Commentary: Consumer Credit in the 1990s, Part Two - The Coming Bankruptcy Explosion and Its Implications for State Law

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Commentary: Consumer Credit in the 1990s, Part Two—The Coming Bankruptcy Explosion and Its Implications for State Law

By Alvin C. Harrell

I. Introduction

In the previous issue of the Quarterly Report, Part One of this Commentary noted that state laws and state-chartered lenders have become increasingly important in the delivery of consumer and commercial credit. Also as noted, this trend has developed despite widespread expectations that

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VI. Conclusion

The elimination of the federal common law D'Oench doctrine and the federal holder in due course doctrine serve to return banking law to the position of the original D'Oench, Duhme decision. The provisions contained in section 1823(e)(1) are sufficient to protect the interests of the FDIC and depository institution depositors. The FDIC and depositors will not see their claims diluted by side agreements or oral conditions that

will cause regulators to mis-judge the financial health of the depository institution. This protection is necessary to prevent abuse of the guarantee on deposits provided by the FDIC.

The claims blocked by the common law D'Oench doctrine that are not covered by section 1823(e)(1), on the other hand, do not require statutory intervention. Because of the addition of a statutory deposer preference rule, any claims against the bank for investor, tort or creditor actions would serve only to diminish the payoff to the other claimants of the bank, but will not diminish the interests of the FDIC or depositors. In addition, the common law doctrine does not aid the FDIC in its reliance on the books of depository institutions. Therefore, it is unlikely that the bank would have an incentive to fraudulently incur these claims, due to the existence of deposit insurance.

Murphy represents a sound analysis under traditional principles of federal law and regulation, and should be followed by other courts considering these issues.

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federal law and regulations would play a dominant role in the financial services arena. But will this reemergence of state law continue?

A number of factors might promote a reversal of this trend. For example, the upcoming 1996 elections may have an impact on the level of federal regulatory enforcement actions. After a difficult period in 1993-1994, over the past year and a half the federal regulatory agencies have been generally more user-friendly. That may be subject to change, and an upsurge in federal enforcement actions would tend to refocus attention on federal law and regulations. But it would require an enormous increase in such actions before the impact would surpass in importance the thousands of private litigators representing consumers in state courts on issues of state law. It is unlikely that increased federal enforcement actions, no matter how annoying (or even disastrous) for their unfortunate targets, will shift the fundamental trend toward the increasing importance of state law.

Another possible factor is the impact of federal preemption. As noted in Part One of this Commentary, federal preemption represents a threat to the viability of state law and regulation. However, the states have the ability to respond, and if they do so effectively there is every reason to expect that federal preemption alone will not doom the state consumer credit law system. In the past the states have been innovative in their responses to federal encroachment; this innovation has served the interests of consumers and the industry. There is reason to hope that this tradition will continue.

But there is another problem on the horizon that may not be so readily handled. The potential for a coming bankruptcy explosion.

II. Origins of the Problem

A number of factors seem to be coalescing to generate the potential for an explosion of consumer bankruptcy cases.

First, and perhaps most obviously, there has been a very large increase in consumer debt over the past two years. As noted previously in this journal, this has been accompanied by a dramatic federal regulatory shift, away from bank safety and soundness concerns and toward a focus on enhanced credit availability, roughly coinciding with the Clinton administration banking agency appointments. As the 1996 elections have approached this effect has accelerated; it would be fair to say that the Clinton administration has strongly supported an expansion of consumer credit over the past two years. No doubt this has been an important factor in maintaining national economic momentum, as discussed infra.

Another factor has been the shift to a lower wage, service-oriented economy. While the U.S. industrial economy has made something of a comeback since 1980, the fact remains that U.S. labor laws, environmental restrictions, taxes, and regulatory compliance costs, in conjunction with less expensive operating costs elsewhere, have resulted in a shift toward service jobs in the U.S., with resultant downward pressure on wages. For a number of years this trend has been mitigated by the increase in two-worker families, but this can only go so far in mending household budgets. It seems clear that increased consumer borrowing has been helping middle America compensate for a widening gap between income and expectations.

A third factor is the ease of modern bankruptcy and the lack of any resulting stigma. This trend began in concert with the Bankruptcy Reform Act of 1978, which was designed in large measure to make bankruptcy easier and more socially accep-

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2. See, e.g., John Carey et al., The Regulators Felt Themselves To the Wrist, Aug. 21, 1995, at 63-64 (Quoting official as saying that the 1997 election has added a new layer of unspoken constraints, "which are not new but which may have been overlooked")

3. An increase in federal bank regulatory actions could also accentuate the shift upward of state-chartered lenders. Although a shift to focus federal enforcement actions on state-chartered lenders could have a counterbalancing impact. See e.g., Jener Seiberg, U.S. Probe Focus on Home Lenders: Unraveling the Web, 47 Am. Bankr. May 28, 1996, at 16 (noting shift of thrifts' Department enforcement actions from banks to mortgage lenders). Jener Seiberg, Renegade Banks Struggle to Meet Spirit of New Laws, 47 Am. Bankr. May 21, 1996, at 1 (same). A number of states have recently taken steps to protect consumers from abusive practices. For example, the New York Attorney General has taken a series of enforcement actions against lenders who engage in predatory lending practices.

remains seemingly a long way from final enactment into law.\textsuperscript{18}

Rather than in the United States Congress, the principal action between the banks and insurance interests is now joined at the state level, as each jurisdiction, in its legislature and affected agencies, works in its own way to accommodate the sweeping changes dictated by the Supreme Court. Most likely some order and uniformity will gradually emerge: first, as national banks, emboldened by their litigation successes, press to enter the market; and later as state-chartered institutions push their legislatures and regulators to meet and better their federally chartered competitors. The threat of unfettered national bank competition is more likely to advance the industry-wide cause for expanded insurance authority for all banks—state and national alike—than any proposed federal scheme to re-instate state hegemony over insurance regulation under the banner of state's rights. Recent state actions—or their reactions to the Court—have opened new opportunities for many banks and insurers and may foreshadow similar market openings elsewhere.\textsuperscript{19}


19. As noted supra at note 11, the Texas Insurance Commissioners recently announced insurance procedures for banks to sell insurance in that state. Significantly, Commissioners Bonner acknowledged the authority of state-chartered banks pursuant to the parity provision of the Texas Constitution and state savings banks under state law to engage in small loan sales of insurance to the same extent as authorized by the Comptroller for national banks. Commissioners Bulletin No. B-4053-90 (June 29, 1990).

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Should the economy slow or slip into a recession, the result may be a bankruptcy explosion of epic proportions.\textsuperscript{7}

Perhaps this is always a risk in a modern economy based on credit and commerce, and is therefore no cause for special concern. But a combination of contradictory federal policy efforts, to encourage a massive consumer credit expansion and at the same time make bankruptcy more attractive, has created the ingredients for a potential economic crisis.

III. Implications for Creditors and State Law

One lesson demonstrated again and again over the past decade is that when federal policy makers create a crisis, the policy response will seek to shift the blame elsewhere. When federal policymakers and the national media "discover" the coming bankruptcy crisis (presumably some time after November 1996), one can presume that the search for blame will focus elsewhere. Other culprits will have to be found. It is quite possible, perhaps even likely, that these culprits will be deemed to include creditors and state consumer credit laws.

Creditors are an obvious target, since they extended the credit that will not be repaid. No doubt some of those who have been complaining about inadequate credit access will now blame creditors for providing too much credit.

State consumer credit laws are a less obvious target, but nonetheless may be at risk. Any time there is a national crisis, one can expect calls for a federal solution. A national bankruptcy crisis may also be viewed as a national consumer credit crisis, with resulting demands for federal solutions. The lack of substantive national consumer protection laws may be noted (most federal consumer credit laws being disclosure statutes) and decreed by media commentators.

National consumer creditors may well join this chorus, seeing an opportunity to eliminate any limits on federal preemption that remain after Smiley\textsuperscript{10} and to create a unified national consumer environment. This correlation of interests may pose a threat to state law and state-chartered lenders.

Obviously this scenario would endanger the traditional relationship between federal and state law. It could also doom the emerging state law financial services industry. This industry has been essential in filling the gaps left by a consolidating federal


10. See Smiley v. Citibank (South Dakota), N.A., 1996 WL 287009 (U.S. Court), June 3, 1996; See text of this Commentary, supra note 1.
a provision under the Virginia Securities Act that required securities brokers to maintain a full-time office in Virginia. The court found that the requirement was discriminatory in effect and thus applied the "strict scrutiny" standard. It found that the cost of maintaining a full-scale office was nearly $68,000 per year, thereby placing out-of-state brokers at a competitive disadvantage versus brokers headquartered in Virginia. It rejected the state's arguments that the statute enhanced investor protections by (1) giving Virginia residents a convenient location to review their accounts, (2) allowing them access to the brokers with whom they deal, and (3) providing State authorities access to brokers' records to investigate consumer complaints. In the court's view, investors who prefer face to face contacts with their brokers and a place to review their accounts could do business with Virginia brokers, and the access to records facilitated by the statute could be accomplished through a less discriminatory and burdensome mechanism, such as a requirement that brokers agree to provide records upon demand in the event of a complaint.

V. Conclusion

Based upon the foregoing authority, your authors believe there are strong Commerce Clause arguments for invalidating state laws requiring lenders to maintain a full-scale office, much less requirements that they conduct all or specified operations from such office. A lender's ability to attack local record-keeping requirements is substantially less clear, although a properly argued case should have considerable prospect for success.

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banking system. Indeed, this banking consolidation (and the resulting market gaps) have resulted in large measure from the burdens imposed by federal regulation of banking. If federal regulation of nonbank consumer creditors is expanded, a similar consolidation can be expected among state-chartered consumer lenders, to the detriment of consumer borrowers, financial competition, and local economies.

If anyone wonders what a substantive federal consumer credit law would look like, take a look at any federal bank regulatory manual or compliance guide, or the cases that have been decided under the federal Fair Debt Collection Practices Act. Then compare these to a state law like the Uniform Consumer Credit Code. For anyone who believes that simplicity and clarity in the law are important social policy objectives, the risks of federalization are obvious.

IV. Conclusion

The rapid expansion of consumer credit, a debtor-friendly Bankruptcy Code, and the prospects for a faltering economy suggest the possibility of a coming bankruptcy explosion. In response there may be calls for new federal consumer credit laws, aided by consumer lenders seeking a federal solution to the nonuniformity of state consumer credit codes.

The result may be heightened risk that the state consumer credit system will be federalized. This would reverse several years of expansion by state-chartered and state-regulated consumer lenders, who are filling market niches left underserved by a consolidating federal banking system, the new compliance costs and burdens resulting from federalization likely would mean the end of opportunities for small "mom and pop" financial services providers to fill local market niches, and would forever change the traditional legal environment for consumer financial services in the United States.

If state consumer credit law is to survive the 20th century, lenders, attorneys, and the states themselves will need to recognize the threats posed by the coming bankruptcy crisis and the continuing nonuniformity of state consumer credit laws. If the states do not anticipate and respond to these issues, others will.

Membership Information

The Conference on Consumer Finance Law was organized more than 70 years ago by leaders of the American Bar Association and the financial services industry. Membership is by invitation only, and requires sponsorship by a current member. Candidates should have demonstrable expertise in the field of consumer financial services, including but not limited to consumer credit, secured transactions, real estate mortgages, banking, bankruptcy or debtor-creditor law. If you would like to become a member or if you know another who meets these qualifications and would like to recommend him or her for membership in the Conference, please forward name and a summary of professional background, along with your recommendation, to the Editor of the Quarterly Report.

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