

# AN EMPIRICAL ECONOMIC ANALYSIS OF THE 2005 BANKRUPTCY REFORMS

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## INTRODUCTION

The Bankruptcy Abuse and Consumer Protection Act of 2005 (the “Act”)<sup>1</sup> was signed into law on April 20, 2005, and took effect on October 20, 2005. The Act represents the most significant change in personal bankruptcy law since the Bankruptcy Code’s (the “Code”) enactment in 1978.

The Act passed into law following a period of time in which bankruptcy filing rates were increasing,<sup>2</sup> despite low unemployment, low interest rates, and generally increasing economic prosperity.<sup>3</sup> Among the stated goals of the Act was to limit access to bankruptcy relief, in part, to ferret out and limit abuse.<sup>4</sup>

The Act generated a large amount of commentary, both from academia and the popular press. Much of the commentary has focused on the addition of the

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<sup>1</sup> Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, 119 Stat. 23 (2005).

<sup>2</sup> For example, consumer bankruptcies rose from approximately 300,000 in 1985 to roughly 1,450,000 in 2006. See Administrative Office of the U.S. Courts Statistics, available at [www.uscourts.gov/bkruptcystats/bankruptcystats.htm](http://www.uscourts.gov/bkruptcystats/bankruptcystats.htm). To illustrate the magnitude of the problem in the United States, Professor Elizabeth Warren wrote in a 2004 article,

This year, more people will end up bankrupt than will suffer a heart attack. More adults will file for bankruptcy than will be diagnosed with cancer. More people will file for bankruptcy than will graduate from college. And, in an era when traditionalists decry the demise of the institution of marriage, Americans will file more petitions for bankruptcy than for divorce.

Elizabeth Warren, *The New Economics of the American Family*, 12 AM. BANKR. INST. L. REV. 1, 27 (2004).

<sup>3</sup> See J. Kumar, R. Mason & D. Ralston, *Consumer Bankruptcies: Causes and Implications for the Credit Industry*, 17 ECON. PAPERS, Sept. 1988, 18, 22.

<sup>4</sup> See, e.g., 151 CONG. REC. S1814 (statement of Sen. Frist) (contending that bankruptcy has become a primary option and “is no longer a last resort. . . . Those who have the means should repay their debts”).

so-called “means test” to be eligible for relief under chapter 7 of the Code.<sup>5</sup> Many have decried the means test, designed to limit access to chapter 7 bankruptcy for debtors of a certain financial stature, as unfairly altering the balance between debtors and creditors in that it could potentially deny bankruptcy relief to a sizable number of individuals.<sup>6</sup> Others have argued that the means test is an appropriate method to deal with certain perceived bankruptcy abuses.<sup>7</sup>

This Article makes three contributions to the debate. First, in Section I, we describe the two primary bankruptcy routes for which consumer debtors may opt: chapter 7 or chapter 13. We include both the major advantages and disadvantages of the respective choices and the primary changes in bankruptcy law stemming from the Act. Second, in Section II, we present empirical evidence of the effect of the Act on both the number of personal bankruptcies, and on the relative fraction of chapter 7 and chapter 13 filings. The goals of the Act were to reduce the total number of bankruptcies, and to reduce especially the incidence of chapter 7 declarations. Using separately gathered national level, state level, and micro-data from the United States Bankruptcy Court for the Northern District of Illinois, we find that the Act was causal in reducing the total number of personal bankruptcies by approximately 200,000 per quarter (a reduction of approximately 40%), and in reducing the fraction of chapter 7 bankruptcies from 0.7 to 0.6. Third, in Section III, we provide a discussion of the meaning of the fresh start, and put the Act in both historical and international perspective.

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<sup>5</sup> For a discussion of the debates surrounding the Act’s lengthy enactment process, see Susan Jensen, *A Legislative History of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005*, 79 AM. BANKR. L.J. 485 (2005).

<sup>6</sup> See, e.g., Jean Braucher, *Increasing Uniformity in Consumer Bankruptcy: Means Testing as a Distraction and the National Bankruptcy Commission’s Proposals As A Starting Point*, 6 AM. BANKR. INST. L. REV. 1 (1998); Marianne B. Culhane & Michaela M. White, *Taking the New Consumer Bankruptcy Model for a Test Drive: Means-Testing Real Chapter 7 Debtors*, 7 AM. BANKR. INST. L. REV. 27 (1999); Charles Jordan Tabb, *The Death of Consumer Bankruptcy in the United States?*, 18 BANKR. DEV. J. 1 (2001).

<sup>7</sup> See, e.g., Edith H. Jones and Todd J. Zywicki, *It’s Time for Means-Testing*, 1999 BYU L. REV. 177. Senator Charles Grassley stated in Congress that “It’s not fair to permit people who can repay to skip out on their debts.” 146 CONG. REC. S5384 (2000) (remarks of Sen. Grassley).

## I. OVERVIEW OF PRE-ACT BANKRUPTCY LAW AND THE MAJOR AMENDMENTS

The Code<sup>8</sup> provides for two primary forms of consumer bankruptcy proceedings. The first, known as chapter 7, has in recent years been the overwhelmingly favored option among debtors.<sup>9</sup> The other is known as chapter 13. The preference for chapter 7 rather than chapter 13 among debtors, and the accompanying ability of chapter 7 debtors on average to discharge far greater amounts of debt than their chapter 13 counterparts, was in large part the motivating force for bankruptcy reform in the United States.

Chapter 7 is designed to provide debtors with a simple and relatively inexpensive method of obtaining a bankruptcy discharge. In chapter 7, debtors may obtain a discharge of prepetition debts without incurring future debt payment obligations as long as they relinquish all non-exempt assets owned at the time of bankruptcy for distribution to creditors. Chapter 7 debtors need not pay creditors out of future income.

The amount of available exemptions is, thus, very significant for chapter 7 debtors and their creditors. Debtors may generally opt for either the Code's exemptions<sup>10</sup> or for those of their state of domicile. The exemption amounts vary greatly, both across states, and between those available under the Code and those available under individual state law. Most notably, the homestead exemption under existing bankruptcy law has been \$15,000.<sup>11</sup> By contrast, those debtors opting for the exemptions available in their state may have a homestead exemption ranging from nothing to the unlimited homestead exemption long available in Texas and Florida.<sup>12</sup>

Under chapter 13 to obtain a discharge, a debtor must repay a portion of his or her indebtedness from future earnings over what historically had been a standard three-year period. These payments are made pursuant to a court-approved plan. Unlike a chapter 7 debtor, a debtor in chapter 13 is not

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<sup>8</sup> The Bankruptcy Code is found at Title 11 of the United States Code. All Code citations herein are thus to 11 U.S.C.A. § 522 (West 2007).

<sup>9</sup> For example, for the 2004 calendar year, the year preceding the enactment of the Act, 1,137,958 Americans filed chapter 7 bankruptcy petitions while 449,129 Americans filed in chapter 13. Administrative Office of the U.S. Courts, <http://www.uscourts.gov/bkprctystats/bankruptcystats.htm> (last visited Apr. 6, 2008).

<sup>10</sup> The bankruptcy exemptions are found in 11 U.S.C.A. § 522 (West 2007).

<sup>11</sup> 11 U.S.C.A. § 522(d)(1) (West 2007).

<sup>12</sup> FLA. CONST. art. 10, § 4; TEX. CONST. art. XVI, §§ 50, 51.

required to relinquish any non-exempt assets. Rather, payment is made out of postpetition assets, including future earnings, acquired during the duration of the plan. In the event that a trustee or an unsecured creditor objects to confirmation of the debtor's proposed payout plan, the plan must conform to the projected disposable income requirement. This requirement mandates that the plan provide for the debtor's entire projected disposable income for the life of the plan be applied to creditor payments under the plan. The projected disposable income calculation requires a projection of how much the debtor will earn over the plan period and a deduction from that amount of expenses that are reasonably necessary for support of the debtor and his or her dependants. The resulting amount must be used to fund the plan.<sup>13</sup>

As an incentive to choose chapter 13 rather than chapter 7, chapter 13 debtors receive what is often referred to as a "super-discharge." Section 523 of the Code provides for numerous types of debt that are non-dischargeable in a chapter 7 proceeding. Of the eighteen non-dischargeable debts under pre-2005 law, all but three had historically been dischargeable in chapter 13.<sup>14</sup>

The treatment of secured claims in chapter 13 is noteworthy. Chapter 13 provides two methods by which debtors may deal with an accelerated secured loan. Under the first, known as modification under pre-Act law, if a secured creditor refused to accept a proposed plan and if the debtor refused to voluntarily surrender the encumbered collateral, a plan could still be confirmed so long as it provided for repayment of an amount, as of the effective date of the plan, that is at least equal to the amount of the allowed secured claim.<sup>15</sup> If the collateral is worth less than the outstanding debt, the value of the secured claim—and thus the amount of payment—is based on the collateral value, not the debt value. This was the so-called "cramdown" effect of chapter 13. Thus, a chapter 13 debtor could, over the objection of the secured creditor, effectively redeem the collateral by paying off its value in installments over the life of the plan.

The second principle method of treating secured claims in chapter 13 is reinstatement and cure. Unlike modification, this is a return to the initial terms of the loan. The default is deemed cured, and the loan is deemed reinstated.

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<sup>13</sup> See generally § 1325(b).

<sup>14</sup> The three which may have not been dischargeable in chapter 13 are debts arising from maintenance and child support obligations, those stemming from educational loans, and those debts resulting from death or personal injury caused by an individual operating a motor vehicle while intoxicated. *Id.* § 1328(a)(2).

<sup>15</sup> *Id.* § 1325(a)(5)(B).

When this happens, the debtor assumes two obligations. First, any obligation that is overdue must be cured within a reasonable time; and second, any obligation that has not yet become due remains payable on the original due date. Reinstatement and cure tends to be used more frequently than modification because unlike modification, reinstatement and cure may be used for debt secured by a debtor's primary residence.<sup>16</sup>

There tend to be a number of factors why individuals choose chapter 13 over chapter 7. Among the most compelling factors are the existence of substantial non-exempt property that would be liquidated in a chapter 7 but which may be retained in chapter 13,<sup>17</sup> and the possibility of discharging certain debts in chapter 13 which cannot be discharged in chapter 7.<sup>18</sup> Alternatively, the debtor may believe that chapter 13 involves less stigmatization or may result in a lesser impact on the debtor's credit rating.

Nationally, the Act's goals—to reduce consumer filings and to alter the percentage of chapter 13 filings relative to chapter 7 filings—appear to have initially succeeded. Consumer filings dropped following the Act's enactment from roughly 1.5 million per year over the past few years to an annualized rate of approximately 800,000.<sup>19</sup> In addition, the percentage of debtors filing under chapter 13 has initially increased.<sup>20</sup>

By moving more debtors into chapter 13, the amount of debt repayment creditors can expect to receive when their debtors enter bankruptcy will likely rise. This result comes from two directions. First, chapter 13 debtors on average repay their creditors significantly more than do chapter 7 debtors.<sup>21</sup> Second, and perhaps more importantly, while virtually all individuals who file under chapter 7 receive a discharge, roughly only one-third of debtors who file in chapter 13 successfully complete the required payment schedule and obtain

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<sup>16</sup> *Id.* § 1322(b)(5).

<sup>17</sup> The clearest example of this is when applicable exemption law places dollar limits on the value of the exemption of the home.

<sup>18</sup> Many non-dischargeable debts in chapter 7 may be discharged in chapter 13. *Id.* § 523(a) (non-dischargeable debts) and § 1328(a)(2) (indicating that most debts included in § 523(a) are dischargeable in chapter 13).

<sup>19</sup> See chart 1 and accompanying citations.

<sup>20</sup> Following the 2005 amendments, roughly forty percent of debtors have filed under chapter 13. The pre-Act percentage was approximately 27.5. *Id.*

<sup>21</sup> Teresa A. Sullivan, Elizabeth Warren & Jay Lawrence Westbrook, AS WE FORGIVE OUR DEBTORS: BANKRUPTCY AND CONSUMER CREDIT IN AMERICA 44 (1999).

a discharge.<sup>22</sup> Thus, roughly two-thirds of chapter 13 debtors obtain little or no relief from their creditors by virtue of the bankruptcy laws. The Act's attempt to accomplish its goals comes largely through an expansion of the definition of when a chapter 7 filing constitutes an abuse of the bankruptcy process. The new standard used to determine chapter 7 eligibility is commonly referred to as the "means test."

Under the Act, when a debtor whose income is greater than the median income for his or her state of residence<sup>23</sup> files a case in chapter 7, the bankruptcy trustee, the court, or any other party in interest<sup>24</sup> may bring a motion to dismiss a chapter 7 filing for abuse<sup>25</sup> under § 707(b) of the Code. In such an occurrence, the "means test"<sup>26</sup> will be employed to determine whether the debtor may remain in chapter 7, whether his or her case will be dismissed, or, with the consent of the debtor, whether the case will be transferred to one under chapter 13. Under the means test, abuse of the bankruptcy process will be presumed<sup>27</sup> if the debtor's current monthly income,<sup>28</sup> less payments on secured and priority debt divided by sixty, minus allowed personal expenses,<sup>29</sup> exceeds one of the Code's two trigger points.<sup>30</sup> If the debtor will have at least \$6575 over five years, abuse is presumed if that income is sufficient to pay at least twenty-five percent of the debtor's general unsecured debt over a five-year period.<sup>31</sup> Additionally, if the debtor will have at least \$10,950 over five

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<sup>22</sup> TERESA A. SULLIVAN, ELIZABETH WARREN & JAY LAWRENCE WESTBROOK, *Who Uses Chapter 13?*, in CONSUMER BANKRUPTCY IN GLOBAL PERSPECTIVE 269, 273 (Johanna Niemi-Kiesilainen, Iain Ramsay & William C. Whitford eds., 2003).

<sup>23</sup> For an example of when the means test would be triggered, for cases filed in Illinois after February 1, 2007, the median income for a one-person household is \$42,995, for a two-person household it is \$54,599, for a three-person household it is \$64,184, and for a four-person household it is \$74,705. See Department of Justice, U.S. Trustee Program, Census Bureau Median Family Income By Family Size, [http://www.usdoj.gov/ust/eo/bapcpa/20070201/bci\\_data/median\\_income\\_table.htm](http://www.usdoj.gov/ust/eo/bapcpa/20070201/bci_data/median_income_table.htm) (last visited Apr. 6, 2008).

<sup>24</sup> 11 U.S.C.A. § 707(b)(1).

<sup>25</sup> If a debtor's income falls below the state median, a bankruptcy court may still find abuse, but the creditors do not have the standing to file such a motion. *Id.* § 707(b)(6).

<sup>26</sup> *Id.* § 707(b)(2).

<sup>27</sup> The presumption may be rebutted only by a demonstration of "special circumstances that justify additional expenses or adjustments of current monthly income." *Id.* § 707(b)(2)(B)(i).

<sup>28</sup> Current monthly income is defined as the debtor's average monthly income over the six months preceding filing. 11 U.S.C.A. § 101 (10A).

<sup>29</sup> The allowed personal expenses are determined based on Internal Revenue Service guidelines which establish appropriate levels of expenses based on family size for such things as food, clothing, personal care, transportation and housing. See Internal Revenue Service, <http://www.irs.gov/businesses/small/article/O,,id=104627,00.html> (last visited Apr. 6, 2008).

<sup>30</sup> Under the Act, abuse warranting dismissal or conversion may also be found by a judge based on the totality of the circumstances, including bad faith in filing. 11 U.S.C.A. § 707(b)(3).

<sup>31</sup> *Id.* § 707(b)(2)(A)(i).

years, abuse is presumed irrespective of the amount of general unsecured debt that the debtor has incurred.<sup>32</sup>

As noted, the means test has been highly controversial. It has been criticized, among other things, for being essentially unnecessary in that most debtors will easily satisfy its requirements,<sup>33</sup> for distracting from more pressing issues,<sup>34</sup> for expending vast amounts in the way of resources for little, if any gain,<sup>35</sup> for failing to force consumer lenders to better monitor their own behavior, for failing to address the underlying causes of consumer bankruptcy,<sup>36</sup> and for being fundamentally unfair.

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<sup>32</sup> *Id.* § 707(b)(2)(A)(ii); see also Richard I. Aaron, *Access to Justice: Consumer Bankruptcy*, 2006 UTAH L. REV. 925, 939–43 (explaining the application of the means test more fully).

In addition, the Act makes other changes designed to impact the choice between chapter 7 and chapter 13. For example, the Act also potentially alters the duration of certain chapter 13 plans. If the chapter 13 debtor's income is greater than the state median income, the plan proposed must be for five, rather than three years. In addition, the Act limits the chapter 13 super-discharge so that a number of debts previously dischargeable in chapter 13, but not in chapter 7, will no longer be dischargeable in chapter 13. These include debts incurred by fraud or by false statements, by failing to schedule debts, by defalcation while acting as a fiduciary and for debts arising from orders to make criminal or civil restitution.

<sup>33</sup> See Culhane & White, *supra* note 6, at 31 (arguing that only 3.6% of chapter 7 debtors in their study could possibly repay a meaningful portion of their debt); see also Gordon Bennett & Ed Flynn, *Income, Debts, and Repayment Capacities of Recently Discharged Chapter 7 Debtors*, Executive Office for United States Trustees (Jan. 1999), available at <http://www.abiworld.org/legis/reform/eoust-99janhtml>.

<sup>34</sup> See Braucher, *supra* note 6.

<sup>35</sup> See Culhane & White, *supra* note 6, at 61; see also Elizabeth Warren, *A Principled Approach to Consumer Bankruptcy*, 71 AM. BANKR. L. J. 483, 506 (1997).

<sup>36</sup> In the United States, significant problems underlying the rise in bankruptcies include the following. For 2005, the last year available at the time of this writing, the number of uninsured Americans was 43.3 million. See Center for Disease Control and Prevention, National Center for Health Statistics, Health Insurance Coverage, <http://www.cdc.gov/nchs/fastats/hinsure.htm> (last visited Apr. 6, 2008). The official poverty rate was 12.6% of the population. See Press Release, U.S. Census Bureau, Income Climbs, Poverty Stabilizes, Uninsured Rate Increases (Aug. 29, 2006), available at [http://www.census.gov/Press-Release/www/releases/archives/income\\_wealth/007419.html](http://www.census.gov/Press-Release/www/releases/archives/income_wealth/007419.html). The number of people unemployed as of July 2007 was approximately 7,100,000, or 4.6% of the population. Employment Situation: July 2007, [http://www.bls.gov/news.release/history/empisit\\_08032007.txt](http://www.bls.gov/news.release/history/empisit_08032007.txt) (last visited June 20, 2008). Divorces continue to grow in number. See U.S. Census Bureau, Vital Statistics, Table 72, <http://www.census.gov/prod/2005pubs/06statab/vitstat.pdf> (last visited Apr. 6, 2008). Being a single parent is one of best indicators that an individual will file for bankruptcy. In fact, in the United States, a home with children is more than three times as likely to file for bankruptcy as a home without. Warren, *supra* note 2, at 1. In 2001, for example, unmarried women with children filed 21.3 bankruptcies per thousand, compared to 14.7 per thousand for married families with children, 7.2 per thousand for childless women, and 6.1 per thousand per childless man. *Id.* at 26 n.79. If current trends continue, by the year 2010, one in seven children in the United States would live in a home where bankruptcy has been declared. *Id.* at 1. The result, according to this argument, is that even if we had a flawless bankruptcy system, the problems giving rise to the indebtedness that leads to bankruptcy would be unaffected.

The second change brought by the Act that has received significant academic and public attention was the change made to the application of the homestead exemption under bankruptcy law. Bankruptcy law—uniform in all other respects—contains a significant anomaly in regard to the homestead exemption. Although the Code provides for a set of exemptions, debtors in most instances may opt to substitute these federally-determined standards with the exemption laws of their state of residence. As there is a great variance in regard to the extent which individual states allow the home to be exempted—ranging from no exemption in Delaware and New Jersey to the unlimited homestead exemptions of Texas and Florida—this aspect of bankruptcy law was ripe for abuse. The Act addresses this by allowing debtors to elect their state exemptions only if they have lived in that state for 730 days prior to the date of filing for bankruptcy.<sup>37</sup> If they have moved during that 730-day period, the state exemptions are those for the state in which they lived the majority of the time for the 180 days prior to the running of the 730-day period.<sup>38</sup> Significantly, irrespective of the level that state exemption law affords, under the Act debtors may exempt only up to \$136,875 of interest in a homestead that was acquired within the 1,215-day period prior to the filing, but the calculation of that amount does not include any equity that has been rolled over during that period from one house to another within the same state.<sup>39</sup> In addition, to the extent the homestead was obtained through fraudulent conversion of non-exempt assets during the ten-year period before the filing, the exemption is reduced by the amount attributed to the fraud.<sup>40</sup> Not surprisingly, the decision for the Act to address possible homestead exemption abuses came in part in response to the large number of incidents in recent years of high profile debtors involved in such things as corporate scandals, securities laws violations, and fiduciary fraud. Thus, finally, the Act provides that in no circumstances may a debtor exempt an amount in excess of \$136,875 if the debtor has been convicted of a felony under circumstances that demonstrate that the filing of a bankruptcy case was an abuse of the provisions of the Code or if the debtor owes a debt arising from violations of securities laws or fraud in either a fiduciary capacity or in connection with the sales or purchases of securities.<sup>41</sup>

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<sup>37</sup> 11 U.S.C.A. § 522(b)(3) (West 2007).

<sup>38</sup> *Id.* § 522(b)(3)(A).

<sup>39</sup> *Id.* § 522(p).

<sup>40</sup> *Id.* § 522(o).

<sup>41</sup> *Id.* § 522(q). An exception to this limitation exists when a court determines that the property is reasonably necessary for the support of the debtor and his or her dependents. *Id.* § 522(q)(2).

A third category of changes that has generated significant commentary is the changes that have been made as to how the Act treats domestic support obligations. There had been significant concern that by enhancing the position of numerous creditors, by such things as making more credit card debt nondischargeable and giving automobile financiers additional rights, the Act would serve to reduce the status of former spouses and their children. As a result of these concerns, Congress responded with a panoply of changes to aid domestic support obligations. To begin with, the Act creates a new definition of what constitutes a domestic support obligation. Section 101(14A) defines domestic support obligations to include not only debts in the nature of alimony, maintenance, and support to a spouse, former spouse, or child, but also those owed to a governmental unit.<sup>42</sup> More substantively, the Act does the following:

- The Act gives a first priority to debts arising from maintenance and child support obligations, with the sole exception that administrative costs of a trustee are paid ahead of the support costs to the extent that the trustee is administering assets that can be used to pay support costs.<sup>43</sup>
- The automatic stay does not apply to the payment of a maintenance and support obligation from property that is not property of the estate or to the enforcement of a wage withholding order under a judicial or administrative order, or statute, including obligations accruing both before and after the bankruptcy filing.<sup>44</sup>
- Failure to remain current on support claims is now grounds for conversion or dismissal of a case.<sup>45</sup>
- And finally, the debtor must be current on postpetition maintenance and support obligations in order to confirm a chapter 13 plan.<sup>46</sup>

In addition, under the Act nobody may become a debtor in bankruptcy unless, within 180 days prior to filing for bankruptcy, he or she has received credit counseling from an “approved nonprofit budget and credit counseling

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<sup>42</sup> *Id.* § 101(14A).

<sup>43</sup> *Id.* § 507(a)(1).

<sup>44</sup> *Id.* § 362(b)(2).

<sup>45</sup> *Id.* § 1307(c)(11).

<sup>46</sup> *Id.* § 1325(a)(8).

agency.”<sup>47</sup> The law provides an exception when there is an emergency and the debtor could not receive counseling within five days, or if the United States Trustee determines that the approved agencies cannot adequately provide the required counseling in the particular case.<sup>48</sup> If, as part of such counseling, a debt management plan is developed, it must be filed with the bankruptcy court.<sup>49</sup>

In addition, the Act makes significant changes in the valuation of personal property securing a lien. Section 506(a)(2), a new provision created in 2005, requires that the value of personal property securing a claim in the case of an individual in chapter 7 will always be based on the cost of the debtor replacing the property, without deduction for costs of sale or marketing, and that if the property was acquired for personal, family, or household purposes, this replacement cost will be the retail price for property of similar age and condition.<sup>50</sup> A related provision will make it appreciably more difficult for debtors to retain automobiles. Under the Act, a debtor who wishes to use the traditional cramdown provision of § 1325(a)(5)(B) to retain a car when the debt is undersecured will now be required to pay off the full amount of the debt—not just the value of the collateral—in cases where the creditor holds a security interest in a motor vehicle purchased within 910 days of the bankruptcy filing.<sup>51</sup>

Extensive new document production requirements have been added by the Act. Under the Act, unless the court orders otherwise, debtors must file, along with their schedules of assets and liabilities, such newly required documents as a statement of itemized monthly net income and an indication of any anticipated increase in income or expenditures over the next twelve months.<sup>52</sup> For the first time, the Act imposes an obligation on debtors to provide recent, relevant tax returns.<sup>53</sup> The failure to provide these additional documents within forty-five days after the filing of a bankruptcy petition results in automatic dismissal of the case.<sup>54</sup> These increased reporting requirements will not only make the administration of the case more efficient, they will also

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<sup>47</sup> *Id.* § 109(h).

<sup>48</sup> *Id.* § 109(h)(2).

<sup>49</sup> *Id.* § 521(b).

<sup>50</sup> *Id.* § 506(a)(2).

<sup>51</sup> *Id.* § 1325(a).

<sup>52</sup> *Id.* § 521(a)(1)(B).

<sup>53</sup> *Id.* §§ 521(e)(2)(A), 521(f)(1)–(3). These must be produced not later than seven days before the initial postfiling meeting of creditors.

<sup>54</sup> *Id.* § 521(i).

likely adversely affect many potential debtors, whose record-keeping and documentation may be sufficiently disorganized to prevent compliance with these requirements and thus, pursuant to these provisions, prevent them from obtaining bankruptcy relief.

The Act may also have a chilling effect on the number of attorneys willing to represent debtors, because the Act for the first time imposes meaningful obligations and sanctions for certain attorney conduct. Most notably, the Act requires attorneys to make “reasonable inquiry to verify that the information contained” in petitions and schedules are correct.<sup>55</sup> By signing the bankruptcy petition, an attorney verifies that he or she has engaged in such inquiry and has no viable reason to suspect that any such information submitted to the court is incorrect.<sup>56</sup> In addition, pursuant to § 707(b)(4), if a trustee’s motion to dismiss or convert a chapter 11 case pursuant to the means test is granted, the attorney may have personal liability in that he or she may be required to reimburse the trustee for costs and may also be obligated to pay a civil penalty.<sup>57</sup> These rules serve to effectively make attorneys guarantors of the information supplied by debtors. The passage of the Act was thus thought to potentially bring about a decrease in the number of attorneys willing to represent debtors, to result in higher attorneys’ fees for those willing to continue to represent consumer debtors, or both.

Finally, the Act enacted a number of changes that confronted the issues of serial and abusive filing. First, the Act adds meaningful limitations on the ability of debtors to file successive chapter 13 cases. Under the Act, a chapter 13 debtor will be denied discharge if a chapter 7 or chapter 11 discharge had been received within four years of the new filing, or if a chapter 13 discharge was granted within two years of the filing.<sup>58</sup> There had previously been no such limitation on chapter 13 filings. This results in the elimination of so-called “Chapter 20s,” whereby debtors would first file in chapter 7 to discharge what unsecured debts they could, then immediately file a chapter 13 to deal with secured claims. In addition, the ban on successive chapter 7 filings was extended from six to eight years.<sup>59</sup> The ramifications of these limitations make the post-bankruptcy debtor a likely target for certain lenders. The debtor has discharged most or all of his or her debt, increasing the likelihood that the

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<sup>55</sup> FED. R. BANKR. P. 9011.

<sup>56</sup> See 11 U.S.C.A. § 707(b)(4)(A), (B), (D); FED. R. BANKR. P. 9011.

<sup>57</sup> 11 U.S.C.A. § 707(b)(4).

<sup>58</sup> *Id.* § 1328(f).

<sup>59</sup> *Id.* § 727(a)(8).

creditor will be repaid. And if the debtor cannot repay the creditor, bankruptcy relief is not an option for the recently discharged debtor.

The Act's direct ramifications on debtors are to make bankruptcy filing a more expensive prospect. This follows from at least three causes. First, due in part to increased court time stemming from the implementation of the means test, more bankruptcy judges were appointed.<sup>60</sup> The cost of adding new members of the judiciary has been covered in large part by raising the filing fees for debtors.<sup>61</sup> Second, the advent of mandatory credit counseling necessitates additional costs for the debtor, an amount on average of roughly an additional \$50 per filing.<sup>62</sup> And third, with new potential liability for attorneys, the prospect that attorneys will charge more to offset these risks is certainly evident.

## II. EMPIRICAL ANALYSIS OF THE EFFECTS OF THE ACT

More than two years have passed since the Act was passed and implemented. With the passage of time it is now possible to obtain some preliminary empirical estimates of the effects of the Act on the number and composition of bankruptcies. The forthcoming analysis will focus on two specific objectives of the Act: first, to reduce the number of bankruptcies; and second, to encourage a larger percentage of debtors to select relief under chapter 13 rather than chapter 7. Reasons to expect that the number of bankruptcies will decrease include alterations to home exemptions laws, a reduced list of super-discharge items, higher filing fees, costly mandatory

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<sup>60</sup> The Act authorized the creation of twenty-eight new judges. While it was widely expected that there would be an immediate, significant surge of bankruptcy filings before the Act's implementation—and there was, more than 600,000 cases were filed in the sixteen days before the Act became effective—it is clear that ongoing costs of the Act will be even more significant. A preliminary analysis indicates that the staffing requirements for bankruptcy courts have grown ten percent as a result of the Act, and “the duties of bankruptcy administrators have increased enormously as a result of the Act.” THE ADMINISTRATIVE OFFICE OF THE U. S. COURTS, REP. ON THE IMPACT OF THE BANKRUPTCY ABUSE PREVENTION AND CONSUMER PROTECTION ACT OF 2005 ON THE WORKLOAD OF THE FEDERAL JUDICIARY FOR THE U.S. H. AND S. COMM. ON APPROPRIATIONS 5 (August 2006).

<sup>61</sup> For example, in 1986, the filing fee for cases commenced under both chapter 7 and chapter 13 was raised from \$60 to \$90. In 1988, it was raised to \$120. In 1992, a \$30 “noticing fee” was added to each chapter 7 and chapter 13 filing. In 1993, the filing fee was raised to \$130, so that debtors had to pay, with the noticing fee, \$160. In 1999, the fee for chapter 7 cases rose to \$200, with the fee for chapter 13 cases rising to \$185. Finally, as of April 9, 2006, fees for chapter 7 cases reached \$299, with fees for chapter 13 cases at \$274. U.S. Bankruptcy Court Fees, <http://www.uscourts.gov/bankruptcycourts/fees.html> (last visited Apr. 6, 2008).

<sup>62</sup> See Kathleen Day, *Bankruptcy's New Era*, WASH. POST, Oct. 17, 2006, at D1.

credit counseling, higher attorney fees, and limits on multiple bankruptcy filings. The primary reason to expect that a larger fraction of debtors will select chapter 13 rather than chapter 7 is the newly-adopted median income means test. However, the increase in the duration of many chapter 13 plans from three to five years for those above the median income threshold, and the reduction in super-discharge items may serve to mitigate some of the expected increase in the number of chapter 13 filers.

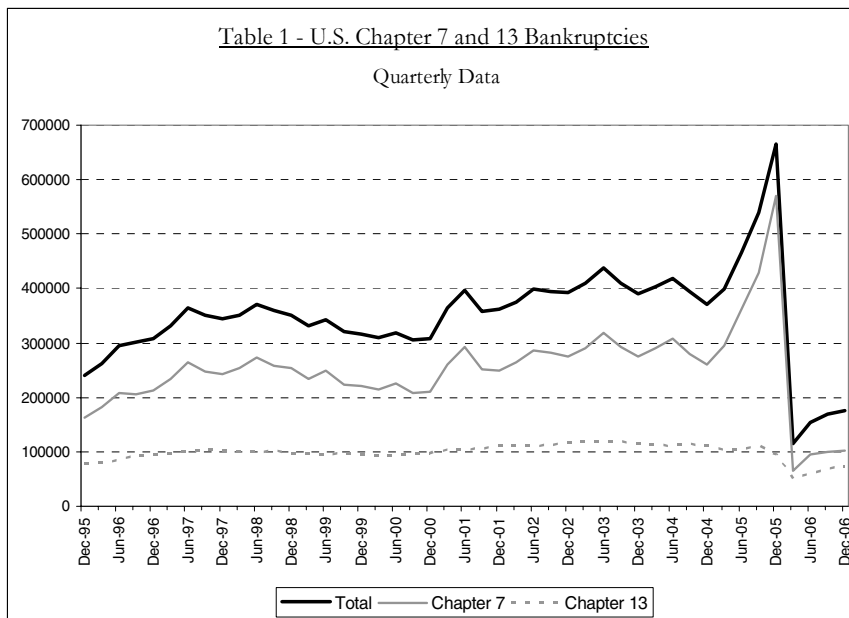
The following three subsections present empirical analysis of three distinct data sets. The first data set consists of bankruptcy statistics drawn nationally. Using the national-level data it will be possible to compare the broad trends in the total number of bankruptcy filings as well as in the composition of chapter 7 versus chapter 13 bankruptcies, both before and after the Act's implementation. The second data set consists of state-level quarterly bankruptcy statistics. By merging the state bankruptcy statistics with state-level unemployment, income per capita, and mass layoff statistics, it is possible to obtain a more nuanced understanding of the Act's effects. Specifically, it will be possible to isolate the Act's effects from those of unrelated economic events, the trend in bankruptcy filings across states, and the relatively different effects of the Act across states. However, despite the usefulness of the big-picture gross number of bankruptcies at the national and state levels, there is necessarily a loss of detail with macro data sets. In an attempt to obtain greater understanding of the issues that affect the bankruptcy decision, an original data set of individual debtors' filings has been constructed from the subset of debtors filing for bankruptcy in the Northern District of Illinois both in the year preceding and in the year following the Act's implementation. With micro-level data it will be possible to control for individual characteristics of debtors in order to gauge the Act's effects on the bankruptcy decision.

#### *A. Empirical Analysis of National-Level Data*

Chart 1 presents aggregate chapter 7 and chapter 13 bankruptcies for the entire United States between December 1995 and December 2006.<sup>63</sup> The Act was passed during the second quarter of 2005 and implemented during the fourth quarter of the same year.

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<sup>63</sup> U.S. Courts Bankruptcy Statistics, Table F-2, Business and Non-Business Cases Commenced, By Chapter of the Bankruptcy Code, During the Three Month Period Ended. . . , available at <http://www.uscourts.gov/bnkrpctystats/statistics.htm>.



Some basic observations regarding the bankruptcy patterns are in order. During the latter half of the 1990s it appears that the number of bankruptcies first increased and then decreased slightly. Beginning in the fourth quarter of 2000 there is a sharp and sustainable increase in the number of bankruptcies. The pattern of bankruptcies between 1995 and 2005 can generally be explained in terms of the overall U.S. economy: the United States was experiencing sustained growth during the 1990s, and then experienced a mild recession beginning in 2001.

It seems reasonable to conclude that the unprecedented variation in the number of bankruptcies, beginning in June of 2005 and lasting through the second quarter of 2006, is the result of the Act. The Act was enacted during the second quarter of 2005, after which the number of bankruptcies increased relatively quickly until the implementation of the Act during the fourth quarter of 2005. After the Act's implementation there is an immediate drop in the number of bankruptcies. During the last three quarters of 2006 the number of bankruptcies stabilized at a new lower level. The observed pattern could be explained by a rush to declare bankruptcy during the period of time between

the Act's adoption and implementation. After the Act's implementation there are fewer bankruptcies for two reasons: first, the Act has made it more costly to declare bankruptcy; second, a large number of people who would have declared bankruptcy during early 2006 behaved strategically and declared bankruptcy prior to the Act's implementation.

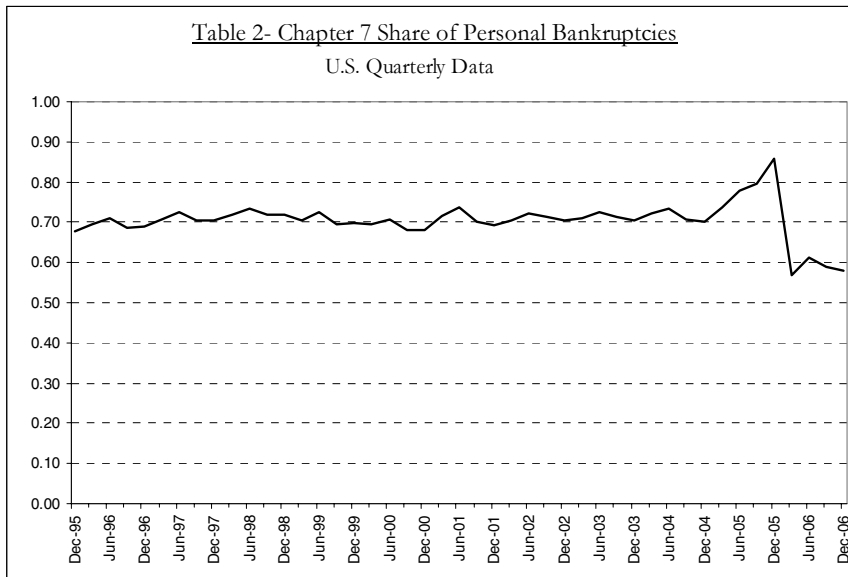
Straightforward regression analysis was employed to determine whether the pattern of bankruptcies represents a significant change. Due to the large variation immediately surrounding the Act's passage and adoption, the data from the third and fourth quarters of 2005 and the first quarter of 2006 are not included in the analysis. The quarterly number of bankruptcies is regressed on interest rates, the long-term trend in bankruptcies, and an Act fixed dummy variable. The regression analysis indicates that the Act reduced the number of quarterly bankruptcies by 234,000 and that the drop is statistically significant at the 1% level.<sup>64</sup>

Chart 2 presents the chapter 7 share of chapter 7 and chapter 13 quarterly bankruptcies for the nation. The average chapter 7 share of bankruptcies was 71% between the fourth quarter of 1995 and the fourth quarter of 2004. Following the Act's passage in the second quarter of 2005, the chapter 7 share of bankruptcies begins to increase. The chapter 7 share reaches its all time high of 86% during the third quarter of 2005, just as the Act took effect. Immediately after the Act's implementation during the fourth quarter of 2005, there was an unprecedented drop in the chapter 7 share of bankruptcies. During the last three quarters of 2006 the average chapter 7 share of bankruptcies were 57%.<sup>65</sup> The overall pattern in the chapter 7 share of bankruptcies is similar to that of the total number of bankruptcies mentioned previously. It seems as if debtors were acting strategically by declaring chapter 7 bankruptcy before the more restrictive rules under the Act took effect. A regression of the share of chapter 7 bankruptcies on interest rates, a long-term trend, and an Act-fixed effect indicates that implementation of the Act resulted in a 14% drop in the chapter 7 share of bankruptcies, and that the drop is statistically significant at 1% level.

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<sup>64</sup> If the data from the third and fourth quarters of 2005 and the first quarter of 2006 are included in the regression analysis it is estimated that the Act reduced quarterly bankruptcies by 341,000. Furthermore, if a trend variable is included in the analysis it is estimated that the number of quarterly bankruptcies increases by over 7000 per year (and that the trend is statistically significant). There is no statistically significant effect of changes in the prime-lending rate on the number of bankruptcy declarations.

<sup>65</sup> While the first quarter of 2006 was omitted from this analysis to guard against a temporary anomalous change, had the figures for this quarter been included, the resulting statistical change would be nominal.



### B. Empirical Analysis of State-Level Data

Quarterly state-level bankruptcy data, between the fourth quarter of 1995 and the fourth quarter of 2006, was obtained for all fifty states.<sup>66</sup> The bankruptcy data was merged with state-level unemployment levels, income per capita, population, and state layoffs.<sup>67</sup>

Table 1 presents various regressions using the dataset that estimate the effect of the Act on the total number of personal bankruptcies and the effect of the Act on the share of chapter 7 bankruptcies.

<sup>66</sup> U.S. Courts Bankruptcy Statistics, Table F-2, Business and Non-Business Cases Commenced, By Chapter of the Bankruptcy Code, During the Three Month Period Ended. . . , available at <http://www.uscourts.org/bkrpctystats/statistic.htm> (last visited Apr. 6, 2008).

<sup>67</sup> See generally Economagic, <http://www.economagic.com> (last visited Apr. 6, 2008).

Table 1  
State Level Quarterly Data

	Total Quarterly Bankruptcies			Chapter 7 Share of Total Bankruptcies		
	(1)	(2)	(3)	(4)	(5)	(6)
Intercept	-518001*** (119793)	-670748*** (58217)	-1158432** (165947)	-5.2** (2.3)	3.12 (2.49)	-8.47** (3.96)
Pre-Post Bankruptcy Indicator	-3356*** (630)	-3281*** (478)	-3555*** (452)	-.079*** (.013)	-.083*** (.012)	-.081*** (.008)
Rate of Unemployment		320*** (48)	85 (60)		-.03*** (.002)	-.0029** (.0012)
Income per Capita (x1000)		-133*** (12)	-.197*** (.052)		.0051*** (.0006)	-.0014 (.0017)
Population (x100,000)		105 (3)	-.0018*** (.0006)			
State Layoffs (x1000)		8* (4.6)	.022* (.012)			
Layoffs as Share of Population					.855*** (.049)	-.073 (.063)
Yearly trend	262*** (60)	337*** (29)	581*** (83)	.003*** (.0012)	-.0010 (.0012)	.0047** (.002)
State Indicator Variables			Included			Included
R <sup>2</sup>	0.01	0.76	0.87	0.02	0.08	0.87
Observations	2279	2279	2279	2279	2279	2279

In regressions 1 through 3 the goal is to estimate the effect of the Act on the total number of quarterly bankruptcies. Regression 1 presents the results of a regression of the total number of state quarterly bankruptcies on a Pre-Post Bankruptcy Indicator and a yearly trend variable. The Pre-Post Bankruptcy Indicator is equal to zero for all periods prior to the Act's implementation and is equal to zero for all periods after the implementation. The coefficient of -3356 on the Pre-Post Bankruptcy Indicator indicates that the Act decreased the average number of bankruptcies by 3356 per state per quarter (a drop of approximately 167,000 per quarter nationally). The bankruptcy coefficient is statistically significant at the 1% level.<sup>68</sup> The coefficient on the yearly trend

<sup>68</sup> Robust standard errors are presented under each coefficient.

indicates that the average number of bankruptcies per state has been growing at a rate of 262 per state per year, or 13,100 per year nationally. The yearly trend is statistically significant. Part of the motivation for passing the Act was the long run increase in the number of bankruptcies. The positive and significant yearly trend indicator confirms that the number of bankruptcies had been increasing over the long term.

In regression 2, a richer set of control variables are included in the analysis. The state rate of unemployment, income per capita, population, and any mass state layoff episodes are all included. The coefficient on the Pre-Post Bankruptcy Indicator indicates that the average number of bankruptcies per state dropped by 3281 after the Act's implementation (164,000 per quarter nationally); the coefficient is statistically significant at the 1% level. The magnitude and signs of the coefficients on the other included variables are reasonable. That is, a 1% increase in the rate of unemployment increases the average number of state bankruptcies by 320 per quarter per state; a \$1000 increase in income per capita decreases the number of bankruptcies by 133; states with larger populations have a larger number of bankruptcies; and state layoffs increase the number of bankruptcies. The reasonable signs and magnitudes of the coefficients on these included variables provide reassurance that the regression analysis is operating as desired.

In regression 3, fifty state indicator variables are added to the analysis.<sup>69</sup> The state indicator variables help to capture omitted state characteristics that may affect bankruptcy filings. For example, they may capture different levels of bankruptcy stigma or homestead exemptions across states. The coefficient on the Pre-Post Bankruptcy Indicator in regression 3 indicates that the number of quarterly state bankruptcies decreased by 3555 as a result of the Act's passage (178,000 per quarter nationally); the coefficient is statistically significant at the 1% level. One complication with including the state indicator variables is that they take up much of the variation in variables that are relatively stable across time, which explains why the coefficients on income per capita and population change so much between regressions 2 and 3. However, for the purposes of analyzing the effects of the Act on the number of bankruptcies per quarter, it is reassuring that the Pre-Post Bankruptcy Indicator is relatively stable across regressions 1 through 3. The inclusion of the various combinations of explanatory variables had a relatively minor impact on the

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<sup>69</sup> The econometric terminology for the state indicator variables is state dummy variables or state fixed effects.

estimates of the effect of the Act on the number of bankruptcies (the quarterly range was from -3555 to -3281 per month, or a decrease of between 164,000 and 178,000 nationally).

In regressions 4 through 6, the objective is to estimate the effect of the Act on the chapter 7 share of total bankruptcies. In all three regressions the chapter 7 share of monthly bankruptcies in each state is regressed on various explanatory variables. The Pre-Post Bankruptcy Indicator is used to estimate the effect of the Act on the share of chapter 7 bankruptcies. The Pre-Post Bankruptcy Indicator is equal to zero prior to the Act's implementation and one afterwards. The estimated coefficient on the Pre-Post Bankruptcy Indicator is the estimated effect of the Act on the share of chapter 7 regressions.

In regression 4 only an intercept trend variable, and the Pre-Post Bankruptcy Indicator are included. Regression 5 employs the full set of explanatory variables. Regression 6 includes the state indicator variables in addition to the full set of explanatory variables.

Across regressions 4 through 6 the coefficient on the Pre-Post Bankruptcy Indicator ranges from -7.9 to -8.3 percentage points, and is always statistically significant at the 1% level. Furthermore, the drop in the chapter 7 share of bankruptcies reverses a trend where the share had been increasing by 0.3 percentage points per year between 1995 and 2006, as indicated by the yearly trend variable. The stability of the estimates across regressions 4, 5, and 6 (despite the large differences in the included control variables) is reassuring, and indicates that the Act was causal in reducing the chapter 7 share of bankruptcies by approximately eight percentage points.

### *C. Empirical Analysis of Monthly Data from the United States Bankruptcy Court for the Northern District of Illinois*

In an attempt to further refine the estimates of the effect of the Act on bankruptcy filings, an original micro-level dataset has been constructed. Random samples of 200 observations per month were selected from the United States Bankruptcy Court for the Northern District of Illinois bankruptcy filings. The data extend back to October 2004, one year prior to the Act's implementation, and includes every month through December 2006, one year after the Act's implementation. The data gathered includes: the date the bankruptcy petition was filed, whether chapter 7 or chapter 13 was selected, the marital status of the debtor, the number of dependants, whether there was a

joint filing, the debtor's sex, the debtor's total assets, the debtor's total liabilities, the total amount of both unsecured and secured debt, the value of all real property owned by the debtor, the amount of the debtor's personal property, and the debtor's monthly income.

Table 2 contains the summary statistics for the dataset. The Chapter 7 Indicator is equal to zero if the debtor declared chapter 13 bankruptcy and one if the debtor opted for chapter 7; a mean of 0.68 indicates that 68% of the bankruptcies in the full statistical sample were chapter 7 debtors. Similarly, the Married Indicator is equal to one if the bankrupt was married and zero otherwise; 33% of bankrupts were married. The Female Indicator is equal to one if the bankrupt was female, and zero otherwise; 48% of the bankrupts in the sample were female. The average number of dependants was 1.1, and the range was zero to sixteen. On average, 12% of bankruptcy filings involve a joint filing. The average total combined monthly income for bankrupts is \$2655, but the reported range is extremely large in the sample, ranging from a low of \$0 to a high of \$395,404 per month.<sup>70</sup> The average total assets came to \$91,369, whereas the median total assets were \$16,092. The value of mean total assets is being driven by a relatively few outlying observations: the 1% to 99% range is \$145 to \$612,586. Similarly for total liabilities, the average is \$115,823 and the median is \$61,138. The mean unsecured and secured debts are \$41,668 and \$74,177, and the medians are \$14,000 and \$26,938.

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<sup>70</sup> The median monthly income is \$2178, and the 1% to 99% range is \$330 to \$7956.

Table 2  
 Summary of Statistical Monthly Data Obtained from the United States  
 Bankruptcy Court for the Northern District of Illinois

Variable	Mean	Std. Deviation	Min	Max
Chapter 7 Indicator	0.68	0.466	0	1
Married Indicator	0.33	0.47	0	1
Female Indicator	0.48	0.50	0	1
# of Dependents	1.1	1.39	0	16
Joint Debtor Indicator	0.0002	0.014	0	1
Total Income per Month	2656	7510	0	395404
Total Assets	91369	147272	0	2833068
Total Liabilities	115823	144605	0	3478627
Unsecured Debt	41668	58417	0	1126358
Secured Debt	74177	119797	0	2352267

In Table 3, regressions 7 and 8 estimate the effect of the Act on the chapter 7 share of total bankruptcies by regressing the chapter 7 share of bankruptcies on various explanatory variables, including a Pre-Post Bankruptcy Indicator. In regression 7 the coefficient on the Pre-Post Bankruptcy variable indicates that the share of chapter 7 bankruptcies dropped by twenty percentage points after the Act was enacted; the coefficient is statistically significant at the 1% level.<sup>71</sup> In regression 8, the full set of explanatory variables is included. In regression 8 it is estimated that the Act caused a 16 percentage point drop in the chapter 7 share of total bankruptcies. There is quite a large difference in the estimated effect of the Act on the drop in the chapter 7 share of bankruptcies between the regressions presented in Table 1 and those just presented in Table 3. We offer no certain explanation for the difference between the two sets of results. One possibility, however, is that the geographically small dataset from Northern Illinois is not representative of the national-level data. Additionally, the Northern Illinois data covers only two full years of data while the state- and national-level data cover more than a decade.

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<sup>71</sup> Note that no trend variable has been included in any of the regressions presented in Table 3; due to the relatively short two-year time frame under analysis a trend would not be an important variable.

Table 3  
Pacer Monthly Data

	Chapter 7 Share of Total Personal Bankruptcies			
	(7)	(8)	(9)	(10)
Intercept	.78*** (.008)	.886*** (.013)	.73*** (.006)	.82*** (.012)
Pre-Post Bankruptcy Indicator	-.20*** (.012)	-.158*** (.012)		
Median Income Indicator			-.33*** (.036)	-.21*** (.04)
Post Reform Median Income Indicator			-.085** (.041)	-.15*** (.043)
Total Monthly Income (x1000)		-.0036 (.00258)		-.002 (.002)
Total Assets (x1000)		-.001*** (.0001)		-.0008*** (.0001)
Marriage Indicator		-.031* (.017)		.002 (.016)
Female Indicator		.017 (.013)		.01 (.013)
Joint Debtor Indicator		-.007*** (.023)		-.65 (.013)
Number of Dependents		-.018*** (.005)		-.029*** (.005)
R <sup>2</sup>	0.05	0.16	0.08	0.17
Observations	5392	5158	5392	5158

The other coefficients of interest from regression 8 are as follows. First, total monthly income had no statistically significant effect on whether debtors chose chapter 7 or chapter 13, whereas total assets did, though the magnitude of the effect of total assets is quite small.<sup>72</sup> If a debtor is married it would drop

<sup>72</sup> A \$1000 increase in total assets will decrease the probability of selecting chapter 7 by 0.1 percentage point.

his or her probability of selecting chapter 7 by three percentage points, and being a joint debtor has a very small negative effect on the probability of selecting chapter 7. As the number of dependants increases, the probability of selecting chapter 7 decreases by 1.8 percentage points per dependant. Finally, a debtor's sex has no statistically significant effect on whether a debtor selects chapter 7 or chapter 13.

As noted previously, one of the major changes to the bankruptcy rules contained in the Act was the introduction of the means test. Following the Act's implementation, for a debtor to be eligible for chapter 7 bankruptcy relief, a debtor had to have income below the state median. The objective of regressions 9 and 10 is to attempt to determine whether the means test is causal in the drop in the chapter 7 share of bankruptcies. By creating median income indicators, it is possible to isolate the specific effect of the median income means test on the share of chapter 7 bankruptcies. In regressions 9 and 10, there are two median income indicators. The variable labeled Median Income Indicator is equal to zero for all debtors with monthly incomes below the Illinois median income level and is equal to one for all bankrupts with income above the median income level.<sup>73</sup> The variable Post-Reform Median Income Indicator is equal to one for all bankrupts above the median state median income who filed for bankruptcy after the Act took effect, and zero otherwise. Interpretation of these two coefficients should be as follows: the coefficient on the Median Income Indicator is the difference in the probability of someone above the median income filing for chapter 7 bankruptcy prior to the Act's implementation relative to a person with below median income; and the Post Reform Median Income Indicator is the difference in the probability of someone with above median income filing for chapter 7 bankruptcy after the Act's implementation relative to someone with above median income prior to the bankruptcy. Accordingly, in regression 9, people with above median income will have a 33% lower probability of filing chapter 7 bankruptcy prior to the Act than people with below-median income. After the Act is implemented, the probability of an above-median income person filing for chapter 7 bankruptcy drops by an additional 8.5 percentage points. In regression 10, where the full set of control variables are included, it is estimated that prior to the Act, having above-median income reduced the probability of filing for chapter 7 bankruptcy by 21%, and that after the Act's

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<sup>73</sup> For the period of analysis, the median income for a person with no dependants is \$42,995, for a family of two it is \$54,599, for three it is \$64,184, and for four people it is \$74,705. For families in excess of four, simply add an additional \$6400 per dependant.

implementation the probability of above-median income debtors selecting chapter 7 dropped by an additional 15%.

At first pass the sign and magnitude of the Post Reform Median Income Indicator could be taken to demonstrate that the median income means test is causal in reducing the chapter 7 share of bankruptcies. There are two problems with this conclusion, however. First, there are not nearly enough above-median income debtors to be driving the overall drop in the share of chapter 7 bankruptcies; in the statistical sample being analyzed, only 13% of debtors have above-median income. Second, when people with income greater than the median threshold are omitted from regressions 7 and 8,<sup>74</sup> it is estimated that the share of chapter 7 debtors still drops by between 14% and 17%. This indicates that something besides the means test is driving people to select chapter 7 versus chapter 13.

### III. DISCUSSION OF THE EMPIRICAL RESULTS AND THE MODEL OF RATIONAL BANKRUPTCY

The Act was the first major change to U.S. consumer bankruptcy law since the bankruptcy laws were completely re-written by the Bankruptcy Reform Act of 1978 (the "1978 Act").<sup>75</sup> The 1978 Act was instrumental in liberalizing personal bankruptcy. Our reading of the empirical papers that investigated the effects of the 1978 Act is that the 1978 Act was causal in increasing the number of personal bankruptcies. For example, Lawrence Shepard estimates that chapter 7 bankruptcies increased by 15% and chapter 13 bankruptcies increased by 20% as a consequence of the 1978 Act.<sup>76</sup> Additionally, William Boyes and Roger Faith found that the 1978 Act increased the bankruptcy filings rate and decreased the secured to unsecured debt ratio.<sup>77</sup> According to Boyes and Faith the change in the secured to unsecured debt ratio was the result of a shift in the ratio of responsible and irresponsible debtors.<sup>78</sup>

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<sup>74</sup> Only debtors with below-median income are included, and so none of those debtors are subject to the means test.

<sup>75</sup> Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (1978).

<sup>76</sup> Lawrence Shepard, *Personal Failures and the Bankruptcy Reform Act of 1978*, 27 J.L. & ECON. 419 (1984).

<sup>77</sup> William J. Boyes & Roger L. Faith, *Some Effects of the Bankruptcy Reform Act of 1978*, 29 J. L. & ECON. 139 (1986).

<sup>78</sup> *Id.*

One complication in using the 1978 Act to estimate the effect of changing bankruptcy rules on the incidence of bankruptcy is that during the same time frame in which the 1978 Act was enacted a number of significant changes in the banking laws in the United States took place. Most notably, as a result of the Supreme Court's ruling in *Marquette National Bank of Minneapolis v. First of Omaha Service Corp.*,<sup>79</sup> borrowing and lending in America were liberalized, and levels of consumer debt began to grow. Therefore, it is difficult to separate the effects on the bankruptcy rates of the 1978 Act from other economic factors such as increased consumer borrowing.

It is advantageous for purposes of analysis that 2005 was a relatively quiet time with regards to major legislation that might impact personal bankruptcy. A rational model of the bankruptcy decision would predict that more difficult and costly bankruptcy proceedings would result in fewer bankruptcies. Our findings indicate that the Act was in fact causal in reducing the number of bankruptcies by approximately 200,000 per quarter. Furthermore, regulations that attempted to reduce the number of chapter 7 filings relative to those of chapter 13 by making chapter 7 less appealing, have also been successful.

In observing the pattern of quarterly bankruptcies in the period between the Act's enactment and its implementation, it seems clear that the rational model of bankruptcy has been in operation. How else to explain an increase in the number of bankruptcies from roughly 400,000 per quarter prior to the Act's passage in the first quarter of 2005, to 465,000 in the second quarter, 540,000 in the third, 665,000 in the fourth, and a drop to 115,000 the first quarter after the Act's implementation? Macro variables such as unemployment rates, interest rates, and others cannot explain the observed pattern. Similarly, explanations stemming from unexpected financial distress will be left wanting; there were no variations in economic outcomes during 2005 that even begin to explain the wide swings in bankruptcy rates. The reasonable explanation is that debtors were acting strategically by declaring bankruptcy under the more favorable terms of the pre-Act rules.

The model of the rational bankrupt has not been universally accepted. Other commentators have focused on a bankruptcy model based on the frequency of instances of acute financial distress due to an improper lack of social safety net. For example, in separate articles, Teresa Sullivan,

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<sup>79</sup> 439 U.S. 299 (1978).

Elizabeth Warren, and Jay Westbrook<sup>80</sup> as well as Susan Block-Lieb and Edward Janger,<sup>81</sup> have argued that the leading cause of bankruptcies, as explained by debtors themselves in survey questionnaires, is acute financial distress stemming from such factors as job loss, divorce, or insurmountable medical bills.<sup>82</sup> Following from this is the suggestion that, if indeed most bankruptcies are caused by unexpected financial distress, then the validity of the model of rational bankruptcy is called into question. But even if acute financial distress is in fact the overwhelming cause of bankruptcy filings, it does not follow that the rational bankruptcy model has been refuted.<sup>83</sup>

Consider the following model of consumer borrowing and bankruptcy. Assume that a person has income of \$40,000 per year, but that there is some probability that they will encounter an income shock during the coming year. The shock could be positive or negative (for example, unexpected bonuses or positive stock market performance would yield positive benefits, and injury or layoff would yield negative shocks). Let us assume that the mean shock is zero, the variance is \$5000, and the distribution is normal.

The person must decide how much to save (or borrow). If interest rates are high and bankruptcy relief is relatively difficult to obtain, then the person would be rational to have high savings or borrow at a relatively low rate. In this instance, even if a negative shock occurs, the person would very likely have sufficient ability to borrow additional funds so that he or she would be able to endure all but the most severe of economic shocks without declaring bankruptcy. We consider this to be reflective of the pre-1978 period, prior to the enactment of the 1978 Act and the liberalization of the banking sector that occurred at approximately the same time.

If, however, credit is relatively cheap (that is, interest rates are low and the cost of applying for additional credit is low) and bankruptcy relief is relatively

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<sup>80</sup> Teresa A. Sullivan, Elizabeth Warren, & Jay Lawrence Westbrook, *Less Stigma or More Financial Distress: An Empirical Analysis of the Extraordinary Increase in Bankruptcy Filings*, 59 STAN. L. REV. 213 (2006).

<sup>81</sup> Susan Block-Lieb & Edward J. Janger, *The Myth of the Rational Borrower: Rationality, Behavioralism, and the Misguided "Reform" of Bankruptcy Law*, 84 TEX. L. REV. 1481 (2006).

<sup>82</sup> *But see* Todd J. Zywicki, *An Economic Analysis of the Consumer Bankruptcy Crisis*, 99 NW. U. L. REV. 1463, 1502–24 (2005) (discussing why unemployment, divorce, and medical costs cannot fully explain the rise in consumer bankruptcy filings).

<sup>83</sup> In addition, one must certainly question the expected accuracy of self-reported reasons for declaring bankruptcy. It appears entirely possible that debtors responding to surveys would not fully acknowledge irresponsible behavior or poor planning on their part as being the primary cause of their need to seek bankruptcy protection.

easy to obtain, then the same person would be rational to save less (or to borrow more). This would be the case even if the person's tolerance for risk, for any potential bankruptcy stigma, and for the distribution of potential income shocks was constant. By borrowing more, the person would be more exposed to negative income shocks; it would take a smaller negative income shock in this instance to push the person over the edge into bankruptcy. There are two reasons for this. First, because bankruptcy relief is relatively easy to obtain, there are fewer disincentives to enter bankruptcy. Second, because the debtor has borrowed more money, it takes a smaller negative shock to push the individual into bankruptcy.<sup>84</sup> The key point is that the person is identical in both instances, and in both instances it is an unexpected negative income shock that pushes the person to declare bankruptcy. When credit is cheap and bankruptcy access is relatively easy, even a rational person will have incentives to take greater risks. And by doing so, the individual increases his or her likelihood of filing for bankruptcy.

Statistics bear out this hypothetical. Between the enactment of the 1978 Act and the 2005 Act, consumer credit increased dramatically, interest rates were low, and bankruptcy access was generally easier than in either the pre-1978 or the post-2005 periods. Not surprisingly, as obtaining credit became easier and interest rates dropped, the rate of bankruptcy filings increased accordingly. From the consumer perspective, this is not surprising. The big question is why lenders continued to keep extending credit to people who would have a difficult time repaying their loans.

With the adoption of the Act, interest rates and credit have remained relatively low, but obtaining consumer bankruptcy relief has become more difficult. The same fictitious person would be rational to cut back on his or her level of borrowing, which will in turn reduce the probability that he or she will ultimately file for bankruptcy relief. This is consistent with the conclusions drawn from the empirical estimates contained herein.

Finally, even if people are miserable in bankruptcy, the rational model of bankruptcy is not refuted. People take many risks in their daily lives, not least of which is the morning automobile commute. Car accidents are one of the leading causes of death in America, and when they occur they cause unimaginable distress, and yet no one is suggesting that people are irrational to

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<sup>84</sup> If the income shocks are normally distributed then whereas there is a 1.5% change of a negative shock of \$10,000 or more, there is a 15% chance of a negative shock of \$5000 or more.

continue driving cars. A similar argument can be made regarding people's behavior regarding personal debt and bankruptcy. People may well be rational to take on debt to improve their current situation by paying for education and medical bills. However, every time they do so they are increasing the odds that another negative economic shock will push them into bankruptcy. The bankruptcy may well cause serious distress, yet the person behaved rationally to take the initial risk, and they may very well take a similar risk in the future.

How then to refute the rational model of bankruptcy? It will be refuted if changes in constraints result in changes in behavior that goes against behavior predicted by the rational model. For example, if bankruptcy rules are eased and the rate of bankruptcy stays constant or decreases, *ceteris paribus*. Similarly, if people do not reduce their borrowing when interest rates increase or if expected negative shocks increase, the same resulting conclusion can be drawn.

#### IV. THE 2005 ACT AND THE MEANING OF THE FRESH START

By exposing certain filers to the means test, limiting discharge, and raising the cost of bankruptcy, the Act represents a fundamental change in the philosophy which has underlined American bankruptcy law since the advent of the first comprehensive Bankruptcy Act in 1898, namely, that debtors are fundamentally honest but unfortunate,<sup>85</sup> as opposed to potential abusers of the bankruptcy process.<sup>86</sup> Policy arguments in the U.S. have thus traditionally

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<sup>85</sup> The concept of a fresh start for the honest but unlucky debtor is firmly rooted in Anglo-American bankruptcy jurisprudence. As early as 1706, English Parliament passed a bankruptcy act which contained a provision for the discharge of the debtor from pre-bankruptcy debts. See 4 Anne, ch. 17, § 7 (1705). The United States Supreme Court stated in 1934 in *Local Loan Co. v. Hunt*, 292 U.S. 244 (1934), that bankruptcy “gives to the honest but unfortunate debtor who surrenders for distribution the property which he owns at the time of bankruptcy, a new opportunity in life and a clear field for future effort, unhampered by the pressure and discouragement of preexisting debt.” Clearly related to the fresh start concept is the decreased likelihood that the debtor will ultimately become dependent upon public support.

<sup>86</sup> Even the Act's name—the Bankruptcy Abuse and Consumer Protection Act of 2005—suggests that its need is in part due to the fact that many debtors are abusing the bankruptcy process. As an interesting aside, arguments have been made that only a fraction of those who would benefit from filing consumer bankruptcy actually do so. See Michelle J. White, *Why Don't More Households File for Bankruptcy*, 14 J. L. ECON & ORG. 205, 206 (1998) (arguing that while at least 15% of American households would benefit from bankruptcy, only slightly more than 1% actually file). Elsewhere, Professor White contends that with some pre-bankruptcy planning, more than 50% of American households would gain by filing, with the greatest gains accruing to the wealthiest. Michelle J. White, *Why it Pays to File for Bankruptcy: A Critical Look at Incentives Under U.S. Personal Bankruptcy Laws and a Proposal for Change*, 65 U. CHI. L. REV. 685, 706

supported a broad fresh start for this honest but unfortunate debtor. Arguments in favor of the broad fresh start—and thus in opposition to restricting open access to bankruptcy via such instruments as the means test—are both economic and moral. Historic economic justifications for the broad fresh start include that discharge shifts the burden of overextensions of credit from debtors to creditors, who are better able to bear these costs. This in turn helps to promote the efficient allocation of losses.<sup>87</sup> The party who can best protect himself or herself bears the greatest risk of loss. This argument assumes, of course, that creditors are both better determiners of risk and better risk bearers than are debtors.<sup>88</sup> As risks to creditors rise, the hope is that they will make more conservative loan determinations.

The second major economic consideration involves the desire to promote entrepreneurial activity. In America, consumer bankruptcy law has historically been viewed as serving a market function. The use of credit and the taking of rational entrepreneurial risk have traditionally been considered desirable, and the presence of bankruptcy law serves to offset some of the associated risk.<sup>89</sup> Thus, the breadth of the American fresh start has historically provided a social safety net by creating a mandatory, immutable form of financial insurance.

Moral arguments in favor of a broad fresh start include that requiring payment of future income comes too close to a violation of the involuntary servitude provision of Thirteenth Amendment to the United States Constitution, and that models of consumer bankruptcy which mandate repayment out of future income, such as those employed in Australia and the United Kingdom, are based on historical and cultural factors that do not exist in the United States, where bankruptcy is not seen exclusively as a mechanism

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(1998); see also Scott Fay, Erik Hurst & Michelle White, *The Household Bankruptcy Decision*, 92 AM. ECON. REV. 706, 712 (2002) (putting the percentage of households that would benefit from filing at about 18%).

<sup>87</sup> See, e.g., Theodore Eisenberg, *Bankruptcy Law in Perspective*, 28 UCLA L. REV. 953, 981 (1981); see also Richard A. Posner, *The Economic Approach to Law*, 53 TEX. L. REV. 757, 764 (1975).

<sup>88</sup> While there are arguments to the contrary, there is much to support this hypothesis. For example, compelling arguments exist that creditors can better evaluate risk since they do so on a regular basis, since they can do so objectively, and that creditors may be able to insure against these losses by, among other things, diversifying their portfolios and monitoring debt consumption. See Steven L. Harris, *A Reply to Theodore Eisenberg's Bankruptcy Law in Perspective*, 30 UCLA L. REV. 327, 362 (1982). Arguments to the contrary include that borrowers have greater control of their financial affairs than do lenders and that borrowers can better assess personal characteristics that could lead to bankruptcy. See Eisenberg, *supra* note 80, at 982–83. For a broad discussion of behavioral issues in considering bankruptcy policy, see SAUL SCHWARTZ, *Personal Bankruptcy Law: A Behavioural Perspective*, in CONSUMER BANKRUPTCY IN GLOBAL PERSPECTIVE, *supra* note 22.

<sup>89</sup> See H.R. DOC. NO. 93-173, at 71–76 (1973).

for creditor debt collection.<sup>90</sup> Further, it has been argued, a broad discharge and fresh start are ethical and humane, and the fresh start provides the prospect of the debtor again becoming a productive member of society. This latter element will occur only if the debtor—rather than his or her creditors—will realize the fruits of his or her prospective labor.<sup>91</sup> A related argument is that means testing tips the debtor-creditor balance in bankruptcy too heavily in favor of creditors, thus harming families by requiring payment of general unsecured debt that would otherwise be used to pay maintenance and child support; finally, the argument has been made that the Act fails to address the critical issues that have caused the vast increase in consumer bankruptcy filings.<sup>92</sup> According to this last argument, the only way of meaningfully addressing bankruptcy issues is by addressing broad social problems such as the high divorce rate, the lack of universal health insurance, and corporate downsizing.<sup>93</sup>

Arguments against the broad fresh start are also both economic and moral. The central economic arguments against a broad fresh start—and correspondingly in favor of the means test—include that the promise to repay money is an important legal obligation, and that maintaining the sanctity of contracts is an essential part of Anglo-American legal tradition. Accordingly, the fresh start jeopardizes the sanctity and efficiency of contracts. The effect of a broad fresh start is thus a liberal extension of an individual's ability to be excused from a contract. This result may have economic ramifications, resulting in increased uncertainty in the market, which in turn affects the efficiency of the market.

A related argument is that in reality, the means test is merely a method of forcing individuals to repay what they are capable of repaying, which is desirable because the degree of bankruptcy relief available should align with

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<sup>90</sup> See Jacob S. Ziegel, *The Philosophy and Design of Contemporary Consumer Bankruptcy Systems: A Canada—United States Comparison*, 37 OSGOODE HALL L.J. 205, 244 (1999).

<sup>91</sup> See Ellen E. Sward, *Resolving Conflicts Between Bankruptcy Law and the State Police Power*, 1987 WIS. L. REV. 403.

<sup>92</sup> For example, divorce. In 2001, for example, unmarried women with children filed 21.3 bankruptcies per thousand, compared to 14.7 per thousand for married families with children, 7.2 per thousand for childless women, and 6.1 per thousand per childless man. Warren, *supra* note 2, at 26 n.79. If current trends continue, by the year 2010, one in seven children in the U.S. would live in a home where bankruptcy has been declared. *Id.* at 1.

<sup>93</sup> See A. Mechele Dickerson, *Bankruptcy Reform: Does the End Justify the Means?*, 75 AM. BANKR. L.J. 243 (2001) (arguing that bankruptcy should be viewed as part of the non-entitlement federal public assistance system).

the actual needs of the individual. Another economic argument in opposition to the means test is that means testing will limit losses to creditors, which in turn means that creditors will not pass additional costs on to their future consumer borrowers. Also, by mandating repayment for those who can afford it, means testing will eliminate some of the strategic elements that go into the decision to file for bankruptcy. Debtors should not enjoy marked advantage over similarly situated nondebtors merely due to the fact that they have chosen to seek bankruptcy protection while others have not.

The moral arguments against a broad fresh start are consistent with religious and historical condemnation of debtors throughout much of history.<sup>94</sup> The argument begins with the contention that the “*fresh start*” has become a “*head start*,” an assertion famously made by Justice Harlan dissenting in *Lines v. Frederick*.<sup>95</sup> The argument is that the fiscally irresponsible are rewarded to the detriment of the fiscally responsible, creating a serious moral hazard problem.<sup>96</sup>

The broad American fresh start falls at one extreme of the continuum.<sup>97</sup> Worldwide, many nations allow no discharge at all.<sup>98</sup> In European civil law countries, the full payment of debts after a bankruptcy has historically been the standard,<sup>99</sup> and the concept of prospective wage protection is largely unknown.<sup>100</sup> However, the reader should note that since the 1980s, the fresh start concept has grown in civil law countries, as numerous countries either enacted or modified their consumer bankruptcy legislation to provide for

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<sup>94</sup> See Rafael Efrat, *The Moral Appeal of Personal Bankruptcy*, 20 WHITTIER L. REV. 141 (1998).

<sup>95</sup> See *Lines v. Frederick*, 400 U.S. 18, 21 (1970) (Harlan, J., dissenting).

<sup>96</sup> See Lynn M. LoPucki, *Common Sense Consumer Bankruptcy*, 71 AM. BANKR. L.J. 461, 464 (1997) (“Consumer bankruptcy contradicts the morality of Aesop’s fable [regarding the grasshopper and the ant]. Today’s ants eat beans at home, don’t buy the kids new sneakers, and don’t try to buy the new house until they have stable jobs and down payments. They hang onto the jobs, even when the going gets tough, particularly if the jobs come with health insurance. The grasshoppers eat at the pizza parlor on Friday night and buy the new sneakers and the houses. They quit their jobs when the going gets tough. The fallout lands on their credit cards. When winter comes, they discharge the credit card debt in bankruptcy. The ant played by the rules, the grasshopper didn’t. In the end, consumer bankruptcy made them equals.”).

<sup>97</sup> See generally Iain Ramsay, *Comparative Consumer Bankruptcy*, 2007 U. ILL. L. REV. 241.

<sup>98</sup> See Rafael Efrat, *Global Trends in Personal Bankruptcy*, 76 AM. BANKR. L.J. 81 (2002) (discussing how many nations, including China, Vietnam, Mongolia, Hungary, Bulgaria, the Ukraine, Brazil, Mexico, Argentina, and Venezuela, allow no debt forgiveness).

<sup>99</sup> See Johanna Niemi-Kiesilainen, *Consumer Bankruptcy in Comparison: Do We Cure a Market Failure or a Social Problem?*, 37 OSGOODE HALL L.J. 473 (1999).

<sup>100</sup> See generally Jason J. Kilborn, *The Innovative German Approach to Consumer Debt Relief: Revolutionary Changes in German Law, and Surprising Lessons for the United States*, 24 NW. J. INT’L. L. & BUS. 257, 289 (2004).

consumer debt adjustment. Among the countries that have made such adjustments to their bankruptcy laws during this period are Denmark, Finland, Norway, Sweden, the Netherlands, France, Belgium, Germany, and most recently, the Czech Republic, whose new bankruptcy and insolvency law became effective on January 1, 2008.<sup>101</sup> However, as a general matter, even where these amendments have occurred in Europe, the respective European laws differ markedly from their American counterparts in numerous important ways. These differences tend to include the lack of open access to bankruptcy in European civil law countries, that payment is generally mandatory for discharge, and that not only debt counseling but also early negotiations with creditors tend to be incorporated as an essential part of these processes.<sup>102</sup>

One country in which recent amendments have aligned with American changes that narrow the fresh start is Australia. The 2002 Australian bankruptcy amendments created new powers for an Official Receiver to reject a debtor's petition when the petition evidenced certain abuses.<sup>103</sup> In addition, the prospect of early discharge after six months was removed, adding a deterrence element to filing in Australia as all Australian debtors now must remain bankrupt for a full three-year period.<sup>104</sup> Another reform consisted of making objections to discharge easier to uphold.<sup>105</sup> By facilitating such objections, the aim was to try to provide increased incentives for debtor cooperation in the process. Perhaps as a result, the number of Australian debtors decreased following the enactment of the amendments for the first time in nearly a decade.<sup>106</sup>

So what should the fresh start accomplish? To a large extent, its historical purpose both in the United States and in the United Kingdom, which has been to serve as a market correction in order to promote entrepreneurial activity, runs contrary to the policy underlying the Act. In the United States, when the

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<sup>101</sup> See JOHANNA NIEMI-KIESILAINEN, *Collective or Individual? Constructions of Debtors and Creditors in Consumer Bankruptcy*, in CONSUMER BANKRUPTCY IN GLOBAL PERSPECTIVE, *supra* note 22, at 41, 42 (discussing European consumer insolvency laws).

<sup>102</sup> See Niemi-Kiesilainen, *supra* note 102, at 475.

<sup>103</sup> Bankruptcy Legislation Amendment Bill 2002, no. 2002 (Austl.).

<sup>104</sup> *Id.*

<sup>105</sup> *Id.*

<sup>106</sup> The number of new Australian bankruptcies for the 2003–2004 financial year—20,497—represented a 9.5% decrease in bankruptcies from the prior fiscal year, and is the lowest number of bankruptcy filings in Australia since the 1995–1996 fiscal year. See Insolvency and Trustee Service Australia, Quarterly Bankruptcy Statistics—Provisional Bankruptcy Statistics—Parts IV and XI, <http://www.itsa.gov.au> (follow “About Us” hyperlink; then follow “Statistics” hyperlink; then follow “Overview of Quarterly Statistics” hyperlink) (last visited Apr. 6, 2008).

new American bankruptcy law was drafted in the 1970s, the focus was on market regulation. Consumer bankruptcy was seen as a market function, with bankruptcy providing a necessary complement to open access to the credit market.<sup>107</sup> The Bankruptcy Laws Commission, in its Report of the Commission of the Bankruptcy Laws of the United States, noted the beneficial aspects of the use of credit and of entrepreneurial risk taking, and argued that the presence of bankruptcy law serve to offset some of the associated risk.<sup>108</sup> As a result, legislators in the United States decided to encourage individuals to be economically active. The breadth of the American fresh start provides a social safety net for those who put money into the American economy. Thus, American bankruptcy law was designed to help promote market efficiency<sup>109</sup> by, in effect, creating a form of mandatory, immutable insurance for all individual credit contracts.<sup>110</sup>

Recent bankruptcy reform in the United Kingdom has taken a policy opposite to that underlying the Act and more in conformity with historic Anglo-American consumer bankruptcy policy.<sup>111</sup> Accordingly, it has been motivated to a large degree by concern over the degree of stigma associated with bankruptcy, with the worry that this stigma has prevented honest individuals from taking rational risks in the conduct of their business affairs. The Enterprise Act<sup>112</sup> was enacted in 2002 in part to encourage entrepreneurial activity in the United Kingdom. A primary goal of the Act is to reduce the stigma of bankruptcy by giving entrepreneurs a second chance if they have failed through no fault of their own.<sup>113</sup> The Act's intent was to accomplish this through a number of changes to the Insolvency Act of 1986, most notably a change in the duration of the period of bankruptcy. The Enterprise Act amended Section 279 of the Insolvency Act. The section previously provided for either a two-year period of bankruptcy in which a certificate for summary administration of the debtor's estate was issued and was not revoked before the

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<sup>107</sup> See Bankruptcy Laws Commission in Report of the Commission of the Bankruptcy Laws of the United States, H.R. DOC. NO. 93-173, at 71-76 (1973).

<sup>108</sup> *Id.*

<sup>109</sup> See Michelle J. White, *Economic Versus Sociological Approaches to Legal Research: The Case of Bankruptcy*, 25 L. & SOC'Y REV. 685 (1991); Doug Rendelman, *The Bankruptcy Discharge: Toward a Fresher Start*, 58 N.C. L. REV. 723 (1980).

<sup>110</sup> See Barry Adler, Ben Polak & Alan Schwartz, *Regulating Consumer Bankruptcy: A Theoretical Inquiry*, 29 J. LEGAL STUD. 585 (2000).

<sup>111</sup> See generally Donna McKenzie Skene & Adrian Walters, *Consumer Bankruptcy Law Reform in Great Britain*, 80 AM. BANKR. L.J. 477 (2006) (discussing consumer bankruptcy reform in the United Kingdom).

<sup>112</sup> Enterprise Act, 2002, c. 40, § 10 (Eng.).

<sup>113</sup> *Id.*

debtor's discharge, and a three-year period in all other cases.<sup>114</sup> Under the new law, the norm for honest and non-reckless debtors is a release from bankruptcy restrictions after twelve months (or shorter if the official receiver files a notice stating that investigation of the debtor's conduct is not needed).<sup>115</sup> As a corollary provision, reckless and culpable debtors will be forced to comply with Bankruptcy Restrictions Orders for a period up to fifteen years.<sup>116</sup> Under Schedule 4A, contained in Schedule 20 of the Enterprise Bill, a myriad of factors can enter into a court's determination that a Bankruptcy Restrictions Order is appropriate, including whether the debtor has failed to keep and provide records, entered into a fraudulent transfer, given a preference, or incurred a debt prior to bankruptcy that was beyond the debtor's ability to pay.<sup>117</sup>

### CONCLUSION

Early statistical data supports the conclusion that the Act, at least initially, has succeeded in altering the ratio of chapter 7 and chapter 13 filings and impacting the rate of bankruptcy filings. Such a result is fully consistent with the model of rational bankruptcy. As we become further removed from the implementation of the Act, a number of factors will change. Debtors will no longer be able to time their bankruptcy filings to take advantage of pre-Act law, and interest rates and credit availability will fluctuate. When these changes occur, it will be interesting to see if the initial filing patterns continue on a long term basis.

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<sup>114</sup> Insolvency Act, 1986, c. 45, § 279 (Eng.).

<sup>115</sup> *Id.* § 256 (amending the Insolvency Act, 1986, c. 45, § 279 (Eng)).

<sup>116</sup> *Id.*

<sup>117</sup> *Id.* § 257 (amending the Insolvency Act, § 279).