

THE COSTS OF BANKRUPTCY*

JOHN C. WEISTART†

INTRODUCTION

Our study of the bankruptcy process provides the occasion to consider again the role that the state should play in adjusting relationships which have their origin in private contract. One cannot venture too far into this subject before encountering substantial controversy. The range of philosophical viewpoints does not suffer from a lack of contrast. Some would regard government intrusions into the area of private contract as a transgression of the highest order. Others would contend that many of the relationships affected by government action—such as those in consumer bankruptcy cases—cannot be characterized as contractual in the traditional sense.¹ This group regards the defense of the “sanctity of contract” as beside the point and would urge that our main concern should be with the role of the state in protecting its citizens from overreaching by creditors.

There is much that remains to be added to our understanding of the role of private contracts in a modern credit society. It will not, however, be found in the pages of this commentary. My purpose is the much less ambitious one of attempting to identify what ought to be the area of debate as we examine the process of bankruptcy. While I conclude that Dean Meckling’s paper has headed us in the right direction, there are some additional notions that warrant attention.

I

WHY BANKRUPTCY?

Before considering the question of the costs of bankruptcy reform, it may be useful to examine some other, preliminary matters. First, I think it is important that we identify where we are in the constitutional (small c) process of bankruptcy. Are we asking whether we should have a bankruptcy system at

* A Commentary on Meckling, *Financial Markets, Default, and Bankruptcy: The Role of the State*, LAW & CONTEMP. PROB., Autumn 1977, at 1. This paper was originally presented, in a slightly different form, at the Liberty Fund, Inc., Seminar on the Economics of Bankruptcy at the Law and Economics Center of the University of Miami School of Law (March 31 - April 2, 1977).

† Professor of Law, Duke University.

1. See, e.g., *Bankruptcy Act Revision: Hearings on H.R. 31 and H.R. 32 Before the Subcomm. on Civil and Constitutional Rights of the House Comm. on the Judiciary*, 94th Cong., 1st & 2d Sess., pt. 2, at 757-66 (Comm. Print 1975-76) (Testimony of David H. Williams, Attorney, Federal Trade Commission) [hereinafter cited as *1975-76 Bankruptcy Hearings*].

all, or are we attempting to define the degree of relief that the system should afford? While I believe the answer is clear—we are addressing the second issue—it is worthwhile to consider the reasons for our lack of concern about the threshold question, Why bankruptcy?

I would suggest that in structuring the legal system for debtor-creditor relationships in our society, most of us would favor the establishment of a formal system for the collective settlement of the obligations of overburdened debtors. And after we consider the various alternative arrangements that might be devised, we would likely conclude that the state should play a central role in the administration of the system. This would be our conclusion, I believe, whether we were voting as debtors or as creditors, or from a more disinterested perspective. For the moment we should leave aside the question whether our system would allow the debtor to be discharged from his debts with something less than full satisfaction of the obligations. A discharge is not an inseparable part of bankruptcy, as evidenced by the fact that the bankruptcy systems of many European countries operate without it. In the absence of a discharge we would use our system to arrange for the extension of debts and perhaps to facilitate voluntary compromises of creditors' claims.

A creditor evaluating bankruptcy systems would likely concede that the government should have a role in this process because private contracts provide an ineffective vehicle for the protection of their interests. Dean Meckling has given us a basic contractual model for debt arrangements, an agreement between B (borrower) and L (lender).² But the world in which this contract arises also includes other parties who may affect the relationship: T₁, T₂, and other third-party creditors. I think we will conclude that it is extremely difficult—to the point of being impractical—for L to use his contract with B to insure that he will be repaid by B. Even if we limit our inquiry to defaults caused by financial mismanagement, we can identify restraints that will operate on L. After contracting with L, B remains free to increase significantly the risk of his default by entering into agreements with T₁, T₂, and others. L might include in the contract a term prohibiting B from assuming further debt or requiring L's prior approval of new obligations, but these devices would not invalidate unauthorized contracts with third parties, and in many cases the costs of truly effective policing would be prohibitive. Moreover, as a practical matter, L would not want to be B's sole creditor. B's credit needs will require many different types of loans, from a long-term home mortgage to short-term credits for consumer goods and services. L is not likely to be organized to handle all of these and, in addition, may have doubts about the wisdom of excluding B from other credit sources. Thus, L can anticipate that

2. Meckling, *Financial Markets, Default, and Bankruptcy: The Role of the State*, LAW & CONTEMP. PROB., Autumn 1977, at 13-15.

B will have other debts which affect his ability to repay L but which cannot be controlled by L's contract.

Another consideration that will influence our creditor's vote is the fact that there is no principle of justice that prohibits a debtor from favoring one unsecured creditor over another when using limited current assets to satisfy outstanding debts. If the debtor has only \$500 remaining, he may use it to satisfy the claim of one creditor, and ignore the commitments he has made to others. Since such preferences are not proscribed in the nonbankruptcy world, all creditors are likely to be concerned about how they will fare when the debtor's affairs deteriorate to the point at which collection actions begin. The process of enforcing their contracts through private lawsuits holds a substantial risk that much may be ventured but little gained. A creditor may initiate a collection action and secure a judgment only to find that another creditor has already consumed all available assets by a prior judgment, private arrangement with the debtor, or otherwise.

If he were asked to vote on proposals for a bankruptcy system, a creditor is unlikely to know how he will fare in the collection race that will be precipitated by the defaults of his future debtors. He will not know whether he will be among those creditors who, through superior knowledge or superior legal counsel, are able to receive preferential treatment. Thus, the creditor may well conclude that he should vote for a system that assures him of equal participation in the distribution of the debtor's estate. And since the institution of private contract cannot guarantee this result, he is likely to elect to have the state administer a system that requires the participation of all creditors.

Others may support the establishment of a bankruptcy system on efficiency grounds. A system that is properly structured and administered would avoid many of the inefficiencies that result when creditors are left to their separate collection remedies. If creditors were left to their individual remedies, certain questions would appear in every creditor's lawsuit. These include questions about the extent and location of the debtor's assets, the existence of priority liens, and the propriety of the debtor's conduct with his estate. Rather than investigate these questions anew in every suit, it is preferable to have a single inquiry, accompanied by provisions for a single administration and distribution. Since some coercion may be necessary to exact truthful answers and since an impartial decisionmaker is important, state control seems appropriate. When this arrangement for a common adjudication is coupled with a rule providing for an equitable distribution of assets, creditors will find that they are able to avoid situations in which, because of imperfect information, they incur significant litigation costs only to find that their judgments are of little value.

Our constitutional debate is likely to heat up somewhat when we turn our attention to the question whether we should permit a court-ordered discharge

of certain debts. It is one thing to authorize the government to intervene to facilitate plans for the extension and voluntary compromise of obligations; it may be quite another matter to force the creditor to accept less than complete satisfaction. We can approach the issue as being whether such a compulsory settlement involving less than the full obligations should ever be required, leaving until later the question which debts should be dischargeable.

The arguments against permitting discharge are likely to have a decided philosophical overtone. Granting discharges may erode the degree of responsibility with which the debtor approaches his affairs and may lessen his incentive to avoid overextension. To the extent that we remove the penalty for insolvency we may actually nudge debtors down the path of imprudence and thus foster the tragedies that attend the disintegration of personal estates. Finally, it would be urged that a contract is a contract, and a creditor who gave fair consideration to his debtor is entitled to the promised return, even if he is required to wait for its receipt.

There are other considerations, however, which are likely to prompt us to accept discharges in some circumstances. For example, we must recognize that some debts are simply uncollectible. The clearest case is one in which the productive capacity of a wage earner is destroyed by a debilitating illness or other tragedy that forces the individual to rely upon state support or private largesse for his continued existence. Obligations may have been accumulated that both the debtor and creditor assumed would be paid out of future earnings. Here the notion of the efficiency of the bankruptcy remedy again comes into play. Rather than require each individual creditor to pursue a costly investigation to discover that his claim is uncollectible, we can use the bankruptcy system to establish that fact by a single inquiry. The granting of discharge will also foreclose vindictive or otherwise unnecessary collection actions.

From this clear case we will want to shift our attention to other situations in which arguments can still be made that it is appropriate to reach a final resolution of creditors' claims. Some cases will benefit from the efficiencies identified above. Many debts may be otherwise collectible, but the costs of private collection may exceed the anticipated return. Here the bankruptcy process may provide the creditor with some return and produce the discharge which would have occurred in any event.

Other situations will require a much different focus. At some point we will want to examine the theory of the fresh start, which encourages liberal dispensations from prior debts. The notion of giving the overextended but honest debtor a second chance is fundamental to our existing system and has prompted new proposals for further reforms to improve the debtor's post-bankruptcy position.³ While the fresh-start doctrine in our existing system

3. Among the reforms that appear to be intended to enhance the debtor's fresh start are

seems to be buoyed primarily by humanitarian concerns, we might want to inquire whether there is not also some economic justification for liberalized access to bankruptcy discharges. The point to be investigated is whether excessive debt, with its attendant pressure on family and emotional stability and job security, does not so inhibit productivity that there would be a net social gain from terminating costly collection actions, excusing the debts, and giving the poorer-but-wiser debtor a second chance.

As we move from the cases of uncollectible debts, in which bankruptcy serves a cost-saving function, to the cases in which we investigate its effects on productivity, the debate about the wisdom of discharges will intensify appreciably. For the present it is enough to suggest that we have crossed the threshold of the discharge question and established that nondischargeability is not an inviolable concept.

Those who would urge that the discharge in bankruptcy violates the basic sanctity of contract must also be prepared to deal with an extensive body of nonbankruptcy law that weighs against that position. Bankruptcy is not the only context in which the dischargeability of obligations is recognized. Indeed, the general law of contracts accepts that there are circumstances in which a party may be excused from commitments that otherwise have all the attributes of a valid contract. Decisions in this area were first categorized under the doctrine of impossibility, which in its early formulations authorized a court to discharge a contractual obligation if performance had been rendered impossible, provided that the court found that the promisor had not assumed the particular risk and that he was not the cause of the circumstances which prevented performance. A leading case in this area is the 1863 English decision in *Taylor v. Caldwell*.⁴ Taylor contracted to rent Caldwell's music hall for a future date. Taylor planned to stage a musical event and, of course, anticipated making a profit by charging admission. Before the agreed-upon date, the hall was destroyed by fire. When Taylor later sued for the damages which resulted from Caldwell's failure to perform, the court concluded that there was no liability. In the court's view Caldwell's duty to deliver the hall was by implication conditional upon its continued existence. As that condition was not satisfied, Caldwell was discharged from his contract.

Since the time of *Taylor v. Caldwell* the trend has been toward increasing liberalization of the grounds for excuse. One important development in this area was the adoption of section 2-615 of the Uniform Commercial Code, which shifts the emphasis in sale-of-goods contracts from a requirement of objective impossibility to a standard that requires a showing that "performance . . . has been made *impracticable* by the occurrence of a contingency the

those which prohibit postbankruptcy reaffirmations, invalidate a debtor's attempt to waive his exemptions, and further restrict the classes of nondischargeable debts.

4. 3 Best & Sm. 826, 122 Eng. Rep. 309.

non-occurrence of which was a basic assumption on which the contract was made”

On the surface it might appear that many debtors who come to the bankruptcy court would otherwise be entitled to a discharge under these principles. Not infrequently the precipitating cause of bankruptcy is major illness or other catastrophe that destroys the debtor's income. Could it not be said that the occurrence of these unexpected events made it impossible for the debtor to perform according to the original terms of his credit contracts? In the same vein, wasn't the debtor's continued earning capacity a basic assumption on which the contract was made? Whatever the appeal of this analysis, it is not generally recognized in the cases applying the impossibility doctrine. We can find authoritative statements to the effect that personal insolvency, whatever the cause, does not discharge performance under a contract, whether the agreement calls for the payment of money or some other type of exchange.⁵ Many older cases suggest that the intervening conditions must indicate "objective impossibility," which is to say it must be shown that no person could have rendered the required performance.⁶

Much is troubling about the defense of impossibility. One might wonder whether *Taylor v. Caldwell* would have been decided the same way if it had arisen in an economic setting in which sophisticated forms of business interruption insurance were available to landlords who rented music halls. But even if we choose not to question the origins of the doctrine, it is not at all clear that we must accept that the distinction between insolvency and other types of impossibility is inevitable. Some suggest that the distinction represents a policy decision that a contrary result would encourage personal irresponsibility.⁷ But that is hardly compelling in cases in which the insolvency is precipitated by such external causes as an illness or economic recession.⁸

II

PROPOSED REFORMS

As suggested at the outset, the preceding paragraphs are attempts to settle some preliminary matters that bear on our discussion of modern bankruptcy systems. I have suggested that we should not be long detained by the question

5. Cases bearing on this question are collected and discussed in 6 CORBIN ON CONTRACTS § 1332 (1962).

6. See *id.*, especially n. 64. See also RESTATEMENT OF CONTRACTS § 455 (1932).

7. 6 CORBIN ON CONTRACTS § 1332 (1962).

8. I believe that there may be an entirely different explanation for the insolvency exception. Much of the law on impossibility evolved during the period when governments were establishing a separate institutional framework for dealing with insolvency problems. Courts considering private contract litigation in which insolvency was raised as a defense may well have concluded that they should defer to those legal mechanisms specifically designated to effectuate the settlement of debts.

whether we should have a bankruptcy mechanism and that we can probably agree that our system should grant discharges in some instances. With those matters aside, we can begin talking more specifically about the operational aspects of our system.

Many questions might be considered. A reading of the congressional hearings on the present proposals for bankruptcy reform indicates that there is a good deal of debate about the structural and procedural aspects of bankruptcy. Should we remove substantial portions of the bankruptcy process from the judicial system and place them in an administrative agency? Should we guarantee bankrupts access to independent legal assistance? Should we undertake to counsel debtors about the availability and consequences of various bankruptcy remedies? Those are interesting questions, but there are other issues that are more germane to Dean Meckling's paper. I would like to focus on the subset of issues that relate to the quality of the discharges received by noncorporate debtors. Here I intend to refer not only to the specific rules that deny a discharge to particular debtors but also to the rules that define the type of debts which will be cleansed in bankruptcy, insure the effectiveness of the discharge, and limit the availability of subsequent discharges.

The present proposals for reform include various rules that define the extent to which the debtor's discharge will be meaningful. Some deal with the conditions under which discharges will be denied. Thus, as Dean Meckling notes, the Commission on the Bankruptcy Laws of the United States proposed that fraud in a financial statement made by a consumer-debtor to a creditor not be a basis for denying the dischargeability of the obligations incurred.⁹ The Commission also endorsed the present practice of denying the dischargeability of certain debts, although the classes of such debts are modified somewhat under the Commission's proposal. The Commission's rules defining the exceptions to discharge presumably represent a judgment that the claims of certain types of creditors are sufficiently worthy to warrant preference over the general goal of giving the debtor a fresh start. Among the debts which would not be dischargeable under the Commission's proposals are certain tax liabilities, child support and alimony obligations, and liabilities for embezzlement, larceny, and willful and malicious torts. One of the more controversial classes of nondischargeable debts covers educational debts, specifically those which were first due within the five years prior to bankruptcy. Under the Commission's proposal the discharge may be allowed, however, if it is established that repayment would impose undue hardship on the debtor.¹⁰

9. The proposals discussed here are outlined in REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. DOC. 137, 93d Cong., 1st Sess., pt. II, §§ 4-503, 4-505, 4-506, at 125-41; and explained in *id.*, pt. I, ch. 7, at 169-81 [hereinafter cited as BANKRUPTCY REPORT].

10. Interestingly, this is one of the few areas in which the availability of the bankruptcy

Other Commission proposals affect the debtor's discharge in a somewhat less direct fashion. For example, one important provision is intended to preclude creditors from coercing debtors to relinquish the benefits of discharge after bankruptcy. Thus, the Commission would provide that a debt discharged in bankruptcy cannot be revived or reaffirmed after bankruptcy, a practice that is currently common in some types of consumer transactions. Another rule worthy of note defines the frequency with which a debtor can claim discharges in bankruptcy. The present law prohibits the debtor from securing a new discharge if he has received a discharge in the previous six years. The Commission proposes two important changes: The six-year limit is reduced to five, and a new discharge will be allowed in a shorter period if it is found that the debtor's new financial difficulties were caused by circumstances beyond his control and that repayment would impose undue hardship.¹¹

In an effort to increase the effectiveness of the debtor's fresh start, the Commission also proposes changes in the exemption rules that, for many debtors, will increase the portion of their estates that they retain after bankruptcy. In addition to setting the amounts that can be exempted for residences, burial plots, household furniture, and similar tangible property, the Commission proposals include a provision that is designed to give a debtor access to cash and similar assets to assist his fresh start. Thus, a debtor would retain up to \$500 in cash, securities, and receivables, including income tax refunds. The reforms would also invalidate agreements that the debtor made with respect to his exempt assets prior to bankruptcy: a voluntary waiver of an exemption in favor of an unsecured creditor would be unenforceable. In addition, the proposals would invalidate certain types of security interests that a debtor has granted in his property. The consensual liens that are abrogated are nonpurchase money security interests in wearing apparel, household goods, and health aids.

III

EVALUATING THE REFORMS

As legislators are called upon to evaluate these various proposals, what should their frame of reference be? Dean Meckling would urge them to consider the economic impact of the reforms. But as the conclusion to the first part of his paper recognizes, they should also weigh carefully the humanitarian concerns that are involved. There are several important points to be made about the balancing that will be undertaken. A perusal of the congressional hearings that have already been held suggests that some legislators as-

remedy is based on a calculation of the debtor's wealth that takes account of his human capital. If we applied such a standard more generally, we would, I believe, eliminate many of the cases which are seen as abuses of the bankruptcy system.

11. See note 10 *supra*.

sume that many of the reforms will indeed transfer wealth from creditors to their debtors. In candor I must indicate that I have not found an explicit statement to this effect. But the questions that are asked often suggest that this is the premise upon which the inquiry is made. For example, when representatives of the consumer finance companies raised objections to various proposals that would affect their operation, particularly the provisions dealing with false financial statements and postbankruptcy reaffirmations, the investigators undertook to establish that the finance companies had tremendous assets, that they were very profitable, and that bankruptcy writeoffs were a "minuscule" part of their total wealth.¹² This implies that the companies could easily absorb the losses that the new measures would generate. Dean Meckling makes clear that the critical issue is different: How will the finance companies redistribute the costs imposed on them? In sum, the code of Robin Hood may have limited utility for gauging the impact of the reforms.

A. Are Reforms Comparable to Limitations on Right to Contract?

We do, however, need to examine Dean Meckling's ultimate conclusions a bit more closely. In his summary he accepts the wisdom of the state's decision to limit a debtor's right to bargain away his personal freedom and bodily integrity as security for his debts: "Those kinds of limitations probably raise the cost of lending a little and may force some borrowers into extralegal markets, but the overall effect is probably negligible."¹³ But Dean Meckling is much less tolerant of other limitations the state imposes on a debtor's right to grant other claims on his labor income. He concludes that these "will significantly increase borrowing costs" and ultimately transfer wealth from responsible debtors to bankrupts.¹⁴ The difficulty in this analysis is apparent, I believe. The fact of the matter is that we simply do not know whether the costs of additional limitations are significant. The first part of Dean Meckling's conclusion accepts that there are some types of freedom that we will not allow the debtor to bargain away in his credit contract. We believe that the values involved are of such a high order, and the costs sufficiently low, that on balance intrusion by the state is proper. However, as to the other limitations that bankruptcy imposes on the credit contract, we do not know how they fare in this equation. Until we begin to identify what the costs are, I believe we have to be more cautious in our conclusion about their desirability.

Many of the consumer advocates involved in the move toward bankruptcy reform believe that certain of the new proposals should be viewed in precisely the same light as a prohibition on imprisonment. They feel that the human values involved are of the same high order: just as the state should protect

12. See, e.g., *1975-76 Bankruptcy Hearings*, *supra* note 1, pt. 1, at 913-17.

13. Meckling, *supra* note 2, at 29.

14. *Id.*

debtors from physical harassment, it should limit creditors' capacity to intrude on a debtor's basic emotional well-being. A debtor's relationship with his spouse and children, his right to continued employment, indeed his basic self-respect, are thought to be at stake if the state does not provide him with adequate exemptions, prohibit postbankruptcy reaffirmation, and so on. And the supporters of these measures would likely deal with the cost issue in the same terms that Dean Meckling applies to the ban on imprisonment. They will contend that the costs are negligible and in any case greatly outweighed by the human values that are at stake. There are many difficulties with this analysis, of course. I believe that we are often too willing to blame creditors for personal problems that have a much more basic source. But more germane to the present discussion is the point that, again, we simply cannot say whether the costs are significant or negligible. We have some hunches about what costs are involved and about the consequences of spreading them among particular groups, but our calculations in this area are almost always predetermined by the philosophical premises from which we proceed.

I do not propose that we shrug off the cost question with a "don't know, can't tell" attitude. Dean Meckling's paper is quite valuable in suggesting that those involved in bankruptcy reform often ask the wrong questions. The issue of the costs of the bankruptcy has received surprisingly little consideration to date despite the extensive attention given to the proposals for reform. There is a pervading tendency to praise or condemn particular provisions without any evidence of what the real effects will be. Perhaps the most optimistic thing that can be said at this point is that there is still time to remedy this situation. We can set out to identify more specifically the reasons why we might want to abate the process of reform in order to give more attention to the matter of costs.

B. What Will the Reforms Cost?

Many of the reforms proposed for noncorporate bankruptcies have the same flavor as other recent efforts to increase governmental control of the consumer credit market. Some of the studies of these other regulations suggest that Dean Meckling's concern for the magnitude of the costs may be well founded. The Benston study cited in Dean Meckling's paper is a case in point.¹⁵ One can find commentators who contend that finance companies are guilty of extending "too much" credit to consumers and that the government should protect us from this practice. One problem with that view—apart from the error of its premise—is that indirect controls restricting the terms of credit contracts are likely to cut with a broad blade. As Benston's findings suggest, the group excluded from the credit market may include many who are appar-

15. Benston, *The Impact of Maturity Regulation on High Interest Rate Lenders and Borrowers*. 4 J. FINANCIAL ECON. 23 (1977), reprinted in LAW & CONTEMP. PROB., Autumn 1977, at 180.

ently quite able to bear the obligations incurred and who presumably take a different view of the utility of the transactions. In a similar vein, those who have looked at the Arkansas experience in limiting interest rates to ten percent have found that consumers experienced untold "benefits" from this effort to legislate cheap credit: many creditors left or refused to enter the Arkansas market, retail prices (where the stores served as creditors) rose, and the business activity in the border towns of adjoining states perked up.¹⁶ These results are hardly surprising in light of other findings which suggest that the creditor's cost for short-term, small loans may reach as high as twenty percent of the principal amount.¹⁷

Recent efforts to abolish the holder-in-due-course rule have prompted similar inquiries into costs. Our accumulated knowledge about this particular reform is still quite imperfect, but we know enough to confirm that legislators have been too casual in the past in dealing with the cost question. An extensive study of credit markets in Puerto Rico indicates that after the abolition of the holder-in-due-course rule, the median rejection rate of applications for used-car credit among commercial banks reached 100%—that is, the majority of banks refused to write these sorts of loans.¹⁸ While the rejection rate apparently was high before the reform became effective, the new law clearly had an effect. The study report states that "forty percent of the respondents [commercial banks] claimed that the abolition of [the holder-in-due-course rule] has made them more selective in the purchase of consumer paper. One large respondent claimed to have stopped financing used cars, while another claimed a 20% reduction in purchased paper activity"¹⁹

Other studies are useful for their suggestions that we ought to be concerned about the ripple effect of consumer protection measures. In 1976 the Wharton Econometric Forecasting Associates, Inc., (EFA) attempted to forecast the impact of the FTC's efforts to abolish the holder-in-due-course rule in consumer transactions. Their primary concern was with the effect of the rule on consumer purchases of new cars, household goods, mobile homes, and home improvements. The original forecast was that the FTC rule might reduce the amount of consumer credit otherwise available by \$2.2 billion in 1976 and reduce the GNP by \$1 billion to \$2 billion.²⁰ The Wharton EFA has been careful to point out that these figures must be approached with great

16. See, e.g., Blades & Lynch, *Credit Policies and Store Locations in Arkansas Border Cities: Merchant Reactions to a 10 Per Cent Finance Charge Ceiling* (Credit Research Center, Purdue University 1976); Lynch, *Consumer Credit at Ten Per Cent Simple: The Arkansas Case*, [1968] U. ILL. L. F. 592.

17. PUERTO RICO DEVELOPMENT GROUP, *CONSUMER CREDIT IN PUERTO RICO* 128-30 (1975).

18. *Id.* at 1-23.

19. *Id.* at 128.

20. See *Holder in Due Course: Does the Consumer Pay?*, 32 BUS. LAW. 591, 621-24 (1977) (panel discussion: remarks of Dr. James F. Smith, Senior Economist, Division of Research and Statistics of the Board of Governors, Federal Reserve System.)

caution. A postforecast inquiry did not confirm these forecasts. I gather that because of the level of aggregation, it is extremely difficult—and expensive—to arrive at reliable conclusions about the consequences of a particular regulation.²¹

The difficulty of securing data of the sort considered above can have interesting effects on the legislative process. For those who begin from the premise that additional regulation will benefit consumers, the difficulty may be seen as a reason for dismissing the cost issue. Some may even acquire new boldness in pursuing a predilection toward reform, knowing that the risk of contradiction is slight. Another danger of a different sort is that legislators, in their search for certainty, will focus on the data to which there is the most ready access and become insensitive to the question of its relevance. It may be this sort of phenomenon which produces accusatory inquiries about the profitability of the consumer finance industry. In any event, I do not have the impression that the very real informational problems in the consumer credit area have led to more cautious decisionmaking.

C. Who Bears the Costs?

As a part of the process of evaluating the costs of bankruptcy, we will want to give close attention to the question who bears those costs. Dean Meckling gives a succinct statement of how increased costs will be allocated:²²

The extent to which specific borrowers or a specific group of borrowers in the consumer loan market bear the increased costs of reducing bad-debt losses depends on the cost to financial institutions of sorting potential borrowers on the basis of the bad-debt losses they are likely to cause The cheaper it is to identify potential bankrupts, the narrower the base will be on which the increased costs of bankruptcy are imposed.

For purposes of legislative policymaking it would seem important to determine what the cost-spreading behavior of particular creditors would be. Indeed, before one can decide that the costs of reform are not excessive, one would presumably need to know which classes of borrowers would bear the costs and then judge whether they could afford them. It seems to me to make a fundamental difference whether the burdens of consumer-bankruptcy reform fall upon all users of the credit system, all nonbusiness debtors, only the near-poor, or worse yet, all certain bankrupts.

While we again must generally register a “don’t know” response, some of the structural aspects of the credit markets suggest that many costs will be allocated to less affluent groups. For example, consumer finance companies are the object of many of the present reform proposals. The proposals to

21. Letter from Richard M. Young, Quarterly Model Project Director, Wharton EFA., Inc. (March 9, 1977).

22. Meckling, *supra* note 2, at 23.

limit reaffirmation of debts, to invalidate nonpurchase money security interests in household goods, and to remove the nondischargeability penalty for false financial statements respond to practices that are common among such firms. But consumer finance companies do not service a representative sample of consumer-borrowers. There are differences in income levels of those who borrow from commercial banks and those who rely on finance companies as a source of credit.²³ Consumer finance clientele includes greatly disproportionate numbers of high-risk borrowers. Given that income level can probably predict the likelihood of bankruptcy, the firms would seem to have the capacity to make further differentiation on the basis of the degree of bankruptcy risk. And the greater the firms' capacity to distinguish probable bankrupts, the more they will allocate the costs to those least able to bear them.

Not all persons share the view that bankruptcy costs may be allocated disproportionately among various classes of debtors. The transcript of the bankruptcy hearings includes an exchange between Kenneth N. Klee, Associate Counsel of the House committee that conducted the inquiry, and Professor Marjorie Girth, coauthor of the immensely useful Brookings study²⁴ of the bankruptcy process:²⁵

Mr. Klee: If bankruptcy filings increase, the reaction of finance companies would be to increase the interest rate to spread the risk across the credit economy. Why should honest consumers be forced to bear the increased costs of credit by default of another person?

Professor Girth: I think all of us, or almost all of us, now are credit users, Mr. Klee. If you think of us all as somewhat vulnerable to the unanticipated crisis which produces most bankruptcy, then any increased cost is more like insurance against our being the one who needs the service.

I personally am much less certain that the costs will be spread across the whole credit economy or that all of us will pay the same premium.

D. Should the Bankruptcy System Preempt the Welfare System?

There is another aspect of the cost-spreading issue which deserves our attention. Assume that our legislators decide that they want rather costly reforms but also want to insure that less affluent credit users do not bear a disproportionate part of the burden that would be imposed. What mechanisms could be used to secure better distribution of the costs? A number of devices might be considered, but the broadest possible spread would probably be achieved through the tax base. The government might use its rev-

23. See PUERTO RICO DEVELOPMENT GROUP, *supra* note 18, at 1-6.

24. D. STANLEY, M. GIRTH, V. COUNTRYMAN, G. JANTCHER, W. LAW, V. ROSENBLUM, & M. SHIMM, *BANKRUPTCY: PROBLEM, PROCESS, REFORM* (1971).

25. *1975-76 Bankruptcy Hearings*, *supra* note 1, pt. 1, at 389.

enues to make grants to reduce the losses that creditors sustain. All taxpayers would of course contribute to these grants and thus bear a portion of the costs.

Let us consider other arguments that give this suggestion some plausibility. The provisions of the law that define exempt property offer a useful area for inquiry. As has already been mentioned, the new proposals address the question of the amount and types of property that will be exempt from the claims that creditors file in bankruptcy. The Commission's bill, for example, not only states what exemptions will be given but also includes various provisions that are intended to insure that debtors get the benefit of their exemptions.²⁶ Thus, it is provided that bankruptcy will not recognize any agreement in which the debtor waives his exemptions and will not enforce certain types of security interests in selected classes of goods. The purpose of the exemption provision is presumably related to the general goal of giving a debtor a fresh start. It defines the assets which a debtor will be able to take with him when he begins his new venture.

We could select any of a number of exemption provisions to examine the arguments in favor of an expanded governmental role, but one provides a particularly useful example. In addition to property that may come under one of the other exemption provisions, a debtor would be allowed to retain up to \$500 in "cash, securities, and receivables, including unpaid personal earnings, accrued vacation pay, and income tax refund"²⁷ Most of these are highly liquid assets, and I gather that the drafters of the measure have concluded that it is desirable for a debtor to have a little cash (or something close to that) to get him going again. And at least within the confines of the fresh-start philosophy, this seems like a good idea. The debtor has just been through a series of traumatic financial experiences in which he has probably lost some assets and in addition may have deferred expenditures that would greatly benefit himself or his dependents. Moreover, he may still be feeling the effects of some specific catastrophe—illness, loss of job, or whatever—which precipitated the bankruptcy. Again, the liquidity exemption will help him get through the adjustment period.

But at some point we have to stop and ask the question, Who is paying the bill? If it is other less affluent credit consumers, we might be troubled. The rationale for the transfer that is being made is similar to that which underlies many public welfare programs. The individual finds himself in a disadvantageous financial position, often precipitated by a personal catastrophe or general economic conditions, and it is thought appropriate that others chip in to improve his circumstances. The difference, of course, is that these other types of grants are financed by public revenues. If government financing is proper in those cases, why is it not also desirable for the liquidity we provide

26. BANKRUPTCY REPORT, *supra* note 9, pt. II, § 4-503 (f), at 126.

27. *Id.*, § 4-503(c)(3), at 125.

to bankrupts? Surely there is little doubt whether the government or the less affluent consumer is better able to absorb these costs.

But if we put the issue of exemptions in these terms, we might want to examine some other questions. First, do the exemption provisions represent a logically designed welfare program? It would appear that the class of recipients is at the same time both underinclusive and overinclusive. On the one hand, it fails to reach all persons who are in serious financial difficulty, for many—and perhaps most—of these never get into the bankruptcy system. On the other hand, it includes persons who do not particularly need further assistance once the major impediment to their financial stability—their debts—has been eliminated. The persons in this group include those who earn adequate incomes and are fully capable of meeting their recently reduced current expenses.²⁸ While I appreciate that there may be a heated debate about how large this group is, I would suggest that we would not operate a program of outright public grants that included them.²⁹ The second question is perhaps more basic: Why should we not rely upon our general programs of public assistance to provide for the truly desperate individuals who appear in bankruptcy court? While I have fundamental objections to our present approach to welfare, existing programs at least employ somewhat more rational criteria for identifying need than those which are used to determine access to the bankruptcy process. If someone who is bankrupt can establish that he qualifies under the existing arrangements, benefits are available. But the fact of bankruptcy is not enough in itself. As for the future, it seems sensible to address the question of welfare reform directly and not complicate the problem with further haphazard responses.

28. See note 10 *supra*.

29. Another problem with the exemptions is that a debtor's access to them is not based strictly on need, but rather on whether he owns assets of the type identified in the various statutory categories. This feature can have a marked discriminatory effect. Imagine a debtor who has foregone opportunities to purchase a home, expensive personal effects, and the like in order to finance a business venture. In the event of bankruptcy he will have very little with which to make his fresh start, even if he has acquired some equity in his business assets. Yet his need may be as great as that of another debtor who chose to invest in a residence, household furnishings, and other assets within the categories of exemptions.

Further discrimination results from differences in the information that debtors have about how the exemptions operate. Most debtors are probably honest—some would say ill informed—and the mix of assets at bankruptcy reflects no conscious effort to take advantage of the exemptions. However, some clearly take a different approach. One of the more interesting sessions in the 1975-76 bankruptcy hearings touched on this problem. The issue was whether it was proper for debtors to convert their assets from nonexempt property to exempt property on the eve of bankruptcy. Two bankruptcy judges expressed the views that such conduct was "outrageous," that it "shocks one's conscience," and that it was tantamount to fraud. *1975-76 Bankruptcy Hearings, supra* note 1, pt. 3, at 1357, 1356. An attorney with a large debtor clientele expressed a different view. He suggested that he would be susceptible to a suit for malpractice if he did not counsel his clients to make such conversions. He also thought that the practice was desirable, because it gave meaning to the concept of a fresh start. *Id.* at 1351, 1350-58.

CONCLUSION

As the foregoing would indicate, I do not see compelling reasons for public subsidization of transfers such as those attempted in the proposed bankruptcy revisions.³⁰ Neither am I warmed by the thought that these might be paid for by a narrow class of debtors. There is another option, but it is clear to me that it will not be discussed until the point of Dean Meckling's paper gains wider appreciation.

Some may make the point that we currently have scant evidence that the less affluent, rather than all, credit users will bear the costs of bankruptcy or that those costs are significant. As earlier indicated, I concede the correctness of that proposition. However, I think we should recognize why there is no evidence. The reason, of course, is that the question has not been asked, at least not in a systematic fashion. To the extent that our bankruptcy policy is shaped without regard to the costs and without concern for who will bear them, its impact is going to be, at a minimum, uncertain and, at worst, unexpected. It seems to me we can do better.

30. Because I dismiss the notion of governmental subsidies for other reasons, I have not addressed the question of how such grants might affect the respective incentives of creditors and debtors. Large subsidies coupled with reduced exemptions presumably would cause creditors to make loans to persons who could not otherwise afford them. Whether small grants would have any significant effect is less certain. Other issues arise when we look at the debtor's incentives. If we subsidize the debtor, we may encourage him to go through bankruptcy in situations in which he otherwise would not. But don't the present exemptions already have that effect? If we could somehow use the subsidies to offset existing exemptions dollar for dollar, there might be little change in the debtor's attitude towards bankruptcy.