

NON-PROCRUSTEAN BANKRUPTCY[†]

Richard M. Hynes*

Many advocates of bankruptcy reform bristle at aspects of the bankruptcy system they find distributively “unfair.” These scholars point to the instances in which wealthy debtors have been able to retain million-dollar homes and luxury items, examples which at first glance might offend any reasonable sense of decency or fairness. Yet if bankruptcy provides insurance otherwise unavailable because of market failures, then an ideal bankruptcy system would embrace much of this inequality in post-bankruptcy standards of living. The wealthy generally choose private contracts that ensure their high standards of living. Though others envy these benefits, they do not wish to pay the premiums these policies require. To the extent that credit markets force a debtor to pay premiums (in the form of higher interest rates) for the debt relief she would likely receive, forcing all debtors to accept the same standard of living forces each debtor to accept the same Procrustean insurance that is too meager for some and too dear for others. This argument requires strong assumptions that reasonable minds may reject. If one rejects these assumptions, however, then one must question not only the debt relief secured by upper-class bankrupts, but also the debt relief offered to the middle class.

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*“Procrustes—legendary robber of ancient Greece who forced his victims to fit a certain bed by stretching or lopping off their legs.”*¹

A central premise underlies the movement for bankruptcy reform: wealthy debtors abuse bankruptcy protection by defaulting on their obligations while maintaining an *excessively comfortable* lifestyle beyond the reach of ordinary Americans.² Many associate bankruptcy abuse with the use of homestead exemptions to shield multimillion dollar mansions.³ The consumer credit industry, however, has not focused its lobbying efforts on exemption reform,⁴ and pending legislation fails to eliminate this

1. WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY 1809 (Philip Babcock Gove ed., 1993).

2. See, e.g., Judge Edith H. Jones & Todd J. Zywicki, *It's Time for Means-Testing*, 1999 BYU L. REV. 177, 183 (“Society should not broadly afford relief to well-off, able-bodied debtors when poorer people, who have not elected that remedy, struggle to keep their commitments and live within their means.”).

3. For example, over sixty-five law professors signed a letter to Sen. Patrick Leahy advocating a cap on state homestead exemptions because of the “fundamental problem of unfairness” that large homestead exemptions create. Letter from Barry E. Adler et al., to Sen. Patrick Leahy (May 22, 2002) [hereinafter May 2002 Letter from Professors] (on file with the author).

4. In fact, credit card companies may have opposed limitations on homestead exemptions in order to limit opposition from politicians in states with unlimited exemptions. See, e.g., Dan Morgan, *GAO: ‘Homestead Exemption’ Aids Well-off Few: Bush, Texas Officials on Record As Opposing Move to Limit Bankruptcy Shelter*, WASH. POST, July 18, 1999, at A6 (“Texans also found allies in credit card company lobbyists who worked against a tough limitation [for homestead exemptions] on grounds that

form of “abuse.”⁵ The consumer credit industry’s primary goal is to impose some sort of “means-testing” in bankruptcy that would limit the bankruptcy relief offered to those Americans who possess an above average income.⁶

Though law professors overwhelmingly oppose the pending bankruptcy reform legislation,⁷ they do not question the basic definition of bankruptcy abuse. Rather, they argue that the reformers exaggerate the incidence of such abuse⁸ and that the reforms would generate administrative costs that would far outweigh any plausible benefits and impose an unacceptable burden on the poor.⁹ Some scholars may oppose means-testing on the grounds that those with incomes slightly above the median do not enjoy an *excessively comfortable* lifestyle and, therefore, are not *abusing* the bankruptcy code.¹⁰ Yet, even these scholars would agree that very wealthy debtors who use bankruptcy and similar laws to protect millions of dollars in home equity or other assets abuse our system of debt relief.¹¹ Indeed, academics are nearly unanimous in calling for exemption

such a provision would turn Texas and Florida legislators against the bankruptcy bill and doom chances of reform.”).

5. The legislation would limit homestead exemptions in bankruptcy to \$125,000 per person in some instances. Bankruptcy Abuse Prevention and Consumer Protection Act of 2002, H.R. 5745, 107th Cong. § 322 (2002). Well-counseled debtors might still be able to bypass this limit, however. *See, e.g.*, May 2002 Letter from Professors, *supra* note 3. For a further discussion of exemptions, see *infra* notes 37–62 and accompanying text.

6. The reforms prohibit debtors from filing under Chapter 7 of the bankruptcy code if they have income above the median of the state in which they live and this income is sufficient, after deducting for prescribed living expenses, to repay a significant amount of debt. Bankruptcy Abuse Prevention and Consumer Protection Act of 2002, H.R. 5745, 107th Cong. § 102 (2002).

7. *See, e.g.*, Charles Jordan Tabb, *The Death of Consumer Bankruptcy in the United States?*, 18 BANKR. DEV. J. 1, 48 (2001) (“About 100 professors have written Congress on four separate occasions imploring Congress not to pass [the bankruptcy reform bills]. Exactly two law professors have urged passage.”) (footnotes omitted).

8. *See, e.g.*, Elizabeth Warren, *The Bankruptcy Crisis*, 73 IND. L.J. 1079, 1080–84 (1998) (arguing that rising consumer debt is primarily responsible for the rise in consumer bankruptcy filings).

9. *See, e.g.*, Jean Braucher, *Increasing Uniformity in Consumer Bankruptcy: Means Testing As a Distraction and the National Bankruptcy Review Commission’s Proposals As a Starting Point*, 6 AM. BANKR. INST. L. REV. 1, 10 (1998). Given that means-testing would only apply to those debtors with an income above the median, some question the extent to which the reforms would negatively impact the poor. *See, e.g.*, Jones & Zywicki, *supra* note 2, at 184 (“By its express terms, this means-testing provision applies *only* to those debtors whose income exceeds the national median. . . . Thus it simply has no impact on the hundreds of thousands of debtors who are poor.”).

10. *See, e.g.*, TERESA A. SULLIVAN, ELIZABETH WARREN & JAY LAWRENCE WESTBROOK, *THE FRAGILE MIDDLE CLASS: AMERICANS IN DEBT* (2000) (chronicling the plight of middle-class debtors in financial distress).

11. *See, e.g.*, Elizabeth Warren, *A Principled Approach to Consumer Bankruptcy*, 71 AM. BANKR. L.J. 483, 494 (1997) [hereinafter Warren, *Principled Approach*] (“When a celebrity can make headlines by avoiding millions in debts by buying beachfront property in a fancy Florida resort, the whole bankruptcy system suffers.”) (footnote omitted); Warren, *supra* note 8, at 1084 (“For example, if the law permits an individual to convey all her property to a self-settled trust while she shields millions of dollars from her creditors, the practice must be curtailed even if it is a rare event because it is unfair to creditors and a violation of underlying bankruptcy principles.”).

reforms that are much more substantial than those ultimately embraced by Congress.¹²

This article rejects the definition of abuse adopted by both the supporters and opponents of the pending bankruptcy reforms, and argues this definition of abuse relies on a Procrustean¹³ definition of *excessively comfortable lifestyle* that is inconsistent with consumer bankruptcy's role as a form of social insurance.¹⁴ At its core, this article defends the marked inequality of U.S. debt relief laws. At first glance, this is a difficult task. Because these laws protect the debtor's income and assets, they sometimes allow wealthy or upper-income debtors to continue a comfortable lifestyle, while offering little help for the truly poor who lack anything significant to protect.¹⁵ Moreover, these laws sometimes require poor debtors to repay their loans, while the debts of their wealthier, and better informed, neighbors are forgiven.¹⁶ This article makes a case for allowing wealthier debtors to maintain a higher standard of living than middle-class or poor debtors after default. This argument requires strong assumptions that reasonable minds may reject; however, if one rejects these assumptions, one must question not only the relief secured by the wealthy deadbeats reported in the papers, but also the relief offered to the middle class.

This article examines two possible justifications for allowing some defaulting debtors to maintain a higher standard of living than others. The first justification relates to the need to provide the debtor with an incentive to work or to engage in other behavior that we find desirable.¹⁷ This justification grudgingly accepts inequality because of the inability of

12. For example, the National Bankruptcy Review Commission called for caps on homestead exemptions that would apply in all instances, NAT'L BANKR. REV. COMM'N, BANKRUPTCY: THE NEXT TWENTY YEARS, FINAL REP. 125 (1997) [hereinafter NBRC REPORT], a call that was echoed by over sixty-five law professors. See May 2002 Letter from Professors, *supra* note 3. Much of the academic literature calls for even more dramatic reforms, such as the wholesale replacement of existing property exemptions with a single exemption that allows the debtor to exempt the property of her choice. See Vern Countryman, *For a New Exemption Policy in Bankruptcy*, 14 RUTGERS L. REV. 678 (1960); Note, *Bankruptcy Exemptions: Critique and Suggestions*, 68 YALE L.J. 1459 (1959). For a more recent article repeating this call, see Richard E. Mendales, *Rethinking Exemptions in Bankruptcy*, 40 B.C. L. REV. 851, 867-70 (1999).

13. See *supra* text accompanying note 1.

14. See *infra* Section VI.C.

15. See, e.g., Mendales, *supra* note 12, at 863-64 ("As § 522 is now structured, the system discriminates against renters in favor of homeowners, against urbanites in favor of rural residents—particularly farmers—and more generally against the poor in favor of the well-to-do. This is true not only for debtors residing in opt-out states, but even for those who can and do elect the federal list of exemptions. It is not only strange to see this in a consumer bankruptcy system, but it goes against the basic principles of equity that are supposed to drive the bankruptcy process.") (footnotes omitted); William T. Vukowich, *Debtors' Exemption Rights Under the Bankruptcy Reform Act*, 58 N.C. L. REV. 769, 770 (1980) ("Another general defect of exemption laws is that they tend to perpetuate our economic class structure. Those who have are allowed to keep; those who do not have are given nothing.").

16. See, e.g., Warren, *Principled Approach*, *supra* note 11, at 495 ("In a complex system, debtors with zealous representation and ample resources can always prosper. At the same time, the system fails to provide even minimal protection to debtors without such resources.").

17. See *infra* Section II.B.

government to implement a Utopian system that would be both equitable and efficient.¹⁸ Surprisingly, however, the existing inequality of debt relief laws does little to create these desirable incentives.¹⁹

This article advances a second justification for inequality based on the role of debt relief as a form of insurance made necessary by various market failures.²⁰ This justification for inequality is independent of the need to encourage a debtor to work and it ultimately rejects the idea that even a Utopian system of debt relief would afford all debtors the same standard of living. Just as consumers choose private insurance contracts that guarantee them different standards of living based on their wealth and their preferences, so too would consumers choose debt relief laws that guaranteed them different standards of living. When providing the protection that an individual should have purchased, the government should, to the extent possible, respect these differences.²¹ As a consequence, one cannot conclude that the wealthy debtor abuses bankruptcy by retaining a lifestyle unavailable to the average American; she may well have bargained for this level of protection. Similarly, one cannot absolve those who retain mere "ordinary" standards of living; they may have chosen a much lower level of protection.

This basic argument requires qualification. If the debt relief afforded the wealthy or upper-middle class imposes significant costs on the poor or society in general, then the government should not provide the wealthy with the generous protection that they should have purchased themselves. There are, however, reasons to believe that the wealthy bear most of the costs associated with the generous protection they receive.²²

Because consumers are free to purchase insurance in private markets, one must carefully examine the source of market failure that makes government-mandated insurance necessary. Some common arguments in favor of debt relief do not justify inequality because they do not justify the standard of living that our current system affords the wealthy or even the middle class.²³ If insurance markets suffer from other forms of market failure, however, then the government is correct to allow some bankrupt debtors to retain a lifestyle beyond the reach of the rest of us.²⁴

18. This is the equity-efficiency trade off discussed in the welfare economics literature. See, e.g., Joseph E. Stiglitz, *Pareto Efficient and Optimal Taxation and the New New Welfare Economics*, in *HANDBOOK OF PUBLIC ECONOMICS* 1006 (Alan J. Auerbach & Martin Feldstein eds., 1985).

19. See *infra* Section II.B.

20. This theory that debt relief can provide insurance has been discussed extensively in the literature. See generally Charles G. Hallinan, *The "Fresh Start" Policy in Consumer Bankruptcy: A Historical Inventory and an Interpretive Theory*, 21 U. RICH. L. REV. 49 (1986) (providing a particularly good overview of the justifications for the fresh start of bankruptcy). This article contributes to the literature by applying the insurance theory of debt relief to the question of inequality.

21. See *infra* Section III.

22. See *infra* Section IV.

23. See *infra* Section V.A.

24. See *infra* Sections V.B, V.C.

Other laws designed to protect consumers against misfortune, such as unemployment insurance or workers' compensation, provide a useful analogy to debt relief. Unlike laws designed to relieve poverty, these programs provide benefits to the wealthy, as well as the destitute.²⁵ In fact, each of these programs provides moderate-income individuals with significantly greater benefits than the truly poor.²⁶ In contrast to bankruptcy, however, these social insurance programs are generally structured so that those with very large incomes receive roughly the same benefits as those who earn only the median income.²⁷ Because the proposed bankruptcy reforms limit the debt relief afforded to the debtors with above average income,²⁸ they would seem to merely align debt relief with these other elements of the social safety net. One can still argue in favor of generous relief for the wealthy and upper-middle class, but to do so one must either argue that social insurance programs are wrongly structured or that debt relief is relevantly different.²⁹

Section I provides a brief overview of the scope of the inequality in debtor-creditor law and how the proposed reforms affect this inequality. Section II presents the standard arguments against the inequality of debt relief and the role that incentives play in tempering egalitarian impulses. Section III sets forth the basic argument that debt relief laws designed to insure debtors against misfortune would provide wealthier debtors with more relief than the poor. Section IV qualifies this argument to the extent that the debt relief afforded the wealthy adversely impacts third parties. Section V examines the market failures that justify government intervention and questions whether they justify the inequality of debt relief. As debt relief is not the only form of mandatory insurance, Section VI examines government-sponsored social insurance programs and finds that although these too provide more generous benefits to wealthier individuals, these programs generally do not afford higher-income individuals significantly greater relief than the average American. Section VII concludes the article.

I. THE INEQUALITY OF DEBT RELIEF

Even after they default on their obligations, the very wealthy are able to enjoy a lifestyle most Americans can only imagine. Bankruptcy abuse has received most of the recent attention, but wealthy debtors can also use various protections afforded by state and federal nonbankruptcy law to retain substantial income and assets without filing for bank-

25. See *infra* notes 325, 371–73 and accompanying text.

26. See *infra* notes 347–52 and accompanying text.

27. See *infra* notes 336–40 and accompanying text.

28. See *infra* note 344 and accompanying text.

29. See *infra* Section VI.

ruptcy.³⁰ Therefore, this article addresses the inequality of debt relief laws more generally rather than limiting itself to the bankruptcy code.

Although newspapers tend to focus on the tales of celebrities or very wealthy individuals who default on their loans,³¹ one must recognize that the inequality of debt relief operates on another level, as well. Debt relief laws allow those with moderate to high incomes to maintain a higher standard of living than the truly poor—and the arguments mustered against the bankruptcy abuse of the wealthy may have implications for this inequality as well.

To better understand the inequality of debtor-creditor law, consider three hypothetical debtors: Adam, Brian, and Clara. Adam and Brian work at a company owned by Clara. Adam earns only the minimum wage, \$5.15 per hour³² or approximately \$10,300 annually.³³ His only assets are some clothes and modest household furnishings. Brian's household income of \$90,000 places him within the top twenty percent of Americans.³⁴ In addition to clothes and household furnishings, Brian owns a \$150,000 home³⁵ and has an ERISA qualified retirement plan. The company pays Clara a \$1,000,000 salary and provides her with a very generous ERISA qualified retirement plan. In addition, she owns a \$5,000,000 home and some financial assets.

A temporary recession leads to severe financial difficulties at Clara's company, and she lays off Adam and Brian. After some time, the company's prospects improve and Clara rehires each of them at their previous wages. All three borrowed substantial amounts from Unsecured Financeco, though none granted Unsecured Financeco a secured interest in his or her property. Additionally, Brian borrowed \$100,000

30. To give two well-chronicled examples, while former baseball commissioner Bowie Kuhn retained a multimillion dollar home and O.J. Simpson retains generous pensions, neither debtor filed for bankruptcy. See, e.g., Charles A. Jaffe, *Fallen Stars, There Are Lessons for All of Us in the Riches-to-Rags Stories of Celebrities*, CHI. TRIB., Apr. 11, 1997, available at 1997 WL 3537654; George Kalogerakis et al., *Red Alert! Bad Investments and Costly Hairpieces Helped Bankrupt Burt Reynolds, but He's Not the Only Star Who Has Been Down and out in Beverly Hills: How to Go Broke on Several Million a Year*, PEOPLE, Feb. 24, 1997, at 101; Dan Morgan, *Bush Opposes Limiting Texas Bankruptcy Shelter*, WASH. POST, July 18, 1999, at A6.

31. See, e.g., Jaffe, *supra* note 30; Kalogerakis et al., *supra* note 30.

32. 29 U.S.C. § 206 (2000).

33. This assumes he works forty hours a week and fifty weeks a year.

34. See U.S. CENSUS BUREAU, HISTORICAL INCOME TABLES—HOUSEHOLDS (2002), available at <http://www.census.gov/hhes/income/histinc/h01.html> (last revised Sept. 30, 2002). Brian is assigned an income of \$90,000 to ensure that his income would be above the median income for a family of four in every state. Connecticut has the highest median family income, \$82,702. See U.S. CENSUS BUREAU, MEDIAN INCOME FOR 4-PERSON FAMILIES, BY STATE (2002) [hereinafter U.S. CENSUS BUREAU, 4-PERSON FAMILIES], available at <http://www.census.gov/hhes/income/4person.html> (last revised Oct. 8, 2003).

35. Although certainly not extravagant and probably quite modest in some markets, this home would still be more valuable than the average American home. See U.S. CENSUS BUREAU, AMERICAN HOUSING SURVEY FOR THE UNITED STATES: 2001 146 (2002), available at <http://www.census.gov/prod/2002pubs/h150-01.pdf> (last visited Jan. 19, 2004) (stating that the American Housing Survey for the United States in 2001 found the median value of an owner-occupied home to be \$123,887).

from Secured Bank,³⁶ and he granted Secured Bank a mortgage on his home. Each debtor now finds his or her debts unmanageable and seeks some form of relief under the law.

A. *Nonbankruptcy Collections*

Much of the inequality of bankruptcy results from the bankruptcy code's incorporation of nonbankruptcy substantive law.³⁷ Also, nonbankruptcy collections law remains vital in its own right, as the majority of debtors who default probably do not file for bankruptcy.³⁸ Therefore, assume Adam, Brian, and Clara fail to pay their obligations but do not file for bankruptcy. Instead, they simply let their creditors pursue them in state court. The relevant state and federal nonbankruptcy laws would protect some of the income and the assets of each debtor.

1. *Protection of Assets—Exemptions and Other Devices*

In discussing debt relief laws, this article focuses on those laws that limit Unsecured Financeo's ability to collect. These laws will not affect Secured Bank's powerful collection tool, its ability to foreclose on Brian's home if it is not paid. This foreclosure right results in dramatically lower charge-off rates for mortgage lenders than for unsecured lenders, such as credit card companies.³⁹ In fact, this threat is so powerful that many debtors try desperately to repay their mortgage lender, even if their efforts otherwise lead to financial ruin⁴⁰—and this article will assume that Brian will do everything in his power to repay Secured Bank. States have enacted laws that limit the ability of Secured Bank to foreclose,⁴¹ but these laws generally have little to do with the tales of abuse that fill the newspapers.

36. For the purposes of this analysis, it does not matter if Brian borrowed this money to purchase his home or if he used a home equity loan to finance other needs.

37. For example, bankrupt debtors can invoke the property exemptions available to them under nonbankruptcy law. 11 U.S.C. § 522(d) (2000).

38. See, e.g., AM. BANKER'S ASS'N, 1997 INSTALLMENT CREDIT SURVEY REPORT 109 (9th ed. 1997) (reporting that approximately seventy percent of all bank consumer credit losses occur outside of bankruptcy). Of course, this figure represents a percentage of the dollar amount of outstanding obligations rather than individuals, and it is possible that some individuals file for bankruptcy long after their creditors account for their debt as unlikely to be repaid. This figure clearly implies, however, that a large number of debtors who fail to repay their loans do not file for bankruptcy.

39. While the average charge-off rate for credit card loans in the year 2001 was approximately 5.48%, the average charge-off rate for residential real estate loans was just 0.24%. See FED. RESERVE BD., CHARGE-OFF RATES, ALL BANKS, NSA (2001), available at http://www.federalreserve.gov/releases/chargeoff/chg_all_nsa.txt (last visited Jan. 19, 2004).

40. See, e.g., SULLIVAN, WARREN & WESTBROOK, *supra* note 10, at 199–237 (describing the “house-poor”).

41. See, e.g., LYNN M. LOPUCKI, STRATEGIES FOR CREDITORS IN BANKRUPTCY PROCEEDINGS 133–34 (3d ed. 1997); Michael H. Schill, *An Economic Analysis of Mortgagor Protection Laws*, 77 VA. L. REV. 489, 526–30 (1991).

Even though the debtors did not grant Unsecured Financeco a mortgage, Unsecured Financeco could obtain a judgment and ask a court to attach a lien to a debtor's home or other assets.⁴² State and federal law, however, will protect some of each debtor's property from attachment,⁴³ and, as a general rule, Clara will be able to protect more assets than Brian and Brian will protect more assets than Adam.

The most famous exemptions⁴⁴ are the so-called unlimited homestead exemptions, found in seven states,⁴⁵ that would allow Clara to keep her five million dollar home as long as her home is on a sufficiently small lot or if she lives in a rural area.⁴⁶ These laws would also allow Brian to shield his home, or more accurately his home equity, from Unsecured Financeco, but he has only \$50,000 of home equity to protect. These laws are of no use to Adam because he has no home.⁴⁷ In fact, Adam does not really have anything of value to protect other than his clothes and household possessions, and the laws of every state would protect these meager belongings.

Most states do place some limit on their homestead exemptions, and although the exemptions of some states are quite large,⁴⁸ most limits would seem reasonable to those with middle- or upper-middle-class sensibilities. For example, roughly twenty percent of all states allow married debtors to exempt less than \$11,000 of home equity, and twenty-eight states allow married debtors to exempt \$50,000 or less.⁴⁹

If one compares these limitations to the actual home equity held by American households, no longer appear so modest. Approximately thirty-one percent of American households do not own a home and

42. For a more thorough description of a judgment creditor's collection remedies, see ELIZABETH WARREN & JAY LAWRENCE WESTBROOK, *THE LAW OF DEBTORS AND CREDITORS* 45-50 (2001).

43. The laws that protect the debtor's assets are commonly referred to as exemptions. For a collection of the exemptions offered by the federal government and each of the fifty states, see, for example, 4 *COLLIER ON BANKRUPTCY* ¶ 522.01 (Lawrence P. King et al. eds., 15th ed. rev. 2003) [hereinafter *COLLIER*].

44. One reason that the homestead exemptions may have captured the public's imagination is that home equity is by far the most significant asset of American households, representing approximately forty-four percent of individual net worth in the United States. See MICHAEL E. DAVERN & PATRICIA J. FISHER, *CURRENT POPULATION REPORTS: THE SURVEY OF INCOME AND PROGRAM PARTICIPATION v-vii* (2001). In addition, a few celebrities have used this exemption to protect large amounts of wealth. See, e.g., Kalogerakis et al., *supra* note 30.

45. Arkansas, Florida, Iowa, Kansas, Oklahoma, South Dakota, and Vermont currently place no limit on the amount of home equity that some of their debtors may exempt. See *infra* tbl.1.

46. For example, Texas allows a debtor to exempt her home equity as long as her home is on a lot of less than ten acres in a town, village, or city, or on a lot less than one hundred acres (200 for a family) elsewhere. See *TEX. PROP. CODE ANN.* § 41.001-.002 (Vernon 2000).

47. Some states allow nonhomeowners to apply some or all of the homestead exemption toward other property. See, e.g., *VA. CODE ANN.* §§ 34-4 (Michie 1996 & Supp. 2003), 34-18 & -20 (Michie 1996). However, none of the states with "unlimited" homestead exemptions give debtors this option.

48. For example, Minnesota has a homestead exemption of \$200,000. *MINN. STAT. ANN.* §§ 510.01-.02 (West 2002), 550.37.12 (West 2000 & Supp. 2003).

49. See *infra* tbl.1. Of course, some of the states that have homestead exemptions less than \$11,000 allow their debtors to use the federal exemptions in bankruptcy. See *infra* tbl.1.

therefore have no home equity.⁵⁰ In 1995, the median homeowner had approximately \$50,000 in home equity,⁵¹ meaning that roughly half of all homeowners could exempt all of their home equity in almost half of all states. But bankrupt homeowners typically do not have anywhere near this amount of home equity; a recent study found that in 1991, the median equity of homeowners in bankruptcy was just \$5,500.⁵²

Although most homestead exemptions would be insufficient to protect Clara's mansion, she can find other ways to protect her substantial wealth even if her state provides no homestead exemption at all. For example, if she owns her home jointly with her husband and she recorded their deed in the form of tenancy by the entirety, then several states would prevent Unsecured Financeco from seizing Clara's home unless her husband co-signed the loan.⁵³ Clara could also place her home in an asset protection trust or a spendthrift trust, thereby placing it beyond the reach of her creditors.⁵⁴ Clara may also wish to use these trusts to protect her financial assets, as few states have exemptions that would exempt a significant amount of this wealth.⁵⁵ Finally, Clara could have avoided personal liability altogether by incorporating her business and incurring the debts through that entity.⁵⁶

Though state property exemptions have received most of the recent attention, federal nonbankruptcy law could enable Brian, and especially Clara, to exempt a significant amount of wealth as well. Most federal nonbankruptcy exemptions will not apply to our three debtors because these exemptions are confined to Social Security benefits,⁵⁷ certain assets

50. See U.S. CENSUS BUREAU, HOUSING VACANCY SURVEY, FOURTH QUARTER 2003, at <http://www.census.gov/hhes/www/housing/hvs/q403tab5.html> (last visited Feb. 5, 2004).

51. See DAVERN & FISHER, *supra* note 44, at v–vii.

52. See SULLIVAN, WARREN & WESTBROOK., *supra* note 10, at 221. Even adjusted for inflation, this represents just \$7,263.24 in year 2002 dollars. See BUREAU OF LABOR STATISTICS, CONSUMER PRICE INDEX—ALL URBAN CONSUMERS, at <http://data.bls.gov/servlet/SurveyOutputServlet> (last visited Sept. 2, 2003).

53. An excellent, if somewhat dated, survey of this doctrine in each of the states can be found in Sawada v. Endo, 561 P.2d 1291, 1294–95 (Haw. 1977). Recently, however, the United States Supreme Court substantially weakened this doctrine, holding that federal tax liens do attach to a debtor's interest in property held in the form of tenancy by the entireties. *United States v. Craft*, 535 U.S. 274 (2002). Significantly, several of the states that protect property held in the form of tenancy by the entirety are frequently listed as having no homestead protection. See, e.g., Wells M. Engledow, *Cleaning up the Pigsty: Approaching Consensus on Exemption Laws*, 74 AM. BANKR. L.J. 275, 276 (2000) (noting lack of homestead exemption in Delaware); Lawrence Ponoroff, *Exemption Limitations: A Tale of Two Solutions*, 71 AM. BANKR. L.J. 221, 222 n.8 (1997) (noting lack of homestead exemption in Pennsylvania and Rhode Island, but acknowledging that federal bankruptcy exemptions are available in those states).

54. See Elena Marty-Nelson, *Offshore Asset Protection Trusts: Having Your Cake and Eating It Too*, 47 RUTGERS L. REV. 11 (1994).

55. Clara may be able to protect some of her financial assets with a wildcard exemption that can apply to any personal property. Although this may appear promising for Clara, the dollar limits on these exemptions are typically fairly low when compared to her wealth. See *infra* tbl.1.

56. MODEL BUS. CORP. ACT § 6.22 (1984).

57. 42 U.S.C. § 407 (2000).

held only by federal employees (such as bankruptcy judges),⁵⁸ and other narrowly defined groups.⁵⁹ Federal law does prohibit the assignment or alienation of many pension benefits,⁶⁰ and thus may protect the retirement benefits of both Brian and Clara.⁶¹ In Clara's case, these benefits may be extremely generous, and even if her plan does not meet the requirements of ERISA, she still may be able to use state law to protect retirement accounts worth well in excess of a million dollars.⁶²

2. *Protection of Income—Limitations on Garnishment*

After obtaining a judgment, Unsecured Financeco can also seek a garnishment order that would force the employer to pay a portion of each debtor's earnings directly to it. Because federal law exempts the greater of seventy-five percent of the debtor's take-home pay or thirty times the federal minimum wage per week,⁶³ debtors with higher earnings will be allowed to exempt a greater amount from their creditors. In our example, Adam would exempt \$7,725 of annual income from his creditors,⁶⁴ an amount that would put him well below the poverty line even if he were single and had no children.⁶⁵ Meanwhile, ignoring taxes, Brian would exempt approximately \$67,500 and Clara would exempt \$750,000.

B. *Bankruptcy*

Bankruptcy largely continues the inequality found in nonbankruptcy collections law and would continue to do so, even if the pending

58. See, e.g., 28 U.S.C. § 376(n) (2000) (exempting annuities paid to survivors of judges, including bankruptcy judges).

59. See, e.g., 25 U.S.C. §§ 543, 545 (2000) (discussing Klamath Indian tribes in Oregon); 33 U.S.C. § 916 (2000) (exempting death and disability benefits paid pursuant to the Longshore and Harbor Workers' Compensation Act).

60. See 29 U.S.C. § 1056(d) (2000) (requiring that pension plans prohibit the assignment or alienation of benefits).

61. It is this exemption that allows O.J. Simpson to live off of his pensions while the tort judgment against him remains unpaid. See, e.g., Kalogerakis et al., *supra* note 30.

62. See, e.g., *In re Solomon*, 67 F.3d 1128 (4th Cir. 1995) (holding that although a debtor filed for bankruptcy, his individual retirement accounts worth approximately \$1,400,000 were exempt under Maryland nonbankruptcy law as well).

63. Fair Debt Collection Practices Act, 15 U.S.C. § 1673 (2000) (restricting garnishment in favor of general creditors to no more than the lesser of twenty-five percent of the debtor's "disposable income" or the amount by which her disposable income exceeds thirty times the federal minimum wage). "Disposable income" is roughly the debtor's take-home pay. Some states further limit garnishment or prohibit it altogether. See, e.g., TEX. PROP. CODE ANN. § 42.001(b)(1) (Vernon 2000) (prohibiting garnishment of earned but unpaid wages).

64. A debtor may exempt thirty times the federal minimum wage each week, or \$154.50. Assuming the debtor works fifty weeks a year, this equals \$7,725 a year.

65. In 2001, the poverty threshold for an individual with no children was \$9,214. See U.S. CENSUS BUREAU, POVERTY THRESHOLDS FOR 2001, BY SIZE OF FAMILY AND NUMBER OF RELATED CHILDREN, available at <http://www.census.gov/hhes/poverty/threshld/thresh01.html> (last revised Sept. 24, 2002). The poverty threshold for a family of four with two children under the age of eighteen was \$17,960. *Id.*

reforms were enacted. In this example, Clara would still enjoy a much higher standard of living after default than Brian, and Brian would enjoy a much higher standard of living than Adam. Perhaps this is unsurprising because bankruptcy law has always relied on nonbankruptcy collections law to determine many of the substantive rights of the participants.⁶⁶ But the inequality of bankruptcy is not merely due to this incorporation of nonbankruptcy rights. To see the source and scope of the inequality, assume that each of our three debtors finds that nonbankruptcy law provides inadequate protection and, therefore, joins the growing number of individuals who file for bankruptcy.⁶⁷

1. *Chapter 7: "Straight Bankruptcy"*

The most dramatic benefit of a Chapter 7 filing, the discharge of all of an individual's debts,⁶⁸ contributes to the inequality of debt relief. Today, Clara may be able to use this discharge to protect her entire one million dollar salary rather than just the portion protected from garnishment under nonbankruptcy law.⁶⁹ Brian and Adam could obtain this same discharge, but it would only protect earnings of \$90,000 and \$10,300, respectively. Therefore, like nonbankruptcy limitations on garnishment, Chapter 7 allows those who earn more to keep more; in fact, the discharge allows individuals to keep all of their future earnings.

If the proposed reforms were to pass, however, then Clara and Brian would probably be ineligible for relief under Chapter 7. The proposed reforms prevent a debtor from receiving relief in Chapter 7 if the difference between her income and certain prescribed living expenses would allow her to repay a sufficient amount of debt.⁷⁰ Therefore, this legislation effectively limits the standard of living that a debtor can finance out of her *income*, but it does not eliminate the disparity in living standards. First, this means-testing only applies to those debtors with household income above the median for similar households in their state;⁷¹ nationally, the median household income for a family of four in the year 2000 was about \$62,000.⁷² Although this income does not make a household wealthy, a household with this income still earns approximately six times as much as a minimum wage worker, such as Adam. Moreover, as more fully discussed below, bankruptcy courts allow

66. See, e.g., THOMAS H. JACKSON, *THE LOGIC AND LIMITS OF BANKRUPTCY LAW* (1986).

67. Adam may be unable to hire a lawyer or even pay the filing fee, but that is a topic for another article.

68. 11 U.S.C. § 727 (2000).

69. Of course, a court could rule that Clara's filing constitutes a substantial abuse of the bankruptcy code. *Id.* § 707(b).

70. Bankruptcy Abuse Prevention and Consumer Protection Act of 2002, H.R. 5745, 107th Cong. § 102(a)(2) (2002).

71. *Id.*

72. See U.S. CENSUS BUREAU, 4-PERSON FAMILIES, *supra* note 34. Connecticut had the highest four person median income, \$82,702, and Arkansas the lowest, \$44,537. *Id.*

higher-income individuals, such as Brian and Clara, to claim living expenses well beyond the reach of the truly poor.⁷³

Even if the proposed legislation makes Brian and Clara ineligible for relief in Chapter 7, one must still examine how their assets would be treated in this chapter because the other bankruptcy chapters will determine their payments by referring to what would have happened if the rules of Chapter 7 did apply.⁷⁴ Notwithstanding the proposed reforms, Clara will retain significantly more assets than Brian, and Brian will retain significantly more assets than Adam because the bankruptcy code largely incorporates the nonbankruptcy exemptions of the state in which the debtor lives.⁷⁵

Clara may be able to keep her five million dollar home, despite proposed limits on the homestead exemption in bankruptcy. As long as she has lived in a state with an unlimited exemption for at least forty months and her debts do not arise from securities fraud or certain other bad acts, the proposed cap on the homestead exemption would not apply.⁷⁶ Even if she did commit one of the specified bad acts, she might be able to retain her home if she files jointly with her husband, her husband is not guilty of these bad acts, and he claims the balance of the equity in his exemption.⁷⁷ In addition, Clara may still be able to use spendthrift or asset protection trusts⁷⁸ to protect her substantial wealth, and the pending legislation would enhance Clara's ability to exempt retirement funds.⁷⁹

Even if the limitations on the homestead exemption did apply, they would still allow Clara to retain an amount of equity vastly in excess of that owned by the average American. The proposed limitations would allow Clara (as an individual) to exempt up to \$125,000 in home equity if also permitted under state law.⁸⁰ Though this may represent a sharp drop from the amount that she can now exempt, and the amount that she would continue to be able to exempt in a state law collections proceed-

73. See *infra* notes 111–19 and accompanying text.

74. 11 U.S.C. § 1325(a)(4) (requiring that the debtor repay her unsecured creditors at least as much as they would have received in Chapter 7); *id.* § 1129(a)(7)(A) (requiring that each holder of an impaired claim or interest either accept the plan of reorganization or receive at least as much as she would have received if the debtor were liquidated under Chapter 7).

75. Debtors are free to use the property exemptions available to them under state law. 11 U.S.C. § 522(b)(2)(A). The bankruptcy code also includes certain federal, bankruptcy-only exemptions. *Id.* § 522(d). In enacting these exemptions, however, the code gave each state the right to opt-out of these exemptions and force their debtors to use the state nonbankruptcy property exemptions, and the vast majority of states quickly did so. See Richard M. Hynes, Anup Malani, & Eric A. Posner, *The Political Economy of Property Exemption Laws*, 47 J.L. & ECON. (forthcoming 2004).

76. See Bankruptcy Abuse Prevention and Consumer Protection Act of 2002, H.R. 5745, 107th Cong. § 322 (2002).

77. The proposed amendments would still allow joint filers to each claim and exemption and the plain language of the cap on the homestead exemption applies only if the debtor has committed one of the specified bad acts. *Id.*

78. 11 U.S.C. § 541(c)(2).

79. See Bankruptcy Abuse Prevention and Consumer Protection Act of 2002, H.R. 5745, § 224.

80. See *id.* § 322.

ing, this is still approximately 2.5 times the home equity held by the median homeowner⁸¹ and well in excess of the median home equity held by households with income in the top twenty percent.⁸² Because of this high proposed limit, the cap on the homestead exemption would actually affect very few Americans.

Although most commentators propose exemption reforms that would apply even if the debtor did not move recently or commit a “bad act,”⁸³ those writing in the last decade or so have proposed dollar amounts vastly in excess of the holdings of the average American.⁸⁴ For example, recent articles that repeat earlier calls for the greater use of bankruptcy exemptions that can be applied to any property of the debtor’s choosing suggest caps for a married couple between \$50,000 and \$100,000.⁸⁵ By contrast, the median net worth for *all* American families—not just those in financial distress—in 1995 was roughly \$40,200,⁸⁶ and the median net worth for those in the lowest income quartile was just \$5,000.⁸⁷ Of course, this amount is net of both secured and unsecured debt, but it is unlikely that adding back unsecured debts would dramatically increase these figures.⁸⁸

81. See DAVERN & FISHER, *supra* note 44, at v–vii.

82. The median home equity for this group is approximately \$65,000. *Id.* at x.

83. Scholars have written too many articles on exemptions to make a true search for a majority productive. See, e.g., William Houston Brown, *Political and Ethical Considerations of Exemption Limitations: The “Opt-out” As Child of the First and Parent of the Second*, 71 AM. BANKR. L.J. 149 (1997) (stating that his research revealed more 225 exemption articles dated January 1979 through May 1996). This statement clearly applies to those articles that have received the most attention. See, e.g., sources cited *supra* note 12.

84. Articles on exemption reform did not always propose relatively generous amounts. For example, the student note that started the chorus in favor of wildcard exemptions proposed a much more modest exemption of \$1,000 in year 1959 dollars. See *Bankruptcy Exemptions: Critique and Suggestions*, *supra* note 12, at 1509. This amount would be approximately \$6,182 in year 2002. See, BUREAU OF LABOR STATISTICS, U.S. DEP’T OF LABOR, INFLATION CALCULATOR, available at <http://data.bls.gov/cgi-bin/cpicalc.pl> (last visited Sept. 16, 2003). Other early articles specified similarly low values. See, e.g., Note, *Bankruptcy Exemptions: A Full Circle Back to the Act of 1800?*, 53 CORNELL L. REV. 663, 678 (1968) (suggesting wildcard exemption of \$3,900 for a married couple with two children).

85. See, e.g., Mendales, *supra* note 12, at 867 (“The amount may be left up to debate, although a figure around \$50,000 seems fair as a starting point for legislative bargaining As under present law, two debtors filing jointly as spouses could aggregate their exemptions.”).

86. See DAVERN & FISHER, *supra* note 44, at v. The Survey of Consumer Finance (SCF) reports sharply higher figures for median net worth, \$60,900 in 1995, though this amount is still less than the amount of the proposed exemptions for a married couple. See ARTHUR B. KENNICKELL ET AL., RECENT CHANGES IN U.S. FAMILY FINANCES: RESULTS FROM THE 1998 SURVEY OF CONSUMER FINANCES, at 7 tbl.3, available at <http://www.federalreserve.gov/pubs/oss/oss2/98/bull0100.pdf> (last visited Jan. 19, 2004). Much of the discrepancy between the SCF and the Survey of Income and Program Participation (SIPP) can be attributed to the fact that the SCF deliberately over-represents wealthy individuals in its data and the fact that the SCF uses a broader definition of asset than the SIPP. See DAVERN & FISHER, *supra* note 44, at vi–vii. The recently released 2001 Survey of Consumer Finance reports that median net worth increased sharply to \$86,100. See ANA M. AIZCORBE ET AL., RECENT CHANGES IN U.S. FAMILY FINANCES: EVIDENCE FROM THE 1998 AND 2001 SURVEY OF CONSUMER FINANCES, at 7 tbl.3, available at <http://www.federalreserve.gov/pubs/bulletin/2003/03bulletin.htm#jan> (last updated Dec. 11, 2003).

87. See DAVERN & FISHER, *supra* note 44, at v.

88. For example, according to the 2001 Survey of Consumer Finance, half of all non-homeowners had a net worth of less than \$4,800. See AIZCORBE ET AL., *supra* note 86, at 7. Only

The typical debtor in bankruptcy, moreover, has a much lower value of asset holdings. According to three leading bankruptcy scholars, the median bankrupt debtor had just \$14,907 in assets in 1991.⁸⁹ This figure likely *overstates* the assets available for exemption because the median debtor also has \$11,519 in secured debts,⁹⁰ and exemptions do not prevent the secured creditor from seizing her collateral. Even the seventy-fifth percentile of bankrupt debtors may not have much wealth available for exemption. Although they had \$67,859 in assets in 1991, they also had \$53,382 in secured debt.⁹¹

The exemption proposals by the National Bankruptcy Review Commission (NBRC)⁹² were similarly well beyond the assets of the average American. For example, while the NBRC proposed minimum exemptions for nonhomeowners of \$35,000,⁹³ a leading study found that half of all bankrupt nonhomeowners had less than \$3,775 in assets in 1991.⁹⁴ Even those nonhomeowners who are not bankrupt do not have many assets. According to the Survey of Consumer Finance, half of all nonhomeowners had a net worth of less than \$4,800 in 2001.⁹⁵ Again, this low net worth does not appear solely attributable to an excess of debts. Only sixty-five percent of these nonhomeowners reported any debts at all; and of those that did list debts, half had debts of less than \$6,000.⁹⁶

2. Chapters 11 and 13: Repayment out of Future Income

Even if denied relief in Chapter 7, Brian and Clara can still find relief in Chapters 11⁹⁷ or 13 of the Bankruptcy Code. The repayment requirements of these chapters are such that Clara will enjoy a higher standard of living in bankruptcy than Brian, and Brian will enjoy a higher standard of living than Adam. To date, few individual debtors have filed under Chapter 11,⁹⁸ though this may change if some very high-income debtors are denied access to Chapter 7 by the proposed reforms and are

sixty-five percent of these nonhomeowners listed any debts at all; and of those that did list debts, half had debts of less than \$6,000. *Id.* at 23.

89. See SULLIVAN, WARREN & WESTBROOK, *supra* note 10, at 66. This represents approximately \$19,689 in year 2002 dollars.

90. See *id.* This represents approximately \$15,215 in year 2002 dollars.

91. See *id.* Expressed in 2002 dollars, these figures are \$89,133 and \$71,431.

92. In 1994, Congress established the National Bankruptcy Review Commission to study bankruptcy. Bankruptcy Reform Act of 1994, Pub. L. No. 103-394 § 603, 108 Stat. 4106, 4147.

93. See NBRC REPORT, *supra* note 12, at 133.

94. See SULLIVAN, WARREN & WESTBROOK, *supra* note 10, at 215. This represents approximately \$4,958 in year 2002 dollars.

95. See AIZCORBE ET AL., *supra* note 86, at 7.

96. *Id.* at 23.

97. While one normally associates Chapter 11 with corporate reorganizations, individual debtors may make use of Chapter 11, as well. *Toibb v. Radloff*, 501 U.S. 157, 166 (1991).

98. For example, in 2001, Chapter 11 filings represented less than five one hundredths of a percent (0.05%) of all nonbusiness bankruptcy filings. See AM. BANKRUPTCY INST., ANNUAL U.S. NON-BUSINESS FILINGS BY CHAPTER, 2000-2001, available at <http://www.abiworld.org/stats/00stateannualnonbuschapter.html> (last visited Jan. 19, 2004).

also denied access to Chapter 13 because they have too much debt.⁹⁹ Because so few debtors have chosen Chapter 11, this section will focus on Chapter 13.

Roughly stated, a debtor in Chapter 13 proposes a plan in which she will make payments over a three to five-year period,¹⁰⁰ and the debtor is given a discharge of any remaining debts if she completes her plan.¹⁰¹ The debtor must once again pay her secured creditors in full if she is to retain the property pledged as collateral.¹⁰² But more pertinent to this article is the amount the debtor must pay to her unsecured creditors. There are two primary tests for how much the debtor must pay her general unsecured creditors in Chapter 13:¹⁰³ the “best interests of the creditors” test¹⁰⁴ and the “projected disposable income” test.¹⁰⁵

The best interests of the creditors test determines the treatment of the debtor’s assets in bankruptcy and requires that the debtor pay her unsecured creditors at least as much as they would have received in a Chapter 7 liquidation.¹⁰⁶ Because this test effectively incorporates the repayment test of Chapter 7, Clara will once again retain more assets than Brian, and Brian will retain more assets than Adam. More specifically, if Clara’s mansion or financial assets are somehow protected by a property exemption or held in a trust,¹⁰⁷ then this wealth will have no effect on the amount that she must repay in a Chapter 11 or 13 filing. This possibility is more than idle speculation; in the past, Chapter 13 debtors have retained significant amounts of wealth in the form of exempt assets.¹⁰⁸

99. Chapter 13 is restricted to individual debtors (other than stockbrokers and commodity brokers) with regular income who have noncontested, liquidated unsecured debts of less than \$290,525 and noncontested liquidated secured debts of less than \$871,550. 11 U.S.C. § 109(a), (e) (2000) (dollar amounts updated by revision of certain dollar amounts in the Bankruptcy Code prescribed under 11 U.S.C. § 104(b), 66 Fed. Reg. 10,910, 10,911 (Feb. 20, 2001)).

100. 11 U.S.C. § 1322(d). A debtor may propose a plan that will last less than three years if she will repay her creditors in full, but this is rare.

101. *Id.* § 1328(a).

102. *Id.* § 1322. This is true in Chapter 11, as well. *Id.* § 1129(b)(2)(A).

103. *Id.* § 1325(a)(4). In addition to the best interests of the creditors test and the projected disposable income test discussed below, a few courts still review the debtor’s proposed payments under the good faith standard of Section 1325(a). However, this practice is less common since the addition of the projected disposable income test in 1984. For a discussion of this issue, see Brandon L. Johnson, Comment, *Good Faith and Disposable Income: Should the Good Faith Inquiry Evaluate the Proposed Amount of Repayment?*, 36 GONZ. L. REV. 375, 390–94 (2000–2001) (reviewing cases). Chapter 11’s repayment requirements are set forth in section 1129.

104. 11 U.S.C. § 1325(a)(4).

105. *Id.* § 1325(b). The pending legislation would add a projected income test to Chapter 11. See Bankruptcy Abuse Prevention and Consumer Protection Act of 2002, H.R. 5745, 107th Cong. § 102(h)(2) (2002).

106. 11 U.S.C. § 1325(a)(4).

107. See *supra* notes 32–82 and accompanying text (arguing that Clara’s wealth may still be exempt even if the proposed legislative reforms are enacted).

108. In one notorious case, a doctor sought to retain over \$2,000,000 in exempt assets while discharging liability for three claims of sexual misconduct filed against him by former patients. *In re Solomon*, 67 F.3d 1128 (4th Cir. 1995). Debtors are able to retain some of these assets despite the dis-

The projected disposable income test appears fairly egalitarian because it requires the debtor to repay her creditors with all of her “projected disposable income,”¹⁰⁹ or income in excess of her “reasonably necessary” living expenses.¹¹⁰ This test appears to leave Adam, Brian, and Clara with the same standard of living, that which is reasonably necessary for maintenance or support. The most that bankruptcy can do for Adam, however, is to allow him to retain all of his meager income and assets. Therefore, bankruptcy can only equalize each debtor’s standard of living by reducing Clara and Brian to the poverty in which Adam lives.

Though the reasonably necessary standard is notoriously subjective,¹¹¹ one can fairly claim that courts allow middle or upper-middle-class debtors like Brian to claim greater expenses than Adam, but that they are likely to challenge Clara’s efforts to claim greater expenses than Brian. For example, some courts follow the suggestion of some commentators and “scrutiniz[e] only for luxuries that are not enjoyed by an average American family.”¹¹² Under this standard, those with moderate incomes are able to maintain a higher standard of living than the poor, but those with higher incomes run the risk that a court could find their choices of goods and services to represent luxuries.¹¹³ A wealthy debtor will have a particularly difficult time if she claims a standard of living that exceeds that of the bankruptcy judge. In the words of one commentator, “[y]ou cannot expect your client to keep a car that is fancier than the one that the judge drives.”¹¹⁴

Though courts perhaps scrutinize the expenses of the very rich, this does not mean that upper-income debtors are unable to claim more expenses. A great many scholars note the inconsistent application of the reasonably necessary standard, implying that at least some wealthy or upper-income debtors are able to claim substantial expenses.¹¹⁵ A bigger concern among academics is that debtors are sometimes able to manipulate the disposable income test by purchasing durable goods on secured credit and thus increase their allowed expenses.¹¹⁶ This approach works especially well in some jurisdictions because courts do not question whether payments to secured creditors can be justified under the rea-

posable income test discussed below because courts will generally refuse to impute income not actually received by the debtor. *Id.*

109. 11 U.S.C. § 1325(b)(1)(B).

110. *Id.* § 1325(b)(2).

111. *See, e.g.*, 2 KEITH M. LUNDIN, CHAPTER 13 BANKRUPTCY §165.1 (3d ed. & Supp. 2002) (“What expenses are ‘reasonably necessary . . .’ is a fact question determined in the context of individual debtors and their dependents. On similar facts, outcomes will vary from judge to judge, from jurisdiction to jurisdiction, from one part of the country to another and even over time within the same jurisdiction.”).

112. 8 COLLIER, *supra* note 43, ¶ 1325.08[4][b][ii].

113. *See In re Zaleski*, 216 B.R. 425, 431 (Bankr. D.N.D. 1997).

114. DOUGLAS G. BAIRD, THE ELEMENTS OF BANKRUPTCY 60 (rev. ed. 1993).

115. *See, e.g.*, 2 LUNDIN, *supra* note 111, at § 165.1 (summarizing extensive case law).

116. *See, e.g.*, Lynn M. LoPucki, *Common Sense Consumer Bankruptcy*, 71 AM. BANKR. L.J. 461, 471–73 (1997).

sonably necessary standard,¹¹⁷ thereby avoiding an uncomfortable inquiry into the appropriateness of the debtor's home or automobile. To the extent that courts do not question payments on secured debts, debtors with bigger homes or with more consumer durables are often able to retain these assets in bankruptcy and thus enjoy a higher standard of living than other debtors.¹¹⁸ According to one commentator, a debtor can avoid repaying anything to her unsecured creditors by accumulating consumer durables "appropriate to her station in life" prior to filing.¹¹⁹

The proposed bankruptcy reform legislation tries to further limit the ability of Brian and Clara to claim a standard of living beyond that of the average American by providing a more detailed definition of the reasonably necessary standard and by relying more heavily on schedules of expenses.¹²⁰ This legislation, however, does not eliminate the inequality inherent in this standard. Though all debtors would be forced to disclose additional information, the means-testing would only apply to the small number (somewhere between eighteen and twenty-four percent)¹²¹ of bankrupt debtors with incomes above the median in their state and thus do little to reduce the disparity in the expenses claimed by the great majority of bankrupt debtors. The expenses implied by the reforms strike those with upper-middle-class sensibilities as quite low, but they are still substantially in excess of what Adam can afford and what social assistance programs provide.¹²² In addition, until a debtor's income passes about \$70,000 per year, she can generally claim more expenses as her income rises,¹²³ prompting one commentator to question "[d]o wealthier people have to eat more?"¹²⁴ More significantly, the enumerated expenses are *in addition* to any payments that the debtor must make to se-

117. See *In re Smith*, 196 B.R. 565, 571 (Bankr. M.D. Fla. 1996); *In re Humphrey*, 165 B.R. 508, 510 (Bankr. M.D. Fla. 1994); *In re Cordes*, 147 B.R. 498, 502 (Bankr. D. Minn. 1992); *In re Jones*, 119 B.R. 996, 1000 (Bankr. N.D. Ind. 1990). But see *In re MacDonald*, 222 B.R. 69, 75 (Bankr. E.D. Pa. 1998) (claiming that a majority of courts subject payments made through the plan to the reasonably necessary test of 11 U.S.C. § 1325(b)(2) (2000)).

118. See LoPucki, *supra* note 116.

119. *Id.*

120. Despite this shift toward more explicit expenses, numerous commentators have criticized the proposed reforms for relying too heavily on judicial discretion in setting the debtor's living expenses. See, e.g., Jean Braucher, *Means Testing Consumer Bankruptcy: The Problem of Means*, 7 FORDHAM J. CORP. & FIN. L. 407, 436 (2002).

121. Tabb, *supra* note 7, at 30 (collecting the results of the relevant studies).

122. For example, the maximum TANF benefit in Virginia is just \$410 per month. See STATE POLICY DOCUMENTATION PROJECT, FINANCIAL ELIGIBILITY RULES FOR TANF CASH ASSISTANCE: VIRGINIA, available at <http://www.spdp.org/compstates/vafinan.pdf> (last visited Jan. 19, 2004). By contrast, the allowance for food clothing and expenses alone would allow Brian and Clara to spend up to \$1,497 per month if part of a family of four. See INTERNAL REVENUE SERV., NATIONAL STANDARDS FOR ALLOWABLE LIVING EXPENSES, available at <http://www.irs.gov/businesses/small/article/0,,id=104627,00.html> (effective Jan. 1, 2004).

123. The Internal Revenue Service schedule referenced by the recent reforms allows debtors with higher incomes to claim higher allowable living expenses for food, clothing and other expenses. See INTERNAL REVENUE SERV., COLLECTION FINANCIAL STANDARDS, available at <http://www.irs.gov/business/small/article/0,,id=104627,00.html> (effective Jan. 1, 2004).

124. Tabb, *supra* note 7, at 24.

cured creditors,¹²⁵ and, as discussed above, wealthier debtors are likely to have larger secured debt payments because they have more valuable homes, cars, and household appliances.¹²⁶

Many scholars believe that courts simply lack the capacity or the time to conduct any meaningful review of the debtor's household budget, and that a debtor should instead be assigned some standardized expenses based on her earnings.¹²⁷ Both the NBRC¹²⁸ and two leading bankruptcy economists¹²⁹ have independently advocated reforms that would do just this by effectively importing garnishment as a standard collection method in bankruptcy.¹³⁰ Though the details of the system advocated by each differ markedly, both argue that the debtor must repay an amount equal to some fraction of earnings.¹³¹ Because these proposals effectively allow debtors to retain some fraction of earnings, they would, like garnishment, allow higher income debtors to consume more than lower income debtors. Each of these proposals allows for the possibility of progressive marginal rates to reduce the effect of this inequality.¹³²

II. STANDARD VIEWS OF ABUSE AND INEQUALITY

Bankruptcy scholars often cite stories of wealthy debtors who retain mansions or other assets in bankruptcy as examples of bankruptcy abuse or violations of fundamental principles of equity without bothering to explain why.¹³³ A few scholars devote some time explaining this seemingly obvious principle.¹³⁴ At their core, these explanations are based on the same principle as progressive taxation: those that can pay more, should.¹³⁵ Just as in the taxation context, however, society must at least *tolerate* some level of inequality in order to provide debtors with incen-

125. 11 U.S.C. § 707(2)(b)(iv) (2002).

126. See LoPucki, *supra* note 116.

127. See, e.g., NBRC REPORT, *supra* note 12, at 263–73; Hung-Jen Wang & Michelle J. White, *An Optimal Personal Bankruptcy Procedure and Proposed Reforms*, 29 J. LEGAL STUD. 255 (2001).

128. See, e.g., NBRC REPORT, *supra* note 12, at 263–73.

129. See, e.g., Wang & White, *supra* note 127. Note that the bankruptcy tax proposed by Professors Wang and White is effectively the same as garnishment in bankruptcy.

130. See NBRC REPORT, *supra* note 12, at 268; Wang & White, *supra* note 127.

131. See NBRC REPORT, *supra* note 12, at 268; Wang & White, *supra* note 127, at 261.

132. See NBRC REPORT, *supra* note 12, at 268; Wang & White, *supra* note 127, at 281–84.

133. See, e.g., Mendales, *supra* note 12, at 863–64:

As § 522 is now structured, the system discriminates against renters in favor of homeowners, against urbanites in favor of rural residents—particularly farmers—and more generally against the poor in favor of the well-to-do. This is true not only for debtors residing in opt-out states, but even for those who can and do elect the federal list of exemptions. It is not only strange to see this in a consumer bankruptcy system, but it goes against the basic principles of equity that are supposed to drive the bankruptcy process.

Id. May 2002 Letter from Professors, *supra* note 3 (“In a bill designed to squeeze hard on working families who have faced unemployment, medical bills and divorce, it is profoundly unfair to leave open a gaping loophole [potentially unlimited homestead exemptions] for the richest executives, doctors and media stars.”).

134. See, e.g., Jones & Zywicki, *supra* note 2, at 181–83.

135. *Id.* at 181–82.

tives to engage in socially useful behavior such as working or cooperating with the collection process. Surprisingly, however, this incentive value of inequality does not explain much of the inequality in our debt relief laws and thus can only serve as a partial justification.

A. *Why Abuse and Inequality Trouble Us*

Allowing a celebrity or tycoon to retain millions of dollars of assets in bankruptcy seems so obviously unfair that few would bother explaining why. But one must be careful in describing just what we find troubling. In some of the more notorious cases, these individuals use debt relief laws to avoid repaying claims based on fraud or some other intentional tort that they have committed.¹³⁶ As discussed more fully below, this article does not attempt a defense of the treatment of these claims or any other obligations not based in contract.¹³⁷ Some may simply object to a world in which some individuals, even those not in default, can own multimillion dollar homes while others go homeless. Yet, reform of the nation's taxation and transfer programs provides a more useful tool for remedying this inequality.¹³⁸ This article focuses on what we find particularly galling about the wealthy who use debt relief laws to avoid repaying loans willingly extended by lenders.

Many of the arguments against this form of bankruptcy abuse are incomplete. For example, some argue that such abuse discredits our entire system of debt relief.¹³⁹ This argument cannot stand on its own, for it requires an explanation as to why the public believes that these cases cast doubt on the efficacy of our system of debt relief; one still needs an explanation for why we find these cases troubling. On the other hand, the argument that generous debt relief harms creditors and raises the costs of borrowing for other consumers¹⁴⁰ simply proves too much. To the extent that this argument is true,¹⁴¹ it is true for defaults in general.

This incompleteness is not lost on other scholars, and they ground their opposition to bankruptcy abuse on the fundamental premise that

136. In some of the more notorious cases, financiers have moved to Florida and exempted multimillion dollar mansions to avoid paying judgments for securities fraud. See, e.g., Leslie A. Shames, *Calling a Fraud a Fraud: Why Congress Should Not Adopt a Uniform Cap on Homestead Exemptions*, 16 BANKR. DEV. J. 191 (1999).

137. See *infra* notes 206–20 and accompanying text.

138. See, e.g., Louis Kaplow & Steven Shavell, *Why the Legal System Is Less Efficient Than the Income Tax in Redistributing Income*, 23 J. LEGAL STUD. 667 (1994).

139. See, e.g., Jones & Zywicki, *supra* note 2, at 183 (“Finally, a spate of high-profile celebrity, sports figure, and political bankruptcies, together with the disillusioning experiences of growing numbers of bankruptcy creditors has called into question the system’s ability to police itself.”); Warren, *Principled Approach*, *supra* note 11, at 493–94 (“While the level of abuse may be low, it is nonetheless important to recognize that public confidence is undermined when *any* debtor can deliberately refuse to pay rent and find a federal court to delay eviction. When a celebrity can make headlines by avoiding millions in debts by buying beachfront property in a fancy Florida resort, the whole bankruptcy system suffers.”).

140. See, e.g., Jones & Zywicki, *supra* note 2, at 182–83.

141. See *infra* Section IV (discussing who bears the costs of debt relief).

those who *can* pay more *should* pay more.¹⁴² Of course, what a debtor *can* pay is equal to the income and assets that the debtor does not need to support herself and thus depends on the standard of living that one is willing to force a debtor to accept.¹⁴³ Fundamentally, the argument that those with greater income and assets should pay more is based on the theory that they do not *need* to enjoy a standard of living beyond the reach of others. In this way, the objection to bankruptcy abuse is similar to basic arguments of “fairness” that underlie much of the argument for progressive taxation.¹⁴⁴ This article does not quibble with the goal of equity in the taxation context; rather, it argues in Section III that the principle does not readily apply to a system of debt relief.¹⁴⁵

B. *Inequality and Incentives: A Limited Justification*

As the literature on optimal taxation demonstrates, even if one adopts the premise that all individuals *should* have an equal standard of living, one may *tolerate* a substantial amount of inequality in order to provide individuals with an incentive to engage in socially useful behavior, such as working hard to generate the goods and services that we all consume.¹⁴⁶ Likewise, even if one believes that all defaulting debtors should receive roughly the same standard of living, one may still tolerate some degree of inequality in order to provide defaulting debtors with incentives to work hard or cooperate with the collections process. These incentive arguments, however, are not as powerful as they would appear (at least not in the context of debt relief), and thus one needs to search further in order to justify the inequality of our debt relief laws.

1. *Inequality and the Debtor's Incentive to Work*

The analogy between the work incentives of the tax structure and the work incentives of debt relief laws appears to be straightforward. Assume, for the moment, that debt relief laws afforded all debtors the same meager existence and required them to repay with anything they earned in excess of this amount. Though Brian and Clara could earn much more than this amount, they would have little, if any, incentive to do so unless they could repay their debts in full. They would face an ef-

142. See, e.g., Jones & Zywicki, *supra* note 2, at 182 (“Debtors with good jobs and regular incomes should be held to a different standard from debtors who confront real hardship or incapacity. Debtors with higher incomes should ordinarily repay more to creditors than debtors with lower incomes.”).

143. See, e.g., SULLIVAN, WARREN & WESTBROOK, *supra* note 10, at 200 (“Where to draw the line—how much sacrifice to require of people in debt—is a key question in bankruptcy.”).

144. See, e.g., Jones & Zywicki, *supra* note 2, at 182 (“These principles are applied routinely by government—higher-income earners are expected to pay more in taxes, just as needs-based relief is the hallmark of most social welfare programs.”) For a review of the literature on optimal progressive taxation, see Stiglitz, *supra* note 18. The idea that those who can pay more should pay more also underlies means-testing in social assistance, though in a slightly different form.

145. See *infra* Section III.

146. See, e.g., Stiglitz, *supra* note 18 (reviewing the relevant literature).

fective marginal tax rate of one hundred percent that would deprive them of additional income earned by working harder. As a consequence, they would likely choose to spend less time at work and more time with their families or relaxing, and the collection system will yield little, if anything, for creditors. Creditors may be able to induce Brian and Clara to work more, and thus pay the creditors an additional amount, by allowing them to keep some portion of their additional earnings.¹⁴⁷

This work-incentive argument is probably most directly applicable in the context of garnishment law, but even there one can question the argument. In advocating the greater use of garnishment in bankruptcy, some commentators specifically cite the premise that debtors must be allowed to retain some fraction of the additional earnings that come from working harder so that they will retain some incentive to do so.¹⁴⁸ This does not mean that the disincentive to work will be completely eliminated. Current federal limitations on garnishment allow general creditors to seize up to twenty-five percent of a debtor's take-home pay,¹⁴⁹ and although some have called for bankruptcy garnishment rates that are exceedingly low,¹⁵⁰ such garnishment would seize at least a portion of the last dollar a debtor earns. Because she will bear the full costs of working the time necessary to earn this last dollar but will not receive the full reward (some of the increased income will be garnished), the debtor may choose to substitute toward more leisure; this is the "substitution" effect. On the other hand, garnishment will make her less wealthy, and she may choose to work more in order to finance her basic needs; this is the "wealth" or "income" effect. Economists typically believe the substitution effect will dominate and lower tax rates will induce individuals to work harder,¹⁵¹ and, in any case, the income effect is irrelevant from the standpoint of efficiency.¹⁵²

147. This argument has obvious similarities to claims that reducing marginal income tax rates would actually increase tax revenues. See, e.g., JOHN W. SLOAN, *THE REAGAN EFFECT: ECONOMICS AND PRESIDENTIAL LEADERSHIP* 7 (1999) ("According to Supply Side Theory, reducing the rates for all groups, and removing six million low-income families from the tax rolls, strengthened incentives to work, save, and invest."). See generally LAWRENCE LINDSEY, *THE GROWTH EXPERIMENT: HOW THE NEW TAX POLICY IS TRANSFORMING THE U.S. ECONOMY* (1990).

148. See, e.g., NBRC REPORT, *supra* note 12, at 269 ("Because the amounts required by the guideline are a percentage of income and not dollar for dollar, the system would not discourage a debtor from increasing productivity."); Wang & White, *supra* note 127, at 257. The statement by the NBRC is plainly incorrect; any marginal tax rate greater than zero will affect the debtors incentive to work. However, the NBRC suggested marginal rates so low (the highest rate of five percent would apply only to those earning more than \$75,000 per year) that the practical effect of their error may be negligible.

149. Fair Debt Collections Practices Act, 15 U.S.C. § 1673 (2000) (restricting garnishment in favor of general creditors to no more than the lesser of twenty-five percent of the debtor's "disposable earnings" or the amount by which her disposable income exceeds thirty times the federal minimum wage, with "disposable earnings" defined in this context to mean roughly the debtor's take-home pay).

150. The NBRC recommended garnishment rates that would at most seize five percent of the debtor's income. See NBRC REPORT, *supra* note 12, at 269.

151. When studying the effect of income taxation on the labor supply, economists refer to two effects, the wealth (or income) effect and the substitution effect. The wealth effect refers to the tendency of an individual to work more when a tax is increased because the tax makes her poorer and

One can uncover the potential flaw in the claim that lower garnishment rates will lead debtors to work harder by examining the analogy that some scholars make between bankruptcy and public assistance programs. These bankruptcy scholars point out that public assistance can provide recipients an incentive to work through a calibration of the benefits-income relationship. If benefits are reduced by less than any increase in income from new employment, then the recipient will have some incentive to seek that new employment.¹⁵³ These scholars overlook a potentially offsetting effect. This approach also invites others in poverty to work a little less and thus qualify for public assistance, and one cannot determine if the *aggregate* incentive to work increases or decreases unless one compares the effects on each group.¹⁵⁴

This potentially offsetting effect applies to garnishment as well, and one cannot, as a matter of theory, conclude that a system that limits garnishment provides greater incentives to work than a system that seizes all of the debtor's wages above some meager amount. The more lenient system may provide a greater incentive for a debtor to work after default. By allowing the debtor to keep more of her wages after default, however, the more lenient system will make default attractive to more debtors and thus might cause some additional debtors to default. As long as the more lenient garnishment system would seize *some* of the wages of the debtors who would not have defaulted but for the leniency of the system, these debtors would keep less of their *marginal* earnings than if they repaid their debts in full and thus they would have less of an incentive to work an additional hour. In addition, the more lenient system increases the debtor's wealth and thus reduces her incentive to work. To determine whether the more lenient system results in more hours worked, one must compare the additional hours worked by the debtors who would default under either system and the reduced hours worked by the debtors who only default when garnishment is limited.

Although one may reasonably believe that, as an empirical matter, limitations on garnishment do increase the aggregate incentive to work,

hence she values an additional dollar of income more highly and is willing to sacrifice more leisure to get it. The substitution effect refers to the fact that the individual does not get to keep all of the last dollar earned. The tax therefore makes leisure "cheaper" and the individual "substitutes" leisure for work. Whether an increase in taxes will induce the worker to work more or less depends on which effect dominates; however, economists generally believe that the substitution effect will dominate in most circumstances. See, e.g., NEIL BRUCE, PUBLIC FINANCE AND THE AMERICAN ECONOMY 428-32 (2d ed. 2001).

152. *Id.* at 430-31 (discussing inefficiency created by substitution effect).

153. See, e.g., LoPucki, *supra* note 116, at 471.

Today, even the crudest welfare proposal must leave the welfare recipient with some incentive to earn the marginal dollar or the proposal has no hope of adoption. It is generally acknowledged that if alimony and child support levels are set too high, they can be counterproductive by discouraging the payer from earning more money. Yet under the scheme of Chapter 13, the debtor who earns an additional dollar is required to pay that additional dollar to unsecured creditors.

Id.

154. See, e.g., Gary Burtless, *The Economist's Lament: Public Assistance in America*, 4 J. ECON. PERSP. 57, 69 (1990).

it is much more difficult to argue that the current inequality of Chapter 13 is designed to induce debtors to work harder. By its terms, Chapter 13 requires the debtor to repay with all of her *projected* disposable income over three years.¹⁵⁵ Some courts adopt a literal interpretation of this test and require a debtor to repay an amount based on her *projected* income rather than her *actual* income.¹⁵⁶ Taken literally, the debtor's *actual* income does not alter the amount that the debtor must repay: if she earns more than her projected income, then she may retain the excess; and if she earns less than her projected income, then she must somehow reduce her living standards to meet the shortfall.¹⁵⁷ If this were the case, then the projected disposable income test would create a lump-sum obligation based on the debtor's ability to earn. A lump-sum tax based on an individual's ability to earn represents the first-best, Utopian tax of the public finance literature because the government can demand that the more able pay greater taxes than the less able while still maintaining a tax system that does not distort anyone's incentive to work.¹⁵⁸ That is, the government can create a tax that is both fully equitable, because everyone consumes the same amount,¹⁵⁹ and fully efficient because the marginal tax on earnings is zero.¹⁶⁰ Similarly, if courts could implement a system that based a debtor's required repayment on her ability to earn, then they could seek any measure of equality they desired without concern for any adverse effects this would have on debtors' incentives to work.¹⁶¹

Unfortunately, the first best taxation system described above is also Utopian in that the government cannot observe an individual's ability to earn and thus cannot implement the tax.¹⁶² Because of this, the government implements a tax based on something that it can observe: the individual's actual income.¹⁶³ Similarly, some judges doubt their ability to project a debtor's income over the course of the plan, and therefore interpret projected disposable income to capture the debtor's actual disposable income over the course of the plan.¹⁶⁴ This creates an effective

155. 11 U.S.C. § 1325(b) (2000).

156. See Anderson v. Satterlee, 21 F.3d 355, 357–58 (9th Cir. 1994).

157. See Richard M. Hynes, *Optimal Bankruptcy in a Non-Optimal World*, 44 B.C. L. REV. 1 (2002).

158. See Stiglitz, *supra* note 18, at 995–96.

159. Additional technical assumptions are required to conclude that everyone would consume the same amount in the Utopian system. For example, one could assume that the individual's enjoyment of an additional dollar of consumption depends solely on her total consumption and not on the number of hours that she works. See, e.g., *id.*

160. *Id.* A lump-sum tax does not distort an individual's incentive to work because she must pay the tax regardless of the actions that she takes; there is no substitution effect. A lump-sum tax may cause an individual to work *more* by reducing her wealth, the income effect, but economists do not focus on this effect because it does not affect the efficiency of the tax. See BRUCE, *supra* note 151, at 428–32.

161. See generally Hynes, *supra* note 157.

162. See Stiglitz, *supra* note 18, at 996–97.

163. *Id.*

164. See, e.g., Rowley v. Yarnall, 22 F.3d 190, 192 (8th Cir. 1994) (interpreting “projected disposable income” to mean “disposable income” for fear that debtor would “predict” that disposable in-

one hundred percent marginal tax rate, though occasionally courts require only that the debtor repay with some fraction, say fifty percent, of her actual income above the projected amount.¹⁶⁵ Even if a court interprets “projected income” to really mean *projected income* instead of *actual income*, there is some chance that the court will later approve a request by the Chapter 13 trustee or an unsecured creditor to modify the plan to increase payments following an improvement in the debtor’s circumstances,¹⁶⁶ and a much greater chance that a court will approve a request by the debtor to modify the plan to reduce payments if her circumstances deteriorate. Because these modifications adjust the required repayment based on the debtor’s actual financial performance, they also create an effective marginal tax on actual earnings and thus may discourage the debtor from working.

A bankruptcy policy that allows a more able individual to claim larger expenses in her initial plan¹⁶⁷ does nothing to reduce the effective marginal tax on earnings, and thus does not increase the debtor’s incentive to work. Rather, such a scheme is more akin to income tax deductions that do not increase an individual’s incentive to work because they do not affect her marginal tax rate. In fact, these deductions may *reduce* a debtor’s incentive to work because they make the debtor more wealthy.¹⁶⁸

The incentive justification for the inequality of debt relief applies even more poorly to the debtor’s physical assets. Allowing the debtor to

come will be zero,” and thus render the entire disposable income test meaningless); Hynes, *supra* note 157, at 55–75 (discussing case law).

165. *In re Krull*, 54 B.R. 375, 378 (Bankr. D. Colo. 1985). This approach was later followed in *In re Riggleman*, 76 B.R. 111, 114 (Bankr. S.D. Ohio 1987). However, the Southern District of Ohio has since adopted the approach of *Anderson*. See *In re Bass*, 267 B.R. 812, 819 (Bankr. S.D. Ohio 2001). Note that this effectively creates a fifty percent marginal income tax rate on top of whatever other taxes the debtor is paying.

166. See, e.g., *In re Anderson*, 21 F.3d 355, 358 (9th Cir. 1994) (basing its holding in part on the ability of the trustee or unsecured creditor to request a modification of the plan to capture the benefit of an unexpected improvement in the debtor’s circumstances).

167. The same analysis does not apply to the adjustment of a debtor’s expenses during subsequent modifications. If the debtor knows that the court will allow her to claim additional expenses should her earnings increase, then she will realize that the marginal tax on earnings will not be one hundred percent. Economists noted this effect in welfare programs in that caseworkers typically adjusted expenses upward when a recipient’s earnings increased and thereby reduced the effective tax on earnings. Burtless, *supra* note 154, at 63. Similarly, in the few cases where judges do increase a debtor’s required repayments following an increase in her earnings, they also increase her allowed expenses and thereby reduce the effective marginal tax rate imposed by postconfirmation modifications. See Hynes, *supra* note 157, at 33–36.

168. See generally BRUCE, *supra* note 151, at 432–33. Note that if the debtor cannot avoid the debt obligation created in Chapter 13, then larger allowed expenses would not increase the debtor’s incentive to work even if the court demanded that the debtor repay with all of her actual income above the allowed expenses. Assume that the judge determines that Brian *should* earn \$90,000 a year and spend \$20,000. She would then demand that he use the remaining \$70,000 per year to repay his creditors. By assumption he cannot avoid the repayment of the \$70,000 debt and therefore must work hard enough to earn the \$90,000 in order to consume the \$20,000. If the judge raised the allowed expenses to \$40,000, then Brian would not work any harder. Again, he would work enough to earn \$90,000 so that he could consume \$40,000.

keep assets that she purchased with income earned after default may provide her with some incentive to work. This argument has limited applicability to nonbankruptcy collection law because the debtor typically shields assets purchased at an earlier time when she had more income. This justification has no applicability to the exemptions of Chapter 7 because the debtor is given a discharge that allows her to spend her post-bankruptcy earnings however she wishes.¹⁶⁹

2. *Inequality and the Debtor's Incentive to Cooperate*

Although the treatment of the debtor's assets cannot be explained by the need to provide her with an incentive to work, perhaps it can be explained by the need to encourage her to otherwise cooperate with the collections process. In fact, this cooperation theory may have broader application; a variant of this theory provided one of the earliest justifications for a discharge of debts in bankruptcy.¹⁷⁰ Under this theory, the discharge of bankruptcy is offered as a carrot to those debtors who cooperate with the bankruptcy process and reveal the location of their assets, so as to maximize the total distribution to creditors.¹⁷¹

The debtor cooperation theory never provided more than a partial explanation for the discharge and has little meaning for the vast majority of bankrupt debtors today. Keep in mind, one can encourage cooperation either by using a carrot or a stick. Under ancient collection laws, creditors could threaten a noncooperating debtor with enslavement or even death,¹⁷² and as late as 1857, creditors in Massachusetts could have a debtor imprisoned.¹⁷³ Perhaps not coincidentally, it was not until well after debtor's prison was abolished in the United States that a lasting Bankruptcy Act was passed.¹⁷⁴

Because the debtor cooperation theory posits that the discharge is needed to maximize creditor collections, it provides a poor justification for a modern bankruptcy system that yields nothing for unsecured credi-

169. See 11 U.S.C. § 727 (2000).

170. See, e.g., Charles Jordan Tabb, *The Scope of the Fresh Start in Bankruptcy: Collateral Conversions and the Dischargeability Debate*, 59 GEO. WASH. L. REV. 56, 89–103 (1990) (discussing the historical development of the justifications for the bankruptcy discharge).

171. *Id.* at 90.

172. Ancient Athens considered defaulting on a debt a capital crime. See, e.g., Lawrence H. White, *Bankruptcy As an Economic Intervention*, 1 J. LIBERTARIAN STUD. 281, 281 (1977). In ancient Rome the creditors of a defaulting debtor could enslave the debtor or “divide the debtor's body into proportionate shares.” *Id.*

173. See CHARLES WARREN, *BANKRUPTCY IN UNITED STATES HISTORY* 52 (1935).

174. *Id.* at 52–92. The U.S. Constitution grants Congress the power to enact uniform bankruptcy laws. U.S. CONST. art. I, § 8, cl. 4. Prior to 1898, however, Congress enacted three bankruptcy acts that together lasted less than twenty years. Congress repealed the Bankruptcy Act of 1800 in 1803, 2 Stat. 248 (1803), the Bankruptcy Act of 1841 in 1843, Act of March 3, 1843, 5 Stat. 614 (1843), and the Bankruptcy Act of 1867 in 1878, Act of June 7, 1878, 20 Stat. 99 (1878). Of course, state law did afford early debtors some protection from their creditors even prior to the abolition of debtor's prison. See generally PETER J. COLEMAN, *DEBTORS AND CREDITORS IN AMERICA: INSOLVENCY, IMPRISONMENT FOR DEBT, AND BANKRUPTCY 1607–1900* (1974).

tors in approximately ninety-five percent of cases filed in Chapter 7.¹⁷⁵ Bankruptcy *may* induce debtors to cooperate with foreclosure by their secured creditors; however, secured creditors already enjoy substantial rights under state law, and it appears that bankruptcy is likely to result in the reaffirmation of a debtor's secured loans rather than foreclosure.¹⁷⁶

The debtor cooperation theory may have some applicability to those few debtors who will repay a significant amount in bankruptcy because these debtors may be encouraged to reveal the location of their most valuable assets. A system that provides potentially unlimited exemptions in assets that are extremely hard to hide, such as the family home, seems poorly designed for this goal. A system like the Bankruptcy Act of 1800 that provides the debtor with exemptions equal to a percentage of the distributions to creditors would seem to provide her with a much better incentive to cooperate. Indeed, scholars commonly argue that the percentage exemption of the Bankruptcy Act of 1800 was designed to increase the returns to creditors.¹⁷⁷ The plausibility of this justification is undermined by the fact that the debtor was only allowed to retain between three and ten percent of the assets that she handed over to her creditors, up to a maximum of \$800.¹⁷⁸ It is questionable, at best, to assert that an effective asset tax of *only* ninety to ninety-seven percent provides a strong incentive for the debtor to reveal her assets.

III. INEQUALITY, DEBT RELIEF LAWS, AND INSURANCE—THE BASIC ARGUMENT

Most would probably agree that debt relief laws, like other laws, must *tolerate* some degree of inequality, so as to encourage more able debtors to cooperate with collection efforts by revealing the location of assets or continuing to work hard to generate income. As demonstrated

175. See U.S. Gen. Accounting Office, Bankruptcy Administration, Case Receipts Paid to Creditors Professionals 1–2 (1994) (on file with the United States General Accounting Office, Washington, D.C.) (“Of the 1.2 million Chapter 7 bankruptcy cases closed in statistical years 1991 and 1992, about five percent (56,994) generated some receipts for distribution to professionals and creditors.”). These figures may *overstate* the repayment in Chapter 7, as most of the five percent of bankruptcies with assets available for distribution to creditors are in fact business bankruptcies. See NBRC REPORT, *supra* note 12, at 137.

176. See, e.g., Marianne B. Culhane & Michaela M. White, *Debt After Discharge: An Empirical Study of Reaffirmation*, 73 AM. BANKR. L.J. 709, 713 (1999) (finding that twenty-five percent of cases sampled had a reaffirmation agreement in the file); Warren, *Principled Approach*, *supra* note 11, at 499 (claiming that more than forty percent of debtors reaffirm some debt).

177. See, e.g., Shames, *supra* note 136, at 193–94; William J. Woodward Jr., *Exemptions, Opting out, and Bankruptcy Reform*, 43 OHIO ST. L.J. 335, 338 (1982).

178. Bankruptcy Act of 1800, 2 Stat. 19 (1800) (repealed 1803). Though this amount represents just \$8,000 in year 2000 dollars, it was still a considerable sum at the time. By comparison, the average daily wage for a laborer in Philadelphia in 1830 was just one dollar. U.S. DEP'T OF COMMERCE, HISTORICAL STATISTICS OF THE UNITED STATES: COLONIAL TIMES TO 1970 pt.1, at 163 (1975) (citing ser. D 715-17: *Average Daily Wage Rates of Artisans, Laborers, and Agricultural Workers, in the Philadelphia Area: 1785 to 1830*).

above,¹⁷⁹ however, this incentive-based justification for the inequality of debt relief cannot justify much of the inequality that characterizes our current system.

To complete the defense of inequality, this article stresses a different argument that suggests that the inequality of debt relief should not merely be tolerated, but actively sought. This argument does not celebrate a world in which wealthy individuals, like Clara, can lead a lavish lifestyle while others, like Adam, struggle to survive. Nor does this article quibble with arguments for greater redistribution through taxation and transfer programs; rather, this article posits that debt relief is ill-suited to aid this effort.

The basic argument starts from the premise that if debt relief laws are to serve any useful purpose, it is as insurance that individuals cannot or will not purchase in the market due to well-recognized market failures. Debt relief, like any other insurance, provides a benefit, but comes at a cost. Therefore, in the absence of market failure, different individuals would choose different levels of debt relief based on their wealth and tolerance of risk. In particular, the wealthy would likely demand greater protection than the middle class and the middle class would likely demand greater protection than the poor. To demand that Adam, Brian, and Clara receive the same standard of living after default would sentence them all to a Procrustean system that would fit, at best, only one of them well.

A. *Debt Relief as Insurance*

Debt relief laws present somewhat of a puzzle because they limit enforcement of the monetary judgments that form the basis of much of the American justice system.¹⁸⁰ By forcing a tortfeasor to pay an amount commensurate with the harm she causes, tort law gives her an incentive to take precautions and provides some compensation to her victims.¹⁸¹ By forcing a party to pay damages upon breach of contract, contract law protects exchange and encourages commerce.¹⁸² To the extent that debt relief renders tort and contract judgments unenforceable, debt relief destroys these desirable incentives.

Scholars have devoted considerable effort to explaining why society limits the ability of creditors to enforce a judgment against a debtor; these works are effectively summarized elsewhere in the literature.¹⁸³ Often these arguments are divided into several distinct categories, such as: (i) debtor cooperation, or the need to encourage the debtor to cooperate

179. See *supra* Section II.B.

180. See, e.g., RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 214–15 (5th ed. 1998).

181. *Id.*

182. *Id.* at 130–44.

183. See generally Hallinan, *supra* note 20; Tabb, *supra* note 170, at 89–103 (reviewing the theories in light of the willful and malicious exception to discharge).

with collection efforts (discussed above); (ii) externalities, or the concern that excessive debt collection will harm society by increasing the strain on charity and the social welfare system or fomenting social unrest; (iii) humanitarianism, or the need to restore the debtor's sense of self-worth and thereby improve society as well; (iv) cognitive failure, or the paternalistic concern that debtors will systematically make mistakes in their financial decisions that will lead to their financial ruin; and (v) insurance, or the theory that debt relief laws can help shift risk to parties who are better able to bear it.¹⁸⁴

With the possible exception of the debtor cooperation theory discussed in Section II, each of the other arguments can be integrated into the insurance theory. For example, the externalities and cognitive failure arguments are really just two sources of market failure that explain why the government may wish to create debt relief laws offering insurance, rather than leave individuals to purchase this insurance in private markets.¹⁸⁵ The humanitarian argument is much more difficult to define, at least in economic terms, but is clearly related to altruism, or an individual's concern for the well-being of her fellow citizens. This theory fails to explain why society should be more concerned about individuals whose destitution results from large obligations than individuals whose destitution results from a simple lack of assets.¹⁸⁶ As discussed below, the insurance theory of bankruptcy provides one possible explanation.¹⁸⁷

Scholars have long characterized debt relief laws as a form of insurance.¹⁸⁸ The standard insurance policy provides a benefit, often a cash payment, to the consumer upon the occurrence of an insured event, such as hospitalization, disability, death, or destruction of property.¹⁸⁹ In exchange, the insurer demands that the insured pay a premium that will, on average, cover the benefits paid, any administrative costs and provide the insurer with some profit. These premiums must also be large enough to account for the moral hazards that insurance creates. Because the insurer will reimburse the consumer for some or all of her loss, the consumer may fail to take the precautions necessary to reduce the risk or severity of loss. In addition, the loss itself may be costly or difficult to verify and the consumer will have an incentive to falsely claim or exaggerate a loss in order to obtain a larger benefit. These moral hazards will increase the consumer's expected loss.

184. See, e.g., Tabb, *supra* note 170, at 89–103.

185. See, e.g., Hallinan, *supra* note 20, at 109–25.

186. That is, it is difficult to argue that humanitarianism or altruism requires the more generous treatment of the destitute that were formerly wealthy than the destitute that never enjoyed a higher standard of living.

187. See *infra* notes 191–93 and accompanying text (discussing the insurance theory of bankruptcy).

188. See, e.g., Hallinan, *supra* note 20, at 98–109 (collecting citations and discussing the relationship between bankruptcy and insurance).

189. *Id.* at 100–03.

The consumer is willing to pay premiums that are, on average, in excess of her expected loss in the absence of insurance because the insurance contract reduces the uncertainty associated with her future standard of living; risk-averse consumers are willing to sacrifice some wealth on average in order to reduce uncertainty. The insurer is not as troubled by the uncertainty because she will contract with many consumers, and, as long as the risks associated with each are not highly correlated, will be able to predict annual claims accurately.¹⁹⁰

Like insurance, debt relief laws provide a benefit to the debtor on the occurrence of some contingency: the debtor's financial distress or unwillingness to repay her debts.¹⁹¹ The benefit provided by this insurance equals the debts the debtor is able to avoid paying. This benefit effectively increases the debtor's wealth and, as with other insurance benefits, she can use this wealth to consume more, to retain assets of particular value that she would otherwise have to sell, or to finance a fresh start in business. Rather than charge premiums, the creditor will charge the debtor a higher interest rate that reflects the increased probability of loss; however, the debtor and creditor may both benefit by shifting the risk to the creditor if the creditor contracts with numerous debtors and, thus, like an insurer, can diversify away much of the risk of loss.

Rather than focus on the benefit provided by debt relief, this article focuses on the standard of living that this benefit allows the debtor to maintain. Consumers buy insurance to minimize large deviations in their standard of living, and an ideal insurance policy would insure this standard of living directly.¹⁹² For example, an ideal health insurance policy will pay the hospital bill, or at least the bill in excess of the deductible, whether it is \$100,000 or \$1,000,000.

Most forms of insurance protect the debtor against a specific risk. Yet, debt relief appears to protect the debtor against a decline in her financial condition more generally. That is, debtors default after suffering a variety of misfortunes including illness, unemployment, or divorce.¹⁹³ A great many of these debtors, however, still would not have found themselves in financial distress had they exercised more prudence in their financial affairs by saving for a rainy day or borrowing a little less,¹⁹⁴ and some debtors owe their financial distress solely to their own profligate spending.¹⁹⁵ But this does not really separate debt relief from other insurance products because this behavior can be roughly characterized as

190. See, e.g., A. MITCHELL POLINSKY, AN INTRODUCTION TO LAW AND ECONOMICS 54 (2d ed. 1989).

191. See, e.g., Hallinan, *supra* note 20, at 98–109.

192. See *id.* at 102–03.

193. See, e.g., SULLIVAN, WARREN & WESTBROOK, *supra* note 10, at 16–21.

194. See, e.g., Warren, *supra* note 8, at 1081 (describing the inability of consumers to withstand shocks such as divorce or unemployment due to debt obligations they have incurred).

195. See, e.g., *id.* at 1087–88.

negligence, and, as a moment's reflection on automobile liability insurance reveals, one can frequently insure against one's own negligence.¹⁹⁶ Of course, bankruptcy may encourage the debtor to engage in risky behavior by shielding her from the consequences of failure,¹⁹⁷ but this is just another example of the first type of moral hazard that insurance creates.

B. *The Wealthy Insure a Higher Standard of Living*

Because insurance is designed to minimize deviations from an individual's expected or average standard of living, those who will, on average, have a higher standard of living will insure a higher minimum standard of living.¹⁹⁸ Note that the effect of wealth on the level of insurance is likely to be quite dramatic. By spending a few minutes on the Internet, an individual can receive quotes for term life insurance that provides a benefit anywhere between twenty-five thousand and twenty-five million dollars.¹⁹⁹ While other factors, such as the size of an individual's family or her tolerance of risk, clearly play a role in the choice of insurance, one

196. Since at least the beginning of the twentieth century, Americans have been able to purchase insurance against their negligent behavior. *See, e.g.*, *Breeden v. Frankfort Marine Accident & Plate Glass Ins. Co.*, 119 S.W. 576 (Mo. 1909). By contrast, Americans generally may not purchase insurance against intentional wrongs. ROBERT E. KEETON & ALAN L. WIDISS, *INSURANCE LAW: A GUIDE TO FUNDAMENTAL PRINCIPLES, LEGAL DOCTRINES, AND COMMERCIAL PRACTICES* § 5.4(a) (1988) ("Insurance policies typically include express provisions which either require that a loss be 'accidental' or preclude coverage for intended results."); Willy E. Rice, *Insurance Contracts and Judicial Discord over Whether Liability Insurers Must Defend Insureds' Allegedly Intentional and Immoral Conduct: A Historical and Empirical Review of Federal and State Courts' Declaratory Judgments—1900–1997*, 47 AM. U. L. REV. 1131, 1145–46 (1998) (describing the main components and clauses of a third-party liability insurance contract); D. Heath Baily, Comment, *Auto-Owners Insurance Co. v. Harrington: Resisting the Impulse to Judicially Rewrite Exclusion Clauses*, 1998 BYU L. REV. 1645, 1645–46 (explaining how insurance companies protect themselves through the use of an intentional acts exclusion clause). Indeed, policies that purport to insure against willful misconduct are generally void as against public policy. *See, e.g.*, *Ambassador Ins. Co. v. Montes*, 388 A.2d 603, 606 (N.J. 1978); KEETON & WIDISS, *supra*, § 5.4(d)(2). For the most part, bankruptcy law follows this logic and exempts debts arising from many forms of willful misbehavior from the discharge of Chapter 7. 11 U.S.C. § 523 (2000). Chapter 13, however, grants a broader discharge that absolves the debtor of liability for some willful misbehavior, including willful and malicious torts. *Id.* § 1328.

197. Society may want to encourage the debtor to engage in risky behavior. For example, risk-averse individuals may be reluctant to engage in entrepreneurial activity for fear that they will become destitute after a business failure. Society may want to encourage such behavior because of the jobs that this activity creates and may be able to do so by reducing the consequences of failure. *See, e.g.*, John M. Czarnetzky, *The Individual and Failure: A Theory of the Bankruptcy Discharge*, 32 ARIZ. ST. L.J. 393, 399 (2000) (arguing that bankruptcy may encourage entrepreneurs to take risks). This explanation for the bankruptcy system, however, must be combined with some form of market failure that explains why the debtor cannot just purchase insurance against the risk of failure. In addition, this explanation is more consistent with early bankruptcy laws that were restricted to merchants than modern bankruptcy, which is dominated by consumers and others who don't owe their financial distress to failed business ventures. Bankruptcy Act of 1800, 2 Stat. 19, 20 (1800) (repealed 1803).

198. The argument requires that the wealthy insure a greater minimum standard of living for themselves, not that they purchase more insurance. It is possible that the very wealthy fail to purchase insurance against risks that many would find significant because these risks cannot have an appreciable impact on the wealthy's standard of living. *See, e.g.*, Herbert Hovenkamp, *Legislation, Well-Being, and Public Choice*, 57 U. CHI. L. REV. 63, 70 n.21 (1990).

199. *See* Instant Life Insurance Quotes, at <http://www.quotesmith.com/cgi/term/qsternindex> (last visited Jan. 19, 2004).

can safely claim that wealthier individuals purchase more generous policies. Everyone would enjoy a life insurance policy that promised to pay their families tens of millions of dollars should they die prematurely, but these policies demand very large premiums. In the case of term life insurance for a thirty-five-year-old male without any unusual risk factors, premiums on a twenty-five million dollar policy would be roughly five to seven thousand dollars a year.²⁰⁰ These premiums would consume too much disposable income for most families, and thus most families purchase less generous policies, if any at all.

Casual perusal of the newspapers reveals stories of highly compensated athletes or entertainers who purchase disability or life insurance policies worth millions of dollars.²⁰¹ For example, before the championship game in college football in January of 2003, the star running back for the University of Miami purchased a two and a half million dollar policy to protect himself against a career ending injury.²⁰² The most lucrative policies often name the employers of these celebrities as the beneficiaries.²⁰³ This is partly because these celebrities often have contracts that guarantee payment in the event of injury;²⁰⁴ these celebrities are already insured against these risks. But, of course, the insurance provided by the guarantee comes at a price; the celebrity would have been able to negotiate a higher salary if she did not receive the guarantee.

When viewed in light of the insurance purchased by the very rich, their ability to “abuse” debt relief laws does not appear so patently offensive. Even a million dollar homestead exemption provides a smaller insurance benefit than that included in many of the policies that the very wealthy enter into voluntarily, and no one would characterize these voluntary policies as abusive.

If one views debt relief as insurance, then it is also much easier to defend the general inequality of debt relief. One could even defend laws that effectively force the poor or middle class to repay even while

200. *See id.*

201. Steve Caulk, *Olympians Find Insurance Costly; Athletes Safeguard Financial Future Against Career-Ending Injuries*, ROCKY MTN. NEWS, Feb. 2, 2002, at 8S; Sally Roberts, *Cards Covered If Big Mac Is Stuck on the Sidelines*, BUS. INS., Jan. 15, 2001, at 4.

202. *See McGahee Will Declare for Draft Despite Injury*, WASH. POST, Jan. 14, 2003, at D2. As an amateur, Mr. McGahee cannot be described as highly compensated. As a projected first-round draft pick, however, he had a reasonable expectation of a lucrative career. In fact, even though injured, Mr. McGahee was drafted, and he signed a contract on August 12, 2003, guaranteeing him seven million dollars, and as much as fifteen million dollars over the next five years. John Wawrow, *McGahee Signs Deal with Bills*, THE ANNISTON STAR, Aug. 15, 2003, available at <http://www.annistonstar.com/sports/2003/as-pros-0813-0-3h12w5146.htm> (last visited Jan. 19, 2004).

203. *See, e.g.*, Ken Rosenthal, *Insurance Should Help Gonzalez Land Long-Term Deal*, SPORTING NEWS, Nov. 26, 2001.

204. For example, baseball's collective bargaining agreement requires that a club pay a player's salary if he is injured in the scope of his employment. *See, e.g.*, Teresa Herbert, *Are Player Injuries Adequately Compensated?*, 7 SPORTS LAW. J. 243, 247 (2000). The Screen Actors Guild Theatrical Contract requires that producers obtain personal injury insurance for actors in the amount of \$1,000,000/\$2,000,000. SCREEN ACTORS GUILD, 2001 CONTRACT SUMMARY: THEATRICAL MOTION PICTURES AND TELEVISION 13 (2001).

wealthy deadbeats retain a higher standard of living. After default, Adam might want the debt relief afforded Brian, and Brian might want the debt relief afforded Clara. But the same would be true of any insurance policy after an insured event. After some injury that leads to disability, Adam would want the insurance policy that affords generous benefits to Brian, and Brian would want the insurance policy that affords even more generous benefits to Clara. The relevant question is whether Adam and Brian would have wanted a different insurance policy *before* the insured event occurred. For example, though Clara might purchase a term life insurance policy that provided the possibility of a multimillion dollar benefit, Adam would not want that policy if he were made to pay the premiums, as well. Therefore, a mandatory term-life insurance policy that applied to both Adam and Clara would either be too stingy for one or too dear for the other. Likewise, unless one can find a way to provide greater relief for the wealthy, one is likely to create a system of debt relief that provides inadequate protection for the wealthy or results in excessive interest rates for the poor.

IV. WHO PAYS FOR DEBT RELIEF

In arguing that the generous debt relief provided to the upper-income or the wealthy is no more offensive than the generous insurance policies purchased by the upper-income or the wealthy, the above analysis presumes that, on average, the upper-income and the wealthy pay for their own expected debt relief. This does not mean that the argument in favor of generous treatment of the upper-income and the wealthy requires that they pay higher interest rates than the poor; clearly they do not.²⁰⁵ Rather, the upper-income and the wealthy must pay higher interest rates than they would if they did not receive generous debt relief, and the increased losses that creditors suffer as a result of the debt relief afforded to the rich must not affect the interest rates paid by the poor or otherwise harm the rest of society. Therefore, the question of who pays the costs of default is central to the analysis.

Because debt relief laws impair the ability of creditors to collect their judgments, creditors bear the costs of debt relief *ex post*, at the time of default.²⁰⁶ For some creditors, such as tort victims, no further analysis is needed because these creditors do not have an opportunity to charge a price that reflects the risk of default. Thus, the retention of a multimil-

205. See, e.g., Reint Gropp et al., *Personal Bankruptcy and Credit Supply and Demand*, 112 Q.J. ECON. 217, 243 (1997) (finding that debtors with higher incomes paid lower interest rates).

206. *Id.* at 219 (arguing higher bankruptcy exemptions "reduce the amount that creditors receive in repayment of debt").

lion dollar home by an executive guilty of securities fraud²⁰⁷ comes at the expense of those she was found to have wronged.²⁰⁸

This article makes no attempt to defend these examples of abuse.²⁰⁹ However, this article's restraint stems not from the amount of wealth retained, but from the nature of the claim that remains unpaid.²¹⁰ This article views debt relief as insurance, and therefore accepts the general premise that insurance will not²¹¹ and cannot²¹² protect an individual from the consequences of her intentional wrongs, and so it becomes equally difficult to defend aspects of debt relief that protect the middle class or even the poor from the consequences of intentional misbehavior. For example, debtors have used the super-discharge of Chapter 13 to seek protection from debts arising out of fraud,²¹³ embezzlement,²¹⁴ misappropriation,²¹⁵ aggravated assault,²¹⁶ intentional shooting,²¹⁷ sexual assault,²¹⁸ and the sexual abuse of a minor.²¹⁹ Although the proposed reforms limit this super-discharge in cases that result in death or personal injury,²²⁰ the ability to seek protection from the consequences of other forms of intentional misconduct remains an anomaly.

For the most part, these *involuntary* creditors represent little more than a sidebar in the debates over bankruptcy reform because the debts

207. See *supra* note 136 and accompanying text.

208. Note that the legislation pending before Congress attempts to address this problem. The proposed reforms restrict the homestead exemption for those liable for securities fraud to \$125,000 per debtor and limit the discharge for willful and malicious acts that result in bodily injury or death. Bankruptcy Abuse Prevention and Consumer Protection Act of 2002, H.R. 5745, 107th Cong. § 314(b) (2002).

209. One might also question the treatment of tort claims based on a theory of negligence, however, this topic is left to another article.

210. The ability to use debt relief laws to avoid the repayment of tort creditors is obviously related to the extensive debate over the limited liability of corporations for torts. See, e.g., Henry Hansmann & Reinier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 YALE L.J. 1879, 1880 n.1 (1991).

211. KEETON & WIDISS, *supra* note 196, § 5.4(a) ("Insurance policies typically include express provisions which either require that a loss be 'accidental' or preclude coverage for intended results."); Rice, *supra* note 196, at 1146 (describing the main components and clauses of a third-party liability insurance contract); Baily, *supra* note 196, at 1645-46 (1998) (explaining how insurance companies protect themselves through the use of an intentional acts exclusion clause).

212. Contracts attempting to insure an individual against her intentional wrongs are typically voided as against public policy. See, e.g., *Ambassador Ins. Co. v. Montes*, 388 A.2d 603, 606 (N.J. 1978); KEETON & WIDISS, *supra* note 196, § 5.4(d)(2).

213. See, e.g., *In re Peterson*, 228 B.R. 19, 26 (Bankr. M.D. Fla. 1998); *In re McBroom*, 51 B.R. 953, 955 (Bankr. W.D. Va. 1985).

214. See, e.g., *In re Nipper*, 224 B.R. 756, 759 (Bankr. E.D. Mo. 1998); *In re Britt*, 211 B.R. 74, 78 (Bankr. M.D. Fla. 1997).

215. See, e.g., *In re Kelly*, 217, B.R. 273, 274 (Bankr. D. Neb. 1997); *In re Ledin*, 179 B.R. 721, 725 (Bankr. M.D. Fla. 1995).

216. See, e.g., *In re Day*, No. 98-3182 (7th Cir. 1999) (aggravated battery); *In re Easley*, 72 B.R. 948, 955 (Bankr. M.D. Tenn. 1987).

217. *In re LeMaire*, 898 F.2d 1346, 1347 (8th Cir. 1990).

218. See, e.g., *In re Solomon*, 67 F.3d 1128, 1134 (4th Cir. 1995); *Petty v. Belanger*, 232 B.R. 543, 549 (D. Mass. 1999); *In re Carsrud*, 161 B.R. 246, 250 (Bankr. D. S.D. 1993).

219. See, e.g., *In re Noreen*, 974 F.2d 75, 78 (8th Cir. 1992).

220. Bankruptcy Abuse Prevention and Consumer Protection Act of 2002, H.R. 5745, 107th Cong. § 314(b) (2002).

discharged in bankruptcy are overwhelmingly held by the consumer credit industry and other creditors with claims arising in contract.²²¹ Large commercial lenders like Citibank are unlikely to receive substantial public sympathy, but one might still question the fairness of forcing consumer lenders to effectively subsidize the lavish lifestyle of the upper-income or the very wealthy.

In contrast with tort victims and other *involuntary* creditors, however, creditors who are in privity of contract with the debtor can adjust their terms to reflect the possibility of debt relief and thus shift some of the costs of debt relief to the debtor.²²² That is, one cannot simply look to the fact that the creditor remains unpaid; one needs to consider the effect that these laws will have on the supply and demand for credit. Economists have long argued that because debt relief laws result in losses for creditors, creditors will restrict the supply of credit by either increasing interest rates or reducing access to credit.²²³ The empirical evidence strongly supports this hypothesis.²²⁴

Even if debt relief laws cause interest rates to rise, creditors may still bear some of the cost of these laws depending on how the supply and demand for credit reacts to changes in the effective interest rate. Note, however, that it is not clear that debt relief laws represent a “cost” at all. If debt relief laws solve some form of market failure and debtors realize this, then these laws *may* increase the demand for credit by more than the reduction in the supply of credit because the debtor will no longer fear that default will result in impoverishment or worse.²²⁵ If so, the relevant question is who captures the gains from these laws, not who bears the costs. In fact, there is evidence that some debt relief laws have provided a net benefit to credit markets.²²⁶

221. See, e.g., TERESA A. SULLIVAN, ELIZABETH WARREN & JAY LAWRENCE WESTBROOK, AS WE FORGIVE OUR DEBTORS 303 (1989)

222. See, e.g., William H. Meckling, *Financial Markets, Default and Bankruptcy: The Role of the State*, 41 LAW & CONTEMP. PROBS. 13 (Autumn 1977).

223. See, e.g., *id.* at 23.

224. See, e.g., James R. Barth et al., *The Effects of Government Regulations on Personal Loan Markets: A Tobit Estimation of a Microeconomic Model*, 38 J. FIN. 1233 (1983); Gropp et al., *supra* note 205; Daniel J. Villegas, *Regulation of Creditor Practices: An Evaluation of the FTC's Credit Practice Rule*, 42 J. ECON. & BUS. 51 (1990). Recently, however, some scholars have questioned whether credit card interest rates are affected by defaults. See *infra* notes 235–49 and accompanying text.

225. See, e.g., Villegas, *supra* note 224. Beneficial laws do not necessarily result in an increase in credit. See Richard Hynes & Eric A. Posner, *The Law and Economics of Consumer Finance*, 4 AM. L. & ECON. REV. 168 (2002).

226. See, e.g., James R. Barth et al., *Benefits and Costs of Legal Restrictions on Personal Loan Markets*, 29 J.L. & ECON. 357 (1986) (finding that statutes limiting deficiency judgments might provide a net benefit, but that legal restrictions on confessions of judgment, garnishment, and security interests in real property create a net cost); see also Villegas, *supra* note 224 (finding that restrictions on personal property and on wage garnishment provide a net benefit but that prohibitions on wage assignment create a net cost). These articles test whether the laws provide a net benefit or a net cost by examining the effect on total borrowing; they argue that if the laws are desirable they should make borrowing a more desirable product. This logic ignores the fact that one of the market failures justifying government intervention is cognitive failure, which prevents consumers from accurately gauging the value of these laws. See Hynes and Posner, *supra* note 225, at 187–88.

Regardless, most economists would probably argue that the supply of consumer credit is extremely responsive to the rate of return, and therefore debtors will bear all of the costs of debt relief laws²²⁷ or reap all of the gain. If credit markets were not competitive, then one might expect lenders to bear some of the costs of debt relief because they would be earning returns higher than they could earn elsewhere in the economy and therefore would be reluctant to withdraw from the market if their return fell only slightly. The evidence suggests that credit markets are highly competitive,²²⁸ and even if consumer lenders cannot themselves profitably find other opportunities in response to a decline in their rates of return, the individuals and institutions who supply them with capital could readily move available funds to more lucrative opportunities.²²⁹ It is possible that the individuals and institutions supplying capital could themselves bear some of the cost of debt relief laws if the laws reduced the rate of return of capital generally,²³⁰ but this effect will be muted by the many uses of capital and the size of worldwide financial markets.²³¹

Of course, the relevant question for this article is *which* debtors bear the cost of debt relief. Insurance spreads the cost of a single loss across many insured parties through insurance premiums.²³² Similarly, debt relief spreads the cost of a single default across many debtors through higher interest rates.²³³ However, the competitive nature of lending markets ensures that these losses will only be spread across debtors who present similar risks for a creditor. Because of this, scholars have traditionally argued that debt relief laws are unlikely to shift wealth between rich and poor debtors.²³⁴ Creditors have a strong incentive to

227. See, e.g., Meckling, *supra* note 222, at 23 (“For the reasons discussed above, all increases in lending costs as perceived by lenders will in the long run be borne by potential borrowers.”).

228. Credit markets may not be perfectly competitive; however, some consumer credit markets, such as those for credit card debt or mortgages, are now truly national markets and it would be very difficult to claim that any lender truly has market power. In addition, state and federal regulatory structures work to prevent excessive concentration in local lending markets. Furthermore, there is some evidence that different types of lenders, banks, finance companies, etc., compete for the consumer’s business. See, e.g., A. Charlene Sullivan, *Competition in the Market for Consumer Loans*, 36 J. ECON. & BUS. 141 (1984).

229. See, e.g., Meckling, *supra* note 222, at 20.

230. See, e.g., J. Fred Weston, *Some Economic Fundamentals for an Analysis of Bankruptcy*, 41 LAW & CONTEMP. PROBS. 47, 48–51 (Autumn 1977).

231. The argument that lenders are unlikely to bear much of the cost of debt relief laws in the long run may seem inconsistent with the consumer credit industry’s recent lobbying efforts. But even if creditors have nothing to gain in the long run from lobbying, they may have plenty to gain in the short run from a change in the law. Even excluding home loans, FDIC insured commercial banks carried approximately \$688 billion in loans to individuals at the end of the third quarter of 2002. See DIV. OF INS. & RESEARCH, FED. DEPOSIT INS. CORP., THE FDIC QUARTERLY BANKING PROFILE 4 (3d Quarter, 2002), at <http://www2.fdic.gov/qbp/2002sep/qbp.pdf> (last visited Jan. 19, 2004). If a change in law could even slightly increase their ability to collect these loans or even just shift losses to other creditors, then it would be rational for them to spend millions of dollars lobbying.

232. See *supra* note 190 and accompanying text.

233. See *supra* note 191 and accompanying text.

234. See, e.g., Hallinan, *supra* note 20, at 136; William C. Whitford, *A Critique of the Consumer Credit Collection System*, 1979 WIS. L. REV. 1047, 1080 (“The credit market is largely organized along

screen debtors based on the probability that a debtor will repay, and the debtors' assets and income are clearly relevant in this inquiry. Simply put, high-income debtors and low-income debtors present relatively different risks and lenders will try to distinguish between them. As long as the creditors collect sufficient information in a relatively inexpensive credit application process that distinguishes between rich and poor debtors, an increase in the probability of default by one type of debtor will not affect the terms offered to the other. For example, assume that a lender tries to charge Adam higher interest rates to compensate for some change that increases the probability that Clara will default (but not the probability that Adam will default). Another lender would simply offer Adam credit at the old terms and the creditor would be unable to shift the costs of Clara's generous expected debt relief to Adam.

Some might question whether the rapid growth of the credit card industry undermines the above analysis.²³⁵ For example, the argument that the wealthy bear the cost of their own debt relief assumes that creditors can distinguish the wealthy from the poor when lending. However, some scholars allege that credit card issuers fail to collect the basic information that would allow them to do so.²³⁶

Some might even question whether, as a group, debtors bear the costs of credit card losses. The traditional model alleges that competition causes the terms of debt relief to be reflected in the interest rate, but some scholars allege that credit card companies do not compete by offering lower interest rates.²³⁷ According to this theory, credit card issuers do not compete by offering lower interest rates because doing so will not attract those debtors that are the most profitable: those that did not intend to become indebted in the first place and thus do not pay attention to the interest that the credit card companies charge.²³⁸ If this allegation is true,²³⁹ then a decline in defaults would not lead to lower interest rates and debtors may not bear much of the costs of debt relief.²⁴⁰

class lines Consequently, any wealth redistribution is likely to be from good to bad credit risks, or from cash to credit buyers, within the same general income class.”).

235. Credit card loans still represent less than half of loans made to individuals by FDIC insured institutions. At the end of the year 2000, commercial banks and savings institutions had approximately \$266 billion in credit card loans outstanding out of a total of approximately \$402 billion in loans to individuals. *Id.* The amount of credit card loans has risen rapidly over time. In 1984, FDIC institutions had just sixty-four billion dollars of credit card loans on their balance sheet, or approximately twenty percent of their loans to individuals. *Id.*

236. *See, e.g.,* SULLIVAN, WARREN & WESTBROOK, *supra* note 10, at 137 (“The practices show that credit card companies increasingly fail to ask for vital information, such as employment and income, even at the start of the credit relationship.”).

237. *See* Lawrence A. Ausubel, *The Failure of Competition in the Credit Card Market*, 81 AM. ECON. REV. 50 (1991).

238. *Id.* at 70.

239. *See, e.g.,* Todd J. Zywicki, *The Economics of Credit Cards*, 3 CHAP. L. REV. 79, 104–09 (2002).

240. Note that debtors may still bear some of the costs of debt relief through reduced access to credit.

This does not, however, necessarily mean that the creditors will bear the cost of debt relief. Even if creditors do not compete by offering lower interest rates, they may still compete on other grounds, such as through annual fees, various reward programs, or better service.²⁴¹ As long as credit card markets may compete vigorously on these grounds, they will not earn abnormal profits in the long run and will not bear the costs of the debt relief laws.²⁴²

Of course, someone must bear the cost of credit card defaults. If credit card issuers compete by offering lower annual fees, better service or reward programs, then higher default rates could merely result in credit card issuers offering less generous reward programs rather than demanding higher interest rates. If this is the case, and if creditors are unable to distinguish between those who use credit cards merely for convenience from those who use them as a source of borrowing, then debt relief laws may effect a transfer from the former to the latter. The potential for a transfer between convenience users and borrowers is similar to an earlier concern that credit losses would be borne by cash purchasers of goods, as retailers who finance some purchases may respond to an increase in defaults by raising prices for all consumers rather than by merely charging a higher rate of interest to those who finance their purchases or by offering a cash discount.²⁴³

Even if one believes that credit card losses could result in higher costs for society generally or higher interest rates for the poor, this fact would not offer a compelling justification for restricting the debt relief offered to very wealthy debtors, like Clara, because the very wealthy probably do not use credit cards as a significant source of their borrowing.²⁴⁴ Occasionally one finds a wealthy debtor who has accumulated significant credit card obligations, but these debts are generally small, rela-

241. See Zywicki, *supra* note 239, at 117.

242. One can extend Professor Ausubel's model to suggest that credit card issuers will fail to compete on these other grounds, as well. According to Professor Ausubel, credit card terms are "sticky" because the old terms may remain an equilibrium after a change in the cost of lending. See, e.g., Lawrence M. Ausubel, *The Failure of Competition in the Credit Card Market*, in *ADVANCES IN BEHAVIORAL FINANCE* 527 (Richard H. Thaler ed., 1993). While Professor Ausubel focuses on the interest rate, his model could apply to any other lending term. His model fails, however, to explain why the lenders would choose the old lending terms from an infinite number of other possibilities that also satisfy his equilibrium criteria.

243. See, e.g., Meckling, *supra* note 222, at 23-24.

244. Unfortunately, it is difficult to obtain good data on the debt holdings of the very wealthy. According to the Survey of Consumer Finance, the percentage of families holding credit card balances peaks at 52.8% for families with incomes in the fortieth to sixtieth percentile and then falls to 33.1% for families with incomes in the top ten percent. See AIZCORBE ET AL., *supra* note 86, at 23. According to the Survey of Consumer Finance, the median income for families with incomes in the top ten percent is \$169,600. *Id.* at 5. Most individuals imagine households with incomes many times this amount when they refer to the very wealthy. Because of their very large incomes and assets, the truly wealthy need to incur a very substantial amount of debt in order to experience financial distress. Due to the availability of less expensive sources of credit, it is somewhat implausible to believe that the very wealthy incur millions of dollars of credit card debt.

tive to the debtor's other obligations.²⁴⁵ Perhaps more telling is the fact that some credit card companies actually *opposed* efforts to cap exemptions.²⁴⁶ Simply put, the credit card industry did not consider the unlimited exemptions sufficiently important to them and wanted to avoid any reforms that could generate opposition from politicians from states, such as Texas, that had these exemptions.²⁴⁷ By contrast, if one posits that credit card debt is primarily a middle-class phenomenon²⁴⁸ and that credit card issuers do very little to distinguish between debtors based on their incomes, then it is at least plausible that affording upper-middle-class debtors like Brian²⁴⁹ a generous fresh start will raise borrowing costs for the poor or the less affluent members of the middle class.

V. CONSIDERING THE SOURCE OF MARKET FAILURE

To explain why society adopts debt relief laws, one must do more than argue that these laws insure debtors against risks; one must also explain why consumers cannot, or will not, buy such insurance in private markets. In fact, private markets do provide insurance against many of the same risks that are commonly cited as leading to financial distress and default. For example, while illness and disability are frequently cited as circumstances leading to bankruptcy,²⁵⁰ many consumers purchase health insurance or disability insurance in private markets. In addition, one can buy insurance that provides a much closer substitute for debt relief: credit insurance. Credit insurance, like bankruptcy, relieves the debtor of the obligation to repay her debt after the debtor has suffered some misfortune, such as unemployment or disability.²⁵¹

Because well-functioning markets produce efficient outcomes, an argument that debtor-creditor law must provide insurance or a "fresh start" to the debtor rests on some theory of market failure. Many standard forms of market failure, such as imperfect competition, have limited

245. An anecdotal survey of newspaper reports on bankrupt celebrities reveals that credit cards do not comprise the primary portion of the debts that drove them into bankruptcy. *See, e.g.*, Kaloogerakis et al., *supra* note 30.

246. *See, e.g.*, Morgan, *supra* note 9, at A6 ("Texans also found allies in credit card company lobbyists who worked against a tough limitation [on homestead exemptions] on grounds that such a provision would turn Texas and Florida legislators against the bankruptcy bill and doom chances for reform.").

247. *Id.*

248. *See, e.g.*, SULLIVAN, WARREN & WESTBROOK, *supra* note 10, at 110.

249. Brian's income may place him beyond what many would consider middle-class. However, the term "middle-class" is not well defined and can be applied to most Americans. *See, e.g., id.* at 28 ("The most important point to make about the American middle class is that most Americans believe that they are in it.").

250. *Id.*

251. *See* CONSUMER CREDIT INS. ASS'N, THE 2000 FACT BOOK OF CREDIT-RELATED INSURANCE 4 (2000). Consumer advocacy groups have been highly critical of credit insurance. *See, e.g.*, CONSUMERS UNION & THE CTR. FOR ECON. JUSTICE, CREDIT INSURANCE: THE \$2 BILLION A YEAR RIP-OFF (1999), available at <http://www.consumersunion.org/pdf/credit.pdf> (last visited Jan. 19, 2004) [hereinafter CREDIT INSURANCE RIP-OFF].

application to credit markets.²⁵² Although insurance creates moral hazards by giving the insured an incentive to seek compensation when she has not in fact suffered a loss and reducing her incentive to take precautions, these moral hazards do not justify government intervention because there is little reason to believe that the government will be more effective than the market at solving these problems.²⁵³ However, scholars have identified several other forms of market failure that could justify government intervention.²⁵⁴ Some of these failures may support the inequality of debt relief while others clearly do not. Therefore, one must determine the market failure that debt relief laws are designed to solve.

A. *Externalities and the Sufficiency of Stingy Debt Relief*

Debtors will overborrow or fail to purchase the correct amount of insurance if their financial failure creates externalities, i.e. if their financial failure affects individuals who are not party to the credit transaction. Self-interested debtors will not consider the effect that their decisions have on these third parties and will purchase only the insurance that is in their own interest, not the greater amount of insurance that is in society's interest. Early justifications for debt relief laws tended to focus on the harm that severe collections efforts have on the debtor's family, rather than on the debtor herself.²⁵⁵ Essentially, this argument held that families must be protected from the improvident borrowing decisions of husbands and fathers who fail to account for the needs of their dependents.

More commonly, scholars argue that credit creates externalities for society as a whole. Some commentators argue that severe collections laws could lead to a large class of destitute individuals and foment social unrest.²⁵⁶ Others cite an externality stemming from society's altruistic nature.²⁵⁷ Because the altruist is saddened when she observes her fellow citizens in poverty, she will be harmed by overly aggressive collections laws that leave her neighbor destitute. Because the debtor does not consider this harm to the altruist when borrowing, she may borrow too much or fail to purchase sufficient insurance.

Of course, society can use government transfers to alleviate the debtor's poverty,²⁵⁸ but this may create a "Samaritan's dilemma."²⁵⁹ Be-

252. See *supra* note 228 (discussing evidence that credit markets are highly competitive).

253. See, e.g., Samuel A. Rea, *Arm Breaking, Consumer Credit and Personal Bankruptcy*, 22 *ECON. INQUIRY* 188, 189 (1984).

254. See *infra* notes 258–62, 270–71, 276–78, 282–84, 308 and accompanying text.

255. See, e.g., WARREN, *supra* note 173, at 62–89; Thomas H. Jackson, *The Fresh Start Policy in Bankruptcy Law*, 98 *HARV. L. REV.* 1393, 1419 (1985).

256. See, e.g., SULLIVAN, WARREN & WESTBROOK, *supra* note 10, at 260 (“[C]onsumer bankruptcy provides critical relief that heads off social unrest and keeps the maximum number of players in the economic game.”); Hallinan, *supra* note 20, at 117–21.

257. See, e.g., Jackson, *supra* note 255, at 1420–24.

258. The individual could also alleviate this poverty through charitable donations; however, each individual would prefer that her neighbor make the necessary contributions as poverty relief is essentially a public good. See, e.g., Harold M. Hochman & James D. Rodgers, *Pareto Optimal Redistrib-*

cause the debtor and creditor know that the social assistance program exists, they know that society will supplement the debtor's income when she becomes impoverished. The creditor may be more eager to lend because she hopes to collect from these government transfers. The debtor may fail to take precautions, such as the purchase of insurance,²⁶⁰ that protect her against loss and may engage in behavior, such as excessive borrowing, that makes her impoverishment more likely.²⁶¹

A closely related problem is created by the possibility that strong collections laws may discourage a defaulting debtor from working. There are really two effects here. If the creditor garnishes the debtor's wages or otherwise lays claim to a fixed percentage of the debtor's future income, then the creditor may reduce the debtor's incentive to work.²⁶² This marginal effect is, however, probably not that important. First, as noted above, it is not clear that reducing the percentage of earnings that a creditor can garnish will increase the aggregate incentive to work.²⁶³ Second, it is not at all clear that this effect creates an externality, as one must explain why the debtor's reduced efforts do not merely result in a loss of earnings. One could find an externality if the debtor's reduced efforts reduced the productivity of other workers.²⁶⁴ Although this may well be true, this problem is not unique to debt collection and is found in income taxation, as well.²⁶⁵ In fact, when measured by historical marginal tax rates, the effective marginal tax created by modern garnishment is actually fairly low. Consider, for example, a single debtor living in Virginia and earning \$25,000 a year. This debtor has a marginal tax rate of approximately 25.7% once all state and federal taxes are considered.²⁶⁶ If her wages are garnished, then the total effective marginal rate will rise to approximately 44%.²⁶⁷ Although this rate is quite high, it is only slightly higher than the marginal rate of 43% that she would pay without gar-

tion, 59 AM. ECON. REV. 542, 543 (1969). In any case, private charity would suffer from the same Samaritan's dilemma.

259. See, e.g., Stephen Coate, *Altruism, the Samaritan's Dilemma and Government Transfer Policy*, 85 AM. ECON. REV. 46 (1995) (explaining the "Samaritan's Dilemma," wherein the poor fail to take precautions against loss in anticipation of government transfers from the wealthy).

260. See, e.g., *id.* at 50–51.

261. See, e.g., JACKSON, *supra* note 66, at 243–48; Jackson, *supra* note 255, at 1402; Eric A. Posner, *Contract Law in the Welfare State: A Defense of the Unconscionability Doctrine, Usury Laws, and Related Limitations on the Freedom to Contract*, 24 J. LEGAL STUD. 283 (1995).

262. See *supra* notes 153–54 and accompanying text.

263. See *supra* notes 153–54 and accompanying text.

264. See Stiglitz, *supra* note 18, at 1019–21 (discussing this assumption in optimal tax literature).

265. *Id.*

266. This assumes that the individual must pay 7.65% in Social Security and Medicare, five percent in Virginia state taxes, and fifteen percent in federal taxes on the amount remaining after the other taxes are assessed.

267. Garnishment would seize an additional twenty-five percent of the debtor's *after-tax* income.

nishment if she earned \$300,000 per year²⁶⁸ and well below some historical federal tax rates, which reached as high as 94% in 1944–1945.²⁶⁹

More serious is the possibility that collection efforts become so onerous that the debtor will forego work altogether and instead rely on social assistance or work in the cash economy.²⁷⁰ This problem, sometimes referred to as the “debt overhang,”²⁷¹ creates an externality because the debtor foregoes productive labor and either becomes a drain on the public fisc or ceases to contribute to such fisc through taxation.

Both the Samaritan’s dilemma and the debt overhang may justify debt relief, but they cannot plausibly justify the debt relief currently offered to the wealthy or even the upper-middle class. To solve the debt overhang, society need only ensure that the debtor will always prefer working in the market sector to relying entirely on government transfers or nonmarket income.²⁷² To do so, debt relief laws may have to forgive all of Adam’s debts without demanding any repayment. But it strains credibility to argue that Clara or Brian must be allowed to retain all of their future income or else they will choose to rely on public assistance or work at a job that pays them a fairly small cash income; public assistance is simply not that generous.²⁷³ For example, in Virginia the maximum weekly unemployment insurance benefit is just \$368.²⁷⁴ Even allowing for the possibility that Brian would prefer more leisure time, it is unlikely that he would leave his job and his approximately \$1730 weekly salary and rely on unemployment insurance if he is asked to repay *some* amount out of future income through a process such as Chapter 13.²⁷⁵

268. This assumes that the individual must pay five percent in Virginia state taxes and 39.7% in federal taxes on the amount remaining after the state taxes are assessed. This individual would face no marginal Social Security or Medicare taxes because she will have exceeded the maximum taxes.

269. STAFF OF JOINT COMM. ON TAXATION, 106TH CONG., OVERVIEW OF PRESENT LAW AND ECONOMIC ANALYSIS RELATING TO MARGINAL TAX RATE AND THE PRESIDENT’S INDIVIDUAL INCOME TAX RATE PROPOSALS 7–8 tbl.1 (2001), at <http://www.house.gov/jct/x-6-01.pdf> (last visited Jan. 19, 2004).

270. See, e.g., JACKSON, *supra* note 66, at 228–48; Hallinan, *supra* note 20, at 120–25.

271. For an explanation of debt overhang, see David G. Carlson & Jack F. Williams, *The Truth About the New Valve Exception to Bankruptcy’s Absolute Priority Rule*, 21 CARDOZO L. REV. 1303, 1317 (2000); Alan Schwartz, *Interdisciplinary Conference on Bankruptcy and Insolvency Theory: The Absolute Priority Rule and the Firm’s Investment Policy*, 72 WASH. U. L.Q. 1213, 1218–20 (1994). For examples in personal bankruptcy, see Evelyn Brody, *Paying Back Your Country Through Income: Contingent Student Loans*, 31 SAN DIEGO L. REV. 449, 506 (1994).

272. Some wealthy debtors with substantial unearned income in the form of pensions may choose not to work. One cannot use the availability of these pensions to justify a generous discharge for the wealthy unless one has an explanation for why these pensions must be exempt.

273. David Gray Carlson, *Philosophy in Bankruptcy*, 85 MICH. L. REV. 1341, 1374 (1987) (reviewing JACKSON, *supra* note 66).

274. Econ. Policy Inst., Weekly Benefit Amount (WBA) Calculator, at http://www.epinet.org/content.cfm/datazone_uicalc_index (last visited Sept. 9, 2003).

275. If Brian voluntarily left his job, then he would not receive any unemployment insurance, but would instead have to rely on other forms of social assistance. See, e.g., Gilian Lester, *Unemployment Insurance and Wealth Redistribution*, 49 UCLA L. REV. 335, 350 (2001). Unfortunately for him, Brian may be ineligible for other forms of social assistance. See Carlson, *supra* note 273, at 1374 (“In the United States, federally funded welfare programs are limited to the aged, blind, disabled, or single parents with dependent children.”).

B. Market Failures That Support Mandatory but Unequal Debt Relief

The externality argument posits that debtors do not buy the insurance that is in *society's* interest. In order to invoke the basic insurance theory of inequality outlined in Section III, one needs to find market failures suggesting that the debtor does not buy the insurance that is in *her own* best interest. The standard theories that support such a proposition are paternalism and adverse selection.

1. Cognitive Failure and Paternalism

A consumer may over-borrow²⁷⁶ or fail to negotiate for enough insurance if she suffers from one of a host of cognitive failures.²⁷⁷ If so, the government may improve the consumer's welfare by forcing her to purchase the insurance that she would have purchased had she only known better. One might believe that the rate of cognitive failure should fall with education, but some scholars argue that members of the middle class remain quite susceptible to these cognitive failures.²⁷⁸ If the latter position is true, and if the debt relief afforded the middle class or upper-middle class does not adversely impact those of lesser means through higher interest rates or reduced access to credit,²⁷⁹ then the government should allow upper-middle-class debtors to maintain a higher standard of living than the poor following default because by doing so the government is just forcing the upper-middle class to purchase the greater protection that they would have demanded had they only known better. That is, unlike the externality arguments discussed above, paternalism may provide a justification for debt relief laws that allow middle-class or upper-middle-class debtors like Brian to maintain a sharply higher standard of living than the less fortunate members of society like Adam.

Once one concludes that paternalism requires the government to enact debt relief laws allowing Brian to maintain a higher standard of living than Adam, it is difficult to argue that Clara does not deserve a higher standard of living than Brian. Just as Brian would demand greater protection than Adam if each thought clearly about the risks involved, Clara would demand greater protection than Brian if each thought clearly about the risks involved. One would, therefore, need to explain why the very rich are smarter or more disciplined than the rest of us in order to explain why debt relief should not afford them a higher standard of living after default. In light of the chronicles of celebrity

276. Of course, many of the cognitive failures that allegedly afflict consumers may also cause them to borrow too little if they underestimate the value of the debt relief that they will receive upon default. See Richard M. Hynes, *Overoptimism and Bankruptcy Policy*, 2004 BYU L. REV. 127.

277. See, e.g., JACKSON, *supra* note 66, at 237–41; Hallinan, *supra* note 20, at 113–17.

278. See, e.g., SULLIVAN, WARREN & WESTBROOK, *supra* note 10, at 140 (“Some people cannot manage credit . . . [and] [t]he availability of consumer debt has forged a crack in middle-class economic stability.”).

279. See *supra* Section IV.

bankruptcies that fill the newspapers,²⁸⁰ this may be difficult to do. In fact, if one believes that some individuals suffer from an inability to manage their money, then it is particularly difficult to argue against some asset protection tools used by the rich to solve this very problem, such as spendthrift trusts.²⁸¹

Of course, one may argue that Clara simply does not need to retain a life of luxury financed by a generous spendthrift trust in order to protect her against her own misspending. After all, if she lost these assets after default, perhaps she would take more care. Luxury, like beauty, is in the eye of the beholder. Brian would consider Clara's lifestyle luxurious because she has far greater assets and income than he does. If viewed from the perspective of Adam, then Brian lives a life of luxury as well. One needs a reason to adopt Brian's, and not Adam's, definition of luxury.

2. *Adverse Selection*

Economists sometimes justify mandatory insurance programs as a solution to asymmetric information, or the possibility that consumers have much greater information about their own risk of injury than do their potential insurers.²⁸² If this is the case, then insurers may refuse to offer any insurance for fear that there will be adverse selection, that only those consumers with a particularly high probability of injury will apply.²⁸³ Insurers may be able to offer some insurance if the low-risk individuals can find some signal to distinguish themselves. In order for this signal to be credible, it must be costly. This adverse selection can lead to a market in which the good individuals are insured at a low rate, but would prefer to forego the costs of the signal and accept the higher premiums associated with the average risk in society.²⁸⁴

These same basic issues of adverse selection are present in credit markets. If creditors cannot cheaply distinguish between debtors with a high probability of default and those with a low probability of default, then low-risk consumers may try to signal their type by agreeing to excessively harsh or even punitive collections methods.²⁸⁵ These harsh collection methods serve as an effective signal because high-risk debtors

280. See Kalogerakis et al., *supra* note 30.

281. For a discussion of spendthrift trusts, see Adam J. Hirsch, *Spendthrift Trusts and Public Policy: Economics and Cognitive Perspectives*, 73 WASH. U. L.Q. 1 (1995).

282. For a discussion of asymmetric information in the context of consumer finance, see, for example, Hynes & Posner, *supra* note 225, at 173-77.

283. See, e.g., Nicholas Barr, *Economic Theory and the Welfare State: A Survey and Interpretation*, 30 J. ECON. LIT. 741, 750-52 (1992) (discussing adverse selection in the context of social insurance programs). The seminal paper on this topic is George A. Akerlof, *The Market for "Lemons": Quality, Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488 (1970) (demonstrating the fundamental problem of adverse selection by using the used car market as an example).

284. See, e.g., Barr, *supra* note 283, at 750-52.

285. See, e.g., Rea, *supra* note 253, at 196-99.

would find these terms more costly, due to their higher probability of default. A rule banning such harsh terms may improve aggregate social welfare; the higher interest rates paid by the low-risk consumers once the punitive collection methods are banned will roughly offset the lower interest rates paid by the high-risk consumers, and society will not need to endure the costs of the punitive collection methods. In fact, it is possible that the low-risk consumers themselves would prefer the new credit contract without harsh collections terms and with an interest rate that reflects the average probability of default in society. Such a contract was not offered prior to the ban on harsh collections terms because lenders believed that consumers who refuse to agree to such terms were high-risk; this belief was confirmed in equilibrium.²⁸⁶ Unfortunately, a rule banning harsh collections tactics will not necessarily improve welfare. If there are enough high-risk debtors in the marketplace, then asymmetric information could lead to credit rationing or cause credit markets to collapse entirely.²⁸⁷

Although asymmetric information *may* imply that *similarly situated* debtors should receive the same treatment after default, this does not mean that Adam, Brian, and Clara must all maintain the same standard of living because creditors can, at very low cost, distinguish between them at the time of lending and thus there is no adverse selection. The adverse selection argument posits a market in which there are groups of debtors that appear identical to our three debtors but have different probabilities of default. For example, assume that there are three more debtors, Alan, Ryan, and Clarice, who have the same relevant observable characteristics (occupation, income, assets, etc.) as Adam, Brian, and Clara, respectively. The adverse selection argument demands that Brian and Ryan receive similar treatment after default, but that each receive more generous treatment than Alan and Adam because creditors can cheaply distinguish between Adam and Brian (or Alan and Ryan). Therefore, like the paternalism argument, the adverse selection argument implies that debt relief laws should allow Clara to maintain a substantially higher standard of living than Brian and Brian to maintain a substantially higher standard of living than Adam following default, because adverse selection prevents each from purchasing the insurance that is in her or her self-interest.

286. See, e.g., Phillippe Aghion & Benjamin Hermalin, *Legal Restrictions on Private Contracts Can Enhance Efficiency*, 6 J.L. ECON. & ORG. 381, 388-92 (1990). The analysis of Aghion & Hermalin is actually more complicated and relies on a modeling assumption known as the "intuitive criterion." *Id.* at 387. Note further that Aghion & Hermalin's argument assumes that the low-risk individual cannot switch to another, unregulated, signal.

287. See, e.g., Joseph E. Stiglitz & Andrew Weiss, *Credit Rationing in Markets with Imperfect Information*, 71 AM. ECON. REV. 393 (1981).

3. *Limits of the Argument*

The paternalism and adverse selection arguments justify a system that affords greater protection to upper-income or wealthy Americans. This does not mean, however, that they support the degree of inequality created by the current debt relief laws. Take, for example, the Chapter 7 discharge that protects all of a debtor's future income.²⁸⁸ This protection allows Clara to support a lifestyle after default commensurate with a \$1,000,000 income, but allows Adam to support a lifestyle commensurate with an income of just \$10,300. Even if one accepts that Clara would demand a higher standard of living than Adam, one does not have to accept that she would have bargained for this level of protection.

One could, for example, believe that a more appropriate system would allow Clara to keep some portion of her additional income and adopt a system of progressive garnishment that has been proposed by the National Bankruptcy Review Commission and by prominent scholars.²⁸⁹ But note that such a system provides imperfect insurance because it sets the debtor's consumption with reference to her current earnings rather than her expected earnings. This distinction is important because the misfortune that forces a debtor into financial distress varies considerably.²⁹⁰

For example, assume that there are two debtors, a low-wage debtor and a high-wage debtor who earns twice the salary of the low-wage debtor. Assuming that these debtors are otherwise equal, the insurance theory of bankruptcy suggests that the high-wage debtor *deserves* a higher standard of living after default than the low-wage debtor.²⁹¹ Assume that each suffers an illness and that although the high-wage debtor's health insurance covers the costs of her treatment, the illness leaves her unable to perform her old job and forces her to accept a position at the same salary as the low-wage worker. The high-wage worker's financial distress results from debts that become unmanageable due to the fall in her wage. By contrast, assume that the low-wage debtor suffers no change in employment or earnings, but her health insurance does not cover the full costs of her treatment and her distress results from these medical bills. The insurance theory of debt relief would have afforded the high-wage worker a higher standard of living than the low-wage worker, but a system of garnishment would equalize their lifestyles.

288. Chapter 7 discharges all of a consumer's debt with the exception of narrowly defined nondischargeable debts and debts voluntarily reaffirmed by the consumer. 11 U.S.C. § 523 (2000). This discharge serves as an injunction against future collections efforts, *id.* at § 524(a), and thus prevents the debtor's pre-petition creditors from making a claim on her post-petition income.

289. *See supra* notes 97–105 and accompanying text. To be clear, the National Bankruptcy Review Commission did not advocate the abolition of Chapter 7, but merely the replacement of Chapter 13 with a system of progressive garnishment. *See* NBRC REPORT, *supra* note 12, at 270–72.

290. *See supra* note 193.

291. *See supra* Section III.B.

Perhaps the current form of Chapter 13 and its reliance on the vague “reasonably necessary” standard provides an alternative. Assume that, as critics probably allege correctly, a debtor’s reasonably necessary expenses are positively correlated with the debtor’s prebankruptcy expenses or “station in life.”²⁹² If individuals set their living expenses at a level appropriate for their expected earnings, then the fact that a debtor’s expenses in bankruptcy are positively related to her prebankruptcy expenses may in fact be desirable, because this would mean that they are positively related to the debtor’s expected earnings.

Unfortunately, one of the primary justifications for debt relief laws is that consumers are not always rational,²⁹³ and many debtors arrive in bankruptcy precisely because their standard of living was *not* commensurate with their expected earnings. Additionally, this use of the debtor’s standard of living invites abuse in that the debtor has a strong incentive to accumulate consumer durables and increase her expenses prior to filing for bankruptcy.²⁹⁴ If courts are unable, or unwilling, to stop this practice, then the debtor’s prebankruptcy expenses will serve as a very poor proxy for the insurance that she would have purchased in the absence of market failure.

The proposed bankruptcy reforms attempt to limit the ability of a debtor to inflate expenses by providing a more elaborate definition of the reasonably necessary standard and by setting a significant portion of the expenses of debtors with income above the median with reference to certain schedules published by the Internal Revenue Service.²⁹⁵ The meagerness of these expenses is well-documented, and even the pending legislation appears to contemplate revision by the Internal Revenue Code to more accurately reflect a reasonable cost of living.²⁹⁶

More interesting from the standpoint of this article is that a significant portion of the debtor’s allowed expenses explicitly increase with the debtor’s past income,²⁹⁷ a fact criticized by some scholars.²⁹⁸ Those debtors who had a higher average income over the preceding six months would be entitled to greater living expenses in bankruptcy. If one is concerned about manipulation, then the debtor’s past earnings may be a much better predictor of the insurance that she would have purchased than the debtor’s living expenses. Of course, the effect of this is not dramatic, and increased earnings beyond approximately \$70,000 per year

292. See, e.g., LoPucki, *supra* note 116, at 478–82.

293. See *supra* Section V.B.1.

294. See, e.g., LoPucki, *supra* note 116, at 472–73.

295. See *supra* notes 122–23 and accompanying text.

296. Bankruptcy Abuse Prevention and Consumer Protection Act of 2002, H.R. 5745, 107th Cong. § 103 (2002).

297. *Id.*

298. See Tabb, *supra* note 7, at 24.

no longer increases allowed expenses.²⁹⁹ As discussed in Section VI, this brings bankruptcy roughly in line with other systems of social insurance.

C. Costly Contracting and Default Rules

To solve each of the above market failures, the government must adopt *mandatory* debt relief laws that debtors cannot contract around in a cost-effective manner. Selfish consumers would gladly waive their right to use a debt relief law in exchange for a lower interest rate if the cost of this waiver would be borne largely by third parties. Cognitively challenged consumers might also waive the debt relief laws in exchange for a lower interest rate if they fail to recognize the value of debt relief.³⁰⁰ If debtors are able to contract around the debt relief laws, then they may still effectively signal their risk of default, leaving the problems adverse selection creates.

Debtors *may* be able to contract around some forms of debt relief, particularly those most often cited as subject to abuse by the very wealthy. Though the doctrine of tenancy by the entirety may protect an unlimited amount of home equity,³⁰¹ it will only do so if the married couple includes the necessary terms in their deed and did not co-sign their loan. Spendthrift trusts and corporations will only protect debtors who have created these entities and utilized them in the correct manner. Some states only allow a debtor to claim a homestead exemption if she files a declaration prior to borrowing.³⁰² Many other states once allowed a debtor to waive property exemptions.³⁰³ Although such waivers are no longer effective,³⁰⁴ debtors may be able to effectively waive some of the more generous exemptions, such as those in the home or in retirement assets,³⁰⁵ by granting security interests in the exempt assets.³⁰⁶

299. See *supra* note 123 and accompanying text.

300. Forcing these debtors to take an affirmative step to waive the use of these laws may serve a useful role in forcing them to consider the value of what they are foregoing. In this manner, waivable laws may act in a way similar to laws with a mandatory cooling off period. See, e.g., Howard Beales et al., *The Efficient Regulation of Consumer Information*, 24 J.L. & ECON. 491 (1981).

301. See *supra* note 53 and accompanying text.

302. See, e.g., MASS. GEN. LAWS ch. 188, § 2 (2000) (restricting homestead exemptions to those who have declared their real property a homestead in the deed of conveyance or a subsequent filing with the county or district in which the property is situated).

303. See, e.g., James B. Haines, Jr., *Security Interests in Exempt Personalty: Toward Safeguarding Basic Exempt Necessities*, 57 NOTRE DAME L. REV. 215, 222–30 (1981).

304. 16 C.F.R. § 444.2(a)(2) (2002).

305. Though the recent bankruptcy reforms significantly expanded the ability of a debtor to exempt retirement savings, these additional exemptions will not apply if the debtor voluntarily borrows against these assets. 11 U.S.C. § 522 (2000).

306. Federal law limits the ability of creditors to take nonpurchase money security interests in the debtor's household goods. See *supra* notes 39–62 and accompanying text. This approach is consistent with the externality argument for debt relief. Society will suffer a clear harm if the individual does not retain the tools or clothes he needs to work and thus becomes a drain on the public fisc. Arguing that a wealthy debtor must retain her mansion or else society will suffer a negative externality is far less compelling.

To the extent that debtors can waive these protections, they become mere default rules; but default rules can play a useful role if contracting is costly. Some argue that the costs of creating debt relief terms would not be very large,³⁰⁷ but the experience of credit insurance indicates otherwise.³⁰⁸ The loss ratio on credit insurance is dramatically lower than that of other insurance products. For example, approximately ninety percent of group life insurance premiums and seventy-five percent of group accident and health insurance premiums are paid out as claims.³⁰⁹ By contrast, the loss ratio on credit insurance averaged just thirty-nine percent and sometimes was far lower.³¹⁰ In the year 1997, the loss ratio on credit unemployment insurance in South Dakota was just 3.6%.³¹¹

These low loss ratios do not necessarily translate into profits for insurers because lenders charge very large commissions when they help write the insurance policy. In 1997, commissions on credit unemployment insurance *averaged* 52.6% of premiums.³¹² Though these high premiums and commissions may result from some sort of cognitive failure that causes debtors to over-pay for credit insurance,³¹³ these high commissions may also suggest that it is extremely costly to negotiate and write these contracts.

If the debtor and creditor are unable to negotiate effectively, then the government may be able to improve on the market solution by setting a default rule that serves as a reasonable estimate of what many debtors would desire and enables other debtors to cheaply contract around these rules. A system of generous exemptions could *plausibly* match this description if debtors would demand very generous debt relief in a well-functioning market. As long as the exemptions are tied to specific assets that are unlikely to change frequently, such as the debtor's home, debtors and creditors may be able to cheaply contract around the exemptions by using mortgages.

307. See, e.g., Rea, *supra* note 253, at 189. According to this argument, while it would be very costly for a debtor to negotiate the terms of this insurance with each and every lender, the costs of choosing the insurance could be greatly reduced by standard form contracts; creditors could compete by offering loan agreements with some combination of interest rates and loan forgiveness terms just as mortgage lenders now compete by offering loans with some combination of an interest rate and origination fees. Consumers could obtain roughly their desired amount of protection by searching for the right contract in the market.

308. See CREDIT INSURANCE RIP-OFF, *supra* note 251, at 2.

309. See *id.* The authors themselves cite Best's Aggregates and Averages.

310. *Id.* at 3.

311. *Id.* at 8.

312. *Id.* at 3.

313. Critics of credit insurance set forth other theories to explain the high commissions. For example, one common complaint is that credit insurance markets exhibit "reverse competition" in that insurance companies are forced to offer high commissions to encourage lenders to carry their product and thus must charge high rates to the ultimate consumer. *Id.* at 11. Of course, this explanation is incomplete as it would seemingly apply to every transaction in which an insurer relied on brokers to sell its product. Ultimately, these stories rely on some sort of cognitive or information failure to explain why the distribution system does not work in this context.

If one accepts the premise that *some* debt relief laws serve as default rules, then one can invoke a much more palatable argument in favor of inequality. The wealthy and the upper-middle class deserve to maintain a more luxurious lifestyle after default because they did, in fact, bargain for this right through their choice of borrowing; they deserve more generous debt relief because they purchased a more generous insurance policy through the way in which they structured their borrowing.³¹⁴ For example, assume Brian lives in a state with an unlimited homestead exemption and needs to borrow a total of \$200,000 from some combination of Unsecured Financeco and Secured Bank. Brian can borrow up to \$150,000, the value of his home, from Secured Bank on a fully secured basis. Because Brian grants Secured Bank a mortgage, Secured Bank is virtually guaranteed repayment and thus will charge a much lower rate than Unsecured Financeco. Brian may, however, rationally choose to borrow much less than \$150,000 from Secured Bank, because by borrowing from Unsecured Financeco he effectively buys more default protection.³¹⁵ If he suffers some misfortune, then he can use his exempt equity to support his lifestyle.

One must be careful not to oversell this argument, as the justification for the default rules is based on the premise that it is costly to contract; therefore, debtors and creditors may have difficulty choosing the level of relief that they desire. Of course, it is very easy to grant a secured interest in a fixed asset like a home and thus one may not be too concerned with the costs of contracting. However, the argument becomes much more tenuous once one introduces prebankruptcy planning that erodes the ability of a debtor to effectively waive the use of an exemption.³¹⁶

VI. DEBT RELIEF AND SOCIAL INSURANCE

This article argues that if debt relief laws are designed to insure debtors against misfortune, one can defend laws that allow wealthier debtors to maintain a standard of living beyond the reach of the poor by noting that wealthier individuals typically insure a higher standard of living for themselves. This argument requires qualifications. First, consider who bears the costs of these laws. To the extent costs are borne by society generally, the argument in favor of generosity for the wealthy and the

314. This argument is a derivation of Ponoroff and Knippenberg's defense of prebankruptcy planning in which they argue that courts should not question prebankruptcy planning because creditors could have bargained for the right to prevent such planning by taking a security interest, presumably in exchange for a lower interest rate, but did not do so. See Lawrence Ponoroff & F. Stephen Knippenberg, *Debtors Who Convert Their Assets on the Eve of Bankruptcy: Villains or Victims of the Fresh Start*, 70 N.Y.U. L. REV. 235 (1995).

315. See generally *id.*

316. A thorough discussion of prebankruptcy planning and exemptions would require a long digression beyond the scope of this article. See, e.g., Ponoroff & Knippenberg, *supra* note 314.

middle class is substantially weakened.³¹⁷ Second, consider the form of market failure that justifies government intervention. Some forms of market failure do justify inequality in debt relief.³¹⁸ If debt relief is intended merely to keep insolvent debtors from draining the public fisc or rioting in the streets, however, one can force the wealthy and the middle class to endure the same miserable standard of living as the poor.³¹⁹

The threat that a debtor may become a drain on the public fisc reminds us that the government has adopted other mechanisms, including income transfer programs, that shield individuals from the consequences of misfortune.³²⁰ Since at least the 1950s, scholars have understood that bankruptcy is part of a larger social safety net.³²¹ Recently, scholars have tried to draw useful analogies between the debate over bankruptcy reform and the debate over the reform of social assistance programs, like public housing or Temporary Aid for Needy Families (formerly Aid for Families with Dependent Children).³²²

Even though some social assistance programs, such as Medicare, insure the poor against specific risks and all social assistance programs can provide some measure of insurance by guaranteeing an individual a minimum standard of living, they provide a fairly sharp contrast with existing debt relief laws because they limit aid to the truly poor and seem designed to provide all recipients with roughly the same minimal standard of living.³²³ This contrast can be partly attributed to the fact that these programs primarily serve goals other than insurance, goals for which debt relief laws are ill-suited.

Other programs, such as unemployment insurance or social security, commonly called social insurance programs,³²⁴ provide a much closer analogy to debt relief. These programs do not restrict relief to the poor. In fact, like debt relief laws, these programs typically provide benefits that increase with the recipient's income before she suffered the misfortune against which she purchased insurance.³²⁵ Unlike some forms of

317. See *supra* Section IV.

318. See *supra* Sections V.B, V.C.

319. See *supra* Section V.A.

320. See *supra* Section V.A.

321. See, e.g., Note, *supra* note 12, at 1497–1502. For a more recent work revisiting this theme, see SULLIVAN, WARREN & WESTBROOK, *supra* note 10.

322. See, e.g., A. Mechele Dickerson, *America's Uneasy Relationship with the Working Poor*, 51 HASTINGS L.J. 17 (1999); A. Mechele Dickerson, *Bankruptcy Reform: Does the End Justify the Means?*, 75 AM. BANKR. L.J. 243 (2001).

323. The programs sometimes allow recipients to consume slightly more in order to provide them with an incentive to work. See, e.g., Timothy Besley & Stephen Coate, *The Design of Income Maintenance Programmes*, 62 REV. ECON. STUD. 187, 190 (1995).

324. Alan B. Krueger & Bruce D. Meyer, *Labor Supply Effects of Social Insurance*, in 4 HANDBOOK OF PUBLIC ECONOMICS 2239–40 (Alan J. Auerbach & Martin Feldstein eds., 2002) (“For our purposes, social insurance programs are defined as compulsory, contributory government programs that provide benefits to individuals if certain conditions are met. . . . Other programs that are considered social insurance: Social Security retirement benefits, Disability Insurance (DI), Unemployment Insurance and Workers’ Compensation (WC) Insurance.”).

325. See *infra* notes 348–52 and accompanying text.

debt relief, however, increases in the debtor's income beyond a fairly modest amount produce little, if any, increase in the benefits provided by these programs.³²⁶ Therefore, a defense of bankruptcy abuse, or the use of debt relief by the wealthy and upper-middle class to finance a lifestyle beyond the means of average Americans, must either argue that these programs are wrongly structured or that debt relief is relevantly different.

A. *Placing Debt Relief Within the Larger Social Safety Net*

Welfare economists typically advance three fundamental arguments in favor of government transfer programs: (i) transfers redistribute wealth from rich to poor and thus enhance equity or fairness in society; (ii) transfers to those in need satisfy the altruistic concerns of society generally; and (iii) transfer programs provide social insurance.³²⁷ The third goal requires little elaboration beyond the discussion of Section III, however, the first two goals require some explanation.

Given the notoriously vague concepts of "fairness" or "equity," economists often formalize the fairness argument by reasoning that because the poor have less money than the wealthy, the poor value it more highly, and the government can increase aggregate social welfare by redistributing wealth or income from the wealthy to the poor.³²⁸ The altruism argument posits that individuals care about the well-being of their fellow citizens, and, therefore, the wealthy may want to transfer money to the poor.³²⁹ Of course, the altruist can help the poor through private charity, but each altruist would prefer that her neighbor make the necessary donations. Poverty relief is effectively a public good and the government may improve on the market solution by forcing all individuals to contribute.³³⁰

Debt relief laws provide a poor tool for achieving the goals of equity and altruism for two reasons. First, debt relief laws only protect the assets and income that an individual has, and the poor, by definition, lack income and assets.³³¹ Debt relief laws may prevent those who once en-

326. See *infra* notes 354–56 and accompanying text.

327. See, e.g., BRUCE, *supra* note 151, at 193.

328. *Id.* Scholars sometimes criticize this argument for assuming that the government can compare the happiness of different individuals. One common response to this criticism is to effectively recharacterize the utilitarian argument as a form of insurance: insurance against the lottery of birth that leaves some individuals wealthy and others poor. See John C. Harsanyi, *Cardinal Utility in Welfare Economics and in the Theory of Risk-Taking*, 61 J. POL. ECON. 434 (1953); John C. Harsanyi, *Cardinal Welfare, Individualist Ethics, and Interpersonal Comparisons of Utility*, 63 J. POL. ECON. 309 (1955); see also A.B. Atkinson, *Income Maintenance and Social Insurance*, in 2 HANDBOOK OF PUBLIC ECONOMICS, *supra* note 324, at 779, 791–95.

329. See, e.g., Hochman & Rodgers, *supra* note 258, at 543.

330. *Id.*

331. See, e.g., Vukowich, *supra* note 15, at 770 ("Another general defect of exemption laws is that they tend to perpetuate our economic class structure. Those who have are allowed to keep; those who do not are given nothing."). One early bankruptcy commentator suggested that the government pro-

joyed a higher standard of living from falling into poverty, but this is just a manifestation of the insurance role of debt relief discussed above.³³² In addition, strong debt relief laws are likely to result in higher interest rates and reduced access to credit, thus leaving debtors to bear much of the cost of the relief that they will receive.³³³ Debt relief laws could effectuate a transfer from rich debtors to poor debtors if the poor tend to make greater use of debt relief than the rich and lenders do not view the rich and poor as relevantly different, or at least not different enough to justify the expense needed to distinguish between them.³³⁴ As suggested above, this is unlikely to be the case.³³⁵

The limitation of debt relief, or at least bankruptcy, as a tool for fighting poverty is further illustrated by the fact that the primary beneficiaries of bankruptcy are not the poor, but the middle class,³³⁶ and by the contrast between debt relief and those programs that are primarily designed to alleviate poverty, such as Temporary Aid for Needy Families (TANF), Supplementary Security Income, the Earned Income Tax Credit, Medicaid, or the Food Stamp Program. These programs are sometimes referred to as “means-tested programs” to distinguish them from the social insurance programs discussed below.³³⁷ As their name indicates, these means-tested programs generally restrict benefits to those who are defined as “poor” by income and asset tests, though many programs further restrict eligibility by requiring additional characteristics, such as disability.³³⁸ Consistent with their goal of poverty relief, these programs are designed to provide recipients with only enough benefits to maintain a minimal standard of living, though programs sometimes allow individuals to fund a slightly higher standard of living out of additional earnings as an incentive to work.³³⁹ Finally, consistent with a goal of redistribution or an effort at providing a public good, these programs are typically funded by general tax revenues.³⁴⁰

Debt relief laws have none of these three characteristics. Aside from judges’ salaries and certain other administrative expenses, debt relief is not financed by the public fisc, but by the cancellation of creditor’s

vide a transfer to low-income debtors to remedy this problem. *See, e.g.*, Note, *supra* note 12, at 1506–07. This commentator gave no reason for why this transfer should be restricted to those who file for bankruptcy rather than the poor generally.

332. *See supra* notes 183–97 and accompanying text.

333. *See supra* Section IV.

334. *Id.*

335. *Id.*; *accord* Hallinan, *supra* note 20, at 135 (“Thus, any subsidization of the cost of credit for high-risk, low-income borrowers will most frequently be at the expense of other high-risk, low-income borrowers, while the cost of any subsidize to low-risk, high-income borrowers will usually be borne by others with similar risk and income characteristics.”).

336. *See, e.g.*, SULLIVAN, WARREN & WESTBROOK, *supra* note 10, at 22–32.

337. *See, e.g.*, BRUCE, *supra* note 151, at 253 (“Social insurance programs differ from means-tested programs in several ways.”).

338. *See, e.g., id.* at 230–37.

339. *See* Besley & Coate, *supra* note 323, at 190.

340. *See* Barr, *supra* note 283, at 768.

contract rights.³⁴¹ The factual premise of this article is that debt relief laws sometimes protect the very wealthy and allow some debtors to maintain a lifestyle that far exceeds any plausible definition of poverty.³⁴² One might object that the pending bankruptcy legislation will move bankruptcy closer to the means-tested government transfer programs, but the level of income at which the reforms would invoke means-testing is so much greater than the level used by means-tested social assistance programs that it is qualitatively different. Consistent with their role in poverty relief, means-tested social assistance programs deny relief to all but the truly poor. Although the qualifying income levels for TANF vary significantly from state to state,³⁴³ on average a family of three must have an income less than \$700 per month to qualify.³⁴⁴ By contrast, means-testing in bankruptcy applies only to those debtors with income above the relevant median; nationally, the median household income for a family of four is about \$5,000 per month.³⁴⁵

Social insurance programs, such as social security and unemployment insurance, provide a much better analogy to debt relief laws. In theory these programs are financed by separate taxes on potential recipients that are paid into special funds and are not to be used for general government purposes.³⁴⁶ More significantly, these programs do not restrict benefits to the poor; in fact, these programs typically restrict benefits to those who have actually paid into the system over a period of fairly stable employment, and thus the programs may exclude the chronically

341. For example, in 1992, the federal government spent approximately 389 million dollars to run the bankruptcy system. See David A. Skeel, *Rethinking the Line Between Corporate Law and Corporate Bankruptcy*, 72 TEX. L. REV. 471, 525 (1994). Of course, this provides an imperfect measure of the cost incurred by the government from consumer debt relief and collections; corporations may also file for bankruptcy, and bankruptcy is but a small part of a larger system of debt relief that also includes federal and state limitations on nonbankruptcy collections. See *supra* Section I.A. It is pointless, however, to try to estimate this cost more accurately because the amount of debt charged-off as uncollectible is an order of greater magnitude. For example, in 1992, commercial banks charged-off (net of recoveries) over six billion dollars in credit card loans to individuals as uncollectible, and by 2002 this amount had risen to over sixteen billion dollars. FDIC, STATISTICS ON DEPOSITORY INSTITUTIONS, at <http://www2.fdic.gov/SDI/main4.asp> (last visited Jan. 19, 2004).

342. See *supra* Section I.

343. For example, in Arkansas applicants with monthly earnings above \$247 do not qualify for TANF regardless of family size, but in Hawaii a family of four may have earnings of \$2,544 and still qualify. STATE POLICY DOCUMENTATION PROJECT, TANF CASH ASSISTANCE: CATEGORICAL AND FINANCIAL ELIGIBILITY RULES, available at <http://www.spdp.org/tanf/cat-fin.htm> (last visited Sept. 16, 2003). In Virginia, the gross income limit for those subject to the time and work requirements is set at the federal poverty guideline; for a family of four, this income limit is \$1,371. *Id.*

344. *Id.*

345. Median household income is about \$62,000 per year. See U.S. CENSUS BUREAU, 4-PERSON FAMILIES, *supra* note 34.

346. See, e.g., BRUCE, *supra* note 151, at 253; Krueger & Meyer, *supra* note 324, at 2239 (“In general, social insurance programs are funded by dedicated taxes or premiums, and have compulsory coverage.”). Of course, as the famous “lock-box” debates of the 2000 Presidential election demonstrated, reality sometimes departs from this theory.

poor.³⁴⁷ For the purposes of this article, however, the most crucial fact about social insurance programs is that they typically provide more generous benefits to individuals with a history of higher earnings, even though one cannot plausibly argue that this inequality provides recipients with an incentive to work harder.³⁴⁸ An individual with average earnings will receive approximately sixty-five percent greater Old-Age and Retirement benefits than an individual with just forty-five percent of average earnings.³⁴⁹ Unemployment insurance varies significantly from state to state, but usually increases with an individual's average weekly wage.³⁵⁰ For example, a single Virginian without children earning \$11.00 an hour would receive roughly double the weekly unemployment benefits of a Virginian earning just \$5.50 an hour, \$313 versus \$157.³⁵¹ Moreover, these characteristics are shared by countries outside of the United States; earnings-related benefits appear to be the dominant form of unemployment insurance and government pensions in the developed world.³⁵²

Of course, society does not *have* to structure debt relief as a social insurance program; some forms of public insurance, like Medicaid, are indeed means-tested and restricted to the truly poor.³⁵³ Society may rationally decide to adopt this approach to debt relief if it decides that the sole purpose of debt relief is to prevent social unrest and mitigate the Samaritan's dilemma described in Section V.A. However, no one seriously advances this position in the current debate over bankruptcy reform.

B. *The Bounded Relief of Social Insurance*

Despite the fact that social insurance benefits generally rise with an individual's earnings history, increases in earnings beyond a fairly modest amount typically have little if any impact on benefits because the rate of increase falls sharply or benefits are capped at some amount. Earnings above \$84,900 have no effect on Old-Age and Survivor's benefits,³⁵⁴ and

347. See, e.g., Lester, *supra* note 275, at 336–37 (“Because [unemployment insurance] explicitly links eligibility to ‘labor force attachment,’ and narrowly construes what counts as involuntary unemployment, it may exclude nontraditional workers from benefits.”).

348. See, e.g., BRUCE, *supra* note 151, at 253. For a discussion of the effects of social insurance on labor supply, see, for example, Krueger & Meyer, *supra* note 324.

349. SOC. SEC. ADMIN., FAST FACTS AND FIGURES ABOUT SOCIAL SECURITY (2002), available at http://www.ssa.gov/policy/docs/chartbooks/fast_facts/2002/ff2002.pdf (last visited Jan. 19, 2004).

350. See, e.g., Econ. Policy Inst., *supra* note 274.

351. *Id.*

352. See Barr, *supra* note 283, at 777 (presenting table summarizing benefits in selected developed countries).

353. See, e.g., Krueger & Meyer, *supra* note 324, at 2230 (“Medicaid receipt is available to all individuals with sufficiently low income.”).

354. SOC. SEC. ADMIN., *supra* note 349, at 9–22. The recipient's benefits are calculated from her primary insurance amount. This primary insurance amount is equal to ninety percent of the individual's first \$592 of averaged indexed monthly earnings (AIME) plus thirty two percent of AIME over

workers who earned this amount receive benefits that are just thirteen percent higher than a worker earning just sixty-two percent of this amount (\$51,514).³⁵⁵ Single Virginians receive the maximum \$368 in weekly unemployment benefits whether they earn \$13.00 an hour or substantially more.³⁵⁶

It is tempting to attribute the limits on relief for the more wealthy members of society to an attempt at redistribution. Though nominally a form of insurance, there is no requirement that the taxes the government imposes to fund a social insurance program be commensurate with the expected benefit that each individual receives. This makes it possible for the government to use these programs to redistribute wealth from rich to poor by setting taxes and benefits. By contrast, the government cannot readily use debt relief to redistribute from rich to poor because it only controls the benefits a debtor receives, not the premium the debtor pays for this benefit. As discussed above, these premiums are set in private markets, and, to the extent that the highly competitive consumer credit markets are well-functioning, debtors will on average pay a premium commensurate with the debt relief that she expects to receive.³⁵⁷

This distinction between debt relief and social insurance programs provides only a partial explanation for the egalitarianism of transfer programs. First, it does not appear that governments, or at least governments within the United States,³⁵⁸ structure the social insurance programs to effectuate massive redistribution from rich to poor. Although social insurance benefits do not increase proportionally with income, neither do the taxes that individuals or their employers must pay. For example, the Federal Unemployment Tax Act only assesses a payroll tax on the first \$7000 of an employee's earnings,³⁵⁹ and although some states use a larger base, none assess unemployment taxes on a base larger than \$29,300.³⁶⁰ In addition, individuals pay social security taxes only on their first \$84,900 of earned income.³⁶¹ If viewed as a program, then Social Security *might* effect some redistribution from rich to poor, as some claim that lower income Americans generally receive larger benefits per dollar of tax paid than do high-income Americans. But this effect is rather modest

\$592 through \$4,567 plus fifteen percent of AIME over \$3,567 through the maximum taxable earnings. *Id.*

355. *Id.*

356. Econ. Policy Inst., *supra* note 274. Unemployment insurance in other states follows this same general pattern, though benefits and caps vary significantly. *Id.*

357. *See supra* Section IV.

358. Some countries structure their social insurance programs to effectuate more significant redistribution. *See, e.g.,* Barr, *supra* note 283, at 777.

359. 26 U.S.C. § 3306(b)(1) (2000).

360. *See* U.S. DEP'T OF LABOR, COMPARISON OF STATE UNEMPLOYMENT LAWS tbl.200, available at <http://workforcesecurity.doleta.gov/unemploy/pdf/2001ch200.pdf> (last visited Jan. 19, 2004).

361. SOC. SEC. ADMIN., *supra* note 349.

relative to the amount that this program redistributes from young to old or even from single workers to one-income married households.³⁶²

This same limitation on benefits is shared by another major form of mandatory insurance program that in the United States is not typically financed by the public fisc: workers' compensation. Workers' compensation serves as a form of mandatory insurance because the employee is guaranteed some compensation for her injuries regardless of fault.³⁶³ Employers have numerous methods of insuring themselves against the risk of having to pay this compensation: depending on the particular state's requirements, employers may participate in a state sponsored or mandated program, they can contract for insurance in the private market, or they can self-insure (which just means that they prove that they have the financial resources to pay any claim made by their employees).³⁶⁴ As long as the party obligated to make the payment is solvent, these details are largely irrelevant to the employee; from her perspective the method the employer chooses to spread the risk is analogous to the purchase of reinsurance by her automobile insurance company.³⁶⁵ If the government leaves the pricing of this reinsurance to the market, then employers should pay insurance rates roughly equal to the expected benefits that their employees will receive.

Just as the debtor bears some of the cost of debt relief laws through higher interest rates, employees are likely to bear some of the cost of workers' compensation through reduced wages.³⁶⁶ Therefore, like debt relief, it is possible that excessively generous workers' compensation laws may actually make the employee worse off, and what is excessively generous will depend in part on how much the employee earns. Perhaps because of this, workers' compensation benefits generally increase with the recipient's prior wage; in the vast majority of states, workers' compensa-

362. A "low earnings" single male retiring in 1995 received benefits roughly equal to 125% of the taxes that he paid while a "maximum earning" single male received benefits of approximately seventy-five percent of taxes paid. BRUCE, *supra* note 151, at 260. A low-earnings, one-earner couple retiring in 1995 received benefits of approximately 300% of taxes paid and a low-earnings single male retiring in 1965 received benefits equal to approximately 500% of taxes paid. *Id.*

363. See, e.g., Thomas C. Grey, *Accidental Torts*, 54 VAND. L. REV. 1225, 1229 (2001).

364. 9 ARTHUR LARSON & LEX K. LARSON, *LARSON'S WORKERS' COMPENSATION LAW* § 150.01[2] (3d ed. 2000). Some states require employers to post a bond or otherwise set aside funds if they wish to self-insure. *Id.*

365. Insurance companies often purchase reinsurance to protect against shocks that will cause a loss in a significant portion of their policies.

366. Like debt relief laws, worker's compensation may actually represent a net benefit to workers and employers if it solves some form of market failure. Dissatisfaction with our nation's costly tort litigation system provides a major justification for the enactment of worker's compensation programs. See, e.g., DAVID A. MOSS, *WHEN ALL ELSE FAILS: GOVERNMENT AS THE ULTIMATE RISK MANAGER* 163-64 (2002). Because worker's compensation limits the ability of the employee to sue, it is possible that the law results in higher wages even though the debtor receives greater expected benefits for each injury. Still, the benefits provided by worker's compensation should decrease the wages paid to the employee. See, e.g., W. Kip Viscusi & Michael J. Moore, *Workers' Compensation: Wage Effects, Benefit Inadequacies, and the Value of Health Losses*, 69 REV. ECON. & STAT. 249 (1987).

tion replaces two-thirds of a recipient's lost income.³⁶⁷ Like social assistance programs, however, workers' compensation provides benefits that do not necessarily increase proportionally with income. For example, Virginia provides a minimum weekly benefit amount of \$170.25 and a maximum weekly benefit amount of \$681 for those workers who earn more than approximately \$51,000 annually.³⁶⁸

C. *Should Debt Relief Be Different?*

Debt relief laws, like social insurance programs, provide benefits to the average American that allow her to maintain a lifestyle unavailable to the truly poor despite similar misfortune. Though social insurance programs provide the wealthy and upper-middle class with roughly the same benefits as the average American, debt relief laws enable the wealthy and the upper-middle class to continue lifestyles that the average American cannot afford.

As noted in Section I, proposed bankruptcy reforms would reduce (but not eliminate) the latter form of inequality but leave the first form intact, and thus can be seen as attempts to conform debt relief with other forms of social insurance. By its terms, the proposed means-testing does not apply to the "average" American³⁶⁹ and thus does not affect her ability to enjoy a higher standard of living than the truly poor after default; means-testing is designed to prevent the upper-middle class from enjoying a standard of living beyond the reach of the average American. Even if it applies, a cap on the homestead exemption of \$125,000 per debtor, or \$250,000 for a married couple, will not affect the vast majority of Americans, as most Americans simply do not own this amount in tangible assets, or, if they do, they will have pledged most of these assets to secured creditors and thus cannot exempt them.³⁷⁰

To say that the proposed bankruptcy reforms help conform debt relief to the structure of social insurance programs does not mean that these reforms are necessarily desirable or that further reform is justified. Alternatively, one can defend the generosity of debt relief laws by arguing that debt relief is somehow different than other forms of social insurance. Professors Sullivan, Warren, and Westbrook seem to embrace this possibility, arguing that debt relief laws complement other forms of social insurance by insuring against many of the same risks that government transfer programs are designed to protect against.³⁷¹ Yet, even if one adopts the view that debt relief and transfer programs serve as com-

367. See, e.g., VA. WORKER'S COMP. COMM'N, RULES AND REGULATIONS, available at http://www.vwc.state.va.us/bene_amts.htm (last visited Jan. 19, 2004).

368. *Id.*

369. Means-testing only applies to those with income above the applicable median. See Bankruptcy Abuse Prevention and Consumer Protection Act of 2002, H.R. 5745, 107th Cong. § 102 (2002).

370. See *supra* notes 49–51 and accompanying text (reporting figures on home equity).

371. SULLIVAN, WARREN & WESTBROOK, *supra* note 10, at 252–61.

plements, one still needs a theory to explain why upper-income Americans are asked to rely on debt relief rather than transfer programs.

Professors Sullivan, Warren, and Westbrook suggest that the American middle class must rely on bankruptcy for protection against misfortune because bankruptcy provides a “market-driven choice to deal with privatized, rather than socialized, risk.”³⁷² It is not clear, however, why they characterize bankruptcy in this manner. A creditor is free to lend or not lend to a debtor, but she is not free to lend on terms that do not include the possibility of a bankruptcy discharge that will force her to bear some of the costs of the debtor’s misfortune.³⁷³ In this way, debt relief is no more “market-based” than other aspects of the social safety net. An employer is free to hire or not hire a worker. But if she hires a worker, the employer must give the employee the right to claim benefits if the employer fires the employee (unemployment insurance) or the employee is injured on the job (workers’ compensation). The employer will often bear some of the costs of the employee’s misfortune either because it chose to self-insure or because it will be forced to pay higher unemployment insurance taxes or workers’ compensation premiums.

Perhaps an explanation is provided by the seminal article on exemption reform, a student note published in 1959.³⁷⁴ Recognizing that exemptions or debt relief generally would do little good for those that had no significant assets or income to protect,³⁷⁵ this student called for transfer payments to the poor in bankruptcy.³⁷⁶ If Sullivan, Warren, and Westbrook are correct in asserting that transfer programs and bankruptcy provide insurance against the same basic risks, then the system proposed by the student commentator does not differ markedly from our current system. Allowing the wealthy to retain at least some of their substantial assets and income after they experience some form of misfortune may provide enough insurance for them, and they do not need transfer programs like unemployment insurance or workers’ compensation to provide benefits that are a large fraction of their income. As one moves down the socioeconomic ladder, individuals have progressively less assets on which to rely to see them through difficult times. Therefore, these individuals need a much larger replacement of their lost income.

372. *Id.* at 260.

373. See Todd J. Zywicki, *Bankruptcy Law As Social Legislation*, 5 TEX. REV. L. & POL. 393, 416–17 (2001).

374. See Note, *supra* note 12.

375. *Id.* at 1506 (“Finally, exemptions, no matter how computed, are of no help to the bankrupt who lacks the figurative shirt on his back.”).

376. *Id.* at 1506–07.

VII. CONCLUSION

Many in Congress argue that bankruptcy reform is necessary to stop abuse.³⁷⁷ To define abuse, however, one must first determine the proper use of bankruptcy and other forms of debt relief. This article follows the literature and assumes that debt relief laws provide needed insurance against misfortune generally. Viewed in this light, some of the proposed reforms are long overdue. For example, amendments limiting the ability of a debtor to use debt relief to avoid the consequences of her own intentional misconduct serve merely to conform bankruptcy to other forms of insurance.³⁷⁸

This article addresses whether the continuation of a luxurious lifestyle after default constitutes an abuse of debt relief, and concludes that one may make a plausible argument that it does not.³⁷⁹ Equalizing the standard of living of all defaulting debtors would be equivalent to forcing each debtor to purchase the same insurance against the hardships that lead to default and sentencing each debtor to a Procrustean bed that would fit only a few. This argument in favor of inequality is merely *plausible*, however, because one may raise legitimate questions about the underlying assumptions. For example, one may believe that the costs of the generous debt relief bestowed on the very wealthy are borne by other debtors or consumers more generally.³⁸⁰ One may also believe that the market failure that makes debt relief necessary does not justify the full extent of relief that the law currently provides.³⁸¹

Embracing these arguments against the relief offered to the very wealthy affects the justifications for the relief given the middle class, as well. In particular, the same market failure arguments used to justify the generous relief bestowed on the wealthy are also necessary to justify the relief bestowed on the middle class, and the argument that defaults by relatively wealthy individuals may raise costs for those less-well-off applies with greater force to the middle class. In short, fully embracing the arguments against the generous debt relief afforded the very wealthy

377. See, e.g., *The Bankruptcy Reform Act of 2001: Hearing on S. 420 Before the Senate Comm. on the Judiciary*, 107th Cong., available at Lexis, Federal News Service File; Pamela Barnett, *Hatch Hopes Bankruptcy Reform Markup to Finish Today*, CONG. DAILY, Feb. 27, 2001, available at 2001 WL 4817746; Pamela Barnett, *Schumer Says Bankruptcy Move Now up to House GOP*, CONG. DAILY, Aug. 1, 2002, available at 2002 WL 24878029.

378. For example, the recent reforms limit the ability of a debtor to claim a homestead exemption after certain bad acts and limit the ability of the debtor to obtain a discharge of willful and malicious acts that result in death or personal injury. See Bankruptcy Abuse Prevention and Consumer Protection Act of 2002, H.R. 5745, 107th Cong. § 314(b) (2002).

379. To be clear, this article does not necessarily reject the need for exemption reform or means-testing. Further exemption reform may address the problem of prebankruptcy planning and means-testing may provide a sensible method of determining which cases deserve greater judicial scrutiny. This article merely argues that the continuation of a luxurious lifestyle after default may not be sufficient for a finding of abuse.

380. See *supra* Section IV.

381. See *supra* Section V.

may logically lead to a world in which bankruptcy seeks only to save us from the abject poverty that our poorest citizens must endure.

TABLE 1: EXEMPTIONS FOR MARRIED COUPLE³⁸²

| State | Allows Federal | Home Equity | Any Property | State | Allows Federal | Home Equity | Any Property |
|-------|----------------|-------------|--------------|-------|----------------|-------------|--------------|
| Fed | N/A | 34,850 | 17,500 | MT | | 100,000 | 0 |
| AL | | 10,000 | 6,000 | NE | | 12,500 | 2,500 |
| AK | | 64,800 | 0 | NV | | 125,000 | 0 |
| AZ | | 100,000 | 0 | NH | Yes | 60,000 | 16,000 |
| AR | Yes | Unlimited | 500 | NJ | Yes | 0 | 2,000 |
| CA | | 75,000 | 30,800 | NM | Yes | 60,000 | 5,000 |
| CO | | 60,000 | 0 | NY | | 20,000 | 0 |
| CT | Yes | 150,000 | 2,000 | NC | | 20,000 | 8,000 |
| DE | | None | 10,000 | ND | | 80,000 | 7,500 |
| FL | | Unlimited | 2,000 | OH | | 10,000 | 800 |
| GA | | 20,000 | 11,200 | OK | | Unlimited | 0 |
| HI | Yes | 50,000 | 0 | OR | | 33,000 | 800 |
| ID | | 50,000 | 1,600 | PA | Yes | None | 300 |
| IL | | 15,000 | 4,000 | RI | Yes | 150,000 | 0 |
| IN | | 15,000 | 8,000 | SC | | 10,000 | 2,000 |
| IA | | Unlimited | 100 | SD | | Unlimited | 10,000 |
| KS | | Unlimited | 0 | TN | | 7,500 | 8,000 |
| KY | | 10,000 | 2,000 | TX | Yes | Unlimited | 0 |
| LA | | 25,000 | 0 | UT | | 40,000 | 0 |
| ME | | 25,000 | 12,800 | VT | Yes | 150,000 | 14,800 |
| MD | | 11,000 | 11,000 | VA | | 10,000 | 10,000 |
| MA | Yes | 300,000 | 0 | WA | Yes | 40,000 | 2,000 |
| MI | Yes | 7,000 | 0 | WV | | 50,000 | 51,600 |
| MN | Yes | 200,000 | 0 | WI | Yes | 40,000 | 2,000 |
| MS | | 150,000 | 10,000 | WY | | 20,000 | 0 |
| MO | | 8,000 | 1,650 | | | | |

382. See 4 COLLIER, *supra* note 43; STEPHEN ELIAS ET AL., HOW TO FILE FOR CHAPTER 7 BANKRUPTCY app. 1/3–1/29 (10th ed. 2002).

