

THE ILLOGIC OF NO LIMITS ON BANKRUPTCY

Brian Rothschild*

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* J.D. University of Southern California Gould School of Law, Judicial Extern to the Hon. Richard L. Speer, Bankr. N.D. Ohio, and the Hon. Richard M. Neiter, Bankr. C.D. Cal. The author would like to thank Professors George Webster, Matthew McCubbins, and Charles Whitebread for their criticism, encouragement, and friendship. Also, the author owes an incalculable debt to Professor Christopher D. Stone. The author may be contacted at uslawyer@yahoo.com.

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INTRODUCTION

Recent legislation restricting access to bankruptcy relief through means testing and other methods has met with unmitigated criticism by bankruptcy scholars.¹ The criticism stems from the traditional view of bankruptcy, as enunciated in Thomas Jackson's seminal work, *The Logic and Limits of Bankruptcy Law*, as a welfare-enhancing debt-collection law.² By this account, restrictions on bankruptcy are both unkind and ineffective. Restrictions are unkind because they deny relief to debtors who are suffering financial distress; ineffective because bankruptcy precipitated by financial distress is involuntary and therefore not effectively deterred by law. Moreover, the traditional theory holds that some level of economic distress and failure is inevitable and the collective debt proceedings of bankruptcy are, in theory, welfare-enhancing.

Despite the consensus of academics against it, the 109th Congress passed a comprehensive bankruptcy reform restricting bankruptcy eligibility beginning in October 2005. According to Congress and the voters, the bankruptcy system was being overused, and this overuse constituted abuse. Academics, on the other hand, steadfastly insisted that rising bankruptcy rates were simply a function of widespread financial distress. Nevertheless, the 2005 reform included a means test, required financial counseling, and placed certain limitations on housing exemptions designed to restrict access to bankruptcy relief.

¹ The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA") was enacted as 109 Pub. L. No. 8, 119 Stat. 23 on April 20, 2005, and went into effect on October 17, 2005, codified into title 11 of the United States Code. All statutory citations in this Article are to the amended title 11 of the United States Code known as the Bankruptcy Code ("Code") unless otherwise noted. Scholars' criticism of the BAPCPA has been consistently negative. See, e.g., Erwin Chemerinsky, *Constitutional Issues Posed in the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005*, 79 AM. BANKR. L.J. 571 (2005) (questioning the constitutionality of BAPCPA provisions on attorney regulation, repayment plans, and means testing); Ronald J. Mann, *Bankruptcy Reform and the "Sweat Box" of Credit Card Debt*, 2007 U. ILL. L. REV. 375 (2007) (arguing that a decrease in consumer debt discharge under the BAPCPA is unlikely to result in savings to credit consumers); Henry J. Sommer, *Trying to Make Sense Out of Nonsense: Representing Consumers Under the "Bankruptcy Abuse Prevention and Consumer Protection Act of 2005,"* 79 AM. BANKR. L.J. 191 (2005) (calling the BAPCPA "Orwellian" and reflecting that it will make consumer bankruptcy more expensive, less effective, and, in many cases completely inaccessible); Steven E. Smith, *Off with debtors' heads?*, L.A. TIMES, Oct. 16, 2005, at M3 (arguing from a debtor's attorney perspective that the BAPCPA is ill-conceived and mean-spirited).

² THOMAS H. JACKSON, *THE LOGIC AND LIMITS OF BANKRUPTCY LAW* 3 (1986).

This Article will seek to answer two questions. First, is Congress justified in placing restrictions on a debtor's eligibility to file for bankruptcy? Second, if it is, by what mechanism should access to bankruptcy be restricted?

This Article, in four Parts, will evaluate the traditional theory's justification of bankruptcy as welfare-enhancing involuntary relief and, thereby, determine if policy-makers are justified in restricting bankruptcy relief. Part I will examine the traditional justification that bankruptcy is welfare-enhancing and will explain why the justification does not apply to the present surge in consumer bankruptcy filings. Part II will recap the debate over whether bankruptcy is voluntary or involuntary, and will explain the policy implications of voluntary bankruptcy. Part III will contrast bankruptcy with other forms of social relief by comparing collection and distribution effects, overlaps and redundancies, and moral hazards. Part III also will demonstrate that bankruptcy does not compare favorably nor fit well with other programs forming the social safety net, and policy-makers are justified in reducing rather than increasing the rate of bankruptcy. Part IV will evaluate the current means test and other BAPCPA reforms and conclude that they do not effectively restrict bankruptcy and then will suggest a mechanism for restricting bankruptcy relief that would be more fair and more accurate than the current means test. The Article will conclude that a return to the fundamental role of bankruptcy as a means of debt-collection will be welfare-enhancing.

I. JUSTIFYING BANKRUPTCY

A. *The Traditional Theory*

The essentially unchallenged traditional theory and justification of consumer bankruptcy is articulated in Thomas H. Jackson's influential book, *The Logic and Limits of Bankruptcy Law*.³ He makes three assertions in defense of the bankruptcy system:

³ *Id.* at 3. Professor Jackson's generalizations about the principles underlying bankruptcy law do not begin by differentiating between chapter 7 consumer bankruptcy filings and chapter 11 business reorganization. This Article will only address chapter 7 consumer bankruptcy liquidation and will not address chapter 11 reorganization.

1. *Bankruptcy Is a Debt-Collection Law*

Bankruptcy law, “at its core, is debt-collection law. This we all agree on.”⁴ The “fresh-start” may be an independent substantive policy to be balanced with other concerns but, nevertheless, the primary purpose of bankruptcy is to make debt collection efficient.⁵

2. *Bankruptcy Is for Insolvent Debtors*

Unlike state law debt collection where each creditor separately attempts to collect, debt collection in bankruptcy brings together all the debtor’s creditors in a collective proceeding. This collective proceeding is necessary because bankruptcy “is not concerned . . . with the means for getting paid when the debtor is solvent—when it has enough assets to satisfy all its obligations in full but . . . only when the debtor does not have enough to repay everyone in full.”⁶ If the debtor had enough assets to pay creditors, state law remedies would arguably be just as efficient as bankruptcy making bankruptcy’s collective proceeding unnecessary.

3. *Bankruptcy Is Welfare-Enhancing for Both Creditors and Debtors*

To illustrate how bankruptcy enhances consumer welfare, Professor Jackson poses a hypothetical about an insolvent debtor who owns a printing business.⁷ The hypothetical debtor’s printing press, if liquidated, is only worth half as much as his debts.⁸ Through bankruptcy’s orderly and equitable distribution, each creditor is guaranteed a pro rata share and saves on transaction costs.⁹ Creditors who are risk-averse benefit because of the reduced risk of receiving nothing.¹⁰ Also, each creditor will not need to spend money closely monitoring her debtor’s financial condition in order to be first in line at the courthouse.¹¹ If the printing press in the hands of the debtor can be operated to produce income worth more than the present liquidation value, both creditors and debtor benefit further because of the “going-concern

⁴ *Id.* at 3.

⁵ *Id.* at 4.

⁶ *Id.* at 8.

⁷ *Id.* at 13–16.

⁸ This could happen through state-law execution, voluntary sale after collection attempts, repossession, or other methods of collection.

⁹ JACKSON, *supra* note 2, at 15–16.

¹⁰ *Id.* at 15.

¹¹ *Id.* at 16.

surplus.”¹² Thus, collective welfare is increased because the creditors are better off than they would have been without the collective proceeding. In addition, in a competitive credit market, creditors will pass these savings on to debtors in the form of lower interest rates.¹³

B. *The Aberration of Consumer Bankruptcy Today*

1. *Debts Are Seldom Collected in Bankruptcy*

Changes in the structure of consumer credit in the last twenty-five years have rendered the assertions in the traditional theory of bankruptcy obsolete; the assertion that bankruptcy is primarily a debt-collection law is no longer true. In theory, a debtor’s assets may be sold to satisfy debts.¹⁴ However, consumer goods have very low liquidation values.¹⁵ When matched against the schedules of exempt items, there is seldom any value left for creditors.¹⁶ In fact, “95 percent of Chapter 7 bankruptcies are no-asset cases” (meaning that the debtor has no assets with liquidation values in excess of the exemptions) in which creditors receive nothing.¹⁷ This dismal collection rate explains why the

¹² *Id.* at 14; see also Omer Tene, *Revisiting the Creditors’ Bargain: The Entitlement to the Going Concern Surplus in Corporate Bankruptcy Reorganizations*, 19 BANKR. DEV. J. 287, 293 (2003) (asserting that “bankruptcy law generates a net gain for society if it prevents a debtor from selling its assets, where the going-concern value of the assets exceeds their piecemeal liquidation value”). Professor Tene is speaking of corporate reorganizations, not consumer bankruptcies.

¹³ See JACKSON, *supra* note 2, at 13; Richard M. Hynes, *Non-Procrustean Bankruptcy*, 2004 U. ILL. L. REV. 301, 336 (2004) (noting that “most economists would probably argue that the supply of consumer credit is extremely responsive to the rate of return, and therefore debtors will bear all of the costs of debt relief laws or reap all of the gain”).

¹⁴ See, e.g., 11 U.S.C.A. § 544(a) (West 2006); Lynn M. Lopucki, *Common Sense Consumer Bankruptcy*, 71 AM. BANKR. L.J. 461, 468 (1997). Advocates of the traditional theory assume that debtors’ assets are sold to satisfy debts. Professors Warren and Tyagi state,

The bankruptcy judge will supervise the case to ensure that creditors are repaid to the extent possible The courts take legal control over all his assets—the bank accounts, the house, the car—everything right down to Fluffy the cat and the old bike with a flat tire. The judge orders those assets to be liquidated and used to repay creditors to the extent possible.

ELIZABETH WARREN & AMELIA WARREN TYAGI, *THE TWO INCOME TRAP: WHY MIDDLE-CLASS MOTHERS AND FATHERS ARE GOING BROKE* 15–54, 75–76 (2003). This suggests that liquidation is regularly a part of bankruptcy filings.

¹⁵ Marianne B. Culhane & Michaela M. White, *But Can She Keep the Car? Some Thoughts on Collateral Retention in Consumer Chapter 7 Cases*, 7 FORDHAM J. CORP. & FIN. L. 471, 472 (2002).

¹⁶ § 522.

¹⁷ See Barry Adler, Ben Polak, & Alan Schwartz, *Regulating Consumer Bankruptcy: A Theoretical Inquiry*, 29 J. LEGAL STUD. 585, 598 n.24 (2000).

collective proceeding, known as the § 341 meeting of creditors, seldom has any creditors present at all.¹⁸

In fact, the availability of bankruptcy's automatic stay *prevents* any debt collection through state law. Garnishments, executions, and judicial proceedings that attempt to collect prepetition debts are prohibited.¹⁹ Despite Jackson's assertion that "[b]ankruptcy law, at its core, is debt-collection law," ninety-five percent of consumer bankruptcy cases do not collect any debts whatsoever.²⁰

2. *Insolvency Is Only Weakly Linked to Bankruptcy Rates*

Thomas's second assertion, that bankruptcy is primarily for insolvent debtors, is also tenuous. The link between bankruptcy and insolvency is weak because insolvency is of little worth in determining which consumer debtors are unable to pay their debts outside of bankruptcy.²¹ Insolvency is calculated by measuring the liquidation value of the debtor's assets minus her debts.²² However, the value of consumer debtors' unencumbered assets—primarily household goods—has very little to do with debtors' ability to pay debts in the normal course of affairs.²³ Debtors normally pay their debts from income, not

¹⁸ As an intern to the Hon. Richard L. Speer, bankruptcy judge for the Northern District of Ohio, I attended sessions of § 341 "meetings of creditors." During any given session, upwards of a hundred debtors and their paperwork moved very efficiently through, however not a single creditor ever attended. I would hypothesize that most creditors know that the likelihood of recovering anything in a consumer bankruptcy is so low as to make it not worth attending.

¹⁹ WILLIAM D. WARREN & DANIEL J. BUSSEL, *BANKRUPTCY* 23 (6th ed. 1999). The automatic stay bars the commencement or even the continuation of judicial proceedings against the debtor or even against property of the debtor, despite the fact that if a debt is secured, the debt will be largely unaffected by the discharge in bankruptcy. § 362; see *infra* notes 84–95 and accompanying text.

²⁰ JACKSON, *supra* note 2, at 3. The percentage of debts collected appears to agree with the number cited by Professors Adler, Polak, & Schwartz, *supra* note 17, at 598 n.24. According to the Congressional Budget Office, only five percent of claims in bankruptcy by states for tax revenue are collected. H.R. REP. NO. 109-31, 114 (2005).

²¹ Because of the discrepancy in measuring debtors' ability to pay, there is widespread disagreement over whether debtors who file for bankruptcy are able to pay their debts. For example, on signing the BAPCPA, President Bush said, "In recent years, too many people have abused the bankruptcy laws. They've walked away from debts even when they had the ability to repay them." Press Release, White House Press Office, *President Signs Bankruptcy Abuse Prevention, Consumer Protection Act*, Apr. 20, 2005, <http://www.whitehouse.gov/news/releases/2005/04/20050420-5.html>. Compare that with the sentiment expressed by Professors Elizabeth Warren and Amelia Warren Tyagi saying that debtors file "[b]ecause they believed they had no other choice . . . given the choice between losing their homes or filing for bankruptcy, they chose bankruptcy." WARREN & TYAGI, *supra* note 14, at 74.

²² See Todd J. Zywicki, *An Economic Analysis of the Consumer Bankruptcy Crisis*, 99 NW. U. L. REV. 1463, 1478 (2005).

²³ See *id.* at 1481.

asset liquidation. Because of the low liquidation value of used consumer goods, most consumers are likely to be insolvent the moment they enter into any credit transaction—insolvent but not unable to pay their debts.²⁴ That is why credit applications generally require disclosure of the applicant's income but do not request valuations of household furnishings.²⁵ Many consumers do not have significant liquid assets but live paycheck to paycheck.²⁶ Therefore, consumers who sign credit agreements are committing to pay a certain amount of income each period toward the satisfaction of the debt.

Modern consumer credit has changed to be even more income-oriented than in times past. Today, purchase money loans for consumer goods are less likely to be secured by goods and more likely to be related to the debtor's income and credit worthiness.²⁷ Information technology has made credit checks quick, affordable, and practical even for small lenders like one-building landlords.²⁸ Credit card companies that finance the purchase of goods through revolving open-ended credit accounts set individual credit limits based on the income, credit score, and transaction history of individual cardholders.²⁹ In addition, numerous purchases of small-ticket consumer goods, which immediately begin depreciating, make the transaction costs of perfecting security interests prohibitively high.³⁰

Because of the income-oriented nature of consumer credit, insolvency is not the best measure of financial distress leading to bankruptcy. Instead of insolvency, a more appropriate measure is the household debt service ratio, which measures the percentage of debtor's income each month that is dedicated to monthly debt payments.³¹

Finally, bankruptcy has no requirement that the debtor be insolvent to file; it is quite possible for a debtor to be fully solvent, file bankruptcy, and retain

²⁴ See WARREN & BUSSEL, *supra* note 19, at 46.

²⁵ See, e.g., Personal Financial Statement and Credit Application, 19–43 California Legal Forms—Transaction Guide § 43.201. Credit card applications are even more income-oriented than commercial loan applications. See, e.g., <http://www.citibank.com>, and follow the link to credit card, then the link to apply for a credit card (last visited Feb. 19, 2007).

²⁶ Senator John Kerry, *Senator John Kerry on Bankruptcy Reform*, AM. BANKR. INST. J. Aug. 2004, 6.

²⁷ Zywicki, *supra* note 22, at 1534–38.

²⁸ Julia R. Gordon, *Legal Services and the Digital Divide*, 12 ALB. L.J. SCI. & TECH. 809, 814 (2002).

²⁹ See *Credit Report Accuracy and Access to Credit*, Federal Reserve Bulletin, June 22, 2004, at 297; see also WARREN & BUSSEL, *supra* note 19, at 46 (noting that consumers rely primarily on their earning capacity to finance the purchase of small-ticket consumer goods).

³⁰ See WARREN & BUSSEL, *supra* note 19, at 46.

³¹ Zywicki, *supra* note 22, at 1479.

all or most of her assets. Recent measurements of household net worth show that just over thirty percent of households had a net worth under \$10,000—a figure which, depending upon the allocation of assets, will fit quite neatly under the exemptions in bankruptcy.³² This is convenient for most debtors, their attorneys, bankruptcy trustees, and courts because it disposes of the case quickly and efficiently without any messy sale of assets.³³ Perhaps as a result of the obvious incentives to all parties involved (except the creditors), the number of no-asset cases increased from 65% in 1976 to 95% of cases in 2005.³⁴

3. *Bankruptcy May Not Enhance Creditor or Debtor Welfare*

The third assertion—that bankruptcy is, in principle, welfare-enhancing—is undercut by the lack of substantial debt collection in consumer bankruptcy today. Recall the hypothetical debtor who owned the printing press posited by Professor Jackson.³⁵ Allowing the debtor to continue in possession of the asset might produce a going-concern surplus for creditors.³⁶ Yet today, there is no mechanism in the Code that determines whether the going-concern surplus is greater than the liquidation value, except, perhaps, the debtor's own choice of chapter 13 repayment over chapter 7 liquidation.³⁷

Professor Jackson also uses the hypothetical to aver that, in the cases when it is better to liquidate, the orderly distribution provides a net benefit for creditors.³⁸ However, as discussed previously, orderly distribution and sale do

³² Economic Policy Institute, Facts and Figures-State of Working America 2004/2005 1, available at http://www.epinet.org/books/swa2004/news/swafacts_wealth.pdf; see also HOWARD KARGER, SHORTCHANGED, LIFE AND DEBT IN THE FRINGE ECONOMY 18 (Barrett-Koehler Publishers 2005) (noting that 40% of all white children and 73% of all African-American children live in a household with zero or negative net worth).

³³ Lopucki, *supra* note 14, at 468 (noting the overwhelming incentives for debtors' attorneys to make sure that their cases are no-asset cases and the very weak incentives for the trustee or court to investigate for fraud).

³⁴ *Id.*; Adler, Polak, & Schwartz, *supra* note 17, at 613 n.24.

³⁵ JACKSON, *supra* note 2, at 13–16.

³⁶ *Id.* at 13.

³⁷ There may be a colorable argument that the tests of § 1325 (best interest of creditor and best efforts of debtor) are meant to discern which estates are worth more liquidated than operating. However, the connection is weak at best. Consumer goods generally are not being salvaged because they are not income-producing. Instead, the debtor is making a determination of whether it would be better to repay in part or receive a discharge now based on the amount of nonexempt property and her current income. 11 U.S.C.A. § 1325 (West 2006).

³⁸ JACKSON, *supra* note 2, at 13.

not occur in ninety-five percent of cases.³⁹ The collective proceeding which might have prevented piecemeal sales of assets that might devalue the estate seldom happens because creditors know there is unlikely to be any distribution at all. The result is that there is no benefit to creditors.

Professor Jackson suggests two possible alternative justifications for the bankruptcy proceeding. When addressing the fresh-start policy, he first suggests that creditors may be the superior risk-bearers.⁴⁰ After all, they have the ability to spread their risks over numerous debtors and can diversify their investments by risk profile. Debtors, on the other hand, usually have only human capital which is not easily diversified.⁴¹ Yet individual borrowing decisions and control over other financial decisions are mostly within control of debtors.⁴² In addition, there is evidence that creditors do not diversify their investments by risk profile, preferring instead to place similar risks together and charge accordingly, effectively casting the risk right back onto the borrower.⁴³ The evidence about which party is the better risk-bearer is at best unclear.⁴⁴

Second, Professor Jackson argues that the prospect of a fresh start through bankruptcy reduces the moral hazard of reliance on social programs or, vice-versa, the existence of social programs reduces the moral hazard of bankruptcy.⁴⁵ While this may be true, it does not provide any useful vindication of bankruptcy as welfare-enhancing. Any reduction of moral hazard in one program will coincide with a commensurate increase in the other. In addition, there is an additional moral hazard in collecting under both bankruptcy and other social programs because, unlike many other welfare programs, there is no mechanism preventing collection under both systems.⁴⁶ The usefulness of bankruptcy as a mechanism for reducing moral hazard is at best indeterminate and could very well increase moral hazard overall. As such, it provides no independent justification for the fresh start in bankruptcy.

³⁹ Adler, Polak, & Schwartz, *supra* note 17, at 613 n.24.

⁴⁰ JACKSON, *supra* note 2, at 229.

⁴¹ *Id.* at 230.

⁴² *Id.* at 229.

⁴³ See Hynes, *supra* note 13, at 336, 337.

⁴⁴ JACKSON, *supra* note 2, at 229.

⁴⁵ *Id.* at 230–31.

⁴⁶ For a discussion of overlapping benefits between social programs and bankruptcy relief, see *infra* Part III.C.

How then, do we justify the system of debt discharge for consumers? Professor Jackson writes: “The policy relating to discharge and notions of a fresh start does in fact represent an independent substantive policy”⁴⁷ This fresh-start principle, he asserts, overrides or provides a limitation on the debt-collection (and welfare-increasing) aspect of bankruptcy law, but only in the case of individuals, not corporations.⁴⁸ In fact, the public no longer perceives bankruptcy law as debt collection but as a part of the social safety net.⁴⁹ Apparently, the justifications that equitable distribution and going-concern surplus in bankruptcy are welfare-enhancing apply primarily to corporations, whereas concerns about a fresh start override welfare concerns when dealing with debtors who are human beings.⁵⁰ But should not the justifications for bankruptcy law be welfare-increasing for individuals, not just corporations? If anything, policy-makers should be *more* concerned with the welfare of individuals than that of corporations.

The remaining justification for prioritizing the fresh start over consumer welfare, then, must be that our notions of consumer welfare must be tempered by compassion for the “honest but unfortunate debtor.”⁵¹ The honest debtor is one who, through unfortunate circumstances, is involuntarily in bankruptcy, although she otherwise would intend to pay her debts. This notion is heavily dependant on bankruptcy as an involuntary act—a form of social aid only used as a last resort, the ignominy of which mutes any concerns about moral hazard.⁵² Yet, as discussed in Part III, it is by no means clear that bankruptcy is involuntary or even ignominious.

⁴⁷ JACKSON, *supra* note 2, at 4.

⁴⁸ *Id.* at 4.

⁴⁹ The President, in signing comprehensive bankruptcy reform recognized the public perception of bankruptcy as primarily a relief mechanism: “Our bankruptcy laws are an important part of the safety net of America. They give those who cannot pay their debts a fresh start.” Statement of President Bush on Signing the Bankruptcy Abuse Prevention Consumer Protection Act of 2005, Press Release, White House Press Office, *President Signs Bankruptcy Abuse Prevention, Consumer Protection Act*, Apr. 20, 2005, <http://www.whitehouse.gov/news/releases/2005/04/20050420-5.html>.

⁵⁰ JACKSON, *supra* note 2, at 4.

⁵¹ *Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934).

⁵² Zywicki, *supra* note 22, at 1464.

II. VOLUNTARY VERSUS INVOLUNTARY BANKRUPTCY

A. *Traditional Theory: Bankruptcy as an Involuntary Act*

The traditional theory holds that bankruptcy is a result of household financial distress, a harbor of last resort, the shame of which renders it an essentially involuntary act.⁵³ Increases in the per capita rate of bankruptcy in the United States are roughly correlated to increased financial distress.⁵⁴ Thus, the rate of personal bankruptcy increased during periods such as the Great Depression when unemployment was higher. Scholars had no reason to question the descriptive accuracy of the traditional model for most of the Twentieth Century, in large part, because it provided what appeared to be an accurate description of reality.⁵⁵

The traditional model, however, has been unable to satisfactorily explain the dramatic rise in personal bankruptcy in the past twenty-five years—a period of relative economic prosperity. The rate of consumer bankruptcy filings in the United States increased steadily from 250,000 in 1979 to over 1.5 million per year in 2005, or 500% per capita.⁵⁶ Individual bankrupts are also increasingly likely to be middle-class rather than poor.⁵⁷ Adherents to the traditional theory have struggled to explain why bankruptcy among the middle class should increase dramatically during a period of economic prosperity.⁵⁸

B. *Variations on the Traditional Theory*

In response, several variations on the orthodoxy have arisen. One popular theory holds that despite a stable economic environment, Americans in the middle class are living beyond their means by overspending on frivolities.⁵⁹

⁵³ *Id.*; WARREN & TYAGI, *supra* note 14, at 74 (arguing that debtors file only because they believe they have no other choice and that stigma associated with bankruptcy is alive and well); accord Barry E. Adler, *The Law of Last Resort*, 55 VAND. L. REV. 1661, 1661 (2002) (“A financially distressed individual or corporation employs the bankruptcy process only as a last resort.”).

⁵⁴ Zywicki, *supra* note 22, at 1466.

⁵⁵ *Id.*

⁵⁶ *Id.* at 1464.

⁵⁷ See WARREN & TYAGI, *supra* note 14, at 5–7.

⁵⁸ Zywicki, *supra* note 22, at 1464 (calling 1980 to 2005 “an era of unprecedented economic prosperity—low unemployment, low interest rates, and a roaring stock market”).

⁵⁹ JOHN DE GRAAF, DAVID WANN, & THOMAS H. NAYLOR, AFFLUENZA, THE ALL-CONSUMING EPIDEMIC (2002) [hereinafter “AFFLUENZA”] (connecting low prices, high employment, consumer spending, spiraling debt, and high bankruptcy rates); though the “affluenza” idea is socially popular, at least one academic view dismisses it as myth. WARREN & TYAGI, *supra* note 14, at 15–54. Warren and Tyagi suggest that the myth is

Americans, the theory goes, are suffering from “affluenza,” a collective lack of willpower resulting in overconsumption and eventual financial ruin.⁶⁰ When the bills finally come due, the household, unable to cope with its enormous debt burden, is forced into bankruptcy.

Though dismissive of this “theory of irresponsibility,” stalwarts of the traditional theory such as Professors Warren and Tyagi maintain that bankruptcy is still an involuntary expediency of last resort.⁶¹ Instead of overconsumption, the reason for the incredible rise in bankruptcy in a period of perceived economic prosperity is the reduced resiliency of the modern two-income family.⁶² Financial shocks like catastrophic medical bills or sudden unemployment more easily sink a family when it has less capacity to augment its income.⁶³ Families are less able to absorb these shocks than in the past because they have more income committed to fixed expenses than in times past.⁶⁴ Fixed expenses are higher because two-income households are engaging in “bidding wars” in the middle class for housing in good neighborhoods, good education, and other expediencies.⁶⁵

C. *A New Economic Theory of Bankruptcy*

Others, however, are skeptical that the level of household financial distress has really increased concurrent with the rise in consumer bankruptcy. Professor Thomas J. Zywicki evaluates the claims by Professor Warren and others that medical bills or unemployment or other oft-cited factors or combination of factors related to household financial distress could be

popular because we regularly see conspicuous consumption and it is but a small leap to assume that those who have it and flaunt it are probably overspending. She dismisses this by showing that the average household spends less today than it did in the past on many items, including food, dining out, clothing, and entertainment. Nevertheless, “affluenza” is remarkably current in the popular mind, having entered the popular lexicon and has even spawned a television series. AFFLUENZA, *supra* note 59, at ix. It has even spawned a self-help industry. See, e.g., JOANNE DAVIS, THE BEST THINGS IN LIFE AREN'T THINGS: CELEBRATING WHAT MATTERS MOST (2003).

⁶⁰ AFFLUENZA, *supra* note 59, at 20–21.

⁶¹ See, e.g., WARREN & TYAGI, *supra* note 14, at 25–28 (equating bankruptcy rates with household economic failure and noting correlation to high debt burdens, but not individuals electing to avail themselves of bankruptcy). Professors Warren and Tyagi spend a chapter dismissing what they call “[t]he myth of the immoral debtor,” which they define as people who voluntarily decide to take the easy way by not paying their debts. *Id.* at 71–96.

⁶² *Id.* at 81–89.

⁶³ *Id.*

⁶⁴ *Id.*

⁶⁵ *Id.* at 8–9.

responsible for the rise in bankruptcy.⁶⁶ Instead, Professor Zywicki argues, Americans have a growing propensity to turn to bankruptcy because legal, social, and economic changes have made it increasingly beneficial for them to do so.⁶⁷ In other words, having done the math, filing for bankruptcy simply makes good economic sense.⁶⁸ Filing makes sense because the costs of filing bankruptcy are dramatically lower than in the past due to more efficient processes, easy postbankruptcy credit, and decreased social costs.⁶⁹ At the same time, the benefits of filing bankruptcy are higher than ever before, including generous exemptions, an automatic stay of collection activities, and discharge of a proportionately larger amount of debt.⁷⁰ Incredibly, an estimated seventeen percent of *all* households would benefit financially from filing bankruptcy, although many do not file.⁷¹ Reacting to these attractive incentives, an increasing number of debtors are choosing bankruptcy discharge over long-term debt repayment.⁷²

D. Policy Implications of Voluntary Bankruptcy

Voluntary bankruptcy may occupy a different role than involuntary bankruptcy in broader social policy. Traditional theory viewed involuntary bankruptcy as separate from the administrable mix of social relief programs. Under this view, the rate of bankruptcy is merely a proxy statistic reflecting economic distress. Because bankruptcy is involuntary, only those in distress

⁶⁶ Zywicki, *supra* note 22, at 1479–1524.

⁶⁷ See generally *id.* Professor Zywicki makes a clear distinction that is lacking in much of the literature. He distinguishes between bankruptcy, the condition in which a household is financially beyond the ability to pay its debts, and bankruptcy, a method of discharging debts to provide relief. By failing to differentiate the two, much of the literature based on the traditional “involuntary” theory of bankruptcy conflates the separate questions of how families get into financial distress and how families get out of financial distress. *Id.* at 1526.

⁶⁸ *Id.*

⁶⁹ The social cost of bankruptcy, in particular, has been lowered dramatically. In times past, creditors and debtors often had personal relationships, lived in the same town and would be likely to engage in business in the future. Today, most creditors are faceless credit card corporations and the like located in Delaware or South Dakota. *Id.* at 1535. The perceived moral cost of discharging debt against a corporation is lower. In addition, debtors are often easily able to secure equivalent credit following a bankruptcy, reducing what was seen as one of the primary costs of bankruptcy in times past—damage to one’s credit. *Id.* at 1531. Professor Zywicki also points out that the cost of asset liquidation which traditionally accompanied bankruptcy in times past, depending upon an individual state’s exemption laws, may be zero. *Id.* at 1528. In 2004, ninety-five percent of consumer bankruptcy filings were no-asset, meaning that the debtor’s assets were completely under the exemptions making the cost of asset surrender zero. Adler, Polak, & Schwartz, *supra* note 17, at 613 n.24.

⁷⁰ Household debt has shifted away from secured credit which is nondischargeable in bankruptcy to unsecured personal lines of credit which is dischargeable in bankruptcy. Zywicki, *supra* note 22, at 1527–34.

⁷¹ WARREN & TYAGI, *supra* note 14, at 73.

⁷² Zywicki, *supra* note 22, at 1463.

who fall through the safety net of other social programs will file. As a result, moderate adjustments in incentives such as property exemptions will not significantly increase or decrease the rate of filing but only inflict hardship. Moreover, if the underlying cause of bankruptcy is household economic distress, the proper policy would be to address the causes of economic distress such as excessive medical costs and unemployment.⁷³

Because involuntary bankruptcy is perceived to be immutable unless underlying causes are addressed, social welfare policy-makers generally have not addressed or advocated changes to the bankruptcy system.⁷⁴ Social welfare scholars and bankruptcy scholars have largely ignored one another.⁷⁵ In the end, discussing the merits of bankruptcy vis-à-vis other relief mechanisms was considered interesting but not useful because the rate of bankruptcy would be dictated by financial conditions, not policy-makers' choices.

Yet policy-makers long have sought for the right mix of other social programs by comparing program costs, moral hazards, and effects on credit and labor markets.⁷⁶ And, if Professor Zywicki is correct and the marginal costs of filing bankruptcy have fallen far enough to make it an elective form of relief, policy-makers may be able to adjust the amount of bankruptcy by adjusting incentives.⁷⁷ Scholars of social welfare and bankruptcy should be comparing bankruptcy to other programs in the social safety net.

⁷³ Traditional theory tends to focus on national unemployment insurance, high costs of health care, and housing and mechanisms to cushion financial distress for financially vulnerable households. See, e.g., WARREN & TYAGI, *supra* note 14, at 81–95.

⁷⁴ Adam Feibelman, *Defining the Social Insurance Function of Consumer Bankruptcy*, 13 AM. BANKR. INST. L. REV. 129, 131–33 (2005).

⁷⁵ *Id.* at 132.

⁷⁶ *Id.* at 133. Professor Feibelman refers to social programs in two groups—social insurance programs and social assistance programs. The former refers to programs in which the beneficiaries bear the cost of the benefit collectively while the latter refers to programs funded through other means, such as taxpayer funds. Bankruptcy more neatly fits into the social insurance category. *Id.* at 138–39. These programs collectively form what this Article will call the social safety net. Though private charities and religious organizations can be included they form no part of the discussion in this Article.

⁷⁷ For example, there is some evidence that the number of bankruptcy filings is higher in states with more generous property exemptions. Zywicki, *supra* note 22, at 1529. The traditional theorist's insistence that bankruptcy is an involuntary act may be restated thus: the associated costs of filing bankruptcy are so high that no one will file unless forced to file. The costs may be social (I will not file because I cannot face my creditors, friends, etc.), personal (I will not file because of my integrity in contract or religious belief), or economic (I will not file because I will lose my property, have to pay a lawyer, etc.). The effective refutation of Professor Zywicki's argument would show some combination of costs (especially social) is still high enough to prevent anyone from filing until "forced" by some exogenous factor such as a foreclosure. There has been very little empirical research into the perceived social costs of bankruptcy or whether or not an exogenous event immediately precedes a high number of bankruptcies. *Id.* at 1527–29.

The comparison will aid policy-makers who wish to provide compassionate, effective relief. Part III of this Article will compare relief through debt discharge in bankruptcy with other programs forming the social safety net including food stamps, disability insurance, and unemployment insurance. Disability and unemployment are especially relevant because of the assertion by the traditional theorists that bankruptcy is caused, in many cases, by income interruption concurrent with disability and medical bills.⁷⁸ Policy-makers have an interest in making these programs interact to provide the most effective relief.

III. THE MERITS OF BANKRUPTCY VIS-À-VIS OTHER RELIEF MECHANISMS

This Part will look at four aspects of bankruptcy relief as compared to other programs to judge their impact on consumer welfare. First, collection (who pays for the relief), second, distribution (who gets the relief and how much), third, coverage (gaps and overlap), and fourth, moral hazards (possible perverse incentives). If, by these criteria, bankruptcy is a welfare-enhancing form of relief, the increase in bankruptcy filings should not discomfit policy-makers or the public. On the contrary, relief through debt discharge should be encouraged in the same way needy families are encouraged to sign up for food stamps and Head Start. If, on the other hand, it is not welfare-enhancing, policy-makers may be justified in limiting access to bankruptcy, especially if other programs can be fashioned to provide superior relief.⁷⁹

A. Collection

A redistributive social program is called progressive if it transfers wealth from rich to poor.⁸⁰ These types of programs may enhance equity or fairness.⁸¹ A prime example is the Earned Income Tax Credit (“EITC”).⁸² In 2002, the EITC distributed more than thirty billion dollars in refundable tax credits to twenty million low-income taxpayers.⁸³

⁷⁸ See, e.g., WARREN & TYAGI, *supra* note 14, at 81–84.

⁷⁹ Feibelman, *supra* note 74, at 132.

⁸⁰ Hynes, *supra* note 13, at 352.

⁸¹ *Id.* at 352.

⁸² KARGER, *supra* note 32, at 81. Professor Karger, at least, is in favor of the program calling it “the nation’s largest and probably most effective anti-poverty program.” *Id.* at 14–15.

⁸³ *Id.*

1. *Collection in Bankruptcy*

Bankruptcy also transfers wealth among members of society.⁸⁴ At first glance, the source of wealth transferred from bankruptcy appears to be ideally progressive. Large corporate creditors in the lending industry whose credit assets are erased in a bankruptcy appear to be ideal donors. Profits in the lending sector have been remarkable over the last twenty-five years and these for-profit corporations could justifiably be called upon to support those on whose backs they make their money.⁸⁵ In addition, other than the administrative costs of courts, debt forgiveness does not require the expenditure of funds from public coffers (because the government does not compensate creditors for the erased debts). This seems especially convenient at a time when both public funds and sympathy for “welfare programs” are at low ebb.⁸⁶ Robin-Hood-like, bankruptcy appears ideally to take from the rich and give to the poor.

A closer inspection of the money flow, however, reveals that corporations are not necessarily the ultimate source of the wealth transfer in bankruptcy relief. Voluntary creditors (credit card companies as opposed to tort creditors) make money through interest payments and fees.⁸⁷ The lending industry is savvy enough to recognize that a certain percentage of the loans it makes will not be repaid and it compensates for this by charging interest and fees

⁸⁴ The “transfer” of funds in bankruptcy occurs when a debtor’s balance with a creditor is “erased.” Unlike direct welfare relief, in which a distressed individual or family is given money or food stamps ex ante to provide needed goods, bankruptcy effects a transfer ex post to erase the debt for goods and services already purchased. Debt discharge in bankruptcy is not actually an obliteration of the debt. Rather, the debtor is absolved of personal liability for that debt. 11 U.S.C.A. § 524(e) (West 2006). Most of the time, this has the effect of “erasing” an individual’s debts. The analytical difference becomes important in real life primarily when the debt is guaranteed (e.g., by a co-signer or surety) or the debt is secured by collateral. Though the debtor is no longer personally liable for that debt (meaning that the debtor cannot be sued and personal judgment brought), the creditor may still use the guaranty or collateral to satisfy the debt. Section 524(e) reads, “discharge of a debt of the debtor does not affect the liability of any other entity on, or the property of any other entity for, such debt.” *Id.*

⁸⁵ KARGER, *supra* note 32, at 9–12.

⁸⁶ See, e.g., CHAMPIONS OF FREEDOM: AMERICAN PERESTROIKA THE DEMISE OF THE WELFARE STATE (Richard M. Ebeling, Lissa Roche, & Lorna Busch eds., Hillsdale College Press, 1995).

⁸⁷ The major exception are small businesses that provide goods and services but do not have a sophisticated credit scoring apparatus to differentiate credit terms for individual customers. This includes the child care center that bills monthly, the doctor, dentist, mechanic, or clinic that allows you to pay over a year’s time. These types of businesses must charge more for services across the board knowing that a certain number of their customers will not pay. Those that do business with a higher risk clientele (i.e., the poor) must offset defaults by charging higher prices. Higher risk customers pay more. KARGER, *supra* note 32, at xii. Tort creditors, who are involuntary creditors, do not have a mechanism for adjusting to default rates. See JACKSON, *supra* note 2, at 8.

according to the risk of the loan.⁸⁸ Lending instruments run the gamut from fully-secured commercial loans to credit cards to payday loan companies all the way to gambling advances from usurious mafia types.⁸⁹ Lending institutions differentiate debtors by their creditworthiness.⁹⁰ Creditworthiness is a rough approximation of wealth.⁹¹ The poor, as measured by income and assets, pay more for credit.⁹² In effect, the poor pay the cost of their own bankruptcy discharge in proportion to their poverty.⁹³

Viewed from this perspective, bankruptcy discharge is essentially a regressive tax that is levied disproportionately on the poor. This view seems fair because it is precisely those borrowers who are less likely to pay their debts who pay the costs of discharge. Here is another fallacy, but even more disturbing: unlike insurance, in which all those insured pay the premium,⁹⁴ those who do not pay their debts also do not pay the exorbitant interest rates and fees. Bankruptcy does not have a mandatory percentage of debt that must have been paid before a discharge is given. The “premium,” in the form of a higher interest rate, is only paid by those among the poor *who pay their debts*, even though they are charged a disproportionately high rate for credit. Thus, bankruptcy discharge is regressive because it transfers money from the poor actually paying expensive debts to the poor who do not or cannot pay their debts. As one scholar succinctly summarizes, “[T]he competitive nature of lending markets ensures that these losses will only be spread across debtors who present similar risks [D]ebt relief laws are unlikely to shift wealth

⁸⁸ Feibelman, *supra* note 74, at 130, 171; *see also* JACKSON, *supra* note 2, at 13.

⁸⁹ *See* KARGER, *supra* note 32, at 5–15.

⁹⁰ *See* Hynes, *supra* note 13, at 336.

⁹¹ *See* Ralph C. Clontz, Jr., Equal Credit Opportunity Manual P. 1.05 [1-19] (3d ed. 1979). The Manual defines creditworthiness as “a function of both the applicant’s willingness and ability to pay the debt, and the creditor’s rights and remedies with respect to property available for debt payment.” Because a debtor’s property (for execution) or income (for garnishment) may be used to satisfy a debt, creditworthiness is roughly a measure of the debtor’s property and income.

⁹² Some counter the assertion that high rates really reflect the rate of default in sub-prime lending. If the market is functioning properly, there is no reason that competition among sub-prime lenders should not keep rates at or near the cost of borrowing plus reasonable profit as in other credit markets. Several facts help assure that the market in sub-prime lending is, indeed, functioning: First, sub-prime lenders are increasingly dominated by corporate arms of mainstream banks like Citygroup and Wells Fargo. KARGER, *supra* note 32, at 14–15. Second, sub-prime lenders are not all making money hand-over-fist and some have actually been in shaky financial condition themselves, suggesting a competitive market. *See id.* at 8.

⁹³ As mentioned above, the major exception to graduated interest rates is involuntary creditors, who cannot differentiate among borrowers by their creditworthiness. Involuntary credit obligations, however, are a very small percentage of debts discharged in bankruptcy. Hynes, *supra* note 13, at 333–34.

⁹⁴ *See* Feibelman, *supra* note 74, at 135–37. Whether or not a debtor eventually files for bankruptcy protection, a debtor pays a premium for the potential availability of bankruptcy discharge. *Id.* at 142.

between rich and poor debtors.”⁹⁵ Thus, the debt discharge for the poor is paid by the poor.

2. *Collection in Other Social Relief Programs*

Collection for other forms of social relief and insurance varies but none approach the regressive scheme in bankruptcy. The federal food stamps program, like most direct forms of relief, is paid from tax revenues.⁹⁶ Federal tax revenues are collected primarily from progressive income taxes, at higher rates for those with higher incomes.⁹⁷

Unemployment insurance is paid through taxes levied on employers.⁹⁸ This cost may be absorbed in lower profits by the employer, passed on to consumers in the form of higher prices, or passed on to employees in the form of lower wages or fewer employees hired.⁹⁹ This is similar to bankruptcy in that some or all of the cost of the benefit is borne by the intended beneficiaries. The rate paid by the employer varies with the employer’s risk of layoffs.¹⁰⁰ Here again, it is similar to bankruptcy in that higher risks result in higher premiums. However, employment in a higher risk occupation may or may not reflect beneficiary wealth: some in high-risk occupations may earn high incomes and some in low-risk occupations may earn low incomes. Conversely, risk in bankruptcy, as discussed above, is a proxy for poverty. Finally, unlike interest rates which are effectively unlimited and specific to each borrower or class of borrowers,¹⁰¹ each state imposes maximum unemployment insurance rates.¹⁰² The difference between premium and cost must be made up through broad collection from lower-risk employers.¹⁰³

⁹⁵ Hynes, *supra* note 13, at 336.

⁹⁶ United States Department of Agriculture (“USDA”), Food and Nutrition Service, About Food and Nutrition Services, March 15, 2007, <http://www.fns.usda.gov/fns/about.htm>. In 2005, the USDA’s food stamp program distributed over \$28 billion in food stamps at a cost of just over \$31 billion. USDA, Food Stamp Program Participation and Costs, March 15, 2007, <http://www.fns.usda.gov/pd/fssummar.htm>.

⁹⁷ Edward J. McCaffery & Jonathan Baron, *Rethinking Redistribution: Tax Policy in an Era of Rising Inequality*, 52 UCLA L. REV. 1745, 1763 (2005).

⁹⁸ Feibelman, *supra* note 74, at 147.

⁹⁹ *Id.*

¹⁰⁰ *Id.*

¹⁰¹ Hynes, *supra* note 13, at 336.

¹⁰² See Feibelman, *supra* note 74, at 135–37.

¹⁰³ TOM BAKER, INSURANCE LAW AND POLICY 6 (2003) (noting that mandatory insurance does not allow low-risk individuals to opt out of the pool causing them to subsidize higher risks).

The Social Security Disability Insurance premiums are collected progressively, as a percentage of earnings of workers paying into the system.¹⁰⁴ The tax is 1.7% of covered earnings up to a maximum; those who earn more, pay more.¹⁰⁵ Of these various forms of relief, only bankruptcy appears to collect money in inverse proportion to the payee's wealth.

B. Distribution

1. Distribution in Bankruptcy

Even if collection is regressive, the bankruptcy discharge may still be desirable as insurance of last resort for the poor. Bankruptcy discharge may function as the backstop of the frayed social safety net¹⁰⁶ in which the poor receive relief in proportion to their poverty. The traditional theory holds that debtors only file bankruptcy as a last alternative.¹⁰⁷ If a debtor had sufficient income or property to satisfy her debts, the logic goes, she would not file for bankruptcy. Therefore, those filing for bankruptcy—those without assets or income—really are the poorest of the poor. From this perspective, bankruptcy aid seems properly targeted to the poorest and most desperate.

Yet bankruptcy distributes more to those who have or have recently had higher income than to those who have lower or no income.¹⁰⁸ Bankruptcy relief distribution does not take the form of fund transfer but works by eliminating consumer debts.¹⁰⁹ Consumers' credit limits are roughly

¹⁰⁴ See Feibelman, *supra* note 74, at 151.

¹⁰⁵ *Id.*

¹⁰⁶ Elizabeth Warren, *The New Economics of the American Family*, 12 AM. BANKR. INST. L. REV. 1, 2, 38 (2004).

¹⁰⁷ WARREN & TYAGI, *supra* note 14, at 74. Professor Warren argues that bankruptcy is so undesirable that it could not possibly be a voluntary act. She emphasizes the social stigma associated with bankruptcy and also notes that the debtor's assets are sold to pay creditors. She fails, however, to note that 95% of bankruptcy cases are "no-asset" filings because the liquidation value of most household goods are too low to bother with a sale and fall under the exemptions, wherever they may be. Adler, Polak, & Schwartz, *supra* note 17, at 613 n.24. Bankruptcy attorneys are astute enough to make sure that, in most cases, debtors' assets will always fit under the exemptions and there are incentives in the Code to make them fit under the exemptions. Lopucki, *supra* note 14, at 468. Therefore, asset liquidation is not likely a disincentive (cost) of filing bankruptcy for most debtors simply because it does not apply to 95% of cases filed.

¹⁰⁸ This assertion is well-documented though not widely the subject of much outrage. See, e.g., Hynes, *supra* note 13 (defending the inequality of the bankruptcy laws and exemptions on the grounds that private systems allow for inequality and there is no reason for government to force all to reduce to the same standard of living); see also Adler, Polak, & Schwartz, *supra* note 17, at 598 ("[t]he inefficiency cost of high exemption levels likely is hardest on relatively poor consumers").

¹⁰⁹ See *supra* notes 84–95 and accompanying text.

proportional to their incomes; those who have higher incomes are able to borrow more and carry a higher debt load.¹¹⁰ When debts are discharged through bankruptcy, those who borrowed more are forgiven of more debt and thus are given a larger benefit.¹¹¹ In fact, those who are too poor to be able to receive goods or services on credit or who are forced by their poor credit ratings to offer collateral will not be helped significantly by filing.¹¹²

Property exemptions in bankruptcy also favor the wealthy over the poor because the wealthy are more likely to have property to exempt.¹¹³ Compare, for example, two debtors, one a middle-class homeowner and the other a poor renter. The middle-class debtor owns \$8000 in home furnishings, appliances, and clothes plus a home with \$15,000 in equity. The poor renter only has \$2000 in home furnishings, appliances, and clothes, and no home equity. Under the federal exemptions of § 522(d), the middle-class debtor's home equity and all \$8000 in furnishings, appliances, and clothes will survive the bankruptcy.¹¹⁴ The poor renter will not be able to claim a homestead exemption because she has no home but her more meager \$2000 in furnishings will be exempted.¹¹⁵ Because money is fungible and may be allocated from income to debt to expenses somewhat freely, the middle-class debtor will be able to salvage a large portion of her prebankruptcy earnings by putting them

¹¹⁰ See Clontz, *supra* note 91.

¹¹¹ A counter point to this might be that, regardless of income, all debtors at the end of bankruptcy have an equal zero balance on their credit accounts. But the larger amount of credit that was given to the debtor with the higher income will be useful *ex ante* to purchase goods and services. Moreover, the value of these goods and services may endure through the bankruptcy and, because of low liquidation values, be easily exempted. As an example, consider household furniture. It has very low liquidation value but may be very useful to the debtor who purchased it. The debtor who had the higher income and was able to purchase more or better furniture will be better off, though the liquidation value of both will be too low to sell in a consumer bankruptcy. See *infra* Part III.B.

¹¹² Feibelman, *supra* note 74, at 143 ("If an individual is unable to borrow money or is unable to secure the necessary goods and service on credit, then bankruptcy provides little or no immediate benefit or protection; such an individual may not be able to secure necessities in the first place without other forms of social assistance or social insurance."). A debtor forced to use collateral to secure a debt will receive no benefit from filing bankruptcy. See *supra* note 84.

¹¹³ Zywicki, *supra* note 22, at 1533.

¹¹⁴ The amount of equity allowed under the homestead exemption varies by state because § 522(a)(2) allows states to substitute their own exemptions for the federal slate. Some states, including Florida and Texas, have an unlimited homestead exemption, creating an incentive to build up equity in the house prior to bankruptcy. *E.g.*, FLA. STAT. CONST. Art. 10 § 4 (1995). Others have very limited exemptions such as the \$5000 Ohio homestead exemption. OHIO REV. CODE ANN. § 2329.66 (A)(1)(b) (2006).

¹¹⁵ If states allow the federal exemptions, the federal homestead exemption is \$18,450. 11 U.S.C. § 522(d)(1) (2000). The household furnishings may be exempted up to \$9850. *Id.* § 522(d)(3).

into home equity.¹¹⁶ This type of prebankruptcy planning has been expressly allowed in case law.¹¹⁷ Similar benefits may be obtained by the wealthy through exemption of retirement accounts and other assets of which, by definition, the wealthy will possess more.¹¹⁸ Finally, financially sophisticated debtors are more likely to avail themselves of financial planning and legal professional help which will further their relative advantage through planning.¹¹⁹ Thus, bankruptcy is providing relief disproportionately to debtors with more substantial means.

2. *Distribution in Other Social Relief Programs*

Unlike the pre-BAPCPA bankruptcy eligibility, distribution of food stamps is subject to stringent means testing. This program and other direct welfare including the EITC and Medicaid have stringent means tests making them available only to those at or below the poverty line.¹²⁰ The resource and income maximums are severe, excluding all but the neediest households.¹²¹ The level of benefits in each of these programs is tied to needs based on the number of family members.¹²²

¹¹⁶ Karen Gross, *The Debtor As Modern Day Peon: A Problem of Unconstitutional Conditions*, 65 NOTRE DAME L. REV. 165, 204 (1990).

¹¹⁷ See, e.g., *Hanson v. First Nat'l Bank in Brookings*, 848 F.2d 866, 868 (8th Cir. 1988) ("It is well established that under the Code, a debtor's conversion of non-exempt property to exempt property on the eve of bankruptcy for the express purpose of placing that property beyond the reach of creditors, without more, will not deprive the debtor of the exemption to which he will otherwise would be entitled.") (citations omitted).

¹¹⁸ The BAPCPA created an unlimited retirement account exemption. 11 U.S.C.A. § 522(b)(4) (West 2005).

¹¹⁹ See Elizabeth Warren, *Reforming Consumer Bankruptcy Law: Four Proposal: A Principled Approach to Consumer Bankruptcy*, 71 AM. BANKR. L.J. 483, 495 (1997) (noting that sophisticated debtors or those who can hire sophisticated professionals can fare significantly better in the very complex system of consumer bankruptcy). Even good-faith attempts to restrict prebankruptcy planning may only exacerbate this knowledge deficit and its results. Juliet M. Moringiello, *Distinguishing Hogs From Pigs: A Proposal for a Preference Approach to Pre-Bankruptcy Planning*, 6 AM. BANKR. INST. L. REV. 103, 139 (1998) (noting that even good-faith attempts to restrict prebankruptcy planning and asset conversion inevitably favor more sophisticated debtors over less sophisticated debtors).

¹²⁰ Warren, *supra* note 106, at 2.

¹²¹ To be eligible for federal food aid, households must have less than \$2000 in countable resources such as a bank account, must not own an automobile worth more than \$4650 or have monthly income in excess of \$1037 (adjusted up approximately \$350 per additional person in household). USDA Food and Nutrition Service: Fact Sheet on Resources, Income, and Benefits, March 15, 2007, http://www.fns.usda.gov/ftp/applicant_recipients/fs_Res_Ben_Elig.htm.

¹²² *Id.*

Unemployment and disability insurance, on the other hand, distribute benefits in proportion to the now disabled wage earner's former income.¹²³ Thus they are similar to bankruptcy in that those with higher incomes are given a higher benefit. Nevertheless, the wage replacement programs limit benefits to fifty percent of the median income for that state.¹²⁴ There are no similar limitations on debt relief in bankruptcy. Those who have not been employed at all for statutory minimum time periods are not eligible for benefits.¹²⁵ In this respect again, these programs are similar to bankruptcy in that some, who appear to be most poor, receive no benefit whatsoever.

If bankruptcy is not demonstrably the most regressive of these programs in its distribution of benefits, it is probably the least restricted.¹²⁶ Prior to the enactment of the means test in 2005, anyone who paid the fee and was not provably a fraud qualified to receive a discharge.¹²⁷ Even under the new means test, any debtor below the state median income automatically qualifies for a discharge and, depending upon their income, many others will qualify as well.¹²⁸ In sum, the distribution of aid given through bankruptcy is not precisely aimed at the most poor in society. It seems loosely targeted, if at all, to help those with higher earnings and more financial sophistication.

C. Coverage: Gaps and Overlaps

If bankruptcy is regressive in both collection and distribution, it may still provide a useful function if it is the only way to aid those who remain unaided by other programs. In other words, if the debt discharge can catch those who would otherwise fall unaided completely through the social safety net, it may be desirable despite some concerns about who pays and who benefits.¹²⁹ Without a fresh start, debtors and their families have no incentive to work and may become wards of the state and a burden to all.¹³⁰ Bankruptcy, therefore,

¹²³ Feibelman, *supra* note 74, at 150.

¹²⁴ Peter G. Gosselin, *If America Is Richer, Why Are Its Families So Much Less Secure?*, L.A. TIMES, Oct. 10, 2004, at A1.

¹²⁵ Feibelman, *supra* note 74, at 145, 150.

¹²⁶ *Id.* at 167.

¹²⁷ There are some narrow exceptions to discharge but mostly for substantial abuse or debts incurred through things like fraud, murder, getting an education, or drunk driving. See 11 U.S.C.A. § 523(a) (West 2006).

¹²⁸ *Id.* § 707(b)(7)(A).

¹²⁹ Hynes, *supra* note 13, at 352.

¹³⁰ *In re White*, 49 B.R. 869, 874 (Bankr. D.N.C. 1985).

provides an incentive to work (for oneself rather than one's creditors) and prevents the state from being burdened with debtors' failures.

Professor Adam Feibelman identifies bankruptcy protection as "a potential substitute for almost any imaginable social insurance program."¹³¹ Professor Feibelman goes on to address the way in which relief to some individuals through bankruptcy will overlap relief through other programs.¹³² He proposes that, based on cost comparisons among the various programs, policy-makers take steps to effectively allocate relief among the desired programs.¹³³

Scholars of the traditional model, equating bankruptcy with failure,¹³⁴ tend to view the bankruptcy relief system as an insurer of last resort, functionally sewing up the gaps in the social safety net.¹³⁵ To what extent this is true remains unexamined; it is also possible that some individuals will completely "fall through" the social safety net unaided by either bankruptcy or any other program.

As noted above, bankruptcy and unemployment insurance function similarly in that they distribute benefits as a proportion to the beneficiary's previous income. Those seeking to collect unemployment benefits must demonstrate that they have earned a minimum amount of wages during a statutory base period, which is usually fifteen months.¹³⁶ Disability insurance has similar workplace participation requirements.¹³⁷ Therefore, those who have not been employed for fifteen months prior to becoming unemployed will be unlikely to qualify for benefits.¹³⁸ The individuals who have steady incomes will be more likely to get unsecured credit, whereas those without income will be forced to offer collateral or go without.¹³⁹

The conclusion that can be drawn is that, if bankruptcy is meant to be "the back-stop of a social safety net filled with 'gaps,'"¹⁴⁰ it aids the same individuals who also receive aid from unemployment insurance and disability. Conversely, those unable to borrow money because they have no income are

¹³¹ Feibelman, *supra* note 74, at 158, 160.

¹³² *Id.* at 155–61.

¹³³ *Id.* at 171.

¹³⁴ See, e.g., Elizabeth Warren, *The Bankruptcy Crisis*, 73 IND. L.J. 1079, 1100–01 (1998).

¹³⁵ Warren, *supra* note 106, at 38.

¹³⁶ Feibelman, *supra* note 74, at 145.

¹³⁷ *Id.* at 150.

¹³⁸ *Id.* at 145.

¹³⁹ See *supra* Part I.B.

¹⁴⁰ Feibelman, *supra* note 74, at 161.

precisely the same individuals who will not qualify for unemployment insurance because they have not had steady employment. The more fortunate beneficiaries of both systems, if they have suffered wage interruption through job loss or disability, are most likely to be receiving higher benefits from unemployment or disability insurance making them less needy. Thus bankruptcy is unable to aid precisely those who are most in need and provides overlapping aid to those who are likely to be receiving greater aid through unemployment and disability insurance.

The overlap in providing redundant benefits for the same occurrence is contemplated in state laws with respect to unemployment insurance and disability insurance. Individuals are proscribed from claiming both unemployment insurance and disability insurance for the same job loss.¹⁴¹ Similarly, the EITC, which is distributed through the IRS tax code, takes into account benefits conferred in the form of income to determine whether an individual qualifies for the EITC.¹⁴² No such redundancy safeguard exists to prevent individuals from claiming benefits under bankruptcy caused by job loss while simultaneously receiving unemployment compensation, disability compensation, or other public relief.¹⁴³

The implication of the substantially similar gaps and overlaps in both systems is that bankruptcy does not add much (other than costs) to the social safety net. This is because bankruptcy is unable to aid those without access to credit.¹⁴⁴

D. Moral Hazard

As mentioned above, bankruptcy can overlap and substitute for public and private insurance against risks as varied as wage interruption, medical bills,

¹⁴¹ Mary F. Radford, *Wimberly and Beyond: Analyzing the Refusal to Award Unemployment Compensation to Women Who Terminate Prior Employment Due to Pregnancy*, 63 N.Y.U. L. REV. 532, 538–39 (1988) (noting that all states have provisions relating to the “eligibility” of a claimant generally requiring that, in order to be eligible to receive benefits, an individual must be currently “able to work” and “available for work”); see also Feibelman, *supra* note 74, at 156–57.

¹⁴² Individuals with an adjusted gross income in excess of \$31,030 (for families with one dependent child) do not qualify for the EITC. IRS Tax Publication 596, Cat. No. 15173A at 6, <http://www.irs.gov/pub/irs-pdf/p596.pdf> (last visited March 11, 2007).

¹⁴³ Feibelman, *supra* note 74, at 160.

¹⁴⁴ Ironically, information technology that makes compiling and sharing information about the creditworthiness of debtors may only exacerbate the problem. As creditors are able to predict with increasing accuracy and at lower cost which debtors will default on their obligations, those debtors’ credit lines may dry up at the first sign of trouble. See Feibelman, *supra* note 74, at 142, 143.

disaster-related losses, and marital dissolution.¹⁴⁵ The idea of bankruptcy as a form of insurance is not new.¹⁴⁶ Debt discharge through bankruptcy has alternatively been espoused as partial wealth insurance, wage insurance, and more recently as a form of medical insurance.¹⁴⁷ Bankruptcy can overlap and even be a substitute for other insurance.¹⁴⁸

One of the most significant concerns about insurance against risks over which the insured has some control is moral hazard.¹⁴⁹ Moral hazard is the possibility that redistributing risk with insurance may tend to produce riskier behavior in the insured.¹⁵⁰ For instance, a driver with full collision coverage might be more inclined to be cavalier about risky driving behavior because the cost of replacing the automobile will be paid by insurance, not by the driver.¹⁵¹ The moral hazard inherent in many forms of insurance is mitigated through devices like co-payments, deductibles, limits, and insurance ratings.¹⁵² These devices pass a part of the cost back to the insured, providing a partial incentive to minimize risk.

In the unemployment insurance context, for example, an employee might be more likely to engage in behavior that might lead to termination. This moral hazard is mitigated by several factors. First, unemployment insurance typically only provides fifty percent of the worker's previous salary up to a certain limit as compensation.¹⁵³ Second, there is a strict time limit on how long a worker may draw the compensation—typically six months.¹⁵⁴ Third, any employee who is terminated for cause (fired) is ineligible.¹⁵⁵ Finally, many programs require that beneficiaries be available for and actively seek new employment.¹⁵⁶

¹⁴⁵ See Feibelman, *supra* note 74, at 130–32.

¹⁴⁶ See, e.g., Hynes, *supra* note 13, at 304.

¹⁴⁷ Feibelman, *supra* note 74, at 132.

¹⁴⁸ *Id.* at 130. Bankruptcy provides many of the same functions as other social insurance programs such as unemployment insurance, Medicare, disability insurance, and workers compensation and even insures individuals against the financial effects of marital dissolution. *Id.* at 132.

¹⁴⁹ *Id.* at 136. Insurance can reduce an insured party's incentives to avoid a risk that he or she is insured against. *Id.*

¹⁵⁰ *Id.*

¹⁵¹ *Id.*

¹⁵² *Id.* at 136–37.

¹⁵³ *Id.* at 146.

¹⁵⁴ *Id.*

¹⁵⁵ *Id.* at 145.

¹⁵⁶ *Id.* at 146.

Employers are thus given an incentive to document cause for termination and also not to fire without cause because they must pay the unemployment insurance premiums for workers that are terminated without cause.¹⁵⁷ It is still possible that the benefits of unemployment insurance are an incentive to disemploy oneself but that incentive is likely reduced through these measures.

Social Security Disability Insurance has similar mechanisms to mitigate moral hazard. To become eligible, disabled individuals must wait five months, and these individuals only receive a percentage of their previous income.¹⁵⁸ In addition, benefits cease immediately upon recovery from the disability.¹⁵⁹

The traditional theory of bankruptcy dismisses moral hazard as insignificant although similar moral hazards may exist.¹⁶⁰ The bankruptcy rate (in theory involuntary and a result of household economic distress) was not viewed as being subject to the individual debtor's control.¹⁶¹ To put it in microeconomic terms, the costs (social stigma, loss of personal pride, difficulty in securing future credit, fees, lawyers, inconvenience) so far outweigh the temptation of debt reduction that individual debtors would not be tempted to act recklessly. Therefore, the mechanisms that place costs on the debtor are relatively modest. First, the debtor must pay a fee for access to the court.¹⁶² Second, there are social costs that may be significant.

On the other hand, there are indications that the social costs of bankruptcy have been dropping, perhaps increasing the moral hazard of bankruptcy relief.¹⁶³ At the same time, the structure of household debt has changed in a way that increases the amount of relief granted through a discharge.¹⁶⁴ The

¹⁵⁷ *Id.* at 146–47. The tax rate that an employer pays is based in part on that employer's "experience rating" which is calculated as a function of the employer's history of layoffs." Employers, therefore, have an incentive to terminate employees only for cause because layoffs (terminations without cause) would trigger a higher tax rate. *Id.*

¹⁵⁸ See Social Security Admin., Disability Planner, How Much You Will Receive, <http://www.ssa.gov/dibplan/dapproval2.htm> (last visited Mar. 15, 2007). The percentage is calculated based on past earnings and beneficiary's age.

¹⁵⁹ Feibelman, *supra* note 74, at 151. Note that disability insurance benefits do not cease upon a return to work but upon recovery from the disability.

¹⁶⁰ WARREN & TYAGI, *supra* note 14, at 72.

¹⁶¹ Feibelman, *supra* note 74, at 136.

¹⁶² The fee was changed from \$115 to \$220 per filing under the BAPCPA. 28 U.S.C.A. § 1930(a)(1)(A) (West 2006).

¹⁶³ Zywicki, *supra* note 22, at 1527–30; see *supra* note 69 and accompanying text.

¹⁶⁴ Zywicki, *supra* note 22, at 1534. Secured debt as a percentage of total household debt has been declining while revolving unsecured credit has been rising. The debt discharge in bankruptcy provides only a discharge of personal liability for debt and leaves secured debts basically undisturbed. 11 U.S.C.A. § 524

social costs are significant and still exist; observe that a large number of households would benefit financially from filing bankruptcy and yet have not filed.¹⁶⁵ The discrepancy can only be explained because there must be some nonfinancial costs, either social or informational, to filing that outweigh the strictly financial benefits of filing.¹⁶⁶ Nevertheless, the dramatic rise in bankruptcy is evidence that perhaps the deficit is narrowing for many households. If trends persist, more than five million families with children will file for bankruptcy by the end of the decade; the ubiquitous nature of bankruptcy itself may reduce the social stigma even further.¹⁶⁷

In contrast to unemployment insurance which provides 50% of the beneficiary's previous income, bankruptcy provides 100% discharge of qualified debts plus accumulated interest, fees, obligations—everything.¹⁶⁸ Additionally, bankruptcy discharges debts no matter when they were incurred—whether thirty days before filing or thirty years before filing. Unemployment insurance only provides its more modest benefit level for a maximum of six months.¹⁶⁹ Finally, the benefits of unemployment are terminated once the unemployed person is re-employed.¹⁷⁰ Bankruptcy will not reinstate the liability for debts if the debtor gets new, more profitable employment, wins the lottery, or inherits a fortune.¹⁷¹

Commentators also have noted that once a debtor decides to file for bankruptcy (but before actually filing), there is very little incentive to stop taking on credit obligations that she is unlikely to be able to pay or has no intention of paying.¹⁷² Other than outright fraud, there is no comparable

(West 2006). Therefore, the change in the structure of household debt has increased the benefit of debt discharge through bankruptcy.

¹⁶⁵ Zywicki, *supra* note 22, at 1527–28 (noting that an estimated one-third of American households could gain financially from filing bankruptcy through maximum use of prebankruptcy planning, and that the financial benefit from filing is greatest for well-off debtors); *see also* Warren, *supra* note 106, at 28 (noting that for every family that officially declares bankruptcy, there are seven more whose debt loads suggest that they *should* file for bankruptcy—if only they were more sophisticated about financial matters).

¹⁶⁶ See Zywicki, *supra* note 22, at 1527–28.

¹⁶⁷ WARREN & TYAGI, *supra* note 14, at 6.

¹⁶⁸ Rafael Efrat, *Global Trends in Personal Bankruptcy*, 76 AM. BANKR. L.J. 81, 87–88 (2002) (listing the United States bankruptcy system among the most liberal in providing generous relief to debtors in comparison to the more draconian terms of bankruptcy in other nations including Britain).

¹⁶⁹ Feibelman, *supra* note 74, at 146.

¹⁷⁰ *See id.*

¹⁷¹ For an interesting treatment of the legal dilemmas created by the Code's forced cleavage of time into "prepetition" and "postpetition" earnings periods, see Adam J. Hirsch, *Inheritance and Bankruptcy: The Meaning of the "Fresh Start,"* 45 HASTINGS L.J. 175 (1994).

¹⁷² Feibelman, *supra* note 74, at 167; Zywicki, *supra* note 22, at 1497.

temptation in insurance or more direct aid programs. In anticipation of bankruptcy, a debtor may consciously choose to run up more unsecured debt which is dischargeable in bankruptcy while staying current on secured obligations which will survive bankruptcy.¹⁷³ There is significant evidence that this happens because, while bankruptcy rates and default rates on unsecured credit have increased dramatically, default rates on home mortgages have stayed relatively constant.¹⁷⁴ This juxtaposition is even more striking in that a higher proportion of home mortgages are now subprime and, in theory, riskier and more burdensome.¹⁷⁵ All of these factors point to strategic behavior on the part of debtors who prioritize mortgage obligations over unsecured obligations that are dischargeable in bankruptcy.

The bankruptcy relief system may present a budgetary moral hazard for the federal government as well. A beneficent government of popularly elected officials has very little incentive to reduce the rate of bankruptcy filings primarily because the cost of discharge is not borne by taxpayers. This is in sharp contrast to direct relief programs like food stamps which must be rationed and carefully controlled because of budgetary restrictions. Though the costs of unemployment insurance are also not directly borne by the government, there is a strong mechanism to control risks and therefore costs.¹⁷⁶ The premiums for unemployment insurance, which must be paid by employers, can be directly controlled to some extent by the employers and perhaps the employees.¹⁷⁷ In contrast, the cost of bankruptcy discharge is borne by creditors and the debt-paying debtors themselves.¹⁷⁸ Creditors, who will fix their interest rate based on the default rate of a given population, only have an interest in the discharge rate being stable or predictable.¹⁷⁹ Debtors in bankruptcy, on the other hand, have no interest in seeing the collective rate go down, so long as their individual discharge is granted. In this respect, it is somewhat like the free rider problem of a commons.¹⁸⁰ Despite fairly consistent criticism and scrutiny of food stamps, unemployment insurance, and

¹⁷³ Feibelman, *supra* note 74, at 142.

¹⁷⁴ Zywicki, *supra* note 22, at 1534–35.

¹⁷⁵ *Id.* at 1486–87.

¹⁷⁶ Feibelman, *supra* note 74, at 147.

¹⁷⁷ *Id.* at 146–47.

¹⁷⁸ *See supra* Part III.A.

¹⁷⁹ *See* KARGER, *supra* note 32, at 9–11 (noting the profitability of the sub-prime lending despite higher default rates because of loan collateral, excessive markup, and socialization of losses among a class of borrowers).

¹⁸⁰ For a discussion of common pool problems, see JACKSON, *supra* note 2, at 11–13.

disability insurance,¹⁸¹ the potential for moral hazard in bankruptcy appears to be significantly higher.¹⁸²

In short, bankruptcy as a voluntary form of relief from economic distress does not compare well nor fit neatly with other programs forming the social safety net. It is regressive in collecting wealth from the very people the system is trying to aid. The system distributes benefits disproportionately to wealthier bankrupts while only giving modest benefits to poorer debtors. The claim that bankruptcy is an insurer of last resort or backstop of a frayed social safety net is dubious because bankruptcy relief distributes overlapping benefits to debtors well-covered by other forms of relief. At the same time, it potentially provides little benefit to those ineligible to secure credit or too poor to exempt property. The moral hazards of bankruptcy are potentially great. Perhaps because the traditional model largely discounted moral hazards, the substantial benefit package of bankruptcy is not checked by safeguards, cost sharing, and, until 2005, was not means tested. In sum, policy-makers seeking to provide a progressive and complete social safety net are justified in reducing rather than increasing the rate of bankruptcy.

IV. PLACING LIMITATIONS ON BANKRUPTCY

Part I of this Article, in searching for a justification for bankruptcy discharge, determined that notions of efficient debt-collection proceedings and derivative welfare-enhancements are no longer a feature of consumer bankruptcy. The remaining justification for debt discharge in bankruptcy was the fresh start that should compassionately be available to the truly “honest but unfortunate debtor” involuntarily brought to bankruptcy. Part II summarized the arguments over whether bankruptcy is still an involuntary act only for honest but unfortunate debtors and concluded that, in all likelihood, bankruptcy is now closer akin to other voluntary relief programs. Part III evaluated the merits of bankruptcy versus other voluntary relief programs and concluded that bankruptcy compares and fits poorly with them. Therefore,

¹⁸¹ Frank Munger, *How Can We Save the Safety Net?*, 69 BROOK. L. REV. 543, 558–59 (2004) (noting increasingly stringent requirements for collecting unemployment insurance benefits becoming politically popular).

¹⁸² *But see, e.g.*, THERESA A. SULLIVAN, ELIZABETH WARREN, & JAY LAWRENCE WESTBROOK, *THE FRAGILE MIDDLE CLASS* (2000) (doubting, as scholars of the traditional model, the existence of moral hazard in bankruptcy and attributing attempts to impose stringent requirements on bankruptcy to erroneous moral stereotypes about debtors).

policy-makers are justified in narrowing the scope or eligibility of debt discharge through bankruptcy.

A. *Restrictions in the 2005 Bankruptcy Reform*

In 2005, Congress enacted comprehensive bankruptcy reform legislation.¹⁸³ The legislation was partly a response to the widespread perception of abuse in consumer bankruptcy filings. President Bush, on signing the 2005 BAPCPA into law stated, “In recent years, too many people have abused the bankruptcy laws. They’ve walked away from debts even when they had the ability to repay them.”¹⁸⁴ Prior to the 2005 BAPCPA, there was no limitation on debtors who wished to file for a discharge, so long as they were willing to surrender their nonexempt assets. The new legislation has three main mechanisms which restrict or adjust the incentives against filing for bankruptcy. First, debtors who wish to file must undergo budget and credit counseling by an approved nonprofit agency.¹⁸⁵ Second, debtors must pay increased filing fees for filing a chapter 7 case. Third, debtors are subject to a means test. Debtors who do not meet the requirements of the means test may convert their cases to a chapter 13 repayment plan.¹⁸⁶

Criticism of the restrictions by academics has been unrelenting.¹⁸⁷ Academics point out that the means test, financial counseling, and increased fees may simply work hardship on debtors while still being simultaneously over-inclusive and under-inclusive.¹⁸⁸

1. *Forced Budget and Credit Counseling*

The effect of the first measure, forced financial counseling, is unclear. The rationale behind financial counseling seems to fit best with the affluenza/irresponsible debtor critique. Consumers who irresponsibly overspend should benefit from a lucid understanding of their financial condition and may take concrete steps to avoid financial trouble. Some,

¹⁸³ The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, 119 Stat. 23 (2005).

¹⁸⁴ Press Release, White House Press Office, *President Signs Bankruptcy Abuse Prevention, Consumer Protection Act*, Apr. 20, 2005, <http://www.whitehouse.gov/news/releases/2005/04/20050420-5.html>.

¹⁸⁵ 11 U.S.C.A. § 109(h) (West 2006).

¹⁸⁶ *Id.* § 348(a).

¹⁸⁷ Smith, *supra* note 1, at M3.

¹⁸⁸ Thomas Schelling, *Economic Reasoning and the Ethics of Policy*, THE PUBLIC INTEREST, Spring 1981, at 38.

however, have asserted that overspending consumers are fully aware of their financial situation but nonetheless are unable to stop themselves. If the rise in bankruptcy, occasioned by financial distress, is a result of compulsive behavior and not the lack of financial sophistication, psychological rather than financial counseling may be in order.

Financial counseling would have very little effect on consumer bankruptcy rates based on the view of bankruptcy espoused by Professors Warren and Tyagi. Intuitively, it seems logical that involuntary bankruptcy occasioned by financial distress would be reduced by teaching consumers to stay out of financial trouble in the first place. But Warren and Tyagi assert that consumer debtors, fully aware of their financial situation, are caught in unavoidable financial difficulties because of expensive housing, education, and other necessities.¹⁸⁹ Instead of overconsuming on frivolities, the modern two-income household has committed a greater portion of its income to fixed expenses and debt service, and thus is unable to make adjustments for financial shocks.¹⁹⁰ Thus, financial counseling will illuminate but not make the choices any easier for struggling families.

Professor Zywicki's economic theory of voluntary bankruptcy would also not expect to see significant reductions in bankruptcy rates as a result of financial counseling. Counseling would not reduce the substantial benefits of debt discharge or the automatic stay of collections against debtors. The inconvenience and social opprobrium of forced financial education may add slightly to the cost of filing for debtors. However, Congress seems to have deliberately reduced inconvenience and opprobrium by writing a provision allowing counseling to be done in groups, by telephone, or even by internet.¹⁹¹ Ironically, if Professor Zywicki's theory is correct (that it makes more economic sense to file for bankruptcy than not), compulsory financial counseling could *increase* filings as more and more debtors discover that it makes financial sense to file. After all, studies have shown that for every family that files bankruptcy, "there are seven more whose debt loads suggest that they *should* file for bankruptcy—if only they were more sophisticated about financial matters."¹⁹² Forcing debtors to undergo credit counseling seems unlikely to reduce the number of bankruptcy filings.

¹⁸⁹ WARREN & TYAGI, *supra* note 14, at 49–54.

¹⁹⁰ *Id.* at 53–54.

¹⁹¹ § 109(h)(1).

¹⁹² Warren, *supra* note 106, at 28.

2. *Increased Filing Fees*

The 2005 BAPCPA increased the fee for filing a chapter 7 case from \$155 to \$245.¹⁹³ The fee for filing a chapter 13 case went from \$155 to \$235.¹⁹⁴ The likely effect of increased fees for chapter 7 if any, is likely to be negligible. In 2000, the unsecured debt in chapter 7 cases averaged about \$40,564.¹⁹⁵ It seems unlikely that a \$90 increase in filing fees (or 0.1% of the discharge benefit) would deter a substantial number of debtors from receiving so much relief. Another feature of a fixed fee is that the higher the consumer debt level, the less the fee matters in comparison.

3. *The Means Test*

The means test in the 2005 BAPCPA denies chapter 7 debt discharge for debtors whose income is above its bar.¹⁹⁶ The tests are complicated. First, if the debtor's income is below the median for the state she lives in, she is automatically exempted from the means test and is eligible to receive a discharge.¹⁹⁷ Second, if the debtor's income is above the median, the amount of income that can be committed to debt repayment is calculated by subtracting an amorphous slate of "reasonable expenses" from the debtor's total income.¹⁹⁸ This list of expenses ranges from contributions to medical savings accounts, food, clothing, care of an elderly parent, private school for dependant children, home utility costs, disability insurance, health insurance, and even contributions to religious organizations.¹⁹⁹

The court uses this new figure of available income (the debtor's income minus reasonable expenses) to determine whether the debtor is eligible to file a chapter 7 or must convert to a chapter 13 repayment plan. If the debtor has enough available income over the next five years to repay at least the lesser of \$10,000 or twenty-five percent of general unsecured claims, but not less than \$6000, the debtor will be forced into a repayment plan.²⁰⁰

¹⁹³ 28 U.S.C.A. § 1930(a)(1) (West 2006).

¹⁹⁴ *Id.*

¹⁹⁵ Gordon Bermant, *Lifestyles of the Rich and Bankrupt*, AM. BANKR. INST. J., Sept. 2000, 22.

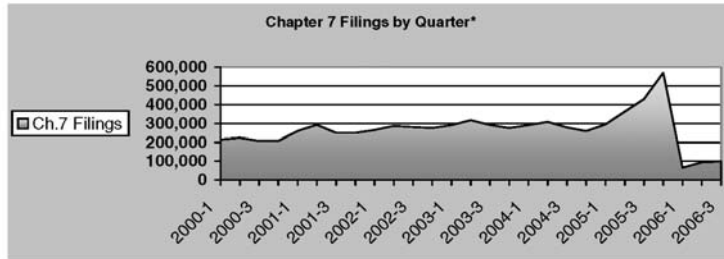
¹⁹⁶ 11 U.S.C.A. § 707(b) (West 2006).

¹⁹⁷ *Id.* § 707(b)(7)(A).

¹⁹⁸ *Id.* § 707(b)(2)(A)(ii), (iii), and (iv).

¹⁹⁹ *Id.*

²⁰⁰ *Id.* § 707(b).



*Source: United States Bankruptcy Courts Statistics, <http://www.uscourts.gov/bkrpctystats/statistics.htm#quarterly> (last visited Mar. 11, 2007).

The median income safe harbor provision insures that the means test will be ineffective in significantly reducing the number of chapter 7 filings. Although there was a precipitous drop in filings following the implementation of the BAPCPA, the consensus is that the drop was merely due to the run in bankruptcy filings just prior to its implementation.²⁰¹ A year or more of consumer bankruptcies were simply filed earlier. If, as noted above, the marginal costs of filing bankruptcy are well below the benefits for most debtors, there is no reason to believe that bankruptcy will be significantly reduced in the long term by the means test. Bankruptcy statistics indicate that consumer filings in the first three quarters of 2006 rose thirty-five percent and are on their way back to pre-BAPCPA levels.

The other effect of the means test may be to reduce credit availability to those below the median income. Unsecured lenders may be wise to surcharge borrowers who are below the median income for their state because they automatically qualify for bankruptcy. The result would be to increase the cost of borrowing for those below the median. In addition, the process of adjudicating a debtor's "reasonable" expenses is a litigable issue and is likely to result in increased lawyers' fees for bankruptcy filings.²⁰²

B. The Means Test Mechanism: A Measure of Probable Income

The new means test may not accurately differentiate among debtors with different income levels. Current income is defined as the income received by

²⁰¹ Jerry Truitt, *The State of Bankruptcy 18 Months after BAPCPA*, AM. BANKR. INST. J., Jan. 2007, 52.

²⁰² Before passage of the BAPCPA, the American Bar Association estimated that the requirements would increase attorney costs by \$150 to \$500 per case. H.R. REP. NO. 109-31, at 116 (2005).

the debtor during the six months prior to filing for bankruptcy.²⁰³ Therefore, it does not account for income earned prior to the six-month period or income earned after the petition is filed. If a high-income debtor loses her job, she needs only wait two or three months to automatically qualify for a chapter 7 discharge.²⁰⁴ Similarly, a debtor with no income in the test period who earns a million dollars in the six months following the petition will automatically qualify. The reverse situation, in which a debtor with no future earnings potential is disqualified by the means test because the last six months have seen a windfall, is also quite possible.

The problem is not where the line is drawn but the mechanism used to draw it. If individuals always earned the same amount of income over their lives, it would not matter which six-month period was used to measure a debtor's income. But many scholars, including Warren, have noted the increased risk of job loss in recent decades.²⁰⁵ Income volatility has gone from 16% in 1970 to 27% by the late 1990s.²⁰⁶ Those in the bottom fifth are experiencing swings averaging more than 50% per year, up from 25% in the 1970s.²⁰⁷ It follows that *any* period used to measure income of an individual will be less likely to be an accurate measure of a debtor's income today than thirty years ago. As a result, some relief will be denied where it should be compassionately given while some will be given that should more properly be denied. The provision of § 707(b) is inaccurately described as a "means test" because it inaccurately assesses the debtor's ability to pay future debts.

C. A Proposed Mechanism to Measure Actual Income

The means test in § 707(b) multiplies the available monthly income figure derived from the period before bankruptcy by sixty.²⁰⁸ Thus it determines the debtor's ability to pay over the ensuing of five years.²⁰⁹ It seems arbitrary, then, to measure a debtor's income during a six month period *before* the start of bankruptcy, when the better measure would be during the *actual* five-year

²⁰³ § 101(10A).

²⁰⁴ Income is calculated as an average over the six-month period ending on the last day of the calendar month immediately preceding the filing of the petition. *Id.* Therefore, if a debtor earned twice the median income for the state, she would qualify for a chapter 7 discharge after waiting three months.

²⁰⁵ Warren, *supra* note 106, at 21–22.

²⁰⁶ Gosselin, *supra* note 124, at A1.

²⁰⁷ Peter G. Gosselin, *The Poor Have More Things Today—Including Wild Income Swings*, L.A. TIMES, Dec. 12, 2004, at A1.

²⁰⁸ § 707(b)(2)(A)(i).

²⁰⁹ *Id.*

period of repayment. The six-month period prior to bankruptcy is a mere proxy measurement of a debtor's ability to repay and, as such, is an inferior measurement when compared to the debtor's actual ability to repay. The question, then, is how to measure the debtor's ability to repay over the five years following bankruptcy.

A consumer debtor who, in incurring consumer debt, promised to pay her income towards the satisfaction of that debt, should have her income for the next five years become part of the estate,²¹⁰ subject to a set exemption.²¹¹ Including income as part of the bankruptcy estate is not new. Profits from income-producing assets are already part of the estate but the present law does not include income from employment.²¹² This is true whether the debtor earns the minimum wage or is a CEO earning a six-figure salary. Scholars of bankruptcy have justified excepting individual income because to do otherwise would remove the incentive for debtors to work.²¹³ Nevertheless, it is possible to include the debtor's future income in the estate without entirely removing the incentive to earn future income.

The debtor's income would be paid directly to the trustee or could be monitored without any duplication of resources by using the existing IRS system of earnings reporting. Up to the point of the exemption, the income would be passed to the debtor or could go directly to the debtor as long as it is accurately reported. Income beyond the exemption would be used to satisfy the debtor's unsecured claims, pro rata. In order to provide an incentive to earn income beyond the exemption, the debtor could receive a graduated percentage of additional income. The debtor would have an incentive to maximize income similar to trustees of corporations in chapter 11 cases. If the debtor is receiving income in the form of disability, social security, or unemployment insurance, that amount would be counted as income, avoiding the redundancy of social programs.

This proposal differs from a chapter 13 repayment plan in several important ways. First, debtors and trustees will no longer have to contend over the reasonable expenses in a chapter 13 plan.²¹⁴ Instead, debtors will have merely the set income exemption and be allowed to do what they wish with that

²¹⁰ *Id.* § 541.

²¹¹ The exemption could be incorporated into the federal exemption slate in § 522.

²¹² § 541(a)(6).

²¹³ *See, e.g.*, Richard M. Hynes, *Why (Consumer) Bankruptcy?*, 56 ALA. L. REV. 121, 140 (2004).

²¹⁴ § 1325.

income. As the system now stands, those with expensive mortgages or higher fixed expenses can submit evidence of those expenses and get more income for themselves in a chapter 13 plan. Once again, this favors those with higher mortgages, upscale rents, and expensive car payments. The proposed flat income exemption also will relieve the courts from having to referee the income/expense disputes of the trustee and debtors. Finally, a debtor who earns more money than projected in a chapter 13 plan is supposed to report it to pay creditors under the plan, thus removing the incentive to work (or to accurately report). Because the proposal gives a graduated amount of the extra income back to the debtor, it will preserve the incentive to work.

The percentage of income above the exemption returned to the debtor would be adjusted based on the amount of outstanding unsecured debts. This would create two very important incentives: first, for debtors with income above the exemption, it would create a disincentive to run up debts prior to filing, and second, it would provide an incentive to work to pay off debts so as to be allowed a greater portion of additional income for personal use. The additional income plus the moral pull of paying creditors (which the traditional theorists insist is alive and well)²¹⁵ should provide more than enough incentive towards work and against fraud.

The level of the exemption could be adjusted for household size but not altered according to any slate of negotiable expenses for more financially or legally savvy debtors to exploit.²¹⁶ For uniformity, the level of exemption should be federally mandated but applied based on state cost of living or median income. The exemption level could be, for example, seventy-five percent of the median income for each state. This would serve to both prevent strategic flight from one jurisdiction to another (a phenomenon associated with varying exemption levels among the states) and to prevent states from competing with each other using exemption levels. This also seems a

²¹⁵ WARREN & TYAGI, *supra* note 14, at 74.

²¹⁶ Some scholars are aware and approve of the fact that the rich benefit relatively more from bankruptcy. *See, e.g.*, Hynes, *supra* note 13, at 304–05. Professor Hynes finds justification for the result (if not the system by which it is presently achieved) in the fact that private insurance markets would provide different levels of protection at different prices and that an incentive to work hard must be maintained. *Id.* at 304–05, 329. Hynes would probably disagree with this Article by positing that the wealthy bear the cost of their discharge while the poor bear the cost of their discharge. Therefore, the system is one in which the poor fund the discharge for the poor. *Id.* at 336. In answer to the assertion that providing varied levels of bankruptcy benefit is no different than that provided by private insurance markets, the author would point out that those who wish for more extensive private wealth insurance may freely purchase it but that it is not the responsibility of the government to provide such a system.

preferable mechanism for debt collection to the present state law system of wage garnishment. Under federal law, creditors may only garnish 25% of a worker's wages.²¹⁷ If a debtor makes a high income, she may be able to pay much more than 25% and, conversely, if a debtor makes a low income, 25% may be unreasonably burdensome. If an exemption level of 75% of the median income is set, then high income debtors will pay anything over and above that level while low income debtors will have their income exempt. Either way, the system would be more fair and more accurate for debtors and creditors.

The litigable issue of "reasonable" expenses would disappear and debtors could choose how to allocate their income, whether towards private school, religious observance, or medical bills.²¹⁸ Similarly, the need for a chapter 13 repayment plan, with the many negotiable provisions contained therein, would also disappear.²¹⁹ In addition, because of the possibility of income instability, income could be averaged over a time period (perhaps six months) to provide steady income for the debtor and to prevent excesses which might be needed in more lean months from being paid to creditors too quickly. To institute this, creditor repayment through the trustee could begin six months after the filing of a petition. Creditors, who do not receive even partial repayment in ninety-five percent of cases under the current system, should have no objection to waiting six months to receive some satisfaction.²²⁰

Thus the benefits of bankruptcy to the honest debtor and her creditors in legitimately hard times will be preserved: the automatic stay and the orderly distribution. The system will eliminate the need on the part of the debtor for guessing the proper time to file for bankruptcy. Because of the graduated return on excess income, it will reduce the incentive to run up debts prior to filing for bankruptcy, a concern expressed in much of the literature.²²¹ In addition, if the exemption is a bright line, bankruptcy will be more egalitarian. Those who are less wealthy will receive a discharge of all their debts and will be allowed to keep all of their income up to the exemption level. Those who are wealthier and have incurred greater debts will receive a smaller percentage

²¹⁷ 15 U.S.C. § 1673 (2000).

²¹⁸ 11 U.S.C.A. § 707(b)(2)(A)(ii), (iii), and (iv) (West 2006).

²¹⁹ *Id.* § 1322. Chapter 13 plans and confirmations can be quite messy. Court approval is necessary. *Id.* § 1325. Numerous tests must be met including the best effort of the debtor (§ 1325(b)), best interest of the creditors (§ 1325(a)(4)), good faith (§ 1325(a)(3)), and measures of disposable income against reasonable expenses (§ 1325 (b)(2)). These requirements would be done away with entirely in favor of a bright-line rule.

²²⁰ Adler, Polak, & Schwartz, *supra* note 17, at 613 n.24.

²²¹ *See, e.g.,* Lopucki, *supra* note 14, at 471–72.

of their income beyond the exemption level until the debts are paid. Neither will be left in the street wearing a barrel.

Though it is unlikely that the change would result in an instant reduction in bankruptcy filings, the inclusion of the consumer debtor's income as part of the estate would restore the benefits of a collective debt proceeding to credit markets. In addition, it would reduce the egregious regressive nature of the benefits conferred by bankruptcy. Overlap with income-replacing social programs like disability and unemployment insurance would be accounted for in the mechanism of the income exemption. The moral hazard of the discharge would be curtailed to some extent by the prospect of being reduced, if only temporarily, to a government-mandated level of subsistence. After the time period, all debtors, rich and poor, would receive a discharge of all remaining debts, having paid *in fact and not in estimation* according to their means.

CONCLUSION

In an influential 1839 address, John Sargeant, a prominent Philadelphia merchant, explained that the guiding lights for bankruptcy proceedings were “a fair disclosure, a full surrender, and an equal distribution.”²²² These principles have been forgotten in consumer bankruptcy today. Bankruptcy, far from benefiting creditors and debtors, is burdening them. The moral hazard of the system is reflected in the dramatic increase in filings over the past twenty-five years. The system of debt forgiveness should be adjusted to reflect the reality of consumer credit based on human capital. A fairer system would make debts borrowed against income repayable from income. By graduating the amount returned from income above income exemptions, bankruptcy will be more progressive, offer correct incentives, and provide a net benefit in the form of an equitable distribution. The resulting system will not impoverish debtors by denying discharge but will compel wealthier filers to submit to the same conditions as those of more humble means. These are logical limitations on bankruptcy and restoring them will return balance to the system.

²²² EDWARD J. BALLEISEN, NAVIGATING FAILURE: BANKRUPTCY AND COMMERCIAL SOCIETY IN ANTEBELLUM AMERICA 70 (2001).

