

THE MORALITY OF DEBT

This evening I'm going to discuss "The Morality Of Debt". By virtue of professional interest, I've long found the concept of debt and its corollary concept of credit, and their place in our economy and in our society, a necessarily interesting subject. And, as a fellow attorney recently pointed out to me, the addition of the concept of morality to any lawyer's discussion on any subject should add a certain foreign spice to the mix and make it much more interesting.

Before launching into issues of morality, however, let's consider for a moment the fundamentals of "What is debt?". Just a primer, if you will.

Essentially, debt involves that which is owed, and it typically concerns the assets of the person who owes the money. In a commercial society like ours, unless all commerce is going to consist of the simultaneous exchange or payment for goods and services – that is, unless the buyer pays the seller at the same time she gets the goods – C.O.D., for example — we are, by definition, conducting business based on a promise. Once we have a promise to pay, we automatically have an extension of credit (a loan) and a matching creation of a debt.

Debt may include a simple loan of goods in exchange for other goods, it may involve money, a simple promise to pay or a more complicated promissory note. It may involve security or collateral, such as when a deed of trust is given

to secure a home loan. Nonetheless, absent a contemporaneous payment, there is a debt.

Before a debt can exist in a commercial setting, both the debtor (he who owes) and the creditor (she to whom the debt is owed) must agree on the manner in which the debt will be repaid. The terms of the agreement or contract must be understood between the parties, including the timing of payment and interest to be paid, if any.

Debts may be owed between individuals, business entities like a corporation, or even a government.

History, literature, and just as much religious texts are replete with admonitions relating to debt. While it seems to be generally agreed upon that debt is a bad thing, and to be avoided, it isn't always as clear whether debt may properly be forgiven, although that does seem to be the general trend. A few examples:

The Old Testament, according to the New International Version of the Bible, says that "At the end of every seven years you must cancel debts. This is how it is to be done: Every creditor shall cancel the loan he has made to his fellow Israelite. He shall not require payment from his fellow Israelite or brother, because the LORD's time for canceling debts has been proclaimed"¹.

¹ Bible, New International Version, Deuteronomy 15:1-2; Note that the King James version uses different wording: "At the end of every seven years thou shalt make a release. And this is the manner of the release: Every creditor that lendeth ought unto his neighbor shall release it; he shall not exact it of his neighbor, or of his brother; because it is called the Lord's release".

New Testament, again from the New International Version of the Bible, says: "Forgive us our debts, as we also have forgiven our debtors "².

In Psalm 37:21 debtors apparently aren't getting off so lightly: "The wicked borrow and do not repay, but the righteous give generously"³.

The Koran also speaks to the issue of debt - "If your debtor be in straits, grant him a delay until he can discharge his debt; but if you waive the sum as alms it will be better for you, if you but knew it"⁴.

Shakespeare has chimed in on the subject, advocating thrift. In Hamlet, Polonius said "Neither a borrower nor a lender be; for loan oft loses both itself and friend, and borrowing dulls the edge of husbandry".

Benjamin Franklin said in "Poor Richard's Almanac" that he'd "Rather go to bed supperless than rise in debt".

Of course, advice against incurring debt states an ideal that simply cannot be met for those taking part in a commercial society and economy. Debt has been around as long as deals have been made between two people. Where there is commerce, there will be debt and there will be credit.

Since the presence of debt in our lives is axiomatic, let's consider some of the historical perspectives on debt and, more to the point, how some societies in the past have approached the problem of what to do when faced with a failure to repay debt.

It's no surprise that different cultures have taken different stances on debt, the stances varying depending on the time, the society, the economy and the

² Bible, New International Version, Matthew 6:12

³ Bible, New International Version, Psalm 37:21

⁴ Koran, The Cow 2:280

collective moral reaction to a debt default. Should a debtor be coerced to repay in full? What if repayment in full is simply not possible given the debtors assets? In that case, should the debt be forgiven?

A society's treatment of debt forgiveness may be viewed alternatively as purely economic in nature or as an issue of social legislation⁵. Or both, as we will see has been the case in the United States over time. Whether we as a society forgive debtors and how we bestow or withhold forgiveness are matters of economic and legal consequence. Our attitudes go to the heart of what our society values, not only commercially, but morally.

In modern times we are used to the concept that a creditor's claim to repayment of a debt may reach the property or assets of the debtor. But, does a creditor's claim to repayment of what they loaned extend to the body of the debtor? Should the creditor have the right to imprison their debtors, or have the debtor bound in servitude? Should an insolvent debtor ever hope for release from his or her debts, short of repayment in full which may be impossible while imprisoned or indentured?

In both Greek and Roman times, laws provided that debtors not only may have their assets turned over to their creditors, but also that the debtors may become "employees" of the creditor or simply be enslaved to the creditor upon default⁶. Apparently recognizing that it's hard to repay your debts while enslaved

⁵ Todd J. Zywicki, "Bankruptcy Law As Social Legislation", ABI web site, 2001; Thomas H. Jackson, "The Logic And Limits Of Bankruptcy Law", 1986, p. 2.

⁶ Joseph Pomykala, "Bankruptcy Reform Principles and Guidelines (Revised Edition)", Regulation, 1997, Vol. 20, No.4, Cato Institute; Francis Regis Noel, "History of the Bankruptcy Law", 1919, C.H. Potter & Co.

or imprisoned, many of the Greek city-states did impose a five-year limitation on the time for slavery, and some even prohibited corporal punishment”⁷.

Similarly, England and Europe have historically had strong laws aimed at punishing debtors and assisting creditors with their collections efforts. In fact, not only have England and Europe historically been less debtor friendly than any law of the United States during the same period, but the United States arguably has had the most debtor friendly laws in the world⁸.

The United States did not originally have a uniform or national law addressing failure to pay debts. Early state laws, however, did provide for tough penalties to encourage debtors to avoid defaulting and to help creditors coerce payment. For example, a colonial-era New York state law permitted debtors to be branded on the thumb with a “T” for “thief”, while the Pennsylvania Bankruptcy Act of 1785 provided for convicted debtors to be nailed by their ear to a pillory and flogged. After the allotted time, the ear would be cut off⁹. Don’t ask me why the ear, or what they did with the ear. I looked, but didn’t find the answer.

In addition to the individual states’ early laws aimed at deterring debtor defaults and assisting creditors with debt collection, the issue of debt treatment is so fundamental that it even made its way into our Constitution. Article I, Section 8 gives the federal government the power to establish “uniform laws on the subject of bankruptcies throughout the United States.”

Before a debtor gets too excited about a right to bankruptcy relief, however, the intent of the founding fathers in including Bankruptcy Clause in the

⁷ Wikipedia, 2006, <http://en.wikipedia.org/wiki/Bankruptcy>

⁸ Zywicki, “Bankruptcy Law As Social Legislation”, ABI web site, 2001.

⁹ Pomykala, 1997.

Constitution needs to be considered. Surprisingly, not much is known about the meaning or importance of the term ‘uniform bankruptcy laws’. What evidence we do have comes from the Federalist Papers No. 42 written by James Madison in 1788, where Madison described federal bankruptcy legislation as being “intimately connected with the regulation of commerce”. Madison also concluded that national bankruptcy laws would be necessary to prevent fraudulent debtors from fleeing to other states to evade local enforcement of their debts¹⁰. In my research I found that it is a common misperception that the Bankruptcy Clause of the Constitution was intended as a protection for debtors. We can see instead that the Bankruptcy Clause was actually meant (at least by Madison) to enhance creditors’ debt collection rights¹¹. So much for “forgive us our debts”.

Even with the inclusion of a Bankruptcy Clause within the Constitution, the issue of debt and debt collection laws was left largely up to the individual states for over one hundred years after the Constitution was ratified. After all, the Constitution doesn’t say that the federal government is required to enact bankruptcy laws.

It was not until 1898 that a permanent, national bankruptcy law was in place. That is not to say there weren’t fitful attempts at establishing a uniform bankruptcy law, each a response to the current financial crisis of the time and being repealed shortly after its enactment. The first of these laws was enacted in 1800, putting an initial end to imprisonment for debt. But that law was

¹⁰ David A. Skeel, Jr., “Debt’s Dominion: A History Of Bankruptcy Law In America” (2001) Princeton University Press, p. 23.

¹¹ Todd J. Zywicki, “The Past, Present, and Future of Bankruptcy Law in America”, Michigan Law Review, 2002, available at SSRN: <http://ssrn.com/abstract=327223> or DOI: 10.2139/ssrn.327223, 2001, p. 201.

repealed in 1803. Another national bankruptcy law was enacted in 1841, but it was repealed 1842. Finally another new law was enacted in 1867, but it only lasted until it's repeal in 1878¹².

Once the 1898 Bankruptcy Act became law, it would last without major change for forty years (some changes were made in 1938 in reaction to the Great Depression, including an increase in the role of the federal government overseeing the bankruptcy process¹³). In fact, since the 1898 Bankruptcy Act, the United States has always had a nationwide bankruptcy law in place, although the emphasis that the law has placed on debtor versus creditor rights has shifted over time.

In understanding the pressures that finally led Congress to put together permanent bankruptcy legislation rather than continuing to leave the matter up the individual states, it's worth taking a look at what economic and societal pressures existed at the time.

For starters, following the Civil War, the United States experienced an increased nationalization of its economy, driven by urban industrialization, a decreasing rural farm population, and advances in communications and transportation technologies, including railroads, electricity, and the steam boiler¹⁴ just to name a few.

At the same time, the economy saw an increased use of paper money, allowing more people to participate more freely and more widely in a national economy, along with the emergence of a broadening consumer marketplace.

¹² Skeel, p. 25.

¹³ Skeel, p. 25-28.

¹⁴ Zywicki, "The Past, Present, and Future of Bankruptcy Law in America", p. 203.

From another angle, some commentators have cited to the spread of written credit instruments, such as notes and bonds, in an increasingly commercial economy, as leading to more impersonal market relationships, where traditionally the relationships had been more local and community oriented. Further, the assignability of notes and bonds severed the connection between debts and their underlying social relations. Simply put, the debtor-creditor relationship had become, as one historian put it: “commercialized, depersonalized, and channeled through the corporate, legalistic and institutionalized structure of commercial finance”¹⁵.

Another important factor in driving the call for a national bankruptcy law was the fact that the economy was moving from a static economy to one in which speculation and investment played growing roles¹⁶.

Resulting from the growth and expansion of a national economy, we also saw for the first time the rise of organized local and national commercial trade groups. Most important among these groups were those whose members who engaged in commerce across state lines. The trade groups argued that, absent a national bankruptcy law, out-of-state creditors were in danger of being paid last or not at all in the event of a default¹⁷, either because the debtors would fraudulently skip to another state or because some state laws effectively preferred in-state creditors over out-of-state creditors¹⁸. Of course, these are

¹⁵ Peter J. Coleman, “Debtors and Creditors in America: Insolvency, Imprisonment for Debt, and Bankruptcy 1600-1900”, 1974, p. 248.

¹⁶ Bruce H. Mann, “Republic of Debtors: Bankruptcy In The Age Of American Independence”, Harvard University Press, 2003, pp. 1-4.

¹⁷ Skeel, p. 36.

¹⁸ Zywicki, “The Past, Present, and Future of Bankruptcy Law in America”, pp. 202-203

much the same concerns Madison expressed a hundred years earlier, but by 1898 they had finally reached a boiling point.

So, as we approached the late 1800's, the change to a larger, more diverse national economy and the depersonalization of the debtor-creditor relationship seemingly shifted the societal and legal view of insolvency away from being seen as primarily a moral failing, and more to an issue of business risk or economic default. Seen from the more detached business or economic risk point of view, it seemed less reasonable to impose imprisonment or corporal punishment¹⁹. As such, the Bankruptcy Act did away with such punishments, although it was still a powerful vehicle for national debt collection efforts.

It was not until 1978 that the Bankruptcy Act was replaced by what is modernly known as the Bankruptcy Code. The Bankruptcy Code was generally considered to have made bankruptcy easier and more attractive to both consumers and businesses than it had ever been before, either under the Bankruptcy Act or prior state debt collection laws²⁰.

In looking back at twenty years of living with the Bankruptcy Code, Professor Elizabeth Warren observed in 1999 that:

“Bankruptcy in America is a booming business. Hundreds of thousands of ordinary Americans each year have joined giant corporations, like Johns Manville and Continental Airlines, and once-wealthy individuals, like John Connally, in filing for bankruptcy”.

¹⁹ Mann, p. 4

²⁰ Zywicki, “The Past, Present, and Future of Bankruptcy Law in America”, p. 205.

Professor Warren went on, however, to ask:

“Is this dramatic growth a result of mushrooming debt--consumer debt and consumer bankruptcy have both more than doubled since the late 1970s--or does it reflect a moral decline that permits the middle class to evade their debts?”²¹

Personal bankruptcy filings increased from under 300,000 in 1980 to just over 1.5 million filings in 2004, approximately a five-fold increase. During that same period, business filings went down from about 44,000 per year to about 34,000 per year²².

At the same time, total consumer credit outstanding in 1980 was about \$350 billion, while in 2004 it was about six times as much, or \$2.2 billion²³.

Can it be said that the increase in consumer bankruptcy filings is related to individual moral decay? If so, would it follow that businesses during the same time became somewhat more moral since business filing actually decreased?

So, now we arrive at the present state of the law. The most recent change to the United States Bankruptcy Code, known as the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA)²⁴, took full effect in October, 2005.

²¹ Teresa A. Sullivan, Elizabeth Warren, Jay Lawrence Westbrook, “As We Forgive Our Debtors: Bankruptcy and Consumer Credit in America”, 1999.

²² American Bankruptcy Institute web site, “Annual Business and Non-business Filings by Year (1980-2005)”
<http://www.abiworld.org/AM/AMTemplate.cfm?Section=Home&CONTENTID=35631&TEMPLATE=/CM/ContentDisplay.cfm>

²³ <http://www.federalreserve.gov/releases/g19/current/>

²⁴ See 11 U.S.C. §101 et seq.

Without getting mired in the detail of the numerous and substantive changes made by the BAPCPA to the Bankruptcy Code as it previously existed, the basic thrust of the new law was to make it more difficult for consumers to discharge their debts in Chapter 7, by forcing more debtors to file Chapter 13. The point here is that while Chapter 7 debtors may be able to receive a discharge of their debts within a few months, Chapter 13 calls upon the debtor to propose a debt repayment plan to be paid over five years in many cases. Creditors hope this will result in more debts being repaid.

The BAPCPA was championed not only by the retail banking and credit industry, which reportedly made \$100 million in contributions over several years to finally get the new law passed²⁵, but by conservatives, including Christian conservatives who were, in the words of the Christian Science Monitor, “appealing to higher authority to tweak the consciences of would-be defaulters”²⁶.

Although it is difficult to separate out the economic from the moral discussion, it is interesting to consider what the politicians were saying about the proposed new bankruptcy legislation before it became law. According to the Congressional Record, in 2001 then House Majority Leader Dick Armey said about the proposed bankruptcy reform legislation:

²⁵ California Bankruptcy Attorneys web site: http://www.ca-bankruptcy-attorneys.com/new_laws.html

Note: There is some dispute about the degree to which the credit industry played a role in pushing forward the BAPCPA, see Zywicki, “The Past, Present, and Future of Bankruptcy Law in America”, p. 215.

²⁶ G. Jeffrey McDonald, “The Moral Burden Of Bankruptcy”, The Christian Science Monitor, July 3, 2006.

“Bankruptcy laws in America have put a lie to one of the most important lessons we teach our children. Bankruptcy laws in America have said to our children, you are a fool if you do not file. That is not right.... It is not about the money. Anybody who thinks this bill is about who gets the money is missing the point.... This bill is about the character of the Nation...”²⁷.

In a similar vein, Judiciary Chairmen Sensenbrenner stated that “[t]he purpose of the bill is to improve bankruptcy law and practice by restoring personal responsibility and integrity in the bankruptcy system, and to ensure that the system is fair to both creditors and debtors”²⁸.

Since our legislators and credit industry question the individual consumer’s morality, believing it to be in need of “restoration” through legislation, it stands to reason that we also need to consider the moral standing of the creditors in our economy. After all, as we saw at the beginning of this evening’s discussion, you can’t have debt without credit, and the debtor-creditor relationship is necessarily a two-way street.

In expressing his frustration with the revisions to the Bankruptcy Code, a Texas bankruptcy judge stated in an opinion published in December 2005:

“Those responsible for the passing of [BAPCPA] did all in their power to avoid the proffered input from sitting United States Bankruptcy Judges, various professors of bankruptcy law at distinguished universities, and many professional associations filled with the best of the bankruptcy lawyers in the country as to the perceived flaws in the Act. This is because the parties pushing the passage of the Act had their own agenda. It was apparently an agenda to make more money off the backs of the consumers in this country. It is not surprising, therefore, that the Act has been highly

²⁷ 147 Cong. Rec. H518 (daily ed. Mar. 1, 2001).

²⁸ 147 Cong. Rec. H517 (daily ed. Mar. 1, 2001).

criticized across the country. In this writer's opinion, to call the Act a "consumer protection" Act is the grossest of misnomers.

It should be obvious to the reader at this point how truly concerned Congress is for the individual consumers of this country. Apparently, it is not the individual consumers of this country that make the donations to the members of Congress that allow them to be elected [House vote] and re-elected [Senate vote] and re-elected and re-elected."²⁹

In July of this year, the Christian Science Monitor published an article discussing the moral issues raised as we watch the effect of the BAPCPA on our economy and our society. The author pointed out that the tightening of the bankruptcy laws is happening while foreclosures were up 38 percent in the first quarter of 2006, and the average American household owes more than \$9,300 on credit cards alone, up from \$3,000 in 1990³⁰.

Other sources indicate that in the first half of 2006, 26% of all mortgage loan originations were for interest-only loans³¹. In turn, the Federal Deposit Insurance Corporation (FDIC), a regulatory agency concerned with promoting "public confidence in the U.S. financial system"³², published a report advising and warning consumers about interest-only ("I-O") mortgages³³. The report suggests that only those consumers falling within three categories should take out I-O mortgages:

²⁹ *In re Sosa*, 336 B.R. 113, Bkrtcy.W.D.Tex.,2005, Frank R. Monroe, Bankruptcy Judge. December 22, 2005.

³⁰ G. Jeffrey McDonald, "The Moral Burden Of Bankruptcy", The Christian Science Monitor, July 3, 2006

³¹ Katie Porter, web site: "Credit Slips: A Discussion On Credit And Bankruptcy"
<http://www.creditslips.org/creditslips/PorterAuthor.html>

³² FDIC web site: <http://www.fdic.gov/about/learn/symbol/index.html>

³³ FDIC web site: <http://www.fdic.gov/consumers/consumer/interest-only/index.html>

1. Those with modest current income, but reasonably certain that income will go up in the future (for example, if you're finishing your degree or training program);
2. Those already with sizable equity in their home and will otherwise invest that money elsewhere or;
3. Those with irregular income (such as commissions or seasonal earnings) and want the flexibility of making interest only or option-ARM minimum payments during low-income periods and larger payments during higher-income periods.

Although I was not able to locate any data in support of my hypothesis, I strongly suspect that if all the consumers falling within all three of these categories were added together, they wouldn't be anywhere near large enough a group to make up the 26% of interest only home mortgages taken out earlier this year.

Another trend within the home lending industry which should concern consumers involves the use of "stated income" home loans. These loans don't have the traditional income verification requirements. Rather, the loan is made based on whatever information has been provided by the borrower - unverified. Or in one case of an elderly widow living in Chicago, the very inflated income information was actually provided by the broker. Her actual income was only about 80% of her loan payment – needless to say, she had to work out a new deal. According to a Wall Street Journal report in August of this year, these

“reduced documentation” loans now account for approximately 40% of the entire U.S. mortgage pool³⁴.

Let’s consider the much battered credit card industry. According to a McClatchy Newspapers report, the credit card industry mailed out slightly over six billion solicitations in 2005³⁵. That’s about 20 solicitations for every man, woman and infant in the United States.

According to a 2005 report by Nellie Mae, a student lender, 76% of undergraduates had a credit card, which isn’t such a bad thing all by itself. However, the report indicates that only 21% of those students pay the cards off each month, and that the average balance on student credit cards was \$2,169.00, with 25% of the students having a monthly balance of \$3,000.00 or more³⁶.

Finally, let’s take a look at the government. On March 20, 2006, President Bush signed a bill raising the United States National Debt Ceiling to \$9 trillion, with an eye towards averting a possible government shutdown. When President Bush took office the national debt was \$5.6 trillion³⁷. As of last evening, according to the U.S. Department of the Treasury's Bureau of the Public Debt

³⁴ Lingling Wei, Wall Street Journal, August 22, 2006, p. D2.

³⁵ Bynyamin Appelbaum, MyrtleBeachOnline, Sun Times, July 11, 2006.

³⁶ Undergraduate Students and Credit Cards in 2004, An Analysis of Usage Rates and Trends by Nellie Mae, Published May 2005, Summary Statistics, http://www.nelliemae.com/library/research_12.html

³⁷ David Welna, “Congress Sets New Federal Debt Limit: \$9 Trillion”, www.npr.org, November 12, 2006.

web site, the national debt is a little over \$8.614 trillion, and has been rising to the tune of \$2.36 billion per day³⁸. That \$9 trillion ceiling isn't far away.

Another story which recently caught my eye involves the government taking action to protect military personnel from predatory lending practices. In a report published by the United States Department of Defense in August³⁹, it was found that soldiers, sailors and aviators are as much as four times likely as likely to avail themselves of so-called "payday loans" than civilians in the surrounding areas. The report also found that the payday lenders are preying on young, financially unsophisticated soldiers, with effective annual percentage rates on the loans topping 400%. Based on the report, the proposed 2007 Defense Authorization Act provides for a 36% interest rate cap for military personnel.

Some concluding thoughts. As an attorney who practices bankruptcy law, I have represented all sides involved in the process who get representation – debtors, creditors, and bankruptcy trustees. From my perspective, the United States already had a fairly well balanced system of bankruptcy laws in place prior to the enactment of the new BAPCPA. The purpose of bankruptcy laws is and should be to maintain a uniform balance of power in the creditor-debtor relationship, for the sake of the economy and for the sake of society. If the rate of debt defaults and bankruptcy filings goes up, it seems to me to be far too simple an answer to say this is the result of a moral decline on the part of

³⁸ <http://www.publicdebt.treas.gov/>

³⁹ http://www.usa4militaryfamilies.dod.mil/dav/lsn/LSN/BINARY_RESOURCE/BINARY_CONTENT/2141721.pdf

consumers. There seems to be little question that morality plays an important role in our economic relationships: Debtors should keep their promises, but creditors also have a responsibility to treat debtors fairly. The challenge is to be sure that, in any discussion of the morality of debt, both sides are considered.