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## FOREWORD

### INTRODUCTION

In July 1970 Congress established the Commission on the Bankruptcy Laws of the United States for the purpose of analyzing, evaluating, and re-drafting the Bankruptcy Act.<sup>1</sup> Three years later the Commission published its report.<sup>2</sup> The report included an evaluation of the existing bankruptcy law, the text of a proposed statute, and a number of detailed studies that had been prepared under the Commission's auspices.<sup>3</sup> The proposed statute was introduced in both House and Senate in 1973.<sup>4</sup> Between 1973 and 1978 an alternative bill, drafted by the National Conference of Bankruptcy Judges, was introduced;<sup>5</sup> in the Ninety-fifth Congress a single bill<sup>6</sup> was substituted in the House for the two bills; that bill was amended<sup>7</sup> and favorably reported by the Committee on the Judiciary.<sup>8</sup> However, an amendment approved during debate in the House in October 1977 caused the bill to be withdrawn for further consideration in committee.<sup>9</sup> In February 1978 the bill was again considered on the floor, and the amendment passed in October was rejected.<sup>10</sup> Three further amendments were adopted, among them an amendment forbidding discharge of federally insured or guaranteed student loans for five years after they become due.<sup>11</sup> In this form the bill was finally approved by a voice

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1. Act of July 24, 1970, Pub. L. No. 91-354, 84 Stat. 468.

2. REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. DOC. 137, 93d Cong., 1st Sess. pts. 1, 2, 3 (1973) [hereinafter cited as REPORT OF THE COMMISSION].

3. For a brief history of recent developments in bankruptcy reform, see AMERICAN ENTERPRISE INSTITUTE FOR PUBLIC POLICY RESEARCH, BANKRUPTCY REFORM (1978).

4. H.R. 10792, S. 2565, 93d Cong., 1st Sess. (1973).

5. H.R. 16643, S. 4046, 93d Cong., 2d Sess. (1974). In the 94th Congress the Commission bill was reintroduced as H.R. 31 and S. 236; the judges' bill was simultaneously reintroduced as H.R. 32 and S. 235.

6. H.R. 6, 95th Cong., 1st Sess. (1977).

7. The amended bill was introduced as H.R. 7330, 95th Cong., 1st Sess. (1977), and further amended as H.R. 8200, 95th Cong., 1st Sess. (1977).

8. HOUSE COMM. ON THE JUDICIARY, BANKRUPTCY LAW REVISION, H.R. REP. NO. 595, 95th Cong., 1st Sess. (1977).

9. See 123 CONG. REC. H11,732 (daily ed. Oct. 28, 1977).

10. See 124 CONG. REC. H478 (daily ed. Feb. 1, 1978).

11. H.R. 8200, 95th Cong., 1st Sess. § 523 (8), 124 CONG. REC. H466-72 (daily ed. Feb. 1, 1978). For a similar provision see Act of Oct. 12, 1976, Pub. L. No. 94-482, § 127, 90 Stat. 2141 (codified at 20 U.S.C. § 1087-3).

vote.<sup>12</sup> A parallel bill, differing in important respects, has been introduced in the Senate.<sup>13</sup> The eventual outcome of the lengthy legislative process is uncertain, but the bill finally adopted will probably contain many of the provisions of the versions considered to this date.

What will be the economic effects of the reform in bankruptcy law? Without knowing its final form we can give no conclusive answer. Economic analysis can, however, be applied to predict the consequences of alternative provisions in the pending bankruptcy-law proposals. Studies sponsored by the Commission on the Bankruptcy Laws included analyses of certain tax-treatment questions<sup>14</sup> and estimates of the costs of administering alternative systems of bankruptcy proceedings.<sup>15</sup> Much attention has been given to the factors leading an individual or firm to bankruptcy.<sup>16</sup> Such analyses have been used to develop methods of predicting credit risk, which have practical value to lending institutions.<sup>17</sup> Many commentators have discussed the impact of proposed changes on the individual persons or firms undergoing bankruptcy.<sup>18</sup> In these and other ways matters connected with the economic consequences of bankruptcy reform have been addressed during the lengthy legislative debate.

In all of this discussion, however, certain fundamental economic aspects of the proposed reforms have been largely overlooked. For example, the implications of reform for the cost of credit have received almost no attention,<sup>19</sup> despite the fact that they are critical in an informed evaluation of the reform proposals. Furthermore, nearly all of the discussion about bankruptcy reform has taken place in the context of the bills submitted by the Commission, the

12. See 124 CONG. REC. H478 (daily ed. Feb. 1, 1978).

13. S. 2266, 95th Cong., 1st Sess. (1977).

14. Plumb, *Report on Federal Income Tax Returns and Liabilities in Bankruptcy*, in 3 REPORT OF THE COMMISSION, *supra* note 2; Plumb, *Report on Loss Carryovers and Debt Reduction in Proceedings under Chapters X, XI, and XII*, in 3 REPORT OF THE COMMISSION, *supra* note 2.

15. Dreyfuss, Greenwood, Fiorello, *The Impact of Proposed Changes in Bankruptcy Administration*, in 3 REPORT OF THE COMMISSION, *supra* note 2; Fiorello & MacInnes, *An Application of Automation to Bankruptcy Administration and Processes*, in 3 REPORT OF THE COMMISSION, *supra* note 2.

16. See, e.g., D. STANLEY, M. GIRTH, V. COUNTRYMAN, G. JANTSCHER, W. LAW, V. ROSENBLUM, & M. SHIMM, *BANKRUPTCY: PROBLEM, PROCESS, REFORM* 24-36, 41-69, 107-117 (1971) [hereinafter cited as STANLEY & GIRTH].

17. A well-known example is E. ALTMAN, *CORPORATE BANKRUPTCY IN AMERICA* (1971).

18. See, e.g., Coogan, Broude, & Glath, *Comments on Some Reorganization Provisions of the Pending Bankruptcy Bills*, 30 BUS. LAW. 1149 (1975); Shuchman, *An Attempt at a "Philosophy of Bankruptcy,"* 21 UCLA L. REV. 403 (1973); Subrin and Rugheimer, *A Statistical Study of One Year of Federal Bankruptcy Cases in Massachusetts, with Emphasis on the Bankruptcy Bar and Examination of the Impact of Proposed Bankruptcy Acts*, in *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 and 2d Sess. at 1142, 1172 (1976); STANLEY & GIRTH, *supra* note 16, at 41-69.

19. They are briefly mentioned but not analyzed at any length in the Brookings Institution study, STANLEY & GIRTH, *supra* note 16, at 39. Mention can also be found at points in the voluminous testimony flowing from the hearings on the several reform bills, but no systematic analysis has been undertaken.

bankruptcy judges, and others. In that context some fundamental questions have gone unasked. The nature and importance of the restrictions that a uniform bankruptcy law places on contracts and, a more radical issue, the rationale for a national, government-administered bankruptcy system are prominent among the issues neglected as a result.

To explore these issues more deeply a seminar on the law and economics of bankruptcy reform was conducted in the spring of 1977 by the Law and Economics Center of the University of Miami School of Law. The seminar was sponsored by Liberty Fund, Inc., as part of its program. Thirty-one economists and law professors gathered for the seminar to discuss the economic implications of bankruptcy reform and to consider the role of the state in the bankruptcy process.<sup>20</sup> The present symposium is the printed result of that seminar, containing the central paper, four prepared commentaries, and an edited transcript of the general discussion that followed those five presentations. As the following pages will demonstrate, a good many topics lying outside the bounds of ordinary bankruptcy discussions were brought forth in the seminar. In this introduction to the symposium I mention only two of the most important issues raised by the authors of the five prepared papers.

## I

### BANKRUPTCY REFORM AND THE COST OF CREDIT

Included in the proposals for bankruptcy-law reform are a number of changes in the scope allowed to credit contracts. These changes may have been included in order to achieve what one seminar participant perceived to be an important purpose of consumer-credit laws, equity in the loan market. Whatever their rationale, by limiting the effective terms of loan contracts, these changes may have an impact upon the cost of credit. Much of the discussion during the seminar concerned various aspects of this possible effect of the reforms: Would the changes affect bankruptcy rates, the rate of bad-debt writeoffs, or the cost of credit? If the reforms increased lending costs, how would those increased costs be distributed among debtors and creditors?

Some argued that several provisions and practices in corporate bankruptcy proceedings favor debtors over creditors. For example, shareholders in chapter XI proceedings, along with the firm's management, may have an advantage over creditors because of the management powers they retain. When shareholders are left in control of an insolvent firm during a chapter XI proceeding, they have an incentive to make riskier policy decisions than they would otherwise, a fact which may lead to a transfer of wealth from creditors to debtor-shareholders. Moreover, it was argued that the valuation practices

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20. A list of the participants appears at the end of this Foreword.

of the Securities and Exchange Commission in chapter X proceedings tend to subvert the absolute priority rule, favor debtors, and, ultimately, raise the cost of credit.

Other participants offered various objections to this view of corporate bankruptcy. First, they argued that retention of the old management is not always opposed by creditors, who prefer dealing with the management they know to accepting the uncertainties of a newly appointed managerial group. Second, the empirical evidence on the distribution of assets between shareholders and creditors was questioned: the critics of that distribution were themselves criticized for citing only "horribles,"—that is, the few highly controversial or unsuccessful proceedings—and for failing to document the claim that the current distribution raises the costs of credit. Finally, some argued that the absolute priority rule is a legal convention that is open to change. In fact, they claimed, it may be desirable to qualify creditors' absolute priority in bankruptcy in order to reduce the shareholders' risk of total loss and thereby to attract investment in risky ventures. If this qualification of the absolute priority rule indeed leads to higher credit costs, shareholders may be willing to pay them.

Similar differences of opinion arose over personal bankruptcy as well. Several participants asserted that certain changes proposed for personal bankruptcy will make it less costly to the individual to elect bankruptcy. Under these proposals a smaller proportion of his estate will be taken in settlement of debts. Garnishment of his wages will be restricted or forbidden, debts obtained through misrepresentation will nevertheless be discharged, the minimum time between successive eligibilities for discharge will be reduced, and so forth. According to these arguments, relatively few proposed changes will work in the opposite direction, offsetting these reductions in the cost of bankruptcy election.

Lower costs of electing bankruptcy will increase the frequency with which bankruptcy is chosen, by this line of reasoning. More debtors will declare themselves bankrupt, obtain discharges, and begin the process over again. Some seminar participants pointed out that full discharge under bankruptcy may make credit easier for individuals to obtain than it would be if they still had heavy debt obligations on the books—yet another reason to expect an increase in the rate of bankruptcy declaration. Qualitatively, these participants argued, it is certain that lowering the cost of declaring bankruptcy will increase its frequency.

One result of an increase in the bankruptcy rate may be a higher rate of bad-debt writeoffs. If this were the only impact of the increase in bankruptcies, the cost of credit would be raised to offset higher bad-debt losses. In addition, lenders may respond to changes in the law by undertaking more extensive credit investigations and otherwise expending resources to reduce

expected losses. In this case bad-debt losses would not rise as much as they would if the bankruptcy-law reforms caused no changes in the behavior of lenders; but the cost of credit would still rise, because of the extra costs of credit investigations and the like. In all likelihood the outcome will be a mixture of these two: both bad-debt losses and the quantity of resources expended by lenders will rise. Both outcomes will raise the cost of credit.

What will be the impact of these cost increases? Proponents of the reforms embodied in pending legislation have implied in congressional testimony that reform can transfer wealth from creditors to debtors. Critics of the reforms contended at the seminar that such wealth transfers are unlikely, and that increases in credit costs will be passed through to borrowers. To the extent that credit-cost increases result from more extensive credit checks, they will be the result of the use of more real resources. In competitive markets the cost of resources used to produce purchased services are borne in full by the purchasers. Since debtors are the purchasers of credit, they will thus bear the costs of the resources used in lending, according to this view.

To the extent that increases in credit costs are the result of bad-debt losses, which require no additional real resources, their incidence will depend upon the elasticity of the supply of credit funds. The critics of the proposed reforms argued that if the supply is perfectly elastic (as they believe it is), and if creditors don't subdivide loan applicants into risk categories to which they lend on different terms, the full costs of increases in bad-debt losses will be borne by debtors as a group. The wealth transfer in this case will be, not from creditors to debtors, but from debtors who pay their debts to debtors who don't. If the supply is not perfectly elastic, by this reasoning, the costs will be borne at least in part by creditors. But only if the elasticity of supply is zero, the critics of reform contended, will the full costs of increases in bad-debt losses be borne entirely by creditors, and only then will the wealth transfer be entirely from creditors to debtors. Finally, to the extent that creditors can divide debtors into risk categories, the cost increases will be apportioned to the debtors whose risk is the highest—precisely those least able to bear them.

In summary, according to this line of reasoning, the net impact of the proposed reforms will be to reduce the cost of bankruptcy to the debtor. Lower bankruptcy costs will cause a higher rate of bankruptcy election by debtors; and that, in turn, will cause higher bad-debt writeoffs or more extensive screening of debtors by creditors, both of which will raise the cost of credit. And increases in the cost of credit will be passed to borrowers, frustrating the attempt to benefit borrowers through legal reform.

These arguments were attacked on methodological, theoretical, and empirical grounds. The arguments use the economic methodology of conditional expectations, and their final predictions therefore depend on satisfaction of the antecedent conditions. The antecedents in the analysis that predicts in-

creased credit costs as a result of the proposed reforms, it was argued, are inadequately analyzed and incomplete, in the sense of excluding factors that overwhelm those that are considered. For example, the reforms may only appear to create greater legal risk for lenders; that is, the reforms will change the risks written into law but may not create higher actual risk if they merely codify existing legal practice.

Going further, some participants suggested that the rational calculus of economic theory may be inappropriate to the prediction of the effects of legal reform. First, these participants argued that lenders and borrowers may not act rationally in their transactions with one another. A bankrupt borrower, for example, may be in too much personal turmoil or under too much pressure from creditors to undertake a cool assessment of the costs and benefits of various legal options. For this reason some participants questioned the prediction that legal reforms lowering the costs of bankruptcy will lead more borrowers to declare bankruptcy. Predictions based on the assumption that lenders act rationally were similarly questioned.

Second, it was objected that lenders' and borrowers' behavior, even if rational, can be explained but not predicted by the economic calculus. According to this view, the statement that economic agents seek to maximize utility is true a priori only because it is empty of content: its truth depends on the meaning of words such as "utility" rather than on real states of affairs. One must specify the arguments in lenders' and borrowers' utility functions before one can make substantive predictions of their behavior. Those making this argument questioned, on the one hand, whether critics of the reforms have given adequate consideration to nonpecuniary factors that influence behavior in financial markets and, on the other hand, whether the importance of those factors can be known before the actual effects of reforms are observed. For example, they challenged the assumption that the employees of lending firms maximize only profit rather than consider a combination of profit, habit, personal job security, and other, possibly unknown quantities. For this reason some participants doubted whether lenders will necessarily raise their interest rates or switch to other forms of lending, as was claimed by those predicting that such elasticity in the credit supply will shift any increases in lending costs to borrowers. Similar objections were made to predictions about the behavior of borrowers.

Finally, these participants offered a number of empirical observations to support their objections to assumptions implicit in the economic model. The wide district-to-district variations in the rate of election of chapter XIII plans were cited as evidence that factors not taken into account by the economic model are important in understanding and predicting the effects of changes in bankruptcy law. The wide variation among districts within New York State indicates that these variations cannot result entirely from differences in

applicable state law. The unchanged rate of bankruptcy in Colorado during a 23-month period when indigent bankrupts could avoid paying a fifty-dollar filing fee was cited as another example of the unimportance of the monetary costs of bankruptcy to the rate at which debtors take advantage of its provisions.

It was also noted that the rate of bad-debt writeoffs isn't strongly correlated with the rate of bankruptcy. If credit costs were to vary only because of differences in writeoff rates, this would mean that even if the reforms led to higher bankruptcy rates, the higher rate would not cause higher credit costs. Finally, critics of the economic model cited evidence that contractual waiver of the borrower's right to keep exempt property in bankruptcy, where permitted, has led to no evident change in the cost or availability of credit; nor has elimination of wage garnishment. Generally, they claim, the cost and availability of consumer credit does not vary with different state exemption laws.

In summary, according to this line of reasoning, the economic model that predicts increased credit costs and prices is inapplicable to that part of lenders' and borrowers' behavior which is irrational; the model can predict actual rational behavior only to the extent that it takes account of both pecuniary and nonpecuniary factors that affect the behavior of lenders and borrowers; ignorance of those nonpecuniary factors which are relevant to prediction of legal reforms' effects may make such prediction impossible; and the assumptions about these factors implicit in the economists' predictions are shown by past observation to be false.

## II

### CONTRACT AND THE ROLE OF GOVERNMENT IN BANKRUPTCY

From one point of view, a centralized, uniform bankruptcy law entails a set of restrictions on the contracts into which individuals can freely enter. The adoption of a uniform law imposes limits on contracts in the sense that it makes certain potential contract terms unenforceable. For example, if one reform provision is enacted, reaffirmation clauses in loan contracts will be unenforceable. Similarly, the statutory elimination of misrepresentation as a bar to discharge would prevent borrowers from agreeing with potential lenders to forego discharge if the information on which credit has been granted turns out to be false. Statutory asset exemptions are another example of legal limitations on contracts imposed by a uniform bankruptcy law.

Several seminar participants objected to these reforms on philosophical grounds, contending that the freedom to contract, like other freedoms, should be protected from undue infringements. These participants also argued that restrictions on credit contracts have undesirable effects on lenders

and borrowers. First, some terms that might be mutually acceptable to lenders and borrowers are precluded. Some borrowers may be quite willing, for example, to accept a wage-garnishment clause in loan contracts if it means the difference between qualifying for a loan and going without—or, the more likely alternative, paying a higher interest rate. The law against garnishment clauses tends to make loans riskier and thus raises interest rates; for the individual with little credit experience, a restricted income, but good employment prospects, the substitution of a garnishment clause for higher interest may seem a very desirable bargain. The same line of reasoning applies to restrictions on the assets that can be pledged, on the ability to waive discharge, on agreements that reaffirm obligations after bankruptcy, and—with only minor alterations—to the elimination of misrepresentation as a bar to discharge.

The second ill effect that these participants attributed to restrictions on credit contracts is an inhibition on innovation in contractual form. This can be illustrated by an example: It is not generally permissible to write a contract of self-indenture, and contracts specifying that an individual is to remain in a particular occupation or line of work are therefore unenforceable. For that reason, there has been difficulty in finding satisfactory surety for student loans: the major problem facing students who want loans to finance their educations is the provision of adequate collateral, and self-indenture proscriptions eliminate one asset from consideration. Indeed, bankruptcy declarations by student debtors who have offered insufficient collateral have been cited as notorious examples of abuse of the bankruptcy system. The special provisions dealing with student loans that have been attached to recent legislation reflect this concern. Participants in this seminar suggested that many of the contract restrictions in present or proposed statutes prevent students and their creditors from solving this problem by using the students' greatest asset—namely, their future income—as collateral. The costs of such losses in innovation, while exceedingly difficult to calculate, are nevertheless part of the price of restricting the right to contract.

Other participants defended the legal restrictions on contracts that are contained in the Bankruptcy Act and its proposed revisions. Some argued that restrictions of this kind are desirable to protect the poorly informed borrower from unwittingly compromising his rights in dealing with unscrupulous creditors. The restrictions were also defended as a means of protecting third parties, such as the borrower's family, from undue suffering under harsh terms the borrower may have accepted. Both of these points were sources of controversy. Opponents of these restrictions noted that poorly informed borrowers are already protected from unscrupulous creditors by the fraud statutes; proponents claimed that the creditor fraud in question is virtually impossible to prosecute under the fraud statutes, and that additional protection for the borrower is therefore desirable in bankruptcy law. Opponents of contract re-



restrictions characterized the extension of third-party arguments to intrafamily relations as an argument for theoretically limitless regulation of personal behavior, since virtually everything that people do has some third-party impact; third-party arguments were defended, however, on the grounds that the costs of third-party suffering should be internalized to the credit market rather than imposed on the public fisc, where the current welfare system—whether rightly or wrongly—would place them.

But the major defense of restrictions on the right to contract rested on a fundamental difference of values. It was pointed out that freedom of contract is only one of many competing values expressed in our legal system and ought not to be defended at the expense of all the others. If the enforcement of contracts is properly the exclusive domain of the state, certain kinds of contracts that would require actions by the state that are generally regarded as immoral should be forbidden. For example, the state is precluded from enforcing contracts that call for execution or imprisonment of defaulting debtors. The defense of other contract restrictions, it was claimed, lies in similar values that are accommodated at relatively little cost to the freedom of credit contracts.

Questions about the rationale for restricting contractual provisions led the seminar participants to a more radical issue: Why do we have a centrally administered, government-operated bankruptcy system at all? It might be that the costs of a centralized system, including the imposition of uniformity in contract terms as well as the direct administrative costs, outweigh whatever benefits flow from the centralized system. If so, it would be more economical to leave the enforcement of credit contracts and the settlement of disputes over them to the general court system, eschewing a federal bankruptcy act and its attendant administrative machinery.

Several arguments favoring centralization were advanced during the seminar. The existence of a uniform, centralized bankruptcy action insures that the actions of all creditors against a particular debtor will be unified in a single proceeding. Without the centralized system, a multitude of creditor actions would often take place, imposing unnecessary costs on all parties. There also are economies to be had in the administration of the debtor's assets if bankruptcy actions involving a single debtor are consolidated into a single proceeding. Further, it was pointed out that a single, standard bankruptcy proceeding imposes, in principle, limits on the actions creditors may take against debtors, and—again, in principle—gives creditors the assurance of uniform treatment.

All of these are reasons for resolving all matters involving a single debtor in a single proceeding, but not necessarily reasons for having a centrally established and centrally administered bankruptcy system. It was therefore argued further that a centrally established law of bankruptcy provides a framework

or set of rules within which credit matters can be settled without resort to the bankruptcy courts. The overwhelming majority of cases involving debtors unable to meet their obligations are settled out of court, and it was argued that the process of settlement depends to an important degree on the existence of a commonly known set of rules that governs such matters.

A national bankruptcy act does provide such a common set of rules, and that was conceded to be one of the strongest arguments in its favor. Still, it is conceivable that a common set of expectations for bankruptcy rules would emerge from a series of precedential cases, just as it has in personal injury cases.

#### CONCLUSION

The points just summarized by no means exhaust the range of issues addressed during the seminar. A number of additional arguments were presented both for and against the formal discharge of obligations in bankruptcy, for example. There was some discussion of the possibility that certain proposed changes—especially the encouragement of wage-earner proceedings (now included under chapter XIII)—would have the effect of reducing the cost of credit. The problems involved in valuing bankrupt firms and determining when an individual is actually insolvent were raised and discussed. The issues touched upon in this introduction and the numerous additional matters raised in the central paper, the formal commentaries, and the general discussion serve to extend the debate about the proposed bankruptcy-law reform into previously neglected but vitally important areas. More than that, they provide an additional and striking example of the importance and extent of the interaction between law and economics.

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