

# A Theory of Discharge in Consumer Bankruptcy

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## I. INTRODUCTION

The purpose of the consumer bankruptcy system, effectuated by discharge, is to give a fresh start to the "honest but unfortunate debtor."<sup>1</sup> Passage of a bankruptcy statute<sup>2</sup> permitting discharge<sup>3</sup> demonstrates Congress' policy determination that a "fresh start" is important enough to merit discharge of some debts and for some debtors. That we should have some system of discharge in bankruptcy is a settled question.<sup>4</sup>

The appropriate scope of the "fresh start" and thus of the discharge that implements it, however, is far from settled. Discharge of legal obligations is an extraordinary exception to the usual obligation orientation of the law and it must have

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1. The usual citation for this proposition is *Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934), but the proposition did not originate with that case. *Local Loan* cited *Williams v. U.S. Fidelity Co.*, 236 U.S. 549, 554-55 (1915), which in turn relied on *Wetmore v. Markoe*, 196 U.S. 68, 77 (1904). In the course of holding that unpaid alimony was not a provable debt and thus was not discharged in bankruptcy, the *Wetmore* Court stated: "Systems of bankruptcy are designed to relieve the honest debtor from the weight of indebtedness which has become oppressive and to permit him to have a fresh start in business or commercial life, freed from the obligation and responsibilities which may have resulted from business misfortunes." *Id.* at 77. A similar statement appeared as early as 1877 in *Neal v. Clark*, 95 U.S. 704, 709 (1877) (Bankruptcy is "a general law by which the honest citizen may be relieved from the burden of hopeless insolvency.").

2. The bankruptcy law currently in effect is the Bankruptcy Reform Act of 1978, Pub. L. No. 85-598, 92 Stat. 2549, as amended by the Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, 98 Stat. 333, and by the Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986, Pub. L. No. 99-554, 100 Stat. 3088 (codified at 11 U.S.C.A. and in scattered sections of other titles) (West Supp. 1985). The current statute will be referred to as the "Code" and cited as "Bankruptcy Code § \_\_\_\_\_." The prior statute will be referred to as the "Act" and cited as "Bankruptcy Act § \_\_\_\_\_."

3. Discharge in Chapter 7 is governed primarily by §§ 523 and 727 of the Code. Section 523 lists debts that are excepted from discharge, including obligations for taxes, child support and educational loans, and obligations incurred by the debtor's willful and malicious injury of another or use of a false financial statement to obtain credit. Section 727 lists reasons why discharge will be totally denied, almost all of them relating to misconduct by the debtor in the bankruptcy proceeding. Discharge under Chapter 13, which is governed primarily by § 1328, is more generous in most cases than the Chapter 7 discharge. For a discussion of this issue, see *infra* text accompanying notes 219-34.

Other sections are an integral part of the "fresh start." Exemptions, governed by Bankruptcy Code § 522, provide the debtor a minimum bundle of assets that are protected from the reach of creditors. Subsections (c) and (d) of § 524 place restrictions on the debtor's power to reaffirm discharged debts and is intended to protect the debtor from sinking back under the weight of debts from which discharge has removed him. Redemption under § 722 is available to a Chapter 7 debtor who wants to prevent repossession of exempt property subject to a lien that passed through bankruptcy. Finally, §§ 524 and 525, respectively, define the effect of discharge and protect the debtor from certain types of discrimination.

4. Some form of discharge has been part of every American bankruptcy statute, although its generosity has varied considerably. The first bankruptcy legislation, passed in 1800, permitted only involuntary petitions against, primarily, traders; it conditioned discharge on the consent of two-thirds of the creditors in number and value. Bankruptcy Act of 1800, ch. 19, § 36, 2 Stat. 31. The second statute, which was passed in 1841 and endured only 18 months, permitted voluntary petitions and allowed discharge unless a majority of creditors in number and value objected in writing. Bankruptcy Act of 1841, ch. 9, § 4, 5 Stat. 443. The third act was passed in 1867. Until its amendment in 1874, it granted discharge only upon the consent of a majority of creditors in number and value unless the estate paid at least 50% of claims. Bankruptcy Act of 1867, ch. 176, § 33, 14 Stat. 533. The 1874 amendment eliminated the requirement of creditor consent for involuntary cases, and, in voluntary cases, reduced the percentage of claims required to be paid and the number and value of creditors needed for discharge. Act of June 22, 1874, ch. 390, § 9, 18 Stat. 178. The fourth statute, passed in 1898 and much amended until its replacement by the Code, allowed discharge without creditor consent or a minimum payment on claims. Bankruptcy Act of 1898, ch. 541, § 14, 30 Stat. 550.

equally extraordinary justification. To describe the goal of bankruptcy as providing a "fresh start" for certain debtors is inadequate. That formulation does not specify the goals of bankruptcy sufficiently to distinguish debts and debtors that should be discharged from those that should not. Thus, legislators faced with proposed modifications to the bankruptcy statute have not been provided guidance that could have been derived from a more specific articulation of the theory underlying discharge in bankruptcy.

In the absence of this specificity, a number of different, sometimes mutually inconsistent, policies have developed to justify isolated aspects of the Bankruptcy Code's discharge rules. Five of these policy threads weave through the Code. First, bankruptcy is a collection device by which a debtor's assets can be discovered and made available for creditors. Second, bankruptcy is intended to reward only an honest or worthy debtor with discharge. Third, bankruptcy should protect the interests of creditors who are particularly worthy. Fourth, bankruptcy is designed to rehabilitate the debtor. The concept of rehabilitation may be further refined to include purposes of consumer education, emotional and psychological cleansing for the debtor, and restored participation by the debtor in the open credit economy. Finally, bankruptcy may be designed to achieve economic efficiency in its allocation of the risk of loss, connected with nonpayment, between debtor and creditor.

This Article first traces these policies, exploring Code provisions that reveal them and evaluating the limits of each. In doing so, the Article draws upon prior scholarship, which has generally been limited to ad hoc consideration of these policies in isolation from each other. Few writers have attempted to state a coherent theory of discharge<sup>5</sup> and no one has previously proposed a functional economic analysis as it informs discharge of consumer debts in bankruptcy. This Article does so. After tracing existing discharge policies, the Article advocates a new functional economic theory of discharge: that discharge should be broadly available in order to restore the debtor to participation in the open credit economy, limited only as is necessary to prevent the skewing of economic decisions, whether to lend or to borrow, by the intrusion of irrelevant noneconomic factors. Finally, this functional economic theory is tested by application to several major policy debates in which legislators have recently been or are currently engaged: reaffirmation of discharged debts; conversion of nonexempt to exempt property on the eve of bankruptcy; the appropriate scope of discharge in Chapter 13; mandatory 13;<sup>6</sup> and the dischargeability of educational loans.

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5. A notable exception is Jackson, *The Fresh-Start Policy in Bankruptcy Law*, 98 HARV. L. REV. 1393 (1985). Professor Jackson's discussion focuses primarily on why discharge is available at all and why the right to discharge in bankruptcy is not waivable. The last section of his article discusses the appropriate scope of the discharge.

6. As the Bankruptcy Code is currently written, a Chapter 13 petition can be filed only by a debtor with a regular source of income. §§ 109(e), 303(b). "Mandatory 13" is a generic term used to describe various proposals for modifications of the Code that would require debtors to file under Chapter 13, rather than Chapter 7, if they are in bankruptcy at all. Most of these proposals derive from a focus on one of the most significant differences between Chapters 7 and 13: under Chapter 7, creditors are paid from the proceeds of liquidation of nonexempt assets owned by the debtor at the moment bankruptcy was filed; under Chapter 13, creditors are generally paid from the stream of the debtor's future earnings.

The Article focuses primarily on creditors without tort-based claims. The reason for this focus is two-fold. First, most claimants in consumer bankruptcies are commercial creditors with claims based on contracts.<sup>7</sup> Second, the functional economic approach advocated here generally disregards the worthiness of the debtor's behavior. To do so may be inappropriate when tort-based claims are involved, given the reasonable concern that bankruptcy not become a shelter for debtors who have engaged in dishonesty or in culpable disregard for the rights of other persons.<sup>8</sup>

## II. GOALS OF BANKRUPTCY—TRACING THE THREADS

### A. Collection Mechanism

The English roots of our bankruptcy system as a collection device have been well-documented.<sup>9</sup> Bankruptcy began in England as a response to inadequate collection remedies.<sup>10</sup> Discharge, which joins with exemptions to provide the major features militating against bankruptcy's collection function,<sup>11</sup> was not a feature of England's first bankruptcy statute, passed in 1542.<sup>12</sup>

England introduced discharge from debt in 1705,<sup>13</sup> but not purely out of the belief that the "honest but unfortunate" debtor should, as a normative matter, be relieved of oppressive debt.<sup>14</sup> Rather, discharge was intended to encourage and reward cooperation by the debtor in the discovery and distribution of his assets<sup>15</sup>—a distinctive collection function.

Although bankruptcy in England has remained primarily a creditors' collection device,<sup>16</sup> collective distribution is only one of its two major functions—along with debtor "rehabilitation"—in United States law.<sup>17</sup> Nevertheless, several features of current American bankruptcy law reveal its continuing purpose as a collective

7. REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. DOC. NO. 137, 93d Cong., 1st Sess., pt. I, at 44, 68, 70 (1973) [hereinafter COMMISSION REPORT]. D. STANLEY & M. GIRTH, *BANKRUPTCY: PROBLEM, PROCESS, REFORM* 57, 247 (1971).

8. The Code currently excepts from discharge, for example, a debt "for willful and malicious injury by the debtor to another entity or to the property of another entity." Bankruptcy Code §523(a)(6).

9. See generally 8 W. HOLDSWORTH, *A HISTORY OF ENGLISH LAW* 236 (1926) (All of the bankruptcy legislation passed in sixteenth century England was "aimed, not at relieving the bankrupt, but at getting his property for the benefit of his creditors.").

10. Boshkoff, *Limited, Conditional, and Suspended Discharges in Anglo-American Bankruptcy Proceedings*, 131 U. PA. L. REV. 69, 111 (1982) [hereinafter Boshkoff, *Limited Discharges*].

11. *Id.* at 106, 107 n.154.

12. This legislation was aimed at dishonest debtors who, "craftily obtaining into their hands great substance of other men's goods, do suddenly flee to parts unknown." 35 & 35 Henry VIII c. 4, quoted in W. HOLDSWORTH, *supra* note 9, at 236.

In England, "bankruptcy" and "insolvency" were distinct systems. The former was an involuntary creditors' collection device under which the debtor's property was attached and divided equally among his creditors. It could be used only against "traders" and allowed a release of debts remaining unpaid. The latter was a voluntary system allowing debtors who placed all of their property at the disposal of their creditors to be discharged from prison, but not to be released from their debts. C. WARREN, *BANKRUPTCY IN UNITED STATES HISTORY* 6-7 (1935).

13. Levinthal, *The Early History of English Bankruptcy*, 67 U. PA. L. REV. 1, 18 (1919).

14. *Id.* at 19.

15. *United States v. Kras*, 409 U.S. 434, 447 (1973) (citing J. MACLACHLAN, *BANKRUPTCY* 20-21 (1956)).

16. Boshkoff, *Limited Discharges*, *supra* note 10, at 100.

17. H.R. REP. NO. 687, 89th Cong., 1st Sess. 2 (1965).

distribution mechanism. It is compulsory.<sup>18</sup> It gathers, liquidates, and distributes the debtor's assets for the benefit of creditors.<sup>19</sup> It prohibits, through several devices, behavior by creditors that might undermine the goal of equitable distribution.<sup>20</sup> And it bars discharge chiefly on the basis of conduct by the debtor that adversely affects efforts to discover and collect assets that will be distributed to creditors.<sup>21</sup>

Bankruptcy's collection purpose is visible despite the fact that our bankruptcy system does not focus on collections for creditors. As bankruptcy's exemption and discharge provisions become more generous, however, its power as a collection mechanism becomes correspondingly constricted. Progressive liberalization of discharge, both procedurally and substantively,<sup>22</sup> therefore, has diluted bankruptcy's collection function.

### B. *The Worthy Debtor*

A second goal of bankruptcy is to reward only the honest debtor with a fresh start.<sup>23</sup> Policymakers have long been concerned that bankruptcy not be a haven for the dishonest. Throughout the nineteenth century, petitions asking Congress to pass a bankruptcy law and the legislative histories of the various statutes passed reveal a concern that discharge be available only for honest debtors.<sup>24</sup> Similar concerns occupied the Bankruptcy Commission in the mid-1970s.<sup>25</sup> The Commission investigated the incidence of dishonest conduct by debtors and found "little empirical

18. Discharge under § 727(a) of the Code discharges all pre-bankruptcy debts whether or not a claim was filed, unless § 523 provides for an exception to the discharge of a particular debt. Section 523(a)(3) excepts a debt that the debtor failed to disclose, if the creditor did not know of the bankruptcy case. Thus, bankruptcy is compulsory in the sense that a creditor's claim can be adjudicated whether or not the creditor participates in the case. *See generally* Radin, *The Nature of Bankruptcy*, 89 U. Pa. L. Rev. 1 (1940).

19. An involuntary case can be commenced by a sufficient number of creditors holding a specified amount of unsecured claims. Bankruptcy Code § 303(b).

20. The automatic stay, for example, halts the creditors' "race of diligence" under state law. Bankruptcy Code § 362. Section 547, in addition, is designed in part to prevent last-minute pre-bankruptcy grabs by creditors of the debtor's property. Eisenberg, *Bankruptcy Law in Perspective*, 28 UCLA L. Rev. 953, 963 (1981) [hereinafter Eisenberg].

Professor Eisenberg's article prompted Professor Harris to respond critically. Harris, *A Reply to Theodore Eisenberg's Bankruptcy Law in Perspective*, 30 UCLA L. Rev. 327 (1982). Professor Eisenberg rejoined. Eisenberg, *Bankruptcy Law in Perspective: A Rejoinder*, 30 UCLA L. Rev. 617 (1983) [hereinafter Eisenberg, *Rejoinder*].

21. Bankruptcy Code § 727. The only important ground for barring discharge for a consumer debtor that does not fit the text's generalization is the six-year bar. Bankruptcy Code § 727(a)(8), (9).

22. *See supra* note 4. *See, e.g., infra* text accompanying notes 42-45, for discussion of the 1978 change making the debtor's use of a false financial statement grounds for excepting the debt from discharge only if the creditor relied on the statement.

23. *See supra* note 1.

24. As early as 1817, Congress was petitioned to pass a bankruptcy law that would "shelter the honest and unfortunate debtor." Petition of Chamber of Commerce of Philadelphia for Uniform System of Bankruptcy (14-2) Misc. 422, House of Rep., Jan. 13, 1817. *See also* H.R. REP. NO. 5, 27th Cong., 1st Sess. 4 (1841) ("With us, in this country, it may be considered as wholly settled, by a wise and humane public sentiment and policy, that the law will pursue and will permit creditors to pursue an honest but unfortunate and hopelessly insolvent debtor no further, after what remains of his wrecked fortune has been equitably divided amongst those to whom he is indebted."); H.R. REP. NO. 1386, 51st Cong., 1st Sess. 6 (1890) ("The granting of discharges is so hedged about that it will be impossible for a dishonest man to secure the benefits of the law if his creditors are at all diligent.").

25. The Commission on the Bankruptcy Laws of the United States was created in 1970 by Pub. L. No. 91-354, 84 Stat. 468, to "study, analyze, evaluate, and recommend changes" in the bankruptcy law then in force. Nine commissioners were appointed by the President, the President of the Senate, the Speaker of the House and the Chief Justice. The staff and consultants who assisted the Commissioners included prominent bankruptcy experts from academia, the bench, and the practicing bar.

substantiation”<sup>26</sup> for the view that debtor dishonesty is a significant cause of bankruptcy. On the contrary, the Commission found that the leading ground for denying discharge—failure of a consumer debtor to turn over an income tax refund—and the most common ground for excepting a consumer debt from discharge—obtaining credit by use of a false financial statement—both involved “little intentional misconduct.”<sup>27</sup> Cases of genuine unworthiness, however, were different: “[C]laims arising from conduct of the debtor egregiously violating community standards, such as claims for fraud, larceny, embezzlement, willful and malicious wrongs, and civil penalties, should not be discharged because social policy directs, impliedly at least, that the debtor should not be able to escape his responsibility through the bankruptcy process.”<sup>28</sup>

Debate centers around the question of what conduct is so dishonest or unworthy that discharge is appropriately jeopardized. The Bankruptcy Commission, on the basis of its findings noted above,<sup>29</sup> recommended that the statute be changed to allow exemption of income tax refunds and to prevent nondischargeability solely because of a false financial statement.<sup>30</sup> As a result, particularly, of the latter recommendation, the Commission was criticized for making discharge too readily available to dishonest debtors.<sup>31</sup> The 1978 Code, which adopted that recommendation,<sup>32</sup> could be criticized on the same ground. Certain omissions from the 1978 Code could be similarly criticized, perhaps chief among them being Congress’ failure to deal with eve-of-bankruptcy splurges.<sup>33</sup> The Bankruptcy Commission found that, although small in number, cases in which individuals buy goods on credit immediately before bankruptcy, then discharging the obligations, discredit the bankruptcy system.<sup>34</sup> The Commission recommended, therefore, that “[a]ny debt incurred for the purpose of obtaining money, property, or services within 90 days of bankruptcy without the intention of paying the debt, and in contemplation of the filing of a petition under the Act, not be dischargeable.”<sup>35</sup> Faced with the opposition of the National Bankruptcy Conference,<sup>36</sup> Congress did not include the provision in the 1978 Act. Debate continued on this issue, however, and the 1984 Amendments added a provision similar to the Commission’s proposal.<sup>37</sup>

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26. COMMISSION REPORT, *supra* note 7, at 54.

27. *Id.* at 83.

28. *Id.* at 79.

29. See *supra* text accompanying notes 26–28.

30. COMMISSION REPORT, *supra* note 7, at 83.

31. Twinem, *Bankruptcy Report: Some Limitations on Creditors’ Rights*, 29 BUS. LAW. 353 (1974).

32. Bankruptcy Code § 523(a)(2)(B).

33. Cf. Eisenberg, *supra* note 20, at 979–80.

34. COMMISSION REPORT, *supra* note 7, at 11, 170.

35. *Id.* at 12.

36. The Conference concluded that the problem was not serious and that the Commission’s proposal “would stand as an invitation to litigation by every creditor who had extended credit with [sic] 90 days of the petition and seems an instance of using an elephant gun to kill a flea.” *Bankruptcy Act Revision: Hearings on H.R. 31 and H.R. 32 Before the Subcomm. on Civil and Constitutional Rights of the House Comm. on the Judiciary*, 94th Cong., 1st & 2d Sess., App. 2 at 357 (1976).

37. Bankruptcy Code § 523(a)(2)(C). It provides, for purposes of § 523(a)(2)(A), which bars discharge of debts incurred by false pretenses or actual fraud, a presumption of nondischargeability for “consumer debts owed to a single creditor and aggregating more than \$500 for ‘luxury goods or services’ incurred by an individual debtor on or within forty days before the order for relief under this title, or cash advances aggregating more than \$1,000 that are extensions of

The policy of rewarding the honest debtor with discharge represents a major departure from the view that defaulters are, simply because of default, deserving of punishment for their guilt, negligence, or indolence,<sup>38</sup> and that the experience of bankruptcy should be a solemn, perhaps punitive, moral lesson.<sup>39</sup> While one might say that bankruptcy law, instead, views the debtor "as either an innocent victim lured beyond his means by a consumption-oriented society, or as the unfortunate object of some calamitous event beyond his control,"<sup>40</sup> bankruptcy law is more accurately interpreted as a series of provisions reflecting ad hoc definitions of what is honest or worthy in particular situations.

The six-year bar provides one illustration. Under this provision, a debtor guilty of no misconduct nevertheless cannot obtain a discharge if he received one within the previous six years.<sup>41</sup> This provision apparently abandons the principle that an honest but unfortunate debtor should receive a discharge, by denying discharge to a debtor accurately described by both adjectives. The provision may, however, merely codify an irrebuttable presumption that a debtor who seeks two discharges within six years has been, at a minimum, so financially negligent that he is not deserving.

The Code's treatment of false financial statements provides a second illustration. Under this provision, the debtor who submitted a false financial statement may discharge the debt despite his reprehensible conduct if the creditor did not rely on the statement in making the decision to lend.<sup>42</sup> Again it appears, as critics charged,<sup>43</sup> that the Bankruptcy Code totally abandons the principle that only an honest debtor should receive a discharge, by granting discharge to a debtor neither honest nor unfortunate. The provision, however, reflects a judgment that the real dishonesty in instances of false financial statements is often not the debtor's but the creditor's—that creditors often provided financial statement forms with insufficient space for the debtor to list all his obligations, then filed the forms for use in barring discharge or obtaining reaffirmation if the debtor happened to file bankruptcy later.<sup>44</sup> Thus, evolution of the so-called "fraud exception"<sup>45</sup> reflects a legislative conclusion that a debtor who

consumer credit under an open end credit plan obtained by an individual debtor on or within twenty days before the order for relief under this title."

38. Note, *Discharge Provisions in Consumer Bankruptcy: The Need for a New Approach*, 45 N.Y.U. L. REV. 1251, 1256 (1970).

39. Shuchman, *An Attempt at a "Philosophy of Bankruptcy"*, 21 UCLA L. REV. 403, 443 (1973) [hereinafter Shuchman].

40. Van Baalen, *Bankruptcy Code Chapter 13—What Price the "Better Discharge"?*, 35 OKLA. L. REV. 455, 486 n.173 (1982).

41. Bankruptcy Code § 727(a)(8). If, however, the prior discharge was granted under Chapter 13, the debtor can obtain another discharge in less than six years if 100% of the unsecured claims were paid in the prior case or if 70% of those claims were paid and the plan was the debtor's best effort and proposed in good faith. Bankruptcy Code § 727(a)(9).

42. Bankruptcy Code § 523(a)(2)(B).

43. See *supra* text accompanying note 31.

44. H.R. REP. NO. 595, 95th Cong., 2d Sess. 130 (1977), reprinted in 1978 U.S. CODE CONG. & ADMIN. NEWS 5963, 6091; S. REP. NO. 1688, 86th Cong., 2d Sess., reprinted in 1960 U.S. CODE CONG. & ADMIN. NEWS 2954, 2955. See also COMMISSION REPORT, *supra* note 7, at 10,176.

45. The debtor's intentional use of a false financial statement on which the creditor relied was, before 1960, a ground for denying discharge altogether. Bankruptcy Act § 14(c)(3). In that year the statute was amended, with the blessings of the credit community, to except that particular debt from discharge but not to bar discharge entirely. Creditors accepted the change because they could enforce the nondischarged obligation post-bankruptcy against a debtor better able to pay once his other obligations were discharged. *The Economics of Bankruptcy Reform*, 41 LAW & CONTEMP. PROBS. (NO. 4) 123, 127 (1977) (remarks of Philip Shuchman) [hereinafter Symposium Discussion].

submitted a false financial statement is not guilty of the kind of dishonesty that will except a debt from discharge, even though the debtor intended to mislead the creditor, unless the creditor was also misled thereby.

A third illustration of the Code's ad hoc definition of what is worthy in particular situations is found in the treatment of willful and malicious torts,<sup>46</sup> and claims based on the debtor's drunk driving.<sup>47</sup> The exception of these claims from discharge is not explained by their particular worthiness.<sup>48</sup> Unlike child support claimants,<sup>49</sup> tort claimants have no special characteristics justifying nondischargeability, other than, perhaps, that they are involuntary creditors who did not choose to deal with the debtor.<sup>50</sup> On the contrary, tort claimants whose claims are discharged because the debtor acted negligently, and tort claimants whose claims are excepted from discharge because the debtor acted willfully and maliciously, are not inherently different from each other.<sup>51</sup> Thus, the dischargeability or nondischargeability of their claims is explained not by the claimant's particular merit, but by the perceived unworthiness of the debtor who inflicted willful and malicious, but not negligent, injury.

The dishonesty standard deals with conduct in two different realms, only one of which it handles well. That one is the candor of the debtor in the collection and distribution of his assets or, in other words, the debtor's behavior in the bankruptcy case itself. It is, perhaps, "procedural" honesty. The Code treatment of this type of misbehavior is the most serious available—denial of discharge—and is meted out for the debtor's intentional concealment of property affected by the bankruptcy,

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Even creditors who had not relied on the false financial statement, however, were frustrating the purpose of discharge by using the false statement to negotiate a reaffirmation or by suing on the discharged obligation in state court. COMMISSION REPORT, *supra* note 7, at 10. In the latter case, the creditor could obtain an enforceable default judgment on the debt if the debtor failed to appear and plead the affirmative defense of discharge. In order to curtail this abuse, Congress in 1970 required creditors to litigate the issue of dischargeability before the bankruptcy court by prohibiting the creditor from "employing any process" against the debtor personally and declaring void any judgment obtained against the debtor on a discharged debt. Bankruptcy Act § 14(f)(1) & (2). (This provision is currently codified at Bankruptcy Code § 524(a)(1), (2).)

Creditors who had not relied on the false financial statements continued to coerce reaffirmation of the debts by filing or threatening to file objections to discharge and accepting reaffirmations in settlement. For this reason, the Bankruptcy Commission recommended that the "fraud exception" be eliminated altogether in consumer cases. COMMISSION REPORT, *supra* note 7, at 12. Congress did not follow this recommendation in 1978, but made these debts more frequently dischargeable by adding the requirement that the creditor's reliance must have been reasonable. Bankruptcy Code § 523(a)(2)(B)(iii). In addition, Congress added § 523(d) to discourage creditors from challenging the debt's dischargeability in order to coerce a reaffirmation in settlement of litigation. That subsection, following further amendment in 1984, allows the debtor to recover attorney's fees if the creditor's challenge "was not substantially justified," unless "special circumstances would make the award unjust."

46. Bankruptcy Code § 523(a)(6).

47. Bankruptcy Code § 523(a)(9). Before 1984, when this subsection was added to the Code, § 523(a)(6) was often used by creditors seeking to except from discharge a claim based on the debtor's drunk driving. Most courts, faced with this argument, held that claims based on injuries caused by the debtor's intoxicated driving were not attributable to willful and malicious conduct within § 523(a)(6) and, therefore, were dischargeable. *See, e.g., In re Greenwell*, 21 Bankr. 419 (S.D. Ohio 1982); *In re Kuepper*, 36 Bankr. 680 (Bankr. E.D. Wis. 1983); *In re Davis*, 26 Bankr. 580 (Bankr. D.R.I. 1983). *But see In re Callaway*, 41 Bankr. 341 (Bankr. E.D. Pa. 1984); *In re Carey*, 35 Bankr. 894 (Bankr. E.D. Tenn. 1983); *In re Cloutier*, 33 Bankr. 18 (Bankr. D. Me. 1983). *See* Annotation, *What Constitutes Willful and Malicious Injury Growing out of Automobile Accident, Excepted from Discharge in Bankruptcy*, 13 A.L.R.2d 168 (1950).

48. *Contra* Weistart, *The Costs of Bankruptcy*, 41 LAW & CONTEMP. PROBS. (No. 4) 107, 113 (1977).

49. *See infra* text accompanying notes 72-74.

50. *See infra* note 82.

51. *See infra* note 155.

unjustified failure to keep adequate records, knowing false oath, and so forth.<sup>52</sup> Little or no criticism of these provisions has appeared, probably because their relevance and necessity are obvious.<sup>53</sup>

When the dishonesty standard is applied in its second realm, however, no shared notions of relevance and necessity are available. This is “substantive” honesty—the realm of behaviors external to the bankruptcy process itself, but concerning claims made in bankruptcy.<sup>54</sup> The difficulty here is that conduct comes in shades of grey. A debtor may, for example, act willfully and maliciously with a conscious intent to injure or defraud another person who, as a result of the conduct and the filing of a bankruptcy petition, becomes an unpaid creditor. Or a debtor may act recklessly, which in turn may encompass a careless disregard for the probability that a debt cannot be repaid or merely a misguided and naive optimism that things will work out. Or a debtor may act negligently, not having exercised reasonable care in his financial affairs, yet lacking any more sinister intent. Finally, a debtor may have been caught up in events beyond his control, through sudden and unexpected illness or loss of a job without fault.<sup>55</sup> A dishonesty standard provides reliable guidance at the extremes—the willful and malicious actor is dishonest,<sup>56</sup> and the debtor faced with unexpected financial catastrophe is not<sup>57</sup>—but the intermediate cases are more difficult. What about the incurably naive optimist? What of the debtor who jumps into bankruptcy too quickly, before his financial situation is beyond reasonable repair or without making a genuine effort to pursue nonbankruptcy remedies?<sup>58</sup> Whether debtor misconduct exists in these cases seems a matter of the eye of the beholder.<sup>59</sup>

The policy against granting discharge to a dishonest debtor is firmly rooted in the normative proposition that debts should be paid.<sup>60</sup> Just as it is feared that removal of

52. Bankruptcy Code § 727(a).

53. Professor Jackson would most likely disagree with this conclusion. He notes that discharge is not denied to debtors guilty of acts more serious than fraud, such as arson and murder, and that criminal sanctions may carry less severe financial consequences for the debtor than does denial of discharge. Jackson, *supra* note 5, at 1441. He also recognizes that “[t]he relation between the activities covered by section 727 and creditors’ collection efforts may be so close as to justify presumptively denying discharge to a debtor who engages in such activities.” *Id.* at 1442. Professor Jackson would not stop there, however. Despite the close tie between the debtor’s disfavored behavior and the creditors’ efforts to collect their debts, he asserts that complete denial of discharge may be inappropriate; the appropriate penalty can only be determined by weighing the benefits of the fresh start “against the effectiveness of using denial of discharge as a lever to enforce behavioral norms.” *Id.*

54. If these claims are nondischargeable, it will be as exceptions to discharge under § 523(a) of the Bankruptcy Code.

55. See Eisenberg, *supra* note 20, at 979–80; Harris, *supra* note 20, at 355–56.

56. And the debt arising out of that conduct is excepted from discharge. Bankruptcy Code § 523(a)(6).

57. Conceivably, even a victim of accident or illness is partly at fault for underinsuring or not insuring at all. COMMISSION REPORT, *supra* note 7, at 51. Be that as it may, at least some debtors could be found totally blameless in these circumstances, having neither courted nor invited their calamity. These debtors would be, for any right-thinking person, the paradigm of the “honest but unfortunate” debtor.

58. One recent study found that 92% of debtors tried at least one alternative, such as rearranged payment schedules, liquidation of assets and debt consolidation loans, before filing bankruptcy. 1 CREDIT RESEARCH CENTER, CONSUMERS’ RIGHT TO BANKRUPTCY: ORIGINS AND EFFECTS 59 (1982) [hereinafter CRC Study].

59. See Harris, *supra* note 20, at 356.

60. A closely related proposition is the “moral obligation theory,” under which the moral obligation to pay a discharged debt supports reaffirmation of the debt in the absence of additional consideration. For a discussion of the moral obligation theory, see *infra* text accompanying notes 177–81.



the fraud exception will encourage fraud,<sup>61</sup> the availability of discharge "may erode the degree of responsibility with which the debtor approaches his affairs" and "may actually nudge debtors down the path of imprudence."<sup>62</sup> Nevermind that less ephemeral explanations for bankruptcy are generally available;<sup>63</sup> morality-based

61. Symposium Discussion, *supra* note 45, at 165 (remarks of Daniel K. Benjamin). *Contra* Shuchman, *supra* note 39, at 469-70.

62. Weistart, *supra* note 48, at 110.

63. To be more accurate, causes of financial crises should be distinguished from causes of bankruptcy, since not all insolvent debtors actually file a bankruptcy petition or suffer an involuntary filing. Rendleman, *The Bankruptcy Discharge: Toward a Fresher Start*, 58 N.C.L. REV. 723, 725-26 (1980). (Of course, insolvency is not required for filing a voluntary petition, although equitable insolvency must be shown in an involuntary case. Bankruptcy Code § 303(h)(1). One may safely assume nevertheless that insolvency is present in virtually all consumer bankruptcies, given that so many are no-asset or nominal-asset cases. D. STANLEY & M. GIRTH, *supra* note 7, at 20. See also Sullivan, Warren & Westbrook, *Folklore and Facts: A Preliminary Report From the Consumer Bankruptcy Project*, 60 AM. BANKR. L.J. 293, 314-19 (1986) [hereinafter Sullivan, Warren & Westbrook, *Folklore and Facts*], reporting that the average debtor in their study owed debts totaling 3.24 years' income, although half the debtors had debt/income ratios lower than 1.38, and that exclusion of mortgage debt from the ratios improved them very little.)

Among these less ephemeral explanations for financial crises are the observations that debtors tend to be in their late 20s or early 30s and are more likely than the general population to be separated, divorced, or experiencing domestic problems. COMMISSION REPORT, *supra* note 7, at 41-42; H. JACOB, DEBTORS IN COURT: THE CONSUMPTION OF GOVERNMENT SERVICES 50 (1969). Consumers' financial crises are generally attributed to loss of employment, whether due to accident, illness, layoffs, or strikes, loss of overtime, uninsured medical expenses, marital problems, and overuse of credit. COMMISSION REPORT, *supra* note 7, at 43, 51, 55; Countryman, *Bankruptcy and the Individual Debtor—And a Modest Proposal to Return to the Seventeenth Century*, 32 CATH. U.L. REV. 809, 825 (1983). Responsibility for debtors' overuse of credit is laid, on the one hand, at the feet of creditors who make credit too easy to get. Ayers, *Reforming the Reform Act: Should the Bankruptcy Reform Act of 1978 Be Amended to Limit the Availability of Discharges to Consumers?*, 17 NEW ENG. L. REV. 719, 738 (1982); COMMISSION REPORT, *supra* note 7, at 55; Countryman, *supra*, at 825; Joslin, *The Philosophy of Bankruptcy—A Re-examination*, 17 U. FLA. L. REV. 189, 194 (1964). Responsibility for debtors' overuse of credit is laid, on the other hand, at the feet of debtors who are incompetent (the Commission Report substitutes "incapability" for "incompetency," to avoid the latter's "connotations of fault or blame." COMMISSION REPORT, *supra* note 7, at 53), irresponsible, inept, and poor managers. *Id.* at 51-52.

Actual dishonesty is not a major factor in debtors' financial difficulties, see *supra* text accompanying note 27, nor is inability to pay coupled with unwillingness:

[N]ot more than a third of the debtors belong to this category, and of those who do, the overwhelming majority tend to be debtors who refuse to pay because they feel they were cheated . . . or debtors who are embroiled in some payment misunderstanding with the creditor. Only a tiny fraction of this minority who have the resources to pay but do not are persons of bad faith, that is, classic deadbeats.

Caplovitz, *The Husk of Puff and the Kernel of Truth: A Critique of Injury, Ignorance and Spite—The Dynamics of Coercive Collection*, 33 U. PITT. L. REV. 672, 675 (1972). Prebankruptcy extravagances are not typically a factor in debtors' financial problems either; most studies of consumer debtors have found that debts were incurred "for necessities or near-necessities for family living." COMMISSION REPORT, *supra* note 7, at 55. Finally, general economic swings are directly correlated with the number of bankruptcies filed. *Id.* at 48-49.

Why some debtors facing financial crisis file bankruptcy and others do not is a more difficult question. A connection between bankruptcy filings and the severity of state wage garnishment laws has been established. Thus, the more severe the garnishment, the more likely a debtor is to file bankruptcy. *Id.* at 49-50; D. STANLEY & M. GIRTH, *supra* note 7, at 29-31, 236-41. *But see* H. JACOB, *supra*, at 56-57. The generosity of available exemptions, however, is not correlated with the number of bankruptcy filings, Countryman, *supra* at 826 n.102, although the combined effects of laws governing creditors' remedies (restrictions on finance charges and laws governing repossession of collateral and confessions of judgment) may affect bankruptcy filings, COMMISSION REPORT, *supra* note 7, at 50. *But cf.* Sullivan, Warren & Westbrook, *Folklore and Facts, supra*, at 321-33, concluding that the varying generosity of state exemptions laws has no effect in encouraging debtors with a greater ability to repay their debts to file Chapter 13 rather than Chapter 7.

Beyond this, explanations of why some defaulters file bankruptcy when others do not tend to focus on even less concrete and more personal factors, such as attitudes and socialization. Professor Shuchman found "adequate basis for [his] conjecture that, controlling for economic circumstance, most families in the group which might benefit from the unique remedies which bankruptcy provides do not file petitions," but he did not know "whether that is by choice due to moral aversion or for lack of knowledge or fear of the consequences." Shuchman, *supra* note 39, at 413. He added that "the anticipated or actual impact of bankruptcy may vary greatly by type of person or group." *Id.*

The decision to file bankruptcy does not appear to be one that is made rationally. COMMISSION REPORT, *supra* note 7, at 47-48; Shuchman, *Theory and Reality in Bankruptcy: The Spherical Chicken*, 41 LAW & CONTEMP. PROBS. (No. 4) 66, 83-84 (1977) [hereinafter Shuchman, *The Spherical Chicken*], *disagreeing with* Meckling, *Financial Markets, Default,*

philosophies of bankruptcy must be concerned, in general, about the effects of bankruptcy on the moral fiber and, in particular, must reflect the social consensus that debts should be paid.

Professor Shuchman's article, *An Attempt at a "Philosophy of Bankruptcy"*,<sup>64</sup> reveals the difficulties of adopting as a guiding principle the normative proposition that debts should be paid. Professor Shuchman points out that the law providing enforceability for certain promises is merely one set of constitutive rules that exists beside another set—bankruptcy. The former cannot be ethically preferred over the latter without resort to principles independent of formal rules, since actions in conformity with either set of rules are equally lawful. Professor Shuchman suggests that a "kind of 'ideal' utilitarianism is the appropriate philosophical basis for evaluation of a system of bankruptcy. Within this narrow framework one asks whether, on the whole, the known consequences of a bankruptcy system and its components are apt to bring about more good than would otherwise be the case."<sup>65</sup> Professor Shuchman rejects the proposition that a single filing of a bankruptcy petition will "tend to bring about many more bankruptcies which, considered not as individual acts but as a class of actions, as a general rule, might be thought bad."<sup>66</sup> Thus, he advocates that each specific petition in bankruptcy be tested by asking whether it has brought about more good results than would have existed in its absence: "[T]he cases in which bankruptcy is the act in moral question will generally be those in which, on the whole, the bad results of attempting to observe the rule, 'One ought to pay one's debts,' will be clearly outweighed by the better results of the discharge in bankruptcy."<sup>67</sup>

The perplexing question, however, which he has not answered, is what results are "better"? Professor Shuchman's formulation provides the appropriate result and the philosophical foundation for reaching it in the easy case. He states that "there is little question but that in some circumstances the failure [to fulfill the promise to pay] is viewed as better by reference to the consequences. Is it, on the whole, a greater good that *D* should pay his debt to the bank or that *D* should buy food for his hungry children?"<sup>68</sup> The latter, clearly, as all save the most dedicated Scrooge would agree. But that is not a hard case. A more difficult case arises when the debtor has post-petition income and the question is whether it is "better" for creditors to be allowed to reach it as a matter of course. No ethical formulation that has yet appeared resolves this mandatory 13 problem.<sup>69</sup> One is left to balance the competing normative and collection policies in accordance with one's personal values.

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and *Bankruptcy: The Role of the State*, 41 *LAW & CONTEMP. PROBS.* (No. 4) 13, 25-27 (1977). Thus the decision to file may be influenced by the degree to which the particular individual feels the "stigma" of bankruptcy, but we do not know the "extent to which the stigma attached to bankruptcy actually stops people from commencing voluntary cases." COMMISSION REPORT, *supra* note 7, at 48.

64. Shuchman, *supra* note 39.

65. *Id.* at 460.

66. *Id.* at 469.

67. *Id.*

68. *Id.* at 461 (brackets added).

69. For a discussion of mandatory 13, see *supra* note 6 and *infra* text at notes 235-59.

In all fairness, one must note that Professor Shuchman seems to have recognized this:

When we are told that we ought to pay our debts (or pay them insofar as we are able) we may legitimately ask for a reason and this reason will always be concerned, not only with the action (the payment or non-payment) itself, but also, and more importantly, with the goodness or badness of the consequences likely to follow from such an action. Thus, to judge what actions are *right*, we need to know what results are good. And if we cannot agree what are the good and bad results of bankruptcy, we may be at an impasse.<sup>70</sup>

There is an impasse indeed and formulations turning on ethical considerations or on quantifying the debtor's honesty are helpless to guide.

### C. Creditor Worthiness

An additional, albeit fairly weak, policy in current bankruptcy law recognizes that some characteristics of the claim or the claimant entitle that claim to special treatment in bankruptcy. This policy looks at more than the conduct of the debtor in creating the debt, which is a factor subsumed under consideration of the debtor's honesty or worthiness, and focuses on the nature of the debt or of the creditor to whom the obligation is owed.

Two provisions of current bankruptcy law reflect the policy that certain claims—specifically, those for family support and tax obligations<sup>71</sup>—should not be discharged in bankruptcy because of the deservingness of the creditor. The discharge exception for family support obligations was found in the pre-1978 bankruptcy statute<sup>72</sup> and the Bankruptcy Commission recommended its retention “not only because of the social primacy of family welfare but also because the claimants are unable effectively to pass on the loss.”<sup>73</sup> Claims for alimony and child support are unique and the discharge exception represents “the state's protection of special values.”<sup>74</sup>

Little cause exists to criticize a discharge exception for support obligations and its appropriateness as federal policy has, apparently, never been seriously questioned. The same cannot be said of the exception for tax obligations, however.<sup>75</sup> The Bankruptcy Commission recommended that the period of accumulation of nondischargeable taxes be reduced from three years to one year.<sup>76</sup> It based this recommendation on the conclusion that

the advantages of position enjoyed by tax debts should generally be reduced in bankruptcy because, notwithstanding the high status of governmental claims in political policy, the

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70. Shuchman, *supra* note 39, at 458–59.

71. Bankruptcy Code § 523(a)(1) & (5). Exempt property is liable for these claims during and after the bankruptcy case. Bankruptcy Code § 522(c)(1).

72. Bankruptcy Act § 17a(7).

73. COMMISSION REPORT, *supra* note 7, at 79. The Commission's recommendation amounts to a conclusion that claims for family support “are sufficiently worthy to warrant preference over the general goal of giving the debtor a fresh start.” Weistart, *supra* note 48, at 113.

74. COMMISSION REPORT, *supra* note 7, at 70. Support obligations are the only class of claims not discharged by completion of payments under a Chapter 13 plan. Bankruptcy Code § 1328(a)(2).

75. Bankruptcy Code § 523(a)(1). Unsecured tax claims also enjoy priority under § 507(a)(7) of the Code.

76. COMMISSION REPORT, *supra* note 7, at 176.

burden of relatively small loss to governments is outweighed by both the goal of a fresh start for the debtor and the individual claims of private creditors.<sup>77</sup>

The current Code, however, continues the nondischargeability of tax debts less than three years old.<sup>78</sup> The sole justification for special treatment of tax claims in bankruptcy is that the government, just because it is the government, is a favored creditor. Unlike support claimants, the government's deservingness does not rest on its special need for the money (not money generally, but *this* money)<sup>79</sup> or its lack of readily available alternative financial sources.

Although current bankruptcy law reflects only a very weak creditor worthiness policy,<sup>80</sup> several suggestions for reform would increase the extent to which the creditor's deservingness is a factor in determining dischargeability of the debt. Professor Shuchman is, perhaps, the leading proponent of this view. He proposed three types of distinctions based on characteristics of the creditor or of the debt itself. He suggested, first, that the size and net worth of the creditor be taken into account, in part because of the increased utility of repayment to a small creditor;<sup>81</sup> second, that the "voluntariness" of the creditor be considered;<sup>82</sup> and third, that the moral worthiness of the debt itself be examined.<sup>83</sup>

77. *Id.* at 78–79. According to Philip Shuchman, Deputy Director of the Bankruptcy Commission, the "biggest hassle" the Commission faced was with the Department of the Treasury. "They were intransigent about their right to be a priority claimant, and didn't want to hear any arguments. . . . The amounts involved were trivial by their standards, but no arguments would persuade them." Symposium Discussion, *supra* note 45, at 166 (remarks of Philip Shuchman).

78. Bankruptcy Code § 523(a)(1). The exception was found before 1978 at § 17a(1) of the Bankruptcy Act.

79. The Bankruptcy Commission found that the government receives an "insignificant" amount of money as a result of tax liens and priorities. COMMISSION REPORT, *supra* note 7, at 216. See also D. STANLEY & M. GIRTH, *supra* note 7, at 131 (recommending repeal of the priority for taxes on the grounds that it "has a minuscule effect on federal revenues").

80. Professor Shuchman noted that bankruptcy law, generally speaking, "does not look to the moral worth of the acts that created the debt, nor does it grade by reference to how needy or deserving is the debt, nor does it grade by reference to how needy or deserving is the creditor." Shuchman, *supra* note 39, at 444. He listed as exceptions to this general rule "support payments for the bankrupt's family, money judgments founded on grossly negligent and intentional torts, wages for employees, and the like, which, as debts, are either not discharged in bankruptcy or are given priority." *Id.* Of those debts Professor Shuchman listed as exceptions, family support obligations are the only debts excepted from discharge for which the exception is justified by characteristics of the creditor. The others reflect policies carried out other than by limitations on discharge (the priority given employees' wage claims under Bankruptcy Code § 507(a)(3), for example) or policies that focus on the debtor's conduct (such as the nondischargeability of money judgments based on intentional torts under Bankruptcy Code § 523(a)(6)).

81. Consider the immediate moral response to the situation in which a loan is made by a friend as against the loan taken from a bank with assets of hundreds of million dollars. Both transactions will found a legal obligation and both obligations will support an action for debt. Can these be considered but different degrees of the same generic order of obligation? . . .

If we accept that there is or ought to be a difference in the nature and effect of these obligations, it would seem to have at least something to do with the intent and situation of one or both of the parties. . . . Is it not that one creditor is in the business of making loans for profit, and that there is nothing philanthropic about the obligation?

Shuchman, *supra* note 39, at 428–29.

82. A second distinction may be made between debts incurred by peradventure and those contracted for by a person free not to so contract. On the whole we make no such distinction between a wholly voluntary act, a promise to pay based on fair consideration and the resultant debt obligation, and an accident, illness, or other "involuntary" creation of (an obligation reducible to) debt. From the standpoint of most moralities, the debt obligation not freely assumed should not be judged in the same manner as one voluntarily undertaken.

*Id.* at 431–32 (footnote omitted).

83. If one were to decide, without reference to existing law, who should get greater rights to payment where, by hypothesis, not all can be paid, what sorts of arrangements would be apt to result? Presumably, one would

These suggestions for reform are particularly radical given that bankruptcy law has never looked behind a contract (to detect, for example, whether the contract would return an unusually generous profit to a creditor-seller), unless the debtor had a defense (for example, usury or unconscionability) assertable by the trustee in bankruptcy to reduce or eliminate the creditor's claim.<sup>84</sup>

#### D. Rehabilitation

A House Judiciary Committee report states that the second purpose of bankruptcy, after equitable distribution of the debtor's assets to creditors, is "the effective rehabilitation of the bankrupt."<sup>85</sup> The term "rehabilitation," however, is "particularly elusive."<sup>86</sup> If it refers to the bare discharge of debt, without more, then it may simply be synonymous with discharge or that equally elusive term "fresh start." To mean anything separate and apart from "fresh start," therefore, the concept of rehabilitation must include something beyond discharge itself.<sup>87</sup>

Rehabilitation has on occasion been used in its broadest sense to include everything that the bankruptcy process does and should give to debtors. The Bankruptcy Commission, for example, referred to the function of bankruptcy "to rehabilitate debtors for continued and more value-productive participation, *i.e.*, to provide a meaningful 'fresh start.'"<sup>88</sup> It then went on to list the requirements for debtor relief "to realize fully the goal of rehabilitation":<sup>89</sup> counseling, to enable the debtor to exercise his choices in bankruptcy intelligently and to avoid future financial difficulties; adequate exemptions; generous discharge, with nondischargeability only of limited types of debts; and protection from erosion of the discharge.<sup>90</sup> If rehabilitation encompasses so much, it provides no usable theory of consumer bankruptcy's purposes at all.

Subsumed under the concept of rehabilitation are at least three analytically separate policy threads: 1) that discharge should (whether or not it does) serve a

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look to the need and deserts of the creditor and the moral worthiness of the debt. For example, we might concede that the physician who renders needed services to an insolvent with little hope of payment and the landlord who chooses not to evict though the rent is unpaid have more worthy debts than one in the business of financing expensive cars.

*Id.* at 446-47 (footnotes omitted).

84. Bankruptcy Code § 558. This provision, found at § 541(e) in the 1978 Code, was moved to its present location by the 1984 Amendments.

85. H.R. REP. NO. 687, 89th Cong., 1st Sess. 2 (1965), reprinted in 1966 U.S. CODE CONG. & ADMIN. NEWS 2468, 2469.

86. Shuchman, *supra* note 39, at 417. See Rendleman, *supra* note 63, at 726-27.

87. "Rehabilitation," however, has been used in a mere "discharge" context. See Boshkoff, *Limited Discharges*, *supra* note 10, at 73; Boshkoff, *The Bankrupt's Moral Obligation to Pay His Discharged Debts: A Conflict Between Contract Theory and Bankruptcy Policy*, 47 *IND. L.J.* 36, 48 (1971) [hereinafter Boshkoff, *Moral Obligation*]; Joslin, *supra* note 63, at 193; Shuchman, *supra* note 39, at 454. If rehabilitation means "to restore to a former state of solvency," it "seems to correspond best with a discharge of *all debts* in straight bankruptcy." Shuchman, *supra* note 39, at 417 (original emphasis).

This definition of rehabilitation is easier than a definition couched in social and psychological terminology; the latter would require one "to investigate and analyze the other consequences of bankruptcy which would result in 'soft' data, difficult to measure." *Id.* at 441-42.

88. COMMISSION REPORT, *supra* note 7, at 71.

89. *Id.* at 79.

90. *Id.* at 79-80.

consumer education function; 2) that discharge constitutes an emotional and psychological purgative for the debtor; and 3) that discharge allows the debtor to resume active participation in the open credit economy. Examination of these policies and purposes individually is much more helpful than generalized reference to the rehabilitative function of bankruptcy.

### 1. *Consumer Education*

A view of bankruptcy as an educational experience for debtors carries an assumption that something inherent in the experience itself equips the debtor to go forth and sin no more. Conceivably, a debtor discharged in Chapter 7 may have learned something in the process that will assist him in avoiding future financial catastrophe, but nothing in the current structure is designed to provide training in financial management. Any such lesson will be a fortuitous and ancillary benefit.

Recognizing a similar result under the prior statute, the Bankruptcy Commission suggested that debtor counseling of several types be routinely provided in bankruptcy. The Commission hoped to achieve several objectives. First, it recognized that a debtor may not fully understand "the options available to him under the Bankruptcy Act."<sup>91</sup> Translated, this means that debtors need assistance—which the 1984 Amendments have attempted to assure<sup>92</sup>—in choosing between Chapters 7 and 13,<sup>93</sup> the hope being that more debtors will opt for 13. Second, the Commission believed that budget counseling should be provided in an effort to counter the "mismanagement, ineptitude, and extravagance"<sup>94</sup> at the root of most consumer bankruptcies. This counseling would help the debtor use credit more wisely in the future.<sup>95</sup> Finally, the Commission recognized that the higher incidence of social and psychological stresses and dysfunctions among the debtor population justified the provision of diagnostic services and referrals,<sup>96</sup> but that this "was beyond the province of the Commission and of the Bankruptcy Act."<sup>97</sup>

Congress' failure to provide debtor counseling (beyond the minimum that any well-advised debtor is already receiving from his attorney) clearly demonstrates that, as a matter of policy, any budget counseling derived from bankruptcy is limited to that inherent in the process itself.

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91. *Id.* at 8.

92. For a discussion of these 1984 changes, see *infra* text accompanying notes 239-44.

93. Although it is difficult to believe that competent attorneys were not informing their clients of alternatives available in bankruptcy, the Bankruptcy Commission found "considerable evidence" that debtors in liquidation were often unaware of the availability of Chapter XIII under the Bankruptcy Act. COMMISSION REPORT, *supra* note 7, at 159. Thus, the Commission recommended that counseling be provided to "appraise the debtor's continuing economic situation in terms of his ability to pay past debts from future wages while maintaining himself and his dependents." *Id.* at 79. For a discussion of Chapter 13's educative potential, see *infra* text accompanying note 249.

94. *Id.* at 52.

95. *Id.* at 79.

96. The higher incidence of marital difficulties and other family problems among financially burdened debtors than among the general population; the employment, rehabilitation, and other nonfinancial difficulties stemming from accident and illness; and the personality inadequacies that lead to irrational spending, compulsive gambling, drunkenness, and other excesses all suggest that many bankrupts may benefit from specialized counseling and treatment services beyond the scope of budget counseling.

*Id.* at 53.

97. *Id.* at 55.

## 2. Psychological Goals

Debt is demoralizing, we are told,<sup>98</sup> and “a hopeless, unbelievable financial situation leads to a very costly social situation with its resulting relief costs, suicides, and criminality concomitant to financial despair.”<sup>99</sup> Discharge of debt in bankruptcy, however, “liberates the bankrupt psychologically.”<sup>100</sup> The newly freed debtor has renewed confidence in his ability to control his future and newly-resurrected self-respect.<sup>101</sup>

The problem is, of course, that we have little empirical support for conclusions about the psychological or emotional impacts of debt and discharge. These effects are difficult to measure<sup>102</sup> and “may vary greatly by type of person, social class, and peer-group support.”<sup>103</sup> The little empirical data available seem contradictory: most post-discharge debtors believe bankruptcy was a good choice,<sup>104</sup> but well over 80% would not consider filing again.<sup>105</sup>

A similar situation exists regarding that aspect of the psychological dimension of bankruptcy known as stigma. Not only is empirical data lacking,<sup>106</sup> but we encounter a no-win situation: a debtor unable to satisfy his obligations experiences resulting feelings of shame,<sup>107</sup> but the bankruptcy process that is supposedly psychologically liberating is now said to be stigmatizing.<sup>108</sup> Thus, the debtor hopelessly mired in debt faces psychological trauma whether he is in bankruptcy or not, and the process is alleged to be simultaneously freeing and stigmatizing.

Given these difficulties, any notion of bankruptcy policy as it relates to the debtor's psychological and emotional state is not helpful to explain the bankruptcy statute as it is drafted or to guide discussions of how the system should be modified.<sup>109</sup>

98. Joslin, *supra* note 63, at 193; Kronman, *Paternalism and the Law of Contracts*, 92 YALE L.J. 763, 785-86 (1983).

99. Joslin, *supra* note 63, at 191.

100. Rendleman, *supra* note 63, at 726.

101. Kronman, *supra* note 98, at 785-86. *Cf.* Shuchman, *supra* note 39, at 416 (stating an argument given to prefer Chapter 13 over Chapter 7).

102. Shuchman, *supra* note 39, at 441-42.

103. Shuchman, *The Spherical Chicken*, *supra* note 63, at 88.

104. D. STANLEY & M. GIRTH, *supra* note 7, at 66. *See also* H. JACOB, *supra* note 63, at 113-14.

105. Sullivan, Warren & Westbrook, *Limiting Access to Bankruptcy Discharge: An Analysis of the Creditors' Data*, 1983 WIS. L. REV. 1091, 1135-37 [hereinafter Sullivan, Warren & Westbrook]. This article strongly criticized a recent consumer bankruptcy study done by the Credit Research Center, CRC Study, *supra* note 58. One of the authors of the CRC Study, with an identical last name, responded to the criticisms. Sullivan, *Reply: Limiting Access to Bankruptcy Discharge*, 1984 WIS. L. REV. 1069 [hereinafter Sullivan, *Reply*]. The Reply sparked a Rejoinder. Sullivan, Warren & Westbrook, *Rejoinder: Limiting Access to Bankruptcy Discharge*, 1984 WIS. L. REV. 1087 [hereinafter Sullivan, Warren & Westbrook, *Rejoinder*].

106. Shuchman, *The Spherical Chicken*, *supra* note 63, at 88; Shuchman, *supra* note 39, at 413, 439. *But see* Sullivan, Warren & Westbrook, *Rejoinder*, *supra* note 105, at 1111 n.114.

107. Boshkoff, *Moral Obligation*, *supra* note 87, at 62.

108. *See, e.g.*, COMMISSION REPORT, *supra* note 7, at 62.

109. Professor Jackson proposes “volitional and cognitive justifications” for the nonwaivability of discharge that are rooted in psychological theories. Jackson, *supra* note 5, at 1405-15. He begins with the notion of “regret,” by which he means a change in an individual's desires over time. *Id.* at 1405-07. He then supplements regret with two additional hypotheses: first, “impulse control,” or the willingness of people to place constraints on their natural tendency to prefer current gratification to postponed, although enhanced, gratification, *id.* at 1408-10; and second, “incomplete heuristics,” or the systematic tendency to underestimate future risks and, thus, to overconsume credit. *Id.* at 1410-15. These concepts are new to the bankruptcy field and, as Professor Jackson notes, not yet rooted in empirical work. *Id.* at 1448.

### 3. Economic Rehabilitation

The last bankruptcy policy subsumed under the concept of rehabilitation is economic rehabilitation—that discharge enables the debtor to resume economic participation in the open credit economy.

The Bankruptcy Commission's report devoted a substantial amount of attention to the central role bankruptcy plays in assuring the debtor's return to productive economic participation.<sup>110</sup> According to the Commission, "the values involved in the 'open credit economy' [are] the principal process, or aggregate of processes, with which the bankruptcy process interrelates."<sup>111</sup> By "open credit economy" in the consumer context the Commission meant the complex system of private financial institutions that extend credit, in the form of cash, goods, or services, on fairly standardized contractual terms<sup>112</sup> to debtors constrained only by economic, not legal, considerations.<sup>113</sup>

The values involved in the open credit economy, identified by the Commission, are the ability of the debtor and his creditors to predict the legal consequences of their conduct, to rely on others to perform their contracts, and to participate in arms' length transactions as persons with capacity to contract.<sup>114</sup> Bankruptcy complements these values by providing an orderly set of rules under which creditors have predictable access to the debtor's assets and the debtor is rehabilitated "for continued and more value-productive participation."<sup>115</sup> One set of bankruptcy goals is to serve these values of the open credit economy, but bankruptcy also has internal goals that must take precedence in the event of conflict.<sup>116</sup> These are, according to the Commission, "(1) equality of distribution among creditors, (2) a fresh start for debtors, and (3) economical administration."<sup>117</sup>

Thus, we return to fresh start with all of the problems of lack of specificity with which we began. Identifying "fresh start" as an internal goal of bankruptcy does not clarify what elements are necessary or appropriate components of the fresh start, beyond saying that some degree of forgiveness of some types of debts, incurred under some kinds of circumstances, is an economic good.

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110. COMMISSION REPORT, *supra* note 7, at 68–74.

111. *Id.* at 68.

112. *Id.* at 68–69. The Commission focused, therefore, on "voluntary creditors" who become claimants in bankruptcy—*i.e.*, those who choose to lend money or to sell goods or services on credit to a debtor—rather than on "involuntary creditors," such as tort victims, who do not make deliberate decisions to deal with a debtor but who, nonetheless, find themselves claimants in bankruptcy. As far as numbers go, the focus is reasonable; most bankruptcy claimants are voluntary, rather than involuntary, creditors. *Id.* at 70.

113. The Commission recognized, of course, that our economy is not entirely unconstrained. *Id.* at 69. *See generally* Kronman, *supra* note 98.

114. COMMISSION REPORT, *supra* note 7, at 70.

115. *Id.* at 71.

116. The Commission recognized that "emphasis on the open credit economy does not imply that its values are the only or the most important ones affected by the bankruptcy process." *Id.* at 68.

117. *Id.* at 75.



### E. Economic Analysis and Efficiency Purposes

Inevitably, discussion of participation in the open credit economy raises questions of the impact of bankruptcy discharge on the economic efficiency of the credit market. Professor Eisenberg's analysis posits that the "risk of financial distress of bankruptcy" should be placed on the party better able to bear the risk. That, in turn, depends on two factors: which party is better able to prevent the risk from occurring; and which party is the "superior insurer" against the risk.<sup>118</sup>

The initial obstacle in ascertaining whether the debtor or creditor is better able to prevent the risk from occurring is to identify exactly what risk is under discussion. The two possibilities—the risk of default and the risk of bankruptcy<sup>119</sup>—are not the same, since many more consumers default on their obligations than end up in either voluntary or involuntary bankruptcy.<sup>120</sup>

Assume first that the risk of concern is the risk that bankruptcy will be filed. The consumer debtor apparently is better able to avoid this risk, given that most consumer petitions are voluntary.<sup>121</sup> To the extent that social and attitudinal factors explain why some defaulters file bankruptcy and some do not,<sup>122</sup> then the debtor appears to have substantially more control than does the creditor.<sup>123</sup> This overlooks, however, external factors such as wage garnishments<sup>124</sup> and other creditor-initiated pressures that often lead a debtor to file a defensive petition to gain the protection of the automatic stay. Thus, even if bankruptcy is the risk of concern, creditors may have substantially more control over the risk than initially appears.

Assume, on the other hand, that default is the risk of concern.<sup>125</sup> Professor Eisenberg asserts that generally "borrowers know more about themselves and have greater control of their affairs than lenders do."<sup>126</sup> That may be true of individual debtors, but the knowledge needed to assess the risk of default is actuarial, not individual.<sup>127</sup> As between consumer debtors and commercial lenders, who constitute

118. Eisenberg, *supra* note 20, at 981–82.

119. Professor Eisenberg discusses bankruptcy discharge as a system for allocating the risk of financial loss between debtor and creditor. *Id.* at 981. The risk a debtor assumes by borrowing is the risk that debts will have to be repaid. (Of course, the risk becomes an actual loss only if the debtor in fact pays, as Professor Eisenberg, by advocacy of mandatory 13, seems to assume the debtor can and will.) When risk is on the creditor, however, the risk is that nothing will be paid. The risk of having to repay and the risk that repayment will not be made are always reciprocal; to the extent that one increases, the other decreases. Bankruptcy does not allocate these risks. Instead, discharge in bankruptcy *shifts* to creditors the risk that would otherwise, under generally applicable laws governing obligations, be on the debtor.

120. The legislative history to the 1978 Code reports, for example, an 18% default rate on educational loans, but of that 18%, only 3 or 4% of the amounts involved are discharged in bankruptcy. H.R. REP. NO. 595, *supra* note 44, at 133, reprinted in 1978 U.S. CODE CONG. & ADMIN. NEWS at 6094. See also H. JACOB, *supra* note 63, at 26, 54 (noting that 10 times as many wage garnishments are filed than bankruptcies, and that 44% of all persons delinquent on their obligations do not file bankruptcy).

121. In 1980, less than .05% of all bankruptcy petitions were involuntary filings. D. BAIRD & T. JACKSON, CASES, PROBLEMS, AND MATERIALS ON BANKRUPTCY 79 (1985).

122. See *supra* note 63.

123. Cf. Eisenberg, *supra* note 20, at 983.

124. See *supra* note 63.

125. Although Professor Eisenberg refers to the risk of bankruptcy, he seems to discuss the risk of default. Eisenberg, *supra* note 20, at 982.

126. *Id.* at 983.

127. See Weston, *Some Economic Fundamentals for an Analysis of Bankruptcy*, 41 LAW & CONTEMP. PROBS. (No. 4) 47, 61 (1977).

the majority of bankruptcy claimants,<sup>128</sup> the latter are clearly better able “to assess the likelihood” of default.<sup>129</sup> They know, statistically, what percentage of loans will result in default<sup>130</sup> for a particular set of credit standards. Thus, lenders are better able to control the incidence of default by manipulation of credit standards and by more thorough credit investigations.<sup>131</sup> Professor Eisenberg apparently would concede this much.<sup>132</sup> He argues, however, that “other lenders, like the corner hardware store selling on credit, are likely to be at an informational disadvantage relative to the debtor.”<sup>133</sup> But sellers, like commercial lenders, are in the business of selling a product—goods or services, rather than money. Stores should price their product to include transaction costs and profit (which are also factors included in a commercial lender’s interest rate) and, if they sell on credit, the risk of default on the obligation.<sup>134</sup> Professor Eisenberg fails to explain why a seller of goods or services should not be expected to set a price for the product that covers risk, since some actuarially calculable percentage of these obligations will end up in default. Nor does he explain why this seller should not require “approved credit” of persons to whom credit terms are offered. Eisenberg would allow sellers who do not understand their markets to remain in business nonetheless.

The second inquiry of the economic approach is which party is the “superior insurer” against the risk. That party is the commercial lender rather than the consumer borrower, whether by “superior insurer” one means the party more aware of the need for insurance or the party who can purchase insurance more cheaply. The commercial lender knows that a determinable proportion of consumer borrowers will default and that bad-debt insurance is available. Undoubtedly, such a lender can purchase bad-debt insurance more cheaply than its borrowers can. Similarly, the corner hardware store that sells on credit is in a better position than its customers to obtain bad-debt insurance.

128. See *supra* note 7.

129. Professor Eisenberg actually says that debtors are better situated than lenders “to assess the likelihood and effect of bankruptcy,” Eisenberg, *supra* note 20, at 983 (emphasis added), but the context suggests that he means the likelihood of default.

130. Default should not be eliminated entirely or loans that should be made are not. D. STANLEY & M. GIRTH, *supra* note 7, at 40.

131. Ayers, *supra* note 63, at 738. “Discharge policy . . . leaves the determination of whether to extend credit to creditors, who presumably are better trained in credit policy than are legislators, and who are better able, by observing individual debtors or by employing specific contractual covenants, to monitor individuals’ consumption of credit.” Jackson, *supra* note 5, at 1426 (original emphasis).

132. Eisenberg, *supra* note 20, at 982–83.

133. *Id.* at 983.

134. This proposition is hardly new, having been recognized by the House Committee on the Judiciary nearly 150 years ago:

The foundation of loan is trust, wherever securities are not taken; it is confidence; it is credit—all terms which imply risk, and the possibility of failure. The risk relates to the question of solvency or insolvency when the period comes for demanding payment. This kind of property is held subject to this contingency; and the lender himself takes the risk; he is his own insurer. If his debtor fails, he loses; if not, he has his own. He charges, too, for this risk—in the shape of interest, premium, or commission. He parts with the immediate possession of his property, expecting it to come back to him, in proper time, with increase; he puts it afloat, and takes the hazards of the voyage for a consideration; if whelmed in the turbulent sea, he expects to sustain the loss.

H.R. REP. NO. 5, 27th Cong., 1st Sess. 3 (1841). See also Levinthal, *supra* note 13, at 19.

Given that most bankrupts are consumer debtors and that most of their creditors are commercial lenders, economic analysis leads to the conclusion that discharge should be freely given. Professor Eisenberg comes out differently: "If bankruptcy law is going to reach a single conclusion with respect to discharge, the single economic answer would most likely be to limit the discharge."<sup>135</sup> This difference derives from his focus on the individual rather than the actuarial. Eisenberg states that to determine which party can better avoid the risk of financial distress one must look at the cause of the financial distress and then decide who can better insure against that cause.<sup>136</sup> He recognizes that his inquiry will almost always point to the debtor.<sup>137</sup> He uses as an illustration a debtor whose business deal goes sour, who could have purchased insurance or could have self-insured.<sup>138</sup> Eisenberg's only example of a case in which the factor of control over financial affairs is even neutral is a case in which a debtor purchases necessities on credit. Eisenberg gives no example in which the creditor had more control over the cause of financial distress, and he admits that his inquiry will almost always point to the debtor and "weigh against a broadly available discharge."<sup>139</sup> What he does not admit, however, is how closely this inquiry into cause and control resembles an evaluation of the debtor's worthiness. To limit discharge for debtors who had more control than did their creditors over the causes leading to default is to dress up deservingness in other clothes. Call it efficiency. It is still an assignment of fault, based on the normative proposition that debts should be paid and that defaulting debtors are unworthy.

Economic inquiry is more useful when the focus is actuarial and looks not at who controls the risk that default will occur, but at who can better bear the risk of the loss that necessarily will flow from the default. This is a simple inquiry into who is the least-cost insurer, free from complex and judgmental conclusions about fault.

After concluding that economic analysis calls for a limitation on discharge, Professor Eisenberg introduces a new argument—the pass-along of increased costs if risk is placed on creditors:

Finally, if one assumes that by increasing interest rates lenders are economically as well placed as debtors to bear the added risk inherent in a discharge system that prevents access to future wages, . . . the existing discharge system can be said to have a questionable interdebtor effect. Those debtors who pay their debts bear the assumed increased credit costs. Nonpaying debtors, to whose defaults the increased cost of credit is attributable, do not fully share in that increased cost. Liberal discharge provisions thus increase the extent to which those who repay their debts subsidize those who do not.<sup>140</sup>

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135. Eisenberg, *supra* note 20, at 983.

136. *Id.* at 982.

137. Professor Jackson finds Professor Eisenberg's conclusion that debtors are probably superior risk bearers to be "by no means beyond question." Jackson, *supra* note 5, at 1400. According to Professor Jackson, "the creditors of an individual, having gained experience through dealing with many debtors, may be more adept than the individual at monitoring his borrowing. This argument squarely questions Professor Eisenberg's analysis." *Id.*

138. Eisenberg, *supra* note 20, at 982.

139. *Id.*

140. *Id.* at 983. Implicit in the quoted statement is the moralistic proposition, neither recognized nor defended, that those who repay their debts should not have to subsidize those who default. See *infra* text accompanying note 150.

The concern with which we should greet this potential pass-along of costs depends in part on its likelihood. That, in turn, depends upon the elasticity of the supply of funds available for lending. If the supply is perfectly elastic, increased costs will be borne completely by borrowers; if the supply is not perfectly elastic, creditors will bear part of these increased costs. "But only if the elasticity of supply is zero . . . will the full costs of increases in bad-debt losses be borne entirely by creditors, and only then will the wealth transfer be entirely from creditors to debtors."<sup>141</sup>

Empirical evidence, such as it is, suggests that the supply of credit funds is not perfectly elastic. First, bad-debt losses may be taken as a tax deduction<sup>142</sup> (which is, in effect, a pass-along to each of us), so only the loss not recouped through the reduced tax is passed to borrowers. Second, other legal changes, akin to changes in discharge availability, that should have increased lenders' costs have had little or no measurable effect on consumer credit. For example, more liberal state exemption laws are not associated with increased cost or reduced availability of consumer credit; states that prohibit wage garnishment do not experience increased cost or reduced availability of consumer credit; and states that permit debtors to waive their right to exemptions do not experience decreased cost or increased availability of consumer credit.<sup>143</sup> Thus, even if we are prepared to concede that the costs of some credit losses are passed along,<sup>144</sup> "we simply do not know" if these additional costs are significant.<sup>145</sup>

Commentators who assert that more liberal bankruptcy discharge raises the cost of borrowing for those who repay their debts argue that this increased cost of borrowing forces some potential borrowers out of the credit market entirely, either because of increased interest rates or more stringent credit screenings.<sup>146</sup> This argument made sense in the mid-1970s when it was advanced in opposition to passage of more liberalized discharge provisions.<sup>147</sup> Today, however, when the effort is to restrict rather than liberalize discharge, the argument necessarily implies that some debtors who are *not* now in the credit market, should be—*i.e.*, that restriction of discharge will lower credit costs in the future, thus including in the credit market persons not currently able to borrow.<sup>148</sup> One problem with this argument is that no empirical support exists for the proposition that persons (obviously of high risk) are

141. Moore, *Foreword: The Economics of Bankruptcy Reform*, 41 *LAW & CONTEMP. PROBS.* (No. 4) 1, 5 (1977).

142. I.R.C. § 166 (1986).

143. Shuchman, *The Spherical Chicken*, *supra* note 63, at 78-79.

144. Even some opponents of restricted discharge concede that at least some costs will be passed along to other borrowers. Sullivan, Warren & Westbrook, *Rejoinder*, *supra* note 105, at 1096. *But see* Symposium Discussion, *supra* note 45, at 126 (remarks of Seymour Smidt).

145. Weistart, *supra* note 48, at 115.

146. Meckling, *supra* note 63, at 23.

147. Even then, however, proponents of the argument were faced with "little empirical evidence that the debt burden is too great for borrowers as a whole." D. STANLEY & M. GIRTH, *supra* note 7, at 40. Discharge has been liberalized since then, but not as much as was feared by opponents of the liberalization, who supported their opposition by the pass-along argument. In particular, changes then under consideration included elimination of the false financial statement exception to discharge and a complete ban on consumer reaffirmations. The changes actually made cut back on cases in which false financial statements will permit exception of the debt from discharge and surrounded reaffirmation with procedural safeguards.

148. *See* Sullivan, *Reply*, *supra* note 105, at 1075.

currently excluded from the credit market who should not be. Furthermore, the argument is hard to square with the commonly held belief that credit is too easy to get.<sup>149</sup> Finally, entry of these high risk borrowers into the credit market would surely result in an increased incidence of default and discharge in bankruptcy, thus compounding the problem of nonrepayment that troubles opponents of liberalized discharge.

The concern with which we should greet the potential pass-along of costs also depends on whether it is viewed as inappropriate. One way of viewing the added cost is as an insurance premium, paid by all users of credit to insure their own access to bankruptcy relief in the event of financial disaster.<sup>150</sup> Viewed in this way, the "bankruptcy premium" is no more an undesirable deadweight economic loss than is insurance generally. In addition, empirical evidence about the relationship between bankruptcy discharge and bad debts generally would have to be adduced to determine whether the availability of discharge has any effect on the amount or distribution of this "insurance premium."

Last, the concern with which we should greet this potential pass-along of costs depends in part on the group to whom costs will be passed. Commentators who argue that this cost will be passed on in the form of increased costs for borrowers who repay their debts do not agree as to the category of borrowers to whom these costs will be passed. The outcome turns on whether lenders are able to, and do, stratify borrowers into various risk groups. If lenders are able to isolate the group of borrowers that poses the highest risk of bankruptcy, lenders will pass increased costs attributable to more liberal bankruptcy discharge on to that group.<sup>151</sup> The result would be to place the cost of the system on those who use it. Unless the consequence would be exclusion of those persons from the credit market altogether, which does not seem to be the case, this outcome seems perfectly acceptable both economically and ethically.

Commentators engaged in the debate about the group to which costs will be passed assume, apparently, that these costs will be passed, in the form of higher interest rates, only to borrowers—either solely to those who default, or to both those who default and those who repay.<sup>152</sup> None of the commentators has discussed the possibility that costs may be spread even more broadly—that is, to all purchasers, whether for cash or on credit—in the form of increased prices of goods and services. At least two factors suggest this possibility. First, putting aside certain gasoline stations that offer "discounts" for cash, sellers typically do not price products differently for users of credit than for users of cash. Second, credit sellers do not typically carry their own notes; rather, they discount their commercial paper to institutional lenders. The discount rate must be accounted for by the seller in setting

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149. See *supra* note 63.

150. See Harris, *supra* note 20, at 364 n.203; Sullivan, Warren & Westbrook, *Rejoinder*, *supra* note 105, at 1142.

151. Meckling, *supra* note 63, at 23–24; Shuchman, *The Spherical Chicken*, *supra* note 63, at 83; Sullivan, *Reply*, *supra* note 105, at 1071–72; Weistart, *supra* note 48, at 118–19.

152. For this purpose, "borrowers" include those who borrow money from commercial banks and those who obtain credit terms from sellers of goods and services. Since, as the text explains, credit sellers typically sell their commercial paper to institutional lenders, those who borrow by purchasing on credit ultimately end up in a debtor-creditor relationship with a commercial lender much like the relationship experienced by those who borrow directly from such lenders.

the price of his goods and services. Since the discount rate reflects, in part, the risk that the obligation will not be repaid, setting prices to account for the discount automatically passes on the cost of default by some credit purchasers to all buyers, including those who pay cash.

If this broader pass-along of costs in fact occurs, then it reduces the extent to which any one group bears the cost and, therefore, reduces the force of the argument that some borrowers will be forced out of the credit market.<sup>153</sup> A broader pass-along also invites the argument that increased costs for cash purchasers, attributable to defaults by credit buyers, will exclude cash buyers from the market by raising the prices of goods and services to levels these cash buyers can no longer afford to pay on a cash basis. (Whether they will then become credit buyers is another issue.) In the absence of empirical evidence to the contrary (and there are, apparently, no empirical data for any of this), one can only speculate that any such price increase would be spread so broadly that the incremental difference would not be sufficiently great to affect any decision to purchase.

Before tinkering with bankruptcy rules in the name of economic efficiency, we should admit our limitations. First, if costs are passed along when creditors bear the risk, so that paying debtors subsidize nonpayers, this pass-along will occur without regard to the rules in bankruptcy. Those who pay subsidize those who *default*, not just those who default and obtain a discharge in bankruptcy. A change in the rules of discharge to reach a debtor's future income would make a difference in this pass-along of costs only to the extent that consumer debtors end up in bankruptcy, are able to pay out of future income and in fact pay through the vehicle of mandatory 13.<sup>154</sup> Second, economic analysis requires a great many assumptions. Before we make major changes in the scope of bankruptcy in order to benefit commercial lenders and sellers,<sup>155</sup> we need substantially more empirical data.

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153. See *supra* text accompanying note 146.

154. The Credit Research Center concluded that a substantial percentage of Chapter 7 debtors could repay some or all of their debts from future income. Specifically, the CRC Study found that 20% of debtors could repay all of their nonmortgage debt in three years, after meeting basic living expenses, and 29% could do so in five years. CRC Study, *supra* note 58, at 57, 59. Furthermore, 31% could repay at least half of their nonmortgage debt in three years, from income remaining after meeting basic living expenses, and 37% could do so in five years. *Id.* The Study found, on the other hand, that 52% of the respondents could repay nothing, whether in three or five years, after meeting basic living expenses. *Id.* For a critique of these findings see Sullivan, Warren & Westbrook, *Rejoinder, supra* note 105. See also Shuchman, *The Average Bankrupt: A Description and Analysis of 753 Personal Bankruptcy Filings in Nine States*, 88 *COM. L.J.* 288 (1983) (concluding that debtors filing under Chapter 7 tend to have large debts and small incomes); H. JACOB, *supra* note 63, at 68-69 (finding that debtors filing under Chapter 13 had lower levels of debt than Chapter 7 filers).

155. As noted above, see *supra* text accompanying notes 7 and 8, tort claimants have been left out of this analysis. While they may not represent a large proportion of the claimants in consumer bankruptcies, the involuntariness of their predicament may make them the most subject to sympathy. Putting sympathies aside, however, economic analysis may call for a different result than that reached for commercial lenders or suppliers of goods.

The first of the two steps in economic analysis identifies the party better able to prevent the risk from occurring. The risk relevant to an economic analysis of torts is the risk that an injury or accident will occur, and the debtor-tortfeasor is clearly the party most able to prevent injury from occurring. This is true whether the debtor's actions were willful and malicious, reckless, or merely negligent, for a component of the latter is failure to exercise the due care expected of a reasonably prudent person. W. KEETON, PROSSER AND KEETON ON THE LAW OF TORTS § 32 (5th ed. 1984).

The second step in economic analysis asks which party is better able to bear the risk. Here the analysis leads to no certain outcome. If the question is whether the debtor or the tort victim is economically better able to bear the loss, then the answer depends upon the facts of each individual case. To leave the risk on the debtor (through bar of discharge) on

### III. A THEORY OF DISCHARGE

These competing policies leave the impression that bankruptcy is expected to serve entirely too many masters. Rather than attempting to serve this range of policies, discharge in the context of non-tort claims should have only one goal—to restore the debtor to economic productivity and viable participation in the open credit economy. This standard calls for making discharge broadly available, since viable economic participation is restored by lifting the burden of impossible debt. No one advocates discharge on demand, however.<sup>156</sup> Thus, some limitation is necessary. This single goal of discharge should be limited only as necessary to prevent skewing of economic decisions, including decisions both to lend and to borrow, by the intrusion of factors irrelevant to economic decisions.

Asking whether a debtor's conduct has skewed economic decisions avoids the difficulties of normatively-based discharge policy. Since little agreement can be found on the question of when it is "better" that debts should be discharged rather than paid, this functional economic approach avoids such ethical dilemmas and looks only at economic factors.

The educational and psychological portions of the rehabilitative goal of bankruptcy play no part under the functional economic approach. This is not to say that discharge has or should have no educational or psychological impacts. It is to say simply that these impacts should play no part in deciding questions relating to the availability of discharge. The educational function is peripheral to bankruptcy; while debtors should be encouraged to learn better money management skills as a result of the bankruptcy experience, discharge should not depend upon demonstration of improved management ability. The psychological function of discharge is far too amorphous to be useful.

Once the normative, ethical, and psychological factors are set aside, only the rehabilitative purpose of restored participation in the open credit economy remains as a meaningful goal of discharge. This goal, limited as necessary to prevent distortion

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the assumption that the debtor is economically better able to bear the loss is also to assume that the debtor will actually pay. That is improbable, given that most debtors cannot repay their debts out of future income (due to the protection of wage garnishment and exemption laws). See *supra* note 154. Second, some tort victims will be better able to bear the costs of injury than the probably-insolvent bankrupt tortfeasor. There is, then, no way to "take into account the allocation of the economic burden of the debt," COMMISSION REPORT, *supra* note 7, at 78, without simply making assumptions about the universe of tort victims. If the question is whether the debtor or tort victim is better positioned to appreciate the need for insurance and to purchase it more cheaply, the analysis remains uncertain. Both tortfeasor and victim can foresee that injury is a predictable possibility and particular circumstances may affect which party is the least-cost insurer. For example, if the debtor's negligent driving is our concern, liability insurance is readily available. So also, however, is uninsured motorist insurance that would protect tort victims from losses caused by the negligence of an uninsured debtor-tortfeasor. If we are concerned about injuries to persons on the debtor's premises, the ready availability of homeowner's insurance probably renders the debtor the least-cost insurer. Potential tort victims are probably unable, as a general rule, to obtain reasonably priced insurance against the general hazards of a non-automotive world.

These considerations suggest that limitations on discharge may not be as inappropriate from an efficiency viewpoint when the claim in bankruptcy is based in tort as when it is based in contract. Indeed, two of the current debts excepted from discharge—those for willful and malicious injury, Bankruptcy Code § 523(a)(6), and those based on drunk driving judgments, Bankruptcy Code § 523(a)(9)—are tort-based, although the justifications for those subsections are not generally phrased in economic terms.

156. See Eisenberg, *supra* note 20, at 977. As Professor Jackson puts it, "free access to discharge would be disastrous for a credit-based economy." Jackson, *supra* note 5, at 1427.

of economic decisions, should guide decision-making concerning the appropriate scope of discharge in bankruptcy. This standard, when applied to particular policy problems in bankruptcy, provides more reliable guidance than any of the policy threads heretofore used.

#### A. *Issues Related To Debtor's Conduct*

A debtor aware of the potential availability of a discharge in bankruptcy might be more inclined to incur debts than would an individual who is making a decision to borrow on the basis of purely economic factors, such as current ability to repay and expected future income. Because this inclination would skew the economic decision by introducing non-economic factors, some limitation on discharge is necessary to control the debtor's conduct. Thus, discharge should be barred for a debtor who has knowingly hindered the bankruptcy proceedings in ways currently covered by the bankruptcy statute.<sup>157</sup> In addition, discharge of particular debts should be barred if the debtor engaged in disfavored kinds of conduct, such as dishonesty, in connection with that particular debt. This limitation, too, is part of current law.<sup>158</sup> These provisions are appropriate not because we dislike dishonesty and want to discourage it. Although discouraging dishonesty is a laudable social policy, bankruptcy law is not a vehicle appropriate for the vindication of all social policies. Provisions discouraging dishonesty are appropriate in bankruptcy because discharge for debts affected by such conduct would introduce noneconomic factors into the decisions to lend and borrow. In particular, the debtor would evaluate not just his financial situation, but also the likelihood of getting away with more credit than his financial circumstances might otherwise justify.

The proposed functional economic approach also helps with the grey areas of conduct alluded to earlier<sup>159</sup>—those areas of debate about whether the debtor's conduct was so dishonest that discharge should be jeopardized. A naively optimistic debtor, for example, may misguidedly believe that things will work out, yet not be introducing into his economic decisions any sinister noneconomic factors. The debtor who engages in a reckless and careless disregard for financial probabilities comes dangerously close to making no economic calculation at all. The proposed standard, therefore, would support statutory modification designed to treat these debtors "less generously in bankruptcy than the other debtor groups."<sup>160</sup>

The functional economic approach lends support to the Code provision making dischargeable a debt incurred through the debtor's use of a false financial statement as long as the creditor did not rely on it.<sup>161</sup> The provision, as noted,<sup>162</sup> reflects Congress' judgment that the actual misconduct in these cases was really the creditor's. But when analyzed under the proposed standard, it becomes apparent that the financial

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157. Bankruptcy Code § 727(a).

158. Bankruptcy Code § 523(a).

159. See *supra* text accompanying notes 54–59.

160. Eisenberg, *supra* note 20, at 979.

161. Bankruptcy Code § 523(a)(2)(B).

162. See *supra* text accompanying notes 42–45.



misinformation supplied by the debtor was not a factor in the creditor's lending decision and cannot be said to have skewed it. Only if the misinformation affected the creditor's decision to lend should it be a reason to bar the debtor's discharge.

The approach advocated here also supports the 1984 addition to the Code of a presumption that debts for luxury goods or services incurred within forty days of bankruptcy were incurred by false pretenses or actual fraud.<sup>163</sup> The probability is strong that these debts were incurred in contemplation of filing bankruptcy, which is an extraneous noneconomic factor skewing the debtor's economic calculation. A rebuttable presumption against discharge is entirely appropriate and allows proof in a particular case that the noneconomic factor did not in fact enter into the debtor's decision.

The worthiness of the creditor or the debt generally would not be a factor under the functional economic approach. This is not to say that family support obligations should suddenly become dischargeable.<sup>164</sup> They should not. The economic viability of the debtor automatically includes the support of those dependent upon him. A bar to the discharge of support obligations treats the fragmented post-bankruptcy family just as the intact family would be treated in bankruptcy by recognizing that economic viability for the debtor necessarily includes economic viability for his dependents, whether under his roof or not. Thus, continuation of support obligations is not inconsistent with the primary purpose of bankruptcy discharge.

Continued nondischargeability of tax obligations,<sup>165</sup> however, is inconsistent with the suggested approach. Although taxes often eat up a bankruptcy estate,<sup>166</sup> policies favoring governmental claimants may justify continuation of a priority for taxes in the distribution of an estate.<sup>167</sup> The purpose of discharge, however, is to restore economic function. That purpose is hindered by nondischarge of tax obligations, since no inappropriate factors can be said to have skewed the debtor's decisions relating to these debts. The Code should be amended, therefore, to permit discharge of tax obligations.

The six-year bar<sup>168</sup> also should be changed in light of the functional economic approach. As previously noted,<sup>169</sup> the bar may codify an irrebuttable presumption that a debtor who seeks a second discharge within six years of the first is unworthy. Although this consideration is inappropriate under the functional economic approach, that does not mean the bar should be dropped. Without the bar, a debtor already familiar with the benefits of bankruptcy might be too ready to make economic decisions negligently or recklessly, with the possibility of repeated bankruptcy in the back of his mind. Because this state of mind would be difficult to prove, a presumption against a second bankruptcy within a given time period may appropri-

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163. Bankruptcy Code § 523(a)(2)(C).

164. They are currently nondischargeable under § 523(a)(5) of the Bankruptcy Code.

165. Bankruptcy Code § 523(a)(1).

166. 2 G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 45.2, at 1288 (1965) (stating that "the real enemy" of unsecured creditors in bankruptcy is not secured creditors, but "the tax collector").

167. Cf. COMMISSION REPORT, *supra* note 7, at 216 (recommending that the priority for tax claims be retained, but that the period of claims entitled to priority be reduced from three years to one year).

168. Bankruptcy Code § 727(a)(8) & (9).

169. See *supra* text accompanying note 41.

ately put the burden on the debtor to prove that extraneous noneconomic factors did not affect his decision to borrow. (The debtor might show, for example, that the decision was based on a reasonable evaluation of current and expected resources, given the information then available.) A presumption of nondischargeability within the six-year period, rather than absolute nondischargeability, would preserve the purpose of bankruptcy to restore the debtor's economic viability, avoid the difficulties of importing other social purposes into bankruptcy, and yet not allow cavalier resort to bankruptcy by a debtor whose economic decisions were inappropriately skewed by noneconomic considerations.

The functional economic approach provides reliable guidance not only on these policy questions; it also provides a standard by which to evaluate a number of more hotly debated bankruptcy issues.

### B. Reaffirmations

The functional economic approach is particularly useful in dealing with the difficult problem of reaffirmation. Debtors choose to reaffirm discharged debts for a number of reasons. First, reaffirmation may be the only feasible way<sup>170</sup> a debtor can prevent a creditor's repossession<sup>171</sup> of property subject to a lien that passed through bankruptcy.<sup>172</sup> Second, a debtor may wish to protect a co-debtor to whom the creditor will turn for payment in the absence of reaffirmation.<sup>173</sup> Third, a creditor may refuse to extend needed post-bankruptcy credit unless a discharged obligation owed him by

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170. The only other way a Chapter 7 debtor can prevent repossession of such property is by redemption under § 722 of the Bankruptcy Code. Redemption will be cheaper than reaffirmation if the creditor is undersecured, since the former requires payment of "the amount of the allowed secured claim," which is measured by the value of the collateral, while the latter requires repayment of the entire debt. Redemption may not be feasible, however, because the majority of courts hold that redemption requires a lump sum payment. *See, e.g., In re Bell*, 700 F.2d 1053 (6th Cir. 1983) (collecting the authorities).

171. Automobiles are the most frequently repossessed items, followed by furniture and household appliances. H. JACOB, *supra* note 63, at 108.

One case illustrating the dilemma facing debtors who must choose between repossession or reaffirmation is *In re Farmer*, 13 Bankr. 319 (Bankr. M.D. Fla. 1981). The court in *Farmer* refused approval of a reaffirmation agreement that debtors signed because they could not afford to contest creditor's threatened foreclosure. Debtors were current in their payments to creditor, but creditor asserted a right to foreclose under an "insecurity clause." The court's holding was obviously influenced by the belief that such a clause is void and that a creditor receiving regular payments cannot foreclose. *Id.* at 320. That view is not universally shared. *Riggs Nat'l Bank v. Perry*, 729 F.2d 982, 987-88 (4th Cir. 1984) (Widener, J., concurring in part and dissenting in part); *In re Bell*, 700 F.2d 1053, 1058 (6th Cir. 1983).

*See also In re McGrann*, 6 Bankr. 612 (Bankr. E.D. Pa. 1980) (approving reaffirmation of a debt secured by motor vehicles, although reaffirmation was not economically feasible, because the vehicles were necessary for transportation to work, but refusing to approve reaffirmation of a debt secured by a television set); *In re Malagesi*, 39 Bankr. 629 (E.D. Pa. 1984) (approving reaffirmation of a debt secured by real property on which debtors' business was located, because foreclosure would cost the debtors their source of income).

172. A creditor with a lien against property of the bankruptcy estate has a secured claim in bankruptcy. § 506(a). If the debtor and/or trustee has the power to avoid a particular lien (under, *e.g.*, §§ 522(f), 544, 547 or 548), that creditor's secured claim is converted into an unsecured claim. If no avoiding power can be brought to bear against a lien, however, it is said to pass through bankruptcy and it remains enforceable against the property; the secured claimant typically receives, in bankruptcy, either the value of the property or the property itself. If the unavoidable lien is in exempt property, it is enforceable against the property even after discharge has been granted and the bankruptcy case has been closed. § 522(c)(2). The proposition that liens pass through bankruptcy was established by *Long v. Bullard*, 117 U.S. 617 (1886).

173. *See In re Avis*, 3 Bankr. 205 (Bankr. S.D. Ohio 1980), and *In re Berkich*, 7 Bankr. 483 (Bankr. E.D. Pa. 1980), discussed *infra* text accompanying notes 191-94.

the debtor is reaffirmed.<sup>174</sup> Fourth, the debtor may be able to avoid criminal prosecution or incarceration for a previous conviction, often on bad-check charges, if the obligation is reaffirmed.<sup>175</sup> And finally, the debtor may simply feel a moral obligation to the creditor and wish to undertake a gratuitous reaffirmation.<sup>176</sup>

Before 1978, the bankruptcy statute had no provision regarding reaffirmations. They were enforceable under general contracts principles<sup>177</sup> that found consideration

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174. Debtor in *In re Stephens*, 2 Bankr. 365 (Bankr. N.D. Ohio 1980), claimed as exempt certain household goods subject to a nonpossessory, nonpurchase money security interest held by Beneficial Finance. Debtor owed Beneficial \$550 and the goods were worth \$500. During the bankruptcy case, debtor went to Beneficial and asked to borrow \$1000. Beneficial refused to extend additional credit unless debtor reaffirmed the debt. Debtor agreed and a new loan was executed that included the prior obligation. A copy of the agreement was not filed with the bankruptcy court and court approval under § 524(c) was not sought. In this action to determine the agreement's validity, the court held, first, that the agreement was unenforceable for the amount of the pre-bankruptcy debt and, second, that Beneficial had violated the provision of the automatic stay that prohibits "any act to collect" a pre-bankruptcy debt, § 362(a)(6). The former holding is unobjectionable due to the parties' failure to obtain necessary court approval of the reaffirmation. The latter holding, however, goes much too far. Beneficial was approached by the debtor, not the other way around, and therefore did not engage in any of the harassment that § 362(a)(6) was intended to prevent. This court would force a creditor to decline all such requests, thus reducing a debtor's chance of obtaining post-bankruptcy credit. Otherwise the creditor risks contempt of court for violation of the automatic stay by merely stating that reaffirmation would be part of the price. Section 362(a)(6) should be read to prohibit creditor initiative, but should not prevent a creditor, approached by a debtor, from conditioning future credit extensions upon reaffirmation.

A much more satisfactory result was reached, on similar facts, by *In re Schmidt*, 64 Bankr. 226 (Bankr. S.D. Ind. 1986). In that case, debtors approached Bank, which held both a secured and an unsecured claim in debtors' Chapter 7 bankruptcy, and inquired about a reaffirmation of the secured debt. Bank refused to consider reaffirmation unless the unsecured debt was also reaffirmed. Debtors declined and Bank repossessed its collateral. Debtors then argued that Bank's "attempt to yoke the secured claim with the unsecured claim and obtain reaffirmation of both" violated § 362(a)(6). *Id.* at 228. The court held that Bank's "passive efforts" to collect its debts, following debtors' initiative, did not violate the automatic stay. *Id.*

175. In *American Express Co. v. Griffin (In re Griffin)*, 13 Bankr. 591 (Bankr. S.D. Ohio 1981), the bankruptcy court refused to approve a reaffirmation that recited creditor's agreement not to file bad check charges against debtor-husband. The court held that reaffirmation was not in the best interests of the joint debtors (especially debtor-wife, who was not obligated on the discharged debt), apparently believing that the threat of criminal prosecution was a subterfuge for abusive collection practices.

The Supreme Court in *Kelly v. Robinson*, 107 S. Ct. 353 (1986), expressed doubt that a criminal restitution award is a "debt" in bankruptcy, which means that the creditor (state Probation Office, in *Kelly*) would have no claim in bankruptcy and could not participate in distribution of the debtor's estate, and that the bankruptcy proceeding would not affect the debtor's obligation. Without deciding whether such an award is a "debt," however (and apparently without noticing that § 523 excepts certain "debt[s]" from discharge), the Court held that any condition a state imposes as part of a criminal sentence is nondischargeable under § 523(a)(7).

Thus, a debtor subject to a criminal restitution order has three choices: continue to make payments in accordance with the order; default on the payments and suffer the consequences of revoked probation; or reach a reaffirmation agreement with state authorities.

176. In *In re Jones*, 6 Bankr. 336 (Bankr. S.D. Ohio 1980), debtor felt a "moral obligation" to repay an unsecured debt to a credit union "because of the assistance she has received from the creditor when she was having financial difficulties." *Id.* at 337. Debtor filed for a declaratory judgment to "clarify" § 524, but exactly what she sought is unclear. She did not seek court approval of a binding reaffirmation agreement (because she did "not believe or represent that a court approved reaffirmation would not impose an undue hardship on herself," *id.*) and it appears that the creditor was concerned that she might later seek restitution of amounts voluntarily repaid. In this regard, the court remarked:

There being no valid legal consideration for such payments, and "moral" consideration under state law having been abolished, it would appear that any demand for reimbursement made by the Debtor must be honored by the creditor, if seasonably made and not barred by equitable principles, such as laches. . . . If a debt is paid which would not have mustered court approval by the reaffirmation process, court sanction should not be expected in case the debtor later seeks restitution.

*Id.* at 339. The court's suggestion that a creditor accepts voluntary repayment at its peril is in conflict with the apparent understanding of other courts. See *In re Long*, 3 Bankr. 656 (Bankr. E.D. Va. 1980), discussed *infra* text accompanying notes 186-89.

177. One study found that debtors who believed they had been treated fairly by their creditors more frequently tried to pay creditor-initiated reaffirmations. H. JACOB, *supra* note 63, at 110. Such gratuitous reaffirmations are enforceable

for a purely gratuitous reaffirmation, *i.e.*, one in which no benefit flows to the debtor, in the moral obligation theory.<sup>178</sup> This contracts analysis rendered reaffirmations generally enforceable.

The Bankruptcy Commission found "substantial evidence"<sup>179</sup> that reaffirmations were being used to undermine bankruptcy discharges:

To the extent reaffirmations are enforceable, the "fresh start" goal of the discharge provisions is frustrated. Reaffirmations are often obtained by improper methods or result from the desire of the discharged debtor to obtain additional credit or continue to own property securing a discharged debt. The Commission has recommended that the reaffirmation of a secured debt be enforceable but only to the extent of the fair market value of the property at the date of the petition. The Commission also recommends that . . . reaffirmations be made [otherwise] unenforceable . . . .<sup>180</sup>

The Commission, in essence, advocated elimination of the moral obligation theory of contractual consideration; when a reaffirmation is based solely on a debtor's desire to "do the right thing" and pay back a creditor, the Commission would have found the promise unenforceable as a matter of federal law.<sup>181</sup>

Rather than adopting the Commission's approach, Congress in 1978 permitted reaffirmations but surrounded them with procedural safeguards.<sup>182</sup> For present purposes the most important of these safeguards was the requirement that the court approve all reaffirmations of consumer debts not secured by a real property mortgage as "not imposing an undue hardship on the debtor or a dependent of the debtor" and as being in the debtor's "best interest."<sup>183</sup>

The 1984 Amendments dropped the requirement of court approval if the debtor's attorney files an affidavit asserting that the reaffirmation "represents a fully informed and voluntary agreement by the debtor" and "does not impose an undue hardship on the debtor or a dependent of the debtor."<sup>184</sup> If the debtor was unrepresented during

contracts. RESTATEMENT (SECOND) OF CONTRACTS § 83 (1979): "An express promise to pay all or part of an indebtedness of the promisor, discharged or dischargeable in bankruptcy proceedings begun before the promise is made, is binding."

178. *See, e.g., Zavelo v. Reeves*, 227 U.S. 625, 629 (1913). *See generally* Boshkoff, *Moral Obligation*, *supra* note 87.

179. COMMISSION REPORT, *supra* note 7, at 177. One study found that over a third of Chapter 7 debtors entered into reaffirmation agreements and that they reaffirmed an average of 20% of their debts. D. STANLEY & M. GIRTH, *supra* note 7, at 60-61. Another study found that more than 50% of debtors reaffirmed debts. H. JACOB, *supra* note 63, at 109. Only 8% reported that their standard of living had improved after filing bankruptcy; 54% reported a reduced standard of living, blamed in part on reaffirmations. Furthermore, the study found that 35% of all creditors routinely seek reaffirmations, but that 90% of heating oil companies and 70% of finance company creditors seek them. *Id.* at 108-09.

180. COMMISSION REPORT, *supra* note 7, at 177.

181. The Commission recommended that "discharge be given the effect of extinguishing a debt so that the debt may not thereafter serve as the basis for an enforceable obligation or judgment as a result of a mere 'reaffirmation.'" *Id.* at 12. The Commission also stated that reaffirmations "should be prohibited," *id.* at 80, but recognized that "discharge is not a sufficient remedy where the debt is secured by an indefeasible lien in property set aside to the debtor as exempt the use of which is necessary to the debtor or his family." *Id.* at 173. Thus, the Commission would recognize an exception to the general prohibition of reaffirmation and permit agreements under which the debtor would pay the fair market value of such property. *Id.* at 174.

182. Bankruptcy Code § 524(c) & (d).

183. Bankruptcy Code § 524(c)(4)(A) (1978). The court could also approve the reaffirmation on the grounds that it was "entered into in good faith" and "in settlement of litigation . . . or providing for redemption." Bankruptcy Code § 524(c)(4)(B) (1978). This ground for approval of reaffirmations was dropped by the 1984 Amendments.

184. Bankruptcy Code § 524(c)(3) (1984). The statute gives no guidance to judges faced with a represented debtor whose attorney refuses to declare that reaffirmation will not pose an undue hardship. These situations can be expected to

the reaffirmation negotiations, the court still must approve the reaffirmation as not imposing an "undue hardship" and as being "in the best interest of the debtor."<sup>185</sup>

The Code has eliminated purely gratuitous reaffirmations, because they generally are not in the debtor's best interests. In *In re Long*,<sup>186</sup> for example, the debtor sought court approval of a reaffirmation of a "minimally secured" \$1300 debt. After finding that reaffirmation would pose no undue hardship, the court turned to the question of the debtor's best interests:

But why would she desire to reaffirm a \$1300 dischargeable debt when she could redeem the property for a very few dollars? She stated she was an employee of Sears, Roebuck and Company and wished to reaffirm for that reason alone.

Ah, job pressure? No, she would admit to no pressure either for possible loss of employment or for possible discrimination in such matters as promotions. We accept that at face value.<sup>187</sup>

The court found reaffirmation was not in the debtor's best interests and stressed that she could voluntarily repay<sup>188</sup> her creditor-employer: "It is not the wisdom of Solomon but a fair solution. She is not then legally bound should circumstances change, but neither is she barred from paying. She can demonstrate her good faith and her employer should take it as such. And everyone can live happily ever after."<sup>189</sup> The court overstated its case somewhat with the claim that everyone can live happily ever after, since the creditor faces the possibility that the debtor will stop paying.<sup>190</sup> Nevertheless, the result seems clearly correct under the statute.

Similar cases arise when gratuitous reaffirmation is sought in order to protect a co-debtor who will, in the absence of reaffirmation, be pursued by the creditor. Courts are again unlikely to find that reaffirmation is in the debtor's best interests. In *In re Avis*,<sup>191</sup> the co-debtor was a nonbankrupt friend. The court denied approval on the grounds that reaffirmation was not in the bankrupt debtor's best interests, reasoning that "[c]ourt approval of an agreement because of the existence of a co-debtor would weaken the 'fresh start' for the bankrupt."<sup>192</sup> Similarly, the court in

arise given the natural caution attorneys are likely to exhibit, coupled with the fact that hardship is often present, although a less undesirable alternative to the debtor than repossession of the collateral. See, e.g., *In re Delano*, 7 Bankr. 72 (Bankr. D. Me. 1980), discussed *infra* text accompanying notes 195-96. Under the 1978 version of § 524(c), debtors often entered into reaffirmations against the advice of counsel. See, e.g., *Green v. National Cash Register Co. CI Corp. Sys.*, 15 Bankr. 75 (Bankr. S.D. Ohio 1981); *In re Long*, 3 Bankr. 656 (Bankr. E.D. Va. 1980), discussed *infra* text accompanying notes 186-90.

185. Bankruptcy Code § 524(c)(6)(A) (1984).

186. 3 Bankr. 656 (Bankr. E.D. Va. 1980).

187. *Id.* at 656.

188. Section 524(f) provides that "[n]othing contained in subsection (c) or (d) of this section prevents a debtor from voluntarily repaying any debt."

189. 3 Bankr. at 657.

190. In the absence of reaffirmation, the creditor is powerless if the debtor stops paying. For example, in *In re Magary*, 22 Bankr. 164 (Bankr. M.D. Fla. 1982), the debtor continued repaying a pre-bankruptcy loan made by his wife's sister for a year following discharge. He stopped paying when he and his wife divorced. The court held the debt discharged and thus unenforceable by the former sister-in-law because no agreement to repay was found.

191. 3 Bankr. 205 (Bankr. S.D. Ohio 1980).

192. *Id.* at 207.

*In re Berkich*,<sup>193</sup> refused to approve reaffirmation of a debt secured by real property of one debtor's mother. The court understood the debtors' wish to save the mother's property from foreclosure by the creditor-bank, but the court pointed out that the debtors "might still forestall Bank action . . . by continuing to make payments as volunteers."<sup>194</sup>

Gratuitous reaffirmations are fairly easy cases under the best interests standard. The elements of undue hardship and best interests become much harder to evaluate when the debtor wants to keep property subject to an unavoidable lien. In *In re Delano*,<sup>195</sup> for example, debtor sought court approval of a reaffirmation of a \$4000 debt owed to a creditor having a purchase money security interest in a car worth \$2400. The debtor was disabled and unemployed; her sole monthly income consisted of \$300 in Social Security disability benefits, and the monthly payment of \$171.43 would clearly be a hardship. The car was her sole means of transportation from her rural home, however, and "a disabled person deprived of her only means of transportation may experience even greater hardship than reaffirmation represents."<sup>196</sup> The court, therefore, did not disapprove the reaffirmation outright. Nor would the court approve it. Instead, the debtor's attorney was directed to initiate redemption proceedings or make a sufficient showing that redemption was unavailable.

*Delano* illustrates the dilemma faced by a skilled judge<sup>197</sup> who realized the harsh consequences of refusal to approve reaffirmation. In that case, the debtor had two distasteful choices—to reassume a burdensome debt, and suffer concomitant impairment of the fresh start, or to lose needed property through repossession. In other cases, the alternatives to reaffirmation are equally distasteful—imprisonment<sup>198</sup> or losing access to needed credit.<sup>199</sup>

Commentators have argued that reaffirmations should be prohibited because they are too often coerced,<sup>200</sup> and the 1978 Code includes a provision that has been described as an "injunction against coercion to reaffirm."<sup>201</sup> Whenever a debtor seeks to reaffirm other than purely gratuitously, however, the reaffirmation can be described as coerced. The debtor is selecting the less distasteful of two unpleasant

193. 7 Bankr. 483 (Bankr. E.D. Pa. 1980).

194. *Id.* at 484. This result is not entirely satisfactory under the best interests standard, however, given that debtors were living on the property and paying rent to the mother. Refusal of permission to reaffirm meant that debtors would lose their home, since the bank was apparently unwilling to accept voluntary payments in lieu of foreclosure. Thus, reaffirmation was not purely gratuitous in this case, even though the property to be saved did not legally belong to debtors, and the court could very easily have found the best interests test satisfied.

195. 7 Bankr. 72 (Bankr. D. Me. 1980).

196. *Id.* at 72.

197. Conrad K. Cyr was a bankruptcy judge in Maine from 1961 to 1981 and has been on the district court bench since 1981. Judge Cyr has been a member of the National Conference of Bankruptcy Judges and testified before Congress on behalf of that organization. He was editor-in-chief of the American Bankruptcy Law Journal from 1970 to 1981 and has been a contributing editor to *Collier on Bankruptcy* since 1980. At the time he decided *Delano*, Judge Cyr was one of the most experienced and prominent bankruptcy judges in the nation. 1 ALMANAC OF THE FEDERAL JUDICIARY 1 (Summer 1987).

198. See *supra* note 175.

199. See *supra* note 174.

200. Ostrow, *The Changing Nature of the Discharge in Bankruptcy*, 1979 ANN. SURV. AM. L. 403, 405; Comment, *Reaffirmation Agreements: A Fight for Enforceability Under the New Bankruptcy Code*, 12 CUMB. L. REV. 431, 432 (1982).

201. Rendleman, *supra* note 63, at 752, referring to Bankruptcy Code § 362(a)(6).

alternatives. In the case of property subject to an unavoidable security interest, the debtor seeking court approval of a reaffirmation has made the judgment that reaffirmation is less unattractive than the prospect of doing without the property or replacing it at retail prices. In effect, this debtor has decided that his fresh start is better served by reaffirmation than by its alternatives.<sup>202</sup>

The functional economic approach examines the impact on the debtor of the repossession or other consequence of non-reaffirmation and asks whether reaffirmation was undertaken for appropriate economic reasons, unaffected by impulses such as pure generosity that, however admirable, may skew economic decisions. A reaffirmation passing this test should be approved because it enhances the debtor's future economic functioning. Indeed, debtors' selection of reaffirmation strongly suggests that it serves their fresh starts better than the otherwise allowable repossession by creditors of property subject to unavoidable liens. That outcome is clearly in the debtor's "best interests."<sup>203</sup>

### C. Exemptions

Both exemptions and discharge are designed to give the debtor a "fresh start."<sup>204</sup> The 1898 Act incorporated state exemption laws, leaving the bankrupt debtor to whatever exemptions his state provided.<sup>205</sup> This approach was strongly criticized because of its nonuniformity and the varying generosity, parsimoniousness, and obsolescence of state statutes.<sup>206</sup>

The Bankruptcy Commission recommended that a uniform federal exemptions list be imposed,<sup>207</sup> but Congress both enacted a federal exemptions list and gave the states power to opt out, requiring debtors to use the state list.<sup>208</sup> In addition, Congress apparently intended to continue the pre-1978 practice of permitting eve-of-bankruptcy conversion of nonexempt property to exempt property.<sup>209</sup> This type of pre-bankruptcy planning continues to provoke policy debate.

202. Professor Jackson cites the Code's treatment of reaffirmations when he cautions against the substitution of social judgments for an individual's subjective preferences. He asserts that "the cases applying these [reaffirmation] rules contain little evidence that judges do anything other than impose their own view of the individual's best interests in deciding which reaffirmations to permit." Jackson, *supra* note 5, at 1416. His citations include *Avis* and *Berkich*, discussed in this Article *supra* text accompanying notes 191-94. *Id.* at 1416 n.73.

203. The policy question for bankruptcy, then, is not whether reaffirmation should be allowed, but whether liens should pass through bankruptcy. Reaffirmation is a vital part of the debtor's future economic functioning as long as liens survive bankruptcy. The issue, therefore, is whether liens that currently survive bankruptcy should do so as a matter of policy or of constitutional necessity. For a discussion questioning the constitutional necessity of giving regard to secured creditors' interests in bankruptcy, see Rogers, *The Impairment of Secured Creditors' Rights in Reorganization: A Study of the Relationship Between the Fifth Amendment and the Bankruptcy Clause*, 96 HARV. L. REV. 973 (1983).

204. COMMISSION REPORT, *supra* note 7, at 169; Countryman, *supra* note 63, at 818; Kronman, *supra* note 98, at 778; Vukowich, *Debtors' Exemption Rights Under the Bankruptcy Reform Act*, 58 N.C.L. REV. 769, 769 (1980).

205. Bankruptcy Act § 6.

206. Countryman, *supra* note 63, at 818.

207. COMMISSION REPORT, *supra* note 7, at 170.

208. Bankruptcy Code § 522(b)(1). Thirty-six states have enacted opt-out legislation. 3 COLLIER ON BANKRUPTCY ¶ 522.02 n.4a (15th ed. 1986).

209. Both the House and Senate reports state: "As under current law, the debtor will be permitted to convert nonexempt property into exempt property before filing a bankruptcy petition. The practice is not fraudulent as to creditors, and permits the debtor to make full use of the exemptions to which he is entitled under the law." S. REP. NO. 989, 95th Cong., 2d Sess. 76, reprinted in 1978 U.S. CODE CONG. & ADMIN. NEWS 5787, 5862; H.R. REP. NO. 595, *supra* note 44, at 361, reprinted in 1978 U.S. CODE CONG. & ADMIN. NEWS at 6317.

Eve-of-bankruptcy conversion of nonexempt to exempt assets has been called "outrageous"<sup>210</sup> on the one hand, and, on the other, has been defended as a practice that gives meaning to the fresh start.<sup>211</sup> Opportunities for the most creative (some would say abusive) uses of conversion have been curtailed by the 1984 Amendments, which placed a ceiling on the aggregate value of household goods and furnishings that a debtor may exempt.<sup>212</sup> Nevertheless, some incentive remains to a debtor to convert assets immediately before bankruptcy is filed<sup>213</sup> and the issue of conversion remains alive.

Eve-of-bankruptcy conversion raises two closely related, but analytically separable, issues: first, whether the debtor can claim an exemption in the recently converted property; and second, whether the debtor who has converted nonexempt to exempt assets immediately before bankruptcy should be denied a discharge under section 727(a)(2) for transferring property "with intent to hinder, delay, or defraud a creditor."

The prevailing view on the first issue, apparently, is that the debtor may claim the exemption despite his eve-of-bankruptcy conversion.<sup>214</sup> This result is sensible under the functional economic approach. A debtor who did not, until immediately before bankruptcy, own assets that would be exempt obviously did not need those particular assets for a minimum level of survival. If bankruptcy exemptions were designed solely to provide that minimum level, then conversion should not be permitted; the prior lack of these items belies their necessity for this particular debtor as part of his survival minimum. If the purpose of discharge and exemptions is to restore a debtor to economic productivity, however, conversion is quite sensible. The debtor may have been willing, before bankruptcy was imminent, to undergo certain

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210. *Bankruptcy Act Revision: Hearings on H.R. 31 and H.R. 32 Before the Subcomm. on Civil and Constitutional Rights of the House Comm. on the Judiciary*, 94th Cong., 1st & 2d Sess., pt. 3, at 1357 (remarks of Judge Conrad K. Cyr) [hereinafter *Hearings on H.R. 31 and H.R. 32*]. See also Eisenberg, *supra* note 20, at 993-96; Eisenberg, *Rejoinder*, *supra* note 20, at 620-22.

211. *Hearings on H.R. 31 and H.R. 32*, *supra* note 210, at 1351 (remarks of Paul L. Winkler). See also Harris, *supra* note 20, at 341-42.

212. Under the 1978 version of § 522(d)(3), the debtor could exempt up to "\$200 in value in any particular item" of household goods and furnishings, clothing, appliances, etc. The court in *In re Wahl*, 14 Bankr. 153 (Bankr. E.D. Wis. 1981), treated each knife, fork, and spoon as an "item" under § 522(d)(3), thus allowing debtors to exempt an entire sterling silverware set worth more than \$6000. The 1984 Amendments changed § 522(d)(3) to allow the debtor to exempt up to "\$200 in value in any particular item or \$4,000 in aggregate value" in the listed property. Results such as *Wahl* should no longer be possible under the federal exemptions list.

213. It is possible to exempt more than the amounts listed for particular items under the current federal exemptions list and similarly-structured state lists. This "stacking" of exemptions is accomplished by use of the "wild card" exemption of § 522(d)(5). Under that subsection, the debtor may exempt \$400 "in any property," plus up to \$3750 of the homestead exemption, if unused, provided by § 522(d)(1). A debtor could exempt up to \$5900 in his tools of the trade, therefore, if he wanted to take the largest exemption possible under the federal list. (The total of \$5900 is derived as follows: \$3750 of the unused homestead exemption, § 522(d)(1), plus \$400 "in any property," § 522(d)(5), plus \$750 in tools of the trade, § 522(d)(6).) Thus, the current federal list does provide debtors some flexibility.

Most states have opted out of the federal list, however, and the degree of incentive to convert assets depends upon the state exemption scheme. For example, in *In re Reed*, 700 F.2d 986 (5th Cir. 1983), debtor sold items of personal property not exempt under state law and used the proceeds to reduce mortgages on his home, which was exempt under state law without dollar limit.

214. The leading case is *In re Reed*, 700 F.2d 986 (5th Cir. 1983). In *Reed*, debtor sold personal property not exempt under state law—antiques, gold coins, and guns—and used the proceeds, which totalled about \$35,000, to satisfy a second mortgage on his home and to pay down the first. State law allowed a homestead exemption without dollar limit. The court cited the legislative history quoted in note 209, *supra*, and allowed debtor the exemption.



deprivations in order to pursue other goals, as revealed by the bundle of assets selected. When other goals prove beyond his reach, however, the debtor may reasonably wish to reallocate his exempt and nonexempt assets with the notion of starting over in mind. Eve-of-bankruptcy conversion allows a debtor who has made a particular pre-bankruptcy allocation of assets, for reasons of his own, to reallocate his assets as needed to assure the greatest probability that economic function can be restored after bankruptcy.<sup>215</sup> Any objection to this reallocation of assets is probably based on dissatisfaction with the generosity of the state's exemption list.<sup>216</sup> Reallocation is, in fact, the best way to achieve the overall purpose of the bankruptcy system—to promote the economic independence of productive persons, rather than the economic dependence of the welfare poor.

Even though the exemption is allowed, the debtor may be denied a discharge on the grounds that he transferred property with intent to delay or defraud creditors.<sup>217</sup> The functional economic approach supports cases holding that the mere fact of eve-of-bankruptcy conversion does not constitute fraud per se. These cases require, before discharge will be denied, a showing not only that such conversion occurred, but also that the debtor had actual intent to defraud creditors.<sup>218</sup> In the absence of additional facts suggesting fraudulent intent, one may assume that only appropriate economic factors contributed to the debtor's decision to convert nonexempt into exempt assets on the eve of bankruptcy. Only if actual fraud is present should it be suspected that the debtor considered inappropriate noneconomic factors.

#### D. Chapter 13

Two issues surrounding Chapter 13 currently provoke, perhaps, the hottest bankruptcy policy debates—the scope of the Chapter 13 discharge and whether

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215. See Weistart, *supra* note 48, at 121 n.29.

216. The analysis presented in the text obviously does not comfortably fit a case like *In re Reed*, 700 F.2d 986 (5th Cir. 1983), in which the debtor was not reallocating his bundle of assets. Rather, he was utilizing conversion in order to increase his equity in an asset exempt under state law without value limitation. One may safely speculate that Congress did not anticipate this sort of case, which is made possible by the state's remarkably generous homestead exemption.

The safeguard against such a strategic use (abuse?) of the exemptions system may be amply supplied by § 727(a)(2). See *infra* note 217 and accompanying text.

217. The court in *In re Reed*, 700 F.2d 986 (5th Cir. 1983), did precisely that. The court permitted debtor to claim an exemption in the converted property, as discussed in note 214, *supra*, but denied him a discharge on the grounds that he had transferred property with intent to defraud creditors under § 727(a)(2). The court reasoned that federal law governed the issue of discharge, while state law determined exemptions, and held that "mere conversion is not to be considered fraudulent unless other evidence proves actual intent to defraud creditors." *Id.* at 991. The court concluded that debtor's pattern of conduct "amply" supported a finding of actual fraudulent intent.

Professor Jackson seems to be critical of *Reed*:

A state that uses a system permitting eve-of-bankruptcy conversions, in the sense of exempting converted assets, may in effect be simply permitting an individual to shelter cash. To the extent a state allows its residents to keep (as exempt) property acquired on the eve of bankruptcy, denial of discharge may be inappropriate. . . . It may therefore be difficult to conclude from section 727(a)(2) that a midnight conversion hinders, delays, or defrauds creditors of a debtor living in a state that would extend exempt status to the resulting property.

Jackson, *supra* note 5, at 1445. Professor Jackson's position is not entirely clear, however, since he goes on to suggest that if the requisite intent is found, denial of discharge, rather than mere denial of exemption, may be the only sufficient deterrent. *Id.* at 1445-46.

218. E.g., *In re Reed*, 700 F.2d 986 (5th Cir. 1983); *In re Adlman*, 541 F.2d 999 (2d Cir. 1976) (decided under the Bankruptcy Act).

consumer debtors should be mandated to file under Chapter 13 rather than Chapter 7. The functional economic approach helps shed light on both of these issues.

### 1. *Scope of Chapter 13 Discharge*

The so-called "better discharge" in Chapter 13 has provoked a great deal of comment, most of it critical.<sup>219</sup> The criticism stems from the fact that a debtor who cannot obtain any discharge in Chapter 7, and a debtor who cannot discharge a particular debt in Chapter 7, can obtain discharge in Chapter 13 without, potentially, paying any more to creditors than would be paid in a Chapter 7 liquidation.

Two features of the statute accomplish this. First, the drafters omitted from the 1978 Code the old Act's requirement that a debtor seeking discharge in Chapter 13 be guilty of no act or omission that would preclude discharge under Chapter 7.<sup>220</sup> Second, the Code requires that a debtor who has completed performance of the Chapter 13 plan be discharged from all debts except support obligations.<sup>221</sup> This second feature of Chapter 13 assumes its full impact when examined in conjunction with section 1325, which requires confirmation of a plan if, *inter alia*, it was "proposed in good faith" and provides an amount to each unsecured claim "not less than the amount that would be paid on such claim if the estate of the debtor were liquidated under Chapter 7."<sup>222</sup> Not unexpectedly, debtors quickly argued that, since most Chapter 7 cases pay little or nothing to unsecured creditors, a zero or nominal payment plan meets the amount requirement of section 1325.<sup>223</sup> Court acceptance of this argument would allow a debtor who had, for example, defrauded a creditor to discharge that debt in Chapter 13 when Chapter 7 would except the debt from discharge, and to do so at little cost.<sup>224</sup>

Many bankruptcy courts, by rejecting this argument, "manned the bastions to defend Chapter 13 against such unprincipled abuse."<sup>225</sup> A majority of these courts

219. Hughes, *Chapter 13's Potential for Abuse*, 58 N.C.L. Rev. 831 (1980); Jackson, *supra* note 5, at 1440 n.147; Van Baalen, *supra* note 40.

220. Bankruptcy Act § 656(a): "The Court shall confirm a plan if satisfied that— . . . (3) the debtor has not been guilty of any of the acts or failed to perform any of the duties which would be a bar to the discharge of the bankrupt . . . ."

221. Bankruptcy Code § 1328(a). A "hardship discharge" may be granted under § 1328(b) to a debtor who has not completed payments under the plan, but debts nondischargeable under § 523(a) will not be discharged. Bankruptcy Code § 1328(c)(2). Judge Hughes calls this "the ultimate irony" because "the more ambitious the payment plan, the more likely section 523 will apply to the debtor." Hughes, *supra* note 219, at 844.

222. Bankruptcy Code § 1325(a)(3) & (4).

223. See, e.g., *In re Hawkins*, 33 Bankr. 908 (Bankr. S.D. N.Y. 1983); *Deans v. O'Donnell*, 14 Bankr. 997 (E.D. Va. 1981); *In re Koerperich*, 5 Bankr. 752 (Bankr. D. Neb. 1980).

224. In *In re Rimgale*, 669 F.2d 426 (7th Cir. 1982), for example, debtor and his wife won the confidence of a young widow under psychiatric care, who was later declared incompetent, and induced her to give them the proceeds of her late husband's life insurance. Her representative obtained a tort judgment against debtor and his wife that would not have been dischargeable in Chapter 7, under §§ 523(a)(4) or (a)(6). Debtor filed a Chapter 13 petition and sought confirmation of a plan that would pay 11% of the unsecured portion of the tort claim. The court rejected creditor's argument that, because the claim was not dischargeable in Chapter 7, she was not receiving at least as much under the plan as she would receive under Chapter 7 and, therefore, the "best interests" test of § 1325(a)(4) was not met. The court remanded, however, for a determination whether the "good faith" test of § 1325(a)(3) was satisfied, listing factors for consideration by the lower court heavily weighted toward the accuracy of the plan's figures. Thus a debtor who has engaged in reprehensible conduct creating a claim nondischargeable in Chapter 7 can look to Chapter 13 for relief.

225. Van Baalen, *supra* note 40, at 462.

used as their vehicle the good faith requirement of section 1325(a)(3), finding that it contains a payment standard and requires that something be paid to unsecured creditors.<sup>226</sup> Courts did not, however, reach any discernible consensus regarding the amount a plan must propose to pay unsecured creditors in order to meet the good faith test.<sup>227</sup>

Issues regarding the statutory acceptability of minimum payment plans may have been resolved by the 1984 addition of section 1325(b), which requires that the debtor commit all of his "disposable income" to payments under the plan when a creditor objects to a plan that proposes to pay less than 100% of unsecured claims. At least one court asserted that section 1325(b) "solves . . . the problem of excess disposable income" and refused to deny confirmation of a plan on the ground that the payments it provided were too small.<sup>228</sup>

The policy debate surrounding zero payment plans in Chapter 13 may be viewed as a dispute over the worthiness of the debtor<sup>229</sup> and the appropriate strength of bankruptcy's collection mechanism.<sup>230</sup> Courts that confirm zero payment plans<sup>231</sup> are, in essence, revealing the minimal power of bankruptcy as a collection device. But a requirement, imposed by some courts, that Chapter 13 plans pay creditors more than a *de minimus* sum<sup>232</sup> does not supply added muscle to bankruptcy's collection function given the debtor's unwaivable right to convert a case from Chapter 13 to Chapter 7 at any time.<sup>233</sup>

Clearly the bankruptcy courts, through manipulation of the good faith requirement and use of other arguments,<sup>234</sup> have found ways to prevent occurrence of the most obvious abuses of Chapter 13 and the bankruptcy system. The proposed functional economic approach provides a more straightforward analysis.

The very availability of the "better discharge" could alter a debtor's economic decision-making, rendering his actions more reckless, if not downright malicious and fraudulent. Moreover, a debtor who did not factor in the availability of a broader bankruptcy discharge in the first instance still might, after an obligation has been incurred and bankruptcy looms, decide to choose a Chapter 13 payment plan rather than a Chapter 7 liquidation on the basis of factors other than economic feasibility.

226. See *In re Johnson*, 43 Bankr. 1016 (E.D. Va. 1984); *In re San Miguel*, 40 Bankr. 481 (Bankr. D. Colo. 1984). For a collection of additional cases, see Van Baalen, *supra* note 40, at 467 n.74.

227. Compare *In re Tramonto*, 23 Bankr. 464 (Bankr. W.D. N.Y. 1982) (confirming a 20% plan that included a claim based on debtor's fraud not dischargeable under Chapter 7), with *In re Williams*, 42 Bankr. 474 (Bankr. E.D. Ark. 1984) (denying confirmation of a 37% plan that included educational loans because debtor had another source of income yet untapped). For a collection of cases, see Van Baalen, *supra* note 40, at 468 nn.75-79.

228. *In re Green*, 60 Bankr. 547, 552 (Bankr. C.D. Cal. 1986).

229. The most absurd of all the absurd results is often identified as granting the better discharge to debtors who pay their creditors no more than would result from liquidation—in most cases, nothing. . . . A debtor unwilling or unable to pay creditors substantially more than the liquidation amount is not deserving of the better discharge.

Van Baalen, *supra* note 40, at 476.

230. One commentator has suggested "that the sole purpose of chapter 13 is to create a greater return for creditors."

Van Baalen, *supra* note 40, at 494 n.210.

231. See, e.g., *In re Koerperich*, 5 Bankr. 752 (Bankr. D. Neb. 1980).

232. See, e.g., *In re San Miguel*, 40 Bankr. 481 (Bankr. D. Colo. 1984); *In re Johnson*, 36 Bankr. 67 (Bankr. S.D. Ill. 1984); *In re Williams*, 42 Bankr. 474 (Bankr. E.D. Ark. 1984); *Deans v. O'Donnell*, 14 Bankr. 997 (E.D. Va. 1981).

233. Bankruptcy Code § 1307(a).

234. For a discussion of these arguments, see Van Baalen, *supra* note 40, at 470-76.

His own ability to repay, in light of his future economic obligations and prospects, may become less important than the opportunity to avoid the economic consequences of his noneconomic conduct. Thus, the bankruptcy process is misused. For this reason, rather than for reasons turning on evaluation of the moral worthiness of a debtor's conduct, the discharge provisions of Chapter 13 should be more carefully coordinated with those of Chapter 7 to eliminate the internal inconsistencies now present.

## 2. Mandatory 13

The policy debate over mandatory 13,<sup>235</sup> like that surrounding zero payment plans in Chapter 13, may be in part a dispute over the appropriate strength of bankruptcy's collection function. Commentators generally accept that creditors will be repaid a larger percentage of their claims if the debtor chooses Chapter 13 rather than Chapter 7.<sup>236</sup> This is especially true with consumer bankruptcies, given that so many are "no asset" cases.<sup>237</sup> Thus, Congress' refusal to adopt a mandatory 13 in 1978<sup>238</sup> may be additional evidence of the low power of bankruptcy as a creditors' collection device.

The 1984 Amendments, however, suggest that an appropriate balance of bankruptcy's collection and debtor rehabilitation goals is still being sought. First, the 1984 Amendments added section 707(b), which permits a court to dismiss a consumer debtor's Chapter 7 petition if the court "finds that the granting of relief would be a substantial abuse of the provisions of this chapter."<sup>239</sup> The probable<sup>240</sup>

235. This issue has stimulated two interesting debates in the literature, each consisting of an opening salvo, reply, and rejoinder. See *supra* notes 20 and 105.

236. See, e.g., Note, *supra* note 38. It may be, however, that Chapter 13 produces a greater return for creditors because attorneys steer clients who can pay toward Chapter 13. D. STANLEY & M. GIRTH, *supra* note 7, at 75 (reporting that 70% of debtors' attorneys they interviewed "said that the debtor's ability to pay was the chief consideration in their recommendation for or against Chapter XIII").

Professor Jackson's analysis of Chapter 13 is refreshingly counter to the trend. See Jackson, *supra* note 5. If a debtor repays creditors out of his existing assets rather than from his future income, according to Professor Jackson, the debtor may end up surrendering noncash assets worth more to him than to his creditors. This, in Professor Jackson's terminology, is the "asset-loss" cost of Chapter 7. Professor Jackson argues that avoidance of the asset-loss cost, which is a feature of Chapter 13, makes bankruptcy more attractive to the debtor by reducing the cost of exercising his right to bankruptcy. *Id.* at 1428-29, 1438-39. While Professor Jackson acknowledges that the relationship between "exercise costs" and the cost of credit is uncertain, *id.* at 1428, he suggests that increased resort to Chapter 13 may increase the costs of credit, *id.* at 1429-30, and ultimately reduce the availability of credit, *id.* at 1428.

See also Sullivan, Warren & Westbrook, *Folklore and Fact*, *supra* note 63, at 323-25, reporting that, although Chapter 7 debtors have higher mean debt/income ratios than Chapter 13 debtors, the difference is not statistically significant, but that a statistically significant difference appears when mean nonmortgage debt/income ratios are compared.

237. D. STANLEY & M. GIRTH, *supra* note 7, at 20.

238. S. REP. NO. 989, *supra* note 209, at 32, reprinted in 1978 U.S. CODE CONG. & ADMIN. NEWS at 5818; H.R. REP. NO. 595, *supra* note 44, at 120-21, 322, reprinted in 1978 U.S. CODE CONG. & ADMIN. NEWS at 6080-81, 6278.

239. Bankruptcy Code § 707(b).

240. Floor debates are the only legislative history available for the 1984 Amendments, so some guessing as to the Amendments' purposes may be inevitable. One group of commentators has asserted that § 707(b) is a product of the CRC Study's proposal that discharge be limited. Sullivan, Warren & Westbrook, *Rejoinder*, *supra* note 105, at 1103 n.112. The CRC Study is cited *supra* note 58. Those same commentators, elsewhere, have characterized § 707(b) as "an unprecedented first step toward requiring repayment." Sullivan, Warren & Westbrook, *Folklore and Fact*, *supra* note 63, at 311. They also admit, however, that "the pages of the advance sheets do not suggest that any but the most apparently egregious or startling cases are being affected [by § 707(b)]." *Id.* at 323 n.59.

purpose of this amendment—to “encourage” Chapter 13 filings, with their concomitant increased payments to creditors—is suggested by simultaneous amendments to section 521(1), requiring that a debtor file “a schedule of current income and current expenditures” in addition to the list of assets and liabilities already required,<sup>241</sup> and to Official Form 1, requiring a consumer debtor filing under Chapter 7 to certify that he is aware of the relief available under both Chapter 7 and 13 and “chooses to proceed under chapter 7.”<sup>242</sup> Thus a bankruptcy court will have information on which to find under section 707(b) that a debtor’s ability to repay all or some portion of his debts out of future income renders his Chapter 7 filing a “substantial abuse” of that Chapter.<sup>243</sup>

Second, the 1984 addition of section 1325(b) enables an unsecured creditor who will not be fully paid under the plan to assure that the debtor is committing to the plan all income not needed for the support of himself and his family. Addition of this provision to the Code suggests that the debtor’s obligation to pay as much as possible is second only to his support obligations.

These recent amendments evidence the continued vitality of bankruptcy’s collection purpose<sup>244</sup> and give the bankruptcy courts some justification for creating a mandatory 13. A reason for them not to do so is what should be a reasonable reluctance to accomplish judicially what Congress has refused to do legislatively. On the other hand, if these new provisions are not an invitation (nay, direction?) by Congress to the courts to do just that, it is hard to see what they are.

Several of the other policy threads previously identified also appear in the mandatory 13 debate. First, many allegations of bankruptcy “abuse” are rooted in the belief that much debt could be repaid<sup>245</sup> and that the failure of debtors to do so is an abuse of the system.<sup>246</sup> Included in this belief is the normative posture that debt should be repaid and, thus, that the failure to do so is a species of dishonesty. This posture inevitably leads to the recommendation that Chapter 13 be made mandatory.

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241. Bankruptcy Code § 521(1).

242. Bankruptcy Official Form 1.

243. For a case discussing factors relevant to dismissal of a Chapter 7 petition for substantial abuse under § 707(b), and dismissing on the facts before the court, see *In re Grant*, 51 Bankr. 385 (Bankr. N.D. Ohio 1985).

244. Professor Harris called Professor Eisenberg’s mandatory 13 proposal “a creditor’s remedy more powerful than any available nonbankruptcy remedy, and . . . more intrusive than any remedy that American bankruptcy law has ever known.” Harris, *supra* note 20, at 353. Professor Eisenberg took some exception to the characterizations. Eisenberg, *Rejoinder*, *supra* note 20, at 623 n.24.

245. See *supra* text accompanying notes 60–63. But see Sullivan, Warren & Westbrook, *Folklore and Fact*, *supra* note 63, at 320, reporting that their preliminary data “strongly suggest that most debtors, whatever their faults or motives, cannot repay any substantial part of their debts.”

246. Under this view, merely taking advantage of the discharge allowed by law is itself an abuse:

Studies undertaken by the creditor lobby have shown that the true “abuse” of the “liberalized” Bankruptcy Code is the number of small debtors who have taken advantage of their right to a “fresh start”—a right which has traditionally been a part of bankruptcy legislation. This concern with aggregate “abuse” is coupled with a belief that there is some potential for recovery should the availability of bankruptcy be limited.

Ayers, *supra* note 63, at 737 (footnote omitted).

Also implicit in this view are two further propositions: first, that debtors who file under Chapter 7 may not want to repay their debts; and, second, that the lack of desire to repay creditors is morally unacceptable. Adherence to these propositions may be a reason to favor mandatory 13. At least one study, however, has found that debtors who file under Chapter 7 as frequently report a desire to repay their debts as do debtors who file Chapter 13 petitions. H. JACOB, *supra* note 63, at 71.

Second, "avoiding the stigma of bankruptcy" is also frequently given as an advantage of Chapter 13,<sup>247</sup> but that view is not universally shared.<sup>248</sup>

Finally, part of the justification for mandatory 13 can be traced to a policy of debtor education, since any money management skill debtors gain in bankruptcy derives from Chapter 13. Professor Van Baalen, for example, posited that if confirmation of a Chapter 13 plan were denied and a non-asset liquidation followed, the debtor "may forfeit a lesson in personal and fiscal discipline" the loss of which "will be the greatest loss of all."<sup>249</sup> The supposition is, of course, that through formulation of and adherence to a manageable repayment plan the debtor will acquire budgeting skill by osmosis. The chances of this happening depend in part upon the degree of acceptance and cooperation the debtor brings to performance of the plan.

One component of the argument against mandatory 13 is the assertion that debtor cooperation is necessary for a Chapter 13 plan to be successfully completed.<sup>250</sup> The debated proposition is whether a debtor forced into Chapter 13, if he is in bankruptcy at all, will lose his incentive to work. The Bankruptcy Commission considered arguments that fulfillment of a Chapter 13 plan "requires not merely a debtor's consent but a positive determination by him and his family to live within the constraints imposed by the plan during its entire term and a will to persevere with the plan to the end," and that an unwilling debtor "would be almost bound . . . to change employment and, if necessary, to move to another area to escape the importuning calls and correspondence of his creditors."<sup>251</sup> The Commission "concluded that forced participation by a debtor in a plan requiring contributions out of future income has so little prospect for success that it should not be adopted as a feature of the bankruptcy system."<sup>252</sup> Congress agreed with the Commission and rejected mandatory 13 in 1978, partly on this ground. The House Committee, for example, concluded that "an unwilling debtor is less likely to retain his job or to

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247. COMMISSION REPORT, *supra* note 7, at 157; Hughes, *supra* note 219, at 832-33; Shuchman, *supra* note 39, at 416; Van Baalen, *supra* note 40, at 483.

248. Note, *Discharge Provisions in Consumer Bankruptcy: The Need For a New Approach*, 45 N.Y.U. L. Rev. 1251, 1268 (1970).

249. Van Baalen, *supra* note 40, at 485, 486.

250. Eisenberg, *supra* note 20, at 987.

Professor Jackson approaches this issue as an externality imposed by the debtor upon society as a whole when creditors' collection efforts cause him to substitute leisure for wages. Jackson, *supra* note 5, at 1420-24. Professor Jackson asserts that "[r]equiring debts to be paid out of future income [i.e., mandatory 13] may lead an indebted individual to devote more of his energies and resources to leisure, a consumption item that his creditors cannot reach." *Id.* at 1420 (brackets added).

251. COMMISSION REPORT, *supra* note 7, at 159. *Cf. Leff, Injury, Ignorance and Spite—The Dynamics of Coercive Collection*, 80 YALE L.J. 1, 15 ("Insofar as something is deducted from a worker's paycheck [through wage garnishment] (and increasingly as the amount increases), the motivation of the worker to perform well also decreases. He is just not as interested in doing his job as well.").

A slightly different view was offered by Professor Boshkoff, who argued that mandatory 13 is not "objectionable because the debtor will not cooperate and will not produce future income," but because "such proposals . . . will work too well and completely undermine the fresh-start policy that has been pursued in this country since 1898." Boshkoff, *Limited Discharges*, *supra* note 10, at 123.

252. COMMISSION REPORT, *supra* note 7, at 159.

cooperate in the repayment plan, and more often than not, the plan would be preordained to fail."<sup>253</sup>

Debate has not ceased on the question whether a forced Chapter 13 would reduce a debtor's incentive to work. One recent study's suggested imposition of Chapter 13 plans, under which debtors would pay all their income above the poverty level to creditors for up to five years,<sup>254</sup> provoked vigorous dissent.<sup>255</sup> Similarly, Professor Eisenberg's advocacy of mandatory 13, based on his belief that "if a debtor is allowed to keep significant portions of his future wages, it is difficult to conceive of many debtors refusing to work just to frustrate a chapter 13 plan,"<sup>256</sup> stimulated a strong rebuttal.<sup>257</sup>

If debtor cooperation is so important to successful completion of a Chapter 13 plan, how much more necessary is a cooperative attitude if the debtor is to learn any new money management skills from the experience. Learning is a notoriously difficult thing to force on the unwilling.<sup>258</sup> As long as Chapter 13 remains voluntary, therefore, it can fairly be said that bankruptcy reflects at least a low-powered policy of consumer education.

However mandatory 13 is defended, mandating 13 comes down to a diminution of the goal of economic productivity. This is true because, during the pendency of the plan, the debtor's assets beyond those required for minimal support are devoted to repayment of creditors.<sup>259</sup> The availability of a debtor's earning capacity as an asset free from the reach of creditors is what gives the debtor a new start. Discharge of old obligations is what makes the start a fresh one. Mandatory 13, therefore, is not a fresh start at all, at least during the pendency of the plan, and does nothing to return the debtor to economic productivity. The debtor is, rather, held in economic limbo while tied to past obligations. Under the functional economic approach, therefore, Chapter 13 should not be mandatory.

### E. Educational Loans

Educational loans are granted special treatment in bankruptcy partly on the ground that governmental claimants are especially deserving.<sup>260</sup> Characteristics of the debtor and the claim itself are the real concerns, however. First, the loan has enabled the debtor to obtain education and training that may very well have equipped him to obtain and hold a profitable job. Thus, the debt has produced human capital for the

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253. H.R. REP. NO. 595, *supra* note 44, at 120, *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS at 6081 (footnote omitted).

254. CRC Study, *supra* note 58.

255. See generally Sullivan, Warren & Westbrook, *supra* note 105.

256. Eisenberg, *supra* note 20, at 989.

257. Harris, *supra* note 20.

258. J. BERGAN & J. DUNN, *PSYCHOLOGY AND EDUCATION: A SCIENCE FOR INSTRUCTION* 203 (1976).

259. Bankruptcy Code § 1325(b)(1)(B) & (2)(A). Professors Sullivan, Warren, and Westbrook argued that mandatory 13 would create a new class they label the "bankruptcy poor," defined as persons "who live at the poverty level, paying to the bankruptcy court all their 'excess' earnings." Sullivan, Warren & Westbrook, *supra* note 105, at 1138. These writers argued that "[t]he 'bankruptcy poor' will work like the working class, consume like the poor, but share fully the lifestyle of neither." *Id.* For a response to this argument, see Sullivan, *Reply*, *supra* note 105, at 1076.

260. Only educational loans "made, insured, or guaranteed by a governmental unit" are nondischargeable. Bankruptcy Code § 523(a)(8).

debtor.<sup>261</sup> Second, a factor revolving around the debtor's honesty or worthiness is also at play. In this respect, the belief is that debtors can afford to repay educational loans, especially if their human capital is valued,<sup>262</sup> and that the failure to do so is a species of dishonesty. This belief also reflects the policy view that bankruptcy's role as a collection mechanism should be enhanced.

Educational loans are said to be unusual in that the creditor cannot recoup what was purchased:

Conventionally, when a debtor goes through bankruptcy and gets his discharge, he has to give back what he got in the first place. The education that a student got for a student loan is something that he can't give back. So a distinct feature of the student's situation is that if he gets his discharge, he can keep the asset.<sup>263</sup>

Educational loans are not unique in this respect, however. Credit extended to purchase consumed goods and most services—travel, meals, and medical care—share this feature. Only some medical expenses, perhaps, carry the further feature of creating human capital, since both educational loans and medical loans used for the restoration of health may give the debtor an earning capacity that might not have been enjoyed without the loan having been made.

The Bankruptcy Commission found that use of bankruptcy to avoid repayment of educational loans was not a numerically significant problem, but stated that “such abuses discredit the system and cause disrespect for the law and those charged with its administration.”<sup>264</sup> The Commission recommended, therefore, “that, in the absence of hardship, educational loans be nondischargeable unless the first payment falls due more than five years prior to the petition.”<sup>265</sup> Congress followed that recommendation and enacted section 523(a)(8).<sup>266</sup>

261. Weistart, *supra* note 48, at 113–14 n.10.

262. Symposium Discussion, *supra* note 45, at 161, 166 (remarks of John C. Weistart and Philip Shuchman, respectively).

Professor Boshkoff has described the significance of the educational loan exception as the reintroduction, after 78 years, of the so-called “conditional discharge,” which authorizes the bankruptcy court to consider the debtor's future earning capacity to decide how much the debtor can repay the educational creditor out of future income. Boshkoff, *Limited Discharges*, *supra* note 10, at 73–74, 115. The difficulties with giving this power to bankruptcy judges have been explored. Ayers, *supra* note 63, at 734–35; Boshkoff, *supra* note 10, at 125; Harris, *supra* note 20, at 357. *But see* Eisenberg, *Rejoinder*, *supra* note 20, at 625.

263. Symposium Discussion, *supra* note 45, at 161 (remarks of John D. Ayer).

Professor Ayer misstated his case somewhat, since a Chapter 7 debtor literally “has to give back what he got” only if the property is subject to an unavoidable lien that passed through bankruptcy. The debtor can keep property that is exempt, as long as it is not subject to such a lien (see § 522(c)(2)). The rest of his property has to be “given back” only in the sense that the trustee liquidates it and distributes the proceeds in accordance with the Code's direction. Unsecured creditors do not get back their goods through bankruptcy; they get only a dividend, large or (more likely) small, on their claim.

264. COMMISSION REPORT, *supra* note 7, at 170.

265. *Id.* at 177.

266. Five years elapsed between the Commission's recommendation and passage of the Code. In the interim, Congress amended the Higher Education Act of 1965 to limit the dischargeability of educational loans in bankruptcy. Guaranteed Student Loan Amendments of 1976, Pub. L. No. 94-482, § 127(a), 90 Stat. 2081, 2141 (repealed 1978) (codified in 20 U.S.C. § 1087-3 (1976)). For a more detailed review of the history of the exception to discharge for educational loans, see H.R. REP. NO. 595, *supra* note 44, at 132, reprinted in 1978 U.S. CODE CONG. & ADMIN. NEWS at 6093.



The educational loan provision was not a legislative response to a statistically significant problem.<sup>267</sup> Rather, the provision is a perfect example of legislation based on pathological cases,<sup>268</sup> in which a result appropriate for a small minority of cases is imposed on substantially all. In the case of debtor dishonesty, by contrast, the Code is drafted so that only the debtor who has actually engaged in the disfavored behavior, such as obtaining credit by false representations,<sup>269</sup> is denied discharge for that debt. Discharge is barred for all governmentally-sponsored educational loans, on the other hand, without regard to the debtor's actual intent or behavior. Exception to this blanket rule is allowed only upon a finding of "undue hardship."<sup>270</sup> This provision, in essence, presumes the propriety of nondischargeability and imposes on the debtor the task of establishing the contrary conclusion, which is available only in limited situations.<sup>271</sup> The other provisions, however, do the opposite; they assume the propriety of discharge and permit nondischarge only upon a showing that the debtor engaged in the disfavored behavior. The "undue hardship" exception to educational loans' nondischargeability carries no assurance that only debtors who are seeking a discharge that, if it were granted, would constitute an abuse of the system will in fact ultimately fail to obtain discharge of educational loans.

The functional economic approach does not support generalized nondischargeability of educational loans. Educational loans should be nondischargeable under the proposed standard only if the debtor incurred the obligation with the intention of filing bankruptcy rather than repaying the loan. In that case, a noneconomic factor—the availability of bankruptcy—would have skewed the economic decision. The real concern of those advocating nondischargeability of educational loans, however, is that debtors who can afford to repay out of future income will discharge the debts instead. The actual issue is the appropriateness of requiring repayment of pre-bankruptcy debts out of post-bankruptcy income, and the ultimate question of dischargeability of educational loans collapses into the policy question of mandatory 13. Educational loans, therefore, should be generally dischargeable and not singled out for mandatory 13-type treatment.

#### IV. CONCLUSION

Strong theoretical justifications should be offered for discharging in bankruptcy obligations that are otherwise enforceable. Justifications that have heretofore been identified have an isolated and ad hoc applicability. Even the strongest of the several discussed in this Article—the goal of rewarding only the worthy debtor with

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267. *Id.* at 133, reprinted in 1978 U.S. CODE CONG. & ADMIN. NEWS at 6094 (reporting that the rate of discharge of educational loans in bankruptcy "compares favorably with the consumer finance industry").

268. *Contra* Sullivan, Warren & Westbrook, *supra* note 105, at 1137 n.283 ("While it may not be clear that student discharges were so serious a problem as to require denial of the discharge, at least the provision was a particularized response to a perceived abuse.").

269. Bankruptcy Code § 523(a)(2)(B). See also Bankruptcy Code §§ 523(a)(4), (6) & (9).

270. Bankruptcy Code § 523(a)(8)(B).

271. The undue hardship test is difficult to meet. Compare *In re* Briscoe, 16 Bankr. 128 (Bankr. S.D.N.Y. 1981) and *In re* Densmore, 8 Bankr. 308 (Bankr. N.D. Ga. 1979), with *In re* Norman, 25 Bankr. 545 (Bankr. S.D. Cal. 1982) and *In re* Diaz, 5 Bankr. 253 (Bankr. W.D.N.Y. 1980).

discharge—suffers from several inadequacies. Perhaps least serious is its failure to explain what bankruptcy in fact does. More serious is its failure to provide guidance to legislators and theorists who must decide what our bankruptcy system should do. Normative justifications for particular bankruptcy provisions ultimately reflect the value preferences of particular decisionmakers. This is true whether the justification is phrased in terms of debtor worthiness or economic efficiency, and one goal of this Article has been to reveal the normative propositions underlying certain economic approaches.

None of the policy goals of bankruptcy, reviewed above, provide a reason to abandon the principle of renewed economic vigor of the debtor as the goal of bankruptcy. This is the goal stated in the functional economic approach under which discharge would be structured to enhanced return of the debtor to productive economic participation, limited only as necessary to prevent skewing of economic decisions by the intrusion of noneconomic factors. This approach focuses on the economic impact on society as a whole that is the appropriate concern of those who structure the bankruptcy system.