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

Alvin C. Harrell, *Oklahoma City University School of Law*

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INDEX

Page

Symposium: Banking Law 1996

Murphy v. FDIC: Is the *D'Oench* Doctrine Doomed? 3
by David F. D'Alessandris

Competition in the Balance: The United States Supreme Court Approves Bank Sales of Insurance 17
by David W. Roderer

Electronic Banking—Smart Cards, Cyberspace and the Internet 22
by Dan L. Nicewander

The Bank-Customer Relation: States' Rights, Bad Press and New Law 32
by Peter G. Pierce, III

Key Issues and Considerations in Drafting Deposit Agreements and Funds Transfer Services Agreements for Financial Institutions 37
by R. David Whitaker

Payment System Issues—UCC Article 4A; Regulations J, S, and D 49
by Alvin C. Harrell

Update on FDIC Deposit Insurance Issues 60
by Andrew J. Pantos

A Summary of the New Texas Banking Act and Related Laws 69
by Sherry Castle Whitley

The Mexican Banking Crisis: Remedies and Opportunities 76
by Stephen L. Fluckiger

A Setback for National Banking: The 30-Mile Leap 84
by David W. Roderer

Plus:

Commerce Clause Limitations on State Laws Affecting Interstate Lending Programs 86
by Jeremy T. Rosenblum and Keith S. Marlowe

Commentary: Do Consumer Protections Help Uniform Laws Get Enacted? Are Consumer Protections Costs or Insurance? Is Consumer Credit Too Available? 90
by David B. McMahon

Commentary: Proposed Consumer Changes to Article 9 of the Uniform Commercial Code Would Adversely Affect Consumer Credit 92
by Richard B. Wagner

UCC Article 9 Drafting Committee March 1996 Meeting Considers Consumer-Related Collateral 95
by Alvin C. Harrell

Twenty Ways to Avoid Liability Under the Federal Fair Debt Collection Practices Act 109
by Alvin C. Harrell

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

(Continued on page 16)

The *Quarterly Report* is published four times each year. Please address all correspondence concerning editorial content to Professor Alvin C. Harrell, Editor, Consumer Finance Law *Quarterly Report*, The Oklahoma City University School of Law, 2501 N. Blackwelder, Oklahoma City, Oklahoma 73106.

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 depositor 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.

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

(Continued from page 2)

federal law and regulations would play a dominant role in the financial services arena.[1] 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.[2] That may be subject to change, and an upsurge in federal enforcement actions would tend to refocus attention on federal law and regulations.[3] 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.[4] 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.[5] 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 come-back 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 social stigma.[6] This trend began in earnest with the Bankruptcy Reform Act of 1978, which was designed in large measure to make bankruptcy easier and more socially ac-

(Continued on page 21)

1. Part One of this Commentary, *The Increasing Importance of State Law*, appears at 49 Consumer Fin. L. Q. Rep. 326 (1995). *See also* Christopher Rhoads, *State Charters Said to Be Gaining Popularity*, Am. Bank., May 10, 1996, at 6; James B. Arndorfer, *Nonbanks Found to Be Closing the Gap in Lending*, Am. Bank., May 6, 1996, at 15; Dwight Golann, Fred H. Miller & Alvin C. Harrell, *Introduction to the 1996 Annual Survey of Consumer Financial Services Law*, 51 Bus. Law. 825 (1996).

2. *See, e.g.*, John Carey, et al., *The Regulators Rein Themselves In*, Bus. Wk., Aug. 21, 1995, at 61-62 (Quoting an observer: before the November 1994 elections, federal agencies "reveled in nailing companies for trivial violations," but after that election the strategy shifted "to buy off the most vocal critics and head off dramatic reform.").

3. An increase in federal bank regulatory actions could also accelerate the shift toward state-chartered lenders, although a shift to focus federal enforcement actions on state-chartered lenders could have a countervailing impact. *See,e.g.*, Jaret Seiberg, *U.S. Probing for Bias in Home Lenders' Use of Brokers*, Am. Bank., May 28, 1996, at 1 (noting shift of Justice Department enforcement actions from banks to nonbank lenders); Jaret Seiberg, *Reno Praises Banks' Strides to Meet Spirit of Bias Laws*, Am. Bank., May 21, 1996, at 1 (same).

4. *See* Alvin C. Harrell, Commentary: *1995 Banking Law Institute Confronts Challenges to the Industry*, 49 Consumer Fin. L.Q. Rep. 238, 287 (1995).

5. The administration's fair lending and CRA initiatives being only one example. *See, e.g.*, Barton Crockett, *Bank America Subsidiary Thrives by Focusing on Minorities and the Poor*, Am. Bank., May 14, 1996, at 7 (noting that Bank America's community development bank is lending at a rate of $750 million per year). Other federal agencies, including the banking agencies and federal housing corporations (FNMA and FHLMC) have also followed the administration's lead in promoting credit availability over the past two years.

6. This has been noted previously in this journal. *See, e.g.*, Dale Ellis, *Introduction to the Symposium: Why Consumer Bankruptcies Will Continue Like a Plague—Structural Forces that Institutionalize Bankruptcy as a Way of Life in America*, 47 Consumer Fin. L. Q. Rep. 391 (1993); Lisa Fickenscher, *Lenders Circle Wagons to Help Slow Stampede Toward Bankruptcy Court*, Am. Bank., June 26, 1996, at 1, 16.

remain seemingly a long way from final enactment into law.[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 reinstate 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.[19]

18. *See, e.g.*, Bill McConnell, *Leach Bags Reg Relief For Modest Reform Bill*, Am. Bank., June 12, 1996, at 1.

19. As noted *supra* at note 13, the Texas Insurance Commissioner recently announced interim procedures for banks to sell insurance in that state. Significantly, Commissioner Bomer 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 town sales of insurance to the same extent as authorized by the Comptroller for national bnaks. Commissioners' Bulletin No. B-0043-96 (June 20, 1996).

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

(Continued from page 16)

ceptable.[7] Most of the subsequent Bankruptcy Code revisions up to 1994[8] were also intended in part to make bankruptcy more attractive for debtors. Bankruptcy scholars have done their part to emphasize the role of bankruptcy as a natural social safeguard.

These efforts have succeeded, perhaps beyond anyone's wildest expectations. Bankruptcy filings are up more than 30% over last year, and are running at a rate of more than one million per year. Bankruptcy has become almost a routine business strategy, and the consumer bankruptcy statistics speak for themselves.

Finally, one must note that the economic recovery since 1990 has lagged behind traditional recoveries in many important respects, and the economy has flirted with stagnation a number of times since 1989. Indeed, there appears to be an unusually close connection between this economic recovery and the expansion of consumer credit. It is probably fair to say that this recovery has been supported if not created by the dramatic expansion of consumer credit.

As a result, maintenance of economic growth has become dependent on a continual expansion of consumer credit, and in turn the ability of consumers to service that debt is dependent on a continuation of the resulting economic growth. As one of your author's academic colleagues recently commented, the result is an economic "house of cards." Should the economy slow or slip into a recession, the result may be a bankruptcy explosion of epic proportions.[9]

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 next 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 decried 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*[10] and to create a unified national compliance 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

(Continued on page 89)

7. As a small but telling example, the term "bankrupt" was changed to "debtor," apparently to help reduce the stigma associated with the label.

8. In 1982, 1984 and 1986.

9. There are disquieting indications in this regard. *See, e.g.*, Bernard Wysocki, Jr., *Missing in Action—About a Million Men Have Left the Work Force In the Past Year or So*, Wall Str. J., June 12, 1996, at A1; Karen Blumenthal, *Mortgage Delinquencies Are Climbing*, Wall Str. J., June 11, 1996, at A2; John R. Wilke, *People Are Spending Briskly, and Keeping the Economy Strong*, Wall Str. J., June 7, 1996, at A1; James J. Daly, *The Pressure Builds*, Credit Card Management, May 1996, at 54; Snigdha Prakash, *Mortgage Delinquencies Worse than 1st Report*, Am. Bank., June 21, 1996, at 16; *Record Number of Bankruptcies Filed*, 29 BCD No. 1 at 1 (June 18, 1996) (consumer bankruptcies up 26.7% in first quarter of 1996 compared to 1995).

10. *See* Smiley v. Citibank (South Dakota), N.A., 1996 WL 287709 (U.S. Code), June 3, 1996; Part One 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.[31] 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.[32] 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.[33] 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.[34]

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.

31. *Id.* at 1152.

32. *Id.*

33. *Id.*

34. *Id.*

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

(Continued from page 21)

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.

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