[Fordham Journal of Corporate & Financial Law](https://ir.lawnet.fordham.edu/jcfl)

Volume 19 | Issue 1 Article 6

2013

The Paradoxical Bankruptcy Discharge: Rereading the Common Law- Civil Law Relationship

Giacomo Rojas Elqueta

Follow this and additional works at: https://ir.lawnet.fordham.edu/jcfl

Recommended Citation

Giacomo Rojas Elqueta, *The Paradoxical Bankruptcy Discharge: Rereading the Common Law- Civil Law Relationship*, 19 Fordham J. Corp. & Fin. L. 293 (2013).
Available at: https://ir.lawnet.fordham.edu/jcfl/vol19/iss1/6

This Article is brought to you for free and open access by FLASH: The Fordham Law Archive of Scholarship and History. It has been accepted for inclusion in Fordham Journal of Corporate & Financial Law by an authorized editor of FLASH: The Fordham Law Archive of Scholarship and History. For more information, please contact tmelnick@law.fordham.edu.

The Paradoxical Bankruptcy Discharge: Rereading the Common Law- Civil Law Relationship

Cover Page Footnote

.J.D. Candidate, University of Pennsylvania Law School; Assistant Professor of Private Law, University of Roma Tre. I am grateful to David A. Skeel for his invaluable comments. I am also grateful to those who gave me comments at the 2011 Italian Society of Law and Economics Annual Conference. From January 2012 until December 2012, I served as a member of the drafting commission for the new Italian consumer bankruptcy law (Law No. 221 of December 17, 2012, modifying Law No. 3 of January 27, 2012), which was established by the Italian Ministry of Justice. The opinions and views expressed in this Article are those of the author and do not necessarily reflect the position of the drafting commission.

This article is available in Fordham Journal of Corporate & Financial Law: https://ir.lawnet.fordham.edu/jcfl/vol19/iss1/6

VOLUME XIX 2014 NUMBER 2

FORDHAM

JOURNAL OF
CORPORATE & FINANCIAL LAW

THE PARADOXICAL BANKRUPTCY DISCHARGE: REREADING THE COMMON LAW – CIVIL LAW RELATIONSHIP

Giacomo Rojas Elgueta

THE PARADOXICAL BANKRUPTCY DISCHARGE: REREADING THE COMMON LAW – CIVIL LAW RELATIONSHIP

Giacomo Rojas Elgueta[1]

TABLE OF CONTENTS

---

1. S.J.D. Candidate, University of Pennsylvania Law School; Assistant Professor of Private Law, University of Roma Tre. I am grateful to David A. Skeel for his invaluable comments. I am also grateful to those who gave me comments at the 2011 Italian Society of Law and Economics Annual Conference. From January 2012 until December 2012, I served as a member of the drafting commission for the new Italian consumer bankruptcy law (Law No. 221 of December 17, 2012, modifying Law No. 3 of January 27, 2012), which was established by the Italian Ministry of Justice. The opinions and views expressed in this Article are those of the author and do not necessarily reflect the position of the drafting commission.

INTRODUCTION

This Article shows the limits of the highly ideological U.S. debate on consumer bankruptcy and challenges the wisdom of both the progressive and law-and-economics bodies of scholarship. In particular, the study employs a descriptive analysis of consumer bankruptcy discharge informed by behavioral law-and-economics methodology in order to show how bankruptcy shapes debtors' behaviors. This Article argues that bankruptcy discharge, traditionally regarded in common law legal systems as a pro-debtors remedy, in its most liberal extension, instead becomes a powerful incentive toward over-indebtedness and therefore, a profitable legal device for financial institutions.

Further, this Article argues that civil law legal systems, which are typically considered pro-creditor due to their much stricter approach toward consumer debt, present an opposite picture: a much less-indebted middle class and a less fertile soil for creditors. By demonstrating the paradoxical effects of the common law and civil law approaches to consumer debt, this Article challenges the traditional wisdom according to which the civil law tradition—based on the "universal patrimonial liability" rule for debtors—is purely a pro-creditor system while the common law tradition—faithful to a liberal notion of bankruptcy discharge—is a pro-debtor one.

This assertion lays the foundation for a new normative analysis of bankruptcy discharge that suggests that in order to truly protect debtors, contrary to traditional progressive ideas, it is necessary to adopt a less paternalistic approach that considers the incentives that bankruptcy discharge poses to debtors. This *ex ante* perspective, different from the one supported by law-and-economics scholarship, arrives at the conclusion that in order to ultimately make debtors safer, it is necessary to tighten access to bankruptcy discharge and restore the mechanism's original founding principle of protecting only the honest but unfortunate debtor, not any over-indebted individual.

This analysis is organized as follows. Part I illustrates the recent global trends in consumer bankruptcy, particularly, the tendency of civil law legal systems to move toward the common law model through the liberalization of discharge of consumer debt. Part II describes the historical evolution of bankruptcy discharge in both England and the United States, and points out the fact that the civil law tradition has taken a different course of development for debtors' liability compared to the direction followed by common law legal systems. Part III shows how the rationale behind discharge has dramatically changed in twentieth-century American bankruptcy law. Part IV illustrates the U.S. debate on the scope of discharge and offers an alternative descriptive analysis based on the results of a behavioral law-and-economics analysis. Lastly, Part V proposes a new normative analysis of discharge that departs from both the progressive and conservative scholarly discourse in the United States.

I. RECENT TRENDS IN CONSUMER BANKRUPTCY

A. THE DEMOCRATIZATION OF CONSUMER CREDIT AND THE BANKRUPTCY DISCHARGE

In the last three decades, several countries belonging to different legal traditions have encouraged the liberalization of consumer bankruptcy by introducing the discharge of consumer debt.[2] This trend[3]

---

2. In general terms, discharge is the legal elimination of a debt through bankruptcy proceedings. After a discharge is granted, a debt is no longer legally enforceable against the debtor. *See* Charles J. Tabb, *The Scope of the Fresh Start in Bankruptcy: Collateral Conversions and the Dischargeability Debate*, 59 GEO. WASH. L. REV. 56, 56 (1990) [hereinafter Tabb, *Scope of the Fresh Start*]. A useful survey of

finds its immediate explanation in the explosion of consumer credit and runs opposite to the pattern in the United States, traditionally the most liberal country in its attitude toward discharge. This "democratization"—or using more honest terms, "deregulation"—of credit has typically been singled out as the reason behind the recent global trends in consumer bankruptcy discharge.[4]

Particularly in the 1990s and early 2000s, the United States and U.K. under the Clinton and Blair administrations, respectively, eased access to consumer credit through deregulation.[5] In order to maximize

---

debtors' liability regimes in different legal systems is offered by Rafael Efrat, *Global Trends in Personal Bankruptcy*, 76 AM. BANKR. L.J. 81 *passim* (2002) [hereinafter Efrat, *Global Trends*]; CONSUMER CREDIT, DEBT & BANKRUPTCY – COMPARATIVE AND INTERNATIONAL PERSPECTIVES 1 *passim* (Johanna Niemi et al. eds., 2009); *see also* Iain Ramsay, *Between Neo-Liberalism and the Social Market: Approaches to Debt Adjustment and Consumer Insolvency in the EU*, *in* CONSUMER BANKRUPTCY IN EUROPE – DIFFERENT PATHS FOR DEBTORS AND CREDITORS 5 *passim* (Robert Anderson et al. eds., 2011) [hereinafter Ramsay, *Between Neo-Liberalism and the Social Market*].

3. *See* discussion *infra* Part III.

4. *See infra* Part I.B.

> The United States emerged from the war with unparalleled prosperity and hardly needed further savings campaigns. Instead politicians, businessmen and labor leaders all promoted consumption as the new driver of economic growth. Rather than democratize saving, the American system rapidly democratized credit. An array of federal housing and tax policies enabled Americans to borrow to buy homes and products as no other people could. But from the 1980s, financial deregulation and new tax legislation spurred the growth of credit cards, home equity loans, subprime mortgages and predatory lending. Soaring home prices emboldened the financial industry to make housing and consumer loans that many Americans could no longer repay. Still, Americans wondered, why save when it is so easy to borrow? Only after housing prices collapsed in 2008 did they discover that wealth on paper is not the same as money in the bank.

Sheldon Garon, *Why We Spend, Why They Save*, N.Y. TIMES, Nov. 25, 2011, at A35.

5. In particular, the U.S. Congress passed the Financial Services Modernization Act of 1999, which repealed part of the Glass-Steagall Act of 1933. The U.K. passed the Financial Services (Open-Ended Investment Companies Act) Regulation in 1997 and the Enterprise Act in 2002. For more on the strong connection between neo-liberal economic theories, the exponential growth of finance, and the deregulation of the consumer credit market, see LARRY ELLIOT & DAN ATKINSON, THE GODS THAT FAILED – HOW BLIND FAITH IN MARKETS HAS COST US OUR FUTURE 1 *passim* (2009); DAVID

welfare, these two countries strongly embraced the ideas that high consumption drives economic growth and that consequently, risk-taking and consumer debt must be spurred even among low-income borrowers—ideas exemplified by the expansion of subprime lending.[6]

HARVEY, A BRIEF HISTORY OF NEO-LIBERALISM 1 *passim* (2007); *see also* Ramsay, *Between Neo-Liberalism and the Social Market*, *supra* note 2.

6. *See* Iain Ramsay, '*Wannabe WAGS' and Credit 'Binges': The Construction of Overindebtedness in the UK*, *in* CONSUMER CREDIT, DEBT & BANKRUPTCY – COMPARATIVE AND INTERNATIONAL PERSPECTIVES 75, 77–78, 84 (Johanna Niemi et al. eds., 2009) [hereinafter Ramsay, '*Wannabe WAGS' and Credit 'Binges'*]. The spread in emerging markets of an economic growth model based on high consumption by lower-income classes is shown in the case of Brazil, where between 2000 and 2007 the number of credit cards increased from 119 million to 413 million. *See* Cláudia Lima-Marques & Antônio Benjamin, *Consumer Overindebtedness in Brazil and the Need for the New Consumer Bankruptcy Legislation*, *in* CONSUMER CREDIT, DEBT & BANKRUPTCY – COMPARATIVE AND INTERNATIONAL PERSPECTIVES 55, 57, 60–61 (Johanna Niemi et al. eds., 2009) (describing the first decade of the 21st century as a "a 'credit hangover' period, a time when these 'new' and poorer consumers cannot afford to pay their own debts, but they are still in the bank and credit card system as solvent clients").

> Our economy depends on consumer spending. Our economists take inconsistent positions about whether the spending is good or bad. They demand that people save more to increase capital investment and productivity at the same time they warn that increased consumption is essential to economic growth. In short, they want more spending and more savings. They are apparently too busy to explain how to do both of these at the same time, especially when incomes are stagnant. One thing Americans can do on the consumption side, despite their stagnant incomes, is to incur more debt. Many people have an enormous economic stake in encouraging us to do just that. No one, it seems, has an interest in providing sober reminders about the risks involved. Adding to these general trends is the growth of a whole new segment of the consumer credit industry . . . . The new segment is concentrated on the very consumers who were feared and avoided by credit granters just a few years ago. They are people at the margins who already have high consumer debts in relationship to their incomes. So called subprime lending – that is, lending to people who have spotty credit histories or are awash in debt – is the most profitable, and hence the most rapidly increasing, segment of consumer lending.

TERESA A. SULLIVAN ET AL., THE FRAGILE MIDDLE CLASS – AMERICANS IN DEBT 23–24 (2000). On the functioning of subprime lending markets, *see* Oren Bar-Gill, *Seduction by Plastic*, 98 NW. U. L. REV. 1373, 1373 (2004); Oren Bar-Gill, *The Law, Economics*

This highly suggestive idea, which has collapsed during the financial crisis of 2008, has deeply influenced financial policies around the globe, triggering a competition among different legal systems to introduce consumption-stimulating measures.[7] The resultant climate, characterized by a shortsighted trust in the ability of consumer credit to promote economic growth, is undoubtedly reflected in E.U. regulation "on credit agreements for consumers and repealing Council Directive 87/102/EEC."[8] This European Directive is strongly inspired by the idea that having access to a good deal of information before concluding a financial agreement is enough to guarantee "responsible" credit.[9] The regulation, which focuses on the supply side of the consumer credit market while neglecting consumers' protection, fully relies upon market dynamics in order to prevent "bad" credit.[10] Several European countries

---

and Psychology of Subprime Mortgage Contracts, 94 CORNELL L. REV. 1073, 1073 (2009).

7. A clear illustration of the influence exercised by the U.S. and U.K. models of consumer credit on continental Europe is provided by the Italian doctrinal debate on the opportunity to introduce bankruptcy discharge, which is seen by some authors as a tool to spur consumption and consumer credit. In fact, some Italian scholars have argued that the low indebtedness of Italian families compared to those in the U.K. is a symptom of Italian economic stagnation. *See* L'INSOLVENZA DEL DEBITORE CIVILE DALLA PRIGIONE ALLA LIBERAZIONE, *in* ANALISI GIURIDICA DELL'ECONOMIA 299 *passim* (Gaetano Presti et al. eds., 2004). In particular, *see* Lorenzo Stanghellini, *'Fresh Start': implicazioni di 'policy'*, *in* L'INSOLVENZA DEL DEBITORE CIVILE DALLA PRIGIONE ALLA LIBERAZIONE 437, 440 n.4 (Gaetano Presti et al. eds., 2004) (arguing that considering "the current and expected trend of consumer credit growth, it is not an exaggeration to state that Italian economy relies on the expansion of this sector in order to develop. This very same conclusion has been reached, with a good deal of realism, by the legislators of other countries, as the United Kingdom, which among the reasons of its recent reform . . . introduced the need to stimulate consumption, which there as in other countries relies for a substantial portion on credit").

8. EUROPEAN PARLIAMENT DIRECTIVE 2008/48/EC (Apr. 23, 2008); *see* Ramsay, *Between Neo-Liberalism and the Social Market*, *supra* note 2, at 6 ("The treatment of over-indebtedness is one part of consumer credit regulation policy which straddles economic and social policy. The EU promotes consumer credit as 'the lubricant of economic life' within the context of a 'competitive social market economy.' The development of debt adjustment systems and insolvency is part of the constitution of this market. The EU has thus far focused more on creating a competitive credit market than addressing its social costs, perhaps reflecting the influence of neo-liberal ideas and financial interests in credit policymaking within the EU.").

9. *See* EUROPEAN PARLIAMENT DIRECTIVE 87/102/EEC, recitals 24 and 26.

10. On the EU Consumer Credit Directive, see Udo Reifner, *'A Call to Arms' – For Regulation of Consumer Lending*, *in* CONSUMER CREDIT, DEBT & BANKRUPTCY –

have also examined the bankruptcy discharge of consumer debt with respect to the demand side of the consumer credit market to further encourage the use of credit.[11]

COMPARATIVE AND INTERNATIONAL PERSPECTIVES 105, 114–15 (Johanna Niemi et al. eds., 2009) ("For the EU regulator, only the market can define what is good and detect what consumers need. . . . The mere fact that people are overindebted proves that the credit was 'bad' for them."). The approach of European institutions to consumer credit can be cited as a tangible demonstration of the recent European trend of distancing itself from its original, more paternalistic approach aimed at protecting consumers' interests in areas such as product safety and quality. More recently, European institutions seem more sensitive to guaranteeing the economic interest of consumers (i.e., purchasing goods at the lowest price). On the abdication of the European model and the dominance of the North American model, see VICTORIA DE GRAZIA, IRRESISTIBLE EMPIRE – AMERICA'S ADVANCE THROUGH TWENTIETH-CENTURY EUROPE 1 *passim* (2005).

> Germany and France, I will argue, remain far more oriented toward producer and distributor interests . . . than the United States, even in this high age of consumerism. . . . Continental law is indeed putting a growing emphasis on the consumer protection interest, developing many paternalistic guarantees of the safety and quality of goods and services. But the consumer economic interest is making slower headway. The result, as I will try to show, is that contemporary continental law can leave many producer protections on the books.

See James Q. Whitman, *Consumerism v. Producerism: A Study in Comparative Law*, 117 YALE L.J. 340, 348 (2007). The author later clarifies his terminology:

> Let us begin with the ambiguities of "consumer interests." On the one hand, when we speak of 'the interest of consumers,' we may be speaking of consumer economic interests, i.e., of the interest of consumers in purchasing goods and services at the lowest possible price, in having access to the widest variety of goods and services, in having easy access to credit, in being able to shop at maximally convenient hours and locations, and the like. On the other hand, when we speak of 'protecting the interest of consumers,' we may be speaking of consumer protection and safety legislation, that is, legislation on such matters as products liability, the purity of food and drugs, nondeceptive advertising, and the like.

Id. at 366–67.

11. *See infra* Part V.B.

B. OVER-INDEBTEDNESS AND BANKRUPTCY DISCHARGE

In keeping the idea that favoring consumption through extensive access to credit is socially desirable, over the last several decades, several civil law countries have begun to view the common law approach to consumer bankruptcy as a viable tool to spur consumption, questioning the efficiency of their regimes in governing individuals' liability toward creditors.[12]

Traditionally in civil law legal systems, an individual is liable for his obligations with all his assets.[13] In particular, the default rule governing relations between debtors and creditors is that all of a person's property (his entire present and future patrimony) is available for seizure and sale to satisfy the claims of creditors (so-called "universal patrimonial liability").[14] Furthermore, in the civil law tradition consumer debts are typically excluded from bankruptcy law. Therefore, discharge is not granted to individuals whose debts are not related to an entrepreneurial activity.[15]

The universal patrimonial liability regime governing consumer debt, which stands in clear contrast to the consumer bankruptcy discharge regimes of common law systems, has recently been viewed as one of the reasons for low indebtedness, low consumption, and consequently, following the rationale of the so-called "consumer

---

12. *See infra* note 14 and accompanying text.

13. *See* Giacomo Rojas Elgueta, *Divergences and Convergences of Common Law and Civil Law Traditions on Asset Partitioning: A Functional Analysis*, 12 U. PA. J. BUS. L. 517, 525 (2010).

14. *See* Rojas Elgueta, *supra* note 13, at 525. The principle of "universal patrimonial liability" was first introduced in modern codifications by Article 2092 of the French *Code Napoléon* of 1804 ("Quiconque s'est obligé personnellement, est tenu de remplir son engagement sur tous ses biens mobiliers et immobiliers, présents et à venir."). The same principle can be found nowadays in many civil codes, including the Italian Civil Code and Civil Code of Québec. *See* Art. 2740 Codice civile [C.c.] (It.) ("The debtor is responsible for his obligations with all his present and future assets."); CIVIL CODE OF QUÉBEC, S.Q. 1991, c. 64, art. 2644 (Can.) ("The property of a debtor is charged with the performance of his obligations and is the common pledge of creditors."); CIVIL CODE OF QUÉBEC, S.Q. 1991, c. 64, art. 2645 (Can.) ("Any person under a personal obligation charges, for its performance, all his property, movable and immovable, present and future . . . .").

15. *See*, *e.g.*, ITALIAN BANKRUPTCY LAW, Royal Decree No. 267 (Mar. 16, 1942) where at art. 1, ¶ 1 it is stated: "Are subject to the provisions of bankruptcy law . . . entrepreneurs that carry on a commercial activity. . . ."

economy,”[16] slow economic growth among European countries.[17] In fact, the severe regime toward debtors’ liability typical of the civil law tradition has been blamed for making individuals more risk-averse and less willing to incur debt than they would under existing bankruptcy law in common law systems.[18] Based on this assumption, several countries—even those with a strong culture of saving[19]—have thought it

---

16. For a criticism of economic theories relying on consumption and indebtedness as tools to achieve economic growth *see* CARMEN M. REINHART & KENNETH ROGOFF, THIS TIME IS DIFFERENT: EIGHT CENTURIES OF FINANCIAL FOLLY *passim* (2009). For a critical sociological examination of the “consumer economy,” see ZYGMUNT BAUMAN, CONSUMING LIFE 1 *passim* (2007).

17. *See* Stanghellini, *supra* note 7, at 443.

18. A typical example of this rhetoric can be found in the Italian doctrinal debate on the opportunity to introduce consumer discharge. *See* Stanghellini, *supra* note 7, at 443:

> On the other hand, a strong pressure and/or an afflictive regime imposed on an insolvent debtor can persuade a person evaluating whether to take on debt not to do it and this is capable of resulting in a contraction of consumptions . . . and in a reduction of propensity to take risks, together with a loss for society both in terms of a reduction of social welfare and a reduction of entrepreneurial initiatives . . . . The prospect of a perpetual liability . . . is capable of producing a loss for society considering that an insolvent debtor will refrain from engaging in profitable activities and, at the same time, creditors will not gain any benefit from this abstention.

See also Riccardo Brogi, *Bilancio e indebitamento delle famiglie italiane*, L’INSOLVENZA DEL DEBITORE CIVILE DALLA PRIGIONE ALLA LIBERAZIONE 265, 280 (Gaetano Presti et al. eds., 2004). According to this author, regulating consumer discharge is a fundamental measure necessary to fill the gap that separates Italy from countries like the U.K. which the author considers, at least until the financial crisis of 2008, more efficient.

19. According to the International Monetary Fund, in 2007 Italian household debt relative to GDP was 48% as compared to 99.5% of U.S. households and 110.2% of U.K. households. *See* Pietro Reichlin, *I vizi e le virtù (nascoste) del debito*, IL SOLE 24 ORE (Feb. 21, 2010), *available at* http://www.ilsole24ore.com/art/SoleOnLine4/dossier/Italia/2009/commenti-sole-24-ore/21-febbraio-2010/vizi-virtu-nscoste-debito_PRN.shtml. Furthermore, in 2008, the Italian debt to income ratio was 45.3%, BANCA D’ITALIA, SUPPLEMENTO AL BOLLETTINO STATISTICO – I BILANCI DELLE FAMIGLIE ITALIANE NEL (2008), *available at* http://www.bancaditalia.it/statistiche/indcamp/bilfait/boll_stat/suppl_08_10_corr.pdf; and increased to 66% in 2011, BANCA D’ITALIA, BOLLETTINO ECONOMICO NUMERO 67 GENNAIO (2012), *available at* http://www.bancaditalia.it/pubblicazioni/econo/bollec/2012/bolleco67/bollec67/boleco_67.pdf. In the U.K., however, it was 152% in 2007, SUSAN BLOCK-LIEB ET AL.,

suitable to reform this liability regime and introduce discharge of consumer debt to boost debt propensity and, consequently, consumption.[20]

Undoubtedly, as American scholars have unanimously pointed, there is a strict correlation between consumer bankruptcy, household over-indebtedness and consumer credit.[21] Nevertheless, the U.S. debate

---

Disclosure as an Imperfect Means for Addressing Overindebtedness: An Empirical Assessment of Competitive Approaches, *in* CONSUMER CREDIT, DEBT & BANKRUPTCY – COMPARATIVE AND INTERNATIONAL PERSPECTIVES 153, 156 (Johanna Niemi et al. eds., 2009); and 155.4 % in 2011, *US, UK Households Start Reducing Their Debt Burdens*, FIRSTPOST, (Sept. 24, 2011), http://www.firstpost.com/world/us-uk-households-start-reducing-their-debt-burdens-91146.html. According to Garon, "[o]ver the past three decades, Germany, France, Austria and Belgium have maintained household saving rates between 10 and 13 percent, and rates in Sweden recently soared to 13 percent. By contrast, saving rates in the United States dropped to nearly zero by 2005; they rose above 5 percent after the 2008 crisis but have recently fallen below 4 percent." *See* Garon, *supra* note 4, at A35.

20. With regard to continental Europe, a very significant development has been the introduction of consumer discharge in France and Germany, which had traditionally adopted a "universal patrimonial liability" regime. In France, consumer bankruptcy was first introduced by Law No. 89-1010 of December 31, 1989 regarding "la prévention et au règlement des difficultés liées au surendettement des particuliers et des familles." This law was subsequently repealed by Decree No. 2004-180 of February 24, 2004 (recently amended by Law No. 2010-737 of July 1 2010 and by Decree No. 2010-1304 of October 29, 2010) regarding "la procédure de traitement des situations de surendettement des particuliers et modifiant le titre III du livre III du code de la consummation." The latter decree has been included in the *Code de la Consommation* (Titre III of the Livre III). In Germany, consumer discharge (Insolvenzordnung) was regulated by Gesetz, October 5, 1994, BGBl.I S. 2866, recently amended by Gesetz, December 9, 2010, BGBl I S. 1885. Greece adopted its first consumer and small business bankruptcy law in 2010 (Law No. 3869/2010). In Italy, consumer bankruptcy was regulated for the first time by Law No. 3 of January 27, 2012, which was later amended by Law Decree No. 179 of October 18, 2012 (later amended by Law No. 221 of December 17, 2012).

21. In the United States between 1979, the year following the enactment of the Bankruptcy Code of 1978, and 2004, consumer bankruptcy filings rose from 250,000 to 1.5 million. *See* Todd J. Zywicki, *An Economic Analysis of the Consumer Bankruptcy Crisis*, 99 NW. U. L. REV. 1463, 1464 (2005). From 1945 to 1970, consumer bankruptcy filings climbed from 11,051 to 178,202. *See* DAVID A. SKEEL, JR., DEBT'S DOMINION – A HISTORY OF BANKRUPTCY LAW IN AMERICA 136–37 (2001) [hereinafter SKEEL, DEBT'S DOMINION]. This increase has been explained as a direct consequence of the expansion of consumer credit, which was particularly encouraged by the introduction of credit cards in the sixties. In fact, in the same period, consumer debt expanded from $30 billion in 1945 to $569 billion in 1974. *See* Vern Countryman, *Improvident Credit*

on consumer bankruptcy has become polarized[22] with strong ideological positions on either side regarding the cause-and-effect relationship of consumer bankruptcy and consumer credit.[23] Pro-debtor scholars (the "progressive bankruptcy scholarship")[24] maintain that creditors and their predatory techniques must be blamed for household over-indebtedness and the consequential rise in consumer bankruptcy filings while pro-creditor scholars (the "conservative bankruptcy scholarship")[25] insist that the ease in obtaining discharge makes individuals opportunistically willing to incur more debt, which in turn, causes lenders to ration credit and demand more collateral.[26] The debtor-oriented approach reasons that ensuring easy access to discharge is a necessary remedy for over-indebted U.S. consumers. On the other hand, the creditor-oriented approach strongly supports the idea of making bankruptcy laws stricter in order to limit debtors' strategic behavior and make consumer credit more efficient.[27] It is worth noticing how these two schools of thought adopt opposite perspectives. While the former appeals to an *ex post* reasoning, viewing discharge as a last-resort remedy to over-indebtedness, the latter takes an *ex ante* approach, arguing that the restriction of discharge would establish the correct incentives for debtors, thereby making credit more available and cheaper.[28]

Extension: A New Legal Concept Aborning, 27 ME. L. REV. 1, 1 (1975). The correlation between bankruptcy and consumer debt is also stressed in RONALD J. MANN, CHARGING AHEAD: THE GROWTH AND REGULATION OF PAYMENT CARD MARKETS AROUND THE WORLD 60–72 (2006); Robert M. Lawless, *The Paradox of Consumer Credit*, 2007 U. ILL. L. REV. 347, 348 (2007); Bar-Gill, *Seduction by Plastic*, *supra* note 6, at 1373–74, 1413; and SULLIVAN ET AL., *supra* note 6, at 129. The financial literature agrees upon a correlation between credit card usage and consumer bankruptcy. *See* Ian Domowitz & Robert Sartain, *Determinants of the Consumer Bankruptcy Decision*, 54 J. FIN. 403 (1999). On the expansion of consumer credit in the United States, see LENDOL CALDER, FINANCING THE AMERICAN DREAM: A CULTURAL HISTORY OF CONSUMER CREDIT 1 *passim* (2001).

22. *See infra* Part IV.

23. The ideological character of the consumer bankruptcy debate in the United States is described by SKEEL, DEBT'S DOMINION, *supra* note 21, at 187–211.

24. *See* David A. Skeel, Jr., *Vern Countryman and the Path of Progressive (and Populist) Bankruptcy Scholarship*, 113 HARV. L. REV. 1075, 1077 (2000) [hereinafter Skeel, *Progressive Bankruptcy Scholarship*].

25. *See* SKEEL, DEBT'S DOMINION, *supra* note 21, at 200 (referring to this scholarship as "law-and-economics scholarship").

26. On the different theories of pro-debtor and pro-creditor scholars, see *infra* Part IV.

27. *See id*.

28. *See id*.

The recent global trends in personal bankruptcy policy—in particular, the European tendency to introduce discharge of consumer debt—represents a unique opportunity to have a second and deeper look at bankruptcy discharge to assess the effectiveness of the American debate on this topic. In fact, as it has been shown, the idea behind the liberalization of discharge practices in Europe is to make individuals more willing to incur debt, and therefore expand the consumer credit supply. Unlike the American progressive bankruptcy scholarship, the European approach does not treat discharge as a remedy for consumers' over-indebtedness, but instead adopts an *ex ante* perspective, regarding it as a way to encourage consumers to take on more debt. Meanwhile, it parts ways with the American conservative bankruptcy scholarship in contending that discharge will provoke the expansion, not rationing, of credit.

II. THE HISTORICAL EVOLUTION OF BANKRUPTCY DISCHARGE

In order to solve this puzzle as to whether discharge is a last resort to protect debtors or a powerful tool to encourage risk-taking behavior, one must understand the original rationale for bankruptcy discharge by exploring its historical evolution.

A. THE COMMON LAW TRADITION

1. England: The Emergence of Bankruptcy Discharge

In the thirteenth century, England passed a statute to introduce the measure of imprisonment for debtors in default.[29] In order to promote commerce, which was highly dependent on credit, such coercive imprisonment was considered to be a fundamental tool to protect

---

29. In particular, imprisonment for debt was introduced by the Statute of Marlbridge of 1267. *See* Jay Cohen, *The History of Imprisonment for Debt and its Relation to the Development of Discharge in Bankruptcy*, 3 J. LEGAL. HIST. 153, 154 (1982); *see also* Louis Edward Levinthal, *The Early History of English Bankruptcy*, 67 U. PA. L. REV. 1, 8–9 (1919). In early Roman law, the Law of the Twelve Tables provided for the physical punishment of an insolvent debtor and also the possibility of apportioning the debtor's body to creditors. *See* Rafael Efrat, *The Evolution of Bankruptcy Stigma*, 7 THEORETICAL INQ. L. 364, 373 (2006) [hereinafter Efrat, *Bankruptcy Stigma*].

creditors' interests.[30] Mere default was sufficient to detain the debtor. The law did not distinguish between defaulting debtors who were solvent and therefore perceived as fraudulent, and those who were honest but unfortunate, insolvent debtors.[31]

The first English bankruptcy laws of the sixteenth century were specifically conceived to protect those creditors who were willing to finance the risky adventures of the emerging English middle class: merchants and traders engaging in mercantile activities.[32] In fact, the earliest bankruptcy proceedings were confined to merchants and traders and not debtors whose obligations originated from different activities. The proceedings were conceived not to relieve debtors but for the exclusive purpose of protecting creditors from fraudulent debtor conduct and payment evasion.[33]

Only in the early 1700s did the idea of incentivizing the most dynamic sector of English society (traders and merchants) find its way into the political agenda.[34] Among the incentives aimed at increasing entrepreneurship and risk-taking was bankruptcy discharge.[35] Since the possibility of incorporating an organization was not generally admitted as a way of limiting debtors' liability, discharge was used as an alternative legal device to achieve a functionally equivalent outcome.[36]

Two fundamental elements characterized the original rationale behind discharge in the eighteenth century. First, a basic distinction was

---

30. Cohen, *supra* note 29, at 154–55.

31. *Id.* at 157; *see also* MICHAEL QUILTER, *The Quality of Mercy - The Merchant of Venice in the Context of the Contemporary Debt and Bankruptcy Law of England*, 6 INSOLV. L. J. 43, 45 (1998).

32. For an overview of the historical evolution of English bankruptcy law, see Ian P. H. Duffy, *English Bankrupts, 1571-1861*, 24 AM. J. LEGAL HIST. 283 (1980).

33. Both the Bankruptcy Act of 1542 and that of 1570 (An Act Touching Orders for Bankrupts) were enacted with the specific purpose of curbing debtors' ability to defraud creditors. *See* Cohen, *supra* note 29, at 155–56.

34. Charles J. Tabb, *The Historical Evolution of the Bankruptcy Discharge*, 65 AM. BANKR. L. J. 325, 335 (1991) [hereinafter Tabb, *The Historical Evolution of the Bankruptcy Discharge*].

35. *See id*.

36. *Id.*; s*ee also* Tabb, *Scope of the Fresh Start*, *supra* note 2, at 100; CHARLES J. TABB, THE LAW OF BANKRUPTCY 68 (1997) [hereinafter TABB, LAW OF BANKRUPTCY]; Thomas J. Jackson, *The Fresh-Start Policy in Bankruptcy Law*, 98 HARV. L. REV. 1393, 1400 (1985); Cohen, *supra* note 29, at 160–62. Discharge is viewed as a means to spur commercial enterprise. *See* Efrat, *Global Trends*, *supra* note 2, at 81 ("Since entrepreneurs generally face a higher risk of financial failure as compared to wage earners, a broad fresh start policy in bankruptcy provides a necessary cushion to accommodate their increased financial vulnerability.").

made between fraudulent traders and merchants and honest traders and merchants who were victims of unavoidable misfortunes related to their highly risky activities.[37] Therefore, bankruptcy discharge was suggested as a means of relief for the latter group that experienced financial distress because of exogenous events.[38]

Second, only traders and merchants were included within the scope of bankruptcy laws.[39] Since discharge was available only through a bankruptcy proceeding, non-trading debtors were unable to benefit from it.[40] Any debt that was not assumed for a commercial enterprise was perceived as unreasonable and morally unacceptable.[41]

---

37. Duffy, *supra* note 32, at 286–87.

38. *See id.*

39. Tabb, *The Historical Evolution of the Bankruptcy Discharge*, *supra* note 34, at 334–35.

40. *See id.*

41. *See id.* The reasons lying behind the restriction of bankruptcy laws to traders and merchants are explained in exemplary fashion by William Blackstone:

> A bankrupt was before defined 'a trader who secretes himself, or does certain other acts, tending to defraud his creditors.' He was formerly considered merely in the light of a criminal or offender; . . . But at present the laws of bankruptcy are considered as laws calculated for the benefit of trade, and founded on the principles of humanity as well as justice; and to that end they confer some privileges, not only on the creditors, but also on the bankrupt or debtor himself. The laws of England . . . are cautious of encouraging prodigality and extravagance by this indulgence to debtors; and therefore they allow the benefit of the laws of bankruptcy to none but actual traders; since that set of men are, generally speaking, the only persons liable to accidental losses, and to an inability of paying their debts, without any fault of their own. If persons in other situations of life run in debt without the power of payment, they must take the consequences of their own indiscretion, even though they meet with sudden accidents that may reduce their fortunes: for the law holds it to be an unjustifiable practice, for any person but a trader to encumber himself with debts of any considerable value. If a gentleman, or one in a liberal profession, at the time of contracting his debts, has a sufficient fund to pay them, the delay of payment is a species of dishonesty, and a temporary injustice to his creditor: and if, at such time, he has no sufficient fund, the dishonesty and injustice is the greater. He cannot therefore murmur, if he suffers the punishment which he has voluntarily drawn upon himself. But in mercantile transactions the case is far otherwise. Trade cannot be

In this cultural and economic context at the outset of the eighteenth century, the proposal to introduce bankruptcy discharge for those unfortunate but honest and cooperative traders and merchants was first accepted and regulated by the Act of 1705.[42] Meanwhile, imprisonment remained the rule for non-trading debtors in default until 1869.[43]

The Act of 1705 represents a fundamental stage in the evolution of bankruptcy law.[44] This law was framed to distinguish among different categories of debtors, taking into consideration both the human vicissitudes lying behind the financial distress in question (fraudulent as opposed to honest but unfortunate debtors) and the activity responsible for the incurred debt (traders and merchants as opposed to non-trading debtors).[45] While sixteenth and seventeenth century bankruptcy law was conceived as a purely pro-creditor device and reserved only for traders and merchants who were thought to be more inclined to defraud creditors, in the eighteenth century, bankruptcy law started appreciating,

---

> carried on without mutual credit on both sides: the contracting of debts is therefore here not only justifiable but necessary. And if by accidental calamities, as by loss of a ship in a tempest, the failure of brother traders, or by the nonpayment of persons out of trade, a merchant or trader becomes incapable of discharging his own debts, it is his misfortune and not his fault.

WILLIAM BLACKSTONE, COMMENTARIES ON THE LAWS OF ENGLAND 473–75 (1765).

42. An Act to Prevent Frauds Frequently Committed by Bankrupts (4 & 5 Anne c. 17) is the name of the Act of 1705 that first introduced the practice of bankruptcy discharge. *See* Tabb, *The Historical Evolution of the Bankruptcy Discharge*, *supra* note 34, at 333–34 (pointing out the fact that discharge was not automatic, but was considered a judicial act within the discretion of the bankruptcy commissioners).

43. Cohen, *supra* note 29, at 155–57, 162–64; *see also* PETER J. COLEMAN, DEBTORS AND CREDITORS IN AMERICA: INSOLVENCY, IMPRISONMENT FOR DEBT, AND BANKRUPTCY, 1607-1900, 7, n.8 (1974) ("If a man be taken in execution, and lie in prison for debt, neither the plaintiff, at whose suit he is arrested, nor the sheriff who took him, is bound to find him meat, drink, or clothes; but he must live on his own, or on the charity of others; and if no man will relieve him, let him die in the name of God, says the law; and so say I.") (quoting Judge Robert Hyde).

44. *See* Tabb, *The Historical Evolution of the Bankruptcy Discharge*, *supra* note 34, at 333.

45. *See id.* at 338; Levinthal, *supra* note 29, at 18–19 (regarding traders and merchants, "[t]he discharge was the result of the gradual realization of the fact that in many cases the bankruptcy might be properly an object of pity"); BLACKSTONE, *supra* note 41, at 471–72 (pointing out, in a perspective that would be defined today as in accordance with law and economics, the benefit to society of eliminating the prior debts of a trader so that he "by the assistance of his allowance and his own industry, may become a useful member of the commonwealth").

through the benefit of bankruptcy discharge, the social value of those groups who were willing to challenge the uncertainties of mercantile activity in order to increase both their own welfare and the social welfare.[46] This shift in the collective perception of traders and merchants triggered a process of transformation in bankruptcy law from a purely creditor-oriented remedy to a pro-debtor one that emphasized risk-taking, debtors' cooperation during the bankruptcy proceeding, and restoring debtors to a productive economic cycle.

In sum, honesty and being the unfortunate victim of an exogenous event are the two fundamental elements that, in the eighteenth century, justified the introduction of discharge and the loosening of creditors' influence in managing the financial distress of their debtors.[47]

2. The United States: From the Origins Through the Nineteenth Century Pro-Debtor Approach

Notwithstanding the U.S. Constitution of 1787, which includes a bankruptcy clause that allows Congress to legislate at a federal level,[48] in the late eighteenth century, this federal power was not exercised.[49] Yet, several states passed laws to grant debtors some sort of relief.[50]

The first federal bankruptcy law was the Bankruptcy Act of 1800. It followed its English precedents and was mainly aimed at protecting creditors rather than implementing a broad discharge policy.[51] As with the English bankruptcy laws, only merchants were included within the scope of the proceeding.[52] In addition, this proceeding was involuntary in the sense that only creditors could file the petition, and discharge was not automatic because the approval of the bankruptcy commissioners

---

46. Tabb, *The Historical Evolution of the Bankruptcy Discharge*, *supra* note 34, at 338.

47. Blackstone recognizes the importance of honesty by stating that "the law seems to be pretty rigid and severe against the bankrupt; but, in case he proves honest, it makes him full amend for all this rigour and severity." BLACKSTONE, *supra* note 41, at 482

48. U.S. CONST. art. I, § 8, cl. 4.

49. Tabb, *The Historical Evolution of the Bankruptcy Discharge*, *supra* note 34, at 344.

50. *Id.* at 345.

51. *Id.*

52. *Id.* at 346.

and creditors was needed.[53] Notwithstanding its pro-creditor approach, the Bankruptcy Act of 1800 was repealed only three years later, unable to hold out against the accusation that it favored mercantile interests over agricultural ones,[54] enabled creditors to receive only a small dividend of their credit, and incited fraudulent behavior on the part of debtors who were granted discharge.[55]

The U.S. Congress then enacted new federal bankruptcy legislation, the Bankruptcy Act of 1841. Unlike the Bankruptcy Act of 1800, which did not depart from its English precedents, the Bankruptcy Act of 1841 represented a significant step in the historical evolution of bankruptcy law, particularly with regard to tensions between the interests of creditors and debtors.[56] This was so because the severe financial crisis of 1837 led to reduced creditor control and the introduction of two major innovations. First, the traditional restriction that allowed only merchants to access the bankruptcy proceeding was repealed, enabling "all persons whatsoever . . . owing debts" to obtain discharge.[57] Furthermore, "voluntary bankruptcy" appeared for the first time, whereby non-merchant debtors were allowed to file a petition for bankruptcy in order to obtain discharge, subject to creditors' approval.[58]

The new voluntary bankruptcy proceeding, together with the possibility for every debtor to file a petition for discharge, dramatically

---

53. *Id.* On the involuntary character of the early bankruptcy laws, *see* ELIZABETH WARREN & JAY L. WESTBROOK, THE LAW OF DEBTORS AND CREDITORS: TEXT, CASES, AND PROBLEMS 107 (2006). It is worth noting that the first voluntary bankruptcy proceeding (where also debtors were allowed to file the petition) was the United States Bankruptcy Law of 1841. *See* Tabb, *The Historical Evolution of the Bankruptcy Discharge*, *supra* note 34, at 349–50.

54. Tabb, *The Historical Evolution of the Bankruptcy Discharge*, *supra* note 34, at 348. The criticism of discharge as a device favoring the mercantile class must be read within the broader tensions among mercantile interests represented by the Federalist Alexander Hamilton, and agricultural interests represented by the Republican Tomas Jefferson. *See* SKEEL, DEBT'S DOMINION, *supra* note 21, at 3, 26.

55. Tabb, *The Historical Evolution of the Bankruptcy Discharge*, *supra* note 34, at 348.

56. *Id.* at 353.

57. *See* Bankruptcy Act of 1841, ch. 9, § 4 Stat. 444 (1841); Tabb, *The Historical Evolution of the Bankruptcy Discharge*, *supra* note 34, at 350. In England, the bankruptcy proceeding became available to all persons, including non-trading debtors in 1861. *See* 1861, 24 & 25 Vict., c. 134, §§ 69, 86 (Eng.).

58. Tabb, *The Historical Evolution of the Bankruptcy Discharge*, *supra* note 34, at 349–50. The voluntary character of bankruptcy was introduced in England three years later. *See* 1844, 7 & 8 Vict., c. 96, § 41 (Eng.).

shifted the equilibrium of bankruptcy law toward favoring debtors.[59] Yet, notwithstanding the new legislation's changing of fundamental aspects, the original rationale of discharge—to protect only the honest but unfortunate debtor—was preserved because debtors who committed fraudulent acts were ineligible.[60]

In 1898, following the repeal of the Bankruptcy Act of 1841 in 1842 and the adoption of the Bankruptcy Act of 1867 (repealed in 1878),[61] the U.S. enacted a new national bankruptcy law, the Bankruptcy Act of 1898.[62] Since then, a federal bankruptcy law has always been in existence.[63] In the 1898 law, both the extension of eligibility to all debtors and the voluntary character of bankruptcy proceeding (available to any debtor except corporations) were confirmed.[64] In addition, discharge—and therefore, a pro-debtor policy—was strengthened thanks to the repeal of two requirements: creditors' consent to the granting of the discharge and the payment of a minimum dividend to creditors.[65]

Thus, the main goal of bankruptcy law was no longer to protect creditors from the abusive behavior of the mercantile class, but rather to allow debtors suffering from business misfortunes to once again become

---

59. *See* Tabb, *The Historical Evolution of the Bankruptcy Discharge*, *supra* note 34, at 349–50.

60. Bankruptcy Act of 1841, ch. 9, § 5 Stat. 440 (1841).

61. Bankruptcy Act of 1867, ch. 176, § 14 Stat. 517 (1867).

62. Bankruptcy Act of 1898, ch. 541, § 30 Stat. 544 (1898).

63. Tabb, *The Historical Evolution of the Bankruptcy Discharge*, *supra* note 34, at 362.

64. *Id.* at 363.

65. *Id.* at 364. "No check on discharges other than the statutory limitations remained. This innovation marked as much as anything else the arrival of the 'modern' American pro-debtor discharge policy." *Id.* ("The reform in the United States thus was more radical than the 1883 English reform, in which control of the discharge simply had been shifted from creditors to the court. Surprisingly, this major change in basic policy occurred with little fanfare or debate."); *see also* SKEEL, DEBT'S DOMINION, *supra* note 21, at 38–39 ("Unlike creditor organizations, farmers and other rural constituencies did not send memorials to Congress or develop specific legislative proposals. Yet bankruptcy was an extraordinarily prominent issue, and lawmakers from farm states actively promoted the ideological views of their rural constituents. Ideological entrepreneurs such as Representative Bailey of Texas, who spearheaded the campaign for a voluntary-only bankruptcy bill in the mid-1890s, and Senator Stewart of Nevada, provided a public face for the prodebtor perspective. . . . By the 1890s, populist lawmakers were the standard bearers for the prodebtor perspective, and the debates that led to the 1898 act were full of their exchanges with proponents of a federal bankruptcy law.").

a useful member of society.[66] Accordingly, discharge—first introduced to encourage debtors' cooperation in satisfying creditors' interests[67]—had entirely become a means to protect debtors.[68] This radical shift within the common law tradition from a pro-creditor to pro-debtor system was justified by the growing acceptance that freeing debtors from their burdensome debts and repositioning them to become productive again would improve economic efficiency.[69]

Yet, the new widespread possibility for merchants to protect their personal assets ("limited liability") through the creation of a new legal entity made discharge less appealing for commercial activities and placed non-trading debtors (those not engaged in a commercial activity) at the center stage of the bankruptcy proceeding.[70] In fact, discharge was—just as it is today—capable of achieving for individuals the same legal effect that was achieved through the formation of a new legal entity in commercial activities: limiting the debtor's liability toward his creditors.[71]

---

66. Local Loan Co. v. Hunt, 292 U.S. 234, 244 (1934) ("One of the primary purposes of the bankruptcy legislation is to relieve the honest debtor from the weight of oppressive indebtedness and permit him to start afresh, free from the obligations and responsibilities consequent upon business misfortunes . . . to give to the honest but unfortunate debtor . . . a new opportunity in life and a clear field for future effort."). *See* Stefan A. Riesenfeld, *The Evolution of Modern Bankruptcy Law – A Comparison of the Recent Bankruptcy Acts of Italy and the United States*, 31 MINN. L. REV. 401, 406 (1947); *see also* SKEEL, DEBT'S DOMINION, *supra* note 21, at 43; Zywicki, *supra* note 21, at 1471.

67. *See supra* Part II.A.1.

68. *See* Tabb, *The Historical Evolution of the Bankruptcy Discharge*, *supra* note 34, at 364–65.

69. *See* TABB, LAW OF BANKRUPTCY, *supra* note 36, at 94–96.

70. *See* Tabb, *The Historical Evolution of the Bankruptcy Discharge*, *supra* note 34, at 363 ("With the increased availability of the corporate form to limit liability for entrepreneurs, discharge in bankruptcy now was principally important only for non-merchants individuals."); *see also* Charles G. Hallinan, *The "Fresh Start" Policy in Consumer Bankruptcy: A Historical Inventory and an Interpretive Theory*, 21 U. RICH. L. REV. 49, 65 (1986) (showing how in the first half of the twentieth century the typical bankrupt shifted from merchant to wage earner). On the historical evolution of organizational forms in the common law tradition, see Henry Hansmann, Reinier Kraakman & Richard Squire, *Law and Rise of the Firm*, 119 HARV. L. REV. 1335 (2006).

71. *See supra* note 36 and accompanying text; *see also* DOUGLAS G. BAIRD & THOMAS J. JACKSON, CASES, PROBLEMS AND MATERIALS ON BANKRUPTCY 34 (2d ed. 1990).

Notwithstanding the further strengthening of debtor interests in the Bankruptcy Act of 1898, the original rationale for discharge (the protection of the honest but unfortunate debtor)[72] was, as with the Bankruptcy Act 1841,[73] reaffirmed in this legislation.

> If the debtor has acted dishonestly by committing certain acts forbidden in the bill he will not be discharged; if he has acted honestly he will be. The granting of a discharge is justified by a wise public policy. The granting or withholding of it is dependent upon the honesty of the man, not upon the value of his estate.[74]

Yet, unlike English bankruptcy law, where discharge was submitted to strict judicial discretion,[75] the Bankruptcy Act of 1898 made discharge more or less automatic, repealing nearly every judicial check on discharge aside from the statutory limitations.[76] The Bankruptcy Act of 1898, therefore, marked the start of a gradual departure of U.S. bankruptcy law from its original intuition, which was to forgive only those debtors that were victims of exogenous misfortunes. It was only until the twentieth century that bankruptcy discharge underwent a more radical ideological transformation: from a safety net for the honest but unfortunate debtor to providing a safe harbor for any over-indebted person.[77]

B. THE CIVIL LAW TRADITION: A PRO-CREDITOR APPROACH

In the nineteenth century, the civil law and common law traditions parted ways regarding the treatment of non-trading debtors' liability toward creditors. Until 1841 in the United States and 1861 in England,[78] only traders and merchants were eligible for bankruptcy discharge while non-trading debtors were forced into coercive imprisonment until they

---

72. *See* Riesenfeld, *supra* note 66, at 406.

73. *See supra* note 60 and accompanying text.

74. H.R. Rep. No. 55-65, at 43 (1897).

75. *See* The Bankruptcy Act, 1883, 46 & 47 Vict., c. 52, § 18(6) (Eng.); *see also* SKEEL, DEBT'S DOMINION, *supra* note 21, at 90; Tabb, *The Historical Evolution of the Bankruptcy Discharge*, *supra* note 34, at 363–64.

76. *See* SKEEL, DEBT'S DOMINION, *supra* note 21, at 90; Tabb, *The Historical Evolution of the Bankruptcy Discharge*, *supra* note 34, at 363–64.

77. *See infra* Part III.A.

78. *See* Tabb, *The Historical Evolution of the Bankruptcy Discharge*, *supra* note 34, at 334–35 n.57 and accompanying text.

could fully repay their debts.[79] Yet, the common law of the mid-nineteenth century, by making all debtors eligible for discharge, radically amended the regime for non-trading debtors.

Meanwhile, during the first half of the 1800s, several civil law countries—particularly those influenced by the Napoleon Code of 1804—also had legal regimes that excluded non-trading debtors from bankruptcy laws and therefore, from discharge. Furthermore, these countries regulated debtor liability on the premise that all of the debtor's property was charged with the performance of the debtor's obligations. Accordingly, debtor property was the common pledge of creditors, a principle known as "universal patrimonial liability."[80]

The historical evolution of the concept of patrimony helps to explain this approach.[81] An anthropocentric vision arose out of the philosophy borne by the Enlightenment and Romantic movements whereby assets or property were conceived as the external manifestation of an individual and thus, a tangible expression of the human personality.[82] The notion of such an indissoluble bond between the individual and his patrimony shifted from a philosophical doctrine to a legal one during the first half of the nineteenth century.[83] "Since human attributes were indivisible and intangible, the patrimony was also considered indivisible and intangible."[84] Therefore, all of a debtor's property was conceived as the common pledge of creditors, leading to the idea of universal patrimonial liability.[85] Although civil law scholars began to question the singleness and indivisibility of patrimony doctrine in the early twentieth century, the fundamental dogma remained that

79. *See id.*; *see also* Cohen, *supra* note 29, at 157–59 (noting that in the seventeenth century, England introduced insolvency proceedings which aimed to exempt from imprisonment those debtors that were not trying to defraud their creditors but were simply insolvent).

80. *See supra* note 14 and accompanying text.

81. *See* Rojas Elgueta, *supra* note 13, at 527–30.

82. *See id.* at 527 & n.40.

83. *See id.* (internal citations omitted). "This shift is normally ascribed to a French [legal] handbook written by a German scholar, K.S. Zachariae, and subsequently updated and augmented by two French scholars, Charles Aubry & Charles Rau, Cours de Droit Civil Français, d'Après l'Ouvrage de M. C.S. Zacharie (1856-1858)." *Id.* at 527 n.41; *see* Charles Aubry & Charles Rau, Cours de Droit Civil Français, d'Après l'Ouvrage de M. C.S. Zacharie (1856-1858), *available at* http://gallica.bnf.fr/ark:/12148/bpt6k5846820d/f8.image.

84. *See* Rojas Elgueta, *supra* note 13, at 527.

85. *See id.* at 525, 527, 529–30.

only a *numerus clausus* of circumstances provided by law could limit a debtor's liability.[86]

Thus, when the common law tradition was introducing bankruptcy discharge for non-trading debtors,[87] the civil law tradition was codifying the universal patrimonial liability principle.[88] The shift in the common law tradition from creditors' dominion—evident in the practice of imprisonment for debts—to a pro-debtor system characterized by a broader scope of bankruptcy discharge was the result of an economics-based premise, according to which it is considered more efficient to readmit debtors into a productive economic cycle.[89] On the other hand, the universal patrimonial liability rule typified by the civil law tradition was shaped around doctrinal and dogmatic debates on the nature of patrimony.[90] The different historical courses of the common law and civil law traditions with regard to non-trading debtors' liability explain the conventional wisdom according to which common law's liberal bankruptcy discharge policy makes it a pro-debtor system, while civil law's universal patrimonial liability rule makes it a pro-creditor one.[91]

---

86. A clear example of this approach can be found in Article 2645 of the Civil Code of Québec: "Any person under a personal obligation charges, for its performance, all his property, movable and immovable, present and future, except property . . . which is the object of a division of patrimony permitted by law." CIVIL CODE OF QUÉBEC, S.Q. 1991, c. 64, art. 2645 (Can.). An identical principle is stated in Article 2740 Italian Civil Code: "The debtor is responsible for his obligations with all his present and future assets. Limitations of liability are not allowed except in the circumstances provided by law." Art. 2740 Codice civile [C.c.] (It.).

87. *See supra* note 57 and accompanying text.

88. *See supra* note 14 and accompanying text.

89. *See supra* notes 45, 64, and 70 and accompanying text.

90. One could argue that bankruptcy discharge is not technically an exception to the universal patrimonial liability rule, since it eliminates the debt itself instead of limiting the assets that are charged with the performance of the debt. Nevertheless, it is apparent that discharge and universal patrimonial liability represent two opposite policies governing debtor-creditor relations. As has been noticed in the Italian doctrine, "Notwithstanding our legal tradition provides that the debtor is responsible for his obligations with all his present and future assets (Art. 2740 C. Civ.), in principle, there's nothing to prevent that that tradition, in light of other requirements in case considered nowadays prevailing, could be changed." *See* Stanghellini, *supra* note 7, at 438.

91. Among the many authors on the favorable treatment that debtors receive in the U.S. system, see SKEEL, DEBT'S DOMINION, *supra* note 21, at 1 ("What is clear, however, is that U.S. bankruptcy law is far more sympathetic to debtors than are the laws of other nations."). The *favor creditoris* in the Italian legal system is emphasized,

III. BANKRUPTCY DISCHARGE IN THE TWENTIETH CENTURY AND THE MOST RECENT TRENDS IN THE UNITED STATES AND EUROPE

A. FROM A REMEDY FOR THE HONEST BUT UNFORTUNATE DEBTOR TO A SAFE HARBOR FOR THE OVER-INDEBTED DEBTOR

Before verifying whether the respective labels of "pro-debtor" and "pro-creditor" for common and civil law regimes are compatible with a new descriptive analysis conducted through the lens of the behavioral law-and-economics methodology, it is worth emphasizing the trends that characterize discharge in the United States over the last fifty years.

As highlighted in Part I.B of this Article, in the past few decades, continental European countries generally trended toward the adoption of bankruptcy discharge and the inclusion of consumers within the scope of bankruptcy laws.[92] In contrast, in the United States—traditionally the most liberal country in terms of access to discharge—the past decades have been marked by a heated debate over the question of whether to limit the scope of discharge.

Starting in the 1960s, the consumer credit industry strongly invoked the adoption of regulations to restrict discharge.[93] In particular, financial institutions lobbied for Congress to adopt the so-called "means test," a provision that would prevent a debtor from obtaining immediate discharge through the liquidation of the debtor's assets and instead force that debtor to go through a program of debt adjustment upon being able to repay at least some of the debts.[94] Despite creditors' aggressive efforts, the National Bankruptcy Review Commission, whose findings shaped the Bankruptcy Code of 1978,[95] rejected the means test and adopted a debtor-oriented approach.

An especially notable innovation is the Commission's proposal to repeal the provision in the Chapter 13 proceedings that denied discharge for any debt based upon a fraudulent financial statement (the "fraud exception").[96] The elimination of this fraud exception from the Bankruptcy Code of 1978 and the resulting Chapter 13 "super discharge," one that includes debt based on a fraudulent statement,

---

among others, by ENRICO MOSCATI, LA DISCIPLINA GENERALE DELLE OBBLIGAZIONI – CORSO DI DIRITTO CIVILE 32 (2012).

92. *See supra* Part I.B.

93. *See* SKEEL, DEBT'S DOMINION, *supra* note 21, at 154.

94. *See id.*

95. *See id.* at 139.

96. *See id.* at 154–55.

reveals the enormous divide between the original rationale of the policy (protecting the *honest* but unfortunate debtor) and the modern version, which also applies to, at least in some circumstances,[97] the *dishonest* debtor.

By the twentieth century, the original prerequisite for obtaining discharge—that an honest debtor was the victim of an exogenous, misfortunate event that caused the financial distress—was no longer required.[98] In this much more basic model, over-indebtedness was the only prerequisite for discharge, regardless of the reasons for the financial distress and the honesty of the debtor.[99] The gradual affirmation of debtors' interests has culminated in a radical new reading of the expression "honest but unfortunate," which now extends the concept of "misfortune" to include all debtors who are unable to repay a debt, even when the debt originated as the result of a bad financial judgment, imprudence, or sometimes, a fraudulent act.[100]

---

97. Section 1328(a)(2) of the Bankruptcy Code of 1978, in its original version preceding BAPCPA (*see infra* note 104 and accompanying text), did not exempt from discharge debt obtained through false pretenses, false representation or actual fraud, missing a specific reference to § 523(a)(2)(A) where exceptions to discharge are regulated. *See also infra* note 107.

98. *See supra* note 66 and accompanying text.

99. The radical shift in the bankruptcy discharge rationale is exemplified by the statement made before the U.S. Congress by Ellen Broadman, representative of the Consumers Union, during the hearings held in 1984 for the reform of the Bankruptcy Code of 1978: "The proposal is totally at odds with the philosophy underlying the bankruptcy law of allowing individuals who are overwhelmed by crushing debt obligations to start a new, fresh life without debt burden." SKEEL, DEBT'S DOMINION, *supra* note 21, at 193–94. The deep transformation of the prerequisites for bankruptcy discharge is also apparent when comparing Broadman's words with an opinion delivered by an English judge in 1810: "[r]elief is to be extended to those who are both honest and unfortunate. Honesty alone will not be a title, if the debtor has come to his ruin by his own imprudence, without misfortune." *Brown's Case*, 1 Mart. (o.s.) 158, 159–60 (La. 1810).

100. This approach is clearly expressed by Douglas G. Baird, *Discharge, Waiver, and the Behavioral Undercurrents of Debtor-Creditor Law*, 73 U. CHI. L. REV. 17, 25 (2006) ("Every debtor in dire financial straits is 'unfortunate.' You are eligible for a discharge even if your financial difficulties arise from bad judgment or improvidence, as long as you are honest. Honest people are sometimes unable to pay what they owe, and when this happens the law should be there to help. So long as they act in good faith, the right to discharge in bankruptcy is available. Instead of limiting the discharge to only some debtors in dire straits, the word 'unfortunate' now merely describes their condition.").

B. A CHANGE IN TREND IN THE UNITED STATES CONSUMER BANKRUPTCY

Due to the relative neglect of the pro-creditor position in the Bankruptcy Code of 1978, the consumer credit industry insisted on the need to restrict access to bankruptcy discharge, stressing that bankruptcy filings increased by 60% within one year of the law's passage and had constantly increased since.[101] In the second half of the 1990s, financial institutions submitted a new proposal to Congress that would introduce a means test into the Bankruptcy Code of 1978 in order to limit automatic discharge under Chapter 7 and instead, have Chapter 13 apply to debtors who were capable of paying some portions of their debts.[102] Despite the efforts of progressive bankruptcy scholars who firmly opposed this means test[103] on the ground that consumers are best protected through broad access to discharge, in 2005, financial institutions won the battle with the enactment of the Bankruptcy Abuse Prevention and Consumer Protection Act ("BAPCPA").[104]

According to the scholars who supported the means test, BAPCPA forces debtors with incomes above their state median and higher than a specified portion of their debts to follow a debt adjustment plan.[105] Ultimately, BAPCPA is designed to end abusive behaviors of those who use discharge to strategically plan their finances (so-called the "bankruptcy of convenience").[106] Furthermore, the lobbyists also

---

101. *See* SKEEL, DEBT'S DOMINION, *supra* note 21, at 190.

102. *Id*. at 202.

103. According to progressive bankruptcy scholars, the elimination of the choice between Chapter 7 and Chapter 13 is equivalent to the re-establishment of a modern form of "involuntary servitude" for individuals and the betrayal of the pro-debtor U.S. approach to consumer bankruptcy. *Id.* at 194–95, 204; *see also* Vern Countryman, *Bankruptcy and the Individual Debtor – and a Modest Proposal to Return to the Seventeenth Century*, 32 CATH. U. L. REV. 809, 826–27 (1983) [hereinafter Countryman, *Bankruptcy and the Individual Debtor*].

104. On the advisability of introducing the "means test," see Edith H. Jones & Todd J. Zywicki, *It's Time for Means Testing*, 1999 BYU L. REV. 215 (1999).

105. The "means test" is regulated by § 707(b) of the Bankruptcy Code of 1978. 11 U.S.C. § 707(b) (2012).

106. *See* Zywicki, *supra* note 21, at 1497 ("Second, a debtor's increased use of credit cards preceding bankruptcy may also reflect strategic behavior taken in anticipation of filing bankruptcy. Credit card debt is unsecured debt that can be discharged in bankruptcy. By contrast, some unsecured debts are not dischargeable in bankruptcy, and secured debts, such as home and auto loans, are minimally affected. For unsecured credit card debt, by contrast, generally the debtor can retain the property purchased with the credit card and discharge the obligation. Given the choice between defaulting on secured or nondischargeable obligations on the one hand versus

promised that the reform would not exclude bankruptcy's prototypical "honest and unfortunate debtor" with median or below-median income from obtaining discharge.[107]

Meanwhile, the progressive camp argued that the real scope of BAPCPA did not limit access to Chapter 7 discharge for solvent debtors, but rather deferred bankruptcy filing for all debtors notwithstanding their income and ability to repay their debts.[108] In other words, financial institutions did not share the goal of limiting the scope of discharge. Instead, they wanted to make filings more complicated in order to delay any proceedings so that debtors would continue to make payments to creditors, thereby increasing creditors' revenues.[109]

In any case, the reform of 2005 undoubtedly marked a clear shift away from the pro-debtor ideological monopoly that had characterized U.S. bankruptcy law since the mid-nineteenth century.

---

dischargeable credit card debt on the other, the incentive is to use credit cards to finance payment of nondischargeable and secured debt."); *see also* Ronald J. Mann, *Bankruptcy Reform and the "Sweat Box" of Credit Card Debt*, U. ILL. L. REV. 375, 376–77 (2007) ("Proponents spent much less time discussing the economics of the consumer credit industry or the business models of those most affected by consumer bankruptcy. In particular, the debates often focused on the concept of needs-based bankruptcy—or the concern that the skyrocketing bankruptcy filing rates indicate that consumers are using the bankruptcy system for financial planning purposes rather than as a last resort. The catch phrase in the legislative history was the 'bankruptcy of convenience.'").

107. *See* Robert M. Lawless, Angela K. Littwin, Katherine M. Porter, John A. E. Pottow, Deborah K. Thorne & Elizabeth Warren, *Did Bankruptcy Reform Fail? An Empirical Study of Consumer Debtors*, 82 AM. BANKR. L. J. 349, 352 (2008). It is worth noting that BAPCPA repealed the *superdischarge* of Chapter 13 first introduced in 1978. After the reform of 2005, § 1328(a)(2) of the Bankruptcy Code of 1978 includes false pretenses, false representation, and actual fraud among the Chapter 13 exceptions to discharge.

108. *See id.* at 377–85; *see also* Mann, *supra* note 106, at 392–400.

109. *See* Mann, *supra* note 106, at 384 ("In my view, the most important aspect of the new law is not the increased payouts associated with means testing, but the way in which the law encourages debtors to defer bankruptcy filings."). *Id.* at 392 ("If those card users continue to make payments until shortly before they surrender and file for bankruptcy, the delay in filing—lengthening the time in the 'sweat box'—will increase the profits the lenders receive from those accounts, or decrease the losses the lenders will face when those customers ultimately file for bankruptcy.").

C. THE EUROPEAN CONSUMER BANKRUPTCY OPPOSITE TREND

Meanwhile, the European approach, which has departed from its traditional pro-creditor approach in the past decades, rejects both the American progressive and conservative bankruptcy traditions by viewing discharge as a way to not only protect consumers but also to encourage them to take on more debt.[110] In rejecting these positions,[111] the European trend represents a unique opportunity to reconsider the traditional analysis and challenge the common picture of discharge as a fundamentally pro-debtor legal device.

IV. A DESCRIPTIVE ANALYSIS OF BANKRUPTCY DISCHARGE

In order to give a new descriptive analysis of bankruptcy discharge, it is first necessary to understand the core characteristics of discharge that both the progressive and conservative bankruptcy traditions recognize.

A. THE UNDISPUTED ASPECTS OF BANKRUPTCY DISCHARGE

It is commonly accepted that bankruptcy discharge aims to achieve three different goals. One is to allow and encourage debtors, freed from their debts, to once again become productive members of society. The underlying premise is that the cost of the discharge is less than the cost that society would bear if debtors, without the availability of discharge, were excluded from economic activity due to the perpetual obligation to repay their debts.[112] This theoretical justification for discharge, explained in terms of "freedom of opportunity," has primarily developed in the United States.[113] According to this deeply rooted theory in American culture, incentivizing individual risk-taking—and therefore, collectively sharing the risk that some private initiatives will fail—is fundamental to maximizing social welfare.[114]

---

110. *See supra* Parts I.A and I.B.

111. *See supra* Part I.B.

112. *See*, *e.g.*, William O. Douglas, *Some Functional Aspects of Bankruptcy*, 41 Y. L.J. 329, 340 (1932); *see also* Local Loan Co. v. Hunt, 292 U.S. 234, 244 (1934); Tabb, *Scope of the Fresh Start*, *supra* note 2, at 90.

113. *See* Douglas, *supra* note 112, at 340.

114. *See id.* ("The theory of freedom of opportunity which has prevailed in this country has resulted in a minimum of governmental interference in strictly private enterprise. Denial of discharges in bankruptcy has been guarded zealously in the

The second goal of discharge is to provide debtors with insolvency insurance.[115] Third, the device seeks to promote debtor cooperation with the bankruptcy trustee and creditors regarding debt collection and asset liquidation during bankruptcy proceedings.[116]

B. THE PROGRESSIVE BANKRUPTCY SCHOLARSHIP

Aside from the aforementioned, uncontroversial aspects of bankruptcy discharge, the analysis is highly ideological and held hostage by the antithetical viewpoints of the progressive and conservative bankruptcy scholarships.

---

interest of hard-pressed debtors who desire a new lease on life. The fact that this is a country with large natural resources has led to the notion that failures can be afforded; that experimentation in enterprise should be encouraged; that out of the failures may come successes which will result in the promotion and development of our industrial and economic potentialities. That the annual bill which consumers pay for such experimentation is large is not denied. But it is insisted that it is worth the price."); *see also* SULLIVAN ET AL., *supra* note 6, at 258 ("In the United States we have opted for dynamic economic change even at the cost of economic risk and instability. We have chosen economic opportunity at the risk of economic hardship. We prefer a world of winners and losers. But a world of winners and losers requires a way to cope with the losers. If they revolt in the streets or withdraw from the economy, the costs of their failure are displaced to the winners who cannot enjoy their prosperity in safety. The bankruptcy discharge is an important part of the traditional, market driven American approach to risk. Bankruptcy reduces the pain of loss while it lets the losers get back in the game. As far back as Henry Clay, American 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.").

115. *See* Barry Adler, Ben Polak & Alan Schwartz, *Regulating Consumer Bankruptcy: A Theoretical Inquiry*, 29 J. LEGAL STUD. 585, 592–93 (2000); *see also* Michelle J. White, *Abuse or Protection? Consumer Bankruptcy Reform Under 'BAPCPA,'* 18-19 ÉCONOMIE PUBLIQUE 1, 2 (2006); Adam Feibelman, *Defining the Social Insurance Function of Consumer Bankruptcy*, 13 AM. BANKR. INST. L. REV. 129, 130 (2005).

116. Tabb, *Scope of the Fresh Start*, *supra* note 2, at 90 ("The debtor cooperation theory justifies the discharge as a carrot dangled in front of debtors to induce them to cooperate with the trustee and the creditors in the bankruptcy case in the location, collection, and liquidation of the debtor's assets. If the debtor cooperates, the discharge is granted; if not, it is denied. Debtor compliance arguably benefits creditors by increasing the size of the asset pie available for distribution and by decreasing the administrative costs necessary to effect that distribution. In short, creditors essentially forego the possibility of post-bankruptcy recovery tomorrow in the hope of reaping larger bankruptcy dividends today.").

Until the reform of 2005, the progressive position predominantly shaped U.S. bankruptcy discharge policy.[117] Under this approach, discharge is functionally equivalent to social insurance by allowing debtors to mitigate the detrimental consequences of a negative exogenous event.[118] In the United States, which typically provides a much more limited welfare system than European countries, bankruptcy discharge is considered to be a legal device to augment Social Security in the absence of other social safety nets.[119] Thus, bankruptcy discharge is considered to be a fundamental tool to protect the American middle class from the risk of exogenous shocks, such as job-related income interruptions, sickness, and costs related to marital problems, that could transform mere indebtedness into pathological insolvency.[120] Progressive scholars identify the combination of such shocks and excessive consumer credit as the primary cause of middle-class over-

117. *See supra* Parts III.A and III.B. The progressive bankruptcy scholarship, which obviously counts numerous scholars among its ranks, is typically identified with the works of three authors, belonging to different generations: William Douglas in the 1930s, Vern Countryman in the 1960s and, since the 1990s, Elizabeth Warren.

118. *See*, *e.g.*, Elizabeth Warren, *The Bankruptcy Crisis,* 73 IND. L.J. 1079, 1100–01 (1998); SULLIVAN ET AL., *supra* note 6, *passim*.

119. SKEEL, DEBT'S DOMINION, *supra* note 21, at 100; *see also* SULLIVAN ET AL., *supra* note 6, at 257; 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, 307 (1995) ("[B]ankruptcy Law is analogous to the welfare system: it is social insurance for the nonpoor."); Jean Braucher, *Consumer Bankruptcy as Part of the Social Safety Net: Fresh Start or Treadmill?*, 44 SANTA CLARA L. REV. 1065, 1073 (2004); Jackson, *supra* note 36, at 1397–98 ("[T]he theory must explain why, in the context of a social and economic order premised on individual autonomy, the law should make inalienable the right to a fresh start. In particular, it must show why the law should specifically protect individuals against the dangers of amassing debts when it provides only a general web of social insurance programs to protect them against the financial risks of their other activities.").

120. *See* SULLIVAN ET AL., *supra* note 6, at 75 ("Our data suggest that job-related income interruption is by far the most important cause of severe financial distress for middle-class Americans."); *see id.* at 141 ("Medical science has flowered beyond the wildest dreams of earlier generations, yet sickness and injury remain a major threat to the economic health of every middle-class family. The two components of that threat—either of which can plunge a family from comfortable circumstances to financial collapse in a matter of months—are the spiraling cost of medical care and the loss of income because of accident, illness, or disability."); *see id.* at 173 ("[B]oth marital problems and financial difficulties may arise from the same sources of trouble. Once financial and marital problems have developed, they are likely to reinforce each other. The interaction is often fatal both to the marriage and to the balance sheet.").

indebtedness.[121] Accordingly, they select bankruptcy discharge as an appropriate response.

In an *ex post* perspective that emphasizes remedies more than incentives, progressive scholars treat discharge as a final resort for reintroducing over-indebted individuals to a productive economic cycle.[122] Such a focus on the remedy to excesses on the supply side of the consumer credit market omits consideration as to whether bankruptcy laws—and in particular, bankruptcy discharge—contribute to shaping debtors' behaviors and their financial choices. Put differently, the *ex ante* perspective, concerned with the incentives that discharge poses on the demand side, is neglected by this body of scholarship, and therefore leaves unanswered the question of whether bankruptcy discharge contributes to over-indebtedness.[123]

C. THE CONSERVATIVE BANKRUPTCY SCHOLARSHIP

Conservative bankruptcy scholars, who are apparently more sensitive to the interests of the consumer credit industry than of debtors, take the opposite stance by arguing that a liberal approach to discharge is the basis for severe inefficiencies.[124] This pro-creditor approach follows the *ex ante* perspective that typifies law-and-economics analysis and assumes that individuals are rational, self-interested actors who are

---

121. *Id*. at 23–26.

122. Countryman, *Bankruptcy and the Individual Debtor*, *supra* note 103, at 817–18; *see also* SULLIVAN ET AL., *supra* note 6, at 22 ("As American families have faced job losses and medical bills, divorces and home mortgages throughout the past decade, bankruptcy has been their safety net . . . consumer debt has lowered many middle-class families' threshold for financial collapse. High consumer debt loads increase families' vulnerability to every other problem—job, medical, divorce, housing—that befalls them.").

123. *See* Skeel, *Progressive Bankruptcy Scholarship*, *supra* note 24, at 1118 ("With respect to the third factor, the rise of law and economics, current progressives remain just as hostile as Countryman himself. In personal bankruptcy, this has meant a vigilant defense of the fresh start, at times to the exclusion of other perspectives. Gone is any serious suggestion that bankruptcy should be used instrumentally to shape debtors' behavior. The occasional exceptions to this stance have a distinctly populist flavor."); *see also* Frank H. Buckley, *The Debtor as Victim*, 87 CORNELL L. REV. 1078, 1079 (2002) ("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.").

124. *See* Zywicki, *supra* note 21, *passim; see also* Jones & Zywicki, *supra* note 104, at 240.

able to make efficient decisions that maximize their individual wealth and in the aggregate, social welfare.[125] Accordingly, discharge creates a moral hazard because it grants debtors the equivalent of free insolvency insurance, thereby incentivizing them to take on more debts and strategically employ the fresh start benefit.[126] These scholars argue that the best response to such rational abuse is to establish stricter lending criteria and demand more collateral, ultimately leading to a higher cost of credit and its subsequent rationing.[127]

---

125. *See* Richard A. Posner, *The Nature of Economic Reasoning*, *in* LAW AND ECONOMICS ANTHOLOGY 1 (Kenneth G. Dau-Schmidt & Thomas S. Ulen eds., 1998); *see also* Robert H. Frank, *Departures from Rational Choice: With and Without Regret*, *in* THE LAW AND ECONOMICS OF IRRATIONAL BEHAVIOR 13 (Francesco Parisi & Vernon L. Smith eds., 2005).

126. *See* Zywicki, *supra* note 21, at 1466 ("On the other hand, the option of bankruptcy creates a moral hazard problem and increases the risk associated with consumer lending, leading creditors to charge higher interest rates, demand collateral or a larger down payment, increase monitoring to prevent default, or increase penalties for risky behavior such as late payments."); *id.* at 1477 ("Thus, if it is easy to file bankruptcy and to discharge debt, individuals will want to borrow more and incur more risk than if bankruptcy makes it difficult to discharge debt. Indeed, this is a primary purpose for bankruptcy law—to make individuals less risk-averse and willing to incur more debt than they would absent a bankruptcy law.").

127. *Id.* ("Lenders, of course, have opposite incentives and will be more willing to provide more credit when bankruptcy laws are strict and less where bankruptcy is easy."); *see also* Jones & Zywicki, *supra* note 104, at 248. Following the idea that the bankruptcy system makes credit more expensive one study has argued that, because of bankruptcy laws, each American household bears a higher cost of credit equal to $280 per year. *See* Kartik B. Athreya**,** *Welfare Implications of the Bankruptcy Reform Act of 1999*, 49 J. MONETARY ECON. 1567, 1583 (2002). When President George W. Bush signed BAPCPA in 2005, echoing conservative bankruptcy scholars, he stated: "when bankruptcy is less common, credit can be extended to more people at better rates." Michael Simkovic, *The Effect of BAPCPA on Credit Card Industry Profits and Prices*, 83 AM. BANKR. L.J. 1, 2 (2009); *see also id*. at 3 (citing the statement made by Prof. Zywicki before the Senate Judiciary Committee during the hearings preceding the approval of BAPCPA in 2005: "This bankruptcy 'tax' takes many forms. It is obviously reflected in higher interest rates. . . . It is [also] reflected in shorter grace periods for paying bills and higher penalty fees and late-charges for those who miss payments . . . [R]educing the number of strategic bankruptcies will reduce the bankruptcy tax paid by every American family . . . . These reforms will make the bankruptcy system more fair, equitable, and efficient, not only for bankruptcy debtors and creditors, but for all Americans."). For an argument against the conservative bankruptcy tradition, see SKEEL, DEBT'S DOMINION, *supra* note 21, at 84 ("[I]f changes in the bankruptcy laws cause more debtors to discharge their debts, for instance, creditors will scrutinize their borrowers more carefully and either ration credit or charge higher interest rates. This solution has downsides for creditors, of course. Rationing

Furthermore, conservative scholars argue that the considerable increase in bankruptcy filings over the past three decades is due to the increased inclination of Americans to strategically use discharge as a financial planning tool,[128] not because of a more fragile condition of the American middle class victimized by predatory lending techniques.[129] These proponents regard the ease of accessing consumer credit as a symptom of American prosperity rather than a source of over-indebtedness and insolvency. Therefore, progressive bankruptcy scholars should not focus on the supply side of consumer credit and instead, look elsewhere to understand why Americans file for bankruptcy so much more than in the past.[130]

---

credit means making fewer loans. And raising interest rates creates an adverse selection problem: the higher interest rates may drive low-risk borrowers out of the credit market, leaving a disproportionate percentage of high-risk borrowers. . . . [I]n either case, however, much of the cost will be passed on to borrowers.").

128. *See supra* note 106 and accompanying text.

129. *See supra* Part IV.B.

130. *See* Zywicki, *supra* note 21, at 1474 ("This rapid increase in filings has been especially difficult to explain in light of the prosperous state of the American economy during most of the past two decades, and, especially, the extraordinary prosperity of the late 1990s. Although the American economy set new records for economic growth, low unemployment, and low interest rates, this same period was also marked by record-high bankruptcy filings. The Traditional model [i.e., the progressive approach] has tried to reconcile this anomaly of record-high prosperity matched with record-high bankruptcy filing rates by arguing that the economic prosperity of the past two decades is superficial and masks real underlying economic distress. Proponents of the Traditional model thus do not question its fundamental validity; rather, they advocate digging deeper into the evidence to locate factual support for its continuing explanatory power."). According to the pro-creditor point of view, consumer credit availability, including subprime lending, functions to strengthen low-income households and does not favor their financial problems. *Id.* at 1487–88 ("For the majority of borrowers, therefore, the growth of the subprime market has enabled them to move from renting to buying housing, permitting them to build equity in their homes as a valuable asset to build wealth, rather than merely paying rent. Moreover, homeownership is the best way for many low-income households to build wealth, as investments in stocks and bonds are not likely to be realistic options. In fact, homeownership has been such a potent vehicle for wealth accumulation that the polarization of wealth between homeowners and renters has risen dramatically in recent years, even as the wealth polarization among different income classes has decreased. For those who also use their homes for a home equity loan, this can be an attractive alternative to the poor credit options otherwise available to high-risk, low-income borrowers. The expansion of the subprime lending market, therefore, has enabled low-income households to acquire an asset that has appreciated in value over the past decade, and thereby has

Having excluded lending techniques as a contributing factor to the financial distress of U.S. households, these scholars explain the rising tendency of the middle class to access discharge as a rational but abusive response to three major changes. First, the Bankruptcy Code of 1978 altered the cost-benefit analysis of discharge, which had become too favorable to debtors at a very moderate cost.[131] Second, the radical change over the last three decades in social norms has reduced, if not annulled, the social stigma that traditionally accompanied discharge.[132] Third, lending techniques have become more impersonal in nature, undermining the trust between debtors and creditors that traditionally reduced the willingness of debtors to default.[133]

D. THE DESCRIPTIVE ANALYSIS OF DISCHARGE RECONSIDERED BASED ON BEHAVIORAL LAW AND ECONOMICS

The financial crisis of 2008 challenges and undermines the logical basis for the conservative position, according to which the ample availability of consumer credit increases the welfare of American households.[134] This is because the crisis plainly illustrates the risks of taking on too much debt (due to the wide availability of consumer credit over the past two decades) and the ability of financial institutions to take advantage of the information asymmetries inherent to loan agreements.[135] A significant percentage of Americans, thanks to the easy access to subprime lending, were able to buy a house and ended up

---

enabled rapid wealth-building. Thus, the data indicates that wealth has increased across the board (albeit at different rates), which suggests that the aggregate figures on household wealth are not disguising unrecognized hardship among some demographic groups.").

131. *See id*. at 1527–32; Jones & Zywicki, *supra* note 104, at 209–15; David B. Gross & Nicholas S. Souleles, *An Empirical Analysis of Personal Bankruptcy and Delinquency*, 15 REV. FIN. STUD. 319, 320 (2002); White, *supra* note 115, at 8–10.

132. On the historical evolution of social stigma related to bankruptcy, *see* Efrat, *Bankruptcy Stigma*, *supra* note 29, at 365–66; Zywicki, *supra* note 21, at 1532–34; Julie Kosterlitz, *Over the Edge*, 29 NAT'L J. 870, 871 (1997) (according to Alan Greenspan, the former Chairman of the Federal Reserve, "personal bankruptcies are soaring because Americans have lost their sense of shame").

133. *See* Zywicki, *supra* note 21, at 1534–36; *see also* Buckley, *supra* note 123, at 1085–86.

134. *See supra* Part IV.C.

135. For more on the financial crisis *see* generally Adam J. Levitin & Susan M. Wachter, *Explaining the Housing Bubble*, 100 GEO. L.J. 1177 (2012).

being over-indebted, resulting in massive exposure to foreclosures.[136] Accordingly, with the benefit of hindsight, the progressive argument that the increase in consumer bankruptcy filings resulted from predatory lending techniques is more accurate. It correctly observes that the over-indebted American middle class, far from growing more prosperous due to consumer and subprime credit, becomes much more vulnerable to potential exogenous shocks.[137]

Yet, while these scholars correctly anticipated the noxious effects of too much debt[138] and identified consumer credit as the fundamental reason behind the filing explosion, they have neither fully accounted for the reasons behind consumers' tendency toward over-indebtedness nor come up with any possible solutions. By focusing on the need to make credit safer through stricter regulation of the supply side of the consumer credit industry,[139] on the demand side, these scholars fail to go much further than merely defending discharge as the last remedy to protect debtors.[140] Their neglect of the *ex ante* perspective overlooks the possibility that bankruptcy discharge shapes inefficient behavior on the part of debtors.[141]

Therefore, in order to fully understand the reasons for consumers' tendency to take on excessive debt, it is necessary to return to the *ex ante* perspective of pro-creditor scholars. To truly grasp individual decision-making processes in this context, more sophisticated analytical tools are needed than the ones suggested by the *homo economicus* paradigm that normally lies at the foundation of law-and-economics bankruptcy discourse.

In 1957, Herbert Simon coined the expression "bounded rationality" to indicate that actors often fail to satisfy the utility-maximization assumption due to "heuristics," which basically are mental shortcuts that people use to simplify decision-making.[142]

---

136. *See* Michele A. Dickerson, *Over-Indebtedness, the Subprime Mortgage Crisis, and the Effect on U.S. Cities*, 36 FORDHAM URB. L.J. 395, 400–05 (2009).

137. *See supra* Part IV.B.

138. *See id.*; SULLIVAN ET AL., *supra* note 6, at 22–26.

139. For more on this perspective, see generally Oren Bar-Gill & Elizabeth Warren, *Making Credit Safer*, 157 U. PA. L. REV. 1 (2008).

140. *See supra* Part IV.B.

141. *See supra* note 125 and accompanying text.

142. *See* HERBERT A. SIMON, MODELS OF MAN: SOCIAL AND RATIONAL 198, 270–71 (1957); *see also* Russel B. Korobkin & Thomas S. Ulen, *Law and Behavioral Science:*

Subsequent research in the behavioral sciences demonstrates that individuals are systematically biased when predicting the results of different events.[143] Both heuristics and biases lead individuals to make decisions that contradict the "rational choice theory" or "expected utility theory," according to which individuals rationally balance the benefits and costs of their actions in order to maximize their personal advantage.[144]

Studies using principles of cognitive psychology to examine consumption habits show that over-indebtedness can be explained, at least to some degree, by bounded rationality because individuals do not always select the "right" amount of debt.[145] In particular, individuals, such as debtors, tend to underestimate the risks of over-indebtedness and the likelihood of default, notwithstanding the statistics showing the high probability of default on certain types of loans (i.e., subprime loans). They tend to exclude the possibility that they could be exposed to an exogenous shock that would undermine their ability to fulfill their obligations.[146] This underestimation of risk in general is called the

---

Removing the Rationality Assumption From Law and Economics, 88 CAL. L. REV. 1051, 1075 (2000).

143. *See* Daniel Kahneman & Amos Tversky, *Choice, Values, and Frames*, 39 AM. PSYCH. 341, 341 (1984).

144. *See* MILTON FRIEDMAN, ESSAYS IN POSITIVE ECONOMICS (1953), at 15–31.

145. Susan Block-Lieb & Edward J. Janger, *The Myth of the Rational Borrower: Rationality, Behavioralism and the Misguided Reform of Bankruptcy Law*, 84 TEXAS L. REV. 1481, 1489 (2006).

146. Bar-Gill, *Seduction by Plastic*, *supra* note 6, at 1400 ("Underestimation of future borrowing may also result from an optimism bias that might lead consumers to underestimate the likelihood of contingencies bearing economic hardship. Specifically, consumers might underestimate the likelihood of adverse events that might generate a need to borrow. Optimistic individuals tend to underestimate the probability of being involved in an accident that might generate high medical bills or other liquidity needs. Similarly, individuals tend to underestimate the probability that either they or a loved one will become ill and require costly treatment (that is not covered, or not entirely covered, by their insurance plan). Finally, individuals tend to underestimate the likelihood that they will lose their job or underestimate the length of time it will take them to find a new job. These and other manifestations of the optimism bias will lead consumers to underestimate the likelihood that they will be forced to resort to credit card borrowing."); Bar-Gill, *The Law, Economics and Psychology of Subprime Mortgage Contracts*, *supra* note 6, at 1079 ("Optimistic borrowers underestimate the future cost of the deferred-cost contract. They overestimate their future income. They expect to have unrealistically attractive refinance options. Or, they overestimate the expected value of a bet placed on the real estate market, perhaps because they irrationally expect that a 10 percent price increase last year will be replicated next year.

"optimism bias."[147] Because of this cognitive distortion, debtors underestimate the costs of borrowing and perform an inaccurate cost-benefit analysis when shopping for loans.[148]

Other biases also help explain why consumers make harmful financial decisions. For example, the use of credit cards diminishes the sensation of loss that consumers experience when they pay in cash, contributing to a phenomenon that cognitive psychologists define as "bounded willpower."[149] This concept explains why small credit card transactions can accumulate into a conspicuous debt that would not have been assumed in a single transaction.[150] "Hyperbolic discount," the preference for immediate gratification over future gains, is also considered to plausibly explain consumers' tendency to take on

---

If myopic and optimistic borrowers focus on the short term and discount the long term, then lenders will offer deferred-cost contracts with low short-term prices and high long-term prices."); *see also* Patricia A. McCoy, *A Behavioral Analysis of Predatory Lending*, 38 AKRON L. REV. 725, 735–37 (2005); Baird, *supra* note 100, at 18; Jackson, *supra* note 36, at 1411–12; Ramsay, '*Wannabe WAGS' and Credit 'Binges'*, *supra* note 6, at 85.

147. *See* Cass R. Sunstein, *Boundedly Rational Borrowing*, 73 U. CHI. L. REV. 249, 252 (2006). Cognitive psychology studies have demonstrated multiple situations where individuals are affected by the optimism bias. For example, it is common among smokers to believe that they will be able to quit smoking in the future. *See* Paul Slovic, *What Does It Mean to Know a Cumulative Risk? Adolescents' Perceptions of Short-Term and Long-Term Consequences of Smoking*, 13 J. BEHAV. DEC. MAKING 259, 261 (2000). Similarly, recently married couples deny the possibility that their relationship will end in a divorce, disregarding statistics showing a high rate of divorce. *See* Bruno S. Frey & Reiner Eichenberger, *Marriage Paradoxes*, 8 RATIONALITY AND SOCIETY 187, 196 (1996).

148. *See* Bar-Gill, *Seduction by Plastic*, *supra* note 6, at 1378 ("The underestimation bias that underlies the identified welfare costs also qualifies the no-intervention presumption of the freedom-of-contract paradigm. If a contracting party misconceives the future consequences of the contract, then the normative power of contractual consent is significantly weakened.").

149. *See* George Loewenstein & Ted O'Donoghue, *"We Can Do This the Easy Way or the Hard Way:" Negative Emotions, Self-Regulation, and the Law*, 73 U. CHI. L. REV. 183, 196 (2006).

150. *See* Bar-Gill, *Seduction by Plastic*, *supra* note 6, at 1399 ("Imperfect self-control leading to the underestimation of future borrowing has been traced back to the temporal separation between the decision to obtain a credit card and the decision to borrow on the credit card. But, in fact, there is not one, but rather many borrowing decisions. Each time the consumer swipes her card, a new loan is entered into. This piecemeal borrowing phenomenon, or 'a-little-at-a-time borrowing,' exacerbates the self-control problem."); SULLIVAN ET AL., *supra* note 6, at 130.

excessive debt.[151] The concept explains that borrowers overestimate the benefit of an immediate loan while underestimating the cost of future interest.[152]

Lastly, the way that borrowers evaluate gains and losses depends on how a certain choice (i.e., taking out a mortgage loan) is framed.[153] "Framing" is a cognitive bias whereby

> two different statements of a choice are logically equivalent but not transparently equivalent. Normally consumers are not conscious of alternate ways of framing decisions or of the psychological effects of different frames. Thus, how a decision is framed can manipulate and momentarily shift the order of a homeowner's preferences. Framing is the alchemy that permits predatory lenders to manipulate the order of homeowners' preferences and overcome their otherwise strong aversion to losing their homes.[154]

This behavioral law-and-economics analysis elucidates that excessive debt is not necessarily the outcome of individual rational choices or a symptom of American middle-class prosperity, as argued

---

151. *See* Drazen Prelec & George Loewenstein, *The Red and the Black: Mental Accounting of Savings and Debt*, 17 MARKETING SCI. 15 (1998); *see also* Bar-Gill, *Seduction by Plastic*, *supra* note 6, at 1396 ("A consumer is said to be a hyperbolic discounter if her short-run discount rate is larger than her long-run discount rate . . . When a hyperbolic discounter is naïve about the nature of her time preferences, she will overestimate her will-power, and consequently underestimate her future borrowing."); Bar-Gill, *The Law, Economics and Psychology of Subprime Mortgage Contracts*, *supra* note 6, at 1119. *But see* Richard A. Epstein, *Behavioral Economics: Human Errors and Market Corrections*, 73 U. CHI. L. REV. 111, 131 (2006) (offering an argument in defense of the economic rationale for teaser rates: "So what is wrong with teaser rates anyhow? Go into any bakery and there are free samples that are intended to entice customers into purchases. The baker gets a new product to customers who might not buy the full package taste unknown. Wine is sold the same way. So it is with lending agreements. Try this bank out to see whether you like their customer service, their monthly payments, their promotional devices. There is an easy informational explanation that does not require an appeal to hyperbolic discount rates. Indeed, if that were the explanation, then we should expect frantic customers in search of short-term gains to grab the next teaser rate that comes along when the first expires. But most customers keep a bank because they like the relationship even when the low rate expires. Banning these rates will do no good, and it could easily work some anticompetitive harm, by making it more difficult for new banks to pry customers away from established competitors.").

152. Bar-Gill, *Seduction by Plastic*, *supra* note 6, at 1396.

153. McCoy, *supra* note 146, at 731–32.

154. *See id.*

by conservative bankruptcy scholars.[155] Rather, over-indebtedness is better explained as the consequence of faulty decision-making processes that are vulnerable to a pandemic of consumer credit and predatory lending techniques.[156]

The aftermath of the 2008 financial crisis has shown that financial institutions ably exploited the aforementioned information asymmetries by shaping offers of credit based on borrowers' cognitive mistakes and aggressively marketing loans that would give prominence to immediate benefits and obscure long-term costs.[157] This contradicts the traditional law-and-economics analysis, according to which the increase in consumer bankruptcy procedures would have led to the rationing of credit by financial institutions,[158] because the financial industry—particularly in the past twenty years—had expanded offers of credit by using subprime loans to reach out to all types of borrowers, including those in financial straits and delinquent debtors desperate to refinance

155. *See supra* Part IV.C.

156. The explosion of consumer credit, and consequent excessive level of household debt that followed, occurred in the U.K. in similar fashion to the United States. Between 2001 and 2005, the newspaper The Guardian published more than 50 pieces covering the "unsuitable borrowing binge." On the U.K. "debt culture," also described as "live now pay later culture," see Ramsay, '*Wannabe WAGS' and Credit 'Binges'*, *supra* note 6, at 75–76, 82. A similar tendency has characterized the Brazilian economy over the past few years, where the high reliance on consumer credit has been described as a "credit hangover." *See* Lima-Marques & Benjamin, *supra* note 6, at 60–61. On the relationship between the increase of consumer credit and the increase in consumer bankruptcy filings, see generally Lawrence M. Ausubel, *Credit Card Defaults, Credit Card Profits, and Bankruptcy*, 71 AM. BANKR. L.J. 249 (1997); David A. Moss & Gibbs A. Johnson, *The Rise of Consumer Bankruptcy: Evolution, Revolution, or Both?*, 73 AM. BANKR. L.J. 311 (1999).

157. *See* Bar-Gill, *Seduction by Plastic*, *supra* note 6, at 1376 ("The underestimation bias can explain the unique pricing patterns in the credit card market. If consumers underestimate their future borrowing, issuers can be expected to raise the long-term, borrowing-contingent elements of the credit card price. Thus, interest rates as well as late and over-limit fees are set above marginal cost, since consumers are insufficiently sensitive to variation in these long-term elements of the credit card price. On the other hand, competition in the credit card market forces issuers to compensate for these high, long-term prices by under-pricing the short-term, non-contingent elements of the credit card contract, which are not subject to the underestimation bias. To attract consumers, issuers must resort to below-marginal-cost (and even negative) prices in setting annual and per-transaction fees as well as introductory, short-term interest rates (teaser rates)."); *see also* Sunstein, *supra* note 147, at 267–68.

158. *See supra* Part IV.C.

their previous obligations. The increase in bankruptcy filings did not result in the rationing of credit because creditors anticipated the rate of default and therefore, passed the cost of discharge onto solvent debtors through higher interest.[159] It appears, then, that the 2005 BAPCPA reform of the Bankruptcy Code of 1978 that financial institutions so fiercely pursued was indeed not aimed at limiting access to bankruptcy discharge, but rather at delaying proceedings to force debtors into remaining in the "sweat box" longer, thereby increasing lenders' profits.[160]

V. A NORMATIVE ANALYSIS OF BANKRUPTCY DISCHARGE

A. RESTORING THE ORIGINAL FOUNDATION OF COMMON LAW BANKRUPTCY DISCHARGE

The behavioral law-and-economics analysis provides a much more realistic picture of the consumer credit market than the traditional economics approach. Over-indebtedness is persuasively explained in terms of the cognitive mistakes that affect the demand side of the consumer credit market, particularly borrowers' tendency to underestimate the expected costs of a loan that results in unreasonably risky financial decisions. It is also explained by the supply side's ability to exploit the information asymmetries pertaining to loan agreements and then pass the costs of bankruptcy discharge onto society, particularly financially sound debtors.

This Part focuses on the demand side of the consumer credit market and aims to show, from a normative perspective, how to shape bankruptcy discharge policy in order to correct borrowers' cognitive mistakes.[161] In particular, this Part challenges the view of progressive

---

159. *See* SKEEL, DEBT'S DOMINION, *supra* note 21, at 190 ("When individual debtors file for bankruptcy, much of what they discharge is consumer credit, since these obligations are generally unsecured and thus unprotected. This does not mean that credit card companies and other consumer creditors lose more and more money as the number of bankruptcy filings increases, of course. So long as consumer creditors can anticipate their losses, they can pass much of the cost on to future borrowers by raising interest rates or restricting access to credit. The cost of these adjustments falls on future debtors, not the consumer creditors.").

160. On the real scope of BAPCPA, as alleged by progressive bankruptcy scholars, see *supra* Part III.B.

161. As shown above, progressive bankruptcy scholars have traditionally neglected to consider the incentives that bankruptcy discharge poses to borrowers, focusing on the opportunity for stricter regulation of the supply side of the consumer credit market. *See*

scholars that discharge should be accessible to any over-indebted individual regardless of the reasons for the debt[162] because this *ex post* perspective fails to consider the contribution of discharge to the structure of incentives that, *ex ante*, influence borrowers' decision-making processes and eventually their financial decisions.[163] This paradigm seems to have overlooked the consequences, on borrowers' incentives, of the dramatic twentieth-century shift in the rationale for discharge, which stopped being the last resort for the honest but unfortunate debtor and became a safe harbor for any debtor in financial distress.[164]

---

supra Part IV.B. In particular, these scholars have suggested correcting information asymmetries through information-based mandatory provisions. *See id*. It has been argued that by making the potential consequences of over-indebtedness more apparent, borrowers would spontaneously correct their optimism bias. *See* Bar-Gill, *Seduction by Plastic*, *supra* note 6, at 1420 ("Information-based intervention has been proven feasible and effective in other contexts. Mandatory warnings on cigarette or drug packaging are a prominent example. The success of the anti-smoking and anti-drug advertisement campaigns is also suggestive. Perhaps the modern tendency to finance consumption with debt, without a complete understanding of the future repercussions of such a tendency, can be (at least partially) overcome through the provision of information."). Information-based regulation could certainly prove to be useful but at the same time insufficient to cure cognitive mistakes. As shown by scholars using behavioral law-and-economics methodology, information provided to consumers may prove ineffective when consumers, affected by the optimism bias, disregard the likelihood of being exposed to a negative event (e.g., defaulting on loan payments). Therefore, the way that information is provided (e.g., framing consequences in terms of losses rather than gain in order to exploit borrowers' loss aversion) is fundamental to the effectiveness of information-based regulations. *See* Lauren E. Willis, *Against Financial-Literacy Education*, 94 IOWA L. REV. 197, 203 (2008); Lauren E. Willis, *Evidence and Ideology in Assessing the Effectiveness of Financial Education*, 46 SAN DIEGO L. REV. 415 (2009); Christine Jolls, Cass R. Sunstein & Richard Thaler, *A Behavioral Approach to Law and Economics*, 50 STAN. L. REV. 1471, 1536–37 (1998); BLOCK-LIEB ET AL., *supra* note 19, at 154, 171; Sunstein, *supra* note 147, at 260–61.

162. *See supra* Part III.A. and notes 99–100.

163. On the contrary, traditional law-and-economics analysis should take credit for adopting an *ex ante* perspective and taking into consideration the "institutions that provide the incentives and constraints on filing bankruptcy." Zywicki, *supra* note 21, at 1526, n.236. If law-and-economics scholars are correct in adopting an *ex ante* perspective, they fall short in recognizing evidence of borrowers' cognitive mistakes, and proven wrong in arguing that consumers opportunistically use bankruptcy discharge as a tool to plan their finances. *See supra* Part IV.C.

164. *See supra* Part III.A.

The term "unfortunate," traditionally tied to the idea of an exogenous shock (i.e., merchant misfortunes at sea, job loss, medical problems, or divorce), gradually became synonymous in U.S. bankruptcy law with "over-indebted." The long-established legal principle that holds individuals liable for negligent behavior (i.e., prodigality or extravagance) while still deserving relief in the case of an "act of God" (i.e., the loss of a ship in a tempest) was abandoned with little challenge during the twentieth century.[165] The resulting prospect of automatic discharge, independent of a judiciary or administrative filter that would assess a borrower's negligence,[166] translates into a direct fall in borrowing costs, which multiplies any existing optimism bias, bounded willpower, and hyperbolic discount.[167] The possibility of bearing no liability for assuming too much debt, while not necessarily translating into opportunistic and hazardous behaviors as conservative scholars would argue,[168] might influence borrowers' decision-making processes and lead to excessive debt.[169]

---

165. *See supra* Part II.A, and note 41 and accompanying text. On the failure to notice how the structure of bankruptcy discharge can change borrowers' incentives, see *supra* note 125 and accompanying text. *See also* Hallinan, *supra* note 70, at 65 ("As the 'typical' bankrupt thus shifted from merchant to wage earner, the rationale of the discharge as an entrepreneurial incentive tended to lose its force and the incentive structure established under that rationale became increasingly problematic. Yet, while there was certainly no shortage of commentary directed to the apparent mismatch between law and policy, the basic legal structure and most of the details of the 'fresh start' remained unchanged until the years shortly before the enactment of the Bankruptcy Code in 1978.").

166. "U.S. and English bankruptcy law went very separate ways during the course of the nineteenth century. English lawmakers adopted a heavily administrative system, which positions an official receiver between debtors and the possibility of a discharge. The Bankruptcy Act of 1898, by contrast, left much of the U.S. process to the parties themselves." SKEEL, DEBT'S DOMINION, *supra* note 21, at 90; *see also* Douglas, *supra* note 112, at 332–33.

167. As discussed, individuals underestimate the costs of borrowing since they are affected by different cognitive mistakes, which undermine their ability to correctly assess the risks hidden behind a financial decision. *See supra* Part IV.D.

168. *See supra* Part IV.C.

169. It is a well understood principle of law-and-economics that when the default rule is "no liability," individuals tend not to exercise any care, for doing so would entail costs without producing any benefit to them. Furthermore, in the absence of liability, economic analysis of law has shown that individuals engage in a certain activity (e.g., borrowing money) to too great an extent since they do not have to subtract costs from the utility deriving from the activity. *See* STEVEN SHAVELL, FOUNDATIONS OF ECONOMIC ANALYSIS OF LAW 179,195 (2004).

Progressive scholars seem to have disregarded the possibility that the very same institution of bankruptcy discharge that they perceive as a fundamental safety net for the American lower-middle class may translate, when shaped in a very liberal fashion, into a powerful stimulus for cognitive mistakes that ultimately cause over-indebtedness. Extending automatic discharge to any over-indebted could eventually impair the very same individuals that discharge intends to protect while spurring the profitability of the financial industry.

This profound split between the original rationale behind bankruptcy discharge (protecting the honest but unfortunate debtor) and its modern version (protecting any over-indebted individual) seems justified only if the mistakes of borrowers cannot be cured or corrected[170] because only then would it make sense to treat the rationally bounded debtor as an unfortunate person whose over-indebtedness was not due to negligence.[171] A large contingent of bankruptcy scholars has embraced this latter approach:

> Blackstone did not understand that the bankruptcy discharge is a way of protecting individuals from themselves: it effectively shields them from consequences of the choice they make. Over time, the bankruptcy discharge has evolved away from the assumption that individuals act completely rationally. We no longer must show that our troubles arose because of something other than our own bad decisions. We no longer have to be both honest and unfortunate to obtain a fresh start.[172]

Essentially, U.S. bankruptcy law seems to embrace the strongly paternalistic view that discharge must apply indiscriminately to any over-indebted borrower for the simple reason that individuals must be protected from themselves. This, in turn, brings paradoxical legal consequences. For example, from the moment individuals enter into a loan agreement, they are treated as legally and mentally capable. Therefore, the contract is considered valid. Nonetheless, when the accrued level of debt becomes excessive, the same individual that was treated as legally capable is then considered to be a rationally bounded

---

170. According to Hallinan, cognitive biases "are not particularly amenable to correction, whether by training, education, or even experience." *Supra* note 70, at 134.

171. *See id.* at 127.

172. Baird, *supra* note 100, at 24–25. These words are in stark contrast to the words delivered by an English judge in 1810. *See Brown's Case*, 1 Mart. (o.s.) 158, 159–60 (La. 1810); *see also supra* note 99 and accompanying text.

victim of that individual's own faulty decision-making process, thereby excusing that individual from any consequences related to the valid loan agreement.

The paradoxical nature of this progressive policy becomes even more pronounced when one accepts that such liberal access to automatic discharge intensifies borrowers' cognitive mistakes, deepening the very same problem of over-indebtedness that discharge is intended to cure. These limitations show the failure to consider the difference between individuals affected by bounded rationality and those who lack the legal and mental capacity to enter into a valid contract (i.e., minors or the mentally ill). The former group is able to learn from their cognitive mistakes while the latter, as a matter of law, is not.

On a hypothetical spectrum with the strong, paternalistic approach of expansive discharge on one end and the strong, libertarian one that entirely denies access to discharge and holds debtors fully liable for their actions on the other, it is possible to envision, somewhere in the middle, sound legal prescriptions that are able to protect deserving over-indebted individuals without making discharge a further incentive for irresponsible behavior.[173] To inhibit the natural human tendency toward over-indebtedness—in other words, to induce borrowers to take on an efficient level of debt—the costs of borrowing must be made more visible so that individuals consider those costs when making decisions. While imposing mandatory, supply-side regulation to increase transparency[174] may partly achieve this goal, discharge should be shaped to make borrowers (the demand side) more careful in their financial decisions.

In order to correct cognitive mistakes, it seems fundamental that individuals are aware that they will be held liable for their activity or to put it differently, that they internalize the costs of borrowing, knowing

---

173. In the past decade, many scholars have written about the possibility of framing regulation that is able to correct cognitive mistakes, and steer people's choices in directions that will improve their welfare without jeopardizing their freedom. On this line of reasoning, see Cass R. Sunstein & Richard H. Thaler, *Libertarian Paternalism Is Not an Oxymoron*, 70 U. CHI. L. REV. 1159, 1161–62 (2003); Colin Camerer et al., *Regulation for Conservatives: Behavioral Economics and the Case for "Asymmetric Paternalism,"* 151 U. PA. L. REV. 1211, 1212 (2003). For a recent skeptical position on "libertarian paternalism," see Lauren E. Willis, *When Nudge Fail: Slippery Defaults*, 80 U. CHI. L. REV. 1155, 1157–58 (2013).

174. This is the prescription commonly suggested by progressive bankruptcy scholars. *See* Bar-Gill & Warren, *supra* note 139, at 157; Bar-Gill, *Seduction by Plastic*, *supra* note 6, at 1419–20.

that their cognitive mistakes will not be forgiven. Despite the largely failed attempts to train people through financial education programs to "debias" their decision-making,[175] denying discharge where the over-indebtedness resulted from negligence may vividly and effectively remind borrowers of the need to account for all costs and possible consequences deriving from their financial decisions.

Restoring the original foundation of bankruptcy discharge (the protection of the honest but unfortunate debtor) by reinstating personal liability (the equivalent of civil law's universal patrimonial liability)[176] for over-indebtedness resulting from negligence and not an exogenous shock would set the right balance between protecting fragile borrowers and creating a structure of incentives that would induce borrowers make more prudent financial choices.[177]

B. BANKRUPTCY DISCHARGE AS A REMEDY FOR THE UNFORTUNATE DEBTOR: INSIGHTS FROM EUROPEAN LEGAL SYSTEMS

An analysis of the prescriptions for bankruptcy discharge that some European legal systems have adopted offers important corroborative evidence for the *ex ante* perspective that this Article suggests.

---

175. *See* Lauren E. Willis, *The Financial Education Fallacy*, 101 AM. ECON. REV. 429, 430 (2011).

176. *See supra* note 14 and accompanying text; *see also supra* Part II.B.

177. For an effective illustration of how the possibility of incurring negative consequences makes individuals more aware of the costs of their actions, see IAN AYRES, CARROTS AND STICKS: UNLOCK THE POWER OF INCENTIVES TO GET THINGS DONE *passim* (2010); *see also* Gerrit De Geest & Giuseppe Dari Mattiacci, *The Rise of Carrots and the Decline of Sticks*, 80 U. CHI. L. REV. 341 (2013). The need to make bankruptcy discharge a non-automatic process has been stressed by the founder of the progressive bankruptcy school: William O. Douglas. Yet, his own disciples, who considered it "un-American," disregarded his proposal. *See* Skeel, *Progressive Bankruptcy Scholarship*, *supra* note 24, at 1110, 1085 ("Douglas strongly believed that many debtors could avoid financial distress if they were encouraged to manage their affairs more carefully. Several of Douglas's proposals sought, in overtly instrumental fashion, to shape future debtors' behavior. . . . Douglas, like many legal realists, was a fervent advocate of judicial and administrative discretion. In his discussion of speculation and gambling, for instance, Douglas insisted: '[An] attempt to treat all cases of speculation and gambling categorically would be absurd. It would seem desirable, however, to provide administrators with discretionary power so as to take cognizance of the variants among the cases.'").

1. England

It is worth mentioning English bankruptcy law first, which until the nineteenth century, has inspired the evolution of U.S. bankruptcy law.[178] In 2007, the Tribunals, Courts and Enforcement Act introduced the "Debt Relief Order" procedure, which applies to debtors who have few or no assets.[179] According to Schedule 4A[2 (2) of the Insolvency Act, the official receiver (a role similar to the one discharged in the United States by the Bankruptcy Trustee) can ask the court to issue a Bankruptcy Restriction Order, which effectively imposes upon the debtor, for anywhere from two to fifteen years,[180] the same restrictions normally applied during the twelve-month bankruptcy period.[181] The receiver may request this if the receiver considers the debtor to have acted in one of the following ways:

> (g) trading at a time before commencement of the bankruptcy when the bankrupt knew or ought to have known that he was himself to be unable to pay his debts; (h) incurring, before commencement of the bankruptcy, a debt which the bankrupt had no reasonable expectation of being able to pay; (j) carrying on any gambling, rash and hazardous speculation or unreasonable extravagance which may have materially contributed to or increased the extent of the bankruptcy or which took place between presentation of the petition and commencement of the bankruptcy.[182]

Even if the Bankruptcy Restriction Order does not prevent discharge, it is important to observe that English bankruptcy law distinguishes not only between the honest, unfortunate debtor and the fraudulent debtor but also between the former and the negligent/reckless, over-optimistic debtor who took on debt that he had no reasonable expectation of repaying.[183] The Order applies not only when the debtor acted opportunistically but also when he "ought to have

178. *See supra* Parts II.A.1 and II.A.2.

179. *See* Insolvency Act of 1986, c. 45, sch. 4A, § 4(2) (Eng.) modified by the Tribunals, Courts and Enforcement Act of 2007.

180. *Id.*

181. Such restrictions include the inability to assume new debts or carry on business (directly or indirectly) in a different name from the one used while becoming bankrupt. *See id.* § 360.

182. *See* Schedule 4A[2 (2) Insolvency Act 1986 as amended by the Tribunals, Courts and Enforcement Act 2007.

183. Adrian Walters, *Personal Insolvency Law After the Enterprise Act: An Appraisal*, 5 J. CORP. L. STUD. 65 (2005).

known that he was himself to be unable to pay his debts," meaning that he will suffer the consequences of his cognitive errors that resulted in financial bad decisions.

2. Denmark and Sweden

Scandinavian legal systems are other examples of bankruptcy prescriptions based on an *ex ante* perspective. Danish bankruptcy law, as amended in 2005, provides that in order to grant the discharge to an over-indebted consumer, the court must carefully consider the causes behind the over-indebtedness.[184] Furthermore, the court must deny the debtor's proposed debt adjustment plan and therefore the debtor's ability to obtain discharge, upon a finding that the debtor behaved in a financially irresponsible way. The denial of discharge must be made in cases where a considerable debt was incurred when the debtor (1) was unable to meet the financial obligations, or (2) undertook a financial risk disproportionate to the debtor's financial situation.[185] Accordingly, Danish bankruptcy law not only denies discharge in cases of fraudulent or opportunistic behaviour, but also when an over-optimistic consumer acting in good faith took on a disproportionate amount of debt.

Swedish law follows the Danish logic, requiring that an independent administrative agency assess the reasonableness of the debt adjustment plan. In 2006, the Swedish Supreme Court stated that the administrative agency must deny access to a debt adjustment plan when the over-indebtedness resulted from speculative behavior and the consumer undertook a disproportionate risk.[186]

The Scandinavian *ex ante* approach aims at preventing the option of bankruptcy discharge from supplying a reason to underestimate the cost of debt and make unreasonably risky decisions.[187]

---

184. *See* DANISH BANKRUPTCY LAW *Konkurslov* (Part IV, *Gaeldssanering* § 197, paragraph 2).

185. *See id.*

186. Jason J. Kilborn, *Out With the New, In With the Old: As Sweden Aggressively Streamlines Its Consumer Bankruptcy System, Have U.S. Reformers Fallen Off the Learning Curve?*, 80 AM. BANKR. L.J. 435 (2007).

187. *See supra* Part IV.D.

3. Italy

The Italian legal system recently followed this Scandinavian approach by introducing its first consumer bankruptcy law at the end of 2012.[188] Pursuant to Article 12-*bis*, paragraph 3 of Italian Law No. 3/2012, the court must deny access to the debt adjustment plan proposed by the consumer upon a finding that the debt was incurred without a reasonable prospect of repayment. The court must also reject the proposal if it finds that the debtor disproportionately relied on consumer credit, and therefore negligently incurred over-indebtedness.[189]

> The Court, after having verified that the debt adjustment is feasible . . . , approves the plan when it excludes that the consumer has undertaken obligations without having a reasonable possibility to discharge them or has negligently caused his over-indebtedness, also through relying on credit that was not proportional to his patrimonial capacity . . . .

4. Comparing the Bankruptcy Laws of Denmark, Sweden, and Italy to the United States

Unlike U.S. bankruptcy law, which allows discharge for any over-indebted person,[190] the Scandinavian and Italian developments effectively restore the original foundation of discharge.[191] In the latter legal systems, the paradigmatic "honest but unfortunate" debtor who took on a sustainable level of debt that later turned into pathological debt due to an independent, exogenous shock is back at the center of the bankruptcy procedure. The deep split between these European prescriptions and contemporary American bankruptcy law is immediately apparent when one juxtaposes the former with the words of

---

188. *See* Law No. 3 of January 27, 2012, which was later amended by Law Decree No. 179 of October 18, 2012 (also amended by Law No. 221 of December 17, 2012).

189. Article 12-*bis*, paragraph 3, Law No. 3/2012: "Verificata la fattibilità del piano e l'idoneità dello stesso ad assicurare il pagamento dei crediti impignorabili, nonché dei crediti di cui all'articolo 7, comma 1, terzo periodo, e risolta ogni altra contestazione anche in ordine all'effettivo ammontare dei crediti, il giudice, quando esclude che il consumatore ha assunto obbligazioni senza la ragionevole prospettiva di poterle adempiere ovvero che ha colposamente determinato il sovraindebitamento, anche per mezzo di un ricorso al credito non proporzionato alle proprie capacità patrimoniali, omologa il piano, disponendo per il relativo provvedimento una forma idonea di pubblicità."

190. *See supra* Part III.

191. *See supra* Part II.A.

Douglas Baird: "we no longer must show that our troubles arose because of something other than our own bad decisions. We no longer have to be both honest and unfortunate to obtain a fresh start."[192] The *ex ante* perspective of some European countries aims at avoiding the fraudulent and opportunistic behaviors that are the main concern of law-and-economics scholars[193] as well as the exacerbation of consumers' irrational tendency toward over-indebtedness.

The notion that an individual must prove misfortune or the absence of negligence in order to benefit from discharge does not reflect any punitive agenda toward the reckless debtor. Instead, making the costs of borrowing more visible would create the right incentives for individuals to correct cognitive mistakes.[194] Once discharge is exclusively granted to the unfortunate debtor, this legal device would cease to exacerbate the problem of over-indebtedness and would reinstate its function as social insurance, whereby only specific risk and not mere financial distress is protected. Once bankruptcy discharge is understood as social insurance, a "private" safety net aimed at protecting honest but "unfortunate" individuals, it could be argued that the scope of this measure should be graduated according to the extent of the functionally alternative, "public" social welfare policies. Following this line of reasoning, it would be reasonable to argue that since the scope of the welfare state in Europe—notwithstanding the current austerity measures—is still significant, discharge should be limited to confined cases, whereas in the United States, in light of its limited welfare state, discharge might be applied more broadly.[195]

CONCLUSION

The reasoning that this Article advances on the problem of consumer bankruptcy, which is also supported by recent trends in some European legal systems, reveals the limits of both sides of the highly ideological debate that characterizes U.S. bankruptcy scholarship. The conservative position relies upon an unrealistic law-and-economics analysis in supporting the BAPCPA reform, which was not intended to limit bankruptcy discharge, but rather to enhance financial industry

---

192. *See* Baird, *supra* note 100, at 25.
193. *See supra* Part IV.C.
194. *See supra* Part IV.D.
195. *See supra* note 121 and accompanying text.

profits. Meanwhile, at the other extreme, progressive scholars entirely neglect to account for the maladaptive incentives that discharge creates for borrowers.

The first paradox that this study unveils is that the very same remedy that pro-debtor scholars intensely defend as an essential safety net for the American lower-middle class is also a powerful incentive for over-indebtedness, and therefore a means of profit for lenders when that policy is shaped in overly liberal terms. The 2008 financial crisis illustrates the perils of too much debt and how individuals tend to underestimate those perils. To truly protect borrowers, these credit market failures must be addressed by both more strictly regulating the supply side of credit and reshaping discharge to encourage borrowers to correct their cognitive mistakes.

This Article also reconsiders the conventional wisdom that assigns a pro-creditor connotation to the civil law tradition, founded on the principle of debtors' universal patrimonial liability, while labeling as pro-debtor the common law tradition, which characterizes for a liberal regime of bankruptcy discharge.

A second paradox emerges when observing discharge through the lens of behavioral law and economics. The tendency toward over-indebtedness and the consequential vulnerability of borrowers and prosperity of the financial industry are much more pronounced in common law regimes, where debtors are considered to be more strongly protected. On the other hand, the civil law systems, which have historically adopted a less debtor-friendly approach to discharge, and are therefore conventionally considered more favorable to creditors, are characterized by more sound, financially solid borrowing practices and a less expansive supply of consumer credit, both of which help to insulate consumers from potentially disastrous debt.

Based on these conclusions, this Article argues that U.S. bankruptcy law should be revised to only protect the honest, unfortunate debtor similar to the bankruptcy laws in England, Denmark, Sweden, and Italy. This would help to correct biases and heuristics, which would discourage over-indebtedness.