Gearing Up, Crashing Loud. Should We Punish High-Flyers for Insolvency?

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ABSTRACT. In the mid-1990s the recession is turning to a recovery. Around the world corporate bodies which fell victim to structural changes and high interest rates finally get buried. However, many feel that corporate funerals are not enough to clear away the litter of the past, crucifying people is required too.

In the common law countries, where the treatment of bankrupts is tougher than in the U.S., and in continental Europe, where discharge of debts has been virtually unheard of until recently, the failed entrepreneurs' heads are wanted on the platter. A high level of debt and an extravagant lifestyle combine to provoke most demands for reprisals.

This paper argues that these hallmarks of high-flying provide neither retributive nor utilitarian grounds for punishing business bankrupts by limiting their access to discharge. Furthermore, it is argued that, from the point of view of distributive justice, wealth appropriated through leverage is ethically no worse than prosperity gained by hard work and parsimony – not even if the gearing eventually leads to insolvency.

The average bankrupt may have been poor, in ill health, and unemployed.[1] However, some bankrupts have led a completely different life, and may succeed in preserving their lifestyle even after a financial failure. Although only few in number, the high-flyers, as the riches-to-not-necessarily-rags bankrupts are commonly called, carry great importance in shaping the institution of bankruptcy. The publicity they attract, and the envy mixed with disgust their activities raise, contribute to the image of bankrupts as crooks.[2] This, in turn, creates an outcry for harsh and punitive proceedings, so that the crooks would get what they deserve. The call for reprisals has not gone unnoticed. In the common law countries, most notably in the U.K. and Australia where the discharge of debts has always been subject to more stringent conditions than in the U.S., recent entrepreneurial failures have led to legal reforms which increase corporate directors' exposure to personal liability and enforce income orders giving creditors access to a bankrupt's earnings.[3] Is the public image of high-flying entrepreneurs based on ethically sound judgement? Do they deserve to be punished for gearing up and crashing loud?

Let us first define 'high-flyer'. Stephen Aris has given two characteristics of high-flyers: they are engaged in high level of debt, and their lifestyle is extravagant.[4] Paul Barry's biography of the famous Australian wheeler-dealer Alan Bond helps us to add more flesh to Aris's definition. It points out that the cruising altitude gets elevated if excesses and extravagancy are associated with ostentatious display and casual treatment of luxuries.[5] Hence, we can conclude that high-flyers are people who are unashamed to indulge openly in luxuries, and use borrowed money more than is customary to finance their business or lifestyle, or both.

Retribution for solvent high-flying

We have to look at punishments from the retributive, as well as from the utilitarian angle. The retributive standpoint is that if high-flyers

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have committed a moral wrong, they should be punished. For instance, if their conduct has in some sense been fraudulent, they definitely deserve retribution. What constitutes a fraud? The distinctive attribute is the intention to cause damage.[6] However, in the absence of *mens rea*, a guilty mind, the ethical problems are more complex.

Since the days Adam Smith published *Wealth of Nations* it should have been clear that there is nothing morally suspicious in credit as such. Smith tells us that a person who does not use all that he owns, or can borrow, to procure enjoyment or profit is perfectly crazy.[7] The modern notion of bankruptcy, adopted by the Anglo-American legal systems and culminating in the discharge of debts, goes a step further: even a debtor's default is not enough to constitute punishable wrongdoing. This conclusion should not be affected by the absolute amount of credit used, or by the gearing ratio. As a social and economic phenomenon credit is a useful form of human activity which rests on the right of autonomous people to engage in voluntary transactions of wealth. The fact that the level of debt is high does not warrant moral censure, nor does an occasional default which should be seen as an undesirable but inevitable side-effect of a beneficial practice.

What about the casual treatment of luxuries? There are plenty of moral theories under which, to mention only a couple of possible moral bads, the inequalities and environmental damage associated with grandiose spending are blameworthy. I have no intention to take sides in regard to these theories. Whether their arguments succeed or fail does not matter for present purposes. What matters is that there is no theory which could establish that a luxurious life is morally wrong only when the indulgent subsequently turns insolvent. The moral problems of insolvency relate to the debtor/creditor relationship, and to the wider impacts it may have. As Thomas Jackson has pointed out: insolvency cannot determine the rights and wrongs of solvent living.[8]

The moral assumption behind bankruptcy laws protecting debtors is that an insolvent should not be punished if her efforts to pay her debts back have been genuine. Now, in the case of high-flyers it could be claimed that the money they have wasted on luxuries is a proof that their effort to pay back has not been a genuine one – the money could have been directed to the repayment of debts. I agree that this argument may have some force had the cost of luxury been such that it would have made the difference between going broke and keeping one's nose above the water, but then the pending failure should also have been obvious to the insolvent herself. Since she rather chose to spend on herself, she intentionally left her obligations unfulfilled. Intentional forfeiture of funds from creditors in the face of insolvency amounts to fraud which deserves punishment.

However, high-flying insolvents hardly come across this situation. Their insolvencies, typically, follow from business failures. In order to get a high level of gearing the entrepreneurs are required to personally guarantee the loans of their companies – or if they manage to avoid this, the chance that they turn penniless is decimated. The immense liabilities high-flying bankrupts personally commit themselves to in the course of their business are in no proportion to their private wealth. Therefore, their spending, although extravagant, usually has had no relevance to the eventual insolvency.

It can be argued, of course, that any insolvent has committed a moral wrong if she has not paid off her debts with every cent disposable after she has ensured the barest minimum of survival to herself and her family. However, this rigorous principle is at odds with the modern concept of credit. The credit contract is based upon an agreement that an individual pays back the credit, and interest accrued on it, according to a certain schedule. It does not presume that the debtor stretches her means to the extreme – although this may actually often be the case – to pay the loan off as quickly as possible. Therefore, an ordinary mortgagee has not broken the contract if she has had a holiday in Queensland, instead of using the two grand to pay the mortgage off, six months before she is made redundant and goes belly up. Since she has not broken her promise while solvent, in spite of the little luxury she had, she has not committed a moral wrong. Nor has a high-flyer broken her promise when

she goes bankrupt as the guarantor of the borrowings of her companies. She has promised nobody that she would use, prior to the bank calling for the guarantee, every penny available to her to improve the financial position of the companies. Her extravagant spending, in relation to the liabilities she has undertaken to guarantee, is as insignificant as the holidays or children's school fees of an ordinary mortgagee.

It is also worth noticing that, according to the definition, the excesses of the high-fliers have been manifest. Therefore they have been known by the creditors, who have not undertaken to curb the personal spending of their clients, but accepted the risk fully informed. The public nature of excesses is further evidence that the lifestyle of solvent high-flyers does not constitute a breach of promise. Hence, it may be morally wrong that people are rich, or that they spend money on luxuries, but the fact of eventual insolvency alone is insufficient to make these wrongs. As long as it is not a moral offence to be ostensively rich, people should not be punished for it – no matter how poor they later become. On the other hand, if extravagant living is a punishable wrong the recriminations should hit the solvent rich as well! This is the retributive verdict in regard to punishing crashlanding high-flyers.

Benefits from penalties

Let us shift the focus to the utilitarian argument. There the punishment imposed upon high-flyers would seem to serve some useful ends. The targets are relatively few in number, so the harms, although personally great, would be rather limited. On the other hand, large benefits could be achieved by deterring people from excessive lifestyles while in debt. Whether this point is correct depends, first, on whether we accept the utilitarian view of punishing innocents, and second, whether the factual belief about the beneficial effects is true. Even if we found it unproblematic to punish innocents, the truth of the factual belief is a vexed question. It rests on the more general view that curbing credit by means of deterrent sanctions is useful.

In particular, the deterrent is seen as useful because it discourages entrepreneurs. However, in the recession of the early 90s, the factors often seen as most desperately in need of a boost have been risk-taking entrepreneurship and business borrowing.[9] Who have demonstrated more stature in the excellences of innovation, risk-taking and borrowing, which are suddenly wanted in order to do away with the recession, than the despicable high-flyers? Their tragedy is that had they just been happy to accumulate their personal wealth, greedy in the most egoistic sense of the word, they would have gone broke in far fewer numbers. But expanding their businesses rather than their private wealth was their obsession. They did not hesitate to put their personal life at risk in order to keep their enterprises on the move. A good Australian example is Alan Bond, who repeatedly pledged his massive private wealth to pay wages in his faltering companies[10] – and in the end fell victim to his commitment.

After all that has happened, it is sad irony that had people like Bond concentrated less on safeguarding their businesses and more on their lifestyle, they would never have gone personally broke. It may be that their commitment and contribution is not so completely negative as it has become customary to assume in the immediate aftermath of their failures. The innovators and entrepreneurs put all they have behind their efforts. It is necessary that many of them fail, nonetheless even the failures are needed to get an economy ahead.[11] Nor should we forget that, in the case of listed companies, their personal guarantees worked in favour of other shareholders as well. All got the upside potential from the gearing, while only the entrepreneur put the total of her private wealth at stake.

The fiascos that resulted from leveraged corporate raiding in late 1980s did cause damage, but they are far from constituting crystal clear utilitarian evidence of the perils of credit. We are now strictly within the confines of a utilitarian theory, so we should measure the harms and benefits by using a neutral unit – a unit which does not attach any special or added value to some effects because of their non-utilitarian moral properties. I suggest that money is a reliable neutral measure. Now, let us see how the

failed debt barons' overall utility contribution should be estimated. It is all too common to add up all the losses of both their companies and their financiers, and cry: here's the legacy of their blunders. For instance, a headline in *The Age*, a leading Australian daily paper, has told us that "Tycoons leave a $30 billion legacy". The story goes on to unveil the sinbin:

> Australian companies lost more than $30 billion in shareholders' and depositors' funds during the frenzied 'boom-and-bust' buying spree that gripped corporate Australia in the late 1980s.[12]

The grim picture is a real one in the sense that it puts together all the suffering. However, it is also a manifestly distorting way of calculating the total disappearance of wealth. *The Age* has listed the ten biggest loss-makers of the 80s, and added up their losses to get the $30 billion figure. This way of counting multiples the effect of the entrepreneurs' mistakes.

Let us suppose that Financier A lends to Company B one billion for a Venture C. Subsequently C fails, and the one billion invested in it is lost. As a consequence B goes bankrupt, and A does not get back the money it has lent. Now A has in its books a bad debt of one billion, B a one billion dollar worthless investment and C a loss of one billion from its operations. All the companies involved include a loss of one billion in their annual statement of profit and loss. Adding them up makes it look like the legacy of the failure was three billion. Nevertheless, it remains a fact that the money lost in Venture C was one billion, not three billions. The real amount of loss is distorted if the loss figures of all the companies associated with a business failure are simply summed together.

Exactly the same happens when exorbitant figures are presented as the legacy of the failed entrepreneurs. In the same article in *The Age*, the ten biggest loss makers are listed. The sum of their losses is allegedly $30 billion. But six of the losers are financiers, whose total losses amount to $14.1 billion, and four represent highly geared borrowers with losses up to $15.3 billion. Even a quick look at the numbers suggests that the total of $30 billion is a figure swollen by reiterating the mischiefs of bad business. The same rotten eggs are included in many different accounts, and in counting the overall harm this should be remembered.

However, it remains a fact that the tycoons did economic harm. But, for a utilitarian, the essential thing is to balance the harms against the benefits. This should be done on a global level, because the interests of all individuals should be taken as equal. Here the utilitarian gets into real difficulty if she wants to show that excessive debt is harmful. We have to keep in mind that for each bad deal, and for each wasted dollar recorded in red print in an annual report, there is someone who has benefited. The wealth invested in failed projects has not vanished from the surface of the earth. There have been wages paid for unproductive work, or prices paid for buildings worth only a fraction of the value of the deal, or may be even grants to centres doing research in business ethics. Someone has always been on the receiving side. If the unit of harm and benefit is money, and if the point of view is global, the harms and benefits of entrepreneurial adventures are even. The wasted dollars have been pocketed by someone, either as hard earned reward for work done or as windfalls.

The credit expansion in the 1980s, and the subsequent assets inflation, were economic disturbances, but it is important to notice how the market mechanism was able to deal with them. It was the market, not any legislation or police operation, that brought down the harm-inflicting debt-barons. Harm was done, but the direct appeal which the collapses may lend to the utilitarians who want reprisals is deceptive. A utilitarian cannot justify the benefits of punishing the high-flying bankrupts simply by pointing to the losses they incurred in their businesses.

I shall not pursue the issue of the overall usefulness of high-flyers any further here. It is a matter of empirical research rather than philosophy. For my purposes it is enough that the utilitarian argument demanding punishment for high-flyers seems suspect when we are reminded that in the real world of bread and butter the economic benefits of credit aversion, even the benefits of aversion to high-risk credit associated with luxury lifestyle are far from self-evident. Let

us recall what Adam Smith took to be the purpose of an economy:

> Consumption is the sole end and purpose of all production.[13]

If anything, the high-flying entrepreneurs, fuelled by credit expansion, boosted consumption – including spending in the lower air-space reserved for more modest mortals. What entrepreneurs did was merely a tribute to capitalism, therefore their deeds cannot add impetus to a moral curse within the terms of reference of that particular economic system.

Insolvency is not enough to make the hallmarks of high-flying, leverage and luxury lifestyle, moral wrongs calling for retribution. Penalties are redundant as deterrents too: sincere insolvents seek to avoid going broke anyway. Deterrence could effectively reduce the number of bankruptcies only if it brought down the overall exposure to credit and risk, an outcome which is not welcome as it would hamper economic activity. In addition, we have empirical evidence that lower bankruptcy rates do not necessarily translate into lower credit losses.[14] Thus, the role of deterring penalties should be restricted to discourage crime, intentional misuse of bankruptcy for profiteering. Punishing innocents is not needed to scare conmen. Sentencing the offenders is enough to ensure that crime does not pay.

Insolvent extravagance

So far we have concentrated on the pre-bankruptcy excesses of insolvent high-flyers. But what makes moral indignation especially tempting is that their lifestyle seems miraculously to survive bankruptcy. The amount of luxuries in their life may be a bit less after the insolvency, but in comparison to the average standard of living most of them continue to be remarkably well off. How can this be explained? Here are three clues: fraud, relatives, and legal means to set property out of the reach of creditors. I shall concentrate on the two latter alternatives as they pose more philosophical problems. Fraud, concealing property from the creditors, is an already exhausted case: it deserves punishment.

Many bankrupts who fall from riches may continue lavish living at the expense of their relatives. Should this be prevented? Should the families be made to pay for the debts of the bankrupt? I start the answer by claiming that if one person wants to donate money to another person, this should be within her powers. I cannot see any ethical reason to restrict a solvent person's right to give away something she is fully entitled to control. It is another matter that as soon as a bankrupt gains control of the wealth donated to her it may be considered as her income, and she may be liable to pass all or part of the income to the trustee.

Even if one is happy to accept that income orders may be enforced to satisfy the creditors, it should be noticed that they cannot be justified as punishments. Honest debtors, those who sincerely have sought to pay their debts, have not committed a moral wrong deserving a punishment, nor would it be beneficial to punish them. The justification of income orders can come only from the monetary gain to the estate. Preventing a bankrupt from driving someone else's car, or from staying in someone else's apartment, does not bring a penny to the creditors' coffers, not even if the cars and apartments were luxury ones. Inter-ference in the bankrupts' enjoyment of luxuries owned by other people would only serve as a punishment, and would therefore be unjustified.

How about making the relatives pay the debts? They are normally the people who support the ex-entrepreneur, and they have often gained their wealth from her leveraged business undertakings. Let us first see if blood or marital ties should make us liable for other people's debts. Here it is quite evident that the answer is no. Every modern ethical outlook takes us as individuals. We are autonomous moral agents, responsible for our actions, not for those of other autonomous agents. In a community we have moral responsibilities in regard to other people, but not in regard to single voluntary acts of individuals not in our custody. A credit contract is an example of such a single voluntary act which cannot impose liability upon anyone else except the

individual undertaking the contract. If we were made to pay other people's debts we would have moral responsibility imposed by something over which we have no control, i.e. other people's promises. This is not a sustainable ethical principle, regardless of the possible family relationship to the promissor.

This may be countered by adding that the family members may have been given, prior to bankruptcy, undeserved profits, salaries, or gifts. First a look at profits and salaries collected by relatives. Undeserved is an important qualification here, since if they have worked for the money, or sold something at fair value, they, in the light of the argument above, should have the same right to the profits they have obtained as anyone else who had received her share of pre-bankruptcy monies.

So, the crucial question is what constitutes an undeserved profit. That is extremely difficult to define in general terms. The money they have made cannot be undeserved simply because the future turned sour. If profiting from a deal that later turns sour for the other party, or getting wages for a negligible employee contribution, were the criteria that determined when people have to share the liabilities of bankrupts, then a huge array of pre-bankruptcy beneficiaries would be exposed. Employees who have not been productive enough, vendors who have sold goods and properties to the failing businesses – all should take their part of the burden. This is not a viable idea. These are third parties, they are not parties to the credit contract establishing the promise to pay back. Therefore, they have no moral obligation to participate in the paying.

Nobody commits a moral wrong by profiting from a contractual relation with a business or an individual who later goes broke. Since blood and marital ties have no relevance in allocating moral responsibility for the voluntary fiscal actions of consenting adults, relatives' pre-bankruptcy profiting is no more wrong than anyone else's. Nevertheless, there remains the possibility that their profits have been intentionally exaggerated in order to improve the post-bankruptcy prospects of the bankrupt or the beneficiaries. If so, the conduct is fraudulent. Judging when it actually is so, is not a matter for an ethical theory, but an empirical matter to be dealt with by appropriate authorities.

With gifts, we have to deal with more complications. It is most appealing to think that entrepreneurs are generous, especially to their relatives, in order to secure benefits for themselves in case of eventual future bankruptcy. The line of thought goes on to the conclusion that it should be within the powers of the creditors to reclaim the donated wealth. When I examine the plausibility of this view I assume that the donor is solvent when the donation is made.

When a solvent debtor gives away something she owns there is always present a chance that she may later go broke. However, since she is solvent she has a full right to control her possessions – unless some contractual covenants apply – and accordingly it is in her discretion to give away some of those possessions. This is true as long as the give-aways do not threaten her solvency. A solvent debtor's right to be benevolent is not altered if her intention in making the gift is to increase her expectations of receiving favours as a potential future insolvent, that is, if she presents her gifts 'just in case', hoping that the recipient will return gratuity should the donor fall victim of misfortune.

Since benevolence, using funds which the donor fully controls, is generally allowed we cannot say that benevolence associated with some assumed subjective state of the donor's mind is not allowed. It would make the line between permissible and prohibited actions too blurred. Also, we would have to assess the solvent donor's subjective intentions after she has actually gone broke. However, it is practically impossible retrospectively to decide whether some particular gift was given 'just in case', or out of genuine love and affection.

When we draw the line between permitted gifts and unethical hiding of property from the creditors we cannot rely on guesses as to the donor's subjective intentions. We have to stick to the facts. The first, and most important, fact is the financial status of the donor: is she insolvent, or should she have been aware of the pending insolvency, at the moment the gift is made? If she is insolvent when she acts generously the moral right to control her property was already in her

creditors' hands. She gives away her creditors' funds. A gift made by a solvent person is different. A solvent mentor spoils others with something which is genuinely her own.

There is another fact which is ethically relevant to solvent debtors' donations, no matter what their intentions are. The intentions of the donor are a fact relative to her, not to the recipient of the donation. The recipient has a right to control her property. Her rights should not be diminished because her benefactor later turns insolvent and has, allegedly, had some unexpressed ulterior motives, or because she happens to be a family member. A creditor's right to get her money back from her debtor cannot be stronger than, for instance, a spouse's right to private property. Matrimonial liabilities would seriously degrade a spouse's status as an individual and a citizen.

Whether a gift is something which violates the moral rights of creditors does not depend on the family relationship between the donor and the recipient. The crucial fact determining when a gift should be forfeited is the financial status of the donor at the time of benefaction. Solvent donors are entitled to alienate their wealth, and recipients of those gifts are entitled to control what they own. Because creditors' rights are not broken in this chain of events, they have no right of recourse. The relation back doctrines common in bankruptcy laws impose time limits seeking to ensure that creditors have access to funds debtors have alienated pending the insolvency. The limits are ethically appropriate as long as beneficiaries are treated equally and recovery is not extended into transactions carried out during genuine solvency.

To avoid misunderstanding I wish to end the discussion on gifts by emphasizing that if they involve reciprocity they should be treated as any other kind of property. Hence, if the donor has some agreement or stipulation which gives her access to the donated funds should she turn bankrupt, they are an asset to her. As such, she should list them as her property when she files for bankruptcy and hands her assets to the trustee. What I have wanted to advocate above is that mutual love and affection is not a distributable asset. It may have been a source of wealth for a solvent debtor's family and friends, and it may be a source of wealth for an insolvent debtor. However, it is not possible to distribute love and affection to the creditors. The gifts a bankrupt has made in her solvent past should stand because the parties were morally entitled to perform the transaction. The gifts made to an insolvent should stand when they have no value to the creditors.

It seems that we have few ethically viable means to prevent bankrupts from a comfortable living at the discretion of their relatives or friends. In addition, the law has, in many countries, left potential bankrupts some legally approved means to safeguard their property. Trusts, in particular discretionary trusts, are the most notable of such vehicles. When property is transferred to a trust where it remains nominally wholly at the trustee's discretion, but in practice at the discretion of the person initiating the arrangement and providing for the trust's capital, a new legal entity is created. This entity is considered as separate from the bankrupt's person to the extent that the property vested in the trust is not available to the creditors. After the discharge there is nothing to prevent the bankrupt from availing herself of the property, which the trustee will generously pass to her upon her request.

It is interesting to note that the legislative reformers, who otherwise have recently advocated harsh measures to defend the commercial morality and creditors' interests, have chosen not to propose legislation which would require the trustee of a discretionary trust to apply in favour of a bankrupt's estate.[15] In the moral sense it seems dubious that a legal technicality can be created between property and a person who factually is in a position to benefit from that property with the effect that the creditors of an insolvent are prevented from taking the position of the factual beneficiary.

Ethics and self-interest

Insolvent high-flyers are not crooks, unless they have done crooked things. Going broke is not a crooked thing if the bankrupt's intentions to pay

her debts have been sincere. Whether a life loaded with debt and luxuries is, may be debated. However, to me it seems unreasonable to say that people are not entitled to use whatever purchasing power a democratic society has considered appropriate for them to have to any legal purpose they wish. It should not matter if the spending takes place in the limelight, or if there is borrowed money involved. Basking in luxuries does not prove a good character. It is no cause for grace and admiration, let alone moral praise. Rather, it reveals self-interested hedonism and ignorance of the pain and want that controls the lives of the majority of humans and animals on the earth. What it reveals is human nature in its average wretchedness. But to do a moral wrong we have to be worse than self-interested. We have to break the moral principles regulating the co-existence of self-interested creatures. These principles may, as Rawls (1971) has brilliantly pointed out, emphasize the needs of those who are worse-off – but only after self-interestedness has been accommodated in the picture.

Ethics cannot require us to do more than we can achieve in virtue of our natural properties. It is an empirical fact that our rationality is guided by self-interestedness. A quick look at the world as it is tells this to our common sense, and the observation is confirmed by what the more scientific faculties, like economics and psychology, assume to be the motives of human behaviour. This is not to say that glorious instances of benevolence and sacrifice never take place. On the contrary, their presence is constant evidence of the human capacity to give consideration to fellow human beings. However, praiseworthy unselfishness does not rule on the earth – if it did, ethics would be redundant.

If ethics ignores the fact that human rationality is guided by self-interestedness, it may be virtuous but can hardly be rational. We can make the point even stronger: the requirement that only altruistic deeds are ethical is without foundation because ethics stems from ourselves. There is no higher power, external to ourselves, which could make it ethically irrelevant that our own interests dominate our thinking – including ethical thinking. Now comes the final blow to the attempts to define ethical good in purely altruistic terms: it is a logical necessity that our voluntary actions are guided by our interests. Even an altruistic person performs her acts of benevolence because she wants to do so. Her interest just happens to be the fulfilment of other people's interests.

When we combine the empirical fact of self-interested rationality as the prevailing mode of human behaviour with the philosophical presumption that ethics arises out of ourselves, and with the logical necessity that our voluntary actions are guided by our interests, we cannot avoid the conclusion that what matters in ethics is our interests. They have to be the starting point of moral inquiry. By the same token, we know the necessity of accommodating our interests with those of other similar agents: ethics has to give equal consideration to everyone's self-interested standpoint. A moral theory has to explain why and when our duty is to look after the interests of others even at the expense of our own pursuits, as well as why and when it is our right to expect that others pay similar respect to our interests. As a result of these considerations there emerges a framework within which it is acceptable for an individual to satisfy her own wishes. As long as she observes the given limits she commits no moral wrong if she chooses to promote her own well-being. Applied to high-flyers this means that if they have, in a democratic society, chosen their flight path in conformity with the rules that define the framework allowed for self-interested aspirations, they have not committed an offence and do not deserve moral blame just because they occupied the upper layers of the financial atmosphere.

Debt and distributive justice

Robert Nozick has drawn a distinction between historical and end-result theories of distributive justice.[16] According to historical theories, to use Nozick's words, the justice of a distribution "depends upon how it came about". Any distribution of wealth is just if it is a result of first acquisition, and consequent voluntary transfers of title. The high-flyer's share of wealth clearly can satisfy the historical criterion as properly as

any non-leveraged accumulation of wealth would do. Use of credit does not break the chain of voluntary transactions. The end-result theories, in contrast, hold "that the justice of a distribution is determined by how things are distributed (who has what)". Moral principles, like Rawls's two principles of justice,[17] are applied to determine each person's just share in a society. The outcome may or may not justify the high-fliers' riches, but it cannot depend on the fact that their wealth is visible, nor on the subsequent incidence of insolvency.

No matter what perspective on distributive justice we adopt, the ways a debtor has spent her money are ethically irrelevant to the debtor/creditor relationship as long as the spending has taken place within the confines of the contractual framework. The ethical dimensions of that relationship are dependent on the promise which is the basis of the contract. If the promise has not been broken while the debtor was solvent, she is ethically in the clear. Her non-performance after she has turned insolvent is not sufficient to constitute wrongdoing. As she is penniless it is impossible for her to meet her liabilities. It would be irrational to claim that she had a moral duty to perform acts which she cannot do.

Whether the bankrupt's passion has been charity or pink convertibles makes no difference at the end of the day. High-flyers who go broke have zoomed around in fast, flashy planes on a lease, and have had a good time aboard, but these facts do not cause the ethical radar to indicate that their crashlanding is a sign of crossing the limits of the authorized airspace. Since this conclusion may sound counter-intuitive to many of us, let's see what could be said of hard work and parsimony, virtues that are often taken to be a more acceptable source of wealth.

Parsimony vs. Leverage

Living an ostentatiously luxurious life and using a high level of debt is contrary to commonly held values. So is going bust. The repugnance we associate with high-flyers is bolstered by the ideals of hard work and parsimony. The Puritan ethos, to use J. K. Galbraiths's designation of these ideals,[18] reserves the privilege of enjoying wordly goods to those who have earned their wealth through the sweat of their brow, and have sparingly put aside the fruits of their labour.

However, these ideals do not represent any ethically defensible justification for distribution of wealth. A coherent ethical theory may argue, as John Locke did, and Robert Nozick is compelled to tacitly assume, that mixing one's labour with unapprehended objects, together with subsequent voluntary exchange, gives a justification for private property.[19] However, a high-flyer may work up as much sweat on her brow in closing leveraged equity deals as the owner of a small business sweat-shop does in supervising her employees. The personal effort of both may be the same, no matter whether we measure it by the amount of their perspiration or by the kilojoules they burn. Both of them use voluntary contracts with other people to maximize their personal reward for the sweat. There is nothing in the labour theory of justice which could make one or another's effort ethically better. If the point is that hard work in a universe of voluntary contracting gives entitlement, we are bound to accept the outcome – regardless of whether it is associated with parsimony or with extravagancy and credit.

From Adam Smith to Karl Marx, and ever after them, economists have highlighted the role of capital as a means of production. As such, since it satisfies human needs, it is good rather than bad. The productive function of capital is vastly improved by the introduction of credit which transfers capital to the hands of those who believe they can get the most out of it, and who also most often succeed in their effort.

> Credit is essentially the creation of purchasing power for the purpose of transferring it to the entrepreneur.[20]

Capital being a necessity for the satisfaction of needs, and credit being a voluntary expression of the will of autonomous agents that leads to a greater satisfaction of needs, we have every reason to regard credit more as a blessing than a curse. It is the mover of economic development.

> Thus, there has been an inexplicable but very real

> retreat from the Puritan canon that required an individual to save first and enjoy later . . .
>
> The process of persuading people to incur debt, and the arrangements for them to do so, are as much a part of modern production as the making of goods and the nurturing of wants.[21]

Since I have made appeal to Adam Smith I should recognize that he might have raised some doubts about the blessings attached to high-flying entrepreneurs. He would, most probably, have taken them as prodigal – a term he reserved for persons who consumed in excess of their productive output.[22] Smith considered frugality, spending which leaves part of a person's production untouched as savings, to be sustainable and useful consumerism. However, Smith's view that only manufacturing, "productive hands", increase national production is mistaken. So is his apparent assumption that if an idle person spends a dollar, that dollar disappears from the surface of the earth. In reality, production of services brings about wealth, and prodigal spending disperses it to those who get paid for their labour and in whose hands the money recreates demand, then production and supply, and in the end consumption and satisfaction of their wants. It is obvious that the Puritan ethos of the noxiousness of credit led Smith to denounce prodigal life in spite of the fact that he otherwise recognized the trickle-down effect of spending.[23]

Parsimony may be a justifiable social norm in the face of environmental destruction, global poverty, and growing population. However, smuggling it in as an associate of a labour theory of justice does not work. The hard work and parsimony ideology is just an attempt to reserve the privilege of wealth to those who already control it, or whose personal skills happen to make them unable to boost their earnings by the use of leverage. Credit is shunned because it is the great egalitarian vehicle of the market economy. It provides people with opportunities to reshuffle the pack, and by doing this it kicks the economy into motion. The kicks may cause less efficient capital to diminish in value, which is the fundamental fear of those who despise borrowers.

The Puritan ethos is advocated by conservative wealth, and by those who assimilate their interests with established and stagnant capital, with the purpose of making the rest of us believe that life should be miserable: if we do not already have the capital to pursue our aims, the conservatives believe that we should not be given the opportunity through borrowing either. Our ethical analysis points in the opposite direction. Some people may find insolvency and credit offensive on an emotional level, yet their emotions should not be a reason for institutional sanctions. The system of free enterprise embeds freedom to get into debt as well as freedom to fail.

The effects of high interest rates, imposed in the early 1990s as a counter-measure to the excessive 1980s, are an empirical confirmation of the ethical conclusion that hard work and parsimony are not good reasons to denounce the use of credit. Parsimony was rewarded as the number one virtue when real-term interest rates were brought to historically unforeseen heights in much of the industrialized world. When the yield on risk-free deposits exceeded the long-term average return on equity in risk ventures, it became irrational to take any financial risk. It no longer made sense to take a loan for investment purposes because there was hardly any hope of enough return to pay the interest. This meant that it became irrational to invest in anything which relates to production, be it property, equipment or people.

While the assets inflation of the booming 1980s distorted economic activity, the interest-rate surge in the early 1990s killed it. High-flyers made ordinary people painfully aware of their relative poverty. The counter-attack, praising hard work and parsimony, made the pain real by introducing mass unemployment and impoverishment in absolute terms. As a matter of fact, parsimony does not create any new wealth, except perhaps interest earned on savings. However, the interest is earned by the debtors, who pay it to their creditors. The lesson of the start of the 1990s was that untenable ethical ideals proved to be untenable economic guidelines too. Or, to be more exact, they succeeded in forcing parsimony upon those who became unemployed, but only at the expense of hard work.

Conclusions

Credit and insolvency are just one example of social practices which may be found offensive, but are not intrinsically evil. To recall Adam Smith: a person who does not employ whatever stock she can command, whether it be her own or borrowed, in procuring either present enjoyment or future profit, is completely crazy. Smith's declaration tells us that the use of credit is as little irrational as it is unethical. In the 1980s, when credit was readily available and asset prices soared much faster than interest accumulated, it would have been simply foolish to focus business on anything other than leveraged asset deals. This reflects an unhealthy direction for the economy, but does not make businessmen involved in the deals bad businessmen. They just picked up the dollar where returns were the best. Those who were not astute or quick enough to see the turning point went broke, but they did not make the decisions that allowed the economy to put assets before production. The irrational decisions were made on the macro-economic level when credit expansion was set loose, not on the micro-level where individuals sought to profit from the distorted climate. Punishments for irrational courses of action may have some utilitarian benefits as a deterrent; punishing high-flyers for insolvency cannot, since their rationality worked as it is supposed to work. They merely erred in matters of fact and timing.

It is appropriate to end the discussion about high-flyers by recalling that they are by no means children of recent times. Since the birth of capitalism there have been cyclical fluctuations of the economy, booms followed by busts. Famous examples are the South Sea Bubble in England after the expansion of colonial trade in the early 18th century,[24] and the railroad collapses in the U.S. after the 19th century expansion to the west.[25] As certainly as booms gave way to busts, moral censure put the blame for the turn of the tide on credit and excessive luxuries.

In the last few years, we have witnessed this happening once again in recent law reform debate and in the media. However, we should keep in mind that high-flyers are a renewable resource, and as such do not pose any particularly new ethical problems for the institution of bankruptcy. The institution should be built upon sound ethical judgement and economic analysis, not on emotions stirred up by few narcissistic individuals who have failed. If high-flyers have done no wrong warranting punishment, the ethics of bankruptcy favours the discharge of their debts. Before the law and ethics, all deserve equal consideration. This means that a lifestyle associated with debt and luxuries is no more a reason to punish ex-entrepreneurs than it may be a reason to punish those able to pay their debts, and that a high-flyer should be presumed honest unless proven fraudulent.

Notes

[1] Research has, consistently, confirmed the frugality of bankrupts. See Ryan (1989, pp. 29, 54–55, 451), Stanley and Girth (1971, pp. 3–4), and Sullivan *et al.* (1989, pp. 208–212).

[2] Fletcher (1990, p. 6), Hoppit (1987, p. 25) and Rubin (1984, p. 273) each give an account of the centuries old stigmatizing tradition which identifies bankruptcy with crime.

[3] Korotkin (1993) is a recent comparison of insolvency law in the U.S. and the U.K. The law reforms are discussed in detail in the Commonwealth of Australia Law Reform Commission (1988) and Report of the Review Committee (1982).

[4] Aris (1986, p. 133).

[5] Barry (1991, p. 61).

[6] Commonwealth of Australia Law Reform Commission (1988, pp. 143–144).

[7] Smith (1950, Vol. I, p. 301).

[8] Jackson (1986, p. 32).

[9] For instance, in the economic summit organized by president Clinton after his election it was widely agreed that increased access to credit for businesses and entrepreneurs is one of the keys to a sustainable recovery (*The New York Times*, December 16, 1992).

[10] Barry (1991, p. 123).

[11] In economic theory Schumpeter (1959) is a recognized account of the constructive role of failures. Hoppit (1987) gives support to the same idea from the perspective of history of economy.

[12] *The Age*, September 20, 1992.

[13] Smith (1950, Vol. II, p. 179).

[14] Shuchman (1973, p. 433).

[15] Commonwealth of Australia Law Reform Commission (1988, p. 337).

[16] Nozick (1974, pp. 153–155).
[17] Rawls (1971, pp. 302–303).
[18] Galbraight (1976, p. 147).
[19] Locke (1960, par. 2.27) gives the theory in a compact form:

> Though the earth and all inferior creatures be common to all men, yet every man has a property in his own person; this nobody has any right to but himself. The labour of his body and the work of his hands, we may say, are properly his. Whatsoever he then removes out of the state that nature hath provided and left it in, he hath mixed his labour with, and joined it something that is his own, and thereby makes it his property.

Nozick criticizes Locke's account but has, in the end as Scanlon (1982) points out, to derive property rights from something like Locke's original acquisition.
[20] Schumpeter (1959, p. 107).
[21] Galbraith (1976, pp. 147–148). A contemporary work by Wray (1990) argues against both Keynesians and monetarists that money was not introduced to facilitate trade but is created naturally in debtor/creditor relationships. This would make debt the most fundamental mover of economic forces; not only an essential part of modern production, as Galbraith says, but of all production.
[22] Smith (1950, Vol. I, pp. 312, 359–360)
[23] Smith (1950, Vol. I, p. 15).
[24] Hoppit (1987, p. 164).
[25] Warren (1972, pp. 121–122).

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