

It's Time for Means-Testing

Judge Edith H. Jones*

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I. INTRODUCTION

In an era of low unemployment, steady economic growth, and general prosperity, one jarring statistic begs for explanation: the unremitting growth in consumer bankruptcy rates during the past decade.¹ Rising from 172,000 filers in 1978,² the last year before the Bankruptcy Code took effect, the number surpassed 1.4 million consumer filers last year, approximately 1% of American households, and the end of this trend is not in sight.³ More filings occurred during six months in 1997 than during the entire decade of the Great Depression.⁴ This record number of bankruptcy filings in an era of prosperity has disturbed all but the most committed bankruptcy advocates. The

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1. See *infra* TABLE I, American Bankruptcy Institute, *Personal Bankruptcy Filings By Quarter 1990-1998* (last modified Aug. 11, 1998) <<http://www.abiworld.org/stats/big98quarter.html>>; see also *infra* TABLE II, American Bankruptcy Institute, *U.S. Bankruptcy Filings 1980-1996* (last modified Mar. 2, 1997) <<http://www.abiworld.org/stats/annualgraph.html>>.

2. See Michelle J. White, *Personal Bankruptcy Under the 1978 Bankruptcy Code: An Economic Analysis*, 63 IND. L.J. 1, 29 (1987).

3. See American Bankruptcy Institute, *2nd Quarter of 1998 Records Highest Number of Bankruptcy Filings Ever* (Aug. 11, 1998) <<http://www.abiworld.org/release/98secondquarterfilings.html>> [hereinafter *Highest Number*].

4. See Joseph Pomykala, *Bankruptcy Reform: Principles and Guidelines*, 20 REGULATION 1 (1997). Consumer filings in 1997 were also 49.9% higher than in 1992, during the height of the last recession, when 900,874 consumer bankruptcies were filed. See *Highest Number*, *supra* note 3.

problem has inspired both an examination of the causes of increased filings and congressional proposals to reform the bankruptcy system.

The most contentious reform that has been suggested to rein in the precipitous increase and costs of bankruptcy filings has been the imposition of means-testing for upper-income debtors. Means-testing expresses no specific proposal but embodies the concept that well-off, income-earning debtors should be required to repay what they can to their unsecured, nonpriority creditors, in exchange for the valuable benefits they receive from bankruptcy. Judging from the critics' reaction, however, an uninformed observer might be led to believe that proposals to means-test the eligibility of debtors for Chapter 7 are tantamount to reviving debtors' prisons and indentured servitude. Consider just a few of the overwrought responses of bankruptcy scholars to proposals for means-testing. "Means testing is mean-spirited," opines Professor Kenneth Klee.⁵ Professor Elizabeth Warren echoes this sentiment somewhat more specifically, "Those who want to say [that] 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."⁶ She opines elsewhere that the answers to "the problems of more than a million families [are] not as easy as closing the doors to the bankruptcy courts."⁷ Other critics of means-testing have picked up the mantra.⁸

It is unfortunate that well-known academics and bankruptcy specialists have chosen to oppose means-testing viscerally. For the fact is, the House of Representatives, while repudiating the silence of the National Bankruptcy Review Commission on the subject,⁹ overwhelmingly supported a means-testing bill in June

5. *NBC Says Credit Industry's Reform Proposals Mean-Spirited*, 32 Bankr. Ct. Dec. (CRR) 4 (Apr. 7, 1998).

6. Peter Pae & Stephanie Stoughton, *Personal Bankruptcy Filings Hit Record; Easy Credit Blamed, Congress May Act*, WASH. POST, June 7, 1998, at A1.

7. Elizabeth Warren, *The Bankruptcy Crisis*, 73 IND. L.J. 1079, 1101 (1998).

8. See, e.g., Michael Higgins, *Putting Back the Bite*, A.B.A. J., June 1998, at 74, 75 (Jeffrey L. Solomon said that "in effect, 'We don't care about the things that happen in the normal vicissitudes of life; pay the damn bank,' . . . It's really that mean-spirited."); Richard A. Schwartz, *CON: Root of Problem is Aggressive Lending*, COURIER-J. (Louisville, KY), June 27, 1998, at 11A (calling H.R. 3150, which would apply a means-test, "one of the most mean-spirited pieces of legislation in recent memory").

9. See Edith H. Jones & James I. Shepard, Nat'l Bankr. Rev. Comm'n, *Additional Dissent to Recommendations for Reform of Consumer Bankruptcy Law*

1998.¹⁰ The Senate passed a modified means-testing bill later in the summer. In the end, however, means-testing foundered in the face of a threatened White House veto. Although bankruptcy reform foundered in the 105th Congress, it has already resurfaced this year, with means-testing as its centerpiece.¹¹ A constructive debate on means-testing, which this article hopes to assist, will aid the legislative process and the interest of society beyond the bankruptcy community.

The debate ought to begin by acknowledging that critics of means-testing have been discussing two separate issues. The first is whether means-testing is a good idea. Both practical and theoretical objections have been deployed against the pending legislation. Critics seek, however, to focus media attention not on the battle they cannot win—that well-off debtors should be required to pay something to unsecured creditors in exchange for the privilege of obtaining the automatic stay and a fresh start—but on longstanding currents of anticreditor populism. The second issue, in which critics blame lenders for inducing consumers to borrow more than they can afford, transcends specific means-testing proposals and embraces broad assumptions about the role of bankruptcy law in redistributing wealth from creditors to debtors.¹² Criticisms of means-testing mask

(visited Nov. 24, 1998) <<http://162.140.225.1/report/24commvi08.html>>.

10. See the Bankruptcy Reform Act of 1998, H.R. 3150, 105th Cong. (1998) [hereinafter H.R. 3150], passed by the House of Representatives on June 10, 1998. Before the end of the 105th Congress, the Senate also passed a bankruptcy bill, the Consumer Bankruptcy Reform Act of 1998, S. 1301, 105th Cong. (1998) [hereinafter S. 1301], see *infra* notes 103-06, and a Conference Committee worked out revisions to H.R. 3150, which the House approved as a substitute on Oct. 9, 1998. The conference bill was not voted on by the Senate because the end of the legislative session approached and a presidential veto was threatened.

The compromise bankruptcy reform bill proposed a means test incorporated in 11 U.S.C. § 707(b) (1994) and based on more lenient standards than those earlier favored by the House of Representatives. Our discussion will focus on the original version of H.R. 3150 for two reasons. First, a successful defense of the “up-front” means test also justifies less demanding compromises that might be passed. Second, the fairest and most uniform way to administer means-tested bankruptcy relief is ultimately through an up-front calculation.

11. On January 19, 1999, Rep. Rob Andrews (D-NJ) introduced a means-testing bill in the 106th Congress. It is expected that Rep. George Gekas (R-PA), who sponsored H.R. 3150 last session, will introduce a comprehensive means-testing proposal this year. See H.R. 333, 106th Cong. (1999); see also American Bankruptcy Institute, *First Means-testing Bill of New Congress Introduced in House* (Jan. 25, 1999) <www.abiworld.org/legis/bills/hr333intro.html>.

12. In their academic writing, scholars such as Elizabeth Warren and Jean Braucher forthrightly favor expansive bankruptcy relief as part of a larger political and

fundamental questions of social policy and demand consideration of the causes of the recent dramatic rise in personal bankruptcies. For if the increase has been spurred by reckless credit-granting policies, means-tested bankruptcy reform is more difficult to justify. Critics of means-testing are quick to assert this pejorative connection, but they have been slow to develop proof of it.

In this article we address both issues. First, we will discuss, as a nonexclusive example of means-testing, the relevant provisions of the bankruptcy reform bill passed by the House of Representatives, H.R. 3150.¹³ An accurate explanation demonstrates that this bill's means test is not only moderate and fair but also practical and administratively reasonable. We will also respond to the most common criticisms of the proposal, criticisms that apply to any bankruptcy means test.

We will then turn to the proper broader issue of the role of consumer bankruptcy in the American economy and society. Unlike, perhaps, the critics of means-testing, we believe that the dramatic escalation in consumer bankruptcies in an era of prosperity is a troubling and costly social phenomenon. In our view, the evidence now available tends to suggest that the recent rise in personal bankruptcies has been significantly influenced by a decline in the personal shame and social stigma traditionally accompanying bankruptcy, and by changes in the law and legal practice that have facilitated filing bankruptcy. On the other hand, the most prominent counter-explanation—rising consumer credit card debt—is based on faulty data and faulty arguments. Other popular explanations for increasing personal bankruptcies are both empirically unproven and ideologically selective. Critics of means-testing have not borne their burden of demonstrating systematic unfairness in credit practices or social policies that would render means-testing unfair.

Braucher forthrightly favor expansive bankruptcy relief as part of a larger political and social agenda in which bankruptcy is a salve for certain excesses of capitalism and creditor overreaching. See, e.g., 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. INST. L. REV. 1 (1998).

13. See discussion *supra* notes 9-10 and accompanying text.

II. THE TRUTH ABOUT MEANS-TESTING

A. *The Underlying Assumptions*

Debt relief should be available to victims of true hardship whose debts exceed their ability to repay. Bankruptcy is an appropriate last resort for individuals who become incapacitated or impecunious because of unforeseen illness, unemployment, or other catastrophe. In many such cases, liquidation of the debtor's nonexempt assets and a fresh start is the only realistic, humane alternative.

But bankruptcy should not merely be a means of violating promises willy-nilly. A promise to repay money is an important legal and moral obligation, neither lightly to be undertaken nor lightly cast away. Filing bankruptcy represents a decision to repudiate promises made in exchange for goods, services, and other promises. Of such promises and reciprocity is the fabric of civil society woven.¹⁴ Henry Sumner Maine famously wrote that the foundation of freedom in the western world was associated with the movement from "Status to Contract."¹⁵ What happens when contracts are routinely swept aside for any reason, let alone as a sheer matter of convenience? Children are taught from a very young age to keep their promises.¹⁶ What is the intangible social impact of rampant promise breaking? Although difficult to quantify, there are unquestionable negative social consequences. It is doubtful, for example, that bankruptcy academics would be sanguine about letting obligors walk away from their debts for payment of child support or alimony rather than creditors' bills. Or, hitting closer to home, it is doubtful that they would advocate a "pay what you want to" approach to law school tuition or lawyers' consulting fees, after promising to pay in full.

Means-testing is thus based on the simple proposition, generally accepted in American society, that people should pay their debts if they are able. Bankruptcy is a serious ethical and economic matter and should not be abused. The amount of bank-

14. See MATT RIDLEY, *THE ORIGINS OF VIRTUE: HUMAN INSTINCTS AND THE EVOLUTION OF COOPERATION* 69-70, 130-31 (1996).

15. HENRY SUMNER MAINE, *ANCIENT LAW: ITS CONNECTION WITH THE EARLY HISTORY OF SOCIETY AND ITS RELATION TO MODERN IDEAS* 174 (reprint. ed. Hasell, Watson & Viney, Ltd. 1924) (1861) ("[W]e may say that the movement of the progressive societies has hitherto been a movement from Status to Contract.").

16. See Jonathan R. Macey, *Public and Private Ordering and the Production of Legitimate and Illegitimate Legal Rules*, 82 CORNELL L. REV. 1123, 1127 (1997).

ruptcy relief afforded a debtor should be adjusted by both his ability to pay and his need. If a debtor can make full or partial repayment to his creditors from future income without unreasonable hardship, he should endeavor to do so. Further, if a debtor is able-bodied and earns an income that will allow him to live comfortably but still make payments to his creditors, the law may require some repayment as a condition of bankruptcy relief. Debtors with good jobs and regular incomes should be held to a different standard from debtors who confront real hardship or incapacity. Debtors with higher incomes should ordinarily repay more to creditors than debtors with lower incomes. These principles are applied routinely by government—higher-income earners are expected to pay more in taxes, just as needs-based relief is the hallmark of most social welfare programs. Those who disagree with bankruptcy means-testing ought to explain why the bankruptcy system is or should be so different from other institutions.¹⁷ Viewed from this larger perspective, means-testing is not designed as a deterrent to filing bankruptcy; it is designed to maximize social equity as well as assure some repayment in the course of discharging debts. It should be no surprise, then, that recent polls suggest strong support for means-testing among the public.¹⁸

It is also advantageous to minimize, to the extent possible, the costs imposed by bankruptcy. Providers of goods and services who become involuntary claimants against the debtor bear the initial brunt of the decision to file. The imposition of losses on creditors by debtors who are able to repay some or all of their obligations is unfair. In some cases, such losses are financially devastating to small creditors, who have less ability to spread those losses. Tangible costs are also borne by consumers, to the extent that creditors pass on their bankruptcy risks and losses.¹⁹

17. See Jones & Shepard, *supra* note 9, at pt. II. As the Jones and Shepard dissent from the NBRC's recommendations observed, "Means-testing is not a radical idea. We already use it to determine child care benefits, Medicaid benefits, social security benefits, supplemental security income, food stamp benefits and student aid benefits at the federal level alone." *Id.*

18. One poll estimated that last year \$4 billion in payable debts had been wiped out by bankruptcy. Seventy-six percent of those polled reacted by saying they were "critical," while forty-three percent were "outraged." Jacob M. Schlesinger, *Card Games: As Bankruptcies Surge, Creditors Lobby Hard to Get Tougher Laws*, WALL ST. J., June 17, 1998, at A1 (reporting results of poll by Frederick Schneiders).

19. See RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* § 14.5, at 443 (5th ed. 1998).

The principle often forgotten by bankruptcy specialists is that bankruptcy is not a victimless event.

Bankruptcy relief should not give debtors a marked advantage over similarly situated nondebtors. Society should not broadly afford relief to well-off, able-bodied debtors when poorer people, who have not elected that remedy, struggle to keep their commitments and live within their means. As a calculating, incentive-driven remedy that can openly be taken advantage of by the opportunistic, bankruptcy dishonors poor but honest nondebtors. An ability-to-pay test minimizes this inequity.

Finally, a spate of high-profile celebrity, sports figure, and political bankruptcies, together with the disillusioning experiences of growing numbers of bankruptcy creditors has called into question the system's ability to police itself. By adjusting the amount of debt relief to the debtor's need, means-testing would increase public confidence in the bankruptcy system. Well-off debtors would not be perceived to get away with abuse, and the system would again be viewed as a refuge for the honest, needy debtor.

A means-testing proposal such as H.R. 3150 implements these commonly shared judgments by providing a rule of decision that distinguishes between those who can and cannot make payments to creditors from future income. Bankruptcy should not be merely a device to cast away promises. Sometimes it is necessary to do so, but the key is *necessity*. Bankruptcy should not be available as a matter of convenience.

B. H.R. 3150

H.R. 3150 directs consumer debtors away from Chapter 7 and into Chapter 13 based on a three-part test. First, the debtor's "current monthly total income," including, if applicable, household income from all sources, must be at least equal to the national median for a family of comparable size.²⁰ For a four-person family, the most recent median annual income was about \$49,000.²¹ Second, the debtor's "projected monthly net income" must exceed \$50.²² Third, the projected monthly net income

20. H.R. 3150, *supra* note 10, § 101(1), (4).

21. See U.S. BUREAU OF THE CENSUS, STATISTICAL ABSTRACT OF THE UNITED STATES: 1997 (117th ed. 1997) (reporting the median income for two-parent families with at least two children in which the parents were married to each other).

22. See H.R. 3150, *supra* note 10, § 101(4). Living expenses (as determined by IRS

must be "sufficient to repay twenty percent or more of unsecured nonpriority claims during a five-year repayment plan."²³ A debtor may avoid an automatic Chapter 13 order by asserting extraordinary circumstances in an itemized statement verified by him and his attorney.²⁴ If no party in interest objects to the statement within sixty days, Chapter 7 relief will be allowed.²⁵

By its express terms, this means-testing provision applies *only* to those debtors whose income exceeds the national median. Given the patently modest application of means-testing, it is bizarre, if not just disingenuous, to characterize H.R. 3150 as "mean-spirited." Even the supporters of H.R. 3150 estimate that this provision will cover fewer than 10% of the consumer bankruptcy cases filed each year.²⁶ Thus, it simply has no impact on the hundreds of thousands of debtors who are poor. Moreover, the reason for filing bankruptcy is irrelevant. The amount of debt a person has upon filing bankruptcy is also irrelevant. What matters is an individual's ability to repay. Those who can make some repayment to unsecured, nonpriority creditors from future income are expected to do so, but the extraordinary circumstances provision affords extra relief for those in need. The *only* effect of means-testing is to prohibit well-to-do debtors who can make some repayment from walking away and sticking creditors and other consumers with the bill.

Indirect confirmation of the need for means-testing is provided by Professor Elizabeth Warren, who asserts that bankruptcy is now a middle-class problem. She contends that debtors in bankruptcy "are middle-class—that's what's scary about this They are not marginal workers. They are you and me, they are our neighbors."²⁷ This observation is not, as Warren concludes, proof of the need for the *status quo* or an argument against means-testing. On the contrary, it is precisely because more middle-class and wealthy gainfully employed people are availing themselves of bankruptcy that means-testing has be-

collection standards), secured debt payments, and priority unsecured debt payments are subtracted from the debtors "current monthly total income." *Id.* The remainder is the debtor's "projected monthly net income." *Id.*

23. *Id.*

24. *See id.*

25. *See id.*

26. *See* discussion *infra* Parts II.B.1, II.C.

27. *Middle class make up bankruptcy filings; Congress trying to slow the surge*, CINCINNATI ENQUIRER, July 27, 1998, at B16.

come important.²⁸ Traditionally, bankruptcy was seen as a last resort, a remedy for those truly down on their luck, not a device for income-earning, middle-class families to walk away from their promises and shift the losses from themselves to others. Means-testing requires well-off debtors, those above the national median income level, to repay what they can to their creditors.

If one accepts the general rationale of means-testing, the practical question is whether its benefits exceed its costs. While the precise impact of H.R. 3150 cannot be known until it is implemented, we are convinced that the results of this assessment will be positive. Means-testing will increase the overall amount collected for distribution to unsecured creditors. The size of this effect is uncertain, but even discounting for uncertainty in the data and methods, it appears that significant recoveries will result from directing high income debtors into Chapter 13 repayment plans. As a benchmark, consider that when a debtor elects Chapter 7, the debtor's unsecured, nonpriority creditors usually receive no distribution at all. Because few consumer debtors claim nonexempt assets,²⁹ more than 90% of Chapter 7 cases pay no dividend to unsecured nonpriority claimants, and the average repayment rate in Chapter 7 cases is only about one to two percent.³⁰ Approximately 70% of consumer debtors file under Chapter 7.³¹ Compared with the Chapter 7 record, the only hurdle for means-testing is whether the plans proposed under it will generate *some* payout larger than zero to unsecured, nonpriority cred-

28. The reasons why bankruptcies among the middle-class have risen will be discussed below. See *infra* Part III.B.

29. In a Chapter 7 case, all assets which are nonexempt are liquidated and the proceeds are distributed to unsecured creditors. Debtors are allowed to retain exempt assets. While exemptions vary greatly by state in both the type of asset involved and the amount of the exemption, most states include exemptions for households, vehicles, and retirement assets. Accordingly, Chapter 7 debtors frequently retain some assets after a bankruptcy discharge.

30. See White, *supra* note 2, at 38-39; cf. 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) ("Even in asset Chapter 7 proceedings, only a small fraction of general unsecured debt is paid."); Note, *A Reformed Economic Model of Consumer Bankruptcy*, 109 HARV. L. REV. 1338, 1345 (1996) (discussing studies of Chapter 7 cases).

31. See American Bankruptcy Institute, *Non-Business Bankruptcy Filings by Chapter 1990-1998 (3rd Quarter)* (visited Feb. 2, 1999) <<http://www.abiworld.org/stats/1990nonbuschapter.html>>.

itors. Common sense, supported by several studies, suggests that means-testing will satisfy this standard.

1. *Studies*

One such study was conducted by Ernst & Young.³² The study is based on an earlier version of H.R. 3150, which triggered means-testing for debtors whose income was at least 75% of the national median income, a level lower than that in the final bill. Thus, the Ernst & Young study overstates both the number of debtors potentially directed into Chapter 13 as well as the amount that may be collected. But even under the more expansive means-testing provision, the Ernst & Young study of petitions filed primarily in 1992-93 found that fewer than 15% of those filing would even be affected by means-testing.³³ The other 85% of debtors would retain full discretion to file under Chapter 7. Among the affected debtors, Ernst & Young found that nearly 40% of those filers would be able to repay *all* of their nonpriority debts over five years.³⁴ Overall, it is estimated, those subject to means-testing could repay an average of 62% of their total debts over five years.³⁵

Ernst & Young subsequently revisited the issue using a new database that draws from a nationwide sample of petitions.³⁶ This study examined 2,200 Chapter 7 petitions filed in 1997 and was drawn from all 90 bankruptcy districts in the nation. Thus, it represents the most recent and the only fully national data set studied to date.³⁷ It was also fully controlled to ensure a representative sample of Chapter 7 filings on a national basis.

The findings of the second Ernst & Young study replicated those of the earlier study. Applying the test of 75% of national median income of the original version of H.R. 3150, the study found that 15% of 1997 Chapter 7 filers would have been im-

32. Tom Neubig et al., Chapter 7 Bankruptcy Petitioners' Ability to Repay: Additional Evidence from Bankruptcy Petition Files (Policy Economics and Quantitative Analysis Group, Ernst & Young LLP) (Feb. 1998) (unpublished manuscript, on file with authors).

33. *See id.* at 1, 3.

34. *See id.* at 21-25.

35. *See id.* at 17. Of course, this figure would also likely be higher if only those above 100% of the national median income were included, rather than 75%.

36. *See* TOM NEUBIG & FRITZ SCHEUREN, ERNST & YOUNG, CHAPTER 7 BANKRUPTCY PETITIONERS' ABILITY TO REPAY: THE NATIONAL PERSPECTIVE, 1997 (March 1998).

37. *Id.* at 1.

pacted by the needs-based provision of H.R. 3150 and required to file Chapter 13.³⁸ Those affected by means-testing would have had the ability to repay 64% of their unsecured nonpriority debts, which represented over \$4 billion.³⁹ Including secured and priority debt, those affected by means-testing could have repaid about \$9 billion of total Chapter 7 debt at risk if they had filed under Chapter 13.⁴⁰ This study updates and confirms the findings of earlier studies and recognizes that some ten to fifteen percent of Chapter 7 bankruptcy filers could repay a substantial portion of their debts if they filed in Chapter 13 instead.

It is also significant that filers impacted in 1997 under H.R. 3150 had median incomes considerably above the 1996 national median income for all households.⁴¹ In addition, filers *not* impacted by means-testing earned less than *half* of the median income of those affected.⁴² Finally, those subject to means-testing could repay the median amount of unsecured nonpriority debt of \$21,679, whereas the comparable figure for all Chapter 7 filers was zero.⁴³ In sum, the idea that means-testing will adversely affect poor bankruptcy filers is a myth.

A study by John M. Barron and Michael E. Staten of the Credit Research Center at the Georgetown School of Business achieved comparable results based on debtors' petitions and schedules.⁴⁴ While this study did not select debtors according to minimum income criteria, its findings are supportive of means-testing. They found that 5% of those filing Chapter 7 could have repaid 100% of their debt in five years. Approximately 25% of Chapter 7 debtors had income sufficient to repay at least 30% of

38. Because this study applied the 75% of national median income test, it tends to overstate the number of people who will be subject to means-testing.

39. See NEUBIG & SCHEUREN, *supra* note 36, at 8. Those affected by means-testing also had more unsecured nonpriority debt (\$30,813 at the median) than those unaffected (\$23,570 at the median). See *id.* at 11.

40. See *id.* at 8.

41. Those affected by H.R. 3150 had median household incomes of \$44,738 compared to the national median income of \$35,492. See *id.* at 11. Of course, this differential is understated in the Ernst & Young study because the median income of those impacted under the final version of H.R. 3150, which requires 100% of the median national income, will be higher than the 75% of national median income used in the study. See *id.* at 11.

42. Those not affected had median incomes of \$20,417. See *id.*

43. See *id.*

44. See John M. Barron & Michael E. Staten, Personal Bankruptcy: A Report on Petitioners' Ability-to-Pay (Oct. 6, 1997) (unpublished manuscript, on file with authors and the Credit Research Center, Georgetown University).

their nonhousing debt over five years while keeping up mortgage or rental payments on their homes. Ten percent of Chapter 7 debtors declared income sufficient to repay at least 78% of their nonhousing debt over five years.⁴⁵

The WEFA Group also conducted a study using the earlier statutory baseline of 75% of national median income.⁴⁶ WEFA estimated means-testing would reduce, by eight to seventeen percent, the losses annually caused by bankruptcy filings, thus saving somewhere from \$3.6 to \$7.4 billion per year.⁴⁷

The findings of the most recent Ernst & Young study suggest that, if anything, the WEFA study underestimates the total amount of Chapter 7 debt in the bankruptcy system and, consequently, the financial costs of the personal bankruptcy system.⁴⁸

The findings of these credit-industry sponsored studies have been largely confirmed in a recent study by Professors Marianne B. Culhane and Michaela M. White of Creighton University School of Law.⁴⁹ Although their sample is smaller in size, less recent, and from fewer districts than the studies discussed above, the Culhane and White study also shows that a substantial number of consumer bankruptcy filers could repay all or a substantial portion of their unsecured nonpriority debts in Chapter 13, and that means-testing provides an effective mechanism for identifying those individuals. Culhane and White studied 150 cases from 7 districts for a total of 1,050 cases, all taken from 1995 files.⁵⁰ Twenty-one percent of Chapter 7 filers in their

45. *See id.* at 25.

46. *See* WEFA GROUP RESOURCE PLANNING SERVICE, *THE FINANCIAL COSTS OF PERSONAL BANKRUPTCY* 19 (1998).

47. *See id.* at 2, 23.

48. *See* NEUBIG & SCHEUREN, *supra* note 36, at 12.

49. *See* Marianne B. Culhane & Michaela M. White, *Means-Testing for Chapter 7 Debtors: Repayment Capacity Untapped?* (December 1, 1998) <<http://www.abiworld.org/research/creightonstudy.html>>.

50. Culhane and White studied the Northern District of California, the District of Colorado, the Northern District of Georgia, the District of Massachusetts, the District of Nebraska, the Middle District of North Carolina, and the Western District of Wisconsin. *See id.* (describing their sample design). The reliability of their study may be suspect as a result of a failure to adjust their sample to account for variations in numbers of filers, income, and ratios of chapter 7 to chapter 13 filers in the districts studied. For instance, Culhane and White drew 150 petitions each from the Northern District of California and the Middle District of North Carolina, despite the fact that 17,437 petitions were filed in the Northern District of California and only 1,151 in the Middle District of North Carolina, California generally has a higher income than North Carolina, and that a much lower percentage of bankruptcy filers choose chapter 7 instead of chapter 13 in the Middle District of North Carolina than in the Northern

sample were above the national median income, adjusted for family size, suggesting that 79% of filers would not even be affected by means-testing. Indeed, the median gross income of the potentially means-tested group was 22% *higher* than the national median income for all families, suggesting that many bankruptcy filers today are relatively well-off. Even under the researchers' restrictive assumptions, approximately one-fifth of those above-median filers had more than \$50 in net monthly income available for a plan as required by the second element of H.R. 3150, and most of them could also repay 20% or more of their unsecured nonpriority debts, as required by the third element of H.R. 3150. In sum, Culhane and White find that approximately 35,000 of last year's one million Chapter 7 bankruptcy filers, could have repaid a substantial portion of their debts had they elected Chapter 13. Those who would be covered by means-testing were able, on average, to repay 70% of their unsecured nonpriority debts. Thus, even under the assumptions made by Professors Culhane and White, many high-income bankruptcy filers would be affected by means-testing, and those individuals could repay a substantial amount of their nonpriority unsecured debts in Chapter 13.

But Culhane and White's study rests on some questionable assumptions that tend to underestimate the number of bankruptcy filers that would be affected by means-testing. In particular, Culhane and White make two dubious assumptions in running their tests. First, they include a "motor vehicle ownership allowance" in the debtor's budget, in effect expecting the debtor to spend up to \$20,100 to buy a *new car* during the term of her plan. They criticize Ernst & Young's "unduly restrictive" assumption that a debtor should only be permitted to pay off the amount owed on her existing car, rather than to provide enough money to buy or lease a new car while in bankruptcy.⁵¹ But what justification can be offered for inviting debtors to buy new cars *while they are in bankruptcy*?

Culhane and White's assumption appears to be based on a misunderstanding of the authority of debtors to incur *new* automobile ownership debts under the terms of the proposed means-testing legislation and applicable IRS policies. The proposed

District of California.

51. *Id.* at pt. II (discussing the IRS Collection Financial Standards).

means-testing provisions permit an allowance for a debtor to pay off his preexisting automobile ownership debts, but they do *not* permit the debtor to incur new debt or to increase his car ownership allowance.⁵² IRS policies similarly (and unsurprisingly) provide an allowance for payment of existing automobile debt but do not make allowance for the debtor to incur *new* automobile debt.⁵³ The statutory language of the actual means-testing proposals and the applicable IRS policies are consistent with the requirements of common sense—a debtor is permitted to pay off his secured debt on an automobile if he has one but not to incur new debt to buy a new car. A revision of the peculiar and incorrect assumption that a debtor would be permitted to buy a \$20,000 new car in bankruptcy raises the number of debtors who qualify for means-testing to over 6% of the sample, a number that is quite similar to the findings of the more extensive studies discussed above.

Culhane and White make a second questionable adjustment in deducting from the debtor's ability to pay a trustee's fee of 5.6%. This assumption appears in two places and each time it reduces the number of debtors who will qualify for means-testing. First, it reduces the debtor's projected net monthly income for purposes of determining whether the debtor can pay at least \$50 per month into her plan. Second, it artificially diminishes the debtor's calculated ability to repay 20% of her unsecured nonpriority debts.

But it is untenable to consider trustees' fees in this manner. Means-testing is concerned with the debtor's ability to *pay* \$50 per month into a plan and to repay 20% of her unsecured debts,

52. The proposed means-testing legislation specifically allows payment of secured debts (not limited to secured debts on automobiles) but provides no basis for allowing the incursion of new secured debt on an automobile or anything else. Moreover, although IRS policies are made applicable for calculating the debtor's monthly expenses, the applicable provisions specifically "exclud[e] payments for debts" from the reach of the IRS rules, subjecting them to special bankruptcy rules. This preemption language actually has the effect of making the means-testing provisions significantly more generous for debtors than would the IRS standards, as it eliminates the caps imposed by the IRS on indebtedness and does not limit the types of secured debt that the debtor is permitted to repay.

53. For instance, the Internal Revenue Manual provides, "If a taxpayer has no car payment, or no car, only the operating costs portion of the transportation standard is used to come up with the allowable transportation expense." INTERNAL REVENUE MANUAL-ADMINISTRATION ¶ 5323.433 sub-¶ 3. Clearly the IRS does not create an allowance for a taxpayer to incur new indebtedness to buy a new car or to replace an old car with a new one.

not with whether the creditors will actually *receive* those amounts. Trustees' fees are irrelevant to the debtor's ability to *pay*—although they are relevant to the creditors' ability to *collect*. The fees reflect the amount that creditors are willing to pay in order to collect a part of the debt owed to them. After these expenses are deleted from the debtor's budget, and the debtor's motor vehicle ownership allowance is eliminated, approximately 7% of debtors qualify for means-testing.⁵⁴

Although their sample is not as extensive or recent as some prior studies, Culhane and White's study is still valuable as it tends to confirm the results of these prior studies. Their results are even more similar once their study is adjusted for its unrealistic and erroneous assumptions. In short, there are many high-income Chapter 7 debtors who could repay a substantial portion of their unsecured nonpriority debts if they were forced to elect Chapter 13.

While there is room for dispute as to how large an impact means-testing will have, it is silly to argue that it will have no impact or to discount the veracity of these studies only because they were funded by the credit industry.⁵⁵ If there really were no benefit to unsecured creditors from channeling more debtors into Chapter 13 payment plans, the credit industry would not be advocating means-testing.⁵⁶ Surrealistically, however, law professors are lecturing the credit industry on the best way for creditors to collect on their outstanding loans.⁵⁷

Independent of cost-benefit analysis, means-testing would send an important moral signal to bankruptcy debtors that if they have the ability to repay a substantial portion of their debt, they should be required to do so. Thus, to the extent that there are doubts about the administrative savings that would result from a bright-line statutory means-testing requirement or about

54. See Culhane & White, *supra* note 49, at pt. II (discussing Administrative Expenses and Chapter 13 Trustee's Fee). It should also be added that adopting means-testing will likely cause many debtors not to file at all, thus no trustee's fees will be included at all in those cases. In particular, debtors who will be forced to repay 100% of their debts will probably choose not to file at all.

55. See Braucher, *supra* note 12, at 8-9; Warren, *supra* note 7, at 1085-95.

56. The consumer credit industry has been a long-time advocate of some form of means-testing for Chapter 7 relief. See Elizabeth Warren, *A Principled Approach to Consumer Bankruptcy*, 71 AM. BANKR. L.J. 483, 503 (1997).

57. See Warren *Challenges Creditor Findings in New Study*, 32 Bankr. Ct. Dec. (CRR) A8 (July 21, 1998) (arguing that even under ideal conditions, creditors get little or no benefit from means-testing) [hereinafter *Warren Challenges*].

the number of individuals who would qualify under means-testing, this moral message must also be put on the scale in favor of means-testing. While different individuals will weigh this variable differently, it is unquestionably relevant to the means-testing debate and should be kept in mind in weighing the costs and benefits of means-testing.

2. Attacks

Attacks on these studies have been vociferous and well-publicized, particularly when they purport to damn the studies' integrity solely because the research was funded by the credit card industry.⁵⁸ Similarly, they routinely refer to means-testing proposals as "the credit industry's means test" in order to tar those proposals with antibank populism.⁵⁹ Guilt by association is an old rhetorical tool, and one that critics have used to great effect. Beyond scoring rhetorical points, however, it is unclear what the purpose is of dwelling on the fact that these studies were funded by the credit card industry. Are the critics claiming that the data are fabricated or falsely reported? Or do they merely disagree with the conclusions drawn from the raw data? Assuming that the data are accurate, the conclusions are the result of simple, easily reproducible, calculations. If so, then the fact that the credit card industry funded the research is a *non sequitur*, repeatedly invoked only to obscure the actual results of the studies.

Moreover, many of the criticisms of the ability-to-pay studies suffer from methodological flaws of their own. For instance, Elizabeth Warren has repeatedly referred to a review of these ability-to-pay studies, conducted by Kim J. Kowaleski of the Congressional Budget Office, as if it were a report by the CBO. In reality, every Kowaleski report identified by Professor Warren contains a footnoted caveat: "The analysis and conclusions presented in this memo are those of the author and do not necessarily represent the position of the Congressional Budget Office."⁶⁰ Nevertheless, Warren, the reporter for the National

58. See, e.g., Warren, *supra* note 7, at 1085. Warren also routinely refers to means-testing as "the credit industry's means test," apparently for rhetorical advantage. Warren, *supra* note 56, at 503.

59. Warren, *supra* note 56, at 503.

60. Memorandum from Kim J. Kowaleski to The National Bankruptcy Review Commission, *Evaluations of Three Studies Submitted to the National Bankruptcy Review*

Bankruptcy Review Commission and the author of its report on consumer bankruptcy, repeatedly describes Kowaleski's work as an official CBO critique. When the sponsor of Dr. Staten's report called this serious error to the attention of the Chairman of the National Bankruptcy Review Commission, he was ignored.⁶¹ Later, in a law review article, Warren continued to refer to Kowaleski's report as a "CBO report," "CBO analysis," or "CBO review."⁶² She and other means-testing critics convey a misleading impression to the public even as they complain that the creditor-supported studies have received undue attention.⁶³ In the end, the strongest inference that can legitimately be drawn from Kowaleski's critique is that he *personally* disagrees with some of the findings of the WEFA, CRC, and Ernst & Young reports.

Reliance on a report by the Government Accounting Office is also questionable. While Professor Warren characterizes the GAO's report as having discredited the earlier studies,⁶⁴ her conclusion differs substantially from that of the GAO itself, which stated that the CRC and Ernst & Young reports "[b]oth . . . represent a useful first step in addressing a major public policy issue—whether some proportion of those debtors who file for personal bankruptcy under chapter 7 of the bankruptcy code have sufficient income, after expenses, to pay a 'substantial' portion of their outstanding debts."⁶⁵ She also omits the

Commission 1 n.* (Oct. 6, 1997) (on file with authors); Memorandum from Kim J. Kowaleski to The National Bankruptcy Commission, *Follow-Up Comments on Dr. Staten's Study 1* n.* (Oct. 10, 1997) (on file with authors).

61. See Letter from Thomas A. Layman, Senior Vice-President, VISA U.S.A., Inc., to Brady Williamson, Chairman, *National Bankruptcy Review Commission 2* (Oct. 14, 1997) (on file with authors). In his letter, Layman notes:

Finally, as we discussed, even though you asked Mr. Kowaleski to prepare this critique in his capacity as an employee of the Congressional Budget Office, Mr. Kowaleski states at the bottom of the first page of his critique that '[t]he analysis and conclusions presented in this memo are those of the author and do not necessarily represent the position of the Congressional Budget Office.' Accordingly, any reference to the Congressional Budget Office in his critique or in related materials describing Mr. Kowaleski is entirely inappropriate, potentially deceptive and must be deleted.

Id. (citation omitted).

62. Warren, *supra* note 7, at 1086 n.25, 1091-92.

63. See generally Warren *Challenges*, *supra* note 57, at A8 (quoting Elizabeth Warren).

64. See Warren, *supra* note 7, at 1092-93.

65. *Personal Bankruptcy—The Credit Research Center and Ernst & Young Reports on Debtors' Ability to Pay, Before the Subcomm. on Admin. Oversight & the Courts*,

following passage from the GAO Report: “[T]he actual number of chapter 7 debtors who could repay at least a portion of their nonhousing debt could be *more* or less than the estimates in these two studies. Similarly, the amount of debt these debtors could potentially repay could also be *more* or less than the reports estimated.”⁶⁶ Thus, according to the GAO, the studies may *underestimate* the total number of filers who could repay a substantial amount of their debt. Given that the authors of those reports deliberately made conservative estimates of repayment ability, it is more likely that they understate rather than overstate their results. Not only that, but GAO’s reason for suggesting that the findings of repayment ability in the CRC and Ernst & Young reports are overstated is implausible on its face.⁶⁷ Even if the GAO’s report may cast some doubt on the ultimate conclusions of the CRC and Ernst & Young reports, it is not clear that this redounds to the critics’ benefit.

On a substantive level, Warren and others have taken issue with the sample size and distribution used by the CRC and

Senate Comm. on the Judiciary, 105th Cong. *3 (1998) (statement of Richard M. Stana, Associate Director, Administration of Justice Issues, General Government Division), available in 1998 WL 130307 [hereinafter *Personal Bankruptcy*].

66. *Id.* at *17-18 (emphasis added).

67. The CRC and Ernst & Young reports both estimate that to the extent that debtors’ schedules inaccurately describe repayment ability, they will tend to understate income, overstate expenses, and thereby understate the net income available for debt repayment. The GAO believes it to be “plausible” that, to the extent there are errors in the debtors’ schedules, they may either understate or overstate “their capacity to repay their debts, with a net unknown bias in the aggregate data reported by all debtors.” *Id.* at *8-9. The GAO gives no reason to believe that a significant number of debtors will be so ignorant of the bankruptcy process that they will overstate their ability to pay their creditors. Even though a large number of debtors have no representation in drawing up their schedules, it is doubtful that many debtors will overstate, as opposed to understate, their ability to repay debts. Anyone familiar with bankruptcy practice will recognize that the GAO’s conclusion that these errors will be randomly distributed is mistaken. It would be equally plausible to argue that because most Americans file their tax returns without professional assistance that they overstate their income, understate their deductions, and otherwise routinely overstate their tax liability by a significant amount. Similarly, the GAO Report faults the authors of the studies for failing to consider that the debtors income may fall or expenses may rise during the period covered by the Chapter 13 plan. *Id.* at *10. While valid as far as it goes, this criticism is also misplaced. First, it is just as likely that a debtor’s income will rise and fall during the pendency of a bankruptcy. For instance, to the extent that the debtor files bankruptcy because she is young and at the beginning of her working career or is changing jobs, her income will be expected to rise during the 3-5 year period of a Chapter 13 plan. Second, to the extent that the debtor learns better financial management techniques, her expenses will tend to fall.

Ernst & Young studies,⁶⁸ alleging that their data bases are too small to support generalized inferences about debtors' ability to repay. Yet the CRC and Ernst & Young studies together include more petitions over a broader geographical scope than Warren's recent research. Ernst & Young studied 5,722 Chapter 7 petitions in four bankruptcy courts, mainly during 1992-93.⁶⁹ CRC studied 2,441 Chapter 7 and 1,357 Chapter 13 petitions, selecting at random approximately 300 petitions in each of thirteen cities primarily from May to July 1996.⁷⁰ Moreover, Culhane and White used the same methodology as Ernst & Young's study, thereby suggesting that their methodology was appropriate.⁷¹ The follow-up Ernst & Young study examined twice as many petitions (2,200) drawn from all 90 bankruptcy courts, all filed during 1997, the most recent year for which data was available.⁷² As the Ernst & Young and CRC studies ask the correct questions, forthrightly acknowledge their assumptions, and link their conclusions to the relevant data, they offer useful, even if not definitive, information.

It is strange that Warren utterly discounts the means-testing studies while defending her own research as simply better than "cursing the darkness."⁷³ Evidently she holds CRC and Ernst & Young to one set of empirical standards and herself to something different. Warren's thesis is that debtors today are on average poorer than they were in past years. Her recent data are drawn from 1,000 petitions filed in seven judicial districts in 1995 and 150 cases filed in one district in 1997. Her article admits its limited sample size, random time periods, and other limitations.⁷⁴ It also appears that she made no effort to adjust

68. See Warren, *supra* note 7, at 1091-92.

69. See Neubig et al., *supra* note 32, at 1.

70. See Barron & Staten, *supra* note 44, at 7.

71. See Culhane & White, *supra* note 49. Although Culhane and White make different assumptions regarding the calculation of ability-to-pay, their methodology for collecting and evaluating the data was similar. Moreover, where their methodologies and assumptions differed, Ernst & Young's approach was generally superior. See *supra* notes 51-54 and accompanying text.

72. See *supra* notes 36-43 and accompanying text (discussing Neubig and Scheuren's March 1998 Report prepared for Ernst & Young).

73. Warren, *supra* note 7, at 1097.

74. See *id.* at 1096 ("Because we have both different districts and different time periods in some of the studies, it is difficult to determine whether the differences were caused because Ohio differed from Texas or whether a 1981 sample differed from a 1997 sample or both. Moreover, it is always difficult to rely on the analysis of a limited number of districts . . .").

the relevant figures or otherwise attempt to ensure that they were nationally representative. Notwithstanding the paucity of her sample and the failure even to attempt to scientifically cabin the time periods under review, Warren asserts that “the suggestion of a trend is strong.”⁷⁵ If the “suggestion of a trend” is so strong in Warren’s limited research, why is it less so for studies that included thousands more petitions in more geographic areas with appropriate weighting to ensure national representativeness than Warren explored? Whether the studies were done by creditor-funded academics and accounting firms or by ideologically motivated academics is ultimately irrelevant or mutually canceling. Standards of proper scientific data collection and analysis are independent of the sincerity or motives of individual authors.

Judged by such objective standards, Warren’s study compares poorly to those she criticizes. Her data limitations are far more problematic than those of CRC and Ernst & Young. More significant, her conclusion—that the average income of bankrupt debtors is quite low—is ultimately irrelevant to means-testing.⁷⁶ As the GAO noted, the relevant question is whether “some proportion” of individual Chapter 7 debtors have sufficient income, after expenses, to pay a “substantial” portion of their debts.⁷⁷ Warren, however, only investigates the circumstances of the *average* debtor. Attempting to evaluate a program to means-test bankruptcy relief for high-income debtors based on the characteristics of average debtors is illogical. While Warren’s sample provides modest insight into the financial condition of some people who file bankruptcy, it is virtually useless for analyzing means-testing of high-income debtors. The light shed by this candle certainly is dim!⁷⁸

75. *Id.* at 1097.

76. Warren is not deterred from asserting the contrary. *See id.* at 1101 (suggesting that means-testing will “clos[e] the doors” of the bankruptcy courts on “more than a million families”).

77. *See Personal Bankruptcy*, *supra* note 65, at *3.

78. *See* Warren, *supra* note 7, at 1097 (“Nonetheless, the comparison among the eleven districts is a little like lighting a candle; it provides limited light and it is more productive than cursing the darkness.”). Given the deficiencies, the publicity it has garnered in some quarters is surprising. *See Warren Challenges*, *supra* note 57, at A12 (“Warren’s study supports what virtually everyone in the bankruptcy community has been saying. Will Congress listen to hard data instead of the numbers in a study paid for by a special interest group—a study that have [sic] been called into question by a government agency?”).

The nub of the problem in Warren's research is its flawed hypothesis. She contends that "[i]f the sharp rise in consumer bankruptcies is attributable to a sharp increase in debtor abuse, then the basic financial profiles of the filers ought to change over time: the addition of more affluent debtors should increase both the mean and the median incomes or lower the relative size of the debts, demonstrating their relatively better ability to repay debts."⁷⁹ This implies that means-testing can only be justified if there are enough bankruptcies of higher income-earning debtors to skew the income average upward over time. Such evidence could support means-testing, but it is hardly a necessary and sufficient condition. Bankruptcies have increased tremendously during five years of allegedly unprecedented national employment and prosperity.⁸⁰ The growing numbers of debtors who are of "average" status even by Warren's standards could swamp the statistical impact of the ten to fifteen percent of filers who would qualify for means-testing under H.R. 3150.⁸¹ And because Warren's research essentially ends in 1995, it fails to capture most of the dramatic increase of filings between 1993 and 1997, in which there is most ground for suspicion that well-off debtors became more common.

Finally, the suggestion that if the average debt load had decreased, this would signal that debtors were filing who had an ability to repay their debt—and its unstated corollary that an increase in average debts means "poorer" debtors are filing—makes no sense. Gamblers often run up high debts relative to their ability to repay, yet few would describe them as poor but honest debtors. Likewise, higher-income earners may be tempted to gamble on overly optimistic forecasts of their own financial well-being and incur extraordinary mortgage, auto loan, and consumption debts before fate takes a bad turn. Nevertheless, because the high earners still have more funds at their disposal than most Americans, it does not seem unreasonable to ask them to repay some of the victims of their profligacy. This last aspect of Warren's investigation has nothing to do with

79. Warren, *supra* note 7, at 1094.

80. See *Highest Number*, *supra* note 3 ("Total personal bankruptcies in . . . 1997 were 1,350,118, a 49.9 percent increase from . . . 1992, the height of the Recession, when personal bankruptcies reached 900,874.").

81. See Neubig et al., *supra* note 32, at 3; *supra* text accompanying note 32.

the ability to repay and the policies that may be warranted toward higher-income debtors.

Even assuming that Warren's averages are accurate and that many debtors are poor, or—counter-intuitively—even poorer than they were during the farm crisis of the 1980s, or the brief but hard recessions of the early 1980s and 1990s, why such facts would administer the coup de grace to means-testing is unclear. The status of average debtors says nothing about the ability of high-income debtors to repay some of their debts. Turning the point around, a means test with an income threshold like that of H.R. 3150 will not affect poor debtors at all. The empirical argument against means-testing, if it exists, must ultimately have a firmer foundation than the one Warren has advanced in order to be persuasive.

Although the exact amount of benefit is uncertain, it is clear that unsecured creditors and nonbankrupt consumers will benefit from means-testing of debtors, as means-testing will increase the amounts collected in bankruptcy and may lead to fewer bankruptcy filings overall. As the subsidy to bankrupts declines, consumers who pay their bills and do not file bankruptcy will benefit from lower costs of goods and services and credit. Means-testing will also increase uniformity in the application of the law, as it will for the first time create a national rule for the availability of consumer bankruptcy relief and the content of Chapter 13 plans. At least as to well-off debtors, gone will be the days when the parties could be treated vastly differently by courts next door to each other, to say nothing of those in different districts or circuits. Both the Constitution and economic sense mandate a uniform bankruptcy law; means-testing progresses far toward that goal.

Critics of means-testing not only discount its benefits but raise various objections to its practicability and fairness. On analysis, however, it is evident that complaints that means-testing will inflict mortal costs on the bankruptcy system are overstated. The primary objection to means-testing is that it would needlessly increase the administrative costs of the bankruptcy

system by making it more complicated.⁸² This concern is misplaced.

Under the current system, a form of means-testing occurs, but in a very uncertain and *ad hoc* manner. Section 707(b) provides no criteria for the definition of "substantial abuse," and caselaw has provided little guidance.⁸³ As a result, there is a wide variation in "local cultures" as to what constitutes "substantial abuse."⁸⁴ To the extent that any consistency can be teased out of the cases, they agree that the primary factor in determining whether "substantial abuse" exists is the debtor's ability to pay.⁸⁵ But there is vast disagreement and inconsistency as to "how much" a debtor must be able to pay before the "substantial abuse" provision is triggered.⁸⁶ The *legal* standard of "how much" varies from case to case and court to court.⁸⁷ Whether a particular debtor is eligible for Chapter 7 is potentially litigable in many cases with highly unpredictable results. Needless to say, the actual administrative costs of this fact-intensive, ruleless inquiry are not trivial; the hidden social costs of non-uniformity and the perceptions of abuse and unfairness it spawns are also considerable.

By statutorily quantifying ability-to-pay as a demarcation for Chapter 7 eligibility, Congress will enhance uniformity, certainty, and consistency of the law and, by definition, will reduce administrative costs associated by the present confusing condition of § 707(b). The critics of means-testing nevertheless complain that, because of this change, the courts and clerks' offices

82. See Braucher, *supra* note 12, at 10; Gary Klein, *Means Tested Bankruptcy: What Would it Mean?*, 28 U. MEM. L. REV. 711, 734 (1998); Warren, *supra* note 7, at 1091.

83. The confusion in the current case law is summarized in Michael D. Bruckman, Note, *The Thickening Fog of "Substantial Abuse": Can 707(a) Help Clear the Air?*, 2 AM. BANKR. INST. L. REV. 193, 205 (1994) (characterizing judicial interpretation of "substantial abuse" as marked by "uncertainty and inconsistency").

84. Indeed, such local variations will be endemic in any standard-based gatekeeper, such as "substantial abuse." See Jack F. Williams, *The Fallacies of Contemporary Fraudulent Transfer Models as Applied to Intercompany Guaranties: Fraudulent Transfer Law as a Fuzzy System*, 15 CARDOZO L. REV. 1403 (1994).

85. See, e.g., *In re Lamanna*, 153 F.3d 1, 4 (1st Cir. 1998) (stating consumer debtor's ability to repay his debts out of future disposable income is strong evidence of "substantial abuse"); *In re Koch*, 109 F.3d 1285, 1288 (8th Cir. 1997) (noting that "the substantial abuse inquiry focuses primarily on Debtors' ability to pay").

86. See *Lamanna*, 153 F.3d at 4 (rejecting "per se rules mandating dismissal for 'substantial abuse' whenever the debtor is able to repay his debt out of future disposable income").

87. See generally Williams, *supra* note 84.

will be forced into making case-by-case evaluations of Chapter 7 eligibility in large numbers of cases, and trustees' burdens will increase. Such criticisms, however, are contradicted by a proper analysis of the proposal.

C. *H.R. 3150 Support*

Under the three-part test described in H.R. 3150, a debtor's income and cost of living is compared to objective standards and data that have been in existence for years and are routinely updated by relevant government agencies.⁸⁸ Thus, the eligibility prong that depends on the debtor's being in the top half of national median income, adjusted for family size, relies on Census Bureau figures for the benchmark.⁸⁹ The second criterion measures monthly income after deducting (a) the debtor's actual payments to secured and unsecured priority creditors; (b) the ordinary and necessary living expenses; and (c) the debtor's expenses for customary charitable contributions and actual medical/dental costs in order to determine whether at least \$50 remains available for payment on unsecured, nonpriority claims.⁹⁰ The \$50 minimum will be calculated, however, not based on the by-guess-and-by-golly "disposable income" test maintained in current law, but based on objective national standards for allowable living expenses published by the Internal Revenue Service.⁹¹ The third criterion, ability to repay at least 20% of unsecured,⁹² nonpriority debt in a five-year plan, is a simple division exercise.

H.R. 3150 contemplates that even if its standards were difficult to ascertain, which they are not, the principal enforcement responsibility lies with the debtor and his attorney. It is the debtor's attorney who will perform the screening function in the course of preparing the debtor's schedules. The schedules will be a modified version of the current Schedules I and J and will not pose an insuperable challenge to debt counselors. Obviously, most debtors whose income is well below relevant national median levels will not require means-test scrutiny. For those rela-

88. See H.R. 3150, *supra* note 10, § 101(4).

89. See *id.* § 101(1)(B).

90. See *id.* § 101(4).

91. See *id.*

92. See *id.*

tively few whose status is dubious, however, a model personal computer program has already been developed by Carl Felsenfeld and William J. Perlstein to conform to the requirements of H.R. 3150.⁹³ Using this or similar software, the attorney or paralegal can, within a few minutes, insert the information pertinent to an individual debtor, and the program will calculate eligibility for Chapter 7. Information technology can likewise be applied by the panel trustees and the courts to simplify the examination of cases that present close questions of means-testing.

In light of the amenability of these tests to standard information processing techniques, it is inaccurate to contend that means-testing will impose case-by-case oversight responsibility on courts. The vast majority of cases will be uncontested and inarguable under the standards. One may quarrel with the normative content of the standards, although as we have noted, the arguments are overwhelming for H.R. 3150's modest means-testing. But disagreement over the substance of the standards should not be confused with their administrative feasibility.

There is also a deeper confusion underlying the general criticism that means-testing will overwhelm courts with individual case decisions. Under Chapter 13 today, comprising about one-third of all bankruptcy filings, the standard for repayment plans is the justly-criticized disposable income test. That test already presupposes individual case determinations concerning debtors' ability to repay. Judges decry the disposable income test in part because they abhor making "judgmental" lifestyle decisions, such as whether to permit private school tuition. Paradoxically, those who criticize the complexity of H.R. 3150 give it no credit for simplifying cases by providing congressional answers to most of the lifestyle problems that plague the disposable income test. H.R. 3150 furnishes objective guidelines for ability-to-pay and, in so doing, erects guideposts that will be readily applicable to the debtors' repayment plans.

Others criticize H.R. 3150 for removing the flexibility that the law now allegedly affords to tailor Chapter 13 to the needs of individual cases.⁹⁴ At the same time, however, it is well known

93. See Carl Felsenfeld & William J. Perlstein, *The Practicalities of a Needs-Based Bankruptcy System* 5 (Apr. 24, 1998) (unpublished manuscript, on file with authors).

94. See *Picking Up the Pieces on Bankruptcy Reform*, AM. BANKR. INST. J., Dec.-

that most Chapter 13 confirmations are routine, uncontested, and based solely on the Chapter 13 trustee's recommendation. Chapter 13 confirmations have, in short, become standardized according to the criteria for disposable income adopted by each court. The "tailoring," to the extent it exists, depends not so much on the individual debtor's predicament as upon the happenstance of the trustee and court he has drawn. A modification in Chapter 13 practice that substitutes national standards (incorporating regional income variations) for the current balkanized regime is far more uniform and equitable than the status quo.

More sophisticated critics of H.R. 3150 go beyond the blunderbuss assertion of its complexity to focus on the IRS standards, contending that they are unduly variable, and on litigation that may be imagined to test the "extraordinary circumstances" exception to the means test.⁹⁵ Several responses to this critique are in order. First, ambiguity in applying the standards will only arise in a limited number of cases. It stands to reason that ambiguity will not be outcome determinative in many of those cases simply because of the large number of variables in the ability-to-pay equation and will thus rarely furnish grounds for litigation. Second, concerns about ambiguity involve short-term costs, not systemic increases in the difficulty and expense of bankruptcy administration, as significant ambiguities will eventually be resolved by authoritative case law. Third, the concept of "extraordinary circumstances" is not meant as a catch-all for expenses the high-income debtor cannot shoehorn into the IRS standards. Where compelling circumstances exist, such as medical needs of a family member, there is no need for individual case determinations. Only where a debtor tries to manipulate the definition of "extraordinary," an effort that the courts should strongly discourage, will this exception generate litigation.

Some opponents of means-testing argue that excessive costs will accrue from the inevitable fraud and prebankruptcy planning done to evade mandated Chapter 13 filings.⁹⁶ While this

Jan. 1999, at 1, 54 (noting that Chapter 13 procedures are better when they are allowed to follow flexible principles).

95. See Henry E. Hildebrand, III, *The Hidden Costs of Bankruptcy Reform*, AM. BANKR. INST. J., Apr. 1998, at 16.

96. See Braucher, *supra* note 12, at 14-15.

view has some theoretical validity, it proves too much, for if the costs of policing fraud were a deterrent to implementing sound social policy, then virtually every government decision would be doomed, including the income tax and social health and welfare programs. Indeed, it is widely understood that debtors' bankruptcy petitions and schedules are, to put it kindly, rife with errors and unreliable. Under the critics' view, the entire current bankruptcy system should presumably be suspect.

But a means test that covers only about 10% of filers and can only be manipulated at the margin will not increase fraud to a degree sufficient to undermine the validity of the entire project. H.R. 3150 also contains provisions designed to reduce the widespread incidence of inaccuracy in bankruptcy petitions by, among other things, requiring debtors to furnish tax returns and pay stubs with their petitions⁹⁷ and requiring attorneys to verify claims for extraordinary expenses. The legislation also expresses the sense of Congress that Bankruptcy Rule 9011 ought to include the attorney's express responsibility for the verification of unsigned documents, like the debtor's schedules, filed at the bankruptcy court.⁹⁸ The possibility of fraud, in short, is not a persuasive objection to means-testing.

The problem of prebankruptcy planning to avoid Chapter 13, while not to be dismissed, is both overstated and not ultimately compelling. It must be kept in mind that under the current regime these debtors would *still* be in Chapter 7. Thus, bankruptcy planning would put them exactly where they are today. Means-testing might be rendered irrelevant by bankruptcy planning, but it would not make matters worse. Thus, this is no argument against means-testing.

It is also argued that debtors could evade the higher-than-average income criterion of the test by not working or by deliberately accepting lower-paying work in order to obtain Chapter 7 relief.⁹⁹ This they could do, although it is not clear what the

97. See H.R. 3150, *supra* note 10, § 406.

98. See *id.* § 410.

99. Professor Marcus Cole has suggested in conversation that perhaps the most likely variant on this strategy would be for one spouse to stop working in a family where both previously worked. To the extent this occurred, one would have to weigh in the "shadow" value of the stay-at-home spouse's domestic production in determining the net welfare loss to society from this stratagem. Given that a spouse who chose to do this would almost by definition value his or her domestic option almost as highly as his or her market option, it is likely that the net loss to society from this behavior would

debtor would really accomplish by this tactic, as the high-income debtors covered by means-testing would have to accept a dramatic decrease in income for this strategy to work, and thus would make themselves worse off by this strategy. Thus, few debtors are going to find this option desirable.

Another self-defeating strategy would have the debtor deliberately incurring unsecured debt while preparing for bankruptcy in order not to be able to repay "20% or more" of such debt through a Chapter 13 plan, as required by the third prong of the means-test. Again, this is not an argument against means-testing at all, because this tactic is available under the current system where the debtor elects Chapter 7. Moreover, the same objections to Chapter 7 discharge that exist today, such as the nondischargeability of fraudulently incurred debts and certain expenditures on luxury goods, would not be affected by the adoption of means-testing.

Finally, a debtor could deliberately incur secured debt, for instance by buying a new car, in order to inflate monthly expenses and have less income to satisfy the \$50 test. Of course, if the debtor succeeded in this last maneuver, his collateral would remain bound to the higher secured debt in Chapter 7. So again, this strategy is implausible.

More generally, any of these devices, such as voluntary unemployment or strategically running up debts, would seem to furnish grounds for dismissal of the case for "substantial abuse" under § 707(b), in addition to complaints against discharge and dischargeability.

Perhaps more telling, the predictions of rampant prebankruptcy planning illustrate the degree of abuse and gamesmanship inherent in the current system. This inference is especially strong, given that in this case the stakes are quite low; if manipulated properly, the debtor can avail himself of Chapter 7 rather than Chapter 13. If the critics are so confident that debtors will play games with creditors and will deliberately take on obligations they cannot repay just to shelter more wealth in a Chapter 7 case and to avoid proposing a Chapter 13 plan, what does this say about more high-payoff strategies such

likely be small. Of course, this strategy is no different from those who "evade" taxes by raising their children at home or earning large amounts of psychic "income." As a result, the same argument could be used even more powerfully to attack the income tax system and social welfare programs.

as hiding assets from creditors? Undoubtedly, the cries for reform would not be so vehement, and the need for means-testing not so pressing, if bankruptcy were in fact the pure refuge of the poor and needy as it is portrayed by its defenders. They cannot have it both ways.

There is also no reason to believe that administrative costs will rise compared to the current system. Most consumer bankruptcies will plainly fall below the income threshold and will be unaffected by means-testing.¹⁰⁰ Further, it will be relatively easy to determine whether someone meets the criteria for a mandated Chapter 13, although in some marginal cases further inquiry may be necessary.¹⁰¹ Means-testing identifies objective rules that will guide eligibility for and the components of Chapter 13 relief. At the same time, it retains focused discretion for a judge to excuse a debtor for hardship. As compared to the open-ended § 707(b) inquiry concerning ability to pay, there is no reason to believe that administrative costs would rise under means-testing. In short, statutory-based means-testing would substitute a bright-line rule for the current murky standard. In general, bright-line rules tend to *reduce* administrative costs relative to standards and increase the predictability of their application.¹⁰² A similar result could be expected by substituting a means-testing rule for the current "substantial abuse" standard. Indeed, the issues in a case under means-testing are much fewer and more sharply focused than under the current system. Means-testing reduces uncertainty as to the legal standard to be applied, as well as the factual findings to be established.

The bright-line nature of H.R. 3150's test also makes it preferable to the Senate's version of means-testing.¹⁰³ Under the Senate's bill, means-testing would not be a prerequisite for Chapter 7 relief. Instead, the Senate bill puts the onus on creditors to bring a motion under § 707(b) to prove "abuse" before a debtor's case can be dismissed (and presumably refiled under Chapter 13).¹⁰⁴ Most individual creditors will lack the incentive

100. See Neubig et al., *supra* note 32, at 3; *supra* text accompanying note 32.

101. Thus, while there may be some eligibility challenges, they are likely to be far fewer than some have suggested. See Braucher, *supra* note 12, at 11.

102. See Isaac Ehrlich & Richard Posner, *An Economic Analysis of Legal Rulemaking*, 3 J. LEGAL STUD. 257 (1974).

103. See S. 1301, *supra* note 10.

104. See *id.*

to bring such an action, as they will have to bear all the costs of litigating, while the benefits of conversion will be shared among all creditors.¹⁰⁵ The standards for conversion under the Senate bill are also more open-ended, requiring a more fact-intensive inquiry on a case-by-case basis and reducing the administrative savings of a bright-line means test. Thus, while the Senate version of means-testing is preferable to the status quo, the administrative savings over the status quo will be smaller than under the House bill.¹⁰⁶

Moreover, because high-income debtors will have to repay greater amounts of their debts under means-testing, they may be less likely to file in the first place. For these completely opportunistic debtors, reducing the number who file bankruptcy is an end in itself.¹⁰⁷ Eliminating these cases from the bankruptcy system will reduce the need to expend judicial and administrative costs on them.

In a last-ditch effort at disproving the practicability of H.R. 3150, critics of means-testing argue that Chapter 13 doesn't work and that it is therefore a mistake to force more debtors into Chapter 13.¹⁰⁸ This argument is based on a faulty premise. Professor Braucher, for instance, argues that "making chapter 13 the only option for many debtors would mean a lot more low percentage plans . . . and an even higher failure rate . . . than we already have."¹⁰⁹ Braucher assumes that means-testing would lead to more low percentage plans but overlooks the fact that means-testing applies only to debtors who can repay at least

105. For instance, "The average balance on a Carsons department store credit card for a customer in bankruptcy is \$794." *Hearing on S. 1301, The Consumer Bankruptcy Reform Act Before the Subcomm. on Admin. Oversight and the Courts of the Senate Comm. on the Judiciary*, 105th Cong. *12 (1998) (testimony of Stanton Bluestone, Chairman, Carson Pirie Scott & Co. on behalf of the National Retail Federation), available in 1998 WL 115686. If recovery in a Chapter 13 allowed creditors to collect 30% payouts, the recovery would be boosted from zero to \$238. Moreover, under the Senate bill, involuntary conversion would not be automatic. Once the costs of attorneys' fees are added in, it is doubtful that similarly situated creditors will find it feasible to avail themselves of the cumbersome procedure put in place by the Senate bill. *See id.* at *11-12.

106. *See Braucher, supra* note 12, at 11 (noting that the House version of means-testing "might be somewhat less burdensome" than the Senate version).

107. *See Warren, supra* note 7, at 1101 ("[L]owering the bankruptcy filing rate should not be an end in itself.").

108. *See Braucher, supra* note 12, at 13.

109. *Id.*; *see also Klein, supra* note 82, at 736-37 (arguing that means-testing will increase the failure rate).

20% of their unsecured, nonpriority debts.¹¹⁰ These debtors are likely to have *high* percentage plans with a *low* failure rate. Further, these well-off debtors will risk far more than the ordinary Chapter 13 participant by defaulting on a plan, and their income level equips them far better to complete it. As a result, data on the general failure rate of Chapter 13 debtors are not persuasive when applied to the high-income debtors who will be placed in Chapter 13 by means-testing.¹¹¹ Again, the critics of means-testing have fallaciously lumped the situation of extraordinary debtors together with averages.

Sober analysis demonstrates that means-testing is an idea whose time has come. Indeed, the idea of means-testing is not new at all, but is conducted every day—albeit inconsistently and unpredictably—in courtrooms under § 707(b). Apocalyptic rhetoric to the contrary, the reality of means-testing is that it will apply only to bankruptcy filers with above median incomes, sufficient disposable income to fund a plan, the ability to repay a substantial portion of their unsecured debt, and no other overriding hardship. Rather than confronting the merits of the *actual* means-testing proposals that have been advanced, opponents have chosen to misrepresent means-testing, implying that it would negatively affect all debtors, even those who are worst off. Professional studies demonstrate that at least some debtors could pay significantly more of their outstanding debt by proceeding in Chapter 13 rather than in Chapter 7.¹¹² Critics of these studies have created a great deal of smoke by questioning the motives and techniques of the studies' authors, but these critiques do not rebut the central conclusions. Given that means-testing would create at most a limited increase in the administrative costs associated with bankruptcy, the benefits of means-testing clearly exceed the costs.

110. See H.R. 3150, *supra* note 10, § 101(4).

111. See Braucher, *supra* note 12, at 10 n.58 (relying on data for general failure rates in Chapter 13).

112. See *supra* notes 32 & 46 and accompanying text.

III. MEANS-TESTING AND THE CAUSES OF BANKRUPTCY

A. *Introduction*

As we have argued, means-testing is warranted on generally accepted principles of fairness. Those who can pay all or some significant portion of their debts should be required to do so. Means-testing is not intended to be punitive; it is a modest tax on the privilege of escaping one's obligations. Thus, the case for means-testing is compelling on its narrow merits.

More general trends in bankruptcy filings lend urgency to the need for means-testing. In particular, we contend in this Part that increased bankruptcy filings have been fueled by an increase in the net economic benefits of filing and by a decline in the level of personal shame and societal stigma that previously deterred individuals from filing bankruptcy. Bankruptcy is now too frequently a choice fostered by irresponsible spending habits and an unwillingness to live up to commitments. In some ways, means-testing can be understood as a necessary substitute for these traditional restraints.

Our view is opposed by those who advocate bankruptcy's status quo. Bankruptcy advocates believe that debtors are overwhelmingly honest, down-on-their-luck individuals buffeted by forces beyond their control. One such force is that of excessive credit card debt, foisted upon consumers by underhanded and hugely profitable credit card issuers. Other forces include divorce, job loss, uninsured medical bills, and traumatic experiences, all of which are assumed to be beyond the debtor's control. Advocates of the status quo view the recent explosion in bankruptcy filings as indicative of economic conditions that reward the ruthless pursuit of profit by banks and other creditors and political decisions that have undermined the vitality of the welfare state. In a variation of the catechism for the status quo, the authors of the majority report for the National Bankruptcy Review Commission argue that the rapid growth in the bankruptcy filing rate has been caused by increased levels of consumer debt.¹¹³ Consumer debt is proffered as independent of consumer choice, and hence consumer responsibility.

113. See Brady C. Williamson et al., National Bankr. Rev. Comm'n, *Bankruptcy: The Next Twenty Years* 84 (Oct. 20, 1997) (visited Jan. 19, 1999) <<http://162.140.225.1/report/05acons.pdf>> [hereinafter NBRC Report].

These models of the bankruptcy process as a haven for victims sound better in theory than they prove to be in fact. First, as we will show, the demonization of the credit card issuers is based on faulty analysis. Second, while in any free society with an advanced market economy, some core number of bankruptcies will be caused by involuntary events such as illness, unemployment, recessions, and fraud, these events cannot and do not explain the unprecedented growth in consumer bankruptcy filings in the era following the enactment of the 1978 Bankruptcy Code, particularly during the past decade. Third, the simplistic equation of rising debt with rising bankruptcy is in fact question-begging, as both consumer debt and the bankruptcy filing rate are endogenous variables.¹¹⁴ If discharge of debts is easy in bankruptcy, debtors will incur more debt. Conversely, if obtaining bankruptcy relief is difficult, debtors will be more reluctant to incur debts. Thus, both personal debt levels and bankruptcy filings must be caused by some independent variable.

B. Growth of Personal Bankruptcy Filings

In our view, the surprising growth in personal bankruptcies in recent years has been influenced by two factors: (1) changes in the law and the bankruptcy system that have increased the net economic benefit of filing bankruptcy and (2) a decline in the personal shame and social stigma traditionally attached to filing

114. See *Delinquency on Consumer Loans Before House Comm. on Banking and Fin. Servs.*, 104th Cong. *8-9 (1996) [hereinafter *Delinquency on Consumer Loans*] (statement of Lawrence B. Lindsey, Member, Board of Governors of the Federal Reserve System), available in 1996 WL 517589. Mr. Lindsey stated:

To the extent that bankruptcy is perceived by consumers as an easier option, the demand for credit, and particularly the willingness to take on high levels of credit, is enhanced. With the consequences of bankruptcy reduced, individuals, other things equal, may be more willing to borrow than would otherwise be the case. One may not wish to foreclose the possibility of renewed credit access to those who have been forced by uncontrollable circumstances to seek the protection of bankruptcy, but it should be recognized that undue generosity on this score only encourages greater use of the bankruptcy remedy and consequent charge-offs.

Id.; see also *Bankruptcy Revision Before the Subcomm. on Commercial and Admin. Law of the House Comm. on the Judiciary*, 105th Cong. *4 (1998) [hereinafter *Bankruptcy Revision*] (testimony of Lawrence M. Ausubel, Dept. of Economics, University of Maryland), available in 1998 WL 107376 (stating we have to "go back a step" to look at the causes of the rise in household debt).

bankruptcy. These two variables are interrelated. Thus, the social stigma from filing could be included as part of the total economic "cost" of filing bankruptcy.¹¹⁵ Indeed, it is probable that continuing shame and stigma restrained bankruptcy filings for many years despite the purely economic benefits of filing. A decline in the stigma attached to bankruptcy filers will therefore reduce the total cost of filing bankruptcy. By the same token, making bankruptcy more economically attractive will tend to increase the number of individuals who file. As more individuals file bankruptcy, that option will tend to become more socially acceptable, thereby reducing the stigma attached to it. Increased advertising of bankruptcy services and the prevalence of celebrities filing bankruptcy reduce both the stigma of filing and the "search" costs of learning about the bankruptcy option. Despite the overlap between these variables, however, it is useful to discuss them separately.

1. *Economic benefits of bankruptcy*

The decision whether to file bankruptcy is in part a function of bankruptcy's relative costs and benefits. The tangible benefits of filing bankruptcy are obvious: an opportunity to discharge debts and to get a "fresh start" at the end of the process. The automatic stay stops creditors cold, allowing debtors to retain houses, cars, and other property for additional periods of time. There are intangible benefits as well, such as putting an end to "annoying" phone calls by creditors seeking to recover assets and money.¹¹⁶

The economic and other benefits of filing bankruptcy are reflected in the high rates of bankruptcy in the United States as compared to the rest of the world. As *The Economist* magazine observed, "America's personal-bankruptcy laws are strikingly kinder to distressed borrowers than those of most other devel-

115. See Gary S. Becker, *A Theory of Social Interactions*, 82 J. POL. ECON. 1063 (1974) (modeling social approval and disapproval as an element of personal welfare).

116. See *People Behind Bankruptcy Numbers: Preliminary Results of Chapter 13 Study in Progress Before the Subcomm. on Admin. Oversight and the Courts of the Senate Comm. on the Judiciary*, 105th Cong. *6 (1998) (testimony of Tahira K. Hira, professor), available in 1998 WL 8992993 (reporting results of survey, demonstrating that bankruptcy filers indicate that benefits of filing bankruptcy are "no more phone calls from creditors" and increasing family solidarity).

oped economies.”¹¹⁷ These differences “in part explain[] why filing rates are higher in the United States than in Canada, where legal barriers to debtor opportunism are more exacting and where fresh-start policies are weaker.”¹¹⁸

Another significant benefit of bankruptcy is that debtors may retain exempt property free of most creditors' claims. In two different studies, economist Michelle White has found that bankruptcy filing rates are, to some degree, positively related to the generosity of exemptions.¹¹⁹ In the most recent study, Hurst, Fay, and White confirm that the financial benefit of filing bankruptcy is strongly correlated with an increase in the number of people seeking bankruptcy protection.¹²⁰ White also shows that at least 15% of American households would benefit financially from filing bankruptcy.¹²¹ When the ability to plan strategically for bankruptcy is factored in, including the conversion of nonexempt to exempt assets or loading up on dischargeable unsecured debt and buying exempt assets, the number of households that would benefit from filing bankruptcy exceeds 20%.¹²² Not surprisingly, the benefits for filing bankruptcy are largest for those with the greatest amount of income and wealth, as they can make greater use of generous exemption laws.

117. *America Goes Bust*, ECONOMIST, July 4, 1998, at 78.

118. F.H. Buckley & Margaret F. Brinig, *The Bankruptcy Puzzle*, 27 J. LEGAL STUD. 187, 192 (1998); see also F.H. Buckley, *The American Fresh Start*, 4 S. CAL. INTERDISC. L.J. 67 (1995).

119. See White, *supra* note 2, at 45; Scott Fay et al., *The Bankruptcy Decision: Does Stigma Matter?* (Jan. 1998) (unpublished manuscript, on file with authors and the Department of Economics, University of Michigan). But see Buckley & Brinig, *supra* note 118, at 204-05 (finding that exemption levels were not related to filing rates); Diane Ellis, *The Influence of Legal Factors on Personal Bankruptcy Filings*, BANK TRENDS (Federal Deposit Ins. Corp., Washington, D.C.), Feb. 1998, at 9 (finding lack of correlation between state homestead exemption rates and state personal bankruptcy rates).

120. Thus, they estimate, “a \$1,000 increase in the financial benefit of filing for bankruptcy is associated with 31,000 additional bankruptcy filings per year.” See Fay et al., *supra* note 119, at 23. An increase of \$1,000 in the bankruptcy exemption level would result in an estimated 5,000 additional bankruptcy filings each year. See *id.* at 24. They also estimate that the NBRC's recommendation for a uniform federal level of exemptions would lead to an overall increase in bankruptcy filings of approximately 89,000 per year. See *id.*

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

122. See *id.* at 214. Caselaw places some outer limits on bankruptcy exemption planning, such as denying the debtor's discharge, but such limits are minor and easily evaded. 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.

But there are also costs associated with pursuing bankruptcy relief. First, a debtor must learn that bankruptcy is a viable option. In economics, this concept is referred to as "search" costs.¹²³ Several changes in the American landscape suggest that the search costs of learning about the bankruptcy option are significantly lower than in previous eras. The 1980s saw a dramatic growth in attorney advertising, which has reduced the information and search costs for debtors and encouraged competition among attorneys.¹²⁴ Daytime and late-night television, as well as newspapers, magazines, and telephone books are now awash in bankruptcy advertisements by lawyers.¹²⁵ This proliferation of attorney advertising has accompanied increasing bankruptcy filing rates.¹²⁶ Moreover, the sheer number of consumer bankruptcies has increased public awareness that bankruptcy is an available and relatively easy process.¹²⁷ This is the "water cooler" effect: people learn about bankruptcy from friends and family who have filed bankruptcy and report that it was cheap, easy, and put an end to creditors' collection efforts. Indeed, a Visa study found that a considerable percentage of bankruptcy filers said that if they had known how easy the bankruptcy process was, they would have done it much sooner.¹²⁸ "A Gallup poll found that 51 percent of filers had a close friend or

123. See George J. Stigler, *The Economics of Information*, 69 J. POL. ECON. 213 (1961).

124. See Terry Calvani et al., *Attorney Advertising and Competition at the Bar*, 41 VAND. L. REV. 761 (1988).

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

126. 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 filings 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. *18-19 (1998) [hereinafter *Rise in Personal Bankruptcy*] (testimony of Stuart A. Feldstein, President of SMR Research), available in 1998 WL 105080. Of course, it is difficult to determine whether these lawyers are responding to extant demand for attorney services for bankruptcy, creating demand for bankruptcy filings through advertising, or both.

127. See McKinley, *supra* note 125, at 38 (discussing a survey conducted by Visa finding that "66% of filers found the bankruptcy process to be an easy one").

128. See *id.* (reporting an April 1997 Visa study). As Fay, Hurst, and White observe, even where there is no direct communication between filers and non-filers, the "herding" literature in economics "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." Fay et al., *supra* note 119, at n.13 (citing Abhijit Banerjee, *A Simple Model of Herd Behavior*, 107 Q.J. ECON. 797 (1992)).

relative who filed bankruptcy.”¹²⁹ A “Visa survey found that 45 percent of filers learned about bankruptcy from friends or family.”¹³⁰

The declining search cost is reinforced by the notoriety of politicians, entertainers, and other celebrities who have recently filed bankruptcy.¹³¹ As performer Toni Braxton told a reporter after her filing in January 1998, “I’m gonna go out and enjoy myself”¹³² Most private companies have to pay celebrities to endorse their products in advertisements; the ease with which Braxton and others have sailed through bankruptcy is equivalent to free advertising for the bankruptcy system.

In the past, a compelling disincentive to file bankruptcy lay in the unavailability of credit for those with an impaired credit rating. Bankruptcy was an almost insurmountable hurdle to re-establishing one’s credit. The disincentive to bankruptcy has, however, significantly declined in recent years due to the flourishing of the “sub-prime” lending market and the willingness of some lenders to look favorably on those who have wiped the slate clean of most other obligations through bankruptcy. No doubt the prospect of paying high post-bankruptcy rates for credit remains a cost of filing, but it is markedly lower than before.

The large number of bankruptcy filings has engendered certain economies of scale which have reduced the out-of-pocket costs of filing bankruptcy. Thus, “do-it-yourself” bankruptcy books have become a staple of bookstores and even grocery store check-out lines.¹³³ Similarly, the creation of bankruptcy “mills” has reduced the costs for attorneys who represent debtors in

129. McKinley, *supra* note 125, at 38.

130. *Id.*; see also *Bankruptcy Law Revision Before the Subcomm. on Commercial and Admin. Law of the House Comm. on the Judiciary*, 105th Cong. *8 (1998) [hereinafter *Bankruptcy Law Revision*] (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.”).

131. See Joshua Wolf Shenk, *Bankrupt Policy*, NEW REPUBLIC, May 18, 1998, at 16 (noting that Toni Braxton, Kim Basinger, Burt Reynolds, and M.C. Hammer have all filed bankruptcy thereby being able to “fend off creditors while continuing to live in luxury”).

132. *Id.* (noting that Braxton’s two albums have earned \$170 million in sales and that she owns “a baby grand piano, a Porsche, and a Lexus”).

133. See, e.g., JAMES P. CAHER & JOHN M. CAHER, *DEBT FREE! YOUR GUIDE TO PERSONAL BANKRUPTCY WITHOUT SHAME* (1996).

high-volume, repetitive cases.¹³⁴ Using teams of paralegals and secretaries, these attorneys represent thousands of debtors per year,¹³⁵ theoretically, at lower cost than in previous eras.¹³⁶

Finally, the passage of the Bankruptcy Code in 1978 significantly reduced the costs¹³⁷ and increased the benefits¹³⁸ to consumers of filing bankruptcy. Thus, it is not surprising that several researchers have found that the enactment of the 1978 Code significantly increased consumer bankruptcy filing rates.¹³⁹ Shepherd's study, for instance, concluded that the enactment of the 1978 Code increased individual bankruptcies by approximately 180,000 per year.¹⁴⁰

During the past twenty years, and especially during the past decade, there is reason to believe that the benefits of filing have at least remained constant and may even have risen as more

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

135. Thus, in the Sullivan, Westbrook, and Warren study, only 4% of 1981 debtors were not represented by attorneys. See TERESA A. SULLIVAN ET AL., AS WE FORGIVE OUR DEBTORS 23 (1989). By 1991-1992, however, paralegals in one California district prepared 14% of the 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). The 1994 amendments to the Code attempted to crack-down on the preparation of bankruptcy petitions by paralegals and other non-lawyers.

136. A Visa study found that about 24% of respondents learned about bankruptcy directly from an attorney. See McKinley, *supra* note 125, at 38.

137. See Ian Domowitz & Thomas L. Eovaldi, *The Impact of the Bankruptcy Reform Act of 1978 on Consumer Bankruptcy*, 36 J.L. & ECON. 803 (1993).

138. See Dianne Ellis, *The Effect of Consumer Interest Rate Deregulation on Credit Card Volumes, Charge-Offs, and the Personal Bankruptcy Rate*, BANK TRENDS (Federal Deposit Ins. Corp., Washington, D.C.), Mar. 1998, at 1.

139. See William J. Boyes & Roger L. Faith, *Some Effects of the Bankruptcy Reform Act of 1978*, 29 J.L. & ECON. 139 (1986); Richard L. Peterson & Kiyomi Aoki, *Bankruptcy Filings Before and After Implementation of the Bankruptcy Reform Law*, 36 J. ECON. & BUS. 95 (1984); Lawrence Shepherd, *Personal Failures and the Bankruptcy Reform Act of 1978*, 27 J.L. & ECON. 419 (1984); William T. Vukowich, *Reforming the Bankruptcy Reform Act of 1978: An Alternative Approach*, 71 GEO. L.J. 1129, 1129 (1983). Other studies failed to detect a significant increase in filing rates as a result of the 1978 Code. See Jagdeep S. Bhandari & Lawrence A. Weiss, *The Increasing Bankruptcy Filing Rate: An Historical Analysis*, 67 AM. BANKR. L.J. 1 (1993); Domowitz & Eovaldi, *supra* note 137. For a criticism of the statistical methods used in these latter two studies, see Buckley & Brinig, *supra* note 118, at 194 n.17. Despite the problems with the statistical methods used in these latter studies, the report of the National Bankruptcy Review Commission referred only to the latter studies which showed no correlation between legal changes and increased bankruptcy rates and made no reference at all to the former group of studies. See NBRC Report, *supra* note 113, at 87 nn.140, 141.

140. See Shepherd, *supra* note 139, at 437.

people become aware of how to plan strategically for bankruptcy. In turn, the economic costs of learning about and filing for bankruptcy and obtaining post-bankruptcy credit have declined significantly. These factors have favored increased filings.

2. *The decline of bankruptcy shame and stigma*

Bankruptcy represents a repudiation of one's promises, a decision not to bestow a reciprocal benefit on someone who has given you something of value. As a result, filing bankruptcy traditionally has been treated as a socially shameful act. Promise-keeping and an instinct for fairness and reciprocity are deeply embedded in our natures and underlie our social structure.¹⁴¹ It is not surprising that most people feel great personal shame from a failure to keep their promises. It is also not surprising that society punishes and stigmatizes an individual's failure to keep his promises. 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.¹⁴²

Shame and stigma associated with filing bankruptcy unquestionably remain a potent force restraining bankruptcy opportunism. As noted above, a large percentage of the population would benefit financially from filing bankruptcy, especially with a relatively small amount of prebankruptcy planning.¹⁴³ Although

141. See, e.g., RIDLEY, *supra* note 14, at 69-70. Indeed, experimental psychology has demonstrated that in a face-to-face setting, humans have a remarkable ability to distinguish those who are likely to keep their promises from those who are less trustworthy. See generally ROBERT H. FRANK, *PASSIONS WITHIN REASON: THE STRATEGIC ROLE OF EMOTIONS* (1988). Similarly, studies have shown that people from small towns are both more trusting and more trustworthy than those from large cities. See RIDLEY, *supra* note 14, at 70. Large cities are characterized by a high degree of anonymity, where repeat dealings with people are infrequent. In smaller towns, by contrast, both formal and informal repeat dealings are far more frequent. Not only will you see a business associate during work hours, but you will also often see him at the grocery store or at the baseball game. This discipline of repeat dealings tends to lead to a higher degree of promise-keeping than the mere legal sanctions that police behavior in large, anonymous cities. Indeed, huge amounts of our brain capacity are dedicated to maintaining reciprocity "scores," i.e., remembering who has proven trusting and trustworthy in the past, so that you know who you can trust to reciprocate in the future. See *id.* at 69-70.

142. See Elizabeth Hoffman et al., *Behavioral Foundations of Reciprocity: Experimental Economics and Evolutionary Psychology*, 36 *ECON. INQUIRY* 335, 350 (1998).

143. See White, *supra* note 2, at 51-52.

a far smaller percentage actually does so,¹⁴⁴ the impact of “defining bankruptcy deviancy downward” has become more pronounced.

The decline in shame and stigma is reflected in the observation that during the 1950s there were two things that “people never did: divorce and bankruptcy.”¹⁴⁵ Just as divorce rates have risen since the 1950s, bankruptcy rates have risen as well.¹⁴⁶ Of course, changes in the law made both divorce and bankruptcy easier.¹⁴⁷ But another overlapping cause has been the decline in the shame and stigma associated with divorce and bankruptcy. As these choices have become more socially acceptable, rates of divorce and bankruptcy have both increased, and even multiple filings have proliferated. Six-time bankruptcy filer Fitzgerald Giscombe of Brooklyn put it well when he confessed, “It gets easier each time. . . . The psychological part of it has changed.”¹⁴⁸

While it is difficult to measure directly how the decline of shame and stigma are associated with the rise of bankruptcy filings, it is possible to do so indirectly. Thus, a recent study by Margaret Brinig and Frank Buckley suggests that both shame and stigma are significant variables in the bankruptcy rate, and that their decline has contributed significantly to the increase in bankruptcies.¹⁴⁹ An independent study by Fay, Hurst, and White similarly concludes that bankruptcy stigma is a highly significant variable in the decision whether to file bankruptcy¹⁵⁰ and that “social disapproval of bankruptcy has been falling over time.”¹⁵¹ Research by David B. Gross and Nicholas S. Souleles

144. See Buckley & Brinig, *supra* note 118, at 194 n.16. (“[D]ebtors do not extract the maximum economic advantage from Chapter 7’s fresh start.”); Fay et al., *supra* note 119, at 28 (discussing the effects of stigma on the decision to file bankruptcy).

145. Jones & Shepard, *supra* note 9, at pt. II.

146. See *supra* notes 2-3 and accompanying text.

147. Divorce and bankruptcy are also directly linked to one another. See *infra* note 264 and accompanying text.

148. Daniel Dunaief, ‘Easy’ US Bankruptcy Attacked, S. CHINA MORNING POST, May 31, 1998, at 10. Indeed, just as we have seen serial marriages and divorces, serial bankruptcy filers have become more common. See *id.* (citing study of Chapter 13 trustees reporting that the percentage of debtors with multiple filings was as high as 23%); see also McKinley, *supra* note 125, at 38 (reporting results of a Visa study that 27% of those responding would consider filing again).

149. See Buckley & Brinig, *supra* note 118, at 200-06.

150. See Fay et al., *supra* note 119, at 19-20.

151. *Id.* at 28. This conclusion is consistent with those of other studies. See VISA, U.S.A., INC., CONSUMER BANKRUPTCY: CAUSES AND IMPLICATIONS 13, 19 (1996). Given

has corroborated the finding that the decline in the constraints of social stigma explains most of the increase in credit card defaults and consumer bankruptcy filings.¹⁵²

Casual empiricism reinforces the findings of these studies. For instance, nondelinquent borrowers are filing bankruptcy at increasing rates.¹⁵³ The increasing numbers of these "surprise" bankruptcies suggests that bankruptcy more and more is looked at as an option of "first," rather than "last" resort. If large numbers of debtors actually felt shame from the decision to file bankruptcy, one would expect them to at least consider trying to work out a repayment agreement before filing bankruptcy. The evidence increasingly suggests the opposite.

In some places, such as Memphis, the sense of shame has all but disappeared, leading to astonishingly high rates of personal bankruptcy.¹⁵⁴ In 1996, 4.3% of Memphis families filed bankruptcy, almost 1 in 23, earning Memphis the sobriquet of the "bankruptcy capital of America."¹⁵⁵ According to a *Fortune* magazine article, there is a "culture of bankruptcy" in Memphis, and bankruptcy is "a way of life."¹⁵⁶ 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 Monypeny, Jerry Lee Lewis' [who also filed bankruptcy]

that Brinig and Buckley's research was published some time ago, it is curious that Warren calls Visa's study "[t]he major effort to develop macroeconomic evidence of some less-mentioned causes of bankruptcy." Warren, *supra* note 7, at 1085.

152. See generally David B. Gross & Nicholas S. Souleles, Explaining the Increase in Bankruptcy and Delinquency: Stigma versus Risk-Composition 16 (Aug. 21, 1998) (unpublished manuscript, on file with authors). According to Gross and Souleles, "A credit card holder in 1997 was 4 percentage points more likely to default, and 1 percentage point more likely to declare bankruptcy, than a cardholder with identical risk characteristics in 1995. These magnitudes are approximately as large as if the entire population of credit card holders had become one standard deviation riskier between 1995 and 1997, as measured by risk scores." *Id.*

153. See *Bankruptcy Law Revision*, *supra* note 130, at *5 (noting that for many retailers "more than 40% of the bankruptcy petitions received are from customers (often long-standing) who are not seriously delinquent"); *Appendix to NBRC Dissent Report* (visited Jan. 19, 1999) <<http://162.140.225.1/report/24commvi08.html>> (reproducing letters from credit unions and other creditors noting increase in bankruptcy filings by nondelinquent borrowers).

154. See Kim Clark, *Why So Many Americans Are Going Bankrupt*, *FORTUNE*, Aug. 4, 1997, at 24-25.

155. See *id.*

156. *Id.* at 25.

manager.”¹⁵⁷ 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.”¹⁵⁸

In this postbankruptcy apocalyptic world, trust has all but disappeared in routine arms’ length transactions that go unnoticed elsewhere. 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.”¹⁵⁹ When the informal norms of shame and stigma break down, the consequences for everyday economic activity are significant.

As depicted by the experience of celebrities, who live as well after bankruptcy as before they filed, bankruptcy is increasingly seen as a big “game,” with the losers being those who live within their means, while the bankrupts pursue more interesting and carefree lives. Examples abound. Compare the situations of a brother and a sister in a family we know who both got married and had similar family incomes. The brother lived in a modest house, took modest vacations, sent his children to public schools and then public universities, because that was all they could afford. At the same time, the sister bought a large house in a wealthy northeastern suburb, took extravagant vacations, sent her children to private high schools and college, financing everything through heavy borrowing. Toward the end of this process the sister filed bankruptcy and walked away from it all. For her, borrowing was simply a way to live a lifestyle that she really could not afford. Bankruptcy provided a painless way to maintain that lifestyle. Needless to say, the brother wonders whether he did the right thing by living within his means and depriving himself and his family of the benefits captured by his sister.

Professor LoPucki colorfully sums up the problem:

157. *Id.*

158. *Id.*

159. *Id.*

Consumer bankruptcy contradicts the morality of Aesop's fable [of the grasshopper and the ant]. Today's ants eat beans at home, don't buy the kids new sneakers, and don't try to buy the new house until they have stable jobs and down payments. They hang onto the jobs, even when the going gets tough, particularly if the jobs come with health insurance. The grasshoppers eat at the pizza parlor on Friday night and buy the new sneakers and the houses. They quit their jobs when the going gets tough. The fallout lands on their credit cards. When winter comes, they discharge the credit card debt in bankruptcy. The ant played by the rules, the grasshopper didn't. In the end, consumer bankruptcy made them equals.¹⁶⁰

Is there any wonder that the next time around the ant (or the ant's children) will choose to follow the path of the grasshopper?

Of course, some of this reduction in shame and stigma was an intentional result of the changes enacted in the 1978 Code. As the dissent from the NBRC Report observed, "[t]he Code, for instance, replaced the term 'bankrupt' with 'debtor' and described a case filing as seeking an 'order for relief.'"¹⁶¹ The non-discrimination provisions of § 525 were also substantially expanded to prohibit many forms of private discrimination against bankruptcy debtors. Given that one goal of the Code reforms was to reduce shame and stigma, it should not be surprising that it in fact has done so.

Shame and stigma have traditionally counterbalanced the economic benefits available from bankruptcy, restraining many debtors from filing.¹⁶² As shame and stigma have declined, however, more and more debtors are recognizing the economic benefits of bankruptcy: This decline in shame and stigma is felt most powerfully with respect to middle-class and upper-income debtors. Just as the economic benefits of filing bankruptcy are greatest for upper-income debtors,¹⁶³ a corollary is that the restraints imposed by shame and stigma have also been most important

160. Lynn M. LoPucki, *Common Sense Consumer Bankruptcy*, 71 AM. BANKR. L.J. 461, 464 (1997).

161. Jones & Shepard, *supra* note 9, at pt. II.

162. Michelle White has provided arguments that explain part of the divergence between expected and actual filing rates, including the difficulties of creditors in exercising non-bankruptcy remedies and the nature of the right to file bankruptcy as an option that gives debtors a discounted value of the benefit they would gain if they actually filed. See White, *supra* note 121, at 215-29.

163. See *supra* notes 121-22 and accompanying text.

with respect to this category of individuals. As shame and stigma decline, therefore, the marginal impact will be felt most heavily with respect to upper-income debtors.¹⁶⁴ As there is little reason to believe that the decline in shame and stigma will reverse in the immediate future, we can expect to see increasing numbers of higher-income debtors. This in turn indicates that means-testing will become increasingly important to require these debtors to repay their debts.¹⁶⁵

History is replete with the tales of honest and noble individuals like Sir Walter Scott and Mark Twain who worked for years to repay their debts, even those that had been legally discharged.¹⁶⁶ Part of Harry Truman's lore and reputation as an honest and principled man was his refusal to file bankruptcy in the face of losses incurred during the 1921 recession that rocked the agricultural Midwest. Rather than file bankruptcy, Truman vowed to pay off his debts. "Fifteen years after the store went under, Harry would still be paying off on the haberdashery, and as a consequence would be strapped for money for twenty years."¹⁶⁷ But he did it, even after his partner filed bankruptcy himself.

In the current social climate, it is easy to suspect that individuals like Scott, Twain, and Truman would be considered not as honest and noble heroes but as saps. As Allan Bloom remarked,

There is a perennial and unobtrusive view that morality consists in such things as telling the truth, paying one's debts, respecting one's parents and doing no voluntary harm to anyone. Those are all things easy to say and hard to do; they do not attract much attention, and win little honor in the world. . . . [It] is a humble notion, accessible to every child, but its fulfillment is the activity of a lifetime of performing the

164. See Fay et al., *supra* note 119, at 27 (noting that the importance of stigma in the decision to file rises as the financial benefit from filing rises); Gross & Souleles, *supra* note 152, at 16 ("Given the large number of people who could potentially benefit from filing for bankruptcy, even relatively small drops in stigma can generate . . . large effects on default.").

165. See Gross & Souleles, *supra* note 152, at 16-17.

166. See Buckley & Brinig, *supra* note 118, at 194.

167. DAVID McCULLOUGH, TRUMAN 151 (1992).

simple duties prescribed by it. This morality always requires sacrifice.¹⁶⁸

Rather than extolling this sacrifice and struggle to live within one's means, too many social factors today encourage the opposite.

IV. ALTERNATIVE THEORIES EXPLAINING THE INCREASE IN BANKRUPTCIES

Advocates of bankruptcy's status quo passionately deny that filings have increased even in part because of economic cost-benefit calculations or reduced shame and stigma. The denials ring somewhat hollow, as it is these same advocates who have labored to enhance the respectability and reduce the costs of filing bankruptcy. Instead, the proponents of the status quo blame the bankruptcy boom on high personal debt levels and on events such as divorce and the cost of catastrophic medical care. In their eyes, bankruptcy filers are buffeted by economic and social forces beyond their control. And, even if some debtors are abusing the system, their implicit attitude is "so what?" as the costs of abuse are shouldered by wealthy banks and other creditors.

This vision of bankruptcy and bankrupts is freighted with implications for bankruptcy policy. For instance, the National Bankruptcy Review Commission, mesmerized by this diagnosis, declined to recommend any significant reforms to curb bankruptcy abuse, even among upper-income debtors.¹⁶⁹ Nor did it take any steps to reduce the economic losses imposed on creditors and other consumers as a result of bankruptcy. Despite its acceptance by a bare majority of the Commission, this view rests on little more than shallow empiricism, isolated anecdotes, and an ideological belief that refuses to admit that any significant number of bankruptcy debtors "game" the system by discharging debts that they have some capacity to repay.

The advocates of the status quo are forced to provide some explanation for the bankruptcy boom. They advance three explanations. First, high levels of personal debt relative to income "cause" increased bankruptcy filings. Second, excessive levels of

168. ALLAN BLOOM, *THE CLOSING OF THE AMERICAN MIND* 325 (1987).

169. See Jones & Shepard, *supra* note 9.

personal debt are strongly influenced by aggressive and even misleading marketing of credit cards to vulnerable borrowers. Third, the other principal causes of consumer bankruptcy are forces beyond the control of individual debtors. On further examination, however, none of these explanations is persuasive.

A. *Debt and Bankruptcy*

For many scholars and commentators, bankruptcy is caused by excessive levels of debt, piled (apparently involuntarily) upon the backs of American families.¹⁷⁰ Elizabeth Warren, for instance, analogizes Americans' taking on consumer debt to hikers' filling up their backpacks with rocks:

Through life, the hike is sometimes uphill and sometimes downhill, and the path is sometimes strewn with obstacles. As they hike, the adults may acquire debt, which is much like putting rocks in their backpacks. If the packs have only a few rocks, the family can withstand most of the events and calamities they are likely to encounter. But as the pack grows heavier, smaller and smaller misfortunes will cause the hikers to fall, unable to continue the hike. The only way they can get back on their feet is by emptying some of the rocks from their packs. More Americans' packs are getting heavier with debts, and more of them find that they can continue only if they unload some of their rocks by declaring bankruptcy.¹⁷¹

The thesis that excessive debt "causes" bankruptcy is flawed in many ways. A correlation between debt and bankruptcy does not equate to causation, especially when the purported causal link is spurious. Taking a historical perspective, bankruptcy filings in the first half of 1997 exceeded those for the entire decade of the Great Depression, but no one would seriously contend that consumer debt levels were more onerous on 1990s debtors than the burdens borne by their grandparents' generation. Indeed, consumer bankruptcy rates are 49.9% higher now than during the height of the last recession.¹⁷² As one commentator observed, even if debt-to-income ratios have worsened, they have done so gradually: "They did not get worse by 29% in

170. See *Highest Number*, *supra* note 3; NBRC Report, *supra* note 113, at 85.

171. Warren, *supra* note 7, at 1080-81.

172. See *Highest Number*, *supra* note 3.

1996 over 1995, but bankruptcies did. They did not worsen again by 20% in 1997 over 1996, but bankruptcies did.”¹⁷³

More fundamentally, there is a logical flaw in the purported causal link between debt and bankruptcy. Even though debt levels relative to income are high, interest rates are also much lower than they have been in many years. Accounting for interest rates, consumers' *current* debt burden, or service payments on debt, is lower than it often was in the past.¹⁷⁴ If debt is relevant to bankruptcy, it is because debt makes it impossible for individuals to make debt payments as they come due.¹⁷⁵ Current indebtedness measures this, not total debt or debt-to-income ratios.¹⁷⁶ While the total debt level may be correlated with bankruptcy filings, it is not clear how total debt, as opposed to current debt levels, could “cause” bankruptcy filings.¹⁷⁷

The idea that debt “causes” bankruptcy is flawed in another way. Consider Professor Warren's analogy of consumers as hikers picking up “debt” stones as they walk. In Warren's view, debt is something that just accumulates on its own over time, as though creditors secretly slip additional rocks in the unsuspecting hiker's backpack. One is reminded of the old Charlie Brown Halloween special where all of the other kids in the neighborhood receive a bag full of candy while trick-or-treating, but Charlie Brown repeatedly gets “a rock.” For Warren, debt is all rocks and no candy.

173. *Rise in Personal Bankruptcy*, *supra* note 126, at *18.

174. See Jonathan McCarthy, *Debt, Delinquencies, and Consumer Spending*, CURRENT ISSUES IN ECON. AND FIN. (Federal Reserve Bank of New York), Feb. 1997, at 1, 3; *Delinquency on Consumer Loans Before the House Comm. on Banking and Fin. Servs.*, 104th Cong. *5 (1996) [hereinafter *Delinquency on Consumer Loans*] (statement of Kenneth Crone, Vice-President of VISA U.S.A., Inc.), available in 1996 WL 520173 (noting that “measured by the amount of scheduled principal and interest payments that consumers are obligated to pay as a percentage of their after tax income, consumer debt burdens are below their historic high”).

175. We are not aware of any studies that actually investigate whether current debt levels are linked to bankruptcy filing rates.

176. See Peter S. Yoo, *Still Charging: The Growth in Credit Card Debt Between 1992 and 1995*, REVIEW (Federal Reserve Bank of St. Louis), Jan.-Feb. 1998, at 19.

177. The NBRC Report also asserted a link between overall debt levels and bankruptcy filing rates, and makes no mention of the current debt level. See NBRC Report, *supra* note 113, at 84-85. Professor Ausubel also presents data on the correlation between overall debt levels and bankruptcy, but he also fails to explain how the purported casual link could work. See Lawrence M. Ausubel, *Credit Card Defaults, Credit Card Profits, and Bankruptcy*, 71 AM. BANKR. L.J. 249, 254-57 (1997).

This is nonsense. Rocks no more magically appear in one's backpack than debt does on a balance sheet. Consumers do not collect debt, they collect the things they buy with debt. They buy refrigerators, cars, orthodontics, college tuition, clothes, and vacations on credit. If the hikers have too many rocks in their backpacks, it is because they put them there. Thus, if debt "causes" bankruptcy, it is only because overspending and an unwillingness to live within one's means "causes" debt. In short, one can simply recharacterize the "debt causes bankruptcy" thesis as "overspending causes bankruptcy."¹⁷⁸ The purported causal link is ambiguous.

Warren and other "debt causes bankruptcy" theorists have confused cause and effect: credit is the *means* used to accomplish the *end* of acquiring possessions by borrowing against future income. What we *want* has nothing to do with how we are going to pay for it.¹⁷⁹ Warren and others may disapprove of some of the purchases that were financed through borrowing. Indeed, many commentators believe that Americans are increasingly unwilling to live within their means.¹⁸⁰ So why does Warren believe it is the debt that consumers should shed, rather than the spending habits that led to the debt? Forcing other hikers to carry "rocks" voluntarily picked up by the irresponsible hardly seems fair.

In this melodrama of borrower versus lender, or perhaps hiker versus rocks, credit card lenders have become the convenient villain.¹⁸¹ The ubiquity and visibility of credit cards, and

178. For instance, a survey by Visa reported that of those "who had filed for bankruptcy during a 12-month period in 1995 and 1996, nearly 29 percent stated that the 'main reason' they filed for bankruptcy was excessive spending (i.e., they said they were 'overextended'), rather than family or professional problems or emergencies." *Delinquency on Consumer Loans*, *supra* note 174, at *7.

179. Moreover, as will be discussed further below, credit card debt is just one of several ways that we can accomplish this same end. *See infra* notes 206-12 and accompanying text.

180. *See* Ellen Goodman, *A Temperance Pledge: 'Don't buy it!'*, DES MOINES REG., June 17, 1998, at 13 ("What we want grows into what we need, at a sometimes dizzying rate . . . being middle class is no longer good enough." (quoting Juliet Schor, author of *The Overspent American*)). A similar sentiment was expressed by a middle-class bankruptcy debtor who said of his family's bankruptcy experience, "We're not doing the pauper thing. . . . We do stuff, but we're not extravagant. We have a nice house. We go to Foxwoods. We have his and her cars. It took us a long time to go from Brooklyn to Queens. We can't go back." Sandra Ward, *Bailing Out: Bankruptcy, Once a Disgrace, Has Become as American as the Fourth of July*, BARRON'S, June 17, 1996, at 17-18.

181. The role of credit cards in bankruptcy is discussed in more detail *infra* Part IV.B.

their apparent high interest rates, make them easy targets. But, as even the bankruptcy advocates know, credit card debt, although historically high, is not nearly the largest component of consumer debt.¹⁸² That distinction goes to housing debt, including mortgages and home equity loans.¹⁸³ According to a study by SMR Research Corporation, "In 1997 the total dollars owed on residential mortgages were \$4.027 *trillion*, and the total owed on all revolving debt had reached \$529.7 billion."¹⁸⁴ And while credit card and related debt increased by \$375.8 billion from 1987 to 1997, "mortgage debt increased by more than \$2 *trillion*" during that same period.¹⁸⁵ As the report concludes, "It just happens to be true that most of the consumer debt in this country is housing debt, not credit card debt, and the real estate debt also is what has been increasing most rapidly by far."¹⁸⁶ *Current* indebtedness on credit cards is even lower.¹⁸⁷ Critics are not only wrong but opportunistic in singling out credit card debt as if it were the major component of the personal debt burden.¹⁸⁸ No

182. See Arthur B. Kennickell & Martha Starr-McCluer, *Changes in Family Finances from 1989 to 1992: Evidence from the Survey of Consumer Finances*, 80 FED. RESERVE BULL. 861, 874 (1994) (noting that credit card debt accounted for 2.3% of a household's total indebtedness in 1989 and 2.9% in 1992); Yoo, *supra* note 176, at 19 (noting that "credit card debt is a small part of a household's total indebtedness").

183. See *Personal Bankruptcy Consumer Credit Crises Before the Subcomm. on Admin. Oversight and the Courts of the Senate Comm. on the Judiciary*, 105th Cong. *6 (1997) [hereinafter *Personal Bankruptcy Consumer Credit Crisis*] (statement of Ian Domowitz, Department of Economics and Institute for Policy Research, Northwestern University), available in 1997 WL 176665 ("[R]eal estate debt accounts for the bulk of outstanding consumer debt.").

184. *Rise in Personal Bankruptcy*, *supra* note 126, at *12 (emphasis added).

185. *Id.* (emphasis added).

186. *Id.*

187. See Wendy M. Edelberg & Jonas D. M. Fisher, *Household Debt*, CHICAGO FED LETTER No. 123 (The Federal Reserve Bank of Chicago, Chicago, Ill.), Nov. 1997 (noting that the level of debt service on credit card debt was only 0.5% of income in 1995).

188. In response to this argument, Ausubel argues that some amount of this mortgage debt actually just represents substitution from credit card loans (which are included as consumer credit) to home equity loans (which are a component of mortgage debt). Ausubel provides no estimate as to how much home equity debt is attributable to this substitution effect. To the extent that this substitution effect is present, however, it must be the case that consumers are shifting from credit card to home equity debt at least in part because of the preferable interest rates presented by home equity loans. The tax-deductibility of interest on mortgages and home equity loans also makes them more attractive than credit cards. In that case, it is even more disappointing that Ausubel's research examines total overall debt levels rather than current debt levels, as the latter would reflect these lower interest rates. See *Bankruptcy Revision*, *supra* note 114 at *6; discussion *supra* note 114, and accompanying text.

one is forcing anybody to buy a larger or more expensive house than they can reasonably afford.

But consumer credit is not limited to its more visible forms of credit card and housing debt. As Stuart Feldstein of SMR Research noted in his testimony to Congress,

Any business is a creditor when it provides good[s] or services and waits to be paid for them later on: electric and gas utilities, phone companies, landlords, retail stores with credit cards or other credit plans, doctors, dentists, hospitals, and others. All these businesses extend credit without collateral and lose what they are owed when unsecured debts are expunged in bankruptcy. So, the cost of bankruptcy is included on the expense side of the income statement. . . . Consumers may or may not be aware of it, but most of what they spend every month has a bankruptcy cost factor built into it, from the phone bill to the car payment to the rent and the credit card bill.¹⁸⁹

Contrary to the mantra of those who oppose bankruptcy reform, we all really do pay for the large number of bankruptcies.

Given the ubiquity of consumer credit in the economy, if it is true that debt causes bankruptcy, then it is simply wrong to lay the blame at the door of credit card issuers, or any other particular segment of the consumer credit market. Instead, if debt causes bankruptcy, this is an indictment of *all* forms of consumer credit. In fact, some have advocated just such broad-ranging limitations on consumer credit, including draconian regulations on mortgage lenders, home equity lenders, unsecured credit card lenders, and secured lenders for personal property. While such a view at least has the virtue of intellectual consistency, it flies in the face of centuries of failed and counterproductive efforts to regulate credit terms. In addition, such proposals would not only inevitably disrupt credit markets significantly, they would tend to harm the very lower-income and marginal borrowers they are presumably intended to help.¹⁹⁰

189. *Rise in Personal Bankruptcy*, *supra* note 126, at *21.

190. See Christopher C. DeMuth, *The Case Against Credit Card Interest Rate Regulation*, 3 YALE J. ON REG. 201 (1986).

B. Credit Cards and Bankruptcy

The argument against credit card issuers ties in closely with the debt-causes-bankruptcy hypothesis.¹⁹¹ Those who believe that lenders are taking advantage of consumers sound a populist theme. They castigate the apparently promiscuous marketing practices of credit card issuers and high and inflexible credit card interest rates. They inveigh against the addictive potential spawned by millions of credit card solicitations, many of them "pre-approved," which are mailed every day by credit card issuers.¹⁹² Critics worry that "[companies] specializing in lending to borrowers with tarnished credit histories have been among the fastest-growing credit issuers in the past five years" and that this market will probably expand in coming years.¹⁹³ Special disdain is reserved for marketing targeted at lower-income and young people, especially college students.¹⁹⁴

Advocates of the status quo for bankruptcy play up the significance of credit card debt for its obvious political value: the issuers are rich banks, they "hook" consumers with aggressive and even misleading marketing campaigns, and because of the high interest rates, consumers become caught on an endless treadmill of monthly payments before they know what hit them. Since credit card issuers have been among the vocal proponents of bankruptcy reform, their proposals, like their ability-to-repay research, can be characterized as an agenda to entrench parasitic lending practices. In short, credit cards have become the modern equivalent to William Jennings Bryan's "Cross of Gold," crucifying consumers in the pursuit of ever-greater profits.

The attack on credit card issuers has gained currency in the popular press¹⁹⁵ and on Capitol Hill. Given the widespread

191. The role of credit cards in the economy and their link to bankruptcy law is discussed in more detail in Todd J. Zywicki, *Credit Cards in Bankruptcy* (Nov. 15, 1998) (unpublished manuscript, on file with authors), an article which will be published in 1999.

192. See NBRC Report, *supra* note 113, at 92 (noting that lenders have mailed 2.5 billion credit card solicitations each year for the past three years, not even counting telephone marketing, print advertisements, and other forms of marketing).

193. *Id.*

194. See *id.* at 93.

195. See, e.g., Hillary Rodham Clinton, *Talking It Over*, WASH. TIMES, Sept. 30, 1998, at A2; Michelle Singletary, *Bankruptcy's Personal Toll*, WASH. POST, Sept. 27, 1998, at H2. Even free-market economist Walter Williams launched an unexpected broadside at credit card issuers, giving them some of the blame for increased bankruptcy filings. See Walter Williams, *Who's to Blame for our Rampant Credit-Card-*

misimpression of the link between credit cards and bankruptcy, it is necessary to discuss the issue in some detail. We do not aim to defend every aspect of credit card lending policies, but we will illustrate that credit card markets are competitive to a degree that the attacks on credit card issuers are ill-founded.

The case against credit card issuers is rooted in the research of Professor Lawrence Ausubel.¹⁹⁶ Ausubel emphasizes the inflexibility of consumer use of credit cards, the “stickiness” of interest rates at a high level, and the issuers’ supranormal profits. Taken together, these factors suggest to Ausubel that the market for credit cards is insufficiently competitive, leading to conditions in which the issuers have the ability and incentive to exploit their customers in the pursuit of ever-higher profits. Although Ausubel has reached a remarkable level of notoriety in bankruptcy circles because of the political implications of his research, all of his central findings and conclusions have been seriously undermined by more comprehensive and current research.

1. *Consumer credit card debt as a result of spending habits*

Ausubel first asserts that consumers are too ignorant or inflexible to modify their credit card usage in order to prevent being exploited.¹⁹⁷ Critical to Ausubel’s inflexibility hypothesis is the claim “that many consumers systematically underestimate the extent of their current and future credit card borrowing and, using these underestimates, make suboptimal decisions regarding the choice and usage of credit cards. In particular, consumers underestimate their credit card balances and, thus, under-rate the importance of credit card interest rates”¹⁹⁸ For Ausubel, credit card companies consider a “good” credit card consumer as one who routinely underestimates his ability to repay his balance and thus carries over a balance from month-to-month. Because so many consumers behave in this manner,

Itis?, SEATTLE TIMES, July 17, 1998, at B5.

196. See Lawrence M. Ausubel, *Failure of Competition in the Credit Card Market*, 81 AM. ECON. REV. 50 (1991); Ausubel, *supra* note 177.

197. See Ausubel, *supra* note 196, at 71-72; Ausubel, *supra* note 177, at 261-62.

198. Ausubel, *supra* note 177, at 261-62 (citation omitted). Ausubel’s methodology for collecting the data that underlies the underestimation hypothesis has been criticized. See generally Thomas F. Cargill & Jeanne Wendel, *Bank Credit Cards: Consumer Irrationality versus Market Forces*, 30 J. CONSUMER AFF. 373, 375-77 (1996).

Ausubel believes that credit card issuers are guaranteed substantial profits for the indefinite future.¹⁹⁹

Theories whose validity depends on the assumption that consumers are stupid about their money ought to arouse suspicion. And, unsurprisingly, a more plausible explanation is available. The transaction between credit card issuers and consumers is far more complex and hardly as exploitative as Ausubel supposes. Credit cards are useful for consumers in two ways.²⁰⁰ They are a useful means for financing transactions for so-called "convenience users" who use them as a substitute for cash and checks. Credit cards are also a useful source of short-term credit for "revolvers" who carry over balances from one month to the next.

For convenience users, credit cards offer an attractive substitute for cash and checks,²⁰¹ making it unnecessary to maintain cash reserves sufficient at all times to cover current expenditures. Given that cash and checking accounts usually produce no or little interest, consumers will seek to minimize the amount of time that their money sits in their wallets or in low-interest checking accounts. For some transactions, such as catalogues, internet sales, and phone orders, credit cards are essential.²⁰² Credit cards also allow the consumer to carry a balance interest-free not only during the credit cycle, but even for a "grace period" of twenty or more days *after* the credit period ends. This feature allows the consumer to continue to have access to his bank balances.²⁰³

199. A variation on Ausubel's theme is offered by Vincent D. Rougeau, who argues that absent interest-rate restrictions, credit card issuers can earn unlimited profits by preying on borrowers' weakness and desire to consume, which often reaches an irrational level. See Vincent D. Rougeau, *Rediscovering Usury: An Argument for Legal Controls on Credit Card Interest Rates*, 67 U. COLO. L. REV. 1 (1996).

200. See Dagobert L. Brito & Peter R. Hartley, *Consumer Rationality and Credit Cards*, 103 J. POL. ECON. 400, 401 (1995).

201. See *id.* at 401 (noting that credit cards "compete with precautionary money balances as a medium for financing transactions").

202. Indeed, the entire catalogue/phone order industry almost certainly would not exist if not for the widespread availability of credit cards. See Ellis, *supra* note 119, at 5.

203. By contrast, the credit card issuer carries an open, zero-interest account for this entire period. As Donald Hester observes,

the charge card allows [its owner] to shift the burden of carrying zero-interest-bearing transaction balances from himself to those issuing the card for at least a month. With a charge card he can reduce his demand account balance[s] . . . [and] it is less important to waste time and effort trying to

Credit cards offer other transactional benefits over checks and cash. Many companies award frequent flyer miles and "bonus points" that can be redeemed for goods and services. End-of-year credit card summaries provide information useful in calculating taxes and household budgets. Consumers can use the leverage of credit card companies to challenge sums due on defective merchandise. Card issuers offer such products as car rental and purchase insurance. The Discover Card even gives its users cash rebates on the amounts charged. Neither checks nor cash transactions offer this wide range of benefits.²⁰⁴ No wonder that more than half of the usage of bankcards is for convenience only and is paid off immediately without revolving.²⁰⁵

For revolvers, credit cards are an effective device for financing short-term swings in expenditures on purchases such as unanticipated car or home repairs, Christmas shopping, and vacations.²⁰⁶ Further, interest rates on credit cards have fallen substantially in recent years, initial "teaser" rates are even lower,²⁰⁷ and annual fees have been eliminated for many cards.²⁰⁸ Again, it must be remembered that credit cards are

minimize them.

Donald D. Hester, *Monetary Policy in the 'Checkless' Economy*, 27 J. FIN. 279, 285-86 (1972) (citations omitted).

204. Brito and Hartley estimate that if bank accounts are earning a real interest rate of 4.2% annually (higher than most checking accounts), and credit card balances accrue interest at 19.6% annually (higher than most cards), and credit cards begin to accrue interest immediately when charges are made (which is rarely the case), credit cards would still be used to finance about 23% of consumer transactions. See Brito & Hartley, *supra* note 200, at 406. Given the harsh and unrealistic assumptions used in their calculations, the 23% figure almost certainly understates the real world percentage of transactions that would be conducted by credit cards.

205. See Cargill & Wendel, *supra* note 198, at 379 (reporting that "[t]he 1989 Survey of Consumer Finances indicates that 68 percent of households report they nearly always pay credit card balances in full," thereby accruing no interest charges). Crone notes that convenience use of credit cards is rising much faster than revolving use, increasing 20% in one year alone. See *Delinquency on Consumer Loans*, *supra* note 174, at *4-5.

206. See Brito & Hartley, *supra* note 200, at 401. Brito and Hartley refer to this use of credit cards as "smoothing irregular consumption or income flows, or providing insurance against unanticipated shocks to expenditure or income." *Id.* at 402.

207. See *Delinquency on Consumer Loans*, *supra* note 114 (discussing fallen interest rates and elimination of annual fees); Ausubel, *supra* note 177, at 262 (discussing teaser rates).

208. See *Delinquency on Consumer Loans*, *supra* note 114, at *4. Despite this good news, Ausubel remains unconvinced that competition has taken root in the credit card market. In particular, he argues that reduced operating expenses and increased use of "hidden fees" have maintained profit levels. See Ausubel, *supra* note 177, at 263. *But*

merely a *means* to conduct these transactions and must be compared against alternative sources of short-term credit. Credit cards enable consumers to borrow amounts within their credit limit at close to zero transaction costs. The low transaction costs of these loans more than offset the higher interest rates of borrowing on credit cards. For instance, a debtor could try to get a bank loan to cover such short-term expenses, as car repairs or the purchase of a refrigerator. According to Brito and Hartley, "A senior bank officer told us that the costs to the bank of processing a loan are so high that they cannot afford to make a loan of less than \$3,000 for 1 year except at interest rates *above* those charged on credit cards."²⁰⁹ Thus, bank loans of similar size and duration either do not exist or are available only at terms more onerous than those offered by credit card issuers.²¹⁰ In fact, few revolvers carry balances close to that figure.

Absent credit cards, therefore, the practical alternatives for a debtor seeking a short-term loan are pawn shops, loan sharks, or low-interest layaway plans.²¹¹ Alternatively, a consumer could sell some of his personal assets for whatever he can get for them. Either way, the burden on the debtor is higher than the interest rates any debtor is paying on credit cards. Restricting the access of low-income and young debtors to credit cards may seem like a fine idea to some, but it would either drive many Americans into the arms of pawn shops, loan sharks, and even higher-interest lenders or force on them difficult financial choices.²¹²

see infra note 259 (concluding that many such fees are not actually enforced in practice).

209. Brito & Hartley, *supra* note 200, at 402 (emphasis added).

210. Brito and Hartley conclude that "[e]ven moderate transactions costs [for regular bank loans] can lead to substantial borrowing on credit cards." *Id.* at 408.

211. Brito and Hartley report that "[i]nquiries in Houston in February 1992 revealed rates ranging from 17 percent and a \$100 fixed fee for a collateralized 1-year loan at a branch of a major national finance company to over 50 percent for small loans (\$300 maximum) at a local finance company." *Id.* at 402 n.6.

212. Poor people are also less likely to have access to other forms of competitive credit, such as home equity loans, further increasing their need for accessible credit card credit. *See* Cargill & Wendell, *supra* note 198, at 385.

2. *Stickiness of credit cards is not evidence of lack of competition*

Ausubel also charges that the "stickiness" of credit card interest rates evidences a lack of competition in the credit card market.²¹³ Brito and Hartley's analysis refutes this charge. Ausubel's model looks only at the supply of funds to the credit card market and ignores consumer demand for credit cards. Once consumer demand for credit cards is considered, it is evident that credit card interest rates will change in tandem with interest rates on competitive assets, such as interest rates on checking accounts and the availability of regular bank loans.²¹⁴ Focusing solely on credit card interest rates is also misleading, in that it ignores many of the other benefits of credit cards identified above, such as the elimination of annual fees and cobranding benefits such as frequent flyer miles.²¹⁵ Significantly, the majority of card users are convenience users who pay their balances each month.²¹⁶ For them, interest rates are irrelevant, especially compared to the other benefits offered by credit cards.²¹⁷ Even for those who use their cards for credit and revolve balances from month-to-month, the advantages of shopping for lower rates are minimal.²¹⁸ Using interest rates as the

213. See Ausubel, *supra* note 177, at 53-56.

214. See Brito & Hartley, *supra* note 200, at 418.

215. See *Delinquency on Consumer Loans*, *supra* note 114. In fact, as a historical matter, annual fees first appeared as a mechanism for card issuers to offset the effects of statutory interest-rate ceilings during the high-inflation period of the late 1970s and early 1980s. See Glenn B. Canner & Charles A. Luckett, *Developments in the Pricing of Credit Card Services*, 78 FED. RESERVE BULL. 652, 654 (1992). Thus, the elimination of annual fees in recent years may have been a substitute for reductions in interest rates.

216. See *supra* note 205 and accompanying text. Consumers who pay their balances in full, of course, accrue no interest charges. See Cargill & Wendel, *supra* note 198, at 379. In addition, "Visa estimates that almost 60 percent of total bankcard volume generates no interest, up from roughly 50 percent six years ago." *Delinquency on Consumer Loans*, *supra* note 174, at *5.

217. See Canner & Luckett, *supra* note 215, at 663 ("Interest rates are largely irrelevant, of course, for convenience users."). Thus, it should not be surprising that convenience users are relatively unconcerned about credit card interest rates but are quite sensitive to the amount of the annual fee and the length of the interest-free grace period. See *id.*

218. Canner and Luckett note that for a family owing the median level of credit card debt in 1989, approximately \$1,250, "a 3 percentage point drop in the rate would reduce the annual interest charge by less than \$40." *Id.* at 664. Moreover, the card holder will likely lose some benefits (such as a high credit limit) and will have to undergo the hassle and uncertainty of switching to a new company. Thus, they

only proxy for vigorous competition is tantamount to saying that the automotive industry is noncompetitive because car manufacturers increase quality through improved safety, comfort, or gas mileage, rather than simply cutting prices.²¹⁹ Such a conclusion would obviously be incorrect when applied to cars, and it is equally incorrect when applied to credit cards.

3. *Credit card companies' mass mailing marketing practices are not exploitative*

Chastising the marketing practices of credit card companies, as many critics do, is also misguided. Mailed credit card solicitations are "merely advertisements," says William Binzel, a spokesman for the credit card industry.²²⁰ "Just as consumers ought not go have a Big Mac every time they see a McDonald's ad, they probably ought not avail themselves of every credit card solicitation they receive."²²¹ Nobody is holding a gun to consumers' heads and forcing them to send in credit card applications. Indeed, the alternatives to direct mail, such as in-person solicitations and telemarketing, are fraught with far more possibilities of abuse and manipulation than is direct mail.

In a market full of credit card choices, aggressive mail solicitations may be necessary to inform consumers of the alternatives. Mail solicitations are perhaps the only reliable way to

conclude, "It is questionable whether a \$40 annual saving would be enough to induce a cardholder to switch from a card that has been providing satisfactory service or attractive enhancements." *Id.*; see also Cargill & Wendell, *supra* note 198, at 380-81 (noting that for "each \$100 of balance carried through the year, the consumer saves \$1 per year for each 100 basis point reduction in the effective annual interest rate," meaning that a household with a balance of \$1,000 through the year can save only \$10 per year for each 100 basis point reduction in the interest rate). As discussed below, the high transaction costs of dealing with credit card accounts means that the cost of funds makes up much less of the interest rate than for other forms of credit, thereby making credit card interest rates less responsive to changes in the cost of funds rate. See *infra* notes 248-49 and accompanying text.

219. Ausubel also argues that the noncompetitive nature of the credit card market is reflected by alleged premiums paid by banks for credit card receivables. See Ausubel, *supra* note 196, at 50. According to Brito and Hartley, however, a large part of this mark-up can be explained by the fact that the purchasing bank will be able to save the transaction costs of processing the application. See Brito & Hartley, *supra* note 200, at 424. Once this variable is added in, most of the premium disappears, as the remaining amounts of the mark-up can be explained by a relatively small growth in the outstanding balance on the accounts at the rate of inflation. See *id.*

220. Shenk, *supra* note 131, at 17 (quoting William Binzel, a spokesman for the credit card industry).

221. *Id.*

obtain information on the customer's finances that will allow an issuer to decide whether to supply a card. At the same time, however, responding to direct-mail solicitations requires effort on the borrower's part, which explains the low yield rate for individuals contacted via direct mail.²²² Finally, it must be remembered that mass credit card solicitations are hardly a unique source of junk mail and that mass solicitations of credit purchases are not unique to credit card issuers. Every time a merchant accepts a check in payment, the merchant is extending short-term credit without knowing the consumer's bank balance. Mass marketing may expend millions of the issuers' dollars, but it is not self-evident that it preys upon consumers.

Accusations that credit card issuers "exploit" young and low-income customers also miss the point both logically and empirically. First, it is not clear why it is a problem for young and lower-income customers to have credit cards. Both groups are unlikely to have access to alternative sources of competitive credit, such as home equity loans. Credit cards allow them to borrow against current and future income with low transaction costs and without having to pledge their personal property as collateral.²²³

Second, if credit card issuers are actually targeting young and low-income borrowers to "hook" them on credit cards, the evidence suggests that their tactics are not working. First, most of the growth in credit card debt in recent years is attributable to increases among *upper-income* debtors, not lower-income

222. See James J. Daly, *Saving on Postage*, CREDIT CARD MGMT., May 1997, at 68 (noting that, in contrast to telemarketing, the most feasible alternative vehicle for solicitation by card issuers, direct mail solicitations require people to "go through all the work to respond to a direct-mail solicitation"); see also Chuck Paustian & Kelly Shermach, *Tough Times in Card Marketing*, CREDIT CARD MGMT., May 1998, at 42 (noting that the overall response rate for direct mail solicitations fell to 1.3% in 1997, the lowest level ever tracked by Mail Monitor tracking service, and down from 1.4% the previous year, with the drop attributable to the "clutter" of multiple competing offers by issuers).

223. The evidence indicates that much of the increase in credit card indebtedness among low-income families is merely as a substitute for other forms of debt. Thus, it has been observed that

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 that these households have merely substituted one type of high-interest debt for another.

Edelberg & Fisher, *supra* note 187, at 3.

debtors.²²⁴ In 1995, upper-income households were more than three times more likely to have a credit card as those in the lowest income groups,²²⁵ and credit card indebtedness was nearly twice as high among upper-income households as lower-income.²²⁶ Moreover, both credit card ownership and indebtedness levels increased with income.²²⁷ And while low-income households were increasing their total credit card indebtedness along with everyone else, the growth in total balances has been consistent with previous eras.²²⁸ The claim that credit cards are exploiting low-income consumers is difficult to square with the evidence.

While there is anecdotal evidence that credit card issuers are aggressively soliciting young and college-age customers, the claim that credit card issuers are exploiting young borrowers is also suspect. Most of the growth in credit card indebtedness is "attributable to higher average credit card debt per household, not from more households with access to credit cards."²²⁹ Young borrowers, by definition, will tend to be new credit card users. Thus, if credit card issuers were being successful in "hooking" young borrowers, the data would indicate a growth in credit card indebtedness among *new* credit card customers, rather than existing credit card holders. As with the claim that credit card issuers are exploiting low-income customers, the data refute the hypothesis that credit card issuers are exploiting young customers as well.

The confusion of those who fault credit card issuers for solicitations concerning "pre-approved" cards is illustrated by an old joke about the person who opened a new checking account and thought he could go out and write all his checks: "After all, they wouldn't have given them to me if I wasn't supposed to use them." Of course, we know we are not allowed to write all those checks if we do not have sufficient funds to pay for them. If a check bounces, no one would blame the bank for giving out the checks and "inducing" the customer to write them. Why, then,

224. See Yoo, *supra* note 176, at 19.

225. See *id.* at 21-22.

226. See *id.* at 22-23.

227. See *id.* at 21-23.

228. See *id.* at 27. This also only speaks to average outstanding balances and does not adjust for changes in interest rates and other measures of current indebtedness.

229. *Id.*

should “pre-approved” credit card applications stand on a different footing from “pre-approved” checks? Both are offered on the assumption that they will be used only if one has the ability to honor the debts incurred.

4. *Moderation in credit card profits suggests robust competition in the credit card industry*

The third prong of Ausubel’s thesis is that card issuers have the incentive to exploit consumers because of the supranormal profits earned on credit cards. While this claim may have had some empirical support at some point in recent history, it is questionable today. In 1991, when Ausubel conducted his initial study, profits may have been higher, as consumers and banks were learning to deal with the explosion of consumer credit in the 1980s.²³⁰ Early entrants into markets can earn economic rents, which are dissipated as the market matures. Thus, Ausubel’s initial study concerned a period of time that may have been uniquely fertile for profits on credit cards.

Banks’ profits on credit cards have, however, declined rapidly in the period following Ausubel’s study and are expected to continue to fall.²³¹ Stuart A. Feldstein of SMR Research observes that for the sixty largest credit card issuers, from 1994 to 1996 “after-tax profits as a percent of average managed assets declined from 2.26% to 1.31%,” primarily due to bankruptcy-related losses.²³² Feldstein further predicted that for 1997, the profit margin will fall to just over 1%.²³³ Another study reports

230. The era of effective interest rate deregulation on credit cards can be dated to the Supreme Court’s decision in *Marquette National Bank v. First Omaha Services Corp.*, 439 U.S. 299 (1978), in which the Court held that the applicable usury rate for credit was that of the lender’s home state, regardless of a lower rate limitation in the customer’s state of residence.

231. Lindsey notes that the rate of return on total assets for credit cards for the 30 largest issuers was 2%, while the rate of return on other banking activities was 1.3%. Lindsey further notes that “While credit card banks remained more profitable than other banks, their profitability has declined a good bit in recent years owing to heightened competition and the erosion of credit quality.” *Delinquency on Consumer Loans*, *supra* note 114.

232. *Rise in Personal Bankruptcy*, *supra* note 126, at *24.

233. See *id.* Other commentators agree that profits will remain low at least through the end of the century. See James J. Daly, *Back from the Brink*, CREDIT CARD MGMT., May 1998, at 54 (noting that Charles M. Hegarty of Wachovia Bank Card Services “predicts the [profit] squeeze will remain through the rest of this year and even into 1999”). Kathy McShane of Kendrew Group said, “I think the industry will remain flat for several years.” *Id.*

an after-tax return of 1.2% in 1996²³⁴ and 1.5% in 1997, well below the peak profitability of 1993.²³⁵

Credit card loans, moreover, are significantly riskier than other loans;²³⁶ thus, *risk-adjusted* profits are significantly lower than Ausubel suggests. As a result of this higher risk, credit card issuers also maintain significantly higher average equity to asset and loan loss reserves to total loan ratios than for other operations.²³⁷ Lawrence Lindsey, a member of the Board of Governors of the Federal Reserve System, testified to Congress,

The strong earnings profiles of the credit card banks, and their associated capital and reserve allocations, are reflections of the risks associated with this form of lending. Higher risk and higher return go hand-in-hand, and the higher capital and reserves associated with this form of credit are required to balance the risk. Put another way, lenders active in the credit card business are conscious of higher potential loss rates and expect returns that will fully absorb these losses and still provide an adequate profit margin.²³⁸

Because the profits that exist are not evenly distributed among all issuers in the market, several card issuers have curtailed their credit card operations in the face of mounting losses.²³⁹ As one article observes,

The bank card industry seems to be dividing into a society of haves and have-nots. On the one hand, there are the monoline credit card issuers and a handful of card operations owned by

234. See Linda Punch, *Subprime's Dangerous Waters*, CREDIT CARD MGMT., Mar. 1998, at 77.

235. See Daly, *supra* note 233, at 54. The data in Ausubel's study run out in 1993, before this decline in credit card profits. See *Bankruptcy Revision*, *supra* note 114, at 259. This is somewhat surprising, however, as the remainder of his data is reported through 1995 and 1997.

236. For instance, credit card loans are unsecured and usually much smaller in amount than other types of credit. Thus, traditional enforcement measures such as repossession and lawsuits often are not effective measures to compel repayment. See Randall J. Pozdena, *Solving the Mystery of High Credit Card Rates*, FRSBF WKLY. LETTER NO. 91-42, Nov. 29, 1991.

237. See *Delinquency on Consumer Loans*, *supra* note 114.

238. *Id.*

239. See *Rise in Personal Bankruptcy*, *supra* note 126, at *24-25 (noting that Advanta Corp. and AT&T have both had to sell their credit card operations to other issuers as a result of losses); see also Mark Calvey, *Bank Wooing Continues, But On New Terms?*, 18 BUS. J.-PHOENIX, Jan. 30, 1998, at 30 (noting that Wells Fargo bank is curtailing credit card marketing in the face of large losses).

large banks. Many of these card programs reported profit increases of 20% or more in 1997 despite high chargeoffs and record consumer bankruptcies. On the other hand are the great majority of card issuers that are experiencing poor or mediocre returns.²⁴⁰

The profits from credit cards during the early 1990s may also have been inflated when compared to the returns from other sectors of the banking industry. The profits from credit cards may be overstated because of the relative *unprofitability* of other sectors of bank activity.²⁴¹ There is substantial evidence that this was indeed the case and that profits were lower than usual in other sectors of the banking industry "due to [banks'] exposures to developing countries, energy sector borrowers, and commercial real estate markets,"²⁴² all of which struggled during the 1980s and early 1990s.

The moderation of profits for credit card issuers was the inevitable consequence of the explosion of competition in the credit card industry in recent years. As Brito and Hartley state the issue, "Several authors . . . have argued that even though the market for bank credit cards is unregulated, has thousands of independent firms, many of them recent entrants, and has millions of consumers, it nevertheless appears to be noncompetitive."²⁴³ Between 1988 and 1991, for instance, the number of companies issuing credit cards grew from approximately 4,000 to 6,000.²⁴⁴ Millions of Americans carry credit cards. Competition has significantly reduced the very profits of which Ausubel complains.²⁴⁵ Consider the following discussion from *Credit Card Management* magazine:

240. Daly, *supra* note 233, at 54; see also Canner & Luckett, *supra* note 215, at 662 (discussing how "it would be expected that when the economy is performing well . . . [large credit card companies] that bear more risk would outperform more conservative" smaller credit card companies).

241. See *Rise in Personal Bankruptcy*, *supra* note 126, at *22 ("As recently as the late 1980s, commercial mortgage loans and loans on apartment buildings had very high delinquency and loss rates, due in part to sloppy lending and due in part to the fact that shopping centers, apartments, and office buildings were overbuilt in the 1980s.").

242. *Delinquency on Consumer Loans*, *supra* note 114, at *11-12.

243. Brito & Hartley, *supra* note 200, at 400.

244. See *id.* at 425 n.23.

245. As Diane Ellis summarizes the situation, "The opportunity to earn high profits has attracted intense competition, which appears to be eroding some of the high profits earned in the early 1990s . . ." Ellis, *supra* note 138, at 9.

Issuers need look back no further than the onset of the 1990s for a textbook case of such an occurrence. At the time, money center banks were the dominant issuers, thanks to the resources brought on by their size. Despite their power, they had become lethargic, charging interest rates of 18.9% or 19.8% and \$20 annual fees for plain-vanilla cards. When the specialty card issuers, such as Household, AT&T, and First USA, began shaking up the business with contrarian marketing strategies that eliminated annual fees, slashed interest rates, and offered cardholders rich rewards for using their cards, the money centers were not creative enough to counter the assault on their domain.²⁴⁶

The result was a precipitous loss of market share for leading banks such as Bank of America, Chase, and others. Of the money centers, only the top issuer Citicorp "managed to hold its place in the standings, but its growth rate in recent years has lagged that of the specialists."²⁴⁷

Ausubel's focus on the alleged premia on interbank sales of credit card accounts as evidence of supranormal returns and a lack of competition in the credit card market is also misplaced. It fails to account for the transaction costs of credit card accounts, which tend to be substantially higher than for other types of bank loans.²⁴⁸ Thus, the higher amounts paid on interbank sales of accounts probably simply reflect the savings on transaction costs of the purchasing bank.²⁴⁹

In short, Ausubel continues to sound warnings about the "credit card menace" without realizing that the consumers have already won the credit card Cold War. The heavy marketing that has been described indicates that the credit card market is ferociously competitive and has generated many benefits for

246. Peter Lucas, *An Irresistible Force?*, CREDIT CARD MGMT., Jan. 1998, at 34.

247. *Id.*

248. Unlike other bank loans, credit cards present a large volume of relatively small transactions and a large number of accounts. Thus, credit card operations are more costly per dollar of receivables than other types of bank lending. See Canner & Lockett, *supra* note 215, at 658. Canner and Lockett note that for credit card accounts, "Operating costs (including such diverse activities as servicing accounts, soliciting new customers, and processing merchant credit card receipts) accounted for nearly 60 percent of the total cost, and the cost of funds 27 percent." *Id.* By contrast, "[T]he cost of funds . . . accounted for 60 percent of total expenses for installment lending, about 70 percent for commercial lending, and nearly 80 percent for mortgage lending." *Id.*

249. See Brito & Hartley, *supra* note 200, at 424.

consumers, from no annual fees, to falling interest rates, to frequent flyer miles. Smaller card issuers have begun to enter into joint ventures with companies with complementary resources, so as to meet consumer demand for these "cobranding" perquisites.²⁵⁰ In such a heavily contested market, common sense alone suggests that long-term high profits are not sustainable, and the evidence confirms this view. It further suggests that credit card losses do not simply reduce supranormal bank profits, but must be passed on in a competitive market. Thus, there are efficiency losses, not just a wealth transfer from creditors to debtors.

The increased competition among issuers is mirrored by increased sophistication among consumers who are turning it to their own ends.²⁵¹ The heaviest borrowers are the ones who will find it most worthwhile to change credit cards in response to low "teaser" rates.²⁵² According to one report, credit card holders "are learning to jump from one promotional low-interest-rate lender to the next, just like shopping for the lowest-priced tank of gas."²⁵³ One such "card surfer" whittled down massive credit card bills by jumping through the low "teaser" rates of five different cards. "I'm beating them at their own game," he says.²⁵⁴ Indeed, card issuers complain about their inability to keep these card switchers "captured," thereby requiring them to "steal[] the

250. See Lucas, *supra* note 246, at 34 (describing joint venture among BankBoston, Bank of Montreal, and First Annapolis Consulting Inc. to jointly run a credit card bank).

251. As Charles M. Hegarty, president of Wachovia Bank Card Services observes, "Cardholders have become more savvy, more demanding," and this is eating into bank profits. Daly, *supra* note 233, at 54.

252. In fact, surveys indicate that those who revolve balances from month to month are more likely than convenience users to shop around for lower rates. See Canner & Luckett, *supra* note 215, at 663.

253. Jeff Bailey & Scott Kilman, *More Borrowers Appear to be Wising Up About Credit*, STAR TRIB. (Minneapolis-St. Paul), Mar. 1, 1998, at D5. Ausubel seems to have missed this fact in his analysis of consumer switches. See *Bankruptcy Revision*, *supra* note 114, at 263. Even assuming that the credit card market is characterized by substantial search/switch costs, those who have the most to gain from incurring these search and switch costs will do so. This will generally be those who are carrying the highest balances. It should be noted that Ausubel provides no evidence for his suggestion that the credit card market is characterized by substantial search/switch costs. My personal experience suggests that it is extremely easy to switch from one credit card issuer to another or to induce concessions from a given credit card issuer purely by threatening to switch. Indeed, the evidence shows that most Americans own two or more credit cards issued by competing issuers. Thus, switching is as simple as pulling one card out of your wallet rather than another.

254. Bailey & Kilman, *supra* note 253, at D5.

same people over and over.”²⁵⁵ An analyst observes that savvy credit card consumers “pay off Peter with Paul—at a lower rate. . . . And by the time Paul wants a bigger payment, Jane comes around with a better offer.”²⁵⁶ Given the low rates offered by these cards, it is difficult for banks to actually make profits from these borrowers during the introductory period.²⁵⁷ And while banks have increased late fees and other charges,²⁵⁸ in practice banks are reluctant to enforce these fees because of their fear of losing customers.²⁵⁹ In short, the image of consumers as passive sheep being shorn by ruthless credit card issuers is outdated.

To the extent that credit cards are blamed for the bankruptcy boom, the charge would appear to lack substance. Credit cards have empowered consumers, furnishing them convenience and nonmonetary benefits. Moreover, they have also aided in the growth of millions of small businesses by reducing the businesses’ risk of loss from nonpayment of accounts and by enabling them to compete with Sears and other big retailers who used to dominate the retail credit market.²⁶⁰ The creation and growth of niche internet and catalogue businesses is almost completely dependent on widespread access to credit cards. That card issuers reaped good profits during the early years of their innovation is neither exceptional nor blameworthy. What is blameworthy is that the industry should be demonized in order

255. *Id.* More than 60% of all Visa and MasterCard offers include an introductory low-interest rate. *See id.*

256. *Id.*

257. As Robert Bzezensky, president of North American Integrated Marketing, observes, “There is no way you can make profits in the bank card industry at a 5.9% interest rate. . . . You will be attracting more rate surfers than potential (long-term) customers.” Daly, *supra* note 222, at 68.

258. *See* Ausubel, *supra* note 177, at 263.

259. *See* Daly, *supra* note 233, at 54 (“Despite rapid increases in penalty fees, with late fees jumping from an average of about \$18 to about \$20, the lower number of revolvers and banks’ unwillingness to anger their cardholders conspired to keep actual [profit] category growth to a mere 2%.”).

260. *See* DeMuth, *supra* note 190, at 238. As DeMuth notes, this was because only large retailers such as Sears could afford the large costs associated with setting-up and running a credit operation in addition to its normal business. In turn, Sears could bury these credit costs in the price of its goods and services, spreading the costs across many transactions and also allowing it effectively to evade usury restrictions. *See id.* The spread of Visa and MasterCard enabled retailers to separate the credit transaction from the retail transaction, increasing the ability of small retailers to compete with Sears and other large retailers. *See id.* at 238-39.

to avoid confronting the real causes of escalating bankruptcy filing rates and to stifle bankruptcy reforms.

C. Other Causes of Bankruptcy

Advocates of the status quo have pointed to additional purported causes of bankruptcy that fortify their belief that bankruptcy represents not a choice but a necessity. Professor Warren, for instance, writes that "inquiries [and possible solutions] must reach well beyond the bankruptcy system."²⁶¹ To the extent that debt and credit cards are not the problem, she points to "[t]he coverage and stiffness of the social safety net, the implications of lack of medical insurance, [and] job layoffs and downsizing."²⁶² The solutions require "[b]etter health insurance coverage, limits on credit solicitations, and better consumer credit disclosures."²⁶³ Jean Braucher similarly argues that the causes of bankruptcy include "the combined effect of various forms of social instability, including divorce, lack of medical insurance, and changes in employment practices (such as downsizing and increased use of contract and part-time workers)."²⁶⁴ These factors have been reported in other publications.²⁶⁵

Although often-repeated, there is little empirical support for these views. Indeed, most credible empirical evidence undermines their presuppositions. The challenge is not to explain every bankruptcy filing of the 1990s but to explain the dramatic increase from less than 800,000 consumer filings in 1993 to 1.35 million in 1997.

We also do not claim that none of these other factors affects bankruptcy filings. Time and further study may reveal their impact, but here we emphasize that the critical studies have not yet been done. On the contrary, several of the popularly-cited factors seem refuted by available evidence. In our view, there are additional hypothetically reasonable factors that have been routinely ignored but should provoke further study. We suggest only that many of the factors commonly advanced as bankruptcy

261. Warren, *supra* note 7, at 1101.

262. *Id.*

263. *Id.*

264. Braucher, *supra* note 12, at 5.

265. See Warren *Challenges*, *supra* note 57, at A8 (discussing factors such as "the coverage and stiffness of the social safety net, the implications of lack of medical insurance, job layoffs and downsizing" (citing Warren, *supra* note 7, at 1101)).

determinants lack empirical support, while other highly-plausible factors have been arbitrarily excluded from the bankruptcy debate.

Consider the references to "job layoffs and downsizing." In the first place, neither Warren nor Braucher defines the term "downsizing," nor do they identify how many workers have been subject to "downsizing."²⁶⁶ To the extent that individual "job layoffs" are something different from downsizing, in an economy where unemployment stands at five to six percent it is hard to imagine that this could explain the recent massive increases in bankruptcy filings.²⁶⁷ Brinig and Buckley, for instance, found little support for the hypothesis that job loss or poverty was a significant factor in bankruptcy filings.²⁶⁸ Fay, Hurst, and White's study also found that unemployment by a head of a household or spouse is not significantly correlated with bankruptcy filings.²⁶⁹ Warren's and Braucher's implication that there is widespread fragility in the labor market, leading to higher systemic level of bankruptcies, lacks proof. And even if layoffs did cause bankruptcies, the unemployed are the low-income debtors that means-testing would leave unaffected.²⁷⁰

266. To the extent that downsizing is defined in relation to the loss of middle-management jobs in large corporations, the evidence indicates that downsizing is a myth. Recent data indicate that the proportion of managers and supervisors in private nonfarm employment has *grown* during the 1990s, not shrunk. See DAVID M. GORDON, *FAT AND MEAN: THE CORPORATE SQUEEZE OF WORKING AMERICANS AND THE MYTH OF MANAGERIAL "DOWNSIZING"* (1996). There is also little evidence to suggest that job stability is lower than it has been in the past, further casting doubt on the notion of "downsizing." Moreover, the proportion of workers in volatile, employment-unstable manufacturing has declined substantially in recent years, suggesting that job stability should be increasing over time.

267. Some studies have found that many bankruptcy filers suffered employment interruptions within two years of filing bankruptcy, but those studies have not been scientifically controlled in a manner that would permit drawing reliable statistical conclusions. Indeed, one such study concluded that the purported link between unemployment and bankruptcy is "only speculative." Theresa A. Sullivan et al., *Consumer Debtors Ten Years Later: A Financial Comparison of Consumer Bankrupts 1981-1991*, 68 AM. BANKR. L.J. 121, 130-31 (1994). At best, studies have identified a correlation between previous job loss and later bankruptcy filing, but they have not established (or even tried to establish) causation. See 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)).

268. See Buckley & Brinig, *supra* note 118, at 204-05.

269. See Fay et al., *supra* note 119, at 22.

270. See Sullivan et al., *supra* note 267, at 130 (noting that job interruption will be reflected in lower incomes).

Large uninsured medical bills and accidents by uninsured motorists are also often cited as causes of bankruptcy.²⁷¹ Empirical support for this proposition is also lacking, as Fay, Hurst, and White found that health problems for the head of a household or the spouse are not significantly correlated with bankruptcy filings.²⁷² More important, no correlation has been shown between such problems, admittedly a factor in some core level of bankruptcies, and the recent explosive growth of filings. Further, it simply does not follow that "better health insurance" is the answer to the problem of high medical bills, as the current system of employer-provided health insurance is partly responsible for the current high costs of the medical system.²⁷³ The idea that high medical bills can explain the spiraling increase in bankruptcy filing rates is also contradicted by the moderation in the rise of health care costs during this period.²⁷⁴ And for both medical bills and automobile accidents, tort reform would be a logical way to reduce the costs of these variables, perhaps making them less cataclysmic. The claim that "better health insurance" is the solution—to the exclusion of all these other factors—reflects ideological bias, rather than sober analysis.

In contrast to speculative observations about job layoffs, downsizing, medical bills, and uninsured auto accidents, Warren and Braucher ignore other factors that actually have been demonstrated to affect certain consumers adversely: legalized gambling, student loans, increases in the minimum wage, and high tax rates. A close association has been demonstrated between legalized gambling and high rates of bankruptcy in the vicinity of the casinos or similar establishments.²⁷⁵ Just as provocative are the negative effects of the minimum wage, most strongly felt

271. See Domowitz & Eovaldi, *supra* note 137, at 825.

272. See Fay et al., *supra* note 119, at 22.

273. See McKinley, *supra* note 125, at 35.

274. During the period that the surge in bankruptcy filings occurred, health care costs remained stable, rising only at a rate sufficient to keep up with inflation. See Bruce Japsen, *Health Coverage Fraying Soaring Costs, Job Changes Drive Many Out of Plans*, CHI. TRIB., Dec. 31, 1998, at 1 (noting "several years" of health care costs "keeping pace with the rate of inflation"); 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 in recent years); Ron Winslow, *Health Care Costs Are Expected to Rise 3.3% in 1998, Employer Survey Finds*, WALL ST. J., June 16, 1998, at B7 (noting "four years of level medical costs").

275. See *Rise in Personal Bankruptcy*, *supra* note 126, at *8-9.

by marginal workers, such as the young and unskilled.²⁷⁶ While economists are notorious for their inability to agree on many concepts, a recent survey of a cross-section of professional economists reveals that 56.5% of those surveyed “generally agree” with the statement that “[a] minimum wage increases unemployment among young and unskilled workers.”²⁷⁷ A recent study estimated that each 10% increase in the minimum wage reduces employment by approximately two to four percent over a two year period.²⁷⁸ Moreover, increases in the minimum wage also are generally offset by reductions in other benefits, such as eliminating bonuses, cutting paid vacations and sick leave, and reductions in severance pay and sick pay.²⁷⁹ Deprivation of these ancillary benefits would seem to be related to the propensity to file bankruptcy, as they impose greater vulnerability in times of illness and forced unemployment. Thus, increases in the minimum wage inevitably result in layoffs and reduced benefits to the most vulnerable workers in the economy.²⁸⁰

Omitting the burden of taxes from the list of bankruptcy causes is an even more glaring oversight. A 1997 Gallup Poll

276. See Murray Weidenbaum, *How Government Reduces Employment*, in *LABOR MARKETS, EMPLOYMENT POLICY, AND JOB CREATION* 279, 284 (Lewis C. Solmon & Alec R. Levenson eds., 1994) (“[T]he great mass of the research has concluded that increases in the compulsory minimum wage cause a rise in unemployment. The segment of the workforce most affected consists of those at or near the minimum wage. This is a group made up primarily of teenagers and others with low skills who thereby lose the opportunity to gain their initial work experience.”).

277. Richard M. Alston et al., *Is There a Consensus Among Economists in the 1990's?*, 82 AM. ECON. REV. 203, 204 (1992). Another 22.4% agreed to the validity of the statement “with provisos,” with only 20.5% generally disagreeing. See *id.*

278. See Nicolas Williams & Jeffrey A. Mills, *Minimum Wage Effects by Gender*, 19 J. LAB. RES. 397, 409 (1998). Williams and Mills note that the unemployment creating effects of the minimum wage dissipate as economic growth and inflation cause the statutorily set minimum wage to fall below the market-clearing wage. Williams and Mills's findings are consistent with similar studies conducted over a range of many decades. See Charles Brown et al., *The Effect of the Minimum Wage Law on Employment and Unemployment*, 20 J. ECON. LIT. 487, 508 (1982) (“In summary, our survey indicates a reduction of between one and three percent in teenage employment as a result of a 10 percent increase in the federal minimum wage.”).

279. See Richard B. McKenzie, *Another Minimum-Wage Clash*, 48 FREEMAN 676, 677 (1998) (arguing that increases in the minimum wage will lead to reductions in other employee benefits); Weidenbaum, *supra* note 276, at 286-87.

280. It should be kept in mind that there is little evidence to support the hypothesis that unemployment is generally a statistically significant predictor of bankruptcy. To the extent such a link exists, however, it would be most likely to be present among those low-skill workers displaced by the minimum wage. Thus, further study on this point is warranted.

revealed that 10% of bankruptcy debtors filed partly because of tax burdens, a percentage that exceeded college expenses and death in family, and was five times higher than those reporting that gambling pushed them into bankruptcy.²⁸¹ A Visa poll showed that 3.1% of respondents filed bankruptcy because of taxes.²⁸² Testimony before the NBRC suggested that tax arrearages play an even greater role than these statistics identify.

Of course, the survey data do not account for the ways in which taxes strip families of take-home pay and sap them of savings that would otherwise be available to withstand financial difficulties. Because large tax payments come "off the top" of family income, survey respondents would tend not to think of them as a proximate cause for bankruptcy, but they are unquestionably significant in the ability to pay family expenses and to save for emergencies. Taxes devour massive amounts of personal income that would be available to finance consumption without having to take on additional debt. For some people, taxes take as much as forty to fifty percent of their income. This burden has increased substantially during the same period that bankruptcies have risen. From 1990 to 1997 taxes increased 58% and as a percentage of GNP now stand near their highest ever percentage levels, thereby cutting substantially into workers' take-home pay.²⁸³ Taxes also drain extra income that Americans could save to deal with unexpected financial catastrophes.²⁸⁴ Nonetheless, while Braucher bemoans the low savings

281. See McKinley, *supra* note 125, at 34 (citing Christine Dugas, *Bankruptcy Stigma Lessens*, USA TODAY, June 10, 1997, at B1).

282. See Visa, *Consumer Bankruptcy: Preliminary Report, Annual Bankruptcy Debtor Survey* (April 1997) (visited Jan. 19, 1999) <<http://www.abiworld.org/research/researchfront.html>>.

283. See *Taxing Savings*, INVESTOR'S BUS. DAILY, Aug. 5, 1998, at A6. Federal tax revenues alone are 21.8% of GDP, and personal federal tax payments as a share of wage and salary income are almost 27%, almost a one-third increase in the past three years. See Lawrence Kudlow, *Big Government Returns*, SAN DIEGO UNION-TRIB., Jan. 31, 1999, at G4. This is a record peacetime high and is close to the tax burden at the height of World War II. See Steve Forbes, *Fact and Comment*, FORBES, Feb. 8, 1999, at 31.

284. The savings rate for 1997 was 2.1%, the lowest level since the Great Depression. See *Taxing Savings*, *supra* note 283, at A6. According to Commerce Department data, in 1997 Americans earned \$6.3 trillion in income and spent \$5.7 trillion on goods and services, meaning that Americans earned \$1.1 trillion more than they spent. Of that \$1.1 trillion, taxes devoured \$989 billion, leaving \$121 billion in net savings (2.1% of disposable income). See *id.* The declining savings rate appears to be

rate,²⁸⁵ neither she, Warren, nor the NBRC suggests that tax reform and tax reduction would be a solution to escalating bankruptcies.

It should also be remembered that most consumer debt is actually housing debt.²⁸⁶ This suggests a number of possible reforms designed either to reduce housing debt directly or indirectly by reducing housing costs. For instance, it seems that those who express concern about consumer debt would oppose the tax deductibility of interest payments on mortgages. The ability to deduct mortgage interest payments invariably leads home buyers to minimize their down payments and take on greater mortgage debt than they can afford. If debt and bankruptcy are, in fact, correlated, then this increases their leverage, potentially making them more vulnerable to bankruptcy.²⁸⁷ Similarly, Warren, Braucher, and the NBRC are silent as to the environmental, labor, zoning, and other regulations which artificially inflate the cost of housing, thereby increasing consumer indebtedness.²⁸⁸ Indeed, it appears that such tax and regulatory reforms never even register in their world views.

primarily a function of increased taxes, rather than increased spending. From 1990 to 1997 taxes increased 58%, while consumer spending increased only 43%. *See id*; *see also* Brian S. Wesbury, *The Tax Man is Stealing Our Savings*, WALL ST. J., Nov. 19, 1998, at A22 (noting that since 1993, consumption as a percentage of income remained stable, but taxes as a percentage of income rose dramatically, thereby squeezing out personal savings). The "double-taxation" of income and investment earnings, of course, creates a disincentive for savings generally. For similar reasons, double-taxation will tend to cause a shift in savings patterns from more-liquid forms of investments that generate regular interest, such as savings accounts, to less-liquid investments such as houses, where income can be deferred and will be subject to deferred income and capital gains taxes. Increasing the amount of money in liquid assets will also tend to make a family more vulnerable to economic downturns.

285. *See* Braucher, *supra* note 12, at 7 ("It would be hard for anyone to disagree with the proposition that Americans have too much debt and not enough savings, and that if we had less debt and more savings, there would be less bankruptcy. Savings provide a way to deal with a sudden loss of income or unanticipated expenses, without incurring debt.").

286. *See supra* notes 182-87 and accompanying text.

287. Ian Domowitz notes that "[i]f mortgage debt is increased from the level of the general population to that typically observed in Chapter 7 filings, the probability of a bankruptcy filing increases by an estimated 133 percent, rising to 172 percent for households with income above the average." *Personal Bankruptcy Consumer Credit Crisis*, *supra* note 183, at *7-8.

288. *See* Todd J. Zywicki, *Environmental Externalities and Political Externalities: The Political Economy of Environmental Regulation and Reform*, 73 TUL. L. REV. (forthcoming 1999) (manuscript at 36, on file with authors) (observing that protection of the spotted owl by the Endangered Species Act alone raises housing prices \$300 for every \$100,000 of housing prices).

We are not claiming that minimum wage, taxes, or a runaway tort system explain the large number of consumer bankruptcies or the rapid growth in recent years. These are mere hypotheses, but they are logically just as related to the problem as economic downsizing and high medical bills. In fact, to the best of our knowledge, the factors we have identified remain untested, whereas there is substantial empirical evidence rebutting the factors identified by advocates of the status quo. Their list is little more than hand waving and faculty lounge speculation, perhaps rooted in ideological biases but most definitely not in scientific evidence. Indeed, as Professor Warren recognizes, the factors that have caused increased filings warrant further investigation. But to be fruitful, further investigation should proceed in an air of full honesty and not according to a highly-selective list of variables identified primarily on ideological or other nonscientific grounds.

V. CONCLUSION

The time for principled means-testing has come. Today, judges struggle to apply means-testing under § 707(b) but have spawned confusion, unnecessary litigation, non-uniformity, and both actual and perceived abuse and unfairness. The bankruptcy boom has been aided and abetted by a combination of the increasing net economic benefits of bankruptcy and the fading self-restraint traditionally produced by the shame and social stigma of bankruptcy. Means-testing will help restore balance, predictability, equity, and public confidence in the system. As passed by the House, it requires well-off, income-earning debtors to earn the benefit of the automatic stay and discharge by making modest payments to unsecured, nonpriority creditors.

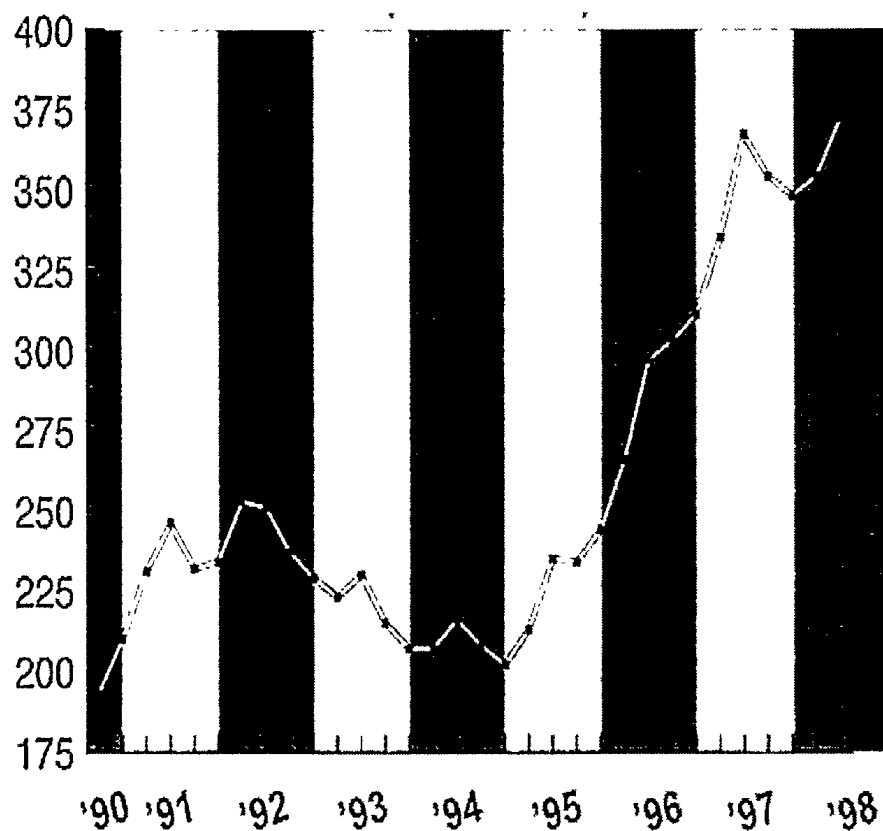
Shame and stigma are precarious social values that can erode rapidly. As we see from the examples in Memphis, everyone is considered a cheat until proven otherwise. The result has been to paralyze the system of consumer credit in Memphis. In the end, all consumers pay for bankruptcy through higher prices and higher interest rates. It is time for the bankruptcy system to become less pro-debtor and more pro-consumer.

TABLE I ²⁸⁹

Personal Bankruptcy Filings By Quarter

1990 (3rd quarter) - 1998 (2nd quarter)

(in thousands)

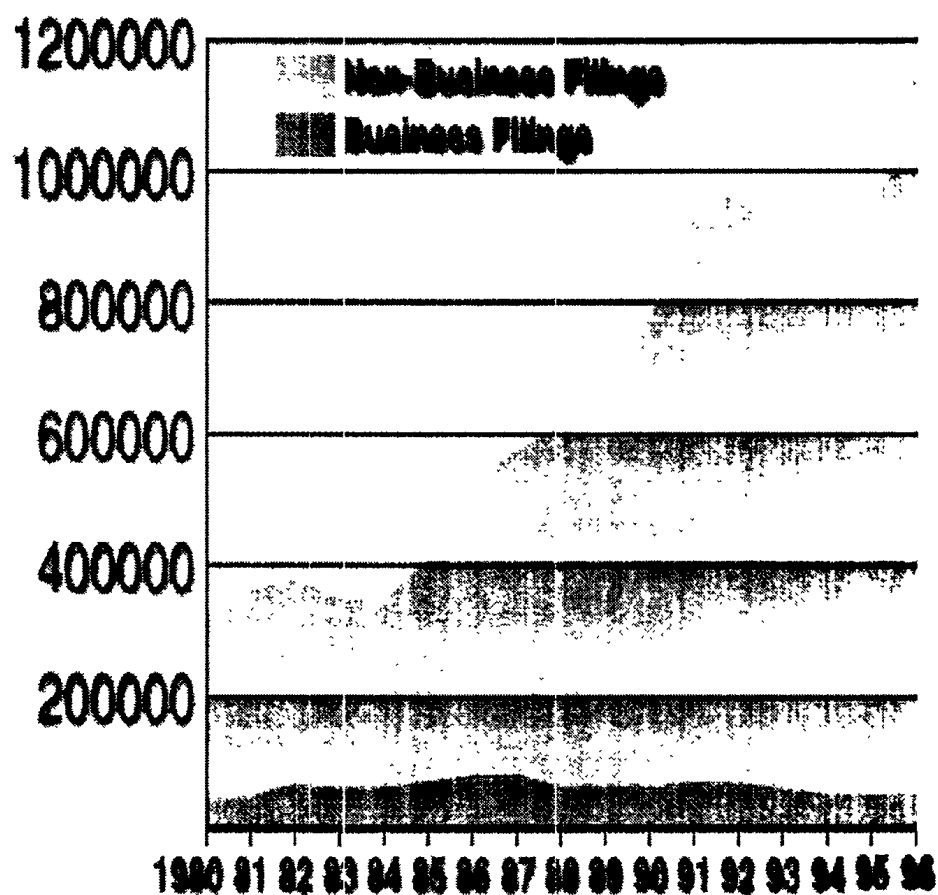


American Bankruptcy Institute

289. See American Bankruptcy Institute, *Personal Bankruptcy Filings By Quarter 1990-1998* (last modified Aug. 11, 1998) <<http://www.abiworld.org/stats/big98quarter.html>>.

TABLE II ²⁹⁰

U.S. Bankruptcy Filings 1980-1996



290. See American Bankruptcy Institute, *U.S. Bankruptcy Filings 1980-1996* (last modified Mar. 2, 1997) <<http://www.abiworld.org/stats/annualgraph.html>>.