

Chapter 7 or 13: Are Client or Lawyer Interests Paramount?*

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Abstract

Households often rely on professionals with specialized knowledge to make important financial decisions. In many cases, the professional's financial interests are at odds with those of the client. We explore this problem in the context of personal bankruptcy. OLS, IV, and fixed effects estimates all show that attorneys play a central role in determining whether households file under Chapter 7 or Chapter 13 of the bankruptcy code. We present evidence suggesting that some attorneys maximize profits by steering households into Chapter 13 bankruptcy even when the households' objective financial benefits are low and the probability of case dismissal is high. An attorney-induced Chapter 13 filing increases household legal fees and reduces the probability of long-term debt relief.

Introduction

Individuals rely on informed professionals for many of their important financial decisions. An emerging literature documents the extent to which professionals sacrifice their clients' interests to increase profits. For example, Levitt and Syverson (2005) show that real estate agents price clients' houses more cheaply than their own. Gruber and Owings (1996) provide evidence that doctors are more likely to perform expensive caesarian sections when there is relatively low demand for their services. Similarly, Harrington and Krynski (2002) discuss how funeral directors often induce households to bury their deceased loved ones in lieu of a less expensive cremation. Chevalier and Ellison (1997) demonstrate that mutual fund managers adjust the risk of their portfolio to maximize fund inflows instead of risk adjusted returns.

In this paper, we examine the principal-agent problem in the context of personal bankruptcy. We document the extent to which bankruptcy attorneys take advantage of their clients' lack of sophistication to steer them into a bankruptcy option that is lucrative for the attorney but poorly suited to the clients' financial situation. Poor advice can cost insolvent households thousands of dollars and usually fails to provide debtors with long-term debt relief.

Personal bankruptcy is one of the most important mechanisms through which Americans are insured against adverse financial, health, and personal shocks. Fifteen of every thousand households in the United States filed for personal bankruptcy in 2003, (Lefgren and McIntyre, 2007) on average discharging approximately \$36,000 in debt (Culhane and White, 1999). Bankruptcy transfers more money than state unemployment insurance programs (UI) and Temporary Assistance for Needy Families (TANF)

combined. Despite the importance of personal bankruptcy as consumption insurance, limited information on the part of debtors induces a situation in which access to appropriate debt relief is based in large part upon which law office a debtor happens to enter.

A debtor's bankruptcy experience crucially depends on whether he files under Chapter 7 or Chapter 13 of the bankruptcy code.¹ Under Chapter 7, often referred to as liquidation, households may only keep exempt property. All other assets of value are liquidated by a trustee and distributed to creditors. Most of the household's unsecured debts are then discharged (forgiven) and the debtor does not have to give up any of his future income. Alternatively, under Chapter 13, the debtor retains all of his financial assets but promises to follow a court approved repayment plan over a three to five-year period. Which chapter is optimal for a debtor depends on the particulars of his financial situation. Most households that file under Chapter 13, however, pay high legal fees and do not receive long-term debt relief.

While it is to be expected that not all bankruptcies will work out as planned, evidence suggests that the chapter under which households file is not purely a function of their financial situation.² Using household level data from California, Texas, and Utah, we show that an attorney's fraction of *other* bankruptcies filed under Chapter 13 explains 10-20 percent of the variation in chapter selection, even controlling for the financial situation of filing households. This relationship is by far the single most important

¹ During the time period in question, Chapter 7 and Chapter 13 relief was available to all debtors. Relief under Chapter 11 was also available to individual debtors, but few debtors chose that option because of the significant cost of filing bankruptcy under Chapter 11.

² For example, Lefgren and McIntyre (forthcoming) report that the fraction of personal bankruptcies filed under Chapter 13 ranges from 0.03 in North Carolina to 0.62 in Georgia, suggesting legal culture plays an important role in chapter choice. Sullivan, Warren, and Westbrook (1998) emphasize that debt loads and repayment ability appear similar for Chapter 7 and Chapter 13 filers. Braucher (1993) presents qualitative evidence on the attorney's role in the chapter decision.

observable predictor of which chapter gets filed and it holds after either (1) instrumenting the actual attorney's fraction of bankruptcies filed under Chapter 13 with a measure of average attorney filing behavior in the debtor's neighborhood or (2) using an identification strategy based on neighborhood fixed effects.

Firms specializing in Chapter 13 collect more for these bankruptcies, although less payment is required upfront. Yet these firms do not offer benefits in terms of lower dismissal rates or more manageable payment plans. Indeed, our instrumental variables (IV) estimates, which focus on households that chose attorneys based on geographic convenience, suggest that those who file under Chapter 13 with Chapter 13 specialists are often objectively poorly suited for this type of bankruptcy and have high dismissal rates.

While attorney specialization yields few benefits for clients, it appears consistent with firm profit maximization. Large firms and firms with a client mix better suited for Chapter 13 bankruptcies tend to specialize in Chapter 13. This is consistent with a model in which firms that expect to file a large number of Chapter 13 bankruptcies engage in fixed investments to reduce the marginal costs of filing such cases. Thus, firms encourage Chapter 13 when the cost is low enough to rationalize (from a profit maximization perspective) pursuing the higher court-regulated payment available under this chapter.

While we cannot test the hypothesis that attorneys have different views regarding the advantages of each type of bankruptcy, attorney specialization is empirically consistent with debtor interests being subordinate to firm profits. Ultimately, a typical lawyer-instigated decision to file under Chapter 13, as opposed to Chapter 7, leads to a

substantial transfer of wealth from insolvent households to specialized attorneys with a *reduced* probability of long-term debt relief.

Review of the Literature

In addition to the empirical principal-agent literature cited in the introduction, our paper relates to a large existing literature on personal bankruptcy found in both the economics and legal disciplines. Most closely related to our analysis is a set of papers that explore factors driving a household's decision regarding bankruptcy chapters. Nelson (1999), Domowitz and Sartain (1999), Sullivan and Worden (1990), Li and Sarte (2002), and Sullivan et al. (1988) all find that financial incentives play a role in the choice of bankruptcy chapter. However, many other economists note that legal culture and the choice of attorney also play important roles in the chapter decision. Specifically, Lefgren and McIntyre (forthcoming) find that the propensity to file under Chapter 13 of the bankruptcy code varies greatly across localities. Because these differences are extremely persistent and exist across adjacent states with seemingly similar populations, they conclude that the differences in the proportion of Chapter 13 filings are likely due to legal culture. Sullivan et al. (1994) also argue that all of the variation across bankruptcy courts in chapter choice cannot be explained by state laws, by the behavior of particular individuals or by other non-legal factors. The authors develop a model in which the local legal culture is dominated by lawyers. According to this model, the lawyer, due to specialty, moral preference, or stereotype influences the chapter choice. Braucher (1993), Neustadter (1986) and Sullivan et al. (1988) all provide important qualitative

evidence that lawyers often steer households toward one particular bankruptcy alternative.

Our paper is also closely related to the medical literature examining variation in treatment choice across providers and locations. Health economists have widely documented the variation in physician practice styles which cannot be explained by income, insurance, or patient preferences. Recent examples including Chandra and Staiger (2004), Epstein, Ketcham and Nicholson (2005), and Grytten and Sørensen (2003) show that choice of service provider plays an important role in the type of treatment patients receive. Chandra and Staiger (2004) and Allgood and Bachmann (2006) highlight the health benefits that patients receive from physician specialization.

The current study makes three contributions to the existing literature on chapter choice. First, we quantify the magnitude of the attorney's role in chapter choice. Second, we address concerns that the apparent role of lawyers is driven by the endogenous sorting of clients to attorneys. Third, we show that attorney Chapter 13 specialization is on average detrimental to clients and plausibly driven by profit maximization on the part of the attorney. Our paper also adds fresh evidence regarding the problems of principal-agent relationships when the principal (the insolvent household in our example) is unsophisticated.

Institution Background

Personal Bankruptcy in the United States

For households unable to service their debts, personal bankruptcy is a primary instrument of debt relief. Federal authority for bankruptcy is found in Article 1, Section

8 of the United States Constitution. For this reason, many aspects of bankruptcy are uniform across states. When households file for bankruptcy, creditors must stop all collection measures; this means that creditors must cease foreclosure proceedings, cannot send the debtor correspondence, and must stop all garnishments.

Once they petition for bankruptcy, debtors must decide whether to file under Chapter 7 or Chapter 13 of the bankruptcy code. Under Chapter 7, households may have to liquidate their assets. Any proceeds are then distributed among their creditors. This process is fast and simple; Chapter 7 debtors are able to obtain a speedy discharge of most unsecured debts and remove some judicial liens. On the other hand, under Chapter 13, debtors keep their property and instead agree to repay their debts using their future income. Chapter 13 cases are comparatively complex and lengthy. From 1999 to 2001, Lefgren and McIntyre (forthcoming) report that 70.5 percent of all personal bankruptcies were filed under Chapter 7.

A Chapter 7 case begins when the debtor files a petition with the bankruptcy court. In addition to the petition, the debtor must detail his assets, liabilities, monthly income, and average monthly expenses. After the petition is filed, a Chapter 7 bankruptcy trustee holds a meeting of creditors, during which the trustee and creditors may ask the debtor questions regarding these documents. After this meeting, the trustee can gather and sell debtor assets. The Bankruptcy Code, however, allows the debtor to keep certain “exempt” property. Specifically, debtors may keep assets with a value below the personal and homestead exemption levels. These exemption levels vary dramatically across states. For example, Florida has an unlimited homestead exemption while Delaware has none. After the debtor’s assets are liquidated, the proceeds are used to

repay creditors and the debtor is discharged (released from liability) of any remaining debts. In other words, all remaining debts are then forgiven.

While the Chapter 7 bankruptcy code allows for contested filings and the liquidation of assets, the typical case involves neither of these. According to conversations with bankruptcy attorneys, often no creditors attend the meeting of creditors. Additionally, the large majority of Chapter 7 cases involve no non-exempt assets that are profitable for the trustee to sell. For this reason, the typical Chapter 7 bankruptcy is quick and simple both for the attorney and for the client. Furthermore, only a small fraction of such bankruptcies are dismissed. In our sample of Chapter 7 filings, only 3 percent were listed as being dismissed.

Not all households can file for Chapter 7 bankruptcy. Households who already filed for Chapter 7 bankruptcy within the past seven years are ineligible. Additionally, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) restricted eligibility for Chapter 7 bankruptcy on the basis of household income.³ Finally, United States trustees, who represent creditor interests, may attempt to force individuals to file under Chapter 13 if it is clear that the debtors possess the ability to pay a substantial fraction of their debts. Rarely are the income restriction or trustee objections an obstacle for households considering bankruptcy.

Under Chapter 13, households retain all of their assets and instead agree to repay some of their debts according to a court ordered payment plan lasting between three and

³ In a sample of 1,938 cases filed nationwide between November 1998 and August 1999, Flynn and Bermant (2000) only found two petitions which were filed under Chapter 7 but failed the means test. Similarly, Culhane and White (1999) estimated that only 3.6 percent of debtors would be barred from Chapter 7 when a “means test” was enacted. True to speculation, within the first year of its enactment, the Acting Director of the Executive Office of the U.S. Trustees testified that approximately 0.5 percent of Chapter 7 filers were being affected by the “means test” (Tabb and McClelland 2007).

five years. Debtors pay their projected monthly disposable income, calculated as the difference between their monthly income and monthly budgeted living expenses, into the Chapter 13 payment plan. An in a Chapter 7, a Chapter 13 case begins when the debtor files a petition with the bankruptcy court. Again, the debtor must detail his assets, liabilities, monthly income, and average monthly expenses. After the petition is filed, however, the legal proceedings around a Chapter 13 become more complex. Following the creditor's meeting, lawyers must complete a Chapter 13 repayment plan. This plan, described in further detail below, specifies the amount debtors will pay to the trustee every month. After a judge confirms the plan (decides that the plan is feasible and meets the standards set forth in the Bankruptcy code), the Chapter 13 trustee will begin to distribute funds to creditors. The funds are first disbursed to the debtor's lawyer, then to creditors with priority claims, and finally, any remaining funds are used to repay creditors with unsecured claims. Upon completion of the plan, the household's remaining debts are discharged. The Chapter 13 discharge is often referred to as the super-discharge; in addition to the debts discharged under Chapter 7, Chapter 13 debtors can discharge debts from property settlements following a divorce, willful and malicious injury, governmental fines and penalties, unpaid taxes, certain fraudulent tax filings, fraud, embezzlement, larceny, and damages from personal injury civil action. Significantly, Chapter 13 bankruptcy also allows debtors to retain possession of collateral even if clients are in arrears with their payments. Often, households will file under Chapter 13 to stay in their home or keep an automobile. Debtors can file under Chapter 13 as frequently as every two years.⁴ The process of creating a household budget and securing

⁴ Prior to the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), households could file a Chapter 13 bankruptcy every six months.

the approval of the payment plan involves substantially more paperwork and time relative to a Chapter 7 bankruptcy.

Relative to Chapter 7, Chapter 13 is advantageous for some households. But, it is a poor choice for many debtors. The benefit of a Chapter 13 is that debtors may keep all of their assets. However, in order to discharge its debts under Chapter 13, a household must complete its repayment plan. Thus, Chapter 13 is designed for households with a continuing ability to earn income and minimize future expenditures. If a debtor is unable to commit to a long-term plan, his case will be dismissed, and he will be liable for all his original debts as well as additional court and lawyer fees. According to Lefgren and McIntyre (forthcoming), while 29.5 percent of bankruptcies are filed under Chapter 13 of the bankruptcy code, the majority of these bankruptcies are dismissed (60 percent) largely due to nonpayment on the debtor's part. Another 12 percent of the Chapter 13 filings are ultimately converted to Chapter 7 for the same reason. Thus, Chapter 13 bankruptcies only represent 10 percent of bankruptcy *discharges*. For these reasons, the majority of households filing under Chapter 13 do not receive long-term benefits.

Lawyer Specialization

Lawyers vary significantly in the fraction of bankruptcies they file under Chapter 13. Figure 1 is a histogram showing the distribution of lawyers in California, Texas, and Utah by the fraction of bankruptcies they file under Chapter 13. This histogram demonstrates the large spread in lawyer behavior. 42 percent of lawyers file less than 10 percent of their cases under Chapter 13 of the bankruptcy code. On the other hand, 20 percent of lawyers file more than 40 percent of bankruptcies under Chapter 13. If

