Bankruptcy Abuse
and Bankruptcy Reform

Douglas G. Baird

When the Framers debated the bankruptcy clause in Philadelphia in 1787, the only objection was that giving Congress the power to enact bankruptcy laws might lead it to impose the death penalty upon bankrupts, as had been done in England. This fear proved unfounded. Indeed, we have long viewed bankruptcy law as a vehicle for debtor protection, and perhaps the most prominent feature of our bankruptcy law is the discharge it provides. Much of the recent criticism of bankruptcy law has been that it provides individuals and corporations with too easy a way out of their obligations. Newspapers tell of individuals who live extravagantly and use bankruptcy to make their creditors pick up the tab. We also read of large, apparently healthy corporations, such as the Manville Corporation, that appear to file bankruptcy petitions to escape their obligations under state law. The debate now is not over whether bankruptcy law is too harsh, but whether it is too permissive.

Abuse of the discharge right by individuals and corporations presents two distinct problems. There are important differences between an individual and a corporation wholly apart from bankruptcy law. Perhaps most important, a corporation, unlike an individual, enjoys limited liability on its obligations. A corporation does not need bankruptcy to escape from them. It can simply dissolve under state law. In effect, it already has a discharge right. With or without bankruptcy, the creditors of a corporation that owes more than it has will not be paid in full. The issue when a corporation is in bankruptcy cannot be how much the corporation pays its creditors. The creditors will receive everything the corporation has. The problem is not how much to give them, but rather how to divide what there is among them.

An individual who enters a bankruptcy proceeding stands on a completely different footing. He does not enjoy limited liability under state law, and he cannot dissolve if times become hard. A right to discharge in bankruptcy is an insurance

*Mr. Baird is Assistant Professor of Law.*

\(^1\) See 2 Farrand, The Records of the Federal Convention of 1787, at 489 (1911). Whether the delegate who voiced this objection was correct in thinking that capital punishment had much to do with English bankruptcy law is, of course, another question.

\(^2\) Shareholders sometimes receive a small share of a reorganized company, but if the firm is insolvent they are not entitled to anything as of right.
policy. Because we have a right to discharge we have the assurance that no matter how bad our financial reverses, through natural catastrophe, bad luck, or simply bad judgment, we can pick up the pieces and start over again. A bankruptcy discharge protects human capital. After a discharge, a debtor no longer has the disincentives that come from the realization that working harder will bring benefits principally to his creditors and not to himself.

The contours of the discharge right are neither immutable nor clear cut. For example, many have found fault with the current law which gives the debtor not only the right to enjoy all his future earnings, but may also allow him the right to keep his home and his household goods, as well as the clothes on his back. Others argue that an individual ought to be able to waive his right to obtain a discharge on a particular obligation, although this creates the potential, at least in the context of extending credit to consumers, for overreaching (through fine print and otherwise). There is, however, the more basic question of whether granting individuals a right to discharge past indebtedness is still worth its costs.

Creditor practices have changed dramatically during the past several decades. Few of us who went to college and law school in the 1970s took very seriously Polonius's advice about never being a borrower.

If we had, we never would have gone to college, let alone law school. We were able to borrow in large part because of the promise of future earnings. If a discharge were freely available to us, many might opt for bankruptcy, and eventually education loans would be harder to come by. This concern prompted Congress to limit the right to discharge for some education loans. One might argue that this same concern justifies much broader limits on discharge.

Everyone from Visa to Marshall Field's relies upon an individual's future earnings more than did their counterparts several decades ago. The less creditors can rely on future earnings, the harder it will be for all of us (including the vast majority who will never file bankruptcy petitions) to obtain credit. Credit may not simply be more expensive. Those without assets might find themselves unable to obtain loans or even credit cards. Moreover, the creditors who discover that they will not be paid will not always be large financial institutions with deep pockets. Those who become creditors involuntarily (because state law gives them claims against those who ran them over with a car or sold them asbestos) will find themselves without recourse, even though the debtor might make enough in the future to pay some of it back.

Like any dramatic change in the legal order, however, the effects of abolishing the right to discharge are not easy to predict. The principal empirical study to date, commonly called the Purdue Study, was financed by consumer lenders and is badly flawed. It is difficult to know how many people who file petitions in bankruptcy would in fact repay money lent them if they were denied a discharge right. Under existing law, debtors can try to repay part of what they owe. Yet these court-approved efforts to reschedule debts frequently end in failure, even though the debtors who succeed prevent creditors from taking any of their assets. Repayment schedules imposed involuntarily might be even less successful.

If an individual had a predictable and consistent record of past earnings and steady fortunes, he probably would not be in bankruptcy. Individuals in bankruptcy have a hard time keeping their jobs even with a discharge. Moreover, keeping track of the hundreds of thousands who file petitions in bankruptcy, finding out how much they make and how much they should keep, and establishing some mechanism to account for changed circumstances are the ingredients of a procedural nightmare. The ability that debtors have shown over the years to rearrange their affairs so as to keep assets from creditors (either legitimately, such as by ensuring that wills are rewritten in favor of someone else, or illegitimately, such as by transferring assets to people or places where they cannot be found) compound all these problems.

We also have to remember that none of this matters very much for those who present the least sympathetic cases for discharge. Someone with an income of $15,000 who has gambled and snorted $100,000 away is never going to be able to repay his creditors in an era in which the consumer lending rate is above 15%.

For a discussion of the problems in the Purdue Study, see Sullivan, Warren & Westbrook, Limiting Access to Bankruptcy Discharge: An Analysis of the Creditors' Data (1983). Among many other problems, the sample does not seem representative, the response rate was low, and there are significant internal inconsistencies in the data that were gathered.

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that we can obtain credit is a subtle and delicate one. Restricting it (perhaps by tying the ability of the debtor to exempt property even more closely to his willingness to repay past obligations out of future earnings) may be in order. But we must act cautiously. Limiting a debtor’s right to future earnings may well not bring benefits worth its costs.

This subtle balance, however, is not at stake in the second kind of abuse of bankruptcy law that I have identified. When a corporation has more obligations than it can pay, our concern is not the corporation itself, but rather the rights of all those with claims (contingent or otherwise) against it. At least some (and usually most) people with claims against the company are not going to be paid in full. There is nothing that bankruptcy law can do to change this. What it can do, however, is ensure that no one gets an unfair advantage over anyone else and that the process is conducted in a way that protects the value of the firm’s assets while the rights to them are being sorted out. Properly understood, a bankruptcy reorganization has nothing to do with giving a “fresh start” to someone (or something) that has been unlucky. A discharge in this context is simply the natural consequence of reallocating shares in the firm to those who have claims against it. All those with claims against the old company receive in exchange for those claims new claims or interests in the reorganized company.

The Manville Corporation presents an unusual case. Its decision to file a bankruptcy petition was only part of a much larger dance. Manville enjoys the benefits of the halt the bankruptcy proceeding has brought to all the lawsuits against it, while at the same time it seeks to shift any liability it has to tens of thousands of victims of asbestosis from itself to insurance carriers or to the federal government. It is useful, nevertheless, to ask whether a bankruptcy proceeding would be appropriate if no one comes to its rescue and if its liability to victims of asbestosis will, as it alleges, ultimately be in the billions of dollars and, with its other liabilities, exceed its assets.

Under these assumptions, a bankruptcy proceeding offers creditors of Manville some notable advantages. A bankruptcy proceeding should see to it that the creditors (who include tort claimants) will get as much as there is, according to their nonbankruptcy priorities. At the same time, it should ensure that the company does not lose its value as a going concern, as might happen if thousands of creditors independently tried to make sure that they (rather than someone else) were paid.¹

One must, however, also weigh the disadvantages of allowing a corporation such as Manville to file a bankruptcy petition. The claim of a victim who does not yet even know he is a victim is hard to evaluate. One can argue that when Congress expanded the number of claims that could be heard in a bankruptcy proceeding, it did not intend that a bankruptcy judge would have to take into account in every case the torts a debtor may have committed by dumping toxic wastes, or selling defective products, or doing anything else that might later result in injury.⁶

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¹Deciding all the claims in a single forum may also bring economies of scale. The enormous expense of litigating tens of thousands of individual lawsuits could be largely eliminated if each claim were not separately adjudicated. There is the chance, albeit remote, that these savings will be so large that Manville, although unable to meet all its obligations outside of bankruptcy, will be able to meet them inside. If these claims cannot be consolidated under a single class action outside of bankruptcy, however, one can argue that they should not be consolidated inside of bankruptcy either.

²A district judge has, in fact, found that claims of those who have yet to come down with asbestosis are not cognizable under the Bankruptcy Code. See In re UNR, 29 B.R. 741 (N.D. Ill. 1983).