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LEGISLATION

UNITED STATES—86TH CONGRESS, 1ST SESSION—BANKRUPTCY—
DETERMINATION OF DISCHARGEABILITY BY COURTS
OF BANKRUPTCY (H. R. 4150).

H. R. 4150, now pending before Congress, represents an effort to
eliminate a present ambiguity in an extremely important phase of bank-
ruptcy administration.¹

Generally, a debtor is entitled to a discharge in bankruptcy unless
one of the several grounds for objection specified in section 14 of the
Bankruptcy Act² is found to exist. By its terms the discharge order pur-
ports to discharge all provable claims except those which are excepted
from its effect by section 17.³ Thus, as against a claim alleged to be
nondischargeable under section 17, the effect of a discharge will not be

¹. H. R. 4150, 86th Cong., 1st Sess. (1959). The body of H. R. 4150, as intro-
duced in the House of Representatives, reads as follows:

"That subsection (a) of section 2 of the Bankruptcy Act, as amended (11
U.S.C. 11(a)), is amended by adding at the end thereof the following:

"(22) Determine the dischargeability or nondischargeability of all prov-
able debts. If a case is reopened solely for the purpose of determining such
dischARGEABILITY or nondischARGEABILITY, no additional filing fees shall be

"Sect. 2. That subsection (a) of section 11 of the Bankruptcy Act, as
amended (11 U.S.C. 29(a)), is amended to read as follows:

"(a) A suit which is founded upon a claim from which a discharge
would be or is claimed to be a release, and which is pending against a person
at the time of the filing of a petition by or against him, shall be stayed until
an adjudication or the dismissal of the petition; if such person is adjudged
a bankrupt, any action upon a claim from which a discharge would be or
is claimed to be a release may be further stayed until the question of his
discharge and the question of the dischargeability or nondischargeability of
the claim are determined by the court after a hearing, or by the bankrupt's
filing a waiver of, or having lost, his right to a discharge, or, in the case of
a corporation, by its failure to file an application for a discharge within
the time prescribed under this act: Provided, however, That such stay shall
be vacated by the court if, in a proceeding under this act commenced within
six years prior to the date of the filing of the petition in bankruptcy, such
person has been granted a discharge, or has had a composition confirmed,
or has had an arrangement by way of composition confirmed."


³. 30 Stat. 550 (1898), 11 U.S.C. § 35 (a) (1952); Bankruptcy Form 45. While
section 17 enumerates various types of claims, those most frequently litigated are
claims alleging the obtaining of money or property by false pretenses or false repre-
sentations, and claims alleging willful and malicious injuries to the person or prop-
erty of another.

(281)
determined fully until the applicability of section 17 is litigated. However, notwithstanding the practical importance of this issue in a given case, courts of bankruptcy have traditionally refused to entertain the question of exceptions under section 17. Instead, it has been regarded as a separate matter to be passed upon by any court in which an action is brought based upon a claim scheduled in the bankruptcy proceedings but alleged to be nondischargeable. This is usually a state court. In such an action the bankrupt must affirmatively plead his discharge in order to obtain its benefit. If pleaded, the issue for the state court becomes one involving an application of section 17 of the Bankruptcy Act to determine if the claim sued upon is thereby excepted from the effect of the discharge. It is in this way that an essentially federal question of bankruptcy administration has been delegated to a multitude of non-federal court systems.

While the procedure described above has been strictly adhered to generally, a none too well defined exception arose after the Supreme Court's decision in Local Loan Co. v. Hunt. It is the purpose of this Comment to examine briefly the effect of this decision on current bankruptcy administration procedure, and the merits of H. R. 4150, designed to broaden and make uniform the practice of determining dischargeability.

I.

LOCAL LOAN CO. v. HUNT.

The Local Loan case, which was decided in 1934, was significant in two important respects. A bankrupt who had previously obtained a discharge petitioned the bankruptcy court to enjoin a creditor from attempting to enforce in a state court a wage assignment based on a claim which had been scheduled in the bankruptcy proceedings. The bankruptcy court granted the injunction, and the creditor ultimately appealed to the Supreme Court. It had been previously decided by the highest court of the state that a wage assignment made prior to bankruptcy created a lien on wages earned after bankruptcy, and was not barred by a discharge. However, the Supreme Court, in affirming the bankruptcy court, held that this rule was in conflict with federal policy since it would be destructive of the purpose and spirit of the Bankruptcy Act. As the final arbiter in such

4. See Teubert v. Kessler, 296 Fed. 472 (3d Cir. 1924); In re Mirkus, 289 Fed. 732 (2d Cir. 1923); In re Setzler, 73 F. Supp. 314 (S.D. Cal. 1947); 1 COLLIER, BANKRUPTCY §§ 17.27, 17.28 (14th ed. 1940); 7 REMINGTON, BANKRUPTCY, §§ 3437, 3439 (5th ed. 1939).

5. This procedure was apparently followed originally in an effort to expedite the administration of bankrupt estates by not complicating the discharge proceedings. Watts v. Ellithorpe, 135 F.2d 1, 3 (1st Cir. 1943); In re Marshall, 24 F. Supp. 1012, 1014 (S.D.N.Y. 1938).

6. Helms v. Holmes, 129 F.2d 263 (4th Cir. 1942); In re Weisberg, 253 Fed. 833 (E.D. Mich. 1918); 7 REMINGTON, BANKRUPTCY § 3459.


matters, the Court was enunciating a rule of federal substantive law based on construction of a federal statute. It met with no misunderstanding.

At the same time, the Court sanctioned the determination of dischargeability under section 17 by the bankruptcy court when necessary to effectuate its discharge order. However, on this procedural question, the Court purported to restrict closely the circumstances in which such jurisdiction could be properly exercised, saying that the lower court "probably would not and should not have done so except under unusual circumstances such as here exist." The Court then summed up these circumstances, emphasizing that in the instant case the issue would have been foreclosed against the bankrupt through the entire hierarchy of state courts because of the peculiar state rule that a wage assignment survived bankruptcy. As a result he would have been put to a long and expensive course of litigation before being able to realize the benefit of his discharge by eventual appeal to the United States Supreme Court. The Court said: "The amount in suit is small, and . . . such a remedy is entirely inadequate because of the wholly disproportionate trouble, embarrassment, expense, and possible loss of employment which it involves." The embarrassment mentioned by the Court was in an especially obnoxious form in that it was the bankrupt's employer against whom the creditor had been proceeding in his effort to enforce the wage assignment.

II.

CASES AFTER LOCAL LOAN CO. v. HUNT.

Notwithstanding the Court's admonition in Local Loan Co. v. Hunt that the exercise of such jurisdiction to determine dischargeability be restricted, some courts have broadly interpreted their authority to adjudicate dischargeability under the theory of that case. Thus, a few courts have granted a creditor's request to exempt a claim from the effect of a discharge after determining it to be nondischargeable. These cases refer generally to the Local Loan case as establishing such authority, when in fact Local Loan dealt with a bankrupt's request in circumstances which could not obtain in the case of a creditor. However, in all of these cases

10. Id. at 242.
11. For a full collection and analysis of many such cases see Smedley, Bankruptcy Courts as Forums for Determining the Dischargeability of Debts, 39 MINN. L. REV. 651, 663-66 (1955).
12. Rees v. Jensen, 170 F.2d 348 (9th Cir. 1948); Harrison v. Donnelly, 153 F.2d 588 (8th Cir. 1946); In re Tamburo, 82 F. Supp. 995 (D. Md. 1949); In re Zitzmann, 46 F. Supp. 314 (E.D.N.Y. 1942). But see In re Barber, 140 F.2d 727 (3d Cir. 1944); In re Hadden, 142 F.2d 896 (6th Cir.), cert. denied, 323 U.S. 752 (1944); Watts v. Ellithorpe, 135 F.2d 1 (1st Cir. 1943).
13. In none of these cases would a creditor have been subjected to special embarrassment, financially or otherwise, by being required to repair to the state courts in order to have the issue determined. The most that is served by granting such a request is the creditor's convenience in being saved the trouble of proving again in a state court the circumstances which make the claim nondischargeable.
the creditor had already reduced his claim to judgment in a state court, and the facts appearing of record in that proceeding were conclusive in favor of the creditor. The courts appear to have been moved by the illogic of requiring the creditor to prove all over again the same facts in the state court.14

Other courts, while recognizing limitations on Local Loan jurisdiction, have exercised their authority at the request of a bankrupt in circumstances far less compelling than those present in the Local Loan case.15 These have most often been cases in which a creditor would otherwise have been permitted to thwart a bankrupt's discharge by what was looked upon as sharp practice.16 For example, in one case,17 a loan company had ignored the bankruptcy proceedings, and while they were still pending brought suit in a state court not of record. It was alleged in the complaint that the claim was nondischargeable because obtained by false representations. A default judgment was taken. After the bankrupt obtained his discharge he petitioned the bankruptcy court to enjoin the loan company from garnishing his wages, and an injunction was granted. The court deplored the practice, said to be prevalent among loan company creditors, of deliberately seeking default judgments in the lowest level state courts where a full inquiry into the facts supporting its claim was not likely. It was observed that the false representations alleged as grounds for nondischargeability were often caused by the questionable practices of the companies themselves:

"Experience with these bankruptcy matters teaches a judge that the view for which the Loan Co. contends would put a premium upon the loan companies' carelessness, if not their collusion, in ob-

14. In addition, in every case granting the creditor's request, the claim had been first reduced to judgment in a state court. While this would not, of course, be res judicata on the issue of dischargeability, it would make the creditor's attempt to satisfy his claim that much more arduous were he required to litigate the matter for a third time.

15. See, e.g., State Fin. Co. v. Morrow, 216 F.2d 676 (10th Cir. 1954) (bankrupt's remedy by way of defense of discharge considered too uncertain and appeal too burdensome when suit had been brought in justice of the peace court); In re Connors, 93 F. Supp. 149 (N.D. Ind. 1950), and In re Patt, 43, F. Supp. 754 (E.D. Tenn. 1941) (in both cases cost of appeal too high in relation to small amount of claim). Illustrative of this attitude is the dissenting opinion of Judge Paul in Helms v. Holmes, 129 F.2d 263, 270 (4th Cir. 1942): "But the right to enjoin being established, the circumstances under which it may be exercised are not confined to any definite and limited state of facts. The reported cases show a tendency to enlarge rather than to restrict its use. In my opinion this tendency is a wise and humane one and necessary to prevent nullification of the beneficent purposes of the bankrupt law at the hands of ingenious and grasping creditors. Certainly the right to an injunction is not barred merely because the bankrupt might have fought the matter out in the state court. Local Loan Co. v. Hunt decided this."

16. See, e.g., Holmes v. Rowe, 97 F.2d 537 (9th Cir. 1938) (bankrupt led to believe that the creditor's judgment had been taken in the state court before the bankruptcy proceedings had begun); In re Cleapor, 16 F. Supp. 481 (N.D. Ga. 1936) (creditor ignored bankruptcy proceedings and sued on his claim in a justice of the peace court to enforce wage assignment).

taining applications for loans which are improperly or inadequately filled out by borrowers. . . . Indeed, in the event the loan turns sour, it will be better for him (the company manager) and his concern if there is an omission or a misstatement in the application. At the lending stage of the transaction, with every pressure upon the loan company official to make the loan, there will be an increased temptation for carelessness, and in some cases actually for collusion. Unhappily, a judge doesn’t have to be on the bench of a bankruptcy court very long before he observes both.”

Opinions such as this indicate a strong feeling on the part of some courts that there exists an acute need for a more thoroughgoing form of bankruptcy administration, at least in the area of wage earners. It is this group which is most vulnerable to sharp legal maneuvering by unscrupulous creditors. In recent years the number of wage earner bankruptcies has risen sharply, apparently as an offshoot of the tremendous increase in consumer credit activity. Most wage earners who seek to unravel their finances in bankruptcy are not men of affairs nor are they familiar with legal process. They tend to place complete reliance upon the protection afforded by the bankruptcy court, and as a result are easily ambushed by wily creditors who skirt the bankruptcy proceedings and catch the debtor disarmed in a lower state court.

There have been other courts, however, that have more narrowly construed Local Loan jurisdiction, and have refused to grant relief in circumstances involving real hardship on the bankrupt although the creditor is thereby able to avoid the effect of a discharge. Thus a bankrupt has been refused an injunction against enforcement of a creditor’s judgment obtained in a state court which determined the claim to be non-dischargeable, notwithstanding the bankruptcy court’s belief that the claim was in fact dischargeable and the bankrupt’s plea that he was financially unable to carry an appeal to a higher state court. It was felt evidently that if a remedy was theoretically available in the state courts by way of appeal, the Local Loan principle did not apply, even though as a practical matter the bankrupt could not afford to invoke that remedy. In another case, relief was denied against the enforcement of a wage assignment as a means of collecting a debt which the bankrupt claimed to be discharged, with the attendant embarrassment to the bankrupt caused by harassment of his employer. Similarly, the fact that a lower state

18. Id. at 478. Of like tenor is the opinion in the earlier case of In re Cleapor, 16 F. Supp. 481, 484 (N.D. Ga. 1936) in which the problems facing a harassed bankrupt are related in vivid detail; perhaps even more vehement are the remarks of the dissenting judge in Helms v. Holmes, 129 F.2d 263, 269 (4th Cir. 1942).
court had erroneously applied state law in ruling a debt not discharged has been held not sufficient to warrant intervention by the bankruptcy court.23 In another case relief against a default judgment was denied although the bankrupt had been erroneously advised by a Legal Aid Society that he could ignore the creditor's suit because his discharge, without more, would release him from the debt.24 In these cases the element of a creditor's overreaching did not predominate so as to arouse the indignation of the court. However, the bankrupt's discharge was nonetheless watered down and its intended effect avoided by legal side stepping. Not only does the bankrupt suffer; the bankruptcy proceedings are to this extent emptied of the practical effect which they were designed to accomplish.25 In addition, when one creditor is able to obtain satisfaction of his claim in full in this manner, one of the basic purposes of the Bankruptcy Act—equal treatment of creditors—is defeated.26

III.

H. R. 4150.

At present there is uncertainty as to the actual scope of the procedural principle laid down by the Local Loan case. Generally, the fact that bankruptcy courts do not assume to determine the effect of a discharge is attributed to policy considerations rather than lack of jurisdiction per se. Under this theory the Local Loan case is merely a special instance where the policy not to exercise an underlying jurisdiction is over-ridden by "unusual circumstances." Basic to this problem is the question of whether the purposes of the Bankruptcy Act would not be better served by having the issue of dischargeability regularly, instead of exceptionally, determined by the bankruptcy court. Disagreement on the scope of the Local Loan case is paralleled by a similar lack of accord on this more fundamental question of bankruptcy administration policy. Those in favor of determining dischargeability in the bankruptcy proceedings support H. R. 4150, introduced in the U. S. House of Representatives by Congressman Celler of New York on February 5, 1959.27 The bill would resolve existing ambiguity by expressly vesting in courts of bankruptcy the jurisdiction to determine the dischargeability of all

25. See Smedley, Bankruptcy Courts as Forums for Determining the Dischargeability of Debts, 39 MINN. L. REV. 651, 666 (1955): "Leaving the determination of the dischargeability of specific debts strictly to any court in which the creditor may choose to proceed tends to defeat both of the basic purposes of the bankruptcy system — release of the debtor from his obligations and equal treatment of creditors with provable claims."
26. Ibid.
27. See note 1, supra.
provable debts when so requested.\textsuperscript{28} It is a controversial proposal and has found little support among creditor interests. Spokesmen representing such groups are quick to point out that the proposed change in procedure would result in an increased workload on already over-burdened referees and district judges sitting as courts of bankruptcy.\textsuperscript{29} They insist that this is contrary to the present trend of attempting to lighten the load of cases in the federal courts. Counterbalancing this prospect of an increased workload is the confirmed need for better effectuating the discharge order. The primary function of bankruptcy courts is the effective administration of the Bankruptcy Act. If the alternative to enlarging jurisdiction is a decree which in some cases can be readily thwarted so as to be of limited practical value, the choice should not be difficult.

Creditors also envisage themselves being placed at a disadvantage by the supposed possible prejudice of the referee or judge, who it is said is apt to be partial to the bankrupt.\textsuperscript{30} This fear may be founded on the feeling that a bankruptcy court would be inclined to favor a determination giving fullest effect to its discharge order. However, if the determination of dischargeability was incorporated into the discharge proceedings, it would eliminate the \textit{Local Loan} setting of a separate proceeding brought to vindicate a prior discharge order.\textsuperscript{31} The question would be decided on the initial application and would embrace at the same time the issue of whether a debtor is entitled to a discharge and to what extent the discharge should operate. On the other hand, apprehension by creditors may be based on the bankruptcy court's greater familiarity with the bankrupt's condition, which presumably could beget sympathy on his behalf.\textsuperscript{32} This ground for objection also provides a reply. Familiarity with the facts of a particular case should lead to a more informed decision, though it may be more often adverse to the creditor.\textsuperscript{33}

Another objection frequently mentioned is that the creditor would be deprived of the right to a jury trial.\textsuperscript{34} In this connection, if the au-

\textsuperscript{28} While the proposed bill does not state that the bankruptcy court's jurisdiction shall be exclusive, it is thought that it will have this effect. See Twinem, \textit{What's Wrong with Proposed Cell Celler Amendment to the Bankruptcy Act Relating to Non-dischargeable Debts?}, 13 Bus. LAW. 254, 263 (1958). \textit{Contra}, 13 Pers. F. L. Q. Rep. 47, 50 (1959) (views on H. R. 4150 submitted by counsel of four consumer finance companies).


\textsuperscript{31} By the time a bankrupt seeks to enjoin a creditor's action subsequent to discharge, he has usually suffered some harassment at the hands of the creditor, and it might well be that a court would be more prone to grant him the relief sought.

\textsuperscript{32} Especially might this be true with courts which have had experience with creditors of the kind described in \textit{In the Matter of Forgay}, 140 F. Supp. 473, 478 (D. Utah 1956).


authority to determine dischargeability was deemed necessary to effectuate discharge orders properly, the end would seem to justify the means. It would be only a relatively minor extension of the province of a bankruptcy court, and a jury does not normally function in the area of bankruptcy administration.  

On the other hand, the bill’s advocates point to the advantage in having a single court, well versed in the problems of bankruptcy, pass upon all questions involved in such proceedings. Since the bankruptcy court is most familiar with the applicable law, has already heard most of the facts in evidence, and has actual knowledge of the bankrupt’s affairs, it is in the best position to make a fair determination of all the rights of the parties. The present procedure seems incongruous when it permits a creditor to seek relief in a state court and further litigate the effect of a discharge order which has been granted by the bankruptcy court after a full hearing and notice to all creditors. If the bankruptcy court were authorized to make a complete disposition of all matters necessary to define the effect of a discharge on any claim, a bankrupt would no longer be required to run the risk of suffering a default judgment in a state court while unaware of the need for defending such actions. In the event he does defend such suits, the expense of an appeal from an adverse judgment is likely to be prohibitive for one who has recently surrendered his assets in bankruptcy. An eligible debtor, qualifying for a discharge in the first instance, should be able to rely upon it without the need for further expensive and burdensome litigation. A more direct and simplified procedure for determining dischargeability would in turn bring about a more prompt and efficient realization of the bankrupt’s assets, and this would benefit all creditors.

IV. CONCLUSION.

The value of a discharge in bankruptcy to the bankrupt is largely a measure of how expeditiously the discharge can be interposed as a bar to outstanding debt. In this connection, the question of who will decide dischargeability is of considerable significance in determining the practical value of a discharge. To the extent that the need for a more efficient procedure to determine dischargeability is either not remedied, or is done so only on an ad hoc basis, effectuation of the purpose and policy of the Bankruptcy Act is hampered.

As an original question, jurisdiction to determine dischargeability as a matter of course, predicated upon judicial efficiency and economy of
effort, might have been found in the broad provisions of section 2 (15) of the Bankruptcy Act, wherein courts of bankruptcy are given jurisdiction 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 title.” However, the courts did not make such a determination, and in view of the decisions under the Local Loan case, such procedure would be better brought about in this day by new legislation. On this point, H. R. 4150 would provide an adequate answer to a problem deserving of solution.

John J. Cleary

(Ed. Note: This bill passed the House of Representatives on September 7, 1959 with amendments, the most substantial of which makes jurisdiction to determine dischargeability contingent upon agreement of both the creditor and the bankrupt. As such, it was referred to the Senate Judiciary Committee on September 8, 1959).