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## "The Bankruptcy Court Is a Court of Equity": What Does That Mean?

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## **"THE BANKRUPTCY COURT IS A COURT OF EQUITY": WHAT DOES THAT MEAN?**

THE HONORABLE MARCIA S. KRIEGER\*

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### I. INTRODUCTION

"The bankruptcy court is a court of equity." The statement is ubiquitous. Parties routinely open their courtroom arguments with the observation.<sup>1</sup> Published bankruptcy decisions of both trial and appellate courts are salted with the reference,<sup>2</sup> and scholars regularly debate the scope of the bankruptcy

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1. In the author's experience, the frequency of reference to the bankruptcy court as a court of equity is second only to introductions, "May it please the Court" or "Good morning (afternoon), Your Honor."

2. At the drafting of this Article, a search of WestLaw bankruptcy-related opinions revealed that nearly 5,000 described the bankruptcy court as a "court of equity."

court's equitable powers and jurisdiction.<sup>3</sup> Assumed to be a truism, the statement is never questioned. Used as a mantra, it is invoked to create a desired effect. The question is, what does it mean?

Nearly two hundred years have passed since the enactment of the first federal bankruptcy laws in this country. Congress is currently considering changes to bankruptcy law to meet the needs of the twenty-first century. Perhaps now is an appropriate time to consider why the bankruptcy court is so frequently characterized as a court of equity and to what degree it can serve as one. To answer these questions it is helpful to explore the historical origins of the Anglo-American bankruptcy system, the degree to which equitable attributes have been integrated into it, and the context of common references to the bankruptcy court as a court of equity. Interestingly, this endeavor leads to several conclusions that are inconsistent with common assumptions.

1. History does not support the common characterization of the bankruptcy court as a court of equity. American bankruptcy law and procedure did not develop out of bankruptcy proceedings before English chancery courts. Anglo-American bankruptcy law has always been a creature of statute, separate and distinct from traditional equity jurisprudence.
2. Bankruptcy laws, by their nature, embody a compromise between fundamental, competing social and economic objectives. The nature of the compromise varies from time to time as public values and economic conditions dictate. Bankruptcy law is implemented by using both legal and equitable procedures.
3. The function of bankruptcy courts is to implement the social policy set forth in bankruptcy law. Although the bankruptcy process in some respects may resemble particular equitable remedies, the bankruptcy court is no more a court of equity than any other court applying statutory law or the Federal Rules of Civil Procedure. Bankruptcy courts exercise power granted by statute and preside in civil actions that may include both legal and equitable claims.
4. Labeling the bankruptcy court as a court of equity is a result of judicial rather than legislative action. The designation has no universal meaning and is, therefore, used for a variety of purposes. Without a generally accepted meaning, the designation confuses more frequently than it clarifies the role of the bankruptcy court and leads to disappointed expectations.

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3. See, e.g., Manuel D. Leal, *The Power of the Bankruptcy Court: Section 105*, 29 S. TEX. L. REV. 487 (1988); G. Ray Warner, *Katchen Up in Bankruptcy: The New Jury Trial Right*, 63 AM. BANKR. L.J. 1 (1989); Robert H. George, Note, *Bankruptcy for Nonbankruptcy Purposes: Are There Any Limits?*, 6 REV. LITIG. 95 (1987); Brian Leepson, Comment, *A Case for the Use of a Broad Court Equity Power to Facilitate Chapter 11 Reorganization*, 12 BANKR. DEV. J. 775 (1996).

## II. THE ORIGINS OF THE AMERICAN BANKRUPTCY SYSTEM

The English chancery court proceeding is commonly accepted as the ancestor of American bankruptcy law and procedure. This assumption is incorrect. Statutes created bankruptcy remedies and insolvency rights in England. Bankruptcy proceedings were different than equity proceedings.<sup>4</sup>

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4. By necessity, this Article summarizes only the differences between English common law and equity traditions, and English bankruptcy and insolvency laws. The author has relied upon and encourages the reader to refer to more comprehensive analyses of common law and equity traditions in England and historical English bankruptcy and insolvency laws. *See generally* Findley v. Falise (*In re Joint E. & S. Dists. Asbestos Litig.*), 878 F. Supp. 473, 515-18 (E. & S.D.N.Y. 1995) (tracing the development of equity jurisdiction and equity trusts in England); THOMAS COOPER, *THE BANKRUPT LAW OF AMERICA, COMPARED WITH THE BANKRUPT LAW OF ENGLAND* ix-x (1801) (providing an overview of bankruptcy concepts as they were understood in nineteenth-century England); S. F. C. MILSOM, *HISTORICAL FOUNDATIONS OF THE COMMON LAW* 1-87 (1969) (discussing the development of the common law and equity principles); THEODORE F. T. PLUCKNETT, *A CONCISE HISTORY OF THE COMMON LAW* 1-76, 139-56 (5th ed. Little, Brown & Co. 1956) (1929) (surveying the development of English legal history and the origins of the central courts); 1 JOHN NORTON POMEROY, *A TREATISE ON EQUITY JURISPRUDENCE* 1-34 (1881) (providing a history of the inception and development of English equity courts); 1 HAROLD REMINGTON, *A TREATISE ON THE BANKRUPTCY LAW OF THE UNITED STATES* xiii (James M. Henderson ed., 5th ed. Law. Co-op. Publ. Co. 1950) (summarizing the development of English law and foundation for American bankruptcy law); EDWARD STANLEY ROSCOE, *THE GROWTH OF ENGLISH LAW* 169-82 (1911) (tracing the history of English bankruptcy legislation); Harold J. Berman, *The Origins of Historical Jurisprudence: Coke, Selden, Hale*, 103 YALE L.J. 1651, 1656-73 (1994) (providing the historical background of English legal and political philosophy from the twelfth to seventeenth centuries); Vern Countryman, *A History of American Bankruptcy Law*, 81 COM. L.J. 226, 226-32 (1976) (surveying the influence of English bankruptcy law on bankruptcy law in the United States); Andrew J. Duncan, *From Dismemberment to Discharge: The Origins of Modern American Bankruptcy Law*, 100 COM. L.J. 191, 200, 216-20 (1995) (analyzing only English bankruptcy acts and their influence on the formation of American bankruptcy law); Rhett Frimet, *The Birth of Bankruptcy in the United States*, 96 COM. L.J. 160, 163-63 (1991) (providing a brief introduction to English bankruptcy law); W.J. Jones, *The Foundations of English Bankruptcy: Statutes and Commissions in the Early Modern Period*, 69 TRANSACTIONS OF THE AM. PHIL. SOC'Y pt. 3 (1979) (tracing the history of English bankruptcy law from Tudor and early Stuart society); Kurt H. Nadelmann, *On the Origin of the Bankruptcy Clause*, 1 AM. J. LEGAL HIST. 215, 215-25 (1957) (explaining the history of the Bankruptcy Clause in the United States Constitution as it developed at the Constitutional Convention); James Monroe Olmstead, *Bankruptcy A Commercial Regulation*, 15 HARV. L. REV. 829 *passim* (1901-02) (recounting the legislative history and key cases in early American bankruptcy law); Thomas E. Plank, *The Constitutional Limits of Bankruptcy*, 63 TENN. L. REV. 487, 500-17 (1996) (discussing the development of bankruptcy law in England); Edward J. Ross, *Federal Jurisdiction in Suits by Trustees in Bankruptcy*, 20 IOWA L. REV. 565 *passim* (1934-35) (tracing the history of jurisdictional problems arising from inconsistencies within the Bankruptcy Act); Stephen N. Subrin, *How Equity Conquered Common Law: The Federal Rules of Civil Procedure in Historical Perspective*, 135 U. PA. L. REV. 909, 914-21 (1987) (reviewing basic characteristics and evolution of the English courts of law and equity); Charles Jordan Tabb, *The Historical Evolution of the Bankruptcy Discharge*, 65 AM. BANKR. L.J. 325, 326-44 (1991) (examining the development of discharge in English law up to the time of the writing of the United States Constitution); Charles Jordan Tabb, *The History of the Bankruptcy Laws in the United States*, 3 AM. BANKR. INST. L. REV. 5, 6-12 (1995) [hereinafter Tabb, *History*] (discussing English antecedents to American bankruptcy law); Warner, *supra* note 3, at 6 (referring to "the

### A. *Distinctions Between English Actions at Law and in Equity*

Modern concepts of equity arise from England's historical distinction between "common law" or "law" courts,<sup>5</sup> and "chancery" or "equity" courts.<sup>6</sup> Although complementary, English law and equity courts had different and distinct procedural systems, jurisprudential foundations, and purposes. "The law courts had three identifying characteristics: the writ . . . , the jury, and single issue pleading."<sup>7</sup> These characteristics, in combination, isolated issues and focused disputes for the purpose of predictable application of the law. In contrast, courts of equity were designed to be flexible and to provide comprehensive determinations which could not be obtained through the common law courts.<sup>8</sup>

Actions at law originated by filing a grievance with the King's Chancellor.<sup>9</sup> The chancellor sold writs authorizing a law court to hear the case and instructing a sheriff to secure the defendant's presence.<sup>10</sup> The nature of the writ determined the subject matter, personal jurisdiction, burden of proof, and methods of execution on any judgment obtained. Parties were entitled to trial by a jury of their peers and a remedy in the form of a money judgment.

The strength of the common law system was its organized body of case law and consequent predictability. However, it was perceived as rigid and rarified. Due to the multitude of procedural rules, parties could lose on technicalities. Lawyers often engaged in legal "fictions" in order to pigeon-hole claims into recognized forms of action.<sup>11</sup>

Equity practice developed in response to the rigidity and technicality of the

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boundaries of law and equity" in England); Robert Weisberg, *Commercial Morality, the Merchant Character, and the History of the Voidable Preference*, 39 STAN. L. REV. 3, 13-39 (1986)(reviewing the history of English bankruptcy and preference law); Mark Bradshaw, Note, *The Role of Politics and Economics in Early American Bankruptcy Law*, 18 WHITTIER L. REV. 739, 740-47 (1996)(explaining the state of English bankruptcy law at the time of the American constitutional convention).

5. Actually, there were a variety of law courts, including King's Bench, Exchequer, and Common Pleas. See MILSOM, *supra* note 4, at 26-46, 53-54; PLUCKNETT, *supra* note 4, at 146-50.

6. *Black's Law Dictionary* has essentially the same definition for "court of chancery" and "court of equity." A court of chancery administers "equity and proceeding according to the forms and principles of equity." BLACK'S LAW DICTIONARY 356 (6th ed. 1990). A court of equity "administers justice and decides controversies in accordance with the rules, principles, and precedents of equity, and which follows the forms and procedure of chancery." *Id.* Both definitions note that equity courts have been abolished in all states that have adopted rules of civil procedure—states in which law and equity actions have been merged procedurally into a single form of civil action. *Id.*

7. Subrin, *supra* note 4, at 914.

8. See MILSOM, *supra* note 4, at 74-87.

9. Often referred to as the chancellor or Lord Chancellor.

10. See Subrin, *supra* note 4, at 915.

11. *Id.* at 917.

writ-dominated common law system.<sup>12</sup> As with common law disputes, equitable matters began with filing a grievance with the chancellor. When the situation was unusual or no common law remedy was available, grievants submitted a "bill in equity" to persuade the chancellor to relieve them from alleged injustices which would result from rigorous application of the common law.<sup>13</sup> Chancery jurisdiction covered fraud, mistake, fiduciary relationships, trusts, and other areas excluded by common law writs.

Initially the chancellor was a bishop, and the equity court became known as the Court of Conscience. This reference had dual importance. First, unlike in common law courts, the chancellor could compel the defendant to testify and could order specific relief to undo past injuries or to regulate the defendant's future conduct.<sup>14</sup> Second, the chancellor was expected to consider all of the circumstances and interests of the affected parties. The chancellor had the ability to join all interested parties in a single action and could consider larger moral issues and questions of fairness. In the beginning, chancellors based their decisions on "the law of God or [on] conscience."<sup>15</sup> Later, their rulings were based upon concepts of "natural justice or the law of nature."<sup>16</sup> The equity procedure was more flexible, discretionary, and individualized than the common law process. The chancellor was free to include more parties and issues, to consider and impose a variety of remedies, was less bound by precedent, and was permitted to determine both questions of fact and law.<sup>17</sup> However, equity was available only when no adequate remedy at law existed. Thus, it grew interstitially to fill the gaps in the common law.

Equity courts were not without critics. The common law courts in the seventeenth century were viewed as the protectors of the rights of citizens because matters were tried to a jury. In contrast, equity courts such as the Court of the Star Chamber and Court of Chancery were seen as dominated and controlled by the crown.<sup>18</sup> Equity courts also developed case precedent that began to burden the process.

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12. See *id.* at 915-18; MILSOM, *supra* note 4, at 74-83; POMEROY, *supra* note 4, § 21.

13. Subrin, *supra* note 4, at 918.

14. These powers gave rise to the contemporary equitable remedies that compel particular behavior of parties. Some of these remedies are injunctions, accountings, rescission of contracts, reformation of instruments, termination of rights or interests, and restrictions on use of property.

15. HENRY L. MCCLINTOCK, *HANDBOOK OF THE PRINCIPLES OF EQUITY* 6 (2d ed. 1948).

16. *Id.*

17. *Id.* at 20-32.

18. In *Findley v. Falise* (In re *Joint E. & S. Dists. Asbestos Litig.*), 878 F. Supp. 473 (E. & S.D.N.Y. 1995), the court recited the history of the conflict between Lord Coke, Chief Justice of the leading common law court, and the Lord Chancellor. A common law court had ruled against a defendant even though an important witness was prevented from testifying by being induced to become drunk. On appeal, the plaintiff violated the Lord Chancellor's order and was imprisoned for contempt. Lord Coke threatened to prosecute the Lord Chancellor but the King intervened, supporting the Lord Chancellor, even to the extent of interfering with the common law court's ability to secure justice. See *id.* at 515-17.

In the English colonies in America, colonists generally preferred jury trials to resolve civil disputes.<sup>19</sup> The concept of equity as an alternative to the common law was adopted, but its application was not always through a chancellor or equity court.<sup>20</sup> One commentator observes:

When the English colonists came to this country, they brought with them the laws of England, including the system of equity which had been developed in England by the chancellors. In many of the colonies, the Puritan opposition to the king led, as it did in England, to an opposition to the chancellor, as a royal appointee, and in most of them there was a struggle between the popular legislatures and the royal, or proprietary, governors, for the control of the administration of equity. Where the governors prevailed, they exercised the power themselves, or appointed chancellors to do so. Where the legislature prevailed, the administration of the system was vested in local courts, often the same courts as were already exercising jurisdiction in common law cases.<sup>21</sup>

When the federal government was formed, federal courts were given jurisdiction in both law and equity actions in accordance with the Constitution.<sup>22</sup> Equity and legal jurisdiction were separate; a federal court could sit either in equity or as a court of law depending on the nature of the claim. Equity trials were presented to the court; at law, trials were presented to a jury. The first judiciary act and its successors provided that equity matters were determined by the precedent of the English Chancery court, except as modified by equity rules promulgated from time to time by the United States Supreme Court.<sup>23</sup> However, in common law actions, federal courts applied state common law. Due to the distinction between equity and legal actions and the difference in the precedent applied, federal courts had little occasion to use equity to fill the gaps in the common law.

Debate about the relative merits of law and equity jurisprudence abounded during the nineteenth and early twentieth centuries.<sup>24</sup> In the federal system the debate ended in 1938 with adoption of the Federal Rules of Civil Procedure, through which equitable and legal claims were merged into a single civil action, subject to a single set of procedural rules.<sup>25</sup> Adoption of similar rules of civil procedure by many states resulted in the merger of equity and law actions

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19. See Subrin, *supra* note 4, at 927-29.

20. McCLINTOCK, *supra* note 15, at 12.

21. *Id.* (footnote omitted).

22. See U.S. CONST. art. III, § 2.

23. See *Mississippi Mills v. Cohn*, 150 U.S. 202, 205 (1893).

24. See Subrin, *supra* note 4, at 931-82.

25. See FED. R. CIV. P. 86.

before state courts and elimination of chancery or equity courts.<sup>26</sup>

This merger did not subordinate equity to law. Some suggest that civil procedure is now largely an equitable process with substantial flexibility, simplified pleading, permissive joinder of parties and issues into a single action, broad-scope discovery, the availability of class actions, and a panoply of remedies that can be considered.<sup>27</sup> Other commentators note that broadening public access to the courts, creating new remedies, and enactment of new federal laws to address social ills served equitable objectives during the last thirty years.<sup>28</sup>

Both federal district courts and bankruptcy courts apply the Federal Rules of Civil Procedure. Therefore, in civil matters before the district court and adversary proceedings before the bankruptcy court, the distinction between law and equity is now limited to the type of remedy imposed and the parties' right to a jury trial. Common law claims give rise to a right to jury trial and result in money judgments. Equitable claims lead to equitable remedies such as injunctions, accountings, interpleader, rescission and reformation of contracts, clearing of title to property, imposition of constructive or resulting trusts, or disposition of proceeds of funds to class claimants. Statutes can give rise to both equitable remedies and legal rights.<sup>29</sup>

### *B. The Origin of American Bankruptcy Law and Process*

Although bankruptcy rights and remedies have existed since early times,<sup>30</sup>

26. Abolition of formal distinctions between actions at law and actions in equity occurred by code or practice acts

in the following states in the years indicated:  
 Arizona, 1864; California, 1850; Colorado, 1877;  
 Connecticut, 1879; Illinois, 1933; Indiana, 1852;  
 Idaho, 1864; Kansas, 1859; Minnesota, 1851;  
 Missouri, 1849; Montana, 1865; Nebraska, 1855;  
 Nevada, 1860; New Mexico, 1897; New York, 1848;  
 North Carolina, 1868; North Dakota, 1862; Ohio,  
 1853; Oklahoma, 1890; South Carolina, 1870; South  
 Dakota, 1862; Utah, 1870; Washington, 1854;  
 Wisconsin, 1856; and Wyoming, 1869.

MCCLINTOCK, *supra* note 15, at 13-14 n.46.

27. Subrin, *supra* note 4, at 923-24.

28. See, e.g., Jack B. Weinstein & Eileen B. Hershenov, *The Effect of Equity on Mass Tort Law*, 1991 U. ILL. L. REV. 269, 270-72 (1991).

29. For example, 28 U.S.C. § 157(b)(2) defines the scope of the bankruptcy court's authority to enter final judgments as "core proceedings." Subject to the courts' "equitable jurisdiction," these matters pertain to certain aspects of bankruptcy estate administration and are tried to the bankruptcy court. However, if a core proceeding requires a jury, 28 U.S.C. § 157(e) authorizes the bankruptcy judge to conduct a jury trial if designated by the district court and agreed to by the parties. Presumably, in this capacity the bankruptcy court sits as a court of law.

30. Historians trace early forms of bankruptcy to ancient societies. Early Roman law authorized creditors to liquidate a debtor's assets, "cut up his body and divide the pieces or leave him alive and sell him into slavery." JAMES WM. MOORE & WALTER RAY PHILLIPS, *DEBTORS'*



the bankruptcy and insolvency laws of seventeenth- and eighteenth-century England greatly influenced American bankruptcy law. English laws were not directly transplanted to American shores; instead American social, economic, and philosophical influences modified English tradition to create American bankruptcy law.

### 1. *English Bankruptcy Laws*

In England bankruptcy law was a creature of statute. Early bankruptcy laws were quasi-criminal in nature, invoked by creditors to preserve and distribute a bankrupt's assets upon the commission of an act of bankruptcy. Scholars generally agree that the first English bankruptcy statute was enacted in 1542.<sup>31</sup> The 1542 Henry VIII statute was entitled "An act against such persons as do make bankrupts."<sup>32</sup> It provided creditors with a remedy against fraudulent and absconding merchants, authorizing imprisonment if necessary.<sup>33</sup> Bankruptcy under this act—and for almost three centuries following—was exclusively involuntary and limited to merchants.<sup>34</sup> As in the common law and equity systems, creditors complained to the chancellor. The statute granted jurisdiction to the "lord chancellor of England, or keeper of the great seal, the lord treasurer, the lord president, lord privy seal, and other of the King's most honourable privy council, the chief justices of either bench . . . or three of them at the least."<sup>35</sup> Upon notice, a debtor's assets were seized, appraised, and sold with the proceeds distributed pro rata to all creditors proving just claims.<sup>36</sup>

Twenty-eight years later, when the number of defaulting debtors was on the rise, England enacted a more comprehensive bankruptcy law entitled "An act touching orders for bankrupts."<sup>37</sup> The 1570 Elizabeth statute amplified the earlier law, expressly limiting its provisions to "traders," defined as "any 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."<sup>38</sup> As with its predecessor, relief under the later act was involuntary, and no discharge was granted.<sup>39</sup>

The 1570 Elizabeth statute is probably most important for its procedure. According to one historian, this statute "discerned the beginning of the whole

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AND CREDITORS' RIGHTS 1-1 (4th ed. 1975); Countryman, *supra* note 4, at 226-27.

31. 34 & 35 Hen. 8, ch. 4 (1542-43) (Eng.).

32. *Id.*

33. See Tabb, *History*, *supra* note 4, at 8.

34. The act only protected traders. *Id.* at 9. "Traders" was defined in the 1570 Elizabeth Statute. See 13 Eliz., ch. 7, § 1 (1570) (Eng.).

35. 34 & 35 Hen. 8, ch. 4, § 1 (1542-43) (Eng.).

36. *Id.*

37. 13 Eliz., ch. 7 (1570) (Eng.).

38. *Id.* § 1.

39. *Id.* § 2.

modern [English] machinery of official assignees, trustees, commissioners, judges, and the rest of the army of officials by whom the State has from time to time endeavoured to protect creditors."<sup>40</sup> Creditors' grievances were submitted to the chancellor, who appointed a commission of "such wise and honest discreet persons as to him shall seem good."<sup>41</sup> The commission took charge of the debtor and his assets and distributed the debtor's property ratably among his creditors.<sup>42</sup> Commissioners were empowered to examine the debtor as well as anyone alleged to be an accomplice to a fraudulent conveyance.<sup>43</sup> If the transfer was found to be fraudulent, the commission could levy a fine equal to twice the value of the assets fraudulently conveyed.<sup>44</sup> If the debtor hid, the commissioners could order the debtor to appear and could imprison or fine anyone who helped the debtor escape.<sup>45</sup> The debtor could appeal the commission's determination to the chancellor.<sup>46</sup>

England again enacted bankruptcy legislation favoring creditors in 1604,<sup>47</sup> 1623,<sup>48</sup> and 1662.<sup>49</sup> New remedies were employed to reach more assets and harsher penalties were imposed against non-compliant bankrupts. All of the acts compelled bankrupts to be examined by the commissioners. Under the 1623 James statute, a debtor who perjured himself at his examination could be pilloried for two hours, then have his ear cut off.<sup>50</sup> This punishment was also applicable to bankrupts convicted of making a fraudulent conveyance or failing to explain why they became bankrupt.<sup>51</sup>

In 1705 Parliament enacted the Statute of Anne,<sup>52</sup> which first addressed debt discharge. As with prior statutes, bankruptcy remained an involuntary procedure available only to creditors of merchants. Discharge was limited to bankrupts who fully complied with the spirit and the letter of the law.<sup>53</sup> Discharge was discretionary, requiring that a majority of the commissioners, with the approval of creditors, certify that the bankrupt had "conformed" to the law,<sup>54</sup> which required full disclosure of financial affairs and delivery of all

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40. ROSCOE, *supra* note 4, at 172.

41. 13 Eliz., ch. 7, § 2 (1570) (Eng.).

42. *Id.*

43. *Id.*

44. *Id.* § 8. Also, for an extensive review of this procedure, see Duncan, *supra* note 4, at 196.

45. 13 Eliz., ch. 7, § 9 (1570) (Eng.).

46. *Id.* This is why many old English bankruptcy decisions are ascribed to the chancellor.

47. See 1 Jam., ch. 15 (1604) (Eng.).

48. See 21 Jam., ch. 19 (1623) (Eng.).

49. See 13 & 14 Car. 2, ch. 24 (1662) (Eng.).

50. 21 Jam., ch. 19, § 7 (1623) (Eng.); see Duncan, *supra* note 4, at 197.

51. Tabb, *Historical*, *supra* note 4, at 331 n.40, 332 n.41.

52. 4 Anne, ch. 17 (1705) (Eng.).

53. *Id.* § 7.

54. *Id.* § 19.

assets to the commissioners.<sup>55</sup> Upon issuance of a “certificate of conformity,” the bankrupt became eligible to receive a monetary allowance from the estate.<sup>56</sup> The chancellor had discretion to adjust the size of the allowance to ensure creditors received a sufficient dividend.<sup>57</sup> If discharge and allowance were carrots inducing a bankrupt’s compliance, the stick to punish noncompliance of fraudulent debtors was that they “shall suffer as a felon without benefit of clergy,” an eighteenth century euphemism for the death penalty.<sup>58</sup>

In 1732 Parliament comprehensively codified and revised English bankruptcy law.<sup>59</sup> The 1732 statute was in effect for almost a century until being repealed in 1824.<sup>60</sup> The 1732 George statute varied little from its predecessor. The bankruptcy process continued to be supervised by a commission that had the power to investigate the affairs of the debtor, collect and sell assets, distribute the proceeds to creditors, issue a certificate of conformity, and award an allowance to a compliant debtor. The statute restricted issuance of the certificate of conformity after the first bankruptcy case; in successive cases, certificates were available only if the debtor paid a seventy-five percent dividend to creditors.<sup>61</sup> If debtors refused to answer, lied, or gave unsatisfactory answers, the commission could commit them to jail without bail or impose the death penalty. For fraudulent conveyances, the commission could impose punishment in the pillory or by mutilation.<sup>62</sup>

## 2. *English Insolvency Laws*

Many debtors were not subject to bankruptcy laws, either because they were not merchants or because they had committed no specified act of bankruptcy. However, these debtors remained subject to individual debt collection through the common law courts.

In eighteenth century England, the creditor’s [non-bankruptcy] remedies were limited to the writ of *feri facias* which authorized the sheriff to seize the goods of the debtor . . . to pay the debt; the writ of *levari facias* enabling the sheriff to seize the personal property of the debtor and the rents from the debtor’s real property to satisfy the debt; the writ of *elegit* allowing delivery of the goods . . . at an appraised value in satisfaction of the debt . . . ; or the writ of

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55. *Id.* § 7; Tabb, *Historical*, *supra* note 4, at 333-35.

56. 4 Anne, ch. 17, §§ 7-8 (1705) (Eng.).

57. *Id.*

58. *Id.* § 18. From all records it appears that the death penalty was rarely imposed.

59. 5 Geo. 2, ch. 30 (1732) (Eng.).

60. 5 Geo. 4, ch. 98, § 1 (1824) (Eng.).

61. 5 Geo. 2, ch. 30, § 9 (1732) (Eng.).

62. For a more comprehensive review of the process, see Duncan, *supra* note 4, at

*capias ad satisfaciendum* by which the debtor was imprisoned until the debt was paid.<sup>63</sup>

Using the *mesne* process, a creditor appeared before a designated court official and swore that the debt was overdue or that the debtor intended to run, hide, or conceal property. The court issued a writ directing the sheriff to seize the debtor. After twenty-four hours in jail the debtor could pay the debt, post bail, or remain in detention until trial. The creditor was required by the end of the following legal term to state a cause of action so the case could be tried. The debtor appeared in court and pled in response. The judge summarized the case and the jury decided liability. Debtors found liable were subject to the various writs for collection.<sup>64</sup>

English insolvency acts allowed certain debtors owing debts in specified amounts to be released from prison by assigning all of their real and personal property for liquidation and satisfaction of the debt.<sup>65</sup> In essence, this allowed debtors to elect to satisfy the debt rather than to be imprisoned, but elections to assign property did not discharge any unpaid portion of the debt. The insolvency acts applied to non-merchants as well as to merchants and were initiated by a debtor's petition. However, the insolvency acts did not protect all debtors. Some acts limited relief to those who were willing to go into military or naval service. Other acts limited relief to those owing debts of particular amounts.

The bankruptcy and insolvency acts first converged in the 1758 George II statute.<sup>66</sup> Insolvency provisions benefitted debtors imprisoned for sums of less than 100 Pounds Sterling.<sup>67</sup>

[A] creditor could compel a debtor who did not seek 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. If the debtor refused, he would be transported to a colony in America for indentured service for seven years.<sup>68</sup>

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63. Plank, *supra* note 4, at 515-16 (footnotes omitted).

64. See Duncan, *supra* note 4, at 212-14.

65. See, e.g., 2 & 3 Anne, ch. 16 (1703) (Eng.); 6 Geo. 1, ch. 22 (1719) (Eng.); 11 Geo. 1, ch. 21 (1724) (Eng.); 2 Geo. 2, ch. 20 (1729) (Eng.); 21 Geo. 2, ch. 31 (1748) (Eng.); 28 Geo. 2, ch. 13 (1755) (Eng.); 9 Geo. 3, ch. 26 (1768) (Eng.); 12 Geo. 3, ch. 23 (1772) (Eng.); 14 Geo. 3, ch. 77 (1774) (Eng.); 16 Geo. 3, ch. 38 (1776) (Eng.); 18 Geo. 3, ch. 52 (1778) (Eng.); 21 Geo. 3, ch. 63 (1781) (Eng.).

66. 32 Geo. 2, ch. 28 (1758) (Eng.).

67. Plank, *supra* note 4, at 514. Originally, insolvency statutes applied to debtors with debts between 50 and 100 Pounds Sterling. Later this was increased to 1,000 to 2,000 Pounds Sterling. *Id.* at 514-16.

68. *Id.* at 516.

### C. *The American Bankruptcy Experience*

Given the colonists' familiarity with seventeenth- and eighteenth-century English law, it is likely that English law influenced the development of similar laws in the colonies and ultimately the formulation of the first federal bankruptcy law. However, neither colonial statutes nor the first federal statutes were carbon copies of English law. In every colony creditors were given the power to execute against a debtor's goods and to imprison a debtor who refused to pay.<sup>69</sup> Some colonies regulated bankruptcy, others regulated insolvency, and some had laws applicable to both.<sup>70</sup> Like their English counterparts, colonial bankruptcy laws were generally limited to involuntary actions against merchants, whereas insolvency laws provided debtors with a means to obtain relief from debtor's prison.<sup>71</sup>

Only Massachusetts, New Hampshire, and Pennsylvania had statutes directly modeled on the English acts.<sup>72</sup> Delaware established an innovative system that allowed certain debtors to be released from prison if they were over a certain age, were responsible for small children, or if they had a small debt and were willing to provide indentured service for up to six months.<sup>73</sup> "Georgia provided no relief of debtors from either debts or imprisonment for debt."<sup>74</sup> For a short time, Virginia law provided for capital punishment for fraudulent debtors.<sup>75</sup>

Apparently, congressional power to legislate a national bankruptcy law was incorporated into the United States Constitution with little debate. The subject of bankruptcy was raised late in the proceedings at the Federal Convention of 1787 by Charles Pinckney of South Carolina.<sup>76</sup> He suggested that a clause be added to the Full Faith and Credit Clause "to establish the uniform laws upon the subject of bankruptcies and respecting the damages arising on the protest of foreign bills of exchange."<sup>77</sup> John Rutledge, also from South Carolina, suggested that the delegates add a power "to establish uniform laws on the subject of bankruptcies."<sup>78</sup> Two days later, on September 3, 1787, the bankruptcy clause was approved.<sup>79</sup> The provision provides that Congress

69. *Id.* at 518.

70. *Id.* at 518-25.

71. See Frimet, *supra* note 4, at 165.

72. Plank, *supra* note 4, at 520 n.165.

73. *Id.* at 522.

74. *Id.*

75. *Id.* at 521 n.169.

76. Frimet, *supra* note 4, at 164.

77. *Id.* (quoting CHARLES WARREN, *BANKRUPTCY IN UNITED STATES HISTORY* 5 (1935)).

78. Olmstead, *supra* note 4, at 831.

79. Frimet, *supra* note 4, at 164. The sole statesman who voted nay was Connecticut's Roger Sherman, who observed that "bankruptcies were in some cases punishable with death, by the laws of England; and he did not choose to grant a power by which that might be done [in the United States]." Olmstead, *supra* note 4, at 831. "Some historians claim that Sherman only voted

has the power "[t]o establish . . . uniform Laws on the subject of Bankruptcies throughout the United States . . . ."<sup>80</sup>

Given the dearth of debate about the Bankruptcy Clause, it is difficult to tell what was in the drafters' minds. However, many historians suggest that congressional regulation of bankruptcy was simply an extension of the commerce power designed to provide uniformity for commercial transactions throughout the country.<sup>81</sup>

Although the Constitution gave Congress the power to enact a uniform, national bankruptcy law, between 1787 and 1898 federal bankruptcy law applied in only sixteen years. In response to periods of economic instability, Congress enacted four bankruptcy statutes—three of which remained in effect for only short periods of time. Each time Congress considered bankruptcy legislation, debate focused upon whether bankruptcy laws also included insolvency laws, issues of state or federal supremacy, and regional political interests.<sup>82</sup>

Congress passed the first federal bankruptcy law on April 4, 1800 in response to the economic panics of 1792 and 1797.<sup>83</sup> The 1800 Act was designed as a temporary measure that would terminate in five years, but was repealed after only three years.<sup>84</sup> It was similar to the 1732 George statute but also contained features drawn from the Pennsylvania model.<sup>85</sup> Bankruptcy was purely a creditor's remedy involuntarily applicable to merchants who committed acts of bankruptcy. Fraudulent acts by bankrupts were criminal offenses, but not punishable by death. Commissioners with powers similar to English commissioners were appointed by federal courts to supervise the bankruptcy process. Discharge of the debts of a cooperative debtor was allowed, but before the discharge was granted, the bankruptcy commissioners were required to certify to the federal judge that the debtor had cooperated and that two-thirds of the creditors had consented to the discharge.<sup>86</sup> Modest

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may because Connecticut had their own bankruptcy law at the time and there was a fear of potential conflict with a federal law." Frimet, *supra* note 4, at 164.

80. U.S. CONST. art. I, § 8, cl. 4.

81. See, e.g., Bradshaw, *supra* note 4, at 746.

82. For a more comprehensive discussion of the development of American bankruptcy law see WARREN, *supra* note 77, Frimet, *supra* note 4, and Tabb, *History*, *supra* note 4. Charles Tabb categorizes constitutional issues generated by the Bankruptcy Clause as follows: (1) What constitutes "the subject of bankruptcies"? (2) Is a bankruptcy law "uniform"? (3) Is state law regulating the relationship between debtors and creditors preempted by federal law? (4) What is the relationship between the Bankruptcy Clause and other constitutional provisions such as the Fifth Amendment Takings Clause and the Seventh Amendment right to a jury trial? See Tabb, *History*, *supra* note 4, at 43-50.

83. Bankruptcy Act of 1800, ch. 19, 2 Stat. 19 (1800), *repealed by* Act of Dec. 19, 1803, ch. 6, 2 Stat. 248 (1803). This act facilitated "a discharge for some of the prominent financiers [of the American Revolution], including Robert Morris, who had been ruined in 1797." See Tabb, *History*, *supra* note 4, at 15.

84. Ch. 6, 2 Stat. 248 (1803) (repealing 1800 Act).

85. See *supra* note 82.

86. Ch. 19, § 36, 2 Stat. at 31.

exemptions, such as necessary wearing apparel and bedding, were permitted.<sup>87</sup>

At the time the Act was repealed in 1803, critics complained that “[s]mall dividends were paid, and many of the discharged debtors were high-rolling speculators who went through bankruptcy and then started their operations anew. In addition, travel to the distant federal courts was difficult. Finally, agricultural interests were outraged at the perceived favoritism of mercantile groups.”<sup>88</sup>

Between 1803 and the enactment of the next federal bankruptcy law in 1841, insolvency and bankruptcy were governed by state law. In 1819 the United States Supreme Court held that state insolvency law could not constitutionally discharge pre-existing debts.<sup>89</sup> This was followed by a ruling in 1827 that state law could not provide for discharge of a debt owed to a citizen of another state.<sup>90</sup> The combination of these rulings created problems during the economic depression of 1819 and 1820 because there was no federal law by which debtors could discharge all debts.<sup>91</sup> As a consequence, “[t]hroughout the 1820s attempts were made to pass a bill permitting voluntary bankruptcy for [both] . . . merchant[s] and non-merchant[s].”<sup>92</sup> These “efforts were rebuffed by an alliance of southerners, who opposed any federal bankruptcy bill, and others who believed that voluntary bankruptcy was unconstitutional.”<sup>93</sup> However, some debtor relief emerged through the abolition of imprisonment for debt at the federal level in 1833 and by many states during the 1830s and 1840s.

The Panic of 1837, combined with the victory by the Whigs over the Democrats in the 1840 election, resulted in adoption of a second bankruptcy law in 1841.<sup>94</sup> The 1841 Act was the first to authorize voluntary bankruptcy and to grant relief to non-merchants. Likely drafted by Supreme Court Justice Joseph Story, it “was a coordinated, simple, and short act” modeled after the Massachusetts insolvency law of 1838.<sup>95</sup> The act vested jurisdiction in the district court “in the nature of summary proceedings in equity,” directed the liquidation of assets and distribution to creditors, and replaced bankruptcy commissioners with an assignee.<sup>96</sup> A bankrupt was allowed basic exemptions, but was not permitted to invoke state exemption laws.<sup>97</sup> Few debts were excepted from the discharge, but there were a number of grounds for denying

87. *Id.* § 5, 2 Stat. at 23.

88. *See* Tabb, *History*, *supra* note 4, at 15.

89. *Sturges v. Crowninshield*, 17 U.S. (4 Wheat.) 122, 200 (1819).

90. *Ogden v. Saunders*, 25 U.S. (12 Wheat.) 213, 255 (1827).

91. *See* Tabb, *History*, *supra* note 4, at 15.

92. *Id.* at 16.

93. *Id.*

94. Bankruptcy Act of 1841, ch. 9, 5 Stat. 440 (1841), *repealed by* Act of Mar. 3, 1843, ch. 82, 5 Stat. 614 (1843).

95. Tabb, *History*, *supra* note 4, at 17.

96. Ch. 9, § 6, 5 Stat. at 445.

97. *Id.* § 3, 5 Stat. at 443.

discharge, including preferring creditors. Commissioners no longer certify a discharge to the court. Instead a district court conducts a hearing on discharge.<sup>98</sup> Finally, the debtor could raise the discharge as an affirmative defense in subsequent actions.

The 1841 Act went into effect in February of 1842 but was repealed a year later. It was disfavored by creditors and bankrupts alike. Creditors saw bankrupts "disavow legitimate debts without any thought of making restitution."<sup>99</sup> Bankrupts "found that the Act preserved state liens, but not the state exemptions [in] . . . property."<sup>100</sup>

The years following the repeal of the 1841 Act brought prosperity and, consequently, no need for a new federal bankruptcy law. States experimented with insolvency laws. At the same time, England "liberalized its bankruptcy law in favor of debtors by abolishing the requirement of creditor consent to the discharge in 1842, allowing voluntary bankruptcy in 1844, and extending eligibility to non-merchants in 1861."<sup>101</sup>

The panic of 1857 and the financial cataclysm of the Civil War, like prior financial crises, spurred consideration of another bankruptcy act in 1867.<sup>102</sup> This act included both voluntary and involuntary bankruptcy and made corporations eligible for relief. An oath of allegiance to the United States was required of every petitioning bankrupt.<sup>103</sup> The act allowed involuntary bankruptcy to be initiated against any person and expanded the list of acts supporting an involuntary petition.<sup>104</sup> Federal district courts were granted original jurisdiction in bankruptcy matters as courts of bankruptcy.<sup>105</sup> These courts appointed one or more "registers in bankruptcy, to assist the judge of the district court in the performance of his duties."<sup>106</sup>

In 1874 new federal legislation authorizing the formulation of composition agreements amended the 1867 Act.<sup>107</sup> The forerunner of modern reorganization plans, this act required bankrupts to pay a percentage of current income to retire past debts. A majority of creditors holding three-fourths in value of the outstanding claims could bind the named creditors by accepting the composition.<sup>108</sup> The "best interests" test required that creditors be paid as much

98. *Id.* § 4, 5 Stat. at 443-44.

99. Frimet, *supra* note 4, at 179.

100. *Id.*

101. Tabb, *History*, *supra* note 4, at 18 (footnotes omitted). See generally Frimet, *supra* note 4, at 180 (describing activities after repeal of the 1841 Act).

102. Bankruptcy Act of 1867, ch. 176, 14 Stat. 517 (1867), *repealed by* Act of June 7, 1878, ch. 160, 20 Stat. 99 (1878); Frimet, *supra* note 4, at 180-83; Tabb, *History*, *supra* note 4, at 19.

103. Ch. 176, § 11, 14 Stat. at 521.

104. *Id.* § 39, 14 Stat. at 536.

105. *Id.* § 1, 14 Stat. at 517.

106. *Id.* § 3, 14 Stat. at 518.

107. Act of June 22, 1874, ch. 390, 18 Stat. 178, *repealed by* Act of June 7, 1878, ch. 160, 20 Stat. 99 (1878).

108. Ch. 390, § 17, 18 Stat. at 183.



as they would receive in a liquidation.<sup>109</sup>

Congress repealed the 1867 Act in 1878, largely at the insistence of creditors complaining about “small dividends, high fees and expenses, and lengthy delays. Northern creditors who had hoped to use the bankruptcy law to facilitate collection from southern debtors were disappointed.”<sup>110</sup> However, bankrupts also did poorly under the 1867 law.<sup>111</sup> “Due to the inclusion of numerous grounds for denying discharge, only about one-third of the debtors received a discharge.”<sup>112</sup>

Finally, in 1898 Congress enacted the Bankruptcy Act which remained in effect for eighty years.<sup>113</sup> The Bankruptcy Act fundamentally changed the balance between creditors and debtors. All prior bankruptcy laws limited a debtor’s discharge, conditioned it upon creditor consent or at least the absence of objection by a specified percentage of creditors, and required a minimum dividend to creditors. The Bankruptcy Act abolished these restrictions and severely limited the grounds for denying a discharge.<sup>114</sup> The Act did not permit federal exemptions.<sup>115</sup> Creditors exercised control through their power to elect a trustee and through creditors’ committees.

In addition to facilitating debtor relief, the Bankruptcy Act also implemented a system for efficient estate administration and distribution.<sup>116</sup> As with the 1867 Act, federal district courts sat as “courts of bankruptcy.”<sup>117</sup> Their bankruptcy jurisdiction was independent from their jurisdiction as a court of law and as a court of equity. For bankruptcy proceedings it included both legal and equitable jurisdiction.<sup>118</sup> Referees in bankruptcy, appointed by the district courts, did the bulk of the judicial and administrative work.

Sitting in bankruptcy, district courts or referees had exclusive summary jurisdiction over administrative proceedings. The term summary jurisdiction was derived from historical bankruptcy court summary proceedings in which formal pleadings were not required.<sup>119</sup> The district court also exercised

109. *Id.*

110. *See* Tabb, *History*, *supra* note 4, at 19.

111. *Id.* at 20.

112. *Id.* (footnote omitted).

113. Bankruptcy Act of 1898, ch. 541, 30 Stat. 544 (1898), *repealed by* Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (1978). This Act continued until the current Bankruptcy Code became effective in 1979.

114. Ch. 541, § 16, 30 Stat. at 550.

115. In 1902 the Supreme Court held that state exemption laws did not run afoul of the bankruptcy clause mandate for uniform laws. *Hanover Nat’l Bank v. Moyses*, 186 U.S. 181, 188-90 (1902).

116. Ch. 541, §§ 61-64, 30 Stat. at 550. The Supreme Court was given the power to prescribe rules and orders for the procedure.

117. *Id.* § 2, 30 Stat. at 550.

118. Section 2 of Chapter II of the Bankruptcy Act granted courts of bankruptcy “such jurisdiction at law and in equity as will enable them to exercise original jurisdiction in bankruptcy proceedings.” *Id.* § 2, 30 Stat. at 545.

119. 2 COLLIER ON BANKRUPTCY ¶ 23.02[1] (James Wm. Moore & Lawrence P. King eds., 14th ed. 1976).

concurrent jurisdiction with state courts over many bankruptcy-related issues. Described as plenary jurisdiction, state and federal courts had concurrent authority to adjudicate issues between the bankruptcy trustee or receiver and third parties concerning property not in the possession of the bankruptcy court. If the adverse party did not consent to bankruptcy court jurisdiction, a case involving a plenary matter could be brought only in a court that would have jurisdiction in a non-bankruptcy context—a state court, or if subject matter jurisdiction existed on an alternate basis, a federal court not sitting in bankruptcy.<sup>120</sup> Litigation over which court had jurisdiction was frequent and the distinction between summary jurisdiction and plenary jurisdiction was the subject of much dispute.

Congress amended the Bankruptcy Act several times between 1898 and the onset of the Depression.<sup>121</sup> Initially, amendments were made to moderate the pro-debtor orientation of the act. Amendments included additional grounds for denial of discharge,<sup>122</sup> additional debts excepted from the discharge,<sup>123</sup> and an increase in the number of defined acts of bankruptcy.<sup>124</sup> Corporations became eligible for voluntary bankruptcy in 1910.<sup>125</sup> Penal provisions were strengthened considerably in 1926.<sup>126</sup> Unsuccessful efforts were made to repeal the law in 1902, 1903, 1909, and 1910."<sup>127</sup>

During the Depression, Congress passed several pro-debtor amendments that facilitated rehabilitation through bankruptcy.<sup>128</sup> In 1933 compositions became more widely available, and agricultural and railroad compositions were permitted.<sup>129</sup> In 1934 Congress authorized corporations<sup>130</sup> and municipalities to reorganize.<sup>131</sup> Subsequent amendments included provisions allowing farmers to keep their farms and facilitating railroad reorganizations.<sup>132</sup> In 1938

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120. 2 *id.* ¶ 23.12.

121. *See supra* note 82.

122. Act of Jan. 7, 1922, ch. 22, 42 Stat. 354; Act of Mar. 2, 1917, ch. 153, 39 Stat. 999; Act of Feb. 5, 1903, ch. 487, § 5, 32 Stat. 797, 798.

123. Act of May 27, 1926, ch. 406, § 6, 44 Stat. 662, 663-64; Act of June 25, 1910, ch. 412, § 6, 36 Stat. 838, 839-40.

124. Ch. 406, § 3, 44 Stat. at 663.

125. Ch. 412, § 3, 36 Stat. at 839.

126. Ch. 406, § 11, 44 Stat. at 665-66.

127. *See supra* note 82; Tabb, *History, supra* note 4, at 27.

128. *See supra* note 82.

129. Act of Mar. 3, 1933, ch. 204, 47 Stat. 1467, 1467-82.

130. Act of June 7, 1934, ch. 424, 48 Stat. 911, 912-25.

131. Act of May 24, 1934, ch. 345, 48 Stat. 798. In *Ashton v. Cameron County Water Improvement District No. One*, 298 U.S. 513, 532 (1936), the Court overturned this statute. Congress passed another version in 1937 which was upheld by the Court. *See United States v. Bekins*, 304 U.S. 27, 51 (1938).

132. Frazier-Lemke Act, ch. 869, 48 Stat. 1289 (1934); Act of Aug. 27, 1935, ch. 774, 49 Stat. 911. Both statutes ultimately survived constitutional challenge. *See generally* Wright v. Vinton Branch of the Mountain Trust Bank, 300 U.S. 440, 470 (1937) (deciding that a provision authorizing agricultural compositions is valid); *Continental Ill. Nat'l Bank & Trust Co. v. Chicago, Rock Island & Pacific Ry. Co.*, 294 U.S. 648, 675 (1935) (holding that railroads may

Congress passed the comprehensive Chandler Act.<sup>133</sup> The Chandler Act revised virtually all the provisions of the Bankruptcy Act. The Chandler Act updated substantive and procedural provisions in liquidation cases, improved bankruptcy administration, and reworked the reorganization provisions into Chapters 10, 11, 12, and 13.<sup>134</sup> Over the following forty years Congress amended the Bankruptcy Act dozens of times, but only as to specific and discrete issues.<sup>135</sup>

Statutory provisions generally governed bankruptcy procedure, but under the authority of Section 30 of the Bankruptcy Act, the Supreme Court periodically enacted general orders in bankruptcy. In 1960 Congress authorized an advisory committee on bankruptcy rules to craft rules of bankruptcy procedure to be approved by the Supreme Court.<sup>136</sup> After years of effort by the rules committee, the Federal Rules of Bankruptcy Procedure took effect in 1973.

In 1970 Congress created a commission to study and report on the Bankruptcy Act.<sup>137</sup> The commission filed its report in 1973.<sup>138</sup> Five years later, after almost a decade of study and debate about bankruptcy reform, the Bankruptcy Reform Act of 1978 replaced the Bankruptcy Act with the Bankruptcy Code.<sup>139</sup>

### III. ATTRIBUTES OF LAW AND EQUITY IN THE BANKRUPTCY PROCESS

Several themes emerge out of the serpentine history of Anglo-American bankruptcy law. First, neither bankruptcy law nor bankruptcy courts can claim roots in English courts of equity. Bankruptcy remedies and insolvency rights have always been a product of legislative enactment rather than case-by-case determination in common law or equity courts.

Second, bankruptcy and insolvency laws inherently embody a compromise of disparate social and economic objectives. Economic transactions necessarily generate competing as well as complementary interests. All economic endeavors entail risk; some endeavors succeed, some fail. Economic hardship can be due to circumstances beyond a debtor's control, to the debtor's own mistake, irresponsibility, or dishonesty, or to a combination of both. It is in the interest of every creditor to be paid, but if full payment cannot be effected, it is in society's interest that all creditors be treated predictably and that debtors be returned to productivity. The differing needs of debtors and creditors have

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reorganize).

133. Ch. 575, 52 Stat. 840 (1938) (repealed 1978).

134. *Id.*

135. *See supra* note 82.

136. *See* Lawrence P. King, *The History and Development of the Bankruptcy Rules*, 70 AM. BANKR. L.J. 217, 218-26 (1996).

137. *Id.* at 236.

138. *See supra* note 133.

139. Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549.

not changed substantially over time, but legislative response to them has changed.<sup>140</sup> Until the middle of the nineteenth century, bankruptcy law was decidedly pro-creditor. Since then it has oscillated between provisions favoring debtors and those favoring creditors, depending on economic and political pressures at a given time.

Over three hundred years ago, Daniel Defoe authored an "Essay upon Projects" commenting on English bankruptcy law. His writings were designed to influence Parliament's consideration of the Statute of Anne.<sup>141</sup> In 1697 Defoe identified four commercial actors whose interests were affected by bankruptcy law:

(1.) There is the Honest Debtor, who fails by visible Necessity, Losses, Sickness, Decay of Trade, or the like.

(2.) The Knavish, Designing, or Idle, Extravagant Debtor, who fails because either he has run out his Estate in Excesses, or on purpose to cheat and abuse his Creditors.

(3.) There is the moderate Creditor, who seeks but his own, but will omit no lawful Means to gain it, and yet will hear reasonable and just Arguments and Proposals.

(4.) There is the Rigorous Severe Creditor, that values not whether the Debtor be Honest Man or Knave, Able, or Unable; but will have his Debt, *whether it be to be had or no*; without Mercy, without Compassion, full of Ill Language, Passion, and Revenge.<sup>142</sup>

He then defined the legislative problem faced by Parliament:

How to make a Law to suit to all these, is the Case: *That a necessary Favour might be shown to the first, in Pity and Compassion to the Unfortunate, in Commiseration of*

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140. As a seasoned law professor stated with regard to law school examinations, "The questions never change—only the answers do." Indeed, in describing the history of bankruptcy in the United States, Charles Warren observed in 1935 that:

Bankruptcy is a gloomy and depressing subject. The law of bankruptcy is a dry and discouraging topic. But the history of bankruptcy legislation as seen in the Congressional debates is colorful; for not only does it reflect the changes in viewpoints and in economic conditions in our National history, but it also reminds us of how frequently the views and conditions of today are mere repetitions of the past.

WARREN, *supra* note 77, at 3. Warren characterized the time between 1789-1827 as the period of the creditor, 1827-1861 as the period of the debtor, and 1861-1935 as the period of national interest. *See id.* at 3, 49, 95.

141. Weisberg, *supra* note 4, at 5.

142. DANIEL DEFOE, AN ESSAY UPON PROJECTS 206-07 (1697).

Casualty and Poverty, which no man is exempt from the danger of. *That a due Rigor and Restraint be laid upon the second*, that Villany and Knavery might not be encourag'd by a Law. *That a due Care be taken of the third*, that mens Estates may, as far as can be, be secur'd to them. *And due Limits set to the last*, that no man may have an unlimited Power over his Fellow-Subjects, to the Ruin of both Life and Estate.<sup>143</sup>

A century later the American colonies faced the same dilemma:

How to ensure the maximum repayment of debt while recognizing that some debtors inevitably would be unable to pay. Too harsh treatment of insolvent debtors wasted the abilities and energies of potentially productive persons and created a burden on state and local governments to maintain debtors' prisons. Too lenient treatment allowed dishonest debtors or debtors who were less than fully committed to the ideal of repaying their debts to avoid their obligations.<sup>144</sup>

The historical dilemma sounds familiar because it is at the heart of current congressional debate about the Bankruptcy Code. How should the Code balance a creditor's rights to collect lawful debts against the societal utility of returning a debtor to economic productivity? Should the law distinguish between types of creditors, and if so, which ones deserve to be paid first? How should the Code distinguish the honest, responsible, but unfortunate debtor deserving of relief from the dishonest or irresponsible debtor who takes advantage of creditors and societal generosity? Proposals for means testing, restricted eligibility for Chapter 7, and specialized treatment for credit-card debt or family-support debt address twenty-first century manifestations of age-old issues.

These fundamental social and economic issues are best identified, discussed, and resolved in the legislative process. In a sense, all bankruptcy laws balance equities, not between individual litigants, but among different segments of society. The legislative forum is particularly suited to consider and balance the rights and competing interests of debtors (businesses, consumers, and tortfeasors) and creditors (lenders, trade creditors, investors, and tort claimants) to benefit society as a whole. Many may criticize the legislative process or result, but it is Congress's function to consider the interests of groups in society and to set social policy. The Bankruptcy Code, like its predecessor statutes, embodies compromises reached in the democratic process,

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143. *Id.* at 207-08. For further discussion and analysis of Defoe's essays, see Weisberg, *supra* note 4, at 5-10.

144. Plank, *supra* note 4, at 525.

incorporating social and economic policies which favor some groups in society over others.

The third observation of the history of bankruptcy is that bankruptcy law has always utilized both legal and equitable mechanisms to implement social and economic objectives. English bankruptcy and insolvency laws borrowed from both legal and equitable traditions. The use of a commission resembled a jury, lending popular legitimacy to the process. Allowing creditors input into the commissioners' determination of whether a certificate of conformity would be issued enhanced popular participation. The collective nature of the bankruptcy process borrowed from the equitable tradition by using a comprehensive proceeding which aggregated bankrupts' creditors and marshaled all of their assets. The commissioner's authority to compel debtors to answer questions concerning liabilities and assets paralleled the chancellor's power to require parties to testify and to order specific relief. Remedies for noncompliance resembled criminal sanctions in the form of fines, mutilation, or in the extreme, execution.

The traditions of both law and equity are woven into current bankruptcy practice as well. Bankruptcy, whether by liquidation or reorganization, serves admittedly equitable objectives. It is designed to provide comprehensive resolution of all claims against a debtor just as early English law did. The automatic stay, a statutory injunction, becomes effective upon the filing of a petition. The broad definition of property of the estate and strong-arm powers are designed to marshal assets. All creditors are included and receive notice of important facets of the process. Avoidance of liens, sale of estate assets free and clear of liens or interests, equitable subordination of claims, and compelling debtors to account for their past financial affairs all resemble specific equitable relief obtainable in non-bankruptcy courts.

Equitable traditions are also apparent in certain procedures employed in bankruptcy case administration. With the exception of contested matters subject to Rule 9014 of the Federal Rules of Bankruptcy Procedure,<sup>145</sup> procedures used in the main bankruptcy case do not always follow the litigation model. Indeed, the administrative process is governed by separate rules of procedure.<sup>146</sup> Some requests are made by application or proof of claim, rather than by motion. Some proceedings are abbreviated. Claims can be allowed without being adjudicated; they may be estimated rather than finally determined. Creditors have the right to notice of impending action, but what constitutes "notice and a hearing" is subject to the court's discretion.<sup>147</sup> Chapter 7 cases without

145. FED. R. BANKR. P. 9014.

146. *Id.* pts. I-VI, VIII, IX.

147. *See* 11 U.S.C. § 102(1) (1994); FED. R. BANKR. P. 9007. Section 102(1) of the Bankruptcy Code states as follows:

(1) "after notice and a hearing", or a similar phrase—

(A) means after such notice as is appropriate in the particular circumstances, and such

reaffirmation agreements, adversary proceedings, or contested matters can be entirely an administrative process without any court appearance being required of the debtor.<sup>148</sup>

Bankruptcy administration is frequently characterized as an equitable receivership, but its scope and effect are significantly broader. A receivership is a remedy for administration and determination of creditors' interests in specific property. It affects only designated property and designated creditors. Because a determination of a creditor's rights is relative and limited to the designated property, creditors not having an interest in the subject property are unaffected. Moreover, a receivership does not determine whether a deficiency is owed to a creditor, nor does it affect a creditor's rights which are unrelated to the *res* being administered. For example, in a real estate receivership the relative rights of creditors in and to the real property is determined, but creditors' rights in other assets or against the owner of the real property are not.

In contrast, bankruptcy is not limited to specific property. Instead, it focuses upon a specific debtor and, therefore, includes all of the debtor's property and creditors. In addition, the bankruptcy process, whether ending in discharge by liquidation or reorganization, fixes all of a creditor's legal rights against the debtor and in the debtor's property.<sup>149</sup> A discharge or confirmed plan of reorganization has the same *res judicata* effect as a determination on the merits of a creditor's claim; it liquidates the debt, fixes the amount of recovery, and forecloses future collection. Due to the breath of the potential impact upon their rights and interests, in a bankruptcy case, creditors are entitled to prior notice and opportunity to object to many different types of action.<sup>150</sup> In the administrative process, creditors are also entitled to jury trials on personal injury claims and recovery claims brought by a trustee if the creditor has filed no proof of claim.

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opportunity for a hearing as is appropriate in the particular circumstances; but

(B) authorizes an act without an actual hearing if such notice is given properly and if—

(i) such a hearing is not requested timely by a party in interest; or

(ii) there is insufficient time for a hearing to be commenced before such act must be done, and the court authorizes such act . . . .

148. Since 1987 discharge hearings have no longer been required except in conjunction with reaffirmation agreements for pro se debtors. 11 U.S.C. § 524(d) (1994).

149. In 1857 the United States Supreme Court recognized this fundamental distinction between bankruptcy and an equity receivership. *See Commercial Bank v. Buckner*, 61 U.S. (20 How.) 108, 122 (1857).

150. *See* FED. R. BANKR. P. 2002, 2004, 2015, 3017, 3018, 6004, 6006, 6007, 6008. In *Hanover National Bank v. Moyses*, 186 U.S. 181 (1902), the United States Supreme Court held that the Bankruptcy Act satisfied the creditors' constitutional right to due process by providing notice of the first meeting of creditors and each subsequent step in administration. *Id.* at 191-92. A creditor has the same right to due process under the Code. *See, e.g., Reliable Elec. Co. v. Olson Constr. Co.*, 726 F.2d 620, 622 (10th Cir. 1984).

A blend of equitable and legal procedures is also apparent in contested matters and adversary proceedings. The Federal Rules of Civil Procedure are, in large part, adopted into Part VII of the Federal Rules of Bankruptcy Procedure.<sup>151</sup> Adversary proceedings and contested matters are triggered by motion or complaint; require traditional pleadings, service of process, and written response; and are determined by entry of a judgment or order. Litigation progresses in substantially the same manner and format as in state courts and federal district courts.<sup>152</sup> Jury trials can be conducted by a district court or, if authorized, by the bankruptcy court.<sup>153</sup> Presentation of evidence is subject to the Federal Rules of Evidence. Like courts of more general jurisdiction, bankruptcy courts can grant both legal and equitable relief.<sup>154</sup> For example, the bankruptcy court may determine the debtor's liability on a debt or the nature and scope of a security interest under state law, then equitably subordinate the claim under section 510 of the Bankruptcy Code<sup>155</sup> or determine it to be nondischargeable under section 523.<sup>156</sup>

The bankruptcy system is supplemented also by criminal law.<sup>157</sup> Debtors must affirm the truth and accuracy of the contents of their schedules and statement of affairs under penalty of perjury.

#### IV. JUDICIAL REFERENCES TO THE BANKRUPTCY COURT AS A COURT OF EQUITY

This is the fundamental question: Why do judges, parties, and scholars colloquially refer to the bankruptcy court as a court of equity when neither its historical origin nor its current functions justify this characterization? While there may be an infinite variety of unarticulated meanings ascribed to the phrase "court of equity," common usage reveals at least three.

Characterization of bankruptcy courts as courts of equity is and has been used to define the scope of the court's jurisdiction and authority. The evocative nature of the phrase "court of equity," which conjures up a variety of popular sentiments—fairness, justness, right dealing, inclusion, and flexibility—has also been used to legitimize the social policy embedded in bankruptcy law. Often the phrase is also used as lubricating language to justify a conclusion or result, particularly when the result is not a result of application of statutory law. As a court of equity, a judge may justify expansion, restriction, or modification of statutory law to achieve justice in a particular case. Finally, powers of a

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151. See FED. R. BANKR. P. 7001 advisory committee's note.

152. The procedure followed varies from court to court as required by the particular legal culture and local practice of a community or caseload pressure.

153. See 28 U.S.C. § 157(e) (1994).

154. The finality of the decision is dependent upon the nature of the issues determined. 28 U.S.C. § 157(b) (1994).

155. 11 U.S.C. § 510 (1994).

156. *Id.* § 523.

157. See 18 U.S.C. §§ 151-57, 1961, 2516, 3057, 3284, 6001 (1994).



court of equity are often invoked by litigants who desire a result that seems fair to them, but that may be at variance with the law.

*A. Court of Equity Used to Define Bankruptcy Jurisdiction and Authority*

Like Congress, during the nineteenth and early twentieth centuries, the Supreme Court focused on the jurisdiction of federal courts sitting in bankruptcy. References to the bankruptcy court as a court of equity were most often used in a technical context to define the scope of exclusive or original bankruptcy jurisdiction. The technical approach probably arose because legal and equitable claims gave rise to different causes of action prior to the adoption of the Federal Rules of Civil Procedure in 1938. Generally, district courts had jurisdiction over claims pled in equity, for which the trial was conducted to the court, or over claims pled at law, for which a jury trial was conducted. However, a district court's jurisdiction in bankruptcy was not characterized as either; instead, bankruptcy jurisdiction covered both legal and equitable claims.

In 1871 the Supreme Court considered whether a determination of property ownership fell within the scope of bankruptcy jurisdiction under the Bankruptcy Act of 1867.<sup>158</sup> The 1867 Act granted federal district courts exclusive jurisdiction over bankruptcy administration and distribution, but concurrent jurisdiction with circuit courts and state courts for "suits at law or in equity . . . brought by the assignee in bankruptcy against any person claiming an adverse interest."<sup>159</sup> In dicta the Supreme Court noted that matters subject to exclusive bankruptcy jurisdiction could be resolved in a summary manner.<sup>160</sup> In contrast, matters falling outside exclusive bankruptcy jurisdiction but within the court's concurrent jurisdiction required a full-blown trial in accordance with the legal or equitable nature of the claim. For example, an action to determine the rights of third parties in specific property fell outside the court's exclusive bankruptcy jurisdiction, but within the scope of the court's concurrent jurisdiction.<sup>161</sup>

The Supreme Court followed this holding in *Lathrop v. Drake*<sup>162</sup> when it held that an action by an assignee in bankruptcy to recover assets could be brought by suit, in law or equity, in a circuit court sitting in a district other than the one where the bankruptcy case was pending.<sup>163</sup> In *Lathrop* the Court utilized the terms "original jurisdiction" to describe a district court's bankruptcy jurisdiction and "ancillary proceedings" to describe concurrent jurisdiction over suits at law or in equity which impacted the bankruptcy

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158. *Smith v. Mason*, 81 U.S. (14 Wall.) 419 (1871).

159. *Id.* at 420.

160. *Id.* at 430.

161. *Id.* at 432.

162. 91 U.S. 516 (1875).

163. *Id.* at 518-19.

case.<sup>164</sup>

Using different labels, the Supreme Court recognized this jurisdictional distinction with regard to the Bankruptcy Act of 1898 in *Bardes v. Hawarden Bank*.<sup>165</sup> In *Bardes* the Court held that a trustee's suit asserting title to property must be brought by an independent action at law or in equity.<sup>166</sup> The Court analyzed the district court's exclusive bankruptcy jurisdiction "at law and in equity" granted by the Act.<sup>167</sup> The court defined proceedings within the scope of bankruptcy jurisdiction as "generally" being "in the nature of proceedings in equity" and speculated that Congress's reference to jurisdiction over matters "at law" was limited to the court's powers to punish debtors and others for bankruptcy crimes.<sup>168</sup> Consistent with its analysis of the 1867 Act, the Court then characterized actions at law or in equity lying outside bankruptcy jurisdiction as plenary matters.<sup>169</sup>

References in *Lathrop* and *Bardes* to the court's equitable powers in the bankruptcy administrative process were dicta; these cases focused on the distinction between original and plenary jurisdiction under the 1867 Act. However, the dicta of *Bardes* and *Lathrop* became precedent when the cases were mis-cited in *Local Loan Co. v. Hunt*<sup>170</sup> for the proposition that bankruptcy courts are courts of equity. *Local Loan* cited *Bardes* for the proposition that jurisdiction of the bankruptcy court "in law" is limited to criminal matters, and that courts of bankruptcy are "essentially courts of equity, and their proceedings inherently proceedings in equity."<sup>171</sup> Not only is the holding of *Bardes* overlooked, *Bardes* is misquoted. The error is compounded by citations to *Bardes*, *Lathrop*, and *Local Loan* in subsequent cases for the proposition that bankruptcy courts are inherently courts of equity.<sup>172</sup>

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164. *Id.* at 517-18.

165. 178 U.S. 524 (1900).

166. *Id.* at 538.

167. *Id.* at 534; Bankruptcy Act of 1898, ch. 541, 30 Stat. 545 (1898).

168. *Bardes*, 178 U.S. at 535. The Court stated:

Proceedings in bankruptcy generally are in the nature of proceedings in equity; and the words "at law," in the opening sentence conferring on the courts of bankruptcy "such jurisdiction, at law and in equity, as will enable them to exercise original jurisdiction in bankruptcy proceedings," may have been inserted to meet clause 4, authorizing the trial and punishment of offences, the jurisdiction over which must necessarily be at law and not in equity.

*Id.*

169. *Id.* at 532.

170. 292 U.S. 234 (1934).

171. *Id.* at 240.

172. *Local Loan* has been cited for this proposition in almost 1,500 subsequent opinions. See, e.g., *Katchen v. Landy*, 382 U.S. 323, 327 (1966); *United States Nat'l Bank v. Chase Nat'l Bank*, 331 U.S. 28, 36 (1947); *Heiser v. Woodruff*, 327 U.S. 726, 732 (1946); *Pepper v. Litton*, 308 U.S. 295, 306 (1939); *Continental Ill. Nat'l Bank & Trust Co. v. Chicago*,

These erroneous references took on new significance in *Katchen v. Landy*.<sup>173</sup> The issue in *Katchen* was whether a defendant in a preference action brought by a trustee was entitled to a jury trial. Building off previous cases, the Supreme Court accepted what had by repetition become fact—that the bankruptcy court is a court of equity. Adding the traditional notion that jury trials are unavailable for equitable claims, the Court concluded that a creditor had no right to a jury trial on issues which arose in the equitable bankruptcy administrative process if the creditor voluntarily submitted itself to the process by filing a proof of claim.<sup>174</sup>

The Court applied this reasoning to the Bankruptcy Code in *Granfinanciera, S.A. v. Nordberg*<sup>175</sup> even though the jurisdictional provisions accompanying the Code abandoned the distinction between summary jurisdiction and plenary jurisdiction and are devoid of reference to bankruptcy courts as courts of equity. In *Granfinanciera* the Supreme Court considered whether defendants in a fraudulent conveyance action brought by a bankruptcy trustee were entitled to a jury trial. Although the focus of the opinion was the Seventh Amendment right to jury trial, the Court relied upon its prior analysis in *Katchen* that the bankruptcy court's role in the administrative process was an equitable one. Consistent with the *Katchen* reasoning, the Court held that because the defendants had not submitted a claim against the bankruptcy estate, thereby triggering the equitable claims process, they retained their right to a jury trial.<sup>176</sup>

*Granfinanciera* adopts the historical mistake made in *Local Loan* that, in matters pertaining to bankruptcy administration,<sup>177</sup> bankruptcy courts sit in equity. Accordingly, parties are not entitled to a jury trial. But the conclusion is wholly unsupported by statutory reference in either Title 28 or Title 11. It is instead the perpetuation of judicial lore.

It is not clear why the Court defined the bankruptcy case administration as an equitable process in *Local Loan*. Such dicta was neither necessary to the holding nor added anything to the Court's reasoning. The reference may have been gratuitous, it may have been due to the need for more expansive bankruptcy court discretion to address social and economic needs of the Depression, or it may have been an outgrowth of the movement to harmonize equity and legal proceedings which ultimately resulted in the adoption of the

Rock Island & Pacific Ry. Co., 294 U.S. 648, 675 (1935).

173. 382 U.S. 323 (1966).

174. See *id.* at 336-38. This conclusion is somewhat ironic in that the Bankruptcy Act and applicable rules authorized jury trials on involuntary petitions and in dischargeability actions, both part of the summary administrative process. See Bankruptcy Act of 1898, ch. 541, 30 Stat. 551 (1898) (codified at 11 U.S.C. § 42(a) (1925-26)). The Judicial Conference issued a resolution that the referee in bankruptcy should not conduct the jury trial under Section 19(a). ANN. REP. OF THE PROC. OF THE JUD. CONF. OF THE U.S. 396 (1960).

175. 492 U.S. 33 (1989).

176. *Id.* at 58.

177. These are defined as "core proceedings" in 28 U.S.C. § 157(b) (1994).

Federal Rules of Civil Procedure in 1938. Whatever the rationale, *Local Loan's* characterization of the bankruptcy court's role in case administration as a court of equity opened the proverbial Pandora's Box. *Katchen* merely took the characterization one step further, likening the equitable nature of administrative proceedings to those equitable actions for which no right to jury trial existed. *Granfinanciera* applied the reasoning to the Bankruptcy Code. Thus, by judicial decree, rather than by congressional directive, the bankruptcy administration process is now defined as an equitable process. Although the historical distinction between legal and equitable claims was abolished by the Federal Rules of Civil Procedure, through judicial precedent the bankruptcy administrative process retains an equitable character. As demonstrated in *Katchen* and *Granfinanciera*, this historical holdover affects parties' rights to a jury trial on certain issues.

*B. Court of Equity Linked to the Social Policy Behind the Bankruptcy Law and to Judicial Discretion*

With the Depression and congressional expansion of debtors' rights, designation as a court of equity took on a moralistic tone which justified and amplified the social policies underpinning the Bankruptcy Act. As a court of equity, the bankruptcy court could properly use broad discretion in service of social policy.

The first of the social policy cases was *Local Loan Co. v. Hunt*,<sup>178</sup> in which the Supreme Court held that a bankruptcy court could enjoin a creditor from enforcing a wage assignment after discharge.<sup>179</sup> Under the Act, a debtor received a decree of discharge, which could be asserted as an affirmative defense to a creditor's subsequent state court collection action. The question posed in *Local Loan* was whether the debtor could affirmatively enjoin a creditor by action brought in the federal district court which sat in the bankruptcy case.<sup>180</sup> Until *Local Loan*, federal courts sitting in bankruptcy declined to entertain such suits on the grounds that the effect of the discharge was a matter to be determined by the court presiding over the subsequent action. But, because the district court sat in equity, the Supreme Court concluded that the debtor could obtain relief from it:

One of the primary purposes of the bankruptcy act is to "relieve the honest debtor from the weight of oppressive indebtedness and permit him to start afresh free from the obligations and responsibilities consequent upon business misfortunes." This purpose of the act has been again and again emphasized by the courts as being of public as well as

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178. 292 U.S. 234 (1934).

179. *Id.* at 244.

180. *Id.* at 238.

private interest, in that it gives to the honest but unfortunate debtor who surrenders for distribution the property which he owns *at the time of the bankruptcy*, a new opportunity in life and a clear field for future effort, unhampered by the pressure and discouragement of preëxisting debt.<sup>181</sup>

The Supreme Court affirmed the district court's injunction, noting that district courts sitting in bankruptcy are obligated to apply the Bankruptcy Act to effectuate its purpose and policy and that "[l]ocal rules subversive of that result cannot be accepted as controlling the action of a federal court."<sup>182</sup>

The next year, the Court considered the bankruptcy court's authority to enjoin holders of collateral notes secured by mortgage bonds from selling the bonds when the sale would hinder or prevent consummation of a railroad reorganization plan.<sup>183</sup> The Court affirmed the injunction again describing the broad powers of bankruptcy courts as courts of equity:

By § 2 of the Bankruptcy Act (U.S.C. Title 11, § 11), courts of bankruptcy are invested "with such jurisdiction at law and in equity as will enable them to exercise original jurisdiction in bankruptcy proceedings." They are essentially courts of equity, and their proceedings inherently proceedings in equity, the words "at law" probably having been inserted only with regard to clause (4) of § 2, which confers authority to arraign, try, and punish bankrupts and others for violations of the act. Their adjudications and orders constitute in all essential particulars decrees in equity. The power to issue an injunction when necessary to prevent the defeat or impairment of its jurisdiction is, therefore, inherent in a court of bankruptcy, as it is in a duly established court of equity. . . .

. . . [C]ourts of bankruptcy are invested with such authority in equity as will enable them to exercise original jurisdiction in bankruptcy proceedings, including the power to "make such orders, issue such process, and enter such judgments in addition to those specifically provided for as may be necessary for the enforcement of the provisions of this act." . . .

The bankruptcy court, in granting the injunction, was well within its power, either as a virtual court of equity, or

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181. *Id.* at 244 (citation omitted) (quoting *Williams v. United States Fidelity & Guar. Co.*, 236 U.S. 549, 554-55 (1915)).

182. *Id.* at 245.

183. *Continental Ill. Nat'l Bank & Trust Co. v. Chicago, Rock Island & Pac. Ry. Co.*, 294 U.S. 648, 650-51 (1935).

under the broad provisions of § 2(15) of the Bankruptcy Act or of § 262 of the Judicial Code.<sup>184</sup>

The linkage between the bankruptcy court's equitable powers and the social policies of the Bankruptcy Act is perhaps most clearly revealed in Justice Douglas's opinion for the Court in the 1939 *Pepper v. Litton*<sup>185</sup> decision. In *Pepper* the Supreme Court considered whether the district court properly disallowed a creditor's claim which previously had been adjudicated by a state court.<sup>186</sup> It is clear, both from the text and the tone of the opinion, that the Court believed the creditor had manipulated and abused the legal process in state court in order to obtain a determination in its favor by the bankruptcy court. The Supreme Court affirmed the district court's disallowance of the claim as a means of correcting the injustice.<sup>187</sup> Justice Douglas only briefly discussed the Court's legal conclusion that the state court judgment did not act as *res judicata* to the validity of the claim, which would have been sufficient to dispose of the matter. Instead, the bulk of the opinion concerns the bankruptcy court's equitable authority to vitiate a creditor's fraud. Relying upon *Local Loan Co.*, Justice Douglas wrote:

Consequently this Court has held that for many purposes "courts of bankruptcy are essentially courts of equity, and their proceedings inherently proceedings in equity." By virtue of § 2 a bankruptcy court is a court of equity at least in the sense that in the exercise of the jurisdiction conferred upon it by the Act, it applies the principles and rules of equity jurisprudence. . . .

The bankruptcy courts have exercised these equitable powers in passing on a wide range of problems arising out of the administration of bankrupt estates. They have been invoked to the end that fraud will not prevail, that substance will not give way to form, that technical considerations will not prevent substantial justice from being done. By reason of the express provisions of § 2 these equitable powers are to be exercised on the allowance of claims, a conclusion which is fortified by § 57 (k). For certainly if, as provided in the latter section, a claim which has been allowed may be later "rejected in whole or in part, according to the equities of the

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184. *Id.* at 675-76 (citations omitted) (quoting *Local Loan Co.*, 292 U.S. 234, 240 (1934) and Bankruptcy Act of 1898, ch. 541, § 2, 30 Stat. 544, 546 (1898), respectively).

185. 308 U.S. 295 (1939). This opinion is truly the mother of all court of equity opinions. It is cited in almost all subsequent Supreme Court decisions for the proposition that the bankruptcy court is a court of equity.

186. *Id.* at 301.

187. *Id.* at 311.

case,” disallowance or subordination in light of equitable considerations may originally be made.

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As we have said, the bankruptcy court in passing on allowance of claims sits as a court of equity. Hence these rules governing the fiduciary responsibilities of directors and stockholders come into play on allowance of their claims in bankruptcy. In the exercise of its equitable jurisdiction the bankruptcy court has the power to sift the circumstances surrounding any claim to see that injustice or unfairness is not done in the administration of the bankrupt estate.<sup>188</sup>

However, during the 1940s the Supreme Court backed away from unlimited equitable discretion. Although the Court continued to identify bankruptcy law with equitable purposes and to describe bankruptcy courts as courts of equity, it limited the bankruptcy court’s discretion to the terms of the operative statute. In *SEC v. United States Realty & Improvement Co.*<sup>189</sup> the Court ruled that equitable doctrines and principles guided the bankruptcy court only insofar as they were consistent with the Bankruptcy Act.<sup>190</sup> The bankruptcy court could not, based on its own notion of equitable principles, act inconsistently with the Act.<sup>191</sup>

The Court continued to limit the bankruptcy court’s equitable discretion in *Heiser v. Woodruff*.<sup>192</sup> In *Heiser* the Supreme Court considered a Tenth Circuit Court of Appeals decision based on *Pepper v. Litton*.<sup>193</sup> The proceeding

188. *Id.* at 304-08 (citation and footnotes omitted) (quoting *Local Loan Co.*, 292 U.S. at 240).

189. 310 U.S. 434 (1940).

190. *Id.* at 455.

191. The Court reasoned:

While a bankruptcy court cannot, because of its own notions of equitable principles, refuse to award the relief which Congress has accorded the bankrupt, the real question is, what is the relief which Congress has accorded the bankrupt and is it more likely to be secured in a Chapter X or Chapter XI proceeding? In answering it we cannot assume that Congress has disregarded well settled principles of equity, the more so when Congress itself has provided that the relief to be given shall be “fair and equitable and feasible.” Good sense and legal tradition alike enjoin that an enactment of Congress dealing with bankruptcy should be read in harmony with the existing system of equity jurisprudence of which it is a part.

*Id.* at 457.

192. 327 U.S. 726 (1946). Notably, in *Heiser*, Justice Douglas dissented from the majority opinion. *Heiser*, 327 U.S. at 740. See *Young v. Higbee Co.*, 324 U.S. 204 (1945).

193. *Heiser*, 327 U.S. at 728.

concerned allowance of the creditor's claim arising from a pre-petition money judgment. Objectors contended that the judgment had been procured by fraud. Relying upon *Pepper v. Litton*, the Tenth Circuit held that the bankruptcy referee could reach behind the pre-petition adjudication to decide whether the claim should be allowed.<sup>194</sup> Reversing the Tenth Circuit's decision, the Supreme Court acknowledged that a bankruptcy court, in exercise of its equity powers, could set aside fraudulent claims based on a "judgment where the issue of fraud has not been previously adjudicated,"<sup>195</sup> but where the issue of fraud had been previously litigated, the bankruptcy court was bound by the determination. Even when a court sits in equity, it is nevertheless subject to the "salutary principle of *res judicata*."<sup>196</sup> The Court reinforced limits on bankruptcy court equitable discretion to statutory provisions in *United States National Bank v. Chase National Bank*,<sup>197</sup> but affirmed the exercise of equitable discretion in determining whether a waiver of liens had taken place.<sup>198</sup>

More recent use of the phrase of court of equity to support social policy underlying the Bankruptcy Code is apparent in *NLPB v. Bildisco & Bildisco*.<sup>199</sup> In *Bildisco* the Court analyzed whether a debtor-in-possession could reject a collective bargaining agreement during a Chapter 11 reorganization.

Since the policy of Chapter 11 is to permit successful rehabilitation of debtors, rejection should not be permitted without a finding that that policy would be served by such action. The Bankruptcy Court must make a reasoned finding on the record why it has determined that rejection should be permitted. Determining what would constitute a successful rehabilitation involves balancing the interests of the affected parties—the debtor, creditors, and employees. . . .

The Bankruptcy Court is a court of equity, and in making this determination it is in a very real sense balancing the equities, as the Court of Appeals suggested. Nevertheless, the Bankruptcy Court must focus on the ultimate goal of Chapter 11 when considering these equities.<sup>200</sup>

The Supreme Court also has recently applied the restrictive trend in judicial discretion with regard to the Code. Although bankruptcy courts continue to be labeled courts of equity, recent opinions restrict the court's equitable discretion

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194. *Id.*

195. *Id.* at 732.

196. *Id.* at 733.

197. 331 U.S. 28 (1947).

198. *Id.* at 37.

199. 465 U.S. 513 (1984). Many lower court opinions use the phrase similarly, but are too numerous to analyze each individually.

200. *Id.* at 527.



to statutory provisions.<sup>201</sup> For instance, in *United States v. Noland*<sup>202</sup> the Supreme Court reversed a bankruptcy court's exercise of equitable discretion in applying 11 U.S.C. § 510(c). The Court stated:

The judge-made doctrine of equitable subordination predates Congress's revision of the Code in 1978. . . . [T]he Fifth Circuit, in its influential opinion in *In re Mobile Steel Co.* . . . observed that the application of the doctrine was generally triggered by a showing that the creditor had engaged in "some type of inequitable conduct." *Mobile Steel* discussed two further conditions relating to the application of the doctrine: that the misconduct have "resulted in injury to the creditors of the bankrupt or conferred an unfair advantage on the claimant," and that the subordination "not be inconsistent with the provisions of the Bankruptcy Act." This last requirement has been read as a "reminder to the bankruptcy court that although it is a court of equity, it is not free to adjust the legally valid claim of an innocent party who asserts the claim in good faith merely because the court perceives that the result is inequitable."<sup>203</sup>

Lower courts have followed the Supreme Court's lead in relying upon the equitable label to justify discretionary decisions or to legitimize a particular determination. Sometimes equitable powers justify a deviation from accepted procedure<sup>204</sup> or an order crafted for a particular situation.<sup>205</sup> Sometimes the

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201. See, e.g., *Midlantic Nat'l Bank v. New Jersey Dep't of Env'tl. Protection*, 474 U.S. 494 (1986).

While the Bankruptcy Court is a court of equity, the Bankruptcy Code "does not authorize freewheeling consideration of every conceivable equity." The Bankruptcy Court may not, in the exercise of its equitable powers, enforce its view of sound public policy at the expense of the interests the Code is designed to protect.

*Id.* at 514 (Rehnquist, J., dissenting) (citation omitted) (quoting *Bildisco*, 465 U.S. at 527).

202. 517 U.S. 535 (1996).

203. *Id.* at 538-39 (citations omitted) (quoting Andrew DeNatale & Prudence B. Abram, *The Doctrine of Equitable Subordination as Applied to Nonmanagement Creditors*, 40 BUS. LAW. 417, 428 (1985)).

204. See, e.g., *In re Jarvis*, 53 F.3d 416, 419 (1st Cir. 1995); *Themy v. Yu (In re Themy)*, 6 F.3d 688, 689 (10th Cir. 1993); *United States v. Richards (In re Richards)*, 994 F.2d 763, 765 (10th Cir. 1993); *Finney v. Smith (In re Finney)*, 992 F.2d 43, 45 (4th Cir. 1993); *Land v. First Nat'l Bank (In re Land)*, 943 F.2d 1265, 1267 (10th Cir. 1991).

205. See, e.g., *Winthrop Old Farm Nurseries, Inc. v. New Bedford Inst. for Sav. (In re Winthrop Old Farm Nurseries, Inc.)*, 50 F.3d 72, 75 (1st Cir. 1995); *Constant Ltd. Partnership v. Jamesway Corp. (In re Jamesway Corp.)*, 179 B.R. 33, 37 (S.D.N.Y. 1995); *In re Dailey*, 36 B.R. 147, 149-50 (Bankr. D. Minn. 1983).

phrase simply refers to a court's consideration of a number of factors,<sup>206</sup> the totality of the circumstances,<sup>207</sup> exercise of section 105 powers,<sup>208</sup> or is linked to the conclusion that evidence presented satisfies an undefined standard such as "cause."<sup>209</sup> Arguably, to the extent bankruptcy courts act within powers granted to them by statute, no further justification is needed for a ruling. However, too often the phrase "court of equity" is lubricating language used to explain or justify a deviation from the express provisions of the Code. In this context, the reference often acts as poor cover.<sup>210</sup>

*C. Court of Equity Is Synonymous With Relaxed Procedure and Individualized Justice*

Scholars observe that the appeal of equity jurisprudence in Anglo-American history has increased during periods of great social change.<sup>211</sup> For example, some argue that access to the courts and the availability of remedies to disenfranchised individuals and groups was expanded in order to cope with social, political, and economic challenges after World War II. Social pressure, such as the civil rights movement, prompted structural reform of institutions. Congress expanded the rights of minorities, the poor, women, workers, prison inmates, and the mentally and physically handicapped. Courts discovered new,

206. See, e.g., *Kline v. Lewis* (*In re Kline*), No. NM-98-009, 1998 WL 637276, at \*4 (B.A.P. 10th Cir. Sept. 14, 1998).

207. See, e.g., *Insurance Co. v. Cohn* (*In re Cohn*), 54 F.3d 1108, 1117 (3d Cir. 1995).

208. Arguably, the powers set forth in 11 U.S.C. § 105(a) to "issue any order, process or judgment that is necessary or appropriate to carry out the provisions of this title," are statutory rather than equitable powers. Many circuits confine such powers to those consistent with and necessary for the enforcement of Bankruptcy Code provisions. See, e.g., *In re Fesco Plastics Corp.*, 996 F.2d 152, 157 (7th Cir. 1993); *Landsing Diversified Properties—II v. First Nat'l Bank & Trust Co.* (*In re Western Real Estate Fund, Inc.*), 922 F.2d 592, 601 (10th Cir. 1990) (per curiam).

209. See, e.g., *Little Creek Dev. Co. v. Commonwealth Mortgage Corp.* (*In re Little Creek Dev. Co.*), 779 F.2d 1068, 1071-72 (5th Cir. 1986). It is interesting that both Article III courts and state courts of general jurisdiction frequently apply the standard of "cause" or "good cause" without any reference to equitable powers.

210. The mischief worked by the designation is evident in numerous appellate decisions limiting bankruptcy court discretion to that specified by the Code. See *Thinking Machs. Corp. v. Mellon Fin. Servs. Corp. No. 1* (*In re Thinking Machs. Corp.*), 67 F.3d 1021, 1028 (1st Cir. 1995); *In re Jarvis*, 53 F.3d 416, 419 (1st Cir. 1995); *Momentum Mfg. Corp. v. Employee Creditors Comm.* (*In re Momentum Mfg. Corp.*), 25 F.3d 1132, 1136 (2d Cir. 1994); *IRS v. Levy* (*In re Landbank Equity Corp.*), 973 F.2d 265, 271 (4th Cir. 1992); *In re Plaza de Diego Shopping Ctr., Inc.*, 911 F.2d 820, 830-31 (1st Cir. 1990); *Shoreline Concrete Co. v. United States* (*In re Shoreline Concrete Co.*), 831 F.2d 903, 905 (9th Cir. 1987); *Chinichian v. Campolongo* (*In re Chinichian*), 784 F.2d 1440, 1443 (9th Cir. 1986); *Johnson v. First Nat'l Bank*, 719 F.2d 270, 273 (8th Cir. 1983).

211. See, e.g., CHARLES W. BACON & FRANKLYN S. MORSE, *THE REASONABLENESS OF THE LAW: THE ADAPTABILITY OF LEGAL SANCTIONS TO THE NEEDS OF SOCIETY* 187 (1924); HAROLD GREVILLE HANBURY & RONALD HARLING MAUDSLEY, *MODERN EQUITY* 13 (10th ed. 1976); see Weinstein & Hershenov, *supra* note 28, at 277-78.

legally cognizable harms and used equitable powers which filled gaps in developing substantive laws.

In the area of mass torts, Judge Weinstein<sup>212</sup> observes that in the last fifty years concepts of equity have advanced the law to meet changing social needs.

American courts responded by radically departing from the traditional models—at least insofar as they began to apply older equitable forms of aggregation to new categories of private litigants. New judicially-created laws were justified in the name of redistributing risk and internalizing costs. Once the province of common law courts and judges, mass tort cases now forced the courts to adopt an equitable posture. Courts of equity traditionally have taken into account the equities—the concrete issues of fact and fairness of the particular situation—in fashioning remedies. In the mass tort context these include: (1) fairly and expeditiously compensating numerous victims, and (2) deterring wrongful conduct where possible; while (3) preventing over deterrence in mass torts from shutting down industry or removing needed products from the market, (4) keeping the courts from becoming paralyzed by tens or even hundreds of thousands of repetitive personal injury cases, and (5) reducing transactional costs of compensation.

....

Were it not for the jury system, protected as it is by the [S]eventh [A]mendment to the United States Constitution, the procedural swing to equity would have been even greater. As it is, the growth of deposition practice, summary judgment and judgment notwithstanding the verdict has tended to attenuate the traditional jury system, characterized as it is by testimony in open court.

On the substantive side, judicially-created equitable-legal doctrines enhanced the ability of toxic tort victims to recover for their injuries in the absence of particularized proof of causation and liability. The courts relaxed traditional concepts of fault and causation and expanded the definition of compensable injuries. These innovations, however, are indebted more to a judicial state of mind than to any substantive equitable antecedents. For, despite the fact that equity in post-medieval England eventually became

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212. Jack B. Weinstein is a judge in the United States District Court for the Eastern District of New York. Judge Weinstein also serves as an adjunct professor at the Columbia and Brooklyn Law Schools. *See* Weinstein & Hershenov, *supra* note 28, at 269 n.\*.

somewhat incapacitated by precedent, it never lost its aura of gung ho problem solving with the concomitant pragmatic, flexible, and activist view that was embodied in that jurisprudential cast. Even when the chancellors were immobilized by self-imposed restraints they worked in the glow of such maxims as "Equity delights in doing equity." This spiritual reserve remained available to permit judges exercising equitable jurisdiction to create new forms and law to prevent modern injustices.<sup>213</sup>

In this same period of time, Congress enacted extensive bankruptcy reform. The Bankruptcy Code and accompanying statutes converted bankruptcy referees into judges, expanded bankruptcy jurisdiction, and provided a broader scope of discharge to more debtors. Although the Code removed bankruptcy judges from certain administrative and supervisory functions previously handled by bankruptcy referees, the expectation of informal procedure unlike that found in state and federal district courts persists.<sup>214</sup>

The expansion in access to the courts, increased variety of remedies, and flexibility in pleading under Federal Rules of Civil Procedure has increased civil case filings and reduced procedural formality. But such benefits have been accompanied by complaints about cost and delay, unwieldy cases, uncontrolled discovery, unrestrained attorney latitude, and abuse of judicial discretion. Such complaints, in turn, have given rise to reform efforts including use of magistrates, alternative dispute resolution, and more numerous, as well as more complex, rules of practice. In addition, bankruptcy courts have implemented "scream or die" notice procedures, testimony by written declaration, and limited discovery. Judicial management has become increasingly important to assure progress of cases through the judicial system.

Characterizing the bankruptcy court as a court of equity is less appropriate in the 1990s than ever before. Putting aside the absence of historical justification for the moniker and the fact that bankruptcy courts apply a statutory scheme rather than equitable maxims, they do not operate in the same fashion as did courts of equity. Historically, courts of equity provided a flexible, summary, and individualized process. But layers of rules, procedures, and forms burden the bankruptcy process often making it more complex than litigation in other courts. Local rules, Federal Rules of Bankruptcy Procedure, Federal Rules of Civil Procedure, and in some contexts, the Federal Rules of Evidence, as well as the Bankruptcy Code apply in bankruptcy cases and adversary proceedings. The combination of complex law and procedure

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213. *Id.* at 273-75 (footnotes omitted).

214. A recent example of this view is the mistaken assumption of one attorney: "The judge is never going to rule on that evidentiary objection. Bankruptcy is a court of equity." *How Important Are the Rules of Evidence in Bankruptcy Court?* BANKR. CT. DECISIONS, Aug. 18, 1998 at A1. Unfortunately, the judge did rule on the objection.

frequently creates obstacles for practitioners who do not routinely practice bankruptcy law and for the increasing number of parties appearing without counsel.

Repeated reference to the bankruptcy court as a court of equity creates an inaccurate impression that the bankruptcy process is simple, summary, and individualized. This, in turn, leads to confusion and disappointed expectations. Social commentary is replete with examples of our modern risk-averse and remedy-sensitive society. For uninsurable risks, society anticipates a legal or equitable remedy. Not understanding the historical or jurisprudential meaning of the phrase “court of equity,” litigants use it to request a result which they perceive as fair and just. In colloquial terms, one might call this “Burger King justice” or “justice my way.” In the author’s experience, almost all arguments which begin with the observation that the bankruptcy court is a court of equity conclude either with a request for social policy change by judicial decree or for a result different than that required by the Bankruptcy Code.

Despite a judge’s desire to “do justice” in every controversy, the bankruptcy court is not free to fashion relief to suit the emotional and economic desires of every litigant. The court’s powers are limited by the Bankruptcy Code and the social policy that underlies it, a policy that necessarily benefits some segments of society at the expense of others. Application of statutory law often disappoints and frustrates parties who expect the result to be “fair” or “equitable.” One common example is the situation where a trustee seeks to recover a pre-petition preferential payment from a creditor. Those who understand the philosophy of the Bankruptcy Code realize that recovery of the payment for the benefit of the estate results in a predictable pro rata distribution of assets among similarly situated creditors. But in the creditor’s eyes there is nothing improper or illegal in obtaining payment of a debt which comes due. Collection of a pre-petition debt not only makes good business sense, it is consistent with non-bankruptcy law. To the creditor, return of the payment to the trustee in order to receive a dividend of a fraction of the payment is neither fair nor equitable. When litigants expect a subjectively fair result from the “court of equity” and the bankruptcy court fails to deliver, it is not surprising that some lose faith in the law and in the judicial system.

## V. CONCLUSION

Describing the bankruptcy court as a court of equity is traditional and convenient, but it is not accurate. This description obscures the true nature of the court and the statutory scheme that it applies. From historical, procedural, jurisprudential, and practical perspectives the bankruptcy court is not a court of equity. It is, instead, a specialized court of limited jurisdiction applying statutory law that embodies a particular, often changing, social objective.

At best the term “court of equity” lacks a generally accepted meaning. At worst it is deceptive because it implies a simple, flexible process to determine individual disputes according to equitable maxims. Whether imprecise or

misleading, the phrase leads to confusion as to the court's jurisdiction and discretion. More importantly, the label disappoints participants who expect, but do not receive a "fair" result.

In considering bankruptcy reform, Congress has an opportunity to enunciate clearly the social policy it adopts. But a greater challenge falls to the judiciary and practicing bar to exercise precision in describing the role and purpose of the bankruptcy court. When judges and attorneys recognize and acknowledge that the bankruptcy court is a statutory court charged with implementing social policy law, predictability in outcome will increase, and, therefore, litigants' confidence in the bankruptcy process will increase as well. Furthermore, our precision in describing the limitations of the bankruptcy court redirects complaints about the social policy embedded in the Bankruptcy Code to those who enacted it and therefore can change it. Ultimately, equity lies not in the court, but in the Bankruptcy Code it applies.

