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**Asset Exemptions and Propensity
to File Personal Bankruptcy**

**ASSET EXEMPTIONS AND PROPENSITY
TO FILE PERSONAL BANKRUPTCY**
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Abstract

This paper analyzes data collected from a sample of consumers who filed for personal bankruptcy after the enactment of the Bankruptcy Reform Act of 1978. The purpose of the study is to evaluate the relationship between the statutory level of assets exempted in a state and the financial characteristics of consumers taking bankruptcy in that state. The data used in the analysis are collected in ten different states that varied considerably in terms of the maximum homestead exemption. We hypothesize that in states that had liberal exemption\$ relatively more petitioners for bankruptcy will be homeowners with a higher amount of equity in their homes than will be the case for petitioners from more restrictive states.

The major evidence presented in the study supports the hypothesis. In the cross-state analysis, petitioners from states with a liberal homestead exemption had significantly more equity in their home relative to petitioners from more restrictive states. Petitioners filing under liberal exemption statutes also had significantly more total assets relative to total debt and were significantly less likely to have had a negative net worth at the time they filed.

In a separate analysis of data collected in a state where petitioners could choose to file under a very liberal state household exemption or the federal exemption, similar evidence is found. Petitioners filing under the state exemption were significantly more likely to own a home and had significantly more equity in their home, on average, than petitioners filing under the less generous federal statute. In addition, petitioners filing under the state statute had significantly more assets relative to debt and were significantly less likely to have a negative net worth than the petitioners in the same state who filed under the federal statute.

In sum, we conclude that the level of exemptions does influence a consumer's decision to take bankruptcy as hypothesized. Where homestead exemptions were relatively liberal, petitioners who owned a home were significantly wealthier than home owning petitioners filing under less liberal exemption conditions. The public policy implication of this study is that, given that no legal definition of need for personal bankruptcy is defined, the exemption definition applicable in a state provides a standard by which consumers evaluate the rationality of the decision to file. Thus, when exemptions are liberal, more consumers can "qualify" for bankruptcy.

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ASSET EXEMPTIONS AND PROPENSITY TO FILE PERSONAL BANKRUPTCY

I. Introduction

An individual who voluntarily petitions for personal bankruptcy under Chapter 7 of the Federal Bankruptcy Reform Act of 1978 is entitled to retain possession of a specified amount of personal and household assets. The purpose of the exemption of these assets is to enable the individual to keep essential assets to make a "fresh start" after bankruptcy.

The dollar value of assets exempted from possible seizure by unsecured creditors was determined by a patchwork of state laws until the Bankruptcy Reform Act became effective in 1979. That legislation established a federal standard for exempt property and gave the petitioner the option of selecting either state or federal exemption standards to govern his or her property in bankruptcy. However, Section 522 (b)(1) of the bankruptcy code permits a state to deny to its citizen⁵ the right to use federal exemptions. When such a state law exists, citizens who file for Chapter 7 must use exemptions provided by the state law. To date, 32 states have passed a law overriding the federal definition of exemptions. As a result, there remains considerable diversity across the states in the types and amounts of household and personal assets that are exempt.

A. Issue

What is the effect of the level of asset exemptions on consumers' propensity to file bankruptcy? The expected costs of bankruptcy include assets that will be forfeited to satisfy claims of unsecured creditors, administrative and legal fees, social stigma attached to bankruptcy, and the effect of bankruptcy on future ability to obtain debt.¹ Thus, the higher the value of exempted assets, holding other things constant, the lower the expected cost of bankruptcy.

For individuals who are considering bankruptcy who have no assets and large amounts of unsecured debt, the value of asset exemptions is immaterial. However, for individuals who have a large amount of assets and debt, the value of asset exemptions may be an important factor in their decision to file bankruptcy. Given the lower expected cost of bankruptcy for wealthy consumers in states with high asset exemptions relative to states with lower exemptions, one would hypothesize that, holding other things constant, wealthy consumers would be more likely to petition for bankruptcy in states with high exemptions than in states with less generous asset exemptions.

In this paper we perform a cross-state analysis of the hypothesized relationship between the value of asset exemptions and the wealth characteristics of petitioners for personal bankruptcy. We also analyze the wealth characteristics of a sample of petitioners in one state where a choice of asset exemptions (federal or state) was available.

¹ See A. Charlene Sullivan, Causes, Costs and Benefits of Personal Bankruptcy, Monograph 24, Credit Research Center, Purdue University, 1982 for estimates of the costs of personal bankruptcy for a sample of consumers.

B. Literature Review

In their analysis of bankruptcy, Stanley and Girth estimated that "liberal state exemption laws, as in Texas, tend to discourage bankruptcy."² However, a rationale for that judgment was not presented, and the "validation" of the hypotheses rested on agreement with that view by a bare majority of five of eight creditors' attorneys interviewed in Western Texas.

In contrast to Stanley and Girth, Apilado, Dauten and Smith (ADS) hypothesized a positive relationship between the rate of personal bankruptcies and "the relative level of personal property exemptions from bankruptcy estate among states."³ The empirical evidence to support the hypothesis was drawn from a cross-state study of factors associated with the incidence of bankruptcy. The results were mixed. On the one hand the number of bankruptcies per 100,000 populations was significantly lower in states with low exemptions relative to states providing high or liberal exemptions. On the other hand, they found that, ceteris paribus, the rate of bankruptcy in states with medium exemptions was significantly higher than the rate in states with generous exemptions. A basic purpose of this study is to resolve the conflict of these two studies by providing additional empirical evidence of the economic effect of asset exemptions from detailed data obtained from a sample of consumers filing for bankruptcy under Chapter 7 in mid-1981.

II. The Analysis

To analyze the relationship between the value of asset exemptions in a state and the wealth characteristics of petitioners for personal bankruptcy, it was necessary to classify states according to the level of exemptions. It is extremely difficult to rank states in terms of the liberality of their asset exemptions because of the complexity and diversity of assets exempted. ADS did not provide specifics concerning the method they used in their study to classify states according to the liberality of asset exemptions. However, they pointed out that the "categorization of a state's exemption statutes depends not so much on the specifics of the statute but on the way they are usually applied."⁴

For this study the maximum value of homestead exemption was chosen as the basis for classification of states into low- and high-exemption groups, because every state provides a homestead exemption in contrast to other types of exemptions. However, it was not always the case that a state providing a liberal homestead exemption also provides liberal exemptions for other types of assets.

The private residence is usually the most valuable asset on the balance sheet of the household and equity in the residence is a major component of household wealth.⁵ However, the Federal Bankruptcy Reform Act allows a person who does not own a home to protect other assets with the homestead exemption, and a person who has less than the maximum exempted equity in the principal residence is permitted to apply the excess against other assets.

Data were collected in ten states that varied considerably in terms of the maximum homestead exemption (Exhibit 1). Five states had low exemption allowances relative to the exemptions-provided by the federal code, except Louisiana. However, because Louisiana had a very low exemption for personal property relative to that allowed by the federal code, that state was included in the low-exemption sample. (All five of the

² David T. Stanley and Marjorie Girth, Bankruptcy: Problem, Process, Reform, (Washington, D.C., Brookings Institution, 1971), p. 82.

³ Vincent P. Apilado, Joel J. Dauten, and Douglas E. Smith, "Personal Bankruptcy," Journal of Legal Studies, 7 (1978) p. 379.

⁴ Ibid., p. 380

⁵ Robert Ferber and Lucy Chao Lu, "Asset Accumulation in Early Married Life," Journal of Finance, 35 (1980) pp. 1173-1188.

low-exemption states had overridden the federal code.) Two of the five high-exemption states included in the study had homestead exemptions that were higher than the homestead exemption allowed by the federal code.

EXHIBIT I

HOMESTEAD EXEMPTIONS

State	Group Designator	Maximum Household Exemption
Ohio	Low	\$5,000 per debtor
Virginia	Low	\$5,000 (one spouse only)
Georgia	Low	\$5,000 (head of household only)
Illinois	Low	\$10,000 (one spouse only)
*Louisiana	Low	\$15,000 (one spouse only)
*New York	High	\$ 7,500 per debtor
*Pennsylvania	High	\$ 7,500 per debtor
*Wisconsin	High	\$ 7,500 per debtor
*California	High	\$45,000 household exemption (head of household only)
*Texas	High	160 acre homestead exemption (head of household only)

*Homestead exemption equal to or greater than federal exemption.

¹The homestead exemption in Louisiana was not more restrictive than that provided by 11 U.S.C.A. Section 522(d) for a couple filing joint bankruptcy. However, the personal property exemption in Louisiana was very low. Consequently, Louisiana was included in the study as a low exemption state.

The other three states included in the study had not overridden the federal code which provided a homestead exemption of \$7,500 in residential property per debtor.⁶

The data were collected in personal interview surveys of consumers who filed bankruptcy under Chapter 7 of the U.S. Bankruptcy Code in June and July 1981.⁷ Almost 1200 consumers in the ten states were randomly selected to be interviewed while they were in the process of filing bankruptcy and key balance sheet information was coded from the bankruptcy petition of each respondent. The present study was performed using data collected from 1139 respondents filing a nonbusiness related personal bankruptcy.

III. Financial Characteristics of Petitioners Filing in Low-Exemption States versus High-Exemption States

Petitioners from the ten states were divided into low-exemption and high-exemption groups, and variables reflecting the mean financial characteristics of petitioners in each group were calculated (Exhibit 2). The dollar values were adjusted to reflect differences in the cost of living across the states by using adjustments based on data from the Bureau of Labor Statistics.⁸

⁶ See 11 U.S.C.A. Section 522 (d).

⁷ For a complete description of the study, see R. W. Johnson, R. L. Peterson, and Blair Shick, Consumers' Right to Bankruptcy: Origins and Effects, Monograph 23, Credit Research Center, Purdue University, 1982.

⁸ U.S. Department of Labor, Bureau of Labor Statistics, Autumn 1979 Urban Family Budgets and Comparative Indexes for Selected Urban Areas, Washington, D.C. April 30, 1980, Table 4.

Because recent studies have shown that annual household income is an important determinant of asset accumulation and financial strength for the household, we expected to find a significant difference in mean annual income across the two groups.⁹ However, the difference between the average before-tax income for petitioners in the low-exemption states (\$12,910) was not significantly different from that of petitioners in the high-exemption states (\$14,710). Although the means were insignificantly different, the percentages of petitioners in the highest income category for each group were significantly different. Eighteen percent of petitioners in the high-exemption states reported an annual before-tax income in the year they filed for bankruptcy in excess of \$20,000, compared to only 13 percent of the petitioners in the low-exemption states.

EXHIBIT 2

FINANCIAL CHARACTERISTICS OF PETITIONERS FILING UNDER ALTERNATIVE DEFINITIONS OF ALLOWED ASSET EXEMPTIONS

(Variable Means)

	Low Exemption	High Exemption
Number of cases	579	560
Before-tax income	\$12,910	\$14,710
Percent homeowners ¹	17.6%	20.2%
Household equity ¹	\$1,688**	\$12,887**
Total assets	\$12,208**	\$16,822**
Total exemptions	\$4,143**	\$9,097**
Total assets/total debts	45.7%	59.6% **
Percent with negative net worth before bankruptcy	73%	66% **
Debt excluding mortgage/before-tax income	241%	183%

** Significantly different at 90 percent level of confidence.

¹ A homeowner was a respondent who indicated they were buying or owned their principal residence and who provided values for the market value of the home and the face value of the claims against the home.

Only about 25 percent of the total sample of non-business petitioners included in the sample (N=1139) indicated that they owned their own home. However, only 19 percent of the sample gave market values and mortgage balances on their principal residences on their bankruptcy petitions. The level of homeownership among petitioners was far below that found among debt-users in general. A 1977 survey of consumers found that 72 percent of consumers who used consumer credit owned their own home.¹⁰

The level of homeownership was not significantly different across the low- and the high-exemption groups. There was, however, a significant difference in the average amount of household equity in the principal residence declared by the two groups on their bankruptcy petitions. Homeowners who provided the necessary information in the low-exemption states reported an average of \$1,688 of household equity relative to an average of \$12,887 for petitioners in the high-exemption states. In both groups, the averages were generally well below the minimum amount of household equity which was exempted.

⁹ Ferber and Lu, *op. cit.*, p. 1187.

¹⁰ Thomas A. Durkin and Gregory Elliehausen, *1977 Consumer Credit Survey*, Washington, D.C.: Federal Reserve Board of Governors, 1978.

A very interesting characteristic of the data on household equity was the percentage of petitioners in each group with negative equity in their principal residence. In the low-exemption states 26 percent of homeowners who provided market and mortgage values reported a negative equity compared to 4.4 percent of homeowners in the high-exemption states. In two-thirds of the cases where negative equity was reported, the petitioners had a second mortgage loan on their principal residence.

The greater wealth of petitioners in the high-exemption states relative to those in the low-exemption states was reflected in other measures of financial condition. Petitioners in the low-exemption states had significantly less total assets than petitioners in the high-exemption states. Further, petitioners in the low-exemption states claimed an average of \$4,143 in exempted assets compared to \$9,097 of exempted assets claimed by petitioners in the high-exemption states.

The financial strength of any entity is generally measured by the relationship between assets and debts and by the relationship between some measure of debt repayment obligations relative to income. Because consumer and mortgage credit contracts generally have maturity exceeding one year, total outstanding debt relative to annual income is not an ideal measure of consumer indebtedness. However, the ratio is a useful measure of relative indebtedness of the two groups. Petitioners in the states that allowed relatively strict exemptions had more nonmortgage debt relative to income than petitioners in the states with more liberal asset exemptions. However, the means were not significantly different. Petitioners in the low-exemption states had significantly higher debts relative to assets than petitioners in the high-exemption states. In fact, there was a significant difference in the percentages of each group that were actually insolvent at the time of filing. About 73 percent of petitioners in the low-exemption states had negative net worth at the time they filed for bankruptcy relative to slightly less than two-thirds of petitioners in the high-exemption states.

The data support our hypothesis that petitioners in states that allowed relatively generous homestead exemptions had significantly greater wealth, primarily in the form of household equity and were in a stronger overall financial position, on average, than petitioners in states that allowed relatively sparse homestead exemptions. This finding could be interpreted in two ways. The first is that petitioners in the low-exemption states simply understated the value of their assets to reduce the amount of nonexempt assets reflected on the petition. The data used in this study were recorded from bankruptcy petitions that had not been reviewed by creditors. Therefore, creditors had not had an opportunity to challenge valuation of property listed on the petitioner. However, Stanley and Girth found that creditors object to exemption allowances in only .5 percent of the cases in their 1964 study of personal bankruptcy.¹¹

An alternative explanation that is consistent with our hypothesis is that the high exemption levels allowed in some states enabled consumers with large amounts of assets to elect to take bankruptcy with little expected loss of assets. Thus, in states with high exemptions, relatively wealthy consumers were more likely to take bankruptcy than was the case in states with less generous exemptions.

IV. Homeowners Taking Bankruptcy

As an additional test of our hypothesis that consumers with large amounts of wealth are more likely to declare bankruptcy in states that provide generous asset exemptions relative to states with less generous exemptions, we analyzed the variation in the incidence of homeownership and characteristics of homeowners in our sample across states grouped according to the maximum homestead exemption allowed in each state (Exhibit 3).

¹¹ Stanley and Girth, *op. cit.*, p. 83.

EXHIBIT 3

HOMEOWNERS FILING PERSONAL BANKRUPTCY

Group	State	Maximum Household Exemption	Percent of Sample who were Homeowners (A)	Average Household Equity	Percent of Homeowners with Equity > \$15,000 (B)	Percent of Sample with Household Equity > \$15,000 (AxB)
A	Georgia Virginia	\$5,000	16%	\$1,504	7.7%	1%
B	Illinois Ohio	\$10,000	18%	\$2,470	4.5%	1%
C	Louisiana New York Pennsylvania Wisconsin	\$15,000	21%	\$4,409	11.5%	2%
D	California Texas	\$40,000 160 acres	19%	\$16,684	53.5%	10%

¹A binomial t-test of the significance of the difference in the percentages of Groups A and had household equity exceeding \$15,000 produced a t-statistic of -4.37 which was significant at t 90 percent level of confidence.

The percent of petitioners who were homeowners Varied across the four groups, increasing as the maximum household exemption increased. However, the differences in the percentage of petitioners who were homeowners in the groups with the lowest and highest household exemptions were not significantly different.

The average household equity for each group increased with the maximum homestead equity allowed. In addition, the percent of homeowners reporting equity in excess of \$15,000 was positively associated with the level of maximum homestead exemption allowed. In the group having the lowest homestead exemption, the average household equity reported was \$1,504 with almost 8 percent of homeowners reporting equity in excess of \$15,000. In the group having the highest homestead exemption, average equity reported was \$16,684 with almost 54 percent of homeowners reporting household equity in excess of \$15,000.

The figures in the last column in Exhibit 3 show that only one percent of the sample in the group of states with the lowest homestead exemption reported household equity in excess of \$15,000. Ten percent of the sample in the states with the highest household exemption reported household equity in excess of \$15,000. The difference in these percentages for the lowest and highest exemption groups was significant at the 90 percent level of confidence.

These data provide further evidence that high exemptions reduce the cost of bankruptcy for consumers with large accumulations of wealth. Given this lower cost of bankruptcy, consumers with significant accumulations of wealth (more than \$15,000 in household equity) were more likely to take bankruptcy in states that provided generous exemptions relative to states that were more restrictive.

V. Within State Comparison of Petitioners Choosing Federal Versus State Exemptions

In Texas petitioners were free to choose to file under the state or the federal exemption. There was an approximately even split among petitioners in that state who chose the federal versus state exemptions. There were 44 petitioners who selected the federal exemptions and 55 who selected the state exemptions. The homestead exemption provided by the state statute in Texas specifies that up to 160 acres of property and employments to that property were exempt. Thus, depending on the value of property, the state statute in Texas is considerably more generous than the federal statute which allowed \$7,500 of household equity to be exempted per debtor.

We analyzed the mean financial characteristics of petitioners in Texas grouped by their choice of exemption statute to determine whether the previous relationship found between exemption levels and petitioners' financial characteristics was possibly attributable to differences in economic characteristics of the high- and low-exemption states. By performing the analysis with data from within one state, we held constant the economic conditions related to the state.

The means of selected financial characteristics of the two groups of petitioners in Texas are shown in Exhibit 4. The data reflect the fact that the state exemptions in Texas could be very generous relative to the federal exemptions at the time of the study. Petitioners filing under the state exemption had significantly more valuable assets on average and significantly more valuable real property than petitioners filing under the federal statute. Those filing under the state statute were significantly more likely to be homeowners than those filing under the federal statute (47 percent vs. 27 percent). Those filing under the state statute appeared to be in a much stronger financial position relative to those filing under the federal statute--the mean ratio of total assets to total debts showed that, on average, petitioners under the state statute were solvent with assets equal to 102 percent of total debts, In contrast, those filing under the federal statute were insolvent on average with assets equal to 62 percent of total debt. Almost three out of every ten of those filing in Texas under the federal exemption definition had a negative net worth at the time of filing while only one out of every ten of those filing under the state statute had negative net worth. The difference in these proportions was significant. Those filing under the state exemption had more nonmortgage debt relative to income than the petitioners filing under the federal statute. However, the difference was not significant.

EXHIBIT 4

PETITIONERS IN THE STATE OF TEXAS

	Federal Exemption	State Exemption
Number of cases	44	55
Before-tax family income	\$14,379	\$16,696
Percent homeowners	27.27%**	47.27%**
Value of real property	\$31,450**	\$46,986**
Equity in principal residence	\$8,792**	\$21,508**
Total assets	\$18,225**	\$31,212**
Total exemptions	\$9,906**	\$27,298**
Total assets/total debts	62%**	102%**
Percent with negative net worth before bankruptcy	27.8%**	9.1%**
Debt excluding mortgage/income	214%	276%

**Significantly different at 90 percent level of confidence.

From this analysis, we conclude that the level of exemptions does influence a consumer's decision to take bankruptcy. Homeowners taking bankruptcy in Texas were significantly more likely to choose the state exemption definition that allowed them to keep more household equity than the federal statute does. Those homeowners who chose the state exemption level owned real property that was significantly more valuable than that owned by petitioners choosing the federal exemption. They had significantly more assets and had exemptions that protected a greater percentage of their assets than those choosing the federal exemption. They had accumulated more nonmortgage debt relative to income than the petitioners choosing the federal exemption, but the difference was not significant. Finally, although they had more nonmortgage debt, on average they owned more valuable real property and had significantly more equity in their personal residence than those filing under the more restrictive federal exemption level (\$21,508 vs. \$8,792). Consequently, their average financial picture was stronger. This was evident in the fact that those filing under the state exemption were more likely to be solvent at the time of filing with assets exceeding debts while those filing under the federal exemption definition were more likely to have assets valued considerably less than total debts.

VI. Conclusions

In contrast to previous studies of the impact of the level of exemptions from bankruptcy estate, this study analyzed the interstate variation in financial characteristics of petitioners for bankruptcy rather than interstate variation in the rate of bankruptcy. The hypothesis examined in this study relates to the relationship between the asset exemptions allowed in a state and the probability of bankruptcy among wealthy consumers. There currently is no legal definition of a need threshold for personal bankruptcy.¹² Consequently, the level of allowed exemptions provided by the law that prevails in a state establishes a standard by which consumers determine, in part, whether it is economically rational to file bankruptcy, given their particular personal balance sheet. The data generally support the hypothesis that consumers who have accumulated large amounts of wealth are more likely to take bankruptcy in states with liberal asset exemptions relative to states with restrictive asset exemptions.

¹² Proposals for establishing a formal needs threshold were being considered by Congressional Committees in 1982 (S2060, H.R. 7786).