Fordham Journal of Corporate & Financial Law

Volume 7, *Number* 2 2002 *Article* 10

Response to Eric Posner

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RESPONSE TO ERIC POSNER

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I am thankful to Eric Posner ("Posner") for helping me to sharpen my own thinking. I agree with him and others that bankruptcy is in part a law of hardship,[1] providing insurance against financial distress, and that it is important to keep the cost of this relief down. This is why I am interested in better means testing, using means that do not burden even the clearest cases of hardship. Most of those in the system are in bad financial shape.[2]

Let me stress that my praise for the current system is qualified. Although better than that proposed in the pending legislation, the current system is far from perfect. The pending legislation would lead to less relief for true hardship and more failure in Chapter 13.[3] Channeling people without the means to succeed into long repayment plans is a problem under current law,[4] one that the

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1. *See, e.g.*, Robert A. Hillman, *Contract Excuse and Bankruptcy*, 43 STAN. L. REV. 99 (1990) (summarizing the conventional justifications for bankruptcy as humanitarian concerns combined with giving incentives to productivity); Margaret A. Howard, *A Theory of Discharge in Consumer Bankruptcy*, 48 OHIO ST. L. J. 1047, 1061-62 (explaining the goal of returning debtors to productive economic participation). I do not agree with Posner that bankruptcy is a law to "prevent" hardship; prevention requires such measures as financial education, better job training, more ex ante consumer protection and a less porous social safety net. When these measures are not taken or fail, bankruptcy ameliorates hardship.

2. *See, e.g.*, TERESA SULLIVAN ET AL., THE FRAGILE MIDDLE CLASS 61-71 (2000) (noting that one-third of debtors in bankruptcy are below the poverty line; the median income of those in bankruptcy is half that of Americans in general, and their median non-mortgage debt equals about a year's income).

3. Jean Braucher, *Means Testing Consumer Bankruptcy: The Problem of Means*, 7 FORDHAM J. CORP. & FIN. L. 407, 411 (concerning two-thirds failure rate in Chapter 13 and likelihood that the proposed legislation would increase failure).

4. Eric A. Posner, *Should Debtors Be Forced into Chapter 13?*, 32 LOY.

"reforms" would make worse. The primary argument of my article is that to achieve more accurate and realistic means testing without burdening the needy, the bankruptcy system must be simplified. My focus is on means of administration.

Posner states that the purpose of the proposed law is to make bankruptcy more difficult,[5] but the proponents do not admit that. They do not say that their purpose is to make bankruptcy more difficult for all, even the most clearly needy, so it is worth pointing out this effect. (One of the techniques for burdening all filers is to require their lawyers to investigate them, adding expense and redefining the lawyer-client relationship; this is not about "sloppy" lawyers, as Posner says.[6])

Posner's main focus is on the moral terms of the debate,[7] not a new phenomenon. Bankruptcy debates have always been conducted in moral terms.[8] In the 1978 debates, creditors argued for something they called "credit morality."[9] In the current round, a leading congressional proponent of the credit-industry package built the case for the legislation on the claim that there is a new "bankruptcy of convenience" [10] used by people with the means to repay their debts. In my article, I draw on the work of many

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L.A. L. REV. 965, 976 (1999). Posner has previously praised the idea of making Chapter 13 "presumptive," but he did so without mentioning the high failure rate in Chapter 13.

5. *See* Eric Posner, *Comments on Means Testing Consumer Bankruptcy by Jean Braucher*, 7 FORDHAM J. CORP. & FIN. L. 457 (2002).

6. *See id.* at 459.

7. *Id.* at 457-58.

8. DAVID A SKEEL JR., DEBT'S DOMINION -- A HISTORY OF BANKRUPTCY LAW IN AMERICA 191 (2001). Not so very long ago, debtors were imprisoned or subjected to corporal punishment. *See* Jay Cohen, *The History of Imprisonment for Debt and its Relation to the Development of Discharge in Bankruptcy*, 3 J. LEGAL HIST. 153 (1982).

9. *See* SKEEL, *supra* note 8 (concerning creditors' campaign for "credit morality," meaning the morality of repaying debts).

10. *See* Braucher, *Means Testing Consumer Bankruptcy*, *supra* note 3, at 419 n.65 (quoting Congressman George Gekas); *see also Bankruptcy and Abortion*, WALL ST. J., May 2, 2002, at A14 (urging, in an editorial, that the conference committee to resolve differences over language to bar discharge of debts for abortion clinic violence so that the legislation could be passed, and arguing, "This isn't just an economic issue; it's also a moral one, promoting more personal responsibility.").

empirical scholars to criticize this claim on factual grounds.[11] I do not understand why it is "sterile," to use Posner's word, to care about facts.[12] The available evidence is that people who file in bankruptcy today are in the same or worse financial condition as they were in the past.[13] The reason for higher filing numbers is that growth in consumer credit means more people are in debt trouble and finding their way to the bankruptcy courts.[14] If we really did have a large number of people of means filing in bankruptcy, I would support finding means to stop that.

Posner's distaste for moral argument is typical of a "law and economics" approach. My own theoretical perspective is more one of traditional political economy, recognizing the value of a mix of market and democratic decision-making, without trying to translate all policy concerns into economic terminology.[15] The worthwhile contribution of law and economics is to urge attention to costs,[16] but often—as with bankruptcy — the goals of law are not merely to keep down costs.

Posner recognizes that a pure[17] market approach would not work to price the value of the mandatory insurance for inability to pay that bankruptcy law provides. He notes that one theory of

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11. *See* Braucher, *Means Testing*, *supra* note 3, at Part II.

12. *See* Margaret Howard, *Bankruptcy Empiricism: Lighthouse Still No Good, Book Review of The Fragile Middle Class: American in Debt,* edited by Teresa Sullivan et al.,, 17 BANKR. DEV. J. 425, 459 (2001) (discussing the problem that more data will not change a closed mind).

13. NATIONAL BANKRUPTCY REVIEW COMMISSION, BANKRUPTCY: THE NEXT TWENTY YEARS, FINAL REPORT 83 & n.124 (1997).

14. *Id.*

15. *See* Daniel McCloskey, *The Rhetoric of Law and Economics*, 86 MICH. L. REV. 752 (1988) (arguing that economic terms are used to evoke a sense of scientific power and to claim precision that is often illusory); *see also* Jean Braucher, *Toward a Broader Perspective on the Role of Economics in Legal Policy Analysis: A Retrospective and an Agenda from Albert O. Hirschman*, 13 L. SOC. INQUIRY 741 (1988) (concerning the need for a balance of market and democratic decision-making), *available at* http://www.law.arizona.edu/library/LibraryInternet/library_info/resultsfacpubs.cfm?MNULastName=Braucher&Offsett (last visited Apr. 2, 2002).

16. Braucher, *supra* note 15, at 770.

17. We already have partial market definition of the bankruptcy discharge, in that consumers, by entering into secured credit contracts, make certain property subject to secured creditors' claims despite the bankruptcy discharge.

consumer bankruptcy law is "market failure" in insurance markets.[18] If the law were changed to permit debtors to waive the bankruptcy discharge in loan contracts, only a small number of consumers would read and understand the significance of such a term, [19] and creditors would hardly wish to compete for those consumers insisting upon non-waiver.[20] An alternative form of insurance for financial distress, our system of social safety nets, is full of holes.[21]

Once real markets are sensibly ruled out, as here, law and economics scholars sometimes resort to the metaphor of a "hypothetical market"[22] or to cost-benefit analysis, and there are elements of both approaches in Posner's comment. These approaches do not avoid normative judgments, but they make them less obvious and put them in terms less offensive to those squeamish about morals.[23] Posner calls for balancing the benefit of

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18. In this context, the term market failure takes in a number of problems — including information costs (such as lack of information about one's own risk of default), adverse selection, and debtors' cognitive and behavioral characteristics.

19. Sometimes shopping by a few may be sufficient to introduce market competition. Alan Schwartz & Louis L. Wilde, *Imperfect Information in Markets for Contract Terms: The Example of Warranties and Security Interests*, 69 VA. L. REV. 1387, 1450 (1983) (noting that because firms cannot distinguish shoppers from non-shoppers, non-shoppers benefit from the shoppers' efforts). But creditors might be glad not to appeal to those shopping for credit that permits a bankruptcy discharge.

20. This is a problem of adverse selection.

21. I agree with Posner that taxes and transfer payments are a better way to deal with redistribution than legal rules such as bankruptcy law. Eric A. Posner, *Contract Law in the Welfare State: A Defense of the Unconscionability Doctrine, Usury Laws, and Related Limitations on the Freedom to Contract*, 24 J. LEGAL STUD. 283, 284 (1995); Jean Braucher, *Defining Unfairness: Empathy and Economic Analysis at the Federal Trade Commission*, 68 B.U. L. REV. 349, 383-84 (1988) (stating that contract rules are a crude, temporary and puny way to redistribute wealth; taxes and transfer payments are a more precise, sustained and significant means of redistribution). On the other hand, when we fail to create an adequate safety net, the legal system is forced to cope.

22. *See, e.g.*, Richard Posner, *Utilitarianism, Economics and Legal Theory*, 8 J. LEGAL STUD. 103 (1979).

23. *See id.* at 123 (noting that "conventional pieties" such as keeping promises reduce the costs of policing markets); *see also* McCloskey, *supra* note 15.

hardship relief against the impact on cost of credit,[24] but there are several inevitable normative questions in doing so. One is what constitutes a hardship case. Another is how to value the benefit that hardship relief provides. The value of bankruptcy relief cannot be precisely quantified;[25] it includes peace of mind and a new incentive to the discharged debtor to be productive. Cost-benefit calculations cannot mechanically tell us where to draw the line on who gets relief and how much.

When it comes to legislative — as opposed to agency[26] — decisions, it strikes me as highly unrealistic to suggest that morality be left out of debate. Creditors would be the last to suggest that we stop thinking that about debt repayment in moral terms. Many judgment-proof debtors are significantly motivated to repay loans because they feel these debts are justly due. Collection agents routinely and effectively use guilt to get people to pay. Erosion of the sense of moral responsibility would have much greater impact on the cost of credit than any tinkering with the bankruptcy laws. Unfortunately, it is possible that a continuing flood of high risk credit will wear down debtors' sense of obligation, and we ought to worry about that. Morality reinforces the utilitarian concern with costs.

The traditional morality about bankruptcy is that we ought to reserve relief for the deserving – those without the means to pay, and those who acted in good faith, if not with textbook prudence. In short, relief is for the "honest but unfortunate,"[27] even if a little foolish. Restricting relief in this way helps to keep down costs.

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24. *See* Eric Posner, *Comments*, *supra* note 5, at 459.

25. A common problem in cost-benefit analysis is that benefits are harder to measure than costs. *See* Duncan Kennedy, *Cost-Benefit Analysis of Entitlement Problems: A Critique*, 33 STAN. L. REV. 387 (1981).

26. Despite the limits of cost-benefit analysis, I have defended its use by administrative agencies in the design of consumer protection regulation as a way for regulators to keep in mind that their task is primarily to empathize with the situation of consumers, thereby avoiding a more patronizing approach to paternalism. *See* Braucher, *supra* note 21, 352-53, 421-26. Posner also defends cost-benefit analysis as a way to discipline agencies. Eric A. Posner, *Controlling Agencies with Cost-Benefit Analysis: A Positive Political Theory Perspective*, 68 U. CHI. L. REV. 1137 (2001); Matthew A. Adler & Eric A. Posner, *Rethinking Cost-Benefit Analysis*, 109 YALE L. J. 165 (1999).

27. Local Loan Co. v. Hunt, 292 U.S. 234, 244 (1934).

But more than a concern with costs is needed to decide who should get how much benefit, obviously points on which there are multiple views.

Finally, Posner overlooks the morally positive story for the creditor and does not make use of the nuances of the unattractive side. The credit industry is well aware of both. During the bankruptcy "reform" campaign of the last few years, the industry coalition put credit unions and conventional home loan bankers[28] out front whenever they could find willing representatives.[29] The coalition never paraded a panel of payday lenders and title pawn operators before the National Bankruptcy Review Commission or a congressional committee. The industry tried to deflect attention from declining underwriting standards and from less savory new credit vehicles that have been part of the recent explosive growth of consumer credit. Banished from view were those creditors providing low-quality credit at very high rates and with predatory foreclosure rates.[30] Posner is aware that not all credit is of equal social desirability.[31] He has even been so bold as to defend usury restrictions.[32] The need for bankruptcy has risen with increased access by low-income persons to low quality credit.[33] This is one

28. *See* IT'S WONDERFUL LIFE (Liberty Films 1946) (a movie in which Jimmy Stewart plays a home loan banker with a heart of gold).

29. I witnessed this phenomenon when I attended a National Bankruptcy Review Commission hearing.

30. A related point is that the consumers who get ahead financially are those who distinguish between debt that improves personal finances in the long term (debt incurred, for example, to get an education, increasing income, or to buy a home, reducing housing expenses and building equity) and debt that only makes one worse off (paying high interest for groceries or restaurant meals consumed last month). Posner treats all consumer credit as equally desirable.

31. Eric Posner, *Contract Law*, *supra* note 21 (arguing for restrictive contract doctrines to deal with the problem of "welfare opportunism" that leads to greater credit risk-taking). This argument is odd; debtors' lack of social benefits probably causes more credit risk-taking than having social benefits does. Debtors often finance uninsured medical expenses or a period of unemployment, without benefit of unemployment compensation, by using credit cards.

32. *Id.* I have given up on that.

33. Diane Ellis, *Bank Trends - The Effect of Consumer Interest Rate Deregulation on Credit Card Volumes, Charge-Offs, and the Personal Bankruptcy Rate* (1998), *available at* http://www.fdic.gov/bank/analytical/bank/bt_9805.html (last modified Aug. 13, 1999) (concerning unprecedented expansion in access to

reason why access to bankruptcy should not now be made more difficult. Another is that over-indebtedness in the United States is not solely a result of the high default rates that inevitably come with low quality credit; it is also a product of deficiencies in our social safety net, leading to the self-financed safety net. As long as we do not address these safety net problems, there will be honest but unfortunate debtors in need of bankruptcy relief.[34]

high interest rate credit for low-income persons following interest rate deregulation in the 1980s); *see also* Lynn Drysdale & Kathleen E. Keest, *The Two-Tiered Consumer Financial Services Marketplace: The Fringe Banking System and Its Challenge to Current Thinking About the Role of Usury Laws in Today's Society*, 51 S.C. L. REV. 589 (2000) (describing the problems consumers get into with certain forms of low quality credit, such as payday and title pawn loans).

34. *See* Eric Posner, *Contract Law, supra* note 21, at 295-96 (noting that it would be better to use taxes and transfer payments to address these problems rather than bankruptcy law).