

OPTIMAL BANKRUPTCY IN A NON- OPTIMAL WORLD

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Abstract: Consumer bankruptcy insures individuals against misfortune. Like other forms of insurance, bankruptcy reduces an individual's incentive to guard against misfortune and provides her with an incentive to overstate her need for relief. The "first-best," or optimal, bankruptcy system, like the first-best tax or public assistance system, solves these moral hazards without any loss of efficiency. In bankruptcy, this first-best approach would deny relief to debtors responsible for their own distress and reduce the deserving debtors' obligations to an amount commensurate with their ability to pay. While the Bankruptcy Code tries (in part) to follow this first-best approach, such a utopian system requires omniscient judges who can perfectly determine which debtors deserve relief and how much a deserving debtor can pay. Real bankruptcy judges have interpreted the Bankruptcy Code to implement a second-best, or feasible, bankruptcy system that accounts for the limited information that they possess.

INTRODUCTION

The truly destitute have little to fear from their creditors. Their poverty prevents their creditors from seizing anything of value, and the days when default meant imprisonment, enslavement, or even death have long since passed.¹ Bankruptcy protects those with something left to lose—a home, a car, future income, etc.² Without con-

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¹ Massachusetts imprisoned defaulting debtors as late as 1857. CHARLES WARREN, *BANKRUPTCY IN UNITED STATES HISTORY* 52 (1935). Ancient Athens considered defaulting on a debt a capital crime. E.g., Lawrence H. White, *Bankruptcy as an Economic Intervention*, 1 J. LIBERTARIAN STUD. 281, 281 (1977). In ancient Rome the creditors of a defaulting debtor could enslave the debtor or divide the debtor's body into proportionate shares. *Id.*

² See, e.g., Kathy Bergen, *Bankruptcy Becoming Prosperity's Partner Largely a Declaration of the Middle Class*, CHI. TRIB., July 5, 1998, at 6 (quoting Elizabeth Warren, "[bankrupt debt-

sumer bankruptcy, creditors could reach these assets,³ and debtors would be worse off. Bankruptcy therefore provides debtors a benefit—debt relief—which has economic value to the debtor only to the extent that the debtor otherwise could have paid the debt. Because an ideal bankruptcy system would provide this benefit only after the debtor has suffered some misfortune, bankruptcy can be viewed as similar to a public insurance program.⁴

If private insurance markets functioned perfectly, society would not need a consumer bankruptcy system to provide this form of insurance. Debtors could instead rely on private contracts to insure against risks such as illness and unemployment that trigger financial distress.⁵ Yet the world is not so perfect. Although consumers currently can purchase various forms of health, property, and credit insurance⁶ that, like bankruptcy, relieve them of their debt after they have suffered some reversal of fortune, private insurance may be unable to achieve perfect outcomes because of certain well-recognized market failures. For example, contracting costs may be too high to allow consumers to negotiate effective insurance against all risks.⁷ Consumers may also suffer from a host of cognitive or volitional failures that prevent them from purchasing appropriate insurance or re-

ors] are middle-class—that's what's scary about this. . . . They are not marginal workers. They are you and me, they are our neighbors.").

³ Non-bankruptcy law protects some of these assets as well. See *infra* notes 165–173 and accompanying text.

⁴ See, e.g., TERESA A. SULLIVAN ET AL., *THE FRAGILE MIDDLE CLASS: AMERICANS IN DEBT* 3–6 (2000) (arguing that bankruptcy plays an important role in the larger social safety net).

⁵ For studies describing the financial shocks that have led to individual bankruptcies, see TERESA A. SULLIVAN ET AL., *AS WE FORGIVE OUR DEBTORS* 95–102, 166–77 (1989); SULLIVAN ET AL., *supra* note 4, at 15–22, 75–107, 141–71, 172–98; Teresa A. Sullivan et al., *Consumer Debtors Ten Years Later: A Financial Comparison of Consumer Bankrupts 1981–1991*, 68 AM. BANKR. L.J. 121, 130–31 (1994).

⁶ Credit insurance typically insures against risks such as unemployment, disability, death, and destruction of property. For an overview of credit insurance, see CONSUMER CREDIT INS. ASS'N, *THE 2000 FACT BOOK OF CREDIT-RELATED INSURANCE* 4–7 (2000). Consumer advocacy groups have been highly critical of credit insurance. See, e.g., Consumers Union & the Ctr. for Econ. Justice, *Credit Insurance: The \$2 Billion a Year Rip-Off, Ineffective Regulation Fails to Protect Consumers* 2–45 (1999), at <http://www.consumersunion.org/pdf/credit.pdf>.

⁷ Some scholars question whether contracting costs can justify the presence of collections limitations because the frequency of credit transactions may allow the use of standardized contracts; debtors could then select a loan based on the forgiveness it offered as well as its other terms. See, e.g., Samuel A. Rea, Jr., *Arm-Breaking, Consumer Credit and Personal Bankruptcy*, 22 ECON. INQUIRY 188, 189 (1984).

sisting the siren song of easy credit.⁸ Finally, individuals may have greater information about their vulnerability to financial distress than do lenders or insurers, and lenders and insurers may refuse to contract for fear of attracting high-risk individuals.⁹

The bankruptcy laws may be viewed as a response to these market failures. Under this view, the "optimal" bankruptcy system could be defined as the set of legal rules that best approximates the insurance contract that the consumer would purchase if the market failures did not exist. Unfortunately, a claim that judges should attempt to implement the optimal bankruptcy system provides little guidance because the literature lacks a good description of such a system. The literature on consumer bankruptcy has focused on issues such as whether debtors should be entitled to a complete or limited discharge of their debts¹⁰ and whether, and to what extent, debtors should be entitled to keep certain types of property after bankruptcy.¹¹ More recently, scholars have focused on other policy issues such as the percentage of a bankrupt debtor's income that should be exempt from

⁸ See, e.g., THOMAS H. JACKSON, *THE LOGIC AND LIMITS OF BANKRUPTCY LAW* 232-42 (1986). This Article suggests that bankruptcy insures debtors against their own negligent financial management. See *infra* notes 227-244 and accompanying text.

⁹ This is what is known as a "market for lemons" problem. Effectively, insurers believe that only high-risk individuals will buy insurance and therefore charge high rates. Because of the high rates, low-risk individuals will not want the insurance and the expectation is self-fulfilling. See George A. Akerlof, *The Market for "Lemons": Quality, Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488, 489-90 (1970) (demonstrating the fundamental problem by using the used car market as an example); Gillian Lester, *Unemployment Insurance and Wealth Redistribution*, 49 UCLA L. REV. 335, 361-62 (2001) (applying the lemons problem to insurance). The "asymmetric" information can have other adverse consequences as well. For example, in the consumer credit context, "good" credit risks may agree to harsh collections terms, such as no bankruptcy protection, in order to distinguish themselves from "bad" risks and thus receive lower rates. "Good" risks will find these terms less costly than "bad" risks because they will default less often. One can construct a model in which both good and bad credit risks would be better off if these harsh terms were banned; one can also construct a model, however, in which these harsh terms are necessary to prevent the lemons problem discussed above. For a more thorough explanation of this problem, see Richard Hynes & Eric A. Posner, *The Law and Economics of Consumer Finance*, 4 AM. L. & ECON. REV. 168, 173-76 (2002).

¹⁰ See, e.g., JACKSON, *supra* note 8, at 229-34; Theodore Eisenberg, *Bankruptcy Law in Perspective*, 28 UCLA L. REV. 953, 976-91 (1981); Margaret Howard, *A Theory of Discharge in Consumer Bankruptcy*, 48 OHIO ST. L.J. 1047, 1047-70 (1987).

¹¹ See, e.g., Vern Countryman, *For a New Exemption Policy in Bankruptcy*, 14 RUTGERS L. REV. 678, 746-48 (1960); Wells M. Engledow, *Cleaning Up the Pigsty: Approaching a Consensus on Exemption Laws*, 74 AM. BANKR. L.J. 275, 275-78 (2000); Note, *Bankruptcy Exemptions: Critique and Suggestions*, 68 YALE L.J. 1459, 1459 (1959).

seizure,¹² the extent to which the debtor should have a choice between complete and limited discharges of debts,¹³ and the limitations on a debtor's freedom to reaffirm pre-bankruptcy debts.¹⁴ Missing from the literature is a broader inquiry into the bankruptcy system that debtors and creditors would themselves choose in the absence of market failure.

To fill this gap in the literature, this Article looks to, and adapts, current theories regarding the optimal structure of public assistance programs and taxation.¹⁵ Bankruptcy has obvious similarities to these programs. Like bankruptcy, public assistance programs provide benefits to individuals based on their need.¹⁶ Although the type of benefit is different in bankruptcy than in public assistance programs—the forgiveness of debts owed to creditors rather than food stamps or welfare payments financed by the public fisc—the systems are otherwise quite similar. Indeed, public assistance programs are frequently justified as a form of public insurance,¹⁷ and both the optimal bankruptcy system and the optimal public assistance program would confer their benefits on the truly needy without blunting the

¹² See, e.g., Wenli Li, *To Forgive or Not to Forgive: An Analysis of U.S. Consumer Bankruptcy Choices*, 87(2) FED. RES. BANK RICHMOND ECON. Q. 1, 15–18, 21 (2001); Hung-Jen Wang & Michelle J. White, *An Optimal Personal Bankruptcy Procedure and Proposed Reforms*, 29 J. LEGAL STUD. 255, 274–86 (2001).

¹³ See Barry Adler et al., *Regulating Consumer Bankruptcy: A Theoretical Inquiry*, 29 J. LEGAL STUD. 585, 587–601, 605–09 (2000); Jean Braucher, *Increasing Uniformity in Consumer Bankruptcy: Means Testing as a Distraction and the National Bankruptcy Review Commission's Proposals as a Starting Point*, 6 AM. BANKR. INST. L. REV. 1, 1–11 (1998); A. Mechele Dickerson, *Bankruptcy Reform: Does the End Justify the Means?*, 75 AM. BANKR. L.J. 243, 245–46, 269–77 (2001); Judge Edith H. Jones & Todd Zywicki, *It's Time for Means-Testing*, 1999 BYU L. REV. 177, 177–83; Elizabeth Warren, *The Bankruptcy Crisis*, 73 IND. L.J. 1079, 1080–1101 (1998).

¹⁴ See, e.g., Adler et al., *supra* note 13, at 601–08; Marianne B. Culhane & Michaela M. White, *Debt After Discharge: An Empirical Study of Reaffirmation*, 73 AM. BANKR. L.J. 709, 709–11 (1999); Elizabeth Warren, *A Principled Approach to Consumer Bankruptcy*, 71 AM. BANKR. L.J. 483, 498–502 (1997).

¹⁵ See generally A.B. Atkinson, *Income Maintenance and Social Insurance*, in 2 HANDBOOK OF PUBLIC ECONOMICS 779 (Alan J. Auerbach & Martin Feldstein eds., 1985) (reviewing the relevant literature on public assistance); Gary Burtless, *The Economist's Lament: Public Assistance in America*, 4 J. ECON. PERSP. 57 (1990) (reviewing the relevant literature on public assistance); Joseph E. Stiglitz, *Pareto Efficient and Optimal Taxation and the New Welfare Economics*, in 2 HANDBOOK OF PUBLIC ECONOMICS, *supra*, at 991 (Alan J. Auerbach & Martin Feldstein eds., 1985) (reviewing the relevant literature on taxation).

¹⁶ See, e.g., A. Mechele Dickerson, *America's Uneasy Relationship with the Working Poor*, 51 HASTINGS L.J. 17, 19, 23–25 (1999).

¹⁷ See, e.g., Harold M. Hochman & James D. Rodgers, *Pareto Optimal Redistribution*, 59 AM. ECON. REV. 542, 542–43 (1969).

incentives for beneficiaries to engage in desirable behavior—for example, to work, to save, etc.¹⁸

But bankruptcy is not just about giving relief to debtors; it is about taking from them too. Like taxation, bankruptcy often requires individuals to pay certain sums of money, although the payments in bankruptcy go to creditors rather than to the public fisc. The goal of optimal taxation mirrors that of an optimal public assistance program: it seeks to extract payments from those capable of paying without diminishing the incentives to engage in productive behavior.

In constructing theories of an optimal public assistance or tax program, economists usually begin by describing the “first-best” system, or the system that society should adopt if the government were omniscient.¹⁹ In both cases, the optimal system would impose a fixed obligation to pay (for taxation) or a fixed benefit (for public assistance) based not on the individual’s *actual* income or assets, but on the individual’s *ability* to earn.²⁰ While this first-best solution is easy to describe, it is also trivial in the sense that it has limited application in the real world where the government is far from omniscient. The solution is, however, still valuable because it establishes a benchmark for evaluating feasible second-best solutions. Deviations from that benchmark are then justified by the imperfections in the governmental processes that run the programs.

The application of optimal tax and public assistance theory to bankruptcy leads to an interesting insight. In many ways, the Bankruptcy Code appears designed to achieve the first-best solution. This goal is particularly evident in Chapter 13, which gives debtors not a complete discharge of their obligations, but merely an adjustment of debts,²¹ replacing one set of debt obligations with another that is, ideally, based on the debtor’s ability to pay.²² If that goal were attainable, the bankruptcy relief conferred would be optimal. It would provide the debtor with insurance against financial distress with none of the efficiency losses associated with diminishing the debtor’s incentives to produce and save.

¹⁸ See *infra* notes 45, 102 and accompanying text.

¹⁹ See, e.g., Timothy Besley & Stephen Coate, *The Design of Income Maintenance Programmes*, 62 *REV. ECON. STUD.* 187, 188, 193–95 (1995).

²⁰ See Stiglitz, *supra* note 15, at 995–96.

²¹ Chapter 13 of the Bankruptcy Code is entitled, “Adjustment of Debts of an Individual with Regular Income.” 11 U.S.C. §§ 1301–1330 (2000).

²² See *id.*

Yet, as in taxation and public assistance, the first-best solution in bankruptcy is also an unrealistically utopian solution because judges lack the information necessary to accurately measure a debtor's ability to pay and to determine whether the debtor deserves relief. Because of this, judges cannot prevent all debtor misbehavior. Just as the opossum plays dead to ward off predators, bankruptcy may cause some debtors to exaggerate their plight in order to avoid repayment or gain a greater amount of relief; call this the "opossum problem." It occurs, for example, when a debtor conceals assets or hides his ability to earn by working less than he is capable of working. In addition, just as the grasshopper fails to plan for the coming winter,²³ the possibility of bankruptcy relief may cause some debtors to live beyond their means or engage in other negligent or even willful misbehavior that makes financial distress more likely; call this the "grasshopper problem." Unlike the opossum, the grasshopper's need is real, though it could have been avoided. In a world with such problems, the optimal bankruptcy system is a second-best solution—meaning one that accounts for the limited ability of courts to identify the grasshoppers and opossums among us and for the inevitable distortion of debtor incentives.

It is here, however, that the Bankruptcy Code is notably deficient. In many instances, the Code gives little guidance to courts that must adjust the utopian goal to the realities of the actual world. In response, courts have improvised. They have seized on the discretion granted them explicitly or implicitly by the Bankruptcy Code and have attempted to develop a second-best bankruptcy system that accounts for their own limitations.²⁴ In many respects, these improvisations parallel solutions developed in implementing tax and public assistance programs.²⁵ This Article concludes that most of this judicial improvisation is both necessary as a matter of policy and consistent with the language of the existing Bankruptcy Code.²⁶

²³ In Aesop's fable of the ant and the grasshopper, the grasshopper plays the summer away while the ant toils to save for winter. There are numerous versions of this fable and they differ largely on how the grasshopper is treated in the winter. See, e.g., Aesop's FABLES 23 (Jacob Lawrence, illus., U. Wash. Press, 1997). Several prominent bankruptcy scholars have used the story of the ant and the grasshopper to explain the moral hazard created by bankruptcy. See, e.g., Jones & Zywicki, *supra* note 13, at 219–20; Lynn M. LoPucki, *Common Sense Consumer Bankruptcy*, 71 AM. BANKR. L.J. 461, 463–65 (1997); Warren, *supra* note 13, at 1084. This Article adopts an expanded definition of the grasshopper problem that includes willful misbehavior, such as a willful and malicious tort, that makes financial distress more likely.

²⁴ See *infra* notes 325–330 and accompanying text.

²⁵ See *infra* notes 62–67, 95 and accompanying text.

²⁶ See *infra* notes 407–424 and accompanying text.

Bankruptcy judges do not deny relief to the spendthrift or the negligent²⁷ and, despite frequent discussion of the grasshopper problem,²⁸ few, if any, academics argue that bankruptcy judges should. Perhaps this should not surprise us. Neither public insurance programs nor private insurance contracts deny relief to the negligent, and the standard explanations for this approach apply to bankruptcy as well.²⁹ Both public insurance programs and private insurance contracts, however, deny relief for willful misconduct.³⁰ Here bankruptcy, or more specifically Chapter 13, provides an exception, in the form of a superdischarge that would even relieve the debtor of a judgment for a willful and malicious tort such as sexual assault.³¹ Most bankruptcy judges limit the impact of this anomaly by using the good faith standard of Chapter 13 to restrict access to the superdischarge to those debtors who have received other punishment and who try to repay as much as possible.³²

Recently, scholars have paid more attention to the opossum problem in the form of proposals for means testing that would test whether a debtor can repay any of his debts.³³ Rather than engage in this debate, this Article focuses on the only major consumer bankruptcy chapter that requires debtors to repay out of future income: Chapter 13.³⁴ Though the text of Chapter 13 appears to invoke the utopian approach of adjusting debts based on a debtor's ability to pay, judges resist this approach because they are skeptical of their own ability to estimate a debtor's future income.³⁵ This causes some judges to adopt a strained reading of the Code that effectively creates a tax on the debtor's income in bankruptcy.³⁶ This approach is unfortunate because judges could address their concerns in ways that do less violence to the plain meaning of the Bankruptcy Code and better use

²⁷ See *infra* notes 228–234 and accompanying text.

²⁸ See *supra* note 23 and accompanying text.

²⁹ See *infra* notes 120–131 and accompanying text.

³⁰ See *infra* notes 142–148 and accompanying text.

³¹ 11 U.S.C. § 1328(a) (2000); see, e.g., *Solomon v. Cosby*, 67 F.3d 1128, 1130 (4th Cir. 1995); *Petty v. Belanger*, 232 B.R. 543, 545 (D. Mass. 1999) (decided under Chapter 7, although debtor originally filed for Bankruptcy under Chapter 13); *In re Carsrud*, 161 B.R. 246, 247 (Bankr. D.S.D. 1993).

³² See *infra* note 284 and accompanying text.

³³ See *supra* note 13 and accompanying text.

³⁴ As discussed below, debtors filing for bankruptcy under Chapter 7 need not repay anything out of their future income. See *infra* note 177 and accompanying text.

³⁵ See *infra* notes 325–330 and accompanying text.

³⁶ See *infra* note 307 and accompanying text.

what abilities they do have.³⁷ Specifically, judges could rely on subsequent modifications to a bankruptcy plan when they can provide a workable estimate of the debtor's future income, and should dismiss a debtor's bankruptcy petition when they cannot.³⁸

Part I provides a brief outline of the optimal taxation and public assistance literatures and the theory of the second-best. Part II applies the lessons of this literature to the bankruptcy context and defines the utopian and second-best bankruptcy systems. Part III compares these bankruptcy systems to the existing Bankruptcy Code and argues that, although several aspects of Chapter 13 of the Bankruptcy Code appear to try to implement a utopian bankruptcy system, judges should instead consider the limits of their abilities and work to implement the second-best system within the constraints of the current language of the Bankruptcy Code.³⁹

I. AN INTRODUCTION TO OPTIMAL TAXATION AND PUBLIC ASSISTANCE

This Article seeks to define the optimal bankruptcy procedure in the abstract and to determine the extent to which this procedure should guide judicial analysis of existing legislation. To accomplish this goal, this Article analogizes the search for an optimal bankruptcy procedure to a well-known problem in economics: the search for an optimal program of progressive taxation and public assistance.⁴⁰

For at least the past one hundred years, economists have tried to define optimal progressive taxation and public assistance programs to deal with the problems of poverty and inequality.⁴¹ Modern analyses of these redistributive programs view them either as a form of altruism or insurance.⁴² The insurance argument takes one of two forms.

³⁷ See *infra* notes 331–333 and accompanying text.

³⁸ See *infra* notes 331–333 and accompanying text.

³⁹ See *infra* notes 163–406 and accompanying text.

⁴⁰ Although public assistance could take the form of a negative income tax such as the earned income tax credit, these problems are often treated separately in the literature. See, e.g., Atkinson, *supra* note 15, at 782, 804–06; Burtless, *supra* note 15, at 68–77; Stiglitz, *supra* note 15, at 1038. The differences in these literatures, however, are unimportant for the purposes of this Article.

⁴¹ See Stiglitz, *supra* note 15, at 991 (“For more than a hundred years, economists have attempted to show that progressive taxation can be justified on more fundamental principles.”).

⁴² See, e.g., Hochman & Rodgers, *supra* note 17, at 542–43. Earlier efforts at justifying progressive taxation and public assistance relied on the idea that redistribution would increase aggregate happiness because the poor value an additional dollar of income more than the rich. See, e.g., NEIL BRUCE, PUBLIC FINANCE AND THE AMERICAN ECONOMY 213–19 (2d ed. 2001). This approach received a great deal of criticism because it assumes that the

First, many forms of public assistance, such as unemployment insurance, may provide real insurance to existing individuals as the high-income individuals of today may be poor tomorrow and thus may themselves benefit from the relief provided.⁴³ Second, other redistributive policies, such as progressive taxation, may insure the individual against the lottery of birth that grants some individuals the ability to earn very little and others the ability to earn a great deal.⁴⁴ Regardless, the concept is roughly the same. The government should choose the redistributive program that an individual would choose before he knew the outcome of the risk against which the system is designed to insure, the system that he would choose behind a "veil of ignorance."⁴⁵

Economic articles on taxation or public assistance usually proceed in two steps. First the author defines the first-best system, or the system that the government should implement if it were omniscient and could directly solve the opossum and the grasshopper problems described above.⁴⁶ But economists generally do not believe that the government is omniscient, and they focus more heavily on the description of the second-best system that is optimal in a world of opossums, grasshoppers, and a government that can only imperfectly identify them.⁴⁷

government can compare the happiness of different individuals. See, e.g., Joseph Bankman & Thomas Griffith, *Social Welfare and the Rate Structure: A New Look at Progressive Taxation*, 75 CAL. L. REV. 1905, 1917-18 (1987). For a review of the development of the justifications for these redistributive policies, see Atkinson, *supra* note 15, at 791-95.

⁴³ See, e.g., BRUCE, *supra* note 42, at 209-13.

⁴⁴ See John C. Harsanyi, *Cardinal Utility in Welfare Economics and in the Theory of Risk-Taking*, 61 J. POL. ECON. 309, 314-35 (1953); John C. Harsanyi, *Cardinal Welfare, Individualist Ethics, and Interpersonal Comparisons of Utility*, 63 J. POL. ECON. 309, 314-16 (1955); see also Atkinson, *supra* note 15, at 793-95 (discussing the insurance justifications of redistributive programs).

⁴⁵ The reader may associate this term with the work of John Rawls. See JOHN RAWLS, *A THEORY OF JUSTICE* 12, 136-42 (1971). In Rawls's version of the veil of ignorance argument, the debtor is not just ignorant as to whether he will be rich or poor in the future, but is also ignorant as to the chance of each circumstance occurring. *Id.* at 12, 137. Therefore, according to Rawls, an individual would want an equal distribution of income unless an unequal distribution aids the most disadvantaged member of society. See *id.* at 148-49. This conclusion has some importance for the interpretation of the second-best tax discussed below. Differences between Rawls's work and the earlier work of Harsanyi, however, are not central to this Article.

⁴⁶ See, e.g., Besley & Coate, *supra* note 19, at 188, 193-95.

⁴⁷ See *id.* at 188, 195-205.

A. *The First-Best Tax or Transfer*

An omniscient government can adopt an elegantly simple first-best tax or transfer system that allows it to achieve whatever social goals it desires without any loss of efficiency: the first-best system imposes on individuals a lump-sum tax or provides to individuals a lump-sum transfer based on their ability to pay.⁴⁸ To implement this system, the government projects how much each individual would earn if he worked the efficient number of hours and then requires the individual to pay an amount equal to any *projected* earnings in excess of the amount that the government decides the individual should consume. If the individual's projected earnings are less than the expenses that the government thinks proper, the government gives the individual a transfer equal to the shortfall. For example, assume that the government determines that all individuals should consume \$50,000 worth of goods and services. If the government determines that a high-ability individual *should* work hard enough to earn \$90,000, it will require that individual to pay a tax of \$40,000 regardless of the amount that he earns. If the government determines that a low-ability individual *should* only have to work hard enough to earn \$10,000, it will give that individual a transfer of \$40,000 regardless of the amount that he actually earns.

Each individual may work more or less than the government estimated, but the amount that the individual works, and therefore the amount that he actually earns, does not affect his tax or transfer; that is the meaning of a lump-sum tax. Because individuals' actual earnings do not affect their tax or transfer, their return from working an additional hour, their take-home pay, matches the social return, the amount that they produce, and they will work the efficient number of hours that the omniscient government predicted. For example, the high-ability individual could work harder and earn \$100,000. If he did, he would be entitled to keep the extra \$10,000 that he earned. He would, however, not value the additional \$10,000 as much as the leisure that he would have to sacrifice in order to earn it. If he did value the additional \$10,000 more than the leisure he had to sacrifice to get it, then it would not have been efficient for him to work only enough to earn \$90,000, and the omniscient government would have determined that he *should* work enough to earn \$100,000. Therefore,

⁴⁸ See, e.g., Stiglitz, *supra* note 15, at 995-96.

the high-ability individual ends up earning the \$90,000 that the omniscient government predicts.

This does not mean that the first-best tax will not affect the number of hours that the individual will work. In fact, the tax will likely cause the individual to work *more* hours than he would have because he will be less wealthy and will therefore be willing to sacrifice more leisure in order to gain more income. For example, if the government requires our high-ability individual to pay a tax of \$90,000 and he earns only \$90,000, he would be left with nothing to eat. To avoid starvation, he would be willing to work a great deal in order to earn just a little more than the government will take. This wealth effect, however, is irrelevant to the question of whether the tax is efficient.⁴⁹ A tax is efficient if, given the current amount of tax the individual must pay, the individual values an hour of leisure more than the amount of money he could produce by working an additional hour. A lump-sum tax is efficient because an individual is free to work another hour and keep the entire amount that he produces, but he chooses not to do so.

The government can use a lump-sum tax to achieve as much progressivity as it desires without any loss of efficiency.⁵⁰ Each individual would work an efficient number of hours if the high-ability individual paid a tax of \$40,000 and the low-ability individual received a transfer of \$40,000 or if the high-ability individual paid no tax and the low-ability individual received no transfer. To determine the amount of each tax or transfer, one must consider the purpose of the program. Assume that the program is motivated by insurance so that the government chooses the program that an individual would choose if he did not know how he would fare in a lottery of birth that gives some individuals the ability to earn \$90,000 and some the ability to earn just

⁴⁹ When studying the effect of income taxation, economists refer to two effects, the wealth (or income) effect and the substitution effect. The wealth effect refers to the tendency of individuals to work more because taxes make them poorer and hence they value an additional dollar of income more highly and are willing to sacrifice more leisure to get it. The substitution effect refers to the fact that the individual does not get to keep all of the last dollar earned. The tax therefore makes leisure cheaper and the individual substitutes leisure for work. It is the substitution effect, and not the wealth effect, that determines the efficiency of a tax. See, e.g., Bruce, *supra* note 42, at 428–32 (describing the income and substitution effects in the context of an income tax).

⁵⁰ See, e.g., Stiglitz, *supra* note 15, at 995–96 (noting that optimal lump-sum taxes can equalize the consumption of each individual and yet still provide each individual with the incentive to work an amount such that her marginal rate of substitution between goods and leisure equals her marginal product).

\$10,000.⁵¹ Assume further that the happiness that an individual derives from an additional dollar of consumption depends only on how much he is consuming,⁵² and that as the individual consumes more each additional dollar yields less happiness. If these assumptions hold, the government should set the first-best tax or transfer such that the individual will always consume the same amount regardless of his ability to earn;⁵³ the government should structure the program so that the low-ability individual and the high-ability individual will each consume \$50,000. Because each is consuming the same amount, each would place the same value on an additional dollar of consumption and there would be no gain from redistributing wealth from one to the other. The government would demand that the high-ability individual pay a tax equal to \$40,000, or the amount by which his projected earnings of \$90,000 exceed \$50,000 and offer a transfer to the low-ability individual of \$40,000 or the amount by which his projected earnings of \$10,000 fall below \$50,000.

B. *The Second-Best and Moral Hazard*

The first-best system described above effectively assumes away the moral hazards (the grasshopper and opossum problems) that redistributive programs create by assuming that the government is omniscient. If the government cannot identify the high-ability individuals, these individuals will have an incentive to "play 'possum" and claim a low earnings ability in order to pay a lower tax or receive a larger transfer. For example, the political debate over whether welfare re-

⁵¹ Because many public assistance programs do not appear to be structured to serve an insurance motive, economists often view them as a product of altruism or at least limited altruism. See, e.g., Besley & Coate, *supra* note 19, at 189. Still, even under these assumptions the first-best system is just a lump-sum tax based on recipients' ability to support themselves. *Id.* at 188.

⁵² This assumption is more controversial than it appears. For example, one might think that the amount of leisure available may affect the happiness an additional dollar yields.

⁵³ The government will assign each individual a consumption level such that the happiness that each individual would derive from an additional dollar of consumption, his marginal utility of consumption, would be the same. If this were not the case, aggregate happiness could be increased by redistributing money to those who valued it more highly. If all individuals have the same preferences and the happiness that they derive from an additional dollar of income depends solely on how much they are consuming, then every individual must consume the same amount. See, e.g., Stiglitz, *supra* note 15, at 995-96. This does not mean that all individuals are equally happy; in fact, those who can earn more are likely worse off because the government will expect them to work more as long as leisure is a "normal" good. See *id.* at 995.

cipients can in fact support themselves⁵⁴ is an argument over the importance of the opossum problem. It is a debate over whether the recipients are truly needy or whether they can support themselves. In addition, if the government cannot distinguish between those whose low-ability is a result of bad luck and those who failed to invest sufficiently in the future, individuals will have an incentive to behave like the grasshopper. The debate over whether welfare laws lead to more teen pregnancies⁵⁵ is a debate over the grasshopper problem. All would agree that the teenage mother is needy, but some would argue that she would not have become needy but for the prospect of relief.⁵⁶ To the extent that the government cannot identify either the opossums or the grasshoppers, the optimal tax is a second-best tax.

1. The Grasshopper Problem and Partial Insurance

The optimal taxation literature sometimes assumes that each individual receives his earnings ability randomly through a lottery of birth;⁵⁷ it effectively ignores the grasshopper problem. One's ability to earn, however, often depends on prior choices such as the decision to seek further education or to work hard and earn a promotion. Although a lump-sum tax based on an individual's earnings ability would not distort his decision to work after the tax is implemented, the individual will have much less incentive to develop the ability to earn if he knows that the tax will be implemented. If the taxation system will leave everyone with the same amount of money to consume, there is no incentive to become skilled.⁵⁸ For example, assume that in order to become a high-ability individual capable of earning \$90,000 a year, an individual must endure several years of rigorous study. If one knew that the tax structure was such that one would consume \$50,000

⁵⁴ See Dickerson, *supra* note 16, at 17–18.

⁵⁵ See, e.g., STAFF OF HOUSE COMM. ON WAYS AND MEANS, 105th Cong., 1998 GREEN BOOK 537, 537–41 (Comm. Print 1998).

⁵⁶ *Id.* (arguing that some teens would not have become pregnant but for the existence of a social welfare system).

⁵⁷ See Louis Kaplow, *Human Capital Under an Ideal Income Tax*, 80 VA. L. REV. 1477, 1482–90 (1994) (describing the endowment at birth with quantifiable earning potential, discountable to present value). But see Lawrence Zelenak, *The Reification of Metaphor: Income Taxes, Consumption Taxes and Human Capital*, 51 TAX L. REV. 1, 7–11 (1995) (arguing, among other things, that human capital endowment is not always a good proxy for earnings potential).

⁵⁸ In fact, individuals may actually be worse off if they have a higher earnings ability. If leisure is a "normal" good so that individuals would want to consume more of it as its price (the available wage) falls, then the government will expect them to work more hours and yet consume the same amount as others. See Stiglitz, *supra* note 15, at 995.

regardless of how much one could earn, there would be no incentive for one to study.

An omniscient government can solve the grasshopper problem. If some individuals have low earnings ability solely because of hard luck and others have low earnings ability solely because of their poor choices, the government could provide relief for the unfortunate but not the lazy. More realistically, both hard work and fate play a role in determining an individual's earnings ability. An omniscient government, however, can still implement a first-best tax or transfer system by assessing an arbitrarily high tax, effectively a punishment, whenever the individual does not invest sufficiently in his future. Because individuals will fear this penalty, they will not shirk.

If the government cannot separate the grasshoppers from the unfortunate, then the only way to make the individual bear the full costs of shirking is to make the individual bear the full costs of adverse events beyond his control as well. The only way to provide the individual with the proper incentives to study and generate the ability to earn \$90,000 is never to provide relief when he may earn only \$10,000, even if this low earnings ability could have resulted from misfortune rather than misbehavior. Because this would destroy the insurance that redistributive programs are designed to provide, the government again faces a trade-off. It must balance its citizens' need for insurance against the fact that this insurance will cause its citizens to shirk. What results is a system of only partial insurance. Low-ability individuals are asked to pay less than high-ability individuals, but not enough less to make them equally well-off. The resulting system is still progressive, just not as progressive as it would have been if the government could solve the grasshopper problem directly. Likewise, public insurance programs offer the individual only partial insurance against his loss. For example, unemployment insurance typically pays about one-half of the unemployed's former wages.⁵⁹

2. The Opossum Problem and Income Taxes

Even if the government could not estimate an individual's earnings ability, a lump-sum tax or transfer would still have the desirable effect on each individual's work incentives because the individual

⁵⁹ See, e.g., MARK A. ROTHSTEIN ET AL., *EMPLOYMENT LAW* 799 (2d ed. 1999) ("States usually set weekly benefit amounts as 1/23, 1/24, 1/25, or 1/26 of the earnings obtained by applicants during the relevant calendar quarters, resulting in benefit amounts ranging from 50 to 56% of average weekly earnings.").

would retain all of his last dollar earned regardless of the size of the tax or transfer.⁶⁰ If the government cannot identify those who can earn more, however, all individuals must pay the exact same amount of tax or else those who are asked to pay more would "play 'possum" and claim that they have a low earnings ability. The government could not meet its progressivity goals with such a system.

The optimal tax literature therefore focuses on the second-best tax or transfer, or the tax that utilizes only the information that the government can actually observe.⁶¹ In the basic optimal taxation model the government can observe the individual's actual income but nothing else.⁶² A precise description of the second-best tax is quite complicated and requires strong mathematical assumptions.⁶³ This Article, however, need only describe the second-best tax as a tax that *generally*⁶⁴ increases with the individual's actual income; the second-best tax is an income tax. Because an income tax deprives individuals of some of the benefit of an additional hour of work, it will discourage them from working and thus lead to some inefficiency.⁶⁵ An income tax allows for some progressivity, however, as the high-ability individual would have to earn, and therefore consume, very little in order to "play 'possum" and emulate the low-ability individual. This second-best tax reflects a compromise between the goals of efficiency and

⁶⁰ See Stiglitz, *supra* note 15, at 996–1004.

⁶¹ See, e.g., Besley & Coate, *supra* note 19, at 195–205 (exploring the optimal system of public assistance); Stiglitz, *supra* note 15, at 996–1023 (reviewing the basic lessons of the literature).

⁶² See Stiglitz, *supra* note 15, at 997. A significant portion of the public assistance literature discusses the use of other proxies to tag individuals deserving of relief or the intentional design of programs to screen those able to support themselves. See, e.g., George A. Akerlof, *The Economics of "Tagging" as Applied to the Optimal Income Tax, Welfare Programs, and Manpower Planning*, 68 AM. ECON. REV. 8, 8 (1978). In addition, the government may be able to punish recipients in order to dissuade those who can support themselves from seeking assistance. See, e.g., Besley & Coate, *supra* note 19, at 188 (discussing the use of "workfare" to screen for those debtors with a low earnings capacity). While punishment mechanisms such as the loss of one's credit reputation undoubtedly could play an important role in an optimal bankruptcy system, they are beyond the scope of this Article.

⁶³ See, e.g., Stiglitz, *supra* note 15, at 1023–30.

⁶⁴ Under some assumptions the optimal income tax may actually decline over some ranges of income. See, e.g., *id.* at 1022.

⁶⁵ In theory, it is possible that the wealth effect could dominate the substitution effect and the individual could decide to work more after the imposition of an income tax. This makes little difference, however, because only the substitution effect has any bearing on whether a tax is efficient. See *supra* note 42 and accompanying text.

progressivity.⁶⁶ Because society must compromise, the second-best tax is neither as progressive nor as efficient as the first-best tax.⁶⁷

II. APPLYING THE OPTIMAL TAX LESSONS TO BANKRUPTCY

This Part applies the results of the optimal taxation and public assistance literature to bankruptcy and demonstrates that the first-best, or utopian, bankruptcy system adjusts the debts of a deserving debtor to an amount that is commensurate with the debtor's potential to repay.⁶⁸ Like the first-best tax, however, this utopian bankruptcy system relies on information that is not realistically available.⁶⁹ Therefore, one needs to define a feasible second-best bankruptcy system.

In a world of limited information, we may not want judges to search for *all* of the grasshoppers among us for fear that they may mistakenly deny relief to the deserving. In addition, the ability of judges to identify the opossums depends on the information that they have at their disposal, and on this matter reasonable minds may disagree. If one follows the fairly pessimistic assumptions of the optimal taxation literature and assumes that judges can only observe a debtor's actual income, the optimal bankruptcy system resembles an income tax.⁷⁰ This Article argues, however, that judges can sometimes use a debtor's earnings history to provide a workable estimate of an individual's potential earnings.⁷¹ When they can, judges should instead adopt an adjustment of debts approach to bankruptcy tempered by subsequent modifications of the amount of debt when the estimation proves grossly inaccurate.

Like progressive taxation or public assistance, bankruptcy policy may be justified either as a means of providing insurance for debtors or as fulfilling certain altruistic goals of society.⁷² While this Article

⁶⁶ See Stiglitz, *supra* note 15, at 1006 (noting the equity-efficiency tradeoff).

⁶⁷ See *id.*

⁶⁸ See *infra* notes 101–114 and accompanying text.

⁶⁹ See *supra* notes 46–47 and accompanying text.

⁷⁰ See *supra* notes 62–66 and accompanying text.

⁷¹ See *infra* notes 420–422 and accompanying text.

⁷² Economists consider an individual altruistic if his happiness depends at least in part on the condition of others. See Hochman & Rodgers, *supra* note 17, at 543. Because altruistic individuals do not want to see their neighbor destitute, they may prefer a system like bankruptcy that makes extreme poverty less likely. Because it is the creditor, and, ultimately, debtors themselves who bear the cost of this insurance, bankruptcy offers some advantages over public assistance financed from the public fisc. In particular, public assistance may encourage debtors to engage in risky financial behavior, such as over-borrowing, because public assistance partially shields them from the consequences of their actions. See Thomas H. Jackson, *The Fresh-Start Policy in Bankruptcy Law*, 98 HARV. L. REV. 1393, 1402

focuses on the insurance that bankruptcy provides, the policy prescriptions would not radically change if altruism were stressed.⁷³ Notwithstanding the commercial success of Las Vegas and Atlantic City, consumers generally do not like risk and purchase insurance even though, on average, they pay more to the insurers than the insurers pay out in claims.⁷⁴ The insurer writes these contracts because the consumer pays a premium that exceeds the expected payments on the insurance contract. The insurer can charge premiums that the consumer is willing to pay because the insurer writes contracts with many different consumers and is therefore fairly indifferent to the risk that any one consumer may suffer an unfortunate event that requires compensation.⁷⁵ In other words, the insurer can effectively "diversify" the risk away.⁷⁶ Consumers choose contracts that balance the insurance that they receive against the premium that they must pay.

Bankruptcy effectively makes creditors the insurer of their debtors by transferring wealth from creditors to debtors, through a reduction in debts, after debtors have suffered some misfortune.⁷⁷ Many

(1985); 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, 286 (1995). The fact that the public fisc does not bear the costs of bankruptcy, however, makes it difficult to offer a prediction of how the altruist would set the debtor's consumption in bankruptcy. Assume that the debtor's consumption in bankruptcy is set by an altruist who is not also a borrower. If the altruist is a true altruist and seeks to maximize the debtor's expected happiness, the altruist would just choose the same bankruptcy procedure that the debtor herself would choose in an insurance model. Therefore, assume that the altruist cares only about the debtor's consumption. Because the altruist does not have to pay for the debtor's consumption, the debtor pays for it through higher interest rates and reduced access to credit; there is nothing to limit the debtor's choice. This is not to say that altruism plays no role; the altruist may care about some combination of the debtor's happiness or consumption or may only care that these stay above certain levels. This Article will focus, however, on the insurance role of bankruptcy to avoid this confusion.

⁷³ The utopian bankruptcy system would still leave the debtor with a fixed obligation. The amount of this obligation, however, would be determined by the amount that the altruist would choose for the debtor rather than the amount that the debtor would choose from behind a veil of ignorance. As explained above, however, the amount that the altruist would choose is uncertain. See *supra* note 72.

⁷⁴ The profitability of insurance companies is based on the premise that they will receive more premiums than they will pay in claims. See, e.g., A. MITCHELL POLINSKY, AN INTRODUCTION TO LAW AND ECONOMICS 54 (2d ed. 1989).

⁷⁵ See *id.*

⁷⁶ See *id.*

⁷⁷ See *infra* notes 203–204, 228 and accompanying text. For a further discussion of consumer bankruptcy as insurance, see Charles G. Hallinan, *The Fresh Start Theory in Consumer Bankruptcy: A Historical Inventory and an Interpretive Theory*, 21 U. RICH. L. REV. 49, 98–109 (1986).

creditors willingly supply this insurance by extending credit while knowing that their debtors may file for bankruptcy. Like the insurance company, the large creditor contracts with many consumers and can diversify away much of the risk of any one consumer's suffering the adverse circumstances that lead to default.⁷⁸ Just as the insurer demands compensation for the risk through premiums, most creditors demand compensation for the risk of default through higher interest rates.⁷⁹

Because lending markets are highly competitive⁸⁰ and money can be readily invested outside the consumer lending market,⁸¹ debtors are likely to bear most if not all of the cost of bankruptcy protection in the form of higher interest rates or reduced access to credit.⁸²

⁷⁸ See *supra* note 76 and accompanying text.

⁷⁹ See, e.g., Hallinan, *supra* note 77, at 105.

⁸⁰ Credit markets may not be perfectly competitive. Some consumer credit markets, however, such as those for credit card debt or mortgages, are now truly national markets and it would be very difficult to claim that any lender truly has market power. In addition, state and federal regulatory structures work to prevent excessive concentration in local lending markets. Furthermore, there is some evidence that different types of lenders—banks, finance companies, etc.—compete for the consumer's business. See, e.g., A. Charlene Sullivan, *Competition in the Market for Consumer Loans*, 36 J. ECON. & BUS. 141, 141 (1984).

⁸¹ Even if consumer lenders are unable to invest readily in other sources, they are only financial intermediaries. The ultimate source of credit, the individuals who own the wealth that is lent, can choose from among a dizzying array of investments including domestic and foreign securities and banks that loan to corporations. See, e.g., William H. Meckling, *Financial Markets, Default, and Bankruptcy: The Role of the State*, 41(4) LAW & CONTEMP. PROBS. 13, 19 (1977).

⁸² According to economists, the question of who bears the cost of bankruptcy is answered by examining the elasticity of the supply and demand for credit. If credit markets were perfectly competitive and if consumer lending were but a small part of the overall investment opportunities, then the supply of credit would be perfectly elastic. That is, if the return to lending increased even infinitesimally above the return to other forms of lending, then money would flow into the consumer lending market until the return fell to the normal level. Likewise, if the return decreased, money would flow out until the return rose to the normal level. Therefore, if generous bankruptcy laws increase the rate of default, then money will flow out of the consumer lending market until interest rates rise to raise the expected return of lending to the normal level. See *id.* at 19–24. Of course, some question the elasticity of the supply of credit and thus question whether creditors and investors will bear more of the costs of bankruptcy. See, e.g., J. Fred Weston, *Some Economic Fundamentals for an Analysis of Bankruptcy*, 41(4) LAW & CONTEMP. PROBS. 47, 48–51 (1977). Empirical evidence suggests that consumers do bear at least some of the costs of laws that restrict collections. See, e.g., Reint Gropp et al., *Personal Bankruptcy and Credit Supply and Demand*, 112 Q. J. ECON. 217, 230–31 (1997) (finding that debtors who live in states with larger property exemptions pay higher interest rates and have a reduced access to credit). The primary results of this Article, however, do not depend on how much of the costs of bankruptcy are borne by lenders. Even if the lenders incurred much of the costs of bankruptcy, debtors would still have an incentive to choose an efficient means of collection because they could then extract a more generous system. Note too that bankruptcy will

Therefore, the optimal bankruptcy procedure is the bankruptcy procedure a rational debtor would include in a hypothetical contract made at the time of borrowing if the debtor knew that the amount of insurance and the structure of the contract would affect the other terms of credit offered by the creditor. The optimal bankruptcy system, like the optimal tax, is the system that an individual consumer would choose at the time of borrowing behind a veil of ignorance as to his future condition.⁸³

In assessing the debtor's ability to pay, the optimal bankruptcy procedure would likely consider several factors including the value of the debtor's assets and any unusual expenses that the debtor faces. This Article follows the general approach of the optimal taxation and public assistance literature, however, and focuses solely on the debtor's earnings.⁸⁴ One can extend the analysis to consider the debtor's assets and expenses, but the gain in realism would not be worth the resulting analytical complications at this time.⁸⁵ The vast majority of bankrupt debtors do not have,⁸⁶ and likely never had,⁸⁷ significant assets. In addition, while unexpected expenses, such as a hospital bill, are often cited as a cause of bankruptcy,⁸⁸ these expenses are often one-time events that affect the total obligations of debtors but not their expenses going forward. Therefore, they do not affect the total amount that debtors should pay in bankruptcy. In addition,

provide a net benefit if consumers value the insurance provided more than the additional costs of credit. Therefore, bankruptcy could actually *expand* the demand for credit, and, if the supply of credit is not perfectly elastic, creditors could actually capture much of the *gain* from bankruptcy. Therefore, the relevant question is whether the insurance provided by bankruptcy is more valuable than the costs of the distortions it creates. See, e.g., Daniel J. Villegas, *Regulation of Creditor Practices: An Evaluation of the FTC's Credit Practice Rule*, 42 J. ECON. & BUS. 51, 56-64 (1990) (testing whether limitations on credit provide a net benefit to consumers and lenders).

⁸³ See analogous discussion, *supra* note 45 and accompanying text.

⁸⁴ See *supra* notes 20, 49 and accompanying text.

⁸⁵ The author plans to revisit these issues in a future paper.

⁸⁶ See, e.g., ELIZABETH WARREN & JAY LAWRENCE WESTBROOK, *THE LAW OF DEBTORS AND CREDITORS* 426 (4th ed. 2001) ("The property exemptions may make little difference because the debtors who file for bankruptcy may not own much of value that isn't already mortgaged to the hilt.").

⁸⁷ According to the 1998 Survey of Consumer Finances, half of all non-homeowners had a net worth of less than \$4,200. See Arthur B. Kennickell et al., *Recent Changes in U.S. Family Finances: Results from the 1998 Survey of Consumer Finances*, Fed. Res. Bull. 7 (Jan. 2000), available at <http://www.federalreserve.gov/pubs/oss/oss2/98/bull0100.pdf>. Moreover, this low net worth does not appear solely attributable to an excess of debts. Only 63.5% of these non-homeowners listed any debts at all, and of those that did list debts, half had debts of less than \$6,000. See *id.* at 21.

⁸⁸ See *supra* note 5 and accompanying text.

many bankruptcy scholars have abandoned faith in the ability of bankruptcy judges effectively to estimate a debtor's reasonably necessary expenses,⁸⁹ and both the National Bankruptcy Review Commission's proposed reforms⁹⁰ and proposed legislation⁹¹ would limit consideration of the debtor's particular expenses in the great majority of filings.

The analogy between optimal bankruptcy and optimal taxation or redistribution is imperfect. Many of the limitations of the analogy are discussed below, but two points deserve special note. First, when implementing a tax or public assistance program, the government may transfer as much wealth to an individual as it wishes, provided that it raises enough money to balance its budget. By contrast, the bankruptcy judge can do no more than forgive all of the debtor's obligations; even in a hypothetical bankruptcy regime it would be odd for a judge to order a creditor to transfer additional funds to a debtor in default.⁹²

Second, while the optimal tax defines how all members of society should be treated, only an extremely small fraction of the population files for bankruptcy.⁹³ The number of bankruptcy filings is even small when compared to the number of individuals who experience the un-

⁸⁹ See, e.g., Braucher, *supra* note 13, at 19. Currently § 1325(b) of the Bankruptcy Code defines "disposable income" as income minus reasonably necessary expenses. See 11 U.S.C. § 1325(b) (2000).

⁹⁰ See, e.g., NAT'L BANKR. REV. COMM'N, BANKRUPTCY: THE NEXT TWENTY YEARS 262-73 (1997) [hereinafter NBRC REPORT]. Interestingly, one of the leading advisors to this commission, Elizabeth Warren, is one of the leading advocates for the argument that unexpected expenses often lead to bankruptcy. See *supra* note 5. This issue fits firmly within the theory of the second-best. While the first-best solution would adjust debtors' required repayment for their reasonably necessary expenses, judges may be unable to determine this amount. To the extent that they are unable to do so, differences in expenses must be ignored.

⁹¹ See H.R. 5745, 107th Cong. § 707(b)(2)(A) (2002).

⁹² One can obscure, at least temporarily, this distinction by assuming that debtors can over-borrow from the creditor and store the amount that they do not consume in a riskless asset so that the debtor will always repay something after default. The need for this assumption, however, has important implications for bankruptcy law that will be discussed below. See *infra* note 290 and accompanying text.

⁹³ In the year 2001 there were approximately 1,452,000 non-business bankruptcy filings. See Am. Bankr. Inst., U.S. Bankruptcy Filings 1980-2001, available at <http://www.abiworld.org/stats/1980annual.html> [hereinafter Bankruptcy Filings 1980-2001]. The population of the United States in the year 2001 was approximately 275,000,000. See U.S. Census Bureau, U.S. Dep't of Commerce, Annual Projections of the Total Resident Population as of July 1: Middle, Lowest, Highest, and Zero International Migration Series, 1999 to 2100, available at <http://www.census.gov/population/projections/nation/summary/np-t1.pdf> [hereinafter Annual Projections of the Resident Population].

fortunate events that are often listed as causing the financial distress that leads to bankruptcy: unemployment, divorce, etc.⁹⁴ If consumers are risk-averse, they should want insurance against all shocks, not just those that are severe enough to land them in bankruptcy. Therefore, the fact that bankruptcy provides no insurance to debtors except in those very rare circumstances when they fail to pay their obligations in full presents somewhat of a puzzle.

This puzzle is not unique to bankruptcy. Perhaps part of the answer⁹⁵ can be found in an argument economists use to explain why many insurance policies only cover losses above some amount.⁹⁶ This literature suggests that the cost of verifying the insured's loss prevents the insurance contract from covering small losses.⁹⁷ Economists extend the same logic to bankruptcy and suggest that because bankruptcy is a costly process, a court should only inquire as to the debtor's circumstances when the debtor's income is particularly low.⁹⁸

⁹⁴ In 1998 there were a total of 1,135,000 divorces (including annulments) in the U.S. See Nat'l Ctr. for Health Statistics, Divorce, available at <http://www.cdc.gov/nchs/fastats/divorce.htm>. In addition, in 1998, there were a total of 6,210,000 unemployed persons in the U.S. See U.S. Census Bureau, U.S. Dep't of Commerce, Statistical Abstract of the United States 404 (2000) [hereinafter Statistical Abstract]. In that same year there were 1,398,182 non-business bankruptcy filings. See Bankruptcy Filings 1980-2001, *supra* note 93. Of course this represents the number of filings and not the number of debtors. Married individuals may file for bankruptcy jointly. See 11 U.S.C. § 302. Debtors may also file under Chapter 13 frequently, perhaps more than once a year, in order to delay foreclosure or other creditor remedies. See, e.g., Warren, *supra* note 14, at 502-03 (discussing strategic refiling by Chapter 13 debtors).

⁹⁵ An alternative answer is suggested by the literature on public assistance which faces a similar issue in that only a small fraction of citizens receive this assistance. See Statistical Abstract, *supra* note 94, at 380 (indicating that of about 71 million families surveyed in 1998, about 2.6 million received some form of public assistance during 1997). Partly as a consequence, many economists focus on the altruistic goals that these programs may serve by ensuring that citizens do not fall below some minimal standard of living. See, e.g., Besley & Coate, *supra* note 19, at 187. Bankruptcy may play a similar role and may do so at less cost to the public fisc because the debtors themselves bear the cost of the protection in the form of higher interest rates and reduced access to credit. As discussed above, however, one needs stronger assumptions to predict the bankruptcy system that the altruist would choose. See *supra* note 72. Moreover, bankruptcy does not appear to be just about concern for the destitute. Studies of debtors in bankruptcy reveal that they resemble society as a whole. See SULLIVAN ET AL., *supra* note 5, at 328; SULLIVAN ET AL., *supra* note 4, at 6.

⁹⁶ See, e.g., Robert M. Townsend, *Optimal Contracts and Competitive Markets with Costly State Verification*, 21 J. ECON. THEORY 265, 265 (1979).

⁹⁷ See *id.*

⁹⁸ See, e.g., Douglas Gale & Martin Hellwig, *Incentive-Compatible Debt Contracts: The One-Period Problem*, 52 REV. OF ECON. STUD. 647, 648 (1985). Many of the results of this "optimal contracts" literature depend on very strong assumptions. The fundamental observation that information itself is costly, however, may have important implications for the structure of collections law. In particular, society may rationally choose to forego information in

When the court does inquire as to debtors' circumstances, however, the court should fully insure debtors so that they always consume the same amount after this investigation.⁹⁹ Therefore, subject to competing goals, bankruptcy should try to ensure that a debtor consumes the same amount regardless of the severity of loss that led to bankruptcy.¹⁰⁰

A. Utopian Bankruptcy

If judges were omniscient and could identify the grasshoppers and opossums, they could implement a utopian bankruptcy system that, like the first-best tax, provides debtors with full insurance against adverse events and does not lead to any inefficiency.¹⁰¹ To avoid the grasshopper problem, this utopian bankruptcy system would deny relief when debtors' financial distress resulted from their own misbehavior. For those debtors deserving of relief, the utopian bankruptcy system would reduce their debt to a new amount based on their ability to repay, thus eliminating the opossum problem.

1. Guarding the Gates of Bankruptcy: Identifying the Grasshoppers

A utopian bankruptcy system would insure debtors against misfortune without encouraging them to borrow an excessive amount or to misbehave in other ways that make financial distress too likely. An omniscient judge could achieve this goal by always granting relief for financial distress resulting from misfortune and never granting relief for financial distress resulting from misbehavior.¹⁰²

Unfortunately, this guideline may prove of little practical use because often both misbehavior and misfortune will jointly cause

some circumstances and rely on other forms of verification such as punishment. See, e.g., Kelly D. Welch, *From Debtor's Prison to Bankruptcy: The Enforcement of Optimal Debt Contracts* 8 (Feb. 2001) (unpublished paper, on file with author). This Article, however, seeks to describe the bankruptcy system that society should choose given that the judge has collected all available information.

⁹⁹ See Gale & Hellwig, *supra* note 98, at 661.

¹⁰⁰ As discussed above, a court may wish to simply forgive all of the debts of all debtors who have no ability to pay. See *supra* note 92 and accompanying text.

¹⁰¹ See *supra* note 48 and accompanying text.

¹⁰² See Karen Gross, *Preserving a Fresh Start for the Individual Debtor: The Case for Narrow Construction of the Consumer Credit Amendments*, 135 U. PA. L. REV. 59, 148 (1986) (arguing for this approach for modifications of bankruptcy plans).

financial distress.¹⁰³ For example, a temporary period of unemployment might not lead to bankruptcy unless the debtor has failed to save a sufficient amount to withstand a temporary loss of income.¹⁰⁴ Moreover, a firm may fire a worker in part because of an economic downturn and in part because the worker was not quite as diligent as his co-workers who were retained.

Still, the utopian bankruptcy system can accommodate these mixed-cause shocks as well by focusing on the reasonableness of the debtor's choices. Just as the first-best tax assesses an arbitrarily large amount against those taxpayers who do not invest sufficiently in their future, the utopian bankruptcy system denies relief for these mixed-cause shocks to those debtors who borrow an excessive amount or who otherwise take actions that unreasonably increase the probability of financial distress. Effectively, utopian bankruptcy denies relief to the negligent.¹⁰⁵ Because debtors realize that they will not receive relief if they are negligent, they will only borrow an appropriate amount and take the proper care to avoid financial distress.

2. Projected and Potential Income: How Much Can the Opossum Pay?

The utopian bankruptcy system, like the first-best tax or transfer system, provides individuals with no more relief than they need. In addition, just as the first-best public assistance program gives recipients a lump-sum transfer based on their need and the first-best tax system assesses a lump-sum amount based on taxpayers' ability to pay,¹⁰⁶ the utopian bankruptcy system leaves debtors with a lump-sum obligation based on their ability to pay. A debt obligation is a lump-sum when the amount debtors must pay does not vary with their actual income.¹⁰⁷ Therefore, the utopian bankruptcy system merely adjusts debtors' obligations to a new (lower) level consistent with their ability to pay. That is, in the utopian bankruptcy system the judge projects how much the debtor would earn if the debtor worked the

¹⁰³ See, e.g., Warren, *supra* note 13, at 1081 (describing inability of consumers to withstand shocks, such as divorce or unemployment, due to debt obligations they have incurred).

¹⁰⁴ See *id.*

¹⁰⁵ The debtors' negligence stems from the fact that their borrowing increases the probability of default by an unreasonable amount.

¹⁰⁶ See *supra* notes 20, 48 and accompanying text.

¹⁰⁷ See *supra* notes 48–53 and accompanying text.

efficient amount and decides how much that debtor should retain for consumption.¹⁰⁸

For example, assume that an omniscient judge determines that if the debtor could have specified the amount in advance, he would have chosen to consume \$3,000 per month in bankruptcy. If the omniscient judge determines that the debtor still has a relatively high earnings ability and thus could earn \$7,000 per month if he worked as many hours as he *should*, then the judge would require the debtor to pay \$4,000 per month. If the judge determines that the debtor has suffered a setback that leaves the debtor only able to earn \$4,000 per month if he works as many hours as he *should*, then the judge would require the debtor to pay only \$1,000 per month. The debtor's new obligations equal the amount by which his projected income exceeds the amount that the judge determines the debtor should consume.¹⁰⁹ Because the debtor's new obligations are set with regard to his projected or potential income, the debtor retains the last dollar of his actual income and therefore he will work the efficient amount that the omniscient judge predicted.¹¹⁰

The optimal tax literature generally focuses on the number of hours that a debtor works, but the analysis can readily be applied to other questions as well. Perhaps because the issue strikes so close to home, law professors ask how much a debtor should be required to repay if he chooses an occupation that offers more attractive non-pecuniary benefits over one that offers a higher salary.¹¹¹ For example, assume that an individual can choose to work in private practice at a salary of approximately \$200,000 a year or in academia at a salary of approximately \$100,000 a year. According to the logic of optimal taxation, even though the debtor would earn double the monetary income by working in private practice, he should still pay the same amount that he would have paid had he worked in academia.¹¹² If the amount that debtors must repay depends on their choice of occupa-

¹⁰⁸ See *supra* notes 48-53 and accompanying text.

¹⁰⁹ See *supra* notes 48-53 and accompanying text.

¹¹⁰ This follows from precisely the same logic as used in the optimal tax context. See *supra* notes 48-49 and accompanying text.

¹¹¹ See JACKSON, *supra* note 8, at 246-47; Gross, *supra* note 102, at 136-38.

¹¹² See JACKSON, *supra* note 8, at 246-47 (arguing that if debtors are asked to pay more when their earnings are higher, they may choose jobs with more non-pecuniary benefits such as teaching). But see Gross, *supra* note 102, at 136-38 (arguing that the repayment required in Chapter 13 of the Bankruptcy Code should not be conditioned on what the debtor could earn because this would reduce the debtor's ability to choose alternative occupations and would therefore reduce the voluntary nature of bankruptcy).

tion, bankruptcy may distort their choices and debtors may choose to work as professors even if they would have preferred the added compensation of private practice to the non-pecuniary benefits of academia.

To say that a fixed repayment does not *distort* a debtor's choice does not mean that it will not *affect* the debtor's choice. A law professor, who under normal circumstances would find the compensation more than adequate, may be forced to work in the private sector if required to pay too much to her creditors. Because of this, Professor Gross suggests that the repayment amount should be set with regard to the debtor's occupation at the time of filing so as to preserve the debtor's freedom of choice.¹¹³ A large required repayment, however, only forces the professor into private practice by affecting her wealth, or lack thereof. Clearly one of the benefits of wealth is that it affords an individual greater choices, and a lower repayment increases the debtor's wealth. This is also true of any other transfer of wealth, however, and one still needs a method for determining whether the debtor or her creditors are entitled to this wealth.

In a utopian bankruptcy system, the judge would allow the debtor to keep as much wealth as the debtor would have included in a hypothetical contract chosen at the time of borrowing from behind the veil of ignorance as to the debtor's actual future condition.¹¹⁴ Note that this does not necessarily mean that debtors must always earn as much as they possibly can. It is easier to understand this point if one first focuses on the question of how many hours debtors should work. Debtors would not agree to a contract that could force them to work twenty-four hours a day, seven days a week; all debtors would gladly pay a slightly higher interest rate in exchange for *some* leisure. Likewise, at least some debtors would contract in advance for the right to work in a position that does not yield the highest pecuniary earnings available because they would find the more remunerative alternative occupation intolerable. Whereas in practice it may be extremely difficult to determine what position the debtor would have chosen, in a utopian world an omniscient judge could accomplish this task. Therefore, the omniscient judge would base the debtor's required repayment on the occupation the debtor would have agreed to choose in the event of default. The judge, however, will require the

¹¹³ See Gross, *supra* note 102, at 136–40.

¹¹⁴ See *supra* note 51 and accompanying text.

debtor to repay the same amount regardless of the occupation that the debtor actually chooses.

3. Accounting for Subsequent Shocks

If a judge were truly omniscient and could predict the future, the debtor would never experience an unexpected shock. One might, however, instead adopt a weaker definition of an all-knowing judge and assume that although he can observe the debtor's innate earnings ability, he cannot necessarily predict whether the debtor will experience the same unfortunate shocks that justify bankruptcy: unemployment, illness, divorce, etc.¹¹⁵ If the judge cannot predict future shocks, a bankruptcy system that merely provides the debtor with a new, albeit reduced, debt obligation and no prospect of further relief cannot be optimal. Although such a system may provide the debtor with the appropriate incentives to work hard after filing for bankruptcy, it provides no insurance against future misfortune. Therefore, the utopian bankruptcy system must allow for repetitive bankruptcy filings or modifications of the debts created by the original bankruptcy filing.

The prospect of further distress replicates the justification for bankruptcy but also replicates the grasshopper problem; this further distress may arise either from misfortune or from misbehavior. An omniscient judge can apply the same solutions that are used to solve the grasshopper problem created by the existence of bankruptcy relief.¹¹⁶ Just as before, if the debtor's future losses are always caused entirely by misbehavior or entirely by misfortune, an omniscient judge would simply deny any further relief in the former case and always grant full relief in the latter.¹¹⁷ In the more realistic scenario in which losses are often caused by both misfortune and misbehavior, the omniscient judge would again focus on whether the debtor took

¹¹⁵ Numerous articles in the optimal taxation literature have taken this approach and demonstrate that a lump-sum tax is not necessarily optimal. See, e.g., P.A. Diamond et al., *Optimal Taxation in a Stochastic Economy*, 14 J. PUB. ECON. 1, 6-7 (1980); Jonathan Eaton & Harvey S. Rosen, *Labor Supply, Uncertainty, and Efficient Taxation*, 14 J. PUB. ECON. 365, 365-66 (1980); Joseph E. Stiglitz, *Self-Selection and Pareto Efficient Taxation*, 17 J. PUB. ECON. 213, 213 (1982); Hal R. Varian, *Redistributive Taxation as Social Insurance*, 14 J. PUB. ECON. 49, 66 (1980). The primary purpose of these articles, however, is to accomplish what the standard optimal tax literature largely failed to do: justify progressive marginal income tax rates.

¹¹⁶ See *supra* Part II.A.1.

¹¹⁷ See Gross, *supra* note 102, at 148 (arguing for this approach for modifications of bankruptcy plans).

sufficient care to avoid future losses and deny relief to those that did not.

B. *Second-Best Bankruptcy and the Centrality of Information*

In the utopian bankruptcy system, an omniscient judge solves the grasshopper and opossum problems by identifying and punishing those who misbehave. In the real world, judges are not omniscient. Because of this, and because some individuals may be unable to control their behavior, society may not want to punish all of the grasshoppers. Society, however, does need some method of catching the opossums. How the judge should search for the opossums among us depends on the information that she has at her disposal. A pessimist would assume that judges cannot observe any relevant facts about the debtor except his actual income and that he is indebted.¹¹⁸ Under this view the second-best bankruptcy system looks very much like the second-best tax; it is effectively an income tax. The guarded optimist would assume that although judges are not omniscient, they can sometimes provide a workable estimate of a debtor's potential income, for example, by using the debtor's past income, level of education, or some other observable predictor. Under this view, the second-best bankruptcy system invokes some of the features of the utopian bankruptcy system, but with some adjustments for the limitations of judicial ability.

1. Catching the Grasshoppers: Barring the Willful but Not the Negligent

The above description of the second-best public assistance program assumed that the government could not determine if an indi-

¹¹⁸ The extreme pessimist might even reject the assumption that the judge may observe the debtor's actual income. To some extent this is undoubtedly true. Judges cannot effectively value some forms of economic income, such as the work product of a spouse that stays home to raise the family's children. But this problem is not unique to bankruptcy law; it is a frequent topic among tax scholars. See, e.g., Nancy C. Staudt, *Taxing Housework*, 84 Geo. L.J. 1571, 1577-79 (1996). A more severe pessimist would assert that judges just do not have the resources to observe a bankrupt debtor's actual income after filing. If this is the case, the only method of solving the opossum problem is to punish those who seek relief; those who "can" pay will pay in order to avoid the punishment. See Rea, *supra* note 7, at 195. Perhaps this is a plausible description of Chapter 7, which appears to rely heavily on the threat of a damaged credit reputation to discourage debtors from filing. The use of punishment in a bankruptcy system is left to a future article as it leaves little role for a bankruptcy judge.

vidual took the appropriate steps to avoid her current state of need.¹¹⁹ This assumption probably understates the government's ability. For example, one might believe that the government can identify those individuals who left school early without a good justification or those workers that were fired due to shoddy attendance at work. Nevertheless, public assistance programs generally will not deny relief on these grounds or similar findings that an individual's distress resulted from her own negligent behavior.¹²⁰ Perhaps this refusal to deny relief to the negligent is an unfortunate result of a "Samaritan's dilemma;"¹²¹ altruists cannot credibly commit to denying relief to those that misbehave because the altruists would be unable to live with the resulting suffering.

Private insurance contracts, however, generally take the same approach as public insurance programs.¹²² Private insurance contracts, like public assistance or bankruptcy, create a grasshopper problem because the insured is insulated from the full consequences of her actions that increase the probability or extent of loss.¹²³ A property owner protected by fire insurance may be less inclined to buy a sprinkler system. A law student whose laptop is insured through a homeowner's policy may take fewer precautions against theft. A motorist fully insured against liability may drive more carelessly.

If insurers can observe undesirable behavior before any harm results, they can adjust their premiums accordingly. If the insurer can do so perfectly, the insured will once again bear the full costs of their behavior and they will choose the efficient level of care;¹²⁴ there will be no grasshopper problem. For example, motorists have a strong incentive to drive at a safe speed because their insurance rates will increase if they receive a speeding ticket. As a practical matter, however, the insurer cannot continuously monitor all of the insured's behavior, and thus this approach cannot completely solve the grasshopper problem.

¹¹⁹ See *supra* note 59 and accompanying text.

¹²⁰ See, e.g., ROTHSTEIN ET AL., *supra* note 59, at 771 ("Mere inadvertence or inattention [that led to termination] will normally be insufficient to disqualify unemployment claimants. There must be evidence of intentional misconduct.").

¹²¹ See, e.g., Stephen Coate, *Altruism, the Samaritan's Dilemma, and Government Transfer Policy*, 85 AM. ECON. REV. 46, 46 (1995).

¹²² See, e.g., POLINSKY, *supra* note 74, at 56.

¹²³ See *id.*

¹²⁴ See *id.* at 56-57; STEVEN SHAVELL, *ECONOMIC ANALYSIS OF ACCIDENT LAW* 211 (1987); Gary T. Schwartz, *The Ethics and the Economics of Tort Liability Insurance*, 75 CORNELL L. REV. 313, 337 (1990).

Alternatively, insurers could just exclude coverage for a loss if they discover that the insured failed to take sufficient care and was therefore negligent. As long as the insurer sets the standard of care correctly, the insured would then always maintain the proper level of care for fear that if he took less care he would receive no insurance at all. This is the same principle as the tort law's use of a negligence theory of liability.¹²⁵ Thus, there would be no reason for the debtor to buy insurance against liability based solely on negligence as it would always be cheaper to take the efficient level of care than to buy insurance against the loss.¹²⁶

At least from the beginning of the twentieth century, however, individuals have been able to purchase insurance against the consequences of their own negligence,¹²⁷ and today such insurance is common. Property insurance protects the insured against accidental loss.¹²⁸ Fire insurance will pay a claim even if the insured negligently started the fire.¹²⁹ In addition, individuals buy insurance against liability based on negligence principles. Individuals buy homeowner's insurance policies that include protections against liability that generally requires a finding of negligence.¹³⁰ Today, many states effectively require motorists to buy insurance against the liability that results from their own negligence,¹³¹ and many motorists voluntarily buy insurance that far exceeds the minimum amount required by statute.

Scholars advance two primary arguments for why the market offers insurance against negligent behavior; both are based on human imperfections. First, an individual might buy insurance based on the belief that the risk of liability cannot be avoided by taking the proper level of care. A system that denies relief due to negligent behavior re-

¹²⁵ See, e.g., SHAVELL, *supra* note 124, at 8.

¹²⁶ See, e.g., *id.* at 212.

¹²⁷ See, e.g., *Breeden v. Frankfort Marine, Accident & Plate Glass Ins. Co.*, 119 S.W. 576, 576 (Mo. 1909).

¹²⁸ See ROBERT E. KEETON & ALAN I. WIDISS, *INSURANCE LAW: A GUIDE TO FUNDAMENTAL PRINCIPLES, LEGAL DOCTRINES, AND COMMERCIAL PRACTICES* 497 (1988). Some courts, however, have suggested in dicta that grossly negligent or reckless conduct could bar recovery. See *id.* at 539-41.

¹²⁹ See *id.* at 492. Some courts, however, have suggested in dicta that grossly negligent or reckless conduct could bar recovery. *Id.* at 492-93.

¹³⁰ See Schwartz, *supra* note 124, at 344. Homeowner's insurance policies also protect the homeowner against other risks as well.

¹³¹ See, e.g., RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 221 (5th ed. 1998) ("Automobile liability insurance is now almost universal, although this is partly because states required drivers to buy liability insurance or present equivalent evidence of financial responsibility for accidents.").

lies on judges and juries to make difficult decisions about whether the individual took the proper level of care, and the trier of fact may sometimes incorrectly deny relief.¹³² Second, and more controversially, individuals might buy insurance based on the belief that they can't always maintain the proper level of care.¹³³ To understand the distinction between these two explanations, consider why drivers buy more than the minimum required liability insurance. The demand for insurance stems at least in part from the fear that a jury would wrongly find that the driver negligently caused an accident. The demand, however, may also stem from the fear that the driver may become momentarily distracted by his child and fail to see a red light.

The insurer who issues a policy that protects the insured against his own negligence must charge higher premiums to account for the increased chance that the insured will suffer a loss and file a claim. In order to mitigate this grasshopper problem, and thus pay lower premiums, the insured agrees to face *some* of the consequences of his negligence; the insured only buys partial insurance.¹³⁴ For example, private insurance contracts often require the insured to pay a deductible to cover part of any loss.¹³⁵ In addition, the insurance policy may not cover all of the harms that are likely to result from the insured's negligence. Some forms of automobile liability insurance decline to cover the damage to the negligent motorist's own vehicle. Health insurance will not pay the insured for the pain of the insured's illness. Finally, the fact that the insured will need insurance in the future also gives the insured an incentive to take care. For example, a motorist found to have negligently caused an accident will pay higher insurance premiums in the future. If the insured has too many accidents, the insured may be unable to buy insurance altogether.

If one views bankruptcy as just another form of insurance, then one might reject the utopian goal of denying relief to negligent debtors. Although bankruptcy judges may be wise, they are clearly not omniscient and therefore will make errors. For example, to the extent that many bankrupt debtors borrowed too much to allow them to withstand a financial shock such as unemployment or divorce,¹³⁶ a bankruptcy judge would be forced to rule on whether a debtor's borrowing choices were reasonable in light of the debtor's financial pros-

¹³² See SHAVELL, *supra* note 124, at 212; Schwartz, *supra* note 124, at 344-45.

¹³³ See Schwartz, *supra* note 124, at 347.

¹³⁴ See, e.g., POLINSKY, *supra* note 74, at 57.

¹³⁵ See *id.*

¹³⁶ See, e.g., Warren, *supra* note 13, at 1084.

pects. A judge viewing the debtor's decision with the benefit of hindsight may incorrectly rule against the debtor.

In some cases, however, debtors will have clearly spent their way into bankruptcy, leaving little room for judicial error. Nevertheless, the second-best bankruptcy system may grant relief to the spendthrift if society believes that some debtors are just unable to resist the temptation of easy credit. Certainly there is support for this theory in the literature. Professor Jackson argues that the need for bankruptcy is largely based on cognitive and volitional failures among debtors that prevent them from making the right credit decisions.¹³⁷ Others argue that society should encourage creditors to restrict access to credit, presumably because debtors are unable to determine when borrowing is in their self-interest.¹³⁸

This does not mean that the second-best bankruptcy system ignores the grasshopper problem. But because this system cannot distinguish between the grasshoppers and the truly unfortunate, society must make bankruptcy less attractive so that individuals have some incentive to avoid financial distress.¹³⁹ The repeat nature of credit markets, like the repeat nature of insurance markets, will provide some help. Just as the insured takes care to avoid the increased premiums that follow an accident, the debtor will take care to avoid the increased interest rates and loss of credit that follow bankruptcy.

The threat of reduced access to credit, however, is only a partial solution, and just as insurance contracts require the payment of deductibles and insure only part of the debtor's loss, the second-best bankruptcy must also offer only partial insurance. That is, the second-best bankruptcy system must be less generous than the utopian bankruptcy system so that debtors will face some of the consequences of actions that make financial distress more likely. Exactly how much relief the second-best bankruptcy system should provide is a matter of compromise. In the private insurance context, society does not need to worry about the correct level of partial insurance so long as the insurance contract has no negative effects on third parties;¹⁴⁰ the insured and the insurer will agree to the most mutually beneficial terms.

¹³⁷ See JACKSON, *supra* note 8, at 232-41.

¹³⁸ See, e.g., Braucher, *supra* note 13, at 6-8.

¹³⁹ By making bankruptcy less generous, society forces debtors to bear more of the costs of their financial failure and thus provides debtors with an incentive to avoid financial distress.

¹⁴⁰ See, e.g., Schwartz, *supra* note 124, at 351 (discussing the under-compensation of victims in the tort system).

Unfortunately, the optimal bankruptcy system, like the optimal tax and public assistance programs, is only part of a *hypothetical* contract, and therefore the correct level of partial insurance is debatable.¹⁴¹

So far, this Article has treated the grasshopper problem as a function of negligence. Financial distress, however, results from far more culpable conduct as well. At the other extreme, the debtor may face a judgment for a willful tort such as sexual assault. Here the analogy to private insurance again provides some guidance.

While private insurance contracts protect debtors from the consequences of their own negligence, these contracts do not protect debtors from the consequences of their own willful misconduct. Private insurance contracts almost always contain some clause excluding liability for intentional acts.¹⁴² Even in the absence of such a clause, courts will often find an implied exception for intentional conduct,¹⁴³ and a contract that purported to insure an individual against willful misconduct would likely be held void as against public policy.¹⁴⁴ Therefore, if a homeowner intentionally sets fire to his house, fire insurance will not reimburse him.¹⁴⁵ If a motorist intentionally hits a pedestrian, automobile insurance would not pay for the damages that would result¹⁴⁶ and would certainly not prevent the driver from serving time in prison.

Public insurance programs often take this same approach. For example, unemployment insurance will deny benefits if the unemployed has engaged in willful misconduct such as a work-related fel-

¹⁴¹ See, e.g., Adler et al., *supra* note 13, at 608-09 (discussing trade-off between the generous treatment of a debtor in bankruptcy and the effect that this generosity has on the debtor's incentives to avoid financial distress).

¹⁴² See KEETON & WIDISS, *supra* note 128, at 498 ("Insurance policies typically include express provisions which either require that a loss be accidental or preclude coverage for intended results."); Willy E. Rice, *Insurance Contracts and Judicial Discord over Whether Liability Insurers Must Defend Insureds' Allegedly Intentional and Immoral Conduct: A Historical and Empirical Review of Federal and State Courts' Declaratory Judgments—1900–1997*, 47 AM. U. L. REV. 1131, 1145–46 (1998) (describing the main components and clauses of a third-party liability insurance contract); D. Heath Bailly, Note, *Auto-Owners Insurance Co. v. Harrington: Resisting the Impulse to Judicially Rewrite Exclusion Clauses*, 1998 BYU L. REV. 1645, 1645–46 (1998) (stating that insurance companies protect themselves through the use of an intentional acts exclusion clause).

¹⁴³ See KEETON & WIDISS, *supra* note 128, at 498 ("Thus, as discussed in the preceding section, courts frequently have held that even in the absence of express provisions, insurance contracts only provide coverage for accidental losses.").

¹⁴⁴ See, e.g., *id.* at 519 (citing *Ambassador Ins. Co. v. Montes*, 388 A.2d 603, 606 (N.J. 1978)).

¹⁴⁵ *Id.* at 516.

¹⁴⁶ See *id.* at 518.

only or misdemeanor.¹⁴⁷ Therefore, one might conclude that bankruptcy should deny relief for willful misconduct as well. This assumption, however, is discussed more fully below.¹⁴⁸

2. Catching the Opossums: The Pessimist and the Guarded Optimist

The utopian bankruptcy system assumes that the judge can perfectly estimate a debtor's earnings ability or *potential* earnings. To the extent that one rejects this assumption, one rejects the feasibility of a bankruptcy system based on debt-adjustment just as economists generally reject the feasibility of a progressive lump-sum tax.¹⁴⁹ If a judge cannot distinguish the high-ability debtors from the low-ability debtors, a debt-adjustment system must leave all debtors with the same amount of debt or else those with a high-ability will just "play 'possum" and claim that they cannot repay anything.¹⁵⁰ Such a scheme would fail to meet the insurance goals assumed to underlie bankruptcy. Therefore, one must search for a feasible second-best approach. What one considers feasible depends on one's assumptions about the actual ability of judges to identify the opossums among us.

a. *The Pessimist and Income Taxes*

Even though pessimists would reject the assumption that judges can observe a debtor's *potential* earnings, they would likely concede that the bankruptcy judge can observe the debtor's *actual* earnings after the bankruptcy filing. This is essentially the same assumption that underlies the analysis of the second-best tax,¹⁵¹ and a similar result follows. According to the pessimist, the second-best bankruptcy

¹⁴⁷ See, e.g., ROTHSTEIN ET AL., *supra* note 59, at 771.

¹⁴⁸ See *infra* notes 246–288 and accompanying text.

¹⁴⁹ See *supra* note 47 and accompanying text.

¹⁵⁰ This statement ignores the use of punishment to separate those debtors who can pay from those who cannot. By punishing the debtor when he defaults, one can again implement a system that provides some relief for the destitute debtor. See, e.g., Rea, *supra* note 7, at 193. Punishment may play a large role in bankruptcy. For example, the threat of the loss of a debtor's credit reputation may deter those debtors who can repay from filing for bankruptcy. This use of punishment is only appropriate in the absence of information. See Welch, *supra* note 98, at 1–2. It is entirely possible that the size of bankruptcy judges' dockets prevents them, or even bankruptcy trustees, from inquiring as to the specific circumstances of most debtors, and therefore a punishment-based system is needed. This Article, however, focuses on the question of how judges should act if they had at least some information about a debtor's ability to pay. Moreover, this reliance on punishment assumes that judges effectively play no role in the bankruptcy process. Therefore, this Article leaves the role of punishment in bankruptcy to future work.

¹⁵¹ See *supra* notes 54–59 and accompanying text.

system would increase the debtor's required repayment as the debtor's actual income increased; the second-best bankruptcy system would effectively include an income tax.¹⁵² This system allows some limited relief because the high-ability debtor would need to earn, and therefore consume, very little in order to "play 'possum" by emulating the low-ability individual. The precise characteristics of this effective income tax, like the precise characteristics of the second-best income tax, balance the individual's need for insurance against the unfortunate consequences that income taxes have on an individual's desire to work.¹⁵³

b. *The Guarded Optimist and Subsequent Modifications*

A guarded optimist would believe that the pessimist understates the ability of judges to estimate a debtor's potential income. Some debtors will work in occupations that yield a fairly regular or stable stream of income over a number of years, and the income history of these debtors, along with other observable characteristics such as level of education, may provide a fairly good basis for estimating their potential earnings. The judge, however, can never perfectly estimate future or potential earnings; the size of a debtor's bonus or the number of overtime hours available to him may change from year to year. More seriously, the debtor may lose his job or may earn a promotion or a substantial raise.

Because the guarded optimist assumes a level of information greater than that underlying the pessimist's view of the second-best bankruptcy system and yet less than that needed to implement the utopian bankruptcy system, the guarded optimist would choose a bankruptcy system that blends the two approaches. Recall that the utopian bankruptcy system bases debtors' required repayment solely on their *potential* income and that the pessimist's second-best bankruptcy bases debtors' required repayment solely on their *actual* in-

¹⁵² See *supra* notes 54-59 and accompanying text.

¹⁵³ The analysis of the proper rates for this effective income tax is a little more complicated than in the tax analysis and more closely resembles the analysis of the effective rates that should be included in second-best public assistance programs. That is, one must consider not only the effect that the effective tax has on the work incentives of those receiving relief but also on the work incentives of those not receiving relief. Because lower effective tax rates may encourage some individuals to work a little less in order to begin receiving relief, one cannot even conclude that an effective tax rate of 100% discourages work in the aggregate. See *infra* note 406 and accompanying text.

come.¹⁵⁴ An intermediate approach would base the debtor's required repayment on the judge's estimate of the debtor's potential income, but then allow for further modifications if the debtor's actual income deviated sharply from this estimate. If judges never modify the initial obligation, this is just the utopian bankruptcy system as the required repayment is based solely on the debtor's projected earnings.¹⁵⁵ If judges always modify the obligation when the debtor's actual income deviated from the estimate, this is just the pessimist's bankruptcy system as the required repayment is based solely on the debtor's actual earnings.¹⁵⁶

Recall that if judges are not truly omniscient in that they cannot perfectly predict the future, the utopian bankruptcy system includes modifications or subsequent bankruptcies to account for unexpected shocks.¹⁵⁷ The utopian system would always adjust debtors' required repayment when the change in their circumstances was entirely due to fate and never adjust debtors' required repayment when the debtors themselves caused the change or when the debtors failed to work hard enough to avoid the ensuing financial difficulties.¹⁵⁸ That is, the utopian bankruptcy system adopts the same negligence standard to solve the grasshopper problem in the context of modifications that it adopts to solve the grasshopper problem in general.¹⁵⁹

The guarded optimist, however, does not advocate the strict use of a negligence standard in bankruptcy and would not advocate for its use in the modification context either. Just as judges may be unable to determine whether debtors' negligent misbehavior resulted in their initial financial distress, they may be unable to determine if the debtors' misbehavior led to the need for further relief.

Recognizing the limited ability of a judge to determine if the change in the debtor's circumstances resulted from fate or the debtor's own efforts, or lack thereof, the guarded optimist might advocate a system that modifies a debtor's required repayment only after a substantial change in the debtor's circumstances. Many small changes in a debtor's income, such as the income resulting from a few extra hours of overtime or a slightly larger bonus, are probably the direct result of the debtor's own efforts. Bankruptcy should not mod-

¹⁵⁴ See *supra* notes 20, 62 and accompanying text.

¹⁵⁵ See *supra* note 20 and accompanying text.

¹⁵⁶ See *supra* note 62 and accompanying text.

¹⁵⁷ See *supra* notes 115–117 and accompanying text.

¹⁵⁸ See *supra* notes 115–117 and accompanying text.

¹⁵⁹ See *supra* notes 115–117 and accompanying text.

ify a debtor's required repayment in response to these changes so that the debtor retains the incentive to work hard.¹⁶⁰ Of course, some small changes in financial condition, such as costs associated with a broken small appliance, are the result of chance and therefore, ideally, should be insured. Nevertheless, by definition these changes are small and therefore the debtor has little need for the insurance.

By contrast, larger changes in a debtor's financial condition may involve a greater element of chance. Workers may to a large extent earn promotions, raises, or large bonuses. Their success, however, also depends on the efforts of their co-workers and the overall success of their firm. Likewise, workers who shirk are more likely to be fired. Nevertheless, macroeconomic forces clearly play a role as is evidenced by the cyclical nature of unemployment.¹⁶¹

The claim that larger changes in the debtor's financial condition are more likely to result from chance than are small changes is an empirical assertion and no proof is offered. But even if this assertion is incorrect, one might still prefer a system that only modifies the debtor's obligations following a large change in the debtor's circumstances. These large changes will occur only infrequently and involve large sums of money. Therefore, it will be cost effective for a judge to at least conduct an inquiry as to whether the change was caused by fate or the debtor's own efforts and perhaps judges are correct just often enough to make such an inquiry worthwhile.¹⁶²

¹⁶⁰ This effect is probably even more dramatic if one focuses on a debtor's disposable income, or income net of expenses. If bankruptcy adjusted for any small change in the debtor's income after expenses, the debtor would have no incentive to live more frugally.

¹⁶¹ For example, in 1992 the unemployment rate was at or above 7.3% each month. See Bureau of Labor Statistics, U.S. Dep't of Labor, Labor Force Statistics from the Current Population Survey, available at <http://data.bls.gov/cgi-bin/surveymost> (last visited Sept. 9, 2002). In 2000, the unemployment rate was at or below 4.1% each month. *Id.*

¹⁶² The family law context provides an interesting analogy. Most states set child support payments equal to the percentage of the parent's income that the child would have received had the family remained together. Barbara R. Rowe & Kay W. Hansen, *Child Support Awards in Utah: Have Guidelines Made a Difference?*, 21 J. CONTEMP. L. 195, 200 (1995). This "income share" model, however, does not require a change in child support payments from month to month as the parent's income changes. Rather the court sets a fixed dollar obligation based on the parent's income at the time of the hearing. See generally NAT'L CENTER FOR STATE COURTS, A SUMMARY OF CHILD SUPPORT GUIDELINES 11 (1990). The parties can seek a modification of the child support obligations, but unless a substantial amount of time has elapsed (often about three years), the moving party usually must show that the amount awarded would change by at least 10%. See *id.* at 17.

III. USING THE OPTIMAL BANKRUPTCY ANALYSIS TO INTERPRET THE CURRENT BANKRUPTCY CODE

Part II described the optimal bankruptcy procedure in the abstract. This Article seeks, however, to offer guidance to real judges who must interpret an existing Bankruptcy Code. Using the analysis of Part II as a guide, this Part argues that courts should interpret the existing Bankruptcy Code in a way that accounts for the moral hazards created by the bankruptcy system. Most courts have already shown a great willingness to improvise when interpreting an imperfect code, and a few have even been willing to ignore the plain meaning of the text of the code.¹⁶³ In many cases, however, the language of the code is either ambiguous or expressly invites bankruptcy judges to use their discretion to account for debtor misbehavior. In such circumstances, courts could address many of the opossum and grasshopper problems identified in this Article while still remaining fairly faithful to the text of the code.

Since this Article discusses how courts should interpret specific provisions of the Bankruptcy Code, Part III-A provides a brief introduction to collections law that will place these provisions in the proper context. Part III-B discusses how courts should address the grasshopper problem, and Part III-C discusses how they should address the opossum problem.

A. A Brief Description of Collections Law

A complex web of state and federal laws regulate collections in modern America. Most consumers who fail to repay their debts probably do not file for bankruptcy.¹⁶⁴ Instead, they rely on state and federal non-bankruptcy laws to protect them from their creditors.¹⁶⁵ For example, federal law limits the manner in which a collections

¹⁶³ See *infra* note 328 and accompanying text.

¹⁶⁴ See, e.g., AM. BANKERS ASS'N, 1997 INSTALLMENT CREDIT SURVEY REPORT 109 (9th ed. 1997) (reporting that approximately 70% of all bank consumer credit losses occur outside of bankruptcy). Of course, this is a percentage of the dollar amount of outstanding obligations rather than individuals, and it is possible that some individuals might file for bankruptcy long after their creditors accounted for their debt as unlikely to be repaid. This figure, however, clearly implies that a large number of debtors who refuse to repay their loans do not file for bankruptcy. See *id.*

¹⁶⁵ Americans also have a long tradition of simply hiding from their creditors, a tradition that continues today. See, e.g., Jean Braucher, *Lawyers and Consumer Bankruptcy: One Code, Many Cultures*, 67 AM. BANKR. L.J. 501, 524 (1993) (noting that lawyers sometimes advise their clients to evade their creditors by moving or changing their telephone numbers).

agency may contact a debtor¹⁶⁶ and limits the amount of a debtor's wages that creditors can garnish to no more than 25% of the debtor's after-tax income.¹⁶⁷ Some state laws restrict garnishment even further or prohibit it altogether.¹⁶⁸ Both state and federal laws also limit the amount and type of physical property that the sheriff can seize to satisfy a creditor's claim.¹⁶⁹ Though property exemption laws vary considerably from state to state,¹⁷⁰ they usually offer at least some protection to debtors for certain types of assets such as their homes,¹⁷¹ their cars,¹⁷² and their tools.¹⁷³ Any theory of bankruptcy must consider the existence of these non-bankruptcy laws.

While non-bankruptcy collections law remains extremely important, scholars now focus more heavily on bankruptcy.¹⁷⁴ As a practical matter, there are two forms of consumer bankruptcy: a Chapter 7 liquidation and a Chapter 13 adjustment of debts.¹⁷⁵ A substantial majority of bankrupt Americans choose a liquidation under Chapter 7.¹⁷⁶ Chapter 7 provides debtors with a full discharge of most unsecured debts,¹⁷⁷ thereby absolving debtors of the need to repay out of their

¹⁶⁶ Fair Debt Collections Practices Act, 15 U.S.C. §§ 1692–1692o (2000).

¹⁶⁷ *Id.* §§ 1672–1673 (restricting garnishment in favor of general creditors to no more than the lesser of 25% of debtors' disposable earnings or the amount by which their disposable earnings exceeds thirty times the federal minimum wage. "Disposable earnings" is defined in this context to mean roughly the debtor's take-home pay).

¹⁶⁸ *See, e.g.*, TEX. PROP. CODE ANN. § 42.001(b)(1) (Vernon 2002) (exempting current wages for personal services).

¹⁶⁹ *See infra* notes 170–173 and accompanying text.

¹⁷⁰ *See, e.g.*, Eric A. Posner et al., *The Political Economy of Property Exemption Laws* 5–6 (Sept. 19, 2001) (working paper, on file with the author) (describing property exemption laws).

¹⁷¹ *See, e.g.*, CAL. CIV. PROC. CODE § 704.730 (West Supp. 2002) (allowing homestead exemptions between \$50,000 and \$125,000, depending on household composition).

¹⁷² *See, e.g., id.* § 704.010 (providing a \$1,900 exemption of equity in a motor vehicle).

¹⁷³ *See, e.g., id.* § 704.060 (providing a \$5,000 exemption for tools).

¹⁷⁴ For example, in one of the leading casebooks on debtor-creditor law only approximately 157 of 1043 pages are devoted to non-bankruptcy collections. *See* WARREN & WESTBROOK, *supra* note 86, at 3–1043.

¹⁷⁵ Individual debtors may also file under Chapter 11. In 2000, however, only 686 of over 1,217,000 non-business bankruptcy filings (less than .05 of 1%) were filed under Chapter 11. *See* Am. Bankr. Inst., *Non-Business Bankruptcy Filings by Chapter, 1990–2001, per Quarter*, available at <http://www.abiworld.org/stats/1990nonbuschapter.html> (last visited Sept. 9, 2002).

¹⁷⁶ For example, in the year 2000 approximately 69% of all non-business bankrupt debtors chose Chapter 7. *See id.*

¹⁷⁷ Some debts are excepted from discharge. *See* 11 U.S.C. § 523 (2000) (amended by Pub. L. No. 107–204, Tit. XIII, § 803, 116 Stat. 745, 801 (2002)). Secured debts, such as a home mortgage or an automobile loan, must be repaid in full if the debtor is to retain the collateral. *See id.* § 724(b). Therefore, many debtors reaffirm these obligations and the debts survive the discharge. *See, e.g.*, Culhane & White, *supra* note 14, at 713 (finding that

future income. In theory, the Chapter 7 debtor receives this discharge in exchange for a damaged credit reputation and the loss of any assets not protected either by state property exemptions or certain bankruptcy specific exemptions available in a few states.¹⁷⁸ In reality, manipulable¹⁷⁹ and generous¹⁸⁰ property exemptions ensure that only a tiny fraction of Chapter 7 debtors forfeit any assets to their general unsecured creditors.¹⁸¹

Anyone can file for relief under Chapter 7; one need not even be insolvent. Nevertheless, Chapter 7 does not offer effective relief to some debtors either because they would lose significant assets¹⁸² or

25% of cases sampled had a reaffirmation agreement in the file); Warren, *supra* note 14, at 499 (claiming that more than 40% of debtors reaffirm some debt).

¹⁷⁸ The Bankruptcy Code gives the debtor the choice of the property exemptions of the state in which the debtor lives or certain uniform bankruptcy exemptions. See 11 U.S.C. § 522(b) (1978). Section 522(d), however, also gives the states the right to "opt-out" and deny their debtors the use of the uniform exemptions. See *id.* § 522(d). Thirty-seven states have chosen to "opt-out" under § 522(d). See Posner et al., *supra* note 170, at 16.

¹⁷⁹ See, e.g., Warren, *supra* note 14, at 495 ("Exemptions were designed to help ensure that families were not put out of their homes in times of temporary financial reversal, but they have become investment vehicles for savvy debtors to protect significant cash assets from creditors.") (citation omitted).

¹⁸⁰ For example, twenty-three states allowed married couples to exempt at least \$60,000 of home equity. See, e.g., 14 MARK BANE ET AL., COLLIER ON BANKRUPTCY AL-1-WY-4 (Lawrence P. King et al. eds., 15th rev. ed. 1996 & Supp. 2001) (listing the homestead exemptions of each state). By contrast, in 1995 the median home equity for all families with a head of household at least twenty-five years of age was less than \$15,000. See Joseph M. Anderson, U.S. Dep't of Commerce, The Wealth of U.S. Families: Analysis of Recent Census Data 6 (Nov. 10, 1999), available at <http://www.bls.census.gov/sipp/workpapr/wp233.pdf>.

¹⁸¹ See Bankr. Admin., U.S. Gen. Accounting Office, Case Receipts Paid to Creditors Professionals 1-2 (1994) (on file with the United States General Accounting Office, Washington, D.C.) ("Of the 1.2 million Chapter 7 bankruptcy cases closed in statistical years 1991 and 1992, about 5% (56,994) generated some receipts for distribution to professionals and creditors."); see also WARREN & WESTBROOK, *supra* note 86, at 426 ("The property exemptions may make little difference because the debtors who file for bankruptcy may not own much of value that isn't already mortgaged to the hilt."). These figures may overstate the repayment in Chapter 7 as they include business bankruptcies filed in Chapter 7 and business bankruptcies account for nearly eighty percent of all creditor receipts in Chapter 7. See NBRC REPORT, *supra* note 90, at 137. This does not mean that consumers repay nothing in Chapter 7; they will often repay their secured creditors or reaffirm their secured loans.

¹⁸² Although almost no debtors in Chapter 7 have non-exempt assets, it is possible that bankrupt debtors who do have assets choose another chapter in order to retain their property. See Ian Domowitz & Robert L. Sartin, *Determinants of the Consumer Bankruptcy Decision*, 54 J. FIN. 403, 416-17 (1999) [hereinafter *Determinants*]; Ian Domowitz & Robert L. Sartin, *Incentives and Bankruptcy Chapter Choice: Evidence from the Reform Act of 1978*, 28 J. LEGAL STUD. 461, 477-82 (1999) [hereinafter *Incentives*] (finding debtors with more equity in their home or car were more likely to choose Chapter 13); Romona K.Z. Heck, *An Econometric Analysis of Interstate Differences in Nonbusiness Bankruptcy and Chapter Thirteen*

because they have significant debts that they could not discharge in Chapter 7.¹⁸³ Moreover, there is some evidence that bankruptcy judges and lawyers in some jurisdictions steer debtors away from Chapter 7.¹⁸⁴ Finally, the code allows judges to dismiss Chapter 7 filings that are a substantial abuse of the Bankruptcy Code.¹⁸⁵ Congress added this provision in 1984 following extensive lobbying by creditors¹⁸⁶ who were concerned with what they perceived to be a large increase in the number of bankruptcy filings¹⁸⁷ and who wanted to force more debtors to either choose Chapter 13 or avoid bankruptcy altogether. This provision, however, does not appear to have had its desired effect as the number of bankruptcy filings has sharply increased,¹⁸⁸ the ratio of Chapter 7 to Chapter 13 filings has remained fairly stable,¹⁸⁹ and the rate at which bankrupt debtors repay unsecured creditors remains close to zero.¹⁹⁰ As a consequence, the con-

Rates, 15 J. CONSUMER AFF. 13, 13-16, 29-30 (1981) (examining factors influencing state Chapter XIII rates under the Federal Bankruptcy Act); Jon P. Nelson, *Consumer Bankruptcy and Chapter Choice: State Panel Evidence*, 17 CONTEMP. ECON. POL'Y 552, 553, 560 (1999). In addition, in Chapter 7 debtors risk losing their most valuable assets—such as their car or their home—unless they can either repay their secured claims in full or can convince their secured creditors to allow them to reaffirm their debts. See 11 U.S.C. § 724(b).

¹⁸³ See 11 U.S.C. § 523.

¹⁸⁴ There is some empirical support for this proposition in that scholars are unable to explain differences in choice of chapter by other theories tested. See, e.g., Teresa A. Sullivan et al., *Consumer Bankruptcy in the United States: A Study of Alleged Abuse and of Local Legal Culture*, 20 J. CONSUMER POL'Y 223, 244-45 (1997) [hereinafter *Study of Abuse*]; Teresa A. Sullivan et al., *The Persistence of Local Legal Culture: Twenty Years of Evidence from the Federal Bankruptcy Courts*, 17 HARV. J.L. & PUB. POL'Y 801, 806, 830 (1994) [hereinafter *Persistence*] (interpreting inability to explain variation in percentage of bankrupt debtors choosing Chapter 13 in different bankruptcy districts to be evidence of the importance of a local legal culture).

¹⁸⁵ See 11 U.S.C. § 707(b) (2000).

¹⁸⁶ See, e.g., Gross, *supra* note 102, at 77-85 (describing lobbying efforts leading to amendments to Bankruptcy Code in 1984).

¹⁸⁷ In 1978, there were 172,000 non-business bankruptcy filings. See Michelle J. White, *Personal Bankruptcy Under the 1978 Bankruptcy Code: An Economic Analysis*, 63 IND. L.J. 1, 29 (1987-1988). By 1984 this figure had risen to 284,517. See Bankruptcy Filings 1980-2001, *supra* note 93.

¹⁸⁸ Between 1984 and 2001 the number of non-business bankruptcy filings rose from 284,517 to 1,452,030. See Bankruptcy Filings 1980-2001, *supra* note 93.

¹⁸⁹ In 1984, approximately 68.8% of non-business filings were made under Chapter 7. See Am. Bankr. Inst., Annual U.S. Non-Business Bankruptcy Filings by Chapter 1980-1984, at <http://www.abiworld.org/stats/1980stateannualnonbuschapter.html> (last visited Sept. 22, 2002) [hereinafter Non-Business Bankruptcy Filings 1980-1984]. By 2001 this figure had risen to 70.1%. See Am. Bankr. Inst., Annual U.S. Non-Business Bankruptcy Filings by Chapter 2000-2001, at <http://www.abiworld.org/stats/00stateannualnonbuschapter.html> (last visited Sept. 22, 2002).

¹⁹⁰ See *supra* note 181 and accompanying text.

sumer credit industry is again pushing for reforms, commonly called "means testing," that would force more debtors into Chapter 13.¹⁹¹ Whether these reforms would have any effect remains an open question.¹⁹²

Unlike Chapter 7, Chapter 13 is not open to all debtors. Chapter 13's predecessor, Chapter XIII of the Bankruptcy Act of 1898,¹⁹³ was restricted to "wage earners."¹⁹⁴ In 1978, Congress broadened eligibility for Chapter 13 to all individuals with regular income and debts below certain ceilings.¹⁹⁵ As discussed below, the meaning of the term "regular income" has important implications for the feasibility of a reorganization-based approach to bankruptcy.¹⁹⁶

Debtors filing under Chapter 13 propose plans that require them to make a series of payments for a period of up to five years.¹⁹⁷ The judge will approve the plan if it is proposed in good faith, is feasible, and meets certain repayment requirements.¹⁹⁸ If debtors make their payments, the judge grants them a discharge of their remaining debts, with relatively few exceptions.¹⁹⁹ Chapter 13 offers debtors a superdischarge that is broader than the discharge available in Chapter 7.²⁰⁰

¹⁹¹ See, e.g., Warren, *supra* note 14, at 486–88, 492–93 (describing the lobbying efforts of the consumer credit industry).

¹⁹² See 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, 31 (1999) (finding that only 3.6% of debtors would be classified as "can pay" under the statute); Jones & Zywicki, *supra* note 13 (discussing Culhane & White as well as other studies that find a greater fraction of debtors that can pay).

¹⁹³ Section 74 was passed in the Act of March 3, 1933, Ch. 204, 47 Stat. 1467 (repealed 1938). It was later revised and incorporated into Chapters XI, XII and XIII in the Chandler Act of June 22, 1938, Pub. L. No. 75–696, 52 Stat. 840–940 (1938) *repealed by Bankruptcy Reform Act of 1978*, Pub. L. No. 95598, 92 Stat. 2549 (1978).

¹⁹⁴ Bankruptcy Act of 1898, Pub. L. No. 696, 30 Stat. 544, § 606 (repealed 1978).

¹⁹⁵ Chapter 13 is restricted to individual debtors (other than stockbrokers and commodity brokers) with regular income who have non-contingent, liquidated unsecured debts of less than \$290,525 and non-contingent, liquidated secured debts of less than \$871,550. 11 U.S.C. § 109(a), (e) (2000) (dollar amounts updated by revision of certain dollar amounts in the Bankruptcy Code prescribed under § 104(b) of the Code, 66 Fed. Reg. 10,910, 10,911 (Feb. 20, 2001)).

¹⁹⁶ See *infra* notes 371–406 and accompanying text.

¹⁹⁷ 11 U.S.C. § 1322(d). Debtors may propose plans that will last less than three years if they will repay their creditors in full, but this is rare. See *In re Leser*, 939 F.2d 669, 672–73 (8th Cir. 1991) (quoting *In re Davidson*, 72 B.R. 384, 387 (Bankr. D. Colo. 1987) (commenting that plans providing for 100% payout are relatively rare)). Bankruptcy practitioners usually use the terms "thirty-six months" or "sixty months" instead of "three years" or "five years."

¹⁹⁸ See 11 U.S.C. § 1325.

¹⁹⁹ See *id.* § 1328(a).

²⁰⁰ Compare *id.* § 1328(a), with *id.* § 727(a)–(e).

Chapter 13's predecessor, Chapter XIII, required debtors to obtain the consent of each of their secured creditors and the majority of their unsecured creditors before judges would approve their plan.²⁰¹ As a consequence, virtually all Chapter XIII plans offered full repayment to all creditors, though often without interest.²⁰² Today, Chapter 13 plans that propose full repayment, even without interest, appear to be more the exception than the norm,²⁰³ and a series of code provisions determine the amount that a debtor must repay.²⁰⁴

Court fees²⁰⁵ and priority claims, including certain tax and family law claims,²⁰⁶ must be paid in full. The debtor will also lose any collateral held by a secured creditor unless the plan provides for the full repayment of the secured claim, though perhaps without interest, or the secured creditor agrees to accept less.²⁰⁷ Because, however, the

²⁰¹ 11 U.S.C. §§ 1051, 1052 (1970). Incidentally, the composition agreements made possible by the 1874 Amendments to the Bankruptcy Act of 1867 required creditor consent of the majority of creditors in number and three-fourths in value. See Ch. 390, § 17, 18 Stat. 183 (1874) (repealed 1878).

²⁰² One survey found that approximately 99% of Chapter XIII plans proposed to pay all debts in full. DAVID T. STANLEY & MARJORIE GIRTH, *BANKRUPTCY: PROBLEM, PROCESS, REFORM* 94 (1971); accord B. WEINTRAUB & A. RESNICK, *BANKRUPTCY LAW MANUAL* ¶ 9.01, at 9-3 (2d ed. 1986). The consent requirement gave creditors significant bargaining power because many of the protections now afforded debtors in non-bankruptcy law did not exist during the term of the Bankruptcy Act or were introduced relatively late in its tenure. For example, prior to a Supreme Court ruling in 1969, many states allowed unsecured creditors to attach property of the debtor prior to a judgment or even a hearing. See *Sniadach v. Family Fin. Corp.*, 395 U.S. 337, 341-42 (1969). Federal limitations on garnishment were not in place until 1968, 15 U.S.C. § 1672 (2000), and many states offered little limitation on its use. See 2 HOWARD J. ALPERIN & ROLAND F. CHASE, *CONSUMER LAW: SALES PRACTICES, CREDIT REGULATION* §§ 630-631, 352-354 (1986). Furthermore, the Fair Debt Collection Practices Act was not passed until 1977. 15 U.S.C. §§ 1692-1692o; Pub. L. No. 95-109, Sept. 20, 1977, 91 Stat. 874. In addition, few states had similar provisions prior to the mid to late 1970s. See ALPERIN & CHASE, *supra*, at 352-54.

²⁰³ See *In re Leser*, 939 F.2d at 672-73 (quoting *In re Davidson*, 72 B.R. 384, 387 (Bankr. D. Colo. 1987) (commenting that plans providing for 100% payout are relatively rare)). But see William C. Whitford, *The Ideal of Individualized Justice: Consumer Bankruptcy as Consumer Protection, and Consumer Protection in Consumer Bankruptcy*, 68 AM. BANKR. L.J. 397, 411 tbl. 2 (1994) (showing that in some jurisdictions a significant number of confirmed Chapter 13 plans do propose 100% repayment).

²⁰⁴ See 11 U.S.C. § 1326.

²⁰⁵ *Id.* § 1325(a)(2).

²⁰⁶ *Id.* §§ 1322(a)(2), 507.

²⁰⁷ See *id.* § 1322(a)(2). If a secured creditor holds collateral that is worth less than the value of its loan, its secured claim will equal the amount that it would cost the debtor to replace the collateral; the remainder of the secured creditor's loan is treated as an unsecured claim. See *Assoc. Commercial Corp. v. Rash*, 520 U.S. 953, 961 (1997). Note that only the secured claim must be promised full repayment for the debtor to retain the collateral. 11 U.S.C. § 506(a). This limitation does not apply, however, to the most important secured creditors, the mortgage lenders, who must receive the entire amount of their loans, includ-

amount that the debtor must pay the secured creditor depends on the value of the debtor's physical assets rather than the value of her earnings, this Article focuses on how much the debtor must pay her unsecured creditors.

There are two primary tests for how much debtors must pay their general unsecured creditors in Chapter 13: the "best interests of the creditors" test of § 1325(a)(4) and the "disposable income" test of § 1325(b). An unsecured creditor may object under § 1325(a)(4) if it does not receive as much as it would have received in a Chapter 7 liquidation.²⁰⁸ Though there is some evidence that debtors with significant non-exempt assets are more likely to choose Chapter 13,²⁰⁹ the near complete lack of repayment for unsecured creditors in Chapter 7²¹⁰ implies that this "best interests of the creditors" test may mean little in practice.

Between 1978 and 1984, the only explicit test for determining the debtor's payment to unsecured creditors was the "best interests of the creditors" test of § 1325(a)(4).²¹¹ Because so few debtors have any non-exempt assets,²¹² and because creditor consent was no longer required, judges accustomed to Chapter XIII plans that proposed full repayment²¹³ began to see Chapter 13 plans that proposed little or no repayment for unsecured creditors. It seems that this change was too much for some judges, and many refused to confirm plans that paid too little to creditors on the grounds that they were not proposed in good faith as required by the Bankruptcy Code.²¹⁴ While this use of the good faith requirement was controversial at the time, it became even more so after the Bankruptcy Amendments and Federal Judgeship Act of 1984.²¹⁵

ing any interest specified in the mortgages, if debtors are to keep their homes. See *Nobelman v. Am. Sav. Bank*, 508 U.S. 324, 325-26, 331 (1993) (interpreting 11 U.S.C. § 1322(b)(2)).

²⁰⁸ 11 U.S.C. § 1325(a)(4).

²⁰⁹ See discussion *supra* note 182.

²¹⁰ See sources cited *supra* note 181.

²¹¹ See 11 U.S.C. § 1325(a)(4).

²¹² See *supra* note 180 and accompanying text.

²¹³ See *supra* note 192 and accompanying text.

²¹⁴ See, e.g., *In re Raburn*, 4 B.R. 624, 625 (Bankr. M.D. Ga. 1980) (refusing to confirm plan unless it paid 70% of unsecured claims); *In re Burrell*, 2 B.R. 650, 653 (Bankr. N.D. Cal. 1980) ("Although debtor's plan meets the best effort test, it falls considerably short of meeting the substantial payment requirement.").

²¹⁵ See, e.g., *Noreen v. Slattengren*, 974 F.2d 75, 76 (8th Cir. 1992) (claiming that 11 U.S.C. § 1325(b) subsumed most of the factors courts may have found relevant in determining good faith, but the totality of the circumstances test remained in place.); *In re Carsrud*, 161 B.R. 246, 250-51 (Bankr. S.D.S.D. 1993) ("The traditional totality of circum-

As part of the Bankruptcy Amendments and Federal Judgeship Act of 1984,²¹⁶ Congress added the "disposable income" test of § 1325(b). Section 1325(b) states that a court may not confirm a plan over the bankruptcy trustee's or a creditor's objection unless the debtor proposes full repayment or the debtor proposes to pay into the plan all of his projected disposable income for a period of three years.²¹⁷ This "disposable income" test has generated a substantial amount of controversy,²¹⁸ and despite its central role in determining the debtor's required repayment and frequent litigation about its meaning, substantial questions remain.²¹⁹

The confirmation of a plan does not end the Chapter 13 process. A debtor who subsequently finds his plan too onerous has several options. Within bankruptcy, the debtor can apply for a hardship discharge²²⁰ or convert the case to Chapter 7.²²¹ Provided the case had not been previously converted from another chapter, the debtor may dismiss the plan²²² and either re-file or rely on federal and state non-

stances approach . . . not addressed by the legislative amendments were preserved."); see generally Brandon L. Johnson, *Good Faith and Disposable Income: Should the Good Faith Inquiry Evaluate the Proposed Amount of Repayment?*, 36 GONZ. L. REV. 375, 381-86 (2000-2001) (reviewing cases).

²¹⁶ The Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, 98 Stat. 333 (codified as amended in scattered sections of 11 U.S.C. and 28 U.S.C.).

²¹⁷ "Disposable income" is defined as "income which is received by the debtor and which is not reasonably necessary to be expended . . . for the maintenance or support of the debtor or a dependent of the debtor . . ." 11 U.S.C. § 1325(b)(2) (2000).

²¹⁸ At first a few courts held that they could ignore this provision, reasoning that the term "may not" is merely permissive. See, e.g., *In re Schyma*, 68 B.R. 52, 63 (Bankr. D. Minn. 1985) (noting the language of § 1325(b)(1) indicates that Congress intended to grant a discretionary power to the court to refuse to approve the plan, rather than to mandate denial of confirmation); *In re Otero*, 48 B.R. 704, 708 (Bankr. E.D. Va. 1985) (reading the section as a voluntary section to be applied at the court's discretion). While these decisions have not been explicitly overruled, few, if any, recent courts have adopted their holding because these early courts ignored a section of the Bankruptcy Code that explicitly states that the term "may not" is prohibitive and not permissive. See 11 U.S.C. § 102(4).

²¹⁹ Much of the controversy about this provision centers on the difficulty courts face when determining a debtor's "reasonably necessary" expenses. See, e.g., LoPucki, *supra* note 23, at 471-73. This Article's analysis can readily extend to this issue. A utopian bankruptcy system would account for differences in each debtor's cost of living and allow each debtor to consume as much as he would have contracted for in advance. To the extent, however, that courts are unable to determine this amount, either directly or by using observable characteristics of the debtor as a proxy for what the debtor would have agreed to, they must ignore expenses entirely or each debtor will have an incentive to overstate his cost of living.

²²⁰ 11 U.S.C. § 1328(b).

²²¹ See *id.* §§ 1307(a), 1307(e).

²²² *Id.* § 1307(b).

bankruptcy laws for protection.²²³ Finally, § 1329 allows the debtor, the Chapter 13 trustee, and the unsecured creditors to seek a modification of the plan prior to the completion of payments.²²⁴ While parties may seek modifications for many reasons,²²⁵ this Article focuses on requests for a modification of the required repayment in response to a change in the debtor's financial condition.

B. Bankruptcy and the Grasshopper Problem

Part II implies that in managing the grasshopper problem, courts should treat negligent and willful misbehavior separately. To a large extent, the existing bankruptcy system does just that. Bankruptcy grants relief to debtors who spend too much or engage in other negligent behavior, but Chapter 7 of the Bankruptcy Code denies relief for willful misbehavior. By its terms Chapter 13, however, will grant a discharge for many forms of willful misbehavior. Courts have struggled to reconcile Chapter 13's expanded discharge with sound policy goals.

Few, if any, commentators argue that courts should deny bankruptcy relief to the spendthrifts or the negligent, and proposals to partially eliminate Chapter 13's expanded discharge have generated little public comment.²²⁶ This silence is explained in part by bankruptcy's similarities to, and differences from, standard insurance.

1. The Negligent Grasshopper and Means Testing

The utopian bankruptcy system denies relief to the debtor who negligently borrows too much or fails to take sufficient precautions to avoid financial distress; essentially, utopian bankruptcy denies relief to the negligent.²²⁷ By contrast, the existing bankruptcy system does not

²²³ Because federal limitations on garnishment do not apply in a bankruptcy proceeding, it is possible that debtors could be required to repay more in bankruptcy than they would under non-bankruptcy law. See 15 U.S.C. § 1673 (2000).

²²⁴ See 11 U.S.C. § 1329 (1978).

²²⁵ See generally Harry L. Deffebach, *Postconfirmation Modification of Chapter 13 Plans: Sheep in Wolf's Clothing*, 9 BANKR. DEV. J. 153, 155-66 (1992).

²²⁶ Of course, this silence may also be explained by the absence of an effective interest group to lobby on behalf of tort victims. Proposed legislation would significantly erode the superdischarge, eliminating the debtor's ability to obtain a discharge for: i) loans procured by fraud or false pretenses; ii) debts for fraud, embezzlement or larceny; and iii) debts for willful and malicious injury to a person. See H.R. 5745, 107th Cong. § 314(b)(4) (2002). Debtors would still be able, however, to obtain a discharge of willful and malicious torts that resulted in damage to property. *Id.*

²²⁷ See *supra* note 105 and accompanying text.

distinguish between the negligent and the unfortunate. Some debtors are in bankruptcy because they could not control their spending habits, others because they suffered some unavoidable expense, and still others because of a combination of misfortune and misbehavior.²²⁸ They all receive the same discharge, however, and bankruptcy law makes little or no effort to distinguish between them.

Chapter 7 does allow the bankruptcy judge to dismiss a filing if granting relief would be a substantial abuse of the Bankruptcy Code,²²⁹ and in looking for abuse courts do inquire into the totality of the circumstances.²³⁰ Courts focus, however, on whether the debtor can in fact pay his debts rather than on whether the debtor should have acted more responsibly to avoid incurring such debt in the first place.²³¹ That is, courts focus on whether the debtor needs bankruptcy relief rather than on why the debtor needs bankruptcy relief. Therefore, the substantial abuse provision appears designed primarily to deal with the opossum problem rather than the grasshopper problem.²³²

²²⁸ Most, if not all, bankruptcy scholars would agree that at least some debtors are in bankruptcy because of their poor spending habits, though they would likely disagree as to the size of this group. See, e.g., Braucher, *supra* note 13, at 7 ("It would be hard for anyone to disagree with the proposition that Americans have too much debt and not enough savings, and that if we had less debt and more savings, there would be less bankruptcy."); Jones & Zywicki, *supra* note 13, at 224 ("In short, one can simply recharacterize the 'debt causes bankruptcy' thesis as 'overspending causes bankruptcy'"); LoPucki, *supra* note 23, at 464 ("The grasshoppers eat at the pizza parlor on Friday night and buy the new sneakers and the houses. They quit their jobs when the going gets tough. The fallout lands on their credit cards. When winter comes, they discharge the credit card debt in bankruptcy."); Warren, *supra* note 13, at 1084 ("Some incur [excessive] debt with little thought about how it adds up, perhaps like the grasshopper who never thought about the coming winter.");

²²⁹ See 11 U.S.C. § 707(b) (2000).

²³⁰ See, e.g., *In re Kornfield*, 164 F.3d 778, 784 (2d Cir. 1999); *In re Lamanna*, 153 F.3d 1, 1 (1st Cir. 1998); *In re Green*, 934 F.2d 568, 572-73 (4th Cir. 1991); *In re Edwards*, 50 B.R. 933, 936 (Bankr. S.D.N.Y. 1985).

²³¹ While most, if not all, courts would consider the debtor's ability to pay in the substantial abuse analysis, there is broad disagreement as to the meaning of the phrase "substantial abuse." Some courts hold that an ability to pay one's debts alone supports a finding of substantial abuse. See, e.g., *United States Tr. v. Harris*, 960 F.2d 74, 77 (8th Cir. 1992); accord *In re Kelly*, 841 F.2d 908, 914-15 (9th Cir. 1988). Other courts, however, find that an ability to pay one's debts is not sufficient by itself to find substantial abuse. See *In re Green*, 934 F.2d at 572-73. Still, most courts seem to regard the ability to pay as the primary consideration in the substantial abuse analysis. See, e.g., *In re Stewart*, 175 F.3d 796, 809 (10th Cir. 1999); see also *In re Lamanna*, 153 F.3d at 4-5.

²³² Occasionally, one finds a case that focuses primarily on the circumstances surrounding the incurrence of the debt. These cases, however, generally involve intentional, as opposed to negligent, behavior. See, e.g., *In re Bruno*, 68 B.R. 101, 102-03 (Bankr. W.D. Mo. 1986) (dismissing filing because husband sought to discharge debts resulting from

Although numerous scholars have written about the grasshopper problem of bankruptcy,²³³ there are no serious proposals for denying a bankruptcy discharge to those who overspend or otherwise negligently cause their own financial distress. Even the credit industry has not tried to limit the grasshopper's access to bankruptcy,²³⁴ preferring instead to lobby for means testing that would identify those debtors who can pay more. As a matter of theory, means testing requires only that the debtor prove that he needs relief; means testing does not ask the debtor to explain *why* he needs relief. Therefore, like the substantial abuse provision, means testing appears aimed primarily at the opossum problem rather than the grasshopper problem.

In light of the analysis of Part II, this approach is unsurprising. The first lasting bankruptcy law in the United States,²³⁵ the Bankruptcy Act of 1898²³⁶ was passed at about the same time that courts began to allow individuals to insure against liability for negligent misconduct.²³⁷ Because bankruptcy is another form of insurance, the justifications for insurance that protects the negligent would seem to apply to bankruptcy as well. Many, if not most, bankrupt debtors are unable to pay their debts both because they suffered some unfortunate shock such as divorce or unemployment *and* because they borrowed too much to allow them to withstand such a shock.²³⁸ Society may not trust the ability of bankruptcy judges to determine if these debtors behaved prudently and therefore deserve relief. Moreover, even when it is clear that debtors spent their way into bankruptcy, society may not want to deny relief because many believe that some debtors just cannot resist the temptation of easy credit.²³⁹

murder of his wife). As discussed below, Chapter 7 has more direct limitations on relief for such behavior. See *infra* note 248 and accompanying text.

²³³ See *supra* note 23 and accompanying text.

²³⁴ See, e.g., Warren, *supra* note 14, at 493 ("The creditors as a group did not quarrel with relief for those in need; instead, they emphasized that consumer bankruptcy should be available *only* to those in need.").

²³⁵ The Constitution grants Congress the power to enact uniform bankruptcy laws. See U.S. CONST. art. I, § 8, cl. 4. Prior to 1898, however, Congress enacted three bankruptcy acts that together lasted less than twenty years. Congress repealed the Bankruptcy Act of 1800 in 1803, 2 Stat. 248 (1803), the Bankruptcy Act of 1841 in 1843, Act of March 3, 1843, 5 Stat. 614 (1843), and the Bankruptcy Act of 1867 in 1878, Act of June 7, 1878, 20 Stat. 99 (1878). Of course, state law did afford early debtors some protection from their creditors. See generally CHARLES WARREN, BANKRUPTCY IN UNITED STATES HISTORY (1934).

²³⁶ Bankruptcy Act of 1898, Pub. L. No. 696, ch. 541, 30 Stat. 544 (repealed 1978).

²³⁷ See *supra* note 127 and accompanying text.

²³⁸ See, e.g., Warren, *supra* note 13, at 1081 (discussing the characteristics of bankrupt debtors).

²³⁹ See *supra* notes 137–148 and accompanying text.

But the second-best bankruptcy system does not ignore the grasshopper problem altogether. Precisely because courts cannot or will not identify the negligent, the second-best bankruptcy system offers only partial relief to the unfortunate as well.²⁴⁰ Debtors receive only partial insurance to the extent that they are worse off after bankruptcy than they would have been had they behaved in the proper manner. In practice, the bankrupt debtor will emerge with severely damaged credit, and, possibly, a damaged social reputation.²⁴¹ On the other hand, the debtor will have enjoyed, at least temporarily, a higher standard of living than if he had behaved prudently. In addition, the debtor may still retain some of the assets purchased on credit. Therefore, bankruptcy should ask the debtor to repay something to his creditors.

Though debtors in Chapter 7 pay virtually nothing to their unsecured creditors,²⁴² they often reaffirm debts to secured creditors so that they may retain their home, their car, or other assets pledged as collateral.²⁴³ Whether this system causes the debtor to suffer enough is open to debate, and if means testing forced debtors to pay more in bankruptcy, it could reduce the level of insurance they receive. Whether this means testing is warranted remains controversial as commentators strongly disagree as to the importance of the grasshopper problem in bankruptcy.²⁴⁴

2. The Willful and Malicious Grasshopper, the Superdischarge and Good Faith

Because neither private contracts nor public insurance programs relieve individuals of the consequences of their willful misbehavior,²⁴⁵ Part II suggests that bankruptcy should not do so either. Traditionally, bankruptcy adopted this approach. The Bankruptcy Act of 1898

²⁴⁰ See *supra* note 139 and accompanying text.

²⁴¹ See, e.g., Todd J. Zywicki, *Bankruptcy Law as Social Legislation*, 5 TEX. REV. L. & POL. 393, 395-408 (2001).

²⁴² See *supra* note 181.

²⁴³ See *supra* note 181. This approach does offer some advantages in that the debtor and creditor can contract in advance for the minimum amount that the debtor must repay in bankruptcy. Unfortunately, the usefulness of this strategy is limited by an inability to pledge one's future income as collateral. Because the amount that must be repaid in Chapter 7 is independent of the debtor's future income, this test provides imperfect insurance and is subject to abuse.

²⁴⁴ Compare Jones & Zywicki, *supra* note 13, at 192-200, 248, with Warren, *supra* note 13, at 1084-87, 1100-01.

²⁴⁵ See *supra* notes 142-147 and accompanying text.

barred the discharge of debts arising from most forms of willful misconduct whether under a Chapter VII liquidation²⁴⁶ or a Chapter XIII wage earner's plan.²⁴⁷ Today, Chapter 7 largely retains and expands the exceptions to discharge of the Bankruptcy Reform Act of 1898.²⁴⁸

By contrast, Chapter 13 provides a superdischarge that is broader than the discharge available in Chapter 7 and can forgive, among other things: i) loans procured by fraud or false pretenses, ii) debts for fraud, embezzlement, or larceny, and iii) debts for willful and malicious injury.²⁴⁹ Because of the superdischarge, and because tort claims often do not count toward the dollar limitations of Chapter 13,²⁵⁰ the reported Chapter 13 case law is populated in part by debtors facing judgments or claims for fraud,²⁵¹ embezzlement,²⁵² misappro-

²⁴⁶ See 11 U.S.C. § 35(a) (1970) (current version at 11 U.S.C. § 523(a)).

²⁴⁷ See *id.* § 1060 (current version at 11 U.S.C. § 1328(a), (c)-(d) (2000)).

²⁴⁸ See *id.* § 523.

²⁴⁹ See *id.* § 1328(a). Originally, Chapter 13 would discharge judgments for criminal restitution as well. See *Pa. Dep't. of Pub. Welfare v. Davenport*, 495 U.S. 552, 564 (1990). Shortly after this case, Congress excepted criminal restitution from the superdischarge. See Crime Control Act of 1990, Pub. L. No. 101-647, Tit. XXXI, § 3103(3), 104 Stat. 4789, 4916 (1990) (codified at 11 U.S.C. § 1328(a)(3)). In 1994, however, Congress changed its mind, and current law no longer excepts criminal restitution from the superdischarge (although § 1328(a)(3) still applies to cases filed before Oct. 22, 1994). See Pub. L. 103-394, § 501(d)(38)(b) (1994). Proposed legislation would significantly erode the superdischarge, eliminating the debtor's ability to obtain a discharge for: i) loans procured by fraud or false pretenses; ii) debts for fraud, embezzlement or larceny; and iii) debts for willful and malicious injury to a person. See H.R. 5745, 107th Cong. § 314(b)(4) (2002). Debtors would still be able, however, to obtain a discharge of willful and malicious torts that resulted in damage to property. *Id.*

²⁵⁰ The Bankruptcy Code limits Chapter 13 to debtors with non-contingent, liquidated unsecured debts of less than \$290,525. 11 U.S.C. § 109(e) (dollar amounts updated by Revision of Certain Dollar Amounts in the Bankruptcy Code prescribed under Section 104(b) of the Code, 66 Fed. Reg. 10,910, 10,911 (Feb. 20, 2001)). Pending tort claims, however, will generally not count toward this amount either because they are contingent (the tort claimant must win at trial) or they are unliquidated (the court cannot determine the amount of the claim until the trial). See, e.g., 14 MARK BANE ET AL., *supra* note 180, at ¶ 109.06 [2][b]-[c].

²⁵¹ See, e.g., *In re Peterson*, 228 B.R. 19, 22 (Bankr. M.D. Fla. 1998); *In re McBroom*, 51 B.R. 953, 955 (Bankr. W.D. Va. 1985).

²⁵² See, e.g., *In re Nipper*, 224 B.R. 756, 757 (Bankr. E.D. Mo. 1998); *In re Britt*, 211 B.R. 74, 76 (Bankr. M.D. Fla. 1997).

priation,²⁵³ aggravated assault,²⁵⁴ intentional shooting,²⁵⁵ sexual assault,²⁵⁶ sexual abuse of a minor,²⁵⁷ and other willful misconduct.

Congress left little record to indicate why it adopted the superdischarge. The commission appointed to study bankruptcy recommended that Congress retain the existing exceptions to discharge in both Chapter 7 and Chapter 13, and the legislative history reveals no justification for why this recommendation was rejected.²⁵⁸ The superdischarge has changed little since 1978,²⁵⁹ however, and a recent study by the National Bankruptcy Review Commission did not suggest a substantive change to this policy.²⁶⁰ This continued support for the superdischarge must be reconciled with the law's general hostility toward insurance that protects an individual from the consequences of his willful misconduct.²⁶¹

The traditional explanation for the superdischarge is that it induces debtors to file under Chapter 13 and thereby increases the repayment for all creditors.²⁶² Given that in 1978, Chapter 13 did not require the debtor to repay any more than he would have in Chapter 7,²⁶³ this explanation for the original superdischarge is questionable. It is at least possible, however, that Congress thought that debtors would pay more,²⁶⁴ and some may support the continued existence of

²⁵³ See, e.g., *In re Kelly*, 217 B.R. 273, 274 (Bankr. D. Neb. 1997); *In re Ledin*, 179 B.R. 721, 722 (Bankr. M.D. Fla. 1995).

²⁵⁴ See, e.g., *In re Day*, 1999 WL 96117, *1 (7th Cir. 1999) (Table decision at 172 F.3d 52) (aggravated battery); *In re Easley*, 72 B.R. 948, 948 (Bankr. M.D. Tenn. 1987).

²⁵⁵ See *Handeen v. LeMaire*, 898 F.2d 1346, 1347 (8th Cir. 1990).

²⁵⁶ See, e.g., *Solomon v. Cosby*, 67 F.3d 1128, 1130 (4th Cir. 1995); *Petty v. Belanger*, 232 B.R. 543, 545 (D. Mass. 1999) (decided under Chapter 7, although debtor originally filed for bankruptcy under Chapter 13); *In re Carsrud*, 161 B.R. at 247.

²⁵⁷ See, e.g., *Slattengren*, 974 F.2d at 75.

²⁵⁸ Robert L. Hughes, *Chapter 13's Potential for Abuse*, 58 N.C. L. REV. 831, 843 (1980) ("Though Section 1328(a) represents a congressional rejection of the Commission's position on t[he] issue [of the exceptions to discharge], the legislative history offers no explanation for that decision.").

²⁵⁹ Since 1978, Congress has excepted some debts from the superdischarge, including criminal restitution (from 1990-1994). See *supra* note 249.

²⁶⁰ See, e.g., NBRC REPORT, *supra* note 90, at 290-91. Notwithstanding the National Bankruptcy Review Commission's views, however, proposed legislation would significantly erode the superdischarge. See *supra* note 249.

²⁶¹ See *supra* notes 143-144 and accompanying text.

²⁶² See, e.g., NBRC REPORT, *supra* note 90, at 290-91.

²⁶³ See *supra* note 216 and accompanying text.

²⁶⁴ See, e.g., Hughes, *supra* note 258, at 845. Moreover, what little legislative history that does exist suggests that some Congressmen accepted the superdischarge under the presumption that the requirement of creditor approval would result in some check on this provision. See Report of the Commission on the Bankruptcy Laws of the United States, H.R. Doc. No. 93-137, 93d Cong., 1st Sess., Pt. I, at 175 (1973) (In considering proposed

the superdischarge if the disposable income requirement now results in a greater repayment under Chapter 13.²⁶⁵

Even if the superdischarge maximizes the repayment to the creditor, however, the same could be said of an insurance policy that covers willful torts; the victim could demand payment from a solvent insurance company rather than an insolvent tortfeasor. While bankruptcy effectively mandates that the creditor insure the debtor against the debtor's willful misconduct, non-bankruptcy insurance law generally *prohibits* insurance policies that cover willful misconduct.²⁶⁶ Courts refuse to allow such insurance policies on public policy grounds, reasoning that these insurance contracts will lessen the deterrence that judgments for willful torts are designed to deliver.²⁶⁷ Because the superdischarge also lessens the deterrent effect of the tort law, one needs a justification for why bankruptcy *requires* this insurance.

Recall that there are two justifications for insurance policies that cover negligence. First, judges and juries will sometimes err when deciding whether a defendant was negligent and therefore society should allow the individual to insure against this error.²⁶⁸ For example, a court could wrongfully find that a motorist negligently drove at an excessive speed and caused an accident. This same argument applies to intentional misconduct, though perhaps with lesser force. For example, a court may wrongfully find that a motorist intentionally struck a pedestrian when in fact he did so by accident. There is no reason to believe, however, that Congress changed its view of the competency of the judiciary in the late 1970s.

By contrast, the period surrounding the passage of the Bankruptcy Reform Act of 1978 did see a change in the law's basic assump-

legislation analogous to the current Chapter 13, the commission stated, "If the debtor wants to pay his debts pursuant to a plan, *and if the creditors are willing to go along*, he should be allowed to do so. The fact that a discharge would not be available in a liquidation case should furnish a greater incentive for the debtor to perform under the plan." (emphasis added). Perhaps Congress assumed that this would mean that Chapter 13 plans would continue to routinely include full repayment of unsecured creditors and did not sufficiently revisit the issue when the creditor consent requirement was dropped.

²⁶⁵ See, e.g., NBRC REPORT, *supra* note 90, at 291.

²⁶⁶ See, e.g., *Ambassador Ins. Co. v. Montes*, 388 A.2d 603, 606 (N.J. 1978) (adopting a minority rule allowing such insurance policies if they benefit innocent third parties, but recognizing that a majority of courts do not allow insurance for willful misconduct); *KEETON & WIDISS*, *supra* note 128, at 519 (stating that insurance law generally prohibits insurance policies covering willful misconduct).

²⁶⁷ See, e.g., *Montes*, 388 A.2d at 606 (noting that the majority of courts reason that "[w]ere a person able to insure against the economic consequences of his intentional wrongdoing, the deterrence attributable to financial responsibility would be missing.").

²⁶⁸ See *supra* note 132 and accompanying text.

tions about the ability of individuals to control their own actions, the second explanation for insurance that covers negligent behavior.²⁶⁹ To the extent that individuals are simply unable to control their own actions, the deterrence value of judgments becomes much less important relative to the other goals that these judgments serve, such as compensating the victim.

This shift in view of individual responsibility can be most clearly seen in the criminal law. For example, the insanity defense traditionally focused on whether the defendant *understood* the nature and quality of his actions or the wrongfulness of his actions.²⁷⁰ In 1962, however, the American Law Institute wrote the Model Penal Code, which expanded the insanity defense to include defendants who could appreciate the wrongfulness of their actions but who were unable to *control* their actions and to conform their conduct to the requirements of law.²⁷¹ The D.C. Circuit adopted this approach in 1972,²⁷² and during the 1960s and 1970s a significant minority of state legislatures and courts, and almost all of the federal circuit courts,²⁷³ followed suit. Similarly, this period witnessed an expansion of the doctrine of diminished capacity that reduces a homicide from murder to manslaughter.²⁷⁴ This culminated in the now infamous "Twinkie defense" in which an individual shot and killed both the mayor of San Francisco and a supervisor but was found guilty of only manslaughter after arguing that he was suffering from depression as evidenced by an excessive consumption of Twinkies.²⁷⁵ The "Twinkie defense" and John Hinckley's acquittal of the attempted murder of President Reagan helped spark a backlash against this trend.²⁷⁶ This backlash came too late,

²⁶⁹ See *supra* note 133 and accompanying text.

²⁷⁰ See *M'Naughten's Case*, 8 Eng. Rep. 718, 719 (H.L. 1843).

²⁷¹ See WAYNE R. LAFAVE, *CRIMINAL LAW* 4 n.9, 348-49 (3d ed. 2000). Prior to this time, many jurisdictions had adopted an "irresistible impulse" test that also looked to the ability of the defendant to control his conduct. See *id.* at 339-40.

²⁷² See *United States v. Brawner*, 471 F.2d 969, 973 (D.C. Cir. 1972).

²⁷³ See LAFAVE, *supra* note 271, at 350.

²⁷⁴ See, e.g., JOSHUA DRESSLER, *UNDERSTANDING CRIMINAL LAW* 367-70 (2001) (discussing expansion of this doctrine in California judicial opinions and in the enactment of the Model Penal Code).

²⁷⁵ See *People v. White*, 172 Cal. Rptr. 612, 615 (Cal. Ct. App. 1981); LAWRENCE M. FRIEDMAN, *CRIME AND PUNISHMENT IN AMERICAN HISTORY* 404-05 (1993).

²⁷⁶ After John Hinckley was acquitted of the attempted murder of President Reagan for reasons of insanity, Congress passed a statute that returned federal courts to something akin to the *M'Naughten* Rule. FRIEDMAN, *supra* note 275, at 405; see 18 U.S.C. § 17 (2000).

however: the Bankruptcy Reform Act of 1978 was passed in the same year as the homicide in the Twinkie case.²⁷⁷

Regardless of whether these changes are related to the creation of the superdischarge, other forms of insurance continue to refuse to shield individuals from the consequences of their willful misbehavior,²⁷⁸ and therefore the superdischarge remains an anomaly. Courts have reacted to this anomaly by turning to another section of the code, the requirement that a plan be proposed in good faith,²⁷⁹ to limit the availability of the superdischarge.

A minority of courts have refused to use this good faith test to question the debtor's pre-petition conduct,²⁸⁰ either because they believe that Congress intended a narrow definition of good faith,²⁸¹ or that the debtor is merely making use of a statutory right.²⁸² A significant majority of courts, however, read good faith more broadly and will consider the nature of the debt sought to be discharged.²⁸³

²⁷⁷ See *White*, 172 Cal. Rptr. at 613.

²⁷⁸ See *supra* notes 142–148 and accompanying text.

²⁷⁹ See 11 U.S.C. § 1325(a)(3) (2000).

²⁸⁰ See, e.g., *Keach v. Boyajian*, 243 B.R. 851, 857, 868 (B.A.P. 1st Cir. 2000); *In re Cathright*, 67 B.R. 384, 385 (Bankr. E.D. Pa. 1986). But see *In re Scotten*, 281 B.R. 147, 149 (Bankr. D. Mass. 2002) (considering pre-petition conduct to determine good-faith despite *Keach*'s lack of consideration of such a factor).

²⁸¹ These courts reason that because courts did not look to the debtor's pre-filing conduct when applying the good faith standard in Chapter XIII of the Bankruptcy Act of 1898, modern courts should not look to pre-filing conduct when applying the same good faith standard in Chapter 13 of the Bankruptcy Code. See, e.g., *Keach*, 243 B.R. at 868–71. Chapter XIII did not offer a superdischarge, however, so courts were generally not confronted with plans that sought to discharge debts arising out of willful misconduct. See *supra* note 247 and accompanying text. Moreover, even if a debtor did file a plan that sought to discharge such a debt, the creditor consent requirements of Chapter XIII meant that the plan would almost invariably propose to pay *all* debts, including unsecured debts, in full. See *supra* note 202.

²⁸² See, e.g., *Keach*, 243 B.R. at 868 (“The contrary view of good faith, so prevalent in the case law, is blatantly inconsistent with a debtor's clear statutory rights.”). Furthermore commentators sometimes suggest that the plain meaning of § 1325(a)(3) precludes the consideration of pre-petition conduct because it only requires that the plan be *proposed* in good faith. See, e.g., 3 KEITH M. LUNDIN, CHAPTER 13 BANKRUPTCY § 180.1, at 180–89 (3rd ed. 2000) (“It is more difficult to explain that distant debtor conduct—for example, at the time of incurring a debt months or years before bankruptcy—illuminates the debtor's good faith in proposing the plan.”); Bradley M. Elbein, *The Hole in the Code: Good Faith and Morality in Chapter 13*, 34 SAN DIEGO L. REV. 439, 456 (1997) (“The explicit terms of § 1325(a)(3) require only an evaluation of good faith in the *proposal* of the plan” Despite the plain meaning of the statute, only a minority of courts apply § 1325(a)(3) as written.).

²⁸³ See, e.g., *In re Day*, 1999 WL at *4; *Gier v. Farmers State Bank of Lucas*, 986 F.2d 1326, 1328–29 (10th Cir. 1993); *Robinson v. Tenantry*, 987 F.2d 665, 668 n.6 (10th Cir. 1993); *Slattengren*, 974 F.2d at 77; *LeMaire*, 898 F.2d at 1349; 3 LUNDIN, *supra* note 282, at

Generally, the courts that use the good faith standard to police pre-petition willful misconduct do not flatly deny access to the superdischarge. Rather, consistent with the public policy goal of retaining adequate deterrence, these courts sometimes will grant a discharge of debts arising from willful misconduct, but only after the debtor has shown that he has received significant punishment for his actions or is sufficiently remorseful.²⁸⁴ Perhaps this inquiry into the debtor's particular circumstances provides an explanation for why the superdischarge protects bankrupt debtors from the consequences of their willful misconduct while other insurance policies may not. While tort liability plays an important role in deterring willful misconduct, society also relies on other tools for deterrence, such as criminal liability. Because bankruptcy is a judicial process, a judge can review the debtor's circumstances and determine if the debtor has received enough punishment from other sources to satisfy the need for deterrence.

In conducting the good faith analysis, however, courts do not just focus on the punishment the debtor has received; they consider the nature of the victim and the financial impact that the plan would have on the victim.²⁸⁵ Consequently, debtors guilty of severe pre-petition misconduct may be forced to make a greater effort at repayment than would other debtors.²⁸⁶

180-89 ("The courts persist in finding relevance to good faith in [pre-petition] debtor conduct without finer distinctions. The reported decisions bucking this (illogical) trend can be counted on few fingers.").

²⁸⁴ See, e.g., *In re Anadell*, 190 B.R. 309, 310, 312 (Bankr. S.D. Ohio 1995) (citing the fact that attorney debtor had lost his law license and was incarcerated in deciding to approve plan paying approximately 10% of judgment for misappropriation of funds); *In re Corino*, 191 B.R. 283, 290-91 (Bankr. N.D.N.Y. 1995) ("As a consequence for embezzling funds from [the bank], Debtor has already served time in prison, has forfeited a savings account and since 1989 has paid [the bank] approximately \$6,500 pursuant to various wage garnishment orders. . . . Debtor not only appeared repentant, but her efforts in negotiation and her proposal to pledge all of her disposable income to a five year plan demonstrates a willingness to pay her debt . . .").

²⁸⁵ See, e.g., *In re Sitarz*, 150 B.R. 710, 722-23 (Bankr. D. Minn. 1993) ("The identity of the creditor, whether institutional or individual, is certainly relevant. The personal impact of the debtor's conduct on an individual creditor, both at the time of the infliction of the injury and in its future, is also significant. . . . The extent to which the debtor's payment proposal would make the objecting creditor financially whole is another factor for consideration.").

²⁸⁶ See 3 LUNDIN, *supra* note 282, at § 184.1, 184-7 ("In anticipation of a good-faith objection to confirmation, the debtor guilty of pre-petition criminal misconduct should consider a five-year plan that maximizes payment to the victim.").

Because this Article focuses on the standard consumer lending transaction, it largely ignores the interests of the creditor. In the standard consumer lending transaction, this approach is justified because, in the long run, the debtor largely bears the cost of bankruptcy in the form of higher interest rates and reduced access to credit.²⁸⁷ This analysis, however, obviously does not apply to the tort victim. To the extent that bankruptcy law discharges judgments for torts, it truly shifts the loss from tortfeasors to tort victims. In addition, tort victims are poorly situated to bear this risk as they cannot easily diversify it away like the consumer lender can. In short, the tort victim is a very poor insurer of the tortfeasor and a rational bankruptcy policy must balance the interests of both creditor and debtor.²⁸⁸

C. Bankruptcy and the Opossum Problem: Assessing the Debtor's Ability to Pay

Even if society decides that an individual deserves some relief, it still must determine how much relief is appropriate. Ideally, bankruptcy would only grant the debtor as much relief as he needs and require the debtor to repay an amount commensurate with his ability to pay. To the extent that one's ability to pay is related to his earning ability, Chapter 7 fails to accomplish this task. While many debtors repay some amount in Chapter 7, this amount is not based on income. Rather, a tiny minority of debtors repay unsecured creditors out of their non-exempt assets, and a larger number of debtors reaffirm secured loans.²⁸⁹ Chapter 7 may still play a role in an optimal bankruptcy system if restricted to debtors whose incomes are so low that a court would have them repay nothing in bankruptcy.²⁹⁰ Perhaps

²⁸⁷ See *supra* notes 80–82 and accompanying text.

²⁸⁸ Perhaps this need to consider the creditor's interest explains why Congress chose to offer the superdischarge only to those debtors who *complete* a Chapter 13 plan; the superdischarge is unavailable to debtors who receive a hardship discharge in Chapter 13. See 11 U.S.C. § 1328(a)–(c) (2000) (applying to hardship discharges granted pursuant to § 1328(b)). Of course, the inability of a tort victim to easily absorb the loss makes the discharge of other tort judgments problematic as well.

²⁸⁹ See *supra* note 181 and accompanying text.

²⁹⁰ See *supra* note 92 and accompanying text; see also Braucher, *supra* note 13, at 13 ("The premise that supports our current system is that the overwhelming majority of people who file in Chapter 7 do not have enough to repay much of anything . . ."). Chapter 7 may also play a role if it is too costly for judges to collect any information about debtors. In this case, society may wish to rely on punishment to deter the debtor from falsely claiming a need for relief. See Rea, *supra* note 7, at 196, 206. Chapter 7 may embody this punishment-based approach to bankruptcy through the loss of collateral and the harm to the

this is why much of the current policy debate over means testing focuses on whether a debtor can repay his debts.²⁹¹ This section focuses, however, on those debtors who should repay *something* in bankruptcy and asks how bankruptcy should collect this amount.

Recall from Part II that the utopian bankruptcy system leaves the debtor with some debts that he must repay, but reduces these debts to an amount commensurate with his potential earnings.²⁹² Recall too that the pessimist rejects the underlying assumption of utopian bankruptcy—that judges can estimate a debtor's potential earnings—and therefore insists that society should adopt a second-best bankruptcy system that bases the debtor's required repayment on his actual earnings.²⁹³

This tension between the utopian and pessimistic views of bankruptcy is reflected in the cases arising under Chapter 13. The language of the Bankruptcy Code invokes the utopian bankruptcy system in that it bases the debtor's required repayment on his estimated or projected earnings.²⁹⁴ Many courts, however, are skeptical of their own ability to estimate a debtor's future income and therefore seek to create a system that bases the debtor's repayment at least in part on his actual earnings. In order to do so, some courts are willing to significantly stray from the plain meaning of § 1325(b). This approach is unfortunate because these courts could better account for their own limitations through other provisions of the code.²⁹⁵ For instance, if judges are concerned that their estimates may, on occasion, significantly understate the debtor's actual earnings, then they can order the debtor to report her income to the bankruptcy trustee and rely on the interested parties to seek a modification of the plan.²⁹⁶ Likewise, if judges believe that the debtor's income is simply too uncertain to estimate, they should dismiss the debtor's bankruptcy petition on the grounds that the debtor lacks a regular income and therefore is not eligible for relief under Chapter 13.²⁹⁷

debtor's credit reputation. Whether the punishment delivered by Chapter 7 could be better designed is left to a future paper.

²⁹¹ See *supra* note 13 and accompanying text.

²⁹² See *supra* notes 110–114 and accompanying text.

²⁹³ See *supra* notes 149–150 and accompanying text.

²⁹⁴ See 11 U.S.C. § 1325(b) (2000).

²⁹⁵ See *infra* notes 296–297 and accompanying text.

²⁹⁶ See 11 U.S.C. § 1329.

²⁹⁷ See *id.* § 109(e).

1. Projected Disposable Income

Academics sometimes criticize Chapter 13 for discouraging debtors from working by depriving them of any earnings above some fixed amount.²⁹⁸ If Chapter 13 seized all of the debtors' disposable income, or all of their actual income above some allowance for what the court determines are their reasonably necessary expenses, then this would be true. Such a system would effectively operate as a prohibitive tax on any income earned above the fixed amount, and the debtor would have no incentive to work any more than required to earn that fixed amount. To the extent that a Chapter 13 bankruptcy emulates the utopian bankruptcy system by leaving debtors with a fixed or lump-sum obligation based on their *projected* earnings, however, it does not discourage them from working at all.²⁹⁹

By its terms, the "disposable income" test of § 1325(b) does *not* base a debtor's required repayments on her *actual* disposable income.³⁰⁰ Like the first-best tax or the utopian bankruptcy system, § 1325(b) bases the debtor's required repayment on her estimated or *projected* disposable income; § 1325(b) requires the debtor to propose a plan in which she uses all of her *projected* disposable income to repay her debts.³⁰¹ A plain reading of this section requires the judge to project the debtor's income at the time of confirmation and set the debtor's repayment obligations equal to the amount by which this projected income exceeds the debtor's reasonably necessary expenses.³⁰² A plain reading of this statute requires the judge to invoke the utopian bankruptcy system.

Some courts follow the plain meaning of this section. In 1994, in *In re Anderson*, the U.S. Court of Appeals for the Ninth Circuit overruled the district and bankruptcy courts' finding that the debtor failed to meet the requirements of § 1325(b)(1)(b) because the debtor refused to sign a best efforts certification that would in effect bind him to pay all of his actual disposable income to his creditors.³⁰³ Relying in part on the language of the statute,³⁰⁴ the court held that

²⁹⁸ See, e.g., LoPucki, *supra* note 23, at 471.

²⁹⁹ See *supra* notes 95–126 and accompanying text.

³⁰⁰ See 11 U.S.C. § 1325(b).

³⁰¹ See *id.* § 1325(b)(1)(b) (emphasis added).

³⁰² See *id.* § 1325(b).

³⁰³ 21 F.3d 355, 356–57 (9th Cir. 1994).

³⁰⁴ *Id.* at 357–58. The court also relied on the ability of the trustee to modify a plan pursuant to § 1329 if the debtor's circumstances substantially improved. See *id.* at 358. As

§ 1325(b)(1)(b) requires only that debtors pledge payment of all of their *projected*, rather than *actual*, disposable income, and that therefore trustees may not require debtors to sign best efforts certifications.³⁰⁵

Although some jurisdictions have followed *Anderson*,³⁰⁶ a few courts have required debtors to promise a repayment contingent on their actual income.³⁰⁷ Unfortunately, the reasoning employed by these courts is not always clear. At least one court that required a debtor to sign a best efforts certification simply ignored the word "projected,"³⁰⁸ as did another court that required debtors to increase plan payments whenever they were able to secure additional overtime work or when they actually received benefits from a profit sharing plan.³⁰⁹ Another court required the debtor to pay an amount equal to his projected disposable income plus half of any amount by which his actual disposable income exceeded his projected disposable income.³¹⁰ Although this court explained that § 1325(b)(1)(b) did not require a debtor to pay all of his actual disposable income,³¹¹ it did not explain why the debtor's actual disposable income was relevant at all.³¹²

discussed below, this is an example of the "guardedly optimistic" approach to bankruptcy. See *infra* notes 334-369 and accompanying text.

³⁰⁵ See *In re Anderson*, 21 F.3d at 357-58.

³⁰⁶ See, e.g., *In re Bass*, 267 B.R. 812, 819 (Bankr. S.D. Ohio 2001); *In re Jobe*, 197 B.R. 823, 826 (Bankr. W.D. Tex. 1996).

³⁰⁷ See *infra* notes 308-312 and accompanying text.

³⁰⁸ See *In re Akin*, 54 B.R. 700, 702-03 (Bankr. D. Neb. 1985) ("The recent amendments to the Bankruptcy Code require that all of the debtor's disposable income to be received in the three-year period beginning on the date that the first payment is due under the plan will be applied to make payments under the plan."); see also *In re Fitak*, 121 B.R. 224, 228-29 (Bankr. S.D. Ohio 1990) (stating in dicta, "[t]his court takes note that had Creditors filed an objection to the Second Amended Plan as confirmed, the Debtors would have been required under 11 U.S.C. § 1325(b) to automatically submit all disposable income to the Trustee over the course of the next three years."). A later decision of the Bankruptcy Court of the Southern District of Ohio, *In re Bass*, adopted the *In re Anderson* approach and thus limited the precedential value of *In re Fitak*. See *In re Bass*, 267 B.R. at 819.

³⁰⁹ See *In re Smith*, 222 B.R. 846, 858, 860 (Bankr. N.D. Ind. 1998).

³¹⁰ See *In re Krull*, 54 B.R. 375, 378 (Bankr. D. Colo. 1985). This approach was later followed in *In re Riggleman*, 76 B.R. 111, 114 (Bankr. S.D. Ohio 1987) (quoting *In re Krull*, 54 B.R. at 378). As noted above, however, the Southern District of Ohio has since followed the approach of *In re Anderson*. See *In re Bass*, 267 B.R. at 819. Note that this effectively creates a 50% marginal income tax rate on top of whatever other taxes the debtor is paying.

³¹¹ See *In re Krull*, 54 B.R. at 378.

³¹² One suspects that the court relied on the good faith provision of 11 U.S.C. § 1325(a)(3).

Much more perplexing are the decisions within the Ninth Circuit that have, subsequent to *Anderson*, required debtors to include a disposable income clause in their plan.³¹³ A disposable income clause appears to be functionally equivalent to a best efforts certification in that debtors promise to repay with all of their actual disposable income.³¹⁴ In the 2001 decision *In re James*, the Bankruptcy Court for the District of Idaho explicitly acknowledged the binding precedent in *Anderson*, yet still based its denial of confirmation in part on the debtor's failure to include a disposable income clause in his plan.³¹⁵ Given the abundant evidence that the debtor's plan was not proposed in good faith,³¹⁶ one would like to assume that the court's insistence on a disposable income clause was merely an isolated occurrence of harmless error. Unfortunately, this does not appear to be the case. The *James* court references other bankruptcy court decisions within the Ninth Circuit that ignore the binding precedent in the jurisdiction, including a decision by the Bankruptcy Appellate Panel for the Ninth Circuit that states, in dicta, that a disposable income clause is required whenever a trustee or the holder of an unsecured claim objects to the plan.³¹⁷ Moreover, one case cited suggests that, at least in

³¹³ See *supra* notes 304–309 and accompanying text.

³¹⁴ In theory, a disposable income clause could be little more than a statement that the plan complies with the "projected disposable income" test and thus does not necessarily mean that the debtor has pledged to repay with all of his or her actual disposable income. Nevertheless, this is not the meaning ascribed by some courts that require debtors to include such clauses as a condition of confirmation. According to these courts, the purpose of such a clause is to allow the unsecured creditors to benefit from any increase in the debtor's actual income. See, e.g., *In re James*, 260 B.R. 498, 514 (Bankr. D. Idaho 2001) ("The purpose of including a disposable income clause is to allow unsecured creditors to share in the debtor's post-confirmation improvement in circumstances.") (citing *J.R. Hollister Co. v. Jackson*, 95 I.B.C.R. 183, 185 (Bankr. D. Idaho 1995)); see also *In re Wages*, 92 I.B.C.R. 75, 78 (Bankr. D. Idaho 1992) (stating that a disposable income clause mandates the debtor to consult with the Trustee regarding any available funds). But see *Max Recovery, Inc. v. Than*, 215 B.R. 430, 432 (B.A.P. 9th Cir. 1997) ("The plan did not contain a 'best efforts' or 'disposable income' provision stating that all of debtor's projected disposable income . . . would be applied to the plan payments.") (emphasis added).

³¹⁵ See *In re James*, 260 B.R. at 513–14.

³¹⁶ Among other things, the court found that the debtor failed to disclose assets, allowed the claim of a very large debt to a family member that conflicted with statements that the debtor made to the Internal Revenue Service, attempted to give preferential treatment to certain creditors, attempted to discharge large court fines for discovery abuse in litigation against one of his major creditors, and attempted to discharge the claims of his ex-wife who had a substantially lower income than he did. *Id.* at 505–12.

³¹⁷ See *Than*, 215 B.R. at 432 ("Such [a] provision [a disposable income clause] is required following an objection to plan confirmation by § 1325(b) . . ."); *Jackson*, 95 I.B.C.R. at 185 ("Section 1325(b)(1) makes it clear that such a requirement [a disposable income clause] need only be included as a condition of plan confirmation '[i]f the trustee

Idaho, debtors are routinely forced to include such clauses in their plans.³¹⁸ One suspects that even if these plans are not required for confirmation, many debtors may simply agree to their inclusion to prevent the trustee from invoking a host of objections.³¹⁹

Some of the courts that require disposable income clauses try to distinguish their facts from those of *Anderson* by stating that such a clause is only required when a trustee or a creditor objects to a plan.³²⁰ This distinction, however, clearly fails because the trustee objected in *Anderson* as well,³²¹ the requirement of a trustee or creditor objection determines whether § 1325(b) applies at all, not whether projected or actual disposable income must be promised.³²² *Jackson*, one of the decisions cited by *James*, recognizes the futility of trying to distinguish *Anderson* and claims that the law on this point is unclear.³²³ While this may be true generally, this is not true within the Ninth Circuit, where *Anderson* should serve as binding precedent for lower courts.³²⁴

What is consistent in each of the decisions that base debtors' required repayment on their actual income is a pessimism about the judge's ability to accurately estimate debtors' earnings. This pessimism has caused judges to ignore the plain meaning of the statute and, in the case of the bankruptcy courts within the Ninth Circuit, the binding precedent in their jurisdiction as well. The judges in these cases almost invariably express frustration at their inability to accurately forecast debtors' earnings. For example, the court may believe that the debtor may earn future promotions or raises or may be able

or the holder of an allowed unsecured claim objects to confirmation") (alteration in original).

³¹⁸ *Jackson*, 95 I.B.C.R. at 185 ("Disposable income clauses are routinely included in plans confirmed in this District, probably not because debtors find such a requirement attractive, but rather, the Court suspects, because the standing Chapter 13 trustees in Idaho usually object to confirmation of any plan that does not include such a clause. While the law on this point is somewhat unclear, the Court has sustained such objections") (citation omitted).

³¹⁹ See *id.*

³²⁰ See, e.g., *Than*, 215 B.R. at 432 ("Such [a] provision [a disposable income clause] need only be included as a condition of confirmation '[i]f the trustee or the holder of an allowed unsecured claim objects to confirmation'").

³²¹ See *In re Anderson*, 21 F.3d at 356-57.

³²² See 11 U.S.C. § 1325(b) (2000) (beginning, "[i]f the trustee or the holder of an allowed unsecured claim object").

³²³ See *Jackson*, 95 I.B.C.R. at 185. As contrary precedent this court cites a bankruptcy case from the District of Idaho that predates *In re Anderson*. See *id.* (citing *In re Wages*, 92 I.C.B.R. at 78).

³²⁴ See *supra* notes 314-319 and accompanying text.

to work additional overtime.³²⁵ The clearest expression of this pessimism can be found, however, in the context of the recently extended Chapter 12 of the Bankruptcy Code, "Adjustment of Debts of a Family Farmer With Regular Annual Income."³²⁶ Chapter 12 contained a projected disposable income test that, for the purposes of this Article, is worded identically to § 1325(b).³²⁷ In 1994, in *Rowley v. Yarnall*, the U.S. Court of Appeals for the Eighth Circuit noted that the plain meaning of the statute required it to base the debtor's repayment only on the debtor's *projected* income, yet chose to ignore the word "projected" in the statute.³²⁸ It did so because it feared that the debtor would merely predict that disposable income will be zero, and thus render the entire disposable income test meaningless.³²⁹ Effectively, the court feared that it would be unable to project debtors' income and that therefore debtors would have an incentive to "play 'possum" and grossly understate their future income.³³⁰

To the extent one shares the skepticism of these courts in their ability to estimate a debtor's future income, one would reject a debt-adjustment bankruptcy system as doomed to failure. This, however, does not justify an interpretation that ignores the plain meaning of § 1325(b). Courts can address their concerns by adopting readings of other sections that do less violence to the plain meaning of the Bankruptcy Code.³³¹ If a court believes that it can provide a fairly good estimate of the debtor's earnings, but that there is some risk of a big

³²⁵ See, e.g., *In re James*, 260 B.R. at 515 ("And in any event, the Court cannot clearly foresee when or in what amounts Debtor's income and billable hours would increase if his plan were confirmed."); *In re Smith*, 222 B.R. at 858, 860 (requiring debtors to submit periodic financial reports and use any actual income above projected income to repay creditors because debtors had previously worked a significant amount of overtime hours and received distributions from a profit sharing plan); *In re Akin*, 54 B.R. at 703 ("[I]t appears that the debtor's employment history and ability to earn and likelihood of future increase in income is such that there will be increases in income which will be available for additional payments."); *In re Krull*, 54 B.R. at 377 ("Thus there is a good chance that his earnings will increase as he gains on-the-job experience, yet the proposed plan makes no provision for future increases.").

³²⁶ Congress just passed an extension of Chapter 12. See Act of Dec. 19, 2002, Pub. L. No. 107-377, 116 Stat. 3115 (extending Chapter 12 until June 30, 2003).

³²⁷ 11 U.S.C. § 1225(b) (2000) (Section 1225(b) contains language not found in § 1325(b) allowing the court to extend the three-year payment period under § 1222(c), and § 1325(b) contains language not found in § 1225(b) excluding charitable contributions from disposable income.)

³²⁸ 22 F.3d 190, 192 (8th Cir. 1994).

³²⁹ See *id.*

³³⁰ See *id.*

³³¹ See *infra* notes 332-333 and accompanying text.

change in the debtor's circumstances, it can rely on future modifications to account for this problem.³³² If the court truly believes that it does not have a sufficient basis to estimate the debtor's future income, then it should dismiss the Chapter 13 filing due to a lack of regular income.³³³

2. Plan Modifications

Even the guarded optimist of Part II does not believe that judges are omniscient and therefore rejects the utopian approach of basing the debtor's required repayment solely on projected income. Just because judges are not omniscient, however, does not mean that they have no ability to project the debtor's income. Rather, one might reasonably believe that judges can often use the debtor's past income to provide a fairly good estimate of the debtor's future income, but that on occasion this estimate will prove fairly inaccurate. As discussed in Part II, this greater confidence in the ability of judges leads one to advocate an intermediate approach between the utopian bankruptcy system that adjusts the amount of an individual's debts based on projected income and the pessimist's bankruptcy system that is effectively a tax on actual income. The optimist's bankruptcy system adjusts debts based on the debtor's projected income but then adjusts these debts again when the debtor's actual income deviates *drastically* from the projected amount.³³⁴ This is at least a partial description of the approach that Chapter 13 actually takes. To understand how bankruptcy reacts to a drastic change in debtors' financial condition, it is best to separate an improvement in debtors' condition from a deterioration in their condition.

a. Sharp Decline in Financial Condition

The extremely low completion rate of Chapter 13 bankruptcies³³⁵ suggests that judges often overestimate debtors' ability to pay.³³⁶ A fall

³³² See *infra* notes 334–369 and accompanying text.

³³³ See *infra* notes 371–406 and accompanying text.

³³⁴ See *supra* notes 157–162 and accompanying text.

³³⁵ See, e.g., SULLIVAN ET AL., *supra* note 5, at 215–17 (finding a two-thirds failure rate for Chapter 13 cases); see also Jean Braucher, *An Empirical Study of Debtor Education in Bankruptcy: Impact on Chapter 13 Completion Not Shown*, 9 AM. BANKR. INST. L. REV. 557, 557 (2001) (finding that a majority of plans in sample were not completed); Marjorie L. Girth, *The Role of Empirical Data in Developing Bankruptcy Legislation for Individuals*, 65 IND. L.J. 17, 40–42 (1989) (finding completion rate of 63% in sample of post-confirmation Chapter 13 cases in Buffalo, N.Y.); Scott F. Norberg, *Consumer Bankruptcy's New Clothes: An Empirical*

in debtors' ability to pay, however, does not necessarily result in a failed Chapter 13 bankruptcy. If debtors' actual income falls sharply below the projected amount, debtors may seek a modification to reduce their required repayment³³⁷ or, in an extreme case, may seek a hardship discharge.³³⁸

The prospect of post-petition relief creates a further grasshopper problem: to the extent that bankruptcy insulates debtors against an additional fall in their earning ability, they have less incentive to work hard. Because of this, some have argued that courts should not grant a modification when the decline in the debtor's financial condition is due to the debtor's own actions.³³⁹ This, however, is just the utopian solution to the grasshopper problem that is generally rejected both inside and outside of bankruptcy due to a concern that judges will be unable to distinguish those who deserve relief from those who do not.³⁴⁰

Though few, if any, reported cases deny relief to debtors on the grounds that they caused their own financial distress, the high failure rate of Chapter 13 plans suggests that this may occur in practice or that debtors sometimes find it too costly to seek a modification. This does not mean, however, that debtors receive no relief for the subsequent shock that they endure. That is, Chapter 13 does not require debtors to make the payments under their plan. Debtors may be able to reduce their required repayment without obtaining judicial approval by converting their filing to Chapter 7³⁴¹ or by simply dismissing their case³⁴² and relying on non-bankruptcy protections.

Study of Discharge and Debt Collection in Chapter 13, 7 AM. BANKR. INST. L. REV. 415, 440 (1999) (finding completion rate in one district in Mississippi of 32%); Whitford, *supra* note 203, at 411 tbl.2 (finding that only 31% of Chapter 13 cases in study closed as completed).

³³⁶ For confirmation, a judge must find that the debtor is likely to be able to complete his plan. See 11 U.S.C. § 1325(a)(6) (2000). Judges, however, may not be responsible for a significant portion of the failure rate. A large number of debtors may file under Chapter 13 solely to obtain temporary relief through the automatic stay and may have no intention of completing a plan. See, e.g., Warren, *supra* note 14, at 502 ("The Commission received a great deal of testimony from debtors' attorneys asserting that many people do not file for Chapter 13 in order to receive a discharge; they file only for the automatic stay.").

³³⁷ See 11 U.S.C. § 1329.

³³⁸ See *id.* § 1328(b)(1).

³³⁹ See Gross, *supra* note 102, at 146.

³⁴⁰ See *supra* notes 127–131 and accompanying text.

³⁴¹ See 11 U.S.C. § 1307(a), (e).

³⁴² See *id.* § 1307(b).

b. Sharp Improvement in Financial Condition

Perhaps more interesting is the fact that § 1329 explicitly allows the Chapter 13 trustee or an unsecured creditor to seek a modification to increase the debtor's required repayments.³⁴³ Although the mechanics of the Bankruptcy Code do not work well in this context, most courts are willing to play an interstitial role and allow for modifications that increase the required payments even when the standards to be applied are unclear at best.³⁴⁴ They are willing to do so because even those courts that follow the plain meaning of projected disposable income are at best guarded optimists.

Congress amended § 1329 to allow creditors to share in the improvement of the debtor's circumstances,³⁴⁵ but provided no standard for determining the amount by which the repayments should increase. Though § 1329 has occasionally been used to force debtors to pay following an appreciation in their assets,³⁴⁶ this Article focuses on the debtor's income. When assessing how much of the increased income the debtor must pay to the creditor, the natural measure is the projected disposable income test of § 1325(b). It is not at all clear, however, whether the projected disposable income test applies to a proposed modification. For example, though § 1329 specifically references four code sections that apply to modifications, including § 1325(a), it does not directly mention the disposable income test of § 1325(b).³⁴⁷ Some courts have therefore held that the disposable in-

³⁴³ *Id.* § 1329(a)(1).

³⁴⁴ See *infra* notes 351-352 and accompanying text.

³⁴⁵ See *Oversight Hearings on Pers. Bankr. Before the Subcomm. on Monopolies & Commercial Law of the House Comm. on the Judiciary*, 97th Cong. 215, 221 (1984) (statement of Hon. Conrad Cyr, Bankr. J. for the Dist. of Me., on behalf of the Nat'l Bankr. Conf. and the Nat'l Conf. of Bankr. Judges); 14 MARK BANE ET AL., *supra* note 180, at ¶ 1329.03 ("This amendment is intended to carry the ability-to-pay standard forward to any modifications of the plan, allowing upward or downward adjustment of plan payments in response to changes in the debtor's circumstances that substantially affect the ability to make future payments.").

³⁴⁶ A few courts would apply the best interests of the creditors test of § 1325(a)(4) to capture appreciation of the debtor's assets beyond the relevant exemptions. See, e.g., *In re Barbosa*, 236 B.R. 540, 554, 556 (Bankr. D. Mass. 1999) (applying the best interests of the creditors test as of the date of the modification), *aff'd on other grounds, sub nom.*, *Barbosa v. Solomon*, 243 B.R. 562 (D. Mass. 2000), *aff'd* 235 F.3d 31 (1st Cir. 2000). But see *Forbes v. Forbes*, 215 B.R. 183, 189-90 (B.A.P. 8th Cir. 1997) (refusing to apply the best interests of the creditors test as of the date of the requested modification). For a general discussion of this issue, see 3 LUNDIN, *supra* note 282, § 254.1.

³⁴⁷ See 11 U.S.C. § 1329.

come test does not apply to modifications.³⁴⁸ Even if one does apply § 1325(b) to a proposed modification, there are further complications.³⁴⁹ The most significant among these is that § 1325(b) is restricted to projected disposable income and therefore arguably should not capture unexpected increases in the debtor's actual income.³⁵⁰

Despite these problems, most courts are generally willing to use the projected disposable income test to allow creditors to capture some of the benefits of an unanticipated increase in the debtor's financial circumstances.³⁵¹ Moreover, even some of the courts that reject the use of the disposable income test in the modification context would still allow a bankruptcy court to consider an increase in the debtor's income when ruling on a creditor's requested modification to increase payments under a plan.³⁵²

This willingness to modify plans erodes the importance of the distinction between *projected* disposable income and *actual* disposable income. As one bankruptcy judge and commentator put it, "[i]f

³⁴⁸ See, e.g., *In re Moss*, 91 B.R. 563, 566 (Bankr. C.D. Cal. 1988); accord *Forbes*, 215 B.R. at 191; *In re Coleman*, 231 B.R. 397, 401 (Bankr. S.D. Ga. 1999); *In re Anderson*, 153 B.R. 527, 528-29 (Bankr. M.D. Tenn. 1993). Section 1325(a) itself references § 1325(b), however, and therefore the disposable income test is arguably incorporated indirectly into § 1329. This argument is complicated by the fact that such logic results in redundancy, as one of the cross-references, § 1325(a)(1), references all "provisions of this chapter" and therefore includes the sections that § 1329 explicitly references. See 3 LUNDIN, *supra* note 282, § 255.1, at 255-1 to 255-4. A second problem is that, by its terms, the disposable income test only applies upon the objection of the trustee or an unsecured creditor and at least one court has therefore held that the disposable income test cannot apply unless the creditor or the trustee objected to the original plan. See, e.g., *Than*, 215 B.R. at 437. One might instead read § 1325(b)'s requirement of an objection to the confirmation of the plan to refer to the modification, but this creates its own difficulties. If the trustee or an unsecured creditor is moving to increase payments under the plan, then it will be the debtor who is objecting and therefore the requirements of § 1325(b) are not met.

³⁴⁹ Some of the questions are more mechanical in nature, such as whether the three-year period of the disposable income test should be measured from the beginning of the plan or from the time of modification. See 3 LUNDIN, *supra* note 282, § 255.1, at 255-7 to 255-9.

³⁵⁰ See *id.* § 255.1, at 255-6 to 255-7.

³⁵¹ See, e.g., *In re Freeman*, 86 F.3d 478, 481 (6th Cir. 1996); *In re Martin*, 232 B.R. 29, 37 (Bankr. D. Mass. 1999); *In re Studer*, 237 B.R. 189, 193 (Bankr. M.D. Fla. 1998); 3 LUNDIN, *supra* note 282, § 255.1, at 255-2 ("A majority of the reported decisions apply the disposable income test at modification of a confirmed plan, though many do so without comment or analysis.").

³⁵² *In re Than*, 215 B.R. at 436 ("Although we hold herein that § 1325(b) does not apply to this plan modification, we also remand with instructions that the bankruptcy court consider the *Powers* standard, along with factors affecting modification expressly or impliedly raised by the pleadings. Some factors might include: 1) *Than's* increased income, if any, due to the changed circumstances and any change in his expenses . . .").

§ 1325(b) is applied at modification after confirmation, the result refused in *Anderson* comes in through the back door"³⁵³ Because judges are not omniscient, however, this ability to modify a plan when a projection of income proves drastically wrong is central to the justification for initially basing debtors' required repayment on their projected income. In fact, *Anderson*, the leading case holding that the projected disposable income test of § 1325(b) does not require debtors to promise to repay with all of their actual disposable income, based its holding in large part on the ability of creditors to seek a subsequent modification should the debtors' circumstances improve.³⁵⁴

Before one decries Chapter 13 for capturing debtors' actual income and thereby removing their incentive to work, one should note the general lack of reported cases in which courts increase debtors' required payments in response to an increase in debtors' earned income.³⁵⁵ In addition, most, if not all, of the reported cases in this category involve a drastic increase in income caused at least in part by circumstances beyond the debtor's control.³⁵⁶ In *Arnold*,³⁵⁷ the court modified the plan payments after the debtor, a paper product salesman, had an increase in income of over 150%.³⁵⁸ While salespeople are compensated through commissions precisely because their own efforts are important in generating sales, larger economic forces and corporate decisions play a strong role as well. In *Louquet*,³⁵⁹ the court modified the plan payments after the debtor, a self-employed insur-

³⁵³ 3 LUNDIN, *supra* note 282, § 255.1, at 255-7.

³⁵⁴ *In re Anderson*, 21 F.3d at 358 ("Under § 1329, the trustee may request modification of the debtor's plan. 11 U.S.C. § 1329(a). If the debtor or a creditor objects to the modification, the trustee 'must bear the burden of showing a substantial change in the debtor's ability to pay since the confirmation hearing and that the prospect of the change had not already been taken into account at the time of confirmation.'").

³⁵⁵ Since 1984, debtors have filed over five million Chapter 13 bankruptcy petitions. See Am. Bankr. Inst., Annual Non-Business Bankruptcy Filings by Chapter, available at <http://www.abiworld.org/stats/bychapter.html> (last visited Sept. 22, 2002). Though, admittedly not all cases are reported, a fairly diligent search in on-line databases revealed only three reported cases of this type. See *In re Arnold*, 869 F.2d 240 (4th Cir. 1989); *In re Louquet*, 125 B.R. 267 (B.A.P. 9th Cir. 1991); *In re Powers*, 202 B.R. 618, 618 (B.A.P. 9th Cir. 1996).

³⁵⁶ Recall that under the utopian approach to modifications, judges would always change the required repayment following a change in debtors' circumstances that was not caused by their own efforts. See *supra* note 158 and accompanying text.

³⁵⁷ 869 F.2d at 240.

³⁵⁸ The debtor's income had increased from about \$80,000 a year to about \$200,000 per year. *Id.* at 241.

³⁵⁹ 125 B.R. at 267.

ance adjuster, had an increase in income of approximately 45%.³⁶⁰ In *Powers*,³⁶¹ the debtor, a card dealer, also had an increase in income of about 45%.³⁶² In addition, this income was reported only after her employer adopted a tip-allocation method that made it much harder to hide cash tips.³⁶³

Still, because the income of these individuals also depended on their own efforts, the possibility of a modification may discourage similarly situated debtors from working to increase their income. Critics of Chapter 13 often point to the debate over the proper structure of public assistance programs for the idea that the debtor must retain some of the marginal dollar earned.³⁶⁴ Economists have found, however, that critics of public assistance programs overstated the effective tax rates these programs create by ignoring how they are actually implemented. In calculating earnings to be counted against benefits, welfare caseworkers generally deduct numerous expenses, and errors in favor of the beneficiary often creep into the calculations.³⁶⁵ This results in recipients being allowed to keep some of the additional dollars earned. This effect is perhaps more pronounced in bankruptcy as each of the above debtors retained at least half of the increase in his earnings. In *Louquet*, the debtors' income grew by almost \$1,000 per month while the trustee only sought an increase in payments of \$350 per month.³⁶⁶ In *Arnold*, the debtor's monthly income increased by over \$10,000 and yet his payments were only increased by \$700 per month.³⁶⁷ The debtor's gross income in *Powers* increased by approximately \$1,000 per month but her payments increased by only \$500

³⁶⁰ *Id.* at 268.

³⁶¹ 202 B.R. at 618.

³⁶² *Id.* at 620.

³⁶³ The casino began pooling tips and distributing them based on the number of hours worked; prior to this change the debtor had used the amount of tips assumed by the Internal Revenue Service. *Id.*

³⁶⁴ See, e.g., LoPucki, *supra* note 23, at 471.

³⁶⁵ Burtless, *supra* note 15, at 63. In addition, even if the programs do create a 100% marginal tax rate, it is possible, as a matter of theory, that they increase the incentive to work in the aggregate because they discourage some individuals from receiving public assistance. See *infra* note 406 and accompanying text.

³⁶⁶ 125 B.R. at 268.

³⁶⁷ 869 F.2d at 243 ("Arnold's arguments that the increased payments will discourage him from working hard ring hollow in light of the fact that, although his *monthly* gross income in December 1987 was nearly \$10,000 higher than at the time of the Chapter 13 confirmation, the bankruptcy court increased his monthly payments only by \$700 per month. Even with the higher Chapter 13 payments, Arnold's hard work has paid off handsomely for him.").

per month because she was able to claim an increase in her expenses.³⁶⁸

Moreover, even if the increase in debtors' payments matches the increase in debtors' income, debtors may still have an incentive to expend the effort necessary to increase their income. The reason for this is outlined in *Arnold*; as long as the underlying cause of the increase in income—say a promotion, a customer contact, or a raise—has a continuing impact after the termination of the debtor's bankruptcy plan, the threat of a modification would not capture all of the debtor's benefit from this change.³⁶⁹

3. The Regular Income Requirement and Non-Bankruptcy Law

A bankruptcy system that adjusts one's debts based on one's projected income would be administratively burdensome if modifications were often necessary. Therefore, the appropriateness of this approach depends on the ability of judges to forecast a debtor's earnings. To estimate the debtor's income over the three years required by the projected disposable income test,³⁷⁰ courts typically multiply the debtor's current monthly income by thirty-six.³⁷¹

This estimation method would fare poorly if the debtor's income varied significantly from month to month. Section 109 of the Bankruptcy Code, however, restricts access to Chapter 13 to an individual with regular income.³⁷² If the regular income test limited Chapter 13 to those debtors with a fairly stable aggregate income, judges could accurately estimate debtors' future income by using their past income. One might therefore believe that an adjustment of debts approach to bankruptcy would work quite well.

Unfortunately, one can interpret the phrase "an individual with regular income" to mean an individual with *some* or *sufficient* regular income rather than an individual with regular *total* income. To understand the distinction, consider a salesperson who earns a salary of

³⁶⁸ 202 B.R. at 623.

³⁶⁹ *In re Arnold*, 869 F.2d at 242–43.

³⁷⁰ 11 U.S.C. § 1325(b) (2000).

³⁷¹ *E.g.*, *In re Solomon*, 67 F.3d 1128, 1132 (4th Cir. 1995) ("Projected disposable income typically is calculated by multiplying a debtor's monthly income at the time of confirmation by 36 months . . ."); *In re Anderson*, 21 F.3d at 357; *In re Killough*, 900 F.2d 61, 64 (5th Cir. 1990) (*per curiam*) (The task of estimating projected income "is usually accomplished by multiplying the debtor's monthly income by 36.").

³⁷² 11 U.S.C. § 109(e). Chapter 12, an analogous provision for family farmers, is also restricted to a "family farmer with regular annual income." *Id.* § 109(f).

\$20,000 per year and who earned no commissions in four of the five previous years and commissions of \$100,000 in the other year. While this individual has *some* regular income, the aggregate amount of his income is not regular.

One can read § 109(e) to allow debtors with irregular total income access to Chapter 13.³⁷³ The Bankruptcy Code defines “[an] individual with regular income” to mean an “individual whose income is sufficiently stable and regular to *enable such individual to make payments under a plan under Chapter 13 of this title . . .*”³⁷⁴ Therefore, as long as debtors have sufficient regular income to satisfy the various repayment provisions of Chapter 13, they should be allowed to file in Chapter 13.³⁷⁵

Prior to the addition of the projected disposable income test, judges had to determine that debtors would have sufficient income to make their payments,³⁷⁶ but judges did not need to consider debtors' income when determining how large those payments should be unless they considered the debtor's income in their good faith analysis.³⁷⁷ The best interests of the creditors test asks only if the unsecured creditor would have received more in a Chapter 7 liquidation and thus focuses only on debtors' non-exempt assets.³⁷⁸ A few courts did consider debtors' income when deciding whether their plans are filed in good faith, but others did not.³⁷⁹ Therefore, in many jurisdictions the minimum required repayment was effectively determined by the value of the debtor's non-exempt assets, if any,³⁸⁰ and the value of any assets pledged by the debtor to secured creditors as collateral.³⁸¹ This allowed judges to adopt a broad interpretation of the term “regular income.” One court even ruled that a debtor had sufficiently regular and stable income even though future income was not readily ascertainable with any degree of certainty.³⁸²

After the addition of the projected disposable income test, at least one court has held that the debtor's income must be substan-

³⁷³ See *infra* note 374 and accompanying text.

³⁷⁴ 11 U.S.C. § 101(30) (emphasis added).

³⁷⁵ See *id.*

³⁷⁶ See *id.* § 1325(a)(6).

³⁷⁷ See *supra* notes 214–215 and accompanying text.

³⁷⁸ *Id.* § 1325(a)(4).

³⁷⁹ See *supra* notes 214–215 and accompanying text.

³⁸⁰ See 11 U.S.C. § 1325(a)(4).

³⁸¹ See *id.* § 1325(a)(5).

³⁸² *In re Hines*, 7 B.R. 415, 418 (Bankr. D.S.D. 1980) (rejecting trustee's claim that farmer lacks regular income because his earnings are too speculative).

tially certain in amount and reasonably predictable.³⁸³ Most courts, however, continue to use an extremely broad definition of "regular income," and their focus remains on whether the debtor is likely to have the income necessary to make the payments called for under the debtor's proposed plan.³⁸⁴ Some courts do deny debtors access to Chapter 13 for lack of regular income, but these decisions usually involve questions of whether debtors had any income at all because the debtors were either unemployed³⁸⁵ or dependent on the support of friends or family³⁸⁶ to complete their plan. It should be noted that even these debtors are sometimes found to have regular income.³⁸⁷

The addition of the projected disposable income test may make such a broad interpretation of "regular income" inappropriate. As a matter of policy, a debt-adjustment bankruptcy system requires that judges be able to estimate the debtor's income and therefore requires the debtor to have fairly stable income. One does not need to resort to public policy arguments, however, to justify a change in the interpretation of "regular income." One can argue that the language of the Bankruptcy Code *requires* that judges dismiss plans filed by debtors with uncertain aggregate income because these debtors will be unable to "make payments under a plan under Chapter 13"³⁸⁸

Consider how the projected disposable income test would apply to our hypothetical salesperson. Assume that the judge believes that the salesperson's earnings history indicates that there is an 80% chance that the salesperson will earn no commissions in a given year and a 20% chance that the debtor will earn \$100,000 in commissions. Although courts typically just multiply the debtor's current monthly income by thirty-six, this is only a presumptive guide and does not preclude other estimation methods.³⁸⁹ While judges should not in-

³⁸³ *In re Hickman*, 104 B.R. 374, 376 (Bankr. D. Colo. 1989).

³⁸⁴ See, e.g., *In re Murphy*, 226 B.R. 601, 604-05 (Bankr. M.D. Tenn. 1998) (discussing precedent).

³⁸⁵ See *In re Smith*, 234 B.R. 852, 855 (Bankr. M.D. Ga. 1999); *In re Crowder*, 179 B.R. 571, 574 (Bankr. E.D. Ark. 1995).

³⁸⁶ See *In re Jordan*, 226 B.R. 117, 120 (Bankr. D. Mont. 1998) (debtor dependent on support from live-in boyfriend); *In re Hanlin*, 211 B.R. 147, 148 (Bankr. W.D.N.Y. 1997) (unemployed debtor dependent on assistance from friends and family); *In re Cregut*, 69 B.R. 21, 22 (Bankr. D. Ariz. 1986) (debtor dependent on monthly gift from parents).

³⁸⁷ See *In re Murphy*, 226 B.R. at 604 (debtor with written commitment from significant other to make plan payments); *In re Antoine*, 208 B.R. 17, 20 (Bankr. E.D.N.Y. 1997) (unemployed carpenter with oral commitment by his wife to support plan obligations).

³⁸⁸ 11 U.S.C. § 101(30) (2000).

³⁸⁹ See, e.g., *In re Heath*, 182 B.R. 557, 559 (B.A.P. 9th Cir. 1995) ("The *Anderson* opinion does not appear to prohibit means other than the "monthly income times 36" test for

clude the entire \$100,000 commission,³⁹⁰ they should not ignore the prospect for earning this amount either. Financial analysts often value corporations based on their projected income or projected cash flow;³⁹¹ in doing so they may discount uncertain earnings more heavily, but they would not ignore them. A firm's, or an individual's, projected or expected earnings is simply the average amount that it can earn. In the case of our salesperson, the projected income consists of the \$20,000 salary and an average commission of \$20,000 (20% multiplied by \$100,000). If our salesperson is asked to repay an amount based on a \$40,000 projected income and the salesperson has at least *some* reasonably necessary expenses, the salesperson will be unable to make payments the 80% of the time when he earns only \$20,000. This would be true even if the court built in a small cushion for unexpected developments.³⁹² Because the salesperson lacks sufficient stable income to make the payments that are required based on his *projected* income, his filing should be dismissed.³⁹³

A debtor denied access to Chapter 13 effectively has two choices: file under Chapter 7 or rely on non-bankruptcy law for protection.

calculating a debtor's projected disposable income, but it clearly requires that future income be subject to some showing of projectability."); *In re Killough*, 900 F.2d at 66 (per curiam) (holding that while overtime pay should sometimes be included as projected income, the potential for that debtor's overtime work was not definite enough to be included in projected income).

³⁹⁰ See, e.g., *Educ. Assistance Corp. v. Zellner*, 827 F.2d 1222, 1226 (8th Cir. 1987); 2 LUNDIN, *supra* note 282, § 164.1, at 164-29 (reviewing cases and arguing that speculative increases in income should not be included in projected income).

³⁹¹ See, e.g., RICHARD A. BREALEY & STEWART C. MYERS, *PRINCIPLES OF CORPORATE FINANCE* 73-78 (5th ed. 1996).

³⁹² See, e.g., *In re Fries*, 68 B.R. 676, 683 n.7 (Bankr. E.D. Pa. 1986); 2 LUNDIN, *supra* note 282, § 164.1, at 164-29 (reviewing cases).

³⁹³ Although this Article argues for a change in the way "regular income" is interpreted, the new interpretation urged is consistent with the relevant legislative history. For example, in explaining that the "regular income test expands eligibility beyond wage-earners," the Senate report states, "[t]he definition [of regular income] encompasses all individuals with incomes that are sufficiently stable and regular to enable them to make payments under a Chapter 13 plan. Thus, individuals on welfare, social security, fixed pension incomes, or who live on investment incomes, will be able to work out repayment plans with their creditors rather than being forced into straight bankruptcy. Also, self-employed individuals will be eligible to use Chapter 13 if they have regular incomes." S. REP. NO. 95-989, at 24 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5809; *see also* H.R. REP. NO. 95-595, at 311-12 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6268-69. Each of the enumerated individuals either receives an aggregate income stream that is fairly stable (welfare, social security, fixed pension income) or their eligibility is contingent on their having "regular income." See *id.* The one possible exception to this is the individual living on an investment income. See *id.* Congress was likely alluding, however, to those individuals relying on a stable stream of dividends or interest payments rather than the modern day-trader. See *id.*

First, consider how the debtor would be treated under non-bankruptcy law. Creditors would be able to garnish the debtor's actual income subject to state and federal limitations;³⁹⁴ non-bankruptcy law effectively taxes the debtor's actual income. Note that this is the second-best bankruptcy system, or the optimal bankruptcy system when a judge cannot estimate the debtor's potential or projected income.³⁹⁵

Like all income taxes, garnishment may discourage the debtor from working. The marginal rates created by garnishment law, however, are not unreasonably large by the standards of income taxation. For example, a single debtor living in Virginia and earning \$25,000 a year has a marginal tax rate of approximately 25.7% once all state and federal taxes are considered.³⁹⁶ If the debtor's wages are garnished, the total effective marginal rate will rise to approximately 44%.³⁹⁷ While this rate is quite high, it is only slightly higher than the 43% marginal rate that the debtor would pay without garnishment if the debtor earned \$300,000 per year,³⁹⁸ and well below some historical federal tax rates which have reached as high as 94%.³⁹⁹ This comparison is not meant to imply that debtors in financial distress should pay the same effective tax rate as the very wealthy; current garnishment rates may be too high to allow low-income debtors to maintain a sufficient standard of living. Rather, it is merely meant to show that society is sometimes willing to accept the work disincentives associated with high marginal rates in order to achieve other goals.

Of course, garnishment will have some effects that are not marginal in nature. The garnishment process may prove so administratively burdensome to the debtor's employer that the employer may decide to simply fire the debtor. If garnishment leaves the debtor with too little take-home pay, the debtor may prefer to forego work altogether.⁴⁰⁰ Non-bankruptcy law, however, is designed to address these

³⁹⁴ See *supra* note 167 and accompanying text.

³⁹⁵ See *supra* notes 149–150 and accompanying text.

³⁹⁶ This assumes that the individual must pay 7.65% in social security and medicare, 5% in Virginia state taxes and 15% in federal taxes on the amount remaining after the other taxes are assessed.

³⁹⁷ Garnishment would seize an additional 25% of the debtor's *after-tax* income.

³⁹⁸ This assumes that the individual must pay 5% in Virginia state taxes and 39.7% in federal taxes on the amount remaining after the state taxes are assessed. This individual would face no marginal social security or medicare taxes because he will have exceeded the maximum taxes.

³⁹⁹ See Cong. Joint Comm. on Taxation, History of Federal Individual Income Tax Rates, available at <http://www.taxplanet.com/library/oldtaxrates/oldtaxrates.html#5> (last accessed on Oct. 8, 2002).

⁴⁰⁰ See JACKSON, *supra* note 8, at 244.

non-marginal effects as well. For example, federal law now prohibits terminations in response to a garnishment order, though some doubt the effectiveness of this prohibition.⁴⁰¹ In addition, note that debtors would only refuse to work if they have some other means of support such as the assistance of family and friends or public assistance; debtors would not choose to forego work if this meant starvation. Therefore, garnishment must always leave the debtor with a sufficient amount so that the debtor would not prefer to rely on this outside source of support. This problem is likely to be particularly severe for the low-income debtor who may earn little more than is available from public assistance or the non-market economy. Perhaps for this reason federal garnishment law also prohibits garnishment that would leave the debtor with take-home pay less than thirty times the federal minimum wage.⁴⁰²

Unfortunately, simply dismissing Chapter 13 filings will not necessarily lead to the optimal result. These dismissals may just result in more Chapter 7 filings, and Chapter 7 ignores the debtor's income entirely. Moreover, as a matter of theory, one cannot even conclude that the current federal limitations of garnishment, which allow the debtor to keep most of each additional dollar earned, offer debtors a greater incentive to work than a system that seizes all of their actual disposable income. To see why this is the case, it is necessary to return to the literature on public assistance.

For years economists complained that public assistance programs that reduced a recipient's benefit with each additional dollar earned effectively created a 100% tax rate and thereby discouraged the recipient from working.⁴⁰³ The same could be said of a disposable income clause as debtors are required to repay with any amount above their reasonably necessary expenses. When economists actually studied how public assistance programs were implemented, however, they

⁴⁰¹ 15 U.S.C. § 1674 (2000); *see, e.g.*, Susan D. Kovac, *Judgment-Proof Debtors in Bankruptcy*, 65 AM. BANKR. L.J. 675, 720 n. 186 (1991) ("Was the debtor fired because his or her wages were garnished or because the debtor missed work to go to court or because worry about his or her financial situation affected the job performance?").

⁴⁰² *See supra* note 167 and accompanying text.

⁴⁰³ *See* Burtless, *supra* note 15, at 62. Legal scholars have cited this criticism of public assistance programs to criticize the disposable income test of Chapter 13. *See, e.g.*, LoPucki, *supra* note 23, at 471 ("Today, even the crudest welfare proposal must leave the welfare recipient with some incentive to earn the marginal dollar or the proposal has no hope of adoption. It is generally acknowledged that if alimony and child support levels are set too high, they can be counterproductive by discouraging the payor from earning more money. Yet under the scheme of Chapter 13, the debtor who earns an additional dollar is required to pay that additional dollar to unsecured creditors.").

found that recipients did retain some of the additional income they earned because welfare caseworkers were liberal in allowing the recipients to deduct certain expenses.⁴⁰⁴ The same is likely to be true in bankruptcy; there is at least anecdotal evidence that debtors retain a large portion of the benefit of an improvement in their circumstances when their plans are modified to increase the required repayments.⁴⁰⁵

Still, the marginal tax rate created by a disposable income clause is likely to be extremely high. But, as a matter of theory, one cannot conclude that a collection system with a high marginal tax rate discourages work more than one with a low marginal rate. Consider a public assistance program again. If recipients are allowed to retain more of their income, the current recipients may very well work more. This change, however, would also make public assistance attractive to more individuals, and these new recipients would work less than they did before. Because benefits are still partially reduced as earnings increase, these individuals retain less of their marginal dollar earned and thus have less incentive to work. In addition, the public assistance gives them additional wealth, further reducing their need for income and their incentive to sacrifice leisure. To determine whether the lower rate resulted in more hours worked one must compare the additional hours worked by the original recipients and the reduced hours worked by the new recipients.⁴⁰⁶

This same logic would apply in bankruptcy. A system that allows bankrupt debtors to retain more of their disposable income may encourage bankrupt debtors to work more. This change may, however, also make bankruptcy attractive to more debtors and thereby encourage others to file. Because bankruptcy would seize *some* of the disposable income of these new bankrupt debtors, they would keep less of their marginal earnings than they did before. In addition, bankruptcy increases their wealth and thus reduces their incentive to work.

Therefore, the correct method of taxing a bankrupt debtor's income depends critically on empirical assumptions. This is not a decision, however, that courts are asked to make in the context of imple-

⁴⁰⁴ See Burtless, *supra* note 15, at 63.

⁴⁰⁵ See *supra* notes 366-369 and accompanying text. Perhaps more significantly, the three-year limitation on the disposable income test places a limit on the effective marginal rate. When debtors work to increase their wages or earn a promotion, their economic income includes not only their current pay but also the increase in their future earnings as well. Because a disposable income clause does not seize the increased future earnings after the termination of the plan, it does not create an effective marginal rate of 100% and debtors retain *some* incentive to work. See *supra* notes 366-369 and accompanying text.

⁴⁰⁶ See Burtless, *supra* note 15, at 69.

menting Chapter 13. The language of the Bankruptcy Code makes it clear that Chapter 13 should only be open to those debtors with sufficient regular income to make the payments required by a plan filed under that chapter. Today, the language of the Code requires that these payments be set with regard to the debtor's *projected* or *expected* income. Therefore, those whose income is highly uncertain are unlikely to earn enough to be able to repay an amount based on their projected income. Dismissing these cases may not lead to the optimal result, but it will not lead to a result that would justify a departure from the plain meaning of the statute.

CONCLUSION

Bankruptcy resembles a public insurance program in that it provides assistance—in the form of debt relief—to individuals who have suffered some misfortune.⁴⁰⁷ Bankruptcy resembles a tax in that it frequently compels individuals to make payments out of their future income. Like public insurance or progressive taxation, bankruptcy creates moral hazards. Because bankruptcy makes financial distress less painful, it creates a grasshopper problem by encouraging debtors to engage in behavior, such as excessive spending, that makes distress more likely.⁴⁰⁸ Bankruptcy also creates an opossum problem by encouraging debtors to claim more relief than their actual circumstances require.⁴⁰⁹ With enough information, a judge can solve both the opossum and grasshopper problems and implement a utopian bankruptcy system that, like the first-best public insurance and tax systems, results in zero loss of efficiency. To do this, the judge would reduce the debts of deserving debtors to an amount commensurate with each debtor's ability to repay.

While such a utopian bankruptcy system provides a useful benchmark, it is a poor model for public policy because it requires omniscient judges who can precisely determine which debtors are deserving of relief and how much they can earn to repay their debts.⁴¹⁰ Of more relevance is the second-best, or feasible, bankruptcy system, which accounts for the limited information real judges possess and the inevitable moral hazards that result from these limitations.⁴¹¹ In

⁴⁰⁷ See, e.g., SULLIVAN ET AL., *supra* note 4, at 5.

⁴⁰⁸ See *supra* notes 26, 122 and accompanying text.

⁴⁰⁹ See *supra* Part II.A.2.

⁴¹⁰ See *supra* note 102 and accompanying text.

⁴¹¹ See *supra* Part II.B.

the absence of explicit code provisions designed to solve these moral hazard problems, judges have seized on the discretion granted them explicitly or implicitly by the Bankruptcy Code to implement important elements of this second-best bankruptcy system.⁴¹² The judicial approaches to the moral hazard problems resemble the approaches taken in actual public insurance and taxation systems.

While the utopian bankruptcy system would instruct judges to solve the grasshopper problem by denying relief to the negligent, judges have not tried to do so.⁴¹³ This approach mirrors that taken by both private insurance contracts and public insurance programs that operate in an imperfect, or second-best, world.⁴¹⁴ Insurance generally protects individuals against the consequences of their own negligence because judges cannot always distinguish between the negligent and the prudent—and individuals may not be able to conform to the judges' expectations even if the judges could make this distinction.⁴¹⁵

Neither public insurance programs nor private insurance contracts, however, provide relief for willful misconduct, whereas bankruptcy does. Chapter 13 of the Bankruptcy Code contains a superdischarge that will even relieve the debtor of a judgment for a willful and malicious tort.⁴¹⁶ Judicial resistance to the superdischarge is predictable because, in affording relief to the willful and malicious, bankruptcy departed from the approach taken in other public insurance programs.⁴¹⁷ Invoking the good faith standard of § 1325(a)(3), judges have limited the superdischarge to those debtors who have received sufficient punishment (satisfying deterrence concerns) and have made a significant effort to repay their victims.⁴¹⁸ In this way, judges have pushed bankruptcy law toward the approach that public insurance programs take toward the grasshopper problem.⁴¹⁹

To solve the opossum problem, the utopian bankruptcy system would instruct the judge to reduce a debtor's obligations to an amount commensurate with the debtor's ability to repay. Chapter 13 appears to embrace this approach by reducing a debtor's obligations to an amount commensurate with the debtor's *projected* income.⁴²⁰

⁴¹² See *supra* note 163 and accompanying text.

⁴¹³ See *supra* notes 227–231 and accompanying text.

⁴¹⁴ See *supra* note 122 and accompanying text.

⁴¹⁵ See Schwartz, *supra* note 124, at 325.

⁴¹⁶ 11 U.S.C. § 1328 (2000).

⁴¹⁷ See *supra* notes 142–148 and accompanying text.

⁴¹⁸ See *supra* Part III.B.2.

⁴¹⁹ See *supra* Part III.B.2.

⁴²⁰ *Id.* § 1325(b).

Judges resist this approach, however, because they are skeptical of their own ability to project income and thus fear that a debtor will "play 'possum" and understate future income. This skepticism causes some judges to adopt a strained reading of the Bankruptcy Code to adopt a second-best approach, a system that creates an effective tax on the debtor's actual income in bankruptcy. This approach mirrors the structure of actual taxation and public assistance programs. In general, citizens are taxed not on what they can earn but what they actually earn. Likewise, public assistance programs frequently reduce the benefits paid as the recipient's actual income increases, but make no attempt to measure a recipient's actual abilities.

In the bankruptcy context, however, judges may be able to account for their limited information in ways that do less violence to the plain meaning of the Bankruptcy Code. If judges can use the debtor's income history to provide at least a workable projection of the debtor's future income, they can base the debtor's required payments on this projection, not on actual income. This approach would be much closer to the ideal solution to the opossum problem and it should be favored, provided that the debtor's income history allows the judge to make a fairly accurate projection.

In the unique context of Chapter 13, which should apply only to debtors with regular income,⁴²¹ the debtor's past income may provide the judge with sufficient information to project future income. If the judge does not have sufficient information—i.e. if the debtor does not have predictable income—the statutory structure suggests that the judge respond by holding Chapter 13 relief to be unavailable rather than by imposing a tax on actual income within bankruptcy.⁴²²

If debtors denied relief in Chapter 13 rely on state law for protection, then they will in fact receive a tax on their actual income in the form of a state garnishment proceeding; this is the appropriate collection mechanism for an individual with irregular income. A debtor also has a right, however, to file under Chapter 7 of the Bankruptcy Code. This chapter ignores debtors' future income—probably their most valuable asset—when setting their required repayment. This Article suggests that, despite this anomaly, Chapter 7 may still play a role in an optimal bankruptcy system if restricted to those debtors who would repay nothing in Chapter 13.

⁴²¹ *Id.* § 109(e).

⁴²² *See id.*

Whether current bankruptcy law contains adequate mechanisms for limiting Chapter 7 to these debtors is questionable,⁴²³ though this is a topic for another day. Nevertheless, the analogy between bankruptcy and public insurance is likely to yield valuable insights.⁴²⁴ The search for the proper tools to deal with the problems of poverty and inequality has represented one of the most vibrant areas of economic research for over one hundred years. Although economists have long agreed on a fairly simple first-best approach, they continue to vigorously debate the precise form of the second-best, or feasible, program. Therefore, if we are interested in a feasible optimal bankruptcy system, the public assistance and taxation literatures do not promise an easy answer. They do offer, however, valuable lessons and remind us that whatever system we do choose must be designed to operate in a non-optimal world.

⁴²³ See SULLIVAN ET AL., *supra* note 4, at 13.

⁴²⁴ Scholars have already noted the analogy between means-testing in public assistance programs and proposals for means-testing in bankruptcy. See, e.g., Dickerson, *supra* note 16, at 52-56. Economists, however, suggest other mechanisms for distinguishing those who are truly in need from those who can in fact support themselves such as the use of punishment or in-kind transfers. See *supra* note 62 and accompanying text.