

## The Debtor as Victim

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## BOOK REVIEW

### THE DEBTOR AS VICTIM

*F.H. Buckley*†

THE FRAGILE MIDDLE CLASS: AMERICANS IN DEBT. By *Teresa A. Sullivan, Elizabeth Warren & Jay Lawrence Westbrook*. New Haven: Yale University Press, 2000. Pp. xvii, 380. \$35.00.

From the earliest days of the Republic, and even before, consumer bankruptcy policy has been a contentious political issue. It has spawned protest movements and populist ferment, and was an important factor in the American Revolution.<sup>1</sup> In recent years, consumer bankruptcy filings have substantially increased and bankruptcy reform proposals have occupied an important place on the legislative agenda. More than a million American households now file for bankruptcy each year, a four-fold increase since 1979.<sup>2</sup> Not surprisingly, the rise in consumer filings during a period of strong economic growth has prompted calls to restrict access to consumer bankruptcy. Over the last decade, lawmakers mounted two major efforts at bankruptcy reform. The first of these failed, and the second remains deadlocked in conference committee.<sup>3</sup>

Consumer bankruptcy policy is thus an important legal issue. Even so, *The Fragile Middle Class*<sup>4</sup> is a remarkably overheated document. With her co-authors, Teresa Sullivan reports that the American middle class is in “crisis.”<sup>5</sup> We might think we are well off, but “[I]urking behind the suburban house” is the frightening specter of “burgeoning consumer debt.”<sup>6</sup> “Many in the middle class are eco-

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<sup>1</sup> See T.H. BREEN, *TOBACCO CULTURE: THE MENTALITY OF THE GREAT TIDEWATER PLANTERS ON THE EVE OF REVOLUTION* 31–32 (1985); WOODY HOLTON, *FORCED FOUNDERS: INDIANS, DEBTORS, SLAVES, AND THE MAKING OF THE AMERICAN REVOLUTION IN VIRGINIA* 61–62 (1999); Emory G. Evans, *Planter Indebtedness and the Coming of the Revolution in Virginia*, 19 *WM. & MARY Q.* 511 (1962).

<sup>2</sup> TERESA A. SULLIVAN ET AL., *THE FRAGILE MIDDLE CLASS: AMERICANS IN DEBT* 4 fig.1.1 (2000).

<sup>3</sup> See Bankruptcy Reform Act of 2001, S. 420, 107th Cong. (2001); Bankruptcy Abuse Prevention and Consumer Protection Act of 2001, H.R. 333, 107th Cong. (2001).

<sup>4</sup> SULLIVAN ET AL., *supra* note 2.

<sup>5</sup> *Id.* at 1.

<sup>6</sup> *Id.* at 2.

nomically fragile, barely able to maintain their lifestyle.”<sup>7</sup> In the face of this, Americans desperately seek to cling to the symbols of middle-class prosperity through bankruptcy. “What declaring bankruptcy [does] for them [is] provide a chance—often a last chance—to retain their middle-class status.”<sup>8</sup> Take this away and we might see “revolt in the streets.”<sup>9</sup>

The book is weakened by its single-minded focus on debtors at the moment they file for bankruptcy. In most cases, the findings are trivial. For example, through a wealth of data we learn that bankruptcy petitioners earn less and owe more than the average American.<sup>10</sup> As an *aperçu*, that ranks with a finding that more people drive through green lights than red lights. What is troubling, however, is the implicit assumption that an *ex post* perspective suffices, and that debtors do not react to the incentive structure of the bankruptcy regime *ex ante* when they borrow. “The problem is not bankruptcy itself,” the authors claim, “bankruptcy is merely the treatment. The core problem is that people are falling out of the middle class because of overwhelming debts.”<sup>11</sup> Whatever the bankruptcy regime, they suggest, the same number of people will tumble into default.<sup>12</sup>

As such, the authors criticize recent efforts at bankruptcy reform that would deny an absolute discharge to debtors who can afford to pay their creditors over time. They report that the great majority of bankruptcy petitioners “are overwhelmed by debt they could not possibly pay.”<sup>13</sup> But while this is so, it ignores the possibility that debtors would react to a more restrictive bankruptcy regime by scaling back their indebtedness and taking greater precautions against risk. In any event, a measure targeted at debtors who are able to pay their way out of default should not be feared if, as the authors claim, nearly all debtors are unable to do so.

Presumably, the authors reject rational choice models of behavior, though their findings are consistent with economic rationality. The fact that bankruptcy filings are higher in this country than in

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<sup>7</sup> *Id.* at xiv.

<sup>8</sup> *Id.* at 5.

<sup>9</sup> *Id.* at 258.

<sup>10</sup> *See id.* at 60 tbl.2.1, 61–62, 73.

<sup>11</sup> *Id.* at 253.

<sup>12</sup> *Id.*

<sup>13</sup> *Id.* at 239. This leaves open the question whether anything would change were consumer debtors more likely to be shunted into a Chapter 13 repayment plan, as is proposed under draft bankruptcy reform legislation. *See, e.g.*, Bankruptcy Reform Act of 2001, S. 420, 107th Cong. (2001). Such a reform would make some debtors less willing to borrow. But others would have an added incentive to increase their leverage, if by increasing the debt burden on default they reduce the likelihood that a Chapter 13 plan would be forced on them. As such, the effect of bankruptcy reform measures is ambiguous. At a minimum, such measures would place a greater burden on courts to police end-period misbehavior.

other common-law countries is consistent with the stronger safety net and tougher bankruptcy laws of those countries. Nor are we surprised to learn that about one-half of the petitioners are homeowners,<sup>14</sup> given the incentives to home ownership in American tax law. We would also expect credit card abusers to be in the minority, since barriers to debtor opportunism in the Bankruptcy Code penalize the end-period behavior of borrowers who spend freely just before filing.<sup>15</sup> As such, the authors' hostility to economic models looks rather like a profession of faith.

No doubt it is far easier to gather survey data at the moment of bankruptcy than at other times. Nevertheless, it would also have been useful to find out how the petitioners fared after they emerged from bankruptcy, in order to see whether they might have repaid their debts. The authors cite studies from the 1980s and early 1990s suggesting that many employees struggle to find new jobs after job losses.<sup>16</sup> Our economy has become far more dynamic in recent years, however, and unemployment rates have declined sharply. The most recent survey indicates that only twenty-five percent of those who lost their jobs between 1995 and 1997 remained unemployed by February 1998.<sup>17</sup> One-half had jobs at their old salaries or better.<sup>18</sup> It is no longer the case that Americans expect to end their careers with the employer they began with, and most of us bounce happily from one job to another. The pink slip is no longer the catastrophe it once was.

The hostility to economic explanations of behavior was also evident in an earlier book by the three authors, which purported to find that economic explanations of bankruptcy were untenable.<sup>19</sup> In fact, their findings were consistent with economic models of the bankruptcy decision, and a review of the book by a prominent bankruptcy theorist concluded that the authors simply failed to understand the economic analysis of bankruptcy.<sup>20</sup> Since the new book also lacks a theoretical account of debt and the bankruptcy decision, I shall sketch one out. I shall then evaluate the argument for the bankruptcy discharge, with particular attention to arguments that *The Fragile Middle Class* seems to favor.

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<sup>14</sup> SULLIVAN ET AL., *supra* note 2, at 202.

<sup>15</sup> See 11 U.S.C. § 707(b) (Supp. V 1999).

<sup>16</sup> SULLIVAN ET AL., *supra* note 2, at 88–90.

<sup>17</sup> *Id.* at 17 & n.17 (citing Press Release, Bureau of Labor Statistics, U.S. Dep't of Labor, Worker Displacement, 1995–97 (Aug. 19, 1998), available at <ftp://ftp.bls.gov/pub/news.release/History/disp.081998.news> (last visited Feb. 7, 2002)).

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

<sup>19</sup> See TERESA A. SULLIVAN ET AL., *AS WE FORGIVE OUR DEBTORS: BANKRUPTCY AND CONSUMER CREDIT IN AMERICA* (1989).

<sup>20</sup> See Michelle J. White, *Economic Versus Sociological Approaches to Legal Research: The Case of Bankruptcy*, 25 *LAW & SOC'Y REV.* 685 (1991) (book review). The review is not cited in the new book.

## I

## THE BENEFITS OF PERSONAL LEVERAGE

A simple way to reduce consumer bankruptcy levels would be to ban consumer debt. However, that would sacrifice the gains that leverage offers consumers. In a world without taxes, personal debt offers benefits to consumers in four ways: (1) as a consumption smoothing device; (2) as a bonding device; (3) as an incentivizing device; and (4) as a means of reducing information costs. In addition, American tax subsidies to personal debt financing provide a fifth explanation for how consumers benefit from personal leverage.<sup>21</sup>

Borrowing is a form of dissaving, in which debtors draw down on future earnings to fund present consumption. For most of us, saving connotes frugal virtue; and, as the reverse of the medal, dissaving suggests prodigality and imprudence. But these are often crude caricatures. Leverage permits the debtor to smooth out consumption so as to avoid feasts and famines, through saving and dissaving at different times in his life cycle. The prudent consumer will save in the fat years and dissave in the lean ones. For example, he will save while he is earning and spend his nest egg during retirement. Saving may thus be excessive when the miser hoards present wealth beyond the reasonable prospect of future consumption (either for him or for his cherished descendants).<sup>22</sup> And dissaving is prudent when the gains from present consumption exceed the costs associated with deferred future consumption. The miser might be a withered, cold-hearted wretch, like Molière's Harpagon; but he might also be an eighteen-year-old with the soul of an accountant who passes up an affordable trip to Europe in order to save for law school. Sometimes it is more prudent to burn one's candle at both ends, and save in the middle years.

The borrowing decision might also be a rational self-binding strategy. Suppose that a person lacks assets to take up a valuable investment opportunity, and to finance it must choose between issuing an equity claim (in the form of a partnership interest) or a debt claim (by borrowing). He might then prefer to issue debt because the possibility of default (which does not exist in pure equity financing) binds him to pursue and exploit the opportunity. When the parties are related, for example, the debtor might insist on debt financing to increase the probability of repayment. The obligation to repay moneys

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<sup>21</sup> See F.H. Buckley, *The American Fresh Start*, 4 S. CAL. INTERDISC. L.J. 67 (1994).

<sup>22</sup> While Franco Modigliani's life-cycle theory assumed that people seek to consume all their wealth in their own lifetimes, other models assume a bequest motive in which people seek to pass on wealth to their survivors after death. See Robert J. Barro, *Are Government Bonds Net Wealth?*, 82 J. POL. ECON. 1095 (1974). But see LAURENCE J. KOTLIKOFF, *ESSAYS ON SAVING, BEQUESTS, ALTRUISM, AND LIFE-CYCLE PLANNING* 175-302 (2001) (finding no evidence of intergenerational altruism).

in the future also disciplines the borrower against future profligacy, just as high leverage binds a firm against the accumulation of "free cash flow" in Michael Jensen's model of corporate borrowing.<sup>23</sup> Jensen argues that the requirement that corporate debt be repaid usefully prevents a firm from hoarding revenues from investors and investing profits in wasteful opportunities.<sup>24</sup> In the same way, the obligation to repay personal debt prevents the accumulation of personal free cash flow that would otherwise burn a hole in the debtor's pocket.

Home purchases are one example of this strategy. While borrowing is usually thought to transfer money from future to present periods, the direction of the wealth transfer is reversed in home mortgages. While the debtor lives in the house he consumes a portion of its value. But he is also saving for future consumption, since houses are durable and appreciable goods and therefore represent an investment. Indeed, houses are often an individual's largest asset and his most important private source of retirement savings.<sup>25</sup> On retirement, the debtor will ordinarily cash in the house by trading down to a smaller house, using the proceeds of the sale as a nest egg. While *The Fragile Middle Class* criticizes the "house poor," whose monthly housing expenses exceed twenty-eight percent of their gross monthly income,<sup>26</sup> this group often includes the richest, savviest, and most prudent consumers.

Debt financing might also be a useful incentivizing strategy for debtors. Since the debtor keeps all of the project's upside above the cost of the loan, he has greater reason to exploit successful projects. This is the flip side of what finance economists call the "cost of debt."<sup>27</sup> Leverage sometimes imposes a cost on the firm by increasing its incentive to invest in suboptimal projects. This might happen when there is a possibility that the firm will default on the loan. Since the firm will not bear the full cost of default, it has an incentive to invest in excessively risky projects. When the probability of default is slight or nonexistent, however, leverage might give firm managers and insiders a stronger incentive to pursue profitable opportunities. When the opportunity is financed with equity, profits must always be

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<sup>23</sup> See Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AM. ECON. REV. 323, 324 (1986).

<sup>24</sup> *Id.*

<sup>25</sup> Steven F. Venti & David A. Wise, *Aging and the Income Value of Housing Wealth*, 44 J. PUB. ECON. 371 (1991).

<sup>26</sup> SULLIVAN ET AL., *supra* note 2, at 218 & n.65 (quoting BUREAU OF THE CENSUS, U.S. DEP'T OF COMMERCE, STATISTICAL BRIEF NO. SB91-19, HOUSE-POOR/HOUSE-RICH (1991)).

<sup>27</sup> The misincentives of risky debt are discussed in Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 333-43 (1976). See Merton H. Miller, *The Wealth Transfers of Bankruptcy: Some Illustrative Examples*, LAW & CONTEMP. PROBS., Autumn 1977, at 39.

shared with outside shareholders or partners. But when the project is financed with riskless debt, firm managers and insiders will not share upside profits with outside investors, and the firm is better incentivized to exploit the project. The benefits of debt might thus outweigh the costs of debt.

Personal debt also reduces the information production costs of financing a project through screening and signaling gains. Screening refers to the information that outside investors must produce in evaluating the claim they receive. In equity financing, the investor must assign a probability and value to the entire spread of outcomes. By contrast, in debt financing the creditor can ignore outcomes above the amount of principal plus accrued interest. When lenders are better informed about low-range outcomes, screening costs may then be reduced through debt financing. For example, a banker might feel reasonably confident about a fledgling lawyer's ability to earn \$50,000 a year, but only the borrower will know whether he possesses the drive and talent to earn \$100,000.<sup>28</sup>

Personal debt financing might also reduce information costs through signaling gains. The debtor's promise of repayment becomes more credible when default imposes a cost upon the debtor, as it would in a world without bankruptcy discharges. The willingness to run the risk of default might then reveal the debtor's private beliefs about project values. High-quality debtors, who run a small risk of default, would be more willing to assume the risk of default than less creditworthy low-quality debtors.<sup>29</sup>

American tax policies provide a fifth benefit of personal leverage. American tax law subsidizes personal debt by treating home residence as a nontaxable benefit and by permitting individual taxpayers to deduct interest payments on home mortgages of under \$1 million.<sup>30</sup> Other countries deny home mortgage deductibility because the taxpayer enjoys the tax-free benefit of the purchase by living in the house: no deductibility, but no imputed taxable benefit either. Only America offers the taxpayer relief at both ends, with mortgage interest deductibility and no imputed taxable benefit, and this tax subsidy biases consumers towards home purchases. As the benefit of the subsidy increases with the size of the mortgage, the richest Americans may

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<sup>28</sup> For an argument that secured lending serves screening efficiencies, see F.H. Buckley, *The Bankruptcy Priority Puzzle*, 72 VA. L. REV. 1393, 1424-26 (1986).

<sup>29</sup> Signaling explanations of debt financing are speculative. They assume that low-quality debtors have the most to fear from default. However, the lowest-quality debtor, who has nothing left to lose, will not be worried by the threat of default, and the signal might thus unwind. See Alan Schwartz, *Security Interests and Bankruptcy Priorities: A Review of Current Theories*, 10 J. LEGAL STUD. 1, 17-21 (1981). Signaling explanations might yet survive if the low-quality debtor could be identified through creditor screening.

<sup>30</sup> See 26 U.S.C. § 163(h)(3) (1994).

find very expensive houses surprisingly affordable when the tax subsidy is taken into account.<sup>31</sup>

## II THE COSTS OF BANKRUPTCY

The benefits of personal leverage would be weakened in a state that refused to enforce promissory obligations or that circumscribed the terms of loan agreements. As such, the debtor's right to seek a bankruptcy discharge is not an unalloyed blessing. Bankruptcy affords relief at the moment of discharge, but makes it more difficult to secure credit when a loan is sought, and the rule of illegality that prevents a debtor from waiving bankruptcy relief might therefore seem a curious piece of paternalism. An absolute promise of repayment is treated like a promise to commit a crime, and made unenforceable as an illegal contract.

Secured lending law affords some relief from paternalistic fetters on free contracting. While the debt obligation is discharged, the secured lender's property rights are afforded a strong measure of protection. So long as the value of the collateral secured by the loan exceeds the value of the loan, the creditor can expect to be paid. This protects the home mortgage financier, as well as the current-assets financier when the debtor carries on a business. However, Article 9 of the Uniform Commercial Code prevents consumer debtors from pledging future earnings or consumer goods as collateral,<sup>32</sup> and the nonwaivable bankruptcy discharge will therefore limit the debtor's ability to borrow.

The bankruptcy discharge introduces an additional cost for consumers. As I noted above, personal leverage imposes incentive costs the magnitude of which depends in part on the probability of default. Riskless debt imposes no incentive costs, but as the probability of default increases so too does the incentive to invest in wasteful high-risk, high-return opportunities. These costs are greatest just before default, when the creditors bear the entire loss and the upside accrues primarily to the individual. We are always ready to gamble with other people's money when it's "heads you lose, tails I win." Moreover, consumer debtors who approach default have an incentive to overconsume, since they can pass the cost on to the creditors. All parties are

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<sup>31</sup> In the Washington area, this phenomenon is called the "McClean McMansion": the 6000-square-foot Elizabethan-Georgian-Victorian pile with Palladian windows and a three-car garage facing the street on a quarter-acre lot.

<sup>32</sup> See U.C.C. § 9-204(2) (1972) ("No security interest attaches . . . to consumer goods . . . unless the debtor acquires rights in them within ten days after the secured party gives value.").

aware of the end-period problem, and this will increase the cost of credit when the individual borrows, even if he is solvent at that time.

Finally, it has been suggested that high bankruptcy levels give rise to distrust externalities. Interpersonal trust is a crucial element in the social norms that Jon Elster calls the cement of society.<sup>33</sup> Without trust, joint plans for cooperation become impossible.

For example, Edward Banfield described a society so riddled with envy—a precapitalist Italian town he called “Montegrano”—that any form of economic progress was unthinkable.<sup>34</sup> The Montegrane thought that every politician was on the take, that every priest was corrupt, that every employer cheated his employees. Only the most basic forms of economic cooperation were possible.

[A]ll those who stand outside of the small circle of the family are at least potential competitors and therefore also potential enemies. Toward those who are not of the family the reasonable attitude is suspicion. The parent knows that other families will envy and fear the success of his family and that they are likely to seek to do it injury. He must therefore fear them and be ready to do them injury in order that they may have less power to injure him and his.<sup>35</sup>

Trust is much more than a matter of economic calculation, for it is basic to the fundamental human desire for solidarity. Without trust our friendships would become affairs of momentary convenience, on which no plans, no projects for future cooperation, could be formed. We rely so often upon friends and associates that we often forget we are doing so. We scatter our promises about, without paying much attention to what we are doing. We make seemingly trivial promises, to meet for lunch or to return a call, on whose performance deep friendships depend. And we make unspoken promises that are the foundation of trust: I will take your side; I will not betray you.

Trust is weakened by legal institutions that are too quick to forgive the promise-breaker. The costs of breach are directly borne by the promisee, such as the spouse who is cast aside under a no-fault divorce law. In addition, promise-breaking may impose the third-party costs that economists call externalities, when others realize they live in a coarser society and future promisors find it harder to persuade promisees to rely on them. With the remarkable rise in consumer bankruptcy filings during a period of prosperity, it is not

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<sup>33</sup> See JON ELSTER, *THE CEMENT OF SOCIETY: A STUDY OF SOCIAL ORDER* (1989).

<sup>34</sup> See EDWARD C. BANFIELD, *THE MORAL BASIS OF A BACKWARD SOCIETY* (Free Press 1967) (1958).

<sup>35</sup> *Id.* at 110–11.

implausible to suggest that American fresh-start policies give rise to similar distrust externalities.<sup>36</sup>

### III

#### THE BENEFITS OF BANKRUPTCY

The costs of bankruptcy that I have outlined are theoretical ones, and theory without facts is sometimes a menace, as Karl Llewellyn reminded us.<sup>37</sup> But facts without theory is a mess. *The Fragile Middle Class* is replete with factual tidbits, often anecdotal, but lacks a unifying theory that explains the authors' support for the present bankruptcy regime and their hostility to bankruptcy reform. Instead, the authors raise a variety of arguments, often without supporting evidence, that point in quite different directions.

Nowhere is the inconsistency more clear than in the two principal claims made by the book: (1) consumer debt levels are too high;<sup>38</sup> and (2) legislative efforts to restrict consumer access to bankruptcy are wrong-headed.<sup>39</sup> Absent some way of determining optimal consumer levels, it is difficult to speak of excessive consumer leverage. But if one wishes to reduce consumer borrowing, the most obvious way to do so is to increase the cost of default. After all, it cannot be an accident that consumer filing rates are lower in countries with tougher bankruptcy regimes. Penalize something and you get less of it; subsidize it and you get more of it. However, this simple lesson in economics seems to have been missed by the authors, who want simultaneously to reduce consumer borrowing while subsidizing default through an easy bankruptcy discharge.

#### A. The Argument from Paternalism

The authors appear to deny any connection between the bankruptcy regime and leverage levels, possibly because they believe that consumers react to market choices as children do. Consider this description of the infantile car purchaser: "Americans are buying larger and more luxurious cars, complete with sound systems, computer monitoring devices, and four-wheel drive. . . . [T]he breathtaking prices of these gleaming machines require most middle-class buyers to incur hefty debt, repayable over ever-longer periods at high

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<sup>36</sup> See Todd J. Zywicki, *Bankruptcy Law as Social Legislation*, 5 TEX. REV. L. & POL. 393, 400-08 (2001).

<sup>37</sup> See Louis J. Hector, Book Review, 81 HARV. L. REV. 1590, 1590 & n.2 (1968).

<sup>38</sup> See SULLIVAN ET AL., *supra* note 2, at 239 ("[T]he great majority of debtors in bankruptcy are overwhelmed by debt . . .").

<sup>39</sup> *Id.* at 253.

interest rates."<sup>40</sup> Describing consumer purchasers in Mexico or South Korea in so patronizing a manner would rightly be thought insulting.

Nevertheless, some purchasers are weak-willed, and the authors might seem on firmer ground when they attribute the run-up in consumer filings to credit card debt.<sup>41</sup> Credit cards are more available than ever before, and it is easy to incur debts through impulse purchases. On average, more than forty-one invitations went out in 1997 to each American household.<sup>42</sup> From 1986 to 1997, credit card debt doubled in the United States, Britain, and Canada.<sup>43</sup> For American bankruptcy petitioners, listed credit card debt increased from a mean of \$3635 in 1981 to \$11,529 in 1991 to \$14,260 in 1997.<sup>44</sup>

Credit card companies make a convenient target for those who oppose bankruptcy reform, and the authors happily take up the cudgels. The interest rates charged by today's credit card lenders would have been illegal in the past, when they were "associated with shadowy alleyways and large men wearing brass knuckles."<sup>45</sup> For consumer borrowers, easy credit is likened to the company store in which workers have no choice but to buy from a single source at inflated prices.<sup>46</sup> What the authors fail to note is that consumer debt levels have been as high or higher in the past,<sup>47</sup> and credit card debt simply takes up a greater share of consumer borrowing today. They also fail to note that the credit card industry is highly competitive, and that there just might be a link between high interest charges and the increasing willingness of consumer debtors to burn off credit card loans through a bankruptcy discharge.<sup>48</sup>

If consumers borrow excessively because they are weak-willed, or because they underestimate the probability of default, the case for enforcing waivers of discharge rights would be much weakened. However, the authors fail to uncover evidence of substantial consumer

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<sup>40</sup> *Id.* at 3–4.

<sup>41</sup> *Id.* at 245. The authors explain:

[T]here are a number of solidly middle-class people in our country—people who get up every morning and go to work and get their kids to school—who cannot handle credit. These people are the object of an endless seduction by an industry willing to play to their weakness and successful at doing so.

*Id.* at 250 (footnote omitted).

<sup>42</sup> *Id.* at 135.

<sup>43</sup> *Id.* at 258.

<sup>44</sup> *Id.* at 122 tbl.4.1.

<sup>45</sup> *Id.* at 248–49.

<sup>46</sup> *Id.* at 248.

<sup>47</sup> In 1890, each household had about \$880 of debt, against an average annual salary of \$475 for nonfarmworkers. LENDOL CALDER, FINANCING THE AMERICAN DREAM: A CULTURAL HISTORY OF CONSUMER CREDIT 40 (1999). Consumer leverage ratios are lower today. See SULLIVAN ET AL., *supra* note 2, at 220 fig.7.2.

<sup>48</sup> See Judge Edith H. Jones & Todd J. Zywicki, *It's Time for Means-Testing*, 1999 BYU L. REV. 177, 227–42.

irrationality. While credit card debt has increased, the percentage of defaults that might be attributed primarily to credit card misuse—perhaps one in ten—remains small.<sup>49</sup> Credit cards take up a greater percentage of consumer indebtedness, but cannot account for the run-up in consumer bankruptcy rates. Moreover, the “tipping point” that drives consumers into bankruptcy has remained unchanged over the last twenty years: the total debt burden in inflation-adjusted dollars and the ratio of total debt to income is a constant.

The picture that emerges from the book is not one of irrational borrowers, but rather of ordinary people who file when they lose their jobs or incur a major medical liability. As such, the argument from paternalism is weak, particularly when raised against bankruptcy reform measures that seek to harmonize America’s bankruptcy laws with those of other first-world countries by denying a discharge to those who are able to pay off their debts.

### B. Debt Slavery

The second argument for bankruptcy is that without a discharge, the overcommitted debtor might lack any incentive to work. By permitting him to retain future earnings, the fresh-start policies of bankruptcy correct this misincentive. “As far back as Henry Clay,” note the authors, “Americans decided that collectively we would all be better off to cut the losers loose from their old debts so they could try the game again.”<sup>50</sup>

While this argument assumes that the alternative to consumer bankruptcy is debt slavery, it ignores the possibility of an ex post private workout. Debt slavery is highly inefficient, and one would expect the parties to seek to bargain around it, as the Coase Theorem would predict.<sup>51</sup> Suppose that in every state of the world all of the debtor’s earnings would go to pay off his debt claims. Since the debtor would have no incentive to work, these claims will be valueless. Creditors might therefore increase the value of their claims by scaling them back, even as a state might increase tax revenues under the Laffer Curve by easing back from a 100% marginal rate. In this way, the parties can always bargain around debt constraints to ensure that all valuable opportunities are taken up.

Nevertheless, the parties might fail to agree on a private workout because of informational asymmetries about future prospects or hidden assets. In addition, holdout problems might make it difficult for the parties to effect a private workout when there are more than a few creditors. While all creditors as a group might be made better off by

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<sup>49</sup> SULLIVAN ET AL., *supra* note 2, at 22.

<sup>50</sup> *Id.* at 258.

<sup>51</sup> See R. H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960).

scaling down debt claims, each creditor has the individual incentive to hold out and let the other creditors take twenty cents on the dollar while he is paid off in full.<sup>52</sup> This might explain why creditors relied on debtors' prisons before the bankruptcy discharge became available.

### C. Debtor Risk Aversion

The argument from paternalism seeks to justify the bankruptcy discharge on the basis that, left on their own, consumers would incur excessive debt. Paradoxically, the third argument for the bankruptcy discharge suggests that, left on their own, consumers would take on too little debt because of their risk aversion. When the debtor is made to bear the full costs of economic failure through a denial of a fresh start in bankruptcy, he might turn down a profitable opportunity because he is not indifferent to risk. He might insulate himself from a portion of the downside risk when it takes the form of a business opportunity by bargaining for a homemade discharge through a limited liability company. For consumer borrowing, however, incorporation is not an option.

Absent a bankruptcy discharge, the costs of consumer risk aversion would plausibly be greater in America than in other countries. As the authors note, the social safety net is less extensive here than in Britain and Canada.<sup>53</sup> In America, job loss often means the loss of medical insurance unless the consumer is so poor that he can qualify for Medicaid. In addition, American tax law gives consumers a greater incentive to increase their leverage through home mortgage deductibility. As such, Americans are more likely to fall into financial distress than Britons and Canadians, as evidenced by the sharp differences in national filing rates.

Since job loss is the most frequent cause of default,<sup>54</sup> bankruptcy might be a particularly useful incentive device in attracting employees to work in high-risk jobs, such as start-up ventures. The risk-averse will ordinarily seek to purchase insurance against losses, but private insurance will not be offered for job losses because of the moral hazard problem—insured people will work less hard when they are cushioned on the risk of job loss. The same problem arises when employees are offered a fresh start in bankruptcy, but to a lesser extent. In addition, a general bankruptcy law does not give rise to the adverse

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<sup>52</sup> See Mark Roe, *The Voting Prohibition in Bond Workouts*, 97 YALE L.J. 232, 238 (1987). But since the cost of holdout strategies is born by the debtor, he has every incentive to ensure that this does not happen by restricting his borrowing to a single major lender. See F.H. Buckley, *The American Stay*, 3 S. CAL. INTERDISC. L.J. 733, 756 (1994).

<sup>53</sup> SULLIVAN ET AL., *supra* note 2, at 257.

<sup>54</sup> *Id.* at 75.

selection problems of private insurance markets, in which those most at risk are most likely to seek coverage.

The authors see bankruptcy as a safety net, but implausibly regard the discharge as a disguised welfare policy and resist bankruptcy reform in the name of distributional justice.<sup>55</sup> This is problematic for two reasons. First, welfare policies should pass the burden of caring for the less advantaged to the wealthiest Americans. However, the burden of easy discharges is placed upon the poorest consumers, in the form of high interest rates on credit cards. The wealthiest borrowers, who pay off their monthly balances on time, never encounter these charges. Instead, credit card debt has become a form of sub-prime lending for those who cannot obtain a personal line of credit from a bank. Second, the beneficiaries of the bankruptcy discharge sometimes include wealthy professionals who shelter large homes from creditors in states that permit them to do so through homestead exemptions. In welfare schemes, the wealth transfer is not supposed to run from the poor to the rich, and bankruptcy reform that would introduce something like means-testing to prevent this would seem eminently just from a distributional perspective. The safety net argument for bankruptcy is eminently plausible, but only as a device to correct an incentive problem and not as a disguised welfare measure.

In sum, economic theory plausibly supports a broad discharge for consumer debtors. However, some form of means-testing would appear sensible, on both efficiency and equity grounds.

#### IV

#### BANKRUPTCY RELIEF AS CONSUMERISM

*The Fragile Middle Class* is a curious relic from an earlier age of legal scholarship, when a lack of economic sophistication did not disqualify academics from making policy pronouncements. To be sure, rational choice models in economics are sometimes criticized for their robust assumptions about consumer choice. However, the debate about “bounded rationality” and information costs takes place within the framework of economics, and no serious modern scholar would suggest that consumers are unable to react in *any* way to the incentive structure of a legal regime.

However, this is just what the authors assert in their study of consumer bankruptcy petitions. For them, economic failure is always a matter of exogenous shocks where the risk of loss cannot be reduced by anything the debtor might do *ex ante* to lower the probability of default. They assume, in short, that the debtor is quite incapable of taking fewer financial risks or borrowing less money. Having made

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<sup>55</sup> See *id.* at 169, 257–58.

this assumption, they then assign the entire blame for the run-up in consumer bankruptcies to credit card companies, even though they report that credit card debt is a minor cause of bankruptcy. Since credit card companies are taking their licks in a highly political debate over bankruptcy reform in Congress, the book reads more like a partisan brief than a work of scholarship.

The book's emphasis on consumer protection also seems frozen in the thirty-year-old amber of 1970s legal scholarship. "If the world were a more comfortable place for middle-class Americans," they say, "we would not be writing this book."<sup>56</sup> However, a more recent vein of scholarship, which cuts across standard political labels, is explicitly anti-consumerist. It prizes private virtue more than consumer spending, being more than having, and St. Francis more than the yuppie debtor. Its members take their inspiration from economists like Robert Frank,<sup>57</sup> historians like Christopher Lasch,<sup>58</sup> and political scientists like Daniel Bell.<sup>59</sup> Not to mention Pope John Paul II.<sup>60</sup> Anti-consumerism sees the overcommitted debtor not as a passive victim who is preyed upon by credit card companies but as an active decisionmaker who is deluded about life's basic goods. He is not a pawn of forces over which he is powerless, but instead is responsible for his actions. Like Imelda Marcos and Madame Bovary, he might even be faintly ridiculous.

Anti-consumerism is not a recent phenomenon, and some of its earliest advocates espoused highly illiberal political beliefs. (Marx and Heidegger come to mind.) After rejecting consumer sovereignty, it might be a short step to impugning the individual's political preferences, which is why consumerism is often a good deal more egalitarian and democratic than its alternatives. Tom Wolfe has noted that passengers on Mediterranean cruises now jostle elbows with working-

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<sup>56</sup> *Id.* at 6.

<sup>57</sup> See ROBERT H. FRANK, *LUXURY FEVER: WHY MONEY FAILS TO SATISFY IN AN ERA OF EXCESS* (1999). Frank sees the competition for status as wasteful, since it generates consumption externalities: consumption of a status good by one person imposes a status cost on another. To address this, he proposes consumption taxes.

<sup>58</sup> Lasch's attack on the hedonism implicit in consumerism may be found in CHRISTOPHER LASCH, *THE CULTURE OF NARCISSISM: AMERICAN LIFE IN AN AGE OF DIMINISHING EXPECTATIONS* (1978). For his praise of the anti-consumerist ideals of craftsmanship, see CHRISTOPHER LASCH, *THE TRUE AND ONLY HEAVEN: PROGRESS AND ITS CRITICS* (1991), and CHRISTOPHER LASCH, *THE MINIMAL SELF: PSYCHIC SURVIVAL IN TROUBLED TIMES 193-95* (1984).

<sup>59</sup> See DANIEL BELL, *THE CULTURAL CONTRADICTIONS OF CAPITALISM* (1976). The contradiction Bell had in mind was that free markets depend on a stock of private virtues that in his view they tend to subvert. History has not been kind to this thesis, first advanced by Bell in 1976.

<sup>60</sup> See POPE JOHN PAUL II, *ON THE HUNDRETH ANNIVERSARY OF RERUM NOVARUM (CENTESIMUS ANNUS): ENCYCLICAL LETTER MAY 1, 1991* paras. 19, 39, available at [http://www.vatican.va/holy\\_father/john\\_paul\\_ii/encyclicals/documents/hf\\_jp-ii\\_enc\\_01051991\\_centessimus-annus\\_en.html](http://www.vatican.va/holy_father/john_paul_ii/encyclicals/documents/hf_jp-ii_enc_01051991_centessimus-annus_en.html).

class Americans,<sup>61</sup> and there is something a little churlish about objecting to this. There is also a heavy seriousness to anti-consumerism that makes one want to reach for the droll celebrations of conspicuous consumption found in P.J. O'Rourke and James Twitchell.<sup>62</sup> Like Molière, we often prefer a comfortable vice to a fatiguing virtue. Finally, there is little evidence that consumerism has done much to weaken the ability of Americans to react to a true crisis, such as the terrorist attack on the World Trade Center and the Pentagon. Indeed, consumerism is now regarded, not implausibly, as a patriotic affirmation of American values.

We need not seek to resolve this debate. Economics is a positive science, and the economist is not called on to take sides. If asked, however, he might offer advice on what would increase or reduce consumer spending. To the anti-consumerist, then, he might propose a reform of bankruptcy law that makes petitioners repay more of their debts. If we are too materialistic or status-driven, the last thing we need is incentive to incur consumer debt through a lax bankruptcy regime.

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<sup>61</sup> See TOM WOLFE, *HOOKING UP* (2000).

<sup>62</sup> See P.J. O'ROURKE, *EAT THE RICH* (1998); JAMES B. TWITCHELL, *LEAD US INTO TEMPTATION: THE TRIUMPH OF AMERICAN MATERIALISM* (1999). For a reminder that consumerism may take a variety of forms, left and right, see DAVID BROOKS, *BOBOS IN PARADISE: THE NEW UPPER CLASS AND HOW THEY GOT THERE* (2000).