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A Descriptive Comparison of Chapter 13 Bankruptcy and Debt Settlement

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EXECUTIVE SUMMARY

This paper compares the financial savings and costs of Chapter 13 bankruptcy protection and debt settlement programs using several administrative datasets.

We document four main results:

1. There is a wide distribution of potential financial outcomes for Chapter 13 filers, with filers at the 25th percentile realizing a normalized savings rate of *negative* 17.7% and filers at the 75th percentile realizing a normalized savings rate of positive 58.2%. We also find that just over 50% of Chapter 13 bankruptcy filers experience financial losses where the attorney and court filing fees exceed the debt discharged through the bankruptcy process. There is a much narrower distribution of potential financial outcomes for debt settlement participants, with participants at the 25th percentile realizing zero financial savings and participants at the 75th percentile realizing a normalized savings rate of 23.9%. Less than 2% of debt settlement participants experience a financial loss overall since fees can only be incurred after a debt has been settled.
2. The re-filing rate for Chapter 13 is substantially higher than the re-enrollment rate at the large debt settlement company in our data, suggesting that additional fees may be accrued through multiple bankruptcy filings but not through multiple enrollments in the same debt settlement program.
3. Chapter 13 bankruptcy includes an automatic stay that immediately stops most collection activities, unlike debt settlement programs where participants may still experience continued collection activities and be charged interest and late fees. Other indirect costs such as the tax implications of debt settlement and the perceived social stigma of bankruptcy are also relevant but difficult to quantify with the available data.
4. The percentage of debt settlement participants that realize an early settlement has consistently increased over our sample period, while the percentage of Chapter 13 filers that are still eligible for a discharge after the first nine months of filing has remained constant or decreased over time.

ABOUT THE AUTHORS

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Will Dobbie is a Professor of Public Policy at the Harvard Kennedy School and a Faculty Research Fellow at the National Bureau of Economic Research. His research examines, among other topics, the labor market consequences of bad credit reports, the origins of financial distress, and the effects of bankruptcy on financial health.

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OVERVIEW

In any given year, approximately one-quarter of Americans have a debt in collections, while one-fifth have had a serious delinquency in the past two years.[1] In addition, about three out of every 10 U.S. credit users now have a FICO® Score of less than 650, increasing their borrowing costs and limiting their access to many forms of credit.[2] This high level of financial stress has contributed to the significant and growing demand for debt relief in the United States.

Two of the most important debt relief options in the United States are consumer bankruptcy and debt settlement. Bankruptcy is a long-standing legal process that provides indebted individuals with a "fresh start" through the liquidation of assets or a structured repayment plan. Debt settlement is a newer option that provides indebted individuals with debt relief through the negotiation and settlement of unsecured debt. Both of these debt relief options are widely utilized, with more than 740,000 individuals filing for bankruptcy and nearly 400,000 individuals enrolling in debt settlement programs in 2017 alone.[3,4] Consumer bankruptcy and debt settlement programs are structured very differently, however, leading to an important debate about the most appropriate debt relief solution for different types of individuals.

In this report, we provide a descriptive comparison of the financial savings and costs of Chapter 13 bankruptcy and debt settlement to provide a framework for this debate. Chapter 13 bankruptcy and debt settlement are a natural comparison, as both generally involve the partial repayment of unsecured debt over relatively long periods without the forced liquidation of assets. Chapter 7 bankruptcy is also an important debt relief option for many indebted individuals, with high discharge rates and a fast time to discharge. Chapter 7 makes for a less natural comparison with Chapter 13 and debt settlement, however, as it includes stricter income eligibility thresholds and requires that individuals liquidate assets not covered by the bankruptcy exemptions. We therefore omit Chapter 7 bankruptcy from our comparison, while again emphasizing that it is an important debt relief option for individuals with lower incomes and fewer assets.

We compare Chapter 13 bankruptcy and debt settlement along four important dimensions: (i) the financial savings after accounting for direct costs such as attorney fees or debt settlement fees; (ii) the re-filing/re-enrollment rates; (iii) the indirect costs of seeking and obtaining debt relief; and (iv) changes in effectiveness over time. Estimating the causal impact of Chapter 13 bankruptcy and debt settlement on financial outcomes such as credit scores is also important for understanding the most appropriate debt relief solution for different types of individuals, but is out of scope for this report. We also emphasize that our report is not intended to provide a recommendation for either Chapter 13 bankruptcy or debt settlement. The most appropriate debt relief option for a given individual will be driven by that individual's financial situation and preferences. By providing a detailed comparison of these two debt relief options across several relevant dimensions, we hope

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[1] https://www.fico.com/blogs/us-average-fico-score-hits-700-milestone-consumers

[2] https://www.fico.com/blogs/us-average-fico-score-hits-700-milestone-consumers

[3] Number of Chapter 7 and Chapter 13 filings were obtained from the Integrated Database of the Federal Judicial Center.

[4] Greg J. Regan. *Options for Consumers in Crisis: An Updated Economic Analysis of The Debt Settlement Industry (Data as of March 31, 2020).*

that indebted individuals can make more informed financial decisions and determine which solution is most appropriate for their needs.

Our first and most important observation is that the structural differences between Chapter 13 bankruptcy and debt settlement yield economically significant differences in the distribution of financial savings after accounting for direct costs such as attorney and court filing fees or debt settlement fees. For bankruptcy, we define financial savings as the debt forgiven through the bankruptcy process (inclusive of debt forgiven if a Chapter 13 case is converted to Chapter 7) less attorney and court filing fees, normalized by the non-priority unsecured claims filed in bankruptcy. For debt settlement, we similarly define financial savings as the debt forgiven through the program less program fees, normalized by the unsecured debt enrolled in the debt settlement program. We refer to these numbers as normalized financial savings/losses and normalized savings rates interchangeably throughout the paper. We directly observe all the necessary information to calculate the savings rate for debt settlement plans. For Chapter 13, we directly observe the debt discharged through the bankruptcy process but not the attorney and court filing fees or the payments to non-priority unsecured claims. We draw on a random sampling of filings from the Public Access to Court Electronic Records (PACER) system during our sample period to infer the missing information and show results for a range of assumptions in the appendix.

We find a wide distribution of financial outcomes for Chapter 13 filings, with filers at the 25th percentile realizing normalized financial *losses* of 17.7%, the median filer realizing normalized financial *losses* of 1.4%, and filers at the 75th percentile realizing normalized financial savings of 58.2%. We also find that 50.8% of Chapter 13 bankruptcy filers experience financial losses where the attorney and court filing fees exceed the debt discharged through the bankruptcy process. This result is driven by the combination of a relatively high dismissal rate and the fact that attorney and court filing fees are incurred upfront regardless of the outcome of the bankruptcy process. By comparison, there is a much narrower distribution of potential financial outcomes for debt settlement participants, with participants at the 25th percentile realizing zero financial savings, the median participant realizing normalized financial savings of 11.6%, and participants at the 75th percentile realizing normalized financial savings of 23.9%. In total, less than 2% of debt settlement participants experience financial *losses* since fees can only be incurred after a debt has been settled.

Taken together, these findings demonstrate that there is a significantly wider distribution of potential outcomes for Chapter 13 bankruptcy compared to debt settlement, with financial savings for filings that successfully end in a discharge of debt but financial losses for filings that, for example, unsuccessfully end in dismissal. Debt settlement programs have a much narrower distribution of potential outcomes, with financial savings for programs that successfully settle at least some accounts and limited to no financial losses for programs that unsuccessfully settle any accounts.

Our second observation is that the Chapter 13 bankruptcy re-filing rate is substantially higher than the debt settlement re-enrollment rate, likely increasing the total attorney and court fees for bankruptcy filers. Between 2013 and 2019, we find that the Chapter 13 bankruptcy re-filing rate ranges from 33.0% to 39.6%, as measured by whether the individual previously filed for bankruptcy at any time in the previous 8 years. Over the same time period, the observed company-level re-enrollment rate in our data ranges from 0.8% to 1.5%, as measured by whether the participant previously enrolled in debt settlement at any time since April 2008. We also find a median normalized savings rate of 37.9% for Chapter 13 filers with no previous filings compared to -7.2% for filers with a previous filing. The high re-filing rate for Chapter 13 combined with the lower discharge rate of repeat filers suggests that considerable fees can be accrued through multiple filings, contributing to the financial losses for filings that unsuccessfully end in dismissal.

Our third observation is Chapter 13 includes an automatic stay that immediately stops most collection activities, unlike debt settlement programs where participants may still experience continued collection activities and be charged interest and late fees. We observe an incremental growth of approximately 12% on the original enrolled balance due to interest and late fees, with an estimated 25% to 30% of participants experiencing the threat of a civil lawsuit while enrolled in a debt settlement program. In practice, more than three-quarters of the accounts in litigation are settled for less than the full balance and the increase in structured settlements that occur before deposits have fully accumulated may have improved debt settlement along these dimensions by reducing accretion and collection activities. We are unable to quantify other important indirect costs of each option with the available data, such as taxes related to debt settlement, the perceived social stigma of bankruptcy, or the feelings of guilt from not being able to pay off debt.

Our final observation is that the percentage of debt settlement clients realizing an early settlement has consistently increased since 2013, likely decreasing the percentage of debt settlement participants with no financial savings and increasing the percentage with some financial savings. By comparison, the percentage of Chapter 13 filers remaining eligible for a discharge nine months after filing has remained constant or decreased over time, likely decreasing the number of filers with financial savings. These different trends may be due to the respective fee structures for Chapter 13 and debt settlement. Debt settlement companies cannot collect fees unless the settlements are reached with the creditor and approved by the individual, in principle encouraging debt settlement companies to generate better outcomes for participants over time. By comparison, Chapter 13 attorneys can generally collect at least a portion of their fees regardless of the outcome of the bankruptcy process, providing much weaker incentives to generate better outcomes for bankruptcy filers over time.

BACKGROUND

BANKRUPTCY

Bankruptcy is the legal process to resolve unpaid debts. In the United States, individuals typically file for bankruptcy protection under either Chapter 7 or Chapter 13.[5] Debt relief from Chapter 7 bankruptcy is achieved through the liquidation of non-exempt assets, while debt relief from Chapter 13 bankruptcy is achieved through the reorganization of debt. While the focus of our report is Chapter 13 and debt settlement, we discuss both bankruptcy options in this section for completeness.

Chapter 7 bankruptcy begins with an individual filing a verified petition with the bankruptcy court. The filing also includes schedules of assets and liabilities, schedules of income and expenditures, schedules of executory contracts and unexpired leases, a statement of financial affairs, and documentation of tax records. A court-appointed bankruptcy trustee is assigned with the primary responsibility of overseeing the liquidation of non-exempt assets to pay creditors. Shortly after filing, the trustee administers a meeting of creditors where the filer is obligated to answer questions regarding the bankruptcy case. A bankruptcy judge then rules on the case and if the case is discharged, the bankruptcy trustee liquidates the filer's non-exempt property and distributes the proceeds to the creditors.

The typical Chapter 7 bankruptcy process is relatively quick, with a median time to discharge of 113 days, or 3.7 months, in the Federal Judicial Center (FJC) data described in more detail below. All unsecured debt is eligible to be discharged through Chapter 7 bankruptcy, except student loans, child support obligations, and debts incurred through fraud. Secured debt such as mortgages and car loans can be discharged if the filer elects to relinquish the property. The direct costs incurred by the filer are filing fees, with a typical amount of $335, and attorney fees, typically ranging between $1,500 and $3,000.[6] Additional expenses would be the surrender of non-exempt property (or its value) to be administered towards the payment to certain creditors. The discharge rate for Chapter 7 is typically very high, ranging between 93% to 95% in the FJC data. Following a discharge, the Chapter 7 filer is free from all eligible debt.

Individuals are assumed eligible for Chapter 7 if their current monthly income is less than or equal to the state median and there are no other disqualifying criteria such as having a bankruptcy filing that was dismissed within the last 180 days because the filer willfully failed to appear before the court or comply with the orders of the court. Individuals with a current monthly income that is greater than the state median must pass a separate "means test" that determines whether their income is low enough to file under Chapter 7, or whether they should file under Chapter 13. Filers are also ineligible to receive another Chapter 7 bankruptcy discharge if they received a discharge of debts in a prior Chapter 7 case in the last eight years or they received a Chapter 13 discharge in the last six years, unless the Chapter 13 discharge was under a confirmed plan that either (1) totaled 100 percent of allowed unsecured claims, or (2) 70 percent of allowed unsecured claims proposed in good faith and was the debtor's best effort, regardless of income. Finally, all Chapter 7 filers are required to receive credit counseling from an approved credit counseling agency within 180 days before filing to remain eligible for Chapter 7.

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[5] There are other chapters under the Bankruptcy Code available for individuals, such as Chapter 11, but they are usually used for more complicated circumstances.

[6] https://www.natlbankruptcy.com/how-much-does-it-cost-to-file-bankruptcy-2/

While Chapter 7 bankruptcy is an important debt relief option for eligible individuals with its high discharge rates and a fast time to discharge, it also makes for a less natural comparison with debt settlement and Chapter 13. Chapter 7 includes stricter income eligibility thresholds and the requirement that individuals liquidate assets not covered by the bankruptcy exemptions recognized by the Bankruptcy Code, differing from both debt settlement and Chapter 13. It is important to keep in mind liquidating non-exempt assets by a Trustee involves additional cost and expenses to the Chapter 7 filer. Additionally, the filer may not be able to voluntarily dismiss a Chapter 7 case once filed. We therefore omit Chapter 7 bankruptcy from our comparison, while again emphasizing that we believe Chapter 7 is an important debt relief option for individuals with lower incomes and fewer assets.

Chapter 13 bankruptcy also begins with the filer filing a petition with the bankruptcy court. Similar to Chapter 7, a Chapter 13 bankruptcy filing includes schedules of assets and liabilities, schedules of income and expenditures, schedules of executory contracts and unexpired leases, a statement of financial affairs, and documentation of tax records. Chapter 13 filers must also propose a three-to-five-year plan to partially repay their unsecured debt using all of their disposable income. A court-appointed bankruptcy trustee is assigned with the primary responsibility of administering the case and collecting monthly payments from the filer and disbursing the payments to the creditors according to the payment plan approved by the court. Shortly after filing, the trustee administers a meeting of creditors where the filer is obligated to answer questions regarding the bankruptcy case. This meeting is also a forum that can be used to resolve issues with the proposed plan. After the meeting of creditors, a confirmation hearing takes place and the bankruptcy judge decides whether the repayment plan is feasible and meets the standards for confirmation established in the Bankruptcy Code. Creditors also have the right to object to confirmation of the plan or contest the valuation of certain assets.

The typical Chapter 13 bankruptcy payment plan takes between three to five years, as mentioned above, with a median time from filing to discharge of 5.1 years in the FJC data. In a Chapter 13 bankruptcy filing, debt is classified as secured, priority unsecured, and non-priority unsecured. In the case of secured debt, filers may elect to keep the collateral if they stay up to date on all current payments and include any arrears in the repayment plan. This provides filers an avenue for keeping select property while still benefiting from the debt relief of a bankruptcy discharge. The filer can also give up the collateral and discharge the remaining debt. Priority unsecured debt includes taxes, child support, alimony, and the cost of the bankruptcy proceeding, and must be paid in full. Unsecured non-priority claims are paid back per the confirmed terms in the payment plan. There are 100% payment plans where the filer is required to pay back 100% of the non-priority unsecured claims, 0% payment plans where the filer is not obligated to pay back any of the non-priority unsecured claims, and a spectrum in between. The smaller the amount paid towards the non-priority unsecured claims, the greater the potential financial savings. Filers on 100% payment plans will not experience any debt forgiveness because they are repaying the full amount back. For simplicity, we will use the terms unsecured debt and non-priority unsecured claims interchangeably when comparing the Chapter 13 bankruptcy to debt settlement.

There are three general outcomes of a Chapter 13 filing. First, debts can be successfully discharged following the completion of the payment plan, with any balance of the non-priority unsecured claims forgiven. Second, cases can be dismissed prior to receiving a discharge for a variety of reasons such as failure to propose a payment plan that complies with the Bankruptcy Code, failure to submit the required documentation to the trustee, or failure to complete the confirmed payment plan. If the case is dismissed for any of these reasons, the filer will not receive the benefit of a discharge and will be obligated to repay the outstanding balance less any payments made while in bankruptcy. Over the course of the three-to-five-year payment plan, the filer's financial situation may change, jeopardizing their ability to adhere to the payment plan. Under this scenario, the filer may request a plan modification and will be subject to another confirmation hearing and possibly additional fees and costs. These modified plans can either lead to a discharge or a dismissal depending on the filer's ability to adhere to the payment plan. Third, a Chapter 13 filing can be converted to Chapter 7, which occurs approximately 9% of the time in our data. Once a Chapter 13 filing is converted to Chapter 7, the case follows the Chapter 7 process outlined above, where non-exempt assets are liquidated in exchange for debt relief.

The direct costs incurred through Chapter 13 bankruptcy are filing fees, which were $281 for most of our analysis period, and attorney fees, which averaged $3,123 in a hand-collected sample of filings from our analysis period. The bankruptcy trustee is paid through the payment plan, with the exact amount varying by case but never exceeding 10% of the plan payments. The discharge rate for Chapter 13 bankruptcy is considerably lower than Chapter 7 bankruptcy at nearly 50% in the FJC data. The key factors determining the financial savings of Chapter 13 bankruptcy are the discharge rate, the percent paid to non-priority unsecured creditors, and the court and attorney fees.

There are several eligibility criteria for Chapter 13 bankruptcy based on the filer's outstanding debt, their disposable income, and the proposed repayment plan. Individuals are only eligible for Chapter 13 if their unsecured debts and secured debts fall within a limit as defined by the Bankruptcy Code. In addition, individuals generally must be employed with sufficient disposable income to cover the monthly payment amount. The proposed repayment plan based on that sufficient disposable income must also meet the "best interest of creditors" test that ensures that creditors receive at least as much as they would have received if the filer's assets were liquidated under Chapter 7 bankruptcy. Similar to Chapter 7 bankruptcy, filers are also ineligible to receive a Chapter 13 discharge if they have received a discharge of debts in a prior Chapter 7 case in the last four years or in a Chapter 13 case in the last two years, or if they fail to receive credit counseling from an approved credit counseling agency within 180 days before filing.

Finally, a key aspect of both Chapter 7 bankruptcy and Chapter 13 bankruptcy is the automatic stay. When a filer is under the protection of an automatic stay, creditors cannot initiate or continue lawsuits, wage garnishments, or phone calls to collect outstanding debt without getting court approval.

DEBT SETTLEMENT

Debt settlement is a process that negotiates the less-than-full-balance resolution of eligible unsecured debt. Debt settlement companies work with creditors to negotiate settlements for less than the full amount owed on behalf of the individuals. Settlements are typically completed by a one-time lump-sum payment or a series of smaller payments. Creditors represent settlements as a partial write-off of principal at the time of settlement. We focus on Freedom Debt Relief, the source of our debt settlement data, throughout this section. As the largest debt settlement company in the nation with approximately 30% to 40% market share during the analysis period, Freedom Debt Relief's practices and data provide a reasonable representation of the financial outcomes created by debt settlement. That said, there may be some variability in the practice of debt settlement with other debt settlement companies that are not accounted for here.

Debt settlement typically begins with an in-depth debt consultation that spans several phone calls and consumes an average of 80 to 90 minutes of elapsed time. The consultation, which includes a review of the individual's credit report and an assessment of the individual's income, expenses, and debt obligations, determines the individual's fitness for the program. As part of the debt consultation, interested individuals are sent a request for financial documentation, regulatory disclosures, and a contract that documents the services and fees of the program. Not all debt is allowed to be included in the program as the typical focus is on unsecured debt. Government student loan debt and tax obligations are also excluded from debt settlement programs. The most common types of unsecured debt enrolled in a debt settlement program are credit card debt, department store charge card debt, unsecured personal loan debt, medical debt, and select private student loan debt. The unsecured debt referred to in debt settlement is thus roughly analogous to the non-priority unsecured claims in Chapter 13 bankruptcy. Upon receipt of the requisite documentation, a final determination is made to determine if the individual can be enrolled in a debt settlement program.

Once enrolled, a dedicated account that is owned and controlled by the individual is established to facilitate the debt settlement program. The debt settlement program has the individual making deposits into the dedicated account, typically at a monthly cadence and primarily funded with an automated electronic draft. A debt settlement company can only access the dedicated account with the individual's consent, generally when a settlement has been negotiated and accepted by the individual. Should the individual elect to leave the debt settlement program, the remaining balance in the dedicated account is directed back to the individual.

As sufficient funds accumulate in the dedicated account, settlements can be made. Fees are collected as these settlements are completed. Debt settlement companies must comply with the "Advanced Fee Ban," a component of the Federal Trade Commission's Telemarketing Sales Rule that prohibits debt settlement companies from collecting fees for settling a debt until the debt settlement company reaches a settlement of the debt, the individual agrees to the settlement, and the individual has made at least one payment to the creditor. The importance of the Advance Fee Ban is that it is designed to align the financial incentives of debt settlement companies with positive financial outcomes for individuals enrolled in debt settlement programs. Financial savings for debt settlement is driven by the settlements, the deposits into the dedicated account, and the fees collected.

Debt settlement companies are for-profit organizations whose primary revenue stream is the fees that are associated with a successfully settled account. The typical debt settlement participant enrolls between $28,000 and $29,000 of debt, experiences 66% to 72% of their enrolled debt being settled, and incurs between $3,400 and $3,800 in fees. The key factors determining the financial savings of debt settlement are these settlement rates and program fees.

Eligibility in a debt settlement program is established by the individual meeting three main requirements. First, the individual must have suffered financial hardship through, for example, a job loss, reduction in income, a medical event, an unexpected expense, or divorce. Second, the individual must be able to demonstrate the capability of making monthly deposits that are applied to their outstanding debt, typically through a detailed cash flow assessment. Finally, the individual must be able to demonstrate that they understand and believe that debt settlement is their preferred option of debt relief, generally through a detailed conversation with the debt consultant and the execution of a debt resolution agreement which includes extensive disclosures.

DATA

Our comparison of Chapter 13 bankruptcy and debt settlement is based on bankruptcy data from the Integrated Database (IDB) of the Federal Judicial Center (FJC) and debt settlement data from Freedom Debt Relief's proprietary customer relationship management database.

FJC BANKRUPTCY DATA

The FJC bankruptcy data contain all the bankruptcy petitions filed on or after October 1, 2007, as well as any petitions filed before October 1, 2007, where the case was still pending. The data contain information on the original filing date, original filing chapter, closing date, closing chapter, final disposition, amount of unsecured non-priority claims, and prior filing. These fields allow us to estimate savings and measure re-filing rates.

We make five primary restrictions to arrive at our analysis sample. We first select only those records filed as a Chapter 13 bankruptcy as represented by the first record submitted by the court. Second, we remove business-related cases by selecting only those cases where the original nature of the debt is consumer-related. Third, we select only those cases where the legal form of the debtor is an individual based on the petition information. Fourth, we remove records associated with intra-district transfers and inter-district transfers to avoid any potential double-counting of cases. Following these first five sample restrictions, the resulting sample yields nearly identical summary statistics as those reported on the U.S. Courts website.

Finally, we drop all cases where the amount of non-priority unsecured claims equals zero to facilitate a comparison with debt settlement. Given that both debt settlement and Chapter 13 bankruptcy are a means to resolve unsecured debt, comparing debt settlement to bankruptcy claims where there was no unsecured debt in the filing is inappropriate. We also cap non-priority unsecured claims at the 1st and 99th percentile of the distribution for Chapter 13 filings in our sample to minimize the role of outlying values. The final sample consists of 2,414,150 filings from 2013 through 2019 in all 50 states.

FREEDOM DEBT RELIEF DATA

The debt settlement data is sourced from Freedom Debt Relief's proprietary customer relationship management database. The data contain participant-level information on the enrollment date and whether the account was a prior enrollment. For every individual enrolled in the program, the data also contain account-level detail on the settlement date, enrolled debt, fees collected, and payments made. This information provides the level of detail required to calculate the savings realized for each debt settlement participant by aggregating the account-level settlements, fees, and payments to the participant level.

We make two primary restrictions to arrive at our analysis sample. First, we only select those individuals making at least one draft into the program, ensuring a population of individuals who have initiated participation in the debt settlement program. Second, to mirror the bankruptcy sample, we limit the sample to those participants enrolling from 2013 through 2019. This sample restriction balances the competing objectives of looking at the most recent data possible while providing a sufficient observation window to allow individuals to go through the Chapter 13 bankruptcy and debt settlement process. An additional benefit of selecting this time frame for analysis is that it removes any confounding effects of the Advanced Fee Ban that was introduced in the debt settlement industry in 2010.[7] There is a much narrower distribution of enrolled debt in the debt settlement data, with the 1st and 99th percentile caps from the bankruptcy data not binding in our analysis sample. The final sample consists of 5,660,312 accounts and 735,565 participants from 2013 through 2019.

Finally, we again note that interviews with creditors suggest that Freedom Debt Relief's market share was approximately 30% to 40% during the study time frame as based on the proportion of active debt settlement inventory. All of our results should be interpreted with this fact in mind.

[7] The Advanced Fee Ban was a component of the Federal Trade Commission's Telemarketing Sales Rule that prohibits debt settlement companies from collecting a fee for settling a debt until the debt relief company successfully reaches a settlement of the debt, the customer agrees to the settlement, and the customer has made at least one payment to the creditor.

A COMPARISON OF CHAPTER 13 BANKRUPTCY AND DEBT SETTLEMENT

In this section, we compare Chapter 13 bankruptcy and debt settlement along four important dimensions: (i) the financial savings after accounting for direct costs such as attorney fees or debt settlement fees; (ii) the re-filing/re-enrollment rates under each option; (iii) the indirect costs of seeking and obtaining debt relief; and (iv) changes in the effectiveness of each option over time. Estimating the causal impact of Chapter 13 bankruptcy and debt settlement on longer run credit outcomes is also of considerable importance for understanding the most appropriate debt relief solution for different types of individuals, but is out of scope for this report.

FINANCIAL SAVINGS

One of the most important dimensions of any debt relief option is the financial savings after accounting for direct costs such as attorney fees or debt settlement fees.

Figure 1 examines the normalized distribution of financial savings after accounting for direct costs such as attorney and court filing fees or debt settlement fees. The calculations are based on Chapter 13 bankruptcy cases filed in 2013 and debt settlement participants enrolled in 2013 to allow for enough time to realize a discharge or to have outstanding debt settled. The normalized financial savings for bankruptcy is defined as the debt forgiven through the bankruptcy process (inclusive of debt forgiven through Chapter 7 conversions) less attorney and court filing fees, normalized by the non-priority unsecured claims filed in bankruptcy.[8] For discharges, debt forgiven is defined as the non-priority unsecured claims discharged less payments made to the non-priority unsecured claims. For dismissals, the debt forgiven is zero. The financial savings for debt settlement is defined as the debt forgiven through the program less program fees, normalized by the unsecured debt enrolled in the debt settlement program. For debt settlement, debt forgiven is defined by the enrolled debt amount less any settlement payments.

We directly observe all the necessary information to calculate financial savings for debt settlement plans. For Chapter 13, we directly observe the debt discharged through the bankruptcy process but not the attorney and court filing fees or the payments to non-priority unsecured claims. We leverage a random sample of filings from the PACER system to form reasonable assumptions for these parameters. We first collected a random sample of 445 Chapter 13 filings from our sample period. We then restricted our attention to the 337 filings containing all relevant information, particularly the percentage paid to non-priority unsecured claims. Based on these data and the schedule of filing fees for this time period, we assume that attorney costs are $3,123, that court filing fees are $281, and that payments to non-priority unsecured claims average 34.0% of the non-priority debt. These values are qualitatively similar to the values reported in Lupica (2012) for an older period that predates our sample.[9]

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[8] Chapter 7 conversions account for approximately 9% of the Chapter 13 filings in our sample, with a median financial savings of 88.1% for these filings compared to just -7.5% for non-conversions in our baseline results. Including Chapter 7 conversions in our financial savings calculations is therefore likely to increase the financial savings of Chapter 13, all else equal.

[9] In the post-bankruptcy reform period, Lupica (2012) reports mean attorney costs of $2,500 and a mean percentage of debt repaid to non-priority unsecured creditors of 26.4%.

Figure 1 Normalized Savings and Losses of Chapter 13 Bankruptcy and Debt Settlement

Note: This figure reports the normalized distribution of financial savings after accounting for direct costs such as attorney and court filing fees or debt settlement fees. Chapter 13 savings are defined as the debt forgiven through the bankruptcy process (inclusive of debt discharged through Chapter 7 conversions) less attorney and court filing fees, all divided by the non-priority unsecured claims filed in bankruptcy. Debt settlement savings are defined as the debt forgiven through the program less program fees and settlement payments, all divided by the unsecured debt enrolled in the debt settlement program. See the text for additional details.

Figure 1 reveals substantial differences in the distribution of financial savings between Chapter 13 bankruptcy and debt settlement. Chapter 13 filers at the 25th percentile realize normalized financial *losses* of 17.73%, the median filer realizes normalized financial *losses* of 1.41%, and filers at the 75th percentile realize normalized financial savings of 58.2%. Expressed differently, our results show that 50.8% of bankruptcy filers experience financial losses, 1.9% experience financial savings between 0% and 20%, 4.8% experience financial savings between 20% and 40%, and 42.5% experience financial savings of at least 40%. The wide distribution of outcomes is driven by the relatively high proportion of early dismissals, which leave filers without the debt relief of a discharge but still encumbered with the court filing and attorney fees, as well as the high proportion of successful discharges, which instead provides generous debt forgiveness that more than offsets the court filing and attorney fees.

By comparison, there is a much narrower distribution of potential financial outcomes for debt settlement participants, with participants at the 25th percentile realizing zero financial savings, the median participant realizing normalized financial savings of 11.6%, and participants at the 75th percentile realizing normalized financial savings of 23.9%. Put another way, we find that less than 2% of debt settlement participants experience financial losses, 26.9% experience no savings at all, 37.6% experience financial savings between 0 and 20%, 28.7% experience financial savings between 20% and 40%, and 4.8% experience financial savings of at least 40%. The reason that less than 2% of debt settlement participants experience financial losses is that fees can only be incurred after a debt has been settled, in contrast to Chapter 13 where fees are charged regardless of the outcome of the filing. The mass of debt settlement participants experiencing zero savings represents the 26.9% of individuals who voluntarily leave the program before experiencing any settlements.

Taken together, our findings show that there is a significantly wider distribution of potential outcomes for Chapter 13 bankruptcy compared to debt settlement, with significant debt forgiveness for filings that successfully end in a discharge of debt but significant fees and financial losses for filings that unsuccessfully end in dismissal. Debt settlement programs have a much narrower distribution of potential outcomes, with generous debt relief for programs that successfully settle at least some accounts and limited to no financial losses for programs that unsuccessfully settle any accounts.

One caveat to our results in Figure 1 is that we rely on a single mean level to determine the fraction of debt repaid to non-priority unsecured creditors in Chapter 13, while the true number differs across payment plans. We explore this issue in the appendix, where we present results in which we sample from the empirical distribution of randomly selected filings from our sample period. The fraction of debt repaid to non-priority unsecured creditors in these filings is bimodal, with modes at 0% and 100%. When we use this distribution to determine the fraction of debt repaid to non-priority unsecured creditors, we find that Chapter 13 filers at the 25th percentile realize financial *losses* of 20.4%, the median filer realizes financial *losses* of 5%, and filers at the 75th percentile realize financial savings of 77.5%. In addition, we find that 60.7% of bankruptcy filers experience financial losses in these appendix results. The increase in the number of filers realizing financial losses is driven by the plans that completely repay non-priority claims, which generally yield financial losses even when there is a successful discharge.

RE-FILING/RE-ENROLLMENT RATE

A second important dimension of any debt relief option is the probability of re-filing or re-enrolling at a future date, either because an individual did not obtain the necessary debt relief or because the individual fell back into debt and needs additional debt relief. The direct costs of each option are also affected by the re-filing and re-enrollment rate, as individuals may have to pay the same set of fees again to receive debt forgiveness.

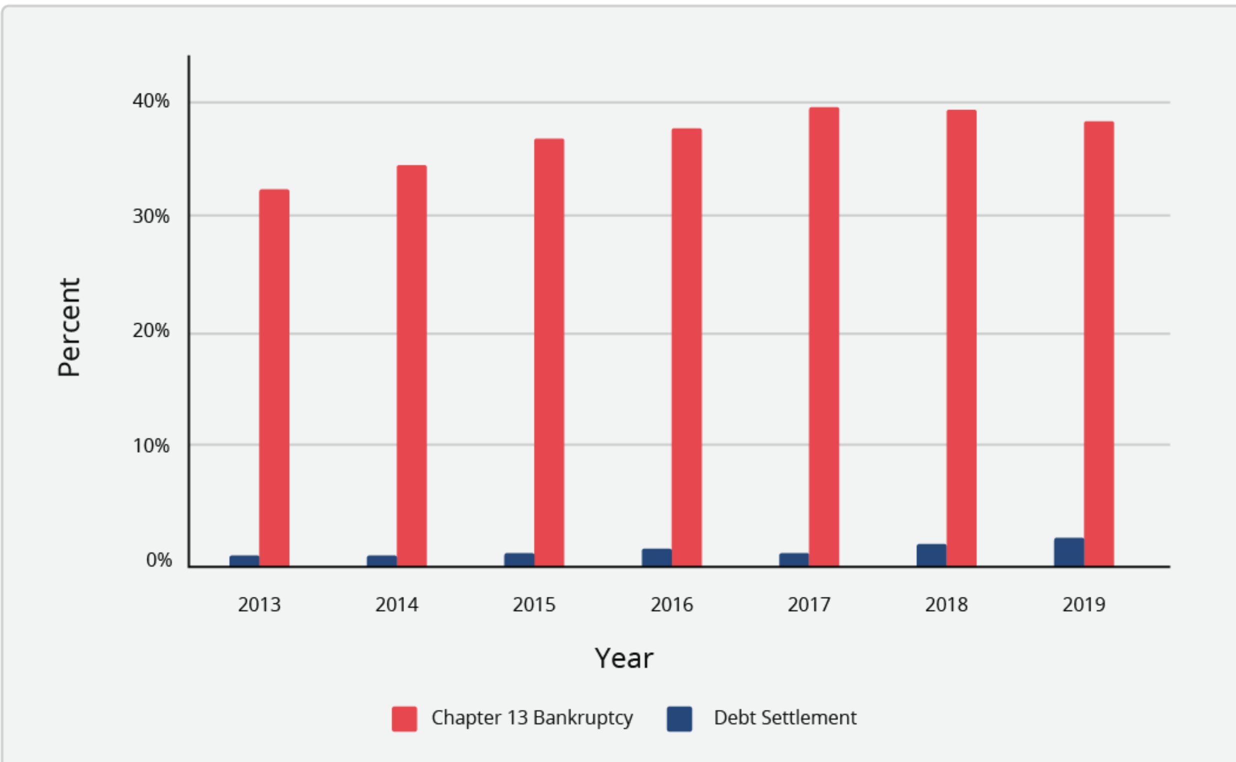
Figure 2 plots the Chapter 13 re-filing rate and the debt settlement re-enrollment rate for each year in our sample window. The Chapter 13 re-filing rate is defined as the fraction of filings each year where there is a prior filing (of any chapter) on record. The debt settlement re-enrollment rate is defined as the fraction of Freedom Debt Relief enrollments each year that had a prior relationship with Freedom Debt Relief. We caution that this is a company-level estimate, not an industry-level estimate, as we are unable to measure whether a Freedom Debt Relief client was previously a client at a different debt settlement company or whether a former Freedom Debt Relief client enrolls in a different debt settlement program. As such, we will be underestimating the percentage of re-enrollments for the debt settlement industry as a whole.[10]

[10] One naïve approach to estimate an industry level re-enrollment rate is to take the company specific results and then adjust them up by market size. This approach assumes that the re-enrollment rate is similar across other debt settlement companies and that the likelihood that a former debt settlement company enrolls with a different debt settlement company is the same, irrespective of the company and the consumer's specific experience. Estimates using this view yield industry level re-enrollment rates ranging from 2.8% to 4.9%.

With these caveats in mind, we find that the Chapter 13 bankruptcy re-filing rate is substantially higher than the debt settlement re-enrollment rate. Between 2013 and 2019, we observe that the Chapter 13 bankruptcy re-filing rate, as measured by the number of filings with a prior bankruptcy case in the previous eight years divided by the total number of filings, ranges from 33.0% to 39.6%. Over the same time period, the observed re-enrollment rate for debt settlement, as measured by the number of re-enrollments divided by the number of total enrollments, ranges from 0.8% to 1.5%.

We also observe a median normalized savings rate of -7.2% for debtors with a previous filing compared to 37.9% for debtors without a previous filing. By comparison, we observe a median normalized savings rate of 2.2% for debt settlement participants with a prior enrollment compared to 11.7% for participants without a prior enrollment.

Figure 2 Chapter 13 Bankruptcy Re-filing Rates vs. Freedom Debt Relief Re-Enrollment Rates



Note: This figure reports the re-filing rate for Chapter 13 bankruptcy and the re-enrollment rate for Freedom Debt Relief by year. The Chapter 13 re-filing rate is defined as the fraction of filings each year where there is a prior filing on record. The debt settlement re-enrollment rate is defined as the fraction of Freedom Debt Relief enrollments each year that had a prior relationship with Freedom Debt Relief. See the text for additional details.

The high re-filing rate for Chapter 13 combined with the lower discharge rate of repeat filers suggests that many individuals may need to re-file to obtain the necessary debt relief. The high re-filing rate also suggests considerable fees can be accrued through multiple filings, potentially increasing the number of bankruptcy filers with economically significant financial losses. Repeated dismissals could also significantly lower an individual's credit scores, with prior work suggesting that the credit scores of individuals with Chapter 13 dismissals are approximately 40 to 50 points lower than those of Chapter 7 successful discharges and Chapter 13 successful discharges.[11]

INDIRECT COSTS

Debt relief can also lead to indirect costs, such as any continued collection activities, additional interest and late fees charged by creditors, taxes related to the debt that is forgiven, and perceptions of stigma or feelings of guilt. While we are unable to quantify many of these costs, this section discusses the most salient indirect costs associated with both Chapter 13 and debt settlement.

Chapter 13 includes an automatic stay that immediately stops most collection activities, including civil lawsuits and collection calls. Late fees and interest payments also cannot be applied to an account while it is in bankruptcy, further benefiting filers. There are also no income taxes applied to debt that has been discharged through bankruptcy, allowing filers to have a "fresh start" if the bankruptcy process is successfully completed.[12] The stigma effects of bankruptcy are harder to quantify, with a generally negative perception of bankruptcy filers perhaps creating a psychological cost to filing.

By comparison, debt settlement participants are still subject to credit collection practices, late fees, and interest during the debt settlement process. This means that individuals enrolled in a debt settlement plan can be subjected to frequent phone calls and potential lawsuits as creditors attempt to collect the outstanding debt. In practice, we observe an incremental growth of the outstanding balance of approximately 12% for accounts enrolled in debt settlement due to interest and late fees that typically stops after 6 to 8 months when the debt is written off. We also find that 25% to 30% of individuals enrolled in a debt settlement program are threatened with litigation to recover any outstanding debt. Such threats are a common collection practice that is meant to force repayment without actually going to court, where the associated attorney and court fees often exceed any recovered debt. The threat of litigation also tends to precipitate a settlement for debt settlement participants, with 77.6% to 79.0% of debt settlement accounts in litigation ultimately settling for less than the current balance. We do not directly observe the number of debt settlement accounts that end up in court, but qualitative reports suggest that the number is less than 5%. In sum, Chapter 13 bankruptcy generally has lower costs associated with credit collection practices, late fees, and interest payments than debt settlement.

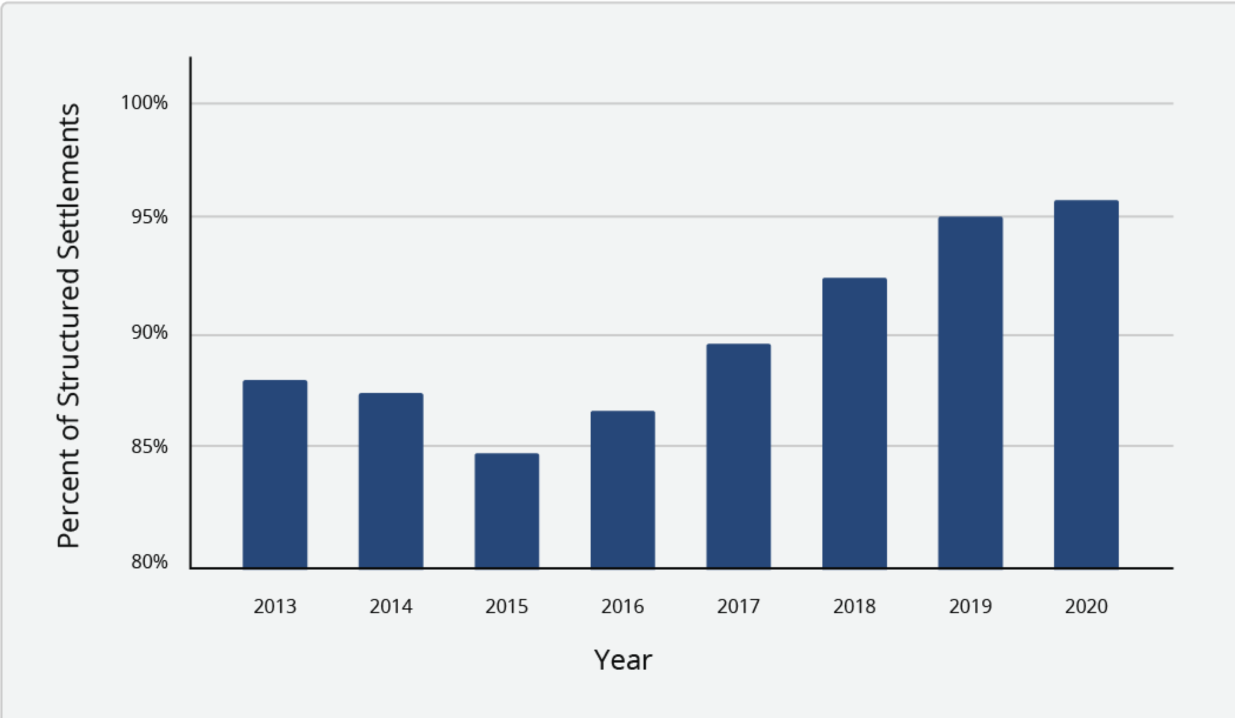
The increasing trend of structured settlements (rather than one-time, lump sum settlements) may help reduce the indirect costs of debt settlement by limiting collection activities and reducing interest and late fees. Settlements were historically realized after sufficient deposits needed to resolve the debt had accumulated in the individual's dedicated account. Structured settlements are different in that a settlement with the creditor is negotiated on behalf of the individual before these deposits have fully accumulated. The negotiated settlement defines a specific amount and time that payments will be made moving forward. Structured settlements may in principle lead to better program outcomes by establishing a settlement earlier and allowing the debt settlement company to set up multiple settlements in parallel, as opposed to organizing settlements

[11] https://libertystreeteconomics.newyorkfed.org/2017/05/do-credit-markets-watch-the-waving-flag-of-bankruptcy.html

[12] If a filer receives a 1099-C for a given debt prior to the filing, that debt cannot be included in the bankruptcy filing because it is technically forgiven. Such debt would then be subject to additional income tax.

serially as the debt settlement account is funded. Figure 3 below illustrates the structured settlement rate over time, increasing from 87.5% in 2013 to 95.5% in 2020.

Figure 3 Structured Settlements Over Time



Note: This figure reports the percent of structured settlements over time. We define the structure settlement rate as the number of structured settlement agreements reached divided by the number of settlement agreements reached. See the text for additional details.

Debt that has been settled through a debt settlement program can also be subject to additional income tax, unlike the debt discharged in bankruptcy. When debt is settled for at least $600 less than the original balance, creditors must submit a 1099-C form to the Internal Revenue Service that documents the portion of the forgiven debt as income. Not all settled debt qualifies as income, with the tax code generally exempting an individual from additional income tax if the individual was insolvent before the creditor agreed to settle the debt.[13] We do not observe the tax liabilities of debt settlement participants.

EFFECTIVENESS OVER TIME

A final important dimension of the comparison is quantifying how Chapter 13 and debt settlement outcomes have changed during our sample period. We calculated the financial savings of both Chapter 13 and debt settlement using information from 2013 to allow sufficient time for Chapter 13 filers to complete a 5-year plan and for debt settlement participants to potentially settle all of their unsecured debt. The effectiveness of Chapter 13 and debt settlement may have changed over time, however, meaning that there is also value in examining shorter run measures of success such as the percentage of Chapter 13 filers still eligible for a

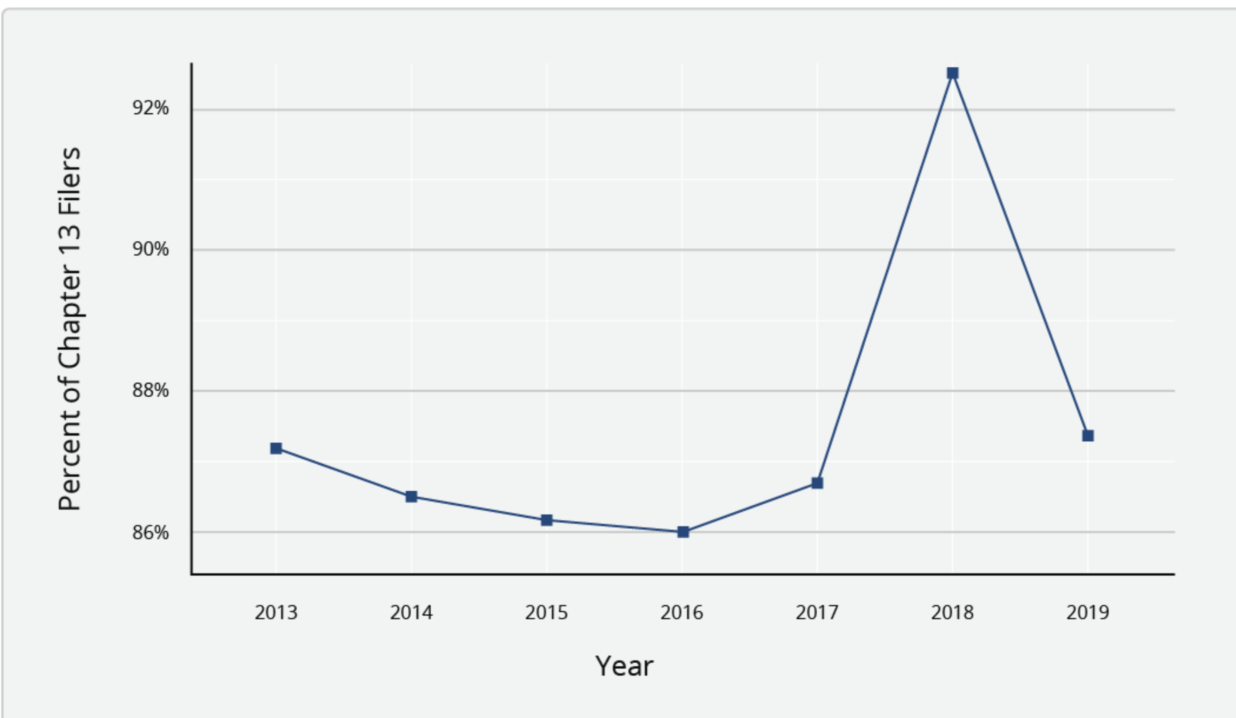
[13] As an example, if the consumer had $2,500 in debts that were forgiven and their liabilities had exceeded their assets by $1,000, only $1,000 would qualify as taxable income. The remaining $1,500 would be excluded.

discharge nine months after filing and the percentage of debt settlement clients realizing settlement in the first nine months after enrollment.

Figure 4 plots the percentage of Chapter 13 filers still eligible for a discharge after the first nine months for each year between 2013 and 2019. If a filer is still eligible for a discharge after the first nine months, that means that the case has not been dismissed in the first nine months. This measure is predictive of a positive financial outcome and can be calculated shortly after filing, allowing for a longer panel. The percentage of Chapter 13 filers still eligible for a discharge after the first nine months after filing is relatively constant or even decreasing over time, going from 88.4% in 2013 to approximately 88.0% in 2020. The flat or decreasing rate of discharge eligibility suggests that a decreasing percentage of Chapter 13 filers will experience a positive financial outcome in the long run.

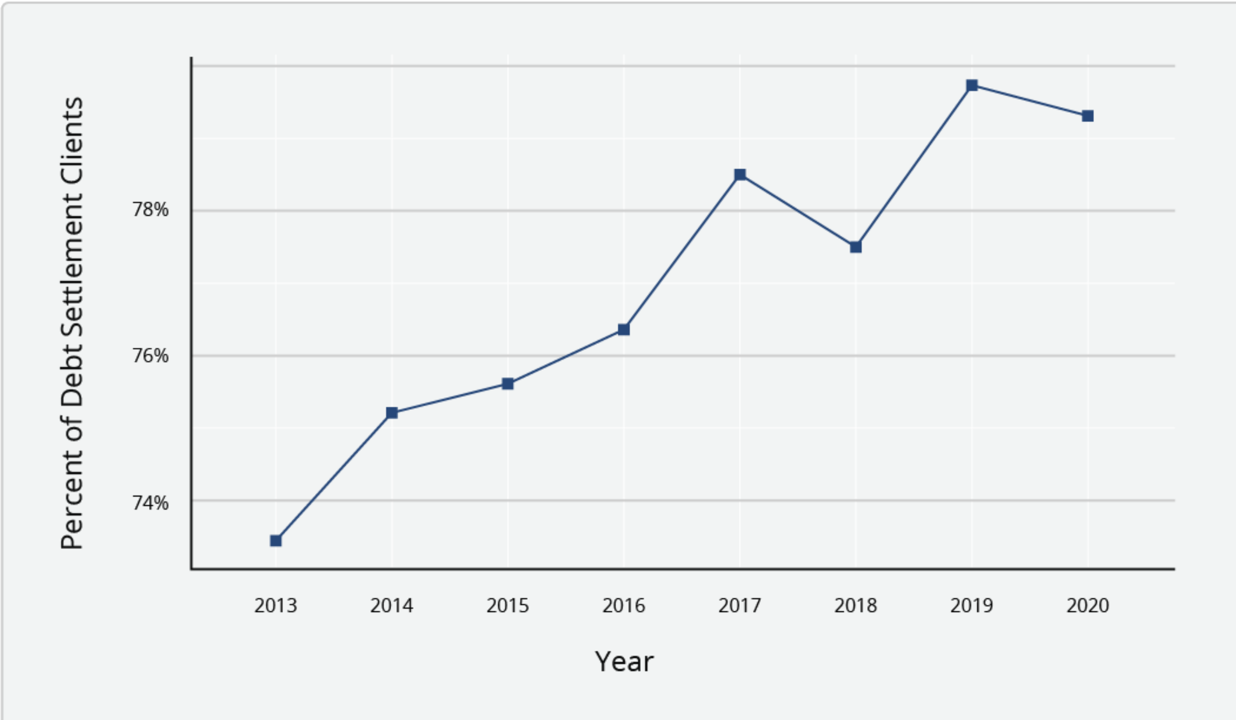
Figure 5 plots the percent of debt settlement clients experiencing a settlement in the first nine months of the debt settlement program between 2013 and 2020. Early settlements are again predictive of a positive financial outcome and can again be measured shortly after enrollment, again allowing for a longer panel. This early settlement rate steadily increases over our sample period, going from 43% in 2013 to 70% in 2020. Such an increasing early settlement rate will generally lead to a smaller percentage of debt settlement clients experiencing no financial savings and a greater percentage of debt settlement clients experiencing some financial savings.

Figure 4 Chapter 13 Filers Eligible For Discharge Nine Months After Filing Over Time



Note: This figure reports the early non-dismissal rate over time. The early non-dismissal rate is defined by the number of cases filed in a particular year that did not result in dismissal within the first 9 months of filing divided by the total number of Chapter 13 filings that year. See the text for additional details.

Figure 5 Debt Settlement Clients Experiencing Early Settlement Over Time



Note: This figure reports the early settlement rate over time. The early settlement rate is defined by the number of participants in a particular year that experienced a settlement within the first 9 months of filing divided by the total number of participants enrolled that year. See the text for additional details.

These different trends may in principle be driven by the respective fee structures for Chapter 13 and debt settlement. Debt settlement companies cannot collect fees unless the settlements are reached with the creditor and approved by the individual, encouraging these companies to deliver better program outcomes over time. By comparison, the Chapter 13 attorney and court filing fees are incurred irrespective of the outcome of the filing. The Chapter 13 attorney and court filing fees are also generally paid by filers early in the repayment plan and then unrecoverable to them if their case is dismissed for any reason, meaning that there are fewer financial incentives to generate better bankruptcy outcomes over time.

CONCLUSION

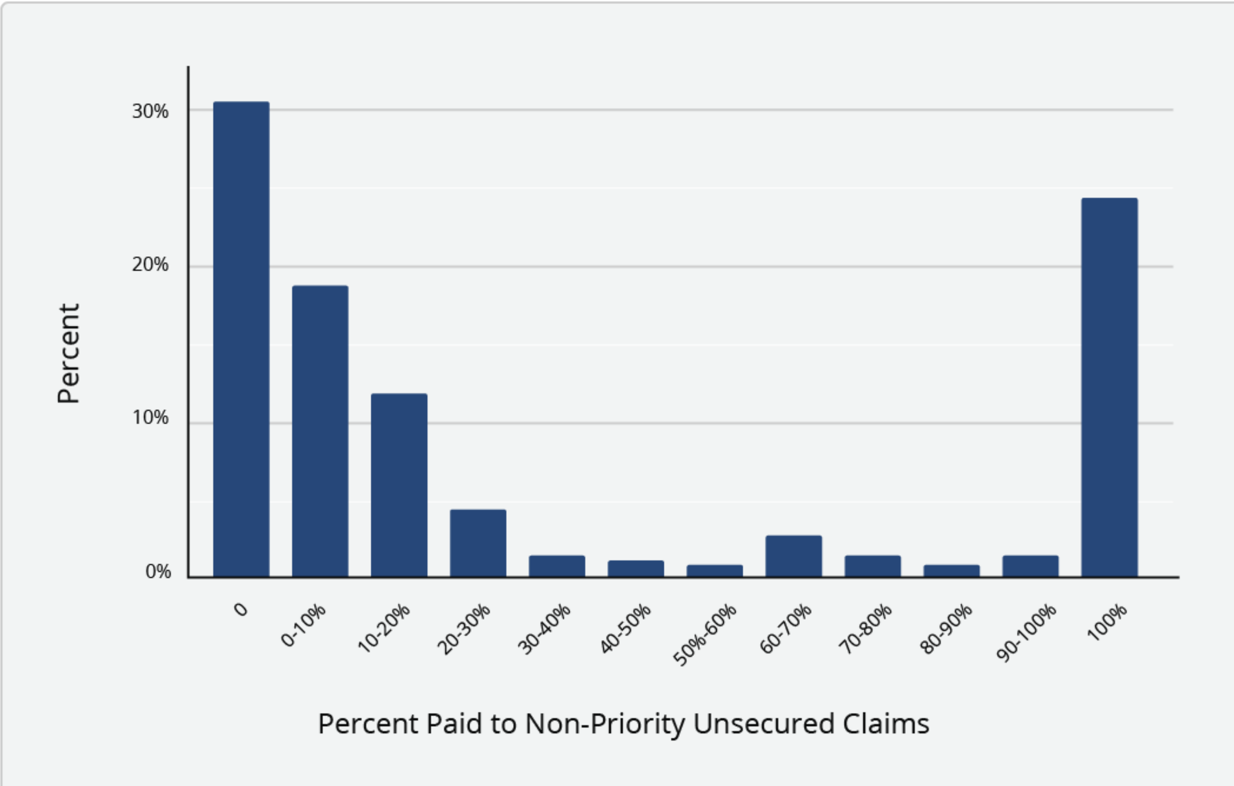
There are four key findings from our descriptive analysis of Chapter 13 bankruptcy and debt settlement programs. First, there is a wide spectrum of financial outcomes for Chapter 13 filers, with nearly half of filers realizing economically significant financial savings through the bankruptcy process and another half experiencing financial losses due to the direct costs of the attorney and court filing fees exceeding the discharge amount. We observe a narrower distribution of financial outcomes for debt settlement programs, with about one-third of program participants realizing economically significant financial savings and virtually none experiencing financial losses. Second, the re-filing rate for Chapter 13 is significantly higher than the re-enrollment rate for a large debt settlement company, suggesting that repeat filers may incur considerable fees with no guarantee of a discharge. By comparison, the re-enrollment rate for the debt settlement company is low throughout our sample period. Third, for indirect costs such as collection activities and interest and late fees, bankruptcy provides an advantage over debt settlement because of the automatic stay that immediately stops most collection activities. Tax implications from debt settlement and the stigma of bankruptcy are also relevant indirect costs, but are difficult to quantify in the available data. Finally, the percentage of debt settlement clients experiencing a settlement in the first nine months of the program generally increased over our sample period, while the percentage of Chapter 13 filers eligible for a discharge nine months after filing has remained constant or decreased over time. While we lack conclusive evidence on this issue, the increasing settlement rates are consistent with the performance-based fee structure of debt settlement encouraging innovation and generating better consumer outcomes over time.

APPENDIX

Recall that financial savings for Chapter 13 bankruptcy is defined as the debt forgiven through the bankruptcy process (inclusive of debt forgiven through Chapter 7 conversions) less attorney and court filing fees, normalized by the non-priority unsecured claims filed in bankruptcy. We directly observe the debt discharged through the bankruptcy process but not the attorney and court filing fees or the payments to non-priority unsecured claims. As discussed in the text, we leverage the PACER system to form reasonable assumptions for these parameters. We first collected a random sample of 445 Chapter 13 filings from 2013. We then restricted our attention to the 337 filings containing all relevant information, particularly the percentage paid to non-priority unsecured claims. Based on these data and the schedule of filing fees, we assume that attorney costs are $3,123, that court filing fees are $281, and that payments to non-priority unsecured claims average 34.0% of non-priority debt.

One caveat to our main text results is that we rely on a single mean level to determine the fraction of debt repaid to non-priority unsecured creditors in Chapter 13, while the true number differs across payment plans. Appendix Figure 1 plots the distribution of payments to non-priority unsecured claims in the random sample of PACER filings, showing a bimodal distribution with modes at 0% and 100%. Collapsing this bimodal distribution of payments to a single mean level means that our financial savings calculations will generally understate the financial losses for cases that pay back a large proportion of debt to non-priority unsecured creditors, as well as the financial savings for cases that pay back a small proportion of debt to non-priority unsecured creditors. As a result, we will likely understate the true dispersion of financial outcomes in Chapter 13 when using a single mean level to determine the fraction of debt repaid to non-priority unsecured creditors in Chapter 13.

Appendix Figure 1 Distribution of Chapter 13 Payments to Unsecured Creditors

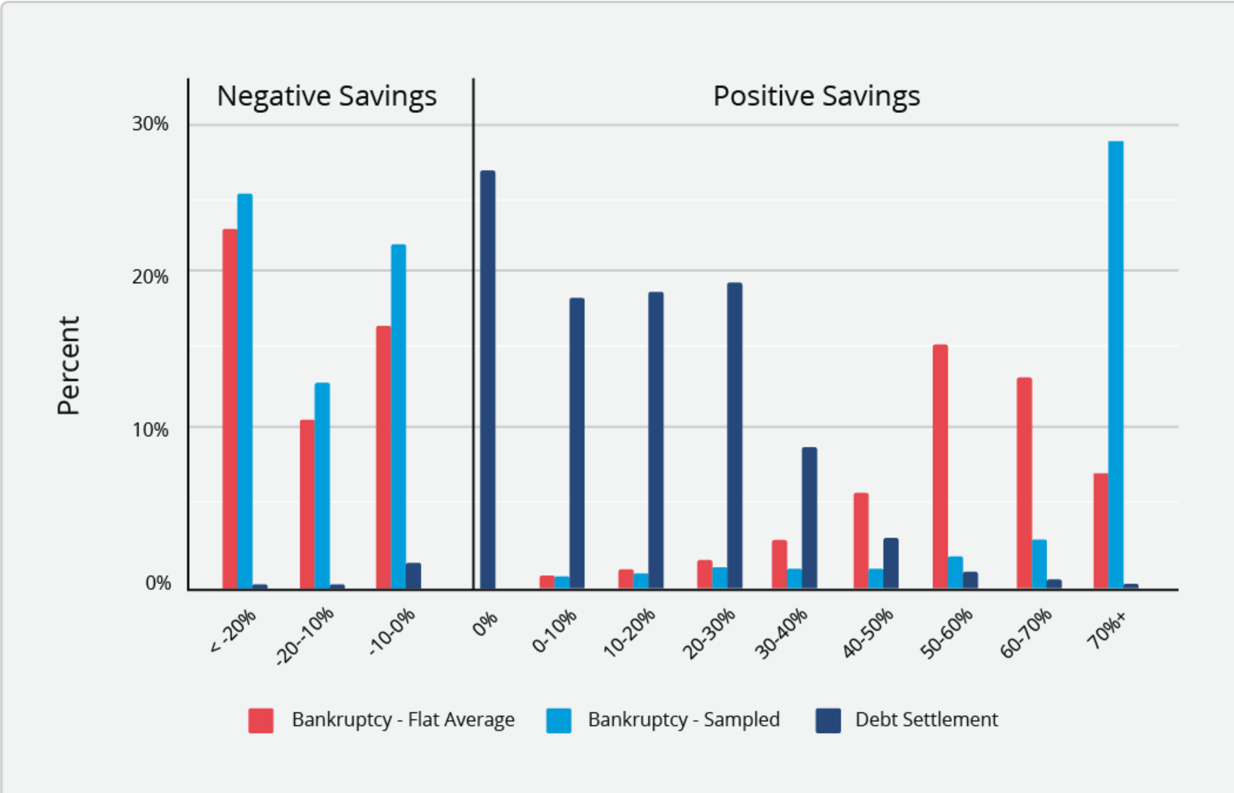


Note: This figure reports the distribution of the percentage paid to non-priority unsecured claims. This distribution was sampled from 337 PACER records from Chapter 13 bankruptcy filings from 2013.

We explore this issue in Appendix Figure 2, which presents financial savings calculations based on the empirical distribution of debt repaid to non-priority unsecured creditors in Chapter 13. For each Chapter 13 filing in the FJC data, we randomly sample with replacement from the empirical distribution of 337 records described above and in the main text. We then repeat our financial savings calculations using this randomly assigned fraction of debt repaid to non-priority unsecured creditors, rather than the single mean previously. We also show our baseline results from Figure 1 for comparability.

When we use the empirical distribution to determine the fraction of debt repaid to non-priority unsecured creditors, we find considerably more dispersion in the financial outcomes in Chapter 13 plans. We find, for example, that Chapter 13 filers at the 25th percentile realize financial *losses* of 20.4%, the median filer realizes financial *losses* of 5%, and filers at the 75th percentile realize financial savings of 77.5%. In addition, we now find that 60.7% of bankruptcy filers experience financial losses in these results. The increase in the number of filers realizing financial losses is driven by the plans that completely repay non-priority claims, which generally yield financial losses even when there is a successful discharge.

Appendix Figure 2 Normalized Savings Results Based on Distribution of Chapter 13 Payments to Unsecured Creditors



Note: This figure reports the normalized distribution of financial savings after accounting for direct costs such as attorney and court filing fees or debt settlement fees. Chapter 13 savings are defined as the debt forgiven through the bankruptcy process (inclusive of debt discharged through Chapter 7 conversions) less attorney and court filing fees, all divided by the non-priority unsecured claims filed in bankruptcy. Debt settlement savings are defined as the debt forgiven through the program less program fees and settlement payments, all divided by the unsecured debt enrolled in the debt settlement program. See the appendix text for additional details.

Conversations with creditors confirm that the payments to non-priority unsecured creditors are generally bimodal, at least initially. The creditors note that the fraction of debt repaid to non-priority unsecured creditors often changes during the three-to-five-year payment plan, generally becoming less bimodal over time. We also emphasize that our random resampling procedure does not consider the joint distribution of filer and plan characteristics, which may yield different savings calculations than those presented in Appendix Figure 2.