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## Making Sense of Nation-Level Bankruptcy Filing Rates

Ronald J. Mann

*Columbia Law School*, [rmann@law.columbia.edu](mailto:rmann@law.columbia.edu)

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## **Making Sense of Nation-Level Bankruptcy Filing Rates**

Ronald J. Mann<sup>\*</sup>

### **I. INTRODUCTION**

Much of the developed world has experienced a similar pattern of spending, debt, and insolvency over the last twenty years. First, as national income and consumer spending rise, the level of consumer debt inevitably increases. When consumer debt becomes commonplace, the incidence of household financial distress rises, with burgeoning rates of insolvency not far behind. What once was a problem only for merchants and businesses quickly becomes a risk that confronts all classes of the populace, rich or poor. As this pattern has played out, financial distress and insolvency have become front-page

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<sup>\*</sup> Professor of Law, Columbia Law School. I am grateful to Michelle White for suggesting this inquiry, for comments from Jean Braucher, Tony Duggan, Angie Littwin, Johanna Niemi Kiesiläinen, Luke Nottage, Katie Porter, Iain Ramsay, Adrian Walters, and Jacob Ziegel, and for input received at presentations of earlier versions of this project at the 2006 Annual Meetings of the American Law and Society Association and the International Academy for Commercial and Consumer Law, at the 2007 International Conference on Law and Society, at the University of British Columbia, at Canada's Annual Review of Insolvency Law, and at the 2007 Conference on Empirical Legal Studies. Bill Whitford's comments in the course of editing the volume were particularly insightful. I also acknowledge splendid assistance from Candace Laning, Sara Bubb, and Alan Drury.

news around the globe.<sup>1</sup> European countries that did not even have bankruptcy systems twenty years ago now confront a rising tide of distress that overwhelms judicial and administrative processes as quickly as legislatures can create them.<sup>2</sup>

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<sup>1</sup> See Adam Bennett, *Bankruptcies on the Rise, Figures Show*, [www.news.com.au](http://www.news.com.au), July 10, 2007 (Australian story noting that '[t]he high cost of living and easy access to credit have led to the highest number of bankruptcies in [New South Wales] for more than 20 years'); 'Head to Head: Is It Too Easy to Escape Debt?' (May 9, 2007) *BBC News* (UK news story noting that 'a record number of individuals declared themselves formally insolvent last year'). 'Sounding the Retreat' (July 13, 2006) *The Economist*, (discussing rampant 'overindebtedness' associated with willingness of British to 'borro[w] with abandon'); 'The FSA Flinches' (Sept. 7, 2006), *The Economist*, ("Reformers worry that too many Japanese are borrowing more than they can hope to repay."); Shawn W. Crispin (Mar. 25, 2004), 'Thailand Acts to Slow Down Some Lending' *Wall Street Journal*, at A15. Although the topic is newsworthy in Canada, Canadians find themselves in the unusual situation of congratulating themselves on a recent decline in filing rates. *Fewer Canadians Going Bankrupt Despite Rising Debt Levels*, Feb. 5, 2007 (government press release suggesting that "low unemployment allowed consumers to cope with higher debt levels").

<sup>2</sup> See Johanna Niemi-Kiesiläinen (1999), 'Consumer Bankruptcy in Comparison: Do We Cure a Market Failure of a Social Problem?' 37 *Osgoode Hall Law Journal* 473 (discussing new systems in Scandinavia). Udo Reifner, 'Thou Shalt Pay Thy Debts': Personal Bankruptcy Law and Inclusive Contract Law' in Johanna Niemi-Kiesiläinen et al (eds), in *Consumer Bankruptcy in Global Perspectives* 143 (2004) (discussing European developments). Jason Kilborn has produced an excellent series of case studies on new European systems. Jason J. Kilborn (2004), 'The Innovative German Approach to Consumer Debt Relief: Revolutionary Changes in German Law, and Surprising Lessons for the United States' 24 *Nw. Journal International & Business*. 257

Yet despite a general upward trend in filing rates, stark differences in nation-level filing rates persist. For the most telling example, consider the United States and the United Kingdom, the two largest English-speaking economies. In 2004, 930 out of every million U.K. residents sought formal insolvency relief, but U.S. residents sought such relief at a rate more than five times as high (5,500 out of every million).<sup>3</sup> Consider

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[hereinafter Kilborn, *Germany*]. Jason J. Kilborn (2005), *La Responsabilisation de l'Economie: 'What the United States Can Learn from the New French Law on Consumer Overindebtedness'* 26 *Michigan Journal of International Law* 619 [hereinafter Kilborn, *France*]. Jason J. Kilborn (2006), 'The Hidden Life of Consumer Bankruptcy Reform: Danger Signs for the New U.S. Law from Unexpected Parallels in the Netherlands' 39 *Vanderbilt Journal of Transnational Law* 77 [hereinafter Kilborn, *Netherlands*]. Jason J. Kilborn (2006), 'Continuity, Change, and Innovation in Emerging Consumer Bankruptcy Systems: Belgium and Luxembourg' 14 *American Bankruptcy Institute Law Review* 69. Jason J. Kilborn (2007), 'Out with the New, in with the Old: As Sweden Aggressively Streamlines Its Consumer Bankruptcy System, Have U.S. Reformers Fallen off the Learning Curve' 80 *American Bankruptcy Law Journal* 435 [hereinafter Kilborn, *Sweden*].

<sup>3</sup> I note Iain Ramsay's point that comparisons of filing rates across national boundaries are complicated not only by differences in the formal liquidation systems, but also by differences in the possibilities for seeking relief through the multifarious rehabilitation systems, which may be more or less formal or voluntary. Iain Ramsay (2007), 'Comparative Consumer Bankruptcy' *Illinois Law Review* 241, 260-62. In this paper, however, I cannot undertake to examine all such systems. Instead, I focus on the major formal national-level systems. Thus, for example, I do not include county court administration orders in the statistics for the U.K. A complete understanding of the U.K. pattern would require assessment of the interaction of those orders with

Canada and Australia, the two largest Commonwealth economies. Commentators note the similarity of their systems for providing bankruptcy relief,<sup>4</sup> but the rate at which Australians and Canadians seek insolvency relief differs sharply. As of 2004, there were 1300 filings per million in Australia, but more than twice as many (3100) filings per million in Canada.

Governments concerned about rising rates of financial distress can respond in various ways. They might try to alter individual behavior, hoping to limit financial distress by discouraging spending.<sup>5</sup> Alternatively, they might intervene in credit markets,

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the bankruptcy and IVA systems that I do consider. It is enough for this paper to suggest (based on the apparent magnitude of county court administration orders) that the U.K. filing rate would remain relatively low even if I included those filings in calculating the U.K. filing rate.

<sup>4</sup> See Anthony Duggan, 'Consumer Bankruptcy in Canada and Australia: A Comparative Overview' in Janis P. Sarra (ed) *Annual Review of Insolvency Law 2006* (Thompson Carswell 2007, Toronto) 857. Jacob S. Ziegel, *Comparative Consumer Insolvency Regimes: A Canadian Perspective* (Oxford and Oregon Hart Publishing, 2003) 96-97.

<sup>5</sup> That approach would not be congenial in many countries. The U.S., for example, has depended for decades on consumer spending to drive economic growth. Elizabeth Cohen, *A Consumers' Republic: The Politics of Mass Consumption in Postwar America* (Knopf, Borzoi Books Random House, 2003). Similarly, Japanese reformers focused on consumer behavior have worried that consumer spending has been too low, not that it has been too high. Souichirou Kozuka & Luke Nottage, 'Re-regulating Consumer Credit in Japan: Culture, Economics and Politics in Contemporary Law Reform' in J. Niemi-Kiesiläinen *et al.* (eds) *Consumer Credit, Over-Indebtedness and Bankruptcy: National and International Dimensions* (forthcoming 2008).

hoping to limit overindebtedness at the source.<sup>6</sup> Countries that ignore the problem face the possibility of ending up like South Korea, which recently spent billions of dollars to bail out leading financial institutions that faced crippling levels of default and insolvency,<sup>7</sup> or the United States, which faces a growing crisis centered on rapid increases in foreclosure rates.<sup>8</sup>

Perhaps the most common response has been to amend the legal system for dealing with financial distress. Even if financial distress is an inevitable by-product of a modern capitalist economy,<sup>9</sup> differences in the formal legal system affect individual responses to financial problems. Most obviously, the rise of consumer debt in recent

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<sup>6</sup> For example, the U.K.'s Office of Fair Trading and Department of Trade and Industry (recently superseded by the Department for Business, Enterprise & Regulatory Reform) have both been aggressive in responding to the perceived problem of overindebtedness in the U.K. *See, e.g.*, OFT, Consumer Credit (Advertisements) Regulations 2007 (SI 2007/827); DTI, *Fair Clear and Competitive – The Consumer Credit Market in the 21<sup>st</sup> Century* (White Paper) (Cm 6040, 8<sup>th</sup> Dec. 2003).

<sup>7</sup> *See* Ronald J. Mann, *Charging Ahead* (Cambridge University Press, 2006) 116-17.

<sup>8</sup> *See* Office of the Comptroller of the Currency *et al.*, *Statement on Subprime Mortgage Lending* (June 29, 2007), available at <http://www.fdic.gov/news/news/press/2007/pr07055a.html>.

<sup>9</sup> *See* Mark J. Roe, *Political Determinants of Corporate Governance: Political Context, Corporate Impact* (Oxford University Press, 2002).

decades has led to the creation of new bankruptcy systems in several continental European jurisdictions.<sup>10</sup>

Even in countries that have had bankruptcy systems for many years, the rising levels of insolvency in recent decades have driven major reforms.<sup>11</sup> Policymakers have struggled with whether – and how – to alter their systems. Hence, the U.S. has adopted reforms designed to limit access at the same time as the U.K. and Japan have implemented reforms to encourage more filings. Which approach is correct? Should legislators permit access by a greater number of debtors, to encourage entrepreneurial risk-taking? Or, should they limit access to a smaller number of debtors to lower the moral hazard of an easy release from obligations?<sup>12</sup> What is the best way to filter out the

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<sup>10</sup> In addition to the sources cited ‘Above in note 2’, see Johanna Niemi-Kiesiläinen (1997), ‘Changing Directions in Consumer Bankruptcy Law and Practice in Europe and USA’ 20 *Journal Consumer Policy* 133; Charles Jordan Tabb (2005), ‘Lessons from the Globalization of Consumer Bankruptcy’ 30 *Law & Social Inquiry* 762 (reviewing *Consumer Bankruptcy in Global Perspectives*, ‘Above n 2’ & Ziegel, ‘Above n 4’).

<sup>11</sup> For a collection of papers on that subject, see Part IV of *Consumer Bankruptcy in Global Perspectives*, ‘Above n 2’.

<sup>12</sup> See, e.g., Samuel A. Rea, Jr. (1984), ‘Arm-Breaking, Consumer Credit and Personal Bankruptcy’ 22 *Economic Inquiry* 188; Barry Adler *et al.* (2000), ‘Regulating Consumer Bankruptcy: A Theoretical Inquiry’ 29 *Journal of Legal Studies* 585.

abusive filings from the “honest but unfortunate” debtors for whom policymakers design the systems?<sup>13</sup>

The disparate responses reflect the likelihood that variations in filing rates rest on different factors in different countries. Some of the variation is attributable to different levels of indebtedness. Some of the variation is attributable to different cultural attitudes about financial failure. Some of the variation is attributable to the accessibility of the legal system as a remedy for irremediable financial distress. Some of the variation is attributable to the availability of informal systems of relief. Yet it is not easy to disentangle how those different attributes affect the aggregate nation-level filing rates. This Chapter explores the possibility that aggregate empirical data can shed light on that question, and analyzes the policy implications of the differences in nation-level filing rates.

First, Part II explains why it is important as a matter of policy to understand whether high or low filing rates stem from economic, cultural, or legal causes. Without understanding why rates are high or low, it is impossible either to assess whether the rate of filing is too high or too low, or to design policies likely to move rates in the appropriate direction.

Drawing on prior work about credit card markets,<sup>14</sup> Part III uses aggregate data to distinguish between the economic explanations for filing rates and the cultural and legal explanations. Two findings are salient. First, the bulk of the uniquely high filing rate in

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<sup>13</sup> The phrase is from *Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934).

<sup>14</sup> Mann, ‘Above n 7’.

the United States appears to be attributable to economic conditions, not cultural attitudes or the legal system. Second, after controlling for economic conditions, Canada's filing rate is by far the highest of any of the countries for which adequate data is available, the other countries being the United States, United Kingdom, Japan, and Australia.<sup>15</sup>

Part IV offers tentative hypotheses to explain the more robust findings in Part III. Thus, it considers both why Canada's propensity to file is so much higher than that of the U.S., and why Australia's is so much lower. The discussion of Japan and the United Kingdom is more tentative, primarily because of limitations in the data<sup>16</sup> that make the statistical findings considerably more ambiguous than they are for Canada, the U.S., and Australia. Generally, I hypothesize that "back-end" issues related to the timing of a discharge and the payments required to obtain it are relatively unimportant. "Back-end" issues matter primarily to the relatively small sector of bankruptcy filers with significant income or assets. For the great mass of potential filers who have little or no income or

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<sup>15</sup> I study these countries because they are the only ones for which I have been able to obtain a sufficiently long time series of data to permit meaningful quantitative analysis.

<sup>16</sup> In the case of the U.K., the apparent problem is that England and Wales have one bankruptcy system, Scotland another, and Northern Ireland no system at all. Thus, statistical models that work well in countries with nationwide bankruptcy systems do poorly in the U.K. At least in theory I could limit my analysis to England and Wales, but the data for my control variables extends to the entire U.K. and I have been unable to locate a time series of data for my control variables that is limited to England and Wales. In the case of Japan, the apparent problem is an unusually long recession that has lasted throughout the study period, so that the data does not include filings from the same mix of economic good and bad periods as the other countries.

assets, the most important issues are “front-end” barriers to filing, whether they come from procedural obstacles or from cultural attitudes about financial distress.

Part V concludes with a normative assessment of those “front-end” barriers. Because those barriers tend to bar filings by the desperately insolvent (the “low-income low-asset” or LILA debtors), they reflect poor policy choices. The net social benefits of returning the LILA debtors promptly to productivity support a simple and effective system of relief for those debtors.

## **II. WHY THE REASONS MATTER**

The first step in analyzing nation-level filing rates is to confront the matrix of factors that affect those rates. Although a rigid categorization is arbitrary, it is useful to distinguish among three different types of factors, each of which relates to financial distress and bankruptcy in a different way and each of which has different policy implications.

### **A. Legal Explanations**

Although I am predisposed to doubt the importance of purely legal explanations,<sup>17</sup> I start there, primarily because of the conventional wisdom that legal explanations are central to the problem. The intuition relies on a rational actor conception of the debtor: fewer debtors file for bankruptcy in countries with bankruptcy systems that offer relief that is less generous, and more debtors file for bankruptcy in countries that offer relief that is more generous. The analytical premise is that the bankruptcy discharge provides an economic benefit to those that file, and systems in which the benefit is greater should

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<sup>17</sup> See Mann, ‘Above n 7, at 96-98’ (explaining that differences in legal protections have little relation to the pattern of debit and credit card use).

produce more filings.<sup>18</sup> The literature written from this perspective suggests that the key variables in explaining filing rates are the ready availability of a discharge, the types of debts excepted from the discharge, and the scope of required post-bankruptcy payments.<sup>19</sup>

That explanation is consistent with the U.S. filing rate. The world's highest filing rate is associated with a system in which a discharge is almost automatically and immediately available and with no general requirement of post-bankruptcy payments to creditors. Similarly, Michelle White's work shows that the propensity to file is higher in U.S. jurisdictions with higher exemption levels and thus more generous bankruptcy relief.<sup>20</sup>

The conclusion that the level of filing rates depends for the most part on the legal system makes it easy to adopt responsive policies. For example, countries like the U.K.

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<sup>18</sup> Michelle White's work provides the most careful support for this line of reasoning, showing that more debtors file in United States jurisdictions in which exemptions are higher. Scott Fay, Erik Hurst & Michelle J. White (2002), 'The Household Bankruptcy Decision' 92 *American Economic Review* 708; Michelle J. White (1998), 'Why It Pays to File for Bankruptcy: A Critical Look at Incentives Under U.S. Bankruptcy Laws and a Proposal for Change' 65 *U. Chicago Law Review* 685 ([hereinafter White, *Why It Pays to File*]; Michelle J. White (1998), 'Why Don't More Households File for Bankruptcy?' 14 *Journal of Law Economics & Organization* 205 [hereinafter White, *Why Don't More Households File?*].

<sup>19</sup> See Fay, Hurst & White, *ibid* n 18; White, 'Why It Pays to File', *ibid* n 18; White, 'Why Don't More Households File?' *ibid* n 18.

<sup>20</sup> See White, 'Why It Pays to File', 'Above n 18'.

and Japan seek higher rates of bankruptcy filings to speed the resolution of financial distress. Those countries need only provide a discharge more promptly, lower requirements for post-bankruptcy payments, or increase the level of exempt assets. Conversely, legislators concerned that spiraling filing rates reflect abuse should interpose obstacles to the discharge or increase the likelihood that filers will be obligated to make post-bankruptcy payments to their creditors.

## **B. Cultural Explanations**

A second possibility recognizes the interaction between the formal legal system and the society in which it is embedded. Cultural predispositions might affect the decision to file for bankruptcy, and those predispositions may differ from country to country. That perspective recognizes that the decision to file for bankruptcy is a permanent one that will have lifelong consequences for the individual that makes it. Hence, if this explanation were important, filing decisions should diverge from those predicted by a rational-actor conception of the bankruptcy decision: individuals might refrain from filing for irrational “emotional” reasons even if the benefits available to them from a bankruptcy filing exceeded the out-of-pocket costs connected with the filing.

Cultural attitudes about bankruptcy also should affect the legal system itself. Iain Ramsay reminds us that legislators adopt laws that reflect the cultural dispositions that prevail among their constituents and the interest groups that are influential in their jurisdiction.<sup>21</sup> For example, UK leaders could embrace bankruptcy reform because of a

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<sup>21</sup> See Iain D.C. Ramsay (2006), ‘Functionalism and Political Economy in the Comparative Study of Consumer Insolvency: An Unfinished Story from England and Wales’ 7

“strong admiration” for a “vibrant enterprise culture” that involved “responsible risk taking.”<sup>22</sup> At the same time, concerns that relief for nonbusiness debtors was an entirely different matter made it important for the Government to emphasize its opposition to “a safety net for overindebted consumers.”<sup>23</sup> In this vein, Rafael Efrat argues that cultural attitudes about entrepreneurs explain a great deal of the variation in the formal legal systems for consumer bankruptcy.<sup>24</sup>

Although those types of effects are difficult to measure directly, proxies might shed light on the differing levels of cultural resistance to bankruptcy in different nations. In the existing literature, for example, cultural explanations gain powerful empirical support from data about United States filings. Specifically, Michelle White’s work indicates that about 15% of all households would benefit in economic terms from filing for bankruptcy, but only about 1% file for bankruptcy in any given year.<sup>25</sup> The size of the gap suggests that the rational-actor conception captures little of the motivations for filing; it is reasonable to infer that a portion of the gap is attributable to cultural resistance to bankruptcy filing.

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*Journal of Theoretical Inquiries Law* 625 [hereinafter Ramsay, Functionalism and Political Economy].

<sup>22</sup> Ramsay, *ibid* n 21, at 17-18.

<sup>23</sup> *Id.* at 18.

<sup>24</sup> See Rafael Efrat (2002), ‘Global Trends in Personal Bankruptcy’, 76 *American Bankruptcy Law Journal* 81.

<sup>25</sup> See White, ‘Why Don’t More Households File?’ ‘Above n 18’.

Although there is a long tradition of designing social programs in a way that stigmatizes their use,<sup>26</sup> it is not clear how often legislators succeed. The mere existence of a national bankruptcy system legitimates bankruptcy filing to a considerable degree.<sup>27</sup> Similarly, high levels of overindebtedness are likely to create a culture in which bankruptcy filing necessarily becomes more culturally acceptable.<sup>28</sup> As more individuals use a bankruptcy system to resolve their financial problems and move forward with their lives, a larger and larger share of the populace will be acquainted with people for whom that choice turned out to be a good one. This in turn will weaken norms that regard bankrupts as an “other” class of people held in general disdain. Moreover, as suggested above, cultural predispositions motivate legislatures as well. Thus, in a society in which compassion for bankrupts becomes widespread, it may become increasingly difficult for legislators to treat bankrupts harshly.

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<sup>26</sup> See Christopher Howard, *The Hidden Welfare State* (Princeton University Press, 1999)

<sup>27</sup> The distinction from welfare is instructive, where stigmatized public assistance programs can be relegated to local authorities. The commitment to a bankruptcy system, by contrast, occurs at the national level. Interestingly, to the extent the United States system has delegated authority to the local standing Chapter 13 trustees, a case can be made that the result has been “local legal culture” that in some locales stigmatizes Chapter 7 bankruptcy filings. See Teresa Sullivan et al. (1994) ‘The Persistence of Local Legal Culture: Twenty Years of Evidence from the Federal Bankruptcy Courts’ 17 *Harvard Journal Law Public Policy* 801.

<sup>28</sup> See Jean Braucher (2006) ‘Theories of Over-Indebtedness: Interaction of Structure and Culture’ 7 *Journal Theoretical Inquiries Law* 323.

### **C. Economic Explanations**

The final possibility resonates with the opening paragraphs of this paper, connecting the increase in financial distress and bankruptcy filings to the rapid increase in consumer debt (and especially credit card debt) in most developed countries. The premise of this explanation is that bankruptcy filings for the most part are the result of exogenous shocks, which result in financial distress that would lead to filings in most cases without regard to legal or cultural factors.

If this explanation were important, the most significant predictors of nation-level filing rates would be consumer debt, credit card debt, and general economic conditions. Again, United States data support this theory. It is striking that the United States for years has experienced both the highest level of credit card debt in the world and the highest bankruptcy filing rate. Econometric models that scholars have used to illustrate connections between rising debt levels and increased filing rates buttress that intuition.<sup>29</sup>

Economic explanations would support intervention in the consumer credit markets. For example, a jurisdiction concerned about excessive insolvency might adopt regulations that limited the profitability of lending to those in severe financial distress, hoping to truncate that lending without undue distortion of the payment system or the broader lending market.<sup>30</sup>

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<sup>29</sup> See Mann, 'Above n 7, at 45-72' (summarizing and extending that literature).

<sup>30</sup> See Mann, 'Above n 7, at 119-206' (detailed proposals for intervention in consumer credit markets in the U.S.).

### III. ECONOMIC AND NON-ECONOMIC EFFECTS ON FILING RATES

The starting point in empirical analysis of consumer bankruptcy systems is the wide disparity in filing rates across national borders. Figure 1 illustrates the magnitude of the disparity, setting out the number of filings per million of population in each of five countries as of 2004 (the last year for which complete data is available). Recognizing the important differences between the legal systems in these countries, Figure 1 provides two data points for each country. The first is the number of liquidation or “straight” bankruptcy filings. The first number is the total number of all insolvency filings, which includes both the number of liquidation or “straight” bankruptcy filings and also the applicable systems for “rehabilitations” or “proposals” or “plans.”<sup>31</sup> Each of the five countries has both types of system.<sup>32</sup> The second number separates out the number of liquidation or straight “bankruptcy” filings.

In isolation, Figure 1 suggests that the U.S. has by far the highest rate of filing, with steadily decreasing filing rates in Canada, Japan, Australia, and the U.K. Although

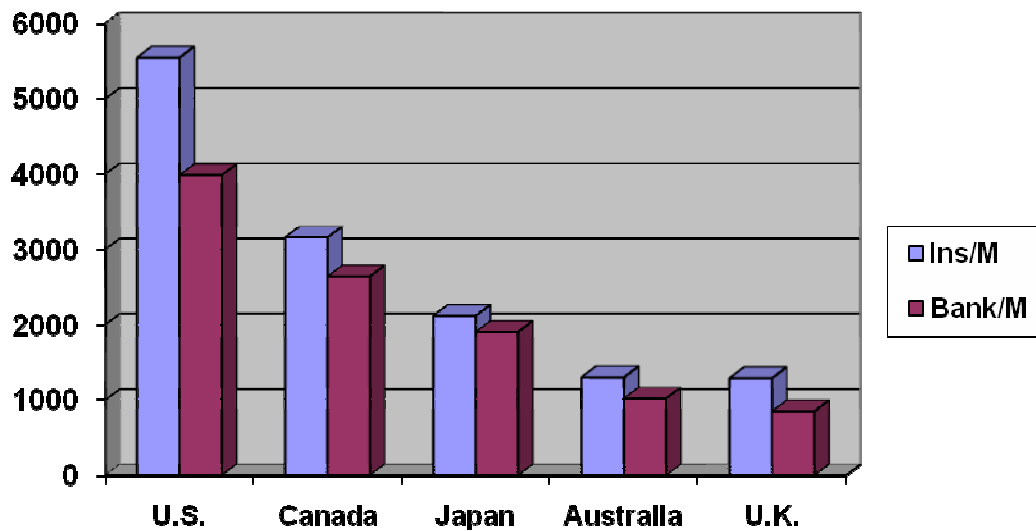
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<sup>31</sup> The Appendix includes a more complete set of charts showing a time series of those filings for each country from 1990 to the present.

<sup>32</sup> As Figure 1 illustrates, including or omitting rehabilitation filings does not alter the relative number of filings for any country except the United States, which has a much higher share of rehabilitation filings than other countries. The more common use of the rehabilitation system in the U.S. may be attributed in part to the maturity of the Chapter 13 system and in part to the value of that system for retaining home and automobile ownership. In none of the other countries in my study would the rehabilitation filing interfere with the ability of a lender to pursue collateral such as a home or automobile.

the disparity is striking, it should be clear from the discussion above that the raw numbers say little about the cause of the disparity. Without further information, it is impossible to tell whether the disparity relates to differences in the systems themselves or rather to cultural differences or differences in economic conditions.

**FIGURE 1: 2004 INSOLVENCIES PER MILLION OF POPULATION**



As it happens, it is possible to identify the economic factors that affect the level of insolvency filings in a particular jurisdiction. In prior work focused on the relation between credit card debt and financial distress, I developed a model that documents a strong and significant relation between changes in the level of credit card debt and changes in bankruptcy filings. The model used credit card debt, credit card spending, total consumer debt, and unemployment (as independent variables) to explain the number of bankruptcy filings (as the dependent variable). Generally, the data suggest, an increase of \$100 in credit card debt per capita will be followed one year later by an increase in

bankruptcy filings of about 200 per million.<sup>33</sup> As the magnitude of the filing rates in Figure 1 illustrates, that effect is large enough to have substantial practical significance.

As I worked with the data I began to explore how the effect differed from country to country. Even when I added variables (country dummies) to isolate country-specific effects, however, the relation between credit card debt and bankruptcy filings remained significant. What led me to this project was the surprising finding that the U.S. was *not* at the top of the scale. Specifically, controlling for economic conditions, the coefficient on the United States variable did *not* suggest that there is a higher propensity to file in the United States than in the other countries. Intrigued by that finding, for this project I updated the data used in that work (to reflect additional years of filings) and also segregated the data to permit separate analysis of liquidation filings, rehabilitation filings, and total filings. My intuition was that data about liquidation filings might be more useful than data about total filings, at least in part because rehabilitation filings in many countries are more closely related to informal or voluntary resolution schemes. Moreover, stark differences in the relation between rehabilitation filings and secured credit suggest that those filings might be used for such different purposes in different countries as to make cross-border comparisons meaningless.<sup>34</sup> Ultimately, the central

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<sup>33</sup> See Mann, 'Above n 7, at chapter 5'.

<sup>34</sup> A Chapter 13 filing in the United States is commonly used to prevent a foreclosure on a home or repossession of an automobile. In none of the other countries in this study would a rehabilitation filing bring with it an automatic stay that would grant that protection. This differential benefit from a Chapter 13 filing is a good explanation for why the rate of

inquiry should relate to total filings in countries (like the United States) in which the big step is to seek any type of formal insolvency relief. By contrast, in countries in which a rehabilitation filing is culturally and legally less significant (Japan, for example), it would be better to examine the smaller number of people that take the more complete step of filing a “straight” or liquidation bankruptcy. The tables and regression analysis in this Chapter consider both metrics.

As summarized in Table 1,<sup>35</sup> Canada moves to the top of the list once the credit-related variables are accounted for, at least for total filings and liquidation filings. As the more detailed information in the Appendix explains, large standard errors suggest that the estimates of the coefficients on the country dummies are relatively imprecise.<sup>36</sup> The relations are statistically significant only for the United States and for Australia, and in Australia only for liquidation filings. Still, the pattern of negative coefficients is striking: the coefficients are negative for each country’s total filing propensity and its liquidation rehabilitation filings in the United States is significantly higher than the rate in Canada, although the rates of liquidation and total filings are higher in Canada than in the United States.

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<sup>35</sup> Although Table 1 does not report it, the results confirm and extend the analysis reported in *Charging Ahead*, because credit card debt remains highly significant with a substantial positive coefficient in all of the different runs, generally significant at a .001 level. Table A1 in the Appendix includes more detailed output.

<sup>36</sup> It would be surprising if the model did capture all of the variation because there have been substantial bankruptcy reforms in several of the countries during the period of the study. As discussed ‘Above note 16’, problems with the U.K. and Japanese data make it easy to see why the model does not produce significant results for those variables.

filing propensity. This suggests that, faced with similar patterns of debt and unemployment, the bankruptcy filing rate would be higher in Canada than in any of the other countries. To put it another way, the data suggest that the high filing rate of the U.S. is largely attributable to the economic conditions captured in the model. Once we control for those conditions, the U.S. gives way to Canada as the nation with the highest propensity to file. This presents a new puzzle for analysis: why, holding economic conditions equal, Canada should have such a higher “propensity” to file than the USA and Australia. For convenience of exposition, the remainder of the paper uses the term “propensity” to reflect this analysis – the extent to which the per capita filing rate in a country is affected by variables other than economic conditions. The next section of the Chapter explores that puzzle.

**TABLE 1: COUNTRY EFFECTS ON INDIVIDUAL BANKRUPTCY FILINGS<sup>37</sup>**

COUNTRY	TOTAL	LIQU.	REHAB.
USA	—**	—**	+*
Japan	—	—	+
Australia	—	—#	—
UK	—	—	+
N	51	69	51
R <sup>2</sup>	.93	.93	.97

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<sup>37</sup> Minus signs indicate a negative coefficient; plus signs indicate a positive coefficient. \*\* indicates significance at the 1% level, \* at the 5% level, and # at the 10% level. Table A1 in the Appendix includes more detailed information about the regressions.

#### **IV. THE PATTERN OF INDIVIDUAL BANKRUPTCY FILINGS**

The point of Part III is that the economic precursors of bankruptcy filings are the easiest to discern and quantify. The object of this part is to resolve the two puzzles most clearly suggested by Table 1: why Canada's propensity to file is so much higher than that of the United States and Australia.<sup>38</sup>

Because the cultural factors are the hardest to quantify, this Part begins by identifying features of the legal systems that are likely to explain the disparities set out in Table 1. The discussion generally rests on three hypotheses. First, the ease or speed of "back-end" legal factors like the discharge is not useful in explaining filing rates. Second, the legal factors with the largest effect on filing rates are "front-end" factors such as the procedural barriers or obstacles to filing; this factor is central to explaining the difference between Canada and the U.S.<sup>39</sup> Third, where no pattern of legal differences appears, it is reasonable to consider whether the residual cause is a strong cultural predisposition.

##### **A. Why Is the Canadian Propensity to File Higher than the U.S. Propensity?**

The most intriguing problem is to explain the disparity in filing propensity between Canada and the U.S. Examining the two countries' systems at a very high level of

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<sup>38</sup> Given the ambiguity of the findings related to the U.K. and Japan, I leave that subject to another day.

<sup>39</sup> For a similar argument about German filing rates, see Götz Gechner *et al.*, 'Consumer Bankruptcy in Germany', in *Consumer Credit, Over-Indebtedness and Bankruptcy: National and International Dimensions*, (forthcoming 2008) 'Above n 5'.

generality, they provide a good empirical test of the hypotheses about front-end and back-end factors. First, the U.S. discharge is considerably more generous than the Canadian discharge, which would support a lower Canadian filing propensity if the terms of discharge were the most important factor. Conversely, the Canadian bankruptcy process is relatively more accessible than the American process, which would support a higher Canadian filing propensity if accessibility were the most important factor. My conclusion is that the data support the hypothesis that accessibility is a more important predictor of propensity than the generosity of the discharge. Again, tying the analysis back to Part III, the argument is that, once we account for the markedly higher level of credit card debt in the United States, we would expect Canada's filing rate to differ from that of the U.S. even more than it does. The reason that it does not is that Canada's relatively accessible bankruptcy system discourages less filers than the relatively inaccessible U.S. system.

On the first point, the United States system offers a faster and almost unconditional discharge, with a stay automatically effective upon filing<sup>40</sup> and a discharge available in theory immediately and in practice after a few months.<sup>41</sup> By contrast,

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<sup>40</sup> BAPCPA did introduce revisions that limit the automatic effectiveness of the stay, but those apply only to repeat filers. *See* Bankruptcy Code § 362(c)(3) (automatic stay against certain creditors lasts only thirty days for certain repeat filers) & (4) (no automatic stay for certain multiple repeat filers).

<sup>41</sup> To be sure, the United States has more exceptions to discharge than the other countries I study. *See* William C. Whitford (1997), 'Changing Definitions of Fresh Start in American

Canada, like most countries, does not permit an immediate discharge. Rather, the discharge cannot be considered for nine months and often involves an unstructured judicial assessment of a report filed by the bankruptcy trustee.<sup>42</sup> To be sure, challenges to discharge are infrequent, apparently affecting far less than one-fifth of the cases.<sup>43</sup> Yet, the fact remains that the delay of the discharge and the risk that it will not be granted

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Bankruptcy Law’ 20 *Journal of Consumer Policy* 179. But those exceptions seem to me back-end issues less likely to affect the decision to file.

<sup>42</sup> BIA § 170; see Stephanie Ben-Ishai, ‘Discharge’, in S. Ben-Ishai & A. Duggan (eds) *Canadian Bankruptcy & Insolvency Law* 357, 358-60 (Lexis Nexis Canada, 2007). Duggan, ‘Above n 4, at 873-76’. Similarly, the Canadian process includes rules under which debtors with substantial “surplus” income must make periodic payments to their creditors. Apparently about one-fourth of Canadian debtors make such payments. See Stephanie Ben-Ishai, ‘Means-Testing’ in *Canadian Bankruptcy & Insolvency Law*, (Lexis Nexis Canada, 2007) ‘Above at 343, 353’. Duggan, ‘Above at 864’. Ben-Ishai emphasizes that this leaves the system more accessible than the U.S. system “because debtors with surplus income are still able to move through the bankruptcy process, they are not directly prevented from accessing the fresh start offered by a liquidation bankruptcy or forced into an enforced payment plan.” *Id.* at 355.

<sup>43</sup> Ramsay reports 1994 data in which about 15% of applications were opposed. Iain Ramsay (1999), ‘Individual Bankruptcy: Preliminary Findings of a Socio-Legal Analysis’ 37 *Osgoode Hall Law Journal* 15, 24. Ziegel reports data indicating that out of 83,000 1998 discharge applications, 93% of debtors received an unconditional discharge, 7% a suspended discharge, and less than 1% received conditional discharges or were denied discharges. Ziegel, ‘Above n 4, at 39.

unconditionally are quite different from the U.S. experience, where objections to discharge are rare.

On the other hand, the procedures for instituting a bankruptcy in Canada are much simpler than the United States procedures. The prospective bankrupt initiates the proceeding by filing a simple standard-form assignment. The fee is CAN\$75 for summary administration (cases with less than \$10,000 in assets, more than 90% of all cases<sup>44</sup>) and CAN\$150 for regular administration.<sup>45</sup> The typical consumer bankrupt does not retain an attorney, though it must pay the fees of the trustee.<sup>46</sup> There is no mandatory examination by creditors, and no “abuse” provision that might force the debtor to use the alternative “proposal” system.<sup>47</sup> There is a mandatory counseling requirement (introduced in 1992), but it occurs after the filing, not before.<sup>48</sup> In the United States, the process is much more cumbersome. The forms are considerably more complex, and BAPCPA has only made them more so. Indeed, it is clear that the timing of bankruptcy filings is affected to a considerable extent by the need to collect the information

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<sup>44</sup> Ziegel, ‘Above n 4, at 19’.

<sup>45</sup> BIA Rules § 132; Duggan, ‘Above n 4, at 870’.

<sup>46</sup> Ziegel, ‘Above n 4, at 18’. It is difficult to generalize about the levels of Canadian trustee fees, which in some cases might approximate the fees of U.S. attorneys. *See* ‘Below note 50’.

<sup>47</sup> Ziegel, ‘Above n 4, at 20-21’.

<sup>48</sup> BIA §§ 66.13, 157.1; Duggan, ‘Above n 4, at 887-90’.

necessary to complete the requisite forms.<sup>49</sup> Thus, although there is no legal requirement that filers retain an attorney or trustee, the overwhelming majority choose to do so. Interestingly, it is not clear that the out-of-pocket costs of filing differ substantially in the two countries.<sup>50</sup>

The juxtaposition of those distinctions with the substantial difference in propensity to file provides powerful support for the hypotheses about legal precursors. If the economic features of the discharge and future income payments – the “back-end” effects of bankruptcy – were an important precursor of a high propensity to file, then it is surprising that they weigh so heavily against a relatively high propensity to file in Canada. Conversely, the difference between Canada’s streamlined procedures and the burdensome procedural obstacles in the United States cuts in the same direction as the propensity data presented in Part III.

#### **B. Why Is the Canadian Propensity to File Higher Than the Australian?**

The second puzzle is how to distinguish Australia from Canada. As Part III illustrates, economic conditions have little to do with the difference. The difference between

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<sup>49</sup> This also has become more significant after BAPCPA. I rely here on an ongoing series of qualitative interviews with bankruptcy professionals conducted for a project with Katie Porter on the triggers of bankruptcy filings.

<sup>50</sup> Although the U.S. filing fees are much lower, the costs of trustees in Canada well might exceed the costs of attorneys in the U.S. At the same time, it appears that U.S. attorneys are much more likely to require up-front payment than Canadian trustees. Jacob Ziegel, ‘Indigent Debtors and Financial Accessibility of Consumer Insolvency Regimes’ in Janis P. Sarra (ed) *Annual Review of Insolvency Law* (Thomson Canada Limited, 2005) 500-504.

Australia and Canada in Table 1 (the propensity to file after accounting for economic conditions) is roughly equivalent to the difference in raw filing rates illustrated in Figure

1. The next question is whether legal or cultural factors can explain the difference.

1. *The Failure of Legal Explanations*

As other scholars have noted, it is difficult to discern credible explanations based on the bankruptcy systems themselves.<sup>51</sup> First, the “back-end” portions of those systems are quite similar. For example, the Australian discharge (historically available after twelve months of surplus income payments)<sup>52</sup> closely resembles the Canadian discharge available after nine months.<sup>53</sup> Because Australia’s propensity to file is so much lower than Canada’s, it is hard to put much weight on the discharge as an explanation.<sup>54</sup> Nor do

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<sup>51</sup> See ‘Above n 4’.

<sup>52</sup> Surplus income payments are even less common in Australia than in Canada. See Jean Braucher, ‘A Comparative Study of Repayment Forms of Individual Bankruptcy’ in *Consumer Credit, Over-Indebtedness and Bankruptcy: National and International Dimensions*, (forthcoming) ‘Above n 5’ reporting a substantial increase in payments, up to 12% of all filings, as compared to more than 20% of filings in Canada).

<sup>53</sup> Australia’s discharge period was lengthened to three years in 2002. See Duggan, ‘Above n 4, at 877’. But Australian rates were much lower than Canada’s even before that change. Moreover, as Figure A1 illustrates, the slight (and apparently temporary) decline in filings after 2002 is a small fraction of the aggregate difference between Canadian and Australian filing rates.

<sup>54</sup> Recent Japanese reforms (intended to *encourage* bankruptcy filings) suggest that the nature of the discharge is similarly unimportant in explaining the low Japanese filing rate. See Junichi Matsushita (2006), ‘Comprehensive Reform of Japanese Personal Insolvency Law’ 7 *Journal of Theoretical Inquiries Law* 555, 560-64 (summarizing those reforms). Although it is too early to be sure (because of the slow process Japan follows for issuing bankruptcy statistics),

procedural obstacles offer anything to explain the distinction.<sup>55</sup> Australia's system for initiating bankruptcies is for the most part quite similar to that of Canada; if anything it appears to be *more* accessible than Canada's not less.<sup>56</sup> Professor Ziegel explains, "the important point worth stressing here is that it is even easier – and certainly much cheaper – for Australian debtors to initiate bankruptcy proceedings than it is for a Canadian

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the early evidence – a substantial *decline* in 2005 bankruptcy filings – at least suggests that these reforms will solve little of Japan's problem. To be sure, the improvement in Japan's economy beginning in 2004 might have caused some of that decline. However, an obvious alternative hypothesis supported by the experience in other countries is that the 2004 reforms – which emphasize increasing exempt assets and broadening the discharge – do little to address the heart of what keeps Japan's filings low: the expensive and cumbersome process for gaining access to bankruptcy.

<sup>55</sup> Procedural obstacles do offer a potential explanation for the low filing rates in the U.K. and Japan. *See* Ziegel, 'Above n 4, at 112-13' (discussing onerous procedures in Great Britain); *see* Kent Anderson & Makoto Ito, 'Insolvency Law for a New Century: Japan's New Framework for Economic Failures' in Dan Foote (ed) *Law in Japan: Into the 21<sup>st</sup> Century* (2003) (discussing onerous process for instituting consumer bankruptcy in Japan, which includes judicial scrutiny for eligibility and traditionally has not included an automatic stay); Matsushita, 'Above n 54, at 561'. Pre-screening of consumer bankruptcy petitions is not unique to Japan. It also is a common feature of Nordic bankruptcy systems. *See* Kilborn, *Sweden*, 'Above n 2, at 443-444'.

<sup>56</sup> Ziegel repeatedly notes the difference in filing rates, but does not undertake to explain it. Ziegel, 'Above n 4, at 94, 106'.

debtor.”<sup>57</sup> For example, a bankrupt commences a case by completing a short standard form of assignment. The only substantive filing requirement is that the debtor be insolvent. Australia offers a summary administration process with no creditor’s meeting for cases with less than \$10,000 in assets (which applies to about 90% of Australian cases). Moreover, debtors typically do not use attorneys or private trustees; rather the Official Trustee administers the case, collecting its fee from the estate and relying on a public subsidy to administer no-asset cases.<sup>58</sup>

## 2. *Cultural Explanations*

If neither economic explanations nor legal explanations are fruitful, an obvious possibility is that cultural explanations provide an explanation for the observed pattern. Because cross-border cultural explanations are inherently nebulous (like dark matter), any such explanation necessarily is speculative. That is particularly true here, where the cultural factors would have to be remarkably powerful to explain the disparities identified in Figure 1 and Table 1. Still, the juxtaposition of nearly identical legal systems and similar economic conditions with starkly different filing rates justifies exploration of the possibility.

One objective place to look for indicators of a strong cultural disposition against bankruptcy is statutes that impose substantial legal disabilities on those who file for

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<sup>57</sup> Ziegel, ‘Above n 4, at 96-97’. Tony Duggan and Jean Braucher share Ziegel’s perspective. See Duggan, ‘Above n 4, at 869-72’; Braucher, ‘Above n 52’.

<sup>58</sup> See Braucher, ‘Above note 52’; Duggan, ‘Above note 4 at 868-69’. Rosalind Mason & John Duns, ‘Developments in Consumer Bankruptcy in Australia’ in *Consumer Bankruptcy in Global Perspectives*, (‘Above n 2, 227, 232-34’.

bankruptcy. Such statutes could persist only in a society with a strong cultural disposition against bankruptcy.<sup>59</sup> Here, there is some evidence to suggest that Australian society takes a harsher perspective than Canada. In contrast to Canadian law, which imposes no substantial disabilities, Australian bankrupts forfeit their passports when they file.<sup>60</sup>

One intriguing suggestion comes from Iain Ramsay, who argues that we observe high filing rates in countries (like Canada and the U.S.) in which private professionals assist bankrupts in initiating proceedings because those professionals have an economic incentive to raise awareness of the bankruptcy process. By contrast, Ramsay argues, we observe low filing rates in countries (like Australia and the U.K.) that rely entirely on public officers to assist filers, because those officers have a significantly lower incentive

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<sup>59</sup> The U.K. provides a startling example. Until the Enterprise Act reforms in 2004, the U.K. bankrupt was subject to numerous serious civil disabilities, akin to those typically imposed on felons. Among other things, British bankrupts (at least before the 2002 Enterprise Act became effective in 2004) could not be a Member of Parliament, Justice of the Peace, company director, chairman of a land tribunal, school governor, estate agent, charity trustee, or even a practicing solicitor or insolvency practitioner. See Adrian Walters (2005), 'Personal Insolvency Law After the Enterprise Act: An Appraisal' 5 *Journal of Corporate Law Studies* 65, 82-83.

<sup>60</sup> Bankruptcy Act 1966 § 272; see Duggan, 'Above n 4, at 892'. It is unclear how important this ban is in practice. Apparently Australians usually can travel abroad after seeking permission from the trustee. Still, the formal requirement is quite stigmatizing.

to publicize the process.<sup>61</sup> It is difficult to evaluate that perspective as an overarching explanation. For example, given the low esteem for lawyers and the legal process in the U.S., many would regard the practical need for lawyers in the U.S. bankruptcy process as an obstacle. A purely administrative process might in practice be much more accessible.

On the other hand, I take Ramsay's central point to be that the private professionals are central in increasing public awareness and receptivity to the bankruptcy process. Even in the U.S. advertising by lawyers appears to play a role in developing a cultural perception of bankruptcy as a routine solution to financial distress.<sup>62</sup> If that is the significance of private professionals, then it is hard to be sure that their appearance is not an effect of a relatively receptive culture rather than a cause. In either case, Ramsay's thesis is consistent with the pattern I identify here.<sup>63</sup>

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<sup>61</sup> Ramsay, 'Above n 3'. *see* Duggan, 'Above n 4, at 893' (tentative endorsement of Ramsay's hypothesis).

<sup>62</sup> That certainly is something for which consumer bankruptcy lawyers routinely are criticized. *See* Ronald J. Mann (2007), 'Bankruptcy Reform and the "Sweat Box" of Credit Card Debt' *Illinois Law Review* 375, 375.

<sup>63</sup> As Tony Duggan has pointed out to me, Ramsay's thesis leaves unexplained why a culture that is by hypothesis so opposed to bankruptcy would embrace a legal system that on its face is so receptive to bankruptcy. One obvious possibility is that Australia tolerated such a system *because* filing rates remained low. When filing rates rose in the late 1990's to levels that were remarkably high by Australian standards (though still far below typical rates for the U.S. and Canada), Australia responded by restricting the relief available to those that file. As

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In a way, the central puzzle the data presents is why Canada's propensity to file is so high, given relatively low levels of debt. One possibility could be that Canadian debt is riskier or more perilous in some way that aggregate data cannot reveal, so that the same level of credit card and other borrowings in Canada would result in higher bankruptcy filings than in other countries. However, the best evidence about global credit card markets makes that hypothesis implausible. If anything, Canada's use of payment cards appears to be considerably more benign than the use in the United States and Australia.<sup>64</sup> That suggests that we must look to legal or cultural explanations. With respect to the United States, the most salient distinction that would explain a relatively higher propensity to file is Canada's decision to make its bankruptcy system so accessible, particularly for those in more desperate condition. With respect to Australia, distinctions are even more elusive because it is difficult to identify any feature of the legal system that makes Canada's bankruptcy system more accessible than Australia's. Recognizing that the inquiry is speculative, it does suggest that cultural predispositions against bankruptcy are remarkably stronger in Australia than in Canada, reinforced by the greater presence of marketing and advertising in Canada.

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suggested above, *see* 'Above n 53', it is not yet clear that those reforms will have a permanent or substantial effect on filing rates.

<sup>64</sup> Compared to the United States market, Canada's use of debit cards is much more common and its level of borrowing in payments transactions is much lower. *See* Mann, 'Above n 7 chs. 9-10'.

## V. POLICY IMPLICATIONS

The analysis in Parts III and IV is descriptive, an attempt to understand the causal relationships between institutional precursors of individual bankruptcy filings and the different filing rates we observe around the world. That discussion, however, does have normative significance. By exposing the reasons for the different rates, it explicates the social impact of existing legal systems as well as the potential gains (and losses) from reforms. Because the focus of this project is the legal systems for consumer bankruptcy, this Part of the Chapter emphasizes the legal explanations rather than the cultural explanations.<sup>65</sup>

If we set cultural explanations to the side, the most important conclusion in Part IV is that nation-level filing rates depend much more on front-end procedural obstacles to filing than they do on back-end issues about the timing and conditions of a final discharge. This was surprising at first, because it is in considerable tension with the conventional understanding that high filings plague the U.S. system because of its undue laxity. Yet on reflection, two points make this finding easier to accept.

The first is a behavioral point, that the typical potential bankrupt will pay more attention to those parts of the legal system that are more immediate and less to those that will not have direct effects until weeks or months after a bankruptcy filing. The typical client will be more concerned about the detailed financial records to be produced and the

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<sup>65</sup> I have argued in prior work that it is a poor policy choice to influence bankruptcy filing rates by enhancing cultural predispositions against filing. Mann, ‘Above note 7, ch. 15’; Ronald J. Mann (2006), ‘Optimizing Consumer Credit Markets and Bankruptcy Policy’ 7 *Journal of Theoretical Inquiries Law* 353.

\$700-\$1000 to be paid up front, than about the lawyer's estimation of the months or years that might pass before the proceeding is finally concluded. This distinction is implicit in my characterization throughout this paper of procedural obstacles as front-end attributes and discharge and payment issues as back-end attributes. The individual's reaction to the immediate and remote attributes of the bankruptcy process differs little from the individual's reaction to the immediate and remote attributes of complex products like cell phones, health clubs, and credit cards.<sup>66</sup>

The second relates to the attributes of the universe of potential bankrupts. Rules about income payments and conditions of discharge have relatively little significance for those who have no income or assets, because whatever the law says they are unlikely in fact to make substantial payments to creditors or to suffer in a material way from post-bankruptcy collection activity. Those issues matter, rather, to the relatively well-off subset of filers for whom future payment obligations are realistic. Conversely, procedural obstacles will matter the most to those without income or assets. A \$1,000 bill for costs and fees of filing a bankruptcy petition is much more likely to slow a filing by a desperate bankrupt with no income or assets than it is a filing by middle-class debtors with steady income but no realistic possibility of meeting their financial obligations. Moreover, the desperately insolvent have relatively little to gain from a

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<sup>66</sup> See Stefano Dellavigna & Ulrike Malmendier (2004), 'Contract Design and Self-Control: Theory and Evidence' 119 *Quarterly Journal of Economics* 353; Xavier Gabaix & David Laibson (2006), 'Shrouded Attributes, Consumer Myopia, and Information Suppression in Competitive Markets' 121 *Quarterly Journal of Economics* 505; Mann, 'Above n 7, ch. 12'; Ronald J. Mann (2006), "'Contracting" for Credit' 104 *Michigan Law Review* 899.

bankruptcy filing (at least in an economic sense). They will pay little or nothing on their debts in any event. For them, the immediate gain from a bankruptcy filing comes from the possibility that creditors might harass them less after they file. The relatively well-off middle-class filers have the most to gain in economic terms, because the bankruptcy process allows them to protect assets or income from creditors who might be able to force payment absent a discharge in bankruptcy.

With respect to the U.S., the Consumer Bankruptcy Project shows that a great many of those who actually file have very little income and few assets. For example, as of 2001, the median household income of debtors in the Consumer Bankruptcy Project was only \$20,172; 41% were below the poverty line.<sup>67</sup> Asset values are harder to judge, because about half of U.S. bankrupts have homes. Considering non real-estate assets (the only likely sources for distributions to creditors), the median value of assets was less than \$10,000, far below the median value for all families (more than \$40,000).<sup>68</sup>

The Consumer Bankruptcy Project, however, does not say anything about how many more people, similarly desperate, are excluded from the system by the procedural obstacles discussed above. The best evidence of the size of that population will be evident whenever post-BAPCPA filing rates become sufficiently stable to allow us to discern the size of the decline attributable to that statute. Figure A5 shows the total

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<sup>67</sup> See Teresa A. Sullivan, Elizabeth Warren & Jay Lawrence Westbrook (2006), 'Less Stigma or More Financial Distress: An Empirical Analysis of the Extraordinary Increase in Bankruptcy Filings' 59 *Stanford Law Review* 213, 222-23.

<sup>68</sup> See *id.* at 226-27.

filings in the United States over time, with a data point for 2007 extrapolated from the data for the first half of 2007. As the figure suggests, the filing rate almost two years after the effective date of BAPCPA remains substantially below the filing rate before BAPCPA. Thus, although it is still too early to speculate on the ultimate size of the gap, it is increasingly clear that there will be some gap, that the post-BAPCPA filing rate will remain below the pre-BAPCPA filing rate for the foreseeable future.<sup>69</sup> Because the most important provisions of BAPCPA that are likely to affect the filing rate are provisions designed to increase the procedural obstacles to bankruptcy,<sup>70</sup> the size of that drop suggests the significance of this group to the total filing rate.

If marginal filers with no substantial assets or income are a large portion of the potential bankrupts, marginal filers also are those for whom there is the greatest divergence between the private and social value of the bankruptcy filing. As discussed above, the economic value of a bankruptcy filing for a debtor with little income and few assets is relatively small, because the debtor gains relatively little from the discharge. However, the net social value of the discharge is considerable. On the one hand, the discharge harms third parties relatively little, because even without a discharge creditors would collect little of their debts from this class of bankrupts. On the other hand, society gains considerably from the discharge, because it is central to redeployment of the debtor's human capital. The premise of the bankruptcy discharge is that it increases the

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<sup>69</sup> For a detailed discussion of the various factors that affect the size and duration of that gap, see Mann, 'Above n 62'.

<sup>70</sup> See Mann, 'Above n 62'.

likelihood that the discharged can move forward with their lives, engaging in productive economic activity – jobs, tax payments, and attention to their family – and decreases the likelihood that they will drift into positively harmful activities – drug use, crime, and the like.<sup>71</sup> The more a legal system can facilitate that redeployment, the greater the net social benefits from the system.<sup>72</sup>

Given the decades of experience that the U.S. has had with its bankruptcy system, it is surprising that the U.S. has not yet come to grips with the reality of the lower middle-class bankrupt who has no substantial income or assets. Many other countries have rapidly developing and widely used systems for “no-income, no-asset” or NINA filings. Thus, following the lead of New Zealand,<sup>73</sup> the U.K.’s Insolvency Service has proposed a NINA Debt Relief Order designed to be a low cost alternative for “the very poorest”

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<sup>71</sup> See Edmund Phelps, *Rewarding Work* (1999).

<sup>72</sup> The concerns about the potential for positive spillover effects from the bankruptcy process that have been so absent from the U.S. deliberations have dominated European debates in recent years. *E.g.*, Kilborn, *Sweden*, ‘Above n 2, at 439’. Kilborn, *Netherlands*, ‘Above n 2, at 93’.

<sup>73</sup> Insolvency Act 2006 (N.Z.) §§ 361-377, 2006/55; see Thomas G.W. Telfer, ‘New Zealand Bankruptcy Law Reform: The New Role of the Official Assignee and the Prospects for a No-Asset Regime’, Johanna Niemi-Kiesiläinen *et al.* (eds) in *Consumer Bankruptcy in Global Perspective* 247 (Hart Publishing Ltd, 2003).

individuals.<sup>74</sup> Available to individuals with no more than £50 in surplus income and no more than £300 in realizable assets, the process would be entirely administrative and have a significantly lower filing fee than the standard bankruptcy process.<sup>75</sup> The Insolvency Service estimates that filings under the NINA system would be at a rate of more than 500 per million per year, a substantial number in a nation that currently has only about 1000 bankruptcy filings per year.<sup>76</sup>

Similarly, although Canada already has a “summary administration” process with reduced fees and process, used by about 90% of its debtors, Canada’s Personal Insolvency Task Force recently spent considerable effort debating an even more streamlined “fast track” process for the poorest debtors.<sup>77</sup> Sweden is implementing this year major reforms designed to truncate the process to speed the return of the insolvent to

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<sup>74</sup> Insolvency Service, Relief for the Indebted – An Alternative to Bankruptcy (March 2005); Insolvency Service, Relief for the Indebted – An Alternative to Bankruptcy: Summary of Responses and Government Reply (Nov. 2005).

<sup>75</sup> See Ramsay, ‘Functionalism and Political Economy’, ‘Above n 21, at 648-50’.

<sup>76</sup> See Ramsay, ‘Functionalism and Political Economy’, ‘Above n 21, at 648-49’.

<sup>77</sup> Ziegel, ‘Above n 4, at 19’. See also Stephanie Ben-Ishai & Saul Schwartz (forthcoming 2007), ‘Bankruptcy for the Poor’ 45 *Osgoode Hall Law Journal* (estimating that 70%-80% of Canadian failures would qualify as NINA filers). Despite the protracted consideration, the task force ultimately made no recommendation on the question, which remains unaddressed in Canadian law. See Duggan, ‘Above n 4, at 872-73’.

economic productivity.<sup>78</sup> Recent Netherlands reforms include a “fast-track” procedure for “extreme” cases in which neither assets nor income are expected to produce a return to creditors. Although administrators are applying the procedure cautiously “‘to create societal support’ for the new law in its early years,” it appears that creditors receive distributions in no more than a fifth of all cases in the Netherlands.<sup>79</sup> Despite the vehement German objections to an American-style discharge, German legislators finally recognized the need for a reduced-cost procedure for no-asset cases, a procedure that has received a major share of filings since its introduction in 2001.<sup>80</sup> Similarly, recognizing that French courts were “literally submerged by the flood of over-indebtedness cases,” French legislators in the 1990’s largely removed any judicial role in most cases.<sup>81</sup> More recently, French legislators adopted a new procedure for “personal recovery” to deal with the large share of cases (about one-quarter of all filings) in which it is immediately obvious that there is no prospect for payments to creditors.<sup>82</sup>

These systems recognize that the appropriate bankruptcy procedure for this slice of the debtor population, what we might call the low-income low-asset (“LILA”)

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<sup>78</sup> See Kilborn, ‘Sweden’, ‘Above n 2, at 457-61’.

<sup>79</sup> Kilborn, ‘Netherlands’, ‘Above n 2, at 107-08’.

<sup>80</sup> See Kilborn, ‘Germany’, ‘Above n 2, at 286-88’.

<sup>81</sup> See Kilborn, ‘France’, ‘Above n 2, at 645-47’.

<sup>82</sup> See Kilborn, ‘France’, ‘Above n 2, at 655-61’.

debtors,<sup>83</sup> is a purely administrative process. For individuals that cannot reasonably be expected to make any substantial payments, processing at the lowest possible transaction costs should be the goal. The U.S., by contrast, continues to use a “one size fits all” system, with procedural obstacles that are wastefully obstructive for much of the bankrupt population.

The evidence points toward bankruptcy simplification.<sup>84</sup> The time has come to abandon the complicated structures, laden with bureaucratic hurdles and special-interest provisions worthy of the Internal Revenue Code. At least for the desperately insolvent, with no substantial income or assets, the best process is one that is stripped down to its most central elements. First, the system should function as an administrative process designed to provide a service at the lowest possible transaction cost rather than as an

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<sup>83</sup> I am reluctant to proliferate acronyms but the NINA terminology is highly misleading, because the filings are not limited to those with no income or assets at all, but rather to those who have no substantial income or assets. It is also unfortunately confusing that the same term has come into common use to describe no-document real-estate mortgages in the subprime sector in recent years.

<sup>84</sup> For a parallel argument, see Jean Braucher (2006), ‘A Fresh Start for Personal Bankruptcy Reform: The Need for Simplification and a Single Portal’ 55 *American University Law Review* 1295. I note that this discussion does not consider the likelihood that debtors often have broader social problems (patterns of drug abuse, dysfunctional family lives, etc.), and that the bankruptcy process might be an ideal opportunity to respond to them. As noted by commenters at the Berlin conference for which this paper was prepared, European insolvency reform has taken that problem much more seriously than American reform has.

adversarial judicial process.<sup>85</sup> In cases with low levels of assets and income there should be few important factual disputes; disputes about the amount of claims and priorities among creditors are important only when there is valuable collateral or nonexempt assets. Judicial staff and attorneys in the U.S. already work hard to process these cases economically, but the excessive requirements of the post-BAPCPA process waste social resources.

Second, the system should provide complete and unconditional relief as quickly as is practicable. This should occur within days or weeks after the filing, not months or years. Again, when the debtor has low levels of income and assets, delaying or conditioning the discharge only delays the return of the debtor to productive economic activity unburdened by the overhang from the debts of the past.

Finally, the system should impose stern criminal sanctions for fraud, with adequate resources to ensure prosecutorial vigilance. A simple and expedient process will collapse if it is tainted by fraud. Among other things, the cultural perception of those who have gone through the process will turn negative, making it harder to persuade the “honest but unfortunate” debtor to take advantage of the process. The simplest way to avoid that problem is with an oversight system that imposes sufficiently severe penalties on abusive filers. If we want to make a cultural point, the point to be made is that abuse

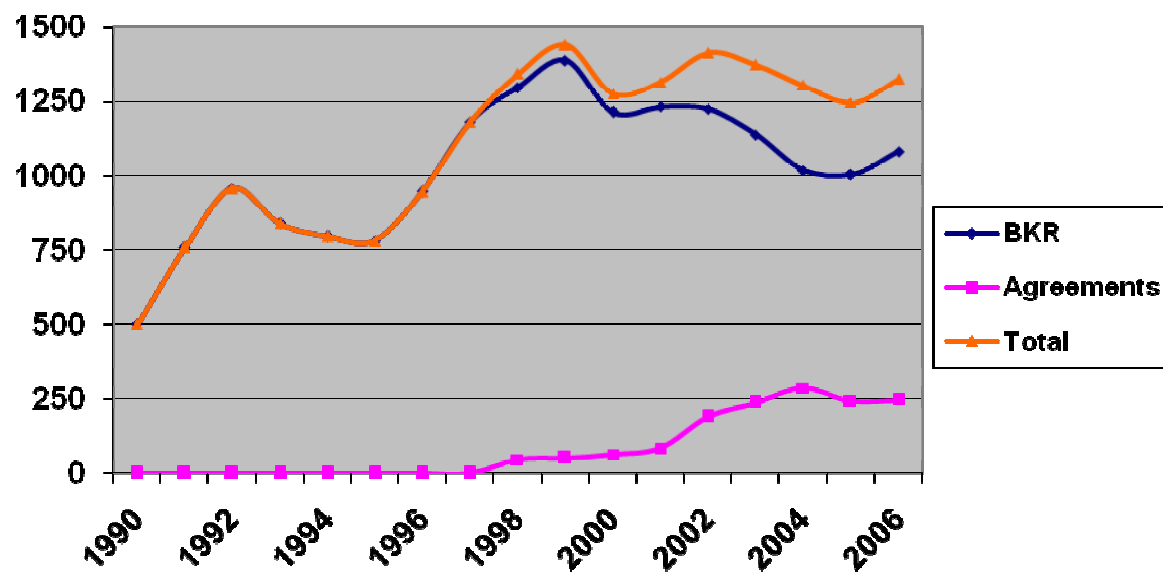
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<sup>85</sup> Drafters of the Bankruptcy Code of 1978 rejected proposals for an administrative process. See David T. Stanley & Marjorie Girth, *Bankruptcy: Problem, Process, Reform* 204-15 (Brookings 1971). Thirty years of domestic experience coupled with the evidence from abroad justifies rethinking that decision.

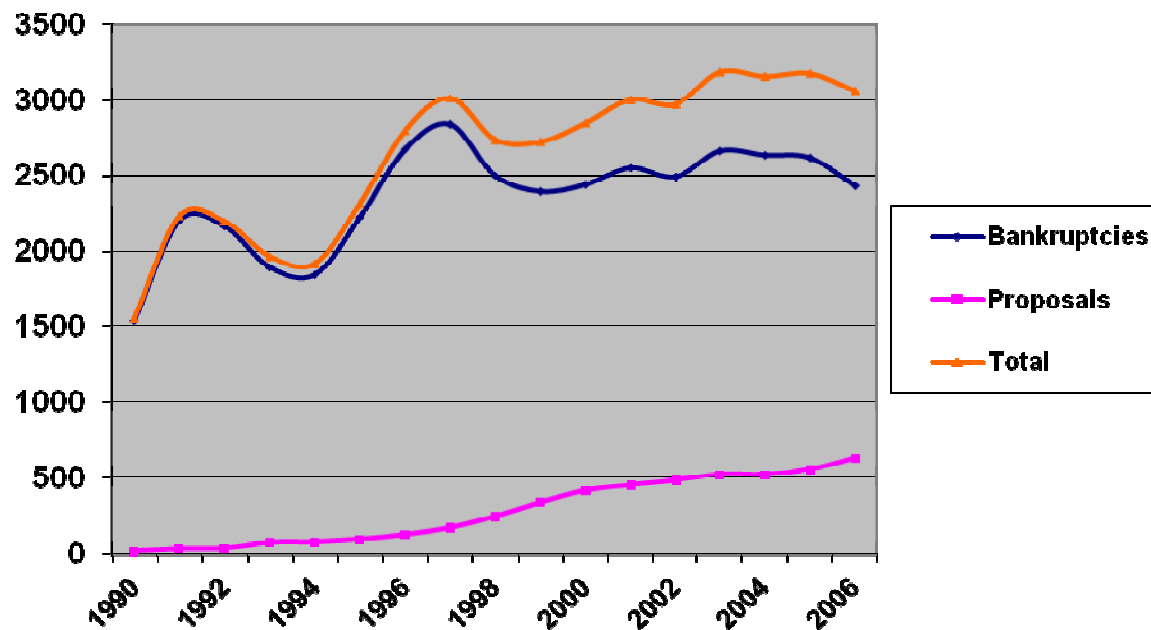
of the system cannot be condoned. An effort to extend that condemnation to the hopelessly insolvent, by contrast, helps none of us.

APPENDIX

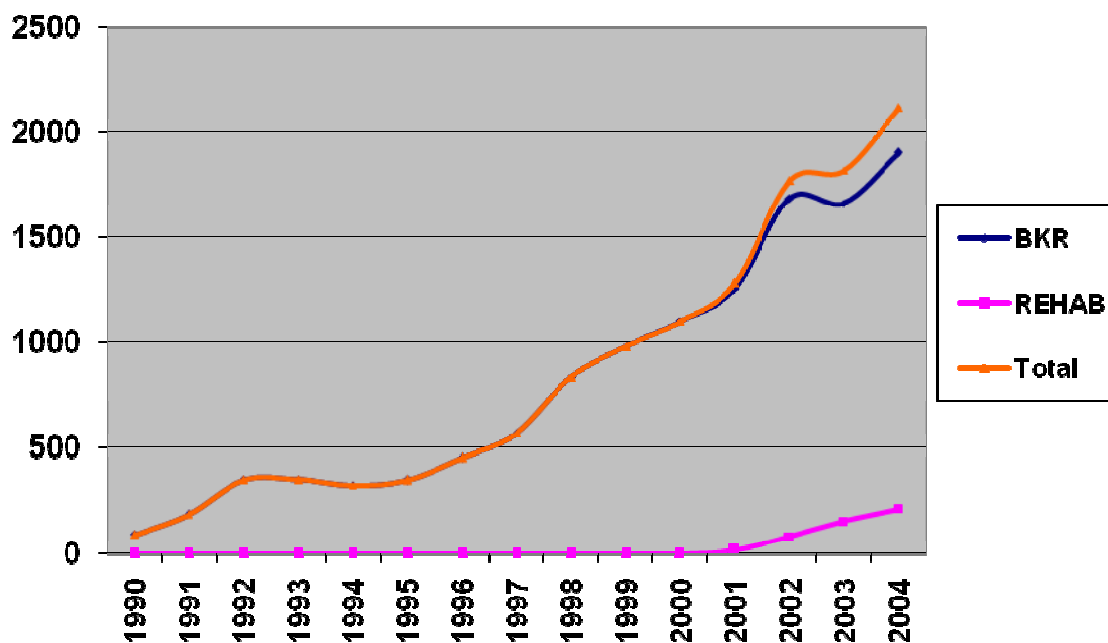
FIGURE A1: AUSTRALIAN INSOLVENCIES OVER TIME



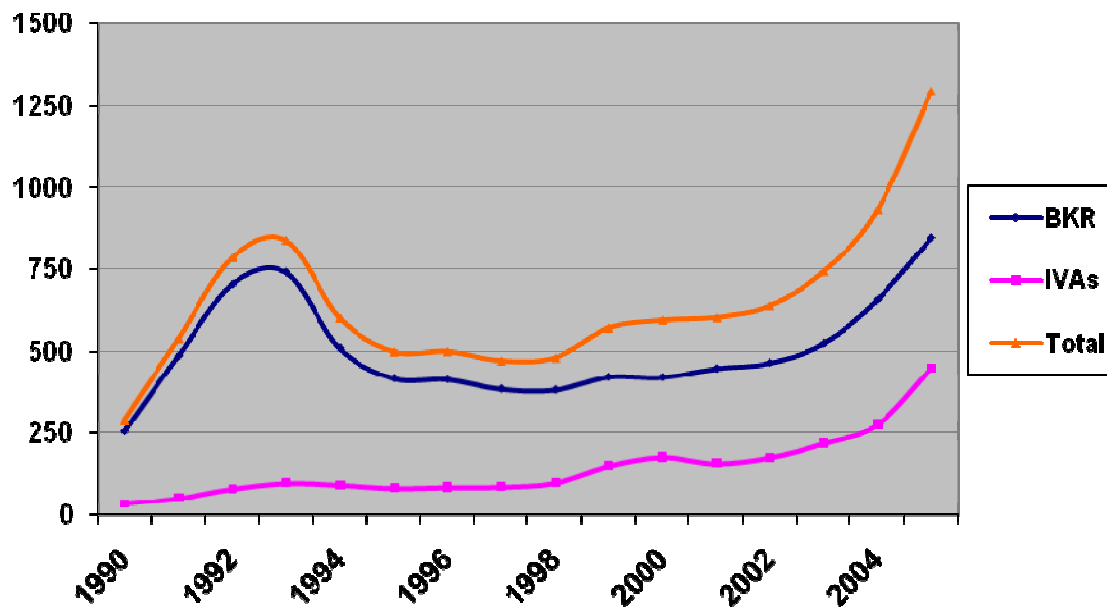
**FIGURE A2: CANADIAN INSOLVENCIES OVER TIME**



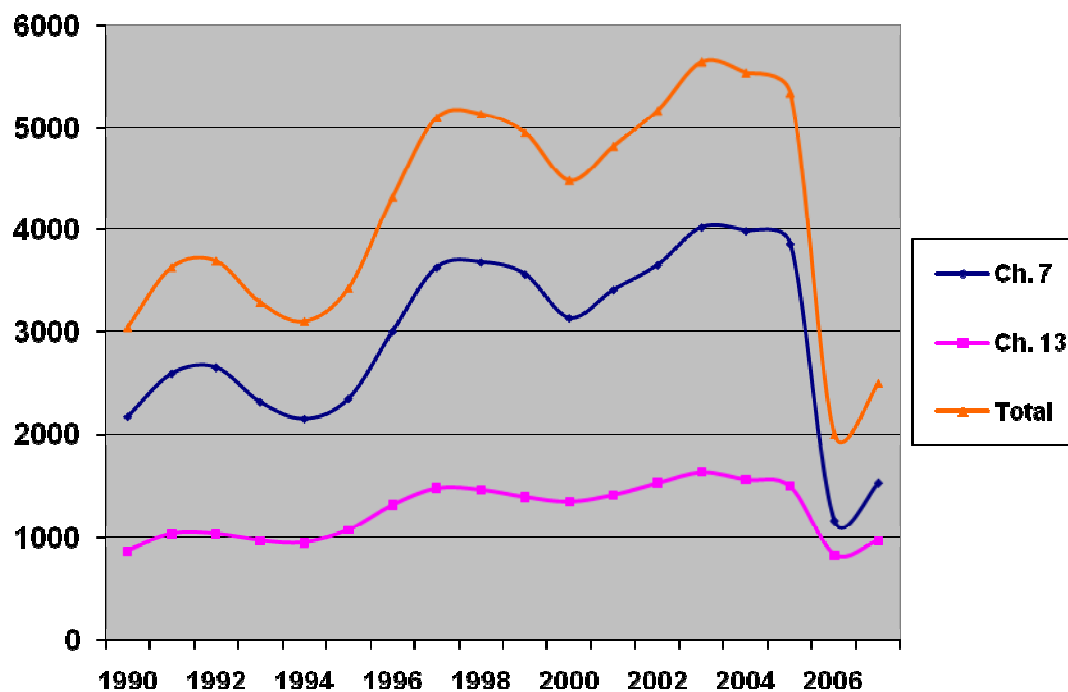
**FIGURE A3: JAPANESE INSOLVENCIES OVER TIME**



**FIGURE A4: UK INSOLVENCIES OVER TIME**



**FIGURE A5: UNITED STATES INSOLVENCIES OVER TIME<sup>86</sup>**



<sup>86</sup> The 2007 data points are estimated from data for the first 26 weeks of 2007. I do not include them in the regressions discussed in the text.

**TABLE A1: SUMMARY OF REGRESSION MODEL**

	<b>Total Bankruptcies</b>	<b>Liquidations</b>	<b>Rehabilitations</b>
<b>Economic Variables</b>			
Credit Card Debt	<b>1.454 (.181)</b> <b>8.03***</b>	<b>1.036 (.164)</b> <b>6.32**</b>	<b>.417 (.068)</b> <b>6.09**</b>
Consumer Debt	.073 (.303) 0.24	-.082 (.198) -0.41	.018 (.082) 0.22
Credit Card Spending	.090 (.149) 0.60	.144 (.131) 1.10	<b>.053 (.017)</b> <b>3.17*</b>
Unemployment	56.89 (81.85) 0.70	83.68 (53.27) 1.57	-5.733(25.33) -0.23
<b>Country Dummies</b>			
USA	<b>-704.75 (150.35)</b> <b>-4.69**</b>	<b>-795.78 (183.92)</b> <b>-4.33**</b>	<b>199.25 (59.81)</b> <b>3.33*</b>
Australia	-1012.01 (679.95) -1.49	<b>-1116.98 (430.93)</b> <b>-2.59#</b>	-115.87 (193.82) -0.60
Japan	-277.60 (692.31) -0.40	-700.09 (469.12) -1.49	32.09 (186.86) 0.17
UK	-627.28 (1106.19) -0.57	-1119.35 (683.77) -1.64	263.29 (284.49) .93
R <sup>2</sup>	.93	.93	.97
N	51	69	51

# - significant at .1 level

\* - significant at .05 level

\*\* - significant at .01 level

\*\*\* - significant at .001 level

The table reports the coefficient, the robust standard error in parentheses, and the t-statistic below. The coefficients are in filings/million. Canada is the omitted case, so the coefficients indicate the extent to which filing rates under the same conditions would fall short of (or in the case of rehabilitation filings, exceed) Canadian rates. The regressions use robust clusters to control for autocorrelation in the time series.