Commentary: The Need for Consumer Bankruptcy Reform

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By Alvin C. Harrell

I. Introduction

The Bankruptcy Reform Act of 1994 created the National Bankruptcy Review Commission (Commission) to consider and make recommendations for future Bankruptcy Code revisions. The Commission is scheduled to issue its report to Congress on October 20, 1997, and has begun to circulate some initial reports and papers describing the issues under consideration. This article discusses some of the issues that are under consideration by the Commission, including the reasons for the upsurge in bankruptcy filings and whether bankruptcy relief should be expanded.

II. The Purposes of Bankruptcy

Any discussion of bankruptcy reform should begin with consideration of the basic purposes of U.S. bankruptcy law. Unfortunately, despite decades of debate, there is little consensus regarding the intended and appropriate purposes of U.S. bankruptcy law. These purposes apparently include an orderly and ratable distribution of the value represented by the insolvent debtor’s unencumbered and underencumbered nonexempt assets, and a fresh start for the honest debtor who is unable to repay, but beyond this there is only limited agreement. Moreover, the optimal priorities of these recognized goals and the best means to achieve them remain contentious issues.

The effects of bankruptcy are more clear. Bankruptcy is designed to result in the discharge of liability for debt, and in some cases the nonconsensual modification of other contracts, liens and property interests; that is to say, among other things, bankruptcy law provides for a nonconsensual rearrangement of legal relations to favor certain private parties at the expense of others. Along with income taxes and government transfer payments, this is one of the most significant examples of wealth redistribution in the United States today. As a result, any expansion of bankruptcy relief inherently will mean a reduction in the effectiveness of private contracts and the ability of individuals to order their lives using contracts and private property.

This is not a power to be treated lightly. There is over a trillion dollars in consumer credit outstanding in this country. Changes in the law that impact this much credit even slightly could have significant consequences for the economy and for millions of Americans who de-
pend on reasonable access to credit to meet their recurring financial needs. Changes in the law that may impair this access may not be promptly corrected. Factors such as the alternatives available or in an action that policies designed to favor defaulting debtors may be pursued without cost to the intended beneficia-

It should also be recognized that dis- charge of indebtedness is not always the simple concept it appears to be. In years of tight bankruptcy law, your bank may have noted that many students are not comfortable with the abstract concept of a new deal. Clearly, there are many factors that can lead to a burdensome debt. However, those students may take a different view when confronted with specific instances where an innocent party has invested time, effort and money in reliance on a contractual promise only to see the asset unilaterally revoked by the filing of a bankruptcy petition.

An unforeseen bankruptcy filing may be precipitated by such events as the al-
gagement of a law firm to represent the debtor against the bank, temporary unemployment, or emergency medical bills. If there is a societal con-
sensus that debtors should be relieved of certain of these liabilities, be it. But there is no such rationale for simultane-
ously discharging liability to all other creditors, including those who did not participate in the filing and who relied on volunteered agreements entered into the requisite of the debtors. Perhaps there should be a more limited discharge pro-
nunciation, to statutorily protect creditors who relied on a voluntary exchange of value and did not participate in the bankruptcy filing.

The point is that discharge of liability for indebted debtors is a focus of the value of the bankruptcy process, but it is often quite differ-
ent. Abstractions based on academic stereotypes are an inadequate basis for analyzing changes in public policy, and should not be a basis for broadly expanding bankruptcy relief. Instead, specific bankruptcy and discharge eligibility and scope requirements should be statu-

![Image](https://via.placeholder.com/150)

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III. The Parties in Interest

From the debtor’s perspective, there are three major groups interested in the bankruptcy process and its outcome: Secured cred-
itors, administrative claimants including the debtor’s or trustee’s attorney and unsecured creditors. At popularly to pop-
ularity, bankruptcy is often a con-

![Image](https://via.placeholder.com/150)

**IV. Reasons for the Bankruptcy Explosion**

Consumer bankruptcies are increasing at a rate that distressed observers must surely consider alarming. It is noteworthy that these increases are not a result of a lessening quality of bankruptcy filings, but rather a genuine increase in the number of consumer bankruptcies.

The bubble is very much alive. The consumer bankruptcy filings nearly doubled between 1980 and 1987. While this increase may appear frightening at first glance, a closer examination reveals that the vast majority of these filings are by lower income families, who have seen their incomes shrink in real terms. The bankruptcy filings of the wealthy have remained stable over the same period. In fact, the number of high-income bankruptcy filings has actually declined.

Thus, the increase in consumer bankruptcies is not due to a decrease in the number of people who can afford to file. The increase is due to a combination of factors, including a decrease in the number of people who can afford to pay their debts, an increase in the number of people who are choosing to file for bankruptcy as a way to avoid paying their debts, and an increase in the number of people who are filing for bankruptcy as a way to avoid paying their debts.

In fact, the vast majority of consumer bankruptcies are filed by individuals with annual incomes below $20,000. This is a significant change from the past, when most consumer bankruptcies were filed by individuals with annual incomes of $50,000 or more. This change is likely due to a combination of factors, including a decrease in the number of people who can afford to pay their debts, an increase in the number of people who are choosing to file for bankruptcy as a way to avoid paying their debts, and an increase in the number of people who are filing for bankruptcy as a way to avoid paying their debts.

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V. Implications for Bankruptcy Reform

As noted above, the current consumer bankruptcy filing volume is being supported by federal policies that simultaneously encourage the expansion of marginal consumer credit and at the same time present bankruptcy as a nearly painless alternative to repayment of that debt.18

Aside from the question of whether this represents an optimal public policy combination, this is creating a perception among some private creditors that their assets are being used to fund the process. This perception is acute among consumer lenders, who provide the sources of credit used by many consumers to meet their recurrent financial needs. Many of these consumer lenders feel that they are not being fairly treated under current bankruptcy law. This perception is fueled by some obvious deficiencies in the current Bankruptcy Code and system, including its law payoffs to unsecured creditors.

With the consumer bankruptcy binge approaching $200 billion, it may become a political crisis point. It is important that these concerns be addressed in an effective manner. If not, the trillion dollar plus consumer credit market may be adversely affected, with consequences for millions of consumers and the entire economy.19

Fortunately, the current Bankruptcy Code contains numerous provisions susceptible to obvious improvement, if the goal is to reduce ambiguities, inefficiencies, and abuses. In the absence of a consensus regarding more fundamental issues, however, more sweeping changes are neither needed nor appropriate.

The Bankruptcy Review Commission has an opportunity to clarify this area of law at a critical stage in bankruptcy history, and perhaps help deal with an emerging bankruptcy crisis, if it can avoid the urge to promote social engineering in the guise of bankruptcy reform. Unfortunately, the early signs are not encouraging.

VI. The Commission Agenda

The Commission has articulated a series of "systemic problems" and resultant goals. These goals include: (1) increasing the likelihood that the cases will be treated alike; (2) providing a "more cost-effective, streamlined predictable system that better reflects lending practices in the 1990s"; (3) creating a "simplified system"; and (4) "making bankruptcy benefits available only to debtors who are legitimately in need of the bankruptcy system."20

While these goals are admirable in a broad sense, they are so general as to be meaningless as a guideline to statutory reform. For example, there is no debate over the need to accommodate debtors who are "legitimately in need of bankruptcy;" the question is how to define "legitimately" in this context. The Commission's "goals" do not address the crucial public policy issues that need to be considered in order to achieve a needed consensus on these important issues.

Another problem with the Commission's stated goals is the emphasis on a "cost-effective, streamlined, predictable,...[and] simplified (bankruptcy) system.21 Again, these goals are admirable in the abstract. However, in this context there is a risk that these goals will merely provide cover for an effort to "streamline" creditor and other legal protections out of the Bankruptcy Code. Obviously such protections add complexity and cost to bankruptcy cases; cases can be made simpler and cheaper by simply eliminating the rights of creditors (and any meaningful role for lawyers). But the Commission does not have a mandate to promote such a radical agenda under the guise of "streamlining" or other lefty-sounding goals.

The Commission's proposal to combine current Chapters 7 and 13 into a new "Basic Bankruptcy" chapter is but one example.22 Together with proposals to "do-link" bankruptcy remedies and creditor protections, this could provide debters or an expanded "menu" of options that would enable a debtor to combine the benefits of Chapters 7 and 13 without any of the current creditor protections. This could create a bonanza for consumer debtors. Mix in the option of an unlimited "strip-down" of unsecured home mortgages,23 plus expanded avoidance of liens on consumer goods in a "streamlined" administrative procedure,24 and the result would fundamentally alter our consumer credit system. This would not be bankruptcy reform, but a new and radical social agenda.

VII. Summary and Conclusion

Bankruptcy filings are increasing at an alarming rate. While this may reflect various societal factors, human nature does not change this rapidly and creditors are not more greedy or profiteering today than in the past. When economic and legal developments coalesce to create this kind of dramatic change, government policies are usually implicated, and that is the case here.

By simultaneously facilitating a consumer credit expansion and making bankruptcy more attractive for debtors, the federal government has created a bankruptcy boom that threatens private creditors, nondefaulting borrowers, and the national economy. The dangers are exacerbated by the perceived deficiencies and unfairness to creditors in the current Bankruptcy Code and process. It is essential that the Bankruptcy Review Commission address these issues, free from the stereotypes and political agendas that have previously plagued bankruptcy reform efforts and have contributed to the current problems.

Commentary: The 1996 Banking Law Institute—Quiet Before the Storm?

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If you would like additional information on these issues, the program materials for the 1996 Banking Law Institute are extensive and are available for separate sale at a cost of $125, postage included. Your EAS order (order@01850.00) or send your check to: The Conference on Consumer Finance Law, 530 S. Western, Oklahoma City, OK 73109.

Conference Publications Available for Separate Sale

Sub-Prime Mortgage Lending and Auto Finance
Feb. 8-9, 1996; $125

Consumer Protection, Debtor's Rights, and Creditors Remedies in the 1990s,
May 9-10, 1996; $75

Oil & Gas Law 1996: The Law of Oil and Gas Titles, Exploration, Production, Acquisitions and Finance,
May 16-17, 1996; $75

The 1996 Banking Law Institute,
Sept. 20-22, 1996; $195

Estate Planning and Asset Protection,
Oct. 3-4, 1996; $95

Real Estate Investment, Development Finance and Management,
Oct. 17-18, 1996; $95

Checking & Savings Accounts, Deposits, and Payment Transactions,
Nov. 8-9, 1996; $195

1995 Checking & Savings Accounts, Deposits, and Payment Transactions,
1995 Program Materials; $50 (or both the 1996 and 1995 program materials for $225)

For a list of Conference events and programs provided by the Conference on Consumer Finance Law, please visit our website at http://www.consumerfinanceconference.com.