Cornell Law Library
Scholarship@Cornell Law: A Digital Repository

Cornell Law Faculty Publications | Faculty Scholarship

6-1-1981

Bankruptcy Law in Perspective

Theodore Eisenberg
Cornell Law School, ted-eisenberg@lawschool.cornell.edu

Follow this and additional works at: http://scholarship.law.cornell.edu/facpub

Part of the Bankruptcy Law Commons, and the Jurisprudence Commons

Recommended Citation
Eisenberg, Theodore, "Bankruptcy Law in Perspective" (1981). *Cornell Law Faculty Publications.* Paper 426.
http://scholarship.law.cornell.edu/facpub/426

This Article is brought to you for free and open access by the Faculty Scholarship at Scholarship@Cornell Law: A Digital Repository. It has been accepted for inclusion in Cornell Law Faculty Publications by an authorized administrator of Scholarship@Cornell Law: A Digital Repository. For more information, please contact jmp8@cornell.edu.

ARTICLES

BANKRUPTCY LAW IN PERSPECTIVE

Theodore Eisenberg*

INTRODUCTION

The new bankruptcy act is a failure. Its shortcomings show that we need to change the way we think about bankruptcy law. The problem is not so much with the new bankruptcy act's treatment of any specific issue, though larger problems manifest themselves through questionable specific provisions. Rather, the problem is the way in which bankruptcy law is perceived as an area separate from the rest of the legal world. In many respects the new bankruptcy act inadequately reflects bankruptcy law's existence as part of a legal structure that includes many other federal laws, a Constitution, and detailed treatment of debtor-creditor issues by over fifty jurisdictions. This Article explores the narrow limits within which bankruptcy reform operates and the prominence of these limits in the new act.

Initially, I discuss the bankruptcy law's inadequate coordination with preexisting federal and state laws. Many commentators have described the substantial role of state law in bankruptcy,[1] but few have prescribed the proper relationship between state law and bankruptcy. My conclusions about the proper relationship differ from those reflected in the new act in important areas including preferences and exemptions. In part because of insufficient attention to a larger legal framework, the new act's treatment of these areas is inconsistent and inefficient.

* Professor of Law, University of California, Los Angeles. I would like to thank Thomas H. Jackson and William A. Klein for their thoughtful comments. Generous financial support was provided by the Dean's Fund of UCLA Law School.

1. 2 G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 45.2 (1965); Countryman, *The Use of State Law in Bankruptcy Cases (Parts I & II)*, 47 N.Y.U. L. REV. 407, 631 (1972); Shimm, *The Impact of State Law on Bankruptcy*, 1971 DUKE L.J. 879.

HeinOnline -- 28 UCLA L. Rev. 953 1980-1981

Although the relationship between state law and bankruptcy has been the object of much study, few commentators discuss the relationship between bankruptcy law and other federal laws.[2] In the new act this myopia prevented full consideration of relevant approaches both to reforming the bankruptcy act and to implementing bankruptcy rules outside of bankruptcy proceedings. The new act fails to coordinate with nonbankruptcy federal law in many ways. First, some rules adopted for bankruptcy proceedings are sufficiently appealing to merit consideration outside of bankruptcy. But the reform movement's isolated focus precluded consideration of these rules' potential application in nonbankruptcy settings. Second, the narrow focus precluded consideration of whether some goals of a bankruptcy law might be more effectively achieved through modification of preexisting nonbankruptcy laws. Although early bankruptcy reformers had few federal statutes through which to implement change, modern reformers should not ignore the vast corpus of federal statutes, particularly those designed to assist debtors in financial difficulty. Finally, because of rather extreme beliefs about the constitutional restraints imposed upon a bankruptcy law, reformers did not seriously consider plausible alternatives to the new act. Too modest a vision about the range of possibilities critically undermines what is for many the heart of a bankruptcy system, the discharge.

By failing to analyze bankruptcy law in the same manner as any other law, Congress ignored at least one question that attends not only bankruptcy laws but all laws. Should people be allowed to adjust their behavior to evade the law's anticipated application? In the case of bankruptcy, should debtors and creditors be allowed, encouraged, or discouraged from planning and adjusting their behavior in anticipation of a forthcoming bankruptcy? Many provisions in the new act reflect a negative answer to this suggestion but other sections offer a different outlook. The new act needs a more general approach to the problem. Before that can be achieved, however, it is necessary to recognize the problem's existence.

In areas in which the bankruptcy process' isolation contributed to inadequate reform, I discuss alternative solutions that

---

2. The substantial attention devoted to the relationship between the business reorganization provisions of the bankruptcy law and their tax counterparts constitute a prominent exception to this pattern. *See, e.g.,* Bankruptcy Tax Act of 1980, Pub. L. No. 96-589; Plumb, *The Tax Recommendations of the Commission on the Bankruptcy Laws—Reorganizations, Carryovers and the Effects of Debt Reduction,* 29 TAX L. REV. 229 (1974); Tillinghast & Gardner, *Acquisitive Reorganizations and Chapters X and XI of the Bankruptcy Act,* 26 TAX. L. REV. 663 (1971). *But see* Sheinfeld & Caldwell, *Taxes: An Analysis of the Tax Provisions of the Bankruptcy Tax Act of 1980,* 55 AM. BANKR. L.J. 97, 98 (1981).

HeinOnline -- 28 UCLA L. Rev. 954 1980-1981

seem more harmonious with our overall legal structure. Regardless of one's views of the specific changes I discuss, however, one should not lose sight of the larger issue. Specific questionable rules adopted in the new act are not as disturbing as the process preceding their enactment. In that process one often finds little or no serious consideration of plausible alternatives and a consistent failure to consider problems from anything but the perspective of a bankruptcy proceeding.

I do not wish to attribute the new act's failings to any particular group. The exigencies of the political process took their toll on rational reform and the act accomplishes as much as it does largely because of the intelligence, public spiritedness and sheer perseverance of an able group of bankruptcy experts. Their performance is available for criticism only because they knew enough and cared enough about bankruptcy law to seek and implement its reform. One may attribute bankruptcy law's isolation as much to the nonbankruptcy community's disinterest as to bankruptcy reformers' actions. I simply wish to highlight the substantial price we may be paying for the narrow perspective from which bankruptcy law is viewed.

I. THE RELATIONSHIPS BETWEEN BANKRUPTCY LAWS AND OTHER LAWS

Federal bankruptcy law could take many possible approaches towards state law. Perhaps the simplest approach is, wherever possible, for state rules to govern in bankruptcy. For example, until recently, this principle regulated bankruptcy exemptions.[3] At the other extreme the Constitution authorizes Congress "[to] establish . . . uniform Laws on the subject of Bankruptcies throughout the United States."[4] A truly uniform law of bankruptcy might require creation of a complete federal law of commercial transactions, but the Supreme Court long ago rejected this view.[5] There are intermediate positions whereby a bankruptcy law neither totally incorporates nor always modifies state rules. There is some effort to coordinate state and federal rules but neither state nor federal law wholly displaces the other.

A single relationship between state law and bankruptcy may be justified on divergent grounds. When bankruptcy law incorpo-

3. Bankruptcy Act of 1898, ch. 541, § 6, 30 Stat. 544 [hereinafter cited to section number only and as Bankruptcy Act of 1898]; Countryman, *supra* note 1, at 475-76. Although Congress repealed the Bankruptcy Act of 1898, effective October 1, 1979, the Act continues to govern cases pending on September 30, 1979. Act of Nov. 6, 1978, Pub. L. No. 95-598, § 402, 92 Stat. 2549.

4. U.S. CONST. art. I, § 8, cl. 4.

5. *See* Hanover Nat'l Bank v. Moyses, 186 U.S. 181 (1902).

HeinOnline -- 28 UCLA L. Rev. 955 1980-1981

rates a state rule, one might think of the federal lawmakers in some sense approving the state rule. Alternatively, it may be thought that whether or not federal lawmakers approve the state rule, state law is the more appropriate source of law even in a federal bankruptcy dispute. For example, it is difficult to imagine federal lawmakers nodding with approval at the fifty different state debtor exemption systems, yet until recently federal bankruptcy law incorporated the fifty different systems.[6] State law, good or bad, may be viewed as the appropriate source of a debtor's exemptions. Similarly, rejection of state law may reflect disapproval of the substance of the state rule or a conviction that a federal standard is necessary regardless of the content of state law.

A rational bankruptcy law most likely would adopt a different attitude towards state law with respect to different provisions. Deference to one state measure may accompany replacement of another. But if this split approach exists, and it does, one might expect explanations or justifications for the divergence. Whether state or federal law is presumptively the proper base, Congress ought to have articulable reasons for imposing a rule that differs from the base.

Inevitably, incorporation of state law cannot shape all features of a bankruptcy law. The very existence of a bankruptcy system creates problems that simply do not exist under state law but to which federal legislation must attend. For example, apart from incomplete priority rules, there are no appropriate state laws upon which to base federal rules of distribution and discharge.[7] Putting aside the areas shared by these problems, let us explore the circumstances under which one might wish to incorporate state law in bankruptcy.

A. *State Law as the Starting Point*

State law should be the point of reference for each bankruptcy rule that may be based on it. Absent some reason for departing from state law, bankruptcy rules can and usually do track state rules. Something more substantial than a mental coin flip leads one to favor state law as a source of bankruptcy rules. As Alfred Hill observed nearly three decades ago, the "apparent purpose" of bankruptcy law is "to provide a system for the effectuation of what are for the most part state-created rights."[8] In

---

6. *See generally* Bankruptcy Act of 1898 § 6.

7. Given the existence of a federal bankruptcy statute, states lack constitutional power to have a complete system of distribution and discharge. *See, e.g.,* International Shoe Co. v. Pinkus, 278 U.S. 261 (1929).

8. Hill, *The Erie Doctrine in Bankruptcy,* 66 HARV. L. REV. 1013, 1035 (1953). Surprisingly, federalism, the common touchstone for most discussions about the rela-

HeinOnline -- 28 UCLA L. Rev. 956 1980-1981

general, property interests that survive bankruptcy do so because bankruptcy law attempts to distribute property in a manner that comports with state laws regulating nonbankruptcy situations.[9] Thus, for example, definitions of liens and secured claims, two interests that often do survive in bankruptcy, rely on state precedent.[10] In many commercial contexts, such concepts have little meaning independent of state law.

Nationwide enactment of the Uniform Commercial Code (UCC) has not altered Professor Hill's insight. In commercial dealings, articles 2, 6 and 9 of the UCC serve as a, if not the, basis for planning secured and unsecured credit transactions. Widespread enactment of the UCC as state law, if anything, reinforces one's leaning towards state law as a starting point. When each state had its own system of regulating commercial transactions, particularly secured transactions, a federal rule could at least serve a unifying function. With some exceptions, the UCC already has secured the benefits of uniformity. Furthermore, on the merits, the UCC is an attractive starting point. It was thought out as much in advance as any statute has been, benefited from years of study and revision, and has stood the test of time. Despite early criticism and some inevitable problems, the legal and business communities regard the UCC as a successful statute. Return to pre-UCC days in credit transactions is unthinkable.

Independently of the content of state law, there is reason to try to have bankruptcy rules track those rules that would govern in a nonbankruptcy setting. Those who engage in commercial transactions are cognizant of the legal framework under which they operate. The commercial world will work more smoothly if planning for commercial transactions may be limited to one set of legal rules. In our society those rules often are those contained in the UCC. When the bankruptcy act imposes a different set of rules that mandate different relative rights of unsecured creditors, secured creditors and debtors, a new and costly level of planning becomes inevitable.[11] The benefits of having a new level of rules may outweigh these costs but the rules are always imposed at some cost. To require another layer of commercial planning, ac-

tionship between federal and state law, played little express role in selecting state or federal rules in the new act. For an exception, see *Bankruptcy Act Revision: Hearings on H.R. 31 and H.R. 32 Before the Subcomm. on Civil and Constitutional Rights of the House Comm. on the Judiciary,* 94th Cong., 1st & 2d Sess., pt. 3, at 1646 (1975-1976) (statement of National Association of Insurance Commissioners) [hereinafter cited as *Bankruptcy Hearings*].

9. 2 G. GILMORE, *supra* note 1, § 45.2, at 1286. *See also* Butner v. United States, 440 U.S. 48, 54-55 (1979).

10. 2 G. GILMORE, *supra* note 1, § 45.2, at 1286.

11. In at least one case, however, the UCC itself contains a different rule for insolvency proceedings. U.C.C. § 9-306(4).

HeinOnline -- 28 UCLA L. Rev. 957 1980-1981

companied by a layer of federal rules, is not likely to be welcome, efficient or simple.

When bankruptcy rules differ from state rules, one also may predict a slightly different set of dislocations. It is not always clear whether those dislocations are desirable or undesirable, but they should not be ignored. Every rule that differs from state law will provide to someone relative advantage in bankruptcy over their position outside bankruptcy. For example, the new bankruptcy law rejects the UCC's decision to fully honor a secured party's security interest in inventory, receivables and other after-acquired property.[12] Each secured creditor with such collateral has a new incentive to keep his debtor from going into bankruptcy. Conversely, each unsecured creditor who is competing with such secured creditors has, by virtue of the new act, some increase in his preference for a bankruptcy setting. Bankruptcy rules regulating commercial transactions have effects beyond the mere change in substantive law.

Overwhelming evidence demonstrates the modern bankruptcy revisers' belief that bankruptcy law generally should accommodate itself to state rules. State law influences the definition and allowability of claims and the existence of secured status.[13] In doing so, it all but determines which claimants have a chance of successfully participating in a bankruptcy proceeding, though it does not necessarily settle which of the group of qualifying secured and unsecured creditors will obtain something or how much they will obtain. Creditors with no rights under state law have little chance of successful participation in a bankruptcy proceeding. The new and old bankruptcy acts specifically rely on state law in outlining the trustees' powers to attack creditors' colorable claims in bankruptcy.[14] In an extraordinary effort to coordinate bankruptcy law with state law, the new act addresses the problem of how to treat a debtor's spouse's creditors in community property states.[15] All commentators agree on a central role for state law.[16]

Given that relevant state law is, has been and will be the starting point for bankruptcy rules, bankruptcy rules nevertheless may depart from state law for several reasons. There should be little debate about some reasons for inventing a federal rule. If the essence of a bankruptcy law is a system of fair distribution and discharge, state law may be an inappropriate guide because it is

12. *See, e.g.,* Young, *Preferences Under the Bankruptcy Reform Act of 1978,* 54 AM. BANKR. L.J. 221, 232-33 (1980). *See* notes 22-29 & accompanying text *infra.*

13. *E.g.,* Countryman, *supra* note 1, at 412-31.

14. 11 U.S.C. § 544 (Supp. IV 1980); Bankruptcy Act of 1898 § 70e.

15. 11 U.S.C. § 726(c) (Supp. IV 1980).

16. *See, e.g.,* authorities cited in note 1 *supra.*

HeinOnline -- 28 UCLA L. Rev. 958 1980-1981

incomplete. Or state law may provide plainly inappropriate guidance because it violates whatever distributional principles one feels ought to govern in bankruptcy. If, for example, state law were to provide that nonsupport credit obligations to the debtor's family are to be paid ahead of all other creditors, it should not and would not be followed.[17] Adherence to state law might also result, as it has in the past, in unnecessary nonuniformity in bankruptcy proceedings.[18]

B. *A Case Study: Preferences*

Sometimes bankruptcy reformers reject state rules neither to enhance uniformity nor to overcome clear inconsistency with federal bankruptcy policy. In some cases, reformers replace state rules with federal rules that they believe to be marginally superior. The new act's treatment of security interests and accounts receivable is perhaps the most important such departure from state law, and to understand this departure one must examine the law and theory of preferences. Upon analysis, existing theories of preferences do not justify the new act's rules limiting the validity of security interests in inventory and receivables. The new rules offer no clear advantages over article 9's prior treatment of the subject. The reform movement's technicians should have articulated the costs of a separate bankruptcy rule and decisionmakers should have considered these costs before imposing such a rule.

A debtor who owes creditors *X* and *Y* equal amounts of money is said to give a preference to *X* if, while insolvent, the debtor repays *X* a greater proportion of *X*'s debt than the debtor pays to *Y* on *Y*'s debt.[19] Outside of bankruptcy, and absent fraud or a fraudulent conveyance, *Y* has no right against *X* merely because the debtor preferred *X* to *Y*.[20] If, however, the same transaction occurs on the eve of bankruptcy, section 60 of the old bankruptcy act[21] and section 547(b) of the new act threaten *X*'s right to retain the preferential payment.

Section 547(b) states:

17. *Cf.* 11 U.S.C. § 545(3), (4) (Supp. IV 1980) (invalidating in bankruptcy state statutory landlords' liens).

18. *See* REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, PART I, H.R. DOC. No. 93-137, 93d Cong., 1st Sess. 171 (1973) [hereinafter cited as COMMISSION REPORT]; Countryman, *For a New Exemption Policy in Bankruptcy,* 14 RUTGERS L. REV. 678 (1960).

19. 2 G. GILMORE, *supra* note 1, § 45.3.3, at 1298.

20. *See, e.g.,* CAL. CIV. CODE § 3432 (West 1970); 2 G. GILMORE, *supra* note 1, § 45.2, at 1285, § 45.3.3, at 1298. For some exceptions to the general rule, see Seligson, *The Code and the Bankruptcy Act: Three Views on Preferences and After-Acquired Property,* 42 N.Y.U. L. REV. 278, 292 (1967); note 69 *infra.*

21. Bankruptcy Act of 1898 § 60.

HeinOnline -- 28 UCLA L. Rev. 959 1980-1981

> Except as provided in subsection (c) of this section, the trustee may avoid any transfer of the property of the debtor—
>
> (1) to or for the benefit of a creditor;
>
> (2) for or on account of an antecedent debt owed by the debtor before such transfer was made;
>
> (3) made while the debtor was insolvent;
>
> (4) made—
>
> (A) on or within 90 days before the date of the filing of the petition; . . . and
>
> (5) that enables such creditor to receive more than such creditor would receive if—
>
> (A) the case were a case under chapter 7 of this title;
>
> (B) the transfer had not been made; and
>
> (C) such creditor received payment of such debt to the extent provided by the provisions of this title.[22]

On the above facts there is a transfer (the repayment) of property of the debtor (money) to or for the benefit of a creditor (*X*) on account of an antecedent debt. If bankruptcy soon follows the repayment to *X* the debtor probably was insolvent when the transfer was made, and the new act assists the trustee in proving this element of a preference by creating a presumption of insolvency for a period of ninety days prior to bankruptcy.[23] Assuming that the transfer occurred within ninety days of bankruptcy and that *X* would not have received the same amount had *X*'s only payment on account of the debt been a bankruptcy dividend, we have a preference.

A preference may exist in situations less obvious than that involving a simple payment to *X* and no payment to *Y*. If, instead of paying *X*, the debtor were to give *X* a security interest in some of the debtor's property during the ninety day period, the effect in bankruptcy is the same as if the debtor had paid *X* cash. *X*'s valid security interest survives bankruptcy and *X* gets the collateral. Preference law has long accommodated itself to this possible subterfuge by deeming a transfer to include grants of security.[24]

An important and controversial recent issue in preference law is whether a debtor's transfer of a security interest in collateral, which first becomes effective during the preference period, may be avoided in bankruptcy. The controversy centers on inventory and

---

22. 11 U.S.C. § 547(b) (Supp. IV 1980). Section 547(b)(4)(B) expands the preference period to one year in the case of creditors who are insiders with reasonable cause to believe the debtor was insolvent at the time of the transfer. The term "insider" is defined in § 101(25) of the Bankruptcy Act, *id.* § 101(25).

23. *Id.* § 547(f).

24. *Id.* § 101(40); Bankruptcy Act of 1898 § 1(30). A less recognized form of preference occurs when a Chapter 13 debtor is allowed to place unsecured creditors in different classes and thereby pay them different percentages of their debts. The status of this practice under the new act is unclear. *See generally* Vihon, *Classification of Unsecured Claims: Squaring a Circle?*, 55 AM. BANKR. L.J. 143 (1981).

HeinOnline -- 28 UCLA L. Rev. 960 1980-1981

receivables financing, in which prior to the preference period, the creditor makes a loan to the debtor secured by collateral consisting of inventory or accounts receivable. Because there is constant turnover of inventory and receivables, the debtor will first obtain an interest in some inventory and receivables during the preference period.[25] If the debtor is deemed to transfer his interest in collateral acquired during the preference period only when he first obtains an interest in it, the secured party's interest in such collateral often will be vulnerable as a preference. The security interest in the recent inventory and receivables will be a transfer on account of an antecedent debt because the debt, which arose prior to the preference period, is antecedent to the transfer, which, it is argued, cannot occur before the debtor has an interest in the collateral. Simultaneously, the transfer automatically will be viewed as occuring during the preference period. If the debtor is in financial difficulty, and these cases do not arise unless the debtor is so situated, the other requirements for a preference will be satisfied and the secured party's interest in the debtor's recently acquired inventory and receivables will pass to the bankruptcy trustee.

Under article 9 of the UCC, however, courts found grants of security interests in after-acquired collateral to be presently effective.[26] For preference purposes, this means the transfer consisting of the security interest occurs when the debtor grants the security interest. Normally, this transfer will occur prior to the preference period and is, therefore, neither within the preference period nor on account of an antecedent debt. The bankruptcy trustees thus usually failed in their efforts under the old bankruptcy act's preference section to recover as preferences inventory and receivables acquired by the debtor during the preference period. Under article 9, the interests in constantly shifting collateral such as inventory and receivables were not generally vulnerable to preference attack. With important exceptions, the new act in section 547(c) and (e) renders not only some such arrangements voidable as preferences but may also invalidate in bankruptcy a secured party's interest in all other forms of after-acquired collateral in which the

---

25. *See generally* Jackson & Kronman, *Voidable Preferences and Protection of the Expectation Interest,* 60 MINN. L. REV. 971, 973 & n.9 (1976) and authorities cited therein; Reisman, *The Challenge of the Proposed Bankruptcy Act to Accounts Receivable and Inventory Financing of Small-to Medium-Sized Business, Part I,* 83 COM. L.J. 169 (1978).

26. DuBay v. Williams, 417 F.2d 1277 (9th Cir. 1969); Grain Merchants, Inc. v. Union Bank & Sav. Co., 408 F.2d 209 (7th Cir.), *cert. denied sub nom.* France v. Union Bank & Sav. Co., 396 U.S. 827 (1969); Jackson & Kronman, *supra* note 25, at 973 n.9 and authorities cited therein. *Contra, In re* Tempco Business Services, Inc., 3 Bankr. Ct. Dec. 446 (E.D. Mich. 1977).

HeinOnline -- 28 UCLA L. Rev. 961 1980-1981

debtor first obtains an interest during the preference period.[27]

To illustrate the problem and the new act's treatment of it, assume that on January 1 secured party lends retailer $100,000 secured by a security interest in retailer's present and after-acquired inventory, which on the date of the loan has a value of $50,000. Secured party properly perfects his security interest. On February 1, because of new purchases by retailer, secured party's collateral is worth $100,000, but retailer has filed a petition in bankruptcy on the same day. By virtue of article 9 and bankruptcy cases decided under the old act, it seemed settled that secured party's security interest was valid in bankruptcy for the full value of retailer's inventory collateral or $100,000.[28] Under the new act, however, secured party's security interest is vulnerable in bankruptcy to the extent of the increase in value in the collateral between January 1 and February 1, that is, $50,000.[29]

---

27. *See* 11 U.S.C. § 547(e)(3) (Supp. IV 1980). The new act's cure may exceed the malady that afflicted unsecured creditors under article 9. Section 547(e)(3) seems to render vulnerable to preference attack not only inventory and receivables financing, which are saved to some extent by § 547(c)(5), but all security interests in after-acquired property that the debtor acquires during the preference period. For example, interests in after-acquired equipment acquired during the preference period are deemed by § 547(e)(3) to be transfers occurring during the preference period. For collateral other than inventory and receivables, there is no rescue provision comparable to that of § 547(c)(5). Section 547(c)(1) may protect after-acquired property where there is a contemporaneous release of collateral of equal value. *See* 4 W. COLLIER, COLLIER ON BANKRUPTCY § 547.22, at 547-79 to -80 (15th ed. 1979); Kaye, *Preferences Under the New Bankruptcy Code,* 54 AM. BANKR. L.J. 197, 199-200 (1980) (both suggesting that "substitution of collateral" doctrine under old act survives under new act). But in the broader class of cases in which collateral acquired during the preference period replaces collateral of lesser value (such as worn out equipment), it is not clear that secured parties may avoid a preference attack. Section 547(e)(3) also seems to threaten some security interests in proceeds of collateral where such proceeds are first obtained by the debtor during the preference period.

The drafters of early versions of the "two-point" test that is contained in § 547(c)(5) were aware of the threats their language posed to all after-acquired property not consisting of inventory and receivables but proposed no modifications to deal with the problem. NATIONAL BANKRUPTCY CONFERENCE, REPORT OF THE COMM. ON COORDINATION OF THE BANKRUPTCY ACT AND THE UNIFORM COMMERCIAL CODE 15-16 (1970) [hereinafter cited as NATIONAL BANKRUPTCY CONFERENCE], *reprinted in* H.R. REP. NO. 95-595, 95th Cong., 1st Sess. 204, 215-16 (1977). This may not be the first instance of incidental or accidental invalidation of after-acquired interests in bankruptcy. *See* 2 G. GILMORE, *supra* note 1, § 45.6, at 1311-13.

The very notion of dealing with after-acquired property through preference provisions is something of an historical accident. It is only because immature security laws could not grapple with interests in after-acquired property, *see* 1 G. GILMORE, *supra* note 1, §§ 7.10-.12; 2 *id.* § 45.5, at 1306; *id.* § 45.6, at 1310, that bankruptcy trustees could attack after-acquired property interests prior to the enactment of the UCC. It was largely fortuitous that preference law became the vehicle through which trustees attack such interests. The attacks never were premised on the traditional preference theories.

28. *See* cases cited in note 26 *supra.*

29. 11 U.S.C. § 547(c), (e) (Supp. IV 1980).

HeinOnline -- 28 UCLA L. Rev. 962 1980-1981

1. Justifications of the New Rule

It is difficult to categorize the states' result under article 9 as plain error. All states chose the result Congress overturned. Of course, even all the states may be wrong, but in the inventory and receivables financing, no existing theory of preferences furnishes persuasive support for one result over the other. Even if one were to accept that unsecured creditors should fare better than they do under article 9, the preference rules in section 547 are a poor vehicle through which to achieve that goal.

The traditional justification for avoiding preferences in bankruptcy is to prevent pre-bankruptcy dissipation of the debtor's assets among a few favored or aggressive creditors. Thus, the Commission on Bankruptcy Laws of the United States, a congressionally chartered group charged with studying bankruptcy law in contemplation of bankruptcy reform,[30] endorsed the late Professor Seligson's statement of the goals of a preference provision.

> A cornerstone of the bankruptcy structure is the principle that equal treatment for those similarly situated must be achieved. It would be highly inequitable to disregard what transpires prior to the filing of the bankruptcy petition; to do so would encourage a race among creditors, engender favoritism by the debtor, and result in inequality of distribution. At bankruptcy, the bankrupt would be left, as Collier says, with only tag ends and remnants of unencumbered assets.[31]

If one is going to have a bankruptcy proceeding to which anyone will wish to come, one had better be prepared to examine and to threaten to undo at least some prebankruptcy transactions. Otherwise nothing will be left for unsecured creditors. As a general principle this seems to justify a preference provision.[32]

Although this theory supplies an appropriate rationale for upsetting eve-of-bankruptcy payments and grants of security, the classic bankruptcy preferences, it offers no justification for the new preference rule unfavorable to accounts receivable and inventory lenders. The article 9 secured party enters the preference period having done all one can to secure an interest in collateral. Secured lenders' treatment in bankruptcy causes displeasure not

30. Congress established the Commission and directed it to "study, analyze, evaluate, and recommend changes" in bankruptcy law. Act of July 24, 1970, Pub. L. No. 91-354, 84 Stat. 468.

31. COMMISSION REPORT, *supra* note 18, at 202 (quoting Seligson, *supra* note 20, at 292).

32. *See* Morris, *Bankruptcy Law Reform: Preferences, Secret Liens and Floating Liens,* 54 MINN. L. REV. 737, 738 (1970). The rationale of limiting dissipation of assets when financial distress occurs may also explain most of the exceptions to preference treatment contained in § 547(c) of the new act. Most of them may be seen as condoning transfers to creditors, either in cash or security, where such transfers are likely to be unrelated to the debtor's weak financial condition.

HeinOnline -- 28 UCLA L. Rev. 963 1980-1981

because of their eve-of-bankruptcy activity but because their interests in the bankrupt's assets can be perfected far in advance with preemptive rights as against subsequent creditors. Section 547's treatment of inventory and receivables financing must be justified on some other ground.[33]

The most popular ground seems to be that, absent some such limitation, secured lenders would fare "too well" in bankruptcy compared with unsecured creditors. "Equality is equity." For example, the National Bankruptcy Conference, a private group involved in bankruptcy reform,[34] noted disapprovingly that under the old bankruptcy law, "it appears that no perfected Article 9 after-acquired property interest in inventory, receivables or any other type of property can ever be set aside in bankruptcy."[35] Yet this straightforward suggestion that too much is too much is also an incomplete justification for the new act's subordination of inventory and receivables secured lending.

Lawmakers face a difficult decision in choosing the ideal ranking of secured and unsecured creditors in a bankruptcy pro-

---

33. One effect of the new act's two-point test for inventory and receivables financing is supportable under traditional preference principles. It captures for the benefit of the estate increases in the value of collateral that result from manipulative creditor action on the eve of bankruptcy. For example, a secured creditor whose collateral consists of accounts receivable may exert pressure on a debtor to sell goods at an artifically low price merely to inflate the value of the debtor's receivables. *See* J. WHITE & R. SUMMERS, HANDBOOK OF THE LAW UNDER THE UNIFORM COMMERCIAL CODE 881 (1972); Kronman, *The Treatment of Security Interests in After-Acquired Property Under the Proposed Bankruptcy Act,* 124 U. PA. L. REV. 110, 144 (1975). But such manipulative creditor conduct has not been the specific source of support for the new act's treatment of inventory and receivables. *See* text accompanying notes 30-43. And if one wishes to capture for the estate increases in the value of collateral attributable to manipulation, § 547's treatment of inventory and receivables financing is grossly underinclusive. It captures only increases that happen to result in collateral value that is greater on the date of bankruptcy than it was 90 days earlier. If, as is likely, collateral values decrease or remain constant during the prebankruptcy period, § 547 leaves the secured creditor free to manipulate them back up to their value as of 90 days before bankruptcy. In light of this and other difficulties attendant to the two-point test, *see* text accompanying notes 44-51 *infra,* the problem raised by manipulative creditor action would seem better addressed by a rule focusing on the routineness and terms of the debtor's eve-of-bankruptcy sales. *See* Hogan, *Games Lawyers Play with the Bankruptcy Preference Challenge to Accounts and Inventory Financing,* 53 CORNELL L. REV. 553, 569-73 (1968); *cf.* 11 U.S.C. § 547(c)(2) (Supp. IV 1980) (focusing on terms and routineness of sales in determining transactions eligible for exceptions to preference rules).

34. *See* Klee, *Legislative History of the New Bankruptcy Code,* 54 AM. BANKR. L.J. 275, 279 n.35 (1980).

35. NATIONAL BANKRUPTCY CONFERENCE, *supra* note 27, at 17, *reprinted in* H.R. REP. No. 95-595, 95th Cong., 2d Sess. 217 (1977). *See also* Gilmore, *The Good Faith Purchase Idea and the Uniform Commercial Code: Confessions of A Repentant Draftsman,* 15 GA. L. REV. 605, 625-29 (1981) (suggestion that rule limiting priority of receivables financers, rather than article 9 structure, better reflects modern commercial realities); Jackson & Kronman, *supra* note 25, at 989-90.

HeinOnline -- 28 UCLA L. Rev. 964 1980-1981

ceeding. Rightly or wrongly, bankruptcy law generally accepts secured lending as a credit vehicle and honors it in bankruptcy.[36] Given this decision, and unsecured lenders' freedom to choose borrowers, a bankruptcy system that fully honors the article 9 security interests of inventory and receivables secured lenders does not seem less equitable than section 547's treatment of inventory and receivables lenders. If it is "equitable" to honor secured credit transactions in all other contexts, notions of fairness cannot require any particular treatment of inventory and receivables.[37] Indeed, since an inventory or receivables lender must follow the article 9 notice system to achieve secured status in bankruptcy,[38] all lenders may discover the likelihood of not being able to seek satisfaction out of the secured lender's inventory or receivables collateral. Even without notice, absent a security interest of their own, other lenders would be foolish to rely on particular assets of the debtor.[39] Finally, both groups know the rules of the game when they extend credit. If the rules favor secured lenders, unsecured lenders should not be able to cry "foul" after the fact. One cannot justify the new act's treatment of inventory and receivables financing on the ground of equity between secured and unsecured lenders.

---

36. *See, e.g.,* 2 G. GILMORE, *supra* note 1, § 45.2, at 1288. Strangely, neither the old nor the new bankruptcy laws affirmatively express the secured creditor's priority status in bankruptcy. *But cf.* 11 U.S.C. § 725 (Supp. IV 1980) (general residual instruction to bankruptcy trustee concerning disposition of property). For a thoughtful discussion of whether security agreements should survive in bankruptcy, see Schwartz, *Security Interests and Bankruptcy Priorities: A Review of Current Theories,* 10 J. LEGAL STUD. 1 (1981).

37. *See* Jackson & Kronman, *Secured Financing and Priorities Among Creditors,* 88 YALE L.J. 1143, 1148 (1979) ("Since creditors remain free to select their own debtors and to set the terms on which they will lend, there is no compelling argument based on considerations of fairness for adopting one legal rule (debtors can rank creditor claims in whatever way they see fit) rather than another (all creditors must share equally in the event of bankruptcy)."). To the extent one's view of how to treat inventory and receivables financing is shaped by bankruptcy law's general decision to honor secured transactions, one might ask the then prior question whether the general decision to honor secured credit agreements is justifiable. For an argument that the decision is justifiable, see *id.* at 1157-58, which supports the honoring of secured credit transactions largely on the notion that the debtor and his creditors would work out such a system by consensual agreement even if the law did not recognize secured credit transactions. *But see* Jackson & Kronman, note 25 *supra* (attempting to justify bankruptcy law's use of preferences to invalidate, in part, consensual security agreements covering inventory and receivables financing); Schwartz, note 36 *supra.*

38. A security interest that is invalid under state law will be vulnerable to attack by the bankruptcy trustee. *See* 11 U.S.C. § 544(a) (Supp. IV 1980).

39. An unsecured creditor has no enforceable interest in particular property of the debtor. The creditor either must obtain a security interest in property or execute upon property in enforcing a judgment. Until one of these steps occurs, the unsecured creditor is continuously threatened with subordination to those who take either of those steps even if they do so after the unsecured creditor has extended credit and with knowledge of his status. U.C.C. § 9-301.

HeinOnline -- 28 UCLA L. Rev. 965 1980-1981

A final effort to justify the new rules rests on the larger economic view that, regardless of the equities, the economy as a whole benefits more from dividing the debtor's assets between the secured and unsecured lenders than from allowing secured lenders to obtain them all.[40] From an economic perspective that encompasses both secured and unsecured lenders, however, the bankruptcy rule probably does not matter. If inventory and receivables lenders fare well under article 9 and bankruptcy law, unsecured lenders will have to charge higher interest rates (explicitly or in higher prices of goods sold on open credit) or lend more carefully (at greater cost) to obtain the same return on their investments given the greater bankruptcy losses they would incur if they continued to follow their prior lending practices. Debtors' reliance on unsecured borrowing may decrease because of the higher cost of money, thereby slowing the presumably desirable flow of unsecured credit. But this damping effect on the flow of credit is matched by an increase in reliance on the inventory and receivables lenders whose cost of doing business is decreased by their favorable treatment in bankruptcy. If differences in the costs of engaging in secured and unsecured credit transactions are ignored,[41] the decrease and corresponding increase will result in no net change in the cost of funds. If one really wishes to justify a particular preference rule on the basis of its widespread economic effects, one would need to know the relative elasticity of demand for the relevant types of secured and unsecured credit and the increased costs associated with more careful lending by the relevant lenders. Indeed, one might also need to know who in the economy really bears the cost of credit increases.[42] Absent such information, and neither Congress, the Commission on Bankruptcy Laws, nor the National Bankruptcy Conference suggest its existence, one cannot justify the new preference rule on the ground that it has anything other than short term beneficial effects for a chosen group of lenders.[43]

---

40. *See* note 43 *infra.*

41. One might expect the costs of entering into unsecured credit transactions to be less than those of entering into secured transactions. *See* Schwartz, *supra* note 36, at 8. Secured creditors must identify collateral, negotiate its use as security, and comply with the technical requirements for the creation and perfection of a security interest. On the other hand, unsecured creditors may have to expend time, effort and money in negotiating financial covenants and secured creditors may enjoy substantial savings in the costs of monitoring their loans. *See generally* Jackson & Kronman, *supra* note 37, at 1149-61. For difficulties in determining what costs should count as transaction costs, see Williamson, *Transaction-Cost Economics: The Governance of Contractual Relations,* 22 J.L. & ECON. 233 (1979).

42. A discussion of who bears the cost of bankruptcy appears in D. STANLEY & M. GIRTH, BANKRUPTCY: PROBLEM, PROCESS, REFORM 37 (1971).

43. The larger economic view that society as a whole will benefit from preference rules that divide debtors' assets between secured and unsecured lenders appears in a

HeinOnline -- 28 UCLA L. Rev. 966 1980-1981

2. The Case for Adhering to Article 9

Once the offered justifications for the new preference rules are put aside, one can build a case for leaving inventory and receivables financing the way they were prior to the new act. Part of that case rests on viewing bankruptcy law's treatment of security interests as essentially a means for enforcing state-created rights. State law determines virtually all other aspects of the creation, perfection and effect of security interests.[44] While bank-

---

modified form in Jackson & Kronman, *supra* note 25, at 989, 990, where the new act's treatment of inventory and receivables financing is explained as spreading the risk of bankruptcy among the debtor's creditors (both secured and unsecured), and thereby reducing the likelihood of an initial bankruptcy triggering other bankruptcies.

Even if one views spreading the risk of bankruptcy as desirable, the use of preference rules for risk spreading has residual effects that make it questionable whether society enjoys a net gain. As the lending community adjusts to a bankruptcy rule more favorable to unsecured lenders, one may expect a relative decrease in the cost of unsecured loans and a relative increase in the cost of secured loans. Whether such developments are beneficial to society will depend on factors like those enumerated in the text with respect to the general economic effects of a preference rule relatively favorable to unsecured lenders. The risk-spreading effect cannot be viewed in isolation from accompanying effects on the credit market.

In fact, the fiscal structure of the credit industry may be such that spreading the cost of bankruptcy among secured and unsecured lenders will cause more domino effect failures than will isolating the effects of bankruptcy upon unsecured lenders. To illustrate, assume a bankrupt debtor has three creditors, two unsecured and one secured. The debtor owes each creditor $50, for a total of $150 in debt, but only $60 is available for distribution among creditors. Thus, a pro rata distribution will lead to each creditor receiving $20. Assume, however, that each of the bankrupt's creditors will experience financial distress unless they receive at least $50 from the bankrupt's estate. Equal distribution will then result in triggering three additional bankruptcies. A distribution calling for one creditor to receive all of the bankrupt's estate will lead to only two residual bankruptcies. Under such circumstances, one cannot justify the new preference rule because of its expected risk-spreading feature. We have no real idea of whether the credit industry is such that the effects of an initial bankruptcy are better cushioned by spreading the risk among creditors or by a distribution scheme that picks a single lender to be paid as much as possible.

When society truly fears the residual effects of an initial bankruptcy it seems reluctant to rely on bankruptcy law to cushion those effects. In the case of financial institutions, where insolvency might well have disastrous ripple effects, we do not even allow bankruptcy law to govern insolvency proceedings. 11 U.S.C. § 109(b)(2), (3) (Supp. IV 1980). The Chrysler, Lockheed and New York City episodes indicate that society will look beyond formal bankruptcy law to ameliorate situations within the law's reach.

44. The major bankruptcy inroads upon state law's dominance of security interests, § 362(a)'s automatic stay against enforcement of security interests and § 363's provisions for the use, sale or lease of collateral, might be justified by considerations analogous to those underlying the preference provisions. The bankruptcy preference rules depart from state law to preserve the vitality of the bankruptcy proceedings. *See* text accompanying notes 28-30 *supra*. The bankruptcy rules interfering with security interests do so to preserve the status quo while the bankruptcy court sorts out the interests in the debtor's property and the importance of any specific property to a reorganization. There is no need for either class of rules under general state debtor-creditor law.

HeinOnline -- 28 UCLA L. Rev. 967 1980-1981

ruptcy law's preference rules do make federal inroads into state systems of security, I have suggested that preference rules do so for reasons different from those underlying the new act's treatment of inventory and receivables financing.[45] The new act singles out security interests in such collateral and replaces article 9's approach with an awkward new rule. Put simply, the reformers failed to meet the burden of justifying a shift from state law's treatment of security interests. We should not have two sets of rules when one will do just as well.

In addition, predictable benefits would accompany adhering to article 9's treatment of inventory and receivables financing. There would be improved coordination with state law. Fitting the language and structure of article 9 into the different vocabulary of the old bankruptcy law was a difficult problem.[46] While the new act ameliorates the old problem by more consistent employ of article 9 terminology, creation of the new exception invites future difficulties. If the new act followed article 9, it would avoid the uncertain technical issues that inevitably plague efforts to incorporate only part of the standards of one technical provision into another such provision. For example, there is already uncertainty about section 547's effect on after-acquired property other than inventory and receivables.[47]

Under article 9's system, secured transactions could be structured on the basis of a single set of more definite constraining rules. Secured lenders know they may look to the debtor's entire inventory or receivables, and both they and unsecured creditors may plan accordingly. Under the new bankruptcy act, both secured and unsecured lenders face increased uncertainty in assessing their interest in the debtor's future inventory and receivables.

Finally, given the complexity of existing preference law, there should be a general bias towards rendering fewer transactions preferential rather than more of them. Each lender who is vulnerable to a potential preference attack must employ counsel to assess and possibly defend his position. The trustee and his counsel expend time and money in developing their preference case. All of this effort is over a seemingly innocent secured transaction. Undoing the transaction increases the costs of bankruptcy for every-

45. *See* text accompanying notes 30-43 *supra.*

46. *See* NATIONAL BANKRUPTCY CONFERENCE, *supra* note 27, at 12, *reprinted in* H.R. REP. NO. 95-595, 95th Cong., 1st Sess. 207 (1978).

47. *See* note 27 *supra* (questions exist about § 547's treatment of after-acquired collateral other than inventory or receivables). And at least some confusion exists with respect to the question whether innocent increases in the value of inventory and receivables are vulnerable under § 547. *See* Mann & Phillips, *Floating Liens As Preferential Transfers Under the Bankruptcy Reform Act,* 85 COM. L.J. 7, 15-16 (1980). But this question seems settled by the new act adversely to secured parties.

HeinOnline -- 28 UCLA L. Rev. 968 1980-1981

one but yields no net increase in the value of assets available for distribution to the total creditor group.

Even assuming unsecured creditors should receive an improved position vis-à-vis inventory or receivables secured lenders, section 547 is a questionable vehicle through which to accomplish such a goal. All of its redistributive effects are achieved at the expense of secured lenders whose collateral happens to increase in value during the preference period. If society would benefit from a more even division of assets between secured and unsecured lenders, that result should not depend on the fortuity of collateral increases during the preference period.[48] If the reformers wished to make a general reallocative choice between secured and unsecured lenders, bankruptcy law provides a much more straightforward route through which to achieve that goal. The new act could more uniformly and simply achieve most allocative choices through a priority such as that given wage earners in section 507(a)(3). If one concludes that secured creditors receive too much, and unsecured creditors too little, a limited priority in favor of unsecured creditors, perhaps consisting of a percentage of the bankrupt's estate, might be a better way to implement the policy choice.[49]

Although the shortcomings in the new act's preference section may be the most important instance of poor coordination with state law, similar defects recur in the act. In section 546(c), the new act attempts to deal with the controversial question whether an unpaid unsecured seller may reclaim delivered goods. The act, tracking in part article 2 of the UCC,[50] seems to answer that the seller may reclaim despite bankruptcy. But the seller's right of reclamation differs from that contained in article 2.[51] Again, article 2's rule of reclamation may not be clearly superior to that of the bankruptcy act. But given the preexistence of article 2's standard, commercial law probably will not benefit from a subtly different rule in bankruptcy.

The new act's treatment of secured parties who delay perfect-

48. For early criticism of the new act's treatment of increases in the value of collateral during the preference period, see Kronman, *supra* note 33, at 153-57.

49. Even then, there would be doubt about the effectiveness of the effort to favor unsecured creditors. Secured creditors could be expected to raise interest rates to assure an increased return in nonbankruptcy situations.

50. U.C.C. § 2-702.

51. For example, § 546(c) requires a credit seller of goods to make a written demand for their return whereas U.C.C. § 2-702(2) does not require a writing. *See generally* Mann & Phillips, *Section 546(c) of the Bankruptcy Reform Act: An Imperfect Resolution of The Conflict Between the Reclaiming Seller and the Bankruptcy Trustee,* 54 AM. BANKR. L.J. 239 (1980); Mann & Phillips, *The Reclaiming Seller Under the Bankruptcy Reform Act: Resolution or Renewal of an Old Conflict?,* 33 VAND. L. REV. 1, 46-56 (1980).

HeinOnline -- 28 UCLA L. Rev. 969 1980-1981

ing their security interests also contrasts with the treatment such creditors receive under article 9. If a secured party delays perfection of its security interests longer than ten days, the bankruptcy act enables the trustee to attack as preferential those grants of security that occur within the preference period in connection with contemporaneous loans.[52] Viewing the trustee as a representative of unsecured creditors, the act renders vulnerable to attack by unsecured creditors security interests whose perfection is delayed.

One may marshall cogent arguments in favor of such as rule; indeed, prior to enactment of the UCC many states had a similar rule to regulate the relative rights of secured and unsecured creditors.[53] But article 9 expressly and intentionally rejects a rule penalizing delayed perfection. A simple unsecured creditor may not defeat a security interest, perfected or unperfected.[54] The unsecured creditor must go further and obtain a specific interest in collateral, usually by judicial proceedings.[55] One of the fundamental premises of article 9 is that unsecured creditors may not rely on any particular assets of a debtor in expecting repayment. Such assets are always susceptible to the preemptive interests of a secured party who obtains a security interest in them after the extension of unsecured credit.[56] As long as unsecured lenders know this, the rule should not provoke controversy, and it is questionable whether bankruptcy law should introduce a new set of planning criteria by imposing a different rule.[57] If a different rule is

---

52. 11 U.S.C. § 547(d)(2) (Supp. IV 1980). The lender who delays perfection having already obtained a security interest, the situation noted in text, should be distinguished from the lender who originally makes an unsecured loan and later seeks security. The latter is seeking a classic preference. *See* 2 G. GILMORE, *supra* note 1, § 45.6, at 1310; text accompanying note 24 *supra*.

53. *See, e.g.,* 1 G. GILMORE, *supra* note 1, §§ 16.2, 16.3. *But see* Morris, *supra* note 32, at 737 (arguing against preference attacks based on delayed perfection).

54. U.C.C. §§ 9-201, 9-301.

55. *Id.* § 9-301(1)(b).

56. *Id.* §§ 9-201, 9-301.

57. The new act's treatment of fraudulent conveyances may reflect poor coordination with state law, poor internal coordination within the bankruptcy act, or some combination of the two. Section 544(b) of the new act, 11 U.S.C. § 544(b) (Supp. IV 1980), incorporates into the bankruptcy act each state's law of fraudulent conveyances. The difficulty arises in the new act's treatment of innocent transferees of a fraudulent conveyance. Section 550 governs the trustee's power to reach transferees, including transferees pursued under § 544. But § 550 is less generous to innocent transferees than is state law, at least in states in which the Uniform Fraudulent Conveyance Act is in effect. *Compare* 11 U.S.C. § 550(a)(1)(d) (Supp. IV 1980) *with* UNIFORM FRAUDULENT CONVEYANCES ACT § 9. The question arises whether § 550 was intended to displace state-law treatment of transferees. If the bankruptcy trustee is given powers under state fraudulent conveyance law, his powers to recover from transferees would seem to be subject to limitations contained in state fraudulent conveyance law. At least one commentator implicitly indicates that when the trustee proceeds under § 544, § 550's reach is subject to the relief state law gives to transferees. *See* D. EPSTEIN, DEBTOR-CREDITOR LAW IN A NUTSHELL 202 (2d ed. 1980). Yet

HeinOnline -- 28 UCLA L. Rev. 970 1980-1981

desirable, should not Congress also explore the desirability of such a rule outside bankruptcy?[58] Unsecured creditors may be misled by delayed perfection even in the absence of a bankruptcy proceeding.

Congress's questionable departures from state law may be readily explainable. Somewhere in the dim history of bankruptcy law, Congress became accustomed to tinkering with the validity of perfected security interests in bankruptcy.[59] In an era when each state had its own system of security, Congress may have had reason for instituting independent federal rules in this area. Given articles 2 and 9, however, absent clear blunder by the states, Congress should resist the temptation to substitute what in effect becomes a new federal security rule. Such an approach has no demonstrable benefits; it does have ascertainable drawbacks.

C. *Bankruptcy Rules and Nonbankruptcy Federal Law*

In some circumstances a federal bankruptcy rule seems preferable to state law as a guide to bankruptcy decision making. But such occasions should engender a further question, one neglected in part because of the narrow, technical atmosphere surrounding bankruptcy reform. Given the superiority of the federal rule in bankruptcy, should the federal rule apply outside bankruptcy as well? The question is related to but distinct from that discussed above: whether, in bankruptcy, state law should be followed or a federal rule created. Here the issue is whether federal rules created for bankruptcy should be extended to nonbankruptcy settings. One may well wish to limit some bankruptcy rules to a bankruptcy setting while extending others to general commercial law. In general, a federal bankruptcy rule is less appealing outside of bankruptcy when the rule caters to a special need of a bankruptcy proceeding, such as its accelerated time frame. Bankruptcy rules that reflect substantive disagreement with state law are prime candidates to consider for enactment outside of bankruptcy because they presumably reflect weaknesses in the state rule. Deliberations on the new act do not reflect the existence of these issues.

The exemption system illustrates one aspect of these issues.

---

§ 550 expressly applies to cases covered by § 544 and provides no such exception. In addition, when the new act is to provide relief for transferees, it expressly does so. *See* 11 U.S.C. § 548(c) (Supp. IV 1980) (protecting transferees who otherwise would be vulnerable to attack under the act's own fraudulent conveyance section).

58. If Congress chose to impose rules outside of bankruptcy proceedings, it would have to derive constitutional authority from some provision other than the bankruptcy clause.

59. *See, e.g.,* J. HANNA & J. MACLACHLAN, CREDITORS' RIGHTS AND CORPORATE REORGANIZATION 722-23 (5th ed. 1957).

HeinOnline -- 28 UCLA L. Rev. 971 1980-1981

The new act provides for a set of federal exemptions in bankruptcy.[60] Presumably, such a provision reflects Congress's judgment as to the minimal amount debtors should be permitted to

---

60. 11 U.S.C. § 522(d) (Supp. IV 1980). In the negotiations to reconcile the House and Senate bankruptcy reform bills, a compromise was reached whereby states may, by passing a law, determine whether the federal exemptions contained in § 522(d) will be an available alternative to the exemptions allowed by state law. *See* 124 CONG. REC. H11,095 (1978) (statement of Rep. Edwards upon introducing House amendment to Senate amendment to H.R. 8200); 124 CONG. REC. S17,412 (1978) (statement of Sen. DeConcini explaining House amendment to Senate amendment to H.R. 8200). Section 522(b)(1) contains the language that allows states to opt out of the federal exemption system. Many states have chosen to do so. *See, e.g.,* VA. CODE § 34.-3.1 (Cum. Supp. 1980); N.Y. Times, Oct. 26, 1981, § D, at 1, col. 5 (about 30 states have enacted legislation abridging the federal system of exemptions).

In states where state law now precludes resort to federal exemptions, on the surface debtors appear to be no worse off than they were under the old bankruptcy act. Under the old act, state law determined a debtor's bankruptcy exemptions. Bankruptcy Act of 1898 § 6. Upon further analysis, however, debtors are likely to be worse off under the new act than under the old. Under the old law, exemptions did not provide the only legitimate route through which debtors could keep assets despite bankruptcy. Courts allowed debtors to keep additional nonexempt assets out of the estate by construing such assets not to be "property" within the meaning of § 70a of the old act, *see* Lines v. Frederick, 400 U.S. 18 (1970) (per curiam) (accrued but unpaid vacation pay not property); Chicago Bd. of Trade v. Johnson, 264 U.S. 1 (1923); Page v. Edmunds, 187 U.S. 596 (1903), or by straining to read state law in a manner that would avoid satisfying one of § 70's requirements for inclusion of an asset in the bankruptcy estate, *see In re* Schmelzer, 480 F.2d 1074 (6th Cir. 1973). Under the new act, § 541, which determines the assets to be included in the bankruptcy estate, was intended to be all inclusive. All of the debtor's assets are to be in the estate and the exemption provisions alone determine what the debtor is permitted to keep. *See* S. REP. NO. 95-989, 95th Cong., 2d Sess. 82 (1978); H.R. REP. NO. 95-595, 95th Cong., 1st Sess. 175-76, 367-68 (1977); J. TROST, G. TREISTER, L. FORMAN, K. KLEE & R. LEVIN, THE NEW FEDERAL BANKRUPTCY CODE 101 (1979). The Senate and House Reports expressly state that § 541 is intended to overrule *Lines v. Frederick.* Thus, Congress meant to foreclose the method of keeping assets out of the bankruptcy estate through interpretation of the term "property." Debtors who may only avail themselves of state exemptions are at least in this respect in a worse theoretical position than under the old act.

Notwithstanding the Senate and House Reports, the *Lines v. Frederick* method—keeping assets out of the estate through construction of the term "property"—may, and perhaps should, survive enactment of the new law. The act includes in the estate a comprehensive list of items, all of which are characterized as "property" or an "interest in property." 11 U.S.C. § 541(a) (Supp. IV 1980). Courts that construed the term "property" in the old act to keep assets out of the bankruptcy estate will not find congressional disapproval of those results in § 541's text. Only the legislative history reveals the plan in this area. And the legislative history can be viewed as more equivocal than it first seems. The statements in the House and Senate Reports about the all inclusive scope intended for § 541 were made at a time when the House version of the bankruptcy reform bill contained a system of federal exemptions that was available in bankruptcy regardless of state law. A system of federal exemptions that could not be stripped away by the states may have been viewed as fair compensation to debtors for the all inclusive nature of § 541. Once § 522 was recast on the eve of passage, and after preparation of the House and Senate Reports, the trade-off between federal exemptions and a broad view of § 541 arguably should no longer govern. *See generally* Klee, *supra* note 34, at 295 (only the floor statements by Rep. Edwards and Sen. DeConcini reflect the final version of the new bankruptcy law). Courts would then

HeinOnline -- 28 UCLA L. Rev. 972 1980-1981

maintain. Yet federal law's overall approach to exemptions contains some disquieting features. If some minimal core of assets is necessary to decent survival in bankruptcy, should not that core also be available in the absence of a bankruptcy proceeding? Should those who, for reasons of timing, are ineligible for bankruptcy relief[61] be deprived of what Congress thinks are life's necessities because they live in a state that has not brought its exemption law into this century? The real problem with state exemptions was not lack of uniformity but plain inadequacy.[62] If state exemption laws are sufficiently archaic to justify federal interference in bankruptcy, it strains credibility to consider them inviolable outside of bankruptcy.

Secondly, Congress, which found some state law exemptions insufficiently generous to be tolerable in bankruptcy, has not been much more generous in providing exemptions from the reach of the creditor most near and dear to Congress's heart, the United States. In its capacity as tax collector, the United States is the single most important creditor in the country.[63] Yet the assets exempt from the tax collector do not compare favorably with the list of exempt assets in many states.[64] Perhaps one could justify a narrower set of exemptions for tax delinquents on the grounds that discouraging nonpayment of taxes is especially important. But that would require Congress to acknowledge either that the new act's exemptions provide more than is necessary for survival or that the Internal Revenue Code's exemptions are insufficient for survival. Neither alternative is appealing. In any event, the new act's history reflects none of the sensitive balancing necessary to support such a fine distinction.[65]

One can make similar arguments with respect to other areas in which the bankruptcy act departs from state rules. If a federal rule is sufficiently important to warrant inclusion in a bankruptcy act, Congress should consider imposing such a rule in nonbank-

---

have no definite statements defining the scope of § 541 in the context of the final act with its provision allowing states to opt out of the federal exemption system.

61. Some debtors are precluded from obtaining a discharge under Chapter 7 more than once every six years. 11 U.S.C. § 727(a)(8), (9) (Supp. IV 1980). No such limitation is applicable to discharges under Chapter 13. *See id.* § 1328.

62. *See, e.g.,* W. WARREN & W. HOGAN, DEBTOR-CREDITOR LAW 112-21 (2d ed. 1981).

63. *See* W. PLUMB, FEDERAL TAX LIENS ix (3d ed. 1972).

64. *See* I.R.C. § 6334.

65. There are also important distinctions between state law treatment of security interests and their treatment under portions of the Federal Tax Lien Act, I.R.C. §§ 6321-23. It is doubtful that the benefits these distinctions confer upon the fisc can justify the near hopeless complexity of the relationship among the Tax Lien Act, state law, and the inchoateness doctrine. For a description of the inchoateness doctrine, see W. PLUMB, *supra* note 63, at 88.

HeinOnline -- 28 UCLA L. Rev. 973 1980-1981

ruptcy cases as well. In some instances merely posing this issue will reinforce doubts that one might have about the efficacy of a separate federal rule. Outside of bankruptcy it seems ludicrous for Congress to tinker with article 2's treatment of the reclaiming seller or article 9's treatment of inventory and receivables financing merely to work marginal change. Unlike exemptions, state law is not an embarrassment in these areas. The marginal benefits, if any, of a different bankruptcy rule do not justify the dislocation resulting from having two different sets of commercial law rules.

One new benefit that Congress conferred on bankrupts raises an interesting twist on the problem of applying bankruptcy rules to nonbankruptcy situations. Section 525 prohibits governmental units from denying an applicant employment or a license solely because the applicant has gone bankrupt or was insolvent before declaring bankruptcy. A person who has been insolvent but managed to scrape by to the satisfaction of his creditors without burdening them, him or the system with another bankruptcy receives no protection from discrimination against him on the ground that he was once insolvent. A person who believes that a licensing decision by a governmental unit might be influenced by his financial responsibility might be better advised to declare bankruptcy than to try to work out his affairs, even if he and his creditors believe the workout is likely to be successful. One need not object to the added protection section 525 affords to question whether Congress should single out bankrupts for such protection.[66]

Of course, there are situations in which a federal bankruptcy rule is needed and a similar rule might be inappropriate outside of bankruptcy. Federal law's preference rules only apply in bankruptcy. The justifiable basis for limiting preference rules to bankruptcy cases lies in the comprehensive scope of a bankruptcy proceeding and the availability of a discharge. In a nonbankruptcy setting, an unpreferred creditor must await satisfaction from the debtor's other present and future assets, if any. But the creditor's claim is not cut off forever. In bankruptcy, a discharge of the debt owed to the pursuing creditor accompanies an unsuccessful effort to recover a preference.[67] In bankruptcy, with few exceptions, it is collect now or never.[68] The consequences of al-

66. Section 3466 of the Revised Statutes, 31 U.S.C. § 191 (Supp. III 1979), which, under some circumstances gives the federal government priority over other creditors, also establishes questionable incentives. Since § 3466's priority is inapplicable in bankruptcy, a creditor threatened with a nonbankruptcy setting in which the government's priority might prevail has an incentive to force the debtor into bankruptcy merely to avoid the effect of § 3466.

67. *See* 11 U.S.C. § 727(b) (Supp. IV 1980).

68. *Id.* § 523 (exceptions to discharge). The discharge exceptions in Chapter 13 are narrower than those in Chapter 7. *See id.* § 1328(a), (c).

HeinOnline -- 28 UCLA L. Rev. 974 1980-1981

lowing preference that is followed by bankruptcy to go unrecovered are more drastic. The bankruptcy proceeding collapses what might otherwise be years of debtor-creditor struggle into one concentrated forum.[69]

The accelerated time frame within which bankruptcy law operates, relative to state law, does more than help explain the need for distinct treatment in bankruptcy of preferences and exemptions. This may also explain limiting other provisions to bankruptcy proceedings. The provisions governing which creditor claims are allowed in bankruptcy depart from state law for this reason. Provisions allowing contingent and unliquidated claims in bankruptcy,[70] claims that would not be viewed as ripe outside of bankruptcy, reflect the need to satisfy bankruptcy creditors now or never. Limits on the amount of an allowable claim for certain long-term debtor obligations, such as leases and employment contracts,[71] are a way of recognizing that in bankruptcy the normal commercial future is collapsed into the present.

The possible desirability of extending bankruptcy rules to nonbankruptcy settings suggests a related question. To what extent may a bankruptcy law's goals be achieved through use of nonbankruptcy rules? When the goals are so achieved, one secures the benefit of having one continuous set of rules both inside and outside of bankruptcy. A growing body of nonbankruptcy debtor protection legislation offers the possibility of achieving some bankruptcy goals through nonbankruptcy laws. The revisers, however, ignored this possibility.

Relief from creditor action may be provided, as it is under the bankruptcy act, by a stay on acts against the debtor and his bankruptcy estate.[72] The Fair Debt Collection Practices Act (FDCPA)[73] offers another approach to debtor relief. Instead of forcing debtors to take the drastic step of filing a bankruptcy petition before providing them with relief from creditors, one could have a set of rules requiring reasonable creditor collection behavior at all times, regardless of the existence of a bankruptcy pro-

69. In cases in which state law serves as a substitute for federal bankruptcy proceedings, one sometimes finds otherwise valid preferences to be vulnerable under state law. For example, insurance companies may not be debtors in a federal bankruptcy proceeding. *Id.* § 109(b)(2), (d). When insurance companies encounter financial difficulty, state law performs the function traditionally associated with federal bankruptcy law. In such cases state law may render preferences vulnerable. *See, e.g.,* Jump v. Goldenhersh, 619 F.2d 11 (8th Cir. 1980) (applying Ohio preference statute in case involving insolvent insurance company); CAL. INS. CODE § 1034 (West 1976).

70. *See* 11 U.S.C. § 502(c)(1) (Supp. IV 1980).

71. *See id.* § 502(b)(7), (8).

72. *Id.* § 362(a).

73. 15 U.S.C. §§ 1692-1692o (Supp. IV 1980).

HeinOnline -- 28 UCLA L. Rev. 975 1980-1981

ceeding. The FDCPA is a step in this direction. It prohibits professional collection agencies from engaging in certain strong-arm and harassment tactics.[74] Understandably, Congress limited the act to professional debt collectors,[75] the group it perceived as most in need of regulation, and a politically less powerful group than that consisting of all creditors who engage in collection activities. But in rethinking a bankruptcy law, reformers should consider borrowing from nonbankruptcy statutes that regulate creditor misbehavior.

Increased coordination with other nonbankruptcy laws might accommodate some remaining debtors' needs. The debtor in financial extremis because creditors can reach his wages may be granted nonbankruptcy remedies that were not generally available when the early bankruptcy acts were enacted. Limits on wage garnishment[76] could be employed to insure debtor survival. For those with insufficient wages, Congress could explore relying on welfare systems for minimal needs.[77]

II. THE CASE OF DISCHARGE

In the area of discharge, the narrow focus of bankruptcy reform limited the new act's achievement in a manner more significant than the mere failure to consider relying on nonbankruptcy law to protect debtors. One promising reform that received too little consideration would require debtors who can afford to do so to pay, or to try to pay, a portion of their debts over a period of time before being eligible for a discharge. Movement in this direction fell victim in part to the bankruptcy community's misconceptions about the Constitution.

A. *Revising the Current Discharge System*

Even creative use of nonbankruptcy law would not provide a complete substitute for the bankruptcy discharge. Regardless of the amount paid to creditors, the current discharge system relieves the debtor of debts arising prior to the filing of the bankruptcy petition.[78] To some, this system is an indispensable feature of

---

74. *Id.* §§ 1692c, 1692d, 1692e, 1692f, 1692j.

75. *Id.* § 1692a(6).

76. *See id.* §§ 1673-1675.

77. *See generally* Weistart, *The Costs of Bankruptcy,* 41 LAW & CONTEMP. PROB. 107, 119-21 (1977). Such use of welfare programs may require modification of their eligibility criteria. *Cf.* Note, *Bankruptcy Exemptions: Critique and Suggestions,* 68 YALE L.J. 1459, 1497-1502 (1959) (exploring use of social welfare programs in lieu of exemptions) [hereinafter cited as *Bankruptcy Exemptions*].

78. A discharge relieves the debtor of the obligation to pay the discharged debt. *See* 11 U.S.C. §§ 727(b), 1328(c) (Supp. IV 1980).

HeinOnline -- 28 UCLA L. Rev. 976 1980-1981

bankruptcy law.[79] Without such a freely available discharge, one would not have a bankruptcy statute worthy of the name. But the range of plausible requirements upon which to condition a discharge is broader than the single approach to which we have grown accustomed.

Almost any plausible discharge system will chart a middle course between two extremes. On the one hand it is unrealistic always to condition a discharge upon full repayment of debts. Many deserving debtors would be disqualified. Some debtors untainted by moral or financial turpitude have serious fiscal problems and no realistic prospect of extricating themselves.[80] On the other hand, a bankruptcy discharge should not be available merely upon request. There would be obvious disincentives to perform contracts. In theory at least, our law has never endorsed such a lenient rule. Debtors are always asked to sacrifice something, to pay what they reasonably can.

There are at least two ways to implement the middle course between full and no repayment of debts. The ways differ in how they measure what the borrower can afford to repay, a difference that translates into attaching different conditions to the availability of a discharge. One method measures what the debtor can afford to pay by the value of his nonexempt assets on the date of bankruptcy. Surrender of such assets entitles the debtor to a discharge.[81] The other method looks to what the debtor can be expected to repay over some future period of time. In this case the discharge is conditioned upon the making of such payments or bona fide efforts to make them. The former method, employed in the liquidating bankruptcy provided for in Chapter 7 of the new act,[82] dominates consumer bankruptcy law and does so more than ever under the new act.[83] The second method bears a kinship

79. *See* Meckling, *Financial Markets, Default, and Bankruptcy: The Role of the State,* 41 LAW & CONTEMP. PROB. 13, 15 (1977). *But see* Weistart, *supra* note 77, at 109-11.

80. From an economic perspective, the absence of some system of relief from debts might overly dampen debt-burdened individuals' incentive to become productive. *See* Whitford, *A Critique of the Consumer Credit Collection System,* 1979 WIS. L. REV. 1047, 1100.

81. The debtor must perform certain other tasks, such as submitting to an examination by creditors, supplying information and cooperating with the trustee. 11 U.S.C. §§ 343, 521 (Supp. IV 1980). The statute effects the debtor's principal financial sacrifice, surrender of his nonexempt assets, by making all the debtor's property part of the bankruptcy estate, *id.* § 541, which is then distributed. *Id.* § 726. The debtor may keep his exempt property. *Id.* § 522.

82. *See* note 81 *supra.*

83. Under the old bankruptcy act, a sizable majority of consumer bankruptcies were liquidation proceedings. *See, e.g.,* D. STANLEY & M. GIRTH, *supra* note 42, at 74. The new act will maintain the dominance of measuring what the debtor can pay by reference to the value of his nonexempt assets. Chapter 13 now reinforces this

HeinOnline -- 28 UCLA L. Rev. 977 1980-1981

both to common law extension, under which debts are repaid over an extended period of time, and to compositions, whereby debts may be both reduced in principal amount and repaid on a modified schedule.[84] Despite the dominance of the Chapter 7 discharge system, a case exists for a shift toward the second method in which discharges are conditioned upon the debtor's future repayment efforts.

One method to implement the second discharge system, and the one I will discuss, would involve greater use of Chapter 13, which already enables debtors to pay creditors out of future wages over a period of years. Under existing law, when the debtor thinks repayment is feasible he is free to pursue the possibility, now without creditor approval, under Chapter 13. Chapter 13 does not force the debtor to surrender all his nonexempt assets to the trustee for the benefit of creditors.[85] Rather the debtor proposes to pay all or part of his debts out of his future income over a period of time not to exceed five years.[86] But the debtor holds all the cards in the current Chapter 13 game. Creditors may not impose Chapter 13 plans on unwilling debtors[87] and the debtor alone specifies how much of each period's wages will go to pay creditors.[88] Congress would have to modify Chapter 13 to allow creditors or courts to raise its possible use and to allow an independent

---

method's dominance. *See* 11 U.S.C. § 1325(a)(4) (Supp. IV 1980) (value distributed in Chapter 13 plan must not be less than value that would be distributed in Chapter 7 liquidation). Chapter 13 might be construed to require payments substantially greater than those required by § 1325(a)(4). *But see* note 114 *infra*. If Chapter 13 is not interpreted to require substantial payments, it is predictable that there will be a shift from the dominance of liquidations as the vehicle for consumer bankruptcies. Under Chapter 13, a debtor may be able to pay creditors a nominal sum, *see* 11 U.S.C. § 1325(a)(4) (Supp. IV 1980), to keep his assets, *see id.* §§ 1306(b), 1322(a)(9), to receive a broader discharge than is available under Chapter 7, *compare id.* § 1328(a), (c) *with id.* § 727(b), and to be more readily eligible for a subsequent bankruptcy than he would be after a Chapter 7 liquidation. *Compare id.* § 1328 *with id.* § 727(a)(8), (9). One disadvantage of Chapter 13 is that a Chapter 13 plan must propose to pay priority claims in full. *Id.* § 1322(a)(2).

84. Congress seemingly would like to see the second method embodied in Chapter 13. *See* S. REP. No. 96-305, 96th Cong., 1st Sess. 14 (1979); H.R. REP. No. 96-1195, 96th Cong., 2d Sess. 138 (1980). *But see* LoPucki, *"Encouraging" Repayment Under Chapter 13 of the Bankruptcy Code,* 18 HARV. J. LEGIS. 347, 361-88 (1981). Cases decided under Chapter 13 offer mixed guidance as to whether courts are reading into Chapter 13 the second method of measuring ability to pay. *See* cases cited in note 114 *infra.*

85. 11 U.S.C. § 1306(b) (Supp. IV 1980). In addition, a Chapter 13 plan may propose that the debtor permanently keep his nonexempt assets. *Id.* § 1322(b)(9).

86. *Id.* §§ 1321-1322.

87. Involuntary cases may be commenced only under Chapters 7 or 11. *Id.* § 303(a).

88. *Id.* §§ 1321, 1322(a)(1). But the debtor's plan must propose to distribute to creditors at least what they would have received in a Chapter 7 liquidation. *Id.* § 1325(a)(4). *See also* note 83 *supra*; note 114 *infra*.

HeinOnline -- 28 UCLA L. Rev. 978 1980-1981

judicial determination of an affordable plan.[89]

In choosing between the current discharge system and greater reliance on Chapter 13, including involuntary Chapter 13 proceedings, it is helpful to strip away matters not at issue. Both systems limit their claims on the debtor's property to some notion of what the debtor can afford to repay. Neither revives debtor's prisons; neither deprives the debtor of the fiscal ability to survive. Both measures acknowledge that debtors should be required to pay something. In theory, neither method simply forgives unpaid debts.

But the second method of measuring ability to repay and entitlement to discharge has advantages over the current system. Initially, the existing method has become something of a sham. Although one can describe it as a middle course between requiring full repayment and no repayment, in practice debtors have made no repayment or *de minimis* repayment.[90] If one believes a middle course to be desirable, the existing system can be discarded on empirical grounds. The second method might be tried simply on the ground that it can be no worse than the current system.

The existing discharge system's record may be even worse than its performance statistics suggest. There may be no widespread agreement on whether bankruptcy laws should protect only debtors who encounter unavoidable or unexpected insolvency or whether it should protect some broader class of debtors including those who imprudently calculate their income and outlays. At some point, however, most would agree that expanding the debtor group protected in bankruptcy will lead to inclusion of unappealing discharge candidates. Some debtors may carefully or carelessly calculate their income and outlays, know there will or is likely to be a shortfall, and plan to declare bankruptcy if all does not go well.[91] Even those who wish to protect the broadest possible debtor group might acknowledge the desirability of treating the last described debtor group less generously in bankruptcy than the other debtor groups. Yet both the old and new bankruptcy

89. Another method of reaching the debtor's future wages would be to postpone determining what is included in the debtor's estate to some date beyond the filing of the petition. *See Bankruptcy Hearings, supra* note 8, pt. 1, at 202, 214 (statement of Judge Cyr). An intermediate range of proposals would not authorize creditors to commence involuntary Chapter 13 proceedings but would allow them to object to a debtor's Chapter 13 proposal on the grounds that the debtor reasonably may afford to pay more. *See* Cyr, *The Chapter 13 "Good Faith" Tempest: Analysis and Proposal For Change,* 55 AM. BANKR. L.J. 271, 281-88 (1981); note 114 *infra.*

90. *Bankruptcy Hearings, supra* note 8, pt. 1, at 158; D. STANLEY & M. GIRTH, *supra* note 42, at 87, 92-93. *See* 2 G. GILMORE, *supra* note 1, § 45.2, at 1288 ("A bankruptcy liquidation is a disaster for everyone concerned except the lawyers.").

91. *See* authorities cited in note 120 *infra.*

HeinOnline -- 28 UCLA L. Rev. 979 1980-1981

acts treat all such classes of candidates for discharge the same.[92] If we wish to encourage repayment of debt, or at least prudent incurrence of debt, making the discharge equally available in all cases may be counterproductive.[93] The traditional system of discharge seems either overinclusive in including too many debtors or insufficiently sensitive to material differences among debtors.

The current discharge system could be modified to delve more deeply into debtors' pre-bankruptcy behavior and to make discharges more readily available to the more "deserving" debtors. But linking the discharge to some effort to repay out of future earnings can lead to a more efficient self-regulating mechanism under which debtors themselves avoid questionable bankruptcies. The discharge connected to use of future earnings discourages planned and negligent bankruptcies because, assuming a debtor's earning power over a period of years exceeds the value of his non-exempt assets on the date of the bankruptcy, the debtor has more to lose under such a system than under the existing system. The proposed system would force unavoidably or justifiably financially distressed debtors to pay more. But this seems unobjectionable if they are allowed sufficient periods of time to pay. Objections to using Chapter 13 to reach future earnings are discussed below.[94]

Repayment plans that draw upon future earnings more accurately reflect a debtor's ability to pay than do liquidation plans. We live to a great extent in a cash flow world. One's ability to purchase large items such as homes and automobiles is measured less by the price of the home or car than by its monthly cost in relation to one's take home pay. In some respects, even the bankruptcy act recognizes this fact of modern economic life. In an involuntary case, regardless of whether a debtor's assets exceed his liabilities, relief may be granted against the debtor only if the debtor is generally not paying his debts as they become due.[95] If the cash flow is right, little else matters.

Yet in deciding what a debtor should pay his creditors in

---

92. Certain categories of debtor misbehavior will preclude a Chapter 7 discharge. 11 U.S.C. § 727(a)(2)-(7) (Supp. IV 1980).

93. One way to provide an incentive to pay debts despite the existence of a bankruptcy proceeding would be to allow the debtor to share in his estate, with his share increasing as the percentage of the debts paid off increases. For an early version of such a system, see Act of April 4, 1800, ch. 19, § 34, 2 Stat. 30-31.

94. *See* text accompanying notes 123-35 *infra.* One questionable argument given in favor of involuntary Chapter 13 plans is that they would enhance the debtor's business education. MacLachlan, *Puritanical Therapy for Wage Earners,* 68 COM. L.J. 87, 89 (1963).

95. 11 U.S.C. § 303(h)(1) (Supp. IV 1980). Section 303(h)(2) allows for relief in the additional circumstance of a third party having been placed in charge of the debtor's property.

HeinOnline -- 28 UCLA L. Rev. 980 1980-1981

bankruptcy, revenue flow becomes irrelevant. The rights of unsecured creditors, who may lend at least in part on an expected flow basis,[96] and the debtor, who borrows on the same basis, suddenly are determined solely by the value placed on the debtor's nonexempt assets on the date of bankruptcy. Some judgment as to what the debtor can afford to pay on a monthly basis over the next few years more accurately reflects economic reality.

B. *The Economics of Discharge*

The argument that a less generous discharge system is more desirable than the current system raises a new range of considerations. Limiting the availability of discharges focuses only on one of the actors in a credit transaction. By focusing on the creditor, one might encourage prudent lending by a generous system of discharge. The relatively lenient discharge rule that makes borrowing more attractive for debtors makes it less attractive for lenders. If a lenient discharge rule is in effect, one expects creditors to charge higher interest rates that offset any increased demand for funds by debtors who seek to avail themselves of a too liberal discharge rule. These Coasian considerations do not suggest that the current discharge system is justifiable. But they raise the possibility that the rule of discharge does not really matter.

Upon deeper analysis, economic considerations may support a more conditional system of discharge. If enforcement of contracts is to foster efficient allocation of resources, one economic theory argues, the contracting party more able to protect himself against loss resulting from an event should bear the risk of such loss.[97] A discharge system provides a technique for allocating the risk of financial distress between a debtor and his creditors. A system that gives creditors an interest in future wages requires the debtor to bear a greater portion of the risk of financial distress than does the current discharge system, which usually leaves the debtor with all or nearly all of his future wages. This result may be economically justified.

There are two factors to explore in deciding which party is the superior bearer of the risk of financial distress of bankruptcy. A party may be a better risk bearer because he is in a better position to prevent the risk from occurring.[98] This factor would al-

96. *See* Shuchman, *An Attempt At A "Philosophy of Bankruptcy,"* 21 UCLA L. REV. 403, 422 (1973).

97. *See* R. POSNER, ECONOMIC ANALYSIS OF LAW § 4.1, at 68, § 4.5 (2d ed. 1977); Posner & Rosenfield, *Impossibility and Related Doctrines in Contract Law: An Economic Analysis,* 6 J. LEGAL STUD. 83, 90 (1977). *But see* Sirianni, *The Developing Law of Contractual Impracticability and Impossibility: Part I,* 14 U.C.C. L.J. 30, 67-81 (1981).

98. Posner & Rosenfield, *supra* note 97, at 90.

HeinOnline -- 28 UCLA L. Rev. 981 1980-1981

most always weigh against a broadly available discharge. Debtors in general have greater control of their financial activities than any particular lender. In extreme cases, where the debtor borrows to finance necessities, one may argue that this factor is neutral. Neither party is capable of preventing the financial distress.

The second basis for determining the superior risk bearer turns on which party to a contract is the superior insurer.[99] This factor provides less clear direction but hardly supports widespread, freely available discharges. To demonstrate this, one must translate economic analysis of contractual relations into a bankruptcy setting.

Outside of bankruptcy, Professsor Posner and others have offered an economic analysis of impossibility,[100] an issue closely akin to that of discharge. Their analysis focuses on the event giving rise to the claim of impossibility and asks which party could have better insured against that event.[101] To apply this analysis in bankruptcy, which can be viewed as a claim of impossibility with respect to all of one's obligations on the basis of general financial distress, one must first ascertain the cause of that financial distress. One then must decide whether the debtor or a creditor is the superior insurer against that cause. For example, if a debtor's bankruptcy is triggered by a poor business deal, the effects of which could have been alleviated through self-insurance or reasonably priced, commercially available insurance, the debtor may well be the superior insurer and, therefore, should bear relatively more of the risk of not performing other contracts endangered by the poor business deal.[102] If a debtor has greater knowledge of the likelihood and magnitude of his potential financial distress than do those who lend to him, that too would weigh against forgiving the debtor's failure to perform by repaying his debts.[103] To implement this thinking outside of bankruptcy we would deny the debtor the defense of impossibility. Inside of bankruptcy the analysis would lead to denying a discharge or limiting its availability.

This basic analysis needs some refinement. As an empirical matter, debtors neither are always superior insurers nor are always better able than creditors to assess the likelihood of bankruptcy and to factor that possibility into the terms of the contract. Some sophisticated commercial lenders probably are better than many of their borrowers about projecting the borrowers' future

99. *Id.*
100. *Id.*
101. *Id.*
102. *Id.* at 90-92.
103. *Id.*

HeinOnline -- 28 UCLA L. Rev. 982 1980-1981

financial status,[104] and some undoubtedly purchase reasonably priced bad-debt insurance. Yet other lenders, like the corner hardware store selling on credit, are likely to be at an informational disadvantage relative to the debtor. The economic case for or against discharge varies at least according to the relative sophistication of lender and borrower.

But even assuming that some lenders are better placed than some debtors to assess the likelihood and effect of bankruptcy, it is implausible that all or even most lenders could be so situated. In general, borrowers know more about themselves and have greater control of their affairs than lenders do. If bankruptcy law is going to reach a single conclusion with respect to discharge, the single economic answer would most likely be to limit the discharge.

Finally, if one assumes that by increasing interest rates lenders are economically as well placed as debtors to bear the added risk inherent in a discharge system that prevents access to future wages, a new issue arises. One may no longer argue that, as between debtors and creditors, efficiency supports access to a debtor's future wages. But now the existing discharge system can be said to have a questionable interdebtor effect. Those debtors who pay their debts bear the assumed increased credit costs. Nonpaying debtors, to whose defaults the increased cost of credit is attributable, do not fully share in that increased cost. Liberal discharge provisions thus increase the extent to which those who repay their debts subsidize those who do not.

The vast majority of bankrupts have only one valuable asset—their earning capacity. The current discharge system guarantees that creditors will never reach that asset. As long as a debtor's assets are defined to exclude earning power, we should not be surprised by oft-quoted statistics showing most consumer bankruptcies yield nothing for creditors.[105] If the bankruptcy judge concludes that the debtor is beyond the point where Chapter 13 is likely to help, a traditional liquidation discharge proceeding could be used. But it should be the last resort, not the first.

C. *Will Involuntary Chapter 13 Plans Work?*

Before considering objections that have prevailed against mandatory use of Chapter 13-type proceedings, one ought to con-

104. *Bankruptcy Hearings, supra* note 8, pt. 2, at 950.

105. *See* authorities cited in note 90 *supra.* Creditors may have been compensated by charging interest rates sufficiently high to reflect their dismal experience in bankruptcy. But the preceding discussion suggests that all or even most creditors are not as well placed as debtors to take account of the risk of a particular debtor's bankruptcy. *See* text accompanying notes 97-104. For proposals to take account of a debtor's future income in voluntary Chapter 13 cases, see Cyr, *supra* note 89, at 281-88.

HeinOnline -- 28 UCLA L. Rev. 983 1980-1981

sider whether the available data suggests that such use would improve the consumer bankruptcy process. No empirical studies have directly addressed the requisite questions, so one must base predictions on data less directly relevant than one would desire. Nonetheless, two sets of data provide relevant guidance. First, studies have examined Chapter 13's operation under the superseded bankruptcy act. Second, we know something about the financial profiles of those who go bankrupt. From this information, one can determine whether there is a basis for optimism about the expanded use of Chapter 13.

On the positive side, when used, Chapter 13 plans under the old act seem to provide a generally more satisfactory experience for both debtors and creditors. The average return to creditors in Chapter 13 is more than twice that in straight bankruptcy.[106] Under Chapter 13 plans that are successfully completed, creditors receive more than ninety percent of the claims proved.[107] Chapter 13 debtors report a more favorable reaction to their bankruptcy experience than debtors who resort to straight bankruptcy.[108]

But the evidence is not one-sided. Chapter 13 debtors seem to have had less debt (as a percentage of assets) than straight bankruptcy debtors, and this undoubtedly contributed at least in part to Chapter 13's greater success.[109] And most Chapter 13 plans under the old act were not successfully completed.[110] But the unsuccessful plans do not necessarily militate against greater use of Chapter 13. The high failure rate of Chapter 13 plans is partly explainable on the ground that debtors were forced to propose plans that were too ambitious. Prior to the new act, Chapter 13 plans had to be approved by creditors.[111] In practice, most creditors only approved extension plans—plans under which creditors are paid in full over an extended payment schedule.[112]

Given that Chapter 13 plans provided for repayment of debts in full, a high failure rate is not surprising. Under the new act, a reduced failure rate can be expected because plans no longer need

106. D. STANLEY & M. GIRTH, *supra* note 42, at 102. *See also Bankruptcy Hearings, supra* note 8, pt. 1, at 339.

107. D. STANLEY & M. GIRTH, *supra* note 42, at 102.

108. *Id.* at 68 (Table 4-6).

109. *Id.* at 57, 248.

110. *Id.* at 100-01. *See also Bankruptcy Hearings, supra* note 8, pt. 2, at 876; Girth, *The Bankruptcy Reform Process: Maximizing Judicial Control in Wage Earners' Plans,* 11 U. MICH. J.L. REF. 51, 58 (1977). *But see Bankruptcy Hearings, supra* note 8, pt. 3, at 1328 (carefully tailored plans in one district have 80% success rate).

111. Bankruptcy Act of 1898 §§ 651, 652.

112. *See* H.R. REP. NO. 95-595, 95th Cong., 1st Sess. 123 (1977); *Bankruptcy Hearings, supra* note 8, pt. 3, at 1327 (statement of Judge Cyr); D. STANLEY & M. GIRTH, *supra* note 42, at 22. *But see* Girth, *supra* note 110, at 58 (creditors cooperate with partial repayment plan because "anything they get is better than nothing").

HeinOnline -- 28 UCLA L. Rev. 984 1980-1981

to be approved by unsecured creditors.[113] With no creditor approval requirement, debtors may propose considerably less than full repayment and still provide creditors with an expected payment well in excess of the *de minimis* amount to be expected in a straight bankruptcy case.[114]

Depriving the debtor of exclusive power to initiate Chapter 13 proceedings is the major factor limiting accurate predictions about future mandatory use of Chapter 13 based on past Chapter 13 experience. But the available profiles of debtors give some reason for optimism.[115] Although their incomes are modest, the overwhelming majority of bankruptcy debtors are employed and earning a regular income.[116]

Perhaps more significantly, many empirical studies suggest

---

113. *See* 11 U.S.C. § 1325(a) (Supp. IV 1980).

114. Although substantial payments are possible within the framework established by the new Chapter 13, if cases litigated to date are representative, plans calling for substantial payments under Chapter 13 are not commonplace. *See, e.g., In re* Hildremyr, 8 Bankr. Rep. 676 (B.C.D.S.D. 1981) (no payment plan confirmed); *In re* Smith, 8 Bankr. Rep. 543 (B.C.D. Utah 1981) (16% plan not confirmed); *In re* Burchett, 8 Bankr. Rep. 473 (B.C.S.D. Ohio 1981) (10% plan confirmed); *In re* Stollenwerck, 8 Bankr. Rep. 297 (M.D. Ala. 1981) (no payment plan confirmed); *In re* Aalto, 8 Bankr. Rep. 157 (B.C.M.D. Fla. 1981) (3% plan not confirmed); *In re* Roberts, 8 Bankr. Rep. 155 (B.C.S.D.N.Y. 1981) (15% plan not confirmed); *In re* Tanke, 4 Bankr. Rep. 339 (B.C.D. Colo. 1980) (nominal payment plan not confirmed); *In re* Jenkins, 4 Bankr. Rep. 278 (B.C.D. Colo. 1980) (nominal payment plan confirmed); *In re* Patterson, 4 Bankr. Rep. 239 (B.C.C.D. Cal. 1980) (1% plan not confirmed); *In re* Beaver, 2 Bankr. Rep. 337 (B.C.S.D. Cal. 1980) (1% payment plan disapproved); *In re* Iacovoni, 2 Bankr. Rep. 256 (B.C.D. Utah 1980) (no payment plan not confirmed); *In re* Curtis, 2 Bankr. Rep. 43 (B.C.W.D. Mo. 1979) (10% plan confirmed); *In re* Fizer, 1 Bankr. Rep. 400 (B.C.S.D. Ohio 1979) (no payment plan not confirmed). *But see In re* Osborne, 8 Bankr. Rep. 200 (B.C.N.D. Ill. 1981) (100% plan confirmed); *In re* Collister, 8 Bankr. Rep. 510 (B.C.M.D. Fla. 1981) (30% plan not confirmed); *In re* Burrell, 2 Bankr. Rep. 650 (B.C.N.D. Cal. 1980), *rev'd,* 6 Bankr. Rep. 360 (N.D. Cal. 1980) (Chapter 13 plan must provide for at least 70% payment of unsecured claims); *In re* Raburn, 4 Bankr. Rep. 624 (B.C.M.D. Ga. 1980) (same); *In re* Powell, 2 Bankr. Rep. 314 (B.C.E.D. Va. 1980) (50% plan confirmed). For a larger collection of cases covering Chapter 13's recent operation, see Cyr, *supra* note 89, at 273-74 nn. 10, 12, 13.

One of the proposed "technical" amendments to the new bankruptcy act would amend Chapter 13 to require that plans represent a "good faith effort" by debtors. S. 658, 96th Cong., 2d Sess. § 128(b) (1979) (amending § 1325(a)(3)). *See also* S. 863, Bankruptcy Amendments Act of 1981, 97th Cong., lst Sess. § 128(b) (requiring a Chapter 13 plan to be a debtor's "bona fide" effort). If courts were to require substantial payments under existing or modified law, one may expect an increase in the popularity of Chapter 7 proceedings, in which future earnings clearly are insulated from creditor claims.

115. D. STANLEY & M. GIRTH, *supra* note 42, at 44-45; *Bankruptcy Hearings, supra* note 8, pt. 2, at 774-77.

116. D. STANLEY & M. GIRTH, *supra* note 42, at 244 (Table C-1); *Bankruptcy Hearings, supra* note 8, pt. 2, at 866; Note, *Bankruptcy Exemptions*, *supra* note 77, at 1499. *See also* Girth, *supra* note 110, at 57 (unemployment rate may affect amounts which debtors propose to repay in Chapter 13).

HeinOnline -- 28 UCLA L. Rev. 985 1980-1981

that many bankruptcy debtors could afford to pay their debts in full over a reasonable period of time.[117] Although some of these studies seem implausible,[118] the new act greatly enhances the debtor's ability to receive confirmation of a plan that proposes substantially less than full repayment. If the empirical studies are accurate, even greater numbers of debtors could be characterized as able to fulfill Chapter 13 plans. If the studies understate the debtor's burden, the reduced burden a modified Chapter 13 composition plan would impose offsets at least some of that understatement.

Requiring the court to pass upon Chapter 13's possible use in each case would overcome one other problem that has limited Chapter 13's effectiveness. Testimony at Congress's bankruptcy reform hearings suggested that many debtors who might have wished to use Chapter 13 did not do so for the simple reason that they were never made aware of it.[119] Neither lawyers nor judges called it to their attention. If the court or creditors may raise the possibility of a Chapter 13 plan, the information problem would greatly decrease.

D. *The Uneasy Case for the Status Quo*

One cannot project that wider use of Chapter 13 or some similar adjustment automatically would improve the bankruptcy system. Undoubtedly, some will disapprove any modification resulting in greater payments by debtors. Others instinctively would approve any such change. Requiring greater efforts from debtors who can repay was and is, however, a possibility worth studying. At a minimum, such potential changes should be presented to a decisionmaker contemplating bankruptcy reform. Congress heard evidence suggesting that many debtors have discovered ways to manipulate, perhaps abuse, the bankruptcy system.[120] Even absent abuse, the current system of consumer

---

117. Their results are summarized in *Wage Earner Plans Under the Bankruptcy Act: Hearings on H.R. 1057 and H.R. 5771 Before Subcomm. No. 4 of the House Comm. on the Judiciary,* 90th Cong., lst Sess. 73 (1967) [hereinafter cited as *1967 Hearings*]. *See also* Girth, *supra* note 110, at 56 (increased resort to Chapter 13 in one district increased disbursements to creditors). Recent empirical studies offer conflicting evidence as to the number of bankrupts who could afford to pay their debts. *See* N.Y. Times, Oct. 26, 1981, § D, at 1, cols. 5-6.

118. Girth, *supra* note 110, at 56. *See also* COMMISSION REPORT, *supra* note 18, pt. 1, at 53; D. STANLEY & M. GIRTH, *supra* note 42, at 37-38; Shuchman, *supra* note 96, at 412-13.

119. *See Bankruptcy Hearings, supra* note 8, pt. 1, at 168, 191 (statement of Professor Kennedy), pt. 2, at 1168; Girth, *supra* note 110, at 56.

120. *Bankruptcy Hearings, supra* note 8, pt. 2, at 870, 980, 1026, 1034, 1102. *But see id.* pt. 1, at 354.

HeinOnline -- 28 UCLA L. Rev. 986 1980-1981

bankruptcies is hardly a resounding success.[121] Yet modification of Chapter 13 to allow involuntary proceedings and to require consideration of a debtor's future earnings in assessing the minimum he is able to pay received no serious consideration. Empirical analysts did not organize their data in a way that would inform decisionmakers about the desirability of so modifying Chapter 13. Bankruptcy experts abruptly dismissed the possibility.[122]

The growing isolation of bankruptcy law partly explains this inadequate consideration. Plausible modifications of Chapter 13 were not considered in part because of bankruptcy reformers' misinformed and unchallenged views of constitutional limitations on the bankruptcy process, views that would not likely have gone unchallenged among any group other than technically oriented specialists. The roots of the problem precede the recent reform movement. In 1932, and again in 1967, Congress conducted hearings on proposals to allow involuntary Chapter 13 plans.[123] The arguments made against these proposals are worth exploring because some of those arguments helped foreclose any serious efforts to include involuntary Chapter 13 plans in the 1978 act.

As summarized in 1967, there are three arguments against involuntary Chapter 13 plans. First, society has progressed away from peonage, other forms of involuntary servitude, and imprisonment for debt. Involuntary Chapter 13 plans are a step backwards. "We can hardly be expected now to approve a system whereby the debtor's opportunity for rehabilitation is to be delayed for a period of bondage during which his future earnings are sequestered for the benefit of his existing creditors."[124] Second, involuntary bankruptcy proceedings just will not work. The debtor who does not wish to be in bankruptcy will not make the effort necessary for a successful Chapter 13 plan. Third, involun-

---

121. *See* authorities cited in note 90 *supra.*

122. *See* COMMISSION REPORT, *supra* note 18, pt. 1, at 158-59.

123. *See 1967 Hearings, supra* note 117, at 73-74. The new bankruptcy act's Chapter 13 plan differs from the 1967 involuntary Chapter 13 plan that Congress rejected. The 1967 proposal would not have modified any of the basic workings of Chapter 13. It simply required a finding that adequate relief could not be obtained under Chapter 13 before a debtor would be eligible for a Chapter 7 proceeding. *See* H.R. 1057 & H.R. 5771, 90th Cong., lst Sess. (1967), *reprinted in 1967 Hearings, supra* note 117, at 2. Because Chapter 13 then required creditor approval of a debtor's plan, one could expect that the only plans that would be approved would be those that promised repayment in full. *See* notes 111-14 & accompanying text *supra.* Congress has eliminated the unsecured creditor approval requirement for Chapter 13. *See* 11 U.S.C. § 1325 (Supp. IV 1980). Involuntary plans designed to extract what debtors can afford to pay obviously have a greater chance for success and are less onerous than those plans that require full repayment without regard to the individual debtor's financial condition.

124. *1967 Hearings, supra* note 117, at 74.

HeinOnline -- 28 UCLA L. Rev. 987 1980-1981

tary Chapter 13 plans discriminate against noncorporate debtors. "The individual bankrupt needs his discharge and, if it were suspended, must perforce attempt to meet the terms of suspension . . . to get it. But most corporate bankrupts do not even bother to apply for a discharge. The stockholders can walk away from the bankrupt corporate shell without fear of unpaid corporate debts for which they were never personally liable."[125]

Although these arguments have preempted serious debate about involuntary Chapter 13 plans, none of them is persuasive. The first reason roughly equates involuntary Chapter 13 plans with peonage and involuntary servitude. Although this seems like dramatic overstatement, the argument is referred to in an even more startling form in hearings connected with the 1978 act. At those hearings it was suggested not merely that involuntary Chapter 13 plans are in the same generic category as involuntary servitude, but that such plans would violate the thirteenth amendment![126] These vulnerable characterizations went unchallenged.

An involuntary Chapter 13 plan, despite the presence of the word "involuntary" in its label, bears none of the offensive attributes of involuntary servitude or peonage. Such a plan does not require the debtor to work under threat of imprisonment. Unlike involuntary servitude, it involves no physical compulsion to work.[127] Like many other conditions to discharge, an involuntary Chapter 13 plan deprives certain uncooperative debtors of what would otherwise be their right to a discharge in bankruptcy. Over the years the bankruptcy act has imposed many other conditions upon the availability of a discharge. Some eminently deserving debtors have never qualified for a discharge.[128] Yet all such debtors are in effect forced to subject a future portion of their earnings, if earned, to claims of existing creditors. But such debtors are not forced to work or to earn wages.

Equating deprivation of discharge with involuntary servitude and peonage suggests that debtors have a right to a discharge. Aside from the many conditions that have always been imposed

---

125. *Id.*

126. *Bankruptcy Hearings, supra* note 8, pt. 1, at 203, 348; *see* H.R. REP. No. 95-595, 95th Cong., 2d Sess. 120 (1977). Another bizarre constitutional view offered at the hearings maintained that a bankruptcy act would be unconstitutional if it provided that a debtor could not reaffirm his debts. *Bankruptcy Hearings, supra* note 8, pt. 2, at 1052. Outside assistance was sought in deliberations concerning the constitutionality of the new bankruptcy court system. *Id.* pt. 4, at 2682-2706; Klee, *supra* note 34, at 280-81. This question may soon be decided by the Supreme Court. *See* Marathon Pipeline Co. v. Northern Pipeline Constr. Co., 12 Bankr. Rep. 946 (D. Minn.), *prob. juris. noted*, 50 U.S.L.W. 3365 (Nov. 10, 1981).

127. *See* Whitford, *supra* note 80, at 1105.

128. *See* note 61 *supra*.

HeinOnline -- 28 UCLA L. Rev. 988 1980-1981

upon the availability of a discharge, the argument ignores the numerous periods in this country's history when there has been no federal bankruptcy law.[129] At those times, except in states with insolvency laws, no debtor could avoid creditor collection efforts through discharge or any other provision of a bankruptcy act. One cannot seriously argue that such debtors were in a condition of involuntary servitude or peonage. Questionable views of the relationship between Chapter 13 and amendment thirteen again highlight the bankruptcy act's failure to coordinate with the outside legal world. A promising, sensitive route for balancing debtor-creditor relationships in bankruptcy received no serious consideration in part because of ignorance of constitutional law.

Skepticism over debtor cooperation forms the second objection to widespread use of involuntary Chapter 13 plans. Even if the law mandates the Chapter 13-type plan as the preferred route in bankruptcy, a debtor may frustrate the system by refusing to work.[130] But if a debtor is allowed to keep significant portions of his future wages, it is difficult to conceive of many debtors refusing to work just to frustrate a Chapter 13 plan.[131] Those so inclined might be persuaded to cooperate by a rule authorizing the court to deny such debtors any discharge if they frustrate what would otherwise be a successful plan. In any event, creditors ought to be able to judge for themselves whether a debtor will cooperate. If they do not believe a Chapter 13 proceeding will yield more than a straight bankruptcy, they will not invoke Chapter 13.

The third objection asserts that involuntary Chapter 13 plans unfairly give individual debtors a worse deal than corporate debtors receive. Corporations are, however, subject to involuntary rehabilitation plans.[132] State laws limiting shareholder liability for corporate debts, rather than bankruptcy law, assure corporations of the functional equivalent of discharge. Should bankruptcy law serve a similar function for individuals? Perhaps, but the equation of corporate limited liability with individual bankruptcy discharges, though widely noted, is not compelling.[133]

The most appealing justification for limited liability is not to

---

129. *See, e.g.,* D. STANLEY & M. GIRTH, *supra* note 42, at 10-11.

130. *See also* COMMISSION REPORT, *supra* note 18, pt. 1, at 159; LoPucki, *supra* note 84, at 381.

131. The loss of incentive argument would seem to undercut all wage garnishment laws, as well as involuntary wage earner plans.

132. *See* 11 U.S.C. § 303(a) (Supp. IV 1980) (involuntary case may be commenced under Chapter 11). Chapter 11 of the Bankruptcy Act provides for business reorganizations. If Chapter 13 were to become less favorable to individual debtors, some envision increased use of Chapter 11 by such debtors. *See* LoPucki, *supra* note 84, at 364-65.

133. *See* R. POSNER, *supra* note 97, § 14.3, at 293; *Bankruptcy Hearings, supra* note

HeinOnline -- 28 UCLA L. Rev. 989 1980-1981

relieve corporations from accumulated debt burdens but to encourage risk-averse individuals to invest in relatively risky ventures without having to put all of their assets on the line.[134] Limited liability allows investors to shift risk to lenders who knowingly accept those risks. Indeed, given the availability of limited liability for individuals through the creation of corporations, it is doubtful that an automatically available bankruptcy discharge for individual business debts is necessary.

By comparison, the discharge seems an unsuitable mechanism to fulfill the goal of a limited liability law. The corporate limited liability structure allows the risk averse to avail themselves of its benefits. Those willing to risk their individual assets may do so and, presumably, borrow funds at a lower rate of interest than if they incorporated by contributing only a portion of their capital to a new corporate enterprise. Lenders unwilling to rely on a corporate debtor's credit may insist upon personal loan guarantees by shareholders. The bankruptcy system, however, offers a discharge to all debtors regardless of their aversion to risk, and an individual debtor cannot effectively waive the availability of a bankruptcy discharge in a manner that unsecured lenders might rely on to lend at a lower rate. There is no back-up credit directly equivalent to the shareholder's personal guarantee of the debtor corporation's obligations. Only costly outside guarantees can serve a similar function. The bankruptcy discharge is overinclusive and redundant as a method of encouraging risky investment.

Finally, the argument based on equating limited liability with a right to discharge proves too much. It would justify eliminating not only any qualifications on a right to discharge inherent in an involuntary Chapter 13 provision, but virtually all other limits that bankruptcy law imposes upon discharge as well. For example, an individual, who may initiate a liquidation proceeding once every six years,[135] is plainly more limited than a corporation which, under state law, may incorporate and go broke more frequently.

One can imagine other, more serious objections to using a new Chapter 13-type plan as the basic bankruptcy prototype in lieu of traditional liquidation proceedings or Chapter 13 in its current form. Courts must make some judgment as to the prospects of successful participation by each debtor. This requires detailed scrutiny of likely future earnings and some assessment of the

8, pt. 1, at 159 (statement of Professor Kennedy); Shuchman, *supra* note 96, at 421, 460; Whitford, *supra* note 80, at 1100 n.198.

134. *See* Posner, *The Rights of Creditors of Affiliated Corporations,* 43 U. CHI. L. REV. 499, 502 (1976); Shuchman, *supra* note 96, at 421.

135. 11 U.S.C. § 727(a)(8), (9) (Supp. IV 1980).

HeinOnline -- 28 UCLA L. Rev. 990 1980-1981

debtor's minimal needs. There will be marginal questions about what percentage or fixed amount of the debtor's wage should go to creditors and how far into the future to reach. A mechanism more sophisticated than the existing one would be required for determining which plans must be approved. Proceedings before the bankruptcy court would remain open for years while payments under the Chapter 13-type plan are being made, and this may increase the administrative burden placed on bankruptcy courts.

Whatever increased administrative burden might result from widespread use of wage earner plans,[136] many of the necessary determinations already must be made in Chapter 13 plans.[137] Courts currently must judge the adequacy of proposed Chapter 13 plans. They must do so, moreover, not on the basis of some assessment of a debtor's actual needs, an asssessment that may be modified to reflect changed circumstances, but on the basis of a totally hypothetical calculation as to what each creditor would have received had there been a Chapter 7 liquidation proceeding instead of a Chapter 13 plan.[138] While the proposed reform requires judging the individual worthiness of debtors by deciding whether a Chapter 13-type plan is feasible, the new act's Chapter 13 already requires the court to assess the debtor's worthiness in deciding whether to grant a discharge despite the failure of an approved Chapter 13 plan.[139] The administrative burdens on bankruptcy courts may increase but they will not be qualitatively different from those already imposed on bankruptcy courts.

III. PLANNING FOR BANKRUPTCY

Improving the quality or quantity of bankruptcy courts or judges will not overcome structural problems in the new act. Bankruptcy law, like any law, is vulnerable to planned efforts to avoid its mandates. For so complex a statute, the new act seems relatively immature in its dealings with possible bankruptcy planning. Deliberations preceding that act reveal no recognition of the general issue, much less systematic consideration of it. Not surprisingly, therefore, the act is inconsistent in its attitude towards such planning, allowing it in some cases but not in others. Reformers' outdated notions about the relationship between state

136. *See* Whitford, *supra* note 80, at 1071.

137. *See* 11 U.S.C. § 1325 (Supp. IV 1980); *In re* Nance, 4 Bankr. Rep. 50 (B.C.W.D. Mo. 1980). Under the old bankruptcy act, the attorneys' perceptions of the bankruptcy judge's attitude towards the adequacy of the plan influenced the contents of the plan before the judge had to rule on it. D. STANLEY & M. GIRTH, *supra* note 42, at 75-76 & n.12; Girth, *supra* note 110, at 48.

138. 11 U.S.C. § 1325(a)(4) (Supp. IV 1980).

139. *See id.* § 1328(b)(1); *cf. id.* § 1129(a)(11) (Chapter 11 plan must be feasible to be confirmed).

HeinOnline -- 28 UCLA L. Rev. 991 1980-1981

and federal law in bankruptcy caused some of the act's problems in dealing with planning. The bankruptcy reform process again seemed incapable of taking a large enough view.

A. *Manipulating the Bankruptcy Law*

All laws face an identity crisis when society must decide whether it wants people to know of the law before engaging in behavior the law regulates. In some cases society hopes that people will modify their behavior in desired ways because of the law. But society simultaneously hopes that the modifications will not be adopted merely to avoid the law's purpose. Any statutory mandate other than the hopelessly ambiguous prescription to "do good" raises this problem. Yet such general standards lack the certainty needed for efficient, legitimate planning. At one level the problem reflects nothing less than the tension between regulating behavior through detailed rules rather than general standards.[140] Often decisionmakers respond to the tension between the need for specificity and the avoidance opportunities specificity creates by engrafting some form of the "do good" exhortation on top of a complex statutory structure. Occasionally courts will try to rescue legislators from the dilemma by appending a judicial mandate to "do good" upon a statutory scheme.

To illustrate, courts and scholars have struggled with the question whether steps taken in contemplation of established tax norms may be honored when those steps are motivated solely by the desire to avoid tax liability.[141] Although a simple answer to this question would have some appeal, it may be more useful to have the answer remain, as it is, ambiguous. Taxpayers strive mightily to avoid tax liability, but lurking in the recesses of their (or their lawyers') brains is the knowledge that if they strive too mightily they will encounter resistance from the Internal Revenue Service and the courts. Some of the worst abuses are thus avoided. Some even have come to regard the tension between the need for definite tax rules and the inevitable incentive to plan around such rules as generating a healthy ambiguity.[142]

---

140. *See, e.g.,* Kennedy, *Form and Substance in Private Law Adjudication,* 89 HARV. L. REV. 1685 (1976).

141. *E.g.,* Helvering v. Gregory, 69 F.2d 809 (2d Cir. 1934), *aff'd,* 293 U.S. 465 (1935); Paul, *Restatement of the Law of Tax Avoidance,* in STUDIES IN FEDERAL TAXATION 9 (1937); Blum, *Motive, Intent, and Purpose in Federal Income Taxation,* 34 U. CHI. L. REV. 485 (1967); Chirelstein, *Learned Hand's Contribution to the Law of Tax Avoidance,* 77 YALE L.J. 440 (1968); Gunn, *Tax Avoidance*, 76 MICH. L. REV. 733 (1978).

142. *See* B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 14.51, at 14-132 (4th ed. 1979) (suggesting benefit of the vagueness surrounding the step-transaction doctrine); Blum, *supra* note 141, at 495.

HeinOnline -- 28 UCLA L. Rev. 992 1980-1981

Although bankruptcy laws have a more ancient lineage than federal income tax laws,[143] our sophistication about the range of problems presented by a bankruptcy law seems infantile by comparison. The bankruptcy planning issue has received little systematic attention from decisionmakers while the interplay between tax planners and decisionmakers has become an art form.[144] Put simply, should bankruptcy law contain measures to prevent debtors and creditors from planning around its mandates?

Planning opportunities in the area of preferences and exemptions illustrate the problem. At least on one level, the bankruptcy law's approach is simple. Creditors who take action on the eve of bankruptcy run a gauntlet of rules that threaten to undo that action. The new act contains important limitations on creditors' ability to insulate themselves by contract from the risk of a debtor's bankruptcy.[145] The preference rules already discussed threaten to undo creditor actions that occur while the debtor is in financial difficulty. Yet debtors may plan in contemplation of their own bankruptcy by eve-of-bankruptcy behavior. With startling brevity, the act's legislative history recites, "As under current law, the debtor will be permitted to convert nonexempt property into exempt property before filing a bankruptcy petition."[146]

Nor is the problem solely one in theory. There are extreme cases of successful bankruptcy planning by debtors. Debtors have successfully transferred assets from nonexempt to exempt investments weeks or even days before bankruptcy.[147] A debtor may preserve extraordinary amounts, even in 1981 dollars, through judicious planning. In one case, an individual converted over

143. The first bankruptcy act was passed in 1800. Act of April 4, 1800, ch. 19, 2 Stat. 19. The first federal income tax law was passed in 1861 to help finance the Civil War. *See* 1 S. SURREY, W. WARREN, P. MCDANIEL & H. AULT, FEDERAL INCOME TAXATION 3 (1972).

144. Tax avoidance was "like taking candy from children. Nowadays the Treasury may comfort itself with the thought that tax-avoiding taxpayers at least have to think." Paul, *The Background of the Revenue Act of 1937,* 5 U. CHI. L. REV. 41, 44 n.28 (1937).

145. 11 U.S.C. §§ 365(e)(1), (f), 541(c)(1) (Supp. IV 1980).

146. S. REP. NO. 95-989, 95th Cong., 2d Sess. 76 (1978); H.R. REP. NO. 95-595, 95th Cong., 1st Sess. 361 (1977).

147. *See* Wudrick v. Clements, 451 F.2d 988 (9th Cir. 1971); *Bankruptcy Hearings, supra* note 8, pt. 3, at 1267 (statement of George Ritner); 1A W. COLLIER, *supra* note 27, ¶ 6.11[5], at 857-59; Resnick, *Prudent Planning or Fraudulent Transfer? The Use of Nonexempt Assets to Purchase or Improve Exempt Property on the Eve of Bankruptcy,* 31 RUTGERS L. REV. 615, 629-43 (1978); *cf.* O'Brien v. Johnson, 275 Minn. 305, 148 N.W.2d 357 (1967) (nonbankruptcy conversion). *But see In re* Schwingle, 4 BANKR. CT. DEC. 434 (W.D. Wis. 1978); *Bankruptcy Hearings, supra* note 8, pt. 2, at 771-72 (statement of Professor Shuchman) (no evidence found of conversion to nonexempt assets). A debtor's handbook designed for laymen advises debtors to convert nonexempt assets into exempt assets. J. HONIGSBERG & R. WARNER, CALIFORNIA DEBTORS' HANDBOOK 161 (3d ed. 1979).

HeinOnline -- 28 UCLA L. Rev. 993 1980-1981

$50,000 to exempt status prior to bankruptcy.[148] Texans' reputation for doing things in a big way was not injured by reports of one bankrupt's success in keeping nearly 200 acres of land with over $400,000 worth of buildings.[149] Courts ought to be able to treat more conversions to exempt assets as what they are: efforts to crowd into exempt categories as much value as possible without regard to what the debtor needs for survival and a fresh start.

Some courts do impose limits on prebankruptcy efforts to convert property to exempt status. But they require a finding of something called actual fraud,[150] which may designate cases in which the proceeds of assets sold on credit are used to purchase exempt property.[151] Actual fraud does not include most simple purchases of exempt assets made in contemplation of bankruptcy.

Accepting that there is a minimal core of assets that debtor's should keep notwithstanding bankruptcy, the conversion question in important respects is similar to that addressed by the preference provisions. In each case the law is concerned with preserving a pool of assets for distribution in bankruptcy. In the case of preferences, this is needed to prevent rapid and unjust accumulation of the debtor's assets in one or more creditors on the eve of bankruptcy.[152] In the case of conversion to exempt assets, the problem is to avoid an unfair accumulation in the debtor's hands. Furthermore, in both cases state law blesses dissipation of the debtor's assets.[153]

There are two peculiarities to the new act's unquestioning continuation of the old state-law system. First, there is an inconsistency between bankruptcy law's traditional treatment of preferences, where state law is not followed, and exemptions, where state law is followed. In the case of eve-of-bankruptcy conversions considerations analogous to those underlying the preference provisions suggest that a federal rule is appropriate. Regardless of state law, if the bankruptcy proceeding is going to have any assets to distribute, one needs rules to limit eve-of-bankruptcy dissipation. Preference rules prevent dissipation to creditors. Exemption

148. *In re* Adlman, 541 F.2d 999 (2d Cir. 1976) (amounts used to pay loans and premiums on exempt insurance policies).

149. *See* Note, *Bankruptcy Exemptions: A Full Circle Back to the Act of 1800?*, 53 CORNELL L. REV. 663, 664-65 (1968).

150. *See In re* Adlman, 541 F.2d 999 (2d Cir. 1976); *In re* Dudley, 72 F. Supp. 943 (S.D. Cal. 1947), *aff'd sub nom.* Goggin v. Dudley, 166 F.2d 1023 (9th Cir. 1948).

151. *See In re* Hunter, [1966-1967 Transfer Binder] BANKR. L. REP. (CCH) ¶ 62,291.

152. *See* cases cited in note 150 *supra.*

153. *See* Resnick, *supra* note 147, at 630 (conversion to nonexempt property not fraudulent); CAL. CIV. CODE § 3432 (West 1970); 2 G. GILMORE, *supra* note 1, § 45.2, at 1285, § 45.3.3, at 1298 (preferences valid outside of bankruptcy).

HeinOnline -- 28 UCLA L. Rev. 994 1980-1981

rules should limit dissipation to the debtor.[154]

The analogy to preference law may be carried one step further. Not only does it suggest a rationale for invalidating some eve-of-bankruptcy conversions, it provides a useful start in working out the details of these rules. As with preferences, a time limit on the period during which conversions are vulnerable seems appropriate.[155] In addition, not all conversions from nonexempt to exempt property within the vulnerable period need or should be undone.[156] The exemption rules could allow replacements of exempt property and could grant the bankruptcy court a general equitable power to allow other conversions. But the presumption should be against valid conversion. If an item is truly necessary for survival, the debtor will already have it prior to the eve of bankruptcy.[157] Most of the benefits of nonconversion can be obtained even with a general ambiguous prohibition against conversion.

The new act's second peculiarity is Congress' failure to rethink the conversion problem given Congress' new activism in the field of exemptions. Prior to the new act there was a rough justice in the area. State laws often gave inadequate exemptions, but debtors could exploit those that did exist with impunity. Now that Congress has decided the states have done an inadequate job in the area of exemptions, there seems little reason slavishly to adhere to a rule permitting conversion merely because it is the states' practice.

If a case exists for Congress at least to consider limiting debtors' planning opportunities, one might ask why bankruptcy law has failed to do so and continues to fail to do so under the new act. Again, a partial explanation may be found in inadequate forethought about, and analysis of, the relation between federal and state law in bankruptcy. Bankruptcy law is so liberal in its treatment of eve-of-bankruptcy conversion because the whole subject of exemptions has for years been treated in bankruptcy as a matter of state law.[158] Yet prebankruptcy conversions from nonexempt to exempt property provide as appropriate an occasion for an independent federal rule as do prebankruptcy preferences. Otherwise, clever debtors can and will frustrate the bankruptcy system. In the preference area the act has acknowledged this need for years. Of course, even a change in the bankruptcy act's treatment of prebankruptcy conversions may not totally achieve its

---

154. Note, *Bankruptcy Exemptions*, *supra* note 77, at 1481.

155. *See* 11 U.S.C. § 547(b)(4) (Supp. IV 1980).

156. *See generally id.* § 547(c) (exceptions to preference provision).

157. *Bankruptcy Hearings, supra* note 8, pt. 2, at 951.

158. 1A W. COLLIER, *supra* note 27, ¶ 6.11[1], at 847; Resnick, *supra* note 147, at 630; Note, *Bankruptcy Exemptions*, *supra* note 77, at 1480.

HeinOnline -- 28 UCLA L. Rev. 995 1980-1981

goal. Despite decades of governmental counterattack, tax planners still thrive. Bankruptcy experts similarly may be able to plan around a specific rule addressing the conversion issue. A general standard's success will turn on the way it is applied by many different courts.

Furthermore, a limit on prebankruptcy exemption planning, even if it worked, would be perceived as unfair to some debtors. It generates unequal treatment between the sophisticated debtor and the unsophisticated debtor. The unsophisticated debtor who waits until the eve-of-bankruptcy to take advantage of his exemptions will be frustrated. A determined, well-advised debtor will convert his assets to exempt property prior to whatever vulnerable period a bankruptcy act imposes on such conversions.[159]

Although legislators should try to minimize disparities between the counselled and the uncounselled, it is far from clear that the best approach to unevenness is to surrender to the abuse in all cases instead of a few. Disparities between the unadvised and the sophisticated exist under any detailed law. In complex areas of taxation, such as reorganizations, rarely do any but the harried, the unadvised or the ill-advised suffer drastic undesirable tax consequences. In part, that is the price one pays for measures to curtail what are perceived as abuses.

Elsewhere in the bankruptcy act, there are opportunities to plan around the law available only to the well-advised. Planning opportunities for debtors seeking to prefer themselves through exemptions are no different than opportunities that have been and remain available to debtors wishing to frustrate the act's preference provisions. A patient, well-advised debtor need only pay his preferred creditor and delay filing a bankruptcy petition until the preference period applicable to the payment has expired.[160] No one suggests that the answer to this relative inequality between the counselled and uncounselled is simply to allow all preferences to go unchallenged. Yet that seems to be the thrust of the argument when it is the debtor who benefits from the planning opportunity.

B. *Sanctions*

If reformers want to limit planning around bankruptcy laws, they must do more than undo transactions between debtors and creditors. Merely unraveling a completed transaction will not necessarily discourage the parties from engaging in the tainted transaction. The need to prevent pre-petition dissipation of assets

159. *See* Kennedy, *Limitation of Exemptions in Bankruptcy,* 45 IOWA L. REV. 445, 479-81 (1960).

160. The debtor also must hope that no involuntary petition is filed against him during the vulnerable period.

HeinOnline -- 28 UCLA L. Rev. 996 1980-1981

to the debtor or his creditors requires consideration of one other possible feature of a bankruptcy law. Should the law impose sanctions beyond the recovery of property upon those who receive preferences, including preferences in favor of the debtor?

There is some question whether a bankruptcy law without such sanctions can achieve its goals. Even the most stringent preference rules will lead a creditor who cannot otherwise avoid them to risk accepting what he thinks will turn out to be a preferential transfer. At worst, the bankruptcy court will order the transfer undone and the creditor will be no worse off than if he had not received the preferential transfer.[161] He might also gain bargaining leverage with the trustee, who often will find it more advantageous to settle than to litigate a preference claim. Creditors of distressed debtors seem to have every incentive to seek or even induce preferences. Similarly, the debtor contemplating converting assets to exempt property on the eve of bankruptcy has little incentive not to try.

In addition, a typical bankruptcy proceeding lacks an important factor present in everyday contractual dealings that reduces the need for sanctions. Parties who do not perform their contracts may well fear the sanctions of the market more than they fear any civil sanctions the law might support.[162] If one fails to perform too frequently, one does not stay in business. A creditor receiving a preference feels no such inhibitions. He is neither violating a contractual duty nor discouraging parties who might contract with him in the future. He may be angering competing creditors but that alone will not adversely affect his business. In a bankruptcy setting, the sanction of the marketplace offers no real obstacle to behavior the bankruptcy act wishes to discourage—accepting a preference. If the artificial construct of bankruptcy is to work, artificial sanctions beyond disgorgement of the preference may be needed.

Despite this need, reason exists for limiting, if not rejecting, sanctions. Imposing sanctions upon those receiving preferences is complicated by the sequence of events triggering the sanction. At the time the debtor gives a preference, a creditor does not violate contractual or statutory duties by his acceptance. A tainted event occurs only if the debtor happens to go bankrupt within the preference period following the transfer. It is awkward at best to have the creditor's activities at time one be altered in legal consequence because of activities beyond the creditor's control that occur at a later time two. At the time of the preference, accepting it may be

161. McCoid, *Bankruptcy, Preferences, and Efficiency: An Expression of Doubt*, 67 VA. L. REV. 249, 264 (1981).
162. *E.g.*, R. POSNER, *supra* note 97, § 4.1, at 66-67.

HeinOnline -- 28 UCLA L. Rev. 997 1980-1981

a totally innocent act blessed or required by contract.[163] That innocence may not be sufficient reason to allow the creditor to keep the preference, but it does give reason to pause before imposing sanctions for accepting the preferences.

One accommodation to the innocent creditor is to limit the circumstances in which sanctions may be invoked. The strongest case for sanctions involves a creditor who receives what turns out to be a preference and who, at the time of receipt, believes the debtor will be bankrupt in the near future. Limiting sanctions to such cases would assuage the fears of innocent preference recipients but might deter those creditors who routinely attempt to extract disproportionate payments and cross their fingers for the duration of the preference period, or worse, those who artificially support the debtor to keep him in business for the duration of that period. But even this limited use of sanctions raises problems. A creditor who believes his debtor is in financial difficulty hardly commits mortal sin by accepting payments on debts owed him. Any penalty for such behavior other than disgorgement may be too great.

The difficulties of arriving at acceptable solutions to the related problems of planning and sanctions in bankruptcy can lead to a different conclusion. One might conclude that the problems are so intractable that Congress should not bother trying to resolve them because no legislative solution is likely to improve the status quo. A conscious decision to that effect has some limited appeal. But even if resolution of these issues would not necessarily result, major bankruptcy reform that fails to bring these matters to the decisionmakers' attention leaves one unsatisfied with the scope of the process.

CONCLUSION

Although a Congress fully cognizant of the issues addressed here might nevertheless adhere to its existing reform decisions, it ought to do so knowing the costs of poor coordination with nonbankruptcy law. Unfortunately, the new act not only reflects these costs but to some degree reinforces bankruptcy law's isolation, a development that can be expected to generate future discontinuities between bankruptcy and nonbankruptcy law. The act's creation of distinct bankruptcy courts expressly removed from the supervision of regular district judges[164] will tend to further isolate bankruptcy law. From one point of view, the new courts merely confirm a reality that already existed under the old

163. *See* 2 G. GILMORE, *supra* note 1, § 45.3, at 1298.

164. *See* 28 U.S.C. §§ 151-160 (Supp. III 1979). In some circuits, however, district courts maintain appellate jurisdiction over bankruptcy courts. *Id.* § 1334.

HeinOnline -- 28 UCLA L. Rev. 998 1980-1981

law. Bankruptcy had become the province of a relatively small group of specialists and referees.[165] From another point of view, this reality is the problem that bankruptcy reform most needed to address. Major bankruptcy reform could have been the occasion to begin reabsorbing bankruptcy back into the legal mainstream. There will be few others.

---

165. *See* New Jersey v. Reading Co., 101 S. Ct. 1997, 1997 (1981) (Rehnquist, J., dissenting from denial of certiorari); H.R. REP. No. 95-595, 95th Cong., 1st Sess. 95-96 (1977); *Bankruptcy Hearings, supra* note 8, pt. 1, at 538 (statement of Harold Marsh, Jr.), pt. 2, at 1153-62 (statement of Stephen N. Subrin and John Rugheimer), pt. 3, at 1557, 1559; 2 G. GILMORE, *supra* note 1, § 45.2, at 1287; Jackson & Kronman, *supra* note 25, at 1003 n.95; Shuchman, *supra* note 96, at 408 & n.17. *But see* D. STANLEY & M. GIRTH, *supra* note 42, at 186-88; Cyr, *Setting the Record Straight for A Comprehensive Revision of the Bankruptcy Act of 1898,* 49 AM. BANKR. L.J. 99, 117-20 (1975).

HeinOnline -- 28 UCLA L. Rev. 999 1980-1981