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# The Constitutional Limits of Bankruptcy

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# THE CONSTITUTIONAL LIMITS OF BANKRUPTCY

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## I. INTRODUCTION

Under the federal Constitution, Congress may enact "Laws on the subject of Bankruptcies."[1] Since the seventeenth century, the subject of bankruptcy law has been the relationship between insolvent debtors and their creditors. Recently, however, Congress and the courts have begun to interpret Congress's power under the Bankruptcy Clause without regard to the limitations implied in the words "the subject of Bankruptcies."

First, even though "bankruptcy" connotes insolvency, a debtor need not be insolvent to begin a bankruptcy case under the Bankruptcy Code.[2] Although most proceedings under the Code do involve insolvent debtors, solvent debtors have filed bankruptcy petitions to take advantage of rules under the Code, not available outside bankruptcy, that were designed to assist insolvent debtors and their creditors. For example, solvent debtors have used bankruptcy proceedings to reject burdensome contracts that they could not terminate under nonbankruptcy law.[3]

More importantly, if insolvency is not a limitation under the bankruptcy power, it logically follows that Congress could use the Bankruptcy Clause to regulate debtors and creditors generally. Although Congress has not explicitly gone so far, it did rely in part on the Bankruptcy Clause in making loan sharking a federal crime and imposing federal restrictions on wage garnishment.[4] In addition, one author has suggested that Congress could rely on the Bankruptcy Clause to enact a federal personal property security law.[5]

Second, Congress has been tempted to use bankruptcy law to solve the problems of third parties who are neither debtors nor creditors to the detriment of the insolvent debtor and her creditors. For example, Congress

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1. Clause 4 of Section 8 of Article 1 of the United States Constitution empowers Congress to "establish . . . uniform Laws on the subject of Bankruptcies throughout the United States." U.S. CONST. art. I, § 8, cl. 4.

2. 11 U.S.C. §§ 101-1330 (1994), enacted by the Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (1978). This act repealed and replaced the Bankruptcy Act of 1898, ch. 541, 30 Stat. 544 (1898), the first permanent United States bankruptcy act. For a description of the earlier bankruptcy acts, see *infra* part III.

3. *See infra* part V.A.

4. *See infra* part V.B.

5. *See, e.g.*, David M. Phillips, *Secured Credit and Bankruptcy: A Call for the Federalization of Personal Property Security Law*, LAW & CONTEMP. PROBS., Spring 1987, at 53. "Congress's power to pass bankruptcy legislation would, in itself, *surely* support the specific suggestion of this article to federalize personal property security law and integrate it with the Bankruptcy Code." *Id.* at 57 (emphasis added) ( footnotes omitted). Professor Phillips' authority for this proposition is Congress's reliance upon the Bankruptcy Clause to enact the federal restrictions on wage garnishments of the Consumer Credit Protection Act, discussed *infra* note 380 and accompanying text. The word "surely" in this statement is surely a tip-off that the author's conclusion is not so sure.

required a bankrupt railroad to finance an assistance program for employees who lost their jobs.[6] Congress and the courts have also impaired the rights of third parties to benefit insolvent debtors and their creditors. An example is the abolition in bankruptcy of the state law rights of a non-debtor co-tenant by the entireties.[7]

The recent expansion of the "subject of Bankruptcies" beyond its historic domain has occurred almost silently because, over the last 100 years, courts and scholars have given little thought to the metes and bounds of the Bankruptcy Clause.[8] Some have suggested that the "'subject of bankruptcies is incapable of final definition.'"[9] On the few occasions when courts or scholars have addressed the scope of the bankruptcy power, most have left the impression that the bankruptcy power is like one theory of the universe: It is constantly expanding.[10] Frank Kennedy has suggested that

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6. *See infra* text accompanying note 399.

7. *See infra* text accompanying note 435.

8. Bankruptcy was once considered a dismal topic. CHARLES WARREN, BANKRUPTCY IN UNITED STATES HISTORY 3 (1935): "Bankruptcy is a gloomy and depressing subject. The law of bankruptcy is a dry and discouraging topic." Recently, bankruptcy law has generated a lively and rich debate among scholars about its purposes and meaning. *See, e.g.*, *The Washington University Interdisciplinary Conference on Bankruptcy and Insolvency Theory*, 72 WASH U. L.Q. 797 (1994). *See also infra* notes 20-21, 46, 388-89, and accompanying text. The constitutional limits of bankruptcy, however, have not received comparable attention.

9. Railway Labor Executives' Ass'n v. Gibbons, 455 U.S. 457, 466 (1982) (quoting Wright v. Union Cent. Life Ins. Co., 304 U.S. 502, 513-14 (1938)). *Wright* is discussed *infra* note 316 and accompanying text.

10. *See, e.g.*, WARREN, *supra* note 8, at 9-10; COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. DOC. NO. 137, 93d Cong., 1st Sess., pt. 1, at 64 (1973) [hereinafter BANKRUPTCY COMMISSION REPORT]. "There has also been a continuing expansion of the meaning of the word 'bankruptcies' as used in the Constitution that has legitimated evolutions in bankruptcy law, such as the introduction of discharge and arrangement and reorganization provisions, since the time of the adoption of the Constitution." *Id.* The Bankruptcy Commission was formed in 1970 to make recommendations for changes in the then Bankruptcy Act of 1898. Its report lead to the enactment of the current Bankruptcy Code in 1978. As discussed in detail below, this statement by the 1973 Bankruptcy Commission is fundamentally wrong. Discharge and arrangement were important parts of English and American bankruptcy and insolvency legislation before the Constitution, and reorganization, a later phenomenon, is a logical extension of the earlier possibilities for relief.

Justice Brennan, in Regional Rail Reorganization Act Cases, 419 U.S. 102 (1974) (rejecting claims that the Regional Rail Reorganization Act was unconstitutional as violating the Fifth Amendment taking prohibition and the uniformity requirement of the Bankruptcy Clause), quoted an earlier Supreme Court bankruptcy case and noted that the Regional Rail Reorganization Act "'advances another step in the direction of liberalizing the law on the subject of bankruptcies.'" *Id.* at 153 (quoting Continental Ill. Nat'l Bank. & Trust Co. v. Chicago, Rock Island & Pacific Ry., 294 U.S. 648, 671 (1935)). *See infra* note 309 and

Congress has full discretion to define the boundaries of its power under the Bankruptcy Clause.[11]

To be sure, within the confines of the "subject of Bankruptcies" Congress has complete discretion, subject only to the now weak requirement for uniformity.[12] It may, subject only to a few other provisions of the Constitution, such as the Fifth Amendment,[13] impair the contract rights and the property rights of insolvent debtors and their creditors or impose additional duties on them.[14] Nevertheless, this discretion *within* the subject

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accompanying text.

11. Frank R. Kennedy, *Bankruptcy and the Constitution, in* BLESSINGS OF LIBERTY: THE CONSTITUTION AND THE PRACTICE OF LAW 131, 137-38 (American Law Inst.-American Bar Ass'n Comm. on Continuing Professional Educ. ed., 1988).

> The argument that a focus on the scope of the bankruptcy power is preferable to a concern with the limitations on its exercise by the amendments [to the Constitution] is of course a plea for according nearly conclusive effect to Congressional enactments on the subject of bankruptcy. When the variety of the provisions enacted by Congress and the frequency and range of attacks on their constitutionality are considered, it must be concluded that the courts have indeed come close to permitting Congress complete freedom in formulating and enacting bankruptcy legislation.

*Id.* The argument to which Professor Kennedy refers was made by James S. Rogers, *The Impairment of Secured Creditors' Rights in Reorganization: A Study of the Relationship Between the Fifth Amendment and the Bankruptcy Clause*, 96 HARV. L. REV. 973, 1031 (1983).

12. *See generally* Judith S. Koffler, *The Bankruptcy Clause and Exemption Laws: A Reexamination of the Doctrine of Geographic Uniformity*, 58 N.Y.U. L. REV. 22 (1983) (criticizing the view that a bankruptcy law is "uniform" if it merely incorporates state law, such as the state law on what property that individual debtors may exempt from the claims of creditors in a bankruptcy case). The Supreme Court weakened the application of geographical uniformity in Regional Rail Reorganization Act Cases, 419 U.S. 102 (1974), when it upheld as uniform a law that applied only to railroads in the northeast and midwest United States on the grounds that these railroads were the only railroads in the country undergoing a certain type of reorganization. *Id.* at 159-60.

13. This Article focuses only on the "subject of Bankruptcies" without regard to the limitations imposed by the uniformity requirement, *see generally* Koffler, *supra* note 12, or the Fifth Amendment, *see generally* Rogers, *supra* note 11.

14. On policy grounds, Congress considered and rejected the idea of allowing creditors to petition a debtor involuntarily into a bankruptcy case under chapter 13, which allows individuals with regular income, pursuant to 11 U.S.C. §§ 1301-1330 (1994), to propose a repayment plan for their creditors and retain their property. H.R. REP. NO. 595, 95th Cong., 2d Sess. 120 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6080-81. The House Report also cited an earlier suggestion that a mandatory Chapter XIII case under the Bankruptcy Act of 1898, the precursor to Chapter 13, would violate the 13th Amendment prohibiting involuntary servitude. *Id.* There is no doubt that a mandatory repayment obligation would be within the scope of the "subject of bankruptcies." Before and after the adoption of the Constitution, Delaware's debtor relief statute required mandatory service for the repayment of debt as a condition of release from imprisonment for debt. *See infra* note 176 and accompanying text. One of the British insolvency acts similarly provided for

of bankruptcies does not imply that Congress has complete discretion to define the *boundaries* of the "subject of Bankruptcies." Could anyone believe, for example, that Congress could use the Bankruptcy Clause as the basis for banning guns from within 1,000 feet of schools?[15] I think not.

As Congress continues its efforts to revise the Code,[16] this Article proposes that Congress and the courts reaffirm the constitutional limits of bankruptcy law.[17] Under the Bankruptcy Clause, Congress may only enact

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indentured servitude. *See infra* note 148 and accompanying text.

15. *See, e.g.*, United States v. Lopez, 115 S. Ct. 1624, 1644-48 (1995). Perhaps the rationale would proceed as follows: If school children cannot carry guns to school, they will be less likely to buy them; if they are less likely to buy them, gun manufacturers will lose sales, and some manufacturers will have a greater risk of bankruptcy. This reasoning suggests another sillier outcome: perhaps Congress should mandate the possession of guns in school. Compare this reasoning with that of the dissent in *Lopez*, *id.* at 1661-62: gun related violence impedes education, which impedes worker's ability to get better jobs and hurts communities and businesses, which in turn affects the economic well being of the nation; therefore, banning guns from school is a regulation of "commerce among the States."

16. Pursuant to the Bankruptcy Reform Act of 1994, Congress has created a National Bankruptcy Review Commission to study the Code and recommend further changes. Pub. L. No. 103-394, 108 Stat. 4106 (1994). The current Code has been amended several times by, among others, the Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, 98 Stat. 333 (1984); the Leasehold Management Bankruptcy Amendments Act of 1984, Pub. L. No. 98-353, 98 Stat. 333 (1984); the Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986, Pub. L. No. 99-554, 100 Stat. 3088 (1986); the Retiree Benefits Bankruptcy Protection Act of 1988, Pub. L. No. 100-334, 102 Stat. 610 (1988); and the Criminal Victims Protection Act of 1990, Pub. L. No. 101-647, 104 Stat. 4916 (1990).

17. The scope of the Bankruptcy Clause also reveals how Congress and the courts have so completely transformed the Commerce Clause, which empowers Congress to "regulate Commerce . . . among the several States." U.S. CONST. art. I, § 8, cl. 3. It reminds us that the Framers intended the Commerce Clause to have a much narrower meaning than current interpretation has given it. Within its proper sphere—adjusting the relations of insolvent debtors and their creditors—the Bankruptcy Clause is broader than the Commerce Clause. It allows Congress to affect the rights and liabilities of insolvent debtors and their creditors within a state as well as among the states. On the other hand, although broader in its subject matter—commerce—the Commerce Clause limits Congress to regulating commerce only "among the States."

In the area of commerce, the Supreme Court has abandoned the historical limits on the Commerce Clause and has allowed regulation of activity that merely affects interstate commerce. *See, e.g.*, Wickard v. Filburn, 317 U.S. 111 (1942) (holding that the Commerce Clause empowered Congress to forbid a farmer from raising wheat for consumption on his own farm by his own family and livestock). Although the Supreme Court's decision in United States v. Lopez, 115 S. Ct. 1624 (1995), applied the Commerce Clause limits to overturn Congress's effort to ban weapons from schools, *Lopez* was the first such opinion to do so in over fifty years. Similarly, scholars are beginning to question the breadth of the Court's interpretation of the clause. *See, e.g.*, Glenn Reynolds, *Is Democracy Like Sex?*, 48 VAND. L. REV. 1635, 1648-59 (1995). Nevertheless, the principal dissent in *Lopez* believed

legislation that regulates the relationship between an insolvent debtor and her creditors. This statement contains two components:

*1. The debtor must be insolvent in some sense.* Insolvency means either balance sheet insolvency, that is, the debtor's liabilities exceed her assets, or cash flow insolvency, that is, she is unable generally to pay current debts as they become due.[18] The insolvency of the debtor in this sense is a jurisdictional requirement for invoking a bankruptcy proceeding. Moreover, because insolvency is a jurisdictional requirement, the bankruptcy power does not extend to the general regulation of debtors and creditors. The bankruptcy power, for example, does not authorize Congress to enact a federal debt collection statute prescribing how creditors may extend credit to debtors or how creditors may collect debts from their debtors generally.

*2. A bankruptcy law may not create direct entitlements or liabilities for parties other than debtors and their creditors.* A bankruptcy law is for the benefit of insolvent debtors and creditors.[19] It should neither benefit third

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that the Commerce Clause authorized the law in question. It maintained that preventing violence in schools enhanced education, and education enhanced the national economy. *Lopez*, 115 S. Ct. at 1661-62 (Breyer, J., dissenting). If, however, the Framers truly intended the Commerce Clause to authorize any legislation that "affected" interstate commerce or that enhanced the national economic well being, there would have been no need for the Bankruptcy Clause. Further, the mode of constitutional analysis that has all but consumed the Commerce Clause has begun to infect the Bankruptcy Clause.

18. A debtor can be solvent in the balance sheet sense and still be insolvent in the cash flow sense. This typically arises when the debtor has illiquid assets, such as real estate, that cannot be quickly converted into cash, but insufficient liquid assets, such as cash, to pay current debts. The Code uses both concepts. For most debtors, the term "insolvent" in the Code means balance sheet insolvency. 11 U.S.C. § 101(32)(A), (B) (1994). For municipalities filing for bankruptcy relief under Chapter 9 of the Code, "insolvent" defines a form of cash flow insolvency: "generally not paying its debts as they become due unless such debts are the subject of a bona fide dispute or unable to pay its debts as they become due." *Id.* § 101(32)(C). As discussed below, cash flow insolvency also appears in 11 U.S.C. § 303(h)(1) (1994). *See infra* note 32 and accompanying text.

19. Insolvency implies the existence of debts and creditors, and if an entity other than the debtor is to be a direct beneficiary of bankruptcy it must be a creditor. For purposes of this Article, I use the term "creditor" as it is defined in the Code. This definition is very broad. A "creditor" includes any "entity that has a claim against the debtor that arose at the time of or before the order for relief concerning the debtor." 11 U.S.C. § 101(10)(A) (1994). A "claim" includes a "right to payment, whether or not such right is reduced to judgement, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured." *Id.* § 101(5)(A). Thus, it includes not only consensual lenders of money but also parties to contracts, tort claimants, and anyone who has a potential right to payment as a result of conduct or status of the debtor before the initiation of a bankruptcy case.

In addition, for purposes of this Article, I bifurcate people according to their roles. Thus, to the extent that an individual has a pre-petition debt, she is a creditor. If she also has some other right, such as a right under a lease to enjoy possession of personal property

parties at the expense of debtors and creditors nor harm third parties for the benefit of debtors and creditors.

This requirement does not preclude any effects on third parties as by-products of adjusting the relationship between insolvent debtors and their creditors. Any provision of a bankruptcy law changing this relationship may adversely or favorably affect society as a whole or specific third parties.[20] For example, a law abrogating the security interest of secured creditors in bankruptcy would no doubt affect the lending practices and costs of borrowers and lenders generally.[21] Such a law falls within Congress's bankruptcy power because it would adjust the relationship between an insolvent debtor and her creditors. The indirect effect on other borrowers and creditors does not violate the constitutional limitation.

The reorganization provisions of the Bankruptcy Code present another example. To the extent that they allow an insolvent corporate debtor and its creditors to adjust their relationship without liquidation and for the benefit of either the debtor (that is, the equity holders) or the creditor, the indirect by-product of continuing employment for employees and continuing business for suppliers is permissible. Congress may not require, however, that a corporation stay in business to provide continuing employment or business opportunities for suppliers when reorganization is not possible or is no longer benefits the corporate debtor or its creditors. Congress may not, in effect, require the assets otherwise available to pay the creditors to be consumed in wages for the employees and continued business for the suppliers. This type of requirement would be an impermissible benefit for third parties to the detriment of the creditors and the insolvent debtor.

Both of the two elements discussed above are important for the principled construction of the Constitution. If some form of insolvency is not required, then the Bankruptcy Clause empowers Congress to regulate all debtor-creditor relations without regard to their relation to interstate commerce.[22] To be sure, whether and when a debtor becomes insolvent in either sense may present difficult factual and conceptual questions. But that is true for any legal rule that sets a limit. Notwithstanding these difficulties, insolvency in the balance sheet sense or in the cash flow sense marked the boundary of the subject of bankruptcy at the time of the adoption of the Constitution.[23] Bankruptcy connotes insolvency. Difficulties in drawing

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leased to her, she in not a creditor in this capacity, even if the lease also makes her a creditor with respect to obligations owed to her by the debtor/lessor.

20. *See* Robert K. Rasmussen, *An Essay on Optimal Bankruptcy Rules and Social Justice*, 1994 U. ILL. L. REV.1, 12.

21. *See, e.g.*, Lucian A. Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE L.J. 857 (1996); Rasmussen, *supra* note 20, at 12-13.

22. *See infra* part V.

23. One could make the case that as a matter of policy bankruptcy law should address

a line required by the Constitution should not allow us to ignore that line or to suggest that the line really does not exist.

The second element precludes using a bankruptcy proceeding as a pretext for providing direct benefits or harms to third parties who are not debtors and their creditors, such as a law requiring a bankrupt debtor to provide a one year severance package for employees. Unfortunately, Congress and courts have occasionally crossed this line, and members of Congress have exhibited a desire to use the Bankruptcy Code to further the interests of third parties.[24] If furthering these interests is desirable, Congress should do so under its appropriate constitutional authority, or leave such legislation for the states if no Congressional authority exists.

Finally, ignoring both elements would enable Congress to legislate on anything it deems desirable. Without both limitations, there really is no limit to the Bankruptcy Clause.

The limits I discuss derive from the original intention of the Framers of the Constitution. They spring from the rich and varied efforts of eighteenth century English and American legislatures to resolve the problems of insolvency of individuals. Except for the need to adjust these efforts to the development of the modern corporation and other artificial entities engaged in business activity that permit limited liability for individual investors, practically all of the essential elements of the current Bankruptcy Code reflect ideas that appeared in one form or another in English or early American bankruptcy or insolvency legislation, as well as the concerns underlying that legislation. The limits I discuss are also consistent with the leading cases on the constitutionality of particular bankruptcy acts. Only recently, because of a creeping loss of our constitutional memory, have Congress and the courts slipped beyond the boundaries of the "subject of Bankruptcies."[25]

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the debtor who is experiencing financial difficulty but who is not yet insolvent. Unfortunately, there does not seem to be any principled way to capture this limitation. Despite its difficulties, "insolvency" is a principle upon which we can rely to make a distinction between bankruptcy law and general debtor-creditor law.

24. *See infra* part VI.

25. *See infra* parts V. and VI. Professor Kennedy suggests that the history of the construction of the bankruptcy clause is a paradigm of the departure from the "original intent" of the Constitution. Kennedy, *supra* note 11, at 137. I disagree. Unlike more controversial provisions of the Constitution (e.g., the Commerce Clause, the Fourth Amendment, and the Fourteenth Amendment) the Bankruptcy Clause has not undergone a dramatic transformation from one interpretation to another. In my view, as discussed below in part IV, all of the presumed "expansions" of Congress's bankruptcy acts adjudicated by the Supreme Court fall well within the original intent of the Bankruptcy Clause. Perhaps because they have become accustomed to the extensive exercise a federal power limited only by the Bill of Rights, Congress (except in one instance discussed *infra* in part VI.B.) and the courts are not so much misinterpreting the Bankruptcy Clause as they are ignoring it. In my view, the Bankruptcy Clause falls outside the debate over originalism and non-originalism

This Article discusses these points as follows. To provide the context for the analysis that follows, part II briefly describes the essential elements of the Bankruptcy Code for those readers not familiar with the Code. Part III examines the English and American efforts before the adoption of the Constitution to address the problem of insolvent debtors. Part IV reviews the development of the subsequent American bankruptcy acts and the challenges to their constitutionality in light of the earlier English and American experience.

Part V examines the limitation of the bankruptcy power to debtors who are insolvent in a balance sheet or cash flow sense. Part VI examines the prohibition against bankruptcy laws that create entitlements for third parties, that is, those who are neither debtors nor creditors, at the expense of insolvent debtors and their creditors or that harm third parties for the benefit of the insolvent debtor or its creditors. It also explores the issue of how to treat those who may have claims against an insolvent debtor, such as claims for latent injuries from pre-bankruptcy conduct, that will not become known until long after a bankruptcy proceeding.[26]

## II. THE ESSENTIAL FEATURES OF THE CURRENT SYSTEM

This part briefly describes the essential elements of the Bankruptcy Code to provide a context for the discussion that follows. Bankruptcy laws have traditionally been procedural statutes providing a means by which a debtor and all her creditors may readjust their relationship when the debtor became insolvent.[27] Under the present Bankruptcy Code, as in every earlier

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in constitutional interpretation. *See, e.g.*, *Symposium: Originalism, Democracy, and the Constitution*, 19 HARV. J.L. & PUB. POL'Y 237 (1996).

26. The "creditor" with extremely contingent rights to payment, such as an unmanifested injury from exposure to hazardous substances that may not develop for 20 years, has troubled courts. *See infra* part VI.C. Including these potential victims as creditors no doubt stretches the Bankruptcy Clause about as far as it can go. Nevertheless, to the extent that nonbankruptcy law recognizes extremely contingent claims, the holders of these claims may be subject to the bankruptcy power. If they are not creditors, however, bankruptcy law may not directly affect them.

27. *See* H.R. REP. NO. 595, 95th Cong., 2d Sess. 10 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5963, 5971 (footnotes omitted):

> The present purposes of the Bankruptcy Act [of 1898] are twofold: either to rehabilitate financially a distressed debtor or to assemble and liquidate his assets for distribution to creditors.
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> In either kind of proceeding, the nature of bankruptcy is to sort out all of the debtor's legal relationships with others, and to apply the principles and rules of the bankruptcy laws to those relationships. Bankruptcy is mainly a procedural device, prescribing the method of accomplishing rehabilitation or liquidation, but generally leaving undisturbed legal relationships that existed before bankruptcy. To this end, the Bankruptcy Act incorporates State and general Federal law in many important areas.

bankruptcy statute, a bankruptcy case begins with a simple petition. With a few exceptions,[28] any individual or entity may commence a "voluntary" case,[29] for which generally there is no requirement of insolvency in any sense.[30] In addition, three or more holders of claims of more than $10,000 can begin an involuntary case against most individuals or entities under Chapters 7 or 11.[31] The debtor may have an involuntary case dismissed if it can show that it is solvent in a liquidity or cash flow sense.[32]

The distinction between a "voluntary" and an "involuntary" case is less than the words suggest.[33] As has long been recognized, a debtor usually commences a voluntary case only when it is forced to do so because of some manifestation of insolvency.[34] This could include a creditor seizing

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28. Domestic and foreign (if engaged in business in the United States) insurance companies, banks, savings banks, cooperative banks, savings and loan associations, building and loan associations, homestead associations, credit unions, and domestic licensed small business investment companies, industrial banks, and similar institutions which are insured banks as defined in the Federal Insurance Act may not be debtors under the Code. 11 U.S.C. § 109(b)(2), (d). Railroads may only file a petition for reorganization under Chapter 11 of the Code, *id.* § 109(b)(1), (d), and stock brokers and commodity brokers may only file a petition for liquidation under Chapter 7 of the Code, *id.* § 109(b), (d).

29. *Id.* § 301.

30. Municipalities may file a petition under Chapter 9 if they meet certain requirements, including a requirement that they be insolvent in a cash flow sense. *Id.* §§ 109(c), 101(32)(C). *See supra* note 18. Farmers and wage earners may also file petitions for special proceeding under Chapters 12 and 13, respectively. *Id.* § 109(e), (f).

31. *Id.* § 303. For a holder of a claim to be eligible to file a petition, the claims of the holder may not be contingent as to liability or subject to a bona fide dispute. *Id.* § 303(b). If there are fewer than 12 such holders, one or two holders of claims aggregating $10,000 may commence an involuntary case. *Id.* § 303(b)(2). Creditors may not, however, begin an involuntary case against a person that is a "farmer, family farmer, or a corporation that is not a moneyed, business, or commercial corporation." *Id.* § 303(a).

32. *Id.* § 303(h)(1): "[A]fter trial, the court shall order relief against the debtor in an involuntary case under the chapter under which the petition was filed, only if—(1) the debtor is generally not paying such debtor's debts as such debts become due unless such debts are the subject of a bona fide dispute."

33. Although the English bankruptcy acts were nominally limited to "involuntary" proceedings, insolvent debtors frequently initiated such proceedings by inducing a friendly creditor to begin a proceeding. *See infra* text accompanying notes 116-26.

34. *See* Max Radin, *The Nature of Bankruptcy*, 89 U. PA. L. REV. 1, 7 (1940) (remarking that the difference between involuntary and voluntary proceedings "does not affect the nature of bankruptcy. Every form of enforcement of a debt is 'involuntary' as far as the debtor is concerned"); *see also* DOUGLAS G. BAIRD & THOMAS H. JACKSON, CASES, PROBLEMS, AND MATERIALS ON BANKRUPTCY 89 (2d ed. 1990); Douglas G. Baird, *The Reorganization of Closely Held Firms and the "Opt Out" Problem*, 72 WASH. U. L.Q. 913, 926-27 (1994) [hereinafter, Baird, *Closely Held Firms*]; Samuel L. Bufford, *What Is Right About Bankruptcy Law and Wrong About Its Critics*, 72 WASH. U. L.Q. 829, 835 (1994); Lynn M. LoPucki, *The Debtor in Full Control—Systems Failure Under Chapter 11 of the*

the debtor's personal property,[35] a real estate lender beginning foreclosure proceedings against the debtor's real estate,[36] the commencement of massive tort litigation against the debtor,[37] or the entry of judgments against the debtor.[38]

There are two basic types of bankruptcy case. In a case under Chapter 7, the debtor or its creditors seek a liquidation of the debtor's assets and liabilities. An appointed trustee gathers the assets of the debtor and liquidates them to pay off the creditors. An individual debtor may retain certain exempt property[39] and will receive a discharge of most debts[40] so that she can obtain a "fresh start" unburdened by those debts.

In a case under Chapter 11, the debtor (usually against the wishes of the creditors) hopes to avoid liquidation and seeks to reorganize its affairs and stay in business.[41] The debtor may retain control of its affairs, may continue to operate its business as the "debtor-in-possession," and may exercise most of the powers of a trustee.[42] The debtor-in-possession has the exclusive right for the first 120 days to propose a plan of reorganization.[43] After that time (and any extensions granted to the debtor-in-possession), creditors may propose plans of reorganization or may seek liquidation.[44]

A Chapter 11 reorganization plan can take several forms. It may call for selling the business as a going concern and using the proceeds of the sale to pay the creditors. Alternatively, it may provide that the unsecured creditors trade their claims for stock in a reorganized entity that will continue in business. Or, the plan may simply change the way the entity conducts business so that existing creditors can be repaid. The theory behind reorganization is that keeping the business alive is better for creditors

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*Bankruptcy Code*, 57 AM. BANKR. L.J. 99, 100, 115 (1983) (reporting that 38 of the 48 Chapter 11 filings in the Bankruptcy Court for the Western District of Missouri during the first year after the effective date of the Code, October 1, 1979-September 30 1980, were a direct response to legal action by a creditor that would have seized the debtor's property or closed the debtor's business within two weeks, and concluding, "While [most of the debtors'] petitions are designated as 'voluntary' in a very real sense they were not.")

35. *See, e.g.*, United States v. Whiting Pools, Inc., 462 U.S. 198 (1983).

36. *E.g.*, Dewsnup v. Timm, 502 U.S. 410 (1992).

37. *E.g.*, *In re* Johns-Manville Corp., 36 B.R. 727 (Bankr. S.D.N.Y. 1984) (15,500 lawsuits pending against the debtor at the time of the filing of the petition).

38. *E.g.*, *In re* A.H. Robins Co., 89 B.R. 555 (Bankr. E.D. Va 1988) (the debtor had settled about 9,000 tort claims for $530 million).

39. 11 U.S.C. § 522 (1994).

40. *Id.* §§ 727, 523, 524.

41. Chapters 9, 12, and 13 also provide for reorganization of municipal governments, family farmers with regular annual income and individuals with regular income.

42. 11 U.S.C. §§ 1101(1), 1107, 1108 (1994).

43. *Id.* §§ 1121(a),(b).

44. *Id.* §§ 1112(b), 1121(c).

because doing so is a more efficient use of assets than liquidation.[45] There is some doubt about the validity of these assumptions.[46] There is little doubt, however, that reorganizations produce more short term benefits for non-creditor beneficiaries, such as managers, other employees, and local taxing authorities (and accountants and lawyers), than do liquidations.

In either a liquidation or a rehabilitation, the Code establishes a simple procedure for determining the existing liabilities of the debtor. The creditor (or the debtor) can file a proof of claim.[47] If no party in interest objects, the claim will be allowed.[48] If any party in interest objects to the proof of claim, the bankruptcy court must determine the amount of the claim and allow that amount.[49] If someone has a claim against the debtor and that claim arose before the order for relief, she must participate in the bankruptcy case, or she will receive nothing from the liquidation or reorganization of the debtor.[50]

Filing a petition creates an estate. The estate consists primarily of "all legal or equitable interests of the debtor in property as of the commencement of the case."[51] In addition, the trustee (including the debtor-in-possession in Chapter 11 cases)[52] has certain powers to enhance the bankruptcy estate of the debtor by avoiding certain pre-petition transfers of property or pre-petition obligations.[53] The trustee may take additional

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45. *See* H.R. REP. NO. 595, 95th Cong., 2d Sess. 220 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6179.

46. *See, e.g.*, Barry E. Adler, *Bankruptcy and Risk Allocation*, 77 CORNELL L. REV. 439 (1992); James W. Bowers, *Rehabilitation, Redistribution or Dissipation: The Evidence for Choosing Among Bankruptcy Hypotheses*, 72 WASH. U. L.Q. 955 (1994); James W. Bowers, *Whither What Hits the Fan?: Murphy's Law, Bankruptcy Theory, and the Elementary Economics of Loss Distribution*, 26 GA. L. REV. 27 (1991); Michael Bradley & Michael Rosenzweig, *The Untenable Case for Chapter 11*, 101 YALE L.J. 1043 (1992) (based on an empirical analysis). Bradley & Rosenzweig's analysis has been criticized. *See* Donald H. Korobkin, *The Unwarranted Case Against Corporate Reorganization: A Reply to Bradley and Rosenzweig*, 78 IOWA L. REV. 669 (1993); Lynn M. LoPucki, *Strange Visions in a Strange World: A Reply to Professors Bradley and Rosenzweig*, 91 MICH. L. REV. 79 (1992); Elizabeth Warren, *The Untenable Case for Repeal of Chapter 11*, 102 YALE L.J. 437 (1992).

47. 11 U.S.C. §§ 501, 1111(a) (1994).

48. *Id.* § 502(a).

49. *Id.* § 502(b).

50. This rule is implemented primarily through the Code's use of the defined term "creditor," which means an "entity that has a claim against the debtor that arose at the time of or before the order for relief concerning the debtor." *Id.* § 101(10).

51. *Id.* § 541(a)(1) (1994).

52. The "debtor in possession" means the debtor unless a separate trustee has been appointed. *Id.* § 1101(1). The debtor in possession has most of the powers of a trustee under the Code. *Id.* § 1107. In Chapter 11, the debtor as a debtor in possession—existing management, in the case of a corporation—retains significant control of the bankruptcy case.

53. These include the power to avoid preferential transfers to creditors on account of

actions to benefit the estate, such as assume or reject executory contracts between the debtor and third parties,[54] use or dispose of property of the estate,[55] and borrow money secured by property of the estate.[56] The filing of a petition also automatically stays all actions by creditors to collect their debts.[57]

Finally, the Code recognizes the property interests that persons, such as secured creditors, have in the debtor's property,[58] prescribes the priorities for distribution of the assets of the debtor among creditors in the case of liquidations,[59] requires meetings of creditors, and prescribes the procedures for devising and implementing a plan of reorganization in Chapter 11.[60]

## III. THE SUBJECT OF BANKRUPTCIES BEFORE THE CONSTITUTION

As I discuss in parts IV and V below, some courts and scholars have taken the view that the Framers intended the Bankruptcy Clause to authorize a bankruptcy system reflecting the English bankruptcy acts of the eighteenth century. Indeed, the first American bankruptcy act, passed in 1801, was a virtual copy of the existing English statutes. Later acts gradually expanded the scope of the bankruptcy laws. From this development, courts and scholars have concluded that the boundaries of the Bankruptcy Clause are constantly expanding to meet the new demands and forms of commercial and business development.[61]

Modern American bankruptcy is different from the system under the eighteenth century English bankruptcy acts. Modern American bankruptcy allows voluntary proceedings for practically all entities. The eighteenth century English bankruptcy system permitted ostensibly involuntary proceed-

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antecedent debts made within 90 days of the filing of a petition, *id.* § 547, to avoid transfers of the debtor's property that actually or constructive defraud its creditors, *id.* § 548, to avoid certain transfers of property or the creation of certain obligations that a hypothetical lien creditor or, in the case of real property, a bona fide purchaser of real property could have avoided, *id.* § 544, and to require persons who have property of the debtor to return it to the trustee, *id.* §§ 542, 543.

54. *Id.* § 365.

55. *Id.* § 363 (1994).

56. *Id.* § 364.

57. Filing a petition automatically stays any acts to begin or continue any proceedings against the debtor; to enforce or collect any judgment or claim against the debtor, its property or property of the estate; to exercise control over property of the estate; to create, perfect or enforce any lien against property of the estate or the debtor's property; or to set off any debt owed to the debtor. *Id.* § 362.

58. *Id.* § 725.

59. *Id.* § 726 (1994).

60. *Id.* §§ 1101-1114, 1121-1129, 1141-1146.

61. *See supra* notes 8-11 and accompanying text and *infra* notes 309, 320, 329, and accompanying text.

ings by creditors only against merchants and traders. Relying on these differences, however, to conclude that the subject of bankruptcy has been constantly expanding is both superficial and myopic. Such reliance is superficial because both systems address essentially the same problem—resolving the relationship between insolvent debtors and their creditors. In this context the differences shrink to matters of detail. Such reliance is myopic because it ignores the role of the English insolvency acts and the multifaceted approaches of the American acts passed before the Constitution in addressing that relationship. The details of how the insolvent debtor-creditor relationship should be adjusted varied over time and among jurisdictions, but the essential problems posed by this relationship did not. From an analysis of these laws, we see that the "subject of Bankruptcies" has remained stable, even as the means of addressing the subject of bankruptcies have changed.

### *A. The English Bankruptcy Acts*

As has been well documented, the English Parliament first passed bankruptcy acts for the benefit of creditors, not for the protection of debtors.[62] They initially represented one effort to fill the void in the law for dealing with debtors who refused to repay their creditors by providing a collective creditors' remedy.[63] In the first bankruptcy act, enacted in 1542 during the reign of King Henry VIII, only creditors could initiate a bankruptcy proceeding against persons who committed certain fraudulent acts.[64] Under the second bankruptcy act, the Statute of 13 Elizabeth, which was enacted in 1570 during the reign of Queen Elizabeth I[65] and which remained in effect for the next 250 years,[66] they could do so only against "merchants" who committed certain "acts of bankruptcy." Debtors in bankruptcy did not receive a discharge from debts until 1705,[67] and Parliament the following year conditioned a discharge on the consent of 80% of the creditors in both number and value of the debts.[68]

Aside from the restrictions on discharge and the limiting of bankruptcy to involuntary petitions against merchant debtors, the essential elements of

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62. Charles J. Tabb, *The History of the Bankruptcy Laws in the United States*, 3 AM. BANKR. INST. L. REV. 5, 6-12 (1995) [hereinafter Tabb, *History*]; Charles J. Tabb, *The Historical Evolution of the Bankruptcy Discharge*, 65 AM. BANKR. L.J. 325, 329-331 (1991) [hereinafter Tabb, *Discharge*].

63. Tabb, *Discharge*, *supra* note 62, at 328.

64. 34 & 35 Hen. 8, ch. 4 (1542-1543) (Eng.); *see infra* note 76.

65. 13 Eliz., ch. 7 (1570) (Eng.).

66. It was repealed by 5 Geo. 4, ch. 98, § 1 (1824) (Eng.).

67. 4 Anne, ch. 17, § 7 (1705) (Eng.); *see infra* note 93 and accompanying text.

68. 5 Anne, ch. 22, §§ 2, 7 (1706) (Eng.) (requiring the consent of 80% in terms of number and value of the creditors holding debts); *see infra* note 96 and accompanying text.

the English bankruptcy acts[69] bear a remarkable resemblance to a modern liquidation case under Chapter 7 of the Code. Under the English bankruptcy acts, upon a petition of creditors, the Lord Chancellor would issue against the debtor a "Commission of Bankrupt" naming several commissioners to conduct the proceedings.[70] The commissioners examined the debtor about his or her property and dealings, and the debtor was obligated to transfer all property to the commissioners.[71] The commissioners conducted meetings of creditors. At such meetings, the creditors appointed assignees to liquidate the debtor's property.[72] The commissioners also received proofs of creditors' claims.[73] Creditors who proved their claims received a pro rata dividend from the liquidation of the debtor's property after the payment of expenses.[74]

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69. By the 1732 Statute of 5 George 2, 5 Geo. 2, ch. 30, § 1 (1732) (Eng.), the English bankruptcy acts had become fairly stable. The 1732 Statute of 5 George 2, entitled "An Act to prevent the Committing of Frauds by Bankrupts," revised and expanded without significant change several earlier bankruptcy acts that had expired, principally, 4 Anne, ch. 17 (1705) (Eng.), as amended by 5 Anne, ch. 22 (1706) (Eng.). *See infra* notes 93-97 and accompanying text. The Statute of 4 Anne was to expire after several years, but it was extended periodically by Parliament until several years before the enactment of the 1732 Act. *See* Tabb, *Discharge*, *supra* note 62, at 340 n.96. This act, along with the 1570 Statute of 13 Elizabeth, as amended, *see infra* notes 119-20, constituted the form of the English bankruptcy law in effect at the time of the adoption of the Constitution in 1787. Tabb, *History*, *supra* note 62, at 12; Tabb, *Discharge*, *supra* note 62, at 340, 344. The 1732 Act remained in effect until the end of the session of Parliament ending after June 1735. It was further continued by 9 Geo. 2, ch. 18 (1736) (Eng.); 16 Geo. 2, ch. 27 (1743) (Eng.); 24 Geo. 2, ch. 57, § 8 (1751) (Eng.); 31 Geo. 2, ch. 35 (1757) (Eng.); 4 Geo. 3, ch. 36, § 1 (1764) (Eng.); 12 Geo. 3, ch. 47 (1772) (Eng.); 21 Geo. 3, ch. 29 (1781) (Eng.); 28 Geo. 3, ch. 24 (1788) (Eng.); 34 Geo. 3, ch. 57 (1794) (Eng.); and 37 Geo. 3, ch. 124 (1796) (Eng.), when it was made perpetual. The 1732 Statute of 5 George 2, along with the 1542 Statute of 34 & 35 Henry VII, 34 & 35 Hen. 8, ch. 4 (1542-1543) (Eng.), the 1570 Statute of 13 Elizabeth, 13 Eliz., ch. 7 (1570) (Eng.), and other miscellaneous bankruptcy acts, was repealed by 5 Geo. 4, ch. 98, § 1 (1824) (Eng.), which modernized the English bankruptcy system.

70. 13 Eliz. ch. 7, § 2 (1570) (Eng.).

71. 5 Geo. 2, ch. 30, § 1 (1732) (Eng.), requiring delivery of

> all such Part of his, her or their the said Bankrupts Goods, Wares, Merchandizes, Money, Estate and Effects, and all Books, Papers and Writings relating thereunto, as at the Time of such Examination shall be in his, her or their Possession, Custody or Power (his, her or their necessary Wearing Apparel and the necessary Wearing Apparel of the Wife and Children of such Bankrupt only excepted).

72. *Id.* §§ 2, 26, 30.

73. *Id.* §§ 26, 33.

74. *Id.* § 33:

> [A]nd the said Commissioners, or the major Part of them, shall order such Part of the neat Produce of the said Bankrupt's Estate, as by such Accounts or otherwise shall appear to be in the Hands of the said Assignees, as they or the major Part of them shall

The English bankruptcy acts also contained other features that appear in the Code today.[75] From the sixteenth century to the eighteenth century, the English bankruptcy acts evolved from a statute designed to punish bad debtors[76] to a statute that recognized the importance of merchants and the role of credit in the life of England.[77] The earlier bankruptcy acts saw the bankrupt only as someone who committed fraud.[78] By the end of the

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think fit, to be forthwith divided amongst such of the Bankrupt's Creditors, who have duly proved their Debts under such Commission, in Proportion to their several and respective Debts.

The 1543 Statute of Henry VIII and the 1750 Statute of 13 Elizabeth also provided for the gathering and sale of the debtor's property and a pro rata distribution of the proceeds to creditors to satisfy their claims, although in much less detail.

34 & 35 Hen. 8, ch. 4 (1542-1543) (Eng.); 13 Eliz., ch. 7, § 2 (1570) (Eng.); *see* Louis E. Levinthal, *The Early History of English Bankruptcy*, 67 U. PA. L. REV. 1, 14-15 (1919).

75. The right of set off, recognized in 11 U.S.C. § 553 (1994), first appeared in the Statute of 4 Anne, ch. 17, § 11 (1705) (Eng.), and was continued in 5 Geo. 2, ch. 30, § 28 (1732) (Eng.). The recovery from the transferee of the value of property fraudulent conveyed, recognized in 11 U.S.C. §§ 548(a), 550 (1994), appeared in all the important English bankruptcy acts. *See infra* note 467.

Denial of discharge to debtors who engage in fraudulent activity under 11 U.S.C. § 727(a)(2)-(7) (1994) and denial of discharge from certain types of debts under 11 U.S.C. § 523(a) (1994) follows the example of excluding gamblers and debtors who made a marriage gift while insolvent from the benefits of bankruptcy in 4 Anne, ch. 17, §§ 12, 15 (1705) (Eng.) which was continued in 5 Geo. 2, ch. 30, § 12 (1732) (Eng.). Concerns about, and attempts to solve, excessive or improper expenses of the bankruptcy proceeding also appeared early. For example, because "Commissions of Bankrupts have been often Executed with great Expence in Eating and Drinking, at the Meetings of the Commissioners, or some of them therein Named, to the great Prejudice of the Bankrupts and their Creditors," the Statute of 4 Anne prohibited the commissioners from charging such expenses to the bankruptcy estate. 4 Anne, ch. 17, § 20 (1705) (Eng.). This clause was continued in 5 Geo. 2, ch. 30, § 42 (1732) (Eng.).

76. The preamble of the first bankruptcy act stated:

Where divers and sundry Persons craftily obtaining into their Hands great Substance of other Mens Goods, do suddenly flee to Parts unknown, or keep their Houses [where they could avoid service of process], not minding to pay or restore to any their Creditors, their Debts and Duties, but at their own Wills and Pleasures consume the Substance obtained by Credit of other Men, for their own Pleasure and delicate Living, against all Reason, Equity and good Conscience . . . .

34 & 35 Hen. 8, ch. 4 (1542-1543) (Eng.) (as reproduced in 2 Statutes at Large 331-35 (London 1770), in which the spelling from the original has been modernized). In this bankruptcy act, the persons described in the preamble are referred throughout the act as "offenders." Similarly, the Statute of 1 James refers to bankrupts as "offenders." 1 Jam., ch. 15, §§ 10, 17 (1604) (Eng.).

77. *See generally* Robert Weisberg, *Commercial Morality, the Merchant Character, and the History of the Voidable Preference*, 39 STAN. L. REV. 3, 5-39 (1986).

78. 34 & 35 Hen. 8, ch. 4 (1542-1543) (Eng.), *quoted supra* note 76. This act was entitled "An Act against such Persons as do make Bankrupt." *Id.* The Statute of 13

seventeenth century, the view of bankrupts had become more complex. By then, the purpose of the English bankruptcy acts was no longer just to provide creditors with remedies against fraudulent debtors; it was to adjust the relations between insolvent merchants and traders and their creditors.[79]

This broader notion of the purpose of bankruptcy appeared in English society before Parliament expressly embraced it. From 1683 to 1703, well before he turned to writing fiction, Daniel Defoe actively engaged in business (as well as the politics of the day) and went through two bankruptcy proceedings.[80] In 1697 he criticized the bankruptcy law under the 1570 Statute of Elizabeth and the seventeenth century statutes as "a Publick Grievance to the Nation."[81] In this criticism, Defoe described the two prototypes of all debtors. One was "the Honest Debtor, who fails by visible Necessity, Losses, Sickness, Decay of Trade, or the like."[82] The other was

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Elizabeth stated that "notwithstanding [the earlier Statute of 34 Henry VIII] . . . those Kind of Persons have and do still increase into great and excessive Numbers." 13 Eliz., ch. 7 (1570) (Eng.).

79. A subtle shift in thinking appears in the 1604 Statute of James I. The title, "An Act for the better Relief of the Creditors against such as shall become Bankrupts," 1 Jam., ch. 15 (1604) (Eng.), reveals a conception of bankruptcy as a condition ("become Bankrupts"), not an act itself as in the earlier Statute of 34 & 35 Henry VIII ("do make Bankrupt"). Still, the condition of bankruptcy is seen as arising from wilful conduct, as shown by the preamble that recites "Frauds and Deceits, as new Diseases, daily increase amongst such as live by buying and selling, to the Hindrance of Traffick and mutual Commerce, and to the general Hurt of the Realm, by such as wickedly and wilfully become Bankrupts . . . ." 1 Jam., ch. 15, §1 (1604) (Eng.); *see infra* note 119 and accompanying text.

80. *See* JOHN R. MOORE, DANIEL DEFOE: CITIZEN OF THE MODERN WORLD 89-103 (1958). Defoe, born in 1660, engaged in different trades from 1683 to 1703. During this time, he also engaged in politics and political pamphleteering. In 1692, he became a bankrupt as a result of losses from insuring merchant vessels during England's long war with France. He, along with 18 other "merchant insurers," was the object of legislation that would have allowed the insolvent insurers to enter into a composition with two-thirds of each's creditors that would have been binding on the minority creditors. This bill passed the House of Commons but was rejected by the House of Lords. *Id.* at 89-94. Later, he went into brickmaking and was prosperous for awhile. Unfortunately, his imprisonment in 1703 (ostensibly for publishing a libelous and seditious pamphlet but actually for political reasons) caused his brickmaking business to fail and he left trade. In 1704, however, he was pardoned, and from 1704 to 1714 he worked as a reporter, pamphleteer, political agent, and adviser for the government. He also produced a periodical, the *Review*, from 1704 to 1713 that appeared at first weekly and then several times a week. He was again subjected to a bankruptcy proceeding under the 1705 Statute of Anne, 4 Anne, ch. 17 (1705) (Eng.), but was never able to obtain a certificate of discharge. *Id.* 95-98. Although best known for his works of fiction, Defoe did not publish his first novel, *Robinson Crusoe*, until 1719, when he was 59 years old. *Id.* at 345-55.

81. DANIEL DEFOE, AN ESSAY UPON PROJECTS 197 (1697).

82. *Id.* at 206-07.

the "Knavish, Designing, or Idle, Extravagant Debtor, who fails because either he has run out of Estate in Excesses, or on purpose to cheat and abuse his Creditors."[83] Defoe complained that the bankruptcy law as then formulated was inadequate to deal with either type of debtor:

> Time and Experience has furnish'd the Debtors with Ways and Means to evade the Force of this Statute, and to secure their Estate against the reach of it; which renders it often insignificant, and consequently, the Knave, against whom the Law was particularly bent, gets off; while he only who fails of mere Necessity, and whose honest Principle will not permit him to practice those Methods, is expos'd to the Fury of this Act.[84]

Defoe then posed a basic question that persists today in all bankruptcy legislation: how to give due consideration to the unfortunate debtors without protecting or encouraging dishonest or extravagant debtors.[85] Defoe suggested legislation that, in the words of one scholar, "anticipates a virtually modern American form of bankruptcy."[86]

In this recommendation, Defoe proposed a completely voluntary bankruptcy system. The debtor who was "unable to carry on his Business, by reason of great Losses and Decay of Trade" would file a petition with a Commission of Enquiry into Bankrupts Estates.[87] Upon signing the petition, which the commissioners must do "of course,"[88] the debtor would make a full disclosure of all his property, and would turn all property and

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83. *Id.* Defoe also describes the two types of creditors, "the moderate Creditor, who seeks but his own, but will omit no lawful Means to gain it, and yet will hear reasonable and just Arguments and Proposals" and "the Rigorous Severe Creditor, that values not whether the Debtor be honest Man or Knave, Able, or Unable; but will have his Debt, *whether it be to be bad or no*; without Mercy, without Compassion, full of Ill Language, Passion, and Revenge." *Id.*; *see also* Weisberg, *supra* note 77, at 8-9 (quoting Defoe, *supra* note 81, at 206-07).

84. DEFOE, *supra* note 81, at 197. Accordingly, he predicted that eventually the laws would be repealed. *Id.*

85. *Id.* at 207-08. Defoe also regarded protecting the reasonable creditor and limiting the severe creditor as a goal of bankruptcy legislation. *Id.*; *see also* Weisberg, *supra* note 77, at 8-9 (quoting Defoe, *supra* note 81, at 206-07).

For a discussion of the difficulties of distinguishing between the "unfortunate" debtor and the "improvident" or "extravagant" consumer debtor in the recent twentieth century, see Charles G. Hallinan, *The "Fresh Start" Policy in Consumer Bankruptcy: A Historical Inventory and an Interpretive Theory*, 21 U. RICH. L. REV. 49, 66-71 (1986). The emphasis has shifted somewhat from the eighteenth century view of the knavish or lazy extravagant debtor seeking to avoid debts already incurred to a more recent view of the incompetent or improvident debtor who gets into financial trouble partially because aggressive creditors make credit too easy to obtain and then use unreasonable efforts to collect those debts. *Id.*

86. Weisberg, *supra* note 77, at 9.

87. DEFOE, *supra* note 81, at 210.

88. *Id.* at 211.

books and accounts over to the commissioners for liquidation for the benefit of the creditors. The creditors would receive a pro rata distribution from the debtor's property, and the debtor would receive an allowance of 5% of his estate and a full discharge of his debts.[89] This proposal represented a comprehensive and rational way of readjusting the relationship between an insolvent debtor and his creditors.

Parliament in the eighteenth century was not willing to go as far as Defoe suggested.[90] Still, the 1705 Statute of Anne acknowledged the two types of debtors. The preamble recited that "many Persons have and do daily become Bankrupt, not so much by reason of Losses and Unavoidable Misfortunes, as to the intent to Defraud and Hinder their Creditors of their just Debts and Duties to then Due and Owing."[91] Although the debtor who intentionally cheated his creditors remained a primary legislative concern, as early as 1705 it was no longer the only concern.[92]

Defoe's suggestions and the 1705 Statute of Anne reflect a significant effort to devise a better system for resolving the conflicts between creditors and their debtors who had insufficient assets to repay their debts. The 1705 Statute of Anne modernized the bankruptcy system and introduced the discharge of the debtor's existing debts.[93] Parliament no doubt did so as

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89. *Id* at 208-24.

90. Daniel Defoe was very active in the passage of the 1705 Statute of Anne, 4 Anne, ch. 17 (1705) (Eng.). MOORE, *supra* note 80, at 96.

91. 4 Anne, ch. 17, § 1 (1705) (Eng.).

92. Ian P. H. Duffy, *English Bankrupts: 1571-1861*, 24 AM. J. LEGAL HIST. 283, 286 (1980) [hereinafter Duffy, *English Bankrupts*] (citing other contemporary writers recognizing the honest but unfortunate debtor). Defoe anticipated one of the "fresh start" rationales for the discharge in his criticism of the bankruptcy law:

> The Severities to the Debtor are unreasonable, and if I may so say, a little inhuman, for it not only strips him of all in a moment, but renders him for ever incapable of helping himself, or relieving his Family by future Industry. . . . Nothing is more frequent, than for men who are reduc'd by Miscarriage in Trade to Compound and Set up again, and get good Estates; but a *Statute*, as we call it, for ever shuts up all doors to the Debtor's Recovery . . . .

DEFOE, *supra* note 76, at 192-94.

93. 4 Anne, ch. 17, § 7 (1705) (Eng.). This provision was incorporated in 5 Geo. 2, ch. 30, §§ 7, 10 (1732) (Eng.). Following Defoe's suggestion, this statute also gave the cooperating debtor an allowance of 5% of the "Neat Product" of the bankrupt's estate received or recovered by the commissioners, not to exceed £200, if the creditors received repayment of at least 40% of the debt owed to them; if the creditors received less than 40%, the debtor received whatever the commissioner thought appropriate. 4 Anne, ch. 17, §§ 7, 8 (1705) (Eng.). The Statute of 5 George II provided a more elaborate allowance: 5%, not to exceed £200, if the creditors received 50%; 7½% not to exceed £250 if the creditors received 62.5%; 10% not to exceed £300 if the creditors received 75%; and only what the commissioners thought fit, not to exceed 3%, if the creditors received less than 50%. 5 Geo. 2, ch. 30, § 7 (1732) (Eng.).

a carrot to induce the debtor's cooperation.[94] To get the discharge, the commissioners had to certify that the debtor had cooperated with the commissioners in locating and turning over all of the debtor's property and in the proceedings generally.[95] The next year, Parliament provided that the debtor could not receive a discharge unless 80% of the creditors, by number and by the value of the outstanding debts, consented.[96] Further, the 1705 legislation that brought the discharge of debts to English bankruptcy also introduced another form of discharge: the fraudulent debtor could receive the death penalty.[97]

Nevertheless, the introduction of the debtor's discharge from existing debts in 1705 coincided with and contributed to the transformation of the view of bankruptcy. From the merchant's perspective, the availability of the discharge gave the bankrupt merchant a reason to view bankruptcy more favorably. If the bankrupt cooperated, the bankrupt could receive a discharge from existing debts. Moreover, the 1732 Statute of 5 George II also provided that every debtor discharged under the act, as well as every debtor who had entered into a composition with creditors and had delivered all of his property to his creditors, and every person who had been discharged by an act of Parliament for the relief of insolvent persons, was no longer subject to imprisonment for his pre-existing debts.[98]

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94. Duffy, *English Bankrupts*, *supra* note 92, at 286-87; Tabb, *History*, *supra* note 62, at 10-11; Weisberg, *supra* note 77, at 30 n.95.

95. 4 Anne, ch. 17, § 19 (1705) (Eng.). This provision was incorporated in 5 Geo. 2, ch. 30, § 10 (1732) (Eng.).

96. 5 Anne, ch. 22, § 1 (1706) (Eng.). The preamble noted: "Whereas [the Statute of 4 Anne, chapter 17] . . . hath not Answered the good Intent thereof; but on the contrary, many notorious Frauds and Abuses have been Committed . . . ." *Id.* § 1. The consent requirement, as incorporated in 5 Geo. 2, ch. 30, § 10 (1732) (Eng.), was refined to count only creditors with debts of £20 or more. These two acts also contained provisions making void any contract or security given to any creditor to induce the creditor to give consent. 5 Anne, ch. 22, § 3 (1706) (Eng.); 5 Geo. 2, ch. 30, § 11 (1732) (Eng.).

97. 4 Anne, ch. 17, §§ 1, 18 (1705) (Eng.). This provision was incorporated in 5 Geo. 2, ch. 30., § 1 (1732) (Eng.). Defoe had also suggested the death penalty for fraudulent debtors who absconded with their property to avoid their creditors. DEFOE, *supra* note 81, at 222-23.

The penalties were milder under the earlier statutes. In 1604, Parliament provided that an uncooperative debtor could be imprisoned, and a debtor who committed perjury could have his ear cut off. 1 Jam., ch. 15, §§ 8, 9 (1604) (Eng.). Parliament later extended the penalty of loss of an ear to debtors who fraudulently transferred their property to evade the provisions of the bankruptcy acts or to defraud their creditors. 21 Jam., ch. 19, § 7 (1623) (Eng.).

98. *See infra* note 144 and accompanying text. Imprisonment for debt was an important creditor collection device in the seventeenth and eighteenth centuries. It reflected a common belief that the refusal to pay debts was willful. The intent was not to punish debtors, but to provide an incentive for debtors who owned property which could not be reached by the legal process of the day, such as real estate and certain types of personal

The transformation of bankruptcy is reflected in the operation of the two distinguishing elements of the English bankruptcy acts, that bankruptcy proceedings were available only against merchants and that they were involuntary proceedings initiated by creditors. The limitation of the bankruptcy acts to "merchants"[99] is a reflection of Parliament's efforts to address one by-product of the growth of the importance of credit in the life of England—the insolvency of a group of debtors who relied most upon credit and their creditors. It also reflected the initial discomfort of sixteenth century English society with middlemen who neither owned land nor produced tangible goods but who derived their wealth and suffered their losses because of their reliance on an intangible form of property—credit.[100] It was not itself, however, an inherent or defining feature of a bankruptcy system.

Indeed, the limitation of the English bankruptcy acts to merchants proved to be highly problematic because of the difficulty in defining "merchant." The English bankruptcy acts as interpreted by the courts never achieved any doctrinal stability on this issue.[101] In the seventeenth century, the courts strained to include shoemakers, drapers, graziers, bakers, dyers, and carpenters but to exclude laborers, husbandmen, tailors, bankers, brokers, financiers, gentlemen, farmers, ranchers, drovers, and innkeepers.[102] After the King's Bench found in 1653 that Sir John Wolstenholme, a knight and a landed gentlemen who had invested in the East India Company, could be a bankrupt because he received as part of his investment

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property, or property that the debtor had moved beyond the jurisdiction or fraudulently conveyed to others, to liquidate it to pay debts. *See generally* PETER J. COLEMAN, DEBTORS AND CREDITORS IN AMERICA: INSOLVENCY, IMPRISONMENT FOR DEBT, AND BANKRUPTCY, 1607-1900 *passim* (1974); Jay Cohen, *The History of Imprisonment for Debt and its Relation to the Development of Discharge in Bankruptcy*, 3 J. LEGAL HIST. 153, 155 (1982).

99. The preamble of the Statute of 13 Elizabeth noted that the Statute of 34 Henry VIII was insufficient to solve the problem of increasing "bankrupts." 13 Eliz., ch. 7, § 1 (1570) (Eng.). The earlier statute, 34 & 35 Hen. 8, ch. 4 (1542-1543) (Eng.), had only referred in the preamble to certain "Persons" who defrauded their creditors. Thus, the later statute expressed the necessity "for a plain Declaration to be made and set forth, who is and ought to be taken and deemed for a Bankrupt." 13 Eliz., ch. 7, § 1 (1570) (Eng.). The first element to being a bankrupt was to be a "Merchant or other Person using or exercising the Trade of Merchandize by way of Bargaining, Exchange, Rechange, Bartry, Chevisance, or otherwise, in Gross or by retail, . . . or seeking his or her Trade of Living by Buying and Selling." *Id.*

100. *See generally* Weisberg, *supra* note 77, at 13-21.

101. *See generally* Duffy, *English Bankrupts*, *supra* note 92, at 292-305; Lawrence M. Friedman & Thadeus F. Niemira, *The Concept of the "Trader" in Early Bankruptcy Law*, 5 ST. LOUIS U. L.J. 223 (1958); Weisberg, *supra* note 77, at 22-34.

102. Friedman & Niemira, *supra* note 101, at 226-33; Weisberg, *supra* note 77, at 22-34. Most of the cases were defamation cases, not bankruptcy cases.

goods that he then sold,[103] Parliament excluded from the definition of "merchants" subject to bankruptcy those who invested in the East India Company, the Guiney Company, or the royal fishing trade.[104] The rationale, according to the preamble, was that "divers Noblemen, Gentlemen, and Persons of Quality, no ways bred up to Trade or Merchandize" invested in these enterprises to the great advantage of the country and that the legislation was necessary so that "such Persons may not be discouraged in those honorable Endeavors for promoting publick Undertakings."[105] Parliament also excluded stockholders in the Bank of England from being adjudged a bankrupt.[106] In 1732, however, Parliament added bankers, brokers, and financiers to the definition of merchants.[107]

By the last quarter of the eighteenth century, the courts by interpretation expanded the scope of merchants almost to the point that any type of business activity not closely dependent upon the ownership of land qualified one to be a merchant.[108] This expansion reflected a change in the underlying beliefs. The sixteenth century view was that only merchants had the ability to contract great debts and that bankruptcy legislation was necessary to protect society from the fraudulent debtor. The eighteenth century view was that merchants innocently suffered losses from their trading activities and were therefore entitled to the benefits of bankruptcy legislation.

The ostensible reason for limiting bankruptcy to merchants was that non-merchants become insolvent because of extravagant living and a wilful refusal to pay their creditors.[109] The extent to which this rationale was

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103. 13 & 14 Car. 2, ch. 24, § 5 (1662) (Eng.). In this section, Parliament reversed the judgment and declared it null and void. *See also* Weisberg, *supra* note 77, at 25 & n.77.

104. 13 & 14 Car. 2, ch. 24, § 3 (1662) (Eng.).

105. 14 Car. 2., ch. 24, §§ 1, 3 (1662) (Eng.).

106. 8 & 9 Will. 3, ch. 20, § 47 (1697) (Eng.).

107. The 1732 Act provided that, because "Bankers, Brokers and Factors, are frequently intrusted with great Sums of Money, and with Goods and Effects of very great Value belonging to other Persons" they were subject to that and the other bankruptcy acts. 5 Geo. 2, ch. 30, § 39 (1732) (Eng.). The same Act, continuing a provision first appearing in 5 Anne, ch. 22, § 8 (1706) (Eng.) also declared that "no Farmer, Grazier or Drover of Cattle, or any Person or Persons, who is or are, or shall be Receiver General of the Taxes granted by Act of Parliament" is subject to that and the other bankruptcy acts. 5 Geo. 2, ch. 30, § 40 (1732) (Eng.).

108. Cohen, *supra* note 98, at 160, 162-63; Friedman & Niemira, *supra* note 101, at 233-46; Tabb, *Discharge*, *supra* note 62, at 344.

109. *See* 1 WILLIAM BLACKSTONE, COMMENTARIES *473-74:

> But still [the laws of England] are cautious of encouraging prodigality and extravagance by this indulgence to debtors [the benefits of the bankruptcy acts]; and therefore they allow the benefit of the laws of bankruptcy to none but actual *traders*; since that set of men are, generally speaking, the only persons liable to accidental losses, and to an inability of paying their debts, without any fault of their own. If persons in other situations of life run in debt without the power of payment, they must take the

truly the reason for the different treatment of merchants and non-merchants or was simply an after-the-fact justification is hard to say. A significant reason for the limitation was the landed gentry's desire to avoid the summary proceedings of bankruptcy.[110] In a bankruptcy proceeding, the commissioners could sell all of the debtor's property, including real estate and intangible property, and apply the proceeds for the benefit of the creditors.[111] Outside of a bankruptcy proceeding, a creditor could not force an execution sale of the debtor's lands or negotiable instruments and similar significant intangible property to obtain money to satisfy the debt.[112]

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consequences of their own indiscretion, even though they meet with sudden accidents that may reduce their fortunes: for the law holds it to be an unjustifiable practice for any person but a trader to encumber himself with debts of any considerable value. If a gentleman, or one in a liberal profession, at the time of contracting his debts, has a sufficient fund to pay them, the delay of payment is a species of dishonesty, and a temporary injustice to his creditor; and if at such time he has no sufficient fund, the dishonesty and injustice is the greater. He cannot therefore murmur, if he suffers the punishment which he has voluntarily drawn upon himself. But in mercantile transactions the case is far otherwise. Trade cannot be carried on without mutual credit on both sides: the contracting of debts is therefore here not only justifiable, but necessary. And if by accidental calamities, as, by the loss of a ship in a tempest, the failure of brother traders, or by the non-payment of persons out of trade, a merchant or trader becomes incapable of discharging his own debts, it is his misfortune and not his fault. To the misfortunes, therefore, of debtors, the law has given a compassionate remedy, but denied it to their faults; since, at the same time that it provides for the security of commerce, by enacting that every considerable trader may be declared a bankrupt, for the benefit of his creditors as well as himself, it has also (to discourage extravagance) declared that no one shall be capable of being made a bankrupt, but only a *trader*; nor capable of receiving the full benefit of the statutes, but only an *industrious* trader.

*See also* EDWARD GREEN, THE SPIRIT OF THE BANKRUPT LAWS ii-iii (London, 4th ed. 1780) (repeating the above almost verbatim without quotes but with attribution); *see also* Cohen, *supra* note 98, at 160-61.

Several authors have noted that the English bankruptcy acts of the eighteenth century were the only general form of providing limited liability to entrepreneurs, since the use of corporations to provide limited liability to individuals did not develop until the nineteenth century. *Id.* at 161; Friedman & Niemira, *supra* note 101, at 243.

110. *See* Duffy, *English Bankrupts*, *supra* note 92, at 289.

111. *See, e.g.*, An Act to prevent the Committing of Frauds by Bankrupts, 5 Geo. 2, ch. 30, § 1 (1732) (Eng.); *see also* 2 BLACKSTONE, *supra* note 109, at *285-86.

112. *See infra* note 144 and accompanying text. *See also* Cohen, *supra* note 98, at 154-155; Duffy, *English Bankrupts*, *supra* note 92, at 285; Israel Treiman, *Acts of Bankruptcy: A Medieval Concept in Modern Bankruptcy Law*, 52 HARV. L. REV. 189, 195 n.21 (1938) [hereinafter Treiman, *Acts*]. The intangible property that was not subject to execution and levy included annuities, bank notes, bonds, book debts, negotiable instruments, and stocks and shares in public funds. Duffy, *English Bankrupts*, *supra* note 92, at 285.

Furthermore, as I describe below, Parliament recognized in the insolvency acts[113] that non-merchants could become insolvent through misfortune. This recognition casts doubt on the true significance for members of Parliament of the belief that only merchants could be the victims of misfortune and therefore only merchants should be subject to the bankruptcy acts. With the continuing expansion of credit and the economy, this rationale could not, in hindsight, survive.[114] Because of the difficulty of capturing the distinction in legislation, the merchant limitation, as Robert Weisberg put it, "finally died of exhaustion" in the middle nineteenth century.[115]

The second distinguishing feature of the English bankruptcy acts was that bankruptcy proceedings were nominally involuntary. Only creditors could initiate proceedings if the debtor committed an "act of bankruptcy."[116] Notwithstanding this limitation, one of the complaints about the operation of the English bankruptcy acts was the apparent ability of debtors to convince friendly creditors to initiate proceedings.[117] The ability of debtors to engineer bankruptcy proceedings increased as the definition of "act of bankruptcy" evolved from limited acts of fraud[118] to a longer

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113. *See infra* note 137 and accompanying text.

114. In his lengthy 1783 study of insolvency and bankruptcy, James B. Burges sharply criticized the distinction between merchants who were subject to the bankruptcy acts and non-merchants: "A Distinction of this nature is contradictory to the great principles of Reason and Natural Law." JAMES B. BURGES, CONSIDERATIONS ON THE LAW OF INSOLVENCY: WITH A PROPOSAL FOR REFORM 319 (London 1783).

115. Weisberg, *supra* note 77, at 33; *see also* Duffy, *English Bankrupts*, *supra* note 92, at 292-305.

116. Beginning in 1706, creditors could file a petition only if the debts owed to them reached a certain level: One creditor who was owed at least £100 could file a petition, as could two creditors owed £150, and three or more owed £200. 5 Anne, ch. 22, § 7 (1706) (Eng.). These provisions were incorporated in 5 Geo. 2, ch. 30, § 23 (1732) (Eng.).

117. Friedman & Niemira, *supra* note 101, at 243 n.93, 247 (citing Lord Hardwicke's complaint about debtors getting creditors to initiate proceedings). GREEN, *supra* note 109, at 18 n.d, reports several cases of debtors engineering their own bankruptcy. In one case, a commission in bankrupt was issued against a heavily indebted government clerk. At the suggestion of his friends, the debtor engineered his own bankruptcy by buying apple cider in his home county and selling it in London to his friends and acquaintances so that he could become a trader and thereby be declared a bankrupt. *Id.*

In 1697, even before the discharge became available, Defoe complained that, debtors would "confederate with some particular Creditor to take out a Statute." DEFOE, *supra* note 81, at 204, *quoted in* Weisberg, *supra* note 77, at 6-7. *See also* BURGES, *supra* note 114, at 336-37, who remarked in 1793: "When a man finds himself in ruinous circumstances, . . . [he] either fabricates a fraudulent Bankruptcy . . . or, if he has too much principle suddenly to become a rogue, he satisfies himself, by prevailing on some relation, or confidential friend, to take out a Commission against him."

118. Under the Statute of 34 & 35 Henry VIII, the acts were "flee[ing] to Parts unknown, or keep[ing] their Houses." 34 & 35 Hen. 8, ch. 4 (1542-1543) (Eng.). The

enumeration of conditions that a debtor could satisfy either voluntarily or passively, such as remaining in prison for at least six months after being detained for unpaid debts,[119] and others.[120]

Provisions in two bankruptcy acts suggest the degree to which debtors had learned to manipulate the nominally involuntary nature of the bankruptcy proceedings. Complaining that "many Abuses have been committed by pretended Creditors of Bankrupts," the 1732 Statute of 5 George II declared that persons falsely swearing to be creditors would be liable for perjury and also liable to pay for the benefit of the creditors double the value of the falsely claimed debt.[121]

Nineteen years later, Parliament addressed another apparent problem: "many Abuses have been committed by Bankrupts, and Person who, with their Privity, have attempted to prove fictitious and pretended Debts under

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Statute of 13 Elizabeth made the acts of bankruptcy more specific, consisting of the following:

> depart the Realm; or begin to keep his or her House or Houses, or otherwise to absent him or herself; or take Sanctuary; or suffer him or herself willingly to be arrested for any Debt or other Thing, not grown or due for Money delivered, Ware sold, or any other just or lawful Cause, or good Consideration or Purposes, . . . suffer him or herself to be outlawed, or yield him or herself to Prison, or depart from his or her Dwelling-house or Houses, to the Intent or Purpose to defraud or hinder any of his or her Creditors, . . . of the just Debt or Duty of such Creditor or Creditors . . . .

13 Eliz., ch. 7, § 1 (1570) (Eng.) (clause numbering omitted). *See generally* Treiman, *Acts*, *supra* note 112, at 193-95.

119. The Statute of 1 James expanded the list set forth in the Statute of 13 Elizabeth. It added as acts of bankruptcy by the debtor (i) wilfully or fraudulently procuring the debtor's arrest or the attachment or sequestration of the debtor's goods and (ii) making a fraudulent grant or conveyance of property. 1 Jam., ch. 15, § 2 (1604) (Eng.). These acts must be taken with the intent of defrauding creditors. The statute also added the "act" of continuing to lie in prison for six months after being imprisoned for debt. *Id.* This "act" need not be done with the intent of defrauding or hindering creditors. *Id.*; *See* Treiman, *Acts*, *supra* note 112, at 196. The shift from action to a passive condition is revealed in the title and preamble to this act. *See supra* note 79.

120. The Statute of 21 James added as acts of bankruptcy several new acts not limited to those done with the intent of defrauding or hindering creditors. These included petitioning the King or the courts to compel any creditor to accept less than full payment of the creditor's debt or for an extension of time to pay a debt, and lying in prison for more than 2 months after being arrested for payment of a debt. 21 Jam., ch. 19, § 2 (1623) (Eng.). These provisions remained a feature of bankruptcy law through the eighteenth century. Other provisions included failing to pay a debt of £100 or more within six months after it was due and being arrested for the debt; failing to pay a debt of £100 or more within six months after a writ to recover a debt had been issued and served; or escaping from prison after being arrested for a debt of £100 or more. *Id.* These latter two acts of bankruptcy were repealed in 1711. 10 Anne, ch. 15, § 1 (1711) (Eng.). *See generally* Weisberg, *supra* note 77, at 36-37.

121. 5 Geo. 2, ch. 30, § 29 (1732) (Eng.)

Commissions of Bankruptcy, in order that such Persons might be enabled to sign their Consent to the Certificates of discharging such Bankrupts from their Debts."[122] Parliament declared that any such certificates of discharge would be void.[123]

More importantly, debtors induced creditors to initiate bankruptcy proceedings out of necessity. In 1725, twenty years after the introduction of the discharge, Defoe remarked on the ability of debtors to arrange for a bankruptcy proceeding:

> A commission of bankrupt is so familiar a thing, that the debtor oftentimes causes it to be taken out in his favour, that he may the sooner be effectually delivered from all his creditors at once, the law obliging him to give a full account of himself upon oath to the commissioners, who, when they see his integrity, may effectually deliver him from all further molestation, give him a part even of the creditors' estate; and so he may push into the world again, and try whether he cannot retrieve his fortunes by a better management, or with better success for the future.[124]

This was not a complaint. Defoe disagreed that the law, with the possibility of a discharge, was too favorable to the debtor. The debtor had to relinquish control over all his property, his discharge was subject to the discretion of his creditors and the commissioners, and he would be forever tarnished as a bankrupt.[125]

Still, Defoe urged merchants in hopeless circumstances to seek bankruptcy sooner, while they still had property, and not later after they had used up all their property in a vain attempt to remain in business:

> Break then in time, young tradesman. If you see you are going down, and that the hazard of going on is doubtful, you will certainly be received by your creditors with compassion, and with a generous treatment; and whatever happens you will be able to begin the world again with the title of an honest man; even the same creditors will embark with you again, and be forward to give you credit as before.[126]

For any trader following this advice, the notion that the bankruptcy petition must be initiated by the creditors is a formality without substance.

The introduction of the discharge, and the expansion of the scope of "merchant" and of acts of bankruptcy reflected the transformation in the

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122. 24 Geo. 2, ch. 57, § 9 (1751) (Eng.).

125. *Id.* at 46-48.

126. *Id.* at 54-55. Defoe was subjected to several bankruptcy proceedings before and after the introduction of the discharge in 1705 and the requirement for consent by 80% of creditors, which Defoe himself could not get. *See* MOORE, *supra* note 80, at 89-103.

127. Parliament allowed voluntary petitions for merchants in 1844, 7 & 8 Vict., ch. 96 (1844) (Eng.); removed the creditor approval for a discharge in 1842, 5 & 6 Vict., ch. 122, § 39 (1842) (Eng.), which was continued in 12 & 13 Vict., ch. 106, § 200 (1849) (Eng.); allowed voluntary petitions for merchants and non-merchants in 1861, 24 & 25 Vict., ch. 134, § 69 (1861) (Eng.); and abolished the distinction between merchants and non-merchants in 1869, 32 & 33 Vict., ch. 71 (1869) (Eng.).

way English society viewed the role of credit, creditors, debtors, and bankruptcy. The bankruptcy acts were one attempt to address the consequences and tensions created by a system of credit. The restrictions of the eighteenth century English bankruptcy acts were not essential elements of a bankruptcy system, but simply one of several approaches that a legislature might choose in addressing the basic problem of debtors who cannot pay their debts. English society was not yet ready to go as far as allowing voluntary bankruptcy and a full discharge of debts in return for the assignment of all of the debtor's property, as Defoe and others suggested or as some of the American colonies in fact allowed. Yet the restrictions that the English bankruptcy acts had erected—only involuntary proceedings against merchants—were unraveling because they were essentially unworkable. Parliament finally recognized these defects in the middle of the nineteenth century.[127]

### *B. The English Insolvency Acts*

In addition to the English bankruptcy acts, the Parliament responded to the insolvency of some of its citizens with periodic insolvency acts typically entitled "An Act for the Relief of Insolvent Debtors" or something very similar.[128] These acts provided the following: Debtors imprisoned for unpaid debts could be released from prison by assigning all of their real and personal property (with exemptions for wearing apparel, bedding, and working tools up to a limited amount) for liquidation in satisfaction of their debts. The creditors received a pro rata share of the proceeds from the debtor's property. Debtors could no longer be imprisoned for the preexisting debts. The debts themselves, however, were not discharged, and any

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128. *See, e.g.*, 2 & 3 Anne, ch. 16 (1703) (Eng.) ("An Act for the Discharge out of Prison such Insolvent Debtors" who will serve in the army or navy); 6 Geo., ch. 22 (1719) (Eng.) (act for "Relief of insolvent Debtors"); 11 Geo., ch. 21, (1724) (Eng.) (same); 2 Geo. 2, ch. 20 (1729) (Eng.) (act for "Relief of Insolvent Debtors"); 21 Geo. 2, ch. 31 (1748) (Eng.) (same); 28 Geo. 2, ch. 13 (1755) (Eng.) (same); 9 Geo. 3, ch. 26 (1769) (Eng.) (same); 12 Geo. 3, ch. 23 (1772) (Eng.) (same); 14 Geo. 3, ch. 77 (1774) (Eng.) (same); 16 Geo. 3, ch. 38 (1776) (Eng.) (same); 18 Geo. 3, ch. 52 (1778) (Eng.) (same); 21 Geo. 3, ch. 63 (1781) (Eng.) ("An Act for the Discharge of certain Insolvent Debtors"). According to Charles Tabb, the first of such acts was 22 & 23 Car. 2, ch. 20 (1670), and later acts included 2 W. & M., Sess. 2, ch. 15 (1690); 5 & 6 W. & M., ch. 8 (1694); 7 & 8 Will. 3, ch. 12 (1696); 8 & 9 Will. 3, ch. 18 (1697); 1 Anne, stat. 1, ch. 25 (1701); 2 & 3 Anne, ch. 16 (1703). Tabb, *History, supra* note 62, at 12 n.47.

future property acquired by the debtor other than exempt property would be subject to later execution.[129]

At first, only those with a small amount of debts (£50 or £100) were eligible for release from prison.[130] Over time, however, more people became eligible. The maximum amount of allowable debt grew to £1,000-£2,000,[131] and creditors holding debts that exceeded the maximum and who did not consent to the release of the debtor were required to pay for the maintenance of the debtor in prison. If they did not pay, the prisoner was released.[132]

Many have, as a technical matter, distinguished the English insolvency acts from the English bankruptcy acts.[133] The reasons are simple. The English insolvency acts applied to non-merchants as well as to merchants not eligible for a commission of bankrupt under the bankruptcy acts.[134] The debtors, not the creditors, initiated the proceedings by petition. Debtors did not receive a discharge of their debts. Finally, unlike the bankruptcy

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129. *See, e.g.*, 2 & 3 Anne, ch. 16 (1703) (Eng.) (summary of provisions); 6 Geo., ch. 22 (1719) (Eng.); 11 Geo., ch. 21, (1724) (Eng.); 2 Geo. 2, ch. 20 (1729) (Eng.); 21 Geo. 2, ch. 31 (1748) (Eng.) (same); 28 Geo. 2, ch. 13, §§ 3, 18, 20, 21 (1755) (Eng.); 9 Geo. 3, ch. 26, §§ 4, 11, 27, 33 (1769) (Eng.); 12 Geo. 3, ch. 23, §§ 4, 12, 27, 28, 34 (1772) (Eng.); 14 Geo. 3, ch. 77, §§ 4, 12, 28, 29, 34 (1774) (Eng.); 16 Geo. 3, ch. 38, §§ 4, 14, 33, 34, 41 (1776) (Eng.); 18 Geo. 3, ch. 52, §§ 4, 14, 33, 34, 41 (1778) (Eng.); 21 Geo. 3, ch. 63, §§ 5, 15, 32, 33 (1781) (Eng.).

130. Treiman, *Acts*, *supra* note 112, at 195 n.22, cites 2 W. & M., Sess. 2, ch. 15, § 9 (1690) (Eng.) (limiting the benefits of that insolvency act to debtors with unpaid debts of less than £100). *See also* 2 & 3 Anne, ch. 16 (1703) (Eng.) (limiting relief to debtors who did not owe more than £100 to one person and who agreed to serve or procured another to serve in the British army or navy); 6 Geo., ch. 22 (1719) (Eng.) (limited to debtors who did not owe more than £50 to one person); 11 Geo., ch. 21, (1724) (Eng.) (debtors owing debts to the Crown and debts of £100 or more to one person not released).

131. *See infra* note 132 and accompanying text. The one exception is the Lord's Act, 32 Geo. 2, ch. 28 (1758) (Eng.), which was a general insolvency act for debtors owing less than £100. *See infra* note 145 and accompanying text.

132. *See, e.g.*, 2 Geo. 2, ch. 20 (1729) (Eng.) (no release for debt to the King or debt of more than £500 to any one creditor, unless the creditor consented; creditors who did not consent to release to pay a sum for the maintenance of the prisoner; if the sum were not paid, then the prisoner was released); 21 Geo. 2, ch. 31 (1748) (Eng.) (same as preceding act); 28 Geo. 2, ch. 13, § 31 (1755) (Eng.) (same); 9 Geo. 3, ch. 26, § 40 (1769) (Eng.) (same, except debt limit raised to £1,000); 12 Geo. 3, ch. 23, § 42 (1772) (Eng.) (same); 14 Geo. 3, ch. 77, § 42 (1774) (Eng.) (same, except debt limit raised to £2,000 and release for debt to King allowed if Privy Council agrees); 16 Geo. 3, ch. 38, §§ 49, 50 (1776) (Eng.) (same, except no release for debt to King, and debt limit of £1,000 to any one person); 18 Geo. 3, ch. 52, §§ 50, 51 (1778) (Eng.) (same); 21 Geo. 3, ch. 63, §§ 3 (1781) (Eng.) (debt limit £500 but not released for debts to Crown).

133. *See, e.g.*, 2 BLACKSTONE, *supra* note 109, at *484; Treiman, *Acts*, *supra* note 112, at 195 n.22.

134. *See generally* acts *supra* note 128.

acts, these insolvency acts, with one exception discussed below,[135] did not operate prospectively. They released only those debtors in prison as of a date certain.[136]

These insolvency acts nevertheless undermined the rationale for limiting bankruptcy to merchants. Like many of the eighteenth century insolvency acts, the preamble to the 1769 insolvency act of 9 George III states:

> Whereas many Persons, by Losses and other Misfortunes, are rendered incapable of paying their whole Debts; and though they are willing to make the utmost Satisfaction they can, and many of them are able to serve His Majesty by Sea or Land, yet are detained in Prison by their Creditors, or have been forced to go into Foreign Parts out of this Realm: And whereas such unhappy Debtors have always been deemed the proper Objects of publick Compassion . . . .[137]

Apparently it was not just merchants who could become insolvent through losses and misfortunes.[138] It is also telling that the Parliament saw that these objects of public compassion could be "forced" to flee the Realm. The act of fleeing the Realm was one of the first acts of bankruptcy of the fraudulent debtor.[139]

Moreover, that Parliament restricted relief under the insolvency acts to release from prison is less important than it looks. In eighteenth century England, the creditor's remedies were limited to the writ of *fieri facias* which authorized the sheriff to seize the goods of the debtor and sell enough of them to pay the debt;[140] the writ of *levari facias* enabling the sheriff to

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135. *See infra* text accompanying note 145.

136. *See, e.g.*, 6 Geo., ch. 22 (1719) (Eng.) (releasing debtors in prison on June 24, 1719, for existing debts); 11 Geo., ch. 21, (1724) (Eng.) (September 29, 1724); 2 Geo. 2, ch. 20 (1729) (Eng.) (September 29, 1728); 21 Geo. 2, ch. 31 (1748) (Eng.) (January 1, 1747); 28 Geo. 2, ch. 13 (1755) (Eng.) (January 1, 1755); 9 Geo. 3, ch. 26 (1769) (Eng.) (September 29, 1768); 12 Geo. 3, ch. 23 (1772) (Eng.) (January 1, 1772); 14 Geo. 3, ch. 77 (1774) (Eng.) (April 28, 1774); 16 Geo. 3, ch. 38 (1776) (Eng.) (January 22, 1776); 18 Geo. 3, ch. 52 (1778) (Eng.) (January 28, 1778); 21 Geo. 3, ch. 63 (1781) (Eng.) (persons in prison on January 1, 1781; also persons who had escaped during disturbances in June 2 through June 8, 1780 that destroyed several jails and who surrendered or offered to surrender by September 1, 1780).

137. 9 Geo. 3, ch. 26 (1769) (Eng.). *See* 12 Geo. 3, ch. 23 (1772) (Eng.) (almost identical language); 14 Geo. 3, ch. 77 (1774) (Eng.) (same); 16 Geo. 3, ch. 38 (1776) (Eng.) (same, except for spelling changes); 18 Geo. 3, ch. 52 (1778) (Eng.) (same); *see also* 21 Geo. 2, ch. 31 (1748) (Eng.) (same, except without the reference to persons willing to serve in the army or navy and the reference to going into "Foreign Parts"); 28 Geo. 2, ch. 13 (1755) (Eng.) (same).

138. *See supra* note 109 and accompanying text.

139. *See supra* note 76.

140. 3 BLACKSTONE, *supra* note 109, at *417. In Blackstone's scheme, chattels and goods meant only certain rights that derived from the land (chattels real) and tangible

seize the personal property of the debtor and the rents from the debtor's real property to satisfy the debt;[141] the writ of *elegit* allowing delivery of the goods to the creditor at an appraised value in satisfaction of the debt and, if there remained a deficiency, giving the creditor possession of one half of the debtor's lands until the debt were repaid;[142] or the writ of *capias ad satisfaciendum* by which the debtor was imprisoned until the debt was paid.[143] A debtor could not, however, permanently lose either his lands or negotiable instruments and certain other intangible property at the instance of a creditor.[144] Accordingly, although all future goods were subject to execution for the satisfaction of the preexisting debts, the creditor could no longer use the threat of imprisonment to induce the released debtor to sell after-acquired lands or intangible property to satisfy the preexisting debts. The perpetual release from prison effected for many a virtual discharge of the debts themselves.

Finally, the English bankruptcy acts and the English insolvency acts began to converge in the 1758 Statute of 28 George II.[145] This act, a general insolvency act for debtors in prison for sums of less than £100,[146] provided a new remedy to creditors against debtors not eligible for a commission of bankrupt. Upon notice to the debtor and other creditors by whose action the debtor was imprisoned, the creditor could compel a debtor who did not seek release from debtor's prison to give an account of his or her property and to assign the property for the benefit of the petitioning creditor and other consenting creditors.[147] If the debtor refused, he would be transported to a colony in America for indentured service for seven years.[148]

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property that was movable. 2 BLACKSTONE, *supra* note 109, at *384-88.

141. 3 BLACKSTONE, *supra* note 109, at *417-18. This writ did not give the creditor the right to possess or cause the sale of the debtor's lands.

142. 3 BLACKSTONE, *supra* note 109, at *418-19. Under this writ, the creditor could not force the sale of the debtor's lands.

143. 3 BLACKSTONE, *supra* note 109, at *414. Debtors of substance sometimes preferred this writ because once the body of the person was taken in execution on the writ, no other writ could be issued against his or her goods or lands. *Id.*

144. *See* Cohen, *supra* note 98, at 154-55; Duffy, *English Bankrupts*, *supra* note 92, at 285; Treiman, *Acts*, *supra* note 112, at 195 n.21. The intangible property that was not subject to execution and levy included annuities, bank notes, bonds, book debts, negotiable instruments, and stocks and shares in public funds. Duffy, *English Bankrupts*, *supra* note 92, at 285.

145. 32 Geo. 2, ch. 28 (1758) (Eng.).

146. This act provided for the assignment of the debtor's property to creditors and release from prison. If the creditors did not consent to the release, they were required to pay fees for continuation in jail. If they failed, the debtor was released from prison. *Id.* §§ 13, 14.

147. *Id.* § 17.

148. *Id.*

In 1783, James Bland Burges, a barrister and bankruptcy commissioner and later a member of Parliament,[149] proposed a reformed system for all insolvent debtors.[150] In particular, he strongly criticized the distinction between merchants and non-merchants and urged that it be abolished.[151] He suggested that a simple requirement of debtor insolvency should replace "acts of bankruptcy" as a jurisdictional requirement for a proceeding.[152] He also recommended that creditors no longer have control over whether a debtor's debts were to be discharged, but that the commissioners should only discharge those debts if they were paid in full or the debtor showed that his insolvency was the product of "unavoidable accidents and misfortunes."[153]

The convergence of the English bankruptcy acts and the English insolvency acts accelerated in the first half of nineteenth century and was complete by the 1860s.[154] Thus, although in the later half of the eighteenth century Parliament chose to use two separate systems to regulate the relations between insolvent debtors and their creditors, that choice does not obliterate the common nature of the underlying problem identified by Daniel Defoe at the end of the seventeenth century: How to devise a system that would (a) provide a reasonable accommodation for the honest but unfortunate debtor, (b) discourage the growth of deadbeats who could manipulate the system to the unfair advantage of their creditors, (c) maximize the return to creditors and (d) discourage overreaching and unproductive harshness by creditors.[155]

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149. IAN P.H. DUFFY, BANKRUPTCY AND INSOLVENCY IN LONDON DURING THE INDUSTRIAL REVOLUTION 44 n.133 (1985) [hereinafter, DUFFY, BANKRUPTCY AND INSOLVENCY].

150. BURGES, *supra* note 114, at 315-91. Burges's proposals are also discussed in Bauer, *supra* note 199, at 85-86; Duffy, *English Bankrupts*, *supra* note 92, at 290 & n.44; DUFFY, BANKRUPTCY AND INSOLVENCY, *supra* note 149, at 44-45, 84-85.

151. BURGES, *supra* note 114, at 318-23, 342-45, 348-53.

152. "Generally, then, every one who is indebted to another, and who neglects or refuses to pay what he justly owes, shall be liable to a Commission of Insolvency." *Id.* at 350.

153. *Id.* at 387-89.

154. Duffy, *English Bankrupts*, *supra* note 92, at 290-92; *see also* note 127 and accompanying text; *see generally* DUFFY, BANKRUPTCY AND INSOLVENCY, *supra* note 149.

155. Burges also echoed Defoe's earlier sentiments about the aims of bankruptcy law. At one point, he stated, "[A] distinction ought constantly to be made between those who become Bankrupts by unavoidable accidents and misfortunes, and those who bring insolvency upon themselves by their own improvidence, profusion, or dishonesty." BURGES, *supra* note 114, at 337. In this regard, he noted that, because of the requirement for the consent of 80% of the creditors (by number and the value of the outstanding debts) for a certificate of discharge,

> The obstinacy or the malevolence of a single Creditor frequently renders it impossible for an honest man to obtain a Certificate. . . . On the other hand, a fraudulent Bankrupt,

### C. The American Experience

Before the adoption of the Constitution, the American colonies and states responded to the insolvency of debtors and creditors in many different ways. The problems faced by the Americans were similar to those of the English. However, the merchant class, though important, was not as predominant in America as in England, and the Americans were not laboring under the legislative legacy of the earlier English bankruptcy acts of Henry VIII, Elizabeth I, and James I.[156]

In all of the American jurisdictions,[157] creditors could imprison debtors who could not or would not pay their debts, as well as execute against goods. In most jurisdictions, creditors could execute against real property as well.[158] As in England, imprisonment was an important creditor collection device. The threat and actuality of imprisonment, it was believed, gave debtors a strong incentive to repay their debts. Imprisonment also immobilized the debtor when the creditor could not find property on which to execute. Nevertheless, it was less than an ideal remedy. Imprisonment usually impaired the debtor's ability to repay creditors. It did not distinguish between debtors who were insolvent in a balance sheet sense—insufficient assets to meet their liabilities—and debtors who were insolvent in a cash flow sense—sufficient net worth in illiquid assets but insufficient liquid assets to pay their current debts. The latter, like a land-rich, cash-poor debtor, would prefer imprisonment over the unwise liquidation of a long-term capital asset on which his or her future well-being and survival rested. Finally, imprisonment imposed burdens on government to maintain the prisoners and to support the dependents of the poorer imprisoned debtors.

Different jurisdictions developed different approaches toward debtors.[159] In addition, throughout the seventeenth and eighteenth centuries,

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such as we have described, finds no difficulty to procure one. It is in his own power to create the prescribed majority, and to render the prevention of it impossible to his bona-fide Creditors.

BURGES, *supra* note 114, at 336.

156. The English bankruptcy acts, as well as the English insolvency acts, were not considered part of the common law incorporated into the American law.

157. By this term, I mean both the colonies before the American revolution and the states formed as a result of the revolution.

158. *See generally* COLEMAN, *supra* note 98; Cohen, *supra* note 98; Stefan A. Riesenfeld, *Enforcement of Money Judgments in Early American History*, 71 MICH. L. REV. 691 (1973).

159. Rhett Frimet, *The Birth of Bankruptcy in the United States*, 96 COM. J.L. 160, 163 (1991), states that the 1570 Statute of 13 Elizabeth, which he calls the "Statute of Bankrupts," "was the bankruptcy law as used in America." As discussed below, this is not accurate. Rhett cites ROBERT L. JORDAN & WILLIAM D. WARREN, BANKRUPTCY 22 (2d ed. 1989), which states that English bankruptcy acts were "the bankruptcy law during the colonial

individual jurisdictions would also experiment with different approaches. In some jurisdictions, acting on the petitions of specific individuals, the legislatures passed acts relieving these debtors from prison upon surrender of their property.[160] These jurisdictions also crafted individualized relief packages, such as moratoria from imprisonment for one to ten years, and imposing a majority creditor agreement with the debtor on dissenting minority creditors.[161] A few legislatures even discharged individual debtors from their debts.[162]

Most jurisdictions enacted general relief laws allowing the release of debtors from prison upon the debtor's petition if the debtor surrendered all of his or her property (with certain standard exemptions, such as wearing apparel, tools, and in some cases weapons). Some official or a designee of the creditors would then liquidate the property and distribute the proceeds pro rata to the creditors. The debtor's after-acquired non-exempt property would remain subject to the unpaid balance of the debts, but the creditor generally could no longer execute on the body of the debtor.[163]

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period in America." This is a more ambiguous statement, which is repeated in the third edition of their casebook. The English bankruptcy acts were the law of England during the colonial period, but they were not the law used in America.

Frimet also cites HOWARD L. OLECK, CREDITORS' RIGHTS AND REMEDIES 93 (1949), which erroneously states "In America the colonies generally followed the English Law on the subject [of bankruptcy]." HOWARD L. OLECK, DEBTOR-CREDITOR LAW (1953) also gives a misleading picture of early american law. Following a brief two paragraph discussion of the English bankruptcy acts, Oleck states, "In the American colonies, of course, English law was followed generally." *Id.* at 177. For this proposition, Oleck cites F. REGIS NOEL, A HISTORY OF THE BANKRUPTCY LAW 36 (1919), which merely cites Story's brief discussion of the pre-Constitutional American insolvency statutes quoted *infra* in the text at note 262. HOWARD L. OLECK, DEBTOR-CREDITOR LAW 177 n.8.

160. Connecticut, 1765-1818, COLEMAN, *supra* note 98, at 79-83; Maryland, 1715-1774, *id.* at 165-68; New Hampshire, 1745-1765, *id.* at 55-56; New York 1771-1775, 1776-1786, *id.* at 113-15; Pennsylvania, 1731, 1760-1793, *id.* at 145, 147; Rhode Island, intermittently, *id.* at 88-89; Vermont, 1785, *id.* at 69.

161. Connecticut, 1765-1800 (granting a stay from arrest to a debtor who became insolvent in 1774 because of a loss of his ship and who entered into an agreement with a majority of creditors allowing the debtor to continue in business for a ten years without arrest after a minority of the creditors refused to agree and threatened imprisonment, and granting a stay of arrest and full discharge of debts to two insolvent partners who entered into a composition agreement with a majority of their creditors to pay 50% of their debts in rum if the debtors performed their agreement), *id.* at 79-81; Maryland, 1715-1723, *id.* at 165-66; Pennsylvania, 1760-1776 (forcing minority creditors to accept compositions), *id.* at 145; Vermont, 1785-1821, *id.* at 69-71.

162. Connecticut, 1765-1818, *id.* at 79-81; Maryland, 1715-1723, *id.* at 165-66; Rhode Island, 1756-1828 (petitions granted on the basis of a general law enacted in 1756 that relieved all debtors insolvent as of June 1, 1756), *id.* at 92-93, 95-97; Pennsylvania, 1760-1776 (one petition), *id.* at 145; Vermont, 1786, *id.* at 69-71.

163. Connecticut, 1765-1767 (this law dissolved pre-existing liens), *id.* at 79;

A few jurisdictions provided for release from prison in exchange for a period of service by the debtor as well as a property assignment.[164] A very few jurisdictions during the later part of the seventeenth century and beginning of the eighteenth century, and Pennsylvania in 1785, enacted legislation styled on the English bankruptcy acts, in which the creditors initiated proceedings against merchants.[165] Massachusetts also adopted a

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Delaware, 1734-1740 (for limited groups of debtors), 1740-1751 (married and middle age debtors; creditors not accepting property assignment required to pay jail fees and to support debtor's dependents), 1751-1808 (same, except only deserving married and middle age debtors), *id.* at 208-10; Georgia, 1766-1770 (all debtors except those who could carry on their trade in prison; no releasee if creditor paid jail fees), *id.* at 234; Maryland, 1708-1711, 1725-1727, 1733, 1774-1787, 1788-1817, *id.* at 164-65; *see also infra* note 177 and accompanying text; Massachusetts, 1698-1725, periodically during 1727-1787, permanently thereafter (excluding debtors owing more than £500 to any one debtor), COLEMAN, *supra* note 98, at 40-42; New Hampshire, 1767-1776, 1782-1791 (all allowing creditors to keep debtors in prison if the creditors paid the jail fees), *id.* at 56-57; New Jersey, periodically from 1686, 1730-1771, 1774-1783, *id.* at 132-135; New York, 1730, 1732-1734, 1743, 1747, 1750, 1751, 1756 (all allowing creditors to keep debtors in prison if the creditors paid the jail fees), 1786, 1787, *id.* at 107, 115-16; North Carolina, 1749-1773 (debtors worth £2 or more; creditor paying jail fees could prevent release of debtor), 1773-1793 (all debtors) *id.* at 218, 220-22; Pennsylvania, 1730 (creditors could keep debtors in prison if the creditors paid the jail fees), 1770, 1784-1793, *id.* at 143-45, 147; Rhode Island, 1745 (this act required a guaranty to repay the debt within five years), *id.* at 91; Vermont, 1782-1797 (creditors could keep debtors in prison if the creditors paid the jail fees), *id.* at 66-67; Virginia, periodically beginning in 1705, *id.* at 195-96.

164. Connecticut, 1763-1764 (service for up to seven years if debtor could not repay three-fourths of debts), *id.* at 78-79; Delaware, 1734-1740 (unmarried debtors under forty years, indentured up to seven years), 1741-1915 (indentured servitude for various groups; debtor discharged from debt if the creditors refused service), *id.* at 208-10; Maryland, 1725-1727, 1733, *id.* at 164-65; *see also infra* note 177 and accompanying text; Massachusetts, 1698-1737, COLEMAN, *supra* note 98, at 40-42; New Jersey, 1761 (allowing debtor to sell services to anyone willing to pay the debt), *id.* at 133; New York, 1732 (debtors owing less than £2 indentured for five or seven months a year), *id.* at 107; Pennsylvania, 1706-1730 (married male debtors indentured up to five years, and single debtors under fifty-three years of age up to seven years; if the creditor refused service, debtor released from prison), 1731-1767 (releasee from prison of debtor under forty years of age owing less than £20 in exchange for service and a property assignment), 1767 (same provision extended to debtors owing less than £150), *id.* at 141-42, 144.

165. Massachusetts, 1714-1717 (modeled on the 1705 Statute of 4 Anne; debtor received discharge of debts and could receive allowance of up to 5% not to exceed £50), *id.* at 45; New Hampshire, 1715-1718 (modeled on the Massachusetts statute), *id.* at 54-55; Pennsylvania, 1785-1793 (modeled on the cumulative English bankruptcy acts, beginning with 5 Geo. ch. 30 (1732) (Eng.), applicable to merchants and related occupations who committed certain acts of bankruptcy), ch. 683, 1785 Pa. Stat. *found in* 12 THE STATUTES AT LARGE OF PENNSYLVANIA FROM 1682 TO 1801, at 70 (Clarence M. Bush, St. printer, 1896) [hereinafter, PA. STAT. 1682-1801]; *see also* COLEMAN, *supra* note 98, at 151-52; and Rhode Island, 1678 (modeled on the earlier English bankruptcy statutes), COLEMAN, *supra*

law in 1757—disapproved a year later by the British authorities—limited to merchants in which either the creditors or the debtor could petition for relief.[166] The debtor could receive a discharge of debts if a majority in number and value of creditors agreed.[167]

Finally, a few jurisdictions enacted legislation providing for the discharge of the debts as well as release from prison upon assignment of the debtor's non-exempt property. Some of these laws required the consent of some or all of the creditors.[168] Other laws did not require creditor consent, but these tended to be shortlived.[169]

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note 98, at 91 n.11.

166. COLEMAN, *supra* note 98, at 45-46. Massachusetts then enacted a more limited act in 1765 allowing creditors to initiate proceedings against absconding and concealing debtors. This three-year statute was limited in effect because of the political turmoil within the state and with the British authorities. *Id.* at 46-48.

167. *Id.* at 45-46.

168. New Jersey, 1771-1775 (requiring joint petition and two-thirds creditor consent), 1783-1786 (requiring 50% creditor consent), 1786-1787 (same, but if no consent, creditors to pay jail fees), *id.* at 134-35; *see also infra* note 172; New York, 1755-1770 (conditioning discharge on consent by three-fourths of the creditors by value; proceedings initiated by creditors, but act applied only if the debtors were willing to give up property), 1771-1772 (release from prison, but exempting all after-acquired property from execution), 1784-1819 (proceedings initiated by debtor or creditor; requiring three-fourths creditor consent to a discharge of debts), COLEMAN, *supra* note 98, at 109, 113, 123; *see also infra* text accompanying note 190; South Carolina, 1745-1751 (discharging debts only of creditors who accepted a dividend from assignment of debtor's property), 1751-1759 (discharging debts only if three-fourths of creditors by number and value agreed and if creditors received 50% of their debts), 1759 and thereafter (permanent statute discharging debts only of creditors who accepted a dividend from assignment of debtor's property and only if all creditors agreed), *see infra* note 197 and accompanying text; COLEMAN, *supra* note 98, at 182.

169. Connecticut, 1765-1767, *id.* at 79; Maryland, 1787-1788, *id.* at 171; *see also infra* note 178 and accompanying text; New Jersey, COLEMAN, *supra* note 98, at 134; *see also infra* note 172; North Carolina, 1749-1773 (for debtors worth less than £2), COLEMAN, *supra* note 98, at 218-19; Rhode Island, 1756 (relieving all debtors insolvent as of June 1, 1756), 1771-1772 (a general law repealed 9 months later), *id.* at 92-93; South Carolina, 1721-1744, *id.* at 181-82; Virginia, 1762-1763, *id.* at 196-97. The Virginia law, enacted at the November 1762 session of the Virginia General Assembly, and entitled "An Act for the relief of insolvent debtors, for the effectual discovery and more equal distribution of their estates," copied several provisions of the 1732 English bankruptcy act of 5 George II, 5 Geo. 2, ch. 30. Although it was not restricted to merchant debtors, and it allowed the debtors to initiate proceedings, it provided that fraudulent debtors would receive the death penalty, it provided for a certificate of discharge, and it authorized an allowance to the cooperating debtor that according to the same formula in the 1732 act, that is, 5% for a 50% return to creditors, 7-1/2% for a 62.5% return, and 10% for a 75% return, and other items. Ch. 8, Nov. Sess., 1762 Va. Laws, §§ 1, 18, *found in* 7 LAWS OF VIRGINIA 549-63 (William W. Hening ed., 1820). The following session, declaring that this act "has been thought injurious to the credit of this colony, and may be of evil consequence to the trade thereof," the Virginia General Assembly repealed it. Ch. 2, May Sess., 1763 Va. Laws, *found in* 7 LAWS OF VIRGINIA 643

On the eve of the adoption and ratification of the Constitution, the thirteen states used different approaches to insolvent debtors. Georgia provided no relief of debtors from either debts or imprisonment for debt. Four states—Massachusetts, New Hampshire, North Carolina, and Virginia—had general laws allowing prisoners to be released from prison if they assigned all of their non-exempt property to be liquidated to satisfy their debts. Pennsylvania enacted legislation in 1785, styled on the English bankruptcy acts, in which the creditors initiated proceedings against merchants.[170]

In 1783, New Jersey replaced its system of releasing debtors from prison[171] with a system of discharging debts with the consent of 50% of the creditors.[172] The legislature abolished this system in 1787.[173] Acting on the petitions of individual debtors to the legislature, Connecticut and Rhode Island released debtors from prison, stayed future arrests of debtors for a time, or discharged debts.[174]

Delaware had a more complicated system for relieving debtors willing to make a property assignment. Unless the creditor were willing to continue paying jail fees, Delaware allowed the release from prison of deserving debtors over the age of forty or in charge of small children, and of insolvent debtors with small debts (£2 or less) willing to be indentured servants for up to six months. It also allowed debtors aged forty or under who were not in charge of small children and who owed more than forty shillings (£2) to be released in exchange for indentured service of up to seven years; if the

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(William W. Hening ed., 1820).

170. Ch. 683, 1785 Pa. Stat., *found in* 12 PA. STAT. 1682-1801, *supra* note 165, at 70; *see also* COLEMAN, *supra* note 98, at 151-52.

171. *See supra* note 163.

172. *See* Ch. 370, 1783 N.J. LAWS, *found in* THE FIRST LAWS OF THE STATE OF NEW JERSEY 339 (John D. Cushing, ed. 1981). This act simply revived the act enacted in New Jersey in 1771, entitled "An Act for the Relief of Insolvent Debtors," 1771 N.J. LAWS, *found in* 5 LAWS OF THE ROYAL COLONY OF NEW JERSEY 1770-1775, at 81-86 (Bernard Bush ed., 1986), with minor modifications. The 1783 act reduced the percentage for creditor consent to discharge from two-thirds to 50%. The 1771 act, which was to expire in 1776, required two-thirds of the creditors to join the debtor's petition. 1771 N.J. LAWS, *found in* 5 LAWS OF THE ROYAL COLONY OF NEW JERSEY 1770-1775, at 86 (Bernard Bush ed., 1986). This act also contained a priority for payment of debts, that is, first the King of England, then the Colony, then the costs of the imprisonment, then the costs of the proceeding, and the residue to be divided among the creditors. *Id.* at 85. The act also provided that single individuals under the age of 40 were not entitled to any benefits of the act unless they were willing to serve seven years of servitude to pay off their debts. *Id.* at 86. In 1775, the requirement that two-thirds of the creditors join in the petition was removed. Act of February 13, 1775, 1775 N.J. LAWS, *found in* 5 LAWS OF THE ROYAL COLONY OF NEW JERSEY 1770-1775, at 321 (Bernard Bush ed., 1986).

173. COLEMAN, *supra* note 98, at 134-35.

174. *Id.* at 79-83, 88-89.

creditor refused the service the debtor was discharged from the debt as well.[175] The Delaware statute also provided for the disposition of the debtor's property "in like manner as Assignees of Commissioners of Bankrupts."[176]

From 1774 to May 1787 and after May 1788, Maryland permitted debtors owing less than £200 to petition for release from prison in exchange for a property assignment.[177] On May 25, 1787, the Maryland General Assembly passed a law authorizing the discharge of all debts.[178] This law provided for the appointment of a trustee for the creditors;[179] assignment and liquidation of the debtor's property;[180] pro rata distribution of the net proceeds to the creditors;[181] exemptions for wearing apparel for the debtor and the family and, "if a mechanic or manufacturer," the debtor's tools, not to exceed £10 in value;[182] proof of claims by creditors;[183] a vague statement voiding preferences by debtors and authorizing the trustee to recover them;[184] a provision that, notwithstanding the discharge, property inherited by the debtor after the property assignment would be liable for the payment of the discharged debts; and payment of any surplus to the debtor.[185]

The law also gave creditors a right of action to declare a debtor owing more than £300 an insolvent.[186] A creditor could petition the chancellor for an order to require such a debtor alleged to be wasting his assets to give security for the debt. If the debtor failed, the chancellor could declare the debtor an insolvent. A creditor of such a debtor who remained in prison without paying his debts could also petition for a declaration of insolven-

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175. *Id.* at 208-210; *see also* An Act for the Relief of Insolvent Debtors, within this Government, ch. 76, 1740 Del. Laws, §§ 1, 11, 19-21, *amended by* ch. 118, 1751 Del. Laws. The section on debtors owing 40 shillings or less states merely that the debtor would be "discharged." Ch. 76, 1740 Del. Laws, § 11. Unlike the provisions for the other debtors, it is not clear whether this is a release from prison or a discharge from the debts.

176. Ch. 76, 1740 Del. Laws, § 2.

177. An Act for the Relief of Insolvent Debtors, ch. 28, Mar. Sess., 1774 Md. Laws.

178. An Act Respecting Insolvent Debtors, ch. 34, Apr. Sess., 1787 Md. Laws. Debtors owing more than £300 applied to the chancellor. *Id.* §1. Debtors owing less applied to, and were discharged by, county courts. *Id.* § 16.

179. *Id.* § 3.

180. *Id.* § 6.

181. *Id.*

182. *Id.* § 5.

183. *Id.* § 9.

184. *Id.* § 10: "And be it enacted, That if any debtor shall prefer any of his creditors, except securities, who have *bona fide* become such before the passing of this act, such preference shall be void in law and equity, and any money paid, or property given, in preference, shall be recovered by the trustee or trustees of such debtor." *Id.*

185. *Id.* § 12.

186. *Id.* § 15.

cy.[187] In either case, if a debtor were declared insolvent, the chancellor would order the debtor to deliver all of his property to a trustee. These debtors then became entitled to and subject to the provisions of the act. Although this act was to expire after one year, reaction to the law apparently was unfavorable. The General Assembly explicitly repealed it on May 20, 1788—saving those proceedings begun before May 24, 1788—and revived the 1774 law.[188]

By special and general acts, New York released debtors from prison and discharged debts upon a property assignment. By two acts passed in 1784, it released from prison and discharged the debts of debtors in prison on the effective dates of the acts.[189] In 1786, it enacted a general relief act discharging all insolvent debtors if three-fourths in value of all unsecured creditors joined in the petition.[190] This act contained the usual provisions for gathering, administering and liquidating the debtor's property, proving the creditors' claims, and a pro rata distribution. It expressly applied to "insolvent" debtors and not just debtors in prison.[191] It excluded creditors secured by the debtor's property unless the creditors relinquished their security interest,[192] and it allowed creditors with unmatured debts to participate, the value of their debts being discounted.[193]

For some reason, this act proved unsatisfactory. In 1788, the legislature repealed it, declaring that it "has been productive of much mischief, and there is great reason to suppose that wicked men have in many instances been guilty of the most fraudulent practices to obtain those benefits which the legislature intended only for the innocent and unfortunate."[194] The following month it provided for the release of debtors from prison upon the joint petition of the debtor and three-fourths by value of the creditors.[195]

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187. *Id.*

188. Ch. 10, 1788 Md. Laws. This act also revived the 1774 act releasing debtors from prison.

189. An Act for Relief of Insolvent Debtors Within This State, ch. 14, 7th Sess., 1784 N.Y. Laws (passed April 17, 1784). Later that year, the legislature revived this act. Act of Nov. 24, 1784, ch. 14, 8th Sess., 1784 N.Y. Law (also discharging several named individuals even though not then in prison, if two thirds in value of their creditors agreed). In 1785, it extended the benefits of the 1784 acts to a large number of named individuals. An Act Granting Relief to Certain Insolvent Debtors, ch. 87, 8th Sess., 1785 N.Y. Laws (passed April 28, 1985).

190. An Act for the Relief of Insolvent Debtors, Ch. 34, 9th Sess., 1786 N.Y. Laws (passed April 13, 1786).

191. *Id.* (first unnumbered paragraph).

192. *Id.* (second unnumbered paragraph).

193. *Id.* (fifth unnumbered paragraph).

194. Act of Feb. 8, 1788, ch. 29, 11th Sess., 1788 N.Y. Laws.

195. An Act for Giving Relief in Cases of Insolvency, ch. 92, 11th Sess., 1788 N.Y. Laws (Mar. 21, 1788).

In the interim, in 1787, it also released, but did not discharge debts of, debtors then in prison on account of debts of not more than £15.[196]

South Carolina's experience was more stable. Since 1759, it had authorized the discharge of debts upon the petition of an imprisoned debtor.[197] It only discharged the debts, however, of creditors who agreed to accept a dividend from an assignment of the debtor's property.[198]

These legislative approaches represent different responses to the same concerns: How to ensure the maximum repayment of debt while recognizing that some debtors inevitably would be unable to pay. Too harsh treatment of insolvent debtors wasted the abilities and energies of potentially productive persons and created a burden on state and local governments to maintain debtors' prisons. Too lenient treatment allowed dishonest debtors or debtors who were less than fully committed to the ideal of repaying their debts to avoid their obligations. These tensions arose in the context of a cumbersome system for the enforcement of claims by individual creditors in which the first to obtain judgment trumped other creditors who expended money and effort to realize on a diminishing pool of debtor assets.[199] No system produced truly satisfactory answers. The only certainty was the lack of consensus within and across the states about the desirability of a voluntary system of collective debtor-creditor relief providing the insolvent debtor with a full discharge of existing debts.

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196. An Act for the Relief of Insolvent Persons, with respect to the Imprisonment of Their Persons, ch. 98, 10th Sess., 1787 N.Y. Laws (Apr. 20, 1787).

197. An Act for the More Effectual Relief of Insolvent Debtors, no. 907, 1759 S.C. Laws, *found in* THE FIRST LAWS OF THE STATE OF SOUTH CAROLINA, pt. 1 (John D. Cushing ed., 1981).

198. *Id.* § 1. It contained the usual provisions for the discovery and assignment of the debtor's property, with exceptions for bedding, clothes, tools, and arms for muster. *Id.*

199. In 1763, Governor Bernard of Massachusetts specifically complained of the problem of the race to the courthouse in his message to the London Board of Trade requesting approval of a law directed against absconding debtors:

> This province has long laboured under the want of a Bankrupt Act. . . . As it has been of late, every Insolvency has afforded instances of great partiality and injustice. The Common Method has been for the Creditors who get the earliest advice of a persons [sic] becoming insolvent to sue out attachments against the goods and credit of the insolvent, according to the custom of the Country, and help himself to such thereof as he pleased. A general scramble ensues, there is no regular audit of the Accounts of the Creditors; The goods are sold in a hurry at a low value; and great part of the effects of the debtor are spent in law proceedings and contests between contending attachments.

4 ACTS AND RESOLVES, PUBLIC AND PRIVATE, OF THE PROVINCE OF MASSACHUSETTS BAY 793 (1881); *see also* George P. Bauer, The Movement Against Imprisonment for Debt in the United States app. c (1935) (unpublished dissertation, Harvard University); *see also* COLEMAN, *supra* note 98, at 46-47.

### D. Common Features

The English bankruptcy acts, the English insolvency acts, and the American statutes differed in several respects. Different debtors were eligible for relief: merchants, or non-merchants, with different or no debt minimums or maximums. They provided different types of relief; release from prison only; full or limited stay from future arrest; enforcement against dissenting minority creditors of composition agreements with majority creditors; no, partial or full discharge of existing debts. Under some statutes only creditors could initiate proceedings; under other statutes debtors with the consent of some creditors could initiate proceedings; still other statutes allowed debtors alone to initiate proceedings.

Nevertheless, all of these acts had substantial similarities. They all provided for a collective proceeding between creditors and an insolvent debtor. Even in those cases where a single creditor could initiate a proceeding against a debtor or a debtor could begin a proceeding against a single creditor, the statutes required either a listing of the debtor's liabilities and creditors or public notice of the proceeding and an opportunity, if not the requirement, for other creditors to participate. Except in the case of the imposition of composition agreements on minority dissenting creditors, all required the debtor to relinquish control over his non-exempt property. These also provided for the administration and liquidation or assignment of that property for the benefit of the creditors (and, in the case of a surplus, the debtor) and for a pro-rata distribution among creditors, with some provision of priority among creditors.

All also allowed the debtor to retain some exempt property under different circumstances. Significantly, all governed debtors who demonstrated an inability or, in the case of involuntary proceedings, an unwillingness to repay their creditors. They did not apply to debtors who repaid their debts. Moreover, none created rights or liabilities for persons other than insolvent debtors and their creditors.

As the federal bankruptcy laws following the adoption of the Constitution evolved, many of the specific distinguishing features of the English bankruptcy acts, the English insolvency acts, and the American statutes disappeared. The gradual development of the federal bankruptcy laws, however, did not change the essential elements that all three bodies of legislation shared.

## IV. THE BANKRUPTCY CLAUSE

### *A. Adoption and Intent*

The proceedings of the Constitutional Convention shed little light on what the Framers explicitly intended by adopting the Bankruptcy Clause.[200] On August 29, 1787, during a discussion of the clause that became the Full Faith and Credit Clause, Charles Pinckney of South Carolina moved to recommit the provision with an addition "[t]o establish uniform laws upon the subject of bankruptcies, and respecting the damages arising on the protest of foreign bills of exchange." The convention approved this motion.[201] On September 1, 1797, John Rutledge of South Carolina reported that the Committee of Detail for Pinckney's proposal, which also included Edmund Randolf of Virginia, Nathaniel Gorham of Massachusetts, William Johnson of Connecticut, and James Wilson of Pennsylvania, recommended adding the power "to establish uniform laws on the subject of Bankruptcies" to the Naturalization Clause in the article on the legislative department.[202]

The convention adopted this proposal with little debate on September 3.[203] Connecticut alone voted against it.[204] Roger Sherman of Connecticut feared that this clause would empower Congress to punish bankrupts by death, as was done in the English bankruptcy acts.[205] Gouverneur Morris of Pennsylvania responded that he saw no danger of abuse by the legislature of the United States.[206] The Committee on Style made this clause 4 after the power to regulate commerce in Section 8 of Article I.[207]

There is no direct evidence whether Pinckney or the Committee on Detail had only the English bankruptcy acts in mind in proposing this clause or whether they intended a broader meaning to the words "subject of Bankruptcies." Kurt Nadelmann has argued that the circumstances of Pinckney's proposal strongly suggest that he used, and the convention understood, the words "subject of Bankruptcies" in the larger sense of insolvencies.[208] Immediately before Pinckney made his proposal on

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200. WARREN, *supra* note 8, at 4-6; Kurt H. Nadelmann, *On the Origin of the Bankruptcy Clause*, 1 AM. J. LEGAL HIST. 215, 216-19 (1957).

201. JAMES MADISON, NOTES OF DEBATES IN THE FEDERAL CONVENTION OF 1787 546-47 (Ohio Univ. Press 1966) (reprint of Madison's Notes edited by Charles C. Tabb in H.R. DOC. 398, 69TH CONG., 1ST SESS., DOCUMENTS ILLUSTRATIVE OF THE FOUNDATION OF THE UNION OF THE AMERICAN STATES (1927)).

202. *Id.* at 569.

203. *Id.* at 571.

204. *Id.*

205. *Id.*

206. *Id.*

207. *Id.* at 620.

208. Nadelmann, *supra* note 200.

August 29, the convention debated a full faith and credit clause reported earlier in the convention. This version stated: "Full faith shall be given in each State to the acts of the Legislatures, and to the records and judicial proceedings of the Courts and magistrates of every other State."[209] During debate on this clause, Hugh Williamson of North Carolina stated that he did not understand the meaning of this version.[210] According to James Madison's notes of the debate, James Wilson of Pennsylvania and William Johnson of Connecticut "supposed the meaning to be that Judgments in one State should be the ground of actions in other States, & that acts of the Legislatures should be included for the sake of *Acts of insolvency*, etc."[211] As Nadelmann has pointed out, that the next entry following these notes is Pinckney's proposal that Congress enact laws on the subject of bankruptcies suggests that the "subject of Bankruptcies" included not only the English bankruptcy acts but the multifarious American approaches to insolvency.[212]

Sherman's objection about the death penalty[213] of course shows an awareness of the English bankruptcy acts. It does not by itself show an expectation that Congress's powers would be limited by those acts.[214] All of the original thirteen states except Rhode Island participated at the constitutional convention, and they used a variety of approaches to dealing with insolvent debtors. Pinckney and Rutledge's state, South Carolina, had an insolvency statute that discharged debts upon the petition of the debtor and the consent of creditors willing to accept a dividend from the liquidation of the debtor's property.[215] Pennsylvania had an English style bankruptcy

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209. MADISON, *supra* note 201, at 394.

210. *Id.* at 546. It differed from the Full Faith and Credit Clause of the Articles of Confederation in that it added the acts of legislatures.

211. *Id.* (emphasis added). Madison inserted at the ellipses the words "as they sometimes serve the like purpose as act" but he later struck them at some time in his life. *See* Nadelmann, *supra* note 200, at 219-20.

212. *See* Nadelmann, *supra* note 200, at 227.

213. The shortlived Virginia discharge statute of 1763 also included a death penalty. *See infra* note 169.

214. Daniel Defoe's *Essay on Projects*, which included his proposal for a voluntary bankruptcy system, was known to Benjamin Franklin. Describing the books that he read in his father's library, Benjamin Franklin wrote: "There was also a book of Defoe's called an *Essay on Projects* and another of Dr. Mather's *Essays to do Good*, which perhaps gave me a turn of thinking that had an influence on some of the principal future events of my life." BENJAMIN FRANKLIN, THE AUTOBIOGRAPHY OF BENJAMIN FRANKLIN 16 (Max Farrand ed., 1949). Franklin outlined and began writing his autobiography in 1771, when this passage was presumably written. He stopped when he had described the first 24 years of his. *Id.* at xii-xiv. He resumed his autobiography in 1784, when he wrote the second installment, *id.* at xxi-xxii, and he wrote the third installment in 1788-1789, just before his death in 1790, *id.* at xxiii-xiv.

215. *See supra* note 197.

act.[216] One of the delegates to the convention, Jared Ingersoll of Pennsylvania, had litigated in Pennsylvania courts the validity of an order of relief from imprisonment under a New Jersey relief act and a discharge of debts under the Maryland law.[217] Connecticut was routinely releasing debtors and discharging debts upon the petition of individual debtors.[218] New York and Maryland had each recently adopted and abandoned a discharge law, New York's law requiring creditor consent[219] and Maryland's law not requiring creditor consent.[220]

An obvious source for determining the Framers' intent is the choice of the word "Bankruptcies." Although the English bankruptcy acts were distinct from the English insolvency acts, by the time of the convention the term "bankruptcy" was not understood as only referring to a proceeding under the English bankruptcy act. Samuel Johnson's *Dictionary of the English Language*,[221] first published in 1755, has the following entries for "bankruptcy" and "bankrupt":

> BANKRUPTCY. *n.s.* [from *bankrupt*] 1. The state of a man broken, or bankrupt. 2. The act of declaring one's self bankrupt; as, he silenced the clamours of his creditors by a sudden bankruptcy.
>
> BANKRUPT. *adj.* [*banqueroute*, Fr. *bancorupto*, Ital.] In debt beyond the power of payment.
>
> The king's grown *bankrupt*, like a broken man.
>
> SHAKESP. RICHARD III
>
> Sir, if you spend word for word with me, I shall make your wit *bankrupt*.
>
> SHAKESP. TWO GENT. OF VERONA[222]

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216. *See supra* notes 165.

217. Nadelmann, *supra* note 200, at 224-25.

218. *See supra* notes 160-62; *infra* note 231 and accompanying text.

219. *See supra* note 190 and accompanying text.

220. *See supra* note 178 and accompanying text.

221. The 1775 fourth edition of Johnson's *Dictionary of the English Dictionary* was a part of Thomas Jefferson's library. 5 CATALOGUE OF THE LIBRARY OF THOMAS JEFFERSON 133-34 (E. Millicent Sowerby ed., 4th ed. 1959).

222. The quoted sentence is by Thurio. Thurio and Valentine, rivals for the hand of Silvia, exchange angry words. Silvia comments on these remarks and the exchange continues:

> *Sil.* A fine volley of words, gentlemen, and quickly shot off.
>
> *Val.* 'Tis indeed, madam; we thank the giver.
>
> *Sil.* Who is that, servant?
>
> *Val.* Yourself, sweet lady; for you gave the fire. Sir Thurio borrows his wit from your ladyship's looks, and spends what he borrows kindly in your company.
>
> *Thu.* Sir, if you spend word for word with me, I shall make your wit bankrupt.

BANKRUPT. *n. s.* A man in debt beyond the power of payment.[223]

Johnson's definitions of "bankrupt" and "bankruptcy" are synonymous with his definitions of "insolvent" and "insolvency," which are respectively "[u]nable to pay debts contracted" and "[i]nability to pay debts."[224] The 1773 fifth edition and the 1799 eighth edition of Johnson's *Dictionary* contained the same or substantially the same definitions.[225]

The first american edition of Perry's *The Royal Standard English Dictionary* printed in 1794, the 1790 third edition, and the 1796 sixth edition (which was printed in Philadelphia) of Sheridan's *Dictionary of the English Language* contains similar definitions for "bankrupt" and "bankruptcy" and their synonyms "insolvent" and "insolvency" or their antonyms "solvent" or "solvency."[226] The 1933 Oxford English Dictionary notes that the distinction between bankruptcy and insolvency, abolished by the United States in 1841 and England in 1869, "had long before disappeared in popular use."[227]

Officials in America used the term "bankruptcy" in the same sense as Samuel Johnson's definition. Nadelmann provides an example from the records of the Connecticut General Assembly. Elijah Buell, apparently a

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*Val.* I know it well, sir: you have an exchequer of words, and, I think, no other treasure to give your followers; for it appears by their bare liveries that they live by your bare words.

*Sil.* No more, gentlemen, no more. Here comes my father.

WILLIAM SHAKESPEARE, TWO GENTLEMEN OF VERONA, act 2, sc. 4, lines 33-49, in COMPLETE WORKS (W.J. Craig ed., Oxford Univ. Press 1966) (1905).

223. 1 SAMUEL JOHNSON, A DICTIONARY OF THE ENGLISH LANGUAGE (London 1755) (unpaginated) (omitting quotations from authors).

224. *Id.*

225. *See* 1 SAMUEL JOHNSON, A DICTIONARY OF THE ENGLISH LANGUAGE (5th ed. London 1773) (omitting the quotes from Shakespeare for the definition of "bankrupt" that appeared in the first edition and the eighth edition) (unpaginated); 1 SAMUEL JOHNSON, A DICTIONARY OF THE ENGLISH LANGUAGE (8th ed. London 1799) (unpaginated).

226. WILLIAM PERRY, THE ROYAL STANDARD ENGLISH DICTIONARY (3rd ed.) (1st American ed. Massachusetts 1794) ("Bankrupt, . . . one who cannot pay his debts"; "Bankruptcy, . . . The state of a bankrupt"; "Solvency, . . . an ability to pay"; "Solvent, a. able to pay debts"); 1 THOMAS SHERIDAN, DICTIONARY OF THE ENGLISH LANGUAGE (3d ed. London 1790) ("Bankruptcy f. The state of a man broken, or bankrupt; the act of declaring one's self bankrupt"; "Bankrupt, f. A person incapable of paying his debts; one against whom a commission of bankruptcy is awarded"; "Bankrupt, a. In debt beyond the power of payment"; "Insolvent, a. Unable to pay"; "Insolvency, f. Inability to pay debts"); THOMAS SHERIDAN, DICTIONARY OF THE ENGLISH LANGUAGE (6th ed. Philadelphia 1796) ("Bankrupt, a. In debt beyond the power of payment"; "Bankrupt, f. A man in debt beyond the power of payment"; "Bankruptcy, f. The state of a man broken, or bankrupt"; "Insolvent, a. Unable to pay"; "Insolvency, f. Inability to pay debts").

227. 1 OXFORD ENGLISH DICTIONARY 655-56 (1933).

blacksmith, petitioned the General Assembly for a discharge from his debts.[228] The May 1787, October 1787, and May 1788 sessions did not take final action on the petition and therefore continued it to the next session, each granting a temporary stay of execution.[229] The records of the first two sessions referred to the petitioner requesting "an Act of *Insolvency*."[230] The records of the May 1788 session, as well as those of the January 1789 session, which granted the petition, refer to the petitioner's prayer for "a special Act of *Bankruptcy*."[231]

Another example is the 1763 letter of Governor Bernard of Massachusetts to the London Board of Trade requesting approval of a limited bankruptcy act directed at absconding debtors. Governor Bernard recounted the problems the colony faced:

> This Winter a gentleman, who had acted considerably as a Banker, stop't payment for £170,000 Sterling. This was like an Earthquake to the Town: numbers of people were creditors, some for their all: Evry [sic] one dreaded the consequences; Lesser Merchants began to fail; a stop to all Credit was expected and a general *Bankruptcy* was apprehended for a time.[232]

The English statutes themselves did not always draw a clear line between bankruptcy and insolvency. The preamble for a 1746 statute, entitled "An Act for amending the Laws relating to Bankrupts" stated:

> Whereas many Persons within the Description of, and liable to the Statutes concerning Bankrupts, frequently commit secret Acts of Bankruptcy unknown to their Creditors and other Persons, with whom, in the Course of Trade, they have Dealings and Transactions; and after the committing thereof, continue to appear publickly and carry on their Trade and Dealings . . . in the usual Way of Trade, and in the same open and publick Manner as if they were *solvent* Persons, and had not become *Bankrupts*.[233]

This statute created an exception for the avoidance of transactions that were bona fide and in the ordinary course of trade.[234] Transferees were not liable to repay moneys received before they knew or had notice that the

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228. Nadelmann, *supra* note 200, at 222 n.29. When the petition was finally granted, the General Assembly exempted one set of blacksmith tools from the property the petitioner was to have assigned in exchange for his discharge. *Id.*

229. *Id.*

230. *Id.* (emphasis added).

231. *Id.* (emphasis added).

232. 4 ACTS AND RESOLVES, PUBLIC AND PRIVATE, OF THE PROVINCE OF MASSACHUSETTS BAY 793-94 (1881) (emphasis added). *See also* Bauer, *supra* note 199, app. C.

233. 19 Geo. 2, ch. 32, § 1 (1746) (Eng.) (emphasis added).

234. *Id.*

debtor had "become a *Bankrupt*, or that he [was] in *insolvent* Circumstances."[235]

Hening's 1820 volume of Virginia law indexes the shortlived Virginia discharge statute[236] under "Bankrupt" and describes it as "Act for relief of insolvent debtors, on the principles of the bankrupt law."[237] Hening also indexed the law under "Insolvents."[238]

At the time of the adoption of the Constitution, the popular use of the term "bankruptcy" meant insolvency; the American jurisdictions addressed the insolvent debtor and her creditors in a great variety of ways; English courts had been liberalizing the interpretation of "merchant," and Daniel Defoe[239] and James Burges[240] had made proposals for a more modern bankruptcy system. Given this background, would the Framers have used the terminology "Laws on the subject of Bankruptcies" if they had wanted to limit Congress to enacting laws providing only for an involuntary bankruptcy proceeding brought against an insolvent merchant like those under the English acts directed against "bankrupts"?[241] I think the answer is no. It is more likely that they actually intended to empower Congress to pass legislation addressing insolvent debtors and their creditors. More importantly, whatever the conscious intent of the individual Framers who were paying attention, given the historical, linguistic, and statutory background, this broader empowerment should be the presumed intent.

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235. *Id.* (emphasis added).

236. Ch. 8, Nov. Sess., 1762 Va. Laws; *see supra* note 169.

237. 7 LAWS OF VIRGINIA 673 (William W. Hening ed., 1820).

238. *Id.* at 681.

239. *See supra* note 86 and accompanying text.

240. *See supra* note 150 and accompanying text.

241. Although I, as do others, refer to the English "bankruptcy" acts, the term "bankruptcy" is little used in these acts. Instead, the term "bankrupt" or "bankrupts" dominates. *See, e.g.*, 34 & 35 Hen. 8, ch. 4 (1542-1543) (Eng.) (entitled "An Act against such Persons as do make Bankrupt"); 13 Eliz., ch. 7 (1570) (Eng.) (entitled "An Act touching Orders for Bankrupts"); 1 Jam., ch. 15 (1604) (Eng.) (entitled "An Act for the better Relief of the Creditors against such as shall become Bankrupts"); 21 Jam., ch. 19 (1604) (Eng.) (entitled "An Act for the further Description of a Bankrupt, and Relief of Creditors against such as shall become Bankrupts, and for inflicting corporal Punishment upon the Bankrupts in some special Cases"); 13 & 14 Car. 2, ch. 24 (1662) (Eng.) (entitled "An Act Declaratory concerning Bankrupts"); 4 Anne, ch. 17 (1705) (Eng.) ("An Act to prevent Frauds frequently committed by Bankrupts"); 5 Geo. 2, ch. 30 (1732) (Eng.) ("An Act to prevent the Committing of Frauds by Bankrupts"). All of the other bankruptcy acts refer to "Bankrupts." Only one statute includes "bankruptcy" in its title. 10 Anne, ch. 15 (1711) (entitled "An Act for repealing a Clause in the Statute made in the twenty-first Year of the Reign of King James the First, entitled, *An Act for the further Description of a Bankrupt, and Relief of Creditors against such as shall become Bankrupts, and for inflicting corporal Punishment upon the Bankrupts in some special Cases*, which makes Descriptions of Bankrupts; and for the Explanation of the Laws relating to Bankruptcy, in case of Partnership") (providing that a discharge of a debtor does not discharge the debtors partner).

### B. Implementation and Interpretation

The first four Congresses gave very brief consideration to bankruptcy legislation.[242] The Fifth Congress gave the subject more extensive treatment,[243] and in 1800 the Sixth Congress enacted the first federal bankruptcy law.[244] This act followed the English bankruptcy practice.[245] It was, in fact, a warmed over version of the 1732 Statute of 5 George II as subsequently extended and amended. Creditors could initiate proceedings only against a merchant that committed acts of bankruptcy that in essence signaled the merchants insolvency.[246] Debtors could not initiate proceedings. An insolvent merchant could receive a discharge if two-thirds of creditors in number and value agreed.[247] A cooperative debtor also received an allowance similar to that allowed by the English act: 5% (not to exceed $500) of the value of the debtor's property for a 50% payout to

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242. 1 ANNALS OF CONG. 433, 1143-44 (Joseph Gales ed., 1849) (First Congress, House of Representatives, committee to prepare a bill on "the subject of bankruptcy" appointed on June 1, 1789; a motion to appoint a committee to prepare bankruptcy legislation tabled on February 1, 1790; one of the speakers referred to England's prospering under its "system of bankruptcy"); 2 ANNALS OF CONG. 166, 618, 708, 742 (1849) (Second Congress, House of Representatives, committee to prepare bankruptcy bill appointed on November 9, 1791; petition from persons from South Carolina urging the passage of a "Bankrupt law" tabled on December 3, 1791; committee appointed on November 21, 1792; bill to establish system of bankruptcy reported, read twice and committed on December 10, 1792); 3 ANNALS OF CONG. 142, 256, 970 (1849) (Third Congress, House of Representatives, committee appointed on December 13, 1793; bill reported, read twice and committed on January 22, 1794 and on December 9, 1794); 4 ANNALS OF CONG. 149, 240, 1739-40 (1849) (Fourth Congress, House of Representatives, committee appointed December 1795; bill reported January 1796; motion to consider in committee as a whole defeated December 1796).

243. 5 ANNALS OF CONG. 692, 786-88, 796-97, 970, 2426, 2441, 2465-69, 2489-90, 2552-54, 2556, 2577-83, 2649-77 (1851). After several postponements, the House of Representatives, on Jan. 14, 1799, engaged in a lengthy debate and defeated a bill establishing a bankruptcy system by a vote of 47-44. *Id.* at 2649-77.

244. Act of Apr. 4, 1800, ch. 19, 2 Stat. 19 (repealed 1803). Probably because of the extensive debate during the preceding Fifth Congress, the bill passed the House of Representatives on February 21, 1780 with little debate or legislative maneuvering by a margin of 49-48 (the Speaker breaking a tie), 6 ANNALS OF CONG. 247, 388-89, 507-08, 533-34 (1851), and passed the Senate on March 28, 1800, by a margin of 16-12, also without any amendments or recorded debate, *id.* at 108-11, 115-16, 124-26.

245. The bill finally enacted, based on the English bankruptcy acts, was similar to bills that had been drafted and presented to the earlier Congresses. *See, e.g.*, 5 ANNALS OF CONG. 2466, 2467 (1851) (references to the fact that the bill being debated by the Fifth Congress, which was enacted by the Sixth Congress, had been before Congress for several years (remarks of Mr. Harper) and "served up constantly almost every session" (remarks of Mr. S. Smith)).

246. Act of Apr. 4, 1800, ch. 19, § 1, 2 Stat. 19 (repealed 1803).

247. *Id.* § 36, 2 Stat. at 31.

creditors, 10% (not to exceed $800) for a 75% payout, and a discretionary amount not to exceed 3% or $300 for a payout of less than 50%.[248] Although the act was to expire by its own terms in 1805,[249] the Congress repealed it in 1803 because it proved to be so unpopular.[250]

In enacting the first bankruptcy act, Congress did not discuss the scope of the Bankruptcy Clause. Because the act was modeled on the English bankruptcy acts, there was no occasion to argue that the act was or was not within the Bankruptcy Clause. Nevertheless, references by two representatives during the debate to the insolvency laws and bankruptcy laws enacted by the states are relevant to the question. John A. Bayard, in asserting the need for a national a bankruptcy act, stated:

> In most of the States there are insolvent laws, which differ in nothing from this [bill], except that they give all the advantages to the debtor, and none to the creditor. . . .
>
> The operation of an insolvent law is to discharge a man from prison; that of a bankrupt law only goes one step further, which is, to discharge his property also. In some of the States, he was told their insolvent law goes as far as this bankrupt law, by releasing both person and property.[251]

Abraham Baldwin, arguing against a single bankruptcy act for the entire nation, remarked:

> [W]hat are the inducements for this Legislature to take up the subject? It must be for the sake of making a uniform system of bankruptcy for the whole country; the arguments to enforce the measure must be derived from the importance of uniformity on this subject, rather than from the general principles of bankrupt laws, on which the States have been in the habit of judging and legislating at their pleasure.[252]

This general use of the term "bankruptcy" belies the notion that the early Congress considered that the "subject of Bankruptcies" was necessarily limited to the narrower English bankruptcy acts.

There were those who believed that the "subject of Bankruptcies" was so limited. In *Storey v. Adams*,[253] Justice Livingston described a "bankrupt" law as only an English styled bankruptcy act limited to involuntary proceeding against merchants.[254] Two years later—three decades after the

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248. *Id.* §§ 34-35, 2 Stat. at 31.

249. *Id.* § 64, 2 Stat. at 36.

250. Act of Dec. 19, 1803, ch. 6, 2 Stat. 248. *See* Vern Countryman, *A History of American Bankruptcy Law*, 81 COM. L.J. 226, 228 (1976); Tabb, *History*, *supra* note 62, at 14-15.

251. 5 ANNALS OF CONG. 2661-62 (1851).

252. *Id.* at 2669.

253. 1 F. Cas. 141 (C.C.D. N.Y. 1817) (No. 66).

254. *Id.* at 142. This case involved a New York insolvency law discharging the pre-

adoption of the Constitution and less than two decades after the first federal bankruptcy act—the Supreme Court rejected this view in *Sturges v. Crowninshield*.[255]

In *Sturges*, a creditor holding two notes issued in New York, sued for payment in Massachusetts. The debtor, maker of the notes, denied liability on the notes on the ground that he had received a discharge of debts pursuant to an 1811 New York statute. The creditor argued that the constitutional grant to Congress to enact bankruptcy laws precluded the state from enacting a "bankruptcy" law, that is, a law discharging debts.[256] The creditor also argued that the New York act impaired the obligation of contract in violation of Article 1, Section 10 of the Constitution.[257] The Court rejected the first argument and upheld the second.[258]

The Court first examined the question of whether the then unexercised power of Congress to pass bankruptcy legislation precluded the state from enacting "bankruptcy" laws allowing the discharge of debts and therefore restricted states to enacting "insolvency" laws that released debtors from prison. Discussing the asserted distinction between bankruptcy laws and insolvency laws, Chief Justice Marshall first noted: "[T]he line of partition between them is not so distinctly marked as to enable any person to say, with positive precision, what belongs exclusively to the one, and not to the other class of laws."[259] He then addressed three possible elements of distinction—what is the relief (release from prison or a discharge of debts), who may initiate proceedings, and what type of debtors are covered:

> It is said, for example, that laws which merely liberate the person are insolvent laws, and those which discharge the contract, are bankrupt laws.

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existing debts contracted in Massachusetts and owed to a Boston creditor. Justice Livingston also held that the law did not impair the obligation of contract in violation of Article I, section 10 of the Constitution. *Id.* at 151.

255. 4 U.S. (17 Wheat) 122 (1819). Justice Livingston did not dissent from the court's holdings.

256. *Id.* at 124-31.

257. *Id.* at 131-34.

258. *Id.* This holding also contradicted Justice's Livingston's holding in *Adams v. Storey*, 1 F. Cas. 141 (C.C.D. N.Y. 1817) (No. 66). *Cf.* Golden v. Prince, 10 F. Cas. 542 (C.C.D. Pa. 1814) (No. 5509). Justice Washington held that an 1812 Pennsylvania statute for the relief of insolvent persons purporting to discharge a debt contracted before the enactment of the law was not effective to discharge an existing bill of exchange. First, as it applied to the specific debt, the act impaired the obligation of contract. *Golden*, 10 F. Cas. at 544. Second, the act was unconstitutional because the power to pass bankruptcy legislation rested solely in the federal government. *Id.* at 547. Curiously, although this law is part of the American family of "insolvency" laws, the court stated "we do not mean to give any opinion on the subject of insolvent laws, acts of limitation, and the like, because they are not now before us . . . ." *Id.* This statement makes sense only if Justice Washington thinks an insolvent law only releases a debtor from prison.

259. 4 U.S. (17 Wheat) at 194.

> But if an act of congress should discharge the person of the bankrupt, and leave his future acquisitions liable to his creditors, we should feel much hesitation in saying, that this was an insolvent, not a bankrupt act; and therefore, unconstitutional. Another distinction has been stated, and has been uniformly observed. Insolvent laws operate at the instance of an imprisoned debtor; bankrupt laws at the instance of a creditor. But should an act of congress authorize a commission of bankruptcy to issue on the application of a debtor, a court would scarcely be warranted in saying, that the [act] was unconstitutional, and the commission a nullity.
>
> When laws of each description may be passed by the same legislature, it is unnecessary to draw a precise line between them. The difficulty can arise only in our complex system, where the legislature of the Union possesses the power of enacting bankrupt laws; and those of the states, the power of enacting insolvent laws. If it be determined, that they are not laws of the same character, but are as distinct as bankrupt laws and laws which regulate the course of descents, a distinct line of separation must be drawn, and the power of each government marked with precision. But all perceive that this line must be, in a great degree, arbitrary. Although the two systems have existed apart from each other, there is such a connection between them, as to render it difficult to say how far they may be blended together. The bankrupt law is said to grow out of the exigencies of commerce, and to be applicable solely to traders; but it is not easy to say, who must be excluded from, or may be included within, this description. It is, like every other part of the subject, one on which the legislature may exercise an extensive discretion.
>
> This difficulty of discriminating with any accuracy between insolvent and bankrupt laws, would lead to the opinion, that a bankrupt law may contain those regulations which are generally found in insolvent laws; and that an insolvent law may contain those which are common to a bankrupt law.[260]

Joseph Story, in his *Commentaries on the Constitution of the United States*, published in 1833, echoed Justice Marshall's view in *Sturges*, adding only a description of the American experience:

> It is believed, that no laws ever were passed in America by the colonies or states, which had the technical denomination of "bankrupt laws."[261] But insolvent laws, quite co-extensive with the English bankrupt system in their operations and objects, have not been unfrequent in colonial and state legislation. No distinction was ever practically, or even theoretically attempted to be made between bankruptcies and insolvencies. And a historical review of the colonial and state legislation will abundantly show, that a bankrupt law may contain those regulations, which are generally

260. *Id.* at 194.

261. Actually, Pennsylvania in 1785 enacted "An Act for the Regulation of Bankruptcy." Ch. 683, 1785 Pa. Stat., *found in* 12 PA. STAT. 1682-1801, *supra* note 165, at 70; *see also* COLEMAN, *supra* note 98, at 151-52.

> found in insolvent laws; and that an insolvent law may contain those, which are common to bankrupt laws.[262]

In a later and expanded version of his *Commentaries on the Constitution of the United States*,[263] Story added more discussion on the insignificance of the limitation of the English bankruptcy acts to merchants:

> In the English system the bankrupt laws are limited to persons, who are traders, or connected with matters of trade and commerce, as such persons are peculiarly liable to accidental losses, and to an inability of paying their debts without any fault of their own. But this is a mere matter of policy, and by no means enters into the nature of such laws. There is nothing in the nature or reason of such laws to prevent their being applied to any other class of unfortunate and meritorious debtors.[264]

Story also gave his own description of the subject of bankruptcies:

> Perhaps as satisfactory a description of a bankrupt law, as can be framed, is, that it is a law for the benefit and relief of creditors and their debtors, in cases, in which the latter are unable, or unwilling to pay their debts. And a law on the subject of bankruptcy, in the sense of the constitution, is a law making provisions for cases of persons failing to pay their debts.[265]

Congress addressed bankruptcy legislation on several occasions during the next three decades, but it did not enact a new bankruptcy law until 1841. Several members of Congress proposed bankruptcy legislation that allowed non-merchants to file voluntary bankruptcy proceedings. These never passed. One of the objections made was that a law including voluntary proceedings for non-merchants was an insolvency law beyond Congress's power. More importantly, however, there was great resistance for reasons of policy among the legislators to allow petitioning non-merchants to avoid their debts through a bankruptcy discharge. On the other hand, there was also great resistance to limiting the benefits of a bankruptcy discharge to merchants.[266]

The second American bankruptcy act, passed in 1841, was broader than the first. Although involuntary proceedings could only be brought against

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262. JOSEPH STORY, COMMENTARIES ON THE CONSTITUTION OF THE UNITED STATES § 543, at 390 (Boston, Hilliard, Gray, and Co. 1833). *See also* 3 JOSEPH STORY, COMMENTARIES ON THE CONSTITUTION OF THE UNITED STATES § 1111, at 50-51 (1851) [hereinafter STORY (1851)].

263. 3 STORY (1851), *supra* note 262.

264. *Id.* § 1113, at 52-53 (footnote citing 2 BLACKSTONE, *supra* note 109, at *473-74 for the proposition in the first sentence omitted).

265. *Id.* § 1113, at 53 n.2.

266. CARL B. SWISHER, HISTORY OF THE SUPREME COURT OF THE UNITED STATES: THE TANEY PERIOD, 1836-1864, at 138 (1974); WARREN, *supra* note 8.

merchants, all insolvent debtors could initiate proceedings to obtain a discharge of their existing debts.[267] Insolvent debtors assigned all their assets to assignees, who liquidated them and distributed the proceeds among the creditors.[268] The debtor received a discharge unless a majority by number and value of creditors filed written objections.[269] This act too proved to be shortlived. It was repealed after eighteen months.[270]

Creditors challenged the constitutionality of the 1841 act as being beyond the bankruptcy power. The district court in *In re Klein* agreed.[271] Relying on the distinction that Blackstone had made between a bankruptcy law and an insolvency law, the court held that the subject of bankruptcy was limited to an English style bankruptcy act in which creditors initiated proceedings against merchant debtors.[272]

On appeal, Justice Catron sitting as the circuit justice reversed.[273] In doing so, he cited the American experience with different forms of insolvency legislation, and held that the Bankruptcy Clause encompassed those as well as the English acts. He concluded:

> [A]nd the true inquiry is, to what limits is that jurisdiction [the Bankruptcy Clause] restricted? I hold it extends to all cases where the law causes to be distributed the property of the debtor among his creditors; this is its least limit. Its greatest is a discharge of the debtor from his contracts. And all intermediate legislation, affecting substance and form, but tending to further the great end of the subject—distribution and discharge—are in the competency and discretion of congress.[274]

This formulation of the bankruptcy power has been cited or quoted with approval by the Supreme Court on several occasions.[275]

Congress enacted a national bankruptcy act for the third time in 1867.[276] It abolished the merchant and non-merchant distinction.[277] All debtors, including for the first time corporations, could initiate voluntary

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267. Act of Aug. 19, 1841, ch. 9, 5 Stat. 440 (repealed 1843). *See* Countryman, *supra* note 250, at 229 (1976); Tabb, *History*, *supra* note 62, at 116-18.

268. Act of Aug. 19, 1841, ch. 9, § 3, 5 Stat. 440, 443 (repealed 1843).

269. *Id.* § 4, 5 Stat. at 443.

270. Act of Mar. 3, 1843, ch. 82, 5 Stat. 614.

271. 14 F. Cas. 719 (D. Mo. 1843) (No. 7866).

272. *Id.* at 728.

273. *In re* Klein, 14 F. Cas. 716 (C.D.D. Mo. 1843) (No. 7865).

274. *Id.* at 718.

275. United States v. Bekins, 304 U.S. 27, 47 (1938); Louisville Joint Stock Land Bank v. Radford, 295 U.S. 555, 588 n.18 (1935); Continental Ill. Nat'l Bank & Trust Co. v. Chicago, Rock Island & Pac. Ry., 294 U.S. 648, 669 (1935); Hanover Nat'l Bank v. Moyses, 186 U.S. 181, 186 (1902).

276. Act of Mar. 2, 1967, ch. 176, 14 Stat. 517 (repealed 1878). *See* Countryman, *supra* note 250, at 229-30; Tabb, *History*, *supra* note 62, at 18-21.

277. Act of Mar. 2, 1967, ch. 176, §§ 11, 39, 14 Stat. 517, 521, 536 (repealed 1878).

proceedings and be the subject of involuntary proceedings.[278] For the first year of its operation, no creditor consent was necessary for a discharge.[279] After that, discharge required a majority of creditors by number and value if the creditors received less than 50% of their debts.[280] A long list of prescribed conduct would also bar a discharge.[281]

Congress added an important innovation in 1874.[282] Debtors could enter into composition agreements and extension agreements that would be binding on all unsecured creditors if a majority in number and 75% in value agreed. Congress, however, repealed the act in 1878.[283]

Creditors challenged the 1874 amendment allowing compositions binding non-consenting minority creditors as beyond the bankruptcy power in *In re Reiman*.[284] In particular, the creditors complained that a composition agreement might provide that the debtor could retain its property.[285] Judge (and later Supreme Court Justice) Blatchford[286] rejected these arguments.[287] In doing so, Judge Blatchford reviewed the development of bankruptcy legislation under the Constitution, the 1851 edition of Story's *Commentaries on the Constitution*,[288] *Sturges v. Crowninshield*,[289] *In re Klein*,[290] and other decisions. Discussing the constitutionality of the 1874 amendment, he addressed the scope of the Bankruptcy Clause: "What is the 'subject of bankruptcies'? It is not, properly, anything less than the subject

278. *Id.*

279. *Id.* §§ 29, 33, 14 Stat. at 531, 533.

280. *Id.* In 1874, this section was amended to provide that no consent was necessary in involuntary proceedings, and that if less than 30% of the claims were paid, the voluntary bankrupt was entitled to a discharge only if one-fourth of the creditors by number and one-third in value consented. Act of June 22, 1874, ch. 390, § 9, 18 Stat. 178, 180 (repealed 1878).

281. *Id.* at 532 § 29. These included wilfully making a materially false affidavit attached to the petition for bankruptcy, concealing or transferring assets to defraud his creditors, destroying or falsifying his books and accounts, removing property from the district to defraud creditors, fraudulently conveying his property or losing part of his property through gaming, having made a preferential payment to creditors, paying money to obtain consent of creditors in the bankruptcy proceeding, or being convicted of a misdemeanor under the act.

282. Act of June 22, 1874, ch. 390, § 17, 18 Stat. 178, 182-83 (repealed 1878).

283. Act of Sept. 1, 1878, ch. 160, 20 Stat. 99.

284. 20 F. Cas. 490, 492 (S.D.N.Y. 1874) (No. 11,673), *aff'd*, 20 F. Cas. 500, 501 (C.C.S.D.N.Y. 1875) (No. 11,675).

285. *Id.*

286. In Memoriam, Samuel Blatchford, 150 U.S. 707, 707-08 (1983).

287. *In re* Reiman, 20 F. Cas. at 492.

288. *Id.* at 493 (quoting STORY (1851), *supra* note 262, §§ 1111, 1113).

289. 4 U.S. (17 Wheat) 122 (1819).

290. 14 F. Cas. 716 (C.D.D. Mo. 1843) (No. 7865).

of the relations between an insolvent or non-paying or fraudulent debtor, and his creditors, extending to his or their relief."[291]

In view of the provisions of the eighteenth century English bankruptcy acts and the American statutes, the court's decision upholding the 1874 amendment is not a surprising result. The English bankruptcy acts bound dissenting creditors to the discharge of the debtors' debts if 80% in number and value agreed.[292] Several of the American statutes, like the New York statute of 1786, bound minority creditors to the discharge of all debts when a specified percentage of creditors agreed.[293] Others bound all creditors to a discharge when no creditor agreed.[294] In Delaware, creditors were bound to accept service in repayment of debt. If they chose not to accept the debtor's service, the debt was discharged.[295] In many of the American statutes of either type and in the English bankruptcy and insolvency statutes, the debtor also was entitled to retain certain property, like tools and clothing, to enable him or her to function in society.[296] Other statutes bound minority dissenting creditors to composition agreements to which a majority of creditors had agreed.[297] Although the composition provisions of the 1874 amendments had a larger scale, since they could be applied to large corporations with huge assets and huge debts, they were conceptually no different from the various relief provisions of a simpler time.

Finally, after an eight year effort, Congress enacted the first permanent bankruptcy law, the Bankruptcy Act of 1898.[298] This law eliminated any requirement for creditor consent to a discharge.[299] Although there were some mild complaints about the liberal discharge provisions,[300] the act

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291. *In re* Reiman, 20 F. Cas. at 496. This statement of the bankruptcy power has been cited or quoted with approval by the Supreme Court on several occasions. Wright v. Union Central Life Ins. Co., 304 U.S. 502, 513-14 & n. 12 (1938); Louisville Joint Stock Land Bank v. Radford, 295 U.S. 555, 588 n.18 (1935); Continental Ill. Nat'l Bank & Trust Co. v. Chicago, Rock Island & Pac. Ry., 294 U.S. 648, 672-73 (1935); Hanover Nat'l Bank v. Moyses, 186 U.S. 181, 187 (1902).

292. *See supra* note 68 and accompanying text.

293. *See supra* note 168 and accompanying text.

294. *See supra* note 169 and accompanying text.

295. *See supra* note 176 and accompanying text.

296. *See, e.g., supra* notes 71, 129, 182, 198, and accompanying text.

297. *See* Countryman, *supra* note 250, at 227; Israel Treiman, *Majority Control in Compositions: Its Historical Origins and Development*, 24 VA. L. REV. 507 (1938) (both describing the early seventeenth century practice of the Privy Council to force dissenting creditors to accept compositions and the shortlived 1697 English statute, 8-9 Will. 3, ch. 18 (1697) (Eng.), authorizing such enforced compositions); *see also supra* notes 80, 161.

298. Ch. 541, 30 Stat. 544 (1898) (repealed 1978). *See* Countryman, *supra* note 250, at 230-31; Tabb, *History, supra* note 62, at 23-26.

299. *See* Countryman, *supra* note 250, at 231.

300. *See* James M. Olmstead, *Bankruptcy a Commercial Regulation*, 15 HARV. L. REV. 829, 834-35 (1909).

easily withstood challenges to its constitutionality as within the "subject of Bankruptcies."[301]

In 1933, Congress broadened the 1898 Act to include reorganization provisions for non-corporations, farmers, and railroads.[302] In 1935, the Supreme Court on its own motion considered the constitutionality of the 1933 amendments authorizing the reorganization of insolvent railroads.[303] In *Continental Illinois National Bank & Trust Co. v. Chicago, Rock Island & Pacific Railway Co.*, the railroad and its affiliates filed a petition for reorganization alleging its inability to pay its debts as they matured.[304] The petitioner then requested, and the bankruptcy court granted, an injunction prohibiting several secured creditors holding mortgage bonds of the railroad as collateral from selling the collateral to repay their debts.[305] The creditors challenged the injunction on several grounds, including that the injunction deprived them of property in violation of the due process guarantees of the Constitution.[306]

Although the parties did not raise the question,[307] Justice Sutherland determined that the 1933 amendment was within Congress's power under the Bankruptcy Clause.[308] In doing so, the Court concluded that the amendment allowing railroad reorganization "advances another step in the direction of liberalizing the law on the subject of bankruptcies."[309] This

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301. *See* Hanover Nat'l Bank v. Moyses, 186 U.S. 181, 187 (1902) (upholding the constitutionality of the Bankruptcy Act of 1898 against claims that it allowed for voluntary petitions by non-merchants and that it was non-uniform because it allowed the debtor to exempt property from the claims of creditors on the basis of state law exemptions).

302. Act of Mar. 3, 1933, ch. 204, 47 Stat. 1467, as amended by Act of Aug. 28, 1935, ch. 792, 49 Stat. 942.

303. Continental Ill. Nat'l Bank & Trust Co. v. Chicago, Rock Island & Pac. Ry., 294 U.S. 648 (1935).

304. *Id.* at 656-57.

305. *Id.*

306. *Id.* at 667.

307. The creditors did not claim that the injunction authorized by Congress exceeded the Bankruptcy Clause. *Id.* at 650-56, 677. As the creditors may have recognized, from almost the beginning, bankruptcy laws interfered with creditor's remedies. Instead, the creditors claimed that the injunction interfered with their state law rights to foreclose on collateral securing their debt and therefore deprived them of property without due process in violation of the Fifth Amendment. *Id.* at 651-52, 680.

308. *Id.* at 671.

309. *Id.* The Court significantly misstated the history of the Bankruptcy Clause. It stated that the 1800 bankruptcy act "so far ignored the English law, which was confined to traders, as to include bankers, brokers, and underwriters as well. The act of 1841 added merchants . . . ." *Id.* at 670. Actually, the English law of the eighteenth century included all of the foregoing except underwriters. *See supra* note 107 and accompanying text. The Court then stated that "[t]he act of 1800, like the English law, was conceived in the view that the bankrupt was dishonest; while the act of 1841 and the later acts proceeded upon the assumption that he might be honest but unfortunate." *Continental Ill. Nat'l Bank & Trust*

statement is ambiguous. It can be read to mean that the Congress's power to legislate on the "subject of Bankruptcies" has expanded, as some have suggested.[310] Or it could simply be a recognition that Congress has expanded its legislative tools within the confines of its legislative power.[311]

Nevertheless, the Court did imply that Congress's power was not limitless, although it was difficult to define.[312] The Court also repeated with approval a state court description that the Bankruptcy Clause essentially meant that Congress could pass laws "'on the subject of any person's general inability to pay his debts.'"[313] Finally, the Court stated that it could not make a distinction between a reorganization under the 1933 amendment and the enforced compositions authorized by the 1874 amendment to the 1867 bankruptcy act.[314] In doing so it cited with approval the conclusion in *In re Reiman* that "the 'subject of bankruptcies' was nothing less than 'the relations between an insolvent or non-paying or fraudulent debtor, and his creditors, extending to his and their relief.'"[315]

The Court's indecisiveness about the limits of the Bankruptcy Clause continued in *Wright v. Union Central Life Insurance Co.*[316] This case involved 1933 and 1935 amendments to the Bankruptcy Act of 1898, which allowed insolvent farmers to seek a composition or extension of time to pay debts.[317] The 1935 amendment automatically extended all state law

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*Co.*, 294 U.S. at 670. In fact, the notion of the honest but unfortunate merchant or trader was the eighteenth century rationale for limiting the English bankruptcy acts to merchants. *See supra* note 109 and accompanying text.

310. *See supra* note 10; *see also* Kennedy, *supra* note 11.

311. Earlier, the court noted, "From the beginning, the tendency of legislation and of judicial interpretation has been uniformly in the direction of progressive liberalization in respect of the *operation* of the bankruptcy power." *Continental Ill. Nat'l Bank & Trust Co.*, 294 U.S. at 668 (emphasis added).

312. The Court stated:

> But, while it is true that the power of Congress under the bankruptcy clause is not to be limited by the English or Colonial law in force when the Constitution was adopted, it does not follow that the power has no limitations. Those limitations have never been explicitly defined, and any attempt to do so now would result in little more than a paraphrase of the language of the Constitution without advancing far toward its full meaning.

*Id.* at 669-70.

313. *Id.* at 670 (quoting Kunzler v. Kohaus, 5 Hill 317, 321 (N.Y. 1843), *cited with approval in* Hanover Nat'l Bank v. Moyses, 186 U.S. 181, 187 (1902)).

314. *Continental Ill. Bank & Trust Co.*, 294 U.S. at 672.

315. *Id.* at 673 (*quoting In re* Reiman, 20 F. Cas. 490, 496 (S.D.N.Y. 1874) (No. 11,673)), *aff'd*, 20 F. Cas. 500 (C.C.S.D.N.Y. 1875) (No. 11,675).

316. 304 U.S. 502 (1938).

317. Act of Mar. 3, 1933, ch. 204, 47 Stat. 1467, as amended by Act of Aug. 28, 1935, ch. 792, 49 Stat. 942.

redemption periods upon the filing of a petition.[318] A creditor which had purchased its debtor's land pursuant to a foreclosure of a mortgage but which had not, because of a one year statutory redemption right under state law,[319] obtained title to the property challenged the automatic extension. The Court held that the automatic extension of state law redemption periods was within Congress's bankruptcy power.

In doing so, the Court stated: "The subject of bankruptcy is incapable of final definition. The concept changes. It has been noted that it is not limited to the connotation of the phrase in England or the States, at the formulation of the Constitution."[320] These sentences represent sloppy writing by the Court. Just two sentences later the Court gave the well known and well cited[321] definition of the bankruptcy power provided by the district court in *In re Reiman* discussed above: "The subject of bankruptcies is nothing less than 'the subject of the relations between the insolvent or nonpaying or fraudulent debtor, and his creditors, extending to his or their relief.'"[322] The automatic extension—an automatic stay—was well within this formulation of the reach of the bankruptcy power and thus within the "subject of Bankruptcies" as understood at the time of the adoption of the Constitution.

The creditor in this case further argued that the automatic extension fell outside of the subject of bankruptcy because it affected not just creditors but also purchasers at mortgage foreclosure sales. The Court rejected this contention by saying that a

> purchaser at a judicial sale does enter into the radius of the bankruptcy power over debts. His purchase is in the liquidation of the indebtedness. The debtor has a right of redemption of which the purchaser is advised, and until that right of redemption expires the rights of the purchaser are subject to the power of the Congress over the relationship of debtor and creditor and its power to legislate for the rehabilitation of the debtor.[323]

The Court does not tell us why the bankruptcy power reaches this purchaser. Broadly read, this "radial" thinking[324] could support a law that included third parties generally in the "radius" of the bankruptcy power if doing so

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318. Act of Aug. 28, 1935, ch. 792, 49 Stat. 942.

319. Under Indiana law, a purchaser at a mortgage foreclosure sale received a certificate of sale. The mortgagor then had one year in which to redeem the land by paying the mortgage debt plus interest and costs. The purchaser had a right to receive either the redemption money during the year or a deed at the end of a year. 304 U.S. at 505, 516.

320. *Id.* at 513.

321. *See supra* note 275 and accompanying text.

322. *Wright*, 304 U.S. at 513-14.

323. *Id.* at 514.

324. Not to be confused with "penumbral reasoning." *See* Glenn H. Reynolds, *Penumbral Reasoning on the Right*, 140 U. PA. L. REV. 1333 (1992).

would help rehabilitate the debtor. The Court's language should not be read so broadly, however, for a simple reason. As the Court later points out, a purchaser at a foreclosure sale becomes a creditor of the debtor. Under the applicable state law, this purchaser had the right either to get back the redemption price from the debtor (plus presumably interest and costs) that it paid at the foreclosure sale or to receive the deed.[325]

In sum, despite some loose language about the subject of bankruptcy being incapable of final definition[326] and the liberalization of the subject of bankruptcy,[327] the Supreme Court in the twentieth century has been consistent in describing the "subject of Bankruptcies" as the relations between the insolvent debtor and its creditors. As the Supreme Court and other courts in the nineteenth century rejected creditor challenges to new ways that Congress chose to adjust that relationship in light of changing commercial conditions, they have not stepped beyond the boundaries of the insolvent debtor-creditor relationship.

### *C. Meaning*

Some scholars have assumed that the scope of Congress's power under the Bankruptcy Clause has expanded as the scope of the laws themselves has expanded.[328] More particularly, some see the initial scope of the Bankruptcy Clause as being limited to an English-style system in which there can be only involuntary proceedings against merchants.[329] This implies that, as the needs of society became more complex, the scope of the Bankruptcy Clause expanded to meet those needs.

These views are historically and analytically incorrect. Certainly, as commerce and business have developed in the United States over the last two centuries, the tools that Congress may choose under its bankruptcy power to help resolve the problems between insolvent debtors and their creditors must change and adapt to new conditions. That is not to say, however, that the scope of the bankruptcy power must change.

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325. *Id.* at 516 ("The rights of the purchaser, who under the state law is entitled to the redemption money or possession within a year, are not substantially different from those of a mortgagee entitled, on the maturity of the obligation, to payment or sale of the property.").

326. *Id.* at 513.

327. *Continental Ill. Nat'l Bank & Trust Co.*, 294 U.S. at 671.

328. BANKRUPTCY COMMISSION REPORT, *supra* note 10; Kennedy, *supra* note 11.

329. FRANK O. LOVELAND, A TREATISE ON THE LAW AND PROCEEDINGS IN BANKRUPTCY §§ 1-8 (4th ed. 1912); Tabb, *History*,*supra* note 62, at 6, 44; Tabb, *Discharge*, *supra* note 62, at 326, 340-41, 345; *see also supra* note 10. The Report of the 1973 Bankruptcy Commission, which lead to the 1978 Bankruptcy Code, overemphasizes the assumed distinction between "insolvency" legislation and "bankruptcy" legislation. BANKRUPTCY COMMISSION REPORT, *supra* note 10, pt. I, at 64.

"Bankruptcy" as understood at the time of the constitutional convention covered a relatively discreet social problem: What to do about debtors who cannot pay their creditors. It was not concerned about the larger questions of how debtors and creditors entered into their relationship. It did not seek to regulate contracts or property rights of creditors or debtors in general or of those who had not extended credit to debtors.[330] It did provide a procedure that altered the rights of debtors and creditors when a debtor became insolvent.

The alteration of the creditors rights will be nominal if the debtor has no assets. A creditor cannot force a debtor who has no assets to pay a debt. The alteration of creditors' rights may also be real, as in the case in which the debtor has sufficient illiquid assets but insufficient liquid assets to pay now. A forced liquidation may be inefficient for the debtor and for society. In either event, stopping the wasteful pursuit of individual creditor remedies against an insolvent debtor and providing the "best" form of relief for the insolvent debtor and his creditors is the subject of bankruptcy.

Regardless of the extent of relief or the particular form of relief, the subject of bankruptcy is adjusting the relationship between an insolvent debtor and her creditors. This fact dictates two logical conclusions. First, Congress's bankruptcy power extends only to insolvent debtors. Second, bankruptcy laws must be for the benefit of insolvent debtors and their creditors. They may not create benefits for third parties to the detriment of those debtors and creditors or impair the rights of third parties for the benefit of these debtors and creditors.

As I discuss in the following parts, we have started to cross the Constitutional boundaries of bankruptcy in several places. Crossing the boundaries of the Bankruptcy Clause erodes a principled interpretation of the Constitution. To arrest this erosion, Congress's laws and courts' interpretations must adhere to the confines of the subject of bankruptcies: adjusting the relationship between an insolvent debtor and her creditors.

## V. INSOLVENCY OF THE DEBTOR

Congress's bankruptcy power extends only to insolvent debtors. This limit implies two conclusions. First, insolvency is a jurisdictional requirement for invoking the Bankruptcy Code. Second, Congress may not rely on the Bankruptcy Clause to regulate generally the relations between debtors and their creditors.

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330. Early bankruptcy legislation often contained provisions allowing the assignees or the trustees for the debtor's property to recover from a third party property fraudulently conveyed to that party by the debtor. Although closely tied to bankruptcy legislation, this possibility of recovery also existed as a separate creditor remedy outside of bankruptcy. *See infra* note 467 and accompanying text.

### *A. Insolvency A Jurisdictional Requirement*

The first three American bankruptcy acts contained an insolvency requirement for voluntary and involuntary proceedings.[331] The Bankruptcy Act of 1898, however, contained no insolvency requirement for voluntary liquidation proceedings.[332] Curiously, the Supreme Court's official form of the voluntary bankruptcy petition under the 1898 act originally included an averment that the debtor "owes debts which he is unable to pay in full."[333] In 1939, the Supreme Court's revision of the official form omitted these words.[334] In 1933 and 1934, Congress amended the 1898 Act to provide for the reorganization of noncorporate persons, farmers, railroads, and corporations, and these provisions did contain an insolvency requirement.[335] Pursuant to the 1938 Chandler Act, Congress revised the

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331. Act of Apr. 4, 1800, ch. 19, § 1, 2 Stat. 19, 20-21 (1800) (repealed 1803) (involuntary proceedings only against merchants who committed certain acts of bankruptcy, including being arrested for debt and remaining in prison for two months), *supra* note 244; Act of Aug. 19, 1841, ch. 9, § 1, 5 Stat. 440, 441-42 (1841) (repealed 1843), *supra* note 267; Act of Mar. 2, 1867, ch. 176, § 11 (voluntary), § 39 (involuntary, based on acts of bankruptcy), 14 Stat. 517, 521, 536 (1867) (repealed 1878), *supra* note 276.

332. Ch. 541, § 4, 30 Stat. 544, 547 (1898) (repealed 1978). Although the legislative history for the Bankruptcy Code does not directly address a requirement for insolvency, the House Report on the Bankruptcy Reform Act of 1978 implicitly recognized that insolvency was an unstated element of the Bankruptcy Act of 1898:

> When the Bankruptcy Act was adopted 80 years ago, the underlying premise was that the money of the estate was essentially a trust for the benefit of the bankrupt's creditors. Consequently, the creditors themselves should be entitled to supervise the collection and liquidation of the estate. . . .
>
> . . . .
>
> The notion of creditor control, while still theoretically sound, has failed in practical terms. Creditor control in bankruptcy cases is a myth. Creditors take little interest in pursuing a bankrupt debtor. They are unwilling to throw good money after bad.

H.R. REP. NO. 595, 95th Cong., 2d Sess. 91-92 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6053 (footnotes omitted). The House Report was addressing the fact that, because of the lack of significant creditor involvement, the administrative burdens of controlling the proceeding fell upon the bankruptcy judge. H.R. REP. NO. 595, at 88-109, *reprinted in* 1978 U.S.C.C.A.N. at 6049-70. The Bankruptcy Reform Act was designed to separate the administrative and judicial functions in the bankruptcy proceeding, take the bankruptcy judge out of the administrative functions and allow her to concentrate on the judicial function. *Id.*

333. General Orders and Forms in Bankruptcy, 172 U.S. 653, 667 (1898) (Form No. 1).

334. General Orders and Forms in Bankruptcy, 305 U.S. 677, 717-18 (1939) (Form No. 1).

335. Act of Mar. 3, 1933, ch. 204, 47 Stat. 1467, 1467, 1471, 1474 (persons other than corporations, farmers and railroads) (adding new §§ 73-77 to the 1898 Act; insolvency requirement contained in new §§ 74(a), 75(c), 77(a)); Act of June 7, 1934, ch. 424, 48 Stat. 911, 912 (corporations) (adding new § 77B to the 1898 Act; insolvency requirement

reorganization provisions for corporate and non-corporate persons and added Chapter XIII for wage earners, all of which contained an insolvency requirement.[336]

The 1978 Code, which replaced the 1898 Act as amended, contains no insolvency requirement for voluntary proceedings except for municipalities.[337] Generally, it is assumed that insolvency is not a jurisdictional requirement for a voluntary proceeding.[338]

One argument against an explicit insolvency requirement is that it is unnecessary. As a practical matter, the vast majority of bankruptcy cases involve debtors who are insolvent.[339] Solvent debtors do not want to give up control over their property or suffer the stigma of bankruptcy.

Also, an insolvency requirement presents many practical problems. If insolvency were a jurisdictional requirement, creditors who want to avoid a bankruptcy proceeding would litigate as a jurisdictional matter many of the issues that the entire bankruptcy proceeding is designed to resolve: what are the assets of the debtor and what are the liabilities. Debtors could also manipulate insolvency in bad faith, such as by refusing to pay debts that they are fully capable of paying, and such manipulation would be difficult to police.[340]

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contained in new § 77B(a)).

336. Act of June 22, 1938, ch. 575, §§ 130, 323, 423, 623, 52 Stat. 840, 896, 907, 923, 932 (1938) (codified as amended at 11 U.S.C. §§ 530, 723, 823, 1023 (1976)) (repealed 1978).

337. *See* 11 U.S.C. § 109(1994). Under 11 U.S.C. § 303(h)(1)(1994), the bankruptcy court may enter a contested order of relief on an involuntary petition only if "the debtor is generally not paying such debtor's debts as such debts become due unless such debts are the subject of a bona fide dispute."

338. *See, e.g., In re* Johns-Manville Corp., 36 B.R. 727, 732 (Bankr. S.D.N.Y. 1984); 1 WILLIAM COLLIER, BANKRUPTCY ¶ 4.03, at 579-82 (James W. Moore ed., 14th ed. 1974) (discussing cases under the 1898 Bankruptcy Act).

339. *See, e.g.*, Jagdeep S. Bhandari & Lawrence A. Weiss, *The Increasing Bankruptcy Filing Rate: An Historical Analysis*, 67 AM. BANKR. L.J. 1, 12-13 (1993) (finding a statistically significant positive relationship between the amount of debt of individual and corporate debtors and the rate of bankruptcy filings, and a statistically significant negative relationship between income and profits on the one hand and the filing rate on the other); Teresa Sullivan et al., *Consumer Debtors Ten Years Later: A Financial Comparison of Consumer Bankrupts 1981-1991*, 68 AM. BANKR. L.J. 121, 140 (1994) ("While there undoubtedly are individual debtors in the system who have misbehaved, these data [presented and analyzed by the authors] demonstrate that, in general, the bankruptcy system is used by the people for whom it was intended: those drowning in debt."); *see also* BANKRUPTCY COMMISSION REPORT, *supra* note 10, pt. I, at 19 (stating, in the context of the recommendation that insolvency of the debtor be presumed 90 days before bankruptcy in avoiding a preferential transfer, that "common sense would indicate that a business is usually insolvent for a number of months before filing a petition in bankruptcy.")

340. The difficulty in policing when a debtor is insolvent in a cash flow sense—unable to pay current debts as they mature—mirrors the difficulty that Congress and the courts have

Congress could ameliorate any difficulty of having insolvency as an express jurisdictional requirement by creating a presumption of insolvency and shifting the burden of proof on those who would contest the debtor's insolvency. Congress did this in the case of preferences under section 547. Under the Bankruptcy Act of 1898, the trustee had the burden of proving that the debtor was insolvent when she made the preferential transfer within four months of bankruptcy.[341] In enacting the Code, Congress recognized that this requirement forced the trustee to prove a fact that was almost always true.[342] Agreeing with the Bankruptcy Commission that it was important to keep the insolvency requirement at the time of a preferential transfer,[343] Congress created a presumption of insolvency.[344]

Despite the difficulties of an express insolvency requirement, it is both necessary as a constitutional matter and desirable as a matter of policy. The absence of insolvency as a jurisdictional requirement has given some solvent debtors an opportunity to use for strategic advantage the special rules available only in bankruptcy.[345] Courts faced with extreme examples of

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had in curtailing a perceived abuse of the bankruptcy process by individuals with high current incomes who receive discharge of debts that they would be able to pay. Pursuant to a 1984 amendment, the bankruptcy court, only on its own motion, may dismiss a petition filed by an individual with mostly consumer debts if it finds that granting relief in a Chapter 7 liquidation would be a substantial abuse of the provisions of Chapter 7. 11 U.S.C. § 707(b) (1994). In enacting this provision, Congress rejected proposals that would have limited a discharge under Chapter 7 in various ways to those who demonstrated an inability to pay. *See generally* Hallinan, *supra* note 85, at 74-75; Raymond T. Nimmer, *Consumer Bankruptcy Abuse*, L. & CONTEMP. PROBS., Spring 1987, at 89, 94-99.

Still, an insolvency test would be less difficult to administer than an "ability to pay" test. If a debtor's liabilities exceed her assets, which occurs in even many of the consumer bankruptcy abuse cases, there is no need as a constitutional matter to address whether the debtor is suffering a good faith cash flow insolvency. The court would only have to determine the latter if her assets exceeded liabilities. In that case, the creditors in most cases may not care whether there is a cash flow insolvency because in a liquidation of the assets they would be paid in full. The principal problem with the lack of an insolvency test is the ability of a solvent debtor to use the bankruptcy process to take advantage of a rule change that is not available outside of bankruptcy.

341. 11 U.S.C. § 96(a)(1) (1976) (repealed).

342. H.R. REP. NO. 595, 95th Cong., 2d Sess. 178 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6138-39.

343. BANKRUPTCY COMMISSION REPORT, *supra* note 10, pt. I, at 19.

344. 11 U.S.C. § 547(f) (1994). The House Report states that this presumption shifts to a challenger the burden of producing of evidence to the contrary, but does not shift the ultimate burden of proof on the issue from the trustee. H.R. REP. NO. 595, 95th Cong., 2d Sess. 178-79 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6139. The Bankruptcy Commission would have shifted the burden of proof from the trustee. BANKRUPTCY COMMISSION REPORT, *supra* note 10, pt. I, at 19.

345. Creditors cannot use bankruptcy proceedings against solvent debtors for strategic purposes because of the insolvency requirement for involuntary petitions. *See supra* notes

this behavior have dismissed voluntary petitions on the grounds that the bankruptcy filing was not filed in "good faith."

For example, in *Shell Oil Co. v. Waldron (In Re Waldron)*,[346] the Court of Appeals for the Eleventh Circuit ordered the dismissal of a Chapter 13 bankruptcy petition filed by solvent debtors for the sole purpose of rejecting an option purchase agreement. The bankruptcy court in *In Re Bandini*[347] dismissed the petition of a solvent debtor who filed a Chapter

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32, 337. Involuntary bankruptcy proceedings should continue to be limited to insolvent debtors. Indeed it is ironic that voluntary bankruptcy under the Code is not limited to insolvent debtors, but that involuntary proceedings are. Initially, the English bankruptcy acts gave creditors a remedy for certain fraudulent acts of the debtor. *See supra* note 118 and accompanying text; *see also* Countryman, *supra* note 250, at 226-27. Technically, insolvency was not required. Nevertheless, by the eighteenth century, the focus of the English bankruptcy acts and the definition of "acts of bankruptcy" evolved to passive acts that in fact reflected the insolvency of the debtor. *See supra* notes 119-26 and accompanying text; *see also* Andrew J. Duncan, *From Dismemberment to Discharge: the Origins of Modern American Bankruptcy Law*, 100 COM. L.J. 191, 203-04 (1995). Even the earlier acts of bankruptcy reflect the effects of insolvency. The debtor who did not have sufficient liquid assets to repay creditors fled to sanctuary or foreign parts or kept to his house. Against the solvent debtor who wished to avoid repaying the creditor altogether, creditors' resort to bankruptcy was not necessary if the creditors could find sufficient property to satisfy the debts. From the creditors' perspective, a debtor committing an act of bankruptcy that represented active fraud rendered himself insolvent in the sense of not paying his debts when they become due.

346. 785 F.2d 936 (11th Cir. 1986), *cert. dismissed*, 478 U.S. 1028 (1986). In 1965, the Waldrons granted Shell Oil Company an option to purchase a parcel of land. Shell could exercise the option between 1984 and 1993 for an option price of $40,000. In 1983, the Waldron's filed a Chapter 13 petition, and they admitted that they did so for the sole purpose of rejecting the unfavorable purchase option agreement. In 1984, an appraisal valued the property at $145,000.00, and Shell valued the parcel at $195,000.00. Although the bankruptcy court found that the Waldrons were completely solvent (they owed no debts, owned a $125,000 home, and had an impressive investment portfolio), the bankruptcy court concluded that the bankruptcy laws were to be widely used, even for a "trouble free debtor," *id.* at 938-39, and allowed the Waldrons to reject the contract. The district court affirmed, but the court of appeals reversed. Citing the requirement of 11 U.S.C. § 1325(a)(3) that a bankruptcy court may not approve a Chapter 13 plan unless the plan has been proposed in good faith, the court of appeals held that the debtors did not satisfy the good faith requirement in filing their petition and ordered the case dismissed. *Id.* at 939-41.

347. 165 B.R. 317 (Bankr. S.D. Fla. 1994). Obtaining a divorce from his wife, the debtor had agreed in 1989 to pay her $2,800 a month in alimony, which amount was explicitly unmodifiable. After he became involved with his second wife in 1992, he failed to meet his alimony obligations. In December 1993, the debtor filed a Chapter 13 bankruptcy petition and proposed a plan to repay his alimony arrearages of $33,000 over 60 months without interest and to reduce his monthly alimony payments to $200.00 a month. The debtor, who was living a lavish lifestyle, had $109,975 in liquid assets, a net worth of $169,000, and an annual income of $107,880. *Id.* at 319-20. The debtor had also appealed a state court's refusal to modify the marriage settlement agreement just before filing his

13 petition for the purpose of modifying a marital settlement agreement with his previous wife. In *In Re Noco*,[348] the bankruptcy court dismissed the Chapter 11 petition of a solvent debtor filed for the purpose of rejecting a franchise agreement that contained a covenant not to compete. Finally, in *In re Ofty Corp.*,[349] the bankruptcy court dismissed a Chapter 11 petition for bad faith because the officers and majority shareholders of a solvent debtor caused the debtors to file solely to stop a state court ordered liquidation of its corporate assets.

*In re Moog*[350] presents a closer case on solvency as evidence of bad faith. Moog filed a Chapter 11 petition to modify a divorce settlement agreement which required him to pay $8.5 million dollars[351] to his former wife. Although arguably such an obligation would render him insolvent in a cash flow sense, he had entered into the agreement with the intention of

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Chapter 13 petition. The bankruptcy court dismissed the case under 11 U.S.C. § 1307 for cause—lack of good faith—for several reasons, including the fact that the debtor's primary purpose, if not the sole purpose, in filing for bankruptcy was to modify his marriage settlement agreement. *Id.*

348. 76 B.R. 839 (Bankr. N.D. Fla. 1987). In 1981, the debtors, Noco, Inc. and its two shareholders, Neil and Carol Ottavi, entered into a franchise agreement to sell pool and spa supplies and accessories which contained a covenant not to compete with the franchisor in the State of Florida for five years after termination of the agreement. In October 1986, near the end of the franchise agreement, the debtors formed the Paradise Pools and Spas of Tallahassee, Inc., and transferred the inventory, equipment, and some accounts receivables of Noco into the new corporation. Three days later, the debtors filed a Chapter 11 petition seeking to reject the franchise agreement and to void the covenant not to compete. The debtors candidly admitted that their primary purpose in filing the petition was to reject the franchise agreement. The debtors were currently paying all creditors in a timely manner with the exception of the franchisor, they owned real estate holdings valued at $1,070,000, they had virtually no unsecured creditors, and they had sufficient cash flow to pay all trade and secured creditors in a timely manner.

349. 44 B.R. 479 (Bankr. D. Del. 1984). The two majority shareholders of a closely held corporation owning and operating real estate were enriching themselves by paying themselves excessive expenses (39% of rents, as compared to a normal management fees of 6% of rents) at the expense of a third shareholder who had been declared mentally incompetent. The committee for the third shareholder obtained appointment of the receiver to liquidate the corporation's assets when he could not enter into a satisfactory settlement with the two shareholders. The corporation then filed a Chapter 11 petition in bankruptcy, which returned control of the corporate assets to the debtor in possession, that is, to the two miscreants. In dismissing the petition, the bankruptcy court found that the corporation was not a financially troubled debtor in need of bankruptcy protection and that its assets greatly exceed its liabilities. *Id.* at 482.

350. 159 B.R. 357 (S.D. Fla. 1993).

351. Moog also agreed to make subsequent annual payments totalling another $4.25 million over three years. Because Moog contemplated selling his corporation, this $4.25 million was to be held in trust and used to pay Mrs. Moog's share of the capital gains taxes upon the sale of the stock. *Id.* at 359.

selling his stock in his company valued at $25 million. After the settlement, however, he changed his mind about selling the company and fought the wife's efforts to collect (including her attempt to have a receiver appointed for the company). Finally, he filed a Chapter 11 petition and proposed a plan that restructured the divorce settlement by giving his former wife one half of the stock with significant restrictions. The court dismissed the petition on the grounds of bad faith.[352]

The Court of Appeals for the Eleventh Circuit has held that bad faith is also "cause" for lifting the automatic stay under 11 U.S.C. §362(d)(1). In *Barclays-American/Business Credit, Inc., v. Radio WBHP, Inc. (In re Dixie Broadcasting, Inc.)*,[353] a debtor who was not financially distressed filed a Chapter 11 bankruptcy petition to evade an impending specific performance order of a state court to consummate an agreed sale of its property. The court of appeals affirmed the bankruptcy's court's order lifting the automatic stay to allow the continuation of the specific performance proceedings in the state court.[354]

Lack of good faith is not the only basis upon which courts have refused to allow solvent debtors to take advantage of the special bankruptcy rules. In *In re Meehan*,[355] a solvent debtor had filed a Chapter 13 petition to avoid a state court judgment ordering specific performance of a contract to sell her house. Instead of relying on a lack of good faith, the district court affirmed a bankruptcy court's refusal to reject the contract under the "business judgment test" for rejection under 11 U.S.C. § 365. Under this test, the court must exercise its discretion to approve or disapprove rejection

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352. The court found that Mr. Moog had no difficulties in paying his other creditors, that he was taking substantial sums out of his corporation (including an annual salary of $2.4 million), and that he had been living a lavish lifestyle. *Id.* at 3362.

353. 871 F.2d 1023 (11th Cir. 1989), *cert. denied*, 493 U.S. 853 (1989).

354. The debtor, Dixie Broadcasting, agreed to sell an FM radio station to WBHP for $925,000, but refused to consummate the sale when it received a $1,250,000 bid from Colonial Broadcasting Company. WBHP sought specific performance of the sale agreement. After two and one half years of state court litigation, and after the trial court announced that it was prepared to rule in favor of WBHP, Dixie Broadcasting filed a Chapter 11 bankruptcy petition during last minute settlement negotiations. WBHP sought to have the petition dismissed for lack of good faith or in the alternative to have the automatic stay lifted for cause under 11 U.S.C. § 361(d)(1). The bankruptcy court lifted the automatic stay for cause on the grounds that the filing was in bad faith. *Id.* at 1026. The district court upheld the order to lift the automatic stay and also remanded to the bankruptcy court to determine if the debtor's bad faith warranted dismissing the petition. *Id.* On further appeal, the court of appeals held that the bankruptcy court was correct in lifting the automatic stay for bad faith, citing several factors including the fact that the debtor was not in any financial distress. *Id.* at 1026-27. It also noted that a decision to lift the automatic stay for bad faith did not automatically warrant dismissing a petition for bad faith. It dismissed the debtor's appeal of the district court's remand order because it was not a final, appealable order. *Id.* at 1028-29.

355. 59 B.R. 380 (E.D. N.Y. 1986).

of an executory contract in the best interest of all the debtor's creditors.[356] The bankruptcy court had found that, because the debtor's assets would have been sufficient to pay all her creditors, rejection would not have benefitted her unsecured creditors.[357] Accordingly, it refused to approve the rejection of the contract.

In addition, the Court of Appeals for the Fourth Circuit, in *Claughton v. Mixson*,[358] affirmed a bankruptcy court's decision that the debtor's solvency was sufficient cause for lifting the automatic stay under 11 U.S.C. § 362(d)(1). The debtor had filed a Chapter 11 petition to prevent the enforcement of a state court decree regarding the distribution of the marital assets. The bankruptcy court found that, after payment of the distribution to the debtor's former wife of almost $4 million, the debtor's assets were sufficient to pay all of his creditors in full.[359] In *In re Tinti Construction Co.*,[360] a bankruptcy court refused to allow Tinti Construction Company, a single-family home builder that was not insolvent but that would have become insolvent without relief, to reject a union wage agreement.[361]

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356. *Id.* at 385.

357. *Id.* In addition, upon the motion of the buyers, the bankruptcy court lifted the automatic stay to allow the enforcement of the state court's judgment for specific performance. *Id.* at 385-86.

358. 33 F.3d 4 (4th Cir. 1994).

359. In April 1991, after sixteen years of litigation following a divorce, a Florida state court entered an order valuing and distributing the marital assets of Edward Claughton, the debtor, and his former wife Beverly Mixson. In July 1991, however, the former wife moved for an amendment of the order because of the debtor's fraudulent concealment of evidence regarding the value of certain marital property. Before the state court could act, the debtor filed a Chapter 11 bankruptcy petition. The parties agreed to allow the state court to enter an amended order, and the court awarded Mixson $3,976,465. Mixson then sought relief from the automatic stay to receive immediate distribution of the marital assets. The bankruptcy court found that the debtor had sufficient assets (over $6 million) to pay Mixson her $4 million and all of his other creditors (owed about $700,000) and that therefore the debtor's solvency was sufficient cause for lifting the automatic stay. *Id.* at 5-6.

360. 29 B.R. 971 (Bankr. E.D. Wis. 1983).

361. *In re* Tinti Construction Co. presents a hard case. Tinti signed the wage labor agreement in 1982. Unfortunately, the construction industry in the area went into a deep recession. *Id.* at 971 The company, though solvent, began losing money and could not compete with non-union contractors for construction contracts because of its agreement to pay union wage scales. *Id.* at 972. Because it financed its activities with cash from the business and the owners, however, it had very few creditors and no long term debt. *Id.* To solve its dilemma, it filed for bankruptcy and as a debtor-in-possession proposed to reject the labor union agreement under section 365 of the Code. *Id.* at 973. The court denied the rejection of the union agreement. *Id.* at 975. Here, the court did not allow a solvent debtor, though one in clear financial trouble, to use bankruptcy to obtain a result that it could not achieve outside of bankruptcy. *Id.* at 974-75.

On the other hand, a bankruptcy court declined to dismiss on the grounds of bad faith a bankruptcy petition by a solvent corporation designed to thwart a state liquidation proceeding brought by 50% of the shareholders.[362] Other solvent debtors have tried to use bankruptcy for nonbankruptcy purposes. In *In re Krystal*,[363] now pending, a solvent corporation filed a Chapter 11 bankruptcy petition solely to force the adjudication of overtime wage claims under the Fair Labor Standards Act in a single forum.[364]

In *WE Financial*,[365] the partners of a solvent special purpose general partnership caused the corporation to file for bankruptcy for the sole purpose of accelerating the payment of thirty five high interest rate loans totalling approximately $125 million that by agreement were not otherwise prepayable.[366] If the debtor could accelerate the loans, it could sell the

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362. *In re* Quarter Moon Livestock Co., 116 B.R. 775, 782 (Bankr. D. Idaho 1990). The board of directors consisted of the husbands and wives of two families. *Id.* at 777. When one of the husbands died, the husband and wife of the other family elected their attorney to the vacant position, gaining effective control of the corporation. *Id.*

363. No. 95-15306, Bankr. E.D. Tenn. 1995.

364. Exhibit A to the debtors voluntary petition lists total assets of $128,015,000 and total liabilities of $88,471,000. Petition, Ex. A., ¶ 3, *In re* Krystal Co., No. 95-15306, Bankr. E.D. Tenn. 1995 (filed December 15, 1995). The company announced that it was filing the bankruptcy petition to resolve five lawsuits by employees. *The Wall Street Journal* reported:

> "This is not a 'typical' bankruptcy," Carl Long, Krystal's chairman and chief executive officer, said in a prepared statement. "Krystal is not insolvent or going out of business. We are simply utilizing Chapter 11 to resolve all valid claims."

Eleena de Lisser, Krystal to File for Bankruptcy to End Disputes, WALL ST. J., Dec. 18, 1990, *corrected*, Dec. 19, 1995, *available in* 1995 WL-WSJ 9912170, at *1. A company spokesman correctly noted also that the bankruptcy filing would force all claimants to present their claims in the bankruptcy proceeding and therefore foreclose future periodic litigation. *Id.* at *1-*2.

365. No. 92-01861-TUC-LO, Bankr. D. Ariz. 1992 (voluntary Chapter 11 petition filed June 11, 1992).

366. The debtor was an indirect subsidiary of a home builder which the builder had established to help finance its building activities. The sole purpose of the debtor was to borrow money from another special purpose lender and pledge to the lender, American Southwest Financial Corporation, as security for the borrowings GNMA certificates that the home builder had acquired to finance the purchase of homes it had sold. The debtor entered into thirty seven funding agreements with the lender and pledged such collateral to the lender as security for these funding agreements. The special purpose lender then issued collateralized mortgage obligations (CMOs) to investors backed by the funding agreements and the pledged collateral. The CMOs and the funding agreements were payable solely from the pledged collateral and neither the CMOs nor the funding agreements could be prepaid if interest rates declined. *See* Findings of Fact and Conclusions of Law, at 2-3, *In re* WE Financial Co., No. 92-01861-TUC-LO (Bankr. D. Ariz. filed February 23, 1993) [hereinafter, Findings of Fact]; Amended Disclosure Statement of WE Financial Co., GWS, and WE 7, Inc. Dated January 11, 1993, as Modified, at 10-21, *In re* We Financial Co., No. 92-01861-

underlying collateral, Government National Mortgage Association mortgage pass-through certificates, that had appreciated in value to an amount greater than their face amount because of a decline in interest rates. The proceeds of the sale of the collateral would pay off the loans at par, that is, 100 cents on the dollar, and the debtor would retain the excess value of the collateral, reported to be about $11,000,000, which would then be paid to the owners of the debtor. The loans were also worth more than par because they bore interest rates higher than the then current market rates, this otherwise unplanned and unavailable prepayment of the loan would deprive the lender of its appreciation in value.[367] After strenuous objection by the lender, this case was settled with a reinstatement of all but two of the loans.[368]

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TUC-LO (Bankr. D. Ariz. 1993) (filed January 11, 1993, and approved by court January 29, 1993) [hereinafter, Disclosure Statement]; Settlement Agreement Dated as of September 1, 1992, at 1-3, *In re* We Financial Co., No. 92-01861-TUC-LO (Bankr. D. Ariz. 1992) (filed November 10, 1992 and approved by court November 24, 1992) (also attached to Disclosure Statement) [hereinafter, Settlement Agreement]; *Bankruptcy Case Tests Builder Bonds*, 7 MORTGAGE-BACKED SECURITIES LETTER, no. 32, Aug. 10, 1992, at 1, 9, *available in* 1992 WL 2747060 [hereinafter MBS LETTER]; Ernie Heltsley, *Estes Unit, in Chapter, Seeks Control of Bonds*, ARIZ. DAILY STAR, June 17, 1992, at 5B, *available in* 1992 WL 7629436 (containing some inaccuracy in describing the structure of the transaction) [hereinafter Heltsley, ARIZ. DAILY 6/17]; Ernie Heltsley, *Estes Firm's Chapter 11 Dispute Called Threat to Bond Payments*, ARIZ. DAILY STAR, June 18, 1992, at 5B, *available in* 1992 WL 7629465 [hereinafter Heltsley, ARIZ. DAILY 6/18]; Ernie Heltsley, *Bondholders to Receive Timely Payoff*, ARIZ. DAILY STAR, July 1, 1992, at 9B, *available in* 1992 WL 7629824 [hereinafter Heltsley ARIZ. DAILY, 7/1] (referring to interim payment of interest on the funding agreements); *Fitch Puts Amer Southwest Fincl AAA CMOs on Alert Neg.*, Dow Jones News Service, June 19, 1992, *available in* WESTLAW, Allnewsplus, DJNS, [hereinafter DJNS 6/19]; *American Southwest Financial 'AAA' CMOs on Fitch Alert Negative*, PR News Wire, June 19, 1992, *available in* WESTLAW, Allnewsplus, PRWIRE, [hereinafter PRWIRE 6/19].

For a discussion of how these types of transactions are structured, see STEVEN L. SCHWARCZ, STRUCTURED FINANCE: A GUIDE TO THE PRINCIPLES OF ASSET SECURITIZATION (2d ed. 1993); Thomas E. Plank, *The Sale of Accounts and Chattel Paper Under the UCC and the Effect of Violating a Fundamental Drafting Principle*, 26 CONN. L. REV. 397, 456-57 (1994).

367. *See* MBS LETTER, *supra* note 366; Heltsley, ARIZ. DAILY 6/17, *supra* note 366; Heltsley, ARIZ. DAILY 6/18, *supra* note 366; Heltsley, ARIZ. DAILY 7/1, *supra* note 366; DJNS 6/19, *supra* note 366; PRWIRE 6/19, *supra* note 366.

368. Findings of Fact, *supra* note 366, at 3-4; Disclosure Statement, *supra* note 366, at 18-21; Settlement Agreement, *supra* note 366, at 1-3; *see also American Southwest Financial Ends Dispute with WE Financial Co.*, ARIZ. DAILY STAR, March 15, 1993, at 6D, *available in* 1993 WL 5743065; Abby Schultz, *American Southwest Bondhldrs Safe After Court Okays Plan*, Dow Jones News Service, March 11, 1993, *available in* WESTLAW, Allnewsplus, DJNS; *S&P Affirms Amer Southwest CMO Ratings; Off Watch*, Dow Jones News Service, March 25, 1993, *available in* WESTLAW, Allnewsplus, DJNS. At the time of the filing, 35 of the funding agreements were outstanding. Pursuant to the Settlement Agreement, two funding agreements for loans totalling $15 million were prepaid. Findings

The requirement of good faith, the ability to lift the automatic stay for cause, and the discretion to disapprove rejection of contracts may be sufficient to prevent solvent debtors from abusing the bankruptcy process. This proposition, however, puts the horse behind the cart. That courts use these tools to prevent abuse by solvent debtors reflects the basic point that bankruptcy is designed to address the problems of insolvent debtors, not solvent debtors. The special bankruptcy rules—such as the automatic stay, the ability to reject executory contracts, the ability to force the estimation of claims in one forum (the bankruptcy court), and the acceleration of liabilities—are designed to help an insolvent debtor liquidate or reorganize. If it were desirable to extend these special rules to assist solvent debtors, they should be made available outside of bankruptcy.

Perhaps it is thought that the costs and the other features of a bankruptcy proceeding—the theoretical loss of control over one's assets, the availability of greater creditor control of the debtor through a trustee, and the requirement for approval of a bankruptcy court—serve as a sufficient deterrent for those solvent debtors merely seeking a rule change. This explanation, however, is tantamount to saying that the features of bankruptcy that would deter this forum shopping constitute a proxy for an insolvency requirement, since these features were intended to assist the best liquidation or reorganization of the insolvent debtor. Moreover, for solvent debtors desperately seeking solutions to a particular problem, these features have not been a sufficient deterrent even though such solvent debtors have generally been unsuccessful in using bankruptcy to solve the nonbankruptcy problem. An explicit insolvency requirement would provide a more direct deterrent and probably a more cost effective one.[369]

Finally, regardless of whether it is desirable, insolvency of the debtor is a constitutional requirement because it forms one of the outer borders of the "subject of Bankruptcies." A unifying feature of the early bankruptcy acts giving the debtor a right to initiate proceedings, usually entitled "Acts for the relief of insolvent persons," was that the debtors be in prison as the result of non-payment of a debt or be insolvent.[370] A debtor with a positive net worth could be in prison for failure to pay debts if the debtor's liquid assets were insufficient. But to obtain relief, the debtor had to swear an oath that she did not have sufficient assets to repay her creditors, and she had to agree to give up her property. These debtor relief acts were not

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of Fact, *supra* note 366, at 2-4; Disclosure Statement, *supra* note 366, at 12, 19; Settlement Agreement, *supra* note 366, Ex. A and Ex. B to Stipulation, Ex. B to Settlement Agreement.

369. This is an empirical question that may be hard to resolve. I expect, however, that overcoming a presumption of either balance sheet or the more difficult cash flow insolvency, *see supra* note 340 and accompanying text, would be easier than establishing the more elusive concept of "bad faith."

370. *See supra* notes 128, 169, 172, 175, 177-78, 189, 190, 195-97.

designed to relieve the Henry David Thoreaus[371] of the world who insist on staying in prison to make some philosophical or political point. The insolvency of the debtor was the problem addressed by the early voluntary bankruptcy acts. If a debtor is not insolvent, she should not be a debtor entitled to relief under a bankruptcy law.

### *B. General Debtor-Creditor Regulation*

The subject of bankruptcy does not extend beyond the insolvent debtor. It does not extend to solvent debtors. Therefore, the bankruptcy power does not authorize Congress to pass a more general debtor-creditor statute. Nevertheless, one author has suggested that the Bankruptcy Clause authorizes Congress to enact a federal personal property security law in lieu of Article 9 of the Uniform Commercial Code.[372] To my knowledge, Congress has not asserted such authority. In 1968, however, Congress relied on both the Commerce Clause and the Bankruptcy Clause in enacting two titles of the Consumer Credit Protection Act that were directed at the broader debtor-creditor relationship and were not limited to insolvent debtors.[373]

Title II of this Act made loan sharking a federal crime.[374] In addition to finding that loan sharking activities were carried on in interstate commerce or directly affected interstate commerce, Congress declared: "Extortionate credit transactions directly impair the effectiveness and frustrate the purposes of the laws enacted by the Congress on the subject of bankruptcies."[375] The managers for the conferees from the House of Representatives explained:

> It is obvious, however, that obligations as to which there is an understanding that they may be collected by extortionate means, or which are actually so collected, are not susceptible of being "discharged" in bankruptcy in any meaningful sense. Such transactions thus deprive the debtor of a Federal statutory right [the right to a discharge in bankruptcy], and at the same time defeat one of the principal purposes of the Bankruptcy Act [of 1898], which is to afford insolvent persons the opportunity to make a fresh start. Thus, it seems clearly within the power of Congress to protect the

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371. Henry David Thoreau spent one night in jail in 1846 for refusing as a matter of principle to pay a poll tax, as had been suggested by the then largely unpopular abolitionists who suggested that citizens should refuse to pay taxes as a protest to the continued toleration of slavery. WALTER HARDING, THE DAYS OF HENRY THOREAU 199-206 (1966). This experience was a catalyst for his essay *Civil Disobedience*. *Id.* at 206-08.

372. *See* Phillips, *supra* note 5, at 57.

373. Consumer Credit Protection Act of 1968, Pub. L. No. 90-321, 82 Stat. 146.

374. Consumer Credit Protection Act of 1968, § 202, Pub. L. No. 90-321, 82 Stat. 146 (codified at 18 U.S.C. §§ 891-896 (1994)).

375. Consumer Credit Protection Act of 1968, § 202(1)(a)(4), Pub. L. No. 90-321, 82 Stat. 146.

> Federal statutory right, and to assure that the bankruptcy laws will be carried into execution, by enacting legislation to prohibit extortionate credit transactions.[376]

This explanation is unsatisfactory. First, it does not fit the statute. The statute was not limited to extortionate credit transactions with insolvent borrowers or with borrowers who became insolvent as a result of the transactions.[377] The problem that Congress was addressing was much larger. The information upon which Congress relied in enacting this legislation, and upon which the Supreme Court relied in holding that Congress's Commerce Clause power authorized the statute,[378] showed that loan sharking funneled money to and from all kinds of borrowers, including those engaged in illegal activities, and not just the poor.[379]

Second, the argument is illogical. A discharge in bankruptcy is nothing other than legal relief from an obligation to pay a debt that otherwise would be enforceable through legal means. Outlawing illegal means to collect a debt does not interfere with this legal right. An insolvent victim of a loan shark may still seek relief under the Code and discharge the debts owed to the loan shark. Congress could certainly punish creditors who attempt to use violence or threats to collect discharged debts. Congress could also punish creditors who use such intimidation to prevent debtors from filing a bankruptcy petition. This is not, however, what Congress did in this Act.

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376. H.R. CONF. REP. NO. 1397, 90th Cong., 2d Sess. (1968), *reprinted in* 1968 U.S.C.C.A.N. 1962, 2025-26.

377. Several courts upheld challenges to Congress's authority to make loan sharking a federal crime under the Bankruptcy Clause. None of these provided any analysis of the Bankruptcy Clause. They merely recited Congress's findings. *See* United States v. Fiore, 434 F.2d 966 (1st Cir. 1970), *cert. denied*, 402 U.S. 973 (1971) (assuming that the victim of the loan shark was insolvent because he could not get conventional credit); United States v. Biancofiori, 422 F.2d 584, 586 (7th Cir. 1970), *cert. denied*, 398 U.S. 942 (1970); United States v. Keresty, 323 F. Supp. 230, 232 (W.D. Pa. 1971); United States v. Curcio, 310 F. Supp. 351, 355-56 (D. Conn. 1970); United States v. Calegro De Lutro, 309 F. Supp. 462, 464-65 (S.D.N.Y. 1970).

378. Perez v. United States, 402 U.S. 146 (1971). The Court did not address Congress's authority under the Bankruptcy Clause. It did not even cite the congressional finding on bankruptcy quoted above, but instead cited the first three findings, two of which relate to the Commerce Clause. *Id.* at 147 n.1.

379. *Id.* at 156. The Court stated that New York's Report, An Investigation of the Loan Shark Racket (1965) found

> that loan sharks serve as a source of funds to bookmakers, narcotics dealers, and other racketeers; that victims of the racket include all classes, rich and poor, businessmen and laborers; that the victims are often coerced into the commission of criminal acts in order to repay the loans; that through loan sharking the organized underworld has obtained control of legitimate businesses, including securities brokerages and banks which are then exploited.

*Id.*

It made loan sharking a federal crime in part on the vague notion that somehow loan sharking affected a debtor's ability to seek relief under the Code.

Title III of the Consumer Credit Protection Act imposed a federal limit on the amount of an employee's wages that a creditor can garnish.[380] To justify its actions to limit wage garnishments under the Bankruptcy Clause, Congress found: "The great disparities among the laws of the several States relating to garnishment have, in effect, destroyed the uniformity of the bankruptcy laws and frustrated the purposes thereof in many areas of the country."[381] The concern about uniformity is nonsense. Under both the Bankruptcy Act of 1898 and the Bankruptcy Code of 1978, debtors could exempt certain items of their property from the claims of creditors. These exemptions are based on the law of the debtors' state.[382] These state law exemptions were and are wildly different. The Supreme Court directly upheld this reference to state law as *not* violating the uniformity requirements of the Bankruptcy Clause.[383]

The real Congressional concern seemed to be the apparent fact that debtors in states that allowed substantial garnishment of wages filed bankruptcy petitions at a much higher rate than debtors in states that restricted wage garnishments.[384] This is not a worthy justification.[385] If it were, any factor that affects the rate at which debtors file for bankruptcy becomes a subject of bankruptcy. For example, abolishing security interests might reduce bankruptcy filings, since many filings are precipitated by a foreclosure action. Restricting divorce might affect the rate of filings. Imposing strict federal interest rate limits on borrowing might reduce filings, since creditors would then extend credit only to the most credit worthy

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380. Consumer Credit Protection Act of 1968, §§ 301-307, Pub. L. No. 90-321, 82 Stat. 146 (codified at 15 U.S.C. §§ 1671-1677 (1994)).

381. 15 U.S.C. § 1671(a)(3) (1994).

382. 11 U.S.C. § 522(b) (1994); ch. 541, § 6, 30 Stat. 544, 548 (codified as amended at 11 U.S.C. § 24 (1976)) (repealed).

383. Hanover Nat'l Bank v. Moyses, 186 U.S. 181, 188, 190 (1902). *See also* Regional Rail Reorganization Act Cases, 419 U.S. 102, 148-61 (1974) (rejecting claims that the Regional Rail Reorganization Act was unconstitutional as violating the Fifth Amendment taking prohibition and the uniformity requirement of the Bankruptcy Clause); Koffler, *supra* note 12, at 104-05.

384. *See* H.R. REP. NO. 1040, 90th Cong., 2d Sess. (1968), *reprinted in* 1968 U.S.C.C.A.N. 1962, 1978. The report noted that in states like Pennsylvania and Texas that prohibited garnishment of wages, the number of non-business bankruptcies were nine and five, respectively, out of 100,000 population, while the number of such bankruptcies in states with harsh garnishment laws ranged between 200-300 per 100,000 population.

385. It is ironic that one of the moving factors behind the Bankruptcy Code adopted eight years later was the desire to make bankruptcy more available to consumer debtors, not to discourage the filing of bankruptcy. *See* H.R. REP. NO. 595, 95th Cong., 2d Sess. 116-19 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6076-80.

debtors.[386] Generous welfare or health insurance benefits for individuals and generous grants or loans or regulatory relief for small businesses might reduce the rate of filings. With analysis like this, a wide range of social and economic programs become authorized by the Bankruptcy Clause. As desirable and as tempting as these programs may be to legislators responding to their constituents, however, neither federal regulation of the debtor-creditor relationship nor these other types of federal legislation legitimately fall within the realm of the "subject of Bankruptcies."

## VI. BENEFITS AND LIABILITIES FOR THIRD PARTIES

### *A. Limits on the Use of Bankruptcy*

Limiting the reach of Congress's bankruptcy power to the creditors of an insolvent debtor is less obvious than the point that the insolvency of the debtor is an essential feature of the subject of bankruptcy. A simple question will illustrate the point: Once a debtor is insolvent, does Congress's bankruptcy power authorize a law distributing the debtor's remaining assets for the benefit of the state or non-creditors? The English parliament used this approach in 1570 in the first English fraudulent conveyance act, which provided that a person transferring property to defraud his creditors forfeited one-half of that property to the Crown.[387]

Too my knowledge, however, none of the pre-Constitutional English or American bankruptcy or insolvency acts appropriated the debtor's property for the benefit of the government or non-creditors. Of course, these acts also did not contain an automatic stay or a power to reject executory contracts, and I do not suggest that these are excluded from the subject of bankruptcy. Still, asking directly whether Congress may appropriate the debtor's remaining assets for itself or other non-creditors suggests an answer: no.

We have bankruptcy laws because such laws may be beneficial to society—individual debtors can make a fresh start and be more productive members of society; reorganized companies can provide jobs to workers, opportunities for others businesses, and taxes for governments. Indeed, one of the primary justifications for the reorganization provisions of the Code, along with the notion that reorganization will produce a higher return for creditors than liquidation, is that allowing financially distressed businesses to reorganize will save jobs.[388]

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386. The credit risk of the borrower is an important component of the interest rate charged for any loan. *See* Thomas E. Plank, *The True Sale of Loans and the Role of Recourse*, 14 GEO. MASON U. L. REV. 287, 336 & n.167 (1991).

387. 13 Eliz., ch. 5, § 3 (1570) (Eng.).

388. *See* H.R. REP. NO. 595, 95th Cong., 2d Sess. 220 (1978), *reprinted in* 1978

The issue then is how far may the Congress go in the name of legislating on "the subject of Bankruptcies"? The answer lies in the basic thrust of bankruptcy law since the early 1700s. The subject of bankruptcy is adjusting the relationship between an insolvent debtor and his creditors. Legislation that benefits the debtor and the creditors, or that benefits an insolvent creditor at the expense of the debtor, or that benefits a creditor at the expense of the debtor or other creditors is within this subject. Whether this legislation benefits others is irrelevant. Legislation that benefits others at the expense of the debtor and her creditors is not legislation on the "subject of Bankruptcies."

The temptation to use bankruptcy legislation to serve the interest of non-creditors at the expense of debtors and their creditors appears most prominently, but not exclusively, in the context of corporate reorganizations. It follows naturally from the economic interdependence of our society.[389]

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U.S.C.C.A.N. 5963, 6179:

> The purpose of a business reorganization case, unlike a liquidation case, is to restructure a business's finances so that it may continue to operate, provide its employees with jobs, pay its creditors, and produce a return for its stockholders. The premise of a business reorganization is that assets that are used for production in the industry for which they were designed are more valuable than those same assets sold for scrap . . . . It is more economically efficient to reorganized than to liquidate, because it preserves jobs and assets.

*Id.* As is obvious, the House Report mixes the two rationales together and does not attempt to distinguish them. Several important commentators emphasize the importance of using bankruptcy reorganization to save jobs. *See* Bufford, *supra* note 34, at 838 (1994): "Chapter 11 protects vital businesses, protects jobs and communities, gives debtors an opportunity to wait out an economic downturn, and avoids a catastrophic destruction of economic values."; Donald R. Korobkin, *Contractarianism and the Normative Foundations of Bankruptcy Law*, 71 TEX. L. REV. 541, 591 (1993); Warren, *Untenable Case for Repeal*, *supra* note 46, at 470, 478; Elizabeth Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 775, 787-88 (1987) [hereinafter Warren, *Bankruptcy Policy*].

389. Elizabeth Warren has argued that the larger benefits to society is a central policy justification of bankruptcy. Warren, *Bankruptcy Policy*, *supra* note 388, at 785-89. In her view, the goal of bankruptcy law is to determine the best way to distribute the losses among those affected by the insolvency of the debtor. *Id.* at 777, 785, 789-93. Although much of her focus is on redistribution among creditors, she suggests that bankruptcy law may properly accommodate the needs of non-creditors:

> But the revival of an otherwise failing business also serves the distributional interests of many who are not technically "creditors" but who have an interest in a business's continued existence. Older employees who could not have retrained for other jobs, customers who would have to resort to less attractive, alternative suppliers of goods and services, suppliers who would have lost current customers, nearby property owners who would have suffered declining property values, and states or municipalities that would have faced shrinking tax bases benefit from the reorganization's success.
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> . . . .

All debtors, whether individuals or artificial entities like a corporations, engage in economic activity. This activity profits third parties to whom the debtor is not indebted. These third parties may be employees expecting to earn wages, suppliers of goods and services hoping to keep a customer, or the taxing authorities who are looking for a continuing stream of tax revenues. They would lose those benefits if the debtor ceased doing business, whether as a result of a liquidation in bankruptcy or a winding up of its affairs outside of bankruptcy or relocating to another country.[390]

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. . . The older employee, the regular customer, the dependent supplier, and the local community are important; and bankruptcy attends to many of their concerns, regardless of whether they have rights recognized at state law.

*Id.* at 787-88; *see also* Korobkin, *supra* note 388, at 572-75.

As I discuss in this part, to the extent that Congress or the courts attend to the concerns of these non-creditors at the expense of creditors (as they are broadly defined to include anyone with a claim arising out of pre-bankruptcy actions of the debtor), they exceed the constitutional bounds of bankruptcy. If it is truly worthwhile to address these concerns, Congress should do so under its other constitutional authority. Of course, trying to do so may be more difficult politically than incorporating these goals in a "bankruptcy" law.

Warren's view of bankruptcy has been criticized, see, e.g., Barry Adler, *A World Without Debt*, 72 WASH. U. L. REV. 811, 825-26 (1994); Barry Adler, *Bankruptcy and Risk Allocation*, 77 CORNELL L.J. 439, 442 n.9 (1992); Douglas Baird, *Loss Distribution, Forum Shopping, and Bankruptcy: A Reply to Warren*, 54 U. CHI. L. REV. 815 (1987) [hereinafter Baird, *Reply to Warren*]; Bowers, *supra* note 46. Christopher W. Frost, *Bankruptcy Redistributive Policies and the Limits of the Judicial Process*, 75 N.C. L. REV. 75 (1995), suggests that the bankruptcy process is not capable of serving the redistributive interests of non-creditors. *See also* Rasmussen, *supra* note 20. For a recent article supporting her view, see Ronald J. Mann, *Bankruptcy and the Entitlements of the Government: Whose Money Is It Anyway?*, 70 N.Y.U. L. REV. 993 (1995).

On the other hand, in my view, the constitutional limits of bankruptcy are broader than the limits of bankruptcy under the creditor's bargain analysis of Tom Jackson, Doug Baird, and Bob Scott, who argue that as a matter of policy bankruptcy law should not reorder the nonbankruptcy entitlements of creditors unless doing so maximizes the return to all of the creditors. *See, e.g.*, Baird, *Reply to Warren*, *supra*; Thomas H. Jackson & Robert E. Scott, *On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors' Bargain*, 75 VA. L. REV. 155, 155-56 (1989); Robert E. Scott, *Through Bankruptcy with the Creditors's Bargain Heuristic*, 53 U. CHI. L. REV. 690, 692, 694-95 (1986) (book review). As a matter of constitutional interpretation, bankruptcy law may do so regardless of whether as a matter of policy it should do so.

390. These concerns prompted Congress to pass the Chrysler Corporation Loan Guarantee Act of 1979, Pub. L. No. 96-185, 93 Stat. 1324 (1979) (codified at 15 U.S.C §§ 1861-1875 (1976 & Supp III 1979)) (authority to make commitments to guarantee expired at the end of 1983). The House Report for the legislation stated that Chrysler, as the nation's then tenth largest corporation, employed 140,000 individuals, that its 4,700 dealers employed 150,000 individuals, and that its 19,000 suppliers employed 250,000. H.R. REP. NO. 690, 96th Cong., 1st. Sess. 9 (1979), *reprinted in* 1979 U.S.C.C.A.N. 2787, 2789. A Chrysler collapse would, it reported, add $3 billion to a trade deficit, which in 1979 was a little less than $10 billion, would produce at least a $2.75 billion loss of revenues for the federal

If an insolvent debtor attempts to reorganize under Chapter 11, these third parties may keep the benefits of their relationship with the debtor so long as the debtor and the creditors believe that a reorganization is possible and that there is greater value in keeping the business going than in liquidating its assets.[391] If reorganization proves unsuccessful, however, the third parties will lose the benefits accruing from an operating business to the same extent as a nonbankruptcy cessation of activities.

To the extent that saving jobs or providing other benefits for third parties is a by-product of adjusting the relationship between an insolvent debtor and her creditors in their best interests, there is no constitutional infirmity. A bankruptcy law, however, may not provide benefits to third parties who are neither debtors nor creditors except as a result of this readjustment.[392]

Accordingly, Congress may not use the Bankruptcy Clause to require companies to continue to provide future employment for employees of a debtor or future business for suppliers to the debtor, or give these third parties a right to compensation for the loss of these benefits. Congress may, under the Commerce Clause or other constitutional grant of power, create

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government (and thereby increase the budget deficit), and would create a $1.1 billion claim on the Pension Benefit Guaranty Corporation for unfunded pension liabilities. H.R. REP. NO. 690 at 10, 1979 U.S.C.C.A.N. at 2790-91. Congress proposed a federal loan guaranty because it believed that, given what it considered its unique circumstances, Chrysler would not be able to reorganize under the Bankruptcy Code. H.R. REP. NO. 690 at 14, 1979 U.S.C.C.A.N. at 2794-95. The Commerce Clause was presumably the constitutional basis for this Act. The House Report contains no attempt to justify the Act as an exercise of power under the Bankruptcy Clause.

Congress authorized a similar bailout for the Lockheed Corporation in 1971, pursuant to the Emergency Loan Guarantee Act, Pub. L. No. 92-70, 85 Stat. 178 (1971) (codified at 15 U.S.C. §§ 1841-1852 (1976 & Supp V 1981) (authority to make commitments to guarantee expired at the end of 1973). It authorized $2 billion in loan guarantees, with a maximum of $250 million for any one company, which was identified in the legislative history as Lockheed. H.R. REP. NO. 379, 92d Cong., 1st. Sess. (1979), *reprinted in* 1971 U.S.C.C.A.N. 1270, 1271. Again, the concern was to preserve jobs and small businesses, among other things. *Id.* About 17,800 jobs at Lockheed and 16,000 jobs at Lockheed's 35,000 suppliers would be lost without the loan guarantee. *Id.* at 1290.

391. *See* Baird, *Closely Held Firms*, *supra* note 34, at 922-23. As Baird notes, suppliers as creditors may be willing to extend trade credit to a firm in financial distress and risk the loss of the value of the trade credit in exchange for the future benefits that accrues to them if the firm continues in business.

392. Karen Gross has suggested that bankruptcy law should take into account the interests of the broader community and not be concerned just with debtors and creditors. Karen Gross, *Taking Community Interests Into Account in Bankruptcy: An Essay*, 72 WASH. U. L.Q. 1031 (1994). In my view, to the extent that the community interests are creditor interests or that accommodating such interests are a by-product of readjusting the insolvent debtor-creditors relationship, bankruptcy law may take them into account. Otherwise, they may not be taken into account *in a bankruptcy law.*

rights and obligations that apply generally—that is, in and outside of bankruptcy. For example, Congress could provide that every employee of a business involved in interstate commerce who is terminated without cause is entitled to one year's severance pay. Such a law creates an obligation, a debt, and this obligation would be treated as any other debt in a bankruptcy proceeding.[393] Congress would not have the power, however, to provide that in every bankruptcy case, employees would be entitled to one year's severance pay. Congress could also mandate that certain businesses, like railroads or nuclear power plants engaged in interstate commerce, must continue to provide service to the public unless permitted to terminate operations by a governmental agency. Congress simply may not do so pursuant the Bankruptcy Clause.[394]

Conversely, that the subject of bankruptcy is limited to the insolvent debtor-creditor relationship requires that Congress may not, in a bankruptcy law, appropriate the property of or impair the rights of third parties for the benefit of the insolvent debtor or his, her or its creditors. The impulse in the Code and among bankruptcy courts to assist the rehabilitating debtor is strong. As the debates on the desirability of Chapter 11 proceedings[395] or

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393. There are plenty of examples of Congressional grant of benefits to third parties outside of bankruptcy that must be recognized in bankruptcy. These include minimum wage standards enacted by the Fair Labor Standards Act of 1938, 29 U.S.C. §§ 201-219 (1994) (recognized in Brock v. Rusco Indus. Inc., 842 F.2d 270. 273 (11th Cir.), *cert. denied*, 488 U.S. 889 (1988) (Secretary of Labor's action to enforce Act not subject to the automatic stay of 11 U.S.C. § 362 (1988)); the denial of power to federal courts to enjoin strikes, under the Norris-LaGuardia Act, 29 U.S.C. §§ 101-115 (1994) (recognized in International Brotherhood of Teamsters Local No. 886 v. Quick Charge, 168 F.2d 513, 516 (10th Cir. 1948) (conflict with the Bankruptcy Act of 1898)); and the requirement that larger employers must warn employees of plant closings or mass layoff under the Worker Adjustment and Retraining Notification Act, 29 U.S.C. §§ 2101-2109 (1994), *discussed in* Daniel Keating, *The Fruits of Labor: Worker Priorities in Bankruptcy*, 35 ARIZ. L. REV. 905, 924 (1993)).

394. Theodore Eisenberg has suggested that the bankruptcy process offers to regulated industries, such as the electric utility industry, an opportunity for increased and presumably better representation of the interests of the customers of the utility, as a form of supplemental regulation. Theodore Eisenberg, *Bankruptcy in the Administrative State*, L. & CONTEMP. PROBS., Spring 1987, at 3, 25-31. The customers are not creditors because they do not have "claims" against the utility. *Id.* at 25-26. Nevertheless, they will help finance the reorganization of an insolvent regulated industry because they pay the rates for service that are approved by a regulatory body. This regulatory body may not fully recognize their interests because it has been "captured" by the interests of the industry it is to regulate. *Id.* at 26. Much of the advantages of this use of the bankruptcy power, however, relates not to the subject of bankruptcies but to providing "better" supplemental regulation of the industry. Bankruptcy may be better because the bankruptcy court system is already in place (in lieu of creating another regulatory system), it is a national system more likely to produce uniform results, and it is not likely to be captured by the regulated industry. Nevertheless, I consider this use of the bankruptcy power beyond the constitutional authorization.

395. *See supra* notes 46, 389.

on the generosity of the Code to individual debtors show,[396] this impulse may reduce the return to creditors in bankruptcy proceedings below some theoretical optimal level. Selecting the optimal balance between creditor protection and debtor relief has been a issue of bankruptcy law almost from the very beginning.[397]

To my knowledge, however, none of the pre-Constitutional English or American bankruptcy or insolvency acts appropriated the property of third parties for the benefit of the insolvent debtor. Any law that did so in effect appropriates that property for the benefit of the creditors. An example would be a law requiring every person living within one mile of an insolvent debtor to contribute $100 to the debtor's rehabilitation. In attempting to assist the rehabilitation of an insolvent debtor, Congress has full power to alter the rights of creditors under the Bankruptcy Clause. Congress and the courts should not, however, reach beyond creditors and alter the rights of third parties, that is, those who are not creditors of the insolvent debtor, even if doing so enhances the creditors' realizations of their debts or the insolvent debtor's rehabilitation.

### *B. Specific Applications*

For the most part, the Bankruptcy Code does not create any direct benefits or liabilities for non-debtors and non-creditors that do not exist outside of bankruptcy. As discussed below, however, Congress has been tempted to create direct third party benefits in the Code and elsewhere.[398]

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396. *See supra* note 85.

397. *See supra* note 85 and accompanying text.

398. In an uncodified provision of the Federal Deposit Insurance Corporation Improvement Act, Congress mandated that any financial institution that acquires substantially all of the assets or liabilities of an insolvent depository institution whose deposits are insured by the Federal Deposit Insurance Corporation, such as a savings association or bank, for which the FDIC has been appointed receiver, must continue to provide the same health insurance benefits that the insolvent institution had provided. Federal Deposit Insurance Corporation Improvement Act, Pub. L. No. 242, § 451, 105 Stat. 2236, 2382-83 (1991), *also found in* 12 U.S.C.A. § 1821 note (West 1995 Supp.).

In 11 U.S.C. § 1114 (1994), Congress has mandated that a debtor attempting to reorganize under Chapter 11 must follow a special procedure before it modifies or terminates health care, life, or disability insurance benefits for retirees. The retiree benefits must be those provided "under a plan, fund or program . . . maintained or established in whole or in part by the debtor prior to filing a petition commencing a case under this title." *Id.* § 1114(a). To the extent that retirees have such benefits pursuant to a pre-petition contract, they therefore have a claim and are creditors. Giving these creditors a type of priority is constitutionally sound. If, however, Congress intended to give a special priority, which will come from the assets available to the creditors or the debtor, to those retirees who had no legally enforceable pre-petition right to them, it has crossed the boundary of the bankruptcy power.

In addition, Congress has included in the Code a few provisions that directly harm third parties. Faced with ambiguous language, courts have also interpreted the Code to provide direct benefits to or impose harms on these third parties in the name of fostering the reorganization of an insolvent debtor. When Congress and the courts create these benefits or impose these harms in the name of the "subject of Bankruptcies," they exceed their constitutional authority.

### 1. Benefits for Future Employees and Suppliers

Congress legislated special benefits for the employees of a single bankrupt railroad, and the Supreme Court struck down that legislation in *Railway Labor Executives' Ass'n v. Gibbons*.[399] In this case, the trustee for the Chicago, Rock Island & Pacific Railroad Co. concluded that reorganization was not possible after four years of effort.[400] After the Interstate Commerce Commission ruled that abandonment and dissolution of the railroad was necessary, the court supervising the reorganization ordered its abandonment.[401] The court also decided that existing law did not authorize any payment of any claim for employment protection for the employees losing their jobs.[402]

Congress responded to the demise of the railroad by enacting the Rock Island Railroad Transition and Employee Assistance Act[403] (the RITA act). The RITA act required the railroad and its unions to negotiate, or the Interstate Commerce Commission to impose, an employee protection plan for the employees who lost their jobs, which could have included relocation incentive compensation, moving expenses, and separation allowances, the total cost of which could not exceed $75,000,000.[404] The RITA act also required that the trustee pay any claim arising out of the agreement as an administrative expense.[405] This provision gave these expenses priority over the claims of existing unsecured creditors.[406]

This act applied only to one railroad and its employees. Accordingly, the Supreme Court held that it violated the requirement that bankruptcy laws

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399. 455 U.S. 457 (1982).

400. *Id.* at 459.

401. *Id.* at 460.

402. *Id.*

403. 45 U.S.C. §§ 1001-1018 (Supp. IV 1980).

404. 45 U.S.C. §§ 1005, 1008(d) (Supp. IV 1980).

405. 45 U.S.C. § 1005(e)(2) (Supp. IV 1980).

406. 45 U.S.C. § 1008(a) (Supp. IV 1980). The reorganization court entered a preliminary injunction against enforcement of this act on the grounds that it violated the fifth amendment of the Constitution. *Gibbons*, 455 U.S. at 463. Congress responded by reenacting the operative provisions of the act with additional provisions suggesting that any claimants deprived of property could seek compensation from the United States under existing legislation. *Id.* at 463-64.

be uniform throughout the United States.[407] To avoid the uniformity requirement the unions had argued that the RITA act was an exercise of power under the Commerce Clause.[408] The court rejected this argument, and concluded that the RITA act was a law on the "subject of Bankruptcies."[409]

In a certain sense, this is true. The RITA act amended an existing bankruptcy proceeding. It required the bankruptcy court to direct the trustee to implement the employee protection arrangements and to pay any claims out of the estate of the bankrupt railroad.[410] Noting that the subject of bankruptcies is the "subject of the relations between an insolvent or nonpaying or fraudulent debtor and his creditors, extending to his and their relief,"[411] the Court concluded that "the subject matter of the [RITA act] is the relationship between a bankrupt railroad and its creditors."[412]

The Court's analysis raises the question of whether a uniform law containing provisions like those of the RITA act, but applicable to all debtors who had filed a petition under the Code, would be within Congress's power under the Bankruptcy Clause. The better answer is no.

Such RITA-like provisions would create claims for parties that have no existing claims outside of bankruptcy and allocate to them the resources of the debtor otherwise available to pay creditors. These kinds of provisions were not included in the English or American bankruptcy or insolvency laws. They would also exceed all of the Supreme Court's formulations of the scope of the Bankruptcy Clause, including the ones cited by *Gibbons*. Although they would represent a bankruptcy law in the sense that they affect insolvent debtors and their creditors, they would nonetheless exceed Congress's power to legislate on the subject of bankruptcies. One can neither read the English and American bankruptcy and insolvency laws of the eighteenth century nor analyze the basic problems that those laws attempted to resolve and conclude that the Framers of the Constitution intended that Congress could pass a uniform RITA-like law in the name of legislating on the subject of bankruptcies.

Further, there is nothing in the problem that Congress was trying to solve in the RITA act that represents a new development, unforeseeable to the Framers. Merchants and non-merchants who engaged in business or consumer transactions in the eighteenth century had employees, suppliers, and revenue-hungry governments to contend with. To be sure, if a debtor became bankrupt and received a discharge, the debtor might continue in

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407. *Gibbons*, 455 U.S. at 471.

408. *Id.* at 465.

409. *Id.* at 468-69.

410. 45 U.S.C. § 1005 (Supp. IV 1980).

411. *Gibbons*, 455 U.S. at 466 (quoting Wright v. Union Cent. Life Ins. Co., 304 U.S. 502, 513-14 (1938)).

412. *Id.* at 467.

business, and therefore might hire the same employees or buy goods and services from the same suppliers. An individual debtor released from jail would presumably be better able to support his or her family. But the bankruptcy laws did not require that the debtor should do so. Discharge and other bankruptcy relief may have helped insolvent debtors become productive members of society, and therefore generate indirect benefits for non-creditors, but they might not have.[413] Certainly, there was no attempt to quantify the value of these future indirect benefits and allocate a portion of the debtor's present property or future income to these future beneficiaries. Even the legislatively mandated composition agreement or stay of arrest was designed to allow the debtor to generate moneys to pay existing creditors, not to promote the interests of non-creditors.

This analysis forces us to look again at the argument made by the unions in *Gibbons* that such a law could be upheld under the Commerce Clause. Justice Rehnquist suggested in *Gibbons* that Congress does not have the power to enact bankruptcy laws pursuant to the Commerce Clause.[414] If it is not a "bankruptcy law" then arguably it would qualify under the Commerce Clause. If it were a law that applied generally to all individuals or entities engaged in interstate commerce, without regard to whether they were participating in a bankruptcy proceeding, it could so qualify. A law that applies only to insolvent debtors in a bankruptcy proceeding but that exceeds the scope of the Bankruptcy Clause should not, however, automatically qualify (assuming the requirement of interstate commerce) under the Commerce Clause. Otherwise, Congress would be permitted to enact "bankruptcy" legislation that is outside of its bankruptcy power.[415] By focusing on the lack of uniformity in the RITA act, the Court in *Gibbons* missed an opportunity to clarify the reach of the Bankruptcy Clause.

### 2. Stays of Actions by Non-Debtors

The modern automatic stay of actions by creditors against the debtor did not exist in early English or American bankruptcy law. The automatic stay and its cousin, the discretionary injunction, however, are logical develop-

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413. The House Report on the Bankruptcy Reform Act of 1978 recognized the importance of allowing an individual debtor to be able to provide for her dependents. The report noted that, in deciding whether to approve a plan for repayment of debts under Chapter 13, the court must consider the debtor's primary ability to support her dependents, or otherwise the plan will not succeed and the debtor or her dependents would become may become public charges. H.R. REP. NO. 595, 95th Cong., 2d Sess. 124 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6085.

414. *Gibbons*, 455 U.S. at 468-69.

415. There is no reason to suppose a perfect symmetry between the Bankruptcy Clause and the Commerce Clause. In their operation, they may overlap, but each also applies to problems that the other cannot address. *See supra* note 17.

ments in legislation aimed at regulating how creditors may deal with their insolvent debtor. Such limitations on creditor rights are within the "subject of Bankruptcies."

A related issue is the extent to which courts may impose such limitations against a defendant who is not a debtor. One manifestation of this issue which is of current significance is whether actual or potential codefendants who are not debtors in bankruptcy are entitled to an automatic stay or a discretionary injunction against actions by creditors, which is available to the codefendant who is a debtor under the Code.

Courts have generally applied the automatic stay or discretionary injunction to non-debtors in a way that is constitutional. Under section 105 of the Code, bankruptcy courts have, for example, stayed actions by a creditor to collect a debt owed by a debtor in bankruptcy from another party who is also obligated on the debt.[416] This co-obligor could be a guarantor of the underlying debt or a co-promisor on a note or agreement. In addition, if a debtor files a petition for relief under Chapter 13 of the Code, which is available to individual debtors with regular income, section 1301 of the Code imposes an automatic stay on collection actions by a creditor against a consumer debt of that debtor from any individual who is liable on the debt or who has provided security for the debt.[417]

The justification for these non-debtor stays is that they are necessary to permit the orderly reorganization or liquidation of the debtor. Nevertheless, the availability of a stay against actions against non-debtors appears to provide a benefit to the non-debtor to the detriment of a creditor. The creditor may not assert her nonbankruptcy rights against a party who is not a debtor in the bankruptcy proceeding. However, this type of co-obligor stay does not exceed the bankruptcy power for the simple reason that co-obligors are by definition creditors. To the extent that a co-obligor were to pay a debt owed by a debtor, the co-obligor would have a claim against the debtor. The co-obligor who assumes liability on a contractual debt as guarantor of or co-promisor with the debtor has a contingent right to payment from the debtor that would mature if the co-obligor paid the debtor's obligation. This obligation arises as a matter of nonbankruptcy law either under a principal of reimbursement and subrogation, in the case of a guarantor, or contribution, in the case of a co-maker of a note or a co-promisor on a promise to pay or perform an obligation.[418] In this case,

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416. *See, e.g.*, G.H. Ishii-Chang, *Litigation and Bankruptcy: The Dilemma of the Codefendant Stay*, 63 AM. BANKR. L.J. 257, 266-69, 273-75 (1989); Joel C. Shapiro, *Non-Debtor Third Parties and the Bankruptcy Code: Is Protection Available Without Actually Filing?*, 95 COM. L.J. 345, 346 (1990); Barry L. Zaretsky, *Co-Debtor Stays in Chapter 11 Bankruptcy*, 73 CORNELL L. REV. 213, 213-14 (1988).

417. 11 U.S.C. § 1301 (1994).

418. *See, e.g.*, 2 FREDERICK M. HART & WILLIAM WILLIER, COMMERCIAL PAPER § 5.05 (MB UCC Serv. 1996); 2A HART & WILLIER, *supra*, § 13.29; JAMES J. WHITE

the co-obligor stay merely adjusts the relations of one creditor against another, long a part of the subject of bankruptcy.

The courts have not relied upon any notion of the limits of bankruptcy power in dealing with co-obligor stays under section 105 or section 1301. With respect to section 105, courts have uniformly stated that section 105 does not authorize the bankruptcy court to create new substantive rights under applicable law, including the Code.[419] With respect to section 1301, Congress did address the constitutionality of section 1301 co-debtor stays. The House Report on the bill stated: "The stay is not questionable on constitutional grounds. It is not relief for an individual that is not a debtor under the bankruptcy laws. It is designed only to protect the principal debtor, not the codebtor. Any protection of the codebtor is incidental."[420]

This particular justification for section 1301 is weak. An analysis that justifies a direct benefit for a third party on the grounds that it is "incidental" will produce much mischief. A more straightforward analysis recognizes that the co-debtor is a creditor. A bankruptcy law may protect one creditor at expense of other creditors for the benefit of the insolvent debtor.

The non-debtor stay also arises under section 105 in another context that is constitutionality sound: the stay of a cause of action by a creditor against the non-debtor where the cause of action itself (or the rights underlying the cause of action, such as a contract) is property of the estate. For example, if the debtor has an insurance policy, the policy is property of the estate.[421] If a creditor may proceed against the policy, payments to the creditor would reduce the amount available to the bankruptcy estate of the debtor. Courts have enjoined such creditors seeking such payment.[422] A

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& ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE § 13-8, at 481-82 (4th ed. 1994).

419. *In re* Morristown & Erie Ry., 885 F.2d 98, 100 (3rd Cir. 1989); NWFX, Inc. v. Carl's Grocery Co. (*In re* NWFX, Inc.), 864 F.2d 593, 595 (8th Cir. 1989); United States v. Sutton, 786 F.2d 1305, 1308 (5th Cir. 1986); Grassmueck v. Zamsky (*In re* EZ Feed Cube Co.), 123 B.R. 69, 73-74 (Bankr. D. Or. 1991); In re First Republic Corp., 95 B.R. 58, 60 (Bankr. N.D. Tex. 1988); Riggs Nat'l Bank v. Perry (*In re* Perry), 25 B.R. 817, 821 (Bankr. D. Md. 1982).

420. H.R. REP. NO. 595, 95th Cong., 2d Sess. 123 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6084. The section 1301 co-debtor stay was also recommended in Bankruptcy Commission Report, *supra* note 10, pt. I, at 166-67; *id.* pt. II, at 214.

421. 11 U.C.C. § 541(a)(1) (1994). *See, e.g.*, A.H. Robbins Co. v. Piccinin, 788 F.2d 994, 1008 (4th Cir. 1986); Forty-Eight Insulations, Inc. v. Lipke (*In re* Forty-Eight Insulations, Inc.), 54 B.R. 905, 908-09 (Bankr. N.D. Ill. 1985).

422. *See, e.g.*, A.H. Robbins Co. v. Piccinin, 788 F.2d 994, 1008 (4th Cir. 1986). *See also* S.I. Aquisitions, Inc. v. Eastway Delivery Serv. (*In re* S.I. Acquisitions, Inc.), 817 F.2d 1142, 1151-52 (5th Cir. 1987) (under state law, alter ego action is the property of the debtor corporation and therefor of the estate). The principal also applies to general partners of a partnership. To the extent that the general partner is liable for the partnership debts, actions against the general partner are asserting control over property that belongs to the estate. *See generally* G.H. Ishii-Chang, *supra* note 416, at 261-63, 272-73, 275.

stay of these causes of action may harm the creditor, but it does not benefit the non-debtor. The bankruptcy trustee retains its rights against the non-debtor.

One application of the non-debtor stay, however, is questionable. This is a stay of an action against an officer, director, or shareholder of the debtor on the grounds that continuation of the action would jeopardize the ability of these managers to devote sufficient time and effort to the reorganization of the debtor. A troubling example is *In re Original Wild West Foods, Inc.*[423] In that case, the Internal Revenue Service assessed a penalty under section 6672 of the Internal Revenue Code against an officer of the debtor corporation responsible for ensuring the payment of withholding tax because the officer had wilfully failed to pay those taxes.[424] Under the Internal Revenue Code, an officer who pays the penalty does not have a right of reimbursement against the corporation.[425] The officer is therefore not a creditor of the debtor. Nevertheless, the bankruptcy court enjoined the collection of the penalty in this case because the officer had threatened to abandon his attempts to reorganize the debtor if his house were seized and sold to enforce the penalty.[426] The court also noted that the reorganization plan provided for the payment of the taxes with interest.[427]

Although Congress seeks to encourage the rehabilitation of corporate debtors, this goal should not allow officers, directors, or shareholders to receive benefits that would not be available outside of bankruptcy.[428] Greater awareness of the constitutional limitations will ensure that these types of stays are limited to the type of relief that any non-debtor could achieve under nonbankruptcy law.[429]

Another example of using the bankruptcy process against non-debtors, of historical interest, is a proposal that a trustee in bankruptcy be able to assert claims against non-debtor defendants that some, but not all of the

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423. 45 B.R. 202 (Bankr. W.D. Tex. 1984).

424. *Id.* at 204-05.

425. *See, e.g.*, Levit v. Ingersoll Rand Fin. Corp., 874 F.2d 1186, 1191 (7th Cir. 1989); *see also* Ishii-Chang, *supra* note 416, at 269-72.

426. 45 B.R. at 205.

427. *Id.* at 208.

428. And of course, if the corporation is solvent, it does not belong in bankruptcy and it is not entitle to an automatic stay either.

429. Other courts have refused to enjoin the Internal Revenue Service from imposing withholding penalties. *See* United States v. Huckabee Auto Co., 46 B.R. 741, 744-45 (M.D. Ga. 1985), *aff'd*, 783 F.2d 1546 (11th Cir. 1986) (reversing a bankruptcy court order enjoining the enforcement of the penalties against the non-debtor because the enforcement might jeopardize the success of the debtor's reorganization); Gennari v. United States (*In re* Educators Investment Corp.), 59 B.R. 910, 914 (Bankr. D. Nev. 1986). Ishii-Chang discusses another type of codefendant stay that is not constitutionally suspect, the cause of action against officers or directors that are in effect disguised actions against the debtor. *See* Ishii-Chang, *supra* note 416, at 270-71.

creditors could assert, for the benefit of those specific creditors. The Supreme Court rejected this proposal under the 1898 Bankruptcy Act in 1972.[430]

The House of Representatives included this proposal in the reported version of House Bill No. 8200. The bill conditioned the trustee's authority on the non-debtor defendant *not* having any right of subrogation against the bankruptcy estate.[431] Therefore, the trustee could proceed only against non-creditors. The report justified this change in the law on the grounds that it would benefit the estate and that the culpable third parties often escaped liability because classes of small creditors rarely bring class action suits against indenture trustees.[432] Although such suits by trustees may have promoted a better use of judicial resources than individual suits by the affected creditors, this laudable goal by itself is not a "subject of Bankruptcies." The final version of the bill deleted this proposal.[433]

### 3. Impairing Marital Rights in Property

Under section 363(f) of the Code, the trustee in bankruptcy may sell property free and clear of the interest that any third party has in the property if the trustee meets certain conditions that protect the rights of the third party.[434] A related provision goes too far, however. Under section

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430. Caplin v. Marine Midland Grace Trust Co., 406 U.S. 416, 423-35 (1972) (holding that the trustee in bankruptcy could not bring an action against a trustee under a bond indenture for negligence in carrying out its duties to the bondholders, even though those bondholder could have brought such an action, since it was not a cause of action that the debtor could have brought or that the trustee could have asserted as a representative of all of the debtor's creditors).

431. H.R. REP. NO. 595, 95th Cong., 2d Sess. 370 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6326-27 (creating a subsection (c) in proposed 11 U.S.C. § 544). The Bankruptcy Reform Commission had also included this proposal in its report to Congress in 1973. BANKRUPTCY COMMISSION REPORT, *supra* note 10, pt. I, at 200; *id.* pt. II, § 4-604(b)(2), at 160; *id.* pt. II, at 161-62 n.6.

432. H.R. REP. NO. 595, 95th Cong., 2d Sess. 179-80 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6140.

433. 124 CONG. REC. H11089 (statement of Rep. Edwards), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6140-41.

434. 11 U.S.C. § 363(f) (1994):

> The trustee may sell property under subsection (b) or (c) of this section free and clear of any interest in such property of an entity other than the estate, only if—
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> (1) applicable nonbanrkuptcy law permits sale of such property free and clear of such interest;
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> (2) such entity consents;
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> (3) such interest is a lien and the price at which such property is to be sold is greater than the aggregate value of all liens on such property;
>
> (4) such interest is in bona fide dispute; or

363(h), the trustee may sell property in which the debtor has an undivided interest with a third party as a tenant in common, joint tenancy, or tenant by the entirety without regard to the protections of subsection 363(f), if certain conditions are met.[435] One condition is that the sale of the entire property would produce more for the bankruptcy estate than the sale of the debtor's undivided interest. Another is that the benefit to the estate outweighs the harm to the co-owner. Thus, the Code authorizes the trustee to harm a third party for the benefit of the estate (and presumably the creditors) in a way that is not permitted by nonbankruptcy law.

One bankruptcy case illustrates the economic significance of this power. In *In re Tsunis*,[436] creditors brought an involuntary petition against the debtor.[437] The debtor moved to dismiss the petition on the grounds that the creditors did not meet the Code's then threshold requirement of having in the aggregate $5,000 of unsecured debt under section 303(b)(1).[438] The debtor owned a house with his wife as a tenant by the entirety subject to a mortgage.[439] The debtor's one-half interest in the equity of the house (conservatively estimated to be about $182,500) exceeded the amount of debt that he owed to the petitioning creditors (in the amount of $181,045).[440] In a bankruptcy proceeding, the trustee could sell this house and make the equity available to the creditors. Under New York law, however, the creditors, who had obtained liens on the house, could not force the sale of the house to collect their debts.[441] They could only execute on

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(5) such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest.

435. *Id.* § 363(h):

Notwithstanding subsection (f) of this section, the trustee may sell both the estate's interest, under subsection (b) or (c) of this section, and the interest of any co-owner in property in which the debtor had, at the time of the commencement of the case, an undivided interest as a tenant in common, joint tenant, or tenant by the entirety, only if—

(1) partition in kind of such property among the estate and such co-owners is impracticable;

(2) sale of the state's undivided interest in such property would realize significantly less for the estate than sale of such property free of the interests of such co-owners;

(3) the benefit to the estate of a sale of such property free of the interests of the co-owners outweighs the detriment, if any, to such co-owners; and

(4) such property is not used in the production, transmission, or distribution, for sale, of electric energy or of natural or synthetic gas for heat, light, or power.

436. *In re* Tsunis, 29 B.R. 527 (Bankr. E.D.N.Y.), *aff'd*, 39 B.R. 977 (E.D.N.Y. 1983), *aff'd*, 733 F.2d 27 (2d Cir. 1984).

437. *Id.* at 528.

438. *Id.*

439. *Id.*

440. *Id.* at 524.

441. *Id.* at 528.

the debtor's interest in the house, which was a right of survivorship if the wife died before he did.[442] Testimony established that this interest was worth only $20,000, substantially less than the aggregate debts owed to the creditors.[443]

The debtor, in seeking dismissal of the involuntary petition, argued that the amount that could be realized under section 363(h) was the appropriate amount.[444] If the court used this amount, the creditors would not have been undersecured, and they would not have met the jurisdictional requirements to bring the involuntary petition. The court disagreed.[445] It held that the amount available to the creditors under state law, $20,000, was the appropriate amount for purposes of meeting the standards for an involuntary petition.[446]

In many of the states in which tenancy by the entireties is recognized, that form of ownership shields the assets of a borrower from the claims of the creditors of the spouse.[447] In New York, Tsunis' wife had the right to continue to live in the house so long as she paid the mortgage. She had the right to receive sole ownership of the house if Tsunis died before she did, without the costs of probating the husband's will.

If the wife in *Tsunis* were an insolvent debtor, creditors could file a petition against both her and her husband and bring the property into a consolidated bankruptcy estate. Under the facts in *Tsunis*, however, having the wife brought into a consolidated case as a debtor under the Code would have brought in the full value of their joint equity in the home. The full value of the equity would have destroyed the creditor's jurisdictional basis for an involuntary case in the first instance.

Moreover, if the wife in *Tsunis* is not an insolvent debtor, what is there about adjusting the relations between an insolvent debtor and his creditors, which after all are created by nonbankruptcy law, that permits the creditors to deprive the debtor's wife, a third party, of her property interests? Of course, it may be more convenient if the bankruptcy court and the creditors need not respect the wife's property interest as a tenant by the entireties. The creditors may realize a greater return. But simply enhancing the insolvent debtor's bankruptcy estate to benefit his creditors or to improve his chances of rehabilitation by eliminating the state law rights of third parties is no reason to allow the appropriation of a third party's property.

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442. *Id.* at 528-29.

443. *Id.* at 529.

444. *Id.*

445. *Id.*

446. *Id.* at 528-29.

447. *See generally* ROGER A CUNNINGHAM ET AL., THE LAW OF PROPERTY § 5.5, at 205-06 (2d ed. 1993); Oval A. Phipps, *Tenancy by Entireties*, 25 TEMP. L.Q. 24 (1951); Janet D. Ritsko, Note, *Lien Times in Massachusetts: Tenancy by the Entirety After* Coraccio v. Lowell Five Cents Bank, 30 NEW ENG. L. REV. 85 (1995).

Requiring everyone who lives within 100 miles of an insolvent debtor to contribute $10 to her bankruptcy estate also would serve these lofty goals. Such a requirement is not and has never been a proper subject of "bankruptcy."[448]

4. "Rejecting" a Lessee's Interest in Personal Property

Under section 365 of the Code, the trustee may assume or reject executory contracts and leases.[449] This power has engendered much discussion, disagreement, confusion, and legislative tinkering.[450] It is also of relatively modern origin. It originated under the Bankruptcy Act of 1898 as a result of court decisions, and it was codified in 1938.[451] The basic idea behind assumption or rejection is to empower the trustee to elect whether to continue to perform an agreement made by the debtor, depending upon whether continued performance would be beneficial or detrimental to the estate and therefore the creditors.

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448. The Code also allows the trustee to sell property "free and clear of any vested or contingent right in the nature of dower or curtesy." 11 U.S.C. § 363(g) (1994). Dower and curtesy no longer perform the function in society that they once did, and the states for the most part have eliminated or so restricted them that the effect of this section is likely to be small. *See* CUNNINGHAM, *supra* note 447, § 2.14, at 75. Nevertheless, it is not the constitutional province of bankruptcy to alter state law entitlements and liabilities for those who are not part of the debtor-creditor relationship.

The 1973 Bankruptcy Commission Report recommended that the trustee in bankruptcy have access to a debtor's interest in a spendthrift trust other than that necessary to support the debtor and his dependents. BANKRUPTCY COMMISSION REPORT, *supra* note 10, pt. I, at 17; *id.* pt. II, § 4-601(b), at 147-48; *id.* pt. II, at 151 n.10. Outside of bankruptcy, this interest would not be available to creditors. The Commission's proposal would have deprived the settlors of spendthrift trusts of their expectations, enforceable under nonbankruptcy law, for the benefit of creditors, and would have exceeded the bankruptcy power. The Code enacted by Congress did not follow this recommendation, and restrictions enacted under spendthrift trusts are respected in bankruptcy. *See* 11 U.S.C. § 541(c)(2) (1994).

449. 11 U.S.C. § 365 (1994).

450. *See generally* Michael T. Andrew, *Executory Contracts in Bankruptcy: Understanding "Rejection,"* 59 U. COLO. L. REV. 845 (1988); Michael A. Bloom & Bryna L. Singer, *The Revised Section 365: Lessor's Panacea?*, 63 AM. BANKR. L.J. 199 (1989) (discussing the 1984 amendments to the Code imposing limitations on the trustee's powers to assume or reject nonresidential real property leases); Vern Countryman, *Executory Contracts in Bankruptcy, Part I*, 57 MINN. L. REV. 439 (1973); Vern Countryman, *Executory Contracts in Bankruptcy, Part II*, 58 MINN. L. REV. 479 (1974); Don Fogel, *Executory Contracts and Unexpired Leases in the Bankruptcy Code*, 64 MINN. L. REV. 341 (1980); Robert L. Tamietti, *Technology Licenses Under the Bankruptcy Code: A Licensee's Mine Field*, 62 AM. BANKR. L.J. 295 (1988); Jay L. Westbrook, *A Functional Analysis of Executory Contracts*, 74 MINN. L. REV. 227 (1989).

451. *See* 4A WILLIAM COLLIER, BANKRUPTCY ¶ 70.43, at 516-20 (James W. Moore ed., 14th ed. 1974) (discussing the history of the trustee's power).

In the main, this power is constitutional. If an insolvent debtor has entered into a contract or lease that is burdensome, rejection by the trustee creates no greater harm for the other party than the debtor's insolvency. An insolvent debtor will be equally as unable to perform the rejected obligations as she is to perform her other obligations. Such failure outside of bankruptcy would give the other party a cause of action for damages, and the trustee's rejection does the same.[452]

On the other hand, assumption by the trustee does nothing more than require the other party to perform to the same extent that it was obligated to do had there been no bankruptcy. If there has been a default under the contract or lease, the trustee must cure the default and provide adequate assurance of performance.[453] The trustee may not assume contracts when applicable law would excuse the other party from accepting performance from someone other than the debtor.[454] If the trustee assigns the contract or lease, the other party must receive adequate assurance of performance by the assignee.[455] If the other party has concerns about the trustee's ability to perform the contract, such as a concern about whether there are sufficient assets to assure payments due, the other party retains its state law rights, such as the right to suspend performance of a contract for the sale of goods when reasonable grounds for insecurity exist, until the party receives adequate assurances of performance.[456]

To be sure, the Code does limit the rights of the other party. Principally, the other party may not terminate the contract or lease solely by reason of the debtor's insolvency.[457] This does not actually affect the other party's rights, since it may suspend its performance until it receives adequate assurance of performance. Presumably, the other party initially believed that the debtor could perform. Otherwise, it would not have entered into the contract or lease.

Prohibiting the other party from terminating an executory contract or lease solely because of the event of insolvency of the debtor is necessary to prevent the other party from enjoying greater rights than it would otherwise enjoy under the contract or lease. The trustee will assume a contract or lease that is favorable to the debtor. This would include a lease of property by the debtor that requires the debtor as lessee to pay a now below market rent or a contract in which the debtor provides services for a now above market compensation. Continued performance by the other party is a burden to it. Outside of bankruptcy, the other party cannot avoid this burden. If

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452. 11 U.S.C. § 502(g) (1994).

453. 11 U.S.C. § 365(b) (1994).

454. 11 U.S.C. § 365(c) (1994).

455. 11 U.S.C. § 365(f) (1994).

456. *See, e.g.*, U.C.C. § 2-609 (1994); RESTATEMENT (SECOND) OF CONTRACTS § 251 (1981).

457. 11 U.S.C. § 365(b)(2), (e), (f)(1) (1994).

it breaches the contract, the debtor would have an ability to obtain damages that would make it whole. An "ipso facto" clause—that is, a clause allowing termination in the event of bankruptcy—simply gives the other party an excuse for getting out of a bad deal. So long as the other party does get what it bargained for, a bankruptcy rule that prevents the other party from benefitting from the debtor's insolvency does not violate the constitutional limit on bankruptcy laws.

On the other hand, to the extent that Congress or the courts create greater harms or benefits for the other party to the contract or lease than exist outside of bankruptcy, they exceed Congress's constitutional authority. One example of concern is the rejection of personal property leases when the debtor is the lessor of the property. Assume that I am in the business of renting computers, and I lease a computer to you for a term of three years. You agree to pay me rent each month, and I agree to provide maintenance services. After one year, I go bankrupt, and my trustee in bankruptcy determines to reject the lease. What exactly does this mean?

Outside of bankruptcy, I have an obligation to provide services. You have a possessory interest in the computer. As long as you pay your rent, I have no right to "cancel" your possessory interest and get back the computer. I could "cancel" my obligations under the lease and refuse to provide the services. You may be a creditor with respect to the obligations that I owe you and therefore could seek your remedies.

In bankruptcy, rejecting the lease means that I no longer have to provide maintenance services to you; you will have a claim in bankruptcy for damages (or an offset against rent) and therefore will be a "creditor" with respect to my obligations to you. But your possessory interest is independent of whether you are a creditor. The trustee, whose job is to maximize the estate for the benefit of creditors, may believe that I charged too little rent for the computer, and may want to get it back so that she can rent it to someone else at a higher rent. Despite this noble goal, as concerns your possessory interest in the computer, the trustee should not be able to retrieve the computer from you as long as you pay the rent. The Code does not explicitly state that the trustee gets the computer back. Nevertheless, there is some authority interpreting the ability to "reject" the lease as cancelling the lease and giving the trustee a right to get the computer back.[458]

An interpretation that suggests the trustee may defeat a non-creditor's property interest exceeds the scope of the bankruptcy power.[459] So would

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458. 2 WILLIAM COLLIER, BANKRUPTCY ¶ 365.08, at 365-65 (Lawrence P. King ed., 15th ed. 1995) (citing *In re* O.P.M. Leasing Services, Inc., 23 B.R. 104 (Bankr. S.D.N.Y. 1982)).

459. The Code explicitly protects the property interests of a lessee of real property under a lease or the purchaser of real property under a land installment sale contract if the lessor or seller become a debtor. 11 U.S.C. §§ 365(h)(1)(A)(ii), 365(j)(1) (1994) (allowing the lessee or purchaser to retain possession of the property).

an express provision. If Congress wants to limit the property or other rights of third parties, or impose obligations on third parties,[460] then it must use some other power, such as the Commerce Clause. Furthermore, it must do so generally, not just for bankruptcy proceedings.

5. Limits on Bona Fide Purchasers in Fraudulent Conveyances

The trustee in bankruptcy has the power under section 548 to avoid fraudulent conveyances.[461] This power in the Code mirrors nonbankruptcy fraudulent conveyance law enacted in most states in the form of the Uniform Fraudulent Transfer Act[462] or the Uniform Fraudulent Conveyance Act.[463] Even before enactment of the Code and the Bankruptcy Act of 1898, the ability of creditors to avoid fraudulent conveyances has been a feature of English and American law since the sixteenth century, separate from the law of bankruptcy.[464]

Fraudulent conveyance law proscribes two types of behavior: actual fraud, that is, a conveyance made with the actual intent to hinder, delay or defraud creditors; and constructive fraud, in which a conveyance is made

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460. An example would be a provision that requires third parties to renew contracts with a debtor in bankruptcy so that the debtor can be rehabilitated. Courts have held that a decision to cancel a contract pursuant to a contractual provision because a debtor files for bankruptcy violates the automatic stay. *E.g.*, *In re* Advent Corp., 24 B.R. 612, 614 (Bankr. 1st Cir. 1982); In re Cahokia Downs, Inc., 5 B.R. 529, 531-32 (Bankr. S.D. Ill. 1980). However, courts have generally recognized that a decision not to enter into a new contract does not violate the stay. *E.g.*, *In re* Advent Corp., 24 B.R. 612, 614 (Bankr. 1st Cir. 1982); *In re* New England Marine Servs., Inc. 174 B.R. 391, 396-97 (Bankr. E.D.N.Y. 1994); *In re* Rives, 95 B.R. 946, 947 (Bankr. W. D. Ky. 1988); Gulf Tampa Drydock Co. v. Insurance Co. of North America (*In re* Gulf Tampa Drydock Co.), 49 B.R. 154 (Bankr. M.D. Fla. 1985); Heaven Sent, Ltd. v. Commercial Union Ins. Co. (*In re* Heaven Sent, Ltd.), 37 B.R. 597, 598 (Bankr. E.D. Pa. 1984); In re Douglas, 18 B.R. 813, 815 (Bankr. W.D. Tenn. 1982).

461. 11 U.S.C. § 548(a) (1994).

462. 7A U.L.A. 639 (1985) (first promulgated in 1984).

463. 7A U.L.A. 427 (1985) (first promulgated in 1918).

464. *See* 4 WILLIAM COLLIER, BANKRUPTCY ¶ 548.01, at 365-65 (Lawrence P. King ed., 15th ed. 1995). For discussions of the origins of and the policies behind fraudulent conveyance law, see Douglas G. Baird & Thomas H. Jackson, *Fraudulent Conveyance Law and Its Proper Domain*, 38 VAND. L. REV. 829 (1985); Robert C. Clark, *The Duties of the Corporate Debtor to Its Creditors*, 90 HARV. L. REV. 505 (1977); Michael L. Cook, *Fraudulent Transfer Liability under the Bankruptcy Code*, 17 HOUS. L. REV. 263 (1980); Thomas H. Jackson, *Avoiding Powers in Bankruptcy*, 36 STAN. L. REV. 725 (1984); Allen J. Littman, *Multiple Intent, Veil-Piercing, and Burdens and Benefits: Fraudulent Conveyance Law and Multiparty Transactions*, 39 U. MIAMI L. REV. 307, 308-12 (1985); John C. McCoid II, *Constructively Fraudulent Conveyances: Transfers for Inadequate Consideration*, 62 TEX. L. REV. 639 (1983); Jack F. Williams, *Revisiting the Proper Limits of Fraudulent Transfer Law*, 8 BANKR. DEV. J. 55 (1991).

without adequate consideration and the debtor is insolvent or is rendered insolvent, left with unreasonably small capital or becomes unable to pay its debts.[465] Fraudulent conveyance law also provides that, if a transfer is avoided because it was constructively fraudulent, the transferee retains a security interest in the property transferred to the extent of any consideration paid.[466]

Some aspects of fraudulent conveyance law have long been part of bankruptcy law.[467] This makes sense. To the extent that a third party has

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465. 11 U.S.C. § 548(a) (1994):

> The trustee may avoid any transfer of an interest of the debtor in property, or any obligation incurred by the debtor, that was made or incurred on or within one year before the date of the filing of the petition, if the debtor voluntarily or involuntarily—
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> (1) made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became . . . indebted; or
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> (2)(A) received less than reasonably equivalent value in exchange for such transfer or obligation; and
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> (B)(i) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation;
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> (ii) was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital; or
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> (iii) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured.

*See also* Unif. Fraudulent Transfer Act, § 4(a)(1) (actual intent to defraud); *id.* § 4(b) (without reasonably equivalent value/unreasonably small capital or unable to pay debts); *id.* § 5 (insolvency/without "reasonably equivalent value"); 7A U.L.A. 639, 652-53, 657 (1985); Unif. Fraudulent Conveyance Act, § 4 (insolvency/without "fair consideration"); *id.* § 5 (without fair consideration/unreasonably small capital); *id.* § 6 (without fair consideration/unable to pay debts); *id.* § 7 (actual intent to defraud); 7A U.L.A. 427, 474, 504, 507, 509 (1985).

466. 11 U.S.C. § 548(c) (1994):

> Except to the extent that a transfer or obligation voidable under this section is voidable under section 544, 545, or 547 of this title, a transferee or obligee of such a transfer or obligation that takes for value and in good faith has a lien on or may retain any interest transferred or may enforce any obligation incurred, as the case may be, to the extent that such transferee or obligee gave value to the debtor in exchange for such transfer or obligation.

*See also* Unif. Fraudulent Transfer Act, § 8(b), 7A U.L.A. 662 (1985); Unif. Fraudulent Conveyance Act, § 9(2) 7A U.L.A. 578 (1985).

467. *See, e.g.*, 13 Eliz., ch. 7, § 7 (1570) (Eng.) (providing for forfeiture by third parties of double the value of debts, goods, lands and tenements that third parties possess or claim, unless they possess or claim them as the result of just consideration and without fraud or collusion); 1 Jam., ch. 15, § 5 (1604) (Eng.) (authorizing the commissioner of bankrupts to convey any property previously conveyed by a bankrupt to a third party except property transferred for the marriage of his or her children or for a valuable consideration); 4 Anne, ch. 17, § 9 (1705) (Eng.) (recovery of a fine of £100 plus double the value of the estate fraudulently concealed by third parties), *continued in* 5 Geo. 2, ch. 30, § 21 (1732) (Eng.);

received the debtor's property in collusion with the debtor to remove the property from the reach of her creditors, bankruptcy law may extend to the co-conspirator to the same extent that it extends to the insolvent debtor. Further, the participant in the active fraud should not acquire any right to the property that he receives. Similarly, to the extent that a third party acquires a debtor's property for low enough consideration to be considered inadequate[468] or not "reasonably equivalent value,"[469] the third party's interest in the property extends only to the extent of the consideration given.

There is one feature of the current Code, however, that exceeds the scope of the subject of bankruptcies. Under both the Uniform Fraudulent Transfer Act and the Uniform Fraudulent Conveyance Act, creditors cannot avoid a transfer of property made with the actual intent to hinder, delay, or defraud creditors if the transferee took the property in good faith and for fair consideration or reasonably equivalent value.[470] Under section 548 of the Code, however, the trustee may avoid such a fraudulent conveyance, and the purchaser retains only a lien for the original purchase price.[471] A trustee in bankruptcy has an incentive to avoid such transfers if the value of the property has risen.[472] There will always be a lag between the time that the trustee asserts her rights in the transferred property and the date of the transfer.[473] Thus, the trustee can deprive the good faith purchaser not only of her possessory interest in the property but also the right to appreciation in the value of that property. The ability of the trustee (for the benefit of the debtor's unsecured creditors) to deprive the right of a non-debtor, non-creditor third party to the appreciation in value of property that she has acquired in good faith and for reasonably equivalent value exceeds the bankruptcy power.

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1788 N.Y Laws 92, ¶ 13 (recovery of a fine of £100 plus double the value of the estate fraudulently concealed by third parties); ch. 683, 1785 Pa. Stat., §§ 9, 10, *found in* 12 PA. STAT. 1682-1801, *supra* note 165, at 70, 74 (recovery of double the value of the estate fraudulently concealed by third parties; commissioner may avoid pre-bankruptcy transfers except those for the marriage of the bankrupt's children or those for a valuable consideration).

468. *See, e.g.*, statutes cited *supra* note 467.

469. 11 U.S.C. § 548(a)(2)(A).

470. Unif. Fraudulent Transfer Act, § 8(a), 7A U.L.A. 662 (1985); Unif. Fraudulent Conveyance Act, § 9, 7A U.L.A. 577-78 (1985).

471. 11 U.S.C. § 548(a), (c) (1994)

472. Presumably, if the value of the property has decreased, the purchaser would receive a lien only to the extent of the value of the property and retain an unsecured claim for the balance. 11 U.S.C. § 506(a) (1994).

473. Under 11 U.S.C. § 548(a), the trustee may avoid transfers that happen within one year before the filing of a petition in bankruptcy.

### 6. Servitudes

The relationship between being a creditor with a prepetition claim and a third party with continuing, post petition rights, arises in servitudes. David Gray Carlson has distinguished three types of servitudes, that is, three types of personal obligations that may be enforced against successor owners of assets solely because the successor owns those assets: (1) covenants running with the land and equitable servitudes on land; (2) product liability servitudes imposed on the buyer of assets from a seller who created a liability; and (3) the toxic waste servitude.[474] He recommends that, on policy grounds, the first category of servitudes not be foreclosable in bankruptcy but that the second category, product liability servitudes, be foreclosable. The third category presents a more difficult problem.

Upholding servitudes of the first type is constitutionally mandated. The only way to foreclose in bankruptcy the rights of those benefitted by a covenant running with the land or an equitable servitude is to destroy those rights. These servitudes are intended to have continuing existence. Because they create rights in favor of persons who are not existing creditors, Congress may not foreclose them in bankruptcy. Of course, to the extent that a current owner has incurred a monetary liability because of a breach of the covenant running with the land, that liability may be discharged in bankruptcy without destroying the continuing viability of the covenant.

The recommendation for the products liability servitude is constitutionally permissible. To the extent that the products liability servitude makes the successor owner of property liable for a claim of a prior owner that arose before the bankruptcy proceeding, Congress may (but need not) discharge this claim and release the property from the servitude.

The toxic waste servitude is different. Fundamentally, the toxic-waste servitude is not foreclosable outside of bankruptcy. First, current law imposes the obligation to clean up the toxic wastes on whomever owns the land.[475] Second, even absent a statute on this issue, once land has been contaminated with toxic wastes, its value will be diminished by the costs to remove those wastes (which costs may even render the land a liability and not an asset). The only way to discharge this servitude is to clean up the toxic wastes. In a bankruptcy case of a debtor owning contaminated property, costs incurred prepetition to clean up the land have already discharged the servitude, and such costs can (but need not) be treated as dischargeable debts. One can treat the costs of future clean up as an administrative expense and foreclose the servitude if the clean up is

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474. David G. Carlson, *Successor Liability in Bankruptcy: Some Unifying Themes of Intertemporal Creditor Priorities Created by Running Covenants, Products Liability, and Toxic-Waste Cleanup*, LAW & CONTEMP. PROBS., Spring 1987, at 119.

475. Comprehensive Environmental Remedial Compensation & Liability Act (CERCLA), 42 U.S.C. § 9601 (1994).

completed. Alternatively, one could constitutionally treat the unmatured present liability of the debtor as a prepetition claim and discharge the debtor from that liability, as in the case of *Ohio v. Kovacs*.[476] That treatment, however, does not foreclose the toxic waste servitude.

On the other hand, abandoning the property to the debtor or otherwise refusing to relieve her of present liability for future clean up costs will not necessarily ensure that the toxic wastes will be removed. Where the costs of clean up exceed the value of the decontaminated land, this result may leave the debtor in a state of perpetual insolvency. Ultimately, for land for which the cost of clean up exceeds the value after decontamination, the government, as a representative of the public interest, must clean up the land, or allow it to remain unproductive and potentially hazardous.

In any event, how one treats the present liability of the debtor for future clean up costs may constitutionally be a bankruptcy issue.[477] The existence and effect of the servitude, however, is a nonbankruptcy fact that bankruptcy law cannot alter, and how to remove the servitude that survives the bankruptcy case is a nonbankruptcy policy issue.

### *C. The Nature of the Creditor*

Historically, bankruptcy law involved adjusting the relations between an insolvent debtor and creditors with matured debts. Creditors with certain types of unmatured claims could also participate.[478] Resort to involuntary or voluntary bankruptcy also depended in many cases on the amount of the debts. Some jurisdictions required a minimum amount of debt for a debtor or creditor to initiate proceedings. Others required that debts not exceed a maximum amount. Finally, these laws drew distinctions between groups of creditors for other purposes in the proceeding.[479]

Accordingly, the concept of bankruptcy that existed at the time of the Constitution permitted flexibility for determining who was an eligible creditor. As a corollary, those not deemed eligible creditors were also not technically bound by the proceedings. They were, of course, affected. If tort victims with unmatured claims were not included, they could not participate in the distribution of the debtor's property. They were also not bound by the debtor's discharge. Before the days of limited liability entities

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476. 469 U.S. 274 (1985).

477. *See* Carlson, *supra* note 474, at 167-71.

478. *See, e.g.*, 7 Geo. 1, ch. 31, § 2 (1719) (Eng.) (creditors could get the present value of unmatured debts); 5 Geo. 2, ch. 30, § 22 (1732) (Eng.) (allowing creditors with unmatured debts to file a petition for a commission of bankrupt, repealing the limitation contained in the Statute of 7 George I); 19 Geo. 2, ch. 32, §2 (1746) (Eng.). Tabb, *Discharge*, *supra* note 62, at 340, 344 & n.127; *see also supra* note 193.

479. *E.g.*, 5 Geo. 2, ch. 30, § 10 (1732) (Eng.) (requiring consent of 80% in number and value of creditors owed more than £20 to discharge of debtor).

that would shield individuals engaged in business from tort liability, this may have been a good trade. After the advent of limited liability, and the liquidation of a limited liability entity, good public policy may require that unmatured tort claims be recognized in some way in a bankruptcy proceeding.

In any event, there is no constitutional infirmity in recognizing unmatured tort claims in bankruptcy. To the extent that nonbankruptcy law makes one a "creditor" then Congress is free to include that creditor in the proceedings.[480] This point gets stretched to its limit in the case of the extremely contingent tort claim. Assume that a manufacturer produced a substance that is later found to cause disease of some kind, such as cancer. Assume that 100,000 people were exposed to this compound. As of today, 1,000 people have contracted the disease and sued the manufacturer. Assume also that the best guess is that 9,000 more people who have yet to be identified will contract the disease in the next 20 years. The manufacturer has long since stopped production of the substance, but because of the suits from the 1,000 present tort claimants and estimates of future liability, it has filed for reorganization in bankruptcy.

This problem presents difficult policy and legal issues, as the Johns-Manville litigation has shown. Johns-Manville had manufactured asbestos.[481] Many who had contracted asbestosis and had sustained other asbestos related injuries sued the company.[482] The company then filed for a Chapter 11 reorganization.[483] In *In re Johns-Manville Corp.*, a bankruptcy court denied motions filed by, among others, representatives of individuals who had contracted the asbestos-related diseases to dismiss the bankruptcy petition.[484] The motions alleged that the company's filing was in bad faith.[485] Noting the substantial impact of the known and estimated liability from the tort litigation, the court denied the motion.[486] Later, the parties crafted a reorganization plan that attempted to provide for the current tort claimants and for those who may contract the diseases in the future, without actually making a ruling that the future tort claimants were "creditors" within the meaning of the Code.[487]

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480. The Senate Report on the bill that enacted the Bankruptcy Code noted that the definition of "creditor" included "holders of prepetition claims against the debtor." It also noted that the definition of "claim" was broad: "[T]he bill contemplates that all legal obligations of the debtor, no mater how remote or contingent, will be able to be dealt with in the bankruptcy case. It permits the broadest possible relief in the bankruptcy court." S. REP. NO. 989, 95th Cong., 2d Sess. 22 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5808.

481. *In re* Johns-Manville Corp., 36 B.R. 727, 729 (Bankr. S.D.N.Y. 1984).

482. *Id.*

483. *Id.*

484. *Id.* at 734.

485. *Id.*

486. *Id.*

487. *In re* Johns-Manville Corp., 68 B.R. 618 (Bankr. S.D.N.Y.), *aff'd*, 78 B.R. 407

At some point, the future tort claimants in our example, as in *Johns-Manville*, will have a right to payment derived from the acts of the manufacturer that caused their injury. This is a right recognized by state law. States may differ on when the right "accrues" for purposes of the statute of limitations, or for purposes of when a cause of action may be brought. A future tort claimant may be unable to sue until injury is manifested, and the statute of limitations may not begin until that time.[488] Nevertheless, because the activity giving rise to the right of payment has created a contingent liability that is recognized outside of bankruptcy,[489] it is (barely) enough of a "debt" to qualify the future tort claimants as "creditors" in a constitutional sense entitled to participate in the proceeding.

This situation is different from attempting to qualify as a creditor someone who asserts a right to payment that, as of the bankruptcy proceeding, has not yet arisen under any conception. This distinction may be hard to draw in individual cases. It is also different from the situation in which no right to payment is recognized under state or federal nonbankruptcy law.

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(S.D.N.Y.), *aff'd*, 843 F.2d 636 (2d Cir. 1988). This problem also arises in the context of a company that has sold goods that contain latent defects. The question is whether the buyers of these goods who may assert a products liability claim against the seller in the future should be recognized in a current bankruptcy case. *See* Epstein v. Official Committee of Unsecured Creditors, of the Estate of Piper Aircraft Corporation (*In re* Piper Aircraft Corp.), 58 F.3d 1573 (11th Cir. 1995) (holding that such future claimants do not hold claims under the Code and therefore should not be so recognized because such claimants do not have any pre-bankruptcy relationship with the seller); *see also* Robert J. Scott, Note, *When a Claim Arises Under the Bankruptcy Code*, 24 HOFSTRA L. REV. 253 (1995). Constitutionally, recognizing such future claims in bankruptcy could be justified. At the time of the first sale of the goods, the buyer of the goods obtains not only the goods themselves but also a contingent right to damages for any latent defects that nonbankruptcy law recognizes. If initial buyer A then sells the goods to buyer B and buyer B sells to buyer C, buyer C has acquired this contingent right to damages. The seller cannot be liable to buyer C for a latent defect unless it exists at the time of the initial sale. The fact that the seller may not know who buyer C is or will be in the future is not relevant. The maker of a negotiable promissory note may not know who may be the ultimate person entitled to enforce the note. This lack of privity does not destroy the right to payment that exists under nonbankruptcy law.

488. *See, e.g.*, *In re* Edge, 60 B.R. 690 (Bankr. M.D. Tenn. 1986).

489. In *Johns-Manville*, the company estimated that it faced tort claims for damages related to its manufacturing and selling asbestos in the amount of $1.9 billion. *In re* Johns-Manville Corp., 36 B.R. at 734-35. Had Johns-Manville not filed for bankruptcy, the company would have had to disclose this liability and would have had to book a reserve for contingent liability in this amount under the Financial Accounting Standards Board, Statement of Financial Accounting Standards No. 5. *Id.* at 734-35. Indeed, by May 1987, those with asbestos related health claims filed approximately 11,850 proofs of claims for $32.4 billion in damages. Harvey J. Kesner, *Future Asbestos Related Litigants as Holders of Statutory Claims Under Chapter 11 of the Bankruptcy Code and Their Place in the Johns-Manville Reorganization*, 62 AM. BANKR. L.J. 69, 73 n.14 (1988) (taken from company filings with the Securities and Exchange Commission).

For example, if the law of a state did not recognize liability for a particular act, Congress cannot create under the Bankruptcy Clause a debt arising out of that act. The basic requirement is that a creditor must be a "creditor" under nonbankruptcy law. Congress under its bankruptcy power may give a broad reach to that term. Congress may not, however, give rights to non-creditors in a bankruptcy law.

## VII. CONCLUSION

Although bankruptcy law under the current Code pervades American society more than ever before, it is still the province of specialists. Fascinating as it is to some of us, it is not a subject on which our representatives in Congress pin their election hopes. It is a subject about which most lawyers and business people know little. Bankruptcy legislation will attract the attention of those interested in the subject, but it is not likely to generate much attention of itself. In this regard, it is different from legislation that Congress may enact under the Commerce Clause, be it legislation to control consumer lending practices or to prohibit children from carrying guns to school.

This is natural. Bankruptcy legislation in the past has generally dealt with a discrete set of problems, and the Bankruptcy Clause commands that bankruptcy legislation be limited to its proper domain. Legislators, however, get their rewards by solving current problems, and not by meticulously complying with what may seem to be only the technical limitations imposed upon them by the Constitution. It may be easier politically to achieve a partial solution of the problems of those who are neither insolvent debtors nor their creditors through bankruptcy law. Fewer people may be paying attention. Nevertheless, in the long run, for the Constitution to have continued viability, Congress must respect what the Framers intended in some sense in adopting the Bankruptcy Clause.

In the area of bankruptcy legislation, Congress and the courts have reached the threshold question: Should legislation enacted under the Bankruptcy Clause be confined to the "subject of Bankruptcies" as broadly understood at the time of the adoption of the Constitution and interpreted fairly consistently since? Congress has arrived at this threshold by expanding the scope of the Bankruptcy Code without much attention to what the Framers had in mind. Of course, Congress has legitimate concerns about the way debtors and creditors relate to each other generally and about the well being of workers, businesses, neighbors, local governments, and local communities dependent upon consumers and businesses. It should not, however, attempt to resolve those concerns in the name of the "subject of Bankruptcies" in a way that gives solvent debtors rights that they do not enjoy under nonbankruptcy law, that benefits entities that are not parties to the insolvent debtor-creditor relationship at the expense of the insolvent debtor or creditor, or that harms those third parties for the benefit of the insolvent debtor or creditor.