EMORY LAW

Emory Bankruptcy Developments Journal

Volume 36
Issue 2 *The Seventeenth Annual Emory Bankruptcy Developments Journal Symposium*

Article 11

2020

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Recommended Citation

David Lander, *Stingy Bankruptcy Relief is Sinking the U.S. Economy*, 36 Emory Bankr. Dev. J. 647 (2020).
Available at: https://scholarlycommons.law.emory.edu/ebdj/vol36/iss2/11

STINGY BANKRUPTCY RELIEF IS SINKING THE U.S. ECONOMY

David Lander[*]

As I considered Professor Martin's thoughtful and incisive article it set me to thinking about the factors that policymakers should consider when they make consumer bankruptcy policy. It also set me to thinking about the forces on the various sides of the debate on that issue.

We often think of the battle for the balance of consumer bankruptcy relief as between consumer advocates and self-proclaimed "do-gooders" on the one side, and moralists, Wall Street, and investors on the other side. Perhaps there are other considerations that should be in the mix.

Perhaps all is not so simple as it seems. Consider, saving is good, right? But if people save, then they are not spending and our economy completely depends on people spending. So, when people save, it is a drag on the economy and other people will lose their jobs. Thus, there is a tug of war between the values of saving and spending. So, where is the balance point?

Now, is borrowing good or bad? Borrowing can be bad, but if people borrow and buy, then that is good for the economy and jobs are created. So, where is the tipping point? And who should borrow? Below where, if anywhere, on the credit rating scale should people not be eligible to borrow?

And if people are overindebted, but the current bankruptcy system will not help them, then they cannot borrow and they cannot spend ever, or at least until something big changes in their life, such as winning the lottery.

Buying and owning a house is good, isn't it?

Home construction is one of the most important job creation engines, and home equity is the primary wealth creation tool for all but the richest households. So, shouldn't people who fall behind on their home mortgages have tools for overcoming their default?

If fewer people had been foreclosed out of their homes during the financial crisis of 2008 then that would have been good for those people and for their neighborhoods and in most ways for the economy and society. So, why was chapter 13 not expanded to allow more homeowners in default to "repurchase"

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their own houses for the then current value rather than sitting vacant and being purchased by investor funds months or even years later and probably for less?

And cars—in most of the country a car is crucial to a good job; yet at the very last moment, when The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) seemed closed for changes, the car financing interests were able to reduce significantly the degree of relief available to consumers in distress. The car financers were able to wrest the few pennies from the unsecured claimants and more than that, deny meaningful relief to the actual consumer debtor with car debt, and keep other potential consumers from becoming bankruptcy debtors for lack of value to the potential debtors in a bankruptcy discharge.

Student loans are another story. First, they grew in importance so very quickly and now they are a crucial micro and macro lug on millions of people, the economy, and society, and yet there is benefit for society, the economy, and for many citizens to go to legitimate colleges or trade schools.

The current formula for bankruptcy relief is resulting in massive underuse. And because the consumer bankruptcy process is so stingy, it also results in people spending less.

When we look at borrowing and spending by consumers prior to the crash we tend only to look at the negative and not the positive. The positive is that the borrowing (and resulting spending) by people who had previously been excluded from borrowing, and the spending that resulted from home equity withdrawals, were very powerful benefits to the economy for many years.

Shift for a moment to look at the impact of the failure of the Bankruptcy Code (Code) to grant relief on student loans. The massive debt is keeping an entire generation of Americans from buying houses, starting new businesses, and otherwise taking steps that have been crucial to the economy in the past. And it is hard to blame the consumers for that debt since they took it on in order to benefit their lives and benefit their families and benefit society by getting college or graduate degrees or trade school expertise.

As large as education debts are, they pale by comparison with mortgage debt.[1] Had congress expanded chapter 13 to allow overindebted homeowners to reduce the debt to the value of the homes and then continue on mortgage

[1] *Household Debt Steps Up, Delinquencies Drop*, FED. RESERVE BANK OF N.Y. (May 24, 2016), https://www.newyorkfed.org/newsevents/news/research/2016/rp160524.

payments, the crash would have been much less devastating on a macro and micro basis. Yet for a series of complicated reasons and non-reasons the decision was made to try a number of non-bankruptcy procedures entitled "forbearance." The costs of this forbearance regime were very high and the benefits to consumers or anyone else were very low.

With regard to auto loans, as auto debt continues to grow and the installment terms continue to become longer, more and more consumers need relief under the Code to reduce their loan to the value of the car, payable over time. Yet, the restrictions added by BAPCPA make this impossible for a significant segment of those who need the help.[2] This failure of relief for many consumers means they lose their jobs because they lose their cars.

Another way of looking at this is to recognize that the economy has been stifled by the lack of borrowing and spending by overindebted consumers. Their efforts to borrow are rejected and if they know that bankruptcy will not avail them then they simply cannot spend. When they do not spend the economy grinds to a halt. The economy of South Korea in the 1990s has demonstrated this clearly.

These are a few of the many indicators that prove our current stingy bankruptcy relief system is killing the economy. And for what benefit?

We normally consider the decision on the extent of bankruptcy relief to be a battle between the lenders, borrowers, consumers, and bankers but it is much more.

I support Professor Martin's proposal to see bankruptcy as a key for reducing inequality for two reasons.[3] First, I see consumer borrowing and bankruptcy as two sides of the same coin. Second, I believe there are already macroeconomic, microeconomic, and sociological implications in formulating bankruptcy policy and in its application.

Consumer borrowing and the terms of relief from debt of the borrowers are major features of our economy and must be recognized as such. The quid pro quo in our economy *should* be that we will encourage the average person to extend herself financially so she can keep the consumer-spending engine running ("keep her on the hamster wheel"). In return, if something bad happens

[2] *See* Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, §418, 199 Stat. 23 (2005).

[3] Nathalie Martin, *Bringing Relevance Back to Consumer Bankruptcy*, 36 EMORY BANKR. DEV. J. 581 (2020).

beyond her control, we will renegotiate the terms of the deal—bankruptcy or some other modification of the debt—to put her back on the wheel as soon as possible. If we do not, everything comes crashing down.

In our consumer-driven economy, we desperately need high levels of consumer debt. Thus, we need to focus on these questions: (1) What is the bargain being offered, and (2) What are the implications of this bargain if circumstances change?

In this case, the bargain in our consumer-driven economy is that we need people to spend as much as they can. Too much saving leads to the "paradox of thrift"—we are all worse off, our incomes decline, and our attempts to save are frustrated because our incomes go down. This leads to an economic depression.

To avoid too much saving (and stagnation), we will lend people the money to keep them spending, even if it jeopardizes their financial stability. The question then becomes, what happens if circumstances change?

The moralists say, "Cannot pay? No sympathy because she borrowed without coercion. We will punish her." But this creates deadweight and stagnation as people reduce their spending in order to pay off debt. It's the "sweatbox."

The more enlightened view recognizes that sometimes people cannot pay even when they made reasonable decisions (as in the case of a mortgage, a car loan, or a student loan). It could be that the economic rug was pulled out from underneath them, as in the recession or the housing crash. Alternatively, the job market may not pay enough to manage her student debt, which she might not have been able to predict when you went to school.

What sense does it make to punish someone who cannot pay for reasons beyond their control? The bargain we offered them was to spend as much as they could; we will provide the financing.

And now if they are cut off from borrowing and spending, we are headed straight back into the paradox of thrift. Everyone will suffer, even the hardline lenders. Weaker economic growth will infect even their stronger borrowers eventually. No one is safe in a depression.

Moralists should overcome their self-righteousness. After all, if the situation becomes bad enough, we will bail out the banks, too—as we always do. They are lucky they do not have to face hardliners like themselves when their circumstances change for the worse.

So, if we recognize the macroeconomic role of consumer borrowing, it is only a small step to making sure bankruptcy moves us in the direction of less inequality.