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ABSTRACT:

This is the entry for "Consumer Bankruptcy, Doctrinal Issues In" in the *Encyclopedia of Law and Society: American and Global Perspectives*. This entry provides a summary and overview of the law and policy of consumer bankruptcy. First, it summarizes the American bankruptcy law legal regime. Second, it explores the competing hypotheses for the rise in bankruptcy filings during the past three decade, contrasting the "traditional" or "distress" model of consumer bankruptcy with the "incentives" or economic model. Third, it describes the recent amendments to the American consumer bankruptcy regime. Finally, it provides a comparative view of consumer bankruptcy law by comparing the American system and trends in American bankruptcy law and policy with Europe and other areas of the world.

JEL Codes: K00, K20, K35

Keywords: Consumer bankruptcy, comparative consumer bankruptcy law

Consumer Bankruptcy, Doctrinal Issues In

Consumer bankruptcy systems in the United States and around the world have undergone unprecedented changes and stresses in recent years. Dramatic economic and technological developments have transformed the nature of consumer credit markets and consumer credit relations, unleashing competition and consumer choice, while simultaneously increasing opportunities for strategic use of bankruptcy. Increased personal mobility and broad societal changes have tended to erode traditional norms or "stigma" that traditionally constrained bankruptcy. These many simultaneous pressures have dramatically affected our understanding of the consumer bankruptcy system, both in theory and in the impact that theory holds for consumer bankruptcy law and policy.

United States Legal Regime

In the United States, two interrelated factors generated renewed debate about consumer bankruptcy. First, there was a staggering and accelerating rise in consumer bankruptcy filings in recent decades. Second, largely in response, Congress enacted the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), Pub. L. no. 109-8.

Congress established the modern consumer bankruptcy system in the United States with the enactment of the 1978 Bankruptcy Code, which substantially liberalized the consumer bankruptcy system. Article I, § 8, of the U.S. Constitution grants to Congress the exclusive authority to enact "uniform laws on the subject of bankruptcies throughout the United States." The framers intended this grant of power to Congress in large part to deal with the problems of debt collection under the Articles of Confederation (1776) and, in particular,

uncertainty about the authority of various states to discharge debts and whether those debts remained enforceable if the debtor relocated to another state.

Otherwise, traditional debtor-creditor relations were largely unaffected by the new Constitution, including the use of debtors' prisons, which continued in several states well into the eighteenth century. Throughout the eighteenth century, Congress exercised its bankruptcy authority only sporadically, leaving most debtor-creditor relations in the hands of the states. In 1898, Congress enacted the first permanent bankruptcy law in United States history, which remained on the books until superseded by the 1978 Bankruptcy Code, which liberalized the consumer bankruptcy system in the United States by substantially increasing the debtor's eligibility for the fresh start.

Following the enactment of the 1978 Code, there was an immediate surge in consumer bankruptcy filing rates. In response, in 1984, Congress enacted piecemeal reforms designed to stem the tide, but these proved largely ineffectual. Throughout the 1980s and into the 1990s, consumer-filing rates continued to rise. Finally, in the mid-1990s, the rates exploded in the face of unprecedented economic prosperity, low interest rates, low unemployment rates, and rapid gains in household wealth as the result of roaring stock and housing markets. During the 1980s, consumer bankruptcy filings doubled from about three hundred thousand annual filings to just over six hundred thousand, then doubled again to about 1.2 million filings by 2000. In 2004, the final full year before BAPCPA, consumers filed 1.5 million bankruptcy cases.

At the same time, the 1994 congressional elections ushered in a political sea change in Washington, realigning the ideological balance away from the

traditional pro-debtor ideology and toward an ideology of personal responsibility, culminating in the enactment of BAPCPA. This statute substantially tightened loopholes in the bankruptcy system. It provided new tools and safeguards against bankruptcy fraud (such as asset concealment) and the strategic use of bankruptcy for such purposes as evading domestic support obligations. It also required filers with above-median income levels who could repay a substantial portion of their debts, to do so through a court-approved chapter 13 repayment plan, rather than being eligible for chapter 7.

Traditional Model to Explain Bankruptcy Use

This confluence of rising consumer bankruptcy filings in the face of great economic prosperity also shook the intellectual foundations of the consumer bankruptcy system. Traditionally, scholars thought that consumer bankruptcy filings were caused by household financial distress and that changes in the filing rate over time could be explained by changes in macroeconomic variables. For instance, consumer bankruptcy filing rates rose during the Great Depression, only to fall off dramatically in the subsequent period. The debtor-friendly 1978 Code reflected this dominant intellectual understanding of the causes of bankruptcy. Notwithstanding the obvious anomaly of rising bankruptcy filing rates in the face of record levels of prosperity, many leading bankruptcy scholars continue to adhere to the traditional distress model as an operative model of consumer bankruptcy filings.

The traditional model argues that consumer bankruptcy filings primarily occur due to underlying household economic distress occasioned by involuntary economic shocks. According to the traditional model, there are thus one or two

basic forces. First, rising bankruptcy rates are a direct function of consumer indebtedness. They argue that consumers have become more indebted over time and are less able to pay their debts and have become more vulnerable to sudden and unexpected income or expenditure shocks. Second, either independently or in connection with overindebtedness, consumer bankruptcies are triggered by unanticipated exogenous shocks to income or liabilities, such as unemployment, divorce, or health problems, which result in financial collapse. Scholars argue that the rising bankruptcy rates of recent years reflect the fact that consumers have become more vulnerable to these exogenous shocks because of their more highly leveraged positions or that these shocks have become more severe over time. As a result, these scholars have argued that efforts to reform the bankruptcy laws are misguided. They believe there is minimal fraud and abuse in the system, and that such reforms may impose unnecessary costs on innocent filers.

A new generation of bankruptcy scholars, however, has questioned the continued scientific validity of the traditional model. Although the factors identified by this model explain some of the variation in consumer bankruptcy filing rates over time, these other scholars argue that the available evidence fails to support the hypothesis that the rising bankruptcy rate of recent decades can be explained by household financial distress. Conventional measures of financial condition, such as "balance sheet" insolvency and equity insolvency, fail to evidence a plague of household overindebtedness. Consumers have increased their total overall outstanding debt, but household wealth has risen much more rapidly than increases in debt during this period, largely because of increasing stock and home values, leaving consumers wealthier than ever.

Moreover, these wealth increases have been experienced across the income spectrum, as even low-income households have increased their wealth, in part due to the expansion of the subprime home mortgage market that have enabled low-income and younger consumers to purchase homes, thereby acquiring a valuable and rapidly appreciating asset. At the same time, despite an overall increase in outstanding debt, record-low interest rates and greater flexibility of maturation terms on consumer loans (such as greater use of home equity loans) have left consumers relatively unchanged in terms of "equity" insolvency, or their ability to pay their debts as they come due each month. Moreover, other causes of financial distress, such as the unemployment or divorce rates, have been either stable or even falling during the relevant period. Overall, there is little evidence to support the hypothesis that increased bankruptcy filings over recent decades have resulted from increased household financial distress.

Incentives Model to Explain Bankruptcy Use

This inability to explain the rise in consumer bankruptcy filings through reference to the factors traditionally thought to cause such filings has led some to seek elsewhere for an explanation for the rise in consumer filings. The *incentives model* argues that one can best explain the rise in bankruptcy filings by reference to the incentives and institutions that govern a debtor's decision to file bankruptcy, rather than changes in the variables that the traditional model asserts exogenously cause bankruptcy. In particular, is the incentives model argues that a variety of changes in legal, social, and economic institutions during the past twenty-five years have increased the attractiveness of bankruptcy and reduced the overall costs of filing bankruptcy.

Important changes occurred in the 1978 Code, which increased the incentives for filing bankruptcy. In addition, there were decreases in the overall costs of learning about and filing bankruptcy (such as the legalization of attorney advertising), changes in social norms that have tended to erode the traditional "stigma" associated with filing bankruptcy, and an evolution in consumer credit relations toward more impersonal and national lending that tends to erode the traditional trust relationships between debtors and creditors. Each of these factors has tended to increase the propensity for debtors to choose bankruptcy in response to financial distress or even to make debtors more willing to be less risk-averse in their finances. Scholars thus argue that bankruptcy reforms tailored to increasing the safeguards against fraud and abuse, such as with BAPCPA, are an appropriate response to these changes in the causes of bankruptcy filings.

The modern debate over consumer bankruptcy law and policy falls along these fault lines between the "distress," or traditional model, on one hand, and the "incentives," or new institutional economics model, on the other. The core value of the debtor's fresh start remains at the heart of the modern consumer bankruptcy system and remains unaffected by recent reforms to the law. The modern debate in modern American bankruptcy law, therefore, turns on the second-order question of the appropriate limits and conditions to place on the debtor's fresh start—to preserve the fresh start while also protecting the system from unnecessary fraud and abuse.

The option to declare bankruptcy is a form of credit insurance that is an immutable term in every consumer credit contract. Moreover, the unwaiveable nature of an individual's right to file bankruptcy reflects the highly paternalistic

nature of the fresh start, as individuals are prohibited from waiving their right to file bankruptcy even if such action would enable them to gain access to credit, or less expensive credit, than would otherwise be the case. In turn, the bankruptcy option tends to increase the cost and decrease the availability of consumer credit; cause substitutions by lenders to less risky forms of credit, such as secured credit and "rent-to-own" agreements; and increase the costs of goods and services in the economy.

The relevant question for the bankruptcy system, therefore, is how to best balance these goals of preserving the fresh start, while at the same time minimizing the increased risk, moral hazard, and adverse-selection problems that follow from providing this insurance. Despite the efforts of some commentators to provide a general theory of the fresh start, therefore, the balance to be struck between the fresh start, on one hand, and minimizing the opportunities for strategic behavior and cost externality, on the other, is a pragmatic and empirical balance. This pragmatic balance between these competing goals is reflected in the case law surrounding bankruptcy.

Comparative View

In the rest of the world, modern pressures have tended to push in the direction opposite from recent trends in the United States, toward a liberalization of consumer bankruptcy laws. In contrast to a history in the United States of extremely liberal bankruptcy laws, Europe and Asia have had traditions of extremely strict bankruptcy laws, reflecting the deep skepticism toward bankruptcy in those cultures. In recent years, however, these societies have started to adopt bankruptcy laws reminiscent of the American system, supporting the

debtor's fresh start. These changes have come about for a variety of reasons, including an expansion in access to consumer credit (such as credit cards) as well as conscious policy making in these countries to encourage higher levels of individual entrepreneurship and risk taking as a means to spur economic growth in stagnant economies. Over time, therefore, the economic forces of globalization seem to be driving a convergence toward efficient bankruptcy systems around the world, leading to greater liberalization in Europe and Asia and greater restraints in the United States.

This comparison of the consumer bankruptcy system in the United States versus the rest of the world illustrates the fundamental fact that consumer bankruptcy law and practice are nested in a cluster of moral, cultural, and economic institutions that vary substantially from one country to another. Strong social or religious norms that stigmatize bankruptcy, for instance, tend to deter bankruptcy filings, even if the formal legal rules are generous. On the other hand, weak social norms, or an erosion of these norms over time, tend to increase bankruptcy filings; in turn, the increase in bankruptcy filings can have the effect of further eroding those norms, creating a vicious cycle. This may necessitate changes in the formal legal regime to restore the equilibrium balance to the system. In this complex social balance, therefore, the legal rules governing bankruptcy can serve as a complement to or substitute for other legal, social, and economic institutions. How to obtain the maximum social benefit from the interaction of these formal and informal institutions is the foundational question for consumer bankruptcy law and policy.

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