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Discharge, Waiver, and the Behavioral Undercurrents of Debtor-Creditor Law

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An individual in financial distress enjoys two important rights. First, she can protect some of her assets from her creditors, whether in bankruptcy or not. A creditor cannot seize the clothes on the debtor's back, her tools of trade, basic household goods, her wedding ring, or her homestead.[1] Second, the "honest but unfortunate debtor" has a right to bankruptcy's "fresh start."[2] She can file a bankruptcy petition and obtain a discharge of past debt. She keeps only the property creditors could not reach outside of bankruptcy, but she enjoys her future income free of the claims of her old creditors. Each right allows the debtor to put some assets (existing property such as household goods in one case and future earnings in the other) beyond the reach of creditors. But the rights differ in a crucial respect. A debtor can allow creditors to take household goods and assets otherwise beyond the creditors' reach by granting a security interest in them. With a security interest, a creditor can seize and sell the assets. By contrast, a debtor cannot give up her right to enjoy future earnings. She has no ability to waive her right to file a bankruptcy petition at the time she borrows.[3] Liens on future income do not survive bankruptcy. This Essay explores the difference between these two rights through the lens of behavioral economics.

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1 The precise contours of these exemptions vary from one state to another. See, for example, NY CPLR § 5205 (McKinney 1997) (exempting, among other items of personal property, all stoves in the home, one sewing machine, the family Bible, a pew in a public house of worship, enough food for sixty days, a wedding ring, and "a watch not exceeding thirty-five dollars in value"); Cal Civ Proc Code § 704.010–704.210 (West 1987) (exempting in general terms homestead, tools of the trade, certain investments, and the family cemetery plot).

2 See 11 USC § 727 (2000) (stipulating that "[t]he court shall grant . . . a discharge, unless" the debtor commits any of several forms of falsehood). As discussed below, the characterization of the "honest but unfortunate debtor" as the one for whom the bankruptcy discharge is intended is a twentieth century development. The phrase itself can be traced to *Local Loan Co v Hunt*, 292 US 234, 244 (1934) (explaining that the Bankruptcy Act "gives to the honest but unfortunate debtor . . . a new opportunity in life and a clear field for future effort, unhampered by the pressure and discouragement of pre-existing debt").

3 A waiver of discharge is enforceable only if the debtor executes it after filing the bankruptcy petition and then only if the bankruptcy judge approves it. 11 USC § 727(a)(10).

As Cass Sunstein shows in his essay in this Symposium, the law has a preference for weak paternalism over strong paternalism.[4] For the most part, the law does not second-guess deliberate, well-considered decisions. But legal rules can prevent us from making decisions that are impulsive or unreflective. Legal rules protect us from ourselves by insisting that legal formalities accompany decisions where we are prone to make systematic misjudgments. These formalities force us to pause and consider what we are doing.

The law puts some household goods and all future earnings beyond the reach of creditors in part because we are inclined to make borrowing decisions without taking full account of the long-term consequences.[5] We underestimate the likelihood of future hard times at the time we borrow. We do not fully realize that, although the chance of any particular reversal might be small, the chance that at least one will come to pass is substantial.[6] Moreover, we do not appreciate the costs of losing some kinds of property or encumbering future income.

Furthermore, if debtors are likely to undervalue the importance of their household goods, debtors will also be too quick to grant a security interest in them. Similarly, they will cede their right to enjoy their future income too readily. The law has to ensure that waivers of these rights, to the extent waivers are allowed at all, are done with sufficient deliberation and reflection.

The first part of this Essay focuses upon the legal rules that exempt some types of property from creditor levy. I show that the formal requirements for granting a security interest in such "exempt" property ordinarily beyond the reach of creditors ensure that debtors act with sufficient deliberation. The warp and woof of these laws turn crucially on what Lon Fuller called the cautionary function of legal rules.[7] When such rules cannot be implemented—and increasingly they cannot be—the law sometimes resorts to strong paternalism and forbids them altogether. The second and third parts of this Essay show how the modern conception of the bankruptcy discharge emerged over time and now takes account of the need to protect individuals from waiving rights they are likely to systematically undervalue. The final

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4 See Cass R. Sunstein, *Boundedly Rational Borrowing*, 73 U Chi L Rev 249, 256 (2006).

5 See Thomas H. Jackson, *The Fresh-Start Policy in Bankruptcy Law*, 98 Harv L Rev 1393, 1405–18 (1985) (arguing that the clean slate of bankruptcy properly balances autonomy with a safety net that protects people from shortsightedness, regret, and mistake).

6 See Amos Tversky and Daniel Kahneman, *Judgment under Uncertainty: Heuristics and Biases*, 185 Science 1124, 1129 (1974) (discussing studies that find people more likely to overestimate the probability of conjunctive events—the success of a plan requiring multiple necessary steps—and underestimate disjunctive events—the risk of one necessary part among many failing).

7 See Lon L. Fuller, *Consideration and Form*, 41 Colum L Rev 799, 800 (1941) (showing that one function of formal rules is to act as "a check against inconsiderate action").

part shows that this understanding of how waivers work in debtor-creditor law suggests a way to think about covenants not to compete in bankruptcy, an issue that has sharply divided courts and stirred considerable confusion.

I. *WALKER-THOMAS* AND WAIVERS OF EXEMPT ASSETS

The idea that some property should be exempt from creditor levy became embedded early in American law long before the Constitution was drafted.[8] Assets that are beyond the reach of general creditors typically include the homestead, tax-favored retirement accounts, family heirlooms, clothes, household furnishings, appliances, and personal effects. Individuals will not always assess the importance of these items accurately when deciding whether to borrow. The individual has to contemplate a sequence of events that has never happened to her (a catastrophic illness, the loss of a job), envision the consequences, and evaluate the probabilities accurately.

But completely insulating such assets from creditor levy comes at a cost. An heirloom or other asset with high subjective value makes for an excellent hostage.[9] Individual debtors can signal their creditworthiness and their confidence that they can repay their obligations by allowing creditors to reach such assets. By requiring that sufficient formalities accompany the creation of security interests, the legal rule can accommodate debtors who want to put up such assets as hostages without undercutting the rationale for providing the exemptions in the first instance. By requiring formalities before a security interest becomes effective, the law serves a cautionary function. The legal rule allows individuals the freedom to make their own decisions, but ensures that such decisions are made with some deliberation.

One example of a common transaction that cannot be done casually or without reflection is a mortgage. The transaction (a transfer of an interest in real property) requires a high level of legal formality, regardless of whether the land is part of the debtor's homestead. Hence, we do not need a formal rule tailored specifically to the homestead exception. In contrast, the creation of security interests in personal property requires little beyond a written agreement describing the

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8 See, for example, Peter J. Coleman, *Debtors and Creditors in America: Insolvency, Imprisonment for Debt, and Bankruptcy, 1607–1900* 191–92 (Hist Soc of Wis 1974) (describing the use of the writ of elegit in colonial Virginia, under which creditors could not force a sale of a borrower's land).

9 See Robert E. Scott, *A Relational Theory of Secured Financing*, 86 Colum L Rev 901, 930 (1986) (suggesting that a hostage "should constrain the debtor, but not tempt the creditor" to resell).

collateral.[10] Hence, we need legal rules that focus particularly on exempt property. The idea that waivers of exempt property cannot be done casually or without reflection lies at the heart of one of the best known unconscionability cases, *Williams v Walker-Thomas Furniture Co.*[11]

Williams bought household furnishings from Walker-Thomas for about $1,300. After Williams had paid all but $164 of this amount, she bought a stereo from Walker-Thomas for $514. The contract she signed included a cross-collateralization clause giving Walker-Thomas a security interest in both the stereo and all the other furniture she bought from it over the years.

Walker-Thomas needed this provision because local law prevented it from reaching this kind of property otherwise.[12] If the household furniture that Walker-Thomas had previously sold Williams were ordinary property subject to creditor levy, the cross-collateralization clause would be superfluous. Even without it, Walker-Thomas could, in the event of default, obtain a judgment, obtain a writ of execution, and require the sheriff to reach all of Williams's assets, except those that are explicitly put out of bounds.[13] Walker-Thomas took the security interest in Williams's household goods only because these assets were ordinarily beyond the reach of creditors. The cross-collateralization clause served this purpose and no other.

The cross-collateralization clause differs from other terms because it waives a right provided by the law to protect us from the consequences of unwise decisions. Given the rationale behind the long-standing legislative policy of putting Williams's household goods beyond the reach of creditors, it makes little sense to allow Walker-Thomas to obtain a waiver of the right in fine print.[14] The waiver of such a right must be done in an environment that allows for reflection

10 See UCC § 9-203(b)(3)(A) (ALI 2002).

11 350 F2d 445 (DC Cir 1965).

12 DC Code § 15-401 (1951).

13 A security interest gives other rights, but they are not relevant here. For example, a secured creditor has a right to repossess collateral in the event of default, but only if it can do so without a breach of the peace. As nonconsensual entry into a private home is necessarily a breach of the peace, the right to repossess has no relevance when the creditor has a security interest in household furnishings.

Some readers of the case are left with the impression that the clause effected a penalty—that it gave Walker-Thomas the right to take much more than it was owed. This is wrong. A secured creditor is obliged to sell the collateral, keep only as much of the proceeds to pay what is owed, and return whatever remains to the debtor.

14 Although the court relied on the general idea of unconscionability in UCC § 2-302, Williams's lawyers did make this argument explicitly. See Robert H. Skilton and Orrin L. Helstad, *Protection of the Installment Buyer of Goods under the Uniform Commercial Code*, 65 Mich L Rev 1465, 1481 (1967). In any event, the unconscionability argument would work only if consequences flowed from the clause; the consequences from the cross-collateralization clause flow only because the property in question is exempt.

and deliberation. If Williams is to give up her right to protect exempt property, she should *know* that she has the right and that she is giving it up. A clause buried in a purchase agreement whose legal consequences are not self-evident (even to many contracts professors who have taught the case for many years) cannot serve that purpose and hence should not be enforced.

It is not easy to ensure that the waiver of the right to keep household goods out of the reach of general creditors is done with sufficient reflection. One possible approach is to require such terms to be disclosed conspicuously. But consumers may pay insufficient attention even to terms that are disclosed conspicuously. Hence, since the time *Walker-Thomas* was decided, we have gone further. Under current law, the only way to give a lender a security interest in many types of property (from furniture to wedding rings) that are ordinarily beyond the reach of creditors is by parting with the items. To use her wedding ring as collateral, a debtor must go to a pawn shop, take the ring off her finger, and hand it over to the pawnbroker.[15] Insisting that she part with possession is a formal rule that serves a cautionary function. Such an act cannot be done without reflection. Although the transaction is utterly different from the ritual associated with the execution of a mortgage, it too ensures deliberate decisionmaking.

II. EVOLUTION OF BANKRUPTCY'S FRESH START AND THE "HONEST BUT UNFORTUNATE DEBTOR"

The right to a discharge in bankruptcy evolved in a fashion completely different from the right to exempt property. Only in the twentieth century did it become a right that protected debtors from their own misjudgments. Bankruptcy law took shape in eighteenth century England, a legal and economic environment utterly alien to our own. Debtor-creditor law of the time was unforgiving. Your assets would be taken from you, and if these proved insufficient to pay what you owed, you would be put in prison. As one judge of the period observed:

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15 Taking a nonpossessory, non-purchase-money security interest in a wedding ring and other household goods is an unfair credit practice. See FTC Credit Practices, 16 CFR §§ 444.1(i) (defining "household goods") and 444.2(a)(4) (2005) (categorizing a nonpossessory security interest as an unfair credit practice). Such a security interest is voidable under 11 USC § 522(f)(1)(B) (prohibiting nonpossessory security interests) and (4)(A)(xiv) (2000 & Supp 2005) (including wedding rings within the definition of "household goods" for the purpose of § 522(f)(1)(B)). There is an exception to the rule. We do allow nonpossessory security interests in household goods when the loan enables the debtor to acquire the property in the first instance. Although Walker-Thomas cannot take back other goods if Williams fails to make payments on the stereo, it can take back the stereo itself. The rationale here rests principally on the idea that Williams should not be able to keep something without paying for it.

> If a man be taken in execution, and lie in prison for debt, neither the plaintiff, at whose suit he is arrested, nor the sheriff who took him, is bound to find him meat, drink, or clothes; but he must live on his own, or on the charity of others; and if no man will relieve him, let him die in the name of God, says the law; and so say I.[16]

In the beginning, bankruptcy law was cut from the same cloth.[17] It was a set of legal rules that enhanced the powers of creditors of merchants. It took away from merchants some of the protections other debtors enjoyed, such as protection from the King's writ while inside their own homes. During the eighteenth century, all bankruptcy petitions were involuntary and could be begun only after the debtor committed "an act of bankruptcy," typically an act that thwarted creditors' efforts to be repaid.

The bankruptcy discharge was introduced for reasons that had nothing to do with solicitude for debtors. Enacted by Parliament in 1705, "An Act to Prevent Frauds Frequently Committed by Bankrupts" was designed to induce reluctant merchant debtors to identify and turn over their assets.[18] It worked by offering a carrot and a stick: a discharge for debtors who were forthcoming and the death penalty for those who were not.[19]

Offering this carrot was not costly to creditors. Bankruptcy allows creditors to assemble all the property of the debtor, examine the debtor, and ensure that nothing is being hidden from them. Many creditors would stop pursuing the debtor once they were satisfied that the debtor could not pay them, independent of whether bankruptcy formally discharged the debt. The process that bankruptcy law puts in place reassures creditors that the debtor does not have other assets and that nothing is being hidden. Having a debt you are owed discharged matters little if there is almost no chance you are going to be repaid anyway. You are better off having the debtor's affairs subjected to scrutiny and walking away.

When Blackstone wrote his *Commentaries*[20] in the 1760s, bankruptcy was still primarily a creditor remedy.[21] Nevertheless, the ration-

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16 These observations of Justice Sir Robert Hyde are quoted in Coleman, *Debtors and Creditors in America* at 5 (cited in note 8).

17 For an illuminating discussion of the evolution of bankruptcy law, see Robert Weisberg, *Commercial Morality, the Merchant Character, and the History of the Voidable Preference*, 39 Stan L Rev 3 (1986).

18 See Statute of 4 Anne ch 17 (1705).

19 See id ¶¶ 1, 7.

20 William Blackstone, *Commentaries on the Laws of England* (Chicago 1979).

21 Blackstone places his chapter on bankruptcy in the volume dedicated to "rights of things" because bankruptcy was for him, primarily, a means of transferring property. See Blackstone, 2 *Commentaries* at *471–88.

ale for the discharge had already evolved. Merchant debtors faced special problems that other debtors did not. The discharge recognized these at the same time it served as a tool that benefited the creditors of merchants. As Blackstone explained:

> [T]he law holds it to be an unjustifiable practice, for any person but a tradesman to encumber himself with debts of any considerable value. If a gentleman ... at the time of contracting his debts, has a sufficient fund to pay them, the delay of payment is a species of dishonesty ... [I]f, at such time, he has no sufficient fund, the dishonesty and injustice is the greater.[22]

The logic here follows naturally from the way Blackstone looked at the world. A gentleman's only asset is land tilled by others. It generates a stable and fixed income stream. Lenders rely on the ability of the land to generate the money to pay them back. They will be repaid unless the debtor either misrepresents the value of the land or transfers the land to someone else after the loan is made. An honest debtor is always able to pay creditors back so long as he holds on to his assets. Once having borrowed, a debtor should not engage in any activity (such as gambling) that would diminish the value of his assets and leave him unable to pay his creditors. Someone who cannot pay his creditors is necessarily at fault. And, as Blackstone notes, "He cannot therefore murmur, if he suffers the punishment which he has voluntarily drawn upon himself."[23]

A merchant, however, is in a fundamentally different position. Those who trade take risks. When one merchant engages in a transaction with another merchant, each understands that events beyond their control might render one merchant unable to pay the other. Again, as Blackstone explained:

> Trade cannot be carried on without mutual credit on both sides: the contracting of debts is therefore here not only justifiable, but necessary. And if by accidental calamities, as by the loss of a ship in a tempest, the failure of brother traders, or by the non-payment of persons out of trade, a merchant or tradesman becomes incapable of discharging his own debts, it is his misfortune and not his fault.[24]

The contrast with other debtors is crucial: "If persons in other situations of life run in debt without the power of payment, they must

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22 Id at *473–74. In an observation omitted from this extract, Blackstone also asserts that those engaged "in a liberal profession" likewise should not borrow. Blackstone seems to have thought, as a general matter, that one should not borrow against future income.

23 Id at *474.

24 Id.

take the consequences of their own indiscretion, even though they meet with sudden accidents that may reduce their fortunes."[25] Merchant debtors could discharge obligations they could not repay because their inability to repay was due to "misfortune" rather than misjudgment. As a judge of the period put it: "[R]elief is to be extended to those who are both *honest and unfortunate*. Honesty alone will not be a title, if the debtor has come to his ruin by his own imprudence, without misfortune."[26]

To connect Blackstone's conception of discharge with our own, we must first recognize, as he did not, that it makes sense for individuals to be able to borrow against their future incomes to engage in consumption smoothing, the ability to enjoy a constant level of consumption across time notwithstanding changes in income from one period to the next. It is quite reasonable to borrow in periods in which income is lower than average and pay it back in periods in which it is higher than average. Unlike eighteenth century farmland, however, future income is unpredictable. We can lose a job or we can become sick. All debtors, not just merchants, can encounter "misfortune" and be without sufficient assets to pay their creditors through no fault of their own.

We can take Blackstone's conception of the bankruptcy discharge and incorporate only the notion that individuals should be able to borrow against future earnings, an asset that, like the assets of a merchant, can fluctuate in value. A discharge should be available to ordinary debtors and not just traders, but only so long as they are honest *and* unfortunate. The inability to repay has to arise by virtue of circumstances beyond the debtor's control (such as the loss of a job or an unexpected illness). If we were to translate Blackstone's vision to our own time to account for human capital, we would recognize that future earnings are an asset against which debtors can borrow and that this asset may prove to be worth less than expected. Honest debtors can encounter misfortunes that render them unable to pay their creditors in full.

The fundamental difference between Blackstone's view of bankruptcy and our own lies elsewhere, however. For him, debtor's prison was unobjectionable because it was merely "the punishment which [the debtor] has voluntarily drawn upon himself."[27] Blackstone did not understand that the bankruptcy discharge is a way of protecting individuals from themselves: it effectively shields them from the conse-

25 Id at *473.

26 *Brown's Case*, 1 Martin 158, 159–60 (La 1810). The law at issue in *Brown's Case* was not a bankruptcy law per se but rather a close cousin, a state insolvency law.

27 Blackstone, 2 *Commentaries* at *474 (cited in note 20).

quences of the choices they make. Over time, the bankruptcy discharge has evolved away from the assumption that individuals act completely rationally. We no longer must show that our troubles arose because of something other than our own bad decisions. We no longer have to be both honest *and* unfortunate to obtain a fresh start.

Blackstone's narrow vision of the discharge as appropriately limited to merchants who were both honest and unfortunate falls short in two ways. First, individuals other than merchants suffer reversals of fortune as well. Second, and much more important for our purposes, misjudgments that render us incapable of repaying creditors are not necessarily culpable, and the law can do something to prevent them from arising or at least minimize their consequences.

Since the start of the twentieth century, we have seen the archetypal debtor as one who was "honest but unfortunate."[28] The difference between the "honest *and* unfortunate" debtor and the one who is "honest *but* unfortunate" is subtle but important. The word "unfortunate" is used in two different ways. In the latter instance, it is not confined to financial reverses strictly beyond our control. Now it encompasses financial reverses of every type. Every debtor in dire financial straits is "unfortunate." You are eligible for a discharge even if your financial difficulties arise from bad judgment or improvidence, as long as you are honest. Honest people are sometimes unable to pay what they owe, and when this happens the law should be there to help. So long as they act in good faith, the right to discharge in bankruptcy is available. Instead of limiting the discharge to only some debtors in dire straits, the word "unfortunate" now merely describes their condition.

Those who seek a bankruptcy discharge typically have mismanaged their financial affairs. When they file for bankruptcy, they typically have debt that is a multiple of their annual income. A divorce, the loss of a job, or illness is often the last straw, but a coldly rational, carefully calculating individual who had reviewed every decision to borrow with deliberation would not be in a bind. The right to a discharge still exists even when imprudence was at least in part responsible for the inability to repay the debt.[29]

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[28] The phrase took root in bankruptcy law in *Local Loan Co v Hunt*, 292 US 234, 244 (1934). It also appeared in some cases in the nineteenth century, but in a context in which the debtor was not honest and the question of what it meant to be "unfortunate" did not arise.

[29] See Jackson, 98 Harv L Rev at 1404–05 (cited in note 5).

III. BEHAVIORAL ECONOMICS AND WAIVER OF THE FRESH START

Once protecting debtors from ill-considered borrowing becomes a principal motivation for the right to a discharge, waivers of that right must be treated very carefully. If the right to a discharge simply protected us from "misfortune" as Blackstone understood it, it would merely be a kind of insurance policy. All debtors pay a higher rate of interest, and in return the creditor bears part of the loss that arises when a particular debtor falls on hard times. The right to a discharge comes with the familiar costs associated with any insurance policy. When the discharge is tied to every extension of credit, those who are more likely not to repay are more inclined to borrow (an adverse selection problem) and those who borrow are more likely to take actions (such as taking on too much debt) that leave them unable to repay (a moral hazard problem). As with other forms of insurance, we can justify the discharge on the ground that the benefits the policy brings outweigh these costs.

If insurance were still our sole rationale for the bankruptcy discharge, we would expect the right to be one that is waivable. But the modern conception of the discharge rests on the idea that honest debtors can make bad judgments when they borrow. The same bad judgment that leads to incurring the debt may lead to waiving the right to a discharge. For this reason, we may want to prevent waivers altogether or at least ensure that the waivers are done with sufficient deliberation. Allowing waivers makes sense only if we can expect reasoned and deliberate decisionmaking to overcome the cognitive biases embedded in the modern conception of the fresh start.

Even after a debtor has filed a bankruptcy petition (and hence long after the debts are incurred), we place tight limits on the debtor's ability to waive the right to a discharge. Such waivers must be written, and the judge must specifically find that the waiver constitutes "a conscious and informed judgment" on the part of the debtor.[30] There is a strong presumption that it is not.[31]

Cases in which a debtor files for bankruptcy and waives her right to a discharge are rare. More common are cases in which the debtor tries to waive discharge with respect to a particular debt. For example, the debtor may want to except a loan from discharge because her

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30 See, for example, *In re Mapother*, 53 BR 433, 435 (Bankr WD Ky 1985).

31 See, for example, *In re Martin*, 211 BR 23, 24 (Bankr ED Ark 1997) (finding upon questioning by the court that the debtor did not understand the implications of her waiver, and denying the waiver for that reason); *In re Rul-Lan*, 186 BR 938, 943 (Bankr WD Mo 1995) (holding that a court order allowing a divorce proceeding to go through did not constitute a deliberate waiver of discharge).

creditor has a security interest in an asset that she wants to keep. Perhaps the bank that made the car loan took a security interest in the car. The discharge affects only the debtor's personal obligation to pay the car loan. The lender's security interest survives.[32] Hence, when the bankruptcy is over, the lender is free to repossess the car. To keep the car, the debtor must make a new bargain with the lender, and the lender typically insists that the debtor agree to reinstate the personal obligation, the one that has just been discharged. We allow such reaffirmation agreements, but we require that an extraordinary level of formality accompany them.

When a lawyer is representing the debtor, we require an affidavit from the lawyer that the agreement is a fully informed and voluntary one, that it does not impose an undue hardship on the debtor, and that the lawyer has fully advised the debtor of the legal effect and consequences of any default.[33] Moreover, the debtor has a sixty-day cooling-off period.[34] If the debtor is not represented by a lawyer, the reaffirmation agreement is effective only if the debtor appears in open court and still agrees to the reaffirmation after the judge informs the debtor of the consequences of default under the new agreement.[35]

For ordinary extensions of credit, we have yet to craft a formal rule that serves the cautionary function adequately. There is no way to insist that the waiver of the right to a discharge be done with reflection in the environment in which most borrowing decisions take place. We no longer live in a world in which consumer borrowing requires a trip to a bank, an interview with a loan officer, and lengthy paperwork.

Debt is incurred every time we use a credit card. Although the terms and conditions of these transactions are largely unknown to us, this is not cause for concern in a credit market that is competitive—the market forces themselves do much to prevent overreaching.[36] But given the rationale for the right to a discharge, waivers in fine print should not be effective. Forbidding the waiver of a discharge is like forbidding a nonpossessory security interest in household goods.

Education loans are a conspicuous exception to the general rule.[37] The obligation to repay an education loan continues after bankruptcy

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32 Security interests and liens "pass through" bankruptcy. See *Long v Bullard*, 117 US 617, 620–21 (1886).

33 11 USC § 524(c)(3).

34 Id § 524(c)(4).

35 Id § 524(d).

36 I discuss this point at length in Douglas G. Baird, *The Boilerplate Puzzle*, 104 Mich L Rev (forthcoming 2006).

37 See 11 USC § 523(a)(8) (2000) (excepting educational loans from discharge). Other debts are also not dischargeable, but these do not involve an honest individual obtaining credit. Some debts (such as debt acquired on the eve of bankruptcy) are excluded from discharge on the

notwithstanding the right to a discharge. Just as a debtor should not expect to keep household goods without paying for them, one should not be able to enjoy the additional income that education brings without paying for it.[38] There is, however, no guarantee that the education the loan makes possible will generate increased income. Moreover, even if the loan does lead to an increase in income, the debtor does not link the loan to the income in the same way that Williams can link the obligation to pay Walker-Thomas to the stereo.

One can, however, reconcile the special status of education loans with the general idea that decisions that compromise the right to a discharge or to exempt property must be made with sufficient reflection and deliberation. Unlike ordinary extensions of consumer credit, someone who takes an education loan before going away to college is not making a decision casually. The decision to take the loan is part of a larger decision (leaving or not entering the workforce and moving) that is made only after considerable thought and care.

When we put the special treatment of education loans in this context, however, we immediately focus on what is perhaps the most significant problem associated with excepting them from discharge. The process associated with going to school full-time may ensure the requisite caution with respect to a college loan, but many education loans are for other programs that rarely require students to move, leave the workforce, or do anything else that ensures deliberation. Even if we stop short of the formalities associated with reaffirmation agreements, some formalities seem sensible here, given the rationale underlying the right to discharge and the right to exempt property. The exception to discharge in bankruptcy should be seen in conjunction with the regulations that we have outside of bankruptcy. The more we ensure that students who enroll in such programs reflect on what they are doing, the less problematic the exception to discharge becomes.

IV. THE FRESH START AND COVENANTS NOT TO COMPETE

This understanding of the right to a discharge allows us to gain some purchase on what has been a longstanding problem in personal bankruptcy—the treatment of covenants not to compete. Actors and

ground that the debtor's own behavior is suspect (even if not so suspect that she should be denied a discharge altogether). Other obligations, such as child support and tax obligations, are thought particularly important. A debtor who can pay such loans back without hardship must do so. They are not dischargeable. Willful and malicious torts and liability for securities fraud are similarly excepted from discharge.

38 An education loan is, in this respect, like the purchase-money loan. As noted above in note 15, purchase-money loans are the sole exception to the ban on nonpossessory security interests in household goods.

recording artists under long-term contracts have been known to file bankruptcy petitions and argue that bankruptcy's fresh start extinguishes the covenant not to compete.[39] Tia Carrere, for example, filed a bankruptcy petition because she wanted to escape from a long-term contract with ABC to appear on *General Hospital*, an afternoon soap opera, and become a regular on a prime-time show on another network.[40] She filed a bankruptcy petition to free herself of a covenant not to compete.

The Bankruptcy Code allows debtors to reject executory contracts, but the ability to reject such contracts does not itself tell us anything about the consequences of rejection. Rejection might free Carrere from working for ABC without eliminating ABC's right to prevent her from working elsewhere. Rejection of an executory contract is merely the bankruptcy analog to breach. Outside of bankruptcy, ABC cannot force Carrere to come to work in the wake of breach. It enjoys instead a right to money damages and a right to enjoin her from working elsewhere. Rejection of such a contract in bankruptcy gives rise to a claim equal to the damages ABC would have against her outside of bankruptcy.[41] Whether it also gives ABC the right to stop Carrere from appearing elsewhere turns on whether this limitation is consistent with the policy of giving financially distressed debtors a fresh start.

If Carrere had borrowed money from ABC and was unable to pay it back, she could rid herself of that obligation in bankruptcy. Any security interest ABC placed on her future earnings would not survive bankruptcy.[42] Carrere's promise not to appear elsewhere, or indeed any individual's covenant not to compete, has the same feature. ABC has what amounts to an ownership interest in Carrere's future income stream. To be sure, if one can discharge a covenant not to compete in bankruptcy, it will be harder for actresses like Carrere to find jobs in the first place. ABC would be less willing to take on new actors if it were not able to keep them when they prove especially popular. But this

39 For example, see generally *Delightful Music Ltd v Taylor*, 913 F2d 102 (3d Cir 1990) (granting James Taylor's petition to reject an executory contract); *Cloyd v GRP Records*, 238 BR 328 (Bankr ED Mich 1999) (allowing the debtor to breach a contract and specifically rejecting an injunction of future performances); *In re Carrere*, 64 BR 156 (Bankr CD Cal 1986) (denying Tia Carrere's ability to use bankruptcy to reject her contract). Courts are sometimes able to skirt the issue, see *Carrere*, 64 BR at 159–60, by finding bad faith in a bankruptcy filing if the debtor is not in financial distress. But often the debtor is in dire financial straits and the question must be confronted squarely.

40 See *Carrere*, 64 BR at 157.

41 11 USC § 365(g) (stipulating that rejection generally constitutes breach, unless the contract is part of the plan or fits into specified exceptions).

42 See *Local Loan Co v Hunt*, 292 US 234, 245 (1934).

does not distinguish ABC from any lender. By the same rationale, lenders are less willing to lend when there is a right to discharge debt.

ABC to some extent stands in a position similar to someone who makes an education loan. The prime-time show (*The A-Team*) might never have recruited Carrere if she had not gained the training and exposure that *General Hospital* gave her. Covenants not to compete often arise in environments in which the employer offers training and wishes to recoup the investment by ensuring that the worker does not leave and use her new skills working for a competitor. The deal is mutually beneficial. The employer's investment in the worker is paid back, and the worker acquires a new skill. The covenant encumbers future earnings, but it is an integral part of a deal that makes the future earnings possible. If ABC had made Carrere a loan so that she could go to acting school, Carrere could waive the right to discharge the debt. Indeed, the background rule is that such debts are not dischargeable.[43] When ABC opts instead to offer on-the-job training, the same principle arguably applies. Carrere should not be able to benefit from the training and then walk away from an implicit obligation to pay ABC back by remaining on the cast of the soap opera for a certain length of time. This reasoning supports an argument in favor of excepting covenants not to compete from discharge.

Whatever the merits of this argument, however, it ought to be a necessary (though not sufficient) condition that those in Carrere's position enter into such arrangements with sufficient awareness of what they are doing. In contrast to education loans, the nonbankruptcy rules governing covenants not to compete do protect us from our tendency to make bad decisions when we take on long-term obligations.[44] Covenants not to compete are suspect under nonbankruptcy law. They must be reasonable, and they can last only for a limited period of time and have only a limited geographic reach. The conspicuous exception is the military. In return for being trained as a pilot, for example, an individual must agree to serve with the Air Force on active duty for ten years. But every manner of formality accompanies a decision to join the military. Someone who decides whether to join the military does so in an environment far different from that of obtaining ordinary extensions of consumer credit.

We permit consumers to use a wedding ring as collateral only when they transfer possession of the ring because only then do they

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43 See 11 USC § 523(a)(8). Indeed, not only is the waiver enforced, it is assumed.

44 See Ronald J. Gilson, *The Legal Infrastructure of High Technology Industrial Districts: Silicon Valley, Route 128, and Covenants Not to Compete*, 74 NYU L Rev 575, 602–07 (1999) (describing limits placed on covenants not to compete in Massachusetts and the even greater limits on them in California).

appreciate the risks of default. We can allow the right to a discharge to be waived when the circumstances are sufficiently compelling (such as an education loan that enables a debtor to increase her human capital), but a necessary condition of such a waiver is that it be done under circumstances that ensure it is a knowing one. We should allow an education loan to be nondischargeable only if it is accompanied by rituals analogous to, if not on a par with, those for reaffirmation agreements. Excepting covenants not to compete from the fresh start may make sense because of the limits placed on them under nonbankruptcy law. Not only is their enforceability sharply limited, but they tend to arise as part of a larger transaction in which a lawyer, manager, or agent reviews the deal. Again, signing a contract with ABC to appear on *General Hospital*, although not the same as enlisting in the military, is so far from routine that the decision tends not to be an impulsive one.

CONCLUSION

In contrast to Blackstone's vision of bankruptcy, modern bankruptcy law is premised on the idea that a fresh start should be available to honest debtors, even when their own bad judgment caused their financial difficulties. We have the right to exempt property and a right to a discharge in bankruptcy because we do not accurately assess the long-term consequences of incurring debt. Hence, the law should limit our ability to waive these rights. When waivers are permitted at all, the law should ensure that the formalities required bring about sufficient deliberation and reflection. Limiting the effect of fine print with respect to exempt property and putting procedural hoops in front of debtors who want to reaffirm debts are examples of Sunstein's weak paternalism and Fuller's conception of formal rules that serve a cautionary function. Our blanket prohibition of nonpossessory, non-purchase-money security interests in consumer goods and blanket waivers of the right to discharge shows where weak paternalism and legal formalities are not strong enough.

Understanding this undercurrent is one of the central challenges in the law governing consumer credit. This challenge becomes increasingly important as technology evolves. Technological change, although salutary, makes it harder to implement formal rules that serve a cautionary function. Sealing wax is hard to use in cyberspace. Credit cards free us from the misery of explaining our affairs to an officious banker. At the same time, however, we increasingly lack the reflection in making credit decisions that we possess when taking out a bank loan. The easier it becomes to go online and obtain a credit card secured by a second mortgage on our homes, the more we should worry about whether the formalities required are sufficient to ensure that the borrowing decision is the product of considered judgment.