A REFORMED ECONOMIC MODEL OF CONSUMER BANKRUPTCY

I. INTRODUCTION

Twenty years ago, the debate over modeling consumer bankruptcy had been settled. The widely accepted "economic model" hypothesized that adjusting the rules of bankruptcy could change the behavior of debtors in predictable ways and that exemption policy was the most effective tool for producing the changes desired by policymakers.[1] In the 1980s and 1990s, however, in reaction to several empirical studies, a number of scholars have questioned the accuracy of the economic model,[2] shifting the focus of the consumer bankruptcy debate back to questions of modeling.

This Note seeks to demonstrate that although the traditional economic approach was flawed in its assumptions, the underlying economic methodology remains an effective way to evaluate the available data and to think about consumer bankruptcy. Through a "reformed economic model" of consumer bankruptcy, this Note provides a predictive model that explains the results of existing empirical studies, can be tested in future empirical studies, and demonstrates why the economic model applied in the 1970s proved inaccurate. Furthermore, it predicts when the effects of sociological factors such as local legal

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[1] *See, e.g.*, William H. Meckling, *Financial Markets, Default, and Bankruptcy: The Role of the State*, LAW & CONTEMP. PROBS., Autumn 1977, at 13, 27 ("Changes in bankruptcy law which lower the costs or raise the benefits to debtors [of default, bankruptcy in Chapter VII, or bankruptcy in Chapter XIII] will without question increase both the number of debtors who elect that option and the total number of debtors who elect one of the three in preference to repayment.").

[2] *See* TERESA A. SULLIVAN, ELIZABETH WARREN & JAY L. WESTBROOK, AS WE FORGIVE OUR DEBTORS: BANKRUPTCY AND CONSUMER CREDIT IN AMERICA (1989); Ian Domowitz & Thomas L. Eovaldi, *The Impact of the Bankruptcy Reform Act of 1978 on Consumer Bankruptcy*, 36 J.L. & ECON. 803 (1993); Michael J. Herbert & Domenic E. Pacitti, *Down and Out in Richmond, Virginia: The Distribution of Assets in Chapter 7 Bankruptcy Proceedings Closed During 1984-1987*, 22 U. RICH. L. REV. 303 (1988); Philip Shuchman & Thomas L. Rhorer, *Personal Bankruptcy Data For Opt-Out Hearings and Other Purposes*, 56 AM. BANKR. L.J. 1 (1982); Teresa A. Sullivan, Elizabeth Warren & Jay L. Westbrook, *Consumer Debtors Ten Years Later: A Financial Comparison of Consumer Bankrupts 1981–1991*, 68 AM. BANKR. L.J. 121 (1994) [hereinafter Sullivan, Warren & Westbrook, *Ten Years Later*]; Teresa A. Sullivan, Elizabeth Warren & Jay L. Westbrook, *The Persistence of Local Legal Culture: Twenty Years of Evidence From the Federal Bankruptcy Courts*, 17 HARV. J.L. & PUB. POL'Y 801 (1994) [hereinafter Sullivan, Warren & Westbrook, *Local Legal Culture*]; William J. Woodward, Jr. & Richard S. Woodward, *Exemptions as an Incentive to Voluntary Bankruptcy: An Empirical Study*, 88 COM. L.J. 309 (1983). *But see* Vincent P. Apilado, Joel J. Dauten & Douglas E. Smith, *Personal Bankruptcies*, 7 J. LEGAL STUD. 371 (1978); Lawrence Shepard, *Personal Failures and the Bankruptcy Reform Act of 1978*, 27 J.L. & ECON. 419 (1984); Michelle J. White, *Personal Bankruptcy Under the 1978 Bankruptcy Code: An Economic Analysis*, 63 IND. L.J. 1 (1987) [hereinafter White, *An Economic Analysis*]; Michelle J. White, *Economic Versus Sociological Approaches to Legal Research: The Case of Bankruptcy*, 25 LAW & SOC'Y REV. 685 (1991) (reviewing SULLIVAN, WARREN & WESTBROOK, *supra*) [hereinafter White, *Economic Versus Sociological Approaches*].

culture are most likely to be significant and when other, more traditional economic variables are likely to dominate. Finally, this Note proposes a workable model of consumer bankruptcy that offers scholars and policymakers a framework that can facilitate the analysis of consumer bankruptcy issues and guide future policy decisions.

Unlike the existing approaches, the reformed economic model balances an accurate description of reality with the capacity to guide policy analysis. The reformed model overcomes the inaccuracies of the traditional economic model yet preserves that model's most desirable feature — a framework that permits evaluation of reform proposals. The reformed model makes it possible to move beyond the current debate over methodology to a discussion of the goals of consumer bankruptcy and the most suitable strategies to achieve those goals.

Part II of the Note outlines the two principal models used in the consumer bankruptcy literature. Part III develops a reformed economic model that seeks to synthesize the two approaches in order to explain the existing data and to guide policymaking. Part IV presents the predictions generated by the reformed economic model and tests those predictions against the available evidence. It also offers predictions that cannot be confirmed with existing data but that could be tested in future research. Part V discusses the advantages offered by the reformed economic model as compared to the other existing approaches. Part VI offers concluding observations.

II. THE COMPETING MODELS

A central point of contention in the debate over the consumer bankruptcy system is the choice of an appropriate model. The economic model assumes that consumer bankruptcies are best understood as the product of debtors' and creditors' reactions to the incentives generated by, among other things, bankruptcy law.[3] An alternative approach, known as the sociological model, describes the consumer bankruptcy system as the product of a large set of complex social interactions that take place at the local level and differ from one locality to another.[4]

A. *The Traditional Economic Model*

Although the economic approach can operate in various ways, its basic premise tends to remain consistent.[5] In abstract form, the ap-

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[3] *See* Meckling, *supra* note 1, at 16–29.

[4] *See* Sullivan, Warren & Westbrook, *Local Legal Culture*, *supra* note 2, at 839–57.

[5] For early forms of the basic economic argument as applied to exemption policy, see Frank R. Kennedy, *Limitation of Exemptions in Bankruptcy*, 45 IOWA L. REV. 445, 452 (1960); Comment, *Bankruptcy Exemptions: Critique and Suggestions*, 68 YALE L.J. 1459, 1509 (1959); and Raymond C. Marier, Note, *Bankruptcy Exemptions: A Full Circle Back to the Act of 1800?*, 53 CORNELL L. REV. 663, 673–74 (1968).

proach assumes that debtors react to existing rules in order to maximize their own utility, subject to a set of constraints on their behavior. In the context of bankruptcy, this reaction means that debtors will file for bankruptcy when the benefits of bankruptcy[6] outweigh the costs of filing.[7]

For chapter 7 consumer filings, the model assumes that debtors will file when the amount of their discharged debt (in present value terms) exceeds the costs of filing plus the value of their nonexempt assets. For chapter 13 filings, the model predicts that debtors will file when the amount of their dischargeable debt exceeds the present value of the repayment plan plus the costs of filing.[8] Differences between chapter 7 and chapter 13, which are discussed in detail in subsection IV.C.1, may also lead a debtor to choose one chapter over the other.

The economic model became the basic analytical tool of consumer bankruptcy commentators in the 1970s and early 1980s.[9] As applied, the model focused heavily on a single aspect of bankruptcy policy — the level of exemptions. Indeed, by the early 1980s, many commentators viewed exemptions as the single most effective tool for influencing debtor behavior.[10] As empirical work on consumer bankruptcy began to emerge,[11] however, the results were often inconsistent with the predictions made by proponents of the economic model. This inconsistency caused some commentators to reevaluate the model itself.

B. *The Sociological Approach*

The most prominent challenge to the traditional economic approach has been the sociological approach. Rather than seeking a set of fundamental principles governing the behavior of individuals, the sociological approach emphasizes that individual decisions are the product of a vast array of influences — with an emphasis on "legal

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6 The most important benefits include the automatic stay, *see* 11 U.S.C. § 362 (1994), discharge of unpaid debts, *see id.* § 727 (chapter 7); *id.* § 1328 (chapter 13), and the exemption of certain assets from the bankruptcy estate, *see id.* § 522.

7 *See infra* pp. 1342–43.

8 *See* White, *Economic Versus Sociological Approaches*, *supra* note 2, at 686–95.

9 The foreword to a 1977 symposium, for example, simply states that "[e]conomic analysis can . . . be applied to predict the consequences of alternative provisions in the pending bankruptcy-law proposals." John H. Moore, *The Economics of Bankruptcy Reform — Foreword*, LAW & CONTEMP. PROBS., Autumn 1977, at 1, 2.

10 *See, e.g.*, William T. Vukowich, *Reforming the Bankruptcy Reform Act of 1978: An Alternative Approach*, 71 GEO. L.J. 1129, 1152 (1983) ("To overcome the major criticisms of the new Bankruptcy Act, one simple and relatively minor change is needed. The exemption policy should be modified . . . ."); White, *An Economic Analysis*, *supra* note 2, at 2–3 ("The Code raised the exemption level applicable in personal bankruptcy cases . . . . As a result, it made bankruptcy potentially much more attractive from the viewpoint of debtors.").

11 *See* sources cited *supra* note 2.

culture" — that can vary from one locality to another.[12] Although the local legal culture school cannot yet claim a predictive model capable of guiding future reforms, its proponents hope to develop such a model.[13]

Because defenders of the sociological approach lack a stand-alone predictive theory, a direct test of the approach is not possible. Instead, commentators have adopted two basic strategies to argue its virtues. The first strategy uses interviews and case studies to suggest that consumer debtors make decisions based on the particular characteristics of their local legal system.[14] An alternative strategy relies on empirical studies to criticize the economic approach and to emphasize the need for a more sophisticated view of the issues.[15]

Commentators using the latter strategy are particularly critical of the claim — usually attributed to the economic model — that a change in the level of exemptions will affect the rate of filing (or the chapter choice).[16] These critics have demonstrated persuasively that the level of exemptions has only a slight impact on the rate of bankruptcy filing[17] and the chapter choice.[18]

A second empirically based criticism of the economic model points out that filing rates and chapter choice ratios vary significantly at the district level.[19] Such variation is difficult to explain under the traditional economic model because the formal rules that govern bankruptcy, and that are of principal interest to economists, tend to be promulgated at the state or federal level.

Critics of the economic model have gone beyond these specific issues and described the model itself as fundamentally flawed.[20] Rather than discard the model entirely, however, it is possible to revisit and revise its underlying assumptions. The view that exemptions represent a critical policy tool, for example, does not necessarily follow from the

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[12] Sullivan, Warren, and Westbrook define "local legal culture" as "systematic and persistent variations in local legal practices as a consequence of a complex of perceptions and expectations . . . in a particular locality, and differing in identifiable ways from the practices, perceptions, and expectations existing in other localities subject to the same or a similar formal legal regime." Sullivan, Warren & Westbrook, *Local Legal Culture*, *supra* note 2, at 804.

[13] "It may be possible to develop principles about dealing with local cultures that can be generalized from one circumstance to another, so that adjustments for local legal cultures may become part of the more sophisticated modeling of legal change." *Id.* at 805.

[14] *See, e.g.*, Jean Braucher, *Lawyers and Consumer Bankruptcy: One Code, Many Cultures*, 67 AM. BANKR. L.J. 501, 512–14, 580–81 (1993).

[15] *See, e.g.*, SULLIVAN, WARREN & WESTBROOK, *supra* note 2, at 230–70.

[16] *See, e.g.*, William J. Boyes & Roger L. Faith, *Some Effects of the Bankruptcy Reform Act of 1978*, 29 J.L. & ECON. 139, 141 (1986); Shepard, *supra* note 2, at 423–24.

[17] *See, e.g.*, Shuchman & Rhorer, *supra* note 2, at 7.

[18] *See, e.g.*, Sullivan, Warren & Westbrook, *Ten Years Later*, *supra* note 2, at 123–24; White, *An Economic Analysis*, *supra* note 2, at 45–46 & tbl. 6 (concluding that the level of exemptions is statistically significant but not "strikingly important quantitatively").

[19] *See* SULLIVAN, WARREN & WESTBROOK, *supra* note 2, *passim*.

[20] *See, e.g.*, *id.* at 256 ("The economic model . . . was completely wrong.").

model. The model posits only that *if* the costs and benefits facing debtors change, then *some* debtors *may* make different choices. Exemptions represent an important factor in the analysis only if the change in the law alters the costs and benefits faced by the debtor. Furthermore, only marginal debtors — those for whom the costs and benefits are nearly equal — will be affected.[21] The traditional economic model predicted an important role for exemptions because of an implicit assumption that many debtors are near the margin. In other words, the model itself is not flawed; rather, it must be applied with more accurate assumptions.

III. THE REFORMED ECONOMIC MODEL

Empirical studies of consumer bankruptcy can and should be used exactly as Sullivan, Warren, and Westbrook — three of the more outspoken critics of the economic model — recommend: to improve the theory of consumer bankruptcy.[22] The reformed economic model developed in this Note offers a more satisfactory theoretical approach to consumer bankruptcy than either the traditional economic model or the sociological approach. The reformed model explains the existing data — which the old economic model cannot do convincingly — and provides a framework for a structured analysis of proposed legal changes — which the sociological approach handles unsatisfactorily. Specifically, the reformed model attempts to address the criticisms leveled at the economic approach by developing a more realistic set of assumptions. These assumptions, in turn, lead to conclusions that are more consistent with the empirical evidence.

The first assumption of the reformed economic model concerns the costs of filing for bankruptcy. Although the pecuniary costs of filing are relatively well understood,[23] commentators have devoted insufficient attention to the nonpecuniary costs of filing. These costs might include the blow to one's self-esteem, the embarrassment of facing friends after a financial failure, a perceived loss of credit worthiness,[24] a hesitation to breach obligations to creditors, and other factors that

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[21] Texas law provides a simple example. Texas currently allows an unlimited exemption for homesteads. *See* TEX. PROP. CODE ANN. § 41.002 (West 1993). If legislators changed the law and only allowed a homestead exemption of up to $10 million, very few potential debtors would find that the cost-benefit analysis of their decision would be affected.

[22] *See* SULLIVAN, WARREN & WESTBROOK, *supra* note 2, at 256 ("This alternation between data and modeling is precisely what is needed, and we look forward to these efforts.").

[23] *See id.* at 23.

[24] Although it is not clear that a debtor who files for bankruptcy and receives a discharge will have more difficulty obtaining credit than a debtor who remains behind on payments and continues to owe large sums to creditors, there remains a widespread perception that a debtor who files for bankruptcy will find it extremely difficult to obtain credit in the future.

would cause debtor resistance to filing for bankruptcy.[25] Although difficult to measure, these costs may have a powerful impact on filing decisions. In order to provoke filing, the benefits of bankruptcy must be sufficiently large to overcome both the pecuniary and nonpecuniary costs of filing. If we omit nonpecuniary costs from the model, as did most proponents of the traditional economic approach, the model will underestimate the level of benefits necessary to induce filing.

The reformed model also considers the limited information debtors possess. Many debtors appear to be unaware of the powerful positive impact that bankruptcy can have on their financial condition.[26] They also often overestimate the negative consequences of bankruptcy: "Common misconceptions are that the debtors will lose their property, their jobs and never get credit again. Some debtors even come in believing that they will go to jail."[27] The most realistic assumption appears to be that debtors know very little about bankruptcy prior to consulting a lawyer.[28]

Finally, the reformed model recognizes that debtors are sensitive to the financial burden that the filing process imposes on them. Although the absolute cost of filing for bankruptcy is small, it can represent a considerable burden to debtors.[29] For example, "[e]ven a small reduction of $50 in the filing fee could affect the decision as to whether the spouse of a married bankrupt also becomes bankrupt."[30]

By incorporating these three simple assumptions, the reformed economic model generates results that are consistent with the empirical evidence, offers predictions that can be tested through further empirical work, and reconciles the observed impact of local legal culture

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[25] For more on this subject, see Lisa J. McIntyre, *A Sociological Perspective on Bankruptcy*, 65 IND. L.J. 123, 130 (1989).

[26] One commentator points out:

> [A] recent large survey of bankrupts indicates that couples typically enter bankruptcy with nonmortgage debts of about $19,000, the majority of which, in practice, are ultimately discharged. Since couples can emerge from bankruptcy with more than $20,000 in net exempt assets, gains in wealth of more than $30,000 are possible by declaring oneself a financial "failure."

Shepard, *supra* note 2, at 426–27 (citation omitted).

[27] Braucher, *supra* note 14, at 554. "One lawyer said, 'if Americans in general knew what you can do in bankruptcy, then we'd really be in trouble.'" *Id.*

[28] Most debtors contact a lawyer only after accepting that filing for bankruptcy may be necessary. Until that time, any misconceptions the debtor may have about bankruptcy will remain uncorrected. *See* William J. Woodward, Jr., *Exemptions, Opting Out, and Bankruptcy Reform*, 43 OHIO ST. L.J. 335, 362–63 (1982). *But see* Shepard, *supra* note 2, at 427–28 (arguing that the general public receives significant information about bankruptcy).

[29] *See* Braucher, *supra* note 14, at 508 (arguing that variation in the rates of use of chapter 7 and chapter 13 in a given locality is in part due to differences in the filing fees); Sullivan, Warren & Westbrook, *Ten Years Later*, *supra* note 2, at 132 ("There are likely to be a significant number of debtors who would use bankruptcy if they could afford legal representation.").

[30] Domowitz & Eovaldi, *supra* note 2, at 810.

with the undeniable fact that bankruptcy is heavily influenced by economic forces.[31]

IV. PREDICTIONS AND EVIDENCE

A. *The Filing Decision*

The reformed model assumes that a debtor will file when the perceived benefits of bankruptcy exceed both the pecuniary and nonpecuniary costs of filing.[32] The assumption that debtors will file merely because doing so will improve their financial position is, therefore, incorrect. Indeed, if the nonpecuniary costs of filing are sufficiently large, debtors will file only when they have no other means to hold off their creditors.

If debtors file only when they have no other choice, several results should follow and can be tested. Specifically, debtors should have accumulated inordinately high secured and unsecured debts and should have liquidated assets when possible — implying a high debt-to-asset ratio relative to the general population. If, on the other hand, debtors file based only on their *financial* interest, debtors in bankruptcy should have net assets only slightly below the level of exemptions.

Empirical research provides strong support for the proposition that most debtors file only when doing so is absolutely necessary to obtain immediate relief from their creditors through the automatic stay.[33] Some debtors finally file when their creditors bring collection suits,[34] some are forced to file because they cannot cope with an interruption in their income,[35] and others file in the face of overwhelming medical expenses.[36] Regardless of the source of the debt, debtors are generally in such poor financial condition when they file that they simply cannot avoid bankruptcy any longer.

If debtors make extraordinary efforts to avoid the bankruptcy courts, as the reformed model predicts, they will file only when their debts are overwhelming. In other words, as their financial situation deteriorates, they will face increasingly burdensome expenses. To cope

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31 The model does not consider the interaction between the debtors and their lawyers. This principal-agent relationship may be an important factor in debtor decisions, but it is omitted from this Note in the interest of simplicity.

32 To the extent that debtors are ignorant of the advantages that bankruptcy offers, *see supra* TAN 26, they will be even more hesitant to file.

33 *See* Woodward & Woodward, *supra* note 2, at 316 ("Studies have suggested . . . that gaining the immediate relief from creditor collection efforts is often a precipitating cause of bankruptcy . . . ." (citing DAVID T. STANLEY & MARJORIE GIRTH, BANKRUPTCY: PROBLEMS, PROCESS, REFORM 47–49 (1971))). The automatic stay is provided by 11 U.S.C. § 362 (1994).

34 *See* Shuchman & Rhorer, *supra* note 2, at 11.

35 *See* Sullivan, Warren & Westbrook, *Ten Years Later*, *supra* note 2, at 131 ("In more than half (52.6%) of all cases in the sample, the petitioners reported a period of unemployment . . . during the two years before filing.").

36 *See* Shuchman & Rhorer, *supra* note 2, at 12.

without resorting to bankruptcy, debtors will have to run up considerable debts as they try to keep up with their bills. Debtors who possess assets with which they can secure asset-based financing will obtain as much secured credit as possible to stave off bankruptcy.[37] Eventually, debtors will be forced to resort to unsecured credit that is relatively easy to obtain and that comes without significant monitoring by the creditor.[38] The reformed model also predicts that when debtors finally file, they will have liquidated their valuable assets. In summary, if the reformed model is correct, debtors who have filed for bankruptcy will have spent their liquid assets, encumbered those assets with which they can obtain secured credit, and accumulated large amounts of unsecured credit.

The evidence supports each of these predictions. Consider first the data on assets. These data establish that, in most cases, no assets are available for unsecured creditors in bankruptcy.[39] In fact, debtors appear to give up very few assets in which they have any equity — even to secured creditors.[40] One study, for example, found that in 96% of all chapter 7 cases no assets were distributed to creditors.[41] Other studies have found similar results.[42]

Unfortunately, little data is available on the amount of unsecured credit that bankrupt debtors possess. There is, however, some data concerning credit card debt, and these data support the predictions of the reformed model. In *As We Forgive Our Debtors*,[43] the authors report that, in their sample, the median bankrupt debtor had $2100 dollars in credit card debt and that a quarter of debtors had debts in

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[37] Although it is true that taking on secured debt may hurt the debtor if bankruptcy occurs because the secured debt will not be discharged in chapter 7, recall that the revised economic model assumes that debtors are not familiar with bankruptcy law. When debtors seek asset-based financing, they probably still have not sought legal advice and may not realize that such financing makes bankruptcy a less favorable option.

[38] The most obvious example is credit card debt. Debtors can often rely on credit card debt to keep them afloat for a certain period. Maintaining large credit card balances is, of course, a large financial burden because of the high interest rates that credit card companies charge.

[39] One study found that no assets were available for creditors in 95.6% of the consumer chapter 7 cases examined. Even when assets were available, debtors paid only 14% of the unsecured claims. *See* Herbert & Pacitti, *supra* note 2, at 311, 316. These figures imply an average payout of only slightly more than 0.5%.

[40] *See id.* at 313. Herbert and Pacitti found that in chapter 7 consumer cases, the value of abandoned collateral was 72.4% of all assets available for distribution and the value of all abandoned and distributed collateral was 74.5% of all assets available for distribution. This finding suggests that only 2.1% of the assets were distributed by a method other than abandonment. *See id.*

[41] *See id.* at 311.

[42] *See* Shuchman & Rhorer, *supra* note 2, at 6–7. A study of districts in Ohio and Texas found that "in the overwhelming majority of cases . . . the chapter 7 cases are no asset [cases], and the chapter 13 cases would be no asset [cases] if filed in chapter 7." Braucher, *supra* note 14, at 516. This result is not novel. *See* Marier, *supra* note 5, at 672 n.53 ("Most bankruptcy filings by individuals involve assetless estates . . . .").

[43] SULLIVAN, WARREN & WESTBROOK, *supra* note 2.

excess of $4200. Almost one-third of the debtors had credit card debt in excess of three months income — in other words, an individual earning $20,000 a year would owe $5000 plus the accumulating interest to credit card companies. "Given the fact that credit cards offer generally the most short-term, high-interest consumer debt available, these ratios are remarkable, even [for bankrupt individuals]."[44]

Debtors who have run up large debts to avoid bankruptcy will also tend to have higher debt-to-income ratios than the general population. In *As We Forgive our Debtors*, the authors make such a comparison. Their results show that "only 5% of Americans owe at least 20% of a year's income in nonmortgage debt . . . . By contrast, the bankruptcy data show that over 90% of those in bankruptcy" owe such a large share of their annual income.[45]

Second, the evidence on homeowners suggests that debtors, as the reformed model predicts, seek asset-based loans in order to stave off bankruptcy.[46] Although the median bankrupt debtor appears to carry a mortgage only slightly larger than that of the median individual,[47] the debtor's mortgage is held on a house of lesser value[48] and is supported with a lower income.[49] Furthermore, roughly one-third of the bankrupt homeowners have a second mortgage, compared with only 9.8% of the general population.[50] All of these results suggest that bankrupt debtors have, prior to filing, taken on additional debt by using their houses as collateral.

Reducing assets by liquidation while increasing debts in both secured and unsecured form will lead to extremely high debt-to-asset ratios. The presence of such ratios in existing studies[51] further supports the conclusions of the reformed model. Sullivan, Warren, and Westbrook, for example, found that the mean net worth of bankrupts was –$13,900, whereas the mean net worth of the general population was $66,100.[52] In fact, 79% of bankrupt debtors had a mean net worth of

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44 *Id.* at 183 & tbl. 10.1. A few debtors had even more staggering credit card debts: "Nearly 13% of the debtors . . . owe more than half a year's income in short term credit cards." *Id.* at 184.

45 *Id.* at 75–76 & tbls. 4.5 & 4.6.

46 Little evidence on nonmortage secured debt exists.

47 *See* SULLIVAN, WARREN & WESTBROOK, *supra* note 2, at 133.

48 *See id.* at 67 (stating that the mean home value in the general population in 1983 was $56,000 (and total assets were over $83,000), whereas the value of debtors' *assets*, including homes and all other assets, was only $24,000).

49 *See id.*

50 *See id.* at 134. This comparison excludes Texas, where the law allows second mortgages only for home improvements. *See id.* at 132.

51 *See* Herbert & Pacitti, *supra* note 2, at 310–11.

52 *See* SULLIVAN, WARREN & WESTBROOK, *supra* note 2, at 71, 72 tbl. 4.3.

less than $0, and another 5% had a net worth between $0 and $5000.[53]

B. Exemption Levels

The reformed economic model, supported by the empirical evidence, suggests that most debtors file only when they have no other choice — that is, when they have spent their liquid assets, collateralized their illiquid assets, and exhausted their supply of unsecured credit. The reformed model predicts, therefore, that changes in the exemption levels will not affect filing rates or chapter choice.[54] The data bear out this prediction — a state's decision to adopt the federal exemption levels[55] or to opt out and retain its own exemption levels is of no consequence to most debtors.[56]

In more sophisticated empirical studies, direct tests of the effects of exemption levels have repeatedly shown those effects to be statistically significant, though small in magnitude.[57] The reformed model explains this result with reference to the deterrent effect of nonpecuniary costs. A small number of debtors will consider the nonpecuniary costs of filing for bankruptcy to be insubstantial. These debtors will file based primarily on their financial interests and, therefore, will be sensitive to exemption policy.[58]

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[53] *See id.* The same authors found very similar results in their 1991 study. *See* Sullivan, Warren & Westbrook, *Ten Years Later*, *supra* note 2, at 135. Another study found that the average consumer debtor "had a total outstanding debt, including secured claims, of $10,663. This total debt is a little over five times the assets claimed by the average debtor . . . ." Shuchman & Rhorer, *supra* note 2, at 11.

[54] The observation that debtors have no nonexempt assets might be interpreted as evidence that they refrain from filing until the value of their assets falls below the amount of their permissible bankruptcy exemptions. If this were so, however, these debtors would have assets close to the level of permissible exemptions. In fact, most debtors have assets far below the value of permissible exemptions, indicating that most debtors do not consider the exemption levels to be a relevant factor.

[55] *See* 11 U.S.C. § 522 (1994).

[56] *See* Shuchman & Rhorer, *supra* note 2, at 20–21 (finding that only 6% of Connecticut debtors would have had to give up assets if Connecticut had opted out of the federal scheme and allowed only the much less generous state exemption). In a study examining the effect of the 1978 Code, Domowitz and Eovaldi concluded that the effect of that Code on the debt-to-income ratios of debtors in a state was independent of whether the state opted out of the federal exemption policy and adopted its own exemption levels. *See* Domowitz & Eovaldi, *supra* note 2, at 828. This result was true for both chapter 13 and chapter 7 debtors. *See id.*

Even proponents of the economic approach now agree that exemption policy is not particularly effective. *See, e.g.*, Shepard, *supra* note 2, at 426.

[57] *See* SULLIVAN, WARREN & WESTBROOK, *supra* note 2, at 253 tbl. 13.5; Apilado, Dauten & Smith, *supra* note 2, at 381 tbl. 3; White, *An Economic Analysis*, *supra* note 2, at 45 tbl. 6.

[58] An alternative explanation might be that in districts with higher exemption levels, lawyers encourage debtors with more assets to file in order to take advantage of those higher levels.

Because the traditional economic model failed to take account of the nonpecuniary costs of filing,[59] it predicted that debtors would file in accordance solely with their financial interest. This error led to the false assumption that there were many marginal debtors. In fact, because debtors' filing decisions also depend on nonpecuniary factors, there will be very few marginal debtors. The traditional model's mistaken assumption suggested, in turn, that exemption policy was a critical policy variable. By considering nonpecuniary costs, the reformed model explains why exemptions are much less important than the traditional model predicts.

C. *Chapter Choice*

The reformed model also yields a series of predictions with respect to a debtor's choice between chapters 7 and 13.[60] Before examining the accuracy of those predictions, however, a brief review of the principal differences between the two chapters is helpful.

1. Chapter 7 Versus Chapter 13. — Both chapter 7 and chapter 13 provide for an automatic stay[61] of creditors' collection activities.[62] Along with the discharge of debts, the stay is the main concern of most debtors. Under chapter 7, all nonexempt property is turned over to the estate and distributed to creditors.[63] Debtors are then granted a discharge[64] and are barred from obtaining another chapter 7 discharge within the next six years.[65] Under chapter 13, debtors keep all their property, promise to pay some proportion of their debts out of future earnings, and propose a three- to five-year plan to this effect.[66] The plan must provide for creditors to be paid at least what they would receive under chapter 7 and must commit all disposable income to the repayment of creditors.[67] Chapter 13 makes discharge contingent upon

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[59] *See, e.g.*, White, *Economic Versus Sociological Approaches*, *supra* note 2, at 688 (stating that "court filing fees are $60, and most consumers use bankruptcy lawyers, whose average charge is $500, so that [the bankruptcy-related costs] = $560" (internal cross reference omitted)).

[60] This Note does not consider consumer filings under chapter 11 — a chapter that is normally used only by very wealthy debtors.

[61] The automatic stay prevents "creditors from taking further action against the debtor, the property of the debtor, or the property of the estate to collect their claims or enforce their liens." DAVID G. EPSTEIN & JONATHAN M. LANDERS, DEBTORS AND CREDITORS: CASES AND MATERIALS 410 (2d ed. 1982).

[62] Unlike the chapter 7 stay, the chapter 13 stay also bars collection efforts against co-debtors. *See* 11 U.S.C. §§ 362, 1301 (1994). The chapter 13 discharge is also slightly broader than the chapter 7 discharge. *See id.* §§ 727(a), 1328.

[63] *See id.* § 726.

[64] *See id.* § 727.

[65] *See id.* § 727(a)(8).

[66] *See id.* §§ 1306, 1322(a), 1322(d).

[67] *See id.* § 1325(a)(4), (b)(1)(B).

successful completion of the plan[68] and, unlike chapter 7, does not preclude a future discharge.[69]

The chapter 13 plan must promise secured creditors the present value of their collateral.[70] The schedule of payments, however, may differ from that set forth in the original contract.[71] Under chapter 7, debtors may retain collateral if the relevant creditors agree to a reaffirmation of the debt.[72]

Although chapter 13 permits debtors to alter the terms of their secured debt, it does not allow them to do so in the case of home mortgages.[73] However, if debtors are in arrears on their mortgage payments, they may pay the arrearage and thereafter force the mortgagee to accept payment according to the original conditions of the loan.[74] Under chapter 7, debtors cannot prevent foreclosure if payments are in arrears.

Chapter 13, then, gives the debtor the ability to retain collateral in situations that would require creditor consent to reaffirmation under chapter 7. However, if a creditor refuses to accept reaffirmation, the refusal may effectively force a debtor to choose chapter 13. The creditor would then be only one of many creditors being paid out of the debtor's future income. In contrast, the creditor who accepts reaffirmation under chapter 7 will be one of only a few creditors (and perhaps the only one) with a claim on the debtor's future income. Because accepting reaffirmation often will represent a better strategy for the creditor, the protections of chapter 13 will, in practice, be available through reaffirmation in chapter 7. On the other hand, if a creditor refuses to accept reaffirmation or if the cost of negotiating a reaffirmation is prohibitively high for the debtor, the advantages of chapter 13 remain.

2. *Testable Predictions.* — The reformed model makes several testable predictions based on the differences between chapters 7 and 13. These predictions deal with the characteristics of debtors, the proportion of debt that is secured, the relationship between home ownership and chapter choice, the frequency with which debtors reaffirm debts, and the amount promised to creditors in chapter 13 repayment plans.

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[68] *See id.* § 1328(a). If the plan is not completed, the debtor may be entitled to a "hardship" discharge. *See id.* § 1328(b).

[69] Under chapter 13, a discharge does not preclude a future chapter 7 discharge if the chapter 13 plan paid 100% of allowed unsecured claims or paid 70% of such claims, was "proposed in good faith, and was the debtor's best effort." *Id.* § 727(a)(9).

[70] *See id.* § 1325(a)(5).

[71] *See id.*

[72] *See id.* § 524(c). One study found that some judges allow debtors to keep the collateral in chapter 7 even without reaffirmation as long as the debtors' payments on the contract are current. *See* Braucher, *supra* note 14, at 528.

[73] *See* 11 U.S.C. § 1322(b)(2) (1994). Chapter 13, therefore, only offers a homeowner more protection than chapter 7 if the creditor refuses to accept reaffirmation.

[74] *See id.* § 1322(b)(3), (5).

Each of these predictions, and the relevant evidence, is considered in turn.

As an initial matter, there should be some cases in which debtors are clearly better off filing under one chapter or the other. Debtors who have very few nonexempt assets and who do not have collateral that they want to keep (along with the corresponding debts) will most likely file under chapter 7. This group probably represents a large proportion of debtors, which explains why consumer debtors use chapter 7 much more frequently than they use chapter 13.[75] On the other hand, debtors who have had a chapter 7 discharge during the past six years or who need the broader discharge offered by chapter 13 will almost certainly file under the latter chapter.

Some debtors who possess secured assets that they would like to protect in chapter 13 would otherwise prefer chapter 7's immediate discharge.[76] For example, if debtors are in arrears on a mortgage, or if they want to alter the repayment schedule on a secured debt, chapter 13 may offer some advantages over chapter 7.[77] According to this analysis, most of the debtors who consider filing under chapter 13 will be seeking to protect some collateralized asset. Prospective chapter 13 debtors must weigh the benefit of retaining the asset against the burden of a three-year repayment plan and a commitment of all disposable income.[78]

The reformed model predicts that, on average, a larger proportion of the debts of chapter 13 debtors will be in the form of secured debt than will the debts of chapter 7 debtors.[79] The data bear out this prediction. Analyzing cases that closed during the summer of 1982, White found that debtors filing under chapter 13 held 68% of their debts in the form of secured debts, whereas debtors filing under chapter 7 held only 42% of their debts in that form.[80]

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[75] In 1990, 70% of bankruptcy cases were filed under chapter 7. In 1980, the figure was 74%. *See* Sullivan, Warren & Westbrook, *Local Legal Culture*, *supra* note 2, at 825 tbl. 3.

[76] Debtors who want the co-debtor stay but who are eligible for a chapter 7 discharge are similar to this group.

[77] *See supra* p. 1349.

[78] Chapter 7's requirement that debtors give up nonexempt assets is probably not an important factor for most debtors because very few of them possess nonexempt assets. *See supra* p. 1347.

[79] Note that the reformed model does not predict that merely having more secured debt is sufficient to make chapter 13 an attractive option. In fact, a proportional increase in overall debt (both secured and unsecured) may make chapter 7 more appealing because there is more debt that can be discharged. For any given level of overall debt, however, a higher *proportion* of debt held in secured form will increase the attractiveness of chapter 13. *See* SULLIVAN, WARREN & WESTBROOK, *supra* note 2, at 237 tbl. 13.1, 253 tbl. 13.5 (examining the impact of secured debt on chapter choice). Even this indicator is a very crude one, however, because debtors will often be willing, in exchange for a discharge, simply to surrender collateral in which they have no equity.

[80] *See* White, *An Economic Analysis*, *supra* note 2, at 34 tbl. 3, 36.

Because homes commonly serve as collateral, and because people often feel an attachment to their homes, the reformed model also predicts that debtors who choose to file under chapter 13 will frequently do so in order to retain their homes.[81] This prediction is consistent with the data. Sullivan, Warren, and Westbrook found home ownership to be positively correlated with the choice of chapter 13.[82] Other scholars have reported similar results.[83]

A further testable prediction of the model is that many debtors who are in chapter 7 and who have significant collateral will have reaffirmed their debt. A direct test of these claims is difficult without data on reaffirmation. There are, however, some relevant studies. Herbert and Pacitti, for example, found that in virtually all chapter 7 cases involving secured claims, debtors had either abandoned the collateral or reaffirmed the debt.[84] These findings suggest that when debtors have equity in an asset (making abandonment inappropriate), they succeed in reaffirming the debt rather than surrendering the asset to creditors.

The model also offers a prediction concerning the repayment plans filed by debtors. As noted above, debtors filing under chapter 13 must promise to pay their creditors at least as much as the creditors would receive in a chapter 7 proceeding.[85] Because the model predicts that many chapter 13 debtors seek to retain some assets, repayment promises to secured creditors should involve more than token repayment. Debtors choosing chapter 13 for other reasons, however, have no need to promise a substantial repayment.[86] If the reformed model is correct, therefore, repayment plans should include significant payments to secured creditors and minimal payments to unsecured creditors. Sullivan, Warren, and Westbrook found exactly this result.[87] In a different study, the same authors found that most chapter 13 debtors

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[81] In addition to empirical evidence, there is anecdotal evidence that illustrates the importance of home ownership. *See* SULLIVAN, WARREN & WESTBROOK, *supra* note 2, at 134 ("Attorneys and judges we interviewed talked about how fiercely the homeowners fought."); Braucher, *supra* note 14, at 542 ("Lawyers say that the number one reason to use chapter 13 is the need to save the home by paying arrearages on a home mortgage.").

[82] *See* SULLIVAN, WARREN & WESTBROOK, *supra* note 2, at 237 tbl. 13.1.

[83] *See, e.g.*, White, *An Economic Analysis*, *supra* note 2, at 45 tbl. 6, 48.

[84] *See* Herbert & Pacitti, *supra* note 2, at 313 n.42 (noting that 97.2% of the stated value of collateral was abandoned or reaffirmed). This study is a one-district study, making generalization difficult. It is, nevertheless, suggestive.

[85] *See* 11 U.S.C. § 1325(a)(4) (1994).

[86] Although chapter 13 debtors must commit "all of the debtor's projected disposable income" to the repayment plan, *id.* § 1325(b)(1)(B), this statutory requirement may not have a significant impact in practice. *See* SULLIVAN, WARREN & WESTBROOK, *supra* note 2, at 36 ("Under either test, much the same inquiry must be made about the 'reasonableness' of each of the claimed expenses . . . .").

[87] *See* Sullivan, Warren & Westbrook, *Local Legal Culture*, *supra* note 2, at 817 n.84 ("Typically, such plans promise some payment to secured creditors, but have nothing left for unsecured creditors.").

filed plans promising substantial — 51% on average — repayment.[88] Because the collateral that motivates a debtor's decision to file under chapter 13 is often the family home, these high repayment promises are not surprising in the context of the reformed economic model.

Other predictions of the reformed model cannot be tested based on currently available data. For example, one would expect that, within the universe of all debtors seeking to protect collateral, those who choose chapter 13 will, disproportionately, be those in arrears on payments (for homes) and those who wish to adjust the payment schedule (for assets other than homes). One might also expect debtors in chapter 13 to have failed in attempts at reaffirmation, either because the creditor refused to agree to reaffirmation or because the debtor could not afford the negotiation. These predictions are currently neither supported nor refuted by empirical evidence. They do, however, provide a basis for further testing of the reformed economic model.

3. The Impact of Local Legal Culture. — The reformed economic model is also able to account for the role of local legal culture, which sociological analysts consider to be a pivotal factor in consumer bankruptcy.[89] Debtors possess considerable information about their personal finances and preferences, but are unlikely to be familiar with bankruptcy law. Lawyers, on the other hand, are experts on bankruptcy law, but know very little about individual debtors. In order to make an informed chapter choice, debtors and their lawyers must communicate to each other the information they possess. Such communication, of course, takes time — time for which debtors must pay. The more time spent tailoring the choice of chapter to a debtor's unique circumstances, the more the debtor must pay.

Because debtors generally cannot afford more than a small amount of a lawyer's time, the choice of chapter must be made quickly. Typically, the client and the lawyer have a single meeting that lasts less than an hour and a half.[90] During their brief time together, the lawyer must establish the debtor's financial situation, explain the rudiments of bankruptcy law, and make a chapter recommendation.[91] At the time of this meeting, the debtor is experiencing a major personal crisis and is only just beginning to understand the available options. The lawyer cannot divine the debtor's chapter preferences and may

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[88] *See* SULLIVAN, WARREN & WESTBROOK, *supra* note 2, at 36.

[89] *See, e.g.*, Braucher, *supra* note 14, at 556–561; Sullivan, Warren & Westbrook, *Local Legal Culture*, *supra* note 2, *passim*.

[90] Braucher found that most lawyers meet the client only once. *See* Braucher, *supra* note 14, at 554. "A few lawyers said that they usually spent a half hour or less with each client. . . . Most spent 45 minutes to an hour and a half, and only a few spent more than that." *Id.* at 555.

[91] "[T]he lawyer must handle each case expeditiously and spend a minimum amount of time conferring with the client. These goals are best served if the attorney effectively makes the decision about which chapter to pursue . . . ." William C. Whitford, *Has the Time Come to Repeal Chapter 13?*, 65 IND. L.J. 85, 89 (1989).

have serious difficulties ascertaining the debtor's ability and willingness to shoulder the burden of a long-term commitment to a plan that may very well never be completed.[92]

Thus, in order to recommend a chapter to debtors, lawyers must make decisions on the basis of incomplete information. This deficiency of information may lead lawyers simply to rely on local norms and practices. The views of the judge likely to hear the case, the chapter 13 standing trustee, and the lawyers' colleagues may all affect the judgment.[93] In other words, when the crude information that the lawyer can acquire during a brief meeting is insufficient to make the chapter choice clear, other factors, including local legal culture, may affect the decision.

Thus, the reformed economic model can account for the significance of local legal culture. Furthermore, it describes a set of debtors who are most likely to be affected by local legal culture. Specifically, debtors who are prepared neither simply to surrender all collateral nor to go to extreme lengths to protect that collateral are the least likely to express clear preferences to their lawyers. These debtors (and their lawyers) are the most likely to be swayed by local legal culture.

Testing this prediction presents the same challenges as does testing the sociological approach.[94] Existing data are not detailed enough to establish the extent to which local legal culture is an important explanatory variable. Current data clearly show, however, that the ratio of chapter 7 to chapter 13 filings varies considerably across districts, and that differences in state laws do not wholly explain these variations. For our purposes, it is enough to note that the reformed economic model is consistent with results suggesting the importance of local legal culture.

V. Advantages of the Reformed Economic Model

This Part discusses the implications of adopting the reformed economic model rather than using either the traditional economic model or the sociological approach. Although the sociological approach has successfully been used to criticize the traditional economic model, it has failed to develop a self-contained model of its own. As a consequence, using the sociological approach to analyze policy proposals in a coherent and systematic way has proven difficult. The reformed

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92 A lawyer may also have difficulty assessing debtors' attachment to their homes. "One lawyer . . . [said that] when a couple wants to attempt a last ditch effort to save a home by using chapter 13, 'I don't like to be a wet blanket. I try to get them to see that it might be better to walk away.'" Braucher, *supra* note 14, at 510.

93 A detailed discussion of local legal culture is beyond the scope of this Note. For such a discussion, see Braucher, cited above in note 14, at 556–61, and Sullivan, Warren & Westbrook, *Local Legal Culture*, cited above in note 2, at 839–64.

94 *See supra* p. 1341.

model, unlike the sociological approach, offers a coherent framework within which to think about consumer bankruptcy. This framework makes possible an analysis of consumer bankruptcy questions and policy proposals that simply cannot be achieved with the sociological approach. Furthermore, the reformed economic model is supported by the existing empirical work and is therefore not subject to the criticisms levelled at the traditional economic model.

Analysis of the role of local legal culture offers an example of the reformed model at work. Unlike the traditional economic model, the reformed model can account for the role of local legal culture.[95] Unlike the sociological approach, the reformed model offers insights into how local legal culture and traditional economic variables interact. Although the data support the importance of local legal culture, the reformed model suggests that incentives created by the legal regime nevertheless have a critical influence on debtors. Such incentives can even affect the importance of local legal culture by influencing debtors' willingness to overcome the informational deficiencies that cause reliance on local legal culture. On the other hand, the role of local legal culture demonstrates that we must be skeptical about how much impact policy changes can have on debtor behavior. Subtle changes to the Bankruptcy Code, for example, are unlikely to affect the crude judgments that are involved in chapter choice.[96] Larger changes such as disallowing the payment of mortgage arrearages in chapter 13[97] or allowing debtors to alter the payment schedule on mortgages,[98] however, are very likely to impact the chapter choice because, as the model suggests, marginal debtors will be affected. The reformed economic model allows a more complete analysis than the sociological approach, which does not identify the circumstances in which local legal culture is most likely to affect debtors' decisions.

The reformed economic model can also help us understand whether particular reform proposals would achieve the goals sought by policymakers. For example, to the extent that chapter 13 seeks to encourage "can-pay" debtors to pay their debts rather than to discharge them in chapter 7, the reformed economic model suggests that chapter 13 is simply a flawed vehicle through which to achieve this objective. The differences between chapter 7 and chapter 13 make the latter chapter attractive to those debtors who have secured assets they wish to keep but whose creditors will not accept reaffirmation (or a strip down) under chapter 7.[99] There is no reason to think that such debt-

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[95] *See supra* section IV.C.3.

[96] *See supra* section IV.C.

[97] *See supra* p. 1349.

[98] *See supra* p. 1349.

[99] Chapter 13 also attracts debtors who are in arrears on their home mortgages. *See supra* p. 1349.

ors are the most able to pay; indeed, given that their creditors have refused reaffirmation, these debtors may be less able to pay than are many chapter 7 debtors whose creditors have agreed to reaffirmation.[100] "Can-pay" debtors are those with either considerable assets or large future incomes. The data show that few debtors have significant assets when they file. For the few who do have assets, limiting exemptions should prevent abuses. Debtors with large future incomes have the *least* incentive to choose chapter 13 because a three- to five- year repayment plan represents a large loss in present value terms. Furthermore, these debtors are the most likely to be able to reaffirm their debts because their creditors will realize that they are able to repay. Chapter 13 is appealing to debtors who have limited future income and a powerful attachment to some secured asset (for example, a home) — factors which make the repayment plan relatively inexpensive compared to a chapter 7 discharge. These debtors are precisely the ones who are most likely to fail in chapter 13, which explains why such a large percentage of chapter 13 plans fail.[101]

The reformed economic model suggests that, in fact, it would be very difficult to get debtors to pay more in bankruptcy. The model and the data demonstrate that debtors file only when they are in dire economic straits. This situation can be changed only by encouraging debtors to file for bankruptcy sooner — before they have spent all their assets and run up such large debts. Doing so would require changing the incentives debtors face prior to filing. Changes to the Bankruptcy Code, however, are unlikely to impact the filing rate because debtors possess little information about the laws of bankruptcy. Another possible strategy to encourage earlier filing is to reduce the stigma associated with bankruptcy, thereby reducing the nonpecuniary costs of filing. How this stigma can be influenced, however, is unclear. Alternatively, policymakers may be able to force debtors into bankruptcy sooner by changing the laws governing lending in order to hamper debtors' ability to obtain credit when they are in dire financial straits. This solution is impractical, however, because other policy concerns that affect the debtor-creditor relationship mitigate against such a strategy.

VI. CONCLUSION

The traditional economic approach offered scholars a model within which to analyze consumer bankruptcy questions. Empirical studies showed, however, that scholars who applied this approach reached

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[100] At least one commentator supports this view. *See* Braucher, *supra* note 14, at 528–30.

[101] Sullivan, Warren, and Westbrook estimate that two-thirds of chapter 13 plans fail. *See* SULLIVAN, WARREN & WESTBROOK, *supra* note 2, at 215–17; *see also* Elizabeth Warren, *Reducing Bankruptcy Protection for Consumers: A Response*, 72 GEO. L.J. 1333, 1356 (1984) (stating that some debtors forced into chapter 13 are unable to complete a plan).

misleading conclusions. This Note suggests that, after fifteen years of empirical work, it is time to return to an economic methodology. By adopting assumptions that are more consistent with the observed behavior of debtors, the reformed economic model is able to explain the empirical results that scholars have presented. The reformed model offers a tool with which to study both consumer bankruptcy and proposals for its reform. It also offers a framework for renewed debate about consumer bankruptcy policy.