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**WHY SO MANY BANKRUPTCIES AND WHAT TO DO ABOUT IT:
AN ECONOMIC ANALYSIS OF CONSUMER BANKRUPTCY LAW AND BANKRUPTCY
REFORM**

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WHY SO MANY BANKRUPTCIES AND WHAT TO DO ABOUT IT: AN ECONOMIC ANALYSIS OF CONSUMER BANKRUPTCY LAW AND BANKRUPTCY REFORM

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ABSTRACT

Since the inception of the first permanent American bankruptcy law in 1898, the intellectual and political understanding of the bankruptcy process has been anchored in a model of the bankruptcy process that views bankruptcies as being driven by household financial distress. For much of the Twentieth Century, this “traditional model” of bankruptcy accurately explained observed trends in bankruptcy filings. Moreover, the widespread consensus on the traditional model was reflected in the enactment of the current Bankruptcy Code in 1978, which rested on the intellectual foundations of the traditional model.

To this day, the overwhelming number of leading bankruptcy scholars continues to believe in the descriptive accuracy and normative policy recommendations of the traditional model. Thus, scholars as diverse as Elizabeth Warren and Jay Westbrook, Douglas Baird, and Kenneth Klee, have all expressed strong opposition to the bankruptcy reform legislation. Regardless of whether they draw from a progressive and sociological background (Warren and Westbrook), law & economics background (Baird), or doctrinal background (Klee), scholars have continued to express consensus belief in the traditional model and the policy implications that it implies.

For most of this period, the traditional model has provided both empirically descriptive findings and normatively clear implications. Over the past two decades, however, the traditional model has broken down. During a period of unprecedented prosperity and economic stability, personal bankruptcies have soared, raising fundamental questions about the validity of the traditional model.

This article argues that there has been an unacknowledged sea-change in the nature of consumer bankruptcy in America and that this requires a new model of the consumer bankruptcy process and that this new model of consumer bankruptcy also implies the need for certain amendments to the Bankruptcy Code. This article first provides a scientific analysis of the traditional model to determine whether these new trends can be accommodated within the traditional model. The model is examined in the light of the available evidence and the conclusion is that the traditional model is unable to account for the upward surge in bankruptcies over the past twenty-five years. The article then offers a new model to explain the anomaly of the rising bankruptcy filings of recent years and examines the available empirical evidence on point. This model draws from the school of New Institutional Economics (NIE) and focuses on the institutions, incentives, and transaction costs associated with filing bankruptcy. Although the model

will require further testing and refinement before it can be said to be definitive, available evidence tends to support the model advanced here.

The article then turns to the normative conclusions that are suggested by the New Institutional Economics model. Widespread acceptance of the traditional model animated the framework of the 1978 Bankruptcy Code and continues to animate the opposition to the current bankruptcy reform movement. The replacement of the traditional model with the NIE model offered here also has certain normative and policy implications. Most fundamentally, whereas the premises of the traditional model are inconsistent with the bankruptcy reform movement, the finding of the NIE model justifies many of the key bankruptcy reform efforts of recent years.

Keywords: Bankruptcy, consumer credit, New Institutional Economics

JEL Classification: G33, Z13, G20, K00, K19

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TABLE OF CONTENTS

- I. Introduction
- II. The Traditional Model Triumphant: 1898-1945
- III. The Crisis of the Traditional Model
 - A. Consumer Indebtedness
 - 1. Equity Insolvency and Consumer Bankruptcy
 - 2. Balance Sheet Insolvency and Bankruptcy
 - 3. Credit Cards and Bankruptcy
 - 4. Summary on Household Financial Condition and Bankruptcy
 - B. Unemployment, Downsizing, and Bankruptcy
 - 1. Unemployment and Bankruptcy
 - 2. “Downsizing” and Bankruptcy
 - 3. Summary on Unemployment, Downsizing, and Bankruptcy
 - C. Divorce
 - D. Health Problems, Medical Costs, and Insurance
 - 1. Health Care Costs and Bankruptcy
 - 2. Health Insurance and Bankruptcy
 - 3. Health Problems and Income Interruptions
 - 4. Summary on Health Care, Insurance, and Bankruptcy
 - E. Other Evidence Questioning the Traditional Model
 - F. Summary: The Intellectual Crisis of the Traditional Model
- IV. Why So Many Bankruptcies? A New Institutional Economics Model of Consumer Bankruptcy
 - A. Changes in the Relative Costs and Benefits of Filing Bankruptcy

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1. The Economic Benefits of Filing Bankruptcy Have Risen
2. The Economic Costs of Filing Bankruptcy Have Fallen
3. Summary on Changes in the Costs and Benefits of Bankruptcy
- B. Changes in the Nature of Consumer Credit
 1. The Shift to Unsecured Consumer Credit
 2. Greater Nationalization and Impersonalization of Consumer Credit
 3. Development of Formal Institutions as “Trust Substitutes”
- C. Changes in Social and Personal Norms Regarding Bankruptcy
 1. Consequences of Change in Social Norms Regarding Bankruptcy
 2. Empirical Evidence of Effects of Changes in Norms on Filings
 3. Causes of Changes in Social Norms Regarding Bankruptcy
- V. What to Do About Rising Bankruptcies?
 - A. Do Nothing? *Ex Ante* Responses to an *Ex Post* Problem
 - B. Bankruptcy Reform: *Ex Post* Responses to an *Ex Post* Problem
 1. Adjust the Relative Costs and Benefits of Filing Bankruptcy
 2. Reversing the Decline of Social Stigma
 3. Increasing Use of Formal Institutions as Trust Substitutes
- VI. Conclusion

I. Introduction

The test of the validity of a scientific theory is its ability to explain the world.¹ Consumer bankruptcy theory has been long-dominated by the “traditional model” of consumer bankruptcy, which views bankruptcy filings as a result of household financial distress. In the traditional model, bankruptcy is seen as a largely involuntary act, a “last resort” to deal with insoluble financial problems.² The traditional model argues that bankruptcy results from factors such as heavy indebtedness or sudden and unexpected income or expense shocks, such as unemployment, medical problems, or divorce. In the traditional model, individuals use bankruptcy as a form of social insurance, allowing individuals to “smooth” unexpected income or expense shocks. To this day, most bankruptcy scholars continue to believe in the descriptive accuracy and normative policy recommendations of the traditional model. Thus scholars as diverse as Elizabeth Warren³ and Jay Westbrook,⁴ Douglas Baird,⁵ and Kenneth Klee,⁶ have all expressed strong opposition to the bankruptcy reform legislation. Regardless of whether they draw from a

¹ See KARL POPPER, CONJECTURES AND REFUTATIONS: THE GROWTH OF SCIENTIFIC KNOWLEDGE (1962); THOMAS KUHN, THE STRUCTURE OF SCIENTIFIC REVOLUTIONS (2d ed. 1970).

² For a recent statement of the traditional model, see TERESA A. SULLIVAN, ELIZABETH WARREN, AND JAY LAWRENCE WESTBROOK, THE FRAGILE MIDDLE CLASS: AMERICANS IN DEBT (2000). The conclusions of the Report of the National Bankruptcy Review Commission also generally reflect the traditional view as well as the policy implications associated with it. See REPORT OF THE NATIONAL BANKRUPTCY REVIEW COMMISSION (Nov. 24, 1998).

³ See Elizabeth Warren, *The Bankruptcy Crisis*, 73 IND. L.J. 1079 (1998).

⁴ See Jay Lawrence Westbrook, *Empirical Research in Consumer Bankruptcy*, 80 TEX. L. REV. 2123 (2002);

⁵ Douglas G. Baird, *Bankruptcy’s Uncontested Axioms*, 108 YALE L. J. 573, 575 n.7 (1998); Douglas Baird, *Bankruptcy Bill Would Prevent Some From Making a Fresh Start*, CHICAGO TRIBUNE 21 (June 25, 1999), available in 1999 WL 2886954.

⁶ See NBC Says Credit Industry’s Reform Proposals Mean-Spirited, 32 BANKR. CT. DEC. 4 (Apr. 7, 1998).

progressive and sociological background (Warren and Westbrook), law & economics background (Baird), or doctrinal background (Klee), scholars have continued to express consensus belief in the traditional model and the policy implications that it implies. Moreover, the success of the traditional model has not been purely academic. The consensus belief in the traditional model animated the drafting of the 1978 Bankruptcy Code, the basic architecture of which remains in place today.⁷

Recent years, however, have seen unprecedented political challenges to the 1978 Code through repeated Congressional efforts to amend the Bankruptcy Code. These political efforts come in response to an unprecedented surge in consumer bankruptcy filings over the past twenty-five years, which accelerated during the past decade. In 2002 bankruptcy filings for the first time exceeded 1.5 million; early reports for 2003 indicate a further rise this year. But these bankruptcy records come on the back of an era of unprecedented economic prosperity—low unemployment, low interest rates, and a roaring stock market. This anomaly of record-high bankruptcy filings during an era of unprecedented prosperity has spurred repeated efforts to amend the bankruptcy code over the past several years to place greater restrictions and conditions on access to bankruptcy.⁸

To date, these reform efforts have been primarily political, not intellectual. And indeed, adherents to the traditional model have sharply criticized these reform efforts as being purely politically-motivated and lacking in intellectual justification.⁹ Adherents to the traditional model argue that the surface appearance of prosperity disguises deeper economic problems that remain consistent with the traditional model. If this is true, then bankruptcy reform designed to place greater conditions on access to bankruptcy appears to be cruel and short-sighted.¹⁰ Instead, it is argued that policy should focus on

⁷ See DAVID A. SKEEL, JR., *DEBT'S DOMINION: A HISTORY OF BANKRUPTCY LAW IN AMERICA* (2002), BRUCE G. CARRUTHERS AND TERENCE C. HALLIDAY, *RESCUING BUSINESS: THE MAKING OF CORPORATE BANKRUPTCY LAW IN ENGLAND AND THE UNITED STATES* (1998); Todd J. Zywicki, *The Past, Present, and Future of Bankruptcy Law in America*, __ MICH. L. REV. __ (Forthcoming 2003); Todd J. Zywicki, Book Review, *RESCUING BUSINESS: THE MAKING OF CORPORATE BANKRUPTCY LAW IN ENGLAND AND THE UNITED STATES* 16 BANKR. DEV. J. 361 (2000). Bankruptcy legislation is sufficiently technical and of low political salience that experts, such as academics and practicing lawyers, tend to exert larger influence over the legislative process than they might on other types of legislation. See Zywicki, Book Review, *supra* note, at 376-84; see also CARRUTHERS & HALLIDAY, *RESCUING*, *supra* note, at 74-99.

⁸ See REPORT OF THE COMMITTEE ON THE JUDICIARY, HOUSE OF REPRESENTATIVES, TO ACCOMPANY H.R. 333, *BANKRUPTCY ABUSE PREVENTION AND CONSUMER PROTECTION ACT OF 2001*, at 3-5 (Feb. 26, 2001) (summarizing political efforts to pass bankruptcy reform legislation over several years).

⁹ See, e.g., Elizabeth Warren, *The Bankruptcy Crisis*, 73 IND. L.J. 1079 (1998); Margaret Howard, *Bankruptcy Empiricism: Lighthouse Still No Good*, 17 BANKR. DEV. J. 425 (2001) (describing letters of law professor opposing bankruptcy reform legislation); Charles Jordan Tabb, *The Death of Consumer Bankruptcy in the United States?*, 18 BANKR. DEV. J. 1 (2001). To a large extent both the support for and opposition to bankruptcy reform is driven by interest group pressures on both sides, rather than intellectual deliberation. See Zywicki, *Past*, *supra* note.

¹⁰ Professor Elizabeth Warren, the leading advocate of the traditional model, for instance, states, "Those who want to say the way to solve rising consumer bankruptcy is by changing the law are the same people who would have said during a malaria epidemic that the way to cut down on hospital admissions is to lock the door." See Warren, *Bankruptcy Crisis*, *supra* note, at 1101.

alleviating the underlying economic distress, of which increased bankruptcy filings is merely the symptom.¹¹

On the other hand, if the traditional model is unable to explain the upward trend in bankruptcy filings over the past several decades as resulting from increased financial distress, then it is appropriate to consider whether an alternative intellectual model exists that better explains the available evidence. The traditional model generates a clear testable hypothesis about trends in consumer bankruptcy filings—consumer bankruptcies should rise as household financial condition deteriorates and should fall during times of prosperity. Household financial condition can change for many reasons, but whatever the causes, the forces must be sufficiently widespread and adverse so as to account for major changes in bankruptcy filings. With respect to an observable trend, such as the upward consumer bankruptcy trend of the past twenty-five years, the traditional model predicts that there must be some important, systematic, and chronic negative effect on household financial condition that has continued to worsen over time.

For much of the Twentieth Century, the traditional model has provided both empirically descriptive findings and normatively clear implications. During the Great Depression, for instance, bankruptcy filings surged, but they returned to a much lower level as prosperity returned.¹² But the surge in filings over the past twenty-five years, however, has come during a period of prosperity, not misery. Because the traditional model argues that consumer bankruptcies stem from household financial distress, this combination of record prosperity and record-high bankruptcy filings is anomalous, providing a new and unprecedented challenge to the traditional model.¹³ Traditional scholars have attempted to reconcile this tension by incorporating the available evidence within the traditional model. If the underlying model is sound, the process of ordinary science will generate increasingly accurate and instructive refinements to the model.¹⁴ If the model is flawed, however, it will become increasingly difficult to account for anomalies. Efforts to account for some anomalies will create incoherence in the model and new factual anomalies.¹⁵ At some point, the model itself will reach an intellectual “crisis” and collapse, creating an opportunity for a new model to arise to replace it.¹⁶

This article reviews the efforts of the traditional model to explain the world of consumer bankruptcy in America over the past century. As will become evident, for

¹¹ See, e.g., Warren, *Bankruptcy Crisis*, *supra* note, at 1101; Jean Braucher, *Increasing Uniformity in Consumer Bankruptcy: Means Testing as a Distraction and the National Bankruptcy Review Commission’s Proposals as a Starting Point*, 6 AM. BANKR. INT. L. REV. 1, 5 (1998).

¹² See discussion *infra* at Section II.

¹³ Thomas Kuhn defines an “anomaly” in a scientific model as the observation of “phenomenon . . . for which [the scientist’s model] has not readied the investigator,” KUHN, *supra* note, at 69, or more simply as a “violation[] of expectation,” *id.* at ix.

¹⁴ See KUHN, *supra* note, at 24.

¹⁵ As Kuhn observes, when anomalies arise that appear to falsify the dominant model, scientists “will devise numerous articulations and *ad hoc* modifications of their theory in order to eliminate any apparent conflict.” KUHN, *supra* note, at 78.

¹⁶ See KUHN, *supra* note, at 77 (“crises are a necessary precondition for the emergence of novel theories”). Kuhn describes as an example the attempts that were made to salvage Ptolemy’s astronomic theories in the face of mounting anomalies, leading to increasingly complex and internally inconsistent models. See KUHN, *supra* note, at 68. The elaborateness and inaccuracy of the Ptolomeic system paved the way for Copernicus’s break-throughs. *Id.* at 69. Rigorous scientific testing similarly exposed anomalies in Newton’s theories of physics, which led to the rise of the theory of relativity. *Id.* at 73-74.

much of this period, the traditional model provided a persuasive explanation of the consumer bankruptcy system. Bankruptcies fell during periods of prosperity and rose during periods of economic stress. Beginning around the time of the enactment of the 1978 Code, however, dramatic changes occurred that fundamentally altered the consumer bankruptcy system. This article examines the efforts of the traditional model to explain these developments within its system. Despite the efforts of the traditional model to account for these anomalies, it is shown that those efforts are in the end unpersuasive. The inability of the traditional model to account for the unprecedented developments of the past twenty-five years has brought the traditional model of consumer bankruptcy to a state of intellectual crisis.

Faced with the intellectual crisis of the traditional model, this article advances a new model of consumer bankruptcy that is both theoretically and empirically superior to the traditional model.¹⁷ The model offered here is anchored in the New Institutional Economics, associated with scholars such as Nobel Laureate Douglass North and Oliver Williamson. Whereas the traditional model focuses on the underlying economic issues that purportedly have caused an increasing number of people to file bankruptcy, the model offered here sees the rising bankruptcy tide as the result of an increasing tendency for individuals to choose bankruptcy as the response to financial problems. By demonstrating that consumer financial distress has *not* increased over the relevant time period, it is apparent that increased bankruptcy filings have not been caused by individuals being “driven” into bankruptcy. Instead, it appears that individuals increasingly are *choosing* to file bankruptcy as a response to financial distress, rather than reducing spending or tapping savings to avoid bankruptcy. Understand the rapid increase in bankruptcy filings during the past twenty-five years, therefore, requires looking beyond the historic relationship between financial distress and bankruptcy. Instead, it is necessary to examine the institutions and incentives that have led Americans increasingly to choose bankruptcy as a response to financial distress.

Moreover, once the New Institutional Economics model of consumer bankruptcy is understood, it generates policy prescriptions dramatically different from those of the traditional model. Just as the traditional model manifested itself in the 1978 Bankruptcy Code, the new model of consumer bankruptcy is consistent with much of the current bankruptcy reform agenda in Congress. In that sense, this article also provides a comprehensive conceptual foundation that explains the rise of the movement toward bankruptcy reform in recent years and many of the particulars of the legislation.¹⁸ In short, policy-makers have recognized what bankruptcy scholars have not yet—that we live in a new world of consumer bankruptcy.¹⁹ Indeed, much of the academic opposition

¹⁷ As Kuhn observes, the test of a new theory is whether it explains the observed evidence better than the prevailing model or “paradigm.” See KUHN, *supra* note, at 77.

¹⁸ Prior to taking up my appointment at the Federal Trade Commission, I was closely involved in the bankruptcy reform legislative process for six years as a professor and advisor to Congress and thus have had an up-close view of the currents that generated the bankruptcy reform legislation.

¹⁹ Kuhn observes that although the resolution of scientific questions arises from an internal dialogue within the relevant academic community, external pressures for reconsideration of dominant paradigms are often spurred by political and social forces external to the scientific enterprise itself. For instance, although Copernicus’s views eventually prevailed due to their greater scientific validity than Ptolomeic astronomy, Copernicus’s eventual success and ability to overturn the Ptolomeic model arose in part from the practical

to bankruptcy reform may result from the reluctance to abandon the traditional model and to adopt a new model of consumer bankruptcy and the policy recommendations it implies.

It should also be noted at the outset that the focus on this article is on the causes and consequences of the underlying upward trend line in consumer bankruptcy filing rates over the past several years. This caveat is important, as there are at least four different ways that one could examine trends in personal bankruptcy filing rates. First, one could create a model of the underlying “frictional” steady-state bankruptcy filing rate that will prevail in any modern industrial economy. This model would be grounded in the factors examined by the traditional model, such as unemployment and unexpected income or cost shocks. Second, one could create a model of the steady-state level of *predicted* bankruptcy filing rates, assuming fully-informed rational use of the bankruptcy system.²⁰ Third, one could create a model that assumes a certain underlying trend line in filing rates and then seeks to explain short-term fluctuations in bankruptcy filing rates from period to period.

Finally, one could focus on the nature of the underlying trend line itself. That is the focus of this article. This article will argue that the underlying trend line in American bankruptcy filing rates is in the result of fundamental changes in the American economy, society, and individual bankruptcy calculus that has led to increased bankruptcy filing rates, and which the traditional model of consumer bankruptcy is unable to explain. Although explaining the trend line is the primary purpose of this paper, the other three ways of examining bankruptcy will be relevant as well. In particular, it will be important to understand how these other factors operate in order to isolate the underlying causes of the upward trend in bankruptcy filing rates. The legal and policy recommendations that this article will make are aimed primarily at responding to the upward trend in bankruptcy filing rates, rather than short-term upward or downward fluctuations in filing rates. This is the fundamental question of the age for consumer bankruptcy, with crucial intellectual, legal, and political ramifications.

Part II briefly introduces the conceptual framework of the traditional model and recounts its general track record of success in explaining consumer bankruptcy trends through much of American history.

Part III turns to an examination of the collapse of the traditional model of consumer bankruptcy. Although the model may be useful to understand the underlying “frictional” rate of bankruptcy filings in an economy, it is unable to explain the dramatic upward surge in bankruptcies over the past two decades. Part III of the article examines several of the important factors that adherents to the traditional model identify as causing rising bankruptcies, such as high consumer indebtedness, unemployment and downsizing, divorce, and finally, health problems, health costs, and lack of health insurance. As will be shown, none of these factors alone or in combination can explain the rise in bankruptcy filings in recent years.

forces of “social pressure for calendar reform,” due to the inability of Ptolemy’s theory to predict the change of seasons. See THOMAS KUHN, *THE STRUCTURE OF SCIENTIFIC REVOLUTIONS* 69 (2d ed. 1970).

²⁰ See, e.g., Michelle J. White, *Why Don’t More Households File for Bankruptcy?*, 14 J. L. ECON. & ORG. 205 (1998).

Part IV of the article then turns to a new model of consumer bankruptcy. This model derives its conceptual framework the “New Institutional Economics.”²¹ As such, the model presented here provides an institutional and transaction costs analysis of bankruptcy law and bankruptcy reform. It is argued that there have been fundamental changes that have altered the framework of individual bankruptcy decision-making. This article identifies three factors that explain the rise of consumer bankruptcies over the past few decades, each of which have operated at the margin to increase the bankruptcy filing rate. Although none of them may be definitive in any individual case to decide to file bankruptcy, they operate jointly to create incentives that increase bankruptcy filing rates or to weaken constraints that traditionally reduced bankruptcy filings. First, there has been a change in the relative economic costs and benefits associated with filing bankruptcy. These economic benefits include not only the direct benefits of filing bankruptcy, such as the generosity of the 1978 Bankruptcy Code and state exemption regimes, but also other economic costs and benefits, such as reductions in the transaction and search costs associated with learning about and filing bankruptcy. Second, there has been a fundamental change in the nature of consumer credit in the economy. There has been a substantial expansion in the use of general unsecured consumer credit in the economy and away from traditional forms of credit. This has tended to increased the benefit of filing bankruptcy by increasing the amount of credit that is dischargeable in bankruptcy. There has also been a shift to greater use of more impersonal and national credit, such as credit cards, which has eroded many of the informal constraints that restrained bankruptcy filings, such as trust, repeat-dealing, and the effects of reputation. Third, there seems to have been a reduction in the personal shame and social stigma associated with filing bankruptcy.²² This decrease in shame and stigma has eroded the noneconomic costs that traditionally constrained opportunistic bankruptcy filings. This article also provides a comprehensive survey of existing empirical literature, the bulk of which tends to disprove the traditional model and to support the New Institutional Economics model.

Having examined the rise in personal bankruptcies in recent years, Part V addresses the question of what, if anything, should be done about it. Adherents to the traditional view have argued that no major bankruptcy reforms are necessary in that the problem can be corrected through the operation of market forces alone. One possible “solution” is to do nothing and to allow market forces to adjust to the new equilibrium, which in fact is occurring in a piecemeal fashion through private market adjustment. Despite this market response, it will be shown that mere market adjustments alone are insufficient to solve the problem and will result in substantial deadweight costs to the

²¹ See DOUGLASS C. NORTH, INSTITUTIONS, INSTITUTIONAL CHANGE, AND ECONOMIC PERFORMANCE (1990); see also Todd J. Zywicki, *The Rule of Law, Freedom, and Prosperity*, 10 S. CT. ECON. REV. 1 (2003); Richard Posner, *The New Institutional Economics Meets Law and Economics*, 149 J. INST. AND THEORETICAL ECON. 73 (1993); Kenneth Scott, *The New Institutional Economics Meets Law and Economics: A Comment*, 149 J. INST. AND THEORETICAL ECON. 92 (1993). For recent summaries of new institutional economics, see Ron Harris, *The Encounters of Economic History and Legal History*, 21 L. & HIST. REV. 297 (2003); Oliver E. Williamson, *The New Institutional Economics: Taking Stock, Looking Ahead*, 38 J. ECON. LIT. 595 (2000).

²² I have elsewhere distinguished these terms: “Personal shame and social stigma go hand-in-hand. Shame is the internal psychological compass that forces one to keep his word; stigma is the external, social constraint that reinforces this.” Jones & Zywicki, *supra* note, at 215.

economy and to consumers. Bankruptcy is a problem of *ex post* contractual opportunism, and *ex ante* market responses alone are an inefficient response to a problem of *ex post* contractual opportunism. The solution rests in addressing the opportunism problem directly so as to mitigate the total social costs of policing post-contractual opportunism and the deadweight costs associated with the inability to police post-contractual opportunism perfectly. The traditional argument to “do nothing,” and rely wholly on *ex ante* market adjustments, therefore, misunderstands the causes of the bankruptcy boom and hence prescribes an unsound solution.

Having determined that formal action is indeed required to address the problem, the article offers several policy prescriptions that follow from understanding the real causes and consequences of the bankruptcy crisis. The article focuses on addressing each of the three factors that have led to the rise in bankruptcy filings in recent years. My policy recommendations follow from the foregoing discussion: (1) readjust the relative costs and benefits of filing bankruptcy and reduce the incentives in the bankruptcy code to engage in post-contractual opportunism; (2) rely on more formal legal and economic institutions as “trust substitutes” to police opportunism; and (3) try address the decline in social stigma and economic trust to the extent possible. Moreover, many of the current policy reforms that have been suggested are shown to be consistent with the premises of the model.

Part VI concludes.

II. The Traditional Model Triumphant: 1898-1978

Throughout the Eighteenth and Nineteenth Centuries in America, debtor relief consisted of a hodge-podge of state laws intermixed with periodic flurries of federal activity.²³ State law provided the basic background set of law for debtor-creditor relations, as it still continues to do so today.²⁴ In the absence of federal legislation, therefore, state law provides the basic substantive and procedural structure for the formation, enforceability, and collection of debt contracts.²⁵ During most of the Eighteenth and Nineteenth Century no federal bankruptcy law was in effect, leaving debtor-creditor law solely in the hands of the states.²⁶

There were, however, periodic flurries of federal bankruptcy law-making. During periods of extreme financial crisis such as recessions or depressions, the federal government would enact federal bankruptcy legislation in response to the financial crisis.²⁷ During the Nineteenth Century, the federal government enacted three bankruptcy laws prior to the 1898 Act: the Bankruptcy Acts of 1800, 1841, and 1867.²⁸

²³ See SKEEL *supra* note, at 1-47.

²⁴ See THOMAS H. JACKSON, *THE LOGIC AND LIMITS OF BANKRUPTCY LAW* (1986). See also Charles J. Tabb, *The History of the Bankruptcy Laws in the United States*, 3 AM. BANKR. INST. L. REV. 5 (1995).

²⁵ See Todd J. Zywicki, *The Bankruptcy Clause*, in *THE HERITAGE GUIDE TO THE CONSTITUTION* (forthcoming 2003). Indeed, the inclusion of the bankruptcy clause in the Constitution primarily was for the protection of creditors more than debtors, to aid in interstate debt-collection. *Id.*

²⁶ SKEEL, *supra* note, at 25.

²⁷ See CHARLES WARREN, *BANKRUPTCY IN UNITED STATES HISTORY* (1935). As David Skeel observes, this simplified history is not wholly accurate in all its specifics, nonetheless it is a useful general observation about the history of bankruptcy law in the Nineteenth Century. See SKEEL, *supra* note, at 24-25.

²⁸ SKEEL, *supra* note, at 25.

Each Act was spawned in the midst of financial crisis and was repealed soon thereafter. The 1800 Act lasted only three years, the 1841 Act lasted only two years, and the 1867 Act was repealed eleven years later. All together, therefore, these three acts lasted a total of sixteen years. In part, this inability to enact a federal bankruptcy law was a result of shifting legislative coalitions in Congress, reflecting a variety of regional-based views about the appropriate role for the federal government to act in this area.²⁹ But more fundamentally, this pattern of legislation reflected an underlying belief that the proper role for federal bankruptcy legislation was in a large sense to track the business cycle—i.e., that bankruptcy relief was a necessary response to widespread financial misery, but that as the economic crisis passed so should the law itself. Thus, even though there were a divergence of legislative opinions regarding the need for and proper scope of a permanent bankruptcy law, there was a shared consensus that in times of economic trouble federal bankruptcy relief was both necessary and appropriate. As the crises waned, however, so did the consensus on the need for a bankruptcy law. As such, the bankruptcy laws of the Nineteenth Century were fundamentally consistent with the traditional model of bankruptcy, in that their very existence was a response to economic hardship.

This era of temporary bankruptcy law-making ended in 1898 with the enactment of the first permanent bankruptcy law in America. The primary focus of the 1898 Act was business bankruptcy rather than individual bankruptcy, but the 1898 Act did create a new permanent edifice for consumer bankruptcies as well.³⁰ Nonetheless, the 1898 Act did not substantially change the justification for bankruptcy or the observed use of bankruptcy. The justification for bankruptcy continued to be to provide relief for the “honest but unfortunate debtor” who stumbled into financial catastrophe through job loss, illness, or other major financial set-back.³¹ On the other hand, it was also implicitly recognized that large-scale changes in the nature of the American economy had increased the vulnerability of Americans to such economic setbacks. The general migration of people from rural farms to urban industrial jobs brought with it a greater and more regular exposure to chronic business cycles and involuntary unemployment.³² In short, it was recognized that some degree of individual and business financial distress was a permanent part of a capitalist economy, thereby implying the need for a permanent bankruptcy law to ameliorate these recurrent economic difficulties.³³ At the same time, the increasing national structure of the American economy suggested the need for a bankruptcy law of national scope. Even in the best of times it was expected that there would be some level of individual and business failure, and that one way to deal with this was to make available a permanent federal bankruptcy law.

²⁹ SKEEL, *supra* note, at 28.

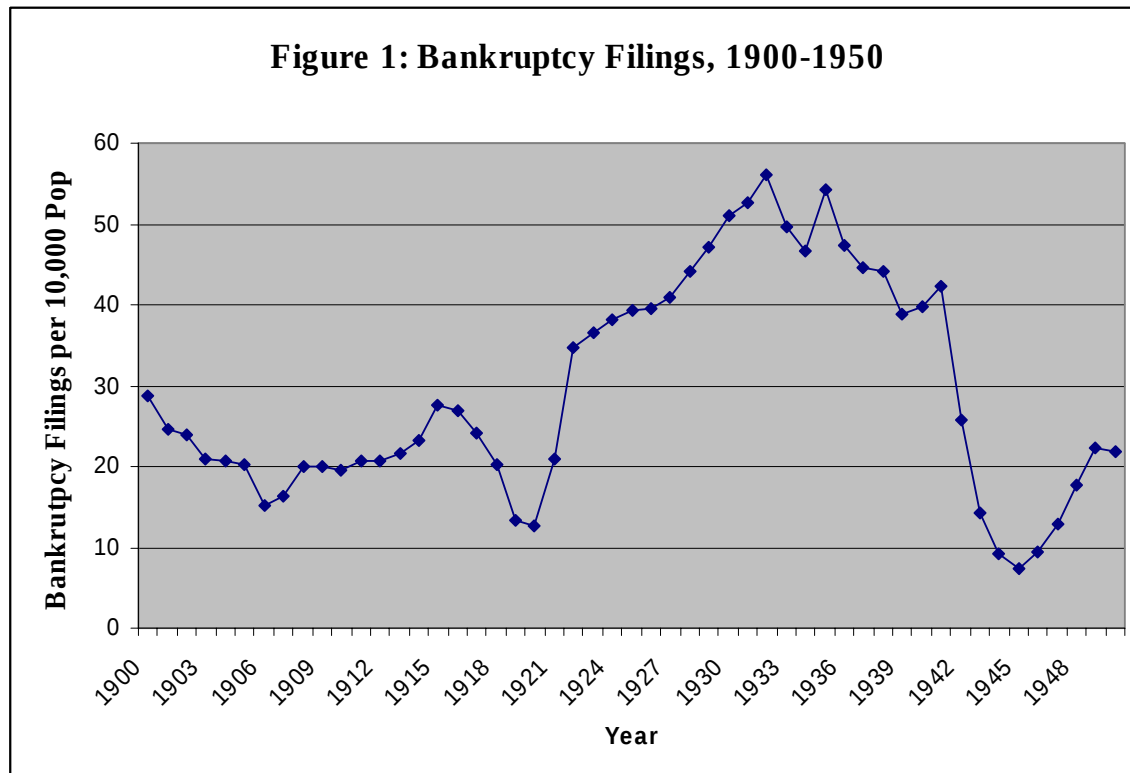
³⁰ See SKEEL, *supra* note, at 35-47; Charles J. Tabb, *Historical Evolution of the Bankruptcy Discharge*, 65 AM. BANKR. L.J. 325 (1991) (noting that 1898 Act liberalized treatment of debtors).

³¹ *Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934) (noting that purpose of consumer bankruptcy is to relieve the “honest but unfortunate debtor” from “the weight of oppressive indebtedness and permit him to start afresh”).

³² See ROBERT PUTNAM, *BOWLING ALONE* 368-71 (1999).

³³ See WARREN, *BANKRUPTCY IN UNITED STATES HISTORY*, *supra* note.

Consumer bankruptcy filings for most of the twentieth century remained generally consistent with the predictions of the traditional model.³⁴ As indicated by Figure 1, filings rose in tandem with financial distress but then declined with the passage of financial crisis:



Source: *Annual Report of the Attorney General of the United States (thorough 1939)* and *Administrative Office of the United States Courts*.³⁵

Perhaps the most striking evidence is provided by the era of the Great Depression and its aftermath. During the Depression, bankruptcy filings peaked in the early-1930s at approximately 70,000 total filings, or a little under 60 per 10,000 population. Beginning with the entry of the United States into World War II and the subsequent post-War boom,

³⁴ See Lawrence Shepard, *Accounting for the Rise in Consumer Bankruptcy Rates in the United States: A Preliminary Analysis of Aggregate Data 1945-1981*, 18 J. CONSUMER AFFAIRS 213 (1984) (finding unemployment, divorce rate, and credit use are factors in post-War growth in consumer bankruptcies); see also Vern McKinley, *Ballooning Bankruptcies: Issuing Blame for the Explosive Growth*, REGULATION 33 (Fall 1997).

³⁵ Prior to 1940, separate records were not kept for individual and business bankruptcies. Nonetheless, Figure 1 illustrates the predominant countercyclical nature of bankruptcy filings for the first half of the Twentieth Century. Moss and Johnson estimate that from 1899-1909, consumer filings were roughly 25-50% of total filings. See David A. Moss and Gibbs A. Johnson, *The Rise of Consumer Bankruptcy: Evolution, Revolution, or Both?*, 73 AM. BANKR. L.J. 311, 314 (1999). Professor Joseph Pomykala estimates that in 1930, approximately 70% of filings were non-business filings, which grew to approximately 75% of filings by the end of the decade. Email from Joseph Pomykala to Todd Zywicki, Aug. 5, 2003 (on file with author). I would like to thank Professor Pomykala for sharing with me the data for the pre-1940 period.

filing numbers plunged, bottoming out at 10,000 filings by 1945. Following the return home after the War and the mild post-War recession, consumer bankruptcies began a brief rise before leveling out at around 30,000 per year in the late 1940s. Indeed, it was not until 1955 that consumer bankruptcy filings eclipsed the record set in 1941 at the height of the Great Depression. For the next several decades, consumer bankruptcy filings follow a similar trend of peaking during recessions but then tailing back off afterwards during subsequent economic recoveries.

Over time, the expansion of consumer credit markets added a new element to the traditional model of bankruptcy. Increased access to consumer credit, it was argued, was increasing the financial vulnerability of American households, making them more susceptible to other financial stresses.³⁶ Like other adverse economic events, such as unemployment or divorce, this increase in consumer credit and the increased susceptibility it created for American households was thought to explain and justify more liberal bankruptcy laws and gradually rising consumer bankruptcy filings over time.³⁷

In short, for much of the Twentieth Century the traditional model of consumer bankruptcy filings provided a compelling explanation of bankruptcy filing patterns. Moreover, business bankruptcy filings have continued to act consistently with the model. After plunging to record-lows during the 1990s, business bankruptcies have risen with the recent recession. This explains why the recent bankruptcy reform legislation has focused primarily on consumer bankruptcy rather than chapter 11—whereas consumer bankruptcies have inexplicably risen during a period of prosperity, business bankruptcies have continued to behave as predicted by the model.

The widespread acceptance of the traditional model also animated the 1978 Bankruptcy Code.³⁸ Over many decades a consensus had emerged that consumer bankruptcy filings could be best understood as a response to household financial distress occasioned by unemployment, illness, and other financial calamities. The widespread acceptance of this model animated the drafters of the 1978 Code in their decision to further liberalize consumer bankruptcy laws and to make the discharge of debts more generous. This consensus as to the causes of consumer bankruptcy as well as the proper policy responses to it underlies the widespread opposition of academics to the proposed bankruptcy reform legislation.³⁹ As will be stressed throughout this article, the traditional model continues to have substantial explanatory power in explaining an underlying level or “frictional” bankruptcy rate as well as variation *around* the upward filing trend line of the past few decades. But it breaks down in trying to explain the fundamental question of the day, the cause of the upward trend in bankruptcy filings over the past few decades. This article, therefore, does not argue that traditional model of

³⁶ This thesis forms the heart of the “Brookings Study” of the consumer system by David T. Stanley and Marjorie Girth, published in 1971, that heavily influenced the Bankruptcy Commission of the 1970s that drafted the 1978 Bankruptcy Code. See DAVID T. STANLEY AND MARJORIE GIRTH, *BANKRUPTCY: PROBLEM, PROCESS, REFORM* (1971); see also Vern Countryman, *Improvident Credit Extension: A New Legal Concept Aborning?* 27 ME. L. REV. 1, 6-8 (1975).

³⁷ See Countryman, *supra* note, at 1; see also David A. Skeel, Jr., *Vern Countryman and the Path of Progressive (and Populist) Bankruptcy Scholarship*, 113 HARV. L. REV. 1075 (2000).

³⁸ See SKEEL, *supra* note, at 136-41.

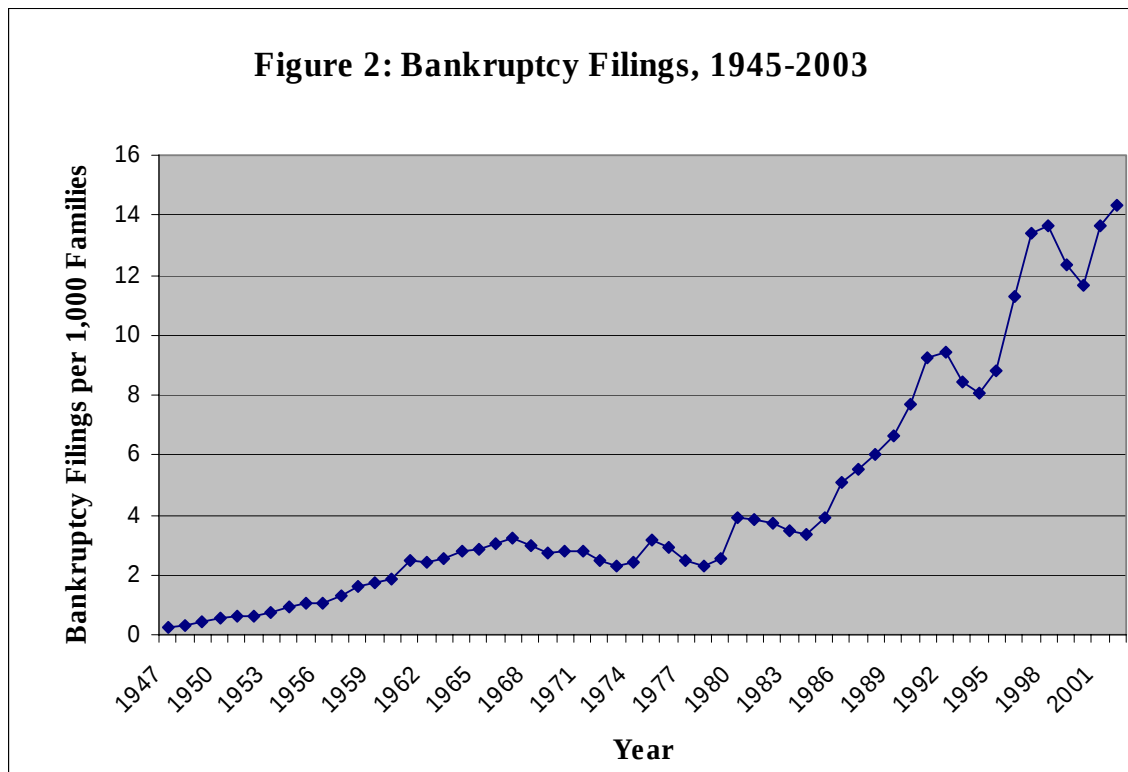
³⁹ See Howard, *Bankruptcy Empiricism*, *supra* note, at 441 n.73 (noting letters from law professors to Congress opposing bankruptcy reform legislation); Tabb, *Death*, *supra* note, at 48, n. 217, n.218 (same).

bankruptcy has nothing to say about consumer bankruptcy issues today. Rather, it is argued that the traditional model cannot explain the rapid rise in consumer bankruptcy filings over the past twenty-five years.

III. The Crisis of the Traditional Model

Drawing from this history, consumer bankruptcy scholarship has been dominated by the traditional model of bankruptcy. In the traditional model bankruptcy is seen as a form of “insurance,” designed to protect individuals from overwhelming indebtedness or from sudden and unexpected exogenous shocks to their incomes or expenses. As a result, the decision to file bankruptcy is seen as a largely involuntary act, a last resort for individuals who need a financial fresh start.

The rise in bankruptcy filings over the past several years has not shaken the faith of traditionalists. Instead, the increase in filings is in itself seen as evidence of growing financial distress.⁴⁰ Although the causes of increased bankruptcy filings can be argued, there is little doubt that consumer bankruptcy filings have exploded in the past two decades, as shown in Figure 2:



Source: *Bankruptcy Filings*, Administrative Office of U.S. Courts; *Number Households*, United States Census Bureau

As Figure 2 indicates, the per capita bankruptcy rate in America has risen dramatically in the past 60 years, with an acceleration in the 1980s and 1990s. The total number of bankruptcies more than doubled during the 1980s and then doubled again from

⁴⁰ See SULLIVAN, et al, *supra* note, at 15.

1990 to 2002, such that by 2002 annual consumer bankruptcy filings were five times higher in 2002 than just twenty year earlier.

This rapid increase in filings has been especially difficult to explain in light of the prosperous state of the American economy during most of the past two decades, and especially, the extraordinary prosperity of the late 1990s. Although the American economy set new records for economic growth, low unemployment, and low interest rates, this was matched by record-high bankruptcy filings as well.

Traditionalists have tried to reconcile this anomaly of record-high prosperity matched with record-high bankruptcy filing rates. This Part will review the efforts of traditionalists to try to square their model with the developments of the past two decades. The basic thrust of the traditionalist's argument is that the economic prosperity of the past two decades is superficial and masks real underlying economic distress.

The traditional model provides the testable hypothesis that consumer bankruptcy filings are driven by changes in household financial condition. They have identified several areas where they believe that economic distress can explain the rise in bankruptcy filings over time. First, it is argued that rising bankruptcy rates is a direct function of rising consumer indebtedness. As consumers become more leveraged they are less able to pay their debts and become more vulnerable to sudden and unexpected income or expenditure shocks. Thus, increased bankruptcy filing rates reflects consumers' increasing indebtedness. Second, it is argued that increasing bankruptcy filing rates is a reflection of the same basic forces that have always driven bankruptcy filings, such as sudden and unexpected exogenous shocks to income and expenditures. In particular, it is argued that unemployment and "downsizing" of middle-class workers has continued to play a crucial role in creating income disruptions that trigger bankruptcy filings. It is also argued that health problems, health expenses, and lack of health insurance have created a new class of unexpected expenditure shocks that trigger bankruptcy filings. Finally, it is argued that divorce, which amounts to both an income and expenditure shock, has created economic distress that has triggered rising bankruptcies.

Closer examination reveals, however, that none of these explanations can explain the upward trend bankruptcy filing rate, whether individually or collectively. Before examining each factor in detail, several more general comments are in order as the traditional model suffers from several theoretical and empirical failings that run through the specific arguments addressed below.⁴¹ First, in some cases the traditional model has relied on a poor choice of proxy variables to measure the impact of certain factors on bankruptcy filing rates, leading to problems of endogeneity and erroneous conclusions of cause and effect.⁴² Second, many key empirical studies of the traditional model have failed to construct a proper control group for their tests. By studying only those *in* bankruptcy, they have failed to recognize that there may be many people with similar financial difficulties who have *not* filed bankruptcy. The failure to create a proper control group undermines the empirical tests of the traditional model.⁴³ Third, the inferences of the traditional model have been based on a confusion of dependent and

⁴¹ Each of these critiques will be developed in more detail in the discussion that follows to illustrate their relevance, but it is useful to list them briefly at the outset.

⁴² See *infra* notes 48-49 and accompanying text.

⁴³ See *infra* note 130-133 and accompanying text.

independent variables, leading to circular reasoning in the model's conclusions.⁴⁴ Fourth, in several cases the conclusions of the traditional model appear to be grounded largely on anecdote, rather than systematic data, generating inaccurate generalizations about the full picture.⁴⁵ Finally, in drawing policy inferences, the traditional model fails to account for offsetting behavioral adjustments by consumers that will tend to undermine the effects of the traditionalists' proposed reforms.⁴⁶

This Part of the article examines each of the factors identified by the traditional model as purported causes of rising consumer bankruptcies. As this Part will show, a close examination of the relevant data fails to confirm the hypothesis of the traditional model that rising consumer bankruptcies have been caused by rising household financial distress.

A. *Consumer Indebtedness*

The first, most recurrent traditionalist argument is that consumer bankruptcies are simply a function of heavy consumer indebtedness. In particular, it is argued that there is a high correlation between consumer bankruptcies on one hand and consumer debt to income ratios on the other.⁴⁷ Heavy debt loads, it is argued, drive consumers into bankruptcy in one of two ways. Either the debt becomes simply "overwhelming," forcing consumers to file bankruptcy simply to get off the treadmill of debt; or large amounts of consumer debt make individuals more highly leveraged, making them more vulnerable to shocks to their incomes or expenditures. And indeed, the correlation between bankruptcy filings and debt-to-income ratios is striking. There is also no doubt that total consumer debt has increased over time. But the mere observation of correlation is not sufficient to infer causation. And, in fact, the traditional model has been unable to establish any causal link using standard measures of financial distress.

As a threshold matter, there is a severe codependent variable problem that traditionalists have failed to consider in their conclusions, much less correct for. The traditional model posits a determinate causal connection that high household debt loads cause high levels of bankruptcy filing. But this causal link is simply posited, not demonstrated. In fact, it is probable that the level of debt that individuals are willing to incur will be a function, at least in part, of the degree of generosity of the bankruptcy system.⁴⁸ Thus, if it is easy to file bankruptcy and to discharge debt, individuals will borrow more and incur more risk than if bankruptcy makes it difficult to discharge debt. Indeed, this is a primary purpose of having a bankruptcy law—to make individuals less

⁴⁴ See *infra* note 186 and accompanying text.

⁴⁵ See *infra* note 134-155 and accompanying text.

⁴⁶ See *infra* notes 178-179, 184, and accompanying text.

⁴⁷ See STANLEY & GIRTH, *supra* note, at 32-35; SULLIVAN, et al., FRAGILE, *supra* note, at 24; Baird, *Bankruptcy's Uncontested Axioms*, *supra* note, at 575 n.7; Moss and Johnson, *supra* note, at 322-27; CONGRESSIONAL BUDGET OFFICE, PERSONAL BANKRUPT: A LITERATURE REVIEW 8-11 (Sept. 2000)..

⁴⁸ See Edith H. Jones and Todd J. Zywicki, *It's Time for Means-Testing*, 1999 BYU L. REV. 177, 209 (1999); see also *Delinquency on Consumer Loans, Testimony Before House Committee on Banking and Fin. Servs.*, 104th Cong. At *8-9 (1996) (statement of Lawrence B. Lindsey, Member, Board of Governors of the Federal Reserve System), available in 1996 WL 517589; David B. Gross and Nicholas S. Souleles, *An Empirical Analysis of Personal Bankruptcy and Delinquency*, 15 REV. FIN. STUD. 319, 324 (2002) (noting that household debt "is an endogenous variable, conflating credit demand and supply, and so cannot itself be said to 'explain' default").

risk-averse and willing to incur more debt than they would absent a bankruptcy law.⁴⁹ On the other hand, lenders will be more willing to provide credit when bankruptcy laws are strict, and less willing to do so where bankruptcy is difficult. In short, there is a classic endogeneity problem of two co-dependent variables—the willingness to incur debt is a function of the bankruptcy regime in place and the likelihood of filing bankruptcy is, in part, a function of individual indebtedness. Lenders confront a similar endogeneity problem. It is not clear that *any* empirical study of consumer bankruptcy from a traditionalist perspective has attempted to correct for this problem of co-dependent variables.

Methodological issues aside, extant data fails to support the thesis that the rising consumer bankruptcy filing rate has been caused by rising household indebtedness. Bankruptcy has two well-established measures of financial distress and insolvency. The first is “equity” or liquidity insolvency, which examines the ability to generally pay one’s debts as they come due.⁵⁰ This measurement is essentially a ratio of one’s current income to current expenses, including current or monthly payments on debt obligations. The second is “balance sheet” or “bankruptcy” insolvency, which finds a debtor to be insolvent if the “sum of the debtor’s debts is greater than all of the debtor’s assets at fair valuation.”⁵¹ Equity insolvency is a “flow” measure of current income and expenditures; balance sheet insolvency is a “stock” measure of total assets and total debt. As applied in the consumer context, this measurement is essentially a measure of the debtor’s net wealth.

There are thus two established measures of financial distress for purposes of bankruptcy, balance-sheet insolvency and equity insolvency. Advocates of the traditional model, however, have posited a novel measurement of financial distress: the ratio of debt to income. This purported measurement is illogical. No explanation is provided for why one should measure financial distress by comparing monthly income (a short-term flow measure of financial assets) to total debt (a long-term stock measure of financial liabilities), including long-term balances owed on debt such as mortgages, car payments, and student loans.⁵² Installment debt is repaid in small increments month-to-month, not

⁴⁹ See F. H. Buckley, *The Debtor as Victim*, 87 CORNELL L. REV. 1078 (2002) (summarizing incentive effects of consumer bankruptcy system). Lenders, of course, have opposite incentives. A looser bankruptcy law will increase the risk of lending, and therefore the cost, and so will tend to restrict the supply of credit. Stricter bankruptcy laws reduce the cost and increase the supply.

⁵⁰ See Uniform Fraudulent Transfer Act §2(b); see also 11 U.S.C. § 303(h)(1) (allowing entry of order for relief for involuntary bankruptcy if “debtor is not paying such debtor’s debts as such debts become due . . .”).

⁵¹ See Uniform Fraudulent Transfer Act §2(a); see also 11 U.S.C. § 101(32) (“insolvent” means “finance condition such that the sum of such entity’s debts is greater than all of such entity’s property, at a fair valuation . . .”).

⁵² I am not aware of any efforts to justify the use of this novel measurement of household financial condition rather than the two standard measurements of insolvency, other than that it seems to “work” as correlation. As will be noted below increased total consumer debt may be relevant to understanding why bankruptcies have risen, but not because it reflects increased financial distress, but rather because it increases the benefits to individuals from filing bankruptcy. See *infra* at notes ____ - ____ and accompanying text.

in one lump sum. Thus, it is not clear what the comparison of short-term income flows to long-term stock debt obligations is supposed to reveal.⁵³

The fallacy of using debt-to-income ratios to measure financial condition can be illustrated by noting that it is equally illogical to measure financial condition through a comparison of current debt obligations (monthly payment obligations on outstanding debt) to one's total assets or total wealth. This obviously is not a useful measurement of household financial condition, as much of one's assets are illiquid and cannot be easily reached to make monthly payments on a mortgage or car loan. This is why balance sheet insolvency contemplates a comparison of total assets and total debts at a liquidation. It should be equally obvious that debt-to-income ratio provides little valuable information about financial condition, as individuals do not pay the entire lump-sum of their indebtedness out of their current income. Mortgages are paid in installments, not lump-sum. Instead, they expect to pay off the indebtedness in installments over time through current savings, wealth increases, and future income increases.

This Section of the article will examine the purported link between financial distress and bankruptcy through the standard measures of insolvency. For reasons that will become clear, the better measure of household financial distress is equity insolvency, as measured through current debt measurements. Thus, this measure will be examined first. Next the data on balance sheet insolvency will be presented. As will be seen, neither of the standard measures of financial condition support the hypothesis that the upward trend in bankruptcy filings is the result of excessive debt burdens.

1. Equity Insolvency and Consumer Bankruptcy

The first way to measure financial condition is through equity insolvency, or the ability to pay one's debts as they come due. Household indebtedness comes in a variety of forms: long-term, low-interest debt, such as a home mortgage or home equity loan; medium-term, moderate-interest debt, such as student loans or car loans; or short-term, high-interest debt, such as credit cards, unsecured personal loans, or pawn shops. Because of this variety of interest rates and maturity terms, the often-cited ratio of *current* income to *total* debt is meaningless as a measurement of household financial condition. More relevant is the debt-service burden, the percentage of one's income each month that is dedicated to monthly debt payments. As the debt-service burden rises, households will become more vulnerable to income or expense shocks that disrupt their ability to service their debt. As the debt-service burden falls, households should find it easier to pay their bills on an ongoing basis and should be more resistant to income or expense shocks.

Unlike total indebtedness, the debt-service burden accounts for the maturity term and interest rate on a loan, which is crucial to understand the true state of household financial condition. Consider first the term of a loan. Holding the principle amount constant, the fraction of household income dedicated to debt service will depend on the loan term: for a given borrowed principle amount, a shorter loan maturity term will

⁵³ See also Glenn Canner, Arthur B. Kennickell, and Charles A. Lockett, *Household Sector Borrowing and the Burden of Debt*, 81 FED. RES. BULLETIN 323, 323-24 (1995) (criticizing use of aggregate debt-to-income ratio as a measure of household indebtedness).

require higher month-to-month payments than one with a longer maturity.⁵⁴ To understand the impact of higher debt levels on household financial condition, therefore, it is necessary to consider the term of the loan as well as the amount. As the loan maturity term rises, borrowers can borrow the same or even more while improving their financial condition because their monthly payments will fall.⁵⁵ The “debt-to-income ratio,” by contrast, does not account for the principle term of the loan.

Second, the debt-to-income ratio does not account for changes in interest rates. Interest rates have plummeted during the past decade, reaching and maintaining record low rates. As interest rates have fallen, households have been able to borrow an equivalent or greater amount of money without a deterioration in their month-to-month household financial condition. The effect of lower interest rates on the debt-service burden can be substantial.⁵⁶ Low interest rates on mortgages, home equity loans, and other long-term debt also improve household financial condition by enabling the substitution of more attractive low-interest forms of household borrowing for less attractive high-interest loans.⁵⁷ Again, the measurement of debt-to-income ratio is inaccurate in that it fails to account for the changes in interest rates, which fell steadily throughout the 1990s and fell even faster since then.

In fact, since the early 1990s interest rates have fallen and loan maturities have lengthened on average. Even as total household indebtedness has gradually and consistently risen during this period, the household debt service burden has remained fairly constant as a result of low interest rates and longer payment maturities.⁵⁸ Indeed, it is likely that total indebtedness has risen *precisely* because of falling interest rates and a

⁵⁴ Consider a hypothetical borrower who borrows \$100,000 at 10% interest rate. If the loan is for a term of 1 year, the borrower will be required to pay \$8,791.59 per month; if the term is 5 years, the payments fall to \$2,124.70 per month; for 10 years it is \$1,321.51 per month; and for 30 years (the conventional term for a mortgage) the required payments are only \$877.57 per month. Clearly the maturity term of the loan makes a large difference in monthly payments.

⁵⁵ For instance, a borrower who borrowed on a 30 year term could borrow over \$1 million for the same monthly payment as a 1 year loan of \$100,000.

⁵⁶ Consider a 30 year mortgage of \$100,000. As noted, at an interest rate of 10%, the month payments on the mortgage will be \$877.57 per month. But if the interest rate falls to 5%, the same mortgage requires only \$536.82 per month—a reduction in the current debt burden of \$340 per month. This means that at an interest rate of 5%, the household could afford to increase their total principle debt burden on the mortgage by *sixty percent* (to over \$160,000) and have their current debt burden remain unaffected.

⁵⁷ For instance, consider an individual with \$40,000 in student loan debt at a 10% interest rate. If that person were to buy a house, she could put down a minimum downpayment of 5% (thereby increasing the amount financed) and use funds that would have been allocated to mortgage payments to pay down her student loan debt. The total debt amount has remained the same, but there has been a substitution of low-interest mortgage debt for higher-interest student loan debt.

⁵⁸ See <http://www.clev.frb.org/research/Et97/0297/charts/houdeb1a.htm>. See also Canner, Kennickell, and Luckett, *Household Sector Borrowing*, *supra* note, at 325 (“Although outstanding debt has risen relative to income since 1992, the debt payments-to-income ratio has changed very little. One reason for the recent stability is that the average interest rate on the stock of debt has continued to decline, offsetting the effect of the recent more rapid growth in outstanding debt.”); Glenn B. Canner, Thomas A. Durkin, and Charles A. Luckett, *Recent Developments in Home Equity Lending*, FED. RES. BULL. 241 (April 1998) (noting that substitution of home equity credit for other consumer credit “generally lowers the interest expense of carrying debt and may further reduce monthly debt service payments in the short run by lengthening loan maturities”).

lengthening of loan maturities.⁵⁹ Low interest rates enable consumers to borrow more without a substantial increase in monthly payments. From January 2001 to December 2002 alone, the weighted average interest rate for non-mortgage debt fell from approximately 12.5% to approximately 9%, a remarkable drop in such a short amount of time.⁶⁰ Mortgage rates began their downward trend in mid-2000 and declined from over 8% to under 6% by January 2003 and, remarkably, continued even further downward during much of 2003. Refinancing of mortgages, of course, have also cut the interest rates on housing debt, as well as lengthening maturities when consumers take out cash to pay off consumer debt as part of a refinancing. These dramatic interest rate drops have made it possible for consumers to increase their total debt loads, without increasing their debt-service burden.⁶¹ They can, and have, borrowed greater principle amounts, but there is no reason to believe that increasing their outstanding debt load alone should substantially increase their financial risk.

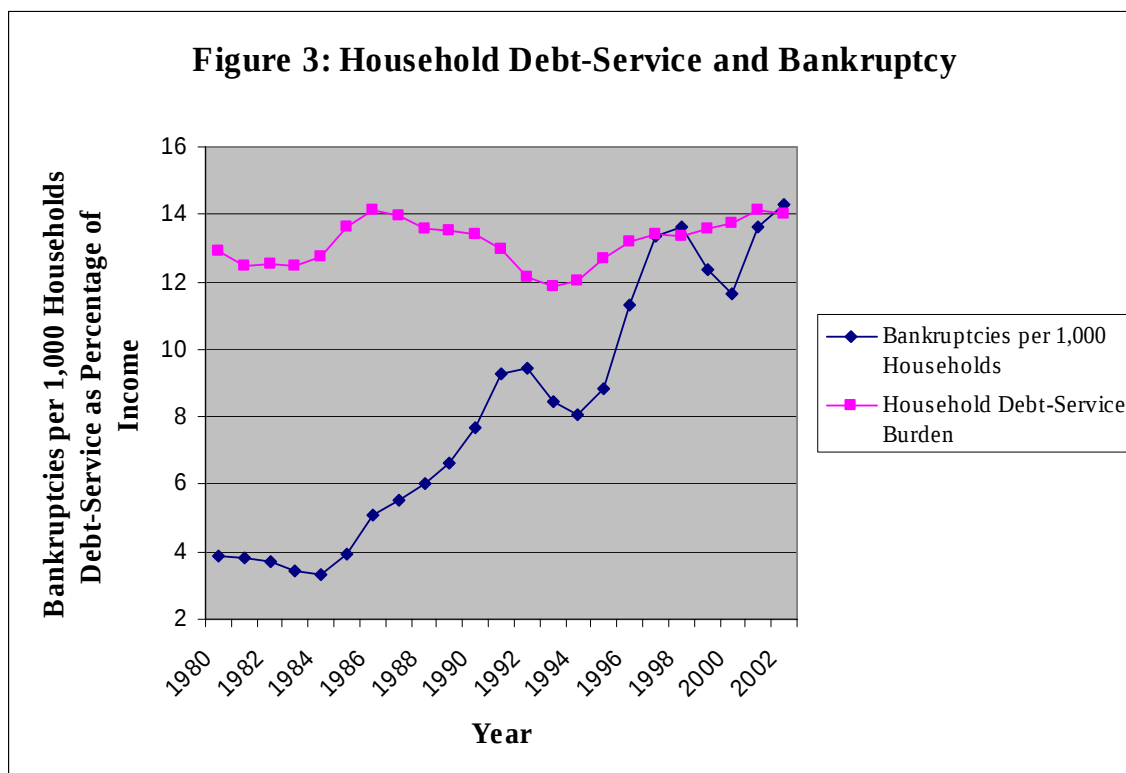
The Federal Reserve has for years collected information on the current debt levels of households, measuring the debt-serving burden of households each month.⁶² Figure 3 reports the relationship between the household debt-service burden and consumer bankruptcy filings:

⁵⁹ For instance, the run-up in housing prices in many areas of the country reflect the fact that low interest rates have enabled home buyers to buy more expensive houses than they could at higher interest rates.

⁶⁰ See Federal Reserve, "Household Borrowing Rates", <http://www.federalreserve.gov>. Canner, Kennickell, and Lueckert argue that this drop in non-mortgage interest rates has resulted in part from aggressive marketing of low-interest auto loans and credit cards. See Canner, Kennickell, and Lueckert, *Household Sector Borrowing*, *supra* note, at 325.

⁶¹ Susan Burhouse, *Evaluating the Consumer Lending Revolution 2*, FDIC FYI (Sept. 17, 2003); available at <http://www.fdic.gov/bank/analytical/fyi/2003/091703fyi.html> (noting that during 2001-02 refinancing boom "homeowners reduced their interest rates and extended loan maturities, resulting in an average annual reduction in mortgage payments (net of taxes) of close to \$300, even with higher principal balances in many cases").

⁶² See *Household Debt-Service Burden*, <http://www.federalreserve.gov/releases/housedebt/about.htm>. The debt-service burden is calculated by summing monthly payments for (1) revolving debt and (2) each type of closed-end debt, then dividing by (3) disposable personal income as reported in the national income and product accounts. The Federal Reserve reports quarterly figures; for purposes of the discussion in the text I have converted the quarterly data into average annual data.



Source: Federal Reserve Board Household Debt-Service Burden and Figure 2

As shown in Figure 3, there may be a slight relationship between short-term fluctuations in household debt-service burden and changes in household bankruptcy filings.⁶³ This is to be expected, as unanticipated changes in interest-rates or income would be predicted to impact bankruptcy filings on a short-term basis by interrupting monthly debt service. With respect to the background upward trend in bankruptcy filings, however, the household debt-service burden does not provide a reliable predictor of the filing trend. From 1980-2002, the household debt-service burden fluctuated within a relatively small range, from a low of 11.89 in 1993, to highs of 14.12 in 1986 and 14.14 in 2001. In 1986, for instance, when the household debt-service burden was 14.12, there were 449,129 consumer bankruptcy filings (or 1,870 per 1 million population). Fifteen years later when the debt-service burden returned to 1986's high level again, there were

⁶³ See Loretta J. Mester, *Is the Personal Bankruptcy System Bankrupt?*, FEDERAL RES. BANK PHILADELPHIA BUSINESS REVIEW 31, 35 (Q1, 2002) Dean M. Maki, *The Growth of Consumer Credit and the Household Debt Service Burden*, Federal Reserve, Feb. 2000; Paul C. Bishop, *A Time Series Model for the U.S. Personal Bankruptcy Rate*, 98-01 BANK TRENDS 1, 6 (Feb. 1998); see also Glenn B. Canner and Charles A. Lockett, *Payment of Household Debts*, 77 FED. RES. BULLETIN 218, 225 (1991) (finding correlation between debt-service burdens and late payment problems). But see Mester, *supra* note, at 35 n.7 (noting that there have been periods, such as between 1988 and 1991 when debt-service burden and filings moved in opposite directions). Professor Lawless also finds no correlation between household debt service burden and bankruptcy filings, but argues that this anomaly probably results from errors in the Fed's estimation of debt service burden and the need for more sophisticated empirical analysis, rather than concerns about the underlying theory. See Robert M. Lawless, *The Relationship Between Nonbusiness Bankruptcy Filings and Various Basic Measures of Consumer Debt*, available in http://www.law.unlv.edu/faculty/rlawless/busbkr/body_filings.htm at 9.

1,452,030 filings (or 5,098 per one million population).⁶⁴ Thus, whereas the household debt-service burden was virtually identical in 1986 and 2001, total consumer bankruptcy filings had *tripled*. Even more striking is that in 1993, when the debt-service burden bottomed out at 11.89 percent, total bankruptcies were almost *double* the rate in 1986 which had posted the highest debt-service ratio of any measured year until 2001.

Moreover, the debt-service ratio is relatively constant across households of varying wealth positions, such that low, medium, and high-wealth households all spend roughly the same amount of their income on current debt-service obligations.⁶⁵ Thus, the aggregate debt-service measurements are not concealing some sort of unrecognized distress among poor or middle-class households. Financial distress, as measured by an equity insolvency yardstick cannot explain the upward trend in consumer bankruptcy filings over the past twenty-five years.

2. Balance Sheet Insolvency and Bankruptcy

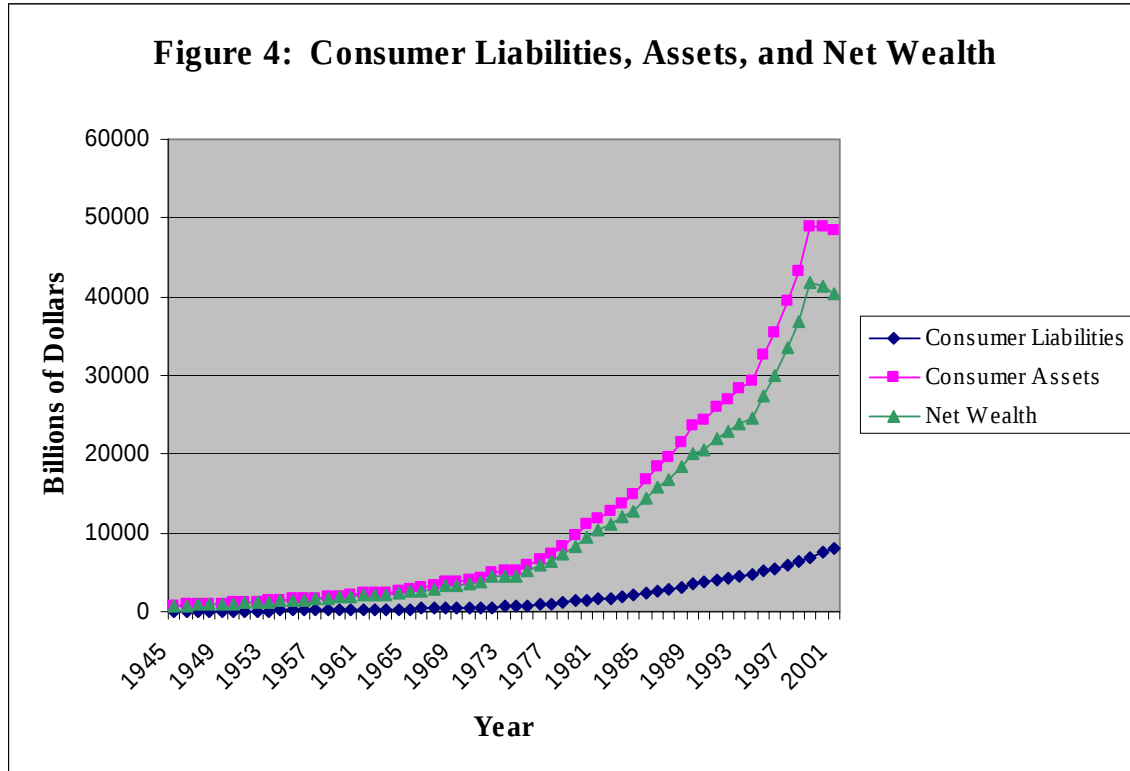
A second commonly-accepted measurement of household financial condition is the ratio of total assets to total debt, also referred to as “balance sheet” or “bankruptcy” insolvency. In the context of consumer households, balance sheet insolvency can be measured by household net wealth. Like balance sheet insolvency, household net wealth is calculated as the difference between total assets and total liabilities. “Total assets” includes such elements as investments (stocks, bonds, and mutual funds), savings, household equity, and durable consumer goods such as automobiles. “Total liabilities” includes the total amount of outstanding debt, such as mortgage balance, student loans, revolving credit obligations, and loans for consumer durables. The comparison of total assets and total liabilities, therefore, takes no account of the interest rate or maturity of the assets and liabilities. Nor does it consider the ease at which these assets could be liquidated or otherwise converted into readily-available assets. For instance, it traditionally was the case that appreciated equity in a house might result in a high degree of wealth that might not be reflected in one’s available income to pay current obligations. On the other hand, this objection is probably less pressing than in the past. The development of home equity loans has made this source of wealth easier to reach. More flexible money market style accounts and investment in mutual funds has also made it easier to access accumulated wealth in securities. As a result, it has generally become easier for consumers to reach their assets and to convert them into sources of income, which should have the effect of making households less vulnerable to unexpected shocks, such as job loss or other adverse economic events.

As household wealth rises, financial security should rise. As individuals have new wealth they have larger amounts of equity that can be sold to raise funds or to be used as collateral for a loan. As a result, as household wealth rises bankruptcy filing

⁶⁴ Contrary to the Federal Reserve’s calculations reported here, the Survey of Consumer Finances concluded that the debt-burden ratio actually *declined* during the period 1998-2001, “after having remained fairly flat over the 1992-98 period.” Aizcorbe, *Recent Changes*, *supra* note, at 27. If this is true, then it casts even greater doubt on the link between debt burden and bankruptcy.

⁶⁵ See Maki, *supra* note, at 7 and Table 2 (noting that poor households spend 14.2% of income on debt service, middle-class spend 18.7%, and wealthy households spend 13.5%). Note that even if income growth has been sluggish among lower-income groups, a stable debt-service burden could still be maintained if interest rates remain low.

rates should decline. During the past fifty years, Americans have benefited from a dramatic increase in household net wealth. Moreover, this increase in wealth has accelerated dramatically during the past twenty years, and exploded during the 1990s. Figure 4 reports the data since 1945 on household assets, liabilities, and net wealth:



Source: Philadelphia Federal Reserve Bank⁶⁶

Over the past several decades it is clear that household wealth has risen steadily and dramatically.⁶⁷ In fact, after a relatively stable level of net wealth for a long period of time, net wealth began to rise rapidly in the 1970s, accelerating in the 1980s, and exploding in the 1990s. At the same time, bankruptcy filings have also risen steadily and dramatically. Moreover, the ratio of consumer credit to net worth has remained almost perfectly constant at four percent of net worth since 1956.⁶⁸ This combination of rising bankruptcies and rising personal wealth suggests that from a balance-sheet insolvency perspective, there is little reason to suggest that mounting bankruptcies is a reflection of increased household financial distress.

⁶⁶ Data available at <http://www.phil.frb.org/src/cf/backgrounddata5.htm>

⁶⁷ See also James M. Poterba, *Stock Market Wealth and Consumption*, 14 J. ECON. PERSPECTIVES 99 (2000) (noting that from 1989 to 1999, the real net wealth of American households increased by nearly \$15 trillion, or by more than 50 percent).

⁶⁸ See Thomas A. Durkin, in DURKIN AND STATEN, *supra* note, at 35, 40 and 40, Figure 4. By contrast, the ratio of mortgage credit to net worth has increased over this period.

Moreover, net wealth has risen for households of all wealth levels, including the poorest quintiles.⁶⁹ Even though the poor remain poorer than average overall, low-wealth households have benefited from the asset growth along with everyone else. Wealth has increased across the board, thus the aggregate figures on household wealth are not disguising unrecognized hardship among some demographic groups.⁷⁰

Although net wealth has risen steadily during this period and has risen for all types of consumer assets, the sources of the rise in net wealth have varied over time.⁷¹ During the 1970s, for instance, much of the growth in net wealth could be attributed to increases in the value of tangible assets, primarily housing values. From 1970-1979, household financial assets rose on average 9 percent per year, whereas tangible assets rose almost 12% per year. During the 1980s, both housing values and financial assets rose steadily and relatively equally. During the mid-1990s, most of the growth in household wealth was attributable to increases in household financial assets, largely as a result of the roaring stock markets of the 1990s.⁷² In fact, even during the disastrous financial market conditions over the past two years, housing prices have continued to rise, offsetting some of the damage to household wealth from the stock market decline. Moreover, households have taken advantage of low interest rates to boost their purchase of household durables, such as cars and appliances, further increasing wealth. Overall, about one-quarter of household wealth derives from stock holdings, one-fourth from tangible assets such as real estate and consumer durables, and the remaining one-half is comprised of other financial assets (such as bonds and interest-bearing accounts) as well as such assets as equity in unincorporated businesses.⁷³

For the period since the enactment of the 1978 Bankruptcy Code, the data on rising consumer net wealth is even more striking:

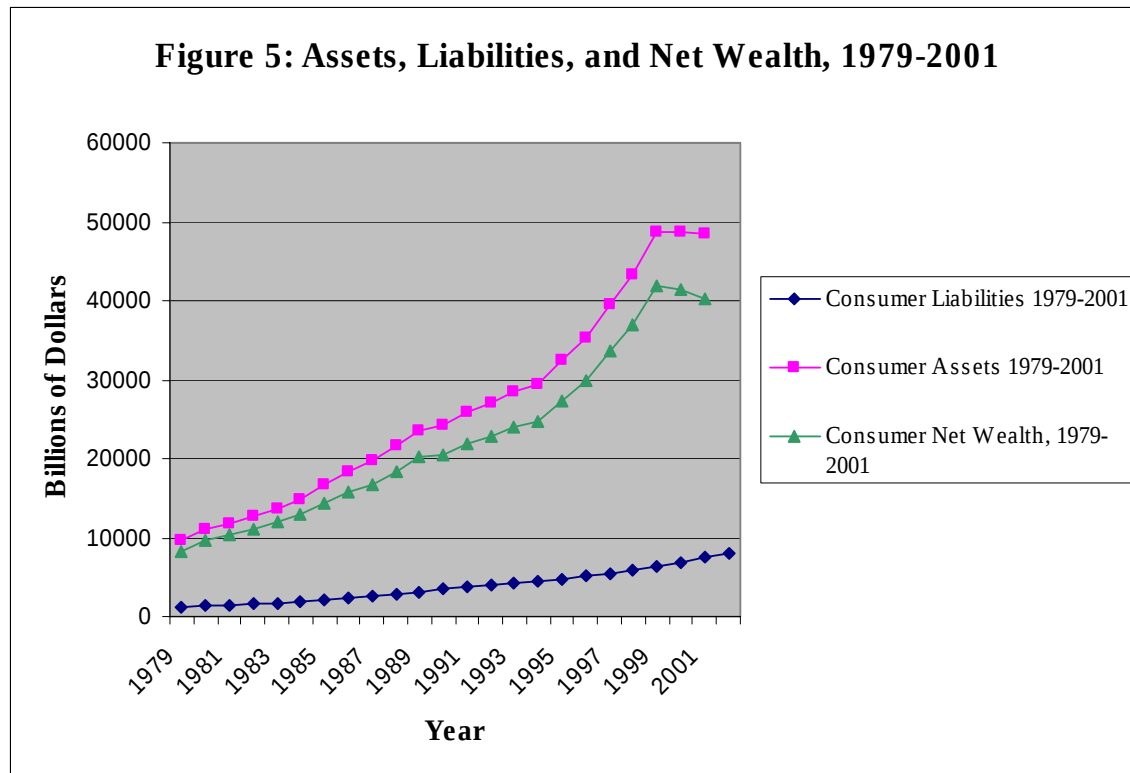
⁶⁹ In fact, in percentage terms, the most rapid growth in wealth was among the poor. See Aizcorbe, et al., *Recent Changes*, *supra* note, at 8. This seems to be primarily because home values may have appreciated somewhat more rapidly among poor households than the public at large. See Karl E. Case and Maryna Marynchenko, *Home Price Appreciation in Low- and Moderate-Income Markets*, COMMUNITIES AND BANKING 8-12 (Spring 2002). Poor households also *bought* house more rapidly than average, thus they increased their ownership of this appreciating asset more rapidly than average, further boosting their wealth. Aizcorbe, *Recent Changes*, *supra* note, at 17.

⁷⁰ See Roy H. Webb, *Personal Saving Behavior and Real Economic Activity*, 79(2) FED. RES. BANK RICHMOND ECON. Q. 68, 77-79 (1993).

⁷¹ See Joanna H. Frodin, *Commentary: Is the Savings Rate Really Negative?*, <http://www.phil.frb.org/src/specialstudies/cfarticle1.html> (identifying three consumer wealth “booms” over past 30 years).

⁷² See also Poterba, *supra* note, at 99 (noting that more than 60 percent of the wealth creation during the 1990s was due to increased value of household stock holdings).

⁷³ Poterba, *supra* note, at 100.



Source: Philadelphia Federal Reserve Bank

Examining the data for the past two decades, there seems to be little ground to believe that rising bankruptcies are related to increased financial distress from a balance-sheet perspective. Instead, the acceleration in household wealth beginning around 1995 was matched by a similar acceleration in bankruptcy filing numbers over the same period. From 1995-1999, household net wealth grew an average of 11.19% per year.⁷⁴ Financial assets rose an average of 12.88% per year during that period. This suggests that the rising bankruptcy filing rates have not resulted from greater financial distress by consumers, but rather that consumers are increasingly choosing to file bankruptcy rather than dip into their accumulated net wealth to repay their obligations.

In part, the failure of bankruptcy scholars to recognize the massive increase in household net wealth may be because of an unduly narrow focus on household “savings,” rather than wealth. Sullivan, et al., argue, for instance, “The declining savings rate [of the 1990s] spoke of how much closer many families had moved toward the margin.”⁷⁵ Throughout much of the 1990s, the measured household savings rate was indeed falling.⁷⁶ But this alone says little about household financial condition because of problems with the way in which the national “savings” rate is calculated. The conventional measure of the American savings rate is the National Income and Product

⁷⁴ Net wealth grew 11.11% in 1995, 9.20% in 1996, 12.53% in 1997, 9.83% in 1998, and 13.27% in 1999. See Philadelphia Fed, *supra* note.

⁷⁵ SULLIVAN, ET AL., FRAGILE, *supra* note, at 31; see also Braucher, *Increasing Uniformity*, *supra* note, at 12.

⁷⁶ See SULLIVAN, ET AL., FRAGILE, *supra* note, at 31-32 (noting declining savings rate of 1990s).

Accounts (NIPA) savings rate assembled by the Bureau of Economic Analysis of the Department of Commerce.⁷⁷ The NIPA measurement of savings is essentially an annual periodic measurement of total income minus personal consumption outlays and tax payments.⁷⁸ In other words, the “savings” rate as conventionally measured is simply the residual amount left over from household income after subtracting out household consumption and tax payments. This is quite obviously a crude measure of household financial condition. The savings rate, therefore, could fall for any one of three reasons: (1) a fall in income, (2) a rise in consumption, or (3) an increase in taxes as a percentage of income. An increase in income, or fall in consumption or taxes, will similarly cause an increase in the savings rate. The savings rate, therefore, could rise or fall for reasons that have little to do with whether or not the financial condition of American households are improving or declining. During the 1990s, for instance, the savings rate plummeted, but this fall in the savings rate appears to have resulted in substantial part from an increase in the tax burden as a percentage of income; both taxes and consumption increased faster than income grew, but the tax burden grew more rapidly than consumption, especially because of higher capital gains taxes resulting from the bull stock market.⁷⁹

More fundamentally, the NIPA measurement excludes capital gains, providing a misleading picture of household financial condition.⁸⁰ Thus, NIPA effectively excludes from its calculation the most important sources of household wealth during the 1980s and 1990s, stock market and home real estate appreciation. The NIPA personal savings rate hovered around 2 per cent of income during the 1990s, but “true” savings increased to 40

⁷⁷ See Annamaria Lusardi, Jonathan Skinner, and Steven Venti, *Savings Puzzles and Saving Policies in the United States*, 17(1) OXFORD REV. OF ECON. POLICY 95, 97 (2001).

⁷⁸ Lusardi, et al., *supra* at 97; Webb, *supra* note, at 70-71.

⁷⁹ See *Taxing Savings*, INVESTOR’S BUS. DAILY, Aug. 5, 1998, at A6 (noting that from 1990 to 1997 total taxes increased 58% while total consumer spending increased only 43%); Brian S. Wesbury, *The Tax Man is Stealing Our Savings*, WALL ST. J., Nov. 19, 1998, at A 22 (noting that from 1993 to 1998, consumption as a percentage of income remained stable, but taxes as a percentage of income rose dramatically); see also <http://www.taxfoundation.org> (documenting rise in total tax burden as percentage of income during 1990s). This result is also consistent with economic theory. During prosperity of the 1990s, the federal government and many state and local governments actually ran budget surpluses. A government budget deficit can be understood as a contingent future tax claim against tax payers, meaning that during a deficit period households can be expected to save more in order to meet these future obligations. A budget surplus, by contrast, can be understood as a *reduced* future tax burden, reducing the need to save for future tax obligations, thus households should save more when government budgets are in deficit. Thus, as both an accounting concept (as measured by NIPA) and an economic concept, government “savings” through surpluses and household savings are essentially mirror images of one another. See Lusardi et al., *supra* note, at 96. Thus, it is not surprising that as government budget deficits began to return in the 2002-03 period, household savings rates began to rise again. See Russ Wiles, *Put It Away for a Rainy Day: Americans Have Begun to Save More*, ARIZONA REPUBLIC, Jan. 20, 2003. Similarly, as the model would predict, may consumers have used the tax credits and tax rebates over the past few years to pay down their own debt, rather than to increase consumption. See Matthew Mogul, *Many August, Ga., Residents to Use Tax Credit to Pay Off Debt, Poll Shows*, AUGUSTA CHRONICLE (Aug. 9, 2003), 2003 WL 61303506. In other words, households have responded to the dissaving activity of the government by increasing their own saving.

⁸⁰ See Lusardi et al., *supra* note, at 96.

per cent when capital gains are added in.⁸¹ With respect to securities, NIPA only includes interest and dividends because they are earned income, but excludes capital gains.⁸² The tendency of American corporations in recent decades to retain more earnings (increasing capital gains) while paying less dividends has exacerbated the disconnect between NIPA accounting and economic reality.⁸³ Increases in wealth through capital gains enable individuals to both spend more and save less. Even if the individual cannot reach his wealth holdings immediately because of liquidity or other constraints, because he knows he is in fact wealthier, he will spend some of his increased wealth today.⁸⁴ The marginal propensity to consume out of increased wealth has been between 3-5% for several decades.⁸⁵ But the increased wealth is not included as an asset for savings purposes, whereas the increased consumption is subtracted from income for purposes of calculating savings. This 3-5% increase in consumption, primarily as a result of the roaring stock market, explains almost all of the decreased savings measured during the 1990s.⁸⁶ In addition, increased wealth holdings that can be accessed in the future

⁸¹ Lusardi et al., *supra* note, at 96-97. In 1999, for instance, the NIPA savings rate was less than 5 percent and the savings rate with stock market wealth included was 38 percent. *Id.* at 99. *See also id.* at 99 (“More precisely, the sharp increase in stock prices after 1995 is paired with a precipitous decline in the savings rate.”). Those with the largest stock market gains also decreased their NIPA-measured savings the most, from 8.5 per cent in 1992 to -2.1 per cent in 2000. *Id.* at 100 (citing D. Maki and M. Palumbo, “Disentangling the Wealth Effect: A Cohort Analysis of Household Saving in the 1990s,” Federal Reserve Board (2001)).

⁸² See Leonard Nakamura, *Investing in Intangibles: Is a Trillion Dollars Missing from GDP?*, BUS. REV. 27 (Q4 2001) (Philadelphia Fed. Res. Bank).

⁸³ See Nakamura, *supra* note, at 27; *see also* Eugene F. Fama and Kenneth French, *Disappearing Dividends: Changing Firm Characteristics or Lower Propensity to Pay?*, 60 J. FIN. ECON. 3 (April 2001).

⁸⁴ This insight is known as the “Life-Cycle Model,” a well-established model of household decision-making. For descriptions and discussions of the life-cycle model, *see* Orazio P. Attanasio and James Banks, *The Assessment: Household Saving—Issues in Theory and Policy*, 17 OXFORD REV. ECON. POLICY 1, 3-7 (2001); Martin Browning and Thomas F. Crossly, *The Life-Cycle Model of Consumption and Saving*, 15 J. ECON. PERSPECTIVES 3 (2001); Martin Browning and Annamaria Lusardi, *Household Saving: Micro Theories and Micro Facts*, 34 J. ECON. LIT. 1797 (1996).

⁸⁵ *See* Dean M. Maki and Michael G. Palumbo, *Disentangling the Wealth Effect: A Cohort Analysis of Household Saving in the 1990s*, Working Paper, Federal Reserve Board, April 2001. With respect to different forms of wealth, one estimate is that the long-run impact of a \$1 increase in stock market wealth increases consumption by 4.2 cents and each \$1 increase in nonstock market wealth (such as home equity) increases consumption by 6.1 cents. *See* Poterba, *supra* note, at 105. Another study estimates that each \$1 increase in stock-market wealth increases consumption 2-12 cents. *See* Lusardi et al., *supra* note, at 100 (citing K. Dynan and D. Maki, “Does Stock Market Wealth Matter for Consumption?” Federal Reserve Board (2000)). A decrease in one’s debt obligation, such as by paying off a car loan or mortgage, also effectively increases wealth. Thus a 10 percent increase in wealth due to the payoff of a long-term loan obligation is estimated to lead to a 2-3.5% increase in non-durable consumption. *See* Melvin Stephens, Jr., *The Consumption Response to Predictable Changes in Discretionary Income: Evidence from the Repayment of Vehicle Loans*, NBER Working Paper 9976 (Sept. 2003); <http://www.nber.org/papers/29976>.

⁸⁶ *See* Maki and Palumbo, *supra* note, at 19 (“The bottom line from this econometric analysis . . . is that the observed decline in the rate of personal saving in the U.S. in the latter half of 1990s can be *fully accounted for* using a simple equation to approximate saving behavior in the face of terrific capital gains from the stock market.” (emphasis added)); Lusardi, et al., similarly conclude that these accounting issues explain almost all of the perceived fall in household savings over the past decade. *See* Lusardi, et al., *supra* note

reduces the need to set aside ordinary savings out of current income for the future, thus increased capital gains directly reduces savings as well.⁸⁷

The increase in capital gains also triggered large increases in capital gains taxes, but because the gains are not counted in NIPA but the tax payments are, as an accounting matter this too reflects an increase in tax obligations without a corresponding increase in income.⁸⁸ Finally, the large increases in stock portfolios reduced the need for businesses to contribute money to fund defined benefit plans for retirees. As a result, retirees could maintain a constant spending level because of unmeasured increases in capital gains for these funds, thereby again permitting consumption expenditures with no corresponding increase in income figures. Thus, there was increased firm-level and government level “savings” that are not reflected in household figures.⁸⁹

The substitution between savings and capital gains is illustrated by the decrease in savings rates among upper-income households, which were the prime beneficiaries of the stock market boom of the 1990s. Lower-income households that do not hold stocks to the same extent nearly *doubled* their savings rate during the same period that stock-wealthy households were reducing their savings.⁹⁰

The decreased savings of the 1990s resulted primarily from increased wealth and higher taxes that resulted in a decline in the measured savings rate.⁹¹ But the measured savings rate bears almost no relationship to any useful measure of household economic condition.⁹² In fact, if increased consumption and increased capital gains taxes are the result of increased wealth from increased home and stock values, a decrease in the measured savings rate actually reflects *stronger* household financial condition, not weaker.⁹³ At the very least, there is no strong evidence that household wealth and/or savings was declining during the past two decades, once those concepts are properly measured.⁹⁴

3. Credit Cards and Bankruptcy

⁸⁷ Lusardi, et al., estimate that the increase in stock market wealth in the 1990s led to an offsetting reduction in personal savings from current income of roughly 3.4 to 4.6 percent percentage points. See Lusardi, et al., *supra* note, at 96.

⁸⁸ See Lusardi, et al., *supra* note, at 96.

⁸⁹ Overall, these various accounting effects of offsetting firm and government-level wealth effects explain up to a 2.4 percentage point decline in NIPA measurements of personal savings during the 1990s. See Lusardi et al., *supra* note, at 96.

⁹⁰ See Maki and Palumbo, *supra* note, at 14 (noting that among the lowest 40 percent of the income distribution savings rates nearly doubled from 1992 to 2000).

⁹¹ Still further flaws in the NIPA measure of savings is its treatment of implicit forms of savings such as in consumer durables or government programs such as Social Security. With respect to household durables, such as cars, it treats them as one-time purchases consumed in the period that it is purchased, rather than a household capital good that generates implicit income over a long period of time. See Browning and Lusardi, *supra* note, at 1813. Second, it does not include implicit savings, such as in Social Security, which was running a net positive balance during the 1990s. See Browning and Lusardi, *supra* note, at 1822.

⁹² See Lusardi, et al., *supra* note, at 96 (“NIPA personal saving is not a useful measure of whether households are prepared for retirement or an economic downturn”); see also MILTON FRIEDMAN, A THEORY OF THE CONSUMPTION FUNCTION 10 (1957) (criticizing NIPA definition of income).

⁹³ See Webb, *supra* note, at 76-78.

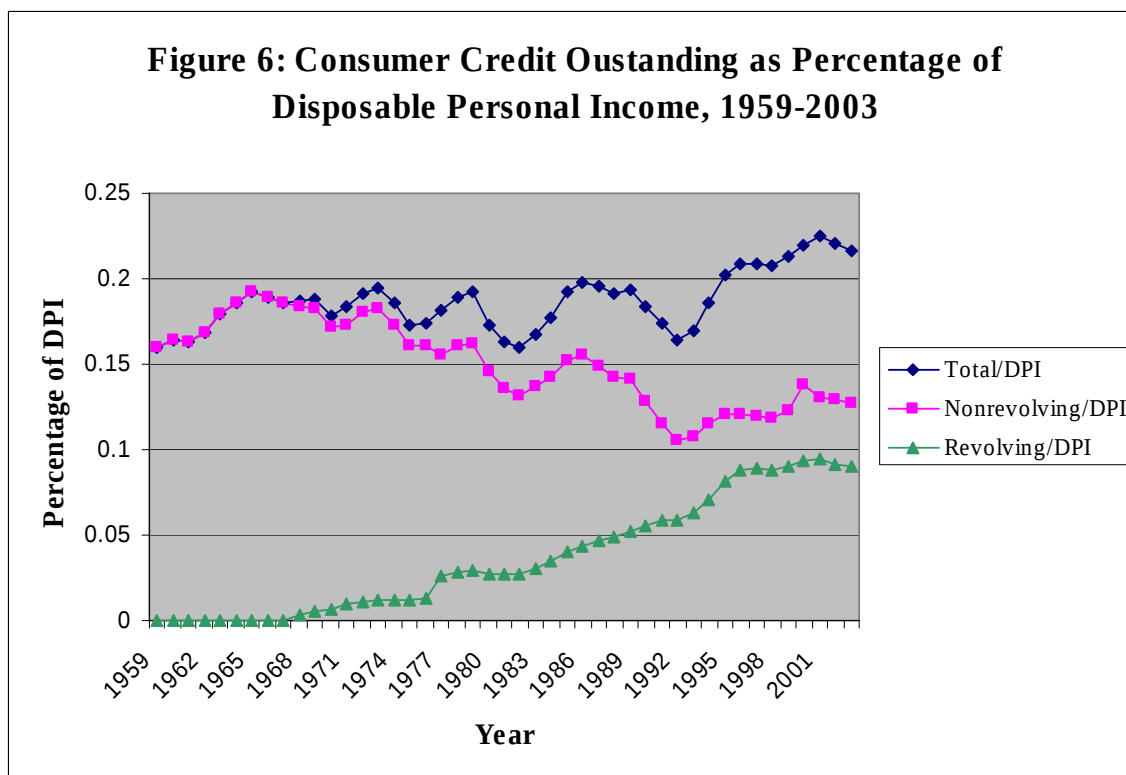
⁹⁴ See Browning and Lusardi, *supra* note, at 1818 (reviewing evidence).

A variation on the argument of consumer over-indebtedness is that credit cards are the problem. Credit cards, it is argued, combine high rates of interest with an “insidious” form of gradual debt accumulation through many routine purchases.⁹⁵ There is also no doubt that credit card use has increased dramatically over the past several decades. On the other hand, if credit cards are both increasing indebtedness while adding high-interest debt, then this should be reflected in a higher debt-service burden, which it is not. This alone, should give pause in embracing the theory that credit cards present a unique burden in this context. Given the widespread belief in both the academy and press that increased use of credit cards have increased financial distress, it is worth saying a few words here.

The conjunction of rising credit card use with a stable level of debt-service burden suggests that credit cards have not substantially changed household financial condition. Instead, it is evident that to the extent that consumers have increased their use of credit cards as a borrowing medium, this increase represents primarily a *substitution* away from other, relatively less-attractive forms of credit to a relatively more-attractive form of credit, *not* an increase in overall indebtedness. Whereas consumers once relied heavily on a myriad of types of consumer credit, such as pawn shops, personal finance companies, retail store credit, and layaway plans, today almost all of these forms of credit have been replaced by credit cards. The result, therefore, has not been to increase household indebtedness, but primarily to change the *composition* of credit within the household credit portfolio. In other words, households do not appear to be borrowing more as a result of increased use of credit cards. Figure 6 illustrates the substitution at work:⁹⁶

⁹⁵ See SULLIVAN, ET AL., FRAGILE, *supra* note, at 108-40 (arguing that credit card debt differs from other forms of debt in that credit card debt can accumulate insidiously and unconsciously through the gradual accretion of many, often small, purchases); Juliet B. Schor, *Who’s Going Bankrupt and Why?*, 79 TEX. L. REV. 1235 (2001).

⁹⁶ Consumer credit covers most short-and intermediate-term credit extended to individuals. It includes revolving and nonrevolving credit, but excludes loans secured by real estate such as mortgage loans, home equity loans, and home equity lines of credit. Credit cards are the primary source of unsecured open-end credit, but also includes outstanding balances on unsecured revolving lines of credit at banks and finance companies. Nonrevolving credit includes most traditional forms of consumer credit, such as secured and unsecured credit for automobiles, mobile homes, trailers, durable goods, vacations, and other purposes. See Thomas A. Durkin, *Credit Cards: Use and Consumer Attitudes, 1970-2000*, FED. RES. BULL. 623 n.1 (Sept. 2000).



Source: Federal Reserve Board and Bureau of Economic Analysis

As Figure 6 shows, total non-mortgage consumer credit outstanding (revolving and nonrevolving combined) has grown at approximately the same pace as disposable income over the past several decades.⁹⁷ For the entire period of 1959-1994, outstanding debt as a percentage of disposable income remained at a relatively constant rate.⁹⁸ This illustrates the second reason why equity insolvency has not risen among borrowers, in that steady income growth has enabled a regular growth in borrowing as well, resulting in a relatively constant ratio of total outstanding debt to disposable personal income.

What is most important for current purposes, however, is the clear indication in Figure 6 that the growth in revolving (credit card) debt has clearly been a *substitution* from nonrevolving debt to revolving debt, rather than resulting in an increase in overall indebtedness. Revolving debt outstanding has risen during this period from zero to

⁹⁷ See also Durkin, *supra* note, at 623-24 (noting that total consumer credit outstanding has risen in tandem with income growth); Thomas A. Durkin, in DURKIN & STATEN, *supra* note, at 35, 38, 39 Figure 2 (noting that ratio of consumer credit to income has remained relatively stable since 1956).

⁹⁸ Moreover, the slight growth in *total* household debt-service burden is largely the result of increase in mortgage debt, which was spurred primarily by rising housing prices, record-low interest rates on home mortgages, and preferential tax treatment for mortgage debt. See Durkin, *supra* note, at 39, Table 2; Canner, Kennickell, and Luckett, *Household Sector Borrowing*, *supra* note, at 328 (noting that between 1989 and 1992 composition of household debt changed as the median amount owed on consumer debt decreased while the amounts owed on mortgage obligations increased). This increase in home mortgage debt, however, has had little impact on mortgage delinquencies. See *infra* at note 120 and accompanying text.

roughly 9% of outstanding debt.⁹⁹ Nonrevolving installment debt, by contrast, has fallen from its level of 19% of disposable income in the 1960s, to roughly 12% today. Indeed, it is striking that the recent bump in total indebtedness in recent years was *not* caused by an increase in revolving debt, which has remained basically constant for several years. Instead, it was caused by an increase in installment debt, primarily as a result of a recent increase in car loans for the purchase of new automobiles.¹⁰⁰ Thus, there is little indication that increased use of credit cards has precipitated greater financial stress among American households. The clear evidence is that the increase in credit card usage has resulted primarily from a substitution of credit cards for other types of consumer credit, rather than an overall increase in indebtedness.¹⁰¹

This substitution of credit cards for alternative, less-attractive forms of credit has dramatically changed the composition of consumer credit among American households, but not its burden. The substitution effect of credit cards has been largest among lower-income households, because these households traditionally have had the most limited and unattractive credit options available to them. In general, the majority of credit users are “convenience users” who use credit cards as a payment mechanism as a substitute for cash or checks and pay off their balances in full each month.¹⁰² The widespread availability of low-interest, tax-deductible home equity loans also provides an attractive alternative to most other forms of consumer credit.¹⁰³ Many low-income households, of

⁹⁹ In fact, this figure probably overstates the amount of revolving debt held by American households. Many credit card users are convenience users who use credit cards as a transactional device and pay their balances in full each month. Nonetheless, during that thirty-day period they are coded as having outstanding credit balances that are added into the calculation of revolving debt. As William Hempel observes for convenience users, “[S]ome people have large balances every month, but also pay their balances in full every month. This exaggerates the size of revolving credit as a proportion of total credit and underestimates the amount of payments that takes place each month.” See William Hempel, *Discussion*, in *THE IMPACT OF PUBLIC POLICY ON CONSUMER CREDIT* 66, 67 (Thomas A. Durkin and Michael E. Staten eds., 2001). See also *id.* (“Very simply, revolving credit . . . is not all debt. I do not know of any data source that tells us how much of current revolving credit is merely transaction balances.”).

¹⁰⁰ See Ana M. Aizcorbe, Arthur B. Kennickell, and Kevin B. Moore, *Recent Changes in U.S. Family Finances: Evidence from the 1998 and 2001 Survey of Consumer Finances* 25 FEDERAL RES. BULL. 24 (Jan. 2003).

¹⁰¹ See Hempel, *supra* note 99, at 67 (“consumer credit has been fairly constant relative to income over the past 30 years, but the composition has changed”).

¹⁰² The majority of credit card users are convenience users, rather than revolvers. See Ana M. Aizcorbe, Arthur B. Kennickell, and Kevin B. Moore, *Recent Changes in U.S. Family Finances: Evidence from the 1998 and 2001 Survey of Consumer Finances* 25 FEDERAL RES. BULL. (Jan. 2003) (reporting that 55.3% of households pay their credit card bills in full each month); Joanna Stavins, *Credit Card Borrowing, Delinquency, and Personal Bankruptcy*, NEW ENGLAND ECON. REV. 15, 20 (July/Aug. 2000) (noting that 58% of households in Survey of Consumer Finances stated that they pay their credit cards in full each month in the past year); see also Thomas F. Cargill and Jeanne Wendel, *Bank Credit Cards: Consumer Irrationality versus Market Forces*, 30 J. CONSUMER AFF. 373, 379 (1996) (noting that 68% of credit card users “nearly always” pay their full balance every month). The percentage of convenience users has risen steadily over the past decade. See *Delinquency on Consumer Loans: Hearing Before the House Comm. On Banking and Fin. Servs.*, 104th Cong. 1 (1996).

¹⁰³ See Canner, Durkin, & Lockett, *supra* note, at 241. This substitution has also occurred through the boom in mortgage refinancing, because many refinancing homeowners liquefy equity in the process, thereby using their home equity to finance consumer transactions or to pay off existing consumer debt. See Glenn Canner, Karen Dynan, and Wayne Passmore, *Mortgage Refinancing in 2001 and Early 2002*, FED.

course, do not own their houses and cannot avail themselves of home equity loans. Thus, they are confronted with a menu of relatively unattractive credit options, such as pawn shops, personal finance companies, and retail store credit.¹⁰⁴ Thus, even if it may seem that credit cards are a poor source of credit, they are *relatively* more attractive than many of the options confronting those who in fact revolve credit card balances.¹⁰⁵ As a report of the Chicago Federal Reserve Bank concluded, “The increase in the credit card debt burden for the lowest income group appears to be offset by a drop in the installment debt burden. This suggests that there has not been a substantial increase in high-interest debt for low-income households, but these households have merely substituted one type of high-interest debt for another.”¹⁰⁶

Credit cards have displaced a number of traditional consumer installment credit options. Economist Thomas Durkin observes that credit cards “have largely replaced the installment-purchase plans that were important to the sales volume at many retail stores in earlier decades,”¹⁰⁷ especially for the purchase of appliances, furniture, and other durable goods¹⁰⁸. Credit cards appear to have been especially important in providing an option to traditional personal finance companies offering high-interest, unsecured personal installment loans with fixed payment terms.¹⁰⁹ Previous studies suggest that

RES. BULL. 469, 470 (Dec. 2002) (45 percent of homeowners in survey who refinanced in 2001-02 liquefied equity); see also Peter J. Brady, Glenn B. Canner, and Dean M. Maki, *the Effects of Recent Mortgage Refinancing*, FED. RES. BULL. 441 (JULY 2000); Canner, Durkin, and Lockett, *Recent Developments*, *supra* at 241. This increased use of home equity to finance consumer purchases has also been encouraged by the fact that consumer real estate loans are much more responsive to changes in the underlying cost of funds in the economy than other forms of consumer credit, thus in the low-rate environment of the past several years, interest rates on home equity loans have fallen relatively more rapidly than for other forms of consumer credit. See Zywicki, *Economics of Credit Cards*, *supra* note, at 121 (noting that cost of funds comprises 80 percent of mortgage lending, 60 percent of consumer installment lending, and 27 percent of credit card operations).

¹⁰⁴ See JOHN P. CASKEY, *FRINGE BANKING: CHECK-CASHING OUTLETS, PAWNSHOPS, AND THE POOR* (1994) (describing economics of several forms of lending to low-income borrowers).

¹⁰⁵ See Zywicki, *Economics of Credit Cards*, *supra* note.

¹⁰⁶ Wendy M. Edelberg and Jonas D. M. Fisher, *Household Debt*, 123 CHICAGO FEDERAL LETTER at 3 (1997); see also *id.* (“[I]ncreases in credit card debt service of lower-income households have been offset to a large extent by reductions in the servicing of installment debt.”); Arthur B. Kennickell, et al., *Family Finances in the U.S.: Recent Evidence from the Survey of Consumer Finances*, 83 FED. RES. BULL. 17 (1997) (noting that the share of families using installment borrowing fell from 1989 to 1995 as a result of increased use of mortgages, credit cards, and automobile leasing); Glenn B. Canner and James T. Fergus, *The Economic Effects of Proposed Ceilings on Credit Card Interest Rates*, 73 FED. RES. BULL. 1 (1987) (noting that rise in credit card use may have been the result of “a substitution of credit card borrowing for other types of installment credit that do not provide flexible repayment terms”).

¹⁰⁷ Durkin, *supra* note, at 623.

¹⁰⁸ *Id.* at 624.

¹⁰⁹ See Kennickell, *supra* note, at 17 (noting that many lenders have stopped offering unsecured lines of credit). A recent survey of consumer banking rates in the Washington, D.C., area found the prevailing interest rate on credit cards to be under 10%, whereas the prevailing rate for personal loans was over 12%. See *Consumer Banking Rates*, WASHINGTON TIMES at p. C12 (May 9, 2003). Although the newspaper chart did not list the fees associated with originating a personal finance loan, they are generally much higher than for credit cards, which have no origination fees. See Dagobert L. Brio and Peter R. Hartley, *Consumer Rationality and Credit Cards*, 103 J. POL. ECON. 400, 402 (1995).

some of this substitution may also have come from reduced use of pawn shops¹¹⁰ and personal loans from friends and relatives.¹¹¹ Previous studies have shown that although one effect of regulation of some forms of consumer credit is to restrict access to credit by higher-risk borrowers, the effects of regulation are predominantly to shift the pattern of credit use by encouraging the substitution of some forms of credit for others, rather than to restrict the overall use of credit.¹¹² In fact, the continued growth in the use of bank cards has come largely from a substitution from *other credit cards*, most notably retail store cards and gasoline company cards.¹¹³ The growth in substitution of bank cards for proprietary retail cards is especially notable, in that it reflects the greater opportunities for individuals of all incomes to take advantage of increased shopping opportunities on the Internet, mail-order, and smaller retailers. Before widespread ownership and merchant acceptance of general-purpose bank cards, by contrast, shoppers were forced to turn to local department stores and retailers for major purchases that were usually purchased on credit, such as appliances and expensive clothing. Traditional retailers, such as department stores, could afford the overhead and risk associated with operating a proprietary credit operation. General purpose bank cards levels this playing field, increasing consumer choice and making it easier for small business and entrepreneurs to enter markets traditionally dominated by larger retail establishments.¹¹⁴

As a result these various substitutions among different types of consumer credit, over the past several years, the total amount of revolving debt carried on credit cards as a whole has largely leveled off, both in terms of the percentage of users who revolve balances as well as the average balance, as consumers have substituted increased use of bank cards for other types of credit cards.¹¹⁵ Increased access to credit cards appears to have had a similar effect of causing a substitution toward credit card use and away from

¹¹⁰ See RICHARD L. PETERSON AND GREGORY A. FALLS, IMPACT OF A TEN PERCENT USURY CEILING: EMPIRICAL EVIDENCE (Credit Research Ctr. Working Paper No. 40, 1981).

¹¹¹ LENDOL CALDER, FINANCING THE AMERICAN DREAM: A CULTURAL HISTORY OF CONSUMER CREDIT 60-64 (1999).

¹¹² See PETERSON & FALLS, *supra* note, at 27-33.

¹¹³ See Aizcorbe, *supra* note, at 25 (noting 5.2% increase in percentage of families with bank cards, and 4.8% reduction in percentage with store cards and 3.1% decrease in percentage of households with gasoline cards). In the 1970s, limited-use cards issued by retail firms, usable only in the firm's stores (such as department stores) were the most commonly held type of credit card. By 1995, however, the holding of bank-type cards was more common than retail store cards. See Durkin, *supra* note, at 624. The recent decision of Sears to sell its credit card operations to a bank issuer will further accelerate this substitution.

¹¹⁴ See Zywicki, *Economics of Credit Cards*, *supra* note, at 88-94. Retailers also had a further advantage when usury laws on credit cards were still in widespread effect. Because usury laws made it impossible to profitably extend unsecured credit to many consumers, banks were unable to lend on general-purpose bank cards. Retailers, by contrast, could raise the price of goods purchased on credit, thereby recouping their credit losses through higher prices on goods. See *id.* at 155-64; LEWIS MANDELL, THE CREDIT CARD INDUSTRY: A HISTORY at xviii (1990); Christopher C. DeMuth, *The Case Against Credit Card Interest Rate Regulation*, 3 YALE J. ON REG. 201, 238 (1986). Empirical studies during the era of widespread usury restrictions found that the price of major appliances was 3-8% higher in states with restrictive usury ceilings than those with less restrictive rules. See Glenn B. Canner and James T. Fergus, *The Economic Effects of Proposed Ceilings on Credit Card Interest Rates*, 73 FED. RES. BULL. 1, 11 (1987). Retailers also offered fewer services, such as free gift-wrapping, in states with restrictive usury ceilings. See RICHARD L. PETERSON AND GREGORY A. FALLS, IMPACT OF A TEN PERCENT USURY CEILING: EMPIRICAL EVIDENCE 35 n.5 (Credit Research Ctr. Working Paper No. 40, 1981).

¹¹⁵ See Aizcorbe, *supra* note, at 24-25.

pawn shops, personal finance companies, and the like. But while this changed the composition of debt in the household financial portfolio, it does not appear to have increased overall household financial distress.

Some scholars have argued that increases in credit card debt play a major role in precipitating bankruptcy filings. Domowitz and Sartain, for instance, conclude that “the largest single contribution to bankruptcy at the margin is credit card debt.”¹¹⁶ But while credit card and bankruptcy may be correlated, it is questionable whether increased credit card debt is properly understood as causing an increased likelihood of bankruptcy filing. Experience suggests that the correlation may be simply that, a correlation. Alternatively, it is equally plausible that debtors increase their credit card borrowing *in anticipation* of filing bankruptcy, thus the anticipation of bankruptcy “causes” the increase in credit card borrowing prior to filing bankruptcy.

The assumption that increased credit card borrowing causes an increased likelihood of filing bankruptcy fails to acknowledge the unique role of credit card borrowing in the downward spiral of a defaulting borrower. Credit cards provide an open line of unsecured credit to be tapped at the discretion of the borrower. Thus, for many debtors they are a “credit line of last resort” in order to stay afloat in order to avoid defaulting on other bills. Thus, there may be nothing more than a simple correlation—a debtor confronting a downward spiral may increase his credit card in the period preceding bankruptcy simply because he has access to no other credit. It may appear that the increased credit card borrowing precipitated the bankruptcy filing, but if the credit card was being used as a source of credit of last resort, this correlation would not support a causal inference.

It is also likely that the debtor’s increased use of credit cards is *in anticipation* of filing bankruptcy. Credit card debt is unsecured debt that can be discharged in bankruptcy.¹¹⁷ Many other debts are not discharged in bankruptcy.¹¹⁸ Other debts, such as home and auto loans, are secured debts; thus the debtor will have to surrender the collateral if he fails to pay those obligations. For unsecured credit card debt, by contrast, the debtor can retain the property purchased with the credit card and discharge the obligation. Given the choice between defaulting on obligations that will be nondischargeable in bankruptcy versus dischargeable credit card debt, the incentive is to use credit cards to finance payment of nondischargeable and secured debt. In fact, empirical evidence shows that although credit card defaults have risen in tandem with bankruptcy filings,¹¹⁹ defaults on secured home and auto loans have remained steady during this period.¹²⁰ Debtors also will have an incentive to “load up” their credit card on the eve of bankruptcy, especially by purchasing goods that will not be classified as “luxury goods and services” but might still be quite expensive and the timing of which

¹¹⁶ Ian Domowitz and Robert L. Sartain, *Determinants of the Consumer Bankruptcy Decision*, 54 J. FIN. 403, 414 (1999).

¹¹⁷ The nondischargeability provision for credit card debt applies only to “luxury goods and services” of greater than \$1,000 purchased within 60 days of bankruptcy. 11 U.S.C. §523(a)(2)(C). Moreover, the burden is on the creditor to prove that the goods purchased were for luxury goods or services.

¹¹⁸ See 11 U.S.C. §523(a).

¹¹⁹ See Lawrence M. Ausubel, *Credit Card Defaults, Credit Card Profits, and Bankruptcy*, 71 AM. BANKR. L.J. 249 (1997).

¹²⁰ See Thomas Durkin, *in* DURKIN AND STATEN, *supra* note.

might be discretionary.¹²¹ Still others simply spend the money or save in exempt assets rather than pay outstanding bills.¹²²

Gross and Souleles, for instance find that in the year before bankruptcy, borrowers significantly increase the use of their credit cards, running up their balances rapidly in the period leading up to bankruptcy.¹²³ If heavy credit card debt was forcing people into bankruptcy, by contrast, then this accumulation of credit card debt should be more gradual and spread out over time. The fact that the rise in credit card debt rises rapidly and is concentrated in the period immediately preceding bankruptcy tends to suggest that the increase in credit card usage is a reflection of the debtor's descent into bankruptcy for other reason (and is thus correlated with bankruptcy), rather than being a cause of it.

As noted, a comprehensive analysis of the relationship between credit cards and bankruptcy is outside the scope of this project and a fuller discussion is provided elsewhere.¹²⁴ For current purposes it is simply important to note that, properly understood, the data on credit cards is consistent with the foregoing discussion that there is no evidence that the rising bankruptcy filing rates over the past two decades can be explained by increased household financial distress. Over this period, household debt burden (as measured by traditional measures) have remained stable, even as credit card use has increased dramatically. This apparent anomaly can be resolved by recognizing that the growth in credit card use has been primarily a substitution away from other less-attractive forms of credit, such as pawn shops, loan sharks, store credit, and personal finance companies. Thus, access to credit cards has not encouraged profligate credit use as much as it has provided low-income and young consumers with an attractive new credit option that has rendered alternative forms of credit obsolete. By contrast, if credit cards tended to increase financial distress, this would be reflected in other measures of financial condition, such as the debt-service burden or balance sheet insolvency.

As will be discussed below, there is likely a link between credit cards and bankruptcy, in that the rise of credit card has increased the propensity of individuals to file bankruptcy in response to financial difficulties. But it is doubtful that credit cards themselves have substantially increased household indebtedness or to otherwise negatively impact household financial condition.

4. Summary on Household Financial Condition and Bankruptcy

Bankruptcy scholars have argued that the rising bankruptcy filing rates of recent decades is a manifestation of rising consumer financial distress. In support of the argument, they point to an observed correlation between household debt-to-income ratio

¹²¹ For instance, in one recent case reported in the news, the debtor charged a substantial amount on his credit card for discretionary car repairs and new tires within weeks of filing bankruptcy, neither of which would be likely to classify as "luxury goods or services." See Manuel Perez-Rivas and Martin Weil, *Massie Filed for Bankruptcy; Montgomery Schools Halt Consideration of Finalist*, May 4, 1999, p. A1, available in 1999 WL 17000928; Bernard Dagenais, *Bankruptcy: Not Quite a Free Ride*, WASH. TIMES, May 10, 1999, p. D3, available in 1999 WL 3084791.

¹²² See Andreas Lehnert and Dean M. Maki, *Consumption, Debt, and Portfolio Choice: Testing the Effect of Bankruptcy Law* at 33, Working Paper, Federal Reserve Board, Feb. 2002).

¹²³ Gross and Souleles, *supra* note, at 338.

¹²⁴ See Todd J. Zywicki, *Credit Cards and Bankruptcy* (Working Paper, George Mason University School of Law, August 2003).

(or changes in that figure) and bankruptcy filings. This measurement of financial condition, however, is unorthodox in that it is a comparison of an income flow to a stock of debt. It fails to account for the term and interest rates on loans, both of which are crucially important in trying to understand household financial condition. Conventional measures of financial condition, such as equity and balance-sheet insolvency, fail to support the traditional model's predictions that increasing bankruptcies have been caused by increased financial distress.

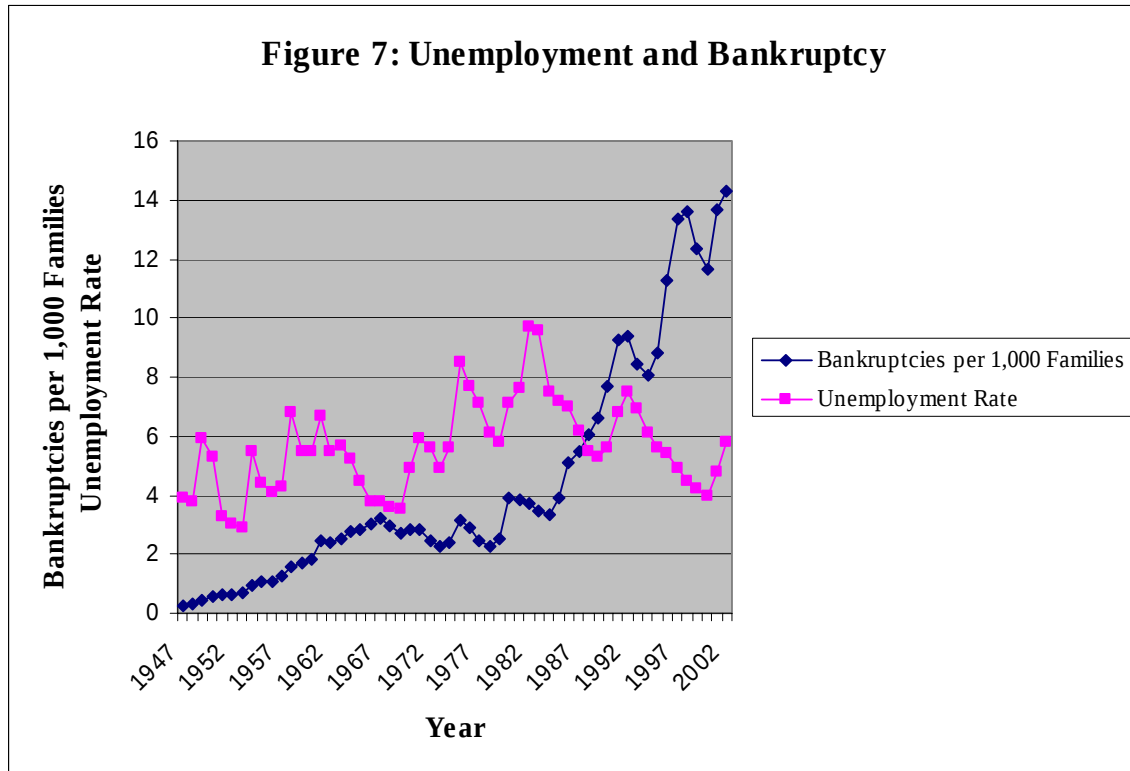
B. Unemployment, Downsizing, and Bankruptcy

1. Unemployment and Bankruptcy

It has also been argued that increased bankruptcy filing rates can be explained by unemployment, “downsizing,” and employment interruptions.¹²⁵ The theory is straightforward. Households adapt their living standards and debt levels to an expected level of income. Sudden and unexpected unemployment, especially of a head wage-earner, creates an exogenous shock to the household budget. Although government unemployment insurance and other programs can provide short-term protection from income interruptions, they are not perfect insurance, especially if the worker is unable to readily find another job. As a result, *if* unemployment rates were rising over the past several years, this would provide a plausible explanation for rising bankruptcy filing rates. But the available information does not support the theory that the bankruptcy boom is the result of rising unemployment.

A simple examination of the purported relationship between bankruptcy and unemployment raises serious doubts about the proffered relationship, however, as shown in Figure 7:

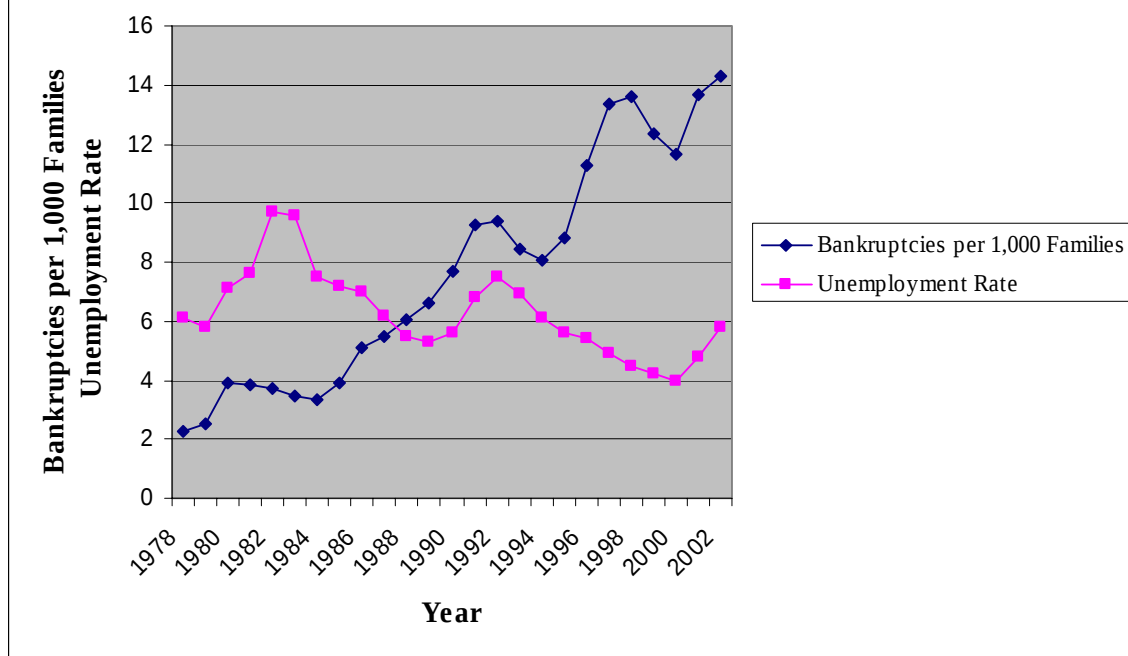
¹²⁵ See SULLIVAN, et al., FRAGILE, *supra* note, at 73 (“Our data suggest that job-related income interruption is by far the most important cause of severe financial distress for middle-class Americans.”); *id.* at 105 (“The jobs data are overwhelming: by every measure, the debtors in bankruptcy are there as a result of trouble at work.”); Braucher, *Increasing Uniformity*, *supra* note, at 5; *but see* VISA U.S.A., INC., CONSUMER BANKRUPTCY: CAUSES AND IMPLICATIONS (1996) (discussed in Luckett, *Personal Bankruptcies*, *supra* note, at 75) (finding that unemployment rate had limited predictive value for number of bankruptcy filings although changes in unemployment rate had a large effect).



Source: Bureau of Labor Statistics and Figure 2

As Figure 7 suggests, there appears to be little or no correlation between aggregate unemployment and the upward trend in the bankruptcy filing rate. In fact, during the run-up in bankruptcy filings in the mid-1990s, unemployment and bankruptcy filings appear to be *inversely* correlated, as suggested by Figure 8:

Figure 8: Unemployment and Bankruptcy, 1978-2002



Throughout most of the 1980s and 1990s, the general trend in the unemployment rate was downward. Nonetheless, the trend in the bankruptcy filing rate was upward. Perhaps most interesting is that while unemployment fell from 1983 to 1990 and 1992 to 2000, during both periods bankruptcies rose. Of course, official unemployment rates are not a perfect measurement for job loss and job adjustments. Nonetheless, this evidence provides little support for the theory that rising bankruptcy rates are caused to any substantial degree by rising unemployment rates.

Moreover, this finding is not inconsistent with finding that those in bankruptcy are more likely to be unemployed than the population at large. Sullivan, Warren, and Westbrook, for instance, conclude that some 18%-21% of their sample was unemployed at the time of filing, much higher the official prevailing rate at that time (6.7% in 1991).¹²⁶ But the unemployed have probably *always* been overrepresented in bankruptcy as compared to the general public. Indeed, the percentage of bankruptcy filers who are unemployed appears to have been relatively constant for at least 30 years.¹²⁷ As a result, although this variable can explain some percentage of the background steady-state, it cannot explain why the bankruptcy rate has been rising.¹²⁸ A static variable or declining

¹²⁶ SULLIVAN et al., *FRAGILE*, *supra* note, at 80.

¹²⁷ See TERESA A. SULLIVAN, ELIZABETH WARREN, AND JAY LAWRENCE WESTBROOK, *AS WE FORGIVE OUR DEBTORS: BANKRUPTCY AND CONSUMER CREDIT IN AMERICA* 96 (1999) (estimating 14 % of debtors in sample were unemployed at time of bankruptcy); see also SULLIVAN et al., *FRAGILE*, *supra* note, at 102-03 (reporting results of PSID study that found similar percentage of unemployed bankruptcy filers during 1970s, 1980s, and 1990s).

¹²⁸ There is evidence that unemployment can explain some of the variation *around* the upward trend line, although it cannot explain the trend line itself. Studies that control for the general upward trend find that

variable over the past 20 years such as the unemployment rate cannot explain an upward trend in bankruptcy filing rates.

Advancing the traditional view, Sullivan, Warren, and Westbrook argue that on the basis of their research, “[O]ur data reveal that any people are finding themselves a part of the rising bankruptcy curve because they have lost their jobs”¹²⁹ This is untenable, as it implies that the rising bankruptcy rate can be explained by rising unemployment. To the extent that unemployment is not the problem, they insist that rising bankruptcies are the result of underemployment, job adjustments, or other diffuse measures of income interruption. They do, in fact, find that two-thirds of bankrupts in their study suffered some sort of “job-related financial stress” in the years preceding bankruptcy. From this evidence they conclude that unemployment, “downsizing,” and employment interruptions are the primary cause of bankruptcy.

But this reasoning is flawed. In order to infer causation from correlation, basic statistical methodology requires a control group that can serve as a baseline for comparison.¹³⁰ If the argument is that unemployment causes bankruptcy filings, then it is necessary to find out how many people suffered unemployment but did *not* file bankruptcy. If there are a large number of people who suffered unemployment but were not forced to file bankruptcy, then this undermines the conclusion that unemployment leads to bankruptcy filings. To illustrate the point, consider the following example. Suppose hypothetically that research indicated that two-thirds of those who file bankruptcy own a car. Would it be justified to conclude that owning a car increases the likelihood of filing bankruptcy? Clearly not—it would be necessary to know how many people own a car but do *not* file bankruptcy. Whether the incidence of a variable is important requires comparison with a control group. It is a well-established truism that the mere correlation between two variables without more cannot establish causation.

Advocates of the unemployment-bankruptcy thesis provide no information on what percentage of the population has suffered a similar job disruption but did not file bankruptcy.¹³¹ Other researchers have done so, however, and have concluded that job disruption by the head of the household is *not* a statistically significant predictor of bankruptcy. Buckley and Brinig found little support in their study for the hypothesis that job loss or poverty was a significant factor in bankruptcy filings.¹³² Fay, Hurst, and White’s study also found that unemployment by a head of household or spouse is not

local or regional recessions that create unusually high unemployment rates will often spawn higher bankruptcy filing rates in those regions as well. See Richard A. Brown, *Time Series Analysis of State-Level Personal Bankruptcy Rates, 1970-1996*, 98-02 BANK TRENDS 4 (FDIC, Feb. 1998); Lawrence A. Weiss, Jadgeep S. Bhandari, and Russell Robins, *An Analysis of State-Wide Variation in Bankruptcy Rates in the United States*, 17 BANKR. DEV. J. 407, 416 (2001); Bishop, *supra* note, at 6.

¹²⁹ SULLIVAN et al., *FRAGILE*, *supra* note, at 16-17.

¹³⁰ Michelle White, *Economic and Social Perspectives*, *supra* note; see also Philip Shuchman, Book Review, *Social Science Research on Bankruptcy*, 43 RUTGERS L. REV. 185, 201-05 (1990) (reviewing TERESA A. SULLIVAN ET AL., *AS WE FORGIVE OUR DEBTORS: BANKRUPTCY AND CONSUMER CREDIT IN AMERICA* (1989)).

¹³¹ Some empirical studies do find evidence of a relationship between unemployment and a subsequent bankruptcy filing. See Michelle J. White, *Personal Bankruptcy Under the 1978 Bankruptcy Code: An Economic Analysis*, 63 IND. L.J. 1, 45 (1987-1988).

¹³² F.H. Buckley & Margaret F. Brinig, *The Bankruptcy Puzzle*, 27 J. LEGAL STUD. 187, 204-05 (1998).

significantly correlated with bankruptcy filings.¹³³ In other words, many Americans suffer job disruptions every year, but the overwhelming majority of them do not respond by filing bankruptcy. Instead, they reduce their spending, tap into their savings, and ride out the short-term storm until a new job is acquired. Quite clearly, then, there is some intervening factor that causes some people to respond to job loss by filing bankruptcy, while others do not, and this factor has become increasingly prevalent over time.

2. “Downsizing” and Bankruptcy

In their most recent work, Sullivan, Warren, and Westbrook argue that the real problem of employment for bankruptcy is not unemployment as measured by official figures, but rather a problem of “downsizing” or “job skidding.”¹³⁴ Downsizing or job skidding is distinguished from unemployment in that these terms identify a problem unique to middle-class white-collar workers. To the extent that these middle managers are laid off, they may be unable to find a job with a similar salary and responsibilities. Thus, they may find a new job, albeit one with a lower salary than the old job. Because they have jobs, downsized workers will not be counted in the official unemployment statistics. Nonetheless, they will have suffered income interruption and a lower income level than previously, thereby creating an income shock and precipitating bankruptcy. In theory, if this phenomenon is in fact new, widespread, and distinct from traditional models of the relationship between unemployment and bankruptcy, it could provide some of the explanation for the underlying upward trend line in bankruptcy filings.

The perception of downsizing of the 1990s appears to have been based primarily on a handful of high-profile anecdotes, rather than reliable data. Reliable data on downsizing is difficult to come by, which has led many scholars to focus on anecdotal evidence of downsizing in some large, well-known corporations.¹³⁵ In fact, even as the number of middle managers was being reduced at some corporations, it appears that middle management was growing even more rapidly at other corporations. As economist David Gordon observed, “Lots of managers can be laid off, resulting in evidence of substantial *gross* job turnover, but lots of managers can also be rehired at similar positions in the same or other companies, potentially producing no *net* change or even a *net* increase in managerial employment. If workplace reductions at the middle managerial level are offset by job expansions in those same job categories, then the bureaucratic burden would not be affected. The aggregate numbers on the expanding managerial employment share . . . suggest that this is exactly what’s been happening—that new managerial positions have been opening up to compensate for those eliminated.”¹³⁶ Or as the *Wall Street Journal* put it in 1995, “Despite years of relentless downsizing, ‘right-sizing’ and re-engineering in corporate America, all aimed in part at

¹³³ See Scott Fay, Erik Hurst, and Michelle White, *The Household Bankruptcy Decision*, 92 AM. ECON. REV. 706, 714 (2002),

¹³⁴ SULLIVAN et al., FRAGILE, *supra* note, at 88-89.

¹³⁵ See *id.* at 104 (discussing several episodes at Kodak and other corporations that were heavily reported in the *New York Times*).

¹³⁶ DAVID M. GORDON, FAT AND MEAN: THE CORPORATE SQUEEZE OF WORKING AMERICANS AND THE MYTH OF MANAGERIAL “DOWNSIZING” 55 (1996). He adds, “For all the talk of ‘downsizing,’ there were more managers in 1994 than there were in 1989 before the ‘downsizing’ began.” *Id.* at 53.

shedding excess bureaucracy, reports of middle management's demise are proving much exaggerated."¹³⁷

Not only is middle-management growing across corporations, there have been trends *within* corporations that have offset downsizing through increases in the ranks of managers.¹³⁸ First, the movement toward more horizontal management structures spread out management work and elevated some rank-and-file workers to managerial status. Outsourcing and technology, cited by some as reducing job stability, actually *increase* the need for managers within a corporation because of the need to supervise these assets and to coordinate their relationship to the rest of the corporation.¹³⁹ Adherents to the downsizing story cite examples of downsized managers who were forced to take new jobs with reduced responsibility and salary, a "job skid."¹⁴⁰ But these examples ignore the fact that by making corporate bureaucracies flatter, many more people are given greater responsibility and decision-making authority simply because there are fewer layers of bureaucracy to navigate.¹⁴¹

Data on the thickening management ranks at the majority of corporations, however, has not been as widely reported as the former, leading many to inadvertently conclude that the well-publicized layoffs were indicative of a larger economic trend. Gordon explored the question in the mid-1990s, the period in which the purported "downsizing" of white collar workers dominated the headlines of many national newspapers.¹⁴² Gordon reports that the proportion of managers and supervisors in private nonfarm employment *grew* during the 1990s, not shrunk. His evidence is summarized in Figure 9¹⁴³:

¹³⁷ Alex Markels, *Restructuring Alters Middle-Manager Role But Leaves It Robust: Even as Laid-Off Struggle, New Supervisory Jobs Arise in Shifting Economy*, WALL ST. J. at p. A1 (Sept. 25, 1995); available in 1995 WL-WSJ 9901022.

¹³⁸ See Markels, *supra* note, at A1.

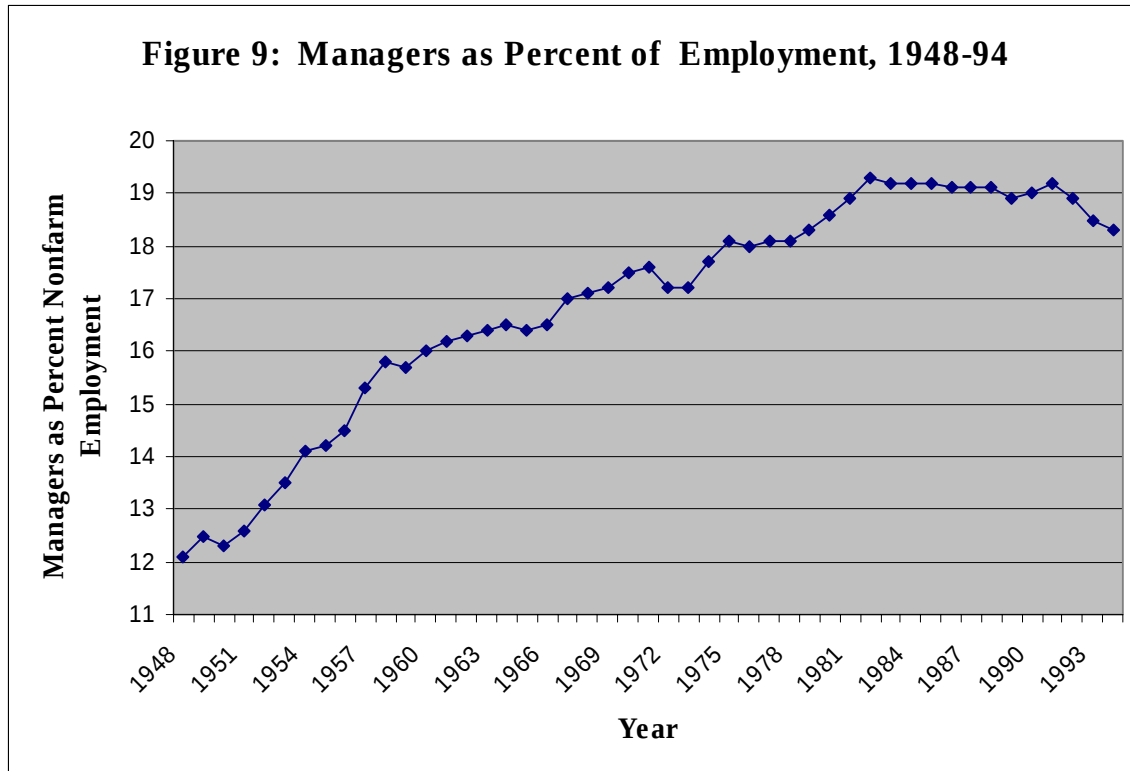
¹³⁹ Markels, *supra* note, at A1. Xerox frequently is cited as a downsizer of management positions during the early-1990s, but a closer examination reveals, however, that most managers were simply moved around so that in the end the total number of middle managers in the core document-processing unit was unaffected. *Id.* Outsourcing, therefore, has little effect on the job status of managers, although it can create layoffs off rank-and-file workers. See *id.* Of course, the corporations that are the beneficiaries of the out-sourced contracts have to hire their own managers to manage the contract and workers to perform the duties previously performed internally.

¹⁴⁰ See KATHLEEN S. NEWMAN, *FALLING FROM GRACE: THE EXPERIENCE OF DOWNWARD MOBILITY IN THE AMERICAN MIDDLE CLASS* (1988); see also SULLIVAN, ET AL., *FRAGILE*, *supra* note, at 88-90 (providing anecdotes of job skid and bankruptcy).

¹⁴¹ See Markels, *supra* note (citing examples of business reorganizations leading to an elevation of workers to managerial status).

¹⁴² GORDON, *supra* note, at 51 (noting widespread media coverage of managerial layoffs at IBM and elsewhere).

¹⁴³ I have been unable to locate comparable data for the post-1994 period, although there is no reason to believe that the post-1994 period differs dramatically from the pre-1994 data.



Source: David Gordon, *Fat and Mean* (1994).

If we assume that the ranks of nonproduction and supervisory employees in the private sector provide at least a rough approximation of the middle-class white collar workers described by Sullivan, Warren, and Westbrook, then what we see is that the number of managers as a percentage of the workforce was *rising* through the 1980s and 1990s, not shrinking.¹⁴⁴ If it was true that there was a job slide taking place during this period, then the ratio of managerial to non-managerial employees would be *falling*, not *rising*. Instead, the data tends to reveal a job *ladder* rather than a job slide as an increasing percentage of rank-and-file workers have been graduating into managerial ranks, rather than managers sliding down to blue-collar work. The combination of low unemployment and a growing managerial composition of the private workforce indicate that the general macroeconomic trend has been for workers to move *up* from laboring jobs to managerial jobs, not *down*.

The overwhelming conclusion of all academic research regarding the downsizing hypothesis has been that there was no discernible reduction in job security during the 1990s.¹⁴⁵ This conclusion is consistent regardless of whether one examines large

¹⁴⁴ Gordon notes that these official figures also probably understate the number of managerial employees because they only count those whose primary job is to supervise others, while excluding the large number of employees who only spend part of their time supervising rather than working directly. See GORDON, *supra* note, at 38-39.

¹⁴⁵ An excellent survey of the literature on job security and downsizing can be found in See Steven G. Allen, Robert L. Clark, and Sylvester J. Schieber, "Has Job Security Vanished in Larger Corporations?" NBER Working Paper No. 6966 (Feb. 1999); available in <http://www.nber.org/papers/w6966>; see also DAN MCGILL, KYLE BROWN, JOHN HALEY, AND SYLVESTER SCHIEBER, FUNDAMENTALS OF PRIVATE

corporations or businesses of all sizes. Indeed, one study found that in large corporations—the purported source of downsizing angst—mean employment tenure and the percentage of employees with ten or more years of service actually *increased* in the study.¹⁴⁶ There is also no evidence that older or mid-career employees have been singled out in downsizing decisions; the impact of downsizing is borne by the most junior workers.¹⁴⁷

Downsized managers also appear to be less adversely affected by their layoffs than most other categories of employees. A study by the Bureau of Labor Statistics following the recession of the early 1990s found that although many white collar workers were laid off during the recession, many more blue-collar workers were laid off.¹⁴⁸ Once the economy began to recover, managerial workers were rehired much more rapidly than *any* other occupational grouping.¹⁴⁹ Among the workers displaced in 1991 and 1992, 80.6 percent of managers were employed in February 1994, as compared to, for example, 74.8 percent of craft workers and 68.8 percent of other blue-collar workers.¹⁵⁰ Thus, the job interruptions to middle-managers appear to be less severe than for other categories of employees, suggesting that these white collar workers should be less financially affected by unemployment and thus less likely to file bankruptcy than most other categories of employees.

Downsized managers also appear to be more resistant than average to “job skid.”¹⁵¹ Following the 1991-92 layoffs roughly 60% of managers and professionals were reemployed as managers and professionals in February 1994.¹⁵² By contrast, less

PENSIONS (1996); U.S. Bureau of Labor Statistics, *Employee Tenure in the Mid-1990s*, available in <http://stats.bls.gov/news.release/tenure.nws.htm>; Henry Farber, *Trends in Long Term Employment in the United States, 1979-96*, Working Paper No. 384, Industrial Relations Section, Princeton University (1997); Francis Diebold, David Neumark, and Daniel Polsky, *Job Stability in the United States*, 2 J. LABOR ECON. 205 (1997); David Neumark, Daniel Polsky, and Daniel Hansen, *Has Job Stability Declined Yet? New Evidence for the 1990's*, NBER Working Paper No. 6330 (Dec. 1997); Daniel Polsky, *Changes in Consequences of Job Separations in the U.S. Economy*, University of Pennsylvania (1996); David A. Jaeger and Ann Huff Stevens, *Is Job Stability in the United States Falling? Reconciling Trends in the Current Population Survey and Panel Study of Income Dynamics* (1998); Peter Gottschalk and Robert Moffitt, *Changes in Job and Earnings Instability in the Panel Study of Income Dynamics and the Survey of Income and Program Participation* (1998).

¹⁴⁶ See Steven G. Allen, Robert L. Clark, and Sylvester J. Schieber, “Has Job Security Vanished in Larger Corporations?” NBER Working Paper No. 6966 (Feb. 1999); available in <http://www.nber.org/papers/w6966>.

¹⁴⁷ *Id.*; see also Jennifer M. Gardner, *Worker Displacement: A Decade of Change*, MONTHLY LABOR REVIEW 45 (April 1995) (noting that “the proportion of long-tenured workers displaced from their jobs . . . was about the same in the 1991-92 [recession] period, 3.8 percent, as it was during the 1981-92 [recession] period.”).

¹⁴⁸ GORDON, *supra* note, at 55.

¹⁴⁹ GORDON, *supra* note, at 56 (citing Jennifer M. Gardner, *Worker Displacement: A Decade of Change*, U.S. Bureau of Labor Statistics, Report No. 2464, July 1995); see also Henry S. Farber, *Job Loss in the United States, 1981-2001*, NBER Working Paper No. 9707, available in <http://www.nber.org/papers/w9707>.

¹⁵⁰ GORDON, *supra* note, at 56. The resilience of the victims of layoffs during the 1991-92 recession is especially probative in this context, as the data for Sullivan, Warren, and Westbrook’s study was collected in 1991. See SULLIVAN, ET AL., FRAGILE, *supra* note, at p. xiii.

¹⁵¹ See SULLIVAN, ET AL., FRAGILE, *supra* note, at 88-90 (describing concept of “job skid”).

¹⁵² GORDON, *supra* note, at 56; Gardner, *supra* note, at 45 (noting that reemployment rate was higher for 1991-92 recession than prior recession).

than half of those in service occupations wound up in the same kinds of jobs.¹⁵³ Moreover, while the media stereotype of the job skidder is a veteran highly-paid executive, those who tended to “skid” out of the managerial ranks were those who had spent the least amount of time as a manager prior to losing their position.¹⁵⁴ The victims of downsizing tend to be the least-experienced managers, not experienced executives.¹⁵⁵ While this is obviously tragic in its own right, it is not consistent with the purported connection between downsizing and bankruptcy, which supposedly turns on the inability of long-time senior executives to find comparable replacement employment and thus find it difficult to maintain the lifestyle and financial obligations to which they have become accustomed. Junior managers, by contrast, would be less likely to have constructed executive lifestyles and financial obligations and therefore should be more able to adapt to their disappointment. Thus, even where there is downsizing and job skid, the data once again fail to support a coherent theory of how this translates into rapidly-rising bankruptcy rates.

In addition, during periods of economic expansion managerial employment rises faster than non-managerial employment. Assuming that this historical trend held during the boom period of the late-1990s, then the number of white collar managers should have been rising rapidly during that period, raising doubts about how “downsizing” could explain much if any of the large jumps in bankruptcy filing rates during that period.

3. Summary on Unemployment, Downsizing, and Bankruptcy

Whether one defines job disruptions as unemployment, downsizing, or some other way, the data fails to confirm the traditional model’s prediction that this factor can explain rising bankruptcies during the past twenty-five years. There is little doubt that unemployment and job loss contribute to the underlying “frictional” bankruptcy rate in the economy. It is thus not surprising that bankrupts are more likely to be unemployed than the population as a whole or that geographic or temporal changes in unemployment explain variation around the trend line.

C. Divorce

Divorce also is a precipitating cause of bankruptcy.¹⁵⁶ The causal link is straightforward. First, divorce reduces the economies of scale of living in a single household. Rather than living in one house, it becomes necessary to maintain two households, with two sets of food, housing, and other expenses. Although the costs obviously will not double, there is still a loss of economies of scale when one household becomes two. Second, divorce often creates an unexpected shock to household income, although alimony and child support payments are obviously designed to ameliorate that disruption. Third, if one spouse has less-valuable market skills or has been out of the labor market for several years (such as to raise children) then that individual will have to support the new household on a lower wage than previously. Thus, there is good reason to

¹⁵³ GORDON, *supra* note, at 56.

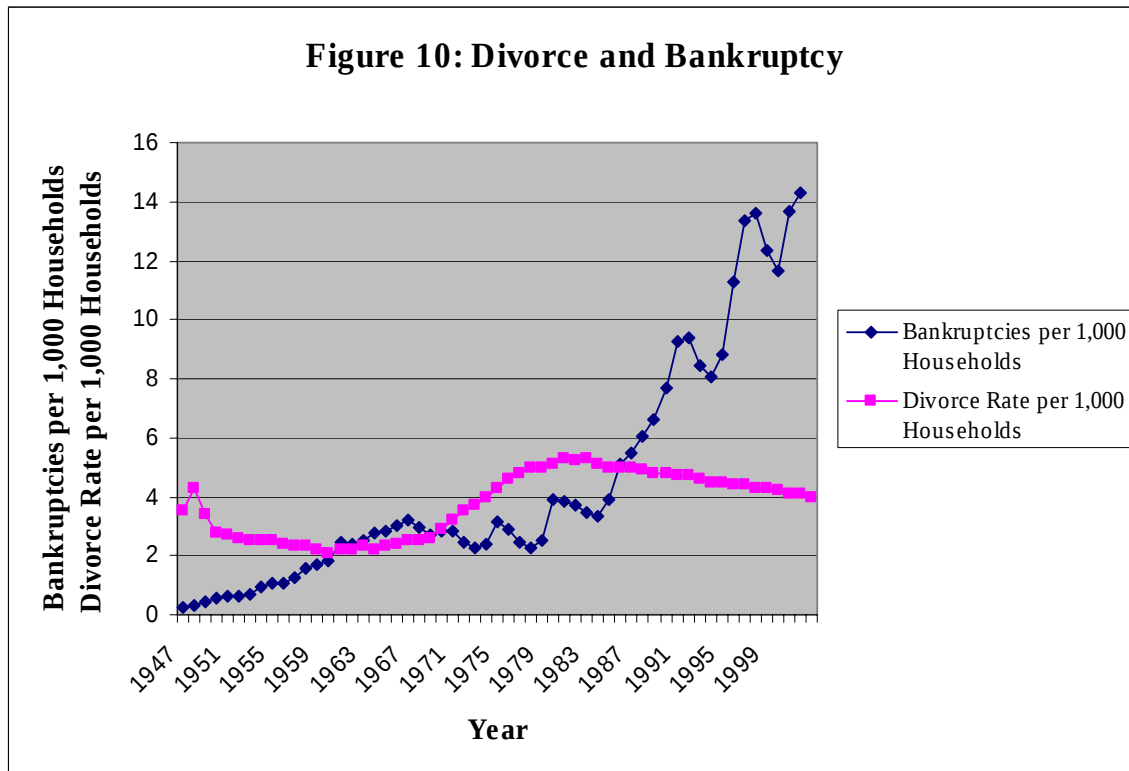
¹⁵⁴ GORDON, *supra* note, at 57 (citing Stephen J. Rose, *Declining Job Security and the Professionalization of Opportunity*, National Commission for Employment Policy, Research Report No. 95-04 (May 1995)).

¹⁵⁵ GORDON, *supra* note, at 57-58. As noted above, the finding that downsizing affects junior workers most dramatically is consistent with the more general pattern for all employees.

¹⁵⁶ See Fay, Hurst, & White, *supra* note, at 716; see also SULLIVAN ET AL., *FRAGILE*, *supra* note, at 172-74.

believe that divorce is to some extent part of the “frictional” element of bankruptcy, such that there will always be some number of households in bankruptcy as a result of divorce.

But divorce cannot explain the rise in consumer bankruptcy filings over the past several decades. If divorce were a cause of rising bankruptcies, then by definition, divorce rates would have to be rising. Instead, the American divorce rate peaked out in 1981 at 5.3 divorces per 1 million population and has fallen steadily since then, as shown in Figure 10:



Source: Bureau of Census and Figure 2

The traditional model cannot reconcile these trends. Divorce undoubtedly is the cause of some bankruptcies, for the reasons specified above. But given that the divorce rate has been stable and even falling a bit over time, the number of bankruptcies caused by divorce should also be *falling* over time, not *rising*. Instead, divorce rates have fallen even as bankruptcies have continuously risen.¹⁵⁷ Econometric evidence also fails to support the view that divorce explains the rising bankruptcy filing rate.¹⁵⁸ Again, once a

¹⁵⁷ See Lockett, *Personal Bankruptcies*, *supra* note, at 76 (“[T]he divorce rate has been so stable over the past several years, it is hard to see it playing much of a role in the substantial increases in bankruptcy.”).

¹⁵⁸ See Fay, Hurst, & White, *supra* note, at 714; Domowitz and Sartain, *supra* note, at 410; Ian Domowitz and Thomas L. Eovaldi, *The Impact of the Bankruptcy Reform Act of 1978 on Consumer Bankruptcy*, 36 J. L. & ECON. 803 (1993).

control groups is added for comparison, it becomes apparent that many people get divorced every year, but relatively few file bankruptcy as a consequence.¹⁵⁹

The bankruptcy filing rate has risen rapidly during an era where the divorce rate has fallen. From 1979 to 2002, the divorce rate fell by 25 percent; during that same period, the bankruptcy filing rate rose by 583 percent. This inverse relationship is especially puzzling, given that the financial impact of divorce should be less catastrophic today than in prior eras, owing to legal and social reforms that have increased the financial resiliency of divorced parents, such as stronger mechanisms for collection of child support, greater job flexibility, and more available child care. Thus, while there is clearly some relationship between divorce and bankruptcy, divorce simply cannot be a cause of the rising bankruptcy filing rates of recent years.

D. Health Problems, Medical Costs, and Insurance

In theory, health problems can precipitate a bankruptcy filing in several ways. First, it can create a shock to household income because disabling health problems make it impossible to work. Second, health problems can also create a shock to household expenses because it can create a large, unanticipated debt, especially if the debtor does not have full health insurance. So again there is some evidence that there is a relationship between health problems and bankruptcy filings.¹⁶⁰

The relevant question, however, is whether there is some dynamic variable regarding health problems that can explain rising bankruptcy filing rates. There is no evidence to suggest that Americans have somehow become more intrinsically unhealthy, such that they now miss greater amounts of work or have substantially more instances of major health care treatment than in the past. If anything, modern medicine and education have tended to make people more healthy, have dramatically reduced the recuperation time associated with recovery from a major health event, and have almost certainly reduced the number of seriously disabling health events suffered by individuals. Thus, it is difficult to believe that any of those factors have changed in such a manner so as to lead to increased bankruptcy filings.

Nonetheless, it has been argued that health care expenses are a leading cause of the rise in bankruptcy filing rates.¹⁶¹ Sullivan et al., for instance, argue that “sickness and injury remain a major threat to the economic health of every middle-class family.”¹⁶² They add, “The two components of that threat—either of which can plunge a family from comfortable circumstances to financial collapse in a matter of months are the spiraling cost of medical care and the loss of income because of accident, illness, or disability.”¹⁶³

¹⁵⁹ Buckley and Brinig, for instance, conclude that divorce is not so much a cause of bankruptcy as it is a correlation, in that both represent promise-breaking behavior, thus they are both caused by a more general independent variable. Buckley and Brinig, *supra* note.

¹⁶⁰ See SULLIVAN, ET AL., FRAGILE, *supra* note, at 141-71.

¹⁶¹ See SULLIVAN, ET AL., FRAGILE, *supra* note, at 141-71; see also Melissa B. Jacoby, Teresa A. Sullivan & Elizabeth Warren, *Rethinking the Debates over Health Care Financing: Evidence from the Bankruptcy Courts*, 76 N.Y.U. L. REV. 375 (2001); Ian Domowitz and Robert L. Sartin, *Determinants of the Consumer Bankruptcy Decision*, 54 J. FIN. 403, 413 (1999).

¹⁶² See SULLIVAN, ET AL., FRAGILE, *supra* note, at 141.

¹⁶³ See SULLIVAN, ET AL., FRAGILE, *supra* note, at 141.

The combination of increased cost and reduced income is said to whipsaw families, thrusting them into unexpected financial chaos and bankruptcy. Health problems, and the resulting costs and loss of income associated with them, are generally recognized as contributing to the decision of many people to file bankruptcy. As with the other factors that have been examined, health problems are part of the “frictional” bankruptcy rate. But some have argued that health problems and medical costs can also account for the rising bankruptcy filing rates of recent years. Sullivan, et al. assert, “Medical costs have burgeoned, especially in the past decade.”¹⁶⁴ “These problems,” they add, “may have increased during the past decade. That increase may explain in part the dramatic rise in bankruptcies in recent years.”¹⁶⁵

According to the theory, therefore, medical problems can contribute to the rising bankruptcy filing rate if one of the following are found: first, that medical costs have been rising over time similarly to the bankruptcy filing rate; second, that an absence of health insurance has substantially increased the incidence of financial ruin; and/or third, that health problems have caused employees to miss more work and thus lose greater amounts of income than previously. On closer examination, there appears to be little evidence that these factors can explain the rise in the bankruptcy filing rate.

1. Health Care Costs and Bankruptcy

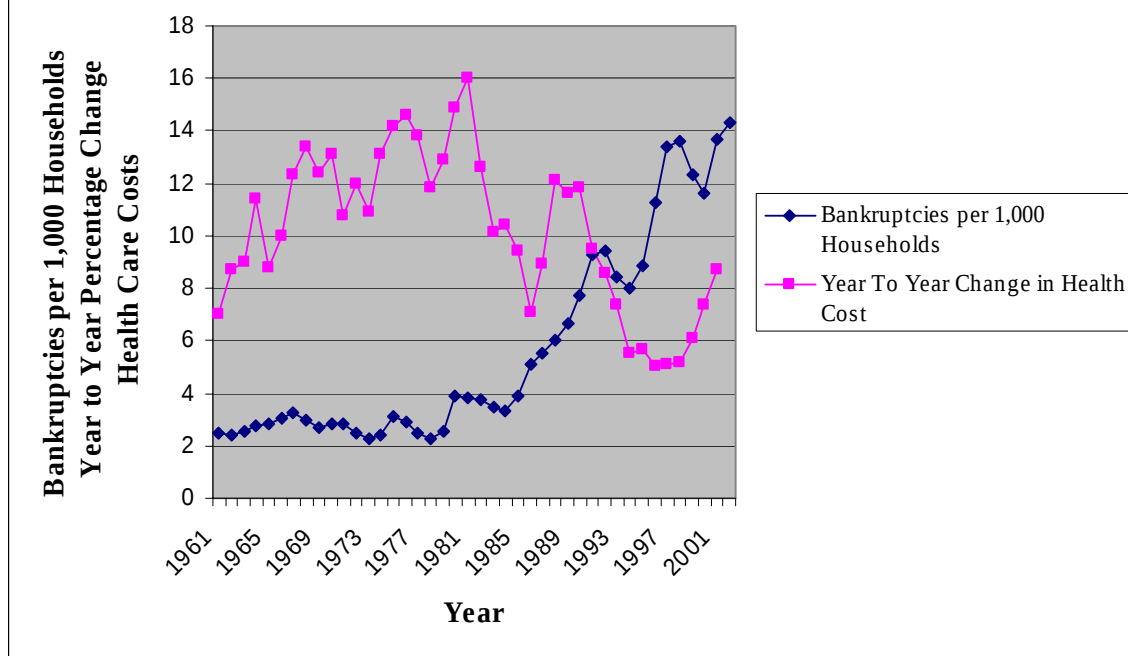
Consider first, the contention that “[m]edical costs have burgeoned, especially in the past decade” and that this may help to explain the rise in bankruptcy filing rates. Like everything else, the cost of health care has risen over time. The fact that health care has gotten more expensive, therefore, says little about the contribution of health care costs to bankruptcy. A better measure, and the measure typically used to understand trends in health care costs, is to measure the *change* in health care costs from one year to the next. This measurement is also more relevant for understanding the relationship between health care costs and bankruptcy filings, as it better measures unexpected increases in health care costs, which would be most prone to plunge people into bankruptcy.

The long-term relationship between health care inflation and bankruptcy, however, is questionable. As shown in Figure 11, there is little evidence that fluctuations in the cost of health care bear much relationship to increases or decreases in bankruptcy filing rates:

¹⁶⁴ *Id.* It should be noted that the phrase “in the past decade” is somewhat ambiguous in this context, as the book was published in 2000, which suggests that the “past decade” refers to the 1990s, yet the data that underlies *The Fragile Middle Class* was collected in 1991.

¹⁶⁵ See SULLIVAN, ET AL., *FRAGILE*, *supra* note, at 142.

Figure 11: Health Care Costs and Bankruptcy



Perhaps most striking is the evidence of the mid-1990s, which indicates that bankruptcies were rising most dramatically during the period when health care inflation had virtually disappeared.¹⁶⁶ In fact, adjusting for inflation, it appears that during some periods during the 1990s there was actually a *decline* in health care costs from one year to the next.¹⁶⁷ From 1995-1996, for instance, consumer bankruptcies jumped 29% and then jumped another 20% the next year. By contrast, during this same period, real health care costs rose 2% and 3.3% respectively each year.¹⁶⁸ Then, when health care costs began to rise again more rapidly, bankruptcy filing rates began to actually decline slightly. This leveling off of health care costs in the mid-1990s is widely recognized to have resulted from the advent and spread of managed care, which was designed with the specific purpose of reining-in health care costs.¹⁶⁹ In the short run, at least, managed care

¹⁶⁶ See Henry Aaron, *The Unsurprising Surprise of Renewed Health Care Cost Inflation*, HEALTH AFFAIRS WEB EXCLUSIVE, Jan. 23, 2002, www.healthaffairs.org.

¹⁶⁷ See Drew E. Altman and Larry Levitt, *The Sad History of Health Care Cost Containment as Told in One Chart*, HEALTH AFFAIRS WEB EXCLUSIVE (Jan. 23, 2002), www.healthaffairs.org.

¹⁶⁸ See Bradley C. Strunk, Paul B. Ginsburg, and Jon R. Gabel, *Tracking Health Care Costs*, http://www.healthaffairs.org/WebExclusives/Strunk_Web_Excl_92601.htm; David M. Cutler and Louise Sheiner, *Managed Care and the Growth of Medical Expenditures*, NBER Working Paper 6140 at Fig. 1 (Aug. 1997); see also Michael Waldholz, *Prescriptions: Health-Care Cost Explosion Will Trickle Down to Workers*, WALL ST. J., Dec. 12, 2002, page D6; Ron Winslow, *Health care Costs Are Expected to Rise 3.8% in 1998, Employer Survey Finds*, WALL ST. J., June 16, 1998, at B7 (noting “four years of level medical costs” in the mid-1990s); Nancy Ann Jeffrey, *Study Says Employees at Small Firms Find Managed Care a Difficult Choice*, WALL ST. J., Sept. 8, 1997, at B2 (noting annual increases in health care costs of one to two percent during mid-1990s).

¹⁶⁹ Aaron, *supra* note; Cutler and Sheiner, *supra* note.

was successful in doing so.¹⁷⁰ If changes in health care costs were a substantial contributor to changes in bankruptcy filings, it would have been expected that bankruptcy filing rates would have leveled off during this period as well. Instead, bankruptcy filing rates rose rapidly, even as health care costs leveled off. In short, there appears to be little correlation between changes in health care costs and changes in consumer bankruptcy filings.

Most studies of bankruptcy filers have failed to find a relationship between health care costs and bankruptcy, although a few studies find that medical debt does play a role in bankruptcy.¹⁷¹ Moreover, these studies do not examine whether *rising* health care costs contribute to a rising bankruptcy filing rate. Nonetheless, the mixed evidence to support even the basic model of the relationship of medical costs to bankruptcy does not increase confidence in the claim that rising bankruptcies can be attributed to rising health care costs.

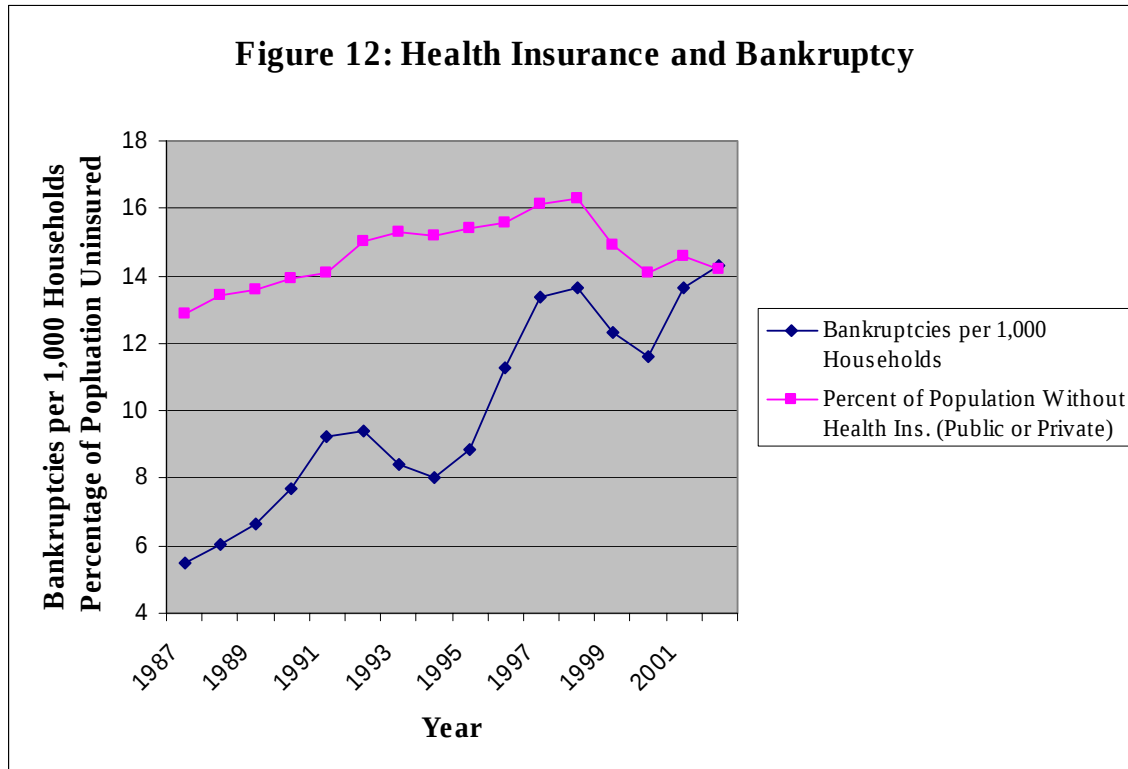
2. Health Insurance and Bankruptcy

Lack of health insurance also can theoretically contribute to bankruptcy filings. If a family lacks health insurance, a catastrophic or long-term illness can deplete family savings and overwhelm the household with debt.¹⁷² As a result, a lack of health insurance may exacerbate the other difficulties created by health problems, such as increased debt and reduced income. As shown in Figure 12, however, lack of health insurance does not explain the upward trend:

¹⁷⁰ The cost-restraints imposed by managed care began to crumble in the late 1990s, leading to a resumption of high health care inflation. See Strunk, et al., *supra* note.

¹⁷¹ See SULLIVAN ET AL., AS WE FORGIVE, *supra* note, at 168-69; Philip Shuchman, *New Jersey Debtors, 1982-83: An Empirical Study*, 15 SETON HALL L. REV. 541 (1985) (finding medical debts not to be an important factor in most bankruptcies); Philip Shuchman, *The Average Bankrupt: A Description and Analysis of 753 Personal Bankruptcy Filings in Nine States*, 88 COMMERCIAL L. J. 288 (June-July 1983) (same); Larry Sitner et al, *Medical Expense as a Factor in Bankruptcy*, 52 NEBRASKA STATE MEDICAL J. 412 (1967) (same); Barry Gold and Elizabeth Donahue, *Health Care Costs and Personal Bankruptcy*, 7 J. HEALTH POLITICS, POLICY, AND LAW 734 (1982) (same); see also Melissa B. Jacoby, Teresa A. Sullivan, and Elizabeth Warren, *Rethinking the Debates Over Health Care Financing: Evidence From the Bankruptcy Courts*, 76 N.Y.U. L. REV. 375, 378 (2001) (noting that “until the 1990s . . . most empirical studies of bankruptcy did not find illness, injury, or medical debt to be a major cause of bankruptcy”). But see Susan D. Kovac, *Judgment-Proof Debtors in Bankruptcy*, 65 AM. BANKR. L. J. 675 (1991) (finding large amounts of medical debt and medical debt present in many cases, but noting limited ability to generalize from her judgment-proof debtors to the larger population of Americans or bankruptcy filers).

¹⁷² SULLIVAN ET AL., FRAGILE, *supra* note, at 147-50.



Source: Census Bureau and Figure 2

As indicated by Figure 12, since 1987, when the Census Bureau started reporting annual records of the percentage of the population without public or private health insurance, the percentage of Americans without insurance has been relatively stable, fluctuating between roughly thirteen percent at the outset of the period to a high of sixteen percent in 1998 before declining again since that time. By contrast, during this same period, bankruptcy filings rose from five per 1,000 households to fourteen per 1,000 households. On the other hand, even though lack of insurance cannot explain the upward trend line, the data is suggestive of some relationship regarding short term fluctuations in the bankruptcy filing rate. Overall, however, the bankruptcy filing rate rose much more rapidly than the percentage of the population without health insurance. Empirical research also tends to find little relationship between lack of health insurance and bankruptcy. Gross and Souleles found that a lack of health insurance was not a statistically significant predictor of bankruptcy.¹⁷³ Economist Joanna Stavins similarly found “no notable difference” in the percentage with health insurance between bankruptcy filers and the population at large.¹⁷⁴

¹⁷³ David B. Gross and Nicholas S. Souleles, *An Empirical Analysis of Personal Bankruptcy and Delinquency*, 15 REV. FIN. STUDIES 319, 334-35, Table 2 (2002). Although they did not find lack of health insurance to be a predictor of bankruptcy, they did find it to be a predictor of credit card default.

¹⁷⁴ See Joanna Stavins, *Credit Card Borrowing, Delinquency, and Personal Bankruptcy*, NEW ENGLAND ECON. REV. 15, 22 (July/Aug 2000). Indeed, she found that those who filed bankruptcy in the past were *more* likely to have health insurance than the general population, although they may have acquired health insurance after the filing. *Id.* at 25. Although it is unlikely that bankruptcy filers are more likely to be

Moreover, it is not clear the actual extent to which an absence of health insurance could realistically influence bankruptcy filing rates substantially. A recent study found that of those who blamed health care problems for their bankruptcy filing, approximately eighty percent *had* health insurance during the relevant period.¹⁷⁵ Thus, if it is true that twenty percent of the 1.5 million annual bankruptcies are caused by health problems (as claimed by some scholars¹⁷⁶) and that twenty percent of those in bankruptcy as a result of health problems also lack health insurance, then this accounts for a mere 60,000 of the 1.5 million bankruptcies per year. Or to put it in larger perspective, from 1995 to 1996, overall bankruptcies jumped by 250,000 in one year. If these estimates are accurate, then a lack of health insurance accounts for approximately 10,000 of that 250,000 increase. Thus, even if a lack of health insurance is a relevant variable for understanding the bankruptcy crisis, it is simply too small of a figure (20 percent of the 20 percent of bankrupts who blame health care problems for their bankruptcies) to account for the massive rise in bankruptcy filings during recent decades.¹⁷⁷

In addition, providing health insurance also will probably lead to offsetting behaviors that would tend to create new vulnerability to bankruptcy. Thus, even though lack of health insurance is probably a factor in only relatively few bankruptcies, providing health insurance to all of the uninsured would probably not lead to a direct one-to-one reduction in bankruptcy filing rates. First, the availability of social insurance programs tends to lead to a reduction in precautionary savings to deal with non-medical financial crises.¹⁷⁸ Second, to the extent that individuals are provided with medical insurance, this will allow them to increase their consumption which will also increase their exposure to other economic stresses.¹⁷⁹ As a result of offsetting behavior, universal health insurance will not fully eliminate all of these bankruptcies.

3. Health Problems and Income Interruptions

If rising bankruptcy filing rates cannot be explained by changes in health care costs or absence of health insurance, what of the third argument advanced for the purported link between health problems and bankruptcy—that health problems often result in disability that make it impossible to work. This, in turn, leads to income interruptions that can catapult an individual into bankruptcy. Again, this factor probably

insured than non-filers, Stavins's findings certainly casts doubt on the claim that they are substantially less likely to be insured.

¹⁷⁵ Jacoby, et al., *supra* note, at 377. Shuchman found that 92% of the debtors in his study had health insurance before the date of the bankruptcy filing. Shuchman, *Average Bankrupt*, *supra* note.

¹⁷⁶ See SULLIVAN ET AL., *FRAGILE*, *supra* note, at 171. Jacoby et al, estimate that health problems were a factor in about 500,000 bankruptcies in 1999, and that of those in bankruptcy as a result of health problems, approximately 20 percent lacked health insurance.

¹⁷⁷ Accord Charles A. Lockett, *Personal Bankruptcies*, in *IMPACT OF PUBLIC POLICY*, *supra* note, at 69, 78.

¹⁷⁸ See Jonathan Gruber and Aaron Yelowitz, *Public Health Insurance and Private Savings*, 107 J. POL. ECON. 1249, 1266-67 (1999) (concluding that the Medicaid program has a “sizable effect” in reducing precautionary savings); R. Glenn Hubbard, Jonathan Skinner, and Stephen P. Zeldes, *Precautionary Saving and Social Insurance*, 103 J. POL. ECON. 360 (1995).

¹⁷⁹ See Gruber and Yelowitz, *supra* note, at 1270-71; Helen Levy and Thomas DeLeire, *What Do People Buy When the Don't Buy Health Insurance and What Does That Say about Why They are Uninsured?* NBER Working paper 9826, available in <http://www.nber.org/papers/9826> (July 2003).

explains some of the background bankruptcy filing rate, but can the rising bankruptcy rates of recent years be explained in any substantial portion by this factor?

An increase in bankruptcy filing rates could be caused by injury-induced income interruptions in two possible ways: either substantially more people are getting injured or those who are getting injured are much more likely to be disabled, to miss longer periods of work, or suffer much greater income loss than previously. There is no evidence to support either of these propositions. Available evidence tends to point in the opposite direction as well. Domowitz and Sartain, for instance, find little correlation of medical debt with other sources of financial distress, such as job loss or income interruption.¹⁸⁰ Fay, Hurst, and White find that health problems by the head of a household or spouse that cause missed work is *not* a statistically significant factor in bankruptcy filings.¹⁸¹

In fact, common sense suggests that income interruptions caused by health problems should be getting less severe over time rather than more severe. There is no reason to believe that more people are suffering disabling illnesses or injuries that lead to bankruptcy filings. In fact, there is circumstantial evidence that the opposite is true. It is well-established that individual health improves as income rises¹⁸² and that there is a strong correlation between wealth and health as well.¹⁸³ Thus, given the steady and at times dramatic increases in health and wealth over the past two decades there is every reason to believe that Americans are getting more, rather than less, healthy.

Nor is there any evidence to suggest that those who are ill or injured have suffered more debilitating or long-lasting injuries than in the past. Indeed, constant medical advances make it probable that *fewer* people are suffering debilitating injuries and illness than ever before. Moreover, those who do suffer illness and injury almost certainly are less likely to be disabled temporarily or permanently by those injuries and probably recuperate more rapidly than ever before, meaning that the amount of time of missed wages is probably falling over time.

There also is no reason to believe that the income loss as a result of illness or injury has become worse over time. First, as noted above, household wealth has risen dramatically over time, increasing the assets available to households to smooth over short-term losses in income. Moreover, the advent of home equity loans as well as various mechanisms for individuals to borrow against accumulated wealth in retirement plans has made it substantially easier for individuals to tap into their accumulated wealth

¹⁸⁰ See Domowitz and Sartain, *supra* note, at 413.

¹⁸¹ Fay et al., *supra* note, at 714.

¹⁸² See Ellen Meara, *Why is Health Related to Socioeconomic Status? The Case of Pregnancy and Low Birth Weight*, NBER Working Paper No. 8231 (April 2001); Peggy McDonough, Greg J. Duncan, David Williams, and James House, *Income Dynamics and Adult Mortality in the United States, 1972 through 1989*, 87 AM. J. PUB. HEALTH 1476 (1997); Susan Ettner, *New Evidence on the Relationship between Income and Health*, 15 J. HEALTH ECON. 67 (1996); see also Peter Boettke and Robert Subrick, *The Rule of Law and Human Capabilities*, 10 S. CT. ECON. REV. 109 (2003) (finding cross-country correlation between per capita income and health amenities).

¹⁸³ See Jonathan Meer, Douglas L. Miller, and Harvey S. Rosen, *Exploring the Health-Wealth Nexus*, NBER Working Paper 9554 (March 2003); James P. Smith, *Health Bodies and Thick Wallets: The Dual Relation Between Health and Economic Status*, 13 J. ECON. PERSPECTIVES 145 (1999). As Meer et al. observe, the causal link is ambiguous, as wealth may be endogenous to health. This caveat is unimportant for the point offered in the text, as all that is necessary is the observed correlation because wealth is being offered simply as a proxy for health.

and to transform wealth into income to smooth over short-term income losses. Second, as it has become increasingly common for both spouses to work in married families, households should be becoming more resilient in the face of job disability as having two workers in a family creates greater income risk diversification against loss of income by one worker. If the head of the household becomes unable to work because of illness or injury, the employment of the other spouse should mitigate the impact of the income loss resulting from a disabling injury or illness.

Workers also have a variety of systems intended to replace some of their income when they suffer illness and injury on the job, such as workers' compensation, Social Security Disability Insurance, and private disability insurance. Of course, these systems do not fully replace all lost income, which is why they are not complete protection for bankruptcy. On the other hand, because these social insurance programs are available in times of need, this provides an incentive to reduce one's precautionary savings or otherwise retain accessible wealth in times of economic stress.¹⁸⁴ But more importantly, there have not been any dramatic adverse changes to any of these systems that would be sufficient to explain why job interruptions due to illness or injury could explain the upward trend in bankruptcy filing rates. These systems have been more or less stable for all of the relevant period, and so there are simply no changes that are dramatic enough to explain the dramatic changes in the bankruptcy rate.¹⁸⁵

4. Summary on Health Care, Insurance, and Bankruptcy

The primary flaw in the argument advanced by those that claim that health issues can explain the rise in bankruptcy filing rates is again that they again study only those who are *in* bankruptcy and conclude from those findings that those same reasons can explain how people choose to file bankruptcy. For instance, they conclude that some ten percent of bankrupts in their 1991 study filed as a result of the combination of medical problems and time lost from work. They thus extrapolate this figure to conclude, "[I]f those numbers could be generalized to the 1997 bankruptcy filings, more than 130,000 families would have filed for bankruptcy *because of a medical problem* resulting in a job loss or interruption."¹⁸⁶

This conclusion does not follow, as it inverts the dependent and independent variables. It is not possible to simply extrapolate from the change in the *dependent* variable—in this case, the increase in bankruptcy filings from 872,438 in 1991 to 1.35 million in 1997—to an estimation of the *independent* variable, health-induced bankruptcies. If it is claimed that there is a change in the value of the independent variable, the theorist must provide an explanation for why that variable has changed. In other words, if it is claimed that health care problems have contributed to the rising bankruptcy filing rates, it is necessary to explain why health care problems have become so much problematic in a way that is relevant to a rise in bankruptcy filing rates. One cannot simply assume that medical problems have worsened proportionately just because bankruptcies have risen, unless one controls for the incidence of filing bankruptcy when

¹⁸⁴ See Hubbard, Skinner, and Zeldes, *supra* note.

¹⁸⁵ There have been some minor changes in state workers' compensation programs, but not any major changes. See Emily A. Spieler, *Perpetuating Risk? Workers' Compensation and the Persistence of Occupational Injuries*, 31 HOUS. L. REV. 119, 247-49 (1994).

¹⁸⁶ See SULLIVAN, ET AL., FRAGILE, *supra* note, at 157 (emphasis added).

confronted with a health problem. This leads to circular reasoning. If it is found that twenty percent of bankruptcy filers suffered a health care crisis in 1991 that catapulted them into bankruptcy, it is then *assumed* that twenty percent of the *growth* in bankruptcy for the next decade is comprised of those who file because of a health care crisis. This reasoning is circular, in that it takes the dependent variable (how many bankruptcies are caused by health care problems) and uses it as an independent variable (explaining the change in bankruptcies over time).

Thus, the relationship between changes in health care costs and bankruptcy are tenuous at best and lend little support to the claim that the bankruptcy crisis of the 1990s was caused by a health care crisis. Personal bankruptcies surged at precisely the moment that the advent of HMOs caused health care costs to level off. With respect to the link between illness-induced lost income and bankruptcy, there is *no* evidence to suggest that this factor rose in any notable importance during this period. There is little reason to believe that more workers became disabled or that injured workers were more likely to become disabled or miss more time from work than in previous times.

E. Other Evidence Questioning the Traditional Model

The factors advocated by the traditional model as explanations for rising bankruptcies in recent decades have been shown to lack empirical support. In addition, there is substantial corroborative data that casts doubt on the traditional model. In particular, there is a great deal of evidence that indicates that controlling for the variables identified as important by the traditional model, there are huge unexplained statistical residual effects that cannot be explained by any traditional variables. A finding of large unexplained residuals provides no evidence in itself of what explains the residual. On the other hand, if the model specification controls for the relevant variables and yet still finds unexplained residual effects, this suggests that the variables that comprise the traditional model *cannot* explain those statistical residuals. Empirical studies have tended to find large unexplained statistical residuals, often swamping the influence of those variables thought to cause bankruptcies under the traditional model.

David Gross and Nicholas Souleles studied a dataset of credit card accounts to analyze personal bankruptcies, among other things.¹⁸⁷ Gross and Souleles compare the incidence of personal bankruptcy in 1995 versus 1997, a period during which bankruptcies rose dramatically. They conclude that after controlling for risk composition and other standard economic variables, the propensity to declare bankruptcy significantly increased during this period. They conclude that the magnitudes of the difference “are almost as large as if the entire population of cardholders had become one standard deviation riskier” during this period, as measure by credit risk scores.¹⁸⁸ As they conclude, “[E]ven after controlling for account age, balance, purchase and payment history, credit line, risk scores, and economic conditions, a given account was more likely to go bankrupt in 1996 and 1997 than in 1995. Some other systematic default factor must have deteriorated”¹⁸⁹ A study by Barron, Elliehausen, and Staten, using aggregate credit bureau data, similarly finds an upward trend in bankruptcy filing rates

¹⁸⁷ Gross & Souleles, *supra* note.

¹⁸⁸ *Id.* at 322.

¹⁸⁹ *Id.* at 335-36.

over time that cannot be explained by any variables that measure economic risk or household financial condition.¹⁹⁰ Brown also finds a nationwide trend line that cannot be explained by any traditional variables.¹⁹¹ Bishop also finds a “large difference” between actual bankruptcy filing rates and the rates that would be predicted by the traditional model, which “suggests that there are other factors of importance,” such as changes in social norms, attorney advertising, and the like.¹⁹² Still further questions about the traditional model are raised by Buckley’s finding of a substantial residual difference in filing rates when comparing the United States and Canada that cannot be explained by any traditional factors.¹⁹³ Overall then, there is a consensus in the empirical literature that the traditional model is incomplete.

F. Summary: The Intellectual Crisis of the Traditional Model

The traditional model of bankruptcy rests on four legs to explain why people file bankruptcy: overindebtedness, unemployment, divorce, and illness. These factors are unquestionably part of the background frictional bankruptcy filing rate. In addition, there appear to be other factors that explain some aspects of the differences among bankruptcy filing rates from state to state, such as the presence of legalized gambling, whether a state requires motorists to have automobile insurance, and the strictness of a state’s garnishment laws.¹⁹⁴ Each of these factors may marginally contribute to bankruptcy filing rates, but as with the other factors identified, these factors appear to be either too small or too stable to explain the surge in bankruptcy filing rates. Although legalized gambling has grown dramatically in the United States in the past decade, it is not large enough to explain the additional million or so bankruptcies that are filed each year as compared to two decades ago. And while uninsured motorists and garnishment rules have been found to have a link to bankruptcies, there is no indication that these rules have changed so much in recent decades to explain the dramatic change in bankruptcy filing rates.¹⁹⁵

None of the variables identified by the traditional model, either alone or in combination, can explain the surge in bankruptcy filing rates seen during the past twenty-five years.¹⁹⁶ In short, the evidence fails to support the hypothesis of the traditional model that rising bankruptcy filing rates are explained by greater household financial distress. Until recently, low interest rates and strong income growth have kept the debt-service burden below its all-time high of the early 1980s. Extraordinary growth in household assets, due to growth in financial assets and housing values, have increased household net wealth rapidly. The unemployment rate was steady through the 1980s and record lows in the mid-1990s, just as the surge in personal bankruptcies occurred. After

¹⁹⁰ Barron, Elliehausen, and Staten, *supra* note.

¹⁹¹ See Brown, *Time Series Analysis*, *supra* note, at 2.

¹⁹² Bishop, *supra* note, at 8.

¹⁹³ See F.H. Buckley, *The American Fresh Start*, 4 S. CAL. INTERDISCIPLINARY L.J. 67 (1995).

¹⁹⁴ See Lockett, *Personal Bankruptcies*, *supra* note 177, at 69, 77-80 (discussing findings of study by SMR Research).

¹⁹⁵ *Id.* at 78. I am not aware of any trend among states to eliminate insurance requirements for motorists or toward permitting substantially more aggressive garnishment by creditors.

¹⁹⁶ Even adherents to the traditional model acknowledge that it has broken down in the past two decades. See Moss and Johnson, *supra* note, at 322.

rising through the 1970s, the divorce rates leveled off in the 1980s and fell through the 1990s; but bankruptcies rose throughout. Finally, although health care inflation is high, year-to-year changes in health care costs are substantially lower than the rapid increases of the 1970s. In fact, the advent of managed care arrested health care inflation in the mid-1990s; again, the same period during which bankruptcy filing rates exploded. Static or declining variables, such as unemployment, divorce, or health care costs, cannot explain a variable that is increasing in value, such as bankruptcy filing rates.

The traditional model also suffers from several conceptual problems. In some cases the traditional model has relied on a poor choice of proxy variables to measure the impact of certain factors on bankruptcy filing rates, such as in its use of debt-to-income ratio to measure household financial condition, rather than one of the standard financial measurements.¹⁹⁷ Many key empirical studies of the traditional model study only those in bankruptcy, thus they lack a control group. It is thus impossible to determine how many people suffer the same financial setbacks as those in bankruptcy, such as unemployment or other job interruption, but do not file bankruptcy.¹⁹⁸ The traditional model also confuses dependent and independent variables, leading to circular reasoning in the model's conclusions, such as its estimation of the number of bankruptcies caused by health problems.¹⁹⁹ Some of the conclusions of the traditional model appear to be grounded on anecdote rather than data. In the case of downsizing, for instance, this focus on a handful of isolated high-profile layoffs has obscured the growth in management jobs at other firms as well as the rapid rate at which white-collar workers have reclaimed their former positions.²⁰⁰ Finally, in drawing policy inferences, the traditional model fails to account for compensating behavior by consumers that will offset policy proposals, such as the likelihood that consumers would respond to guaranteed health insurance by increasing consumption and reducing precautionary savings.²⁰¹

Adherents to the traditional model have assumed that because bankruptcies have risen, there also “must be” rising financial distress and it is just a matter of finding the right variables.²⁰² But it is not correct to infer that because bankruptcy filings have been rising over time, it “must be” that the financial condition of American households is deteriorating. The traditional model provides clear testable implications—if bankruptcy filings are rising then the evidence should demonstrate household financial condition should be getting worse, and that this worsening financial condition is causing the rise in bankruptcy filings. If household financial condition is improving, however, then the traditional model predicts that bankruptcy filings should be falling over time. There is nothing in the traditional model that can reconcile rising bankruptcies with a steady or improving household financial state. Instead of testing the premises of the model, therefore, traditionalists have simply *assumed* that rising bankruptcies evidence worsening financial condition and then have set out to find statistical correlations that may or may not have causal significance over time.

¹⁹⁷ See *supra* notes 50-53 and accompanying text.

¹⁹⁸ See *supra* note 130 and accompanying text.

¹⁹⁹ See *supra* note 186 and accompanying text.

²⁰⁰ See *supra* note 134-155 and accompanying text.

²⁰¹ See *supra* notes 178-179, 184, and accompanying text.

²⁰² Kuhn notes that this is a standard response when a prevailing scientific model or paradigm is challenged by recurrent anomalies. See KUHN, *supra* note, at 78.

To explain a change in bankruptcy filings as a result of changing financial condition, however, there must be *some* relevant variable that is actually *changing* in value over time. As noted, the variables that the traditional model identifies as underlying increased household financial distress simply cannot explain the rise in bankruptcy filings because those variables have either been constant over time or changing in a manner contrary to the predictions of the model. Indeed, because some of these variables have unambiguously improved over time (such as divorce, wealth, and unemployment), this raises the burden still further for the traditional model, because if bankruptcy filings result from such variables as these, then the remaining variables must be worsening at a still faster rate in order to offset improvements in these variables. The traditional model provides a set of straightforward testable hypotheses that, when tested against the data, fail to confirm the model's predictions. In short, the traditional model is unable to explain the crucial bankruptcy question of the age—why have consumer bankruptcies risen so rapidly in an era of unprecedented prosperity? Given the intellectual crisis of the traditional model, therefore, is there an alternative model of bankruptcy that can better explain the world?

IV. Why So Many Bankruptcies? A New Institutional Economics Model of Consumer Bankruptcy

A review of the evidence thus indicates that the surge of bankruptcy filings over the past two decades cannot be explained by the traditional model. Increased bankruptcy filings are not and cannot be explained as a function of greater household economic distress. The data support what casual observation suggests—American households are wealthier and more financially secure than at any time in recent history. The model constructed by the traditionalists is increasingly unable to explain the observed trends in bankruptcy filing rates. Although there have been great efforts to try to explain the data in without abandoning the prevailing theoretical model, these efforts are becoming increasingly unpersuasive and difficult to justify. Given the intellectual crisis of the traditional model, it is time to consider whether a different model better explains the world.

The foregoing discussion suggests that rising consumer bankruptcy filing rate over the past several years is not the result of increasing economic distress, but rather, results from an increasing *propensity* of American households to file bankruptcy in response to economic problems. In the past, households that suffered an economic dislocation tended to respond by reducing spending, tapping savings, and eventually repaying their obligations. Although most Americans today still respond to financial distress in the same way, an increasing number are likely to respond to financial problems by filing bankruptcy and discharging their debts, rather than reining in their spending or tapping their accumulated wealth. Problems of unemployment, divorce, health, and indebtedness have been a part of the human condition since human societies have existed. What is novel, therefore, are not the underlying problems, but rather, the increasing willingness of individuals to use bankruptcy as a *response* to those underlying problems.²⁰³

²⁰³ Accord Glenn B. Canner and Charles A. Lockett, *Payment of Household Debts*, 77 FED. RES. BULLETIN 218, 223 (1991)

Because the traditional model focuses on the underlying household financial problems, rather than the individual choice among strategies to respond to those problems, it has largely missed the point. The factors emphasized by the traditional model will be present in almost every bankruptcy because most people do not file bankruptcy without some financial setback. But it is not inevitable that a person confronting financial difficulty will file bankruptcy. Financial difficulty presents a menu of options in addition to bankruptcy, from increasing one's income (such as by taking on a second job), decreasing one's expenditures (such as by eating out less or vacationing less), or by liquidating assets and using the proceeds to pay debts (such as moving to a smaller house). The combination of a rise in bankruptcy filings with no evident rise in underlying financial distress suggests that what has changed is the increased popularity of bankruptcy as a choice from the menu of financial options confronting financially-troubled households. Whether this is because of increased awareness of bankruptcy as an option, because of increased willingness of individuals to choose bankruptcy as an option, or both, is the question that this Part addresses.

The traditional model focuses on the question of how households get *into* financial trouble, hypothesizing that that this explains how families end up in bankruptcy. An alternative model, by contrast, inquires how consumers come to choose bankruptcy to get *out* of financial trouble. Understanding why bankruptcy filings have risen by 500% over the past two decades requires looking beyond the causes of household financial distress and instead to the changes that have generated an increased propensity for households to choose bankruptcy as their response to financial problems. This requires an examination of the consumer bankruptcy institutions that supply the incentives and constraints on filing bankruptcy, not the factors that cause financial distress.²⁰⁴

Institutions serve two functions: they provide incentives and they provide a transactional framework.²⁰⁵ First, institutions provide incentives by channeling individual behavior in particular directions. For instance, criminal law is an institution that provides incentives to acquire property by consensual exchange rather than by theft. This channels behavior toward wealth-creation and peaceful exchange of property. Second, institutions provide a transactional framework, such as rules of property and contract, that instruct people on how to coordinate their affairs so as to accomplish their plans. Contract law, for instance, instructs people on how to enter into enforceable exchanges of entitlements; property law instructs people on how to protect their property from the claims of others.

Institutions can be formal or informal. Criminal law is an institution, but so is morality, which also constrains individuals from theft and violence. Contract law is an institution, but so is the development of a reputation or trademark that also encourages

²⁰⁴ Douglass North has defined an "institution" as: "[T]he humanly devised constraints that structure human interaction. They are made up of formal constraints (e.g. rules, laws, constitutions), informal constraints (e.g. norms of behavior, conventions, self-imposed codes-of-conduct), and their enforcement characteristics. Together, they define the incentive structure of societies and specifically economies." See Douglass C. North, *Economic Performance Through Time*, 84 AMER. ECON. REV. 359, 360 (1994).

²⁰⁵ See DOUGLASS NORTH, INSTITUTIONS, INSTITUTIONAL CHANGE, AND ECONOMIC PERFORMANCE 27 (1990).

the performance of promises even where contract enforcement is lacking.²⁰⁶ Social norms that encourage cooperative behavior and punish opportunistic behavior has been identified as a particularly important type of informal institution that provides both incentives on how to act as well as conserving on the transaction costs associated with social interaction.²⁰⁷

A focus on institutions and transaction costs is the centerpiece of the “New Institutional Economics” (NIE). NIE enriches the standard neoclassical model of economic behavior by providing an institutional context for individual behavior. Crudely stated, the standard neoclassical model of economic behavior stresses individual self-interested, rational behavior. Human beings are treated as largely homogeneous, responding predictably to changes in relative prices, including incentives. Information, transaction costs, and social norms play a minor role in the neoclassical model, as individual choice, self-interest, and rationality are elevated to a primary position. Notwithstanding the fundamental differences of economic and sociological models of bankruptcy,²⁰⁸ both models generally assume that the fundamental explanation for rising bankruptcy filings are fundamentally caused by simple and predictable variables. The traditional model assumes that bankruptcy is largely involuntary, thrust upon consumers by unexpected financial catastrophe; the neoclassical model assumes that rising bankruptcies result from simple economic maximizing behavior by consumers.²⁰⁹

The NIE model offered here, by contrast, looks at changes in the institutional framework in which consumers act, focusing particularly on incentives, constraints, and transaction costs. Because increased financial distress cannot explain the rise in bankruptcies, the rise in bankruptcies most likely results from changes that have caused individuals increasingly to choose bankruptcy as a response to their financial problems. Because financial condition has remained largely constant, for some reason there has been a *substitution* by consumers toward bankruptcy and away from the other methods that they historically have used as a response to financial problems. This suggests that bankruptcy has thus become relatively more attractive over time when compared to the other options that individuals historically used in response to financial problems. Moreover, in order to explain how changes in these factors have driven changes in bankruptcy filing rates it is necessary for these factors to be *dynamic*, not static. They must be capable of explaining change over time.

This Part of the article identifies the factors that appear to have changed the propensity of Americans to file bankruptcy in response to financial hardship. Three general factors appear to have driven the increase in bankruptcy filing rates in recent years: (1) Changes in the relative economic costs and benefits of filing bankruptcy; (2) Changes in the nature of consumer credit that have led to an increased willingness of borrowers at the margin to discharge their obligations in bankruptcy; and, (3) A change in the social norms regarding bankruptcy. The empirical evidence that is available to test

²⁰⁶ See Benjamin Klein and Keith B. Leffler, *The Role of Market Forces in Assuring Contractual Performance*, 89 J. POL. ECON. 615 (1981).

²⁰⁷ See ROBERT C. ELLICKSON, *ORDER WITHOUT LAW: HOW NEIGHBORS SETTLE DISPUTES* (1991).

²⁰⁸ See Michelle J. White, *Economic Versus Sociological Approaches to Legal Research: The Case of Bankruptcy*, 25 LAW & SOC'Y REV. 685 (1991).

²⁰⁹ See Michelle J. White, *Why Don't More Households File for Bankruptcy?* 14 J. L. ECON. & ORG. 205 (1998).

these propositions is somewhat sparse unfortunately, but tends to support the model advanced here. Most available empirical evidence has been grounded in the traditional model of bankruptcy, and thus does not focus on the factors identified here.²¹⁰ It is hoped that by identifying the relevant factors that may help to explain the bankruptcy boom this will help to elicit better empirical testing by future. This Part explores the key changes in institutional constraints and incentives over time.

It should also be stressed that many of the factors discussed here are driven by forces that increase economic efficiency. Unfortunately, many of these developments also have tended to lead to increased bankruptcy filings as a side effect. The policy goal, therefore, is to design the efficient mix of institutions that preserves these increased economic efficiencies while at the same time responding with institutional innovations that will mitigate the side-effects of increased bankruptcies.

A. *Changes in the Relative Costs and Benefits of Filing Bankruptcy*

Institutional analysis of the bankruptcy system and the individual bankruptcy filing decision turns on an examination of incentives, transaction costs, and incentives. An increase in the marginal benefits associated with a particular action or a decrease in the costs associated with that behavior can be predicted to lead to an increase in the amount of that behavior. By contrast, a reduction in benefits or an increase in costs will generally lead to a reduction in the incidence of the behavior in question. Historically, the prevailing neoclassical paradigm in economics has abstracted away from institutions and transaction costs. New Institutional Economics, by contrast, studies institutions and transaction costs to understand the purpose of institutions and how institutional change can alter the behavior of individuals by changing the incentives and constraints that they face. In contrast to traditional economics, for instance, new institutional economics is particularly focused on problems of information, opportunism, and coordination, issues that are generally ignored or assumed away in traditional economic analysis.²¹¹

To fully explain a phenomenon as complex and diffuse as the rising personal bankruptcy filing rate, “costs” and “benefits” must be defined broadly to include all relevant costs associated with the bankruptcy filing decision. The analysis in this article, therefore, adopts the spirit of NIE in defining institutions, constraints, and transaction costs broadly to encompass the full range of social factors that have contributed to the rise in bankruptcy filing rates over the past several years.

²¹⁰ This may also explain why policy-makers have not paid much attention to existing empirical studies of consumer bankruptcy, which has been a source of frustration for some bankruptcy scholars. See Jay Lawrence Westbrook, *Empirical Research in Consumer Bankruptcy*, 80 TEXAS L. REV. 2123 (2002). Much of the existing empirical literature, however, is irrelevant to the question confronted by policy-makers in recent years—namely, why bankruptcies have been rising in recent years, and what the effects would be of various reform proposals. See Jones and Zywicki, *supra* note, at 196. I served as an advisor to Congress on bankruptcy reform issues for several years, and indeed am currently serving as a senior policy-maker at the Federal Trade Commission, and can say with confidence that Congress and other policy-makers pay a lot of attention to sound empirical evidence where it is available.

²¹¹ For a discussion of the differences between NIE and traditional economic analysis and some of its implications for policy-making, see Timothy J. Muris, *Improving the Economic Foundations of Competition Policy*, __ GEORGE MASON L. REV. __ (forthcoming 2003).

In the context of individual bankruptcy, there simultaneously have been increases in the economic benefits and reductions in the economic costs of filing bankruptcy.²¹² These changes in the relative costs and benefits associated with declaring bankruptcy create incentives at the margin to file bankruptcy that are reflected in the increasing bankruptcy filing rates of recent decades. Given the substantial economic benefits available to bankruptcy filers, even a small decline in the relative costs of filing bankruptcy could be expected to elicit a substantial increase in the number of bankruptcy filings.²¹³

1. The Economic Benefits of Filing Bankruptcy Have Risen

a. The 1978 Code Increased the Economic Benefits of Filing Bankruptcy

There is widespread recognition that the economic benefits to an individual from filing bankruptcy increased substantially with the enactment of the 1978 Bankruptcy Code.²¹⁴ There is less agreement on whether these increased benefits have led to increased observed bankruptcy filing rates as an empirical matter, although the bulk of the evidence suggests that the enactment of the Code did significantly increase bankruptcy filings.²¹⁵ At the same time it is difficult to argue that the more generous bankruptcy rules enacted by the 1978 Bankruptcy Code did not have at least *some* effect on increasing bankruptcy filing rates either independently or in conjunction with other factors.²¹⁶

²¹² One could also consider reduced stigma as a reduction in the social “cost” of filing bankruptcy. See Gary S. Becker, *A Theory of Social Interactions*, 82 J. POL. ECON. 1063 (1974). For purposes of exposition, I have treated the effects of reduced social stigma separately, although they certainly could be classified as a relevant “cost” of bankruptcy if one were so inclined to treat it that way.

²¹³ See Gross and Souleles, *supra* note, at 320.

²¹⁴ Summaries of some of the major pro-debtor changes ushered in by the 1978 Code can be found in Ian Domowitz and Robert L. Sartin, *Incentives and Bankruptcy Chapter Choice: Evidence from the Reform Act of 1978*, 28 J. LEGAL STUD. 461, 467 (1999); Charles Jordan Tabb, *The History of the Bankruptcy Laws in the United States*, 3 AM. BANKR. INST. L. REV. 5, 34-37 (1995); Kenneth N. Klee, *Legislative History of the New Bankruptcy Code*, 54 AM. BANKR. L.J. 275, 275-97 (1980). In congressional testimony, the American Bankruptcy Institute acknowledged that the 1978 Code “made bankruptcy a much more debtor-friendly law.” See *Personal Bankruptcy Consumer Credit Crises: Hearings Before the Subcomm. On Admin. Oversight and the Courts of the Comm. On the Judiciary*, 105th Cong., 1st Sess. (April 11, 1997) (Statement of the American Bankruptcy Institute), available in 1997 WL 176645 at 7. Others have argued that although the legislative changes made in 1978 were in a pro-debtor direction, their overall effect was not large enough to account fully for the large increase in filings. See Vuckowich, *supra* note, at 1131.

²¹⁵ Most studies have concluded that the enactment of the Bankruptcy Code has caused an increase in the bankruptcy filing rate. See Buckley, *American Fresh Start*, *supra* note, at 76-77; Lawrence Shepard, *Personal Failures and the Bankruptcy Reform Act of 1978*, 27 J. L. & ECON. 419 (1984); Richard L. Peterson and Kiyomi Aoki, *Bankruptcy Filings Before and After Implementation of the Bankruptcy Reform Law*, 36 J. ECON. & BUS. 95 (1995); William J. Boyes and Roger L. Faith, *Some Effects of the Bankruptcy Reform Act of 1978*, 29 J. L. & ECON. 139; William T. Vukowich, *Reforming the Bankruptcy Reform Act of 1978: An Alternative Approach*, 71 GEO. L.J. 1129 (1983). Other studies failed to detect a significant increase in filing rates as a result of the 1978. See Jagdeep S. Bhandari and Lawrence A. Weiss, *The Increasing Bankruptcy Filing Rate: An Historical Analysis*, 67 AM. BANKR. L.J. 1 (1993); Ian Domowitz and Thomas L. Eovaldi, *The Impact of the Bankruptcy Reform Act of 1978 on Consumer Bankruptcy*, 36 J. L. & ECON. 803 (1993). For a criticism of the statistical methods used in these latter two studies, see Buckley & Brining, *supra* note, at 194 n.17.

²¹⁶ Professor William Whitford has observed “it is hard to believe that the enactment of the Code has not had any effect on bankruptcy filing rates.” William C. Whitford, *The Ideal of Individualized Justice*:

As originally enacted, 1978 Code placed few restrictions on a debtor's ability to file bankruptcy, regardless whether the debtor needed bankruptcy relief or not. The motivation of the drafters of the 1978 Code for doing this is somewhat unclear, but it seems that they believed that legal restraints on debtor opportunism were unnecessary and that social and economic constraints would be sufficient to prevent opportunistic use of the bankruptcy system by debtors. Whatever the rationale, the Legislative History to the 1978 Code states, "The section does not contemplate . . . that the ability of the debtor to repay his debts in whole or in part constitutes adequate cause for dismissal."²¹⁷

Concerned by an immediate surge in bankruptcy filings following the enactment of the 1978 Code, in 1984 Congress amended the Code to place some modest limits on the ability of consumers who file bankruptcy opportunistically. In particular, the 1984 amendments added §707(b) to the Code, empowering bankruptcy judges to dismiss a debtor's bankruptcy case if granting relief would amount to a "substantial abuse" of the bankruptcy system. In practice, however, this power has been used only rarely, sporadically, and inconsistently to police debtor opportunism.²¹⁸ Thus, §707(b) has done little in practice to reduce the economic benefits associated with filing bankruptcy. It has been estimated by one scholar that with a modest degree of pre-bankruptcy planning as much as one-third of American households could gain financially from filing bankruptcy and the financial benefit from filing is greatest for well-off debtors.²¹⁹ Calculation of the economic benefits from filing bankruptcy also partially explains debtors' choices between Chapter 7 or Chapter 13.²²⁰

But bankruptcy does not merely give a debtor the opportunity to discharge financial obligations. There are also intangible benefits associated with filing bankruptcy that are not directly found on a balance sheet. For instance, the initiation of a bankruptcy case imposes an automatic stay against all efforts by creditors to collect prepetition

Consumer Bankruptcy as Consumer Protection, and Consumer Protection in Consumer Bankruptcy, 68 AM. BANKR. L. J. 397, 399 n.11 (1994). He adds, "It is indisputable that consumers can often achieve better economic results through bankruptcy today than they would have been able to achieve if the law had not been changed. To assume that this change has had no effect on decisions to file, one would have to make monumental changes in the usual assumptions about the responsiveness of humans to financial incentives in commercial matters." *Id.* In fact, a specific purpose of exemptions is to protect property believed necessary for the debtor's fresh start, and thereby to reduce the burden of filing bankruptcy. If higher exemptions did not encourage bankruptcy filings, therefore, this raises the larger question of whether exemption law is accomplishing its purposes.

²¹⁷ Legislative History to 11 U.S.C. §707(b). For a discussion of the political developments that led to the emergence of §707(b), see SKEEL, *supra* note, at 196-97.

²¹⁸ Jones & Zywicki, *supra* note; Zywicki, *Screw tape*, *supra* note. See also Fay, Hurst, & White, *supra* note, at 707 n.4 (noting that "later court decisions and lack of enforcement made [the substantial abuse provision] ineffective"); Wayne R. Wells, Janell M. Kurtz, and Robert J. Calhoun, *The Implementation of Bankruptcy Code Section 707(b): The Law and the Reality*, 39 CLEVELAND ST. L. REV. 15 (1991); Karen Gross, *Preserving a Fresh Start for the Individual Debtor: The Case of Narrow Construction of the Consumer Credit Amendments*, 135 U. PA. L. REV. 59 (1986).

²¹⁹ See Michelle J. White, *Why It Pays to File for Bankruptcy: A Critical Look at Incentives Under U.S. Bankruptcy Laws and a Proposal for Change*, 65 U. CHI. L. REV. 685 (1998); Michelle J. White, *Why Don't More Households File for Bankruptcy?*, 14 J. L. ECON. & ORG. 205, 214 (1998) (concluding that a minimum of 15% and as much as 23% of American population could financially benefit from filing bankruptcy); Fay, Hurst, & White, *supra* note, at 712 (finding 18% of households in study would benefit financially from filing bankruptcy).

²²⁰ See Domowitz and Sartain, *Incentives and Bankruptcy Chapter Choice*, *supra* note, at 481-82.

debts.²²¹ This provides the debtor with relief from bill collectors, litigation, and the other inconveniences of defaulting on credit obligations. Indeed, Jean Braucher reports that the primary financial goal of bankruptcy filers is “stopping creditors’ collection efforts (foreclosure, repossession, suit, garnishment, phone calls, letters, home visits).”²²² Second on the list is “keeping property, often serving as collateral, such as homes, cars and household belongings.”²²³ Thus, bankruptcy procedures such as the automatic stay provide additional economic benefit for filing bankruptcy.²²⁴

The substantial benefits provided by the current bankruptcy system has created an arbitrage opportunity for many to gain financially by filing bankruptcy. The rising bankruptcy rates of the past decade provide evidence that this arbitrage opportunity is gradually being recognized and exploited by bankruptcy filers. On the other hand, this arbitrage opportunity is not likely to be instantly recognized and acted upon. As is discussed below, there are substantial information and transaction costs associated with learning about and filing personal bankruptcy.²²⁵ This suggests that the consumer response to the existing arbitrage opportunity will be quite gradual as information percolates through the system. At some point equilibrium will be restored at the higher bankruptcy rate, but the path toward this end result will likely be gradual.

The diffusion of knowledge of a new economic opportunity will tend to be gradual rather than instantaneous. This especially would be the case where the information costs of learning about the opportunity are high and the *ex ante* risk of acting are high. In such situations, individuals will have to be especially persuaded that acting will be profitable. Filing bankruptcy is such an experience—a relatively rare social phenomenon with a high degree of risk. Indeed, bankruptcy filers report that the most common source of information that led them to file bankruptcy is friends and relatives, i.e., high reputable sources who can overcome these problems of risk and information.²²⁶

The spread of knowledge of an economic opportunity has been modeled as an S-shaped curve.²²⁷ At first the innovation is adopted only by those who have a large

²²¹ 11 U.S.C. §362(a).

²²² Jean Braucher, *Lawyers and Consumer Bankruptcy: One Code, Many Cultures*, 67 AM. BANKR. L. J. 501, 522 (1993).

²²³ *Id.*

²²⁴ See Sugato Chakravarty and Eun-Young Rhee, *Factors Affecting an Individual’s Bankruptcy Filing Decision*, Working Paper, Purdue University (May 4, 1999) (reporting survey data that second-most common reason for filing bankruptcy was in response to lawsuits and collection harassment); see also “People Behind Bankruptcy Numbers: Preliminary Results of Chapter 13 Study in Progress,” Testimony Before the Subcomm. On Admin. Oversight and the Court of the Senate Comm. On the Judiciary, 105th Cong. At *6 (1998) (testimony of Professor Tahira K. Hira), available in 1998 WL 8992993 (reporting results of survey of bankruptcy filers who state that “no more phone calls from creditors” is a leading reason for filing bankruptcy).

²²⁵ See *infra* at notes ____ - ____ and accompanying text (discussing transaction costs of bankruptcy).

²²⁶ See McKinely, *supra* note, at 38 (noting results of Gallup poll, which found that 51 percent of bankruptcy filers had a close friend or relative who filed bankruptcy previously); *Id.* (noting Visa survey of bankruptcy filers that found that 45 percent of filers learned about bankruptcy from friends or family). Lawyers and lawyer advertising are the second most common source of information. See McKinely, *supra* note, at 38.

²²⁷ See Zvi Griliches, *Hybrid Corn: An Exploration in the Economics of Technological Change*, 25 ECONOMETRICA 501 (1957). I wish to thank my colleague Richard Ippolito for bringing to my attention Griliches’s model of the diffusion of knowledge through the economy. See also Pauline M. Ippolito and

amount to gain from the innovation will act and so the spread of information is slow. But at some point the awareness of the new higher-level equilibrium becomes apparent to others, and knowledge spreads quickly through the economy until the new equilibrium level is reached. Where the gain from adopting the new knowledge is high or the cost of adopting it is low, the knowledge will be expected to spread more rapidly *ceteris paribus*.²²⁸

In a famous article, Professor Zvi Griliches modeled the spread of information through the American farm belt of the development of high-yield hybrid corn during the mid-Twentieth Century.²²⁹ Some estimates were that when adopted, hybrid corn increased productivity by 300 to 1,000 per cent.²³⁰ Nonetheless, hybrid corn was not introduced immediately or at the same time in all parts of the country. Rather, its introduction ranged from the mid-1930s in Iowa to the mid-1940s in Alabama, with several intermediate states. Nonetheless, once introduced the diffusion of knowledge of hybrid corn followed a nearly-identical S-shaped curve in each area introduced. Once introduced, Griliches observes, there is a predictable adjustment path that may have some short-term variation, but which over time shows more or less uniform movement toward a new equilibrium path.

It is interesting that Figure 2 above, which plots a curve of bankruptcy filing rates over the past half century, bears a strong resemblance to Griliches's S-shaped curve of transmission of information across the economy, rising gradually at first but then accelerating over time. In short, there seems to be a more or less consistent march to a higher equilibrium level of consumer bankruptcy filings, such that at some point the curve will level off at its new higher equilibrium level. At the current time, however, it appears that we have not yet reached that point, but the long-term trend line in bankruptcy filings is exhibiting a predictable rise towards a new higher equilibrium level.

The Bankruptcy Code provides a type of profit opportunity because many people could benefit financially by declaring bankruptcy. In part the benefits of filing bankruptcy reflect the substantial amounts of property that people can protect in bankruptcy through property exemptions.²³¹ Moreover, because of the property-based nature of bankruptcy exemptions, this benefit rises as household wealth rises. Because a chapter 7 discharge protects future income from creditors, this benefit rises as income rises. In other words, both high wealth and high income households benefit the most from bankruptcy filings.

But individuals with large amount of *debt* will also benefit from filing bankruptcy. The greater the amount of household debt, the greater will be the benefit of

Richard A. Ippolito, *Measuring the Value of Life Savings from Consumer Reactions to New Information*, 25 J. PUB. ECON. 53 (1984); Richard A. Ippolito, R. Dennis Murphy, and Donald Sant, *Staff Report on Consumer Responses to Cigarette Health Information* (Federal Trade Commission Staff Report, Aug. 1979) (observing gradual spread of knowledge to consumers regarding health information about cigarettes).

²²⁸ Griliches, *Hybrid Corn*, *supra* note, at 522.

²²⁹ See *id.*; see also Zvi Griliches, *Research Costs and Social Returns: Hybrid Corn and Related Innovations*, 66 J. POL. ECON. 419 (1958). For a more modern application of Griliches's model to innovation activity see Michael R. Darby and Lynne G. Zucker, *Grilichesian Breakthroughs: Inventions of Methods of Inventing and Firm Entry in Nanotechnology*, NBER Working Paper 9825, available in <http://www.nber.org/papers.w9825>.

²³⁰ Griliches, *Hybrid Corn*, *supra* note, at 521 n.43.

²³¹ See *infra* at notes ____-____ and accompanying text.

being able to discharge debt. There is an observable correlation between household debt levels and consumer bankruptcy filings.²³² As noted, the debt-to-income ratio is not a useful measure of financial distress; nonetheless, there is an observable correlation between this ratio and bankruptcy filings.²³³ Traditionalists have assumed that this correlation is explained by overwhelming debt forcing individuals to file bankruptcy. But the causal link more plausibly runs the other way. High levels of household debt increase the economic benefit of filing bankruptcy by allowing the discharge of more debt.²³⁴ As total debt rises, bankruptcy becomes more attractive, because it increases the benefit received from a bankruptcy discharge *ex post*. This is also consistent with the other evidence surveyed, which finds an absence of household financial distress using conventional measurements. If causation ran in the direction postulated by the traditional model, then this proffered measure of economic distress should be reflected in other measures as well. Moreover, as noted earlier, debt levels themselves are to some extent endogenous, reflecting the generosity of the bankruptcy system itself.²³⁵ The correlation is apparent, but the causal explanation offered by the traditionalists is probably incorrect.

The assumption of the traditional model, that consumer debt provides a causal explanation of the bankruptcy filing rate, is a classic manifestation of the *ex post ergo propter hoc* fallacy²³⁶—namely, that the observed correlation supports a determinate causal relationship. But there is no *a priori* reason to believe that causation runs in the direction assumed by the traditional model, nor is there corroborating empirical evidence to support this model. The correlation between total debt and bankruptcy, therefore, is more plausibly attributed to the increased benefit that this provides for highly-indebted consumers to file bankruptcy to gain the relief of the bankruptcy discharge.

b. The Role of Property Exemptions

At the same time, the 1978 Code enlarged one of the more powerful incentive mechanisms governing bankruptcy filings, the structure of property exemptions in bankruptcy.²³⁷ Exemptions govern the amount of property, and what types of property, a debtor can retain when she files bankruptcy. Moreover, exemption law has traditionally been a creature of state law, rather than federal law. Although the Code provides a standardized federal menu of exemptions, it also provides states with the power to opt-out of the federal menu and to allow debtors to use the state exemption regime instead.²³⁸

²³² See Lawless, *supra* note.

²³³ The relationship between total debt and bankruptcy filings is similar.

²³⁴ See Chakravarty and Rhee, *supra* note, at 12 (finding increase in likelihood of individual filing bankruptcy as benefit rises, as measured in terms of dollar amount of debts discharged under bankruptcy protection net of non-exempt property).

²³⁵ See discussion at *supra* notes ____ - ____ and accompanying text.

²³⁶ See James Tobin, *Money and Income: Post Hoc Ergo Propter Hoc?* 84 Q. J. ECON. 301, 302-03 (1970) (discussing perils of inferring determinate causal relationships from correlations).

²³⁷ See Barry Adler, Ben Polak, and Alan Schwartz, *Regulating Consumer Bankruptcy: A Theoretical Inquiry*, 29 J. LEGAL STUD. 585, 608-09 (2000).

²³⁸ 11 U.S.C. §522. Prior to the 1978 Code, the states had exclusive control over exemptions. Where a state does not opt-out, the 1978 Code provides a choice between the state exemptions and the federal menu of exemptions. See 11 U.S.C. §522(d). Thus the 1978 Code did nothing to reduce the value of state exemptions, but also offered residents of some states the federal exemptions as well. Where the

Some three-quarters of the states have chosen to opt-out of the federal exemption regime and to use their traditional state law exemptions instead. As a result, the amount of property that debtors can retain notwithstanding bankruptcy varies widely across the nation depending on the various state's exemption law regimes.

Given this diversity of exemption laws, this also means that the relative economic benefits accruing to debtors from filing bankruptcy will vary across the country.²³⁹ Debtors in states with more generous exemption law regimes will be able to keep more property in bankruptcy than those in states with less generous exemption laws. As a result, debtors living in more generous exemption states will have a greater incentive at the margin to file bankruptcy relative to debtors living in less-generous exemption states. There is some evidence that individuals do respond to these incentives, and that more generous exemption laws lead to increased bankruptcy filings at the margin.²⁴⁰ Moreover, there appears to have been a tendency for property exemptions to rise in recent years, both by a steady increase in the value of exemptions (several states have created homestead exemptions or increased the cap on their homestead exemptions in recent years), as well as through the creation and recognition of new categories of exempt property, most notably the providing new or expanded exemptions for retirement accounts.²⁴¹

2. The Economic Costs of Filing Bankruptcy Have Fallen

At the same time, the economic costs of learning about and filing bankruptcy have fallen. This decline in costs has taken a number of different forms, including reductions in the search costs of learning about bankruptcy and the transaction costs of filing bankruptcy. At the same time, increases in the availability of sub-prime and home equity secured lending have reduced the costs of obtaining credit following bankruptcy. These various reductions in the costs of filing bankruptcy have also created incentives at the margin to increase bankruptcy filing rates.

It should be stressed at the outset that a decline in search and transaction costs for filing bankruptcy is a *good* thing from an economic perspective, even though it increases bankruptcy filings. The relevant concern is *not* the total number of bankruptcy filings *per se*, but rather an *efficient* level of bankruptcy filings that accurately matches actual bankruptcy filings with those who society determines should be entitled to bankruptcy relief, while preventing access by abusers. Rationing access by high search and transaction costs, therefore, furthers no coherent or persuasive goal as a matter of social policy.

federal exemptions are more generous than the state, therefore, bankruptcy filers can elect the federal menu.

²³⁹ See Eric A. Posner, Richard Hynes, and Anup Malani, *The Political Economy of Property Exemption Laws*, John M. Olin Law & Economics Working Paper No. 136 (2d Series), University of Chicago, available in <http://papers.ssrn.com/abstract=285172>.

²⁴⁰ See Michelle J. White, *Why It Pays to File for Bankruptcy: A Critical Look at the Incentives Under U.S. Personal Bankruptcy Law and a Proposal for Change*, 65 U. CHI. L. REV. 685 (1998). On the other hand, although the effects are positive, they appear to be modest in magnitude. See Note, *A Reformed Economic Model of Consumer Bankruptcy*, 109 HARV. L. REV. 1338, 1347 (1996) (summarizing studies).

²⁴¹ For a comprehensive survey of state policies related to exemptions, see C. Scott Pryor, *Rock, Scissors, Paper: ERISA, The Bankruptcy Code and State Exemption Laws for Individual Retirement Accounts*, 77 AM. BANKR. L. J. 65 (2003).

a. *Declining Search Costs*

As noted, bankruptcy relief is extremely beneficial to many of those who file, and that many American families would benefit from filing bankruptcy. But there are also costs associated with pursuing bankruptcy relief. Most notably, the debtor must become aware of the benefits associated with filing bankruptcy. If he is ignorant of the benefits of filing bankruptcy, then he would not respond to the benefits created.

Information about the benefits of bankruptcy is not free. A debtor must thus undertake some effort to learn about bankruptcy and the benefits that bankruptcy can bring. In economics, this concept is referred to as “search costs.” Debtors must make some investment on the front-end in learning about bankruptcy before they can file. Bankruptcy is usually an unplanned, once-in-a-lifetime event, thus most individuals will also not have much in the way of shared background knowledge of bankruptcy prior to their consideration of bankruptcy. As the search costs of learning about bankruptcy relief fall debtors will tend to increase their demand for bankruptcy, thereby increasing the number of bankruptcies. There are a number of factors that suggest that search costs have fallen in recent years.

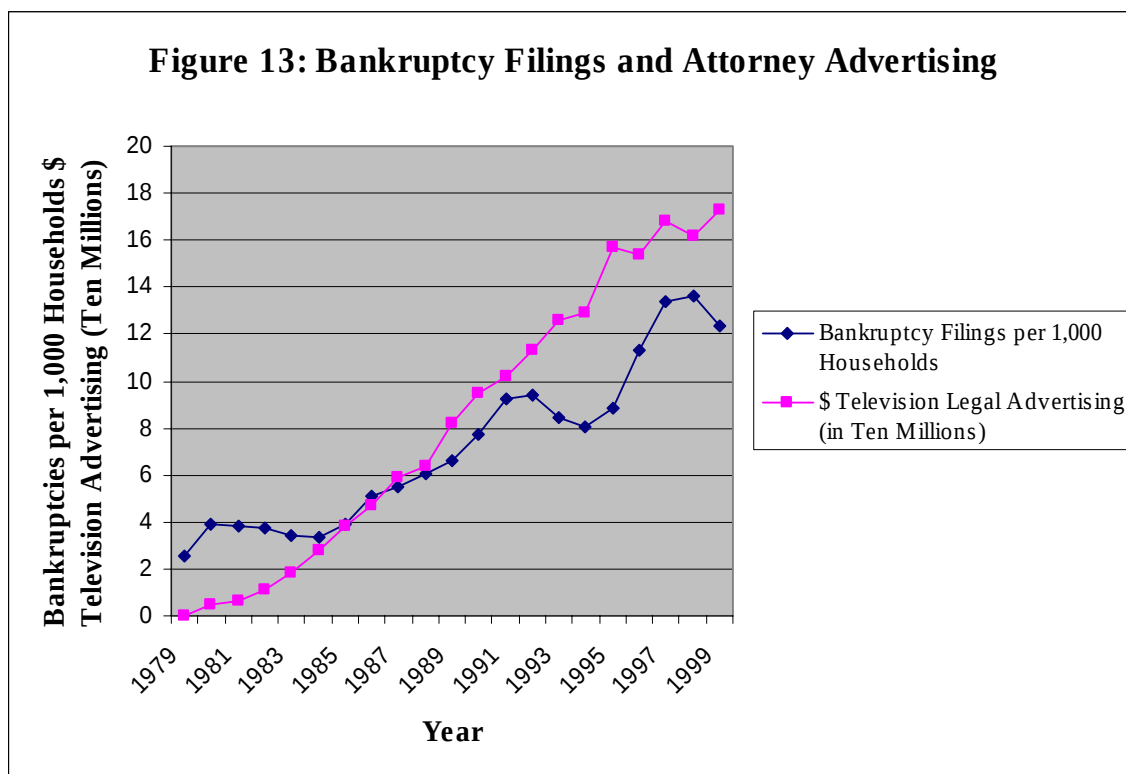
Attorney advertising about bankruptcy is much more widespread than in the past.²⁴² There is some evidence that the extent of attorney advertising of bankruptcy services is correlated with the number of bankruptcy filings in the relevant community, but the direction of the causal influence is ambiguous.²⁴³ On the other hand, there is ample empirical evidence that in general attorney advertising tends to increase the demand for lawyers’ services.²⁴⁴ There is no reason to believe that demand for bankruptcy would be inconsistent with this general model, which suggests that advertising generates increased bankruptcies.²⁴⁵ Figure 13 is suggestive of the relationship between bankruptcy filings and advertising for legal services:

²⁴² See *Bates v. State Bar of Arizona*, 433 U.S. 350 (1977) (ruling that lawyer advertising is commercial speech protected by First Amendment).

²⁴³ SMR Research “did a brief study of telephone book ads and found that cities with high bankruptcy filing rates usually do have higher levels of lawyer advertising than cities with low filing rates.” See *The Rise in Personal Bankruptcy: Causes and Impact, Before the Subcomm. On Commercial and Admin. Law of the House Comm. On the Judiciary*, 105th Cong. At *18-19 (1998) (testimony of Stuart A. Feldstein, President of SMR Research), available in 1998 WL 105080. The causal link is ambiguous, however, because it is not clear whether these lawyers are responding to extant demand for attorney services for bankruptcy, creating demand for bankruptcy filings through informative advertising, or both.

²⁴⁴ See WILLIAM J. JACOBS, ET AL., IMPROVING CONSUMER ACCESS TO LEGAL SERVICES: THE CASE FOR REMOVING RESTRICTIONS ON TRUTHFUL ADVERTISING 172 FTC Staff Report, 1984); Terry Calvani, James Lagenfeld, & Gordon Shuford, *Attorney Advertising and Competition at the Bar*, 41 VAND. L. REV. 761 (1988); John Schroeter, Scott Smith, and Steven Cox, *Advertising and Competition in Routine Legal Service Markets: An Empirical Investigation*, 35 J. INDUS. ECON. 49 (1987); Timothy J. Muris & Fred McChesney, *Advertising and the Price and Quality of Legal Services*, 1979 AM. BAR FOUND. RESEARCH J. 179 (1979); Geoffrey C. Hazard, Jr., Russell G. Pearce, and Jeffrey W. Stempel, *Why Lawyers Should be Allowed to Advertise: A Market Analysis of Legal Services*, 58 NYU L. REV. 1058 (1983); see also George J. Stigler, *The Economics of Information*, 69 J. POL. ECON. 213 (1961); Lester G. Telser, *Advertising and Competition*, 72 J. POL. ECON. 537 (1964).

²⁴⁵ A study by Visa reported that 19% of bankruptcy filers learned about bankruptcy through attorney advertisements. See Vern McKinley, *Ballooning Bankruptcies: Issuing Blame for the Explosive Growth*, Regulation, Fall 1997, at 33, 38.



Source: Figure 2 and Statistical Abstract of the U.S.

There are a number of qualifications to Figure 13 that should be noted. First, the amount of money spent on attorney advertising is for *all* legal services, not just personal bankruptcy services. Nonetheless, casual empiricism suggests that personal bankruptcy is one of the more heavily-advertised forms of legal services. Second, these figures represent only expenditures on television advertising, and therefore do not reflect amounts spent on other forms of media, such as radio, print, and Internet. On the other hand, personal bankruptcy services appear to be overrepresented as a percentage of the advertising on this media as well. Third, as noted, the causal link is indeterminate—increased attorney advertising may be a reflection of increased bankruptcy filings, rather than a cause. Due to these necessary qualifications, it would be imprudent to draw firm conclusions from the observed correlation between personal bankruptcy filings and attorney advertising. Nonetheless, the observed correlation is suggestive of the possible role of attorney advertising with respect to bankruptcy filings.

There is also substantial anecdotal and qualitative evidence that attorney advertising increases bankruptcy filings. Consumer bankruptcy lawyers report that they make substantial use of advertising in attracting new clients.²⁴⁶ Indeed, several of the lawyers that Braucher interviewed in her 1993 study had hired marketing firms to shape their advertising and marketing strategies.²⁴⁷ At a minimum, consumer bankruptcy lawyers generally place display advertisements in the Yellow Pages but also often

²⁴⁶ Braucher, *supra* note, at 543.

²⁴⁷ *Id.*

advertise in major newspapers. Some even run television and radio advertisements. Some lawyers use direct mailings to persons whose homes have been publicly listed for foreclosure. Braucher concludes that the modest investments made in advertising had more than recouped themselves in fees generated by clients. Yellow Page advertisements are reported as the top source of clients in Braucher's study.²⁴⁸

According to Braucher, one of the biggest difficulties for a lawyer meeting with a new client is persuading the client that the bankruptcy system truly is as generous as it seems to be, i.e., that there is no "catch." The generosity of the current system defies individuals' expectations and common sense about what could plausibly be expected from bankruptcy. "People are pleasantly surprised" about what they can do in bankruptcy, lawyers reported.²⁴⁹ One lawyer observed that chapter 7 "sometimes seems to debtors to be 'too good to be true; they can't believe it.'"²⁵⁰ Debtors are skeptical of lawyers' promising a "free lunch" and for many the search costs include the need to be persuaded that the bankruptcy system really is as generous as represented. Given this, many lawyers expressed concern about the implications of the widespread knowledge of bankruptcy's benefits. As one lawyer stated the issue, "if Americans in general knew what you can do in bankruptcy, then we'd really be in trouble."²⁵¹

A recent spate of high-profile celebrity bankruptcies has also increased public awareness of the benefits of bankruptcy. The list includes celebrities such as Mike Tyson, Toni Braxton, Kim Basinger, Burt Reynolds, M.C. Hammer,²⁵² and, most recently boxer Mike Tyson.²⁵³ Many lawyers, in fact, identify these famous bankrupts in order to persuade clients of the propriety of filing bankruptcy.²⁵⁴ Although the direct impact of this publicity is hard to measure empirically, it certainly contributes to public awareness of bankruptcy and increases the social acceptance of bankruptcy generally.

Perhaps more important in increasing public awareness of the substantial benefits of bankruptcy is "word of mouth" as a result of the sheer number of bankruptcies itself, which surpassed 1.5 million households last year and continues to rise. The large numbers of bankruptcy filing means that over time most everyone has come into contact with the bankruptcy system either by filing themselves or by knowing a friend or family member who has filed. This phenomenon is known as a "contagion" effect in economics.²⁵⁵ Beyond some point this tends to create an ever-expanding circle of bankruptcy filing. How the model works is relatively simple: as more people file bankruptcy, then there are more people in the populace to tell their friends and relatives about the benefits and ease of the bankruptcy system. As a result, this reduces the costs of those parties in learning about bankruptcy, resulting in more bankruptcy filings. This

²⁴⁸ *Id.* at 551.

²⁴⁹ Braucher, *supra* note, at 553.

²⁵⁰ Braucher, *supra* note, at 553.

²⁵¹ Braucher, *supra* note, at 554.

²⁵² See Joshua Wolf Shenk, *Bankrupt Policy*, NEW REPUBLIC, May 18, 1998, at 16.

²⁵³ See *Tyson Filing for Bankruptcy*, MIAMI HERALD 17 (Aug. 3, 2003).

²⁵⁴ Braucher, *supra* note, at 509 ("[Some debtors'] lawyers . . . in essence try to give their clients 'permission' to opt for quick discharge in chapter 7 . . . by naming famous people who have received a bankruptcy discharge.").

²⁵⁵ See also Fay, Hurst, & White, *supra* note, at n.13 (describing "herding" model in economics that "suggests that information flows from early filers could cause non-filers to revise their estimates of the costs of bankruptcy downward, so that they become more likely to file").

second wave of filers comes into contact with yet more potential filers and describe the process to them. Over time through this word of mouth process an increasing number of individuals come into contact with beneficiaries of the bankruptcy system. This self-reinforcing dynamic creates a hydraulic upward pressure on bankruptcy filing rates. A Visa study reports that friends and family are the single most important source of information about bankruptcy and that a majority of bankruptcy filers knew a friend or family member who had filed bankruptcy.²⁵⁶ Consistent with the model, this number of people who first heard about filing bankruptcy from a personal acquaintance also seems to rising over time.²⁵⁷

Today individuals receive information about bankruptcy from a large variety of sources: attorney advertising, celebrity reports, and from friends and family. This has tended to create a familiarity with the bankruptcy system that has made people increasingly aware of the benefits associated with filing bankruptcy. This has tended to decrease the search costs associated with learning about bankruptcy and the benefits it offers. This reduction in costs also would be expected to lead to increased bankruptcy filings.

b. Declining Transaction Costs

The transaction costs associated with filing bankruptcy have also declined in recent years. In major part these transaction cost reductions have flowed from the increased number of consumer bankruptcy filings. A large and steady flow of consumer bankruptcy filings makes possible the establishment of certain economies of scale and specialization that decrease the marginal cost of processing bankruptcy cases. A large and steady flow of consumer bankruptcies also makes possible certain capital investments in technology and the like that are economically efficient only if they can be amortized over a large number of bankruptcy cases. If this steady supply of cases is forthcoming, however, then the capital investments will tend to reduce the marginal cost of bankruptcy cases. As the costs of processing bankruptcy cases fall, demand for bankruptcies will tend to rise.

Consumer bankruptcy filing rates have remained fairly high for quite some time and few expect any substantial decline in filing rates in the foreseeable future. This high and steady demand has made it possible for certain law firms to specialize in the production of bankruptcy cases. Over time these bankruptcy “mills” have developed processes and procedures that produce bankruptcy cases as largely standardized commodities. Their practice is a high-volume, repetitive one. Making heavy use of technology that allows them to crank out “cookie cutter” bankruptcy pleadings, these mills have been able to drive down the cost of filing bankruptcy substantially. Using teams of paralegals and secretaries to supplement their efforts, these attorneys represent

²⁵⁶ See Jones & Zywicki, *supra* note, at 212-13 (summarizing studies); Braucher, *supra* note, at 544 (reporting that many client referrals come from more people telling relatives, friends, and co-workers about their bankruptcies).

²⁵⁷ See *Bankruptcy Law Revision Before the Subcomm. On Commercial and Admin. Law of the House Comm. on the Judiciary*, 105th Cong. At *8 (1998) (testimony of Mallory B. Duncan, Vice-President, General Counsel of National Retail Federation), available in 1998 WL 8993460 (“[O]ne recent study found a five hundred percent increase in less than two years in the number of filers who say they first heard about the idea of filing from a friend or relative.”).

hundreds of debtors per year.²⁵⁸ Most lawyers in high-volume practices meet only once with the client before filing a bankruptcy petition.²⁵⁹ At this meeting the debtor must decide whether to file and under which chapter to file.²⁶⁰ Very few lawyers meet more than twice with their clients.²⁶¹ For those who do not want to or cannot pay for a lawyer, “do-it-yourself” bankruptcy books have become a staple of bookstores and even grocery store check-out lines. Huge amounts of information about bankruptcy is also available on the Internet, including the forms needed to file bankruptcy.

The high volume of consumer bankruptcy filings has made it possible for certain lawyers to establish practices focused on high-volume, repetitive cases.²⁶² This focus has allowed them to realize economies of scale and to make capital investments that have driven down the marginal cost of filing bankruptcy. As these transaction costs of filing bankruptcy have fallen, this decreased price has created incentives for higher bankruptcy filing rates.²⁶³ Increased filings have also indirectly increased the benefits of bankruptcy, because the large number of filings has swamped courts and trustees with a wave of cases, thereby reducing the attention that courts and trustees can pay to each case in order to weed-out fraud and abuse.

c. *Greater Availability of Post-Bankruptcy Credit*

Traditionally a major cost of filing bankruptcy was the negative effect it had on access to credit following bankruptcy.²⁶⁴ Indeed, it was traditionally perceived that filing bankruptcy would cripple an individual’s ability to acquire new credit following bankruptcy. Today there have been changes in credit markets that have made credit more available to former bankruptcy filers. One survey done a decade ago found that over 16 percent of bankruptcy filers were able to gain unsecured credit within one year after filing bankruptcy and over 55 percent within five years.²⁶⁵ A more recent survey finds that three-quarters of bankruptcy filers have at least one credit card within a year after filing.²⁶⁶ Bankruptcy filers were able to gain access to a broad cross-section of revolving

²⁵⁸ Thus, in the Sullivan, Westbrook, and Warren study, only 4% of 1981 debtors were not represented by attorney. See SULLIVAN ET AL., *AS WE FORGIVE*, *supra* note, at 23. By 1991-92, however, paralegals in one California district prepared 14% of consumer filings. See Susan Block-Lieb, *A Comparison of Pro Bono Representation Programs for Consumer Debtors*, 2 AM. BANKR. INST. L. REV. 37, 40 (1994); Geraldine Mund, *Paralegals: The Good, The Bad, and the Ugly*, 2 AM. BANKR. INST. L. REV. 337, 340-41 (1994).

²⁵⁹ Braucher, *supra* note, at 554.

²⁶⁰ Braucher, *supra* note, at 555.

²⁶¹ Braucher, *supra* note, at 555.

²⁶² This development in the economics of bankruptcy filings is not unique to bankruptcy. Similar developments have occurred in many other areas of legal practice. See David A. Hyman and Charles Silver, *And Such Small Portions: Limited Performance Agreements and the Cost/Quality/Access Trade-Off*, 11 GEO. J. LEGAL ETHICS 959, 975-77 (1998).

²⁶³ I have not located any direct evidence on changes in the cost of filing bankruptcy over time, but I have seen nothing to rebut the observation that the price of filing bankruptcy has fallen over time.

²⁶⁴ Today, filing bankruptcy remains on one’s credit rating for ten years. See 15 U.S.C. § 1681c(a)(1).

²⁶⁵ See Michael Staten, *The Impact of Post-Bankruptcy Credit on the Number of Personal Bankruptcies* 10-11, Credit Research Center, Krannert Graduate School of Management Working Paper, No. 58, Purdue University (1993). Staten argues that for various reasons this estimate probably underestimated access to credit at that time.

²⁶⁶ VISA, CONSUMER BANKRUPTCY: ANNUAL BANKRUPTCY DEBTOR SURVEY (1997).

credit, such as bank cards, department stores, gas cards, and finance companies, as well as installment lenders.²⁶⁷ Given the growth in the subprime lending market, it is likely that figure would be substantially higher today.

Two types of credit stand out in particular. First is the development of a class of “sub-prime” lenders who focus on lending to higher-risk borrowers, such as bankruptcy filers. The economics of these lenders is somewhat fuzzy, but it appears that they serve as lenders of last resort for high-risk borrowers foreclosed by other credit avenues. By bundling and securitizing a large number of these borrowers, it appears that these lenders have been able to structure the risk of these borrowers in such a way as to turn a profit. Whatever their economic structure, these lenders appear to have filled a market niche that did not exist until fairly recently.

The rise of home equity loans also may have taken some of the sting out of filing bankruptcy, especially for the middle class. The availability of a robust home equity loan market opens up an avenue for debtors who would have difficulty obtaining unsecured credit on favorable terms. In the home equity situation the lender is lending in reliance on the collateral offered by the debtor, rather than only on the debtor’s promise to pay. Thus, the willingness to offer home equity loans will depend more on the existence and ability to enforce the equity in the property rather than the debtor’s credit history. Ironically, this tends to reward the sophisticated bankruptcy filer with the foresight to pay down his mortgage prior to bankruptcy, thereby increasing the equity in his house. If the homestead exemption in a given state is sufficiently generous, this would allow the debtor to protect the equity in his home throughout bankruptcy. Then, following bankruptcy, the debtor can borrow on a home equity loan and minimize her need for unsecured credit. In this scenario, the debtor’s access to home equity credit would eliminate much of the hardship traditionally imposed by bankruptcy. Recent years also have seen the development of a variety of other secured financing vehicles, such as secured credit cards and the like. Because these also are collateralized, a debtor can access them even if he has a poor credit rating.

Thus, the traditional belief that bankruptcy filing would restrict access to credit following bankruptcy no longer constrains a debtor’s behavior to the degree it once did. To be sure, the debtor will likely suffer some penalty as a result of having a bankruptcy filing on her credit rating. Nonetheless, developments in credit markets means that this hardship is no longer as severe as it once may have been. As a result, this too has reduced the costs associated with declaring bankruptcy.

3. Summary on Changes in the Costs and Benefits of Bankruptcy

Little strong empirical evidence exists on the constellation of factors that have been identified as factors driving the upward surge in bankruptcy filing rates in recent years. Taken together, however, they are strongly suggestive and imply that the overall relative benefits of filing bankruptcy have increased and the overall relative costs have declined during the era of the bankruptcy boom. As information has disseminated across society, the response was gradual at first but has been rising rapidly, following a Grilitchean curve of information transmission. Economic theory and common sense suggest that the combination of these factors has had an effect at the margin in increasing

²⁶⁷ Staten, *Impact*, *supra* note, at 11-12.

the demand for bankruptcy and thus bankruptcy filing rates. Again, it should be recognized that to the extent that the fall in transaction costs and search costs have made bankruptcy relief available to more of those who need it, this is a socially-beneficial development and should be maintained.

B. *Changes in The Nature of Consumer Credit*

A second set of reasons helps to explain the rise in bankruptcy filing rates in recent years, which can be grouped under the umbrella of changes in the nature of consumer credit and in consumer credit relations. Consumer credit relations have changed in a number of ways that at the margin would be expected to destabilize traditional debtor-creditor relationships and thereby increase bankruptcy filing rates. Similar forces have tended to make it more difficult for creditors to monitor a debtor's behavior, making post-contractual opportunism more likely. Most of these changes have been inevitable – they are the outgrowth of technological and economic changes that have created more efficient and pro-consumer credit relations. Thus, from an economic perspective they are beneficial and should be encouraged even though a side-effect is that these same forces tend to undermine many of the traditional mechanisms for restraining opportunistic breach of credit contracts and have tended to exert upward pressure on bankruptcy filing rates. So long as the overall benefits of more efficient credit markets exceed the costs of increased bankruptcies, this is a positive development. The policy question is how to devise the set of institutions that maximizes the benefits of these financial innovations while minimizing the costs associated with them in terms of higher bankruptcies.

1. *The Shift to Unsecured Consumer Credit*

The economic benefits associated with filing bankruptcy have also increased for a reason that is largely exogenous to the incentives provided by federal bankruptcy law and state exemption laws. This is what can be referred to as the “rise of unsecured consumer credit.” As suggested above, recent decades have seen a shift in consumer credit toward unsecured credit, primarily in the form of general purpose bank credit cards.²⁶⁸ Unsecured credit, such as credit cards and medical bills, is generally dischargeable in bankruptcy absent some particular limitation imposed by bankruptcy law making certain unsecured debts nondischargeable.²⁶⁹ These limits on nondischargeability are relatively narrow and pertain to situations where the debtor is using the bankruptcy system for fraudulent purposes or because Congress has decided that certain public policies trump the public policy favoring the debtor's fresh start in bankruptcy.²⁷⁰ Absent falling into one of these specific categories of nondischargeability, the debtor is entitled to a discharge of all unsecured debts by filing bankruptcy. By contrast, the bankruptcy discharge is of little use to the debtor with respect to secured credit, such as home mortgages, home equity loans, security interests in personal property, layaway plans, or pawn shops. Bankruptcy discharge will also not help a debtor with informal credit arrangements such as loans from family members, historically the dominant source of

²⁶⁸ See discussion at *supra* notes ____-____ and accompanying text.

²⁶⁹ See 11 U.S.C. § 727(a).

²⁷⁰ See 11 U.S.C. § 523.

most consumer credit.²⁷¹ This suggests that, holding everything else constant, as debtors make greater use of unsecured credit relative to other forms of credit, the value of the bankruptcy discharge will also increase. As the value of the bankruptcy discharge increases, debtors will have a greater incentive to file bankruptcy.

Unlike these older forms of credit, however, credit card and other unsecured debt is generally unsecured and dischargeable in bankruptcy. Thus, holding total debt constant, substituting dischargeable unsecured debt for nondischargeable forms of debt would be expected at the margin to increase the propensity of a given individual to file bankruptcy. This may explain the observed tendency of credit card defaults and defaults on other forms of unsecured consumer debt to track bankruptcy filing rates, whereas there seems to be no similar correlation between bankruptcy filings and defaults on home mortgage loans.²⁷² In the former case, the debtor can discharge the debts in question at little cost, whereas in the latter case the debtor will suffer the high cost of losing his house. If bankruptcies were best explained as an involuntary response to adverse economic shocks, it would be expected that defaults on mortgage, automobile, and credit card debt, should be rising more or less in unison, because there would be no obvious reason why an individual would be “unable” to pay some debts but not others. Given the different default rates on these various forms of credit, it is evident consumers are consciously choosing to pay some debts but not others—defaulting on their unsecured obligations, but paying their secured debts. This incentive is reinforced as the value of a state’s homestead exemption rises, as debtors face strong incentives to act strategically in paying their mortgage debts at the expense of their unsecured creditors.²⁷³ Thus, the general substitution by consumers in recent years toward unsecured debt, primarily as the result of greater use of credit cards, would be predicted to lead to increased bankruptcy filing rates. Greater use of unsecured credit increases the marginal benefit of filing bankruptcy by increasing the percentage of debt that is dischargeable in bankruptcy. This factor, along with the generosity of the 1978 Code and the incentive effects of state exemption law regimes, have combined to create a general increase in the economic benefits of filing bankruptcy over the past two decades.

2. Greater Nationalization and Impersonalization of Consumer Credit

This expansion of unsecured credit has also led to an increased “impersonalization” of consumer credit relations. Although such forces as “increased impersonalization” are difficult to measure, there is a widespread perception that credit relations, especially for consumer credit, have become increasingly impersonalized in

²⁷¹ See CALDER, *supra* note.

²⁷² See Thomas A. Durkin, in DURKIN AND STATEN, *supra* note, at 36, 38, and Figure 3.

²⁷³ Indeed, one study has suggested that because of this incentive for debtors to act strategically to pay down their mortgages at the expense of their unsecured creditors, interest rates on mortgages may actually be lower in states with high homestead exemptions. See Jeremy Berkowitz and Richard Hynes, *Bankruptcy Exemptions and the Market for Mortgage Loans*, 42 J. LAW & ECON. 809-819-22 (1999); but see Emily Y. Lin and Michelle J. White, *Bankruptcy and the Market for Mortgage and Home Improvement Loans*, 50 J. URBAN ECON. 138 (2001). By contrast, unsecured creditors in high homestead exemption states tend to offer less credit at higher interest rates so as to compensate for the increased risk associated with lending in those states. See Reint Gropp, John Karl Scholz, and Michelle J. White, *Personal Bankruptcy and Credit Supply and Demand*, 112 Q. J. ECON. 217 (1997).

recent years as compared to the past.²⁷⁴ This change in credit relations has affected the willingness of individuals to file bankruptcy in three different ways: (1) by undermining the development of commercial trust relationships; (2) by undermining the constraints imposed by repeat dealings; and, (3) by reducing the constraints of commercial reputation.

The historical model of commercial consumer credit was of a highly personalized nature, e.g., a corner grocery store or Main Street tailor selling goods to their customers on credit.²⁷⁵ Bank credit required the debtor to withstand a personal and intrusive series of face-to-face interviews and probing inquiry into his social and business relationships to determine the debtor's trustworthiness and reliability. Even more, much of traditional credit was wholly informal in nature, such as loans between family members.²⁷⁶ This credit is of a face-to-face nature and the credit relationship is embedded within an ongoing economic and social relationship with the credit issuer. Where the credit relationship is embedded in a larger social and economic relationship, it is more likely that a trust relationship will arise between the parties.²⁷⁷

Today, many consumer financial relations are conducted with large interstate banks and South Dakota and Delaware-based credit card issuers such as Citibank and MBNA. Impersonal credit relations, such as dealing with these institutional lenders, are less likely to evolve into high-trust relations.²⁷⁸ In part, this is because individuals do not tend to form trust relationships with artificial entities, such as corporations, in the same way that they do with other human beings. These economic exchange relations lack the embedded personal and extended economic relations that characterize older and more local forms of credit. Thus, an individual is less likely to feel himself bound in a trust relationship with his credit card issuer than he would be if he purchased a suit on store credit from his local tailor.²⁷⁹ Indeed, as David Skeel observes, part of the impetus for the 1898 Bankruptcy Act was the concern of merchants who engaged in interstate commerce that when debtors ran into financial trouble they "played favorites" with their

²⁷⁴ Rafael Efrat, *The Moral Appeal of Personal Bankruptcy*, 20 WHITTIER L. EV. 141, 161 (1998); see also Braucher, *Lawyers and Consumer Bankruptcy*, *supra* note, at 564.

²⁷⁵ See LENDOL CALDER, *FINANCING THE AMERICAN DREAM: A CULTURAL HISTORY OF CONSUMER CREDIT* (1999).

²⁷⁶ CALDER, *supra* note.

²⁷⁷ Efrat, *supra* note, at 159.

²⁷⁸ Efrat, *supra* note, at 159.

²⁷⁹ As Efrat observes: "[A] consumer debtor is less likely to develop a trust relationship beyond the deterrence-based level with a large credit card company. The consumer debtor is not likely to have any face-to-face contact with the institutional creditor. The parties infrequently communicate, and when they do, they mainly use impersonal channels such as a telephone. Furthermore, a courtship will not likely develop between the parties. The parties are not likely to watch each other act in social situations or observe each other in [a] variety of emotional states. Therefore, the lack of personal bonding precludes most of these types of relationships from developing into a knowledge-based credit trust relationship." Efrat, *supra* note, at 159. This same analysis presumably would apply to the development of trust relationships by creditors. But it is not clear how this decline of trust on the creditors' behalf would necessarily be linked to the question of post-contractual opportunism by creditors. Although trust may matter on this side of the equation, it is not clear how it would affect post-contractual opportunism or otherwise be directly related to bankruptcy issues. Perhaps most importantly, lenders will be constrained by contracts and other more formal institutions, including legislation and regulation, thus trust likely plays a much smaller role from the lender's perspective.

creditors, preferring “family members and local creditors, not the out-of-state merchants.”²⁸⁰

The development of credit cards illustrates this trend toward more national and impersonal credit. Prior to the widespread development and use of credit cards, the American consumer economy was a highly localized economy. Even if one was merely traveling, it could be very difficult to get credit if necessary. In the past, individuals had to make use of more indirect and costly means for proving their creditworthiness to strangers. When Max Weber visited the United States in 1904, he witnessed an adult baptism by immersion.²⁸¹ When he inquired as to why the individual sought baptism he was informed that it was so that he could open a bank. Because Baptist congregations conducted in-depth character evaluations of individuals before admitting them as members, “Admission to the congregation [was] recognized as an absolute guarantee of the moral qualities of a gentleman, especially of those qualities required in business matters.”²⁸² Thus, “When a sect member moved to a different place, or if he was a traveling salesman, he carried the certificate of his congregation with him; and thereby found not only easy contact with sect members but, above all, he found credit everywhere.” As Shearmur and Klein note, these informal means of establishing credit have been supplanted by credit cards a universal medium of credit. “The sects’ inquiries into the would-be member’s probity are paralleled by the credit card company’s scrutiny of the would-be cardholders’ credit record.”²⁸³ As a result, “In a large and anonymous society such as the United States, many people carry credit cards, which speak for them to people with whom they have had no previous contact and with whom they may well never be in contact again.”²⁸⁴

Individuals psychologically evaluate transactions differently depending on whether they are of a personalized or an impersonalized nature. The closer is the social connection between the trading partners, the greater is the likelihood that the individuals will trust one another.²⁸⁵ The longer the parties have known each other, the more likely they are to trust one another.²⁸⁶ The more integrated their social network and the number of mutual friends they have in common, again the more likely they are to trust one another.²⁸⁷ Individuals also appear to be more likely to recognize the positive-sum nature of personal relations marked by an ongoing reciprocity of mutual advantage.²⁸⁸ By contrast, individuals tend to see impersonal relationships as zero-sum in nature, removing a psychological constraint on acting opportunistically.²⁸⁹

This trend towards more impersonalized credit has increased the efficiency of American consumer credit markets and expanded consumer choice in credit. Prior to the

²⁸⁰ SKEEL, *supra* note, at 36.

²⁸¹ See Jeremy Shearmur and Daniel B. Klein, *Good Conduct in the Great Society: Adam Smith and the Role of Reputation*, in REPUTATION 29 (1997) (describing Weber’s report).

²⁸² MAX WEBER, THE PROTESTANT SECTS AND THE SPIRIT OF CAPITALISM, *quoted in* Shearmur and Klein, *supra* note, at 36.

²⁸³ Shearmur and Klein, *supra* note, at 41-42.

²⁸⁴ Shearmur and Klein, *supra* note, at 41.

²⁸⁵ See Edward L. Glaeser, et al. *Measuring Trust*, 115 Q. J. ECON. 811, 834 (2000).

²⁸⁶ *Id.*

²⁸⁷ *Id.*

²⁸⁸ See Vernon L. Smith, *Reflections on Human Action After 50 Years*, 19 CATO J. 195, 207 (1999).

²⁸⁹ *Id.*

nationalization of credit markets, rural consumers suffered from the lack of competition among banks as issuers of credit.²⁹⁰ Small-town debtors had limited ability to shop around to get competing offers of credit. Thus, while a debtor might personally know the loan officer at the bank, in many instances this personalized relationship came at the cost of reduced competition and customer choice.²⁹¹ On the other hand, the personalized nature of these traditional lending relationships could give rise to subtle bias and even discrimination. Reliance on impersonalized systems such as credit-scoring and the like has substantially reduced racial and other improper bias from the lending decision, thereby leading to an expansion of credit to traditionally underserved individuals.²⁹² Finally, the nationalization of credit has generated competition on a massive scale. For instance, there are currently over 6,000 issuers of credit cards, and barriers to entry are low. This has led to robust static and dynamic competition in the credit card market, driving economic efficiency and pro-consumer innovation.²⁹³

The increasingly impersonalization of credit has had dramatic consequences in expanding customer choice and liberating customers from the constraints of traditional credit relations. The substitution by consumer of these new types of credit in place of the old is indicative of how they have benefited. But because of the more impersonal nature of this credit, it would be expected that increasing impersonalization of debt would undermine the moral obligation that a debtor would feel, thereby increasing the likelihood that the debtor would engage in post-contractual opportunism and to avoid repaying these debts. As a result, even though the primary financial effect of this development has been to change the composition of consumer debt rather than an increase in the overall debt burden, everything else being equal he will become more likely to file bankruptcy so as to avoid repayment.²⁹⁴ This decline of a trust relationship may help to explain the decrease in personal shame or conscience of filing bankruptcy.²⁹⁵

In addition to leading to a decrease in personal shame, there has also been a reduction in the constraint imposed by repeat dealing. Repeat dealing constrains

²⁹⁰ See Zywicki, *Economics of Credit Cards*, *supra* note (discussing effect of lack of competition on bank lending terms).

²⁹¹ Consider in this context the dramatic difference between the availability of 24-hour customer service for credit card operations versus the lasting practice of “banker’s hours” for traditional deposit banks.

²⁹² See INFORMATION POLICY INSTITUTE, *THE FAIR CREDIT REPORTING ACT: ACCESS, EFFICIENCY, & OPPORTUNITY* (2003).

²⁹³ See Zywicki, *Economics of Credit Cards*, *supra* note, at 128-45.

²⁹⁴ The reduction in transaction costs and availability of credit on more competitive terms would, of course, have a wealth effect, shifting out consumer budget constraints. But because they would also be wealthier, consumers could borrow more without increasing their effective debt burden, thus this increase in indebtedness would not be expected to have any greater correlation with bankruptcy. As noted above, the fact that current indebtedness and debt-to-asset ratios have remained largely constant during recent years further confirms the idea that the increase in new forms of debt are largely a substitute away from old forms of debt.

²⁹⁵ The uncoupling of the credit transaction from the retail transaction may also have other unanticipated psychological consequences. When the debtor receives goods or services in exchange for the credit, there may be an obvious causal connection present that is lacking where the credit transaction is separated from the goods. It may be that this undermines the borrower’s sense of reciprocity because it is not readily apparent that he is receiving anything tangible when he receives his credit card bill. I have seen no evidence on this point, although it seems plausible. I would like to thank Professor Owen Jones for suggesting this point to me.

opportunistic behavior by holding out the prospect that the long-term benefit from the maintenance of the continue relationship exceeds the gain that an individual could make by acting opportunistically.²⁹⁶ Because of the expansion of credit markets, borrowers are no longer limited to dealing only with local merchants for credit. Consumer borrowers historically were quite limited in their credit options, primarily because of geographic limitations on the number of credit issuers with whom the debtor could reasonably interact. Traditionally, retail goods and credit were tied together, such that a borrower who failed to pay his credit bills would be unable to purchase goods on credit in the future.²⁹⁷ It was also relatively more expensive for debtors in prior eras to relocate to a new community to start over after filing bankruptcy. Given this small set of initial credit issuers, the debtor dared not to default, as it would be exceedingly difficult to obtain credit in the future. The fact that the debtor was locked into repeat-dealing relationships with a relatively small number of credit issuers with whom he would have to deal in the future placed constraints on the willingness of the debtor to breach his promises.

Today, however, the multitude of options available to a former bankrupt removes much of this constraint from repeat dealing. Although bankruptcy filers will face some restriction on the number of creditors who will lend to them and may have to pay somewhat higher credit terms, post-bankruptcy debtors will find a relatively vibrant and competitive market for lending. Thus, a bankruptcy filer is not required to go back to the same lenders that he dealt with previously. This attenuates the repeat-dealing relationship, thereby increasing the debtor's willingness to file bankruptcy at the margin.

For similar reasons, these developments have attenuated the constraining effects of commercial reputation.²⁹⁸ Maintaining a reputation-based system of contract enforcement also requires the maintenance of a system of ostracism, both for the defector, but *also* for any member who enters into later dealing with that defector. This willingness to punish a defector even at some cost to yourself creates a public goods problem.²⁹⁹ The willingness to punish someone who fails to punish the initial party creates a second-order public goods problem. Such punishment raises substantial collective action problems, as it becomes necessary not only to monitor misbehavior by the original party, but it is also necessary to monitor the behavior of all the other members of the group to ensure that they are not reneging on *their* independent promise to ostracize those who cheat one member of the group. As the size of the group increases, it becomes increasingly difficult to overcome these collective action problems and to detect and punish those who fail to punish the original defector.

²⁹⁶ See, e.g., ROBERT AXELROD, *THE EVOLUTION OF COOPERATION* (1984); Lester G. Telser, *A Theory of Self-Enforcing Agreements*, 53 J. BUS. 27 (1980).

²⁹⁷ A similar system, albeit in a non-consumer context is described by Karen Clay in her analysis of trade and credit in Mexican California in the 1840s. See Karen Clay, *Trade Without Law: Private-Order Institutions in Mexican California*, 13 J. L. ECON. & ORG. 202 (1997); Karen Clay, *Trade, Institutions, and Credit*, 34 EXPLORATIONS IN ECONOMIC HISTORY 495, 505 (1997).

²⁹⁸ Reputation in this context can be distinguished from repeat-dealing in that the discipline of repeat-dealing turns on the bilateral exchange between a specific borrower and lender, whereas reputation includes monitoring and punishment by third-party lenders. For purposes of this article, sanctioning behavior by other consumers is labeled as "social norms" or "social stigma" to distinguish it from the commercial reputation effects of third-party lenders.

²⁹⁹ See RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* §8.5 (6th ed. 2003)

In part, this explains the relative ease with which bankruptcy filers can now find access to credit following bankruptcy as compared to prior eras.³⁰⁰ Whereas lenders may prefer as a *group* to ostracize borrowers who file bankruptcy, in practice each lender has an *individual* incentive to lend to a debtor who files bankruptcy. Ironically, a debtor who files bankruptcy and receives a discharge is a relatively better credit risk, *ceteris paribus*, than prior to filing bankruptcy, because she cannot receive another discharge for six years.³⁰¹ Thus, each lender individually has a private incentive to deal with a bankrupt at the right price, notwithstanding the fact that lenders as a group might prefer not to extend credit to bankruptcy filers.

This second-order punishment problem becomes more acute where the existing group cannot restrain entry into the group. If they are unable to exclude new entrants, then if barriers to entry are sufficiently low new entrants will be able to enter the market to serve those subject to ostracism at the hands of the incumbents.³⁰² In the past, lenders in a small stable community could share information and “blackball” those who failed to pay their bill. Consumer credit markets today, however, are characterized by relatively low barriers to entry.³⁰³ Moreover, many of the subprime lenders in this market are new entrants who specialize in such matters, rather than older general-purpose banking institutions. Given the ease of entry and large number of firms in this market, it is now virtually impossible for lenders to enforce any sort of ostracism against one another from dealing with a bankruptcy filer.

3. Development of Formal Institutions as “Trust Substitutes”

A decline in the constraining effects of informal institutions has two predictable effects. The first is an increase in the amount of social behavior traditionally constrained by social norm in question. The greater impersonalization of consumer credit has led to a reduction in the informal institutions that historically constrained opportunism, such as trust, repeat dealing, and reputation. The second effect is an increased reliance on more formal social institutions that are designed to perform the functions previously performed by the informal institutions. These formal substitutes that are created to replace and supplement weakening informal institutions can be called “trust substitutes” because they substitute for the network of informal institutions that are available to govern social behavior.

³⁰⁰ Staten found, for instance, that bankruptcy filers who reacquired credit were much more likely to obtain credit from a new lender rather than a pre-bankruptcy lender. See Staten, *Impact*, *supra* note, at 12. Nor did it make a difference whether a debtor discharged his debts in chapter 7 or filed chapter 13 and presumably attempted to repay some of his prepetition debts. *Id.* at 16.

³⁰¹ See 11 U.S.C. §727(a)(8).

³⁰² See POSNER, *supra* note, at §8.5, p. 262.

³⁰³ See discussion at *supra* notes ____ - ____ and accompanying text.

There is an interaction between formal and informal institutions.³⁰⁴ Formal institutions can be either a complement to or substitute for informal institutions.³⁰⁵ For instance, informal measures such as reputation, repeat-dealing, and interpersonal trust can be a substitute for formal rules of contract enforcement.³⁰⁶ Stuart Macaulay's classic study of commercial relations in business and the minimal reliance placed on written contracts illustrates the point.³⁰⁷ Similarly, the traditional reluctance of the common law to intervene in contracts made among family members reflects the judgment that legal enforcement of these promises adds little to their efficient level of enforcement.³⁰⁸ On the other hand, where these informal institutions are weak, legal enforcement of promises can increase their reliability, providing a greater measure of reliance. As philosopher Robert Goodin states the point, "Through the institutions of contract law, private promises are publicly enforced. Public sanctions can in that way substitute for private honor, and trust in the public institutions might therefore substitute for trust in private individuals."³⁰⁹

But increasing complexity of economic exchange tends to drive the institutions governing exchange to greater reliance on more formal and abstract institutions.³¹⁰ Increasing the heterogeneity and number of trading partners also tends to lead to a greater formalization of exchange institutions by undermining the homogeneity of norms and stability of social groups that are necessary for informal institutions to operate efficiently. Over time, therefore, there is a general tendency toward the development of formal "trust substitutes" that can supplement informal institutions that weaken in the face of these economic pressures. As Anthropologist Sally Merry has observed, "With increasing social complexity, informal social controls diminish in significance and are replaced by formal mechanisms of social control."³¹¹

Although these trust substitutions can offset some of the negative social consequences of a decline in informal institutions, it is likely that the new social

³⁰⁴ Some economists have remarked on the interaction between formal institutions and informal norms and practices in policing opportunism in the context of corporate bankruptcy. See OLIVER E. WILLIAMSON, *THE ECONOMIC INSTITUTIONS OF CAPITALISM* 122 (1985) (noting that in Japan "[t]he hazards of trading are less severe . . . because of cultural and institutional checks on opportunism"); Marc Ramseier, *Sanctions without Law: The Japanese Financial Clearinghouse Guillotine and Its Impact on Default Rates*, in Klein, *REPUTATION*, at 225. On the other hand, there has been little discussion of the interaction between formal and informal institutions in the context of consumer bankruptcy.

³⁰⁵ See Larry Ribstein, *Law v. Trust*, 81 B.U. L. REV. 553 (2001).

³⁰⁶ See POSNER, *supra* note, at §4.1; see also

³⁰⁷ See Macaulay, *supra* note.

³⁰⁸ See Charles J. Goetz and Robert E. Scott, *Enforcing Promises: An Examination of the Basis of Contract*, 89 YALE L.J. 1261 (1980).

³⁰⁹ Robert E. Goodin, *Trusting Individuals Versus Trusting Institutions: Generalizing the Case of Contract*, 12 RATIONALITY AND SOCIETY 381, 382 (2000).

³¹⁰ See NORTH, *INSTITUTIONS*, *supra* note; see also Lisa Bernstein, *Private Commercial Law in the Cotton Industry: Creating Cooperation Through Rules, Norms, and Institutions*, 99 MICH. L. REV. 1724 (2001) (noting increased reliance on formal institutions in response to decline in "Old South" norms of Memphis cotton exchange).

³¹¹ Sally E. Merry, *Rethinking Gossip and Scandal*, in TOWARDS A GENERAL THEORY OF SOCIAL CONTROL 271, 288 (Donald Black, ed., 1984); see also Klein, *Promise Keeping in the Great Society*, *supra* note, at 271. A similar evolution towards governance by more formal institutions characterizes the evolution of national courts and formal contract law. See Todd J. Zywicki, *The Evolution of Contract Governance*, *supra* note.

equilibrium combination of formal and informal institutions may well be at a higher level of social disorder than before the decline in the social norm. Nonetheless, the increased benefits from larger and more efficient markets should be sufficient to outweigh these risks of greater opportunism. Thus, the trust substitutes will often be imperfect replacements for the informal institutions that they replace, but the benefit is in the offsetting economic and social benefits from the entire cluster of new exchange relationships that develop.

Regarding the greater impersonalization of consumer credit, for example, there has been both an increase in the incentives for opportunism as well as the evolution of new institutions by private actors to try to constrain opportunism. A reduction in the strength of informal institutions such as trust, repeat dealing, and reputation has led to increased bankruptcy filings. But it has also led to the development of new “trust substitutes” that have supplemented and replaced the weakening informal institutions. The development of credit bureaus in the United States illustrates this evolution of more formal institutions as trust substitutes as commercial exchange becomes more complex.³¹² Credit bureaus can be understood as a formal substitute for the repeat dealing and reputational information of historic localized credit markets.³¹³ Credit records were initially proprietary, consisting of one merchant’s records about borrower’s accounts. These proprietary records, however, did little to prevent opportunism, as borrowers could simply jump from one credit to another, taking advantage of each in turn. Merchants and lenders eventually came to “pool” their information, formally and informally, allowing a more complete report on each potential borrower and a more robust system of reporting on reputation. Through this process, the first credit bureaus were born. Originally, however, they were local in scope, relegated to a single city or town.³¹⁴ Over time, however, these local credit bureaus pooled their available information into larger regional and finally national credit reporting bureaus. Today there are three major national credit bureaus, with a variety of regional and industry-specific bureaus as well.³¹⁵

Larger networks of credit reporting co-evolved with the rise of a national consumer credit economy. A national credit system would be difficult without national credit bureaus; at the same time the need for national credit bureaus arose from the hydraulic forces pushing toward more nationalized credit markets.³¹⁶ Technological

³¹² See Daniel B. Klein, “Knowledge, Reputation, and Trust, By Voluntary Means,” in *REPUTATION*, *supra* note, at 1, 3-7; Daniel B. Klein, *Credit Information Reporting: Why Free Speech is Vital to Social Accountability and Consumer Opportunity*, available in <http://lsb.scu.edu/faculty/creditreporting.html>, at p. 6 (“The histories of other social accountability mechanisms show a similar pattern of development—from informal gossip to local associations to efficient integrated systems serving a great society.”); See Daniel B. Klein, *Promise Keeping in the Great Society: A Model of Credit Information Sharing*, 4 *ECON. AND POLITICS* 117 (1992), reprinted in *REPUTATION*, *supra* note, at 267; Robert M. Hunt, *The Development and Regulation of Consumer Credit Reporting in America*, Working Paper No. 02-21, Fed. Res. Bank of Philadelphia (Nov. 2002); Stewart Macaulay, *Non-Contractual Relations in Business: A Preliminary Survey*, 28 *AM SOCIOLOGICAL REV.* 55 (1963).

³¹³ See Merry, *Rethinking*, *supra* note, at 271.

³¹⁴ See Hunt, *supra* note, at 8-9.

³¹⁵ See Hunt, *supra* note, at 8-9.

³¹⁶ See Marco Pagano and Tulio Jappelli, *Information Sharing in Credit Markets*, 43 *J. FIN.* 1693 (1993). It would be possible for large lenders to collect nationwide information on a proprietary basis, and many

advances such as computers also made it technologically feasible to collect and access large amounts of data relevant to individual reputations. At the same time, however, there has been a dramatic change in the *type* of information collected. In order to allow for the nationwide collection and access of reputation information, it became necessary for information to be recorded and accessed in a simplified, standardized form. Gossip about reputations in a local community can be personalized, nuanced, and subtle in its judgments of an individual's reputation. Credit reports, by contrast, collect far more information about an individual's finances, but do so in a standardized and "cold" paper format that sacrifices much of the nuance and context of more informal systems. In other words, information is now a commodity, that can be mass-produced and marketed. Like other goods, this standardization reduces costs and increases volume, but lacks the depth of hand-crafted and tailored goods. Credit bureaus, therefore, evolved from local reputational institutions, but can be seen as a more formal institution for the recording and processing of standardized information about individual commercial reputations.

The evolution of consumer credit in the United States shows an evolutionary trend from governance by informal, localized institutions to national, formal institutions such as credit bureaus. The development of credit cards as a substitute for local reputation institutions, and the rise of national credit bureaus from informal reputational networks both show this same tendency. As commercial exchange becomes more complex, involves larger numbers of people, and deals with a more heterogeneous and mobile population, informal mechanisms of social control, such as trust, reciprocity, and reputation, tend to break down and to be supplanted by more formal mechanisms of social control, such as credit cards, credit bureaus, and formal contractual agreements. Over time, therefore, these formal institutions arise as "trust substitutes" for the informal institutions that previously governed interactions, but which break down under the pressures of size and complexity. These formal institutional trust substitutes, therefore, serve the function of older informal institutions.

The development of trust substitutes is a necessary response to reduce the negative effects of the diminishment of informal institutions of social control. Nonetheless, it is likely that the end result will be both greater reliance on formal institutions but also a higher level of the socially undesirable behavior. This seems to be true for the increasing impersonalization of consumer credit and the resultant costs of that system in terms of higher bankruptcies and greater expenditures on an intricate system of consumer credit reporting. On the other hand, it is no question that the social and economic benefits of national and impersonal credit markets substantially outweigh these costs in terms of a higher risk of opportunism. But it must be realized that the only reason this is so is that formal institutions have evolved that can fill the gap created by the reduction in the power of informal institutions to control social behavior. Absent the ability of formal institutions to evolve as "trust substitutes" to supplement weakened informal institutions, there is little reason to believe that this evolution toward nationalized and impersonal credit would be so benign, or would have even occurred in the first place. The policy goal in this area should be to devise the efficient combination

lenders supplement credit bureau data with their own proprietary information. But the fact that current credit bureaus evolved from this sort of proprietary system suggests that the current system is more efficient.

of institutions that maximizes the advantages of efficient consumer credit institutions while minimizing the costs of opportunistic behavior. In the end, this efficient institutional mix will tend to place greater reliance on formal institutions than previously.

C. Changes in Social and Personal Norms Regarding Bankruptcy

Increasing bankruptcy filing rates can also be explained by changes in social and personal norms regarding bankruptcy. There is a widespread perception that bankruptcy has lost much of its previous social stigma, and that this explains at least some part of the increase in bankruptcy filing rates.³¹⁷ Alan Greenspan, for instance, has stated bluntly, “Personal bankruptcies are soaring because Americans have lost their sense of shame.”³¹⁸ The impact of this decline in social stigma on bankruptcy filing rates is straightforward. Reducing the generalized social stigma of filing bankruptcy will reduce the negative impact that a particular individual will suffer to his personal reputation from filing bankruptcy. Unlike repeat-dealing and more specific reputational sanctions, the pressure from social stigma comes from other consumers, family, friends, and colleagues who morally disapprove of bankruptcy. Thus, it is more diffuse than sanctions imposed by creditors. As bankruptcy becomes a less socially stigmatized activity, the reputational harm from filing bankruptcy falls as well. At the margin, therefore, reduced social stigma from filing bankruptcy can be predicted to lead directly to increased bankruptcy filings. In fact, it is not even necessary that there is a decline in the *actual* stigma attached to filing bankruptcy, so long as potential bankruptcy filers *perceive* that there has been a reduction in the stigma attached to filing bankruptcy.

1. Consequences of Change in Social Norms Regarding Bankruptcy

The negative social and economic effect of changes in social norms regarding bankruptcy is amplified because it disproportionately affects a discrete category of individuals who have the most to gain financially from filing. Under current bankruptcy law, the benefits of filing bankruptcy tend to rise as the filer’s income and wealth rises. The benefit of bankruptcy is positively correlated with wealth because exemptions are linked to specified types of property deemed essential to the debtor’s fresh start, such as houses, cars, and other such property. Because wealthier individuals are likely to have greater amounts of the types of property protected by exemptions and greater ability to convert nonexempt assets to exempt status on the eve of bankruptcy, they have the greatest economic benefit from filing bankruptcy. The benefits of Chapter 7 also increase with income. Chapter 7 bankruptcy acts as income insurance; as a debtor’s post-bankruptcy income is expressly excluded from the bankruptcy estate.³¹⁹ High-income debtors, therefore, can protect more income from creditors, thereby by increasing the

³¹⁷ For instance, in his floor statement on the Bankruptcy Reform Act of 1999, Senator Charles Grassley referred to a public opinion poll that indicated that fully 85% of Americans believe that bankruptcy has less social stigma than in previous eras. Professor Braucher also quotes numerous lawyers who opine that the increase in bankruptcy filing rates has been driven in part by a decline in the traditional social stigma associated with filing bankruptcy. See Braucher, *supra* note, at 540; *id.* at 545. See also Luckett, *Personal Bankruptcies*, *supra* note, at 73 (“It is widely recognized, though hard to measure, that the stigma of bankruptcy is not what it used to be . . .”).

³¹⁸ Quoted in Julie Kosterlitz, *Over the Edge*, 29 NAT’L J. 870, 871 (1997).

³¹⁹ See 11 U.S.C. §541(a)(6).

benefit of filing bankruptcy.³²⁰ Because the financial benefit of bankruptcy is largest for high-income and high-wealth debtors, the marginal effect of social norms in restraining bankruptcy filing is highest also. If those constraints fall, therefore, the impact at the margin will be a direct function of the benefit of filing, which means that the greatest impact will be for wealthier and higher-income debtors.

Although the theory is straightforward, empirically measuring changes in broad and diffuse social factors such as shame and stigma is difficult and do not easily lend themselves to direct testing.³²¹ For instance, it is not methodologically correct to simply ask bankruptcy filers whether they felt “ashamed” or perceived social disapproval from filing bankruptcy.³²² What is relevant for determining whether a link exists between diminished stigma and increased bankruptcy filing rates is not whether an individual feels ashamed of having filed bankruptcy *after* he or she actually files, but whether the shame of filing is sufficiently large to deter the prospective filer *before* he or she actually files. If a bankruptcy filer feels ashamed of bankruptcy, but still nonetheless files a bankruptcy petition, by definition it is the case that with respect to that person the shame and stigma of bankruptcy was not sufficiently strong to deter a filing. The relevant inquiry, therefore, is whether the constraint imposed by personal shame and social stigma have declined at the margin such that financially-troubled individuals who in the past would have eschewed bankruptcy as a solution now instead choose bankruptcy. For purposes of the stigma-bankruptcy connection it is completely beside the point whether people feel bad about bankruptcy after they actually file; what matters is whether the stigma is sufficiently strong to deter them from filing at all, or perhaps even more importantly, to encourage them to live a sufficiently prudent life such that financial distress does not occasion itself. To clarify the point, it should be stressed that the argument is *not* that the shame and stigma associated with bankruptcy have been completely eliminated, but that the constraining effect of shame and stigma has gradually declined, thereby reducing the constraint imposed by this variable at the margin, resulting in an increase in filings.

A direct test of the effect of personal shame and social stigma on bankruptcy filings, therefore, is fundamentally impossible—it would require identifying those marginal individuals who would have filed bankruptcy but for the negative effect on his conscience or reputation from doing so. Because these individuals never show up in bankruptcy court, it is almost impossible to identify this group of people for research purposes. Even more difficult to identify would be that category of individuals who find the prospect of bankruptcy sufficiently distasteful that they act in a financially-responsible manner and avoid living on the financial edge.³²³

³²⁰ An individual’s future income stream constitutes the most valuable asset for the overwhelming number of people. See Buckley, *American Fresh Start*, *supra* note, at 67; James Davies and John Whally, *Taxes and Capital Formation: How Important is Human Capital?*, NBER Working Paper No. 2899 (1989).

³²¹ See Lockett, *Personal Bankruptcies*, *supra* note, at 76 (noting that “none of the typically cited social or legal factors are easily quantifiable”); Gross and Souleles, *supra* note, at 321 (“The various costs of default, especially social, legal, and information costs, are inherently difficult to measure. Most of the proxies that have been suggested run into problems of endogeneity and reverse causality.”); Moss and Johnson, *supra* note, at 326 (“stigma is very difficult to measure”).

³²² See, e.g., SULLIVAN, ET AL., *FRAGILE*, *supra* note, at 32.

³²³ Perhaps a better indicator of the decline of the constraint associated with the social stigma of bankruptcy is not bankruptcy filing rates *per se*, but rather the seemingly increased willingness of many to live closer to the financial edge.

It is clear, however, that a change in social norms regarding bankruptcy will impose substantial economic and social cost. As with informal institutions of repeat-dealing and reputation, social norms are valuable in that they are generally a low-cost mechanism for promoting social order and discouraging anti-social behavior. Norms substitute for more formal economic, political, and social institutions, such as police and courts. For instance, a society that develops and maintains a social norm against property theft (in addition to having a police force that prevents theft) will achieve more order at less expense than a society that can prevent theft only through the maintenance of a large police force with no norm against theft.³²⁴ Moreover, in order to attain the same degree of social harmony, it will be necessary to support a larger police force in the latter society as compared to the former. A reduction in the moral force of a prosocial norm, therefore, will impose costs on society, both in the form of reduced social harmony as well as a requirement to construct and operate more formal institutions, such as police. It is difficult to quantify the full costs associated with a decline in social norms against bankruptcy.

The experience of Memphis, Tennessee, however, is illustrative.³²⁵ In 1996, 4.3% of Memphis families filed bankruptcy, almost 1 in 23, earning Memphis the sobriquet of the “bankruptcy capital of America.” According to a *Fortune* magazine article, there is a “culture of bankruptcy” in Memphis, and bankruptcy is “a way of life.” As the magazine notes, “Because so many people have lived through bankruptcy, there’s a strong informal support network for anyone in financial trouble. Friends and neighbors tell each other ‘bankruptcy works,’ says David Monypenny, Jerry Lee Lewis’s [who also filed for bankruptcy] manager.” Other indicia of an active bankruptcy culture are prominent. The article continues, “There’s also plenty of professional support for bankruptcy: The Memphis Yellow Pages features more than a dozen large lawyers’ ads offering to wipe out debts for no down payment; a Honda dealer (its slogan: ‘The bankruptcy specialists’) runs TV commercials promising to sell you a car no matter what your credit history.”

In the context of bankruptcy, therefore, the costs of a decline in norms discouraging bankruptcy are both a reduction in social harmony as well as increasing use of substitutes to offset the lower reliability of financial contracts. Consider *Fortune*’s description of everyday financial life in Memphis: “It’s almost impossible to cash checks in Memphis. Used-car dealers charge their wholesale cost as a down payment. And lenders are either tightening or giving up. First Enterprise Financial Group, for instance, an Illinois-based sub-prime lender, closed its Memphis operations in May.”³²⁶ Thus, more formal institutional responses, such as large downpayments and higher interest rates

³²⁴ An analogy is the well-established finding that voluntary norms of tax compliance substantially reduce the amount of resources that the Internal Revenue Service has to expend on audits, enforcement, litigation, and other compliance measures. If voluntary tax compliance were to fall, this would require greater expenditures on tax-compliance. See Eric A. Posner, *Law and Social Norms: The Case of Tax Compliance*, 86 VA. L. REV. 1781 (2000); James Andreoni *et al.*, *Tax Compliance*, 36 J. ECON. LIT. 818 (1998).

³²⁵ Kim Clark, *Why So Many Americans Are Going Bankrupt*, *FORTUNE*, Aug. 4, 1997, at 24. This example, of course, is not intended to be a substitute for systematic analysis, but is rather intended to be suggestive of some of the effects of changing social norms regarding bankruptcy.

³²⁶ Clark, *supra* note, at 24.

can provide some response to fill the vacuum created by the breakdown of informal bonds of trust. But the deadweight losses and costs to innocent consumers of expansive bankruptcy use are clear.

2. Empirical Evidence of Effects of Changes in Norms on Filings

Indirect proxies have been used to try test for the effect of changes in social stigma regarding bankruptcy.³²⁷ Using district-level data, Fay, Hurst, and White find that after controlling for other relevant variables, there are systematic patterns of higher filing rates in particular districts, either because the higher level of filings increases information about bankruptcy or because the prevalence of bankruptcy in the community reduces the stigma attached to filing.³²⁸ Using similar statistical measures Gross and Souleles similarly find that after controlling for economic risk, the probability that a given individual will file for bankruptcy is in part a function of the number of people who filed for bankruptcy in the recent past in that community.³²⁹ This correlation in filing rates that cannot be explained by economic risk variables also suggest the presence of a stigma or information effect in local communities that explain bankruptcy filing rates.³³⁰

Another way empiricists have tried to test for the effect of stigma on bankruptcy filings has been to identify measurable variables that can serve as an effective proxy for stigma. To be motivated by social approval or disapproval it is necessary both to be known in the community as well as to engage in acts disapproved of in the community. One way to test for stigma, therefore, is to examine the size of the relevant community to determine if bankruptcy filing rates differ according to community size. If a fear of social disapproval deters bankruptcy filing, then bankruptcy filings should be higher in larger, more anonymous communities as compared to small communities. Residents of larger communities are likely to possess less knowledge of their neighbors' reputations and also less-likely to fear their disapproval. And in fact, cities with higher population densities have higher bankruptcy filing rates than smaller communities.³³¹ This finding is consistent with studies suggest that individuals who live in small towns tend to be both more trusting and more trustworthy than those from big cities.³³² These factors indicate

³²⁷ For a review and critique of several of the studies discussed here, see Gordon Bermant, *What's Stigma Got to Do with It?*, ABI JOURNAL 22 (July/August 2003).

³²⁸ See Fay, Hurst, and White, *supra* note, at 712; see also *id.* at 716 ("These results are consistent with local trends occurring in which increases in a district's bankruptcy filing rate cause attitudes toward bankruptcy to become more favorable and therefore individual households' probability of filing rise.").

³²⁹ See Gross and Souleles, *supra* note, at 340.

³³⁰ Gross and Souleles, *supra* note, at 345 ("The fact that the omitted default factor rises with the number of people in one's state who have previously filed for bankruptcy is suggestive of a decline in social stigma or information costs, but it is not conclusive.").

³³¹ See John M. Barron, Gregory Elliehausen, and Michael E. Staten, *Monitoring the Household Sector with Aggregate Credit Bureau Data*, BUSINESS ECON. 63, 71 (Jan. 2000); SMR Research, *supra* note; see also Luckett, *Personal Bankruptcies*, *supra* note, at 85..

³³² See PETER SINGER, HOW ARE WE TO LIVE? ETHICS IN AN AGE OF SELF-INTEREST 141 (1993); see also MATT RIDLEY, THE ORIGINS OF VIRTUE 70 (2000); ROBERT WRIGHT, THE MORAL ANIMAL 221-22 (1998). This difference between urban and rural life appears to be universal and is based on the relationships formed in small rural communities characterized by repeated-dealings that give rise to higher degrees of cooperation. See WRIGHT, MORAL ANIMAL, *supra* note, at 47 ("Children in rural villages in Mexico, Columbia, Kenya, the Philippines, Israel, Korea, and aboriginal Australia are more cooperative with each

that trust and reciprocity are higher in small communities, suggesting that the conditions for trust and reciprocity to flourish (repeat-dealing and reputational mechanisms) are present in these communities.

For similar reasons, bankruptcy filing rates are also correlated with levels of migration. Societies with higher patterns of migration tend to have higher bankruptcy filing rates.³³³ This is to be expected – high-migration societies will be more transient, meaning that people are less-invested in the community and the social and economic relationships of the community. Repeat dealings will be of shorter duration and subject to a greater discount rate than in more-stable societies. Where conditions make detection and monitoring of neighbors’ reputations difficult, social norms will be less powerful in discouraging disapproved behavior. Thus, in high migration areas where individuals frequently move on to other communities in a short period of time, it is difficult to punish those who behave improperly, thereby reducing the incentives of others to collect and act on reputational information.

A final way of measuring stigma is to recognize stigma as part of the residual effect that remains after controlling for all other variables. As discussed above, explained residuals in bankruptcy filing rates remain after accounting for the variables included in the traditional model.³³⁴ Although these residuals could result from a number of possible causes, Charles Lockett observes, “Of course, to the extent that a model is comprehensive in its incorporation of likely determinants of bankruptcy, declining stigma may be left as the most plausible candidate to account for the otherwise unexplained component of rising bankruptcies.”³³⁵

3. Causes of Changes in Social Norms Regarding Bankruptcy

The reasons for the erosion of the traditional stigma of filing bankruptcy are multiple and are hard to pin down with precision and providing a theory of the evolution of social norms over time is beyond the scope of this article. Social theorists have long struggled with developing a theory of how social norms are created and evolve over time,

other than those living in urban settlements in New England, Israel, Australia, Mexico, Korea, and so on.”).

³³³ Buckley & Brining, *supra* note; SULLIVAN, *et al.*, AS WE FORGIVE OUR DEBTORS 244-46 (noting correlation of migration history with propensity to file bankruptcy).

³³⁴ See *supra* notes ____-____ and accompanying text.

³³⁵ Lockett, *Personal Bankruptcies*, *supra* note, at 89; see also Fay, Hurst, & White, *supra* note, at ____ (“Although we cannot rule out the possibility that the local bankruptcy culture variables are serving as proxies for something else, our results are consistent with the hypothesis that social disapproval of bankruptcy has declined over time.”). On the other hand, it may be that declining stigma may be the most plausible explanation for some cases but not others. For instance, it may be that declining stigma may be the most important factor for middle-class and upper middle-class filers who have the most to gain financially from filing bankruptcy and have access to the greatest amount of information regarding bankruptcy. With respect to lower-income individuals, by contrast, it may be that they are most affected by the reduction of transaction costs and search costs discussed above, rather than changes in social stigma. To the extent that disapproval of bankruptcy reflects middle-class bourgeois values, it may be more constraining on middle-class families than poor families. See *infra* at notes ____-____ and accompanying text; see also Zywicki, *Bankruptcy Law as Social Legislation*, *supra* note, at 402-08; Robert B. Chapman, *Missing Persons: Social Science and Accounting for Race, Gender, Class, and Marriage in Bankruptcy*, 76 AM. BANKR. L. J. 347, 355 (2002). Given the current difficulty of measuring changes in these diffuse social and economic variables in the first place, efforts to establish the relative importance of these variables within different demographic subgroups is even more daunting.

so any observations here are necessarily speculative. Complaints about the supposed “decline in stigma” have recurred many times in American history.³³⁶ The question, therefore, is whether there really has been a change in social norms regarding bankruptcy during the past 25 years, and if so, why such a dramatic change occurred in such a short period of time. Given the difficulty in understanding such broad social currents as changes in social norms, the discussion presented here is necessarily tentative. Nonetheless, given the importance of the issue and a widespread perception that it is indeed an important element of the explanation of rising bankruptcies, the issue merits some discussion.

A possible explanation turns on the generational change associated with the rise of the “Baby Boom” generation to a position of leadership in American society.³³⁷ Sullivan, Warren, and Westbrook observe, “The overrepresentation of the baby boom [in bankruptcy] is striking.”³³⁸ If there has been a change in social norms, the explanation may rest in deep-seated changes in American culture in that have tended to erode the value of promise-keeping and performing one’s obligations.³³⁹ In general, changes in broad social norms tend to occur only gradually,³⁴⁰ but there is reason to believe that the period associated with the dominance of the baby boomers has been a period of rapid change in social norms. Although obviously an overgeneralization, the Baby Boom generation has been notable in its willingness to challenge established traditional American values, good and bad.³⁴¹ Thus, there has been general overturning of traditional taboos regarding issues as varied as marriage, sexuality, recreational drug use, and role of women in society.³⁴² Moreover, given the very size and self-confidence of the baby boom generation, they have arguably been able to influence social norms to a greater degree than most generations. The Baby Boom generation has served as a sort of collective “norms entrepreneur” for widespread changes in a variety of traditional social norms.³⁴³ It may be that these broad social changes also tended to undermine social norms regarding personal financial responsibility and the social stigma associated with bankruptcy.³⁴⁴ Earlier generations seem to have held a much more negative view of the

³³⁶ See Moss and Johnson, *supra* note; CALDER, *supra* note (describing “the myth of lost financial virtue”).

³³⁷ See Zywicki, *Bankruptcy Law as Social Legislation*, *supra* note, at 410-13.

³³⁸ SULLIVAN, ET AL., FRAGILE, *supra* note, at 39.

³³⁹ See ROBERT H. BORK, SLOUCHING TOWARDS GOMORRAH: MODERN LIBERALISM AND AMERICAN DECLINE 64-65 (1997); ALLAN BLOOM, THE CLOSING OF THE AMERICAN MIND 325 (1987); Buckley and Brinig, *supra* note.

³⁴⁰ See JAMES S. COLEMAN, FOUNDATIONS OF SOCIAL THEORY (1990).

³⁴¹ See PAUL C. LIGHT, BABY BOOMERS 115-17 (1988).

³⁴² See Review & Outlook (Editorial), *No Guardrails*, WALL ST. J., at A12 (Mar. 18, 1993), available in 1993 WL-WSJ 706182.

³⁴³ In this vein, it has been observed that with respect to social attitudes toward divorce, “the oldest baby boomers were at once deviant and trend setters . . . helped to establish new normative societal standard that permit a generally high rate of divorce.” LIGHT, *supra* note, at 147 (quoting Census Bureau experts Arthur Norton and Jeanne Moorman). For more on norms entrepreneurship, albeit in a very different context than here, see Robert C. Ellickson, *The Market for Social Norms*, 3 AM. L. & ECON. REV. 1, 10-17 (2001); Cass R. Sunstein, *Social Norms and Social Roles*, 96 COLUM. L. REV. 903, 929-30 (1996) (discussing “norm entrepreneurs” who can help society reach “a ‘tipping point’ when norms start to push in new directions”).

³⁴⁴ See Michael J. Boskin and Lawrence J. Lau, *An Analysis of U.S. Postwar Consumption and Saving: Part II Empirical Results* 72-76 NBER Working Paper No. 2606 (June 1988) (finding that “vintage effect”

personal shame and social stigma associated with bankruptcy than do the Baby Boomers.³⁴⁵ Although these observations fall far short of a rigorous proof of the possible relationship between the rise of the Baby Boom generation and the decline in stigma beginning in the 1970s and 1980s, they are consistent with other characteristics of the Baby Boom generation, as well as providing at least one possible explanation as to the specific timing of this change in social norms.³⁴⁶

Sociologist Robert Putnam has argued that the transition from the World War II generation to the Baby Boom generation marked a dramatic change in American life, and in particular, with respect to changing attitudes of social engagement and personal responsibility.³⁴⁷ In fact, Baby Boomers are dramatically over-represented in bankruptcy filings relative to their percentage in the population.³⁴⁸ In addition, their overrepresentation in bankruptcy has following them through their economic life-cycle, indicating that the tendency toward bankruptcy is a reflection of factors unique to their generation, not a function of more generic passage through age.³⁴⁹ When they were the 25-34 year-old cohort of the population, they were both the largest single group in bankruptcy, as well as having the highest rate. Ten years later, when they were aged 35-44, they were again the largest group in bankruptcy as well as having the highest filing rate.³⁵⁰ Moreover, because the baby boomers are such a large cohort, the spike in bankruptcy filings among their generation counts for about 14 percent of the growth in the filing rates.³⁵¹ This overrepresentation of baby boomers in bankruptcy is particularly difficult for the traditional model to explain, in that baby boomers have come of age in a period of unusually high prosperity and economic opportunity, as well as a fully-developed welfare state that should have helped to soften any financial blows that they have sustained. More than any other generation, they benefited from the unprecedented wealth accumulation of the past two decades. Speculation that baby boomers have been subject to unusually high levels of economic deprivation and stress during the 1980s and 1990s are difficult to sustain, especially when compared to those who entered the

of baby boom generation explains decrease in U.S. savings rates over time); *but see* Barry Bosworth, Gary Brutless, John Sabelhaus, James M. Poterba, and Lawrence H. Summers, *The Decline in Saving: Evidence from Household Surveys*, 1991 (No. 1) BROOKINGS PAPERS ON ECONOMIC ACTIVITY 183, 199 (1991) (arguing that cohort effect predated baby boom generation).

³⁴⁵ See, e.g., TOM BROKAW, *THE GREATEST GENERATION* 39-44 (1998) (describing Wesley Ko's refusal to file bankruptcy); *id.* at 47 (describing James Dowling).

³⁴⁶ See also David Frum, *Bankruptcy Reform is a Moral Issue*, WALL ST. J., Feb. 11, 2000, at A14.

³⁴⁷ See ROBERT D. PUTNAM, *BOWLING ALONE* 249-50 (2000).

³⁴⁸ Although Baby Boomers comprise only 39% of the American population, they are 55% of bankruptcy filers. SULLIVAN, ET AL., *FRAGILE*, *supra* note, at 39. In fact, the representation of Baby Boomers in bankruptcy may be as high as 63%, depending on the dates used to describe the Baby Boom generation. *Id.* at 304 n.38. Similarly, the disproportionately large bankruptcy filings among baby boomers is reflected in a shift in the average age of bankruptcy filers toward middle age. See Teresa A. Sullivan, Deborah Thorne, and Elizabeth Warren, *Young, Old, and In Between: Who Files for Bankruptcy?* 9 NORTON BANK. L. ADVISOR 1 (2001).

³⁴⁹ See SULLIVAN, ET AL., *FRAGILE*, *supra* note, at 39-41.

³⁵⁰ Teresa A. Sullivan, Elizabeth Warren, and Jay Lawrence Westbrook, *Baby Boomers and the Bankruptcy Boom*, 4 NORTON'S BANKRUPTCY LAW ADVISOR 1 (April 1993).

³⁵¹ Sullivan, Warren, and Westbrook, *Baby Boomers*, *supra* note.

workforce during the Great Depression or 1970s.³⁵² A more fruitful hypothesis for further examination may be that the passage of the baby boom generation through American society and the economy effected a dramatic change in all social norms, including traditional norms regarding bankruptcy.

With respect to the declining social stigma of bankruptcy specifically, however, the decline was to some extent to be predicted as a consequence of the enactment of the 1978 Bankruptcy Code. Indeed, a diminishment of the stigma associated with filing bankruptcy was implicit in the 1978 Code. The Code expanded the nondiscrimination provisions of § 525 to prohibit many forms of private discrimination against bankruptcy debtors and virtually all forms of public discrimination against debtors.³⁵³ The Code also consciously purged the normatively-laden but ancient term “bankrupt” from the Code, substituting the more value-neutral term “debtor.”³⁵⁴ Rather than being adjudged “bankrupt,” a case filing is described as an “order for relief.”³⁵⁵ The intent of these provisions was clear—to strip bankruptcy of irrational moral and emotional “baggage” that had previously interfered with this calculation.

The sheer number of filers alone has also probably helped to reduce the stigma associated with filing bankruptcy. As more individuals file bankruptcy, more people know others who have filed bankruptcy. The recognition that others have filed bankruptcy and have survived – indeed, in many cases prospered – makes bankruptcy more routine in society, reducing the stigma associated with it. Thus, the sheer numbers of individuals who file bankruptcy contribute to the perception that bankruptcy is a common and routine process.³⁵⁶ As late Senator Daniel Patrick Moynihan observed in his famous article, society can only define so much of a given behavior as “deviant.”³⁵⁷ Once a behavior becomes sufficiently widespread, at some point society redefines the behavior so as to relieve it of its “deviant” label.³⁵⁸

The problem of enforcing traditional social norms is probably made more difficult by the existence of celebrities and others who publicly flout those norms. As noted, there have been several high-profile celebrity bankruptcies in recent years, which has arguably

³⁵² Sullivan, et al, argue that Baby Boomers entered the economy during a period of unusually high economic stress. SULLIVAN, ET AL., *FRAGILE*, *supra* note, at 39-40. They provide little support for this claim, however. Some of their argument, such as the argument that baby boomers were subject to “corporate downsizing,” have been discussed elsewhere in this article.

³⁵³ 11 U.S.C. §525.

³⁵⁴ See Jones and Zywicki, *supra* note, at 219.

³⁵⁵ *Id.*

³⁵⁶ Thus, the argument regarding declining stigma and rising bankruptcy rates is not circular, as argued by some. See SULLIVAN ET AL., *FRAGILE*, *supra* note, at 265. It is not circular because this feedback loop takes place gradually and over time. This is why stigma does not disappear all and once and bankruptcy rates do not immediately jump to a higher equilibrium level. Instead, there is a gradual unraveling over time, as higher filings and declining stigma create a feedback loop.

³⁵⁷ Daniel Patrick Moynihan, *Defining Deviancy Down*, 62 AMERICAN SCHOLAR 17, 19 (1993).

³⁵⁸ One recent bankruptcy filer confessed in a CNN interview, “When I found out—this was watching it on the news, on the newspapers—that more and more people are doing it [filing bankruptcy], and . . . it’s not just a middle class you know, upper class too—rich people—everybody’s doing it. And . . . I said: Why not me? You know, I’m just one more of theme.” *Your Money with John Metaxas* (CNN television broadcast, Jan. 18, 1999). In fact, whereas bankruptcy itself was once thought a deviant activity, today it is only abuse of bankruptcy that is thought of as deviant, and some bankruptcy scholars appear to have doubts about even this. See, e.g., KAREN GROSS, *FAILURE AND FORGIVENESS* (2000).

contributed to the sense that the bankruptcy stigma is eroding.³⁵⁹ Similar views are expressed by more pedestrian bankruptcy filers, a large number of which report that filing bankruptcy was fast, easy, and painless and that they would consider filing again if necessary.³⁶⁰

This is not to say that changes in social norms regarding bankruptcy are all-powerful. Filing bankruptcy and breaching the obligations of reciprocity strongly contradicts our inherent tendencies toward reciprocity and promise-keeping. To the extent that social norms and other incentives can override these innate tendencies, they do so only after long-lasting and intense pressure. Breaching reciprocal obligations is difficult to do and is a very difficult lesson to learn. It would be inaccurate today to say that society actively encourages filing bankruptcy. But it does not seem inapt to characterize attitudes as drifting toward benign tolerance. To the extent that this drift continues, it could create a vicious cycle, further undermining social norms and leading to still higher bankruptcy filings.

V. What To Do About Rising Bankruptcies?

The upward trend line in consumer bankruptcy filing rates over the past two decades thus appears to have resulted from a confluence of three general factors: (1) a change in the relative costs and benefits of filing bankruptcy; (2) changes in the consumer credit market that have eroded the informal institutions of trust, repeat dealing, and commercial reputation; and (3) a change in the social norms traditionally associated with filing bankruptcy. Available empirical evidence tends to support this argument, but further testing will be necessary before reaching a final conclusion. The evidence seems conclusive, however, on the recognition that the traditional model of bankruptcy no longer accurately explains the consumer bankruptcy process. Nonetheless, the currently bankruptcy system was created according to this model. Assuming that the New Institutional Economics model of bankruptcy advanced here is correct, what, if anything, does this say about appropriate reforms to the consumer bankruptcy system?

A. Do Nothing? Ex Ante Responses to an Ex Post Problem

One possible response would be to simply do nothing at all as a formal matter, and allow market adjustment through higher credit terms and greater credit rationing. This is not a wholly implausible argument; in fact many prominent bankruptcy experts have made exactly this argument in arguing against recent efforts to reform the Bankruptcy Code.³⁶¹ But this approach would be economically inefficient, in that it fails to recognize the bankruptcy problem as a problem of *ex post* contractual opportunism that can be mitigated but never wholly solved by *ex ante* market adjustments alone. It thus misdiagnosis the problem and therefore offers an incomplete solution.

The argument in favor of a hands-off “do nothing” approach to bankruptcy law is straightforward. The argument is that it is unnecessary to amend the Bankruptcy Code or take other steps to constrain *ex post* opportunistic behavior because borrowers and

³⁵⁹ See *supra* notes ____-____ and accompanying text.

³⁶⁰ See Vern McKinley, *Ballooning Bankruptcies: Issuing Blame for the Explosive Growth*, Regulation, Fall 1997, at 38 (describing findings of a Visa survey that “66% of filers found the bankruptcy process to be an easy one” and that 27% of respondents would consider filing again).

³⁶¹ See discussion at *supra* notes ____-____ and accompanying text.

lenders can address these problems of post-contractual opportunism through *ex ante* contractual adjustments, such as higher interest rates and stricter credit rationing. Creditors could also increase their monitoring activities so as to try to prevent post-contractual opportunism. *Ex post* expected costs, it is argued, can be seamlessly converted into *ex ante* contractual adjustments. There would be wealth redistributive effects in the short run for loans entered into prior to the social and economic changes that have increased the likelihood of post-contractual opportunism, but not necessarily large efficiency effects.

The “do nothing” approach, however, ignores the reality that a greater risk of post-contractual opportunism cannot be costlessly converted into *ex ante* contractual adjustments. As a result, there will be deadweight costs and harm to consumers from this risk adjustment process. Extending the “do nothing” argument to its logical conclusion exposes the flaw in the argument. Allowing debtors an unconstrained option to file bankruptcy would be equivalent to eliminating the legal enforcement of contracts. Bankruptcy discharge relieves debtors of the legal obligation to pay their debts. Bankruptcy discharge is functionally identical to eliminating legal enforcement of those contracts to which the discharge applies. Creditors will respond to this reduction in the enforcement of legal obligations in the same way as they would to an absence of contract law generally, by increasing their use of extralegal sanctions. But just as a lack of contract enforceability obviously reduces social welfare, an unfettered ability to escape legal obligations through bankruptcy will similarly have negative implications for social welfare. So, while it is true that creditors can respond to a lax bankruptcy system through extralegal adjustments, it is doubtful that these responses alone will be an optimal response to the general reduction in the enforceability of contractual obligations.

One could imagine a contractual regime with no legal enforcement of contracts.³⁶² In such a regime, parties could escape a contract at any time without fear of legal liability, with only extralegal sanctions being imposed, such as reputational effects, loss of collateral, or other forms of private sanctions. Private remedies are always available, but enabling parties to rely on legal enforcement of contracts substantially reduces the threat of post-contractual opportunism, which allows for greater positive reliance on contractual promises and reduces the resources expended on self-help arrangements. Legal enforcement of contracts, therefore, can substantially increase social welfare. Limitations on the power to opportunistically escape contractual obligations through bankruptcy has similar efficiency effects.

Creditors could respond to this increased general risk of post-contractual opportunism by simply increasing the risk premium they charge to all borrowers, such as by raising interest rates, increasing downpayments, and the like. In fact, creditors appear to be responding to the increased systematic risk of recent years by taking steps to compensate for this risk through market mechanisms. Thus, creditors have been moving to reduce credit lines and increase penalties for late payments and other indicia of default.³⁶³ As recounted earlier, the experience in Memphis provides an example of the types of market mechanisms that are available to creditors seeking to reduce their

³⁶² See Anthony T. Kronman, *Contract Law and the State of Nature*, 1 J. L. ECON. & ORG. 5 (1985).

³⁶³ See Zywicki, *Economics of Credit Cards*, *supra* note, at 103-04.

systematic risk.³⁶⁴ These examples suggest that creditors are, in fact, already adjusting to the new higher-risk lending environment. They have taken *ex ante* market steps to reduce the costs imposed upon them by *ex post* post-contractual opportunism. Thus, some of the costs of this new risk environment have been ameliorated by adjustments in the marketplace; on the other hand, it is doubtful that consumers as a group are made better-off as a result.

Relying solely on *ex ante* adjustments to offset the risk of *ex post* bankruptcy could be very expensive. Economist Kartik Athreya, for instance, estimates that interest rates on unsecured credit are as much as 50% higher under a regime of easy access to bankruptcy than would be the case otherwise.³⁶⁵ Moreover, this cost is disproportionately borne by poorer people because they are more dependent on access to unsecured credit than are wealthy, because the poor have less access to property to use as collateral for loans. Given this, Athreya notes that the *ex ante* costs of easy *ex post* bankruptcy access falls hardest on poor consumers, and that the countervailing *ex ante* adjustments would be equivalent to taking away 3.51 percent of the household's income, or roughly \$900 for the average household.³⁶⁶ Moreover, these estimates exclude other social deadweight losses that cannot be easily estimated, such as exclusion from credit markets and greater reliance on informal institutions and creditor self-protection.³⁶⁷ Athreya concludes that consumers as a whole are made much worse under a regime of open access to bankruptcy with *ex ante* credit risk adjustment, when compared to a regime of more restrictive access to bankruptcy. Others have similarly estimated substantial social welfare losses as a result of *ex ante* adjustments to *ex post* bankruptcy access.³⁶⁸ While these are obviously rough estimates, they are suggestive of the substantial costs associated with trying to impose an *ex ante* adjustment to the risk of *ex post* bankruptcy losses.

Efficiency will not be achieved by relying solely on *ex ante* marketplace adjustments by creditors to adjust to what is a problem of *ex post* post-contractual opportunism, just as it is obvious that abolishing the *ex post* legal enforceability of contracts would reduce efficiency. If the problem is in fact a problem of post-contractual opportunism, then the optimal response should be to address that problem directly, rather than relying solely on indirect, *ex ante* measures to confront the problem. The failure to

³⁶⁴ See *supra* notes ____-____ and accompanying text.

³⁶⁵ See Kartik Athreya, *The Growth of Unsecured Credit: Are We Better Off?* 87(3) FED. RESERVE BANK RICHMOND ECON. QUARTERLY 11, 27 (Summer 2001); see also *id.* at 29 (noting that interest rates “rise dramatically”) . Athreya estimates that equilibrium interest rates on unsecured credit could be as much as 50% higher as a result of easy access to bankruptcy than otherwise would be the case. See *id.* (estimating an average interest rate of 18.6% on unsecured loans with current bankruptcy regime).

³⁶⁶ Note that this is a prediction about the equilibrium welfare loss from *ex ante* adjustments to predicted bankruptcy losses, not an estimate of the pass-through costs of debt actually discharged under the current bankruptcy system, which has been a hotly contested issue in the context of the current bankruptcy reform debate. See Jack F. Williams, *Distrust: The Rhetoric and Reality of Means-Testing*, 7 AM. BANKR. INST. L. REV. 105, 107 (1999).

³⁶⁷ Athreya, *supra* note, at 29-30.

³⁶⁸ See Satyajit Chatterjee, Dean Corbae, Makoto Makajima, and Jose-Victor Rios-Rull, *A Quantitative Theory of Unsecured Consumer Credit with Risk of Default*, Working Paper No. 02-6 (Fed. Reserve Bank of Philadelphia, May 2002). The authors note that adopting a means-testing requirement for above-median income earners would substantially improve social welfare by increasing credit access and reducing interest rates. See discussion *infra* at notes ____-____ and accompanying text.

address *ex post* problems with *ex post* solutions will result in deadweight loss to the economy and harm to consumers in the form of higher interest rates, higher downpayments (where applicable), less access to credit, higher costs of goods and services, and more onerous credit terms generally. This deadweight loss is imposed on all other consumers in the form of a “bankruptcy tax.”³⁶⁹ Because this risk of post-contractual opportunism is not unique to any identifiable class of consumers, creditors will respond by imposing the bankruptcy tax on all consumers generally.

Raising interest rates *ex ante* also does not solve the moral hazard problem inherent in the current system. Because the right to file bankruptcy cannot be waived by contract, low-risk borrowers cannot sort themselves from high-risk borrowers *ex ante*. This creates an inefficient “pooling” equilibrium, where it is impossible for low-risk borrowers to credibly identify themselves and precommit themselves to remaining low-risk borrowers. Even if a creditor can use some proxy to approximate a borrower’s risk characteristics, there is still the problem of ensuring that the borrower will retain the same low-risk status throughout the lending relationship, rather than suddenly becoming a high-risk borrower due to job loss or the like. The decision to switch from being a low-risk borrower to a high-risk borrower is wholly in the control of the borrower rather than the lender, giving rise to a classic moral hazard problem.

Credit cards are particularly prone to this sort of opportunism. Credit cards are subject to high monitoring costs for issuers, because the debtor has an outstanding line of credit that he can draw on at his discretion. Often the debtor will draw down the line of credit when his financial condition deteriorates.³⁷⁰ Because of this inability to perfectly separate low-risk borrowers from high-risk borrowers, creditors will have to assume that all borrowers are *potentially* high-risk borrowers and act accordingly. For instance, it has been argued that it is because of this inability of low-risk borrowers to credibly distinguish themselves from high-risk borrowers that credit card interest rates remain somewhat “sticky.”³⁷¹ Because credit cards offer an open-ended line of unsecured credit, they are exactly the sort of financial instrument that will be most subject to the moral hazard problems described. Knowing this, credit card issuers are forced to generally keep their interest rates relatively high and discriminate between good and bad credit risks on other card terms, such as length of grace period, annual fees, penalty fees, late charges, and the like.³⁷² To the extent that credit card issuers offer lower interest rates to some borrowers, they do so only to very carefully selected borrowers who can be identified as low-risk and likely to remain as such with a relatively high degree of certainty.³⁷³ Within any consumer segment, however, the existence of the moral hazard problem means that the lender must assume the “worst case” risk exposure within each segment, and price the credit terms accordingly.³⁷⁴ Credit card loans are also relatively small relative to other forms of consumer credit, thus it is rarely economically feasible for

³⁶⁹ See Todd J. Zywicki, *Cramdown and the Code: Calculating Cramdown Interest Rates Under the Bankruptcy Code*, 19 T. MARSHALL L. REV. 241 (1994).

³⁷⁰ See Randall J. Pozdena, *Solving the Mystery of High Credit Card Rates*, 42 FRBSF WEEKLY LETTER 1, 4 (1991).

³⁷¹ See Pozdena, *supra* note, at 2.

³⁷² See Zywicki, *Economics of Credit Cards*, *supra* note, at 124-25.

³⁷³ See Pozdena, *supra* note, at 3.

³⁷⁴ Pozdena, *supra* note, at 2.

credit card issuers to sue and collect on outstanding balances, thus it is difficult for credit card issuers to collect against debtors who misuse their cards.³⁷⁵

Thus, it is possible to take a hands-off approach and rely solely on private marketplace adjustments to respond to the increased risk of post-contractual bankruptcy opportunism that has manifested itself in recent years. In fact, it appears that creditors are already responding to this increased risk by altering their behavior and credit terms. But there is obvious deadweight loss in these adjustments. Both lenders and borrowers as a whole, for instance, would benefit if truly low risks could credibly commit to remaining low risk on their credit cards, rather than being pooled with higher risk borrowers.

It is also possible that advances in technology may make it possible for creditors to monitor borrowers more closely so as to limit the moral hazard problems associated with post-contractual opportunism.³⁷⁶ Lenders have adopted many of these devices as well. Advances in monitoring technology such as the Internet may make it possible for creditors to more accurately gauge a borrower's expected riskiness *ex ante* and to limit *ex post* post-contractual opportunism. Technology also increases the ease with which lenders can share information about borrowers' reliability.

The difficulty with these monitoring techniques is that if applied too rigorously, they can interfere with the usefulness of the credit relationship itself.³⁷⁷ Thus, for instance, a borrower vacationing in a foreign country find great utility in the use of credit cards for conducting transactions, especially in an emergency situation. On the other hand, this type of "surprise" emergency use of the credit card is likely to raise red flags about the riskiness of the transactions being conducted.³⁷⁸ Advances in technology, therefore, can reduce some of the problems of post-contractual opportunism by making monitoring of misbehavior easier. Again, sole reliance on unilateral individual lender self-help is expensive and can interfere with the benefit to consumers. Nonetheless, the bankruptcy problem still remains, and at the current time it is not clear what the end result of technology will be on the ability of creditors to police post-contractual opportunism by borrowers. *Ex ante* contractual adjustments should and will play a role in mitigating the negative effects of rising bankruptcies, but it is inefficient to rely on these adjustments alone.

³⁷⁵ See Zywicki, *Economics of Credit Cards*, *supra* note, at 126.

³⁷⁶ Similar arguments have been offered in related contexts. See, e.g., Ronald Mann, *Information Technology and Non-Legal Sanctions in Financing Transactions*, 54 VAND. L. REV. 1627 (2001) (describing possible applications of information technology to improve monitoring of financial transactions).

³⁷⁷ Anyone who has found himself temporarily unable to use his credit card because of erroneous "fraud alert" will appreciate the difficulties that can be presented by overzealous monitoring of card misuse.

³⁷⁸ This scenario is similar to that in *American Express Travel Related Services Company Inc. v. Hashemi* (*In re Hashemi*), 104 F.3d 1122 (9th Cir. 1996). In that case, the debtor racked up a massive credit card bill while traveling in Europe and then filed bankruptcy on return to the United States. The court noted that this behavior by the debtor was not unprecedented, as he had incurred debts of similar size in the past and had paid them off. Thus, the creditor had no reason to believe that the behavior in this particular situation was unusual. Had the creditor acted more aggressively to limit the debtor's use of the credit card then this would have undermined the usefulness of the card to the borrower in all the prior situations where the debtor in fact intended to pay off the debt.

B. Bankruptcy Reform: Ex Post Responses to an Ex Post Problem

The optimal solution to the bankruptcy crisis, therefore, must combine *ex ante* adjustments with new institutions to prevent *ex post* opportunism. This Section discusses some possible measures that could be taken to reduce the risk of post-contractual opportunism.

The discussion to this point has made clear that the optimal mix of institutions to constrain opportunistic use of bankruptcy has fundamentally changed in recent years. Under current law, the Bankruptcy Code itself does little to constrain debtor opportunism, placing the burden almost entirely on marketplace adjustments, social norms, and residual moral and trust relationships between debtors and creditors. For the reasons that have been described, constraints of norms and reputation no longer function as effectively as they once did. Greater impersonalization of credit relationships, economies of scale in the production of bankruptcies, and a decline in social stigma, have fundamentally altered the bankruptcy landscape. Given these realities, it is myopic to ignore the fact that these changes have increased availability and willingness of individuals to use the bankruptcy system. This failure to recognize and coherently address the problem has resulted in social dead-weight loss and imposed costs on consumers generally.

There are three fundamental policy responses that are appropriate to reduce opportunistic bankruptcy filings, each of which responds to the three trends driving rising bankruptcy filings.³⁷⁹ The first is to readjust the relative costs and benefits of filing bankruptcy. In part, rising bankruptcy filings are a response to changes in bankruptcy's legal regime that have dramatically increased the benefits to debtors from filing bankruptcy. An obvious response is to take appropriate steps to reduce the economic benefits available to bankruptcy filers.³⁸⁰ This section discusses two possible approaches for reducing the economic benefit of bankruptcy—first, applying a means-test to high-income filers to condition their access to bankruptcy and second, adopting reforms to reach debtor wealth where appropriate. Next, this Section will suggest some possible ideas for reversing the decline in personal shame and social stigma associated with filing bankruptcy. Finally, this section will argue that the observed changes in the nature of consumer credit are largely irreversible and will inevitably be accompanied by a larger number of bankruptcies. This section argues, therefore, that an appropriate response to these developments is the need to create new formal institutional “trust substitutes” to replace the decline in informal institutions. At the same time, many of these factors causing increasing bankruptcies have also been economically efficient and have resulted

³⁷⁹ Richard Hynes has suggested that the optimal bankruptcy policy would be to attack opportunism directly by denying relief to any debtor who has caused his own misfortune. See Richard M. Hynes, *Optimal Bankruptcy in a Non-Optimal World*, 44 B.C. L. REV. 1 (2002). Professor Hynes concludes, however, that the optimal bankruptcy system is infeasible given that judges possess limited information about the moral worthiness of each individual debtor and limited borrower self-control. See *id.* at 75. As a result, any response to opportunism will be a second-best response to the problem.

³⁸⁰ Note, however, that it is *not* appropriate to needlessly increase the costs of filing bankruptcy, although this would reduce filings. See *supra* notes ____-____ and accompanying text. On the other hand, it may be appropriate to impose new costs if the offsetting benefit justifies it, such as with the new requirement of the bankruptcy reform act for mandatory consumer credit counseling before a debtor may file bankruptcy. See discussion *infra* at notes ____-____ and accompanying text.

in substantial consumer benefits. Thus, it is essential that in reducing the costs of bankruptcy, reforms do not interfere with these pro-consumer innovations.

Although much of the focus in this Section is on the pending bankruptcy reform legislation, it should be stressed that it is just a partial step toward addressing the factors discussed in this article. One could consider more comprehensive and far-reaching reforms, such as contracting-out of bankruptcy and the like. Given the speculative nature of many of these ideas, however, this article will not address them in detail, but will focus on some of the more important contemporary reform proposals. As has been noted, the traditional model provided a coherent intellectual framework that was implemented in 1978 Code, albeit partially imperfectly. Similarly, as will be seen, the NIE model advanced here similarly provides a guiding framework for many of the reforms offered in the current bankruptcy reform legislation, although the legislation itself only imperfectly reflects these ideas.

1. Adjust the Relative Costs and Benefits of Filing Bankruptcy

At the heart of the problem is the generosity of the American bankruptcy system and its lack of effective safeguards against opportunism. Institutional reform must begin with a readjustment of the relative costs and benefits of filing bankruptcy. As noted, the generosity of the Bankruptcy Code and the absence of any real constraints on opportunism have created an arbitrage opportunity where many can benefit from filing bankruptcy. That they do not testifies to the residual strength of the other constraints on post-contractual opportunism. But the fact that the number of people filing bankruptcy has risen so rapidly in recent years also testifies to the gradual erosion that is taking place in these informal institutions. So long as the economic benefits of filing bankruptcy remain high and the economic costs of filing bankruptcy continue to fall, bankruptcy rates will continue to rise.

Promise-keeping is encouraged by internal beliefs and social norms. But these restraints operate on the margin – meaning that they can be offset by other marginal forces. Put bluntly, it is easier to keep one's promise when it requires foregoing a small benefit but it is more difficult to keep one's promise when it requires foregoing a large benefit. Few people will file bankruptcy if they can gain only \$100 from it, given the time, energy, uncertainty, and threat of social and economic sanction from doing so. If the benefit were raised to \$10,000, then more people would file.³⁸¹ What was once largely inconceivable can become much more palatable as the economic incentives of engaging in the behavior increase.³⁸²

It should be emphasized that some increase in the bankruptcy filing rate will be a natural outgrowth of positive developments in the economy and consumer credit system. The greater impersonalization of credit has arisen as a byproduct of more efficient and comprehensive consumer credit markets. Competition and financial networks are

³⁸¹ See ROBERT H. FRANK, *PASSIONS WITHIN REASON: THE STRATEGIC ROLE OF THE EMOTIONS* 13 (1988). It has been observed that the propensity for individuals to cooperate in economic experiments falls as the rewards to noncooperative behavior rise (i.e., as cooperation becomes more costly). Stated differently, this recognizes that decision-making is based on notions of opportunity cost and relative reward, and not on an absolute scale of values generated by the brain. See Smith, *Reflections*, *supra* note, at 202.

³⁸² This is not to imply that everything has a price; clearly this is not the case. But although distasteful, filing bankruptcy is probably not in the category of behaviors that is priceless.

national in scope. This has led to pro-consumer competition, innovation, and an efficient scale of operations for consumer credit issuers. This has created a more integrated and competitive consumer credit system. Thus, even though this development has made the consumer credit system more impersonal and more prone to opportunism, it is evident that the benefits of a nationwide consumer credit system and heightened competition substantially outweigh the offsetting costs of reduced trust and greater opportunism.

In addition, many of the innovations in the consumer bankruptcy system has made the system more efficient in delivering relief to those who need it. Reduced transaction and information costs have reduced the deadweight loss associated with legitimate filers gaining relief. There is no sensible argument for rationing access to the bankruptcy system on the basis of higher transaction and information costs. For instance, even though attorney advertising has almost certainly increased the bankruptcy filing rate by providing information to potential filers, it would be nonsensical to reduce bankruptcy filings by reducing attorney advertising.³⁸³ If bankruptcies are too high, an appropriate response is to address the problem directly, rather than rationing bankruptcy relief through an irrelevant process such as increasing transaction costs. An efficient bankruptcy system should be judged according to its ability to both deliver relief to those who need it as well as preventing relief to those who do not. Increasing the costs of filing bankruptcy is thus not an appropriate response to excessive bankruptcy filings, even though it is evident that reductions in these costs have done much to increase bankruptcy filings in recent years.

An efficient response to excessive bankruptcy filings should instead focus on making sure that bankruptcy relief is delivered only to those who need it, but not those who do not. There are two possible ways that this could be done. First, the benefits to high-income filers could be reduced by means-testing bankruptcy relief to condition its availability to high-income filers. Currently, high-income filers face few constraints on their ability to discharge their debts in Chapter 7 while retaining all of their income going forward. Second, the legal regime could be changed to reduce the ability of debtors to protect their wealth in bankruptcy. Some of these wealth-protection mechanisms, such as unlimited homestead exemptions, are of long-standing if relatively trivial importance. Others, such as a greater ability to protect vast amounts of retirement savings, are of more recent vintage but are probably of much greater practical importance. This section will briefly discuss both of these possible responses.

a. Reduce the Benefits to High-Income Debtors

In fact, some efforts aimed at reducing some of the more extreme forms of opportunistic bankruptcy have been made in recent years. Each of the past two United States Congresses have passed bills designed to reduce bankruptcy fraud and abuse. These bills focus on a number of important reforms, such as providing for a system of needs-based bankruptcy designed to reduce abuse of the bankruptcy system by high-income debtors with substantial repayment capacity. They also eliminate some of the more noxious forms of bankruptcy fraud and dishonesty, such as concealing income and assets and interfering with creditors' legitimate exercise of their rights.

³⁸³ Leaving aside First Amendment issues, which would presumably prohibit most such regulations.

The cornerstone of the proposed bankruptcy reform legislation is a proposal to “means-test” eligibility of bankruptcy filers for Chapter 7 relief.³⁸⁴ Under means-testing, a debtor would be *presumed* to have to file in Chapter 13 rather than Chapter 7, if she: (1) earns above the state median income, and (2) could repay a substantial portion of her debts out of “disposable income” in Chapter 13. The definition of “disposable income” for means-testing purposes, however, excludes a standard budget for living expenses, adjusted for income and family size, plus all secured debt, priority debt, and several other enumerated expenses such as school and medical expenses. Even if the debtor satisfies these criteria, she would still be entitled to rebut the presumption by explaining to the court any mitigating or other circumstances that make it inappropriate for her to be required to file in Chapter 13 and that she should therefore be allowed to receive a Chapter 7 discharge. A debtor who was means-tested into Chapter 13 thus would not be denied a discharge on account of triggering the means-testing provisions of the code; she would simply have her discharge conditioned on completing a Chapter 13 plan and paying off what she can to unsecured creditors.

The means-testing provisions of the proposed legislation, therefore, are quite mild. Moreover, section 707(b) of the current law requires courts to dismiss a Chapter 7 case where granting relief would constitute “substantial abuse” of the Code. Although case law is somewhat confused on what constitutes substantial abuse,³⁸⁵ it has been established that the primary factor in determining whether “substantial abuse” exists is the debtor’s ability to repay some or all of his debt in Chapter 13.³⁸⁶ Notwithstanding section 707(b), however, there is a widespread consensus that only a trivial amount of abuse is actually caught by the courts and leads to dismissal of the case. In large part this is due to the large number of bankruptcy filings, which makes it practically impossible to monitor the hundreds of thousands of debtors who flow through the bankruptcy courts every year. It is also due to the nature of the complex and multi-factored “totality of the circumstances” test that courts have coalesced upon, which creates confusion and inconsistency about what constitutes substantial abuse in a given case.

The primary effect of the means-testing provisions of the bankruptcy reform legislation, therefore, is *procedural*, in that it carves out a category of cases thought most susceptible to abuse and places the burden on them to explain why they should be permitted to file in Chapter 7 instead of Chapter 13. Debtors who earn below the state median income or who are unable to repay a substantial portion of their debts without significant hardship would be unaffected by the means-testing provisions of the bill.³⁸⁷

³⁸⁴ A detailed examination of the means-testing provisions of the bankruptcy reform legislation is provided in Jones & Zywicki, *supra* note, at 181-208, on which this Section draws. The relevant provision appears as §102 of the Bankruptcy Reform Act. See also REPORT OF THE COMMITTEE ON THE JUDICIARY HOUSE OF REPRESENTATIVES TO ACCOMPANY H.R. 333, BANKRUPTCY ABUSE PREVENTION AND CONSUMER PROTECTION ACT OF 2001 2 (Feb. 26, 2001) (“The heart of H.R. 333’s consumer bankruptcy reforms is the implementation of an income/expense screening mechanism (‘needs-based bankruptcy relief’) to ensure that debtors repay creditors the maximum they can afford.”).

³⁸⁵ See Michael D. Bruckman, Note, *The Thickening Fog of “Substantial Abuse”: Can 707(a) Help Clear the Air?*, 2 AM. BANKR. INST. L. REV. 193 (1994).

³⁸⁶ See, e.g., *In re Lamanna*, 153 F.3d 1, 4 (1st Cir. 1998); *In re Koch*, 109 F.3d 1285, 1288 (8th Cir. 1997).

³⁸⁷ It is estimated that approximately 80% of bankruptcy filers earn less than the median income and so therefore would be eliminated from the means-test on that basis alone. See Jones and Zywicki, *supra* note, at 186-92 (discussing empirical studies).

Thus, the bill is a targeted procedural response to problem of growing bankruptcies by upper middle-class filers who file bankruptcy to escape debts that they have the ability to repay.

It is estimated that approximately 7-10% of bankruptcy filers would satisfy all elements of the means-test under the proposed legislation and be required to file in Chapter 13.³⁸⁸ This amounts to approximately 100,000-150,000 bankruptcy filers per year who would be required to file in Chapter 13. Because the means-test targets those with the highest repayment capacity, by capturing this 7-10% of filers, this would result in a substantial repayment of debt currently discharged in bankruptcy.³⁸⁹ By contrast, under current law, there is no distribution at all in 96% of Chapter 7 cases, and only a trivial distribution in other cases.³⁹⁰

As noted, current law officially mandates that middle-class filers who can repay a substantial portion of their debts in Chapter 13 should be required to do so. In practice, however, the infrequency with which substantial abuse is detected and challenged means that middle-class filers have little to fear from the current law. Means-testing would reduce the benefits that middle-class filers currently gain from the bankruptcy system, thereby reducing the incentives to file bankruptcy. Given the incentives provided under current law, this is a substantial improvement over the current system.

b. Reduce the Benefits to High-Wealth Debtors

Several tools are available to reduce the benefits of bankruptcy to high-wealth debtors. The incentives of high-wealth debtors to file bankruptcy results primarily from property exemptions and exceptions of certain property from the bankruptcy estate, such as ERISA-qualified pension plans.³⁹¹ Given the increasing ability of debtors to act strategically to transfer assets to these exempt and excepted sources as part of pre-bankruptcy planning activities, it may be appropriate to give new statutory and equitable tools to judges to try to reduce these benefits. Two basic categories of approaches are available to address the problem. The first is to create new safeguards to minimize bankruptcy fraud, such as by concealing assets and bad-faith filings. A second approach is to place limits on the amount of property that bankruptcy filers can protect through bankruptcy exemptions.

1. Attack Bankruptcy Fraud and Abuse.—There is a general consensus that bankruptcy fraud is a serious problem in the current system, and that the problem is epidemic in some areas of the country.³⁹² As a result, there is a widespread consensus on the need to weed-out bankruptcy fraud and abuse.

³⁸⁸ See *id.*

³⁸⁹ One estimate concluded that means-tested debtors could repay 64% of their unsecured nonpriority debts, or over \$4 billion, in addition to all of their priority and secured debts. See Jones & Zywicki, *supra* note, at 187.

³⁹⁰ See Michael J. Herbert & Domenic E. Pacitti, *Down and Out in Richmond, Virginia: The Distribution of Assets in Chapter 7 Bankruptcy Proceedings Closed in 1984-1987*, 22 U. RICH. L. REV. 303, 315-16 (1988); see also White, *Personal Bankruptcy Under the 1978 Code*, *supra* note, at 38-39 (estimating average repayment rate of one to two percent in Chapter 7 cases).

³⁹¹ See 11 U.S.C. §510(c); *Patterson v. Shumate*, 504 U.S. 753 (1992).

³⁹² See Tamara Ogier and Jack F. Williams, *Bankruptcy Crimes and Bankruptcy Practice*, 6 AM. BANKR. INST. L. REV. 317 (1998), Craig Peyton Gaumer, *Policing the Bankruptcy System: An Informal Statistical*

One reform included in the proposed legislation would prevent abusive filings through the use of so-called “fractional interests.”³⁹³ In this scheme, a debtor facing foreclosure on his house can “sell” a small fraction of the ownership in his house (such as a 1/32 interest in the property), to a family member or other third-party, who then files bankruptcy. This triggers the automatic stay and delays foreclosure until the creditor and the court can sort out the scam. Indeed, in some cases the sale is to a wholly fictional person, or even a victim of identity theft, in whose name the case is filed.³⁹⁴ In response to the problem of problem of bankruptcy fraud, the bankruptcy reform legislation also adds new resources for the prosecution of bankruptcy crimes and bankruptcy fraud.

It is also widely acknowledged that bankruptcy schedules are riddled with error, fraud, and abuse.³⁹⁵ In some cases the debtor understates his income in order to prevent a “substantial abuse” challenge; in other cases he is simply hiding assets by not declaring them to the bankruptcy court.³⁹⁶ Given the sheer volume of consumer bankruptcy cases, it is impossible for the United States Trustee to investigate even a fraction of bankruptcy fraud that occurs.³⁹⁷ In response to this problem, the bankruptcy reform bill would require modest new safeguards, such as requiring the filing of tax returns with one’s petition, that will help to identify fraud and abuse in the system.³⁹⁸ Finally, the bankruptcy reform legislation would limit repeat filings by extending the eligibility waiting period from six years to eight years.

As noted above, opportunism and abuse are particularly pronounced for credit cards.³⁹⁹ Credit cards offer a line of unsecured credit that can be tapped at the debtor’s discretion, providing borrowers with an opportunity to switch from being a low-risk borrower to a high-risk borrower with no notice. Debtors also have the ability to “load-up” their credit cards on the eve of bankruptcy, especially by buying goods and services that do not qualify as “luxury goods and services.” Because of the unique problems of opportunism presented by credit cards as well as the effect that this has on responsible borrowers, the bankruptcy reform legislation moves in the correct direction by reinforcing protections for credit card issuers from credit card abuse. Current law presumes that a debt incurred for a credit card or a cash advance on a credit card is

Analysis of U.S. Bankruptcy Fraud Prosecutions, 74 AM. BANKR. INST. J. 8 (2000). The Los Angeles area of the Central District of California has been rocked by several notable cases of bankruptcy fraud and criminal prosecutions. See *Los Angeles U.S. Trustee’s Office Receives Fraud-Prevention Award*, 38, No. 8 BANKR. CT. DEC. 3 (Sept. 18, 2001).

³⁹³ See Bankruptcy Reform Act §303 (“Curbing Abusive Filings”).

³⁹⁴ See *EOUST Pilot Study: Consumer Must Soon Show Proof of Identity*, 38(21) BANKR. CT. DEC. 3 (Jan. 15, 2002).

³⁹⁵ Steven W. Rhodes, *An Empirical Study of Consumer Bankruptcy Papers*, 73 AM. BANKR. L.J. 653 (1999).

³⁹⁶ See *Statement of Lawrence A. Friedman, Director, Executive Office for United States Trustees, United States Department of Justice, Before the Subcomm. On Commercial and Administrative Law, United States House of Representatives* (Mar. 4, 2003) (describing debtor who sought to discharge \$650,000 in debt, without disclosing a revocable trust into which he transferred his residence,, personal property, and summer home).

³⁹⁷ See Wayne D. Holly, *Criminal and Civil Consequences of False Oaths in Bankruptcy Help Ensure Reliable Information*, 71-Mar N.Y. ST. B.J. 38 (1999).

³⁹⁸ This provision will help to identify cases where the debtor understates his income or where his reported assets seem suspiciously small in light of his income.

³⁹⁹ See *supra* notes ____-____ and accompanying text.

nondischargeable if it exceeds \$1,000 and was incurred within 90 days of bankruptcy. Under the reform bill, these debts would be presumed nondischargeable if they are for more than \$550 for “luxury goods” incurred within 90 days of filing, and for cash advances of more than \$750 within 70 days of filing.⁴⁰⁰ Perhaps more importantly than these particular protections, however, is the new means-testing regime, which will aid all unsecured creditors in receiving greater distributions in bankruptcy. As noted, given the fungibility of money in a debtor’s budget, the “luxury goods” test is easily evaded, as is the 90 day window. Moreover, as noted, it is often the case that the administrative costs of collecting on a credit card debt are usually high relative to the outstanding debt. By increasing the payout in many cases, means-testing will also tend to increase the protection for credit card lenders, reducing the costs that are passed on to other borrowers.

2. *Place New Limits on Bankruptcy Exemptions.*—A second approach is to limit the benefits of bankruptcy by limiting the amount of exempt property that a debtor can protect in bankruptcy. At least two avenues seem especially appropriate for reform. The first is to rein in the noxious unlimited homestead exemptions in several states, which Congress is doing in the bankruptcy reform legislation. The second is to address new forms of exemption abuse, most notably the increasing use of exempt retirement plans by debtors to retain large amounts of wealth while leaving little for creditors.

The notorious unlimited homestead exemptions available in a handful of states has come in for special criticism in this context. The unlimited homestead exemption has come in for an unusual amount of attention, especially in the popular press.⁴⁰¹ Other exemptions under state law are potentially subject to abuse as well, but in practice courts have been more deferential to protecting large amounts of wealth in homestead exemptions than in other forms of unlimited or high-value exemptions.⁴⁰² Some cases involving homestead exemptions have been quite egregious, allowing debtors to pour massive amounts of wealth into a homestead exempt in bankruptcy.⁴⁰³ In practice, however, the impact of the unlimited homestead exemption on bankruptcy filings is relatively trivial. Fay, Hurst, and White, for instance, conclude that were a cap of \$100,000 to be imposed on the amount of equity one could protect in a homestead, this would reduce bankruptcy filings only about 6,000 per year (out of 1.5 million).⁴⁰⁴ The reason for this is obvious—few bankruptcy filers have more than \$100,000 in equity in their homes. As a result, while symbolically significant, capping unlimited homestead exemptions would have little effect on the bankruptcy filing rate. On the other hand, a systematic ratcheting down of all homestead exemptions to much lower levels could

⁴⁰⁰ Bankruptcy Reform Bill §310.

⁴⁰¹ For a comprehensive analysis of the empirical and political debates regarding homestead exemptions, see G. Marcus Cole, *The Federalist Cost of Bankruptcy Exemption Reform*, 74 AM. BANKR. L. J. 227 (2000).

⁴⁰² See DAVID G. EPSTEIN, STEVE H. NICKLES, AND JAMES J. WHITE, BANKRUPTCY §8-32, p. 650 (1993).

⁴⁰³ See *GAO Finds Some Florida and Texas Debtors Have Expensive Homes*, CONSUMER BANKR. NEWS, Aug. 12, 1999, at 1, 6; *Protecting Rich Bankrupts*, N.Y. TIMES, Aug. 13, 1999, at A-20.

⁴⁰⁴ Fay, Hurst, and White, *supra* note, at 715-16.

dramatically decrease total filings.⁴⁰⁵ Even less common is the concern that bankruptcy debtors will relocate on the eve of bankruptcy in order to take advantage of other states' unlimited homestead exemption.⁴⁰⁶ Reducing the amount of wealth that can be protected in a Chapter 7 filing by reducing bankruptcy exemptions would also tend to cause a substitution by filers from Chapter 7 to Chapter 13, which might increase returns to creditors and reduce some of the benefits of filing bankruptcy.⁴⁰⁷

Moreover, it is well-established that there is no necessary problem with pre-bankruptcy planning by debtors to maximize the amount of wealth shielded by exemptions. Courts occasionally have been willing to disallow a debtor's claimed exemption or denied discharge based on overzealous use of pre-bankruptcy planning. Such incidents, however, are rare and are invoked in only the most extreme cases and thus provide little deterrence to future parties' aggressive invocation of exemptions.⁴⁰⁸ To the extent that bankruptcy law (or state law) provides multiple categories of property eligible for exemptions, debtors will usually be able to easily convert nonexempt property to exempt property on the eve of bankruptcy and thereby maximize the financial advantages from filing bankruptcy.

Given the real and perceived abuse of the unlimited homestead exemption under current law, the proposed bankruptcy reform legislation would eliminate two of the most egregious forms of abuse.⁴⁰⁹ First, any debtor who moved from a state with a limited exemption to a state with an unlimited exemption would face a 40 month waiting period before she could avail herself of the new state's homestead exemption. By imposing a waiting period, this provision would eliminate the incentives for a debtor to relocate on the eve of bankruptcy in order to gain the benefits of a more generous homestead exemption. Second, the legislation would permit a ten year statute of limitations for claims that a debtor had fraudulently manipulated her homestead exemption as a fraudulent transfer.⁴¹⁰ On the other hand, the legislation does not go so far as to impose a flat cap on the amount of equity a debtor can protect in his homestead exemption.⁴¹¹ By preventing eve of bankruptcy relocation and fraudulent use of the homestead exemption, however, the legislation does eliminate the two most glaring abuses.

⁴⁰⁵ See Lehnert and Maki, *supra* note, at 31 (concluding that reducing all state homestead exemptions to average level of lowest quartile of states would be predicted to reduce filings by 18%).

⁴⁰⁶ See Ronel Elul and Narayanan Subramaniam, *Forum-Shopping and Personal Bankruptcy*, Working Paper 99-1, Department of Economics, Brown University (1999) (finding that a small number of individuals relocate from low-exemption to high-exemption states for purposes of filing bankruptcy).

⁴⁰⁷ See Ian Domowitz & Sartain, *Determinants*, *supra* note, at 404.

⁴⁰⁸ See Todd J. Zywicki, *Rewrite the Bankruptcy Laws, Not the Scriptures: Protecting a Bankruptcy Debtor's Right to Tithe*, 1998 WIS. L. REV. 1223, 1264, n.170 (1998).

⁴⁰⁹ Bankruptcy Reform Act §307.

⁴¹⁰ Bankruptcy Reform Act §308.

⁴¹¹ It can be argued that this decision is defensible in that it appears that most of the cost associated with generous state exemption policies are borne by other consumers within the state, in terms of less access to credit, lower loan approval rates, and higher interest rates, than for residents of states with lower exemption rates. See Gropp, Scholz, and White, *supra* note, at 217. Because both the benefits and costs of a state's homestead exemption policy remain within the state and do not spillover onto residents of other jurisdictions, this policy choice arguably is protected by traditional principles of federalism. As noted, the legislation would impose a new 40 month waiting period, thereby eliminating the abuse that may flow by an individual borrowing funds under one state's exemption policy and then "deadbeat jumping" to another state prior to filing bankruptcy.

Perhaps more problematic than traditional forms of exempt property, however, is the increasing ability of bankruptcy debtors to protect substantial amounts of retirement savings from creditors. Unlike other forms of wealth, it is not that unusual for a middle-class or upper-middle class bankruptcy debtor to have accumulated tens or hundreds of thousands of dollars in a retirement account at the time of bankruptcy. Preferential tax treatment and the ability of invested funds to grow tax-free provide great opportunity for the accumulation of wealth in retirement plans. Although only ERISA-qualified pension plans are excepted from the bankruptcy estate,⁴¹² states increasingly are adding other forms of retirement plans to their lists of exempted property protected in bankruptcy.

Courts appear to be becoming increasingly aware of the potential for high-wealth debtors to use bankruptcy to discharge debts while protecting substantial amounts of wealth in excepted or exempt pension plans. As Bankruptcy Judge Ninfo observed in a case decided a few years ago, “[N]otwithstanding that many debtors have such substantial unsecured consumer debt, few seem to own (or report) any significant non-exempt tangible personal property, but many report substantial exempt retirement funds (IRA, 401K or Keough accounts).”⁴¹³ In that case, for instance, one of the debtors was a successful doctor who had amassed interests in IRA, ERISA, Keough, and other exempt pension plans of over \$390,000, and nonetheless sought relief in Chapter 7.⁴¹⁴ The Bankruptcy Court took the debtor’s large exempt pension assets into account in dismissing the case for substantial abuse, a decision that was later affirmed by the Second Circuit.⁴¹⁵ Other cases have involved Chapter 7 debtors who had accumulated \$200,000,⁴¹⁶ \$285,000,⁴¹⁷ and \$96,000⁴¹⁸ in exempt pension plans. In another case, the debtor substantially increased his contributions to his pension plan from 6% of his salary to 15% of his salary in the month preceding bankruptcy (and ten days after his lawyer began drafting his bankruptcy petition).⁴¹⁹ In that case, the court observed that given that the “Debtor increased his pension contributions to the maximum amount only one month prior to filing bankruptcy, when he had contributed only one-fourth of that amount for one and one-half years before, smacks of abuse.”⁴²⁰

Another case dealt with a doctor forced to file bankruptcy in response to lawsuits by several patients for sexual misconduct.⁴²¹ The debtor filed bankruptcy in Chapter 13 in order to avail himself of the super-discharge to discharge these claims.⁴²² Although the plaintiff’s sought \$160 million in damages for debtor’s intentional sexual abuse, debtor proposed a Chapter 13 plan to pay them \$45,000 over a five-year plan period. At

⁴¹² See 11 U.S.C. §510(c); *Patterson v. Shumate*, 112 S. Ct. 2242 (1992).

⁴¹³ *In re Carlton*, 211 B.R. 468, 475 (Bankr. W.D. N.Y., 1997).

⁴¹⁴ *Carlton*, 211 B.R. at 468.

⁴¹⁵ *Kornfield v. Schwartz*, 164 F.3d 778, 784 (2d Cir. 1999) (holding that even though the pension plan was exempt property, the Bankruptcy Court acted within its discretion in considering it under the totality of the circumstances test for substantial abuse).

⁴¹⁶ *In re Summer*, 255 B.R. 555, 558 (Bankr. S.D. Ohio, 2000).

⁴¹⁷ *In re Dabbas*, 2000 WL 33672948 (Bankr. D. Utah, Aug. 24, 2000). The court made no mention of the pension in dismissing the case for substantial abuse.

⁴¹⁸ *In re Haddad*, 246 B.R. 27, 35 (Bankr. S.D. N.Y. 2000).

⁴¹⁹ *In re Aiello*, 284 B.R. 756 (Bankr. E.D. N.Y. 2002).

⁴²⁰ *Id.* at 764.

⁴²¹ *Solomon v. Cosby*, 67 F.3d 1128 (4th Cir. 1995).

⁴²² 11 U.S.C. §1328(a).

the same time, he held three exempt IRA accounts with a total value of \$1.4 million.⁴²³ Notwithstanding the disparity, the court in that case held that debtor was not required to include any of the \$1.4 million or income derived from it in his “disposable income” for purposes of his plan payment obligations.

In each of these cases, courts have confronted the growing problem of debtors filing bankruptcy notwithstanding the fact that they own substantial wealth in the form of exempt retirement assets. While the results are mixed, it shows a greater judicial awareness of the ability to protect large amounts of wealth from creditors. Unfortunately, the bankruptcy reform legislation would move the law in the opposite direction, by creating greater protections for retirement savings.⁴²⁴ Thus, while the abuse of the unlimited homestead exemption is the most notorious form of exemption abuse, other forms have developed in recent years as well. Given the growing sophistication of high-wealth debtors advised by attorneys to engage in pre-bankruptcy planning to maximize exempt assets, courts should be aware of the incentives for high-wealth debtors to file bankruptcy and to protect their exempt assets.

2. Reversing the Decline of Social Stigma

It is difficult to know what is to be done to reverse the decline in social stigma that has generated much of the increase in bankruptcy filing rates. In fact, the powerful restraints imposed by personal shame and social stigma made possible the implementation of the exceedingly generous bankruptcy system that has prevailed in recent decades without a complete collapse of the bankruptcy system.⁴²⁵ In recent years, however, the decline of these central constraints has illuminated the incentives created by the bankruptcy system. In part, this has made necessary a tightening of the bankruptcy laws. But in part it also spotlights the general downward trend in social stigma that has developed in recent years. As discussed, this has been the result of many factors, most of which go beyond the scope of this article. This section will discuss some of the measures that might be taken to help reinstate the stigma of bankruptcy.

a. The Nature of the Problem

Some of these factors that have led to increasing bankruptcy filing rates are inevitable outgrowths of the increasing complexity and large population of the economy and civil society. Thus, the decline of face-to-face credit relations in favor of less relationship-dependent credit was likely inevitable as the result of advances in technology and finance theory, as well as increased individual migration, that substantially increased the competitive attractiveness of alternative forms of credit. In turn, this development would have the predictable consequence of altering the traditional

⁴²³ *Solomon*, 67 F.3d at 1134 (Michael, J., dissenting).

⁴²⁴ Bankruptcy Reform Legislation §224.

⁴²⁵ An analogy is the well-established finding that voluntary norms of tax compliance substantially reduce the amount of resources that the Internal Revenue Service has to expend on audits, enforcement, litigation, and other compliance measures. If voluntary tax compliance were to fall, this would require greater expenditures on tax-compliance. See Eric A. Posner, *Law and Social Norms: The Case of Tax Compliance*, 86 VA. L. REV. 1781 (2000); James Andreoni *et al.*, *Tax Compliance*, 36 J. ECON. LIT. 818 (1998).

lending relationships between debtors and lenders and the ability of lenders to police opportunistic behavior.

For similar reasons, the discipline of repeat dealings no longer imposes as powerful of a constraint as before. As noted, the number of sources of credit options has increased as the size of the consumer credit market has increased. This has substantially decreased the ability of any creditor to be able to punish debtors who defaulted on the debts they owed. In addition, the general unhooking of the credit relationship from a retail goods relationship has further reduced the control exerted by creditors, as retailers have no reason to refuse continued dealings with debtors who default on their creditors.⁴²⁶

Although social trust and economic institutions are substitutes across many margins, they are *complements* across many margins as well. Thus, for instance, high-trust societies on average also tend to have more reliable contract enforcement mechanisms, and less-corrupt and more democratic forms of government.⁴²⁷ In a fundamental sense, all of these institutions rest on a foundation of reciprocity, mutual respect, and promise-keeping. Thus, habits of reciprocity developed in one of these areas can be expected to spill over into improving the operation of other areas.

Given the complementary nature of institutions and social norms, this provides an independent reason for placing greater legal constraints on opportunistic use of the bankruptcy system.⁴²⁸ In a high-trust society such as America where laws tend to have a high degree of legitimacy, placing limits on opportunistic promise-breaking will tend to provide moral support for the primacy of promise-keeping as a social value. Thus, means-testing and other institutional innovations will tend to signal the public consensus that bankruptcy is a serious step, freighted with moral and economic consequences, and not one that should be entered into opportunistically. By shoring up these social norms, this should release some of the pressure imposed on formal institutions to police opportunism. Changes in the legal regime, therefore, can complement the social norm of promise-keeping by sending a moral signal regarding the value placed upon this norm.

Indeed, by reducing abuse and by reducing the public perception of widespread abuse of the system, narrowly-tailored bankruptcy reform will tend to increase support for the bankruptcy system as a whole.⁴²⁹ By reserving bankruptcy relief for those who need it and preventing abuse by those who do not, the reform measures discussed will increase public confidence that the system is operating properly to forgive those who need it. Measured reforms to reduce abuse, therefore, will help to head-off more aggressive and sweeping changes later that would attack opportunistic and legitimate bankruptcy filers equally.

⁴²⁶ Note, by contrast, that retailers are *not* indifferent to debtors who bounce checks, thereby defaulting on the promise represented by a personal check. In the check-writing situation the retailer bears the cost of the uncollectable check; by contrast, they feel no pain when the debtor defaults on a credit card or some other credit obligation. Thus, it is not surprising to see small retailers post the names of check-kitters who they will exclude, but do not similarly post the names of credit card defaulters.

⁴²⁷ See Paul J. Zak and Stephen Knack, *Trust and Growth*, 111 *ECON. J.* 295 (2001).

⁴²⁸ See *supra* notes ____-____ and accompanying text for a description of some of the institutional proposals.

⁴²⁹ Cf. Posner, *Tax Compliance*, *supra* note (noting that transparent tax shelters and other obvious abuses of the tax system undermine faith in the fairness and integrity of the tax system and thereby reduce voluntary compliance).

Societal patterns of cooperation or noncooperation usually develop over long periods of time and can be very difficult to change. “Trust and distrust feed upon each other,” Matt Ridley observes.⁴³⁰ “Stocks of social capital, such as trust, norms, and networks, tend to be self-reinforcing and cumulative. Virtuous circles result in social equilibria with high levels of cooperation, trust, reciprocity, civic engagement, and collective well-being. These traits define the civic community,” writes Robert Putnam. “Conversely,” he continues, “the absence of these traits in the *uncivic* community is also self-reinforcing. Defection, distrust, shirking, exploitation, isolation, disorder, and stagnation intensify one another in a suffocating miasma of vicious circles.”⁴³¹ Thus, undermining habits of reciprocity in commercial exchange will tend to erode the values of reciprocity and trust in social, economic, and political relations.⁴³²

Given the diffuse and wide-ranging nature of the changes, it is difficult to identify what to do in order to reverse this social slide. Few theorists have provided persuasive prescriptions as to how to build social trust or to reverse a decline in social trust.⁴³³ On the other hand, if the change is in part merely generational, then it is possible that the ascendancy of a new generation into positions of political and economic leadership will help to reverse the trend.

In fact, there is some evidence that this generational change may already be having some effect. Whereas baby boomers have filed bankruptcy at much higher rates than the rest of the population at large at every stage of their life-cycle, the early evidence is that per capita filings among so-called “Generation X” have actually fallen from that of the baby boomers at the same stage of their life cycle.⁴³⁴ And, in general, members of so-called “Generation X,” for instance, appear to be more financially and socially responsible than the Baby Boom generation, which may reverse or slow some of the baby boomer’s effects on changing social norms regarding bankruptcy.⁴³⁵ On the other hand, although Generation X’s bankruptcy filing rate is lower than the boomers, it still remains high by historical standards, suggesting that generational change alone will not solve the underlying bankruptcy crisis.⁴³⁶

The details of this debate go well beyond the scope of the current discussion. What is relevant for the current discussion is that it appears that the social stigma associated with filing bankruptcy has declined in recent years, and that this decline is related to many factors. The permissiveness of the bankruptcy law undoubtedly has contributed to the problem by raising the cost of personal responsibility, effectively penalizing those who forego the incentives for opportunism. As noted, technological change has contributed to the problem as well by making credit more impersonal in nature. But much of the decline can be attributable to deep-seated changes American

⁴³⁰ RIDLEY, ORIGINS OF VIRTUE, *supra* note, at 250.

⁴³¹ PUTNAM, MAKING DEMOCRACY WORK, *supra* note, at 177.

⁴³² Frank Buckley refers to this effect as creating “distrust externalities.” Buckley, *Debtor as Victim*, *supra* note, at 1086.

⁴³³ See Stephen Knack and Paul J. Zak, *Building Trust: Public Policy, Interpersonal Trust, and Economic Development*, 10 S. CT. ECON. REV. 91 (2003) (identifying investments that can help to build social trust).

⁴³⁴ Sullivan, Thorne, and Warren, *supra* note (noting a 7.2% decrease in the rate at which debtors under the age of 25 file bankruptcy from boomers to Generation X).

⁴³⁵ See Zywicki, *Bankruptcy Law as Social Legislation*, *supra* note, at 412.

⁴³⁶ See Sullivan, Thorne, and Warren, *supra* note.

society regarding attitudes toward personal responsibility and the like. If so, it is difficult to know what can be done to reverse the trend.

b. What is to Be Done?

Despite the deep-seated nature of the changes under consideration, there are several things that could be done to offset some of the decline in social norms that have manifested themselves in higher bankruptcy filings. Nonetheless, there are some tangible reforms that might stop or slow the slide in social norms regarding bankruptcy.

For instance, the drafters of the 1978 Code sought to eliminate the stigma traditionally associated with filing bankruptcy.⁴³⁷ In so doing, they underestimated the probability of debtor opportunism, and the effect this value-neutral approach to bankruptcy would have on social norms. It may be worth reconsidering this conscious decision of the 1978 Code to de-stigmatize bankruptcy and to de-emphasize the moral qualities of bankruptcy.

The bankruptcy reform legislation contains a requirement that debtors seek mandatory consumer credit counseling in order to try to work out a voluntary repayment plan with creditors before they can file for bankruptcy.⁴³⁸ This provision has been strongly supported, even by critics of bankruptcy reform generally.⁴³⁹ Although this provision would increase the cost of filing bankruptcy, it is likely that these costs would be outweighed by the benefits of the provision, both in terms of its direct benefits as well as the effect it may have on buttressing social norms related to bankruptcy.

This requirement will reaffirm the social value of paying one's debts. More pragmatically, it will also provide a salutary independent check on the natural incentives that lawyers hold to stampede their clients into bankruptcy without fully explaining the full consequences of filing or the alternatives to bankruptcy a debtor may have. Lawyers only get a fee from the debtor if she files bankruptcy; if the debtor instead agrees to a voluntary repayment plan with her creditors, then the lawyer receives no fee. This provides lawyers with a strong incentive to steer debtors toward bankruptcy, even if it is not in their clients' best interests.⁴⁴⁰ Given that lawyers and lawyer advertising is one of the most common sources of information about bankruptcy, the problems created by these incentives can be troublesome. Thus, the debtor may not be fully aware of her options and the lawyer can use this ignorance to steer her toward bankruptcy. Mandatory credit counseling will ensure that debtors receive advice from a party other than an attorney, creating an important gate-keeping function that will reduce at least some filings.

⁴³⁷ See *supra* notes ____ - ____ and accompanying text.

⁴³⁸ See Bankruptcy Reform Act §106. This provision has been part of all of the various iterations of the bankruptcy reform legislation over the past several years. See SKEEL, *supra* note, at 207-08 ("From the earliest days of the [reform] debate, the bankruptcy legislation included provisions requiring every debtor to submit to credit counseling before filing for bankruptcy, and again after the conclusion of the bankruptcy case.").

⁴³⁹ See SKEEL, *supra* note, at 207-08 (describing comments of Professor Karen Gross and lawyer Henry Sommer). On the other hand, some leading bankruptcy scholars have criticized this requirement as unnecessarily increasing the cost and complexity of seeking bankruptcy relief. See *id.* See also David Wessel, *The Muddled Course of Bankruptcy Law*, WALL ST. J., Feb. 22, 2001, at p. A1, available in 2001 WL-WSJ 2855047 (quoting Professor David Skeel).

⁴⁴⁰ See Braucher, *Lawyers*, *supra* note; SULLIVAN, ET AL., AS WE FORGIVE, *supra* note.

Academic research indicates that bankruptcy lawyers are aware that debtors feel a residual duty of reciprocity to creditors, and that attorneys believe that it is their obligation to reduce this sense of obligation. Debtors' attorneys seem to be on average far more hostile toward creditors than are their clients and are especially skeptical of their clients' belief that they owe a moral obligation to their institutional creditors. Thus, Braucher's interview subjects complain strongly about their clients' belief that they have a moral obligation to repay the debts that they have incurred. Much of the counseling that goes on between debtors' attorneys and their clients seems to revolve around this desire to defeat the client's moral desire to repay his debts so as to ameliorate their concerns about filing bankruptcy. One lawyer observed, "[S]ome people feel there is a moral issue; frankly I don't."⁴⁴¹ Another lawyer stated, "My attitude is – the law is there. The credit card companies charge 20% interest. Discharge is a risk of doing business. I don't feel bad about it. Some debtors feel so harassed. Some debtors say they feel bad about discharging debt, and I wonder if they do. Some are overly emotional, and I'm thinking, 'What's the big deal?' Especially with credit cards – it's not like a friend or a relative."⁴⁴²

Many attorneys attack the moral and trust basis of the debtor-creditor relationship by contrasting this obligation with others that are generally regarded as having greater moral weight. "A number of lawyers in the study," Braucher reports, "said that they find themselves trying to talk debtors out of [the desire to repay their debts in] chapter 13. They use such tactics as raising the question of their clients' moral obligations to their families, especially to their children, in order to diffuse clients' sense of moral obligation to repay creditors."⁴⁴³ When the moral obligation to pay creditors, especially distant institutional creditors, is pitted against the moral obligations owed to one's family, it is evident that the latter obligation will almost always prevail.⁴⁴⁴ Requiring credit counseling before filing bankruptcy will thus allow the debtor to gain the advice of an alternative source other than a lawyer, thereby potentially strengthening any determination a debtor may have to pay his debts rather than file bankruptcy. This will help to buttress the value of traditional social norms against the pressures of the debtor's and lawyer's self-interest.

Means-testing also formalizes the requirement that bankruptcy filers have an obligation to repay their debts to the extent that they reasonably can, thereby reinforcing the social disapproval of bankruptcy by unequivocally stating the moral obligation of debt repayment.⁴⁴⁵

3. Increasing Use of Formal Institutions as Trust Substitutes

⁴⁴¹ Braucher, *Lawyers*, *supra* note, at 523.

⁴⁴² Braucher, *Lawyers*, *supra* note, at 563.

⁴⁴³ Braucher, *Lawyers*, *supra* note, at 509. This statement of the position is consistent with the views expressed in the Bible, which command a debtor to repay his creditors, but excuse him from doing so if it would cause great harm to his family. See Zywicki, *With Apologies to Screwtape*, *supra* note, at 613.

⁴⁴⁴ For an explanation as to why this is the case, see Todd J. Zywicki, *Evolutionary Psychology and Social Science*, 13 HUMANE STUDIES REV. 1 (2000), available in <http://www.theihs.org/libertyguide/hsr/>.

⁴⁴⁵ See Jones and Zywicki, *supra* note, at 191; see also Richard M. Hynes, *Non-Procrustean Bankruptcy* (Forthcoming 2003).

In large part increased bankruptcy filings are a natural byproduct of the modern commercial economy. Greater population heterogeneity, greater individual mobility, and greater impersonalization of credit relationships have broken down many of the traditional extralegal constraints that limited full opportunistic use of the bankruptcy system. Many of these factors are irreversible; nor would it be wise policy to try to reverse them given the positive effects they have had on economic efficiency and individual empowerment.

At the same time, dramatic and irreversible shifts in commercial relationships are not unique to the current period. The advent of money, printing, and many other technological and economic innovations had exerted even greater impact on the commercial system for centuries.⁴⁴⁶ Economic history reveals important lessons about how commercial institutions have evolved over time in response to these developments, lessons that are suggestive about appropriate responses in the current environment.

As discussed, increased population mobility and general changes in social norms have eroded the traditional stigma attached to filing bankruptcy, especially among middle-class families. In addition, the transition from local, face-to-face consumer credit networks to impersonal national networks has reduced the trust relationships and reputation-based sanctions that discouraged bankruptcy filings. In short, the same pressures that led to the erosion of trust-based governance institutions for consumer credit and credit reporting are undermining the trust-based social institutions that traditionally discouraged opportunism in the bankruptcy system. The lessons of economic history, therefore, is that formal institutions should be altered to fill the gap created by receding informal norms. Just as it would have been inefficient to try to run a national system of consumer credit on an informal, local system of consumer reputation monitoring, it is becoming increasingly untenable to try to govern the American consumer bankruptcy system purely on the basis of informal norms, social stigma, and personal shame.

Where informal institutions weaken, the efficient response historically has been to devise formal “trust substitutes” to supplement and replace them.⁴⁴⁷ This logic of creating new institutional “trust substitutes” is the animating logic of the proposed bankruptcy reform legislation. Innovations such as means-testing, mandatory consumer credit counseling, and the like, can be seen as institutional responses to declining social norms that traditionally eschewed bankruptcy and encourage debt repayment. Given the incentives provided by the law to file bankruptcy, however, these norms are losing strength over time. The bankruptcy reform bill contains several crucial innovations that can be understood as developing new “trust substitutes” that amend the existing institutional framework based on the recognition that there has been an erosion in the informal institutions that traditionally constrained bankruptcy filings.

The provision for means-testing Chapter 7 eligibility in the bankruptcy reform legislation is illustrative. Traditionally, bankruptcy opportunism was constrained by informal measures such as personal shame and social stigma. As society has become larger and more heterogeneous, however, these traditional norms have weakened. It was once possible to rely on broadly-accepted principles of “bourgeois virtue” that praised

⁴⁴⁶ See ROBERT WRIGHT, *NONZERO: THE LOGIC OF HUMAN DESTINY* (2000).

⁴⁴⁷ See discussion at *supra* notes ____-____ and accompanying text.

honesty and personal responsibility, and condemned bankruptcy and other forms of reckless behavior.⁴⁴⁸ Today, however, that consensus has weakened, creating a need for formal institutional trust substitutes. Moreover, as noted throughout, social mobility and technological innovation has brought about a general decline in the ability and incentives of creditors to monitor debtor misbehavior and to constrain bankruptcy filing. This has broken down historic systems of repeat-dealing and localized reputation-based networks, thereby reducing the efficacy of these informal systems in constraining opportunistic behavior.

Given this reduction in the effectiveness of informal institutions such as shame and stigma, the lessons of economic history are clear—the appropriate response is to devise formal “trust substitutes” that substitute for the informal institutions that they replace. Just as the credit bureau came to replace the system of local gossip and reputation, so too is it necessary to devise more formal and abstract systems to deal with the increasing problem of consumer bankruptcy. Means-testing, therefore, stands on the premise that there has been a change in the constraining effect of informal norms and that this change necessitates an appropriate institutional response in the form of a “trust substitute.” Opponents of means-testing, by contrast, have failed to recognize that these informal institutions have eroded over time, and that therefore, new institutions must be devised to take their place and to perform the functions that they once served.

The bankruptcy reform act’s requirement that a debtor first seek credit counseling before filing bankruptcy is also justified in this light. In the past, it could have been assumed that most debtors had a great reluctance to file bankruptcy except as a last resort. As a result, it could be expected that most debtors would first seek to repay their debts voluntarily and would support a consensual repayment plan through consumer credit counseling if possible. Thus, there was little benefit to requiring consumer credit counseling as a prelude to bankruptcy. In the current environment, however, this is no longer the case. Given the lack of confidence that debtors will first seek to voluntarily repay their debts before filing, or that lawyers will direct appropriate clients to consumer credit counseling before filing, it is now appropriate to mandate that the debtor seek consumer credit counseling before filing bankruptcy. Again, this is a natural and practical response to create a more formal institutional system to perform the function that informal social norms historically performed.

Another substitute for trust in contractual relations is the use of hostages or security interests to constrain borrower opportunism.⁴⁴⁹ Security interests and hostages reduce the benefit of bankruptcy by allowing the creditor to attach specific property, rather than being subject to the debtor’s discharge of all obligations in bankruptcy. Even if the creditor is not forced to actually repossess or foreclose on the security interest, its power to do so gives the creditor leverage to increase their ability to collect through a redemption or reaffirmation.⁴⁵⁰ In fact, the increased use of home equity loans in recent years may already evidence a greater reliance on security interests to constrain borrower

⁴⁴⁸ See Donald McCloskey, *Bourgeois Virtue*, 63 AM. SCHOLAR 177 (1994).

⁴⁴⁹ See Kronman, *Contract Law*, *supra* note, at 5 (suggesting that use of security is a substitute for “union,” i.e., trust, to increase the reliability of contracts); *id.* at 27 (noting that collateral provides mechanism for collection in bankruptcy).

⁴⁵⁰ See Scott F. Norberg, *Consumer Bankruptcy’s New Clothes: An Empirical Study of Discharge and Debt Collection in Chapter 13*, 7 AM. BANKR. INST. L. REV. 415, 421-25 (1999).

opportunism. The steady growth of home equity credit is suggestive of efforts to use secured credit as a mechanism to substitute for the uncertainty of unsecured debt.⁴⁵¹ So long as minimal restraints on the opportunistic use and discharge of unsecured credit remain in place, it is likely that this growth in secured credit may continue.

Thus, the innovations in revised Article 9 of the U.C.C. appear to be appropriate so as to reduce the cost and increase the efficiency of secured credit. In general, a central purpose of these revisions was to ease the ability of creditors to take and enforce security interests in personal property.⁴⁵² Innovations in technology may further reduce the costs of taking and enforcing security interests by reducing the costs of providing notice of one's security interest to third-parties as well as protecting the value and safety of one's security interest. For instance, advances in information technology may make it easier for a lender to identify the whereabouts of a personal property or to restrict improper sale. Centralized electronic databases may relieve the confusion and cost associated with state titling laws and security interest recordation. Similarly, it may become less costly for a secured lender to identify damage to the collateral or failure of the debtor to adequately protect the collateral by failure to carry adequate insurance. All of these factors tend to reduce the cost of creating and enforcing security interests in personal property, thereby generally making secured lending arrangements more feasible. The expansion of secured lending to new frontiers may thereby serve as a "trust substitute" by making security interests more feasible.

By contrast, this suggests that reforms advocated by the National Bankruptcy Review Commission to interfere with security interests in consumer credit markets should be resisted. For instance, the NBRC would have permitted the avoidance of any consensual security interest on any household goods worth less than \$500.⁴⁵³ By making it more difficult to take and enforce a security interest in consumer durables, this provision would further increase the benefit to debtors of filing bankruptcy. The National Bankruptcy Review Commission also recommended reinstating the dischargeability of student loans by repealing Section 523(a)(8) of the bankruptcy code.⁴⁵⁴ By making this large unsecured obligation dischargeable, adopting this recommendation would dramatically increase the benefit to middle-class university and professional school graduates from filing bankruptcy. Finally, the NBRC recommended the repeal of the states' power to opt-out from the federal exemption regime, thereby making the exemptions for all states uniform.⁴⁵⁵ The NBRC's recommendations also would add new exemptions or expand the generosity of current exemptions. In general, the federal property exemptions are more generous than the state exemptions; as a result,

⁴⁵¹ This development probably also reflects the fact that mortgage-based lending is more responsive to changes in the underlying cost of funds. See note _____. Given the low interest rates of recent years, rates on home equity loans probably have fallen more rapidly than for unsecured credit, leading to a substitution toward greater use of this credit. If interest rates begin to rise again, however, then the opposite effect should occur, leading to a substitution toward unsecured credit. See ALEXANDER RASKOVICH AND LUKE FROEB, HAS COMPETITION FAILED IN THE CREDIT CARD MARKET? (U.S. Dep't of Justice, Economic Analysis Group Discussion Paper EAG 92-7, 1992).

⁴⁵² See UNIFORM COMMERCIAL CODE §9-101, Official Comment.

⁴⁵³ NATIONAL BANKRUPTCY REVIEW COMMISSION, RECOMMENDATIONS TO CONGRESS, Recommendation 1.3.4. Current law permits only the avoidance of judicial liens on this property.

⁴⁵⁴ *Id.* Recommendation 1.4.5.

⁴⁵⁵ *Id.* Recommendation 1.2.1.

this reform would increase the economic benefit of filing bankruptcy for many people. Indeed, one study estimates that this change would increase the annual bankruptcy filing rate by 15.8 percent, or roughly 205,000 per year.⁴⁵⁶ On the other hand, the Commission also recommended placing a \$100,000 cap on the homestead exemption, thereby reducing the attractiveness of bankruptcy in the handful of states with an unlimited homestead exemption. Although this would reduce the economic benefit from filing bankruptcy, few debtors have over \$100,000 of equity in their homes or dischargeable debt in excess of \$100,000. As a result, it is estimated that the cap would be predicted to decrease bankruptcy filings by less than 0.5 percent—or roughly 6,000 filings per year.

VI. Conclusion

Science proceeds through a process of hypothesis-testing and efforts to refine scientific models to better account for the elements of the world it seeks to explain. For many years the traditional model of consumer bankruptcy performed this function well, generating important insights about the bankruptcy system and the economy more generally. The traditional model gained a consensus of adherents, including the most distinguished scholars, practitioners, and judges in the country. Indeed, the traditional model is embedded in the 1978 Bankruptcy Code itself.

During the past twenty-five years, however, the traditional model has failed to accurately explain the world. We are confronted with a fundamental anomaly—rising consumer bankruptcy filings during an era of unprecedented prosperity in American history. The traditional model has postulated that this appearance of prosperity disguises economic distress. This article has examined the evidence and failed to find persuasive support for the traditional model. Americans are not being increasingly *forced* to file bankruptcy; rather, the evidence suggests that Americans have acquired an increasing propensity to *choose* to file bankruptcy in response to financial stresses that would not have precipitated bankruptcy in the past. The traditional model thus stands at a state of intellectual crisis, its tools unable to explain the overriding question of the age.

This article has suggested a new model of consumer bankruptcy rooted in new institutional economics. It has also reviewed some of the evidence that has been offered on the point, most of which has proven to be consistent with this new model. More testing, of course, is needed. But identifying a model that can be subjected to empirical testing is the first step in the analysis.

Finally, this article has offered several policy recommendations that follow from the model of consumer bankruptcy offered here. Just as the traditional model of bankruptcy animated the 1978 Code, the model offered here is consistent with many of the proposals contained in recent bankruptcy reform legislation. Although most academics have been reluctant to abandon the old model, it appears that policy-makers have already implicitly accepted the new model, which can be expected to increasingly influence Congress in the future.

⁴⁵⁶ Fay, Hurst, & White, *supra* note, at 715-16.