

BANKRUPTCY AND THE SUPREME COURT

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Excerpt from Chapter 6, pages 439–46

LANDMARK CASES

The Supreme Court cases of the past 111 years range in importance from relatively insignificant to very consequential. This chapter discusses some of the most important cases of the past century that have had the greatest impact on the practice of bankruptcy law.

CASES RULING ON THE CONSTITUTIONALITY OF BANKRUPTCY LAWS

Some of the Court's most significant cases declared all or part of the bankruptcy law unconstitutional or upheld its constitutionality.¹ During the 1930s a conservative Supreme Court twice struck down bankruptcy laws as unconstitutional. Twice Congress amended and reenacted the laws. And twice the Court, probably responding to the pressure of President Franklin Roosevelt's court packing plan,² reversed course and upheld the constitutionality of the legislation.

In 1935, the Court considered the constitutionality of bankruptcy laws designed to retard the progress of farm foreclosures. The Court's holding in

1. Although this chapter discusses several of the Court's more important decisions, Ch. 3 *supra* contains a more thorough discussion of bankruptcy law and the Constitution. See pp. 122–165.

2. See, e.g., Barry Cushman, *Rethinking the New Deal Court*, 80 VA. L. REV. 201 (1994); Laura Kalman, *Law, Politics and the New Deal*(s), 108 YALE L.J. 2165 (1999).

Louisville Joint Stock Land Bank v. Radford,³ unanimously struck down the first Frazier-Lemke Act⁴ for unconstitutionally taking a mortgagee's property rights without just compensation.⁵ As such, *Radford* identified certain protected constitutional rights of secured creditors. Specifically, the *Radford* Court held that the Frazier-Lemke Act unconstitutionally deprived the mortgagee of the following specific state property rights⁶

1. The right to retain the lien until the indebtedness thereby secured is paid.
2. The right to realize upon the security by a judicial public sale.
3. The right to determine when such sale shall be held, subject only to the discretion of the court.
4. The right to protect its interest in the property by bidding at such sale whenever held, and thus to assure having the mortgaged property devoted primarily to the satisfaction of the debt, either through receipt of the proceeds of a fair competitive sale or by taking the property itself.
5. The right to control meanwhile the property during the period of default, subject only to the discretion of the court, and to have the rents and profits collected by a receiver for the satisfaction of the debt.

The taking of these rights occurred because the Act deprived the mortgagee of possession for five years while the debtor was permitted to retain possession by paying a fair annual rent or purchasing the property at its appraised value with deferred payments bearing annual interest at 1% and paid under an amortization that has 85% of the principal paid after six years.⁷ The Court did

3. 295 U.S. 555 (1935).

4. Pub. L. No. 73-486, 48 Stat. 1289 (1934).

5. See *Radford*, 295 U.S. at 588-90.

6. See *id.* at 594-95.

7. See *id.* at 591-92, 601-02 & n.21.

not opine whether the Constitution required protection of each of these five property rights

As more fully discussed in Chapter 3, almost immediately after the Court declared the first Frazier-Lemke Act unconstitutional, to protect farmers from losing their farms in foreclosures Congress enacted the second Frazier-Lemke Act,⁸ which the Court upheld as constitutional in *Wright v. Vinton Branch of the Mountain Trust Bank*.⁹ Significantly, *Vinton Branch* sustained constitutionality based on the second Frazier-Lemke Act's preservation of only three of the five property rights identified in *Radford*.¹⁰ The three preserved rights are the right to retain the lien until the secured indebtedness is paid; the right to realize on the security by a judicial public sale; and the right to bid in the secured debt at a foreclosure sale.¹¹ These three rights continue to serve as a baseline protection for secured creditors in bankruptcy cases.¹² Whether these rights survive as constitutional guarantees or only as statutory protections is open to doubt.¹³ In *Wright v. Union Central Life Insurance Co.*,¹⁴ the Supreme Court clarified and defined the basic constitutional rights of secured creditors in the context of a sale of farm property: "Safeguards were provided to protect the rights of secured creditors throughout the proceedings, to the extent of the value of the property. There is no constitutional claim of the creditor to more than that."¹⁵

In a parallel but narrower context, in 1936 the Court overturned the nation's first municipal bankruptcy law¹⁶ as unconstitutional before upholding the

8. Act of Aug. 28, 1935, Pub. L. No. 74-384, 49 Stat. 941 (1935).

9. 300 U.S. 440, 458-61 (1937) ("*Vinton Branch*").

10. *See id.* at 458.

11. *See id.* at 458-59, noting that the last of these rights was not provided for in the Frazier-Lemke Act but in the legislative history.

12. *See supra* Ch. 3, nn. 671-677 and accompanying text.

13. *See supra* Ch. 3, nn. 678-684 and accompanying text.

14. 311 U.S. 273 (1940).

15. *See id.* at 278-79. (citations omitted).

16. Act of May 24, 1934, Pub. L. No. 73-251, 73d Cong., 2d Sess., ch. 345, §§ 78-80, 48 Stat. 798.

constitutionality of its successor statute.¹⁷ In *Ashton v. Cameron County Water Improvement District*,¹⁸ the Court held that Congress lacked the power to require creditors to accept a composition plan offered by a public corporation.¹⁹ The Court reasoned that since Congress cannot exercise its taxing power to tax municipal bonds without infringing state sovereignty, it likewise cannot exercise its bankruptcy power to infringe municipal bonds because the bankruptcy power cannot have any higher “rank or importance in our scheme of government” than the taxing power.²⁰ Moreover, because the Contracts Clause²¹ forbids the states from impairing the obligations of their municipal bonds, the States cannot consent to federal legislation under the bankruptcy clause that accomplishes an end run around this restriction.²² Furthermore, for Congress to do so directly without the consent of the states would impermissibly violate state sovereignty.²³ Thus, the Court struck down Chapter IX of the Bankruptcy Act²⁴ as unconstitutional.²⁵

Two years later in *United States v. Bekins*²⁶ however, the Court examined the constitutionality of Chapter X of the Bankruptcy Act,²⁷ a municipal debt adjustment statute passed by Congress after the Court’s decision in *Ashton* struck down Chapter IX. The Court held that Congress could constitutionally provide a composition chapter applicable to arms of the state without violating state sovereignty reserved under the Tenth Amendment, because the state

17. Act of Aug. 16 1937, Pub. L. No. 75-302, 75th Cong., 1st Sess., ch. 657, 50 Stat. 653

18. 298 U.S. 513 (1936).

19. See *id.* at 530-31.

20. See *id.* at 530

21. U.S. CONST. art. I, § 10.

22. See *Ashton*, 298 U.S. at 531.

23. See *id.*

24. Act of May 24 1934 Pub. L. No. 73-251, 73d Cong., 2d Sess., ch. 345 §§ 78-80, 48 Stat. 798.

25. See *Ashton*, 298 U.S. at 532.

26. 304 U.S. 27 (1938).

27. Act of Aug. 16 1937, Pub. L. No. 75-302, 75th Cong., 1st Sess., ch. 657, 50 Stat. 653

retains both ultimate approval of the composition plan under state law and the ability to limit access of its instrumentalities to bankruptcy relief.²⁸ The Court distinguished its decision in *Ashton* by noting that Chapter X was carefully crafted to avoid federal interference with the power of the state or its subdivisions to manage their own affairs.²⁹

The Court also has declared more modern bankruptcy laws unconstitutional. In 1982, the Court decided *Railway Labor Executives' Ass'n v. Gibbons*³⁰ and, on Uniformity Clause grounds, struck down bankruptcy legislation drafted so specifically on its face that it would apply in practice to the reorganization of only one large railroad debtor.³¹ Later in 1982, within a few years after the enactment of the 1978 Bankruptcy Code, in *Northern Pipeline Construction Co. v. Marathon Pipe Line Co.*³² the Court³³ declared the Bankruptcy Code's pervasive grant of jurisdiction to non-Article III judges to be unconstitutional.³⁴ Although the controversy arose in an adversary proceeding in which the debtor in possession, as plaintiff, asserted a state law breach of contract and warranty cause of action,³⁵ the Court held the jurisdictional infirmity to be non-severable and struck the constitutionality of the entire bankruptcy court system.³⁶ Two years later, Congress enacted the "Bankruptcy

28. See *Bekins* 304 U.S. at 54.

29. See *id.* at 49-51. ("The statute is carefully drawn so as not to impinge on the sovereignty of the State. The State retains control of its fiscal affairs"). See *id.* at 51.

30. 455 U.S. 457 (1982).

31. See *id.* at 469-73. ("A law can hardly be said to be uniform throughout the country if it applies only to one debtor and can be enforced only by the one bankruptcy court having jurisdiction over that debtor.") *Id.* at 470.

32. 458 U.S. 50 (1982).

33. The *Northern Pipeline* decision must be analyzed with great care because the judgment of the Court was accompanied by a four justice plurality opinion authored by Justice Brennan, a two justice opinion authored by Justice Rehnquist concurring in the judgment, and a three justice dissent authored by Justice White. Chief Justice Burger joined in Justice White's dissent and wrote his own dissenting opinion. See *id.*

34. See *id.* at 87.

35. See *id.* at 56-89.

36. See *id.* at 87-88, 91-92.

Amendments and Federal Judgeship Act of 1984” proposing a new bankruptcy court system.³⁷ The Court has not yet ruled on the constitutionality of the current jurisdictional scheme.³⁸

The Court also has used the Supremacy Clause of the Constitution to overturn state statutes that conflict with the bankruptcy laws. Thus, in *Perez v. Campbell*,³⁹ the Court used the Supremacy Clause to invalidate an Arizona motor vehicle safety responsibility statute⁴⁰ as inconsistent with the dischargeability provisions of the Bankruptcy Act.⁴¹ Adolfo Perez and his wife confessed judgment in a suit arising from personal injuries and property damage he caused while operating his uninsured motor vehicle. Shortly after the confession of judgment, Mr. and Mrs. Perez each filed voluntary bankruptcy petitions and received a discharge of the judgment. Because the Perez’s did not pay the judgment, the Superintendent of the Arizona Motor Vehicle Division suspended their drivers’ licenses as required by the Arizona statute, notwithstanding discharge of the judgment.⁴² The Court engaged in “a two-step process of first ascertaining the construction of the two statutes and then determining the constitutional question whether they are in conflict.”⁴³ After ascertaining that the Arizona statute was designed to protect judgment creditors from “financially irresponsible persons” and the Bankruptcy Act was designed to give the financially-troubled debtor a fresh start, the Court determined that the Arizona statute unconstitutionally interfered with and frustrated the discharge provisions of the Bankruptcy Act because it stood “as

37. See Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 353, 98th Cong., 2d Sess., 98 Stat. 333, § 101 (1984) (enacting 28 U.S.C. §§ 157 & 1334 (1988)).

38. The scope of Bankruptcy Court jurisdiction, including the responses to *Northern Pipeline*, is discussed more fully in Ch. 4 *supra*, pp. 200-220.

39. 402 U.S. 637 (1971).

40. See *id.* at 651-52.

41. See *id.* at 638. (The Arizona statute was based on the Uniform Motor Vehicle Safety Responsibility Act).

42. See *id.* at 641-42.

43. See *id.* at 644.

an obstacle to the accomplishment and execution of the full purposes and objectives of Congress”⁴⁴ Congress later codified and expanded the anti-discrimination principle of *Perez* in Bankruptcy Code § 525(a).⁴⁵

Perhaps the most important Court opinion on bankruptcy law and the Constitution upheld the constitutionality of bankruptcy reorganization provisions. In *Continental Illinois National Bank & Trust Co. of Chicago v. Chicago, Rock Island & Pacific Railway Co.*,⁴⁶ the Court rejected the argument that congressional power to enact bankruptcy laws is confined to liquidation cases, noting that, taken as a group, the bankruptcy laws passed by Congress before enactment of § 77, “far-reaching though they be, have not gone beyond the limit of congressional power; but rather have constituted extensions into a field whose boundaries may not yet be fully revealed.”⁴⁷ The Court confirmed Congress’ power to provide for railroad reorganizations by noting that § 77 “does no more than follow the line of historical and progressive development projected by previous acts”⁴⁸ This important holding affirmed the power of Congress to enact corporate reorganization statutes, including chapter 11 of the Bankruptcy Code.

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44. See *id.* at 644-49 (citation omitted).

45. See 11 U.S.C. § 525(a) (2000).

46. 294 U.S. 648 (1935).

47. See *id.* at 671.

48. See *id.* at 672.

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