



The Insolvent Consumer and the Legal System

RISING FORECLOSURE AND BANKRUPTCY RATES HAVE PLACED consumer insolvency on the front page, but America has always been a nation of debtors. In 2009 bankruptcy courts received approximately one bankruptcy filing for every two hundred Americans; in 1833 America imprisoned approximately one debtor for every two hundred Americans. Although consumer insolvency is not new, the nature of consumer finance and the law's treatment of the defaulting debtor have changed. While most bankruptcy scholars focus on corporate insolvencies, Professor Richard Hynes has devoted most of his scholarship to the understanding of consumer insolvency in the modern world.

Hynes joined the University of Virginia in 2007 after having spent seven years on the faculty of the College of William & Mary. In just one decade in the legal academy, Hynes has made an important mark on his field. Because of his inter-disciplinary training, Hynes brings to his study of consumer insolvency formidable empirical skills. Relying

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on these skills, Hynes has been able to answer some important policy questions, and also to raise new ones. Hynes has also made a signature conceptual contribution to his field by more completely studying the way the legal system handles consumer debt. The bankruptcy system tends to have pride-of-place in scholarship about consumer debt, but Hynes has called attention to and analyzed the parallel legal system, which is both vast and understudied, that handles debtor-creditor relations outside of bankruptcy. Hynes' study of these parallel systems for handling consumer debt—bankruptcy and non-bankruptcy debtor-creditor law—has produced several lasting insights.

In his article, "Bankruptcy and State Collections Proceedings: The Case of the Missing Garnishments," 91 *Cornell L. Rev.* 603 (2006) Hynes looks to state court records to quantify the importance of non-bankruptcy debtor-creditor law. The consumer bankruptcy literature had assumed that state courts played little role in debt collection because studies of consumer bankruptcy filings found that few bankrupt debtors had been sued. Hynes's examination of garnishment records in Virginia and Cook County, Illinois revealed that, at least in some jurisdictions, creditors commonly use state courts to collect consumer debts. In fact, the number of garnishments issued by Virginia courts in 2004, 188,325, dwarfed the number of non-business bankruptcies filed in Virginia in that year, 39,726.

The Case of the Missing Garnishments also offers evidence that may help resolve an important debate about the reason for the rapid rise in bankruptcy filings prior to the passage of the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA) of 2005. Annual bankruptcy filings rose more than six hundred percent between the first years after the passage of the Bankruptcy Reform Act of 1978 and 2005. This startling rise in filings was explained by some as evidence of a consumer debt crisis; for others, it was proof that the law made it too easy to file for bankruptcy. *The Case of the Missing Garnishments* reveals that garnishment and bankruptcy have followed very different trends. Between 1992 and 2004 Virginia's non-business bankruptcy filing rate (bankruptcy filings divided by population) was *relatively* stable, but it still rose almost thirty percent.

By contrast, the garnishment rate fell by about eight percent. To the extent that garnishment serves as a proxy for consumer insolvency and default, *The Case of the Missing Garnishments* provides some evidence for those who argue that the dramatic rise in consumer bankruptcy filings was due at least in part to an increase in a willingness to file for bankruptcy and not just an increase in financial distress.

In “Broke but Not Bankrupt: Consumer Debt Collection in State Courts,” 60 *Fla. L. Rev.* 1 (2009) Hynes extends his analysis of *The Case of the Missing Garnishment* in two ways. First, this article verifies that the relative stability in civil litigation is not an artifact of Hynes’ earlier focus on one remedy (garnishment) in just two jurisdictions. Looking at civil filing statistics in nearly all states, *Broke but Not Bankrupt* reveals that the rate of civil litigation remained remarkably stable during the years of rapidly rising bankruptcy filing rates. Between 1980 and 2002 the average number of civil filings per person rose by just twelve percent; the bankruptcy filing rate rose by over 275%. This comparison between civil filing rates and bankruptcy filing rates is only interesting if consumer debt collection comprises a significant portion of the civil docket. *Broke but Not Bankrupt* therefore looks more closely at litigation in one of the most litigious states, Virginia. In some years Virginia courts receive more than one million civil filings, and *Broke but Not Bankrupt* finds evidence that consumer debt collection dominates the civil docket. Over ninety percent of suits list an individual as the defendant, and the claims and stakes are consistent with consumer debt collection. Only about twenty percent of judgments are ever satisfied, but only twelve percent of the debtors who failed to pay their judgments for several years bothered to file for bankruptcy.

Broke but Not Bankrupt, however, does more than provide important insights about the rate of bankruptcy filings. It maps a large, parallel system of creditor-debtor law that occurs outside of bankruptcy. In doing so, Hynes demonstrates that a complete understanding of legal responses to consumer insolvency includes not only the formal bankruptcy system, but also the much more commonly used (and less studied) “informal” bankruptcy system in which debtors simply fail to pay. In subsequent work,

Hynes begins to ask and answer questions about the relationship between these parallel legal systems for handling creditor-debtor relations.

“Non-Judicial Debt Collection and the Consumer’s Choice among Repayment, Bankruptcy and Informal Bankruptcy,” a working paper co-authored with Lawrence Ausubel and Amanda Dawsey, asks what determines the debtor’s choice between formal or informal bankruptcy. More specifically, *Non-Judicial Debt Collection* focuses on state laws that provide a private right of action against an abusive creditor. Many debtors are effectively judgment-proof. For these debtors, the primary benefit of bankruptcy is that it will stop the telephone calls and other non-judicial collection effects. Federal law provides some protection against abusive debt collectors, but this law contains an important gap—it applies only to third party debt collectors and creditors who purchased the loan after it was in default. About half of the states fill this gap with a statute that provides debtors with a private right of action against an abusive creditor.

To the extent that these laws lessen the ability of creditors to harass debtors, they make a formal bankruptcy filing less necessary. *Non-Judicial Debt Collection* presents empirical evidence to support this theory. First, it uses aggregate filing statistics to show that counties in states with these anti-abuse statutes tend to have lower bankruptcy filing rates. Second, it uses individual level data to show that credit-card holders are more likely to choose informal bankruptcy (simply refuse to pay) if they live in a state with an anti-abuse statute.

In “Why Consumer Bankruptcy,” 56 *Ala. L. Rev.* 121 (2004) Hynes tries to understand the proper roles for the parallel systems of debt relief—formal and informal bankruptcy. Standard theory provides two justifications for bankruptcy law: i) to maximize creditor return by preventing a wasteful race to the assets and ii) to provide a fresh start to the honest but unfortunate debtor. The first theory cannot apply to consumer bankruptcy because the most common form of consumer bankruptcy, Chapter 7, does not generate *any* distributions for general creditors in over ninety-five percent of cases. The second theory is incomplete because non-bankruptcy law offers protection for the honest but unfortunate debtor as well.

Why Consumer Bankruptcy suggests that the presence of the two systems may allow the law to address the fact that procedures appropriate for some debtors may be far too expensive for others. Bankrupt consumers frequently spend thousands of dollars on court and attorneys' fees. A rational system would seek to avoid spending much money to verify a debtor's inability to pay when the creditors have prior knowledge that this is the case. By protecting at least some income and assets outside of bankruptcy, non-bankruptcy law can allow the debtor and her creditors to avoid the expense of a formal bankruptcy proceeding. To the extent that policy makers are worried that legal reforms have made bankruptcy too expensive for the poor, the remedy may not require a reform of our bankruptcy laws. We may be better served by simply increasing the level of protection afforded to those debtors who proceed in the parallel, informal bankruptcy system.

While *Why Consumer Bankruptcy* addresses the inequality in the procedures applied to defaulting debtors, "Non-Procrustean Bankruptcy," 2004 *Ill. L. Rev.* 301 addresses the inequality in the living standards afforded to defaulting debtors. News reports of celebrity bankrupts remind us that some debtors maintain lavish standards of living even after default, and debtor-creditor law also allows middle-class debtors to maintain a standard of living far beyond the reach of the poor. Debtor-creditor law only allows debtors to keep what they have, and it therefore cannot offer as much to those debtors without significant assets or income. However, debtor-creditor law also explicitly endorses inequality. For example, exemptions from wage garnishment protect a percentage of the debtor's income; those who earn more can protect more from their creditors. Similarly, bankruptcy law now explicitly allows debtors to include payments to secured creditors, such as mortgage or car payments, in the calculation of allowable living expenses. Those who lived in larger homes or drove more expensive cars prior to bankruptcy are entitled to continue doing so after filing.

If debtor-creditor law were a social assistance program funded by the taxpayer, this inequality would be hard to explain. However, bankruptcy is most commonly justified as a form of social insurance, not social assis-

tance. Bankruptcy provides a benefit, debt-relief, when debtors are unable to repay their debts, and debtors pay premiums for this insurance in the form of higher interest rates. If debtors contracted for this insurance, wealthier debtors would demand greater benefits. Poorer debtors would like to have a high standard of living after default just as poorer individuals would like large life insurance benefits. They would not, however, want to pay the necessary premiums. As long as most debt is contractual in nature and creditors can distinguish rich from poor at the time of contracting, the higher standard of living afforded to wealthier debtors will not affect the interest rates that poorer debtors must pay. To the extent that this is the case, the inequality provided by debtor-creditor law is unobjectionable.

Hynes has also brought his empirical skills to bear on the property exemptions that protect a defaulting debtor's assets both inside and outside of bankruptcy. The literature has studied these exemptions extensively due to their dramatic variation from state to state. For example, seven states, including Florida and Texas, protect a debtor's home regardless of its value while four others have no homestead exemption at all. Despite extensive study, the literature has not demonstrated that these exemptions have a robust effect on debtor or creditor behavior. Some studies find that they increase bankruptcy filings, but others find that they do not. Some studies find that these exemptions reduce access to credit, but these studies sometimes find the most pronounced effects for debtors with nothing to exempt. If one does not own a home, it should not matter whether the state's homestead exemption is \$100,000 or unlimited. "Credit Markets, Exemptions and Households with Nothing to Exempt," 7 *Theoretical Inq. L.* 493 (2006) makes precisely this point and suggests that the exemptions may be serving as proxies for other laws that do affect creditor or debtor behavior.

"Bankruptcy Exemptions and the Market for Mortgage Loans," 42 *J. L. & Econ.* 809 (1999), co-authored with Jeremy Berkowitz, attempts to bring some clarity to the question of the effect of these exemptions on availability of credit. It argues that researchers must distinguish between secured and unsecured loans when discussing exemptions. Exemptions do

not prevent a secured creditor from seizing her collateral and thus should have no direct effect on a creditor's willingness to lend. It is possible that there will be indirect effects. For instance, homestead exemptions may reduce mortgage creditor recoveries if they encourage debtors to file for bankruptcy and delay the mortgage creditor's recovery. But these transaction cost effects are likely to be small and other factors point in the opposite direction. Exemptions are only relevant when the mortgage creditor is fully secured and therefore entitled to interest in bankruptcy. Moreover, a bankruptcy filing may actually improve the mortgage creditor's return if it discharges the debtor's unsecured debts and allows the debtor to repay the mortgage lender in full. *Bankruptcy Exemptions* finds some support for the claim that exemptions should not have a negative effect on the availability of credit, and in fact may have a positive effect. The data show that larger homestead exemptions seem to increase the willingness of mortgage creditors to lend, though the effect is very small.

The literature on property exemptions suffers from a common problem in empirical scholarship. The literature treats the exemptions as exogenous, but they are a product of legislative choice. The legislature may consider factors such as the bankruptcy filing rate or the availability of credit when setting exemptions, and this would bias the result of a study of the effect of exemptions on these variables. "The Political Economy of Property Exemption Laws," 47 *J. L. & Econ.* 19 (2004), co-authored with Anup Malani & Eric Posner, examines the determinants of the legislative choice to adopt or modify an exemption. The most robust finding is that a state's current exemptions are strongly affected by the exemptions it had in place in the late 19th or early 20th century. This mitigates concerns of bias in the literature and suggests a proxy (historical exemptions) to avoid this bias in future studies.

The law must protect debtors who cannot repay their debts without undue hardship, but it must do so without severely limiting the ability of creditors to collect from debtors who can pay or creditors will be unwilling to lend. Bankruptcy law plays an important role in the effort to separate the debtors who can pay from those who cannot, but Hynes' scholarship

reminds us that it is but a part of a larger system of debtor-creditor law. He has used his legal and economics training to establish himself as a leading scholar in consumer finance. Given the long history of consumer insolvency, this area should provide important research questions for years to come. 🌿

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The Regulation of Non-Judicial Debt Collection and the Consumer's Choice among Repayment, Bankruptcy and Informal Bankruptcy

(Working Paper)

ECONOMISTS STUDYING THE EFFECTS OF THE LAW ON THE consumer bankruptcy filing decision generally look at statutes limiting the enforcement of judgments. Typically, the focus is on exemptions of assets in bankruptcy (the level of the homestead exemption and other property exemptions) or limitations on creditors' ability to seize property or garnish wages in state courts prior to bankruptcy. This article examines another set of laws that could play an equally important effect on the bankruptcy decision: laws that regulate aggressive non-judicial debt collection.

Many creditors rely heavily on non-judicial debt collection techniques such as dunning letters and telephone calls to debtors, foregoing the legal process altogether. Bankruptcy rarely serves as a means of collection for general unsecured creditors; fewer than five percent of Chapter 7 cases have non-exempt assets available for distribution. Creditors do collect in state court, but the use of courts to collect consumer debt varies tremendously by state. Moreover, even in the most litigious states many creditors choose not to sue.... Lawsuits may also be declining in importance as a means of collecting debts. The rate of civil litigation has remained fairly stable over the last thirty years, and the evidence suggests that the change in rate of consumer debt collection litigation has not matched the generally upward trend of consumer borrowing or the bankruptcy filing rate.

The fact that creditors do not sue does not mean that they do not try to collect. Either they or third-party debt collectors will use telephone

calls, dunning letters, and a variety of other non-judicial debt collection techniques to try to convince the debtor to pay. The pressure on the debtor may be severe, and may often be enough to cause a debtor to choose bankruptcy. Sullivan, Warren & Westbrook (1989) find that about two-thirds of bankrupt debtors file before they are sued, and Stanley & Girth (1971) found similar results a generation ago.

At least some of the non-judicial collection techniques employed by creditors and their agents can be fairly described as aggressive, if not harassing or abusive, and the law tries to limit this conduct. For example, the New York State Attorney General's office recently obtained a court order to shut down a Buffalo-area debt collection operation. Employees were alleged to have routinely impersonated police officers, threatening to arrest consumers and throw them in jail unless they made arrangements to pay the company immediately. In more common incidents, collectors threaten debtors that if they are successfully sued and do not pay, they may be jailed; and collectors telephone debtors at their workplace, knowing that the employer does not permit such contacts.

The federal Fair Debt Collections Practices Act (FDCPA) regulates collection practices. It limits whom the creditor may contact and when the creditor may contact them, and it gives the consumer the right to sue the creditor for violations of this act. Significantly, however, the federal FDCPA largely exempts the original creditors from its coverage; rather it targets third-party debt collectors (including lawyers) and creditors who purchased the debt after default.


The original creditors, however, are not entirely free from regulation. The Federal Trade Commission uses its power to police "unfair or deceptive acts or practices" to bring administrative actions against creditors for overly aggressive debt collection. State unfair trade practice statutes and tort law provide further protection. In addition, many state legislatures have passed statutes specifically regulating non-judicial debt collection. These laws vary greatly. Some merely require licensing and others apply only to third-party debt collectors. This article focuses on those statutes that fill the gap created by the Fair Debt Collection Practices Act by giving

the consumer a private right of action against the abusive or harassing original creditor. About half of the states have such a statute.

Section III uses the existence of these anti-harassment statutes and county-level bankruptcy data to reexamine one of the most commonly-asked questions in the consumer finance literature: whether differences in the law affect the consumer's bankruptcy filing decision. Anti-harassment laws may reduce the pressure that creditors can exert on a consumer in default, and they may therefore reduce the demand for bankruptcy protection. We find that counties in states without anti-harassment statutes have average bankruptcy filing rates that are twelve to nineteen percent higher than counties in states that do. This effect remains statistically and economically significant in a wide variety of regressions using county-level data.

Regressions that use aggregate bankruptcy filing rates could confound several effects because, in addition to the direct effects discussed above, anti-harassment laws may have several indirect effects on the bankruptcy filing rate. Anti-harassment laws may reduce the cost of default and thereby increase the number of defaults, and some of these additional defaults could ultimately lead to bankruptcy. To the extent that these laws reduce the ability of a creditor to collect, they may also reduce the supply of credit. If this results in lower debt burdens, it may ultimately lead to fewer bankruptcies. Ideally one would use individual repayment records to separate these three effects, and Section IV uses data from individual credit card accounts to do just this. Section IV finds that defaulting credit-card holders who live in states with anti-harassment laws are more likely to become "informally bankrupt." *Informal bankruptcy* is a term that describes borrowers who have defaulted, but who have not filed for formal bankruptcy protection. At the same time, borrowers in these states are less likely to file for bankruptcy. We find that the thought experiment of moving a borrower from a state without an anti-harassment law to a state with an anti-harassment law increases the likelihood of informal bankruptcy by fourteen percent, and decreases the likelihood of formal bankruptcy by fifteen percent. These results, taken together, strongly suggest that

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anti-harassment laws significantly decrease the cost of resisting creditors' collection activities and thereby significantly decrease consumers' use of the bankruptcy courts. 

Bankruptcy and State Collections: The Case of the Missing Garnishments

91 *Cornell L Rev.* 603 (2006)

AFTER YEARS OF INTENSE LOBBYING BY THE CONSUMER CREDIT industry, Congress enacted reforms that reduce the generosity of consumer bankruptcy and restrict the availability of bankruptcy. Consumer advocates and most bankruptcy scholars vigorously opposed these reforms, and will almost certainly strive to limit the impact of these reforms by influencing judicial interpretation. Consumer advocates have not merely played defense, however, and they have extended the fight far beyond bankruptcy. Congress and the states have passed legislation designed to stop “predatory lending,” and many scholars advocate much stronger reform, such as a return to strict usury laws and other limits designed to stop lenders who “seduce” consumers with easy credit.

Much of the interest in consumer finance stems from the continued rise in consumer bankruptcy filings. Americans filed over 1.5 million nonbusiness bankruptcies in 2004, a sharp increase from the roughly 189,000 total (business and nonbusiness) bankruptcies Americans filed in 1974 and the roughly 53,000 total bankruptcies Americans filed in 1954. These stark filing statistics dominate much of the modern consumer finance literature, though scholars interpret the numbers differently. Some espouse an “Incentive Theory” of bankruptcy that claims more Americans choose bankruptcy to avoid paying their debts, either because various changes have made bankruptcy more attractive or because more consumers are aware of bankruptcy’s benefits. According to the competing theory, the “Distress Theory,” bankruptcy’s role in financial distress has not changed significantly, and more Americans are forced into bankruptcy by an increase in social instability and indebtedness. Though they generally disagree on policy, proponents of the two theories share the belief that the bankruptcy statistics indicate a deepening crisis.

The consumer finance literature's focus on federal bankruptcy law has come at a cost, as scholars have largely ignored collections efforts that occur outside of bankruptcy. If the bankruptcy statistics indicate a serious problem, the problem is not really bankruptcy itself, but rather financial distress and default more generally. In fact, many, and probably most, Americans who do not repay their debts do not bother filing for bankruptcy. A consumer suffers financial distress regardless of whether she admits failure by filing for bankruptcy. A creditor must write off a bad debt regardless of whether the debt is discharged in bankruptcy or if the creditor simply cannot collect using state collections proceedings and nonjudicial collections techniques. If we are to understand the extent of consumer financial distress, we must look beyond bankruptcy.

This Article adds to our understanding of financial distress by examining one of the most important collections tools afforded by state law: garnishment. Garnishment is a judicial remedy used to seize property of a debtor held by a third party, such as unpaid wages in the hands of an employer or money deposited in a bank account. . . . Surprisingly, this is the first article in thirty years to carefully examine garnishment statistics.

These new data present a surprising puzzle for consumer finance scholars that challenges some of their most basic assumptions. While the nonbusiness bankruptcy filing rate has increased dramatically over the last ten to fifteen years, the rate of garnishment has declined slightly in Virginia and appears to have fallen dramatically in Cook County, Illinois. Though the data uncovered by this Article do not predate the late 1980s, they do provide insight into the state collections proceedings of Cook County, including the city of Chicago, one of the jurisdictions that Professor David Caplovitz studied a generation ago. Comparing Professor Caplovitz's estimate of the number of garnishment orders in the late 1960s with the number of garnishment orders in recent years suggests that state collections proceedings may have been more common in the past than they are today. Given the sharp rise in bankruptcy filings during this period, the relative decline in garnishments is striking. Thus, this Article uncovers a new puzzle in consumer finance: the case of the missing garnishments.

Assuming the missing garnishments are part of a national trend, they have important implications for the ongoing debate over the cause for the rise in bankruptcies and the need for reform. Fundamentally, the Incentive Theory claims that Americans in financial distress today are more likely to file for bankruptcy, and the Distress Theory claims that today there are more Americans in financial distress. Both claims could be true, and the debate is really over their relative importance. Unfortunately, one cannot weigh the relative importance of these two theories by counting the number of Americans in financial distress, as it is difficult to measure or even define financial distress. Until now, scholars have largely focused on the bankruptcy filing rate as “a thermometer, recording the economic temperature of American families.” This Article argues that the rate of garnishment serves as an additional indicator that tells a markedly different story.

The missing garnishments appear to be much more consistent with the Incentive Theory than with the Distress Theory. An increased willingness of debtors to file for bankruptcy could cause the rate of garnishment to fall because the bankruptcy discharge will protect the debtor from garnishment. By contrast, the missing garnishments appear sharply inconsistent with the claim that the rising tide of bankruptcy filings consists of debtors forced into bankruptcy by crushing debt levels, or at least sharply inconsistent with the claim that an increasing number of debtors are forced into bankruptcy by their creditors’ efforts to collect these debts. While this apparent inconsistency can perhaps be explained, many of the most obvious explanations are inconsistent with the data, and others are either incomplete or lack empirical support at this time.

The most important implication of this Article may be the need for more research. If the opponents of the recent reforms are correct, bankruptcy may no longer shield distressed debtors from debt collectors. Consequently, policymakers concerned with the plight of these debtors must seek a better understanding of nonbankruptcy collections. Moreover, even after the proper interpretation of the new legislation is settled, broader questions concerning the regulation of consumer finance will remain open, and policymakers will need data to inform their decisions. Viewed with a

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wider lens, the world of consumer finance may not have changed as much as previously thought—or at least not in the ways previously thought. Policymakers should facilitate more research to better inform their decisions and should make more information about nonbankruptcy debt collection publicly available. 🌿

The Political Economy of Property Exemption Laws

47 *J. L. & Econ.* 19 (2004)

EVERY STATE HAS LAWS THAT PROTECT SOME OF THE ASSETS of debtors from the satisfaction of claims by creditors. These property exemption laws, which are also called bankruptcy exemptions, have long and important political histories. Texas entered the union as the first state with property exemptions—designed, it was said at the time, to draw settlers from other states—but the southern states responded quickly with exemptions of their own, and today every state has property exemptions, frequently quite generous. Like usury, stay, and currency laws, exemption laws have played an important role in the perennial conflict between debtors and creditors.

Exemption laws also play an important role in federal bankruptcy law, and it is here that they enjoy a higher profile. The treatment of state property exemptions in the federal bankruptcy code of 1978 resulted from a compromise between the House, which sought to establish a mandatory system of federal exemptions, and the Senate, which sought to incorporate state exemption laws as the older bankruptcy law did. The compromise law established a set of federal exemptions and permitted debtors to choose between these federal exemptions and the exemptions of the state in which they reside, unless that state had by statute “opted out” of the federal system, in which case the debtors would have to use that state’s exemptions. Feelings about exemptions were strong enough in 1978 that this compromise almost did not occur, and these strong feelings persist today. Recent efforts to amend the federal bankruptcy law have foundered over, among other issues, the question of whether state exemptions should be capped by a federal ceiling, and more than sixty-five law professors have written to Congress to ask for greater federal control over bankruptcy exemptions.

Exemptions are important because of their role in the regulation of consumer credit and the light they shed on the federal relationship between the states and the national government. But they are a puzzle for economists because, like usury laws, they restrict credit markets in the absence of a well-defined market failure to which they would be a suitable response. Studies of the impact of exemptions on credit markets show that, while exemption laws may provide some insurance against income shocks, they increase the cost of credit, particularly for the poor.

Many scholars have tried to explain the effect of exemption laws on economic behavior, including lending practices and the bankruptcy filing rate. The latter had been rising gradually through the 1960s and 1970s, but after the enactment of the Bankruptcy Reform Act of 1978, the filing rate increased markedly. Some commentators have blamed the increase on the generosity of federal exemption laws, but the evidence is conflicting. Nevertheless, concerns about the default rate and the bankruptcy filing rate have provoked calls for reform of the Bankruptcy Code, including a provision that would cap exemptions so that states can no longer provide generous relief to the wealthiest debtors, but this could hardly be expected to affect the filing rate, because very few debtors who have valuable assets file for bankruptcy.

A separate concern is that state property exemptions are not sufficiently generous and that they vary too much across states. Many state property exemption laws have archaic provisions that have not been changed since the nineteenth century. In Oklahoma, for example, the debtor can exempt a gun, 20 head of sheep, and “all provisions and forage on hand.” Commentators assume that state legislatures must not care enough about exemptions to update them, which would justify a federal role. Although, as we will see, these concerns are exaggerated, the debate reflects the important role of federalism in bankruptcy policy.

Despite the absence of an intuitive theory to explain the market failure for which exemptions would be the solution, no one has tried to explain why states create exemption laws in the first place or why these laws differ across states. Understanding this relationship also has important

implications for studies that attempt to determine the effect of exemptions on lending and bankruptcy. These studies often treat exemptions as exogenous variables. If exemptions are instead driven by the very economic outcomes that these studies examine, the studies may suffer endogeneity bias and be suspect.

This paper attempts to fill this gap in the literature. An initial examination of a data set of the exemption laws of the 50 states between 1975 and 1996 reveals only that the best predictor of current levels of a state's exemption is that state's historical exemptions. To overcome this difficulty, we exploit the opt-out provision of the 1978 Bankruptcy Code, which confronted states with a stark choice of whether to allow their residents to use new, federal exemption that were often much more generous than the exemptions in effect in the state at the time or whether to restrict their residents to the state's exemptions. By examining how states reacted, we can discover some of the factors that influence their exemption choice

WE HAVE NOT FULLY EXPLAINED EXEMPTION LAWS, BUT WE HAVE fitted together a few pieces of the puzzle. Historical evidence suggests that exemptions were initially popular as a way to protect existing debtors against creditors and, thus, of attracting migrants to sparsely populated states. The best predictor of current levels of exemptions is historical levels of exemptions. This is not surprising. Existing law always supplies the starting point from which legislators bargain over reform, and so very old laws exert influence over the present and recent past. Although we do not have enough observations for our initial regressions to pick out the determinants of recent variation in exemption levels, regression of exemption levels to the mean suggests that these determinants are converging.

In 1978, state legislatures were confronted with federal exemptions that were often more generous than state homeowner exemptions and nearly always greater than state nonhomeowner exemptions. States with below-federal exemptions opted out. Although expected, this validates other

evidence, such as the frequency with which states modify their exemptions, that exemptions are still important to most states. Also as expected, states that ultimately opted out did so almost immediately after the passage of the 1978 act. Finally, the 1978 act shifted bargaining power in favor of state legislators who preferred generous exemptions. As a consequence, legislators who preferred less generous exemptions had to agree to moderate levels in order to obtain the political support for opt out.

Our main finding with respect to the question of why states care about exemptions is that states with high bankruptcy rates were more likely to opt out; the effect was larger for states with lower-than-federal homeowner exemptions. The latter group also opted out more quickly. Moreover, states that were conservative, at least in terms of their attitude toward government transfers of wealth to the poor, were more likely to opt out of the more generous federal exemptions. But this effect was relatively small. It appears, therefore, that the perception that generous exemptions increase the costs of existing bankruptcies or raise the rate of future bankruptcies explains why low-exemption states care about exemptions.

The findings in this paper also give us some clues about the political history of the Bankruptcy Reform Act. The battle between the House and the Senate over exemptions was, it turns out, really a battle over whether nonhomeowners ought to enjoy more generous exemptions (the original House bill) or be stuck with the original ungenerous state exemptions (the original Senate bill). The compromise was the opt-out system, and it really was a compromise in the sense that the effective exemptions for nonhomeowners in nearly all ungenerous states rose—either because federal exemptions became available to debtors or states increased their exemptions as they opted out. At the same time, the law permitted the states more local control and resulted in more variation than would have been the case if the Senate and House had merely agreed on uniform federal exemptions that were somewhat lower than those in the House bill. ☺

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