The Enforceability of Security Interests in Consumer Goods

Author(s): Alan Schwartz


Published by: The University of Chicago Press for The Booth School of Business, University of Chicago and The University of Chicago Law School

Stable URL: http://www.jstor.org/stable/725188

Accessed: 03-10-2017 21:49 UTC

REFERENCES

Linked references are available on JSTOR for this article:

You may need to log in to JSTOR to access the linked references.
THE ENFORCEABILITY OF SECURITY INTERESTS IN CONSUMER GOODS*

ALAN SCHWARTZ
University of Southern California Law Center and California Institute of Technology

Consumers who grant security interests to creditors pay lower interest rates in return, but this seemingly innocuous arrangement has recently been regulated extensively. The Uniform Consumer Credit Code authorizes courts not to enforce certain security interests if enforcement would impose "undue hardship" on the consumer.¹ Several states also prohibit creditors who foreclose from later suing for deficiency judgments,² in which they attempt to recover the difference between the unpaid debt and the amount realized on foreclosure. This prohibition reduces the attractiveness of security as a risk reduction device. In addition, proposals have been made to prevent creditors from taking security interests in consumer goods collateral except for purchase money security interests.³

Contracts made between competent and informed persons in competitive markets are presumptively enforceable. This is because such contracts maximize the utility of the parties to them, and commonly social

* This paper was originally given as an Addison Harris lecture at Indiana University Law School (Bloomington). I am grateful for the extraordinary hospitality extended to me by the Indiana Law School and for the useful comments its faculty made on a prior version of the paper. The paper also benefited from comments received at a seminar in contract theory held in the Berkeley Law School and at workshops held at the USC Law Center and the Northwestern University Law School. In addition, Alan Axelrod, Melvin A. Eisenberg, Thomas Jackson, Will T. Jones, Michael Moore, Stephen J. Morse, Margaret Jane Radin, John Schmitz, Matthew Spitzer, James Strnad, and Louis Wilde also made very helpful suggestions. Portions of this paper appear in different form in Alan Schwartz and Robert Scott, Commercial Law: Principles and Policies (1982).

¹ Uniform Consumer Credit Code (UCCC) § 5.116. The section applies to collateral that "is or may be claimed to be exempt from execution on a money judgment under" state law but not to purchase money security interests or automobiles.

² See text at notes 20–24, infra.

³ See, for example, Consumer Credit in the United States, Report of the National Commission on Consumer Finance 27 (1972). A purchase-money security interest is taken by a seller or lender to secure the debt the buyer incurs in making the purchase. Model Uniform Commercial Code (UCC) § 9-107.
utility as well. Also, most nonutilitarian moral schemes accord free and autonomous persons the right to make enforceable contracts. If the general enforceability of contracts is assumed, two types of reasons may justify regulating contracts to give security. First are reasons that follow from the failure of the presuppositions on which the "enforceability assumption" rests. When consumers are incompetent or uninformed, or markets behave noncompetitively, regulation of consumer transactions often is justifiable. Reasons to regulate occasioned by the inapplicability of the enforceability assumption are here called "contract law reasons." As an example of their application in this context, a court could use the unconscionability doctrine to strike down a broad security interest clause that is written in fine print and arcane legal language. When no contract law reasons support nonenforcement, other reasons of fairness or utility could require regulation in particular cases. A second set of reasons arguably justifying the regulation described above thus may derive from the peculiar nature of security interests in consumer goods. Consumers may be unjustifiably disadvantaged by the giving of security in ways that do not disadvantage business debtors. A set of reasons of this second sort is in large part responsible for the regulation for the regulation just described and is the subject of this paper. The reasons in this second set are as follows:

4 See Alan Schwartz, A Reexamination of Nonsubstantive Unconscionability, 63 Va. L.R. 1053 (1977). The caveat respecting social utility follows from the possibility that outsiders to a contract may prefer that it not be made or made in a different form. In this circumstance, enforcing the contract as made reduces the utility of the outsiders; depending on the relevant magnitudes, enforcement could actually diminish social utility. This possibility does seem remote. Also, in consumer contexts the outsiders desiring nonenforcement are likely to occupy social statuses higher than those of the consumer parties. When this is so, nonenforcement increases the utility of the relatively well off at the expense of the relatively worse off, which redistributes wealth in the wrong direction. See id. at 1061-63.


7 See Williams v. Walker-Thomas Furniture Co., 198 A.2d 914 (D.C. App. 1964). This paper uses the term "contract law reasons" to capture the notion that some legal problems are best analyzed from an ex ante or contract law perspective, where the primary concern is whether a set of outcomes—for example, contracts—was generated by a normatively satisfactory process, rather than analyzed from an ex post perspective, where the primary concern is whether a set of outcomes is itself satisfactory, decided largely independently of the process that generated it. In a more concrete sense, "contract law reasons" are those that would be grounds for refusing to enforce according to such standard contract law doctrines as unconscionability. The reasons about to be considered as justifications for the regulation described above fit uneasily, if at all, into standard contract doctrines, which may explain why consumer goods security problems seldom are analyzed in contract law terms. Ultimately, of course, there are only good or bad reasons for regulation.

8 A third possible set of reasons that could justify restricting security has to do with the nature of security generally. Secured debt may sometimes have undesirable distributional
1. Secured creditors are said systematically not to maximize the value obtained on resale of the collateral because these creditors can sue for deficiency judgments. For example, if the unpaid debt on default is $1,500 and the collateral has a fair market value of $1,000, a secured creditor, it is claimed, will sell the collateral for less than $1,000 and sue for a deficiency in excess of $500. The Uniform Commercial Code prohibits this practice and gives debtors a cause of action should it occur. The UCC’s sanctions, however, are said to be inadequate; alternatively, consumers allegedly lack the resources or sophistication to use the Code’s protection. In either case, further regulation, such as banning deficiency judgments, is thought necessary.

2. Repossession “destroys value” because individual debtors commonly value goods in excess of their market prices but repossessing creditors at best resell at these prices. Because repossession imposes greater harms on debtors than it creates gains for creditors, it actually minimizes welfare.

3. Creditors seldom repossess in order to reduce the size of the unpaid debt with the proceeds of the collateral because these proceeds often are trivial. Instead, creditors take security to enable them to coerce payment by threats to repossess. This coercion sometimes causes consumers to pay debts that are neither legally nor morally owing. Such “in terrorem repossessions” use people as means rather than respect them as ends and as such are wrongful.

4. Enforcing broad security interests may violate some inalienable right of debtors to retain the property at issue. An untrammeled power to repossess could enable creditors to deprive persons of goods that may be necessary to their leading full and autonomous lives. Because people have a right to lead such lives, unrestricted security can violate their rights. This property rights theme is more hinted at than developed in the discussions concerning regulation, but it seems an important influence. It apparently explains such statements as that full enforcement of security interests in consumer durables “would cause too great a personal hardship.”

---

9 UCC §§ 9-504, 9-507.
10 These three themes are discussed in an interesting and comprehensive paper, William C. Whitford, A Critique of the Consumer Credit Collection System, 1979 Wis. L. Rev. 1047.
11 Consumer Credit in the United States, supra note 3, at 31. Of the four justifications for regulation listed above, the first, that creditors systematically fail to maximize the proceeds of repossessed collateral, seemingly could be analyzed under the contract law doctrine of good faith; failure to maximize could constitute a violation of the creditor’s duty to act in
This paper argues that these four reasons cannot justify restricting security interests in consumer goods. One way to sustain this argument is to suppose consumers to be perfectly informed of the post-default strategies that creditors may pursue. As an example, if consumers knew that some creditors would not maximize the value of repossessed collateral, and if consumers could conveniently monitor creditor promises to maximize, creditors would have an incentive to make and comply with such promises. The market would create incentives for creditors to compete along this dimension of transaction fairness as well as along the more familiar dimensions of price and quality. Consumers, however, often seem imperfectly informed respecting creditor strategies, and regulators commonly suppose consumers to know little. It thus is useful to ask whether the four reasons just set forth can justify regulating security interests if the only post-default strategy of which consumers are aware is that secured creditors will repossess on default. This paper concludes that these justifications are unpersuasive even given such limited knowledge. Hence, the law applicable to security interests in consumer goods should be drawn only from contract law doctrines.12

The practical importance of this conclusion is that contract theories suggest different forms of regulation from those now used. For example, unconscionability decisions traditionally are made case by case rather than in the form of statutory prohibitions. Alternatively, a legislature might choose to regulate security in the way warranties are often regulated now; that is, it may permit enforcement only of those security interest clauses that are set forth in "clear and conspicuous" language.13 Broad statutory prohibitions, however, such as those banning deficiency judgments, could be justified only by the second set of reasons just sum-

12 This paper assumes rather than determines that consumers are adequately informed respecting the prices and terms that constitute credit contracts. See text at notes 6–8, supra. For a discussion of how the state should make such determinations and respond to the existence of inadequate information, see Alan Schwartz & Louis Wilde, Intervening in Markets on the Basis of Imperfect Information: A Legal and Economic Analysis, 127 U. Pa. L. Rev. 630 (1979); Alan Schwartz & Louis Wilde, Competitive Equilibria in Markets for Heterogeneous Goods under Imperfect Information: A Theoretical Analysis with Policy Implications, 12 Bell J. Econ. 181 (1982).

marized. Because these reasons are unpersuasive, prohibitions of this sort should not be used.

Part I briefly describes the principal legal limitations on the taking of security. Part II shows that creditors have incentives to maximize the proceeds from resale and that the scanty available evidence suggests that they do so. Part III argues that no value is lost through repossession or that value is merely transferred; if either outcome occurs, the "value destruction" case against security falls. Part IV next argues that in terrorem repossessions are less common than is generally supposed and that they are not objectionable when their effect is understood. Finally, Part V argues that the moral theories underlying the objection that security violates persons' property rights may accord people rights to things but cannot sustain present limitations on the power of people to mortgage those things. In consequence of these arguments, this paper concludes that contracts to give security interests in consumer goods pose only the problem that consumer contracts generally pose, which is that the consent of consumers to them sometimes may not be fully free.14

I. THE LAW

Section 9-507(3) of the Uniform Commercial Code provides that "every aspect of the disposition [of collateral by the secured creditor] including the method, manner, time, place and terms must be commercially reasonable." Resale "may be by public [i.e., auction] or private proceedings"; in either case, "reasonable notification" of the sale must be sent to the debtor. The secured party is liable to the debtor for "any loss" caused by a failure to comply with Article 9. Also, if the collateral is consumer goods, the Code imposes a penalty on a creditor who fails to resell in a commercially reasonable manner, independently of whether the consumer debtor suffered loss: the noncomplying creditor is liable for "the credit service charge plus ten percent of the principal amount of the debt . . . plus ten percent of the cash price."15

These Article 9 rules respond only to one of the grounds that could justify regulation of security interests in consumer goods, that creditors systematically fail to maximize the collateral's value. The rules, however,

---

14 Much of the argument made below also applies to state statutes that permit creditors to execute on property after a judgment of default is rendered. Indeed, execution laws may be thought of as state-supplied security terms. This paper focuses on consensual security interests because much regulatory attention has been devoted to them; readers can make the obvious connections to execution laws. Those laws, however, regulate repossession sales differently than does the Code and thus deserve independent study.

15 UCC § 9-507(1).
may be thought not to create sufficient incentives for creditors to maximize. This is partly because § 9-507(2) provides that a sale cannot be found unreasonable just because "a better price could have been obtained by a sale at a different time or in a different method"; rather, the price obtained is only one of the factors relevant to ascertaining reasonableness. This latitude could make it difficult for a debtor to prove that his creditor actually made a nonmaximizing resale. In addition, many consumers may lack the resources and sophistication to police compliance with Article 9.

Largely in consequence of these felt difficulties, courts have insisted on strict compliance with Article 9 procedures, in particular the notice-of-resale requirement, and have created their own sanctions to deter creditor misbehavior. The principal sanctions are: (a) in some states, to deny a deficiency judgment to a creditor who fails to comply with the Code,\(^{16}\) and (b) in other states, to impose on the noncomplying creditor the burden of proving that the collateral actually was worth less than the unpaid debt.\(^{17}\) A creditor who cannot show that the collateral was worth less than the unpaid debt has no grounds on which to claim a deficiency. In addition, courts have begun to require creditors to explain large differences between repossession sale prices and the collateral's apparent value, even when a debtor fails to prove the creditor's noncompliance with the statute. A creditor who cannot give a satisfactory explanation is precluded from recovering a deficiency judgment.\(^{18}\)

These judicial additions to Article 9 respond only partially to the concerns that underlie the "failure to maximize" justification for limiting the ability of consumers to grant security. For example, suppose that automobile dealers in a given locality agree to sell repossessed cars to one another at less, but not excessively less, than fair market value; however, when each dealer repossesses he gives his debtor the requisite Article 9 notice and otherwise apparently complies with the statute. Few consumer debtors have the resources to prove that such a cartel exists, yet without such proof the judicial sanctions just set out could not be imposed. Also, Article 9, even as supplemented by the courts, is not at all responsive to the concerns that commercially reasonable resales can destroy value, be used for in terrorem purposes, or violate persons' property rights. Additional regulation of security interests in consumer goods thus seems necessary and exists.

\(^{16}\) For example, Wilmington Trust Co. v. Conner, 28 U.C.C. Rep. 900 (Del. 1980).

\(^{17}\) For example, Mack Financial Corp. v. Scott, 606 P.2d 993 (Idaho 1980).

The Uniform Consumer Credit Code limits sellers to taking purchase-money security interests, which secure the unpaid portion of the sales price.\textsuperscript{19} Also, when this price is $1,750 or less, the creditor is put to an election; if he repossesses, he cannot sue for a deficiency judgment, while if he forgoes repossession to sue on the debt, he cannot attach the goods in which he has a security interest.\textsuperscript{20} Finally, the UCCC authorizes courts to prevent enforcement of a security interest that a lender takes in household goods if nonenforcement "is necessary to avoid undue hardship for the consumer or a member of a family . . . supported by him."\textsuperscript{21} Several states regulate much as the UCCC does. California bans deficiencies in sales-finance transactions for automobiles;\textsuperscript{22} Washington bans deficiencies in all sales-finance transactions but not for loans;\textsuperscript{23} and a variety of states ban deficiencies in sales transactions when the sales price is below a specified amount.\textsuperscript{24} In addition, the Federal Trade Commission recently developed a proposed Trade Regulation Rule that would prevent creditors from taking security in household goods, except purchase money security.\textsuperscript{25} This Rule also would ban deficiency judgments in connection with purchase money security unless "the debtor is credited with the fair market retail value of the collateral as determined by a sale in an established retail market."\textsuperscript{26}

These rules respond in different ways to the four justifications for regulation set forth above. Banning security is responsive to all of them. Banning deficiency judgments responds to the first justification, that creditors fail to maximize the proceeds obtained on foreclosure, because it limits creditors to these proceeds and thus creates a strong incentive for creditors to maximize them. The proposed Federal Trade Commission Rule also responds to the failure to maximize justification. This is because

\textsuperscript{19} UCCC § 3.301.
\textsuperscript{20} UCCC § 5.103.
\textsuperscript{21} UCCC § 5.116.
\textsuperscript{22} West's Ann. Calif. Civil Code § 1812.5.
\textsuperscript{24} See Ala. Code § 5-19-13 (sales price $1,000 or less); Ariz. Rev. Stat. Ann. § 44-5501 ($1,000); Colo. Rev. Stat. § 5-5-103 ($2,000); Idaho Code § 28-35-103 ($2,800); Ind. Code Ann. § 24-4,5-5-103 ($2,200); Okla. Stat. Ann. tit. 14A, § 103 ($2,000); Utah Code Ann. § 70B-5-103 ($2,800); Wyo. Stat. § 40-14-503 ($1,000). In addition, six states ban deficiency actions in connection with sales or loans when the unpaid balance at the time of default is less than a specified amount. See Mass. Gen. Laws Ann. ch. 255D; § 22(d) (unpaid balance $1,000); Me. Rev. Stat. Ann. tit. 9A, § 5-103 ($2,200); Kan. Stat. Ann. § 16a-5-103 ($1,000); Ore. Rev. Stat. § 83.830, 83.840 ($1,250); W. Va. Code § 46A-2-119 ($1,000); Wis. Stat. Ann. § 425.209 ($1,000).
\textsuperscript{25} Proposed Trade Regulation Rule "Credit Practices," 16 C.F.R. 444.2(a)(4).
\textsuperscript{26} Id. at 444.2(a)(7).
fair market retail value is the most the collateral could yield; requiring creditors to reduce the outstanding debt by this value creates an incentive for creditors actually to obtain it. The ban on deficiency judgments also discourages the taking of security when the collateral is worth little in relation to the debt. It is in this case that the latter three justifications seem most compelling, as I will show below.27

Article 9 of the UCC apparently responds intelligently to the occasional cases of creditors' venality or sloth that will inevitably arise. The judicial additions to it and the recent statutory and administrative regulation just described presuppose the validity of one or more of the four justifications for regulation listed above. It is to these justifications that attention must be paid.

II. CREDITORS DO NOT FAIL TO MAXIMIZE

Many items are repossessed and resold each year. Because persons sometimes are careless or lazy, some of these items would be sold at less than their best price even if creditors sought to maximize resale proceeds. This fact cannot support the legal reforms just described because any system is subject to occasional human errors. Supporters of these reforms thus must make the stronger claim either that factors systematically prevent secured creditors from maximizing resale proceeds or that secured creditors have incentives not to maximize. No systematic factors have been identified that could prevent creditors from maximizing. Perhaps because of this, reformers claim that creditors have no incentive to maximize and that the evidence indicates that nonmaximizing resales are common.

Part II shows that it would be irrational of secured creditors wishing to maximize profits to fail to maximize resale proceeds, so long as each creditor does not act in concert with other creditors. A failure to maximize is a profitable strategy for creditors only if creditors form cartels. Part II goes on to argue that creditor cartels to depress the resale prices of

27 These justifications also support related regulation. As an example, §§ 5.110 and 5.111 of the UCCC accord consumers a right to cure defaults: if a consumer is in default for ten days for failure to make a payment, the creditor is required to send a notice of default; the consumer then has twenty days to cure the default. The creditor cannot foreclose during the requisite thirty-day period. Comment 3 to § 5.110 explains that the right to cure is meant to prevent excessively prompt repossessions. This seemingly suggests that creditors do better by repossessing, selling the goods for less than their market value and suing for a deficiency. The first and most well known claim for this view is Philip Shuchman, Profit on Default: An Archival Study of Automobile Repossession and Resale, 22 Stan. L. Rev. 20 (1969). The right to cure also is justified, in the comment, as preserving the consumer’s ability to present defenses before foreclosure, which is a major theme underlying the distaste for in terrorem repossessions. See text at notes 59–60, infra.
collateral are unlikely to exist. Before reaching the arguments underlying these conclusions, it is worth stressing what claim actually is to be made below and the "deeper" assumptions on which this claim rests. The claim is that profit-maximizing creditors have incentives to maximize resale proceeds and to eschew cartels. It rests on two deeper assumptions, neither of which is defended here: that creditors act as if they attempt to maximize profits and that by and large people act effectively in pursuit of their goals, which means here that creditors will maximize resale proceeds if maximizing is their most profitable strategy.

A. Creditor Incentives

The Federal Trade Commission Staff Report on the Proposed Trade Regulation Rule described above concisely summarized the claim that creditors systematically fail to maximize:

The creditor does not necessarily have an incentive to obtain the highest possible price for the collateral. There are a number of reasons for this, including [1] the fact that Article 9 of the UCC which requires that any surplus be repaid to the consumer imposes a ceiling on the return available to a creditor in a repossession sale. [2] At the same time, the fact that a deficiencies [sic] can be collected from consumers in many cases tends to mitigate any necessity of maximizing the repossession sales price. [3] Moreover, any loss to a creditor in the form of an uncollected deficiency is mitigated by immediate tax benefits which tend to reduce the amount of the actual loss by 50 percent.28

The report explained, in connection with the second reason given: "In the area of high priced collateral, creditors will invest in a repossession sales effort only to a point where the net return from the repossession sale equals the net return from resources invested in the collection of deficiencies. Thus, where the right to collect deficiencies exists, a lesser sales effort is a reasonable expectation."29 Respecting the first of these reasons, creditors do lack an incentive to maximize the surplus—the excess of the collateral's resale price over the unpaid debt—because the surplus accrues to debtors. The perceived problem that prompted the legal reforms described above, however, was not that resales generated insufficient surpluses; a surplus is rare when consumer goods are resold. Decision makers were instead concerned with the possibility that non-maximizing resales increased the deficiencies that consumers had to pay. Moreover, if creditors maximize the proceeds received from resold collat-


29 Id. at 289.
eral when its value equals or is less than the outstanding debt, the problem of insufficient surpluses should vanish. This is because creditors commonly set up systems whereby repossessed collateral is sold. If these systems are designed to maximize resale proceeds, because the collateral commonly is worth less than the unpaid debt, the occasional surplus will also be maximized, for creditors have no reason to identify resales likely to generate surpluses and then vary the standard routine only for the purpose of reducing them. Thus, if standard practice is to maximize, surpluses also should be maximized.

When the collateral will bring less than the unpaid debt, standard practice allegedly is not to maximize because of the availability of deficiency judgments, the second reason the FTC staff gave, but this reason is false. If secured creditors maximize profits and do not act in concert with other creditors, each creditor must do worse by not maximizing resale value than by maximizing it.

To see why, suppose first that (1) creditors bear their own litigation costs; (2) these costs vary directly with the sums at issue; (3) debtors bear their creditors' resale costs; (4) debtors always can pay judgments entered against them; (5) creditors value dollars obtained through litigation equally with dollars obtained through resale, even though "litigation dollars" are obtained some time after resale dollars. In these circumstances, a creditor has an incentive to sell the collateral for as much as possible and to sue for as little as possible. This is because resale costs are free to him, while litigation costs are not free and rise with the amounts for which he sues. Respecting the first three of these assumptions, § 9-504 of the UCC authorizes creditors to charge debtors with resale costs, and in the United States parties commonly bear their own litigation costs. These costs probably do rise with the amounts at issue since large claims are likely to be more seriously contested than small ones and courts are more likely to demand convincing proof of the validity of large claims. Hence, creditors have an incentive to maximize resale revenues, which can only be done by reselling the collateral at the market price.

It may be objected that creditors often shift their litigation costs to defaulting debtors by contract. This objection must fall because the conclusion that creditors have an incentive to maximize resale proceeds obtains even if assumption 1 is false, when assumptions 4 and 5 also are false. To see that these assumptions are both false and germane, one should realize that secured creditors actually attempt to recover unpaid debts in two stages. At the first stage the creditor repossesses and resells the collateral; at the second stage he sues for a deficiency. The first stage recovery is certain, in the sense that the creditor always can resell at the market price, and is relatively prompt because the creditor can resell soon
after default. The second stage recovery is subject to risk because the debtor may be or become insolvent, in which case the creditor will recover only a fraction of the debt; the second stage recovery is also delayed, for even uncontested lawsuits take time, and the legal rate of interest allowed on judgments commonly is lower than the rate the creditor could earn on the same sum. Because the stage 1 recovery is certain and prompt while the stage 2 recovery is risky and delayed, the creditor has an incentive to make the former recovery as large as possible and the latter as small as possible. This incentive exists even if the sales contract shifts the creditor's litigation costs to the debtor. The largest recovery possible at stage 1 equals the collateral's market value; therefore, the creditor has an incentive to recover this amount—to maximize the proceeds of resale.

This conclusion also obtains independent of the costs of recovering a debt by resale as contrasted with the costs of recovering a debt by legal action. Although the creditor has a right to recover resale costs in the deficiency suit, it would be unlawful and unwise of the creditor to resell when resale costs exceed resale proceeds. When resale costs are less than resale proceeds, the creditor's incentive is to maximize the difference between these values, for it actually is this sum that is obtainable without risk or delay. The difference between resale gains and costs is maximized at the highest price the collateral can command, its value in the market. Perhaps a more concise way of putting this is that every dollar the creditor nets by resale reduces the outstanding debt by a dollar; every dollar the creditor defers to the deficiency action to collect will reduce the outstanding debt by less than a dollar because the expected value of a litigation dollar is less than one, these dollars being subject to risk and delay. Thus the creditor's incentive is to maximize the net gain from resale.

An example may illuminate this analysis. Suppose that a bank takes a security interest in a new car, the debtor makes several payments and defaults, and the bank repossesses. Then, (i) the unpaid debt \(D\) is $5,000; (ii) the value a maximizing resale \(M\) would bring is $3,000; (iii) the value of a nonmaximizing resale \(N\) is $1,500; (iv) the probability \(p\),

\[\text{UCC § 9-504(3) requires resales to be conducted in a "commercially reasonable" manner. This section would bar a creditor from suing for the excess of resale costs over gains. This is because the creditor would resell when the costs exceed the gains only to impose a penalty on the debtor in the amount of the difference, and penalties have been held to be inappropriate sanctions for contract breaches; hence it is "unreasonable" of creditors to exact them. Creditors are said sometimes to repossess when resale costs exceed resale gains in order to establish a credible threat that will induce other debtors to pay, see text at notes 59–60, infra; they would not resell in this event, however, because they could not recover the resultant loss.} \]
as observed by the creditor, that the defaulting debtor will become (or is) insolvent is .2; (v) the bankruptcy discount \( b \) is $0.12, in that the creditor would collect $0.12 on the dollar if the debtor actually became insolvent and entered bankruptcy proceedings;\(^\text{31}\) (vi) the creditor can collect a deficiency judgment no sooner than three months after resale of the collateral and can collect in insolvency proceedings no sooner than six months after resale; (vii) the creditor's discount rate \( r \) is 10 percent; (viii) for simplicity, fixed costs are zero and marginal collection costs per dollar collected by resale are constant at \( c \), while marginal collection costs per dollar collected by a deficiency action are constant at \( c' \); (ix) \( c = c' = $0.20 \) per dollar; and (x) the debt remaining after a maximizing resale is \( D - M = A \); the debt remaining after a nonmaximizing resale is \( D - N = B \), where \( B > A \).

Suppose first that the creditor considers making a maximizing resale. At stage 1, he could recover \( M - cM = $2,400 \). The expected value of his stage 2 recovery is

\[
(1 - p)\left( (A + cM) - c'(A + cM) \right) \left( \frac{1}{1 + \frac{r}{4}} \right) = $1,624.06
\]

and

\[
p(b)\left( (A + cM) - c'(A + cM) \right) \left( \frac{1}{1 + \frac{r}{2}} \right) = $47.52.
\]

Hence, the expected value of maximizing resale proceeds and then suing for a deficiency is $4,071.58. Using the same formula but substituting \( N \) for \( M \) and \( B \) for \( A \), the expected value of not maximizing and then suing is...

\(^{31}\) The $0.12 figure is a rough approximation. A well-known early study reported that creditors recover approximately $0.08 on the dollar in insolvency proceedings. See Vern Countryman and Andrew Kaufman, Commercial Law 170 (1971). More recent studies show that in 1977 creditors received no money at all in 81 percent of bankruptcy cases. In cases in which assets were distributed, general creditors received 27 percent of the $229 million available for distribution—$61 million—but more than $1.1 billion of claims were discharged. A creditor suing for a deficiency is a general creditor and is unlikely to do as well as $0.12 on the dollar if the debtor does go bankrupt. See V. Countryman, A. Kaufman, & Z. Wiseman, Commercial Law Cases and Materials 250 (1982). On the other hand, some deficiencies may be collected without bankruptcies. Recovery percentages reported by major creditors to the FTC ranged from 6 to 25 percent of deficiencies outstanding, but the figures were ambiguous in some cases. See Martin White, Consumer Repossessions and Deficiencies: New Perspectives from New Data, 62 B. U. L. Rev. 385 (1982). The text's conclusions, as the App. below shows, are not sensitive to the precise portion of the debt that creditors can recover in deficiency actions.
$3,643.09. In this illustration, the costs of recovering a dollar of debt were assumed not to vary with the collection method used \((c = c')\). Suppose instead that \(c = 16c'\), where \(c = $0.80\) per dollar collected by resale and \(c' = $0.05\) per dollar collected by suit for a deficiency. Then, using the values set out above, the expected value of making a maximizing resale and then suing is $3,959.24, while the expected value of making a non-maximizing resale and then suing is $3,888.29. The principal illustration also supposed the creditor to bear his own litigation costs. Let the debtor bear these costs and again let \(c = 16c'\). Then the expected value of a maximizing resale ($4,131.02) is $56.67 greater than the expected value of a nonmaximizing resale ($4,074.35). A proof in the Appendix generalizes all of these examples; it shows that maximizing resale proceeds is always the dominant creditor strategy.32

The examples also illustrate the error of the third reason the FTC staff gave to explain why creditors would not maximize, that a creditor’s concern over an unpaid deficiency judgment is mitigated by his ability to deduct bad debt losses. In the principal example above, the expected after-tax loss to the creditor who maximizes the proceeds of resale, supposing a marginal corporate tax rate of 44 percent, is $519.92. (An unpaid debt of $5,000 less $4,071.58, the expected value of collection, leaves an expected tax deduction of $928.42, which with a 44 percent marginal corporate tax rate imposes on the creditor an after-tax loss of \(.56 \times \) the deduction.) The expected after-tax loss to the creditor who does not maximize is higher—$799.87, a difference of $239.95. This result is not surprising because the effect of the tax is to enable a corporate creditor to keep $0.56 of every dollar it earns and to benefit by $0.56 from every dollar it deducts, supposing it to have income. Thus the creditor cannot gain by forgoing income, which loses it $0.56 per dollar, in order to increase deductions, for these gain it only $0.56 per dollar. A creditor therefore will regard the availability of tax deductions as irrelevant to the decision whether to maximize or not.33

32 See App., infra.
33 Creditors may be thought to have an incentive not to maximize resale proceeds in order to impose a penalty on defaulting debtors; the penalty would be the difference between the collateral’s fair market value and the lower resale price the creditor actually obtains. This penalty would be imposed to deter defaults. See Sec. IV, infra, discussing in terrorem repossessions. For such a penalty to be effective, debtors would have to know both that creditors will fail to maximize and the consequences to debtors of this failure. If debtors were informed about possible creditor post-default strategies when they initially bought credit, however, they could cause creditors to face the choice of abandoning unfair strategies or losing business. This paper plausibly assumes a lower level of debtor knowledge. See text at note 12, supra. A consequence of this assumption is to render ineffective a creditor strategy of not maximizing in order to penalize and thereby deter defaults. Also, creditors should be reluctant to make explicit the intention not to maximize, for this would be to admit openly to an illegal practice.
B. Wholesale Sales

Financial creditors such as banks and sales finance companies frequently sell repossessed collateral in wholesale rather than retail markets. Because retail sales generate higher returns, the practice of wholesaling repossessions is thought to disadvantage consumers. Moreover, the practice of some creditors to make wholesale sales when retail markets are available is considered to support the claim that creditors systematically fail to maximize resale proceeds. In consequence of these views, proposals have been made to require or encourage retail sales in all cases. An example of such a proposal is the FTC's suggested rule that would permit wholesale sales but require financers to credit consumers with the amount that actual good faith retail sales would bring. The Commission staff apparently thought their rule would work in the following way: Let a bank repossess a car on which $8,000 is owed and sell the car to a dealer for $4,000. The dealer retails the car for $6,000. Under the proposed rule, the bank must credit the debtor with the amount that the retail sale brought—$6,000—and thus could sue only for a $2,000 deficiency. Since the bank would then incur a $2,000 loss, banks are likely to sell at retail if the rule is passed. Whether they do or not, consumers will benefit because they will be liable for lower deficiencies.

The examples in Section IIA above showed that creditors always do better by maximizing resale proceeds. Consumers do better as well, because a maximizing resale reduces the deficiency that the debtor owes. In the example just used, however, a bank chose to resell at wholesale, recovering $4,000, rather than to obtain $6,000 by selling at retail. This example does not refute the analysis above when resale costs are considered. Section IIB next shows, through a more careful analysis of this example, that a profit-maximizing financer probably would want to wholesale his repossessions.

It is best to begin by focusing on the difference between the wholesale

34 For claims in this regard, see, for example, Credit Practices, supra note 28, at 275–87, 317–18; Comment, Defaulting Debtors and the Judicial Process—the FTC’s Proposed Restriction on Deficiency Judgments: section 444.2(a)(7) of the Rule on Credit Practices, 8 Conn. L. Rev. 457 (1976); Note, I Can Get It for You Wholesale: The Lingering Problem of Automobile Deficiency Judgments, 27 Stan. L. Rev. 1081 (1975).

35 See text at note 26, supra. White, supra note 31, proposes that the retail price should be presumptive evidence of the maximizing price; creditors could rebut the presumption “by establishing suitable facts concerning the condition of the repossessed vehicle or unique market circumstances.” Id. at 414 (footnote omitted). Two states have adopted limited versions of the rule requiring firms to credit consumers with the retail price. Florida Statutes Annotated § 516.31(3) (applies only to licensed small loan companies); Connecticut Gen. Stat. § 42-98(g) (retail value is an important element in determining the “fair market value” that firms must credit against deficiencies).
and retail prices—the $2,000 premium in the illustration above. This premium has two elements: the cost of putting a repossessed car in shape for resale and a payment to the retail dealer, including the dealer’s profit, for the service of running a retail business. Because the dealer cannot conduct his business unless he is able to buy at wholesale, a portion of the $4,000 deficiency judgment that current law allows the bank to recover actually supports the retail facility.

If the bank, in this illustration, had instead retailed its repossessions, debtors would be liable for a deficiency that would amount to at least $4,000. This is because the bank would need a retail facility. Suppose that the bank had the same retail costs as the dealer and resold for $6,000; it would then be able to sue for a $4,000 deficiency under the Code, calculated as follows: deficiency = unpaid debt ($8,000) – proceeds of resale ($6,000) + costs of resale ($2,000) = $4,000. To deny the bank the $2,000 in resale costs would be to require it to provide a retail facility for free.36 Thus, if banks and dealers could retail cars at equal cost, both banks and consumers would be indifferent to whether banks wholesaled or retailed; either method would generate the same deficiency.

Dealers, however, commonly can retail repossessed cars at less cost than banks or finance companies because financers have expertise in the lending business but not in the used goods business, while dealers commonly have the reverse competencies.37 When the financer’s cost disadvantage is considered, the error of encouraging financers to become retailers becomes apparent. Suppose that it would cost the bank in the illustration above $2,200 to retail the car rather than the $2,000 it costs the dealer. A retail sale then would net the financer $3,800–$6,000 in proceeds.

36 The FTC, proceeding by adjudication, recently held that an automobile dealer committed an unfair trade practice by charging indirect expenses such as overhead and lost profits to consumers who had defaulted and whose cars were repossessed. It was industry practice to make such charges. On appeal, the Ninth Circuit reversed without reaching the merits, holding that the rule developed by the FTC “will have general application” because “credit practices similar to those of the dealer are widespread in the car dealership industry,” and therefore the FTC had to proceed by rulemaking; it could not create such a widespread rule through adjudication. Ford Motor Co. v. FTC, 654 F.2d 599, 601 (9th Cir. 1981). The justification for allowing retailing banks or dealers to recover profit and overhead is identical to the justification for allowing sellers to recover these items under § 2-708(2) of the UCC. Creditors invest resources in creating facilities to retail used goods; if they cannot recover the resultant capital costs and fixed costs (profit and overhead), they will not be put in the position they would have been had debtors performed.

37 Many creditors testified before the FTC that they made wholesale sales because they preferred to lend money rather than sell cars. See Credit Practices, supra note 28, at 289–90. The FTC staff said of this policy that it “reflects the fact that higher returns are available to the creditor when resources are devoted to activities other than U.C.C. sales,” but the staff believed that this application of the principle of comparative advantage injured consumers. Id. at 290–91. The text next shows that this belief is false.
less $2,200 in costs. A wholesale, however, nets $4,000. Thus when financers are less efficient retailers than dealers, which often seems the case, a wholesale sale actually maximizes net resale proceeds. Because this is so, the common practice of financers to make wholesale sales cannot count as evidence in support of the claim that creditors systematically fail to maximize the value of repossessed collateral. In addition, efforts such as those of the FTC’s staff to encourage financers to retail repossessions would disadvantage debtors by increasing the deficiencies for which debtors would be liable. In the illustration above, the deficiency would increase from $4,000 to $4,200 were the FTC rule to apply.

To summarize the argument to this point, secured creditors who wish to maximize profits and who do not act in concert with other creditors always will do better by maximizing the proceeds from resale of the collateral. The common practice of financing creditors to wholesale repossessions does not contradict this conclusion. The failure to maximize justification for law reform therefore must fall unless cartels exist.

C. Cartels

Cartels of two kinds might exist respecting the resale of repossessed goods. First, a group of dealers could agree to bid collusively on repossessed items offered for sale such that each dealer is assured a supply of low-priced goods which can then be resold at retail prices. In this circumstance, the creditor that actually repossessed could be attempting to maximize the resale value of the collateral but be prevented from doing so by the dealer cartel. ‘Collusive bidding cartels’ might exist in connection with public resales, when repossessed items are sold at auction. Second, a group of dealers who carry their own paper or who use recourse financing might agree to resell collateral to each other for less than the collateral’s value. For example, suppose dealer A repossessed a car worth $3,000 when the unpaid debt was $5,000, sold the car to dealer B for $1,500, and sued for a $3,500 deficiency. Section IIA showed that this was a losing strategy. But suppose dealer A knew that dealer B would resell him a repossessed car for $1,500 less than its actual value shortly thereafter. Then dealer A’s expected loss from failing to maximize—$428.49 in the principal example above—is swamped by his expected gain—the large difference between the retail price of the car later to be purchased from dealer B and the low wholesale price that dealer B will exact. Be-

38 In a recourse financing arrangement, the dealer extends purchase money credit to the consumer and sells the consumer’s obligation to a financer, but the dealer is responsible for collecting the debt if the consumer defaults. Thus the dealer commonly repossesses and resells the collateral.
cause any two dealers are unlikely to have precisely matching repossession experiences, a "dealer trading cartel" such as this would need several members, although probably fewer than the collusive bidding cartels described above.39

The gain to participants in both of these cartels comes from being able to buy repossessed goods at artificially depressed wholesale prices and to resell them for full retail value. Because banks and sales finance companies sell repossessed goods but never buy them, these financers have no incentive to join either cartel. Indeed, the financers would oppose collusive bidding cartels because these cartels reduce the returns from repossession sales. And dealer trading cartels would seldom be market-wide because financers can compete with dealers to finance sales. The question is whether either form of cartel could function in these circumstances.

This is an empirical question that cannot be finally answered on the available data. No persuasive evidence of the existence of either form of cartel has been adduced, nor has any been successfully prosecuted. These facts are not conclusive. Successful cartels seldom are revealed by academic inquiry. Also, academic inquiries must use publicly available data, such as profits and price movements. Outsiders cannot easily obtain profit figures for the small, often privately held firms that will constitute any cartel; and actual transaction prices of used goods are difficult to observe.

39 Section 9-504(3) of the UCC requires a creditor to give the debtor notice of a repossession sale, and § 9-506 gives the debtor a right to redeem the collateral by paying the debt in full plus the creditor's expenses. If a creditor proposes to sell the collateral for much less than its value, the debtor, in theory, could refinance on the strength of its actual value and redeem. Thus both versions of the cartel explanation must presuppose the inefficacy of debtor redemption rights. Defaulting debtors seldom do redeem, which is consistent with this presupposition; but they also may fail to redeem because the collateral is routinely resold at the market price. A third way in which creditors could do better by not maximizing would be for them to buy at their own repossession sales. Suppose that a creditor repossesses a car worth $3,000 when the debt was $5,000, "sells" the car to himself for $1,500, and sues for a $3,500 deficiency; the creditor then resells the car for $3,000. This creditor would do better than if he initially had sold the car for $3,000 because, while in both cases he recovers the car's actual value, in the latter case he could claim only a $2,000 deficiency. Creditors sometimes do buy at their own repossession sales, but the evidence fails to show that they claim deficiencies greater than those claimed by creditors who do not. Perhaps this is because courts will scrutinize more carefully sales to oneself and because a debtor could so easily show bad faith in these cases; a comparison of the sale to oneself with the sale to others would generally suffice. In this connection, § 9-507 of the UCC, which creates a statutory penalty for noncompliance with Article 9, seems less toothless than is commonly supposed. As an example, in one case the amount financed on a car was $5,938.67 and the finance charge was $1,363.51. On default, the creditor resold the car without giving the debtor the statutory notice and sued for a deficiency of $1,392.61. The debtor, representing himself, successfully claimed that the failure to give notice invoked the 9-507 penalty; that this penalty amounted to $1,957.37; and that the deficiency claim thus was wiped out. See Garza v. Brazos County Federal Credit Union, 608 S.W.2d 298 (Tex. Civ. App. 1980).
These problems would make hard evidence of the existence of cartels unusual even if the cartels themselves were common. In addition, cartels in connection with the resale of used consumer goods will occur—if at all—in local markets, and state antitrust enforcement is seldom vigorous. Thus little can be inferred from the absence of prosecutions against them. With the record in this state, the best that can be done is to ask whether the industry or firm traits that seemingly correlate with collusive behavior exist when repossessed collateral is resold. If these traits exist in insufficient degree, as is argued below, the burden should shift to proponents of the failure to maximize justification for law reform to prove that creditor cartels are in fact present. This is because, as shown above, without cartels such as those described here this justification must fall. The discussion focuses mainly on used car markets because creditor misbehavior is said to be most prevalent there.40

1. Collusive Bidding Cartels. The likelihood that firms will cartelize an industry varies inversely with the costs to the firms of making and policing collusive arrangements and varies directly with the ability of firms to retain significant gains from cartel behavior. Several more specific factors that seem to correlate positively with the existence of cartels have been derived from these general observations. Firms will incur relatively lower costs in forming and policing cartels when few firms exist because it is easier to make lasting arrangements among few than among many. Also, cartel costs are lower when firms deal in homogeneous goods because then the only variable on which agreement must be secured is the price. Respecting the ability of firms to retain gains from cartel behavior, cartel members have an incentive to steal customers from one another by offering buyers prices below the high cartel price but above the competitive price; if many members act in this way, the cartel will dissolve because firms that adhere to cartel arrangements would have no customers. The opportunities for cheating are lower when all sales are made publicly, so that the terms are observable; when firms have large market shares, so that the expansion of firm output that cheating produces is noticeable; and again when product and sales terms are homogeneous, so that firms cannot grant difficult-to-detect nonpecuniary price reductions such as more extensive warranties. Finally, the ability of firms to retain gains from cartel behavior is higher when entry into the industry is difficult. Were entry easy, outside firms would have a strong incentive to come in and steal cartel customers by undercutting the cartel’s price. The

40 See, for example, “Consumer Credit in the United States,” supra note 3, at 31.
prospect of such entry could reduce the expected gain from cartelizing below the expected cost; in this event, a cartel is unlikely to be formed.\textsuperscript{41}

These factors suggest that effective collusive bidding cartels to depress the prices at which collateral is resold should rarely exist. This is because such cartels would have to contain many members, concern heterogeneous goods, and be sustainable although entry is easy. Respecting the first difficulty, almost all dealers in a given market would have to be members because a very few firms could destroy a cartel by overbidding at public auctions. Used car markets commonly contain a considerable number of firms; hence, effective collusive bidding cartels must have a relatively large membership. Respecting the second difficulty, the supply curve of repossessed cars will contain goods that differ by age and physical condition as well as make and model. Also, potential cartel participants are likely to have different capacities and profit experiences. In these circumstances, the problem of constructing a price schedule—the amount to be bid per car—and an allocation—the number and type of cars each member is permitted to buy—seems more difficult to solve than the coordination problems that faced most reported cartels.\textsuperscript{42} Respecting the last difficulty, entry is "free" in the sense that a potential entrant would suffer no disadvantage in either production technique or perceived product quality (per unit of cost) relative to incumbents; the entrant needs primarily to lease a lot, for he can draw cars and sales personnel from the same distributions that incumbents face. A cartel might consider setting prices above the monopsony level to deter entry, but given the ease of entry, it would seem that entry-deterring bids on repossessed collateral would have to be close to actual values; in this event, the gains from cartel behavior are unlikely to exceed the costs. Also, because used car markets are regional in scope at the wholesale level, firms in other local markets

\textsuperscript{41} A good analysis of the factors seemingly conducive to collusion is found in F. M. Scherer, Industrial Market Structure and Economic Performance 199–227 (1980). See also John M. Kuhlman, Nature and Significance of Price Fixing Rings, 2 Antitrust Law and Econ. Rev. 69 Spring (1969). The analysis above ignores two factors commonly discussed in connection with cartels, the effect on the likelihood of cartel behavior of the ability of firms to innovate and of declines in demand for the industry’s product. See Scherer, supra; Kuhlman, supra; John Palmer, Some Economic Conditions Conducive to Collusion, 6 J. Econ. Stud. 29 (1972). These factors are ignored here because potential cartel members are retail dealers and thus have a limited ability to innovate, and because the proponents of the failure-to-maximize justification apparently assert its applicability under all market conditions. The factors the text does discuss must be regarded as tentatively valid because they are based primarily on studies of cartels that have been prosecuted. Whether these factors characterize all firms or only those in the "prosecution prone" category is unknown, but the factors are the best we have. See Peter Asch & Joseph Seneca, Characteristics of Collusive Firms, 23 J. Indus. Econ. 223 (1975).

\textsuperscript{42} See authorities cited in note 41, supra.
will enter to bid up prices whenever a cartel has depressed these prices by more than the difference between actual wholesale value and shipping costs. Creditors such as banks have an incentive to notify outside firms of such opportunities.

If a collusive bidding cartel overcame these difficulties, it would have to face the problem of a vanishing supply of cars. This is because financers seriously disadvantaged by cartels probably would refuse to make purchase money loans to consumers. Instead, they would buy consumer paper from dealers pursuant to recourse arrangements. In such arrangements, the dealer must repay the financer if the debtor defaults and then must dispose of the collateral. If many financers shift to recourse financing rather than repossess and resell the collateral themselves, the cartel’s supply of cars will vanish. To be sure, recourse financing is more costly to financers than direct consumer loans when these loans are routinely made but probably would be less costly than remaining supine before an effective collusive bidding cartel.

To summarize, analysis suggests that collusive bidding cartels are unlikely to depress the prices at which repossessed collateral is sold. As indicated above, little direct evidence of such cartels exists.\textsuperscript{43} Respecting indirect evidence, casual surveys of automobile repossessions show that financing creditors recover approximately 80 percent of the “wholesale value” of the cars they sell.\textsuperscript{44} This wholesale value represents a prediction by knowledgeable observers of the selling prices of used cars in salable condition at the beginning of each car’s model year. At least part of the apparent 20 percent discount off wholesale value is accounted for by three

---

\textsuperscript{43} The FTC staff asserted that collusive practices were common but that their “clandestine nature” made it “impossible to quantify their prevalence.” A California bank did testify to the Commission that it faced “unduly depressed bidding” when making “remote dispositions” of collateral. It avoided the problem by creating a “centralized ‘Collateral Control Center.’” See “Credit Practices,” supra note 28, at 292. Apparently, no other financial creditor testified respecting collusive bidding. In very small towns, few enough dealers may exist to make plausible their attempting to form a cartel, but as the testifying bank’s experience shows, the regional nature of used car markets makes the success of such cartels unlikely.

\textsuperscript{44} The FTC study indicated that Ford Motor Credit Co. obtained 82 percent of the wholesale book value, Bank of America obtained 79 percent of wholesale, and Security Pacific National Bank recovered 77.1 percent of wholesale. See “Credit Practices,” supra note 28, at 266–67, n. 42. The Stanford study showed that creditors in Alameda County, California, received 84 percent of the wholesale book value. See Note, supra note 34, at 1085. A study of repossessions in Washington, D.C., indicated that creditors obtained 81 percent of the wholesale value. See Note, Business as Usual: An Empirical Study of Automobile Deficiency Judgment Suits in the District of Columbia, 13 Conn. L. Rev. 511, 516–21 (1971). Professor Schuchman’s initial study of Hartford, Conn., repossessions revealed a 71 percent average and a 75 percent median recovery of wholesale value. See Schuchman, supra note 27, at 62–67.
factors: the expense of putting repossessed cars into salable condition;\(^45\) the fact that used cars are offered for sale throughout the year; and the riskiness of purchasing from financers, who commonly lack the facilities to diagnose and remedy defects. Any unaccounted-for difference between book and actual wholesale prices seems too small alone to support the inference that collusive bidding cartels exist.

2. Dealer Trading Cartels. In dealer trading cartels, a relatively small group of dealers resell repossessed cars to each other at less than wholesale prices. These cartels need fewer members than collusive bidding cartels, but they too face the difficulties of product heterogeneity and ease of entry. Respecting entry, if cartelization generated excess profits in particular markets, new firms probably would enter because entry costs are low. In addition, dealers compete with financers in offering credit to consumers. If dealers routinely began to claim greater deficiencies than financers on otherwise similar loans, because of dealer trading cartels, dealer credit would become more expensive than financer credit. Consumers would then have an incentive to shift away from dealer credit; their ability to do this conveniently also reduces the expected gain to cartel behavior.

Perhaps the most significant obstacle to the formation of dealer trading cartels lies in the opportunity members would have to cheat and in the difficulty of detecting and preventing cheating. Firms would be tempted to lie about their bad debt experiences when participating in the creation of periodic allocations of purchases they make from and sales they make to the cartel. This is because each cartel member has an incentive to purchase goods from the cartel at very low wholesale prices but to retail these goods at market value. Members would justify making many low-price purchases by claiming that their debtors are quite likely to become insolvent; in such cases the expected loss from making low-price sales— from not maximizing—is high,\(^46\) so the ability to make low-price purchases is essential to profitability. Cartel members also have an incentive to sell goods to the cartel at high prices because, respecting each individual default, the higher the price obtained on resale the lower is the expected loss. Members would justify making high-price sales by claiming

\(^{45}\) General Motors Acceptance Corp. reported to the FTC that its repossessed cars were in "good," "fair," "poor," or "wrecked" condition. GMAC claimed to recover 94.4 percent of wholesale value on good cars and 80.8 percent of wholesale for fair cars. ("Credit Practices," supra note 28, at 300.) A recent study using FTC data reached approximately the same results. See Philip Schuchman, Condition and Value of Repossessed Automobiles, 21 Wm. & Mary L. Rev. 15 (1979).

\(^{46}\) When the probability of debtor insolvency increases, the expected yield of a deficiency action falls, thereby increasing the expected loss to the creditor of not maximizing the proceeds from resale. See App.
that other members' debtors probably can satisfy deficiency judgments in full. When this is the case, a dealer would lose relatively little from making low-price sales and thus would not need to make many low-price purchases.

The probability that a given firm’s debtor will enter insolvency is difficult for outsiders to assess and is excessively costly for the firm to establish convincingly to outsiders. This probability must be inferred largely from the particular circumstances of the individual debtor who has defaulted rather than, as in the original credit extension, from characteristics the debtor has in common with many other consumers. Put another way, the judgment of whether a person is creditworthy is more likely to be made on objective factors, while the judgment of whether a person who has missed payments is likely to drown or recover is more likely to be made on individual, subjective factors. In consequence, cheating in the form of members attempting to make too many low-price purchases from and too few low-price sales to the cartel is likely to be common and difficult to stop. Also, each cartel member has an incentive to retail some cars but to continue making low-price wholesale purchases from the cartel; a creditor who maximizes resale value on his own repossessions but is able to purchase goods at artificially depressed wholesale prices will do better than “honest” cartel members, who necessarily must make many low-price wholesale sales as well as low-price purchases. Because retail sales can be made privately and because a dealer probably can conceal or explain a failure to make numerous sales to the cartel, at least for a time, cheating in the form of retailing cars is also likely to occur, especially by dealers who are facing hard times that they consider temporary. The strong incentives to cheat that dealer cartel members have and the apparent ease with which cheating can be done suggest that dealer trading cartels would be quite unstable.

Dealer trading cartels, analysis suggests, thus seem not much more likely to influence the prices at which repossessed collateral is sold than are collusive bidding cartels. No direct evidence of the existence of dealing trading cartels has been offered, nor is there indirect evidence. In particular, dealers seemingly do not claim larger deficiencies than financiers on similar credit extensions, as they would if dealer trading cartels were common. If a decision maker nevertheless believed that such car-

47 When the creditor plans to make a private sale, he must notify only the debtor. See UCC § 9-504(3).
48 One study reported that deficiencies were no larger than usual when financiers resold to dealers pursuant to recourse arrangements and the dealers then sued the debtors. See Comment, Defaulting Debtors and the Judicial Process, supra note 34. Another study showed that deficiencies were lower in this circumstance. See Schuchman, supra note 27, at 40.
tels pose a danger, a legal remedy that would be as effective as and less intrusive than the reforms summarized in Section I would be to require that all sales be public. Since nonmembers would then learn of the sales, they could overbid the cartel for repossessed goods, causing the cartel to dissolve. The likelihood that dealer trading cartels exist, however, seems too low to justify incurring the costs that would flow from a complete ban on private sales.49

D. Summary

The belief that creditors systematically fail to maximize the value of repossessed collateral has been influential in causing decision makers to adopt or propose restrictions on the taking of security interests in consumer goods. Section IIA has shown that creditors acting alone have incentives only to maximize resale value. Section IIB then demonstrated that the practice of many creditors to wholesale rather than retail their repossessions is consistent with the view that creditors maximize. Indeed, requiring retail sales, as some have proposed, actually would cause debtors to pay higher deficiencies than they now do. Finally, Section IIC showed that creditors could do better by failing to maximize resale value if they could successfully cartelize resale markets. Section IIC went on to argue that no persuasive evidence of the existence of creditor cartels exists, and that theory suggests that their existence is improbable. In consequence of this analysis, public policy should no longer be made on the assumption that creditors do not maximize; the assumption must be the other way.

III. REPOSESSION AND THE ALLEGED DESTRUCTION OF VALUE

Coercive repossession is said to impose greater harms on debtors than it creates gains for creditors. This might occur in four ways. First, debtors may value goods in their possession in excess of the goods' market price.

49 The difficulties discussed above respecting dealer trading cartels seemingly could be avoided by secret side payments. For example, if the dealer in the first illustration in Sec. IIA sold the $3,000 car for $1,500 and sued for a $3,500 deficiency, but later received a secret $500 side payment from the second dealer, he would do $71.51 better than if he sold the car for $3,000. No cartel would be necessary; rather the market would have repossessing dealers offering cars for less than their actual value to whoever would make the highest side payments. But if this were so, the side payments would actually run the other way: the first dealer would sell the car for $3,000, its actual price, less the sum the second dealer would demand to cooperate in creating a bill of sale that said "$1,500." Apparently no one believes that such blatant lying about the prices at which collateral is resold is common. This may be because lying would be relatively easy to detect if the repossessing creditor reported the difference between the $3,000 actually received and the $1,500 claimed to be received in the deficiency action to its shareholders and on its tax returns. On the other hand, the failure to report this income is grounds for criminal sanctions.
For example, a consumer would sell his stereo for no less than $600, but its used goods price is $500. When the stereo is repossessed and resold for $500, $100 of value allegedly is destroyed. Second, the lack of effective resale markets may unduly depress the value of used goods. Suppose that the debtor's stereo would be worth at least $500 to anyone who knew how reliable it was, such as the debtor himself, but strangers would fear breakdowns and thus would pay no more than $400 for the stereo. The market price for used stereos is artificially depressed because owners know more about their goods than outsiders do. In this illustration, the information asymmetry causes a $100 value loss because the repossessing creditor could sell the stereo for at most $400. Third, repossession could destroy human capital. As an example, the stereo may work perfectly if used in a certain fashion that the debtor has discovered. When the stereo is repossessed and resold, the new owner must take time to learn—if he ever does learn—how best to use it. In consequence, the debtor's investment in learning how to use his stereo is wasted. Fourth, repossession may impose psychic losses on debtors that are not offset by psychic or other gains elsewhere.

These harms could not occur if debtors were perfectly informed of the consequences of granting security. If security imposed greater expected harms on debtors than it created expected gains for creditors, creditors could not purchase the consent of debtors to grant it; rather, debtors would forgo granting security in favor of paying higher interest rates. As was noted in the Introduction, this paper assumes instead that consumers when they borrow are ignorant of the possibility that repossession could impose on them losses such as those just described. If debtors are so uninformed and if these losses do occur, repossession would be objectionable because it minimizes welfare. Section III next argues, depending on the way in which repossession is alleged to impose harm, that no such losses occur from it, that no net losses can be shown to occur, or that any net losses are trivial.

The first form of the value destruction claim, that a debtor loses the difference between the value he attaches to the goods and their market price, seemingly assumes what is to be decided. To see why, let \( P = \) the collaterals' used goods market price and \( W = \) the price that the debtor would charge to sell the collateral voluntarily. In the illustration that introduced Section III, \( P = $500 \) and \( W = $600; \) thus repossession imposed a $100 loss on the debtor. However, one can "lose" only what one "owns." Suppose that the state had previously decided to confer on secured creditors the absolute right to repossess whenever a debtor defaulted. Then the debtor seemingly would lose nothing from repossession because after default he would own nothing. The question, that is, appar-
ently is whether creditors or debtors have a right to the collateral on default, and the initial version of the value destruction claim presupposed but did not justify an answer to this question; it simply assumed that debtors had the right.

This version of the value destruction claim can be stated in a nonconclusory way if a debtor who lacked the right to keep the collateral in the event of default would bid in excess of its market price to prevent repossession. Let $V =$ the price a debtor would pay to keep the goods if he had no legal right to them. Then if $V > P$, the debtor incurs a value loss even though he lacks the property right. Proponents of the value destruction claim seemingly suppose the losses that debtors incur from repossession to be nontrivial; in the terminology used here, they suppose $W - P$ to be large. If they are right, $V$ also is likely to exceed $P$. This is because the price which the debtor would bid for the right to keep the goods ($V$) is unlikely to be very much lower than the price the debtor would choose to sell the right ($W$), so that if the latter is considerably greater than the market price ($P$), the former will exceed the market price also. In this event, the value destruction claim can be made out independently of where the property right is. The debtor’s loss is $W - P$ if he owns the right and $V - P$ if he does not, with both magnitudes exceeding zero. It is a separate question whether in fact both magnitudes are positive, but for now this is assumed.

A complete statement of the initial version of the value destruction claim must also explain why a debtor who values goods in excess of their market price would ever default. To understand this problem, let $D$ be the

---

50 $W$ and $V$ will differ in part because of income effects. If the right to keep particular goods on default is a normal good, a debtor would spend the same proportion of his income on this right regardless of how much he makes. Because a debtor without the right is poorer—by the value of the right—than is a debtor with the right, a debtor without it would spend less of his income in dollars to purchase it than he would charge in dollars to give it up. The text assumes the right to keep the collateral on default to be a normal good, and so suppose $W$, the ask price, to be greater than $V$, the bid price, but not very much greater. Economists usually assume that income effects of this sort are small because owning a legal right is unlikely to add very much to a person’s wealth, nor will losing one make a person considerably poorer. In consequence, the prices one will pay to keep or to buy a right should seldom differ significantly. See Robert D. Willig, Consumer's Surplus without Apology, 66 Am. Econ. Rev. 589 (1976). Recent evidence, however, suggests that differences between bid and ask prices, at least in laboratory settings, commonly are too large to be accounted for by income effects alone. See Jack Knetch & Charles Sinden, Willingness to Pay and Compensation Demanded: Experimental Evidence of an Unexpected Disparity in Measures of Value, Q. J. Econ., in press (1982). If this evidence generalizes to real cases, the assignment of legal rights could determine outcomes more frequently than is commonly supposed. For example, repossession could destroy value if the debtor is assumed to own the right, $W > P$, but may not destroy value if the creditor has the right, $V < P$. If this outcome seems possible, the assignment of rights must be independently justified. Section V, infra, does consider noninstrumentalist justifications for assigning the right to the debtor.
outstanding debt, which is the unpaid portion of the price, with \( V \) and \( P \) being defined as above. Suppose the debtor’s circumstances have changed after a sale such that he comes to believe that the goods are worth less to him than the unpaid price; for example, the debtor has become unemployed and would rather spend scarce resources on rent than on stereo payments. In this event, the debtor has an incentive to abandon the deal because the goods are worth less to him than the outstanding debt (\( D > V \)). Repossession and a deficiency action would also disadvantage him. As an example, let \( D = 650 \), \( V = 590 \), and \( P = 500 \). If the creditor repossesses and resells, he will sue for \( D - P = 150 \). If the creditor can sue only for the debt, the debtor’s loss is the debt less the value of the goods the debtor retains, \( D - V = 60 \). Thus repossession and a suit for the deficiency impose an additional $90 loss on the debtor. However, if the debtor believed with certainty that the creditor would sue for \( D - P \), he seemingly would not default; rather, he would retain the goods and pay \( D \), although \( D > V \), because this cuts his loss to \( D - V \), which is $60 here.

It thus is difficult to explain default when debtors value the collateral at more than its market price. A debtor might believe that his creditor will repossess but not sue because deficiencies are sought in a minority of cases; if the debtor is correct, default gains him the difference between the outstanding debt and the value he attaches to the goods. Also, default enables the debtor to reallocate his resources to meet immediate needs. The benefit of being able to do this may sometimes exceed the net loss that repossession plus a deficiency action impose.\(^5\)

It is now possible to state the initial version of the value destruction claim completely: If (1) debtors would ask a sum in excess of the collateral’s used goods market price to allow a creditor to repossess on default, \( W - P > 0 \); or (2) debtors would bid a sum in excess of the used goods market price to retain the collateral in this event, \( V - P > 0 \); and (3) debtors routinely default when the utility they would derive from retaining the unpaid portion of the price exceeds the utility they would derive from retaining the goods, \( D > W \) or \( V \), then repossession causes debtors to lose value. Further, if (4) creditors necessarily derive less value from

---

\(^5\) Another form of the value destruction claim that is sometimes made is that consumers lose the goods’ replacement value while creditors recover only the used goods market price. If replacement value is conceived of as this used goods’ market price, this form of the claim adds nothing to what has been said: the consumer can replace his used goods with other used goods, paying \( P \), and so loses \( V - P \). If replacement value is conceived of as the new goods price, this version of the claim is false. Consumers default when the value to them of retaining the goods is less than the unpaid price (\( D > V \)). Since the new goods price must exceed \( D \), consumers would not buy new goods and so would not lose the new goods replacement value.
repossessed goods than debtors lose and (5) repossession does not otherwise create value, repossession also causes net social harms.

The latter two assumptions seem less likely to hold than the first three. Respecting assumption 4, consider the repossessing creditor in his status as a seller of used goods. Firms commonly are assumed to sell until marginal cost equals marginal revenue. Most units that are sold, however, are inframarginal; they bring in revenue in excess of cost. Suppose then that (a) the market price of a used item is $500; (b) the defaulting debtor would pay $590 for the right to retain the item; (c) the product when repossessed and resold is inframarginal to the creditor, bringing in revenue of $120 over costs; and (d) the debtor and creditor have the same marginal utility for money. In this circumstance, repossession actually creates a net social gain; the creditor gains $30 of utility more than the debtor loses. In actual cases, it would be impossible to know whether repossession creates net social gains of this sort. This is because the parties probably will have different marginal utilities for money, but these utilities as well as the debtors' bid and ask prices are unobservable. The point of the illustration rather is to show that the creditor's net gain from repossession and resale is not necessarily less than the debtor's loss.

Assumption 5 above also is unlikely to hold because second buyers commonly value resold goods in excess of their price. This point is made clearly with a graph (Figure 1). The curves S (supply) and D (demand) are for used goods when the debtor decides that the goods are worth less to him than the unpaid portion of the price. The debtor in this illustration is located at point A on the supply curve S; this means, supposing him to

![Figure 1](image-url)
have the property right, that he would not sell the collateral at its used goods market price, $P^*$, but would sell if the price rose to $P^1$. The difference between these two prices, $P^1 - P^*$, is the debtor’s loss from repossession, in the sense at issue here. The second buyer is located at point $B$ on the demand curve $D$; this means that he would buy the product if its price were as high as $P^1$. The difference between this price and the market price at which he is able to purchase, $P^1 - P^*$, is the second buyer’s gain. In this illustration, these gains and losses exactly offset one another, but they need not; considering just the debtor and second buyer, repossession and resale could create net social gains or losses, depending on the valuations the parties attach to the goods. Unfortunately, these valuations are unobservable, but the point is the same; repossession does not necessarily destroy value.

To summarize, if the debtor’s loss from repossession is conceptualized as the difference between the price for which the debtor would buy or sell the right to keep the collateral and the collateral’s market price, repossession would create net social losses only if the debtor’s loss typically exceeds the creditor’s and second buyer’s gain. Decision makers cannot know whether this is the case. From a utilitarian perspective, however, the analysis does show the fallacy of a claim that repossession necessarily creates net social losses because debtors always lose value. Also, if speculation is fair, repossession may create net social gains. This is because debtors seem more likely to default when they care relatively less about retaining possession. The smaller the debtor’s loss, the more likely it is to be outweighed by the gains repossession creates for the creditor and second buyer.

The second version of the value destruction claim asserts that repossession creates greater harms than gains in consequence of the rapid and extensive depreciation to which consumer goods often are subject. This depreciation allegedly is a function of the absence of effective resale markets for used consumer goods. It is said to destroy value because repossessed goods are “worth” more than the unduly low prices they command.52

Two factors apparently contribute most to the depreciation of consumer goods, neither of which supports the conclusion that repossession destroys value. First, new goods command a premium partly because of their newness; consumers want the experience of the first few drives in a new car or the first views of a new television. Because each such experience can be had only once, when they are important new goods will sell

52 This claim is commonly made. See “Credit Practices,” supra note 28, at 227, 321 and authorities cited in n. 189, id. See also Whitford, supra note 10.
for much more than used goods. Although the premium that new goods command may sometimes be large because of the “newness” factor, repossession cannot destroy value in this sense. The debtor, being the first buyer, by then has consumed the relevant good; he has exhausted the product’s newness. Thus he loses nothing when the product is taken and resold at a discount that reflects its used goods character.

A second factor that may contribute to the allegedly excessive depreciation of consumer goods collateral is a function of the greater probability that these goods will fail and of the inability of buyers to observe this probability. To understand the possible effect of the resultant information asymmetry, suppose that cars are of two kinds, good ones and bad ones, but that consumers cannot tell the difference before they purchase. After use, a consumer knows which kind of car he has. An information asymmetry has then developed, since car owners know more than (used) car buyers about vehicle quality. In this circumstance, price within a model class will reflect consumer views of average car quality. If consumers supposed average quality to be higher than it is, the market would be swamped with bad cars, offered for sale at the “good car price.” Consumers probably are aware of this possibility, however, and when they lack information about actual quality will suppose average quality to be relatively low. A person owning a car whose quality is above this perceived average is therefore locked in. His car is worth more than the market price, yet that price is all he can get for it. More to the point, when this debtor’s car is repossessed, it will be resold at the market price. If the debtor had a good car, and more cars are likely to be above the perceived average than below it, repossession would inflict harm on the debtor in excess of the price the car can command in the market.53 Also, this harm occurs independent of which party is assumed to have a right to the goods in the event of default. If the debtor has the right, he suffers harm in the fashion just described. If the creditor has the right, the information asymmetry prevents the creditor from selling the goods at their “true” value; in consequence, the deficiency that the debtor will have to pay is increased.

Although debtors sometimes may lose value in the sense at issue here when goods are repossessed, for three reasons the conclusion that repossession creates net social harms does not follow. First, the quality of some used goods, such as furniture, seems observable before purchase.

As to this collateral, the information asymmetry on which the argument rests does not exist. Second, when a good repossessed car is offered for sale, the percentage of good cars in the market has increased, although potential car buyers do not know this. A buyer of this repossessed car thus gets a windfall, an above average car at the "average" price. This gain must be set against the loss that the debtor suffered; depending on the parties' preferences, repossession again could create net social gains or losses. For example, if the debtor used the car occasionally for recreational use but the second buyer was a traveling salesman, the second buyer probably would gain more from owning an above average car than the debtor would lose by being without one. Third, market institutions often will correct for the information asymmetry, so that the prices of repossessed items will reflect their actual value. Such institutions include guarantees and the concern of sellers for their reputations. As an example of their possible effectiveness, a recent study of the market for used pickup trucks supposed that if the information asymmetry just discussed did in fact exist, owners of high maintenance trucks would exploit it by selling them in the used market; hence, this partial consumer market—59 percent of pickups are used for personal transportation—would be a "market for lemons." The study reported, however, "that trucks that were purchased used required no more maintenance than trucks of similar age that had not been traded." Institutions such as guarantees thus will often prevent debtors from losing value in the sense at issue here.

See Eric Bond, A Direct Test of the "Lemons" Model: The Market for Used Pickup Trucks, 72 Am. Econ. Rev. 836 (1982). This information problem could also be less serious than is commonly thought if debtors are more likely to default when they own bad cars. See also Yoram Barzel, Measurement Cost and the Organization of Markets, 25 J. Law & Econ. 27 (1982). Commentators sometimes attribute the value loss debtors may suffer to the absence of well-developed markets for used goods (see authorities cited note 52, supra) but the alleged absence of such markets is not explained. A market for private goods could fail to arise for supply side reasons, such as barriers to entry, or demand side reasons, such as consumers' unwillingness to pay enough to have the product be produced. Supply side obstacles to the formation of used goods markets seem slight, for entry into retail markets is relatively cheap. The text discusses two demand side obstacles, that consumers want only to purchase "newness" and that information asymmetries may make consumers reluctant to purchase. Neither obstacle seems serious enough to support the value destruction claim. Also, the assumption that viable resale markets for used goods do not exist seems overdrawn. Two investigators sampled 203 households in the Cedar Rapids, Iowa, area to see what percentage of consumer durables in each home were used. See Dean Roussos & Leonard Konopa, Ownership Levels, Acquisition and Disposition Channels of Selected Consumer Durable Used-Goods, 8 Akron Bus. & Econ. Rev. 30 (1977). They found that 18.49 percent of the durable goods owned by the sample were purchased. Some 55.6 percent of these were purchased, the remainder being gifts. Also, 15.6 percent of the used goods were purchased from "Business Firms or other Institutions"; that is, approximately 3 percent of the durables owned by the sample were bought used from institutions. Considering the very large number of consumer durables that Americans own, these figures suggest that used goods markets for such frequently repossessed items as major appliances, boats, dressers,
The third way in which repossession is said to destroy value is through the destruction of human capital that repossession creates. To see how this could occur, suppose the debtor owns a car that always starts if treated in a certain way but will not start in cold weather if treated otherwise. The car is then repossessed and resold but the second buyer is ignorant of its character. The investment the debtor made in learning how to use the car is thus destroyed, with no offsetting gain.55

Value is lost when human capital is destroyed in this way, but the losses seem occasional and slight for three reasons. First, human capital will not exist respecting many consumer goods. There is no trick to making a couch work. Second, people seldom need tricks to make new goods work. This is partly because they often do work. When they do not—a new car does not start in cold weather—the goods commonly are fixed under warranty or a disadvantaged buyer has the right to revoke his acceptance. Because repossessed goods often are nearly new—default can occur only during the payment period—debtors seldom will have invested human capital in learning how to use them.56 Third, most consumers lack technical skills. In consequence, the methods they develop to make used goods work commonly are easy to discover. Thus the second buyer in the illustration above should quickly learn how to start the car. These three reasons taken together show that the destruction of human capital inherent in repossession is too trivial to support extensive restrictions on security interests in consumer goods.

In summary, if the harm that repossession imposes on debtors is conceptualized in "economic" terms—debtors lose human capital or the difference between the goods' value to them and its price—repossession imposes trivial harms, no harms at all, or harms that cannot be shown to exceed the gains, depending on how one considers the harm to have been inflicted. Under none of these outcomes is the welfare-minimizing objection to repossession persuasive.

If "psychic" rather than "economic" costs are considered, debtors could suffer losses from repossession not offset by gains elsewhere, at

55 Professor Leff first made this claim. See Arthur A. Leff, Injury, Ignorance and Spite—the Dynamics of Coercive Collection, 80 Yale L. J. 1 (1970).

56 This observation is more true of purchase money security than of security interests that lenders take in their debtors' existing possessions, for some of these possessions will not be new.
least in theory. Suppose that debtors are humiliated when creditors fore-
close on liened property. Then if (1) creditors derive no pleasure from
repossessing other than the pleasure of reducing the debt; (2) buyers of
repossessed goods derive no pleasure from knowing (if they do know) that
the goods were repossessed; and (3) debtors would regard the withholding
of a portion of their wages from each paycheck—garnishment—as less
humiliating than repossession, coercive property execution imposes psy-
chic harms not offset by gains elsewhere.57

This line of attack against repossession is unconvincing given present
understanding of the phenomenon. Initially, whether repossession creates
net psychic losses is uncertain. Assumption 1 above is problematic and
assumption 3 is more so, for while the debtor’s family and close friends
would know whether garnishment or repossession has occurred, garnish-
ments seem at least as public as repossessions, since garnishments be-
come known to the debtor’s employer and co-workers. Further, banning
repossession entails costs. Under current law, creditors have the choice of
repossession or garnishment. That many creditors choose the former
method suggests that it sometimes has advantages over the latter.58 Ban-
ning repossession thus will create costs that must be set against any
psychic losses that repossession may cause. Precisely comparing these
sets of costs seems impossible so a utilitarian case against repossession is
unpersuasive even when psychic costs are considered. Finally, in the
absence of a coherent claim that repossessions impose greater dignitary
harms on persons than garnishments, a fairness case against reposses-
sion, on the ground that it inevitably is disrespectful to persons, is not
compelling.

IV. IN TERROREM REPOSESSIONS

The disapproval of security in consumer contexts rests partly on the
belief that creditors do not take security to raise revenue in the usual
sense—through foreclosure and resale. Instead, creditors use the threat

57 For an argument along these lines, see George J. Wallace, The Logic of Consumer
Credit Reform, 82 Yale L. J. 461 (1973).
58 Income execution—that is, garnishment—has higher procedural costs than private
repossessions because courts are involved. Also, income execution is a time-consuming
collection method, especially for large claims, because the law prevents creditors from
taking more than 25 percent of the debtor’s take-home pay per paycheck. Consumer Credit
Protection Act § 303(a) (1968). This delay imposes two sorts of costs: (1) if creditors earn
more with money than the legal rate of interest, delay creates opportunity cost losses; (2)
delay also increases the likelihood that debtors will go bankrupt and thus erase part (or all) of
the debt. In addition, although it is unlawful for an employer to dismiss an employee whose
wages have been garnished only once, employers are commonly believed often to dismiss or
otherwise sanction garnished employees. This is a cost peculiar to income execution.
of foreclosure to coerce payment. The belief that security functions primarily as an in terrorem device is linked to the two justifications discussed above: because creditors are indifferent to the returns that foreclosure brings (the failure to maximize claim) and because repossessed goods are worth little (version 2 of the destruction-of-value claim) creditors must take security only for its threat value. That creditors commonly so act should now seem less plausible, but the issue here is whether in terrorem repossessions are blameworthy, however often done. In this Section I argue that some of the concerns that seemingly animate the distaste for in terrorem repossessions are misplaced and others are unpersuasive.

Before reaching the analysis, it is helpful to define an in terrorem repossession. Suppose that creditors repossess only when the gains to them from doing so exceed the costs. Let these gains be direct and indirect: direct gains derive from resale revenues; indirect gains derive from the expected improvement in the creditor’s collection experience because each actual repossession makes more credible the creditor’s constant threat to impose costs on nonpayers. An in terrorem repossession then occurs when repossession costs exceed the direct gains but are less than the sum of direct and indirect gains. This definition captures the allegedly objectionable feature of in terrorem repossessions—that they would not be made except for their value in establishing credible threats. The definition also rests on the premise that repossessions cannot be objectionable, in the sense at issue here, when their direct gains exceed their direct costs, even though they may produce indirect gains. This is because the debtor’s agreement to give security implies his consent to the use of security for its plainly legitimate purpose—to reduce the outstanding debt.

In terrorem repossessions may be thought improper for ex ante reasons (it is wrong for creditors to coerce payment by threatening foreclosure) or for ex post reasons (it is wrong for creditors to make examples of debtors who differ in no relevant respects from those whose goods are untouched). Regulating security is an inappropriate response to the first set of concerns. The alleged evil of threats to take the collateral at once is that the threats may cause debtors to forgo defenses to the underlying claim. These defenses are of two kinds: reasons not to pay that are sufficient

59 A typical statement of this view asserts that nonpurchase money security interests “equip a creditor with a capacity to threaten the consumer with extreme deprivation to induce the consumer to acquiesce to the creditor’s demands whether or not the demands are reasonable.” Credit Practices, supra note 28, at 193–94. See also id. at 210–11; J. Spanogle and R. Rohner, Consumer Law Cases and Materials 328 (1979); Whifford, supra note 10; H. R. Rep. No. 595, 95 Cong. 1st Sess. 126–27 (1977) (discussing § 522(f)(2) of the Bankruptcy Code).
under current law, such as a creditor's breach of warranty, and reasons not to pay that "in good conscience" should prevail, such as the debtor's illness. The response that is called for by the former concern is to require creditors to justify their claims to an impartial third party and to permit debtors to assert defenses before the goods can be repossessed. This is best done by means of a preliminary hearing, such as may be constitutionally required when creditors attach property under the authority of state statutes rather than private contracts. In light of the very small percentage of debtors who could raise tenable legal defenses to a claim of foreclosure, prohibiting foreclosure altogether or making it materially more difficult are responses that seem disproportionate to the alleged evil.

Critics of security also are concerned with "moral" defenses to non-payment. The literature supporting regulation often contains claims that debtors fail to pay largely because of circumstances beyond their control, such as illness or unemployment. The premise underlying these claims apparently is that it is too harsh to make debtors who have suffered such misfortune choose between payment or repossession. Regulating repossession is an inappropriate response to this concern because the concern

The constitutional requirements are described in Mitchell v. W. T. Grant Co., 416 U.S. 600 (1974). A hearing is not constitutionally required when the creditor repossesses pursuant to a Code security interest. For example, Adams v. Southern California First National Bank, 492 F.2d 324 (9th Cir. 1973), cert. denied, 419 U.S. 1006 (1974). See also Flagg Bros., Inc. v. Brooks, 436 U.S. 199 (1978). The Model Consumer Credit Act (1973), drafted by the National Consumer Law Center, requires repossession to be by legal action, § 7.202, but no state has adopted this statute. Wisconsin has come close, requiring repossession to be by action unless "the customer has surrendered the collateral." Wisconsin Consumer Act § 425.206(1)(b) (1973). A surrender "is not . . . voluntary" if it is "made pursuant to" the creditor's "request or demand" or "pursuant to a threat, statement or notice by the . . . [creditor] that [he] . . . intends to take possession of the collateral." Id. at § 425.204(3). The text does not advocate hearings prior to repossession; instead, it claims that if threats to repossess in fact cause many consumers to forgo legal defenses, the appropriate remedy is a hearing, not the regulation of security. A major debate took place in the 1970s over whether a hearing should be constitutionally required when creditors attached goods pursuant to state statute. Opponents of the requirement argued that debtors seldom had good defenses and that hearings would be excessively costly; proponents disputed both assertions and claimed that consumers had a dignitary interest that unregulated attachment could violate. A representative exchange is Robert W. Johnson, Denial of Self-Help Repossession: An Economic Analysis, 47 S. Cal. L. Rev. 82 (1973); Edward A. Dauer & Thomas K. Gilhool, The Economics of Constitutionalized Repossession: A Critique for Professor Johnson, and a Partial Reply, id. at 116; Robert W. Johnson, A Response to Dauer and Gilhool: A Defense of Self-Help Repossession, id. at 151. See also Robert E. Scott, Constitutional Regulation of Provisional Creditor Remedies: The Cost of Procedural Due Process, 61 Va. L. Rev. 807 (1975).

The market allows debtors to insure against some of these harms: credit life and health insurance, for example, are frequently offered in connection with extensions of credit to consumers, and protect them against many of the hardships that unexpected illness could cause.

60 The constitutional requirements are described in Mitchell v. W. T. Grant Co., 416 U.S. 600 (1974). A hearing is not constitutionally required when the creditor repossesses pursuant to a Code security interest. For example, Adams v. Southern California First National Bank, 492 F.2d 324 (9th Cir. 1973), cert. denied, 419 U.S. 1006 (1974). See also Flagg Bros., Inc. v. Brooks, 436 U.S. 199 (1978). The Model Consumer Credit Act (1973), drafted by the National Consumer Law Center, requires repossession to be by legal action, § 7.202, but no state has adopted this statute. Wisconsin has come close, requiring repossession to be by action unless "the customer has surrendered the collateral." Wisconsin Consumer Act § 425.206(1)(b) (1973). A surrender "is not . . . voluntary" if it is "made pursuant to" the creditor's "request or demand" or "pursuant to a threat, statement or notice by the . . . [creditor] that [he] . . . intends to take possession of the collateral." Id. at § 425.204(3). The text does not advocate hearings prior to repossession; instead, it claims that if threats to repossess in fact cause many consumers to forgo legal defenses, the appropriate remedy is a hearing, not the regulation of security. A major debate took place in the 1970s over whether a hearing should be constitutionally required when creditors attached goods pursuant to state statute. Opponents of the requirement argued that debtors seldom had good defenses and that hearings would be excessively costly; proponents disputed both assertions and claimed that consumers had a dignitary interest that unregulated attachment could violate. A representative exchange is Robert W. Johnson, Denial of Self-Help Repossession: An Economic Analysis, 47 S. Cal. L. Rev. 82 (1973); Edward A. Dauer & Thomas K. Gilhool, The Economics of Constitutionalized Repossession: A Critique for Professor Johnson, and a Partial Reply, id. at 116; Robert W. Johnson, A Response to Dauer and Gilhool: A Defense of Self-Help Repossession, id. at 151. See also Robert E. Scott, Constitutional Regulation of Provisional Creditor Remedies: The Cost of Procedural Due Process, 61 Va. L. Rev. 807 (1975).

61 See, for example, Credit Practices, supra note 28, at 236. The market allows debtors to insure against some of these harms: credit life and health insurance, for example, are frequently offered in connection with extensions of credit to consumers, and protect them against many of the hardships that unexpected illness could cause.
actually goes to the circumstances under which payment should be excused. It is best to focus directly on the excuse issue rather than treat it obliquely by restricting security. To see why, suppose that involuntary unemployment is a proper excusing circumstance. Current restrictions on the taking of security permit a secured creditor to foreclose if he then eschews a suit on the debt or to sue but forgo foreclosure. The secured creditor thus can collect at least some of the debt even though security is regulated. If unemployment should excuse payment, however, the creditor should receive nothing. Suppose instead that unemployment does not excuse default. Then restrictions on security are unfair, because they often cause creditors to be paid less than in full although debtors have no legitimate excuse for defaulting. It is, in short, unwise to respond to the excuse issue by regulating security, because such regulation seemingly insures only that debtors will have to pay too much or too little.

The second set of objections to in terrorem repossessions focuses on their property of making examples of particular debtors. This concern has two aspects. The first is an expectations objection: the debtor whose goods are taken could not reasonably think it would be he who would suffer. The second is an equality claim: many debtors fail to pay; no good reason exists to punish this debtor. Neither claim is persuasive. Respecting expectations, the signing of a security agreement is notice to the debtor that the goods may be taken if he fails to pay; no good reason exists to punish this debtor. Neither claim is persuasive. Respecting expectations, the signing of a security agreement is notice to the debtor that the goods may be taken if he fails to pay. Also, creditors have incentives to overstate the frequency with which they foreclose, and probably they often do so. In these circumstances, each debtor should and likely does know that repossession is a live prospect. Thus claims of unfair surprise will seldom be tenable.

The equality claim is not compelling because good reasons exist to make in terrorem repossessions, supposing them to occur. They may encourage repayment at least cost to debtors as a group because creditors have incentives to use cost-minimizing collection methods. If one such method is banned a more costly one will be used, and debtors will bear part of the resultant cost increase. If the threat of repossession is the least-cost method and is to be effective, some repossessions must be made. The question then becomes whether the equality goal—all debtors are relevantly alike and thus all or none should be foreclosed against—should take precedence over the group welfare and desert goals—consumers generally benefit from selective foreclosure and this debtor deserves to be foreclosed against because he did not pay. In the criminal

62 That unanticipated financial hardship should excuse default is considered in George J. Wallace, The Uses of Usury: Low Rate Ceilings Reexamined, 56 B.U.L. Rev. 451, 468–70 (1976).
law, the equality goal—all persons who commit crimes should be similarly prosecuted and punished—is subordinated to the group welfare and desert goals; no one has a right to avoid conviction because a similar perpetrator was not prosecuted. This principle becomes controversial in only two circumstances: when the state proceeds against persons partly with the goal of using their punishment to deter others but punishes them in a drastic and irreversible fashion such as by execution;\(^63\) or when resource constraints enable the state to proceed against only a subset of suspected criminals and the subset is selected by disfavored criteria such as race. A defaulting debtor whose goods are taken for deterrence reasons has prima facie no better claim of excuse than the burglar who is fairly caught. Most burglars are not caught, but this burglar actually committed the crime, and burglary is a bad action that may be reduced by conviction. By the same reasoning, the debtor failed to pay, and unjustified nonpayment is a bad action that may be reduced by foreclosure. In addition, relevant differences often may exist between debtors whose goods are taken and those who escape. Creditors have incentives to preserve good will while collecting debts. These incentives should lead them to make in terrorem repossessions only against obvious deadbeats, and creditors claim to proceed, in the contexts in which in terrorem repossessions are said to occur, primarily against persons who do not pay without even the moral excuses discussed above.

V. PROPERTY RIGHTS OBJECTIONS TO SECURITY

The justifications for regulating security discussed above, in particular the claims that repossession destroys value or is done for in terrorem motives, seem animated by a set of inchoate moral concerns. Allowing creditors to take unrestricted security interests in consumer goods is felt unjustifiably to deprive persons of property, but those who believe this have yet to show how their belief follows from current normative conceptions of the sources of property rights. In consequence of the belief and this failure, critics of security often cast moral objections to it in the more familiar language of economics. These objections should be evaluated directly. Section V attempts to explicate theories of property rights from which objections to unregulated security could tenably be derived; it then argues that these objections cannot support present regulation.\(^64\)


\(^64\) The literature supporting the reforms discussed here seldom explicitly justifies them on distributional grounds, but a distributional theme may underlie the case for regulation. If so, for two related reasons the theme is inappropriate. The supply of consumer credit probably
Two preliminary matters should be clarified before reaching the analysis. First, the argument assumes: (1) people understand that to give a security interest means to authorize the creditor to repossess the specified collateral in the event of nonpayment; (2) consumer credit contracts are set forth in readily understandable language and requisite disclosures are made in such fashion as to be easily acted on; and (3) consumer credit markets are competitive. These assumptions are made, not because they are true, but to focus attention on the question whether security is morally objectionable in relatively ideal circumstances. Regulation to cure the problems generated by the failure of any of these assumptions to obtain in actual markets has familiar justifications that can be derived from contract law doctrines.

Second, recent legislation in this area has been influenced by a belief that consumers in unregulated markets put their property too much at risk. This belief is partly responsible for two kinds of regulation: restrictions on the granting of security belong to the class that directly limits risk taking; relaxed requirements for becoming a bankrupt and expanded bankruptcy exemptions, in contrast, ameliorate the consequences of risk taking. An ideal treatment of any particular aspect of this legislation would consider both types of responses to risk taking because they may be related. For example, decision makers could want to relax restrictions on risk taking initially because, through bankruptcy legislation, they have minimized the consequences that risk taking creates. This paper nevertheless only discusses an aspect of risk-limiting regulation. This is because the subject of risk taking in consumer transactions seems too broad and complex to be treated as a whole, given present levels of understanding; rather, the best chance of understanding it lies in making detailed analyses of various of its parts.
An analysis of property rights objections to the taking of security must focus on the relationship that people have to physical things. The principal coercive collection devices used in consumer transactions are garnishment and foreclosure. Restrictions on the taking of security will increase the use of garnishments. Since it is assumed here that collecting debts is an innocent activity in the absence of a bankruptcy proceeding, the question then becomes whether security poses a greater threat to property rights than garnishment does. It is this question that requires an inquiry into the possible evils of creditors taking things rather than money.

Two related theories of property rights, both of which derive from the effect on personal autonomy of the possession of things, seem germane. The first is a welfare rights theory which holds that each person needs an irreducible minimum of physical things in order to lead a full and autonomous life. Such a life cannot be led by one destitute of possessions. If the state were to sanction the taking of everything a person owns, it would therefore be permitting the destruction of his ability to be a full member of society. To treat persons in this way poses a threat to the community's viability and also is impermissibly disrespectful to them. In consequence, the state should ensure that people will always retain the requisite minimum of possessions. The second theory focuses more directly on the relation of people to physical objects, holding that people partly constitute themselves through their possession of tangible things; people, in effect, are at least partly what they own. Much property that people own obviously is "fungible"—a toaster or a tire iron—but some property is "personal" in the sense that the possessor's personality is bound up with owning it—a wedding ring or a home. The same property may be fungible to one owner and personal to another because people invest themselves in different kinds of things, but the relevant point is that some property is personal in a wholesome rather than a fetishistic sense. If the state were to allow the taking of anything a person may own, it must necessarily allow the taking of personal property; this could result in the destruction of important aspects of people's personalities. Because people have a right to be whole, they have a right to own those things in which their wholeness partly resides.

Both of these theories accord people rights to things that are good against (at least some forms of) involuntary divestment. The issue in this

---


67 This second theory is set out in Margaret Jane Radin, Property and Personhood, 34 Stan. L. Rev. 957 (1982). It has Hegelian roots.
context, however, is alienability: can a person voluntarily pledge his refrigerator or his father's watch as security for a loan?68 In answering this question, it is helpful to distinguish between security interests of this sort and purchase-money security interests, which are taken by sellers or lenders to secure the purchase price. Purchase-money security interests are common in connection with installment sales of consumer goods. It would be contradictory of the property rights theories just set out to prohibit them. If people prefer to give purchase-money security interests rather than pay higher interest rates or cash prices, making purchase-money security less attractive to creditors will compel people to forgo purchases or will increase their difficulty in purchasing. Respecting the welfare rights theory, it is contradictory to increase the costs to a person of assembling the irreducible minimum of goods necessary to his leading a full and autonomous life in the name of enabling him to lead that life. Respecting the second theory, it is contradictory to increase the difficulty a person has in buying goods that will become a part of himself in the name of protecting his interest in goods that are a part of himself. Because both relevant property theories protect people's rights to own things, these theories seemingly should permit persons to alienate—to mortgage—goods when alienation will materially increase the opportunity for ownership. Moral objections to the giving of security thus must inhere in the unrelatedness of security to acquisition; people can give purchase-

68 Modern property theory recognizes three sources of property rights, broadly speaking. One source derives from the Lockean notion that a person owns things in virtue of his mixing his labor with them; a second derives from utilitarianism, holding that rights should be assigned in such fashion as to maximize utility; and the third derives, in a more or less immediate sense, from concern for individual personality, assigning rights to people in such ways as to preserve or create their ability to be fully free. This paper speaks only of the third source of property rights because the relevant legal issue is when people can alienate things. Locke's theory seemingly assumes a virtually untrammeled right of alienation. Once one has acquired rights in a thing, by mixing one's labor with it, nothing internal to the theory supports restricting the person's power to exchange that thing for another. In addition, Locke seemingly justifies property rights partly by recourse to utilitarian reasons, after money has been invented; in a world with money, the institution of private property is justifiable partly because it increases social utility. See S. D. Drury, Locke and Nozick on Property, 30 Pol. Stud. 28 (1982). Utilitarianism also supports a broad power to alienate, especially if the modern view that people can best choose the actions that maximize their own utility is accepted. For then voluntary exchanges must be permitted, on the ground that they are made only when they maximize the utility of the parties to them. In contrast to Locke and utilitarian theories, an unrestrained power to alienate could erode the basis of the property right itself when that right derives from notions of individual personality. This is because persons, at least in theory, could alienate property necessary to their leading autonomous lives or necessary to their personhood. The support that personality theories of property provide to restraints on alienation may partly explain why objections to freedom of contract in consumer contexts sometimes have a welfare rights tone. The text thus attempts to show that even personality theories cannot sustain present regulation of consumer goods security.
money security interests but perhaps should not be allowed to mortgage what is already theirs.

The conclusion that broad security interests in consumer goods should be restricted does not follow from the notion of unrelatedness alone. To see why, recall that people now are free to sell their possessions: a person can convert the irreducible minimum of goods to cash or sell "the old home place." This freedom is only partly justified by administrative convenience, for institutions such as conservatorships exist or could be fashioned to prevent people from selling all their goods. Rather, the freedom to sell is also justified by notions of personal autonomy. Should these notions permit sales but prevent mortgages?

Answers seemingly must derive from the uncertainties that attend the mortgage decision. One such answer may run like this: a person deciding whether to make a present sale of his property can know what affect on his life being without the goods at issue will have. More accurately, because the effects of a sale are felt immediately, a person can predict his reaction to these effects as well as he can predict his reaction to any action he will take. The decision to mortgage, in contrast, requires a person to predict the affect on his life of the later forcible removal of many of his possessions or a significant few. The effects of repossession, however, may be incommensurable in the sense that one must experience it to know it. In consequence, people cannot assess adequately the threat to their autonomy posed by mortgages. If people underestimate this threat, an unregulated right to mortgage will permit them heedlessly to imperil their autonomy by putting their possessions too much at risk.

This justification for limiting the ability to mortgage rests on a factual premise that is difficult to test. If people have no appreciation at all of the consequences of giving security, regulating it is uncontroversial. On the other hand, if people have as full an appreciation of what it means to mortgage as to sell, unrestricted mortgages should be allowed. No one knows, however, what people actually understand or need to understand about the mortgage decision, in the sense of understanding now at issue, nor is it clear how the relevant facts could be obtained. When the ultimate question is factual but the facts are very hard to get, it is often sensible to resolve the matter by considering the consequences of assigning to one or the other position the burden of persuasion. Section V next makes three arguments in support of the view that people should be allowed to mort-

gage whatever they are allowed to sell, at least until further facts about the mortgage decision are developed. These arguments have a common theme, which is that the restrictions on personal autonomy that seem to flow from constricting people’s ability to transact are unacceptable unless the autonomy-enhancing effects of a limited right to transact are plain. Because these latter effects are obscure in this context, the property rights objections to limiting security that are discussed here should fall.

The first argument is that the uncertainties which attend the decision to mortgage are not unique. Our society allows people to make many decisions that affect their futures in an important way, such as where and at what to work, whom to marry, whether to have children, whether to be soldiers, and where to live. People seem equally well equipped to evaluate the potentially adverse consequences to them of borrowing on the strength of a used car. Nor do these consequences appear graver than those people face in other areas where autonomy is given scope. Until new facts shatter the commonsense intuition that the mortgage decision is relevantly similar to decisions that people can now freely make, people should be allowed to mortgage.

The second argument is concerned more directly with the potentially contradictory effects on autonomy that flow from restrictions on the ability to transact. These restrictions could increase autonomy, in the sense of enabling people to keep a necessary minimum of goods or a particularly important few, but the restrictions also decrease autonomy by diminishing the set of transactions people can make. It is argued below that limiting the ability to give security decreases the autonomy of poor persons, in this latter sense, more than that of middle-class persons. The autonomy-enhancing effect of this regulation, however, is difficult to assess. When the autonomy-increasing effect of regulation is unclear but its autonomy-decreasing effect seems both clear and especially burdensome to a group commonly thought most in need of help, the regulation is unwarranted.

Respecting the effect that limiting security has on poor persons, regulation of the sort described above creates incentives for creditors to lend to better risks, raise interest rates, or shift to other forms of security such as second mortgages on homes. This change in the mix of credit offerings constricts the ability of poor people to borrow more than it constricts the middle class. Poor people are relatively bad credit risks, are less able to pay high interest rates, and seldom can offer second mortgages. To show

70 The FTC staff said of its proposed rule banning security interests in household goods that it was “not [meant] to prevent consumers from borrowing on the equity in their homes, stocks and bonds.” Credit Practices, supra note 28, at 244.
that regulation of this sort has a differential effect on the poor’s autonomy, however, it is not enough to show that the law imposes greater constraints on them. If freedom of contract poses a greater threat to the poor’s autonomy than to the autonomy of others, correspondingly greater restrictions on the poor’s ability to contract are necessary.

Two ways to show that security poses a peculiar threat to the poor exist, but neither seems persuasive. The first is to argue that the poor are less able than others to make intelligent choices between risking garnishment or foreclosure; as a result, they will risk foreclosure too frequently. The few studies of the poor’s ability to conduct commercial transactions fail to support the conclusion that they are less competent than others to make decisions of this sort.\(^{71}\) The second way to show that security poses a greater threat to the poor’s autonomy is to establish that erroneous economic choices have graver consequences for them. In this context, such an argument seems straightforward: the poor own fewer goods through which to realize themselves than do the middle class; hence, foreclosure poses a greater threat to their autonomy. For this argument to succeed, however, a theory must exist relating the nature of a loss to its effect on autonomy. No such theory is now available.

To perceive the effect of this absence, suppose that a middle-class person gives a second mortgage on his home to finance recreational expenditures. The debtor knows that he will have difficulty in paying the debt when it is due but expects to refinance it on the strength of appreciation in his home’s value. Instead, interest rates rise and housing prices fall, in consequence of which the debtor defaults and loses his home.\(^{72}\) The debtor has lost not only money but also social status, for he is no longer a homeowner; he cannot realize his life’s plan in the manner he had expected. Also, he has lost a place with which his “personhood” may have been bound up. Do losses of this sort pose less grave threats to personal autonomy than a poor person’s loss of particular household effects, such as a television? It is difficult to derive an answer to this question from either of the property theories discussed above. But if the relation between type of loss and autonomy is obscure, the claim that greater restrictions on the poor’s ability to contract are necessary because unregulated contract poses a greater threat to the poor’s autonomy cannot be sustained. Rather, what is left is the apparent fact that regulation limiting security constrains the choices of poor people more than it constrains the choices of middle-class people, even though no showing has

\(^{71}\) See Schwartz, supra note 4, at 1079–81.

\(^{72}\) For stories like this, see “Creative Financing” Comes Homes to Roost in Bankruptcy Court, Los Angeles Times, December 28, 1981, §4, at 1–2.
been made that the poor's autonomy is put more at risk by the mortgage decision. To justify a rule that makes things relatively worse for poor people, the autonomy-enhancing effects of this rule for all should be plain. The illustration above, however, seemingly fails to support this; what is to be gained from restricting security, in terms of increases in the ability of persons to lead fuller and freer lives, is quite hazy.

The third argument in support of treating mortgages like sales is that the threat to autonomy that foreclosure may pose should be dealt with in bankruptcy contexts if at all. This again is largely because of the obscurity of the relevant property theories. The theory that justifies allowing people to retain an irreducible minimum of goods in order to lead full and autonomous lives is of little help in specifying the minimum in a concrete sense, partly because the minimum varies as among persons. Also, the theory that protects "personal property" is so far unable to identify what property falls into this class apart from a few paradigm cases, again because what is personal varies with people's preferences. Restrictions on the taking of security thus will be both over- and underinclusive; they will leave particular people with too few or too many goods or goods of the wrong kind. The degree of misspecification cannot now be assessed given the relatively primitive nature of the theories. To be sure, doing some of the right thing often is preferable to doing nothing, but the issue is when the something should be done. The choice is to pursue autonomy concerns in the context of bankruptcies, largely by exempting assets, or to pursue them prophylactically, by prohibiting contracts. It was said above that giving a general answer to this question requires a fuller treatment than can be attempted here. But when so little is known about the effects—in the relevant moral sense—of restricting a particular form of contracting, it seems more appropriate because less intrusive to pursue the relevant moral concerns in the bankruptcy context, when financial disaster has actually occurred. At least then the law confronts people who plainly need help.

To summarize, moral objections to security apparently follow from a concern for personal autonomy; people should be allowed to retain a minimum of goods, or goods that have peculiar significance to them, in order to lead full and autonomous lives. The question these objections pose, however, is not whether people should have rights to things against involuntary seizure but whether whatever rights they do have are alienable. Persons should be allowed to give purchase money security interests because this form of security helps them to acquire the things in which their autonomy partly inheres. The case against security of other sorts must lie in the supposed inability of people to perceive fully the threat to their autonomy that mortgages pose; for society's moral intuitions seem
untroubled by the right people now have to sell property that they cannot fully lien. The ability of persons to mortgage, however, should be treated as the ability to sell now is. This is because moral theories that relate autonomy to the possession of things seem insufficiently developed to justify the actual interference with autonomy that restricting the ability to mortgage seemingly creates.

VI. Conclusion

The ability of parties to consumer credit transactions to contract for security interests in consumer goods has been significantly limited in recent years, and further limitations are commonly proposed. Three justifications for this regulation have been influential with decision makers: creditors systematically fail to maximize the proceeds from the sale of repossessed collateral, thereby increasing the size of the deficiency judgments that debtors must pay; repossession of consumer goods "destroys value," in the sense that debtors lose the difference between the valuation they attach to the collateral and its used goods market price, with no corresponding gain being conferred on anyone; and repossession is not done to acquire the proceeds the collateral could bring but for in terrorem purposes, to coerce repayment. The current opposition to personal property security also seems animated by moral concerns, in particular the belief that an untrammeled right to repossess will unduly erode the personal autonomy of debtors by depriving them of property necessary for the leading of full and autonomous lives.

This paper has shown that these justifications cannot support limiting the parties' ability to contract for security. Creditors have strong incentives to maximize the value of repossessed goods, and the sparse available evidence indicates that they do so. Repossessions either do not destroy value at all or merely transfer it, thereby vitiating objections to it resting on the premise that it is wasteful. In terrorem repossessions occur less frequently than is commonly supposed; and they are not morally offensive when their purpose and effect are understood. And the property rights case against security, that its use threatens personal autonomy, cannot sustain limitations on the ability of informed and competent consumers to mortgage their property.

The argument made here, however, does not assert that personal property security should be unregulated. When particular consumers are uninformed or incompetent, for example, traditional contract law reasons drawn from unconscionability theory support refusing to enforce unpleasant aspects of the contracts they make. Of greater importance, "markets for contract terms" sometimes may not reach competitive equilibria because of the expense to consumers of acquiring information about their
contracts; a good case for regulation often exists when information problems cause markets to behave badly. Regulation following from traditional unconscionability theory or that is likely to cure information problems will differ in form and effect from the restrictions on security discussed here. It is regulation of this latter type that is without coherent justification and that should not be used. Attention instead should turn to the question whether contracts to grant security interests in consumer goods raise problems similar to those thought to be raised by contracts containing broad warranty disclaimers and the like.

APPENDIX

The proof below generalizes the textual examples in Sec. IIA above to show that it always pays a creditor to maximize the proceeds of resale. For convenience, the proof assumes that the creditor’s discount rate, $r$, is zero; this assumption is relaxed at appropriate points.

$D = \text{total unpaid debt;}$

$M = \text{value of a maximizing resale;}$

$N = \text{value of a nonmaximizing resale;}$

$b = \text{discount rate for bankruptcy recovery ($0.12$ on the dollar in the text);}$

$p = \text{probability of debtor insolvency;}$

$c = \text{marginal cost per dollar of debt collected by resale;}$

$c' = \text{marginal cost per dollar of debt collected by deficiency action;}$

$R_m = \text{creditor’s recovery when he maximizes resale value;}$

$R_n = \text{creditor’s recovery when he does not maximize resale value;}$

$D - M = \text{debt remaining after a maximizing resale = A;}$

$D - N = \text{debt remaining after a nonmaximizing resale = B.}$


74 These differences should not be overstated. For example, the most appropriate response to information problems is to require disclosure, but if the costs of disclosure are excessive, an outright ban of a particular practice is occasionally the best solution. These cases, however, are unlikely to correspond closely to the cases for regulation that have been developed from the four justifications rejected here, because information problems raise quite different issues. The statutes criticized here may also be thought of as provisions of a state-supplied insurance contract; debtors pay higher interest rates but are “insured” against an unpleasant consequence that would otherwise attend default, the consequence that is repossession. The question then is whether the insurance contract is optimal. This largely is a function of whether consumers are informed, an issue beyond the scope of this paper. In addition, if these statutes are regarded as an insurance policy, other questions arise. For example, do the statutes generate an unacceptable level of moral hazard, in the sense that they help cause an excessive number of defaults? If these statutes were repealed, and if creditors had difficulty distinguishing debtors likely to default from those who are not, would low risk debtors have an incentive to grant excessively broad security interests to creditors as a way of demonstrating their creditworthiness? See Schwartz, supra note 8, at 14–21; Samuel A. Rea, Arm-breaking Consumer Credit and Personal Bankruptcy, Working Paper No, WSIV-10, L. & Econ. Workshop Ser., Univ. Toronto (1982). These questions also fall within the set of contract law reasons which, though excluded from discussion here, are of considerable importance.
If \( R_m > R_n \), it pays to maximize.

\[
R_m = (M - cM) + (1 - p)[(A + cM) - c'(A + cM)]
+ p(b)[(A + cM) - c'(A + cM)].
\]

\[
R_n = (N - cN) + (1 - p)[(B + cN) - c'(B + cN)]
+ p(b)[(B + cN) - c'(B + cN)].
\]

\( M - N = B - A \) because the difference between a maximizing and a nonmaximizing resale, \( M - N \), equals the difference between the value of the debt remaining after a nonmaximizing resale and that remaining after a maximizing resale, \( B - A \). Let \( (M - N) - c(M - N) = (B - A) - c(M - N) = X \). Consider the expression \( X > (1 - p)(X - c'X) + p(b)(X - c'X) \). The right-hand side of this inequality is always less than the left-hand side. Substituting for \( X \) yields

\[
(M - N) - c(M - N) > (1 - p)(B - A) - c(M - N) - c'(B - A) - c(M - N)
+ p(b)(B - A) - c(M - N) - c'(B - A) - c(M - N).
\]

Rearranging terms yields

\[
(M - N) + (1 - p)[(A + cM) - c'(A + cM)]
+ p(b)[(A + cM) - c'(A + cM)] > (N - cN)
+ (1 - p)[(B + cN) - c'(B + cN)] + p(b)[(B + cN) - c'(B + cN)].
\]

The expression to the left of the inequality sign is \( R_m \); the expression to the right is \( R_n \). Thus it always is the case that \( R_m > R_n \); creditors do better by maximizing resale proceeds. This result obtains independently of the costs of recovering a debt by resale as contrasted with the costs of recovery in a deficiency action.

To better understand what has been proved, focus once more on the expression

\[
X > (1 - p)(X - c'X) + p(b)(X - c'X).
\]

The left-hand side is the net difference between a value-maximizing and a nonmaximizing resale. This sum is greater than the right-hand side—the inequality is satisfied—when \( p = 0 \) or \( b = 1 \). What primarily drives the proof is the creditor’s assumed inability to recover the costs of suit; if these costs vary directly with the amounts involved, which seems likely, the creditor has an incentive to sue for as little as possible. As a consequence, he has an incentive to sell the collateral for as much as possible—to maximize resale value. Creditors often use contract clauses that attempt to impose litigation costs on debtors. Supposing such a clause to exist, if \( p = 0 \) (the debtor with certainty can respond to a damage judgment), the inequality cannot be satisfied, for the right-hand term reduces to \( X \); the creditor is indifferent to whether he maximizes or not. But it is plausible to assume that the creditor’s discount rate is positive; the right-hand side then must be divided by a number greater than one, and so becomes less than \( X \). Thus even when the debtor bears the costs of suit and can respond with certainty to any judgment against him, maximizing resale proceeds remains the profitable strategy. Finally, if \( p > 1 \) but \( b = 1 \)—the creditor can collect 100 percent on the dollar including litigation costs in a bankruptcy proceeding—the inequality also cannot be satisfied; the right-hand side once more reduces to \( X \). Again, however, if \( r > 0 \), it still pays to maximize. The significant point, though, is that \( 0 < p < 1 \) and \( 0 \leq b < 1 \) always; hence, maximizing resale proceeds is the profitable strategy regardless of whether litigation costs vary with the amounts involved, or of which party bears these costs, or of the creditor’s discount rate.