which the current proposal could be improved upon. Let me give them to you.

Page 208 PREV PAGE TOP OF DOC

First, the bill provides that a post-filing consumer debtor education program would be under the auspices of the Executive Office of the United States Trustee. That for me is not problematic, at least in terms of a pilot program. But, what is provided is in consultation with whom the director of that program will develop the program, and it limits the group of people with whom that director should consult. It specifically provides that they will consult with Chapter 13 trustees—such as Mr. Olson—who are running programs.

But, in point of fact, there are lots of people who should be consulted: Chapter 7 trustees, debtor lawyers, creditor representatives, credit counsellors, financial planners, legal and non-legal academics. So it seems to me we have to have a consensus-based, broad-based, quality-based input to create a debtor education program that will work.

Second, the time tables in the bill are too short. There must be more than 60 days to develop the program. It will take much longer than that. And, the pilot should extend beyond a year. In fact, longitudinal studies are key.

And lastly, there is a requirement that the court can require debtors to attend this debtor education program in the pilot project as a precondition to discharge. It seems to me, stated most simply, that this provision, while well-meaning, is premature. One of the points of a pilot project is to test how well debtor education works. It is to see if it is effective. To require debtors to take it when we do not know its effectiveness does not seem right at this juncture. Moreover, one of the things one is testing in a pilot project is how many debtors volunteer. That gets completely skewed if you start requiring it in some districts. Thirdly, there is a problem of a lack of geographic uniformity if debtors in some areas of the country can lose their discharge whereas debtors in other areas could not.

Page 209 PREV PAGE TOP OF DOC

So, I think H.R. 3150 is an important step. I would urge all of you to include a post-filing debtor education program in whatever legislation is ultimately passed. But, it must be created through multi-constituency-based input. It must have more pilots, and it must have a serious study component.

[The prepared statement of Ms. Gross follows:]

PREPARED STATEMENT OF KAREN GROSS, PROFESSOR, NEW YORK LAW SCHOOL, NEW YORK, NY

My name is Karen Gross, and I am a law professor at New York Law School. Since my entry into academia in 1984, I have lectured and written about bankruptcy related issues,(see footnote 53) and most recently, I completed a book titled *Failure and Forgiveness: Rebalancing the Bankruptcy System* (Yale University Press 1997) which provides a descriptive and prescriptive account of the present bankruptcy system. My exposure to bankruptcy is not purely academic; during my most recent sabbatical and subsequent thereto, I worked with individual debtors at the New York Legal Aid Society, and I was appointed by the court as a Special Representative in the Integrated Resources Chapter 11 case pending in the Southern District of New York. I also serve as a contributing author to *Collier on Bankruptcy* (15th rev. ed.).

My testimony today focuses on the topic of post-filing consumer bankruptcy debtor education.(see footnote 54) This is an area of critical importance given that over 1 million individuals are accessing the bankruptcy system annually. Regrettably, until recently, it is a topic that has *not* generated significant interest. However, it may be the one area in respect of which parties of diverse perspectives can come together, without partisanship, to achieve something that will benefit debtors, creditors and the larger community. To that end, I will: briefly describe what debtor education is (and is not), including an historical perspective; outline the contours of a debtor education program; address the possible sources of funding for a pilot project; and evaluate and provide suggestions in respect of Section 112 of H.R. 3150.

Page 210 PREV PAGE TOP OF DOC

Descriptive Overview

The fresh start is a significant first step in enabling debtors to get back on their feet;(see footnote 55) however, it is not enough because it does not provide debtors with the tools they need to re-enter the credit marketplace as responsible consumers of credit. This is not a new observation; when the bankruptcy laws were being reformed in the early 1970's, similar observations were made (unfortunately without much effect).(see footnote 56) Currently, debtors emerge from the bankruptcy system in most regions of the country without understanding their rights and responsibilities during and after the bankruptcy process. Debtor entry into improvident reaffirmation agreements and post-discharge "voluntary repayment" agreements are but two examples of this. To a limited extent, Chapter 13 debtors garner a sense of fiscal responsibility through the budgeting and payment process that necessarily accompanies a Chapter 13 plan and its confirmation. Indeed, in select regions of the country, Chapter 13 trustees provide educational programs for their Chapter 13 debtors; these trustees can be viewed as debtor education pioneers.(see footnote 57) However, Chapter 7 debtors, who rarely see a judge and frequently spend only a limited amount of time with the Chapter 7 trustee, generally emerge from the bankruptcy system without gaining money management skills in the process.(see footnote 58) This means that, whether or not debtors re-access the bankruptcy system,(see footnote 59) they become marginalized economically.

Post-filing consumer debtor education is intended to provide debtors, once they have filed for bankruptcy relief, with the tools necessary to re-enter the credit marketplace; debtors would become more knowledgeable about the nature of spending and the use of credit. Debtor education is not intended to replace lawyers who counsel their clients about chapter choice; it is not intended as a means of discouraging bankruptcy relief in the first instance; it is not intended to replace the work of credit counsellors or financial planners.(see footnote 60) In this sense, post-filing debtor education should be distinguished from pre-bankruptcy financial education and counselling. There are a growing number of current initiatives to provide individuals with financial education and/or counselling *before* they access the bankruptcy system.(see footnote 61) Financial literacy has been the subject of recent attention; indeed, Americans find it more difficult to talk about money than lots of other seemingly more sensitive or personal topics. We need to increase the understanding of money, buying, saving and credit by elementary school students, high school students, college students and adults. The present efforts in this area should be encouraged and fostered. However, the presence of *Pre*-bankruptcy education or counselling does not eliminate the need for *Post*-filing debtor education. It is not a matter of the horse already being out of the barn; even if the horse is out of the barn, that does not mean he should romp around unnoticed. Stated differently, even the best preventative medicine program does not eliminate the need for an emergency room.

Page 211 PREV PAGE TOP OF DOC

Let me be very clear on one further point. A debtor education program is *not* like drunk driving school, although that comparison is made with increasing frequency. Drunk driving school is viewed as a punishment for committing a wrong; it is a way of recovering one's license to drive; it is an alternative method of rehabilitating a bad driver. Debtor education, on the other hand, should not signal that the debtor has committed a criminal wrong of any kind; non-payment of debt is not a punishable act (absent fraud). A debtor education program stands on a different footing altogether. It is a means of assisting debtors for their sake and our own; it allows debtors to re-enter our market-based economy better able to function within it.

Contours of a Program

Agreeing that post-filing consumer debtor education is a worthy goal is only the first step. Our attention must then turn to the much more complicated task of developing a quality nationwide debtor education program; ad hoc programs simply will not do the trick. Reasonable people can and will differ over what a debtor education program should provide. Commonly raised issues include: What would the course content be? How often would the program meet? What materials would the debtors use? Where would the program be offered? Who would teach the program? How would the debtor educators receive training? What follow-up would there be for the debtors? How would the program be studied?

There are a number of thoughtful individuals who can assist in answering these questions. Indeed, it is my view that the contours of a debtor education program are best achieved through consensus. A debtor education program designed with insights from debtor representatives, creditor representatives, legal and non-legal academics, judges, psychologists, empiricists, credit reporting representatives and government officials is more likely to succeed than one designed from one particular, partisan perspective. However good a program may be that is created by one group, others from outside that group will always be suspicious as to its overt and more subtle messages. Therefore, development of a program through consensus is essential.(see footnote 62) We should look at existing programs and materials, by whomever developed, and work to pick and choose to develop the best possible program. If the efforts of the Coalition for Consumer Bankruptcy Debtor Education are any indicator, the prospects for achieving agreement are not far-fetched; indeed, there is every reason to be optimistic about a coordinated effort.

Page 212 PREV PAGE TOP OF DOC

I do have some specific suggestions as to the topics to be addressed in a debtor education program. By proffering same, I do not intend to foreclose debate; instead, I hope they serve as a useful starting point for thinking more concretely about post-filing debtor education. There is one important theme to keep in mind. The needs of debtors will differ depending on their location; debtors' problems may be geographic specific. There are issues of language and diverse local cultures and norms. Whatever program exists must be sufficiently flexible to take regional variations into account.

That said, a post-filing consumer debtor education program should seek to accomplish the following:

Identify and address the root causes of the debtors' bankruptcy filings, both financial and non-financial;

Provide basic information about financial management; the usage, costs and management of credit; spending habits; distinguishing wants and needs; setting priorities; budgeting; and life planning;

Provide basic information about the bankruptcy system so as to dispel confusion and mystery and enable debtors to be more effective participants in the process they have selected;

Provide some psychological (group) support to debtors and their families during the bankruptcy process;

Page 213 PREV PAGE TOP OF DOC

Identify debtors in need of non-financial counselling or other similar services and then refer said debtors to such resources; and

Assist debtors with the re-establishment of their creditworthiness through a cleaning up of their credit reports and the addition of a legend on the credit report to show successful completion of the debtor education program.

There are a number of individuals who could teach such a program. Debtor lawyers, law professors and Chapter 7 and Chapter 13 trustees are possible candidates although it is questionable as to how many of these individuals would

like the responsibility for same and whether the compensation therefore would be sufficient. Consumer credit counselors, financial planners, university extension teachers, professors of financial education and law students are other possible candidates. All teachers in the program should receive training. This is to insure that the program will have some uniformity in content and approach. Indeed, we should be mindful of the experience of our neighbors to the north; Canada has the only mandatory debtor education program in existence. The Canadian experience (its programmatic materials; teacher training; empirical assessments) should be immensely helpful to us, recognizing that there are vast differences between our two nations.

One central issue that runs through this discussion is whether debtor education should be voluntary or mandatory. I presently favor voluntary education; it empowers debtors to learn because they want to, not because they have to; it fosters responsibility; it is more economic and practical. Unlike Canada which has 100,000 debtors each year, we would need to educate over 1.35 million people annually. However, we should re-assess this issue following completion of a pilot debtor education program.

Page 214 PREV PAGE TOP OF DOC

Any voluntary program would need some incentives to encourage debtor participation. Several come to mind: different legending on the debtor's credit report and an opportunity to correct errors on said report in an easy, cost-free manner; some materials to take home—whether a book, a magazine subscription, a video, a computer program, a newsletter; and some sort of certificate evidencing completion of the program in a satisfactory manner.

Achieving a successful program can only be accomplished through a coordinated effort. While the free market may be a useful concept in lots of contexts, this is not one of them. We cannot rely on letting whatever programs may flourish independent of each other be the norm; if we did, debtors in different parts of the country would be treated differently. Moreover, there are certain common goals and information that should be at the core of all programs. This is not to disparage, in any way, the existing programs. Indeed, these programs would be important to study in the pilot program. And, aspects of these programs could be implemented on a nationwide basis if it turns out that they are sound and thoughtful. Indeed, expressing a preference for one group of materials or one approach seems premature at this juncture. Instead, we should be working together to develop the best program possible.

Possible Funding Sources

We could not and should not commence a nationwide debtor education program immediately. Instead, we should begin with a pilot program that studies various models (and a control group) to assess success.(see footnote 63) A pilot project could be funded in a variety of ways and could provide a testing ground for what will work (fiscally and substantively) on a nationwide basis. Before I articulate six suggested sources, I want to be very clear on one point. As I conceptualize it, neither a pilot nor a nationwide debtor education program would create another federal bureaucracy.(see footnote 64) The whole idea of the project is to eliminate administrative delays and hurdles; debtor education neither requires nor mandates any Congressional appropriation. Funding could come from a combination of the following six sources:

Page 215 PREV PAGE TOP OF DOC

Contributions of a small amount ($15—$25) from debtors and their families, with a provision that there be a fee waiver for those debtors who could not pay same;(see footnote 65)

Contributions from the credit community, particularly those creditors who extend significant credit to individuals;

Grants from foundation sources, most particularly groups interested in financial literacy, minority enhancement and the growing poverty of women;

Settlement funds established in bankruptcy related litigation; the Sears and Federated settlements both establish funds for consumer education, and a debtor education project along the lines set forth herein seems consistent with the goals

of the settlement itself;

Cy pres awards; in state court consumer litigation and bankruptcy litigation where the harmed parties cannot be identified, monies could be allocated to the debtor education initiative; and

Escheated funds; presently, monies that are available for distribution to creditors in a bankruptcy case but the creditor cannot be located are placed in a special account and presently go undistributed; it is estimated that this fund presently contains millions of dollars, and interest on the principal balance alone could assist in funding a pilot project.

One additional, though less formal, source of funding should be noted—in kind contributions by individuals interested in the success of the program. Many individuals have already expressed a willingness to work on this project on a pro-bono basis; indeed, to date, the efforts of the Coalition for Consumer Bankruptcy Debtor Education are rooted in volunteerism.

Page 216 PREV PAGE TOP OF DOC

Evaluation of Section 112 of H.R. 3150

H.R. 3150 should be commended for being the only pending bankruptcy legislation that addresses the need for post-filing debtor education. Indeed, Section 112 of H.R. 3150, titled "Debtor Financial Management Training Test Program," provides for an initial pilot project. It also provides for a study component which is essential to determining such a project's success. Clearly, in my judgment, this bill starts us off in the right direction by recognizing the importance of education.(see footnote 66)

However, there are aspects of Section 112 that are problematic as drafted. Without intending to undermine the significant positive signal this Section provides, I want to alert members of this Subcommittee as to areas of concern in the bill's language. For clarity, I will work through Section 112 sequentially.

Subsection (a) places the program under the direction of the Executive Office of the United States Trustee. At least for a pilot program, that choice does not trouble me. However, subsection (a), I assume unintentionally, limits the parties with whom the Director should consult. Subsection (a) specifically provides that the Director will consult with "trustees who are appointed in Chapter 13 . . . and who operate financial management programs for debtors . . .".

While I believe that consultation with existing Chapter 13 trustees who are running programs is important, indeed essential, these are *not* the only parties with expertise or interest in this field. Moreover, Chapter 13 trustees deal with Chapter 13 debtors; debtor education would encompass Chapter 13 debtors *and* Chapter 7 debtors. Indeed, one of the primary goals of the education is to reach Chapter 7 debtors. So, the Director should consult with individuals with expertise in Chapter 7 cases, including debtor representatives and Chapter 7 trustees. Moreover, the Director should consult with creditor groups, credit counsellors, credit reporting representatives, psychologists specializing in money management issues, debtor representatives, legal and non-legal educators and empiricists.

Page 217 PREV PAGE TOP OF DOC

The proposed language should be changed to provide that *the Director shall consult with a wide range of individuals expert in the field of debtor education, including but not limited to. . . .*

Subsection (b)(1) provides for a pilot program in three regions of the country. Based on other pilot programs within the bankruptcy system, a test in three regions is not sufficient. Bankruptcy is practiced very differently in different parts of the country, and for a pilot to provide meaningful data for a nationwide project, more regions would need to be tested. Clearly, adding pilot regions increases cost. I recommend that the number "3" be deleted and in its stead that the number "6" be inserted.

Subsection (b)(2) seems to contemplate that the Director would have material available for distribution within 60 days.

That subsection also contemplates a one year pilot. The nature of the program, other than the development of materials, is left uncertain; there is no mention of who would teach the program and how often education would be offered.

I appreciate the desire to avoid details of a pilot project in the legislation itself. However, it is unlikely that the Executive Office could develop quality materials within 60 days. Existing materials would need to be evaluated; perhaps a video would need to be developed; teacher training would need to be conducted and so on. Moreover, a one year pilot is very short indeed. One of important aspects of the debtor education program would be to study debtors following completion of the bankruptcy process. Longitudinal studies are essential in this area. Moreover, the subsection suggests that the only thing that would be provided to debtors would be materials. I appreciate that educational materials can be good. However, from a pedagogical perspective and as a matter of learning styles, not all debtors would be able to grasp all that a program offers if it is only available in written form. Debtor education must, in my judgment, include at least one session with a debtor educator, trained to lead a discussion on the topic.

Page 218 PREV PAGE TOP OF DOC

Subsection (b)(3) permits courts to require debtors to participate in debtor education as a condition to discharge. I have several concerns about this suggestion. First, it is not clear as to what exactly judges would be requiring of debtors in the pilot regions. As drafted, Section 112 seems to involve a curriculum and materials. Second, I am concerned about deprivation of the discharge; what if the debtor missed the education program due to a family illness? or work? or some other immutable commitment? Third, such a provision makes the study of the success of a voluntary program more problematic since it eliminates choice for a select group of debtors, maybe the very debtors in respect of whom we would want to ascertain participation levels. Fourth, I would prefer fine-tuning a debtor education program before we mandate its utilization.

Subsection (c) correctly calls for a study of the pilot project and existing Chapter 13 programs. While the study of existing programs can be conducted while the pilot project is running, it seems better to study the pilot project only following its completion. Moreover, I suspect that such a study could take longer than three months to complete.

Section 112 is silent regarding the funding for the pilot project and the accompanying study. Since I assume that means some federal monies, I worry about the time delay in getting such funding.

Conclusion

Debtor education can help literally millions of debtors and their families. The benefits will also inure to the benefit of present and future creditors. In some respects, we can think about debtors as a captive audience of over one million people a year. What a waste it would be to by-pass the opportunity to offer that group something productive that will help them and the rest of us as well. We should, to utilize an old adage, seize the moment before it passes us by. Section 112 of H.R. 3150 is a step in the right direction. With further refinement and clarification, it will enable us to achieve what has long been desired—giving true meaning to the fresh start that the U.S. bankruptcy laws offer.

Page 219 PREV PAGE TOP OF DOC

I would be more than happy to address any of the matters referred to herein in greater detail.

Respectfully Submitted,

Karen Gross,
Professor of Law, New York Law School.

Appendix B

COALITION FOR CONSUMER BANKRUPTCY DEBTOR EDUCATION

Board of Directors

Raymond P. Bell, Jr.
Assistant Vice President
NationsBank
Three Commercial Place, 9th Floor
Norfolk, VA 23510
757–533–7008
757–533–7987 *fax*

Donald Bradley
Senior Economist
Freddie-Mac

Page 220 PREV PAGE TOP OF DOC

8200 Jones Branch Drive
McLean, VA 22102
703–506–8626, 703–903–2346
703–903–4045 *fax*

Susan Block-Lieb
Professor of Law
Seton Hall University School of Law
One Newark Center
Newark, NJ 07102–5210
201–642–8839
201–642–8194 *fax*

Judith Cohart
Director of Education/Training
National Foundation for Consumer Credit
8611 Second Avenue, Suite 100
Silver Springs, MD 20910
301–589–5600
301–495–5623 *fax*

Raymond E. Forque, Ph.D.
Associate Professor
University of Kentucky
Department of Family Studies

Page 221 PREV PAGE TOP OF DOC

315 Funkhouser Building
Lexington, KY 40506–0054
606–257–7756
606–257–4095 *fax*

Marjorie L. Girth
Professor of Law
Georgia State University College of Law
140 Decatur Street
Atlanta, GA 30302–4037

404–651–4916
404–651–2092 *fax*
mgirth@gsu.edu

Karen Gross
Professor of Law
New York Law School
57 Worth Street
New York, NY 10013
212–431–2154
212–431–1864 *fax*
kgross@nyls.edu

Norma Hammes, Esq.
President, National Association of Consumer Bankruptcy Attorneys

Page 222 PREV PAGE TOP OF DOC

Gold & Hammes
1570 The Almeda, Suite 223
San Jose, CA 95126
408–297–8750
408–297–1189 *fax*

Kathleen Keest, Esq.
Assistant Attorney General
Deputy Administrator
Iowa Consumer Credit Code
Hoover Building
Des Moines, IA 50319
515–281–6386/5926
515–281–6771 *fax*
kkeest@max.state.ia.us

Richard M. Kipperman
Chapter 7 Trustee
Corporate Management, Inc.
P.O. Box 3939
La Mesa, CA 91944–3939

Page 223 PREV PAGE TOP OF DOC

619–668–4500
619–668–9014 *fax*

Richardo I. Kilpatrick, Esq.
Partner, Shermeta, Chimko & Kilpatrick, P.C.
445 S. Livernois, Suite 221
Rochester Hills, MI 48308–5016
248–652–8200
248–652–1292 *fax*

Gary Klein, Esq.
Staff Attorney
National Consumer Law Center
18 Tremont Street
Boston, MA 02108
617–523–8010
617–523–7398 *fax*

David A. Lander, Esq.
Thompson Coburn
One Mercantile Center, Suite 3500
St. Louis, MO 63101
314–552–6067
314–552–7067 *fax*
dlander@thompsoncoburn.com

Page 224 PREV PAGE TOP OF DOC

Olivia Mellan
Psychotherapist
President, Olivia Mellan & Associates, Inc.
2607 Connecticut Avenue, N.W.
Washington, DC 20008
202–462–5112
202–234–3552 *fax*

Cecelia Morris
Clerk of Court
U.S. Bankruptcy Court
One Bowling Green
New York, NY 10004
212–668–2891
212–668–2878 *fax*

Alan Rudi
Senior Vice President
Experian Information Solutions Marketing
505 City Parkway West—5th Floor
Orange, CA 92868
714–385–7734
714–938–2504
alan.rudi@experian.com

Page 225 PREV PAGE TOP OF DOC

Henry J. Sommer, Esq.
Supervising Attorney, Consumer Bankruptcy Assistance Project
7118 McCallum Street
Philadelphia, PA 19119–2935

215–242–8639
215–242–2075 *fax*

Hon. Jo Ann C. Stevenson
U.S. Bankruptcy Judge
U.S. Bankruptcy Court
110 Michigan, N.W., Suite 712
Grand Rapids, MI 49503
616–456–2949
616–456–2425 *fax*

Pamela Stokes
Associate Professor of Business Law
Texas A&M University—Corpus Christi
6300 Ocean Drive
Corpus Christi, TX 78412
512–994–2434

Page 226 PREV PAGE TOP OF DOC

512–994–2725 *fax*
713–994–2725 *fax*

Andrea Stowers
Director Risk Management
VISA, U.S.A.
900 Metro Center Boulevard, #M1–7P
Foster City, CA 94404
650–432–5706
650–432–2944 *fax*

Hon. Laura Taylor Swain
U.S. Bankruptcy Judge
U.S. Bankruptcy Court
75 Clinton Street
Brooklyn, NY 11201
718–330–2188 ext. 309
718–596–7742 *fax*

Joan Warrington, Esq.
Vice President
CitiCorp Credit Services, Inc.
One Court Square
29th Floor
Long Island City, NY 11120

Page 227 PREV PAGE TOP OF DOC

718–248–5103
718–248–5092 *fax*

Ex Officio
Joseph A. Guzinski
Assistant Director
U.S. Department of Justice

Executive Office for U.S. Trustee
901 E Street, N.W.
Suite 700
Washington, DC 20530
202–616–9193
202–307–0672 *fax*

Mr. **GEKAS.** We thank the lady and turn to Dean Mandell.

STATEMENT OF LEWIS MANDELL, DEAN AND PROFESSOR OF FINANCE, COLLEGE OF BUSINESS ADMINISTRATION, MARQUETTE UNIVERSITY, MILWAUKEE, WI

Mr. **MANDELL.** Thank you, Mr. Chairman.

My name is Lewis Mandell and I serve as Dean and Professor of Finance for the College of Business Administration, Marquette University in Milwaukee. I am here today, however, as a representative of the Jump Start Coalition for Personal Financial Literacy.

Page 228 PREV PAGE TOP OF DOC

The Jump Start Coalition, which was launched last year, consists of Federal agencies, universities, associations, and other organizations which have come together in a national effort to improve financial literacy among young adults. One of the Coalition's first order of business was to determine the level of knowledge that young people have when it comes to personal finance.

To answer this question, the Coalition conducted a survey last year of 1,532 high school seniors from 65 high schools throughout the United States which I personally designed, supervised, and analyzed. These students were asked questions about such personal finance basics as taxes, retirement, insurance, credit use, inflation, and budgeting. The questions were phrased as little cases that would be relevant to 12th grade students rather than pedantic educator-designed questions.

As you might guess, the results were dismal. Overall, students correctly answered just 57.3 percent of the 31 multiple choice questions. More shocking is the fact that just over 10 percent scored a C or better. Basically they got three-fourths of the questions right.

Most relevant to this committee's deliberations is a comparison of personal financial literacy scores within States with bankruptcy rates in those States. This was something we tested for. We really didn't have any priors as to what would emerge, but when we ran the data, the survey found a very strong negative relationship between personal financial literacy and the personal bankruptcy rate in the student's State.

Page 229 PREV PAGE TOP OF DOC

In other words, students who came from States with high rates of personal bankruptcy tended to have the lowest scores on the financial literacy test. This relationship held true even after adjusting for the student's income, parental education, sex, race, and region—all factors which tended to have some influence on personal financial literacy. The finding implies that increasing financial literacy may go a long way to decreasing the misery caused by personal bankruptcies.

Without question, the degree of financial literacy is strongly and negatively related to the rate of personal bankruptcy. For example, in States where the rate of personal bankruptcy was very low—that is below .5 percent of households—mean scores on the survey were 70.3 percent. In States where the rate was very high—that is more than 1.5 percent of households file a bankruptcy in a year—mean scores were just 55.6 percent. The relationship was supported through more detailed, more scholarly analysis—I am not going to bore the panel with that because it is part

of the written statement—and even after controlling on other factors likely to influence financial literacy scores.

Although direct causation cannot be shown because high school seniors themselves seldom declare personal bankruptcy, the results are very meaningful. They show that financial literacy, while by no means the only cause, appears to be an important factor affecting the number of bankruptcy filings. If a State has a high rate of personal bankruptcy, it probably does little to ensure that its citizens are well-educated in personal finance.

States that wish to reduce the pain and economic cost of personal bankruptcies should probably consider implementing an effective curriculum of personal finance in its primary and secondary school systems. According to our survey, just 10 percent of students learn most of what they know about personal finance at school. The majority learn at home, often from parents who themselves have not had the opportunity to study the appropriate techniques. They are perpetuating the problems of financial distress from one generation to the other.

Page 230 PREV PAGE TOP OF DOC

Nor do consumers learn by doing. Our results showed that those who have hands-on experience managing their own finances—for example, those who had credit cards in their own names, who own stocks and mutual funds, who used ATM cards, who paid their own automobile insurance—know no more than others about the financial instruments that they purportedly manage, be they credit cards, securities, ATM cards, or auto insurance.

And going a little further, experience which is unaccompanied by basic understanding can be absolutely misleading to consumers and have dangerous results. For example, perhaps a preponderant cause of credit difficulty is the assumption of too much debt in anticipation that the person will be able to repay in the future.

When we asked these high school seniors what would happen to taxes if their income doubled as a result of their getting a job out of school, fewer than half felt that taxes would at least double. It means that at least half the students who probably pay very little in taxes now since their income is so low, did not anticipate that the bite of taxes would erode a larger chunk of their future income. If these young people are making credit decisions based on anticipated future gross income, they are in for a big surprise, and so are their creditors.

To finish up, those of us in the non-profit Jump Start Coalition believe that personal bankruptcy will be a much less severe problem if consumers are equipped with the literacy needed to make reasonable personal financial decisions. We feel that the literacy must be acquired while the students are young and that the only place to make sure they get it is in grades kindergarten through 12. If we are successful in persuading school systems to adopt meaningful personal financial standards, we absolutely expect to see bankruptcy filings decline precipitously in the future as measured rates of personal financial literacy climb.

Page 231 PREV PAGE TOP OF DOC

Thank you.

[The prepared statement of Mr. Mandell follows:]

PREPARED STATEMENT OF LEWIS MANDELL, DEAN AND PROFESSOR OF FINANCE, COLLEGE OF BUSINESS ADMINISTRATION, MARQUETTE UNIVERSITY, MILWAUKEE, WI

Recent evidence shows that one of the causes of personal bankruptcy is low levels of personal financial literacy among consumers. This finding comes from analysis of the 1997 *Personal Financial Survey* which was administered to 1532 high school seniors from 65 high schools throughout the United States by the Jump$tart Coalition for Personal Financial Literacy.

Overall, students correctly answered just 57.3 percent of the 31 question multiple choice examination which was designed by a team of educators to test basic financial survival skills. More shocking is the fact that only 10.2 percent

of the students scored a "C" or better on the exam.

Most relevant to this Committee's deliberations is a comparison of personal financial literacy scores within states with bankruptcy rates in those states. The survey found a strong *negative* relationship between score and the personal bankruptcy rate in the students' state. In other words, students who came from states with high rates of personal bankruptcy tended to have the lowest scores on the financial literacy "test." This relationship held true even after adjusting for the students' income, parental education, sex, race and region. This finding implies that increasing financial literacy may go a long way to decreasing the misery caused by personal bankruptcies.

Page 232 PREV PAGE TOP OF DOC

The following table relates mean test scores by the rate of personal bankruptcy filings per household in the students' state for 1996. It shows that the degree of financial literacy is strongly and *negatively* related to the rate of personal bankruptcy. For example, in states where the rate of personal bankruptcy was very low (below one half of one percent of households), mean scores on the survey were 70.3 percent. In states where the rate was very high (above one and a half percent of households), mean scores were 55.6 percent.

Table 15

To insure that these startling results were not due to differences in demographic variables that help predict financial literacy scores, a regression was run using score as the dependent variable and the demographic categories of sex, race, region, income, and education as well as the state bankruptcy rate as independent variables. The other demographic categories were added as control variables to eliminate their separable impact on the dependent variable.

Together, the six background factors explained 9.7 percent of the difference in scores (adjusted r squared). The results of the regression are given below.

Score = 55.3%– 1% if male + 7.1% if White + 1.2% if live in North + 1.7% if income is over $40,000 + 2.7% if parent attended college– 3.8% for every percentage point of the state's bankruptcy rate.

Bankruptcy rate was significant at the one tenth of one percent level as were race and education, making it one of the strongest predictors of low financial literacy. Income was significant at the 3 percent level and none of the other variables were significant at even the 5 percent level. This means that even after controlling on other factors that are likely to influence financial literacy scores, bankruptcy is strongly and negatively related to financial literacy.

Page 233 PREV PAGE TOP OF DOC

Although direct causation cannot be shown, because high school seniors seldom declare personal bankruptcy, the results are very meaningful. They show that financial literacy—while by no means the sole cause—appears to be an important factor affecting the number of bankruptcy filings. If a state has a high rate of personal bankruptcy, it probably does little to insure that its citizens are well educated in personal finance. States that wish to reduce the pain and economic cost of personal bankruptcies should probably consider mandating and implementing an *effective* curriculum of personal finance in its primary and secondary school systems.

According to the survey, only 10 percent of students learn most of what they know about personal finance at school. The majority learn at home, often from parents who themselves have not had the opportunity to study the appropriate techniques of financial management. Problems are thus perpetuated from one generation to the next.

Nor do consumers learn by doing. Survey results show that those who have hands-on experience managing their own finances, by having credit cards in their own names, owning stocks and bonds, using ATM cards and paying their own automobile insurance, *know no more than others* about the financial instruments that they purportedly manage, be

they credit cards, securities, ATM cards or auto insurance.

Very often experience, which is unaccompanied by basic understanding, can be absolutely misleading to consumers and have dangerous results. For example, a likely cause of credit difficulty is the assumption of too much debt in anticipation of higher income and repayment ability in the future. When students were asked what would happen to taxes if their income doubled as the result of their getting a full time job, fewer than half felt that taxes would double, at least. This means that at least half the students, who probably pay little of their low part-time job income in the form of taxes, did not anticipate that the bite of taxes would erode a larger chunk of their future income. If they are making credit decisions based on anticipated future *gross* income, they are in for a big surprise, and so are their creditors.

Page 234 PREV PAGE TOP OF DOC

Those of us in the non-profit Jump$tart Coalition believe that personal bankruptcy will be a much less severe problem for everyone if consumers are equipped with the literacy needed to make reasonable personal financial decisions. We feel that this literacy must be acquired while students are young and that the only place to acquire it is in grades K through 12. If we are successful in persuading school systems to adopt meaningful personal finance standards, we expect to see bankruptcy filings decline in the future as measured rates of personal financial literacy climb.

Mr. **GEKAS.** We thank the gentleman.

We turn to Mr. Olson.

STATEMENT OF MARION A. OLSON, JR., STANDING CHAPTER 13 TRUSTEE FOR THE UNITED STATES BANKRUPTCY COURT, WESTERN DISTRICT OF TEXAS, SAN ANTONIO DIVISION

Mr. **OLSON.** Mr. Chairman and members of the subcommittee, my name is Al Olson and I am the Chapter 13 trustee in San Antonio, Texas.

I very much appreciate the opportunity to appear today before the subcommittee and thank the chairman for including debtor education programs in H.R. 3150.

Debtor education in Chapter 13 cases has been in existence for at least 25 years. The first program was started in the early 1970s by Bankruptcy Judge Rufus Reynolds and Chapter 13 trustees in North Carolina.

Page 235 PREV PAGE TOP OF DOC

In 1978, I began exploring ways to assist Chapter 13 debtors in San Antonio to more easily achieve the goals of Chapter 13, to pay their debts to the best ability, and to financially rehabilitate themselves. I found too many debtors who were woefully undereducated in credit management and personal budgeting.

We implemented a debtor education program which consists of two basic elements: a budgeting class taught by an education professional from Texas A&M Agricultural Extension Service; and a credit management session. Our program has expanded over the years and now we also aid business debtors as well as individual consumer debtors.

The success of our program is shown in the higher completion rates in San Antonio in Chapter 13 cases. Over 50 percent of our Chapter 13 cases are completed in San Antonio as compared with the national average anywhere from 25 to 33 percent. More telling, over 75 percent of our confirmed Chapter 13 plans in which debtors pay 75 to 100 percent of their unsecured debts are completed. Also the debtors who go through our program tell us that the school has been very beneficial to their lives.

Since the program was established in 1979, additional debtor education programs have been established in Texas and around the country as well. An excellent program is run by Chapter 13 trustee Tim Truman in Fort Worth. I have

included a partial list of Chapter 13 trustees who have programs in various stages of development in my written statement.

Most recently, with my assistance and that of several of my colleagues, Visa has developed a program that helps Chapter 13 trustees establish debtor education programs. I believe that this program could serve as a model for future Chapter 13 education programs.

Page 236 PREV PAGE TOP OF DOC

In addition, Frank Pees, a Chapter 13 trustee in Columbus, Ohio, along with creditors in Columbus, developed a debtor education credit reestablishment program in 1986. This program is remarkably positive, innovative, and productive. The concept is very simple. Creditors in a given city agree that debtors who choose Chapter 13 and pay a substantial amount of their unsecured debt in a completed plan will be considered for credit regardless of their prior credit history. This is a true fresh start.

We started just such a program in San Antonio in early 1990 and our results have been phenomenal. The share of Chapter 13 cases as a percentage of total consumer filings doubled to 50 percent. Almost all our plans last 5 years unless they pay 100 percent of allowed claims before that time. Total disbursements have also doubled since 1991 to $31.6 million in 1997. Of the amount disbursed to creditors in 1997 in San Antonio, over 23 percent was paid to unsecured creditors.

This program changes lifestyles and promotes personal responsibility. Of the $14.7 million in credit extended to debtors who have participated in this program, the default rate over 8 years is less than .5 percent.

Finally, I would like to close by recommending two modifications to H.R. 3150. First, the bill should amend the code to clarify that expenditures by Chapter 13 trustees on behalf of debtor education and credit reestablishment be deemed to be actual and necessary expenses of a Chapter 13 trustee's operation. This will clarify the existing uncertainty about the status of such programs.

Page 237 PREV PAGE TOP OF DOC

Second, I recommend the modification to authorize bankruptcy judges in every district across the country to require debtors to undergo education as a condition of receiving a discharge.

Again, I thank you for inviting me to testify and for including debtor education in this bill.

[The prepared statement of Mr. Olson follows:]

PREPARED STATEMENT OF MARION A. OLSON, JR., STANDING CHAPTER 13 TRUSTEE FOR THE U.S. BANKRUPTCY COURT, WESTERN DISTRICT OF TEXAS, SAN ANTONIO DIVISION

The History of the Debtor Education/Credit Re-establishment Program

Chapter 13 debtor education began in the early 1970's in the Middle District of North Carolina with a program developed by Bankruptcy Judge Rufus Reynolds and Chapter 13 Trustees Anita Jo Troxler, Richard Hutson, and Donald Billings. Classes on basic credit management and budgeting were taught by representatives of the North Carolina Agricultural Extension Service, Chapter 13 Trustees, and Trustee staff members. These classes continue today, and are now taught by an Education Coordinator for the Chapter 13 Trustees, with the assistance of the Extension Service.

After learning of the North Carolina program in 1978, my staff and I studied its curriculum. We determined that a similar educational program would be extremely beneficial for Chapter 13 debtors in San Antonio, both while they were in Chapter 13 as well as after they completed their plans. In developing our program, we engaged the services of

Mrs. Shirley Johnson of the Texas A&M Agricultural Extension Service to teach a two hour budgeting course, while my staff and I taught an additional two hour course which consisted of basic credit management and a review of administrative procedures.

Page 238 PREV PAGE TOP OF DOC

From 1979 to 1991 the format remained constant. Since then, our Education/Rehabilitation Director has led our programs and our classes consist of one mandatory four-hour session for all Chapter 13 debtors and another 4hour session near plan completion for debtors interested in credit rehabilitation. Special sessions are offered on an as needed basis for business debtors, with our business case investigator and representatives from the Internal Revenue Service contributing additional information designed specifically for this group. Ongoing budgeting classes are offered as demand necessitates.

Soon after the San Antonio debtor education program was started, additional programs were developed by the Chapter 13 Trustees in El Paso and Dallas/Ft. Worth. In recent years, as inforrr ation about these programs has become more widely known, many other Chapter 13 Trustees have become very interested in developing similar programs. Exhibit C is a listing of all of the known Chapter 13 Trustees who are currently considering the development of debtor education programs.

Our office developed these educational programs because we found that many debtors in Chapter 13 cases are undereducated in credit management and budgeting skills. We believed then, and still strongly believe today, that with even minimal training in basic budgeting, shopping for the best bargains, discerning wants vs. needs, examining the cost of credit, and living within one's income, that Chapter 13 debtors would have a far better chance of completing their plans, thereby greatly benefiting creditors, as well as creating a new foundation for a better way to live in the future.

The success of these programs is proven by the high completion rate of confirmed plans in San Antonio vs the national average. Over the last several years, at least 50% of confirmed plans completed, compared to the much lower national average, which is reportedly as low as 25%. Additionally, 60 to 75% of confirmed 100% plans filed today in San Antonio complete, and more than 75% of plans confirmed to pay 75% or more of unsecured debt complete.

Page 239 PREV PAGE TOP OF DOC

Further, the positive comments we receive almost unanimously from the debtors who attended our class justify the need for the educational program. The debtor testimonials on Exhibit A and our statistics on Exhibit B show the effectiveness of the school and the positive effect it has for debtors and creditors. After administering Chapter 13 programs for more than 22 years, the San Antonio office is of the opinion that debtors need education to independently resolve administrative barriers to credit re-establishment and to learn how to use consumer credit wisely.

On somewhat of a parallel track with debtor education classes, the Debtor Rehabilitation/Credit Re-establishment Program was developed in Columbus, Ohio in 1986 by Chapter 13 Trustee Frank Pees and many of the creditors in that city. In 1986, creditors in Columbus began to notice the large increase in Chapter 7 filings and the low dividend paid to unsecured creditors in most Chapter 13 plans. After many meetings between Mr. Pees and the credit community, it was determined that one of the main problems was that creditors did not differentiate between a consumer debtor who had filed a Chapter 7 case and a debtor who had filed and completed a Chapter 13 plan in future lending practices. It was, in fact, often easier for debtors who had just received a discharge in Chapter 7 to receive new loans from the credit community than it was for Chapter 13 debtors who had paid all their debts over an extended period of time. Mr. Pees saw this problem, and he suggested to the creditors that there might be a better way for them to motivate debtors in financial trouble to file and complete Chapter 13 plans with high percentage payouts to unsecured creditors.

The credit community agreed to offer debtors who filed and completed Chapter 13 plans which paid a high percentage of unsecured debt an opportunity to be considered for credit without having the Chapter 13 case or the prior credit history held against them. As knowledge spread that this potential fresh start program was being offered, the

number of Chapter 13 cases versus Chapter 7 filings began to increase as well as the number of plans which paid a high percentage of unsecured debt. Of particular interest is that disbursements in Mr. Pees' district have more than tripled in the past 10 years, and the ratio of Chapter 13 over Chapter 7 filings has increased significantly.

Page 240 PREV PAGE TOP OF DOC

In 1989, when the success of the credit re-establishment program in Columbus became obvious, I determined that San Antonio should have the second Credit Re-establishment program to compliment the educational programs already in place. Since the program began in early 1990, the ratio of Chapter 13 to Chapter 7 filings began to rise from one out of four cases (25%) to one out of two cases (50%) within a very short period of time and has remained fairly constant for several years. Disbursements in Chapter 13 cases have grown from $15,600,000 in 1991 to more than $32,600,000 in 1997. Creditors in San Antonio have loaned Chapter 13 debtors more than $14,700,000 under this program and the default rate is far less than one half of one percent. This is a win/win program for everyone involved in the process.

Tim Truman in Fort Worth, Texas has developed another successful debtor education/credit rehabilitation program. As shown on Exhibit C, his statistics demonstrate similar success. From 1991 to 1996, the ratio of Chapter 13's to Chapter 7's increased from 42%/58% to 50%/50%. Further, disbursements in Chapter 13 cases in Ft. Worth have grown from $33.6 million in 1991 to $51.6 million in 1996. Mr. Truman is just one of many other Chapter 13 trustees in the process of developing these programs.

In conclusion, I believe that debtor education and credit rehabilitation programs have the potential of having a very positive effect on the otherwise very disturbing trend in increased consumer bankruptcy filings. The comments on Exhibit D indicate the overwhelming support of creditors for these types of programs. Congressional support for this incentive based win/win program would potentially benefit all parties involved in the Chapter 13 process.

Page 241 PREV PAGE TOP OF DOC

Mr. **GEKAS.** The Chair is compelled to inconvenience you by asking you to remain here until we come back. We have to run to vote and we will be back in 10 minutes.

[Recess.]

Mr. **GEKAS.** Pursuant to the aforementioned rules, we will await the attendance of a second member of the subcommittee.

[Recess.]

Mr. **GEKAS.** We want to yield to the Chair the 5 minutes to which it is accustomed.

Professor Gross, I am very pleased that my ego is tickled a little bit because this is the first I have learned that somebody in the outside world commends H.R. 3150 for its debtor-side provisions. I want to tell you that I am very much willing to look at an expansion of the definitions that we are employing and the way the debtor education would be conducted.

Are you saying that if we have a forced debtor education program as a condition of discharge that then it would be like the drunk driving courses we now have? You said at the outset that drunk driving courses would be totally different because that has a compulsory nature to it.

Page 242 PREV PAGE TOP OF DOC

Ms. **GROSS.** It also has a punitive nature to it. And I think it is very important that debtor education not be viewed as punitive—that it be viewed as constructive.

Part of my problem, also, is that I do not think we are in a position yet to make a decision as to whether debtor education nationwide should be voluntary or mandatory. I think you have to test it out on a voluntary basis first. There is no reason why judges should not encourage debtors in the pilot regions to participate, but that is very different from hinging discharge of completion of a program that we do not know works and where other debtors in the country are not subjected to a similar standard.

So, at least at this juncture, it seems to me premature to link debtor education with the discharge.

Mr. **GEKAS.** And you think we ought to have a longer start-up time to engage the pilot program?

Ms. **GROSS.** Absolutely. I think it is unrealistic that you could develop the requisite educational materials in a thoughtful way with a number of constituencies participating within 60 days, which is the time period in your bill.

Mr. **GEKAS.** And you also feel that we ought to expand the list of consultation targets?

Ms. **GROSS.** Yes, experts.

Page 243 PREV PAGE TOP OF DOC

Mr. **GEKAS.** An expert is only someone who comes from out of town. I learned that a long time ago. [Laughter.]

Ms. **GROSS.** Or the ones that get enumerated in your bill, sir. [Laughter.]

Mr. **GEKAS.** I want you to know that these suggestions are going to be seriously considered, at least by the Chair. I hope I can convince other members of the subcommittee as to their value.

Ms. **GROSS.** I assume you know that I could object on other parts of the bill as it relates to debtors. But, as to this, I am very supportive.

Mr. **GEKAS.** That's all right.

Dr. Mandell, your presentation was very worthwhile and something for us to try to articulate in the future. But it is totally outside the purview of the immediate target of H.R. 3150, except that in debtors education we may have a preemptive strike if we follow your program before we have to get to a post-filing or a filing itself.

Mr. **MANDELL.** Mr. Chairman, you are quite right. My testimony was largely outside the purview of the bill. However, the evidence that I relayed on the effectiveness of education in reducing bankruptcy could very well extrapolate to support the position of Professor Gross and of my other colleague on the panel that education certainly seems to have some value. Whether it should be mandatory, whether it is feasible over a very short period of time—in other words, tying up the discharge with education—is something we have not looked into and we really have no evidence.

Page 244 PREV PAGE TOP OF DOC

But it is very clear that financial literacy, that the ability of people to understand what goes on in the world around them and to make informed decisions with respect to debt as well as to other things is very critical in avoiding bankruptcy or perhaps avoiding repeat filings.

Mr. **GEKAS.** I suppose we should aim some of our rhetoric toward the Departments of Education in the 50 States to see if they can seep it down through their school boards to have possible curriculum at that level in financial management, et cetera.

Mr. **MANDELL.** Yes, sir. And I think the evidence shows that the benefit to everyone—it is almost an apple pie

issue. I can see very few people who would be opposed to reducing the number of bankruptcy filings through education. It is something that allows our free market system to operate with great efficiency, allows consumer choice, but it basically says that people do need to be sophisticated enough to make those choices.

Mr. **GEKAS.** And one small question for Mr. Olson. You said that your programs are aimed at people in a friendly invitation that they don't have to worry about the status of their prior credit. It reminds me too much about some of these advertisements we see, "No matter who you owe or what status your credit, we are willing to lend you money," something to which the gentleman from Massachusetts has alluded. But it is in a different context, is it not?

Mr. **OLSON.** Yes, sir. The credit reestablishment program is a joint effort by creditors in a community who let it be known in the community that if debtors who are in financial trouble do file and complete Chapter 13 plans which pay most of their debts, they will be treated as if they had never had a credit problem in the past. We are talking about banks, credit unions, and other creditors. It has been very well-supported by the debtor bar, by the creditors in the community, and certainly many debtors strive to be eligible for this program.

Page 245 PREV PAGE TOP OF DOC

The results are great. We are talking about debtors who are actually not being treated in a high-risk category anymore, but as if they had never had a credit problem. These debtors are able to talk to and get credit from institutions that they would probably not have had the chance to work with without the program.
Mr. **GEKAS.** The time of the Chair has long expired.

The gentleman from Massachusetts is recognized.

Mr. **DELAHUNT.** Thank you, Mr. Chairman.

Let me applaud all of you. I dare say this is an area where there seems to be unanimous agreement. But without getting into the specifics of the various bills, I appreciate what you said, Professor Gross, about the need for a pilot and some sort of assessment and evaluation as to efficacy.

Dean Mandell, I also agree that the earlier the better. I want to join with Chairman Gekas in filing the Gekas-Delahunt bill to encourage the Department of Education to communicate to local school boards and establish a national policy because clearly there are so many financial instruments today that are available that didn't exist 15, 20, or 25 years ago that it is confusing for even sophisticated, well-educated individuals. I really believe that if we are going to do something—and maybe this is where the disagreement comes—again, I want to get back.

The means testing provision in H.R. 3150 really deals with 130,000 cases. I think that was the testimony proffered by Mr. Wallace. It does nothing about that other 1.3 million. I certainly am extremely concerned that if H.R. 3150 should pass in *toto,* without any changes whatsoever, we are not going to accomplish what I perceive to be the real goal—or at least my goal and that of other Members of Congress—which is to reduce the number of bankruptcy filings. I think your testimony goes to that issue.

Page 246 PREV PAGE TOP OF DOC

I would be happy also to hear from Professor Gross as to any other comments regarding debtor provisions. You have heard the colloquy among members of the subcommittee as well as previous testimony. I would be interested in your observations—each and every one of you—about the statement I just made about the efficacy of this approach as opposed to means testing.

By the way, I want to make it very clear to both the chairman and to others that I am open-minded. I have yet to sign on to any bill. I am here to learn. But I think it is very important that we have a balanced approach. What I am hearing from you I find reassuring.

Ms. **GROSS.** Let me address two aspects of what I heard this morning, one on needs-based bankruptcy and the other on why filing rates are as high as they are and what is happening in our economy.

Let me start by saying that providing education does not solve the problem. Education post-bankruptcy provides the group who is in the system with something so that when they emerge, they are better off. So, it does not go to pre-bankruptcy education. It goes to the issue of how many filings there are. Post-filing is to give something to people——

Mr. **DELAHUNT.** I understand, but let me interrupt, Professor.

What about the chairman's suggestion about encouraging these skills in terms of living in a rather complex financial world to be part and parcel of curricula in our secondary educational level?

Page 247 PREV PAGE TOP OF DOC

Ms. **GROSS.** Actually, I think elementary and secondary and college levels. It is my belief that that is a very wise suggestion and a much needed one.

Mr. **DELAHUNT.** Again, you are right. That doesn't solve the problems in terms of reducing the number of filings and saving that $40 billion—if in fact it is $40 billion because I keep hearing contradictory data, but accepting that estimate for one moment.

Ms. **GROSS.** But, let me turn to needs-based testing. It seems to me that there has been a lot of attention focused on the empirical aspect of the issue. And, it seems to me that it is not the only reason why we should think about whether needs-based bankruptcy is the right thing.

I am not sure that we will ever resolve empirically how many debtors could or could not repay. What is true, I might add, is that there is lots of reasons to be skeptical about the studies that are out there.

Mr. **DELAHUNT.** Give me two reasons.

Ms. **GROSS.** The underlying assumptions are problematic at best and the sampling has been weak. So, between the sampling and the erroneous assumptions, it seems to me the data is flawed. But, even if you take the data to be right as an empirical matter, the conclusions that are drawn from the data are not right. For example, if needs-based bankruptcy only affects 15 percent of the debtors—which was in the chart this morning—there was the assumption that the other 85 percent of the debtors are not implicated. That is simply not true. They have to defend against needs-based bankruptcy. In other words, they have to get themselves out of the system. So, they are touched in the sense that they need a lawyer, they need to appear before a judge, and they need a way to prove they are not part of the 15 percent. That costs money.

Page 248 PREV PAGE TOP OF DOC

So, empirically, it seems to me there is a problem already. But, there are reasons to have trouble with needs-based bankruptcy beyond empiricism. Pragmatics is one. It is extremely taxing on the system in terms of judge time, trustee time, lawyer time. And, the system already is substantially taxed in terms of the wear and tear. And, you have to think of the wear and tear on the system in order to find a very limited group of people. In many ways, it is like using a cannon to get rid of a gnat. There are gnats, but it seems to me that we must find a better way of dealing with them other than building a huge machine. It is very much like creating a very expensive Federal collection mechanism to ferret out that the 15 percent of debtors that creditors want to reach.

I have empirical concerns, I have pragmatic concerns, and then, I have philosophical concerns about the nature of our fresh start and how we should be treating debtors in a market-based economy. It seems to me very different from how we have approached the issue philosophically to date—this takes away debtor choice. Should we ferret out abusers? Yes. And, there are lots of ways to do it within the system. Many of them are already there. But what we

shouldn't do is eliminate a fundamental tenet of our bankruptcy system, which is that debtors can choose which chapter they want to use. I have lots of bases for having concerns about needs-based bankruptcy.

In terms of reasons for filing and why filing rates are so high, I think people look for an easy answer. I don't think there is an easy answer for why filing rates are high. I think it is a multi-faceted problem. But, let me suggest several reasons that have not been mentioned for why filing rates are high.

Page 249 PREV PAGE TOP OF DOC

I do not have a problem, unlike most people who are debtor-inclined, to creditors extending credit. Indeed, it is remarkable that default rates are very low. What is problematic is not the extension of credit, but the failure to monitor credit. So, in essence, instead of monitoring credit, bankruptcy becomes the mechanism for monitoring. The costs and roles shift from the credit industry onto the Federal Government.

Second, it has been my experience in talking to a number of people that creditors have been remarkably unwilling to work with debtors outside of bankruptcy in meaningful ways. In fact, many people would tell you it is much easier to do an out-of-court workout for someone who owes a bank $5 million than for someone who owes a bank $5,000. So, there are lots of problems with the filing rates being inflated because debtors use bankruptcy as a means of resolving financial problems that they can't effectively resolve elsewhere. And there are a number of clients I saw during my sabbatical at Legal Aid who said, "If I could find another way, I would." Indeed, I thought I could do a workout with a debtor. He owed five creditors $3,000. I thought it was ridiculous to go into bankruptcy. I thought I could work it out.

I called the creditors, and I could not do it. I would say to a number of those creditors, "When I was a corporate lawyer and my client owed you $50 million, you would ask how quickly I could get to your office. Now, I cannot even get to someone I can talk to." So, it seems to me that it is not a simple question of lots of credit cards or lots of debtor abuse. It is an immensely complex problem with lots of variables that go into it.

Mr. **GEKAS.** The time of the gentleman of Massachusetts has expired.

Page 250 PREV PAGE TOP OF DOC

Mr. **DELAHUNT.** I have no further questions. I would just ask the chairman if he would allow Dean Mandell or Mr. Olson——

Ms. **GROSS.** I am sorry I took so much time. My apologies.

Mr. **GEKAS.** It's all right with me.

Mr. **MANDELL.** Not being an attorney as my colleagues are, I don't feel qualified to speak on that aspect of it.

Mr. **DELAHUNT.** Mr. Olson.

Mr. **OLSON.** I think your first question, Mr. Delahunt, was the needs-based bankruptcy test. I do have some trouble with it. I think there should be encouragement to pay debt. I think what we're talking about in education is trying to help people not only be better able to determine their ability to handle debt before they get into it, but hopefully to be able to live their lives as more responsible people, which gives them a much better chance of being successful in this country.

The problem I have specifically of the needs-based bankruptcy test, as was discussed in panels earlier today, is that I think it would be not only very costly but you would be dealing with a tremendous number of exceptions all the time, a lot of court time that probably would not yield a lot of results. The issue of substantial abuse is better dealt with in the context of Section 707(b).

Page 251 PREV PAGE TOP OF DOC

I would support what Professor Gross said. It is a multi-faceted problem. What we have tried to do in dealing with the problem is help those people who came into Chapter 13 have a better education and it has worked. Then the credit reestablishment program gave debtors something to shoot for so that they could really have a goal to reenter the credit world responsibly, which almost all of the former debtors who have been in the program have done.

In our program once debtors have completed their plans and they are considering entering the credit reestablishment program, they come to another class where we help them update their credit reports, and they are tested on a wants versus needs program and the ability to pay. The most important statistic in the credit re-establishment program is that 57.5 percent of the debtors who have completed—many of them working toward this goal of new credit—decide at that time either that they cannot afford or do not need new credit. That is one of the main reasons our statistics are so good. There are 5 percent of the debtors that get turned down because the creditor did not think they could afford it, and another 37.5 percent who have received new credit and almost none of them have defaulted.

Working together for these kinds of incentive-based programs is where bankruptcy legislation needs to head. Generally most debtors I have seen are not abusers of the system. Most of them never intended to be in bankruptcy court. They find themselves there. Those of us who have been involved in this process are just trying to find ways to help them as best we can.

Mr. **GEKAS.** We thank the panel.

We all agree that there is abuse in the system. We all agree that there are too many filings. Nobody is certain what to do. I certify to you that this is a bona fide attempt to address the problem with sincerity, with eagerness to protect the debtor who is overwhelmed by debt, but to give justice to the system in every form. That should go without saying. I will repeat it as often as necessary to make the point clear.

Page 252 PREV PAGE TOP OF DOC

Secondly, I wish to inform the gentleman from Massachusetts that I have already given instructions to the staff to look at a possible piece of legislation that would direct or at least suggest to the State Legislatures about the curriculum that might address some of the problem. The gentleman is the first to be invited to cosponsor it.

The meeting is adjourned with the thanks of the committee.

[Whereupon, at 1:55 p.m., the subcommittee was adjourned, to reconvene subject to the call of the Chair.]

A P P E N D I X

Material Submitted for the Hearing

Report on Cost to Administer Chapter 13 Cases Under H.R. 3150

[Prepared by Devin Derham-Burk, Chapter 13 Standing Trustee, San Jose, CA]

INTRODUCTION

What is a Chapter 13 Trustee?

The Chapter 13 trustee is an individual who in all states except Alabama and North Carolina is appointed by the United States Trustee to serve as standing trustee in all Chapter 13 cases filed in a particular geographic area. The United States Trustee Program, an arm of the Justice Department, appoints and supervises Chapter 13 trustees but the Chapter 13 trustee is not a federal employee. The Chapter 13 trustee occupies a unique role in the bankruptcy relationship between debtor and creditor. The Chapter 13 trustee has a fiduciary responsibility to creditors and her

major responsibilities are to make payments to creditors under the Chapter 13 plan, review Chapter 13 cases and recommend confirmation of Chapter 13 plans, where appropriate. In addition, the Chapter 13 trustee has a statutory duty to advise and assist the debtor in performance under the plan. The Chapter 13 trustee cannot give legal advice to nor be an advocate for either the creditor or the debtor.

Page 253 PREV PAGE TOP OF DOC

The expense of administering Chapter 13 cases in a trusteeship is paid through the trustee's collection of a percentage fee of the funds paid to creditors. By statute, the maximum percentage a trustee may take is 10%. The current percentage fee collected in the San Jose trusteeship is 5.2%.

Personal Background

I am an attorney and have been in practice since 1983. Prior to my appointment as the Chapter 13 standing trustee for San Jose in July 1996, I practiced for two years in the areas of commercial litigation and creditor rights for a San Jose business law firm, primarily representing financial institutions. For seven years prior to that, I worked for the Federal Deposit Insurance Corporation, serving as a litigation department supervisor and, later, as the Managing Senior Attorney for the Legal Division of the San Jose Consolidated Office. As Managing Senior Attorney I had oversight responsibility for all legal and administrative issues arising out of FDIC's role as receiver of failed financial institutions in seven Western states. I was responsible for supervising approximately 50 professional and support staff members in a variety of departments, including bankruptcy. I was also responsible for administering a $4.5 million annual operating budget. In this capacity, I had the responsibility of allocating staff resources to meet the ever-changing workload requirements associated with failed bank liquidations. Prior to my employment with the FDIC, I practiced consumer bankruptcy for five years in San Jose, primarily representing debtors in Chapter 13 and Chapter 7 cases.

Assumptions Made for this Report

Page 254 PREV PAGE TOP OF DOC

This report is based on data collected and compiled from cases in the San Jose trusteeship. The trusteeship currently has approximately 8,000 open, active cases, 7,000 of which are confirmed. There are currently 27 full time employees in the trusteeship.

For the 1998 fiscal year budget, this trusteeship projects net receipts (payments from debtors) to be $31,000,000. The trusteeship projects disbursements of approximately $29,388,000 to creditors in fiscal 1998. Trusteeship income(see footnote 67) is projected to be $1,777,500. Operating expenses for 1998 fiscal year are projected at $1,673,087. On average, in the San Jose trusteeship, approximately 350 new cases are filed each month. For purposes of this report, no increase or decrease in the number of Chapter 13 cases filed per month is assumed.

This report was written from the perspective of a Chapter 13 trustee. The purpose of the report is to quantify, to the extent possible, the amount of additional work which will be required to administer Chapter 13 cases under H.R. 3150. It should be noted that only work that is *in addition to* work currently required to administer cases is addressed in this report. This report does not address any additional administrative expenses such as increased bankruptcy court clerk's fees, increased debtor's counsel fees, or increased costs to the United States Trustee Program which would be incurred in order to implement H.R. 3150.

This report is divided into the following sections:

Changes to Chapter 13 Trustee Duties under 11 USC §1302

Changes to Chapter 13 Trustee Duties due to Adequate Protection Provision 11 USC §1307A

Page 255 PREV PAGE TOP OF DOC

Other Provisions of H.R. 3150 Which Will Impact Chapter 13 Workload

Summary of Estimated Additional Expenses

Summary of Total Expense Changes to Trusteeship.

Changes to Chapter 13 Trustee Duties Under 11 USC §1302

Section 101 amends 11 USC §1302 to add the following Chapter 13 Trustee duties:

1. Investigate and verify the debtor's *projected monthly net income*

2. Investigate and verify the debtor's *monthly net income*

3. Investigate and verify information provided by the debtor pursuant to 11 USC §111 to adjust *monthly net income*

4. Investigate and verify information provided by the debtor pursuant to 11 USC §521, as amended

5. File annual reports with the court regarding propriety of plan modifications due to changes to debtor's *monthly net income*

Page 256 PREV PAGE TOP OF DOC

Comments, Explanations and Additional Expense Estimates

DUTY #1 INVESTIGATE AND VERIFY THE DEBTOR'S PROJECTED MONTHLY NET INCOME

Projected Monthly Net Income

This provision requires both the Chapter 7 trustee and the Chapter 13 trustee to investigate and verify the debtor's *projected monthly net income.* It also requires the trustees to file a report with the court within 30 days of the filing of the petition indicating whether the debtor qualifies for relief under Chapter 7. It is unclear whether imposing this duty on the Chapter 13 trustee was a drafting oversight. Even if it is not an oversight, the analysis to determine *projected monthly net income* is nearly identical to the analysis to determine *monthly net income.* Determining *monthly net income* is clearly a new Chapter 13 trustee duty, therefore the cost to the Chapter 13 trusteeship in performing the *projected monthly net income* analysis would be negligible. The only additional expense would be the employee time/paper costs incurred in preparing and filing the report.

As a practical matter, even for the Chapter 7 trustee this report will be difficult to compile within the 30-day deadline since Section 408 gives the debtor 45 days from the filing of the petition within which to file all of the information which is necessary to perform the *projected monthly net income* analysis.

Table 16

DUTY #2 INVESTIGATE AND VERIFY THE DEBTOR'S *monthly net income*

Page 257 PREV PAGE TOP OF DOC

Monthly Net Income

This provision requires the Chapter 13 trustee to investigate and verify the debtor's *monthly net income.* Section 102 replaces the "disposable income" test in 11 USC §1325(b)(1)(B) with a provision that requires that the total amount of monthly net income received by the debtor (minus §1326 (b) payments) be paid to unsecured non-priority creditors. Calculation of *monthly net income* for each case will require a complex analysis which is not currently part of the income analysis that is performed under the "disposable income" test. The monthly net income analysis involves the following steps:

1. Determination of *current monthly total income* of the debtor. *Current monthly total income* is defined in Section 101 to include the average monthly income (whether or not taxable) from all sources for the prior six months. Pay stubs for the 60-day period prior to filing the petition are required to be submitted in every case (Sec. 407) and will need to be analyzed. Federal tax returns for the three most recent tax years prior to filing are required to be provided by the debtor to the U.S. Trustee. (Sec. 407) The Chapter 13 trustee will need to obtain copies of the tax returns from the United States Trustee and analyze them.

Current monthly total income also includes non-cash income that will need to be investigated and valued. Items of non-cash income include food stamps, school lunches, housing subsidies, Medicare, Medicaid, employer contributions to health insurance and other benefits.

2. Subtraction of expense allowances under the applicable IRS National Standards, Local Standards and Other Necessary Expense allowances. (See Exhibit A.) Debtors who claim more than the total allowed for the National Standards or the Other Necessary Expense allowance will need to substantiate and justify the excess. The Chapter 13 trustee will need to review the justification and determine whether it meets the IRS test for a necessary expense which is an expense used for a taxpayer's health and welfare and/or production of income.

Page 258 PREV PAGE TOP OF DOC

Chapter 13 trustee staff will need to be trained to analyze expenses and use the IRS expense allowance standards in the same way IRS workout personnel analyze expenses submitted by taxpayers in connection with offers in compromise. The Chapter 13 trustee will need to subscribe to the IRS Manual and updates in order to keep apprised of changes to IRS expense allowance procedures.

3. Subtraction of secured debt. To determine this number, the remaining amount owed on all secured debt (including projected interest) is divided by the number of months in the Chapter 13 plan. To obtain an accurate number, the Chapter 13 trustee will need to obtain and review copies of contracts, security agreements, documents evidencing perfected security interests, and current billing statements from lenders. Determination of the amount of the secured debt will need to be performed by an experienced paralegal because of the level of legal knowledge required to analyze contracts and secured transactions.

4. Subtraction of priority debt. To determine the proper amount for priority tax debt, the Chapter 13 trustee will need to conduct a full legal analysis of the debtor's tax liability under 11 USC §507(a)(8). This will require obtaining and analyzing IRS and state income tax transcripts in every case since debtors and their attorneys are frequently unaware of the correct amounts and priority classification of taxes owed. To determine the amount for non-tax priority debt a full legal analysis under 11 USC §507(a)(7) will need to be conducted. The priority debt analysis will need to be performed by an experienced paralegal due to its complexity.

Table 17

DUTY #3 INVESTIGATE AND VERIFY INFORMATION PROVIDED BY THE DEBTOR PURSUANT TO 11 USC §111 TO ADJUST MONTHLY NET INCOME

Page 259 PREV PAGE TOP OF DOC

Adjustment to Monthly Net income

Section 102 creates a new section 11 USC §111 that allows a debtor to adjust his monthly net income when the debtor's extraordinary circumstances require an adjustment to income or expenses. Pursuant to this provision, the debtor must file a detailed written statement of extraordinary circumstances and serve it on the Chapter 13 trustee. This statement is to be filed whenever the debtor's monthly net income increases or decreases. The Chapter 13 trustee must give notice to all creditors that such statement has been filed and advise the creditors of the amount of the debtor's monthly net income as shown in the statement.

The Chapter 13 trustee will need to review each statement of extraordinary circumstances and determine whether additional documentation is needed in order to justify the loss of income or increased expense.(see footnote 68) Pay stubs will need to be obtained and reviewed in every case in order to verify that the debtor has properly calculated monthly net income. A re-calculation of the debtors monthly net income will be necessary to confirm that it equals the amount shown in the debtors statement. The Chapter 13 trustee will need to decide whether the change in monthly net income is substantiated and should be allowed. The period for objecting to the statement of extraordinary circumstances (30 days) must be calendared and tracked by the Chapter 13 trustee. If the monthly net income figure is changed, the debtors plan will need to be modified by the Chapter 13 trustee in order to adjust the amount paid to unsecured non-priority creditors. That modification can likely be accomplished through submission of a modification order by the Chapter 13 trustee to court without the need for a hearing.

Page 260 PREV PAGE TOP OF DOC

Table 18

DUTY #4 INVESTIGATE AND VERIFY INFORMATION PROVIDED BY THE DEBTOR PURSUANT TO 11 USC §521, AS AMENDED

Information Provided Pursuant to 11 USC §521 at Time of Filing

Section 407 amends 11 USC §521 to require the debtor to file the following statements with the court within 45 days of the filing of the petition. There is no annual filing requirement for these statements.

1. Statement of the amount of projected monthly net income itemized to show how calculated.

2. Statement of extraordinary circumstances(see footnote 69) for each expense which exceeds the IRS standard expense allowance.

3. Statement disclosing any reasonably anticipated increase in income or expenditures over the next twelve months.

The Chapter 13 trustee will need to review the statements, analyze them in connection with performing the projected monthly net income and monthly net income analyses, and compare the information in the statements with schedules I and J. Any anticipated increase in income will need to be tracked by the Chapter 13 trustee for follow-up with the debtor to confirm whether plan modification is warranted at the time the increase/decrease in anticipated.

Information Provided Annually Pursuant to 11 USC §521

Page 261 PREV PAGE TOP OF DOC

Section 521 is also amended to require the debtor to provide the United States Trustee with copies of all Federal tax returns, including all schedules, attachments and amendments for each of the debtor's tax years ending while the case is pending.

The Chapter 13 trustee will need to obtain copies of the returns from the United States Trustee and perform the same

tax return analysis which was performed when the case was originally filed. (See discussion at page 10.)

In addition to requiring copies of annual Federal tax returns, Section 521 is amended to add the requirement that a Chapter 13 debtor must annually file a statement of income and expenditures for the preceding tax year and monthly net income, showing how calculated. The statement must disclose (1) amount and sources of income of the debtor, (2) the identity of any persons responsible with the debtor for the support of any dependents of the debtor and (3) the identity of any persons who contribute to the debtor's household and the amount contributed.

This statement of income and expenditures is filed with the court but is not served on the trustee. The Chapter 13 trustee will need to obtain a copy from the court. The statement will need to be reviewed and compared with all other income information the Chapter 13 trustee has received, i.e., annual tax returns and statements of extraordinary circumstances, if any, under 11 USC §111 to see if there are any discrepancies. In addition, the Chapter 13 trustee will need to request and review pay stubs for prior months to verify whether the income and expenditure statement is accurate. If there is a discrepancy between the pay stubs and income statement, the Chapter 13 trustee will need to do further investigation and possibly apply to the court to modify the plan.

Page 262 PREV PAGE TOP OF DOC

Because the debtor must file the income and expenditure statement annually, the Chapter 13 trustee will need to implement a procedure to track the deadline for receipt of the statement and follow-up with steps to enforce compliance.

Table 19

DUTY #5 FILE ANNUAL REPORTS WITH THE COURT REGARDING PROPRIETY OF PLAN MODIFICATIONS DUE TO CHANGES TO DEBTOR'S MONTHLY NET INCOME

Section 101 amends 11 USC §1302 to require the Chapter 13 trustee to file annual reports with the court, with copies to creditors, as to whether a modification of amounts paid to unsecured non-priority creditors is appropriate because of changes to the debtor's *monthly net income.* The bill does not provide a filing deadline for this report. It is logical to assume that this report should be prepared after the Chapter 13 trustee has received and analyzed the annual tax return and annual statement of income and expenditures.

Time estimates to review and analyze the tax return and statement of income and expenditures are provided under Duty #4. After performing the analysis, the Chapter 13 trustee will need to compile the data, draft the report and presumably make a recommendation as to whether a plan modification is appropriate.

If a modification is appropriate, the trustee will need to apply to the court to modify the plan.

Table 20

Page 263 PREV PAGE TOP OF DOC

CHANGES TO CHAPTER 13 TRUSTEE DUTIES DUE TO ADEQUATE PROTECTION PROVISION 11 USC §1307A

Section 162 amends Title 11 to add §1307A which is a new section pertaining to adequate protection payments in Chapter 13. Under §1307A the debtor is required to make adequate protection payments to purchase money secured creditors until the time the creditor begins to receive payments under the plan.

Unless the debtor obtains a court order to reduce the amount, the payment amount must be the same as the amount under the contract. The payment due date must also be the same as the due date under the contract unless the debtor obtains a court order changing the due date. Adequate protection payments may be made directly by the debtor to the creditor, outside of the Chapter 13. Alternatively, adequate protection payments may be made through the Chapter 13 plan.(see footnote 70)

Section 1307A does not contain a mechanism that apprises the Chapter 13 trustee of the fact that a debtor is making direct payments to a secured creditor.(see footnote 71) Nor does Section 1307A provide for a way to adjust the amounts owed to a secured creditor after adequate protection payments are made. This will create a problem for the Chapter 13 trustee at the point where the plan has been confirmed and the trustee must begin disbursing money to secured creditors. The Chapter 13 trustee will not be able to verify the proper amount remaining to be paid on the secured claim. The trustee has a duty under 11 USC §1302(b)(1) (referencing 11 USC §704 (5)) to examine proofs of claim and object to the allowance of any claims that is improper. This issue is further complicated by the fact that Section 403 provides that creditors need not file proofs of claim since a proof of claim is deemed filed for any claim that appears in the schedules except a claim scheduled as disputed, contingent, or unliquidated. The reality is that a creditor who has received pre-confirmation adequate protection payments directly from the debtor may not file a claim to supersede the scheduled claim amount and properly account for the adequate protection payments.

Page 264 PREV PAGE TOP OF DOC

In order to avoid overpayment to secured creditors, the Chapter 13 trustee will need to implement a procedure that (1) identifies cases where adequate protection payments may be required, (2) tracks those cases for further contact with the debtor and creditor by the trustee at the time of confirmation to obtain an accounting of adequate protection payments, and (3) resolves discrepancies if the creditor and debtor are in dispute as to the amount owed on the secured debt.

Table 21

OTHER PROVISIONS OF H.R. 3150 WHICH WILL IMPACT CHAPTER TRUSTEESHIP WORKLOAD

Several other sections of H.R. 3150 will create additional work for the Chapter 13 trusteeship. Because of the difficulty involved in quantifying the amount of extra work that will be required under these sections, no estimates of time or cost are provided.

Section 103—Definition of Inappropriate Use

This section changes 11 USC §707(b) to give any party in interest standing to file a §707(b) motion to dismiss a case if the granting of Chapter 7 relief would be a substantial abuse of Chapter 7. Currently, only the court or United States Trustee has standing to file these motions. Often, instead of dismissal of the case, the case is converted to a Chapter 13 because the debtor has sufficient income with which to fund a plan. The result of this change will be increased conversions from Chapter 7 to Chapter 13. Typically, cases converted to Chapter 13 pursuant to a §707(b) motion require substantial additional work due to the following factors: (1) frequently the original case was prepared by a petition preparer or attorney unfamiliar with Chapter 13 making it more difficult to get appropriate amendments filed and/or trustee objections resolved, and (2) debtors are not motivated to cooperate, make payments and participate in a lengthy reorganization case. They are in a Chapter 13 involuntarily, due to the §707(b) conversion. These cases usually take longer than normal to get confirmed and require many hours of staff time to get the paperwork to a point where confirmation is even possible.

Page 265 PREV PAGE TOP OF DOC

Section 112—Debtor Financial Management Training Test Program

This section directs the United States Trustee Program to develop a program to educate debtors regarding how to better manage their finances. The debtor education program to be will be tested in three judicial districts. After the test programs have been evaluated by the United States Trustee, Congress will study the findings.

If Chapter 13 trustees are required to provide debtor education programs, the trusteeship will incur additional expenses for staffing, facilities in which to conduct the education, and educational materials.

Section 114—Disclosures

This section requires non-lawyer petition preparers to give legal advice to debtors including advice regarding how to value assets at replacement value, how to determine current monthly total income, projected monthly income and net monthly income and, how to determine what property is exempt under applicable exemption statutes. This section promotes and encourages the use of petition preparers. Any increase in Chapter 13 filings by petition preparers will result in substantial additional work for the Chapter 13 trustee. Even under the existing bankruptcy code, which is less complex than H.R. 3150, the Chapter 13 paperwork is nearly always inadequately prepared if it is prepared by a petition preparer. Administering cases like this requires significant trustee staff time to work with the debtor to prepare amended paperwork and get objections resolved.

Page 266 PREV PAGE TOP OF DOC

Section 404—Audit Procedures

This section directs the Attorney General to establish procedures for auditing the accuracy and completeness of petitions, schedules, and other information which the debtor is required to provide under 11 USC §521, §111, and §1322. Audits will be performed by certified public accountants by contract with the United States Trustee. The section calls for two types of audits. One audit type is for random audits of one out of fifty cases in each federal judicial district. second type of audit will be required in every case where income and expense schedules reflect "higher than average variances from the statistical norm" of the district in which the case was filed. Although the debtor and not the Chapter 13 is required to produce the relevant documents for the auditors and participate in the audit, the Chapter 13 trustee is likely to be involved in the audit process.

Since the Chapter 13 trustee has a duty to investigate the financial affairs of the debtor (11 USC §1302(b)(1), referencing 11 USC §704(4)) and has already analyzed the case for accuracy and completeness, the auditors may need information from the Chapter 13 trustee (e.g., case notes, correspondence, other written materials provided by the debtor for which the debtor did not keep copies) in order to conduct the audit. At a minimum, the Chapter 13 trustee will need to obtain and review a copy of the audit report to confirm whether case analysis procedures used by the Chapter 13 trustee are adequate to identify inaccuracies and material misstatements in the Chapter 13 petition and schedules.

Section 441—Bankruptcy Statistics

This section directs the United States Trustee Program to compile statistics on Chapter 13 cases and report annually to Congress on the information collected. Currently, to the extent the United States Trustee Program maintains statistics on Chapter 13 cases, that statistical information is provided to the United States Trustees by the Chapter 13 trustees. If the United States Trustee Program seeks to obtain the Chapter 13 statistics required under this section from the Chapter 13 trustees, significant additional expense to the trusteeship will be incurred.

Page 267 PREV PAGE TOP OF DOC

The bill seeks statistical information regarding seven categories of data that are relevant to Chapter 13. Most Chapter 13 trustees are currently only capturing and tracking data for two of the seven categories of data. To provide the United

States Trustee Program with the rest of the data required under this section, additional data entry employees would be needed, as well as significant upgrades to existing system hardware and software.

Section 442—Bankruptcy Data

This section sets forth categories of data to be included by Chapter 13 trustees in final reports which are prepared when cases are closed. hour of the 11 categories of data require data not currently tracked by most Chapter 13 trustees. None of this data duplicates the statistical information to be compiled by the United States Trustee Program in Section 441, above. The inclusion of this additional data in the Chapter 13 final reports will require extra data entry employees and hardware and software upgrades.

CONCLUSION

As is set forth in the attached summaries, implementation of H.R. 3150 will increase expenses to the San Jose trusteeship by $1,466,377.71 annually. This does not include expenses that would be incurred by the implementation of those provisions of H.R. 3150 for which quantification of the amount of extra work was not possible.

The trustee percentage fee in the San Jose trusteeship would need to be increased from 5.2% to 10.12% in order to fund the additional administrative expense. The net effect to unsecured non-priority creditors due to the increased administrative cost is a loss of $1,525,200 in annual payments.

Page 268 PREV PAGE TOP OF DOC

SUMMARY OF ESTIMATED ADDITIONAL EXPENSES

Table 22

Table 23

Table 24

Table 25

Table 26

SUMMARY OF TOTAL EXPENSE CHANGES TO TRUSTEESHIP

Trustee Percentage Fee Increase

The trustee percentage fee for the San Jose trusteeship would need to increase from 5.2% to 10.12% in order to meet the increase in expenses due to implementation of H. R. 3150.

Table 27

Table 28

INSERT OFFSET RING FOLIOS 26 TO 32 **HERE**

PREPARED STATEMENT OF JOSEPH POMYKALA, PH.D.

It is the belief of many members of Congress that current national bankruptcy filings are too high. The benefit of discharging debts while keeping significant property attracts consumer debtors to file for bankruptcy, and often such relief is not warranted or clearly abused. The National Bankruptcy Review Commission in 1994 was not given the clear objective of submitting statutory recommendations to lower filings, and this was reflected in their Report submitted 20 October 1997. Current legislation under consideration, bills H.R. 3150 and S. 1301, attempt to impose "means testing" in order to 1.) steer consumer debtors away from Chapter 7 with its quick discharge into Chapter 13 repayment plans where a portion of future income may be used to pay back debts, and 2.) discourage debtors from filing for bankruptcy to access the discharge when they could otherwise pay back their debts. The reform bills in question would be helpful in achieving these goals.

Page 269 PREV PAGE TOP OF DOC

While bankruptcy is often myopically viewed as a creditor funded social welfare program helping debtors, the opposite is true. Lenders take into account risks associated with debt when contracting loans. By allowing debtors to legally discharge their debts without payment, risk of nonpayment is substantially increased. Higher interest rates commensurate with this risk along with more stringent loan qualification requirements. The bankruptcy discharge is not paid by the expropriation of the property rights of creditors, but rather by "protected" debtors in the terms they borrow. Interest rates on unsecured credit card debt are reflective of the high risk lenders face because of the ease and generosity of the bankruptcy discharge. The bills in question by seeking to limit abuse would be beneficial overall for debtors and the economy.

It is imperative to amend the bankruptcy statute and limit access to the discharge. While filings are now at record levels, the potential for abuse is great. Approximately one-sixth of American households would financially benefit from filing, but only about one percent actually do so. Moral cost is a factor, but bankruptcy is increasingly viewed as smart financial decision rather than an embarrassment. Many debtors do not file because they do not know of the ease of obtaining a discharge while keeping substantially all property until they seek legal council. Others learn from the growing number of friends who have filed. A large increase in filings followed the U.S. Supreme Court's decision to legalize law advertising. Almost nine percent of filings are serial where the debtor has before tasted the forbidden fruit of the discharge and has come back for another bite. In Chapter 7, where most consumer filings occur, ninety-six percent of cases are "no asset"—debtors relinquish no property and legally discharge debts without payment.

Page 270 PREV PAGE TOP OF DOC

Historical Note on the Bankruptcy Power

Consumer bankruptcy did not exist until the mid-19th century. The first exercise of the bankruptcy power delegated to Congress occurred in 1800 and was largely a copy of the existing British Bankruptcy Statute of, 5 George II, c. 30, many clauses verbatim. The latter was entitled "AN ACT to prevent the committing of frauds by bankrupts." Its preamble begins,

"WHEREAS commissions of bankrupt have been issued against several persons . . . and such persons have been declared bankrupts by the commissioners by such commissions authorized, and yet several of such bankrupts . . . have not only refused to surrendered themselves to the commissioners, and to discover and deliver up their estates and effects to the said commissioners for the benefit of their creditors, but have carried away and concealed the same in such manner, that the said commissioners have not been able to seize the same, to the manifest wrong and injury of their creditors, and to the great discouragement of trade: and whereas many evil-minded persons have . . . brought and taken upon trust and credit divers great quantities of goods, wares and merchandises, and have thereby, and by their extravagant manner of living and otherwise, contracted great debts, and having gotten such goods and effects into their custody, have sold or pawned the same for less than the value thereof, and thereby raised ready money, and have withdrawn themselves from their usual places of abode, with their effects, into secret places, in order to oblige their

creditors to accept of such composition or their respective debts, as such evil-minded persons think fit to offer, or have carried away their effects beyond the seas, whereby their creditors have been totally deprived of their debts: and whereas many persons have and do daily become bankrupts, not so much by reason of losses and unavoidable misfortunes, as to the intent to oblige their creditors to accept such their unjust proffers and composition, and to defraud and hinder their creditors of their just debts: therefore to remedy the said abuses."

Page 271 PREV PAGE TOP OF DOC

Bankrupts at the time of the U.S. Constitutional Convention were defendants accused of committing acts of bankruptcy by plaintiff creditors. Bankruptcy was intended to provide for pro rata sharing among unsecured creditors and a means to prevent debtors from absconding to different states and judicial systems. Bankruptcy also contained various statutory punishments. Pennsylvania's Bankruptcy Act of 1785 and the British statute allowed cutting off the bankrupt' ear after it was nailed to the pillory. Besides serving as a punishment, such was to "earmark" him as not being a reputable person with whom to contract future debts—a warning of a bad credit risk. Shaving the bankrupt's head and branding were also common. Earlier in France, bankrupts were subject to public humiliation, paraded naked at the time of their estate's attachment, and forced later to wear shameful green berets. European countries typically did not allow bankrupts to hold public office, nor engage in future commercial enterprise unless they later paid back their debts and thus were legally rehabilitated and taken off the list of bankrupts.

When the U.S. Constitution was drafted, the sole member voting against including the bankruptcy power it was Roger Sherman, objecting because the potential to impose the death penalty under bankruptcy law. James Madison records,

"Mr. SHERMAN observed that Bankruptcies were in some cases punishable by death by the laws of England, & He did not chase to grant a power by which that may be done here.

"Mr. GOVR. MORRIS said this was an extensive & delicate subject. He would agree to it because he saw no danger Of' abuse of the power by the Legislature of the U.S."

Page 272 PREV PAGE TOP OF DOC

A congressional citation by one of your honorable predecessors during the first suggestion of what has become consumer bankruptcy is by Senator Rufus King, one of the framers and signers of the U.S. Constitution at the 1787 Philadelphia Convention (also the author of the contract clause). [text abridged from my dissertation],

Senators Mellon and Dickerson were concerned that Van Dyke's amendment would facilitate fraud. Senator Burrill said the amendment was an insolvency law and "an entirely new system." Senator Rubus King (New York), who himself had been an influential member of the Convention framing the U.S. the Constitution, objected, "[A] *bankruptcy law, applying peculiarly and solely to persons engaged in trade, was the only kind in the contemplation of the Constitution: that therefore the proposed amendment would be exercising a power which, if not left to the States, did not reside in Congress, and was unconstitutional.,"* and on the day the bill was rejected, King reiterated his opinion "that Congress had no power to enact an insolvency law." (March 22, 30; 1820).

This amendment to the bankruptcy bill in question was the first attempt at voluntary bankruptcy open to nonmercantile debtors. Van Dyke's proposal would have allowed any person being imprisoned for debts amounting over $200, or being indebted to one creditor for $1,000, two or more for $ 1,500, to become voluntarily bankrupt upon his own petition; a time when the daily wage was less than a dollar. The depression following the Panic of 1819 circa was the most severe economic downturn suffered in U.S. history since the Revolution. Additionally, during 1819 the Supreme Court invalidated two state debtor laws, New York's so called "jubilee act" in *Sturges* v. *Crowninshield,* and a Louisiana bankruptcy law in *McMillan* v. *McNeill.* The Supreme Court ruled that the discharge of indebtedness arising from state law was an unconstitutional violation of the U.S. Constitution's contract clause. The same (now archaic) constitutional concerns surrounding the 1820 bill resurfaced during consideration of later bills, e.g. Senator Woodbury (New Hampshire) would ask, "What framer in the [1787 Constitutional] Convention dreamed that he was conferring

such a power over anybody but merchants?" (January 27, 1827); but mainly circa enactment of the 1841 Bankruptcy Act following the Panic of 1837, but this later act only remained law a mere 13 months before repeal. It failed to be invalidated by the U.S. Supreme Court and formed precedent for subsequent exercise of the bankruptcy power (the 1867 Act) applicable to consumer debtors. Most U.S. enactments of bankruptcy law ratcheted up debtor relief during economic downturns.

Page 273 PREV PAGE TOP OF DOC

With respect to insolvency law once considered the domain of the states by the Tenth Amendment, laws by which small consumer debtors could be discharged from debtor's prison upon assigning their estate to creditors less meager exemptions, more akin to modern consumer bankruptcy law than actual bankruptcy law of the period, see *Blackstone's Commentaries* which was used by the Framers as a reference book defining legal words utilized at it and the explicit differences between insolvency and bankruptcy law. Delegates to the U.S. Constitutional Convention, many whom were lawyers schooled in England, were fully cognizant that insolvency law applied to poor commoners at their suit as a means to secure release from prison in contrast to bankruptcy directed exclusively against merchants, mostly fraudulent ones, on the behalf of creditors to make property liable for debts on a fair pro rata basis.

When the US Constitution was ratified at the New York Constitutional Convention of 1788, New York proposed a clarifying amendment, "That the Power of Congress to pass uniform Laws concerning Bankruptcy shall only extend to Merchants and other Traders; and that the States respectively may pass Laws for the relief of other Insolvent Debtors." This was submitted to the Continental Congress along with proposed amendments to the U.S. Constitution made by six other states upon ratification. The House reduced this tol7, and the Senate lessened this to 12 of which the states then ratified 10 by 1791 becoming the Bill of Rights and including the Tenth Amendment reserving powers not delegated to the federal government to the states. Since insolvency law was not included in the list of federal powers, such was assumed the to be retained by the states. Bankruptcy law was delegated to the federal government, but interstate respect of laws pertaining to insolvency were covered by Framer's carefully worded "full faith and credit" clause. This is apparent from reading Madison's journal of the U.S. Constitutional Convention.

Page 274 PREV PAGE TOP OF DOC

Interpretations have changed,

U.S. Supreme Court in 1819, *Sturges* v. *Crowninshield,* "The distinction between bankrupts and insolvent laws was perfectly well known to our ancestors, who, in their legislation and usages, have always considered insolvent as different from bankrupt laws."

in stark contrast to

U.S. Supreme Court in 1934, *Continental Illinois Bank* v. *Rock Island & Pacific Railway,* "While attempts have been made to formulate a distinction between bankruptcy and insolvency, it has long been settled that within the meaning of the constitutional provision, the terms are convertible . . . and that no distinction, practically or even theoretically, could be made between bankruptcies and insolvencies."

The transformation of bankruptcy law from being pseudo-criminal in origin into its modern form, a seemingly creditor funded social welfare program, is an interesting story in jurisprudence. Contemporary exercise of the bankruptcy power with respect to consumers may be regarded as unconstitutional in a historical context, but given modern intrastate debt contracting and consumer credit, such easily fits into the federal domain under the broadly interpreted commerce clause. The contract clause only bars individual states from passing laws impairing the obligation of contracts, such clearly applicable to the discharge of indebtedness, but inapplicable to federal legislation. However, I question constitutionality on the basis of the due process and taking clause under the Fifth Amendment, "No person shall be . . . deprived of . . . property, without due process of law; nor shall private property be taken for public use, without just compensation." The original Frazier-Lemke Amendment of 1934 amending the 1898 Bankruptcy Act was found unconstitutional on this basis by the U.S. Supreme Court in *Louisville Bank* v. *Radford* in 1935, and I concur

with respect to applying the ruling to contemporary exercise of bankruptcy power. The private property of creditors—debts owed and lienholder rights, is taken for public use—financial rehabilitation of debtors, without just compensation. The ruling mentioned, "If the public interest requires, and permits, the taking of property of individual mortgagees in order to relieve the necessities of individual mortgagors, resort must be had to proceedings by eminent domain; so that, through taxation, the burden of relief afforded in the public interest may be borne by the public. "If Congress appropriated $30–40 billion annually to discharge private debts out of tax revenues and the general fund, perhaps they would be a bit less generous with conveying relief.

Page 275 PREV PAGE TOP OF DOC

Current Legislation

The means by which current bills H.R. 3150 and S. 1301 seek to improve the ability of debtors to borrow is by making debtors ineligible for Chapter 7 relief if they could pay back at least 20% of nonpriority unsecured debts under a Chapter 13 plan. This would alleviate a degree of the gross abuses by debtors by limiting access to the quick Chapter 7 discharge. The income qualification is a clear and needed step in the right direction. However, certain provisions in the bills under consideration need to be fine tuned to prevent circumvention and strengthen applicability which could otherwise defeat intentions in applied practice. Other supplementary provisions should be added.

The proposed 20% payback threshold or "means testing" is easy to circumvent. A detrimental side effect is the incentive for debtors to become unemployed—suppose a potential no asset Chapter 7 debtor weighs $40,000 in debts discharged versus a few months income—the decision is weighted towards unemployment. The calculation should be based not on projected individual income, but rather a floor based on national statistics to avoid this. Also with respect to the projected disposable income calculation, the provision for "extraordinary circumstances," will be subject to case law only replacing the interpretive morass now surrounding "necessary maintenance" in Chapter 13, yet to a lesser degree. What is extraordinary? Would a person such as Donald Trump need a helicopter under the provision? Judges need a clear definition or they will rely on subjective personal values with differing definitions developing in each circuit. Federal Judges need not be turned into social workers. The explicit extension of Chapter 13 plans from three to five years is clearly an improvement as is the extension of the duration between serial discharges from six to ten years.

Page 276 PREV PAGE TOP OF DOC

The 75% median income exclusion in the bill would exempt most filers from the 20% payback test barring Chapter 7 relief. This provision defeats the intention of the bill. Many petty filers would not be subject to the 20% payback threshold and still would access the quick Chapter 7 discharge. Many of those falling through the loophole are small debtors responding to legal adds and filing *pro se,* and could somehow pay or finance smaller debts. An alternative provision which would reimpose a debt minimum, say $10,000 or $20,000, under all chapters would root out petty filers not needing relief who could otherwise manage their debts, and whose property and income are already now sufficiently protected by generous state set nonbankruptcy property and wage garnishment exemptions. A debt minimum is a relatively simple way to exclude a large percentage of filers from becoming no asset Chapter 7 cases and should replace the proposed 75% median income exclusion loophole.

A supplementary means to lower filings would be to lower other available benefits with respect to retained debtor property exempted from the estate. The 1994 Bankruptcy Reform Act doubled the dollar value of most personal and real property exemptions under §522. This allowed more property to be retained by debtors while they discharge debts in those states which have adopted the federal list as opposed to the opt-out states which set their own exemption levels, generally identical to exemptions under nonbankruptcy law. The amendment served as a further incentive to become bankrupt. Between 1994 and 1995, total bankruptcy filings increased 17 percent in the areas using the higher federal exemptions compared to only 10.4 percent in the opt-out states where exemption levels did not change. It is outrageous that some states allow extremely generous exemptions set by extent (acreage) such uncapped by value, and a mansion perhaps worth several million dollars is exempted from the estate while debts are discharged. Clearly a federal cap should be put on the utilization of state homestead exemptions. Legislation introduce last session by Senator Kohl under bill S.530 would have done this. A similar provision should be added to bill H.R. 3150 to end

clear abuse by affluent filers. Under state law, debtors are adequately protected from creditors. Under federal bankruptcy law, property is also sheltered, but debtors can access the discharge erasing indebtedness. To balance this, exemptions should be sufficiently low when debts are discharged under federal bankruptcy law, and such would serve as an incentive for debtors not file for bankruptcy merely to seek a discharge.

Page 277 PREV PAGE TOP OF DOC

The substantial abuse clause under §707 allows dismissal of a Chapter 7 case, but judges have had difficulty interpreting this clause. Legislation now under consideration would allow creditors to motion for a hearing, and cause for dismissal would include the proposed 20% payback threshold making debtors ineligible for Chapter 7 relief. This helps, but ideally the clause should be made applicable to all chapters and more importantly, the definition of "substantial abuse" and thus grounds for a dismissal should be partially enumerated. Grounds should include the ability to repay using future income; but similar to various case law and prior bankruptcy law, additionally should include prepetition behavior, e.g. fraudulent conveyance, bankruptcy planning, or if debts were incurred recklessly by gambling, consuming luxury good and services on the eve of filing, or incurred without the ability to repay. The window of nondischargeablity of prepetition debts should also be extended to 90 days before filing and made applicable to all debts.

Bills H.R. 3150 and S. 1301 do not include provisions to protect tithing end charitable donations as under bills H.R. 2604 and S. 1244. The latter inclusion was a promoted by special interest groups representing religious organizations in reaction to several court rulings allowing prepetition conveyances to be avoided as not for value. Designating prepetition charitable donations as unavoidable is a mistake and such should not be attached to the final bill. This is mere favoritism and akin to letting debtors buy generous presents for friends and family members while on the verge of bankruptcy and defeats the notion of fraudulent conveyance. Charitable organizations are deemed just causes more worthwhile than creditors. The bills protecting charitable transfers also extend to postpetition plans under Chapter 13 by amending §1325 in the disposable income calculation. Therefore, every extra dollar going to such charitable organizations is a dollar less for unsecured creditor recovery. This leaves the door wide open for fraud and abuse of the provision. Giving away cash to charitable organizations is not akin to necessary maintenance of the debtor and a nonessential expense only benefitting special interests promoting such legislation. Such provisions should remain out of bills H.R. 3150 and S. 1301.

Page 278 PREV PAGE TOP OF DOC

A provision should be added to the bills excluding individual debtors who are natural persons from being eligible under Chapter 11. More than a thousand consumer filings occur annually under Chapter 11. The business chapter is intended for large corporations, and the small number of affluent debtors with debts above the Chapter 13 debt eligiablity limits who now seek relief under Chapter 11 clearly should not be filing under it.

Respectfully,

Joseph Pomykala, Ph.D.

Table 29

Subcommittee on Commercial and Administrative Law
GEORGE W. GEKAS, Pennsylvania, *Chairman*
LAMAR SMITH, Texas
BOB INGLIS, South Carolina
ED BRYANT, Tennessee
STEVE CHABOT, Ohio
LINDSEY O. GRAHAM, South Carolina

JERROLD NADLER, New York
SHEILA JACKSON LEE, Texas
MARTIN T. MEEHAN, Massachusetts
WILLIAM D. DELAHUNT, Massachusetts

Page 279 PREV PAGE TOP OF DOC

RAYMOND V. SMIETANKA, *Chief Counsel*
SUSAN JENSEN-CONKLIN *Counsel*
JAMES W. HARPER, *Counsel*

C O N T E N T S

HEARING DATE
March 12, 1998

OPENING STATEMENT

Gekas, Hon. George W., a Representative in Congress from the State of Pennsylvania, and Chairman, Subcommittee on Commercial and Administrative Law

WITNESSES

Brewer, William E., Jr., Esq., National Association of Consumer Bankruptcy Attorneys, Raleigh, NC

Gross, Karen, Professor, New York Law School, New York, NY

Hammes, Norma L., Esq., Gold and Hammes, San Jose, CA, Representing National Association of Consumer Bankruptcy Attorneys

Mandell, Lewis, Dean and Professor of Finance, College of Business Administration, Marquette University, Milwaukee, WI

Page 280 PREV PAGE TOP OF DOC

Mitsch, Robert F., Esq., Mitsch & Crutchfield, St. Paul, MN, Representing National Retail Association

Neubig, Thomas S., Partner and National Director, Policy Economics and Quantitative Analysis, Ernst & Young, LLP, Washington, DC

Olson, Marion A., Jr., Standing Chapter 13 Trustee for the United States Bankruptcy Court, Western District of Texas, San Antonio Division

Scheuren, Fritz J., Associate National Technical Director, Statistical Sampling, Ernst & Young, LLP, Washington, DC

Stana, Richard M., Associate Director, Administration of Justice Issues, U.S. General Accounting Office

Staten, Michael E., Credit Research Center, Georgetown School of Business, Georgetown University

Waldschmidt, Robert H., Esq., Howell & Fisher, Nashville, TN, Representing National Association of Bankruptcy Trustees

Wallace, George J., Esq., Eckert Seamons Cherin & Mellott, LLC, Washington, DC, Representing American Financial Services Association

Page 281 PREV PAGE TOP OF DOC

LETTERS, STATEMENTS, ETC., SUBMITTED FOR THE HEARING

Brewer, William E., Jr., Esq., National Association of Consumer Bankruptcy Attorneys, Raleigh, NC: Prepared statement

Gekas, Hon. George W., a Representative in Congress from the State of Pennsylvania, and Chairman, Subcommittee on Commercial and Administrative Law: Prepared statement

Gross, Karen, Professor, New York Law School, New York, NY: Prepared statement

Hammes, Norma L., Esq., Gold and Hammes, San Jose, CA, Representing National Association of Consumer Bankruptcy Attorneys: Prepared statement

Jackson Lee, Sheila, a Representative in Congress from the State of Texas: Prepared statement

Mandell, Lewis, Dean and Professor of Finance, College of Business Administration, Marquette University, Milwaukee, WI: Prepared statement

Mitsch, Robert F., Esq., Mitsch & Crutchfield, St. Paul, MN, Representing National Retail Association: Prepared statement

Neubig, Thomas S., Partner and National Director, Policy Economics and Quantitative Analysis, Ernst & Young, LLP, Washington, DC: Prepared statement

Page 282 PREV PAGE TOP OF DOC

Olson, Marion A., Jr., Standing Chapter 13 Trustee for the United States Bankruptcy Court, Western District of Texas, San Antonio Division: Prepared statement

Stana, Richard M., Associate Director, Administration of Justice Issues, U.S. General Accounting Office: Prepared statement

Staten, Michael E., Credit Research Center, Georgetown School of Business, Georgetown University: Prepared statement

Waldschmidt, Robert H., Esq., Howell & Fisher, Nashville, TN, Representing National Association of Bankruptcy Trustees: Prepared statement

Wallace, George J., Esq., Eckert Seamons Cherin & Mellott, LLC, Washington, DC, Representing American Financial Services Association: Prepared statement

APPENDIX

Material submitted for the hearing

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

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

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

(Footnote 4 return)
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.

(Footnote 5 return)
Bankruptcy: The Next 20 Years (October 20, 1997).

(Footnote 6 return)
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).

(Footnote 7 return)
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.

(Footnote 8 return)
This study was funded by Visa U.S.A. and MasterCard International.

(Footnote 9 return)
Administrative Office of the U.S. Courts (1998). Total 1997 non-business filings were 1.35 million, consisting of 957,000 Chapter 7 filings, 392,000 Chapter 13 filings, and about 1,000 Chapter 11 filings. These numbers differ from those in Table 2, because they include filings outside the 50 states and the District of Columbia.

(Footnote 10 return)
The courts studied in this earlier report were Boston, Chicago, Los Angeles, and Nashville. For a full description of that (mainly 1992/93) database, see Visa (1997) and Ernst & Young (1998). See also the related study, Barron and Staten (1997), based largely on 1996 bankruptcy petitions from 13 cities.

(Footnote 11 return)
For example, while the 1996 national median income was $35,492 for all households; for a household of four, it was $51,405. (U.S. Bureau of the Census, 1997) Accordingly, for a family of four, the test would be whether the family's gross income exceeded 75 percent of $51,405, or $38,554. Families above this level would be impacted.

(Footnote 12 return)
The margin of error on this estimate of the percentage impacted by H.R. 3150 is such that we can state with 95% confidence that the true value lies between 13.1% and 16.9% (See Appendix 2).

(Footnote 13 return)
The sample had to be drawn separately for two time periods because data for the entire year were not available until mid-January 1998. The sample for the first 11 months of 1997 was completed during the week of January 5, 1998. The sample for December 1997 was finished on January 16, 1998.

(Footnote 14 return)
Not all districts had 500 Chapter 7 filings. When this occurred, the available number were selected. This initial sample was for potential later use in taking larger samples in certain target districts. This part of the sampling is ongoing. For example, there will eventually be district level estimates possible in the four courts used in Ernst & Young (1998).

(Footnote 15 return)
About 95% of Chapter 7 filings nationally are "no-asset" cases. A "no-asset" case refers to the situation where there are no funds remaining to be dispersed to creditors, *after the debtor is allowed to keep all exempt assets.* To achieve 200 Chapter 7 "asset case" selections, the actual sampling rate was doubled over that applicable for the "no-asset" cases. This oversampling was done to draw enough cases to make comparisons between the two types of Chapter 7 filers. Petitions were weighted so that the results would reflect the appropriate mix of "asset cases" and "no-asset" cases.

(Footnote 16 return)
The second stage sample started out, effectively, as a stratified random sample by district with the selection probabilities all equal—that is, a self-weighting sample. The number of Chapter 7 asset cases selected was then doubled and the samples in the smaller districts were increased so that the minimum was 12. At this point, the sample was judged too large and a systematic subsample was taken after sorting by district, chapter, and month of filing—arriving at the final counts summarized in Table 1.

(Footnote 17 return)
Administrative Office of the U.S. Courts (1998). As discussed in Appendix 1, there was a net shortfall in coverage between the Visa BNS database and the official counts. The slight discrepancy involved, under three percent, is not believed to be an important limitation to the analyses carried out in this report. In the table, the adjustments for net incompleteness have been made by circuit.

(Footnote 18 return)
At this point, full information is not yet available on all 1997 dismissed cases. To obtain the adjusted total, we looked at the very large first stage sample (43,730 cases); and for the petitions filed through June 1997, we estimated the fraction of cases found to be dismissed during January–June 1997 compared to the total of dismissed plus discharged cases for that period. Our estimate was slightly over one percent overall. The adjustments for dismissed cases have been made in the table by circuit.

(Footnote 19 return)
A full description of the methodology for this determination is found in Appendix 2. Basically, the usable sample consists of all original selections, except identified dismissals, for which there was enough information to do the calculations under H.R. 3150. Aside from a small number of identified dismissals, therefore, the cases excluded either were never obtained or were too incomplete to use.

(Footnote 20 return)
A detailed description of the methodology used for the repayment calculations is provided in Appendix 3.

(Footnote 21 return)
These figures understate the total debt repaid over the life of the loan. For example, a petitioner with a mortgage would likely continue to make payments after the five year period called for in the needs-based proposal.

(Footnote 22 return)
See Ernst & Young (1998) for details. Had the law been in effect in the four cities studied in 1992/93, we can state with 95% confidence that the true value would lie roughly between 11 and 13 percent—a finding that is quite comparable to the share of Chapter 7 filers impacted in this study. It should be noted that the methodologies used for the two estimates are not directly comparable, because of factors such as differences in data availability, and the different cities and years covered by the samples. See the appendix in Ernst & Young (1998) and Appendix 2 in this report for methodological details.

(Footnote 23 return)
The Georgetown study, Barron and Staten (1998), calculated the ability to repay non-housing non-priority debt, and used reported petitioner expenses rather than IRS standards.

(Footnote 24 return)
Appendix 2 contains a full discussion of the procedures used in processing the petitions, and an assessment of the importance of sampling error. Here, attention is confined to conceptual clarifications.

(Footnote 25 return)
The repayment calculations include interest on back taxes and secured debt. See Appendix 3 for details.

(Footnote 26 return)
We examined two measures of income in our analyses: current 1997 gross monthly income and the equivalent income concept for 1996. The more conservative of these, 1997 current monthly income, was used as the starting point in the projections. As noted earlier, we found that 15 percent of the 1997 Chapter 7 filers would have been required to file Chapter 13 under the H.R. 3150. If we had used 1996 income, the fraction of the population covered by the needs-based provision would have risen to over 21 percent.

(Footnote 27 return)
In the treatment of these issues, it should be acknowledged that Ernst & Young was considerably aided by a careful review of the GAO report (GAO, 1998) of the work done by Barron and Staten (1998). Many of the concerns expressed in the GAO report have been addressed by the fact that this study is based on a national probability sample that randomly selected cases from the entire year, employing tight controls and fully auditable processes. Still, some of

the issues GAO raised could not be dealt with relying solely on the petitions themselves. In particular, the impact of administrative expenses on our results had to be developed from outside sources. The five-year projection of income, as required by H.R. 3150, is also an issue. As noted in Section 3 and Appendix 3, alternative income measures were considered and the most conservative approach was chosen. Full resolution of issues such as these, of course, might only come if legislation, such as H.R. 3150 were enacted and the bankruptcy process changed accordingly.

(Footnote 28 return)

"Fail-safe" methods included, for example, using medians rather than means, and employing graphical methods, alongside analytic ones, so that anomalies were discovered and addressed. When estimating total Chapter 7 debt (presented in Section 3 and Chart 4), additional steps were taken to model the upper tail of the debt distribution, so as to dampen the impacts of sampling and nonsampling errors. Full details are in Falk, et al. (forthcoming).

(Footnote 29 return)

See Section 2 of the main report for a discussion of the sampling. Because of problems obtaining petitions in a few small courts, there were about 50 cases which remained outstanding, and for which no substitutes were obtained. In Table 2, the difference between the final selected sample (2,220) and the usable sample (2,142) was 78 cases. As discussed later in this appendix, some of these 78 were found to be dismissed cases and some were too incomplete to use.

(Footnote 30 return)

The substitutes were matched by district, chapter, and, where possible, also by month of filing. As generally calculated, therefore, the unit nonresponse for the study, counting the cases for which substitutes were sought, plus those that were unavailable, amounted to just under seven percent. This, in our view, is an amazingly low proportion for a study of this size, within the short time frame.

(Footnote 31 return)

We speculate that some of these may have been as a result of data entry problems on the BNS database that was used to draw the sample.

(Footnote 32 return)

The reasons given ranged from the general one of unavailable/unable to locate (26), to out to staff (7), out to court (1), out to hearing (2), misplaced by court (7), in judge's chambers (3), etc. Most of the reasons, including "sent to archives," suggest that a second search, by April/May 1998, might be more successful.

(Footnote 33 return)

See Chapman (1983), pp. 45–61, for a general discussion of the value of substitution and concerns about its use.

(Footnote 34 return)

When in full operation, there were seven or eight people entering data at any one time, with an onsite manager and a second person providing computer processing support, as required. One of the keyers was dedicated solely to controlling the receipt of petitions. Because of the size of the petitions and the built-in checking to be done, the remaining keyers averaged about 15 documents per day.

(Footnote 35 return)

There were about 40 summation, or "cross-footing" checks possible per document. Most of these were built into the petitions—schedule totals and the like. Some additional "footing" was added, however, when the petition forms were

being set up for electronic processing.

(Footnote 36 return)
"Face Sheet Only" petitions basically contain no information on the debtors' financial affairs and could not be used. Fortunately, there were very few of these—only 14 altogether.

(Footnote 37 return)
This should be evident from the brief discussion given of process management above. Not discussed but also quite important were the numerous checks built into the sampling and analysis steps.

(Footnote 38 return)
We did examine the handful of dismissed petitions, already identified as such and in our sample. Those complete enough to make a determination about appeared to have a higher than average repayability ratio. If the remaining dismissals, which cannot yet be identified (and which, therefore, remain in the sample) are similar, then given the way we have adjusted for dismissals, our results could be slightly overstated—albeit in no material way.

(Footnote 39 return)
The only cases excluded, therefore, from the analysis were those not returned, the few "incomplete," and those identified as dismissals.

(Footnote 40 return)
Current monthly income from Schedule I was present in all but 6 cases. These cases were among those dropped as too incomplete to use.

(Footnote 41 return)
Originally, we considered doing some sensitivity analyses to capture this source of uncertainty; however, the occurrences were so infrequent that this did not seem necessary. In addition, looking at specific cases suggested that, at the median, inconsistencies were small and largely canceled out.

(Footnote 42 return)
Two petitions were selected at random from each keyer each day. Usually this meant about 14 cases in all. One of the cases was among those reviewed operationally. The other was to be among those unreviewed.

(Footnote 43 return)
Variable inconsistency rates are calculated as the number of variables with an inconsistency divided by the total number of variables. Similarly, petition inconsistency rates are the number of petitions with an inconsistency divided by the total number of petitions, and keystroke inconsistency rates are the number of keystrokes with an inconsistency divided by the total number of keystrokes.

(Footnote 44 return)
Most of the nonsampling errors (except likely minor biases) discussed above appear to be in the category of simple response variances or shortfalls in desired sample size and hence are actually measured in the sampling error already. It turns out that if the biases are of modest size relative to the sampling error, they do not greatly increase the margin of error. This is what we believe to be the situation here. For more on this, see, for example, Hansen, et al. (1953), pp. 56–59.

(Footnote 45 return)
A qualification which remains is related to possible misstatements by debtors of income or expenses on the petitions, and the obvious difficulty of projecting these out over five years, even if the data were without error.

(Footnote 46 return)
See Ernst & Young (1998) for details on how these calculations were made using comparable 1992/93 data.

(Footnote 47 return)
"Current monthly total income" is defined by H.R. 3150 as "the average monthly income from all sources derived which the debtor, or in a joint case, the debtor and the debtor's spouse, receive without regard to whether it is taxable income, in the six months preceding the date of determination. . ." Average income over the six months prior to filing is not easily captured from the petition data. Analysis of the data revealed that, on average, current monthly income on Schedule I was lower than the prior year's (1996) income from employment, business and other sources from Form 7 divided by 12. Current monthly income from Schedule I was therefore used as a conservative approach which underestimates the amount of repayment ability under H.R. 3150. Repayment calculations were also done using prior year's income. It is reasonable to expect that the average income over the six months prior to filing would lie within the range represented by current monthly income and prior year's income.

(Footnote 48 return)
The calculations assumed a debtor is a homeowner if the petitioner had home or second mortgage debt on Schedule D, and had real property on Schedule A that was either a primary residence or multiple family housing unit.

(Footnote 49 return)
The number of vehicles was obtained by taking the larger of the number of personal property items identified on Schedule B as a vehicle, and the number of secured debts identified on Schedule D as vehicle debt.

(Footnote 50 return)
Mortgage payments were multiplied by 85 percent to remove taxes and mortgage insurance from the payment amount. The outstanding mortgage debt amount does not include interest, so the amount was grossed up by 10 percent. The 10 percent gross up for accrued interest is the ratio of the remaining cumulative interest to outstanding principal for an 8 percent 30 year amortized mortgage with 2 to 3 years to maturity.

(Footnote 51 return)
The 10 percent future accrued interest on secured non-mortgage debt is the ratio of remaining cumulative interest to outstanding principal for a nine percent four year automobile loan with 2 years to maturity. The nine percent market interest rate was obtained from Federal Reserve Board (1997).

(Footnote 52 return)
Debtors would disclose their income and expenses, and calculate and disclose their federally defined "net income" based upon actual gross income less IRS guidelines for reasonable living expenses. They would also provide their last three years' tax returns and be subject to audit. Provision is made for flexibility if there are extraordinary expenses.

(Footnote 53 return)
A selected bibliography appears as Appendix A.

(Footnote 54 return)
At the request of the National Bankruptcy Review Commission, I submitted two reports to the Commission on debtor education and testified before the Commission on this topic on two occasions. My final report to the Commission (dated July, 1997) appears as an appendix to the Commission's Final Report. Additional copies have been made available to the Subcommittee, and further copies are available upon request.

(Footnote 55 return)
There is currently a vigorous debate on the nature, scope and meaning of the fresh start; "means-based testing," as proposed in H.R. 3150 and S. 10899, curtails the fresh start for a group of consumer debtors. An analysis of the propriety of eliminating chapter choice is beyond the purview of this prepared statement.

(Footnote 56 return)
See e.g. David Stanley and Marjorie Girth, *Bankruptcy: Problem, Process, Reform* at 197 (1971); Report of the Commission on the Bankruptcy Laws of the United States, H. Doc. 93–137, parts I and II, at 109.

(Footnote 57 return)
While these programs have not been studied in any systematic way, the existing evidence suggests that they are successful. These Chapter 13 programs provide a useful prototype for study and possible expansion as more fully discussed *infra.*

(Footnote 58 return)
Some Chapter 7 debtors gain insights into their financial situation through their attorneys or Chapter 7 trustee; however, the level of lawyer or trustee counselling regarding financial management is not substantial.

(Footnote 59 return)
There is a paucity of data generally about the bankruptcy system, including information about re-filing. Re-filing can take various forms: seeking relief within six years from the initial filing; using a different name to re-file; seeking relief at some point in the future beyond the six year period. Recidivism is generally considered to be between 7–9% of all debtors, although the data are not firm on this issue. Debtor education is *not* designed purely to stop repeat filings; it is much more pro-active than that.

(Footnote 60 return)
The quality and quantum of debtor counselling, whether by lawyers credit counsellors and financial planners, is a topic worthy of discussion. However, it is beyond the scope of this presentation.

(Footnote 61 return)
The Jump Start Coalition is an example of this effort.

(Footnote 62 return)
The Coalition for Consumer Bankruptcy Debtor Education is a newly formed not-for-profit entity whose board is composed of these various constituencies. (The Coalition is seeking Section 501(c)(3) status.) The Coalition's mission is to develop and then implement a pilot debtor education program. The Coalition's strength rests in its diversity. A copy of the Coalition's initial Board of Directors is attached as Appendix B.

(Footnote 63 return)
What constitutes success is not a simple question either. From my perspective, success need not be as lofty as some might anticipate. If debtors feel better about themselves, if they believe they are handling money and finances better than they did before, that is success. For a thoughtful dialogue about the differing perspectives on what constitutes "success" in debtor education, there will be a forthcoming article in Mortgage Banking magazine this Spring. In this article, Steve Holiga (VISA), Joseph Guzinski (Executive Office of the U.S. Trustee), Raymond Bell (NationsBank); Joan Warrington (CitiCorp), and I each answer several questions (in dialogic fashion) on debtor education in general and "success" in particular.

(Footnote 64 return)
Despite this stand, the program is often criticized for creating another federally funded governmental program.

(Footnote 65 return)
The elimination of the pilot fee waiver program has reinforced the adage that "one can be too poor to go broke." Whatever one's position on in forma pauperis filings, the payment of a fee should not be a condition to receipt of the education. There is some sense among educators that a fee, however modest, evidences a level of commitment on the part of debtors.

(Footnote 66 return)
Both H.R. 3150 and S. 10899 address pre-bankruptcy counselling. The provisions related to counselling in both bills are problematic although that, too, is a topic for another day.

(Footnote 67 return)
Income consists of trustee percentage fee (taken on monies disbursed to creditors), interest on savings account and certificate of deposit on trust monies for confirmed cases, and reimbursement from debtors for actual expenses on cases closed prior to confirmation.

(Footnote 68 return)
A similar analysis will be required if the statement of extraordinary income is being filed due to increased income or decreased expenses.

(Footnote 69 return)
This differs from the statement of extraordinary circumstances (11 USC §111) discussed at page 12. The statement of extraordinary circumstances that is filed at the time of the pension pertains to expense items that exceed the IRS standard expense allowances. The §111 statement of extraordinary circumstances addresses lost income as well as expenses in excess of the IRS standards.

(Footnote 70 return)
As a practical matter, this report assumes that the majority of debtors will em choose to make adequate protection payments through the Chapter 13 plan because the trustee's percentage fee is added to all disbursements made to creditors. The cost of administering adequate protection payments through the Chapter 13 plan is not addressed in this report.

(Footnote 71 return)
Presumably, if the debtor obtains an order which changes the amount of the adequate protection payment or timing of

the due date, the Chapter 13 Trustee would be served with a copy of the order and will learn at that time that direct payments are being made by the debtor.