

## ABUSE OR PROTECTION? ECONOMICS OF BANKRUPTCY REFORM UNDER BAPCPA

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*Prior to the enactment of the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA) of 2005, United States bankruptcy law provided a number of different mechanisms designed to both facilitate credit markets and provide some measure of consumption insurance. The interplay between chapter 7 and chapter 13 discharge procedures in particular influenced debtor behavior such that debtors sought to maximize financial gain from bankruptcy by transferring wealth from nonexempt forms to exempt forms.*

*BAPCPA dramatically altered the procedures affecting debtor behavior. In an effort to stop opportunistic behavior, BAPCPA eliminated a number of wealth manipulation strategies. However, BAPCPA provided new strategies and incentives to transfer wealth to new exempt forms, manipulate the means test, and ultimately succeed in avoiding debt repayment.*

*This article examines incentives to act opportunistically before and after BAPCPA. As demonstrated in the article, BAPCPA creates a ten-fold incentive to curtail work six months before filing to reduce median income for purposes of manipulating the means test. However, because of increased costs to file, BAPCPA significantly deters nonopportunistic debtors. After examining BAPCPA's deleterious effect on bankruptcy law as a source of consumption insurance, the article suggests an alternate approach. Under the approach, a single filing procedure is created where debtors must repay debts from both income and wealth in an effort to track obligation to repay with ability to repay. The article suggests this approach creates greater economic efficiency, significantly deters opportunistic behavior, and maintains bankruptcy as a source of consumption insurance. Ultimately, the article suggests that BAPCPA benefits credit markets,*

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*damages consumption insurance goals, and may not have a significant effect on opportunistic behavior.*

### I. WHY HAVE BANKRUPTCY? THE ECONOMIC MODEL

From an economist's standpoint, the main reason for having a personal bankruptcy procedure is to provide individual debtors with consumption insurance by discharging some or all of their debt when reductions in their income or wealth would cause their consumption to fall sharply.<sup>1</sup> This type of insurance is valuable because sharp falls in consumption can have permanent negative effects on debtors and their families—for example, debtors' illnesses may turn into disabilities for lack of medical care, debtors may become homeless, or debtors' children may drop out of school in order to work, leading to lower earnings as adults.<sup>2</sup> Another important objective of bankruptcy law is to facilitate the operation of credit markets, because consumers benefit from being able to borrow in order to smooth consumption over the life cycle. Bankruptcy law accomplishes this goal by providing a state-sanctioned procedure for resolving all debts at once.<sup>3</sup> Bankruptcy law also may facilitate credit markets by discouraging debtors from filing for bankruptcy if they have *not* experienced a drop in income or wealth, that is, by discouraging debtor opportunism, and by encouraging debtors to work before and after filing for bankruptcy.<sup>4</sup>

To illustrate how the features of bankruptcy law affect these objectives, consider exemption levels—the amounts of wealth and postbankruptcy income that debtors are allowed to keep in bankruptcy.<sup>5</sup> When the sum of wealth and income exemptions are higher, debtors gain because their minimum consumption levels rise—that is, they have more consumption insurance. Also, when the income exemption is higher, debtors have stronger incentives to work following bankruptcy because they keep more of what they earn for their own consumption. However, because higher exemptions for wealth and income make filing for bank-

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1. The earliest discussion of bankruptcy as a policy for providing debtors with insurance was Samuel A. Rea, Jr., *Arm-Breaking, Consumer Credit and Personal Bankruptcy*, 22 *ECON. INQUIRY* 188 (1984).

2. Consumption insurance is mainly provided by the public sector in the form of welfare payments, food stamps, Medicaid, and subsidized housing—the social safety net. However, bankruptcy is similar to a safety net program because it discharges debt when debtors' consumption falls and therefore allows debtors to shift funds from debt repayment to consumption. Bankruptcy also transfers some of the costs of the safety net from the public to the private sector because the cost of the discharged debt is ultimately borne by debtors who repay. See 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, 307–08 (1995).

3. See THOMAS H. JACKSON, *THE LOGIC AND LIMITS OF BANKRUPTCY LAW* 225–52 (1986), for an analysis of the societal justifications for sanctioning such relief.

4. See generally *id.* (discussing the objectives of bankruptcy).

5. See generally 11 U.S.C. § 522 (2000 & Supp. III 2003) (listing property that a debtor may exempt from the bankruptcy estate).

ruptcy more attractive, the number of filings increases.<sup>6</sup> As a result, lenders raise interest rates or ration credit,<sup>7</sup> which harms debtors who repay as well as those who would like to borrow but are rejected.<sup>8</sup>

The features of bankruptcy law also affect how much opportunism occurs. This can be illustrated with a concrete example. Suppose there are two types of debtors: opportunists and nonopportunists. Nonopportunists borrow to smooth their consumption over the life cycle, but do not plan in advance for bankruptcy. However, they are assumed to file for bankruptcy if doing so is financially beneficial. Opportunists, in contrast, plan in advance to maximize their financial gain from filing for bankruptcy. Opportunistic behavior may include borrowing more than nonopportunists,<sup>9</sup> reallocating assets so as to increase the amount of wealth that is exempt in bankruptcy, reallocating work effort so as to increase the amount of income that is exempt in bankruptcy, hiding some assets or income from the bankruptcy court,<sup>10</sup> or moving to states with higher exemptions.<sup>11</sup> Lenders are assumed to be unable to identify individuals' types when they make their lending decisions, so that both opportunists and nonopportunists borrow on the same terms.<sup>12</sup>

The features of the bankruptcy system affect whether debtors choose to behave opportunistically or nonopportunistically. Suppose the bankruptcy system had both a 100% exemption for postbankruptcy income and a high wealth exemption. Many debtors would then behave

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6. See, e.g., Michelle J. White, *Personal Bankruptcy Under the 1978 Bankruptcy Code: An Economic Analysis*, 63 IND. L.J. 1, 45–46 (1987) (discussing data indicating that an increase in the bankruptcy exemption level corresponds with an increased bankruptcy filing rate).

7. Reint Gropp, John Karl Scholz, & Michelle J. White, *Personal Bankruptcy and Credit Supply and Demand*, 112 Q.J. ECON. 217 (1997) (showing that higher exemption levels result in higher interest rates).

8. The optimal exemption levels in bankruptcy are determined by trading off debtors' gain from having additional consumption insurance and better work incentives when exemption levels are higher against their losses from higher interest rates and reduced access to credit. For a formal model and simulations, see Michelle J. White, *Personal Bankruptcy: Insurance, Work Effort, Opportunism and the Efficiency of the "Fresh Start,"* (May 2005) (unpublished manuscript, on file with author), available at <http://www.econ.ucsd.edu/~miwhite/bankruptcy-theory-white.pdf>, and Hung-Jen Wang & Michelle J. White, *An Optimal Personal Bankruptcy Procedure and Proposed Reforms*, 29 J. LEGAL STUD. 255, 265 (2000).

9. See Steven H. Resnicoff, *Barring Bankruptcy Banditry: Revision of Section 523(a)(2)(C)*, 7 BANKR. DEV. J. 427, 434 (1990) (discussing the possibility that an insolvent may borrow unrestrainedly to purchase luxuries).

10. Cf. Todd J. Zywicki, *Bankruptcy As Social Legislation*, 5 TEX. REV. L. & POL. 393, 399–400 (2001) (“[T]he current bankruptcy system provides opportunities . . . to hide assets . . .”).

11. See Margaret F. Brinig & F.H. Buckley, *The Market for Deadbeats*, 35 J. LEGAL STUD. 201, 208 (1996).

12. Lenders have in fact developed methods of identifying opportunists, but these methods are imperfect. See Tullio Jappelli & Marco Pagano, *Information Sharing in Credit Markets: A Survey* 7–8 (Centre for Stud. in Econ. & Fin., Working Paper No. 36, 2000), available at <http://www.iue.it/FinConsEU/ResearchActivities/EconomicsOfConsumerCreditMay2003/Papers/Jappelli>. For example, individuals' credit records contain information about whether they have previously defaulted or filed for bankruptcy. See, e.g., David K. Musto, *What Happens When Information Leaves a Market? Evidence from Postbankruptcy Consumers*, 77 J. BUS. 725, 726 (2004). This information allows lenders to identify some opportunists. However, not all debtors who default or file for bankruptcy are opportunists.

opportunistically because they can borrow heavily and avoid having to repay by filing for bankruptcy. Now suppose the bankruptcy system required that debtors use a high fraction of their postbankruptcy income to repay. In this case, fewer debtors would behave opportunistically because high income debtors would face a heavy repayment burden. Now assume the costs of filing for bankruptcy are high—say, several thousand dollars. High costs would not discourage opportunistic debtors from filing because they can plan in advance by borrowing more to pay the fee. Nonopportunists, however, might be unable to file at all due to a lack of funds.

U.S. personal bankruptcy law before 2005 provided a high level of consumption insurance by having a high wealth exemption,<sup>13</sup> a 100% exemption for postbankruptcy income,<sup>14</sup> and low filing costs.<sup>15</sup> However, these features encouraged opportunistic behavior.<sup>16</sup> The adoption of the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA) of 2005<sup>17</sup> shifted the focus of personal bankruptcy law from providing consumption insurance to discouraging bankruptcy filings by both opportunistic and nonopportunistic debtors.<sup>18</sup> BAPCPA did this both by abolishing the 100% exemption for earnings<sup>19</sup> and by imposing new fees and filing requirements.<sup>20</sup>

This article addresses how these changes affect the economic efficiency of personal bankruptcy law. Part II of the paper analyzes incentives to file for bankruptcy and to behave opportunistically under bankruptcy law before BAPCPA. Part III does the same for bankruptcy law after BAPCPA. Part IV considers an alternate approach to bankruptcy reform.

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13. See 11 U.S.C. § 522(d) (2000) (listing exemption amounts for different types of property). See also NATHALIE MARTIN WITH STEWART PALEY, J.K. LASSER'S THE NEW BANKRUPTCY LAW AND YOU 72–73 (2006).

14. See Michelle J. White, *Why It Pays to File for Bankruptcy: A Critical Look at the Incentives Under U.S. Personal Bankruptcy Laws and a Proposal for Change*, 65 U. CHI. L. REV. 685, 687–91 (1998) (explaining that debtors can choose to file bankruptcy under either chapter and that chapter 7, unlike chapter 13, does not force debtors to use future income to repay debts).

15. See STEPHEN ELIAS, THE NEW BANKRUPTCY: WILL IT WORK FOR YOU? 1/6 to 1/7 (Lisa Guerin ed., 2006) (stating that the filing fee is \$274 under chapter 7 and \$189 under chapter 13).

16. See White, *supra* note 14, at 687–92.

17. Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA) of 2005, Pub. L. No. 109-8, 199 Stat. 23 (codified as amended in scattered sections of 11 U.S.C.).

18. Cf. Susan Jensen, *A Legislative History of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005*, 79 AM. BANKR. L.J. 485, 488 (2005) (observing that the impetus for BAPCPA included an awareness that “the number of consumer bankruptcies [had] reach[ed] unprecedented levels” and that bankruptcy had “become a first resort rather than a last measure”).

19. See Susan Block-Lieb & Edward J. Janger, *The Myth of the Rational Borrower: Rationality, Behavioralism, and the Misguided “Reform” of Bankruptcy Law*, 84 TEX. L. REV. 1481, 1484 (2006) (noting that BAPCPA enhances creditors’ rights in bankruptcy by providing for repayment from the debtor’s postbankruptcy income).

20. ELIAS, *supra* note 15, at 1/23 to 1/25 (listing new requirements imposed by BAPCPA).

## II. BANKRUPTCY BEFORE BAPCPA

### A. *Incentives to File Under Chapter 7 and Chapter 13*

Under pre-BAPCPA bankruptcy law, debtors had the right to choose between two personal bankruptcy procedures, chapter 7<sup>21</sup> and chapter 13.<sup>22</sup> Under chapter 7, most types of unsecured debt were (and still are) discharged.<sup>23</sup> Debtors were required to use all of their wealth above an exemption level to repay their debt;<sup>24</sup> but, their postbankruptcy income was completely exempt.<sup>25</sup> Exemptions for wealth in bankruptcy are set by the states and vary widely.<sup>26</sup>

Consider a nonopportunistic debtor's decision to file for bankruptcy. The debtor's financial gain from filing for bankruptcy under pre-BAPCPA chapter 7 is shown in condition (1):

$$\text{Min}[D - \max[W - X, 0], 0] - C$$

where  $D$  is the amount of unsecured debt that will be discharged in bankruptcy,  $W$  is the debtor's wealth,  $X$  is the exemption for wealth in the debtor's state of residence,<sup>27</sup> and  $C$  is the cost of filing for bankruptcy, including lawyers' fees, filing fees, and the costs of bankruptcy stigma and reduced access to future credit.

A debtor's financial benefit from filing under chapter 7 equals the amount of unsecured debt discharged,  $D$ , minus the value of nonexempt assets that must be used to repay, which is either  $W - X$  or zero, minus the costs of filing,  $C$ . For each debtor, there is a threshold wealth level,  $W^*$ , such that the debtor is equally well off regardless of whether the debtor files for bankruptcy. This situation satisfies the condition  $W^* - X + C = D$ . If a debtor's wealth is less than  $W^*$ , the debtor gains financially from filing for bankruptcy. If the debtor's wealth is greater than  $W^*$ , the debtor is better off not filing. Because  $W^*$  depends on  $X$ ,  $D$ , and  $C$ , the threshold is higher for debtors if they have more debt, if their wealth has fallen, perhaps due to job loss or health problems, if they live in states with higher exemptions, or if bankruptcy costs are low.

Figure 1 shows wealth on the horizontal axis and income on the vertical axis. The shaded area shows the set of wealth and income levels at which debtors gain financially from filing for bankruptcy. Because of the

21. 11 U.S.C. §§ 701–784 (2000 & Supp. III 2003); ELIAS, *supra* note 15, at 1/23. *See generally id.* at 1/3 to 1/9 (describing chapter 7 bankruptcy).

22. 11 U.S.C. §§ 1301–1330 (2000 & Supp. III 2003). *See generally* ELIAS, *supra* note 15, at 1/9 to 1/14 (describing chapter 13 bankruptcy).

23. White, *supra* note 14, at 688.

24. *Id.* at 687; Michelle J. White, *Why Don't More Households File for Bankruptcy?*, 14 J.L. ECON & ORG. 205 (1998).

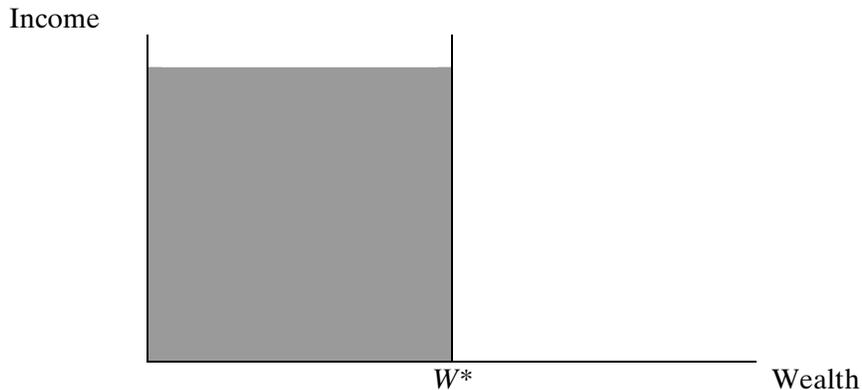
25. White, *supra* note 14, at 687.

26. *See infra* Part III.A for a discussion of how BAPCPA changed chapter 7.

27. This discussion treats all wealth as homogeneous. In reality, wealth comes in various forms, and states have different exemptions for different forms of wealth. Thus  $X$  represents the sum of all wealth exemptions. *See infra* Part II.B for further discussion.

100% income exemption in chapter 7,<sup>28</sup> debtors gain from filing for bankruptcy regardless of how high their incomes may be, as long as they have wealth less than or equal to  $W^*$ . Because  $W^*$  is higher for debtors who live in high-exemption states, the shaded area is larger and more debtors gain from filing for bankruptcy in these states.

FIGURE 1  
WEALTH—INCOME LEVELS AT WHICH DEBTORS BENEFIT FROM FILING  
FOR BANKRUPTCY PRE-BAPCPA



Now turn to chapter 13. Before BAPCPA, debtors filing under chapter 13 were obliged to propose a plan to repay some of their debts from future income over a period of three to five years after filing.<sup>29</sup> Their wealth, however, was entirely exempt from the obligation to repay.<sup>30</sup> The plan required approval from the bankruptcy judge, but not creditors.<sup>31</sup> Debtors who completed their repayment plans received a discharge from their remaining unsecured debts.<sup>32</sup> Because debtors had the right to choose between the two chapters,<sup>33</sup> they were never obliged to repay more from their future income under chapter 13 than the amount they would be obliged to repay from nonexempt wealth under chapter 7. As a result, many debtors who filed under chapter 13 proposed to repay either an amount equal to their nonexempt wealth,  $W - X$ , or a token amount if all of their wealth would be exempt under chapter 7. This meant that the financial benefit from filing under chapter 13 was the same as the benefit from filing under chapter 7.<sup>34</sup>

28. See White, *supra* note 14, at 687–88.

29. *Id.* at 691.

30. *Id.*

31. *Id.*

32. 11 U.S.C. § 1328(a) (2000).

33. 11 U.S.C. §§ 109(a)–(b), (e), 301, 706(a) (2000).

34. This neglects specific features of chapter 13 that made it attractive to particular types of debtors. For example, certain types of debts—such as debts incurred by fraud—could be discharged

Thus, the right to choose between the two chapters meant that many debtors could gain financially from filing for bankruptcy, even if they had high incomes. Because debtors could choose to repay from either wealth or postbankruptcy earnings, they could repay from whichever source they did not have!<sup>35</sup> Of course, not all debtors who might gain financially from filing for bankruptcy actually file. However, in a study examining households' decisions to file for bankruptcy, I found that the likelihood of households to file for bankruptcy increased as their financial gain from filing increased.<sup>36</sup>

### B. *Opportunistic Behavior and the Bankruptcy Filing Decision*

Now consider opportunistic debtors' decisions to file for bankruptcy prior to BAPCPA. These debtors are assumed to engage in "bankruptcy planning" that increases their financial gain from filing—similar to the "tax planning" that taxpayers use to reduce their taxes.

Bankruptcy planning strategies often involve maximizing the gain from filing for bankruptcy by converting wealth from nonexempt to exempt forms.<sup>37</sup> Most states have separate exemptions for equity in owner-occupied homes (homesteads), equity in automobiles, personal property, cash,<sup>38</sup> clothing and household goods,<sup>39</sup> and other categories.<sup>40</sup> The largest and most variable exemption is the homestead exemption,<sup>41</sup> which ranges from no exemption in two states<sup>42</sup> to an unlimited exemption in several other states, including Texas and Florida.<sup>43</sup>

As an example of a bankruptcy-planning strategy, consider a debtor who lives in Massachusetts, which has a \$500,000 homestead exemption, but only a \$125 exemption for cash.<sup>44</sup> Suppose the debtor has unsecured debt of \$40,000, a \$30,000 bank account, and a home in which her equity is \$100,000. Also suppose bankruptcy costs are \$1000. If the debtor files for bankruptcy under chapter 7, then—using condition (1)—her financial

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only under chapter 13. Also, debtors who are homeowners often filed under chapter 13 to delay mortgage lenders from foreclosing. See White, *supra* note 14, at 687–732.

35. Amendments to the Bankruptcy Code adopted in 1984, Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. 98-353, §§ 301–553, 98 Stat. 333, 352–92 (codified as amended in scattered sections of 11 U.S.C.), were intended to prevent debtors from 'abusing' the bankruptcy system by filing under chapter 7 when they had high incomes. However, these provisions had little effect. See Richard M. Hynes, *Optimal Bankruptcy in a Non-Optimal World*, 44 B.C. L. REV. 1, 40 (2002); Jensen, *supra* note 18, at 492.

36. See Scott Fay, Erik Hurst & Michelle J. White, *The Household Bankruptcy Decision*, 92 AM. ECON. REV. 706, 708 (2002). This study used a representative sample of U.S. households.

37. See White, *supra* note 14, at 713.

38. White, *supra* note 24, at 207.

39. *Id.* at 207 n.3.

40. See *id.* at 208 tbl.1.

41. *Id.* at 207.

42. See, e.g., N.J. STAT. ANN. § 2A:17-19 (West 2000); 42 PA. CONS. STAT. ANN. §§ 8123–8124 (West 1998).

43. See MARTIN WITH PALEY, *supra* note 13, at 162, 199.

44. See *id.* at 175–76.

benefit is  $\$40,000 - (\$30,000 - \$125) - \$1000 = \$9125$ . This is because her unsecured debt is discharged and her home equity is entirely exempt, but only \$125 of her bank account is exempt. Suppose, however, before filing, the debtor uses her bank account to repay \$30,000 of her mortgage, thus raising her home equity to \$130,000. Her assets will then be entirely exempt, and her financial benefit from filing increases to \$39,000.

Debtors can also increase their benefit from bankruptcy by moving from low-exemption to high-exemption states. Suppose the same debtor lives in New Hampshire rather than Massachusetts. Because New Hampshire has a \$100,000 homestead exemption and an \$8000 exemption for cash,<sup>45</sup> her financial benefit from bankruptcy would increase from \$17,000 to \$39,000 if she moved to Massachusetts before filing.<sup>46</sup> When debtors engage in strategies such as shifting their financial assets from bank accounts to home equity or moving from low-exemption to high-exemption states, they raise  $W^*$  and increase the width of the shaded area in figure 1.

However, debtors who are renters gain less from filing under chapter 7 because they cannot make use of state homestead exemptions. The federal bankruptcy exemptions allow renters to shelter about \$21,000 in assets<sup>47</sup>—more than nearly all state exemptions.<sup>48</sup> Fifteen states and the District of Columbia allow their residents to use the federal bankruptcy exemptions.<sup>49</sup> For debtors who are renters rather than homeowners,  $W^*$  is lower and the size of the shaded area in figure 1 is correspondingly smaller than for homeowners.

In a recent study,<sup>50</sup> I calculated the fraction of U.S. households that could benefit financially from filing for bankruptcy under chapter 7, using a representative sample of U.S. households taken from the *Survey of Consumer Finances*, conducted in the early 1990s.<sup>51</sup> This survey, run by the Federal Reserve Board of Governors, asked detailed questions about household assets and liabilities.<sup>52</sup> For each household, I calculated the benefit from filing for bankruptcy on the day of the survey, using condition (1).<sup>53</sup> The calculations allowed for the fact that many states permit married couples to take higher exemptions in bankruptcy<sup>54</sup> and the fact that fifteen states permit debtors to choose between the state's exemp-

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45. *See id.* at 184.

46. Using condition (1), *see supra* text accompanying note 27, the debtor's financial benefit in New Hampshire is:  $\$40,000 - (\$30,000 - \$8000) - \$1000 = \$17,000$ .

47. This represents the total of separate exemptions for any property, equity in a car, personal property, clothing, and household goods. *See* MARTIN WITH PALEY, *supra* note 13, at 74.

48. *Compare id.* at 74 (federal exemptions), *with id.* at 151–208 (state exemptions).

49. *See id.* at 30.

50. White, *supra* note 24.

51. FED. RESERVE BD., 1992 SURVEY OF CONSUMER FINANCES (1992), <http://www.federalreserve.gov/pubs/oss/oss2/92/scf92home.html>.

52. *See id.*

53. *See supra* text accompanying note 27.

54. White, *supra* note 24, at 207.

tions and the federal bankruptcy exemptions.<sup>55</sup> For each household, the exemptions that result in the highest financial benefit were used. I then computed the percentage of all U.S. households that would benefit financially from filing for bankruptcy.<sup>56</sup>

The results for households in several large states and for all households are shown in table 1.

TABLE 1  
PERCENTAGE OF HOUSEHOLDS THAT WOULD BENEFIT FINANCIALLY  
FROM FILING FOR BANKRUPTCY BEFORE BAPCPA<sup>57</sup>

	Base case	Strategy I	Strategy II	Strategy III	All
California	16%	18%	22%	20%	
Florida	16%	23%	34%	24%	
Illinois	9%	10%	11%	13%	
New York	9%	10%	14%	14%	
Texas	29%	37%	54%	36%	
U.S.	15%	18%	23%	20%	34%

In the column labeled “Base case,” about 15% of households in the United States would benefit from filing for bankruptcy, compared to 29% of households in Texas alone. The figure for Texas is higher because homeowners benefit from Texas’s unlimited homestead exemption<sup>58</sup> and renters benefit from the federal bankruptcy exemptions, which Texas allows.<sup>59</sup> In the next three columns of table 1, the data is recalculated by assuming that households use three different bankruptcy planning strategies to behave opportunistically. In Strategy I, households use their nonexempt assets to pay off part or all of the mortgages on their principle residences. Under this strategy, the percent of households that would benefit from bankruptcy increases by about 2% in the United States overall and by 7% in Texas. In Strategy II, households either move to more expensive homes or improve their current homes. Under this strategy, the proportion of households that would benefit from filing increases by 5% in the United States and 17% in Texas. In Strategy III, households borrow up to the credit limits on their existing credit cards, but do not obtain additional credit cards. (They do not follow Strategies I and II.) Compared to the base case, this strategy causes the proportion of households that benefit from filing to increase by 5% in the United States and 6% in Texas. Finally, in a fourth strategy not shown in table 1, debtors move to Texas before filing for bankruptcy and invest all of

55. *Id.* at 207–09.

56. *Id.* at 213–15. These calculations do not include the cost of filing for bankruptcy. In a similar set of calculations, I assumed that the costs of filing for bankruptcy were \$350, but everything else remained the same. Then the percentage of households in the United States that would benefit from filing fell by about 2%. *Id.* at 215 n.17.

57. See White, *supra* note 24, at 214 tbl.2.

58. White, *supra* note 24, at 208–09 tbl.1.

59. *Id.*

their nonexempt assets in a house. Under this “Texas” strategy, 54% of all households would benefit from filing for bankruptcy.<sup>60</sup>

*C. Effect of Bankruptcy Law on the Amounts Paid to Creditors in Bankruptcy and the Number of Bankruptcy Filings*

This discussion suggests that pre-BAPCPA bankruptcy law gave both opportunistic and nonopportunistic debtors strong incentives to file. Nonopportunists were encouraged to file because many of them gained financially from filing without planning in advance. Opportunists were encouraged to file because planning in advance greatly increased their gains. Opportunists in particular could gain from filing for bankruptcy even if they had not experienced any reduction in their ability-to-repay. In fact, between 1994 and 2000, unsecured creditors received

TABLE 2  
NONBUSINESS BANKRUPTCY FILINGS, 1980–2005<sup>61</sup>

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

nothing in about 96% of chapter 7 bankruptcy filings,<sup>62</sup> and in most chapter 13 cases, only mortgage creditors received anything at all.<sup>63</sup> In addition, as table 2 shows, the yearly bankruptcy filing rate rose steadily from

60. Another common bankruptcy planning strategy is for debtors to put their assets into “asset protection trusts” before filing. See Stewart E. Sterk, *Asset Protection Trusts: Trust Law’s Race to the Bottom?*, 85 CORNELL L. REV. 1035, 1036 (2000). Or, if debtors are a married couple, they can incur all the debt in one spouse’s name and put all their assets into a house owned in “tenancy by the entirety.” Then, fifteen states and the District of Columbia exempt the entire value of the house as long as only one spouse files for bankruptcy. See MARTIN WITH PALEY, *supra* note 13.

61. Data on the number of nonbusiness bankruptcy filings are taken from Am. Bankr. Inst., *Annual Business and Non-business Filings by Year (1980–2005)*, <http://www.abiworld.org/ContentManagement/ContentDisplay.cfm?ContentID=18753> (last visited Aug. 22, 2006), and data on the number of U.S. households, used to compute the percentage of households that file for bankruptcy, are taken from U.S. CENSUS BUREAU, *STATISTICAL ABSTRACT OF THE UNITED STATES: 2004–2005*, at 7–8 tbls.2 & 3 (2004), available at <http://www.census.gov/prod/2004pubs/04statab/pop.pdf>.

62. See Sterk, *supra* note 60, at 1036.

63. See Ed Flynn & Gordon Bermant, *Bankruptcy by the Numbers: Chapter 7 Asset Cases*, AM. BANKR. INST. J., Dec. 2002–Jan. 2003, at 22, 22 [hereinafter Flynn & Bermant, *Bankruptcy by the Numbers*]; Ed Flynn & Gordon Bermant, *What is “Success” in Chapter 13? Why Should We Care?*, AM. BANKR. INST. J., Sept. 2004, at 20.

0.13% of the U.S. population in 1980<sup>64</sup> to 0.53% of the population in 2002–2004.<sup>65</sup> It jumped further to 0.69% in 2005,<sup>66</sup> when debtors rushed to file before BAPCPA went into effect. The steady increase in the number of bankruptcy filings suggests that debtors gradually realized how favorable bankruptcy was, presumably by hearing about it from friends or relatives who had filed themselves or knew someone who had. A recent study suggests that individual households are more likely to file for bankruptcy in regions where the filing rate is higher than the national rate, because more households in the region know about bankruptcy, and because filing has become more socially acceptable in that region.<sup>67</sup> Another study found that the bankruptcy filing rate increased from 1995 to 1997 by more than household characteristics could explain.<sup>68</sup> Both studies suggest the stigma of bankruptcy has fallen.<sup>69</sup> Despite the large increase in bankruptcy filing rates nationally, filing rates vary widely across states. For example, in 2003 the yearly bankruptcy filing rate in Massachusetts was only one-quarter of the rate in Tennessee—0.28% versus 1.11%, respectively.<sup>70</sup> This suggests that filing rates might have continued to increase had BAPCPA not been adopted in 2005. Overall, the figures in tables 1 and 2 suggest the reason the credit card lending industry lobbied so fervently for bankruptcy reform.

### III. BANKRUPTCY UNDER BAPCPA

#### A. Major and Minor Changes Under BAPCPA

The most important change under BAPCPA is that debtors no longer have the right to choose between filing under chapter 7 or chapter 13 without restriction;<sup>71</sup> instead, they must “pass” a new “means test” in order to file under chapter 7.<sup>72</sup> The means test has two separate parts,<sup>73</sup> which I refer to as the median income test and the repayment test. An-

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64. See U.S. CENSUS BUREAU, *supra* note 61, at 7; Am. Bankr. Inst., *supra* note 61.

65. See U.S. CENSUS BUREAU, *supra* note 61, at 7; Am. Bankr. Inst., *supra* note 61.

66. See U.S. CENSUS BUREAU, *supra* note 61, at 7; Am. Bankr. Inst., *supra* note 61.

67. Fay, Hurst & White, *supra* note 36, at 710.

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

69. Fay, Hurst & White, *supra* note 36, at 707; Gross & Souleles, *supra* note 68.

70. These figures represent the number of nonbusiness bankruptcy filings in each state in 2003, from [www.abiworld.org](http://www.abiworld.org), divided by the state's population in 2003, from table 17 of STATISTICAL ABSTRACT OF THE UNITED STATES 2004–2005. See U.S. CENSUS BUREAU, *supra* note 61, at 20 tbl.17; Am. Bankr. Inst., Annual Business and Non-business Filings by State (2000–2005), <http://www.abiworld.org/ContentManagement/ContentDisplay.cfm?ContentID=19250> (last visited Aug. 22, 2006). Note that filings by married couples are counted as one filing, so the data understate the proportion of the population that files for bankruptcy.

71. BAPCPA, Pub. L. No. 109-8, § 102, 119 Stat. 23, 27–35 (codified as amended at 11 U.S.C. § 707).

72. *Id.*

73. *Id.* § 102(a)(2)(C), 119 Stat. 23, 27–32 (codified in part C at 11 U.S.C. § 707(b)(2)(A)(i)–(iii)).

other important change is that all debtors filing for bankruptcy must overcome a set of new hurdles. I discuss the two parts of the means test, the new hurdles, and several other changes separately.<sup>74</sup>

### 1. Median Income Test

Define a debtor's average monthly current income (*AMCI*) to be the debtor's monthly income (*MI*) averaged over the six months prior to filing, or

$$AMCI = \left(\frac{1}{6}\right) \sum_{t=t-6}^{t-1} MI.$$

Here *t* is the month of filing. Suppose *MSI* denotes the median income level per month, adjusted for family size, in the debtor's state of residence. Debtors "pass" the median income test and are allowed to file under chapter 7 if  $AMCI \leq MSI$ . If  $AMCI > MSI$ , those debtors "fail" the median income test and must take the repayment test.

### 2. Repayment Test

The repayment test determines both whether debtors who "fail" the median income test must file under chapter 13 and, if so, how much they must repay in chapter 13. Define "monthly allowable consumption," *MAC*, to be the amount that debtors in chapter 13 are allowed to spend per month on their own consumption. Define "monthly disposable income," *MDI*, to be the difference between average monthly current income and monthly allowable consumption, or  $MDI = AMCI - MAC$ . Note that *MAC*, *AMCI*, and the amount of unsecured debt that the debtor owes, *D*, all differ among debtors.

The repayment test uses  $60MDI$ , which equals the debtor's disposable income over five years. If  $60MDI$  exceeds \$10,000 (or  $MDI > \$167$ ), the debtor must file under chapter 13 regardless of the amount of debt he or she owes.<sup>75</sup> If  $60MDI$  is between \$6000 and \$10,000 (or  $\$100 \leq MDI \leq \$167$ ), the debtor is allowed to file under chapter 7 so long as the debtor's disposable income over five years is less than 25% of the debtor's unsecured debt (or  $60MDI < .25D$ ).<sup>76</sup> Finally, if  $60MDI$  is less than \$6000 (or  $MDI < \$100$ ), the debtor is allowed to file under chapter 7 uncondition-

74. For a discussion of changes under BAPCPA, see Bruce A. Markell, *A Short Guide to the New "Means" Test*, in NEVADA CLE COURSE MATERIALS (2005); MARTIN WITH PALEY, *supra* note 13, at 119-25; Henry J. Sommer, *Trying to Make Sense Out of Nonsense: Representing Consumers Under the "Bankruptcy Abuse Prevention and Consumer Protection Act of 2005"*, 79 AM. BANKR. L.J., 191 (2005); and Eugene R. Wedoff, *Means Testing in the New § 707(b)*, 79 AM. BANKR. L.J., 231 (2005).

75. See ELIAS, *supra* note 15, at 2/22, 2/25 to 2/26.

76. *Id.* at 2/25 to 2/26.

ally. Combining these conditions with the median income test, debtors are allowed to file under chapter 7 if, as shown in condition (2):

$$\text{AMCI} \leq \max[\text{MSI}, \text{MAC} + 100, \\ \min[\text{MAC} + (.25/60)\text{D}, \text{MAC} + 167]]$$

This condition is more permissive than the median income test alone, because debtors are allowed to file under chapter 7 even if their annual income is above their state's median income level. For purposes of later discussion,<sup>77</sup> suppose the maximum level of income at which debtors qualify to file under chapter 7, the right-hand side of condition (2), is denoted *MAXI*.

### 3. The “Hurdles”

There are new requirements that increase the burden of filing for bankruptcy, regardless of whether one files under chapter 7 or chapter 13. Under BAPCPA, debtors must undergo credit counseling before filing<sup>78</sup> and must take a financial management course before they can receive a discharge.<sup>79</sup> In addition, attorneys must investigate their clients' bankruptcy petitions and certify that the petitions do not constitute an abuse<sup>80</sup> (attorneys may be sanctioned if they file petitions that are dismissed because of abuse).<sup>81</sup> BAPCPA creates new paperwork requirements for administering the means test and for administering chapter 13 plans—about twenty-five forms in all.<sup>82</sup> These forms document debtors' income, expenses, priority and secured debt payments, in addition to their assets and debts.<sup>83</sup> Debtors are also required to file copies of their wage stubs and income tax returns with the bankruptcy court—even if they never filed tax returns in the past.<sup>84</sup>

The “hurdles” raise the cost of filing for bankruptcy. Before BAPCPA, bankruptcy attorneys generally charged less than \$1000 (plus filing fees) for a chapter 7 filing. However, a recent publication predicts that, under BAPCPA, the costs of filing under chapter 7 will be \$1500 to \$2500 for lawyers' fees plus nearly \$300 in filing fees.<sup>85</sup> The costs of filing under chapter 13 will be \$2500 to \$3500 in lawyers' fees plus \$189 in filing fees.<sup>86</sup> These higher costs reflect the extra time that bankruptcy lawyers must spend to investigate and certify assets, liabilities, income, and consumption figures.

77. See *infra* text accompanying note 95.

78. BAPCPA § 106(a), 119 Stat. at 37–38 (codified at 11 U.S.C. § 109(h)).

79. *Id.* § 106(c), 119 Stat. at 38 (codified at 11 U.S.C. § 1328(g)).

80. *Id.* § 102(a)(2)(C), 119 Stat. at 27–32 (codified in part at 11 U.S.C. § 707(b)(4)(C)).

81. *Id.* (codified in part at 11 U.S.C. § 707(b)(4)(B)).

82. See *id.* (codified in part at 11 U.S.C. § 707(b)(2)–(7)).

83. *Id.*

84. *Id.*

85. ELIAS, *supra* note 15, at 10/10.

86. *Id.* at 10/10.

#### 4. *Other Changes Under BAPCPA*

Another important change is that BAPCPA reduced the amount of debt discharged in bankruptcy by ending discharge of some types of loans.<sup>87</sup> Most of these changes involve debts that previously could be discharged only under chapter 13.<sup>88</sup> After the adoption of BAPCPA, these debts are no longer dischargeable at all. Debts that are no longer dischargeable include loans obtained by fraud,<sup>89</sup> debts for intentional torts,<sup>90</sup> and debts incurred for cash advances and purchases of luxury goods obtained shortly before the bankruptcy filing.<sup>91</sup> BAPCPA also ended the practice of “stripping-down” car loans, which reduced the principle of these loans to the market value of the car.<sup>92</sup> Finally, BAPCPA lengthened the minimum period between bankruptcy filings, thereby reducing the number of debtors eligible to file at any given time.<sup>93</sup>

#### B. *Incentives to File Under Chapter 7 and Chapter 13*

How do these changes affect nonopportunistic debtors' incentives to file for bankruptcy? Figure 1<sup>94</sup> showed that, before BAPCPA, debtors benefited from filing for bankruptcy under chapter 7 as long as their wealth was less than  $W^*$ , even if they had high incomes. Now consider the situation after BAPCPA. Assuming debtors can “pass” the means test and file under chapter 7, they will gain financially from filing as long as their wealth is less than a new threshold  $W^{*'}$ , determined by the condition  $W^{*'} - X' + C' = D'$ . Here the primes denote values under BAPCPA, such that  $X'$  denotes the wealth exemption under BAPCPA,  $C'$  denotes bankruptcy costs under BAPCPA, and  $D'$  denotes the amount of debt discharged under BAPCPA. Post-BAPCPA, a debtor's financial gain from filing under chapter 7 becomes  $\min[D' - \max[W - X', 0], 0] - C'$ . This expression takes the same form as the pre-BAPCPA expression, condition (1), but the values of the variables differ due to higher bankruptcy costs under BAPCPA, possibly lower exemption levels, and lower amounts of debt discharged for some debtors. Under BAPCPA, debtors gain from filing for bankruptcy under chapter 7 if  $W \leq W^{*'}$ . Because  $W^{*'} < W^*$ , fewer debtors now gain from filing under chapter 7 than before BAPCPA was adopted.

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87. MARTIN WITH PALEY, *supra* note 13, at 37.

88. *Id.*

89. BAPCPA § 322(a), 119 Stat. at 96–97 (codified at 11 U.S.C. § 522(p)–(q)); MARTIN WITH PALEY, *supra* note 13, at 37.

90. BAPCPA § 322(a) (codified in part at 11 U.S.C. 522(q)(1)(B)(iv)); MARTIN WITH PALEY, *supra* note 13, at 37.

91. BAPCPA § 310, 119 Stat. at 84 (codified at 11 U.S.C. § 523(a)(2)(C)).

92. *See id.* § 306(b), 119 Stat. at 80 (codified at 11 U.S.C. § 1325(a)).

93. *See generally* MARTIN WITH PALEY, *supra* note 13; Markell, *supra* note 74; Sommer, *supra* note 74; Wedoff, *supra* note 74.

94. *See* discussion *supra* Part II.B.

Consider now the conditions under which debtors gain from filing under chapter 13. Suppose that the debtor has debt greater than \$40,000. Then condition (2)<sup>95</sup> provides that debtors cannot file under chapter 7 if  $AMCI > MAC + 167$ . Assuming that debtors file for bankruptcy under chapter 13, their financial benefit becomes condition (3):

$$\min[D' - \max[60MDI, 0], 0] - C'$$

This condition may be solved for the maximum monthly income, denoted  $AMCI^*$ , such that nonopportunistic debtors gain financially from filing under chapter 13. Setting condition (3) equal to zero and using  $MDI = AMCI - MAC$ , one arrives at the expression  $AMCI^* = MAC + (C' - D')/60$ . Debtors gain financially from filing for bankruptcy under chapter 13 if  $AMCI \leq AMCI^*$ . By combining these conditions, one sees that debtors who are barred from filing under chapter 7 but gain financially from filing under chapter 13 must have  $AMCI$  within the range specified by condition (4):

$$MAXI < AMCI \leq AMCI^*$$

In addition, the “best interests of creditors” test<sup>96</sup> requires that debtors filing under chapter 13 must not repay less than they would be obliged to repay from nonexempt wealth in chapter 7.<sup>97</sup> This condition implies that debtors cannot gain from filing under chapter 13 if their wealth exceeds  $W^*$ . Thus the set of debtors who gain from filing for bankruptcy under BAPCPA includes both chapter 7 filers for whom  $AMCI \leq MAXI$  and  $W \leq W^*$  and chapter 13 filers for whom  $MAXI < AMCI \leq AMCI^*$  and  $W \leq W^*$ .

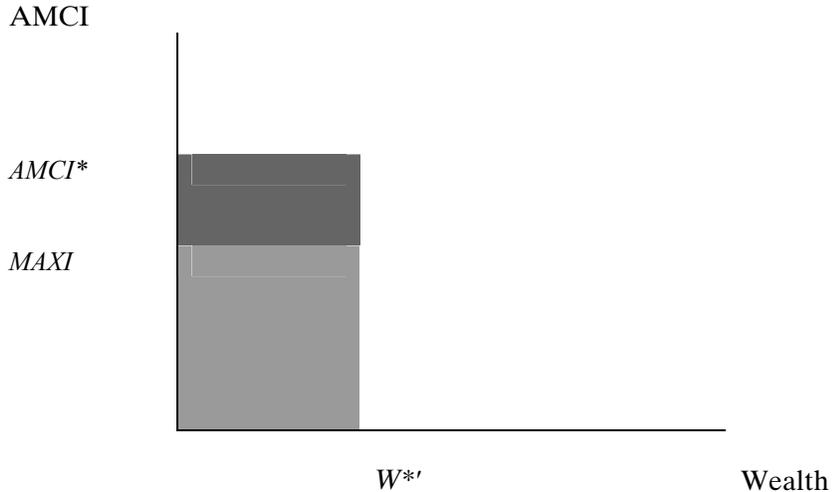
Figure 2 is similar to figure 1, but applies to conditions under BAPCPA. Debtors’ wealth is on the horizontal axis and debtors’ income—now interpreted as  $AMCI$ —is on the vertical axis. The light grey shaded block in figure 2 is the area in which debtors gain from filing under chapter 7. This area is narrower than the shaded area in figure 1 because  $W^* < W^*$  and, because of the means test, the area is cut off vertically at an income level of  $MAXI$ . The dark grey shaded block in figure 2 represents the set of variables such that debtors gain from filing under chapter 13. Debtors in the dark grey shaded area cannot file under chapter 7 because their  $AMCI$  is too high, but they benefit from filing under chapter 13 because their repayment obligation is low relative to the amount of debt discharged in bankruptcy. The comparison of figures 1 and 2 suggests that BAPCPA greatly reduces the number of nonopportunistic debtors who benefit from filing for bankruptcy.

95. See *supra* text accompanying notes 76–77.

96. See 11 U.S.C. § 1307 (2000).

97. ELIAS, *supra* note 15, at 9/15; MARTIN WITH PALEY, *supra* note 13, at 142–43.

FIGURE 2  
WEALTH—INCOME LEVELS AT WHICH DEBTORS BENEFIT FROM FILING  
FOR BANKRUPTCY POST-BAPCPA



C. *Effect of the Means Test and the Hurdles on the Number of Bankruptcy Filings*

What proportion of bankruptcy filers will be forced to file under chapter 13 rather than chapter 7 as a result of the adoption of BAPCPA? The median income for all U.S. households in 2002 was \$3533 per month.<sup>98</sup> A study<sup>99</sup> by the Executive Office for U.S. Trustee found that the breakdown of chapter 7 bankruptcy filers by income in 2000–2002 was as shown in table 3.

Using these figures, a bankruptcy filer with income of \$3000 per month is at the 70th percentile of the income distribution for bankruptcy filers, and a filer with income of \$4000 per month is at the 86th percentile. Assuming that filers' monthly incomes in the \$3000 to \$4000 range are uniformly distributed, 78% of bankruptcy filers would be expected to "pass" the median income test and be allowed to file under chapter 7.<sup>100</sup> Additionally, some debtors who "fail" the median income test may still file under chapter 7 because such debtors "pass" the repayment test. Two studies in 1999<sup>101</sup> and 2000<sup>102</sup> estimated the percent of bankruptcy

98. See Daniel Weinberg, Chief, Hous. & Household Econ. Statistics Div., U.S. Census Bureau, Press Briefing on 2002 Income and Poverty Estimates (Sept. 26, 2003), <http://www.census.gov/hhes/www/income/income02/prs03asc.html>.

99. See Flynn & Bermant, *Bankruptcy by the Numbers*, *supra* note 63, at 20 tbl.3.

100. This assumes that the median income test is based on median income for the United States rather than state median income levels, and that debtors do not change their behavior.

101. Marianne B. Culhane & Michaela M. White, *Taking the New Consumer Bankruptcy Model for a Test Drive: Means-Testing Real Chapter 7 Debtors*, 7 AM. BANKR. INST. L. REV. 27, 37–38 (1999).

102. Flynn & Bermant, *Bankruptcy by the Numbers*, *supra* note 63, at 22, 23.

filers that would “fail” both tests and be forced to file under chapter 13. Less than 1% of filers failed both tests, which suggests that BAPCPA will force very few bankruptcy filers to shift from chapter 7 to chapter 13.<sup>103</sup> However, a more important effect of the adoption of BAPCPA is that the new “hurdles” are likely to cause many debtors who would previously have filed under chapter 7 to avoid filing for bankruptcy at all.

TABLE 3  
CHARACTERISTICS OF BANKRUPTCY FILERS IN 2000–2002<sup>104</sup>

Monthly Income	% of filers	Average credit card debt
0	4	\$22,867
< \$1000	10	\$14,298
\$1000–2000	30	\$14,707
\$2000–3000	26	\$15,850
\$3000–4000	16	\$19,387
\$4000–5000	8	\$21,050
\$5000–6000	3	\$26,153
> \$6000	3	\$41,978

#### D. Opportunistic Behavior Under BAPCPA

BAPCPA does not abolish incentives to behave opportunistically in making bankruptcy decisions, but it changes the nature of opportunistic strategies. In particular, opportunistic debtors before BAPCPA focused on the relatively simple task of shifting wealth from nonexempt forms to exempt forms.<sup>105</sup> Under BAPCPA, opportunistic debtors face a more complicated planning system that involves not only their wealth, but also their income, expenditures, and debt. First, opportunistic debtors have an incentive to reduce their incomes enough to “pass” either the median income test or the repayment test because passing either test allows them to file under chapter 7.<sup>106</sup> Second, these debtors have an incentive to acquire more debt before filing because doing so does not increase their repayment obligation in chapter 7 or chapter 13 and may even help them

103. See Culhane & White, *supra* note 102, at 61; Flynn & Bermant, *Bankruptcy by the Numbers*, *supra* note 63, at 22, 23. Both studies are based on early versions of the bankruptcy reform legislation, so that they differ in some details from BAPCPA. However, studies sponsored by the credit industry found that as many as one-third of debtors could repay a significant portion of their debts. See Richard L. Peterson, *Bankrupt Debtors’ Ability to Repay Debts*, in CREDIT RESEARCH CENTER, MONOGRAPH NO. 23, 1 CONSUMER BANKRUPTCY STUDY: CONSUMER’S RIGHT TO BANKRUPTCY ORIGINS AND EFFECTS 23, 149 (1982). See Culhane & White, *supra* note 102, at 58–61, and Theresa A. Sullivan et al., *Limiting Access to Bankruptcy Discharge: An Analysis of the Creditors’ Data*, 1983 WIS. L. REV., 1091, 1145–46, for critiques of credit industry studies and discussion.

104. See *id.*

105. See Stephen G. Gilles, *The Judgment-Proof Society*, 63 WASH. & LEE L. REV. 603, 654–55 (2006) (noting the popularity of “exemption maximizing” strategies that shift assets from nonexempt categories to exempt categories with the goal of lowering a plaintiff’s expected gain through bankruptcy litigation).

106. *Id.* at 656 (citing BAPCPA, Pub. L. No. 109-8, § 102(a)(2)(C), 119 Stat. 23, 27–32 (codified in part at 11 U.S.C. § 707(b)(2)(A)(i)).

“pass” the repayment test to file under chapter 7.<sup>107</sup> Third, opportunistic debtors who are forced to file under chapter 13 have an incentive to raise their maximum allowable consumption (*MAC*) as much as possible because doing so lowers their repayment obligation in chapter 13.<sup>108</sup> Fourth, opportunistic debtors who “pass” the means test and are allowed to file under chapter 7 have the same pre-BAPCPA incentive to shift wealth from nonexempt categories to exempt categories in order to reduce their obligation to repay.<sup>109</sup> I discuss these issues separately.

### 1. *Incentives to Reduce Income*

Under BAPCPA, an opportunistic debtor’s strongest incentive is to reduce her income during the six months prior to filing if such income is above the relevant median monthly state income (*MSI*). To illustrate, suppose a debtor who has income above *MSI* reduces his or her work hours enough to lower earnings by \$100 per month for each of the six months prior to filing. The debtor’s *AMCI* then falls correspondingly by a total of \$600 during the six month period. This reduction in *AMCI* reduces the debtor’s obligation to repay in chapter 13 by \$100 per month for sixty months, or by \$6000—for a ten-fold return. The debtor continues to receive this ten-fold return for working less before bankruptcy until the debtor’s *AMCI* falls to the point where the debtor “passes” the means test and is allowed to file under chapter 7. This point is expressed in condition (2).<sup>110</sup> Beyond this point, the debtor’s return from working less falls to zero because the obligation to repay in chapter 7 does not depend on income.<sup>111</sup>

The ten-fold incentive for debtors to work less during the six-month period prior to filing reduces economic efficiency and is a serious drawback of BAPCPA. Consider whether it would be possible to redesign the median income test to reduce this distortion to work effort. Obviously it would not improve efficiency to base a debtor’s obligation to repay on postfiling income rather than prefiling income because this would simply shift the time period of distortion. Another possible solution is to base the repayment obligation on a debtor’s average income between one and two years before filing because debtors are less likely to plan for bankruptcy more than one year in advance. However, if debtors file for bankruptcy because of a fall in consumption that occurs less than one year before filing, this solution would force debtors to repay too much in bankruptcy, since their actual incomes would be lower than their incomes during the reference period. Similarly, the repayment obligation

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107. See Sommer, *supra* note 74, at 203.

108. Wedoff, *supra* note 74, at 242.

109. See Fay, Hurst & White, *supra* note 36, at 707.

110. See *supra* text accompanying notes 76–86.

111. See 11 U.S.C. § 541(a)(1) (2000); 3 DEBTOR-CREDITOR LAW § 31.06[1] & n.13 (Theodore Eisenberg ed., 2005).

could be based on something other than a debtor's actual income before filing, such as the average income level in the debtor's occupation. This again may lead to unrealistically high repayment obligations, however, because debtors who file for bankruptcy are likely to have lower-than-average income levels for their occupations. Another possibility is to base the repayment obligation on the average income level in the debtor's occupation discounted by the average loss of income that bankruptcy filers experience during the year or two before filing. This last solution would have the perverse effect of rewarding opportunistic behavior, however, because debtors who filed for bankruptcy would face a low obligation to repay even if their incomes were high. Overall, although any obligation to repay from income gives debtors an incentive to reduce their incomes, BAPCPA gives debtors an extremely strong incentive to do so.

There are other strategies that allow debtors to "pass" the median income test besides reducing their work hours. For example, debtors who are two-earner couples may reduce their *AMCI* by legally separating and filing for bankruptcy as individuals.<sup>112</sup> Alternatively, one spouse may file for bankruptcy and claim that because the other spouse's income is not regularly used for household expenses, that income is not part of the filing spouse's *AMCI*.<sup>113</sup> Debtors having income from capital may reduce their *AMCI* simply by shifting wealth from interest-paying bonds and dividend-paying stocks to assets that do not pay interest or dividends. If debtors have rent or royalty income, they may reduce their *AMCI* by arranging not to receive payments during the six months prior to filing. Debtors may also "pass" the median income test by increasing their family size (perhaps by counting their adult children) because *MSI* levels are higher for larger families.<sup>114</sup> Finally, debtors planning for bankruptcy may start businesses or claim that they used to own small businesses because debtors are not subject to the means test unless their debts are "primarily consumer debts."<sup>115</sup>

## 2. *Incentives to Acquire Additional Debt*

Opportunistic debtors always have an incentive to borrow more before bankruptcy, as long as the additional debt will be discharged. Borrowing more dischargeable debt increases one's financial gain from bankruptcy without increasing one's obligation to repay, denoted as either  $W - X$  for chapter 7 or *60MDI* for chapter 13. In addition, BAPCPA gives debtors an extra incentive to borrow more if their disposable income, or  $AMCI - MAC$ , is in the range between \$100 and \$167

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112. BAPCPA, Pub. L. No. 109-8 § 102(a)(2)(C), 199 Stat. 23, 27-32 (codified in part at 11 U.S.C. § 707(b)(7)(B)).

113. *See id.* § 102(b), 199 Stat. at 32 (codified in part at 11 U.S.C. § 101(10A)(B)).

114. *See id.* § 102(a), (c), (h), 199 Stat. at 27-34.

115. MARTIN WITH PALEY, *supra* note 13, at 147.

per month. This is because if additional debt causes  $AMCI - MAC$  to be less than  $(0.25/60)D$ , the debtor may “pass” the repayment test and file under chapter 7.

### 3. *Consumption Incentives*

Suppose debtors “fail” the median income test and are subject to the repayment test. To “pass” this test, debtors may rearrange their consumption so as to increase their maximum allowable consumption ( $MAC$ ) to the point that  $AMCI < MAC + 167$  (assuming that debt exceeds \$40,000). To investigate how easy it would be for debtors to avoid chapter 13 by increasing  $MAC$ , I examine three hypothetical debtor households. All are assumed to have higher-than-median income levels, to have families of four (a married couple plus two children), and to own homes. The three debtors are assumed to live in Charleston, West Virginia; New Haven, Connecticut; and San Diego, California, respectively. The Charleston and New Haven debtors illustrate the effect of low versus high median state income levels, and the New Haven and San Diego debtors illustrate the effect of low versus high housing prices. All three debtors are assumed to have income greater than their states’  $MSI$  because otherwise those debtors would pass the median income test. Therefore, the debtors in Charleston and New Haven are assumed to have  $AMCI$  equal to 150% of their states’  $MSI$ , and the San Diego debtor is assumed to have  $AMCI$  equal to 200% of California’s  $MSI$ . The three debtors’  $AMCI$  levels, shown in table 4, are \$6474, \$11,034, and \$11,385, respectively.<sup>116</sup>

TABLE 4  
INCENTIVES FOR OPPORTUNISTIC BEHAVIOR UNDER BAPCPA<sup>117</sup>

	Charleston, WV	New Haven, CT	San Diego, CA
State median income level for 4-person families	\$46,169	\$86,001	\$67,814
Debtor’s monthly income (150% or 200% of state median income) ( $AMCI$ )	\$6474	\$11,034	\$11,385
<i>IRS deductions:</i>			
food	\$865	\$865	\$865
housekeeping	\$110	\$110	\$110
apparel	\$317	\$317	\$317
personal care	\$81	\$81	\$81
<i>(Continued on next page)</i>			

116. These figures are based on estimated median income levels for four-person families in each state in federal fiscal year 2006. See Notice of Estimated State Median Income, 70 Fed. Reg. 8102, 8102 tbl. (Feb. 17, 2005).

117. See Notice of Estimated State Median Income, 70 Fed. Reg. 8102, 8102 tbl. (Feb. 17, 2005).

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TABLE 4—Continued

	Charleston, WV	New Haven, CT	San Diego, CA
miscellaneous	\$188	\$188	\$188
housing / utilities	\$1133	\$1971	\$2363
transportation	\$1149	\$1292	\$1228
federal income tax	\$600	\$1081	\$548
state income tax	\$284	\$517	\$153
term life insurance	\$50	\$50	\$50
health care	\$100	\$100	\$100
child / spousal support (court-ordered)	0	0	0
mandatory payroll de- ductions	0	0	0
childcare / health care	\$600	\$600	\$600
telecommunication ser- vices	\$200	\$200	\$200
Total	\$5677	\$7372	\$6803
<i>Additional bankruptcy deductions:</i>			
medical care, health and disability insurance	\$600	\$600	\$600
care of family members	\$500	\$500	\$500
family violence preven- tion	\$100	\$100	\$100
additional home energy cost	\$100	\$100	\$100
children's educational expenses	\$250	\$250	\$250
5% of IRS food / ap- parel deduction	\$49	\$49	\$49
car loan	0	0	0
home mortgage net of IRS deduction	\$285	\$1072	\$3373
property tax	\$63	\$596	\$512
homeowners' insurance	\$14	\$34	\$63
education savings ac- counts	\$170	\$170	\$170
charitable contributions (5%)	\$324	\$552	\$569
priority claims, other secured debt, past due debt costs and administrative ex- penses	0	0	0
Total	\$2452	\$4023	\$6286
Total deductions	\$8132	\$11,395	\$13,089
Monthly MDI	-\$1658	-\$361	-\$1704

Now consider monthly allowable consumption (*MAC*). This analysis follows form B22A, Statement of Currently Monthly Income and Means Test Calculation, to determine what consumption expenditures are allowable.<sup>118</sup> The form specifies two sets of deductions, those based on IRS Financial Collection Standards for delinquent taxpayers, and additional expense deductions allowable under BAPCPA. This article turns to the IRS deductions first. As noted in table 4, the IRS deductions include separate allowances for food, housekeeping, apparel and services, personal care, and miscellaneous expenses, which are uniform nationally but vary by family size and broad categories of income.<sup>119</sup> These deductions total \$1561 for all three debtors.

The next IRS deductions shown in table 4 are for housing and include separate allowances for the costs of operating a home and for the costs of either renting or owning. These vary by county and family size, but not by income. Debtors who own homes are allowed to deduct their actual mortgage payments up to the IRS ownership allowance.<sup>120</sup> (They are separately allowed to deduct their additional mortgage payments, as discussed below.) The combined operating and ownership deductions for housing are \$1133 for Charleston, \$1971 for New Haven, and \$2363 per month for San Diego.

The IRS deductions for transportation include separate allowances for the costs of operating, owning, or leasing one or two cars, or using public transportation.<sup>121</sup> Only two cars are permitted per family,<sup>122</sup> and users of public transportation are not permitted to deduct ownership allowances.<sup>123</sup> I assume that each household owns two cars and deducts the maximum IRS ownership allowance.<sup>124</sup> The combined operating and ownership allowances for cars are \$1149, \$1292, and \$1228 per month for the three debtors, respectively.

The next IRS allowances are for federal and state taxes. I calculate federal and state income taxes for the three debtors, using the program TaxCut<sup>125</sup> for federal taxes and using the three states' tax schedules and

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118. FORM B22A (CHAPTER 7): STATEMENT OF CURRENT MONTHLY INCOME AND MEANS TEST CALCULATION (2006), available at [http://www.uscourts.gov/rules/Revised\\_Rules\\_and\\_Forms/BK\\_Form\\_B22A.pdf](http://www.uscourts.gov/rules/Revised_Rules_and_Forms/BK_Form_B22A.pdf) [hereinafter FORM B22A]. Because BAPCPA contains many ambiguities, some of the allowable deductions on form B22A could be subject to challenge. For example, Sommer, *supra* note 74, discusses the possibility that debtors may be able to deduct both the IRS ownership allowances for cars and homes plus their actual payments on car loans and mortgages. Form B22A does not allow these double deductions.

119. U.S. Dep't of Justice, IRS National Standards for Allowable Living Expenses, [http://www.usdoj.gov/ust/eo/bapcpa/20061001/bci\\_data/national\\_expense\\_standards.htm](http://www.usdoj.gov/ust/eo/bapcpa/20061001/bci_data/national_expense_standards.htm) (last visited Oct. 1, 2006).

120. Sommer, *supra* note 74, at 199.

121. Culhane & White, *supra* note 102, at 43.

122. *Id.* at 44.

123. *Id.*

124. See U.S. Dep't of Justice, Means Testing: Census Bureau, IRS Data and Administrative Expenses Multipliers, <http://www.usdoj.gov/ust/eo/bapcpa/20061001/meanstesting.htm> (last visited Oct. 1, 2006), for local housing and transportation allowances.

125. H&R Block, TaxCut, <http://taxcut.com/> (last visited Sept. 4, 2006).

tables. For purposes of federal income taxes, I assume that all three debtors itemize their deductions and take deductions for state taxes, mortgage payments, property taxes, and charitable contributions, as discussed below. Federal taxes are \$600, \$1081, and \$548 per month for the Charleston, New Haven, and San Diego debtors, respectively. State taxes are \$284, \$517, and \$153 per month, respectively.

The remaining IRS allowances are for mandatory payroll deductions (such as union dues, uniform costs, and mandatory retirement contributions),<sup>126</sup> the cost of term life insurance premiums for the debtor, the cost of childcare, spousal or child support, health care costs not covered by insurance, health savings accounts, and the cost of telecommunications services.<sup>127</sup> I assume that debtors deduct \$50 per month for term life insurance, \$100 per month for the cost of health care or health savings accounts, \$500 per month for childcare, and \$200 per month for telecommunications. Opportunistic debtors are assumed to increase their expenditures to these levels before filing if their previous expenditures were lower.

Subtracting these allowances from *AMCI* yields a debtor's obligation to repay based exclusively on IRS deductions. The table shows that the *MDI* levels for the Charleston, New Haven, and San Diego debtors are \$797, \$3662, and \$4582 per month, respectively. Because these amounts are far higher than the allowable \$167 per month, all three debtors would be required to file under chapter 13 and to repay substantial amounts.

IRS allowances presumably are intended to discourage opportunistic behavior by delinquent taxpayers. Therefore, their structure is relevant in considering whether BAPCPA discourages opportunism. One important feature of the IRS approach is that the consumption allowances in *MAC* are mainly fixed amounts, which means that debtors cannot reduce their repayment obligations by increasing expenditures. (This is not completely true, because the IRS allowances for telecommunications, health care, and childcare are based on the debtor's actual expenditures.)<sup>128</sup> Another feature is that the level of income that determines a debtor's obligation to repay, *AMCI*, is fixed once the debtor files for bankruptcy. This means that debtors in bankruptcy do not have an incentive to work less in order to reduce their repayment obligation. However, debtors do have an incentive to work less before bankruptcy, as discussed above.<sup>129</sup> In addition, because the IRS consumption allow-

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126. See I.R.S. INTERNAL REVENUE MANUAL, FINANCIAL ANALYSIS HANDBOOK § 5.15.1.23 (2004).

127. *Id.* § 5.15.1.10.

128. *See id.*

129. *See supra* note 106 and accompanying text. Because the IRS, rather than the taxpayer, chooses when to conduct an audit, the issue of whether taxpayers reduce their work effort in order to reduce their obligation to repay delinquent taxes is likely to be less important than whether debtors reduce their work effort before filing for bankruptcy.

ances are set at a middle class expenditure level and do not include necessary expenditures such as insurance and property taxes, debtors' overall obligation to repay is high. Therefore, to pay *MDI* each month, debtors are forced to cut their standard of living, with the size of the cuts increasing with debtors' income. The IRS likely assumes that most delinquent taxpayers have assets concealed from tax authorities. The high obligation to repay is intended to induce taxpayers to use their hidden assets to pay the delinquent taxes in order to avoid cutting their standard of living.

However, debtors in bankruptcy do not face such stark choices as delinquent taxpayers because the repayment requirements under BAPCPA are not as stringent as the IRS Financial Collection Standards.<sup>130</sup> In particular, BAPCPA adds several "additional expense deductions" that are based on actual consumption rather than formulas,<sup>131</sup> so that opportunistic debtors can reduce their obligation to repay by increasing expenditures in these categories. The bottom section of table 4 lists these additional deductions. The first deductions are for health and disability insurance, care for elderly, disabled or chronically ill family members,<sup>132</sup> and prevention of family violence.<sup>133</sup> Expenditures in these categories can vary widely. I assume that debtors spend \$1200 per month on all three together, perhaps after increasing expenditure levels by purchasing an alarm system, a dog, additional insurance, or additional services for family members (the \$1200 per month can be distributed in any way among these categories). BAPCPA also allows deductions of up to \$125 per month per child under 18 for educational expenses.<sup>134</sup> I assume that all three hypothetical debtors deduct the maximum of \$250 per month (\$125 per month for each child). Table 4 also contains BAPCPA allowances for additional home energy costs<sup>135</sup> and for extra food and clothing expenditures up to 5% of the IRS allowances.<sup>136</sup> I assume that all three debtors are able to justify spending an additional \$100 per month for home energy (extra heat in New Haven and Charleston, extra air conditioning in San Diego) and that they take the extra BAPCPA deduction of \$49 per month for food and clothing.

Now consider the costs of secured debt. One way for debtors to increase their monthly allowable consumption (*MAC*) is to purchase new cars with loans before filing for bankruptcy.<sup>137</sup> However, the IRS allowance for car loans is nearly as high as the cost of financing two new cars

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130. See, e.g., BAPCPA, Pub. L. No. 109-8, § 102(a)(2)(C), 119 Stat. 23, 27–32 (codified in part at 11 U.S.C. § 707(b)(2)(A)(ii)(IV)).

131. See *id.* (codified in part at 11 U.S.C. § 707(b)(2)(A)(ii)(II)–(V)).

132. *Id.* (codified in part at 11 U.S.C. § 707(b)(2)(A)(ii)(II)).

133. *Id.* (codified in part at 11 U.S.C. § 707(b)(2)(A)(ii)(I)).

134. *Id.* (codified in part at 11 U.S.C. § 707(b)(2)(A)(ii)(IV)).

135. *Id.* (codified in part at 11 U.S.C. § 707(b)(2)(A)(ii)(V)).

136. *Id.* (codified in part at 11 U.S.C. § 707(b)(2)(A)(ii)(I)).

137. Culhane & White, *supra* note 102, at 44–46.

costing \$25,000 each,<sup>138</sup> so I assume that debtors do not deduct any additional car loan payments.<sup>139</sup> Now consider mortgage loans. I assume that, before filing, each debtor owns or purchases a house having the median value of single-family houses recently sold in the relevant metropolitan area—\$121,000 in Charleston, \$292,000 in New Haven, and \$615,000 in San Diego.<sup>140</sup> Suppose each debtor obtains a new mortgage for 100% of the home's value, with a fifteen-year repayment period and a 6% interest rate. These new mortgages create additional monthly mortgage expenditures (beyond the IRS ownership allowances) of \$285, \$1072, and \$3373 for the Charleston, New Haven, and San Diego debtors, respectively.<sup>141</sup> In addition, BAPCPA allows debtors to deduct their property taxes and homeowners' insurance costs, assuming that these expenditures are required by the mortgage lender.<sup>142</sup> As seen in the table, property taxes of \$63, \$596, and \$513 per month for Charleston, New Haven and San Diego, respectively, are accordingly deducted.<sup>143</sup> Homeowner's insurance costs of \$14, \$34, and \$72 per month, respectively, are also deducted.<sup>144</sup>

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138. *Id.*

139. The monthly cost of two car loans, each for \$25,000 and each having five-year terms at six percent interest, totals \$966 per month, while the IRS car ownership deduction for two cars is \$803. See Internal Revenue Service, Allowable Living Expenses for Transportation, <http://www.irs.gov/businesses/small/article/0,,id=104623,00.html> (last visited Oct. 1, 2006). Note that the IRS allowances for car ownership are intended as maximums. See IRS, Collection Financial Standards, <http://www.irs.gov/individuals/article/0,,id=96543,00.html> (last visited Sept. 4, 2006). However, under BAPCPA they are fixed allowances. BAPCPA § 102(a)(2)(C) (codified in part at 11 U.S.C. § 707(b)(2)(A)(iii)). See Wedoff, *supra* note 74, at 274–75, for discussion.

140. These figures are based on sales of existing single-family homes during the third quarter of 2005. See NAT'L ASS'N OF REALTORS, MEDIAN SALES PRICE OF EXISTING SINGLE-FAMILY HOMES FOR METROPOLITAN AREAS (2006), available at [http://www.realtor.org/Research.nsf/files/REL06Q2T.pdf/\\$FILE/REL06Q2T.pdf](http://www.realtor.org/Research.nsf/files/REL06Q2T.pdf/$FILE/REL06Q2T.pdf).

141. Online mortgage calculators are readily available to calculate mortgage costs. See, e.g., Simple Loan Payment Calculator, <http://www.mortgage-calc.com/mortgage/simple.php> (last visited Sept. 4, 2006).

142. BAPCPA § 102(a)(2)(C).

143. Property taxes for the Charleston debtor were calculated assuming an assessment rate of 60% of market value and a tax rate of 1% per year. The assessment rate is state mandated, W. VA. CODE § 11-1C-7 (2006), and the property tax rate is the state-mandated maximum property tax, W. VA. CODE § 11-8-6b to -6d (2006). For the New Haven debtor, the property tax is calculated by assuming an assessment rate of 70% and using the 2001 New Haven property tax of 3.5% per year. See Conn. Dep't of Econ. & Cmty. Dev., Connecticut Tax Information, <http://www.ct.gov/ecd/cwp/view.asp?a=1106&q=250680> (last visited Sept. 14, 2006). For the San Diego debtor, the assessment rate is 100% of market value and the property tax rate is 1%. Both are mandated by the California Constitution. CAL CONST. art. XIII A. However, because assessments in California cannot rise by more than 2% per year, the debtor's assessment could be less than 100% if she had owned the property for several years and if property values since the purchase had risen at a higher rate than 2% per year.

144. These figures are based on a single online quote from State Farm for a homeowners' policy with a 1% deductible and policy limits of \$300,000 for the house and \$3000 for medical costs. State Farm Insurance, Homeowners Rate Quote, <http://www.statefarm.com/insurance/quote/homeowners.asp> (last visited Sept. 4, 2006). The quote assumed that the house has a centrally monitored alarm system. The cost of the policy was 0.21% of the policy limit per year. For each debtor, I assume that the policy limit is 67% of housing value. (This means that one-third of housing value is attributable to the value of the land.)

BAPCPA also allows a deduction for education savings accounts up to \$5000 per child or grandchild.<sup>145</sup> Assuming that each of the three debtors creates two of these accounts before filing, borrowing \$10,000 at 6% for a five-year term, the monthly cost comes to \$170. BAPCPA also allows deductions for charitable contributions up to 15% of *AMCI*.<sup>146</sup> I assume that the three debtors each contribute 5% of their *AMCI* to charity.

The last set of allowable BAPCPA deductions includes expenditures to pay priority claims (including alimony and child support),<sup>147</sup> other secured debt, past due priority or secured debts, the cost of providing adequate protection to secured creditors,<sup>148</sup> the cost of repaying loans taken out against retirement plans,<sup>149</sup> and administrative costs equal to 10% of payments to unsecured and secured creditors.<sup>150</sup> In these categories, debtors may purchase a boat, a vacation home, or a luxury car, or renovate their existing homes, as long as the costs are financed with secured loans obtained before filing. Debtors may also borrow against their retirement plans before filing and deduct the cost of paying off such loans.<sup>151</sup> New contributions to 401(k) plans may also be deductible, particularly if the debtor's employer matches the contributions.<sup>152</sup> Past-due mortgage or car loan payments are deductible in addition to regular payments.<sup>153</sup> Thus, debtors gain from falling behind on their child support or loan payments before filing for bankruptcy and then deducting the past due amounts in addition to their regular payments. I do not include any costs for these categories in table 4.

The row labeled "Total deductions" in table 4 shows the sum of the IRS allowances and the additional BAPCPA deductions. Comparing these deductions to each debtor's income and computing monthly disposal income, *MDI*, one finds that the three debtors have *MDI* of -\$1658, -\$361, and -\$1704, respectively. Therefore, all three debtors "pass" the repayment test and are allowed to file under chapter 7. This suggests that opportunistic debtors may avoid being forced to file under chapter 13 even if their incomes are as high as \$135,000 per year, as long as they rearrange their consumption expenditures before filing to maximize *MAC* deductions. As of 2002, 14.1% of all U.S. households had incomes above \$100,000.<sup>154</sup> This in turn suggests that the proportion of U.S.

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145. BAPCPA § 225(a)(1)(C), 119 Stat. at 65–66 (adding 11 U.S.C. § 541(b)(5)(C)).

146. *Id.* § 102(h)(2), 119 Stat. at 33–34 (codified at 11 U.S.C. § 1325(b)(2)(A)(ii)).

147. *See id.* § 102(a)(2)(C), 119 Stat. at 27–32 (codified in part at 11 U.S.C. § 707(b)(2)(A)(iv)).

148. *See id.* (codified in part at 11 U.S.C. § 707(b)(2)(A)(iii)).

149. *See id.* § 224, 119 Stat. at 62–65.

150. *See id.* § 102(a)(2)(C), 119 Stat. at 27–32 (codified in part at 11 U.S.C. § 707(b)(2)(A)(ii)(III)).

151. *See id.* § 224, 119 Stat. at 62–65.

152. *See id.* § 323, 119 Stat. at 97–98.

153. *See id.* § 102, 119 Stat. at 27–35.

154. *See* CARMEN DENAVAS-WALT ET AL., INCOME IN THE UNITED STATES: 2002, at 17 tbl.A-1 (2003), available at <http://www.census.gov/prod/2003pubs/p60-221.pdf>.

households with income greater than \$135,000 is under 10%. Thus the means test under BAPCPA is sufficiently porous such that opportunistic debtors, given sufficient advance planning, may still qualify for chapter 7 even if they are in the top 10% of the income distribution.

#### 4. *Incentives to Reduce the Repayment Obligation in Chapter 7*

This article now examines the interaction between strategies to reduce repayment obligations in chapter 7 and strategies to escape chapter 13. First, consider housing debt. Opportunistic debtors have an incentive to obtain additional mortgage debt before filing in order to avoid chapter 13, but an important strategy for debtors in chapter 7 is to partially or fully repay their mortgages to shelter nonexempt financial assets. The combination of additional mortgage debt plus additional home equity may force debtors to consume more housing than they want or can afford. In the example just discussed, the New Haven debtor obtained a new mortgage of \$291,000 before filing to avoid chapter 13. If the debtor also has nonhousing wealth of \$130,000, she must own a house worth at least \$421,000 to accomplish both objectives.

Creating an additional problem, BAPCPA includes new restrictions on a debtor's use of high state homestead exemptions to shelter nonhousing assets.<sup>155</sup> Under BAPCPA, debtors are limited to a homestead exemption of \$125,000 if they moved to their current state of residence within the past forty months.<sup>156</sup> Thus, debtors can no longer take advantage of the unlimited Florida and Texas homestead exemptions<sup>157</sup> by moving to these states just before filing. Also, if debtors shelter financial assets by using them to pay for home improvements, the increase in the value of their homes is not exempt under the homestead exemption unless the improvements were made more than 2½ years prior to filing.<sup>158</sup> If debtors convert nonexempt assets into home equity by paying down their mortgages, the additional home equity is not exempt unless the conversion occurred more than ten years prior to filing.<sup>159</sup> Thus, BAPCPA eliminated many of the asset-sheltering strategies, discussed in Part II, that opportunistic debtors could previously use to avoid repaying debt in chapter 7. These changes mean that opportunistic debtors may find it easier under BAPCPA to avoid chapter 13 than to avoid forced repayment of their debt from wealth in chapter 7.

However, BAPCPA created a new shelter for wealth in chapter 7—a federal bankruptcy exemption of \$1,000,000 per person and \$2,000,000 for a married couple for assets in tax-sheltered individual retirement ac-

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155. See BAPCPA § 322, 119 Stat. at 96–97 (codified at 11 U.S.C. § 522(p)–(q)).

156. *Id.*

157. See Charles J. Tabb, *The Top Twenty Issues in the History of Consumer Bankruptcy*, 2007 U. ILL. L. REV. 9.

158. MARTIN WITH PALEY, *supra* note 13, at 75.

159. BAPCPA § 308, 119 Stat. at 81–83.

counts.<sup>160</sup> Because of this new exemption, opportunistic debtors can now use retirement accounts to avoid both chapter 13 and the obligation to repay debt in chapter 7. As discussed above, debtors may deduct from their median disposable income payments on loans incurred to make new retirement contributions and payments on loans drawn against their existing retirement accounts. These loans may either take the form of mortgages or be unsecured. New contributions to retirement accounts may also be deductible from *MDI*. In chapter 7, the retirement accounts themselves are exempt from the obligation to repay as long as the accounts are less than the exemption. Thus, by borrowing to finance retirement contributions, debtors can both escape chapter 13 and shelter assets from the chapter 7 obligation to repay. Although the amount that people may contribute each year to individual retirement funds is limited, there are a number of different types of retirement accounts, each having its own limit. Debtors who are eligible to contribute to Roth IRA,<sup>161</sup> 401(k),<sup>162</sup> 403(b),<sup>163</sup> and 457<sup>164</sup> retirement accounts may contribute a total of \$40,000 to \$50,000 per person per year, depending on age.<sup>165</sup> Thus, although BAPCPA made the homestead exemption less useful for sheltering wealth in chapter 7, the Act provided opportunistic debtors with an alternative shelter for wealth in the form of individual retirement accounts.

Overall, BAPCPA has made “bankruptcy planning” more complicated and costly. Planning must encompass a debtor’s income, consumption, and debt as well as assets. Opportunistic debtors must also plan far in advance rather than wait until just before filing. Debtors who plan to shelter wealth under the high Florida or Texas homestead exemptions must move to those states and purchase high-value homes years before filing. Debtors who plan to shelter wealth under the new federal exemption for retirement accounts must contribute to these accounts steadily for several years before filing. Because bankruptcy planning is more costly, fewer debtors will behave opportunistically.

Finally, how does BAPCPA affect the incentives of debtors who do not behave opportunistically and do not have high incomes? These debtors are less likely to file for bankruptcy under BAPCPA due to the new hurdles and the increase in filing costs. Nonopportunistic debtors are therefore more likely to default without filing for bankruptcy. Creditors will benefit from this change because they can continue their collec-

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160. BAPCPA § 224(e)(1), 119 Stat. at 65 (codified at 11 U.S.C. § 522(n)).

161. I.R.C. §§ 219, 408 (2000 & Supp. III 2003).

162. *Id.* § 401(k).

163. *Id.* § 403(b).

164. *Id.* § 457.

165. BAPCPA § 323, 119 Stat. at 97–98 (codified at 11 U.S.C. § 541(b)). IRA accounts allow contributions of \$4000 or \$5000 per year, depending on whether the debtor is less than or more than age 50, I.R.C. § 414(v) (Supp. III 2003), 401(k) accounts allow \$11,000 or \$12,000 per year depending on age, plus 25% of income, *id.* § 401(k)(11) (2000 & Supp. III 2003), and 403(b) and 457 accounts each allow \$15,000 to \$18,000 per year, depending on age. *Id.* §§ 403(b), 457.

tion efforts for a longer period of time. Debtors will make payments on some debts that would otherwise have been discharged, and creditors will be able to collect from some debtors by garnishing their wages.<sup>166</sup> Eventually, many of these debtors will file for bankruptcy anyway. They will “pass” the means test, avoid chapter 13, and have no nonexempt assets in chapter 7. The high costs of filing undermine the value of bankruptcy-provided consumption insurance.

#### IV. ALTERNATIVES TO BAPCPA

Are the changes under BAPCPA likely to increase economic efficiency? As discussed above, the economic objectives of bankruptcy include providing partial consumption insurance to risk averse debtors, maintaining incentives to work before and after bankruptcy, facilitating the operation of credit markets by encouraging repayment when debtors have sufficient ability-to-repay, and discouraging debtors from behaving opportunistically, that is, filing when they have not experienced a sharp fall in consumption.

Bankruptcy law before BAPCPA provided effective consumption insurance and, because of the 100% exemption for postbankruptcy earnings, did not reduce incentives to continue working. Pre-BAPCPA law, however, encouraged opportunistic behavior; debtors could borrow and have their debts discharged in chapter 7, even though they had not experienced any drop in consumption. BAPCPA reversed the direction of bankruptcy policy by emphasizing the objective of discouraging opportunistic behavior and de-emphasizing the objectives of maintaining work incentives and providing consumption insurance. The new means test discourages opportunistic behavior by debtors who have a high ability-to-repay—if they file for bankruptcy at all—because such debtors may be forced to file under chapter 13 and to repay part or all of their debt. This change increases efficiency, but is likely to affect only a few debtors. The new hurdles, however, affect all debtors by raising bankruptcy costs and discouraging bankruptcy filings. This severely undermines bankruptcy as a source of consumption insurance. In addition, the means test gives filers a 10-to-1 incentive to act extremely inefficiently by reducing work effort before filing.

In a recent paper, Hung-Jen Wang and I explored an alternative approach to bankruptcy reform.<sup>167</sup> Under our proposal, chapter 7 and chapter 13 are combined into a single bankruptcy procedure, and bankruptcy filers are obliged to repay debt, subject to exemptions, from both

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166. See the contribution by Ronald Mann for discussion of creditors' gains under BAPCPA. Ronald J. Mann, *Bankruptcy Reform and the “Sweat Box” of Credit Card Debt*, 2007 U. ILL. L. REV. 375.

167. Wang & White, *supra* note 8, at 255–86.

wealth and postbankruptcy earnings.<sup>168</sup> Requiring debtors to repay from both sources has the advantage of improving the match between their ability to pay—which depends on both wealth and income—and their obligation to repay. For wealth, we assumed a fixed dollar exemption determined to maximize economic efficiency;<sup>169</sup> for earnings, we assumed a proportional exemption equal to either 85% or 93% of postbankruptcy earnings.<sup>170</sup> Requiring debtors to use a fraction of their future income to repay debt reduces their incentive to work—because they must share their income with creditors—but the incentive to reduce work effort is much smaller than under BAPCPA. The proposed reform also deters opportunism because high income debtors are less likely to benefit from filing for bankruptcy when they must use some of their future earnings to repay. The proposal is also more effective than BAPCPA at maintaining bankruptcy-provided consumption insurance. In the paper, we indicate that wealth and earnings exemptions are partial substitutes for each other in providing insurance, so that if the earnings exemption is reduced to a level below 100%, the optimal wealth exemption increases.<sup>171</sup> Using a simulation model, the paper demonstrates that the proposed reform increases efficiency relative to bankruptcy law before BAPCPA.<sup>172</sup> Although we have not tested our proposed reform relative to BAPCPA, we feel confident that our approach is more economically efficient and hope that Congress will adopt it.

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168. *Id.* at 257.

169. *Id.* at 260.

170. *Id.* at 260–61, 273 tbl.1.

171. *Id.* at 286.

172. *Id.* at 285–86.