BANKRUPTCY BY THE NUMBERS

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PLANNING FOR CHANGE: CREDIT COUNSELING AT THE THRESHOLD OF BANKRUPTCY

It is plausible that the 107th Congress will pass a bankruptcy bill and the President will sign it. The bill is likely to contain many of the same consumer bankruptcy provisions that were already approved in S. 3186, incorporated into and passed by the House as Bankruptcy Reform Act of 2000 (H.R. 2415), and subsequently pocket-vetoed in December of last year.

Section 106 of that legislation requires every individual debtor, no more than 180 days before filing, to have received from an approved agency "an individual or group briefing (including a briefing conducted by telephone or on the Internet) that outlined the available opportunities for credit counseling and assisted that individual in performing a related budget analysis."

This provision substantially alters the threshold requirements for all consumer filers under section 109 of the Code. It also creates a new relationship between consumer credit counseling organizations and the agencies in the government (United States Trustees, the Bankruptcy Administrators in Alabama in North Carolina, and the bankruptcy Clerks' offices throughout the country) that are assigned by the statute to approve initially, review periodically, and supply notice to would-be filers about, the credit counseling operations. And, beyond doubt, the enactment of this provision would create a large amount of new business for credit counseling organizations. There are many aspects to this new threshold of bankruptcy that will need careful analysis and administrative organization.

Here we take a first look at one small part of this potential development. We compare the financial profiles of consumer debtors in bankruptcy and clients of a consumer credit counseling agency (CCA) in one geographical area. We also compare the expense analyses used by the CCA in counseling their clients with the expense analyses, based on IRS guidelines, that are required by other sections of the legislation

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[1/] All views expressed in this article are those of the authors, and do not necessarily represent the views of the Executive Office for United States Trustees or the Department of Justice.

as part of the means testing regime for all consumer debtors.[2] The bill as now worded requires a CCA to "provide adequate counseling with respect to client credit problems that includes an analysis of their current situation, what brought them to that financial status, and how they can develop a plan to handle the problem without incurring negative amortization of their debts;..." Among a client's alternatives, arguably, are the opportunities for avoiding negative amortization through chapters 7 or 13.

Data sources[3]

Our data all arose from CCA clients and bankruptcy debtors in south-eastern California, in the area known as the Inland Empire. There are places of holding court, with standing trustee offices, in Riverside and Santa Ana. There is also a large CCA headquartered in Riverside with offices and clients throughout the area. The chapter 7 data came from the set of chapter 7 cases that the Executive Office for U.S. Trustees examines on an ongoing basis. The chapter 7 cases were filed in late 1998 and early 1999. The CCA files were opened in 1998 and 1999. The chapter 13 cases were closed during 2000, which means that they had been opened from less than one to more than three years earlier.

Income comparisons

Table 1 shows the average and median annual after-tax incomes for CCA clients and bankruptcy filers.

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[2] These are contained in section 102 of the Reform Act of 2000. See the articles available at www.usdoj.gov/ust/press/articles/ for reviews of various aspects of means testing and its likely consequences in consumer bankruptcy.

[3]We thank Amrane Cohen, Rod Danielson, and Dianne Wilkman, and their respective organizations, for providing us with data for this study.

TABLE 1
NET ANNUAL INCOMES FOR CCA CLIENTS AND DEBTORS IN CHAPTER 7 AND 13

GROUP	COUNT	AVERAGE	STANDARD DEVIATION	MEDIAN
CCA	7,570	$26,798	$23,425	$23,160
CHAPTER 13[4/]	3,873	$33,088	$110,774	$25,200
CHAPTER 7	222	$25,393	$16,699	$22,230

The chapter 13 group shows a substantially larger average net annual income than the other groups. This is due in part to the presence of very significant outliers on the high end of the income distribution. There were 71 cases (2%) with annual net incomes greater than $100,000; three of these reported annual net incomes of more than $1 million. The effect of these outliers is removed by using the median, as shown in the last column in the table.

Disposable Income Comparisons: CCA and Chapter 13

CCA clients and chapter 13 debtors must determine how much money they will be able to devote to their repayment plans. In chapter 13, the debtor may be required to put all disposable income into servicing the plan (11 U.S.C. §1325(b). The CCA forms that we have examined do not use “disposable income” as a technical term, but they do subtract allowed expenses from after-tax income as a basis for determining repayments under a Debt Management Plan.

Table 2 compares disposable incomes of CCA clients and a subset of chapter 13 debtors for which we have the disposable income calculations. A certain percentage of each group reported zero or negative disposable incomes. These cases are not included in the group statistics shown in the table.

TABLE 2
DISPOSABLE INCOMES FOR CCA CLIENTS AND DEBTORS IN CHAPTER 13

GROUP	COUNT	% WITH NO DISPOSABLE	AVERAGE	STANDARD DEVIATION	MEDIAN
CCA	7,570	25%	$438	$1,574	$302
CHAPTER 13	1,062	7%	$752	$928	$577

The data suggest that, in general, chapter 13 debtors were found to have more disposable income than CCA clients. The CCA

[4/] Our data reported gross income. We assumed a 30% tax burden. This probably overestimated taxes at the low end, and underestimated them at the high end, of the income distribution.

population displayed very large variability, with extreme outliers on the high side of the distribution and a quarter of all the population with no disposable income. With the data in hand, we cannot determine whether the difference in disposable income between the two groups arises from the higher incomes of chapter 13 debtors (see table 1), different approaches to and results of expense calculations (see table 3), or both.

In a future article we will report on the rates of returns to creditors in CCA and chapter 13 plans.

Disposable Income Comparisons: CCA Clients in CCA and as Hypothetical Filers Under Means Testing Legislation

If the means testing provisions of H.R. 2415 become law, all would-be bankruptcy filers must first go through a CCA briefing to receive the certificate required to become a debtor under the Code. Consumers with a debt problem could have at least three ways to "handle the problem without incurring negative amortization of their debts": a Debt Management Program through CCA, a chapter 7 liquidation, or a chapter 13 adjustment of debt. Given the exigencies of such consumers' circumstances, rapid decision making is often required. The details of how this process will work have not been worked out among all those who are responsible. But it is clear in any event that the guidelines and rules of thumb now used by CCA to determine their clients' expenses and disposable incomes were not developed on the basis of the IRS expense guidelines that are the basis of expense allowance calculation in the means tests of H.R. 2415. It is important, therefore, to ask how the disposable incomes of CCA debtors might change if they were calculated by H.R. 2415's rules.

There is a lot a stake for the debtor in these calculations: for example, they determine whether the debtor can qualify for chapter 7.

We have calculated the expense allowances of 5,153 CCA clients using IRS guidelines and compared them to the expenses allowed by the CCA's.[5/] Table 3 divides the clients into 10 groups of equal size, from low to high in terms of net income. For each group, the table shows the percentage of cases in which the IRS expense allowance was greater than the CCA allowance.

[5/] The IRS allowances comprise housing, transportation, and food plus other living expenses. The housing allowances vary with family size and county of residence. We worked with client records from Los Angeles, Riverside, San Bernardino, and San Diego counties. The transportation allowances vary by county. We assumed that every one-person household owned and operated 1 car and that every household with two or more persons owned and operated two cars. The food allowances vary with gross income and family size. Because CCA reports net income, we had to make a correction back to estimated gross income. We assumed a 30% tax take against gross income, which is equivalent to a 42.8% addition to net income [(1/.7)= 1.428].

TABLE 3
COMPARING IRS AND CCA EXPENSE ALLOWANCES

GROSS MONTHLY INCOME RANGE		IRS > CCA ALLOWANCE (% CASES)
FROM	TO	
$0	$1,143	99.6%
$1,144	$1,629	100%
$1,630	$2,007	99.6%
$2,008	$2,386	99.4%
$2,387	$2,806	99.6%
$2,807	$3,289	97.7%
$3,290	$3,874	97.1%
$3,876	$4,572	94.2%
$4,573	$5,714	80.8%
$5,715	$36,829	44.4%

For almost the entire income range, IRS allowances were greater than the CCA allowances. The relationship began to shift between the 80th and 90th centiles, and in the top 10% of the cases the CCA Guidelines were greater in about 56% of the cases.

Income thresholds for assessing abuse under 707(b)

Another important analysis of these data is based on the provisions of the reform bill that set threshold disposable incomes for the purpose of determining whether there will be a presumption of abuse of the Code under section 707(b). In a nutshell, slightly oversimplified, the rule is this: debtors with disposable monthly incomes of less than $100 are essentially safe from a claim of abuse. Debtors with disposable monthly incomes of greater than $166 will be presumed to be abusive unless they can show why they deserve extra expense allowances that take their disposable incomes below $166. Debtors with disposable incomes between $100 and $166 per month will be tested in terms of the ratio of their disposable income (multiplied by 60 to allow for a five year repayment plan) to their general unsecured debt. If that ratio is less than 25%, they are unlikely to be at risk for a claim of abuse (all else equal).

As might be expected from the results in Table 3, CCA disposable income analyses produce disposable incomes that are much more likely to put the debtor at apparent risk of an abuse claim. For the entire population of 5,153 cases, CCA analyses resulted in 35% showing disposable incomes of less than $100, and an additional 9% ranging between $100 and $166. Using the IRS allowances, 60% showed disposable income less than $100 and an additional 2% were between $100 and $166. Calculating disposable income using IRS guidelines thus reveals an additional 18% of the population eligible for relief under chapter 7, all else equal.

Interpretation

Debtors (and their attorneys) who wish to file in chapter 7 will be responsible for knowing whether they qualify under the means testing calculations. Debtors must go in the first place to a CCA to learn about their opportunities to solve their financial problems. There are no rules in place about what they should be told about their opportunities in bankruptcy. What the data presented here show, we believe, is that would-be debtors in bankruptcy should be informed during the mandatory credit counseling, *at the very least*, that expense allowances (hence budgets and disposable incomes) in bankruptcy may be based on different principles than those that the CCA will use for its own purposes. Absent this caveat, debtors could be misled about their opportunities for relief under the Code.