BALLOONING BANKRUPTCIES

ISSUING BLAME FOR THE EXPLOSIVE GROWTH

by Vern McKinley

IN A PERIOD OF HISTORICALLY low unemployment and in the seventh year of economic expansion, the courts strain each year with a record number of consumer bankruptcies; a record 1.3 million are expected in 1997. Ninety-five percent of all bankruptcy filings are by consumers.

Who or what is to blame for the explosive growth is subject to debate. Michelle Cottle wrote in a *Washington Monthly* article titled "The Right to Default" in March 1997, "The lawyers blame the banks for making excess credit too obtainable; the banks blame the government for making filing too easy and the lawyers for being too quick to recommend bankruptcy . . . thus removing the stigma from financial bankruptcy."

Legislation in 1994 created a National Bankruptcy Review Commission (NBRC) that reported its findings on 20 October 1997. Congress will use the report as a starting point to overhaul the current bankruptcy code. Unfortunately, the Commission's recommendations, if enacted into law, would more likely make the current bankruptcy crisis even worse.

BANKRUPTCY: WHAT AND WHY

A record 1.1 million consumers filed for bankruptcy in 1996 (See Table 1), a whopping 29 percent jump from the nine hundred thousand filers in 1995. Preliminary data for 1997 has led many to predict yet another record year for bankruptcy filings, with approximately 1.3 million consumer filings expected.

Through the late 19th century, bankruptcy helped creditors collect debts pursuant to the Constitutional requirement that Congress establish "uniform Laws on the subject of Bankruptcies." The modern role of bankruptcy is to allow debtors who have no chance of paying off their debts to have a "fresh start." As Supreme Court Justice Sutherland stated in the 1934 *Local Loan Company v. Hunt* decision, bankruptcy should "relieve the honest debtor from the weight of oppressive indebtedness and permit him to start afresh."

From the debtor's standpoint, the prerequisites to bankruptcy are few, as insolvency is not even required. Alternatively, the relief available from the fresh start is extraordinary. A "discharge," which releases a debtor from the legal obligation to pay debts, implements the fresh start. But discharge should be recognized for what it is, at least in the short run: a transfer of wealth from creditors to debtors. If the discharge feature were not enough to attract filers, an "automatic stay" allows a debtor to put all debts on hold throughout the bankruptcy process.

Table 1

Number of Consumer Filings Per Year

1940 - 39,329	1955 - 50,219	1970 - 178,202	1985 - 341,233
1941 - 44,713	1956 - 52,608	1971 - 182,249	1986 - 449,203
1942 - 24,853	1957 - 63,617	1972 - 164,737	1987 - 495,553
1943 - 13,604	1958 - 80,265	1973 - 155,707	1988 - 549,612
1944 - 10,081	1959 - 88,943	1974 - 168,766	1989 - 616,226
1945 - 8,385	1960 - 97,750	1975 - 224,354	1990 - 718,107
1946 - 11,540	1961 - 131,402	1976 - 211,348	1991 - 872,438
1947 - 15,574	1962 - 132,125	1977 - 182,210	1992 - 900,874
1948 - 21,048	1963 - 139,190	1978 - 172,423	1993 - 812,898
1949 - 26,515	1964 - 155,209	1979 - 196,976	1994 - 780,455
1950 - 25,040	1965 - 163,413	1980 - 287,469	1995 - 874,462
1951 - 27,806	1966 - 175,924	1981 - 315,833	1996 - 1,125,006
1952 - 28,331	1967 - 191,729	1982 - 311,045	1997 - 1,300,000(est.)
1953 - 33,315	1968 - 181,266	1983 - 286,469	
1954 - 44,248	1969 - 169,500	1984 - 284,307	

Source: U.S. Administrative Office of the Courts.

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Table 2

Major Reasons for Bankruptcy Filing

Credit card bills - 63%	Lawsuit/legal bills - 12%
Job loss/cut in pay - 50%	Taxes - 10%
Mismanagement of personal finances - 37%	College expenses - 8%
Medical bills - 28%	Death in family - 7%
Difficulty with business - 15%	Gambling - 2%
Divorce/marital breakup - 13%	

Source: Christine Dugas, "Bankruptcy Stigma Lessens," USA Today, June 10, 1997, B1 (Conducted by Gallup Polling).

Finally, even if a debtor has filed for bankruptcy previously, it does not generally preclude a repeat filing, so long as six years have passed since the last discharge was granted.

A filer can even choose the most attractive filing option. Roughly 70 percent of filers choose Chapter 7, the "liquidation" chapter. It allows consumers to walk away from their debts in a relatively short period of time, often within a few months. Chapter 7 contains no requirement for committing future income to pay creditors. The debtor is required only to offer assets not exempted under federal laws or under the laws of states that opt for their own exemption levels, to pay back creditors. Exemptions essentially allow select assets to be ignored or shielded during bankruptcy. A 1994 GAO report, "Bankruptcy Administration," notes that in 95 percent of Chapter 7 cases, no assets are sold. That is due to either generous state laws shielding debtor's assets or a paucity of assets held by the debtor. As a result, the creditors that suffer the largest direct losses under Chapter 7 are unsecured creditors, such as credit card companies.

Exemptions vary dramatically among the individual states. For example, an individual filer in Texas can shield unlimited amounts of equity in a home and value in a vehicle of up to $60,000; but, a filer in Ohio can only shield $5,000 of equity in a home and value in a vehicle of up to $1,000. Thus, a Chapter 7 liquidation for a debtor under federal law in one state may not mean the same in another and the attractiveness of filing varies accordingly. As a result of those and other differences in state law, the percentage of households filing per year varies greatly from state to state, ranging from 0.5 percent in Alaska to 2.2 percent in Tennessee.

The other bankruptcy alternative, Chapter 13, chosen by 30 percent of filers, allows for "adjustment of debts of an individual with regular income." A debtor choosing to file under Chapter 13 is put on a plan to pay off as much in outstanding debts as possible over a period that lasts between three to five years. In contrast to Chapter 7, Chapter 13 allows debtors to shelter assets from creditors. All creditors, especially unsecured creditors, are more likely to receive more under Chapter 13 than under Chapter 7, since the amount paid back under Chapter 7 acts as a floor on what will be paid back in Chapter 13. Debtors usually choose Chapter 13 because they do not want to liquidate their assets valued above the amount protected by state law exemptions. Only under extraordinary circumstances, where "granting of relief would be a substantial abuse," is a debtor prohibited from receiving a discharge under Chapter 7. However, the debtor may still be allowed to file under Chapter 13, if eligible.

WHY THE FILE

The substantial abuse standard has been applied, for example, to dismiss the filing in 1992 in Colorado by television sportscaster Michael Nolan who was earning $172,000 per year and maintained condominiums in Denver and Avon. It was used to reject the filing in 1992 in New Mexico of Steve Traub, an oral surgeon earning $228,000 per year who enjoyed regular ski trips to Telluride and Taos. It was used to dismiss the filing in 1994 in North Carolina of Eric Dominguez, a recent Harvard medical school graduate just beginning his residency. Finally, it was utilized in 1990 in South Dakota to dismiss the case of debtors Ronald and Rhonda Harris who were capable of paying back 156 percent of their unsecured debt over three years if they were placed under a Chapter 13 plan.

However, in Pennsylvania in 1988, a dismissal was denied for Chapter 7 debtors Robert and Joyce Latimer who had mortgage payments of $1,640 per month, sent their children to private schools, and rented a Mercedes. In practice, the courts have applied the substantial abuse standard inconsistently. They have also applied it infrequently because only the court or trustee, rather than a creditor, can make such a motion.

One way to determine why bankruptcy has skyrocketed recently is simply to ask individuals why they filed. A 1997 Gallup poll allowed respondents to give more than one reason (see Table 2). Alternatively, a Visa Bankruptcy Debtor Survey, published in 1997, allowed only one response and came up with very different results (see Table 3).

Table 3

What Was the Main Reason You Had to File Bankruptcy?

Over extended - 29.2%	Medical/Health - 14.7%
Other - 26.2%	Divorce/Separation - 10.6%
Unemployment - 14.9%	Taxes - 3.1%

Source: Visa, Consumer Bankruptcy: Annual Bankruptcy Debtor Survey, August 1997, p. 13.

RECESSIONS, RECOVERIES AND BANKRUPTCY

A major reason cited for filing bankruptcy is the loss of a job or a cut in pay. The fact that there was a record number of bankruptcy filings for 1996 and even higher levels are expected in 1997 during a lengthy economic recovery is counterintuitive. One might expect that when economic times are bad, filings would rise and when economic times are good, filings would fall. Prior to the last major overhaul of the bankruptcy laws—the Bankruptcy Reform Act of 1978—large increases in consumer filings generally accompanied economic downturns. For example, during the twenty years prior to the implementation of the 1978 Act, every time consumer filing rates increased by more than 15 percent in a single year, the economy was in the midst of a recession. But the pattern changed after the 1978 Act when consumer filings became more attractive. As the economy entered into recessions in 1980 and 1990, the rate of filings increased over prior years (see Table 4). Then in 1982 and 1993, as the economy neared the end of the recessions and entered into recovery, the number of filings actually declined. That might be attributed to the tightening of credit during the recessions. However, well into the recovery, consumers apparently became more confident and took on more debt, resulting in a dramatic increase in filings, ultimately to record levels. In 1986, four years into recovery, filings rocketed up by 32 percent. In 1996, five years into recovery, filings rose by nearly 30 percent. The pattern suggests that another recession could produce a truly staggering number of filings. It further suggests that bankruptcy now has almost nothing to do with bailing people out of economic hardship when the general economy goes sour and almost everything to do with letting people quickly and easily out of their debts, especially during good economic times.

Table 4

Year-to-Year Change in Consumer Bankruptcy Filings Since 1978 Bankruptcy Legislation

Year	Percentage Change in Filings	Point in the Business Cycle From Table 4
1979	14%	Late Recovery
1980	46%	Recession (N)
1981	10%	Recession (N)
1982	<2%>	Recession
1983	<8%>	Early Recovery
1984	<1%>	Early Recovery
1985	20%	Mature Recovery (N)
1986	32%	Mature Recovery (N)
1987	10%	Late Recovery (N)
1988	11%	Late Recovery (N)
1989	12%	Late Recovery (N)
1990	17%	Recession (N)
1991	21%	Recession (N)
1992	3%	Early Recovery (N)
1993	<10%>	Early Recovery
1994	<4%>	Early Recovery
1995	12%	Mature Recovery
1996	29%	Mature Recovery (N)

(N)=New Record Level of Filings

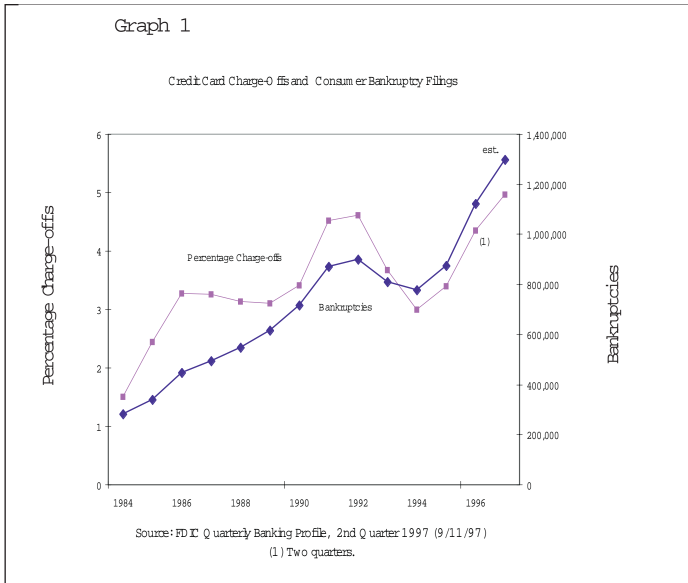
Source: Data on bankruptcy filings is from the Administrative Office of the Courts. Data on business cycle activity is from the arbiter of the business cycle, the National Bureau of Economic Research .

MEDICAL BILLS AND DIVORCE

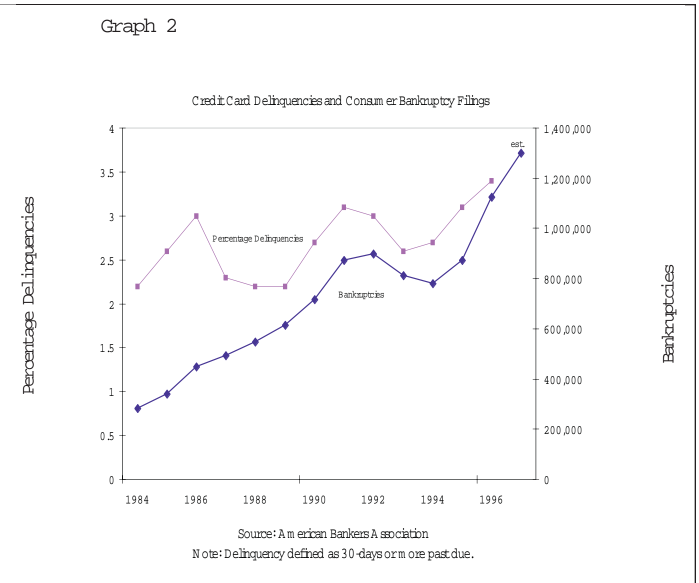
Another major reason cited for filing for bankruptcy is large medical bills. A 1997 study by Ian Domowitz and Robert L. Sartain, "Determinants of the Consumer Bankruptcy Decision," found that households with medical debt in excess of 2 percent of income were twenty-eight times more likely to file than an average household. However, the impact of medical debt on the total number of filings was not large; only 1.6 percent of the sample had medical debt in excess of 2 percent of income. That figure might understate the impact of medical problems manifesting themselves in other ways, such as unemployment or underemployment, legal expenses related to accidents, or credit card debt not reflected as purely medical debt. Such deviations may explain the higher percentage of responses in the previously-cited polls attributing their financial problems to medical debt.

It might seem that those with large medical bills are just the sort of victims of unforeseen circumstances that bankruptcy provisions are meant to help. But did individuals who were fully capable of purchasing medical insurance before an emergency or illness fail to do so through negligence or an "it can't happen to me" attitude? Further, a bankruptcy system that invites such negligence, in the end, simply will shift medical expenses to hospitals, other health care providers and ultimately, consumers. Since such a large portion of medical bills is paid by third party providers, health care consumers have little incentive to contain health care costs, leading to enormous debts for the uninsured or underinsured. Fixing the system is important, but will only make a small dent in the bankruptcy rate.

About 13 percent of respondents in the Gallup poll listed divorce as one of the major reasons for bankruptcy, and nearly 11 percent of the respondents in the Visa survey listed it as the major reason. Divorce often leaves one partner with a dispro-



Source: FDIC Quarterly Banking Profile, 2nd Quarter 1997 (9/11/97)
(1) Two quarters.



Source: American Bankers Association
Note: Delinquency defined as 30-days or more past due.

portionate amount of debt compared the ability to repay. But it is not likely the cause of the recent surge in filings since the early 1980s. Although the divorce rate rose steadily throughout the 1960s and 1970s to a peak rate of 5.3 per thousand, it has flattened out through the 1980s and 1990s at a level of less than 5.0 per thousand.

EASY ACCESS TO CREDIT CARDS

In the Gallup survey, credit card debt was identified by the largest proportion of filers—63 percent—as a primary reason for bankruptcy. Of course, being in debt is a necessary condition for filing bankruptcy. But there seems to be a strong statistical relationship between credit card debt and the recent increase in bankruptcy filings. For example, credit card companies write off loans each year that they judge to be uncollectible. As the charge-off rate on credit cards drifted upward throughout the 1980s, so too did the number of personal bankruptcy filings (see Graph 1). As the loss rate peaked in the early 1990s during the recession and then drifted downward during the early parts of the current economic recovery, so too did the number of bankruptcy filings. Finally, as the loss rate began to rise again over the past three years, the number of bankruptcies also began an equivalently dramatic rise.

A closely-related statistic, delinquency rates on credit cards, also has tracked with bankruptcy filings, drifting upward to a peak in the recession in the early 1990s, and reaching new highs during the current expansion (Graph 2).

Concomitant with the run-up in the number of bankruptcies has been an increase in the number of credit card solicitations. (See Table 5).

Finally, the Domowitz and Sartain study found that if a household reaches the level of credit card debt as a percentage of income of the average Chapter 7 filer, that household will be six times more likely to file. If it reaches the level of credit card debt as a percentage of income as the average Chapter 13 filer, that household will be five times more likely to file.

Table 5

Credit Card Solicitations (in billions)

1990 - 1.117	1994 - 2.406
1991 - 0.989	1995 - 2.698
1992 - 0.916	1996 - 2.383
1993 - 1.523	1997 - 3.000

Source: Behavior Analysis, Inc., Tarrytown, New York. Earlier data not collected.

CREDIT CARD CULPRITS

A February, 1997 report by Stephen Brobeck for the Consumer Federation of America entitled "The Consumer Impacts of Expanding Credit Card Debt," directly places the blame for the recent increase in bankruptcies on "aggressive credit card marketing by issuers, chiefly banks, who have increasingly been targeting low and moderate income households." The Consumer Federation report also belittles consumers from lower-income groups for having "poor money management skills" and criticizes consumers generally as having "difficulty managing their finances competently . . . [as] they spend beyond their means and fail to accumulate savings to cover unexpected expenses or income loss." However, the report opposes changes in bankruptcy laws that would require consumers to pay back their accumulated debts. For example, it denounces limits on the use of Chapter 7 as "punitive and unnecessary."

The Consumer Federation's answer to that perceived problem is for credit card companies to voluntarily offer credit cards only to households with a "reasonable" ratio of total

credit lines to total income, which they would set at 20 percent. For example, if a household has income of $40,000, it would be allowed total credit lines of no more than $8,000. The Consumer Federation also wants companies to educate consumers in the prudent use of credit cards. If the voluntary approach does not work, the Consumer Federation urges lawmakers to "compel responsible marketing and granting of credit by issuers."

The legislative approach would have the government in effect dictate to consumers how to make their credit decisions. But all users of credit cards are not alike. People of different ages and lifestyles use cards in dramatically different ways. Some use their cards only for convenience, some pay only their minimum balance each month and allow their balance to grow, and others are somewhere in between. The Consumer Federation's one-size-fits-all formula does not take into account the individualized circumstances of consumers; it instead acts as a credit allocation device by squelching market signals that indicate where credit is needed.

THE CONSUMER FEDERATION URGES LAWMAKERS TO "COMPEL RESPONSIBLE MARKETING AND GRANTING OF CREDIT BY ISSUERS."

The expansion of credit availability to lower-income households is a positive development. Ironically, the Consumer Federation that would limit availability of credit cards to lower-income households supports tougher enforcement of fair lending laws and the Community Reinvestment Act as a means to require financial institutions to increase lower-income lending.

The only party that should be making decisions regarding how many credit cards to have, how much in credit limits to maintain, how much to charge every month, and how much to pay when the monthly statement arrives is each individual consumer, limited only by a financial institution's willingness to supply such credit. As former Federal Reserve Governor Lawrence Lindsey noted in testimony before the House Committee on Banking and Financial Services, "Individuals know their circumstances far better than any government official."

CARELESS CREDIT CARD COMPANIES?

The Consumer Federation also chides credit card companies for not "carrying out their historic role of allocating credit on the basis of risk assessment," and claims that "[c]reditors could very easily lower credit card charge-offs and personal bankruptcies by extending credit more prudently." However, an analysis of the level of charge-offs is incomplete, as it only focuses on the costs of this comparatively riskier lending, while ignoring the higher income from such lending. Banks that specialize in credit card lending are much more profitable, as such institutions have a return on assets approaching 2 percent, while the return for all insured institutions is roughly 1.2 percent.

Credit card companies currently use a system called "credit scoring" to allocate credit. Although not perfect, it takes into account the individual circumstances of the borrower. The use of any mandated formula-based system that does not take individual circumstances into account will surely misallocate credit among consumers.

Credit card companies have difficulty gauging the consumers most likely to declare bankruptcy. In fact, they currently face a phenomenon known as "surprise" bankruptcies: filings by debtors who are rarely or never late on loan payments and do not seem to have liquidity problems. The surprise filings may be occurring because consumers cannot pass up the good deal offered through bankruptcy.

Recent evidence shows that a market reaction to the nonmarket option of bankruptcy has taken hold and that lenders are tightening consumer credit standards, in particular for credit card lending. The Federal Reserve Board periodically publishes a *Senior Loan Officer Opinion Survey* on bank lending practices. The last seven quarterly surveys reflect a tightening of consumer credit, with an indication that this sector is as tight as it was in the 1981-82 recession. Over 70 percent of the large banks surveyed in the May, 1997 report had tightened standards for new credit card accounts over the preceding three months and 50 percent of those respondents expected charge-off rates for consumer loans to go up over the remainder of the year, with the increased willingness to declare bankruptcy being the single greatest reason for the expectation.

Another indicator of increased tightening is the level of credit card solicitations. After dramatically rising from 1992 to 1995, the number of solicitations for credit cards dropped by 12 percent from 1995 to 1996 and now appears to be leveling off at a more sustainable level. The easy availability of bankruptcy and uncertainty about who will declare it has forced credit card companies to limit lending to marginal risks who might otherwise receive credit.

WHO PAYS THE PRICE?

According to MasterCard, credit card losses from consumer bankruptcy totaled $7.4 billion for 1996, while Visa estimates the figure at $11.3 billion for 1996. However, those estimates are overstated. The bankruptcy process itself should be blamed only for the marginal losses that occur because of the availability of the bankruptcy option. The figures include all the losses resulting from those filings, many of which would occur even without the availability of bankruptcy.

Whatever the cost figures should be, MasterCard argues that they are passed along to good credit risks in the form of higher interest rates and fees. Although MasterCard does not publicize it, shareholders of credit card companies also share in the costs, as evidenced by recent losses suffered by large credit card companies like Advanta Corporation.

CHANGING SOCIAL MORES

Beyond the direct causes cited by filers, Visa has cited a decline in the stigma associated with bankruptcy as a reason for increased filings. As a result, consumers with debt problems are

more willing to file bankruptcy, even at the risk of having friends, relatives and acquaintances find out about the filing. It is difficult to directly measure this declining stigma. But one indicator is the sheer number of people filing as there have been ten million filings over the past twenty years. A Gallup poll found that 51 percent of filers had a close friend or relative who filed bankruptcy. Consistent with that evidence, the Visa survey found that 45 percent of filers learned about bankruptcy from friends or family. That survey also discovered that 66 percent of filers found the bankruptcy process an easy one.

Another indicator of a decreased stigma is the willingness to file bankruptcy more than once. That group makes up roughly 10 percent of filers, with some filing as many as ten times. The Visa survey found that 27 percent of respondents would consider filing again. Additionally, in a Visa report entitled Qualitative Research: Bankruptcy Process, published in April 1997, several filers responded that if they knew how easy a process filing was they would have done it much sooner. So if potential filers know someone who has filed and they're told the process is an easy one, then many stigmatic barriers may be dramatically reduced, leading many to file more than once.

SEVERAL FILERS RESPONDED THAT IF THEY KNEW HOW EASY A PROCESS FILING WAS THEY WOULD HAVE DONE IT MUCH SOONER.

THE LAWYER'S ROLE

Attorneys who specialize in bankruptcies also contribute to the decrease in social stigma associated with filing. The Visa survey found that about 24 percent of respondents learned directly from an attorney about the bankruptcy option, and another 19 percent learned from an advertisement, many of which are placed by attorneys. As summarized by Charles A. Luckett in a September 1988 Federal Reserve Bulletin article, "Personal Bankruptcies," advertising by attorneys "helps create a climate in which the declaration of bankruptcy is more readily seen as a legitimate response to financial distress."

Further, coinciding with the increase in bankruptcy rates and the 1978 bankruptcy legislation was a 1977 Supreme Court case that protected advertising by attorneys as commercial speech under the First Amendment. Prior to that time, many states, under the guise of their individual state bar disciplinary rules, forbade most types of lawyer advertising.

Thus there are few ethical or financial reasons refraining attorneys from advising to file for bankruptcy. Existing financial incentives actually encourage a high-volume, full-time bankruptcy practice. For example, Jean Braucher in the piece "Lawyers and Consumer Bankruptcy: One Code, Many Cultures," in the *American Bankruptcy Law Journal* in 1993, estimates that a standard bankruptcy filing will generate about $800-$1000 for an attorney in a larger city. Also found was that a full-time bankruptcy attorney does about thirty filings a month, with some attorneys having as many as sixty per month. Thus annual fees generated by such a practice can easily reach $300,000, with upwards of $600,000 well within reason.

Attorneys are not the only ones profiting from bankruptcy. An estimate for one district in California by Honorable Geraldine Mund in her article "Paralegals: The Good, The Bad and the Ugly," in *American Bankruptcy Institute Law Review* in 1994 revealed that of 51,500 filings during a recent year, 48 percent were prepared by attorneys and 38 percent were prepared by the debtor without any assistance at all. But the remaining 14 percent were filed with the assistance of a paralegal who was not a licensed attorney. Obviously, other bankruptcy facilitators, paralegals and nonparalegals, would like a part of the market. Competitive pressures, which ultimately manifest themselves in social pressures by bankruptcy service providers (lawyers and nonlawyers alike), bias the system toward higher filings.

The organized bar, holding a government-enforced monopoly on the practice of law in forty-nine states, has not taken kindly to competition for fees. They refer to it as the unauthorized practice of law (see *Regulation,* Winter 1997). The backlash was manifested in amendments in 1994 to the federal bankruptcy Code, creating a section entitled "Penalty for persons who negligently or fraudulently prepare bankruptcy petitions." The provision, which only applies to preparers who are not attorneys or are not employees of an attorney, extensively regulates nonattorney providers of bankruptcy services and even requires disclosure of all fees received. The court can confiscate any fee it finds "excessive," a clear effort to impose price controls on bankruptcy services. Fines of up to $500 are levied against violators of any of the section's provisions.

CHANGES IN DEMOGRAPHICS

There is also evidence that changing demographics and the aging of the baby boom generation have contributed to the recent increases in bankruptcy filings by increasing the pool of potential bankruptcy filers. According to Donald P. Morgan and Ian Toll in "Bad Debt Rising," published in the March 1997 Federal Reserve Bank of New York, *Current Issues in Economics and Finance*, the prime years for bankruptcy filing are the peak borrowing years of age 24 to age 54. As the baby boom generation has entered that age range the last thirty years, the percentage of the American population in the category has increased from 34 percent to 44 percent (see Table 6).

CHANGES IN LEGISLATION

A clear culprit of the rise in bankruptcies is the Bankruptcy Reform Act of 1978 that moved the Code in a decidedly prodebtor direction as part of the "consumer" movement of that period. For the twenty years prior to the implementation of the 1978 Act, a timeframe during which three economic recessions occurred, bankruptcies trended upward from roughly one hundred thousand filings per year to about two hundred thousand filings per year, a yearly rate of increase of less than 5 percent per year. For the nearly twenty years since the 1978 Act, also a timeframe during which three economic recessions

occurred, bankruptcies trended dramatically upward from two hundred thousand filings per year to 1.1 million filings per year, nearly a 12 percent rate of increase.

Even the Clinton Administration's most recent 1997 Economic Report of the President acknowledges, "[t]he recent rise in nonbusiness bankruptcies is probably the result of changes in bankruptcy law and a number of broader social changes." It further recognizes that "[r]esearchers generally attribute much of the increase in bankruptcies since the late 1970s to effects of the Bankruptcy Reform Act of 1978."

Table 6

Percentage of U.S. Population Aged 25 to 54

1967 - 34.1%	1977 - 36.0%	1987 - 40.6%
1968 - 34.2%	1978 - 36.3%	1988 - 41.1%
1969 - 34.2%	1979 - 36.6%	1989 - 41.6%
1970 - 34.2%	1980 - 37.0%	1990 - 42.1%
1971 - 34.1%	1981 - 37.4%	1991 - 42.4%
1972 - 34.3%	1982 - 37.8%	1992 - 42.6%
1973 - 34.7%	1983 - 38.3%	1993 - 42.9%
1974 - 35.1%	1984 - 38.9%	1994 - 43.1%
1975 - 35.4%	1985 - 39.4%	1995 - 43.2%
1976 - 35.7%	1986 - 40.1%	1996 - 43.5%

Source: Donald P. Morgan and Ian Toll, "Bad Debt Rising," Federal Reserve Bank of New York, *Current Issues in Economics and Finance*, March 1997, p. 3.

NATIONAL BANKRUPTCY REVIEW COMMISSION

The Bankruptcy Reform Act of 1994 established the National Bankruptcy Review Committee (NBRC), which on 20 October 1997 submitted its report on the bankruptcy problem. Currently, individual states can opt out of the current system of federal exemptions. The NBRC recommends the elimination of that option. In the opt out states where exemption levels are currently lower than the federal minimum, there would be an increased incentive to file under the NBRC recommendations.

Currently, student loans insured or guaranteed by a governmental unit within the first seven years that it comes due are considered exceptions to discharge. The public policy justification for that exception is obvious. One should not be allowed to become highly educated by borrowing money from a federal program, and then file bankruptcy and discharge the obligation leaving taxpayers to pick up the tab. The NBRC proposes to eliminate that exception, arguing that, "a debtor overloaded with consumer debts incurred to buy a car, a vacation or a pizza can resort to bankruptcy but a debtor who borrows to pay tuition and books cannot." However, the logical way to level the playing field for discharging of debts is to make it more difficult to discharge loans for "a car, a vacation or a pizza." It does not take a great deal of imagination to conjure up images of lawyers placing ads in the yellow pages or local newspaper asking, "Student loans got you down? We can make them go away!"

The NBRC was given a clear opportunity to make proposals that would bring the number of bankruptcies under control. But it failed miserably by making proposals that at best will not alter the current rate of increase of bankruptcy filings, and at worst will cause the rate to increase.

PINPOINTING THE CAUSE

A number of interconnected forces have driven up the number of bankruptcy filings. But the underlying cause is a legal structure, culminated in the Bankruptcy Reform Act of 1978, that treats the act of escaping from debts freely entered into as an entitlement. Chicago bankruptcy attorney David Mucklow highlighted that fact well when he observed, "I get so many people who call and they think bankruptcy is a government-sponsored program to get rid of your debts. People are sometimes surprised that you do have to pay for secured items like cars and appliances, TVs and stereo equipment, if you want to keep those items. They appear to be shocked."

The many other supposed "causes" of bankruptcy clearly rest on the underlying statute. For example, encouragement from friends or relatives familiar with the bankruptcy process or attorneys specializing in bankruptcy would mean little if the choice to file was not such an attractive and lucrative one. Easy access to credit cards that many "consumer" groups decry would also mean nothing were it not for a legal structure that makes irresponsible handling of personal finances a nearly painless problem. The market process whereby consumers obtain credit should not be tainted by the nonmarket option of allowing debtors to escape all their debts by filing for bankruptcy.

The changing demographics that have caused an increase in the pool of potential filers may have caused an increase in the sheer number of people experiencing financial distress. But, the fact that a phenomenon such as the "prime age for filing" exists is troubling, and it is attributable to the underlying legal structure. An entire generation has matured under a legal regime that permits consumers of a certain age to engage in an orgy of consumption fueled by excessive assumption of debt followed by a quick and easy trip to the bankruptcy court.

CHANGING THE CODE

The underlying justification for granting Congress the Constitutional power to establish a system of bankruptcy laws was to assist creditors in collecting debts from interstate and international merchants. The primary purpose of the current system of bankruptcy laws is for consumers to claim an entitlement to be free of their debts.

One step to restore the system to its original purpose would require filers to offer both their assets and future income to

pay back their debts. The current system which makes assets available to pay debts under Chapter 7 and makes future income available to pay debts under Chapter 13 is arbitrary and unjustifiable. Another step would be for Congress to provide the debtor a brief stay to reorganize assets and debts with only a small federal exemption mandated on all states. The present patchwork of exemptions that varies among the States violates the Constitution's Bankruptcy Clause, since it does not provide for uniform laws of bankruptcy. Furthermore, any State exemption above the federal minimum impedes the collection of debts in interstate commerce. Congress has the power to regulate that collection under the Commerce Clause.

Yet another step would be to strictly limit or even eliminate the current option for consumers of Chapter 7 liquidation. That choice makes sense in the context of a business debtor where all assets are gathered and liquidated, all proceeds are used to pay off outstanding liabilities, and the business ceases to exist. But, it makes little sense in the context of a consumer debtor.

All consumer debtors should commit to a plan pledging at least some of their future income and some of their current assets to repaying their creditors. If the consumer debtor expects no income over the ensuing five years (for example, because of a debilitating injury or illness), and has no assets to liquidate, then, and only then, should a discharge be considered. That is simply a recognition of economic reality; the lending industry expects that some debts will not be repaid. Because bankruptcy would largely become an exercise in financial planning, nonattorney providers, such as accountants and financial planners, should be allowed to prepare bankruptcy plans, similar to the way tax advice is currently available.

Even under those stricter limits, discharge should be limited to once in a lifetime. The justification for bankruptcy is that individuals who overestimated their ability to pay back their debts should have a fresh start. It dilutes the notion of a fresh start to repeatedly offer the same option to persons who have already been through the process. The fact that 10 percent of filers did not learn the first time around that they must be responsible for their finances reveals the extensive abuse of the current bankruptcy system.

The current system of bankruptcy laws hurts consumers in many ways. The recent increase in filings has made lenders more hesitant to extend credit, especially to marginal credit risks. A share of the costs of bankruptcy is passed along to other users of credit cards, although not to the extent the credit card companies argue. If filing bankruptcy were not such an easy choice, credit would be more readily available, at a lower cost.

Unfortunately, it appears that the NBRC—given the task of sorting through the various contributing factors to the dramatic increases in filings—has turned a blind eye to the current code's evident problems. The recommendations of the NBRC, if implemented by the Congress, would likely increase the number of filings. Congress should instead ignore the findings of the NBRC and independently make the necessary changes to bring mounting bankruptcy filings and their adverse impact upon consumers to a close.

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