

Local Labor Markets, Employment Distributions and Consumer Bankruptcy Filings: Evidence from Eastern Washington

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Using individual level data collected in the Eastern District of Washington State, the type of employment is indentified as a significant factor in chapter choice. Additionally, a typical debtor's field of employment could either increase or decrease the likelihood of filing for bankruptcy protection under Chapter 7 of the U.S. Bankruptcy Code relative to Chapter 13 of the Code. Given that counties have different distributions of employment by industry, that different industries pay different wages (at the mean) and that under the Bankruptcy Abuse Prevention Consumer Protection Act (BAPCPA) guidelines chapter choice is significantly driven by income, these findings imply that the BPCPA legislation is creating a distortion which makes filing a Chapter 7 bankruptcy (relative to a Chapter 13 filing) easier in certain counties than in others. Thus, BAPCPA has created local economic discrimination across counties within a particular bankruptcy court jurisdiction.

INTRODUCTION

American consumers, when confronted with overwhelming financial burdens, have historically had access to several bankruptcy-related options to discharge and/or negotiate favorable repayment options. Between 1985 and 2005, and in both recessions and economic expansions, there was a consistent and dramatic increase in both consumer bankruptcy filings and the dollar amount of debt being discharged. In response to rising public concerns about the explosive and consistent growth in bankruptcy filings, Congress adopted the Bankruptcy Abuse Prevention Consumer Protection Act (BAPCPA) of 2005.

One notable component of BAPCPA was the use of a "means test" to force debtors into filing under specific chapters of the Bankruptcy Code (usually either Chapter 13 or Chapter 7) depending on a debtor's ability to repay some or all of their debts. BAPCPA attempts to establish guidelines for chapter choice based solely on economic characteristics that are defined at the regional and state levels. More

specifically, a debtor's (family) income is compared against a set of pre-defined expenses, and income in excess of those expenses is considered as "excess income" which can be used to repay creditors. Debtors whose excess income is sufficiently high (usually \$100 per month, although courts exercise discretion in setting the exact amount) are precluded from filing under Chapter 7 of the Bankruptcy Code (i.e., they are "forced" to file under Chapter 13). The expenses for "means test" analysis are based upon IRS standards which vary by expense category and by region, State, or metropolitan area of the filer.¹

From a policy prospective, chapter choice is extremely important, as Chapter 7 filings provide for no repayment of most classes of unsecured debt. Chapter 13, however, is designed to put the debtor on a budget and pay at least some portion of the unsecured debt in order to gain a discharge of the balance. Chapter 7 filings tend to shift the cost of this unpaid debt to businesses, other creditors and society as a whole. Because the chapter filing choice is guided by the means test, and by extension the allowable expenses which characterize the means test, it is vitally important to ensure that the allowable expenses and the means test are implemented appropriately. Failure to do so could lead to a socially sub-optimal number of filings in a given chapter, and a disproportionate cost placed upon society as a whole.

As noted above, BAPCPA mandates that the means test is based on allowable expenses that are determined at the level of the state. In particular, IRS guidelines set allowable expenses based on the median levels of household income and expenses (adjusted for family size) in a particular state. As such, BAPCPA guidelines could have different and potentially inequitable impacts on chapter filing decisions at a more disaggregated level, for example, at the county level. In counties where economic opportunities are limited and wages are low, it may be much easier to file for Chapter 7 bankruptcy protection (compared to Chapter 13) than in counties where wages are higher and the number and distribution of employment opportunities are available.

This study examines the effect of changes in the distribution of employment on the Chapter 7-Chapter 13 bankruptcy decision process. One possible difficulty with the means test is local labor market conditions are not considered, most notably differences in industry mix and employment patterns (which drive wages and cost of living differentials) across local labor markets. In urban areas, wages and costs of living are higher, and job opportunities are more abundant than in rural areas. This implies that workers in urban areas (especially in specific, higher paying industries) are more likely to be forced into a Chapter 13 filing than other debtors living in rural areas. Similarly, workers in lower paying industries are more likely to "pass" the means test (and file under Chapter 7) than workers in industries that pay higher wages.

BACKGROUND

American bankruptcy law is codified under Title 11 of the United States Code (11. USC.). Consumer debtors overwhelmingly have their bankruptcy cases handled under two of the operative sections of 11. USC. Chapter 7, Liquidations, or what legal practitioners refer to as "straight" bankruptcy, is the most common. Chapter 13, Adjustment of Debts of an Individual with Regular Income, is commonly referred to as "wage earners" by both lawyers and the public. After the adoption of BAPCPA, attorneys were required to advise prospective filers of the basic differences between Chapters 7 and 13 (11. USC. 342(b)).

Debtors are formally (11. USC. 342(b) signed notice) advised as follows, "Chapter 7 is designed for debtors in financial difficulty who do not have the ability to pay their existing debts." Debtors are subject to a "means test" that may limit their ability to use Chapter 7. Debtors who qualify are also generally advised that Chapter 7 provides a discharge which legally releases them from most debts (certain listed debts are not dischargeable). A trustee will take control and sell any non-exempt property, and a discharge may be denied for improper conduct.

"Chapter 13 is designed for individuals who have the ability to pay all or part of their debts in installments over a period of time." In addition, debtors may be forced into Chapter 13 if they do not qualify for Chapter 7 under the "means test." The notice also advises Chapter 13 filers that there is an upper limit on how much debt qualifies for Chapter 13 protection. It specifies that the installment repayment plan may range from 3 to 5 years and must be approved by the Bankruptcy Court. The Chapter

Chapter 13 debtor will receive a discharge after successful completion of the plan payments, and not all debts will be discharged. The Chapter 13 debtor will still be subject to certain non-dischargeable debts, but a smaller non-dischargeable class than the Chapter 7 debtor.

A debtor's attorney typically expands on the respective advantages and disadvantages of the choice of the chapter. The advantages to Chapter 7 are that the bankruptcy is fast, less expensive, there is no supervision of the debtor's budget choices by a Trustee, and the rehabilitation process for the debtor's credit commences immediately.

Chapter 13 also has its advantages. Under this chapter, a mortgage default can be cured, time is allowed for the payment of non-dischargeable debts, there is a broader range of dischargeable debt, and legal obligations owed on certain secured debts may be altered. For example, alterations can be made in the duration of the payment obligation, the portion of debt treated as secured or unsecured (based upon a current valuation of the collateral), and the interest rate paid on the obligation. In a broad sense, the advantages of one chapter could be seen as a disadvantage of the other. No unique advantages would apply to any age, race, sex or ethnicity.

As mentioned earlier, BAPCPA required that income must be documented and that filers were subject to a "means test" to determine which chapter they may file. The purpose of the means test was to limit abuses to the Bankruptcy Code and mandate that filers who have sufficient income to pay some portion of their debts file chapter 13 instead of the more consumer-friendly chapter 7. Therefore, any significant filing differentials among these demographic and employment categories would have to be explained by factors outside the plain language of the Bankruptcy Code. One potential "outside" factor is a difference in economic vitality across local markets within a single jurisdiction. Because these guidelines are established at the mean for a particular jurisdiction, it is possible that BAPCPA creates "local economic discrimination" in the sense that the industries, employment opportunities and wages present in specific local economies may impact income levels and/or wealth accumulation differently than neighboring local economies in the same state or jurisdiction. If true, this would lead to differences in bankruptcy filing chapter choice in each of these local economic regions.

LITERATURE REVIEW

Surprisingly little research has examined BAPCPA's impact on the chapter choice decision, given the long-lived implications of the decision. The available literature is overwhelmingly located in specialized law journals sponsored and published by law schools. This literature is heavily focused on particularly legal issues – statutory construction, analysis of recent case decisions, and other issues of interest to the legal community. The result is a relative paucity of quantitative analysis; moreover, much of what exists focused on risk and the debtor's willingness to default (Gross & Souleles, 2002) and the debtor's financial benefit from filing (Fay et al., 2002).

Others have focused on the chapter choice decision. For example, Bermant (1999) directly addresses the question of consumer choice between Chapters 7 and 13. Based upon data maintained by the executive office for the US Trustees, chapter filing differentials by states were examined. The results reflected major regional differentials in bankruptcy choice. These major filing choice differentials were attributed to "legal culture", with Chapter 13 filings heavily concentrated in the Southern United States. Pollak (1997) analyzed bankruptcies in Nebraska from 1967-1997. The author noted a shift from male to female filers over the study period. In addition, a doubling in the Chapter 13 percentages was found over the same time period. Nelson (1999) utilized data from 1989-1996 and emphasized the role of state exemption statutes on chapter choice. This study showed that both garnishment and homestead exemption laws were statistically significant determinants of bankruptcy choices. Therefore, changes in exemptions were important for bankruptcy policy. Domowitz and Sartain (1999) utilized household data and examined the chapter choice decision. Medical and credit card debt were found to be the most important contributors to bankruptcy. Other determinants included home ownership, marriage rates, employment rates, and income.

Taken collectively, these studies fail to address two critical issues in the literature. First, all of the previously mentioned studies used data collected prior to the implementation of BAPCPA. Because BAPCPA dramatically changed the parameters governing bankruptcy chapter filing decisions, the literature may not adequately characterize current filing choices. Second, none of these studies examined how the distribution of filings within a jurisdiction is affected by local economic and labor market characteristics. By addressing these two issues, this paper provides an important contribution and critical first step in characterizing post-BAPCPA chapter filing decisions.

DATA AND METHODS

The data come from the Eastern District of Washington State in 2009. The Public Access Electronic Court Records (PACER) System was used to randomly identify approximately 5 percent of all consumer bankruptcy petitions filed in this district (269 filings) during this year. All petitions are signed “under penalty of perjury”, which should ensure complete, accurate and precise responses (or no response at all). After eliminating incomplete files (did not provide enough financial information to ensure that the cases were successfully filed), a sample of 244 cases was finalized. Information on the filer’s home county, the filing chapter and the general employment status of the primary filer are utilized in the analysis.

Because court documents use an open ended question to obtain the primary filer’s occupation, there is a very wide variety of responses, not all of which are interpretable. To that end, the authors used professional judgment to classify filers into one of seven potential categories: unemployed, retired/disabled, employed in a “blue collar“ (general laborer, truck driver, etc.) job, employed in a medical or social services job, employed in a retail/sales job, employed in a non-medical, non-retail “white collar” (administrative assistant, manager, etc.) job, employed in all non-identifiable field (including those who are ”self-employed” or work “part-time”) and those not reporting a decipherable response (“all other”).

The Eastern District of Washington is also unique in that it contains over 20 counties, some of which are highly urban, distinct metropolitan areas (Spokane county, Benton-Franklin counties, and Yakima county), and the remainder are very rural areas with an agricultural, natural resource or small manufacturing emphases. Thus, filers into one of four county designations: Spokane, Benton/Franklin, Yakima, and all other.

Given the paucity of post-BAPCPA research on the issue chapter filing choice, and more specifically on the county-level distortions that may arise in the use of the means test in determining chapter filing choice, this analysis adopts an exploratory perspective. The null hypothesis for the study is that there is no significant difference in the distribution of filers by county or type of employment. This implies that BAPCPA (which is based on average household expenses across all of Washington State) does not make passing the means test than more or less likely for any particular filer. If the null is rejected, an examination of the distribution of responses provides insights into the distortions caused by the means test. Given the data consist of frequency distributions of filers, the null hypothesis is tested using the chi-square test of homogeneity.

RESULTS

First, consider the distribution of filings by chapter and county (see Table 1, Panel A). Chapter 7 filings (by county) are 72 (Spokane), 36 (Benton/Franklin), 41 (Yakima), and 53 (all other/rural). Chapter 13 filings (by county) are 11 (Spokane), 8 (Benton/Franklin), 18 (Yakima), and 5 (all other/rural). The chi-square test statistic value (11.266) statistically significant (probability = 0.010).

Next, consider Table 1, Panel B, the filings by chapter and occupation category. Chapter 7 filings (by occupation) are 12 (retired/disabled), 37 (unemployed), 28 (non-medical, non-sales, white collar job), 56 (blue collar job), 18 (medical and social services), 14 (sales/retail), 9 (all other employed), 28 (all other). Chapter 13 filings (by occupation) are 2 (retired/disabled), 2 (unemployed), 9 (non-medical, non-sales, white collar job), 20 (blue collar job), 2 (medical and social services), 0 (sales/retail), 3 (all other

employed), 4 (all other). The chi-square statistic (14.464) is statistically significant (probability = 0.044), primarily due to the large number of blue collar workers filing under Chapter 13.

Employment patterns and county of residence by chapter filing is also examined and reported in Table 1, Panel C. The small sample size necessitates that employment categories are pooled to preserve degrees of freedom and ensure high expected cell counts for the chi-square test. To that end, two employment categories are utilized: those that are employed, and those that are not. Filings by unemployed individuals (Chapter 7 and Chapter 13, respectively) are 23 and 3 (Spokane County), 13 and 1 (Benton/Franklin counties), 15 and 3 (Yakima County) and 26 and 1 (all other counties). Among employed filers, Chapter 7 and 13 filings are 49 and 8 (Spokane County), 23 and 7 (Benton/Franklin counties), 26 and 15 (Yakima County) and 27 and 4 (all other counties). The chi-square test (statistic = 17.440, probability = 0.015) is significant, primarily due to the high proportion of Chapter 13 filers in Yakima county.

TABLE 1
ANALYSIS OF BANKRUPTCY FILINGS

Panel A: Total Filings by County and Chapter

| <u>County</u> | <u>Chapter 7</u> | <u>Chapter 13</u> | <u>Total</u> |
|--|------------------|-------------------|---------------|
| Spokane County | 72 | 11 | 83 |
| Benton/Franklin Counties | 36 | 8 | 44 |
| Yakima County | 41 | 18 | 59 |
| All Other Counties | 53 | 5 | 58 |
| Total | 202 | 42 | 244 |
| Chi-Square Statistic (3 Degrees of Freedom) | | | 11.266 |
| Probability Value | | | 0.010 |

Panel B: Total Filings by Chapter and Primary Filer Employment Category

| <u>Employment Category</u> | <u>Chapter 7</u> | <u>Chapter 13</u> | <u>Total</u> |
|--|------------------|-------------------|---------------|
| Retired/Disabled | 12 | 2 | 14 |
| Unemployed | 37 | 2 | 39 |
| Non-Medical, White Collar | 28 | 9 | 37 |
| Blue Collar | 56 | 20 | 76 |
| Medical/Social Services | 18 | 2 | 20 |
| Sales/Retail | 14 | 0 | 14 |
| All Other Employed Individuals | 9 | 3 | 12 |
| All Other Responses | 28 | 4 | 32 |
| Total | 202 | 42 | 244 |
| Chi-Square Statistic (3 Degrees of Freedom) | | | 14.464 |
| Probability Value | | | 0.044 |

Panel C: Total Filings by Year, Primary Filer Employment Category and Chapter

| <u>Employment Category</u> | <u>County</u> | <u>Chapter 7</u> | <u>Chapter 13</u> | <u>Total</u> |
|--|--------------------------|-------------------------|--------------------------|---------------------|
| Unemployed | Spokane County | 23 | 3 | 26 |
| Unemployed | Benton/Franklin Counties | 13 | 1 | 14 |
| Unemployed | Yakima County | 15 | 3 | 18 |
| Unemployed | All Other Counties | 26 | 1 | 27 |
| Employed | Spokane County | 49 | 8 | 57 |
| Employed | Benton/Franklin Counties | 23 | 7 | 30 |
| Employed | Yakima County | 26 | 15 | 41 |
| Employed | All Other Counties | 27 | 4 | 31 |
| Total | | 202 | 42 | 244 |
| Chi-Square Statistic (3 Degrees of Freedom) | | | | 17.440 |
| Probability Value | | | | 0.015 |

DISCUSSION

Counties with larger populations and a larger base of firms to employ workers also had a lower average incidence of filing a Chapter 7 bankruptcy versus a Chapter 13 bankruptcy petition. This finding is also intuitive, since larger counties tend to have a more diverse array of employment opportunities and higher mean wages per position, holding constant the distribution of employment and various socio-demographic characteristics. As mean wages and employment opportunities (which allow workers to change positions to increase wages) increase, those declaring bankruptcy are more often forced into a Chapter 13 filing by the BAPCPA means test.

In some cases, changes in the distribution of employment affect the Chapter 7 – Chapter 13 bankruptcy decision. Unemployed and retired/disabled individuals are much more likely to file under chapter 7, a finding which supports the use of the bankruptcy process as a social safety net. However, the finding that blue collar workers are more likely to file under Chapter 13 than individuals employed in many white collar jobs is potentially troubling. While certain blue collar occupations (welders, commercial drivers, etc.) undoubtedly have earnings potentials which, relative to white collar occupations (administrative assistant, etc.), would prevent blue collar workers from passing the means test, in all likelihood this is not true overall. This suggests (but in no way proves) that the means test is being distorted in a manner that potentially harms blue collar workers.

A third finding of interest is the high incidence of Chapter 13 filings in Yakima County. One possible explanation might be due to the “legal culture” of bankruptcy; that is, a predisposition among attorneys to advocate one type of filing over another. Another related explanation is that more educated and highly paid individuals have enough training, experience and resources to mask income or otherwise circumvent the means test. However, while interesting to consider, they cannot be conclusively proven using the data in this study, and we leave the investigation of these issues for future research.

CONCLUSIONS

Overall, the results corroborate previous research arguing that local labor market characteristics distort the effectiveness of the BAPCPA means test. This implies that policy makers should re-evaluate the means test to ensure the intended outcome is achieved, without creating inequitable distortions. This research suggests that the means test should not be applied using state-wide averages. Rather, the test should be applied at a more local level (perhaps at the level of the county) to ensure more appropriate measures of a debtor’s ability to repay his/her obligations.

While these results are interesting, they are not exhaustive. Further research is necessary to examine whether these findings hold true in other areas of the U.S., and at other points in time. More detailed information at the level of the individual, as opposed to the level of the county, may shed additional light on the bankruptcy chapter filing decision process.

ENDNOTE

¹ Allowable expenses are contained in the Internal Revenue Service Collections financial Standards.

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