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Introduction

Since the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA) was signed into law on April 20, 2005, debate on its effects on the economy has been raging. Proponents argue that the provisions of the law evolved out of the need to prevent opportunistic filings and curb bankruptcy filings for convenience. Critics, however, view BAPCPA as solely serving the interest of the credit industry which they accuse of writing, buying, and paying for the legislation in total disregard of the economy (Dickerson, 2006). Though the interests of debtors or creditors cannot be delinked from bankruptcy policy deliberations, this paper proposes that the effects of bankruptcy provision on the economy should take precedence in any such discussions. The gains made by the BAPCPA in limiting losses accruing from bankruptcy filings are yet to be evident twelve years after it took effect. In view of this, the ethical and legal implications of the BAPCPA are discussed in this document so as bring out its inherent weaknesses. This document principally proposes reforms to corporate ethics with regard to bankruptcy.

Bankruptcy ideology

Phillips (2013) argues that in the previous century, bankruptcy ideology was to accord a fresh start for debtors by discharging debts – a charge that fortifies the notion that BAPCPA borrows heavily from pro-creditor mentality. The paradigm shift the new legislation embodies basically aims at preventing financially solvent individuals and corporate debtors from unethically taking advantage of bankruptcy laws. The nineteenth century's bankruptcy provisions (such as the 1978 Code) are deemed as promoting moral hazards by relieving (discharging) the poor from debts. The concept of moral hazards is articulated in the rational choice theory

(Baker, 1996). According to the theory, an individual would rationally go for choices with the most beneficial outcomes and those that serve their highest self-interest. Subsequently, the concept of moral hazards assumes that cushioning people from the consequences of an undesirable behavior encourages that behavior. Creditors claim that a window for debt cancellation motivates debtors to resort to bankruptcy in spite of their ability to settle the debts (Zywicky, 2002). The legislators envisioned that by creating the law that limits financial relief (poor-relief), more Americans who are financially solvent will responsibly meet their financial obligations.

The BAPCPA spells out conditions a debtor must meet in order to get a discharge. An important prerequisite is the means testing for bankruptcy relief. Means testing uses a formula to determine whether debtor’s earnings are more than the state median income. Debtors found to earn income above the state median are required to clear substantial fraction of their debts through a restructured payment schedule instead of receiving a total discharge. The legislation also limits the number of repeat filings that one as well as placing limits on involuntary creditors. The involuntary creditors are also protected by the legislation. By so doing this law tries to deter moral hazard by placing disincentives and obstacles in the way of debtors who consider bankruptcy as an option. The begging question in both legal and ethical circles, however, persists: what is the extent to which insolvent debtors should take the responsibility for repaying their burdensome debts?

Extraneous factors

Though bankruptcy legislation places the burden of responsibility on the consumers, the implementation of new rules in curbing the moral hazard has been greatly hampered be extraneous factors. The most significant of these factors include influential debtor and creditor interest groups, macro-economic and societal environment, and the intervention of other players such as judges and lawyers in bankruptcy cases. The key proposal this paper makes will address these external factors and also deal with internal corporate actions. It is therefore prudent to review the contributions of these external influences in shaping bankruptcy policies over the years. These extraneous influences justify changes not only contained in the BAPCPA, but also the ones this document suggests. Evidence from bankruptcy literature, filing records, socio-legal texts and economic papers will elucidate our position in regard to reforming bankruptcy corporate ethics.

Four main politico-economic crises have defined the course and effects of American bankruptcy policies: the Panic (1796-1797), the Civil War (1861-1865), the Great Depression (1929-1941), and the Great Recession (2008). Lessons from these eras would duly inform future legal and ethical interventions. A year after the Panic that led to a serious economic downturn, an article that empowered Congress to implement federal bankruptcy laws was adopted in the US Constitution. The Bankruptcy Clause of 1798 set to regulate commerce and to prevent fraudulent actions involving parties or their activities being moved from one state to another. The Panic also led to the rise of incarcerated financially depressed debtors in prisons, and this led to the passing of the first bankruptcy law in 1800. Though the law rolled out a five-year creditor remedy plan, its critics felt that it encouraged risky ventures by decreasing failure costs (Russell & Cohn, 2012). It was hence repealed three years later.

The first worldwide economic crisis coupled with the American Civil War led to the enactment of Bankruptcy Act of 1867 aimed at providing insolvency relief but it was later repealed and replaced by another Act in 1898 for the same reason as its predecessors. The Great Depression, like previous crises led Congress to make pro-debtor amendments to the Bankruptcy Act of 1898, but the most debtor-friendly legislation in American history is what has become to be known as the 1978 Code. Phillips (2013) notes that the Bankruptcy Act of 1978 was historically unique since it was the first time a federal bankruptcy law was enacted in the absence of a deep economic crisis. Coco (2012) observes that the Code made bankruptcy to more effectively remedy the insolvent debtors thereby giving them a fresh start.

The debtor-friendly remedies in the 1978 Code prompted an increase of filings from an annual average of 288,000 in 1980 to 1.5 million in 2004 (White, 2007). The economic impact of this debtor behavior on creditors was greater in cases of unsecured claims. The unethical debtors find bankruptcy the easiest option for discharging debts. In order to check the upward thrust of bankruptcy filings, the BAPCPA was enacted in 2005. As stated earlier, the legislation's intends to regulate and limit access to bankruptcy relief, and to prevent opportunistic abuse of bankruptcy laws by financially solvent debtors.

The BAPCPA has failed to significantly reduce bankruptcy filings. Though the 34.5% rise in consumer bankruptcy filing s in 2008 can be attributed to the Great Recession only comparable to the Great Depression, the upward trend has not changed. As of March 2013, the filings for bankruptcy have risen to 1.1 million annually (United States Courts, 2013).

Before the failure of bankruptcy policies to satisfactorily check individual and corporate irresponsibility, it is important to outline lessons learnt from past failures. From the foregoing, it is clear that most of the bankruptcy policies arise as knee jack reactions to economic crises. Their failure can be attributed to the gaps they leave while addressing financial setbacks at the time.

For example, the Bankruptcy Act of 1841 was aimed at cushioning the public from the adverse effects of prolonged unemployment which resulted into masses of insolvent debtors. The legislation's failure to address the ripple effects of its provision led to its abuse and subsequent repeal. Similar legislation passed in reaction to economic meltdown failed due to restricted focus. Two landmark laws have been enacted without necessarily reacting to economic crises: the 1978 Code and the BAPCPA. While the former is reckoned as the bankruptcy act that has so far remained in force for the longest period, it left gaps that allowed abuse by unethical debtors. The BAPCPA has been in force for over a decade now, but it has not limited bankruptcy filings as intended. The 2008 recession exposed the flaws in the bankruptcy policies in operation**.**

Flaws in the current bankruptcy policies

Using the financial crisis of 2008 as the reference point, this document traces the relationship between the holes in the bankruptcy policies and financial impropriety. To illustrate that BAPCPA has not reduced bankruptcy filings, records show that the filing rate in 2004, a year before its enactment was 14 per 1,000 households while the rate dropped to 5.2 per 1000 in 2006 then steadily rose to 9.2 in 2008 (United States Courts, 2009). It is further estimated that in 2010, Americans who filed for bankruptcy reached 1.5 million – the highest figure since the inception the BAPCPA that made it more costly and difficult to file for bankruptcy. Li and White (2009) are of the view that the new bankruptcy legislation exacerbated the economic recession of 2008 – a view this document adopts.

Though many financial analysts concur that the bursting of the housing bubble as well as the 2006/7 subprime mortgage crisis triggered the 2008 economic recession, BAPCPA also played a significant role. It is estimated that the new legislation was responsible for 800,000 and

250,000 additional mortgage and foreclosures respectively in the years preceding the financial crisis (Li, White & Zhu, 2009). Bankruptcy filing and mortgage default may arise from genuine insolvency, but this document is more concerned with strategic defaults and filings. That is, situations in which such filings leave the defaulters better off. The loopholes in the bankruptcy and other micro-economic

Proposed ethical reforms

The connection between bankruptcy legislation and strategic bankruptcy filing has been established in the preceding discussions. Bankruptcy legislation affects the magnitude of both bankruptcies and foreclosures. In retrospect, changing bankruptcy laws would reverse unethical bankruptcy filing. Since foreclosures leads to high external costs as witnessed in the 2008 economic downturn, changes in bankruptcy laws should take into account implications on foreclosures. Also to be considered is the complementary relationship between mortgage default, bankruptcy and foreclosures.

This document, therefore, proposes a paradigm shift in the bankruptcy policy from pro-creditor to pro-debtor axis so as to mitigate the rise in the number of foreclosures. But since debtor-friendly bankruptcy policies are open to opportunistic abuse, harsher repercussions for default and increased repayment requirements would reduce the number of bankruptcies. In view of the default-bankruptcy-foreclosure nexus, it is prudent to institute debtor-friendly policies for honest beneficiaries which are forfeited and replaced with stiffer penalties in the event of abuse.

Another measure that would fortify corporate ethics in matters of bankruptcy is by protecting corporate income from garnishment in the event of default. Income and asset protection will militate against filing for bankruptcy.

In cases of mortgages, the best intervention is to lower mortgage payments in order to forestall foreclosure. As the law stands now, the lenders have the final say on the rate of mortgages since they can veto any request for lower payments. The federal government should intervene in order to reduce the social cost of foreclosures.

As had been mentioned earlier, some of the external players in bankruptcy policies are the judges and lawyers. To this end, bankruptcy lawyers and judges should be authorized to modify mortgage terms. The current U.S. law does not allow judges to change mortgage terms. If this was reversed, then a reduction in foreclosures would be recorded.

Conclusion

Bankruptcies policies in the U.S. have either have favored either debtors or creditors. And in either case incidence of opportunistic abuse have always followed. While creditors have traditionally favored bankruptcy laws that over-restrict debtors from filing for bankruptcy, bankruptcy advocates have pressed for debtor-friendly policies. The political class has typically made bankruptcy provisions that largely react to the prevailing economic environment. This has resulted into pro-creditor policies have notably encouraged risky investment or pro-debtor policies have resulted into abusive strategic bankruptcy filing. The current bankruptcy legislation (BAPCPA) is largely pro-creditor though some of provisions protecting honest debtors. The new law failed to stem default and bankruptcy filings in the run up to the Great recession of 2008. The defaults led to foreclosures which was a significant feature of the financial crisis at the time.

This paper has suggested middle ground bankruptcy policies that neither exclusively favors creditors or debtors. In cognizing the fact that neither bankruptcy which stems from pro-debtor policies nor foreclosures which largely benefit creditors are good for the American economy, policies that discourage both are required. These policies will not only fortify corporate ethics, but they will also ameliorate adverse financial losses accruing from abuse of bankruptcy filing, and external and social costs of foreclosures in the event of default.

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