What Do We Know About Chapter 13 Personal Bankruptcy Filings?

BY WENLI LI

Since 1980, the number of households filing for bankruptcy has more than tripled. This drastic increase in personal bankruptcy filings led to substantial debate among economists and policymakers. That debate subsequently resulted in the enactment of extensive reforms in 2005 when Congress passed the Bankruptcy Abuse Prevention and Consumer Protection Act. Ultimately, the rationale for this legislation is the presumption that Chapter 13 leads to more appropriate outcomes compared with either Chapter 7 filings or other options outside bankruptcy. In this article, Wenli Li outlines the results of two recent studies that have taken a more detailed look at actual outcomes in Chapter 13.

The U.S. personal bankruptcy filing rate has gone up dramatically for the past two decades. In 1980, for every 1,000 households, only four filed for bankruptcy. Today, the number has more than tripled. About one-third of the bankruptcies were filed under Chapter 13 (Figure 1). The U.S personal bankruptcy code has two key features: Chapter 7 and Chapter 13. Under Chapter 7, debtors sacrifice part of their assets in exchange for a discharge of their debts. Under Chapter 13, debtors sacrifice part of their future earnings in exchange for a partial discharge of their debts. This drastic increase in personal bankruptcy filing rates led to substantial debate, academic as well as legislative, and finally resulted in the enactment of extensive bankruptcy reforms in 2005 with the passage of the Bankruptcy Abuse Prevention and Consumer Protection Act. The core of the legal reform is to further restrict debtors' access to Chapter 7 personal bankruptcy and to force some debtors to file under Chapter 13 or not at all, so that debtors with sufficient income would be forced to repay at least part of their debt through their future earnings.[1]

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Ultimately, the rationale for this legislation is the presumption that Chapter 13 leads to more appropriate outcomes (for some debtors) compared with either Chapter 7 or options outside of bankruptcy. But what do debtors and creditors really achieve under Chapter 13? Or more important, how does the Chapter 13 bankruptcy system serve its two conflicting objectives: to provide debtors with a partial financial fresh start by discharging some of their debt, and to help creditors collect their defaulted loans by enforcing debtors' obligation to repay?

Two recent studies have taken a more detailed empirical look at actual outcomes in Chapter 13. One is my study with Hülya Eraslan and Pierre-Daniel Sarte, and the other is a study by Scott Norberg and Andrew Velkey.

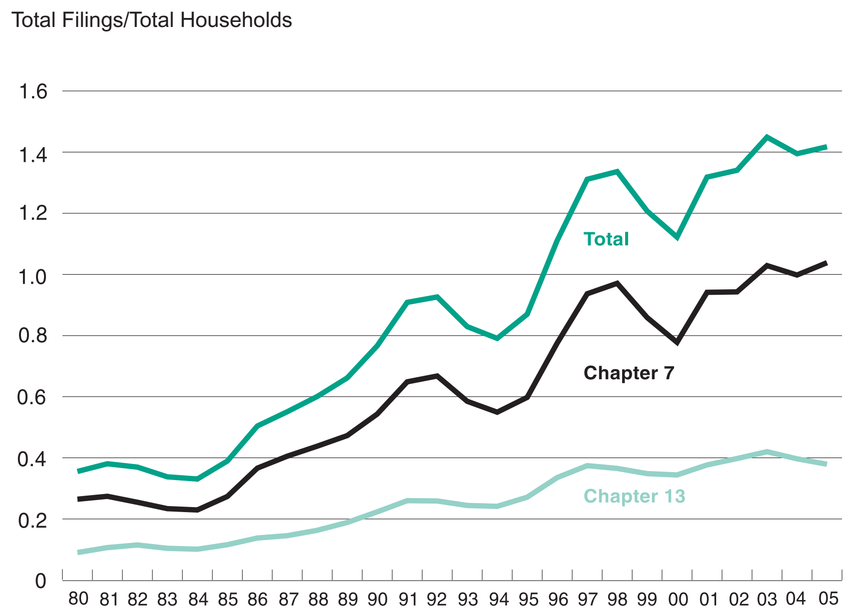
FEATURES OF U.S. BANKRUPTCY LAW

The key feature of U.S. personal bankruptcy law, both before and after passage of the 2005 reform act, is that it contains two basic types of bankruptcy proceedings: Chapter 7 and Chapter 13. Before passage of the 2005 reform act, a debtor's bankruptcy decision and choice between chapters were

[1] Some of the other significant changes the Bankruptcy Reform Act introduced to bankruptcy doctrine include increasing the amount of paperwork that must be filed by every debtor; requiring pre-filing counseling and post-filing financial education for debtors whose debts are primarily consumer debts; and making Chapter 13 less attractive by, among other things, requiring five-year payment plans (for above-median debtors) rather than the three-year plans that were previously the norm.

FIGURE 1

Annual Household Bankruptcy Filing Rate



mostly voluntary. The 2005 reform act abolished some debtors' right to choose between chapters. To file under Chapter 7, debtors whose incomes are above their state median family income must now pass a "means test" that requires that (i) their monthly income net of allowable expenses calculated according to IRS rules be less than $166.67 per month and (ii) their net monthly income multiplied by 60 be less than 25 percent of their unsecured debt.[2] If their incomes are above the median level and they fail the means test, debtors must file under Chapter 13 if they file for bankruptcy at all.

Chapter 7 is often called liquidation. Under Chapter 7, a debtor gives up all of his assets above a certain exemption level. In exchange, the debtor gets almost all of his unsecured debt discharged. The exemption level varies with states. A debtor cannot file for bankruptcy for six years after the last filing.

Chapter 13 is also called a wage earner's plan. Under Chapter 13, a debtor gets to keep all of his assets. However, he must repay some of the unsecured debt out of future earnings through a repayment plan over three to five years. Only after the completion of the repayment plan will the debtor obtain a legal discharge of his remaining debts. In principle, a debtor can file for Chapter 13 repeatedly without a time limit between the two adjacent filings. In practice, bankruptcy courts often require a 180-day gap.

A debtor can also choose to remain delinquent on his loans without filing for bankruptcy, something known as informal bankruptcy. In that case, if the loan is secured by a house or a car, lenders can seize the house or the car, a process legally called foreclosure. If the loan is unsecured, such as credit card debt, lenders will immediately start adding finance charges and late fees to the amount owed. They will also likely make phone calls and write letters soliciting payments. Shortly after that, unsecured lenders typically sell their debts to collection agencies. Unsecured creditors as well as collection agencies can also sue the debtor and obtain a court judgment against the debtor. They collect the judgment by garnishing the debtor's wages.[3]

Individuals who choose informal bankruptcy over formal bankruptcy and debt payment are often those who do not have regular jobs, assets, or bank accounts. This means that even if a creditor obtained a judgment against a debtor, it would be nearly impossible for the creditor to collect on it. In their study of informal bankruptcy, Amanda Dawsey and Lawrence Ausubel point out that high bankruptcy costs also contribute to informal bankruptcy.

HOW DOES CHAPTER 13 BANKRUPTCY WORK?

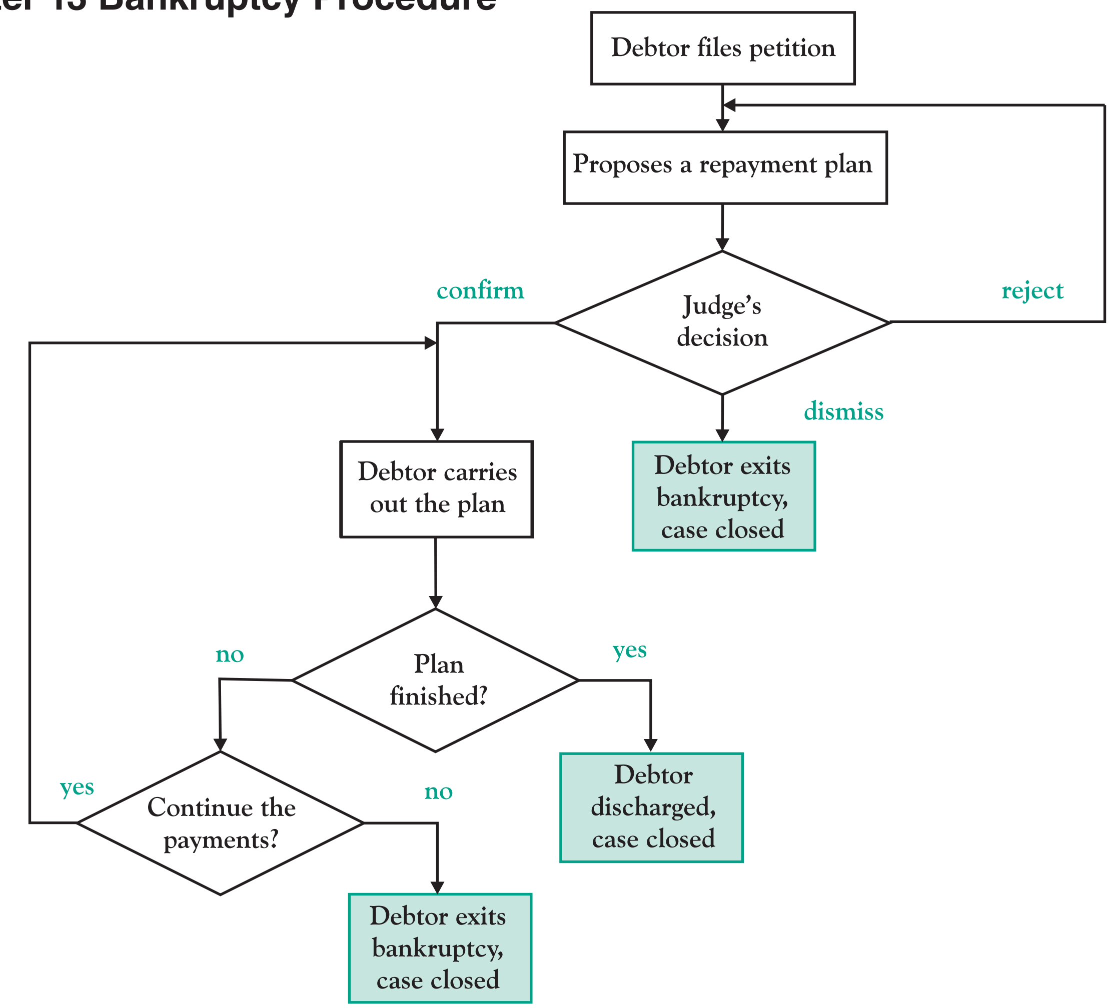
Figure 2 lists the basic steps of a typical Chapter 13 case. The case starts with the debtor's submitting a petition and a repayment plan. Prior to April 2006, the filing fee for a Chapter 13 case was $185; it's now $235 plus a $39 miscellaneous administrative fee. In general, the filing fee is due at the time of petition. The court sometimes may allow the debtor to pay this filing fee in installments if the debtor cannot

[2] The state median income divides the higher half of the population in the state from the lower half in terms of income level. In other words, half of the population in the state has income greater than the median, and half have income less than the median.

[3] See Robert Hunt's *Business Review* article for more details.

FIGURE 2

Chapter 13 Bankruptcy Procedure



pay all at once.[4] If the debtor hires a private attorney, he will also have to pay the attorney's fees. The attorney's fees can be anywhere from a couple of hundred dollars to a few thousand, depending on the complexity of the case and the experience of the attorney.

As soon as a debtor files for bankruptcy, something called the "automatic stay" goes into effect. The automatic stay prohibits virtually all creditors from taking any action directed at collecting the debts the debtor owes them until the court says otherwise. These actions include foreclosures, termination of contracts for deed, repossession actions, and lawsuits to obtain judgments on debts and pressure to sell off equipment, crops, and livestock.

The petition contains schedules A to J, which detail the debtor's assets (real estate assets such as housing, and personal assets such as furniture and jewelry); income, expense, and debts (secured, unsecured priority, and unsecured nonpriority); pending lawsuits, including foreclosures; and past income.[5] Together with the

[4] The filing fee may be waived entirely only for individuals who qualify under very strict fee-waiver provisions.

[5] Types of unsecured priority claims include, among others, alimony, maintenance and support, taxes and certain other debts owed to government entities, and money owed to employee benefit plans for services rendered within the 180 days immediately preceding filing of the original petition. Unsecured nonpriority claims are mostly credit card debt. The plan must pay priority claims in full before unsecured nonpriority creditors receive any money unless a particular priority creditor agrees to different treatment of the claim or, in the case of a domestic support obligation, unless the debtor contributes all "disposable income"— discussed below — to a five-year plan.

petition, the debtor must also submit a repayment plan that devotes all of his disposable income – income net of necessary expenses – to the payment of claims.

For a proposed payment plan to be confirmed, it must extend for at least three years, but it cannot exceed five years. It must also be filed in good faith. In particular, the plan must propose to pay at least as much as the value of the assets creditors would have received under Chapter 7. Finally, the plan must make up all missed payments on secured debt before submitting payments to unsecured creditors.

Within a few days after the debtor files the bankruptcy petition, the bankruptcy court assigns a Chapter 13 trustee to oversee the case. The trustee may be a local bankruptcy attorney, who will be very knowledgeable about Chapter 13 bankruptcy generally, as well as the local court's rules and procedures specifically. In some courts, trustees are not attorneys but business people with specialized knowledge of finance or personal bankruptcy. The trustee serves primarily as a mediator between the debtor and his creditors. In almost all cases, the debtor deals mostly with the trustee, and a bankruptcy judge follows the recommendations of the trustee.

Shortly after his appointment, the trustee schedules a section 341 meeting for creditors to attend. This is the first court appearance for the debtor. At the meeting, creditors will be given an opportunity to ask any questions regarding the debtor's financial situation that may affect the plan. Although they can raise objections, creditors do not actively vote on a repayment plan. After the meeting, the judge decides whether to dismiss the case, reject the plan, or confirm the plan.

The plan can be dismissed either because it was not filed in good faith or because it is not viewed as feasible. When the repayment plan is dismissed, the case ends. But several important consequences remain. First, all liens on the debtor's property are reinstated. The automatic stay is lifted. Creditors can resume their legal remedies outside of bankruptcy to pursue the payment of their debts. Interest (and in some cases penalties) that stopped accruing during the bankruptcy will be added to the debts. In other words, interest and penalties are retroactive from the time of the stay.

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Sometimes, the court does not dismiss the case outright. Instead, the plan is simply rejected and the debtor is given a chance to propose a modified plan. After modification, the plan will again be subject to court decision.

If the plan is confirmed, the debtor starts making payments according to the confirmed plan.[6] The debtor will be discharged only upon completion of the plan. A confirmed plan can be renegotiated. For example, the debtor can prepay in the event that his assets appreciate or he receives additional income from other sources, such as an inheritance. The debtor can also convert the case into Chapter 7 with the court's agreement or simply default on the confirmed plan and then have the plan dismissed. The trustee can also force the debtor to alter the plan when he observes that the debtor has had a substantial increase in income.

CHAPTER 13 BY THE NUMBERS

In my research project with Hülya Eraslan and Pierre-Daniel Sarte on the realities and dynamics of Chapter 13 personal bankruptcies, we collected all Chapter 13 bankruptcy filings between August 1, 2001, and August 1, 2002, in the federal bankruptcy court, district of Delaware. About 10 percent of the cases were excluded from the sample because of incomplete information resulting either from a filing error (deficient filing) or a court recording error. Almost all of these excluded cases were dismissed subsequently. The final sample contained 904 cases.[7] At the time of the writing of this article, about 190 cases remain open.

In another study, Scott Norberg and Andrew Velkey examined a sample made up of 795 Chapter 13 cases filed in 1994 in seven federal judicial districts, which comprise 14 Chapter 13 trusteeships. The seven federal judicial districts are Northern District of Georgia, Southern District of Georgia, Middle District of North Carolina, Middle District of Tennessee, Western District of Tennessee, District of Maryland, and Western District of Pennsylvania. In each district, a quota sample of roughly 1 percent of the Chapter 13 cases filed in 1994, but not fewer than 100 cases, was pulled.[8]

Each sampling approach has its merits. The two benefits of my study

[6] Often, debtors start making payments to the trustee as soon as they submit their proposed plans. The payment minus court expenses will be refunded to debtors if their cases are dismissed. This requirement militates against the possibility of debtors' lingering in bankruptcy court, reaping all the gains without making any payments.

[7] For the purposes of this article, we do not include the 72 cases filed initially under Chapter 13 but converted to Chapter 7. Since this article was written, more cases have closed. See our Working Paper for updated information.

[8] The data source for both studies is the U.S. Public Access to Court Electronic Filing Service Center, the federal judiciary's centralized registration, billing, and technical support center for electronic access to U.S. district, bankruptcy, and appellate court records.

with Eraslan and Sarte are: (i) The data are recent. This is important, since there was a significant increase in personal bankruptcy in the 1990s. (ii) For further analysis, it is helpful to look at a more homogeneous population. For example, if we want to examine the effect of family income on bankruptcy outcomes, we prefer that unobserved differences between families in different states not affect our results. The benefit of Norbert and Velkey's study is that their sample is more representative of the nation as a whole.

TABLE 1

Profiles of Chapter 13 Filers

	Eraslan, Li, and Sarte	Norberg and Velkey	National Data (SCF)
Male	29.8%	36.7%	
Female	35.1%	36.3%	
Joint filing	35.1%	27.0%	
Marriage	41%		40%
Average household size	2.67	2.69	2.50
Homeownership rate	87%	54%	72%
Average monthly income ($)	1646	946	2297
Debt excluding mortgages-annual income ratio	1.36	1.29	0.28
With previous filing history	22%	32%	

Note: Monthly income is real income constructed by deflating nominal income by the consumer price index, setting 1982-84 to 100.

WHO FILES FOR CHAPTER 13 PERSONAL BANKRUPTCIES?

Table 1 presents profiles of the Chapter 13 filers in the two studies. To draw a comparison with an average household, I've also included, when available, information derived from the 2001 Survey of Consumer Finances. As can be seen, Chapter 13 filers are far from being the most destitute of the general population. Both studies indicate that these people tend to have regular jobs, and the unemployment rate among filers is far lower than the state or national unemployment rate. Thus, they all receive regular incomes, although their incomes fall short of the national average by 30 to 60 percent.

The majority of the debtors also own their homes, and the homeownership rate among the debtors is substantially higher than the national average in our more recent sample. The homeownership rate is lower among debtors than among the general population by about 10 percentage points in Norberg and Velkey's sample. But the rates among debtors vary quite a bit among the seven districts in their sample, ranging from 33 percent in the Middle District of Tennessee to 79 percent in the Western District of Pennsylvania.

Not surprisingly, despite their income and assets, the Chapter 13 filers are heavily indebted. The debt to income ratio, excluding mortgages, averages 1.36, with a median of 1.02. According to the 2001 Survey of Consumer Finances, the average debt to income ratio, excluding mortgages, is 0.28 and the median is 0.06 for the nation. Norberg and Velkey found similar numbers for their 1994 sample.

Another remarkable finding is that a substantial portion of filers, over 20 percent in our sample and nearly 32 percent in Norberg and Velkey's, have filed for bankruptcy previous to the case under study.

In terms of other demographics, Chapter 13 filers in both studies do not differ much from the general population in terms of marital status and household size.[9]

The profiles of Chapter 13 filers uncovered in the two studies are in contrast to those of Chapter 7 filers documented by other studies. For example, in their study, Scott Fay, Erik

[9] We also report filing status by gender, and we infer debtors' gender from their first names.

[10] Fay, Hurst, and White's sample consists of both Chapter 7 and Chapter 13 filers. Given the relatively small number of Chapter 13 filers in their sample, the reported sample statistics reflect mostly those of Chapter 7 filers.

Furst, and Michelle White find that Chapter 7 filers have the same rate of unemployment as the general population.[10] The homeownership rate in their study is far lower than the general population's. The average monthly income is about 50 percent below the nation's average. Most important, filers in this study experienced, on average, a much higher income drop at the time of filing.

HOW SUCCESSFUL HAS THE CHAPTER 13 SYSTEM BEEN?

The success of the bankruptcy system depends on how well it serves its dual goals: maximizing return to creditors by enforcing debtors' obligation to repay their debts and providing debtors with a financial fresh start by discharging some of their debt. The two goals are obviously at conflict. Unfortunately, the law does not explicitly specify how the two goals should be balanced.

Even without a precise way of evaluating the success or failure of Chapter 13, we can make headway by thinking about some features of a desirable bankruptcy procedure. First, all confirmed cases should eventually be discharged. Remember, a case that is not discharged shifts the debtor and his creditors back into a private collection procedure. Second, recovery rates for unsecured creditors should not be lower than those gained from other solutions to borrower default. From the creditors' standpoint, a higher recovery for unsecured debt is the primary advantage of Chapter 13 over Chapter 7 and other remedies outside of bankruptcy. Finally, multiple filings should be the exception, not the rule, especially for those who had successfully obtained a previous discharge.

The Grim Realities of Chapter 13 Personal Bankruptcy. I summarize the performance measures in the two studies in Table 2. Several findings emerge from the two studies. First, although a large percentage of Chapter 13 filers do have their proposed plans confirmed, the success rate measured by the percentage of cases discharged is low.[11] In our sample, about 18 percent of the cases remained open as of October 30, 2006. Even if we assume that all of the cases still open will be ultimately discharged, the maximum rate of discharge would be 51 percent, about half of the cases. In 1994, according to Norberg and Velkey, only 33 percent of the cases obtained a discharge. This strongly suggests that a substantial fraction of repayment plans were unrealistic in the first place, either because the debtors were "forced" to agree on a plan that demands an "unrealistic" amount of repayment or because the debtors did not fully take into account the possibility of future adverse events that would affect their ability to pay.[12]

Related to the low discharge rate is the finding that creditors, secured and unsecured, receive very little on their debts. Specifically, on average, secured creditors receive at most 36 cents on the dollar in our sample, assuming that the remaining open cases will result in a 100 percent recovery rate. In Norberg and Velkey's sample, they receive only 31 cents on the dollar, even though secured creditors are supposed to receive full payments in a successful Chapter 13 case, according to the bankruptcy law.[13]

[11] Recall that a Chapter 13 bankruptcy case is ultimately either dismissed or discharged. A discharge is granted only after a debtor successfully finishes his confirmed repayment plan.

[12] Of course, some consumers certainly did experience adverse events subsequent to filing a plan. But it seems unlikely that plans that are unsuccessful between 50 to 70 percent of the time can be ascribed to pure bad luck.

[13] Because a trustee's commission is proportional to the amount of payments under Chapter 13, debtors often choose to have their regular mortgage or car loan payment outside of their repayment plans to reduce the payment amount under bankruptcy. Arrears, however, have to be paid through repayment plans.

TABLE 2
Performance of the Chapter 13 Bankruptcy System

	Eraslan, Li, and Sarte Study	Norberg and Velkey Study
Confirmation rate	82%	77%
Discharge rate	33%	33%
Recovery rate of all debt	27%	30.1%
Recovery rate of secured debt	22%	30.6%
Recovery rate of unsecured debt	16%	19.5%
Subsequent refiling rate	30%	33%

Note: Eraslan, Li, and Sarte's sample is as of October 30, 2006.

Unsecured creditors fare worse, receiving, on average, at most 31 cents on the dollar in our sample and 20 cents on the dollar in Norberg and Velkey's. Over half of the creditors in our sample, secured as well as unsecured, receive absolutely nothing and just a few cents on the dollar in Norberg and Velkey's sample. Although it is not directly comparable, according to the 2001-2002 Reports of Income and Financial Conditions from the nation's commercial banks, the recovery rate for overdue credit card loans is 23 cents per dollar.

The payoffs to the creditors are strikingly low considering the substantial cost associated with Chapter 13 bankruptcy cases. In addition to the filing fee and attorney's fees, the debtor pays the trustee 3 to 10 percent of each payment he makes to his creditors through the trustee. Thus, for every dollar owed to creditors, it costs 0.6 to 3 cents in trustee fees alone to collect 20 to 30 cents.

Another striking finding that emerges from both studies is the high rate at which debtors file again after the termination of the case under study. Of the 726 debtors who have exited bankruptcy through either discharge or dismissal, 30 percent of them filed again at least once. The refiling rate is as high as 33 percent for Norberg and Velkey's sample. Even for those who emerged successfully from their cases through discharge, the refiling rate exceeds 20 percent. These numbers are very high considering that from the mid-1990s to 2006, the unconditional bankruptcy filing rate for households in general is less than 1.4 percent in the U.S.

To sum up, the numbers uncovered from both studies show that debtors did not succeed in completing their plans in the majority of cases, and when they did succeed, a substantial fraction of them were still at risk of filing again. Furthermore, creditors did not recover much under Chapter 13: median creditors received close to nothing. Thus, the performance of Chapter 13 poses a challenge to any argument that it is an efficient mechanism for resolving the two objectives of the bankruptcy law: debt relief and debt collection. In particular, proponents of the 2005 law would instead have to base their support for the law on the possibility that Chapter 13 has strong, desirable benefits in disciplining consumers, lenders, or both.

> Lenders in states with relatively more generous bankruptcy laws take into account the potentially higher personal bankruptcy filing rate in those states and consequently charge a higher rate to borrow.

POSSIBLE CONSEQUENCES OF THE 2005 REFORM ACT

As mentioned earlier, at the center of the 2005 Bankruptcy Abuse Prevention and Consumer Protection Act is a means test that intends to move a potentially large number of would-be Chapter 7 filers into Chapter 13. The purpose is to return more money to general unsecured creditors than the creditors would otherwise receive. Whether this purpose is served depends on the actual effectiveness of Chapter 13 bankruptcy as a means to collect debts.

According to the two studies reviewed here, however, Chapter 13 bankruptcy is an ineffective collection device. Median creditors receive almost nothing *after discharge* and nearly half of debtors do not get their debt discharged. If those who end up in Chapter 13 because of the new law are mostly people who fail the means test *narrowly*, our evidence indicates that Chapter 13 collection procedures are unlikely to be effective against them.[14] This suggests that the rationale for the new bankruptcy act must be sought in its other effects, such as deterring bankruptcy altogether among those who have the capacity to repay.

Of course, what we have discussed so far concerns Chapter 13 bankruptcy provisions from an efficiency standpoint *after the fact*. That is, we ask: once a debtor has entered bankruptcy, how well does Chapter 13 perform? It should be kept in mind that bankruptcy law has broader effects. For example, researchers Reint Gropp, John Scholz, and Michelle White, and Emily Lin and Michelle White find that bankruptcy law affects the supply of credit. Specifically, lenders in states with relatively more generous bankruptcy laws take into account the potentially higher personal bankruptcy filing rate in those states and consequently charge a higher rate to borrow.

Jeremy Berkowitz and Michelle White and Wei Fan and Michelle White find that bankruptcy law also affects the incentive to take risks, in particular, the decision to become

[14] Recall that a large number of Chapter 13 filers have income less than their state median income. We can't make the same statement for relatively high-income debtors who may be forced to choose Chapter 13 instead of Chapter 7 under the new law because they differ in fundamental ways from our sample of Chapter 13 filers.

entrepreneurs. Both homeowners and renters respond strongly to increases in homestead exemptions in making their decisions to be self-employed.

In light of these studies, an outcome that looks inefficient conditional on the borrower's entering bankruptcy may have positive effects. For instance, consumers or lenders may be more prudent in their borrowing or lending decisions when they expect to fare poorly in bankruptcy. Whether Chapter 13 outcomes we observed can be rationalized in a broader view of the goals of bankruptcy will require further research.

CONCLUSION

Two recent studies of Chapter 13 personal bankruptcy provide a detailed picture of who enters Chapter 13 and how well borrowers and creditors fare. The two studies uncover evidence that paints a rather grim picture of the realities of Chapter 13 personal bankruptcy. Plans are seldom completed successfully, creditors recover relatively little, and borrowers are very likely to re-enter bankruptcy. Thus, these findings raise some flags about the stated rationale for the reform, moving more borrowers from Chapter 7 to Chapter 13. To put it simply, despite some caveats mentioned in the article, based on our research, the Chapter 13 bankruptcy system has a long way to go in terms of providing debt relief for borrowers and debt collection for creditors.

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