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Abstract

This paper provides an illustration of the mechanisms that can give rise to path dependence in legislation. Specifically it shows how debtor-friendly bankruptcy law arose in the United States as a result of a path dependent process. The 1898 Bankruptcy Act was not regarded as debtor-friendly at the time of its enactment, but the enactment of the law gave rise to changes in interest groups, beliefs about the purpose of bankruptcy law, and political party positions on bankruptcy that set the United States on a path to debtor-friendly bankruptcy law. Analysis of the path dependence of bankruptcy law produces an interpretation that is more consistent with the evidence than the standard interpretation that debtor-friendly bankruptcy law was the result of a political compromise in 1898.

Key words: bankruptcy, path dependence

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The argument that institutional change is characterized by path dependence has appeared in economics (North 1990, 2005), political science (Pierson 2002), sociology (Mahoney 2000), and law (Bebchuk and Roe 1999; and Hathaway 2001). Many social scientists in these disciplines believe that path dependence is the key to answering fundamental questions about institutions, including questions about how institutions evolve over time and why institutions sometimes persist even when they seem to have negative consequences for economic growth, political participation, or justice.

But not all observers are convinced that an emphasis on path dependence enhances our understanding of institutions. Gerald Alexander (2001) argues that most political institutions are not path dependent. Colin Crouch and Henry Farrell (2004) argue that emphasis on path dependence leads us to ignore the opportunities to switch paths. Amy Bridges (2000) suggests that the idea of path dependence has been misapplied to the analysis of institutions. Even proponents of the examination of path dependence complain that the term is misused (Mahoney 2001, 4; and North 2005, 51).

Arguments about the value of path dependence as a methodological approach have taken place largely on a theoretical, rather than an applied, level. Applications demonstrating how path dependence improves our understanding of institutions remain relatively scarce. In fact, Douglass North recently suggested that “a major frontier of scholarly research is to do the empirical work necessary to identify the precise sources of path dependence” (North 2005, 77). We explore this frontier of research on institutions by identifying the sources of path dependence in the development of American bankruptcy law during the years 1880 to 1938.

We argue that a path dependent interpretation of the development of bankruptcy law is more consistent with the available evidence than is the standard interpretation in the literature.

The standard interpretation is that the modern, debtor-friendly, U.S. bankruptcy law resulted from a political compromise in 1898 (Tabb 1991; Buckley 1994, Skeel 2002; Moss 2002). While the initial push for the Bankruptcy Act of 1898 came from associations of creditors, the standard interpretation claims that the original bill was amended to gain the support of legislators who were more sympathetic to debtors (Skeel 2000, 43). Charles Jordan Tabb states that, "Notwithstanding its origins with the credit industry, the 1898 Act ushered in the modern era of liberal debtor treatment in United States bankruptcy law (Tabb 1995, 24)." Indeed, bankruptcy rates in the United States in the twentieth century were among the highest in the world, and the vast majority of cases were filed by debtors. David Moss concludes that since 1898 a "debtor-friendly bankruptcy system…has remained a permanent and vital feature of American capitalism" (Moss 2002, 137). In fact, not until 2005 was there any significant movement away from debtor- friendly bankruptcy law. The problem with this interpretation is that the 1898 Bankruptcy Act has only been viewed as unusually debtor-friendly in retrospect; contemporary observers did not see it that way.

In 1898, Democrats argued that the Bankruptcy Act was nothing more than a national collection law. After the 1898 law was enacted, Democratic members of Congress continued to argue that it was oppressive for debtors and continued to seek its repeal. Opponents of the 1898 Bankruptcy Act did not believe there had been any compromise.

During the last two decades of the nineteenth century the United States had no bankruptcy law and several different types of bankruptcy law were considered. The law that was adopted in 1898 emphasized creditor control in the administration of bankruptcy cases and appeared to most observers to be much more a creditors' collection tool than a means for relieving insolvent debtors. In the first 20 years after it was enacted, the law was widely used by creditors and most cases were business bankruptcies. In the 1920s, expanded access to consumer credit led to an increase in wage earner insolvency. Because there were no assets in most wage earner cases creditors had no incentive to be involved, and wage earners found that creditor control in the administration of bankruptcy meant an almost certain discharge in bankruptcy court. Under the changed economic circumstances, the creditors' collection tool of the 1890s became a tool of debt relief for insolvent wage earners.

In the late 1920s and early 1930s, critics of the law proposed moving away from creditor control, but by then the 1898 law had given rise to three forces that prevented major amendment. First, a well-organized group of legal professionals had an interest in preventing changes in bankruptcy administration. Second, the Democratic Party had dropped its opposition to the bankruptcy law as it became increasingly clear that the law was actually used more by debtors than by creditors. Third, the change in the way the law was used prompted people to change their beliefs about the purpose of bankruptcy law. By the 1930s, legislators, judges, and even creditors stated that the primary purpose of bankruptcy law was to aid debtors. We, therefore, argue that the debtor-friendliness that emerged in the twentieth century was an unintended and path-dependent outcome of the 1898 Bankruptcy Act.

1. Using Path Dependency to Study Legislative Change

Path dependence, lock-in, multiple equilibria, and inefficiency result from self-reinforcing mechanisms (Brian 1988). Examples of self-reinforcing mechanisms include choice of technology when there are significant network externalities and choice of location when there are positive externalities in production. When there are network externalities, the choice of a particular technology is influenced by the number of people who have already adopted it. When there are positive externalities in production, the location chosen by a firm is influenced by the number of firms that have already located nearby. Brian used path dependence to refer to situations in which events early in the history of the system, including small and contingent events, "determine which solution prevails" (Arthur 1988, 11).

Although Brian used path dependence to refer to only one consequence of self-reinforcing choices, the term has subsequently been used more broadly. For instance, consider Margaret Levi's definition: "Path dependence has to mean, if it is to mean anything, that once a country or region has started down a track, the costs of reversal are very high. There will be other choice points, but the entrenchments of certain institutional arrangements obstruct an easy reversal of the initial choice" (Levi 1997, 28). Levi takes path dependence to include situations in which multiple equilibria and lock-in exist. We also use this broader definition of path dependence to explain how a creditor-controlled bankruptcy law became debtor-friendly.

In order to use this definition to demonstrate that the debtor-friendly bankruptcy law that existed by 1938 was the result of path dependence, we must demonstrate that the history of the law has four features: (1) that it was the result of a dynamic process, (2) that different paths were viable, (3) that one or more events early in the history of the law influenced the choice of path, and (4) that self-reinforcing mechanisms inhibited departure from the selected path.

Because bankruptcy law in the United States is the result of legislation, a self reinforcing mechanism must work through the choices that legislators make. Numerous theoretical and empirical analyses of legislation have attempted to explain the choices of legislators at a point in time as a function of legislator preferences, party influence, constituent interest, and organized interests. For legislation to be path dependent it is necessary that it cause changes in organized interest groups, constituent interests, or party influence which then affects subsequent legislation.

There are several avenues by which legislation might influence organized interests, political parties, and constituents. First, legislation can cause changes in the costs and benefits of interest group organization. The enactment of the Reciprocal Trade Agreement Act of 1934, for example, promoted the formation of associations of exporters, who then promoted preservation of the Act (Irwin and Kroszner 1999). Second, legislation can affect the resources available to an interest group and thus its ability to provide resources to legislators. For instance, in their study of the origins of federal deposit insurance Charles Calomiris and Eugene White conclude that "once unit bankers had been given a new lease on life by deposit insurance, they were able to exert influence over other areas of regulation as well" (Calomiris and White 2000, 202). Third, providing information to legislators that enhances the probability of their reelection promotes continued access to those legislators. Farm groups, for instance, were able to effectively influence legislation in the 1930s and 1940s because legislators believed information provided by these groups in the past had generated legislation that enhanced the probability of reelection (Hansen 1991). Fourth, changes in legislation may also cause changes in the costs and benefits of including a particular element in a party's program. For example, although overall ideological positions of Republicans and Democrats did not change from 1932 to 1946, Republicans found it useful to drop dogmatic support of high tariffs after World War II (Irwin and Kroszner 1999). Finally, legislation may cause changes in beliefs. Robert Higgs compares such ideological change to technological change, pointing out that both are types of knowledge. In the case of technological change, for example, the adoption of capital intensive techniques might promote learning that leads to the development and implementation of more capital intensive techniques. He suggests that "ideological change may be similarly self-reinforcing" (Higgs 1987, 71).

We trace the path dependent development of bankruptcy law from the deliberations leading to the 1898 Bankruptcy Act through the amendments made to it during the 1930s. The next section emphasizes how several paths were viable for bankruptcy law before the passage of the 1898 Act.

2. Proposals for Bankruptcy Legislation: 1881-1898

The federal government enacted four bankruptcy laws during the nineteenth century, in 1800, 1841, 1867 and 1898. The first two were passed in the wake of financial crises and repealed within a few years because of complaints of high expenses and low dividends. The third law was enacted in 1867. It was amended several times and lasted longer than its predecessors, but again, complaints of excessive fees and expenses led to its repeal in 1878.

In 1881, three years after the repeal of the 1867 Bankruptcy Act, The New York Board of Trade and Transportation organized a National Convention of Boards of Trade and asked Judge John Lowell to draft a bankruptcy bill. Merchants and manufacturers were concerned with bankruptcy law because they typically provided unsecured trade credit to their customers. Their desire for a federal bankruptcy law arose from three features of state collection laws. First, the details of collection laws varied from state to state, forcing merchants and manufacturers offering trade credit to learn the laws in all the states in which they wished to sell goods. Second, many state laws discriminated against creditors who were not citizens of the state. Third, many of the state laws were codified versions of common law remedies and provided a first-come, first-served distribution of assets. The first-come, first-served rule of collection created incentives for creditors to race to be the first to file a claim.

Lowell's bill was introduced in the Senate in 1882, and the next year Senator John Ingalls, a Republican from Kansas, introduced an alternative bill. Both the Lowell bill and the Ingalls bill used systems of administration referred to as officialism. Official systems relied on government officials to oversee the administration of cases and the investigation of the bankrupts. The Lowell bill would have appointed a salaried official in each circuit to oversee the administration of bankruptcy cases. Lowell believed these officials would provide the "supervision over the speedy and economical settlement of bankrupt estates which creditors can not be relied on to furnish" (quoted in Dunscomb 1893, 147). Inglalls, on the other hand, would have placed the administration of bankruptcy cases in the hands of courts of equity.

After failing to obtain passage of either bill, merchants and manufacturers met again under the name of The National Convention of Representatives of Commercial Bodies in 1889. The president of the Convention, a lawyer and businessman named Jay Torrey, drafted another bill which the Convention lobbied for throughout the 1890s.

In contrast to Lowell and Ingalls, Torrey believed that creditor control rather than officialism would provide the best remedy for the high fees and expenses that had plagued previous American bankruptcy laws. Under the Torrey bill, the court was required to schedule a meeting of creditors within 30 days of the filing of a petition. The creditors were authorized to select a trustee. Creditors were expected to play an active role in the examination of bankrupts, insuring honesty and the highest possible dividends. According to Chapter IV of the Act, "the creditors shall at each meeting take such steps as may be pertinent and necessary for the promotion of the best interests of the estate and enforcement of this act."

The National Convention of Representatives of Commercial Bodies presented bankruptcy law as an important means of promoting interstate commerce. As a measure promoting interstate commerce, bankruptcy law fit into the ideological conflict that already existed between Democrats and Republicans. Richard Bensel (2002) argues that the three pillars of Republican policy in the late nineteenth century were the gold standard, protective tariffs, and a national market. Bankruptcy law was incorporated as part of the program of promoting a national market. The position of the Republican Party on bankruptcy was well summarized by George Ray of New York:

> We have tried to so frame the bill as to promote business intercourse and the giving of credit. Under its provisions, when in operation, the manufacturer and merchant in New England will not hesitate to extend credit to the trader in New Orleans. The merchants and traders of the great Northwest will not fear to extend it to those asking it all through out the South (*Congressional Record* June 28,1898, 6435).

Bankruptcy was not primarily about discharging insolvent debtors for Republicans; it was part of a broader program for creating the conditions necessary to support a modern commercial nation.

Like Republicans, Democrats regarded bankruptcy as one piece in a puzzle. Opposition to the Torrey bill was part and parcel of Democratic opposition to the gold standard, monopolies, and expanded power of federal courts. Representative James Gunn of Idaho, while expressing his opposition to the Torrey bill, argued that people should keep in mind the true sources of the country's economic problems: the Dingley Tariff and Republican monetary policy *(Congressional Record* February 19, 1898, 1928). As an alternative to the Torrey bill, Democrats advocated a purely voluntary (only debtors could file petitions), and temporary bankruptcy law that would be administered through state courts rather than federal courts. In 1884, Joseph William Bailey (Democrat, Texas) put forward such a bill as an alternative to the Lowell and Ingalls bills. Later Democrats put forward similar plans as alternatives to the Torrey bill.

The conflicts expressed in congressional debates were not just cheap talk. Voting was split along partisan (Hansen, 1997, 1998) and ideological lines (Berglof and Rosenthal 2000).

Erik Berglof and Howard Rosenthal (2000, 2003) find that legislator ideology was by far the most important factor explaining voting behavior in the late nineteenth century; bankruptcy law was no exception. Republicans voted for the bill developed by the commercial associations and against temporary bankruptcy laws; Democrats voted for temporary laws for the relief of debtors and against the Torrey bill (Hansen 1997). Because of the highly partisan voting on bankruptcy, no law was enacted until the Fifty-fifth Congress when Republicans were firmly in control of both the House and Senate.

It has been suggested that numerous amendments softened the Torrey bill before its enactment, but most members of the Democratic Party did not see it that way. Representative Robert Henry of Texas referred to the version of the bill introduced in the House in 1898 as "simply a sugar coated edition of the Torrey bill"(*Congressional Record* February 16, 1898, 1804). The primary features of the bill remained unchanged over the course of the decade. From the beginning, the Torrey bill had been based on creditor control, had prohibited involuntary bankruptcy petitions against wage earners and farmers, had specified that exemptions were to be determined by each state, and had made acts of fraud, false statements, and concealing property grounds for criminal punishment and denial of a discharge.[1] Trade creditors were not primarily concerned with wage earners or farmers, they regarded state exemptions as a political necessity, and they did not oppose discharge of honest debtors (National Convention of Representatives of Commercial Bodies 1889, 94, 102,106, and 119).

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[1] Compare "A Uniform System of Bankruptcy" House Report No. 1674, 52nd Congress, 1st Session, 1892, with "Unifrom System of Bankruptcy," Senate Document No. 294, 55th Congress, 2nd Session, 1898. The latter is the conference report that was passed by both houses.

The Bankruptcy Act of 1898 allowed individuals and most businesses to file voluntary bankruptcy petitions. It allowed creditors to file involuntary petitions, although not against farmers or wage earners. Under the Act, filing for bankruptcy stopped other collection proceedings, provided for the liquidation of a debtor's non-exempt assets, required pro-rata distribution of the proceeds among like creditors, and allowed for a discharge of the remaining debts. Compared to current bankruptcy law in the United States, the 1898 legislation was rather limited in scope. It did not include corporate reorganization or wage earner workouts. The Act did include a provision for composition (voluntary agreements about the payoff of debt), but a composition had to be approved by a group of creditors who constituted a majority in both number and claims and it was seldom used. In 1930, for example, only 695 of 60,548 cases closed were compositions (U.S. Department of Justice 1930, 207).

One of the features of the Torrey bill that its Democratic critics found particularly troublesome was the system of creditor control. The system of creditor control led Congressman David De Armond to complain: "Scarcely can the insolvent get through under this law and with this machinery if those who take the other side—the creditors—choose to bar the exit and deny him a discharge" (*Congressional Record* June 28, 1898, 6429). Amendments to the Torrey bill did little to reduce the partisan rhetoric or voting. De Armond declared of the conference report: "No man can read a page of it without finding upon that page indisputable evidence that the bill originated with those who have debts to collect" (*Congressional Record* June 28, 1998, 6429). In the final vote in the House, more than 80 percent of the Democratic votes were cast against bankruptcy legislation.

To summarize, during the last two decades of the nineteenth century several paths were viable for bankruptcy law in the United States. There was clear distinction between bills put forward by commercial associations and Republicans (the Lowell bill, the Ingalls bill and the Torrey bill) and the bills put forward by Democrats (the Bailey bill, among several). But even between the Lowell bill, the Ingalls bill, and the Torrey bill, there were significant differences in the way that bankruptcy cases would be administered. The Lowell bill and the Ingalls bill relied on officialism while the Torrey bill relied on creditor control.

Creditor control was not an inevitable component of bankruptcy law. Up until 1889, the commercial associations had generally supported the Lowell bill, and some creditors had regarded the Ingalls bill as an acceptable substitute. Internationally, the momentum was moving towards officialism. English bankruptcy law, which is generally regarded as less generous to debtors than American law, had switched from creditor control to officialism in 1883. Later, the Canadian Credit Men's Trust Association pressed for a bill that required that a government official examine each bankrupt (Telfer 1994). Ironically, it was the legislative choice of the Torrey bill, with its system of creditor control, that set the United States on the path toward debtor-friendly bankruptcy law.

3. Unchanging Views and Changing Interest Groups, 1899-1919

In the first two decades of the twentieth century people continued to view the Bankruptcy Act as primarily a commercial regulation. James Olmstead's 1902, *Yale Law Journal* article "Bankruptcy a Commercial Regulation," has frequently been cited as evidence that people regarded the 1898 Bankruptcy Act as debtor-friendly because of his reference to bankruptcy law as a “Hebrew Jubilee”(Skeel 2000, 251; Tabb 1995, 23). Olmstead’s point, however, was precisely the opposite. He warned that “if the ‘Hebrew Jubilee’ idea is to prevail, the country will be confronted with successive repeals as heretofore”(Olmstead, 843). He did not believe the 1898 Bankruptcy Act was a “Jubilee.” He argued that both the constitutional history and late nineteenth century congressional debates showed that the Bankruptcy Act “is essentially a commercial regulation, and that its main objects are administration or distribution, rather than the relief of the debtor” (Olmstead 1902, 843). He went so far as to quote Senator Lindsay who declared that the Bankruptcy Act would “remain for all time as an example of how laws should be prepared” (Olmstead 1902, 843). Olmstead’s article was a warning against regarding bankruptcy law as a jubilee, not a declaration that the 1898 Bankruptcy Act was a jubilee.

Conviction that the primary purpose of bankruptcy law was to serve creditors is also clear in court decisions. Soon after the 1898 Act was passed, Judge Addison Brown declared that “the most fundamental element in every system of bankruptcy has been to provide for and regulate the distribution of the bankrupt’s property among his creditors” (quoted in Olmstead 1902, 844). This was still the view of the courts in 1915, when Justice McReynolds wrote: “It is the purpose of the Bankrupt Act to convert the assets of the bankrupt into cash for distribution among creditors and then to relieve the honest debtor from the weight of oppressive indebtedness and permit him to start afresh free from the obligations and responsibilities consequent upon business misfortunes” (*Williams v. U.S. Fidelity & G. Co.*, 236

U.S. 549). The primary function of bankruptcy law was to distribute assets among creditors of a businessman; the relief of insolvent debtors was secondary.

Legislators viewed bankruptcy similarly. In 1902, Democratic members of Congress still called attention to "the fact that the present act is the most oppressive law, so far as the unfortunate debtor is concerned, that has ever been enacted" (*Congressional Record*, 1902, 6945). In 1910, Republicans still argued that the purpose of the law was to create a national market; the law "encourages commercial activity, no matter how distant the creditor and the debtor may be" (*Congressional Record* February 23, 1910, 2265). They claimed it had "done more to increase the credit of the poorer sections of this country than any law that was ever put on the books" (*Congressional Record* February 23, 1910, 2273).

The continuing partisan and ideological divide over bankruptcy is reflected in the voting record. Democrats tried to repeal the 1898 Act while Republicans amended it to increase the number of criminal acts and to increase the grounds on which a discharge might be denied. In a 1902 House vote, 60 out of 80 Democratic votes were cast for repeal of the law, while 117 out of 121 Republican votes were against repeal. In 1910, 81 out of 121 Democratic votes were cast for repeal, while 126 out of 135 Republican votes were against repeal.

While neither beliefs about the purpose of bankruptcy law or partisan conflicts over the law changed in the first decades after its enactment, change was brewing within interest groups that sought to influence bankruptcy legislation. Creditor control provided many opportunities for lawyers. Lawyers represented debtors, creditors and trustees in bankruptcy court, and they served as receivers and referees. In 1902, Representative Bartlett of Georgia declared that “the existing bankruptcy law might well be termed a law neither to aid the creditor to collect his debts nor to relieve the honest debtor of his burdens, but to aid those who make fortunes on both” (*Congressional Record* June 17, 1902, 6956.). In 1910, Representative Clayton expressed how legislation could create a self-reinforcing mechanism in the form of an interest group, declaring that “whenever a special interest is sheltered behind special legislation, then immediately...there is formed some sort of trust, some sort of association for the perpetuation of that special interest”. In the case of bankruptcy that special interest was “the referees in bankruptcy, the receivers in bankruptcy, the court favorites, the men who are fed by virtue of the bankruptcy law” (*Congressional Record*, Feb. 23, 1910, 2272)”

David Skeel (1999) argues that “the genius of the Bankruptcy Act” was precisely that it gave rise to a group of lawyers with a vested interest in preserving the law. The bankruptcy bar opposed repeal of the law and became a force in shaping future legislation, but its significance should not be overstated. Lawyers had also benefited from earlier bankruptcy laws. By the 1860s it was already an old joke that lawyers were the primary beneficiaries of bankruptcy law. In 1867, Senator Cragin declared that the only correspondence he had received in favor of a bankruptcy law was from a lawyer who said “that the law business in his community was very dull and he hoped the bankrupt bill might pass so as to give more business to the legal profession” (*Congressional Globe* February 12, 1867, 1189). The difference between the 1898 Act and previous bankruptcy laws was it worked well enough that merchants and manufacturers did not organize to seek its repeal.

No mention is made of the National Convention of Representatives of Commercial Bodies after 1898. The organization disappeared with the enactment of the bankruptcy law. The Convention had been formed for the sole purpose of obtaining bankruptcy legislation. Unlike some lobbying activities such as seeking subsidies, a working bankruptcy law did not have to be pursued anew with each Congress. Individual trade associations, especially the Credit Men's Association, did press legislators to vote against repeal and to pass minor amendments to improve the law, but they did not press for any wholesale changes.

In the first two decades after it was enacted, creditors were generally pleased with the operation of the law. They were particularly pleased that the law ended the race of diligence and facilitated out-of-court settlements that had been difficult to obtain before. The number of private adjustment bureaus recognized by the National Association of Credit Men increased from 5 in 1904 to 84 in 1922. The association estimated that in 1929 such bureaus handled assignments involving liabilities of over $31,000,000 (U.S. Senate 1932, 184). According to a 1923 text on legal aspects of credit by Stanley Brewster, the spread of private adjustments was part of the new business practice of trying to assist debtors to pay, "as contrasted with the hasty and intolerant policy of creditors prior to the enactment of the National Bankruptcy Act" (Brewster 1924, 454). For creditors, the Bankruptcy Act was most successful when it enabled them to collect debts *and* to stay out of bankruptcy court.

4. The Rise of Bankrupt Wage Earners, 1920-1932

Despite numerous amendments, the primary features of the bankruptcy law remained largely the same in the 1920s as when it was enacted in 1898, but the way the law was used changed dramatically. Wage earner cases surpassed business cases. Figure 1 shows wager earner, and merchant and manufacturer bankruptcy cases from 1899 to 1933. Prior to 1924, business cases (merchants and manufacturers) exceeded wage earner cases by a small margin. After 1924 wage earner cases always exceeded business cases and the gap widened as the rate of wage earner bankruptcy increased. The wage earner bankruptcy rate was less than 10 per 100,000 persons from 1899 to 1923, but reached 17 per 100,000 by 1928, and 21 per 100,000 by 1929. The rapid increase in wage earner bankruptcy further promoted the financial interest of legal professionals in the bankruptcy system and led to changes in beliefs about the purpose of bankruptcy law.

The increase in wage earner bankruptcy cases was fueled by increased availability of consumer credit. Consumer debt expanded rapidly in the 1920s due to innovations in credit supply (Olney 1990 and 1991). Finance companies were created to finance inventories of retailers, and buying on installment became ubiquitous (Olney 1991, 126-28; and Calder 2000, 184-91). Morris Banks and small lenders provided loans of no more than $300 and average loans sizes were well below that. A coalition of small lenders and the Russell Sage Foundation drafted the Uniform Small Loan Law. By 1933, 21 states had adopted some version of the Uniform Small Loan Law. The law provided for licensing of small lenders and allowed them to charge higher interest rates than most usury laws had allowed. Lenders also developed new methods for securitization of commercial and residential mortgages (Persons 1930; White 2000, 755).

Innovations in credit supply increased consumer indebtedness, but it was the bankruptcy law that made it possible for them to obtain an easy discharge if they failed to pay the debts. Ironically, the ease of discharge arose directly from the system of creditor control that critics had claimed would make it possible for creditors to thwart any discharge they opposed.

The merchants and manufacturers who drafted the 1898 Bankruptcy Act were primarily concerned with business failure. The system of administration they wrote into the law depended on active participation by creditors, but in wage earner cases there were no assets for creditors to recover. A 1929-1930 study of bankrupts in Boston found that in 85 percent of wage earner cases the debtor had no assets, and in an additional 9.4 percent of cases the debtor had less than $100 in assets (Sadd and Williams 1931). A survey of bankruptcy referees in 1930 found that in 87 percent of non-commercial cases no creditors attended the meeting arranged by the court (U.S. Senate 1932, 174). There was nothing for creditors to gain by participating in wage earner cases. When no creditor opposed a discharge, the court granted it. Discharges were denied in less than one-half of one percent of wage earner cases (Douglas and Marshall 1931, 33).

The changes in the way the law was used did not go unnoticed. The authors of a Department of Commerce study conducted in 1929-30 asked "whether the law is being put to the use that it was intended and whether the law and its administration are particularly suitable for changed economic and social conditions?" (U.S. Bureau of Foreign and Domestic Commerce 1931, 26). Another report declared that the 1898 Act had been "carefully drawn and thoroughly considered," but concluded that "under the stress of greatly changed social and economic conditions it has had quite unforeseen consequences, the most serious of which have resulted from a failure of the theory that creditors can be relied upon to take charge of the management and enforcement of the act" (U.S. Senate 1932, 3).

In the absence of countervailing creditor interest, the rapid increase in bankruptcy cases during the 1920s served to increase the stake of lawyers in the bankruptcy system. Figure 2 shows the increase in fees paid to lawyers from 1920 to 1933. As their stake in bankruptcy law increased, legal professionals formed associations dedicated specifically to bankruptcy law. In 1929 they organized the National Association of Referees in Bankruptcy and in 1933 they formed the National Bankruptcy Conference.

As the primary use of bankruptcy law shifted from the distribution of an insolvent's assets to the relief of the debtor, people adjusted their beliefs about the functions of bankruptcy law. In the late nineteenth century, proponents of bankruptcy law emphasized its role in determining the distribution of assets amongst creditors and its importance in promoting interstate commerce. By the mid 1920s, the discharge of the debtor was perceived to be of equal importance in the case of voluntary bankruptcy. In 1924 F. Regis Noel, an historian of bankruptcy law, claimed that "the crown jewel of this legislation is its capacity to discharge the bankrupt from the payment of his provable debts." He argued that insolvency "is now regarded not as a crime, but as a misfortune, not as a disgrace, but as a malady which needs the soothing remedy of sympathy and encouragement" (Noel 1925, 154). Such views would mean little if they were simply those of an individual or even a minority, but they were also expressed by those in a position to influence the evolution of the law.

One can see, for instance, a gradual change in the view of bankruptcy expressed by the Supreme Court. In 1915 Justice McReynolds had made clear that discharge was a secondary function of bankruptcy law, but as early as 1925, the discharge of debtors was beginning to rival the distribution of assets as the function of bankruptcy law. Justice Sutherland wrote: "A proceeding in bankruptcy has for one of its objects the discharge of the bankrupt from his debts. In voluntary proceedings...that is the primary object" (*Freshman v. Atkins* 269 U.S. 121). Wage earner cases were necessarily voluntary and by the mid 1920s represented the largest category of bankruptcy cases. So, by 1925 the court had declared that in the majority of cases, discharge was the primary object of the law.

It also became increasingly clear that the criticisms the Democratic Party had traditionally leveled at bankruptcy law did not reflect the reality of bankruptcy law by the 1920s and 1930s. Because creditor control actually resulted in an easy discharge for wage earners, opposing the existence of federal bankruptcy law no longer served a useful role in Democratic Party ideology. By the latter half of the 1920s most Democrats were interested in amending bankruptcy law, not repealing it. When the Act was amended in 1926 to clarify administrative fees and procedures the vote in the House was 276 yeas to 17 nays. In contrast to voting on bankruptcy in the first decade of the twentieth century 113 of the yea votes were cast by Democrats.

5. Staying on the Path to Pro-Debtor Bankruptcy Law, 1933-1938

In the late 1920s and early 1930s there was an attempt to block the path to easy discharge. Government studies concluded that the law was flawed in its assumption of creditor participation, and that as a consequence there was virtually no oversight of wage earner cases. The studies recommended that Congress reverse course and institute a bankruptcy law more like the Lowell and Ingalls bills that had been advanced earlier and which, like systems in England and Canada, relied on government officials to handle bankruptcy cases rather than creditors, lawyers and courts. The Thacher Report stated: "In order to correct the fundamental weakness of the act in permitting bankrupts to obtain its benefits without adequate, and often without any, inquiry into their conduct, it is proposed to create a staff of examining official, appointed under civil service rules" (U.S. Senate 1932, 93). President Hoover also suggested: "The act should be amended to require the examination of every bankrupt by a responsible official…for consideration of the court in determining if he should have his discharge" (quoted in Levi and Moore 1937, 390).

The Thacher report also recommended that corporate reorganization and wage earner amortization plans be incorporated into bankruptcy law as alternatives to liquidation. During the nineteenth century, courts had developed procedures for corporate reorganization through equity receiverships. But courts did not make the remedy available to all corporations and many lawyers believed that the process could be improved. The idea for amortization came from private amortization companies that helped insolvent wage earners arrange to repay their debts over an extended period of time. In the end, the administrative recommendations were not implemented, but reorganization and wage earner workouts were. Amendments of 1933 and 1934 introduced corporate reorganization into bankruptcy law. In 1933, Congress added section 74 (arrangements of unsecured debts of unincorporated business), section 75 (adjustments for farmers) and section 77 (railroad reorganization). In 1934, Congress added section 77b (which made it possible for any corporation to attempt reorganization). In 1938, Congress passed the Chandler Act, extensively amending the

Bankruptcy Act. The Chandler Act created Chapter XI (arrangements for small businesses), Chapter X (corporate reorganization), and Chapter XIII (wage earner workouts).

The recommendations for administrative changes were introduced in the Hastings-Michener bill of 1932. Associations of legal professionals vigorously opposed the changes in administration (Skeel 2001, 83). The American Bar Association, for instance, argued that the body of legal decisions that had been built up around the Bankruptcy Act "must not be destroyed or abandoned in favor of theoretical and untested innovations" (quoted in Douglas 1933, 592).

In addition to administrative changes, the bill would have required suspension of the discharge of wage earners for two years, during which time they would have to turn over any income over and above that which was necessary for living expenses. These stringent requirements for a discharge were out of step with changing conceptions of the purpose of bankruptcy law. One witness before the Senate Judiciary Committee declared: "It is shocking that an American Congress could ever foist upon a liberty loving people such a document as has been here drafted." He believed that the founding fathers would turn over in their graves at the thought of an American citizen having to go before a government official and "explain to the court how much he needs for food and shelter and clothing for his family"(quoted in Boshkoff 1982, 113). A referee from Alabama likened the proposed rules to slavery and suggested that the law would say to wage earners "either go into servitude or stay out of the bankruptcy court" (quoted in *In re Perry* 272 F. Supp. 73).

Having organized to protect their financial interest in maintaining the administration of bankruptcy, lawyers took on the leading role in revising the bankruptcy law during the

1930s. When the Chandler Act was passed in 1938, Representative Hobbs of Alabama observed that Chandler had "summoned to his aid the experts of the Nation on the subject of bankruptcy" (*Congressional Record* August 10, 1937, 8646). Chandler's experts were almost all lawyers or law professors, members of the National Bankruptcy Conference, the National Association of Referees in Bankruptcy, the Committee on Bankruptcy of the American Bar Association, or similar organizations.

Bankruptcy lawyers were not, however, the only interest group that influenced bankruptcy law during the 1930s. David Skeel argues that the participation of trade creditors in bankruptcy legislation "dwindled after the early New Deal" (Skeel 1998, 511). But creditors were not entirely displaced by lawyers as lobbyists for bankruptcy legislation. As bankruptcy shifted from business bankruptcy to wage earner bankruptcy, lobbying shifted from trade creditors to retailers. Specifically, the National Retail Credit Association and the American Retail Federation actively promoted the idea of wage earner workouts. Although criticisms of the Hastings-Michener bill made it clear that forcing wage earners into repayment plans was not politically feasible, the retail associations stressed the findings of the Thacher Report that "most wage earners who fall into debt desire to pay their debts in full and avoid the stigma of bankruptcy" (U.S. Senate 1932, 80). The retail associations were not only successful in obtaining wage earner workouts, but were able to obtain the inclusion of a section requiring creditors to state that their claims were not usurious, even though the requirement had been opposed by the National Bankruptcy Conference (*In re Perry* 272 F. Supp. 73). Although intended to encourage the repayment of debts, the legislative changes proposed by the retail creditors were also consistent with the view that the purpose of bankruptcy law was to provide relief for insolvent debtors. They did not propose to create new barriers to discharge, but to create an additional opportunity for repayment.

The belief that the primary object of bankruptcy law was relief of the debtor was widely acknowledged by the second half of the 1930s. In 1935, Justice Brandeis put the two purposes of bankruptcy law on equal footing when he wrote that "discharge of the debtor has come to be an object of no less concern than the distribution of his property" *(Louisville Joint Stock Land Bank v. Radford*, 295 U.S. 555). In 1937, Senator Michener declared: "a new concept of bankruptcy has been accepted during the last 4 or 5 years." He explained that "when financial evil days come upon one he may seek the aid of the bankruptcy court of the United States, and by this method may keep his creditors at bay until he has had time to regain his financial equilibrium" (*Congressional Record* August 10, 1937, 8649). Bankruptcy was no longer primarily seen as a commercial regulation to promote the supply of credit. Bankruptcy law was a tool for the relief of people made insolvent by circumstances beyond their control.

The most compelling evidence that there was a change in fundamental beliefs about the role of bankruptcy comes not from Congress or the Court, but from creditors. In 1939, The National Association of Credit Men pointed out to its members that "it is well to recall that all bankruptcy legislation is primarily for the benefit of the bankrupt. It is an established part of the public policy of this country that unfortunate debtors must have an opportunity to rehabilitate themselves from becoming public charges." The reversal of priorities is clear: "A secondary object of the bankruptcy statute is to bring about an efficient and economical liquidation of an insolvent debtor's assets so they may be equitably distributed to his creditors" (National Association of Credit Men 1939, 467). They were correct; by 1938 debt forgiveness was an established part of public policy.

The new view of bankruptcy law as protection for insolvent debtors, especially wage earners, made it possible for the Democratic Party to change its stance on bankruptcy law. The Democratic Party became the champion of not just preserving but extending bankruptcy law. The numerous amendments of the 1930s, extended the scope of bankruptcy and were all enacted with large Democratic majorities in both houses. Almost all of the bankruptcy bills in the 1930s passed through both the House and the Senate without a single roll call vote.

It is important to note that the changes in beliefs, party position and organized interest groups were not simply the result of the economic crisis that began in 1929. There was not a crisis in wage earner bankruptcy during 1929-1932. The number of wage earner cases increased by an annual average of 16 percent between 1921 and 1929, but increased only 12 percent in 1930, 2 percent in 1931, less than 1 percent in 1932, and fell by 8 percent in 1933. The changes had also begun well before the onset of the Great Depression. By the second half of the 1920s one can already see the end of Democratic opposition to federal bankruptcy law, lawyers taking the leading role in trying to shape bankruptcy legislation, and changing beliefs about the primary purpose of bankruptcy law.

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6. Conclusion

Our analysis of path dependence in the development of bankruptcy law led us to uncover the origins of debtor-friendly bankruptcy law. The standard interpretation asserts that debtor- friendly bankruptcy law was the result of a political compromise in 1898, but neither the rhetoric nor the voting record is consistent with that view. Debtor-friendly bankruptcy law does trace back to choices made by Congress when it passed the 1898 Bankruptcy Act. Because of the choice of creditor control rather than government oversight the 1898 Act unintentionally gave lawyers a vested interest in a system that presented almost no obstacles to bankrupt wage earners. As it became apparent that the bankruptcy law had come to be used primarily to relieve insolvent debtors, people changed their beliefs to match the new reality. Bankruptcy law had become debtor-friendly before Congress intentionally enacted debtor-friendly bankruptcy legislation in the 1930s.

Our analysis illustrates the complementarities between path dependent analysis of law and traditional analysis of voting behavior. Legislative action during any particular Congress is the result of the factors that have traditionally been emphasized: ideology, constituent interest, party influence and interest group activity. Path dependence arises when legislative action causes changes in these factors, which in turn influence future legislation.

Finally, consider how the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 relates to our analysis. Does the movement away from debtor-friendly bankruptcy law contradict path dependence? We argue that it does not. Path dependence suggests that self-reinforcing mechanisms can make it difficult to exit from a particular path. Path dependence does not imply that external shocks cannot change conditions sufficiently to move the law onto a different path. In the case of recent bankruptcy reform, deregulation of credit card interest rates appears to be an external shock associated with particularly rapid increase in consumer indebtedness and bankruptcy. The deregulation of interest rates can be traced to the Supreme Court's 1978 decision that credit card interest rates were subject to regulation by the state from which the card was issued, rather than by the state of the card holder (*Marquette National Bank v. First of Omaha Service Corporation, 439 U.S. 299*).

The subsequent rise in consumer indebtedness and consumer bankruptcy led to the formation in 1997 of the Coalition for Responsible Bankruptcy Law (originally the National Coalition for Consumer Bankruptcy), which is an umbrella organization of consumer creditors formed in 1997. The Coalition played a significant role in keeping bankruptcy reform before Congress (Nunez and Rosenthal 2002), just as the National convention of Representatives of Commercial Bodies did in the 1880s and 1890s.

Recent reform efforts focused on forcing more wage earners into Chapter 13, forcing those who are able to pay off their debts over time. The first step on that path had been taken in the 1930s and the reform in many ways resembled the original Hastings-Michener proposal to suspend discharges for two years while debtors tried to repay what they owed. Even as the law changed, the path of change was influenced by the history of the law.

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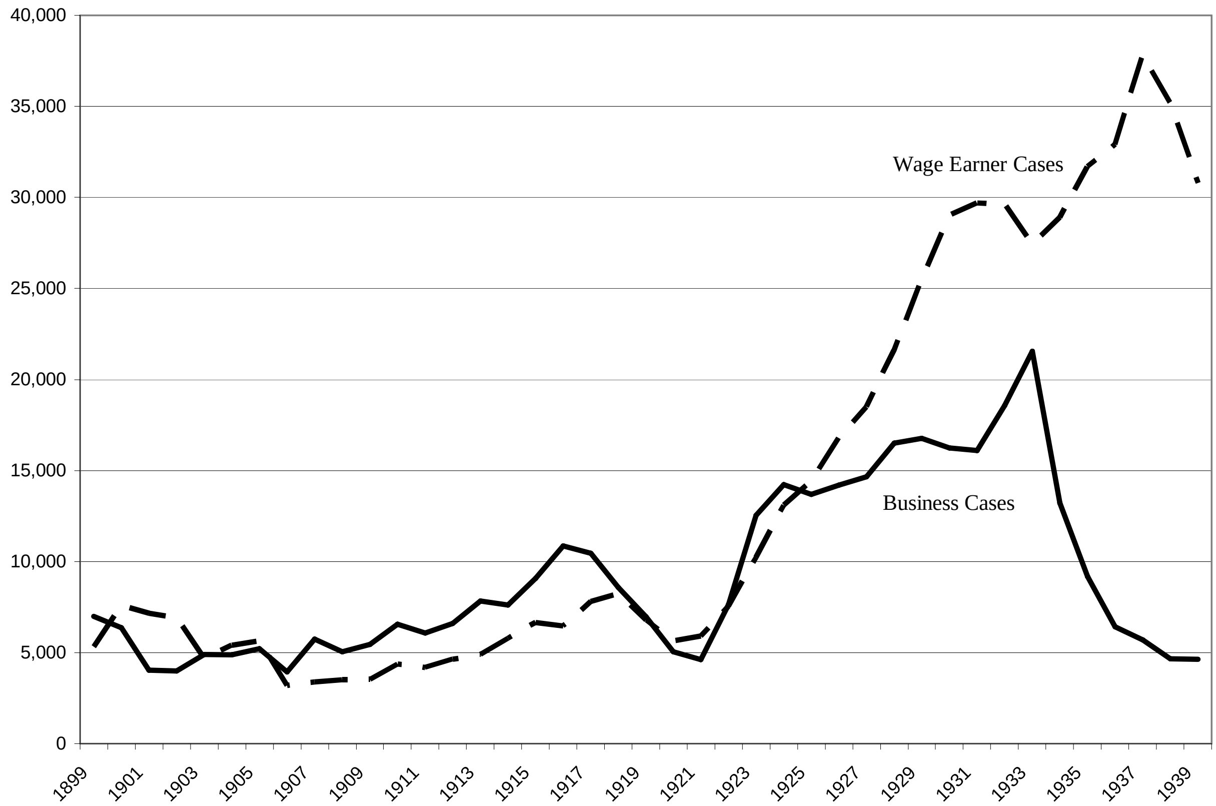
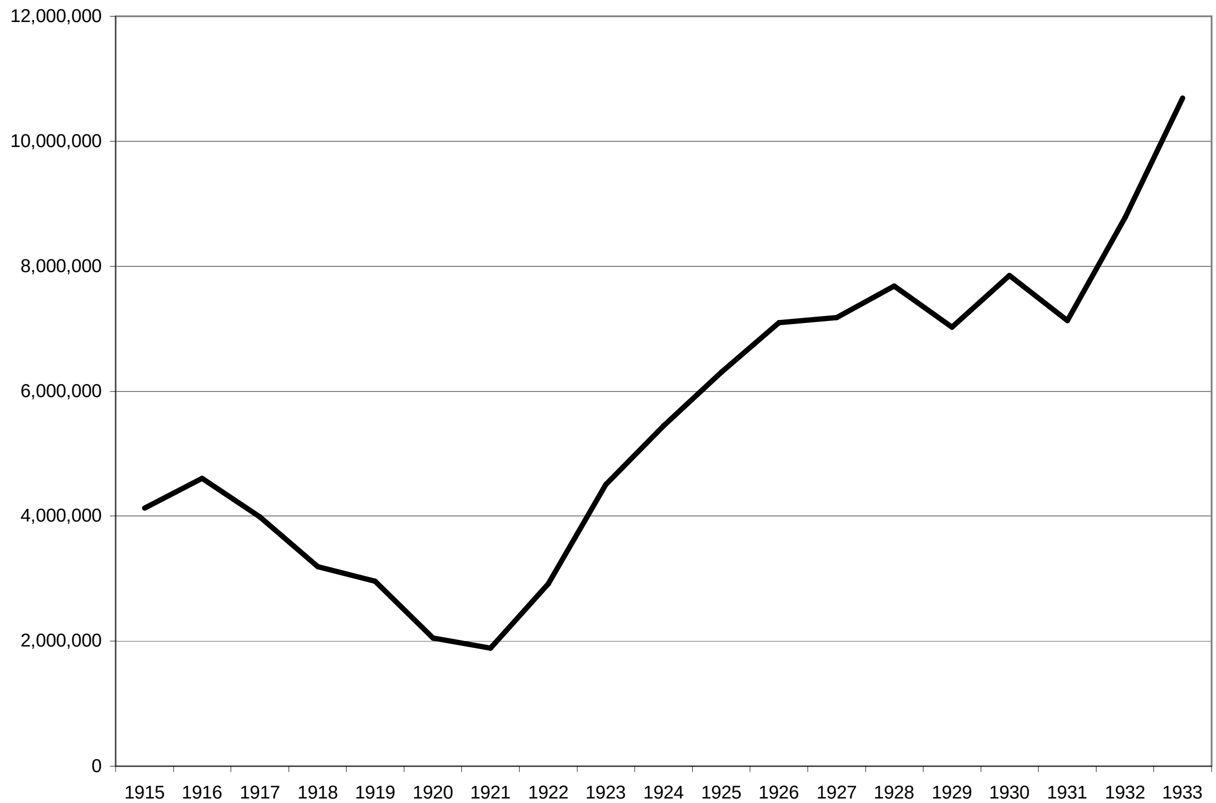
Figure 1. Wage Earner and Business Bankruptcy Cases, 1899-1939



Source: *Annual Report of the Attorney General of the United States*. Washington: GPO. Years 1899-1939.

Figure 2. Lawyers' Fees, 1915-1933 (in 1929 $s)



Source: *Annual Report of the Attorney General of the United States*. Washington: GPO, years 1915-1933.