

Integrating the Legal Regimes for Secured Transactions and Bankruptcy: Economic Issues

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Bankruptcy laws aim at terminating the debt collection process; secured transactions laws aim at facilitating the debt collection process. Though they serve different ends, they are closely related: the terms of bankruptcy laws can change the usefulness of collateral under the secured transactions laws. This note summarizes the issues in integrating the legal regime for bankruptcy with the legal regime for secured lending. It discusses how a broader revision of laws that affect the claims of presently unsecured creditors can permit a better system for bankruptcy without reducing the benefits from the system for secured lending.

Bankruptcy and Secured Lending

Though sometimes grouped together under the rubric of "debtor-creditor" laws, bankruptcy and secured lending serve different economic purposes and social ends:

Bankruptcy is a system for *terminating* the debt collection process. Bankruptcy replaces other penalties on defaulting debtors, including debtors prison, slavery, dismemberment, and transportation.

Secured lending is a system for *facilitating* debt collection. It works by improving security and information so that borrowers can more readily prove their creditworthiness, and lenders can make loans with less risk and collect them more easily.

Their Interaction

While bankruptcy and secured lending serve different ends, they are inextricably linked: when bankruptcy terminates the debt collection process, it may also terminate or curtail the collection of secured loans. Depending on how bankruptcy terminates

collection of secured loans, it will affect the gains from secured lending.

Integrating these Legal Frameworks: Economic Issues

Some systems of bankruptcy delay the claims of the secured lender, subsuming them to other claims that had less seniority prior to bankruptcy, or even setting them aside.

If the law states, effectively, that it will set aside a borrower's promise to deliver collateral when that borrower is in sufficiently serious difficulty, then the law will seriously limit the value of that collateral to lenders.

As an economic issue, the social desirability of limiting secured creditors to assist other unsecured creditors in a bankruptcy proceeding depends on weighing two broad benefits: the benefit from a system of secured lending against the benefit from a system of bankruptcy that undercuts the system of secured lending. . The socially desirable outcome would integrate the two systems in a way that produced the greatest total benefit for society.

The Gain from Secured Lending

A legal framework that permits offering property as collateral for a loan offers broad benefits in reducing risk. In systems where borrowers can offer a broad range of property as collateral, they get larger loans, at lower interest rates, repayable over longer periods of time.

At the most reputable and serious financial institutions, for example the credit unions of the World Bank, the Inter-American Development Bank and even the International Monetary Fund and the Federal Reserve, the very same borrower offering movable property or real estate as collateral will receive considerably better terms on a loan than when offering only a signature. For a loan secured by real estate, a borrower could expect to get a loan nine times larger, repayable over a period of time eleven times longer, at an interest rate about 50% lower than if the borrower offered only a signature. For a loan secured by movable property, the loan terms would fall somewhere in between those unsecured and those secured by real estate.

This enormous increase in credit from secured loans need not increase risk to the financial system. Its benefits are clear: more credit at lower interest rates permits higher rates of investment and more capital per worker, leading to much higher incomes. Seventy percent of bank loans in the United States are secured; at the same time, credit relative to GNP in the United States is about ten times higher than in most developing countries. Farmers and business operators in the United States borrow routinely at interest rates about 600 basis points higher than the government-borrowing rate, a fraction of the spread facing their counterparts in most developing countries. These larger spreads over the government borrowing rate cannot be explained by country risk. The typically large

spread between loans secured by movable property and loans secured by real estate can only be explained by collateral risk. Cross country difference in collateral risk arise nearly entirely from problems in the legal framework.

The Gain from Bankruptcy

The original gain from bankruptcy laws arose from the role of these laws in ending practices of incarceration, deportation, and maiming previously used to punish debtors who didn't pay. These practices came to be perceived as generating social harm with no offsetting social gain. This innovation of bankruptcy has no direct effect on the position of the secured lender: the secured lender's first recourse lies in seizing and selling the collateral for the loan. Only if that collateral is insufficient does the bankruptcy framework determine the secured lender's ability to recover a deficiency balance -- a debt balance in excess of that realized from the sale of the collateral.

Subsequently, however, several different types of unsecured claims have been added to the bankruptcy process. Some legal frameworks have given these claims priority higher than the claims of the secured lender. That is, the collateral securing the loan can be sold and the proceeds used to satisfy other claims before those of the secured lender. Among these are:

- Debts to the state
- Unpaid wages of workers
- Tort claims
- Subcontractors
- Attorneys fees and costs of the bankruptcy court
- Preservation of the ongoing value of the firm

Evaluating the social value of these provisions is a difficult task involving both; complex issues in productive efficiency, and troubling issues of fairness about which reasonable people might reasonably disagree.

Fortunately, better public policy approaches can bypass most of these issues: other methods exist for achieving these same ends that would not damage the framework for secured lending or reduce the benefits that it confers. Debts to the state could be collected in the same framework as other secured loans if the state merely filed a lien in the debtors property at the time that the debt to the state was created; the unpaid claims of workers could be protected by a floating lien equal to the unpaid claims; tort claims could better be provided by requiring insurance by the firm in question; subcontractors, like workers, could file liens when the debtors obligation was created; attorneys fees and the costs of bankruptcy would have priority only from the time of bankruptcy, thereby minimizing incurring social costs for dissolving firms with no net assets left.

Preserving the Ongoing Value of the Firm

The desirability of preserving the ongoing value of the firm is a more difficult question, as it nearly must always require a stay in execution of the secured creditors rights and a risk that they will be diminished in the course of the reorganization proceedings.

While this issue merits further investigation, the evidence to date indicates little social gain from the reorganization of firms. Most studies have difficulty finding any gain from reorganization proceedings at all; none appeared to have studied the partial impact on the gain from a stay in executing the claims of secured creditors. The marginal gain from a stay in execution of secured claims in this process would be lower still.

Integrating these Legal Frameworks: Tentative Conclusions

The economic gain from secured lending is large; it is distributed over a wide group of rich and poor citizens. This large and widely distributed gain justifies extreme caution in abridging the system.

However, crucially important policy issues are raised by those who support higher priority for the claims of the state, the workers in the firm, and the citizens at large. These concerns cannot be dismissed merely by listing the gains from the regime of secured lending. Rather, addressing the serious issues raised by those who would limit the rights of secured creditors requires a broad reform of a wide range of laws, concerning tax collection, workers rights, and coverage of risk to the citizens at large.

Nonetheless, that broad range of reforms would, without question, promote public welfare better than would limiting the rights of secured creditors without passing the reforms suggested above.

On the difficult question of judicially administered reorganizations, further study is necessary. However, based on the existing studies, no involuntary delay in the exercise of the rights of secured creditor can be justified.

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