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CONSTITUTIONAL LAW--MORTGAGES--FRAZIER-LEMKE ACT

COMMENTS

CONSTITUTIONAL LAW — MORTGAGES — FRAZIER-LEMKE ACT — In 1922 and 1924 appellee mortgaged property worth $18,000 to secure a loan of $9,000 from appellant which was to be repaid in installments over a period of thirty-four years. Default being made on the covenants in the mortgage, the mortgagee declared the full amount due and brought a suit to foreclose. Proceedings were stayed when the appellee sought relief under Section 75 of the Bankruptcy Act, but he was unable to obtain the requisite majority in number and amount to the composition proposed. The state court entered a foreclosure judgment and ordered a sale. The mortgagor then sought relief under sub-section (s) of Section 75, known as the Frazier-Lemke Act,[1] which

[1] Amendatory Bankruptcy Act, adding subsection (s) to section 75, 11 U. S. C. tit. 11, sec. 203.

was passed June 28, 1934. In accordance with paragraph 3 [2] of that Act the property securing the debt was appraised at $4,445. The mortgagee refused to consent to a sale of the property to the mortgagor at that price so the latter sought relief under paragraph 7. The bankruptcy court ordered that all proceedings to foreclose the mortgage be postponed for five years, that the mortgagor pay an annual rental of $325, and that the mortgagor be given the opportunity to purchase the property any time within the five year period at its then appraised value, or at a reappraised value, if requested by the lienholder. The appellant contended that the act was unconstitutional on two grounds: (1) that sub-section (s) of Section 75 is not a law on the subject of bankruptcy, and (2) that it deprives creditors of their property without due process of law. The Supreme Court of the United States, reversing the decisions of the lower courts, held the act unconstitutional. *Louisville Joint Stock Land Bank v. Radford*, 2 U. S. LAW WEEK, index p. 919 (1935).

Article 1, section 8, clause 4, of the federal Constitution vests Congress with the power "To establish . . . uniform Laws on the subject of Bankruptcies throughout the United States." The notion that the framers of the Constitution, by this bankruptcy clause, intended to limit the power of Congress to the then existing laws on the subject has been dispelled.[3] Congress repeatedly and radically extended in the nineteenth century the concept of bankruptcy and always, until the decision of the principal case, this legislation has been upheld by the courts. The Act of 1841 [4] took a decisive step in advance when it permitted voluntary petitions in bankruptcy and allowed a discharge from past debts. In 1874,[5] the Court upheld the constitutionality of the composition provisions of the Act of 1867 by which the debtor was permitted, in lieu of liquidation of his assets, to propose terms of composition to his general creditors, to become binding upon their acceptance by a designated majority and confirmation by the judge. Sections 77 and 77B of the Bankruptcy Act, providing for a composition among the secured creditors which would bind the dissenting secured creditors if accepted by a designated two-thirds of that class have raised the same

[2] The constitutionality of paragraph 3 cannot be challenged on the due process point because it provides that no action shall be taken until all parties consent.

[3] The courts have, in effect, adopted the view of Mr. Justice Story: "Perhaps as satisfactory a description of a bankrupt law as can be framed is that it is a law for the benefit and relief of creditors and their debtors, in cases in which the latter are unable or unwilling to pay their debts." COMMENTARIES ON THE CONSTITUTION, c. 16.

[4] 5 Stat. 440. Constitutionality upheld in In re Klein, 42 U. S. (1 Howard) 277 (1843), and Kunzler v. Kohaus, 5 Hill (N. Y.) 317 (1843).

[5] In re Reiman, (D. C. N. D. N. Y. 1874) Fed. Cas. No. 11,673. See also Hanover Nat. Bank v. Moyses, 186 U. S. 181, 22 Sup. Ct. 857 (1901), upholding the constitutionality of the Bankruptcy Act of 1898.

questions regarding the extent of the power of Congress under the bankruptcy clause.[6] The Supreme Court sustained the general theory of these amendments in a recent decision.[7] Sub-section (s) of Section 75 provided that the procedure proposed by the statute would become effective without confirmation by a designated proportion of the creditors. This was the first instance of an attempt by a bankruptcy act to abridge solely at the instance of a debtor a substantive right of a lienholder in specific property held as security.[8]

From the viewpoint of the lawyer there are two practical problems to be considered: (1) what is the effect of this decision on the recent amendments to the Bankruptcy Act, viz., sections 74, 75 without subsection (s), 77, and 77 B; and (2) what can Congress do?

In the most general terms, the doctrine of this case is simply this, that the bankruptcy power, delegated to Congress, is subject to the limitation of due process found in the Fifth Amendment.[9] Congress may pass laws which impair the obligations of contract [10] but it cannot pass laws which deprive a person of substantial rights in specific property even though it may be exercising its expresssly delegated control over bankruptcy.[11] This suggests a basic distinction between secured and unsecured claims when considering the power of Congress over bankruptcy, but one should not put too much faith in this classification. The conceptual enlargement of the term "bankruptcy" in the past century has demonstrated the difficulty of any clear line of demarcation. On the one hand, it seems probable that the power of Congress with respect to unsecured claims is not unlimited. If, for example, it should provide for a discharge of such claims without either the ancient process of liquidation or the more modern procedure of reasonable composition, the statute would be questionable, to say the least. On the other hand, the *Rock Island* case [12] establishes the power of Congress

[6] Garrison, "The Power of Congress over Corporate Reorganizations," 19 VA. L. REV. 343 (1933); Sabel, "The Corporate Reorganizations Act," 19 MINN. L. REV. 34 (1934); Hanna, "Agriculture and the Bankruptcy Act," 19 MINN. L. REV. 1 (1934); 44 YALE L. J. 677 (1935).

[7] Continental Ill. Nat. Bank & Trust Co. of Chicago v. Chicago R. I. & P. Ry. Co., (U. S. 1935) 55 Sup. Ct. 595.

[8] For discussion of constitutionality of the section, see 29 ILL. L. REV. 645 (1935), and 44 YALE L. J. 651 (1935).

[9] Monongahela Nav. Co. v. United States, 148 U. S. 312 at 336, 13 Sup. Ct. 622 (1892); Nichols v. Coolidge, 274 U. S. 531 at 542, 47 Sup. Ct. 710 (1927); and other cases cited in note 19 to the principal case, 2 U. S. LAW WEEK, index p. 923 (May 28, 1935).

[10] Sturges v. Crowninshield, 17 U. S. (4 Wheat.) 122 (1819).

[11] See note 2 to the principal case, 2 U. S. LAW WEEK, index p. 923 (May 28, 1935), for citation to cases in lower federal courts which have arisen under subsection (s).

[12] See note 7, supra.

to adjust secured claims by the use of a reorganization procedure analogous to the composition feature of the Act of 1867 which applied only to general creditors.[13]

Another distinction which might be suggested is based on the necessity for the consent of the creditors affected. All composition arrangements authorized by Congress prior to the Frazier-Lemke Act required the consent of a majority, or more than a majority, of the creditors affected.[14] Under the Frazier-Lemke Act the creditors were given no voice in the matter except that unanimous consent was required for the proceeding under paragraph 3; if that proceeding failed, the provisions of paragraph 7 became mandatory. While such an analysis would lend itself to a clear distinction between this act and the earlier acts of bankruptcy, Judge Simons, in his decision of the principal case in the Circuit Court of Appeals,[15] disposed of it rather convincingly. It cannot be said that a person extending credit and taking security therefore impliedly represents that he will be bound by the will of the majority. Such a creditor does not stand in the same position as stockholder who, by taking stock in a common business enterprise, impliedly represents that he will be bound by the will of the majority on questions arising in the normal course of business. It should also be observed that the Supreme Court did not allow its decision to turn on the right of Congress to set up a plan which did not provide for consent by creditors affected. One hesitates, then, to lay down a rigid distinction which will make consent of a majority of creditors absolutely essential to a composition scheme.[16]

A third, and perhaps determining distinction might still be made, viz., the elusive but altogether familiar distinction between reasonable and unreasonable legislation. The two recent decisions of the United States Supreme Court can be reconciled on this basis. In the *Rock Island* case Mr. Justice Sutherland relied heavily upon the essential

[13] In that case the holding, strictly speaking, merely sustained an injunction against foreclosure of a pledge pending reorganization under Section 77. It might be added that the decision on the injunction would be meaningless if the general scheme of reorganization set up by Section 77 were invalid. The opinion contained broad language sustaining the scope and aim of the entire section which includes provisions for an adjustment of secured claims.

[14] Under sections 74e and 75g consent of majority of all creditors, taken as one class, is essential. However, secured claims cannot be brought into the composition without the creditor's consent. Under sections 77e and 77 B (e) consent of two-thirds of the affected creditors in each class is required.

[15] Louisville Joint Stock Land Bank v. Radford, (C. C. A. 6th, 1935) 74 F. (2d) 576.

[16] See GLENN ON LIQUIDATION, sec. 434 (1935), where the author suggests reasons for a possible distinction being made between an individual debtor and the corporate debtor.

fairness of the set-up in Section 77. In the *Radford* case Mr. Justice Brandeis discussed at length certain details of the Frazier-Lemke Act which he stamped as unfair. The mortgagee was compelled to stay any proceedings for the recovery of the full amount of the indebtedness for over five years; under paragraph 3 he would not even receive the appraised value of the land because of the provisions for payment over a period of six years with interest at one per centum; during that period he must accept the appraised value of the land in full satisfaction of the debt if the bankrupt chooses to exercise his option to purchase; further, he is deprived of the right to purchase at a judicial sale of the property. The provision that the Act was mandatory without any provisions for seeking the consent of the creditors or for confirmation by the court tended to emphasize the unreasonableness of the Act. The real substance of these two decisions may be summarized in this manner. Congress can set up a scheme of composition which will adequately protect the rights of creditors from unreasonable destruction if it provides in very broad terms for a composition which meets the approval of a fairly representative group of the affected creditors together with the approval of the court. It is made clear that such a glaring absence of safeguards as was evident in the Frazier-Lemke Act is fatal.

We conclude, (1) that it is very doubtful whether Congress can salvage anything from what remains of the Frazier-Lemke Act or whether, within the limitations of the Constitution, it can in any substantial sense effect the general objective of the defunct statute. The farmer's needs were so grave and unusual that Congress was convinced that an adjustment such as was provided in Section 77 would not meet the situation. Among other things, it was believed that veto power could not be given to a majority of creditors because, in the typical farm case, one mortgage creditor constituted a majority, in amount. This makes critical the question suggested above, whether *both* creditor and court veto are essential to constitutionality. As already indicated, we feel sure that the *Radford* case does not lay down an absolute requirement of creditor veto. However, it must be admitted that the case does not definitely reject that position. We conclude that the question must be regarded as open. (2) Even though detailed points of procedure may still be upset by the courts, the decision of the principal case does not disturb the validity of the major features of sections 74, 75 as originally enacted, 77, and 77 B.

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