

“Opportunistic” debtors appear to have little to fear from the 2005 bankruptcy reforms.

Abuse or Protection?

BY MICHELLE J. WHITE
University of California, San Diego



LAST FALL, AFTER YEARS OF EFFORT AND more than \$100 million in lobbying expenditures by the large credit card lenders, Congress passed the “Bankruptcy Abuse Prevention and Consumer Protection Act of 2005” (BAPCPA). The new bankruptcy law followed years of rapid increases in the number of bankruptcy filings — from 341,000 in 1985 to 1,263,000 in 1997 (when the earliest predecessor to BAPCPA was introduced in Congress), to more than 1.5 million per year in the years before BAPCPA went into effect. (See Table 1.)

U.S. bankruptcy law was very debtor-friendly prior to BAPCPA. It has become much more pro-creditor today.

It is not surprising that personal bankruptcy law is controversial. Bankruptcy balances the conflicting objectives of helping debtors in financial distress and promoting credit availability by protecting creditors. Bankruptcy law provides debtors with consumption insurance by discharging some or all of their debts when their ability to pay falters. This increases debtors’ minimum consumption levels by allowing them to use funds for consumption that would otherwise go to repayment.

Preventing debtors’ consumption from drastically falling is economically worthwhile because illnesses can turn into disabilities if debtors cannot pay for medical care, debtors and their families may become homeless if they cannot pay rent, and debtors’ children may drop out of school in order to work, leading to lower earnings as adults. Debtors may also require charity or public assistance.

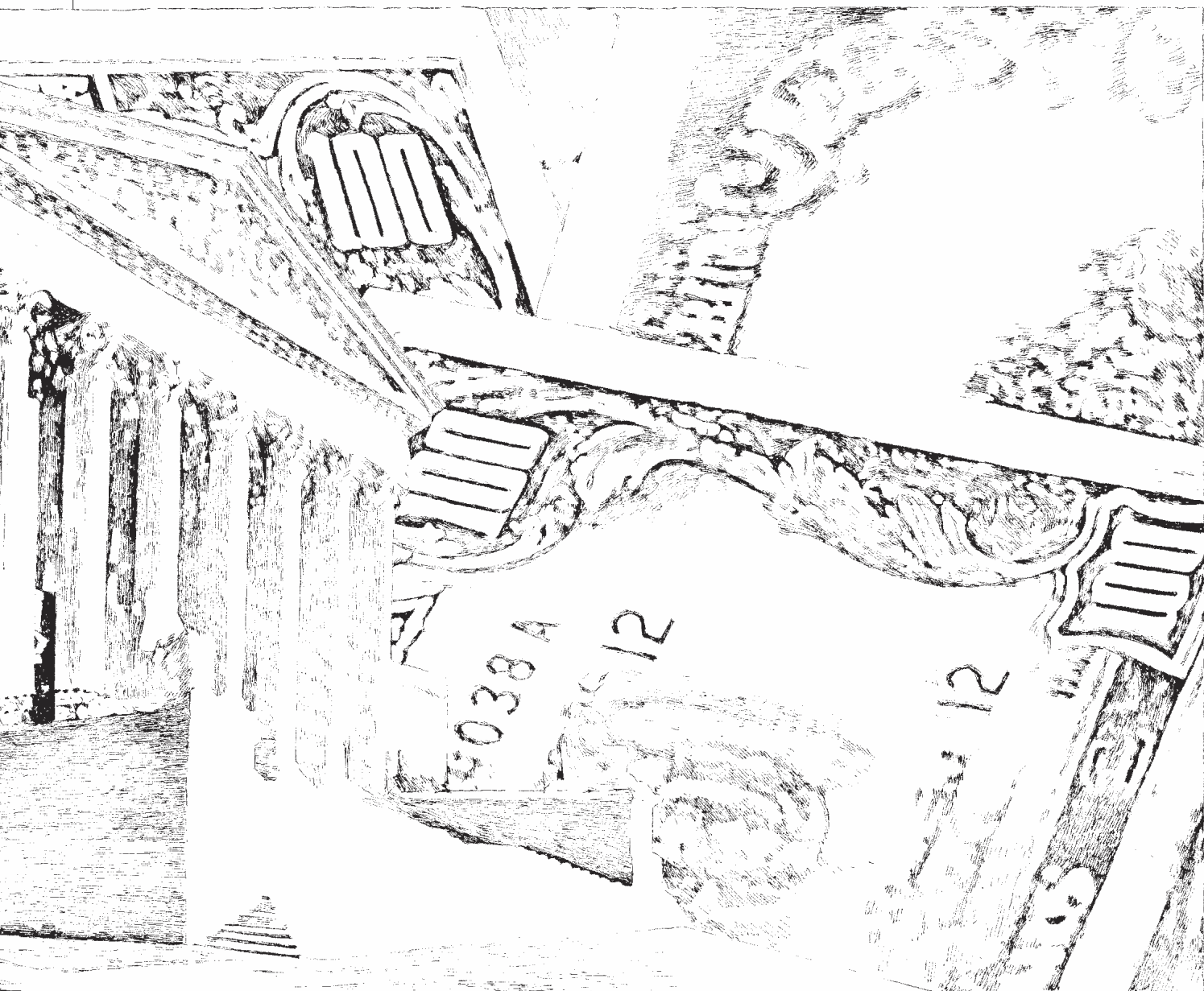
However, providing consumption insurance also has costs. Credit availability falls, debtors who repay bear higher interest rates when default rates are higher, debtors may work less because the consequences of job loss or business failure are not

as bad, and debtors may file for bankruptcy even when they have not experienced any reduction in consumption. The obligation to repay in bankruptcy and state-sanctioned procedures for enforcing it are intended to reduce those costs.

Suppose debtors who file for bankruptcy are divided into two groups: opportunists and non-opportunists. Non-opportunists who borrow intend to repay their debts and they borrow an amount that they normally could repay. They file for bankruptcy only if they experience a drop in their incomes or some other hardship — they are the people for whom bankruptcy debt relief was intended. Opportunists, in contrast, plan in advance to maximize their gains from bankruptcy. They often have high incomes and borrow as much as possible. They may have substantial assets, but they shelter the assets from the obligation to repay. They file for bankruptcy even though they have not experienced any drop in their incomes. Famous examples of opportunistic bankrupts include the actor Burt Reynolds (who had \$10 million in debt discharged while keeping a \$2 million house), corporate raider Paul Bilzerian (who kept a 38,000 square foot house in bankruptcy), actress Kim Basinger, rapper MC Hammer, and boxer Mike Tyson.

In reality, many debtors are a mixture of both types. For example, optimistic debtors may borrow amounts that they can only repay if they are promoted, when in fact they are in occupations where promotions are rare. Or they may lose their jobs and borrow to support consumption while they search for a new job. If the job search lasts a long time, they may end up in bankruptcy because they accumulate more debt than they can repay.

Michelle J. White is professor of economics at the University of California, San Diego and research associate for NBER. She may be contacted by e-mail at miwhite@ucsd.edu.



The large credit card lenders and their supporters in Congress justified BAPCPA on the grounds that many bankruptcy filers are opportunists. For example, Rep. George W. Gekas (R-Pa.), who introduced the 1998 legislation, claimed, “The bankruptcy crisis is endemic.... Bankruptcy has become a way for reckless spenders to escape their debts.” Senate Majority Leader Bill Frist (R-Tenn.) argued, “Bankruptcy is for those who need help, not those who want to shift costs to other hardworking Americans.... This legislation restores personal responsibility and fairness to an abused system.” To back up those arguments, the credit card lenders financed several studies that concluded that a substantial minority of bankruptcy filers could afford to repay most of their unsecured debt.

Although BAPCPA was sold on the grounds that it would discourage opportunism, I argue here that it will mainly affect non-opportunistic debtors. Many of them will find themselves unable to file for bankruptcy even when their incomes have declined substantially and they cannot repay any of their debt.

BANKRUPTCY PRE-BAPCPA

Under bankruptcy law before BAPCPA, there were two separate bankruptcy procedures, Chapters 7 and 13, and debtors were allowed to choose between them. Under Chapter 7, debtors were obliged to repay only from wealth above an exemption level, while post-bankruptcy income was entirely exempt. Under Chapter 13, debtors were obliged to use part of their post-bankruptcy income to repay, but their wealth was entirely exempt. Most unsecured debts were discharged under both procedures.

The peculiar feature of U.S. bankruptcy law that either income or wealth was entirely exempt made filing for bankruptcy very favorable for debtors because they could choose to repay from whichever source they did not have. Even if debtors had both non-exempt wealth and non-exempt income, they could often convert their non-exempt wealth to exempt and then file under Chapter 7.

Suppose debtors borrow some amount D on an unsecured basis in period 1 and must repay in period 2. In period 2, they

TABLE 1

Non-Business Bankruptcy Filings

1980-2005

	Non-business filings	Percent of U.S. population
1980	287,570	0.13%
1985	341,233	0.14%
1990	718,107	0.29%
1995	874,642	0.33%
2000	1,217,972	0.43%
2001	1,452,000	0.51%
2002	1,539,000	0.53%
2003	1,625,000	0.56%
2004	1,563,000	0.53%
2005	2,000,000	0.68%

NOTE: Married couples who file for bankruptcy are counted as a single bankruptcy filing, so the number of filings is less than the number of people who file for bankruptcy.

SOURCE: www.abiworld.org

have wealth of W and earn income of I . Both are assumed to be uncertain, the former because financial returns are risky and the latter because debtors get divorced, lose their jobs, experience business failure, etc. At the beginning of period 2, debtors learn their draws on both wealth and income. Then they make their bankruptcy decisions.

Consider non-opportunistic debtors' decisions to file for bankruptcy under Chapter 7. Debtors' cost of filing for bankruptcy is assumed to be C_p and the amount of debt discharged in bankruptcy is D_p , where the p subscripts indicate pre-BAPCPA values. Because not all debt is discharged in bankruptcy, D_p may be less than D .

Exemptions for wealth in bankruptcy were (and still are) set by the states and they vary widely. Most states have a blanket exemption for "household goods" that covers furniture, household equipment, and clothing, plus separate exemptions for particular types of assets, each with a fixed dollar limit. The largest exemption in most states is the "homestead" exemption for equity in owner-occupied homes, which varies from zero in two states to unlimited in Texas, Florida, and several other states. Many states also allow married couples and elderly debtors in bankruptcy to take larger exemptions and some states allow debtors to choose between the state exemptions and a separate set of federal bankruptcy exemptions. Thus, Chapter 7 wealth exemptions are fixed dollar amounts that differ across individual debtors depending on their state of residence, whether they are homeowners, and other factors. Suppose the exemption for a particular debtor is denoted X_p .

Non-opportunistic debtors benefit from filing for bankruptcy if the amount of debt discharged in bankruptcy D_p exceeds the cost of filing for bankruptcy C_p plus the value of non-exempt wealth that debtors must give up, which is either $W - X_p$ or zero, whichever is greater. For each debtor, there is a threshold level of wealth W_p^* such that the debtor is indifferent between filing or not filing for bankruptcy because ben-

efits equal costs, or $D_p = \max[W_p^* - X_p, 0] + C_p$. Prior to BAPCPA, non-opportunistic debtors gained from filing under Chapter 7 if their actual wealth turned out to be below the threshold, or if $W < W_p^*$.

GAMING THE SYSTEM What about opportunistic debtors? Prior to BAPCPA, they made their bankruptcy decisions in the same way, but they planned in advance to increase their financial gain from bankruptcy. Pre-BAPCPA bankruptcy planning strategies included borrowing more by acquiring additional credit cards and charging more on each card, converting non-exempt assets to exempt by paying down their mortgages or renovating their homes (assuming that the additional home equity would be exempt under the state's homestead exemption), moving to states with higher exemptions, and sheltering non-exempt assets by putting them into "asset protection trusts."

These strategies raised the amount of debt discharged in bankruptcy D_p or raised the amount of wealth that was exempt in bankruptcy X_p , thus increasing debtors' financial gain from filing. They also raised the threshold level of wealth W_p^* , so that debtors gained from filing for bankruptcy at higher wealth levels.

In a study done in the mid-1990s, I used a representative sample of U.S. households — the Federal Reserve Board's Survey of Consumer Finances — to calculate the proportion of U.S. households that would benefit from filing for bankruptcy under Chapter 7. I found that if debtors behaved non-opportunistically, then about 15 percent of U.S. households would gain financially from filing. But if debtors behaved opportunistically by charging more on their credit cards, using non-exempt assets to reduce their mortgages or renovate their homes, or moving to Texas or Florida, then more than half of all households would gain from filing. The more debtors used these strategies, the higher their benefit from filing for bankruptcy was. Thus, pre-BAPCPA bankruptcy gave debtors strong incentives to behave opportunistically.

FIGURE 1

Non-Opportunists, Pre-BAPCPA

Non-opportunistic debtors benefited under the pre-BAPCPA bankruptcy laws if their income and wealth were to the left of line W_p^* .



Now turn to Chapter 13. Prior to BAPCPA, debtors filing under Chapter 13 had to propose a plan to repay some or all of their debt from post-bankruptcy income over a period of three to five years. Only the approval of the bankruptcy judge — not creditors — was required for approval of Chapter 13 repayment plans. Most debtors in Chapter 13 proposed to repay either an amount equal to the value of their non-exempt assets, $W - X_p$, or a token amount such as 1 percent of debt if they had no non-exempt assets. Bankruptcy judges generally accepted the plans because debtors could otherwise shift their filings to Chapter 7. This meant that the conditions under which debtors gained from filing for bankruptcy under Chapter 13 and Chapter 7 were the same — that debtors' wealth W was less than the threshold W_p^* .

Pre-BAPCPA Chapter 13 also included some special features that were intended to encourage debtors to use it rather than Chapter 7. If debtors were behind on their mortgage payments and lenders were about to foreclose, debtors could delay foreclosure by filing under Chapter 13 (although they were still required to repay the entire amount owed on the mortgage). Some car loans were partially discharged in Chapter 13 because the loan principle could be “stripped down” to the value of the car if the former was greater than the latter. Also, certain types of unsecured debts, such as debts incurred by fraud, could be discharged in Chapter 13.

None of those features were available in Chapter 7. While the special features increased the number of debtors who filed under Chapter 13, they did not generally affect the amounts that debtors repaid on their unsecured debts — most Chapter 13 debtors would pay what they owed on their mortgages or car loans and then stop making payments on their plans.

Figure 1 shows debtors' period 2 wealth W on the horizontal axis and their period 2 income I on the vertical axis. Although wealth is a stock and income is a flow, debtors' short-run ability to pay equals the sum of wealth plus income, so that ability-

to-pay increases with distance from the origin. The area to the left of the vertical line at W_p^* is the region where non-opportunistic debtors gained from filing for bankruptcy pre-BAPCPA. Regardless of whether they filed under Chapter 7 or 13, they gained from bankruptcy as long as their wealth was less than W_p^* . And because income was completely exempt under Chapter 7, debtors gained from filing regardless of how high their incomes were.

The area to the left of the vertical line in Figure 2 shows the same region for opportunistic debtors. The strategies that opportunistic debtors follow in planning for bankruptcy cause the threshold level of wealth W_p^* to shift to the right, so that opportunistic debtors' region of gain from bankruptcy is larger than that of non-opportunistic debtors.

Figures 1 and 2 suggest that debtors could gain from filing for bankruptcy pre-BAPCPA even if they had high ability to pay. If they behaved opportunistically, they could gain from filing even if they were millionaires. While not all debtors whose income and wealth placed them in the regions of gain actually filed for bankruptcy, pre-BAPCPA debtors were more likely to file for bankruptcy as their financial gain from bankruptcy increased. Thus, the larger the area to the left of the W_p^* line, the more bankruptcy filings occurred. In addition, pre-BAPCPA bankruptcy filers on average repaid only about 1 percent of their unsecured debt. It is thus not surprising that banks specializing in credit card lending lobbied hard for bankruptcy reform.

OPPORTUNISTS? But the fact that opportunists gain more from filing for bankruptcy than non-opportunists does not imply that most pre-BAPCPA bankruptcy filers were opportunists. How much opportunism actually occurred prior to the adoption of BAPCPA? Little good research is available on this issue, but the Administrative Office of the U.S. Courts occasionally publishes figures that suggest whether debtors in bankruptcy can repay a substantial amount of their debt.

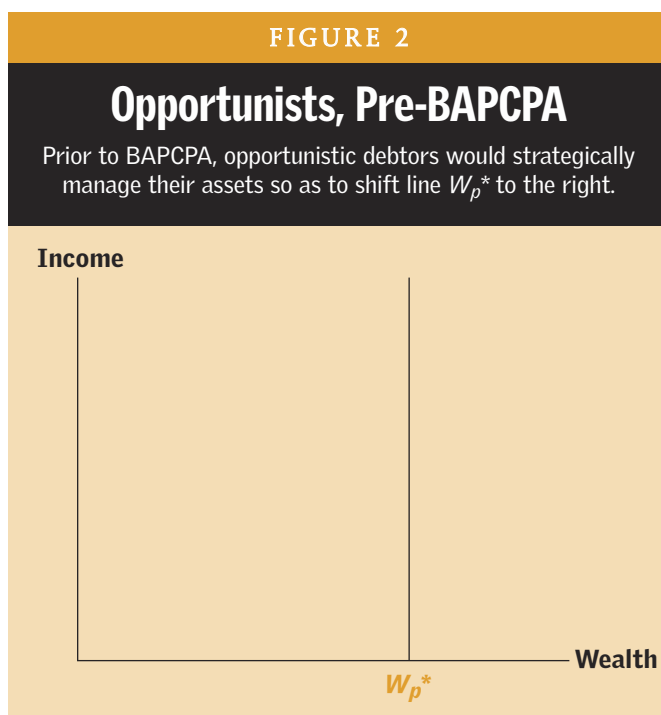
Consider “no-asset” Chapter 7 filings, in which debtors repay nothing in bankruptcy because all of their wealth is exempt. No-asset filings constitute nearly three-quarters of all personal bankruptcy filings and 96 percent of Chapter 7 filings. Three percent of no-asset filers have annual incomes of \$72,000 or more and the median amount of credit card debt for these filers is \$33,500 — twice the average level for all bankruptcy filers. Clearly, some of these debtors are opportunists, as they have both high debt and the ability to repay at least part of it. In addition, the top 0.4 percent of no-asset filers have at least \$500,000 in credit card debt. But three-quarters of this group of debtors owned failed businesses and most of their debts presumably were business debts. Because their incomes were low, they probably had little ability to repay. There is little information on the fraction of debtors who borrow “recklessly” with little intention to repay.

Thus while some bankruptcy filers behave opportunistically and many run up credit card debt beyond their ability to repay, the proportion of pre-BAPCPA bankruptcy filers who were opportunists appears to have been fairly small. This suggests that the reforms under BAPCPA may have had a broader agenda than just reducing debtor opportunism.

FIGURE 2

Opportunists, Pre-BAPCPA

Prior to BAPCPA, opportunistic debtors would strategically manage their assets so as to shift line W_p^* to the right.



BANKRUPTCY UNDER BAPCPA

BAPCPA retained both the Chapter 7 and Chapter 13 personal bankruptcy procedures, but it abolished debtors' right to choose between them and replaced it with a "means test" for Chapter 7. To qualify for Chapter 7, debtors must demonstrate that their incomes are below a certain cutoff and, if not, they must file under Chapter 13. BAPCPA also changed debtors' obligation to repay in Chapter 13. Instead of debtors proposing their own repayment plans, the new means test determines debtors' "disposable income" and requires that they use all of it for five years to repay.

Also, the special features that previously encouraged debtors to choose Chapter 13 have been abolished. In Chapter 7, the system of wealth exemptions that vary across states remains the same, but BAPCPA introduced new restrictions on when debtors are allowed to use them. Finally, BAPCPA made some types of debts non-dischargeable, greatly raised bankruptcy costs by adding new fees and hurdles to the filing process, and lengthened the minimum period between bankruptcy filings — from six to eight years for Chapter 7 and from six months to two years for Chapter 13.

Consider bankruptcy costs first. Under BAPCPA, debtors must take an approved credit counseling course before filing, and they must take a financial management course before receiving a discharge of debt. They must file about 30 forms with the bankruptcy court that document their real and personal assets, assets claimed as exempt, retirement accounts, debts of all types, income, business income, expenditures, alimony/child support payments, contractual and lease obligations, and information about legal representation. They must also submit copies of their tax returns and wage stubs. (Most of this information was not required pre-BAPCPA.) Bankruptcy lawyers must investigate and verify the accuracy of the information on the forms — lawyers can be fined if any of the information is inaccurate. Also, if the forms contain errors, then debtors' bankruptcy filings can be dismissed and their lawyers may be required to give up the fees they have collected. Those new requirements are likely to cause some bankruptcy lawyers to leave the field while the others will raise their rates. One bankruptcy guide predicts that the cost of filing under BAPCPA will be around \$2,500 for lawyers' fees plus \$200–300 in filing fees, compared to less than \$1,000 before BAPCPA. Those changes cause C_b to exceed C_p (where b refers to values under BAPCPA).

BAPCPA also made some types of debt non-dischargeable in bankruptcy. Car loans can no longer be "stripped-down" and debts incurred by fraud are no longer dischargeable. Student loans from private lenders are no longer dischargeable. (Student loans from government sources were already non-dischargeable.) Also, cash advances greater than \$750 and charges for luxury goods costing more than \$500 are now non-dischargeable if they are obtained less than 70 days or 90 days prior to filing, respectively. Those changes mean that the amount of debt discharged in bankruptcy under BAPCPA, D_b , is smaller than the amount discharged pre-BAPCPA, D_p .

Now turn to the new BAPCPA restrictions on debtors' use of wealth exemptions. If debtors move to a new state less than two years before filing, they must use the homestead exemption in

their old state. They can no longer gain from moving to Texas or Florida unless they plan for bankruptcy far in advance. Also, debtors can no longer convert non-exempt assets into home equity by paying down their mortgages or renovating their homes, unless they do so at least 40 months or 10 years, respectively, before filing. Otherwise, the additional home equity will not be exempt. Also under BAPCPA, states' general exemptions for household goods are limited to one television, one computer, etc. Overall, the new restrictions reduce the wealth exemption so that, for some debtors, X_b is lower than X_p . The reductions in the amount of debt discharged and the wealth exemption and the increase in bankruptcy costs all have the effect of reducing the wealth threshold for filing for bankruptcy under BAPCPA.

Now turn to the means test, which all debtors in bankruptcy must take. The first part of the test determines whether debtors are allowed to file under Chapter 7. Debtors must determine their annual family income I , which BAPCPA defines as the average monthly family income over the six-month period before the bankruptcy filing, multiplied by 12. They are allowed to file under Chapter 7 if I is less than the median family income in their state of residence for families of the same size. If debtors do not qualify for Chapter 7 under this test, then they must determine their yearly income exemption, denoted E_b , and their yearly disposable income, which is $I - E_b$. The means test also allows debtors to file under Chapter 7 if their disposable income is less than \$6,000 over five years (\$1,200 per year) or if their disposable income is as high as \$10,000 over five years (\$2,000 per year) but is less than 25 percent of their debt. Taking these conditions together, suppose M_b denotes the maximum yearly income level at which debtors pass the means test and are allowed to file under Chapter 7. Debtors who fail the means test because I exceeds M_b must file under Chapter 13 if they file for bankruptcy at all. The second part of the means test says that debtors who are required to file under Chapter 13 must use their entire disposable income for five years after filing, or $5(I - E_b)$, to repay.

The BAPCPA income exemption, E_b , is entirely new (prior to BAPCPA, debtors proposed their own income exemptions as part of their Chapter 13 plans). The BAPCPA income exemption equals the sum of a variety of separate allowances for different types of expenditures. One set of allowances, for housing, transport, food, apparel, and personal care, is determined by formula. The housing allowance depends on housing costs where the debtor lives, the debtor's family size, and whether the debtor is an owner or a renter. The transport allowance depends on where the debtor lives and whether the debtor's family owns 0, 1, or 2 cars. Other allowances depend on the debtor's family size and broad categories of income. A second set of allowances covers expenditures that are (mainly) outside the debtor's control, including income tax payments, court-ordered spousal and child support payments, childcare costs, uninsured health care costs, the cost of term life insurance, the cost of telecommunication services, and several minor categories. Finally, a third set of allowances is based on debtors' actual expenditures. These include allowances for spending on health and disability insurance, contributions to the care of elderly or ill family members, additional home energy costs, additional food and clothing expenses up to certain limits, chari-

FIGURE 3

Non-Opportunists under BAPCPA

Non-opportunistic debtors benefit from filing for bankruptcy if their wealth/income places them to the left of line W_b^* , but they must file for Chapter 13 if they are above M_b .

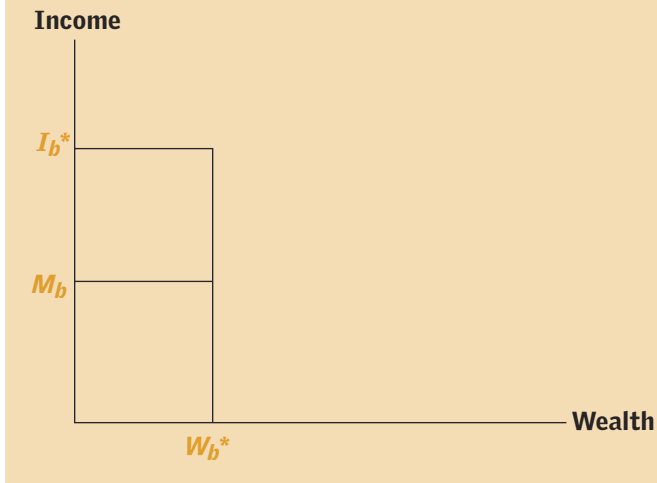


table contributions, the costs of protection against family violence, loans to finance contributions to tax-sheltered individual retirement plans and education savings accounts, and all payments on secured debt.

OPPORTUNISTS AND NON-OPPORTUNISTS Under what conditions would non-opportunistic debtors gain from filing for bankruptcy under BAPCPA? To decide whether to file under Chapter 7, debtors first must determine whether their incomes satisfy the means test, which requires that $I \leq M_b$. Assuming that they pass the means test, debtors must go through the same procedure as previously discussed to determine their gains and costs from filing under Chapter 7. This determines a new threshold level of wealth W_b^* such that debtors are indifferent between filing under Chapter 7 versus not filing for bankruptcy, where $W_b^* - X_b + C_b = D_b$. Debtors gain from filing under Chapter 7 if their actual wealth W is below the new threshold wealth level W_b^* . The lower block in Figure 3 shows the region where $I \leq M_b$ and $W \leq W_b^*$, so that non-opportunistic debtors gain from filing under Chapter 7 and are allowed to do so.

Now consider non-opportunistic debtors' decisions to file under Chapter 13. Under BAPCPA, their gain from filing for bankruptcy is still the amount of debt discharged D_b , but their cost of filing is the sum of bankruptcy costs plus five years of disposable income. Debtors are indifferent between filing under Chapter 13 versus not filing for bankruptcy at all if $5(I - E_b) + C_b = D_b$. This condition determines a threshold level of income, denoted I_b^* , such that debtors are indifferent between filing under Chapter 13 or remaining out of bankruptcy. They gain from filing if $I < I_b^*$, and they are better off avoiding bankruptcy otherwise. In addition, debtors fail the means test and are not allowed to file under Chapter 7 if their incomes exceed M_b . This means that debtors both gain from filing under Chapter 13 and are barred from filing under Chapter 7 when $M_b < I \leq I_b^*$. Finally, a further limitation on debtors' use of Chapter 13 is the "best interest of creditors" test,

which requires that debtors repay at least as much in Chapter 13 as they would in Chapter 7. This means that debtors must repay at least an amount equal to the value of their non-exempt wealth, so that they gain from filing under Chapter 13 only if their wealth is less than the wealth threshold, or $W \leq W_b^*$. The upper block in Figure 3 shows the region where non-opportunistic debtors gain from filing under Chapter 13 because all of the conditions are satisfied, but they are not allowed to file under Chapter 7.

How does the bankruptcy decision differ for opportunistic debtors? As already discussed, BAPCPA closed off many of the strategies that opportunistic debtors previously used to raise their wealth thresholds for bankruptcy, including no longer allowing discharge of some types of debt and preventing some debtors from using high state homestead exemptions. But BAPCPA left some old strategies intact and also opened up some new ones.

Debtors are still allowed to use asset protection trusts to shelter large amounts of wealth in Chapter 7 bankruptcy. (A bill recently introduced in Congress to limit the use of asset protection trusts in bankruptcy is titled the "Billionaire's Loophole Elimination Act.") In about 20 states, married debtors can still shelter the entire value of their homes, as long as they own the homes in "tenancy by the entirety" and only one spouse files for bankruptcy. BAPCPA also provides a generous new exemption in Chapter 7 for up to \$1 million in tax-sheltered individual retirement accounts (up to \$2 million for married couples who file for bankruptcy). But using that exemption requires that debtors plan for bankruptcy far in advance, as federal law limits the amount that can be contributed to tax-sheltered retirement accounts each year. BAPCPA also exempts debtors from the means test if their debts are not "primarily consumer debts," so that opportunistic debtors can avoid the means test and file under Chapter 7 by setting up a business and acquiring business debt before filing. These strategies have the effect of raising debtors' wealth thresholds, W_b^* .

Opportunistic debtors can also use various strategies to raise their income thresholds for filing for bankruptcy, I_b^* . One such strategy involves working less before bankruptcy. Because BAPCPA defines debtors' annual incomes I based on their incomes during the six month period before filing, opportunistic debtors can reduce their obligation to repay in Chapter 13 by working less during this period. To illustrate, suppose debtors earn \$100 per month less during each of the six months before filing. Doing so costs them \$600, but lowers their Chapter 13 repayment obligation by \$100 per month for 60 months, or \$6,000. Thus, they receive a 10-fold return per dollar of reduced earnings. The high return to working less persists until debtors' income is low enough that they pass the means test and are allowed to file under Chapter 7. Debtors can also gain by simply shifting their incomes so that the money is paid outside of the six-month window before bankruptcy.

Opportunistic debtors can also re-arrange their spending so as to raise their income exemption E_p . Under BAPCPA, some of the expenditure allowances are formula-based, which prevents debtors from manipulating them. But others are based on debtors' actual spending levels, so opportunistic debtors can reduce their obligation to repay in Chapter 13 by spending more on those categories.

To get a sense of how far the BAPCPA income exemption can be stretched, I calculated expenditure allowances and the means test for three hypothetical debtors who were assumed to live in three different states, have families of four, and have either 150 percent or 200 percent of their states' median income levels. Each debtor was assumed to own a house having the median value of single-family homes in the relevant metropolitan area and to obtain a new mortgage before filing that covered 100 percent of house value. Each debtor was also assumed to own two relatively new cars financed with car loans. Each debtor purchased health and disability insurance and borrowed to finance retirement contributions and education savings accounts for their children. (BAPCPA limits these accounts to \$5,000 per child.) Debtors also spent more on a combination of charitable contributions, cell phones, additional food, clothing and energy, and an alarm system or a dog for protection. I found that debtors having incomes as high as \$135,000 per year could pass the means test and file under Chapter 7 by reducing their disposable incomes to less than \$2,000 per year. These calculations suggest that opportunistic debtors who engage in bankruptcy planning can still qualify to file under Chapter 7 even if their incomes are as high as the 90th percentile of the U.S. income distribution.

Thus, the BAPCPA means test forces non-opportunistic debtors into Chapter 13 even if they have relatively low incomes, but allows opportunistic debtors with much higher incomes to file under Chapter 7. The main determinant of whether debtors pass or fail the BAPCPA means test is not their "means," but whether they plan for bankruptcy in advance.

Figure 4 shows the income/wealth region where opportunistic debtors gain from filing for bankruptcy. Compared to Figure 3, the lower block in Figure 4 where debtors gain from filing under Chapter 7 is both wider and taller and the upper block where debtors gain from filing under Chapter 13 has nearly disappeared. This is because when debtors behave

opportunistically, they qualify to file under Chapter 7 even at high income levels and, as a result, few if any will choose to file under Chapter 13. The wealth threshold for filing under Chapter 7 also shifts out, because opportunistic debtors are more likely than non-opportunists to benefit from the new exemption for retirement accounts.

Finally, how has BAPCPA changed the attractiveness of bankruptcy? We can address this question for non-opportunistic debtors by comparing Figure 1 to Figure 3 and for opportunistic debtors by comparing Figure 2 to Figure 4. To do so, we must re-interpret the wealth and income thresholds as applying to the average debtor of each type. The region in which non-opportunistic debtors benefit from filing for bankruptcy is smaller under BAPCPA than before, i.e., the blocks in Figure 3 are smaller than the area to the left of the wealth threshold in Figure 1. This is because pre-BAPCPA debtors benefited from filing for bankruptcy at any income level, but BAPCPA debtors no longer benefit from filing — even under Chapter 13 — if their incomes are above I_b^* . In addition, the combination of much higher bankruptcy costs, narrower discharge of debt, and restrictions on debtors' use of high homestead exemptions imply that the wealth threshold is lower under BAPCPA. Overall, BAPCPA is likely to reduce the number of non-opportunistic debtors who file for bankruptcy.

What about BAPCPA's effect on opportunistic debtors? The comparison between Figure 2 and Figure 4 is more ambiguous. BAPCPA eliminated debtors' automatic right to file under Chapter 7, but it provided many strategies for avoiding Chapter 13 even at high income levels. BAPCPA seems unlikely to prevent determined opportunists from planning for and benefiting from bankruptcy, even if they have high ability to pay.

THE BANKRUPTCY BALANCE

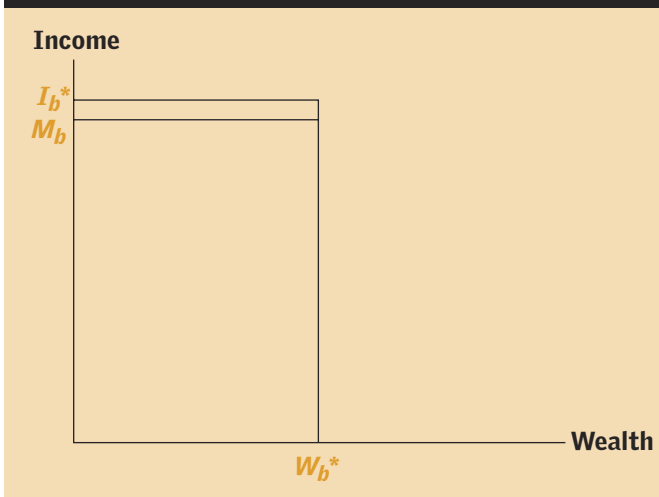
As discussed in the introduction, bankruptcy policy balances conflicting objectives of providing consumption insurance to debtors and protecting creditors. The adoption of BAPCPA shifted the balance toward creditors by raising debtors' cost of filing for bankruptcy and reducing the amount of debt that is discharged in bankruptcy. The changes will have little effect on opportunistic debtors, who can still use pre-bankruptcy planning to avoid Chapter 13 and shelter substantial assets in bankruptcy. But the changes are likely to harm many non-opportunistic debtors simply because they cannot afford the high cost of filing.

Because the pressure to reform bankruptcy law came from the large credit card lenders, consider how the changes under BAPCPA affect them. Credit card lenders compete heavily for new customers — U.S. households receive an average of 45 credit card solicitations per year. Lenders encourage consumers to accept new cards by offering front-loaded rewards such as low annual fees, low introductory interest rates, and frequent flier miles or other benefits. But if customers pay late, use their cards over the credit limit, or make only minimum payments on their balances, then lenders charge high fees (\$40 is a common late or over-limit fee) and raise interest rates to extremely high levels (30 percent is a typical rate for high-risk debtors). Over the past decade, competition among credit card lenders has led to reduced fixed charges such as annual fees

FIGURE 4

Opportunists after BAPCPA

Opportunistic debtors can shift line M_b upward, increasing the area in which they can benefit from filing under Chapter 7.



and increased penalty charges such as late fees and high-risk interest rates.

This pattern of charges increases debtors' borrowing costs when their wealth/incomes turn out to be low, because debtors in this situation are likely to pay late, charge over the limit, and make low monthly payments. Conversely, the pattern of charges reduces debtors' borrowing costs when their wealth/incomes turn out to be high, because in this situation they are likely to repay in full or make high monthly payments. The result is that debtors face high borrowing costs when their ability to pay is low and low borrowing costs when their ability to pay is high.

Prior to BAPCPA, debtors with low ability to pay could easily file for bankruptcy, which allowed them to shift funds from repayment to consumption. But the adoption of BAPCPA means that debtors must pay nearly \$3,000 to file for bankruptcy and, once in bankruptcy, they receive less debt relief. As a result, debtors are likely to delay filing or not file at all. This gives lenders longer to collect the high fees and interest charges and, if debtors default but do not file for bankruptcy, then lenders will have more time to collect by garnishing debtors' wages. (Most U.S. states allow lenders to garnish up to 25 percent of debtors' wages following default, but garnishment ends when debtors file for bankruptcy.) In addition, BAPCPA lengthened the minimum period that must elapse between bankruptcy filings, so that fewer debtors are eligible to file for bankruptcy. Thus, for credit card lenders, the adoption of BAPCPA means higher profits.

For debtors, the changes in the pricing of credit card loans increased the variance of consumption so that debtors' minimum consumption levels fell. This change makes bankruptcy-provided consumption insurance more valuable because filing for bankruptcy increases debtors' consumption levels when they are lowest. But BAPCPA's adoption reduced the amount of insurance that bankruptcy provides because many debtors will not qualify for bankruptcy, will not be able to afford the \$3,000 in bankruptcy costs, or will not have enough debt discharged to make filing worthwhile. As a result, more debtors will be subject to wage garnishment, some will quit their jobs to avoid repaying, and some will drastically cut their consumption levels in order to repay. The social costs of debt are likely to increase.

Thus, at a time when changes in the pricing of credit card loans made bankruptcy-provided consumption insurance more valuable to debtors, the adoption of BAPCPA made it less available.

A BETTER SOLUTION Overall, U.S. personal bankruptcy law pre-BAPCPA certainly needed reforming. But BAPCPA harms non-opportunistic debtors while doing little to discourage opportunism.

In a recent study with Hung-Jen Wang, I argued that a better approach to bankruptcy reform would be to combine Chapters 7 and 13. Instead of allowing debtors to choose between repaying from only income or only wealth, debtors would be required to repay from both sources, subject to separate exemptions for each. In our simulations, we assumed that the current wealth exemptions would continue and that 93 percent of income would be exempt, i.e., debtors would be required to use 7 percent of their post-bankruptcy earnings over several

years, as well as their non-exempt wealth, to repay.

This approach has the advantage of improving the match between debtors' ability to pay and their obligation to repay in bankruptcy, because their ability to pay depends on the combination of wealth and income rather than on just one or the other. It maintains bankruptcy-provided consumption insurance, as debtors with low wealth and low incomes would repay little or nothing. Finally, it deters opportunism, because high income debtors are less likely to file for bankruptcy when they must use some of their future income to repay. **R**

READINGS

- "Abuse or Protection: Bankruptcy Reform under BAPCPA," by Michelle J. White. *University of Illinois Law Review*, forthcoming 2007.
- "Bankruptcy by the Numbers: Chapter 13 Disbursements in Fiscal Year 2001: Continued Growth and a New Finding," by Ed Flynn and Gordon Bermant. *American Bankruptcy Law Journal*, Vol. 22 (Feb. 2003).
- "Bankruptcy by the Numbers: Credit Card Debt in Chapter 7 Cases," by Ed Flynn and Gordon Bermant. *American Bankruptcy Law Journal*, Vol. 22 (Dec. 2003–Jan. 2004).
- "Bankruptcy by the Numbers: High-debt Debtors," by Ed Flynn and Gordon Bermant. *American Bankruptcy Law Journal*, Vol. 22 (March 2003).
- "Bankruptcy Reform and the 'Sweat Box' of Credit Card Debt," by Ronald Mann. *University of Illinois Law Review*, forthcoming 2007.
- "The Household Bankruptcy Decision," by Scott Fay, Erik Hurst, and Michelle J. White. *American Economic Review*, Vol. 92, No. 3 (June 2002).
- "It's Time for Means-Testing," by Edith H. Jones and Todd J. Zywicki. *Brigham Young University Law Review*, 1999.
- J.K. Lasser's *The New Bankruptcy Law & You*, by Nathalie Martin. Hoboken, N.J.: John Wiley & Sons, 2006.
- *The New Bankruptcy: Will it Work for You?* by Stephen Elias. Berkeley, Calif.: Nolo Press, 2006.
- "An Optimal Personal Bankruptcy System and Proposed Reforms," by Hung-Jen Wang and Michelle J. White. *Journal of Legal Studies*, Vol. 29, No. 1 (January 2000).
- *Paying With Plastic: The Digital Revolution in Buying and Borrowing*, by David S. Evans and Richard Schmalensee. Cambridge, Mass.: MIT Press, 1999.
- "Taking the New Consumer Bankruptcy Model for a Test Drive: Means-Testing Real Chapter 7 Debtors," by Marianne B. Culhane and Michaela M. White. *American Bankruptcy Institute Law Review*, Vol. 7, No. 27 (1999).
- "Why Don't More Households File for Bankruptcy?" by Michelle J. White. *Journal of Law, Economics, and Organization*, Vol. 14, No. 2 (October 1998).
- "Why It Pays to File for Bankruptcy: A Critical Look at Incentives under U.S. Bankruptcy Laws and a Proposal for Change," by Michelle J. White. *University of Chicago Law Review*, Vol. 65, No. 3 (1998).