THE FRAGILE MIDDLE CLASS

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Americans in Debt

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Yale University Press New Haven and London

Designed by James J. Johnson and set in E&F Swift type by Tseng Information Systems, Inc.
Printed in the United States of America by Vail-Ballou Press, Binghamton, New York.

Library of Congress Cataloging-in-Publication Data

Sullivan, Teresa A., 1949–
The fragile middle class : Americans in debt / Teresa A. Sullivan, Elizabeth Warren, Jay Lawrence Westbrook.
p. cm.
Includes bibliographical references and index.
ISBN 0-300-07960-5 (alk. paper)

1. Bankruptcy—United States. 2. Consumer credit—United States. 3. Finance, Personal—United States. I. Warren, Elizabeth. II. Westbrook, Jay Lawrence. III. Title.
HG3766.S794 2000
332.7'5'0673—dc21 99-41894

A catalogue record for this book is available from the British Library.

The paper in this book meets the guidelines for permanence and durability of the Committee on Production Guidelines for Book Longevity of the Council on Library Resources.

10 9 8 7 6 5 4 3 2 1

In memory of our parents

GORDON H. & MARY E. SULLIVAN

DONALD J. & PAULINE REED HERRING

JOEL & ELAINE WESTBROOK

They taught us the middle-class values that carried them through the Great Depression and World War II to the prosperity that followed

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Preface

In 1989 we published *As We Forgive Our Debtors: Bankruptcy and Consumer Credit in America* (Oxford University Press 1989; reprint, Beard Books, 1999), a study of people who filed for bankruptcy in 1981. In that book we compared how the bankruptcy process was supposed to work with how it was actually working. That project, dubbed the Consumer Bankruptcy Project, provided a great deal of information, but it also posed questions we could not adequately answer. One of the most important of those questions was why so many families were in economic trouble.

That question formed a cornerstone for the current project, Consumer Bankruptcy Project II. Conducted in 1991, this second study collected the same information from some of the case files, but it added a questionnaire for all the debtors in our sample. With the questionnaires, we were able to collect demographic data as well as information about why the respondents filed for bankruptcy. These data permit us to compare the debtors with the general population, so we could learn about the economic fractures in American society by looking at the people in bankruptcy. Our prior book was about bankruptcy and the people in bankruptcy; this book is about the middle class as viewed through the lens of bankruptcy.

Throughout the 1990s bankruptcy filings soared—and so did the stock market. The juxtaposition of prolonged economic prosperity with high rates of personal economic failure is a paradox we seek to explain. We argue that the problems that have driven the petitioners into bankruptcy are in fact widespread and indicate the fault lines that underlie the apparent economic stability of the American middle class. Many in the middle class are economically fragile, barely able to maintain their lifestyle. The bankrupt debtors represent those who have publicly announced their economic failure, but the fragility is wider and deeper than many observers of the middle class have acknowledged.

Readers of our earlier book may be disappointed to find that we do not use this volume to update our earlier findings about bankruptcy. We leave that task to articles we have written for the professional periodical literature. Our intention here is different: not to learn about bankruptcy but to discover what bankrupt debtors can tell us about the rest of society.

We are grateful to many people and institutions for their assistance in completing this book, although any opinions, conclusions, and recommendations do not necessarily reflect the views of any of those who provided funding or other support for our efforts. Our first debt is to the Education Endowment of the National Conference of Bankruptcy Judges, whose grant made possible the initial collection of data. We are also grateful for financial support and computing equipment made available by Dean Colin Driver of the University of Pennsylvania Law School, Dean Robert Clark of Harvard University Law School, and former Dean Mark G. Yudof and current Dean M. Michael Sharlot of the University of Texas School of Law. Support from Harvard was made possible by the partners of Cleary, Gottlieb, Steen, & Hamilton, who honored their founder, Leo Gottlieb, with their generous contributions for research, and particularly by Jerome Hyman, whose advocacy on behalf of legal education has been extraordinary. We received funds to pay graduate assistants through the University Research Institute at the University of Texas at Austin and the Cox & Smith, Inc., Faculty Fellowship at the University of Texas School of Law. Because Judge Arthur Moeller was himself so committed to legal scholarship in general and to empirical work in particular, we were especially pleased to receive important support from the Arthur Moeller Chair for Research in Bankruptcy and Com-

mercial Law at the University of Texas School of Law. We received summer undergraduate assistance through the Research Experience for Undergraduates project, which is funded by the National Science Foundation and administered through the Population Research Center at the University of Texas at Austin. The Rockefeller Foundation provided additional research support at its Bellagio Study Center. The magnitude of these contributions reminds us that empirical research is an expensive, lengthy, and arduous undertaking. For all these contributions, we are deeply grateful and mindful that without them we would have no data to analyze.

It was necessary to mobilize a large research team to complete this project, and we were fortunate to work with wonderful people. Catherine Nicholson supervised the data collection, and no research team was ever blessed with a more capable and dedicated person. Without her remarkably hard work and extraordinary talents, this project would not have been possible. For collection of a mountain of data, we especially want to thank Judy Tumbleson of Rock Island, Illinois, who gathered data from courthouses in Illinois for both our first and our second consumer bankruptcy studies. Linda Zimmermann gathered our comparison sample from the Eastern District of Pennsylvania; we recall her cheerful efficiency with great fondness. The Honorable Samuel Bufford and the Honorable Keith Lundin provided unswerving support for our empirical undertakings. The Office of the United States Trustee and the Administrative Office of the United States Courts both provided enormous assistance that we gratefully acknowledge. A host of people in the Texas bankruptcy courts helped us gather the data there. In Pennsylvania, the Honorable Thomas C. Gibbons and the Honorable Joseph Cosetti, along with Joseph Simmons, Carol Emerich, Theodore S. Hopkins, Margaret Smith, Thomas E. Ross, Steve Goldring, Brian J. Williams, John J. Grauer, and Jean Vajda, were very helpful. In California, the Honorable Lisa Hill Fenning, the Honorable Christopher Klein, the Honorable Thomas E. Carlson, and the Honorable James W. Meyers, along with Shawnna Jarrott, Sandra Whitman, Lorraine Green, Larry Ramsey, Anthony G. Sousa, Diana Gilbertson, and Charmayne Mills, worked hard under trying conditions to help us collect useful samples. In Indiana, E. Franklin Childress and, in Texas, the Hon. Larry Kelley and William T. Neary gave us important help in our collection efforts. In Illinois, the Honorable Larry L. Lessen and the Honorable John D. Schwartz, along with Thomas J. Mackin, Harden W. Hawes, Ray Safanda, Ella J. Bright, and Randall W. Moon, assisted in our data collection efforts. In Tennessee, the Honorable George Paine II, Beth Broomfield, and Jed Weintraub offered their help cheerfully and efficiently.

Any effort to do research on a tight budget requires the special efforts of generous friends, and in that category we must include Judge Bufford's assistants, Gloria Faust, and Judge Lundin's assistants, Lisa Perlen and Anne Davis, along with Steven Reed at Stutman Treister & Glatt and Kenneth Klee, who arranged for Stutman's support in copying cases. Without their help, this project would have died in its infancy. Roy Mersky of the University of Texas Law Library procured some very expensive documents for us, and his able librarian David Gunn located elusive reports. William Draper of the University of Pennsylvania Law Library also found reams of data for us. Our thanks go also to H. Spencer Nilson at the Nilson Report for lending us 1981–82 back issues and a full set of 1991–92 and 1992–93 reports. James Watkins and Alaine Becket of Becket & Watkins kept the credit card data coming in for years. An extraordinary group of scholars led by Professor Jacob Ziegel of the University of Toronto Law Faculty exposed us to important data from Canada and elsewhere around the world in connection with a conference on consumer bankruptcy held in Toronto in August 1998. Ronald Mann provided a thoughtful review of the housing chapter, and Lynn LoPucki gave insightful (and sometimes tart) comments throughout.

Matthew Ploeger (before he became Dr. Ploeger) was the outstanding research assistant who designed our database and performed the initial analyses; we are pleased that his doctoral dissertation applied our methods to another issue in federal civil litigation. Carter Hay provided much of the library research that helped make our analysis possible. Other research assistants who ably assisted us with library research, coding, and analysis include Marie Britton, Nicola Fuentes, Melissa Tarun, and Lisa Wyatt. Jennifer Frasier, now herself a published bankruptcy empirical researcher, helped us in the early stages of this project. Grant Mallie contributed additional data analysis, and Ryan Bull and Dirk Suringa provided editorial assistance. David Johnson ably and creatively provided final help with statistics and substance. Elizabeth Guerrero spent countless hours on the final preparation of the manuscript, demonstrating unfailing good humor and supreme professionalism. At Yale University Press, we thank John Covell for his patience and enthusiasm for the project and Laura Jones Dooley for her perceptive editing.

The Honorable Barbara Sellers, a bankruptcy judge in the Southern District of Ohio, collected her own data about 1998 filings in her district and gave us permission to code and analyze the data. The Honorable Randall Newsome, a bankruptcy judge in the Northern District of California, collected data on Chapter 7 filers in 1997 and generously shared them with us. The Honorable Barry Russell, a bankruptcy judge in the Central District of California, gave us access to data he collected over the ten-year period 1975–85. The willingness of these judges to expand their workloads so that they could better understand the debtors in their districts is inspirational, and their willingness to share their work product is exemplary.

As these paragraphs indicate, we owe a great deal to many people, but our foremost debt is to the professionals of the U.S. Bankruptcy Courts, whose dedication in the face of mounting caseloads is inadequately appreciated. We are deeply grateful to all of the bankruptcy judges, their clerks, and the trustees who made our data collection possible in the sixteen districts we used for the study. Their cooperation was essential, and they were cheerful and helpful in providing us access. We must mention in particular the U.S. trustees and their staffs who distributed and collected the questionnaires that provided the heart of our data for this book. They cheerfully added to their already substantial burdens for no return except the improvement of knowledge. Without such public-spiritedness, our sort of research would not be possible.

Our families have continued to tolerate our long-distance coauthorship and our passion for empirical research. In the decade of work on Consumer Bankruptcy Project II, two of us lost our parents and all of us saw children enter college. We experienced many of the stresses reported by our respondents, including buying and selling homes, changing jobs, and handling catastrophic medical expenses. Our problems—and the problems of many readers of this book—differ from those of our respondents principally as a matter of degree, not of kind.

Chapter 1

Americans in Financial Crisis

In the early years of the Republic's third century, America stands more economically and militarily dominant in the world than ever before. The middle class, backbone of the Republic, has experienced one of the longest runs of economic prosperity in its history. Yet in the bright blue sky there is a line of clouds. We cannot know if it is just another summer squall or a terrible storm headed our way. Prognosticators examine the entrails in their economic models while the rest of us cross our fingers. Stolid middle-class people, such as ourselves, would naturally check the house for holes in the roof and rotten floorboards. We have done just that, and in this book we report what we have found.

To many molders of opinion, the notion that the middle class could be in crisis is remote, even unrealistic. Their part of the middle class is thriving, and they point proudly to the growing ranks of young high-tech millionaires as signs of the success of the great American economic engine. The proportion of Americans living below the poverty level has also declined, suggesting that the benefits of economic expansion have been widespread. To hint at economic vulnerability seems at best naive, perhaps unpatriotic.

For other Americans, however, the 1990s were economically frustrating and confusing. The median real income recovered to its 1989 level only in 1996. For many families, income rose during the decade only because two or more earners went to work. The popular press focused on these dual-earning families who managed thirty-minute suppers, juggled chores with aplomb, and sought quality time with their children. Less often noticed was that all of this work was barely keeping the family financially afloat. In fact, some of these miracle families only *appear* to be afloat. Lurking behind the suburban house, explicit in the divorce settlement, and implicit in the pediatrician's office, is burgeoning consumer debt. The middle-class way of life can be maintained for quite a while with smoke and mirrors—and many credit cards.

In this book we examine hard data about the forces pressing on middle-class Americans. Our focus is primarily on economic effects, although social and moral factors are very much on the table as well. We do not try to resolve the debates, but we can cast some important light on them. With data drawn from federal bankruptcy courts throughout the United States, we can examine the crash victims of the American economy to better understand the financial risks all middle-class Americans face. These data permit us to quantify the stress that arises from five sources: the increased volatility of jobs and income; the explosion of consumer debt with sky-high interest rates; divorce and changing parenting patterns that are increasing the number of single-adult households; the astonishing ability to treat medical problems—at astonishing prices; and the fierce determination that Americans have to buy and retain a family home at all costs.

Our understanding of these middle-class distresses began to emerge in earlier empirical work in the bankruptcy courts. In that study, reported in a book called *As We Forgive Our Debtors: Bankruptcy and Consumer Credit in America* (1989), we found, to our surprise, that Americans in bankruptcy looked a lot like the rest of us. They were not a substratum of day laborers or housemaids but people with the characteristics of the middle class, though with lower-class incomes. Only so much could be learned from courthouse files about the middle-classness of bankrupts, however, so we undertook a second study, reported here, that added questionnaires about the personal characteristics of bankrupts, including their education levels, occupations, and other relevant data. On that basis, we report in this book that the bankrupts do represent a fair cross-section of the American middle class. On that basis, we have realized that our data from the bankruptcy courts was akin to a financial pathology of middle-class Americans. Because people's financial troubles so often arise from other sources, such as divorce or serious illness, they also reflect in part the social pathology of the great middle of American society.

Since World War II the increase in bankruptcy filings in the United States has been relentless, and recently spectacular. The increases accelerated during the 1980s and 1990s, frequently breaking records from quarter to quarter and year to year. Between 1979 and 1997 personal bankruptcy filings increased by more than 400 percent.[1] The upsurge in personal bankruptcies during the mid-1990s was especially striking because it occurred during a widespread economic recovery. Burgeoning financial collapse in the midst of prosperity is particularly poignant and deeply worrisome.

The dynamics of capitalism, combined with a thin social safety net, guarantee that some families will always fail. Without universal health insurance to protect every family from the financial ravages of illness and without higher levels of unemployment compensation to cushion the effects of a layoff, each day, in good times and in bad, some families will fall over the financial edge. And in a market that provides access to almost unlimited amounts of consumer credit, some people will accumulate a debt load that eventually takes on a life of its own—swelling on compound interest, default rates, and penalty payments until it consumes every available dollar of income and still demands more. Just as the poor will always be with us, so will the bankrupt middle class. Yet what makes the phenomenon so noteworthy in our time is that the proportion of middle-class America finding its way to the bankruptcy courts has jumped beyond any reasonable expectation (fig. 1.1).

Will Rogers said during the Great Depression that America was the first country to drive to the poorhouse in an automobile. The automobile remains a potent symbol of the economic times and our financial mores. Americans are buying larger and more luxurious cars, complete with sound systems, computer monitoring devices, and four-wheel drive. These cars, trucks, and vans are better built and

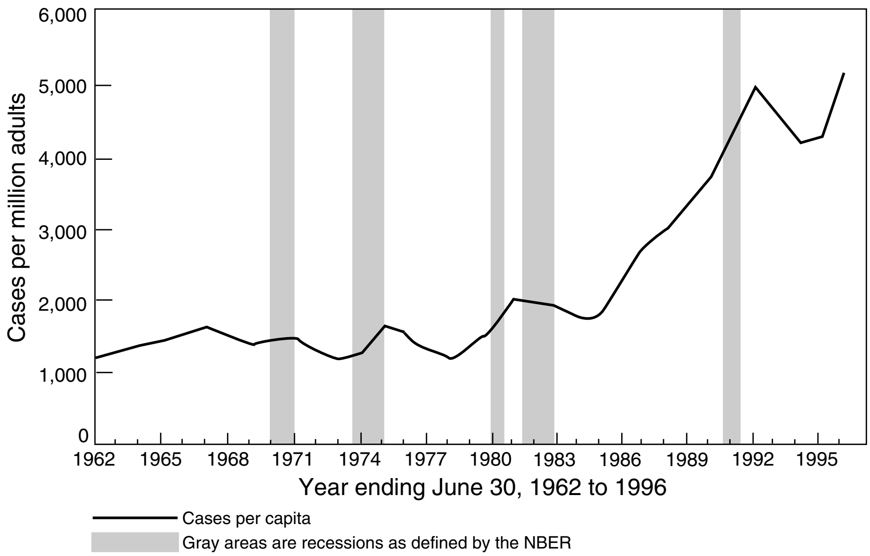

Fig. 1.1 Consumer bankruptcy filings, 1962–96. *Source:* Derived from "The Increase in Personal Bankruptcy and the Crisis in Consumer Credit," Hearing Before the Senate Judiciary Committee Subcommittee on Administrative Oversight and the Courts, 105th Cong., 1st sess., (1997), 39 (statement of Kim J. Kowalewski, Chief, Financial and General Macroeconomic Analysis Unit, Macroeconomic Analysis Division, Congressional Budget Office).

safer than ever before. But the breathtaking prices of these gleaming machines require most middle-class buyers to incur hefty debt, repayable over ever-longer periods at high interest rates. A single transaction encapsulates both prosperity and the risk of financial collapse.

The current prosperity is driven to a large extent by consumer debt, while inflation is largely tempered by downsizing and contract employment. Whether the combination of these factors is stable for the economy as a whole remains to be seen, but it is beyond doubt that they create instability for many American families. Even if one assumes that economic forces ultimately balance out, with new jobs and opportunities replacing old ones, transitional interruptions and reductions in income pose serious problems for families with monthly debt obligations. The combination of two elemental factors—increases in debt and uncertainty of income—contributes importantly to middle-class distress.

The Bankruptcy Laboratory

In the 1980s, we undertook an empirical study of the debtors who filed for bankruptcy. That study, Phase I of the Consumer Bankruptcy Project, involved about 1,550 debtors from ten judicial districts around the country who filed for bankruptcy in 1981. We examined a systematic sample of 150 consumer bankruptcy cases filed in 1981 in each of ten federal court districts spread across three states: Illinois, Pennsylvania, and Texas. The data collected in Phase I emphasized the financial condition of the debtors, especially their debts, assets, and income. We used the detailed financial and demographic information from these bankruptcy files to draw a picture of those Americans who fell all the way into bankruptcy. We found that the bankruptcy laws served as a social safety net for middle-class people caught in financial reversal. Because of bankruptcy, people who were once solidly middle class did not lose everything and fall into the lower class. Declaring bankruptcy allowed them to shed debt, recover from pressing medical bills, and otherwise free up their income so that they could concentrate on their current bills—groceries, utilities, and medical care—as well as on their old home mortgages, car loans, and taxes. They might not keep much property after bankruptcy, years later they are likely to be still making substantial debt payments, and bankruptcy certainly did not guarantee them a job or good health. What declaring bankruptcy did for them was provide a chance—often a last chance—to retain their middle-class status. They could deal with some of the debts that threatened to move them out of their homes, take away their property, encumber their future incomes, and force them to live with a steady stream of debt collectors. They might sink lower in the middle class, but by dealing with their most overwhelming debts, they could preserve a handhold on their way down the social and economic ladder.

In the 1990s, we undertook Phase II of the Consumer Bankruptcy Project. This study, reported here, was based on a larger sample of people who filed for bankruptcy during 1991 in sixteen federal districts. Once again, the data reveal a middle-class population of bankrupts. For this project we obtained written surveys from debtors in bankruptcy and the court records for the debtors in five of the districts. As a result, we now have more nonfinancial information about these families and their financial collapse.[2] Throughout this book we look both at the court data and the survey data to explore who these people are and to outline their financial woes.

In this book we explore the persistence of the stereotype that bankruptcy is a lower-class, not a middle-class, phenomenon. We also examine the evidence that, even though some upper- and lower-class Americans may find themselves in bankruptcy court, bankruptcy is a largely middle-class phenomenon. As measured by the key nonmonetary measures we can develop—information about educational levels and occupations—the people in bankruptcy are solidly middle class. And even the monetary data, which show a substantial portion of the debtors in poverty, contain evidence of the debtors' once-middle-class financial lives: their educational attainments, their formerly higher incomes, and their substantial rates of homeownership hark back to an earlier time of more middle-class financial, as well as social, status. The middle class is, of course, a huge portion of the American population. The families in bankruptcy are a good, though not perfect, cross-section of America by age, by gender, by race, by marital status, by ethnicity, by citizenship status, by employment status. If the world were a more comfortable place for middle-class Americans, we would not be writing this book—or at least one with this title. Instead, bankruptcy would be a distant phenomenon, a last resort for the uneducated, chronically unemployed margins of society whose improvident debts outstripped their meager incomes. In short, we would write a book about *them,* not about *us.*

The debtors in our sample include accountants and computer engineers, doctors and dentists, clerks and executives, salesclerks and librarians, teachers and entrepreneurs. They are middle-class folks who are supposed to be gathering around the barbecues on the patios outside their three-bedroom, two-bath houses, not waiting to be examined under oath by their creditors in austere federal courthouses. The debtors were the first to succumb to difficulties that also face many of their fellow citizens. They are like the proverbial canaries in the mineshafts; the bankrupt debtors comprise an early warning system for all Americans. They are a silent reminder that even the most secure family may be only a job loss, a medical problem, or an out-of-control credit card away from financial catastrophe.

In Phase II of the project, we expanded our study to cases filed in 1991 in sixteen districts spread across five states: all the districts in Illinois, Pennsylvania, Texas, and California and two of the three districts in Tennessee. We thus studied the same ten districts profiled in Phase I and added six districts in two states. The five states we sampled accounted for 31 percent of all bankruptcies in the United States in 1991.[3] With 150 cases in each district, we had a sample of about 2,400 cases.

With the cooperation and help of the Office of the U.S. Trustee and the Administrative Office of the United States Courts, we asked the individuals filing for bankruptcy in these sixteen federal judicial districts to complete a questionnaire that provided information on their age, education, occupation, marital status, race or ethnicity, and citizenship.[4] When married couples filed jointly, we asked for information about both spouses. We also collected financial data from the court records for the sample of 150 debtors in five districts, one district in each of the five states. Chapter 2 gives an overall picture of the demographic, social and economic profiles of the debtors. The grittier details of the study design and a copy of the questionnaire are set forth in Appendix 1.

The final question in the survey asked debtors to explain why they had filed their bankruptcies. There we hoped to uncover more information about the factors that put people at financial risk. Some people gave only terse responses—"too much debt, too little income"—while others poured out complex stories about faithless ex-spouses and gave detailed medical histories. In the next six chapters, we develop more data both from the debtors and from a variety of other sources to explore the fractures in the middle class that they have identified.

We quote many of the debtors' explanations in the course of this book to give the reader a genuine, unfiltered glimpse at the difficulties with which these people were confronted. The debtors' names and other identifying information have been disguised to protect privacy, but their words are uncensored and uncorrected, and the financial and demographic details are accurate as the debtors reported them to us and to the courts. The debtors are not composites; they are real, live people who went through the bankruptcy system. In addition to telling their stories, we also quantify their collective responses and analyze them statistically. Again, our methods are detailed in Appendix 1.

We try to interpret these data to create a coherent picture of the stresses middle-class Americans face today. We are keenly aware of the value judgments that creep into any discussion of information about American families, particularly data dealing with such topics as debt and the failure to honor one's promises. We have given our conclusions as best we can, mostly with a focus on the economics of where the debtor is at the time of filing for bankruptcy. But in every case we have tried to expose as much of the data as possible to give anyone with another perspective the opportunity to evaluate these data critically. We also provide as much detail as we can in the recognition that some subsequent researchers will use the data to support other interpretations, even those contrary to our own. We invite their efforts, secure in the belief that by expanding the dialogue about financial failure and what it signals about the health of middle-class America, a more thoughtful and nuanced picture will emerge.

We assume that there are errors in the reported data we collected. The bankruptcy files require the debtors to record extensive information on income, assets, debts, previous trips to the bankruptcy court, current address, former addresses, ongoing payment obligations, lawyers' fees, and so on. It would be extraordinary if every dollar value, every date, every address, and every description were accurate in all respects. Families in financial crisis may not be the most careful and reliable record keepers, and the bankruptcy forms are complex and detailed. Even so, the forms are filled out in a lawyer's office, typically with the help of an attorney, paralegal, or other person familiar with gathering personal financial information. They are filed under penalty of perjury.[5] Some reported data are backed up with hard evidence. For example, many courts require that debtors include recent paystubs to verify their current incomes. The largest assets—the home and the car—typically have easily determined market values, and those listings are usually scrutinized by all the parties.[6] A trustee is assigned to review the data in each file, and the debtors must sit for examination under oath for questioning by the trustee and the creditors about the representations in the file. In addition, creditors can challenge any of the reported information at any time, challenges they have a particular interest in presenting if the debtor either understates assets or incorrectly states debts. The penalties for misrepresentation are severe: the forms are signed under a declaration warning the debtor that misreporting is perjury. A debtor who falsifies his or her financial condition is subject to losing the bankruptcy discharge and, in extreme cases, to prosecution for a bankruptcy crime. Even debtors who shade the truth may find that a court will use such lack of candor as grounds for a dismissal for filing in bad faith. In short, there are substantial reasons to support the general accuracy of the data reported in the files. Moreover, there is no reason to believe in systematic error—persistent undervaluation or overvaluation of one entry or another. Discussion in the bankruptcy community about inaccuracies in the bankruptcy files generally relates to careless—not systematic—errors.[7] Most judges and practitioners believe that the incidence of misrepresentation is more likely to occur in the areas where debtors are asked to estimate future expenses and incomes, notoriously unreliable numbers even for those in the steadiest of financial circumstances. Those data are not used in this book.

It is always possible that someone may have misrepresented his or her age or marital status on the questionnaire, but there is little incentive for someone to do so and the information asked is fairly straightforward. The one question that might trigger the least accurate response is the one that asks the debtor to explain why he or she filed for bankruptcy. Here the debtor may tend to give highly self-serving answers that bear little relation to what an independent financial analyst with full information of the debtor's circumstances would say.

In one sense, we can never know the reason for anyone's bankruptcy. Even if the debtors reported full information, independent analysts would see different causes. Consider the debtor who lost his job because his company cut back on staff. But the company kept some of its employees, and the debtor had failed to take additional training and didn't get moved to the more critical division of the company. The reason he didn't move was that the new job would have involved longer hours and he didn't have child care after 5:30 P.M. Was the reason for filing a layoff? Too little training? Family responsibilities? Even independent analysts might dispute the cause of economic distress. And why bankruptcy as a solution? Some people choose to lose their homes and cars rather than go to bankruptcy court. Others move off in the middle of the night, becoming economic nomads. Still others work for cash in the underground economy. And others continue the shell game of paying one creditor one month and another the next, always half a step ahead of financial collapse but never in the bankruptcy courts. When we deal with the reasons for filing, we take what the debtors say, recognizing that we are seeing their explanations, and perhaps rationalizations.

The debtors may offer the most socially acceptable versions of their reasons, but much of the information they give in their explanations for filing can be corroborated independently. When debtors describe a recent divorce and an ex-spouse's failure to pay child support, the questions about current and past marital status will offer consistent evidence of a recent breakup and the bankruptcy file may show child support owed as a source of income. The high incidence of job-related problems reported in the debtors' questionnaires is entirely consistent with our other studies, drawn entirely from court file data, which show income patterns consistent with job losses in the two years preceding the bankruptcy filing. The data are also generally consistent with some smaller, single-district studies, which we cite in our chapter on jobs. Even though we cannot verify every story or even every type of story, the debtors' descriptions of their problems are consistent with the pattern of information we can observe.

Ultimately, however, we must face the fact that we are dealing with how the people in trouble describe their own problems. Although many are full of self-loathing, others are looking for another place to lay the blame for their decline into bankruptcy. Faced with explaining either that he or she was fired for getting drunk on the job or merely that he or she lost a job, a debtor may well give the second briefer and more acceptable account. The data we have collected are not useful for assigning a carefully calibrated personal blameworthiness quotient or for evaluating debtors' morality to distinguish them from their middle-class cohorts who are not in bankruptcy. What we can document with some confidence is the mess these debtors are in. Regardless of the combination of bad judgment and bad luck that brought these families to bankruptcy court, we can verify that (1) they are in desperate financial shape and (2) they repeatedly identify similar problems to explain their circumstances.

The Bankruptcy Process

For most individual consumers, filing for bankruptcy is a matter of collecting and reporting a great deal of financial and sometimes personal information. The process requires filing long schedules about the family's income, assets, and debts. The debt listings include home mortgages, car loans, tax debts, credit card debts, medical debts, finance company loans, and a potpourri of other debts. There are other questions about lawsuits, business activities, and previous trips to the bankruptcy courthouse. If a creditor charges the debtor with fraud or if a good deal of valuable property is involved, things can get complicated quickly, but for most people the filing is a fairly straightforward process of following the lawyer's instructions. The responses we have received make it clear that bankruptcy remains a painful and shameful experience for many people, but it is not hard to understand the major points, and the lawyer takes care of most of the details.

Most people hire a lawyer to help them through the bankruptcy process. It generally costs between $750 and $1,500. Where does someone who is stone-cold broke get that kind of money? That is the first trade secret the lawyer puts at the client's service. Sometimes the lawyer will recommend payment of fees and debts over time in a trustee-supervised plan. In other situations, the lawyer will suggest letting other bills go while the debtor gets enough cash together to pay the lawyer in advance. The lawyer then helps the debtor discharge the debts to the other creditors. Only in America would we encounter people saving up for their bankruptcies.

Bankruptcy is governed by federal law and administered in the federal courts throughout the country. Something under half of the filings are made jointly, by married couples, even though 56 percent of adults in the general population are married.[8] The other half are single filings, made by unmarried people or by one half of a married couple. The most important decision a couple or an individual debtor has to make is whether to file for a *Chapter 7* liquidation or a *Chapter 13* payout plan.

A Chapter 7 case requires the debtors to give up all their non-exempt property to a trustee for the benefit of their creditors, in exchange for which they will be *discharged* from most of their preexisting debts. Some debts will survive the bankruptcy, such as alimony and child support, taxes, and educational loans. Other debts must be paid in full or the debtor will lose the collateral that secured the loan, such as the family home or the car. Many debtors choose to keep the collateral by keeping the debt. This means that for most families who file for bankruptcy, the first postbankruptcy reality is that they will still have substantial debts to pay: the home mortgage, the home equity line of credit, the car loan, the student loans, any outstanding taxes and any alimony or child support. Bankruptcy is a "fresh start" only in a relative sense—tens of thousands of dollars of credit card debt, retail store card debts, medical debts, and other "unsecured" debts can be wiped out with a Chapter 7 filing.

The alternative to Chapter 7 is Chapter 13, a vehicle for debtors to try to repay all or some part of their debts over time under the eye of a court-appointed trustee. If the family's payment plan is approved and they make the promised repayments, they may keep all of their property and receive a discharge from the portion of their debts they did not pay. Plans typically provide for payments over three to five years.

The reality of consumer choice is often even more constrained than these two legal descriptions suggest. In Chapter 7 liquidation, most consumer debtors will have little or no property that is not already protected by state exemptions, because they have few assets of any value that are not already subject to liens and mortgages. In other words, they do not own outright much of anything valuable. They will have to give up any property that has a mortgage or a lien on it, unless they can make a deal with the lender to keep paying on the lien. Most families' remaining property usually has less resale value than state or federal law allows as the amount of exemption, and therefore they may keep it. The real objective for many debtors is keeping a house or a car or a refrigerator that is subject to a lien or mortgage. If they cannot arrive at an agreement with the lienholder, they may choose Chapter 13, where they can maintain the payments on the encumbered property and hold on to it, even over the lienholders' objections.

The usual price for a Chapter 13 payment plan is some payment to unsecured creditors as well. If Joe and Jane want to keep their car by paying off the lien on it, they may also have to pay a good part of their Visa bill over a three-to-five-year payment plan. The debtors must devote to their Chapter 13 plan all of their *disposable income,* which is defined as all the income remaining after a certain allowance is made for expenses. In reviewing a plan, courts also review home budgets and projected payments to see if the family is actually giving up all the disposable income. If they are willing to let the car go, or if they can strike a separate deal with the company holding the car lien, then a Chapter 7 plan and a quick discharge of their MasterCard balance and their other debts may seem much more attractive.[9] They will have the "fresh start" that is the traditional objective of American bankruptcy law, with their future income free of old debts.

The Chapter 7 alternative is not quite as attractive as it may seem for many debtors.[10] As we noted, debtors in Chapter 7 cannot keep property subject to a lien unless they can make a deal with the creditor who holds the lien. If the creditor takes a tough bargaining position, the debtor may be able to pay less to keep property under a Chapter 13 plan.[11] Other debtors face debts that cannot be discharged in Chapter 7, such as recent income tax liability, alimony and child support, education loans, and liability for drunken driving or deliberate injury to another. Those debtors may be able to use Chapter 13 to pay nondischargeable debts in full over time.

In either type of bankruptcy, a filing produces an *automatic stay,* a statutory injunction that immediately freezes all collection efforts and is one of the main benefits of bankruptcy for most debtors. As soon as creditors receive notice of the filing, the phone calls and collection suits must stop, bringing a blessed silence. Also under either chapter, the debtors typically go to the courthouse just once.[12] They attend a "Section 341 meeting" with a court official, where they are sworn in and the proceedings are recorded. There they are asked a set of standard questions about their financial affairs. Creditors are entitled to attend these meetings and ask questions (for example, about fraudulent purchases or hidden assets), but few bother to exercise this right. The amounts at stake in any single case are usually small, and the debtors often have no property of value.

In a Chapter 7 case, the debtors will get a discharge certificate in the mail a few weeks after the 341 meeting. They will be discharged from most prebankruptcy debts, though many of them will still owe debts to creditors holding liens, because they will have entered into payment agreements with them in order to keep the house or the car or other property subject to a lien. They may also still owe alimony and support payments or other nondischargeable debts. A fair number of them will have promised to make some repayments of dischargeable debts notwithstanding their discharges. In any case, the debtors will be barred from filing for Chapter 7 again for six years.

In a Chapter 13 case, the debtors' plan will soon be approved (the lawyer is unlikely to submit a plan the judges would not approve), and they will try to continue payments as promised in the plan. The percentages of their unsecured debts that debtors promise to pay vary greatly from one part of the country to another.[13] In some parts of the country, many debtors promise to pay 100 percent of their debts, merely seeking more time to do so. In other areas, most debtors promise far smaller percentages of payment, often under 50 percent. Whatever the promise, it often goes unfulfilled. Our studies and others indicate that most Chapter 13 cases fail before all the promised payments have been made. When that happens, one of two events usually occurs. The case may be dismissed, leaving the debtors to file again or to struggle on without bankruptcy relief. Or the case may be converted into a Chapter 7 liquidation. If the debtors beat the odds over the next three to five years and complete their promised payments—as only about one out of three do—they will be discharged from almost all preexisting debts above the amount they have paid. They will still have their home mortgages, and any second or third mortgages, the alimony and child support payments, and any outstanding taxes and student loans, but they will otherwise be back to zero—owning little, but owing little.

Bankruptcy as a Barometer of Social Change

Like studies from any good pathology lab, the data tell us what went wrong. They reveal two things about the debtors. The data are a catalogue of the financial missteps and misfortunes that brought many ordinary families to economic catastrophe. In addition, they give some basis for exploring how those cracks may be widening. As the number of people in bankruptcy climbs, the information about why they are in bankruptcy says something about where financial risk is increasing.

The data help us to understand the dramatic increases in bankruptcy over the past two decades. There were three possibilities: more people were in serious financial trouble, a larger fraction of people in serious financial trouble chose bankruptcy as a solution, or people in not-as-serious financial trouble decided on a bankruptcy escape. The data can eliminate the last; they show that from 1981 to 1991 the circumstances of those who filed bankruptcy actually worsened. On the other hand, neither these data nor other generally available data can tell us for sure which of the other two possibilities are correct. It may be that more people are in big trouble or it may be that more of those in big trouble are choosing bankruptcy as a way out. In spite of that uncertainty, these data suggest that bankruptcy is a potential indicator of social conditions. The mix of reasons that bring people to bankruptcy may change over time, reflecting the changing risks that face American families. Because there are no national studies of the reasons for bankruptcy filings from ten and twenty years ago, it is difficult to identify whether the mix of reasons for filing is changing. It is possible, however, to look at a few single-district bankruptcy studies and at economic data from outside bankruptcy courts to get some idea of which risks may be rising.

In this study, the debtors were asked to explain why they were in bankruptcy, with no limits on the number or kind of responses they could give (fig. 1.2). They told us that employment problems are at the heart of nearly two-thirds of bankruptcy filings, with other reasons spread among specific credit problems, illnesses and accidents, family troubles, housing difficulties, and a mix of additional problems.

Income Interruptions

Not surprisingly, anything that causes income to decline puts a family at risk for bankruptcy. Layoffs and firings create huge vulnerability. Even if the worker finds another job, a period without income may create insurmountable debts, especially if that worker was carrying substantial debt loads when unemployment hit. Job turnover, rather

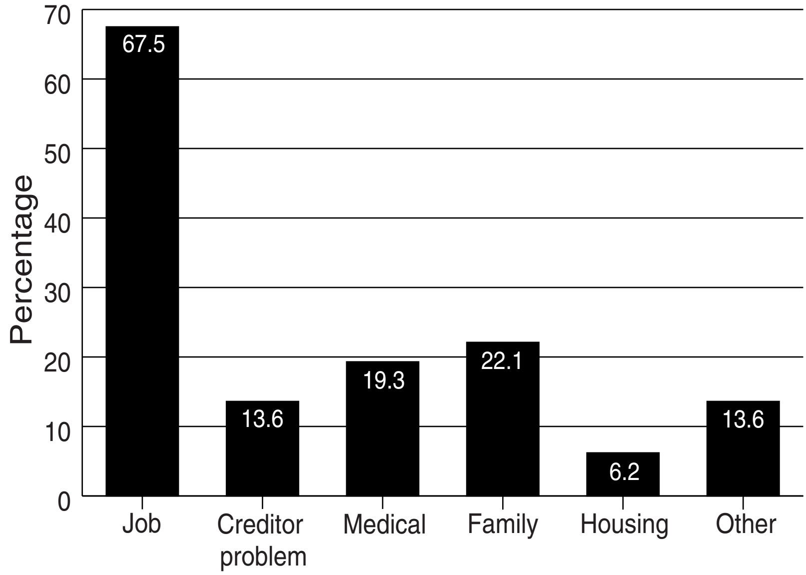

Fig. 1.2 Respondents' reasons for filing for bankruptcy. *Note:* Multiple responses were permitted.

than the actual unemployment rate, may be a better predictor for economic distress.

As dread as the word *unemployment* may be, many other income-related setbacks will also contribute to a debt-income mismatch that may lead to bankruptcy. Losing overtime hours or moving from a well-compensated executive position to a commission sales job may be enough. Employees with full benefits who become "outsourced" as contract workers with uncertain incomes and no fringe benefits may suddenly find income and debt out of balance.

Our autopsy of financial failure casts some light on the debates about the causes and cures of the pressures middle-class people are experiencing. Much of the debate, for example, has centered on the "downsizing" of corporations and the idea that long-term job security is a thing of the past. Some analysts have argued that job tenure is shrinking rapidly, while others say that it is much the same as it has always been in a country accustomed to economic change.[14] Whatever the conclusion, our data reveal that many people are finding themselves a part of the rising bankruptcy curve because they have lost their jobs, often positions they had held for some years and thought secure. Those data fit with a federal government survey of displaced workers that found that more than 30 percent of displaced, long-tenured workers had not found new employment. Of those who were working again, about 20 percent had found only part-time work or had become self-employed. This means that about 45 percent of long-tenured displaced workers had not found new full-time jobs.[15]

One aspect of the debate about job tenure—and about the export of jobs overseas—has been the claim that the recent hardships are falling most heavily on the undereducated. Even if that is true, the people we found in bankruptcy include a fair number with college degrees. In fact, the people in our sample are on the whole slightly better educated than the general population. At a minimum, therefore, a substantial group of educated people at the margins seem to be suffering job losses. That finding is consistent with the most recent figures from the Bureau of Labor Statistics and the Council of Economic Advisors, which report that in the early 1990s the risk of displacement for white-collar workers rose sharply as compared with
blue-collar workers.[16]

It is further agreed that job displacement results in significant lost income for most people, even if they get another full-time job. The most recent Labor Department survey indicates that approximately eight million workers were displaced between 1995 and 1997, where "displacement" means that they lost their jobs because the plant closed or their positions were abolished. By February 1998, half were reemployed at their old salaries or better, but 25 percent remained unemployed and another 25 percent were earning 20 percent or less of their prior salaries.[17] Thus about two million workers released by one form of downsizing or another remained unemployed and another two million were working at substantially lower wages. An earlier report estimated the average loss at about 14 percent. We all appreciate that such a reduction would require a wrenching adjustment in our way of life, yet that adjustment becomes acutely difficult if the employees had already committed most of their earlier, higher disposable income to debt repayment at high interest rates. Future expenses can be slashed, albeit painfully, but existing debts cannot. Instead, debts keep climbing, often compounding at 18 percent or more. It is highly significant that a survey conducted in 1998 showed that almost half of the consumers who report high consumer debts relative to their incomes also reported that their incomes were "unusually low" at that time. Their incomes had recently declined, creating the classic debt-income mismatch.[18] For some, the mismatch is great enough to cause financial collapse.

Credit Cards and Consumer Debt

The debt-income mismatch can also occur when incomes are stable but debts rise to unpayable levels. If consumers incur debt at higher levels in relation to their incomes, then they will be at greater risk for bankruptcy. The preconditions for that development are that consumers must become more willing to incur debt and the consumer credit industry must become more willing to extend it.

Stagnant incomes have affected many Americans for twenty years. Through the recessions of the early 1980s and 1990s and the recoveries in between and since, the median income of American households has remained about the same, after adjusting for inflation.[19] The increases in income since 1980 have mostly gone to the wealthiest one-fifth of the population.[20] At the same time, the willingness of consumers to borrow and of lenders to lend has increased dramatically. From 1980 to 1992, total home mortgage and consumer installment debt rose more than 400 percent in unadjusted dollars, from about $1.4 trillion to about $5.7 trillion.[21] From 1980 to 1994, total household debt had increased from 65 percent to 81 percent of total income.[22] In short, real consumer debt has risen dramatically over a long period during which real incomes for many people have stayed the same or declined. The result is exactly what a sensible observer would predict it to be: a great increase in the bankruptcy rate.

One more piece of the puzzle is interest rates. Even with stable income and debt levels, the debt burden increases when interest rates increase. Since the early 1980s, when extreme inflation led to the abolition or radical loosening of usury laws at both the state and federal levels, consumer interest has remained at historically high rates. The cost that Citibank pays its investors for the money it uses to lend out on credit cards fell by more than 50 percent (7.5 percentage points), but credit card interest rates dropped by only about 10 percent (1.7 percentage point).[23] The average 18 percent rate that consumers have been paying on credit cards would have landed the credit company executives in the penitentiary twenty years ago. Today it lands the same executives in flattering profile stories in *Forbes* and *Business Week.* In 1998, an article published by the Federal Deposit Insurance Corporation identified the repeal of usury rates as the triggering event for a glut of consumer credit and the resulting rise in bankruptcy filing rates.[24] The dramatic expansion of consumer credit, and of all-purpose credit cards in particular, is largely a function of the enormous premiums permitted under current usury laws.

Because interest charges generate a continuing increase in debt, even if the consumer has stopped making any new charges because of adverse financial conditions, these high interest charges create a momentum that debt has never had before. Many creditors now impose a "default" rate of interest on the customers who fall behind, compounding the balance owed at rates of 24 percent and higher.[25] There is every reason to think that people have adjusted only slowly and imperfectly to this radical change in financial life. Furthermore, only since 1989 has ordinary consumer interest not been tax deductible, so that some people may not have fully adjusted to the ultimate, after-tax cost of these new, far-higher interest rates.

Changes in social values and behavior are both cause and effect of changes in popular culture, but popular culture is also changed deliberately by those who have something to sell, from movies to new cars to credit. Enormous amounts of talent and money fuel these efforts to change the way people perceive products and services and to generate increased demand for them. Insofar as those efforts are directed at stimulating buying by people with stagnant incomes, they must lead to increased debt and eventually to increased bankruptcy rates. Whether these efforts change moral values or simply connect with people whose values have changed for other reasons, the effect is greater financial precariousness.

Accidents and Illnesses

The mismatch between income and debt also occurs when debts increase unexpectedly, even if income remains the same. An uninsured medical emergency will do the trick. If more people are suffering serious medical problems, or if medical problems produce greater costs, or if fewer people have insurance to cover their medical costs, debtors will go to the bankruptcy courts in greater numbers.

Medical costs have played a prominent role in discussions of middle-class struggles, including the problem of workers' losing medical insurance when they lose their jobs. About 25 percent of long-tenured, displaced workers surveyed by the Department of Labor in 1996 remained uncovered by medical insurance, although this figure was somewhat improved over the numbers from a decade earlier.[26] The number of uninsured children in the United States continues to rise; four-fifths of these children live in homes where incomes are above the poverty level.[27] A Census Bureau study in 1995 revealed that in a three-year period, about 64 million people faced some time when they had no insurance as a backstop against medical bills, including about 9.5 million who had no insurance protection at any time during this timespan.[28]

Although our data show that medical costs contribute materially to the financial struggles of families, the medical data also show that families are vulnerable in other ways. The more serious problem for many families may be income lost due to an illness or injury. The medical problem that leads to a job problem can become an income problem that a family cannot survive. In that regard, social policies that deliberately limit disability payments to a percentage of prior income may make previously incurred debts virtually unpayable. The lower payments provide an incentive to return to work but may leave creditors holding the bag. The social safety net erected to permit families to seek medical treatment not only affects how their health care providers will be paid but may also affect all their other creditors as well.

Divorce and Remarriage

Changes in social mores can have profound financial effects. Divorce is a key example. In addition to its social and moral characteristics, the family is a financial unit, and the breakup of a family often creates expenses and debts quite disproportionate to the incomes available to pay them. Whenever two households suddenly must split an income that once supported only one, a financially precarious period ensues. A general increase in family instability—at a time when families are already loaded with debt—may lead to an increase in bankruptcy filings.

One in every ten adults in the population generally is currently divorced—not single, married, or widowed. Among people in bankruptcy, however, that number is two in ten—meaning that a divorced person is twice as likely to be in bankruptcy in a given year than their proportion in the population. The high proportion of divorced people in bankruptcy illustrates that the financial cost of family dissolution is often a body blow to anyone trying to re-form a new household. Both men and women flock to bankruptcy court after a divorce, although the evidence suggests that the economic straits facing women, particularly those rearing children, are even more acute than those confronting men.

Home Mortgages

One cause for bankruptcy filings, drowning-by-mortgage, is less obvious than the rest. Mortgages are, of course, a large and important sort
of debt for most Americans, but no one ever says that buying homes causes bankruptcy. Yet people do use phrases like "house-poor" to describe a friend. In bankruptcy we find the extreme examples. The culprit once again is change. Ever since World War II, Americans have been taught that owning your own home is the ultimate investment, the ticket to long-term financial security, along with social acceptance and a nice tax deduction. Rising interest rates, stagnant incomes, and increasing housing costs (including property taxes) have made that investment a greater risk for people who can no longer be sure of their jobs. Home ownership, when combined with the need to move quickly to follow a job, second-mortgages to finance college educations and orthodontia, and stagnant or declining housing markets, can rapidly shift from the asset to the liability column in any family's balance sheet. And there has recently arisen a strong trend to use second (or third) mortgages on homes to refinance ordinary consumer debt.[29]

Homeownership is one of the most visible signs of participation in the middle class. Families in bankruptcy often want desperately to hold on to their homes, and their bankruptcy filings may be an attempt to clear out other debts so that they can pour their often-shrinking incomes into their mortgage payments. For many, hanging on to a home is no longer a matter of economic rationality; it has become a struggle to save an important part of their lives, one that a financial adviser might tell them to let go.

Home ownership problems often intersect powerfully with employment problems. The data also reveal important differences by race, suggesting that African-American and Hispanic-American homeowners may have a more tenuous grasp on their homes and may be struggling harder in bankruptcy to save them.

Increasing Vulnerability

As American families have faced job losses and medical bills, divorces and home mortgages throughout the past decade, bankruptcy has been their safety net—much as it has throughout the past century. By themselves, the stories are interesting and the aggregated data help identify the main fault lines in the solid, reliable middle class. But the 1990s were unlike any other in the bankruptcy courts. As we noted at the beginning of this chapter, the number of families flocking to the bankruptcy courts has set new filing records. We know why the debtors are there, but the question remains: Why are so many more there now than in the early 1980s? Are the cracks in middle-class stability widening?

That question brings us to a crucial point in our findings: the central role of consumer debt in the middle-class crunch. As we noted earlier, a sharp increase in consumer debt can lead directly to a bankruptcy filing. But the proportion of people who have filed for bankruptcy because they have run up consumer debt to unmanageable levels is somewhat more modest than many might guess—perhaps about one in ten. The number is not insubstantial, but it cannot account for the threefold rise in bankruptcy filings.

Instead, consumer debt has lowered many middle-class families' threshold for financial collapse. High consumer debt loads increase families' vulnerability to every other problem—job, medical, divorce, housing—that befalls them. Six weeks of unemployment for a worker with $200 in short-term, high-interest credit card debt may be tough but manageable. That same six weeks without a paycheck is a disaster for a worker who must feed a relentless $20,000 credit card balance