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STATEMENT OF SENATOR BOB DOLE
BEFORE THE
SUBCOMMITTEE ON COURTS
SENATE JUDICIARY COMMITTEE
GENERAL BANKRUPTCY HEARING

APRIL 3, 1981

TODAY AND MONDAY, APRIL 6, 1981, THE SUBCOMMITTEE ON COURTS WILL TAKE A MUCH NEEDED LOOK AT THE NEW BANKRUPTCY CODE.

SINCE THE NEW BANKRUPTCY LAW WENT INTO EFFECT ON OCTOBER 1, 1979, FILING FOR BANKRUPTCY HAS BECOME EPIDEMIC. ACCORDING TO FIGURES FROM THE ADMINISTRATIVE OFFICE OF THE UNITED STATES COURTS, IN 1978, THE LAST FULL YEAR THE OLD STATUTES WERE IN FORCE, THE NUMBER OF TOTAL ESTATES FILED WAS LESS THAN THAT IN 1967. IN STARK CONTRAST, FOR THE FIRST TWELVE MONTHS UNDER THE NEW CODE, TOTAL BANKRUPTCIES NUMBERED SOME 425,000, WITH CLOSE TO 50,000 BUSINESS FAILINGS AND ROUGHLY 375,000 PERSONAL BANKRUPTCIES. THIS REPRESENTS A 60 PER CENT INCREASE OVER THE PRECEDING TWELVE-MONTH PERIOD -- WITH COMMERCIAL FILINGS UP 50 PER CENT, WHILE PERSONAL FILINGS CLIMBED A STAGGERING 75 PER CENT. LAST YEAR OVER 150,000 MORE BANKRUPTCIES WERE FILED THAN IN THE PREVIOUS RECORD HIGH YEAR OF 1975. THE CONSUMER LOAN INDUSTRY ESTIMATES LOSSES OF $2 BILLION FROM PERSONAL BANKRUPTCY ALONE IN 1980. MOREOVER, THE DEBTS OF FAILING COMPANIES LAST YEAR WERE APPROXIMATELY $4.5 BILLION.

MANY FACTORS HAVE PROBABLY CONTRIBUTED TO THIS RECENT NATIONWIDE SURGE IN BANKRUPTCIES BESIDES THE NEW FEDERAL CODE. THE PERSISTENCE OF DOUBLE-DIGIT INFLATION AND INTEREST RATES COUPLED WITH SUSTAINED WIDESPREAD UNEMPLOYMENT FORCE MANY AMERICANS INTO FINANCIAL PERIL. MORE AGGRESSIVE ADVERTISING BY ATTORNEYS, NOW LEGAL AS A RESULT OF A RECENT U.S. SUPREME COURT DECISION, HAVE MADE IT VERY EASY TO UNDERTAKE FILING FOR BANKRUPTCY WITH MINIMAL LEGAL HELP AND EXPENSE. THE DEVELOPMENT AND WIDESPREAD EXPANSION OF THE CREDIT CARD INDUSTRY IN THE LAST TEN YEARS HAVE MADE UNSECURED CREDIT READILY AVAILABLE

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TO AN UNPRECEDENTED EXTENT. THESE CAUSES HAVE HELPED TO FOSTER AN ATTITUDE AMONG SOME OVERLY SELF-INDULGENT MIDDLE-CLASS AMERICANS THAT BANKRUPTCY IS NO LONGER THE SOCIAL AND PERSONAL EMBARRASSMENT IT ONCE WAS, BUT RATHER A COMPLETELY LEGAL AND VERY CONVENIENT WAY OF BEING FREE OF DEBT (AT LEAST FOR THE TIME BEING) WITHOUT BEING DESTITUTE. THIS PERVADING ATTITUDE IN TURN ENCOURAGES MORE BANKRUPTCY FILINGS.

THUS, TODAY, WITH THE DISTINGUISHED PANELS OF THE PERSONAL LOAN INDUSTRY AND CREDITOR-ORIENTED LAWYERS, WE WILL TRY TO DETERMINE HOW MUCH OF THE CONSUMER BANKRUPTCY PROBLEM LIES WITH THE FEDERAL LAW, AND HOW MUCH HAS BEEN CAUSED BY THE ECONOMY, LAWYER ADVERTISING, INDUSTRY PRACTICES, LENIENT ENFORCEMENT AND ADMINISTRATION, INADEQUATE STATE LAWS, OR PERSONAL DEBTOR IRRESPONSIBILITY. ON MONDAY, APRIL 6, WE WILL ADDRESS THE GROWING PLIGHT OF OUR NATION'S GRAIN FARMERS FACED WITH INDEPENDENT ELEVATORS GOING BANKRUPT. WE WILL ALSO HAVE PANELS OF HIGHLY RESPECTED BANKRUPTCY JUDGES, COMMERCIAL EXPERTS, U.S. TRUSTEES, AND A DEBTOR-ORIENTED LAWYER TO PROVIDE US THEIR PERSPECTIVES AND INSIGHTS.

HOPEFULLY, EXTENSIVE DISCUSSION BY OUR DISTINGUISHED WITNESSES WILL FOCUS ON CONTROVERSIAL PROVISIONS SUCH AS FEDERAL EXEMPTIONS IN PERSONAL BANKRUPTCIES, PREFERENCE TEST IN COMMERCIAL BANKRUPTCIES, RE-AFFIRMATION, AND DISCHARGEABILITY OF DEBTS. SUCH TESTIMONY FROM THESE HEARINGS WOULD THEN PROVIDE THE GENESIS FOR APPROPRIATE LEGISLATION TO CORRECT PROPERLY IDENTIFIED PROBLEMS WITH THE FEDERAL BANKRUPTCY CODE.

AT THIS TIME, I WOULD LIKE INSERTED IN THE RECORD TWO RECENT ARTICLES FROM THE NEW YORK TIMES, WHICH VIVIDLY PORTRAY THE GRIM SITUATION WITH PERSONAL AND BUSINESS BANKRUPTCIES.

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LOSSES UP SHARPLY ON CONSUMER LOANS BY BANKS, RETAILERS

Many Lenders Found Cutting Back on Credit Given to Individuals, Especially Less Affluent

By ROBERT A. BENNETT

Losses on consumer loans have increased sharply at banks, finance companies and retailers around the country. As a result, many of these institutions are cutting back on credit to individuals, an informal check with the creditors shows. Individuals in the lower-income brackets, and those who do not own real estate that can be used as collateral, may find it especially difficult to obtain credit.

James A. Matthews, vice president of the Continental Illinois National Bank and Trust Company of Chicago, the nation's seventh-largest bank, said that "consumers might have to use credit more judiciously." It might be necessary to return to the way of living of the 1950's, he continued, when people "had a healthy attitude toward credit."

There are no reliable statistics on the overall dollar amount of consumer-loan losses, but industry sources estimate that $2 billion was lost from personal bankruptcy alone in 1980. The sources had made no estimate for 1979 since losses from personal bankruptcies posed no significant problem that year. But court records show that the number of personal bankruptcies rose 76 percent last year, to 367,000, from 209,500 in 1979. As a result, lending institutions have reported sizable losses on consumer credit.

Bank of America Losses Up 40%

In San Francisco, for example, the Bank of America, the nation's largest, said its losses on consumer loans were up 40 percent from 1979. The bank declined to put a dollar value on the losses.

Citibank, the second largest, said losses on consumer loans rose 56 percent, to almost $200 million, in 1980 from $125 million in 1979. Five years earlier, they totaled $[illegible]3 million.

At the Beneficial Corporation, a leading finance company, losses on consumer loans last year soared almost 54 percent, to $109 million, from $71 million.

Also Sears, Roebuck & Company, a major retailer, reported that losses from personal bankruptcies in the first 11 months of 1980 rose 124 percent, to $40 million, from $18 million in the comparable 1979 period.

Lenders attributed the losses to many factors, including the combination of recession and inflation. But the problem that most troubles the creditors is the

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Federal bankruptcy law that went into effect on Oct. 1, 1979.

The law enabled individuals to protect much more of their property against seizure by creditors than previously. In some states, such as New York, Michigan and California, state laws increase the amount of protected assets. Some lawyers estimate that a married couple declaring bankruptcy in California can retain more than $100,000 in personal property.

In addition, the Supreme Court ruled in the last year that lawyers may advertise, and many law firms have been aggressively promoting their services, for $250 to $300, to help individuals ease or eliminate their debt burden through bankruptcy laws.

Almost every consumer lender in the country has been trying to find characteristics that would identify a probable bankrupt, but no organization maintains that it has had any success.

"The bankruptcy problem is not confined to the lower end of the economic spectrum," said Edward D. Miller, senior vice president of the Manufacturers Hanover Trust Company. "Many of the individuals declaring bankruptcy are the guys who used to be our best customers."

Unable to identify the individuals most likely to declare personal bankruptcy, many lenders are simply tightening credit standards.

Beneficial Finance, for example, which has traditionally lent primarily to individuals in the lower-income brackets, has begun to give preference to borrowers who can put up real estate as collateral for a loan, which gives the lender some protection against bankruptcy. Today, almost three-quarters of Beneficial's loans are secured by real estate, up from a quarter five years ago. "The availability of unsecured credit has been significantly diminished," said F.M.W. Caspersen, Beneficial's chairman.

Banks, too, have been tightening their standards. Manufacturers Hanover, for example, has stopped issuing its MasterCard or Visa credit cards to individuals with incomes of less than $15,000. Previously, it had no minimum.

"The face of consumer credit will change to a good degree," said Luther G. French Jr., senior vice president of the North Carolina National Bank. "Unsecured loans will become more and more difficult to come by."

Many, perhaps most, banks have been increasing the so-called credit scores needed by consumers to obtain unsecured loans. Potential borrowers fill out forms giving information about their financial position. Based on the past performance of individuals with similar characteristics, the applicant is given a score. If his total score is high enough, he usually gets the loan.

Citibank, which has decided that little can be done to reduce the rate of loan losses, appears to be taking a different approach than most other consumer lenders. Its strategy is to accept the losses and pass these costs on to its good customers in the form of higher charges.

"We are going to have to accept these losses as an incremental cost of doing business," said Richard S. Braddock, a senior vice president of Citibank. "It will be reflected in our pricing."

On its credit cards, for example, Citibank charges an annual rate of interest on outstanding balances of 19.8 percent, compared with 18 percent for most other credit-card issuing banks in New York.

Bankruptcies Quintupled

"There is absolutely no question that the bankruptcy law has been a major factor in 1980," said William H. Piper, executive vice president of the Genesee Bank in Flint, Mich.

At Genesee, the number of personal bankruptcies has quintupled in the last five years, Mr. Piper said. Although the recession has had a more dramatic impact on Flint than most other cities — its unemployment rate stands at 20 percent because of the city's dependence on the depressed automobile industry — Genesee's experience has not been very different from that of banks and other lenders elsewhere in the country. Creditors are particularly disturbed by this trend because they have not been able to discover a pattern that would help them in determining likely candidates for bankruptcy.

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Bankruptcies Soaring As High Interest Rates Cause Cash Shortages

By KENNETH B. NOBLE

Business bankruptcies are spreading through the nation's economy at a spectacular pace, largely because of last year's recession and current high interest rates.

In the first 10 weeks of this year, business bankruptcy filings soared to 2,933, a gain of 63 percent from the comparable period last year and the highest number reported for the period since 1953. The gain early last year was already 53 percent above that for the similar period in 1979, according to data released last week by Dun & Bradstreet Inc.

While the rash of business failures has swept across nearly the entire spectrum of business concerns — manufacturing, wholesaling and retail services have all experienced increases of more than 60 percent — a few areas were especially hard-hit.

Problems in Housing and Autos

"Contractors are really taking a bath around the country," said Leonard Andrews, whose company publishes the National Bankruptcy Reporter, a legal newsletter. New housing construction plunged 25 percent in 1980, its worst per-

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formance since 1975, ruining many small contractors.

Another major casualty has been automobile dealers. Buffeted by the downturn in Detroit's fortunes, more than 1,600 of the nation's 28,000 dealers closed their doors for good in the past year, according to industry surveys. For the automotive retail industry as a whole, bankruptcies last year rose more than 94 percent, Dun & Bradstreet estimated.

For the first 11 months of 1980, a total of 10,727 businesses filed bankruptcy petitions, 52 percent more that the 7,055 filings in the similar period of 1979, the business survey group reported; it said it did not yet have figures for December.

Some economists say, however, that the bankruptcy rate may not necessarily foreshadow disastrous changes in the business climate.

"Many people worry that the dramatic business-failure rate is going to throw the whole financial market into a sort of tailspin," said Alan Murray, an economist with Citibank. "But I don't think these statistics point to some factor that is going to have a large independent influence on the course of the economy.

"I think there's a very good likelihood that the conditions that caused these failures will ease. Interest rates will come down, the whole economy will become less subject to abrupt fluctuations, a better business climate will be restored, and growth will start again."

Too Late for Leon Teich

Any upturn in business activity, however, will be too late for Leon Teich, the 68-year-old president of Celectro-Knit Fabrics on Coney Island. For more than 40 years, he had weathered his share of business reverses in New York's highly cyclical apparel industry.

But in the wake of last year's recession, when sluggish consumer demand combined with unusually high interest rates, Celectro-Knit, like many small and medium-sized businesses, was squeezed to the point of insolvency.

"We were still liquid, but we had no cash flow," Mr. Teich said. "We didn't have enough money to purchase raw materials or meet our payroll." Faced with rising credit and energy costs, he filed for bankruptcy.

William C. Dunkelberg, an economics professor at Purdue, said: "For companies operating at the margin, high interest rates might be the straw that breaks the camel's back. But if you really think about the role of interest costs in a firm's operations, that's not it, it's the sick bottom line: Sales are going up, but not as much as inflation, and companies can't get their prices up fast enough, so their cash flow is squeezed. That's really the problem. If the economy picks up, they'll do just fine, even with high interest rates."

Although interest rates have dropped in recent weeks, they are still high by historical standards, and they continue to hit many smaller companies hard, since such concerns must borrow at higher rates than more creditworthy large corporations.

For small manufacturers like Mr. Teich, the problems began early last year as consumer demand began to lag. Inventories piled up, and those stored goods, in turn, had to be financed, frequently through a factor.

A factor, most commonly used in the apparel industry, buys from a company the right to collect its accounts due, and then grants credit to the company in return. But the interest charged by factors can run several points above the prime rate. For Mr. Teich, this meant finance charges approaching 23 percent when the prime lending rate stood at 20 percent last April.

"We used to buy natural yarns from down South, dye them, put them on knitting machines and sell the finished fabric," Mr. Teich recalled. But with the rise in credit costs, "We could no longer finance the purchase of the yarn or the making of the fabrics."

The fear of paying high interest rates also deters companies that are in fairly sound financial condition, but which may need to borrow in order to expand and prosper.

"It's almost a cultural kind of thing," said Larry Weinberg, president of Brooklyn Economic Development, a government agency advising small businesses.

"Fortune 500 companies understand how to pass along the high cost of borrowing. They are sure enough of their market share that by raising their prices, they won't be pricing themselves out of business. The small manufacturer thinks that if he starts to pass along the cost of 24 percent borrowing, he will price himself out of a market in which he's a very small piece," Mr. Weinberg said.

The interest rate phenomenon has also haunted creditors.

"Because of the number of bankruptcies that are being reported, our members have become much more stringent in their credit policies," said Cooke O'Neale, a vice president of the National Association of Credit Management, a trade group representing credit granters. "They may put a company on cash-on-delivery, or cash in advance, and they are making collection calls earlier." The result: "Tightening credit is just going to add to a company's woes, it might just be pushing them toward bankruptcy."

In addition, the recently revised Federal bankruptcy law may have encouraged some companies to file for bankruptcy, although, according to accountants and legal experts, the new law is not significantly more lenient to business debtors than the previous one.

The new law affects both arrangements with creditors and the so-called preference law, which governs funds already paid out by the company filing for bankruptcy.

According to legal sources, factors were almost always protected under the old preference law, but now they might find themselves vulnerable. They say some factors might be tightening payment terms to 45 days from the more typical 60- or 90-day periods, which spells trouble for a manufacturer who has late payments from some of his retail accounts.

The debts of failing companies rose to about $4.3 billion during the January-November period last year, the latest available figures show, compared with $2.5 billion in the similar period of 1979. In addition, the average $405,000 debt of a company now in bankruptcy proceedings — allowing for inflation — is almost double the average in 1932, the biggest year for business failures ever.

Most smaller businesses in distress have two major legal alternatives: Chapter 7 — straight bankruptcy — or Chapter 11, which includes debt reorganization.

Under Chapter 7, the company's assets are auctioned off and distributed to creditors in order of priority. In such cases, holders of common stock are almost always wiped out.

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Most companies prefer to file under Chapter 11, which is tailored to enable management to continue running a business, but sets up a committee of the company's major creditors to work out a plan for debt payments.

Companies that try to revive after bankruptcy almost invariably emerge in sharply shrunken form.

Celectro-Knit Fabrics, operating out of six buildings, employed more than 200 people when it closed its doors last October. Mr. Teich is now starting a smaller contract-finishing company, occupying only one of the buildings. There are only 10 employees.

But with borrowing costs still high, Mr. Teich is not optimistic about the new enterprise. "As the business stands now, it's probably too small to be viable," he said, and increasing its size would be difficult since "I have no credit at all, not a dollar."