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THE PHILOSOPHY OF BANKRUPTCY — A RE-EXAMINATION

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Whatever may have been the role of bankruptcy in other countries, its firm place in the Anglo-American economic society began in the first half of the sixteenth century.[1] The pressures bringing this institution into general use resulted from the credit dealings of merchants and traders, the only groups making use of credit at this early time.[2] It is not surprising, then, to find that the situation designated by the term "bankruptcy" evolved from *banca rupt* or broken bench, the symbol of the insolvent merchant. For many years bankruptcy was available only to, or against, those designated as merchants.[3] As other groups began to use credit, the scope of bankruptcy extended until all persons may now take advantage of its processes. In recent years the institution has more extensively been used by the consumer class as a result of the shifting of credit buying to this class.[4] This shows that the need for bankruptcy processes shifts with the changing major credit use and these processes should be examined and readjusted with this in view. In England the major credit relationship involved in bankruptcy is among the merchant class composed mainly of small shopkeepers and contractors, and the bankruptcy law there

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1. See Bankruptcy, 1542, 34 & 35 Hen. 8, c. 4; 2 HALSBURY, LAWS OF ENGLAND 251 (3d ed. 1953); JENKS, A SHORT HISTORY OF ENGLISH LAW 382 (5th ed. 1938).

2. "Where divers and sundry Persons craftily obtaining into their Hands great Substance of other Mens [*sic*] Goods, do suddenly flee to Parts unknown, or keep their Houses, not minding to pay or restore to any [*sic*] their Creditors, their Debts and Duties, but at their own Wills and Pleasures consume the Substance obtained by Credit of other Men, for their own Pleasure and delicate Living, against all Reason, Equity and good Conscience . . . ." Preamble to the First Act in England, Bankruptcy, 1542, 34 & 35 Hen. 8, c. 4; 1 POLLOCK & MAITLAND, THE HISTORY OF ENGLISH LAW BEFORE EDWARD I 467 (2d ed. 1923).

3. Bankruptcy Act, ch. 19, §1, 2 Stat. 19 (1800); 13 HOLDSWORTH, A HISTORY OF ENGLISH LAW 377 (7th ed. rev. 1952). Distinction between traders and non-traders abolished in Ireland. Bankruptcy Amendment Act, 1872, 35 & 36 Vict., c. 58, §17 (Ire.).

4. Of the total 155,493 bankruptcies in the United States in the fiscal year 1963, 89.5% were employees and others not engaged in business. [July 1962-June 1963] ADMINISTRATIVE OFFICE OF THE UNITED STATES COURTS TABLES OF BANKRUPTCY STATISTICS 5.

is geared to that relationship.[5] As credit is increasingly extended to the consumer class, the bankruptcy process in England will in all probability recognize the change in its bankruptcy base and the new needs that enter into the institution. In the United States the major concern of students of bankruptcy is to follow the new consumer credit volume, which in all probability will continue to increase steadily. Thus, bankruptcy law, based upon credit between merchants, is out of touch with an economic system in which most of the relevant economic and social problems develop out of consumer credit.

In its inception, the need for bankruptcy legislation was confined to the merchant class. Its compelling force, however, was the welfare of the creditor not the debtor. The first bankruptcy process, then, was concerned with the protection of creditors and no concern was evidenced over the plight of the debtor.[6] In the scheme of sixteenth century bankruptcy provisions there was no process by which creditors, as a group, could seize and distribute ratably among themselves the assets of a debtor. Each creditor was left to his own devices such as seizure, execution, and body imprisonment, with the inevitable competition among them in the race for collection of their accounts. The processes available to the creditor for the discovery of assets were inadequate and absconding debtors were too common.[7] It was to be expected, then, that the first legislation, being concerned only with the recovery by merchant creditors, was designed to give creditors the machinery for seizing and distributing ratably the debtor's property. The debtor himself was condemned and no consideration was given to the situation that resulted from the seizure of his property. The compassionate concept of discharge gradually seeped into the minds of legislators many years later.

From this phase of bankruptcy, which was concerned only with seizing assets and distributing the proceeds ratable among the creditors, a new concern and attitude towards the debtor gradually developed. In the beginning of the eighteenth century the debtor was at last recognized in English legislation when it provided a narrow and well-guarded path to the debtor's discharge of his debts.[8] This

5. In the fiscal year of 1962 there were 4,145 bankruptcy estates administered in England and of these approximately 90% were in small business not wage earners. See [July 1961-June 1962] GR. BRIT. BD. OF TRADE BANKRUPTCY ANN. REP. Table IV, at 14.

6. See authorities cited note 2 *supra*. The early bankruptcy laws made no provision for discharging the debtor from his debts. See MACLACHLAN, BANKRUPTCY 88 (1956).

7. JENKS, *op. cit. supra* note 1, at 382.

8. See Bankruptcy Act, 1711, 10 Anne, c. 15; "The early eighteenth century is remarkable for the first sign of any relenting from the pitiless severity of its predecessors towards the unfortunate merchant." JENKS, *op. cit. supra* note 1, at 383.

heralded the gradual relaxation of the coercive, unrelenting, severe attitude toward the bankrupt, and most of the general legislative revision in England and in the United States since then has liberalized and humanized its discharge provisions.[9] In England, the discharge is still quite charily given,[10] but in the United States the compassionate statutory law of discharge[11] is outrun by the more compassionate judicial and administrative process that applies to it.[12]

The change in attitude from one that considered bankruptcy as a distributive process for the benefit of creditors to one that included a concern for the debtor and his rehabilitation did not come primarily from a pious attitude of forgiveness. Rather it came from a practical realization that a hopeless, unrelievable financial situation leads to a very costly social situation with its resulting relief costs, suicides, and criminality concomitant to financial despair. Although there are more elements present in England requiring a change, they are not as evident as in the United States.[13] In all probability changes will be more evident as the need for England's bankruptcy processes shifts more and more to the consumer class as is now the case in the United States.

As institutions shift their attention from one problem to another, new problems are created by the shift. This is reflected in the change in the direction of our bankruptcy laws from a sole concern for creditors to perhaps a major concern for the debtor. The problems that follow the liberalization and availability of bankruptcy and discharge are many. This philosophy of bankruptcy that is based upon

9. Note the change in attitude toward discharge in the following: Bankruptcy Act, ch. 19, §§34, 36, 2 Stat. 30 (1800); Bankruptcy Act, ch. 9, §§4, 12, 5 Stat. 443, 447 (1841); Bankruptcy Act, ch. 176, §29, 14 Stat. 531 (1867); Bankruptcy, 1542, 34 & 35 Hen. 8, c. 4; Bankruptcy Act, 1869, 32 & 33 Vict., c. 71, §48; Bankruptcy Act, 1883, 46 & 47 Vict., c. 52, §§28 (1), 30 (1).

10. In the fiscal year of 1962, 4,145 bankrupt estates were administered. During that year only 583 applcations for discharge were made. Of these, 7 were granted unconditionally, 83 granted with conditions, 105 granted subject to suspension and conditions, and 45 refused. [July 1961-June 1962] GR. BRIT. BD. OF TRADE BANKRUPTCY ANN. REP. Table VII, at 24. The number of estates administered in 1963 was 3,934. There were 676 applications for discharge and 8 granted unconditionally. In fact these figures are misleading unless it is understood that many discharges are given subject to very minor conditions or suspensions. [July 1962-June 1963] GR. BRIT. BD. OF TRADE BANKRUPTCY ANN. REP. Table VII, at 7, 30.

11. Bankruptcy Act §14, 52 Stat. 850 (1938), 11 U.S.C. §32 (1958), as amended, 74 Stat. 408 (1960), 11 U.S.C. §32 (Supp. V, 1964).

12. In the United States discharges were denied in less than 1% of the total bankruptcy cases in the fiscal year of 1963. See [July 1962-June 1963] ADMINISTRATIVE OFFICE OF THE UNITED STATES COURTS TABLES OF BANKRUPTCY STATISTICS Table F 4a.

13. See discharge decrees in the Bankruptcy Discharge Section of any London Gazette, a semi-weekly report.

a process in which an honest debtor, overburdened with debt, may make his assets available for distribution equitably among his creditors, and thereafter be released from his debts for a new start in life, is, of course, subjected to the usual human frailties. There may be tendencies for certain debtors to seek to be absolved by the bankruptcy process as an "easy way out" before their financial situation warrants it. Others may be disingenuous in the disclosing of assets in order to get the benefit of the process without the shedding of assets for distribution to creditors. The seriousness and currency of these evils, or the fear that they may become so, should determine the degree of the screening to which applicants should be subjected and which is thought to be required in the bankruptcy process itself. The whole bankruptcy process in England is closely observed and disciplined by full-time government officers and their staffs,[14] while in the United States there is very little machinery for screening the debtor and his use of the bankruptcy process. The major burden in the United States is thrown upon creditors, who evidence little interest in the ostensible small asset debtor. The argument in favor of a staff for the purpose of carefully investigating and supervising the bankrupt is usually premised on the benefit to creditors and to society, that is, the recovery of assets that would otherwise be improperly retained by the bankrupt and the disciplining effect upon the bankrupt of close supervision. It would seem, however, that any extra assets recovered by the policed process would be slight and the disciplinary process questionable. Thus, these premises may be open to careful consideration in determining bankruptcy needs in the future.

In the past the law of bankruptcy has been intended to punish and deter, much as criminal law was fashioned. In early England, bankruptcy was quasi-criminal[15] and is still so considered by many. In modern England a bankrupt is disqualified from most government positions and other positions of trust.[16] In the United States, no disqualifications result from bankruptcy and while one may become somewhat stigmatized as a result of bearing the label of a bankrupt, this stigma is becoming of diminishing social importance. Any

14. The Board of Trade closely supervises the bankruptcy process in England. An official receiver and his staff police the process and take an active part in it. They are full-time, salaried officials. See 2 HALSBURY, *op. cit. supra* note 1, at 364-66. For example, in Sheffield, the organization supervising the bankruptcy process includes one official receiver, two assistant official receivers, eight examiners, one executive officer, five clerical officers, two assistant clerical officers, and five typists. The Sheffield information was furnished the author by Mr. Morris, the Inspector General in Bankruptcy.

15. 2 HALSBURY, *op. cit. supra* note 1, at 251.

16. *Id.* at 351-52.

philosophy of bankruptcy that is based upon punishment and deterrent will be a harsh one, resulting in civil disqualifications, harsh debtor examinations, and restricted discharge features. It is questionable whether any individual, in planning his economic life, does so thinking of the cruelty of the bankruptcy process. The first realization of the features of any bankruptcy law comes when one is well mired in his financial morass. In fact, a severe bankruptcy law, coming to the attention of the debtor in financial trouble, only causes him to continue to grasp at straws while miring himself deeper and involving more and more creditors, until the inevitable financial crash is complete with its resulting despair. To punish a bankrupt by refusing to discharge him from his debts only prolongs his state of hopelessness from which so many social problems develop. The philosophy of bankruptcy, then, should not be based upon penalty or deterrent, but upon rehabilitation. With this as a base, any resulting law will be more lenient in its discharge provisions. A lesson from a similar change in the philosophy of criminal law should be taken here.

In the process of bankruptcy, which is the collecting of assets, the distribution of them to creditors, and the granting of a discharge, the underlying justification for a discharge is the forthrightness of the debtor. The question whether or not a debtor has been forthright may be approached from two different views evidencing the philosophy of those espousing the view. One view is to presume the debtor forthright and the other is to put him to its proof. In the bankruptcy proceedings, financial transactions, which occurred long before the initiation of the proceedings, are examined in retrospect. These transactions seem to have an evil pallor in the light of later financial collapse and they cannot adequately be explained if proof is required. On the other hand, if the bankrupt's forthrightness is presumed, the proof of the unforthrightness of transactions is on others. As the United States Bankruptcy Act is applied, a strong presumption of the honesty and forthrightness of the bankrupt is raised.[17] The opposite is true in the United Kingdom; the strong presumption is that a financially embarrassed debtor is or was at fault, and he has the heavy burden of proving sufficient facts to overcome the presumption.[18] This results in few discharges in England,[19] while in the United States discharges are granted almost automatically.[20] Although

17. Bankruptcy Act §14, 52 Stat. 850 (1938), 11 U.S.C. §32 (1958), as amended, 74 Stat. 408 (1960), 11 U.S.C. §32 (Supp. V, 1964). Referees generally require strong proof upon which to deny a discharge and usually no attempt is made to produce it.

18. See 2 HALSBURY, *op. cit. supra* note 1, at 517-34.

19. See authorities cited note 10 *supra*.

20. See authorities cited note 12 *supra*.

this generosity in discharges in the United States may reflect the underlying attitude of those who administer it, this result is certainly facilitated by the initial presumption favorable to the bankrupt and the lack of active interest on the part of creditors to offset this presumption.

Not only has the philosophy of bankruptcy softened in its treatment of debtors, but the changing attitude in the United States toward favoring the debtor and his relationship to creditors has changed. These attitudes have indirectly influenced the function of bankruptcy law. This function is influenced by the concept of "exemptions" that determines the minimum assets necessary to sustain a man and his family and that may not be seized by his creditors.[21] This concept has expanded tremendously in the United States, thus saving the debtor from being reduced to utter poverty by the taking of these necessities to satisfy creditors. A bankruptcy law that recognizes liberal exemptions must be evaluated with this in mind. The bankruptcy law of the United Kingdom provides for extremely small exemptions.[22] In practice, however, oversights are intentionally made by compassionate administrators. This humanizes and modernizes an admittedly harsh and outdated law. It would seem that a bankruptcy process in which high exemptions are granted will not necessitate the close supervision that may be required in the low exemption jurisdiction because fewer bankrupt estates would have nonexempt assets available to satisfy the claims of creditors.

As the process of bankruptcy becomes more and more an institution for the relief of the small consumer debtor, and as it becomes more favorable to him by the liberality shown in the granting of exemptions and discharge, a new evaluation by creditors may be needed. This may result in a request for a stricter policing of the debtor in bankruptcy by a government agency created for this purpose, or the policing of the credit and bankruptcy process by the creditors themselves. It does not seem that the average small consumer-debtor alone is to be condemned for his overpurchasing, but much of the blame may be placed on easy credit, discount paper, and high-pressure and commission-type selling in which the seller may impose his will upon the gullible wage earner. It may be that self-policing in the competitive sales market is impossible, but that does not justify a conclusion that stricter policing in the bankruptcy process is unnecessary.

In conclusion then, it seems that the need for the future function of bankruptcy will be to alleviate the critical financial situation into

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21. Bankruptcy Act §6, 52 Stat. 847 (1938), 11 U.S.C. §24 (1958); Joslin, *Debtors' Exemption Laws*, 34 IND. L.J. 355 (1959).

22. See 2 HALSBURY, *op. cit. supra* note 1, at 410, 432.

which a very small percentage of the small consumer class will find itself as a result of the expanding liberal credit given to it. In the bankruptcy process, the discharge will be the most important feature and this should be liberally granted. Presumptions of honesty should be extended to the bankrupt debtor, and some of the blame for the insolvency must be borne by the creditor class. A penalty or disability imposed in order to deter the debtor's use of the relief of the bankruptcy process is ineffective and, in fact, tends to drive the debtor deeper into financial catastrophe before the inevitable bankruptcy relief is elected by or is forced upon him. The process of distribution of assets among creditors will become a less important phase of bankruptcy because the volume of bankruptcies will be made up of the small consumer who benefits most by exemptions. Any effective policing of the bankruptcy process can be justified only on moral or ethical grounds and not on the grounds of financial return from that policing. One might say that the controlling philosophy will be "let the credit seller beware."