# A BRIEF LOOK AT (SOME OF) THE HISTORY OF VOLUNTARY BANKRUPTCY IN AMERICA: HOW BANKRUPTCY WENT FROM PUNITIVE IN THE 19TH CENTURY TO REHABILITATIVE IN THE 20TH CENTURY

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## Introduction

For most of our history in the United States, individuals suffering from financial distress had no opportunity for debt relief without complete surrender of their property. For most of our history, individuals overburdened by debt had no opportunity to restructure their debts without affirmative consent from their creditors. Until 1978. A glimpse at bankruptcy laws in America before the 1978 Code reveals a framework in which the individual debtor lacked control, choice, and for the most part, relief.

## Voluntary Bankruptcy? Who ever heard such language before?

Most Americans before 1841 had never fathomed a voluntary bankruptcy proceeding. The first federal law in the United States to authorize voluntary bankruptcy relief surfaced in 1841.[1] At the time, the idea that a debtor could *choose* to be declared a bankrupt was revolutionary. Until 1841, a bankruptcy was filed *against* the debtor in order to remove him from his property because of his failure to repay his debts. As described by an opponent of the legislation, "[v]oluntary bankruptcy is a new term. Who ever heard such language before? Under this bill, discharge of debtor is the thing principally aimed at. Under previous acts, surrender of property was the chief object."[2]

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1 Bankruptcy Act of 1841, ch. 9, 5 Stat. 440, *repealed by* Act of Mar. 3, 1843, ch. 82, 5 Stat. 614.

2 CHARLES WARREN, BANKRUPTCY IN UNITED STATES HISTORY 72–73 (1935) (describing comments of representative Joseph Trumbull of Connecticut).

The 1841 Act was short lived. The voluntary bankruptcy experiment was met with skepticism. Part of the distaste was that the debt forgiveness was not commensurate with surrender of property (that is, voluntary bankruptcy allowed disproportionately large amounts of debt to be forgiven for relatively small amount of property to be surrendered).[3] "In the 18 months of [the Act granting a discharge to debtors who filed a voluntary petition in bankruptcy] more than 28,000 debtors had been relieved of nearly $445,000,000 of obligations by the surrender of less than $45,000,000 in property."[4] The Act was repealed on March 3, 1843, after having been passed just eighteen months earlier on August 19, 1841.[5]

**Early 19th Century American Bankruptcy Law: Involuntary and Punitive**

No wonder Congressmen were shocked by the introduction of *voluntary* bankruptcy in 1841. Prior to that time, bankruptcy in America was anything but voluntary. Some interesting features of the 19th century laws are highlighted below.

*The Bankruptcy Act of 1800*[6]

The Bankruptcy Act of 1800 was the first federal bankruptcy law enacted in America. The Bankruptcy Act of 1800 provided that (among other things):

> any merchant, or other person, residing within the United States, actually using the trade of merchandise, . . . or as a banker, broker, factor, underwriter, or marine insurer, shall, with intent unlawfully to delay or defraud his or her creditors, depart from the state in which such person usually resides, or remain absent therefrom, or conceal him or herself therein, or keep his or her house, so that he or she cannot be taken, or served with process, or willingly or fraudulently procure him or herself to be arrested, or his or her lands, goods, money or chattels to be attached, sequestered, or taken in execution . . . or being arrested for debt, or having surrendered him or herself in discharge of bail, shall remain in prison two months or more, or escape therefrom, or whose lands or effects being attached by process . . . shall not, within

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3 *See* John Hanna, *Bankruptcy Amendments of 1933*, 2 MERCER BEASLEY L. REV. 113, 114 (1933).
4 *Id.*
5 Act of Mar. 3, 1843, ch. 82, 5 Stat. 614.
6 Act of Apr. 4, 1800, ch. 19, 2 Stat. 19, *repealed by* Act of Dec. 19, 1803, ch. 6, 2 Stat. 248.

> two months after written notice thereof, enter special bail and dissolve the same, . . . every such person shall be deemed and adjudged a bankrupt.[7]

The creditors (not the debtor) petitioned for bankruptcy, and after "the creditor or creditors petitioning shall make affidavit or solemn affirmation before the said judge, of the truth of his, her, or their debts, and give bond, to be taken by the said judge, in the name, and for the benefit of the said party so charged as a bankrupt," then the judge would appoint "such good and substantial persons . . . as such judge shall deem proper, not exceeding three, to be commissioners of the said bankrupt."[8] The commissioner then "as soon as may be" must conduct an examination and ultimately "upon due examination, and sufficient cause appearing against the party charged, shall and may declare him or her to be a bankrupt."[9] The proceeding was *against* the debtor to be "charged as a bankrupt."[10]

If the debtor "shall refuse to be examined, or to answer fully . . . it shall be lawful for the commissioners to commit the offender to close imprisonment, until he or she shall conform him or herself."[11] As if that was not bad enough, if the person was adjudicated a bankrupt, the commissioners "shall have power forthwith, after they have declared such person a bankrupt, to cause to be apprehended, by warrant under their hands and seals, the body of such bankrupt, wheresoever to be found, within the United States . . . and . . . shall have power to cause the doors of the dwelling-house of such bankrupt to be broken, or the doors of any other house in which he or she shall be found."[12] Not only that, but the commissioners also "shall have power to take into their possession all the estate, real and personal, of every nature and description to which the said

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7 *Id.* § 1.
8 *Id.* § 2.
9 *Id.* § 3.
10 *See id.*
11 *See id.* § 20.
12 *Id.* § 4.

bankrupt may be entitled . . . (his or her necessary wearing apparel, and the necessary wearing apparel of the wife and children, and necessary beds and bedding of such bankrupt only excepted)."[13] The Act required the debtor to surrender himself and his property and

> execute . . . [an] assignment of his or her estate, whatsoever and wheresoever, as shall be devised and directed by the commissioners, to vest the same in the assignees, their heirs, executors, administrators, and assigns forever, in trust, for the use of all and every [of] the creditors of such bankrupt, who shall come in and prove their debts under the commission; and deliver up unto the commissioners all such part of his or her the said bankrupt's goods, wares, merchandises, money, effects and estate, and all books, papers and writing relating thereunto, as at the time of such examination shall be in his or her possession, custody or power . . . .[14]

The debtor had simply no option to retain his assets. Failure to submit to examination and failure to disclose his assets and assign the same to his creditors, if willful, resulted in the debtor being "adjudged a fraudulent bankrupt" and put in prison for up to ten years (but for no less than twelve months).[15] And on top of that, the Act stated it "shall be lawful" to "break open . . . the houses, chambers, shops, warehouses, doors, trunks, or chests of the bankrupt . . . and to take possession of the goods, money, and other estate, deeds, books of account or writings of such bankrupt."[16]

After the commissioners had declared the person a bankrupt, they "forthwith" shall set "some convenient time and place for the creditors to meet, in order to choose an assignee or assignees of the said bankrupt's estate and effects; at which meeting the said commissioners shall admit the creditors of such bankrupt to prove their debts."[17] At the meeting, creditors voted and ultimately, "the said commissioners shall assign . . . all . . . the said bankrupt's estate . . . to such person or persons as the major part, in value, of such creditors, according to the several debts then

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13 *Id.* § 5.
14 *Id.* § 18.
15 *Id.*
16 *Id.* § 20.
17 *Id.* § 6.

proved, shall choose as aforesaid: [p]rovided always, that in such choice, no vote shall be given by, or in behalf of any creditor whose debt shall not amount to two hundred dollars."[18]

As it happens, given the challenges of transportation during that time, ultimately the burden on creditors to appear "to prove" their debt to commissioners or a judge was burdensome enough that Congress repealed the law in 1803.[19]

**Later 19th Century American Bankruptcy Law: At Times Voluntary and Less Punitive**

*Bankruptcy Act of 1841*[20]

The Bankruptcy Act of 1841 is among the most significant because it first introduced voluntary bankruptcy to federal law in America. Under the 1841 Act, a proceeding began by either a petition filed "by any bankrupt" or "by a creditor against any bankrupt"; or, in other words, the 1841 Act allowed voluntary and involuntary petitions.[21] The Act did not require imprisonment but did require surrender of property and compliance with all orders of the court.[22] Like the 1800 Act, the debtor surrendered all of his property.[23] After that (and after notice and opportunity for creditors to object over a period of 70 days), "every bankrupt, who shall bona fide surrender all his property and rights of property . . . for the benefit of his creditors, and shall fully comply with and obey [all court orders and directions] and shall otherwise conform to all the requisitions of this act, shall . . . be entitled to a full discharge from all his debts" unless a majority in number and

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18 *Id.*

19 *See* Act of Dec. 19, 1803, ch. 6, 2 Stat. 248; David S. Kennedy & R. Spencer Clift, III, *An Historical Analysis of Insolvency Laws and Their Impact on the Rule, Power, and Jurisdiction of Today's United States Bankruptcy Court and its Judicial Officers*, 9 J. BANKR. L. & PRAC. 165, 170–71 (2000). Another interesting feature reflecting the respect of federalism of the time was section 61 of the Act of 1800 which expressly honored state insolvency proceedings when noting "this act shall not repeal or annul, or be construed to repeal or annul the laws of any state now in force, or which may be hereafter enacted, for the relief of insolvent debtors, except so far as the same may respect persons who are or may be clearly within the purview of this act." Act of Apr. 4, 1800, at § 61.

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

21 *Id.* § 7.

22 *See id.* §§ 3–4.

23 *See id.* § 3.

value of his creditors who have proved their debts disapprove, or unless the bankrupt was not eligible to discharge his debts (if he had not "kept proper books of account" or did not "conform to" the "requisites of this act" among other apparently bad acts).[24] This opportunity for a personal discharge in return for voluntary surrender of property was groundbreaking. Yet, the opportunity for discharge was limited: a person could not obtain a future discharge in bankruptcy unless (in the second case) "his estate shall produce (after all charges) sufficient to pay every creditor seventy-five per cent. on the amount of the debt which shall have been allowed to each creditor."[25]

While less punitive, and somewhat voluntary, the 1841 Act was rarely used and as already noted, was short lived.

*Bankruptcy Act of 1867*[26]

The Bankruptcy Act of 1867 reintroduced the option of a voluntary bankruptcy proceeding. Once again, the option to file a voluntary bankruptcy allowed a debtor to obtain a discharge of debt in return for surrender of property. Under the 1867 Act, a person residing within the jurisdiction of the United States whose provable debts exceeded $300 could apply by a petition in which he stated "his inability to pay all his debts in full, his willingness to surrender all his estate and effects for the benefit of his creditors, and his desire to obtain the benefit of this act."[27] The filing of the petition "shall be an act of bankruptcy, and such petitioner shall be adjudged a bankrupt."[28] If a judge was satisfied that the petitioner had provable debts exceeding $300, the judge would issue a notice stating the following:

First. That a warrant in bankruptcy has been issued against the estate of the debtor.

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24 *Id.* § 4.
25 *Id.* § 12.
26 Bankruptcy Act of 1867, ch. 176, 14 Stat. 517, *repealed by* Act of June 7, 1878, ch. 160, 20 Stat. 99.
27 *Id.* § 11.
28 *Id.*

> Second. That the payment of any debts and the delivery of any property belonging to such debtor to him or for his use, and the transfer of any property by him, are forbidden by law.
> Third. That a meeting of creditors of the debtor . . . will be held at a court of bankruptcy . . . .[29]

In the bankruptcy proceeding, an assignee was appointed from one of the creditors[30] (like the commissioners from the 1800 Act).[31] The assignee collected property of the debtor, sold property, accounted for it, and disbursed its proceeds, among other duties.[32] During the course of the proceeding, three meetings of creditors were convened[33] over a period of six months or longer, at which the assignee provided a report and accounting of the assets of the estate.[34] The creditors, at each of these meetings, determined, by majority vote, whether and what of the proceeds should be divided among the creditors (in what dividend amounts).[35] After having been adjudicated a bankrupt, and having cooperated with all orders of the court, the bankrupt may apply for a discharge.[36] No second discharge could be granted if the estate in the second case was "insufficient to pay seventy per centum of the debts proved against it, unless the assent in writing of three fourths in value of his creditors who have proved their claims is filed[,] . . . but a bankrupt who shall prove to the satisfaction of the court that he has paid all the debts owing by him at the time of any previous bankruptcy, or who has been voluntarily released therefrom by his creditors, shall be entitled to a discharge in the same manner and with the same effect as if he had not previously

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29 *Id.*

30 At the meeting of creditors, the assignee was selected by "the greater part in value and in number of the creditors who have proved their debts," but if no choice was made, the judge could appoint an assignee. If the assignee failed to accept the assignment timely, the "judge or registrar [would] fill the vacancy." *Id.* § 13.

31 Assignees were appointed under the 1841 Act as well.

32 *See id.* §§ 13–17.

33 "At the expiration of three months from the date of the adjudication of bankruptcy . . . the court, upon request of the assignee, shall call a general meeting of the creditors," *id* § 27, and "the like proceedings shall be held at the expiration of the next three months, or earlier, . . . and a third meeting of creditors shall then be called by the court, and a final dividend then declared," *id* § 28.

34 *Id.* § 27.

35 *Id.*

36 *Id.* § 29.

been bankrupt."[37] As described by one scholar, "under the Bankruptcy Act of 1867, it was not difficult to find a reason to force a debtor into bankruptcy, but it was exceedingly difficult for the debtor once adjudicated to obtain his discharge."[38] For example, simply having "lost any part thereof [his property] to gaming" at any time was grounds to deny a bankruptcy discharge as was having made "in contemplation of becoming bankrupt" any transfer (directly or indirectly) "for the purpose of preferring any creditor or person having a claim against him."[39]

As the name implies, the assignee became owner of all property interests of the debtor.[40] The assignee (not the debtor) could designate and set apart "necessary household and kitchen furniture, and such other articles and necessaries of such bankrupt" as exempt from sale.[41]

Although the statute did not provide for the debtor to be imprisoned for debt defaults, the statute did not prevent arrest for debt if the civil action was for a debt or claim the "discharge [in bankruptcy] would not release."[42]

Once again the bankruptcy law provided little option for debtor. His sole choice was either to submit to a complete surrender of property now or hold out until an involuntary action was filed against him later (and surrender his property at that time).

*Bankruptcy Act of 1874*[43]

The Bankruptcy Act of 1874 was initially intended as a total repeal of the 1867 Act.[44] As it happened, the 1874 Act did not repeal the 1867 Act. It simply amended the 1867 Act but retained nearly all of its provisions, with adjustments. One notable adjustment was to the discharge

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37 *Id.* § 30.
38 Vincent L. Leibell, Jr., *The Chandler Act—Its Effect upon the Law of Bankruptcy*, 9 FORDHAM L. REV. 380, 384 (1940).
39 Bankruptcy Act of 1867, at § 29.
40 *See* Bankruptcy Act of 1867, at §§ 13–17.
41 *Id.* § 30.
42 *See id.* § 26.
43 Act of June 22, 1874, ch. 390, 18 Stat. 178, *repealed by* Act of June 7, 1878, ch. 160, 20 Stat. 99.
44 Kennedy & Clift, *supra* note 19, at 173.

provision. The 1874 amendments provided "in cases of voluntary bankruptcy, no discharge shall be granted to a debtor whose assets shall not be equal to thirty per centum of the claims proved against his estate, upon which he shall be liable as principal debtor, without the assent of at least one-fourth of his creditors in number and one-third in value."[45] But in the case of an involuntary bankruptcy under the 1874 amendments, the debtor [bankrupt] could apply for a discharge regardless of the percentage paid to creditors or requisite creditor consent (as contrasted from prior law).[46] But perhaps the most consequential aspect of the 1874 amendments was the addition of section 17. In this section, "compositions" were authorized, and this planted a seed for what would ultimately become bankruptcy reorganizations.

The 1874 amendments provided that unsecured creditors may consider a "composition[47] proposed by the debtor" as satisfaction of their debts. If accepted by a majority in number of creditors and those holding three fourths in value of the debts, and subsequently confirmed by two thirds in number and one half in value of all the creditors of the debtor, it may be approved as a resolution.[48] If "at any time" the composition could not proceed "without injustice or undue delay to the creditors or to the debtor," the court may set aside the composition and "the debtor shall be proceeded with as a bankrupt."[49] The requirement for some form of creditor consent to the discharge remained part of bankruptcy law until the Bankruptcy Code in 1978.

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45 *See* Act of June 22, 1874, at § 9.

46 *Id.* Under the 1800 Act, after surrender of property, if at least 50% had been paid to creditors the court may discharge the balance of the debt and permit the debtor to keep 5% of his estate. *See* Act of Apr. 4, 1800, at §§ 34, 35.

47 Generally, a composition (sometimes called an arrangement) was a settlement of the debt agreed upon with the creditor and usually involved a cash payment in a lesser amount of the total debt in return for a release and settlement of the unpaid debt balance.

48 Act of June 22, 1874, at § 17.

49 *Id.*

Complaints about the 1874 law cited the excessive costs of administration causing the small bankruptcy estates to be "entirely absorbed in fees."[50] Only four years later, in 1878, the Bankruptcy Act of 1867 and its amendments in 1874 were repealed.[51]

*Bankruptcy Act of 1898*[52]

The Bankruptcy Act of 1898 set forth a bankruptcy framework that would endure for eighty years, unlike the oscillating bankruptcy statutes of the 19th century. The 1898 Act was followed by various amendments, most of which expanded relief for debtors or provided administrative improvements to manage the growing caseload. Ultimately most of the amendments opened the door to greater options for debtors and paved the way for the 1978 Code and its momentous shift to a comprehensive voluntary bankruptcy structure.

**Early 20th Century and the Origin of Chapter 13**

The 1898 Act embraced the feature of compositions and thereby made voluntary bankruptcy more attractive than the earlier attempts. Yet the 1898 Act retained limitations which no doubt curbed the voluntary bankruptcy option. First, as with prior bankruptcy acts, the 1898 Act required the debtor to first have "committed an act of bankruptcy" in order to proceed in the bankruptcy case. The act of bankruptcy included having "admitted in writing his inability to pay his debts and his willingness to be adjudged a bankrupt on that ground."[53]

Unlike the forced liquidation of earlier bankruptcy law, under the 1898 Act, an individual could file a voluntary bankruptcy petition (if he was unable to pay his debts) and propose a

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50 *See In re Oakland Lumber Co*., 174 F. 634, 637 (2d Cir. 1909) (cautioning against hastily appointing a receiver in a bankruptcy case that may not proceed to administration and commenting "nothing contributed so much to bring about the repeal of the act of 1867 [amended in 1874] as the large expense of administration, the small estates being entirely absorbed in fees").

51 Hanna, *supra* note 3, at 115.

52 Bankruptcy Act of 1898, ch. 541, 30 Stat. 544, *repealed by* Pub. L. No. 95-598, 92 Stat. 2549 (1978).

53 *See id.* § 3(a)(5).

"composition" to satisfy his creditors.[54] If the terms of the composition were accepted in writing by a majority in number of creditors and majority in amount of claims, the application could then be filed in the court, and the consideration to be paid to the priority creditors under the composition, along with all fees and costs, deposited at that time[55] with the court or such place as designated by the court.[56] The composition was hardly a realistic or viable option for the individual in bankruptcy. First, it would be challenging to obtain the written consent of the majority of his creditors to his composition plan (especially if he was solvent). More than that, because the individual had insufficient income with which to pay his debts, it was even more unlikely he could obtain sufficient funds to deposit with the court to pay the required composition amounts at the time the proposed composition was filed with the court. If the composition was not approved (if for example the consideration could not be paid), the estate was to "be administered in bankruptcy."[57]

Furthermore, the debtor was not protected from all creditor collection actions. Like prior bankruptcy acts, under the 1898 Act, the filing of a bankruptcy case in a federal court did not stay or "exempt [the bankrupt] from arrest upon civil process . . . [w]hen issued from a State court . . . upon a debt or claim from which his discharge in bankruptcy would not be a release."[58] Plus, only a "suit which [was] founded upon a claim from which a discharge would be a release, *and which [was] pending against a person at the time of the filing of the petition against him*" was stayed.[59]

The 1898 Act was much less punitive than prior acts, yet it did allow, in certain circumstances, a court to "issue a warrant to the marshal, directing him to bring such bankrupt

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54 *See id.* § 12.

55 Generally, these amounts were paid with the application and the other payments under the composition were paid at confirmation.

56 *Id.* § 12(b).

57 *Id.* § 12(d).

58 *See id.* § 9(a).

59 *Id.* § 11(a) (emphasis added).

forthwith before the court for examination" and "keep such bankrupt in custody not exceeding ten days, but not imprison him, until he shall be examined and released or give bail."[60]

The commissioners and assignees of prior law were replaced with bankruptcy trustees.[61] The trustee was vested with title to all property and interests of the debtor (unless the property was exempt) and, as with prior acts, would collect and liquidate property.[62] If a composition was confirmed, title to property would revest in the debtor, and the case was dismissed.[63]

As noted, compositions were nearly impossible for the cash strapped insolvent individual. Other than a composition or complete liquidation, the individual had no other alternative to relieve financial distress. Sadly, even if the individual had the ability to make payments, he had no option under federal bankruptcy law to remain in possession of property and simultaneously make payments over a term (rather than a lump sum under a composition). And he had no protection under the law if he attempted to do so because his wages were subject to garnishment. That is, until 1933.

*The Origin of Chapter 13: 1933 Amendments*

In 1933, Congress amended the Bankruptcy Act to open extensions and compositions to individuals.[64] No longer was the aim of the bankruptcy legislation penal consequences for debt default. Indeed, the title of the amendment was "Provisions for the Relief of Debtors."[65]

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60 *Id.* § 9(b).
61 *See id.* § 44(a).
62 *See id.* §§ 47–49, 70.
63 *Id.* §§ 12(e), 70(f).
64 An Act, ch. 204, 47 Stat. 1467, 1467–70 (1933) [hereinafter "1933 Amendments"].
65 *See id.* § 73 ("In addition to the jurisdiction exercised in . . proceedings to adjudge persons bankrupt, courts of bankruptcy shall exercise original jurisdiction in proceedings for the relief of debtors, as provided in sections 74, 75, and 77 of this Act.").

Generally, an extension was a request to permit a longer time period in which to pay debts, but not discharge the unpaid indebtedness.[66] Compositions, on the other hand, allowed for a discharge of debts (other than those agreed to be paid by the terms of the composition and those not affected by the discharge). If a debtor sought an extension, he was not adjudicated a bankrupt and a trustee was not appointed until requested by creditors,[67] except that a custodian would be appointed to conduct a creditors' meeting or a receiver to administer the payments.[68]

By contrast to the extension in which payments were made over time, to obtain confirmation of a composition, the individual was required to deposit with the court, in cash, payments required by the plan. At confirmation the payments were immediately disbursed. After confirmation, the case was dismissed and the court no longer had jurisdiction over his wages (stated differently, the court had no supervision and control over the debtor's future earnings).[69] Consequently, the court could not approve a composition plan if based on future earnings and could not enforce an extension plan that contemplated future payments.[70]

Compounding this defect was the fact that relief was conditional; the petition had to be approved before a stay would be imposed[71] and the stay of collection by a secured creditor was

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66 *See In re Thompson*, 51 F. Supp. 12, 13–14 (W.D. Va. 1943) (noting that in a "composition" the debtor settles his indebtedness in an agreed amount less than the amount owed but in an "extension" he obtains an extension of time within which to pay the debts in full).

67 The trustee had the duty to collect and liquidate property, not to serve as disbursing agent under a wage earner plan. *See* Bankruptcy Act of 1898, at § 47.

68 *See* 1933 Amendments § 74(b), (c), (d)(2).

69 *Id.* § 74(j). In an extension, the court could "dismiss the proceeding or may retain jurisdiction of the debtor and his property during the period of the extension." *Id.*

70 *See id*. § 74(e); Leibell, *supra* note 38, at 404.

71 "Upon the filing of such a petition or answer [to an involuntary proceeding] the judge shall enter an order either approving it as properly filed under this section, if satisfied that such petition or answer complies with this section and has been filed in good faith, or dismissing it. If such petition or answer is approved, an order of adjudication shall not be entered [unless the debtor defaults on his obligations] . . . ." *Id.* § 74(a). In other words the court is "staying" the action for adjudication [bankruptcy liquidation], but in so doing, "the court shall make such stay conditional upon such terms for the protection and indemnity against loss by the estate as may be proper, and . . . the court may, as the creditors at the first meeting may direct, impose similar terms as a condition of delaying the appointment of a trustee and the liquidation of the estate." *Id.*

optional.[72] Of course, neither a composition nor an extension could alter or restructure secured debt.[73]

Before considering the further developments following the 1933 Amendments, it is important to comment on the constitutional challenges to the federal bankruptcy law developments during this era. The 1898 Act (and the 1933 Amendments to the 1898 Act) addressed provisions for compositions (not simply surrender of property), did not require the immediate appointment of a trustee or assignee, and addressed "debtors" as well as "bankrupts." The law appeared to address more than "bankruptcies." And so, for these reasons, the law was challenged as exceeding the constitutional authority of Congress.

*Is It Constitutional?*

In reaction to the 1898 Act, two challenges to the constitutionality of compositions surfaced. First, compositions under the Bankruptcy Act were challenged as beyond the constitutional authority of Congress to enact "uniform laws regarding bankruptcy." Second, compositions were challenged as an unconstitutional taking of property in violation of the Fifth Amendment.

The first concern was that Congress did not have the power to enact laws for insolvency relief different from "bankruptcy." States have the power to enact laws regarding insolvency, and the Constitution conferred Congress only with the power to draft uniform laws regarding *bankruptcy* which appeared to be distinct from insolvency. Since the relief envisioned by a composition was something other than liquidation, for someone other than "a bankrupt," it was

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[72] "In addition to the provisions of section 11 of this Act for the staying of pending suits, the court, on such notice and on such terms, if any, as it deems fair and equitable, *may* enjoin secured creditors who may be affected by the extension proposal from proceeding in any court for the enforcement of their claims until the extension has been confirmed or denied by the court." *Id.* § 74(n) (emphasis added).

[73] *Id.* § 74(i) ("[S]uch extension or composition shall not reduce the amount of nor impair the lien of any secured creditor, but shall affect only the time and method of its liquidation.").

not clear that Congress had such authority. This concern was alleviated when the Supreme Court determined that a) insolvency and bankruptcy are indistinguishable and b) laws addressing such options as compositions are within the purview of bankruptcy law.[74]

The second constitutional challenge was more potent. Critics challenged the constitutionality of the 1933 Amendments adding section 74 (the wage earner plan provision) and section 75 (farmer relief). These sections permitted a bankruptcy court to approve a composition plan or extension plan by vote of a majority of creditors, potentially infringing the rights of the minority in opposition. As to this point, the Supreme Court upheld the constitutionality of a *court approved* composition.[75] But the most problematic, and ultimately indefensible, provisions were found in section 75, particularly as amended in 1934, which afforded dramatic relief to farmers.[76] Section 75 permitted a farmer (mortgagor) who had been unable to obtain the consent of his mortgagee (secured creditor) to a composition two methods to retain possession when not maintaining the mortgage debt. First, the farmer could purchase the property at the then appraised value over a period of six years, but second, if the mortgagee objected to the proposed sale or payments, the court would stay "all proceedings for a period of five years" during which time the farmer retained possession and paid a "reasonable annual rent" (contemplated to be paid to the court) after which time he could purchase the property at the appraised value (based on either the appraisal made at the beginning of the five years or at the new appraised value at the end of the five year term). The mortgagee had no option to purchase the property at the sale (could not bid

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74 *Hanover Nat'l Bank v. Moyses*, 186 U.S. 181 (1902); *see Wilmot v. Mudge*, 103 U.S. 217, 218 (1880) ("[T]he provision for composition is a proceeding in bankruptcy . . . .").

75 *See Moyses*, 186 U.S. at 186–87; *see also Cont'l Ill. Nat'l Bank & Tr. Co. v. Chi., Rock Island & Pac. Ry. Co.*, 294 U.S. 648, 672 (1935) ("The constitutionality of the old provision for a composition is not open to doubt."). For these reasons, the legislation authorized a court to disapprove a plan, even if sufficient numbers of creditors voted in favor.

76 *See* An Act, ch. 869, 48 Stat. 1289, 1289–91 (1934) (adding subsection (s) to section 75 of the Bankruptcy Act).

at a sale), had no opportunity for relief from the five-year stay, and was not permitted compensation for the decline in value of the property during the period that the mortgagee was stayed from enforcing the mortgage while the mortgagor was not maintaining the mortgage payments or maintaining insurance or property taxes.[77]

In short order, section 75 of the Act was challenged as violating the Fifth Amendment by taking property without compensation and due process. The United States Supreme Court agreed and struck down the provisions.[78] After this decision, Congress responded. Congress revised the law and placed conditions upon the debtor's retention of property while in default on the mortgage and without the mortgagee's consent. This time, the Supreme Court upheld the constitutionality.[79] Yet concerns regarding just how to achieve the appropriate balance between a secured creditor's rights and a debtor's rights to the same property continue to plague lawmakers and courts alike from 1935 to the present. One obvious lesson from these Supreme Court decisions in the 1930s is the need for restructuring laws to include provision for adequate protection of a creditor's interest in the debtor's interest in property. And one enduring challenge is achieving it.

*The Chandler Act:*[80] *The Wage Earner Plan of 1938*

In 1938, Congress passed the Chandler Amendments to the Bankruptcy Act. These amendments fixed some of the flaws from the 1933 Act.[81]

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77 *See id.* §75(s)(3), (s)(7); *see also* Leibell, *supra* note 38, at 391 ("[T[his Act was declared unconstitutional because it deprived secured mortgagees of certain rights in particular property. To be specific, these rights were five in number: 1-the right to insist on full payment before releasing the lien; 2-the right to an auction sale; 3-the right to bid at the sale; 4-the right to select the time for the sale with the consent of the court; 5-the right to control the property during the period of default, subject to the discretion of the court, and to have the rents and profits collected by a receiver for the satisfaction of the debt.").

78 *Louisville Joint Stock Land Bank v. Radford*, 295 U.S. 555 (1935).

79 *Wright v. Vinton Branch of Mountain Tr. Bank of Roanoke*, 300 U.S. 440 (1937).

80 Chandler Act, ch. 575, 52 Stat. 840 (1938) [hereinafter "Chandler Act"].

81 *See* Frederick Woodbridge, *Wage Earners' Plans in the Federal Courts*, 26 MINN L. REV. 775, 775–76 (1942) (remarking that the 1933 statute "did not meet with much success due principally to failure to give to the court jurisdiction over the future wages of the debtor and to provide for a discharge").

The primary attraction for this novel alternative was protection from wage garnishment and retention of property, even property that was not otherwise exempt from collection. As described by William McCarty, "the single most important benefit . . . is that when he files his Chapter XIII petition the court will enjoin the continuation of any and all garnishment proceedings against him. Since it is common knowledge that garnishments are the most potent weapon for driving debtors into bankruptcy, the importance of any measure that can stop them cannot be overemphasized."[82] A stated purpose of the Act included "providing for wage earners' and real property arrangements"[83]

That an individual who was in default of his obligations to his creditors could obtain some form of protection from creditor collection activity and ultimately some debt forgiveness, without having to give up his property, was extraordinary (and propitious). Allowing an alternative to liquidation ("straight bankruptcy") permitted an opportunity for rehabilitation.[84] Unlike the measurements of the brief experiment in 1841, this time the voluntary option coupled with protection from creditor collection resulted in greater recovery for creditors. Now it appeared that denying someone who is in default from any alternative to liquidation resulted in *less* debt recovery.[85]

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[82] William E. McCarty, *Wage Earners' Plan–Chapter XIII*, 45 MARQ. L. REV. 582, 598 (1962).

[83] *See* Leibell, *supra* note 38, at 386 (citing 8 C.J.S. 17 (Supp.)). The legislation reflected a departure from "a system of law conceived in the theory that bankruptcy is a crime to one where compositions and creditor control have risen to the point of paramount importance. Rehabilitation not wanton destruction, has become the keynote of bankruptcy legislation." *Id.* at 385.

[84] *See* Charles Jordan Tabb, *The History of the Bankruptcy Laws in the United States*, 3 ABI L. REV. 5, 28 (describing the intent of the 1933-1938 amendments as measures intended to facilitate rehabilitation through bankruptcy). *But see* Donald L. Boren & August Ralston, *Chapter XIII Wage Earner Plans: An Analysis of Their Effectiveness*, 15 AM. BUS. L.J. 293 (1978) (concluding that rehabilitation under Chapter XIII is questionable and advocating the use of Chapter XIII remain voluntary and not unduly encouraged).

[85] For example, the Report of the Judicial Conference of the United States, Proceedings, September 20-21, 1961, noted "The Committee called attention to the value of the proceedings under Chapter XIII as reflected in the amounts paid to creditors in Chapter XIII cases and in no-asset straight bankruptcy cases. During the fiscal year 1960, the *unpaid* liabilities scheduled in the 63,086 straight bankruptcy cases closed during the year were $469,865,567. During the same period the debts affected in the 5,920 Chapter XIII cases completed were $5,277,737, of which $5,168,251, or 98 percent, was paid to creditors."

As described by then Solicitor General and U.S. District Judge Thomas D. Thacher in 1931, wage earners in need of protection from garnishment resorted to liquidation even though they had the desire to repay their debts—they simply could not do so when subject to garnishment. Worse, they resorted to loans with exceedingly high interest rates solely to avoid the stigma of bankruptcy.[86] In his *Proposed Change to the Bankruptcy Act*, Solicitor General Thacher noted that the current system failed in providing sufficient debt recovery:

> In practice we have found that debtors usually have such meagre assets by the time they go into bankruptcy that it would make little difference whether these assets were paid preferentially to one creditor or were distributed to all in fractional proportions or (as is generally the case) were consumed in fees and expenses of administration.
> The bankruptcy court has increasingly become a dumping ground for the refuse of commercial wreckage, and a sanctuary where debtors obtain cancellation of their debts regardless of how they may have wasted their property.[87]

Then Solicitor General Thacher argued for statutory changes to allow and encourage debtors, "if wage earners, to have the aid of the court, with full relief from garnishments and other attachments, in providing for the amortization of debts out of earnings."[88] The Chandler Act, therefore, intentionally referred to a person who filed a petition "under this chapter" as a "debtor" as distinguished from a person who filed a petition "under this Act" who was defined as a "bankrupt."[89] And as long as he was proceeding under Chapter XIII, he "shall not be adjudged a bankrupt."[90] In other words, the proceeding was distinct from "bankruptcy" and did not require surrender of property or the attendant consequences of bankruptcy (harm to employment prospects

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86 Timothy W. Dixon & David G. Epstein, *Where Did Chapter 13 Come From and Where Should It Go?*, 10 ABI L. REV. 741, 743–45 (2002) (describing the nationwide study of bankruptcy proceedings performed under the direction of former U.S. District Judge Thacher).

87 Hon. Thomas D. Thacher, *Proposed Change in Bankruptcy Act Submitted by Thomas D. Thacher*, 3 N.Y. ST. BAR ASS'N BULL. 532, 534–35 (1931).

88 *Id.* at 545.

89 *Compare* Chandler Act §§ 606(3), 602, *with* §§ 30(f), 1(2).

90 *Id.* § 668; *see also id.* § 625.

and denial of future credit, for example). A proceeding under Chapter XIII was permissible if the wage earner was insolvent or solvent.[91]

To provide sufficient relief for individuals while operating under a wage earner plan, Chapter XIII permitted a court to stay "the commencement" as well as the continuation of suits by unsecured creditors and "upon notice and for cause shown" to stay suits filed by secured creditors.[92] Although not automatic, the imposition of a stay against future collection actions and the protection of postpetition income from garnishment was innovational. To provide opportunity for a debtor to have flexibility in his plan, Chapter XIII allowed debtors to reject executory contracts.[93]

Over the next decades, the wage earner plan proceeding was praised.[94] Although the wage earner plan was welcome, it was not without weaknesses. For example, under the Chandler Act:

- Only individuals with wages under a certain threshold qualified; those self-employed or those with income from other sources were excluded from this option.[95]
- The individual could not separately classify his unsecured debts; all unsecured debts had to be treated alike and without discrimination.[96]

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91 *See id.* § 623. The 1933 Act likewise authorized a proceeding if the debtor was insolvent or unable to pay his debts as they matured; both were not required.

92 *Id.* § 614.

93 *Id.* § 613(1).

94 *See Wage Earner Bankruptcy: A Neglected Remedy?*, Comment, 34 FORDHAM L. REV. 528 (1966) (noting among other things the availability of discharge within six years of a bankruptcy discharge); William Jefferson Giles, III, *The Overlooked Debtor's Remedy—Wage Earner Proceedings Under Chapter XIII of the Bankruptcy Act*, 15 S.D. L. REV. 273 (1970); Milton J. Morris, *The Wage Earner Plan—A Superior Alternative to Straight Bankruptcy*, 9 UTAH L. REV. 730 (1965).

95 Chandler Act § 606(8).

96 *Id.* § 646.

- The plan had to be accepted in writing by secured creditors whose claims are dealt with[97] by the plan and by a majority in number of all unsecured creditors whose claims have been allowed and a majority in amount.[98]
- Actions against co-signers were not stayed.[99]
- A wage earner could not cure a defaulted mortgage without the express consent of the mortgage holder.[100]

And there were some practical shortcomings of wage earner plans, as mentioned in the next paragraphs.

A judge could appoint any person as trustee for the wage earner plan, whose role was primarily as a disbursing agent.[101] This power differed from that in "bankruptcy proceedings" in which the creditors would select the appointment of a trustee and only in the absence of a selection or declination of the appointment would a judge appoint a trustee.[102] The Act did not require, or prohibit, having one person be appointed trustee for all Chapter XIII proceedings.[103] It was not uncommon (in the early decades of the wage earner proceedings) for a court to appoint debtor's counsel or the debtor as disbursing agent.

The Act did not set parameters for the term period for the plan. Section 646 describes what terms may be (or must be) included in a plan yet is silent upon the plan length. Likewise, the

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97 The concept of when a creditor's claim is "dealt with" by the plan was not explained in the statute or legislative history. Most courts determined if the plan did not provide payment terms according to the terms of the original contract (or the contract was not assumed), then the creditor's claim was "dealt with" (because the creditor could not pursue remedies available under state law). *In re O'Dell*, 198 F. Supp. 389 (D. Kan. 1962).

98 *See* Chandler Act §§ 646, 652(1).

99 *See id.* § 614.

100 *See id.* §§ 646, 652(1).

101 *Id.* § 633(4). It was unclear if section 45 of the Act applied to the Chapter XIII proceeding. *See id.* § 602. Section 45 provided that "individuals who are competent to perform their duties and who reside or have an office in the judicial district within which they are appointed" qualify to be trustees. *Id.* § 45.

102 *Id.* § 44.

103 *See id.* § 601–686; Woodbridge, *supra* note 81, at 783.

confirmation requirements of section 656 do not refer to the minimum or maximum plan length. It was generally understood that since creditor consent was required to approve a composition (or arrangement), the amounts required under the plan to be paid were made contemporaneously with confirmation. But under an extension, the debtor would propose, and carry out, a plan for whatever length needed to complete it,[104] although the statute did permit a debtor to apply for a discharge at the end of three years even if he had not completed his plan payments at that time if the failure was due to circumstances for which he could not be justly held accountable.[105] The Act permitted the court "during the period of extension" to increase or reduce, or extend or shorten the time for, the installment payments.[106]

The Act permitted dismissal postconfirmation only in the event of a default in the terms of the plan. The debtor could not voluntarily dismiss his proceeding after it was confirmed. Under the Act, the court could dismiss the proceeding and as a result convert the case to a "bankruptcy proceeding" (liquidation, or "straight bankruptcy") depending on how it had been filed. A Chapter XIII proceeding was filed one of two ways. First, a debtor could initiate a Chapter XIII wage earner plan if he was in a bankruptcy proceeding, and otherwise eligible for Chapter XIII, by simply filing a petition under Chapter XIII in the pending bankruptcy proceeding and thereby in effect "converting" to a Chapter XIII proceeding.[107] In such event, if he did not obtain approval of his wage earner plan or defaulted under the plan, the judge would dismiss the Chapter XIII proceeding and "direct that bankruptcy be proceeded with."[108] Second, the debtor could initiate a

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104 *See id.* §§ 660, 666.

105 *Id.* § 661 ("If at the expiration of three years after the confirmation of a plan the debtor has not completed his payments thereunder, the court may nevertheless, upon the application of the debtor and after hearing upon notice, if satisfied that the failure of the debtor to complete his payments was due to circumstances for which he could not be justly held accountable, enter an order discharging the debtor from all his debts and liabilities provided for by the plan . . . ."). This option was not available under the 1933 Act.

106 *See id.* § 646(5).

107 *Id.* § 621.

108 *Id.* § 666(1).

Chapter XIII wage earner proceeding by filing a voluntary petition to proceed under Chapter XIII even if no bankruptcy was pending.[109] In this second scenario, if the plan was not approved or he defaulted, then the court would dismiss the Chapter XIII proceeding or, with the debtor's consent, would "adjudge[e] him a bankrupt and direct[] that bankruptcy be proceeded with."[110]

During the first decades after the enactment of the Chandler Act, it was unclear if the creditors were bound by a bar date or even had to file a proof of claim at all if they consented to the wage earner's plan.[111] Likewise, it was unclear if creditors had to use an official form to file proof of their claim[112] or if any writing would do.

The judge (or referee, if the judge referred the proceeding) would preside at the meeting of creditors.[113] At the meeting of creditors, the court "shall receive and determine the written acceptances of creditors on the proposed plan,"[114] and confirm the plan if "accepted in writing by all creditors affected thereby" and if "the debtor shall have made the deposit required under this chapter and under the plan."[115] If the plan was consensual, confirmation hearings were not required.[116] The court would "fix a time for the filing of the application to confirm the arrangement[117] and for a hearing on the confirmation thereof . . . unless all creditors affected by the arrangement have accepted it."[118] If the debtor proposed an extension, and it was approved by

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109 *Id.* § 622.

110 *Id.* § 666(a)(2).

111 *See* Henry W. Parker, *Must a Proof of Claim be Filed?*, 19 J. NAT'L ASS'N REF. IN BANKR. 123 (1945); Woodbridge, *supra* note 81, at 798; *see also In re Heger*, 180 F. Supp. 147, 148 (D. Minn. 1959).

112 The definition of "claims" in Chapter XIII specifically excluded "claims secured by estates in real property or chattels real." Chandler Act § 606(1).

113 *Id.* § 633(1).

114 *Id.* § 633(3).

115 *Id.* § 651.

116 *See id.* "This provision . . . is designed to obviate the filing of a formal application for confirmation where all creditors affected by a plan have accepted it. Furthermore, where all the creditors accept a plan, there is no one to object, and, therefore, there is no occasion for a formal application to confirm or for a hearing thereon." JACOB I. WEINSTEIN, BANKRUPTCY LAW OF 1938 CHANDLER ACT COMPARATIVE ANALYSIS PREPARED FOR THE NATIONAL ASSOCIATION OF CREDIT MEN 348 (1938).

117 The "arrangement" referred to the composition plan.

118 Chandler Act § 633(5).

the creditors, then the court would "appoint a trustee to receive and distribute . . . all moneys to be paid under the plan."[119]

*The 1978 Code and Chapter Choice for Individuals*

Use of the wage earner plan as an alternative to surrender of property for liquidation grew over the next forty years, and so did suggestions to improve it.[120] In 1978, Congress passed the Bankruptcy Code,[121] replacing the Chapter XIII wage earner plan with Chapter 13. The Bankruptcy Code removed the requirement for "acts of bankruptcy" as a condition of eligibility. No longer was a person required to be insolvent, or unable to pay their debts as they come due, to petition the Bankruptcy Court for protection and relief. No longer was an individual compelled to surrender property or forbidden from altering secured debt payment terms absent affirmative consent, and on top of that, the debtor could change his mind and so convert from one chapter to another or dismiss his case entirely. The debtor had new forms of relief and protections previously nonexistent.

For individuals, the law added options and incentives. For the first time, an individual with unsecured debts up to $100,000 and secured debts up to $350,000 could file a bankruptcy petition, could select to proceed under Chapter 13, and could:

- obtain a stay of collection actions against a co-signer *who did not file bankruptcy*;
- modify secured debts *without* consent of the secured creditor;
- cure mortgage defaults *without* the consent of the mortgage holder;
- cure defaults over time;

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119 *Id.* § 633(4).

120 *See* James H. Johnson, *Nonassenting Secured Creditors to Chapter XIII Wage Earner Plans*, 47 TEX. L. REV. 302 (1969); Theodore J. Biagini, *Emergence of the Wage Earner's Plan*, 4 SANTA CLARA L. REV. 72 (1963); Syndney Krauss, *Arrangements and Wage Earner Plans: Proceedings under Chapters XI and XIII*, 15 VAND. L. REV. 151 (1961).

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

- use income from various sources *other than* "wages" to fund a plan for a period no longer than five years;
- voluntarily dismiss or convert;
- separately classify his debts;
- combine extension and composition options;
- satisfy priority claims without interest;
- remain in possession and control of property;
- not be denied a discharge for "bad acts;"
- discharge debts that would be nondischargeable in "straight bankruptcy" (Chapter 7);
- use the services of a Chapter 13 trustee to administer payments; and
- retain the option to file a new case after dismissal or completion of a prior Chapter 13 case.

With these and other changes, the aim of the bankruptcy law was relief for the debtor and effective administration for creditors. The law now balanced the interests of both debtors and creditors.

The voluntary aspect of the 1978 Code was momentous. No longer were debtors punished for their choices or their circumstances. Debtors could remain in possession and control of their property, could draft their own plan to provide for their creditors' claims, and could elect to remain in bankruptcy or elect to convert to a different chapter of bankruptcy. These were no small benefits.

The 1978 statutory changes permitted individuals to creatively navigate resolutions to their insolvency. The individual had the freedom to choose options for debt restructuring and debt relief all the while under protection from collection action. A debtor could strategize how to tackle his financial insolvency and meet his individual needs. The individual could experience personal recovery and rehabilitation coupled with protection and debt forgiveness.

## Conclusion

Over the last two centuries, the aim of bankruptcy law has changed from punishment of debt defaults to relief for financially distressed debtors. Along the way, the process has resulted in greater recovery for creditors and ease of administration. And while terminology changed only incrementally, the substance changed radically. The glimpse back reveals a dynamic legislative journey.