The Expansive Trend of Bankruptcy Legislation

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ORIGIN

Bankruptcy Law of this country has its source in the English Acts of Parliament, the first enactment having been passed in 1542 during the reign of Henry VIII. In this country the first Bankruptcy Act was passed by Congress in 1800 pursuant to the provisions of the Federal Constitution to establish "uniform laws on the subject of bankruptcies throughout the United States," Const. Art. I., Section 8, Clause 4. This law was repealed in 1803 and a second Bankruptcy Act was passed in 1841, following a severe financial depression. This second Act was repealed after two years and it was not until 1867 that the third Act was passed by Congress, designed to meet the financial stress which followed the close of the Civil War. This Act was in force eleven years and was succeeded twenty years later by the present law which became effective July 1, 1898. All of the bankruptcy enactments were passed to alleviate the hardships due to financial crises. In Williston's Collection of Cases on Bankruptcy will be found an excellent historical introduction reviewing the legislation in England and in this country.


It will be noted that the previous bankruptcy laws were of short duration, whereas the Act of 1898 together with its supplements and amendments now constitutes a permanent part of our Jurisprudence with the experience of almost a half century.

DEVELOPMENT

An eminent legal historian\(^1\) has said:

"A steadily expansive interpretation, however, has been given to the Bankruptcy Clause during the one-hundred and forty-eight years which have ensued. As long ago as 1837 Senator Thomas H. Benton said: 'We are to use our granted powers, according to the circumstances of our own country, and according to the genius of our republican institutions, and according to the progress of events and the expansion of

light and knowledge among ourselves... It is bankruptcies and not bankruptcy that is to be the object of those uniform laws.' And it is now substantially settled by legislative practice and by judicial decision (though for many years challenged) that a statute may be 'on the subject of bankruptcy,' without being technically 'a bankruptcy law'—in other words, that any National law which deals with inability to pay debts and which is uniform throughout the country is a law 'on the subject of bankruptcy.' Whatever may have been the anticipation of the framers, the fact is that the Bankruptcy Power has developed steadily, from being a regulation of traders for purely commercial purposes, into a National policy of relief, for creditors and debtors of all classes and for the restoration of business life, with debts adjusted or discharged. Moreover, there has been a steady progress of the idea that these statutory methods of relief should be based on the interest of the Nation at large; and as the particular needs and interests of the Nation change in different periods of distress and disaster, so the exercise of the Bankruptcy Power may be expanded to meet these National needs."

The same thought is echoed with further authority cited by the writer in the recent edition of a well known work:2

"In addition, if it is remembered that the first English acts, as well as the early American Act, were designed for the protection of the commercial community, and that insolvency was not an element in those laws, although that element has been drawn into the modern legislation, it can be seen that the constitutional grant of power over the subject of bankruptcies embraces the entire field of debtor-creditor relationships for the purpose of equitable distribution of a debtor's estate, rehabilitation of the debtor, and protection of the credit structure against anything materially contributing toward its impairment. Judge, later Justice Blatchford, commented:

"'It cannot be doubted that Congress in passing laws on the subject of bankruptcy is not restricted to laws with such scope only as the English laws had when the Constitution was adopted. The power given must, indeed, be held to be general, unlimited, and unrestricted over the subject.'"

Mr. Warren in his book3 not only traces in an interesting way the history of bankruptcy, but likewise affords the reader an excellent review of the outstanding economic events in the United States. He divides the history of bankruptcy into three periods:

I. The period of the Creditor, 1789-1827, treating the following topics:
   The Constitution and Bankruptcy
   Stock and Land Speculations and the Act of 1800
   The Supreme Court and State Insolvency Laws

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The Depression of 1819-1824
Ten Years of Bankruptcy Debates in Congress

II. The Period of the Debtor, 1827-1861, treating the following topics:
The Supreme Court Again
The Panic of 1837 and the Banks
The Fight for Voluntary Bankruptcy
Whig Politics and the Act of 1841
State Stay-Laws

III. The Period of National Interest, 1861 to recent times, treating the following topics:
The Civil War and the Act of 1867
The Panic of 1873 and Repeal
The South and West for the Debtor
The Depression of 1893-1897 and the Act of 1898
Expansion of the Bankruptcy Power

ORTHODOX BANKRUPTCY

Throughout the long history of bankruptcy legislation until 1933 its administration was confined to what is termed Orthodox Bankruptcy, that is to say, the filing of petitions either voluntary or at the instance of creditors, followed by an adjudication and an order of reference to the appropriate referee, the proving of claims by creditors, the election or appointment of a trustee, and other steps incident to a complete liquidation of the bankrupt's estate, and a distribution of the proceeds among the proving creditors according to their merits, and closing the estate with a discharge of the bankrupt from his indebtedness.

It is interesting to note that in no instance during the extended history of Orthodox Bankruptcy has the Supreme Court of the United States declared unconstitutional any provisions on the subject as enacted by Congress and in *Hanover National Bank vs. Moyer*4, decided in 1902, there was set at rest practically all mooted questions upon the constitutionality of the National Bankruptcy Act of July 1, 1898.

In Collier on Bankruptcy5 14th Edition, the writer traces the matter of ordinary bankruptcy as follows:

"Before the last economic crisis, which began in 1929, the more important amendments were made in 1903, 1906, 1910, 1915, 1916, 1917, 1922 and 1926. The acts of bankruptcy, the discharge, and the criminal provisions had been strengthened to some extent. The acts of bankruptcy were: (1) fraudulent transfer, (2) preferential transfer, (3) and (4) preference through legal proceedings, (5) general assignment for the benefit of creditors or a receivership, and (6) written confession of bankruptcy. Insolvency was not an element of acts (1), (6), and so much of (5) as dealt with a general assignment, but solvency at date

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4186 U. S. 181 (1902) 22 Sup. Ct. R. 857, 46 L. Ed. 1113, extended opinion by FULLER, C. J.
of petition was a defense to a proceeding based on act (1). These acts were substantially those of the Canadian Act as it stood until amended in 1922, when it was there provided that it was an act of bankruptcy for a debtor to fail to meet his liabilities as they became due. Proceedings under the American Act had to be begun within four months after the commission of the act. Provisions as to who may become bankrupts were analogous to the Canadian provisions. 'Any person, except a municipal, railroad, insurance, banking corporation, or a building and loan association' might become a voluntary bankrupt. Under this provision, unlike the Canadian Act, no specific amount of liabilities was required. 'Any natural person, except a wage earner or farmer, any unincorporated company, and any moneyed, business, or commercial corporation (except a municipal, railroad, insurance or banking corporation, or a building and loan association) owing debts to the amount of $1,000 or over, may be adjudged an involuntary bankrupt . . .' Insolvency as an element of bankruptcy, as noted, was the excess of liabilities over assets at a fair valuation.

"The administration of the estate was conducted by the federal courts of bankruptcy, largely through referees. In theory, trustees were to be selected by creditors, appointed by the referee, but thereafter subject to the directions of the court."

Thus the entire legislative scheme of ordinary bankruptcy as heretofore described under the Act of 1898 and its amendments was eventually centered and is at the present time embodied in Sections 1-72.

RELIEF PROVISIONS

In Orthodox Bankruptcy as reflected in the original legislative plan of the Act of 1898, the only provisions relative to adjustment of the debtor-creditor relationship are found in Sections 12 and 13, but the terms of these two sections were found wholly inadequate to meet the stress of the depression of 1929. In the well known authority referred to above the steps taken are thus succinctly described:

"The financial strain caused by the economic crisis which began in 1929 made it inevitable that legislation would be enacted to supplement sections 1-72, which were divided into seven chapters and comprised the Act of 1898, and which for convenience may be referred to as ordinary bankruptcy or liquidating provisions. This supplementary legislation was aimed at rehabilitation and reorganization.

"The Act of March 3, 1933, added Chapter VIII entitled Provisions for the Relief of Debtors. This act contained five sections, sections 73, 74, 75, 76 and 77. Section 73 was a general section conferring additional original jurisdiction upon courts of bankruptcy as provided in sections 74, 75 and 77. Section 74 provided for compositions and exten-

sions; it was not available to corporations. Section 75 provided for agricultural compositions and extensions for farmers. Section 77 provided a method for the reorganization of railroads engaged in interstate commerce. This organization statute was rewritten by the Act of August 27, 1935. Section 76 provided that extensions made pursuant to sections 74 and 75 should apply to persons secondarily liable.

"The Act of May 24, 1934, added Chapter IX (sections 79-80), which provided for Municipal Debt Readjustments.

"The Act of June 7, 1934, added sections 77A and 77B to Chapter VIII. Section 77A conferred additional jurisdiction upon courts of bankruptcy as provided in section 77B. Section 77B provided for the reorganization of corporations generally along lines comparable to those provided in section 77 for railroad corporations.

"Act of August 6, 1937. Chapter IX, dealing with municipal debt readjustments, was invalidated by the Supreme Court on May 25, 1936. On August 6, 1937, Congress added a new municipal debt readjustment statute to the bankruptcy act, Chapter X (sections 81-84)."

**CHANDLER REVISION**

The Act of Congress approved June 22, 1938, known as the Chandler Act, is the final phase of present bankruptcy legislation, the result of much discussion and debate of the experts over a period of forty years. The sections treating of orthodox bankruptcy are numbered 1-72, omitting, however, the old sections 12 and 13, which dealt with compositions. The enumeration, therefore, is 1-11, inclusive, and 14-72, inclusive.

In the relief, rehabilitation and reorganization sections, Section 75 deals with Agricultural Compositions and Extensions; Section 77, with Reorganization of Railroads Engaged in Interstate Commerce; sections 81, 82, 83 and 84, with Municipal Debt Readjustments. The sections in Chapter X, Corporate Reorganizations, are numbered from 100 to 300; Chapter XI, Arrangements, from 300 to 400; Chapter XII, Real Property Arrangements by Persons Other Than Corporations, from 400 to 600; Chapter XIII, Wage Earners' Plans, from 600 to 700; and Chapter XIV, Maritime Commission Liens, from 700 to 800.

**CONSTITUTIONALITY**

As already stated there has been no instance during the extended history of orthodox bankruptcy of the Supreme Court declaring unconstitutional any provision on that subject enacted by Congress, and on the other hand in *Hanover National Bank vs. Moyses*, many points were laid at rest as to the constitutionality of the Act of 1898.

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7Effective September 22, 1938.
8Introduced originally May 28, 1936, H.R. 12889, by Representative Walter Chandler at Second Session of the 74th Congress.
9See note (4) supra.
However, the desperate financial plight of the country in the years following 1929 impelled Congress to enact for the first time as a part of the general bankruptcy law certain relief measures for individuals and corporations. Among these measures is Section 75 containing originally subdivisions a to r but to which Congress in 1934 enacted subdivision s, generally known as the Frazier-Lemke Act, also called the Moratorium Provision. In the consideration of 75s the Supreme Court broke its long record and on May 27, 1935 declared the measure unconstitutional in *Louisville Joint Stock Land Bank vs. Radford.*

Justice Brandeis stated:

"It is true that the position of a secured creditor, who has rights in specific property, differs fundamentally from that of an unsecured creditor, who has none; and that the Frazier-Lemke Act is the first instance of an attempt, by a bankruptcy act, to abridge, *solely in the interest of the mortgagor*, a substantive right of the mortgagee in specific property held as security. But we have no occasion to decide in this case whether the bankruptcy clause confers upon Congress generally the power to abridge the mortgagee's rights in specific property. Paragraph 7 declares that 'the provisions of this act shall apply only to debts existing at the time this act becomes effective.' The power over property pledged as security after the date of the act may be greater than over property pledged before; and this act deals only with pre-existing mortgages. Because the act is retroactive in terms and as here applied purports to take away rights of the mortgagee in specific property, another provision of the Constitution is controlling. (Italics mine.)"

Mr. Warren further observed, commenting on the above quotation, as follows:

"The very extreme provisions of this statute undoubtedly warranted the decision. But there still may be a doubt whether every retroactive interference with a creditor's rights is rendered impossible, under his decision. For retroactive action has been an essential part of the Bankruptcy power in the past, and one of the chief reasons for the enactment of bankruptcy laws has been to wipe out debts existing at the date of such enactments. Since the Court has long held that the grant of the Bankruptcy Power to Congress involves the power to impair the obligation of contracts, it is difficult to see why the contract of a secured creditor may not be impaired as well as the contract of an unsecured creditor. It would appear that a statute which prevents A from suing on B's unsecured note takes away property rights belonging to A as well as discharges B's personal obligation. To the extent that it deprives A of a property right of suit which he had in the past, it is retroactive in the same manner as a statute which takes away property held by A under B's secured note. In both cases, it would seem that the statute was retroactive as to a property right of A. If Congress may abolish the entire indebtedness of B to A on B's unsecured note, is it entirely without power to affect the indebtedness of B to A on B's secured note? Is it with-

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11Quoted from Warren, supra, page 156.
out power to reduce such indebtedness, on equitable terms under the Bankruptcy Clause? Certainly the Railroad Reorganization Act of 1934 (which the Court has upheld) interfered with pre-existing rights of secured creditors. It is to be noted that in the Radford Case, the abridgment of the creditor’s rights made by the statute was stated by the Court to be ‘solely in the interest of the mortgagor.’ If the abridgement had been or should be made in the interest of all parties concerned, creditors, debtors, and the general public, would the mere fact that it affected retroactively prior existing rights of a creditor render it invalid under the Fifth Amendment? There may at least be room for doubt.’

On August 28, 1935, Congress enacted a new 75s which is in the present law and in so enacting the framers sought to avoid the objections to the old subdivision as pointed out in the Radford case. This new provision came before the Court in 1937 and was declared constitutional.18

In 1935 the constitutionality of Section 77 was determined favorably.18 The writer in Collier on Bankruptcy, 14th Edition, has remarked:

“In general, section 77 as originally enacted in 1933 was deemed constitutional. This conclusion was taken as highly persuasive of the constitutionality of the subsequent revision effected in 1935. Section 77 was enacted pursuant to the power delegated to Congress to pass uniform laws on the subject of bankruptcies. While the Congress may not impair the obligation of contracts by laws acting directly and independently to that end, it has authority to enact legislation on the subject of bankruptcies which may operate collaterally or incidentally to impair or destroy the obligation of private contracts.’ As pointed out in Warren vs. Palmer, ‘Railroad reorganization in bankruptcy is a field completely within the bankruptcy powers of Congress.’ Hence any general objection as to the constitutionality of section 77 is doomed to failure.”14

On May 25, 1936 the Municipal Debt Adjustment sections, 78-80, were declared unconstitutional in Ashton vs. Cameron County Water Imp. Dist. No. 1,16 and on August 16, 1937 the present Chapter IX, Sections 81-84, were enacted and later in U. S. of America vs. Bekins16 were declared constitutional.


14Vol. 5, page 471.


From this review it appears that but in two instances has the Supreme Court declared the Congressional enactments relative to the Relief Sections of bankruptcy as unconstitutional, viz., in the case of the Frazier-Lemke first enactment and the one just considered of the original Municipal Debt Adjustment provision.

RECENT LEGISLATION

By the terms of the Chandler Revision the provisions of Section 75 and the provisions of Chapter IX, Sections 81-84, were declared emergency measures and therefore with a time limit as to their operation. However, by the Act of Congress approved July 1, 1946, the limitation on Chapter IX as embodied in Section 84 was lifted by the repeal of this section and consequently the Chapter is now a permanent part of Bankruptcy Legislation.

In addition thereto by the terms of Sections 81, 82 and 83 as now revised, the scope of the chapter has been broadened by the amendment to Section 81 (6) and the addition of (7), so as to read as follows:

"or (6) incorporated authorities, commissions, or similar public agencies organized for the purpose of constructing, maintaining and operating revenue-producing enterprises; or (7) any county or parish or any city, town, village, borough, township, or other municipality: Provided, however, that if any provision of this chapter, or the application thereof to any such agency or district or class thereof or to any circumstance, is held invalid, the remainder of the chapter, or the application of such provision to any other or different circumstances, shall not be affected by such holding."

From the report of the House Committee on the Judiciary which considered this amendatory measure, the following quotation is illuminating:

"H.R. 6682 amends the existing statute so as to make it applicable to any type of revenue bond issued by a city, town, county, and so forth, and also to make the act applicable to 'authorities.' The extension of the act along these lines is singularly appropriate because the revenue bonds issued by municipalities or authorities are for the purpose of financing revenue-producing enterprises rather than governmental functions. They are essentially business enterprises. The investor purchases these bonds relying upon the ability of the municipality to operate such business enterprises at a profit. Obviously these businesses are subject to the same hazards as other businesses financed by private capital. That fact is realized by the investor when he purchases such bonds and he does not depend upon the taxing power of the municipality to meet the principal and interest. Such bonds today enjoy a very wide market.

"Under the existing law the holders of revenue bonds are in the same position as were the holders of general obligation bonds of a municipality prior to the enactment of the Municipal Act. A small minority would be in a position to veto a settlement to which the overwhelming majority of the holders of such bonds had agreed."17

17For further comments on other features of the amendments, see U.S. Code Congressional Service, 1946, Advance Sheet No. 6, page 2, 190 and following.
Thus Section 75 is the only portion of present bankruptcy legislation remaining in the emergency class and by the terms of Section 75c amended by the Act of Congress of June 3, 1946, Section 75 has been again extended to March 31, 1947.

Relative to the possible permanency of this legislation and the merits thereof, the following comment is found in Collier, 14th Edition:

"In the main, subdivisions a-r, inclusive, are based on the principle that a farmer may obtain a composition or extension of his debts if he obtains the consent of a majority in number and amount of his creditors. Pending suits are stayed while the attempt to gain consent is carried on. A conciliation commissioner is to be appointed by the bankruptcy court for each county having an agricultural population of five hundred or more, and his duty is to aid the farmer in preparing his petition and to perform many of the functions of a referee. Subdivision s provides an alternative remedy if the debtor cannot gain the necessary consent from his creditors, or if he feels aggrieved by the composition or extension. He may petition to and be adjudged a bankrupt, and then obtain a three year moratorium. Because of the tremendous difficulty of obtaining the consent of a majority of creditors, section 75 becomes really effective through the utilization of subdivision s. It has been aptly pointed out by Circuit Judge William Clark that in practical effect, subdivision s constitutes a wide departure from the usual concept that bankruptcy legislation should preserve and distribute the debtor's estate for the creditors' benefit. Although creditors are afforded a certain measure of protection to the extent of the value of the property, the provision is framed so as 'to keep the farmer-debtor in possession of his farm perhaps for the general benefit of the state, but at any rate at the expense of his creditors' for designated period.

"It may be that section 75, or something closely akin to it, will become a permanent addition to our bankruptcy law. However, the continued extensions of the life of the section are still justified as emergency measures; and it is evident that the draftsman of the Chandler Act of 1938 anticipated an eventual demise of section 75. Yet the farm situation, through good years and bad, may well deserve the specialized treatment accorded it by section 75. In the event of permanent retention, there will probably be a shift from the emphasis of 'emergency' as alone calling for a broad and liberal application of the statute. Moreover, if the provision, or its counterpart, becomes permanent legislation, the terms thereof should be more carefully drawn and some effort made to integrate it with the provisions covering ordinary bankruptcy. As the statute now stands it is, to say the least, not a model piece of legislative skill."

Another important amendment to the bankruptcy law is the Act of Congress approved June 28, 1946, amending Section 1 of the Chandler Act by adding certain new paragraphs and also amending Sections 34, 35, 37, 40, 43, 53, 62 and 72, all on the subject of referees, their appointment, term of office and compensation.
It is not within the province of this article to go into this matter but in general the legislation is aimed primarily at setting up a system of full-time salaried referees to replace the present system of essentially part-time referees compensated on a fee basis. This matter has been under consideration for some years past and is most important looking to the general administration of bankruptcy law, it having been contended that a fee system of compensation is objectionable for many reasons, and has been done away with in most public offices—state and national. In many matters that come before the referee for decision his compensation will be directly affected by the decision he reaches. Whether his decision is or is not affected, it is unfair to place him in this position. Furthermore, under the existing system, due to the great fluctuation and volume of business, referees are poorly paid in many districts, and it is becoming increasingly difficult to secure competent referees. Again, referees are now required to pay the expense of operating their offices out of the business coming to each office. These and other matters have impelled this legislation.19

CONCLUSION

From the foregoing review it is apparent that bankruptcy legislation is not only now a permanent part of our national law, but through the additions to the law in the past thirteen years the general scope has been expanded far beyond the probable vision of the framers of the Federal Constitution but justifiable in the national interest.

As pointed out by Mr. Warren in viewing the possibilities of constitutional power under the bankruptcy laws, we come back to what Henry Clay said, April 4, 1840:20

"The right of the State (Nation) to the use of the unimpaired faculties of its citizens as producers, as consumers, and as defenders of the Commonwealth, is paramount to any rights or relations which can be created between citizen and citizen . . . I maintain that the public right of the State (Nation), in all the faculties of its members, moral and physical, is paramount to any supposed rights which appertain to a private creditor. This is the great principle which lies at the bottom of all bankrupt laws."

19For further elaboration of this matter and a summary of the Bill, see Report of Senate Committee on the Judiciary, U.S. Code Congressional Service 1946, Advance Sheet No. 6, page 2—175.