Personal Bankruptcy

Economics of Personal Bankruptcy and Insolvency

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Introduction

Personal bankruptcy law is the legal process for resolving the debts of insolvent individuals and married couples – referred to here as "filers." It is a collective procedure that simultaneously resolves all of filers' debts, regardless of their due dates or characteristics. The resolution may involve filers repaying particular debts in full or in part, using either their pre-bankruptcy assets or their future earnings or both. Debt that is not repaid in bankruptcy may be discharged, either immediately or following a period during which filers are obliged to repay from future earnings. Bankruptcy law also specifies how the total repayment amount is divided among creditors. At the time of filing, bankruptcy law requires that creditors terminate all collection efforts, so that all debt repayment comes through the bankruptcy procedure. Bankruptcy laws also specify punishments for filers. Although all countries' bankruptcy procedures follow this general outline, the specifics vary widely and individual countries' laws may favor creditors or debtors.

Insolvency, in contrast, occurs when debtors are unable to make debt payments as they come due and is used here to refer to default outside of bankruptcy. Creditors pursue collection efforts against debtors who default and this often causes debtors to file for bankruptcy.[2]

This article begins by discussing the basic features of debt collection and bankruptcy law for individuals and small business, highlighting contrasts between the US and European countries. It then considers the economic objectives of bankruptcy law.

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[2] In some countries, the term insolvency is used to refer to the bankruptcy procedure.

Debt collection and bankruptcy law

Let us first consider creditors' remedies when debtors have defaulted, but not filed for bankruptcy. Following default, creditors start by mailing, calling and/or visiting debtors at their homes or workplaces to demand repayment. They sometimes threaten debtors and engage in harassment.[3] Additional creditors' remedies vary depending on the type of claim. Unsecured creditors can take debtors' bank accounts or garnish their wages if they are employed, but only after obtaining a court order. Secured creditors such as car lenders can repossess their collateral, without going to court in some cases.[4] Mortgage lenders can force a sale of the mortgaged property, but generally need to obtain a court order to do so. Creditors also may report default to the credit rating agencies, harming debtors' credit scores.[5]

Unsecured lenders have an incentive to race against each other to be first to collect, because debtors' ability to repay is often less than the total amount owed and the first creditor to obtain a court order receives more than other creditors.[6] Secured creditors also have an incentive to act quickly, since collateral assets lose value over time. But races to be first to collect can be inefficient because they severely harm debtors and their families: examples are when debtors cannot pay for rent or health care because creditors have garnished their wages, when debtors lose their jobs because creditors have repossessed their cars or when debtors' businesses shut down because creditors grab essential business assets. To avoid races to be first, bankruptcy law provides for a stay on legal proceedings that starts immediately when debtors file for bankruptcy. This "automatic stay" stops creditors' collection efforts, ends garnishment of wages, and terminates the obligation to pay interest on unse-

[3] US Federal law limits the extent to which creditors can engage in harassment, but the law has many loopholes. See Dawsey, Hynes and Ausubel (2013) for discussion.

[4] In the US, defaulting on an automobile loan often leads to a "repo man" who works for the lender driving the automobile away during the night. But if the automobile is in a garage, the lender must obtain a court order to repossess it.

[5] See Mann (2006) for an international comparison of debt collection procedures for credit card lenders.

[6] In the US, Federal law limits wage garnishment to 25 percent of wages and a few states have higher limits, so that a late creditor may not be able to garnish the debtors' wages if the limit has already been reached. Employers may have the right to fire workers in response to garnishment. See US Department of Labor (2009).

cured loans. Instead, all repayment must come through the bankruptcy procedure.[7]

The legal process of bankruptcy starts by creating a list of filers' debts. Not all debts are dischargeable in bankruptcy – in the US, claims for taxes, child support, alimony, debts incurred by fraud, and student loans cannot be discharged. Dischargeable debts include credit card loans, installment loans, medical debts, business debt, and debts for utilities and rent. After meeting the expenses of bankruptcy, these debts all are repaid at the same fraction of their face values. In most personal bankruptcies, unsecured creditors receive little or nothing. On secured loans such as automobile loans, debtors can choose between keeping the collateral by continuing to make payments on the loan versus giving up the collateral and having the debt discharged.[8]

Bankruptcy law also determines the amount that filers must repay. Filers create a list of their assets, including real and personal assets, financial assets and future earnings. They are generally allowed to keep some or all of both their assets and their future earnings. The amounts that filers can keep are called "exemptions." In the US, there are separate exemptions for different types of assets, including equity in owner-occupied homes, equity in automobiles, personal property, "tools of the trade," and retirement accounts. The asset exemptions differ across US states and the exemption for home equity is usually the largest: seven US states have unlimited exemptions for home equity.[9] Assets that exceed the relevant exemption must be used to repay debt. There is also an exemption for future earnings and US bankruptcy law specifies a formula for computing an earnings exemption for each filer. Exemptions for future earnings vary widely across countries and range from no obligation to repay to no limit on the obligation to repay. In the US only bankruptcy filers with earnings above the median household income level in their states are obliged to repay anything from future earnings, meaning that most filers get a full exemption for their future earnings. For those who are required to repay from future earnings, the period of obligation is five years.[10] In France, all filers are obliged to repay from future earnings for eight to ten years and the exemption level for earnings is lower than in the US; whereas in Germany, the period of obligation to repay is three to five years. Some countries have no limits on the period of time that bankruptcy filers are obliged to repay from future earnings, so that the obligation to repay ends only with the filer's death.[11] Following the obligatory repayment period, filers' remaining debt is usually discharged, although filers in France must convince the bankruptcy judge that they have no reasonable prospect of repaying the remaining debt. The asset and earnings exemptions plus the time limit on the obligation to repay from future earnings together determine how much filers are required to repay.

Insolvency and bankruptcy law also provide for punishments for default and bankruptcy. In the past, default was considered to be a criminal offense and punishments were very harsh: they included the death penalty, maiming, selling defaulters into slavery, forcing them into exile, and holding them in debtors' prisons. In the modern world, default and bankruptcy are no longer criminal offenses, but lighter punishments still exist. In the US, default and bankruptcy both lower debtors' credit ratings, making it more difficult for them to borrow, rent housing, and get jobs. Names of bankruptcy filers are made public and the filing stays on filers' credit records for ten years. In the UK, filers cannot manage firms or hold certain public offices for several years after filing. Longer required repayment periods and lower asset and earnings exemptions also make punishments for bankruptcy harsher.[12]

The US differs from most other countries in that it has two separate personal bankruptcy procedures. One procedure (Chapter 7) requires that filers only repay from their assets and the other (Chapter 13) requires that filers only repay from their future earnings. Prior to 2005, filers were allowed to choose between the two procedures and this led to many instances in which high-income debtors filed for bankruptcy under Chapter 7 and were not obliged to repay anything because they converted all their assets from non-exempt to exempt categories before filing. US bankruptcy law thus encouraged debtors to behave strategically by borrowing as much as possible and using bankruptcy to avoid repayment, even in cases where they had high incomes. Debtors' incentive to behave strategically was reduced by the US bankruptcy reform of 2005 that forced most filers with high incomes

[7] Filers may have to continue payments to secured creditors during the bankruptcy process if they wish to keep the collateral.
[8] If the sale value of the collateral is less than the secured creditor's claim, then the creditor has an unsecured claim for the difference.
[9] Bankruptcy law in the US is Federal law and is uniform all over the country, but the US Bankruptcy Code allows states to adopt their own exemptions for assets. See § 11 US Code 522 for a list of exemptions and Elias (2007), and White (2009) for discussion.
[10] See White (2009) for discussion of the procedure for determining filers' obligation to repay.
[11] France also has low exemptions for assets, while the exemptions in the US, Germany and the United Kingdom are higher. See Knobloch (2012) for a comparison of personal bankruptcy laws in European Union countries.
[12] Sandage (2005) and Mann (2002) discuss attitudes toward debt and default in the US during the 19th century. Efrat (2002) gives multi-country information on punishments for default and bankruptcy.

to use Chapter 13.[13] In other countries, debtors' incentives to behave strategically with respect to bankruptcy are more limited because debtors are nearly always required to repay from future earnings and exemptions for both assets and earnings are lower.[14]

Personal bankruptcy laws also apply to entrepreneurs and small business owners. When small businesses are non-corporate, debts of the business are personal obligations of the business owner. Then if the business fails, business owners typically have high business debts in addition to their personal debts. The same consideration applies to owners of small corporations, since lenders often require that owners personally guarantee loans to their corporations. Should the corporation fail, its owners are personally liable for the corporate debts they guaranteed, as well as for their personal debts. As a result, entrepreneurs have a particularly strong incentive to file for bankruptcy following a business failure if their business debts are dischargeable.

Economic objectives of personal bankruptcy law

Personal bankruptcy law has a number of economic objectives, some of which conflict with each other. In discussing these objectives, bankruptcy law is characterized as "harsh" if it has high repayment requirements and/or high punishments for filing and "lenient" if it has low repayment requirements and/or low punishments. Of course, bankruptcy law can also be in-between.[15]

One important objective of bankruptcy is to protect the availability of credit. Researchers have shown that harsh bankruptcy laws increase the supply of credit by increasing lenders' expected returns, since debtors default less and repay more following default.[16] Harsh bankruptcy laws discourage bankruptcy filings because debtors' gain from debt discharge is more than offset by the harsh punishments and high repayment requirements in bankruptcy (Fay, Hurst and White 2002).

A second objective of bankruptcy law is to discourage creditors from racing to be first to collect when debtors are in financial distress. A harsh bankruptcy law does this more effectively than a lenient bankruptcy law, because total debt repayment is higher under a harsh law. But even a harsh bankruptcy law probably does little to discourage creditors from racing to be first, since the repayment rate in personal bankruptcies is typically very low and individual creditors therefore have a lot to gain from winning the race to be first.

Probably the most important objective of bankruptcy law is to provide debtors with partial consumption insurance. Individuals benefit from borrowing because it allows them to smooth their consumption over time, but they face consumption uncertainty due to the possibility of adverse events such as losing their jobs, becoming ill, having high health care costs, or their businesses failing. These downside risks are made worse by borrowing, since debtors may be obliged to repay when their earnings are low or their consumption needs are high. Bankruptcy provides partial consumption insurance to debtors by discharging some debt when they file for bankruptcy in response to shocks that reduce their ability-to-repay. This partial consumption insurance is particularly valuable to debtors who are risk-averse, making them more willing to borrow and better off when they do borrow. The amount of partial consumption insurance that bankruptcy provides depends on whether bankruptcy law is harsh or lenient: harsh bankruptcy laws do little to insure debtors' consumption, while lenient bankruptcy laws provide additional consumption insurance as asset and earnings exemptions rise and bankruptcy punishments fall. Thus an argument for lenient bankruptcy laws is that they make risk-averse individuals better off by reducing consumption uncertainty.

Providing partial consumption insurance through bankruptcy law also affects debtors' demand for other types of insurance and insurance substitutes. When bankruptcy law is lenient, debtors have more consumption insurance, and therefore reduce their demand for insurance and insurance substitutes. Recent research has shown that in US states with more lenient bankruptcy laws (i.e., higher asset exemptions), demand for health insurance is lower because health insurance and lenient bankruptcy laws both provide partial consumption insurance. Bankruptcy probably has similar effects on demand for other types of insurance, such as homeowners' insurance and automobile insurance, although these relationships have not been tested. Marriage provides another form of partial consumption insurance when both

[13] See White (1998a) and (1998b) for models of how the rules of credit collection versus bankruptcy affect whether debtors default, but avoid bankruptcy versus file for bankruptcy. Dawsey et al. (2013) provide empirical evidence.

[14] In France, judges can give filers an immediate discharge of debt if judges are convinced that filers will never be able to repay any of their debt. The immediate discharge amounts to an informal second bankruptcy procedure. See White (2006) for discussion.

[15] Bankruptcy law is also harsher when court fees and lawyers' fees are higher and when filers must provide additional information to the bankruptcy court or meet additional requirements such as getting credit counselling.

[16] See Gropp, Scholz and White (1997), Berkowitz and White (2004), and Davydenko and Franks (2008) for empirical work that supports this hypothesis.

spouses work, since each spouse's income insures the other spouse's consumption. In states with more lenient bankruptcy laws, research has found that divorce rates are higher because the consumption insurance gains from being married are smaller.[17]

The same type of argument suggests that government taxing and spending are alternate sources of consumption insurance that are valuable to risk-averse debtors when bankruptcy law is harsh. In particular, tax systems with high tax rates reduce the variance of debtors' incomes net of tax and generous social safety net programs guarantee debtors a high minimum consumption level. Both thus provide debtors with additional consumption insurance and are more valuable to debtors in countries where bankruptcy laws are harsh. Harsh versus lenient bankruptcy laws also affect whether private lenders versus governments bear the cost of default and bankruptcy: holding the social safety net and tax rates constant, more lenient bankruptcy laws force private lenders to bear more of the cost of default and bankruptcy, while harsher bankruptcy laws transfer more of the cost to the government. [18]

Another objective of bankruptcy law is to give filers a "fresh start," meaning that their incentive to work after filing for bankruptcy is not undermined by the obligation to repay. Debtors receive a fresh start if they are obliged to repay only from assets when they file for bankruptcy and all of their post-bankruptcy earnings are exempt. If they are required to repay from future earnings, by contrast, then their incentives to work are reduced because there is a "bankruptcy tax" on their future earnings. The problem of filers having little incentive to work following bankruptcy is particularly acute in the US and other countries that use fixed earnings exemptions, since all of filers' earnings above the exemption level must be used to repay following bankruptcy.[19] Overall, maintaining debtors' incentive to work after filing for bankruptcy is an important objective of bankruptcy and one that is sacrificed when bankruptcy law is harsh.

A version of the fresh start argument also applies to the treatment of entrepreneurs in bankruptcy. As discussed above, going into business is particularly risky, but the downside risk faced by entrepreneurs is reduced when bankruptcy law is lenient rather than harsh. In particular, entrepreneurs benefit if bankruptcy law provides for the immediate discharge of old business debt, no obligation to repay from future earnings and/or a high home equity exemption that allows them to keep their homes when their businesses fail. Thus lenient bankruptcy laws both encourage potential entrepreneurs to start businesses and allow entrepreneurs to start new businesses following a prior business failure. Researchers have found support for the hypothesis that lenient bankruptcy laws encourage entrepreneurship.[20]

These considerations suggest that optimal bankruptcy policy involves a number of tradeoffs. A harsh relative to a lenient bankruptcy law has the advantages of increasing the supply of credit, discouraging risk-averse individuals from borrowing too much, and discouraging default. But a harsh bankruptcy law reduces demand for credit by risk-averse individuals, discourages debtors from working after they file for bankruptcy, and discourages entrepreneurs from starting new businesses, especially if they have had a previous business failure. A harsh bankruptcy law also raises demand for other forms of partial consumption insurance, including health insurance, marriage and more generous social safety net programs that are financed with higher tax rates. A lenient bankruptcy law has the opposite effect.

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[17] See Traczynski (2011), Mahoney (2015) and the article by Traczynski (2015) in this issue for discussion.
[18] See Posner (1995) for discussion of the effect of bankruptcy on the cost of government safety net programs.
[19] However debtors' incentive to work could alternatively increase rather than decrease following bankruptcy if they were subject to wage garnishment that ends at the time of filing and they are not required to repay from future earnings. See Han and Li (2007).

[20] See Fan and White (2003) and Armour and Cumming (2008) for empirical tests using US and European data.

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