Insolvency and its Consequences: A Historical Perspective[1]

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Religion and default

The individual duty to repay one's debts is reflected in the beliefs associated with many religions. On the one hand, creditors are sometimes urged to be lenient. For example, the Jewish Bible provides for forgiveness for debts owed by poor Jews every seven years (Lev 25:35-43, Deut 15:1-2). The New Testament exhorts Christian creditors to forgive debtors who cannot pay (Mt 18:23-35). The Koran likewise asks of creditors that they extend repayment, or even forgive debts, when their debtors are facing dire circumstances (Qur'an II:280; see, e.g., Seniawski 2001). On the other hand, in many sets of religious beliefs the debtor's duty to repay is reinforced by the threat of dire consequences in this world or the next. Early Hindu law, for instance, permitted the killing of a defaulter and the enslavement of his wife (Kilpi 1998). For Hindus, defaulting is also a transgression and failed debtors' prospects in the next life are dim (Chatterjee 1971). In Judaism, despite a stipulation that poor people's debts be periodically forgiven, the moral obligation to repay one's debt remains (Efrat 1998). Christians have the same obligation (Rom 13:7). In Islam, "all agreements must be observed, since God is a witness to any contract entered by individuals" (Efrat 1998; see Qur'an II:282).

Introduction

This paper presents a history of penalties imposed on individuals when they default on their loans. It shows that harsh monetary and non-pecuniary penalties are not mere relics from a bygone era and, at the same time, that debt release and limited liability are far from recent institutions. The paper collects salient facts about the consequences of financial default from Babylonian to modern times. This approach allows the reader to contrast the evolution of penalties over time with the seemingly lesser variation across countries or nations in a given era, and to discuss topics such as monetary vs. non-monetary penalties, liability limits, the reputational costs of default, and debt renegotiation. The first part of the paper focuses on the duty to repay and the incentives to do so. The subsequent section focuses on relief for non-commercial debtors and the final section offers a few conclusions.

A history of the duty to repay

Paying off one's debts is typically viewed as a moral or religious obligation. However, when religious edicts and customs are not the only set of formal rules governing people's lives, or when incentives associated with the afterlife and the social stigma associated with default are not sufficient to elicit proper behaviour, secular legal rules must fill the gaps.

In some cases, the legislator gives contracting parties strong incentives to fulfil their obligations. An extreme example is early Roman law: the third of the Twelve Tables (ca. 451 BC) let private creditors seize their debtors unless they made a settlement and, after a sixty-day grace period, put them to death or sell them into slavery "across the Tiber," i.e., abroad. In many other ancient societies, penalties allowed by the legal system were also drastic: while the failed debtor may not always have had to fear death, he still faced involuntary servitude. In Babylonian times, for instance, loans were guaranteed by the person of the debtor or one of his kin (Johns 1910). A similar principle is found in traditional Chinese society.[4] The Jewish law in Moses' time, like its Mesopotamian forebears, allowed for debt bondage. In pre-Solonian Athens, likewise, failure to pay off private debts that had been secured on a free person led to the loss of both freedom and the right to the fruits

[1] We thank B. Demonty, D. Demougin, A. Duru, P.-A. Michel, S. Pallage, D. Reeb, M. Vanwijck, and participants into seminars at the Max Planck Institute of Economics (Jena) and American University, and brownbags at the Norwegian School of Management (Oslo) and the Copenhagen Business School for useful comments and suggestions on an early draft.

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[4] The legal tradition and ethical concept of „father's debt to be paid by the sons" prevailed in China until reforms under the Qing dynasty at the beginning of the twentieth century (Zhou 1995).

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of one's labor (Kilpi 1998). Even in early Roman practice, the defaulted debtor was often made to work for his creditor until the fruits of his labour had repaid the debt (Vigneron 1998).

The Middle Ages and the Renaissance of Europe saw alternatives to debt bondage. In Venice, for instance, a law enacted in 1195 gave creditors the right to seize not just the debtor's person, but his assets as well as one third of his future income, until all claims were satisfied (Besta and Predelli 1901). Still, in most places, creditors' right to seize their debtors remained. The purpose of this right, however, had changed: seizure did not typically result in bondage to the lender any longer. Instead, it was now principally a prelude to recalcitrant debtors' sojourn in another institution that had become prevalent: the debtors' prison.[5]

A key distinction between bondage and debtors' prison is that remanding a debtor to prison provides no utility to the creditor *per se*.[6] Instead, imprisonment acts principally as a way of prompting payment.[7] By contrast, forced servitude can be viewed not only as a punishment for perceived misconduct but, in addition, as a means of compensating the creditor.

Debt relief and personal bankruptcy

A worldwide consensus now appears to exist to make the most ruthless methods of forcing compliance with the terms of loan contracts illegal. Virtually all countries have committed to various charters and conventions of the United Nations (UN) stating that failed debtors should not be imprisoned or put to death.[8] By contrast, it is only

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[5] Instances of debt bondage could still be found. As late as the seventeenth and the eighteenth centuries, a large fraction of white settlers in Britain's American colonies came as indentured servants or bondsmen - see Smith (1947); Christianson et al. (1996); Grubb (2003). In 1795, a New Jersey act - purporting to provide relief to insolvent debtors - mandated that the latter not be released from jail unless they were willing to "make satisfaction of [their] debts by servitude for up to seven years." That provision was not repealed until 1819.

[6] In England, incarceration could even be costly for the creditor, as he was responsible for the provision of "bread and water" to his jailed debtor. In practice, though, this obligation was consistently ignored (Babington 1971).

[7] The general squalor found in prisons at the time was a strong additional incentive to avoid or get out of jail (Babington 1971; Mann 2003; Pugh 1968). In cases where these threats were deemed insufficient, some lawmakers used even harsher non-monetary punishments. In the US state of Pennsylvania, for example, a 1785 law mandated public flogging and the cutting of an ear for deadbeats (Pomykala 1997).

[8] The UN's 1948 Human Rights Charter prohibits slavery. Its Convention Concerning the Abolition of Forced Labor makes debt bondage illegal: out of 191 member countries, 174 have ratified it since 1957. Moreover, 168 countries have ratified the UN's 1966 International Covenant on Civil and Political Rights, whose eleventh article prohibits imprisonment merely on the ground of a person's inability to fulfil a contractual obligation.

Debtors' Prisons

London's Fleet Prison, one of the oldest English jails, was a bogy for the English Crown's debtors as early as the middle of the thirteenth century (Pugh 1968). As of 1352, it also held reluctant or unfortunate private debtors. Seizure could take place as soon as the debtor defaulted and release was typically conditional upon settlement of the debt (Brown 1996). In France, the *contrainte par corps* or *prison pour dettes* was turned into a general means to coerce payment by the *Ordonnance* of Moulins in 1673 (t'Kint 1991). Comparable methods were in use throughout Europe by that time. For example, Antwerp lenders to Elizabeth I in the mid-sixteenth century would have been entitled to seize, in the event that she had defaulted, not only the goods, but also the persons of the English merchants who had guaranteed the loans contracted by their queen (Outhwaite 1968; Kohn 1999). In the seventeenth and eighteenth centuries, debtors' prisons flourished. The gaols of Italian states and cities, such as the Malapaga *carcere* in Genoa, detained *debitori insolventi* throughout that period. In 1716, over one percent of the population of England and Wales was in prison for debt (Babington 1971). The institution's reach there was wide-ranging: a list of the Fleet Prison's pensioners at the time would have included not only the perennially downtrodden, but also the fallen mighty (Muldrew 1993). Famous inmates of the Fleet include the founder of the colony of Pennsylvania William Penn in 1708 (Peare 1956) and Lord Nelson's mistress Lady Emma Hamilton in 1812 (Sinoué 2002). British colonies in the Americas, and later the newly independent United States, imitated and sometimes outdid the example set by the home country (Christianson 1996). In the young United States after Independence, debtors' prison even hosted a signee of the constitution, as well as a former delegate to the Continental Congress (US Congress 1999). Debtors' prisons remained a pillar of financial relationships in many countries well into the nineteenth century. London's Fleet was not closed until 1842 and Genoa's Malapaga, did not shut down until 1850. Further confirmation that the practice was still an integral part of life at the time can be found in the literary works of Balzac and Dickens, which are peppered with references to individuals jailed for their unpaid debts. By the mid-1800s, pressures built up to contain the excesses of debtors' prisons and eventually led to their demise in most countries. US states banned them during the depression that followed the Panic of 1837 (Pomykala 1997). England and Wales abolished debtors' prison for private debts in 1869 (Tabb 1995). In states soon to become part of the German Empire, *leibliche Schuldhaftung* was taken off the books in 1868 (Erler, Kaufmann and Stammler 1971). France followed suit in 1871 and Italy, in 1876 (di Martino 2005). This widespread use of debtors' prisons until rather recently illustrates that threatening harsh penalties to coerce the payment of private debts was not solely the purview of ancient legal systems.

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in the last three decades that some convergence has taken place on how long-lasting the legal consequences of default should be.

Historically, most legislators have recognized inherent differences between commercial loans, meant to finance trade or risky investments, and consumer loans. Whereas in many countries there was until recently no way out of debt for delinquent non-commercial borrowers, commercial borrowers have often been treated more leniently.[9]

Legislators have also had to struggle with whether, and how, credit and bankruptcy laws should differentiate between "responsible" borrowers (those viewed as the victims of bad luck) and "culpable" bankrupts (those viewed as recklessly overextended, deficient in their efforts to repay, or plain dishonest). In ancient Babylon, while the Code of Hammurabi (1780 BC) generally called for bondage in case of default, it allowed for debt relief when the inability to pay was due to events beyond the debtor's control.[10] In contrast, the *nexum* contract in republican Rome, whereby the debtor agreed to be seized by the lender in case of default, left no room for ill luck – but was banned in the fourth century BC because of abuses (Vigneron 1998). Roman principles continued to be applied for many centuries in the Byzantine empire under the Justinian code (534 AD). In the Middle Ages of Europe, the Roman view lived on and default was again seen as misdeed, rather than misfortune.[11] Almost all medieval bankruptcy laws applied only to traders; non-traders faced ordinary laws. These laws treated defaulting debtors as quasi-criminals (Tabb 1995). It is only in the eighteenth century that England innovated by rediscovering the possibility of offering some leniency when default could be attributed to ill luck. The 1705 Statutes of Queen Anne instituted the possibility of debt discharge for borrowers whose pre-default behaviour conformed to a list of good-conduct standards (whereas, in theory at least, fraudulent defaulters faced the death penalty).

The idea of debt discharge, however, is much older. The Code of Hammurabi limited debt bondage to three years.[12] Other early examples are the forgiveness of debts owed by poor Jews, mandated every seven years by the Jewish Bible (Lev 25:35-43, Deut 15:1-2), and the Jewish Jubilee (Rosenberg and Weiss 2001).[13] Even in the Middle Ages, at the same time that harsh penalties were being meted out in most locales, the idea of discharge re-emerged in Spain. Specifically, the *Siete Partidas* codification of 1342 limited debt collection to the debtor's assets and prescribed that, once bankruptcy proceedings had ended, old debt could no longer be called (Scheppach 1991).

Nevertheless, until the nineteenth century, insolvency and bankruptcy laws were typically very harsh and only merchants were seen as worthy of any bankruptcy procedure (Tabb 2005). The United States is therefore exceptional in long having had very pro-debtor bankruptcy statutes for all borrowers (White 1996; OECD 1998).

The first US bankruptcy law, introduced in 1800, was lifted straight from contemporary English law. Both applied only to merchants and were creditor-friendly. Debtors could not initiate the bankruptcy proceedings. Since 1898, however, even non-commercial US debtors have been able to file for personal bankruptcy, ask that some or all of their debts be dismissed, see their request granted, and move on with their lives.[14]

An important objective of the debtor-friendliness of these US personal bankruptcy regulations is to avoid distorting the debtor's future economic performance. As the US Supreme Court stressed in an influential ruling (Local Loan Co. v. Hunt 1934), the "bankruptcy discharge gives to the honest but unfortunate debtor (...) a new opportunity in life and a clear field for future effort." Without debt discharge, "from the viewpoint of the wage-earner, there is little difference between not earning at all and earning wholly for a creditor."

[9] For a review of the history of debt default in an entrepreneurial context, see Robe, Steiger and Michel (2006).

[10] See, for example, Article 48: "If anyone owe a debt for a loan, and a storm prostrates the grain, or the harvest fail, or the grain does not grow for lack of water; in that year he need not give his creditor any grain, he washes his debt-tablet in water and pays no rent for this year" (Johns 1910).

[11] In the thirteenth century, sanctions such as banishment or even the death penalty were the norm for defaulting merchants in the Italian cities of Siena and Vercelli (Pontani 2004). The unforgiving legislations that originated in the medieval Italian towns were used in much of Western and Northern Europe. In England, for example, the first bankruptcy laws (1542/43, 1571, 1604 and 1624) codified very harsh penalties for failed borrowers, regardless of their circumstances.

[12] See, for instance, Article 117: "If anyone fail to meet a claim for debt, and sell himself, his wife, his son, and daughter for money or give them away to forced labour: they shall work for three years in the house of the man who bought them, or the proprietor, and in the fourth year they shall be set free" (Johns 1910).

[13] What makes these debt releases unique is that they were economically motivated. Other contemporaneous uses of generalized debt releases were political, often to curry the favour of a constituency at home or to win over parts of the population in recently conquered territories. In such clean slate proclamations, the ruler or the conqueror would decree that "any land sold because of economic distress (be) returned to its original owners, anyone forced into servitude by debts (be) liberated, and back debts (be) cancelled" (Rosenberg and Weiss 2001). In modern times, debt release was again used as a political tool when various US states such as Texas instituted generous homestead exemption laws to attract settlers (Goodman 1993; Hynes, Malani and Posner 2004).

[14] American debtors have enjoyed this right continuously since the US Congress passed the Nelson Act of 1898.

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In sharp contrast, it took till the late 1990s for many more countries to move their legal codes away from viewing bankrupts as offenders and to introduce rules for consumer debt discharge. Many countries used to impose *additional* monetary and non-monetary penalties on failed debtors. The latter could lose retirement benefits (e.g., Belgium), lose the right to vote (e.g., Italy), be banned from managing companies or carrying out entrepreneurial activities (e.g., Australia, France, United Kingdom), or incur civil liability and possible criminal penalties (e.g., Germany). Finally, laws traditionally treat fraudulent debtors more harshly than their merely hapless counterparts. Hence, to the extent that many bankruptcy regimes used to effectively classify most bankruptcies as fraudulent, they were harsher than regimes with a narrower interpretation of fraud.

In the case of consumers, most legal systems used to simply rule out any possibility that they might get their debts discharged. In countries where a discharge was possible, consumers who had filed for bankruptcy had to wait several years for the release to take place (two or three years in the United Kingdom, and up to ten years in Japan, for example, Martin 2005) and typically had to surrender some of their post-bankruptcy earnings to their creditors.

Today, however, the majority of industrialised countries have regulations that offer consumers a way out of debt. In the European Union (EU), default rates have risen considerably amidst the recent financial crisis (Domurath, Comparato and Micklitz 2014). While many governments had regulated debt release procedures for non-merchant debtors introduced in the 1990s, such procedures are missing in countries like Bulgaria, Italy and Poland (Micklitz 2012), for instance.[15] So far, the European Union has failed to provide minimum standards for the release of ordinary people in distress (Niemi 2012). These differences in the level of protection entice insolvency tourism, which, of course, is only open to those with sufficient remaining resources (Hoffmann 2012).

The common idea behind these new bankruptcy or insolvency laws, as well as behind the 2005 US reform, has been to allow debt release, while still encouraging a responsible use of credit by placing significant obstacles before a discharge can be granted. Although the specific prerequisites for a release differ across individual countries, two common tools are the seizure of current assets above a certain threshold and the garnishment of future income for a predetermined period.[16] Debt counselling is often mandatory. Of course, apart from these monetary and non-monetary legal penalties, other costs associated with bankruptcy also remain – such as the harm to the future acquisition of credit and the stigma associated with going bankrupt.

Conclusion

This paper documents historical facts about the consequences of financial default in ancient and modern times. The evidence suggests that, while the most severe penalties (such as debt or slavery) have virtually vanished nowadays, a fresh start is still not granted in many places.

While there remains to this day a substantial amount of cross-sectional variation in the extent to which non-commercial debtors can hope for leniency after defaulting, our analysis suggests that a significant amount of legal convergence has taken place in the last two decades. In the United States, where many academics and policy makers had been questioning the personal bankruptcy law's generosity towards debtors (Wang and White 2000), reforms in 1984, 1994 and 2005 have made it considerably harder for individuals to shed debts. In Europe, harsh insolvency regimes were widely seen as having adverse consequences on local economies (OECD 1998). They have been softened and consumer bankruptcy procedures have been introduced in many countries. Other countries, especially in Asia, have followed suit or are likely to adopt middle-of-the-road systems (Martin 2005).

[15] Denmark started the process in 1984 with Finland, Norway and Sweden following suit between 1992 and 1994 (Niemi-Kiesilainen 1997). In France, the „Loi Neiertz“ came into effect in 1990 (Kilborn 2005). It served as a model for Belgium in 1999 and Luxembourg in 2001 (Kilborn 2006a). In Austria, legislation providing for consumer debt release was enacted in 1994 (Holzhammer 1996). In England, substantial reforms were carried out in 1990 and again in 2004. Germany started allowing for consumer-debt discharge in 1999, with subsequent reform in 2004 and 2014 (Roethe 2012). Similar regulations were introduced in the Netherlands in 1998 (Kilborn 2006b).

[16] The garnishment period varies widely across countries, adjustment and insolvency relief through a discharge of debt after just one year in some cases (e.g. U.K. and France), but often after a debt repayment plan over a period of three to seven years (Ramsay 2012). In Spain only 50 percent of the debt can be discharged (Micklitz 2012). In the United States, (relatively) better-off bankrupts are now barred from a Chapter 7 discharge and must reorganize under the revised Chapter 13, with a repayment period of five years (Jeweler 2005). In particular, the US bankruptcy reform of 2005 has increased the obstacles put before a fresh start (White 2005). While, prior to the reform, it had sometimes been possible for bankrupt individuals to retain property while discharging their debts (White 1998), the 2005 reform removed such possibilities (Li, Tewari and White 2014), further accelerating foreclosure rates during the mortgage crisis in 2008 (Li, White and Zhou 2011; Posner and Zingales 2009).

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