

The Power of Federal Bankruptcy Courts to Enjoin State Proceedings as an Incident of Discharge

St. John's Law Review

Follow this and additional works at: <https://scholarship.law.stjohns.edu/lawreview>

Recommended Citation

St. John's Law Review (1963) "The Power of Federal Bankruptcy Courts to Enjoin State Proceedings as an Incident of Discharge," *St. John's Law Review*: Vol. 38 : No. 1 , Article 4.
Available at: <https://scholarship.law.stjohns.edu/lawreview/vol38/iss1/4>

This Note is brought to you for free and open access by the Journals at St. John's Law Scholarship Repository. It has been accepted for inclusion in St. John's Law Review by an authorized editor of St. John's Law Scholarship Repository. For more information, please contact lasalar@stjohns.edu.

NOTES

THE POWER OF FEDERAL BANKRUPTCY COURTS TO ENJOIN STATE PROCEEDINGS AS AN INCIDENT OF DISCHARGE

One of the purposes of the Bankruptcy Act is "to relieve the honest debtor from the weight of oppressive indebtedness and permit him to start afresh free from the obligations and responsibilities consequent upon business misfortunes."¹ To effect such a goal, the Act provides for the requisite statutory machinery. For example, federal courts are empowered to "discharge or refuse to discharge bankrupts. . . ."² A discharge is defined as a release from all provable debts,³ but certain types of debts, such as those represented by judgments for willful or malicious injuries or debts which have not been properly scheduled in the bankruptcy proceeding, are expressly denied the benefit of the discharge.⁴

With this statutory foundation in mind, the effect of the discharge decree should be examined. It is a personal defense that may be utilized by a bankrupt in any action on a discharged debt.⁵ The effect of the discharge decree, as distinguished from the right thereto which is passed on by a federal court, is determined by the court in which it is interposed as a defense.⁶ This forum is usually a state court.⁷ This "right-effect" distinction has been made traditionally.⁸

As far as a creditor's conduct is concerned, federal case law reveals that there are many paths which he may pursue. A creditor is under no duty to appear in a bankruptcy proceeding.⁹ Having appeared in the bankruptcy proceeding and accepted partial

¹ *Williams v. United States Fid. & Guar. Co.*, 236 U.S. 549, 554-55 (1915).

² 30 Stat. 545 (1898), 11 U.S.C. § 11(a)(12) (1958).

³ 30 Stat. 544 (1898), 11 U.S.C. § 1(15) (1958).

⁴ 30 Stat. 550 (1898), 11 U.S.C. § 35(a) (1958).

⁵ *In re Innis*, 140 F.2d 479, 481 (7th Cir.), *cert. denied*, 322 U.S. 736 (1944); *Aiken v. Bank of Georgia*, 101 Ga. App. 200, 113 S.E.2d 405 (1960).

⁶ *Peck v. Jenness*, 48 U.S. (7 How.) 611, 623-24 (1849); *Milando v. Perrone*, 157 F.2d 1002 (2d Cir. 1946); 1 COLLIER, BANKRUPTCY 1698 (14th ed. 1962).

⁷ *First Discount Corp. v. Applegate*, 104 Ohio App. 84, 143 N.E.2d 868 (1957).

⁸ *In re Marshall Paper Co.*, 102 Fed. 872, 874 (1st Cir. 1900).

⁹ *Personal Industrial Loan Corp. v. Forgay*, 240 F.2d 18, 20 (10th Cir. 1956), *cert. denied*, 354 U.S. 922 (1957); 1 COLLIER, *op. cit. supra* note 6, at 1700.

payment of his claim, a creditor may still sue on the balance of the debt in a state court and have that forum decide whether his claim was discharged by the decree.¹⁰ Moreover, a creditor's appearance in the federal bankruptcy court does not give the bankrupt the benefit of the defense of res judicata in any subsequent state action.¹¹

In derogation of the general rule that a state court passes on the dischargeability of a specific debt, *Local Loan Co. v. Hunt*¹² held that a federal court can, under "unusual circumstances," enjoin the creditor from initiating a state proceeding which would decide whether or not his claim had been discharged by the bankruptcy decree. It will be the purpose of this note to examine the manner in which federal courts have applied the test enunciated in that case, and to analyze certain instances where it would be fruitless for a bankrupt to petition for an injunction based on *Local Loan*.

Local Loan Co. v. Hunt

In order to appreciate the significance of this case, one must realize that prior to *Local Loan*, federal courts operated on the theory that their contact with the bankrupt was terminated with the discharge decree.¹³ In *Local Loan*, Hunt, as security for a loan, executed an assignment of his future wages. Two years later he was adjudged bankrupt. His creditor instituted an action in an Illinois state court to compel Hunt's employer to comply with the wage assignment. Hunt found himself in a difficult position. This was so because the Illinois lower courts had uniformly held that a wage assignment was nondischargeable. Although the state's highest court had not passed on the question, it seemed clear that if he defended on the merits, the decision would certainly be adverse. Hence, in order to protect the advantage of his discharge decree, he would then have to resort to a costly appeal. Rather than incur this expense, which would be great in proportion to the amount in controversy, Hunt petitioned the federal district court to enjoin the creditor from prosecuting

¹⁰ *Friend v. Talcott*, 228 U.S. 27 (1913); *Bates, The Practitioner and the Bankruptcy Process*, 15 VAND. L. REV. 1, 8 (1961).

¹¹ *Friend v. Talcott*, *supra* note 10; *cf. Meier Credit Co. v. Yeo*, 129 N.J.L. 82, 28 A.2d 227 (1942).

¹² 292 U.S. 234 (1934).

¹³ *In re Havens*, 272 Fed. 975 (2d Cir. 1921); *In re Boardway*, 248 Fed. 364 (N.D.N.Y. 1918). However, two decisions prior to *Local Loan* indicated that a federal court would enjoin a state action so that the general purpose of the Bankruptcy Act might not be thwarted. *In re Skorcz*, 67 F.2d 187 (7th Cir. 1933); *Seaboard Small Loan Corp. v. Ottinger*, 50 F.2d 856 (4th Cir. 1931).

the state action. The injunction was issued, and the Supreme Court upheld its issuance.

However, the rationale of the Court presented a problem. The Court premised its argument on the fact that a bankruptcy court is essentially a court of equity. Since courts of equity have authority to issue decrees supplemental to an original decree (in this instance, a discharge in bankruptcy), the Supreme Court concluded that the federal district court had the power to issue the injunction. Next, the Court had to formulate some test which could be employed to determine under what circumstances an injunction should be issued. The Court declared: "[T]he court was [not] bound to exercise its authority. And it probably would not and should not have done so except under unusual circumstances such as here exist."¹⁴

The nature of these "unusual circumstances" is a question that has plagued federal courts whenever they have been petitioned to issue an injunction on the basis of *Local Loan*. Although the Court in *Local Loan* relied to a large extent on the element of excessive expense, it would be inaccurate to conclude that this factor alone warrants a *Local Loan* type of injunction. In *Csatari v. General Fin. Corp.*¹⁵ the bankrupt was financially unable to post an appeal bond as required by state statute. He petitioned the federal district court for injunction on the theory that the necessity of the bond was an "unusual circumstance" that warranted injunctive relief. His petition was denied on the theory that such a requirement was reasonable.

Res Judicata

At times, the principle of res judicata may weigh against the issuance of an injunction.¹⁶ In *Walters v. Wilson*,¹⁷ the creditor obtained a state judgment prior to the debtor's discharge in bankruptcy. The debtor appeared in the state court to have the garnishment decree vacated by reason of his bankruptcy discharge. The superior and district courts of California decided in favor of the bankrupt. But, the Supreme Court of that state reversed. The bankrupt petitioned the federal court for an injunction prohibiting execution, alleging that loss of employment might result. The court denied the injunction because the principle of res judicata would be violated by relitigating the issue of dischargeability.¹⁸

¹⁴ *Local Loan Co. v. Hunt*, 292 U.S. 234, 241 (1934).

¹⁵ 173 F.2d 798 (6th Cir. 1949).

¹⁶ *Otte v. Cooks, Inc.*, 113 F. Supp. 861 (D. Minn. 1953).

¹⁷ 142 F.2d 59 (9th Cir.), cert. denied, 323 U.S. 722 (1944); see *In re Johnson*, 211 F. Supp. 337 (D.N.J. 1962).

¹⁸ *Accord, In re Devereaux*, 76 F.2d 522 (2d Cir.), cert. denied, 296 U.S. 589 (1935); *In re Grover*, 63 F. Supp. 644 (D. Minn. 1945).

A different situation can occur when the bankrupt does not plead his discharge in a state action, but defends on another ground and is unsuccessful. Res judicata would likewise prompt a federal court to deny the bankrupt's petition for injunctive relief where he designates this other ground as an "unusual circumstance."¹⁹ Hence, courts seem reluctant to find "unusual circumstances" whenever the principle of res judicata would be threatened by such a determination.

Default Judgment

Many bankrupts erroneously believe that a discharge extinguishes their debt.²⁰ In *Helms v. Holmes*,²¹ the bankrupt, thinking that his discharge acted as an automatic defense, failed to defend a state action instituted by his creditor. The creditor obtained a default judgment, and then sought to execute it by having the sheriff levy on the bankrupt's property. The bankrupt then petitioned the district court for an injunction, which was granted. The Court of Appeals reversed, holding that the bankrupt was not entitled to equitable relief because he did not appear in the state action and plead his defense of bankruptcy.²² In effect, the court seemed to imply that ignorance is not an "unusual circumstance" that demands injunctive relief.

Having considered the problem of a state default judgment subsequent to discharge, let us examine the reverse, that is, where the default judgment occurs prior to discharge. Although courts will not enjoin the execution of a state judgment obtained subsequent to discharge, there is some authority for the proposition that a court will enjoin execution on a default judgment rendered prior to discharge.²³ However, it should be noted that the prior default judgment might represent a cause of action which is dischargeable on its face, or one which might be exempted from

¹⁹ *In re Harris*, 28 F. Supp. 487 (E.D. Ill. 1939).

²⁰ *Stevenson, Protecting the Bankrupt*, 30 OKLA. B.J. 902, 903 (1959). This situation is described in the dissenting opinion in *Helms v. Holmes*, 129 F.2d 263 (5th Cir. 1942), where Judge Paul states: "[T]he average bankrupt is a layman who has been advised that a discharge in bankruptcy releases him. . . . It has become a custom for greedy creditors to take advantage of this situation by ignoring the bankruptcy proceedings . . . and suing on their debts in the state courts, hoping that the bankrupt, because of his ignorance . . . will fail to appear and plead the discharge. . . ." *Id.* at 269 (dissenting opinion).

²¹ 129 F.2d 263 (5th Cir. 1942).

²² *Accord, In re Innis*, 140 F.2d 479 (7th Cir.), *cert. denied*, 322 U.S. 736 (1944); *Household Fin. Corp. v. Dunbar*, 262 F.2d 112 (10th Cir. 1958).

²³ In the Matter of *Forgay*, 140 F. Supp. 473 (D. Utah), *aff'd sub nom. Personal Industrial Loan Corp. v. Forgay*, 240 F.2d 18 (10th Cir. 1956), *cert. denied*, 354 U.S. 922 (1957); *In re Tillery*, 16 F. Supp. 877 (N.D. Ga. 1936).

discharge by the terms of the bankruptcy act; that is, which might be nondischargeable.

With respect to the former, *In the Matter of Forgay*²⁴ involved a situation where the creditor's state action was dischargeable on its face, and was reduced to judgment during the debtor's bankruptcy proceeding but prior to his discharge. This case held that a federal court will enjoin the execution of such a prior state default judgment, providing the creditor's claim was properly scheduled, and the creditor had actual notice of the bankruptcy proceeding.

The district judge postulated that the power to grant such injunctive relief is discretionary. He then proceeded to condemn loan companies for completely disregarding bankruptcy proceedings in favor of a state court where the likelihood of a default judgment, that avoids "a searching inquiry into the facts,"²⁵ is great. Believing this to be the conduct of the loan company, he granted the injunction in the hope that it would curb such behavior which makes a mockery of the Bankruptcy Act.

On the other hand, where the prior default judgment is for some cause of action which might not be dischargeable on its face, the creditor will invariably contest the bankrupt's injunction proceeding on that ground. Now, the federal court must decide whether the standard used in the state court meets the exemption requirements of the Bankruptcy Act. In *re Tillery*²⁶ presented a situation where the bankrupt had a judgment rendered against him for "deliberate negligence." Thereafter, he procured a bankruptcy decree, listing this judgment as a debt. When the judgment creditor attempted to execute it, the bankrupt petitioned the bankruptcy court for an injunction, alleging harassment as the "unusual circumstance." The judgment creditor answered by claiming that the state judgment was a debt based on a willful or malicious injury, and thereby exempt from the discharge as provided by the Bankruptcy Act.²⁷ The district court, in granting the injunction, held that "deliberate negligence" was not within the statutory exemption. However, in *Harrison v. Donnelly*,²⁸ the district court held that a state judgment for "wanton and reckless conduct" did meet the statutory standard and was, therefore, exempt from the discharge. Thus, when the federal court is presented with a prior default judgment, it may have to look behind the judgment in order to arrive at its own independent determination as to whether or not the creditor's claim is dischargeable, before it can enjoin.

²⁴ *In the Matter of Forgay*, *supra* note 23.

²⁵ *Id.* at 477.

²⁶ *Supra* note 23.

²⁷ 30 Stat. 550 (1898), 11 U.S.C. § 35(a) (1958).

²⁸ 153 F.2d 588 (8th Cir. 1946).

Unusual Circumstances

Having analyzed the problem of res judicata and default judgments, reference should now be made to the cases defining the nature of "unusual circumstances." A bankrupt may find himself in a situation in which he seeks an injunction because his remedy in the state courts "involves trouble, embarrassment, expense, and possible loss of employment."²⁹ Courts have characterized the following as unusual circumstances that warrant injunctive relief: excessive expense of appeal in the state courts,³⁰ the charging of a usurious rate of interest,³¹ the lack of expertise on the part of a state court,³² and the possible loss of employment due to the harassment of the bankrupt's employer through garnishment proceedings.³³ However, in *Poolman v. Poolman*,³⁴ the bankrupt executed a separation agreement with his wife whereby he was to pay \$50 a week for her support. Upon his default, she obtained a judgment for the money she had to borrow when he failed to meet the payments. Thereafter, the husband had himself declared a bankrupt. When his wife jeopardized his employment by attempting to collect the judgment, he petitioned for and was granted an injunction. The Court of Appeals reversed on the theory that the state judgment debt was of a nondischargeable nature, and therefore, the bankrupt was not entitled to injunctive relief. The decision indicates that the mere existence of an unusual circumstance does not entitle a bankrupt to equitable relief where the debt is nondischargeable in the first instance.

Some Recent Views Concerning Local Loan

There is the hope among some writers that injunctions will be granted more liberally in this area.³⁵ In opposition to this is the attitude expressed by the following: "*Local Loan Co. v. Hunt* has been interpreted to mean that . . . ancillary jurisdiction is exceedingly narrow, to be exercised only 'under unusual cir-

²⁹ *Seaboard Small Loan Corp. v. Ottinger*, 50 F.2d 856, 859 (4th Cir. 1931).

³⁰ *In re Connors*, 93 F. Supp. 149 (N.D. Ind. 1950).

³¹ *In re Taylor*, 29 F. Supp. 656 (N.D. Ga. 1939).

³² *State Fin. Co. v. Morrow*, 216 F.2d 676 (10th Cir. 1954).

³³ *In re Caldwell*, 33 F. Supp. 631 (N.D. Ga.), *aff'd sub nom. Davison-Paxon Co. v. Caldwell*, 115 F.2d 189 (5th Cir. 1940), *cert. denied*, 313 U.S. 564 (1941); *cf. Gore v. Gorman's Inc.*, 143 F. Supp. 9 (W.D. Mo. 1956), where an action for malicious prosecution was allowed when a creditor's continual harassment threatened bankrupt's chance for steady employment.

³⁴ 289 F.2d 332 (8th Cir. 1961).

³⁵ Moore, *Res Judicata and Collateral Estoppel in Bankruptcy*, 68 YALE L.J. 1, 26-27 (1958); Smedley, *Determination of the Effect of a Discharge in Bankruptcy*, 15 VAND. L. REV. 49, 82 (1961).

cumstances.'"³⁶ In the recent case of *Briskin v. White*,³⁷ the Court of Appeals for the Ninth Circuit appears to have adopted the latter approach. It interprets "unusual circumstances" to mean the existence of state law adverse to the position of the bankrupt,³⁸ as was the case in *Local Loan*. Hence, by implication, the court rejects the other traditional types of "unusual circumstances."³⁹

Proposed Legislation

In order to remedy this problem, there has been a steady movement to amend the Bankruptcy Act.⁴⁰ The Celler Bill,⁴¹ the predecessor of the latest attempts to allow the bankruptcy court to determine the effect of its own decree, provides that a bankruptcy court should determine the dischargeability or non-dischargeability of all provable debts. There is a divergence of opinion as to the utility of such an innovation. Its proponents argue that it "will correct a serious defect in the Act and add to the dignity of the bankruptcy court by requiring it to vindicate its own decrees,"⁴² and that the court's "determination would not only be quick but final, it would be 'one stop' *res adjudicata*."⁴³ On the other hand, its opponents contend that the amendment would delay bankruptcy procedure because the court would have to consider discharge controversies, for example, whether or not a tort was willful or malicious and therefore a nondischargeable debt.⁴⁴ Additionally, it is suggested that it would be an unwise federal usurpation of an area that has traditionally been thought to be within the state's jurisdiction, that the cost to the federal government of providing more facilities would be prohibitive, and that there is no reason to assume that a federal court would be more qualified to determine the dischargeability of a debt since it would be applying state law.⁴⁵

Remedies Other Than a Local Loan Injunction

In certain cases, where the bankrupt still has some other remedy available, federal courts have refused to issue an injunction,

³⁶ *Ciavarella v. Salituri*, 153 F.2d 343, 344 (2d Cir. 1946).

³⁷ 296 F.2d 132 (9th Cir. 1961).

³⁸ *Id.* at 134.

³⁹ Herzog, *Bankruptcy Law—Modern Trends*, 35 REF. J. 87, 89 (1962).

⁴⁰ H.R. 11543, 84th Cong., 2d Sess. (1956); H.R. 106, 85th Cong., 1st Sess. (1957); H.R. 4150, 86th Cong., 1st Sess. (1959); H.R. 1742, 87th Cong., 1st Sess. (1961).

⁴¹ H.R. 106, 85th Cong., 1st Sess. (1957).

⁴² Herzog, *supra* note 39, at 90.

⁴³ Friebolin, *Want to Make a Federal Case of It?*, 62 COM. L.J. 249, 256 (1957).

⁴⁴ Smedley, *supra* note 35.

⁴⁵ Friebolin, *supra* note 43.

and have expressly advised the bankrupt to pursue this other course of action first.⁴⁶ The two most notable remedies are: pleading the discharge as a personal defense (absent a *Local Loan* type situation), and utilizing a state cancellation statute if the jurisdiction has such a statute.

With respect to the first, the discharge is a personal defense to any state action by a creditor, *i. e.*, waived if not pleaded.⁴⁷ Once the discharge decree has been introduced into evidence, the burden of proof is on the creditor to demonstrate why his specific claim is exempt from discharge.⁴⁸ Of course, if the bankrupt believes that the state court has erroneously decided the question of dischargeability, he may ultimately appeal to the Supreme Court of the United States.⁴⁹

Some jurisdictions have enacted statutes that provide a bankrupt with an inexpensive remedy for having a creditor's judgment cancelled.⁵⁰ For example, Section 150 of the New York Debtor and Creditor Law allows a bankrupt to petition the court that rendered a judgment against him for the purpose of having it cancelled on the basis of his discharge decree. If that court decides that the debt upon which the judgment was based was dischargeable, the judgment will be cancelled.

Under this type of legislation, there are three possible situations that might arise: (1) the state judgment may have been obtained prior to discharge; (2) the state judgment may have been rendered subsequent to discharge and may have been taken by default; or (3) the judgment may have been obtained subsequent to discharge with the bankrupt having appeared and defended. If the judgment was rendered prior to discharge, section 150 clearly applies since the question of dischargeability could never have been considered by the state court.⁵¹ When there is a default judgment subsequent to discharge, the bankrupt may still take advantage of the cancellation statute, despite the fact that he did not appear in the state action and plead his discharge. In *Rukeyser v. Tostevin*,⁵² the bankrupt listed the creditor's debt in the bankruptcy proceeding. Subsequent to his discharge, the creditor obtained a

⁴⁶ *Gathany v. Bishopp*, 177 F.2d 567 (4th Cir. 1949); *In re Innis*, 140 F.2d 479 (7th Cir.), *cert. denied*, 322 U.S. 736 (1944); *In re Stoller*, 25 F. Supp. 226 (S.D.N.Y. 1938).

⁴⁷ *Household Fin. Corp. v. Dunbar*, 262 F.2d 112 (10th Cir. 1958).

⁴⁸ *Whelan v. United States Guar. Co.*, 252 F.2d 851 (D.C. Cir. 1958); *National Fin. Co. v. Valdez*, 11 Utah 2d 339, 359 P.2d 9 (1961).

⁴⁹ *In re Devereaux*, 76 F.2d 522, 524 (2d Cir. 1935).

⁵⁰ See, *e.g.*, N.Y. DEBT. & CRED. LAW § 150; MINN. STAT. ANN. § 548.18 (1945); N.D. REV. CODE § 28-20-30 (1943).

⁵¹ *Rukeyser v. Tostevin*, 188 App. Div. 629, 631, 177 N.Y. Supp. 291, 292 (1st Dep't 1919); *Multiple Trading Corp. v. Berta Saggese-Edilizia, Inc.*, 178 Misc. 1077, 37 N.Y.S.2d 296 (Sup. Ct. 1942).

⁵² *Supra* note 51.

default judgment on the listed debt. The bankrupt petitioned that court under the cancellation statute and the judgment was cancelled. As to the third possibility, although no case law has been found, it would seem that if the bankrupt has appeared in a subsequent state action, the doctrine of *res judicata* would prevent him from utilizing the statute.

Conclusion

Varied solutions to the problem of what constitutes an "unusual circumstance" have been advanced. For some, proposed legislation provides the answer. Others believe that the Supreme Court should grant certiorari to the proper case in an effort to redefine the test with more precision. Yet, it should be borne in mind that the bankruptcy court, as a court of equity, requires a certain flexibility, lest the equitable remedy become frozen. The present test seems to provide that degree of elasticity necessary for a court of equity to grant relief when the remedy at law is inadequate and, perhaps, should not be so readily abandoned. Most of the problems that arise in this area could be averted if the attorney who represents the bankrupt in the bankruptcy proceeding would advise him as to the effect of his discharge.



THE CHANGING APPROACH TO "TRIAL BY NEWSPAPER"

One of the basic rights guaranteed by our Constitution is that one accused of a crime be afforded a fair trial by an impartial jury. This guarantee is made applicable to state prosecutions by the due process clause of the fourteenth amendment.¹ An essential ingredient of that right is that an accused be tried by jurors whose verdict is based solely upon a consideration of competent evidence received in open court.² However, as the incidence of crime reporting has increased,³ it has become difficult to empanel jurors who have not read something of the case. Often, the publicity to which they have been exposed will be extremely prejudicial.⁴

¹ *In re Murchison*, 349 U.S. 133 (1955); *In re Oliver*, 333 U.S. 257, 266-73 (1948).

² *People v. Sprague*, 217 N.Y. 373, 380, 111 N.E. 1077, 1080 (1916).

³ In discussing the amount of publicity attendant to a particular trial one writer commented that there were "Words enough, if put into book form, to make a shelf of novels 22 feet long." BARNES & TEETERS, *NEW HORIZONS IN CRIMINOLOGY*, 192, 193 (2d ed. 1951).

⁴ For a discussion of the type of publicity that precedes a sensational trial see SULLIVAN, *TRIAL BY NEWSPAPER* (1961); Issacs, *The Crime of Present Day Crime Reporting*, 52 J. CRIM. L., C. & P.S. 405 (1961).