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The Abuse and Use of Federal Bankruptcy Power

*Morris G. Shanker**

In its proposals for a new bankruptcy act, the Commission on Bankruptcy Laws frequently recommends that federal bankruptcy power be exercised to write a new set of debtor-creditor rules which will be applicable only in bankruptcy courts. (The Bankruptcy Judges in their proposed Bankruptcy Act do likewise.) Professor Shanker argues that these recommendations exercise the federal bankruptcy power in an unwise and counterproductive fashion. He asserts that (1) they will cause uncertainty and instability in legal relationships since the parties will not know the law which ultimately will govern, and (2) they will bring about tension-creating situations in which the existence of conflicting nonbankruptcy and bankruptcy law will result in the parties maneuvering to enter or avoid bankruptcy for reasons totally inconsistent with the objectives of the bankruptcy system. Professor Shanker suggests that the Bankruptcy Commission made these errors because of an unduly narrow perspective of the debtor-creditor universe and because of its failure to appreciate the appropriate and unique role of the bankruptcy system in that universe. If reform of nonbankruptcy law is needed, then Professor Shanker urges that this be accomplished for all (not just bankruptcy) purposes through state or general federal legislation.

* The Author: Morris G. Shanker (B.S.E.E., Purdue University; M.B.A., J.D., University of Michigan) is the John Homer Kapp Professor of Law at Case Western Reserve University and has been a Visiting Professor of Law at the University of Michigan, University of California (Berkeley), Wayne State University, and the University of London, England. His teaching specialties include *Commercial Law*, *Creditors' Rights*, and *Property Security*. He is admitted to the Ohio Bar and, prior to entering full-time teaching, practiced law in Cleveland, Ohio for 10 years.

The author is a member of the Advisory Committee on Bankruptcy Rules of the Judicial Conference of the United States and also of the National Bankruptcy Conference. The views expressed, however, are the author's and not those of the above bodies.

I. ABUSE — THE QUESTIONABLE FEDERALISM IN THE PROPOSED BANKRUPTCY ACT

A. *Unfortunate Tensions*

THE BANKRUPTCY COMMISSION proposes to exercise the federal bankruptcy power in a way which is quite different from the present situation.[1] The dominant and overriding theme of the present bankruptcy act is that property rights and the basic debtor-creditor law created by nonbankruptcy sources will continue to be recognized in bankruptcy.[2] If the bill proposed by the Bankruptcy Commission is enacted, this dominant theme will be seriously eroded. With far more frequency than is true today, the Bankruptcy Commission proposes that the federal bankruptcy power be exercised to write completely new governing rules which are to apply *only* in the bankruptcy courts. Consequently, in these situations, one set of rules, the nonbankruptcy rules, would govern property rights and the debtor-creditor relationship before bankruptcy; quite another would govern in bankruptcy. This quite different approach to the use of the federal bankruptcy power, if adopted, will bring about curious and questionable results. Just how curious and how questionable can be dramatized by the following playlet which might well be entitled, "Bankruptcy and the Disappearing Dower."

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1. *See* COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. Doc. No. 93-137, 93d Cong., 1st Sess. (1973) [hereafter cited as REPORT].

The Bankruptcy Judges have proposed an alternative bankruptcy bill. H.R. 32, 94th Cong., 1st Sess. (1975). The comments in this paper are for the most part equally applicable to it.

2. *See, e.g.*, J. HANNA & J. MACLACHLAN, CASES AND MATERIALS ON CREDITORS' RIGHTS 283 (5th ed. 1957), who state the following: "The central idea of bankruptcy is simple enough. The trustee succeeds to property owned by the bankrupt, as determined by state law of property, including contracts." In Vanston Bondholders Protective Comm. v. Green, 329 U.S. 156, 169 (1946), in which Mr. Justice Frankfurter states:

> Parties are in a bankruptcy court with their rights and duties already established, except insofar as they subsequently arise during the course of bankruptcy administration or as part of its conduct. Obligations to be satisfied out of the bankrupt's estate thus arise, if at all, out of tort or contract or other relationship created under applicable law. And the law that fixes legal consequences to transactions is the law of the several States.

See 1 G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 13.1, at 403 (1965) which states: "In general Congress has chosen [in the Bankruptcy Act] to do no more than provide a mechanism for the distribution of assets of insolvent estates, leaving to the background of state law the determination of the validity of property rights and other claims to the assets."

See also Countryman, *The Use of State Law in Bankruptcy Cases* (pts. 1 & 2), 47 N.Y.U.L. REV. 407, 631 (1972).

Scene 1

Time: The future
Place: State Court

Assignee for Benefit of Creditors: Your Honor, we would like to distribute to creditors of this insolvent estate the proceeds of the debtor-assignor's interest in his land, Blackacre. What is more, we should like to do so free and clear of his wife's inchoate dower interest. As you undoubtedly recognize, it is quite a nuisance to have me compute and set off that inchoate dower interest. What is more . . .

Judge (*interrupting*): Hold on there! So long as our state law recognizes inchoate dower as some kind of a property interest, then it will be upheld in this court, notwithstanding the inconvenience to you in having to figure it out. There is something, you know, to the legal principle that creditors are entitled to be paid only from the property of their debtors, and not from the property of third parties who don't owe the debts.[3]

Assignee: But, Judge, inchoate dower makes no sense today. It is an old and archaic concept. Aren't creditors of the husband more worthy than the wife's antiquated claim to dower?

Judge: I understand that a good many people in this world agree with you. However, until you convince our state legislature of your arguments, I cannot, simply for your convenience or upon your representation of the worthiness of your creditors, use the wife's property to pay off the debts of her husband. Accordingly, you are to prepare an order allowing and setting off to the wife the value of her inchoate dower interest before you distribute to your creditors the proceeds of the husband's land.

Scene 2

Time: Same as Scene 1—the future
Place: Same state as Scene 1, but in the Bankruptcy Court across the street

Trustee in Bankruptcy: Your Honor, we would like to distribute to the creditors of this bankrupt estate the proceeds of the bankrupt's interest in his land, Blackacre. Moreover, we should like to do so free and clear of his wife's inchoate dower interest.

Wife: But, your Honor, the value of the inchoate dower is my prop-

3. This principle is supported by many authorities. *See, e.g.*, Mr. Justice Black in Pearlman v. Reliance Ins. Co., 371 U.S. 132, 135 (1962).

erty; and everyone here has stipulated that I am in no way obligated to pay my husband's debts. Moreover, my inchoate dower in this case is worth quite a bit, particularly when you consider that I am only 30 years old and my 70-year-old bankrupt husband has become deathly ill as a result of this terrible bankruptcy.

Bankruptcy Judge: Sorry, madame, your points would be well taken if you were across the street in the state court dealing with an assignment for the benefit of your husband's creditors or a levying creditor on your husband's land. But, as your lawyer has probably told you, we now have a new Bankruptcy Act; and section 4-601(c) says that you lost the inchoate dower interest that you might otherwise have had when your husband filed for bankruptcy.[4] So, what used to be the value of your inchoate dower interest in Blackacre now belongs to your husband's creditors.

[*Whispers, murmurs, and grumbling are heard in the courtroom.*]

Creditors (*whispering to each other*): Saaay, I sure like this Bankruptcy Judge. Let's try to get into his courtroom just as often as possible.

Bankrupt husband (*murmuring to his wife*): Why did I ever file this stupid bankruptcy petition?

Wife (*grumbling to her husband*): We should have sold this land and grabbed the money before you filed for bankruptcy.

End of Scenes

1. *The Message of this Paper*

Exactly what is the message to be learned from these two scenes? They were not intended to suggest that states ought to retain inchoate dower. Indeed, strong arguments have been made for its elimination.[5] Nor were these scenes intended to suggest that the Federal Bankruptcy Act should never be used to effect rights which are otherwise available under nonbankruptcy (typically state) law. Just when the Bankruptcy Act *appropriately* may do so in order to

4. A judge less sensitive to the wife's feelings might also have mentioned that the wife economically would have been better off by being a widow. If the husband had died before the filing of the bankruptcy petition, then the wife's dower interest would no longer be inchoate but vested and, therefore, not subject to termination under section 4-601(c) of the proposed Bankruptcy Act. REPORT pt. II, § 4-601(c).

5. The arguments for eliminating inchoate dower are found in the assignee's statements in Scene 1 and were essentially lifted from *id.* § 4-601, Notes 11, 15 & 16.

accomplish its *unique* objectives will be discussed later.[6] What these scenes are intended to dramatize is the effect of the Bankruptcy Commission's proposals wherein non-bankruptcy-created rights (inchoate dower in these scenes) are denied validity *only* in the bankruptcy court, but remain valid in all other forums where creditor-debtor problems are adjudicated. As illustrated by the whispers, murmurs, and grumbling at the end of Scene 2, this situation produces the following unfortunate tensions:

1. It encourages creditors to press for the bankruptcy of their debtors, not because that is the last resort after all reasonable efforts outside of bankruptcy to solve the debtor-creditor problem have been exhausted. Rather, creditors are encouraged to precipitate an early bankruptcy of their debtor simply to get an asset which otherwise would not be available to them.[7] Recall the creditors' whispers.

2. It discourages debtors from filing bankruptcy when, in fact, that may well be the desirable solution to rid themselves of their overburdening debts. Take a look at the husband's murmur.

3. It encourages the family unit to dispose of their assets, not because that seems to be a sensible business or personal goal. Rather, this will be done only because it avoids a severe monetary disadvantage to the family unit which will result from the husband's bankruptcy. Remember the wife's grumble.

To summarize: The Bankruptcy Commission's proposals frequently bring about what I will hereafter refer to as a *tension-creating situation.* These words will be shorthand in this paper to describe the mix of tensions, such as those illustrated above, wherein the parties' motives are strong (1) to precipitate or avoid bankruptcy for reasons that are not consistent with the unique purposes and goals for which our bankruptcy system was established,[8] and (2) to take precipitous action before bankruptcy, even though that action may not be consistent with their best personal or business objectives. Such tension-creating situations, I submit, are not the kinds of things which ought to be encouraged by our bankruptcy act.

And if this were not enough, the Commission's proposals also create uncertainty and instability, since the various parties, *i.e.* the debtor and his creditors, will be unable to predict at the inception of their relationship what law will ultimately govern that relationship. Under the present Bankruptcy Act, one can fairly predict that state

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6. *See* text accompanying notes 55-76 *infra.*

7. And one should also keep in mind that under section 4-205(a) of the Commission's proposed Act only one creditor, who need allege only that the debtor is unable to pay his current debts, is needed to file an involuntary petition in bankruptcy.

8. *See* text accompanying notes 55-76 *infra.*

law will control the relationship, even if the consequences of that relationship are adjudicated in a bankruptcy court.[9] But, if the Bankruptcy Commission's proposals are adopted, one simply will not know at the time of contracting just what law will eventually control. That will depend entirely on the happenstance of whether the matter is decided before or after bankruptcy. Such uncertainty regarding the applicable law on which parties may rely is hardly a situation which commends itself.

2. *The Better Solution*

Even if one assumes (as did the Bankruptcy Commission) that inchoate dower unfairly impacts upon the debtor-creditor relationship, then is there a better way of dealing with this evil than that proposed by the Bankruptcy Commission which causes the tension-creating situation already described? Indeed, there is! That better solution is to attack this evil right at its source and to eliminate it for all purposes, both within and without bankruptcy. This can be achieved by following either of these alternatives:

1. Persuade the state legislatures to eliminate inchoate dower against a husband's creditors. Indeed, such legislation, the Uniform Probate Code, has already been proposed and adopted in several states.[10]

2. Enact a general federal statute which will preempt state law and eliminate inchoate dower for all debtor-creditor purposes. Presumably, Congress would not adopt such preemptive federal legislation without giving due consideration to the role of the states in marital matters under the federal system set up in our Constitution.[11] However, where national objectives are being defeated by in-

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9. "[E]very debt is contracted with reference to the rights of the parties thereto under existing [state] exemption laws." Hanover Nat'l Bank v. Moyses, 186 U.S. 181, 189 (1902), quoting Mr. Chief Justice White in *In re* Deckert, 7 F. Cas. 334 (No. 3728) (C.C.E.D. Va. 1874). *See also* note 2 *supra.*

10. Both Alaska and Idaho have adopted the Uniform Probate Code. *See* ALASKA STAT. §§ 13.06.005 to 13.36.100 (1973); IDAHO CODE §§ 15-1-101 to 15-7-307 (1972).

11. Congress, at least on some occasions, has been reluctant to enact federal preemptive legislation until the states were given the opportunity to try to solve a problem normally assigned to them. For example, Congress deferred to the states in the drafting of a Uniform Commercial Code rather than adopt a federal act. More recently, Congress seems willing to permit the states to try to work out their own versions of no-fault insurance for auto accidents before considering federal legislation. *See* Cleveland Plain Dealer, June 16, 1975, at 3-A, col. 1, which reports that Attorney General Edward Levi, in testimony before the Senate Commerce Committee, "questioned the wisdom of imposing any plan for nationally regulated no-fault insurance at a time when many states are experimenting with their own no-fault

appropriate and unresponsive state law, ample precedent[12] already exists for enacting federal preemptive statutes.[13]

3. *The Bankruptcy Commission's Non-Solution*

The Bankruptcy Commission follows neither of the above alternatives. Rather, it would have us embark upon some in-between road in which federal power is used to "solve" the inchoate dower evil only in the bankruptcy forum and in no other. That "solution" is a cure which is probably worse than the disease. Indeed, it can hardly be classified as a solution at all. Accepting, for argument's sake, that inchoate dower does impact unfairly on the debtor-creditor relationship, then that evil will, under the Bankruptcy Commission's approach, continue to exist in all nonbankruptcy situations. And this quantitatively amounts to a good many situations —perhaps more than the Bankruptcy Commission may have conceived. Included are all state proceedings dealing with a debtor's estate: *e.g.*, assignments for the benefit of creditors, receiverships, probate administration,[14] liquidations of insurance companies,[15] and enforcement of individual creditor process against a husband's land. Indeed, the inchoate dower evil will be very much alive in every federal forum other than the bankruptcy court. Thus, enforce-

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systems." For a more complete report on Attorney General Levi's views, see 11 TRIAL, July/August, 1975, at 29.

12. There are many such federal preemptive statutes. Among those most recently adopted is the so-called Federal Warranty Act, more properly cited as the Magnuson-Moss Warranty-Federal Trade Commission Improvement Act, 15 U.S.C.A. § 2301 *et seq.* (Supp. I, 1975).

13. With respect to debtor-creditor law, perhaps the most pertinent of such federal statutes is the Federal Truth in Lending Act, 15 U.S.C. §§ 1601-81 (1970), where federal power was used to preempt entirely the minimum wage exemptions formerly available to debtors under state law.

14. Where a probate administration is under way, there is not going to be any "inchoate dower." By this time, the inchoate dower would have become a vested property interest in the widow and, therefore, not subject to termination under section 4-601(c) of the proposed Bankruptcy Act. Nevertheless, there are many other examples, beyond inchoate dower, where the inapplicability of the Bankruptcy Commission's proposals to probate administration (in fact, decedent's estates are not even eligible for bankruptcy, *see* REPORT, pt. I, at 184) very much contributes to and demonstrates the questionable use of federal power employed by the Bankruptcy Commission. *See* text accompanying note 17 *infra.* Thus, even though the present discussion deals specifically with inchoate dower, it seems appropriate at this point to mention probate administration as among those places where nonbankruptcy rules would continue to apply even if the Commission's proposed Bankruptcy Act were adopted.

15. Obviously, an insurance company has no wife who can claim inchoate dower rights in its property. But again, these institutions are listed for the same reasons set out with respect to the probate administration. See note 14 *supra.*

ment in civil actions in the United States district courts of individual creditor claims and federal tax liens asserted against a husband will be plagued by it. And, even beyond the federal courts, the inchoate dower evil would rear its head in federally administered liquidations of insolvent banks, since the Bankruptcy Commission has excluded them from federal bankruptcy eligibility.[16] Perhaps the crowning irony is that even trustees in bankruptcy seeking to reach land interests belonging to their estates, *e.g.*, a lien held by the bankrupt against one of his nonbankrupt debtors, will find that they are subject to whatever inchoate dower claims exist against that land.

Thus, if inchoate dower is such an evil, then the Bankruptcy Commission's proposals will not rid us of it. Indeed, worse than presenting no solution at all to the problem, the Bankruptcy Commission's proposals are counterproductive in that they cause the tension-creating situations which have already been discussed—namely, a situation where the parties are motivated to maneuver before bankruptcy, or to maneuver to precipitate or to avoid bankruptcy, for reasons that are entirely inconsistent with the unique and basic objectives for which the bankruptcy system was developed.

B. *More Tension-Creating Situations*

If the inchoate dower situation just discussed were the only example of a tension-creating situation found in the Bankruptcy Commission's proposals, then this paper need not have been written. The problem could be dismissed as quantitatively insignificant. The tension-creating situation could arise only in those states which still recognize a wife's inchoate dower as some kind of a property interest which is not available to her husband's creditors.[17] And, even in those states, the money amounts attributable to the value of inchoate dower would not likely reach a high-enough level to cause the parties to maneuver seriously for a favorable pre- or post- bankruptcy advantage, unless the husband were a great deal older than the wife.

However, the inchoate dower example does not stand alone. Quite to the contrary, there are many more tension-creating situations which the Bankruptcy Commission's proposals will bring about.

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16. *See* REPORT pt. I, at 195; pt. II, §§ 4-201, -204.

17. According to the Bankruptcy Commission there are only nine states that so hold. *See* REPORT pt. I at 195. *See also* 2 R. POWELL, REAL PROPERTY ¶ 213(1), at 170-17 (1966).

Some by themselves—and certainly all of them collectively—present a quantitative level of tension-creating situations which is too high to be ignored. Here are some of them:

a. *Exemptions.* Perhaps the example which individually will have the greatest quantitative impact is the Bankruptcy Commission's proposal regarding exemptions. In section 4-503, there is set out a list of exempt property which will be applicable only in bankruptcy, but not elsewhere. Thus, in states (*e.g.*, Ohio) where exemptions are significantly less than those proposed by the Bankruptcy Commission, it is hard to fathom why any individual debtor would not fly for the bankruptcy door at the first sign of creditor pressure. In these states, the debtor has so much to gain by filing bankruptcy and, correspondingly, so little motive to seek resolution of his problems outside of bankruptcy.[18] Indeed, if the debtor failed to seek this bankruptcy haven, one suspects it would be because he was not advised of its existence.

Looking at the creditor side of the coin in these states, the pressure is strong for them to move as quickly and as vigorously as possible to enforce their state law remedies, in the hope that they can thereby reach their debtor's assets before the bankruptcy bell rings. Of course, in states (*e.g.*, Texas) where exemptions are "better" than those set out in the Bankruptcy Commission bill, the roles to be played by the debtor and creditor would be reversed.[19] But in every state the motivation to resolve the problem outside of bankruptcy is much reduced. Instead, one party is strongly motivated to race for the bankruptcy door while the other seeks to trip him up before he makes it. Is this the kind of scenario which our Bankruptcy Act should encourage?

I emphasize that this is not meant to be a criticism of the exemp-

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18. *See, e.g.*, Kennedy, *Limitations of Exemptions in Bankruptcy*, 45 IOWA L. REV. 445, 485 (1960), in which Professor Kennedy, executive director of the Bankruptcy Commission, stated:

> For all the antiquarianism, diversity, and inadequacies of state exemption legislation, there seems to be no impelling need to impress a federal mold on the exemptions recognizable in bankruptcy. Certainly it would be a dubious approach to the problem of modernizing such legislation for Congress to confer exemptions beyond those recognized by state law. A new incentive for entering the gates of voluntary bankruptcy would be afforded. Any proposal increasing the spate of wage-earner bankruptcies will be viewed askance.

See also Holahan & Hemmings, *Judicial Expansion of Exemptions in Bankruptcy*, 80 COM. L.J. 102, 110 (March, 1975), who also recognized that the Bankruptcy Commission's approach "would create new incentives for debtor or creditor to shop the bankruptcy forum for more favorable outcome." These authors, however, find little fault with this result.

19. *See, e.g.*, Kennedy, *supra* note 18, at 452.

tions which the Bankruptcy Commission has proposed. Quite to the contrary, I personally regard them as an excellent model from which to work in developing a sensible exemption law to govern *all* debtor-creditor situations. My criticism is directed to the questionable and curious way by which the Bankruptcy Commission used federal power to enact these exemptions only for bankruptcy purposes. As I have already pointed out with respect to my discussion of inchoate dower,[20] that approach will not solve the evil of "bad" exemption laws. Those "bad" laws will continue to exist in the significant number of debtor-creditor cases being resolved outside of a bankruptcy court.[21] And, not only is this a "non-solution" to "bad" exemption laws, it is entirely counterproductive because (1) it generates another tension-creating situation where maneuvering to get in or stay out of bankruptcy may become the paramount consideration, and (2) it leaves the parties at the time of contracting uncertain as to whether the state or bankruptcy exemptions will ultimately control.

b. *Statutory Liens and Security Interests.* Yet another example of a tension-creating situation is found in section 4-606(a) of the proposed act. There, the Bankruptcy Commission proposes the elimination, again only in bankruptcy, of numerous statutory liens. Undoubtedly, the most important of the statutory liens to be eliminated are those intended to secure payment of delinquent state and federal income taxes. With such a situation facing a tax collector, his motive quickly to assert and then precipitously to enforce these liens before bankruptcy, while they will be fully valid, seems self-evident. Equally self-evident is the motive of the debtor's other creditors to precipitate bankruptcy where the lien will be invalidated. (Distressingly, in this particular case, the debtor finds himself right in the middle of this nutcracker!) Again, the race for the advantage (or disadvantage) of the bankruptcy court may become paramount to the determination of a sensible solution to the debtor-creditor problem. And, again, neither set of parties knows at the inception of the relationship what will be its ultimate rights.

A similar tension-creating situation will arise under section 4-503(f) where the Bankruptcy Commission proposes the invalidation, again only in bankruptcy, of non-purchase-money security interests in household goods.[22] Here, the competing parties become

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20. *See* text accompanying notes 14-16 *supra*.

21. A partial list of the federal and state forums where nonbankruptcy exemptions will control is set out in the text accompanying notes 14-16 *supra*.

22. The "better" solution, *i.e.*, invalidation of these security interests for *all*

the finance company which can enforce a perfectly valid security interest before bankruptcy, and the other creditors of the debtor (or the debtor himself if he can claim the asset as exempt in bankruptcy) who can invalidate it by precipitating bankruptcy.

More of the same is found in section 4-406(2). There, the Commission proposes to subordinate, again only in bankruptcy, the claims (whether secured or unsecured) of insiders of a corporate bankrupt, even though the relative priority of those claims would be upheld under general equitable principles and corporate and business law. What a temptation this raises for other creditors to precipitate bankruptcy just to get this advantage! And, how discouraging this rule makes it for insiders ever to advance monies which might have entirely rescued the corporation from its financial stress.

c. *Fraudulent Transfers and Spendthrift Trusts.* Yet another example of a tension-creating situation is found in section 4-608 where the Bankruptcy Commission has proposed a new fraudulent transfer act. Again, it is a rule which will define what is a fraudulent transfer only in bankruptcy, but not in other forums. So again, creditors are encouraged to precipitate a bankruptcy because that might get for them a "fraudulently transferred" asset which they could not otherwise reach. One may wonder why a transfer which is perfectly valid and nonfraudulent under the governing law before bankruptcy suddenly should become invalid and fraudulent simply because bankruptcy takes place. But the purpose of this paper is not to argue about the merits of the proposals which the Bankruptcy Commission has made. Rather, it is to question the wisdom of a bankruptcy statute which makes it possible for creditors to obtain additional assets only in bankruptcy and thereby motivates them to precipitate the process.

The tension-creating list may be continued with the Bankruptcy Commission's treatment of spendthrift trusts. In bankruptcy, but not elsewhere, they will be denied their full validity. Again, the added encouragement this gives to creditors to precipitate a bankruptcy of the beneficiary seems evident.

Undoubtedly, one can expand even further the list of tension-creating situations which the Bankruptcy Commission's proposals

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purposes (see text accompanying n. 10 *supra*) has already been proposed in the 1974 text of the Uniform Consumer Credit Code, section 5.116. Actually, this section would not invalidate these security interests entirely. Rather, it would permit the court to refuse enforcement of a non-purchase-money security interest in property that was otherwise exempt if the "continued possession and use of the item is necessary to avoid undue hardship." UNIFORM CONSUMER CREDIT CODE § 5.116(3).

bring. But sufficient numbers have already been given to illustrate that there are enough to cause concern.

C. *How Did It Happen?*

How did this situation come about? Some of the reasons which led the Commission to propose these tension-creating situations are set out in its report. Their validity will now be discussed.

1. *Historical Precedent*

In some cases, the Commission apparently felt that it was simply following historical precedent. In other words, certain tension-creating situations can already be found in the present Bankruptcy Act. Thus, it appears that the Commission was not particularly troubled to continue and, indeed, to enlarge upon them. One example of a tension-creating situation found in the present Bankruptcy Act is section 67(d)[23] which enacts, only for bankruptcy purposes, a slightly different version of the Uniform Fraudulent Conveyance Act. Another example is found in section 67(c),[24] which denies full validity to a tax lien on personal property unaccompanied by possession, even though that tax lien would be fully efficacious outside of bankruptcy.

It goes without saying that errors of the past ought not be perpetuated simply because they have existed.[25] Further, it should

23. 11 U.S.C. § 107(d) (1970).

24. *Id.* § 107(c)(3).

25. It is gratifying to note that the Commission in at least one place rejected a bad historical precedent. Not all creditors recognized by nonbankruptcy law may presently participate in *strict* bankruptcy proceedings, but only those whose claims are "provable." 11 U.S.C. § 103(a) (1970). Thus, creditors whose claims are "provable" are subject to the benefits and burdens of their debtor's bankruptcy whereas the "nonprovable" creditors are not. Thus, a tension-creating situation is presently generated wherein the parties are encouraged to seek (or avoid) bankruptcy simply to take advantage of this senseless dichotomy. For example, negligent bankrupts often avoid filing bankruptcy—even though that may be clearly called for—until the negligence claim against them has been reduced to judgment. This is because an unliquidated tort claim may not be provable (and thus not dischargeable) under sections 63(a)(7) and 63(d). *Id.* §§ 103(a)(7), (d). On the other hand, tort claims which have been reduced to judgment are provable (and thus possibly dischargeable). Thankfully, the Bankruptcy Commission, following the lead already set in the present Bankruptcy Chapters 10, 11, 12 and 13, would eliminate the senseless distinction between those creditors who are recognized by nonbankruptcy law but not in bankruptcy. *See* REPORT pt. I, at 213 (discussion); *id.* pt. II, § 4-403. Unfortunately, the Commission waffled on this positive approach when it refused in its proposals to recognize completely in bankruptcy certain claims which are otherwise fully valid under state law. *Id.* pt. II, § 4-403(b) (particularly clause 6 which limits the extent of landlord damage claims and clause 7 which limits the extent of an employee's damage claim). So, more tension-creating situations are born!

be noted that the Bankruptcy Commission proposes an entirely different tune from that being played in the present Bankruptcy Act. Under the present Act, the fundamental and overriding theme is that property rights and the basic debtor-creditor law created by nonbankruptcy sources will continue to govern in bankruptcy.[26] As pointed out above, there are exceptions to this basic theme. But these are very much exceptions, and their quantity and degree are fairly nominal. Thus, referring back to the two examples just mentioned, section 67(d)[27] changes the state Uniform Fraudulent Conveyance Act in only fairly minor details. Specifically, a different definition of insolvency is used, a definition for determining the time of the transfer is inserted, and bona fide transferees are protected only where they give "present fair equivalent value" rather than "fair consideration."[28] Similarly, under section 67(c)(3),[29] the lien for unpaid taxes on personal property unaccompanied by possession is not ignored in bankruptcy. Rather, it continues to be recognized. However, the payment thereof may be postponed if the assets to which it attached are needed to pay the costs of administration and wage claims of the bankrupt.

Compare this with the new basic theme proposed by the Bankruptcy Commission. Its proposals would create many new situations where nonbankruptcy law is interfered with; and when this is done, the interference will be at a much higher level.

Illustrations of entirely new situations where nonbankruptcy law is interfered with are the following:

(1) Inchoate dower rights, unaffected by the present Bankruptcy Act, will be eliminated.

(2) The nonpurchase money security interest in household goods, unaffected by the present Act, will be eliminated.[30]

(3) State law exemptions, fully valid under the present Act,

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26. *See* note 2 *supra.*

27. 11 U.S.C. § 107(d) (1970).

28. In states still operating under the Statute of Elizabeth rather than the Uniform Fraudulent Conveyance Act, section 67(d), 11 U.S.C. § 107(d) (1970), may produce more purely bankruptcy changes than those set out in the text. But even in these states, these changes are not likely to be significant since the basic drafting approach to the Uniform Fraudulent Conveyance Act was to codify and clarify the better decisions under the Statute of Elizabeth rather than to change it fundamentally. "In most states, the [U.F.C.A.] if enacted will not so much change the law as clearly define what heretofore has been indefinite." *See* UNIFORM FRAUDULENT CONVEYANCE ACT, 7 UNIFORM LAWS ANNOTATED 424 (Commissioners' Prefatory Note, 1970).

29. 11 U.S.C. § 107(c)(3) (1970).

30. *Cf.* UNIFORM CONSUMER CREDIT CODE § 5.116, *discussed in* note 22 *supra.*

will be eliminated in favor of a new set of exemptions operable only in bankruptcy.

(4) Statutory liens for income taxes on real estate and personal property accompanied by possession, unaffected by the present Act, will be eliminated.

(5) Spendthrift trusts, unaffected by the present act, will be severely restricted.[31]

(6) And so on.

Illustrations of situations where the degree of interference with nonbankruptcy law is increased are the following:

(1) The Uniform Fraudulent Transfer Act will not be rearranged in detail. It will be entirely rewritten.[32]

(2) Liens for income taxes on personal property unaccompanied by possession which may be postponed under the present Act will be entirely eliminated.

(3) Claims, which today must pass state unconscionability standards to be allowed, will hereafter also have to measure up to a newly imposed bankruptcy unconscionability test.[33]

(4) And so on.

The point should be clear. While there are today some rather low-keyed tension-creating situations generated by our Bankruptcy Act, the Bankruptcy Commission's proposals will require that we do our dancing to a basically new and significantly louder melody. The fact that we have so far managed a trickle of tensions hardly means that we can survive a flood of them. Just because we have

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31. *See* REPORT pt. I, at 197.

32. The Bankruptcy Commission urges that its proposal will not produce many substantive changes from the law presently found in section 67(d), 11 U.S.C. 107(d) (1970). Rather, the Commission states it was seeking merely to simplify and eliminate the substantial complexity found in the present Bankruptcy Act. REPORT pt. I, at 211.

Perhaps so. The fact remains, however, that the Commission chose to write an entirely new fraudulent transfer act, rearranging words and adding new phrases not found in any of our previous fraudulent transfer statutes. The likelihood is that this experiment in statutory drafting will add something new to the field that was not there before.

One might also note that the new fraudulent transfer statute proposed only for bankruptcy in section 4-608 will be in addition to the power a trustee already has to recover fraudulent transfers under nonbankruptcy law. *See* REPORT pt. II, § 4-608. *See also* § 4-604(b), which is intended to replace § 70(e) of the present Bankruptcy Act, 11 U.S.C. 110(e) (1970).

33. For a highly critical discussion of this approach, see Bernstein and Schwartz, Section 4-403(b)(8) of the Proposed New Bankruptcy Act: Disallowance of "Unconscionable" Claims (Unpublished 1975) (Report to the Committee on Creditors of the National Bankruptcy Conference).

till now tolerated the camel's nose under the tent door hardly means that we will live comfortably with the camel right in the tent.

2. *Dislike of Nonbankruptcy Law*

Perhaps the reason most often articulated by the Commission to support its tension-creating proposals was its dislike for certain features of the nonbankruptcy creditor-debtor law. Rather uncomplimentary words to describe these laws, such as "archaic," "no sound justification," and the like are often used to support the Commission's broadside attack on them.[34] However, assuming *arguendo* that these nonbankruptcy laws are as evil as the Commission fears, then is not the better solution the one which has already been suggested: that is, to repeal those laws for all debtor-creditor purposes and not just for the bankruptcy court, either by state legislation or, if necessary, by federal preemptive legislation.[35] I need not repeat my essential thesis that using the federal power to invalidate these laws only in bankruptcy does not solve these evils and, indeed, is counterproductive.

Since the Bankruptcy Commission was operating under federal auspices, one is puzzled by its failure to suggest, at least in some of these situations, the federal preemptive approach. The question is particularly puzzling since that is the approach that so often is now appearing on the scene.[36]

Was the Bankruptcy Commission deterred from suggesting federal preemptive legislation because it conceived its jurisdiction to be limited to proposing only a bankruptcy statute? Rather unlikely,

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34. Regarding exemptions, the Commission noted "state exemption laws seem generally archaic and some unduly generous in some states and exceeding niggardly, particularly as to urban residents, in others." REPORT pt. II, § 4-503 Note 1.

Regarding spendthrift trusts—"There is no sound justification for permitting a debtor . . . to shield from creditors assets [like beneficial interests in spendthrift trusts] because local law does not allow creditors to reach its interest." *Id.* pt. I, at 197.

Regarding inchoate dower—"There does not seem to be any sound policy reason why a spouse's dower or curtesy rights should come ahead of creditors." *Id.* pt. II, § 4-601 Note 16.

35. *See* text accompanying notes 10-13 *supra.*

36. For example, where state wage garnishment laws were found destructive of national policy, they were preempted in favor of an overriding federal standard set out in the Federal Truth in Lending Act, 15 U.S.C. § 1671-77 (1970). Title I of this act is also pertinent in that it preempts state disclosure rules applicable in consumer credit transactions.

A more recent example is the Federal Warranty Act (actually, the Magnuson-Moss Warranty-Federal Trade Commission Improvement Act, 15 U.S.C.A. § 2301, *et seq.* (Supp. I, 1975), wherein certain aspects of state products liability law found to be inconsistent with national policy were entirely displaced.

since the Commission was bold enough to propose amendments both to the Federal Judicial Code and to the federal tax statutes, when they produced unacceptable results for bankruptcy.[37]

Did the Bankruptcy Commission perceive the bankruptcy court as the only forum having any significant impact on the debtor-creditor relationship? If it did, then that would appear to be a rather narrow perspective of the boundaries of the debtor-creditor legal universe.[38] As previously discussed, other forums play a significant role, both qualitatively and quantitatively, in debtor-creditor matters.[39]

Was the Commission deterred by a lack of political nerve? Did it fear going to the public at large to test out the wisdom and political acceptability of the changes in the debtor-creditor relationship which it had proposed? It is, after all, far simpler to get enacted a bankruptcy act which will, for the most part, be scrutinized only by the bankruptcy community. A far more formidable job is faced by the proposer of federal preemptive legislation that would so markedly impact on important and sensitive areas of state law dealing with property rights and the debtor-creditor relationship. Not only do such proponents have to persuade a much larger audience —the state bar associations, the American Bar Association Committees beyond its bankruptcy committee, the Commissioners on Uniform State Laws, the many consumer and business groups, etc.—of the intrinsic merits of their proposals, they must equally persuade this audience that federal preemptive legislation, rather than uniform state legislation, is for these specific proposals both wise and politically correct under our federal system.[40]

But generating the tension-creating situations which have been described is too high a price to pay for this lack of political nerve, if, in fact, it existed. Equally important, if the nonbankruptcy laws are as adverse to the debtor-creditor relationship as the Commission has suggested, then should not the forum to discuss their change (either by state legislation or federal preemptive action) be the larger

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37. REPORT pt. II, at 293-300.

38. *See* text accompanying notes 48-49 *infra.*

39. *See* text accompanying notes 14-16 *supra.*

40. Another tactical advantage exists in favor of the dedicated law reformer by seeking at this point in time only to propose change in the Bankruptcy Act. Not only does that avoid the difficult (and more frustrating) job of obtaining uniform state or federal preemptive laws, but if adopted, the Bankruptcy Act may serve as a magnet for the nonbankruptcy law to follow. Professor Kennedy, among others, has recognized the existence of this phenomenon: "It is of course to be anticipated that the existence of any federal exemption allowance will exert a powerful pressure to bring state exemption up to the federal figure." Kennedy, *supra* note 18, at 452.

audience and not just the smaller bankruptcy community? Should not the wisdom of this large audience be consulted? In fact, does it not have a right to be consulted?

3. *Uniformity*

Failure to achieve "uniformity" in all of the bankruptcy courts was another reason often articulated by the Bankruptcy Commission to justify its proposals that generate these tension-creating situations. Since the Constitution authorizes the Congress to enact "uniform laws on the subject of bankruptcy,"[41] a point often made by the Commission was that such uniformity could not be achieved where the results in individual bankruptcy courts depended upon the different state laws on a particular subject.[42] One wonders if the Bankruptcy Commission really believed its own statement that uniform results in all bankruptcy courts are needed or even desirable. In this respect, it is worth noting that the Commission was quite content to leave critical aspects of bankruptcy administration to be determined not by a single uniform bankruptcy rule, but, by state (and therefore nonuniform) law. For example, determining who is or who is not a creditor of the bankrupt appears largely to be left to state law. Similarly, defining what is property which passes to the bankrupt estate is left to state law; and as the Commission itself at page 194 in Part I of the *Report* states: " . . . this reference has not proved too troublesome, and what difficulty it may create is far overshadowed by the difficulty of codifying rules of property solely for the purpose of bankruptcy administration."

In any case, these statements about uniformity are more of a play with words than a serious legal problem. The definition of what the word "uniform" means in the bankruptcy clause of the Constitution has been long settled; and the Supreme Court has made clear that it does not require that the results be the same in the bankruptcy courts of the different states and that there is, indeed, much justice in applying in bankruptcy the state law with respect to which the parties originally contracted.[43]

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41. U.S. CONST. art. I, § 8, cl. 4.

42. *See, e.g.*, REPORT pt. I, at 171 ("reference to nonbankruptcy law to determine exemptions . . . [has] caused substantial nonuniformity").

43. Hanover Nat'l. Bank v. Moyses, 186 U.S. 181 (1902). The Court justifies this result on the ground that it

> [i]s not unjust [to apply state law in bankruptcy], as every debt is contracted with reference to the rights of the parties thereto under existing [state] exemption laws. . . . It is quite proper, therefore, to confine [the bankruptcy system's] operation to such property as other [nonbankruptcy] legal process could reach.

Id. at 189-90.

Nevertheless, much can be said for having one law govern debtor-creditor law throughout the nation. If this is the goal which the Commission really was urging, then would it not be better achieved by either uniform state action or federal preemptive legislation, as has already been discussed?[44] If, indeed, there is merit to the Bankruptcy Commission's argument that debtor-creditor rights should not vary in different bankruptcy courts, then why should they vary when the same parties appear in a nonbankruptcy forum across the street? The Commission's proposals do not produce "uniformity" in this much broader, national, and more useful sense of the word. Worse, the rather high and counterproductive price to be paid for the Bankruptcy Commission's unduly narrow view of "uniformity" is the tension-creating situations which have been described already.

4. *Increase the Assets of the Estate*

The Bankruptcy Commission sought to justify at least one of its tension-creating proposals on the ground that it would increase the amount available for the bankrupt estate. Specifically, that was one of the reasons used to justify the elimination in bankruptcy of inchoate dower or its statutory equivalents.[45]

The Commission, of course, states a truth. A bankrupt's estate can be increased by a rule that invalidates in bankruptcy some third party's property rights. But one hopes that the Commission was not serious in pushing this point. Constitutional limitations aside, one simply cannot within the notions of fair play accept the idea that third party rights should be confiscated for the benefit of somebody's creditors, simply because that somebody goes bankrupt. Justification for changing rules solely in the bankruptcy forum must be based on firmer ground than this.[46]

5. *Administrative Convenience*

Lastly, the Commission has justified its tension-creating proposals on the ground that they would serve the administrative conven-

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44. *See* text accompanying notes 10-13 *supra*.

45. "To . . . enhance the market value of property of the estate, dower, curtesy, and similar statutory interests are not recognized." REPORT pt. II, § 4-601 Note 11.

46. In other contexts, the Bankruptcy Commission seemed to have recognized that one's property ought not be sacrificed to pay claims of somebody else's creditors. The Commission proposes to eliminate the doctrine of Moore v. Bay, 284 U.S. 4 (1931), under which a trustee in bankruptcy may recover property of a third party not otherwise available to creditors under nonbankruptcy, fraudulent, or voidable transfer law. REPORT pt. II, § 4-604 Note 4. Having done this, the Commission curiously took the inconsistent position of making "fraudulent" in bankruptcy transfers

ience of bankruptcy officials. Again, this is one of the justifications used to invalidate inchoate dower or, to use the words of the Commission, "to facilitate administration" and to avoid "the complexity of the [valuation] problem."[47]

If parties and courts beyond bankruptcy can and do surmount these inconveniences and complexities, one expects and presumes that bankruptcy officials are equally hardy and can do likewise.

II. The Proper Use of Federal Bankruptcy Power

A. *The Bankruptcy Commission's Basic Errors*

So much for the reasons given by the Commission to justify its tension-creating proposals. None seem particularly persuasive. Yet, the Commission was composed of wise and learned men. Why, then, did they reach these results? With respect, I am inclined to think that the Commission's actions are largely attributable to two basic errors in its overall thinking: (1) the Commission viewed its assignment from far too narrow a perspective, and (2) the Commission failed to appreciate the appropriate and unique role of the bankruptcy system in our law.

1. *Narrow Perspective*

The Bankruptcy Commission seems to have been hypnotized by what was going on only in the bankruptcy courts. It appears that it conceived its authority as a fairly limited one—namely, the writing of a new bankruptcy statute.[48] Putting it another way, the boundaries of the universe which the Bankruptcy Commission conceived was the bankruptcy court alone. So long as its proposals appeared to make that court run smoothly and so long as the results taking place in that court seemed to be "fair," then the Commission was satisfied.

It is regrettable that the Commission operated from so narrow a perspective. Involved is a far bigger universe—namely, the totality of the law of debtor-creditor relationships.[49] Sound proposals for

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that are perfectly valid outside of bankruptcy. *See* note 32 *supra* and accompanying text.

47. *See* Report pt. II, § 4-601 Notes 11 & 15.

48. The Bankruptcy Commission, on the first page of its report, states that it "was established to 'study, analyze, evaluate, and recommend changes' in the Bankruptcy Act." Report pt. I, at 1.

49. It was recognized early that the constitutional power granted to Congress to enact uniform bankruptcy laws might include the power to affect *all* debtor-creditor relationships, not just those in bankruptcy.

It is *bankruptcies* and not *bankruptcy* that is to be the object of those uniform

change in this universe cannot be limited to how the debtor-creditor relationship will be governed only in the bankruptcy court. They must equally take into consideration their impact in the nonbankruptcy forums as well. Producing what appears to be "fairness" only in the bankruptcy court may not really be "fair" in this much larger picture. Indeed, apparent tranquility in the bankruptcy forum is only an illusion if there are storms of tension beyond. As I have argued, it is these storms of tension which the Bankruptcy Commission has in reality produced. A more orderly universe of the entire creditor-debtor relationship can be accomplished, but to do so requires a rejection of the Bankruptcy Commission's tunnel vision of what are its boundaries.

2. *Appropriate Role of Bankruptcy System*

Closely related to the Bankruptcy Commission's narrow perspective was its failure to appreciate what is the appropriate and unique role which the bankruptcy courts are intended to play in the total universe of debtor-creditor law. Putting it another way, it was never contemplated that the bankruptcy system operate in a vacuum. Rather, it was established to obtain and achieve certain unique objectives that cannot be obtained elsewhere.

The function of bankruptcy is not to derogate from the general debtor-creditor law; rather, it is to support it. Bankruptcy's unique function is to provide a forum of last resort—more or less of a safety valve to give relief when the outside rules governing debtor-creditor relationships become unbearable.[50] But, like any well-designed safety valve, the bankruptcy system must have two characteristics: First, it should not be engineered to go off too soon, and second, it should not be engineered to interfere with the normal functioning of the outside machine. Thus, the best engineered banruptcy sys-

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> laws . . . . [T]hat a statute may be "on the *subject* of bankruptcy" without being technically a "bankruptcy law"—in other words, that any National law which deals with inability to pay debts and which is uniform throughout the country is a law "on the subject of bankruptcy."

Statement made in 1837 by Senator Thomas H. Benton, *quoted in* C. WARREN, BANKRUPTCY IN U.S. HISTORY 8 (1935). *See also* Continental Ill. Nat'l Bank & Trust Co. v. Chicago, R.I. & P. Ry., 294 U.S. 648, 672-73 (1935): "[T]he 'subject of bankruptcies' was nothing less than 'the subject of the relations between an insolvent or non-paying or fraudulent debtor, and his creditors, extending to his and their relief'."

50. The Canadians have expressed this point well. Their chapter which discusses bankruptcy is entitled "The Last Resort Solution" and starts with these words: "When all else fails, bankruptcy is needed by both creditors and debtors." *Report of the Study Committee on Bankruptcy and Insolvency Legislation* 101 (Canada 1970).

tem is one that supports, permits, and, indeed, encourages to the maximum extent possible the resolution of debtor-creditor problems outside of bankruptcy before the safety valve of bankruptcy is activated.[51]

As this paper seeks to demonstrate, the Commission either did not accept or did not appreciate this overriding bankruptcy goal—the goal that permits nonbankruptcy law to operate with a minimum of interference from the bankruptcy system.[52]

B. *Use—When the Bankruptcy Act May Be Used to Interfere With State Law*

When, then, may a bankruptcy statute interfere with the nonbankruptcy rules? The answer ought to be fairly clear: Only when that is required to accomplish some unique objective for which bankruptcy was established as a separate institution in our legal system. Failure of bankruptcy statute drafters to exercise discipline by adhering strictly to this principle brings about the counterproductive consequences and tension-creating situations which have already been described. This is so, even when departure from the principle is done in the name of law reform. Useful law reform with respect

51. Judge Lord's statement, while stated in another context, strikes me as capturing what ought to be the appropriate philosophy of the bankruptcy statute. In *In re* Elkins-Dell Mfg. Co., 253 F. Supp. 864, 871 (E.D. Pa. 1966), he stated: "[There] are considerations particularly impelling upon the bankruptcy court, which, charged with responsibility for the liquidation of business misfortunes, has a corresponding interest in keeping businesses afloat. . . . The bankruptcy court has no desire to force the entrance of more small businesses through its portals."

See also Bankruptcy and Insolvency Study, *supra* note 50, ¶ 3.1.42, at 99 which emphasizes the desirability that "all debtors should try to pay their due debts, without resorting to bankruptcy . . . ."

52. The proof of this pudding is, like any other pudding, in its eating; and my paper to this point has sought to demonstrate that the actual and specific results of the Commission's pudding may give all of us a rather bad stomach ache. The results which actually will take place in practice under the Commission's proposals are what really count. Nevertheless, those interested in the more conceptual aspects of the Commission's work might find interesting reading in what the Commission designated "A Philosophical Basis for a Federal Bankruptcy Act." REPORT pt. I, ch. 3. That chapter strikes me as an apology for the Bankruptcy Commission's proposals rather than a carefully analyzed and consistent statement of what are or should be the unique bankruptcy goals. The chapter has grist for everybody's mill, including mine. For my mill, I liked its statement that the internal goals of bankruptcy should "comport with and support the external goals" and should "discourage ill-founded petitions." But these nice-sounding words became rather hollow as a result of what struck me as the Commission's emphasis on the paramountcy of the "internal goals" of the bankruptcy system over the "external goals" of the open credit economy, particularly when among these paramount internal goals are "open access . . . to the bankruptcy process," and how "the [bankruptcy] process should encourage resort to it." *See* REPORT pt. I, at 75. *See also* note 51 *supra*.

to bad nonbankruptcy law can be accomplished only by changing that bad law for all purposes—not just for bankruptcy purposes.

In seeking to define what are the unique bankruptcy objectives, it might be helpful to ignore temporarily the fact that the United States Constitution lodges federal power in Congress to enact a bankruptcy statute and that such a statute, under the supremacy clause of the Constitution, displaces all contrary state laws. Consequently, one charged with writing a federal bankruptcy statute in the United States incidentally picks up the power to change state law. But that exactly may have been the nub of the problem. As conventional wisdom tells us, one having power, unless he carefully restrains himself, will have a tendency to expand the use of that power, even beyond the realm for which it was intended.[53] Could this tendency have been at work, sub silentio, in the Bankruptcy Commission? The Commission was given the authority and power to write a federal supreme statute. They often observed what they conceived to be bad debtor-creditor law in the nonbankruptcy system. Regrettably and unwisely, they used their federal power to make proposals which attempt to correct that bad nonbankruptcy law, even though such proposals had nothing to do with any unique bankruptcy objective.

However, one can imagine systems wherein the bankruptcy statute is written by the very same legislature that writes the nonbankruptcy rules. Indeed, such legal systems actually exist. If one were drafting a bankruptcy statute under that kind of legal system, that statute would hardly be the vehicle used to rearrange what was conceived to be bad nonbankruptcy rules. Rather, the bankruptcy statute would be limited only to those things which are essential for the unique purposes of bankruptcy. If reform of the nonbankruptcy rules were necessary, then that would be accomplished by changing those rules themselves.

It is submitted that this is exactly how the Bankruptcy Commission should have proceeded. It should have disciplined itself to write a bankruptcy statute whose specific proposals were directed only at achieving those objectives which are unique to bankruptcy.

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53. *See* Keystone Aeronautics Corp. v. R. J. Enstrom Corp., 499 F.2d 146 (3d Cir. 1974), which recognized the not unfamiliar result of "overkill" when a legal principle completely valid in its original context is extended so far that the mischief caused may be equal to the original disorder sought to be remedied.

In a lecture before the Ohio Supreme Court and Ohio State Bar Association on May 15, 1975, Dean Griswold also noted and criticized the growing tendency, particularly in the federal arena, to inflate legal principles to cover areas never intended by the original principle. [Unpublished]

It should have disdained using the federal bankruptcy power simply to attempt to bring about reform in nonbankruptcy rules.

1. *The Unique Bankruptcy Objectives*

What, then, are the unique objectives which a bankruptcy system is established to accomplish. Actually, there seems to be a great deal of agreement about them. While the following list of these objectives may not be exclusive, it probably contains most that are commonly accepted today.

From the debtor's point of view, the unique objectives to be served by the bankruptcy system are the following:

1. Relief from an overburden of debts.
2. In nonliquidation cases, the power to continue in business for reasonable periods of time while seeking to work out a settlement of the debtor-creditor problem.

From the creditor's point of view, the unique objectives sought to be served by the bankruptcy system are the following:

1. The ending of the race of diligence for the debtor's assets.
2. The collection of the debtor's assets which are available to creditors under nonbankruptcy law.
3. The "equal" sharing of those assets or, more precisely, the distribution of those assets according to a bankruptcy set of priorities.[54]

Some of the implications that flow from each of the above objectives will now be discussed.

a. *Relief From Overburden of Debts.* One of the fundamental and unique objectives for establishing bankruptcy as a separate legal institution is to give relief to an honest debtor from an overburden of debts which he can no longer handle. Thus, discharge rules quite properly belong in a bankruptcy act, even though they override important rights created by nonbankruptcy law. However, bankruptcy as we know it today simply would not exist without the availability of a discharge to the debtor. Further, it is worth noting that the bankruptcy court today is the only place in the American legal system where a discharge of debts can be obtained, illustrating rather dramatically how unique the discharge concept is to the federal bankruptcy system.

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54. In the Canadian *Report*, it is succinctly stated: "from the viewpoint of the creditors, bankruptcy provides a system of collective execution and equitable distribution of the assets of a failing debtor. On the other hand, to the debtor, bankruptcy represents the means of obtaining relief from an overwhelming burden of debt and the opportunity to make a new financial start in life. *Bankruptcy and Insolvency Study*, *supra* note 50, ¶ 3.2.001 at 101.

Rather obviously, the ability to get a discharge "encourages" debtors to hurry through the bankruptcy doors rather than seeking to resolve their creditor problems outside of bankruptcy. Yet, this bankruptcy safety valve of discharge is essential if relief is to be granted in the American legal system from the pressure of overburdening debt. But, as has been previously suggested, even this safety valve must be carefully engineered to avoid undue interference with or abuse of the normal workings of the nonbankruptcy system. This can and has largely been accomplished by limiting the kinds of debtors who may obtain the discharge,[55] the frequency with which they can obtain it,[56] and, finally, the kinds of debts which are subject to the discharge.[57]

One should be careful of carrying this idea too far. It is relief from an overburden of debts which the bankruptcy system was uniquely set up to accomplish, and not the "rehabilitation" of the debtor which the Bankruptcy Commission (and a good many others) are prone to emphasize. Quite true, discharge, by permitting the accumulation of new assets free of past creditors' claims to them, makes it possible for one to become an economically productive person.[58] In this sense, discharge assists in the rehabilitation process. But the means with which, and the conditions under which, the debtor actually accumulates those new assets are really determined by the nonbankruptcy rather than the bankruptcy system. To illustrate, a debtor, after financial failure, may need a new job or a new business with which to accumulate new wealth and, thus, start afresh. But the bankruptcy system is not set up nor particularly well-suited to provide discharged debtors with such jobs or new businesses. That function instead is allocated to the nonbankruptcy system. By the same token, the bankruptcy system cannot, and should not, guarantee the minimum wage or profit to be earned on a post-bankruptcy job or business. Nor is the bankruptcy system

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55. *See* section 14(c) of the present Bankruptcy Act, 11 U.S.C. § 32(c) (1970); section 4-505(a) of the proposed Act, REPORT pt. II, § 4-505(a) (providing which debtors may obtain the discharge).

56. Six years under section 14(c) of present Act, 11 U.S.C. § 32(c) (1970), and five years under section 4-505(a) of the proposed Act, REPORT pt. II, § 4-505(a). However, under the proposed Act, the five-year period could be ignored if the court found that enforcing it would produce "undue hardship." *Id.* § 4-505(a)(7).

57. *See* section 17 of the present Act, 11 U.S.C. § 35 (1970), and section 4-506 of the proposed Act, REPORT pt. II, § 4-506.

58. *See* Local Loan Co. v. Hunt, 292 U.S. 234, 244 (1934) where the Court emphasized that bankruptcy affords the bankrupt "a new opportunity in life and a clear field for future effort, unhampered by the pressure and discouragement of preexisting debt."

the appropriate vehicle for providing welfare benefits if the discharged debtor is unable to start a business or get a job. Most would agree that all of these functions are to be performed by the nonbankruptcy system.

From this, it would seem to follow that it is equally the role of the nonbankruptcy system to determine a debtor's exemptions. Exemptions are really only one narrow aspect of the total wherewithal needed by a debtor to stay alive and to start afresh after financial distress, in or out of bankruptcy, has befallen him. Indeed, exemption laws are closely related to the welfare role which society must play; and, again, almost all agree that welfare is a function allocated to the nonbankruptcy system.[59] Thus, it seems incongruous for a bankruptcy statute to define exemptions which, after all, are only a single and narrow aspect of the so-called "rehabilitation" devices; that is, the means which a debtor needs to get his "fresh start" after financial distress. Rather, it seems best to leave it to nonbankruptcy law to develop exemptions as part of a total and coordinated package of benefits—*e.g.*, job, minimum wage, welfare, —which are needed for a debtor's "rehabilitation."

As mentioned earlier, if there is some convincing national need to make exemptions uniform throughout the country, then that national uniformity ought to be mandated for every situation where a debtor faces financial distress and not simply the bankruptcy case—something which can be accomplished either by uniform state action or by federal preemptive legislation.[60] However, adopting exemptions only for bankruptcy generates another tension-creating situation without serving any unique bankruptcy goal.

b. *Continue in Business in Nonliquidation Cases.* In nonliquidation cases, a unique bankruptcy objective is to permit a debtor to continue in business for reasonable periods of time while trying to work out a settlement with his creditors. This unique objective seems to justify bankruptcy rules which stay for that reasonable period the enforcement of both unsecured and secured claims.[61] It equally supports rules permitting the debtor to use the collateral belonging to a secured party, provided that the secured party's position is fully protected.[62]

59. Even the Bankruptcy Commission recognized that a major purpose for exemptions is "that the debtor not be left destitute." REPORT pt. I, at 172.

60. *See* text accompanying notes 10-13 *supra.*

61. *See* R. BANKRUPTCY P. 11-44 Such stay rules are now found in the Rules of Bankruptcy Procedure, *e.g.*, Rule 11-44. Section 4-501 of the proposed Bankruptcy Act would do likewise. REPORT pt. II, § 4-501.

62. *See* REPORT pt. II, § 2-203(b) and accompanying notes. It is crucial that these rules be tailored to assure that the secured party's position is, in fact, pro-

c. *Ending Race of Diligence.* Bankruptcy substitutes a procedure whereby creditors act collectively rather than individually. In other words, a unique objective of bankruptcy is to end the race of diligence by individual creditors for the debtor's assets. This objective justifies bankruptcy rules which stay the nonbankruptcy right of the creditor to pursue his state-created enforcement remedies.[63] It also supports the preference-avoidance rules which will be discussed below in connection with the equality in bankruptcy-distribution objectives.

d. *Collection of Debtor's Assets.* Another fundamental bankruptcy objective is to permit the collection by some official of assets which creditors could have obtained outside of bankruptcy. This supports rules, such as those found in section 70(c)[64] of the present Bankruptcy Act and section 4-604(a) of the proposed Act wherein the trustee may obtain for the estate all assets available to a judicial-lien creditor, whether or not such a judicial-lien creditor exists. In fact, this judicial-lien creditor rule does not really change for bankruptcy purposes a nonbankruptcy rule, even though at first blush it may appear to do so. Quite to the contrary, the judicial-lien creditor bankruptcy rule fully supports and is completely consistent with nonbankruptcy law rather than interfering with or derogating from it. This is true because the levying-creditor rule simply gives to creditors in bankruptcy exactly what they probably would have reached outside the bankruptcy if they had not been stopped by the bankruptcy bell.

e. *Share "Equally" According to Bankruptcy Priority Scheme.* Once the assets are collected for the estate, it is well-accepted that a fundamental and unique purpose of bankruptcy is to distribute them "equally" among the creditors.[65] More precisely, the distribution isn't exactly equal. Rather, it is equal among creditors of the same priority class. Moreover, it is generally accepted that the definition of the various priority classes is to be made by the bankruptcy system; and, of course, this "equal" treatment bankruptcy objective is closely related to and intertwined with the ending of the race of diligence previously discussed.

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tected. If this is not done, then the practical end result is to generate, without justification, a tension-creating situation wherein security, fully valid outside of bankruptcy, is diminished within bankruptcy.

63. For examples of such stay rules in the present Bankruptcy Act see R. BANKRUPTCY P. 401, 601, 11-44; they are also found in the proposed Bankruptcy Act. *See* REPORT pt. II, § 4-501.

64. 11 U.S.C. § 110(c) (1970).

65. Subject, however, to their respective priority class. *See* text accompanying notes 72-76 *infra*.

This unique "equal treatment" bankruptcy objective supports the preference-avoidance rules found in section 60 of the present Bankruptcy Act[66] and section 4-607 of the proposed Act. Little, if anything, would be left in the debtor's estate at the time of bankruptcy against which to apply the unique "equal treatment" objective, unless some kind of a preference-avoidance rule was adopted. Without such a rule, the bankrupt estate would be left "with only tag ends and remnants of unencumbered assets."[67]

Quite obviously, preference-avoidance rules interfere rather drastically with a creditor's nonbankruptcy right to receive and retain payment of his lawful debts. In this sense, they do encourage other creditors to precipitate a bankruptcy to get the advantage of avoidance.[68] However, this possibility is limited and undue interference with the new bankruptcy system is controlled by limiting (1) the suspect period for preference avoidance,[69] (2) the kinds of payments which can be recovered as a preference,[70] and (3) the kinds of creditors (*i.e.*, those who have reasonable cause to believe of the debtor's insolvency) who must disgorge the preference.[71]

f. *Bankruptcy Priority System.* The bankruptcy goal of distributing assets to creditors according to bankruptcy-determined priority classes also sanctions the writing of bankruptcy rules which invalidate state attempts to interfere with that priority system. Such rules include those which are now found in sections 67(c)(1)(A) and (B) of the present Bankruptcy Act[72] wherein nonbankruptcy-

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66. 11 U.S.C. § 96 (1970).

67. *See* REPORT pt. I, p. 202, *citing* Seligson, *The Code and Bankruptcy Act: Three Views on Preferences and After-Acquired Property*, 42 N.Y.U.L. REV. 292 (1967), *quoting* 3 COLLIER, BANKRUPTCY §§ 60.02-.03 (14th ed. 1964).

68. *See, e.g.*, Holahan & Hemmings, *Judicial Expansion of Exemptions in Bankruptcy*, 80 COM. L.J. 102, 110 (March, 1975).

69. This period is limited to 4 months under section 60A of the present Bankruptcy Act, 11 U.S.C. § 96(a)(1) (1970), while under the proposed Bankruptcy Act it is 3 months generally and 12 months for insiders. REPORT pt. II, § 4-607(a).

Query: Are these periods too long? One must remember that state law considers these preferences to be debt transactions which were finally and lawfully concluded by a valid payment (or other property transfer). Is it really desirable that the expectations which creditors had regarding the lawfulness and finality of the payments they received be kept on tenterhooks and subject to reopening for periods as long as three months (and, indeed, in some cases as long as twelve months)? Wouldn't the unique bankruptcy objectives which support preference-avoidance be satisfactorily achieved, with much less of a tension-creating situation, by a shorter preference-avoidance period?

70. *See id.* §§ 4-607(b) & (c).

71. The reasonable-cause-to-believe element is applicable to all cases under section 60B of the present Act, 11 U.S.C. § 96(b) (1970). Under the proposed Bankruptcy Act, it would be applicable only to insiders who receive preferences more than 3 but less than 12 months before bankruptcy. REPORT pt. II, § 4-607(a)(2).

72. 11 U.S.C. §§ 107(c)(1)(A) & (B) (1970).

created statutory liens are invalidated. Indeed, these particular bankruptcy sections do not interfere in any real sense with rights and expectations created by nonbankruptcy law. Quite to the contrary, these sections essentially do nothing more than define rather clumsy and apparent attempts by nonbankruptcy law to create rights which will operate only in bankruptcy, but will have no significance outside the bankruptcy.[73]

Surely, nonbankruptcy law owes the same duty to support the bankruptcy system as the bankruptcy system owes to support it.[74] Thus, where nonbankruptcy rules seek to create "rights" or "liens" intended to have meaning only for bankruptcy purposes, then the bankruptcy statute is fully justified in striking them down.[75]

For similar reasons, the invalidation of bankruptcy termination clauses is equally justified.[76] Here again is an example of nonbankruptcy law seeking to give rights which will have meaning only in bankruptcy, but not elsewhere. In particular, bankruptcy termination clauses seek to deny to creditors in bankruptcy the benefit of contracts and leases which otherwise would have been available to them outside of bankruptcy.

SUMMARY

As previously stated, the itemization above is probably not the exclusive list of unique and fundamental objectives which warrant a bankruptcy statute interfering with nonbankruptcy law. But the point should be clear. The Bankruptcy Act is not the vehicle to reform nonbankruptcy law, even though those who draft the Bankruptcy Act find fault with it. If those nonbankruptcy laws are "evil," then the remedy should be to eliminate the evil for all

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73. *See* Kennedy, *The Bankruptcy Amendments of 1966*, 41 REF. J. 5 (1967). Professor Kennedy states: "As the legislative reports accompanying the statutory lien bills point out, this clause (A) of section 67(c)(1) strikes at patent priorities which are disguised as liens." *Id.* at 6. With respect to clause (B) of Section 67(c)(1), Professor Kennedy states:

> The introduction of the bona fide purchaser test into the Bankruptcy Act's scheme for adjusting the rights of statutory lienors rests on the premise that if a statutory lien does not follow the property into the hands of a bona fide purchaser, it is primarily a statutory device for establishing priority among competing creditors and ought not prevail as against the order of priorities established by section 64 in the event of bankruptcy.

Id. at 7.

74. *See* text accompanying notes 48-53 *supra.*

75. However, the invalidation of statutory liens that are fully efficacious for nonbankruptcy purposes is not justified. *See* text accompanying note 22 *supra*, regarding the Bankruptcy Commission's proposal to invalidate such statutory liens, particularly those statutory liens intended to secure the payment of income taxes.

76. *See* REPORT pt. II, § 4-602(b)(1).

debtor-creditor purposes through uniform state or federal preemptive legislation. However, the Bankruptcy Act itself should not interfere with nonbankruptcy law unless that is essential to accomplish some fundamental bankruptcy goals—that is, a goal which supports the establishment of bankruptcy as a separate legal institution intended to serve unique objectives. Even then, appropriate safeguards must be engineered into these Bankruptcy Act interferences to assure that their tension-creating effects are minimized.

When these principles are not carefully followed, then the Bankruptcy Act's interference with nonbankruptcy law does not bring about reform or solve the problem of "bad" creditor-debtor law. Quite to the contrary, that "bad" law continues to exist in the numerous debtor-creditor situations that will continue to be governed by the nonbankruptcy law. Moreover, this kind of interference by the Bankruptcy Act is actually counterproductive. It sets up tension-creating situations in which persons are encouraged to act outside of bankruptcy or to precipitate (or to avoid) bankruptcy for reasons which have little, if anything, to do with the singular and unique purposes which underlie the establishment of our bankruptcy system. Further, it leaves parties at the time of contracting uncertain as to which law will ultimately govern, since that will depend on the happenstance of bankruptcy.

There is much good in the Bankruptcy Commission's proposed Act. But its proposals which generate the described tension-creating situations detract from its final product. These tension-creating proposals can be attributed to two factors: First, the Commission's unduly narrow perspective of the debtor-creditor universe, and second, the Commission's failure to appreciate the appropriate and unique role of the bankruptcy system in the universe of debtor-creditor law. A review of the Commission's proposed Act seems to be in order so that these tension-creating situations can be identified and then eliminated. Most, although probably not all, of these tension-creating situations have already been pinpointed in this article, and finding the others should not prove to be a particularly burdensome job. The totality of debtor-creditor law will be far more orderly for having done so.