Fordham Law Review

Volume 71 | Issue 3 Article 14

2002

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Recommended Citation
Thomas E. Plank, *Bankruptcy and Federalism*, 71 Fordham L. Rev. 1063 (2002).
Available at: https://ir.lawnet.fordham.edu/flr/vol71/iss3/14

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BANKRUPTCY AND FEDERALISM

*Thomas E. Plank**

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* Visiting Professor of Law, Notre Dame Law School; Professor of Law, University of Tennessee College of Law; A.B. 1968, Princeton University; J.D. 1974, University of Maryland; Of Counsel, McKee Nelson, LLP. I thank David Gray Carlson and George Kuney for their helpful comments on drafts of this article.

INTRODUCTION

Bankruptcy law illuminates the tensions in our federal system between state and federal law better than any other body of law. Congress enacted the Bankruptcy Code[1] pursuant to its power under the Constitution to enact laws "on the subject of Bankruptcies."[2] The Code, a federal statute, creates a procedure for adjusting the relationship between a debtor in financial distress and its creditors, through either liquidation of its property for distribution to creditors or reorganization of its business affairs. The Code, however, does not create this debtor-creditor relationship. Nonbankruptcy law—predominantly state law—creates this relationship.

The Code explicitly and implicitly recognizes its dependence on state law in altering the relationship between the debtor and its creditors.[3] Many provisions of the Code incorporate state law. On the other hand, many other provisions of the Code overrule state law. Unfortunately, neither courts nor scholars have developed a coherent theory for deciding when Congress must follow state law and when it may overrule state law.

This article provides an analytical framework for determining when Congress may decline to follow state law and when it must follow state law. This framework requires that Congress and courts identify and respect the limits of Congress's power to enact bankruptcy law under the Constitution. In my view, Congress may use its power to enact bankruptcy law only to adjust the relationship between an insolvent debtor and his, her, or its creditors. Therefore, Congress may use its bankruptcy power to overrule state law only to the extent that it is adjusting this relationship. Congress may not do more.

Understanding Congress's limits on modifying state law in bankruptcy is important for several reasons.[4] The Supreme Court and

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1. 11 U.S.C. §§ 101-1330 (2000), enacted by the Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (1978).

2. The United States Constitution empowers Congress to "establish . . . uniform Laws on the subject of Bankruptcies throughout the United States." U.S. Const. art. I, § 8, cl. 4.

3. *See infra* Part I.

4. Recognizing the limits on Congress's power under the Bankruptcy Code to alter state law will also enable federal courts in bankruptcy to produce analytically sounder and more predictable judicial decisions in applying the Code when the Code does not provide a clear answer. In my view, federal courts in bankruptcy are bound by *Erie Railroad Co. v. Tompkins*, 304 U.S. 64 (1938). At its very core, *Erie* is a particular expression of the limitation on federal power inherent in the Constitution: Federal courts may not create federal common law in matters beyond the scope of Congress's enumerated powers. This core principle of *Erie* requires that, in a bankruptcy case, federal courts must find and follow the state law when resolving state law issues that are beyond the scope of the Bankruptcy Clause. For example, under my view of the limits of the Bankruptcy Power, Congress and federal courts must defer to state law on the question of what constitutes an interest in property of the debtor that may be liquidated for distribution to creditors. Thus, when there is no

other federal courts have begun to take more seriously the limitations on congressional power under the Commerce Clause[5] and other parts of the Constitution.[6] Bankruptcy law plays an important role in the economic life of the country, both in planning transactions and in litigating disputes.[7] Accordingly, maintaining the integrity of our federal constitutional structure—federalism in the broadest sense[8]—requires that both Congress and the federal courts recognize and respect the limitations on Congress's power to enact bankruptcy laws. Moreover, as Congress continues to tinker with the Code[9] and

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direct state law authority on a particular issue, federal courts cannot simply fall back onto "federal policy" and create, in effect, federal common law. They must strive to resolve the issues by analyzing all of the potential elements under the richer and broader body of state law. I address how the Erie doctrine applies in bankruptcy and all of the complications that such application presents in a forthcoming article. *See* Thomas E. Plank, *The* Erie *Doctrine and Bankruptcy* (forthcoming 2003) (draft manuscript on file with the Fordham Law Review).

5. *See* United States v. Morrison, 529 U.S. 598, 617-19 (2000) (holding that the Commerce Clause of the Constitution did not permit Congress to enact the civil remedy provision of the Violence Against Women Act); United States v. Lopez, 514 U.S. 549, 567-68 (1995) (holding that the Commerce Clause does not authorize Congress to ban weapons from schools).

6. Recently, the Court has invalidated the application of federal statutes to the states on grounds that they violate the Eleventh Amendment. *See, e.g.*, Fed. Mar. Comm'n v. S.C. State Ports Authority, 122 S. Ct. 1864 (2002) (holding that state sovereign immunity precluded the Federal Maritime Commission from adjudicating a private party's complaint that a state-run port had violated the Shipping Act); Alden v. Maine, 527 U.S. 706 (1999) (holding that Congress could not subject state to suit by state probation officers for violation of overtime provisions of Fair Labor Standards Act in state court without state's consent); Fla. Prepaid Postsecondary Educ. Expense Bd. v. Coll. Sav. Bank, 527 U.S. 627 (1999) (holding that neither the Commerce Clause nor the Patent Clause authorized Congress to abrogate state sovereign immunity under the Patent and Plant Variety Protection Remedy Clarification Act); Seminole Tribe of Fla. v. Florida, 517 U.S. 44 (1996) (holding that Congress lacked authority under the Indian Commerce Clause to abrogate the states' Eleventh Amendment immunity and compelling negotiations under the Indian Gaming Regulatory Act).

7. *See, e.g.*, Nat'l Bankr. Rev. Comm'n, Bankruptcy: The Next Twenty Years § 3.1, at 722 & n.1739 (1997) [hereinafter NBRC Rep.].

8. This article does not address the extent to which Congress may empower actions against state governments in federal courts in bankruptcy. Commentators classify the issue of a State's immunity from suit in federal court as an issue of "federalism." *See, e.g.*, Richard H. Fallon, Jr., *The "Conservative" Paths of the Rehnquist Court's Federalism Decisions*, 69 U. Chi. L. Rev. 429, 431 (2002). I consider this issue to be a narrower one, a subset of the larger question of federalism, concerning the relationship between the federal government and state governments under the U.S. Constitution.

9. Since the Code's enactment in 1978, Congress has amended it numerous times. Congress has been actively debating significant bankruptcy amendments since 1997 and finally passed the Bankruptcy Reform Act of 2000, *see* H.R. 2415, 106th Cong. § 1 (2000) (providing for enactment into law of the provisions of S. 3186 of the 106th Congress, as introduced on October 11, 2000 by the conference committee for the House and Senate bills, which was passed December 7, 2000). The text of S. 3186 is included in the H.R. 2415 conference report: H.R. Rep. No. 106-970 (2000). President Clinton pocket vetoed the bill on December 19, 2000. The bill that passed in 2000 was reintroduced in Congress in 2001, but the House and Senate passed somewhat

scholars debate the merits of bankruptcy,[10] Congress needs a clearer idea of the constraints of a constitutionally permissible bankruptcy law, especially as it responds to focused and effective special interest groups seeking to shape the Code.[11]

As a prelude to analyzing when Congress must respect state law entitlements, Part I briefly describes the significant extent to which the Code defers to and depends on state law. In essence, the Code embraces federalism. However, the Code's reliance on state law, which is the dominant source for nonbankruptcy law, masks an important question: To what extent may Congress override state law and to what extent must Congress respect state law? The answer to this question depends in turn on understanding the limits of Congress's power to enact bankruptcy law under the Constitution.

Part II begins the process of identifying Congress's power to enact laws "on the subject of Bankruptcies" by analyzing the understanding of "bankruptcies" at the time of the enactment of the United States Constitution as reflected both in the term "bankruptcy"[12] and in the then extant varieties of bankruptcy laws. From this understanding and core elements of these bankruptcy laws, I conclude that the "subject of Bankruptcies" is limited to the adjustment of the relationship between an insolvent debtor and his, her, or its creditors.

In Part III, I describe four principles that amplify the meaning of the "subject of Bankruptcies." Three of these principles directly govern the relationship between the federal government under the Bankruptcy Power and the states, and the extent to which Congress

different versions of the bills. *See* Bankruptcy Reform Act of 2001, S. 220, 107th Cong. (placed on the calendar in the Senate January 31, 2001); Bankruptcy Abuse Prevention and Consumer Protection Act of 2001, H.R. 333, 107th Cong. (passed by the House March 31, 2001). The House and the Senate were not able to reconcile differences between the two versions, and these bills expired when the 107th Congress adjourned.

10. *See, e.g.*, Douglas G. Baird, *Bankruptcy's Uncontested Axioms*, 108 Yale L.J. 573, 576-80 (1998) (dividing bankruptcy scholars into two large groups, designated "traditionalists" and "proceduralists"); Linda Rusch, *Bankruptcy Reorganization Jurisprudence: Matters of Belief, Faith, and Hope—Stepping into the Fourth Dimension*, 55 Mont. L. Rev. 9 (1994) (analyzing two views of the purpose of bankruptcy reorganization, maximizing creditor wealth and loss allocation among various constituencies, and the values underlying each view).

11. *See generally* David A. Skeel, Jr., Debt's Dominion: A History of Bankruptcy Law in America (2001) (describing how the self interest of debtors, creditors, and bankruptcy professionals have shaped bankruptcy law in America); Thomas E. Plank, *Bankruptcy Professionals, Debtor Dominance and the Future of Bankruptcy: A Review and a Rhapsody on a Theme*, 18 Bankr. Dev. J. 337 (2002) (reviewing David A. Skeel, Jr., Debt's Dominion: A History of Bankruptcy Law in America (2001), and describing the recent battles between pro-debtor interests and secured creditors over Revised Article 9 of the Uniform Commercial Code as well as the attack by pro-debtor interests on securitization and the efforts of the securitization industry to broaden securitization).

12. *See, e.g.*, Randy E. Barnett, *An Originalism for NonOriginalists*, 45 Loy. L. Rev. 611, 620-21, 633 (1999).

may overrule state law. These three principles are the Debtor-Creditor Adjustment Principle, the Non-Expropriation Principle, and the Non-Interference Principle. The fourth principle, the Debtor-Insolvency Principle, does not directly govern the extent to which Congress may overrule state law, but it does limit Congress's ability to alter the state law rights of creditors and debtors to those debtors who are insolvent in some sense.[13]

Under the Debtor-Creditor Adjustment Principle, Congress may adjust the debtor-creditor relationship by curtailing the nonbankruptcy rights of a debtor for the benefit of the debtor's creditors and by curtailing the nonbankruptcy rights of creditors against the debtor for the benefit of the debtor or other creditors.

Under the Non-Expropriation Principle, however, Congress may not expand the rights of debtors or their creditors beyond those necessary to adjust their relationship or otherwise diminish either (i) the rights or prerogatives of parties outside of the debtor-creditor relationship ("Third Parties") for the benefit of the debtor or the creditors or (ii) the nonbankruptcy rights of the debtor or the creditors for the benefit of these Third Parties. For example, bankruptcy law may not expropriate the home of the debtor's neighbor to help pay the debtor's creditors; give claims in bankruptcy to Third Parties like workers, governments, or businesses that they do not have outside of bankruptcy; or grant a debtor a divorce from the debtor's spouse, no matter how much such actions would facilitate liquidation or reorganization of the debtor or help an individual debtor obtain a fresh start.[14]

The Non-Interference Principle constrains the Non-Expropriation Principle. It provides that Congress may prevent a Third Party from using nonbankruptcy law to frustrate the bankruptcy process or from using the bankruptcy of a debtor to obtain a benefit that the Third Party could not obtain under nonbankruptcy law.

Part IV describes the interaction of these principles in the Code. Congress has not exercised the full extent of its powers under the Debtor-Creditor Adjustment Principle to alter the rights of creditors. Specifically, under the Bankruptcy Clause, Congress could abolish security interests in bankruptcy.[15] Congress has not done so, although it has reduced the rights of secured creditors in bankruptcy.[16]

Consistent with the Non-Expropriation Principle, the Code for the most part respects the property interests of Third Parties. In addition,

13. *See infra* note 115 and accompanying text (describing both cash flow insolvency and balance sheet insolvency).
14. *See infra* Part III.B.
15. I do think, however, that the Fifth Amendment of the United States Constitution prohibits Congress from completely abolishing security interests in bankruptcy. *See infra* note 106 and accompanying text.
16. *See infra* note 180 and accompanying text.

consistent with the Non-Interference Principle, the Code generally prevents a Third Party from using the debtor's commencement of a bankruptcy case to obtain a benefit that the Third Party could not obtain outside of bankruptcy, such as termination of a contract with the debtor solely because of a bankruptcy filing. The Code, however, does violate these principles in a few instances.[17]

Others may not agree with my conception of the limitations that the Bankruptcy Clause places on Congress. Nevertheless, unless one takes the position that the Bankruptcy Clause serves as a general welfare provision empowering Congress to take any action it deems appropriate, one must conceive of some demarcation of the limits on Congress's power to alter nonbankruptcy entitlements. Of course, the extent to which Congress should alter or respect nonbankruptcy entitlements of debtors, creditors, and Third Parties depends on both the constitutional and the normative limits of bankruptcy law. There is no consensus on the normative limits of bankruptcy law,[18] and that topic is beyond the scope of this article. Nevertheless, whatever view one has of the purpose of bankruptcy law, any view must fit within, and may not exceed, some concept of a limited Bankruptcy Power.

I. THE FEDERALISM INHERENT IN THE CODE

The Bankruptcy Code establishes a comprehensive procedure for adjusting the relationship between an insolvent debtor and its creditors. The Code provides for: (1) the commencement of a case by the filing of a petition by the debtor or its creditors;[19] (2) the filing of proofs of claims of the creditors;[20] (3) the allowance of creditors' claims;[21] (4) the gathering, liquidation, and distribution of the debtor's property to satisfy creditor claims;[22] (5) as an alternative to liquidation, the preparation, dissemination, and approval of a plan of

17. *See infra* Part IV.

18. *See, e.g.*, Baird, *supra* note 10 (summarizing two prominent views of the purposes of bankruptcy law).

19. *See* 11 U.S.C. § 301 (2000) (voluntary petition by debtor); *id.* § 302 (voluntary joint petition by individual debtor and spouse); *id.* § 303 (involuntary petition by creditors).

20. *See id.* § 501 (specifying who may file proofs of claims).

21. *See id.* § 502 (specifying how claims may be allowed, disallowing certain claims and allowing estimates of certain contingent claims or unliquidated claims).

22. *See id.* § 704(1) (specifying the duty of a trustee in a Chapter 7 liquidation to gather and reduce to money the property of the estate); *id.* § 726 (requiring distribution of property of the estate). From the beginning, federal bankruptcy law has provided for liquidation of the debtor's property to satisfy creditor claims. *See* Bankruptcy Act of 1898, ch. 541, 30 Stat. 544 (1898) (codified as amended at 11 U.S.C. §§ 1-1103 (1976 & Supp. II 1978) (repealed 1978)); Act of Mar. 2, 1867, ch. 176, § 14, 14 Stat. 517, 22-24 (repealed 1878); Act of Aug. 19, 1841, ch. 9, § 3, 5 Stat. 440, 442-43 (repealed 1843); Act of Apr. 4, 1800, ch. 19, § 5, 2 Stat. 19, 23 (repealed 1803). The 1800 Act was based on the English Bankrupt Acts in effect at that time.

reorganization that provides for payment of creditor claims;[23] and (6) the discharge of the debts of an individual debtor in a liquidation and the discharge of the debts of any debtor under a confirmed reorganization plan.[24]

The Code also contains many other provisions that support the bankruptcy process. It imposes an automatic stay of creditor collection actions during the case.[25] It authorizes the trustee to use, sell, or lease property of the estate;[26] to assume or reject executory contracts and unexpired leases;[27] to operate the debtor's business;[28]

23. *See* 11 U.S.C. §§ 1121-1129(2000) (specifying, in a Chapter 11 case, the filing of a plan of reorganization, the contents of the plan, and the procedure for acceptance of the plan by creditors and confirmation of the plan by the court); *id.* §§ 1221-1225 (specifying the same in a Chapter 12 case for farmers); *id.* §§ 1321-1325 (specifying the same in a Chapter 13 case for individuals with regular income). Congress first provided a comprehensive scheme for reorganizing debtors in 1933. *See* Bankruptcy Act, §§ 73-77 (added by Act of Mar. 3, 1933, ch. 204, 47 Stat. 1467) (adding three new reorganization sections: section 74 for persons other than corporations; section 75 for farmers; and section 77 for railroads). The following year, Congress added new section 77B to provide for the reorganization of corporations. *See* Bankruptcy Act, § 77B (added by Act of June 7, 1934, ch. 424, § 1, 48 Stat. 911 (codified as amended at 11 U.S.C. § 207 (1934) (repealed 1938))). Finally, pursuant to the 1938 Chandler Act, Congress replaced the more general reorganization sections, sections 74 and 77B, with four new chapters—chapter X for the reorganization of large corporations; chapter XI for the adjustment of the unsecured debt of smaller businesses; chapter XII for the adjustment of real estate debt of individuals and partnerships; and chapter XIII for the adjustment of debts of wage earners. *See* Bankruptcy Act, §§ 101-276 [ch. X], 301-399 [ch. XI], 401-526 [ch. XII], 601-686 [ch. XIII] (as added by Act of June 22, 1938, ch. 575, § 1, 52 Stat. 840, 883-938 (codified as amended at 11 U.S.C. §§ 501-676 [ch. X], 701-799 [ch. XI], 801-926 [ch. XII], 1001-1086 [ch. XIII] (1976) (repealed 1978))). Section 75, for farmers, initially applied only to petitions filed within five years. *Id.* § 75(c), 47 Stat. at 1471. This deadline was eventually extended to March 1, 1949. Section 77, codified as amended at 11 U.S.C. § 205 (1976) (repealed 1978), remained in effect until the adoption of the Bankruptcy Code.

Before 1933, bankruptcy law did allow arrangement of the debtor's affairs in lieu of liquidation, with the consent of a supermajority of the debtor's creditors. *See* Bankruptcy Act of 1898, ch. 541, § 12, 30 Stat. 544, 549-50 (1898) (codified as amended at 11 U.S.C. § 30 (1926) (repealed 1933)); Act of June 22, 1874, ch. 390, § 17, 18 Stat. 178, 182-83 (repealed 1878) (adding to the short-lived bankruptcy law of 1867 provisions allowing debtors to enter into composition agreements and extension agreements binding on all unsecured creditors if a majority in number and 75% in value agreed, upheld in *In re Reiman*, 20 F. Cas. 490, 492 (S.D.N.Y. 1874) (No. 11,673), aff'd, 20 F. Cas. 500, 501 (C.C.S.D.N.Y. 1875) (No. 11,675). *See also infra* note 102 and accompanying text (discussing eighteenth-century legislation imposing on minority creditors an arrangement between an insolvent debtor and a majority of his or her creditors).

24. *See* 11 U.S.C. § 727 (2000) (providing when an individual may receive a discharge of debts in Chapter 7); *id.* § 1141(d) (providing that the effect of a confirmed Chapter 11 plan is to discharge the debts of the debtor); *id.* § 1228 (authorizing a discharge of debts of a debtor in a Chapter 12 case upon completion of all payments required by a confirmed plan); *id.* § 1328 (same for debtor in a Chapter 13 case).

25. *See id.* § 362(a) (providing that the filing of a petition operates as a stay of numerous acts against the debtor, property of the estate, or property of the debtor).

26. *See id.* § 363.

27. *See id.* § 365.

and to recover preferential, fraudulent, unperfected, and other inappropriate transfers.[29]

As comprehensive as the Bankruptcy Code is, however, it is still a thin veneer built on a much deeper body of nonbankruptcy law, most of which is state law.[30] Many Code provisions explicitly defer to:

(i) a specific type of "law,"[31]

(ii) applicable law,[32]

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28. *See id.* § 721 (providing that the bankruptcy court may authorize the trustee to operate a debtor's business for a limited time if such operation is in the best interests of the estate and consistent with the orderly liquidation of the estate); *id.* §§ 1107, 1108 (allowing the trustee, including the debtor in possession, to operate the debtor's business unless the court orders otherwise); *id.* §§ 1202(b)(5), 1203 (providing that debtor in a Chapter 12 case, or a trustee if the debtor ceases to be a debtor in possession, may operate the debtor's farm); *id.* § 1304 (allowing an individual engaged in business to continue to operate the business); *see also id.* § 364 (authorizing the trustee to borrow money).

29. *See id.* § 547(b) (avoidance of preferential transfers); *id.* § 548 (avoidance of fraudulent transfers); *id.* § 544(a) (avoidance of unperfected transfers); *id.* § 546 (avoidance of certain statutory liens); *id.* § 549 (avoidance of postpetition transfers).

30. The Code also specifically defers to federal law. *See id.* § 362(b)(8) (excepting from the automatic stay an action by the Secretary of Housing and Urban Development to foreclose a mortgage insured under the National Housing Act); *id.* § 362(b)(12) (excepting from the automatic stay an action involving a Chapter 11 debtor brought by the Secretary of Transportation "to foreclose a preferred ship or fleet mortgage, or a security interest in or relating to a vessel or vessel under construction, held by the Secretary of Transportation"); *id.* § 362(b)(13) (excepting from the automatic stay an action by the Secretary of Commerce to foreclose a preferred ship or fleet mortgage in a vessel or a mortgage, deed of trust, or other security interest in a fishing facility held by the Secretary of Commerce); *id.* § 362(b)(16) (excepting from the automatic stay "any action by a guaranty agency . . . [under] the Higher Education Act of 1965 or the Secretary of Education regarding the eligibility of the debtor to participate in programs authorized under such Act"); *id.* § 364(f) (providing that, except for certain underwriters, section 5 of the Securities Act of 1933 and the Trust Indenture Act of 1939 does not apply to the offer or sale under section 364 of a security that is not an equity security); *id.* § 522(b)(2) (providing that a debtor may exempt from the claims of creditors in a bankruptcy case property exempt under nonbankruptcy federal law); *id.* § 541(b)(3) (excluding from property of the estate any eligibility of the debtor to participate in programs authorized under the Higher Education Act of 1965); *id.* § 1145 (exempting the issuance of certain securities pursuant to a reorganization plan from the registration requirements of the Securities Act of 1933); *id.* § 1166 (subjecting railroad reorganizations to certain provisions of federal law, including subtitle IV of title 49 and section 601(b) of the Regional Rail Reorganization Act of 1973).

31. *See, e.g.*, *id.* § 101(9)(A)(ii) (defining a "corporation" to include a "partnership association organized under a law that makes only the capital subscribed responsible for the debts of such association"); *id.* § 110(k) (providing that nothing in this section dealing with negligent or fraudulent bankruptcy petitions "shall be construed to permit activities that are otherwise prohibited by law, including rules and laws that prohibit the unauthorized practice of law").

32. *See id.* § 101(1) (defining "accountant" as an "accountant authorized under applicable law to practice public accounting"); *id.* § 101(4) (defining an "attorney" as an "attorney, professional law association, corporation, or partnership, authorized under applicable law to practice law"); *id.* § 101(11) (defining a "custodian" with reference to "applicable" law); *id.* § 365(c)(1)(A) (prohibiting the trustee from assuming or assigning any executory contract or unexpired lease of the debtor if

(iii) nonbankruptcy law,[33]

"applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to an entity other than the debtor"); *id.* § 502(b)(1) (disallowing claims to the extent that the claims are "unenforceable against the debtor and property of the debtor, under any agreement or applicable law for a reason other than because such claim is contingent or unmatured"); *id.* § 505(c) (providing that notwithstanding the automatic stay, a governmental unit charged with responsibility for collection of tax determination by the court under section 505 may assess such tax subject to any otherwise applicable law); *id.* § 507(a)(8) (providing an eighth priority for certain taxes owed to governmental units under applicable law); *id.* § 543(c) (protecting a custodian against a surcharge for a disbursement made in accordance with applicable law); *id.* § 544(b) (giving to the trustee the right to avoid transfers of property or obligations incurred that creditors could avoid under "applicable law"); *id.* § 546(b)(1) (providing that a trustee's avoidance powers are subject to "generally applicable law" permitting certain actions to perfect or continue or maintain perfection); *id.* §§ 547(e)(1), 548(d)(1), 549(c) (defining when certain transfers of property are deemed made or are protected by reference to perfection under applicable law); *id.* § 723 (providing that the trustee of a partnership debtor whose estate is insufficient to pay in full all allowed claims has a claim against any general partner to the extent that under applicable nonbankruptcy law the general partner is personally liable for such claims); *id.* § 761 (10)(ix) (defining "customer property" to include "property of the debtor that any applicable law, rule, or regulation requires to be set aside or held for the benefit of a customer").

33. *See, e.g.*, *id.* § 101(35A) (defining "intellectual property" as "(A) trade secret; (B) invention, process, design, or plant protected under title 35; (C) patent application; (D) plant variety; (E) work of authorship protected under title 17; or (F) mask work protected under chapter 9 of title 17 [in each instance] to the extent protected by applicable nonbankruptcy law"); *id.* § 106(a)(4) (providing that enforcement of a bankruptcy court order against a governmental unit "shall be consistent with appropriate nonbankruptcy law applicable to such governmental unit"); *id.* § 108 (providing for the extension of time periods provided by nonbankruptcy law for the commencement of an action or the filing of pleadings); *id.* § 363(f)(1) (authorizing the trustee to sell property free and clear of any interest in such property of an entity other than the estate if "applicable nonbankruptcy law permits sale of such property free and clear of such interest"); *id.* § 365(c)(3) (prohibiting the trustee from assuming a lease of "nonresidential real property [that] has been terminated under applicable nonbankruptcy law prior to the order for relief"); *id.* § 365(h)(1)(A) (allowing a lessee under a lease of real property under which the debtor is the lessor and which the trustee has rejected to treat the rejection as a termination to the extent that applicable nonbankruptcy law would allow such treatment, or to retain its rights under the lease to the extent that such rights are enforceable under applicable nonbankruptcy law); *id.* § 365(h)(2)(A) (giving similar rights to the purchaser of a time share interest sold by a debtor under a contract rejected by the trustee); *id.* § 365(n)(1) (giving similar rights to a licensee of a right to intellectual property under an executory contract rejected by the trustee under which the debtor is a licensor); *id.* § 510(a) (providing that a subordination agreement is enforceable in a bankruptcy case "to the same extent that such agreement is enforceable under applicable nonbankruptcy law"); *id.* § 552(b)(1) (providing that if a security interest created by a security agreement extends to property of the debtor acquired before the commencement of the case and to proceeds of such property, then the security interest extends to the proceeds acquired by the estate after the commencement of the case to the extent provided by the security agreement and by applicable nonbankruptcy law); *id.* § 723 (providing that the trustee of a partnership debtor whose estate is insufficient to pay in full all allowed claims has a claim against any general partner to the extent that under applicable nonbankruptcy law the general partner is personally liable for such claims); *id.* § 927 (providing that the

(iv) state, territorial, or local law,[34] and

(v) in a few instances, "common law" and "law merchant."[35]

Other important sections of the Code do not expressly refer to nonbankruptcy law. Nevertheless, they directly incorporate nonbankruptcy law. Two significant provisions of the Code fall into this category: (1) the definition of the property of the estate to be distributed to creditors, and (2) the definition of creditors who may participate in the estate.

Under section 541(a), the commencement of a bankruptcy case creates an estate. The principal components of property of the estate are "all legal or equitable interests of the debtor in property" as of the filing.[36] The Bankruptcy Code does not define "interests of the debtor

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holder of a claim payable solely from special revenues of a municipal debtor under applicable nonbankruptcy law will be treated as having a non-recourse claim under the Code); *id.* §§ 1123(d), 1222(d), 1322(e) (providing that, if a Chapter 11, 12, or 13 plan proposes to cure a default, the amount necessary to cure the default is determined in accordance with the underlying agreement and applicable nonbankruptcy law).

34. *See id.* § 109(c)(2) (providing that a municipality may be a debtor under Chapter 9 if it is "specifically authorized, in its capacity as a municipality or by name, to be a debtor under such chapter by State law, or by a governmental officer or organization empowered by State law to authorize such entity to be a debtor"); *id.* § 346(b)(1) (authorizing the imposition of certain taxes against a debtor under "a State or local law"); *id.* § 364(f) (providing that, except for certain underwriters, "any State or local law requiring registration for offer or sale of a security or registration or licensing of an issuer of, underwriter of, or broker or dealer in, a security does not apply to the offer or sale under... section [364] of a security that is not an equity security"); *id.* § 507(a)(7) (providing a seventh priority to the payment of certain alimony, maintenance, or support claims owed under a "determination made in accordance with State or territorial law by a governmental unit"); *id.* § 522(b)(2) (providing that a debtor may exempt from the claims of creditors in a bankruptcy case property exempt under "State or local law"); *id.* § 523(a)(5), (15), (18) (providing that a discharge does not discharge certain alimony, maintenance, or support claims owed under a determination made in accordance with State or territorial law by a governmental unit, or certain claims owed under State law to a State or municipality that is in the nature of support); *id.* § 547(c)(7) (providing that on certain alimony, maintenance, or support claims owed under a "determination made in accordance with State or territorial law by a governmental unit" may not be avoided as preferences).

35. *See id.* § 101(45) (defining "relative" as an "individual related by affinity or consanguinity within the third degree as determined by the common law, or individual in a step or adoptive relationship within such third degree"); *id.* § 546(c), (d) (providing that the trustee's avoidance powers are subject to certain "statutory or common-law" rights of reclamation); *id.* §§ 556, 559-660 (defining the contractual right of a commodity broker, forward contract merchant, repo participant, or swap participant to liquidate a commodity contract, a repurchase agreement, or a swap agreement to include a right "arising under common law [and] under law merchant").

36. *See id.* § 541.

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

in property." Nonbankruptcy law is the only source for determining the "interests of the debtor in property." Accordingly, the many provisions of the Code that explicitly refer to "property of the estate" also depend fundamentally on nonbankruptcy law.

Other Code sections also require the determination of the prepetition property interests of the debtor.[37] The most prominent examples are those sections that allow the trustee to avoid unperfected, preferential, or fraudulent prepetition transfers of an "interest of the debtor in property"[38] or "property of the debtor"[39] or

Id. The other enumerated items refer to community property, *id.* § 541(a)(2), and to property added to the estate after the commencement of the case, *id.* § 541(a)(3)-(7). For the adjustment of debts under Chapter 12 (family farmers) and Chapter 13 (individuals with regular income), property of the estate also includes property of the kind specified in § 541 acquired by the debtor and earnings from services performed after the commencement of the case until the case is closed, dismissed, or converted. *See id.* §§ 1207, 1306.

37. *See id.* § 101(2)(D) (defining affiliate); *id.* § 101(11)(A), (C) (defining custodian); *id.* § 101(28) (defining indenture); *id.* § 102(2) (defining claim against the debtor to include a claim against property of the debtor); *id.* § 109(a) (specifying eligibility requirements for a debtor); *id.* § 303(b)(1), (h)(2) (governing involuntary petition); *id.* § 346(j)(5) (enacting special tax provisions); *id.* § 362(a)(5) (imposing stay of acts against property of debtor); *id.* § 362(b)(3), (17) (excepting certain acts from the automatic stay); *id.* § 365(d)(1), (2), (6)(C) (setting forth time limits on assumption of leases of property of the debtor); *id.* § 365(d)(3), (10) (requiring the trustee to perform obligations of the debtor under unexpired leases of real or personal property); *id.* § 365(j) (providing lien on interest of the debtor in property for amounts paid by purchaser under rejected executory contract to purchase property); *id.* § 502(b)(1) (requiring disallowance of certain claims against property of the debtor); *id.* § 522(b), (d) (authorizing individual debtors to exempt certain interests in property); *id.* § 522(f), (h) (authorizing individual debtors to avoid liens on and transfers of property that may be exempted); *id.* § 541(a)(2), (5) (including in property of estate interest of the debtor in community property or certain property acquired within 180 days after the petition); *id.* § 541(b)(2), (4), (5) (excluding certain property of the debtor from property of the estate); *id.* § 541(c)(1) (invalidating clauses terminating or conditioning property interests because of bankruptcy); *id.* § 541(d) (distinguishing legal and equitable interests of the debtor); *id.* § 543(a), (b) (requiring the return of debtor's property in possession of a custodian); *id.* § 552(b) (security interest in proceeds and rents); *id.* § 557 (providing for expedited disposition of interests in grain held by debtor that owns or operates a grain storage facility); *id.* § 722 (authorizing redemption of consumer property of the debtor); *id.* § 727(a)(2)(A), (4)(D) (providing exceptions to discharge); *id.* § 749(a) (allowing the trustee to avoid transfers of property in a stockbroker liquidation); *id.* § 764(a) (allowing the trustee to avoid transfers of property in a commodity broker liquidation); *id.* § 902(1) (defining property of the estate in a municipal reorganization); *id.* § 904(2) (limiting the court's powers over the property or revenues of the debtor); *id.* § 926(b) (limiting avoidance of payments to bondholders as a preference); *id.* § 1222(b)(7) (authorizing a plan to provide for payment of claims from property of the debtor in a farmer reorganization); *id.* § 1322(b)(8) (authorizing a plan to provide for payment of claims from property of the debtor in a wage-earner reorganization).

38. *See id.* § 544(b) (authorizing the trustee to avoid a transfer of "an interest of the debtor in property" that would be avoidable by an actual creditor); *id.* § 547(b) (authorizing the trustee to avoid preferential transfer of "an interest of the debtor in property"); *id.* § 548(a), (b) (authorizing the trustee to avoid fraudulent transfer of an interest of the debtor in property).

39. *See id.* § 544(a) (authorizing the trustee to avoid unperfected transfer of

the fixing of certain statutory liens on "property of the debtor."[40] A few other sections of the Code require determination of the interests in property that the estate may have[41] or that other entities may have.[42] Other sections simply require a determination of what is "property."[43] Again, the Code depends on nonbankruptcy law for the determination of these property interests.

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property of the debtor).

40. *Id.* § 545.

41. *See id.* § 328(c) (permitting courts to deny attorney's compensation or reimbursement); *id.* § 362(a)(2), (3), (4) (imposing automatic stay of acts against property of the estate); *id.* § 363(a) (defining cash collateral); *id.* § 363(b)(1), (c)(1) (authorizing sale or use of property of the estate); *id.* § 364(c), (d) (authorizing lien on property of estate to secure borrowing); *id.* § 502(b)(3) (requiring disallowance of certain tax claims against property of the estate); *id.* § 506(a) (defining secured claim); *id.* § 541(a)(6), (7) (including in property of the estate proceeds from property of the estate other than an individual's earnings and property acquired by the estate after the commencement of the case); *id.* § 552(a), (b) (invalidating security interests in property acquired by the estate postpetition other than proceeds of a prepetition security interest); *id.* § 724(b) (specifying the distribution of property in which the estate has an interest and which is subject to a lien of a secured creditor and to a tax lien).

42. *See id.* § 361 (providing for adequate protection of interest of entity in property); *id.* § 362(d), (f) (providing for relief from stay for a party in interest with an interest in property subject to the stay); *id.* § 363(a) (defining cash collateral); *id.* § 363(c)(2) (restricting the use of cash collateral in which an entity other than the estate has an interest); *id.* § 363(e) (conditioning use of property upon providing adequate protection for entity with interest in property); *id.* § 363(f), (g), (h), (i) (authorizing under specified conditions the sale of property in which an entity other than the estate has an interest); *id.* § 364(d) (requiring adequate protection to existing secured creditor if court authorizes a lien of equal or superior priority on property in which estate has an interest to secure borrowing); *id.* § 506(a), (b) (defining a secured claim and allowing secured creditor interest on claim if the value of property securing claim exceeds amount of claim); *id.* § 541(a)(2), (7) (including in property of estate interest of the debtor's spouse in community property and property acquired by the estate); *id.* § 557(c) (providing for expedited disposition of interests in grain); *id.* § 725 (requiring disposition of any property in which an entity other than the estate has an interest); *id.* § 741(4) (defining customer property held by a debtor for or on account of a customer in a stockbroker liquidation); *id.* § 761(10)(A)(vii), (ix) (defining customer property held by a debtor for or on account of a customer in a commodity brokers liquidation); *id.* § 1110(a)(1) (exempting holders of claims secured by aircraft equipment or lessors or conditional sellers of aircraft equipment from restrictions of Code); *id.* § 1168 (exempting holders of claims secured by railroad rolling stock equipment or lessors or conditional sellers of railroad rolling stock equipment from restrictions of Code); *id.* § 1205(b) (authorizing adequate protection of interest of an entity in property in a farmer reorganization); *id.* § 1206 (authorizing the sale of farmland or farm equipment that is property of the estate free and clear of any interest in such property of an entity other than the estate).

43. *See, e.g.*, *id.* § 101(21A) (defining farmout agreement); *id.* § 101(25), (26) (defining forward contract and forward contract merchant); *id.* § 101(32)(A), (B) (defining insolvent); *id.* § 101(35A) (defining intellectual property); *id.* § 101(38) (defining margin payment); *id.* § 101(53) (defining statutory lien and distinguishing judicial lien and security interest); *id.* § 101(53D) (defining time share plan and time share interest); *id.* § 101(56A) (defining term overriding royalty as an "interest in liquid or gaseous hydrocarbons"); *id.* § 346(b)(1), (g)(1)(A) (special tax provisions); *id.* § 362(b)(2)(B) (excepting from the automatic stay "the collection of alimony,

Similarly, section 101(10) defines a creditor as an entity that has a "claim" that "arose" before the filing of a bankruptcy petition.[44] A "claim" is a "right to payment."[45] The Code defines neither "right to payment" nor "arose." Thus, the Code depends on nonbankruptcy law for the determination of who is a creditor eligible to receive a share of the debtor's prepetition property. Finally, other essential concepts, such as "corporation,"[46] "transfer"[47] of property, "lien,"[48] "security interest,"[49] "lease,"[50] and "contract,"[51] depend on nonbankruptcy law.

Because the bulk of nonbankruptcy law is state law, the Code expressly and impliedly depends on state law. Thus, the Code specifically embraces the federalism of our system of government. As

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maintenance, or support from property that is not property of the estate"); *id.* § 362(b)(6), (7) (excepting from automatic stay certain setoffs); *id.* § 362(b)(13) (excepting from automatic stay the foreclosure of security interest held by the Secretary of Commerce in a fishing facility); *id.* § 365(h)(2), (i) (allowing rejection of timeshare interest); *id.* § 523(a)(2), (6) (disallowing discharge of debt for property obtained by fraud or for debt for malicious injury to property of another entity); *id.* § 548(d)(2)(A) (defining value of property of debtor in connection with the trustee's power to avoid fraudulent transfers); *id.* § 741(7) (defining securities contract in a stockbroker liquidation).

44. *See id.* § 101(10) (defining "creditor" as an "entity that has a claim against the debtor that arose at the time of or before the order for relief concerning the debtor").

45. Under section 101,

> (5) "claim" means—
> (A) right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured; or
> (B) right to an equitable remedy for breach of performance if such breach gives rise to a right to payment, whether or not such right to an equitable remedy is reduced to judgment, fixed, contingent, matured, unmatured, disputed, undisputed, secured, or unsecured.

Id. § 101.

46. *See id.* § 101(9). The section defines a "corporation" to

> (A) include[] (i) association having a power or privilege that a private corporation, but not an individual or a partnership, possesses; (ii) partnership association organized under a law that makes only the capital subscribed responsible for the debts of such association; (iii) joint-stock company; (iv) unincorporated company or association; or (v) business trust; but (B) does not include limited partnership.

Id.

47. *See id.* § 101(54) (defining "transfer" as "every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with property or with an interest in property, including retention of title as a security interest and foreclosure of the debtor's equity of redemption").

48. *See id.* § 101 (37) (defining "lien" to mean "charge against or interest in property to secure payment of a debt or performance of an obligation").

49. *See id.* § 101(51) (defining "security interest" to mean "lien created by an agreement").

50. *See id.* § 365 (providing that the trustee may assume or reject unexpired leases).

51. *See id.*

a matter of statutory command, federal courts must in many instances follow and apply state law.

Underlying the Code's express and implicit reliance on state law is an important issue. In enacting the Code, to what extent *may* Congress overrule state law and to what extent *must* Congress defer to state law? The resolution of this issue depends on the constitutional limits of bankruptcy law. Defining these limits is essential to preserving our federal system. The remainder of this article describes these constitutional limits and analyzes how well the Code has complied with them.

II. THE ORIGINAL UNDERSTANDING OF THE "SUBJECT OF BANKRUPTCIES"

Under the Constitution, Congress may "establish . . . uniform Laws on the subject of Bankruptcies throughout the United States."[52] There has been little analysis of the limits of Congress's power under the Bankruptcy Clause.[53] Nevertheless, the meaning and limits to Congress's Bankruptcy Power are not hard to discern.[54] I conclude that the "subject of Bankruptcies" means the subject of adjusting the existing relationship between a debtor who is insolvent in some sense[55] and the debtor's creditors.

52. U.S. Const. art. I, § 8, cl. 4.

53. *See* Thomas E. Plank, *The Constitutional Limits of Bankruptcy*, 63 Tenn. L. Rev. 487 (1996) (arguing that the original understanding of the Bankruptcy Clause has not changed since the adoption of the Constitution) [hereinafter, Plank *Constitutional Limits*].

54. The Supreme Court and a few other authorities have suggested that the Bankruptcy Clause has an indeterminate or unlimited meaning. *See* Ry. Labor Executives' Ass'n v. Gibbons, 455 U.S. 457, 466 (1982) (quoting Wright v. Union Cent. Life Ins. Co., 304 U.S. 502, 513-14 (1938)) (suggesting that the "'subject of bankruptcies is incapable of final definition'"); Commission on the Bankruptcy Laws of the United States, H.R. Doc. No. 137, 93d Cong., 1st Sess., pt. 1, at 64 (1973) [hereinafter Bankruptcy Commission Report] (stating that "[t]here has also been a continuing expansion of the meaning of the word 'bankruptcies' as used in the Constitution that has legitimated evolutions in bankruptcy law, such as the introduction of discharge and arrangement and reorganization provisions, since the time of the adoption of the Constitution"); Frank R. Kennedy, *Bankruptcy and the Constitution*, *in* Blessings of Liberty: The Constitution and the Practice of Law 131, 137-38 (1988) (stating that relying on the scope of the bankruptcy power was equivalent to "according nearly conclusive effect to Congressional enactments on the subject of bankruptcy. When the variety of the provisions enacted by Congress and the frequency and range of attacks on their constitutionality are considered, it must be concluded that the courts have indeed come close to permitting Congress complete freedom in formulating and enacting bankruptcy legislation."). The idea that the Bankruptcy Clause has an indeterminate or unlimited meaning, however, cannot be correct if the Federal Government is to continue to be one of enumerated powers under the Constitution.

55. *See infra* note 115 and accompanying text (describing both cash flow insolvency and balance sheet insolvency).

This interpretation of the "subject of Bankruptcies" derives from both the understanding of the concept of "bankruptcies" at the time of the adoption of the Constitution and the different legislative responses to bankruptcies that preceded that adoption. First, in the latter half of the eighteenth century, the term "bankruptcy" was synonymous with "insolvency." Both "bankruptcy" and "insolvency" were defined in the dictionaries of the day as the condition of being unable to pay one's debts.[56] Similarly, the terms were used interchangeably in different kinds of legal documents.[57] Linguistically,

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56. *See, e.g.*, 1 Samuel Johnson, A Dictionary of the English Language (London 1755) (unpaginated) (defining "bankrupt" as an adjective as "[i]n debt beyond the power of payment" and a noun as a "man in debt beyond the power of payment" and defining "insolvent" and "insolvency" respectively as "[u]nable to pay debts contracted" and "[i]nability to pay debts."); 1 Samuel Johnson, A Dictionary of the English Language (5th ed. London 1773) (same); 1 Samuel Johnson, A Dictionary of the English Language (8th ed. London 1799) (unpaginated) (same). The 1775 fourth edition of Johnson's Dictionary of the English Language was a part of Thomas Jefferson's library. 5 Catalogue of the Library of Thomas Jefferson 133-34 (E. Millicent Sowerby ed., 4th ed. 1959); *see also* William Perry, The Royal Standard English Dictionary (3d Worcester ed., 1st Am. ed. 1794) ("Bankrupt, . . . one who cannot pay his debts"; "Bankruptcy, . . . The state of a bankrupt"; "Solvency, . . . an ability to pay"; "Solvent, a. able to pay debts"); 1 Thomas Sheridan, Dictionary of the English Language (3d ed. London 1790) ("Bankruptcy f. The state of a man broken, or bankrupt; the act of declaring one's self bankrupt"; "Bankrupt, f. A person incapable of paying his debts; one against whom a commission of bankruptcy is awarded"; "Bankrupt, a. In debt beyond the power of payment"; "Insolvent, a. Unable to pay"; "Insolvency, f. Inability to pay debts"); Thomas Sheridan, Dictionary of the English Language (6th ed. Philadelphia 1796) (same); *see generally* Plank, *Constitutional Limits*, *supra* note 53, at 529-32.

57. *See infra* text accompanying note 61; *see also* 7 Laws of Virginia 673, 681 (1820) (indexing the short-lived Virginia discharge statute, ch. 8, Nov. Sess., 1762 Va. Laws, discussed *infra* note 92, under "Bankrupt," describing it as "Act for relief of insolvent debtors, on the principles of the bankrupt law," and also indexing the law under "Insolvents"); Miller v. Hall, 1 U.S. (1 Dall.) *229 (Pa. 1788), *reprinted in* Pa. Reports 240 (4th ed. 1880) (in which the Supreme Court of Pennsylvania in early 1788 referred to Maryland's 1787 insolvency act discussed *infra* in text accompanying note 103, as being "in the nature of a general bankrupt law"); *see also* Kurt H. Nadelmann, *On the Origin of the Bankruptcy Clause*, 1 Am. J. Legal Hist. 215, 222 n.29 (1957) (describing the actions of the Connecticut General Assembly over five sessions from 1787-1789 on a petition by Elijah Buell for a discharge from his debts, the records of which described the petitioner initially as requesting "an Act of Insolvency" and later requesting "a special Act of Bankruptcy").

In *Sturges v. Crowninshield*, 4 U.S. (17 Wheat.) 122 (1819), the Supreme Court rejected any constitutional distinction between a "bankrupt" law and an "insolvency" law. In this case, a Massachusetts creditor challenged the discharge of debts under an 1811 New York statute on the ground that the constitutional grant to Congress to enact bankruptcy laws precluded the state from enacting a "bankruptcy" law, that is, a law discharging debts. *Id.* at 124-31. Although noting the differences between the two types of bankruptcy legislation, the Court stated, "This difficulty of discriminating with any accuracy between insolvent and bankrupt laws, would lead to the opinion, that a bankrupt law may contain those regulations which are generally found in insolvent laws; and that an insolvent law may contain those which are common to a bankrupt law." *Id.* at 195. The Court did hold, however, that the New York act impaired the obligation of contract in violation of Article 1, Section 10 of the Constitution. *Id.*

then, the "subject of Bankruptcies" in the Constitution is the subject of a debtor who is unable to pay his, her, or its creditors.

Second, by the time of the adoption of the Constitution, the English and American governments had responded to the problem of debtors' inability to pay their debts by enacting three different groups of bankruptcy laws: (1) the English Bankrupt Acts, (2) the English Insolvency Acts, and (3) a wide variety of American laws. Though these laws differed in some respects, they all shared common features: they authorized a collective creditor proceeding against an insolvent debtor involving all the creditors in place of the creditor enforcement action of each creditor against the insolvent debtor.

Outside of bankruptcy, each creditor pursued its own collection actions against a debtor who did not pay his or her debts. In eighteenth-century England, to collect an unpaid debt, creditors could seize and force the sale of the goods of the debtor and had a limited ability to reach the productive aspects of real estate, although they could not force the sale of real estate.[58] Jurisdictions in America followed the English practice, although most states allowed creditors to force the sale of real estate as well as goods.[59] Creditors who were the first to seize the executable property of the debtor received full or partial payment, while later creditors received nothing. Creditors who remained unpaid, however, could continue to seize property that the debtor later acquired. Creditors could also imprison the debtor until the debt was paid, on the theory that a refusal to pay debts was a voluntary choice by the debtor.[60] This system worked very poorly for

58. Creditors' remedies were limited to the writ of *fieri facias*, which authorized the sheriff to seize the tangible goods of the debtor and sell enough of them to pay the debt; the writ of *levari facias*, which enabled the sheriff to seize the personal property of the debtor and the rents from the debtor's real property to satisfy the debt (but not the right to possess or cause the sale of the debtor's lands); the writ of *elegit*, which allowed delivery of the goods to the creditor at an appraised value in satisfaction of the debt and, if there remained a deficiency, gave the creditor possession of one half of the debtor's lands until the debts were repaid (but did not allow the creditor to force the sale of the debtor's lands); or the writ of capias ad satisfaciendum, which imprisoned the debtor until the debt was paid. *See* 3 William Blackstone, Commentaries *414, *417-19.

59. *See* Peter J. Coleman, Debtors and Creditors in America: Insolvency, Imprisonment for Debt, and Bankruptcy, 1607-1900 at 4, 15 (1974).

60. Imprisonment for debt was an important creditor collection device in the seventeenth and eighteenth centuries. It reflected a common belief that the refusal to pay debts was willful. The intent was not to punish debtors, but to provide an incentive for debtors who owned property which could not be reached by the legal process of the day to pay their debts. *See generally* Jay Cohen, *The History of Imprisonment for Debt and its Relation to the Development of Discharge in Bankruptcy*, 3 J. Legal Hist. 153, 155 (1982); Coleman, *supra* note 59, at 5. Debtors of substance sometimes preferred imprisonment, because once the body of the person was taken in execution on the writ, no other writ could be issued against his or her goods or lands, and creditors also used this writ because they could not force the sale of the debtor's lands. *See supra* note 58. In addition, creditors could not levy on negotiable instruments and certain other intangible property. *See* Cohen, *supra*, at

the creditors of a debtor who had insufficient assets to repay all of his or her creditors.

In 1763, Governor Bernard of Massachusetts specifically complained of this state of affairs in his message to the London Board of Trade requesting approval of a law directed against absconding debtors:

> This province has long laboured under the want of a Bankrupt Act.... As it has been of late, every Insolvency has afforded instances of great partiality and injustice. The Common Method has been for the Creditors who get the earliest advice of a persons [sic] becoming insolvent to sue out attachments against the goods and credit of the insolvent, according to the custom of the Country, and help himself to such part thereof as he pleased. A general scramble ensues, there is no regular audit of the Accounts of the Creditors; The goods are sold in a hurry at a low value; and great part of the effects of the debtor are spent in law proceedings and contests between contending attachments.[61]

The bankruptcy laws of the eighteenth century replaced the race to the courthouse with a collective proceeding under the control of either the creditors or an administrative or judicial official when the debtor had become unable to repay his or her debts. These laws mandated the gathering, liquidation, and distribution of the debtor's property on a pro-rata basis to creditors in satisfaction of the debts. They also provided some form of debtor relief, such as release from debtor's prison and in some cases discharge of existing debts. In a few instances, legislation imposed on all creditors an arrangement negotiated with a majority of creditors that provided for future payment to the creditors and allowed the debtor to retain his or her property in accordance with the arrangement. Also, some of these bankruptcy laws allowed the creditors to reach more property than they could under nonbankruptcy law.[62]

Of the three groups of bankruptcy laws, the English Bankrupt Acts were the most developed. These Acts consisted of the 1570 Statute of 13 Elizabeth,[63] the 1604 Statute of 1 James,[64] the 1623 Statute of 21

154-55; Ian P.H. Duffy, *English Bankrupts 1571-1861*, 24 Am. J. Legal Hist. 283, 285 (1980) [hereinafter, Duffy, *English Bankrupts*]; Israel Treiman, *Acts of Bankruptcy: A Medieval Concept in Modern Bankruptcy Law*, 52 Harv. L. Rev. 189, 195 n.21 (1938). The intangible property that was not subject to execution and levy included "annuities, bank notes, bonds, book debts, copyhold land, negotiable instruments, shares and stocks in public funds." *See* Duffy, *English Bankrupts*, *supra* at 285.

61. *See* 4 Acts and Resolves, Public and Private, of the Province of Massachusetts Bay 793 (1881); *see also* George P. Bauer, The Movement Against Imprisonment for Debt in the United States app. c (1935) (unpublished dissertation, Harvard University); *see also* Coleman, *supra* note 59, at 46-47.

62. *See infra* notes 76, 80, 89-98.

63. 13 Eliz., c. 7 (1570) (Eng.). This was the first act that allowed creditors to begin a bankruptcy case against "merchants" who committed certain "acts of bankruptcy." The English Parliament passed the first Bankrupt Act in 1542 during

James,[65] and the 1732 Statute of 5 George II,[66] as extended and amended.[67] These Acts—frequently referred to as "Bankrupt" and not "Bankruptcy" acts[68]—provided a detailed procedure for adjusting

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the reign of King Henry VIII. 34 & 35 Hen. 8, c. 4 (1542-1543) (Eng.). This act authorized creditors to initiate a bankruptcy proceeding against persons who committed certain fraudulent acts. The 1542 Act is generally considered the first English bankruptcy act. *See* Charles Jordan Tabb, *The History of the Bankruptcy Laws in the United States*, 3 Am. Bankr. Inst. L. Rev. 5, 7 (1995) [hereinafter Tabb, *History*]; Charles Jordan Tabb, *The Historical Evolution of the Bankruptcy Discharge*, 65 Am. Bankr. L.J. 325, 331 (1991) [hereinafter Tabb, *Discharge*]. Although the 1542 Act remained in effect until 1824, the later acts so changed and amplified the bankruptcy law that it retained little independent significance. *See* Bromley v. Goodere, 1 Atk. 75, 77, 26 Eng. Rep. 49, 50-51 (Ch. 1743) (allowing interest to creditors where bankrupt's estate is sufficient to pay all creditors); 1 Edward Christian, The Origin, Progress, and Present Practice of the Bankrupt Law Both in England and in Ireland 9 (London, W. Clarke & Sons 2d ed. 1818). Christian called the Statute of 13 Elizabeth, as of 1818, "the foundation of all the bankrupt law." *Id.* at 10. All citations to and quotations from English statutes, including the year of enactment, are from the Statutes at Large (Owen Ruffhead, ed., vols. 1-9, 1762-1765, reprinted 1769-1770, vol. 10-14, 1771-1786).

64. *See* Tabb, Discharge, *supra* note 63, at 331; 1 Jam., c. 15 (1604) (Eng.). This act amended the Statute of 13 Elizabeth. *Id.* § 3; *see also* Thomas E. Plank, *Why Bankruptcy Judges Need Not and Should Not be Article III Judges*, 72 Am. Bankr. L.J. 567, 581 & n.88, 585-86 & nn.107-13 (1998) [hereinafter, Plank, *Bankruptcy Judges*].

65. See Tabb, *supra* note 63; 21 Jam., c. 19 (1623) (Eng.). This act amended the Statute of 13 Elizabeth and the Statute of 1 James. 21 Jam., c. 19, § 3 (1623) (Eng.); *see also* Plank, *Bankruptcy Judges*, *supra* note 64, at 581 & n.88, 586 & nn.114-18.

66. 5 Geo. 2, c. 30 (1732) (Eng.). The 1732 Statute of 5 George II revised and expanded, without significant change, several earlier Bankrupt Acts that had expired, principally the 1705 Statute of Anne, 4 Ann., c. 17 (1705) (Eng.), which itself modernized the bankruptcy system. The Statute of 4 Anne was to expire after several years, but it was extended periodically by Parliament until several years before the enactment of the 1732 Act. *See* Tabb, *Discharge*, *supra* note 63, at 340-41 & n.96.

67. The 1732 Act remained in effect until the end of the session of Parliament ending after June 24, 1735. 5 Geo. 2, c. 30, § 49 (1732) (Eng.). It was further continued by 9 Geo. 2, c. 18, § 2 (1736) (Eng.); 16 Geo. 2, c. 27 (1743) (Eng.); 24 Geo. 2, c. 57, § 8 (1751) (Eng.); 31 Geo. 2, c. 35 (1757) (Eng.); 4 Geo. 3, c. 36, § 1 (1763) (Eng.); 12 Geo. 3, c. 47, § 1 (1772) (Eng.); 16 Geo. 3, c. 54 (1776) (Eng.); 21 Geo. 3, c. 29, § 8 (1781) (Eng.); 26 Geo. 3, c. 80, § 2 (1786) (Eng.); 28 Geo. 3, c. 24, § 2 (1788) (Eng.); 34 Geo. 3, c. 57 (1794) (Eng.); and 37 Geo. 3, c. 124 (1797) (Eng.), when it was made perpetual. In addition, several acts made minor amendments to the provisions of 5 Geo. 2, c. 30. *See* 19 Geo. 2, c. 32 (1746) (Eng.) (protecting bona fide transferees of the bankrupt's property before notice of the act of bankruptcy, and allowing sureties to be admitted as creditors); 24 Geo. 2, c. 57, § 9 (1751) (Eng.) (voiding certificates based on fictitious debts). *See also* Tabb, *History*, *supra* note 63, at 12; Tabb, *Discharge*, *supra* note 63, at 340, 344.

68. *See* 34 & 35 Hen. 8, c. 4 (1542-1543) (Eng.) (entitled "An Act against such Persons as do make Bankrupt"); 13 Eliz., c. 7 (1570) (Eng.) (entitled "An Act touching Orders for Bankrupts"); *see also Ex parte* Bowes, 4 Ves. Jun. 168, 176, 31 Eng. Rep. 86, 90 (Ch. 1798) (containing several references to "the Bankrupt Laws"); Alexander v. Vaughan, 1 Cowp. 398, 403, 98 Eng. Rep. 1151, 1154 (K.B. 1776) (entering a nonsuit on the grounds that the plaintiff was not a merchant or trader, within the description of the "bankrupt laws"); William Cooke, A Compendious System of The Bankrupt Laws (Dublin, 1786); Thomas Cooper, The Bankrupt Law of America Compared with the Bankrupt Law of England (Philadelphia, John Thompson 1801); Edward Green, The Spirit of the Bankrupt Laws (London, 4th ed.

the relationship between certain debtors and their creditors. A creditor[69] could initiate a bankruptcy proceeding against a merchant[70] who had committed an act of bankruptcy[71] by filing a petition with the Lord Chancellor.[72] The Lord Chancellor appointed "Commissioners of Bankrupt" to supervise the proceedings.[73] Assignees appointed by the commissioners or a majority of the creditors[74] gathered and liquidated the debtor's property [75] and distributed the proceeds to creditors who established their debts before the commissioners.[76] Beginning in 1705, cooperating debtors could receive a discharge of

1780). Other sources, however, sometimes referred to the "bankrupt laws" as the "bankruptcy laws." *See, e.g.*, 2 William Blackstone, Commentaries *473 (referring to the English Bankrupt Acts as "laws of bankruptcy"), and one of the elements for a "commission of bankrupt" was the commission of an act commonly referred to as an "act of bankruptcy." *See infra* note 117 (describing the "acts of bankruptcy").

69. One creditor who was owed at least £100 could file a petition, as could two creditors owed a total of £150, and three or more owed a total of £200. *See* 5 Geo. 2, c. 30, § 23 (1732) (Eng.); *see also* Plank, *Bankruptcy Judges*, *supra* note 64, at 576, 587 & n.127.

70. Under the Statute of 13 Elizabeth, a bankrupt had to be a "Merchant or other Person using or exercising the Trade of Merchandize by way of Bargaining, Exchange, Rechange, Bartry, Chevisance, or otherwise, in Gross or by retail, or seeking his or her Trade of Living by Buying and Selling." 13 Eliz., c. 7, § 1, cls. (2), (3) (1570) (Eng.). This definition proved to be troublesome for close cases, and later statutes and court decisions amplified and expanded the definition so that by the end of the eighteenth century, almost any type of business activity not closely dependent upon the ownership of land qualified one to be a merchant. *See* Cohen, *supra* note 60, at 160, 162-63; Lawrence M. Friedman & Thadeus F. Niemira, *The Concept of the "Trader" in Early Bankruptcy Law*, 5 St. Louis U. L.J. 223, 233-46 (1958); Plank, *Constitutional Limits*, *supra* note 53, at 507-10; Tabb, *Discharge*, *supra* note 63, at 344.

71. *See infra* note 117 (describing the "acts of bankruptcy").

72. *See* 13 Eliz., c. 7, § 2 (1570) (Eng.).

73. *See id.*

74. The commissioners could appoint provisional assignees to receive all of the bankrupt's property. 5 Geo. 2, c. 30, § 30 (1732) (Eng.). At the first meeting of creditors, the creditors could elect new assignees. *See id.* §§ 26, 30.

75. *See* 13 Eliz., c. 7, § 2, cls. (2)-(9) (1570) (Eng.); 5 Geo. 2, c. 30, § 1 (1732) (Eng.). The property included property that was not subject to nonbankruptcy creditor collection actions, see *supra* note 58, such as real estate. *See* 13 Eliz., c. 7, § 2, cls. (3), (4) (1570) (Eng.) (the property of the estate included "Lands, Tenements, Hereditaments, as well Copy or Customary Hold as Freehold" held by the bankrupt); 5 Geo. 2, c. 30, § 1 (1732) (Eng.) (property of the estate includes all "Estate" of the bankrupt).

76. The statute provided:

> [A]nd the said Commissioners, or the major Part of them, shall order such Part of the neat Produce of the said Bankrupt's Estate , as by such Accounts or otherwise shall appear to be in the Hands of the said Assignees, as they or the major Part of them shall think fit, to be forthwith divided amongst such of the Bankrupt's Creditors, who have duly proved their Debts under such Commission, in Proportion to their several and respective Debts. . . .

5 Geo. 2, c. 30, § 33 (1732) (Eng.). The 1542 Statute of Henry VIII and the 1570 Statute of 13 Elizabeth also provided for the gathering and sale of the bankrupt's property and a pro rata distribution of the proceeds to creditors to satisfy their claims, although in much less detail. 34 & 35 Hen. 8, c. 4, para. 1 (1542-1543) (Eng.); 13 Eliz., c. 7, § 2, cl. (10) (1570) (Eng.); *see also* Louis Edward Levinthal, *The Early History of English Bankruptcy*, 67 U. Pa. L. Rev. 1, 14-17 (1919).

their debts with the approval of a supermajority of creditors[77] and could receive a small percentage of their property that would otherwise be distributed to creditors.[78]

The second group of bankruptcy laws of the eighteenth century consists of the Insolvency Acts periodically enacted by the English Parliament, typically entitled "An Act for the Relief of Insolvent Debtors."[79] Under these acts, a debtor imprisoned because of a failure to repay his or her debts could obtain release from prison by filing a petition with the justice of the peace. The debtor's real and personal property was assigned to assignees who liquidated the property and distributed the proceeds pro rata to the creditors in payment of his or her debts.[80] The creditors could no longer imprison the debtors for the preexisting debts. The Insolvency Acts did not discharge the debts, and creditors could execute on any future goods acquired by the debtor to satisfy the preexisting debts.[81] In the beginning of the eighteenth century, these acts applied only to those

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77. *See* 4 Ann., c. 17, § 7 (1705) (Eng.), as amended in 1706 by 5 Ann., c. 22 (1706) (Eng.), which conditioned a discharge on the consent of eighty percent of the creditors in both number and value of the debts, *id.* § 2. The provision was continued in 5 Geo. 2, c. 30, §§ 7, 10 (1732) (Eng.).

78. The Statute of 5 George II provided an elaborate formula for the allowance to the bankrupt of the "Neat Product" of the bankrupt's estate received or recovered by the commissioners: 5%, not to exceed £200, if the creditors received 50%; 7½% not to exceed £250 if the creditors received 62.5%; 10% not to exceed £300 if the creditors received 75%; and only what the commissioners thought fit, not to exceed 3%, if the creditors received less than 50%. 5 Geo. 2, c. 30, § 7 (1732) (Eng.).

79. *See, e.g.*, 2 & 3 Ann., c. 16 (1703) (Eng.) ("An Act for the Discharge out of Prison such Insolvent Debtors" who will serve in the army or navy); 6 Geo., c. 22 (1719) (Eng.) (act for "Relief of insolvent Debtors"); 11 Geo., c. 21 (1724) (Eng.) (same); 2 Geo. 2, c. 20 (1729) (Eng.) (act for "Relief of Insolvent Debtors"); 21 Geo. 2, c. 31 (1748) (Eng.) (same); 28 Geo. 2, c. 13 (1755) (Eng.) (same); 9 Geo. 3, c. 26 (1769) (Eng.) (same); 12 Geo. 3, c. 23 (1772) (Eng.) (same); 14 Geo. 3, c. 77 (1774) (Eng.) (same); 16 Geo. 3, c. 38 (1776) (Eng.) (same); 18 Geo. 3, c. 52 (1778) (Eng.) (same); 21 Geo. 3, c. 63 (1781) (Eng.) ("An Act for the Discharge of certain Insolvent Debtors"). According to Charles Tabb, the first of such acts was 22 & 23 Car. 2, c. 20 (1670) (Eng), and later acts included 2 W. & M., sess. 2, c. 15 (1690) (Eng.); 5 & 6 W. & M., c. 8 (1694) (Eng.); 7 & 8 Will. 3, c. 12 (1696) (Eng.); 8 & 9 Will. 3, c. 18 (1697) (Eng.); 1Ann., stat. 1, c. 25 (1701) (Eng.); 2 & 3 Ann., c. 16 (1703) (Eng.); *see also* Tabb, *History*, *supra* note 63, at 12 n.47.

80. *See, e.g.*, 28 Geo. 2, c. 13, § 3 (1755) (Eng.); 9 Geo. 3, c. 26 §§ 6, 11 (1769) (Eng.); 12 Geo. 3, c. 23, §§ 6, 12 (1772) (Eng.); 14 Geo. 3, c. 77, §§ 6, 12 (1774) (Eng.); 16 Geo. 3, c. 38, §§ 6, 14 (1776) (Eng.); 18 Geo. 3, c. 52, §§ 6, 14 (1778) (Eng.); 21 Geo. 3, c. 63, §§ 6, 15 (1781) (Eng.). Hence, a debtor seeking relief had to relinquish property that could not be sold under nonbankruptcy creditor collection law. *See supra* note 58.

81. *See, e.g.*, 2 & 3 Ann., c. 16 (1703) (Eng.) (summary of provisions); 6 Geo., c. 22 (1719) (Eng.); 11 Geo., c. 21 (1724) (Eng.); 2 Geo. 2, c. 20 (1729) (Eng.); 21 Geo. 2, c. 31 (1748) (Eng.); 28 Geo. 2, c. 13, §§ 3, 18, 20, 21 (1755) (Eng.); 9 Geo. 3, c. 26, §§ 4, 11, 27, 33 (1769) (Eng.); 12 Geo. 3, c. 23, §§ 4, 12, 27, 28, 34 (1772) (Eng.); 14 Geo. 3, c. 77, §§ 4, 12, 28, 29, 34 (1774) (Eng.); 16 Geo. 3, c. 38, §§ 4, 14, 33, 34, 41 (1776) (Eng.); 18 Geo. 3, c. 52, §§ 4, 14, 33, 38, 45 (1778) (Eng.); 21 Geo. 3, c. 63, §§ 5, 15, 32, 33 (1781) (Eng.).

with a small amount of debt (£50 or £100).[82] Toward the end of the century, the maximum amount of allowable debt grew to £1,000-£2,000. The acts also induced creditors holding debts that exceeded the maximum to comply with their terms.[83]

To be sure, the English Insolvency Acts differed from the English Bankrupt Acts on some important matters. Under the Bankrupt Acts, debtors received a release from prison and a discharge of their debts; under the Insolvency Acts, debtors received only a release from prison. The Bankrupt Acts operated prospectively for debtors who became insolvent after the enactment of the Acts. With the exception of the Lord's Act,[84] the Insolvency Acts did not operate prospectively. They released only those debtors in prison as of a specified date.[85]

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82. *See* Treiman, *supra* note 60, at 195 n.22 (citing 2 W. & M., sess. 2, c. 15, § 9 (1690) (Eng.) (limiting the benefits of that insolvency act to debtors with unpaid debts of less than £100)); *see also* 2 & 3 Ann., c. 16 (1703) (Eng.) (limiting relief to debtors who did not owe more than £100 to one person and who agreed to serve or procured another to serve in the British army or navy); 6 Geo., c. 22 (1719) (Eng.) (limited to debtors who did not owe more than £50 to one person); 11 Geo., c. 21 (1724) (Eng.) (debtors owing debts to the Crown and debts of £100 or more to one person were not released).

83. Creditors holding debts greater than the maximum who did not consent to the release of the debtor were required to pay for the maintenance of the debtor in prison. If they did not pay, the prisoner was released. *See, e.g.*, 2 Geo. 2, c. 20 (1729) (Eng.) (no release for debt to the King or debt of more than £500 to any one creditor, unless the creditor consented); 21 Geo. 2, c. 31 (1748) (Eng.) (same); 28 Geo. 2, c. 13, § 31 (1755) (Eng.) (same; except creditors who did not consent to release had to pay a sum for the maintenance of the prisoner; if the sum were not paid, then the prisoner was released) 9 Geo. 3, c. 26, § 40 (1769) (Eng.); 12 Geo. 3, c. 23, § 42 (1772) (Eng.) (same); 14 Geo. 3, c. 77, § 42 (1774) (Eng.) (same, except debt limit raised to £2,000 and release for debt to King allowed if Privy Council agreed); 16 Geo. 3, c. 38, §§ 49, 50 (1776) (Eng.) (same, except no release for debt to King, and debt limit of £1,000 to any one person); 18 Geo. 3, c. 52, §§ 55, 56 (1778) (Eng.) (same); 21 Geo. 3, c. 63, §§ 5, 13, 48 (1781) (Eng.) (debt limit £500 but not released for debts to Crown).

84. The Statute of 32 Geo. 2, c. 28 (1758) (Eng.), a general insolvency act for debtors in prison for sums of less than £100, provided for the assignment of the debtor's property to creditors and release from prison. If the creditors did not consent to the release, they were required to pay the fees for continuing the debtor's imprisonment. If they failed to pay, the debtor was released from prison. *Id.* §§ 13, 14. This act also provided a new remedy to creditors against debtors not eligible for a commission of bankrupt. Upon notice to the debtor and other creditors by whose action the debtor was imprisoned, the creditor could compel a debtor not seeking release from debtor's prison to give an account of his or her property and to assign the property for the benefit of the petitioning creditor and other consenting creditors. *Id.* § 17. If the debtor refused, he would be transported to a colony in America for indentured service for seven years. *Id.*

85. *See, e.g.*, 6 Geo., c. 22 (1719) (Eng.) (releasing debtors in prison on June 24, 1719, for existing debts); 11 Geo., c. 21 (1724) (Eng.) (September 29, 1724); 2 Geo. 2, c. 20 (1729) (Eng.) (September 29, 1728); 21 Geo. 2, c. 31 (1748) (Eng.) (January 1, 1747); 28 Geo. 2, c. 13 (1755) (Eng.) (January 1, 1755); 9 Geo. 3, c. 26 (1769) (Eng.); 12 Geo. 3, c. 23 (1772) (Eng.) (January 1, 1772); 14 Geo. 3, c. 77 (1774) (Eng.) (April 28, 1774); 16 Geo. 3, c. 38 (1776) (Eng.) (January 22, 1776); 18 Geo. 3, c. 52 (1778) (Eng.) (January 28, 1778); 21 Geo. 3, c. 63 (1781) (Eng.) (persons in prison on January 1, 1781; also persons who had escaped during disturbances on June 2 through June 8, 1780 that destroyed several jails and who surrendered or offered to surrender by

Only merchants were eligible for relief under the Bankrupt Acts. The Insolvency Acts applied to nonmerchants and to merchants not eligible under the Bankrupt Acts. Proceedings under the Bankrupt Acts were nominally involuntary, that is, initiated by the creditors; under the Insolvency Act, the debtors, not the creditors, initiated the proceedings.

Because the Bankrupt Acts were more fully developed and created a more comprehensive system, the Bankrupt Acts have received more attention as important sources of American bankruptcy law, and the Insolvency Acts have received insufficient attention. This is unfortunate for two reasons. First, both the Bankrupt Acts and the Insolvency Acts incorporated the essential features of bankruptcy law: (i) a summary proceeding providing (ii) the gathering, liquidation, and distribution of the debtor's property (iii) to satisfy creditor claims on a pro rata basis and (iv) significant debtor relief.

Second, the differences between the Bankrupt Acts and the Insolvency Acts are less significant than they appear. Although bankruptcy proceedings under the Bankrupt Acts were only nominally involuntary, it was easy and commonplace for a debtor to induce a creditor to initiate a bankruptcy proceeding.[86] The limitation to merchants proved to be so unstable that almost any person engaged in a business that did not depend upon the ownership of land could be a merchant.[87] Release from prison provided important and effective relief to debtors even without a discharge because of the limitations in the eighteenth century on individual creditor collection remedies.[88] Indeed, the end of the eighteenth century saw serious efforts to merge the Bankrupt Acts and the Insolvency Acts.[89]

September 1, 1780).

86. *See* Plank, *Constitutional Limits*, *supra* note 53, at 510-12.

87. *See* Cohen, *supra* note 60, at 160; Friedman & Niemira, *supra* note 70, at 233-46; Plank, *Constitutional Limits*, *supra* note 53, at 507-11; Tabb, *Discharge*, *supra* note 63, at 344. Indeed, I believe that the limitation to "merchants" reflected more a desire of the landed gentry in England to prevent the liquidation of land to pay debts than a sensible expression of bankruptcy policy. *See* Plank, *Constitutional Limits*, *supra* note 53, at 507-11.

88. *See supra* note 58 (describing the limitations on the types of property interests of the debtor on which a creditor could execute).

89. For example, in 1783, James Bland Burges suggested a reform that melded many of the features of the Bankrupt Acts and the Insolvency Acts, such as abolishing the distinction between merchants and nonmerchants, replacing a simple requirement of debtor insolvency for "acts of bankruptcy" as a jurisdictional requirement for a proceeding, and abolishing creditor approval for the debtor's discharge. James B. Burges, Considerations on the Law of Insolvency: With a Proposal for Reform 318-23, 342-45, 348-53, 387-89 (London, T. Cadell 1783). Burges's proposals are also discussed in Ian P.H. Duffy, Bankruptcy and Insolvency in London During the Industrial Revolution 44-45, 84-85 (1985), and in Duffy, *English Bankrupts*, *supra* note 60, at 283, 290 & n.44. Burges was a barrister and a commissioner of bankrupt and later a member of Parliament. *See* Duffy, *supra* note 60, at 44 n.133.

These were not entirely new ideas. In 1697, Daniel DeFoe proposed a voluntary bankruptcy system in which the debtor received a full discharge of debts.

In eighteenth-century America, the colonies and states enacted a wide variety of bankruptcy laws that I lump into the third group of eighteenth-century bankruptcy legislation. Further, the same jurisdictions experimented with different types of laws at different times.[90] Most jurisdictions enacted statutes providing relief upon a petition by debtors or creditors and liquidation and distribution of the debtor's property similar to the English Insolvency Acts. Most of these statutes only released debtors from prison.[91] A few jurisdictions, however, allowed the discharge of debts with the consent of some or all of the creditors.[92] A very few enacted short-lived acts that allowed

See Daniel Defoe, An Essay upon Projects 197 (1697), also discussed in Plank, *Constitutional Limits*, *supra* note 53, at 503-05, and Robert Weisberg, *Commercial Morality, the Merchant Character, and the History of the Voidable Preference*, 39 Stan. L. Rev. 3, 9 (1986).

90. For a more detailed summary of this American legislation, *see* Plank, *Constitutional Limits*, *supra* note 53, at 518-25, and Plank, *Bankruptcy Judges*, *supra* note 64, at 600-06.

91. *See, e.g.*, An Act for the Relief of Insolvent Debtors, within this Government, ch. 76, 1740 Del. Laws, amended by ch. 118, 1751 Del. Laws; An Act for the Relief of Insolvent Debtors, ch. 28, Mar. Sess., 1774 Md. Laws (three years duration but continued by subsequent acts until it expired 1787, revived 1788, and continued until at least 1810); An Act for the Relief of Insolvent Persons, with respect to the Imprisonment of Their Persons, ch. 22, 9th Sess., 1786 N.Y. Laws (Mar. 31, 1786) (total debts not more than £15); An Act for the Relief of Insolvent Persons, with respect to the Imprisonment of Their Persons, ch. 98, 10th Sess., 1787 N.Y. Laws (Apr. 20, 1787) (same); An Act for Giving Relief in Cases of Insolvency, ch. 92, 11th Sess., 1788 N.Y. Laws (Mar. 21, 1788) (requiring consent of three-fourths by value of creditors); An Act Directing the Manner of Levying Executions, and for Relief of Poor Prisoners for Debt, ch. 37, 1705 Va. Laws (debts under 10 pounds money or 2,000 pounds in tobacco), *in* 3 Statutes at Large Being a Collection of the Laws of Virginia 385, 386-88 (William Waller Hening ed., 1823) [hereinafter Laws of Virginia]; An Act Declaring the Law Concerning Executions, and for Relief of Insolvent Debtors, ch. 12, 1748 Va. Laws, §§ 24, 26 (effective June 1, 1751), *in* 5 Laws of Virginia, *supra*, at 526, 589 (1819); ch. 1, 1753 Va. Laws, § 31, *in* 6 Laws of Virginia, *supra*, at 325, 342-43 (1819); ch. 22, 1769 Va. Laws, § 7, *in* 8 Laws of Virginia *supra*, at 326, 329 (1821); *see also* Coleman, *supra* note 59, at 79 (discussing a shortlived 1765 Connecticut act that also discharged liens); *id.* at 208-10 (discussing Delaware laws enacted during 1734-1808); *id.* at 234 (discussing Georgia laws enacted during 1766-1770); *id.* at 164-65 (discussing Maryland laws enacted during 1708-1711, 1725-1727, 1733, 1774-1787, 1788-1817); *id.* at 40-42 (discussing Massachusetts laws enacted during 1698-1725, periodically during 1727-1787, and permanently thereafter); *id.* at 56-57 (discussing New Hampshire laws enacted during 1767-1776, 1782-1791); *id.* at 132-35 (discussing New Jersey laws enacted during 1686, periodically from 1730 to 1771); *id.* at 107-08, 115-16 (discussing New York laws enacted during 1730, 1732-1734, 1743, 1747, 1750, 1751, 1756, 1776, 1786, 1787); *id.* at 218-20 (discussing North Carolina laws enacted during 1749-1773); *id.* at 143-45, 147 (discussing Pennsylvania laws enacted during 1730, 1770, 1784-1793); *id.* at 91 (discussing Rhode Island laws enacted in the year 1745); *id.* at 66-67 (discussing Vermont laws enacted during 1782-1797); *id.* at 195-96 (discussing Virginia laws enacted periodically beginning in 1705).

92. *See, e.g.*, An Act for the Relief of Insolvent Debtors, 1771 N.J. Laws, *in* 5 Laws of the Royal Colony of New Jersey 1770-1775, at 81-86 (Bernard Bush ed., 1986) [hereinafter Laws of New Jersey]; ch. 370, 1783 N.J. Laws, *in* The First Laws of the State of New Jersey 338 (John D. Cushing ed., 1981); An Act for the Relief of Insolvent Debtors, ch. 34, 9th Sess., 1786 N.Y. Laws (Apr. 13, 1786) (general relief act

the discharge of the debtor's debts without creditor consent.[93] For example, in early 1787, Maryland enacted "An Act Respecting Insolvent Debtors"[94] that in essence resembles Chapter 7 of the Bankruptcy Code: It provided for a voluntary petition by any debtor;[95] liquidation and pro rata distribution of the debtor's property

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applying to "insolvent" debtors and not just debtors in prison; required consent of debtors with three-fourths of total debt) (repealed by Act of Feb. 8, 1788, ch. 29, 11th Sess., 1788 N.Y. Laws.); An Act for the More Effectual Relief of Insolvent Debtors, No. 882, 1759 S.C. Laws (Apr. 7, 1759) (only discharging the debts of creditors who agreed to accept a dividend from an assignment of the debtor's property); An Act for the relief of insolvent debtors, for the effectual discovery and more equal distribution of their estates, Ch. 8, Nov. Sess., 1762 Va. Laws, §§ 1, 18, *in* 7 Laws of Virginia 549-63 (1820) (repealed Ch. 2, May Sess., 1763 Va. Laws, *in* 7 Laws of Virginia 643 (1820)) (providing a discharge for debtors under terms similar to the 1732 English Bankrupt Act of 5 George II, 5 Geo. 2, c. 30, but not limiting relief to merchant debtors, and allowing debtors to initiate proceedings). *See also* Coleman, *supra* note 59, at 134-35 (discussing New Jersey laws enacted during 1771-1775, 1783-1787); *id.* at 109, 113, 123 (discussing New York, 1755-1772, 1784-1819).

93. 1775 N.J. Laws, *in* 5 Laws of New Jersey, *supra* note 92, at 321 (removing creditor consent requirement from existing law that was to expire in 1776); An Act for Relief of Insolvent Debtors Within This State, ch. 34, 7th Sess., 1784 N.Y. Laws (Apr. 17, 1784) (releasing and discharging debtors then in prison); Act of Nov. 24, 1784, ch. 14, 8th Sess., 1784 N.Y. Laws (same); An Act for the relief of insolvent debtors, for the effectual discovery and more equal distribution of their estates, ch. 8, Nov. Sess., 1762 Va. Laws, §§ 1, 18, *in* 7 Laws of Virginia 549-63 (William W. Hening ed., 1820) (repealed ch. 2, May Sess., 1763 Va. Laws, *in* 7 Laws of Virginia 643 (William W. Hening ed., 1820)) (providing a discharge for debtors under terms similar to the 1732 English Bankruptcy Act of 5 George II, 5 Geo. 2, c. 30, but not limiting relief to merchant debtors, and allowing debtors to initiate proceedings); *see also* Coleman, *supra* note 59, at 79 (discussing Connecticut laws enacted during 1765-1767); *id.* at 134 (discussing New Jersey laws enacted in the year 1775); *id.* at 218-22 (discussing North Carolina laws enacted during 1749-1773, for debtors worth less than £2; 1773-1774 & 1777-1778, for all debtors); *id.* at 92-93 (discussing Rhode Island laws enacted in the year 1756, relieving all debtors insolvent as of June 1, 1756; 1771-1772, a general law repealed nine months later); *id.* at 181-82 (discussing South Carolina laws enacted during 1721-1744) (discharging debts of debtors owing more than £2 but having less than £5 of property or annual income).

A few jurisdictions allowed some form of relief in exchange for service. *See, e.g.*, An Act for the Relief of Insolvent Debtors, within this Government, ch. 76, 1740 Del. Laws, § 11, amended by ch. 118, 1751 Del. Laws (indentured servitude up to seven years for various groups; debtor discharged from debt if the creditors refused service); An Act for the Relief of Insolvent Debtors, 1771 N.J. Laws, *in* 5 Laws of New Jersey, *supra* note 92, at 81, 86 (requiring up to seven years of service by certain debtors to obtain discharge) (expired 1776; revived 1783; repealed 1787). *See also* Coleman, *supra* note 59, at 78-79 (discussing Connecticut laws enacted during 1763-1764); *id.* at 208-10 (discussing Delaware laws enacted during 1734-1915, indentured servitude up to seven years for various groups; debtor discharged from debt if the creditors refused service); *id.* at 164-65 (discussing Maryland laws enacted during 1725-1727, 1733); *id.* at 40-42 (discussing Massachusetts laws enacted during 1698-1737); *id.* at 133 (discussing New Jersey laws enacted in the year 1761); *id.* at 107 (discussing New York laws enacted in the year 1732); *id.* at 141-42, 144 (discussing Pennsylvania laws enacted during 1706-1767, various groups of debtors indentured up to five or seven years).

94. *See* An Act Respecting Insolvent Debtors, ch. 34, Apr. Sess., 1787 Md. Laws.

95. *See id.* §§ 1, 16.

to creditors;[96] full discharge of debts without creditor consent;[97] and even a rudimentary avoidance of preferences.[98] In contrast, Pennsylvania enacted a statute in 1785 that was a composite of the English Bankrupt Acts.[99]

Another form of relief in some jurisdictions consisted of private acts passed by the legislature as the result of petitions of specific individuals. Usually, these acts released debtors from prison upon surrender of their property.[100] Some also discharged individual debtors from their debts.[101] A few provided individualized relief, such as a moratorium from imprisonment and the imposition on dissenting minority creditors of a debt adjustment agreement between the debtor and a majority of the creditors.[102]

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96. *See id.* § 6.

97. *See id.* §§ 1, 3.

98. *See id.* § 6.

99. *See* An Act for the Regulation of Bankruptcy, ch. 1183, 1785 Pa. Stat. § 2, *in* 12 The Statutes at Large of Pennsylvania From 1682 to 1801, at 70 (Clarence M. Bush St. printer, 1896); *see also* Plank, *Bankruptcy Judges*, *supra* note 64, at 602-06 (presenting a detailed summary of the Pennsylvania Act and comparing the provisions with those of the English Bankrupt Acts). A few colonies had earlier enacted shortlived acts that resembled the English Bankrupt Acts. *Id.* at 602 & n.198.

100. *See, e.g.*, An Act for the Revival and Continuance of an Act Entitled, An Act for the Relief of Poor Distressed Prisoners for Debt, 1751 N.J. Laws ("sundry Persons . . . by their petition . . . praying the Relief of the Legislature"), *in* 3 Laws of New Jersey 173; *see also* Coleman, *supra* note 59, at 79-83 (discussing Connecticut laws enacted during 1765-1818); *id.* at 165-68 (discussing Maryland laws enacted during 1715-1774); *id.* at 55-56 (discussing New Hampshire laws enacted during 1745-1765); *id.* at 113-15 (discussing New York laws enacted during 1771-1775, 1776-1786); *id.* at 145, 147 (discussing Pennsylvania laws enacted during 1731, 1760-1793); *id.* at 88-89 (discussing Rhode Island laws enacted intermittently); *id.* at 69-71 (discussing Vermont laws enacted during 1785-1821).

101. *See, e.g.*, Act of Nov. 24, 1784, ch. 14, 8th Sess., 1784 N.Y. Laws (discharging debts of several named individuals with consent of creditors with two-thirds of total debt); An Act Granting Relief to Certain Insolvent Debtors, ch. 87, 8th Sess., 1785 N.Y. Laws (Apr. 28, 1785) (releasing from prison certain named debtors and discharging their debts); *see also* Coleman, *supra* note 59, at 79-81 (discussing Connecticut laws enacted during 1765-1818); *id.* at 165-66 (discussing Maryland laws enacted during 1715-1723); *id.* at 92-93, 95-97 (discussing Rhode Island laws enacted during 1756-1828, petitions granted on the basis of a general law enacted in 1756 that relieved all debtors insolvent as of June 1, 1756); *id.* at 145 (discussing Pennsylvania laws enacted during 1760-1776, one petition); *id.* at 69-71 (discussing Vermont laws enacted during 1786-1821).

102. *See, e.g.*, Coleman, *supra* note 59, at 79-81 (discussing Connecticut laws enacted during 1765-1800, granting a stay from arrest to a debtor who became insolvent in 1774 because of a loss of his ship and who entered into an agreement with a majority of creditors allowing the debtor to continue in business for ten years without arrest after a minority of the creditors refused to agree and threatened imprisonment, and granting a stay of arrest and full discharge of debts to two insolvent partners who entered into a composition agreement with a majority of their creditors to pay fifty percent of their debts in rum if the debtors performed their agreement); *id.* at 165-66 (discussing Maryland laws enacted during 1715-1723); *id.* at 109 (discussing New York laws enacted during 1755, forcing minority creditors to accept compositions with majority of creditors); *id.* at 145 (discussing Pennsylvania laws enacted during 1760-1776, same); *id.* at 69-71 (discussing Vermont laws enacted

The English Bankrupt Acts, the English Insolvency Acts, and the great variety of American legislation represent somewhat different responses to the problems posed by insolvent debtors unable to pay their creditors. The Framers of the Constitution were no doubt familiar with this great variety of legislation. Indeed, one of the delegates to the constitutional convention, Jared Ingersoll of Pennsylvania, was an experienced commercial and bankruptcy lawyer knowledgeable not only about Pennsylvania's act that copied the English Bankrupt Acts but also with the different American acts, including Maryland's short-lived full bankruptcy act.[103]

The technical differences among the three types of bankruptcy legislation should not obscure the essential elements that all shared. All of this bankruptcy legislation was directed toward one particular problem: What is the best form of relief for the creditors and their debtor when the debtor has insufficient liquid assets to repay her creditors? This question is the "subject of Bankruptcies."

The bankruptcy legislation of the eighteenth century superceded the nonbankruptcy individual creditor collection actions, which were (and still are) wasteful and ineffective against an insolvent debtor. In place of individual creditor action, all of the eighteenth-century bankruptcy legislation established a single collective proceeding in which all creditors could share in a more efficient pro-rata distribution of the debtor's assets. Significantly, none of this bankruptcy legislation attempted to do more than adjust the relationship between an insolvent debtor and his or her creditors. None attempted to regulate how debtors and creditors entered into their relationship. None created the property rights or contract rights underlying the

during 1785-1821).

103. *See, e.g.*, Miller v. Hall, 1 Dall. 229 (Pa. 1788), discussed *supra* in note 57 and accompanying text (discussing how Ingersoll successfully obtained the release from prison of a Maryland resident arrested in an action by a resident of Pennsylvania on a debt contracted in Pennsylvania but discharged under Maryland's shortlived general insolvency law, discussed supra notes 94-99 and accompanying text); Thompson v. Young, 1 Dall. 294 (Pa. Ct. C.P. of Philadelphia County 1788) (in which Ingersoll unsuccessfully represented Pennsylvania resident trying to collect on a debt discharged under Maryland's insolvency act, the court following *Miller v. Hall*); Gorgerat v. McCarthy, 1 Dall. 366 (Pa. Ct. C.P. of Philadelphia County 1788) (in which Ingersoll was unable to obtain the release from prison of a debtor who had declared himself a bankrupt under the laws of France but who had not yet received a discharge of debts); Gibbs v. Gibbs, 1 Dall. 371 (Pa. Ct. C.P. Philadelphia County 1788) (priority dispute over bankrupt's property between judgment creditor and bankruptcy commissioners; Ingersoll represented the bankruptcy commissioner); *see also* Robert J. Lukens, *Jared Ingersoll's Rejection of Appointment as One of the "Midnight Judges" of 1801: Foolhardy or Farsighted?*, 70 Temp. L. Rev. 189, 201-02 & n.57 (1997) (discussing Mr. Ingersoll's background). Ingersoll also litigated the validity of an order of relief from imprisonment under a New Jersey relief act. *See* Kurt H. Nadelmann, *On the Origin of the Bankruptcy Clause*, 1 Am. J. Legal Hist. 215, 224-25 (1957). Ingersoll apparently played a small public role at the constitutional convention. *See* Lukens, *supra*, at 202. To what extent other delegates consulted with him is not known.

debtor-creditor relationship. None affected the rights of debtors or creditors beyond that which was necessary to adjust their relationship. None affected the rights of Third Parties other than transferees of the debtor's property who colluded with the debtor to defraud his or her creditors.

III. THE PRINCIPLES DEFINING THE "SUBJECT OF BANKRUPTCIES"

Because the word "bankruptcy" was synonymous with "insolvency" in the eighteenth century, and the eighteenth-century bankruptcy legislation only adjusted the previously established relationship between an insolvent debtor and his or her creditors, I conclude that the "subject of Bankruptcies" in the Bankruptcy Clause is limited to the adjustment of the relationship between an insolvent debtor and the debtor's creditors.[104] To amplify this limitation of the Bankruptcy Clause, I have derived four guiding principles. Three of these principles directly govern the extent to which Congress may disregard or must respect state law. These principles are the Debtor-Creditor Adjustment Principle, the Non-Expropriation Principle, and the Non-Interference Principle. These principles, described below and examined in greater detail in part IV, govern the extent of the relief that bankruptcy law may afford an insolvent debtor. The fourth principle, the Debtor-Insolvency Principle, does not directly govern the extent to which Congress may disregard state law. Nevertheless, this principle, which I also describe below, is a precondition to Congress's ability to alter the state law entitlements under the Bankruptcy Power.

A. *The Debtor-Creditor Adjustment Principle*

Bankruptcy law may provide that any right or privilege that the debtor could use—whether the debtor wants to or not—to satisfy her debts outside of bankruptcy may be used in bankruptcy to satisfy those debts. Bankruptcy law may appropriate these rights and

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104. Although the actual scope of bankruptcy laws enacted by Congress has expanded, none of the expansions blessed by the Supreme Court and other federal courts, including the addition of reorganization instead of liquidation, has (with a few minor exceptions) exceeded the scope of the Bankruptcy Clause. *See* Plank, *Constitutional Limits*, *supra* note 53, at 534-44. The exceptions are described *infra* notes 141-52 and accompanying text. In addition, in 1968, Congress relied on both the Commerce Clause and the Bankruptcy Clause in enacting two titles of the Consumer Credit Protection Act directed at the general debtor-creditor relationship, one making loan sharking a federal crime, *see* Consumer Credit Protection Act of 1968, § 202, Pub. L. No. 90-321, 82 Stat. 146 (codified at 18 U.S.C. §§ 891-896 (2000)), and the other imposing a federal limit on the amount of an employee's wages that a creditor can garnish. *Id.* §§ 301-307 (codified at 15 U.S.C. §§ 1671-1677 (2000)). I describe and criticize this impermissible use of the Bankruptcy Clause in Plank, *Constitutional Limits*, *supra* note 53, at 556-59.

privileges even if creditors under state law could not directly reach such rights or privileges.[105]

Bankruptcy law may also provide that any liability of the debtor, no matter how remote or contingent, that exists before or during a bankruptcy case may be the subject of the bankruptcy case. Congress's discretion under the Bankruptcy Clause over such liabilities is complete. It may reduce, subordinate, or discharge any prebankruptcy liabilities that the debtor owes to creditors. It may delay, modify, or eliminate any remedies of creditors against the debtor for such liabilities under state law. For example, putting aside other constraints imposed by the Constitution,[106] the Bankruptcy

105. Hence, even if creditors could not cause real property to be seized and sold outside of bankruptcy to satisfy debts, the debtor herself could do so. Accordingly, bankruptcy law may administer such exempt property for the benefit of creditors, and historically did so. *See supra* note 75 & 80 and accompanying text.

106. I believe that the complete abolition of security interests would violate the Fifth Amendment to the Constitution. *See* U.S. Const. amend. V (stating "nor shall private property be taken for public use, without just compensation"). Although several commentators have argued that a congressional abolition of prospective security interests would not violate the Fifth Amendment, these authors analyze the interests of the secured creditor. *See, e.g.*, David Gray Carlson, *Postpetition Interest Under the Bankruptcy Code*, 43 U. Miami L. Rev. 577, 585 (1989) (stating that Congress can prospectively ban security interests by essentially preventing their recognition as property that a secured party may hold, and also stating that a retroactive denial of adequate protection of the secured creditor's interest would not be unconstitutional); James S. Rogers, *The Impairment of Secured Creditors' Rights in Reorganization: A Study of the Relationship Between the Fifth Amendment and the Bankruptcy Clause*, 96 Harv. L. Rev. 973, 987 (1983). *But see* Julia Patterson Forrester, *Bankruptcy Takings*, 51 U. Fla. L. Rev. 851 (1999) (disagreeing with Rogers).

Nevertheless, the authors supporting the prospective abrogation of security interests have not analyzed the effect of such abolition on the property interests of the owner of the property. Eliminating the ability of an owner of property to grant a security interest would be a sufficiently severe limitation on the use of the owner's property as to constitute a "regulatory taking" in violation of the Fifth Amendment. *See, e.g.*, Tahoe-Sierra Preservation Council, Inc. v. Tahoe Regional Planning Agency, 122 S. Ct. 1465, 1479-1481 (2002) (analyzing the difference between a physical taking and a regulatory taking in a case involving temporary moratoria on development of land and noting that in "deciding whether a particular governmental action has effected a taking, this Court focuses rather both on the character of the action and on the nature and extent of the interference with" the property interest (quoting Penn Central Transp. Co. v. New York City, 438 U.S. 104, 130-31 (1978))). For example, as of March 31, 2002, there was approximately $5.81 trillion of single family mortgage loans outstanding. *See* Bd. of Gov. of Fed. Res. System, Domestic Financial Statistics, 88 Fed. Res. Bull. 8, A33, tbl. 1.54, line 2 (Aug. 2002). It is very unlikely that most of the homeowners who borrowed this amount could afford to buy single family homes if they could not grant a security interest in the homes to obtain financing to purchase the home. They would either have to borrow at a higher unsecured rate or not be able to obtain financing at all. *See also* Forrester, *supra*, at 891-94 (stating that the abrogation of security interests would be a taking of an owner's substantial property interest as well as a taking of secured creditor's substantial property interest). Lesser restrictions on security interests, such as those currently imposed by the Bankruptcy Code, would most likely not rise to the level of a regulatory taking.

Clause does empower Congress to abolish security interests granted by the debtor to secure the creditor's debts.

B. *The Non-Expropriation Principle*

The Non-Expropriation Principle limits the Debtor-Creditor Adjustment Principle. Subject to the Non-Interference Principle discussed below, bankruptcy law may not go beyond the Debtor-Creditor Adjustment Principle. It may not expand the rights of debtors or their creditors beyond that necessary to adjust their relationship, and it may not otherwise adversely affect the rights or legal relations of Third Parties, that is, persons who are neither the debtor nor the creditors of the debtor.

Hence, bankruptcy law may not create rights or property interests for insolvent debtors or their creditors (other than rights arising between them under the Debtor-Creditor Adjustment Principle) that do not exist under state law or federal nonbankruptcy law. Bankruptcy law may not appropriate property interests of Third Parties for distribution to creditors. In addition, to the extent that a debtor has an interest in property items or privileges that contain inherent limitations that inure to the benefit of a Third Party, bankruptcy law may not disregard those limitations.[107] Thus, if state law requires the satisfaction of conditions other than the repayment of a debt, such as the approval of a private organization or governmental entity, then the trustee must satisfy such conditions, again, subject to the Non-Interference Principle discussed below.[108] Moreover, bankruptcy law may not alter the substantive legal relationship between a debtor and the other party to an executory contract or a lease to the extent that the relationship is not a debtor-creditor relationship.

Furthermore, just as bankruptcy law may not expropriate property interests of Third Parties to benefit the debtor or its creditors, it may not appropriate property interests of the debtor to create a liability that does not exist under state law nor expand an existing liability. For example, if state law does not recognize the liability of the debtor

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107. *See, e.g.*, 11 U.S.C. § 541(d) (2000) (providing that property in which the debtor holds only legal title and not an equitable interest becomes property of the estate only to the extent of the debtor's legal title to such property, but not to the extent of any equitable interest in such property that the debtor does not hold).

108. *See, e.g.*, United States v. Professional Sales Corp. (*In re* Professional Sales Corp.), 56 B.R. 753, 764 (N.D. Ill. 1985) (holding that, even if an interim status authorization from the EPA to operate a hazardous waste site were property of the estate, the interim status was encumbered with statutory conditions that were an incident of any property right that the debtor enjoyed and therefore reversed a bankruptcy court injunction against termination of the interim status under 11 U.S.C. § 105 (2000), stating that the bankruptcy court's order limiting the EPA "expands [the debtor's] property rights beyond what they would be outside Chapter 11," an expansion that § 105 did not allow").

for a particular act, bankruptcy law may not create a liability for the act. If a creditor is entitled to repayment of principal and 10% interest on the unpaid balance, bankruptcy law may not give the creditor principal plus 12% interest on the outstanding balance.[109] Nor may it appropriate property interests of the debtor or the creditors for the benefit of Third Parties.

Finally, the prohibition on affecting the legal relations of Third Parties goes beyond property interests and contractual relations. Hence, no matter how much a divorce may give an individual debtor a "fresh start," bankruptcy law may not grant a divorce to the debtor, as Alfred Hill remarked in 1953.[110] Bankruptcy law may not prevent prosecution of a debtor for committing a crime[111] or prevent governmental entities from enforcing their police powers against a debtor.[112]

C. *The Non-Interference Principle*

The Non-Interference Principle complements the Non-Expropriation Principle. Bankruptcy law may prevent creditors and Third Parties from interfering with the bankruptcy process. Accordingly, although bankruptcy law may not expropriate the rights of Third Parties to benefit the debtor and its creditors, bankruptcy law may invalidate efforts by Third Parties to prevent a debtor or creditor from initiating a bankruptcy case or otherwise obtaining the benefits of bankruptcy law.[113]

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109. *See infra* notes 184-87 and accompanying text.

110. *See* Alfred Hill, *The Erie Doctrine in Bankruptcy*, 66 Harv. L. Rev. 1013, 1037-38 (1953).

111. *See* 11 U.S.C. § 362(b)(1) (2000) (providing that the automatic stay does not apply to the commencement or continuation of a criminal proceeding against the debtor).

112. *See id.* § 362(b)(4) (providing that the automatic stay does not apply to the commencement or continuation of an action or proceeding by a governmental unit to enforce the governmental unit's police and regulatory power).

113. The Code implements this aspect of the Non-Interference Principle in several provisions. *See id.* § 525(c)(1) (providing that a governmental unit operating a student grant or loan program or a person that makes loans guaranteed or insured under a student loan program, each as defined under part B, D, or E of title IV of the Higher Education Act of 1965 or a similar program operated under State or local law, may not deny a grant, loan, loan guarantee, or loan insurance to a person that is or has been a debtor under Bankruptcy Code); *id.* § 1125(d) (providing that whether a disclosure statement soliciting approval of a proposed plan required under section 1125(b) contains adequate information is not governed by any otherwise applicable nonbankruptcy law, rule, or regulation); *id.* § 1125(e) (providing that a person that solicits, or participates in, the acceptance or rejection of a plan, in good faith and in compliance with the applicable provisions of the Code in the offer, issuance, sale, or purchase of a security, offered or sold under a reorganization the plan is not liable on account of such solicitation or participation for violation of any applicable law, rule, or regulation governing solicitation of acceptance or rejection of the offer, issuance, sale, or purchase of securities); *id.* § 1142(a) (providing that a reorganization plan must be implemented notwithstanding any otherwise applicable nonbankruptcy law,

Similarly, the Code may constitutionally prevent a Third Party from using a debtor's bankruptcy to obtain a benefit that it could not obtain outside of bankruptcy. Hence, bankruptcy law may invalidate "ipso-facto" provisions that purport to terminate or modify contract rights and other property interests because of the filing of a bankruptcy petition.[114] For example, the Code may prevent a landlord from terminating a lease that is favorable to the tenant solely because the tenant filed a bankruptcy petition so long as the tenant is not otherwise in default under the lease.

In implementing the Non-Interference Principle, federal courts in bankruptcy, like all courts, may look beyond the formalities of any legal relationship and analyze the substance of that relationship. Thus, federal courts may prevent a Third Party from using an otherwise legitimate provision in state law or an agreement—such as a right to terminate a contract for any reason—if the Third Party is exercising that right solely because a debtor filed a bankruptcy petition. Nevertheless, federal courts in bankruptcy must be sensitive to the legitimate concerns of Third Parties, and may not sacrifice those concerns for the benefit of the debtor or its creditors. In some instances both the Code and its judicial application are constitutionally suspect.

D. *The Debtor-Insolvency Principle*

The Debtor-Insolvency Principle requires that a debtor may not be in bankruptcy unless he, she, or it is insolvent in a broad sense, that is, the debtor's liabilities exceed its assets, or the debtor is otherwise unable to pay its debts as they come due.[115] I conclude that the

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rule, or regulation relating to financial condition); *id.* § 1145 (providing certain exemption from federal or state securities laws for the offer or sale under a plan of certain securities in connection with the plan).

Courts also recognize this principle. *See, e.g.*, Hayhoe v. Cole (*In re* Cole), 226 B.R. 647, 651-52 nn.6-7, 654 (B.A.P. 9th Cir. 1998) (holding that prepetition waiver of discharge was unenforceable against debtor in bankruptcy); *In re* Tru Block Concrete Products, Inc., 27 B.R. 486, 492 (Bankr. S.D. Cal. 1983) (holding void as against public policy covenant not to file bankruptcy petition in agreement among shareholders of debtor and creditors to liquidate debtor outside of bankruptcy); *see also* Marshall E. Tracht, *Contractual Bankruptcy Waivers: Reconciling Theory, Practice, and Law*, 82 Cornell L. Rev. 301, 303-15 (1997) (describing and questioning the conventional wisdom of unenforceability of bankruptcy waivers); David S. Kupetz, *The Bankruptcy Code is Part of Every Contract: Minimizing the Impact of Chapter 11 on the Non-Debtor's Bargain*, 54 Bus. Law. 55, 67-69 (1998) (summarizing law on pre-bankruptcy waivers).

114. I describe the Code's invalidation of these "ipso-facto" provisions and their close cousins, anti-assignment provisions that purport to prevent the bankruptcy trustee from obtaining the property interests of the debtor, in greater detail in Part IV, *infra*.

115. Insolvency is either balance sheet insolvency—the debtor's liabilities exceed assets—or cash flow insolvency—the debtor is generally unable to pay debts as they become due. The latter typically arises when the debtor has illiquid assets that cannot

"subject of Bankruptcies" includes the Debtor-Insolvency Principle for two reasons. First, as discussed above, the word "bankruptcy" was synonymous with the word "insolvency" when the Bankruptcy Clause was written and the Constitution adopted. The word means the condition of being unable to repay one's debts.[116]

Second, although "insolvency" was not always a direct condition to relief under the three groups of eighteenth-century bankruptcy legislation, almost all of that legislation had jurisdictional requirements that represent more particular examples of insolvency. For example, the English Bankrupt Acts and the 1785 Pennsylvania Bankruptcy Act required that a merchant have committed one or more "acts of bankruptcy." These acts consisted either of deliberate acts by which the debtor attempted to avoid the repayment of his or her debts or the condition of being unable to repay his or her debts, such as remaining in prison for more than two months for the non-payment of debts.[117] Similarly, the English Insolvency Acts and most

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be quickly converted into cash, but insufficient liquid assets, such as cash, to pay current debts. The Code uses both concepts. For most debtors, the term "insolvent" in the Code means balance sheet insolvency. 11 U.S.C. § 101(32)(A), (B) (2000). For municipalities filing for bankruptcy relief under Chapter 9 of the Code, "insolvent" defines a form of cash flow insolvency: "generally not paying its debts as they become due unless such debts are the subject of a bona fide dispute or . . . unable to pay its debts as they become due." *Id.* § 101(32)(C). Cash flow insolvency also appears in *id.* § 303(h)(1) (providing that the court shall order relief against the debtor in an involuntary case only if the debtor is generally not paying such debtor's debts as such debts become due unless such debts are the subject of a bona fide dispute).

116. *See supra* note 115 and accompanying text.

117. The early definitions of the "acts of bankruptcy" in the English Bankrupt Acts focused on the deliberate acts to avoid repayment of debts. Later additions to the definition, however, reflected the condition of insolvency. Hence, under the 1542 Statute of 34 & 35 Henry VIII, the acts of bankruptcy were "flee[ing] to Parts unknown, or keep[ing] their Houses." 34 & 35 Hen. 8, c. 4, § 1 (1542-1543) (Eng.). The 1570 Statute of 13 Elizabeth made the acts of bankruptcy more specific, consisting of the following:

> [I]f . . . any such person . . . depart the realm; or begin to keep his or her House or Houses, or otherwise to absent him or herself; or take Sanctuary; or suffer him or herself willingly to be arrested for any Debt or other Thing, not grown or due for Money delivered, Ware sold, or any other just or lawful Cause, or good Consideration or Purposes, . . . suffer him or herself to be outlawed, or yield him or herself to Prison, or depart from his or her Dwellinghouse or Houses, to the Intent or Purpose to defraud or hinder any of his or her Creditors, . . . of the just Debt or Duty of such Creditor or Creditors . . . .

13 Eliz., c. 7, § 1 (1570) (Eng.) (clause numbering omitted). *See generally* Treiman, *supra* note 60, at 193-95.

In 1604, the Statute of 1 James expanded the acts of bankruptcy set forth in the Statute of 13 Elizabeth. It added (i) willfully or fraudulently procuring the bankrupt's arrest or the attachment or sequestration of the bankrupt's goods and (ii) making a fraudulent grant or conveyance of property, both with the intent of defrauding creditors, and (iii) continuing to lie in prison for six months after being imprisoned for debt, which need not be done with the intent of defrauding or hindering creditors. 1 Jam., c. 15, § 2, cls. (5), (7), (9) (1604) (Eng.); *see* Treiman, *supra* note 60, at 196.

of the American bankruptcy legislation required that the debtor be in prison for the non-payment of debts.[118]

The Debtor-Insolvency Principle is a precondition to Congress's power under the Bankruptcy Clause to override state law entitlements of creditors. The purpose of the permissible bankruptcy rules that alter the state rights of the debtor or creditor is specifically to solve the basic social problem of an insolvent debtor who cannot repay her creditors. The Debtor-Insolvency Principle prevents debtors and creditors from taking advantage of these rules, which are not available under nonbankruptcy law, to alter the rights of debtors and their creditors when the debtors can repay their creditors.[119]

IV. THE CODE UNDER THE CONSTITUTION: COMPLIANCE AND DEFIANCE

The Code reflects the three principles discussed above that directly govern the extent to which Congress may alter the state law rights of debtors and creditors.[120] As I discuss in Parts IV. A and B below, it

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The 1623 Statute of 21 James added several new acts of bankruptcy. These included petitioning the King or the courts to compel any creditor to accept less than full payment of the creditor's debt or for an extension of time to pay a debt; lying in prison for more than two months after being arrested for nonpayment of a debt; or escaping from prison after being arrested for a debt of £100 or more. 21 Jam., c. 19, § 2, cls. (5), (7), (8) (1623) (Eng.). These provisions remained a feature of bankruptcy law through the eighteenth century. *See* William Cooke, A Compendious System of The Bankrupt Laws 86-89 (Dublin, 1786).

Other provisions included failing to pay a debt of £100 or more within six months after it was due and being arrested for the debt, and obtaining release ["enlargement"] from prison by obtaining bail. 21 Jam., c. 19, § 2, cls. (6), (8). These acts of bankruptcy were repealed in 1711. 10 Ann., c. 15, § 1 (1711) (Eng.).

The 1785 Pennsylvania Bankruptcy Act essentially copied all of the "acts of bankruptcy" of the English Bankrupt Acts. *See* An Act for the Regulation of Bankruptcy, c. 1183, 1785 Pa. Stat. § 1, *in* 12 The Statutes at Large of Pennsylvania From 1682 to 1801, at 70 (Clarence M. Bush, St. printer, 1896).

118. *See supra* notes 79-80 & 91 and accompanying text.

119. *See also* Plank, *Constitutional Limits*, *supra* note 53, at 545-56 (explaining the extent to which courts refuse to permit solvent debtors from abusing the bankruptcy process to obtain a benefit that they could not obtain outside of bankruptcy); Plank, *Bankruptcy Judges*, *supra* note 64, at 629-36 (arguing that bankruptcy judges need not be appointed for life under Article III of the U.S. Constitution so long as their activities are limited to the permissible scope of bankruptcy law, the adjustment of the insolvent debtor-creditor relationship).

120. The article addresses the relationship between bankruptcy law and state law. As noted above, the Bankruptcy Code also refers specifically to federal law. *See supra* note 30. More generally, the Bankruptcy Code refers to nonbankruptcy law, which includes federal nonbankruptcy law. *See, e.g.*, Patterson v. Shumate, 504 U.S. 753, 757-60 (1992). In this case, the Court held that the anti-alienation requirements of the Employment Retirement Income Security Act, 29 U.S.C. § 1056(d)(1) (2000) (requiring qualified pension plans to provide that benefits may not be assigned or alienated), was applicable nonbankruptcy law for purposes of section 541(c)(2), which provides that a restriction on the transfer of a beneficial interest of the debtor in a trust that is enforceable under applicable nonbankruptcy law is enforceable in a bankruptcy case under this title. *Id.* at 765-66. In doing so, the Court rejected those

has broadly defined the property interests of the debtor that may be used to repay creditors, and it has broadly defined the creditors who may share in those property interests. In doing so, it has generally respected the Non-Expropriation Principle while implementing the Non-Interference Principle. In a few instances, however, the Code authorizes the expropriation of the property interests of Third Parties for the benefit of debtors and their creditors.

The case of executory contracts and leases presents a more complicated picture of the interrelationship of the three principles. There are two reasons for this complexity. First, each executory contract or lease represents both a contingent asset and a contingent liability. Second, the other party to the executory contract or lease may have rights both as a Third Party (generally, with regard to future activities) and as a creditor holding a pre-petition claim. I address this interrelationship below in Part IV. C. Finally, Part IV. D analyzes how the abolition of "ipso-facto" provisions is consistent with the three principles.

A. *The Property Available to Creditors*

1. Broad Inclusion of the Debtor's Property

The Code implements the Debtor-Creditor Adjustment Principle to a substantial degree by broadly defining the property of the estate to

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federal court decisions that held that the exclusion of 541(b)(2) applied only to valid spendthrift trusts under state law. *Id.* at 760-61.

In other cases, the Code may not specifically refer to federal law or nonbankruptcy law but the application of the Code nevertheless requires reconciling a conflict between bankruptcy law and federal nonbankruptcy law. *See, e.g.*, NLRB v. Bildisco & Bildisco, 465 U.S. 513 (1984). In this case, the Court reconciled a conflict between the Code and the National Labor Relations Act, 29 U.S.C. § 158(d) (2000), *see Bildisco*, 465 U.S. at 523, and held that (1) section 365 of the Code authorized the debtor in possession to reject a labor agreement without complying with the procedural requirements of the National Labor Relations Act, *see id.* at 526-27 (noting, however, that the bankruptcy court should take into account the policies of the NLRA and not approve rejection unless persuaded that reasonable efforts to negotiate a voluntary solution were made but those negotiations were not likely to produce a prompt settlement) and (2) the debtor's failure to comply with the collective bargaining agreement during the bankruptcy case was not an unfair labor practice under the NLRA. *See id.* at 531-34.

Although the Court treated this as a matter of statutory interpretation requiring reconciliation of different provisions of the Bankruptcy Code and the NLRA, this statutory conflict contains a constitutional element. To the extent that any federal law creates rights in favor of Third Parties, the Bankruptcy Code may not violate the Non-Expropriation Principle and abrogate those rights. Of course, a federal court may interpret the federal nonbankruptcy law in a way that accommodates the Bankruptcy Code or its policies. The constitutional dimension still exists, but the fact that both the bankruptcy law and federal nonbankruptcy law emanate from the same sovereign governments eases the task of reconciling any conflict between the two bodies of law.

include "all legal or equitable interests of the debtor in property" as of the filing of the petition.[121] The Code then authorizes the trustee to use, sell, or lease property of the estate[122] and to sell property in which the estate has an interest under specified circumstances.[123]

The Code could go further. First, the Code could define property of the estate in all cases to include some or all of the income of an individual debtor earned after the filing of the bankruptcy petition.[124] Some authorities[125] have expressed a concern that the mandatory inclusion of the postpetition income of an individual debtor in the property of the estate[126] would violate the Thirteenth Amendment's prohibition against involuntary servitude.[127] I would disagree with this view. There is no constitutional right to have a discharge in bankruptcy.[128] Without a discharge, the debtor's income remains

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121. 11 U.S.C. § 541(a)(1) (2000), quoted *supra* note 36.

122. *See id.* § 363(b), (c).

123. *See id.* § 363(f).

124. The Code excludes this income because (a) this income is not an interest in property as of the commencement of the estate and (b) to the extent that this income could be seen as the proceeds of a contract that was property of the estate, it is expressly excluded under section 541(a)(1). *See generally* Louis M. Phillips & Tanya Martinez Shively, *Ruminations on Property of the Estate—Does Anyone Know Why a Debtor's Postpetition Earnings, Generated by Her Own Earning Capacity, Are Not Property of the Bankruptcy Estate?*, 58 La. L. Rev. 623 (1998).

125. *See, e.g.*, H.R. Rep. No. 95-595, at 120 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6080-81; *Karen Gross, The Debtor as Modern Day Peon: A Problem of Unconstitutional Conditions*, 65 Notre Dame L. Rev. 165, 167-68 (1990); *see also In re* Fluharty, 23. B.R. 426, 428 (Bankr. N.D. Ohio 1982) (holding that a creditor could not move for modification of a Chapter 13 plan, and stating that a debtor may not be required to file a Chapter 13 petition, "as it has been suggested that this may be in violation of the Thirteenth Amendment's prohibition against involuntary servitude"). *But see* Steven L. Harris, *A Reply to Theodore Eisenberg's Bankruptcy Law in Perspective*, 30 UCLA L. Rev. 327, 348-49 (1982) (suggesting that the non-mandatory nature of Chapter 13 reflects a policy preference and not a strong conviction that a mandatory Chapter 13 would violate the Thirteenth Amendment). *See also* Theodore Eisenberg, *Bankruptcy Law in Perspective*, 28 UCLA L. Rev. 953, 988 (1981) (arguing that requiring debtors to repay debts would not violate the Thirteenth Amendment); Kenneth N. Klee, *Restructuring Individual Debts*, 71 Am. Bankr. L.J. 431, 447-49 (1997) (same).

126. The Code includes in property of the estate the postpetition income of debtors who file a petition for relief under Chapter 13. *See* 11 U.S.C. § 1306 (2000) (including in property of the estate (1) all property specified in section 541 that the debtor acquires during the case, and (2) earnings from services performed by the debtor during the case). Chapter 13 cases, however, can only be initiated by the debtor and not by creditors. *See id.* § 1321.

127. *See* U.S. Const. amend. XIII, § 1 ("Neither slavery nor involuntary servitude, except as a punishment for crime whereof the party shall have been duly convicted, shall exist within the United States, or any place subject to their jurisdiction.").

128. *See, e.g.*, United States v. Kras, 409 U.S. 434, 446-47 (1973) (holding that there was no constitutional right to a bankruptcy discharge and therefore an individual had no right to waiver of bankruptcy filing fees); In re Krohn, 886 F.2d 123, 127 (6th Cir. 1989) (affirming the dismissal of an individual's Chapter 7 petition for substantial abuse); *In re* Herberman, 122 B.R. 273, 283-85 (Bankr. W.D. Tex 1990) (holding that a plan requiring an individual debtor in Chapter 11 to receive only 75% portion of the individual's gross billing revenues (less expenses) did not violate the

subject to the claims of creditors. Hence, requiring a debtor to devote postpetition income to the repayment of creditors does not put the debtor in a worse position than he or she would be without a discharge. Nevertheless, there may be good policy reasons for not including an individual debtor's postpetition income. This issue arises in the recent debate over the extent to which an individual's right to obtain a discharge should be "means tested," that is, limited to those individuals who do not have sufficient postpetition income to repay their debts.[129]

In addition, Congress need not limit the powers of the trustee to "interests in property." Any privilege or right that a debtor could use for the repayment of creditors could be used by the bankruptcy trustee. For example, the bankruptcy court in *In re McCourt*[130] held that an individual debtor's statutory right under New York law to elect to take one-third of his wife's estate in lieu of the amount left under the wife's will was not property of the estate. This decision, in my view, is a correct decision. Nevertheless, Congress could specifically authorize the trustee to exercise these kinds of privileges to the same extent that the debtor could. On the other hand, these circumstances may be sufficiently rare as not to justify the effort of crafting the necessary language that would not be too broad.

The Code does allow the trustee to recapture property interests that the debtor transferred before bankruptcy to Third Parties for the purpose of defrauding its creditors.[131] The recapture of property interests transferred to Third Parties who colluded with the debtor to defraud the debtor's creditors does not violate the Non-Expropriation Principle if those Third Parties do not acquire a legitimate property

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Thirteenth Amendment).

129. *See generally* Skeel, *supra* note 11, at 154, 194-96, 204-05; Jean Braucher, *Means Testing Consumer Bankruptcy: The Problem of Means*, 7 Fordham J. Corp. L. 407 (2002) (arguing that the proposed 2002 consumer bankruptcy legislation adopting a complicated means testing procedure would impose greater burdens on the innocent, but unfortunate, individual debtor without any significant reduction in the few abusers of the current bankruptcy process or increase of collections in bankruptcy); Jean Braucher, *Increasing Uniformity in Consumer Bankruptcy: Means Testing as a Distraction and the National Bankruptcy Review Commission's Proposals as a Starting Point*, 6 Am. Bankr. Inst. L. Rev. 1 (1998) (criticizing means testing in several bills introduced in Congress in 1998); Melissa B. Jacoby, *Collecting Debts from the Ill and Injured: The Rhetorical Significance, But Practical Irrelevance, of Culpability and Ability to Pay*, 51 Am. U. L. Rev. 229, 253-62 (2001); Ted Janger, *Crystals and Mud in Bankruptcy Law: Judicial Competence and Statutory Design*, 43 Ariz. L. Rev. 559, 615-20 (2001) (explaining why the then pending proposals for means testing create "a rule that is likely to accomplish virtually none of the stated goals of its drafters"); Zachary Price, *The Bankruptcy Abuse Prevention and Consumer Protection Act*, 39 Harv. J. Legis. 237 (2002) (criticizing the version of the bankruptcy reform pending in the 107th Congress); Charles Jordan Tabb, *The Death of Consumer Bankruptcy in the United States?*, 18 Bankr. Dev. J. 1 (2001) (discussing recent trends in consumer bankruptcy laws).

130. 12 B.R. 587 (Bankr. S.D.N.Y. 1981).

131. *See* 11 U.S.C. § 548 (2000).

interest or if under state law a creditor could avoid the transfer. Similarly, the Code allows the trustee to recapture property interests that the debtor transferred before bankruptcy to preferred creditors on the eve of bankruptcy.[132] The ability to avoid preferential transfers does not violate the Non-Expropriation Principle because this avoidance power simply recaptures property that would, without such preferential transfer, be available to all creditors. Moreover, the avoidance of preferential transfers is also justified under the Non-Interference Principle. The avoidance of preferences prevents creditors who get the first hint of the insolvency of the debtor from avoiding the mandatory collective action of a bankruptcy by obtaining payment on the eve of a filing.

In addition, the trustee under the strong arm power may avoid the unperfected transfer of a property interest to Third Parties if a lien creditor could take priority over the transferee.[133] This power falls within the Bankruptcy Clause because, absent a bankruptcy filing, a lien creditor retains the power to levy on that property interest for payment of its debt.[134] Similarly, the trustee may avoid the unperfected transfer of real property to a Third Party if a bona fide purchaser for value could take priority over the transferee.[135] Allowing the trustee to recapture this real property interest does not violate the nonbankruptcy rights of the prior unperfected transferee because outside of bankruptcy, notwithstanding the prior unperfected transfer, the debtor retains the power to sell that real property to a bona fide purchaser.[136]

By defining the estate as "all of the legal or equitable interests of the debtor in property," the Code necessarily requires that any conditions or limitations inherent in those property interests must be respected.[137] Under the Non-Expropriation Principle, the Code must do so. For example, assume that *O* had conveyed Blackacre to *D* in fee simple determinable so long as *D* does not serve liquor on the premises and upon *D* serving liquor on the premises, Blackacre automatically reverts to *O*. If *D* files a bankruptcy petition, the estate remains subject to the limitation that the fee simple will terminate if

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132. *See id.* § 547.

133. *See id.* § 544(a)(1).

134. *See* U.C.C. § 9-317(a)(2) (2001).

135. *See* 11 U.S.C. § 544(a)(3) (2000).

136. *See, e.g.*, William B. Stoebuck & Dale A. Whitman, Law of Property § 11.9, at 871-72 (3d ed. 2000) (describing how the recording system may give priority over a later transferee if the first transferee fails to record the instrument of transfer).

137. *See, e.g.*, Thomas E. Plank, *The Outer Boundaries of the Bankruptcy Estate*, 47 Emory L.J. 1193, 1219-34, 1254-62 (1998) [hereinafter Plank *Bankruptcy Estate*] (explaining that Congress intentionally defined property of the estate to contain only those specific rights in a property item that a debtor had and how *Citizens Bank of Maryland v. Strumpf*, 516 U.S. 16, 21 (1995), endorsed this explicit definition of property of the estate to exclude from property of the estate the rights that an entity other than the estate has in the property item).

the trustee serves liquor on the premises. Even though Blackacre may become more valuable without the ban on serving liquor, both the express definition of property of the estate and the Non-Expropriation Principle prevent the bankruptcy trustee from freeing Blackacre of the limitation.

The only exceptions to the requirement to respect conditions and limitations inherent in the debtor's property interests are those that fall within the Non-Interference Principle. Hence, as discussed in Part IV.D below, the Code abrogates certain "ipso-facto" provisions that purport to modify or terminate the debtor's rights if the debtor files for bankruptcy. Further, the Code properly disregards anti-assignment provisions that purport to prevent property interests of the debtor from becoming property of the estate.[138] This abrogation of state law rights is fully within the Non-Interference Principle. To the extent that the debtor has an interest in property, the trustee for the debtor should be able to succeed to those interests even if state law or an anti-assignment provision enforceable under state law would prevent a transfer of those interests to another person.

Whether the trustee can later sell a property interest without regard to the state law limitations on assignment is a different question. To the extent that the anti-assignment provisions are part of an interest of a Third Party, other sections of the Code generally protect[139] the state law rights of the Third Party. In a few instances, such as disregarding a spouse's interests as a tenant by the entireties, the Code violates the Non-Expropriation Principle by overruling the state law rights of one spouse who is a tenant by the entirety to prevent alienation of the other spouse's interest in the tenancy by the entirety.[140] The Code also abrogates anti-assignment provisions in the case of the assumption and assignment of executory interests and leases, and as discussed below in Part IV.C, the Code in some instances authorizes a violation of the Non-Expropriation Principle.

2. Constitutional Violations: Expansion of the Estate by Expropriation

In a few sections, the Code violates the Non-Expropriation Principle by expropriating the property interests of Third Parties for the benefit of creditors. The most significant violations occur in section 363(h). Section 363(h) is, in essence, a federal "partition by sale" statute that applies only in bankruptcy. It permits a bankruptcy court to sell a property item in which the estate has an interest and a

138. *See* 11 U.S.C. § 541(c)(1)(A) (2000).

139. *See id.* § 363(f) (providing that the "trustee may sell property under subsection (b) or (c) of this section free and clear of any interest in such property of an entity other than the estate, only if" the conditions of that subsection are satisfied).

140. *See infra* note 141 and accompanying text (describing the abrogation of the rights of a tenant by the entirety).

Third Party has an interest as a co-tenant if certain conditions are satisfied.[141] These conditions displace state law.

Under state law, a co-tenant has a right to partition a jointly owned property item, such as a parcel of land.[142] This partition may be a partition in kind—a physical division of the property item—or a partition by sale—a judicial sale of the property item and the division of the proceeds of sale.[143] The parties, however, may agree that the property item may not be partitioned, and state law generally will honor the agreement if the restriction is limited to a reasonable time or if the agreement is necessary to carry out the purpose of the co-tenancy.[144]

The conditions set forth in section 363(h) of the Code do not take into account the enforceability of agreements not to partition. The key conditions of section 363(h) are that (i) sale of the estate's undivided interest in the property item would realize significantly less

141. Section 363(h) provides:

> Notwithstanding subsection (f) of this section, the trustee may sell both the estate's interest, under subsection (b) or (c) of this section, and the interest of any co-owner in property in which the debtor had, at the time of the commencement of the case, an undivided interest as a tenant in common, joint tenant, or tenant by the entirety, only if—
> (1) partition in kind of such property among the estate and such co-owners is impracticable;
> (2) sale of the estate's undivided interest in such property would realize significantly less for the estate than sale of such property free of the interests of such co-owners;
> (3) the benefit to the estate of a sale of such property free of the interests of co-owners outweighs the detriment, if any, to such co-owners; and
> (4) such property is not used in the production, transmission, or distribution, for sale, of electric energy or of natural or synthetic gas for heat, light, or power.

See 11 U.S.C. § 363(h) (2000).

142. *See, e.g.*, Stoebuck & Whitman, *supra* note 136, § 5.11, at 215-16 (discussing the availability of judicial partition); *see also* 7 Powell on Real Property § 50.07[3][a], at 50-40 (Richard R. Powell & Michael Alan Wolf eds., 2002) ("Each tenant in common has the right to compel partition of the estate under judicial supervision.")

143. *See* 7 Powell on Real Property, *supra* note 142, § 50.03[7][c], at 50-42 & n. 29; Stoebuck & Whitman, *supra* note 136, § 5.13, at 221-24.

144. *See* Stoebuck & Whitman, *supra* note 136, § 5.11, at 216-17; Wade R. Habeeb, *Annotation, Contractual Provisions as Affecting Right to Judicial Partition*, 37 A.L.R.3d 962, 967-73 (1971). In addition, courts have implied a waiver of partition when partition would frustrate the initial purpose of the co-tenants. *Id.* at 976. The waiver of partition, however, may only extend for a reasonable time, and an agreement never to partition property would not be enforceable. *Id.; see also* Duffy v. Duffy, 81 Pa. D. & C. 366, 372 (1951) (denying partition of a home purchased in 1942 by a brother and two sisters as joint tenants to serve as a family home because of an oral agreement among the siblings that the property not be partitioned until there were only one survivor); Coleman v. Coleman, 19 Pa. 100, 107 (1852) (upholding an agreement among co-tenants made in 1787 not to partition property containing iron ore because the purpose of the agreement was still being served; the court noted that "[I]f the ore should fail (a contingency which at that day may have been deemed probable), or the manufacture of iron on the estate should cease, the agreement would have accomplished its mission, and the hills might then be parted").

for the estate than sale of the property item free of the interests of the co-owners, and (ii) the benefit to the estate of a sale of the property item free of the interests of co-owners outweighs any detriment to such co-owners.[145]

The test that balances the benefits to the estate against the detriments of the Third Party violates the Non-Expropriation Principle. This federal balancing test replaces the protections that state law provides to co-tenants. A bankruptcy trustee need only resort to section 363(h) if she cannot force the sale of the property item under section 363(f). Section 363(f)(1) specifically authorizes the bankruptcy trustee to sell a property item free of any interest of any other person if applicable nonbankruptcy law permitted such a sale.[146] Because state law already allows for a partition sale, a bankruptcy trustee need only resort to section 363(h) if the co-tenants had entered into an agreement not to partition the property item enforceable under state law. Accordingly, the Code allows the trustee to override the interests of the Third Party co-tenant if the benefit to the estate is greater than the detriment to the co-tenant.

This is not a trivial matter. Every co-tenant has the right to use the jointly owned property item. The ability of a bankruptcy trustee under section 363(h) to force a partition sale notwithstanding an agreement of the co-tenants inhibits the ability of one co-tenant to develop the jointly owned property item and to obtain financing for such development. Any person, including a creditor, potential tenants, and interested government agencies, dealing with the co-tenant who proposes to develop the property item must take into account the possibility that the co-tenant will become a debtor under the Code. The evaluation of this risk is a normal part of any development project. Under section 363(h), however, that person must also take into account the possibility that one of the other co-tenants will also become a debtor under the Code. If the bankruptcy court orders a sale of the jointly owned property item, a non-debtor co-tenant does have the right to buy the entire property item.[147] However, the non-

145. *See* 11 U.S.C. § 363(h)(1) (2000), quoted *supra* note 141. The first condition, that partition in kind be impracticable, *see id.*, mirrors state law. *See, e.g.*, Stoebuck & Whitman, *supra* note 136, § 5.13, at 222-23 (stating that courts have a preference for partition in kind, but that all states allow partition by sale whenever a fair and equitable physical division of the property is impossible, and that most partition actions result in partition by sale); Candace Reid, Note, *Partitions in Kind: A Preference Without Favor*, 7 Cardozo L. Rev. 855, 864-72 (1986) (arguing that, notwithstanding the common statement of the preference for partition in kind, courts in practice favor partition by sale).

146. 11 U.S.C. § 363(f)(1) (2000) (providing that the "trustee may sell property under subsection (b) or (c) of this section free and clear of any interest in such property of an entity other than the estate, only if (1) applicable nonbankruptcy law permits sale of such property free and clear of such interest").

147. *See id.* § 363(i) (providing that before the consummation of a sale of property under (h), "the co-owner may purchase such property at the price at which such sale

debtor co-tenant may not have sufficient liquid resources at the time of the sale to do so. In fact, the co-ownership structure may have been used precisely because of a lack of sufficient equity funds by the co-owner developing the property item.[148]

Indeed, Congress explicitly recognized the importance of protecting facilities that produce or distribute electricity and gas from partition by sale by a bankruptcy court.[149] The Non-Expropriation Principle requires that, to the extent that state law protects a co-tenant of any property item from a partition by sale, the Code must respect such a limitation.

Other violations of the Non-Expropriation Principle include the ability of the trustee to sell property items free of a spouse's interest as a tenant by the entirety[150] and a spouse's rights of dower or curtesy.[151] Further, the ability of the trustee under the Code to reclaim a property item fraudulently transferred to a good faith purchaser in exchange for the value given by that purchaser also violates the principle because it would deprive the purchaser of the

is to be consummated").

148. For example, if a sole owner of a development project valued at $100 million obtained an 80% loan for $80 million, the owner would only need to provide $20 million of equity to complete the development. However, if a 90% co-owner of the project obtained the 80% loan for $80 million (secured by the entire project), the co-owner would only need to provide $10 million of equity and the other co-owner would provide the remaining $10 million.

149. *See* 11 U.S.C. § 363(h)(4) (2000), quoted *supra* note 141; Statement of Representative Edwards, 124 Cong. Rec. H11089, H11093, *reprinted in* 1978 U.S.C.C.A.N. 6436, 6446:

> Section 363(h) of the House amendment adopts a new paragraph (4) representing a compromise between the House bill and the Senate amendment. The provision adds a limitation indicating that a trustee or debtor in possession sell jointly owned property only if the property is not used in the production, transmission, or distribution for sale, of electric energy or of natural or synthetic gas for heat, light, or power. This limitation is intended to protect public utilities from being deprived of power sources because of the bankruptcy of a joint owner.

150. The conditions for sale set forth in section 363(h) do not adequately protect the substantial property interests of a tenant by the entireties in about 30 states, which give a tenant by the entirety a right of survivorship that can be destroyed only by a divorce or voluntary joint conveyance and that also prevent, in some states, the complete alienation of one spouse's interests without the consent of the other spouse. *See* 7 Powell on Real Property, *supra* note 142, § 52.01[3], at 52-4 through -12 (surveying the laws in 30 states and the District of Columbia); Stoebuck & Whitman, *supra* note 136, § 5.5, at 195-97 (describing the limitations on the individual tenants' rights); *see also* Plank, *Constitutional Limits*, *supra* note 53, at 571-74 (discussing in greater detail the affect of the abolition of a spouse's property rights).

151. *See* 11 U.S.C. § 363(g) (stating that "the trustee may sell property under subsection (b) or (c) of this section free and clear of any vested or contingent right in the nature of dower or curtesy"). Curtesy has been abolished in all states, and dower has been abolished in all but a few states and does not appear to be a significant property interest in those states. *See* 2 Powell on Real Property, *supra* note 142, § 15.08, at 15-95 through 15-98; Stoebuck & Whitman, *supra* note 136, § 2.14, at 69-72. Hence, the constitutional violation is minor. Nevertheless, it is a violation.

appreciation in the market value of the property item after the transfer.[152] Finally, as discussed in Part III.C below, certain of the provisions of the Code authorizing the assumption and assignment of executory contracts and leases expropriates the property rights of Third Parties for the benefit of debtors and their creditors.

B. *The Creditors Who May Share*

1. Defining the Creditor

The initial question in implementing the Debtor-Creditor Adjustment Principle is the definition of a creditor who may share in the assets of the debtor. The Code defines a "creditor" as a person holding a "claim" that "arose" before the order for relief.[153] A claim is a "right to payment," even if unliquidated, contingent, unmatured, or disputed.[154] The Code does not define either "right to payment" or "arose." As a threshold constitutional matter, the definition of "right to payment" or "arose" is a matter of nonbankruptcy law. A "right to payment" must exist under nonbankruptcy law. The time when it "arises" must also be determined under nonbankruptcy law.

In most instances, it is not difficult to determine who is a creditor. A person who signs a note or purchases goods on account incurs an obligation to pay, and the payee has a right to payment that arose at the time of the signing of the note or the purchase of the goods.[155] If the obligor later files a bankruptcy petition, the payee becomes a "creditor" with a right to payment that arose before the commencement of the case.[156] Similarly, if a person injures another in an automobile accident and then files a bankruptcy petition, the

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152. *See* 11 U.S.C. §§ 548 (a)(1)(B)(c) (providing that, if a debtor conveys property with actual intent to defraud creditors, and the transferee does not know of or participate in the fraud, the Code allows the trustee to the avoid the transfer and simply return the original consideration). The trustee would only avoid such a transfer if the property item had appreciated in value between the time of purchase, which could have been up to one year before the filing of the petition, see *id.* § 548(a)(1), and the time the trustee initiates a fraudulent conveyance avoidance action, which could be up to three years, after the filing of the petition, see *id.* § 546(a).

In the case of a constructively fraudulent transfer, which requires that a transferee takes property for less than reasonably equivalent value, avoided under § 548(a)(1)(B), the transferee is or should be on notice that she received less than reasonably equivalent value and therefore is not entitled to any appreciation in the value of the property.

153. *See id.* § 101(10), quoted *supra* note 44.

154. *See id.* § 101(5), quoted *supra* note 45.

155. *See, e.g.,* U.C.C. § 3-412 (2001) (providing that an issuer of a note is obligated to pay the note according to its terms at the time of issuance); *id.* § 9-102(a)(2) (defining "account" to mean a right to payment of a monetary obligation for various purposes).

156. *See* Charles J. Tabb, The Law of Bankruptcy § 7.1, at 471, § 7.2, at 472 (1997) [hereinafter Tabb, Bankruptcy].

victim will have a cause of action and a right to payment for her injuries that arose before the bankruptcy petition.[157] Even contingent obligations, such as a guarantee by one person of the payment of a debt by another, create a right to payment at the time of the issuance of the guarantee. If the guarantor becomes a debtor, the payee on the debt will have a contingent claim against the guarantor and will be a creditor.[158]

The question of when a right to payment arises has troubled many bankruptcy courts in the case of latent torts, when the injury may not become manifest until long after the conduct that produced the injury. Bankruptcy courts have generally used three different tests: the conduct test, the relationship test, and the state law accrual test.[159] Under the conduct test, the claim of a victim arises at the time of the conduct that causes injury. Under the relationship test, the claim arises at the later of the time of the conduct or the time that the victim and the tortfeasor enter into a relationship. Under the state law accrual test, the claim arises when the cause of action "accrues" under various state law tests, most commonly when the victim discovers the injury and the cause of action begins to accrue for purposes of the statute of limitations.

An example will illustrate these tests. Assume that, in Year 1, Manufacturer manufactures an airplane that contains a latent defect and, without knowledge of the defect, sells the airplane to Pilot. In Year 3, because of the defect in the airplane, the airplane crashes and injures both Pilot and Bystander.

Under the conduct test, a claim for liability of either Pilot or Bystander arises when Manufacturer manufactures and sells the airplane in Year 1.[160] Under the relationship test, the claim of Pilot arises when Pilot purchases the airplane in Year 1, and the claim of Bystander arises when Bystander is injured by Manufacturer's airplane in Year 3 because that is when Bystander has a "relationship" with the Manufacturer. Finally, under the state law accrual test, in a state that follows the discovery rule for its statute of limitations,[161] the claims of Pilot and Bystander arise in Year 3 when the airplane

157. *See id.* § 7.1, at 469, § 7.2, at 473.

158. *See* S. Rep. No. 95-989, at 22 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5808; Tabb, Bankruptcy, *supra* note 156, § 7.2, at 472-73.

159. *See, e.g.*, Epstein v. Official Comm. of Unsec. Cred. of Estate of Piper Aircraft Corp., 58 F.3d 1573, 1576-77 (11th Cir. 1995); Alan N. Resnick, *Bankruptcy as a Vehicle for Resolving Enterprise-Threatening Mass Tort Liability*, 148 U. Pa. L. Rev. 2045, 2070-75 (2000) (also identifying a fourth test, the "fair contemplation test" and advocating the adoption of a modified conduct test). *See* NBRC Rep., *supra* note 7, § 2.1.1, at 323; Tabb, Bankruptcy, *supra* note 156, § 7.2, at 473-75.

160. *See also* U.C.C. § 2-314(1) (2001) (providing that in every sale of a good there is implied a warranty of merchantability).

161. *See* Dan B. Dobbs, The Law of Torts § 218, at 554-57 (2000).

crashes, causes injury to Pilot and Bystander, and each therefore discovers the existence of the defect.

Assume further that, in Year 2, Manufacturer files a bankruptcy petition, the bankruptcy case is administered, and the bankruptcy court determines that all of Manufacturer's creditors other than Pilot and Bystander would receive payment of approximately 50% of the value of their claims either through a liquidation of Manufacturer's assets or through confirmation of Manufacturer's plans. Assume further either that Manufacturer receives a discharge from all prepetition debts pursuant to a reorganization plan[162] or, as an individual, in a Chapter 7 liquidation,[163] or that Manufacturer as a corporation is liquidated and all its assets are distributed.[164]

Under the conduct test, both Pilot and Bystander would be "creditors" whose claim arose before the filing of the petition in Year 2 and would share in the liquidation of Manufacturer's assets or receive the benefits of Manufacturer's reorganization plan but whose claims would be discharged (or in the case of a corporate liquidation, all of whose assets would be distributed). Hence, neither Pilot nor Bystander could collect their claims from the post-discharge income or property of Manufacturer.

Under the relationship test, Pilot would be a "creditor" whose claim arose in Year 1, before the petition, and who would share in the liquidation of Manufacturer's assets (or receive the benefits of Manufacturer's reorganization plan) but whose claim would be discharged. Bystander would not be a "creditor" who would share in the liquidation of Manufacturer's assets (or receive the benefits of Manufacturer's reorganization plan) and Bystander's claim would not be discharged because Bystander did not have a relationship with the Manufacturer until after the filing of the bankruptcy petition. Therefore, although Pilot could not collect her claims from the post-discharge income or property of Manufacturer, Bystander could collect her claims from the post-discharge income or property of Manufacturer, if there were any.

Finally, under the state law accrual-discovery test, neither Pilot nor Bystander would be a "creditor" who would share in the liquidation of Manufacturer's assets (or receive the benefits of Manufacturer's reorganization plan). The claims of neither Pilot nor Bystander would

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162. *See* 11 U.S.C. § 1141(d) (2000) (providing that the effect of a confirmed Chapter 11 plan is to discharge the debts of the debtor); *id.* § 1228 (authorizing a discharge of debts of a debtor in a Chapter 12 case upon completion of all payments required by a confirmed plan); *id.* § 1328 (same for debtor in a Chapter 13 case).

163. *See id.* § 727 (providing when an individual may receive a discharge of debts in Chapter 7).

164. Corporations that liquidate under Chapter 7 do not receive a discharge, *see id.* § 727(a)(1), but do not need one. All assets of the corporation are used to pay expenses and creditors and the corporation remains an empty shell that will eventually be dissolved under state law.

be discharged and, therefore, both Pilot and Bystander could collect their claims from any post-discharge income or property of Manufacturer.

The practical effects of the different treatment of the claims of Pilot and Bystander are further complicated by the nature of Manufacturer and the nature of the bankruptcy relief. If Manufacturer is an individual who earns income after the discharge, Pilot and Bystander might be better off not being "creditors" because they might be able to obtain full payment from Manufacturer's postpetition income and accumulated property. Similarly, if Manufacturer is a corporation that successfully reorganizes under Chapter 11 of the Code, Pilot and Bystander might be better off not being "creditors" because they might be able to obtain full payment from Manufacturer's postpetition income and accumulated property. However, if their claims are of such a magnitude that prevents the confirmation and consummation of a reorganization plan, Manufacturer will be liquidated. If Manufacturer liquidates as a corporation under Chapter 7 of the Code, Pilot and Bystander would be better off being "creditors" because they could at least share in Manufacturer's existing assets. Those who are not "creditors" can only seek payment against an empty shell. Therefore, if Manufacturer is a corporation, the ability of Manufacturer to reorganize under Chapter 11 may depend on whether Pilot and Bystander are included in the reorganization plan as creditors.

These results are summarized in the following table:

Test	Share: current assets	Share: future income of individual or reorganized corporation; claim against liquidated corporate shell	Discharge for individual or reorganized corporation
Conduct	Pilot; Bystander	None	Pilot; Bystander
Relationship	Pilot	Bystander	Pilot
State accrual	None	Pilot; Bystander	None

In my view, the Bankruptcy Clause permits the broadest definition of a claim, that is, a definition of a claim based on the conduct test because, under state law, a claim comes into existence at the time of the conduct. Latent defects in products and latent torts in the case of services present two unknowns: whether (and when) a right to payment will mature and who is the person with the right to payment. These unknown contingencies, however, do not prevent the treatment of the liability that arises out of prepetition conduct as a "right to payment" that "arose" prepetition. Contingent rights to payment, such as a guarantee issued prepetiton, have long been recognized as claims that can be administered in a bankruptcy case.[165] Moreover, if a guarantor issues a guarantee of a negotiable instrument or other type of assignable debt, the identity of the potential future claimant—the holder of the debt—is not known at the time of the issuance of the guarantee. Accordingly, the fact that the issuer of the guarantee does not know if it will have to pay the guarantee or who the future payee will be does not prevent the payee with the guarantee from being a "creditor" with a prepetition claim.

More broadly, any type of human activity—including the manufacturing and selling of products and the provision of services—creates under state law the possibility of a claim that will mature in the future. This reality is well known. For example, assume that Manufacturer is a corporation and that, instead of filing a bankruptcy petition in Year 2, the owner of Manufacturer sells its stock to New Stockholder. In Year 2, New Stockholder will care very much about Manufacturer's possible liability to make payments in the future to claimants for the conduct of Manufacturer in Year 1. New Stockholder will calculate the present value of such future payments and will reduce the purchase price of Manufacturer's stock by that amount. Indeed, a buyer of a business will often structure the transaction to avoid any possible liability for actions taken by Manufacturer in Year 1, such as by purchasing Manufacturer's assets instead of buying the corporate entity. Such a purchase, however, could also create future liability by the purchaser.[166] Hence, for state law purposes, even though Pilot's and Bystander's cause of action against the Manufacturer may not have accrued under a statute of limitations in Year 2 and Manufacturer has no way of knowing the identity of Bystander in Year 2, the actors in the real world will treat the Manufacturer as having a liability based solely on the conduct of Manufacturer in Year 1.

Because of Congress's discretion under the Debtor-Creditor Adjustment Principle, the Code need not include all potential "creditors" in a bankruptcy case. Whether all creditors should be included is a matter of policy.[167] Nevertheless, Congress has implicitly

165. *See, e.g.*, 19 Geo. 2, c. 32, § 2 (1746) (Eng.) (allowing an obligee under certain insurance policies to prove a claim as a creditor of an insurer even if the claim were still a contingent claim at the commencement of the case because the contingency insured against had not occurred by that time).

166. The general rule is that a purchaser of assets for fair consideration does not become liable for the seller's liabilities, even when the purchaser purchases substantially all of the assets of the seller. *See, e.g.*, Schwartz v. McGraw-Edison Co., 92 Cal. Rptr. 776, 783 (Cal. Ct. App. 1971); Dana Corp. v. LTV Corp., 668 A.2d 752, 756 (Del. Ch. 1995); Schumacher v. Richards Shear Co., 451 N.E.2d 195, 198 (N.Y. 1983); Husak v. Berkel, Inc., 341 A.2d 174, 176 (Pa. Super. Ct. 1975). Under certain circumstances, however, a successor may be exposed to liability. *See* Restatement (Third) of Torts § 12, Reporter's Note (1998) (collecting and discussing authorities); Dobbs, *supra* note 161, § 375, at 1040.

167. *See* NBRC Rep., *supra* note 7, §§ 2.1.1-2.1.5, at 315-50 (proposing explicit

adopted the conduct test for those persons who have claims as a result of exposure to asbestos that will mature in the future. Section 524(g) of the Code authorizes a bankruptcy court to enjoin any person from seeking to collect a "demand" for damages resulting from exposure to asbestos against a debtor that reorganizes pursuant to a plan that meets the requirements of the section.[168] One of the requirements is that the reorganization plan establishes a trust fund to fund payments to persons who may make such a "demand." The section also defines a "demand" as a demand for payment that is not a "claim" in the bankruptcy case.[169]

Section 524(g) essentially adopts the solution to latent asbestos tort claims in the Johns-Manville bankruptcy reorganization. In that case, Johns-Manville Corporation attempted to reorganize in the face of substantial liability to persons who would have a future matured claim for damages from exposure to asbestos that Johns-Manville

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treatment of mass future claims in bankruptcy); Jeffrey Davis, *Cramming Down Future Claims in Bankruptcy: Fairness, Bankruptcy Policy, Due Process, and the Lessons of the Piper Reorganization*, 70 Am. Bankr. L.J. 329, 330, 361-62 (1996) (arguing that all future claims based on prepetition conduct be treated as prepetition or preconfirmation claims but proposing a flexible approach that would allow such claims to be included or excluded from the bankruptcy process); Kathryn R. Heidt, *Future Claims in Bankruptcy: The NBC Amendments Do Not Go Far Enough*, 69 Am. Bankr. L.J. 515, 522 (1995) (proposing that Congress adopt the conduct test for when a claim has arisen); Kathryn R. Heidt, *Products Liability, Mass Torts and Environmental Obligations in Bankruptcy: Suggestions for Reform*, 3 Am. Bankr. Inst. L. Rev. 117, 127 (1995) (same); Frederick Tung, *Taking Future Claims Seriously: Future Claims and Successor Liability in Bankruptcy*, 49 Case Western Res. L. Rev. 435, 442, 495-97 (1999) (arguing that all claims arising out of the debtor's prepetition conduct should be included in a bankruptcy case).

In addition to policy considerations, Congressional authorization of the discharge of claims deemed to arise at the time of the prepetition conduct must satisfy other constitutional limitations, such as the Fifth Amendment. *See, e.g.*, Davis, *supra*, at 375-79 (arguing that subjecting all future claims to bankruptcy process would satisfy due process concerns); Ralph R. Mabey & Jamie Andra Gavrin, *Constitutional Limitations on the Discharge of Future Claims in Bankruptcy*, 44 S.C. L. Rev. 745, 760-84 (1993) (arguing that the discharge of future claims in a bankruptcy is constitutional under the Fifth Amendment).

168. *See* 11 U.S.C. § 524(g)(1) (2000) (providing that (A) "a court that enters an order confirming a plan of reorganization under Chapter 11 may issue, in connection with such order, an injunction in accordance with this subsection to supplement the injunctive effect of a discharge under this section" and (B) that an "injunction may be issued under subparagraph (A) to enjoin entities from taking legal action for the purpose of directly or indirectly collecting, recovering, or receiving payment or recovery with respect to any claim or demand that, under a plan of reorganization, is to be paid in whole or in part by a trust described in paragraph (2)(B)(i)").

169. *See id.* § 524(g)(5). The statute provides that, for this subsection:

> the term 'demand' means a demand for payment, present or future, that (A) was not a claim during the proceedings leading to the confirmation of a plan of reorganization; (B) arises out of the same or similar conduct or events that gave rise to the claims addressed by the injunction issued under paragraph (1); and (C) pursuant to the plan, is to be paid by a trust described in paragraph (2)(B)(i).

Id.

manufactured and sold before the filing of the bankruptcy petition. In this case, the court never ruled that those "future claimants" were "creditors" who had claims that "arose" before the petition.[170] Nevertheless, the plan approved by the court treated these future claimants in substantially the same way as those "creditors" who were already identified as having claims for exposure to asbestos.[171] The court entered an injunction against these future claimants that had the same effect as a discharge of the creditors' claims under a reorganization plan.[172]

Hence, without calling these future claimants "creditors," Congress specifically endorsed the treatment of the future claimants for asbestos damages as "creditors" by validating an injunction against these future claimants that requires them to seek payment only pursuant to the plan. Congress may only do so if such an injunction is within Congress's bankruptcy power. As discussed above, I believe this aspect of section 524(g)'s limitation of the state law rights of these future claimants is permitted by the Bankruptcy Clause.[173]

2. Limitations of Creditor Rights

The Code's alteration of the state law rights of creditors fall well within the Debtor-Creditor Adjustment Principle. Claims do not accrue interest after the order for relief[174] unless the claim is secured by property, the value of which exceeds the amount of the claim,[175] or the debtor has sufficient assets to pay all expenses and claims.[176]

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170. *See In re* Johns-Manville Corp., 36 B.R. 743, 754 (Bankr. S.D.N.Y. 1984) (holding that future claimants who may have a cause of action for damages from exposure to asbestos were parties in interest for which a future representative could be appointed and noting that, in doing so, the court need not face the issue of the dischargeability of the claims of these future claimants—that is, whether these future claimants were "creditors" whose claims could be discharged by a plan), *aff'd sub nom.* Robinson v. Johns-Manville Corp. (*In re* Johns-Manville), 52 B.R. 940, 943 (S.D.N.Y. 1985) (rejecting the argument that the bankruptcy court's order made the future claimants "creditors," and finding "no implication in the [court's order] that the future claimants are 'creditors' whose interests are dischargeable in bankruptcy).

171. *See In re* Johns-Manville Corp., 68 B.R. 618, 621-22 (Bankr. S.D.N.Y. 1986) (noting that the reorganization plan established a trust to resolve the claims of victims of asbestos-related diseases that drew no distinction between victims on the basis of the date of the manifestation of their disease), *aff'd* 78 B.R. 407 (S.D.N.Y. 1987), *aff'd* 843 F.2d 636, 645-46 (2d Cir. 1988).

172. *See In re* Johns-Manville Corp., 68 B.R. at 622, 624.

173. On the other hand, section 524(g) authorizes an injunction precluding claimants from seeking reimbursement from those who are not debtors under the Code or their successors in interest. *See* 11 U.S.C. § 524(a)(4) (2000). To the extent that section 524(g) involuntarily deprives a person with such a claim her state law right to collect from a non-debtor (other than a successor in interest to the debtor's property), section 524(g) is constitutionally suspect. *See* Plank, *The* Erie *Doctrine and Bankruptcy*, *supra* note 4.

174. *See* 11 U.S.C. § 502(b) (2).

175. *See id.* § 506(a), (b).

176. *See id.* § 726(a)(5), discussed *infra* note 184 and accompanying text.

During the case, the Code stays creditors' enforcement actions.[177] The Code specifically allows an individual debtor to exempt from creditors' claims some of the debtor's property that could otherwise be used to satisfy those claims.[178] Other Code provisions expressly overrule state law or the rights of creditors under state law,[179] including the rights of secured creditors.[180]

The Code does, as a matter of policy, respect some of the nonbankruptcy rights of creditors. It has not abolished security

177. *See* 11 U.S.C. § 362(a) (providing that the filing of a petition operates as a stay of numerous acts against the debtor, property of the estate, or property of the debtor).

178. *See id.* § 522(b). Section 522 provides that a debtor may exempt from the claims of creditors in a bankruptcy case either (i) property described in section 522(d) or (ii) property exempt under nonbankruptcy federal law or state or local law. *See id.* § 522(b)(2). The Code also provides that states may prohibit the debtor from using the federal bankruptcy exemptions of the Code. *See id.* § 522(b)(1). Many commentators, including the Bankruptcy Review Commission, have criticized this reliance on state law for exemptions. *See* NBRC Rep., *supra* note 7, § 1.2.1, at 121-25.

179. *See* 11 U.S.C. §§ 346(a), 728, 1146, 1231 (overruling the claims of certain taxing authorities under state or local law); *id.* § 1123(a)(5)(G), (b)(1), (5) (providing that, notwithstanding any otherwise applicable nonbankruptcy law, a plan may cure or waive any default, impair any class of unsecured claims, or modify the rights of holders of unsecured claims); *id.* § 1222(b)(2), (3), (6) (providing that a plan may modify the rights of holders of unsecured claims and cure or waive any default); *id.* § 1322(b)(2), (3), (6) (same).

180. The automatic stay prevents secured creditors from exercising their state law rights to repossess and cause the sale of collateral securing the loan. *See* 11 U.S.C. § 362(a)(6) (staying any "act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case"). Also, the trustee can grant a security interest to another lender that has priority over the security interest of a secured creditor. *See id.* § 364(d)(1)(B) (authorizing a superpriority lien if the trustee is unable to obtain credit otherwise and if the interest of the existing secured creditor is adequately protected). In addition, except for proceeds of or rents from prepetition collateral, the filing of a bankruptcy petition prevents the attachment of a security interest to collateral that is acquired by the debtor after the filing, notwithstanding a security agreement granting the secured creditor a security interest in after-acquired collateral. *See id.* § 552; *see also id.* § 522(f) (authorizing a debtor to avoid certain liens to the extent that any such lien impairs an exemption to which the debtor would have been entitled); *id.* § 1123(a)(5)(E), (F), (b)(1), (5) (providing that, notwithstanding any otherwise applicable nonbankruptcy law, a reorganization plan may satisfy or modify any lien, cancel or modify any indenture or similar instrument, impair any class of secured claims, modify the rights of holders of secured claims, other than a claim secured only by a security interest in real property that is the debtor's principal residence); *id.* § 1222(b)(2) (providing that a plan may modify the rights of holders of secured claims); *id.* § 1322(b)(2) (same); *id.* § 1322(c) (providing that, notwithstanding applicable nonbankruptcy law, a default with respect to, or that gave rise to, a lien on the debtor's principal residence may be cured until such residence is sold at a foreclosure sale that is conducted in accordance with applicable nonbankruptcy law); Juliet M. Moringiello, *A Tale of Two Codes: Examining § 522(f) of the Bankruptcy Code, § 9-103 of the Uniform Commercial Code and the Proper Role of State Law in Bankruptcy*, 79 Wash. U. L.Q. 863, 864, 888-90 (2001) (arguing that Congress should define "purchase money security interest" for purposes of § 522(1)(B), which permits a debtor to avoid a non-purchase money security interest on certain potentially exempt property, and noting that such a federal definition falls well within the Bankruptcy Power).

interests, and it respects at least the nominal value of security interests[181] and setoff rights of creditors.[182] These choices, however, are policy choices—good choices in my view. They are not mandated by the Bankruptcy Clause, although they may be mandated by other provisions of the Constitution.[183]

The only potential constitutional problem with the Code's treatment of creditors is the provision for interest to be paid to creditors under the rare case where there are sufficient assets to pay the face amount of creditor claims. Specifically, section 726(a)(5) authorizes the distribution of property of the estate, after the payment of administrative expenses and allowed claims, for the payment of interest "at the legal rate from the date of the filing of the petition" on any allowed claim.[184] Any residue goes to the debtor.[185] The Code does not specify what "legal rate" is to be used, but some courts have held that the legal rate is the federal legal rate.[186] To the extent that the federal legal rate is greater than the applicable rate under state

181. *See, e.g.*, 11 U.S.C. § 725 (requiring the trustee to distribute property in which another entity has an interest to that entity); *id.* § 362(d)(1) (providing relief from the automatic stay for cause, including lack of adequate protection of a creditor's security interest); *id.* § 1129(a)(7),(b)(2)(A) (requiring that a confirmed plan give the secured creditor the present value of its security interest).

182. *See, e.g.*, *id.* § 506(a) (defining a claim subject to setoff as a secured claim); *id.* § 542(b) (providing that a person who owes a debt to the estate need not pay that debt to the extent that the debt is subject to the person's setoff rights); *id.* § 553 (preserving setoff rights in bankruptcy).

183. *See supra* note 106 (suggesting that the Fifth Amendment of the Constitution would prevent the abolition of security interests).

184. *See* 11 U.S.C. § 726(a). The relevant subsections of this section provide::

> (a) Except as provided in section 510 of this title, property of the estate shall be distributed . . .[(1) - (4) in payment of claims specified in section 507 and in payment of any allowed unsecured claim, and] . . .
>
> (5) fifth, in payment of interest at the legal rate from the date of the filing of the petition, on any claim paid under paragraph (1), (2), (3), or (4) of this subsection; and
>
> (6) sixth, to the debtor.

Id.

185. *See id.*

186. In addition, if the debtor is solvent at the end of the case, it is a violation of the Non-Expropriation Principle for the creditor to get less than it would be entitled to under state law. Depriving the creditor of its state law interest rate is not necessary to the adjustment of the insolvent debtor-creditor relationship when, at the end of the bankruptcy process, there are sufficient assets to pay all creditors in full. Accordingly, cases such as *Onick v. Cardelucci* (*In re* Cardelucci), 285 F.3d 1231, 1233 (9th Cir. 2002) (holding that "legal rate" of interest to which an unsecured creditor holding a state court judgment was entitled on its claim in a Chapter 11 case of solvent debtor was the federal judgment rate of 3.5%, rather than the California statutory rate of 10%), and *Beguelin v. Volcano Vision, Inc.* (*In re* Beguelin), 220 B.R. 94, 96 (9th Cir. BAP 1998) (to the same effect, allowing a federal rate of 5% instead of the Nevada legal rate of 10.25%) are wrongly decided. *But see* Federal Sav. & Loan Ins. Corp. v. Moneymaker (*In re* A & L Properties), 96 B.R. 287, 290 (C. D. Cal. 1988) (holding that the "legal rate" is the rate specified in the contract and, alternatively, the "applicable prejudgment rate" for breach of contract under state law, which is also the rate specified in the contract).

law (either the contract rate or the state's "legal rate"), this provision authorizes, at the expense of the debtor, greater payments to creditors in bankruptcy than they would receive outside of bankruptcy.[187] This violates the Non-Expropriation Principle.

C. *Leases and Executory Contracts: The Mixed Treatment of Third Parties*

Executory contracts and leases in bankruptcy present more difficult questions. An executory contract represents both a contingent asset and a contingent liability for each party to the contract. For example, assume that *S* and *B* enter into an agreement in which *S* agrees to sell 100 widgets at a future date to *B* for $20 for each widget, and *B* agrees to buy those widgets. *B* has a contingent asset—the right to receive the widgets upon payment for the widgets. *B* also has a contingent liability—the obligation to pay for the widgets if *S* delivers for them.[188] Similarly, *S* has a contingent asset (the right to receive the payment of $20 for each widget if *S* delivers them), and a contingent liability (the obligation to deliver the widgets to *B*).[189]

The relative value of each party's rights and obligations can change after the date of the contract. If the market value of each widget increases to $25, *S* as seller will have suffered an economic loss of $5 a widget. *S* cannot avoid this loss by refusing to perform. If *S* fails to deliver the widgets, *B* will have a damage claim for $5 a widget.[190] Alternatively, if the market value of widgets decreases to $15, *B* as buyer will have suffered an economic loss of $5 a widget. *B* cannot

187. A similar constitutional violation may occur under 11 U.S.C. § 506(b). Under this section, oversecured creditors are entitled to interest on their claims. The section is silent on the rate at which interest accrues, but many courts allow the accrual of interest at the market rate and not the contract rate. *See* 2 Grant Gilmore & David Gray Carlson, Gilmore and Carlson on Secured Lending: Claims in Bankruptcy, § 31.01, at 717-267 (2d ed. 2000). To the extent that the market rate is higher than the contract rate, the debtor's property—or the property that the other creditors would receive—is being expropriated to give the secured creditor more than it is entitled to receive.

188. *See* U.C.C. § 2-507(1), (2) (2001) (providing that, unless otherwise agreed, tender of delivery of goods is a condition to the buyer's obligation to pay for them, and that the buyer's rights to retain or dispose of the goods is conditional upon the buyer making any payment that is due).

189. *See id.* § 2-507(2) (providing that the buyer's rights to retain or dispose of the goods is conditional upon the buyer making any payment that is due); *id.* § 2-511(1) (providing that, unless otherwise agreed, tender of payment is a condition to the seller's duty to tender and complete any delivery of goods).

190. *See id.* § 2-711(1) (providing that if the seller fails to deliver, the buyer can cover and recover the difference between the cost of cover and the contract price—$5 a widget under the hypothetical—as provided in section 2-712, or recover damages—the difference in market value and contract price, or $5 a widget—under section 2-713).

avoid this loss. If *B* repudiates the contract before the date of delivery, *S* will have a damage claim for $5 a widget.[191]

If *B* files for bankruptcy, *B*'s right under the contract to receive the widgets becomes property of the estate, subject to the condition of full payment. In the bankruptcy case, the other party to the contract has potentially two roles, that of a creditor and that of a Third Party. If the trustee cannot pay for the widgets, *S* is relieved of its obligations to deliver them. If the contract is favorable to *S*, that is, the contract price is higher than the market price, *S* may have a claim for damages that initially arose, although it was contingent, upon the signing of the contract. In this instance, *S* is a creditor, fully subject to the Debtor-Creditor Adjustment Principle.

However, *S*'s contingent obligation under the contract to deliver the widgets does not make *S* a "creditor." *S* is a Third Party. Under the Non-Expropriation Principle, *S* cannot be required to deliver the widgets to the bankruptcy trustee (including *B* as debtor in possession) if the trustee does not pay the full contract price for them. Thus, although *S* has a contingent "right to payment" of $20 for each widget delivered that arose before the filing of the petition, *S* cannot be treated as a "creditor" who receives from the assets of the debtor, *B*, only a pro-rata portion of the full price. That is, if all of *B*'s creditors were only to receive 50% of their claims in bankruptcy, *B*'s trustee cannot require *S* to deliver the widgets to the trustee for only 50% of the contract price. The Code, for the most part, implements this principle in section 365, which authorizes the trustee to assume or reject executory contracts.

Leases present more complications. For a lessee under a lease, the lease is comparable to an executory contract. The lessee has both a contingent asset and a contingent liability. The contingent asset is the leasehold interest in the leased property items and any other contractual rights under the lease, and the contingent liability is the obligation to pay rent and to perform other any other contractual obligations under the lease.[192] Hence, if the lessee becomes a debtor, the lessee's rights become a contingent asset (to the extent that the value of the rights under the lease exceeds the costs of the lease) that can be used to pay creditors in a liquidation or a reorganization. If, at the time of the filing of the petition, the lessee has not paid rent, the lessor becomes a creditor with a claim for damages—the past due rent and any other damages provided by the lease—subject to the bankruptcy case. However, under the Non-Expropriation Principle, the bankruptcy trustee for the lessee cannot retain the leasehold interest without paying the full rent as well as otherwise complying

191. *See id.* § 2-706(1) (providing that the seller can resell the goods and recover damages in an amount equal to the difference in resale price—$15 in our hypothetical—and the contract price, or $5 a widget).

192. *See, e.g.* Stoebuck & Whitman, *supra* note 136, § 6.10, at 253-54.

fully with the lease. If the trustee fails to pay the rent that accrues after the filing of the bankruptcy petition, the Non-Expropriation Principle dictates that the lessor must be allowed to terminate the lease and regain possession of the leased property item.

For a lessor, the lease need not be comparable to an executory contract. The lessor has conveyed to the lessee a property interest—a leasehold—but may have no other obligations under the lease. The lessee's interests may be contingent upon the lessee performing her obligations under the lease, but no action by the lessor can deprive the lessee of her interest. If the lessor has no other obligations under the lease, then the lease is a grant of a property interest and has none of the characteristics of an executory contract because the lessor has fully performed its obligations.[193] If the lessor becomes a debtor in bankruptcy, the bankruptcy trustee for the lessor cannot adversely affect the lessee's interests so long as the lessee performs her obligations under the lease. Again, the Code's treatment of leases applies the Debtor-Creditor Adjustment Principle and, for the most part, complies with the Non-Expropriation Principle. The Code does, however, authorize violations of the Non-Expropriation Principle.

1. Rejection

Under section 365(a), the trustee may reject executory contracts and leases.[194] This power does not violate the Non-Expropriation Principle and is consistent with the Debtor-Creditor Adjustment Principle. Rejection is simply the trustee's determination not to perform the debtor's obligations under the contract or lease.[195]

In the case of an executory contract, rejection by trustee does not change the other party's rights. Outside of bankruptcy, either party could choose not to perform the contract. Under state law, a party's failure to perform typically creates a claim for damages. If the breaching party were insolvent, the other party's chances for collecting its claim for damages against the insolvent breaching party is no better than what the other party would receive in a bankruptcy case.

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193. *See id.* § 6.12, at 256-57.

194. *See* 11 U.S.C. § 365(a) (2000) (stating that "[e]xcept as provided in sections 765 and 766 of this title and in subsections (b), (c), and (d) of this section, the trustee, subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor).

195. *See* Michael T. Andrew, *Executory Contracts in Bankruptcy: Understanding "Rejection,"* 59 U. Colo. L. Rev. 845, 848-49, 931 (1988) (stating that "rejection" of an executory contract or a lease is a decision by the trustee not to assume the contract or lease); Jay L. Westbrook, *A Functional Analysis of Executory Contracts*, 74 Minn. L. Rev. 227, 230, 250-51, 281 (1989) (stating that "rejection" of an executory contract or a lease is a decision by the trustee to breach the contract).

Recall our hypothetical contract in which *S* agrees to sell 100 widgets for $20 each. Assuming no transaction costs, if the market value of the widgets increases to $25 and *S* fails to deliver the widgets to *B*, *S* owes *B* $500 in damages. If *S* owes $500 to only one other creditor, and *S* has only $500 in assets, the present value of *B*'s contract claim against *S* is $250 because *B* has a 50% chance of collecting its $500 debt. If *B* is the first to levy on *S*'s assets, *B* would be paid in full. If the other creditor levies first, *B* gets zero.

Inside bankruptcy, rejection by the trustee for *S* puts *B* in the same place.[196] *B* has a right to payment that arose upon the execution of the contract and that matures upon rejection. Hence, in our hypothetical in which the price of widgets has increased to $25 a widget, the trustee in bankruptcy for *S* will reject the contract to sell the 100 widgets for $20 because the contract is a net burden to the estate. *B* will have a claim for damages for $500 in bankruptcy, just as it has a claim outside of bankruptcy.[197] *B*'s other creditor will have a claim for $500. *B* will receive a pro rata share of *S*'s assets, 50%, or $250.

Similarly, rejection by the trustee of a lease simply allows the other party to terminate the lease and seek damages. If the debtor is a lessee, rejection of a lease therefore allows the lessor to regain possession of the leased property as well as to seek damages from the debtor/lessee. If the lease is a net burden to the estate (the market value of the rent is less than the contract amount of the rent) the trustee will reject the lease as a net burden to the estate. If the lessor for some reason elects not to terminate the lease and tries to hold the trustee to the terms of the lease by insisting that the trustee still has a property interest the trustee must continue to pay for, the trustee can simply abandon the leasehold to the lessor.[198]

On the other hand, if the debtor is a lessor, the results of rejection are different. Because rejection of a lease is a determination not to perform the obligations of the lessor, rejection may give the lessee the option to return possession of the leased property item to the trustee. On the other hand, if the lessor has no obligations to the lessee, rejection may not even give the lessee an option to return possession and use of the property item to the lessor.

In either event, if the lessee wishes to retain the leased property item notwithstanding the refusal of the trustee as lessor to perform the lessor's obligations, rejection does not allow the trustee as lessor to regain possession of the leased property item from the lessee. The lessee has a property interest in the item—the right to possess and to use the premises and the right to exclude others from using the leased

196. *See* 11 U.S.C. § 365(g).

197. *See supra* note 190 and accompanying text.

198. *See* 11 U.S.C. § 544 (providing that after notice and a hearing, the trustee may abandon any property of the estate that is burdensome to the estate or that is of inconsequential value and benefit to the estate).

property item. Under the Non-Expropriation Principle, rejection of a lease by the trustee may not alter that property interest. The Code explicitly recognizes this principle for a lease of a real property item.[199] Courts must also respect this principle for leases of personal property items.

2. Assumption and Assignment

Under section 365(a) & (f), the trustee may assume executory contracts and leases and assign them to strangers notwithstanding an anti-assignment provision under state law or in the contract or lease.[200] Under the Non-Expropriation Principle, bankruptcy law may not force Third Parties to enter into or maintain a legal relationship with the debtor to an extent greater than that required by nonbankruptcy law. This Principle is limited only by the Non-Interference Principle. Bankruptcy law may prevent a Third Party from using a debtor's resort to bankruptcy to obtain a benefit that it could not obtain outside of bankruptcy.

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199. *See id.* § 365(h)(1) (providing that if the trustee rejects an unexpired lease of real property under which the debtor is the lessor and the rejection amounts to a breach that would entitle the lessee to treat the lease as terminated under its terms, applicable nonbankruptcy law, or any agreement made by the lessee, then the lessee under such lease may treat such lease as terminated by the rejection or the lessee may retain its rights under such lease in or appurtenant to the real property to the extent that such rights are enforceable under applicable nonbankruptcy law, but giving the lessee the right to offset against the rent the value of any damage caused by the nonperformance of any obligation of the debtor).

200. These subsections state:

> (a) Except as provided in sections 765 and 766 of this title and in subsections (b), (c), and (d) of this section, the trustee, subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor.
>
> . . . .
>
> (f)(1) Except as provided in subsection (c) of this section, notwithstanding a provision in an executory contract or unexpired lease of the debtor, or in applicable law, that prohibits, restricts, or conditions the assignment of such contract or lease, the trustee may assign such contract or lease under paragraph (2) of this subsection; [certain exceptions omitted].
> (2) The trustee may assign an executory contract or unexpired lease of the debtor only if—
> (A) the trustee assumes such contract or lease in accordance with the provisions of this section; and
> (B) adequate assurance of future performance by the assignee of such contract or lease is provided, whether or not there has been a default in such contract or lease.
> (3) Notwithstanding a provision in an executory contract or unexpired lease of the debtor, or in applicable law that terminates or modifies, or permits a party other than the debtor to terminate or modify, such contract or lease or a right or obligation under such contract or lease on account of an assignment of such contract or lease, such contract, lease, right, or obligation may not be terminated or modified under such provision because of the assumption or assignment of such contract or lease by the trustee.

See id. § 365.

The issue of an anti-assignment provision arises in two instances. First, should an anti-assignment provision prevent the trustee in bankruptcy (which includes the debtor as debtor in possession) from assuming the executory contract or leases? Second, if the trustee may assume the contract or lease, may she assign it to another person? In many situations, the abrogation of anti-assignment provisions in contracts and leases for either assumption or assignment to a third person does not violate the Non-Expropriation Principle. Nevertheless, the trustee's power does violate the Non-Expropriation Principle when it authorizes the abrogation of the state law right of the other party to prevent assignment for a reason other than the debtor's seeking bankruptcy relief.

State law overrules prohibitions on the assignment of many contract rights when the assignment does not change the substantive rights of the other party and the other party to the contract receives the benefit of its bargain. For example, an obligor under a contract for the payment of money, e.g., a seller of goods under a sales contract, may not prevent the other party from assigning the right to payment.[201] Other rights under a contract may generally be assigned unless the assignment would be detrimental to the other party.[202] Hence, the

201. *See, e.g.*, U.C.C. § 2-210(2) (2001) (providing that a right to damages or to payment upon performance of a contract for the sale of goods may be assigned notwithstanding an agreement otherwise); *id.* §§ 9-404(d), 9-408 (generally invalidating anti-assignment provisions in agreements or law that would prevent or limit the sale or pledge of accounts, chattel paper, payment intangibles, and promissory notes but also, in the case of certain transfers of payment intangibles or promissory notes, limiting the rights of the assignee to proceed against the other party to the agreement), analyzed in Thomas E. Plank, *The Limited Security Interest in Non-Assignable Collateral Under Revised Article 9*, 9 Amer. Bankr. Inst. L. Rev. 323 (2001); *see also* Restatement (Second) of Contracts § 317 cmt. c (noting the disappearance of the common law historical rule that choses in action could not be assigned and stating that, except as stated in this section, discussed *infra* note 202, contract rights may effectively be assigned).

202. Section 2-210 provides:

> (1) A party may perform his duty through a delegate unless otherwise agreed or unless the other party has a substantial interest in having his original promisor perform or control the acts required by the contract. . . .
> (2) Except as otherwise provided in Section 9-406, unless otherwise agreed, all rights of either seller or buyer can be assigned except where the assignment would materially change the duty of the other party, or increase materially the burden or risk imposed on him by his contract, or impair materially his chance of obtaining return performance. . . .

See UCC § 2-210 (2001); *see also* Restatement (Second) of Contracts § 317(2)(a), (c) (providing that a contractual right can be assigned unless the assignment materially (i) changes the duty of the other party, (ii) increases the burden on or risk to the other party, or (iii) impairs the chance for return performance, or unless the assignment is validly precluded by contract); *id.* § 322(2) (providing that, unless other intent is manifest, a contract provision prohibiting assignment may give rise to right to damages but does not render the assignment ineffective); 1 Grant Gilmore, Security Interests in Personal Property §§ 7.3-7.5, at 200-10 (1965).

power of the trustee to assign an executory contract mirrors state law in many respects.

State law does protect one party to a contract from having to accept performance from a stranger when the identity of the other original party is significant.[203] Accordingly, to the degree provided for by state law, bankruptcy law may not force a Third Party to accept performance from the bankruptcy trustee or an assignee of the trustee if such performance depends on the specific identity of the debtor. The Code protects this Third Party right in section 365(c)(1).[204]

The language of section 365(c)(1) has generated significant controversy and litigation. The plain language establishes a "hypothetical test"—whether applicable law excuses the other party from accepting performance from a stranger—for when the trustee may assume a contract. This language presents an anomalous situation when the debtor in possession seeks to assume the contract. The debtor in possession is the same entity as the debtor,[205] although in a different capacity,[206] but the literal language prevents the debtor in possession from assuming the contract.

Agreeing with most scholars, some courts consider this result an anomaly, and have interpreted this language to require an actual assignment to a person other than the debtor in possession or prejudice to the other party to the contract from assumption by the debtor in possession as a condition to preventing assumption by a debtor in possession.[207] Although I think courts should follow the

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203. *See* U.C.C. § 2-210(1) (2001), quoted *supra* note 202; *see also* Restatement (Second) of Contracts § 318(2) (permitting the delegation of an obligation to perform unless the obligee has substantial interest in performance by the original obligor).

204. *See* 11 U.S.C. § 365(c) (2000), which provides:

> The trustee may not assume or assign any executory contract or unexpired lease of the debtor, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties, if—
>
> (1)(A) applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties; and
>
> (B) such party does not consent to such assumption or assignment . . .

205. *See id.* § 1107 (providing that, subject to any limitations on a trustee serving in a case under Chapter 11, a debtor in possession shall have all the rights, other than the right to compensation, and powers, and shall perform all the functions and duties, with certain exceptions not relevant to a debtor in possession, of a trustee serving in a case under Chapter 11).

206. *See* Thomas E. Plank, *The Bankruptcy Trust as a Legal Person*, 35 Wake Forest L. Rev. 251, 289-91 (2000) (arguing that the debtor in possession is not a separate legal entity, but that the Bankruptcy Code creates a separate legal entity, the bankruptcy trust, for which the debtor in possession is the trustee).

207. *See, e.g.*, Summit Inv. & Dev. Corp. v. Leroux, 69 F.2d 608, 612, 614 (1st Cir. 1995). *See generally* Daniel J. Bussel & Edward A. Friedler, *The Limits on Assuming and Assigning Executory Contracts*, 74 Am. Bankr. L.J. 321 (2000) (providing a good summary of the controversy and proposing an interpretation that harmonizes §

hypothetical test mandated by the statute, the "actual test" is constitutionally permissible so long as bankruptcy courts apply the test in a neutral manner and respect the nonbankruptcy interests of the non-debtor party.

However, in some circumstances, the "actual test" permits a debtor in possession to evade a restriction on assignment that would otherwise be enforceable under the "actual test." For example, under the "actual test," a debtor in possession who held a patent license cannot assign the license to an assignee that is not acceptable to the licensor. Nevertheless, under this test it could, pursuant to a reorganization plan, assume the license and become the wholly owned subsidiary of the unacceptable assignee.[208] Hence, the actual test would need to be modified and applied in a way that prevents this evasion of the substantive right of the Third Party licensor .

State law also respects the choice that parties make in contracts and leases to prevent a party from assigning that party's rights under the lease or contract even when the identity of the party to the contract is not an essential element of the contract.[209] This kind of an anti-assignment provision may protect the legitimate interests of the parties in the performance of the contract or lease, such as the interest of a landlord in preserving the value of leased premises. The Code partially protects these interests and ameliorates the effect of the invalidation of an anti-assignment provision on the state law rights of the non-debtor party. Specifically, section 363(f)(2) requires as a condition to assignment of the debtor rights and duties under a contract or lease to another person that the trustee provided adequate assurance of due performance by that other person.

An anti-assignment provision, however, may also be used by one of the parties to recapture a future benefit that it otherwise would have

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365(c)(1) with § 365(f)(1), which overrides nonbankruptcy law that would prevent assignment of an executory contract or unexpired lease to another party).

208. *Compare* Perlman v. Catapult Entertainment, Inc. (*In re* Catapult Entertainment, Inc.), 165 F.2d 747, 747-48, 750-51 (9th Cir. 1999) (under the hypothetical test, not permitting the assumption of a patent license by the debtor in possession whose reorganization plan provided that the debtor in possession became a wholly owned subsidiary of another corporation), *with* Institut Pasteur v. Cambridge Biotech Corp., 104 F.3d 489, 491, 493-94 (1st Cir. 1997) (under the actual test, approving the assumption of a patent license by the debtor in possession over the objections of the licensor, even though the reorganization plan provided that the debtor in possession became a wholly owned subsidiary of a competitor of the licensor and the licensor would not have consented to an assignment to such competitor). The court of appeals in *Institut Pasteur* made much of the fact that the licensor had not negotiated a provision limiting or terminating the license upon a change in the corporate control of the debtor, *see id.* at 494-95, but did not consider that such a change in the control provision would likely be an unenforceable ipso-facto or anti-assignment clause.

209. *See, e.g.*, Stoebuck & Whitman, *supra* note 136, § 6.71, at 385-87 (noting the enforceability of anti-assignment clauses but describing the judicial hostility to such clauses).

contracted away. This use may be the reason for judicial hostility to anti-assignment provisions.[210] Some may not consider this ability to be a legitimate interest. Nevertheless, state law still protects this interest to a certain extent.

A hypothetical will illustrate this point. Assume that landlord *L* leased a parcel of real estate for a 10-year term to tenant *T* for a fixed rent of $10,000 a month, which was the fair market rent at the time of the lease. Assume, however, that five years has passed and the fair market rent has increased to $15,000 a month. *L* can do nothing about this unfavorable lease for another five years so long as *T* performs the lease. Without a restriction on assignment, *T* could assign the lease to assignee *A* for the present value of the increase in value of the leasehold, that is, the present value of $5,000 a month for the next five years. This increase in value is substantial, and it represents the increase in the market value of the lease to the lessee.[211] If the lease contains an anti-assignment provision, however, *L* can prevent the assignment to *A*.

L has an interest in assuring that *A*, as the new tenant, has the financial capacity and character to assure payment of the rent and maintenance of the leased premises. The use of an anti-assignment provision to protect this interest is unexceptional. On the other hand, *L* could use the anti-assignment provision in the lease to extract from *T* some of the increase in market value of the leasehold. Such use of an anti-assignment provision appears to contradict the property interest that *L* conveyed to *T*. If *L* wanted to retain the benefit of increased market rents, it could have leased the premises for a shorter term. Of course, under a shorter term, *L* would also have taken the concomitant risk of a decline in market rent at the end of the shorter term. Under the hypothetical 10-year lease, however, *T* took the risk of a decrease in market rents.[212]

It is not necessarily "unfair" to allow *L* to capture the upside in future market value but stick *T* with the downside. *L* also retains a significant risk of the downside. If market values decline and *T* can no longer pay the now higher than market rent—a likely occurrence in the case of a general economic decline—*L* can exercise its remedies. *L* can retake the premises, rent it at the lower rent, and seek damages from *T* representing the difference between the present value of the lease rent and the now market rent. Even without bankruptcy,

210. *See, e.g.*, 1 Gilmore, *supra* note 202, §§ 7.6-7.9, at 210-28.

211. The present value of $5,000 a month for the next five years at an annual discount rate of 12%, calculated on a monthly basis, is approximately $225,000.

212. If the rental value had declined, say to $6,000 a month, for a loss in rental value of $4,000 a month, the trustee would reject the lease, and *L* would be entitled to terminate the lease. *L* would have a claim in bankruptcy for damages, although the damages are limited. Since *L* is a creditor in this instance, the Code may alter his state law rights to damages.

however, there is no assurance that *L* will be able to collect those damages. Accordingly, allowing *L* to recapture a portion of the possible–but not assured–increase in market value of the leasehold when a lessee seeks to assign it may be reasonable compensation for the risk that *L* will bear the loss of a possible–but not assured–decline in the market value of the leasehold.

Although state courts have been hostile to anti-assignment provisions, state law does respect the use of the anti-assignment provision to recapture an increase in market rents as an important and legitimate interest of the lessor when the parties clearly express their intent.[213] Therefore, section 363(f)(1)'s abrogation of anti-assignment provisions does violate the Non-Expropriation Principle. If *T* files for bankruptcy and the trustee rejects the lease because the value of the leasehold has declined—making the lease burdensome to the estate—*L* suffers the loss. *L* only obtains a limited part of its market rate damages.[214] On the other hand, if the trustee assumes the lease because the value of the leasehold has increased and then assigns the lease, the trustee receives the benefit of the increase in market value, which is distributed to creditors. *L* cannot obtain any of that increase.

Section 365 is also constitutionally problematic in other ways. To ensure further that the trustee's power to assume and assign executory contracts and leases does not violate the Non-Expropriation Principle, that power must be subject to other limitations that, unfortunately, the Code does not contain. First, to the extent that a party has a state law right to terminate or cancel a contract (for reasons other than the bankruptcy of the other party, which is discussed below[215]), bankruptcy law must respect this right. The Code may not prevent a Third Party from exercising these state law rights.

Second, to the extent that the other party is forced to maintain an ongoing relationship with the bankruptcy trustee (including the debtor in possession), that Third Party should have the right to receive adequate assurance of due performance of the obligations of

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213. *See, e.g.*, Stoebuck & Whitman, *supra* note 136, § 6.71, at 387.

214. Not only will *L*'s damages be paid on a pro-rata basis along with the other creditors, the Code specifically limits the amount of damages resulting from the decline in the market value of a real estate leasehold. *See* 11 U.S.C. § 502(b)(6)(A). This subsection disallows any claim of a lessor for damages resulting from the termination of a lease of real property to the extent that such claim exceeds:

> (A) the rent reserved by such lease, without acceleration, for the greater of one year, or 15 percent, not to exceed three years, of the remaining term of such lease, following the earlier of (i) the date of the filing of the petition; and (ii) the date on which such lessor repossessed, or the lessee surrendered, the leased property.

Id. The landlord can claim full damages for rent due before the times specified in section 502(b)(6)(A). *See id.* 502(b)(6)(B).

215. If the cancellation is the result of the filing of the bankruptcy petition, such cancellation would violate the Non-Interference principle. *See supra* note 114 and accompanying text.

the trustee as successor in interest to the debtor. Although the Code expressly provides for such assurance when the trustee seeks to cure a default in the contract or lease and then assume,[216] or when the trustee seeks to assign a contract or lease to another entity,[217] the Code does not require adequate assurance of due performance by the trustee (including the debtor in possession) when there has been no default and the contract or lease is not being assigned. Under state law, all parties to a contract or a lease are entitled to this assurance.[218] This requirement must be respected in a bankruptcy case.

Under the Non-Interference Principle, the trustee may be allowed a short period of time before Third Parties may exercise their nonbankruptcy rights, so long as such delay does not prejudice their rights.[219] Currently, in a liquidation, the bankruptcy trustee has sixty

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216. Section 365(b)(1) provides:

> If there has been a default in an executory contract or unexpired lease of the debtor, the trustee may not assume such contract or lease unless, at the time of assumption of such contract or lease, the trustee—
> (A) cures, or provides adequate assurance that the trustee will promptly cure, such default;
> (B) compensates, or provides adequate assurance that the trustee will promptly compensate, a party other than the debtor to such contract or lease, for any actual pecuniary loss to such party resulting from such default; and
> (C) provides adequate assurance of future performance under such contract or lease.
> (2) Paragraph (1) of this subsection does not apply to a default that is a breach of a provision relating to—
> (A) the insolvency or financial condition of the debtor at any time before the closing of the case;
> (B) the commencement of a case under this title;
> (C) the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement; or
> (D) the satisfaction of any penalty rate or provision relating to a default arising from any failure by the debtor to perform nonmonetary obligations under the executory contract or unexpired lease.

11 U.S.C. § 365(b)(1).

217. Section 365(f)(2) states:

> The trustee may assign an executory contract or unexpired lease of the debtor only if—
> (A) the trustee assumes such contract or lease in accordance with the provisions of this section; and
> (B) adequate assurance of future performance by the assignee of such contract or lease is provided, whether or not there has been a default in such contract or lease.

Id. § 365 (f)(2). Thus, the trustee need not cure a prepetition default of a covenant to maintain a certain positive net worth in assuming an executory contract or unexpired lease under section 365(b)(2), quoted *supra* note 216, but if the trustee wants to assign the contract or lease it must assure adequate performance by any assignee of such contract, including a net worth covenant. *Id.* § 365(f)(2)(B).

218. *See* U.C.C. § 2-609 (2001), discussed *infra* note 229 and accompanying text; Restatement (Second) of Contracts § 251 (1981), discussed *infra* note 229 and accompanying text.

219. In addition, the Code extends the time period in which the debtor may take legal action against a Third Party. *See* 11 U.S.C. § 108(a) (time period within which

days to decide whether to assume or reject an executory contract or unexpired lease.[220] As a general matter, this sixty days may be a reasonable limitation. After all, the trustee needs time to sort out the affairs of the debtor.

The bankruptcy court may extend this sixty days, but as matter of constitutional right it may do so only if such extension does not prejudice the Third Party's rights. Further, to the extent that any delay does prejudice the rights of the Third Party—say, because of a change in market conditions or the loss of an opportunity—the bankruptcy estate should compensate the Third Party fully for such loss. The bankruptcy case is administered for the benefit of the creditors, and the creditors should bear the costs of such administration—not the Third Party.[221]

Reorganizations are more problematic. In a reorganization, the trustee has until plan confirmation to accept or reject an executory contract or a lease, other than a lease of non-residential property.[222] To the extent that federal courts in bankruptcy interpret the provisions of section 365 to require that Third Parties continue to perform the contract or lease in the face of the debtor's or trustee's nonperformance,[223] this amount of time would be unreasonable and

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the debtor may commence an action extended two years); *id.* § 108(b) (time period within which the debtor may file any pleading, demand, notice, or proof of claim or loss, cure a default, or perform any other similar act extended 60 days after the order for relief).

220. *See id.* § 365(d)(1) (executory contract or unexpired lease of residential real property or of personal property); *id.* § 365(d)(4) (deeming any unexpired lease of nonresidential real property rejected unless assumed within 60 days); *see also id.* § 365(d)(3) (requiring the trustee to perform all the obligations of the debtor arising after the order for relief under any unexpired lease of nonresidential real property, until such lease is assumed or rejected, except that such time for performance may be extended by no more than 60 days).

221. *See, e.g.*, Reading Co. v. Brown, 391 U.S. 471 (1968) (holding that the bankruptcy estate of a debtor that attempted to reorganize under chapter XI of the Bankruptcy Act of 1898 should bear the costs of damages caused by the receiver's negligence since the chapter XI case was attempted for the benefit of the creditors and therefore such damages should be treated as an administrative expense).

222. *See* 11 U.S.C. § 365(d)(2).

223. One author has stated that the non-debtor party to a contract is bound by the contract but the debtor party is not bound. *See* Douglas W. Bordewieck, *The Postpetition, Pre-Rejection, Pre-Assumption Status of an Executory Contract*, 59 Am. Bankr. L. J. 197, 200, 214 (1985). This can only be true in a limited sense. Certainly, the non-debtor party cannot obtain specific performance of the contract, and indeed for a limited period of time may be precluded from terminating the contract. The trustee has a right to assume an executory contract, and section 365 puts the burden on the non-debtor party to seek an expedited decision. Nevertheless, the non-debtor party—a Third Party—cannot be forced to perform the contract unless it is assured of performance by the trustee, and its ability to terminate the contract should not be frustrated if the trustee refuses both to perform and to reject the contract. *See also In re* El Paso Refinery, L.P., 220 B.R. 37 (Bankr. W.D. Tex. 1998). In this case, the bankruptcy court, citing *Bordewieck* and a few cases, stated that a non-debtor party cannot enforce the contract against the debtor and therefore cannot obtain relief from the automatic stay to terminate the contract. *Id.* at 43-46. However, the court had

unconstitutional. One saving provision allows the other party to request expedited decision.[224] As a matter of constitutional right, the court must require an expedited decision if delay will prejudice the rights of the other party.

Other sections provide a partial cure to the potential unconstitutional deprivation of Third Party rights. In the case of a nonresidential real property lease, such lease is deemed rejected if not assumed within sixty days after the order for relief.[225] For most personal property leases, the trustee must perform the debtor's obligations within sixty days of the order for relief until the lease is either assumed or rejected.[226]

These sections, by themselves, provide only a partial cure. First, there is no requirement for performance of obligations under executory contracts pending rejection or assumption. Second, the Code excuses the trustee from performing obligations under residential real property leases and personal property leases for personal, family, or household uses.[227] This exception may be desirable to protect consumer debtors, but in my view it is not constitutionally permissible. If an individual debtor files for Chapter 11 and wishes to continue to live in a rented apartment, whether a penthouse suite or a one-room efficiency apartment, and to continue to drive his leased automobile, whether it be a Maserati or a Hyundai, he should be required to make all payments and perform all other obligations. If he cannot so perform, he should give up the apartment or the car.

The failure of the Code to require performance of certain leases and contracts would not be constitutionally problematic if the Third Parties were allowed to exercise their nonbankruptcy rights after the first sixty days. In the case of leases, exercising these remedies—eviction from the residential rental property or repossession of the personal property item—would require lifting the stay against acts to obtain possession of property from the estate.[228] In the case of

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previously granted relief from the automatic stay to permit termination of a contract. *Id.* at 47-50. Accordingly, it held that such grant of relief was in effect a decision giving the debtor a limited amount of time to assume or reject the contract, and it allowed the non-debtor damages as if the debtor had rejected the contract. *Id.*

224. *See* 11 U.S.C. § 365(d)(2) (2000).

225. *See id.* § 365(c)(4).

226. *See id.* § 365(d)(3).

227. *See id.* § 365 (d)(10).

228. *See id.* § 362(a)(3) (providing that the filing of a petition stays "any act to obtain possession of property of the estate or of property from the estate"); *id.* § 362(d) (providing that "[o]n request of a party in interest and after notice and a hearing, the court shall grant relief from the stay provided under subsection (a) of this section, such as by terminating, annulling, modifying, or conditioning such stay (1) for cause, including the lack of adequate protection of an interest in property of such party in interest"). Failure of a party to a contract or lease to receive or secure the benefit of its nonbankruptcy property interests would be lack of adequate protection,

contracts, exercising these remedies would include suspending performance until the trustee provided adequate assurance of due performance from the other party, and canceling the contract if such assurance is not provided.[229] Bankruptcy law may not interfere with this right.[230]

D. *Invalidation of "Ipso-Facto" Provisions*

"Ipso-facto" provisions are those provisions found in nonbankruptcy law[231] and agreements[232] that allow the discretionary

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but providing adequate assurance of due performance would suffice as adequate protection.

229. *See* U.C.C. § 2-609 (2001) (providing that a party to a contract who has reasonable grounds for insecurity with respect to the performance by the other party may demand adequate assurance of due performance and may suspend performance until assurance is received; failure of the other party to provide such assurance within a reasonable time constitutes a repudiation of the contract); *id.* § 2-703(f) (seller's right to cancel contract if buyer repudiates); *id.* § 2-711(1) (buyer's right to cancel contract if seller repudiates); Restatement (Second) of Contracts § 251 (1981) (providing a procedure for obtaining adequate assurance of due performance similar to U.C.C. § 2-609, *supra*); *id.* § 252 (providing similar relief if one party becomes insolvent); *id.* § 253(2) (providing that one party's repudiation discharges other party's remaining duties to perform).

230. As a matter of strict statutory interpretation, the Code respects this right. The automatic stay precludes acts "to exercise control over property of the estate." *See* 11 U.S.C. § 362(a)(3). A debtor's rights under a contract are property of the estate under § 541(a)(1). Those rights, however, are subject to a condition that, if a party to a contract with the debtor becomes insecure about the debtor's ability to perform the contract, the other party may demand adequate assurance of due performance, suspend performance until assurance is received, and cancel the contract if the assurance is not provided or if the debtor defaults. *See supra* note 229. Hence, the property of the estate contains its own inherent limitation. Just as the automatic termination of a debtor's leasehold interest under lease for a five-year term at the end of five years is an inherent part of the limitation on the property of the estate, the ending of the estate's interests in a contract pursuant to the contract's own limitations is part of the property of the estate. Just as the termination of the five-year leasehold in favor of the landlord is not "exercising control" over property of the estate, the termination of the contract by the other party consistent with the inherent limitations in the contract also in not "exercising control" over property of the estate. *See* Thomas E. Plank, *The Creditor in Possession Under the Bankruptcy Code: History, Text, and Policy*, 59 Md. L. Rev. 253, 312-16 (2000) (explaining why a secured creditor's exercise of its nonbankruptcy rights against a property item previously owned by the debtor and now by the estate is not an act to control property of the estate stayed by § 362(a)(3), but is an act to collect a claim stayed by § 362(a)(6)); Plank, *Bankruptcy Estate*, *supra* note 137 at 1193, 1219-34, 1254-63 (explaining that Congress intentionally defined property of the estate to contain only those specific rights in a property item that a debtor had and how *Citizens Bank of Maryland v. Strumpf*, 516 U.S. 16, 21 (1995), endorsed this explicit definition of property of the estate to exclude from property of the estate the rights that an entity other than the estate has in the property item).

231. *See, e.g.*, Unif. Limited Liability Co. Act § 601(7) (1995), 6A U.L.A. 425, 472 (1995) (providing that a member in a limited liability company will become disassociated from the limited liability company upon becoming a debtor in bankruptcy or upon certain other enumerated events of bankruptcy); Del. Code Ann. tit. 6, § 18-304 (providing that, unless otherwise agreed, a member in a limited liability

or automatic termination of the debtor's contract and property rights because the debtor filed a bankruptcy petition or becomes insolvent.[233] They can be justified under state law on the theory that the bankruptcy of one party in a transaction signals that party's inability to perform. On the other hand, an ipso-facto provision also allows the other party in a transaction to recapture a net benefit that it had contracted or conveyed away to the party that becomes a debtor in bankruptcy. For example, if continued performance of an executory contract by the Third Party is a net benefit for the debtor (and therefore the bankruptcy estate), it is also a net burden to the Third Party.[234] Even if the debtor or the bankruptcy trustee can continue to perform, the "ipso-facto" provision would allow the Third Party to get out of an unfavorable transaction.

If the bankruptcy trustee cannot perform the contract, requiring continued performance by the Third Party would violate the Non-Expropriation Principle. However, if the trustee can perform the contract and the Third Party continues to receive the benefit of the bargain, no matter how unfavorable that bargain may have become for the Third Party, requiring the Third Party to continue to perform does not violate the Non-Expropriation Principle. Under the Non-Interference Principle, if the Third Party may not avoid its obligations under an unfavorable contract under state law (aside from the "ipso-facto" provision), it may not use the filing of relief under bankruptcy law to avoid the burden in bankruptcy. Prohibiting the Third Party from using the filing for bankruptcy relief to recapture this benefit does not violate the Non-Expropriation Principle, so long as the Third

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company ceases to be a member upon filing a voluntary petition in bankruptcy or otherwise is subject to several enumerated events of bankruptcy); Unif. Limited Partnership Act § 603(6) (2001), 6A U.L.A. 1, 54 (2002 Supp.) (providing that a general partner in a limited partnership will become disassociated from the limited partnership upon becoming a debtor in bankruptcy or upon certain other enumerated events of bankruptcy); Rev. Unif. Ltd. Partnership Act § 402(4) (1985), 6A U.L.A. 1, 172 (1995) (providing that, unless otherwise agreed, a general partner in a limited partnership ceases to be a general partner upon filing a voluntary petition in bankruptcy or otherwise is subject to several enumerated events of bankruptcy); Unif. Partnership Act § 601(6) (1997), 6 U.L.A. (pt. 1) 1, 163-64 (2001) (providing that a partner will become disassociated from a partnership upon becoming a debtor in bankruptcy or upon other enumerated events of bankruptcy).

232. 5A Am. Jur. Legal Forms 2d § 68:297, at 454 (2002) (providing an example of a provision permitting either party to a contract to terminate the contract if the other party were to file a bankruptcy petition or become insolvent); 11A Am Jur. Legal Forms 2d § 161:830, at 254 (1998) (providing an example of a lease provision permitting the lessor to repossess leased premises if the lessee were to file a bankruptcy petition or become insolvent).

233. The insolvency conditions are generally stated as "the insolvency or financial condition of the debtor, . . . the commencement of a case under this title, or . . . the appointment of or taking possession by a trustee in a case under this title . . . or a custodian." *See* 11 U.S.C. 363 (*l*) (2000); *see also id.* § 363(b)(2), quoted *supra* note 216; *id.* § 365(e)(1); *id.* § 541(c)(1).

234. *See, e.g.*, *supra* note 198 and accompanying text.

Party retains during and after the bankruptcy case the benefit of its prebankruptcy bargain with the debtor, through either performance by a comparable substitute party or continued performance by a reorganized debtor.

The Code properly invalidates "ipso-facto" provisions. Thus, an "ipso-facto" provision may not prevent property from becoming property of the estate[235] or prevent the trustee from using, selling, or leasing property of the estate.[236] Most significantly, an "ipso-facto" provision may not effect a forfeiture, termination, or modification of the debtor's interests in executory contracts or leases.[237] Accordingly, if *S* had agreed to sell 100 widgets to *B* for $20, and the market price declines to $15 (resulting in a net loss to *B* of $5 for each widget), a provision in the contract allowing *B* to terminate the contract if *S* files for bankruptcy is invalid in bankruptcy. So long as the trustee (including *S* as debtor in possession) provides adequate assurance of due performance, the trustee can assume the contract and assign it to another person.

The Non-Interference Principle applies to express and implied "ipso-facto" provisions. Hence, federal courts in bankruptcy may prevent Third Parties from using a discretionary power as a disguised "ipso-facto" provision to terminate the debtor's contract or property rights if in fact the sole reason for the action of the Third Party is the debtor's filing of a bankruptcy petition.[238]

The Code's description of the insolvency conditions in an impermissible "ipso-facto" provision is broad; they go beyond the commencement of a case under the Code to include the insolvency or financial condition of the debtor. Going beyond the simple filing of a petition is not constitutionally problematic. The overruling of these "ipso-facto" clauses based on a broadly defined insolvency condition occurs only in bankruptcy. If one party to a contract is not a debtor in bankruptcy, the other party is free to exercise "ipso-facto" provisions based on the debtor's financial condition.

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235. *See id.* § 541(c)(1)(A) (providing that an interest of the debtor in property becomes property of the estate notwithstanding an insolvency condition).

236. *See id.* § 363(*l*) (providing that the trustee may use, sell, or lease property of the estate, or that a plan under chapter 11, 12, or 13 may provide for the use, sale, or lease of property, notwithstanding an insolvency condition, quoted *supra* note 233, "that effects, or gives an option to effect, a forfeiture, modification, or termination of the debtor's interest in such property").

237. *See id.* § 365(e)(1) (providing that an executory contract or unexpired lease of the debtor or rights under them may not be terminated or modified after the commencement of the case solely because of an insolvency provision, quoted *supra* note 233).

238. *See, e.g.*, Holland America Ins. Co. v. Sportservice, Inc. (*In re* Cahokia Downs, Inc.), 5 B.R. 529, 530, 532 (Bankr. S.D. Ill. 1980) (holding that insurance company may not use its discretionary power to terminate insurance contract for any reason in order to terminate debtor's insurance policy shortly after filing of bankruptcy petition when only reason for termination was filing of petition).

CONCLUSION: BANKRUPTCY POLICY AND THE BANKRUPTCY CLAUSE

I do not seek to establish either an expansive or a restrictive interpretation of the Bankruptcy Clause, simply a more precise interpretation. In my view, Congress's power to enact laws "on the subject of Bankruptcies" is limited to the adjustment of the relationship between an insolvent debtor and his, her, or its creditors. I have developed four principles that amplify this meaning. Three of these principles directly govern the relationship between the federal government under its Bankruptcy Power and the states and the extent to which Congress may overrule state law: the Debtor-Creditor Adjustment Principle, the Non-Expropriation Principle, and the Non-Interference Principle.

Under the Debtor-Creditor Adjustment Principle, Congress may adjust the debtor-creditor relationship by curtailing the nonbankruptcy rights of a debtor for the benefit of the debtor's creditors and by curtailing the nonbankruptcy rights of those creditors against the debtor for the benefit of the debtor or other creditors. Under the Non-Expropriation Principle, however, Congress may not expand the rights of debtors or their creditors beyond that necessary to adjust their relationship or otherwise diminish either (i) the rights or privileges of parties outside of the debtor-creditor relationship for the benefit of the debtor or the creditors or (ii) the nonbankruptcy rights of the debtor or the creditors for the benefit of these Third Parties. Finally, the Non-Interference Principle provides that Congress may prevent Third Parties from using nonbankruptcy law to frustrate the bankruptcy process. Congress, in enacting or amending the Code, and federal courts, in applying the Code, must comply with these principles. For the most part, the Code does comply. In a few instances, it does not.

My view of the constitutional scope of bankruptcy law raises the practical difficulty of distinguishing between a creditor and a Third Party, an essential distinction for applying the Debtor-Creditor Adjustment Principle and the Non-Expropriation Principle. This difficulty is exacerbated when the same entity wears two hats, such as a landlord who is a "creditor" for past due rent and a Third Party holder of a reversionary interest in the leasehold that may continue after the commencement of the bankruptcy case. This duality also regularly appears in the case of parties to executory contracts, at-will employees, and governmental regulating and taxing entities, and also may appear, to a lesser extent, in the case of joint holders of a property interest.

Nevertheless, the practical difficulties should not overrule the principles if they are sound. Under the Code today, bankruptcy courts often must draw lines that are difficult. For example, courts must and do draw a line between a prepetition claim, entitled to a speculative, pro-rata distribution, and a postpetition administrative expense entitled to priority and more likely payment in full.[239]

Moreover, if we do not draw the line between a creditor and a Third Party, we must draw the line somewhere. One can only avoid the necessity of drawing a line between bankruptcy law and nonbankruptcy law if one believes that under the Constitution there are no limits to bankruptcy law.[240] Accordingly, regardless of the appropriate limit on bankruptcy law under the Constitution, the existence of a constitutional limitation on bankruptcy law requires that Congress and federal courts in bankruptcy identify and distinguish permissible bankruptcy law—in a constitutional sense, not in a normative sense—and unalterable nonbankruptcy law.[241]

Those who believe that the normative role of bankruptcy is only to maximize the return to creditors[242] will want Congress to refrain from altering the rights of creditors more than necessary to meet their goals. This view of the normative limits on bankruptcy law fits well within my view of the constitutional limits of bankruptcy as discussed in this article. Those who espouse a broader view of bankruptcy policy[243] will want Congress to exercise its full power under the

239. *See, e.g.*, Microsoft Corp v. DAK Indus. (*In re* DAK Indus.), 66 F.3d 1091, 1095 (9th Cir. 1995) (holding that Microsoft's "royalty rate" owed by the debtor in connection with the licensing and distribution by the debtor of Word for Windows software was a prepetition claim and not an administrative expense).

240. *See supra* note 54.

241. In 1953, Alfred Hill remarked about the apparent lack of consensus on the limits of bankruptcy law but posited that it must have some limits. *See* Hill, *supra* note 110, at 1036-38.

242. *See, e.g.*, Douglas G. Baird & Thomas H. Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy*, 51 U. Chi. L. Rev. 97, 100-01 (1984); Thomas H. Jackson & Robert E. Scott, *On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors' Bargain*, 75 Va. L. Rev. 155, 155-56 (1989); Robert E. Scott, *Through Bankruptcy with the Creditors' Bargain Heuristic*, 53 U. Chi. L. Rev. 690, 692, 694-95 (1986) (reviewing Douglas G. Baird & Thomas H. Jackson, Cases, Problems & Materials on Bankruptcy (1985)).

243. *See, e.g.*, Karen Gross, Failure and Forgiveness: Rebalancing the Bankruptcy System (1997); Hon. Samuel L. Bufford, *What Is Right About Bankruptcy Law and Wrong About Its Critics*, 72 Wash. U. L.Q. 829, 838 (1994) (stating that "Chapter 11 protects vital businesses, protects jobs and communities, gives debtors an opportunity to wait out an economic downturn, and avoids a catastrophic destruction of economic values"); Ronald J. Mann, *Bankruptcy and the Entitlements of the Government: Whose Money Is It Anyway?*, 70 N.Y.U. L. Rev. 993, 1000, 1056-57 (1995) (arguing that, to the extent that the federal bankruptcy system creates excess value over what creditors could collect under state collection laws, the federal government could divert that excess value from creditors to further any legitimate governmental interest); Elizabeth Warren, *Bankruptcy Policy*, 54 U. Chi. L. Rev. 775, 785-88 (1987) (arguing that the goal of bankruptcy law should be to determine the best distribution of losses from a debtor's failure among those affected by the insolvency of the debtor, including the interests of many who are not technically "creditors" and not just the maximization of the return to creditors); Elizabeth Warren, *The Untenable Case for Repeal of Chapter 11*, 102 Yale L.J. 437, 470, 478 (1992) (arguing the importance of using bankruptcy reorganization to save jobs).

Bankruptcy Clause in a manner consistent with their normative view of bankruptcy. Those normative views may require that Congress exceed what, in my opinion, are the constitutional limits on Congress's Bankruptcy Power. If so, the sponsors of those views need to develop their own theory on why the Bankruptcy Clause provides Congress with the necessary power to implement their views.

Notes & Observations