Boston College Law Review

Volume 5 | Issue 2 Article 25

1-1-1964

Bankruptcy—Equity vs. State Law in Bankruptcy Courts.—In the Matter of Harold Laskin, Bankrupt

W Joseph Engler Jr

Follow this and additional works at: http://lawdigitalcommons.bc.edu/bclr

Part of the Bankruptcy Law Commons

Recommended Citation
W Joseph Engler Jr, *Bankruptcy—Equity vs. State Law in Bankruptcy Courts.—In the Matter of Harold Laskin, Bankrupt*, 5 B.C.L. Rev. 430 (1964), http://lawdigitalcommons.bc.edu/bclr/vol5/iss2/25

This Casenotes is brought to you for free and open access by the Law Journals at Digital Commons @ Boston College Law School. It has been accepted for inclusion in Boston College Law Review by an authorized administrator of Digital Commons @ Boston College Law School. For more information, please contact nick.szydlowski@bc.edu.

Exchange to have deprived petitioner of "fair procedures," thus impliedly placing a duty on exchanges to observe due process requirements.

In addition to injunctive relief, a strong position could be urged that petitioner is entitled to damages for breach of the Exchange's duty to afford due process to an aggrieved party.[32] Further, there are available the common law remedies for tortious interference with contractual relations and wrongful harm without reasonable cause, both of which were included in petitioner's original declaration.[33]

The above alternatives are all predicated upon the assumption that the Exchange's rule falls within the scope of its statutory duty of self-regulation. There are other remedies available but it is submitted that antitrust law and its severe treble damage sanctions is not properly included therein.

JOSEPH J. REARDON

Bankruptcy—Equity vs. State Law in Bankruptcy Courts.—*In the Matter of Harold Laskin, Bankrupt.*[1]—Laskin, prior to filing a voluntary petition in bankruptcy, executed a promissory note on which he signed the name of the corporation of which he was president and his own name.[2] There was no indication that Laskin's signature appeared in a representative capacity. The payee subsequently filed a proof of claim and was listed among scheduled claims, and, upon allegations of fraud, objected to bankrupt's discharge. Bankrupt filed exceptions to these objections and received permission to delete the payee from the list of creditors on the grounds that the payee was a creditor of the corporation only, not of Laskin personally. Upon a hearing on the status of the payee the referee found, on the basis of parol evidence, that at the time of the execution of the note it was intended that Laskin sign only in a representative capacity, and, hence, that the payee was not his creditor and lacked standing to object to the discharge. The district court reversed[3] holding that the controlling law was the Pennsylvania Uniform Commercial Code. Parol evidence was inadmissible to show Laskin's representative capacity.[4] The Circuit Court of Appeals reversed. HELD:

[32] See note 29 supra.

[33] Supra note 4.

[1] 316 F.2d 70 (3d Cir. 1963).

[2] Laskin Bros. of Phila. Inc. Harold Laskin. For a discussion of the signature rule under the UCC and examples thereof see Willier and Hart, Forms and Procedures Under The Uniform Commercial Code ¶ 32.07 (1963). See also Uniform Commercial Code § 3-403(3) (1962 ed.).

[3] 204 F. Supp. 106 (E.D. Pa. 1963). See annot., 4 B.C. Ind. & Com. L. Rev. 108 (1963).

[4] "An authorized representative who signs his own name to an instrument is also personally obligated unless the instrument names the person represented and shows the signature is made in a representative capacity." Pa. Stat. tit. 12A § 3-403 (1953). An amendment to the Code which allows parol evidence to show the representative capacity as between the immediate parties was in effect in Pennsylvania at the time of the court's decision. Uniform Commercial Code § 3-403 (1958). The former provisions were in effect, however, at the date of the note's execution.

however, that in the case now under discussion, it was not the statutory sanction rule of the Exchange which was the subject matter of the litigation but rather the factual application thereof. Consequently, the Court may quite properly have determined that this was not an issue requiring expertise. Quite another problem would have been raised had the rule itself been in issue.

However that may be, the wisdom of applying antitrust law and its severe sanctions[27] may be seriously challenged in this type of situation. If the Exchange acted improperly, that it should be held liable for any ensuing damage thereby occasioned to the petitioner is a readily acceptable result. But subjecting the Exchange to treble damage liability for action taken in good faith pursuant to valid rules appears to be rather harsh and unwarranted. The Court apparently felt that there was no other remedy available. However, it is submitted that injunctive relief was available by way of a petition couched in terms of deprivation of a valuable property right without due process of law by an organization possessing a quasi-governmental status, asserting that the Securities Exchange Act of 1934 impliedly gave the Exchange this status.[28] In *Steele v. Louisville & Nashville R.R. Co.*,[29] the Court determined that a labor organization, acting as the exclusive bargaining agent of employees pursuant to authority vested in it under the Railway Labor Act,[30] was subject to the constitutional limitations imposed by the Fifth Amendment even though it was not a governmental agency. In *Public Utilities Comm'n v. Pollak,* the Court held that the transmission of radio programs through receivers in its passenger vehicles by a street railway corporation which operated under the regulatory supervision of the Public Utilities Commission of the District of Columbia, an agency authorized by Congress, sufficiently involved the federal government in the responsibility for the radio programs so as to make the Fifth Amendment applicable.[31]

These are two examples of the application of the Fifth Amendment to private concerns wherein the Court found sufficient connection with the federal government to impose constitutional limitations. It is submitted that the statutorily imposed duty of Exchange self-regulation may also be an adequate basis for asserting the application of the due process requirements of the Fifth Amendment to exchanges. This proposition receives added support from the fact that the Court, in the *Silver* case, held the action of the

---

27 See note 5 supra.

28 The Act of 1934 places a statutory duty of self-regulation on all exchanges. Supra note 11.

29 323 U.S. 192, 207 (1944). Petitioner, a negro, was held to be entitled to equal status and representation by the labor organization notwithstanding the Railway Labor Act's conference upon the labor organization of the power to create and restrict rights of those whom it represented. The Court construed the Act as imposing a duty on the union to represent and bargain for *all* the members of a craft regardless of race. The Act itself provided no express means for administrative remedy but the Court held that it "contemplates resort to the usual judicial remedies of injunction and award of damages when appropriate for breach of that [statutory] duty."

30 48 Stat. 1185 (1936), 45 U.S.C. 151 et seq. (1958).

31 343 U.S. 451 (1952). Petitioner, who was a regular passenger on the vehicles of the street railway, sought to prohibit the playing of music, contending that it was an invasion of his right to privacy. The Court held that the First and Fifth Amendments were properly available to the petitioner, but dismissed on other grounds.

Bankruptcy courts are essentially courts of equity and the referee properly considered all the evidence available pursuant to the equitable distribution of bankrupt's estate.[5]

The precise location of the line separating equity in bankruptcy proceedings and state law has evaded both discovery by legal commentators and court definition.[6] The holding in the Laskin case appears to conceal this location beneath an even heavier veil while suggesting that it lies farther beyond the boundaries of state law than had previously been believed. A number of cases were cited by the court to support its holding, but an examination of these cases reveals that the broad language of equity powers stated therein was rendered in the context of rather narrowly restricted factual situations. Whether they were intended to extend to situations like the one presented in the *Laskin* case is dubious.

In *Vanston Committee v. Green*[7] the Supreme Court held that a claim in bankruptcy for interest upon interest, whether or not valid under state law, was inconsistent with established equitable principles of bankruptcy and, therefore, violative of the Bankruptcy Act itself. The case of *Prudence Realization Corp. v. Geist*[8] presented the question of the subordination of the claims of an insolvent defaulting guarantor of certificates of participation in a mortgage who was also the owner of part of the mortgage indebtedness. While explicitly stating that state law did not control, the Court held, again on the basis of affirmative federal precedent, that to allow the guarantor a *pro rata* share with other creditors would be contrary to the purpose of the indemnity and inconsistent with bankruptcy principles. *Pepper v. Litton*,[9] often cited as the leading case recognizing the broad equity power of referees in bankruptcy, involved the claim of a controlling stockholder of a bankrupt corporation. The Court sustained the disallowance of the claim because of the referee's finding that it was made pursuant to a scheme to defraud other creditors and that it constituted a breach of a fiduciary duty owed by the claimant to other creditors.

These cases, it is obvious, were decided upon the equitable powers of bankruptcy but the factual situation in each one is very distinct from that of the *Laskin* case. In only one of the aforementioned cases, *Vanston*, was there a right created under state law which the Court denied on equitable grounds, as such, and this decision rested on previously defined principles of bankruptcy derived from the Court's interpretation of the Bankruptcy Act. In *Prudence*, the Court was confronted with a legal right the exercise of which, because of the indemnity issue, would create an inequitable relationship among the other creditors. The *Pepper* decision was rendered from the context of circumstances suggesting fraud and a breach of a fiduciary

[5] Upon remand the district court was directed to review the allegations of fraud made by the payee.

[6] See, Hill, "The Erie Doctrine in Bankruptcy," 66 Harv. L. Rev. 1013 (1953); 3 Collier, Bankruptcy (14th ed. 1961) § 63.03; 1A Moore's Fed. Practice (2d ed. 1961) § 0.322.

[7] 329 U.S. 156 (1946).

[8] 316 U.S. 89 (1942).

[9] 308 U.S. 295 (1939).

obligation. On the other hand, the only fraud suggested in *Laskin* has been alleged by the payee; no fiduciary obligation is running nor would an inequitable status be granted the payee by recognizing Laskin's obligation on the note. Nor does any well-established federal precedent obtain here. No equitable principle supports the rewriting of state law by referees—which is what the court in *Laskin,* in effect, did. Moreover, along with the language of "equity" pronounced by the Court was an affirmance of the role of state law in bankruptcy proceedings. "What claims of creditors are valid and subsisting obligations against the bankrupt at the time the petition in bankruptcy is filed is a question which, in the absence of *overruling* federal law, is to be determined by reference to state law."[10] (Emphasis supplied.) Also, bankruptcy courts should proceed "not without appropriate regard for rights acquired under state law."[11] It has been explicitly held by the Supreme Court that a claim valid under state law cannot be modified or ignored in equity no matter how harsh or oppressive the terms of the obligation may appear to the federal court.[12]

The holding in the *Laskin* case certainly runs counter to the "one fundamental principle that pervades our system of bankruptcy liquidation, namely that validity or non-validity of a claim is and should be ascertained in the light of state law that would be applicable in the absence of bankruptcy proceedings."[13] Faced with a choice between two enunciated principles of the Supreme Court, the court here chose to rely on the grant of equitable powers. It is submitted, on the other hand, that, as earlier suggested, the cases cited do not support the finding and that certainly no "overruling federal law" was here involved. The Bankruptcy Act itself contains no mandate in this regard;[14] the court's holding is, rather, an extension of the prior holdings far beyond that which was probably intended.[15]

However, several factors must be noted which, undoubtedly, exercised considerable influence on the court and strongly colored its decision. To begin with, the court was presented with the evidence and finding of the referee that the parties had not intended personal liability of Laskin when the note was executed. In addition, the majority rule was that parol evidence was admissible as between the immediate parties to establish the representative capacity of the signer and this was the Pennsylvania rule before the Code's

---

[10] Vanston Committee v. Green, supra note 7, at 161.

[11] Heiser v. Woodruff, 327 U.S. 726, 732 (1946).

[12] Manufacturers' Fin. Co. v. McKey, 294 U.S. 442, 448 (1935). In the same opinion the Court quoted with approval from a Pennsylvania decision: "Legal rights are as safe in chancery as they are in a court of law, and however strong an appeal may be to the conscience of a chancellor for equitable relief, he is powerless to grant it if the one from whom it must come will be deprived of a legal right." 294 U.S. at 449. Colonial Trust Co. v. Central Trust Co., 243 Pa. 268 at 276, 90 Atl. 189 at 191 (1914).

[13] 3 Collier, Bankruptcy, op. cit. supra note 6.

[14] "Courts of bankruptcy are created . . . and invested . . . with such jurisdiction at law and equity as will enable them to exercise original jurisdiction . . . to allow claims, disallow claims. . . ." Bankruptcy Act § 2(a), 52 Stat. 842 (1938), 11 U.S.C. § 11 (1958). This is the extent of the Act's grant of equity jurisdiction. The extent of the powers thus granted is a matter of court interpretation.

[15] For a discussion of the extent of the equity powers of a referee in bankruptcy see Hill, supra note 6.

adoption. Furthermore, the Code did provide for the admission of parol evidence for the purpose of reformation, a fact noted by the court.[16] Finally, the Code had been amended in Pennsylvania by the time of the litigation to permit parol evidence in the same type situation. The weight of all these factors was probably a determining element.

For yet another substantial reason, the decision appears to be inconsistent with those cases on which it purports to rely. Each case cited by the court for support dealt with the question of the *allowability* of certain claims. The *Laskin* holding determined the creditor status of the payee on the note or the *provability* of the claim. The distinction is crucial; the discharge of Laskin will not affect the payee's claim against him in subsequent proceedings.[17] It is upon the allowance of claims that equity heretofore had been called to judge. In *Laskin* the court employed equity to determine the validity or existence of a claim and was without precedent in this respect. It is precisely in the area of the validity of a claim that state law is critical and, of necessity, controlling. The Bankruptcy Act provides that "a proof of claim shall consist of a statement under oath, in writing and signed by a creditor. . . ."[18] No standard is available in the Act to determine the validity of a claim. The only determinant is obtained by recourse to the pertinent state law. No other standard exists. Certainly not some vague and undefined principles of federal equity. The Bankruptcy Act itself refers to equity only in respect to the allowance of claims.[19] Furthermore, that state law is controlling on the question of the existence of claims is evident from several recent decisions.[20] And, according to the state law applicable in the *Laskin* case, a valid claim against him did exist.

In summary, it is concluded that the holding in the *Laskin* case lacks support of prior decisions and is contrary to the general rule that state law determines the validity of contracts executed under those laws. The provisions of the Bankruptcy Act conferring equitable jurisdiction on bankruptcy courts deal with the allowance of claims, not their validity. The Act provides no authority for the decision here. The case stands alone in the long line of bankruptcy decisions. If it is followed it will precipitate

[16] In the Matter of Harold Laskin, Bankrupt, supra note 1, at 75.

[17] "A discharge in bankruptcy shall release a bankrupt from all of his provable debts. . . ." Bankruptcy Act § 17(a), 74 Stat. 409 (1960), 11 U.S.C. § 35(a) (Supp. IV 1959-62). The distinction is evident from the terms of the Act itself and has been treated at length in Collier, op. cit. supra note 6, § 63.05, and in In re Hornstein, 122 Fed. 266, 274 (N.D.N.Y. 1903), "A claim must be proved before it can be allowed. . . ." See also, 9 Am. Jur. 2d Bankruptcy § 428 (1963).

[18] Bankruptcy Act § 57(a), 74 Stat. 217 (1960), 11 U.S.C. § 93(a) (Supp. IV 1959-62).

[19] Bankruptcy Act § 57(k), 52 Stat. 866 (1938), 11 U.S.C. § 93(k) (1958). See also Collier, op. cit. supra note 6, § 63.06(5); 9 Am. Jur. 2d, op. cit. supra note 17, Bankruptcy § 430.

[20] Hulsart v. Hooper, 274 F.2d 403 (5th Cir. 1960) (Alaska law determines validity of mortgage); In re Alikasovich, 275 F.2d 454 (6th Cir. 1960), (Michigan law determines validity of chattel mortgage). The principle is succinctly stated in *In re American Metals Prods. Co.*, 276 F.2d 701, 705 (2d Cir. 1960): "A federal court may not deflect or defeat the force of that enactment [by the Conn. Legislature] by applying an equitable doctrine where the statute does not leave room for interstitial judicial legislation."

a return to a theory "that all transactions underlying claims in bankruptcy would, in effect, be subject to federal review in the light of overriding federal commercial law,"[21] a concept already rejected in *Erie v. Tompkins*.[22]

W. JOSEPH ENGLER, JR.

Guaranty—Partial Failure of Consideration in the Principal Contract—Pro Tanto Defense for the Guarantor.—*Walcutt v. Clevite Corp.*[1]— In February of 1959, the plaintiffs sold their holdings in several corporations to the Clevite Corporation. They also agreed in separate assignable writings not to compete with Clevite for a period of ten years, during which time Clevite was to remunerate them in equal quarter-annual instalments. In September, 1960, Clevite sold both the assets of the plaintiffs' former corporations and the agreements not to compete to Walco Electronics Company. As part of the bargain, Walco promised Clevite that it would pay the plaintiffs their regular instalments; moreover, Richmond, the president and sole shareholder of Walco, guaranteed Clevite that he would pay if Walco did not. The payments not forthcoming, the plaintiffs sued Clevite directly on the noncompetition agreements. They also, as third party beneficiaries of Richmond's guaranty to Clevite, sued Richmond. Walco was not served. Richmond answered, *inter alia*, that Clevite had grossly exaggerated the value of the assets sold to Walco, that Walco's agreement to pay the plaintiffs was thus obtained by fraud, and that because of such fraud *on Walco*, he, Richmond, should be freed from his obligations as Walco's guarantor. Special Term granted summary judgment in favor of the plaintiffs against both defendants, and to Clevite on its crossclaim against Richmond. Appellate Division affirmed. Upon appeal, the Court of Appeals, in concluding that the summary judgments against Richmond must be reversed, HELD: First, that although Richmond's defense of fraud upon Walco was unavailing as a matter of law, nevertheless, sufficient facts had been pleaded to support a pro tanto defense which had not been pressed, namely partial failure of consideration in the Walco-Clevite contract; and second, that since Richmond and Walco were "truly one and the same," that Richmond should be deemed to have had the implied consent of Walco to assert against the plaintiffs Walco's claim of fraud against Clevite.

In New York, it has long been the rule that a surety[2] when sued alone cannot defend by showing that his principal was defrauded by the creditor

[21] Hill, supra note 6, at 1013.
[22] 304 U.S. 64 (1938).

[1] 13 N.Y.2d 48, 191 N.E.2d 894 (1963).
[2] Richmond is in fact a guarantor and not a surety as strictly defined. Accordingly, his obligation is secondary, that is, conditioned upon the default of Walco. Nevertheless, since the term surety is often broadly used to indicate any responsibility for the debt of another and since the legal consequences in the instant case are the same whether Richmond is a surety or guarantor, this writer has chosen for the sake of simplicity and clarity of expression to use the term surety even when technically incorrect.
For distinction between surety and guarantor, see Simpson, Suretyship §§ 3-6 (1950).