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Institutions, Incentives, and Consumer Bankruptcy Reform

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Institutions, Incentives, and Consumer Bankruptcy Reform

Todd J. Zywicki*

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I. Introduction

Consumer bankruptcy filing rates have soared during the past twenty-five years. From 225,000 filings in 1979, consumer bankruptcies topped 1.5 million last year. This relentless upward trend is especially striking in light of the generally high prosperity, low interest rates, and low unemployment during that period. This anomaly of ever-rising bankruptcy filing rates during a period of economic prosperity culminated in spring 2005 with the enactment of comprehensive bankruptcy reform legislation that places new conditions on bankruptcy relief. Although supported by a broad bipartisan consensus on Capitol Hill, these proposals have been controversial within the academy. Critics argued that these reforms are unnecessary and punitive, and that private market adjustments such as higher interest rates and more restrictive credit rationing are suitable policy responses.

Critics of reform argue that consumer bankruptcy filings today are caused by the same basic forces that traditionally have caused bankruptcy filings—heavy household distress caused by over-indebtedness, often combined with unexpected income or expense shocks, such as unemployment, divorce, or health problems. Although this "traditional model" of consumer bankruptcy explained the world tolerably well for several decades, it cannot explain the upward trend in bankruptcy filing rates over the past twenty-five years.¹ Individuals increasingly appear to be *choosing* to file bankruptcy as a response to financial distress, rather than reducing spending or tapping savings to avoid bankruptcy.

Other scholars have advanced a second approach, an "economic incentives" model that views the consumer bankruptcy filing decision as a direct and predictable response to the incentives provided by the bankruptcy law. As will be

1. See Todd J. Zywicki, *An Economic Analysis of the Consumer Bankruptcy Crisis*, 99 NW. U. L. REV. (forthcoming 2005).

seen, neither the traditional model nor the economic maximization model can fully explain the observed pattern of bankruptcy filings. The observed rate is much higher than the traditional model would predict, and much lower than the economic maximization model predicts. Moreover, neither model can explain the dynamic upward trend in filing patterns over time.

But critiquing the prevailing models is insufficient; it is essential to offer an alternative model that better explains the observed data.² This Article provides a new model of consumer bankruptcy that can explain the trends of the past twenty-five years more persuasively than the prevailing models. Anchored in the New Institutional Economics associated with scholars such as Nobel Laureate Douglass North and Oliver Williamson, the model offered here sees the rising consumer bankruptcy rate as reflecting an increasing tendency for individuals to choose bankruptcy as a response to financial problems. This trend reflects changes in the institutions and incentives involved in the decision to file bankruptcy, which have increasingly led Americans to choose bankruptcy in response to financial distress.

This Article identifies three institutional changes that have contributed to the increase in consumer bankruptcies over recent decades. First, there has been a change in the relative economic costs and benefits associated with filing bankruptcy. The economic benefits of bankruptcy have increased because of the adoption of the 1978 Bankruptcy Code. At the same time, the costs associated with filing bankruptcy, such as transaction and search costs associated with learning about and filing bankruptcy, have fallen. Second, there has been a change in social norms regarding bankruptcy, reducing the shame and stigma that traditionally constrained bankruptcy filings.³ Third, there has been a fundamental change in the nature of consumer credit in the economy, which has expanded the use of general unsecured consumer credit and reduced the use of traditional local and informal types of credit. This evolution has increased the relative use of unsecured revolving consumer credit that is dischargeable in bankruptcy, in addition to eroding many of the informal constraints that restrained bankruptcy filings, such as trust, repeat-dealing, and the effects of reputation. Ironically, those who have argued that the expansion of credit card use has contributed to rising bankruptcy filings may be correct—but for the wrong reason. It is

2. As Kuhn observes, the test of a new theory is whether it explains the observed evidence better than the prevailing model or "paradigm." THOMAS KUHN, *THE STRUCTURE OF SCIENTIFIC REVOLUTIONS* 77 (2d ed. 1970).

3. I have elsewhere distinguished these terms: "Personal shame and social stigma go hand-in-hand. Shame is the internal psychological compass that forces one to keep his word; stigma is the external, social constraint that reinforces this." Edith H. Jones & Todd J. Zywicki, *It's Time for Means-Testing*, 1999 BYU L. REV. 177, 215 (1999).

generally assumed that credit cards have increased overall indebtedness and household financial distress. This is not true, as consumers have simply substituted credit cards and other modern forms of unsecured credit for other types of credit, thereby leaving total consumer debt levels largely unaffected. By substituting more impersonal forms of credit for traditional locally-based credit relations, however, this evolution has weakened the traditional extralegal checks on bankruptcy filings. It is argued that this new model of consumer bankruptcy offered here is both theoretically and empirically superior to the traditional model.

The Article then briefly discusses some policy implications of the model described here.⁴ First, the analysis provides a conceptual justification for many of the key elements of the bankruptcy reform agenda, which are designed to modify the incentives and institutions surrounding consumer bankruptcy. Just as the traditional model manifested itself in the 1978 Bankruptcy Code, the new model of consumer bankruptcy is consistent with the recently enacted bankruptcy reform legislation named the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA).⁵ In that sense, this Article is the first to provide a comprehensive conceptual explanation for the bankruptcy reform movement. Ironically, it appears that policy-makers may have recognized what most bankruptcy scholars have not yet—that we live in a fundamentally new world of consumer bankruptcy.

Finally, the model presented here raises new questions about the scope of the fresh-start policy in American bankruptcy law. In particular, by showing that the bankruptcy decision is to some extent under the control of the debtor and that this choice is based on unobservable information such as personal commitment to repayment of financial obligations, the analysis presented here raises new questions about the mandatory fresh-start policy embedded in American consumer bankruptcy law.

II. New Institutional Economics and Consumer Bankruptcy

Consumer bankruptcy filing rates are usually explained according to two different models.⁶ The first model, which I have labeled the "traditional" model

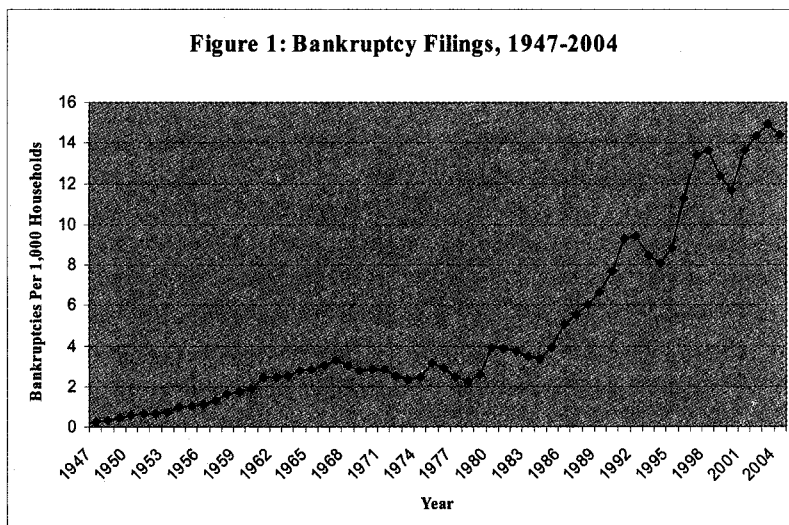
4. These policy implications are discussed in greater detail in a subsequent article. *See generally* Todd J. Zywicki, *The Law and Politics of Bankruptcy Reform* (unpublished manuscript, on file with author).

5. *See generally* Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, 119 Stat. 23 (codified at 11 U.S.C. § 101 et seq. (2005)).

6. Richard Hynes usefully refers to these as the "distress" and "incentives" models. Richard M. Hynes, *Bankruptcy and State Collections: The Case of the Missing Garnishments*, 91 CORNELL L. REV. (forthcoming 2006). Others have characterized them as "sociological" and

(and which others have labeled the "distress" model), views consumer bankruptcies as arising from household financial distress. Under this model, higher bankruptcy filings are predicted to be caused by higher levels of household financial distress. The second model, variously called the "economic maximization" or "incentives" model, views consumer bankruptcy filings as a direct and predictable response to the economic incentives provided by the Bankruptcy Code. As the Code increases the benefits of filing bankruptcy, it is predicted that more consumers will file bankruptcy. Both claim that bankruptcy filings are caused predictably and largely exogenously, rather than by a debtor's conscious decisionmaking. Neither can explain the consumer bankruptcy filing patterns of recent years.

For most of the twentieth century, consumer bankruptcy filings followed a relatively predictable pattern, rising in times of economic recessions (peaking at the height of the Great Depression), but then falling to a low, steady-state rate after the economic crisis abated. Beginning in the 1950s, however, consumer bankruptcy filings have started to trend gradually upward. Beginning in the 1980s, bankruptcy filing rates rose more rapidly and began to rise dramatically during the 1990s. After a brief dip at the end of the 1990s, bankruptcies have surged upward in the new century, reaching 1.5 million in 2004. These trends are shown in Figure 1:



Source: Bankruptcy Filings, Admin. Office of U.S. Courts; Number Households, U.S. Census Bureau

"economic" models. See generally Michelle J. White, *Economic Versus Sociological Approaches to Legal Research: The Case of Bankruptcy*, 25 LAW & SOC'Y REV. 685 (1991) (comparing economic versus sociological approaches to legal research and specifically the economic model of bankruptcy).

This upward trend in filing rates has come during a period of unprecedented economic prosperity. The experience of the 1990s is especially striking given that bankruptcies surged in the face of low unemployment, low interest rates, and record-high wealth accumulation due to gains in the stock market and household real estate holdings.⁷

The evidence indicates that the rise in consumer bankruptcy filing rates is the result not of greater economic distress, as the traditional model would predict, but rather from an increasing propensity of American households to file bankruptcy in response to economic problems.⁸ In the past, households that suffered an economic dislocation tended to respond by reducing spending, tapping savings, taking a second job, and eventually repaying their obligations. Although many Americans today still respond to financial distress in the same way, an increasing number are filing bankruptcy and discharging their debts instead. What is novel are not the underlying problems, but rather the increasing frequency of Americans choosing bankruptcy as the preferred response to those underlying problems.

The fundamental problem with the traditional model is that it conflates two conceptually distinct questions: first, how families get into financial distress in the first place and second, how they choose to get out of financial distress. Financial difficulty presents a menu of options in addition to bankruptcy, from increasing one's income (for example, taking on a second job), to decreasing one's expenditures (for example, eating out or vacationing less), to liquidating assets and using the proceeds to pay debts (such as drawing on savings or moving to a smaller house).

On the other hand, adherents to the economic maximization or incentives model have found a substantial difference between the bankruptcy filing rates that would be predicted to result from simple consumer maximizing behavior and what is actually observed in practice.⁹ Estimates are that as many as 15–33% of Americans would financially benefit from filing bankruptcy; in practice, however, only a small fraction actually do so.¹⁰ Moreover, it is argued that although the 1978 Code increased the incentives to file bankruptcy, it did not change the law so dramatically as to explain the subsequent jump in bankruptcy filing rates. This gap suggests that there must be some sort of

7. See Zywicki, *Economic Analysis*, *supra* note 1.

8. *Id.*

9. See Michelle J. White, *Why Don't More Households File for Bankruptcy?*, 14 J.L. ECON. & ORG. 205, 206 (1998) (noting that while at least 15% of American households would benefit from bankruptcy, only slightly over 1% actually file).

10. See discussion *infra* note 23 and accompanying text (noting that a large portion of society could financially benefit from filing bankruptcy).

extralegal mediating institutions affecting the choice by consumers to file bankruptcy that are not captured in the neoclassical economic model. Moreover, in order to explain how changes in these factors have driven changes in bankruptcy filing rates it is necessary for these factors to be dynamic, not static. They must be capable of explaining change over time. Given the absence of any significant amendments to the Bankruptcy Code during the past twenty years, it is difficult to see how the economic incentives model, standing alone, can explain a 500% increase in bankruptcy filings during that period.¹¹ This suggests that there are some sort of mediating institutional influences that are not captured in the incentives-based economic model.

Both the traditional and economic maximization models, therefore, suffer from a common limitation—they both fail to account for the complexity of the individual decision to file bankruptcy and the institutional framework that surrounds it. Understanding the bankruptcy filing decision requires an examination of the consumer bankruptcy institutions that provide the incentives and constraints on filing bankruptcy, not just the factors that cause the underlying financial distress.¹²

In the New Institutional Economics (NIE) framework, institutions serve two functions: They provide incentives and they provide a transactional framework.¹³ First, institutions provide incentives by channeling individual behavior in particular directions. For instance, criminal law is an institution that provides incentives to acquire property by consensual exchange rather than by theft, channeling behavior toward wealth-creation and peaceful exchange of property. Second, institutions provide a transactional framework, such as rules of property and contract, which instruct people on how to coordinate their affairs so as to accomplish their plans. Contract law, for instance, instructs people on how to enter into enforceable exchanges of entitlements; property law instructs people on how to protect their property from the claims of others. Institutions can be formal or informal. Criminal law is an institution, but so are

11. In addition, as Richard Hynes finds, there also appears to be substantial stability in nonbankruptcy debt collection rules that have traditionally been thought to lead to bankruptcy, such as garnishment, suggesting a basic constancy to direct nonbankruptcy incentives as well. Hynes, *supra* note 6.

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

13. DOUGLASS C. NORTH, INSTITUTIONS, INSTITUTIONAL CHANGE, AND ECONOMIC PERFORMANCE 27 (1990).

morality and social norms, which also constrain antisocial behavior. Contract law is an institution, but so is the development of a reputation or trademark that also encourages the performance of promises even when contract enforcement is lacking.¹⁴ Thus, institutions provide incentives, but they need not be consciously designed for that purpose, nor are they necessarily under conscious design and control.

This Article discusses the institutional changes that have increased the propensity of Americans to file bankruptcy in recent years. Three general factors appear to have driven the increase in bankruptcy filing rates in recent years: (1) changes in the relative economic costs and benefits of filing bankruptcy; (2) a change in the social norms regarding bankruptcy; and (3) changes in the nature of consumer credit that have led to an increased willingness of borrowers at the margin to discharge their obligations in bankruptcy. Each factor tends to push in the direction of increasing filings. This Article also reviews the available empirical evidence, which tends to support the model advanced here.¹⁵ It is hoped that by identifying the relevant factors that may help to explain the bankruptcy boom, this Article will help to elicit better empirical testing in the future.

III. Changes in the Relative Benefits and Costs of Filing Bankruptcy

The first factor that has contributed to increasing consumer bankruptcies is a change in the relative benefits and costs associated with filing bankruptcy. In the past twenty-five years, there simultaneously have been increases in the economic benefits and reductions in the economic costs of filing bankruptcy.¹⁶

14. See generally Benjamin Klein & Keith B. Leffler, *The Role of Market Forces in Assuring Contractual Performance*, 89 J. POL. ECON. 615 (1981) (discussing the enforcement of contracts by means other than contract law).

15. Most previous empirical study has been grounded in the traditional model of bankruptcy, and thus does not focus on the factors identified here. Professor Robert Chapman has observed that statistical analysis of bankruptcy, as with all social science, is heavily dependent on externally chosen assumptions about conceptual categories and causal relationships. Robert B. Chapman, *Missing Persons: Social Science and Accounting for Race, Gender, Class, and Marriage in Bankruptcy*, 76 AM. BANKR. L.J. 347, 397-98 (2002). Chapman notes that statistics "[b]oth depend on and create a view of the world." *Id.* at 397.

16. One could also consider reduced stigma as a reduction in the social "cost" of filing bankruptcy. See generally Gary S. Becker, *A Theory of Social Interactions*, 82 J. POL. ECON. 1063 (1974) (discussing the concept of social income and its effects on social interactions); see also Note, *A Reformed Economic Model of Consumer Bankruptcy*, 109 HARV. L. REV. 1338, 1347 (1996) (noting that although exemption levels have changed, few debtors' decisions are affected by this change). For purposes of exposition, in this Part I have focused on more tangible and direct economic costs and discuss the effects of reduced social stigma separately,

These changes in the relative costs and benefits associated with declaring bankruptcy create incentives at the margin to file bankruptcy that are reflected in the increasing bankruptcy filing rates of recent decades.

A. The Economic Benefits of Filing Bankruptcy Have Risen

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

It is generally accepted that the economic benefits to an individual from filing bankruptcy increased with the enactment of the 1978 Bankruptcy Code. The primary point of disagreement has been the extent to which consumers have responded to these changed incentives from an economically rational perspective and whether this change has been good or bad overall from a normative perspective.¹⁷ Although the evidence of an increased filing effect is somewhat mixed, most scholars conclude that the enactment of the Code did have some effect on increasing bankruptcy filings at the margin, although the changes from previous law were not large enough to account for all of the subsequent rise in filings.¹⁸

although those factors could be classified as a relevant "cost" of bankruptcy if one were inclined to treat it that way.

17. Professor William Whitford has observed that "it is hard to believe that the enactment of the Code has not had any effect on bankruptcy filing rates." William C. Whitford, *The Ideal of Individualized Justice: Consumer Bankruptcy as Consumer Protection, and Consumer Protection in Consumer Bankruptcy*, 68 AM. BANKR. L.J. 397, 399 n.11 (1994). Whitford adds:

It is indisputable that consumers can often achieve better economic results through bankruptcy today than they would have been able to achieve if the law had not been changed. To assume that this change has had no effect on decisions to file, one would have to make monumental changes in the usual assumptions about the responsiveness of humans to financial incentives in commercial matters.

Id.; see also *id.* at 399 ("The massive revision of the bankruptcy laws in 1978 may also have been an important factor, because that revision considerably improved the extent of debt relief a typical consumer could obtain through bankruptcy."). For summaries of some of the major debtor changes ushered in by the 1978 Code, see Ian Domowitz & Robert L. Sartin, *Incentives and Bankruptcy Chapter Choice: Evidence from the Reform Act of 1978*, 28 J. LEGAL STUD. 461, 467 (1999); Charles Jordan Tabb, *The History of the Bankruptcy Laws in the United States*, 3 AM. BANKR. INST. L. REV. 5, 34-37 (1995); Kenneth N. Klee, *Legislative History of the New Bankruptcy Code*, 54 AM. BANKR. L.J. 275, 275-97 (1980). In congressional testimony regarding the new amendments to the Bankruptcy Code, the American Bankruptcy Institute acknowledged that the 1978 Code "made bankruptcy a much more debtor-friendly law." *Personal Bankruptcy Consumer Credit Crises: Hearings Before the Senate Subcomm. on Admin. Oversight and the Courts of the Comm. on the Judiciary*, 105th Cong. (1997) (statement of the American Bankruptcy Institute), available at 1997 WL 176645, at *5.

18. Most commentators have concluded that the enactment of the Bankruptcy Code has caused some increase in the bankruptcy filing rate. See F.H. Buckley, *The American Fresh*

In fact, recent events have provided a sort of "natural experiment" on the question of whether individual consumers respond to incentives in deciding whether to file bankruptcy. Although BAPCPA was enacted in April 2005, most of its provisions were not scheduled to go into effect for six months, until October 2005. As a result, during that six-month period, bankruptcy filers could file under the old rules, with the knowledge that if they were to wait, they would be required to file under the new less debtor-friendly rules imposed by BAPCPA, creating incentives for consumers to file bankruptcy sooner rather than later. Those who believe that consumer bankruptcy is a "last resort" primarily caused exogenously by consumer debt and other financial obligations would presumably predict that this grace period would have little effect on consumer behavior, as no underlying economic risk variable would be likely to change during that period, such as outstanding debt levels or the propensity to be unemployed, divorced, or the like. An incentives theory, by contrast, would predict that consumers would rush to take advantage of the relatively more generous law before BAPCPA went into effect. In fact, in the quarter immediately following the passage of BAPCPA, consumer bankruptcy filings rose dramatically, suggesting that consumers were filing bankruptcy to beat the effective date of the new law.¹⁹

As originally enacted, the 1978 Bankruptcy Code placed few restrictions on a debtor's ability to file bankruptcy, regardless of the debtor's need for

Start, 4 S. CAL. INTERDISC. L.J. 67, 76-77 (1995) (noting that bankruptcy rates cannot be explained by other social and economic variables alone); Lawrence Shepard, *Personal Failures and the Bankruptcy Reform Act of 1978*, 27 J.L. & ECON. 419, 437 (1984) (finding additional bankruptcy filings that would not have occurred in the absence of the 1978 Act); William J. Boyes & Roger L. Faith, *Some Effects of the Bankruptcy Reform Act of 1978*, 29 J.L. & ECON. 139, 148 (1986) (finding that the 1978 Act was a determining factor in the increase in bankruptcy filings); William T. Vukowich, *Reforming the Bankruptcy Reform Act of 1978: An Alternative Approach*, 71 GEO. L.J. 1129, 1130-31 (1983) (noting that the Act may have marginally increased filings). See generally Richard L. Peterson & Kiyomi Aoki, *Bankruptcy Filings Before and After Implementation of the Bankruptcy Reform Law*, 36 J. ECON. & BUS. 95 (1995). Other studies failed to detect a significant increase in filing rates as a result of the 1978 Bankruptcy Code. See Jagdeep S. Bhandari & Lawrence A. Weiss, *The Increasing Bankruptcy Filing Rate: An Historical Analysis*, 67 AM. BANKR. L.J. 1, 2 (1993) (noting that the introduction of the Code did not have a significant effect on the filing rate); Ian Domowitz & Thomas L. Eovaldi, *The Impact of the Bankruptcy Reform Act of 1978 on Consumer Bankruptcy*, 36 J.L. & ECON. 803, 805 (1993) (finding that the 1978 Act "cannot be established as the cause" of the increase in filing). For a criticism of the statistical methods used in these latter two studies, see F.H. Buckley & Margaret F. Brinig, *The Bankruptcy Puzzle*, 27 J. LEGAL STUD. 187, 194 n.17 (1998).

19. Press Release, Administrative Office of the United States Courts, Number of Bankruptcy Cases Filed in Federal Courts Up Less Than One Percent for 12-Month Period, Quarterly Filings up 11 Percent (Aug. 24, 2005), available at http://www.uscourts.gov/Press_Releases/bankruptcyfilings82405.html.

bankruptcy relief or ability to repay her debts. The motivation of the drafters of the 1978 Code is somewhat unclear, but it seems they believed that legal restraints on debtor opportunism were unnecessary and social and economic constraints would be sufficient to prevent opportunistic use of the bankruptcy system.²⁰ Whatever the rationale, the Legislative History to the 1978 Code states, "The section does not contemplate . . . that the ability of the debtor to repay his debts in whole or in part constitutes adequate cause for dismissal."²¹ Likewise, insolvency is not required before filing.

Concerned by an immediate surge in bankruptcy filings following the enactment of the 1978 Code, in 1984 Congress amended the Code to place some modest limits on the ability of consumers who file bankruptcy opportunistically. In particular, the 1984 amendments added § 707(b) to the Code, empowering bankruptcy judges to dismiss a debtor's bankruptcy case if granting relief would amount to a "substantial abuse" of the bankruptcy system. In practice, however, this power has been used rarely, sporadically, and inconsistently to police debtor opportunism.²² Thus, § 707(b) has done little in practice to reduce the economic benefits associated with filing bankruptcy, even for those with high repayment capacity.

It has been estimated by one scholar that with a modest degree of prebankruptcy planning, more than half of American households could gain financially from filing bankruptcy, with the financial benefit being greatest for well-off debtors.²³ Calculation of the economic benefits from filing bankruptcy

20. See DAVID A. SKEEL, JR., *DEBT'S DOMINION: A HISTORY OF BANKRUPTCY LAW IN AMERICA* 131–60 (2002) (detailing a history of the enactment of the 1978 Code).

21. Legislative History to 11 U.S.C. § 707(b) (2000). For a discussion of the political developments that led to the emergence of § 707(b) see SKEEL, *supra* note 20, at 196–97.

22. Jones & Zywicki, *supra* note 3, at 248; Todd J. Zywicki, *With Apologies to Screwtape: A Response to Professor Alexander*, 9 J. BANKR. L. & PRAC. 613, 618 (2000). Professor Jack Williams, for instance, has noted that § 707(b) has been described by many as a "dismal failure" in preventing abuse. Jack F. Williams, *Distrust: The Rhetoric and Reality of Means-Testing*, 7 AM. BANKR. INST. L. REV. 105, 110 (1998); see also Scott Fay, Erik Hurst & Michelle J. White, *The Household Bankruptcy Decision*, 92 AM. ECON. REV. 706, 707 n.4 (2002) (noting that "later court decisions and lack of enforcement made [the substantial abuse provision] ineffective"); Wayne R. Wells, Janell M. Kurtz, & Robert J. Calhoun, *The Implementation of Bankruptcy Code Section 707(b): The Law and the Reality*, 39 CLEV. ST. L. REV. 15, 42–44 (1991) (recommending that § 707(b) be repealed because of the confusion it has caused); Karen Gross, *Preserving a Fresh Start for the Individual Debtor: The Case of Narrow Construction of the Consumer Credit Amendments*, 135 U. PA. L. REV. 59, 95–98 (1986) (noting the difficulties courts have had in interpreting § 707(b) consistently and in accordance with its purpose).

23. Michelle J. White, *Why It Pays to File for Bankruptcy: A Critical Look at Incentives Under U.S. Bankruptcy Laws and a Proposal for Change*, 65 U. CHI. L. REV. 685, 706 (1998); see also White, *supra* note 9, at 214 (concluding that a minimum of 15% and as much as 23% of American population could financially benefit from filing bankruptcy); Fay et al., *supra* note 22,

also partially explains debtors' choices between Chapter 7 or Chapter 13.²⁴ Overall, there appear to be substantial economic benefits from filing bankruptcy for many people.

But bankruptcy does not merely give a debtor the opportunity to discharge financial obligations. There are also intangible benefits associated with filing bankruptcy that are not found on a balance sheet. The initiation of a bankruptcy case imposes an automatic stay against all efforts by creditors to collect pre-petition debts.²⁵ Professor Jean Braucher reports that the primary goal of bankruptcy filers is "stopping creditors' collection efforts (foreclosure, repossession, suit, garnishment, phone calls, letters, home visits)."²⁶ Second on the list is "keeping property, often serving as collateral, such as homes, cars and household belongings."²⁷ Thus, bankruptcy procedures such as the automatic stay provide additional economic benefits from filing bankruptcy above and beyond the discharge itself.²⁸

The substantial benefits provided by the current bankruptcy system have essentially created a sort of arbitrage opportunity for many to gain financially by filing bankruptcy. The rising bankruptcy rates of recent years provide evidence that this arbitrage opportunity is gradually being recognized and exploited by bankruptcy filers. The steady upward trend in bankruptcy filing rates, rather than an immediate jump, is also consistent with NIE theory. There are substantial information and transaction costs associated with learning about and filing personal bankruptcy, which means that consumer response to the existing arbitrage opportunity will tend to be gradual, rather than immediate, as

at 712 (finding 18% of households in study would benefit financially from filing bankruptcy).

24. See Domowitz & Sartain, *supra* note 17, at 477-85 (discussing the factors involved in choosing what chapter to file under). For instance, states with higher state exemption values appear to have higher rates of Chapter 7 filings relative to Chapter 13 than those with lower exemptions. Higher exemption values permit debtors to retain more property in Chapter 7; thus, where exemption values are lower, filers must choose Chapter 13 to retain property. *Id.* at 481-82.

25. 11 U.S.C. § 362(a) (2000).

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

27. *Id.*

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

information percolates through the system. This will especially be the case for a rare and relatively risky event such as the decision to file bankruptcy.

Economists have modeled the spread of knowledge of an economic opportunity as following an S-shaped curve.²⁹ At first an innovation is adopted only by those who have a large amount to gain from behaving differently and are willing to bear the risk associated with it. As a result, information spreads slowly at first. At some point, however, the awareness of the new higher-level equilibrium becomes apparent to others, and knowledge spreads quickly through the economy until the new equilibrium level is reached. Where the gain from adopting the new knowledge is high or the cost of adopting it is low, the knowledge will be expected to spread more rapidly.³⁰

In a path-breaking article examining the diffusion of information through the economy and society, economist Zvi Griliches modeled the spread through the American farm belt of the development of high-yield hybrid corn during the mid-Twentieth Century.³¹ When adopted, hybrid corn increased productivity by 300 to 1000%.³² Nonetheless, hybrid corn was not introduced immediately or at the same time in all parts of the country. Rather, its introduction ranged from the mid-1930s in Iowa to the mid-1940s in Alabama, with several intermediate states. Once introduced into a region, however, the diffusion of knowledge of hybrid corn followed a nearly identical S-shaped curve in each area introduced, starting slowly, then moving dramatically upward before leveling off at a new higher equilibrium. Once the information was first made available, Griliches observed, a predictable adjustment path followed that showed some short-term variation, but which, over time, exhibited more or less uniform movement toward a new equilibrium path.

It is interesting that Figure 1 above, which plots a curve of bankruptcy filing rates over the past half century, resembles Griliches's S-shaped curve of

29. See generally Zvi Griliches, *Hybrid Corn: An Exploration in the Economics of Technological Change*, 25 *ECONOMETRICA* 501 (1957); Pauline M. Ippolito & Richard A. Ippolito, *Measuring the Value of Life Savings from Consumer Reactions to New Information*, 25 *J. PUB. ECON.* 53 (1984). See also Richard A. Ippolito, R. Dennis Murphy & Donald Sant, *Staff Report on Consumer Responses to Cigarette Health Information* (Federal Trade Commission Staff Report, Aug. 1979) (observing gradual spread of knowledge to consumers regarding health information about cigarettes).

30. Griliches, *supra* note 29, at 522.

31. See generally *id.*; Zvi Griliches, *Research Costs and Social Returns: Hybrid Corn and Related Innovations*, 66 *J. POL. ECON.* 419 (1958). For a more modern application of Griliches's model to innovation activity see Michael R. Darby & Lynne G. Zucker, *Grilichesian Breakthroughs: Inventions of Methods of Inventing and Firm Entry in Nanotechnology* (NBER Working Paper No. 9825, 2003), available at <http://www.nber.org/papers/w9825> (last visited Aug. 18, 2005).

32. Griliches, *supra* note 29, at 521 n.43.

transmission of adoption of hybrid corn across the economy, rising gradually at first but then accelerating over time. There appears to be a more or less consistent march to a higher equilibrium level of consumer bankruptcy filings, such that, at some point, the curve will level off at a new higher equilibrium level, whatever that may be. The new equilibrium has not yet been reached, but the long-term trend line in bankruptcy filings is exhibiting a predictable rise toward a new higher equilibrium level.

The Bankruptcy Code provides a type of economic profit opportunity because many people could benefit financially by declaring bankruptcy. Bankruptcy filers can protect substantial property through property exemptions. Moreover, because of the property-based nature of bankruptcy exemptions, this benefit rises as household wealth rises.³³ Because a Chapter 7 discharge protects future income from creditors, the value of this benefit also rises as income rises.³⁴ In other words, both high wealth and high income households have the largest potential benefit from filing bankruptcy, so, counterintuitively, the upward trends in wealth and income over the past two decades may result in higher bankruptcy rates by increasing the benefits to bankruptcy filers.

Just as the benefits of filing bankruptcy rise with increasing household wealth, so do they rise with increasing debt. The greater the amount of household debt, the greater the benefit of discharging that debt. In fact, there is an observable correlation between household debt levels and consumer bankruptcy filings.³⁵ Adherents to the traditional model have assumed that this correlation implies a determinate causal direction and have posited that consumer debt is an exogenous variable that causes bankruptcy filings as an endogenous variable. But the causal link more plausibly runs the opposite way. It is unlikely that debt levels are chosen wholly exogenously by consumers;

33. This is because rather than giving a general dollar allowance for exempt property, exemption regimes enumerate specific exempt property that is thought necessary to the debtor's fresh start, such as houses, automobiles, and retirement plans. In practice, middle class families are more likely to own this sort of property and have higher values than lower-income households, thus the property-based nature of the exemption regime tends to favor upper-income debtors.

34. See 11 U.S.C. § 541(a)(6) (2000) (exempting future earnings from the bankruptcy estate). A future income stream constitutes the most valuable asset for the overwhelming number of people. Buckley, *supra* note 18, at 67. See generally James Davies & John Whally, *Taxes and Capital Formation: How Important is Human Capital?* (NBER Working Paper No. 2899, 1989), available at <http://www.nber.org/papers/w2899> (last visited Aug. 18, 2005).

35. Robert M. Lawless, *The Relationship Between Nonbusiness Bankruptcy Filings and Various Basic Measures of Consumer Debt*, available at http://www.law.unlv.edu/faculty/rllawless/busbkr/body_filings.htm at 9 (last visited Aug. 18, 2005). The relationship between total debt and bankruptcy filings is similar. REPORT OF THE NATIONAL BANKRUPTCY REVIEW COMMISSION 85 (1997).

rather, debt levels are partly endogenous, reflecting the ease with which these obligations can be discharged in bankruptcy.³⁶ In turn, high levels of household debt increase the economic benefit of filing bankruptcy by permitting the discharge of more debt.³⁷ As total debt rises, bankruptcy becomes more attractive, because it increases the benefit received from a bankruptcy discharge. The benefits rise still further in a system like America's, which permits bankruptcy filers to pick and choose which debts they want to pay, providing the option, for instance, to reaffirm some debts (such as mortgages and car loans), but to discharge others (such as credit cards).³⁸ If causation ran in the direction postulated by the traditional model, then the correlation between debt and bankruptcy should also be reflected in more conventional measures of indebtedness—such as the debt-service ratio and balance sheet insolvency—which account for factors such as interest rates and household assets. But it does not.³⁹ The correlation between debt and bankruptcy is apparent, but the causal explanation proposed by the traditional model appears to be incorrect.

The assertion of the traditional model, that consumer debt provides a causal explanation of the bankruptcy filing rate, is a classic manifestation of the *post hoc ergo propter hoc* fallacy⁴⁰—namely, that an observed correlation results from an assumed, rather than demonstrated, causal relationship. But there is no a priori reason to assume that causation runs in the direction assumed by the traditional model, nor is there corroborating empirical evidence to support this causal inference. The correlation between total debt and bankruptcy, therefore, may be more plausibly attributed to the increased benefit that a bankruptcy discharge provides for highly indebted consumers. Reducing the benefits of bankruptcy, therefore, probably would decrease consumer demand for debt, and increase the willingness of creditors to lend. The overall effect on household debt levels is thus indeterminate.

36. Zywicki, *Economic Analysis*, *supra* note 1.

37. See Chakravarty & Rhee, *supra* note 28, at 12 (finding increase in likelihood of individual filing bankruptcy as benefit rises, as measured in terms of dollar amount of debts discharged under bankruptcy protection net of nonexempt property).

38. See Scott F. Norberg, *Consumer Bankruptcy's New Clothes: An Empirical Study of Discharge and Debt Collection in Chapter 13*, 7 AM. BANKR. INST. L. REV. 415, 461 (1999) (noting that debtors in bankruptcy repay very little unsecured debt, but pay a nontrivial percentage of secured debt through reaffirmations and the like).

39. See Zywicki, *Economic Analysis*, *supra* note 1.

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

2. *The Role of Property Exemptions*

The 1978 Code also enlarged one of the more important benefits governing bankruptcy filings, the structure of property exemptions in bankruptcy.⁴¹ Exemptions govern the amount and type of property a debtor can retain when she files bankruptcy. Exemption law has traditionally been a creature of state law, rather than federal law. The 1978 Code, however, added an additional slate of federal exemptions, giving filers a choice of exemption regimes (except in states that have "opted-out" of the federal menu and require debtors to use the state exemption regime instead).⁴² The Code, therefore, left unaffected the exemption regimes in place for filers in opt-out states, but increased the benefits for those filers who now have a choice between the state and federal slates of exemptions.

State variation in exemptions means that the relative economic benefits accruing to debtors from filing bankruptcy will vary across the country.⁴³ Debtors in states with more generous exemption law regimes will be able to keep more property in bankruptcy than those in states with less generous exemption laws, increasing incentives at the margin to file bankruptcy relative to debtors living in less-generous exemption states. There is some empirical evidence that individuals do respond to these incentives and that more generous exemption laws lead to increased bankruptcy filings at the margin.⁴⁴ Moreover, there appears to have been a tendency for property exemptions to rise in recent years, through both a steady increase in the dollar value of exemptions (several states have recently created homestead exemptions or increased the cap on their homestead exemptions), and the creation and recognition of new categories of

41. See Barry Adler et al., *Regulating Consumer Bankruptcy: A Theoretical Inquiry*, 29 J. LEGAL STUD. 585, 608–09 (2000) (discussing the theoretical effects of changes in the size and type of exemptions).

42. 11 U.S.C. § 522 (2000).

43. See generally Richard Hynes et al., *The Political Economy of Property Exemption Laws*, 47 J.L. & ECON. 19 (2004).

44. See generally White, *supra* note 23 (arguing that the incentives of bankruptcy should be reformed in order to discourage opportunistic bankruptcy filings). On the other hand, although the impact of exemptions is positive, it appears to be modest in magnitude, probably because residents of high-exemption states generally have less access to credit *ex ante*, which dampens some of the direct benefit of filing. See Note, *supra* note 16, at 1347 (summarizing studies and noting that the effect of exemption levels is significant, but small); Kartik Athreya, *Fresh Start or Head Start? Uniform Bankruptcy Exemptions and Welfare* (Aug. 12, 2003) (unpublished manuscript, on file with author); see also Reint Gropp et al., *Personal Bankruptcy and Credit Supply and Demand*, 112 Q. J. ECON. 217, 219–20 (1997) (finding that credit is more expensive and less available in high-exemption states).

exempt property, especially new or expanded exemptions for retirement accounts.⁴⁵

This expansion in the value of exemptions may explain some of the increase in consumer bankruptcy filings, especially when combined with other developments. Household wealth and household bankruptcies have both increased dramatically during the past few decades. Household wealth has exploded, going through several periods of rapid wealth accumulation.⁴⁶ In fact, after remaining relatively stable for over half a century, household net wealth began to rise rapidly in the 1970s, accelerated in the 1980s, and exploded in the 1990s. Consumer bankruptcy filings also rose steadily and dramatically during that same time. In the mid-1990s, for example, household net wealth grew by about 10% per year, even as consumer bankruptcies jumped as much as 20% per year. Moreover, the ratio of consumer credit to household net worth has remained almost perfectly constant at 4% of net worth since 1956.⁴⁷ This combination of rising bankruptcies and rising personal wealth contradicts the hypothesis that mounting bankruptcies reflect increased household financial distress, but is consistent with the view that consumers can shield more wealth in bankruptcy. The sources of the rise in net wealth have varied over time, but, in general, there have been large rises in the value of residential real estate (throughout the period) and financial assets (particularly during the stock market boom of the 1990s).⁴⁸

The steady increase in home property values over the past thirty years has increased the effectiveness of the homestead exemption by increasing the amount of wealth available to be protected in bankruptcy. Some cases involving homestead exemptions have been quite egregious, allowing debtors to pour massive amounts of wealth into a homestead exempt in bankruptcy, often on the eve of bankruptcy.⁴⁹ Although homestead exemptions in general

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

46. Zywicki, *Economic Analysis*, *supra* note 1.

47. Thomas A. Durkin, *Discussion: The Evolution of Consumer Credit in the United States*, in THE IMPACT OF PUBLIC POLICY ON CONSUMER CREDIT 40 fig. 4 (Thomas A. Durkin & Michael E. Staten eds., 2002). Not coincidentally, this ratio is also consistent with the long run estimated marginal propensity to consume out of household wealth, which has been stable between 3–5% for many years. Zywicki, *Economic Analysis*, *supra* note 1.

48. Joanna H. Frodin, *Commentary: Is the Savings Rate Really Negative?* (Federal Reserve Bank of Philadelphia, Sept. 10, 1999) (identifying three distinct consumer wealth "booms" over past 30 years); William G. Gale & John Sabelhaus, *Perspectives on the Household Savings Rate*, in BROOKINGS PAPERS ON ECONOMIC ACTIVITY 181, 200–02 (William C. Brainerd & George L. Perry eds., 1999).

49. GAO Finds Some Florida and Texas Debtors Have Expensive Homes, CONSUMER

have become more valuable, the impact of the unlimited homestead exemption on bankruptcy filings is relatively trivial. Fay et al., for instance, conclude that if a cap of \$100,000 were imposed on the amount of equity one could protect in a homestead, filings would be reduced by only about 6,000 per year (out of 1.5 million).⁵⁰ The reason for this is obvious—few bankruptcy filers have more than \$100,000 in equity in their homes. On the other hand, the aggregate value of all homestead exemptions is significant.⁵¹

The increase in wealth from the increased value of financial assets has also increased the effective value of bankruptcy-exempt retirement plans.⁵² Although there is little systematic empirical evidence on the effect of more generous treatment of retirement savings on bankruptcy filing rates, anecdotal evidence through case filings suggest that it is becoming increasingly common for bankruptcy filers to have substantial amounts of excepted or exempt pension plans at the time of filing bankruptcy. One bankruptcy judge observed in a case a few years ago: "[N]otwithstanding that many debtors have such substantial unsecured consumer debt, few seem to own (or report) any significant nonexempt tangible personal property, but many report substantial exempt retirement funds (IRA, 401K or Keough accounts)."⁵³ In that case, for instance, one of the debtors was a successful doctor who had amassed interests in IRA, ERISA, Keough, and other exempt pension plans of over \$390,000 and nonetheless sought relief in Chapter 7.⁵⁴ The Bankruptcy Court took the debtor's large exempt pension assets into account in dismissing the case for substantial abuse, a decision that was later affirmed by the Second Circuit.⁵⁵ Other cases have involved Chapter 7 debtors who had accumulated \$200,000,⁵⁶

BANKR. NEWS, Aug. 12, 1999, at 1, 6; *Protecting Rich Bankrupts*, N.Y. TIMES, Aug. 13, 1999, at A-20.

50. Fay et al., *supra* note 22, at 715–16.

51. See Andreas Lehnert & Dean M. Maki, *Consumption, Debt, and Portfolio Choice: Testing the Effect of Bankruptcy Law* 31 (Federal Reserve Board Working Paper No. 2002-14, 2002) (concluding that reducing all state homestead exemptions to the average level of the lowest quartile of states would be predicted to reduce filings by 18%), available at <http://www.federalreserve.gov/pubs/feds/2002/200214/200214abs.html>.

52. See 11 U.S.C. § 542(c)(2) (2000) (allowing debtors to retain interest in trusts that are transfer restricted); *Patterson v. Shumate*, 504 U.S. 753, 766–67 (1992) (concluding that debtor's interest in an ERISA qualified pension plan can be excluded from the bankruptcy estate).

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

54. *Id.* at 471.

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

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

\$285,000,⁵⁷ and \$96,000⁵⁸ in exempt pension plans that were either excepted or exempt in bankruptcy. In another case, a doctor filed bankruptcy after being sued for \$160 million in damages for the debtor's intentional sexual abuse.⁵⁹ The debtor proposed a Chapter 13 plan to pay them \$45,000 over a five-year plan period, while at the same time, he held three exempt IRAs with a total value of \$1.4 million.⁶⁰ The court held that debtor was not required to include any of the \$1.4 million or income derived from it in his "disposable income" for purposes of his Chapter 13 plan payment obligations.⁶¹ This combination of rising financial assets and expanding exemptions for retirement plans has increased the financial benefit of filing bankruptcy, especially for wealthier debtors.

B. The Economic Costs of Filing Bankruptcy Have Fallen

The economic costs of learning about and filing bankruptcy have also fallen over time, thereby causing increased bankruptcies. This cost reduction has taken a number of different forms, including reductions in the search costs of learning about bankruptcy and the transaction costs of filing bankruptcy. At the same time, increases in the availability of sub-prime and home equity secured lending have reduced the costs of obtaining credit following bankruptcy. These various reductions in the costs of filing bankruptcy have also increased incentives at the margin for higher bankruptcy filing rates. Given the substantial economic benefits available to bankruptcy filers, even a small decline in the relative costs of filing bankruptcy could be expected to elicit a substantial increase in the number of bankruptcy filings.⁶²

It should be stressed at the outset that a decline in search and transaction costs for filing bankruptcy is generally considered a good thing from a normative economic perspective, even though it increases bankruptcy filings. The relevant policy concern is not the total number of bankruptcy filings per se, but rather an efficient level of bankruptcy filings that accurately matches actual bankruptcy filings with those who society determines should be entitled to

57. *In re Dabbas*, 2000 WL 33672948, at *1 (Bankr. D. Utah Aug. 24, 2000). The court made no mention of the pension in dismissing the case for substantial abuse. *Id.* at *4.

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

59. *Solomon v. Cosby*, 67 F.3d 1128, 1130 (4th Cir. 1995).

60. *Id.* at 1131.

61. *Id.* at 1132-33.

62. David B. Gross & Nicholas S. Souleles, *An Empirical Analysis of Personal Bankruptcy and Delinquency*, 15 REV. FIN. STUD. 319, 320 (2002).

bankruptcy relief, while limiting fraud and abuse. Rationing access by high search and transaction costs, therefore, furthers no coherent or persuasive goal as a matter of social policy. Leaving aside the normative question of where to draw this line between access and minimizing abuse, it is first necessary to understand as a positive question how reduced search and transaction costs translate into increased bankruptcy filings.

1. Declining Search Costs

Bankruptcy relief can be extremely beneficial to many of those who file and many American families could benefit financially by filing bankruptcy. But there are also costs associated with pursuing bankruptcy. Most notably, debtors must become aware of bankruptcy as an option and the benefits it provides. Information about the benefits of bankruptcy is not free, thus a debtor must undertake some effort to learn about bankruptcy before filing. In economics, this concept is referred to as "search costs." As the search costs of learning about bankruptcy relief fall, debtors will tend to increase their demand for bankruptcy, thereby increasing the number of bankruptcies. Today, individuals receive information about bankruptcy from a large variety of sources—including attorney advertising, celebrity reports, and from friends and family—suggesting that the search costs of bankruptcy have fallen in recent years.

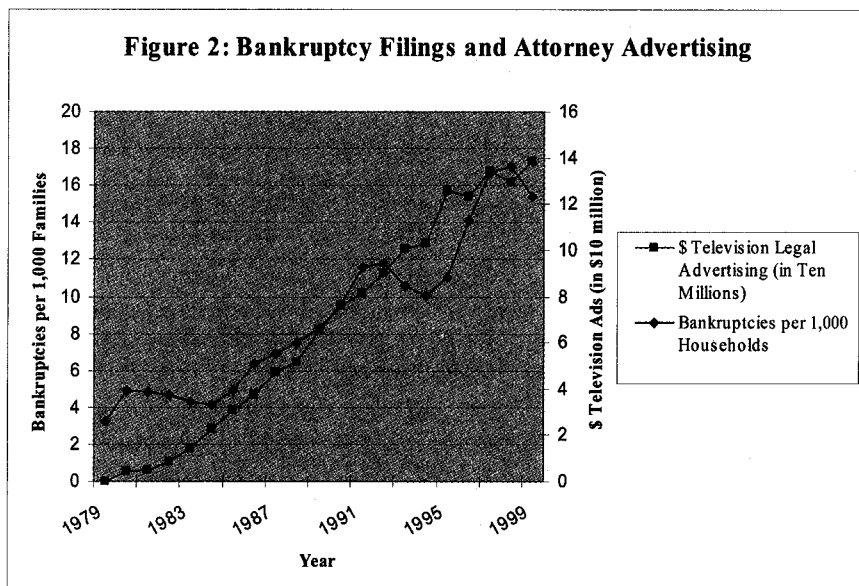
Attorney advertising about bankruptcy is much more widespread than in the past.⁶³ There is some evidence that the extent of attorney advertising of bankruptcy services is correlated with the number of bankruptcy filings in the relevant community, but the direction of the causal influence is ambiguous.⁶⁴ On the other hand, there is ample empirical evidence that, in general, attorney advertising tends to increase the demand for lawyers' services.⁶⁵ There is no

63. Coincidentally, at almost the same time the Code was amended, the Supreme Court held that attorney advertising is commercial speech protected by the First Amendment, thereby legalizing attorney advertising. *Bates v. State Bar of Arizona*, 433 U.S. 350, 384 (1977).

64. 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." *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. (1998) (testimony of Stuart A. Feldstein, President of SMR Research), available at 1998 WL 105080, at *18–19. The causal link is ambiguous, however, because it is not clear whether these lawyers are responding to extant demand for attorney services to file bankruptcy, creating demand for bankruptcy filings through informative advertising, or both.

65. See generally WILLIAM J. JACOBS ET AL., IMPROVING CONSUMER ACCESS TO LEGAL SERVICES: THE CASE FOR REMOVING RESTRICTIONS ON TRUTHFUL ADVERTISING 172 (FTC Staff

reason to believe that demand for bankruptcy would be inconsistent with this general model, which suggests advertising generates increased bankruptcies.⁶⁶ Figure 2 is suggestive of a relationship between bankruptcy filings and advertising for legal services:



Source: Statistical Abstract of the U.S.

Report 1984); Terry Calvani et al., *Attorney Advertising and Competition at the Bar*, 41 VAND. L. REV. 761 (1988); John Schroeter et al., *Advertising and Competition in Routine Legal Service Markets: An Empirical Investigation*, 35 J. INDUS. ECON. 49 (1987); Timothy J. Muris & Fred McChesney, *Advertising and the Price and Quality of Legal Services*, 1979 AM. BAR FOUND. RES. J. 179 (1979); Geoffrey C. Hazard, Jr. et al., *Why Lawyers Should be Allowed to Advertise: A Market Analysis of Legal Services*, 58 N.Y.U. L. REV. 1084 (1983); George J. Stigler, *The Economics of Information*, 69 J. POL. ECON. 213 (1961); Lester G. Telser, *Advertising and Competition*, 72 J. POL. ECON. 537 (1964). Advertising can have two distinct effects, either increasing the market demand for a particular product category (i.e., cars, shoes, legal services) or merely shifting demand among different brands within a given product category (i.e., Ford v. Chevrolet, Nike v. Adidas). Todd J. Zywicki et al., *Obesity and Advertising Policy*, 12 GEO. MASON L. REV. 979, 1000–01 (2004). The empirical analyses cited conclude that advertising about the availability of legal services predominantly has the former effect of increasing market demand and overall use of legal services rather than simply shifting market share among different law firm suppliers of legal services.

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

Figure 2 does not purport to demonstrate a causal relationship between bankruptcy filing rates and attorney advertising, but in the absence of systematic data on the scale of attorney advertising, this may be illustrative of the level of information available to consumers through advertising.⁶⁷ On that basis, at least, it seems that there is some ground for encouraging further research regarding the empirical relationship between attorney advertising and consumer bankruptcy filings.

There is also anecdotal and qualitative evidence that attorney advertising probably increases bankruptcy filings. Consumer bankruptcy lawyers report that they make substantial use of advertising in attracting new clients.⁶⁸ Indeed, several of the consumer bankruptcy lawyers interviewed by Braucher in her 1993 study had hired marketing firms to shape their advertising and marketing strategies.⁶⁹ At a minimum, consumer bankruptcy lawyers generally place display advertisements in the Yellow Pages, but also often advertise in major newspapers.⁷⁰ Some even run television and radio advertisements, while some use direct mailings to persons whose homes have been publicly listed for foreclosure.⁷¹ Braucher concludes that the modest investments made in advertising had been more than recouped by fees generated by clients.⁷² Yellow Page advertisements are reported as the top source of clients in Braucher's study.⁷³

That information costs about bankruptcy are a significant barrier to filing bankruptcy is evidenced in Braucher's observation that one of the biggest difficulties for a lawyer meeting with a new client is persuading the client that the bankruptcy system truly is as generous as it seems to be—i.e., there is no

67. There are a number of qualifications to Figure 2 that should be noted. First, the amount of money spent on attorney advertising is for all legal services, not just personal bankruptcy services. Nonetheless, casual empiricism suggests that personal bankruptcy is one of the more heavily advertised forms of legal services, especially on television. Second, these figures represent only expenditures on television advertising, and therefore, do not reflect amounts spent on other forms of media, such as radio, print, the Yellow Pages, and Internet. On the other hand, personal bankruptcy advertisements are represented in those media as well, seemingly at least to the same extent as on television, and perhaps more. Third, the causal link is indeterminate—increased attorney advertising may be a reflection of increased bankruptcy filings, rather than a cause. Due to these necessary qualifications, it would be imprudent to draw firm conclusions from the observed correlation between personal bankruptcy filings and attorney advertising.

68. Braucher, *supra* note 26, at 543.

69. *Id.*

70. *Id.* at 543–44.

71. *Id.* at 544.

72. *Id.*

73. *Id.*

"catch."⁷⁴ The ease and generosity of the current system defies individuals' expectations about what could be expected from bankruptcy. "People are pleasantly surprised" about what they can do in bankruptcy, lawyers reported.⁷⁵ One lawyer observed that Chapter 7 "sometimes seems to debtors to be 'too good to be true; they can't believe it.'"⁷⁶ Some actually expressed concern about the implications of the widespread knowledge of bankruptcy's benefits; one observed, "if Americans in general knew what you can do in bankruptcy, then we'd really be in trouble."⁷⁷

A recent spate of high-profile celebrity bankruptcies has also increased public awareness of the benefits of bankruptcy. The list includes celebrities such as Toni Braxton, Kim Basinger, Burt Reynolds, M.C. Hammer,⁷⁸ and, most recently, boxer Mike Tyson.⁷⁹ Many lawyers, in fact, identify these famous bankrupts in order to persuade clients of the social acceptability of filing bankruptcy.⁸⁰ Although the direct impact of this publicity is hard to measure empirically, it certainly contributes to public awareness of bankruptcy and increases the social acceptance of bankruptcy generally.

Perhaps more important in increasing public awareness of the substantial benefits of bankruptcy is "word of mouth" as a result of the sheer number of bankruptcies, which surpassed 1.5 million households last year and continues to rise.⁸¹ The large numbers of bankruptcy filings means that, over time, almost everyone has come into contact with the bankruptcy system, either by filing themselves or by knowing a friend or family member who has filed. This phenomenon is known as a "contagion" or "herding" effect in economics, or less formally, as a "water cooler" effect.⁸² As more people file bankruptcy, there are more people in the populace to tell their friends and relatives about the

74. *Id.*

75. *Id.* at 554.

76. *Id.*

77. *Id.*

78. Joshua Wolf Shenk, *Bankrupt Policy*, NEW REPUBLIC, May 18, 1998, at 16. In fact, Mr. Hammer spoofed his bankruptcy filing in several television ads that aired during the 2005 Super Bowl.

79. *Tyson Filing for Bankruptcy*, MIAMI HERALD, Aug. 3, 2003, at 17.

80. Braucher, *supra* note 26, at 509 ("[Some debtors'] lawyers . . . in essence try to give their clients 'permission' to opt for quick discharge in chapter 7 . . . by naming famous people who have received a bankruptcy discharge.").

81. Mamie Marcuss, *A Look at Household Bankruptcies*, COMMUNITIES & BANKING 15, 17 (Spring 2004).

82. See also Fay et al., *supra* note 22, at 710 (discussing how people who have been told by friends or relatives how quick and easy the bankruptcy process is are more likely to file bankruptcy).

benefits of bankruptcy. As a result, the cost of learning about bankruptcy decreases, resulting in more bankruptcy filings. This second wave of filers comes into contact with yet more potential filers and describes the process to them. This self-reinforcing dynamic creates a hydraulic upward pressure on bankruptcy filing rates. Surveys of bankruptcy filers reveal that friends and family are the single most important source of information about bankruptcy and that a majority of bankruptcy filers knew a friend or family member who had filed bankruptcy.⁸³ Consistent with the model, the number of people who first heard about filing bankruptcy from a personal acquaintance also seems to be rising over time.⁸⁴

2. Declining Transaction Costs

The transaction costs associated with filing bankruptcy have also declined in recent years, in major part, as an outgrowth of the increase in filings. A large and steady flow of consumer bankruptcy filings has made possible the establishment of certain economies of scale and specialization that decrease the marginal cost of processing bankruptcy cases, such as capital investments in electronic technology and specialized paralegals. As the costs of processing bankruptcy cases fall, demand for bankruptcies will tend to rise.

In particular, so-called bankruptcy "mills" have evolved, that produce bankruptcy cases as largely standardized commodities. Their practice is a high-volume, repetitive one. Making heavy use of technology that allows them to generate "cookie cutter" bankruptcy pleadings, these mills have been able to drive down the cost of filing bankruptcy substantially. Using teams of paralegals and secretaries to supplement their efforts, these attorneys represent hundreds of debtors per year.⁸⁵ Most lawyers in high-volume practices meet

83. See Jones & Zywicki, *supra* note 3, at 212–13 (summarizing studies); Braucher, *supra* note 26, at 544 (reporting that many client referrals come from more people telling relatives, friends, and co-workers about their bankruptcies); McKinley, *supra* note 66, at 38 (noting the results of a Gallup poll that found 51% of bankruptcy filers had a close friend or relative who filed bankruptcy previously and a Visa survey of bankruptcy filers that found 45% of filers learned about bankruptcy from friends or family).

84. See *Bankruptcy Law Revision Before the Subcomm. on Commercial and Admin. Law of the House Comm. on the Judiciary*, 105th Cong. 8 (1998) (testimony of Mallory B. Duncan, Vice President, General Counsel of National Retail Federation) ("[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.").

85. In 1981, only 4% of debtors were not represented by an attorney. TERESA A. SULLIVAN ET AL., AS WE FORGIVE OUR DEBTORS: BANKRUPTCY AND CONSUMER CREDIT IN AMERICA 23 (1989). By 1991–92, however, paralegals in one California district prepared 14% of consumer filings. Susan Block-Lieb, *A Comparison of Pro Bono Representation Programs*

only once with the client before filing a bankruptcy petition; few meet more than twice.⁸⁶ For those who do not want to or cannot pay for a lawyer, "do-it-yourself" bankruptcy books have become a staple of bookstores and even grocery store check-out lines. Huge amounts of information about bankruptcy are also available on the Internet, including all of the forms needed to file bankruptcy.

The high volume of consumer bankruptcy filings has made it possible for certain lawyers to establish practices focused on high-volume, repetitive cases.⁸⁷ This specialization has allowed these firms to realize economies of scale and to make capital investments that have driven down the marginal cost of filing bankruptcy.⁸⁸ As these transaction costs of filing bankruptcy have fallen, the decreased price has created incentives for higher bankruptcy filing rates. The large number of filings has also indirectly increased the benefits of filing. Historically, a "substantial abuse" action under § 707(b), could be brought only by the United States Trustee or a Bankruptcy Judge; thus, the rising number of filings dramatically decreases the scrutiny that can be applied to any particular case, increasing the possibility of abuse.⁸⁹

3. Greater Availability of Post-Bankruptcy Credit

Traditionally a major cost of filing bankruptcy was the perceived negative effect it had on access to credit following bankruptcy.⁹⁰ Indeed, traditionally it

for *Consumer Debtors*, 2 AM. BANKR. INST. L. REV. 37, 40 (1994); see also Geraldine Mund, *Paralegals: The Good, the Bad, and the Ugly*, 2 AM. BANKR. INST. L. REV. 337, 340-41 (1994) (discussing the role of paralegals in the bankruptcy process).

86. Braucher, *supra* note 26, at 554-55.

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

88. I have not located any direct evidence on changes in the price of filing bankruptcy over time, but it is generally accepted that this is the case and I have seen no evidence inconsistent with that observation. See Adam Feibelman, *Defining the Social Insurance Function of Consumer Bankruptcy* (unpublished manuscript, on file with author); see also Buckley & Brinig, *supra* note 18, at 195 (discussing costs and competition in the provision of bankruptcy services); Gross & Souleles, *supra* note 62, at 320 (noting that many analysts believe that a decline in the cost of filing is a factor in the increase in filing).

89. The BAPCPA substantially expands the list of parties empowered to bring an abuse challenge under § 707(b) to include any party in interest.

90. Today, filing bankruptcy remains on one's credit rating for ten years. 15 U.S.C. § 1681c(a)(1) (2000).

was perceived that filing bankruptcy would cripple the ability to acquire new credit following bankruptcy. Today, however, there have been changes in credit markets that have made credit more available to former bankruptcy filers. One survey done a decade ago found that over 16% of bankruptcy filers were able to gain unsecured credit within one year after filing bankruptcy and over 55% within five years.⁹¹ A more recent survey finds that three-quarters of bankruptcy filers have at least one credit card within a year after filing.⁹² Bankruptcy filers are able to gain access to a broad cross-section of revolving credit, such as bank cards, department stores, gas cards, and finance companies, as well as installment lenders.⁹³ In fact, the figure would probably be higher today as a result of the growth in the subprime lending market which has created an entire industry that caters to consumers with damaged credit.

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

IV. Changes in Social and Personal Norms Regarding Bankruptcy

Increasing bankruptcy filing rates can also be explained by changes in social and personal norms regarding bankruptcy. There is a widespread perception that bankruptcy has lost some of its previous social stigma and that this has contributed to the increase in bankruptcy filing rates.⁹⁴ Federal

91. See MICHAEL STATEN, THE IMPACT OF POST-BANKRUPTCY CREDIT ON THE NUMBER OF PERSONAL BANKRUPTCIES 10-11, (Credit Research Ctr., Krannert Graduate Sch. of Mgmt., Purdue Univ., Working Paper No. 58, 1993) (arguing that for various reasons this estimate probably underestimated access to credit at that time), available at <http://www.msb.edu/prog/crc/pdf/wp58.pdf>.

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

93. STATEN, *supra* note 91, at 11-12.

94. For instance, in his floor statement on the Bankruptcy Reform Act of 1999, Senator Charles Grassley referred to a public opinion poll that indicated that fully 85% of Americans believe that bankruptcy has less social stigma than in previous eras. Professor Braucher also quotes numerous lawyers who opine that the increase in bankruptcy filing rates has been driven in part by a decline in the traditional social stigma associated with filing bankruptcy. See Braucher, *supra* note 26, at 540 ("Many lawyers said the sense of social stigma about bankruptcy has been waning in recent years . . ."); *id.* at 545 (noting the declining social stigma attached to bankruptcy). This concern about the decline in the social stigma regarding bankruptcy and its impact on bankruptcy filing rates has been remarked upon by both

Reserve Chairman Alan Greenspan, for instance, has stated bluntly, "[p]ersonal bankruptcies are soaring because Americans have lost their sense of shame."⁹⁵ The impact of a decline in personal shame and social stigma on bankruptcy filing rates is straightforward. A reduction in the generalized social stigma associated with filing bankruptcy will reduce the negative impact that an individual will suffer to his personal reputation by filing bankruptcy, making individuals more willing to file. As bankruptcy becomes a less socially stigmatized activity, the reputational harm from filing bankruptcy falls as well, creating a vicious cycle of eroding norms and rising bankruptcy filings. In fact, it is not even necessary that the *actual* stigma attached to filing bankruptcy decline, so long as potential bankruptcy filers *perceive* that there has been a reduction in the stigma attached to filing bankruptcy.

A. Consequences of Change in Social Norms Regarding Bankruptcy

The negative social and economic effect of changes in social norms regarding bankruptcy is amplified because it disproportionately affects a discrete category of individuals who have the most to gain financially by filing. Prior to the enactment of BAPCPA, the economic benefits of filing bankruptcy tended to rise as the filer's income and wealth rose because exemptions were linked to specified types of property deemed essential to the debtor's fresh start, such as houses, cars, and certain other property.⁹⁶ Because the financial benefit of bankruptcy is largest for high-income and high-wealth debtors, the importance of social norms in restraining bankruptcy filing is also highest for this same group. If those constraints weaken, therefore, the impact at the margin in terms of higher filings will be largest for high-income and high-wealth individuals.⁹⁷

Although the theory is straightforward, empirically measuring changes in broad and diffuse social factors such as shame and stigma is difficult, and does

Republican and Democratic leaders. See Rafael Efrat, *The Evolution of Social Norms in Bankruptcy*, 7 THEORETICAL INQUIRIES IN LAW (forthcoming 2005) (quoting Senators Grassley, Hatch, Kerry, and other leading members of Congress); see also Charles A. Luckett, *Personal Bankruptcies*, in IMPACT OF PUBLIC POLICY, *supra* note 47, at 73 ("It is widely recognized, though hard to measure, that the stigma of bankruptcy is not what it used to be . . .").

95. Julie Kosterlitz, *Over the Edge*, 29 NAT'L J. 870, 871 (1997).

96. See *supra* notes 33–34 and accompanying text (discussing the higher economic benefits of filing bankruptcy associated with higher income and wealth).

97. As will be discussed, this interaction between social norms and economic benefits provides part of the justification for the legal changes effected by BAPCPA.

not easily lend itself to direct testing.⁹⁸ For instance, it is not methodologically correct to simply ask those who have already filed bankruptcy whether they felt "ashamed" or perceived social disapproval before doing so.⁹⁹ For analytical purposes it is completely beside the point whether people feel remorse after they actually file bankruptcy; what matters is whether the stigma is sufficiently strong to deter them from filing at all, or perhaps even more importantly, to encourage them to live a sufficiently prudent life such that financial crises are less likely to arise. The argument is that the constraining effect of shame and stigma has gradually declined at the margin, reducing the psychological cost of filing bankruptcy and making some people more willing to file than they otherwise would be, *not* that the shame and stigma associated with bankruptcy have been completely eliminated or that those who actually file bankruptcy do not feel ashamed anymore.

A direct test of the effect of personal shame and social stigma on bankruptcy filings, therefore, is essentially impossible. Such a test would require identifying those marginal individuals who would have filed bankruptcy but for the negative effect on his conscience or reputation from doing so. Because these individuals never show up in bankruptcy court, it is almost impossible to identify this group of people for research purposes. Even more difficult to identify would be that category of individuals who respond to the reduced shame associated with bankruptcy by living closer to the financial edge than they otherwise would. Nonetheless, if social norms have changed, there is little doubt it would lead to increased filings.

Social norms are a low-cost mechanism for promoting social order and discouraging anti-social behavior. Norms substitute for more formal economic, political, and social institutions, such as police and courts. For instance, a society that develops and maintains a social norm against property theft (in addition to having a police force that prevents theft) will achieve more social order at less expense than a society that can prevent theft only through the

98. See Lockett, *Personal Bankruptcies*, *supra* note 94, at 76 (noting that "none of the typically cited social or legal factors are easily quantifiable"); Gross & Souleles, *supra* note 62, at 321 ("The various costs of default, especially social, legal, and information costs, are inherently difficult to measure. Most of the proxies that have been suggested run into problems of endogeneity and reverse causality."); David A. Moss & Gibbs A. Johnson, *The Rise of Consumer Bankruptcy: Evolution, Revolution, or Both?*, 73 AM. BANKR. L.J. 311, 326 (1999) ("stigma is very difficult to measure").

99. Nonetheless, some scholars have done exactly that. See, e.g., Constance M. Kilmark, *Inside the World of the Troubled Debtor*, 10 J. BANKR. L. & PRAC. 257, 262 (2001) (noting the shame felt by debtors in interviews); see also ELIZABETH WARREN & AMELIA WARREN TYAGI, *THE TWO-INCOME TRAP: WHY MIDDLE-CLASS MOTHERS AND FATHERS ARE GOING BROKE* 73-75 (2003); TERESA A. SULLIVAN ET AL., *THE FRAGILE MIDDLE CLASS: AMERICANS IN DEBT* 32 (2000) (describing feelings of shame felt by those who have filed bankruptcy).

maintenance of a large police force with no norm against theft.¹⁰⁰ In order to attain the same degree of social harmony, it will be necessary to support a larger police force in the latter society as compared to the former. A reduction in the constraining force of a pro-social norm, such as financial responsibility and promise keeping, therefore, will impose costs on society, both in the form of reduced social harmony and lower levels of economic exchange, and in the expense of constructing and operating more formal institutions, such as police.

It is difficult to quantify the full costs to the American economy and society of the decline in social norms against bankruptcy. The experience of Memphis, Tennessee, however, is suggestive. In 1996, 4.3% of Memphis families filed bankruptcy, almost 1 in 23, earning Memphis the sobriquet of the "bankruptcy capital of America."¹⁰¹ According to a *Fortune* magazine article, there is a "culture of bankruptcy" in Memphis, and bankruptcy is "a way of life."¹⁰² As the magazine notes, "[b]ecause so many people have lived through bankruptcy, there's a strong informal support network for anyone in financial trouble."¹⁰³ Friends and neighbors tell each other 'bankruptcy works,' says David Monypenny, Jerry Lee Lewis's [who also filed for bankruptcy] manager.¹⁰⁴ Other indicia of an active bankruptcy culture are prominent. "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."¹⁰⁵ But the costs are also significant. 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

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

101. Kim Clark, *Why So Many Americans Are Going Bankrupt*, FORTUNE, Aug. 4, 1997, at 24.

102. *Id.*

103. *Id.*

104. *Id.*

105. *Id.*

Financial Group, for instance, an Illinois-based sub-prime lender, closed its Memphis operations in May."¹⁰⁶

As this example suggests, a decline in norms discouraging bankruptcy thus has two effects: a deadweight loss from the reduction of mutually-beneficial trades, and a reduction in economic efficiency as a result of increasing reliance on "self-help" ex ante measures by lenders to offset the lower reliability of financial contracts. Given the variety of possible responses, it may be difficult to estimate the full social loss that results from these various offsetting costs. More formal institutional responses, such as large down payments and higher interest rates can provide some response to fill the vacuum created by the breakdown of informal bonds of trust, but these deadweight losses and ex ante adjustment costs fall on innocent and opportunistic borrowers alike.

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

Because of the inability to measure changes in social norms directly, indirect proxies have been used to try to test for the effect of changes in social stigma regarding bankruptcy, primarily by trying to isolate the features of "bankruptcy cultures" that exhibit persistently high filing rates after controlling for other economically relevant variables.¹⁰⁷ Using district-level data, Fay, Hurst, and White find that after controlling for other relevant variables, there are systematic patterns of higher filing rates in particular districts, either because the higher level of filings increases the available information about bankruptcy or because the prevalence of bankruptcy in the community reduces the stigma attached to filing.¹⁰⁸ Gross and Souleles use similar statistical measures, and similarly find that after controlling for economic risk, the probability that a given individual will file for bankruptcy is, in part, a function of the number of people who filed for bankruptcy in the recent past in that

106. *Id.*

107. For a review and critique of several of the studies discussed here, see Gordon Bermant, *What's Stigma Got to Do with It?*, AM. BANKR. INST. J. 22, 22 (July/Aug. 2003). See generally Kartik Athreya, *Shame as it Ever Was: Stigma and Personal Bankruptcy*, 90 FED. RES. BANK RICHMOND ECON. Q. 1 (Spring 2004) (arguing that a decline in stigma increases bankruptcies but has an ambiguous effect on consumer debt).

108. Fay et al., *supra* note 22, at 712; see also *id.* at 716 ("These results are consistent with local trends occurring in which increases in a district's bankruptcy filing rate cause attitudes toward bankruptcy to become more favorable and therefore individual households' probability of filing rise.").

community.¹⁰⁹ This correlation in filing rates, which cannot be explained by economic risk variables, suggests the presence of a stigma or information effect in local communities.¹¹⁰

Empiricists have also tried to test for the effect of stigma on bankruptcy filings by examining quantifiable proxy variables for the strength of social norms generally, such as examining the size and stability of the relevant community to determine if bankruptcy filing rates differ according to community size. If a fear of social disapproval deters bankruptcy filing, then bankruptcy filings should be higher in larger, more anonymous communities than in smaller communities. Residents of larger communities are likely to possess less knowledge of their neighbors' reputations and are also less likely to fear their disapproval. In fact, cities with higher population densities have higher bankruptcy filing rates than smaller communities.¹¹¹ This finding is consistent with more general studies that find that individuals living in small towns tend to be both more trusting and more trustworthy than those from big cities.¹¹² These factors indicate that norms of trust and trustworthiness are higher in small communities, suggesting that the conditions necessary for trust and reciprocity to flourish (repeat-dealing and reputational mechanisms) are present in these communities.

Societies with higher patterns of migration also tend to have higher bankruptcy filing rates, presumably because more transient populations will tend to have more attenuated social ties, less concern about social reputation, and weaker norms.¹¹³ Repeat dealings will be of shorter duration and subject to a higher discount rate than in more stable societies. Where conditions make

109. Gross & Souleles, *supra* note 62, at 340.

110. *Id.* at 345 ("The fact that the omitted default factor rises with the number of people in one's state who have previously filed for bankruptcy is suggestive of a decline in social stigma or information costs, but it is not conclusive."). Note, this same finding may also support the evidence of reduced information costs or the "water cooler" effect, as it is difficult to distinguish the effect of interpersonal transmission of information about bankruptcy from interpersonal transmission of information about norms.

111. John M. Barron et al., *Monitoring the Household Sector with Aggregate Credit Bureau Data*, BUS. ECON., Jan. 2000, at 63, 71; Luckett, *supra* note 94, at 85.

112. See PETER SINGER, *HOW ARE WE TO LIVE? ETHICS IN AN AGE OF SELF-INTEREST* 141-42 (1993) (noting studies indicating that character traits such as the ability to manipulate and deceive other people are more common and pronounced among people living in larger cities); MATT RIDLEY, *THE ORIGINS OF VIRTUE* 70 (2000) (contrasting the character of people found in large cities with those in small towns and rural areas); ROBERT WRIGHT, *THE MORAL ANIMAL* 221-22 (1998) (discussing the negative cultural influences of large cities).

113. See Buckley & Brinig, *supra* note 18, at 89-94 (discussing the relationship between immigration and bankruptcy); SULLIVAN ET AL., *AS WE FORGIVE*, *supra* note 85, at 244-46 (discussing the role social and demographic factors play in the bankruptcy filing decision).

detection and monitoring of neighbors' reputations difficult, social norms will be less powerful in discouraging disapproved behavior. Thus, in high migration areas, where individuals frequently move in and out of the community in a short time frame, it is difficult for social stigma to punish those who behave improperly, thereby reducing the incentives of others to collect and act on reputational information.

Scholars have also measured the influence of norms on bankruptcy rates by the statistical residual that remains after controlling for all other variables that might otherwise be thought to explain bankruptcy filings. Empirical studies of bankruptcy filing rates consistently find large, unexplained statistical residuals after controlling for all other economic variables. These statistical residuals could result from a number of possible causes, but many have attributed them to a change in social norms. As economist Charles Luckett observes, "Of course, to the extent that a model is comprehensive in its incorporation of likely determinants of bankruptcy, declining stigma may be left as the most plausible candidate to account for the otherwise unexplained component of rising bankruptcies."¹¹⁴ Even Moss and Johnson, who continue to adhere to the traditional model that rising bankruptcies are caused by rising consumer indebtedness, acknowledge that there has been a dramatic upward surge in the "multiplier" effect of the relationship between debt and bankruptcy filings since 1985.¹¹⁵

Finally, Professor Rafael Efrat has ingeniously tried to measure the change in social norms regarding bankruptcy through an examination of press characterization of the bankruptcy system and bankruptcy filers from 1864 to the present.¹¹⁶ Efrat finds a dramatic change in the characterization of

114. Luckett, *supra* note 94, at 89. It may be that declining stigma is the most plausible explanation for some cases but not others. For instance, it may be that declining stigma is the most important factor for middle-class and upper middle-class filers who have the most to gain financially from filing bankruptcy and have access to the greatest amount of information regarding bankruptcy. With respect to lower-income individuals, by contrast, it may be that they are most affected by the reduction of transaction costs and search costs discussed above, rather than changes in social norms. To the extent that disapproval of bankruptcy reflects middle-class bourgeois values, it may be more constraining on middle-class families than poor families. See also Todd J. Zywicki, *Bankruptcy Law as Social Legislation*, 5 TEX. REV. L. & POL. 393, 402-08 (2001) (discussing the effects of changing levels of social trust); Chapman, *supra* note 15, at 355 (discussing the effects on commerce of moral and social virtue). Given the difficulty of measuring changes in these diffuse social and economic variables in the first place, efforts to establish the relative importance of these variables within different demographic subgroups is even more daunting.

115. Moss & Johnson, *supra* note 98, at 326-31 (calling the "rapid growth" of the consumer bankruptcy multiplier since 1985 "both striking and unprecedented").

116. Efrat, *Evolution of Social Norms*, *supra* note 94.

bankruptcy filers beginning in the 1960s. "Prior to the 1960s," he observes, "newspaper articles depicted the debtors largely as manipulators and fraud promoters. Debtors in bankruptcy were represented as a manifestation of decline of societal moral values and were frequently referred to as evil doers, dishonest, cheaters, crooks, fools, or perjures."¹¹⁷ Beginning in the 1960s, however, "bankruptcy petitioners were no longer regularly referred to as deceitful. Instead, the newspaper articles have begun referring to the petitions merely as irresponsible or unethical individuals who lack discipline."¹¹⁸ He adds, "For the first time, petitioners were depicted in newspaper articles using compassionate sentiments. Petitioners were referred to as hardworking, poor, struggling, and needy."¹¹⁹ During this same time period, newspaper articles ceased attributing bankruptcy filings to debtors' fraud, but instead portray bankruptcy as resulting from events beyond the debtors' control.¹²⁰ Efrat concludes that this change in the characterization of bankruptcy debtors reflects an underlying change in the public perception of bankruptcy and bankruptcy filers that is consistent with a change in social norms regarding bankruptcy.¹²¹

Efrat suggests that the shame associated with bankruptcy has continued to decline since that time. For instance, he reports that a study from the 1960s found that almost a quarter of the petitioners felt ashamed about filing bankruptcy.¹²² But by 1995, however, only 10% of surveyed bankruptcy filers indicated that they felt shame for filing bankruptcy.¹²³

C. Causes of Changes in Social Norms Regarding Bankruptcy

The reasons for the erosion of the traditional stigma of filing bankruptcy are multiple and difficult to pin down with precision. Providing a theory of the evolution of social norms over time is beyond the scope of this Article. Social theorists, however, have long struggled with developing a theory of how social norms are created and evolve over time, so any observations here are necessarily speculative. If there has been a change in social norms, the explanation may rest in deep-seated changes in American culture that have tended to erode the value of promise-keeping and performing one's obligations

117. *Id.*

118. *Id.*

119. *Id.*

120. *Id.*

121. *Id.*

122. *Id.*

123. *Id.*

generally, which might be reflected in changing attitudes regarding bankruptcy.¹²⁴ McCloskey, for instance, argues that there has been a general attrition of broadly-accepted middle-class values of "bourgeois virtue" that praised thrift and personal responsibility, and condemned bankruptcy, divorce, and other similar behaviors.¹²⁵

With respect to bankruptcy specifically, complaints about the supposed "decline in stigma" regarding bankruptcy have recurred many times in American history.¹²⁶ The question, therefore, is whether there really has been tangible a change in social norms regarding bankruptcy during the past twenty-five years, and if so, why has such a dramatic change occurred in such a short period of time? Given the difficulty in understanding such broad social currents as changes in social norms, the discussion presented here is necessarily tentative. Nonetheless, given the importance of the issue and a widespread perception that it is indeed an important element of the explanation of rising bankruptcies, the issue merits some discussion.

One possible explanation turns on the generational change associated with the rise of the "Baby Boom" generation to a position of leadership in American society.¹²⁷ Changes in broad social norms tend to occur only gradually,¹²⁸ but sociologist Robert Putnam has argued that the transition from the World War II generation to the Baby Boom generation marked a dramatic change in American life, in particular with respect to attitudes toward social engagement and personal responsibility.¹²⁹ Although an overgeneralization, the Baby Boom generation has been notable in its willingness to challenge established

124. See ROBERT H. BORK, *SLOUCHING TOWARDS GOMORRAH: MODERN LIBERALISM AND AMERICAN DECLINE* 64–65 (1997) (discussing the decline of traditional morality in recent decades); ALLAN BLOOM, *THE CLOSING OF THE AMERICAN MIND* 325 (1987) (discussing the decline of traditional morality). See generally Buckley & Brinig, *supra* note 18.

125. Donald McCloskey, *Bourgeois Virtue*, 63 AM. SCHOLAR 177, 177–78 (1994).

126. See Moss & Johnson, *supra* note 98, at 312–22 (reciting a recurrent theme of complaints associating rising bankruptcy with a decline in social stigma about bankruptcy). See generally LENDOL CALDER, *FINANCING THE AMERICAN DREAM: A CULTURAL HISTORY OF CONSUMER CREDIT* (1999) (describing the recurrent "myth of lost financial virtue" in United States history).

127. See Zywicki, *Bankruptcy Law*, *supra* note 114, at 410–13 (discussing the role of the Baby Boom generation). This is also consistent with Efrat's finding that there was a dramatic change in the social perception of bankruptcy in the decade of the 1960s. Efrat, *Evolution of Social Norms*, *supra* note 94. Efrat observes that there was a "growing tendency in society beginning in the 1960s to generally shift blame for individual failure away from the person and towards environmental factors. . . ." *Id.*

128. See generally JAMES S. COLEMAN, *FOUNDATIONS OF SOCIAL THEORY* (1990).

129. ROBERT D. PUTNAM, *BOWLING ALONE* 249–50 (2000).

traditional American values, good and bad.¹³⁰ Thus, there has been general overturning of traditional taboos regarding issues as varied as marriage, sexuality, recreational drug use, and the role of women in the economy and society.¹³¹ Moreover, given the very size and self-confidence of the Baby Boom generation, they have arguably been able to influence social norms to a greater degree than most generations. The Baby Boom generation has served as a sort of collective "norms entrepreneur" for widespread changes in a variety of traditional social norms.¹³² It may be that these broad social changes also tended to undermine social norms regarding personal financial responsibility and the social stigma associated with bankruptcy.¹³³ Earlier generations seem to have held a much more negative view of the personal shame and social stigma associated with bankruptcy than do the baby boomers.¹³⁴ Although these observations fall far short of a rigorous proof of the possible relationship between the rise of the Baby Boom generation and the decline in stigma beginning in the 1970s and 1980s, they are consistent with other characteristics of the Baby Boom generation, as well as providing at least one possible explanation as to the specific timing of this change in social norms.¹³⁵

The specific bankruptcy filing patterns of baby boomers is consistent with these more general observations. Baby boomers are dramatically over-represented in bankruptcy filings relative to their percentage in the population.¹³⁶ Sullivan observes that "[t]he overrepresentation of the baby

130. PAUL C. LIGHT, *BABY BOOMERS* 115–17 (1988).

131. See generally Editorial, *Review & Outlook: No Guardrails*, WALL ST. J., Mar. 18, 1993, at A12.

132. In this vein, it has been observed that with respect to social attitudes toward divorce, "the oldest baby boomers were at once deviant and trend setters . . . [who] helped to establish new normative societal standard that permit a generally high rate of divorce." LIGHT, *supra* note 130, at 147 (quoting Census Bureau experts Arthur Norton and Jeanne Moorman). For more on norms entrepreneurship, albeit in a different context than here, see Robert C. Ellickson, *The Market for Social Norms*, 3 AM. L. & ECON. REV. 1, 10–17 (2001). See also Cass R. Sunstein, *Social Norms and Social Roles*, 96 COLUM. L. REV. 903, 929–30 (1996) (discussing "norm entrepreneurs" who can help society reach "a 'tipping point' when norms start to push in new directions").

133. See Michael J. Boskin & Lawrence J. Lau, *An Analysis of U.S. Postwar Consumption and Saving: Part II Empirical Results* 72–76 (NBER Working Paper No. 2606, 1988) (finding that "vintage effect" of baby boom generation explains decrease in U.S. savings rates over time). But see Barry Bosworth et al., *The Decline in Saving: Evidence from Household Surveys*, 1991 (No. 1) in BROOKINGS PAPERS ON ECONOMIC ACTIVITY 183, 199 (arguing that cohort effect predated baby boom generation).

134. See, e.g., TOM BROKAW, *THE GREATEST GENERATION* 39–44 (1998) (describing World War II Veteran Wesley Ko's refusal to file bankruptcy); *id.* at 47 (describing James Dowling).

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

136. Although baby boomers comprise only 39% of the American population, they are

boom [generation in bankruptcy] is striking."¹³⁷ In addition, the overrepresentation of baby boomers in bankruptcy has been following them through their economic life-cycle, indicating that the tendency toward bankruptcy is a reflection of factors unique to their generation, not a function of more generic passage through age and financial life cycle.¹³⁸ When they were the 25–34 year-old cohort of the population, they were the largest single group in bankruptcy and had the highest filing rate. Ten years later, when they were aged 35–44, they were again the largest group in bankruptcy and had the highest filing rate.¹³⁹ Moreover, because the baby boomers are such a large cohort, the spike in bankruptcy filings among their generation counts for about 14% of the growth in the filing rates, certainly enough of a critical mass to move social norms.¹⁴⁰ Baby boomers have matured during a period of economic growth and record wealth accumulation, so it is doubtful that their high filing rate reflects unusual levels of economic stress, especially compared to earlier generations such as the Great Depression. This persistent record of unusually high bankruptcy filings is consistent with the impression that the Baby Boom generation has effected a dramatic change in social norms, for both good and bad, including traditional norms condemning bankruptcy.

The unique baby boomer effect on changing social norms about bankruptcy is reflected in the difference between their filing rates and subsequent generations as well. Whereas baby boomers have filed bankruptcy at much higher rates than the rest of the population at large in every stage of their life-cycle, the early evidence is that the per capita filing rate among members of so-called "Generation X" is lower than that of the baby boomers at the same stage of their life cycle.¹⁴¹ According to researchers, members of Generation X appear to be more financially and socially responsible and

55% of bankruptcy filers. SULLIVAN ET AL., *FRAGILE MIDDLE CLASS*, *supra* note 99, at 39. In fact, the representation of baby boomers in bankruptcy may be as high as 63%, depending on the dates used to describe the Baby Boom generation. *Id.* at 304 n.38.

137. *Id.* at 39.

138. *Id.* at 39–41. Similarly, the disproportionately large number of bankruptcy filings among baby boomers is reflected in a shift in the average age of bankruptcy filers toward middle age, tracking their movement through their economic life cycle. See Teresa A. Sullivan et al., *Young, Old, and In Between: Who Files for Bankruptcy?* 9 NORTON BANKR. L. ADVISOR 1, 2–3 (Sept. 2001) (noting statistics showing the baby boomers high filing rates at various ages).

139. Teresa A. Sullivan et al., *Baby Boomers and the Bankruptcy Boom*, 4 NORTON BANKR. L. ADVISOR 1, 3 (1993).

140. See *id.* at 4 (noting that twenty-somethings appear to be following the filing patterns of baby boomers).

141. Sullivan et al., *Young, Old, and in Between*, *supra* note 138, at 2 (noting a 7.2% decrease in the rate at which debtors under the age of twenty-five file bankruptcy from boomers to Generation X).

traditionalist than the Baby Boom generation, which may reverse or slow some of the baby boomers' effects on changing social norms regarding bankruptcy.¹⁴² On the other hand, although Generation X's bankruptcy filing rate is lower than the boomers', it still remains high by historical standards, suggesting that the baby boomers have left a permanent mark on the nation's social norms regarding bankruptcy, and that generational change will not reverse the underlying change in norms.¹⁴³

The intervention of bankruptcy attorneys may also play a role in eroding personal shame regarding bankruptcy. In general, debtors' attorneys seem to be somewhat more hostile toward creditors than are their clients and are especially dismissive of the belief that there is a moral, as opposed to purely legal, obligation to repay creditors. Thus, Professor Braucher's interview subjects express frustration regarding their clients' belief that they have a moral obligation to repay the debts they have incurred. Much of the counseling that goes on between debtors' attorneys and their clients seems to revolve around this desire to counsel the client out of his moral desire to repay his debts. One lawyer observed, "some people feel there is a moral issue; frankly I don't."¹⁴⁴ Another lawyer stated:

My attitude is—the law is there. The credit card companies charge 20% interest. Discharge is a risk of doing business. I don't feel bad about it. Some debtors feel so harassed. Some debtors say they feel bad about discharging debt, and I wonder if they do. Some are overly emotional, and I'm thinking, 'What's the big deal?' Especially with credit cards—it's not like a friend or a relative.¹⁴⁵

Many attorneys attack the moral and trust basis of the debtor-creditor relationship by contrasting this obligation with others that are generally regarded as having greater moral weight. "A number of lawyers in the study," Braucher reports, "said that they find themselves trying to talk debtors out of [the desire to repay their debts in] chapter 13. They use such tactics as raising the question of their clients' moral obligations to their families, especially to

142. Zywicki, *Bankruptcy Law*, *supra* note 114, at 412; *see also* NEIL HOWE & BILL STRAUSS, 13TH GEN: ABORT, RETRY, IGNORE, FAIL? 114–20 (1993) (discussing the financial trends among Generation X); NEIL HOWE & BILL STRAUSS, MILLENNIALS RISING: THE NEXT GREAT GENERATION 263–86 (2000) (discussing commerce and finance as it pertains to Generation X). *See generally* FRANCIS FUKUYAMA, THE GREAT DISRUPTION: HUMAN NATURE AND THE RECONSTITUTION OF SOCIAL ORDER (1999) (predicting return to traditional social norms following "great disruption" of recent decades).

143. Sullivan et al., *Young, Old, and in Between*, *supra* note 138, at 3.

144. Braucher, *supra* note 26, at 523.

145. *Id.*

their children, in order to diffuse clients' sense of moral obligation to repay creditors."¹⁴⁶ When the moral obligation to pay creditors, especially distant institutional creditors, is pitted against the moral obligations owed to one's family, it is evident that the latter obligation will almost always prevail.¹⁴⁷

A change in social norms regarding bankruptcy also may, to some extent, be a consequence of the enactment of the 1978 Bankruptcy Code. A diminishment of the stigma associated with filing bankruptcy was implicit in the 1978 Code. The Code expanded the nondiscrimination provision of § 525 to prohibit many forms of private discrimination and virtually all forms of public discrimination against bankruptcy debtors.¹⁴⁸ The Code also purged the normatively laden but ancient term "bankrupt" from the Code, substituting the more value-neutral term "debtor."¹⁴⁹ Similarly, a case filing is now described generically as an "order for relief."¹⁵⁰ The intent of these semantic changes was in part to strip bankruptcy of moral and emotional baggage that had previously interfered with a straight financial calculation.¹⁵¹ To the extent that legal rules have an "expressive" function in shaping social norms, it is possible that these semantic changes and the behaviors they regulate could also have the effect of reducing general attitudes of opprobrium toward bankruptcy filers.¹⁵²

146. *Id.* at 509.

147. See Zywicki, *With Apologies to Screwtape*, *supra* note 22, at 614 (noting that debtors are expected to perform unless it would result in injustice or undue hardship to their family); see also Todd J. Zywicki, *Evolutionary Psychology and the Social Sciences*, 13 HUMANE STUD. REV. 1 (2000) (noting the inherent preference for one's family over strangers), available at <http://www.theihs.org/libertyguide/hst/> (last visited Aug. 18, 2005).

148. 11 U.S.C. § 525 (2000).

149. Jones & Zywicki, *supra* note 3, at 219.

150. *Id.*

151. 11 U.S.C. § 101 (2000) ("Paragraph (12) defines 'debtor.' This is a change in terminology from present law, which calls a person that is proceeding in straight bankruptcy liquidation case the 'bankrupt'. . . . The general term debtor is used . . . as a means of reducing the stigma connected with the term bankrupt."); see also *Bankruptcy Reform Act of 1978: Hearing Before the Subcomm. on Courts of the Senate Comm. on the Judiciary*, 97th Cong., 1st Sess. 40-42 (1981) (testimony of Professor Jonathan Landers) (stating that the substitution of term "debtors" for "bankrupts" in 1978 Bankruptcy Act reduced the stigma associated with filing for bankruptcy). Efrat observes that France, Germany, and Holland have recently renamed their bankruptcy process as "debt settlement" in order to reduce the stigma traditionally associated with filing bankruptcy. See Efrat, *Evolution of Social Norms*, *supra* note 94 (citing Nick Hulls, *Overindebtedness and Overlegalization: Consumer Bankruptcy as a Field for Alternative Dispute Resolution*, 20 J. CONSUMER POL'Y 143, 144 (1997)).

152. See generally Robert Cooter, *Expressive Law and Economics*, 27 J. LEGAL STUD. 585 (1998) (developing an economic theory of expressive law). See also Efrat, *Evolution of Social Norms*, *supra* note 94 (noting decline in Scotland of social stigma regarding bankruptcy following change in terminology from "bankrupt" to "debtor" in the mid 1980s (citing Bill

The sheer number of filers alone has also probably tended to reduce the stigma associated with filing bankruptcy. As more individuals file bankruptcy, more people know others who have filed bankruptcy. The recognition that others have filed bankruptcy and have survived—in many cases prospered—makes bankruptcy more routine in society, reducing the stigma associated with it. Thus, the sheer numbers of individuals who file bankruptcy contribute to the perception that bankruptcy is a common and routine process.¹⁵³ As the late Senator Daniel Patrick Moynihan observed in a famous article, society can only define so much of a given behavior as "deviant."¹⁵⁴ Once a behavior becomes sufficiently widespread society redefines the behavior so as to relieve it of its "deviant" label, thereby implicitly tolerating previously inappropriate behavior.¹⁵⁵ Thus, as bankruptcy becomes more common, especially among the middle class, it may lose some of its previous "deviant" social character and become more socially acceptable.

The problem of enforcing traditional social norms may also be made more difficult by the existence of celebrities and others who publicly flout those norms. As noted, there have been several high-profile celebrity bankruptcies in recent years, which have arguably contributed to the sense that the bankruptcy stigma is eroding. These celebrities may be unintentional "norms entrepreneurs" who subtly shift patterns of behavior in society. Similar views are expressed by more pedestrian bankruptcy filers, a large

McBryde, *The Scottish Experience of Bankruptcy*, in *INSOLVENCY LAW THEORY & PRACTICE* 117, 123 (Harry Rajak ed., 1993)).

153. Thus, the argument regarding declining stigma and rising bankruptcy rates is not circular, as argued by some, see SULLIVAN ET AL., *FRAGILE MIDDLE CLASS*, *supra* note 99, at 265, because this feedback loop takes place gradually and over time. Social norms do not change immediately and all at once, and bankruptcy rates do not immediately jump to a higher equilibrium level. Instead, there is a gradual unraveling over time, as higher filings and declining stigma create a feedback loop. See generally COLEMAN, *supra* note 128.

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

155. *Id.* One bankruptcy filer confessed in a CNN interview, "When I found out—that was watching it on the news, on the newspapers—that more and more people are doing it [filing bankruptcy], and . . . it's not just a middle class you know, upper class too—rich people—everybody's doing it. And . . . I said: Why not me? You know, I'm just one more of them." *Your Money with John Metaxas* (CNNfn television broadcast, Jan. 18, 1999). In fact, whereas bankruptcy itself was once thought a deviant activity, today it is only bankruptcy fraud and abuse by rich filers that is thought of as deviant, and some bankruptcy scholars appear to have doubts about even this. See, e.g., KAREN GROSS, *FAILURE AND FORGIVENESS* 244–45 (2000) (criticizing efforts to place any legal limits on access to bankruptcy for even high income and wealthy debtors).

number of whom report that filing bankruptcy was fast, easy, and painless and that they would consider filing again if necessary.¹⁵⁶

This is not to say that changes in social norms regarding bankruptcy are automatic or immediate. Filing bankruptcy and breaching the obligations of reciprocity strongly contradicts our inherent tendencies toward reciprocity and promise-keeping.¹⁵⁷ To the extent that negative social norms and other incentives break down these innate cooperative tendencies, they generally do so only after long-lasting and intense pressure.¹⁵⁸ It would be inaccurate today to say that society actively encourages filing bankruptcy, but it seems accurate to characterize attitudes as drifting toward benign tolerance, thereby leading to increasing bankruptcies. To the extent that this drift continues, it could create a vicious cycle, further undermining social norms and leading to still higher bankruptcy filings.

V. *Changes in The Nature of Consumer Credit*

A final contributing factor to the rise in bankruptcy filing rates in recent years is a change in the nature of consumer credit and in consumer credit relations. Consumer credit institutions have changed in a number of ways that, at the margin, would be expected to destabilize traditional debtor-creditor relationships and thereby increase bankruptcy filing rates. Many of these changes have been inevitable—they are the unintended side-effect of technological and economic changes that have created a more economically efficient consumer credit system. From an economic perspective, they are beneficial and should be encouraged, even though a side-effect is that these same forces tend to undermine many of the traditional mechanisms for restraining opportunistic breaches of credit contracts and have tended to exert upward pressure on bankruptcy filing rates. So long as the overall benefits of more efficient credit markets exceed the costs of increased bankruptcies, this

156. See McKinley, *supra* note 66, at 38 (describing findings of a Visa survey that "66% of filers found the bankruptcy process to be an easy one" and that 27% of respondents would consider filing again); Efrat, *Evolution of Social Norms*, *supra* note 94, at n.244 (citing VISA, QUALITATIVE RESEARCH: BANKRUPTCY PROCESS 19 (1997) ("For others the decision to file for bankruptcy was actually reinforced by friends and relatives. They reported knowing many other people, including relatives and close friends, who had filed for bankruptcy or had urged them to do so.")).

157. See generally Todd J. Zywicki, *The Reciprocity Instinct* (unpublished manuscript, on file with author).

158. See generally Kevin McCabe, *Fiat Money as a Store of Value in an Experimental Market*, 12 J. ECON. BEHAV. & ORG. 215 (1989).

is a positive development. The policy question is how to devise the set of institutions that maximizes the benefits of these financial innovations while minimizing the costs associated with higher bankruptcies.

A. The Shift to Credit Cards and Unsecured Consumer Credit

A general shift toward greater use of unsecured credit, such as credit cards, has increased the frequency of bankruptcy. Recent decades have seen a shift in consumer credit toward unsecured credit, primarily in the form of general purpose bank credit cards. Unsecured credit—such as credit cards and medical bills—is generally dischargeable in bankruptcy absent a particular limitation imposed by bankruptcy law.¹⁵⁹ By contrast, a bankruptcy discharge is of little use to a debtor with respect to secured credit, such as home mortgages, home equity loans, security interests in personal property, layaway plans, or pawn shops. Bankruptcy discharge will also not help a debtor with informal credit arrangements such as loans from family members, which was historically the dominant source of consumer credit.¹⁶⁰ Holding everything else constant, as debtors make greater use of unsecured credit relative to secured and informal credit, the value of the bankruptcy discharge will also increase. As the value of the bankruptcy discharge increases, debtors will have a greater incentive to file bankruptcy.

Although credit card use has risen dramatically during this period, contrary to conventional wisdom there is little evidence that credit cards have increased overall consumer indebtedness. Rather the increase has primarily been a *substitution* of credit card debt for other types of consumer debt. Although this may seem irrational at first glance given the seemingly "high" interest rates charged on credit cards, consider that the alternatives may include pawn shops, personal finance companies, retail store credit, and layaway plans, all of which are either more costly or otherwise less attractive than credit cards.¹⁶¹ Credit cards are also generally less expensive for lenders to issue, which is reflected in the overall price of credit cards relative to these other forms of credit. The result, therefore, has not been to increase household indebtedness, but primarily to change the *composition* of debt within the

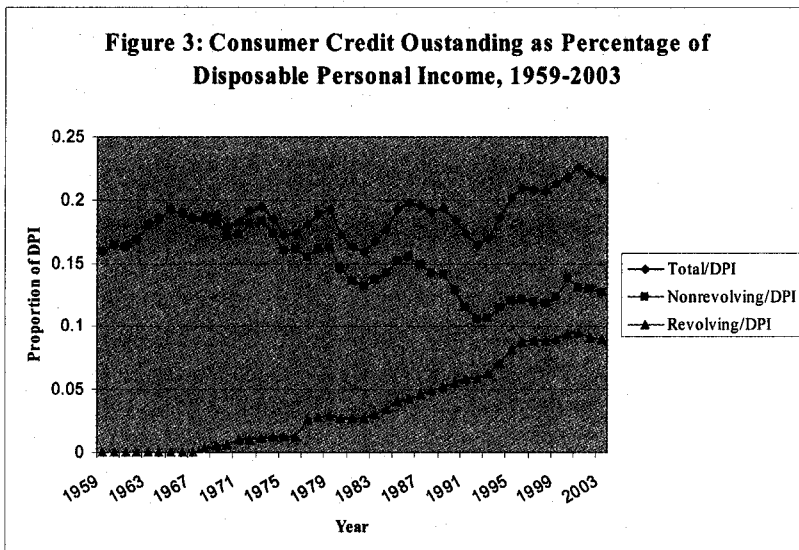
159. 11 U.S.C. § 727(a) (2000).

160. See CALDER, *supra* note 126, at 60–64 (discussing the role of lending between friends and family).

161. See Todd J. Zywicki, *The Economics of Credit Cards*, 3 CHAP. L. REV. 79, 94–110 (2000) (discussing credit cards and the types of alternatives that credit cards replace). Presumably there has been a substitution for informal credit as well, such as family loans and pawn shops, but there is little data on the amount of informal borrowing in the economy.

household credit portfolio.¹⁶² The substitution has increased the use of "revolving" credit card debt, which a borrower can revolve from month to month, and decreased "installment" debt—such as car loans, credit from retailers (such as furniture stores), and personal finance loans—where the debtor borrows a fixed amount of money and repays it in fixed installments over a fixed period of time.

Figure 3 shows that the increase in credit card debt is offset by a reduction in other traditional forms of consumer installment debt:



Source: Federal Reserve Board and Bureau of Economic Analysis

As Figure 3 indicates, the growth in revolving (credit card) debt over the past thirty years has clearly been a *substitution* from nonrevolving consumer debt to revolving debt, thus leaving overall consumer indebtedness (as a percentage of disposable income) largely unaffected.¹⁶³ Revolving debt outstanding has risen

162. The reduction in transaction costs and availability of credit on more competitive terms would, of course, have an implicit wealth effect, shifting out consumer budget constraints and enabling marginally more borrowing. But because they would also be wealthier, consumers could borrow more without increasing their effective debt burden, thus, this increase in indebtedness would not be expected to have any greater correlation with bankruptcy. In fact, the debt-service and debt-to-asset ratios have remained largely constant during recent years, further confirming the idea that the increase in new forms of credit are largely a substitute away from old forms of debt. Zywicki, *Economic Analysis*, *supra* note 1.

163. See also Thomas A. Durkin, *Credit Cards: Use and Consumer Attitudes, 1970-2000*, 86 FED. RES. BULL. 623, 623-24 (2000) (noting that total consumer credit outstanding has risen in tandem with income growth); Durkin, *supra* note 47, at 38, 39, fig. 2 (noting that the

during this period from zero to roughly 9% of disposable income.¹⁶⁴ Nonrevolving installment debt, by contrast, has fallen from its level of 19% of disposable income in the 1960s, to roughly 12% today. Thus, the increase in revolving debt has been almost exactly offset by a decrease in the installment debt burden. In fact, the recent bump in total indebtedness in recent years was *not* caused by an increase in revolving debt, which has remained largely constant for several years, but by an increase in installment debt, primarily as a result of a recent increase in car loans for the purchase of new automobiles.¹⁶⁵ Because the increase in credit card usage has resulted primarily from a substitution of credit cards for other types of consumer credit, rather than an overall increase in indebtedness, there is little indication that increased use of credit cards has precipitated greater financial stress among American households.¹⁶⁶

Unlike traditional forms of consumer credit, however, credit card and other unsecured debt is generally unsecured and dischargeable in bankruptcy. Thus, holding total debt constant and substituting dischargeable unsecured debt for nondischargeable forms of debt will increase the propensity of a given individual to file bankruptcy. This may explain the observed tendency of credit card defaults and defaults on other forms of unsecured consumer debt to track bankruptcy filing rates, whereas there seems to be no similar correlation

ratio of consumer credit to income has remained relatively stable since 1956).

164. In fact, this figure probably overstates the amount of revolving debt held by American households. The majority of credit card users are convenience users who use credit cards as a transactional device and pay their balances in full each month, rather than revolving. The percentage of convenience users relative to revolvers has risen steadily over time as credit cards have replaced cash as a transaction mechanism. Zywicki, *Economics of Credit Cards*, *supra* note 161, at 101; Ana M. Aizcorbe et al., *Recent Changes in U.S. Family Finances: Evidence from the 1998 and 2001 Survey of Consumer Finances*, 89 FED. RES. BULL. 1, 25 (Jan. 2003) (reporting that 55.3% of households pay their credit card bills in full each month). Nonetheless, during that thirty-day cycle-period, convenience users are measured statistically as having outstanding credit balances that are added into the calculation of revolving debt. As William Hampel observes, "[s]ome people have large balances every month, but also pay their balances in full every month. This exaggerates the size of revolving credit as a proportion of total credit and underestimates the amount of payments that take place each month." William Hampel, *Discussion: The Growth of Consumer Credit and the Household Debt Service Burden*, in IMPACT OF PUBLIC POLICY, *supra* note 47, at 67; *see also id.* ("Very simply, revolving credit . . . is not all debt. I do not know of any data source that tells us how much of current revolving credit is merely transaction balances.").

165. Aizcorbe et al., *supra* note 164, at 24. In particular, the growing popularity of sport utility vehicles, which are both more expensive and more valuable than traditional cars, thus, they simultaneously increased indebtedness and increased household assets through their purchase. *Id.* at 17.

166. *See* Hampel, *supra* note 164, at 67 ("[C]onsumer credit has been fairly constant relative to income over the past 30 years, but the composition has changed.").

between bankruptcy filings and defaults on home mortgage loans or secured auto loans.¹⁶⁷ For unsecured debts, the debtor can discharge the debts in question at little cost, whereas in the latter case the debtor will suffer the high cost of losing his house or car. If bankruptcies were best explained as an involuntary response to adverse economic shocks, it would be expected that defaults on mortgage, automobile, and credit card debt should be rising more or less in unison, because there would be no obvious reason why an individual would be "unable" to pay some debts but not others. Given the different default rates on these various forms of credit, it is evident that consumers are consciously choosing to pay some debts but not others—defaulting on their unsecured obligations, but paying their secured debts. Thus, the recent shift by consumers toward unsecured debt, primarily as the result of greater use of credit cards, would tend to increase bankruptcy filing rates by increasing the percentage of debt that is dischargeable in bankruptcy.

In addition, there is some evidence that bankruptcy filers tend to increase their credit card balances in the period leading up to bankruptcy.¹⁶⁸ Credit card debt rises rapidly and is concentrated in the months immediately preceding bankruptcy, suggesting that credit card indebtedness does not cause bankruptcy in many cases, rather the debtor is already on the way toward bankruptcy when credit card borrowing begins and is either acting strategically as part of a credit card "bust out" or is simply drawing on credit cards as a last resort. Regardless, the effect is to dramatically increase credit card use during a time when the debtor knows she is either going to file bankruptcy eventually or is likely to do so.¹⁶⁹

It also has been argued that credit cards have contributed to increased bankruptcies through a profligate expansion of credit card credit to high-risk borrowers, especially low-income borrowers.¹⁷⁰ Although often-repeated,

167. See Lawrence M. Ausubel, *Credit Card Defaults, Credit Card Profits, and Bankruptcy*, 71 AM. BANKR. L.J. 249, 250 (1997) (finding a correlation between credit card defaults and bankruptcy filings); Durkin, *supra* note 47, at 38, fig. 3 (finding no correlation with defaults on automobile loans and home mortgages).

168. Gross & Souleles, *supra* note 62, at 320.

169. These credit card debts may be presumed nondischargeable under § 523(a)(2)(C) as fraudulently induced, but only if they aggregate to over \$1225 within sixty days of bankruptcy for "luxury goods and services." 11 U.S.C. § 523(a)(2)(C) (2000). Such limits are easily evaded, either by maxing out the card sixty-one days before bankruptcy, or charging discretionary but nonluxury items prior to bankruptcy that would not be considered "luxury" expenditures, such as discretionary car or house repairs.

170. See, e.g., Elizabeth Warren, *The Bankruptcy Crisis*, 73 IND. L.J. 1079, 1081–84 (1998) (noting the correlation between credit card default and bankruptcy); Susan L. DeJarnatt, *Once is Not Enough: Preserving Consumers' Rights to Bankruptcy Protection*, 74 IND. L.J. 455, 499 (1999) (concluding that the credit card industry's choice to lend to people with weak

empirical studies have failed to support this theory. As with consumers in general, the growth in credit card debt among low-income households has been primarily a substitution of credit cards for other types of credit, such as pawn shops and payday lenders, not an overall increase in indebtedness. In fact, empirical researchers have failed to find evidence that rising consumer bankruptcies have been caused by extension of credit cards to less credit-worthy borrowers, because the growth in credit card debt represents a substitution from other forms of credit, not an expansion of overall consumer indebtedness.¹⁷¹

Thus, there is an observed correlation between credit card defaults and bankruptcy, but the available evidence fails to provide an economic risk-based explanation for the correlation. This anomaly suggests that those who believe that the expansion of credit card use has contributed to rising bankruptcy filings may be correct, but for the wrong reason. Credit cards have not increased indebtedness and household financial distress, but instead have simply substituted impersonal unsecured credit for more localized secured credit. Because credit card debt is unsecured and dischargeable in bankruptcy, this substitution has increased the benefits of filing bankruptcy, notwithstanding the fact that overall consumer indebtedness has not increased.

B. Greater Nationalization and Impersonalization of Consumer Credit

This trend in consumer credit has also led to increased bankruptcy filings in a second way, by making consumer credit relations less "personal" in nature. Although "greater impersonalization" of consumer credit is difficult to measure, there is a widespread perception that credit relations, especially for consumer credit, have become increasingly impersonal in recent years as compared to the past.¹⁷² This change in credit relations has affected the willingness of

credit histories is part of the problem); Bernard R. Trujillo, *The Wisconsin Exemption Clause Debate of 1846: An Historical Perspective on the Regulation of Debt*, 1998 WISC. L. REV. 747, 749 (1998) (noting that one reason for the explosion in bankruptcies is extension of credit to subprime borrowers).

171. See Donald P. Morgan & Ian Toll, *Bad Debt Rising*, CURRENT ISSUES IN ECON. & FIN. Mar. 1997, at 1, 4 (finding "no evidence" that lending to riskier borrowers was the problem); Gross & Souleles, *supra* note 62, at 344-46 (not finding lending to riskier borrowers to be a factor in bankruptcy filing rates); see also Zywicki, *Economic Analysis*, *supra* note 1 (discussing empirical evidence). Consistent with the argument presented in the text here, Morgan and Toll conclude that increased consumer demand for credit cards, relative to other forms of consumer credit is driving the increase in credit card debt, not a supply-side shift by lenders. Morgan & Toll, *supra* at 4.

172. Rafael Efrat, *The Moral Appeal of Personal Bankruptcy*, 20 WHITTIER L. REV. 141,

individuals to file bankruptcy in three different ways: (1) by undermining the development of commercial trust relationships; (2) by undermining the constraints imposed by repeat dealings; and (3) by reducing the constraints of individual credit reputation.

Consumer credit was historically a highly personalized transaction, for example, a corner grocery store or Main Street tailor selling goods to their customers on credit.¹⁷³ Bank credit, for instance, required the debtor to withstand a personal and intrusive series of face-to-face interviews and probing inquiry into his social and business relationships to determine the debtor's trustworthiness and reliability. In fact, historically, a major source of consumer credit was informal loans between family members.¹⁷⁴ Traditional credit was of a highly personal and face-to-face nature, and the credit relationship was embedded within an ongoing economic and social relationship with the credit issuer. Where the credit relationship is embedded in the context of a social and economic relationship, it is more likely that a trust relationship will arise between the parties.¹⁷⁵

Today, many consumer financial relations are conducted with large interstate banks and South Dakota and Delaware based credit card issuers such as Citibank and MBNA. Impersonal credit relations, such as dealing with these institutional lenders, are less likely to evolve into high-trust relationships, and these weaker extralegal constraints make individuals more willing to breach those promises.¹⁷⁶ In part, this is because individuals do not tend to form trust relationships with artificial entities, such as corporations, in the same way that they do with other human beings. These economic exchange relations lack the embedded personal and extended economic relations that characterize older and more local forms of credit. Thus, an individual is less likely to feel himself bound in a trust relationship with his credit card issuer than he would be if he purchased a suit on store credit from his local tailor.¹⁷⁷

161-62 (1998); see also Braucher, *supra* note 26, at 564 (noting the perceived distinction between owing friends or family and owing a credit card company).

173. See CALDER, *supra* note 126, at 37-42 (discussing the rise of retail credit).

174. *Id.* at 60-64 (discussing the role of family lending).

175. Efrat, *Moral Appeal*, *supra* note 172, at 159.

176. *Id.*

177. *Id.* This same analysis could apply to the development of trust relationships by creditors, but the primary constraint on lender opportunism are contracts and other more formal institutions, including legislation and regulation, as well as repeat-dealing and reputation effects, thus trust seems much less relevant on the lender's side of the transaction. As Efrat observes:

[A] consumer debtor is less likely to develop a trust relationship beyond the deterrence-based level with a large credit card company. The consumer debtor is

Indeed, as David Skeel observes, part of the impetus for the 1898 Bankruptcy Act was the concern of merchants who engaged in interstate commerce that when debtors ran into financial trouble they "played favorites" with their creditors, preferring "family members and local creditors, not the out-of-state merchants."¹⁷⁸ Lower-trust relationships, therefore, are more prone to opportunism than high-trust relationships.

Individuals psychologically evaluate transactions differently depending on whether they are of a personalized or an impersonalized nature. The closer the social connection between the trading partners is, the greater the likelihood that the individuals will trust one another.¹⁷⁹ The longer the parties have known each other and the more integrated their social network, the more likely they are to trust one another.¹⁸⁰ Individuals also appear to be more likely to recognize the positive-sum nature of personal relations marked by an ongoing reciprocity of mutual advantage and vest these "win-win" relationships with positive moral weight.¹⁸¹ By contrast, individuals tend to see impersonal relationships as zero-sum in nature, removing a psychological constraint on acting opportunistically.¹⁸²

The growth of credit cards illustrates the trend toward more national and impersonal credit. Prior to the widespread development and use of credit cards, the American consumer economy was highly localized. Even if one was merely traveling, it could be very difficult to get credit when necessary. In the past, individuals had to make use of more indirect and costly means for proving their creditworthiness to strangers. For instance, when Max Weber visited the United States in 1904, he witnessed an adult baptism by immersion.¹⁸³ When

not likely to have any face-to-face contact with the institutional creditor. The parties infrequently communicate, and when they do, they mainly use impersonal channels such as a telephone. Furthermore, a courtship will not likely develop between the parties. The parties are not likely to watch each other act in social situations or observe each other in [a] variety of emotional states. Therefore, the lack of personal bonding precludes most of these types of relationships from developing into a knowledge-based credit trust relationship.

Id.

178. SKEEL, *supra* note 20, at 36.

179. See Edward L. Glaeser et al., *Measuring Trust*, 115 Q. J. ECON. 811, 834 (2000) (discussing the relationship between social ties and trust).

180. *Id.*

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

182. *Id.*

183. See Jeremy Shearmur & Daniel B. Klein, *Good Conduct in the Great Society: Adam Smith and the Role of Reputation*, in REPUTATION: STUDIES IN THE VOLUNTARY ELICITATION OF GOOD CONDUCT 29 (Daniel B. Klein ed., 1997) (describing Weber's report).

he inquired as to why the individual sought baptism, he was informed that it was so that he could open a bank.¹⁸⁴ Because Baptist congregations conducted in-depth character evaluations of individuals before admitting them as members, "[a]dmission to the congregation [was] recognized as an absolute guarantee of the moral qualities of a gentleman, especially of those qualities required in business matters."¹⁸⁵ Thus, "[w]hen a sect member moved to a different place, or if he was a traveling salesman, he carried the certificate of his congregation with him and thereby found not only easy contact with sect members but, above all, he found credit everywhere."¹⁸⁶

These informal means of establishing credit have been supplanted by credit cards as a universal medium of credit. "The sects' inquiries into the would-be member's probity are paralleled by the credit card company's scrutiny of the would-be cardholders' credit record."¹⁸⁷ Today, "[i]n a large and anonymous society such as the United States, many people carry credit cards, which speak for them to people with whom they have had no previous contact and with whom they may well never be in contact again."¹⁸⁸

This trend towards more impersonalized credit has increased the efficiency of American consumer credit markets and expanded consumer choice in credit. Prior to the nationalization of credit markets, rural consumers suffered from the lack of competition among banks as issuers of credit.¹⁸⁹ Small-town debtors had limited ability to shop around to get competing offers of credit. Thus, while a debtor might personally know the loan officer at the bank, in many instances this personalized relationship came at the cost of reduced competition and customer choice.¹⁹⁰ On the other hand, the personalized nature of these traditional lending relationships could give rise to subtle bias and even discrimination. Reliance on impersonalized systems such as credit-scoring and the like has substantially reduced racial and other improper bias from the lending decision, thereby leading to an expansion of credit to traditionally underserved individuals.¹⁹¹ Finally, the nationalization of credit has generated

184. *Id.*

185. MAX WEBER, *THE PROTESTANT ETHIC AND THE SPIRIT OF CAPITALISM*, quoted in Shearmur & Klein, *supra* note 183, at 36.

186. Shearmur & Klein, *supra* note 183, at 36.

187. *Id.* at 41–42.

188. *Id.* at 41.

189. See Zywicki, *Economics of Credit Cards*, *supra* note 161, at 94–110 (discussing the effect of a lack of competition on bank lending terms).

190. Consider in this context the dramatic difference between the availability of twenty-four hour customer service for credit card operations versus the lasting practice of "banker's hours" for traditional deposit banks.

191. See generally INFO. POLICY INST., *THE FAIR CREDIT REPORTING ACT: ACCESS*,

competition on a massive scale. For instance, there are currently over 6000 issuers of credit cards and barriers to entry are low. This has led to robust competition in the credit card market, driving economic efficiency and pro-consumer innovation.¹⁹²

The greater impersonalization of consumer credit has had dramatic consequences by expanding customer choice and liberating customers from the constraints of traditional credit choices. But this increasing impersonalization of lending also tends to undermine the moral obligation that borrowers feel toward lenders, thereby increasing the likelihood that the debtor would engage in post-contractual opportunism to avoid repayment. Bankruptcy filers acknowledge that although they generally feel guilty about not being able to pay their debt to their creditors, "many had less guilt feelings about not paying large creditors or creditors they did not know personally."¹⁹³ Moreover, in order to reduce debtor guilt regarding bankruptcy, lawyers distinguish between personal moral obligations owed to family and friends, versus financial obligations owed to credit card lenders and other abstract institutions.¹⁹⁴ Such a distinction between debts owed to friends versus institutional lenders would not have been as tenable in the past, when most credit was local in nature and often bundled with retail transactions from a lender who was also a local merchant and neighbor. This decline of the trust relationship between lenders and borrowers may help to explain the increasing willingness to discharge these contractual obligations through bankruptcy.

In addition to leading to a decrease in personal shame, there has also been a reduction in the constraint imposed by repeat-dealing. Repeat dealing constrains opportunistic behavior by holding out the prospect that the long-term benefit from the maintenance of the relationship exceeds the gain that an individual could make by acting opportunistically.¹⁹⁵ Consumer borrowers historically had limited credit options, primarily because of geographic limitations on the number of credit issuers with whom the debtor could reasonably interact. Traditionally, retail goods and credit were tied together, such that a borrower who failed to pay his credit bills would be unable to

EFFICIENCY, & OPPORTUNITY (2003).

192. See generally Zywicki, *Economics of Credit Cards*, *supra* note 161.

193. Efrat, *Evolution of Social Norms*, *supra* note 94 (citing VISA, QUALITATIVE RESEARCH: BANKRUPTCY PROCESS 9 (1997)).

194. See *supra* notes 144–47 and accompanying text (contrasting the moral issues associated with borrowing from family and friends versus institutions).

195. See generally ROBERT AXELROD, *THE EVOLUTION OF CO-OPERATION* (1984); Lester G. Telser, *A Theory of Self-Enforcing Agreements*, 53 J. BUS. 27 (1980).

purchase goods on credit in the future.¹⁹⁶ It was also relatively more expensive for debtors in prior eras to relocate to a new community to start over after filing bankruptcy. Given the small number of credit issuers, the debtor dared not default, as it would be exceedingly difficult to obtain credit in the future. The fact that the debtor was locked into repeat-dealing relationships with a relatively small number of credit issuers with whom he would have to deal in the future placed constraints on the willingness of the debtor to breach his promises.

Today, by contrast, the multitude of options available to a former bankrupt removes much of the constraint imposed by repeat-dealing. Although bankruptcy filers will face some restriction on the number of creditors who will lend to them and may have to pay somewhat higher credit terms, post-bankruptcy debtors will find a relatively vibrant and competitive market for borrowing.¹⁹⁷ Thus, a bankruptcy filer is not required to go back to the same lenders with whom she previously dealt. This attenuates the constraint of repeat-dealing relationships, thereby increasing the debtor's willingness to file bankruptcy at the margin.

For similar reasons, these developments have attenuated the constraining effects of reputation.¹⁹⁸ Maintaining a reputation-based system of contract enforcement also requires the maintenance of a system of ostracism, both for the "defector," and also for any member who enters into later dealings with the defector.¹⁹⁹ This willingness to punish a defector even at some cost to oneself

196. A similar system, albeit in a nonconsumer context, is described by Karen Clay in her analysis of trade and credit in Mexican California in the 1840s. Karen Clay, *Trade, Institutions, and Credit*, 34 *EXPLORATIONS IN ECONOMIC HISTORY* 495, 505 (1997). See generally Karen Clay, *Trade Without Law: Private-Order Institutions in Mexican California*, 13 *J. L. ECON. & ORG.* 202 (1997). The uncoupling of the credit transaction from the retail transaction may also have other unanticipated psychological consequences. When the debtor receives both goods and credit from the same seller, there may be an obvious transactional connection that is absent where the credit transaction is separated from the goods. The uncoupling of the credit transaction from the goods that were purchased may weaken the borrower's sense of reciprocal obligation by eliminating the obvious and direct causal nexus between the credit bill and what it purchased. I have seen no evidence on this point, although it is a plausible hypothesis. I would like to thank Professor Owen Jones for suggesting this observation.

197. See *supra* notes 90–91 and accompanying text (discussing post-bankruptcy credit options).

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

199. I use the term "defector" here in the descriptive manner used in the game theory literature to refer to a noncooperator, here the bankruptcy filer.

(or to forego the benefits of trading with her) creates a public goods problem that can lead to free riding by others who are benefited but do not have to bear the cost themselves.²⁰⁰ The willingness to punish someone who fails to punish the initial party creates a second-order public goods problem. Such punishment raises substantial collective action problems, as it becomes necessary not only to monitor misbehavior by the original party, but also to monitor the behavior of all the other members of the group to ensure that they are not reneging on their independent promises to ostracize those who cheat a member of the group. As the size of the group increases, it becomes increasingly difficult to overcome these collective action problems and to detect and punish those who fail to punish the original defector.

This collective action problem explains, in part, the relative ease with which bankruptcy filers today can find access to credit following bankruptcy as compared to prior eras. Staten found, for instance, that bankruptcy filers who reacquired credit were much more likely to obtain credit from a new lender rather than a prebankruptcy lender.²⁰¹ Whereas lenders may prefer as a group to ostracize borrowers who file bankruptcy, in practice each lender has an individual incentive to lend to a debtor who files bankruptcy. Ironically, a debtor who files bankruptcy and receives a discharge may be a relatively better credit risk than prior to filing bankruptcy, because she cannot receive another discharge for six years.²⁰² The expansion of home equity lending further reinforces this, because many lenders will lend on collateral even if they would not extend unsecured credit. Thus, each lender individually has a private incentive to deal with a bankrupt at the right price, notwithstanding the fact that lenders as a group might prefer to "blackball" all bankruptcy filers.²⁰³

200. See RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* § 8.5 (6th ed. 2003) (discussing the free-rider problem that can arise in the enforcement of social norms).

201. Staten, *supra* note 91, at 12. Nor did it make a difference whether a debtor discharged his debts in Chapter 7 or filed Chapter 13 and presumably attempted to repay some of his prepetition debts. *Id.* at 16.

202. 11 U.S.C. § 727(a)(8) (2000).

203. This second-order punishment problem becomes more acute where the existing group cannot restrain entry by new lenders who can enter the market to serve those subject to ostracism at the hands of the incumbents. POSNER, *supra* note 200, § 8.5. Barriers to entry are low in consumer credit markets, especially with the invention of nonbank finance companies, and, in recent years, the greatest amount of entry appears to have occurred in the subprime market, which specializes in lending to consumers with previous bankruptcies and tarnished credit. Zywicki, *Economics of Credit Cards*, *supra* note 161, at 128–29.

VI. *What To Do About Rising Bankruptcies?*

This Article has proposed a new model of consumer bankruptcy rooted in the New Institutional Economics (NIE). It is argued that the upward trend line in consumer bankruptcy filing rates over the past two decades has resulted from a confluence of three general factors: (1) a change in the relative costs and benefits of filing bankruptcy; (2) a change in the social norms traditionally associated with filing bankruptcy; and (3) changes in the consumer credit market that have eroded the informal institutions of trust, repeat-dealing, and commercial reputation. Available empirical evidence tends to support the model, but further testing will be necessary before reaching a final conclusion.

Assuming that the NIE model of bankruptcy advanced here is correct, what, if anything, does this say about appropriate reforms to the consumer bankruptcy system? By synthesizing academic research and turning it into applied legislative reform, the traditional model of consumer bankruptcy provided the intellectual foundation for the 1978 Code.²⁰⁴ Similarly, the NIE model of consumer bankruptcy described in this Article provides a conceptual foundation for many of the legislative reforms included in the recently-enacted bankruptcy reform legislation.

This Part briefly reviews possible policy implications of the model described here.²⁰⁵ In particular, three lines of policy reforms are examined. First, amendments are proposed to the bankruptcy reform legislation that would reorient the relative costs and benefits associated with filing bankruptcy. Second, policy initiatives are suggested that are designed to reverse or compensate for the change in social norms that has reduced bankruptcy's stigma. Finally, I will briefly explore the implications of the model here regarding fundamental reforms proposed by some scholars, such as eliminating the mandatory fresh-start provision of current law and instead reformulating the fresh start as a default rule that can be waived by the debtor.

A. *Adjust the Relative Costs and Benefits of Filing Bankruptcy*

The first and most direct policy response to rising bankruptcy filings would be to rebalance the benefits and costs associated with filing bankruptcy. Increasing the costs associated with filing bankruptcy, however, would not be

204. See generally SKEEL, *supra* note 20.

205. I have addressed these policy arguments in more detail elsewhere and just provide a brief overview here. See generally Todd J. Zywicki, Bankruptcy Reform: An Economic Analysis (unpublished manuscript, on file with author).

appropriate, in that increasing the deadweight cost of learning about and filing bankruptcy would advance no valuable policy goal.²⁰⁶ The goal of the bankruptcy system should be to deliver relief to those who are thought to deserve it, while limiting its use by others. Increasing the transaction costs of filing bankruptcy surely would reduce bankruptcy filings, but this would advance no coherent policy goal.²⁰⁷ Thus, the focus should be on decreasing the benefits associated with bankruptcy, especially to high-income and high-wealth debtors who could repay a substantial portion of their debts in bankruptcy, but choose not to.

Several of the provisions in the BAPCPA are designed to reduce some of the benefits associated with filing bankruptcy. To reduce the attractiveness of bankruptcy for high-income debtors, the bankruptcy reform legislation will "means-test" eligibility of bankruptcy filers for Chapter 7 relief.²⁰⁸ Under means-testing, a debtor will be required to file in Chapter 13 rather than Chapter 7, if she: (1) earns above the state median income; (2) could repay a substantial portion of her debts out of "disposable income" in Chapter 13 after subtracting out a slate of allowed expenses; and (3) does not have significant special circumstances that offset the presumption of a Chapter 13 filing. As a substantive matter, means-testing simply institutionalizes the "substantial abuse" (now "abuse") inquiry of § 707(b), and invigorates enforcement of that moribund provision by shifting the burden of persuasion in cases where the concern about abuse is highest.²⁰⁹ A debtor who is means-tested into Chapter 13 thus would not be denied a discharge on account of triggering the means-testing provisions of the Code; she would simply have her discharge conditioned on completing a court approved Chapter 13 plan and paying off what she can to unsecured creditors.

It is estimated that approximately 7%–10% of current bankruptcy filers would satisfy all elements of the means-test under the legislation and be

206. Unless, of course, the increased costs were just a by-product of reforms for which the benefits exceeded the costs. For instance, proposals to reduce fraud and abuse could have small costs associated with them, but have substantial offsetting benefits.

207. For instance, we could have a rule of randomly dismissing every tenth bankruptcy filing, which would reduce filings, but would accomplish no coherent policy goal.

208. Bankruptcy Reform Act of 2005, Pub. L. No. 109-8, § 102, 119 Stat. 23, 29–35. A detailed examination of the means-testing provisions of the bankruptcy reform legislation is provided in Jones & Zywicki, *supra* note 3, at 181–208, on which this subpart draws. See also REPORT OF THE COMMITTEE ON THE JUDICIARY HOUSE OF REPRESENTATIVES TO ACCOMPANY H.R. 333, BANKRUPTCY ABUSE PREVENTION AND CONSUMER PROTECTION ACT OF 2001, at 2 (2001) ("The heart of H.R. 333's consumer bankruptcy reforms is the implementation of an income/expense screening mechanism ('needs-based bankruptcy relief') to ensure that debtors repay creditors the maximum they can afford.").

209. See Jones & Zywicki, *supra* note 3, at 181–208 (discussing means-testing in depth).

required to file in Chapter 13.²¹⁰ Because the means-test targets those with the highest repayment capacity, this would result in a substantial repayment of debt currently discharged in bankruptcy.²¹¹ Under current law, by contrast, because of exemptions and prebankruptcy planning, there is no distribution at all to general unsecured creditors in 96% of Chapter 7 cases and only a trivial distribution in other cases.²¹² Recovering some of this discharged debt through means-testing would reduce bankruptcy losses and, therefore, the cost to lenders. In turn, some of these savings would be passed on to consumers in terms of lower interest rates, lower credit costs generally, and greater benefits to consumers. Because little is known about the exact elasticity of supply and demand for consumer credit, it is not clear how much of these savings would be passed on to consumers in the form of lower credit costs and increased benefits, as opposed to increasing creditors' return on assets.²¹³

In addition, the bankruptcy reform legislation amends the Code to reduce the benefits of bankruptcy to high-wealth debtors.²¹⁴ The incentives of high-wealth debtors to file bankruptcy results primarily from real property exemptions and exceptions of certain personal property from the bankruptcy estate, such as ERISA-qualified pension plans.²¹⁵ Given the increasing ability of debtors to act strategically to transfer assets to exempt and excepted sources as part of prebankruptcy planning activities, it may be appropriate to give new

210. *Id.* at 184.

211. One estimate concluded that means-tested debtors could repay 64% of their unsecured nonpriority debts, or over \$4 billion, in addition to all of their priority and secured debts. *Id.* at 187 (citing Tom Neubig & Fritz Scheuren, Ernst & Young, *Chapter 7 Bankruptcy Petitioners' Ability to Repay: The National Perspective*, 1997, at 8 (Mar. 1998)).

212. Michael J. Herbert & Domenic E. Pacitti, *Down and Out in Richmond, Virginia: The Distribution of Assets in Chapter 7 Bankruptcy Proceedings Closed in 1984-1987*, 22 U. RICH. L. REV. 303, 315-16 (1988); see also Michelle J. White, *Personal Bankruptcy Under the 1978 Bankruptcy Code: An Economic Analysis*, 63 IND. L.J. 1, 38-39 (1987) (estimating average repayment rate of one to two percent in Chapter 7 cases).

213. See Kartik B. Athreya, *Welfare Implications of the Bankruptcy Reform Act of 1999*, 49 J. MONETARY ECON. 1567, 1583 (2002) (estimating that means-testing would reduce credit costs to households by approximately \$80 per year).

214. In addition, Congress could improve safeguards against outright fraud, such as concealing assets. The FBI estimates that roughly 10% of bankruptcy filings have some sort of fraud, usually asset concealment. See FED. BUREAU OF INVESTIGATION, BANKRUPTCY FRAUD, at http://www.fbi.gov/hq/cid/fc/video_text/bf_txt.htm (last visited Aug. 18, 2005). Although greater safeguards would reduce the benefits of filing bankruptcy for fraudulent filers, this is sufficiently obvious that it is not discussed in the text. Nonetheless, many of the provisions in the bankruptcy reform legislation accomplish this purpose.

215. 11 U.S.C. § 541(c)(2) (2000); *Patterson v. Shumate*, 504 U.S. 753, 766-67 (1992) (ruling that a debtor's interest in an ERISA-qualified pension plan may be excluded from the bankruptcy estate).

statutory and equitable tools to judges, enabling them to reduce these benefits by limiting the amount of property that bankruptcy filers can protect through bankruptcy exemptions.

The notorious unlimited homestead exemption available in a handful of states has come in for special criticism in this context, especially in the popular press.²¹⁶ Other exemptions under state law are potentially subject to abuse as well, but, in practice, courts have been more deferential to protecting large amounts of wealth in homestead exemptions than in other forms of unlimited or high-value exemptions.²¹⁷ Even less common is the concern that bankruptcy debtors will relocate on the eve of bankruptcy in order to take advantage of other states' unlimited homestead exemption.²¹⁸ Nonetheless, the homestead exemption is symbolically important and, even though the tangible benefits of greater limits on homestead are relatively small given the relatively small number of affected filers, the marginal costs of reform are small as well.²¹⁹ Reducing the amount of wealth that can be protected in a Chapter 7 filing by reducing bankruptcy exemptions would also tend to cause a substitution by filers from Chapter 7 to Chapter 13, which might increase returns to creditors and reduce some of the benefits of filing bankruptcy.²²⁰ There is also a high correlation between income and wealth; thus, means-testing high-income debtors into Chapter 13 will reduce some of the benefits of bankruptcy even to those who retain large homestead exemptions.

A potentially larger problem arises from the interaction of rising housing values during recent decades, the operation of the homestead exemption, and the blossoming of home equity lending markets. By increasing accumulated home equity, increases in home values also increase the effective value of the homestead exemption to potential filers. Through prebankruptcy planning, a debtor can strategically increase her home equity by paying down her home

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

217. DAVID G. EPSTEIN ET AL., BANKRUPTCY § 8-32 (1993).

218. See Ronel Elul & Narayanan Subramaniam, *Forum-Shopping and Personal Bankruptcy* (Brown Univ., Dep't of Econs., Working Paper No. 99-1, 1999) (finding that a small number of individuals relocate from low-exemption to high-exemption states for purposes of filing bankruptcy), available at <http://people.brandeis.edu/~nsutra/wp/forum.pdf>; Vukowich, *supra* note 18, at 1139-42 (noting the small number of filers benefited by unlimited homestead exemption).

219. See *supra* notes 49-51 and accompanying text (discussing the effect of the homestead exemption on bankruptcy filings).

220. See Ian Domowitz & Robert L. Sartin, *Determinants of the Consumer Bankruptcy Decision*, 54 J. FIN. 403, 404 (1999) (discussing the effect of the exemption level on the choice of Chapter 7 or Chapter 13).

mortgage at the expense of her unsecured creditors and then discharge her unsecured debt in bankruptcy. Following bankruptcy, the debtor will likely be able to gain credit on a home equity loan, secured by the equity that was accumulated prior to filing bankruptcy. Because the loan is secured rather than unsecured, a typical middle-class debtor with substantial accumulated home equity will likely be able to obtain a home equity loan on competitive terms. As a result, a sophisticated debtor can essentially "launder" pre-petition money to herself post-petition, by combining the homestead exemption with a post-bankruptcy home equity loan.²²¹

The proposed bankruptcy reform legislation would eliminate several of the most egregious forms of abuse. First, any debtor who moved from a state with a limited exemption to a state with an unlimited exemption would face a two-year waiting period before she could avail herself of the new state's exemptions²²² and all filers will face a new cap on any homestead acquired within forty months prior to bankruptcy, regardless of whether the debtor relocated from another state.²²³ These waiting periods eliminate the opportunity for a debtor to relocate on the eve of bankruptcy in order to gain the benefits of a more generous homestead exemption. Notably, this would prevent individuals such as O.J. Simpson from relocating to a new state such as Florida in order to take advantage of Florida's unlimited homestead exemption.²²⁴ Second, provisions in the reform act also would potentially allow victims of securities and other financial fraud to reach the homestead assets of individuals such as Scott Sullivan, the former WorldCom executive who owns a \$15 million homestead outside Boca Raton, Florida.²²⁵ Third, the legislation would permit a ten-year statute of limitations for claims that a debtor had fraudulently manipulated her homestead exemption.²²⁶ The legislation does not impose a flat cap on the amount of equity a debtor can protect in his homestead exemption, a decision that arguably is justified by federalism concerns.²²⁷ By

221. Todd J. Zywicki, *Rewrite the Bankruptcy Code, Not the Scriptures: Protecting a Debtor's Right to Tithe in Bankruptcy*, 1998 WIS. L. REV. 1223, 1264-65 (1998).

222. Bankruptcy Reform Act of 2005, Pub. L. No. 109-8, § 307, 119 Stat. 23.

223. *Id.* § 322.

224. Stephen Frater, *Home Sweet Home*, SARASOTA HERALD-TRIB., May 31, 2004, at A12.

225. Bankruptcy Reform Act of 2005, Pub. L. No. 109-8, § 322, 119 Stat. 23 (capping value of homestead exemption against claims of fraud, securities fraud, and other intentional harms at \$125,000 if acquired within 1215 days of bankruptcy). It is not clear when exactly Sullivan acquired his Florida homestead. Frater reports the value as \$15 million, which served as collateral on Sullivan's \$10 million bail bond for his criminal securities fraud prosecution. Frater, *supra* note 224, at 12.

226. Bankruptcy Reform Act of 2005, Pub. L. No. 109-8, § 308, 119 Stat. 23.

227. It can be argued that this decision is defensible in that it appears that most of the cost

preventing forum-shopping and fraudulent use of the homestead exemption, the legislation eliminates the most glaring abuses of current law.

As noted above, there also appears to be a rising number of cases where debtors file bankruptcy despite possessing substantial retirement savings.²²⁸ The caselaw results are mixed on the willingness of judges to police this behavior and to dismiss these filings. Certainly, judges could be more consistently vigilant in reviewing and dismissing cases where debtors possess very substantial exempt retirement savings. Unfortunately, the bankruptcy reform legislation would actually move the law in the opposite direction, by creating greater protections for retirement savings.²²⁹ Ideally, this safe harbor should be struck from the legislation, although it was added some time ago in response to an earlier proposal to codify greater restrictions on the exemption of retirement savings.

More fundamentally, by reducing abuse and by reducing the public perception of widespread abuse of the system, bankruptcy reform will tend to increase support for the bankruptcy system as a whole.²³⁰ By reserving bankruptcy relief for those who need it and preventing abuse by those who do not, the reform measures discussed will increase public confidence that the system is operating properly to forgive those who need it. Measured reforms to reduce abuse, therefore, may help to head off more sweeping changes later that would attack opportunistic and legitimate bankruptcy filers equally.

B. Reversing the Change in Social Norms

Societal patterns of cooperation or noncooperation usually develop over long periods of time and can be very difficult to change. "Trust and distrust

associated with generous state exemption policies are borne by other consumers within the state, in terms of less access to credit, lower loan approval rates, and higher interest rates, than for residents of states with lower exemption rates. See generally Gropp et al., *supra* note 44. Historically, the purpose of homestead exemptions has been to protect family farmers, who are unlikely to relocate on the eve of bankruptcy. Both the benefits and costs of a state's homestead exemption policy remain mainly within the state and do not spillover onto residents of other jurisdictions, thus this policy choice arguably is protected by federalism principles. As a result, the statutory waiting periods imposed by the legislation permits creditors to adjust to the higher risk of a debtor's move to a more generous state.

228. See *supra* notes 53–58 and accompanying text (discussing bankruptcy cases involving retirement savings).

229. Bankruptcy Reform Legislation of 2005, Pub. L. No. 109-8, § 244, 119 Stat. 23.

230. Cf. Posner, *supra* note 100, at 1814–19 (noting that transparent tax shelters and other obvious abuses of the tax system undermine faith in the fairness and integrity of the tax system and thereby reduce voluntary compliance).

feed upon each other," Matt Ridley observes.²³¹ "Stocks of social capital, such as trust, norms, and networks, tend to be self-reinforcing and cumulative. Vicious circles result in social equilibriums with high levels of cooperation, trust, reciprocity, civic engagement, and collective well-being. These traits define the civic community," writes Robert Putnam.²³² "Conversely," he continues, "the absence of these traits in the *uncivic* community is also self-reinforcing. Defection, distrust, shirking, exploitation, isolation, disorder, and stagnation intensify one another in a suffocating miasma of vicious circles."²³³ Thus, undermining habits of reciprocity in commercial exchange will tend to erode the values of reciprocity and trust in social, economic, and political relations.²³⁴

The vicious-cycle characteristic of negative changes in social norms, as well as the diffuse nature of evolution of norms, makes it difficult to identify particular policy proposals that could reverse the deterioration of social norms regarding bankruptcy.²³⁵ Few theorists have provided persuasive prescriptions as to how to build social trust or to reverse a decline in social trust.²³⁶ In fact, there may be little that law can do to reverse these sorts of large social movements. According to the "expressive" theory of law, however, legal rules can shape social norms at the margin. The bankruptcy reform legislation contains several provisions that would be consistent with a goal of reinstating some of the traditional social norms regarding bankruptcy. For instance, it requires a debtor to seek mandatory consumer credit counseling in order to try to work out a voluntary repayment plan with creditors before she can file for bankruptcy, which will tend to reinforce the value of voluntary repayment.²³⁷

231. RIDLEY, *supra* note 112, at 250.

232. ROBERT PUTNAM, *MAKING DEMOCRACY WORK: CIVIC TRADITIONS IN MODERN ITALY* 177 (1993).

233. *Id.*

234. Frank Buckley refers to this effect as creating "distrust externalities." F. H. Buckley, *The Debtor as Victim*, 87 CORNELL L. REV. 1078, 1086 (2002).

235. I assume for purposes of this discussion the desirability of reinstating traditional social norms regarding bankruptcy and leave aside normative arguments about the desirability of this policy goal.

236. See generally Stephen Knack & Paul J. Zak, *Building Trust: Public Policy, Interpersonal Trust, and Economic Development*, 10 SUP. CT. ECON. REV. 91 (2003) (identifying public policies that can build social trust).

237. Bankruptcy Reform Act of 2005, Pub. L. No. 109-8, § 106, 119 Stat. 23. This provision has been part of all of the various iterations of the bankruptcy reform legislation over the past several years and has been widely supported, even by critics of bankruptcy reform generally. See SKEEL, *supra* note 20, at 207-08 ("From the earliest days of the [reform] debate, the bankruptcy legislation included provisions requiring every debtor to submit to credit counseling before filing for bankruptcy, and again after the conclusion of the bankruptcy

The means-testing provisions, which require high-income debtors to repay a substantial portion of their debts if they can do so without significant hardship, would send a powerful social message regarding the importance of living up to financial obligations to the best of one's ability.²³⁸ Although not part of the current reform proposals, it also may be worthwhile to reconsider the decision of the 1978 Code to de-stigmatize bankruptcy and to de-emphasize the moral qualities of bankruptcy by resuscitating the traditional term "bankrupt" and reconsidering the broad prohibition against discrimination against bankruptcy filers currently found in the Code.²³⁹

In addition to trying to reverse the atrophy of social norms, it may also be efficient to simply acknowledge this fact, and propose amendments to formal legal institutions that correct for these changes. Much of the decline in social norms regarding bankruptcy is an inevitable outgrowth of the increasing complexity and mobility of modern society. Trying to reverse these trends in social norms, therefore, may not be practical. Instead, it may be more promising to update formal institutions to serve as "trust substitutes" that can take the place of weakening social norms.

There is an interaction between formal and informal institutions.²⁴⁰ Formal institutions can be either a complement to or substitute for informal institutions.²⁴¹ For instance, informal measures such as reputation, repeat-dealing, and interpersonal trust can be a substitute for formal rules of contract enforcement.²⁴² Stuart Macaulay's classic study of commercial relations in business and the minimal reliance placed on written contracts illustrates the

case."); *id.* at 208 (describing comments of Professor Karen Gross and lawyer Henry Sommer). On the other hand, some have criticized this requirement as unnecessarily increasing the cost and complexity of seeking bankruptcy relief. *Id.*; see also David Wessel, *The Muddled Course of Bankruptcy Law*, WALL ST. J., Feb. 22, 2001, at A1 (quoting Professor David Skeel).

238. See Jones & Zywicki, *supra* note 3, at 207 (discussing the benefits of means-testing).

239. See *supra* notes 148–52 and accompanying text (discussing the prohibition of discrimination in the 1978 Code).

240. Some economists have remarked on the interaction between formal institutions and informal norms and practices in policing opportunism in the context of corporate bankruptcy. See OLIVER E. WILLIAMSON, *THE ECONOMIC INSTITUTIONS OF CAPITALISM* 122 (1985) (noting that in Japan "[t]he hazards of trading are less severe . . . because of cultural and institutional checks on opportunism"); Marc Ramseyer, *Sanctions Without Law: The Japanese Financial Clearinghouse Guillotine and Its Impact on Default Rates*, in REPUTATION, *supra* note 183, at 225. On the other hand, there has been little discussion of the interaction between formal and informal institutions in the context of consumer bankruptcy.

241. See Larry Ribstein, *Law v. Trust*, 81 B.U. L. REV. 553, 555–56 (2001) (suggesting that law substitutes for, rather than complements, trust).

242. POSNER, *supra* note 200, § 4.1.

point.²⁴³ Similarly, the traditional reluctance of the common law to intervene in contracts made among family members reflects the implicit judgment that formal legal enforcement of these promises adds little to their efficient level of enforcement beyond that provided by informal extralegal enforcement of family ties.²⁴⁴ On the other hand, where informal institutions are weak, legal enforcement of promises can increase their reliability, providing greater opportunities for efficient reliance. As philosopher Robert Goodin states, "[t]hrough the institutions of contract law, private promises are publicly enforced. Public sanctions can in that way substitute for private honor, and trust in the public institutions might therefore substitute for trust in private individuals."²⁴⁵

Increasing complexity of economic exchange tends to drive the institutions governing exchange to greater reliance on more formal and abstract institutions.²⁴⁶ As anthropologist Sally Merry has observed, "[W]ith increasing social complexity, informal social controls diminish in significance and are replaced by formal mechanisms of social control."²⁴⁷ The development of credit bureaus in the United States illustrates the evolution of more formal institutions as trust substitutes when commercial exchange becomes more complex.²⁴⁸ Credit records were initially proprietary, consisting of one

243. See generally Stewart Macaulay, *Non-Contractual Relations in Business: A Preliminary Study*, 28 AM. SOC. REV. 55 (1963) (discussing the limited reliance that business places on contracts).

244. See Charles J. Goetz & Robert E. Scott, *Enforcing Promises: An Examination of the Basis of Contract*, 89 YALE L.J. 1261, 1272–73 (1980) (discussing promise enforcement among family members).

245. Robert E. Goodin, *Trusting Individuals Versus Trusting Institutions: Generalizing the Case of Contract*, 12 RATIONALITY & SOC'Y 381, 382 (2000).

246. See generally NORTH, *supra* note 13; see also Lisa Bernstein, *Private Commercial Law in the Cotton Industry: Creating Cooperation Through Rules, Norms, and Institutions*, 99 MICH. L. REV. 1724, 1749–50 (2001) (noting increased reliance on formal institutions in response to a decline in "Old South" norms of the Memphis cotton exchange).

247. Sally E. Merry, *Rethinking Gossip and Scandal, in TOWARDS A GENERAL THEORY OF SOCIAL CONTROL* 271, 288 (Donald Black ed., 1984); see also Daniel B. Klein, *Promise Keeping in the Great Society: A Model of Credit Information Sharing*, 4 ECON. & POL. 117 (1992), reprinted in REPUTATION, *supra* note 183, at 267, 271. A similar evolution towards governance by more formal institutions characterizes the evolution of national courts and formal contract law. See Todd J. Zywicki, *The Evolution of Contract Governance* (unpublished manuscript, on file with author).

248. See Daniel B. Klein, *Knowledge, Reputation, and Trust, By Voluntary Means, in REPUTATION*, *supra* note 183, at 1, 3–7; Daniel B. Klein, *Credit Information Reporting: Why Free Speech is Vital to Social Accountability and Consumer Opportunity*, available at <http://lsb.scu.edu/faculty/credireporting.html> ("The histories of other social accountability mechanisms show a similar pattern of development—from informal gossip to local associations to efficient integrated systems serving a great society."). See generally Klein, *Promise Keeping*,

merchant's records about borrower's accounts. These proprietary records, however, did little to constrain opportunism, as borrowers could simply jump from one creditor to another, taking advantage of each in turn. Merchants and lenders eventually came to "pool" their information, formally and informally, allowing a more complete report on each potential borrower and a more robust system of reporting on reputation. Through this process, the first credit bureaus were born. They were local in scope originally, relegated to a single city or town.²⁴⁹ Over time, however, these local credit bureaus pooled their available information into larger regional and finally national credit reporting bureaus. Today there are three major national credit bureaus, with a variety of regional and industry-specific bureaus as well.²⁵⁰ The development of national credit bureaus with standardized reporting replaced more informal institutions of word-of-mouth gossip and local credit reporting. This increasing formalization of consumer credit reporting both reflects and maintains national consumer credit markets.²⁵¹

Where informal institutions weaken, the efficient response historically has been to devise these formal "trust substitutes" to supplement and replace them. The logic of creating new institutional "trust substitutes" is the animating logic of BAPCPA. Innovations such as means-testing, mandatory consumer credit counseling, and the like, can be understood as efforts to develop institutional substitutes for the declining influence of social norms that traditionally eschewed bankruptcy and encouraged debt repayment.

C. Contracting Around Bankruptcy

In addition to the more gradual reforms proposed by the bankruptcy reform legislation, some scholars have suggested the possibility of more radical long-run reform, such as permitting consumers to opt-out of bankruptcy by allowing contractual waiver of the right to file bankruptcy.²⁵² Under this proposal, the right to elect bankruptcy would no longer be a mandatory rule, but rather would be a default rule that debtors could elect to waive by contract. In

supra note 247; Robert M. Hunt, *The Development and Regulation of Consumer Credit Reporting in America* (Fed. Reserve Bank of Phila., Working Paper No. 02-21, 2002); Macaulay, *supra* note 243.

249. Hunt, *supra* note 248, at 8–9.

250. *Id.*

251. Marco Pagano & Tulio Jappelli, *Information Sharing in Credit Markets*, 43 J. FIN. 1693, 1713–14 (1993).

252. See, e.g., Adler et al., *supra* note 41, at 609 (suggesting that the ability to contract around bankruptcy should be given consideration).

exchange for waiving the right to file bankruptcy *ex post*, the debtor presumably would gain access to credit on better terms *ex ante*. The costs of the mandatory bankruptcy discharge provision are substantial—one estimate places it at roughly \$280 per year per household and an increase in interest rates on unsecured credit of 3.2%; others place the cost as high as \$900.²⁵³ Moreover, these costs will generally have their greatest impact on marginal borrowers—young lower-income, lower-wealth borrowers who are most likely to be turned down for credit as the cost and risk rises, who can least afford to pay higher credit costs, and who have the fewest number of credit options. In addition, because these borrowers will have accumulated lower household wealth holdings, they will be the most dependent on unsecured credit, which is most likely to be adversely affected by increases in credit costs. Middle class borrowers, by contrast, will be more likely to hold homes and cars, and therefore to substitute the use of secured credit for unsecured credit as the cost of unsecured credit rises.

The consumer bankruptcy model described here does provide some support for the proposition that the right to a discharge should be a waiveable default rule, rather than a mandatory term. The model indicates that some part of an individual's decision to file bankruptcy is a function of the strength of her moral and psychological commitment to performing her contractual obligations rather than filing bankruptcy. This particular information is private, idiosyncratic, and not observable or subject to third-party verification. Nonetheless, it is relevant information in determining the economic risk of a loan. As a result, if this information could be accurately and credibly disclosed to the market through signaling, it would permit a more efficient risk-based pricing, allowing those with a stronger commitment to paying their debts and living within their means to obtain more credit on less-expensive terms.²⁵⁴ Because of the mandatory discharge of the current system, however, the ability to credibly provide this information to the market is limited.

Making the discharge optional, rather than mandatory, would reduce this problem of asymmetric information by enabling credible signaling to the market of one's private information regarding personal reliability and psychological commitment to repaying debts and thus one's lower risk. By agreeing to waive the discharge, the debtor could signal his commitment to repaying that debt, even if he might otherwise be able to discharge it in bankruptcy. Moreover, because this action would be costly to the debtor, it

253. Athreya, *supra* note 213, at 1569.

254. See generally Alan Schwartz, *Security Interests and Bankruptcy Priorities: A Review of the Current Theories*, 10 J. LEGAL STUD. 1 (1993) (discussing argument that secured credit is a similar signaling device).

would provide a credible signal that would be difficult to fake.²⁵⁵ As a result, the willingness to waive the bankruptcy discharge with respect to certain debts could allow more accurate pricing of loan terms in the market. Agreeing to waive the discharge would permit trustworthy debtors to reveal private information to the market about the reliability of their characters, while making it difficult for less-trustworthy debtors to do the same.

Historical justification for the primacy of the "no waiver" rule in American bankruptcy law is surprisingly thin. The development of a voluntary, mandatory, *and* highly-generous fresh start has existed only since the enactment of the 1978 Code, and even that commitment was scaled back by the 1984 amendments. As noted, BAPCPA conditions the generosity of the bankruptcy exemption still further. During the Nineteenth Century, bankruptcy backed by a fresh start was the exception rather than the rule, as state law was frequently invoked to permit a stay or reordering of consumer debts but not to permit a discharge. The purpose of the Federal Bankruptcy power in Article I, Section 8 of the U.S. Constitution was in part to increase the ability of creditors to collect on debts from out-of-state borrowers and to offset excessively pro-debtor state discharge laws, rather than to enlarge debtors' rights to a discharge.²⁵⁶ In fact, it remains unclear whether this provision of the Constitution even provided Congress with the power to enact laws governing consumer insolvency, as opposed to business bankruptcy.²⁵⁷ Moreover, the generosity of the current American bankruptcy system is unique not only in American history, but also in the world.²⁵⁸ European countries have far less-generous fresh-start policies

255. It may be objected that creditors could "force" debtors into waiving their discharge involuntarily. This objection, however, is not very plausible. First, as noted earlier, consumer credit markets today are extremely competitive, and consumers have the ability to shop among many different lenders offering many different terms. Second, unsecured creditors today could theoretically "force" debtors to give them a security interest for any loan made. In fact, lenders do not and cannot impose security interests on debtors, and there is no reason to believe that they will be any more successful in forcing debtors to waive their discharge.

256. See Todd J. Zywicki, *The Bankruptcy Clause*, in THE GUIDE TO THE CONSTITUTION (forthcoming 2005).

257. It has been argued that the use of the term "Bankruptcies" in the Constitution invoked a term of art from English law, which distinguished between "bankruptcy" proceedings involving merchant debtors on one hand, and consumer "insolvency" proceedings on the other. Unlike the former, "insolvency" proceedings generally did not result in a discharge of the individual debtor, but rather a repayment plan designed to enable the debtor to repay his debts and thereby avoid debtor's prison.

258. See Feibelman, *supra* note 88 (unpublished manuscript, on file with the author); Rafael Efrat, *Global Trends in Personal Bankruptcy*, 76 AM. BANKR. L.J. 81, 82-91 (2002) (discussing the prevalence of the fresh start policy globally). See generally Hung-Jen Want & Michelle J. White, *An Optimal Bankruptcy Procedure and Proposed Reforms*, 29 J. LEGAL STUDS. 255 (2000) (discussing an efficient or optimal bankruptcy model and proposing reforms

than does the United States, and countries such as Japan still less so. Thus, the mandatory, generous fresh start policy that characterizes current American bankruptcy law is anomalous in both American and world history, suggesting that it is worth considering either narrowing the fresh start (as described above) or eliminating its mandatory character.

The idiosyncratic character of America's current fresh start policy also raises doubts about the theoretical justifications that have been offered in defense of it. Tom Jackson, for instance, has explained the fresh start policy as a response to inherent limitations on individual cognition and borrower over-optimism.²⁵⁹ But if the justification rests in inherent limits on human foresight, it seems unlikely that American law would be unique in implicitly recognizing this fact in its bankruptcy laws. Even in the United States, it is difficult to see why the recognition of this fact would have taken over 200 years before the 1978 Code; even then, the expansive fresh start in the 1978 Code was quickly conditioned by the 1984 amendments that added the "substantial abuse" provision of Section 707(b).²⁶⁰ Instead, it would be expected that if the fresh start is justified by inherent psychological limits on human foresight, then presumably this aspect of human nature would have manifested itself in other legal systems around the world and at a much earlier date in the United States.²⁶¹ This circumstantial evidence suggests that Jackson's conclusion that the mandatory fresh-start policy is efficient in light of human cognitive limits is incorrect. Instead, the universal prevalence of a more restrictive fresh start policy, both in American history and throughout the world, actually implies the opposite, that America is unique and that the universally-adopted rule is likely to be more efficient than America's unique, outlier system.²⁶² Similar problems plague all other justifications for a mandatory fresh start policy, whether

to the bankruptcy code).

259. Thomas H. Jackson, *The Fresh-Start Policy in Bankruptcy Law*, 98 HARV. L. REV. 1393, 1394-95 (1985).

260. See SKEEL, *supra* note 20, at 187-97 (describing the lead up to the 1984 amendments).

261. See Zywicki, *Reciprocity Instinct*, *supra* note 157 (arguing that a universal characteristic of human nature and cognition should lead to the evolution of universal norms and legal rules).

262. See generally A.C. Pritchard & Todd J. Zywicki, *Finding the Constitution: An Economic Analysis of Tradition's Role in Constitutional Interpretation*, 77 N.C. L. REV. 409 (1999) (arguing that one can draw inferences of efficiency, consent, and wisdom from universal adoption of certain legal rules that evolve over long periods of time through decentralized processes). Indeed, one effect of the bankruptcy reform legislation would be to move the United States closer to the world norm regarding the scope of the bankruptcy discharge. See Todd J. Zywicki, *The Past, Present, and Future of Bankruptcy Law in America*, 101 MICH. L. REV. 2016, 2034-35 (2003) (noting that bankruptcy laws globally appear to be converging).

grounded in ethics,²⁶³ communitarianism,²⁶⁴ or traditional economic analysis.²⁶⁵ In each case, the effort to provide a universal justification for America's fresh start runs up against the fact that the recent American fresh start policy is simply idiosyncratic and presumably stands as an exception to any general theory of the bankruptcy discharge, rather than illustrating a general principle.

Given the absence of a compelling historical or theoretical justification for the current fresh start policy, the balance struck in the 1978 Code thus appears to be little more than conventional, based on a crude cost-benefit analysis and drawing on idiosyncratic elements of American history and political balances struck at the time.²⁶⁶ In other words, there is nothing "sacred" or inherently logical about the particular balance that American bankruptcy law struck at that time, and that balance should be subject to reassessment in light of changes in society, the economy, and new information. As I have noted elsewhere, the 1978 Code rests on a particular intellectual foundation about the causes of consumer bankruptcy filings.²⁶⁷ As such, it also contains implicit assumptions about the relative costs and benefits of the current fresh start policy. To the extent that model no longer accurately explains consumer bankruptcy filings, this also casts doubt on the cost-benefit analysis that justifies the current regime.

VII. Conclusion

Recent research has found that the rise in consumer bankruptcy filings over the past twenty-five years has been caused by an increasing propensity of households to file bankruptcy in response to financial shocks, rather than worsening household financial condition. This Article has offered a model of the consumer bankruptcy process that can explain these trends. Although the

263. See generally Peter C. Alexander, *With Apologies to C.S. Lewis: An Essay on Discharge and Forgiveness*, 9 J. BANKR. L. & PRAC. 601 (2000).

264. See DOUGLAS G. BAIRD ET AL., CASES, PROBLEMS, AND MATERIALS ON BANKRUPTCY 469–75 (3d ed. 2000) (discussing the rationale for the fresh start policy, particularly with reference to the effect of bankruptcy on the debtor's community).

265. See generally Nicholas L. Georgakopoulos, *Bankruptcy Law for Productivity*, 37 WAKE FOREST L. REV. 51 (2002).

266. Zywicki, *Past, Present, and Future*, *supra* note 262, at 2017; see also Todd J. Zywicki, Book Review, *Rescuing Business: The Making of Corporate Law in England and the United States*, 16 BANKR. DEV. J. 361, 362–63 (2000) (noting the political influences involved in the 1978 Code). See generally BRUCE G. CARRUTHERS & TERENCE C. HALLIDAY, *RESCUING BUSINESS: THE MAKING OF CORPORATE LAW IN ENGLAND AND THE UNITED STATES* (1998).

267. See Zywicki, *Economic Analysis*, *supra* note 1.

empirical evidence to support the model is still early in its development, it generally tends to support the model. More empirical research should be done.

This Article is the first word, not the last, in the effort to develop and test a model of the consumer bankruptcy process. Dramatic changes have transformed the consumer bankruptcy system over the past twenty-five years; nonetheless, the current system remains largely unaltered and unresponsive to this revolution. Most research for the past several decades has been designed around the traditional model of consumer bankruptcy. This Article calls for a new era in consumer bankruptcy scholarship that will help to understand the world we observe today, rather than that of the past.

The model proposed here has served as the animating model for the recently enacted bankruptcy reform legislation, dramatically amending the 1978 Bankruptcy Code, which was predicated on an older and no longer valid model of the individual bankruptcy filing decision. As times have changed, the Bankruptcy Code has also changed to meet the new challenges presented by the economy and culture of modern America.

NOTES
