CONSUMER BANKRUPTCY: A THIRD WAY BETWEEN AUTONOMY AND PATERNALISM IN PRIVATE LAW

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Abstract

The introduction of American ideas of consumer bankruptcy in European continental civil law systems appears to present an opportunity to resolve some of the paradoxes of paternalism analysed by Ogus.[1] Bankruptcy law for individuals in Europe has evolved from a neglected field of procedural civil law, in which creditor autonomy was the prevailing norm, into a blossoming field of social policy and consumer protection. This article sketches the history of 'bankruptcy waves' and reflects on the possibilities of a future regulatory wave in which the lessons of the credit crunch have been incorporated. It concludes with some thoughts on the theme of this issue of the *Erasmus Law Review*.

1 Introduction

The tension between autonomy and paternalism in private law has a long history. In this article, I will present consumer bankruptcy as a hyper-modern private law institution in which a middle ground has been realised, at both national and European level.

I have never believed that private law institutions are politically neutral and have found it rewarding to explore the political dimensions of substantive and procedural regulations in the fields of debtor-creditor law. Unlike law and economics scholars, in the field of socio-legal studies we are not so much inclined to define contractual relations in individual, but in social, societal and sociological terms. Furthermore, unlike Margaret Thatcher, we believe that there is such a thing as society, not only individuals.

I have deliberately chosen the include the phrase 'a third way' in the title of this article, because it refers to – and is an icon of – the discussions in the 1990s about the renewal of social-democratic political thought.[2] This makes the concept relevant for the juxtaposition of autonomy and paternalism in contract law. Third-way thinkers have tried to find an ideological middle way between the dynamics of market forces and societal innovation, on the one hand, and a leaner welfare state that is aimed at activating rather than pampering its citizens, on the other.

In 2010, we are facing the results of a big credit crunch after decades of unprecedented economic growth in the West, which has been financed to a large extent with borrowed money. Now that the financial system and the underlying markets have obviously failed to produce eternal prosperity, governments, businesses and consumers must pay back the debts that they previously accumulated.[3] One of the battlegrounds will be the bankruptcy of individuals, which makes this an ideal opportunity to test autonomous and paternalistic assumptions that constitute private law in action. Rich Western societies have to devise policies to distribute the damage between creditors, debtors and society at large in a fair and acceptable manner.

I have been a student of consumer credit contracts since I wrote my dissertation in 1981[4] and was involved in drafting the Dutch Consumer Credit Act (1984-1990).

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1 A. Ogus, 'The Paradoxes of Legal Paternalism and How to Resolve Them' (2010) 30(1) *Legal Studies* 61-73.

2 A. Giddens, *The Third Way: The Renewal of Social Democracy* (Polity Press 1998).

3 See R.A. Posner, *A Failure of Capitalism: The Crisis of '08 and the Descent into a Depression* (Harvard University Press 2009).

4 N. Huls, *Consumer Credit, Socio-Economic Considerations, Especially in Relation to Hire Purchase* (dissertation (in Dutch), Utrecht) (Deventer: Kluwer 1981).

Substantive consumer credit contract law is a very timely subject in 2010, as we are facing pay-back time after the credit crunch. In credit law we can examine the strengths and weaknesses of both consensual and institutional approaches.

When a consumer signs a consumer credit contract, he uses his future earning power in the present. In the credit market, the person is a free and autonomous consumer, but for his future income he is usually dependent on his employer. Credit contracts constitute long-term relationships, and this means all kinds of events may interfere in the normal execution of the contract (e.g. divorce, unemployment, etc.). If the debtor is unable to continue his payments, he has a problem with his creditor. Because credit is so readily available nowadays, a debtor in default normally has many creditors. If a debtor cannot pay his debts, there will also be a fight between the creditors for the debtors' assets and future income. Here, procedural private law comes into play: collective debt enforcement often ends in bankruptcy.

In this article, I will examine the birth and development of the consumer bankruptcy model that Europe has modelled after the US Bankruptcy Code.

My starting point is a book that I published in 1994 – together with some colleagues – at the request of the European Commission.[5] The book was an academic attempt to promote the combination of existing informal social practices with a new legal impetus from the US Bankruptcy Code, at both EU and national level.

More recently, I have participated in the collective efforts of the Working Group on Consumer Bankruptcy of the Law and Society Association.[6]

2 A Short Political History of Debt Enforcement

Pacta sunt servanda is the ultimate incentive for the autonomous individual to take full responsibility for keeping the promises he has made. As such it is a rock-solid moral, legal and policy principle of human coexistence.[7] The binding power of agreements is also a vital element of our daily social life.

In pre-modern times, not paying debts was regarded as a punishable offence. Not honouring personal promises was considered a morally reprehensible deed. Non-payment of debt was primarily an offence against the contractual party, but it was also a social evil that lent itself well to a public response. Cruel practices (e.g. drawing and quartering or the stocks), forms of slavery (e.g. peonage or forced labour) and incarceration (debtors' prison) were the severe responses by which society and the legal system traditionally expressed their abhorrence.[8] Therefore, bankruptcy has a long and depressing[9] tradition of retribution.

A first breakthrough occurred when capitalism began to develop and industrial production methods became increasingly large-scale. Commercial transactions became larger and riskier, which meant that private entrepreneurs/owners were no longer willing to guarantee their companies' obligations. The legal answer to this need for restricting liability was the legal person (*rechtspersoon*). If an entrepreneur did not want to be liable in person, his company's debts were borne by a legal construct. The societal gain attached to the entrepreneurial spirit and risk-taking were considered to be greater than that of bearing personal liability for debts. The idea behind this legal construct was that

[5] N. Huls et al., *Overindebtedness of Consumers in the EC Member States: Facts and Search for Solutions*, Collection Droit et Consommation No. 29 (Diegen, Belgium: Story Scientia 1994).

[6] J. Niemi-Kiesliainen, W.C. Whitford and I. Ramsay (eds.), *Consumer Bankruptcy in Global Perspective* (Oxford/Portland, Oregon: Hart 2003); and J. Niemi, I. Ramsay and W.C. Whitford (eds.), *Consumer Credit, Debt and Bankruptcy: Comparative and International Perspectives* (Hart 2009).

[7] H. Arendt, *The Human Condition* (University of Chicago Press 1958). See, in particular, the final sections of Part V.

[8] J.H. Dalhuisen, *Compositions in Bankruptcy: A Comparative Study of the Law of the EC Countries, England and the USA* (doctoral dissertation, Amsterdam 1968).

[9] 'Bankruptcy is a gloomy and depressing subject' is the famous opening phrase of Charles Warren's *History of Bankruptcy Law* (Harvard University Press 1935).

society as a whole benefited from the legal protection of adventurous entrepreneurs. This limitation of the entrepreneur's liability was not considered to be paternalistic at all!

A second development was the need for bankruptcy as a collection tool against small entrepreneurs. This legal instrument is of particular importance in preventing individual creditors of a company in financial difficulties from jumping the queue and causing a damaging mutual struggle entailing significant social costs. Because bankruptcy is also a conflict between creditors inter se, the law traditionally recognises the figure of an independent administrator (trustee), who is responsible for the optimal and honest settlement of the claims, or an honest distribution of the losses, in order to prevent the bankruptcy degenerating into a situation in which the debtor is 'robbing Peter to pay Paul'. This is a classic collective action problem[10] that creditors themselves cannot resolve, given their conflicting individual interests. Government intervention in this multi-party constellation is necessary, without a need for paternalistic justification. Creditor autonomy does not do much good when the insolvent debtor has many creditors.

In contrast to the commercial world, bankruptcy law for individuals long remained an underdeveloped area. This legal field only really gained importance in the 1960s when Western economies developed into full-blown consumer societies, where credit began to play an increasing role. Credit was regarded as an important positive engine for economic growth. The moral objections to 'live now, pay later' faded into the background when big bona fide financial institutions began providing large-scale credit to broad swathes of the population. Initially the focus was on installment payments, credit linked to specific purchases, but later loans and revolving credit came to prominence: credit the consumer could utilise freely.

Once consumer credit reached full maturity virtually everywhere in rich Western European countries, the interest in consumer bankruptcy along American lines arose of itself.[11] In America, the limited liability of the consumer in bankruptcy functioned as a social safety net for which the Europeans had welfare state provisions. American concepts like 'discharge of debts' and the 'fresh start' policy appealed to European policy-makers for various reasons. It fitted well in a period of deregulation and privatisation, where state interference was regarded, in the famous words of Ronald Reagan 'not as the solution, but as the problem'. European politicians wanted to slim down the bloated welfare state, and a debt clean-up law sat well within liberal thinking. It was after all a type of social policy for which the politicians could receive credit, while passing the bill to the creditors.

Furthermore, the American legal concepts fitted well in Europe's *zeitgeist* of the 1990s. The overindebted consumer was no longer regarded as a deviant who readily became dependent on the state but as someone who has taken too much risk on the financial markets. Entrepreneurial risk-taking was then part of the new ideal of citizenship in civil society. In that same period, the OECD criticised European governments[12] for the fact that their harsh bankruptcy laws made small entrepreneurs risk-averse to setting up new businesses, and they became a target group for the new bankruptcy legislation.

In sum, the political message of the 1990s was: protection of debtors against creditors yields big societal benefits, and the transformation of old-fashioned procedural private law is a good mechanism for gaining these benefits.

[10] M. Olson, *The Logic of Collective Action. Public Goods and the Theory of Goods* (Harvard University Press 1965).

[11] See G. Hörmann (ed.), *Consumer Credit and Consumer Insolvency: Perspectives for Legal Policy from Europe and the USA* (ZERP/Bremen University Press 1986); M. Balz, 'Insolvenzverfahren für Verbraucher?' (1986) *Zeitschrift für Rechtspolitik* 12 ff..

[12] For example, OECD, *Reviews of National Science and Technology Policies: The Netherlands* (1986).

3 Historical and Comparative Analysis of 'Waves' of Bankruptcy Regulation[13]

Historically, there are four periods of more or less intense activity by legislators in developing bankruptcy law.

3.1 The First Wave: Fair Distribution of Property

The first regulations were derived from the French Commercial Code of 1806. The French regulated the distribution of the property of merchants in favour of their creditors through a form of creditor self-regulation. The French code mandated the *tribunal de commerce* (lay institutions) to proceed in bankruptcy cases.

The second step in the regulation of bankruptcy occurred at the end of the nineteenth century and took place not only in continental Europe but also in England and America. Bankruptcy had become particularly important against the background of the industrial revolution in continental Europe. In 1877, Germany passed a more general bankruptcy code that incorporated merchants and companies but, significantly, did not exclude individual debtors. Similar legislation was adopted elsewhere in Europe. The US Bankruptcy Act was passed by the US Congress in 1898.

This late nineteenth century law was based on the idea that bankruptcy should help creditors to recover as much as possible of the debt owed to them from the commercial debtor's assets. In fact, under the Greek, French and Belgian bankruptcy schemes, only merchants and companies can be declared bankrupt. Other schemes, like the Spanish, British and German ones, distinguish between companies and individuals. Although they do not expressly exclude the individual's debtor whose indebtedness does not arise from commercial activity, the design of these bankruptcy codes shows a clear leaning towards commercial debts.

At the heart of the bankruptcy procedures is the property of the debtor. Without property there is no bankruptcy. In most bankruptcy schemes, the interests of the creditors are paramount. The distribution of the debtor's property is consequently the main purpose of continental bankruptcy legislation. The discharge of debts and the protection of debtors is not its primary focus.

3.2 The Second Wave: Restructuring

The second wave of reforms in bankruptcy legislation came at a time when the world economic crisis of the 1920s and 1930s highlighted the problems of over-indebted companies and merchants whose economic survival was seen as valuable for the whole economy. Rescue plans and state support for weak enterprises in order to save jobs brought a whole new philosophy: that one should not only consider the interests of creditors in recovering outstanding debts but also give assistance and support to overcommitted debtors. The US Chandler Act of 1938 introduced bankruptcy procedures that were intended to provide an alternative settlement that would facilitate the survival of bankrupt enterprises. The rights of the creditors were not challenged, but measures intended to bring about an equitable settlement were proposed. These measures included the suspension of payments during the 'bankruptcy' procedure, which gave the debtors relief so that they could seek such settlements. The American division between chapters 7 and 13 of the Bankruptcy Code characterised the new dualism in bankruptcy law.

The suspension of payment rules required the consent of the creditors before they could be applied. This approach lacked some of the traditional stigma attached to bankruptcy, but the influence of the second wave in bankruptcy law on the real economy was not very large.

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13 This paragraph is based on Udo Reifner's analysis in chapter 6 of Huls et al., above n. 5.

3.3 The Third Wave: Emergence of Debtor's Protection in Bankruptcy Law

While the second wave of reforms in bankruptcy law can be located quite precisely in time (the Great Crash of 1929), the development of exemption laws to protect the standards of living of the debtor (the third wave) were mostly introduced into civil codes as general principles of protection against garnishment of wages and seizure of property.

The primary objective was to guarantee the physical survival of the debtor, and thus to limit the social welfare spending of the state, on the one hand, while trying to ensure that the debtor was still able to earn a living, on the other. The law lists the items that are exempt from garnishment. Most bankruptcy laws make reference to these exemption laws.

3.4 The Fourth Wave: Reregulating Insolvency (1980s)

While bankruptcy laws increasingly regulated the ways in which the insolvency of the debtor was dealt with instead of simply enforcing the creditors' claims, a new breed of creditors, in particular the banks, devised new means of debt enforcement that rendered bankruptcy steadily less efficient. The banks developed their own forms of insolvency regulation through reservation of property, leasing, wage assignments and pre-authorised rights to auction real estate.

In the early 1960s, studies showed that bankruptcy procedures had become inefficient. As a result most practical insolvency measures had developed outside traditional legal procedures.

Coinciding with the demise of traditional bankruptcy philosophy, there was trade union pressure to rescue important industries. This pressure pushed the idea of general bankruptcy reform. In the 1980s, nearly all EEC countries worked on proposals to revise their regulations on the insolvency of debtors. The shift from bankruptcy to insolvency regulation was also visible in the new categories of debtors in the bankruptcy laws.

While the bankruptcy reforms in all countries reflected some shift in emphasis from protecting the creditors' interests to protecting the debtor, bankruptcy regulation still essentially remained a market-based solution. It was a response to problems that had arisen much earlier and an attempt to impose a legal framework on what was an economic development. The insight that debt problems and insolvency do not require the protection of creditors so much as that of debtors led to a paradigm shift that focused on making bankruptcy procedures fit for the idea of consumer protection. During this period, the consumer credit revolution was taking place.

Problems of new poverty, over-indebtedness and lifelong dependence on banks and other creditors made it obvious that social protection laws targeting seizure of property, wage garnishment and other forms of debt enforcement were no longer adequate in modern consumption societies.

The traditional bankruptcy schemes did not allow ordinary people access to a fresh start. The reasons were as follows:

- Insolvency procedures for merchants and companies were designed to be self-financing procedures. They presupposed some minimum level of assets owned by the debtor and therefore barred from insolvency procedures those people who had nothing to sell apart from their labour.
- Insolvency procedures for commercial organisations were intended to achieve the distribution of property to the creditors or the restructuring of the company's assets. Over-committed private debtors, however, did not generally have any seizable property.
- Bankruptcy legislation was much too complicated for consumer problems.

3.5 The Post-1990 Paradigm of Consumer Bankruptcy in Europe

The laws that were developed in this period have many common elements, namely:

- all countries agreed that their traditional bankruptcy legislation did not meet the needs of individual debtors;
- nearly all procedures restrict access for individuals in non-commercial activity, even though it is acknowledged that individual debtors may have old commercial debts;
- all procedures can only be instigated by the debtor;
- all procedures include the future earnings of the debtor;
- all procedures allow for discharge from those debts that are included in the plan and will not be paid off within their given time limit;
- all schemes make provision to exclude those who abuse the scheme;
- the procedures have little or no costs attached to them and are specially designed to allow access for poor people.

The intellectual underpinning of modern insolvency law was laid down in the Cork Report.[14] There are three parties: the debtor, the creditor and society. Society is concerned with relieving and protecting the individual insolvent from the harassment of creditors and enabling the individual to regain financial stability and have a new chance. It accords the insolvent this relief in return for contributions, not only from his (non-exempt) assets but also from his future earnings, as can reasonably be made by him without reducing him and his family to undue and socially unacceptable poverty and without depriving him of the incentive to succeed in this new chance.

This led to the following principles:

- To recognise that we are living in a society based on credit, which has brought us great prosperity. This requires, as a necessary result, proceedings to remedy the accidents of the credit society.
- To diagnose and treat imminent insolvency at an early stage rather than at a late stage.
- To protect the debtor and his family from undue demands and harassment by their creditors and, at the same time, to have regard for the rights of the creditor, whose position can also be threatened.
- To prevent conflicts between individual creditors through a fair distribution of the proceeds among all creditors.
- To sell the non-exempt assets of the insolvent, which should properly be taken to satisfy his debts, with the minimum of delay and expense.
- To establish and encourage professional and independent debt-counselling.
- To determine the causes of over-indebtedness and to take suitable measures if fraudulent behaviour is found.
- To guarantee the public interest that is at stake in cases of insolvency.
- To lower the unproductive costs of ineffective debt-collection.

4 Where Autonomy and Paternalism Meet: US Consumer Bankruptcy

The US Bankruptcy Code makes it very easy for debtors in the most capitalistic and materialistic country on earth to free themselves of their debts. In the 1980s, the American

[14] *Insolvency Law and Practice*, Report of the Review Committee (HMSO June 1982).

'fresh start' policy inspired many European countries to transform their bankruptcy laws from a collection mechanism serving creditors into a social policy instrument that offered debtors in financial difficulty the opportunity of a new perspective.

The US Bankruptcy Code has its own very typical American 'wild west' history: the struggle between bonded labour and peonage, the Supreme Court ruling in *Local Loan Company v. Hunt* (1934), states that offer generous exemptions to become an attractive base for immigrants and, last but not least, the fact that bankruptcy is included in the Constitution, which gives the federal government the authority to act as a regulator in this private law area.[15]

What particular aspects of the Bankruptcy Reform Act of 1978 made it so attractive for European countries, which had completely different legal culture, to remodel their laws?

I believe that the most inspiring aspect of the 'fresh start' policy is its future-oriented perspective. While traditional European bankruptcy laws put the emphasis on the blame of the debtor in the past, when he incurred his debt, US law looks to the future. How can the debtor be put back on his feet, how can he regain a perspective on life and, most pragmatically, how can he be turned once again into a productive taxpayer? In other words, how can his life be prevented from becoming 'a walking debtors prison' and how can he regain his autonomy?

Financial risk-taking and its associated entrepreneurial spirit is regarded positively in the US The stories of successful entrepreneurs whose first companies went bankrupt are well known. A bankruptcy in the US is a chapter in someone's life that should be closed as quickly as possible, so that he can move on.

In the US, bankruptcy has the effect of a social safety net for a number of events in the lives of citizens that in Europe are covered by social welfare provisions: unemployment, illness, hospital admission and so forth. As a result of events beyond his control, a consumer can end up in financial difficulty. If he does not have the perspective of a better future, this could tempt him into dishonest behaviour, which is socially undesirable. In the US, this system is financed not by taxpayers' money but by creditors.

It also sits uncomfortably with American regulatory culture to have the government impose restrictions on credit provision. This is regarded as politically undesirable intervention in corporate decisions of the banks, on the one hand, and as an infringement of the freedom of the consumer, on the other. Credit was and continues to be regarded as a positive engine driving economic growth. Concepts such as improvident credit-granting and usury rates can count on little sympathy, because their effect is to exclude poor people from credit. There are, of course, some concerns about excessive credit-granting, but the problems that arise from this can best be resolved by the self-regulating powers of the market and liberal bankruptcy law.

It should not go unreported that the financial services industry has lobbied for years against some very liberal components of the BRA (Bankruptcy Reform Act). An important criticism was that the consumer's choice between chapter 7 (liquidation) and chapter 13 (the repayment plan) provokes strategic behaviour. For a debtor without income but with assets, it is very attractive to opt for chapter 13, while a debtor without assets and with a regular income gains by opting for chapter 7. In both cases, the debtor gets a cheap discharge of debts at the expense of his creditors. The financial services industry lobby has succeeded twice. In 1984, a substantial abuse clause restricting free choice between chapter 7 and chapter 13 was added to the law. In 2005, the financial services industry was again successful in its frontal attack on the misuse of the bankruptcy regulations by consumers, resulting in the Bankruptcy Abuse Protection and Consumer Protection Act (BAPCPA) 2005.

15 From D.T. Stanley and M. Girth, *Bankruptcy. Problems, Process, Reform* (Brookings Institute 1971) to E. Warren, J.L. Westbrook and T.A. Sullivan, *The Fragile Middle Class: Americans in Debt* (New Haven: Yale University Press 2000).

4.1 Differences and Similarities between the US and Europe

There are considerable differences in the legal cultures of the US and the countries of north-western Europe. This has to do with the fact that countries adhering to the civil law tradition have something like an '*ordre public*',[16] a facet of a state that aspires towards what is good for the collective as a whole and a legal order that is perceived as 'just' by the people.

Another major difference is that when Americans hear the word solidarity, they quickly place their hands on their wallets, afraid as they are of tax increases. In Europe, it goes without saying that certain risks will be carried collectively and financed from the public purse, while in the US these risks are dealt with in the private insurance market.[17]

However, there are similarities as well. Credit in Europe is now totally democratised: all segments of the population make extensive use of it. The expression 'living beyond one's means' has lost its pejorative connotation. In modern capitalism, extending credit to consumers has been depersonalised to a high degree. In other words, it is based on technologically advanced credit scoring and assessment techniques.

Boundaries were also shifted in the investment market. Investors without collateral were also able to benefit from the rising stock and house prices. One of the many innovations in the financial markets was investing with borrowed money.

Since the 1990s, the various financial markets in Europe are no longer separated. Politicians expressed their approval for the fact that banks and insurers merged and that financial institutions began operating in each others' turf. In a very short period, an integrated global market for financial services had come into being. Saving, investing, insuring, lending, asset management and payments were no longer separate markets but were melding into each other. The advent of the internet meant that distance and time differences very quickly ceased to play a role in international exchanges. Huge sums of money flashed around the world in an instant, seeking the highest return. The financial vanguard consisted of gigantic multinationals and huge professional investors doing business worldwide. All manner of new and complex financial products were developed which also further transcended the traditional boundaries.

4.2 The Politics of Autonomy and Paternalism

Radical market thinking dominated political, economic and legal discussions in the 1990s. The 'system' provided unbroken economic growth, and because there had been no other ideological alternative since the fall of the Berlin Wall in 1989, free-market capitalism developed into the dominant global perspective.

The past few decades in Europe were characterised by the celebration of the autonomy and self-regulation by the market. Anyone arguing for protection of debtors, prudent banking or limits on risk acceptance by financial institutions was not only seen as paternalist but also demonstrated a lack of knowledge in terms of keeping up with the speed of financial innovation. The advanced mathematics of calculating and estimating risk margins (computational finance) created its own world, with its own mandarin language that was only comprehensible to very specifically trained insiders (quants).[18] The burden of proof for the usefulness or necessity of government intervention was on the paternalists.

In this period, critical questions about the desirability of teaser rates, payment protections insurance and stock trading with borrowed money in the consumer arena were all dismissed. In the period before 2007, pleas for consumer protection were

[16] See Ogus, above n. 1, at 65 and Wagner in this issue. See also M. Garcia Villega, 'Comparative Sociology of Law, Legal Fields, Legal Scholarship and Social Science in Europe and the United States' (2006) 31 *Law and Social Inquiry* 2, also published in French in (2009) *L'Année sociologique* 29-62, at 50. Peter Gabel once observed that 'European lawyers always have the fog of the State in their heads'.

[17] See the contribution of Schwarcz in this issue

[18] W.H. Buiter, 'Lessons from the Global Credit Crisis for Social Democrats', Den Uyl lecture (December 2008).

regarded as hard paternalism: a wish to deny the common man the benefits which the free capital market or the stock market also holds in store for him. The consumer was considered to be perfectly capable of deciding for himself (autonomously) whether a transaction was too risky.

The rhetoric of the proponents of consumer bankruptcy emphasised the autonomous core: private law provides the consumer – the sovereign ruler of the market – with a mechanism to deal with his many selfish creditors. Because they grant credit so easily, it is fair that creditors are forced to share the burden of over-indebted consumers. Debt enforcement and its consequences are never left entirely to the autonomy and contract freedom of the parties involved. State involvement is necessary and desirable to achieve acceptable outcomes. In the modern credit society, consumer bankruptcy is not only a problem for the debtor-creditor relationship at the individual level but also for the relationships between the various creditors.

5 The Conventional Wisdom after the Credit Crunch

Nowadays, for the first time in ages, the American way of life, including living on credit, is regarded as a problem in an economic sense. Because of the high risks involved, lending to consumers who could not repay was an extremely profitable activity. The risky packages in which the subprime loans were cut up and securitised could be used in the short term to speculate on international stock markets.

When it became apparent in 2007 that a lot of toxic financial products had been put on the market, because the value of the homes under the mortgages had dropped, the worldwide financial bastion collapsed. From that moment onwards, the issue was no longer how to share the profits but how to shift and recoup the losses. The happy consumer, who had sensed profit as an investor, became an angry debtor who felt betrayed when confronted with his losses. Suddenly, the success stories dried up and the search for (or pursuit of) scapegoats was in full cry. The anger of the public at large was directed at the bonuses of the bankers and the laxity of the regulators.

Because the various barriers that were intended to restrict financial market forces had been removed, a complicated global financial system, over which regulators had very little control, had come about in a fairly short time. The massive use of credit and debts in the corporate world was an important component of capitalism's success story in the 1980s and 1990s, because of the leverage effect. As long as economic growth persisted, the developments were characterised as the intended product of financial and technological innovation. When the financial system imploded, the excess leverage effect was fingered as one of the most important causes.

The financial crisis struck in 2007 in the US, when it appeared that the risks that the banks had taken using highly complicated financial constructions were ultimately insufficiently covered by the value of the properties on which mortgages had been issued and the repayment capacity of the debtors to whom the loans had been issued.

The government had to step in at this point, because some financial institutions were 'too big to fail'. The bankruptcy of big banks and insurance companies was not seen as a viable or acceptable political option, neither in the US nor in Europe. This was a clear example of market failure: big financial institutions could not take care of themselves but needed government help. The giants of financial capitalism were kept afloat with public money. The *masters of the universe*[19] needed the help of governments, which suddenly found themselves in the totally unexpected role of (temporary) owner of nationalised major banks.

A particular curiosity relating to the recent credit crisis is that some of the problems that, according to the law and economics literature, lead to dishonesty on the consumer side (e.g. information asymmetry and moral hazard) can now be identified just as clearly on the creditor side.

19 So well portrayed by Tom Wolfe in his novel *Bonfires of the Vanities* (New York: Farrar Straus and Giroux 1987).

The financial industry has designed products that made the economic rationale of the transaction expressly misleading. Contracts were explicitly aimed at providing the consumer with insufficient information about its advantages and disadvantages. This is apparent from such terms as investment insurance, stock lease, repayment protection and so forth. The way in which costs are passed on to the consumer, for example with credit cards and usury policies, also excels in deliberately created vagueness. Because only the creditors have access to knowledge and information from the specialist whiz kids (quants), there is an information asymmetry in their favour. The financial industry cannot apportion responsibility for this to middlemen, regulators or consumers. Complexity and vagueness aimed at misleading and cheating consumers were at the core of the financial industry's earning model.

Another pillar of economic wisdom has been devastated as well. We have always been taught that no rational banker would lend money to people who cannot repay their debts. The subprime market has shown that it is extremely profitable to sell financial products to poor people. Bankers seduced consumers with teaser rates, divided these high-risk loans in credit default swaps, etc., securitised them and sold them on the stock market. When the creditor eventually sold his part in these complex products in time, he obtained large profits. After a while, the losses were passed on to the creditors at the end of the transaction line and the debtors who faced high interest rates after the teaser period had passed. The short and unhappy story of subprime market practices is an indication that unfettered market forces are profitable for some but ruinous for many others. We can only hope that this experience will be in the minds of the lawmakers who are now designing policies to clean up the mess.

When some major financial institutions appeared to be 'too big to fail', i.e. too big for bankruptcy, the moral hazard problem was also brought clearly into focus.[20] Were the banks able to take such substantial risks because they knew that at the end of the day the state would come to their rescue? Whatever the case, the concept of prudent credit provision, in other words a bank that only lends money to those who can repay it, became an old-fashioned and outmoded idea.

Following the credit crunch and the election of Barack Obama as US president, liberals in America wonder whether, in the new political climate, the burden of proof may be shifted to the financial institutions, now that the consequences of the credit crisis are becoming clear and considerable damage has been inflicted. The costs and benefits have not been divided equitably between Wall Street and Main Street.

How will the damage that has been caused be settled? Does *casum sentit dominus* apply here, or will angry taxpayers force politicians to translate their rage into (collective) legal and financial claims?

Some people believed that the fall of the Berlin Wall in 1989 marked the end of Marxism; others wonder whether the credit crunch of 2007 signalled the end of ideological marketism.

6 Paternalism with a Father

Once the largest consequences of the credit crunch are behind us, normal commercial credit provision will quickly manifest itself again. Not only the commercial entities selling products in the real economy but also the state will attempt to persuade citizens to borrow money as an alternative to collective subsidies (e.g. for education). This means that the number of creditors with which the consumer will enter into credit relationships will certainly not diminish drastically in the near future.

On the consumer side, too, the consequences of the credit crunch will soon become tangible. Some people will lose their jobs or part of their pension benefits; others will need to take on fresh debts in order to maintain their standard of living or refinance their loans.

[20] See Buiter, above n. 18, at 17; and the Posner Becker blog at the website of the University of Chicago Law School.

For creditors, unsuccessful contracts are part of the cost of doing business in terms of granting consumer credit. Irrecoverable loans are sold on the commercial market to process servers or collection agencies, which in turn have a direct interest in dynamic collection. This sector is undergoing both increased professionalisation and significant hardening. The market is dominated by large commercial companies.

Additionally, non-paying debtors are listed with the credit registration agency, causing difficulties for them when it comes to obtaining future credit. Credit reference in Europe was initially set up as a neutral instrument to combat excess credit, but the market for credit information has rapidly commercialised. Hopefully, some lessons may be drawn from the history of the credit rating agencies in the commercial financial markets.

All things considered, I expect financial stress for consumers to increase. More creditors will jostle consumers who can no longer meet their obligations. Various classic political questions accordingly arise: who gets what, when and how?[21] Commercial creditors try to circumvent bankruptcy via secured debts (mortgages!) and governmental bodies try to create privileged legal claims for themselves (e.g. taxation, social security and fines). On the other hand, there will (and must) always be exceptions to the possibility of granting the consumer a fresh start if he has not behaved in a morally responsible manner.

In the remaining part of this section, I will formulate some ideas for future regulation in the field of consumer credit and debt. My examples are taken from Dutch practice, but they may be of interest to foreign observers as well.

6.1 Strict Supervision

It has become clear that supervision in the financial world did not keep up with the developments in the market. This lack of equilibrium must be repaired. Professional financial institutions need a licence, which should form the basis of supervision by the state. Among other things, the law stipulates responsible credit provision. This can be linked to the norms that the bona fide sector has itself developed within the context of self-regulation. Apart from restrictions on abuse clauses in contracts[22] and advertising, a maximum interest rate is a good way to regulate responsible credit provision.

Because the financial markets (credit, insurance, savings, investment, etc.) were steadily converging as a consequence of liberalisation and deregulation, the regulatory system needed an update. In the Netherlands, the Dutch Central Bank (DNB) was responsible for prudential supervision and the Financial Markets Authority (AFM) for the behaviour of financial institutions. It took quite a while before the two regulators became mutually attuned. For a long time, new products like stock leasing (a combined loan and an investment vehicle) were not monitored by either regulator. The credit crunch revealed that Dutch supervision of the financial markets was also not functioning properly. This lax supervision might aptly be called paternalism without a father.

What we need for the future is a supervisor who is present in the market and prevents banks from bringing toxic products on the market again. In 1994, Norbert Reich[23] already framed credit as an 'unsafe product' in order to find a legal basis for his Draft Consumer Financial Services Marketing Directive. The Commission was not at all enthusiastic about this approach to the problem.

In the US, Oren Bar-Gill and Elisabeth Warren[24] have argued for *ex ante* regulation of complicated financial products by a financial product safety commission. The Obama administration has translated their ideas into the Consumer Financial Protection Agency Act of 2009. The reception accorded to these proposals by the financial lobby shows how extremely politicised economic relations are in the US The proposed interventions

21 H.D. Laswell, *Politics: Who Gets What, When, How* (New York: Peter Smith 1936).

22 Even in the US, see the CARD legislation (Credit Card Accountability, Responsibility and Disclosure Act) that came into effect on 22 February 2010.

23 In Huls et al., above n. 5, at chapter 11.

24 O. Bar Gil and E. Warren, 'Making Credit Safer' (2008) 157 *University of Pennsylvania Law Review* 101 ff.

immediately conjured up the bogeyman of the all-powerful state that knows better than the citizens themselves. In this case, state intervention is not framed as paternalism but as maternalism: 'Big Nanny'.[25]

In this ideological context, the need for independent empirical research is obvious, because the creditors have an enormous informational advantage.[26]

I believe that credit is indeed a dangerous product if it is not regulated adequately. We should not base our policies on abstract economic and legal models alone, but focus more on concrete social human needs and societal processes. With a wise combination of pre-market approval of new products by a supervisor, combined with solid maximum interest rates, the state can regain some of its authority in this field.

6.2 Inclusion of Intermediaries

A second target group of regulation in the credit field are the intermediaries. It has long been known that intermediaries and sellers play a significant role in the creation of excess credit. Intermediaries are only interested in their own commission and can exercise considerable pressure on banks to accept poor credit risks, for example by offering them as part of a *package deal* with a number of good applicants.

In the past, the Dutch government has attempted to set upper limits on payments to intermediaries by credit providers and link them to consumer repayment, but these rules were circumvented to a considerable degree and were later withdrawn in the context of deregulation. This mistake should be addressed in the coming years.

7 Nudging[27] Collective Mechanisms in Private Law

Supervision by the state is classic paternalistic intervention. However, the state can also nudge the consumer side by means of indirect interventions that create more space for autonomous societal developments. Two Dutch practices in the context of modern consumer protection are worth mentioning here.

7.1 Collective Claims[28]

An important recent Dutch legal innovation is the Act on the Collective Settlement of Mass Claims (WCAM), on the basis of which a court can declare as binding a settlement that has come about following a collective action. The new law was first applied in an exceptionally large collective action in the Legio Lease affair. Some 400,000 consumers had bought shares with borrowed money, which turned out to be loss-making when share prices dropped after 1 January 2000 and interest tax deductions for consumer credit were halted. Dexia, a Franco-Belgian multinational, was forced into a settlement following a professionally constituted class action. This updating of Dutch tort law could contribute substantially to the (collective) autonomy of the consumer over a professional opponent who has offered hybrid financial products to inexperienced investors in a misleading, aggressive and non-transparent manner.

This initial campaign was developed and directed by two law firms in The Hague. They sought a professional collaboration with the mass media and the political world (spin doctors) and made inventive use of the opportunities offered by the internet to communicate with tens of thousands of clients simultaneously.

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[25] D.S. Evans and J.D. Wright, 'The Effect of the Consumer Protection Agency Act of 2009 on Consumer Credit', George Mason University Law and Economics Research Paper Series No. 09-50.

[26] See E. Warren, 'The Market for Data: The Changing Role of the Social Sciences in Shaping the Law' (2002) 1 *Wisconsin Law Review* 20-25.

[27] See Richard H. Thaler & Cass R. Sunstein, Nudge. Improving decisions about health, wealth and happiness, New Haven and London: Yale University Press, 2008.

[28] See W.H. van Boom, 'Collective Mass Claims in the Netherlands', in M. Casper. et al. (eds.), *Auf dem Weg zu einer Europäischen Sammelklage?* (Munich: Sellier 2009) 171-192.

Just as employees are able to enforce certain improvements through unionisation, here we have an exceptionally powerful type of collectivisation in private law, which is able to develop a momentum to which huge and powerful financial institutions have to respond.

7.2 Collective Bargaining of Consumer Contracts

A second, more harmonious type of collectivisation is negotiation between consumer organisations and central business organisations about general legal provisions governing consumer transactions. Led by independent chairmen and under the auspices of the Social Economic Council (SER), the standard bearer of the Dutch *polder model* (i.e. consociational politics),[29] general terms and conditions are being created in a number of important sectors and are being thoroughly tested by consumer organisations. The SER hallmark engenders confidence in consumers that the legal provisions in the contracts are in order. This mechanism has not yet been fully implemented in the field of credit and debt.

8 The Ethics of Consumer Bankruptcy

How can we encourage all autonomous market participants to conduct themselves in a morally responsible fashion?

I think strict supervision is necessary to keep the financial world in good ethical shape. A robust combination of extensive truth in lending regulation and an aggressive fight against abusive practices is already on the political agenda. We need the law to tame the predators among the creditors and to put the interests of consumers first.[30]

However, there are also moral ambiguities on the consumer side. Hans Boutellier has carried out an interesting analysis of the mindset of the modern citizen.[31] He suggests that the modern citizen wants 'safe freedom'. Because of the increased vitality that is propagated in current culture, the modern citizen wants to explore the world, take risks and run his own life without borders. He hates being patronised by the state, particularly when it comes to his consumer freedom. The citizen wants as few rules as possible that might restrict his own behaviour. However, if another citizen or an organisation causes him loss or restricts his freedom, he invokes the help of the government, because he wants to claim damages and also wants the existing rules to be applied rigorously to the other party.

I believe Boutellier's analysis paints a keen picture of how the consumer behaves in the market for financial services. In times of economic prosperity and growth, and if interest rates are low and the prices of shares and houses rise, no-one needs a cautioning state that preaches restraint or sings the praises of saving. The sovereign consumer can decide this for himself and does not want to listen to warnings.[32]

However, if the economic tide turns, interest rates rise and the underlying asset values drop, and loans must be repaid, the citizen suddenly looks very critically towards the state. Why are the savers (the rich) protected by a deposit system while the borrowers are not? In these circumstances, the debtor-citizen wants protection and redress from the government and wants to be declared free of liability by those who recommended the uncomplicated loan to him. The consumer, cradled in his sovereignty and autonomy,

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29 A. Lijphart, *Thinking about Democracy: Power Sharing and Majority Rule in Theory and Practice* (London/New York: Routledge 2008).

30 See U. Reifner and J. Ford (eds.), *Banking for People: Social Banking and New Poverty Consumer Debts and Unemployment* (Berlin/New York: Walter de Gruyter 1992); U. Reifner, *Die Geldgesellschaft. Aus die Finanzkrise lernen* (Wiesbaden: VS Verlag für Sozialwissenschaften 2010).

31 H. Boutellier *The Safety Utopia: Contemporary Discontent and Desire as to Crime and Punishment* (Kluwer Academic Publishers 2004).

32 Posner, above n. 3, at 328: 'Cassandras rarely *receive a fair hearing*' (emphasis added).

then becomes furious with the rich bankers, who told him he could also become rich on the money and capital market, loses his trust in the government, which does not resolve this problem for him, and casts a vote for a populist political party.

It is clear that some key political tensions between autonomy and paternalism are neutralised in bankruptcy law. However, consumer protection in the modern credit world is both necessary and full of ambiguity on both sides.

9 Concluding Thoughts on the Autonomy-Paternalism Debate: Power, Numbers and Social Values

We have seen that the juxtaposition of autonomy and paternalism is not a timeless issue and that societal forces have contributed much to its cyclical development. Over time, Western societies have looked for an optimal mix of harder and softer mechanism to deal with debtors in distress. I consider consumer bankruptcy to be a modern human invention, an example of what Schumpeter calls 'creative destruction'.[33] Debts are repudiated – or forgiven[34] – in order to enable human individuals to go on with their lives. One might also hope that this form of limited liability of consumers will also nudge commercial creditors to lend money more carefully.

9.1 Autonomy v. Paternalism, or Autonomy v. Heteronomy

Ideally, a contract aims at a win-win situation. Both contracting parties hope to benefit from signing the agreement. Although the death of the contract has been predicted repeatedly in the past, contracts are omnipresent and alive and kicking in the real world of 2010. Even in the public domain – traditionally the field of public law – all kinds of new contractual relations are developing.[35]

If a law and economics scholar or a civil law professor looks at a contract, he will normally focus on the preferences of the contracting parties. In the autonomous paradigm, parties can take care of themselves while carrying out the contract, whereas in the paternalistic paradigm one of them needs the help of the state (or the courts). As a socio-legal scholar, my interest lies in the societal relationship between the parties and the legal institutions that determine such relations. Contract law is socially embedded.

A contract establishes a relationship between two parties. Because there is often an unequal power balance in credit and debt relationships, it is also worthwhile to look into the heteronomous dimensions of the contractual debtor-creditor relationship in its various stages.

The distribution of wealth and power in a given society is too important to ignore, and the ways of achieving a just distribution is an eternal topic of fierce political debates. Traditionally, labour law and tenant law have been fields of private law, where the concept of 'subordination' has been evolving, because the unequal bargaining power of the contracting parties was always obvious.[36]

Historically, we have seen a combination of the collectivisation of labour contracts via unions and state intervention, and many private labour scholars wonder if these fields of law still belong to private law or whether they now belong to welfare law.

Ironically, bankruptcy is also related to distribution – not primarily of wealth but of scarcity: the assets of a destitute debtor. Some powerful creditors are in a position to evade the effects of the bankruptcy of their clients; others may not be so autonomous. The power relationship between creditors should not be ignored in procedural private law if society wants to achieve a fair loss distribution.

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33 J.A. Schumpeter, *Capitalism, Socialism and Democracy* (London: George Allan & Unwin 1942).

34 K. Gross, *Failure and Forgiveness: Rebalancing the Bankruptcy System* (New Haven: Yale University Press 1997).

35 I. Harden, *The Contracting State* (Open University Press 1992).

36 L. Nogler, *The Concept of 'Subordination' in European and Comparative Law* (University of Trento Press 2009).

9.2 Individual and Collective Arrangements

The concepts of autonomy and paternalism seem to date from the period when one-to-one contractual relationships prevailed in society. In our present mass consumer society, a big challenge for private law lies in the handling of the masses and multi-party relations. This is where the problems of the ‘asymmetric society’[37] arise: information surplus on the creditor side, credit score techniques, credit reference innovation and commercialisation place the consumer in a dependent and unequal position. The repeat players dominate the one-shotters.[38]

On the other hand, lawyers have designed mechanisms that create countervailing forces that are able to direct masses of claims against big organisations. Mass is power, and creative lawyers can translate many individual claims of consumers into a language that big business understands and cannot ignore: money. So there is no reason to lament about powerless consumers. If they are many and they can organise themselves, we do not have to worry very much about their loss of autonomy.

However, numbers also matter on a smaller scale. Even in an average consumer bankruptcy, between ten and twenty creditors are confronted with each other and share the problems of enforcing their claims. Talking about the autonomy of the creditor when he is part of a multi-party constellation does not deliver many economic results. He is in a distributional game with other creditors, who all try to jump the queue.

9.3 Social Values in Substantive and Procedural Civil Law

Advocates of consumer protection have made many intellectual efforts to infuse substantive private law with social values. A lot of consumer protection was smuggled into the Dutch Civil Code of 1992, and EU Directives introduced protective elements into the national civil law systems.

In the field of credit and debt, Thomas Wilhelmsson has coined the concept of ‘social force majeure’ as part of the bigger project of importing ‘welfarism in contract law’.[39]

Especially in the field of credit law, we see a perfect culture clash of market values and social values. In the market, the debtors that represent a high risk for their creditors have to pay high premiums. While tax law in the welfare state is based on the principle that ‘the strongest shoulders carry the heaviest burdens’, the market is guided by Caplovitz’s law that ‘the poor pay more’.[40]

The European Coalition for Responsible Credit (ECRC) promotes ‘productive credit’ as the key concept for modern law.[41] In this context, the substantive credit contract itself must reflect its life-time character, so that many contractual concepts from one-spot commercial market transactions do not apply here. Under this approach to contract law, consumer bankruptcy (which is part of civil procedural law) comes too late and is critically characterised as a means of ‘keeping substantive contract law free from social poison’.[42]

From my perspective, however, procedural law – which is generally considered to be a very dull field of civil law – is an exciting field to explore the autonomy-paternalism tension, because it constitutes a battleground for competing claims of all kinds of creditors, both among themselves and *vis-à-vis* their debtors. Bankruptcy is the litmus test of the strength and weaknesses of civil obligations and liabilities. All civil law, be it substantive or procedural, must have beneficial consequences for society.

37 J.S. Coleman, *The Asymmetric Society* (University of Syracuse Press 1982).
38 M. Galanter, ‘Why the “Haves” Come Out Ahead: Speculation on the Limits of Social Change, (1974) 9 *Law & Society Review* 95.
39 R. Brownsword, G. Howells and T. Wilhelmsson (eds.), *Welfarism in Contract Law* (Aldershot: Dartmouth 1994).
40 D. Caplovitz, *The Poor Pay More: Consumer Practices of Low-Income Families* (New York/London: Free Press 1967).
41 Niemi, Ramsay and Whitford (2009), above n. 6, at 109 ff.
42 U. Reifner in Niemi-Kiesliainen, Whitford and Ramsay (2003), above n. 6, at 152.