

Scheduling Overview

- **Tuesday:**
 - Basics about personal bankruptcy
- **Thursday:**
 - Household decisions in filing bankruptcy
 - What is informal bankruptcy?
 - How bankruptcy affects supply of credit



Personal Bankruptcy

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A thought on bankruptcy...

- "It gives to the honest but unfortunate debtor...a new opportunity in life and a clear field for future effort, unhampered by the pressure and discouragement of preexisting debt."

Local Loan Co. v. Hunt, 292 U.S. 234, 244 (1934).

Basics of personal bankruptcy



Background

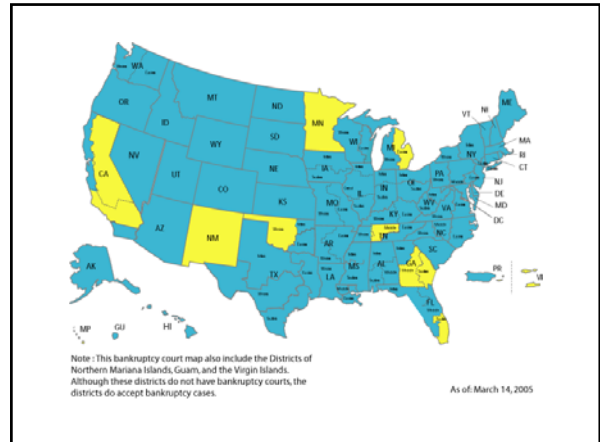
- Article I, Section 8, of the United States Constitution authorizes Congress to enact uniform "Laws on the subject of Bankruptcies."
- Under this grant of authority, Congress enacted the "Bankruptcy Code," and has amended the code several times with bills such as the Bankruptcy Reform Act of 1994 & the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005.
- This is the uniform federal law that governs all bankruptcy cases.

Background

- Many states have taken advantage of a provision in the Bankruptcy Code that permits each state to adopt its own **exemption** law in place of the federal exemptions, while other jurisdictions may allow individual debtors to choose between a federal package of exemptions or the exemptions available under state law
- This goal is accomplished through a bankruptcy discharge, which releases debtors from personal liability from specific debts and prohibits creditors from taking any action against the debtor to collect those debts
- Debtors should also be aware that out-of-court agreements with creditors or debt counseling services may provide an alternative to a bankruptcy filing.

Districts

- There is a bankruptcy court for each judicial district in the country.
- Each state contains at least one district (depending on the size of population and geography).
- There are 90 bankruptcy districts across the country.



Authority

- The court official with decision-making power over federal bankruptcy cases is the United States bankruptcy judge, a judicial officer of the United States district court.
- Each state's judicial districts contain bankruptcy courts and state judges with similar authority over state bankruptcies.
- The bankruptcy judge may decide any matter connected with a bankruptcy case, such as eligibility to file or whether a debtor should receive a discharge of debts.
- Much of the bankruptcy process is administrative, however, and is conducted away from the courthouse.
- In cases under chapters 7, 12, or 13, and sometimes in chapter 11 cases, this administrative process is carried out by a **trustee** who is appointed to oversee the case.

Types of Bankruptcy

- **Chapter 7**
 - *Liquidation of estate and distribution to creditors*
- Chapter 9
 - *Adjustments of Debts of a Municipality* (similar to chapter 11)
- Chapter 11
 - *Reorganization* of commercial entity to continue ongoing business and maximize payout to creditors
- Chapter 12
 - *Adjustment of Debts of a Family Farmer or Fisherman with Regular Annual Income*
- **Chapter 13**
 - *Adjustment of Debts of an Individual With Regular Income*
- Chapter 15
 - *Ancillary and Other Cross-Border Cases* (for international bankruptcy)

Chapter 7 bankruptcy

"Stays against action"

- Filing a petition under chapter 7 automatically "stays" most collection actions against the debtor or the debtor's property.
- The stay arises by operation of law and requires no judicial action.
- But filing the petition does not stay certain types of actions, and the stay may be effective only for a short time in some situations.
- As long as the stay is in effect, creditors generally may not initiate or continue lawsuits, wage garnishments, or even telephone calls demanding payments.

Chapter 7 Bankruptcy

Non-Dischargeable debts

- The most common types of non-dischargeable debts are:
 - Debts not included by the debtor on the lists and schedules the debtor must file with the court (unsecured creditors)
 - Certain types of tax claims
 - Debts for spousal or child support or alimony

Chapter 7 Bankruptcy

Non-Dischargeable debts

- The most common types of non-dischargeable debts are:
 - Debts to governmental units for fines and penalties
 - Debts for most government funded or guaranteed **educational loans** or benefit overpayments
 - Debts for personal injury caused by the debtor's operation of a motor vehicle while intoxicated
 - Debts for certain condominium or cooperative housing fees.
 - Debts for willful and malicious injuries to person or property

Chapter 7 bankruptcy

Basic procedures

- Entitled **Liquidation**, is an orderly, court-supervised procedure by which a **trustee** takes over the assets of the debtor's estate, reduces them to cash, and makes distributions to creditors.
- Because there is often little or no nonexempt property in most chapter 7 cases, there may not be an actual liquidation of the debtor's assets. Cases without asset or liquidation are called "no-asset cases."
- The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 made significant amendments to the Bankruptcy Code, requiring the application of a "**means test**" to determine whether individual consumer debtors qualify for relief under chapter 7. If a debtor's income is in excess of certain thresholds, the debtor may not be eligible for chapter 7 relief.

Chapter 7 bankruptcy

"341 meetings"

- Usually, the only formal proceeding at which a debtor must appear is the meeting of creditors, which is usually held at the offices of the trustee. This meeting is informally called a "341 meeting" because section 341 of the Bankruptcy Code requires that the debtor attend this meeting so that creditors can question the debtor about debts and property.
- During this meeting, the trustee puts the debtor under oath, and both the trustee and creditors may ask questions. The debtor must attend the meeting and answer questions regarding the debtor's financial affairs and property. If a husband and wife have filed a joint petition, they both must attend the creditors' meeting and answer questions. Within 10 days of the creditors' meeting, the U.S. trustee will report to the court whether the case should be presumed to be an abuse under the **means test**.
- In order to preserve their independent judgment, bankruptcy judges are prohibited from attending the meeting of creditors.

Chapter 7 bankruptcy

Denials

- The grounds for denying an individual debtor a discharge in a chapter 7 case are narrow and are construed against the moving party.
- Among other reasons, the court may deny the debtor a discharge if it finds that the debtor:
 - Failed to keep or produce adequate books or financial records
 - Failed to explain satisfactorily any loss of assets
 - Committed a bankruptcy crime such as perjury
 - Failed to obey a lawful order of the bankruptcy court
 - Fraudulently transferred, concealed, or destroyed property that would have become property of the estate
 - Or failed to complete an approved instructional course concerning financial management.

Chapter 7 bankruptcy

Trustees

- The primary role of a chapter 7 trustee in an asset case is to liquidate the debtor's nonexempt assets in a manner that maximizes the return to the debtor's unsecured creditors.
- The trustee accomplishes this by selling the debtor's nonexempt property if it is free and clear of liens. The trustee may also attempt to recover money or property under the trustee's "avoiding powers." The trustee's avoiding powers include the powers to:
 - set aside preferential transfers made to creditors within 90 days before the petition
 - undo security interests and other transfers of property that were not properly finalized by the time of the petition
 - pursue non-bankruptcy claims such as fraudulent conveyance.
- In addition, if the debtor is a business, the bankruptcy court may authorize the trustee to operate the business for a limited period of time, if such operation will benefit creditors and enhance the liquidation of the estate (similar to Chapter 11 cases.)

Chapter 7 bankruptcy

Estates

- Commencement of a bankruptcy case creates an "estate." The estate technically becomes the temporary legal owner of all the debtor's property. It consists of all legal or equitable interests of the debtor in property as of the commencement of the case, including property owned or held by another person if the debtor has an interest in the property. Generally speaking, the debtor's creditors are paid from nonexempt property of the estate
- The creation and payment from an estate is subject to
 - The debtor's right to retain certain exempt property
 - The rights of secured creditors.

Chapter 7 bankruptcy

Secured Creditors & Reaffirmation

- Secured creditors may retain some rights to seize property securing an underlying debt even after a discharge is granted.
- Depending on individual circumstances, if a debtor wishes to keep certain secured property (such as an automobile), he or she may decide to "**reaffirm**" the debt. A **reaffirmation** is an agreement between the debtor and the creditor that the debtor will remain liable and will pay all or a portion of the money owed, even though the debt would otherwise be discharged in the bankruptcy. In return, the creditor promises that it will not repossess or take back the automobile or other property so long as the debtor continues to pay the debt.
- If the debtor decides to reaffirm a debt, he or she must do so before the discharge is entered. The debtor must sign a written reaffirmation agreement and file it with the court

Chapter 7 bankruptcy

Unsecured Creditors

- Unsecured creditors must file their claims with the court within 90 days after the first date set for the meeting of creditors (A governmental unit, however, has 180 days from the date the case is filed to file a claim.)
- A creditor holding an unsecured claim will get a distribution from the bankruptcy estate only if the case is an asset case and the creditor files a proof of claim with the bankruptcy court.
- In most chapter 7 cases, if the debtor is an individual, he or she receives a discharge that releases them from personal liability for certain dischargeable debts.
- The debtor normally receives a discharge a few months after the petition is filed.

Chapter 7 bankruptcy

Non-Dischargeable debts

- There are 18 categories of debt that cannot be discharged under chapters 7, 11, and 12 (chapter 13 is subject to a limited selection from these.)
- Congress has determined that these types of debts are not dischargeable for public policy reasons

Chapter 13 bankruptcy

Basic procedures

- Entitled **Adjustment of Debts of an Individual With Regular Income**, is designed for an individual debtor who has a regular source of income.
- Chapter 13 is often preferable to chapter 7 because it enables the debtor to keep valuable assets such as their home, and because it allows the debtor to propose a "plan" to repay creditors over time – usually three to five years.
- Chapter 13 is also used by consumer debtors who do not qualify for chapter 7 relief under the **means test**.

Chapter 13 bankruptcy

Hearings & Discharges

- At a confirmation hearing, the court either approves or disapproves the debtor's repayment plan, depending on whether it meets the Bankruptcy Code's requirements for confirmation.
- Chapter 13 is very different from chapter 7 since the chapter 13 debtor usually remains in possession of the property of the estate and makes payments to creditors through the trustee, based on the debtor's anticipated income over the life of the plan.
- Unlike chapter 7, the debtor does not receive an immediate discharge of debts. The debtor must complete the payments required under the plan before the discharge is received.
- The debtor is protected from lawsuits, garnishments, and other creditor actions while the plan is in effect. The discharge is also somewhat broader (i.e., more debts are eliminated) under chapter 13 than the discharge under chapter 7.

Chapter 13 bankruptcy

Hardship Discharges

- Although a chapter 13 debtor generally receives a discharge only after completing all payments required by the court-approved repayment plan, there are some limited circumstances under which the debtor may request the court to grant a **"hardship discharge"** even though the debtor has failed to complete plan payments.
- Such a discharge is available only to a debtor whose failure to complete plan payments is due to circumstances beyond the debtor's control.
- The scope of a chapter 13 "hardship discharge" is similar to that in a chapter 7 case with regard to the types of debts that are excepted from the discharge.

The Process

Qualifying requirements

- An individual **cannot** file under **any** chapter of bankruptcy if:
 - during the preceding 180 days (6 months) a prior bankruptcy petition was dismissed due to the debtor's willful failure to appear before the court or comply with orders of the court
 - the debtor voluntarily dismissed the previous case after creditors sought relief from the bankruptcy court to recover property upon which they hold liens (a bankruptcy discharge does not extinguish a lien on property.)

Qualifying requirements

- In addition, no individual **cannot** only file under **any** chapter of the Bankruptcy Code unless they have, within 180 days before filing, received credit counseling from an approved credit counseling agency either in an individual or group briefing.

Filing for bankruptcy

Overview

- In addition to the basic bankruptcy petition, the debtor must also file with the court:
 - A list of all creditors and the amount and nature of their claims
 - The source, amount, and frequency of the debtor's income
 - A list of all of the debtor's property
 - A detailed list of the debtor's monthly living expenses (i.e., food, clothing, shelter, utilities, taxes, transportation, medicine, etc.)

Filing for bankruptcy

Detailed Process

- In addition to the basic bankruptcy petition, the debtor must also file with the court:
 - a certificate of credit counseling and a copy of any debt repayment plan developed through credit counseling
 - schedules of assets and liabilities
 - a schedule of current income and expenditures
 - evidence of payment from employers received 60 days before filing
 - a statement of monthly net income and any anticipated increase in income or expenses after filing
 - a record of any interest the debtor has in federal or state qualified education or tuition accounts
 - a statement of financial affairs
 - a schedule of ongoing contracts and unexpired leases

Filing for bankruptcy

Detailed Process

- Debtors must also provide the case trustee with:
 - a copy of the tax return or transcripts for the most recent tax year
 - Any tax returns filed during the case (including tax returns for prior years that had not been filed when the case began).

Filing for bankruptcy

Marriages

- Married individuals must gather this information for their spouse regardless of whether they are filing a joint petition, separate individual petitions, or even if only one spouse is filing.
- In a situation where only one spouse files, the income and expenses of the non-filing spouse is required so that the court, the trustee and creditors can evaluate the household's financial position.

Filing for bankruptcy

Fees

- There are a variety of mandatory administrative fees associated with filing for bankruptcy. These fees cost about \$300 in total and can be paid in installments. The number of installments is limited to four, and the debtor must make the final installment no later than 120 days after filing the petition.
- If the debtor's income is less than 150% of the poverty level (as defined in the Bankruptcy Code), and the debtor is unable to pay the chapter 7 fees even in installments, the court may waive the requirement that the fees be paid.

Filing for bankruptcy

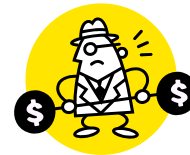
Personal role

- A debtor's involvement with the bankruptcy judge is usually very limited.
- A typical chapter 7 debtor will not appear in court and will not see the bankruptcy judge unless an objection is raised in the case.
- A chapter 13 debtor may only have to appear before the bankruptcy judge at a plan confirmation hearing.

The Means Test

- If the debtor's current monthly income is more than the state median, the Bankruptcy Code requires application of a "means test" to determine whether the chapter 7 filing is presumptively 'abusive.'
- Abuse is presumed if the debtor's aggregate current monthly income over 5 years, net of certain allowed expenses, is more than
 - \$10,000
 - Or 25% of the debtor's non-priority unsecured debt, as long as that amount is at least \$6,000.
- The debtor may rebut a presumption of abuse only by a demonstrating special circumstances that justify additional expenses or adjustments of current monthly income. Unless the debtor overcomes the presumption of abuse, the case will generally be converted to chapter 13 (with the debtor's consent) or will be dismissed.

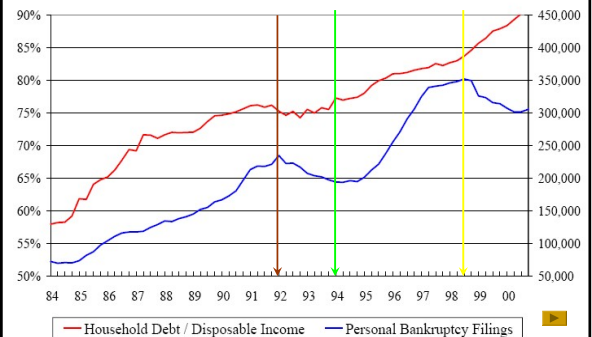
Factors Leading to Personal Bankruptcy



Why File for Bankruptcy?

- Who might consider filing?
 - Overwhelming debts that exceed the household income and assets.
 - Factors that may cause/affect debts
 - Factors that may affect income/assets
- How might households make their decisions?

Household Debt Burden and Personal Bankruptcy Filings, 1984-2000



Phase 1: 1984~1992 Rising

- Economic recovery: rising stock market and sharp drops in energy prices, inflation and interest rate
- Consumer's positive expectation about future
- Baby-boom generation entered into the family-formation phase: spending on housing and related goods, home mortgage, and etc.
- Deregulation of credit markets: using more credit cards instead of cash
- The Tax Reform Act of 1986 increased the Home Mortgage Interest Deduction to promote home ownership.

Phase 2: 1992~1994 Declining

- Economic recession contained the demand for credit by consumers and potential home buyers.



Phase 3: 1994~1998 Bankruptcy Crisis

- Better economic conditions: lowest unemployment rate, interest rate fell while inflation remained under control, prosperous stock market increased household assets.
- Consumer confidence and expectations grew accordingly.
- Technical innovations, and competition among lenders contribute to the increased availability of credit.
- The influence from the new policy-“Bankruptcy Reform Act of 1999”. “Needs-based bankruptcy” was proposed to be incorporated.

Phase 4: 1999~2000 Declining

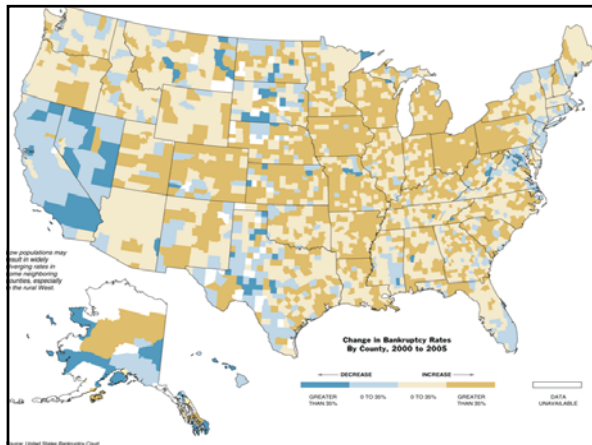
- Lenders tightened their underwriting standard because of high rate of default.
- The large amount of mortgage refinancing. Lower interest rates for mortgages have allowed homeowners to reduce their monthly mortgage payments and their potential for financial trouble.





Phrase 5: 2000~2005 ...

- The rise has been far from uniform around the country: While there have been large increases in much of the South and Midwest, sections of the East and West Coast have had declines in filings over the last five years.
- The increases in the South and Midwest reflect job losses from manufacturing and agriculture (job instability).
- New bankruptcy law makes it harder for many people to clear away debts.
- "There is still a strong relationship between higher home prices and lower bankruptcy."



Macroeconomic Conditions

- Unemployment rate
- Inflation
- Prices for goods such as food & energy
- Financial market: Competition among credit lenders; Interest rate; Stock market



Policy

- Tax policy such as the provision of tax deductible
- Personal bankruptcy law changes, such as exemption level, means-testing
- Garnishment law: filing for bankruptcy stops multiple wage garnishments dead in their tracks.

Social Factors

- The stigma of bankruptcy
- Local trends: Study shows that households are more likely to file for bankruptcy if living in districts with higher aggregate bankruptcy filing rates (Fay et al. 2002).



Household Bankruptcy Decision

- For higher financial benefit from filing
- Solution when adverse events occur (health problems for the household head or spouse, spells of unemployment for the head or spouse, and the household head being divorced in the previous year.)
- Localities influence

TABLE 2—THE PERCENTAGE OF HOUSEHOLDS THAT WOULD BENEFIT FINANCIALLY FROM FILING FOR BANKRUPTCY

Financial gain ($FinBen_{it}$)	1984	1989	1994	All years
Greater than \$0 (percent)	17.9	18.6	16.8	18.5
Greater than \$2,500 (percent)	10.6	8.8	11.8	10.0
Greater than \$10,000 (percent)	3.1	2.5	4.8	3.1
Median	-\$27,000	-\$29,000	-\$34,000	-\$26,000
Mean	-\$145,000	-\$160,000	-\$162,000	-\$144,000

Notes: $FinBen_{it}$ equals the value of household i 's debt that would be discharged if it filed for bankruptcy in year t minus the value of household i 's nonexempt assets in year t . $FinBen_{it}$ must be nonnegative. All dollar values are in 1996 dollars.

$$FinBen_{it} = \max(D_{it} - \max(W_{it} - E_{it}, 0), 0)$$

TABLE 5—PREDICTIONS

Variable	Hypothesized change	Percentage point marginal effect	Percentage change in the filing rate
Regression I			
Financial benefit	+\$1,000	0.021 (0.005)	7.0
■ 1997 NBRC proposal	(see text)	0.048 (0.011)	15.9
Cap on homestead exemption	(see text)	-0.0014 (0.00053)	0.46
Lagged bankruptcy rate	+1 standard deviation	0.094 (0.047)	31
	= 0.0054		
Last year's income (increase)	+\$10,000	-0.042 (0.012)	-14
Last year's income (decrease)	-\$10,000	0.086 (0.028)	28.5
Years of education	+1 year	-0.024 (0.010)	-8.0
Age	+10 years	-0.080 (0.018)	-26.5
Regression III			
Divorce	From 0 to 1	0.261 (0.200)	86.5

Notes: We compute each household's estimated probability of bankruptcy under the hypothesized change, holding all other household characteristics fixed. The marginal effect is the change in the probability of bankruptcy for that household. We average these marginal effects over all households, using the PSID weights, to get the results reported in the middle column. The rightmost column converts these marginal effects into a percentage change in the filing rate by dividing by the average probability of bankruptcy for the sample, which is 0.3017 percent. Figures in parentheses are bootstrapped standard errors, computed using 1,000 repetitions of the sample.

Proposal from National Bankruptcy Review Commission (NBRC)

- Universal national bankruptcy exemption:
 - \$20,000 for homeowners
 - \$35,000 for renters
 - doubled for married couples
- Opt-out states requirement:
 - Range: (\$20,000, \$100,000)

Conclusion

- Discharge of debt is the dominant consideration in households' decisions to file.
- Little support for the hypothesis that households file for bankruptcy when adverse events occur.
- Local trends are important determinant.

Informal Bankruptcy

[Informal Bankruptcy]

- Definition: non-repayment without the benefit of the formal bankruptcy process. (Substitute of formal bankruptcy)
- According to Visa U.S.A., some 67% of credit card loans in 1999 were charged off for reasons other than bankruptcy, and this percentage has been nearly constant in recent years
- A “charge off” is a loan that the lender has written off as a loss for regulatory purposes. However, the loan may still be collectable unless the account was charged off for bankruptcy discharge, death, or fraud. Under current federal banking regulations, credit card accounts should be charged off when they are 180 days delinquent. Accounts in bankruptcy should be charged off within 60 days of notification of bankruptcy filing.

[Why choosing informal bankruptcy?]

■ Cost of formal bankruptcy:

- Renouncing the claim on nonexempt assets. e.g. Delaware-no homestead exemption + \$5,000 personal property exemption.
- Foregoing the option value of waiting to file until later, since a Chapter 7 filing is permitted only once every six years.
- A bankruptcy stays on an individual's credit report longer, and may be viewed as a worse signal



The legal and court costs associated with a bankruptcy filing

[Bankruptcy & Supply of Credit]

[In Theory...]

- Bankruptcy law *can* affect the supply of credit, particularly unsecured credit such as credit card lending.
- An actual or an expected boost in bankruptcy losses will/could encourage creditors to employ some combination of stricter lending standards and terms, such as:
 - higher interest rates
 - larger down payments
 - smaller supply of credit
- These practices would affect borrowers who pose greater risks.
- These strategies may help stave off greater losses from bankruptcies.

[In Theory...]

- The opposite is also true...
- Stricter bankruptcy provisions give creditors an incentive to relax their lending standards and terms
- This encourages borrowing and thus raises the chances that more borrowers will default and file for bankruptcy.

[Who is burdened?]

- Over the long haul, borrowers bear the costs of bankruptcy-related (and other) loan losses.
- If creditors cannot distinguish which borrowers are poor credit risks, they will [hypothetically] charge all borrowers – *not just the riskiest* – **more** for loans, as well as make less credit available all together.
- In the short run, lenders do indeed bear most of the costs of unexpected loan losses – until they tighten their lending terms/standards.
- Taxpayers also suffer!!! Losses are tax-deductible! Taxpayers also pay for the bankruptcy court system.

[Affect on credit markets]

- Little is known about the ways personal bankruptcy affects credit markets.
- More evidence is needed to see how creditors respond to changes in bankruptcy law.
- Without this evidence, it is unclear exactly how any reduction in losses stemming from a means-testing bankruptcy requirement would affect the cost and availability of unsecured credit for consumers.