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INTRODUCTION

Bankruptcy courts and other federal courts in bankruptcy[1] wield considerable power in our society. In addition to deciding a substan-

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1 The term "federal courts in bankruptcy" as used in this Article refers to (1) all Bankruptcy Courts (including Bankruptcy Appellate Panels) and (2) United States

tial volume of commercial and business law disputes,[2] they play a significant role in mass tort litigation,[3] environmental litigation,[4] and other noncommercial litigation.[5] More significantly, their influence extends well beyond litigation. Their pronouncements influence how the parties to a myriad of business transactions, aggregating trillions of dollars, structure and price those transactions in light of the costs that bankruptcy law creates. Indeed, the entire securitization industry, involving more than six trillion dollars of outstanding securities, developed in the last twenty years as a response to the costs that bankruptcy law imposes on traditional secured creditors.[6]

District Courts, United States Courts of Appeals, and the United States Supreme Court when they are deciding bankruptcy law issues.

2 *See, e.g.*, NAT'L BANKR. REVIEW COMM'N, BANKRUPTCY: THE NEXT TWENTY YEARS 722 & n.1739 (1997) [hereinafter NBRC REPORT]. For the fiscal year ending September 30, 2002, there were 39,091 business bankruptcy filings, and 1,508,578 nonbusiness bankruptcy filings. ADMINISTRATIVE OFFICE OF THE U.S. COURTS, 2002 ANNUAL REPORT OF THE DIRECTOR: JUDICIAL BUSINESS OF THE UNITED STATES COURTS 27 tbl.6, 263 tbl.F-2, *available at* http://www.uscourts.gov/judbususc/judbus.html. During this period, over 73,900 adversary proceedings were filed in bankruptcy court. *Id.* at 28–29, 266 tbl.F-8. During this time, the following cases were filed in the district courts: 56,824 diversity jurisdiction cases, of which approximately 26,300 were contract actions and real property actions; approximately 7400 private federal question cases consisting of contract and real property actions; and approximately 10,000 contract and real property actions involving the United States as a party. *Id.* at 129 tbl.C-2.

3 As of the end of 2002, over sixty companies had filed for bankruptcy to deal with the liabilities arising out of the manufacture and sale of asbestos. *See Insurance Study Examines Cost of Asbestos Litigation*, 40 Bankr. Ct. Dec. (LRP) 2 (Dec. 17, 2002), *available at* Westlaw, 40 No. 12 BCD (LRP) 2 (noting that asbestos litigation has led sixty-one companies to file for bankruptcy); *Next Wave of Asbestos Filings will Stretch on as Companies Buckle Under Weight*, 39 Bankr. Ct. Dec. (LRP) 1, (June 18, 2002), *available at* Westlaw, 39 No. 15 BCD (LRP) 1 (asserting that the approximately 200,000 estimated pending asbestos injury cases and the expected liability of United States companies of $200 billion "virtually assures that many companies will be seeking Chapter 11 protection").

4 *See generally* KATHRYN R. HEIDT, ENVIRONMENTAL OBLIGATIONS IN BANKRUPTCY (2002).

5 *See, e.g.*, Nancy A. Peterman et al., *American Bankruptcy Institute: The Healthcare Industry Bankruptcy Workouts Forum*, 8 AM. BANKR. INST. L. REV. 5 (2000) (discussing the financial difficulties in the health care industry and noting the effect of the bankruptcy of health care providers on patients and the community); *see also* FCC v. NextWave Pers. Communications Inc., 537 U.S. 293, 307 (2003) (holding that, under the Bankruptcy Code, the Federal Communications Commission "is not to revoke a bankruptcy debtor's [broadband personal communications service] license solely because of a failure" to make purchase price installment payments); *infra* note 12.

6 For example, the total debt of issuers of asset backed securities, which are securities backed by non-mortgage business and consumer loans acquired by issuers from originators of the loans, equaled $2.4 trillion as of the end of 2002. *See Domestic*

This influence extends well beyond federal law. Although the Bankruptcy Code (Code)[7] is a comprehensive federal statute, it essentially establishes a method for adjusting the relationship between an insolvent debtor and his, her, or its creditors.[8] The underlying debtor-creditor relationship exists under nonbankruptcy law, and the Bankruptcy Code itself recognizes this reality. The Code contains more than fifty references to "applicable law," "nonbankruptcy law," "state law," "local law," "common law," other federal law, a specific type of law, and even the "law merchant."[9] In addition, the definitions of the two most important concepts in the Bankruptcy Code—"property of the estate"[10] and "creditor"[11]—depend on nonbankruptcy law.

Financial Statistics, 89 FED. RESERVE BULL. A4, A38 *l.*47 (Oct. 2003). In addition, as of the end of 2002, about $8.5 trillion of single family and commercial mortgage loans had been originated and remained outstanding, of which about $4.2 trillion had been securitized. *Id.* at A33 *ll.* 1 & 53. Securitization has become important because it avoids the costs imposed on secured credit by the Bankruptcy Code. *See, e.g.*, Thomas E. Plank, *Bankruptcy Professionals, Debtor Dominance, and the Future of Bankruptcy: A Review and a Rhapsody on a Theme*, 18 BANKR. DEV. J. 337 (2002) (reviewing DAVID A. SKEEL, JR., DEBT'S DOMINION: A HISTORY OF BANKRUPTCY LAW IN AMERICA (2001), and describing the unsuccessful attack by pro-debtor interests on securitization and the unsuccessful efforts of the securitization industry to exempt securitizations from the Bankruptcy Code); Thomas E. Plank, *The Security of Securitization and the Future of Security*, 25 CARDOZO L. REV. (forthcoming 2004) (manuscript on file with author) (arguing that the legal foundations of securitization are strong and that its importance in lowering costs for businesses and consumers ensures its long-term viability).

7 11 U.S.C. §§ 101–1330 (2000) (enacted by the Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549).

8 The Bankruptcy Code provides for the repayment, to the extent possible, of the debtor's debts either from the liquidation of the debtor's assets and distribution of the net proceeds to creditors or pursuant to a reorganization plan accepted by the creditors or approved by the bankruptcy court.

9 *See* Thomas E. Plank, *Bankruptcy and Federalism*, 71 FORDHAM L. REV. 1063, 1070–72 & nn.30–35 (2002) (citing the provisions of the Bankruptcy Code).

10 *See* 11 U.S.C. § 541(a)(1):

> (a) The commencement of a case under section 301, 302, or 303 of this title creates an estate. Such estate is comprised of all the following property, wherever located and by whomever held:
>
> (1) Except as provided in subsections (b) and (c)(2) of this section, all legal or equitable interests of the debtor in property as of the commencement of the case.

Id. The language in clause (1), of "all legal or equitable interests of the debtor in property," is the most significant element of the definition. The other parts of the definition refer to community property, *id.* § 541(a)(2), and to property added to the estate after the commencement of the case, *id.* § 541(a)(3)–(7). The term "property of the estate" pervades the Bankruptcy Code. *See* Thomas E. Plank, *The Outer Boundaries of the Bankruptcy Estate*, 47 EMORY L.J. 1193 (1998).

Although some nonbankruptcy law is federal law,[12] the overwhelming body of nonbankruptcy law is state law. For this reason, federal courts in bankruptcy play a significant role—perhaps the most significant of all federal courts—in adjudicating state law issues. The way federal courts in bankruptcy adjudicate these state law issues seriously affects the ultimate allocation of power between states and the federal government.

The role of federal courts in bankruptcy in deciding state law issues raises the question of what constrains the federal courts in bankruptcy. An obvious constraint, of course, is the Bankruptcy Code itself. To the extent that the Code refers either expressly or implicitly to state law, federal courts in bankruptcy must, as a matter of statutory interpretation, discern and apply state law.

Nevertheless, despite the comprehensive coverage of the Code, many issues arise in bankruptcy for which the Code does not provide a clear answer. In these instances, federal courts in bankruptcy are bound by the holding of the U.S. Supreme Court in *Erie Railroad Co. v. Tompkins*[13] that "[e]xcept in matters governed by the Federal Constitution or by Acts of Congress, the law to be applied in any case is the law of the State. . . . There is no general federal common law."[14]

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11 A "creditor" is an "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 "claim" means a

> (A) right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured; or
>
> (B) right to an equitable remedy for breach of performance if such breach gives rise to a right to payment, whether or not such right to an equitable remedy is reduced to judgment, fixed, contingent, matured, unmatured, disputed, undisputed, secured, or unsecured.

Id. § 101(5).

12 *See, e.g.*, Patterson v. Shumate, 504 U.S. 753, 765–66 (1992) (holding that the anti-alienation requirements of the Employment Retirement Income Security Act, 29 U.S.C. § 1056(d)(1), were applicable nonbankruptcy law for purposes of § 541(c)(2) of the Bankruptcy Code, which provides that a restriction on the transfer of a beneficial interest of the debtor in a trust that is enforceable under applicable nonbankruptcy law is enforceable in a bankruptcy case); NLRB v. Bildisco & Bildisco, 465 U.S. 513, 523, 526–27, 531–34 (1984) (reconciling a conflict between the Code and the National Labor Relations Act (NLRA), 29 U.S.C. § 158(d), and holding that (1) § 365 of the Code authorized the debtor in possession to reject a labor agreement without complying with the procedural requirements of the NLRA, and (2) the debtor's failure to comply with the collective bargaining agreement during the bankruptcy case was not an unfair labor practice under the NLRA).

13 304 U.S. 64 (1938).

14 *Id.* at 78.

This statement encompasses several distinct ideas.[15] One idea is the absolute limit on federal judicial power grounded in the federalism of the Constitution: If Congress does not have the power under Article I of the Constitution to prescribe a rule to be applied in a particular controversy,[16] then federal judges may not prescribe a federal rule and must apply state law.[17] How this aspect of *Erie*, which I call the primary *Erie* doctrine, applies to bankruptcy is the focus of this Article.

A more prominent, ambiguous, and difficult aspect of *Erie* addresses the separation of judicial and legislative powers and the proper role of the federal judiciary: If Congress has the power to prescribe a rule to be applied in a particular controversy but has not done so (and the Constitution is also silent), then, in the absence of an important and discernible federal interest, federal judges should apply state law and not prescribe a federal rule.[18]

The following diagram illustrates the different aspects of *Erie*.

15 *See generally* PETER W. LOW & JOHN C. JEFFRIES, JR., FEDERAL COURTS AND THE LAW OF FEDERAL-STATE RELATIONS 12–13 (4th ed. 1998) (describing two different views of *Erie*); 19 CHARLES ALAN WRIGHT ET AL., FEDERAL PRACTICE AND PROCEDURE §§ 4504–4505, at 26–73 (1996) (noting the different meanings of the *Erie* doctrine); John Hart Ely, *The Irrepressible Myth of* Erie, 87 HARV. L. REV. 693 (1974) (arguing that there is no single *Erie* doctrine and describing three different standards for applying *Erie*).

16 Although the focus of the inquiry here is Congress's powers under Article I, the United States may also exercise power under other articles of the Constitution, and federal courts may therefore exercise appropriate jurisdiction under those articles consistent with the *Erie* doctrine.

17 *See infra* Part I.A. Some have questioned whether *Erie* stands for this view and have asserted that federal courts may create federal common law in areas beyond Congress's Article I powers. *See, e.g.*, Partrick J. Borchers, *The Origins of Diversity Jurisdiction, the Rise of Legal Positivism, and a Brave New World for* Erie *and* Klaxon, 72 TEX. L. REV. 79, 118 (1993) (stating, in the context of diversity jurisdiction, that "[t]here is nothing absurd or implausible in having the federal courts fashion and apply common-law rules in areas in which congressional power does not reach"). I would disagree with this view as it applies to bankruptcy. Borchers cites federal courts' exercise of admiralty jurisdiction under Article III, *id.*, but there is nothing in the Constitution to empower federal courts to exercise admiralty jurisdiction over matters that fall outside of admiralty and other federal powers.

18 *See infra* Part I.C.

State Law Domain
Current State Law but Potential Federal Law Domain
Current Federal Law Domain

If the entire box represents the universe of American legal issues, the top, clear portion represents that domain where federal law may not intrude under the Constitution, an admittedly small portion.[19] The middle, light-gray portion represents the domain where federal law could operate but currently does not, and the bottom, darker-gray portion represents the domain where federal law currently operates.

Under the primary *Erie* doctrine, federal courts may not enter the clear box, the State Law Domain. In the context of federal diversity jurisdiction, this proposition seems unremarkable.[20] Almost all of the controversy over the *Erie* doctrine centers on the separation of powers aspect of *Erie*: When can federal courts enter the middle area, the light-gray domain? The controversy arises because of the difficulties in determining when to apply a state rule in light of a potentially applicable federal statute or policy.[21]

Without citing *Erie*, federal courts in bankruptcy have applied the separation of powers aspect of *Erie*. Specifically, the Supreme Court stated in *Butner v. United States*,[22] and reiterated in *Raleigh v. Illinois Department of Revenue*,[23] that federal courts in bankruptcy should follow state law if federal policy does not require a different result.[24] Many courts have cited *Butner* for the proposition that federal courts

19 *See infra* note 55 and accompanying text.

20 *See, e.g.*, Ely, *supra* note 15, at 704 (refuting the argument that there is no constitutional basis for *Erie* and noting that "the Constitution's utility as a point of reference was ended" by the primary *Erie* doctrine's "point having been made").

21 *See, e.g.*, 19 WRIGHT ET AL., *supra* note 15, §§ 4504–4505, 4508–4517, at 26–73, 220–559 (examining the difficulties of applying *Erie*); Joseph P. Bauer, *The* Erie *Doctrine Revisited: How a Conflicts Perspective Can Aid the Analysis*, 74 NOTRE DAME L. REV. 1235 (1999) (suggesting an analytical model for the *Erie* doctrine that weighs the relative strengths of the federal and state interests to determine when to apply a federal rule); Martha A. Field, *Sources of Law: The Scope of Federal Common Law*, 99 HARV. L. REV. 881 (1986) (arguing that the permissible scope of federal common law is broader than previously thought, and analyzing the way federal judges have used their discretion to create federal common law).

22 440 U.S. 48, 55 (1979); *see also infra* notes 73–76, 79–81, 193 and accompanying text.

23 530 U.S. 15 (2000); *see also infra* notes 77, 196 and accompanying text.

24 *See Butner*, 440 U.S. at 55; *see also infra* text accompanying note 76 (quoting the Court's statement, which is known as the "*Butner* principle").

in bankruptcy should look to state law.[25] The *Butner* principle, however, suggests that federal courts in bankruptcy need not follow state law if federal bankruptcy policy requires a different result.[26] And federal courts in bankruptcy have created federal bankruptcy rules that override state law entitlements when they thought such rules necessary to further some bankruptcy policy.[27]

Just as federal courts in diversity cases have had difficulty applying the separation of powers *Erie* doctrine,[28] federal courts in bankruptcy have not developed any consistent theory on when they may overrule state law. This lack of a consistent theory, however, is not the most serious shortcoming in how federal courts in bankruptcy address state law issues. The most significant shortcoming is the failure to recognize that, for some state law issues, federal courts in bankruptcy do not have the power under the Constitution to override state law regardless of what "bankruptcy policy" might suggest. In other words, the "federal policy" exception in *Butner*'s explication of the separation of powers aspect of *Erie* fails to respect the primary *Erie* doctrine. The purpose of this Article is to demonstrate how federal courts in bankruptcy must comply with the primary *Erie* doctrine.

Congress has enacted the Bankruptcy Code pursuant to one of its enumerated powers under the U.S. Constitution, the power to enact laws "on the subject of Bankruptcies."[29] Congress is bound by the limitation of this grant of power.[30] Therefore, federal courts in bankruptcy are bound by the limitation on federal power inherent in Congress's Bankruptcy Power. Notwithstanding the federal policy exception of *Butner*, federal courts may not create federal common law and must find and follow state law when confronted with a legal issue that is beyond the scope of the Bankruptcy Clause.[31] In such cases, they may not disregard state law even if they think that "bankruptcy policy" requires a different result. As discussed in Part I.A below, they must adhere to the primary *Erie* doctrine.

25 *See, e.g.*, *In re* Kenneth Allen Knight Trust, 303 F.3d 671, 678–79 (6th Cir. 2002); *In re* Kalter, 292 F.3d 1350, 1353 (11th Cir. 2002); *In re* Universal Seismic Assocs., Inc., 288 F.3d 205, 208 (5th Cir. 2002); *In re* Crystal Props., Ltd., 268 F.3d 743, 749 n.1 (9th Cir. 2001); *In re* Newpower, 233 F.3d 922, 928 (6th Cir. 2000).

26 *See, e.g.*, *infra* note 118 and accompanying text.

27 *See infra* notes 66, 71, 159–71 and accompanying text.

28 *See supra* notes 15, 21.

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

30 *See generally* Plank, *supra* note 9.

31 If the nonbankruptcy issues depend on federal law other than bankruptcy law, then courts are similarly bound by the federal nonbankruptcy law.

Elsewhere, I have developed my own view of the limits of Congress's Bankruptcy Power.[32] I describe my views in Part I.B below. The applicability of *Erie* in bankruptcy, however, does not depend on my view or any other view of the particular limits of bankruptcy. As long as there is some limit on Congress's power under the Bankruptcy Clause, federal courts will similarly be limited by Article I of the Constitution and the primary *Erie* doctrine.

Requiring federal courts in bankruptcy to apply the state law for nonbankruptcy law issues is necessary to honor our federal system of government. In holding that the Commerce Clause[33] does not authorize Congress to ban weapons from schools in *United States v. Lopez*[34]—the first time in fifty years that the Court recognized a limit on the Commerce Clause[35]—the Supreme Court emphasized that, yes, the federal government is a government of limited powers.[36] The Court has also honored the limitation on the federal judicial power against the states expressed in the Eleventh Amendment,[37] and the limitation on congressional ability to impose obligations on the states.[38] Bankruptcy law should not be exempt from a robust recognition of a meaningful allocation of powers between federal and state

32 *See* Plank, *supra* note 9, at 1089–95.

33 U.S. CONST. art. I, § 8, cl. 3.

34 514 U.S. 549, 567–68 (1995).

35 *See, e.g.*, Robert A. Schapiro & William W. Buzbee, *Unidimensional Federalism: Power and Perspective in Commerce Clause Adjudication*, 88 CORNELL L. REV. 1199, 1220 (2003).

36 *See also* United States v. Morrison, 529 U.S. 598, 617–19 (2000) (holding that the Commerce Clause of the Constitution did not permit Congress to enact the civil remedy provision of the Violence Against Women Act).

37 *See, e.g.*, Fed. Mar. Comm'n v. S.C. State Ports Auth., 535 U.S. 743, 769 (2002) (holding that state sovereign immunity precluded the Federal Maritime Commission from adjudicating a private party's complaint that a state-run port had violated the Shipping Act); Alden v. Maine, 527 U.S. 706, 712 (1999) (holding that Congress could not subject the state to suit by state probation officers for violation of overtime provisions of Fair Labor Standards Act, in state court without the state's consent); Fla. Prepaid Postsecondary Educ. Expense Bd. v. Coll. Sav. Bank, 527 U.S. 627, 636 (1999) (holding that neither the Commerce Clause nor the Patent Clause, U.S. CONST. art. I, § 8, cl. 8, authorized Congress to abrogate state sovereign immunity under the Patent and Plant Variety Protection Remedy Clarification Act); Seminole Tribe of Fla. v. Florida, 517 U.S. 44, 76 (1996) (holding that Congress lacked authority under the Indian Commerce Clause, U.S. CONST. art. I, § 8, cl. 3, to abrogate the states' Eleventh Amendment immunity and compel negotiations under the Indian Gaming Regulatory Act).

38 *See* Printz v. United States, 521 U.S. 898, 935 (1997) (invalidating on Tenth Amendment grounds certain provisions of the Brady Handgun Violence Prevention Act, requiring state officials to conduct background checks on prospective handgun purchasers).

institutions. Therefore, as described in detail in Parts I through IV, when a federal court in bankruptcy must decide an issue that is beyond the constitutional scope of bankruptcy law, all the force of the primary *Erie* doctrine applies, and the "federal policy" exception in *Butner* may not apply.

To be sure, federal courts have faced difficulties in applying *Erie* in diversity cases.[39] These difficulties also arise in bankruptcy. Further complicating the application of the *Erie* doctrine in bankruptcy is the different procedural process of bankruptcy law. The issues that arise in a diversity case are often similar to those that arise in a state court case because federal diversity cases are parallel to state court cases. This parallel structure does not exist in bankruptcy. The mandatory state law issues that bankruptcy courts must address in bankruptcy cases usually do not arise in state law courts in the same way, because states do not have comparable bankruptcy statutes.

Nevertheless, as discussed in Part V, respecting *Erie* in bankruptcy will produce more analytically sound results. State law is the primary source for defining contract and property rights. To adjust the relationship between an insolvent debtor and the debtor's creditors—the province of bankruptcy law—federal courts in bankruptcy must decide fundamental questions of state law. When these fundamental questions have not been decided by state legislatures or state courts, a federal court in bankruptcy must look broadly and deeply into all aspects of state law to resolve the issue. No longer may federal courts in bankruptcy slight a state law analysis on difficult issues by falling back on "federal law" or "bankruptcy policy."[40] Instead, the federal court must decide these fundamental state law questions as if the federal court were a state court applying the Bankruptcy Code, and as if the Code were a state bankruptcy law.

Honoring *Erie* in this way produces an irony. Except in those instances when states have chosen to follow different rules,[41] the reasoned determination of fundamental state law questions by federal courts in bankruptcy will produce a cumulative body of state law analy-

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39 *See, e.g.*, Bradford R. Clark, *Ascertaining the Laws of the Several States: Positivism and Judicial Federalism after* Erie, 145 U. PA. L. REV. 1459 *passim* (1997) (describing several current approaches to finding state law and arguing that the federal courts should employ a presumption in favor of certifying unresolved issues to state courts).

40 *See infra* note 118 and accompanying text.

41 For example, about thirty states recognize the tenancy by the entirety. *See* 7 POWELL ON REAL PROPERTY § 52.01[3], at 52-4 to 52-12 (Michael Allan Wolf ed., 2003) (surveying the laws in fifty states and the District of Columbia); WILLIAM B. STOEBUCK & DALE A. WHITMAN, THE LAW OF PROPERTY § 5.5, at 195–97 (3d ed. 2000) (describing the limitations on the individual tenant's rights).

sis that will begin to resemble an American general commercial law. The American general commercial law, developed by following *Erie* in bankruptcy will partially resurrect the vision of a general commercial law that Justice Story articulated more than 150 years ago in *Swift v. Tyson*[42]—the case that *Erie* overruled.

I. *ERIE*'S CONSTRAINT ON BANKRUPTCY

Although the Bankruptcy Code implicitly and expressly relies on state law to a substantial degree,[43] applying state law in bankruptcy law involves more than statutory interpretation of the Bankruptcy Code. *Erie Railroad Co. v. Tompkins*,[44] at the very least, requires federal courts in bankruptcy facing state law outside the scope of the Bankruptcy Clause to find and to apply state statutory or common law.

A. *The Primary* Erie *Doctrine*

In 1938, the Supreme Court in *Erie* overruled *Swift v. Tyson*[45] and held that, in a diversity case, there is no federal general common law. Tompkins had sued the Erie Railroad Co. in the New York federal district court for injuries suffered in Pennsylvania, and sought to use a federal common law of torts to obtain relief that would not have been available under Pennsylvania law.[46] Tompkins obtained a jury verdict for his injuries on the basis of the federal rule. Reversing, the Court declared: "Except in matters governed by the Federal Constitution or by Acts of Congress, the law to be applied in any case is the law of the State. . . . There is no federal general common law."[47]

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42 41 U.S. (16 Pet.) 1 (1842); *see also infra* note 45.

43 *See supra* notes 9–11 and accompanying text.

44 304 U.S. 64 (1938).

45 *Swift* held, as a matter of statutory construction and not as a matter of constitutional power, that the Rules of Decision Act, part of the Judiciary Act of 1789, ch. 20, § 20, 1 Stat. 73, requiring federal courts to follow state laws, did not apply to state common law. *Swift*, 41 U.S. (16 Pet.) at 18–19. Accordingly, the Court relied on general principles of commercial law to hold that a transferee, who took an instrument in satisfaction of an antecedent debt, gave sufficient "value" to be a holder in due course, and who took free of the personal defenses of the obligor on the instrument. *Id.* at 18–22.

46 Tompkins was injured by an object protruding from a moving rail car while he was walking on a commonly used footpath alongside the railroad's right of way in Pennsylvania. Under Pennsylvania law, Tompkins would be considered a trespasser and therefore not entitled to recover absent the railroad's gross negligence. *See Erie*, 304 U.S. at 69–70. The federal common law rule provided that Tompkins was a licensee to whom the railroad owed a duty of care. *Id.* at 70.

47 *Id.* at 78.

By the time *Erie* was decided, *Swift* had received much criticism. Criticisms noted by the Court in *Erie* included assertions that *Swift* was incorrectly decided,[48] that *Swift* had proved to be unworkable,[49] and that *Swift* had created problems of forum shopping between state and federal courts.[50] The Supreme Court, however, specifically eschewed relying on any of these rationales. The Court emphatically grounded its decision in the limits of the Constitution: "If only a question of statutory construction were involved, we should not be prepared to abandon a doctrine so widely applied throughout nearly a century. But the unconstitutionality of the course pursued has now been made clear and compels us to do so."[51] Moreover, *Erie* is not limited to cases in which the basis for the jurisdiction of the federal courts is diversity of citizenship.[52]

Although some have questioned how far *Erie* goes as a matter of constitutional mandate,[53] the primary *Erie* doctrine dictates that federal courts may not declare federal common law in those areas beyond Congress's legislative power (or some other federal power under the Constitution).[54] Some scholars have suggested that, given the current broad reach of Congress's Commerce Clause power, this aspect

48 The Court held in *Swift* that the words "laws of the several states" in the Rules of Decision Act, requiring federal courts to follow state laws, meant only the laws enacted by the legislature (including the interpretations by courts) and to local real estate law, and did not apply to the construction of "questions of a more general nature . . . as, for example, to the construction of ordinary contracts . . . and especially to questions of general commercial law." *Swift*, 41 U.S. (16 Pet.) at 18–19. The Court in *Erie* noted the criticism that this was an erroneous interpretation of the Rules of Decision Act. *See Erie*, 304 U.S. at 72.

49 *See Erie*, 304 U.S. at 74–78.

50 *Id.*

51 *Id.* at 77–78 (citation omitted).

52 *See* 19 WRIGHT ET AL., *supra* note 15, § 4520, at 635–36; Henry J. Friendly, *In Praise of* Erie*—And of the New Federal Common Law*, 39 N.Y.U. L. REV. 383, 408 n.122 (1964) (characterizing the view that *Erie* only applies in diversity cases as an "oft-encountered heresy"), *cited with approval in* Agency Holding Co. v. Malley-Duff & Assoc., Inc., 483 U.S. 143 (1987).

53 *See* 19 WRIGHT ET AL., *supra* note 15, § 4505, at 58 & n.31 (noting those who question the constitutional basis for *Erie*).

54 *Erie*, 304 U.S. at 78–79.

> Congress has no power to declare substantive rules of common law applicable in a State whether they be local in their nature or "general," be they commercial law or a part of the law of torts. And no clause in the Constitution purports to confer such a power upon the federal courts. . . . "Supervision over either the legislative or the judicial action of the States is in no case permissible except as to matters by the Constitution specifically authorized or delegated to the United States. Any interference with either, except as thus permitted, is an invasion of the authority of the State . . . ."

of *Erie* would leave it with little force.[55] After all, if Congress can, under the Commerce Clause, regulate almost all aspects of American life, then under the primary *Erie* doctrine, federal courts in diversity cases could create a federal "Commerce Clause" common law for these areas.[56]

Nevertheless, in the case of Congress's Bankruptcy Power, the primary meaning of *Erie* retains significant force. Congress's Bankruptcy Power has definite and discernible limits. Accordingly, when facing an issue that is beyond the scope of the Bankruptcy Clause, federal courts in bankruptcy must find and apply state law and may not rely on a notion of federal bankruptcy common law.[57]

Id. (quoting Justice Field's dissent in *Balt. & Ohio R.R. Co. v. Baugh*, 149 U.S. 368, 401 (1893)); *see also* 19 WRIGHT ET AL., *supra* note 15, § 4505, at 60 (stating that the "broad constitutional holding appears to be that neither Congress nor the federal courts can create rules of law unless authorized to do so by the terms of the Constitution"); Bauer, *supra* note 21, at 1243 (analyzing the separation of powers aspect of *Erie* as the *Erie* doctrine, but noting that Congress's authority to create federal courts and to confer substantive jurisdiction "on them does not carry with it the power to create substantive law in areas beyond the ability of Congress to legislate"); Ely, *supra* note 15, at 702–04 (arguing that *Erie* overruled *Swift v. Tyson* because the Constitution did not give the federal government the general lawmaking authority that the Court had been exercising under *Swift*); Field, *supra* note 21, at 923–24 (suggesting that the primary *Erie* doctrine may be the only limit on the federal judiciary's common lawmaking power); Friendly, *supra* note 52, at 394–95 (same); Peter Westen & Jeffrey S. Lehman, *Is There Life for* Erie *after the Death of Diversity?*, 78 MICH. L. REV. 311, 338–39 (1980) (same).

55 *See* LOW & JEFFRIES, *supra* note 15, at 13; *see also* 19 WRIGHT ET AL., *supra* note 15, § 4505, at 64–65 (stating that "[g]iven the expansive construction accorded the Constitution's grants of legislative power, together with the deferential test for valid congressional rulemaking, it is arguable that the significant limitations upon congresssional rulemaking are more a matter of congressional will and the political process than a matter of constitutional authority") (citations omitted).

56 *See* Field, *supra* note 21, at 923–24 (suggesting that the primary *Erie* doctrine may be the only limit on the federal judiciary's common lawmaking power).

57 I do not rest my argument on the fact that bankruptcy judges are not Article III judges, appointed for life terms by the President and subject to confirmation by the Senate. Bankruptcy judges are appointed by the U.S. Courts of Appeals for the respective circuits for fourteen-year terms. 28 U.S.C. § 152(a)(1) (2000). Notwithstanding *Northern Pipeline Constr. Co. v. Marathon Pipe Line Co.*, 458 U.S. 50 (1982) (holding that bankruptcy judges who were not Article III judges could not adjudicate a breach of contract claim by a debtor in possession against a third party who had not filed a claim in the bankruptcy case), and *Granfinanciera, S.A. v. Nordberg*, 492 U.S. 33 (1989) (holding that a third party sued by the trustee in bankruptcy to recover a fraudulent conveyance was entitled to a jury trial), I believe that bankruptcy judges have complete power to adjudicate initially any issues that fall within the scope of the Bankruptcy Clause. *See generally* Thomas E. Plank, *Why Bankruptcy Judges Need Not and Should Not Be Article III Judges*, 72 AM. BANKR. L.J. 567 (1998).

B. *The Limits of Congress's Bankruptcy Power*

To apply the primary *Erie* doctrine in bankruptcy, a court must first recognize the limits of Congress's Bankruptcy Power, that is, the power to enact laws "on the subject of Bankruptcies." Although there may be different views of what those limits are, there must be limits or the federal government is no longer a government with delegated powers. For the remainder of this Article, I will analyze the *Erie* doctrine under my interpretation of the constitutional limits of the Bankruptcy Power.[58] Nevertheless, it is important to emphasize that the *Erie* doctrine must be applied in bankruptcy regardless of the details of the constitutional limits of Congress's Bankruptcy Power.

In my view, the subject of bankruptcies is limited to adjusting the relationship between a debtor that is insolvent in some sense[59] and that debtor's creditors. I deduce this interpretation of the "subject of Bankruptcies" from the understanding of the term "bankruptcies" when the Constitution was adopted, and from the various legislative responses to bankruptcies before the adoption of the Constitution. First, in the latter half of the eighteenth century, the term "bankruptcy" was synonymous with "insolvency." Both "bankruptcy" and "insolvency" were used interchangeably in a variety of legislative acts and other documents, and were defined in the contemporary dictionaries as the condition of being unable to pay one's debts.[60] Accord-

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58 *See* Plank, *supra* note 9, at 1077–78.

59 Either the debtor's liabilities must exceed the debtor's assets, that is, the debtor is insolvent under a balance sheet test, or the debtor must be generally unable to pay debts as they become due, that is, the debtor is insolvent under a cash flow test. Often a debtor in financial distress is insolvent in both senses, but it is not uncommon to be solvent under a balance sheet test and still not be able to pay debts as they become due. This situation occurs when the debtor's principal assets—such as land—cannot quickly be converted into cash, and the debtor has insufficient cash or other liquid assets to pay current debts. The Code uses both concepts. For most situations under the Code in which "insolvency" is relevant, such as avoidance of fraudulent and preferential transfers, *see* 11 U.S.C. §§ 547(b)(3), 548(a)(1)(B)(ii)(I), the term "insolvent" means balance sheet insolvency. *Id.* § 101(32)(A), (B). Cash flow insolvency, however, is a requirement for municipalities filing for bankruptcy relief under Chapter 9 of the Code. *Id.* § 109(c)(3) (requiring a municipality to be "insolvent"); *see also id.* § 101(32)(C) (defining "insolvent" for a municipality to mean "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"). Cash flow insolvency is also a requirement for the entry of an order for relief under a controverted involuntary bankruptcy petition. *Id.* § 303(h)(1) (providing that the court shall order relief against the debtor in an involuntary case 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").

60 *See* Plank, *supra* note 9, at 1077–78.

ingly, the "subject of Bankruptcies" in the Constitution is the "subject of debtors who are unable to pay their creditors."

Moreover, in the seventeenth and eighteenth centuries, English and American legislatures addressed the problem of debtors' inability to pay their debts by enacting a variety of laws that, though different in important respects, had certain common features and limitations. The common features were a collective proceeding involving all of the creditors by which the debtor's property was liquidated and the proceeds distributed pro rata to the creditors, or, in a few instances, a collective proceeding in which all creditors were obligated to accept an arrangement negotiated between the debtor and a majority of the creditors. The common limitation of all of this legislation was that none attempted to do more than alter the relationship between the debtor and the creditors. No legislation regulated or created the debtor-creditor relationship, or the property rights or contract rights underlying that relationship.[61]

From the language of the Bankruptcy Clause and the legislative enactments that preceded it, I have derived four principles: the Debtor-Creditor Adjustment Principle, the Non-Expropriation Principle, the Non-Interference Principle, and the Debtor-Insolvency Principle.

The Debtor-Creditor Adjustment Principle provides that Congress has complete discretion to adjust the debtor-creditor relationship. It may curtail the nonbankruptcy rights of a debtor for the benefit of that debtor's creditors, and it may curtail the nonbankruptcy rights of some or all of those creditors against the debtor for the benefit of the debtor or some or all of the other creditors. For example, Congress may provide that any property interest that the debtor could use to satisfy her debts outside of bankruptcy may, but need not be, distributed to creditors in bankruptcy. Congress may also provide that any liability of the debtor, regardless of how remote or contingent, may be reduced, subordinated, or discharged. Congress may also delay or modify any creditor remedies.[62]

The Non-Expropriation Principle, however, forbids Congress from expanding the rights of debtors or their creditors beyond that necessary to adjust their relationship or from otherwise diminishing either (1) the rights or prerogatives of parties outside of the debtor-creditor relationship (third parties) for the benefit of the debtor or the creditors, or (2) the nonbankruptcy rights of the debtor or the creditors for the benefit of these third parties. For example, Congress

61 *Id.* at 1078–89.

62 *Id.* at 1089–91.

may not (a) create rights or property interests for insolvent debtors or their creditors that do not exist under state law or federal nonbankruptcy law; (b) appropriate property interests of third parties for distribution to creditors, including disregarding inherent limitations in property interests of the debtor that inure to the benefit of a third party; (c) alter the substantive legal relationship between a debtor and another party to the extent that the relationship is not a debtor-creditor relationship; or (d) create a liability that does not exist under state law, nor expand an existing liability.[63]

The Non-Interference Principle provides an important but limited constraint on the Non-Expropriation Principle. Under this principle, Congress may prevent a third party from using its nonbankruptcy entitlements to impede the bankruptcy process. Congress may also prevent a third party from using the filing of a bankruptcy petition by a debtor to obtain a benefit that the third party could not obtain outside of bankruptcy.[64] Finally, the Debtor-Insolvency Principle provides that debtors may not be in bankruptcy unless they are insolvent in some sense.[65] If a debtor is not insolvent, Congress's discretion under the Debtor-Creditor Adjustment Principle does not apply.

To the extent that these principles govern the limits of Congress's Bankruptcy Power, they similarly constrain the rules that federal courts in bankruptcy may choose when deciding an issue for which the Code provides no clear guidance. Hence, if the issue to be decided falls within the Debtor-Creditor Adjustment Principle or Non-Interference Principle, the court does not violate the primary *Erie* doctrine by adopting a federal rule. As discussed below, federal courts in bankruptcy have done so in many instances. Several important provisions of the Bankruptcy Code represent codification of judicial decisions under the Bankruptcy Act of 1898. For example, federal courts in bankruptcy first authorized the rejection or acceptance of executory contracts and leases.[66] Congress added the statutory authority for rejection and acceptance in 1938.[67] Similarly, the power of the bankruptcy trustee to abandon burdensome or inconsequential property of

63 *Id.* at 1091–92.

64 *Id.* at 1092–93.

65 *Id.* at 1093–95.

66 *See* Michael T. Andrew, *Executory Contracts in Bankruptcy: Understanding "Rejection,"* 59 U. COLO. L. REV. 845, 856–62 (1988).

67 *See* Act of June 22, 1938, ch. 575, § 1, 52 Stat. 840, 880–81 (amending Bankruptcy Act of 1898, ch. 541, § 70(b), 30 Stat. 544, 565–66) (codified as amended at 11 U.S.C. § 110(b) (1976) (repealed 1978)) (current version at 11 U.S.C. § 365 (2000)); *see also* Plank, *supra* note 9, at 1113–26 (analyzing why rejection or assumption of

the estate,[68] first codified with the enactment of the Bankruptcy Code, originated in judicial decisions under the Bankruptcy Act.[69]

Accordingly, a federal court in bankruptcy may, under the Debtor-Creditor Adjustment Principle, determine that a creditor in possession of property items owned by the debtor must return them to the bankruptcy trustee.[70] Under the Non-Expropriation Principle, however, the court may not give the debtor in bankruptcy greater rights in a property interest than it has outside of bankruptcy. On the other hand, a court may prevent a third party from using its nonbankruptcy rights to interfere with the bankruptcy process or obtain a benefit as the result of a bankruptcy case that it would not achieve without the filing.[71]

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executory contracts and leases under § 365 generally falls within the Debtor-Creditor Adjustment Principle and the Non-Interference Principle).

68 *See* 11 U.S.C. § 554 (2000). The question of what particular property items of the debtor should be administered for the benefit of creditors falls well within the "subject of Bankruptcies." *See* Plank, *supra* note 9, at 1096–100.

69 *See* Midlantic Nat'l Bank v. N.J. Dep't of Envtl. Prot., 474 U.S. 494, 500–01 (1986) (describing the history of the abandonment power).

70 *See, e.g.*, United States v. Whiting Pools, Inc., 462 U.S. 198, 209 (1983). In this case, the Court held that a bankruptcy court could direct the Internal Revenue Service, which had seized all the goods of Whiting Pools to obtain repayment of past due taxes, to return the seized goods to Whiting Pools after it filed a Chapter 11 bankruptcy petition. *Id.* at 209. The Court ostensibly relied on 11 U.S.C. § 542(a), *id.* at 205–08, but the plain language of the Code does not support the result. The Court also relied upon some shaky legislative history and a general policy of favoring reorganization. *Id.* at 207 n.16. I have severely criticized the Court's poor reasoning in this case. *See* Plank, *supra* note 10, at 1234–54; Thomas E. Plank, *The Creditor in Possession Under the Bankruptcy Code: History, Text, and Policy*, 59 MD. L. REV. 253, 255–58, 301–07, 311, 343–44 (2000). Nevertheless, as an exercise in federal common law rulemaking, the Court's decision falls squarely within the Debtor-Creditor Adjustment Principle. *See* Charles Jordan Tabb, *The Bankruptcy Reform Act in the Supreme Court*, 49 U. PITT. L. REV. 477, 507–14 (1988) (suggesting that the Court should have acknowledged that the Code did not accomplish Congress's intent and should have declared simply that the Code provides for the result).

71 *See* Holland Am. Ins. Co. v. Sportservice, Inc. (*In re* Cahokia Downs, Inc.), 5 B.R. 529 (Bankr. S.D. Ill. 1980). In this case, an insurance company insured a race track operated by Cahokia Downs. After Cahokia Downs became a debtor under the Bankruptcy Code, the insurance company terminated the insurance policy under a contractual provision authorizing either party to terminate the contract for any reason upon thirty days notice. *Id.* at 530. The bankruptcy court half-heartedly held that such action violated the automatic stay of acts to control property of the estate. *Id.* at 531 (stating that "cancellation of the insurance would *certainly* come within the provisions of the automatic stay under § 362(a)(3)") (emphasis added). This conclusion is wrong. The property of the estate consisted of the rights of the debtor under the contract, and those rights were subject to termination for any reason. More importantly, the court noted that the Code authorized the trustee in bankruptcy to use

C. *Of* Erie *and* Butner*: Beyond the Primary* Erie *Doctrine*

The dominant view of *Erie* is that considerations of separation of powers embodied in the Constitution limit the ability of federal courts to make federal common law in those areas that are within Congress's powers but on which Congress has been silent.[72] This view of *Erie* follows logically from the facts of the case and the current broad view of Congress's Commerce Clause power. The legal issue in *Erie* was the standard of negligence to be applied to a railroad that injured an individual walking along a common pathway next to the railroad's tracks. Under its Commerce Clause power, Congress most likely can enact legislation prescribing such a negligence standard. It had not done so. In the absence of a congressional command or some other federal interest, federal courts should not adopt a federal common law standard.

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property of the estate and that the Code prohibited ipso facto clauses that allowed termination of contracts because of the filing of a bankruptcy petition. *Id.* at 531. The court also found as a fact that the primary reason for the termination of the insurance policy was the filing of the petition. *Id.* Because the Code does not expressly prohibit the discretionary termination of contracts, this case presents an example of a bankruptcy court creating a bankruptcy common law rule. *Cahokia Downs* properly stands for the proposition that a party may not use a discretionary termination provision to terminate a contract when the only reason for doing so is the filing of a bankruptcy petition. Such a proposition, though not expressly in the Code, falls within the Non-Interference Principle, and does not violate the Non-Expropriation Principle, because a party to a contract may not use its nonbankruptcy rights to interfere with the bankruptcy process or use the filing of a bankruptcy petition to obtain a benefit that it could not acquire outside of bankruptcy. The insurance company stated that it canceled the contract because the race track lost its racing days and the loss of racing days increased its risk. *Id.* at 532. However, the track lost its racing days more than six months before the filing. *Id.* The filing of the bankruptcy petition alerted the insurance company of its increased risk, a risk that it had or should have anticipated in pricing its premium. Cancellation of the policy for no reason other than the filing interferes with the bankruptcy process and, if not prevented, would have allowed the insurance company to receive a benefit—the notice of and avoidance of an increased risk that should have been included in the premium—that it would not have had absent the filing.

72 *See* LOW & JEFFRIES, *supra* note 15, at 13–14; *see also* 19 WRIGHT ET AL., *supra* note 15, § 4505, at 60–68; Friendly, *supra* note 52, at 407 (noting with approval that the promulgation of the primary *Erie* doctrine has "caused the principle of specialized federal common law" to develop); Paul J. Mishkin, *Some Further Last Words on* Erie*—The Thread*, 87 HARV. L. REV. 1682, 1683 (1974) (agreeing with John Hart Ely's discussion of the primary *Erie* doctrine, *see* Ely, *supra* note 15 *passim*, but arguing that *Erie* also constrains federal courts' common lawmaking powers in areas of congressional power).

Although it did not refer to *Erie*, the Supreme Court in *Butner v. United States*[73] applied this aspect of *Erie*. Butner acquired a second mortgage on real estate of a bankrupt real estate developer, but did not acquire a direct security interest in the rents collected on the real estate. Under applicable state law, Butner would not have been entitled to a security interest in the rents until he had taken certain steps, such as appointment of a receiver or foreclosure of the mortgage. Nevertheless, Butner asserted a perfected security interest in the rents under a federal bankruptcy rule of equity adopted by courts of appeals in two federal circuits that gave the mortgagee a security interest in the rents upon the filing of the bankruptcy petition regardless of state law.[74] The Court of Appeals for the Fourth Circuit applied the state law and ruled that Butner had no security interest in the rents.

Resolving a conflict among the federal circuits on whether to apply the relevant state law or the federal bankruptcy rule of equity, the Supreme Court held that federal courts in bankruptcy should apply the relevant state law and not the federal rule.[75] The Court enunciated the *Butner* principle: "Property interests are created and defined by state law. Unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding."[76]

Recently, the Supreme Court reiterated the *Butner* principle in *Raleigh v. Illinois Department of Revenue*.[77] In *Raleigh*, the State of Illinois presented a claim for state taxes owed by the debtor in a bankruptcy case based on a notice of tax liability. Under Illinois law, the notice established the tax liability and the tax payer—the debtor in *Raleigh*—had the burden of proving that the liability was incorrect or invalid. The bankruptcy court, however, held that Illinois had the burden of proving its claim for taxes in the bankruptcy case. The Su-

73 440 U.S. 48 (1979).

74 *Id.* at 53–54. Under the law in most states, a mortgagee could not get an interest in the rents under the mortgage until it had taken some affirmative action, such as obtaining appointment of a receiver, getting possession of the mortgaged property, or commencing or completing foreclosure of the mortgage. *Id.* at 52–53 & nn.2–5. The rationale for the federal equity rule was that the automatic stay in bankruptcy prevented such creditor action, and the rule balanced the equities between the debtor/mortgagor and the creditor/mortgagee. *Id.* at 53–54 & n.6.

75 *Id.* at 53–54.

76 *Id.* at 55.

77 530 U.S. 15, 20 (2000).

preme Court reversed, holding that a bankruptcy court was not free to alter the burden of proof.[78]

The *Butner* principle reflects the separation of powers aspect of *Erie* that, in the absence of some federal interest, federal courts should defer to state law in areas in which Congress may legislate, when Congress has chosen not to establish a specific rule. Indeed, the Court in *Butner* stated that, although Congress had not done so, the Bankruptcy Clause "would clearly encompass a federal statute defining the mortgagee's interest in the rents and profits earned by property in a bankrupt estate."[79] This statement is imprecise. The Non-Expropriation Principle precludes Congress from defining a mortgagee's property interest. But, under the Debtor-Creditor Adjustment Principle, Congress can determine the extent to which a mortgagee, as a creditor, may share in the bankruptcy estate up to the limit of its claim; whether or how to recognize a creditor's security interest in rents in bankruptcy is within the scope of bankruptcy law.[80]

The Court's admonishment in *Butner* to rely on state law contains an important caveat: State law applies "[u]nless some federal interest requires a different result."[81] Under the facts of *Butner*, this caveat is correct. Because the issue before the Court was within the realm of bankruptcy law, federal policy may overrule state law. The *Butner* principle, however, fails to recognize another important limitation on federal judicial power. When the issue is beyond the scope of the Bankruptcy Clause, nonbankruptcy law *must* control. When the

78 *Id.* at 24–25 (stating that "[b]ankruptcy courts are not authorized in the name of equity to make wholesale substitution of underlying law controlling the validity of creditors' entitlements, but are limited to what the Bankruptcy Code itself provides").

79 *Butner*, 440 U.S. at 54.

80 Under the Debtor-Creditor Adjustment Principle, Congress is free to adopt any particular rule on this issue that it believes would assist in adjusting the debtor's relationship with all of its creditors. It may give a mortgagee the first priority or no priority in rents generated by a debtor. It may abrogate the mortgagee's claim. Under the Non-Expropriation Principle, however, it may not give the creditor an interest in rents greater than that necessary to pay the creditor in full.

In 1994, Congress apparently eased the mortgagee's ability to perfect a security interest in rents by allowing perfection by notice as a substitute for perfection by seizure or by commencing an action. *See* Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, § 204, 108 Stat. 4106, 4122 (codified as amended at 11 U.S.C. § 546(b)(2) (2000)). The Bankruptcy Reform Act, however, revised another provision of the Code, § 552(b)(2), that was apparently intended to allow the continuation of security interests in rents, but that is literally incompatible with revised § 546(b)(2). *See* David Gray Carlson, *Rents in Bankruptcy*, 46 S.C. L. REV. 1075, 1145–46 (1995) (describing the interplay between § 552(b)(2) and § 546(b)).

81 *Butner*, 440 U.S. at 55; *see also supra* text accompanying note 76 (quoting the "*Butner* principle").

nonbankruptcy law is state law (as it most often is), the primary *Erie* doctrine, not *Butner*, dictates that federal courts in bankruptcy must respect the limits of the Bankruptcy Power and defer to state law, even if such state law produces a result that is contrary to what a court thinks is proper "bankruptcy policy."

II. SCHOLARLY AND JUDICIAL TREATMENT OF *ERIE* IN BANKRUPTCY

Few commentators or cases have addressed the role of *Erie* in bankruptcy. In an article published in 1953 analyzing the extent to which federal courts in bankruptcy may apply equitable principles to overrule state law rights, Alfred Hill asserted that the principles of *Erie* applied to bankruptcy.[82] Hill reasoned that Congress's power under the Bankruptcy Clause must have some limits.[83] As an example, he stated that a federal court in bankruptcy could not grant a divorce and that it was unlikely that Congress under the Bankruptcy Clause could authorize it to do so.[84] Accordingly, he asserted that the power of federal courts in bankruptcy to apply equitable principles to overrule state law entitlements is constrained by the scope of Congress's Bankruptcy Power.[85]

Hill's article, however, is limited. He did not try to define the boundaries of Congress's power under the Bankruptcy Clause, and he did not distinguish between actions that exceed Congress's constitutional power and actions that contradict his view of good bankruptcy policy. Moreover, he focused on only a few issues in which federal courts used their equitable powers to overrule creditors' state law rights.[86] The examples that he analyzed—whether a claim of one creditor should be subordinated to the claims of other creditors or whether a creditor's claim should be disallowed—fall within the permissible scope of the Bankruptcy Power.[87] He did not distinguish the primary *Erie* doctrine and the separation of powers *Erie* doctrine. Instead, his argument reflects the separation of powers aspect of *Erie* and presages the *Butner* principle that, absent some discernible fed-

82 *See* Alfred Hill, *The* Erie *Doctrine in Bankruptcy*, 66 HARV. L. REV. 1013, 1031–36, 1050 (1953).

83 *Id.* at 1036–38.

84 *Id.* at 1037–38.

85 *Id.* at 1035–39.

86 *Id.* at 1038–50.

87 *Id.* Hill did comment in one subpart that a federal court could not override substantive state law when the trustee was seeking to recover from a noncreditor who had injured the debtor or its property, but his principal purpose in doing so was to distinguish a wrongdoer who was a creditor (and therefore could be subordinated to other creditors) and one who was not. *Id.* at 1046–48.

eral bankruptcy policy, federal courts should respect substantive state law.[88]

Twenty years later, Vern Countryman rejected the applicability of *Erie* to bankruptcy in two well known articles published shortly before the drafting and adoption of the Bankruptcy Code.[89] In these works, Countryman urged Congress to reduce its reliance on state law in bankruptcy.[90] The theoretical foundations of his argument, unfortunately, are cloudy. At the outset, he asserted that *Erie* was limited to diversity cases.[91] He specifically disagreed with Alfred Hill's statement that *Erie* does apply to bankruptcy.[92] He also quoted with approval, but out of context, Judge Friendly's statement in his concurring opinion in *Fore Improvement Corp. v. Selig (In re Tru-Seal Aluminum Products Corp.)*[93] that "Congress is not required to direct the federal courts to look to state law for the definition of state-created rights asserted in bankruptcy, as it is when federal jurisdiction rests solely on diversity of citizenship. The question is of intent, not of power."[94] Countryman concluded that, in cases in which the Bankruptcy Act was silent, courts should reject state law whenever bankruptcy policy required such re-

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88 This lack of distinction is evident in Hill's conclusion:

> It has been shown that *Swift v. Tyson* stood for a philosophy of law which had substantially the same implications on the equity side of the federal courts as on the law side, and that the repudiation of this philosophy in *Erie R.R. v. Tompkins* had similarly broad implications. It is now clear that the federal courts may make substantive law only in effectuation of a policy derived from the Constitution or from a valid act of Congress. The exercise of non-diversity jurisdiction cannot expand their powers in this respect.
>
> In bankruptcy this means that the power to override state law can be determined only by reference to bankruptcy objectives. . . . [I]n view of the amorphous nature of bankruptcy it is difficult to perceive how bankruptcy objectives may be defined with any precision save in relation to particular problems. Once the bankruptcy objectives are defined in a given situation, the equity jurisdiction of the bankruptcy courts affords a flexible and effective instrument for attaining them.

Id. at 1050.

89 *See* Vern Countryman, *The Use of State Law in Bankruptcy Cases (Part I)*, 47 N.Y.U. L. REV. 407 (1972) [hereinafter Countryman I]; Vern Countryman, *The Use of State Law in Bankruptcy Cases (Part II)*, 47 N.Y.U. L. REV. 631 (1972) [hereinafter Countryman II].

90 *See* Countryman I, *supra* note 89 *passim*; Countryman II, *supra* note 89 *passim*.

91 *See* Countryman I, *supra* note 89, at 409–11.

92 *Id.* at 410 (disagreeing with Hill, *supra* note 82, at 1034–35); *see also supra* notes 82–88 and accompanying text.

93 278 F.2d 143, 147 (2d Cir. 1960) (Friendly, J., concurring).

94 *See* Countryman I, *supra* note 89, at 410 (quoting *Fore Improvement*, 278 F.2d at 147 (Friendly, J., concurring)).

jection:[95] "*Erie* should not be read to mean that state law must be automatically applied."[96]

Countryman's rejection of *Erie* is unpersuasive. Perhaps because he perceived no limits to bankruptcy law, he failed to make any distinction between permissible bankruptcy law and mandatory state law. He did not refute the necessity to make this distinction and to respect the constitutional requirement for the application of state law in bankruptcy.

Countryman's argument reflects the federal policy exception to the use of state law, an exception that complies with the separation of powers aspect of *Erie* and that the Supreme Court enunciated in *Butner* a few years after the publication of Countryman's articles. Almost all of the specific instances of state law that he urged Congress to modify lie well within the reach of the Bankruptcy Power. These include (1) the option of the bankruptcy trustee to assume an executory contract[97] and the abrogation of ipso facto clauses for executory contracts;[98] (2) disallowance of unconscionable claims and subordination of the claims of improvident credit grantors;[99] (3) a simplified and more inclusive definition of property of the estate;[100] (4) uniform provisions for the exemption of property of the estate from creditor claims;[101] (5) clarification and modification of the rules on avoiding preferential transfers,[102] judicial liens,[103] unperfected security interests,[104] and the trustee's general avoidance power;[105] (6) priorities

95 *Id.* at 410–11. Countryman cited *Local Loan Co. v. Hunt*, 292 U.S. 234 (1934) (rejecting a state law that provided that a wage garnishment survived a bankruptcy discharge as incompatible with bankruptcy policy, and announcing that a prepetition lien on wages of an individual did not extend to wages earned by an individual after the filing of the bankruptcy petition). *See* Countryman I, *supra* note 89, at 411 n.23.

96 Countryman I, *supra* note 89, at 411.

97 *Id.* at 420. The trustee's power to assume executory contracts is constitutional if the other party continues to receive the benefit of its bargain. *See* Plank, *supra* note 9, at 1113–26.

98 *See* Countryman I, *supra* note 89, at 425–26; *see also* Plank, *supra* note 9, at 1126–28 (discussing the constitutionality of abrogating ipso facto clauses).

99 *See* Countryman I, *supra* note 89, at 430–31.

100 *Id.* at 473–75; *see also* Plank, *supra* note 9, at 1096–100 (discussing the Debtor-Creditor Adjustment Principle as it relates to the use of property interests of the debtor to satisfy creditor claims). *But see infra* notes 115–16, 118 and accompanying text (discussing Countryman's confused discussion of property resulting from the failure to distinguish when bankruptcy courts may override state law and when they must respect state law).

101 *See* Countryman I, *supra* note 89, at 475–76.

102 *See* Countryman II, *supra* note 89, at 635–39.

103 *Id.* at 640–45.

104 *Id.* at 655–56.

among creditors;[106] and (7) the extent of the discharge of the debtor's debts.[107] All of these issues fall within the Debtor-Creditor Adjustment Principle or the Non-Interference Principle.

Countryman's reliance on Judge Friendly's concurrence in *Fore Improvement*[108] suffers from the same limitation. *Fore Improvement* involved the availability to a creditor of a right of set-off under the Bankruptcy Act. This question is well within the constitutional realm of bankruptcy.

Worse, Countryman took Judge Friendly's statement completely out of context. The majority opinion, citing Hill's article,[109] stated that the "determination of set-off would seem to be intimately related to the distribution of the bankrupt's assets, the essential basis for federal concern."[110] The majority found that the claimed set-off did not meet the "mutuality" requirement for set-off under the Bankruptcy Act.[111] Judge Friendly's concurrence reached the same result by relying instead on state law. After noting that Congress was not required to direct federal courts to look to state law in this case,[112] Judge Friendly applied the separation of powers aspect of *Erie* and presaged the *Butner* principle. "[T]he Bankruptcy Act must be read today in the light of the policy of *Erie*. . . . Absent any overriding bankruptcy policy, it seems to me far more likely that Congress would wish the 'mutuality' of state-created claims to be determined by reference to the law that gave them birth . . . ."[113] Judge Friendly would have then

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105 *Id.* at 658–63.

106 *Id.* at 663–67.

107 *Id.* at 668–73.

108 Fore Improvement Corp. v. Selig (*In re* Tru-Seal Aluminum Prods. Corp.), 278 F.2d 143, 147 (2d Cir. 1960) (Friendly, J., concurring); *see also supra* text accompanying note 94.

109 *See supra* note 82 and accompanying text.

110 *See Fore Improvement*, 278 F.2d at 146.

111 *Id.* In *Fore Improvement*, a tenant had given its landlord a security deposit. *Id.* at 144. The tenant then defaulted on the lease, and the landlord obtained a judgment against the tenant. *Id.* The tenant was then adjudicated a bankrupt, and the bankruptcy trustee sought return of the security deposit. *Id.* The landlord sought to offset the security deposit against its claim. *Id.* Under New York law, the security deposit was to be held in trust for the tenant, but New York courts had permitted set-off when the tenant sought return of the security deposit. *Id.* at 146. The federal court held that, because of the trust characterization under New York law, the obligation to return the security deposit did not satisfy the mutuality requirement of the Bankruptcy Act for a set-off, and it was not bound by the New York cases allowing set-off. *Id.*

112 *Id.* at 147 (Friendly, J., concurring); *see also supra* text accompanying note 94.

113 *Fore Improvement*, 278 F.2d at 147 (Friendly, J., concurring).

ruled against the creditor on the grounds that the creditor had not satisfied the mutuality requirements for a set-off under state law.[114]

Neither the majority opinion nor Judge Friendly's concurrence support the proposition that the primary *Erie* doctrine does not extend to bankruptcy law. At most they represent different views on the extent to which a federal court in bankruptcy should defer to state law on an issue that is within the constitutional realm of bankruptcy.

Countryman's failure to distinguish permissible bankruptcy law and mandatory state law—the failure to distinguish the separation of powers *Erie* doctrine and the primary *Erie* doctrine—led to confusion in his analysis of property of the estate. First, Countryman misread a pre-*Erie* Supreme Court case, *Chicago Board of Trade v. Johnson*,[115] for the proposition that "[w]hat was 'property,' as that term is used in section 70a(5) [of the Bankruptcy Act, defining property of the estate], was said to be a 'federal question.'"[116] As discussed below, this is a questionable characterization of *Chicago Board of Trade*.[117]

Countryman followed this assertion with more confusion: "[W]hile what is 'property' was a question of federal bankruptcy law, the attributes of that property were still determined by state law."[118] This is an illogical statement. The determination of what is "property" cannot be a federal question if the attributes of that property are de-

114 *Id.* at 148 (Friendly, J., concurring).

115 264 U.S. 1 (1924).

116 *See* Countryman I, *supra* note 89, at 438 (quoting *Chicago Board of Trade*, 264 U.S. at 10). Further, Countryman followed his conclusion that "the meaning of 'property' in section 70(5) [of the Bankruptcy Act] is a question of federal bankruptcy law," *id.*, by analyzing cases that addressed the issue of whether an expectancy of future receipts of property items would itself be treated as property. Almost all of the cases that he discussed, however, involved whether such an expectancy would qualify as property under federal nonbankruptcy law. *Id.* at 439–44. The cases include *Williams v. Heard*, 140 U.S. 529, 539, 545 (1891) (upholding an award for indirect losses under federal statute); *Phelps v. McDonald*, 99 U.S. 298, 303–04 (1878) (upholding an award of damage claims under a treaty with Great Britain); *Milnor v. Metz*, 41 U.S. (16 Pet.) 221, 227 (1842) (addressing a federal statute pay increase to a federal employee who had previously been discharged in bankruptcy); *Emerson v. Hall*, 38 U.S. (13 Pet.) 409, 412–14 (1839) (upholding an award under a federal statute of sale proceeds to survivors or heirs of customs agents who seized and sold a ship that was violating slave trading laws); *Comegys v. Vasse*, 26 U.S. (1 Pet.) 193, 216–18 (1828) (upholding an award for damage claims made pursuant to a treaty with Spain twenty-two years after discharge of bankrupt); *Harlan v. Archer*, 79 F.2d 673, 680 (4th Cir. 1935) (finding no existing property interest in claim of damages for condemnation of business later authorized by federal private act); and *In re Ghazal*, 174 F. 809, 811 (2d Cir. 1909) (finding right to a reward from the Secretary of the Treasury under federal statute for informing on smugglers).

117 *See infra* Part V.B.

118 *See* Countryman I, *supra* note 89, at 438.

termined by state law. The statement can only make sense if we add a distinction between what is "property"—the nonbankruptcy issue—and what is "property of the estate" to be distributed to creditors—the bankruptcy issue. Under the Non-Expropriation Principle,[119] Congress has no power under the Bankruptcy Clause to define what is "property." Whether something is property—including its attributes—is a matter of state law. On the other hand, whether any particular property interest should be included in or excluded from the bankruptcy estate is a bankruptcy law question within Congress's Bankruptcy Power.

Finally, in a few instances, Countryman urged Congress to eschew the use of state law for issues that lie beyond the permissible reach of bankruptcy law without providing any justification for disregarding mandatory state law. Specifically, he asserted that the state law right of a party to a contract to demand adequate assurance of due performance[120] should not constrain a bankruptcy trustee's decision to assume or reject an executory contract.[121] He also suggested that Congress could authorize a bankruptcy trustee to transfer property that is nontransferrable under nonbankruptcy law with no apparent regard for the nonbankruptcy law entitlements of third parties.[122] In neither instance, however, does he explain why bankruptcy law may interfere with the rights of third parties who are not creditors.

In my view, these propositions violate the Non-Expropriation Principle.[123] Bankruptcy law may not expropriate the rights of third parties, such as a party to an executory contract[124] or a party who has a

119 *See supra* notes 63, 80 and accompanying text (describing the Non-Expropriation Principle).

120 *See* U.C.C. § 2-609 (2001).

121 *See* Countryman I, *supra* note 89, at 421–23.

122 *Id.* at 474.

123 *See supra* notes 63, 80 and accompanying text (describing the Non-Expropriation Principle).

124 Countryman's discussion on the question of adequate assurance of due performance is problematic because he sees no limits on the trustee's power. The state law right to demand adequate assurance of due performance should not prevent a trustee from having a reasonable but short period of time to decide to assume or reject, and the state law right to cancel the contract upon the failure to receive the assurance can be stayed for a reasonable but short time. Nevertheless, the other party should be able to suspend performance until receiving assurance, and the other party should be fully compensated for any loss occasioned by delay. *See* Plank, *supra* note 9, at 1122–26 (discussing why the Non-Expropriation Principle requires the bankruptcy trustee to honor the state law right of the nondebtor party to an executory contract to adequate assurance of due performance and to suspend performance pending such assurance from the bankruptcy trustee).

legitimate interest in the nontransferability of property interests in the hands of a debtor.[125]

A few judicial decisions have addressed the applicability of *Erie* in bankruptcy. The Supreme Court in *Vanston Bondholders Protective Committee v. Green*[126] rejected the application of *Erie* in a bankruptcy case in holding that a creditor was not entitled to interest on unpaid interest despite the contract. The Court stated that "[i]n determining what claims are allowable and how a debtor's assets shall be distributed, a bankruptcy court does not apply the law of the state where it sits. *Erie Railroad Co. v. Tompkins* has no such implication."[127] If the claims and assets exist, the Court's statement is correct as far as it goes. Determining whether a creditor should receive interest owed on its debt and how much of that interest it should receive is within the permissible realm of bankruptcy law. The Court therefore concluded that the bankruptcy policy favoring the equitable distribution of the debtor's property required the denial of its claim for interest on the unpaid interest.[128]

Justice Frankfurter concurred in the result but disagreed with the majority's promulgation of a federal rule on the payment of interest

125 *See* Plank, *supra* note 9, at 1120–22 (discussing why the Non-Expropriation Principle requires honoring the right of a party to an executory contract or lease to prevent assignment to the extent that state law respects that right).

126 329 U.S. 156 (1946).

127 *Id.* at 162 (citations omitted); *accord* Heiser v. Woodruff, 327 U.S. 726 (1946). The *Heiser* Court stated that "nothing decided in *Erie R.* [sic] *Co. v. Tompkins* requires a court of bankruptcy, in applying the statutes of the United States governing the liquidation of bankrupts' estates, to adopt local rules of law in determining what claims are provable, or to be allowed, or how the bankrupt's estate is to be distributed among claimants." *Id.* at 732 (citations omitted). But the Court held that principles of res judicata precluded the bankruptcy court from relitigating a creditor's judgment that the bankrupt and the bankruptcy trustee had unsuccessfully challenged in nonbankruptcy court. *Id.* at 739–40.

128 *See Vanston Bondholders*, 329 U.S. at 165–67. This is a questionable result, and the Court offers no explanation of why the denial of interest on interest is "equitable." The secured creditors, holders of bonds secured by a mortgage on the debtor's property, had bargained for the payment of interest on any unpaid interest, and the value of the mortgaged property was sufficient to pay the outstanding principal, interest on the principal, and interest on the unpaid interest. The bondholders had not received payments of interest for more than five years, and the amount of the interest on interest totaled approximately $500,000. Interest is simply compensation for the use of money. The bondholders could not cause an immediate foreclosure of their security interest and receive immediate payment, and the reorganization was for the benefit of the unsecured creditors. Therefore, it hardly seems "equitable" to deprive the bondholders of their entitlements—interest on their unpaid interest, if permitted by state law—and divert their entitlements to the unsecured creditors.

on the unpaid interest.[129] His analysis neatly summarized both the primary *Erie* doctrine and the Non-Expropriation Principle.[130] First, he noted that "it was beyond the power of federal law to create" the claim for interest on the unpaid interest.[131] He amplified this statement:

> The business of bankruptcy administration is to determine how existing debts should be satisfied out of the bankrupt's estate so as to deal fairly with the various creditors. The existence of a debt between the parties to an alleged creditor-debtor relation is independent of bankruptcy and precedes it. . . . 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. Except for the very limited obligations created by Congress, . . . a debt is not brought into being by federal law. Obligations exist or do not exist by force of State law though federal bankruptcy legislation is in force . . . . The fact that subsequent to the creation of a debt a party comes into a bankruptcy court has no relevance to the rules concerning the creation of the obligation.[132]

Justice Frankfurter recognized that existence of a claim may not require that the claim be allowed in bankruptcy. That is a matter for bankruptcy law. Nevertheless, Justice Frankfurter stated correctly that the existence of a claim under state law is a necessary condition to its allowance in bankruptcy:

> Of course a State may affix to a transaction an obligation which . . . federal courts need not enforce because of overriding considerations of policy. And so, in the proper adjustment of the rights of creditors and the desire to rehabilitate the debtor, Congress under its bankruptcy power may authorize its courts to refuse to allow existing debts to be proven. . . . But the threshold question for the allowance of a claim is whether a claim exists. And clarity of analysis justifies repetition that except where federal law, wholly apart from bankruptcy, has created obligations by the exercise of power granted to the federal government, a claim implies the existence of an obligation created by State law. If there was no valid claim before bankruptcy, there is no claim for a bankruptcy court either to recognize or to reject.[133]

129 *Id.* at 167–73 (Frankfurter, J., concurring).

130 *See supra* notes 63, 80 and accompanying text (describing the Non-Expropriation Principle).

131 *See Vanston Bondholders*, 329 U.S. at 168 (Frankfurter, J., concurring).

132 *Id.* at 169 (Frankfurter, J., concurring).

133 *Id.* at 169–70 (Frankfurter, J., concurring).

Justice Frankfurter repeated his observation that if state law has not created a claim, then a federal court in bankruptcy need not decide as a matter of bankruptcy policy whether and to what extent that claim should be recognized.[134] Finding that, under the applicable state law, the covenant to pay interest on interest was void, Justice Frankfurter rejected the necessity for deciding whether bankruptcy policy permitted or rejected the payment of interest on interest for fully secured creditors.[135] Indeed, if Justice Frankfurter was correct in his reading of state law, the court could not include the claim in the bankruptcy case.

III. The Bankruptcy Trust and the Federal Entity Exception

Several years after *Erie*, the Supreme Court held in *Clearfield Trust Co. v. United States*[136] that a federal court properly applies federal common law to a check issued by the federal government.[137] Clearfield Trust was a guarantor of prior indorsements on a federal government check that contained a forged indorsement of the payee's signature.[138] The federal government was tardy in notifying Clearfield Trust of the forgery.[139] Under applicable state law, the delay would have discharged the guarantor's liability.[140] The Court held, however, that *Erie* did not require the application of state law, that federal law applied, and that in the absence of direct federal statutory authority, federal courts could fashion a federal common law rule.[141] The Court declined to apply *Erie* because the federal government had a direct interest in a uniform rule that applied throughout the United

134 *Id.* at 170 (Frankfurter, J., concurring).

> [N]othing comes into a bankruptcy court to which congressional policy can apply unless it is an obligation created by applicable State law. And no obligation finds its way into a bankruptcy court unless by the law of the State where the acts constituting a transaction occur, the legal consequence of such a transaction is an obligation to pay.

Id.; see also id. at 171:

> [T]he existence of a debt comes about not by federal law but by force of some State law, even though the right to enforce the debt, if it exists, may raise federal questions if bankruptcy ensues. Bankruptcy legislation is superimposed upon rights and obligations created by the laws of the States.

135 *Id.* at 171–72 (Frankfurter, J., concurring) (applying New York law).

136 318 U.S. 363 (1943).

137 *Id.* at 366.

138 *See id.* at 364–65.

139 *See id.* at 365.

140 *See id.* at 366.

141 *Id.*

States.[142] The Court then applied a federal rule that the federal government's delay in notifying the guarantor of the forgery of a prior indorsement did not automatically discharge the guarantor.[143] Since *Clearfield Trust*, many courts have recognized that *Erie* does not apply when a federal entity is a party to the issue being litigated.[144]

Because of the dual nature of bankruptcy law—a federal law that may or may not alter state law, depending on the issue—*Clearfield Trust* and the primary *Erie* doctrine co-exist in bankruptcy. *Clearfield Trust* is consistent with the exception in *Butner* that authorizes the use of a federal bankruptcy rule.

Specifically, the Bankruptcy Code creates a federal entity. Many have characterized the bankruptcy estate as this entity.[145] Because the Code defines the bankruptcy estate as a collection of assets, I believe that this separate entity should more properly be characterized as the

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142 *Id.* at 367.

143 The Court applied the rule of *United States v. National Exchange Bank of Providence*, 214 U.S. 302 (1909), that a delay in notification does not bar the United States' cause of action for breach of a warranty of presentment. The Court had developed this rule under *Swift v. Tyson*, 41 U.S. (16 Pet.) 1 (1842), as general commercial law, no longer valid under *Erie*. Nevertheless, the Court accepted this rule as a good source for a federal rule. *See Clearfield Trust*, 318 U.S. at 367–69. In addition, the Court stated that delay in notification could be a defense. *Id.* at 369–70. The Court affirmed the decision of the U.S. Circuit Court of Appeals for the Third Circuit, which had held that an unreasonable delay that caused loss to the presenter could be a defense and remanded the case for further proceedings. *See* United States v. Clearfield Trust Co., 130 F.2d 93, 95–96 (3d Cir. 1942).

144 *See* 19 WRIGHT ET AL., *supra* note 15, § 4515, at 482–500.

145 *See* CHARLES JORDAN TABB, THE LAW OF BANKRUPTCY § 5.1, at 271 (1997) (describing the estate as a separate and distinct legal entity); ELIZABETH WARREN, BUSINESS BANKRUPTCY 41 (1993); ELIZABETH WARREN & JAY LAWRENCE WESTBROOK, THE LAW OF DEBTORS AND CREDITORS 178 (4th ed. 2001) (commenting that the creation of the estate is "as if a new corporation or a new trust had been established"); Donald P. Board, *Retooling "A Bankruptcy Machine That Would Go of Itself,"* 72 B.U. L. REV. 243, 260–63 (1992) (reviewing DOUGLAS G. BAIRD & THOMAS H. JACKSON, CASES, PROBLEMS, AND MATERIALS ON BANKRUPTCY (2d ed. 1990)); Ralph Brubaker, *On the Nature of Federal Bankruptcy Jurisdiction: A General Statutory and Constitutional Theory*, 41 WM. & MARY L. REV. 743, 813 (2000) (arguing that the status of the bankruptcy estate as a federal entity provides the foundation for federal bankruptcy jurisdiction); Jesse M. Fried, *Executory Contracts and Performance Decisions in Bankruptcy*, 46 DUKE L.J. 517 (1996) (referring to the status of the bankruptcy estate in the context of executory contracts); Donald R. Korobkin, *Rehabilitating Values: A Jurisprudence of Bankruptcy*, 91 COLUM. L. REV. 717, 721–22, 769–72 (1991) (arguing that the bankruptcy estate should be viewed as a dynamic separate legal entity through which the different values of the participants in the debtor's financial distress are recognized and reconciled). *But see* Stephen McJohn, *Person or Property? On the Legal Nature of the Bankruptcy Estate*, 10 BANKR. DEV. J. 465, 470–71 (1994) (arguing that the bankruptcy estate is not a separate legal entity).

bankruptcy trust. The Code provides for the appointment of a trustee (including the debtor in possession) with powers to operate a trust estate, the bankruptcy estate, for a specific purpose and therefore creates an entity that has all of the primary attributes of a business or statutory trust—long recognized as a distinct legal person.[146] In any event, whether the estate or the bankruptcy trust is the federal entity, this federal entity provides the foundation for the jurisdiction of federal courts in bankruptcy.[147] Thus, because the bankruptcy entity serves as the basis of federal bankruptcy jurisdiction, federal courts in bankruptcy may create federal common law under the holding of *Clearfield Trust.*

Clearfield Trust applies, however, only to the extent that the bankruptcy trust as a federal entity is operating within its permissible constitutional powers. In *Clearfield,* as the Court expressly noted, the activities of the federal government that generated the issue to be resolved by federal common law—the issuance of its checks to pay its debts—were well within the federal government's constitutional powers.[148] Similarly, federal courts in bankruptcy may create federal bankruptcy common law, if the Code is silent, when the issue involves the adjustment of the insolvent debtor-creditor relationship.[149]

On the other hand, there is nothing in *Clearfield Trust* or its progeny[150] to suggest that a federal court can create federal common law on issues that are outside of the scope of federal power under the Constitution even if a federal entity is a party to the litigation. Congress may not empower any federal entity to exceed Congress's limitations under the Constitution. In a bankruptcy case, then, Congress may not authorize a federal court to exceed the permissible scope of bankruptcy law simply because the Bankruptcy Code creates a federal entity, the bankruptcy trust.

For example, under the Non-Expropriation Principle, Congress may not empower the bankruptcy trust or the bankruptcy estate as a federal entity to expropriate the property of third parties for distribution to the debtor or the creditors. Congress may not empower a bankruptcy court to give an individual debtor a divorce simply be-

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146 *See* Thomas E. Plank, *The Bankruptcy Trust as a Legal Person,* 35 WAKE FOREST L. REV. 251 (2000).

147 *See* Brubaker, *supra* note 145, at 813–31.

148 *See* Clearfield Trust Co. v. United States, 318 U.S. 363, 366 (1943) ("The rights and duties of the United States on commercial paper which it issues are governed by federal rather than local law. When the Unites States disburses its funds or pays its debts, it is exercising a constitutional function or power.").

149 *See, e.g., supra* notes 70–71 and accompanying text.

150 *See* 19 WRIGHT ET AL., *supra* note 15, § 4515, at 482–500.

cause the activities of the bankruptcy trust may result in a discharge of the debtor's debts and give the debtor a "fresh start." Federal courts in bankruptcy have no greater power. Federal courts may implement the Bankruptcy Code within the limits of the Bankruptcy Power. The status of the bankruptcy trust as a federal entity does not authorize federal courts to create a federal common law rule in bankruptcy that exceeds what Congress can do under the Bankruptcy Power.

IV. Equity and *Erie* in Bankruptcy

A. *Federal Courts' Equitable Powers Under* Erie

Before *Erie*, federal courts exercised broad powers as courts of equity, including the power to grant forms of equitable relief in diversity cases that were not available in state courts.[151] *Erie* called into question the extent to which federal courts could disregard state law in the name of equity.[152] Several years later, the Supreme Court in *Guaranty Trust Co. v. York*[153] held that a federal court's equity powers could not materially affect the substantive rights of diversity liti-

151 *See* Guffey v. Smith, 237 U.S. 101, 114–17 (1915) (authorizing the grant of injunctive relief even though not available under Illinois law); *see also* Waterman v. Canal-La. Bank & Tr. Co., 215 U.S. 33, 43–47 (1909) (upholding the federal court's jurisdiction to determine the rights of a legatee under a will without interfering with the administration of the estate by the state probate court); Miss. Mills v. Cohn, 150 U.S. 202, 204–06 (1893) (holding that a creditor could maintain a bill in equity for the return of fraudulently transferred property notwithstanding an adequate remedy at law that would preclude such a bill under state law); Dodge v. Tulleys, 144 U.S. 451, 457–58 (1892) (holding that the federal rule of equity allowing compensation to trustees, including reimbursement for attorneys' fees, in administering a trust prevailed over a state law provision disallowing the payment of attorneys' fees); McConihay v. Wright, 121 U.S. 201, 205–06 (1887) (holding that a bill in equity to quiet title to land could be maintained in federal court notwithstanding the availability of an action for ejectment under state law that would preclude such a bill); Payne v. Hook, 74 U.S. (7 Wall.) 425, 430 (1869) (holding that a federal court could entertain a suit in equity for an accounting and other equitable relief against an administrator of an intestate's property notwithstanding state law that permitted such actions in the state probate court); Livingston v. Story, 34 U.S. (9 Pet.) 632, 653–59 (1835) (holding that a federal court could entertain a suit in equity to declare a sale of land to be merely a pledge and to have an accounting of rents and profits of the property despite the absence of such relief under Louisiana law); United States v. Howland, 17 U.S. (4 Wheat.) 108, 115 (1819) (holding that a creditor could maintain a bill in equity for the return of property even though such bill could not be maintained in state court because state law granted the creditor a remedy at law); 19 Wright et al., *supra* note 15, § 4513, at 425–29; Hill, *supra* note 82, at 1027–29.

152 *See* 19 Wright et al., *supra* note 15, § 4513, at 434.

153 326 U.S. 99 (1945).

gants[154] and that therefore a suit brought in federal court was subject to the applicable state's statute of limitations. In its discussion, however, the Court did not eliminate all federal court equity powers. It noted that "federal equity is a separate system . . . properly understood,"[155] by which federal courts may afford relief that the Court of Chancery could have afforded in England in the eighteenth century.[156] Indeed, the Court specifically noted that a "federal court may afford an equitable remedy for a substantive right recognized by a State even though a State court cannot give it."[157] Nevertheless, broader notions of a general equity power "have been replaced by a sharper analysis of what federal courts do when they enforce rights that have no federal origin."[158]

During the first half of the twentieth century, federal courts in bankruptcy relied heavily on their equity powers to override creditors' state law rights in resolving issues on which the Bankruptcy Act of 1898 was silent.[159] A prominent example is the 1935 Supreme Court

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154 *Id.* at 108–09. The Court noted that the right to recover was derived from the state and not the United States, and held that

> since a federal court adjudicating a State-created right solely because of the diversity of citizenship of the parties is for that purpose, in effect, only another court of the State, it cannot afford recovery if the right to recover is made unavailable by the State nor can it substantially affect the enforcement of the right as given by the State.

Id.

155 *Id.* at 105.

156 *Id.*; Sprague v. Ticonic Nat'l Bank, 307 U.S. 161, 164–65 (1939); Hill, *supra* note 82, at 1027–29.

157 *Guaranty Trust*, 326 U.S. at 106.

158 *Id.* at 112.

159 Federal courts' equity powers also played an important role in reorganizing insolvent corporations before the enactment of the Bankruptcy Act of 1898 through the creation of the equity receivership. The equity receivership first developed in the nineteenth century, when there was no bankruptcy law in effect, to resolve the insolvency of interstate railroads. At the petition of a creditor or the railroad, a federal court would, under its general powers as a court of equity, appoint a receiver who would operate the railroad until it could be sold as a going concern instead of being liquidated. Use of the equity receivership expanded to corporations and became the dominant method for corporate reorganization until the 1930s, when Congress added comprehensive reorganization provisions to the Bankruptcy Act of 1898. *See* 6 COLLIER ON BANKRUPTCY ¶ 0.04, at 28–61 (James Wm. Moore ed., 14th ed. Supp. 1978) (noting that "reorganization through a federal equity receivership was easily the most popular and practicable procedure available prior to the enactment in 1933 and 1934 of §§ 77 and 77B"); DAVID A. SKEEL, JR., DEBT'S DOMINION: A HISTORY OF BANKRUPTCY LAW IN AMERICA 50–69, 100–23 (2001) (describing the development of the equity receivership and its replacement by the corporate reorganization acts of 1934–1938); Charles Jordan Tabb, *The History of the Bankruptcy Laws in the United States,*

decision, *Continental Illinois National Bank & Trust Co. v. Chicago, Rock Island & Pacific Railway Co.*,[160] involving a railroad reorganization under section 77 of the Bankruptcy Act of 1898.[161] In *Rock Island*, the railroad filed a petition for reorganization and requested an injunction prohibiting several secured creditors holding mortgage bonds issued by the railroad as collateral from selling the collateral to repay their debts.[162] No specific provision of the Bankruptcy Act authorized such an injunction.[163] Nevertheless, the district court sitting as a bankruptcy court granted the request,[164] and the Supreme Court upheld the injunction.[165] The Court stated that a bankruptcy court was essentially a court of equity[166] and that the power to issue an injunction when necessary to prevent the impairment of its jurisdiction was inherent in a court of bankruptcy as a court of equity.[167]

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3 AM. BANKR. INST. L. REV. 5, 21–23 (1995) (stating that the use of equity receivership "blossomed in the late nineteenth century").

160 294 U.S. 648 (1935).

161 *Id.* at 656–57.

162 *Id.*

163 *Id.* at 651.

164 *Id.* at 666.

165 *Id.* at 675–84.

166 The Court quoted the statutory language giving bankruptcy courts "such jurisdiction at law and in equity as will enable them to exercise original jurisdiction in bankruptcy proceedings." *Id.* at 675 (quoting Bankruptcy Act of 1898, 11 U.S.C. § 11 (1934)) (internal quotation marks omitted). The Court also relied on the All Writs Act, 28 U.S.C. § 377 (1934) (codified as amended at 28 U.S.C. § 1651(a) (2000)), which authorized U.S. courts "to issue all writs not specifically provided for by statute, which may be necessary for the exercise of their respective jurisdictions." *Id.* (internal quotation marks omitted).

167 *Id.* The Court also recited the grant of jurisdiction to bankruptcy courts in section 2(15) of the Act to issue orders necessary for the enforcement of the Act's provisions. *Id.* at 676 (citing Bankruptcy Act of 1898, 11 U.S.C. § 11(15) (1934) (empowering the bankruptcy court to "make such orders, issue such process, and enter such judgments in addition to those specifically provided for as may be necessary for the enforcement of the provisions of this act")).

In addition, the Court noted that the bankruptcy court had summary jurisdiction over the debtor's "property." It stated that the debtor had equity in the collateral, that this equity was a property interest, and that it was "property" within the statutory grant of jurisdiction. *Id.* at 681, 683. Accordingly, the Court concluded that the bankruptcy court had the power to issue the injunction and had properly exercised its discretion. *Id.* at 676. *See generally* Plank, *supra* note 70 (discussing *Rock Island* and other related cases). The Court also held that the reorganization provisions of section 77 were within the congressional power under the Bankruptcy Clause. *Id.* at 671. *See generally* Thomas E. Plank, *Constitutional Limits of Bankruptcy*, 63 TENN. L. REV. 487, 541–42 (1996) (discussing the Court's views of Congress's power to legislate under the Bankruptcy Clause).

In several cases decided after *Erie*, the Supreme Court upheld the reliance by the bankruptcy courts on their equitable powers to overrule creditors' state law rights. For example, in *Taylor v. Standard Gas & Electric Co.*,[168] the Court held that considerations of equity and the conduct of the holder of all the debtor's common stock who also held debt claims against the debtor required the subordination of those debt claims to the claims of unaffiliated holders of preferred stock.[169] In *Pepper v. Litton*,[170] the Court held that the bankruptcy court had the power to disallow the claim of the debtor's stockholder for salary, evidenced by a confessed judgment entered under questionable circumstances.[171]

These decisions are consistent with the primary *Erie* doctrine. These cases involved the use of the special federal bankruptcy common law power to adjust the debtor-creditor relationship when the Bankruptcy Act was silent. None exceeded the Bankruptcy Power. Enjoining a creditor's collection action against the debtor or subordinating one creditor of a debtor to another falls squarely within the Debtor-Creditor Adjustment Principle and therefore is within the "subject of bankruptcies."

On the other hand, in *Callaway v. Benton*,[172] the Court rejected the use of federal equity powers in a situation that was beyond Congress's Bankruptcy Power. In this case, an insolvent railroad leasing real estate, including railroad lines, from another railroad not in bankruptcy proposed a plan of reorganization providing that the reorganizing railroad would acquire the other railroad's reversionary interest in the real estate.[173] The lessor railroad agreed to sell its reversion if a majority of its stockholders approved the sale, which they did.[174] Minority shareholders of the lessor railroad then sought an injunction in Georgia courts against the sale on the grounds that Georgia law required unanimous stockholder approval of a sale of all of the lessor's assets.[175] The trustee for the reorganizing railroad sought a permanent injunction against the state court litigation, which the federal district court sitting as a court of bankruptcy

168 306 U.S. 307 (1939).

169 *Id.* at 313–14, 322–23, *see also* Hill, *supra* note 82, at 1014–15 (discussing *Taylor*).

170 308 U.S. 295 (1939).

171 *Id.* at 296, 311–12.

172 336 U.S. 132 (1949).

173 *Id.* at 134–36 & 134 n.1.

174 *Id.* at 136 (noting that 30,137 shares voted in favor of the sale and 9057 opposed).

175 *Id.* at 135–36.

granted. The district court held that the state action interfered with the consummation of the reorganization plan and that the question of the legal standards for the seller's approval of the sale was a federal and not a state law question.[176] On appeal, the Court of Appeals for the Fifth Circuit reversed, and the Supreme Court affirmed the reversal.

First, the Supreme Court noted that the Bankruptcy Act "gives no clue to what proportion of the lessor's stockholder must vote to accept the offer if state law is not controlling."[177] The Court then held that the bankruptcy court's jurisdiction over the bankruptcy estate did not give it jurisdiction to decide the state law issue:[178] "Congress did not give the bankruptcy court exclusive jurisdiction over all controversies that in some way affect the debtor's estate."[179] The bankruptcy court had jurisdiction over the debtor's interest in the railroad property, a leasehold interest, but it did not have jurisdiction over the lessor's reversionary interest, the subject of the state court action.[180]

The Court expressly found no basis in the Bankruptcy Act for the injunction:

> The bankruptcy power unquestionably gives the . . . court, working within the framework of the [Bankruptcy] Act, full and complete power not only over the debtor and its property, but also, as a corollary, over any rights that may be asserted against it. These rights may be altered in any way thought necessary to achieve sound financial and operation conditions for the reorganized company, subject to the requirement of the Act. The purchase of formerly leased property does not involve rights asserted against the debtor, however. . . . We conceive the jurisdiction asserted by the district court over a solvent lessor not in reorganization to be an extension of these traditional powers not justified by any provision of the Bankruptcy Act.[181]

The Court did not indicate any constitutional basis for the limitation on the bankruptcy court's power. Nevertheless, it is my view that the limits of the Bankruptcy Clause, and specifically the Non-Expropriation Principle, prevented the bankruptcy court from interfering with the state law rights of the stockholders of the nondebtor railroad.

176 *Id.* at 136–37.

177 *Id.* at 139. The Court also rejected other proffered statutory grounds for the injunction. *Id.* at 139–40 (concluding that the Interstate Commerce Act did not authorize the injunction).

178 *Id.* at 141–42.

179 *Id.* at 142.

180 *Id.* at 142–44.

181 *Id.* at 147–48.

It remains fashionable to say that bankruptcy courts are "courts of equity."[182] This statement had some validity under the Bankruptcy Act of 1898 because under that Act the "bankruptcy court" was the U.S. District Court, which did have broad equity powers.[183] This characterization, however, is not accurate under the Bankruptcy Code. Under the Code, bankruptcy courts are not Article III courts and do not have the full equity powers of Article III courts.[184] They are courts of limited jurisdiction that do have some equitable powers.[185] As the successors to the "commissioners of bankrupt" under the English Bankrupt Acts,[186] the justices of the peace under the English Insolvency Acts,[187] the commissioners under the Bankruptcy Act of 1800,[188] and the referees under the Bankruptcy Act of 1898,[189] however, bankruptcy courts have never been part of the equity court system.[190] They have, and can only have, those equitable powers that Congress can grant them under the Bankruptcy Clause.

Whatever the status of federal courts in bankruptcy as "courts of equity," the Supreme Court has reined in their ability to use equity as a means of altering state created rights even in areas well within Con-

182 *See, e.g.*, Young v. United States, 535 U.S. 43, 50 (2002). In holding that a lookback period allowing the Internal Revenue Service to collect taxes against a debtor was equitably tolled during an earlier bankruptcy case, the Court in 2002 stated that "bankruptcy courts . . . are courts of equity and 'appl[y] the principles and rules of equity jurisprudence.'" *Id.* (citing Pepper v. Litton, 308 U.S. 295, 304 (1939), which was decided under the Bankruptcy Act of 1898); *see also* Marcia S. Krieger, *"The Bankruptcy Court Is a Court of Equity": What Does That Mean?*, 50 S.C. L. REV. 275, 275–76 (1999) (noting correctly that the frequent but misleading characterization of the bankruptcy court as a court of equity more often confuses than clarifies the role of the bankruptcy court).

183 *See* Bankruptcy Act of 1898, 11 U.S.C. § 11(15) (1976) (repealed 1978); *see also supra* note 166 and accompanying text.

184 *See generally* Plank, *supra* note 57 (arguing that bankruptcy judges need not be Article III judges to adjudicate bankruptcy law issues).

185 *See* 11 U.S.C. § 105(a) (2000) (providing that the bankruptcy court "may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of [title 11]").

186 *See generally* Plank, supra note 57, at 575–90 (discussing the role of commissioners of bankrupt adjudicating bankruptcy issues under the English Bankrupt Acts).

187 *See generally id.* at 596–99 (discussing the role of justices of the peace adjudicating bankruptcy issues under the English Insolvency Acts).

188 *See generally id.* at 606–10 (discussing the role of commissioners adjudicating bankruptcy issues under the Bankruptcy Act of 1800).

189 Bankruptcy Act of 1898, ch. 541, §§ 33, 34, 38, 39, 30 Stat. 544, 555–56 (codified as amended at 11 U.S.C. §§ 61, 62, 66, 67 (1976) (repealed 1978)) (specifying the appointment, jurisdiction, and duties of referees, the predecessors to current bankruptcy judges).

190 *See* Krieger, *supra* note 182, at 277–85.

gress's Bankruptcy Power. For example, the Court in *Butner v. United States*[191] imposed significant limitations on a bankruptcy court's ability to rely on principles of equity to alter a creditor's state law rights. Indeed, although many courts have cited *Butner* for the proposition that federal courts in bankruptcy should look to state law,[192] *Butner* is more significant for signaling the demise of a broad use of equity powers by courts to "do equity." The Court stated:

> The equity powers of the bankruptcy court play an important part in the administration of bankrupt estates in countless situations in which the judge is required to deal with particular, individualized problems. But undefined considerations of equity provide no basis for adoption of a uniform federal rule affording mortgagees an automatic interest in the rents as soon as the mortgagor is declared bankrupt.[193]

The Supreme Court recently reiterated *Butner*'s limitations on the use of a federal equity power in bankruptcy in *United States v. Reorganized CF&I Fabricators of Utah, Inc.*,[194] *United States v. Noland*,[195] and most recently *Raleigh v. Illinois Department of Revenue*.[196]

Butner and these more recent decisions limit the ability of federal courts in bankruptcy to use a general equity power to overrule state law entitlements when Congress has not specified a particular rule even though Congress does have the power under the Bankruptcy

191 440 U.S. 48 (1979).

192 *See supra* note 25.

193 *Butner*, 440 U.S. at 55–56.

194 518 U.S. 213, 228–29 (1996).

195 517 U.S. 535, 539–43 (1996). In both *CF&I* and *Noland*, the lower courts subordinated noncompensatory tax penalty claims to the claims of general unsecured creditors on the grounds that it would be inequitable to allow such claims to reduce the recoveries of creditors who suffered actual pecuniary losses. *CF&I*, 518 U.S. at 217–18; *Noland*, 517 U.S. at 537–39. This ability to subordinate certain creditors' claims on equitable grounds was a power historically exercised by bankruptcy courts and is not codified in the Bankruptcy Code. *See* 11 U.S.C. § 510(c) (2000). *See generally* Robert M. Lawless, *Legisprudence Through a Bankruptcy Lens: A Study in the Supreme Court's Bankruptcy Cases*, 47 SYRACUSE L. REV. 1, 94–100 (1996) (discussing equitable subordination and the *Noland* and *CF&I* cases). Nevertheless, in *Noland*, the Supreme Court reversed the equitable subordination in this case and held "that (in the absence of a need to reconcile conflicting congressional choices) the circumstances that prompt a court to order equitable subordination must not occur at the level of policy choice at which Congress itself operated in drafting the [Bankruptcy] Code." 517 U.S. at 543.

196 530 U.S. 15, 24–25 (2000) ("Bankruptcy courts are not authorized in the name of equity to make wholesale substitution of underlying law controlling the validity of creditors' entitlements, but are limited to what the Bankruptcy Code itself provides.").

Clause to do so. These decisions show a respect for federalism inherent in the separation of powers aspect of the *Erie* doctrine.

This respect for the separation of the judicial and legislative powers inherent in *Butner* and these other cases does not contradict the primary *Erie* doctrine. Congress could have empowered federal courts in bankruptcy to use a far-reaching federal bankruptcy equity power to resolve the issues that arose in *Butner* and the other cases. These cases involved the adjustment of the debtor-creditor relationship. On the other hand, Congress can not expand its power under the Constitution by delegating to a federal court a broad equity power. Under the primary *Erie* doctrine, then, federal courts in bankruptcy may not use their equity power to go beyond Congress's power under the Constitution. To the extent that equity plays a role in bankruptcy, that role must be confined to the limits of bankruptcy law.

B. *Expropriation in the Name of Equity*

Despite the many admonitions of the Supreme Court and other courts to limit their use of equity powers to matters authorized by the Code, some federal courts in bankruptcy have used their powers as courts of equity under § 105 of the Code[197] to abrogate state law interests of creditors in ways that exceed Congress's Bankruptcy Power. The mandatory release of creditor claims against nondebtor co-obligors is a prominent example of actual impermissible expropriation of creditors' rights for the benefit of third parties. A related, but permissible, use of equity if properly constrained is the temporary stay of creditor actions against nondebtor co-obligors.

1. Nondebtor Releases

When a debtor enters bankruptcy, creditors may naturally seek to collect all or a part of the debts owed to them from other persons who may share liability with the debtor. These other nondebtor co-obligors may include officers; directors; shareholders of the debtor; the debtor's insurers; lenders to the debtor; underwriters and financial and investment advisors for the debtor; and other joint tortfeasors. In Chapter 11 cases and their predecessors under the Bankruptcy Act of 1898,[198] these debtors and the related nondebtor co-obligors have for many years sought, pursuant to a confirmed reorganization plan or

197 *See* 11 U.S.C. § 105(a) (providing that the bankruptcy court "may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of [title 11]").

198 *See, e.g.*, Callaway v. Benton, 336 U.S. 132 (1949); *see also supra* notes 172–81 and accompanying text.

the bankruptcy court's equitable powers under § 105, to obtain the voluntary and involuntary release by creditors of claims that such creditors may have against the nondebtor co-obligors. Many courts have refused to allow involuntary releases of nondebtors,[199] and at least one court has disallowed even voluntary releases.[200] Nevertheless, despite the absence of any specific statutory authority, some courts have approved plans that release some or all of these nondebtor co-obligors from their liability to creditors. These courts often enter an accompanying mandatory injunction preventing the affected creditors from pursuing their claims against the released nondebtor co-obligors.[201]

In re Dow Corning Corp.[202] illustrates the use of nondebtor releases. This case involved a confirmed reorganization plan for the Dow Corning Corporation that resolved massive tort litigation against Dow Corning for its sale of silicon gel breast implants. The plan contained mandatory releases of claims against nondebtors and enjoined any action to enforce a claim against the specified nondebtors. Specifically, the plan provided that personal injury claims held by Dow Corning's creditors against the debtor's shareholders, subsidiaries, other affiliates, their representatives, insurance companies that had settled with the debtor, and physicians and health care providers that settled with the debtor were deemed waived and released.[203] The plan also provided that the holders of these claims were enjoined from commencing or continuing any action seeking to enforce their claims against the released parties.[204] Moreover, many of the claims

199 *See* Ralph Brubaker, *Nondebtor Releases and Injunctions in Chapter 11: Revisiting Jurisdictional Precepts and the Forgotten* Callaway v. Benton *Case*, 72 AM. BANKR. L.J. 1, 10–11 & n.46 (1998) (describing cases disallowing nonconsensual releases of nondebtors).

200 *See* Bill Roderick Distrib., Inc. v. A.J. Mackay Co. (*In re* A.J. Mackay Co.), 50 B.R. 756, 763 (Bankr. D. Utah 1985) (holding that bankruptcy court does not have jurisdiction to authorize consensual nondebtor releases).

201 *See* Ralph Brubaker, *Bankruptcy Injunctions and Complex Litigation: A Critical Reappraisal of Non-Debtor Releases in Chapter 11 Reorganizations*, 1997 U. ILL. L. REV. 959, 962–64 (describing prominent cases allowing nonconsensual releases); Brubaker, *supra* note 199, at 2–6 (same); *see also In re* Cont'l Airlines, Inc., 203 F.3d 203, 212–13, 215 (3d Cir. 2000) (surveying the law regarding nondebtor releases and reversing a bankruptcy court order approving a reorganization plan containing a nonconsensual release of the debtor's officers and directors); Sally S. Neely, *The Continuing Debate re: Non-Debtor Releases/Permanent Injunctions in Chapter 11*, *in* CHAPTER 11 BUSINESS REORGANIZATIONS 385 (ALI-ABA eds., May 1–3, 2003).

202 Class Five Nev. Claimants v. Dow Corning Corp. (*In re* Dow Corning Corp.), 280 F.3d 648 (6th Cir. 2002), *rev'g In re* Dow Corning Corp., 255 B.R. 445 (E.D. Mich. 2000).

203 *See In re Dow Corning Corp.*, 255 B.R. at 475.

204 *Id.*

were released and enjoined whether the creditors had consented to the plan or not.

The bankruptcy court had confirmed the plan, but held that the nondebtor co-obligor releases applied only to creditors who voted to accept the plan.[205] The district court affirmed the confirmation of the plan, but overruled the bankruptcy court's ruling regarding the nonconsenting creditors.[206] It held that the plan's provision releasing the nondebtor co-obligors bound nonconsenting creditors.[207] On further appeal, the court of appeals held that the bankruptcy court had the power to release nondebtor co-obligors from the claims of nonconsenting creditors but that there was insufficient factual basis for such action.[208] On remand, the district court made specific findings and approved the mandatory release of nonconsenting creditors.[209]

Dow Corning illustrates the tremendous difficulties that attend mass tort litigation against a company, its parents, its affiliates, and other defendants, including insurance companies and, in the case of medical products, physicians and health care providers. It also illustrates the tendency of federal courts in bankruptcy to exalt a successful reorganization plan over all other values. In the case of Dow Corning, the desire to implement a successful reorganization of a debtor using bankruptcy to resolve its potential mass tort liability allowed Dow Corning's two stockholders, Corning, Inc., and Dow Chemical Corp., to use their control over the debtor to obtain releases from their creditors that they could not have obtained outside of bankruptcy.[210]

Professor Ralph Brubaker has convincingly demonstrated that mandatory, involuntary releases of nondebtor co-obligors violates sound bankruptcy policy and exceeds the jurisdiction of bankruptcy courts.[211] I take this view one step further. Beyond questions of policy and jurisdiction, in my view, the involuntary release of claims that

205 *Id.*

206 *Id.* at 480–81.

207 *Id.*

208 *See* Class Five Nev. Claimants v. Dow Corning Corp. (*In re* Dow Corning Corp.), 280 F.3d 648, 655–58 (6th Cir. 2002).

209 *See In re* Dow Corning Corp., 287 B.R. 396 (E.D. Mich. 2002). Because the bankruptcy judge who had presided over the proceedings recused himself in December 2001, the district judge withdrew the reference of this case from the bankruptcy court and made the necessary findings. *Id.* at 401–02.

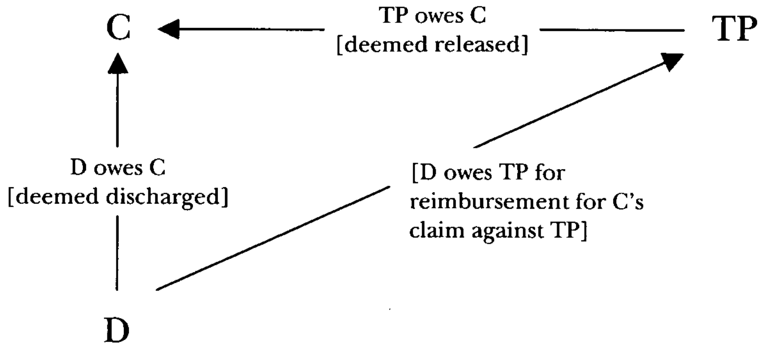
210 *In re Dow Corning Corp.*, 280 F.3d at 654–55.

211 *See* Brubaker, *supra* note 201 *passim* (discussing how nondebtor releases violate both bankruptcy policy and the limits on bankruptcy jurisdiction); Brubaker, *supra* note 199 *passim* (describing why bankruptcy courts lack jurisdiction to grant nonconsensual releases of nondebtors).

creditors of the debtor have against nondebtor co-obligors violates the Non-Expropriation Principle and therefore exceeds Congress's power under the Bankruptcy Clause. Federal courts in bankruptcy may not approve or enforce such releases, no matter how much the releases may be "equitable" or useful for a successful reorganization.

Figure 1 illustrates the effect of the nondebtor co-obligor releases on the parties:

FIGURE 1



Assume that creditor *C* has a products liability claim against debtor *D* for $100. Assume also that *C* has a claim against *TP* for the same cause of action on the grounds that *TP* is jointly and severally liable under state law. In many cases, when creditor *C* has a claim against both the debtor *D* and the nondebtor third party *TP*, the third party *TP* will also have a contingent claim against *D* for indemnification or contribution and will therefore also be a contingent creditor of the debtor. Certainly, against the debtor *D* and its property, Congress may regulate these creditors, *C* and *TP*. Congress has done so by (1) disallowing the claims of the contingent creditor—*TP* in our example—who has a contingent claim for reimbursement or contribution against the primary debtor[212]—*C* in our example—but (2) providing that the contingent creditor—*TP*—is subrogated to the rights of the primary creditor, *C*.[213] If *C* can only obtain $50 from *D*'s

212 *See* 11 U.S.C. § 502(e)(1)(B)–(C) (2000) (providing that the court shall disallow any claim for reimbursement or contribution of an entity that is liable with the debtor on, or has secured, the claim of a creditor, to the extent that such claim for reimbursement or contribution is contingent as of the time of allowance or disallowance of such claim for reimbursement or contribution, or such entity asserts a right of subrogation to the rights of such creditor).

213 *Id.* § 509 (providing that, except as otherwise provided in the section, an entity that is liable with the debtor on, or that has secured, a claim of a creditor against the debtor, and that pays such claim, is subrogated to the rights of the creditor to the extent of such payment).

bankruptcy case but $100 from *TP*, obviously *C* would prefer to collect from *TP*. *TP* would then collect $50 out of *D*'s bankruptcy case. *TP* will have suffered a loss of $50.[214]

Under *Dow Corning*, however, *C* can only look to *D*'s bankruptcy case for payment of its claim; *TP* will suffer no loss and will not need to present its subrogated claim against *D*. Discharging *C*'s claim against *D* is well within the Debtor-Creditor Adjustment Principle under the Bankruptcy Clause. Absent some other consideration,[215] however, abrogating *C*'s claim against *TP* violates the Non-Expropriation Principle.[216] The Bankruptcy Clause does not allow an adjustment of the relationship between the creditor *C* and the third party *TP* unless *TP* is a debtor in a separate bankruptcy case. Destroying the rights of the primary creditor *C* against *TP* is expropriating a property interest of *C*—*C*'s right to payment from *TP*—for the benefit of *TP*.

One may argue that such expropriation is necessary to effect a successful reorganization plan. For example, officers, directors, and shareholders may not agree to adopt a plan unless they obtain that extra benefit. Nevertheless, a policy favoring reorganization does not allow either Congress or federal courts in bankruptcy to exceed bankruptcy law's constitutional limitation to adjusting the relationship between a debtor and the creditors of *that* debtor.[217] Judicial approval of

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214 If *C* had collected $50 from *D*, the result would be the same. *C* would still be entitled to collect an additional $50 from *TP*. Since *C*'s claim against *D* would be discharged, and *TP* is only subrogated to *C*'s claim, *TP* would have to pay *C* $50 and would not be able to recover anything from *D*.

215 If *TP*'s obligation to *C* is part of the property of *D*'s estate, as in the case of an insurance policy and its proceeds covering *D*'s liability to *C*, and *C*'s attempt to collect from *TP* would deplete the assets available to all of *D*'s creditors, then temporarily preventing *C* from collecting from *TP* until conclusion of the bankruptcy case is permitted under the Non-Interference Principle. *See supra* note 64 and accompanying text (discussing the Non-Interference Principle); *infra* note 226 (discussing permissible injunctions of creditor actions against third party insurers when the insurance proceeds are part of the bankruptcy estate).

216 *See supra* note 63 and accompanying text.

217 Congress has specifically authorized the expropriation of the creditor's rights against a nondebtor co-obligor. *See* 11 U.S.C. § 524(g). This section provides that a court confirming a plan of reorganization under Chapter 11 may enjoin entities from recovering damages for future tort liability from asbestos if the plan of reorganization establishes a trust to pay such damages in whole or in part. *Id.* § 524(g)(1)(A)–(B). This injunction may bar any action directed against third parties alleged to be directly or indirectly liable with the debtor for such liability by reason of being (1) an owner of the debtor or of an affiliate or predecessor in interest of the debtor; (2) a manager, officer, director, or employee of the debtor; (3) an insurer of the debtor; or (4) a lender, underwriter, or financial or investment advisor to the debtor. *Id.*

these permanent involuntary nondebtor co-obligor releases violates the primary *Erie* doctrine.[218]

Theoretically, voluntary nondebtor releases would not violate the Non-Expropriation Principle. Because of the costs and uncertainties of collecting from *TP*, *C* might be willing to accept $50 from *D*'s bankruptcy case in return for a release of *TP*. One must be suspicious, however, about whether such releases are truly voluntary. An important test would be whether the creditors approving a plan that waives their rights to pursue claims against nondebtor co-obligors received

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§ 524(g)(4)(A). The section does provide some protection for the interests of the future claimants by requiring that the court appoint a legal representative to protect the rights of the future claimants, and that the court determines whether enjoining such future claimants is fair and equitable, in light of the benefits provided to such trust by or on behalf of such debtor or third party. *Id.* § 524(g)(4)(B). This requirement, however, does not cure the constitutional violation.

The provisions of § 524(g), enacted by the Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, § 111(a), 108 Stat. 4106, 4113–17 (codified at 11 U.S.C. § 524(g)), were applied retroactively to plans dealing with mass asbestos claims that were confirmed before its enactment. *Id.* § 524(h).

218 The court of appeals in *Dow Corning* stated that a mandatory release of and injunction against nonconsenting creditors is appropriate only in "unusual circumstances." Class Five Nev. Claimants v. Dow Corning Corp. (*In re* Dow Corning Corp.), 280 F.3d 648, 658 (6th Cir. 2002). The court required the presence of the following seven factors:

> (1) There is an identity of interests between the debtor and the third party, usually an indemnity relationship, such that a suit against the nondebtor is, in essence, a suit against the debtor or will deplete the assets of the estate; (2) The nondebtor has contributed substantial assets to the reorganization; (3) The injunction is essential to reorganization, namely, the reorganization hinges on the debtor being free from indirect suits against parties who would have indemnity or contribution claims against the debtor; (4) The impacted class, or classes, has overwhelmingly voted to accept the plan; (5) The plan provides a mechanism to pay for all, or substantially all, of the class or classes affected by the injunction; (6) The plan provides an opportunity for those claimants who choose not to settle to recover in full and; (7) The bankruptcy court made a record of specific factual findings that support its conclusions.

Id. The district court on remand made the necessary finding to uphold the plan. None of these factors cures the constitutional defect. Even the factor requiring a mechanism for paying all or substantially all of the affected creditors is not sufficient. The federal court in bankruptcy does not have the jurisdiction to make this determination. If the affected creditors were in fact being paid in full, then they would voluntarily release their claims against the nondebtor obligor. The fact that some of the creditors in *Dow Corning* objected to the mandatory release strongly suggests that they did not believe that they were being paid in full.

market value for the rights that they waived.[219] To the extent that the value received by the waiving creditors is less than reasonably equivalent value, then such waiver would be a fraudulent transfer to the nondebtors if the consenting creditors were insolvent. More importantly, there is a question whether the process of obtaining consent provides meaningful bargaining for the waiving creditors. If the "voluntary" waiver of rights is in fact *not* voluntary, plans providing for such waiver also violate the Non-Expropriation Principle.[220]

219 The value of such rights would approximately equal the present value of the recovery from the nondebtors, taking into consideration such factors as probability of a favorable recovery, the costs of obtaining recovery, and the possibility that the nondebtors would become insolvent and be unable to pay any final recovery in full.

220 The bankruptcy case of Conseco, Inc. provides an example of how creditors may be deemed to have given consent. Conseco, Inc., was a holding company for two operating businesses—finance and insurance. Because of significant losses by its subsidiaries in the finance business and other reasons, Conseco, Inc. and certain of its subsidiaries sought to reorganize pursuant to a Chapter 11. *See* Voluntary Petition, *In re* Conseco, Inc. (Bankr. N.D. Ill.) (No. 02-49672) (doc. no. 1 filed Dec. 17, 2002). In its first five reorganization plans, the debtor proposed a release of nondebtor obligors, including officers and directors, by each holder of a claim (1) who had accepted the plan or (2) who received a distribution under the plan. *See* Debtor's Joint Plan of Reorganization at art. 40 sec. C, *In re Conseco, Inc.* (doc. no. 989 filed Jan. 31, 2003); Reorganizing Debtors' [First Amended] Joint Plan of Reorganization at art. 43–44 sec. C, *In re Conseco, Inc.* (doc. no. 2018 filed Mar. 12, 2003); Reorganizing Debtors' Second Amended Joint Plan of Reorganization at art. 45 sec. C, *In re Conseco, Inc.* (doc. no. 2148 filed Mar. 18, 2003); Reorganizing Debtors' Third Amended Joint Plan of Reorganization at 8 para. 71, 47 sec. C, *In re Conseco, Inc.* (doc. no. 3988 filed June 16, 2003); Reorganizing Debtors' Fourth Amended Joint Plan of Reorganization at 8 para. 72, 47 sec. C, *In re Conseco, Inc.* (doc. no. 4797 filed July 15, 2003). The Securities and Exchange Commission and the United States Trustee objected to the nondebtor releases for several reasons, including lack of meaningful consent by creditors. Specifically, they argued that receipt of a payment under the plan should not be deemed to be consent. *See* Objection of the Securities and Exchange Commission to Confirmation of Second Amended Joint Plan of Reorganization at 6–7, *In re Conseco, Inc.* (doc. no. 3257 filed May 14, 2003); Objection of the Securities and Exchange Commission to Confirmation of Debtors' Third Amended Joint Plan of Reorganization at 3–6, *In re Conseco, Inc.* (doc. no. 4850 filed July 11, 2003); Objection of the United States Trustee to Reorganizing Debtors' Third Amended Joint Plan of Reorganization at 2, 5, exh. A at 4, *In re Conseco, Inc.* (doc. no. 4608 filed July 9, 2003). Eventually, the debtors filed a plan providing a creditor who had not voted to accept the plan with a choice of accepting a distribution and still rejecting the release. *See* Reorganizing Debtors' Fifth Amended Joint Plan of Reorganization at 8 para. 73, 50 sec. C, *In re Conseco, Inc.* (doc. no. 5424 filed Aug. 18, 2003) (defining "Consenting Parties" as collectively a holder of a claim who either voted to accept the plan (and was a member of class who accepted the plan) or "who (a) receives a distribution of property if the Plan is Confirmed, and (b) has not properly and timely submitted the Opt Out Notice"); Reorganizing Debtors' Sixth Amended Joint Plan of Reorganization at 8 para. 73, 50 sec. C, *In re Conseco, Inc.* (doc. no. 5828 filed Sept. 9, 2003)

2. Temporary Stays of Actions Against Nondebtors

A more limited infringement of creditor rights against nondebtor co-obligors is the temporary stay of enforcement actions against nondebtor co-obligors. Section 1301 of the Code imposes a stay of actions by a creditor of a Chapter 13 debtor against an individual guarantor of a consumer debt.[221] In addition, courts have often temporarily enjoined creditors from pursuing claims against nondebtors.[222] Professor Brubaker has remarked that such temporary injunctions have long been considered within the jurisdiction of bankruptcy courts.[223]

These temporary stays do expropriate the property rights of the stayed creditors. Accordingly, they can only be justified under the Non-Interference Principle.[224] For example, § 1301 may be a justifiable means to prevent a creditor owed a consumer debt from intimidating the debtor from filing a Chapter 13 proceeding because of a creditor's threat against an individual family member who guaranteed the consumer debt.[225] Similarly, a temporary nondebtor stay may be justified to prevent the dissipation of property of the estate, as in the case of a fixed amount of insurance proceeds owed to the bankruptcy estate that may be diminished by payments to creditors who have an independent claim against the insurance company and therefore direct access to such proceeds.[226]

(same). The court approved the plan. *See* Order Confirming Reorganizing Debtors' Sixth Amended Joint Plan of Reorganization, *In re Conseco, Inc.* (doc. no. 5840 filed Sept. 9, 2003).

221 *See* 11 U.S.C. § 1301 (2000).

222 *See, e.g.*, Celotex Corp. v. Edwards, 514 U.S. 300, 302 (1995) (holding that a U.S. district court was bound by an injunction issued by a bankruptcy court prohibiting creditors from collecting from sureties on a supersedeas bond).

223 *See* Brubaker, *supra* note 201, at 968, 1055–58 (discussing the jurisdictional foundation for temporary nondebtor stays); Brubaker, *supra* note 199, at 33–39 (same).

224 I previously thought that the fact that both the creditor and the third party nondebtor were creditors provided sufficient justification under the Bankruptcy Clause. *See* Plank, *supra* note 167, at 568–69 (justifying co-obligor stays as adjusting the relationship of one creditor against another as a part of the subject of bankruptcy). My earlier analysis did not distinguish between preferring one creditor over another in sharing in the debtor's assets—well within the scope of the Bankruptcy Power—and abrogating one creditor's independent rights against another creditor—outside the scope of the Bankruptcy Power—except to the extent justified by the Non-Interference Principle.

225 *See* H.R. REP. NO. 95-595, at 123 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6084 (describing the purpose of this section).

226 Several bankruptcy courts have enjoined creditor actions against the debtor's insurers on the grounds that the insurance policies were property of the estate. *See,*

Nevertheless, the standard for justifying these temporary nondebtor stays should not be a loose one based on what will aid in the reorganization effort of the debtor.[227] The court must apply a stricter standard complying with the Non-Interference Principle. The court may stay an action by the creditor against the nondebtor that would impede the debtor's ability to invoke the bankruptcy process or hinder the trustee's ability to gather or protect the bankruptcy estate, or to use its avoidance powers to enhance the estate.

V. APPLYING *ERIE* IN BANKRUPTCY

A. *The Difficulties of the* Erie *Doctrine*

Applying *Erie* in federal diversity cases has not been without its difficulties. These difficulties include (1) determining the sources of state law and even the methodology for finding the state law; (2) deciding the extent to which federal courts are bound by state procedural rules; and (3) in a case involving the law of more than one state,

e.g., MacArthur Co. v. Johns-Manville Corp., 837 F.2d 89, 91–93 (2nd Cir. 1988) (affirming a bankruptcy court order enjoining suits by creditors against the debtor's insurers entered as part of a settlement agreement between the debtor and the insurers on the grounds that the proceeds of the policies were property of the estate); A.H. Robins Co. v. Piccinin, 788 F.2d 994, 1001–03, 1008 (4th Cir. 1986) (holding that the district court had the authority to enter a preliminary injunction against creditors suing the debtor's insurer because the insurance was property of the estate); *In re* Davis, 730 F.2d 176, 184–85 (5th Cir. 1984) (holding that the bankruptcy court had the authority to enjoin creditors' direct action under Louisiana law against debtor's insurers because the insurance was property of the estate). On the other hand, the bankruptcy court in *In re Celotex Corp.*, 128 B.R. 478 (Bankr. M.D. Fla. 1991), incorrectly held that a supersedeas bond issued by an insurance company to enable the debtor to appeal a pre-petition judgment and secured by property of the debtor was itself property of the estate justifying an injunction preventing a judgment creditor from collecting on the supersedeas bond. *See id.* at 480–83; *see also* Edwards v. Armstrong World Indus., 6 F.3d 312, 317, 320 (5th Cir. 1993), *rev'd on other grounds by* Celotex Corp. v. Edwards, 514 U.S. 300 (1993) (holding, in an appeal from a collateral attack on the bankruptcy court's injunction, that the supersedeas bond was not property of the estate). Of course, by the very terms of a supersedeas bond issued for appellate proceedings that had not been completed, a creditor could not collect on the bond if completion of the appellate proceedings were automatically stayed by the filing of a petition. The bankruptcy court did not, however, rely on this rationale, and for at least one of the supersedeas bonds, the appellate proceedings had been completed before the debtor filed its petition. *See Celotex*, 514 U.S. at 301–02, 313 (holding that, regardless of the merits of the bankruptcy court's injunction, the bankruptcy court had jurisdiction to issue the injunction and the creditor could not collaterally attack the bankruptcy court's decision by proceedings in another federal court).

227 *See, e.g.*, Callaway v. Benton, 336 U.S. 132 (1949); *see also supra* note 172 and accompanying text.

choosing which state's law should apply. These difficulties also apply in bankruptcy, but because of the differences between a diversity case and a bankruptcy case, the resolution of the issues may differ.

Federal courts use a variety of methods in determining the content of state law. Of course, if a state statute is on point, the determination of state law is usually easy. If there is a decision of the state's highest court on point, the determination of state law may also be relatively simple. On the other hand, if the decision is not of recent origin, and developments in the law elsewhere suggest that the state's highest court may rethink its current precedent, the federal court faces a dilemma. Should it adhere to the existing case law—the static approach—or should it attempt to discern what the highest court would decide today?[228] Further, what should a federal court do if the only relevant case law is that of a lower court or if there is no relevant case law? In these cases, federal courts often attempt to predict what the highest court would rule.[229] One solution to these problems is the certification by the federal court of state law questions to the state's highest court.[230] When a federal court in bankruptcy must resolve a discrete state law issue, it faces the same problems as other federal courts.

As to the issues of how the substance-procedure dichotomy or the choice of law conundrum affects the application of *Erie* in bankruptcy, an exposition of these issues deserves a fuller treatment that is beyond the scope of this Article. I will simply make a few observations.

Bankruptcy law has its own procedure that is unique in many ways. This procedure is designed to foster the bankruptcy goal of efficient administration of bankruptcy cases involving insolvent debtors. The procedures necessarily differ from state court procedures. Nevertheless, federal courts in bankruptcy may not fashion procedural rules that have the effect of violating the limits on Congress's Bankruptcy Power.

Raleigh v. Illinois Department of Revenue[231] illustrates the point. In *Raleigh*, the State of Illinois presented a claim in the bankruptcy case

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228 *See, e.g.*, Clark, *supra* note 39 *passim* (describing the static approach and the predictive approach and arguing that the federal courts should employ a presumption in favor of certifying unresolved issues to state courts).

229 *See generally* 19 WRIGHT ET AL., *supra* note 15, § 4507, at 115–85 (describing federal courts' methods of and difficulties in determining the content of state law).

230 *Id.* § 4507, at 169–85 (describing the certification process and the difficulties arising from its use); Clark, *supra* note 39, at 1544–49 (describing the availability of certification as of the late 1990s, in which some form of certification was available in more than forty states).

231 530 U.S. 15 (2000).

of the debtor based on a notice of tax liability.[232] Under Illinois law, the tax payer—the debtor in *Raleigh*—had the burden of proving that the tax liability was incorrect or invalid.[233] The bankruptcy court, however, held that despite state law, Illinois had the burden of proving its tax claim in the bankruptcy case.[234] The Supreme Court reversed, holding that a bankruptcy court was not free to alter the burden of proof.[235]

As the Court noted in *Raleigh*, the burden of proof in this context is considered a matter of substance, not procedure.[236] As noted above,[237] the Court's holding is consistent with a separation of powers understanding of *Erie*. Congress, however, is free to reduce the rights of creditors under the Bankruptcy Power, and it could choose to change the burden of proof. Therefore, a federal bankruptcy common law rule that altered the burden of proof for creditors would not violate the primary *Erie* doctrine.

On the other hand, a bankruptcy court could not alter the burden of proof of a claim held by a debtor against a third party. If the bankruptcy estate of a debtor included a contract right against a third party, and state law imposed the burden of proof on the trustee in bankruptcy to establish all of the elements necessary to enforce that right, neither Congress nor a federal court in bankruptcy could alter that state law allocation of the burden of proof. Similarly, federal courts in bankruptcy must follow other state rules of "procedure" that go to the substance of a third party's rights.

This analysis applies equally to choice of law. Under *Klaxon Co. v. Stentor Electric Manufacturing Co.*,[238] a federal court should apply the choice of law rule of the state in which the federal court is sitting.[239]

232 *Id.* at 18.

233 *Id.*

234 *In re* Stoecker, 202 B.R. 429, 437 (Bankr. N.D. Ill. 1996), *rev'd*, 179 F.3d 546 (7th Cir. 1999), *aff'd sub nom.* Raleigh v. Ill. Dep't of Revenue, 530 U.S. 15 (2000).

235 *Raleigh*, 530 U.S. at 24–25 ("Bankruptcy courts are not authorized in the name of equity to make wholesale substitution of underlying law controlling the validity of creditors' entitlements, but are limited to what the Bankruptcy Code itself provides.").

236 *Id.* at 15. For certain purposes, the burden of proof may be considered procedural. *See, e.g.*, Sampson v. Channell, 110 F.2d 754, 762 (1st Cir. 1940) (holding that a Massachusetts federal court in a diversity case must apply the Massachusetts law on the allocation of the burden of proving contributory negligence, which the Massachusetts courts describe as a matter of procedure, and noting that federal and state courts have upheld statutes retroactively changing the burden of proving contributory negligence on the grounds that such statutes are procedural and not substantive).

237 *See supra* Part I.C.

238 313 U.S. 487 (1941).

239 *See id.* at 496.

Some would say that this rule is problematic.[240] In bankruptcy, there is a further complication.[241] A bankruptcy case may be filed in a federal district in which no diversity case involving the debtor or creditors could be filed. In any event, the choice of law rule that is to be applied may not violate the Non-Expropriation Principle. Hence, a choice of law rule may not be applied in a way that gives a debtor or the creditors greater rights against a third party than what the debtor or creditors would have outside of bankruptcy.[242]

The distinct nature of a bankruptcy case presents additional challenges for applying *Erie*. Although many questions of state law presented in bankruptcy cases also occur in state court proceedings, bankruptcy cases generate some important issues for which there are no state court analogues. The most significant of these are whether a debtor has an interest in property and when a claim arises. The next two sections discuss how federal courts in bankruptcy should apply the primary *Erie* doctrine in resolving these issues.

B. *Property—State, Not Federal Law*

A bankruptcy case administers all of the interests of the debtor in property as of the commencement of the case. These interests constitute the property of the estate.[243] In a Chapter 7 liquidation, a bankruptcy trustee will liquidate the property of the estate and distribute the proceeds pro rata to the unsecured creditors. The theoretical

240 *See* Scott Fruehwald, *Choice of Law in Federal Courts: A Reevaluation*, 37 BRANDEIS L.J. 21 (1998).

241 *See generally* John T. Cross, *State Choice of Law Rules in Bankruptcy*, 42 OKLA. L. REV. 531 (1989) (analyzing the application of choice of law rules in bankruptcy cases and arguing that a bankruptcy court should select the law of the state whose court would have heard the dispute if there had been no bankruptcy case).

242 *Id.* at 534, 576–78 (stating that the resolution of the forum choice of law issue in bankruptcy should mirror the result that a nonbankruptcy court would meet); *see also Conflict of Laws in Bankruptcy: Choosing Applicable State Law and the Appropriate (State or Federal?) Choice-of-Law Rule*, BANKR. L. LETTER, July 2001, at 1 (discussing Bianco v. Erkins *(In re* Gaston & Snow*)*, 243 F.3d 599 (2d Cir. 2001)). In *Bianco*, the bankruptcy court sitting in New York applied the six-year New York law on the statute of limitations to enable a debtor to collect a debt owed by an obligor located in Idaho that would have been barred by the Idaho statute of limitations even though under nonbankruptcy law, New York law would never have applied to recover. Professor Ralph Brubaker, the contributing editor of *Bankruptcy Law Letter*, rightly criticized this decision and argued that the court should have applied a federal choice of law rule to prevent the forum shopping that the application of *Klaxon* in bankruptcy permitted. *Id.* at 5. I would characterize such a rule not as a federal choice of law rule but as the correct state law rule.

243 *See supra* note 10 (defining property of the estate under 11 U.S.C. § 541(a)(1) (2000)).

goal of a Chapter 11 reorganization is the confirmation of a plan under which the debtor could retain the property of the estate and reorganize its affairs.[244] Determining the property of the estate—the interest of the debtor in property—is fundamental in every bankruptcy case.

State courts typically do not face what is an interest in property in this context. More typically, the issue that a state court might face is whether a particular interest is "property" subject to (1) a creditor's judicial lien, (2) a form of taxation, (3) the state's laws on inheritance, and (4) other discrete issues.[245] Accordingly, when a federal court in bankruptcy must decide whether a particular thing or interest is an "interest in property," it must answer that question by looking at the fundamental elements of a property interest.

In many cases, this task is not difficult. A bankruptcy court does not have difficulty determining that a debtor's fee simple ownership interest in Blackacre or a leasehold interest in an automobile is an "interest of the debtor in property." Other more esoteric interests, however, have presented problems for federal courts in bankruptcy.

One example of an esoteric property interest is the renewal right to season tickets for sports teams. In *In re I.D. Craig Service Corp.*,[246] the bankruptcy court held that the debtor's right to renew season tickets to the Pittsburgh Steelers home football games was an "interest in property" under state law.[247] Therefore, the renewal right was included in the property of the estate of the debtor and could be sold by the trustee in bankruptcy for the benefit of the debtor's creditors.[248] The court found that, though the season tickets were revocable, the Pittsburgh Steelers automatically offered to the holders of season tickets the right to purchase season tickets for the following season.[249] More importantly, the court found that the club routinely allowed any

244 A significant number of Chapter 11 cases, however, represent orderly liquidations by the debtor in possession. *See* Elizabeth Warren & Jay Lawrence Westbrook, *Financial Characteristics of Business in Bankruptcy*, 73 AM. BANKR. L.J. 499, 523–24, 566 (1999) (reporting that a large number of Chapter 11 filings may in fact be liquidations); *see also* Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 STAN. L. REV. 751 (2002) (asserting that Chapter 11 is generally no longer used as a means to effect traditional corporate reorganizations).

245 One exception is a determination of whether a particular thing or interest is an interest in property for which the state must provide compensation in connection with the condemnation of property for a public use. *See infra* note 256 and accompanying text.

246 138 B.R. 490 (Bankr. W.D. Pa. 1992).

247 *Id.* at 502.

248 *Id.*

249 *Id.* at 495–97.

season ticket holder to transfer the holders' renewal right to another person.[250] The renewal right itself had value because season tickets represented approximately ninety-five percent of the available seats.[251]

Although the court did not expressly state its analysis in terms of the nature of property interests, the facts that it relied upon demonstrate that the right to renew tickets in this particular instance had all of the attributes of a property interest. The season ticket holder had an exclusive right to renew the season tickets;[252] the renewal right itself had value; and the renewal right was transferrable.[253]

Conversely, the U.S. Court of Appeals for the Ninth Circuit, applying Arizona law in *Abele v. Phoenix Suns Ltd. Partnership (In re Harrell)*,[254] held that the right to renew season tickets to the Phoenix Suns home basketball games was not an interest in property that became part of the bankruptcy estate.[255] The court in part relied upon Arizona case law to the effect that an expectation of renewal of a lease was not a property interest for which the lessee was entitled to receive compensation when the leased premises were taken in a state condemnation proceeding.[256] The court unfortunately did not present an analysis of the attributes of renewal rights. For example, the court did not say whether the renewal right could be transferred, or whether the Phoenix Suns keep greater control over those rights. A faithful application of *Erie* in this case requires a more thorough analysis of the attributes of the particular thing in question.[257]

Abele exemplifies a too superficial analysis of state law precedents to determine whether a debtor has an interest in property. On the

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250 *Id.* at 496–97.

251 *Id.* at 493.

252 The holder's rights were subject to revocation by the club, and therefore the club retained some control over those rights. Still, until the holder transferred the right, the holder was the only one who had the right to renew. *See id.* at 493–97.

253 *See* John G. Sprankling, Understanding Property Law § 1.03[B], at 4–6 (2000); Stoebuck & Whitman, *supra* note 41, § 1.1, at 2–3.

254 73 F.3d 218 (9th Cir. 1996).

255 *Id.* at 219.

256 *Id.* at 219 (citing State *ex rel.* Miller v. Gannett Outdoor Co. of Ariz., 795 P.2d 221 (Ariz. Ct. App. 1990)).

257 *In re Liebman*, 208 B.R. 38 (Bankr. N.D. Ill. 1997), presented a fuller analysis in holding that the right to renew season tickets to Chicago Bulls home games was not an interest of the debtor in property. *Id.* at 39. In that case, in addition to the characterization of the right to renew as a "license," the Chicago Bulls emphatically announced to their season ticket holders that season tickets were offered on a one-year basis, that the Bulls reserved the right to review accounts each year before offering renewal, and that the Bulls prohibited transfers of season tickets except in limited circumstances. *Id.* at 40.

other hand, other federal courts in bankruptcy rely too much on a characterization of the issue of whether a particular thing or interest is an interest in property as an issue of "federal" law.[258]

The Supreme Court's pre-*Erie* decision of *Chicago Board of Trade v. Johnson*[259] can be interpreted as an erroneous reliance on a "federal" question approach. The issue in that case was whether an individual's membership on the Chicago Board of Trade was an interest in property that could be included in the bankruptcy estate under the Bankruptcy Act of 1898.[260] Under the Act, the definition of property of the estate consisted of a laundry list of ten specific types of property interests, the most general of which was "property . . . which prior to the filing of the petition [the bankrupt] could by any means have transferred or which might have been levied upon and sold under judicial process against him."[261] Under the rules of the Chicago Board of Trade, an individual could become a member upon approval of ten members of the Board of Directors, no disapproval by three or more directors, and payment of a $25,000 fee.[262] A member could transfer his membership so long as all assessments had been paid and there were no outstanding claims against the member.[263] In this case, the debtor, Henderson, was indebted to other members for $60,000, and at the time of filing the membership was worth $10,500.[264] The district court had ruled that the membership was property of the estate and could be sold free and clear of the creditors' claims.[265]

The Supreme Court rejected the argument of the creditors that the membership was not a property interest at all, but it held that the membership as a property interest retained all of its inherent limita-

258 *See, e.g., In re* Gunder, 8 B.R. 390 (Bankr. S.D. Ohio 1980). In this case, the bankruptcy court held that it was not bound by a state automobile titling statute that provided that the owner of an automobile was the person noted on the title issued by the state. *Id.* at 392. The court properly concluded that an automobile titled in the father's name was property of the estate of the son and his wife, but failed to provide any meaningful analysis. *Id.* The son and the wife had possession and use of the car, had borrowed the money to purchase the car, and were paying the debt service on the car. *Id.* at 392–93. At most, the father had bare legal title. *See id.* at 392. The son and wife had the equitable ownership interest which became part of their bankruptcy estate. *See id.* at 393.

259 264 U.S. 1 (1924).

260 *Id.* at 8.

261 *Id.* (quoting 11 U.S.C. § 110(a) (1976) (repealed 1978)).

262 *See id.* at 7.

263 *Id.*

264 *Id.* at 7–8.

265 *Id.* at 6.

tions.[266] Accordingly, it ruled that the bankruptcy trustee could not transfer the membership unless all of the claims of the members were satisfied in accordance with the Board's rule.[267]

The Court's analysis of the nature of the membership is, unfortunately, wanting. It noted several Supreme Court precedents holding that similar memberships were property interests subject to the Bankruptcy Act.[268] The Court also rejected the argument that it was limited by the ruling of the Illinois Supreme Court that membership in the Board of Trade was not property subject to execution and levy to satisfy a debt owed to a judgment debtor.[269] Instead of an analysis of whether the membership was "property" in a broader sense, the Court simply relied upon the power of federal courts:

> Congress derives its power to enact a bankrupt law from the Federal Constitution, and the construction of it is a federal question. Of course, where the bankrupt law deals with property rights which are regulated by the state law, the federal courts in bankruptcy will follow the state courts; but when the language of Congress indicates a policy requiring a broader construction of the statute than the state decisions would give it, federal courts can not be concluded by them.[270]

This is an ambiguous statement. On the one hand, it could be read to imply that federal courts can determine whether something is a property interest as a matter of federal law, notwithstanding state law.[271] On the other hand, it could simply mean that a federal court in bankruptcy is not bound by the conclusiveness of a narrow state court determination of a related but different issue. This latter interpretation is consistent with *Erie* and is the better one.

The state court had held that a membership on the Board of Trade was not a property interest that could be levied upon by a judgment creditor. That a particular "thing" or interest is not subject to execution and levy by a judgment creditor under a creditor collection statute is not at all conclusive of whether that "thing" or interest is an interest in property. Indeed, before and after the enactment of bankruptcy laws in England and America, many different types of property, such as real estate, securities, and negotiable instruments, were not

266 *Id.* at 11.

267 *Id.* at 12–13.

268 *See id.* at 10–11.

269 *Id.* at 8–9.

270 *Id.* at 10.

271 This is how Vern Countryman interpreted the case. Countryman I, *supra* note 89, at 438; *see also supra* text accompanying note 118.

subject to execution and levy by creditors.[272] Certainly, no one would claim that real estate, securities, or negotiable instruments were not "property."

Further, a thorough examination of the attributes of the membership in *Chicago Board of Trade* reveals that it is a property interest. It had value, it gave Henderson the exclusive right to its benefits, and it was transferable. Instead of distinguishing the Illinois case law on a cryptic notion of federal supremacy, the Court could have and should have distinguished the Illinois case law dealing with the rights of judgment creditors under a creditor collection statute from the more fundamental question of whether the particular set of rights constitutes a property right. In any event, after *Erie*, whether rights created pursuant to state law are an interest of the debtor in property is not a federal question. Under the Non-Expropriation Principle,[273] neither Congress under the Bankruptcy Clause nor federal courts in bank-

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272 For example, in eighteenth century England, creditors' remedies were limited to the writ of *fieri facias*, which authorized the sheriff to seize the tangible goods of the debtor and sell enough of them to pay the debt; the writ of *levari facias*, which enabled the sheriff to seize the personal property of the debtor and the rents from the debtor's real property to satisfy the debt (but not the right to possess or cause the sale of the debtor's lands); the writ of *elegit*, which allowed delivery of the goods to the creditor at an appraised value in satisfaction of the debt and, if there remained a deficiency, gave the creditor possession of one half of the debtor's lands until the debt was repaid (but did not allow the creditor to force the sale of the debtor's lands); or the writ of *capias ad satisfaciendum*, which imprisoned the debtor until the debt was paid. *See* 3 WILLIAM BLACKSTONE, COMMENTARIES *414, *417–19. Imprisonment for debt, an important creditor collection device in the seventeenth and eighteenth centuries, reflected a common belief that the refusal to pay debts was willful and that imprisonment provided an incentive for debtors who owned property which could not be reached by the legal process of the day to pay their debts. *See generally* PETER J. COLEMAN, DEBTORS AND CREDITORS IN AMERICA: INSOLVENCY, IMPRISONMENT FOR DEBT, AND BANKRUPTCY, 1607–1900 (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). Indeed, debtors of substance sometimes preferred imprisonment, 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. 3 BLACKSTONE, *supra*, at *415. Also, creditors used imprisonment because they could not force the sale of either the debtor's lands or negotiable instruments (and certain other intangible property). *See* Cohen, *supra*, at 154–55; Ian P.H. Duffy, *English Bankrupts, 1571–1861*, 24 AM. J. LEGAL HIST. 283, 285 (1980); Israel Treiman, *Acts of Bankruptcy: A Medieval Concept in Modern Bankruptcy Law*, 52 HARV. L. REV. 189, 195 n.21 (1938). 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. *See* Duffy, *supra*, at 285. In America, a few states continued the prohibition against the seizure and execution sale of land for the satisfaction of debts. *See* COLEMAN, *supra*, at 191–92 (discussing colonial Virginia law).

273 *See supra* text accompanying note 63.

ruptcy under the primary *Erie* doctrine have the power to make a "thing"—such as my right to vote—a property interest that can be distributed to creditors if that "thing" is not a property interest under state law.

C. *Creditors, Claims, and State vs. Federal Law*

The purpose of a bankruptcy case is to provide an efficient method of repaying the creditors of a insolvent debtor. Thus, the determination of who are the creditors is an essential part of any bankruptcy case. A creditor has standing to participate in the case. In a liquidation, a creditor will receive a pro rata share of the debtor's assets.[274] In a reorganization, the creditor will receive repayment pursuant to a reorganization plan upon which the creditor may vote. Unless it otherwise agrees, the creditor must receive under a reorganization plan at least what it would have received in a liquidation.[275] Also, a creditor's claim will be discharged in either a liquidation[276] or a reorganization.[277] A creditor is an entity who has a claim—a right to payment—that arises before the "order for relief."[278] In almost all instances, a creditor is a person whose claim arose before the filing of the petition, because a voluntary petition in bankruptcy constitutes an "order for relief."[279] If a claim arises after the order for relief, the

274 *See* 11 U.S.C. § 726 (2000) (providing for distribution of property of the estate to creditors).

275 *Id.* § 1129(a)(7)(A) (providing that one of the requirements for court approval of a reorganization plan is either that the holder of a claim has accepted the plan or would receive at least what it would receive in a liquidation).

276 *Id.* § 727 (providing when an individual may receive a discharge of debts in Chapter 7). Debtors who are not individuals that liquidate under Chapter 7 do not receive a discharge, *id.* § 727(a)(1), but do not need one. All the assets of the debtor are used to pay expenses and creditors and the debtor remains an empty shell that will eventually be dissolved under state law. In effect, a nonindividual debtor gets a de facto discharge in a liquidation.

277 *Id.* § 1141(d) (providing that the effect of a confirmed Chapter 11 plan is to discharge the debts of the debtor); *see id.* § 1228 (authorizing the discharge of debts of a debtor in a Chapter 12 case upon completion of all payments required by a confirmed plan); *see also id.* § 1328 (same, for debtor in a Chapter 13 case).

278 *See supra* note 11 (defining "creditor" and "claim").

279 *See* 11 U.S.C. § 301. The "order for relief" is different for an involuntary petition, that is, one filed by the creditors. *Id.* § 303(b). The court will enter an order for relief after the filing of the involuntary petition unless the petition is contested, in which case it will enter an order for relief only if the debtor is not generally paying its debts as they come due, or a custodian of less than all the debtor's property was appointed within 120 days before the filing of the petition. *Id.* § 303(h).

claim may be an administrative expense entitled to payment in full before creditor's claims.[280]

Finally, if the claim arises after the conclusion of the case, the ability of the claimant to be paid depends on the type of bankruptcy case. If the case is an individual debtor in a Chapter 7 liquidation, the individual debtor will retain full liability for the post-bankruptcy claim and the debtor's fresh start will not encompass the claim. Hence the individual's future income will be available to satisfy the post-bankruptcy claim. If the case is a Chapter 7 liquidation of a debtor who is not an individual, the debtor will retain full liability for the post-bankruptcy claim, but the debtor will be an empty shell that has no assets.[281] Hence, the claimant will not recover its claim. Finally, if the case is a Chapter 11 reorganization, whether an individual or not, then the debtor will retain full liability for the post-bankruptcy claim and the debtor's future income will be available to satisfy the claim.

The simple claims present no problems. If a debtor borrows money and then files for bankruptcy, the lender is a "creditor." If a debtor injures another person in an automobile accident and then files for bankruptcy, the victim is a "creditor." However, in the case of torts involving latent injuries that do not become manifest until after the act that caused the injury, the question of when a claim arises has troubled many federal courts in bankruptcy.

To determine when a latent tort claim arises, federal courts in bankruptcy have generally used three different tests: the conduct test, the relationship test, and the state law accrual test.[282] Under the conduct test, the claim of a victim arises at the time of the conduct that causes injury.[283] Under the relationship test, the claim arises at the later of the time of the conduct or the time that the victim and the

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280 *Id.* §§ 503(b)(1)(A), 507(a)(1). Administrative expenses include tort claims that arise after the order for relief. *See* Reading Co. v. Brown, 391 U.S. 471, 482–83 (1968) (holding that the bankruptcy estate of a debtor that attempted to reorganize under Chapter XI of the Bankruptcy Act of 1898 should bear the costs of damages caused by the receiver's negligence because the Chapter XI case was attempted for the benefit of the creditors, and therefore such damages should be treated as an administrative expense).

281 *See supra* note 276.

282 *See, e.g.*, Epstein v. Official Comm. of Unsecured Creditors of Estate of Piper Aircraft Corp., 58 F.3d 1573, 1576–77 (11th Cir. 1995); Alan N. Resnick, *Bankruptcy as a Vehicle for Resolving Enterprise-Threatening Mass Tort Liability*, 148 U. PA. L. REV. 2045, 2070–75 (2000) (identifying a fourth test—the "fair contemplation test"—and advocating the adoption of a modified conduct test); *see also* NBRC REPORT, *supra* note 2, § 2.1.1, at 323; TABB, *supra* note 145, § 7.2, at 473–75.

283 *See Epstein*, 58 F.3d at 1577.

tortfeasor enter into a relationship.[284] Under the state law accrual test, the claim arises when the cause of action "accrues" under various state law provisions, most commonly when the victim discovers the injury and the cause of action begins to accrue for purposes of the statute of limitations.[285]

I have previously expressed my view that Congress may adopt the broadest definition of a claim and adopt the conduct test for when a claim arises.[286] In my view, the conduct test—the broadest test—is the proper state law test. The relationship test represents a federal bankruptcy common law test. The state law accrual test is simply the "erroneous state law" test. I draw these distinctions because in my view, under state law, a contingent tort claim arises at the time of the conduct. Some courts reject the conduct test and adopt the relationship test on policy grounds. Those policy grounds—be they bankruptcy policy or other constitutional policy concerns—may be appropriate.[287] The policy concerns do not negate the fact that the actors in the real world for the most part treat any latent contingent tort as having been created at the time of the conduct and that any type of human activity—including manufacturing and selling products and providing services—creates the possibility of a claim under state law that will mature in the future.[288] The conduct test recognizes and the state law accrual test ignores this reality.

The state law accrual test, which has been rejected by most federal courts in bankruptcy,[289] reflects an erroneous reliance on a specific point of state law that has a different and much narrower concern than when, under state law, a claim first comes into existence. It also presents a good example of how federal courts in bankruptcy should not interpret and apply state law. A good—or should I say bad—example of the reasoning that created this test is *Avellino & Bienes v. M. Frenville Co. (In re M. Frenville Co.)*.[290] In this case, Avellino & Bienes audited M. Frenville Co. and prepared certified financial statements for the years 1978 and 1979.[291] In August 1980, and February 1981, M. Frenville Co. and Rudolf Frenville became debtors in bankruptcy.[292] Before the debtors filed their bankruptcy petitions,

284 *See id.*
285 *See id.* at 1576.
286 *See* Plank, *supra* note 9, at 1105–10.
287 *Id.* at 1108 & n.167.
288 *Id.* at 1107–08.
289 *See, e.g.*, *Epstein*, 58 F.3d at 1576.
290 744 F.2d 332 (3d Cir. 1985).
291 *Id.* at 333.
292 *Id.*

Chase Manhattan Bank and other banks had lent M. Frenville Co. a substantial amount of money on an unsecured basis. After the bankruptcy case had commenced, these banks sued Avellino & Bienes for $5,000,000 alleging that the negligent and reckless preparation of false financial statements caused the banks' loss.[293] Later, Avellino & Bienes filed a complaint in bankruptcy court for relief from the automatic stay of creditor suits under § 362(a)(1) of the Code.[294] Specifically, Avellino & Bienes sought to join M. Frenville Co. and Rudolf Frenville as third party defendants in the banks' suit to obtain indemnification and contribution from M. Frenville Co. and Rudolf Frenville if the accounting firm were found liable to the banks.[295]

The bankruptcy court found that the Avellino & Bienes suit would violate the stay and refused to lift the stay.[296] The district court affirmed.[297] The court of appeals reversed on the grounds that under § 362(a)(1) of the Code, Avellino & Bienes' suit was not a proceeding "to recover a claim against the debtor that arose before the commencement of the case."[298] The court stated that, under state law, the accounting firm's cause of action for indemnification and contribution from a third party could not have been commenced until the accounting firm had been sued and had filed its answer. The court applied this state rule to hold that the accounting firm's contingent right to payment for indemnification and contribution did not *arise* under bankruptcy law until it had been sued and had filed its answer.[299]

The court's analysis and application of state law in the bankruptcy case is seriously flawed. It is just plain wrong to say that the accounting firm had no right to payment until it could file suit. The court itself recognized that if the debtor had entered into a written indemnity agreement in favor of the accounting firm, then the firm would have had a right to payment, although contingent, that arose at the time of the execution of the indemnity agreement.[300] The court sim-

293 *Id.*
294 *See* 11 U.S.C. § 362(a)(1) (2000).
295 *See Avellino & Bienes*, 744 F.2d at 333–34.
296 *Id.* at 334.
297 *Id.*
298 *Id.* (quoting 11 U.S.C. § 362(a)(1)).
299 *Id.* at 335.
300 *Id.* at 336.

ply declared that the accounting firm's common law right to payment was different, without explaining how.[301]

The court admirably stated that it had to follow state law.[302] Unfortunately, its analysis of applicable state law is wanting. In particular, the New York rule that limits the filing of actions for indemnification serves a particular purpose: the efficient administration of the court system. That purpose is not relevant to the question that was before the court. Every person who provides professional services, such as a lawyer or accountant, knows or should know that there is always a possibility of a suit against the professional. In some cases, the professional will have a claim for indemnification or contribution from the client. Assume that a professional serves 1000 clients and that there is a probability that the representation of one of those clients will produce a suit by a third person and a claim for indemnification from the client. The claim, though contingent, arises out of the conduct of the client in the course of the professional's representation.

From the perspective of managing a litigation system, it makes sense that the professional need not file suit (and indeed may not file suit) until the contingency occurs. But a rule designed to provide for an efficient management of the state court system has nothing to do with the question of when the claim first comes into existence. As described above, conduct can produce a tort claim. The claim, though contingent, first comes into existence at the time of the conduct. It may take time for the claim to mature, and no claim may mature, but the contingent nature of when or whether the claim will mature does not change the fact that the claim comes into existence at the time of the conduct. Focusing on the irrelevant state law does not serve either the requirements of the primary *Erie* doctrine or the separation of powers aspect of *Erie*.

Conclusion

State law issues arise all the time in bankruptcy cases because the Code itself depends heavily on state law either expressly or implicitly. When resolving these state law issues, federal courts in bankruptcy must respect the limits on Congress's power to alter state law entitlements. Congress, and therefore federal courts in bankruptcy, may alter the relationship between an insolvent debtor and his, her, or its

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301 *Id.* The court also held that, under § 362(a)(1) of the Code, Avellino & Bienes' suit was not a proceeding that could have been commenced before bankruptcy. *Id.* at 233. This portion of the ruling was correct.

302 *Id.* at 337.

creditors that is based on state law. However, neither Congress nor federal courts may do more. They must respect the rights of third parties who may be affected by a bankruptcy case. They may not create property or contract rights that do not exist outside of bankruptcy. They must respect the principles of federalism and the limits of Congressional power expressed in the primary *Erie* doctrine.

To be sure, applying *Erie* in bankruptcy is challenging. Many of the difficulties seen in applying *Erie* in diversity cases apply in bankruptcy. Moreover, because of the significant differences between a bankruptcy case and a diversity case, federal courts in bankruptcy may face a more difficult time resolving some state law issues. Every bankruptcy case presents two fundamental questions: (1) what property of the debtor should be liquidated or reorganized for the benefit of creditors, and (2) who are creditors who should participate in and be bound by the bankruptcy case—that is, who has a claim that arises before the bankruptcy case begins. These bankruptcy questions require the resolution of fundament state law issues.

States are free to vary the extent to which they will recognize property interests, contract rights, and tort claims. In the absence of deliberate variations, many of the property interests, contract rights, and tort claims that exist under state law nevertheless have the same essential elements. Respecting the primary *Erie* doctrine in resolving the fundamental issues of state law that appear in bankruptcy cases will lead to the development of a body of general state law. This body will begin to resemble the early nineteenth century vision of a general commercial law that found its expression in *Swift v. Tyson.* However, consistent with *Erie,* which overruled *Swift v. Tyson,* this development will not be a federal general common law, but rather an American general common law.