NÚMERO 14 / Outubro '00 / PREÇO 1.500$00 / ISSN 0872-4733
SUPLEMENTO

NOTAS ECONÓMICAS 14

REVISTA DA FACULDADE DE ECONOMIA DA UNIVERSIDADE DE COIMBRA

# COLÓQUIO INTERNACIONAL
# O ENDIVIDAMENTO DOS CONSUMIDORES
# ACTAS

# Perspectives on Consumer Bankruptcy Law

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## Introduction

As more and more nations develop credit economies, it becomes important — indeed essential — for these nations to consider the adoption of bankruptcy laws. Moreover, as the credit market extends to consumers, these bankruptcy laws must address the financial failures of *both* businesses and individuals. The development of corporate insolvency systems has been met with some resistance and has produced considerable debate. However, the existence of corporate bankruptcy laws has come increasingly to be viewed as essential if businesses want to participate in our global economy; without such laws, international business is fraught with too much uncertainty. That said, the installation of consumer bankruptcy laws has not kept pace with its business counterpart as actual consumer indebtedness (over-indebtedness) has lagged behind corporate development. But, as more and more consumers gain access to credit markets and become indebted, it becomes increasingly important for nations to address how to deal with individuals overburdened with deb[1].

The development of consumer bankruptcy laws is not an easy process, and it is filled with moral question[2]. Indeed, what works in one environment will not necessarily work in another. What is important, though, is to consider first what one seeks to accomplish in a personal bankruptcy system. Then, one can better assess what is the essential element of any system designed to achieve the designated goals. For me, one of the most intriguing and interesting issues is whether, once one has admitted to the need to have a consumer bankruptcy system, there are certain minimum basic requirements — certain essential elements — that underlie *any* consumer bankruptcy system. In other words, are there certain features that should be present in *every* law created to assist individual debtors regardless of the vast differences among nations, cultures and people? I think the answer to that is yes; there are certain minimum features of any consumer bankruptcy regime. To that end, this paper addresses the nature of consumer bankruptcy in the United States and how one can begin thinking, from a conceptual standpoint, about consumer over-indebtedness. The paper concludes with a list, albeit a very tentative one, of the eight key elements of any consumer bankruptcy system. It is my hope that this paper and the list it proffers will serve to further the effort to develop consumer bankruptcy systems across the globe. Perhaps it will encourage other and future dialogue about this important topic.

## The United States System — An Overview

In the United States, an individual seeking bankruptcy relief has two options[3]. S/he can liquidate in which case non-exempt, unsecured assets are distributed[4] to creditors. This is commonly referred to as a Chapter 7 case. Alternatively, a debtor can reorganize, repaying creditors over time, usually out of future income. The most common reorganization chapter for individuals is

1 Readers may be interested in a forthcoming symposium issue (August, 1999) of the Osgoode Hall Law Review (Canada); this volume contains a series of papers on consumer bankruptcy around the globe based on a symposium held in the summer of 1998 at the University of Toronto School of Law. For more information, readers should contact Professor Jacob Ziegel at j.Ziegel@utoronto.ca.

2 For a very useful new book on how to think about the philosophical underpinnings of consumer bankruptcy and its moral implications for various nations, *see* Kilpi (1998). I have prepared a short review of this book for the Journal of Law and Society (December 1999 issue); copies of the review are available from the author in the interim. My email address is kgross@nyls.edu.

3 In the United States, bankruptcy laws are federal and are housed in 11 U.S.C. sec. 101 et. seq. This is commonly referred to as the «Bankruptcy Code» or the «Code.» The Code was adopted in 1978 and has been amended numerous times since then, most recently in 1998. Prior to 1979, the U.S. bankruptcy laws were referred to as the «Bankruptcy Act».

Chapter 13. In a liquidation case, an individual debtor's future income remains available to the debtor, not creditors; in a reorganization case, future income is allocated to creditor repayment, after the debtor retains what is necessary for supporting him/herself and dependents. In both chapters, debtors are entitled to keep certain real and personal property (termed «exempt» property); this is property that creditors cannot reach. Debtors gain a discharge in both liquidation and reorganization cases, although the scope of the discharge is expanded in reorganization cases. Moreover, not all categories of debt are dischargeable[5] in bankruptcy, and certain types of debtor bad-acts preclude a discharge altogether[6]. In both liquidation and reorganization cases, debtors can retain secured collateral (upon satisfying certain requirements) or can return same to the secured creditor. However, except as to homes and in limited other situations, a secured creditor is only secured to the extent of the value of the secured collateral — not the amount of the overall indebtedness. In both Chapters 7 and 13, a trustee oversees the administration of the bankruptcy case[7]; the majority of debtors are represented by counsel although a sizable portion of debtors appear pro se. All debtors are required to pay a filing fee to access the system, although that fee can, in certain circumstances, be paid in installments[8].

There has been a growing effort in the United States to pass legislation limiting an individual debtor's ability to liquidate (obtain relief under Chapter 7) based on whether a debtor is capable of repaying at least a portion of his/her indebtedness out of future income[9]. Led by the credit industry, this proposed approach (commonly referred to as «means-testing» or «needs-based bankruptcy») has gained considerable support in Congress where debates have centered around the rising levels of U.S. bankruptcy filings in a time of relative economic prosperity and low unemployment. (At last count, there were more than 1.3 personal bankruptcy filings per annum although the rate of increase is diminishing; in the United States, personal bankruptcy accounts for more than 96% of all bankruptcy cases filed[10].) The creditors argue that the only explanation for the current high level of bankruptcy filings in the United States is that bankruptcy has lost its stigma, and debtors who are not unfortunate are, without any concern or restraint, accessing the bankruptcy system to find an easy solution to their self-made problems. However, many who have worked with debtors and/or studied this issue empirically do not see support for this observation[11]. Moreover, any discussion of bankruptcy filing rates must also be evaluated in the context of creditor behavior — in terms of extending credit (including to individuals previously ostracized from the credit market), monitoring outstanding credit and collecting past due amounts.

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4 I have simplified the process for purposes of this paper. For a detailed overview of the U.S. bankruptcy system, see Gross (1997). This book contains (at p. 42) a useful flowchart, identifying the key elements of the U.S. bankruptcy process. The book is available through amazon.com.

5 There are currently 18 categories of non-dischargeable debt, including domestic support obligations, student loans, certain taxes and select credit card debt incurred through fraud.

6 Fraud is a common example. Another example is knowingly failing to comply with court orders or to complete accurately documents filed with the court.

7 Trustees tend to be lawyers, although they can be accountants. In no-asset Chapter 7 cases, they are paid a pre-determined flat fee; in other cases, they are paid on the basis of the assets they collect and distribute to creditors.

8 Based in a 1973 Supreme Court decision, an individual can be denied a discharge because he/she has not paid the requisite filing fee. Recently, there was a three year pilot program which according in forma pauperis relief to debtors in select regions of the country; a report assessing the feasibility of a nationwide in forma pauperis system was prepared by the Federal Judicial Center. Versions of the pending legislation have sought to remedy this problem by allowing poor debtors to enter the system without paying the requisite fee.

9 House Bill 833 and Senate Bill 625, both introduced into the 106th Congress, are the most recent examples. These bills, as introduced and amended, can be accessed via the Internet at <http.www.abiworld.org>. Detailed summaries of this proposed legislation are available from the author.

10 The most recent filing numbers are accessible on-line through <http.www.abiworld.org>. The relevant data appear under the caption «statistics».

11 I place myself in this category for numerous reasons, including my experiences working with individual debtors at the New York Legal Aid Society and interviewing pro se debtors on behalf of the Southern District of New York Bankruptcy Court.

## The Arguments Surrounding Consumer Bankruptcy

People[12] disagree — at times vehemently — over how to treat individuals in financial distress. I suspect that it is because bankruptcy is not just a legal concept; the issues it raises extend well beyond the law[13]. By treating bankruptcy as purely a legal doctrine and ignoring its other dimensions, we mask the deeper, more controversial issues. Bankruptcy — and the accompanying possibility of a discharge of indebtedness — makes us think about money, debt, credit, risk-taking, loss, failure and forgiveness. In addition to its obvious economic dimension, bankruptcy has political, moral and psychological dimensions. It speaks to how a nation operates — whether it operates in a market-based economy, whether personal credit is available and on what basis, at what cost and to whom. It speaks to whether we live in a society with one or more governmental safety nets available to assist those less fortunate. Bankruptcy speaks to family structure and family support (or the lack thereof). Bankruptcy speaks to how we live, how we pay for our lives, how we deal with the myriad of choices that currently confront us and the choices we have made in the past. It speaks to whether we save or spend; it makes us confront whether we can control our lives and if so, at what cost.

Thus, a purely legal focus on bankruptcy and the treatment of consumer over-indebtedness is far too narrow; it strips bankruptcy of its richness. One consequence of broadening the basis upon which we think about bankruptcy is that people, indeed people within different nations, necessarily and inevitably approach the issue from different perspectives. That is why defining the U.S. bankruptcy's law's fresh start (encapsulated in the concept of the discharge) is no simple task; the definition depends on one's perspective. And, one can come at the issue from a wide range of perspectives, many of which are intersecting and intertwined — and perhaps even contradictory.

To elaborate on this point, look at the attached drawing of the «duckrabbit»[14]. Some people only see the rabbit; some only see the duck. What one sees depends on one's perspective. But once one can see both the duck and the rabbit, one is looking at the drawing from multiple perspectives. In this latter instance, one sees two distinct images at once, demonstrating what artists term «rival-form ambiguity», two competing images viewed at a single moment. Seeing multiple perspectives all at once is precisely what is required to understand bankruptcy. Bankruptcy requires that we see, at a minimum, the interests of debtors and creditors (ducks and rabbits so to speak!). The interests of debtors and creditors are both in competition with each other and, at times, in conflict with each other. However, a bankruptcy system designed with only a debtor perspective or only a creditor perspective in mind is doomed to fail. The perspectives of both debtors and creditors must be addressed in any functioning bankruptcy system.

To add to this already complex task of recognizing the intertwined and competing interests of debtors and creditors, we also need to recognize that bankruptcy happens in a context. One could call this a «pond»; one needs to see the duck and rabbit contextually — in their pond. Seeing the «duckrabbitpond» is very difficult indeed. But, however difficult it is to see the complexity, the risk of failing to see it produces even greater difficulty[15]. Context means several things. First, we need to recognize that debtors and creditors may be very different from each other and, in different nations, the relationships between debtors and creditors may be different.

12 This includes businesses, industries, academics, lawyers, judges, economists, consumer advocates, politicians among others. There are many constituencies interested in and affected by bankruptcy.

13 Select portions this paper have been excerpted (with permission) from a paper delivered at a conference at the University of Toronto, in August 1998, *The Contemporary Challenges of Consumer Bankruptcies in a Comparative Context*. The paper will be printed in a forthcoming issue of the Osgoode Hall Law Review. *See supra* footnote 1.

14The drawing appears as an appendix.

15 The discussion of the «duckrabbitpond» and its implications are more fully addressed in my book, Gross (1997).

So, we cannot develop a bankruptcy system acontextually; it needs to fit into the society in which it is being adopted, and what is developed has to work from a practical perspective. For example, in countries with advanced judicial systems, a court-based approach is workable; in nations without a well-developed or well-functioning court system, consumer bankruptcy may need to be housed in some sort of administrative agency.

Second, bankruptcy affects a larger community than just that of a debtor and his/her creditors. A single bankruptcy case has a ripple effect on a debtor's spouse, children, friends and employer. It may affect a debtor's social network. It may affect a debtor's ability to work. It may affect a debtor's physical and emotional well-being that in turn affects those around him. So, it is important to recognize that bankruptcy does not occur in a vacuum, and its tentacles reach far and wide.

There is also the underlying and deeper-seeded question: what is a consumer bankruptcy system designed to accomplish? At one level, bankruptcy becomes a receptacle for solving failures that manifest themselves in economic terms. In that way, the lack of money of debtors is a stand-in for other «lacks». A failure in one's finances is a stand-in for failures in one's health, one's job, one's marriage, one's business, one's investment choices, one's saving habits and so on. But, I think that money — or the lack of it — is more than a symbol. It is significant in and of itself.

Money is a powerful language in society — and it has been for centuries[16]. Money is the basis for social structure, for power (or lack of power), for status. It is how we measure who we are; it is how we compare ourselves to others. Money is, in essence, as basic and as fundamental as written or spoken language; it is how we communicate with each other and with ourselves. Indeed, money is itself a language — the language of exchange. It is no wonder, then, that the loss of money — for both the debtor and the creditor — cuts right to the core of our identity.

Historically, the loss of money has not been treated as a «sympathetic» event for people. Despite being a nation of debtors, America has a history replete with stories of individuals (including women and their children) imprisoned for debt; indeed, debtors' prisons did not disappear until the mid-1800's. In Roman times, debtors were forced to go naked into the public square and rub their buttocks on a rock. In the Middle Ages, some debtors were forced to wear a symbol of their indebtedness; for example, some French debtors were required to wear a green beret. These types of treatment can be categorized as shaming sanctions, much like the scarlet «A» that Hester Prynne was required to wear as a symbol of adultery in Nathaniel Hawthorne's famous book, *The Scarlet Letter.*

In the United States, until recently, we had moved far away from overt shaming sanctions. Debtors' clothing was not branded; debtors were not singled out for public humiliation in town meetings; debtors were not deprived of the right to vote; debtors could continue to serve as corporate officers and directors. Debtors were not under house arrest; they were not imprisoned. Debtors were not denied credit prospectively. But, it is a mistake — a very large mistake — to assume that the absence of outward shame is evidence of bankruptcy being a shame-free event for debtors. Indeed, many debtors in the United States experience the filing of a bankruptcy case as a shameful event. Filing bankruptcy remains an overt statement of failure. Bankruptcy filings are a matter of public record. Evidence of the filing can appear on one's credit report for ten years. Some local newspapers print lists of the names of debtors. Some landlords and employers will not rent to or hire individuals who have been debtors. While obtaining credit is possible, it remains costly. Various licenses and applications ask whether the applicant has sought bankruptcy relief. And, of course, one's family is frequently aware of the very real psychic price a

16 There has been some interesting and important recent work on the history of money. Some scholars date money to 3800 B.C. *See e.e.* Weatherford (1997). For an interesting collection of recent articles on money, see the October 1998 issue of the magazine Discover: The World of Science.

debtor pays for his/her failure. This latter type of shame — internal shame — may be even more powerful than branding the letter «B» (for «bankruptcy») upon a debtor's chest. So, even in the nation with what is perceived as the most debtor-friendly bankruptcy laws, debtors do not sense they are escaping from their obligations without paying a price. The price is, though, usually not a monetary one — it is an emotional one.

## The Minimum Requirements: What Are They?

As I indicated in the Introduction, I think it is possible, in the duckrabbitpond world, to identify certain minimum prerequisites of a consumer bankruptcy system. Although the list I have prepared is certainly an area worthy of debate, it is a starting place. So, in the interest of advancing the dialogue, let me suggest that every consumer bankruptcy system should contain at least EIGHT key elements. (This assumes that there is some structure to administer these suggestions — whether that is a judicially based system, some governmental unit or some other nonpartisan organization.) They are:

- *A Discharge of Indebtedness.* Ideally, the debtor's ability to obtain a discharge would not be linked to a debtor's future income. In whatever form it ultimately takes, debtors should have an opportunity to obtain relief from pre-existing indebtedness and to begin afresh, free from their past financial obligations.
- *Exemptions.* All debtors, wherever they live, should be able to retain certain real and personal property; this is property that is beyond the reach of creditors. Exactly what and how much property should be retained is a matter requiring considerable cultural and social input. For example, if a debtor is entitled to retain a car of a certain value, that signifies the importance of automobiles to a debtor's future livelihood and continued functioning in society.
- *Avoiding Powers.* Creditors should not be able to retain transfers received from the debtor in the period immediately before bankruptcy. Otherwise, there is no incentive for creditors to work collectively as the «first to the finish» would be the winner.
- *Automatic Stay.* Creditors should be prohibited from pursing the debtor during a bankruptcy case. If this were not so, creditors who chose not to be bound by the bankruptcy process would prevail over those utilizing the collective mechanism bankruptcy accords.
- *Educational Initiatives.* All debtors should be offered financial management training so that they emerge from the bankruptcy system as more knowledgeable and thoughtful consumers of credit. This does not diminish the need for greater financial management training *before* someone experiences financial distress. However, debtors clearly need more information.
- *Bad Actor Provisions.* A select number of debtors and debts that do not merit the benefits of bankruptcy should be identified. This pool of people and debts should be limited; otherwise, bankruptcy becomes the exception as opposed to the rule. An example of a debtor who should be precluded from bankruptcy is one who has lied on his/her documents and with intent, has defrauded his/her creditors.
- *Anti-Discrimination Provisions.* If debtors experience discrimination, then the benefits of bankruptcy are severely diminished. For example, if a debtor loses his/her drivers license because of bankruptcy, that debtor cannot return to his/her life and may be deterred from working. That said, prospective lenders and landlords should be able to look into a debtor's financial past to determine whether to deal with this individual.
- *Data Collection.* To insure transparency and an understanding of how the system is operating, data on debtors and creditors are essential (recognizing certain privacy considerations). Bankruptcy statistics will reveal important information that will assist the parties to the system and society as a whole.

## Conclusions

Establishing a consumer bankruptcy system where none existed before implicates a wide range of issues. In a world in which we are all debtors at one level or another, it becomes difficult to distinguish among debtors. Which debtors are in such financial distress that they deserve special attention? We also need to recognize and be mindful of the moral hazard problem. We do not want to create a system that encourages people to «game» the system. At the present moment, even though the United States has had a bankruptcy law since 1898 (and episodically before then), the contours of the consumer bankruptcy system are being debated. While there are certainly many reasons for the current U.S. debate, one thing remains true: no quality bankruptcy system can be developed and sustained without seeing the duckrabbitpond. Only those thinking multi-perspectivally can begin to address this immensely complex and value-laden issue in a meaningful way.

## References

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