SHOULD DEBTORS BE FORCED INTO CHAPTER 13?

*Eric A. Posner**

Under § 707(b) of the current bankruptcy law, a bankruptcy court may dismiss an individual's filing under Chapter 7 if it finds that the filing is a "substantial abuse" of the Bankruptcy Code.[1] However, the Code does not define "substantial abuse," and the legislative history is ambiguous. Because earlier drafts of § 707(b) referred to debtors who could pay off a good portion of their debt out of future income, some argue that bankruptcy courts should interpret substantial abuse to refer to the Chapter 7 filings of such debtors. But others argue that the replacement of earlier language with the vague substantial abuse standard means that Congress did *not* have such an intention.[2] In any event, dismissals of Chapter 7 cases on grounds of substantial abuse are relatively uncommon and usually involve objectionable behavior on the part of the debtor beyond the use of the bankruptcy law despite the capacity to satisfy creditors out of future income.[3]

---

* Professor of Law, University of Chicago. Thanks to Michelle White for helpful comments, and to Chris Perrin for valuable research assistance and comments.

1. *See* 11 U.S.C. § 707(b) (1988).

2. Compare the majority and dissenting opinions in *In re Walton*, 866 F.2d 981 (8th Cir. 1989). *See generally* F.H. Buckley, *The American Fresh Start*, 4 S. CAL. INTERDISC. L.J. 67, 69 (discussing the legislative history of § 707(b)).

3. This is the implication of DAVID G. EPSTEIN ET AL., BANKRUPTCY §§ 7-45, 7-48 (1992); *see also* Wayne R. Wells et al., *The Implementation of Bankruptcy Code Section 707(b): The Law and the Reality*, 39 CLEV. ST. L. REV. 15 (1991). However, there seems to be a steadily increasing stream of § 707(b) dismissals. *See* Kornfield v. Schwartz (*In re* Kornfield), No. 97-5080, 1999 WL 5307 (2d Cir. Jan. 7, 1999); First USA v. Lamanna (*In re* Lamanna), 153 F.3d 1 (1st Cir. 1998); Kestell v. Kestell (*In re* Kestell), 99 F.3d 146 (4th Cir. 1996); *see also* Huckfeldt v. Huckfeldt (*In re* Huckfeldt), 39 F.3d 829 (8th Cir. 1994) (decided under § 707(a)).

One of the most important provisions of House Bill 3150 is its resuscitation of § 707(b). Section 102 of the bill amends § 707(b) of the Code by requiring bankruptcy courts to dismiss cases in which the debtor has an income above the national median income and has a high enough expected income over five years to enable him or her to pay off a relatively small portion of unsecured, nonpriority debt.[4] This Article describes section 102 in detail, speculates about its potential effects, and evaluates it in light of the goals of bankruptcy law.

Initially, one should note a cosmetic but telling change in the relevant language. Currently § 707(b) requires a finding of "substantial abuse." The bill would require a finding only of "abuse." The drafters of the bill appear to be signaling that they want § 707(b) to be applied routinely, not only to outrageous conduct. But the significance of the bill lies in the way that it defines abuse.

The bill contains a formula for determining whether abuse has occurred. This formula is designed to prevent a debtor from filing under Chapter 7 if the debtor's income exceeds the national median income for the debtor's family size and if the debtor's expected disposable income is high enough that a substantial amount of debt could be paid off over five years. To understand the formula, let i equal the debtor's current monthly income; e equal the debtor's monthly expenses as defined under regulations issued by the Internal Revenue Service; s equal the debtor's average monthly payments to secured creditors over the next sixty months; p equal the debtor's average monthly payments to priority claimants over the next sixty months; and c equal the debtor's nonpriority unsecured claims. The bankruptcy court shall presume that abuse occurs if: $60(i - e - s - p) \geq \min \{.25c, \$5000\}$.[5] The presumption can be

4. *See* H.R. 3150, 105th Cong. § 102 (1998). Although this bill was not enacted into law prior to the expiration of the 105th Congress, it appears as of this writing that its provisions on § 707(b) are being reintroduced in the 106th Congress as H.R. 833. *See* Daniel J. Pauks, *Creditors Push to Revive Bankruptcy Overhaul Bill with Minimal Changes*, CONGRESSIONAL QUARTERLY WEEKLY REPORT, Feb. 13, 1999, at 391. For a discussion of House Bill 3150 and means-testing, *see* Edith H. Jones & Todd J. Zywicki, *It's Time for Means-Testing* (visited Mar. 15, 1999) <http://www.house.gov/gekas/bankruptcy/jon-2yw.html>.

5. Because a motion can be brought only if the debtor's income exceeds

avoided under extraordinary circumstances, but the standard appears to be high, and so we will ignore it.

The left side of the formula is an estimate of how much cash the debtor will have over sixty months, given that the debtor must use some portion of his or her income for ordinary expenses and for payments to secured and other priority creditors. One might think of this amount as the debtor's "cash cushion" or expected disposable income over five years. When you receive your paycheck every month, you have to pay your creditors and your ordinary expenses, but it is useful to think of the remainder as a cushion that you might save or spend on luxury goods.

Now observe the right side of the equation. If the debtor owes more than $20,000 to unsecured, nonpriority creditors, then the right side equals $5000. If the debtor owes less than $20,000, then the right side equals one quarter of that amount. For example, if a debtor owes $10,000 to unsecured, nonpriority creditors, the right side of the inequality equals $2500.

To illustrate the effect of the formula on different kinds of debtors, we let $e = \$400$, $s = \$0$, and $p = \$0$, and vary i and c.[6]

Monthly Income (i)	Cushion ($i - e - s - p$)	Total unsecured claims (c)	Presumed abuse?
$500	$100	$30,000	yes: $6000 > $5000
$500	$100	$10,000	yes: $6000 > $2500
$450	$50	$30,000	no: $3000 < $5000
$450	$50	$10,000	yes: $3000 > $2500

If the debtor has a large enough cushion, filing under Chapter 7 will be deemed an abuse regardless of the size of the debt. If the debtor has a small cushion, this filing is more likely to be deemed an

the national median income for his family size, this formula applies only to such relatively high-income debtors. *See* H.R. 3150 § 102(b).

6. Of course, the numbers are only illustrative. As noted above, the formula applies only if the debtor's income exceeds the median national income.

abuse as the size of the debt declines. Put more succinctly: wealthier people cannot file under Chapter 7; less wealthy people can, but only if their debts are high enough.

People whose cases are dismissed under the new version of § 707(b) would not be without any remedy. They would be able to file under Chapter 13 rather than under Chapter 7. Under Chapter 7 the debtor must use all non-exempt property to pay debts, but does not have to use money from future income. Under Chapter 13 the debtor may sometimes keep some non-exempt property, but must pay debts out of future income, over three to five years. For most debtors, particularly high-income debtors, Chapter 7 is the preferred choice. Imagine a doctor who earns $500,000 per year, has $1 million in non-exempt assets, and owes $10 million to creditors. Chapter 7 is painful: he must pay $1 million to the creditors. But he also gets to keep $2.5 million that he will earn over the next five years. Under Chapter 13 he might be required to liquidate some of his non-exempt assets *and* pay a good portion of the $2.5 million in future earnings.

It should be clear, however, that the new law would not apply only to doctors and other high-income individuals. Indeed, simple algebra shows that anybody whose cushion exceeds $83.33 per month will be forced into Chapter 13 as long as his yearly income exceeds the national median income for his household size. The national median income for a household with two or three children was $50,752 in 1996.[7] Among higher-income debtors, only those who have substantial secured debt or priority debt, such as child support obligations, could avoid dismissal under § 707(b). But secured debt is limited by the value of available assets and priority debt is a relatively narrow category in the Bankruptcy Code. Chapter 13 would take Chapter 7's place as the normal form of bankruptcy for higher-income debtors.

To understand how House Bill 3150 would affect people's behavior, one can divide people's bankruptcy-related behavior into three temporal components: (1) the purchase of credit, (2) the decision to file for bankruptcy, and (3) the behavior during the pendency of a Chapter 13 plan.

7. *See* U.S. DEPARTMENT OF COMMERCE, STATISTICAL ABSTRACT OF THE UNITED STATES, Tbl. No. 751 (1998).

Working backwards, we start with behavior under a Chapter 13 plan. Under Chapter 13, all of a debtor's disposable income must be used to repay debts unless the creditors consent to a more generous plan. Thus, every dollar that the debtor might earn by working harder will be taken by creditors, so the debtor has little incentive to work hard. Indeed, many debtors might stop working and instead live off their families or collect welfare benefits, because by doing so they do no worse than they do by working and losing their entire disposable income. People who refuse to work will neither pay off their debts, nor receive a discharge; but creditors will not be paid, either. This would not be a happy state of affairs. The bankruptcy law is motivated in part by the fear that tough loan-forgiveness laws would produce a class of people who would be continually dependent on social welfare programs. Thus, one might argue that the revised § 707(b) would defeat a purpose of bankruptcy law.

However, it is not clear how serious a problem this is. It seems reasonable to think that people with significant education and skills will eventually want to go back to work even if they are heavily taxed by a Chapter 13 plan. However burdensome the payments, they can last no more than three to five years, after which the debtor's income is free from past debts. In addition, if the disincentive presents a serious problem, creditors will agree to a more generous plan that preserves the incentive to work as long as they receive more value than they would under Chapter 7. Alternatively, Chapter 13 could be amended in order to allow the debtor to pay less than his or her entire disposable income.[8] Finally, the people who would have the strongest incentives not to work in Chapter 13—the relatively poor—would probably be able to use Chapter 7 under section 102. In any event, creditors currently seem to believe that they would do better in a system that made Chapter 13 routine than under the current system, and it seems unlikely that they are seriously mistaken.[9]

8. *See infra* note 16 and accompanying text.

9. *See* Pauks, *supra* note 4. However, this may be because they would not bear the full costs of default, given the existence of the social welfare system. *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 (1995).

Now consider the debtor's incentive to file for bankruptcy in a world where section 102 has been enacted. Wealthier debtors realize that they will be forced into Chapter 13. If section 102 is enacted, it is likely that fewer wealthier debtors will file for bankruptcy because they gain less by filing under Chapter 13 than they do currently by filing under Chapter 7. Furthermore, those who do file for bankruptcy under Chapter 13 will pay more to creditors than those who currently file under Chapter 7.[10]

One might worry that wealthy debtors might avoid a § 707(b) dismissal by engaging in strategic behavior. One strategy would be to switch from a high-paying to a low-paying job before entering bankruptcy. A doctor, for example, might give up a $200,000 salary and take a low-paying job at a clinic operated by a charity, or even refuse to work, claiming that he or she cannot find an adequate position. If permitted to do this, his income would be zero. Under the formula in section 102, his filing would not be deemed an abuse.[11] However, courts can probably police this behavior easily.[12] Courts can probably also police other forms of strategic behavior that might be motivated by section 102,[13] such as substituting secured debt for unsecured debt.

The incentives of less wealthy debtors are more complex and interesting. As noted above, a court is less likely to find that a person has committed abuse under section 102 as his total unsecured debt *increases*. For example, a person with $50 monthly disposable income engages in abuse under section 102 if his total unsecured claims equal $10,000, but not if the total unsecured claims equal

10. A recent study of an early version of H.R. 3150 found that only 3% of a sample of Chapter 7 debtors would be subject to section 102. *See* Marianne B. Culhane & Michaela M. White, American Bankruptcy Institute, *Taking the New Consumer Bankruptcy Model For a Test Drive: Means-Testing Real Chapter 7 Debtors*, (last modified Mar. 23, 1999) <http://www.abiworld.org/research/creightonstudy.html>. The earlier version is stricter than the current version, so presumably, the 3% figure understates the likely effect of the current version.

11. *See supra* note 5 and accompanying text.

12. *See* Huckfeldt v. Huckfeldt (*In re* Huckfeldt), 39 F.3d at 832 (finding that a doctor who took a position that paid $45,000 per year could earn $110,000 to $120,000 after expenses, and thus could pay off a substantial portion of his debts).

13. *See* EPSTEIN ET AL., *supra* note 3, at 435-37.

$30,000. This is a natural consequence of the goal of making people use Chapter 13 if their expected future income is substantial enough to pay off a large portion of their current debt. But this means that a rational person will take on *more* debt if he believes that he will soon enter bankruptcy.

Imagine a debtor with a disposable income of $50 per month and unsecured debt of $10,000. He loses his job, and realizes that he will not be able to pay off his debts. If he files for bankruptcy, section 102 would force him to file under Chapter 13, which would mean that a portion of his future income would have to be used to pay off some of his debt. If instead he borrows another $20,000 and then files for bankruptcy after a suitable period of time has elapsed, he will be able to file under Chapter 7 and obtain a discharge of all his debts, which would allow him to keep his future income.

One response to this problem is to give bankruptcy judges the authority to deny a Chapter 7 filing to people who engage in this behavior. But it is doubtful that bankruptcy judges would use this authority any more eagerly than they have used their authority under § 707(b). Another solution is to use a constant amount in the formula, like $5000, rather than the minimum of a portion of unsecured debt and $5000.

Finally, let us consider the debtors' and creditors' incentives prior to entering a credit contract. If, as creditors seem to believe, the perverse incentives in the second and third stages are not too serious, they will be more willing to extend loans to high-risk debtors, and they will generally charge lower interest rates than they do under current conditions. If debtors are relatively risk-neutral, they will be better off under this arrangement. Risk-averse debtors may fear taking on credit if they are not well-protected against income shocks,[14] but in theory they can respond to this fear either by taking on less debt or negotiating contracts with creditors that release them from their debts if they suffer income shocks. Whether this will happen is another question.

With these observations as background, it is important to focus now on whether the proposal to reform § 707(b) is a good idea. The answer to this question depends on what one thinks bankruptcy

14. *See infra* note 16.

should accomplish. Although people disagree about the goals of bankruptcy law, most people agree that one purpose of bankruptcy law is to minimize the cost of credit, and another purpose of bankruptcy law is to provide insurance against income shocks.[15] Accordingly, I will focus on whether the proposed bill would serve either of these purposes.

In the absence of bankruptcy law, creditors would sue the insolvent debtor under state law and in state courts. The creditors who win the race to the courthouse would obtain greater value than those who drag their feet. The debtor's assets would be liquidated piecemeal even when those assets are worth more if liquidated as a group. Creditors would incur costs monitoring the debtor, or simply swallow their losses. In either situation they would charge higher interest rates than they would if a bankruptcy law ensured that the debtor's assets would be sold in an organized way.

Unless the perverse incentives mentioned above are serious, the goal of cost minimization would be advanced by the new bill because it increases the amount of assets available to creditors in case of default and bankruptcy. By forcing more debtors into Chapter 13, the amended § 707(b) would make a portion of debtors' future income available to creditors. Because creditors would expect higher returns in case of default, they would charge less for credit *ex ante*. In addition, the bill would probably reduce costs by improving the debtor's incentives to take risks. Currently, people who enter bankruptcy lose their non-exempt assets, and the prospect of such a loss may deter some people from engaging in risky credit transactions. But exemption laws are fairly generous, and for many people the value of their non-exempt assets is too low to deter them from engaging in risky credit transactions. Creditors must either swallow their losses or incur costs in monitoring debtors, and they must pass on the costs to debtors by raising interest rates or reducing the supply of credit. If, under the proposed law, debtors had to pay some of their debts out of future income, they would be more reluctant to file

15. *See* THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW (1986); Douglas G. Baird, *A World Without Bankruptcy*, 50 LAW & CONTEMP. PROBS. 173 (1987); Theodore Eisenberg, *Bankruptcy Law in Perspective*, 28 UCLA L. REV. 953 (1981); Samuel A. Rea, Jr., *Arm-Breaking, Consumer Credit and Personal Bankruptcy*, 22 ECON. INQUIRY 188 (1984).

for bankruptcy.[16] This means both that fewer debtors would default and those who did default would repay a larger portion of their loans. As a result, creditors would have lower costs, and would pass on their savings in the form of lower interest rates.

In addition to minimizing the cost of credit, bankruptcy law provides people with insurance against income shocks. To understand this theory, assume that a person borrows money in period 1 for the purpose of consuming in period 1, and anticipates paying the debt out of his or her presumably greater income in period 2. However, there is a small probability that a shock will occur that will eliminate all or most of the income in period 2. The person might be injured in an accident, struck down by a serious disease, divorced by a breadwinning spouse, compelled to care for a sick relative, or laid off by a factory closing. If the market offered insurance against these shocks, the person would buy that insurance in period 1. Because people are generally risk-averse, people want to equalize their wealth over different states of the world. Almost all people would rather have a 100% probability of $99,000 if they are healthy and a 100% probability of $99,000 if they are sick, than a 99% probability of $100,000 if they are healthy and a 1% probability of $0 if they are sick. So almost all people will pay $1,000 for health and disability insurance worth $99,000, and the market will supply such insurance as long as the insurer can determine that the probability of illness is less than about one in a hundred.

The market offers insurance against theft, death, and damage to property, but it does not, for the most part, offer insurance against loss of income. Insurance companies do not offer such contracts, nor do creditors who might otherwise release a debtor from payment in the case of a job loss or other calamity in return for a higher interest rate. The reason why the market does not offer such contracts is not entirely clear, but it is well known that insurance markets can fail because of information problems. If a person is insured against job

16. This point is emphasized in Michelle J. White, *Why It Pays to File for Bankruptcy: A Critical Look at the Incentives Under U.S. Personal Bankruptcy Law and a Proposal for Change*, 65 U. CHI. L. REV. 685 (1998) [hereinafter White, *Why It Pays*]. *See also* Hung-jen Wang & Michelle J. White, *An Optimal Personal Bankruptcy Procedure and Proposed Reforms*, (1998) (unpublished working paper 98-07, University of Michigan, Dept. of Econ., on file with *Loyola of Los Angeles Law Review*).

loss, he or she might act carelessly at work. If an insurer cannot detect such carelessness and deny coverage on the basis of it, which is in all likelihood the case, then it could not offer employment insurance except at prohibitive prices. The absence of employment insurance may also result from adverse selection. As long as the insurer cannot distinguish better and worse workers in advance, it would have to charge a premium that reflects the average chance of being fired. The better workers would refuse to buy insurance; the worse workers alone would buy insurance; but this would drive the premium up to prohibitive levels.

On this view, bankruptcy law—and state property exemption law[17] generally—cures a market failure. When creditors converge on the debtor, he or she can avoid losing all his or her property by declaring bankruptcy or by taking refuge under state property exemption laws.[18] However, bankruptcy law does not allow the debtor to keep all his or her property, either. Because the debtor loses non-exempt assets, he or she shares some of the risk with the creditors. A debtors will be discouraged from carelessness at work, because he or she bears some of the loss, even if not all of the loss, as would be the case if bankruptcy and exemption laws did not exist. Although incentives are not perfect, the protection of some assets but not others creates a compromise between the goal of insurance and the goal of minimizing careless behavior. The law in this way sensibly mimics insurance markets, which typically insist on a deductible or co-payment.

This still leaves us with the question of whether the bankruptcy "deductible" should come out of current assets, future income, or both. Chapter 7 is currently biased heavily in favor of current assets.[19] A debtor in bankruptcy with exempt property worth $10,000, non-exempt property worth $10,000, and debt worth $50,000, is—in effect—paid insurance worth $40,000 by the bankruptcy system. The reason is that the debtor is released from claims worth $50,000, but must pay a "deductible" of $10,000, the non-exempt assets. But this system can be improved by requiring the debtor to pay the deductible out of future income as well.

17. *See* Eisenberg, *supra* note 15, at 955-59.
18. *See id.* at 993-94.
19. *See* White, *Why It Pays*, *supra* note 16, at 687-88.

To see why, suppose the debtor borrows in period 1 for the purpose of consumption, and expects to obtain future income in periods 2 and 3. If a shock occurs in period 2, the debtor receives no income in that period. The debtor's non-exempt assets are assumed to be worth \$50 in period 2. Under Chapter 7, the debtor loses assets in period 2 but is entitled to keep all income in period 3. Under Chapter 13, the debtor gives up assets in period 2 and some income in period 3. Imagine that the debtor borrows \$100 at 0% interest, and will earn either \$0 or \$100 in period 2, and \$100 in period 3. Suppose a shock does in fact occur in period 2. Now under Chapter 7, the debtor pays \$50 in period 2 and keeps \$100 in period 3. Suppose that under Chapter 13 the debtor pays \$25 in period 2 and keeps \$75 in period 3. Because the debtor is better off with \$25 in period 2 and \$75 in period 3, than with \$0 in period 2 and \$100 in period 3, the use of Chapter 13 makes the debtor better off without making the creditor—who receives \$50 in either case—any worse off. If we adjust the debtor's payoff so that he or she does no worse in Chapter 13 than in Chapter 7, then the excess may be given to the creditor. The result is that the cost of credit would be reduced *ex ante*.[20] Both purposes of the Bankruptcy Code—insurance and cost minimization—would be served.

If this were the entire story, one might wonder why the revised § 707(b) is necessary. As described, both the debtor and the creditor are made better off by the use of Chapter 13 rather than Chapter 7. We would already observe plenty of Chapter 13 cases, and when we observe Chapter 7 cases, that would mean that a conversion to Chapter 13 would make the parties worse off. Indeed, something like this must have been the original rationale for leaving the choice of chapter to the debtor.[21]

The answer to this puzzle is not difficult to find. In most bankruptcy cases, very little is at stake. Creditors do not bother trying to persuade debtors to use Chapter 13, because the costs of negotiation

20. *See id.* at 710-16 (discussing how a bankruptcy system that requires some payments out of future income would reduce the incentive to file for bankruptcy).

21. This is also accomplished when debtors reaffirm debts in bankruptcy. By reaffirming a debt, the debtor keeps some assets, thus increasing the value retained in period 2, while promising to pay out of future income, thus reducing the value the debtor will have in period 3.

probably exceed the gains from increased repayment. Most Chapter 7 cases are not heavily contested. In addition, the bargaining surplus that would result when Chapter 13 is superior to Chapter 7 would usually go to the debtor, or at least be split between the debtor and the creditor. But if property exemptions adequately insure the debtor against income shocks, there is no reason to give him or her this additional benefit, and if they do not, then an amendment of the property exemption is the proper response. The value of revised § 707(b) is that it makes the superior form of bankruptcy—Chapter 13—presumptive.

It makes sense to rationalize bankruptcy relief by requiring higher-income debtors to pay out of future income as well as current assets. To the extent that section 102 of House Bill 3150 succeeds in doing this, it would reduce the cost of credit without also reducing the amount of credit insurance available to debtors. There is the further question of how much future income the debtor should be required to pay to creditors. If the amount is too great, debtors will refuse to work in Chapter 13 or will be deterred from filing for bankruptcy in the first place even when they ought to be able to obtain a discharge. But the current system—in which the amount of future income that must be paid to creditors is pretty much zero—is, as Michelle White has persuasively argued, neither an equitable way of discharging debtors nor a rational way of deterring unnecessary bankruptcy.[22]

22. *See* White, *Why It Pays*, *supra* note 16, at 710-16; JACKSON, *supra* note 15, at 256-58.