BANKRUPTCY AS AN ECONOMIC INTERVENTION*

LAWRENCE H. WHITE

Department of Economics, University of California, Los Angeles

Bankruptcy law is a system of interventionary legislation which interferes with the ability of individuals freely to establish the terms of loan contracts. It benefits the less prudent and less scrupulous borrowers — indeed may encourage their conduct — while making loans costlier for the honest and conscientious. Bankruptcy is defined as "that system of laws by which an insolvent debtor surrenders his property to a court which distributes the proceeds proportionately among his creditors and usually declares the debts discharged". It is a system which provides, in other words, for the coercive elimination of contractual obligations. There is no common law bankruptcy procedure; it is entirely statutory.

The earliest historical evidence of a bankruptcy law is in the Code of Hammurabi, the jurist-king of Babylonia who reigned in the 18th century B.C. Hammurabi provided for liquidation of the assets of the insolvent debtor and their distribution among creditors on a pro rata basis, very much like contemporary law.

In ancient Athens, the harsh criminal code of Draco in 623 B.C. considered default on debt a capital crime. The death penalty was usually waived, however, in favor of the sale of the debtor and his family as slaves, the proceeds to be distributed among the creditors. The alternative for the insolvent debtor was to flee the country, and this became a common practice. The Draconian Code was revised in 594 B.C. by Solon, who abolished servitude and the pledging of the person of the debtor as security. In exchange for the legal discharge of his debts, the bankrupt was to forfeit Greek citizenship for himself and his heirs.

Under the Roman Law of the Twelve Tables, drawn up in 451 B.C., the borrower again pledged himself as collateral. The creditors were not only empowered to sell or take the debtor into slavery, but as a final resort to divide the debtor's body into proportionate shares. The laws were mollified in 326 B.C. to make imprisonment for debt the rule. Under the Cessio Bonorum of Caesar's era citizens were exempted from imprisonment, but their debt was not discharged nor future earnings exempted from attachment. The discharge of debts upon the testimony of the debtor that he was insolvent was introduced by Justinian in 533 A.D. and immediately led to widespread fraud and perjury and total disruption of the credit market.

In medieval Italy, the law called for imprisonment of a merchant who failed to pay his creditors, and the sale of his property to cover the debt. If the sale failed to raise enough, and the creditors were unwilling to forgive the remainder of the debt, the merchant stayed in jail for a term and was usually expelled from the guild. In practice, however, the insolvent merchant would usually leave town. If he never returned, he was declared bankrupt in absentia, his property sold and distributed among his creditors. More commonly, friends of the bankrupt would contact his creditors and receive a temporary "safe-conduct", a grace period during which the bankrupt would return and negotiate settlement with his debtors. This was a system which depended upon private arbitration of claims, but it proceeded under threat of violation of contract by the debtor.

In England imprisonment for debt was instituted during the reign of Henry III, not to be repealed by Parliament until the 19th century. The debtor was regarded as a thief.

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first specific bankruptcy statute was established in 1542 under Henry VIII. This act dealt only with "involuntary" bankruptcy (in which creditors initiate legal action against the debtor) and applied only to traders and merchants. The delinquent debtor was incarcerated and remained behind bars until he had settled his obligations. It was the practice in England to distinguish bankruptcy law, which was only commercial, from insolvency law, which dealt with non-commercial debtors. This distinction was originally continued in America, as evidenced by the placement of the bankruptcy clause in the commerce section of the U.S. Constitution.

By the early 19th century English bankruptcy procedure was in shambles. Bankruptcy courts were largely bypassed in important cases, which were settled by private arrangements. Under the common law of private adjudication, creditors instituted attachment proceedings, and received compensation according to the priority with which they lodged their claims — i.e. according to whether they beat other creditors to the punch. Several historians have commented that anxious creditors thus may have occasionally forced liquidation where patience might have allowed repayment, in time, of the entire debt.

The law regarding insolvency varied widely from place to place in colonial America and the early United States, as each colony had developed its own independent legal system. Most colonial bankruptcy laws were "voluntary" (allowing the insolvent debtor to initiate legal action to forestall debt collection by his creditors) but few provided for the complete legal discharge of debts.

The current U.S. bankruptcy statute has been in effect since 1898, and has been amended more than 90 times during those years. The most extensive revisions were contained in the Chandler Act in 1938. Prior to the passage of the Bankruptcy Act of 1898 there had been three congressional attempts to establish a bankruptcy system, all three short-lived. A bill passed in the financial doldrums of 1800 was repealed in 1803. Much of the support for the bill had come from Federalists and northeastern commercial interests, much of the opposition from Jeffer-sonian Anti-federalists and southern agrarian interests. The depression of 1837 prompted passage of the Whig-backed Bankruptcy Act of 1841, which was repealed in 1843. The financial crises brought on by Confederate debt repudiation inspired the Act of 1867. This act, even more disruptive and chaotic than the previous two, was finally repealed in 1878. The current law, drafted in 1890 and sponsored by national commercial organizations, was spurred by pressure arising out of the Panic of 1893. The last serious attempts to repeal it were made more than 50 years ago.

The major function of contemporary bankruptcy is to liquidate the debtor's assets, pay his court costs and creditors, and discharge the debtor from all remaining obligations. This is the "straight bankruptcy" procedure used in 85% of the more than 200,000 cases filed annually. Any person or corporation, except a municipal, railroad, or banking corporation, or a savings and loan association, may declare voluntary bankruptcy. There is no minimum debt requirement, and a person may declare as often as once every six years. All those eligible for voluntary bankruptcy, except for low-wage earners, farmers, and non-profit corporations, may be declared involuntarily bankrupt upon petition of a sufficient number of creditors, whose claims together must exceed $1000. Until the modern era all bankruptcy proceedings were involuntary; today involuntary bankruptcies constitute fewer than 1% of all straight bankruptcy cases.

In practice, creditors rarely receive even partial payment from the bankrupt. No-asset cases, in which no property is available for administrative expenses let alone for creditors, each year comprise approximately 73% of all straight bankruptcies. Nominal-asset cases, in which any property available is consumed entirely by the considerable administrative expenses involved, make up approximately 12%. Only the remaining 15% are asset cases — cases in which creditors receive any payment at all.

In asset cases the average return to the creditor varies with the status of his claim. Secured creditors (ones who hold or can repossess collateral property), whose claims
accounted for 11% of all creditor’s claims in asset bankruptcy cases during fiscal years 1965–1968, received an average of 66¢ per dollar of debt due. Priority creditors, whose claims made up 9%, averaged 35.5¢ on the dollar. Those paid last, the unsecured creditors whose claims constituted 80% of the total, received only 7¢ on the dollar. In no-asset and nominal-asset cases, of course, all creditors received zero. Estimates by a Brookings Institute study put the average return to all creditors in all straight bankruptcy cases at about 6¢ on the dollar of outstanding debt.

These figures unfortunately aggregate personal with business bankruptcy statistics. While the number of business bankruptcies is but one-twelfth that of personal bankruptcies, it is estimated by the Brookings study that some two-thirds of the total dollar-volume of creditors’ claims were registered in business bankruptcy cases. There is no estimate of the fraction of all payments to creditors which took place in business bankruptcies, but the study speculates that it was greater than two-thirds. That is, the creditors in business bankruptcy cases likely receive more cents-on-the-dollar than do creditors in personal bankruptcies.

The Brookings study points out that the volume of debt repaid in bankruptcy settlements is inconsequential compared to the volume of normal debt repayment. From this relationship, the authors conclude that: “The effect of bankruptcy on the general economy is not substantial or detrimental.” Such a conclusion is a blatant non sequitur. Not only would the volume of debt discharged, rather than repaid, provide a better clue to the magnitude of bankruptcy’s effect, but one must consider much more than numbers in assessing the impact of an interventionary measure on the economy. There is too much that the hints provided by statistics do not and cannot disclose, that requires the elucidation of economic reasoning.

In order to focus our attention on bankruptcy qua intervention, we must first develop our understanding of the working of the hypothetical unhampered market economy. We confront the difficult question of how a laissez-faire society would handle the inevitable problem with which bankruptcy attempts to deal, namely, the inability to repay contracted debts. The alternatives to bankruptcy are many, as the historical account of insolvency laws above should make clear. In evaluating the alternatives, we must for our purposes examine their consistency with an entitlement theory of property rights and a title-transfer theory of contracts, which are the fundamental principles upon which the concept of a pure market system must rest.

According to the title-transfer view of a loan contract, the creditor first transfers title to his money (in the amount of the loan) to the debtor. At a contractually agreed-upon later date (or dates, if repayment is in installments), the creditor gains title to the debtor’s money in the agreed amount (loan plus interest and other charges). The debtor who fails to honor fully the creditor’s claim is at that point in illegitimate possession of the creditor’s property. The creditor’s claim is part of his property and is not, unless the loan contract so stipulates, contingent upon the ability of debtor to pay at that time. The creditor has a right to payment which is not eliminated by any fact of adverse circumstances surrounding the debtor. Only forgiveness of the debt can eliminate the creditor’s unsettled claim by transferring title to the debtor.

There is therefore no warrant for the legal discharge of debtors from the payment of their debts for as long as they continue to live or their estates continue to exist. To put it another way, the debtor is not entitled to the legal elimination of his debt. On the contrary, the creditor is entitled to (properly has a lien against) the future earnings of the insolvent debtor. Thus the feature of contemporary bankruptcy law which most differentiates it from the rule of law which would prevail in an unhampered market system is its provision for the extra-contractual dissolution of debts.

Of course the parties to a loan contract on the free market need not adopt a rule of strict liability; they may agree to almost any sort of arrangement concerning the burden of loss in case of insolvency. Loans could be made on the basis of a “gentleman’s agreement”, with no obligation for repayment incurred if the debtor
goes broke. Or a rule akin to current bankruptcy provisions could be adopted, with the debtor's obligation recognized as extending only to his assets at the time the debt falls due. Arbitration could be employed to settle the particulars in such cases. These two possibilities are less binding than the attachment of future earnings by the creditor, the provisions of which could also be spelled out in the loan contract rather than left to the court. More severe are such possibilities as indentured servitude.\(^{221}\)

It is difficult to say much \textit{a priori} about which sorts of arrangements would be most popular in the unhampered market. It does not seem unlikely, however, that the riskier personal borrowers would tend toward the more binding provisions to mitigate high gross interest charges. Corporate borrowing arrangements would likely tend to be more along the lines of bankruptcy, with debts terminating upon the failure and dissolution of the borrowing corporation.

The magnitude of the economic impact of contemporary bankruptcy law, particularly its provision for the discharge of debts, depends on the degree to which arrangements in the free market would be otherwise. Thus it seems their impact is greater in the area of personal loans than in that of business loans, if we assume that creditors making personal loans will not agree to elimination of the debt in case of insolvency (though they might well provide for the extension of repayment). Creditors should not be insensitive to the fact that provision in the law for the discharge of debts has throughout history encouraged dishonesty and fraud, and continues to do so today.\(^{23}\) Some debtors, while not fraudulent under the law, will resort to bankruptcy rather than tighten their belts to meet obligations, as long as a discharge is offered.

Studies of personal bankrupts have indicated that up to one-half of personal bankrupts could pay off their obligations in a small number of years.\(^{24}\) The typical bankrupt owes less than 9 months' salary, and only in 27% of personal bankruptcies does the debt exceed a year's salary.\(^{25}\) Moreover, these studies take the volume of debt contracted by bankrupts as given, when in fact it is likely to be bloated by the knowledge on the part of the debtors that in bankruptcy court all their debts will be discharged. Highly suggestive of this effect is the striking discovery that shortly before filing, at which point the decision to go bankrupt seems already to have been made, the typical bankrupt will have gone on huge credit-buying sprees. Between the fourth and second month before filing, credit purchases more than triple. Purchases of non-critical medical services (e.g., cosmetic dentistry) climb to five times normal.\(^{26}\)

The returns of creditors are further diminished by the fact that an abnormally high proportion of the bankrupt's spending in this period is on goods which cannot be liquidated by the bankruptcy court: personal services (such as medical care) and exempt assets (assets which are legally immune from liquidation, such as homes, life insurance, clothes, furniture, and tools of trade). Wealth in non-exempt assets is frequently converted into exempt assets, if not hidden. This is why so few cases are asset cases, and why the worth of declared assets so frequently coincides with the exempt limit. It is not exemption alone, which itself would presumably be part of insolvency law in a pure market system,\(^{27}\) but its combination with the discharge provision that accounts for this phenomenon. Without discharge — with the knowledge that he must eventually repay his debts — the debtor would gain no advantage in switching his wealth about. It is the knowledge that he will not be held any longer liable for any part of his debts that prompts the prospective bankrupt to consume, or to hide, or to convert to exempt form his non-exempt wealth.

By these influences, bankruptcy increases the probability of default on debts and diminishes the return which the creditor can expect on personal loans. An element of risk will always be present in granting credit, with or without bankruptcy laws. There will always be the possibility that a debtor may default on a loan, out of fraudulent intentions or out of sheer inability to pay.\(^{28}\) In what manner the availability of recourse to bankruptcy for the debtor alters or exacerbates this situation is the question at hand.\(^{29}\)

It is important to distinguish actuarial risk from uncertainty. Some forms of uncertainty
are measurable or estimable; that is, they concern events belonging to a class within which the distribution of outcomes is more or less regular and predictable. In business such uncertainties constitute actuarial risk, which can be converted into a cost of production. A firm may know from experience, for example, that a certain percentage of the light bulbs it produces will be defective. The random occurrence of defects in the bulbs is not part of the uncertainty faced by the entrepreneur, but an actuarial risk which can be accounted for in his calculations of cost. Another hazard (such as fire) may be too rare and irregular for a single firm to handle for itself, but over a large number of firms be of regular enough frequency that the risks of the individual firms may be pooled. This pooling is done by an insurance company which serves the many firms. An insurance premium takes the place of a spoilage allowance or contingency reserve on the bill of costs.130

The creditor or lender always faces uncertainty of repayment on each loan he grants. He can only reap interest when his loans are actually repaid; some will not be. This fact prompts the lender to add to the pure rate of interest a premium which varies with the degree of risk he perceives. Consequently there exists on the market a whole family of interest rates. Uniformity of market interest rates would require the disappearance of this risk component in the gross market rates of interest and would only be possible in a world without risk. This risk component has been called "the entrepreneurial component" in the gross market rates of interest, but in many cases it is an insurance component covering risk which is actuarial in nature.

In at least one group of instances, the uncertainty in granting credit is clearly actuarial risk and can be insured against. Trade credit (credit extended by one non-financial firm to another) is insured by financial institutions known as factors. Factoring is defined as the discounting or purchasing of accounts receivable on a non-recourse basis. The factor is essentially a service firm that guarantees credit for a fee. The factor also relieves its client of the expense of running a credit department, screening prospective customers itself. Responsibility for payment by approved customers is assumed by the factor: the client is paid even if the customer does not remit payment to the factor. Commissions for this bookkeeping and insurance service range from 0.5 to 2% of the sales volume factored, varying with the probability of default in the industry involved. Factors "insulate a client from the big bad debt losses that might well spell doom for some firms, but otherwise the client pays for bad debts through the commissions."135

While the granting of trade credit clearly involves actuarial risk against which the factor gives insurance, it is instructive that the factor assumes control over the granting of credit. The factor must provide that each debtor is one of a general group of instances (namely, good credit risks) among which the frequency of adverse outcomes is more or less known. Such a condition must be met for the group as a whole to be insurable.

The critical difference between instances of actuarial risk and of genuine uncertainty is that in the case of uncertainty no such general group can be formed: each instance to be dealt with is highly unique. This uniqueness is to some degree present in most credit and moneylending operations. It prevails most especially in capitalist advances to entrepreneurs. It is precisely this uniqueness that requires lenders to be in part entrepreneurs.

Every loan, including every grant of trade credit, is to some degree unique. The factoring firm must screen each case due to this fact. Degrees of uniqueness, and with them the proportions between actuarial risk and genuine uncertainty, come in a wide range and vary with each group of cases. Each individual case is to a varying degree a member of a more general class. As knowledge about the regularity of outcomes within a class becomes more certain (it is always imperfect), the decision to bear its risks becomes correspondingly one more of insurance and less of speculation. Conceptually, the risk component in the gross market rate of interest demanded by the lender becomes more an insurance component than a speculative component.

This analysis of the nature of the risk involved in lending explains why credit institutions tend
to pigeonhole borrowers according to discernible characteristics. The institutions are attempting to evaluate individual borrowers with regard to their likelihood of default on the basis of the relevant sub-group of borrowers to which they evidently belong. The height of the rate of interest charged reflects the appraised degree of actuarial risk (based on knowledge of the general group).\[138\]

The lender in effect insures himself against losses by adding an insurance premium to the pure interest charge.

Because bankruptcy diminishes the return the creditor can expect on personal loans, the insurance element of the risk component in the gross market rate of interest (the insurance element predominates over the speculative element in personal loans and trade credit) must increase to cover the added actuarial risk. The cost of credit must rise. To the extent that those who bankrupt come from an identifiable class of high-risk borrowers, conscientious members of this group bear the burden of higher credit costs. Otherwise, all responsibility users of credit will have to pay more for credit.\[138\]

The lender can insure himself — by pooling risks as described above — only where he can deal with many members of a general group. It follows that the lender faces genuine uncertainty insofar as he deals with cases which admit of membership in no general group, cases which for all practical purposes are *sui generis*. In such cases, which are the rule in the venture capital market, the capitalist must judge the risk involved on the basis of his knowledge of the individual case. Where he deals with an entrepreneur, and the repayment of the loan depends entirely on the success or failure of the project, the capitalist becomes an entrepreneurial actor.

The capitalist and the entrepreneur must in effect form a partnership. Where a would-be entrepreneur envisions an opportunity for profit, but fails to act on that vision, there is no entrepreneurship.\[40\] Where he lacks the means to finance a productive process which spans time (between purchases of complementary factors of production and receipts from sale of product), he must convince a lender in the capital market of the existence of that opportunity. The forms of their partnership, and the division of decision-making between the two actors, can vary. The would-be entrepreneur in the limiting case is in effect hired by the capitalist to direct the chosen enterprise and becomes merely a profit-maximizer pursuing a given end.

Even in such a case, the creditor's success or failure rides with that of the debtor. To the extent that the debtor lacks the means to finance the project himself, he is in a position to repay the debt only so far as the enterprise succeeds. The creditor is less exposed to loss only insofar as legal institutions allow him to enforce his claims (which may be limited by the loan contract as discussed above) on the debtor. If the creditor is entitled to repayment even in case of default then his position is less insecure than that of the debtor-entrepreneur.\[41\] In such a case bankruptcy occasions a shifting of uncertainty-bearing, and undoubtedly with it responsibility for ultimate decision-making, from entrepreneur to creditor. Though it is not clear that venture capital would be loaned on such a basis in the absence of bankruptcy law, that is something which the market should be left free to decide.

NOTES

2. Admirers of the common law may regard this fact as already a fair indication that interventionism is afoot. For a discussion of the common law, see Murray N. Rothbard, *For A New Liberty* (New York: Macmillan, 1973), pp. 236–239.
5. Noel, op. cit.; Rutberg, op. cit.
8. John C. Calhoun, “Speech of Mr. Calhoun of South Carolina on the Bankrupt Bill,” United States Senate, June 2, 1840. Delivered during debate over passage of the Bankruptcy Act of 1841, this address contains an early and trenchant critique of state capitalism,
especially its privileged banking system.

The Bankruptcy clause was inserted in the Constitution at the behest of banking and creditor interests who desired national uniformity of law, namely Robert Morris and his followers. See Merrill Jensen, *The New Nation* (New York: Vintage Books, 1950), p. 228. Interestingly enough, Morris took advantage of the first American bankruptcy statute based upon the constitutional clause to discharge the millions of dollars worth of debts which he had accumulated through speculation in land and government securities in the 1790's. See Coleman, *op. cit.*, p. 28.


15. *Ibid.*, p. 20. In order to hold down administrative costs, a Rand Corporation report has recommended that the processing of bankruptcy cases be "streamlined" and automated, with no courtroom questioning allowed: "An Application of Automation to Bankruptcy Administration and Processes" (prepared for the Commission on the Bankruptcy Laws of the United States) by M. R. Fiorello and A. B. Maclnnes (Santa Monica, Ca: The Rand Corporation, 1973). The report fails to consider the potential impact of making bankruptcy fast and easy upon the volume of cases filed and thereby upon the credit market.


19. Mises argues (*ibid.*, pp. 720-722) that the problem of the delimitation of the proper and just sphere of coercion (governmental activity) is irrelevant to the problem of interventionism. Yet without some conception of that sphere or the principles which limit it, it is impossible to speak of "interventionism." Mises himself presumes the "desired" role of government to be "safeguarding the social order." Arguments for a free market (as opposed to its conceptualization) need not rest on principles of right and justice; they may be based purely on expediency.


21. It is interesting to note that the "debts" which are not dischargeable under U.S. bankruptcy law are non-contractual. Foremost among these are federal tax liabilities. Others are alimony and child-support payments. Failure to meet the latter two legal obligations results not in attachment of earnings but in imprisonment. Attachment of earnings is the rule in the case of federal personal income tax liabilities even before the liability has fallen due.

22. I am indebted to Professor Gerald P. O'Driscoll and especially to Professor J. Huston McCulloch for their helpful suggestions here and elsewhere.

Professor Robert Nozick has raised the question of whether permission by the debtor for his leg to be broken (for example) in the event of default (in order to lower risk and thereby the loan rate of interest) should be an enforceable part of a loan contract.

23. See Earl, *op. cit.*, and Rutberg, *op. cit.*, for all the scandal surrounding personal and business bankruptcies, respectively.

24. Earl, *op. cit.*, p. 136; Stanley and Girth, *op. cit.*, p. 38. Stanley and Girth remark, "Probably a substantial part of these debts would have gone unpaid until they were written off as uncollectible," but such an attitude on the part of creditors is undoubtedly the result of the easy availability of debt discharge in bankruptcy.


27. This is an extremely difficult question to answer *a priori*; indeed it begs the whole question of the extent to which we can specify a legal code *a priori* and the extent to which it must be the result of historical evolution. Does an entitlement theory of justice in holding recognize limits on a creditor's right to reclaim property from a delinquent debtor, or does the creditor have carte blanche to snatch from the debtor his home, clothing, food, even his limbs (as under Roman law) to satisfy the debt? It is clearly not in the creditor's interest to establish a general reputation for undue severity, nor in the individual case to impair the future earning ability of the debtor. But such considerations do not answer the question concerning the creditor's rights. Perhaps some distinction among the debtor's assets in terms of alienability can be made according to a standard of subsistence, though this obviously creates further problems of definition. I do not think this whole question is the same as the question of whether a starving man has any right to steal food (he does not) for the existence of a prior contract between creditor and debtor and the debtor's prior entitlement to his own holdings make default different in important respects from theft.


31. Ibid., p. 539.
34. Garyantes, op. cit., p. 20.
35. Ibid., p. 23.
37. We are justified in focusing on the supply side of the loan market to the exclusion of the demand side to the extent that no independently-established, uniform market price for credit, against which the borrower can gauge the offer of the lender, exists. This is more true of the capital market than of the consumer credit market. See Grinder and Hagel, op. cit.
39. Stanley and Girth, op. cit., include these among their many offhand speculations as to who might bear the costs of bankruptcy.
40. I have dealt elsewhere with the nature of entrepreneurship ("Entrepreneurship, imagination, and the question of equilibration," unpublished MS.). What I wish to emphasize here is that entrepreneurship involves action and not just thought.
41. Mises, op. cit., p. 540.