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RECENT DECISIONS

BANKRUPTCY — EFFECT OF RULE OF ERIE RAILROAD v. TOMPKINS ON PRIORITIES IN FEDERAL BANKRUPTCY PROCEEDINGS — A company engaged in the mortgage-guaranty business became bankrupt, the respondent being the successor company resulting from reorganization proceedings under section 77B of the Bankruptcy Act.¹ The original company had loaned money secured by a bond and mortgage and then sold certificates to the public representing undivided shares in the mortgage, the certificates being guaranteed by the same company. The mortgagor having defaulted, the controversy in the principal case arose because the now bankrupt company had before bankruptcy repurchased two of the certificates, acquired title to a third, and held the balance of the loan for which no certificates had been issued. In the reorganization proceedings the successor company, respondent, protested the lower court's subordination of its claims (the reacquired certificates and the uncertificated balance) to the claims of the public holders of these certificates. The lower court had applied the New York rule that a guarantor of mortgage certificates cannot share in the collateral until all certificate holders are paid unless there is a clear reservation of a right to share on a parity. *Held*, on appeal, one judge dissenting, that this was a case of construction of the certificates and not of the administration of insolvent estates and, therefore, the New York rule was properly applied, under the doctrine of *Erie Railroad v. Tompkins*.² *Geist v. Prudence Realization Corp.* (C. C. A. 2d, 1941) 122 F. (2d) 503, cert. granted (U. S. 1942) 62 S. Ct. 479.

Assuming that the principal case is one calling for the application of the *Erie* rule, the right result was reached. The New York courts have consistently applied the rule as stated in the principal case subordinating any claims of the guarantor company on repurchased certificates, on the ground of an intention implied from the contract.³ Even though the federal court may think the state rule wrong, the position now accepted is that the state rule should be followed⁴

¹ Under the Chandler Act of 1938 the corresponding provisions, pertinent to the present discussion, are found in 11 U. S. C. (Supp. 1939), §§ 621(2), 616 (12)(b) (1). There were no substantial changes made by the Chandler Act, priorities still being determined by the "strict priority" equity receivership rules. 37 MICH. L. REV. 796 (1939); Dean, "A Review of the Law of Corporate Reorganizations," 26 CORN. L. Q. 537 (1941); 10 REMINGTON, BANKRUPTCY, Supp. 100 (1941).

² 304 U. S. 64, 58 S. Ct. 817 (1938). This case overruled the 100-year-old case of *Swift v. Tyson*, 16 Pet. (41 U. S.) 1 (1842), and decided that federal courts should follow state decision law as well as statutory law.

³ One of the most recent of these New York cases is *In re Title & Mtge. Guaranty Co. of Sullivan Co.*, 275 N. Y. 347, 9 N. E. (2d) 957 (1937), cited in the majority opinion of the principal case.

⁴ See Smith, "Erie Railroad Co. Versus Tompkins: Two Years After," 12 ROCKY MTR. L. REV. 184 at 191 (1940); 13 UNIV. CIN. L. REV. 469 at 479 (1939). That it includes equity cases, McCormick and Hewins, "The Collapse of 'General' Law in the Federal Courts," 33 ILL. L. REV. 126 at 140 (1938); *Wichita Royalty Co. v. City Nat. Bank*, 306 U. S. 103, 59 S. Ct. 420 (1939).

since the reason for the overruling of *Swift v. Tyson*⁵ by the *Erie* case was the lack of uniformity between the federal and state courts and the consequent abuse of the diversity of citizenship jurisdiction of federal courts.⁶ Certainly in the principal case it is necessary to resort to this idea, for it seems obvious the New York rule causes a most inequitable result when the guarantor company is bankrupt too.⁷ It is submitted, though, that the *Erie* rule should not have been applied to this case arising under the federal bankruptcy laws. The reason for the *Erie* rule is not present here because the bankruptcy jurisdiction of the federal courts does not depend upon diversity of citizenship.⁸ The power of Congress to enact reorganization laws under the bankruptcy power is not now questioned⁹ nor is the right of Congress to supersede state laws.¹⁰ The difficult question is whether Congress has done so and the interpretation to be given when no specific reference to state-given priorities has been made. Some have argued that once Congress has enacted comprehensive laws all state laws are superseded ipso facto.¹¹ Again, though the priorities in strict bankruptcy proceedings are not

⁵ 16 Pet. (41 U. S.) 1 (1842).

⁶ As to this underlying reason, see 36 MICH. L. REV. 1312 (1938); Fordham, "Swift v. Tyson and the Construction of State Statutes," 41 W. VA. L. Q. 131 (1935); Ball, "Revision of Federal Diversity Jurisdiction," 28 ILL. L. REV. 356 at 362, 364 (1933); Frankfurter, "Distribution of Judicial Power Between United States and State Courts," 13 CORN. L. Q. 499 at 524 (1928); and Holmes' dissent in *Kuhn v. Fairmont Coal Co.*, 215 U. S. 349 at 371, 30 S. Ct. 140 (1910).

⁷ The real basis of this rule of subordination seems to be avoidance of circuitry of action, since the guarantor would have to pay the certificate holder any deficit. When the guarantor also is bankrupt, though, the reason disappears, and to follow the rule means one set of creditors gets an advantage over others for which it did not contract and which it should not receive. *Kelly v. Middlesex Title Guarantee & Trust Co.*, 115 N. J. Eq. 592, 171 A. 823 (1934), *affd.* on opinion below, 116 N. J. Eq. 574, 174 A. 706 (1934); 47 YALE L. J. 480 (1938); Bonbright and Bergerman, "Two Rival Theories of Priority Rights of Security Holders in a Corporate Reorganization," 28 COL. L. REV. 127 (1928).

⁸ Federal bankruptcy jurisdiction depends on residence in the federal court district, state citizenship being irrelevant. 1 REMINGTON, BANKRUPTCY, § 32 (1934). But *Erie Railroad v. Tompkins* in practice has been extended far beyond the diversity field and does present a serious problem in bankruptcy cases. See Dye, "Development of the Doctrine of *Erie Railroad v. Tompkins*," 5 MO. L. REV. 193 at 206 (1940).

⁹ Though reorganization proceedings are not strictly bankruptcy proceedings the power of Congress to legislate is not now questioned. See Weiner, "Corporate Reorganization: Section 77B of the Bankruptcy Act," 34 COL. L. REV. 1173 (1934); 12 N. Y. UNIV. L. Q. REV. 198 (1934); GLENN, LIQUIDATION, § 436 (1935); *Hanover Nat. Bank v. Moyses*, 186 U. S. 181, 22 S. Ct. 857 (1902); *Continental Illinois Nat. Bank & Trust Co. v. Ohio, R. I. & P. Ry.*, 294 U. S. 648, 55 S. Ct. 595 (1935).

¹⁰ There is no doubt the state law is superseded when it is in direct conflict. *International Shoe Co. v. Pinkus*, 278 U. S. 261, 49 S. Ct. 108 (1929); GLENN, LIQUIDATION, §§ 81, 125, 187 (1935); GERDES, CORPORATE REORGANIZATION, § 883 (1936); 5 REMINGTON, BANKRUPTCY, §§ 2103-2117 (1936); FINLETTER, THE LAW OF BANKRUPTCY REORGANIZATION 265-270 (1939); 42 HARV. L. REV. 823 (1929).

¹¹ McCormick and Hewins, "The Collapse of 'General' Law in the Federal Courts," 33 ILL. L. REV. 126 at 142 (1938), say the federal law is supreme and federal common law should prevail in such things as procedure, acts of Congress (such

applied in reorganization proceedings,¹² the effect of state rules in either case should be the same and the examples of supersedence by federal rules in the former proceedings are numerous.¹³ There are some exceptions, though, to this supersedence of state law, the most important being priorities granted to specific state statutory liens and those resulting from interpretation of contracts, in which cases the federal courts follow the state decisions.¹⁴ As the dissenting judge pointed out, the principal case fails to fit either exception.¹⁵ In the light of the

as the bankruptcy acts), interstate commerce, etc. That it should in the bankruptcy field too, see Williston, "The Effect of a National Bankruptcy Law Upon State Laws," 22 HARV. L. REV. 547 (1909); 35 COL. L. REV. 98 (1935); O'Brien v. Western Union Telegraph Co., (C. C. A. 1st, 1940) 113 F. (2d) 539; Barks v. Kleyne, (C. C. A. 8th, 1926) 15 F. (2d) 153 at 155. Such has not always been the fortune of the federal acts. 42 YALE L. J. 1140 (1933) (state interpretation of state laws); 11 MICH. L. REV. 60 (1912) (only superseded in so far as in direct conflict); 18 N. Y. UNIV. L. Q. REV. 122 (1940) (Railway Labor Act has not had this effect). A good summary of the cases deciding where Erie Railroad v. Tompkins does and does not apply is found in Smith, "Erie Railroad Co. Versus Tompkins: Two Years After," 12 ROCKY MOUNTAIN L. REV. 184 (1940).

¹² Strict bankruptcy (not reorganization) priorities are governed by § 64 of the Bankruptcy Act, 11 U. S. C. (Supp. 1939), § 104, while reorganization priorities are controlled by the equity receivership rules. FINLETTER, THE LAW OF BANKRUPTCY REORGANIZATION 344 (1939); 10 REMINGTON, BANKRUPTCY, § 4571 (1939); GLENN, LIQUIDATION, § 430 (1935).

¹³ New York v. Irving Trust Co., 288 U. S. 329, 53 S. Ct. 389 (1939); In re Watts & Sachs, 190 U. S. 1 at 27, 23 S. Ct. 718 (1903); Chicago Title & Trust Co. v. Wilcox Bldg. Corp., 302 U. S. 120 at 126, 58 S. Ct. 125 (1937); International Shoe Co. v. Pinkus, 278 U. S. 261, 49 S. Ct. 108 (1929); 49 HARV. L. REV. 1111 at 1180 (1936); 29 COL. L. REV. 519 (1929); 81 UNIV. PA. L. REV. 210 (1932). But see the language in Marshall v. New York, 254 U. S. 380 at 385, 41 S. Ct. 143 (1920). Some of these cases came before the decision in Erie Railroad v. Tompkins but involved statutes and so did not need the *Erie* rule to make them binding on federal courts.

¹⁴ FINLETTER, THE LAW OF BANKRUPTCY REORGANIZATION 265-270, 343-360 (1939); GERDES, CORPORATE REORGANIZATION, § 659 (1936); Moore v. Illinois Central R. R., 312 U. S. 630, 61 S. Ct. 754 (1941). But this was all true before the *Erie* case, so it would seem the *Erie* case does not rule the bankruptcy cases. Board of Commissioners of Sweetwater County v. Bernardin, (C. C. A. 10th, 1934) 74 F. (2d) 809, cert. denied 295 U. S. 731, 55 S. Ct. 645 (1935); In re Kountze Bros., (C. C. A. 2d, 1939) 103 F. (2d) 785 [but see In re Koepfel, (D. C. N. Y. 1938) 24 F. Supp. 703]; In re Prudence Co., (C. C. A. 2d, 1936) 82 F. (2d) 755; In re Standard Oak Veneer Co., (D. C. Tenn. 1909) 173 F. 103 [but see Smith v. Mottley, (C. C. A. 6th, 1906) 150 F. 266]. The construction-of-contracts exception is the basis of the majority opinion in the principal case.

¹⁵ As the dissenting judge suggests, even the New York courts surely would admit they are not actually construing the contract, since they talk in terms of *implied* intent. It is obvious the New York rule is actually one of priority. See 47 YALE L. J. 480 (1938). This is supported by the fact that if the certificates were held by the public and not repurchased there would be no subordination, a fact hardly consistent with the idea that the contract is being interpreted. That priorities should not be affected by an assignment or gift, see GERDES, CORPORATE REORGANIZATION, § 640 (1936); Dunham v. Cincinnati, P. & C. Ry., 68 U. S. 254 (1863). The courts do not speak

mandatory language of the Bankruptcy Act to the effect that the plan for reorganization must be "fair and equitable,"¹⁶ the result reached by the dissenting judge would seem correct, since it could well be argued that this is one case where Congress has expressed a specific policy and by implication meant to supersede any state rules leading to a different result. Since priorities do have such a great effect on the "fairness" of the plan¹⁷ and in the light of analogous federal cases holding the *Erie* case not applicable, such as, inferences from facts¹⁸ (the New York rule is certainly almost exactly this), application of the six months rule,¹⁹ construction of federal statutes,²⁰ jurisdiction of federal courts

in terms of a lien, and even if a priority is granted by state statute it does not prevail unless very specifically made a lien. GERDES, *supra*, § 662; *Schmidtman v. Atlantic Phosphate & Oil Corp.*, (C. C. A. 2d, 1910) 230 F. 769; 6 *TULANE L. REV.* 322 (1932); FINLETTER, *THE LAW OF BANKRUPTCY REORGANIZATION* 351 (1939); *Globe Bank & Trust Co. v. Martin*, 236 U. S. 288 at 298, 35 S. Ct. 377 (1915); *Moore v. Bay*, 284 U. S. 4, 52 S. Ct. 3 (1931). FINLETTER, *supra*, in a footnote on page 359 says the fact the recent amendment to § 64 of the Bankruptcy Act left out the provisions as to state-given priorities indicates an intent of Congress to abolish them now even in reorganization cases. And see note 18, *infra*.

¹⁶ The federal courts have consistently held "fair and equitable" to mean "strict priority," with all claims of the same class getting equal treatment. *Northern Pac. Ry. v. Boyd*, 228 U. S. 482, 33 S. Ct. 554 (1913); *Case v. Los Angeles Lumber Products Co.*, 308 U. S. 106, 60 S. Ct. 1 (1939); *Consolidated Rock Products Corp. v. Du Bois*, 312 U. S. 510, 61 S. Ct. 675 (1941); 39 *MICH. L. REV.* 1222 (1941); 7 *UNIV. CHI. L. REV.* 549 at 550 (1940); 49 *YALE L. J.* 881 (1940); 53 *HARV. L. REV.* 485 (1940); GERDES, *CORPORATE REORGANIZATION*, § 1045 (1936); 10 *REMINGTON, BANKRUPTCY*, § 4608 (1939) (and the same under the Chandler Act, 1941 *Supp.*, p. 100). But the federal court has the power to adjust claims so as to get a "fair and equitable" result. *Crowder v. Allen-West Comm. Co.*, (C. C. A. 8th, 1914) 213 F. 177 at 184; *Sampsell v. Imperial Paper & Color Corp.*, 313 U. S. 215, 61 S. Ct. 904 (1941). The present decision flies directly in the face of this rule, and there are not even any compelling equities. *Supra*, note 7.

¹⁷ "The priorities of claims are therefore important in determining whether or not a plan of reorganization is fair and equitable." GERDES, *CORPORATE REORGANIZATION*, § 639 (1936). See also *Sampsell v. Imperial Paper & Color Corp.*, 313 U. S. 215, 61 S. Ct. 904 (1941).

¹⁸ For the cases and arguments in support of this proposition, see 88 *UNIV. PA. L. REV.* 220 (1939). But see *Hagan & Cushing Co. v. Washington Water Power Co.*, (C. C. A. 9th, 1938) 99 F. (2d) 614; *Schopp v. Muller Dairies*, (D. C. N. Y. 1938) 25 F. *Supp.* 50; and *Erie Railroad v. Tompkins*, of course. Also 37 *MICH. L. REV.* 1249 (1939); Smith, "Erie Railroad Co. Versus Tompkins: Two Years After," 12 *Rocky Mt. L. Rev.* 184 (1940).

¹⁹ GERDES, *CORPORATE REORGANIZATION*, § 665 (1936); Fordham, "Preferences of Receivership Claims in Equity Receiverships," 15 *MINN. L. REV.* 261 at 287-288 (1931). Once again this was all before the *Erie* case but applied as to state statutes too, which were to be followed even under *Swift v. Tyson*.

²⁰ 26 *IOWA L. REV.* 391 (1941); 38 *COL. L. REV.* 1472 (1938); *Summers v. Hearst*, (D. C. N. Y. 1938) 23 F. *Supp.* 986 at 992 (federal rules of procedure still supreme in spite of the *Erie* rule); *O'Brien v. Western Union Telegraph Co.*, (C. C. A. 1st, 1940) 113 F. (2d) 539; *Vaigneur v. Western Union Telegraph Co.*, (D. C. Tenn. 1940) 34 F. *Supp.* 92; *Western Union Telegraph Co. v. Boegli*, 251 U. S. 351, 40 S. Ct. 167 (1920); Biklé, "The Silence of Congress," 41 *HARV. L. REV.*

under various federal acts,²¹ and even bankruptcy cases,²² the better approach, consistent with the constitutional power to enforce *uniform* bankruptcy laws,²³ would seem to be for the federal court to adopt its own rule, probably bringing about a different result in the principal case.²⁴ The need for national uniformity in federal bankruptcy proceedings would seem paramount to uniformity between state and federal courts.²⁵

200 at 221 (1927); 30 ILL. L. REV. 373 (1935). These would seem to be ample authority upon which the federal courts could base a decision contrary to the majority opinion in the principal case.

²¹ Hedrick v. Canadian Pac. Ry., (D. C. Ohio, 1939) 28 F. Supp. 257; Kravas v. Great Atlantic & Pacific Tea Co., (D. C. Pa. 1939) 28 F. Supp. 66; Smith, "Erie Railroad Co. Versus Tompkins: Two Years After," 12 ROCKY MT. L. REV. 184 (1940); Neirbo Co. v. Bethlehem Shipbuilding Corp., 308 U. S. 165, 60 S. Ct. 153 (1939).

²² Sampsell v. Imperial Paper & Color Corp., 313 U. S. 215, 61 S. Ct. 904 (1941); Bryant v. Linn County, Oregon, (D. C. Ore. 1938) 27 F. Supp. 562; Jennings v. United States Fidelity & Guaranty Co., 294 U. S. 216, 55 S. Ct. 394 (1935); National Automatic Tool Co. v. Goldie, (D. C. Minn. 1939) 27 F. Supp. 399; In re Koeppel, (D. C. N. Y. 1938) 24 F. Supp. 703; dissent in In re Pointer Brewing Co., (C. C. A. 8th, 1939) 105 F. (2d) 478. But see majority in In re Pointer Brewing Co., supra; Prudential Ins. Co. of America v. Land Estates, (D. C. N. Y. 1939) 27 F. Supp. 668; Paul v. Craemer, (D. C. Cal. 1938) 24 F. Supp. 353.

²³ Art. I, § 8, cl. 4: "The Congress shall have power . . . to establish . . . uniform laws on the subject of bankruptcies. . . ."

²⁴ Though Justice Frank in dissenting dismissed the idea, it may well be argued that, even assuming the New York rule not to be applicable, this is not a case for equality, but rather for classification. Cf. Jenkins v. National Surety Co., 277 U. S. 258, 48 S. Ct. 445 (1928); Taylor v. Standard Gas & Electric Co., 306 U. S. 307, 618, 59 S. Ct. 543 (1939). See also FINLETTER, THE LAW OF BANKRUPTCY REORGANIZATION 141, note 51; 199, note 36; 441, note 56 (1939). This still would not justify the use of the New York rule, dictated by the *Erie* case.

²⁵ Williston, "The Effect of a National Bankruptcy Law Upon State Laws," 22 HARV. L. REV. 547 (1909), argued that the effect of the Federal Bankruptcy Act of 1898 was to make for national uniformity and abolish even state assignment laws. The facts that the statute gives the trustee title to the bankrupt's property all over the United States, GLENN, LIQUIDATION, § 191 (1935), and that certain ancillary powers of the court extend over the whole United States, though the original court's jurisdiction is restricted to its district, GERDES, CORPORATE REORGANIZATION, § 892 (1936), would seem to indicate a recognition of the need for this national uniformity by Congress.