CHAPTER ONE

Driven by Debt

Bankruptcy and Financial Failure in American Families

Katherine Porter

The waiting room is ordinary enough—lined with rows of simple metal chairs and barren of decoration other than a government poster of rules and regulations. The people in the room are ordinary too. They wear jeans and work boots, simple sun dresses and sandals, khaki pants and button-down shirts, or uniforms from retail stores. A few navigate into the room with a walker, and others try to find a space to accommodate a baby stroller. The room could be a local Social Security office or a parking permit bureau, just another pedestrian pause in daily life, but its atmosphere is the giveaway. Rather than the heavy stickiness of boredom, the room is filled with quiet anxiety. Conversations are hushed and brief. Many people twist their hands or study their shoes. The scene is like the waiting area in an emergency room, and for good reason.

This is the room where people wait to be diagnosed with a financial emergency—bankruptcy. The bankruptcy trustee calls people inside a small examination room and quickly reviews their debts, assets, income, and expenses. The trustee asks few questions; it's an easy diagnosis of flat broke in most cases. The need for these families to have legal help with their debts is obvious from their bankruptcy court records. Credit card debts, medical debts, and other unsecured debts typically total more than an entire year of the family's current income, and more than half of them are behind on their mortgage or car payments, facing foreclosure or repossession. Satisfied in most instances that the family qualifies for bankruptcy relief, the bankruptcy trustee sends husbands and wives, mothers and fathers, widows and young singles back to work or home.

As they leave the trustee's office, most people ask their attorney, "What's next?" They have typically struggled seriously with their debts for the previous one to two years. In fact, many households spent months simply scraping together the money and paperwork needed to file a bankruptcy petition. Most are skeptical that their problems just ended. What comes next in bankruptcy varies with people's circumstances. Some will receive a discharge of their debts in a few weeks, while others will struggle to repay creditors for

years. Some will save their houses and see bankruptcy as a miraculous cure. Others will suffer continued hardships, skid farther down the economic ladder, and view bankruptcy as a plea for help that went unanswered.

Nearly all of these families will remember their few minutes with the bankruptcy trustee as one of the most painful moments of their lives. Bankruptcy is a head-on encounter with promises to pay that cannot be honored and privations suffered trying fruitlessly to make ends meet. These families' aspirations of middle-class security evaporated under pressure from debt collectors. At least for now, their version of the American Dream has been replaced by a desperate hope that things do not get even worse. Driven by debt, these families are at rock bottom.

• • •

Anthropologist Katherine Newman asserts that there are no ceremonies to mark downward mobility.[1] This is a stark contrast to the graduation ceremonies and housewarming parties that mark upward mobility. But meeting the bankruptcy trustee is exactly such a ceremony. It is a visible group experience characterized by a routine series of events that tangibly marks a decline in class status. Bankruptcy is a public declaration that a family has "fallen from grace," to borrow Newman's characterization of Americans who skid down the economic spectrum.

In the waiting rooms of bankruptcy trustees across the United States, in 2010 approximately 1.5 million families endured the bankruptcy ritual.[2] Their experiences are evidence that some people lose the borrowing game that has become the American economy. Increased consumption was largely financed by debt, rather than by increases in wages or appreciation of assets. The consumer spending that drove the economy at the end of the twentieth century was not costless. It was bought and paid for with interest charges, late fees, increased stress about making ends meet, and sometimes, the humiliation of bankruptcy.

The debt loads that are commonplace among today's families would have been unthinkable a mere generation ago. The Great Recession that began in mid-2007 has widened the scope of the financial pain caused by overindebtedness, but the problem predated the large-scale economic meltdown that captured headlines. And all indicators are that consumer debt will be a defining feature of middle-class families in years to come. The "deleveraging" process of paying down debt and increasing savings has just begun. Along the way, more families will lose their homes or cars, trade off family time for second jobs, endure dunning from debt collectors, and slip farther down the economic ladder.

This book exposes the underbelly of consumer debt. It tells the stories of families who filed for bankruptcy in early 2007. Even at that time when the

economy was still strong, some households could not make ends meet. The plight of the bankrupt families in this book illustrates the financial pain that the Great Recession inflicted on tens of millions of middle-class families as the economy crashed in late 2007.[3] A survey by RAND researchers found that between November 2008 and April 2010, 39 percent of families had experienced one or more indicators of financial distress: being unemployed, having negative equity in their homes, or being two months behind on their mortgage or in foreclosure.[4] This "new normal"—a world of layoffs and job losses, cuts in social programs, and continued housing depreciation—only means that more people will find themselves collapsing under the weight of debts incurred in brighter economic times.[5]

Bankruptcy is a public window into how consumer debt has reshaped the middle class and its economic and social life. The staples of middle-class life—going to college, buying a house, starting a small business—carry with them more financial risk than ever before because they require more borrowing and new, riskier forms of borrowing. This book is about the endgame for those who borrowed in the hope of prosperity but could not sustain the heavy debt burdens of middle-class life. In telling these stories, we use empirical data. The figures and tables in this book reveal who suffers serious financial distress, how they get to that point, the hardships they face as they deal with overwhelming debt, and the difficulty they have righting their financial lives. Real people stand behind these statistics. This book tells the stories of their financial failures, exposing a part of middle-class life that is often lost in the success stories that dominate the American economic narrative.

DEBT: THE NEW MIDDLE-CLASS STATUS SYMBOL

The middle class is a powerful concept. Historically, the size and prosperity of the American middle class has been heralded as a great social and economic achievement. Membership in the middle class is associated with homeownership, educational opportunity, comfortable retirement, access to health care, and last but certainly not least, an appetite for consumer goods.[6] The middle class also has political appeal, as demonstrated by President Barack Obama's decision during his very first week in office to establish a Middle Class Task Force.[7] As chair of the task force, Vice President Joe Biden explained that middle-class life is the "old-fashioned notion of the American Dream" and that he and the president had "long believed that you can't have a strong America without a growing middle class. It's that simple. It's that basic."[8] The task force has focused its energy on job creation, retirement security, work-family issues, and higher education.[9]

But the task force has ignored entirely a revolutionary change in the lives of middle-class Americans: the increase in household debt. In the mid-1980s, the ratio of debt to personal disposable income for American households was 65 percent. During the next two decades, U.S. household leverage more than doubled, reaching an all-time high of 133 percent in 2007.[10] Measured in the aggregate, the ratio of household debt to gross national product reached its highest level since the onset of the Great Depression.[11] This record debt burden, which crested just as the financial crisis began, set up families to suffer deeply as foreclosures, unemployment, and wage stagnation set in for the years to follow.

The consumer debt overhang, however, began long before the financial crisis and recession. Exhortations about subprime mortgages reflect only a relatively minor piece of a much broader recalibration in the balance sheets of middle-class families. Debt began to climb steeply beginning in about 1985, with its growth accelerating in nearly every subsequent year. The run-up in consumer debt coincided with a period of deregulation of financial institutions and the preemption of state usury laws that capped interest rates. Unfortunately for American families, the debt binge was not accompanied by meaningful increases in disposable income. While income crept up, debt shot up, as Figure 1.1 illustrates. As debt grows relative to income, fami-

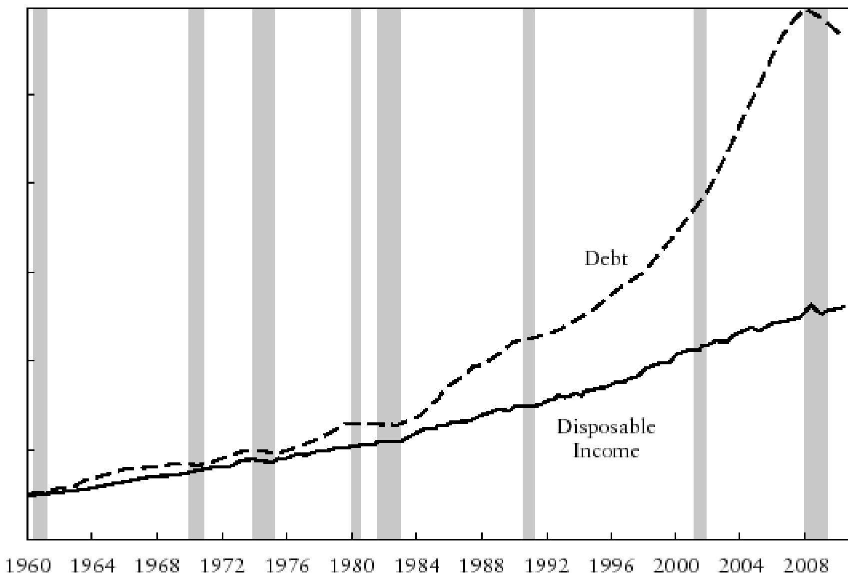

Figure 1.1 Real household debt and income, 1960–2010

SOURCE: Glick and Lansing, "U.S. Household Deleveraging"; updated data through Q1:2010 courtesy of Federal Reserve of San Francisco.

NOTE: All series normalized to 1960:Q1. Recession periods are shown in gray.

lies must stretch their dollars farther to pay for current consumption, while keeping up with debt payments. At some point, income simply becomes insufficient, and families must either curtail spending or default on debt.

The growth in debt outstripped the appreciation of assets during this same period. In other words, increases in liabilities—mortgage debt, home equity lines of credit, student loans, and credit cards—collectively grew faster than increases in assets—houses, cars, stocks, or cash savings. Edward Wolff of the Levy Economics Institute has calculated that as far back as 1995, the amount of mortgage debt began to increase faster than house values.[12] The result of the increased borrowing was to constrain or retard growth in household wealth. Indeed, between 2001 and 2004, the typical (median) American household's wealth actually declined.[13] This was an unprecedented event because the wealth decline occurred during a period of economic expansion. Household debt outstripped household asset accumulation for the middle class. For households with wealth between the 20th and 80th percentiles of the entire distribution, the debt-to-equity ratio climbed from 37.4 in 1983 to 51.3 in 1998, and then topped off at 61 percent in 2004 and 2007.[14] Whether assessed against income or assets, debt grew in proportion to other changes in families' balance sheets.

The boom in borrowing spans social classes, racial and ethnic groups, sexes, and generations. Every age group, except those seventy-five years or older, had increased leverage ratios between 1998 and 2007.[15] Similarly, African Americans, Hispanics, and non-Hispanic whites all saw their leverage ratios grow from 2001 to 2007.[16] This is not to suggest that the debt explosion was equally distributed. For example, between 2004 and 2007, typical people who lacked a high school diploma and typical households headed by a person between ages sixty-five and seventy-four experienced particularly sharp increases in their debt burdens.[17] In particular periods, some groups saw modest declines in consumer debt, but the overwhelming trend was increased amounts of debt among nearly every type of family. By 2007, when debt burdens peaked, 77 percent of American households had some type of outstanding debt.[18] Consumer debt has become one of the most common shared qualities of middle-class Americans, usurping the fraction of the population that owns a home, is married, has graduated from college, or attends church regularly.[19]

TOO BIG TO FAIL AND TOO SMALL TO SAVE: MIDDLE-CLASS FAMILIES IN CRISIS

As debt increases, so too does the risk of financial failure. This is as true for American families as it is for large corporations, where the catchy phrase "highly leveraged" captures a profound tilt into the red on a company bal-

ance sheet. Over the long haul, increases in consumer debt seem to explain a significant portion of the increased numbers of consumer bankruptcies.[20]

The escalation in debt has turned the smart financial decisions of the prior generation, such as purchasing a home or taking on student loans, into high-stakes economic gambles for middle-class families. Today, millions of Americans are losing those bets, struggling to avoid financial collapse. This statement was as true before the Great Recession as it is today. As President Obama explained in January 2010, "Too many Americans have known their own painful recessions long before any economist declared a recession."[21] The per capita bankruptcy rate, shown in Figure 1.2, provides one example of this phenomenon. Bankruptcy has become more frequent in the American population over the past three decades, although the filing trend of the past few years reflects the major reform of the bankruptcy laws in 2005.

Other markers of debt problems have also increased in recent years. The percentage of consumers who experienced a third-party debt collection activity has grown steadily in the past decade, doubling from 7 percent in 2000 to 14 percent in 2010.[22] Foreclosure filings, for example, climbed in the 1980s and 1990s.[23] The crisis in the mortgage markets sharply escalated the foreclosure rate; in 2009, one in forty-five homeowners received a foreclosure notice.[24] Debt collection was the leading complaint to the Federal Trade Commission in each of the past several years.[25] Credit card charge-offs, while highly sensitive to economic conditions, have generally crept higher (see Figure 1.3). The volatility of debt default has also increased. The Great Recession is causing a spike in credit card charge-offs that is much larger than other recent recessions.

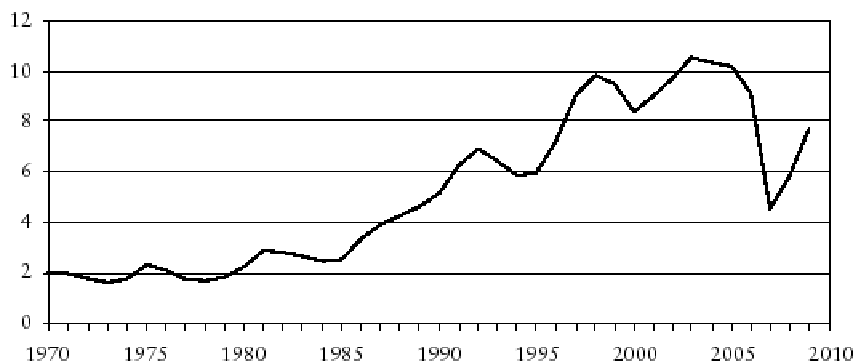

Figure 1.2 Consumer bankruptcy filings, 1970–2010 (per 1,000 25- to 64-year-olds)

SOURCE: Calculations by Robert Lawless and Katherine Porter from U.S. Census Population Estimates and Administrative Office of U.S. Courts data.

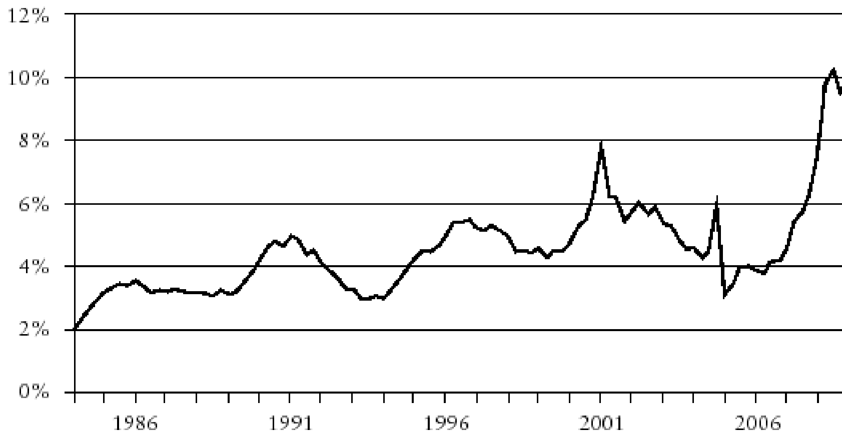

Figure 1.3 Credit card charge-off rate, seasonally adjusted, 1985–2009
SOURCE: Federal Reserve Bank Statistical Release.

Subjective measures of prosperity tell a story similar to the hard data: Americans' insecurity about their financial lives is on the rise. A New York Times/CBS poll found that in 1995, about one in six people did not think they would reach the "American Dream," as they defined it, within their lifetime. In 2005, more than 25 percent of people said the American Dream would remain out of their reach.[26] In 2008, the Pew Research Center reported data from surveys asking whether people were better off, the same, or worse than they were five years before, noting that the responses reflected "the most downbeat short-term assessment of personal progress in nearly half a century of polling."[27]

Despite the ubiquity of debt problems, most people in financial distress suffer silently.[28] The Great Recession may have shifted this cultural norm somewhat, particularly in locations where job loss or foreclosure is relatively common. But it is hard to dispute the fact that the media, Congress, and pundits have spent more time on the financial collapse of big banks than of everyday families.[29] At a conference I attended, someone quipped that while banks were "too big to fail," families were "too small to save." In part, this comment reflects the powerful importance of the risk frame in public policy: small incidences of harm rarely receive the attention of large ones, even if the accumulation of small harms dwarfs the single large harm. This preference to prioritize single large events over multiple smaller ones shortchanges middle-class families. The U.S. Treasury's bold intervention in the capital markets is a stark contrast to its anemic response to foreclosures at the family level: the Home Affordable Modification Program (HAMP), which has been criticized as inadequate.[30]

The inattention to the financial well-being of American families existed long before the collapse of Bear Stearns or Lehman Brothers demanded the attention of policymakers. Alan Greenspan's surprise at the number of subprime mortgages that originated during his tenure as chairman of the Federal Reserve is an example of the failure of government to monitor consumer finance at the household level.[31] When consumer credit did come to the fore, concerns about the dangers of borrowing were met with dogged claims that credit regulation would only lead to less availability of credit and no appreciable benefits to consumers.[32] In retrospect, retrenchment in borrowing seems like a good idea. The blind eye that policymakers turned to the risks of consumer borrowing has cost the world economy dearly.

Although the Great Recession had many causes, recent research demonstrates a link between household balance sheets and the economic downturn. Using cross-sectional, county-level data, finance professors Atif Mian and Amir Sufi conclude that their analysis supports "the hypothesis that the initial economic slowdown was a result of a highly-leveraged household sector unable to keep pace with its debt obligations."[33] The borrowing binge has certainly slowed; household debt contracted for the first time in the fourth quarter of 2008.[34] Since 2009, middle-class families have made efforts to pay down debt and to save,[35] although this progress remains small given the lopsided nature of families' balance sheets. This reduced debt may improve the stability of the overall U.S. economy in the long term, but the inability of families to keep borrowing to make ends meet will plunge some into hardship. A 2011 study found that if faced with a financial emergency, half of families could not come up with $2,000 from savings, family or friends, or borrowing. This evidence of widespread financial fragility illustrates the risks facing middle-class families during the recovery from the recession.[36] Decreased debt also will mean decreased consumer spending. Yet, middle-class consumption is the major driver of growth in the postindustrial economy. Families' efforts to pare down their debts by substituting repayment for spending, or their decision to forego repayment entirely by walking away from their mortgages or filing for bankruptcy, are likely to be drags on any economic recovery in the foreseeable future.[37]

Ultimately, we may recognize that in the U.S. economy, the middle class is too big to fail. This emerging insight will challenge the idea that consumer debt is too small of a subject to study deeply and with rigor. In exploring the plight of families whose debt problems drove them to bankruptcy, this book suggests the kinds of policies that might prevent or remediate unmanageable consumer debt.

THE 2007 CONSUMER BANKRUPTCY PROJECT

While bankruptcy is only one measure of serious financial distress, it is the most visible sign of financial catastrophe. It is a public place for seeing financial pain that is largely endured in private, behind closed doors. And because it represents a particularly extreme form of financial distress, it is a useful barometer of the financial suffering of American families. This book uses bankruptcy data to examine how growth in consumer debt undermines financial security and prosperity.

Researchers have studied families in bankruptcy for at least forty years.[38] Much of that work documented the financial profiles of people in bankruptcy, their demographic characteristics, and people's self-reported causes of their financial problems. This book updates and extends that literature. The dataset used in this book is the most recent iteration of the Consumer Bankruptcy Project (CBP), which was conducted in 2007. The CBP did its first study in 1981 and conducted expanded versions of similar studies in 1991 and 2001 (see the appendix for more details).

The 2007 CBP collected data on bankruptcy cases filed in the first few months of 2007. A random sample of about five thousand households was drawn from all Chapter 7 or Chapter 13 consumer bankruptcies, and these households were mailed a four-page written survey that asked for demographic information and reasons for bankruptcy.[39] On this survey, debtors were asked whether they would be willing to complete a telephone interview about their bankruptcies. More than twenty-four hundred households returned completed surveys, for a response rate of approximately 50 percent. The CBP researchers then completed telephone interviews lasting sixty to ninety minutes with 1,032 of these households about six to twelve months after they had filed for bankruptcy. Information on financial characteristics from these debtors' bankruptcy court records also was coded. Collectively, the three instruments (written surveys, bankruptcy court files, and telephone interviews) gathered thousands of pieces of data. The 2007 CBP is both the largest and the most comprehensive study ever conducted of families in bankruptcy.

The 2007 CBP coprincipal investigators came from several disciplines and had a wide array of research questions (see the appendix). Reflecting this diversity, the data are expansive in their scope. The CBP collected data on demographics, such as age, education, race, and marital status; financial characteristics at the time of bankruptcy, such as current income, current expenses, debts owed and names of creditors, and assets and their values; causes of bankruptcy, assessed both by self-reporting and by specific inquiries about certain bankruptcy triggers, such as a pending foreclosure; and

experiences in financial distress and bankruptcy, such as effects on children and marriages, emotional reactions to debt, and assessments of the bankruptcy process. This book provides comprehensive coverage of these areas; several other published works also use the 2007 CBP data.[40]

The appendix provides a more detailed methodology of the 2007 CBP. It describes the data collection process, calculations of response rates, and tests for response bias. The addendum to this introduction is a primer on consumer bankruptcy and will be particularly useful for those without legal training or who are not familiar with the prior literature on consumer bankruptcy. It describes the bankruptcy filing process, differences between the Chapter 7 (liquidation) and Chapter 13 (repayment plan) types of bankruptcy, and outcomes from bankruptcy.

FAILURE STORIES

Bankruptcy is contested terrain. One measure of this fact is that Congress spent ten years debating reforms to the consumer bankruptcy system before they ultimately became law in 2005. Some see bankruptcy as the refuge of the profligate, impulsive, or greedy—a symbol of consumption excesses and weakening moral fiber. Others see bankruptcy as the locus of the fallout from decades of structural changes in the allocation of financial risk among families, businesses, and the government—a symbol of a weakened social safety net and shifts in wealth away from the middle class.

This book's purpose is to counter the rhetoric about bankruptcy by providing data on the real families who file for bankruptcy. In analyzing their financial situations, we identify gaps and inconsistencies in the law, policy, and economics of consumer credit. Each chapter examines a different slice of the bankruptcy system, but the chapters together give a useful overview of the severe financial distress that plagues many American families struggling with their debts.

Part I. The Debtor Next Door

The book opens with an inquiry into who files for bankruptcy. In Chapter 2 Elizabeth Warren and Deborah Thorne describe the "bankrupt tribe,"[41] the families who live and work among us and whose financial problems remain largely invisible. They examine the socioeconomic status of families and show that measured by enduring socioeconomic characteristics such as education, occupation, and homeownership, more than 90 percent of bankrupt people are members of the middle class. Because their incomes at the time of bankruptcy hover between poverty and working class, these families are experiencing dramatic reversals of fortune when they collapse into bank-

ruptcy. Their stories are a rare opportunity to observe downward mobility, a phenomenon that is widespread in modern America but is much less studied than upward mobility.

Because the families in bankruptcy look so much like the rest of us, their problems—job instability, illness and injury, and family breakup—serve as a case study of the economic vulnerabilities of America's middle class. The bankruptcy data suggest that the old strategies for wealth building—homeownership, a well-regarded job, and college attendance—are increasingly correlated with financial insecurity. The demographics of bankruptcy in 2007 reflect the economic insecurity that plagues middle-class Americans, even during the best of times for the overall economy. The data also suggest that the path to middle-class prosperity may be perilous as traditional strategies for economic security do not offer insulation from financial distress.

The bankrupt are only one category of those with financial problems; millions of other households are financially vulnerable but not bankrupt. Brian Bucks in Chapter 3 compares bankrupt households with households in the general population using data from the CBP and the Federal Reserve's Survey of Consumer Finances. As alternatives to bankruptcy in understanding the breadth of household economic insecurity in the United States, he develops four measures of financial distress: households with very low financial assets, households with high debt payments relative to their incomes, households that were turned down for credit, and households that were delinquent on debt payments. The relatively small overlap between these groups and bankrupt households highlights the challenges for designing policies that take aim at reducing the overall level of financial vulnerability among Americans.

Part II. Starting Right, Ending Wrong

The causes of bankruptcy are complex. For most families, a confluence of factors rather than a single decision or event explains their overwhelming debts. The groundbreaking research of Teresa Sullivan, Elizabeth Warren, and Jay Westbrook pointed to three major life events that families frequently experience before bankruptcy: job problems, such as unemployment or a reduction in hours; illness or injury; and a major change in family structure, such as divorce or the death of a spouse.[42] This book explores three other life decisions that have a powerful influence on a family's risk of bankruptcy: owning a home, attending college, and starting a small business. Although these are typically viewed as "smart" financial decisions, they bring with them serious consequences for one's financial situation, largely because homeownership, college, and business startups today are financed with large amounts of debt. The data on the bankruptcies of these households are reminders that pursuing opportunity for upward mobility can itself lead to downward mobility.

In the years after the housing bubble burse in 2007, it is painfully easy to observe the risks of homeownership. The American economic landscape is littered with families who bought too much house with too little income and too little understanding of their mortgage obligations. Foreclosures remain at or near their highest levels in fifty years.[43] Underwriting criteria have constricted, closing off or at least significantly delaying homeownership for young families or those with limited savings;[44] and governments continue to reduce services to neighborhoods in the wake of declines in tax revenues and strain on social programs.[45] The fallout from the mortgage excesses of the 2000s has created a dire need for research that helps to identify the appropriate level of financial risk for homeowners.

In Chapter 4 Jerry Anthony explores the housing cost burdens of families in bankruptcy, including how those burdens vary by demographic factors. Among other findings, he identifies the higher likelihood of widowed or divorced people having high housing cost ratios and significant differences in ratios by age, a finding that has implications for financial planning over the lifecycle. He also analyzes whether housing cost ratios are associated with how households and lenders react to loan default. The findings have implications for designing policy responses to foreclosure.

Chapter 5 examines the intersection of education and bankruptcy risk. For the past several decades, policymakers have embraced the mantra that "college pays."[46] I test this idea against the educational experiences of bankrupt people and do not find the expected linear relationship between more education and less bankruptcy. In fact, the people who attended college but did not graduate with a four-year degree are overrepresented in bankruptcy. While this outcome does not seem to be driven by student loan debt, it nonetheless suggests the existence of long-term financial consequences of attending college without earning a bachelor's degree. Advocates of more vocational or community college attendance may want to reevaluate policies to expand college attendance if further research bears out a relationship between some college attendance and financial insecurity and bankruptcy. This chapter's analysis does not purport to be causal, but it challenges conventional ideas about the traditional paths to middle-class prosperity.

Robert Lawless, in Chapter 6, tackles another example of how assumptions about the path to achieving the American Dream may mask the hard realities of financial risk taking. His analysis finds that self-employed people are overrepresented in the bankrupt population. Furthermore, when these people collapse into the bankruptcy system, they do so with very large debts, even compared with other bankrupt families. His data are a powerful reminder that starting a business may pay big dividends, but like all things with the potential for higher-than-average financial returns, it carries

a higher-than-average level of risk. He juxtaposes the failures of the self-employed whom he observes in bankruptcy against the dominant narrative of successful entrepreneurship.

Part III. Hurting at Home

Bankruptcy is a profound financial event that has the potential to rewrite a family's balance sheet, eliminating some debts and forcing the surrender of some assets. These financial changes should not undercut the ways in which bankruptcy is also a social and emotional phenomenon. In this part of the book, Marianne Culhane and Deborah Thorne describe the personal, not merely the financial, consequences of financial distress.

Between 2007 and early 2010, 6.6 million families had foreclosures initiated on their homes.[47] This number is only a rough estimate and may miss families who surrendered or sold their houses because of financial pressures. In Chapter 7 Marianne Culhane uses the bankruptcy data to reveal what happens to families who lose their homes. She shows that many of them return to renting or live with family or friends for a significant period—if not for the rest of their lives. Using debtors' own words, she documents the reasons that families desperately wanted to hang on to their homes. For Americans, their own home is an anchor in the social landscape. Without this mooring, many families are fearful about their futures and experience a loss of place that leaves them disoriented in their social worlds.

Marriage is to be "for better or for worse"; for many couples, bankruptcy and the financial distress that precedes it is a time of "for worse." Sociologist Deborah Thorne in Chapter 8 connects the emotional experiences of men and women in bankruptcy to the literature on gendered patterns of work. Women in financially distressed families overwhelmingly bear both the responsibility for paying bills and the emotional fallout of trying (but failing) to make ends meet in the years before the family files for bankruptcy. Thorne exposes how gender-neutral legal systems, such as bankruptcy, rarely operate in ways that affect men and women equally. Financial distress seems to hurt nearly everyone who falls into that condition, but these two chapters suggest that homeowners and women experience particularly acute emotional pain.

Part IV. The Hard Road Out

Bankruptcy is not itself supposed to be a problem. By design, it is meant to be a solution to the problem of financial distress. But like most policies, it is far from a perfect solution. Those who look to bankruptcy for easy relief are surely disappointed. The data show that the bankruptcy system is expensive, complicated, and sometimes unjust in its operation. The financial crisis may provoke a renewed interest in designing a better safety valve for families

with overwhelming debts. Chapter 9 by Angela Littwin on the importance of attorney representation in bankruptcy, and Chapter 10 by Dov Cohen and Robert Lawless on racial disparities in the bankruptcy system, point to two important considerations in any redesign of the bankruptcy system.

Although one would expect consumer law to be accessible to consumers, bankruptcy may be the poster child for the failure of the law to achieve that criterion. Bankruptcy law is, in fact, quite complex, at least in part because it is designed around a one-size-fits-all system that accommodates the insolvency of both multimillion-dollar corporations and the family next door. Littwin's analysis shows that unrepresented debtors, those who file pro se without lawyers, fare significantly worse in bankruptcy than their counterparts who have lawyers. She documents who foregoes a lawyer and shows a surprising effect: it is not the poorest or least sophisticated debtors who attempt bankruptcy on their own, but rather those who seem to believe that the high cost of a lawyer is an expense they can forego. The data show the folly of that hope. Even in the simpler form of bankruptcy, Chapter 7, the lack of an attorney increases by ten times the likelihood that a debtor will fail to receive a discharge of debt. In Chapter 13 bankruptcy, the outcome of doing it oneself is near certain dismissal of the case without substantial debt relief. The stakes are high in bankruptcy, and families who take the bankruptcy gamble by themselves are certain to suffer.

On its face, bankruptcy law is race blind; it has no equivalent to financial affirmative action or discrimination imbedded in it.[48] The system's operation may not be neutral as to race, however—a possibility that has particular cultural resonance in the United States where African Americans have long suffered financial disadvantages. Cultural psychologist Dov Cohen and law professor Robert Lawless find that African American households file Chapter 13 bankruptcy at more than double the rate of debtors of other races. Because Chapter 13 debtors, as compared with Chapter 7 debtors, are less likely to receive a discharge of their debts, more likely to pay higher attorneys' fees, must stay in the bankruptcy system longer, and typically must repay some of their debts, the differential in chapter choice translates to differential debt relief among racial groups. Cohen and Lawless link their findings to a long literature on "local legal culture" in bankruptcy and suggest that racial bias may be a hitherto unforeseen aspect of legal decisions.

Part V. The Once and Future American Dream

The last two chapters of the book put financial distress from unmanageable debt in a larger perspective. In Chapter 11 Kevin Leicht provides historical and social context for the remarkable growth in household borrowing. The expansion in debt coincided with two other powerful economic phenomena:

a stagnation in wages and a sharpening of inequality between the richest households and middle-class households. His statistical simulation shows how the debt burdens of today's families would have been unthinkable in the prior generation. Leicht describes how debt is used as a tool to simulate social class. He conceptualizes debt as a buoy to keep middle-class lifestyles afloat in the face of trends such as stagnant wage growth that would otherwise undermine middle-class consumption desires. In this way, the book reconnects firmly to its opening focus on the way in which debt is ubiquitous in the middle class.

Chapter 12 locates bankruptcy risk in the context of an overall decline in economic security for American families. Political scientist Jacob Hacker describes the need for a twenty-first-century social contract that protects families against the most severe risks they face, including problems such as job dislocation, medical bills, family care-giving obligations, and retirement insecurity, which can push families into overwhelming debt and even bankruptcy. He argues that economic security is a necessary component of economic opportunity and that an improved social safety net requires a redistribution of economic risks among families, private industry, and government.

PROTECTING MIDDLE-CLASS PROSPERITY

America's relationship with borrowing is at a turning point. Lenders have tightened underwriting standards, and households are reducing their spending and saving more of their incomes. Even the federal government has taken decisive action with the creation of a new regulator, the Consumer Financial Protection Bureau, which is specifically charged with monitoring the functioning of the consumer credit markets.[49] The open question is whether this retrenchment will endure or accelerate. In the early twenty-first century, debt is still near record levels, relative to income, and twice as high per family as in the 1980s.[50] Will the United States reverse more than two decades of reliance on consumer borrowing and gradually work its way back to debt burdens of the post–World War II period of prosperity? Or will the borrowing habit return in a few years as the Great Recession recedes, with another boom in borrowing replacing the past few years of bust? The choice between these paths has profound consequences for the economic security of America's middle class.

The bankruptcy data illustrate the deep economic pain experienced by millions of middle-class families. Consumer debt is not the only reason for the increasing financial vulnerability of Americans; stagnant wages, increased volatility in the labor market, health-care and college costs that outpace inflation, and longer lifespans that strain retirement savings all play a

role. Consumer debt is particularly useful as a lens for middle-class prosperity, however, because in the past two decades debt was the crutch of families wounded by other economic harms. Debt smoothes consumption over time; for example, it can ease the uneven income that characterizes the rising cadre of temporary and contract workers in the country. Debt substitutes for cost controls in markets gone astray; for example, people increasingly must finance medical bills because they overwhelm their monthly budgets. Debt fills gaps in people making ends meet when social programs erode; for example, people may borrow from a payday lender to cover utility bills as local governments eliminate energy subsidy programs.

These functions for debt are not inherently bad. To the contrary, debt has long been a lynchpin of opportunity in our society. But there is concern that too many Americans have borrowed too much and that they have often taken on debts that will worsen, rather than improve, their financial situations. This book exposes the harms of consumer debt because those harms are one piece of information needed to regulate consumer credit markets. The cost of debt is not just the annual percentage rate charged to a family; it is also the social costs of some borrowers becoming hopelessly mired in debt and the macroeconomic effect of overleveraged households. Those costs are being paid by today's middle-class families during the Great Recession and will likely continue to be paid in the upcoming decade. Economic models of the amount that families would need to save to push the debt-to-income ratio down to 100 percent over the next ten years show that such dramatic changes in household behavior would subtract about three-fourths of a percentage point from annual consumption growth each year in the next decade, relative to the savings rate remaining at its 2008 level of 4 percent.[51] The cumulative result of households' addressing their unstable and risky debt burdens will be to drag down economic growth for the entire nation.

Going forward, we cannot afford to adopt a blind belief that more debt equals more prosperity. We cannot sustain national economic prosperity while unmanageable borrowing undermines the prosperity of American families. But neither can we afford to limit opportunity and shunt upward mobility for the middle class by buying into fear that all borrowing is bad. The challenge is to figure out how to calibrate consumer credit markets to balance the harms described in this book against the benefits of borrowing.

ADDENDUM: A PRIMER ON BANKRUPTCY

Bankruptcy is one of the most common legal processes in the United States. In 2010, about one consumer bankruptcy case was filed for every 76 households in the country. Put differently, if you were to drive past one thousand

houses in a subdivision that was representative of the U.S. population, you would pass thirteen households that had just filed for bankruptcy. But despite its widespread use by everyday people, bankruptcy is a complicated process. The public understanding of bankruptcy is mired in myths and misunderstandings, often by those who see its relief as a panacea for all financial ills. While many of the authors of the chapters in this book are legal experts on bankruptcy, others write as outsiders to the system. This book is designed to be accessible to anyone who wants a better understanding of the problems of consumer debt in American families and who has some familiarity with social science statistics. Particularly for people interested in legal policy or methodology, however, a basic knowledge of bankruptcy may be useful. Here I outline the broad contours of the consumer bankruptcy system, describing the relevant law on the books and the empirical data about how that law operates in reality.

Nearly all consumer bankruptcies in the United States are voluntary. The process usually begins with people contacting a bankruptcy attorney, or less commonly, making the decision to file without an attorney representation. The bankruptcy attorney will typically gather information about the family's financial characteristics, such as assets, debts, and income. The family will often describe the particular problems that triggered their decision to seek bankruptcy relief. The most common pressures are repeated contact with debt collectors or concern about losing a home to foreclosure.[52]

Attorneys will counsel debtors on which type, or chapter, of bankruptcy to file.[53] About two-thirds of consumer bankruptcy cases are filed under Chapter 7, with the remaining one-third being Chapter 13 cases.[54] Chapter 7 differs greatly from Chapter 13; the choice of which chapter to file influences everything from the cost of legal fees and the length of the bankruptcy to the substantive type of debt relief available. Table 1.1 shows the main differences between Chapter 7 and Chapter 13.

Chapter 7 is the more familiar "liquidation" bankruptcy. The trustee reviews the debtor's assets and determines what, if any, property the law permits to be sold to satisfy debts. The makeup of this "exempt property" varies depending on the debtor's state of residence but often includes things thought to be necessary for basic existence, such as clothing, modest household furnishings, or a single household vehicle. The two most important exemptions are probably the amount, if any, of protection for a family home ("homestead exemption") and for cash (often a pending tax refund) because these are often the most important property of debtors. If debtors want to avoid the sale of property that is not exempt, they may choose to file Chapter 13 instead.

In the vast majority of Chapter 7 cases, there are no nonexempt assets for the trustee to liquidate.[55] In other words, the debtor does not have any

TABLE 1.1
Major differences between Chapter 7 and Chapter 13 bankruptcy

	Chapter 7	*Chapter 13*
Type of procedure	Liquidation ("sell off")	Reorganization ("pay out")
Exempt property	Nonexempt property sold and proceeds distributed to creditors	Retain all property regardless of exemptions
Treatment of collateral	Must be current on payments or creditor usually will be permitted to foreclose/repossess	Can be retained even if behind on payments; can catch up on missed payments over repayment plan
Payments to creditors	No payments required to unsecured creditors; debtor retains all future income	Payments made to unsecured creditors out of future income; payment amounts vary
Court involvement	Minimal; often only if debtor reaffirms a dischargeable debt or a creditor contests discharge	Moderate to heavy; court must approve repayment plan; debtor's plan is administered by trustee
Discharge	About four months after filing	After plan completion (three to five years)
Attorneys' fees	Usually $1,000–$1,500	Usually $2,000–$4,000

property that can be sold to repay unsecured creditors. The trustee examines the debtor at the meeting described in the opening of this chapter and files a report that there are no assets, and the debtor's unsecured creditors receive no repayment from the bankruptcy. If there are nonexempt assets to sell, the trustee will sell them and distribute the sale proceeds pro rata to the debtors' creditors. This means that each unsecured creditor receives a share of the proceeds that is in proportion to how much it is owed as a share of the total unsecured debt.

Secured creditors, such as mortgage companies or car lenders, have taken collateral to secure repayment of the debt, so they are treated differently in bankruptcy. They have more rights, including most fundamentally the right to repossess the property if the debt remains unpaid during the bankruptcy proceedings. In Chapter 7, debtors are often current on their mortgage or car payments and simply continue making the payments. Alternatively, debtors will be required to reaffirm the debt in order to keep the property. A reaffirmation is a legally binding promise to repay the debt. These agreements must be filed with the bankruptcy court. Sometimes debtors cannot afford to keep the collateral. They may have been behind on payments when they filed for bankruptcy or not be able to keep up with payments during or after the bankruptcy. In these situations, the secured creditor will repossess the collateral (or foreclose on the home). The creditor gets the property or its value upon sale. A bankruptcy discharge, however, means that the debtor will not

owe the creditor the deficiency amount; this is any amount that remains due to the creditor after the collateral is sold.

Chapter 7 bankruptcies usually last only four months. The debtor files the required paperwork, the trustee reviews the case, and the debtor receives a discharge from the bankruptcy court. The discharge is an injunction that forbids the debtor's creditors from attempting to collect the discharged debts. The discharge is powerful relief, letting the debtor off the hook for many common debts, including credit card bills, hospital and medical bills, and deficiency obligations. A bankruptcy discharge is not complete relief, however, from all financial problems. Student loans, certain tax debts, and some obligations incurred shortly before bankruptcy usually are not discharged. Just as importantly, debtors emerge from Chapter 7 back into their regular lives, having to make ends meet on whatever income they earn. Many debtors continue to struggle financially, largely because the majority of bankrupt people have low incomes.[56]

Chapter 13 bankruptcy operates on a different premise from Chapter 7. Debtors can retain all of their property, regardless of whether the law exempts it, but they in turn must commit to using all of the disposable income they have during the next three to five years to repaying their creditors. Some debtors cannot file Chapter 13 because they do not have any income at all, or more commonly, they do not have enough income to confirm a repayment plan. The operative issue in Chapter 13 is usually whether the debtors' proposed treatments of their secured creditors are in accord with the requirements of bankruptcy law. Debtors must have enough income to keep up with payments on any property they want to keep, such as their house or car, and also to catch up on any missed past payments. While the law has some flexibility to adjust the terms of these debts, it is fairly limited, especially for mortgage debts. Successful Chapter 13 debtors need to have enough money to keep up with their regular, ongoing secured debt payments; find additional money in their budgets to make up missed payments; and keep their households supplied with food, clothing, gas, and other necessities. Perhaps because of these challenges, some Chapter 13 debtors do not confirm a repayment plan, either dropping out of bankruptcy entirely or converting their cases to Chapter 7.[57] Many Chapter 13 debtors do confirm a plan but then stumble as they try to make the required payments for the three- to five-year plan period. In Chapter 13, the discharge of unsecured debts does not occur until the end of the repayment plan. Only one in three Chapter 13 filings gets to this point.[58] The norm in Chapter 13 is not discharge (the standard outcome in Chapter 7) but instead continued liability for unsecured debts, along with temporary relief during the attempted repayment plan.

Chapter 13 cases require more intensive court and trustee involvement. The court must approve the Chapter 13 repayment plan, finding that it is

feasible and that it provides the required treatment to secured and unsecured creditors. If in the trustee's judgment the debtor's budget does not look reasonable or does not propose to pay all disposable income to unsecured creditors, the trustee may object to the plan being confirmed. Courts are also often asked to rule on whether a secured creditor can repossess collateral or a case should be dismissed. The trustee collects the debtor's payments in the repayment process, distributing them as appropriate to secured creditors, unsecured creditors, and the debtor's attorney. The trustee will move to dismiss the case if the debtor misses payments.

In both kinds of bankruptcy, debtors file extensive paperwork—typically about fifty pages.[59] This paperwork is complicated and often completed with the help of an attorney. It includes a petition with basic information about the debtor, with the debtor's signature indicating under penalty of perjury that the paperwork filed in the case is correct. The debtor also files various schedules, which are essentially lists of the debtors' assets, debts, income, expenses, and significant past financial events. These court records are public, but the court system requires a nominal fee and password for someone to access them electronically or a trip to the courthouse for someone to see them for free in person. Bankruptcy is reported to credit-reporting agencies and can stay on a debtor's records for up to ten years.[60]

The complex legal choices and paperwork requirements of the consumer bankruptcy system mean that legal fees are fairly expensive. In 2007, the median Chapter 7 debtor paid $1,000; the median Chapter 13 debtor paid $2,500.[61] On top of these charges, debtors must pay about $300 in filing fees to the bankruptcy court. In Chapter 7, the attorneys' fees are paid up front, usually requiring debtors to save them up over several months or to delay filing until they have some extra income, such as a tax refund. In Chapter 13, debtors usually pay only a small fraction (often $200) of the total attorneys' fees at the time of filing. The attorney collects the rest in the form of disbursements from the trustee during the debtor's repayment plan.

Nearly everything just discussed is subject to dozens of exceptions, some resulting from legal loopholes, but primarily because bankruptcy practice varies tremendously across the country. On paper, bankruptcy is federal law, codified in Title 11 of the U.S. Code. Indeed, even back in 1787, the people who drew up the U.S. Constitution recognized that interstate commerce would necessitate "uniform laws on the subject of bankruptcies throughout the United States."[62] In reality, however, the practices of judges, trustees, attorneys, and even debtors themselves vary.[63] For example, Chapters 9 and 10 in this book describe variation in the proportion of pro se (no attorney) cases and in the fraction of cases that are Chapter 13s. The number of people who have previously filed for bankruptcy also varies by location, but an estimate for the national rate of repeat filings is 8 percent.[64]

Some readers will notice that the centerpiece of the 2005 amendments to the bankruptcy laws, the so-called means test, has not been mentioned in the discussion thus far. This omission is intentional and reflects the fact that the largest discernable effect of the means test seems to have been to dramatically increase attorneys' fees, rather than to force large numbers of debtors to repay their debts. The basic thrust of the means test is to apply standardized criteria to determine whether debtors have sufficient income to repay their debts and therefore should be forced to file Chapter 13 or abstain from bankruptcy relief altogether. The financial profiles of bankruptcy debtors did not change dramatically because of the means test.[65] Most debtors have incomes that are low enough to allow them to remain eligible for Chapter 7 bankruptcy, and most of the remaining group has expenses that the law permits them to deduct to avoid being screened into Chapter 13. Of course, we do not know how many families may be deterred from bankruptcy because of the means test. We see only those who do file. This is another reminder that people who file for bankruptcy represent only one segment of people in financial distress; for every family who files for bankruptcy, more families narrowly scrape by without bankruptcy or hover only one financial event from collapse into bankruptcy.

ADDITIONAL RESOURCES FOR THIS BOOK

This book has a website, *www.sup.org/broke*. It contains additional tables and data for some chapters. The book is designed to be useful as a reader for a course in law or social stratification. The website contains two sample syllabi that may be reproduced in their entirety or may serve as models for instructors wishing to design their own courses around the book. One syllabus is for an upper-class seminar in a law school; it contains descriptions of writing assignments and in-class exercises as well as a complete reading list for the semester. The other syllabus is appropriate for a graduate course in public policy, sociology, or similiar disciplines. Assigning one chapter for each of the twelve weeks of the course provides students with continunity of material and exposure to different disciplines that study consumer debt issues.