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### Repository Citation

James E. McCarty, *Federal Bankruptcy or State Court Receivership?*, 48 Marq. L. Rev. (1965).  
Available at: <http://scholarship.law.marquette.edu/mulr/vol48/iss3/3>

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# FEDERAL BANKRUPTCY OR STATE COURT RECEIVERSHIP\*

JAMES E. McCARTY\*\*

This subject requires consideration of the legal effect of chapter 128 of the Wisconsin Statutes of 1961, the legislative history thereof, the state court decisions construing and interpreting these various sections, and the history, legal effect, and scope of the federal bankruptcy act.

## *History of the Federal Bankruptcy Act*

The United States Constitution<sup>1</sup> gives Congress the power "to establish . . . uniform laws on the subject of bankruptcies throughout the United States." This clause did not obligate Congress to pass a federal bankruptcy law nor did it deny the power of the states to pass bankruptcy or insolvency laws.<sup>2</sup>

The first bankruptcy act was passed in 1800 and repealed less than four years later, and until 1841 there was no federal bankruptcy law in the United States. The second federal bankruptcy act was enacted in 1841 and was repealed within two or three years. The third federal bankruptcy act was passed in 1867 and repealed in 1878. The fourth federal bankruptcy act was passed in 1898, so that for about twenty years we had no bankruptcy act. The present basic federal bankruptcy act was that of 1898, which was completely revised by the Chandler Act in 1938.

Congress has exercised its constitutional power by enacting bankruptcy legislation. The power of Congress is paramount and state laws in competition with the subject matter covered by Congress are superseded.<sup>3</sup> The doctrine has been well settled

that state insolvency laws which are tantamount to bankruptcy because they provide for an administration of the debtor's assets in a winding up of his affairs similar to that provided by the national act, are suspended while the latter remains in force and proceedings under them are utterly null and void whether commenced within four months of the filing of a petition in bankruptcy or before.<sup>4</sup>

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\* This article is based upon a paper presented to the Board of Circuit Judges of the State of Wisconsin on August 26, 1964.

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<sup>1</sup> Art. I, §8, ch. 4.

<sup>2</sup> *Sturgis v. Crowninshield*, 17 U.S. (4 Wheat.) 122 (1819).

<sup>3</sup> *Ibid.*; *Ogden v. Saunders*, 25 U.S. (12 Wheat.) 213 (1827); *Straton v. New* 283 U.S. 318 (1930).

<sup>4</sup> *Straton v. New*, *supra* note 3, at 327.

*History of Chapter 128 of the Wisconsin Statutes of 1961*

Chapter 80 of the Revised Wisconsin Statutes of 1878 related entirely to voluntary assignments and prescribed regulations therefor. Provisions for the discharge of debtors were added by enactment of chapter 385 of the Laws of 1889, subsequent revisions placed the discharge provisions relating to voluntary assignments in chapter 80, and thereafter chapter 80 was renumbered chapter 128. Please note that these laws were enacted by the Wisconsin legislature during the period when no federal bankruptcy act was in force or effect.

In 1926, after the Congress of the United States had enacted the Bankruptcy Act of 1898, our state supreme court had occasion to consider the validity of the discharge provisions of chapter 128, and the court held that the provisions of said chapter relating to the discharge of insolvent debtors<sup>5</sup> were completely superseded by the federal bankruptcy act as to all matters comprehended within that legislation.<sup>6</sup> It was only the discharge features which were declared to be suspended and wholly superseded by the federal bankruptcy act, while the other features relating to voluntary assignments were held to be still in force and effect and not in contravention of nor in conflict with the federal act. The court, in effect, held that the discharge features of chapter 128 were separable from those relating to voluntary assignments.

In 1932, the Wisconsin court again considered chapter 128 of the Wisconsin Statutes of 1929 in *Pobreslo v. Joseph M. Boyd Co.*,<sup>7</sup> and again held that the provisions of said chapter, absent the discharge features, were enacted for the purpose of regulating voluntary assignments and were not in conflict with nor in contravention of the federal bankruptcy act. Since both *Tarnowski* and *Pobreslo* were, in fact, voluntary assignments, there was no need in those areas to decide the validity of other sections of chapter 128. After the aforesaid decisions, the discharge features of chapter 128 were repealed.<sup>8</sup> Chapter 128 was again amended by chapter 308 of the Wisconsin Laws of 1939. These were the Wisconsin statutes in force at the time of the decision of the Honorable Robert E. Tehan, Chief Judge of the United States District Court for the Eastern District of Wisconsin, in *In re Wisconsin Builders Supply Co.*<sup>9</sup>

Judge Tehan's exhaustive opinion affirmed the order of the then referee in bankruptcy enjoining the state court receiver under chapter 128 from proceeding further with liquidating or administering the assets of the corporation, and directed the state court receiver to turn over the

<sup>5</sup> Wis. Laws 1889, ch. 385.

<sup>6</sup> Voluntary Assignment of Tarnowski, 191 Wis. 279, 210 N.W. 836 (1926).

<sup>7</sup> 210 Wis. 20, 242 N.W. 725 (1932).

<sup>8</sup> Wis. Laws 1937, ch. 431.

<sup>9</sup> 136 F. Supp. 439 (E.D. Wis. 1955).

assets to the bankruptcy court trustee. In *Wisconsin Builders* there was a voluntary assignment in October 1951 for the benefit of creditors of said corporation, and the assignee was subsequently appointed receiver by the Circuit Court of Milwaukee County, the physical assets of the corporation were sold, and the sale was duly confirmed by the circuit court order. However, before any distribution had been made, the assignor, Wisconsin Builders, filed a voluntary petition in bankruptcy in the United States District Court for the Eastern District of Wisconsin on June 6, 1952, and a bankruptcy trustee was subsequently appointed by the federal court. Over seven months had elapsed between the appointment of the state court receiver and the filing of the voluntary petition in bankruptcy.

It must be conceded that the bankruptcy court has the full power and authority to require receivers or trustees appointed in proceedings not under the act "to deliver the property in their possession or under their control to the . . . trustee . . . debtor or other person entitled to such property"<sup>10</sup> as the case may be, provided that the receiver or trustee was appointed within four months prior to the date of the filing of the petition in bankruptcy. A state court receivership is superseded by adjudication of bankruptcy.<sup>11</sup> In the instant case, since more than four months had elapsed since the appointment of the state court receiver, the federal court could not obtain exclusive jurisdiction over the assets in the state court receiver's possession unless the state court proceedings were tantamount to bankruptcy. However, the state court proceedings were held to be insolvency proceedings and the lien created thereby null and void because of conflict with the Bankruptcy Act.

The principle is now well settled that while federal bankruptcy statutes supersede state bankruptcy statutes, bankruptcy does not supersede a state court proceeding for the enforcement of a lien and the appointment of a receiver therein where the institution of the suit created a valid lien or was for the enforcement of a valid existing lien obtained more than four months prior to bankruptcy.

Judge Tehan, in *Wisconsin Builders*, after a thorough discussion of all the provisions of the then chapter 128, held that the only substantial difference between the Wisconsin act and the federal bankruptcy act was that the state act did not provide for a discharge; that as to corporations such as the bankrupt, the granting of a discharge was meaningless; that all of the provisions of the then chapter 128 dealing with marshalling, liquidation, and ratibility of the debtor's assets were suspended during the existence of the Bankruptcy Act; that chapter 128

<sup>10</sup> Bankruptcy Act §§ 2a (21), 52 Stat. 844 (1938), 11 U.S.C. § 11(a)(21) (Supp. V, 1963).

<sup>11</sup> *In re Lustron Corp.*, 184 F.2d 789 & 798 (7th Cir. 1950), *cert. denied*, 340 U.S. 946 (1951); 1 COLLIER, BANKRUPTCY § 2.78, at 369-70 (14th ed. 1962).

constituted a comprehensive system covering both voluntary and involuntary actions; and that the act did not lend itself to the application of the doctrine of severability. Upon appeal, the United States Court of Appeals for the Seventh Circuit reversed Judge Tehan and stated as follows:

A comparison of the provisions of Chapter 128 with those of the prior act compels a conclusion that Chapter 128, except for the involuntary provisions, is substantially a re-enactment of the earlier law. We fail to find any significant departures which would cause Chapter 128 to be legislation 'tantamount to bankruptcy.' There is little that is new. The character and purpose of the Act is the same, i.e., judicial supervision of general assignments for the benefit of creditors. The powers and procedures have been altered somewhat, but not in any significant respect. . . .<sup>12</sup>

The court further held that

Chapter 128 is an expansion of the prior Wisconsin general assignment legislation but it has not been turned into a system of insolvency administration opposed to the Bankruptcy Act, at least as concerns its voluntary provisions.<sup>13</sup>

The appellate court affirmed in part and reversed in part, since it held that the involuntary provisions of chapter 128 were suspended by the federal bankruptcy act but the voluntary provisions were not so suspended, and, in disagreement with Judge Tehan, that the involuntary provisions could be severed while the voluntary provisions could be sustained.

Thus, after years of litigation in the courts, both federal and state, it appears that chapter 128 of the Wisconsin statutes, insofar as it merely regulates or controls voluntary assignments for the benefit of creditors, is valid and not in conflict with the federal bankruptcy act.

While the litigation and legislation relative to state court and federal jurisdiction in Wisconsin in receiverships and insolvency matters would now at long last appear to be settled, this is not so because, after *Wisconsin Builders*, the Wisconsin legislature again amended chapter 128 by enactment of chapter 274 of the Laws of 1957. The present law relates to voluntary assignments for the benefit of creditors; defines insolvency; makes provision for dissolution of liens; voids preferences; sequesters property; appoints and vests title in receivers and provides for their supervision; and provides for meetings of creditors, the filing and adjudication of claims, examination of debtors, and liquidation and distribution of assets.

Where formerly section 128.05 provided that upon the filing of the

<sup>12</sup> 239 F.2d 649, 655 (7th Cir. 1956).

<sup>13</sup> *Id.* at 656.

assignment the court shall designate the receiver, the statute now provides that the court upon filing of the assignment shall order the *assignee* to administer the debtor's estate, said assignee to be vested with powers of a receiver.

Section 128.06, condemned in *Wisconsin Builders*, was repealed. The provisions of the present section 128.06 are immaterial herein for the purposes of this discussion.

Section 128.08, formerly entitled "Insolvent corporations; receiver, custodian," has been repealed and is now entitled "Receiver; custodian" and provides as follows:

(1) The court within the proper county may sequester the property of a debtor and appoint a receiver therefor:

(a) When an execution against a judgment debtor is returned unsatisfied in whole or in part.

(b) When a corporation has been dissolved or is insolvent or is in imminent danger of insolvency or has forfeited its corporate rights.

(2) Upon application duly made, the court shall appoint as receiver the person nominated by the petitioning creditor or creditors, subject to [section] 128.10.

Subsection (b) of section 128.08 is the same as subsection (4) of section 268.16. There are other Wisconsin statutes relating to appointment of receivers in chapters 273, 286, and 180.

The order of distribution as set forth in section 128.17 was changed by the most recent enactment. Whereas formerly payment of taxes, assessments, and debts due the United States followed wages due workmen, etc., and were on a parity with taxes and debts due to state, county, district, or municipality, such taxes, assessments, and debts due the United States were given a higher priority under the 1957 amendment so that they are now to be paid after the costs of preserving the estate and the costs of administration. This differs from the distribution provided by section 64 of the Bankruptcy Act, which provides a fourth priority for taxes owing by the bankrupt to the United States or any state or any subdivision thereof and a fifth priority for debts owing to the United States, the priority and payment to the United States being subsequent to costs and expenses of administration and wages due workmen. The reason for this change is evident since it would be impossible for the state court to distribute in this manner because of the provisions of section 3466 of the Revised Statutes, which provides as follows:

Whenever any person indebted to the United States is insolvent, or whenever the estate of any deceased debtor, in the hands of the executors or administrators, is insufficient to pay all the debts due from the deceased, the debts due to the United States shall be first satisfied; and the priority hereby established shall extend as well to cases in which a debtor, not having sufficient

property to pay all his debts, makes a voluntary assignment thereof, or in which the estate and effects of an absconding, concealed, or absent debtor are attached by process of law, as to cases in which an act of bankruptcy is committed.<sup>14</sup>

This section, however, does not apply to proceedings under the Bankruptcy Act insofar as debts due the United States for taxes are concerned. This change in the state statute results in a different distribution from that provided under the provisions of the Bankruptcy Act. Where formerly the court was empowered to sequester the property of the debtor and appoint a receiver therefor when an execution against a domestic corporation was returned unsatisfied, it is now, under the new section 128.08, empowered to sequester said property and appoint a receiver when an execution against a judgment debtor (individual, partnership, association, domestic or foreign corporation) is returned unsatisfied, and when a corporation has been dissolved, is insolvent, is in imminent danger of insolvency, or has forfeited its corporate rights. Do the provisions of section 128.08, when construed in conjunction with the other applicable provisions of chapter 128 except those relating to voluntary assignments, constitute an insolvency law? The absence of a discharge feature is not the sole test to be applied in determining whether a state act is suspended or inoperative. Federal courts have held specifically that state acts may be suspended by the federal act even though the state acts do not provide for a discharge.<sup>15</sup> In the case of *In re Weedman Stave Co.*,<sup>16</sup> the court said:

The first question to be determined is whether the Arkansas statute, under which the proceedings in the state court were had, is an insolvency law. What constitutes an insolvency law? The elements of an insolvency law are insolvency, surrender of property, its administration by a receiver or trustee, distribution of the assets among the creditors, and a provision for priorities or other matters not permissible in the absence of such a statute. A provision for the discharge of the debtor from the unpaid balances of his debts is not essential to make it an insolvency law.<sup>17</sup>

In *International Shoe Co. v. Pinkus*,<sup>18</sup> which involved the Arkansas statute, the United States Supreme Court stated as follows:

The national purpose to establish uniformity necessarily excludes state regulation. It is apparent, without comparison in detail of the provisions of the Bankruptcy Act with those of the Arkansas statute, that intolerable inconsistencies and confusion would result if that insolvency law be given effect while the national Act is in force. Congress did not intend to give insolvent

<sup>14</sup> 31 U.S.C. § 191 (1958).

<sup>15</sup> *Stellwagen v. Clum*, 245 U.S. 605 (1917); *In re Salmon & Salmon*, 143 Fed. 395 (W.D. Mo. 1906); *In re Smith*, 92 Fed. 135 (D. Ind. 1899).

<sup>16</sup> 199 Fed. 948 (E.D. Ark. 1912).

<sup>17</sup> *Id.* at 950.

<sup>18</sup> 278 U.S. 261 (1929).

debtors seeking discharge, or their creditors seeking to collect claims, choice between the relief provided by the Bankruptcy Act and that specified in state insolvency laws. States may not pass or enforce laws to interfere with or complement the Bankruptcy Act or to provide additional or auxiliary regulations.<sup>19</sup>

It appears, therefore, that the provisions of section 128.08, when considered with sections of the chapter other than the voluntary assignment portion, may be held to be an insolvency law. In one author's opinion, these provisions are clearly invalid.<sup>20</sup>

It must be conceded that for over 100 years the return of an unsatisfied execution against a judgment debtor is a recognized ground for the appointment of a receiver. As to an individual debtor, these proceedings have always been instituted pursuant to the provisions of chapter 273 of the Wisconsin statutes, entitled "Remedies Supplementary to Execution." In the latter instance, the receiver obtains an equitable lien on behalf of the judgment creditor, which lien is recognized as valid in a subsequent bankruptcy proceeding if the lien was obtained more than four months prior to bankruptcy.<sup>21</sup>

There is no question but that the state has the right and, in fact, the duty to see to the proper winding up of the affairs of the dissolved corporation or a corporation which has forfeited its charter, and may, of course, properly provide statutory regulations therefor. Does the state have the right to appoint a receiver and grant him powers to set aside liens and preferences, liquidate the assets of the judgment debtor, incorporate or otherwise, and distribute the debtor's estate among all his creditors according to the provided statutory distribution which differs from the distribution provided by the Bankruptcy Act, if the judgment debtor is insolvent or in imminent danger of insolvency? May a state, absent some voluntary act on the part of the debtor such as a voluntary assignment, liquidate the corporate assets when the corporation is insolvent or in imminent danger of insolvency, or are such proceedings tantamount to bankruptcy resulting in supersedure by the federal bankruptcy act, and are such laws suspended as long as there is a federal bankruptcy act in full force and effect? It must be admitted that there is inherent power in equity courts to appoint a receiver of an insolvent corporation and such authority does not depend for its vitality upon any statutory provisions, as statutory provisions do not create the remedy.<sup>22</sup> If the courts are exercising a power which was inherent in the equity courts prior to the enactment of the federal bankruptcy act, we must assume

<sup>19</sup> *Id.* at 265.

<sup>20</sup> Comment, *A Challenge to the Validity of Certain Sections of Wisconsin's Chapter 128*, 45 MARQ. L. REV. 403 (1961).

<sup>21</sup> *Straton v. New*, *supra* note 3; *Metcalf v. Barker*, 187 U.S. 165 (1902); *Atlantic Flooring & Insulation Co. v. Oberdorfer Ins. Agency*, 136 F.2d 457 (5th Cir. 1943); *Alexander v. Wald*, 231 Wis. 530, 286 N.W. 6 (1939).

<sup>22</sup> *Hazelwood v. Third & Wells Realty Co.*, 205 Wis. 85, 236 N.W. 591 (1931).

that the proceedings are valid, but it is extremely difficult to determine whether the provisions of chapter 128, absent the voluntary assignment provisions, are, in fact, an insolvency law or a regulation of an equity receivership.<sup>23</sup> At any rate, it cannot be doubted that the provisions of chapter 128, as amended by chapter 274 of the Laws of 1957, are at least open to attack and there is a possibility that this law may be held to be in contravention of the federal bankruptcy statutes. If so, all proceedings thereunder in the state courts would be superseded by the federal bankruptcy act and suspended while said federal act is in force and effect. If the proceedings, resulting in the appointment of a receiver by reason of an execution returned unsatisfied or because of the insolvency or imminent danger of insolvency of a debtor, are only in the nature of an equitable attachment of the property of a debtor for the benefit of creditors, it is most probably a valid exercise of the inherent powers of the court of equity. However, if the Wisconsin law is suspended, even though more than four months have elapsed between the appointment of the state court receiver and the filing of the bankruptcy petition, or if a petition for reorganization<sup>24</sup> or real property arrangement<sup>25</sup> is filed so that the four month rule does not apply,<sup>26</sup> or if the bankruptcy petition is filed within the four month period, the result is two liquidations with the additional possibility that if the state court proceeding is held to be a system of insolvency administration in conflict with the Bankruptcy Act and therefore void, actions may be instituted to set aside all transfers and conveyances made during the state receivership.

Bankruptcy actions in the United States courts are "actions in rem" and essentially creditors' actions. Creditors have many rights not granted to them by state law. They may appoint a creditors' committee and the trustee,<sup>27</sup> whereas in the state court voluntary assignment proceedings the assignee is selected by the debtor and most probably, in many instances, is not unfriendly toward the debtor. When a creditor with execution returned unsatisfied seeks liquidation of the debtor under chapter 128, he is primarily interested only in collecting his own debt and he may bring the action even though only a nominal amount may be due upon his debt and, if satisfied, he will dismiss or not file the action.

In state court proceedings, little use is made of discovery under section 128.16 of the Wisconsin statutes and the debtor or corporate representatives of the debtor are seldom examined under oath. In bankruptcy proceedings, the debtor, and if a corporation, the officers, are

<sup>23</sup> *In re Schwartz Bros.*, 58 F. Supp. 761 (D. Minn. 1945).

<sup>24</sup> Bankruptcy Act, ch. X, 52 Stat. 883 (1938), 11 U.S.C. §§ 501-676 (1958), as amended, 11 U.S.C. §§ 502-665 (Supp. V, 1963).

<sup>25</sup> Bankruptcy Act, ch. X, 52 Stat. 916 (1938), 11 U.S.C. §§801-926 (1958).

<sup>26</sup> Bankruptcy Act § 2a(21), 52 Stat. 844 (1938), 11 U.S.C. § 11(a)(21) (Supp. V, 1963).

<sup>27</sup> Bankruptcy Act § 44, 52 Stat. 860 (1938), 11 U.S.C. § 72 (1958).

examined at the first meeting of creditors and are subject to further examination under the provisions of section 21a of the Bankruptcy Act; and any person may be examined under the provisions of said federal statute concerning the acts, conduct, and property of the bankrupt. A dishonest or unscrupulous bankrupt may succeed in defrauding his creditors or in perpetrating a fraud upon the court by the means and machinery of a voluntary assignment or state court receivership, whereas he is not likely to succeed in accomplishing the fraud in a bankruptcy proceeding. This is because Congress has set up in the federal court system and in the administrative office of the court an elaborate system for the administration of bankruptcy proceedings, and the state has made no special provisions for its courts in this respect. Fraudulent concealment or transfer of property, etc., are bankruptcy crimes.<sup>28</sup> If, during the course of a proceeding, suspicious circumstances arise, the matter is reported to the appropriate United States Attorney,<sup>29</sup> who has at his command the full investigative powers of the Federal Bureau of Investigation.

Costs of administration in bankruptcy cases is a matter of continuing concern to the Chief Justice of the Supreme Court of the United States, and he has urged the courts to bring about a more economical administration of bankruptcy cases. These costs are likewise of equal concern to the Judicial Conference of the United States. A series of studies of these costs was recently completed by the Administrative Office of the United States Courts. These costs, which include receivers and trustees costs and expenses; reporting, accounting and auctioneers' fees; attorneys fees for creditors, receivers, and trustees; rent and other expenses; and contributions to the Referees' Salary and Expense Fund, amounted to 26.4 per cent in asset cases having an average realization of \$5,688.00, and this is considered too high. The average costs of administration in the Eastern District of Wisconsin amounted to 24.8 per cent. Since receivers' fees and trustees' fees are strictly limited in asset cases by section 48 of the Bankruptcy Act and since attorney fees and all other fees are subject to the economical spirit of the Bankruptcy Act, it would appear that bankruptcy proceedings are less costly than state court liquidation proceedings.

In fiscal year 1964, 171,719 bankruptcy cases were filed in the United States, a 10.4 per cent increase over the prior year. Of this number, 2,615 cases were filed in the United States District Court for the Eastern District of Wisconsin and approximately 700 in the Western District of Wisconsin. About 10 per cent of these cases are business or asset cases. A check of the files of the Circuit Court of Milwaukee County dis-

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<sup>28</sup> 18 U.S.C. §§ 152-54 (1958).

<sup>29</sup> 18 U.S.C. § 3057 (1958).

closes that only 17 voluntary assignments and 9 receiverships were filed in the calendar year 1963. If approximately the same number of receiverships and voluntary assignments are being filed in the state courts throughout the state of Wisconsin, it is apparent that the greater number of business insolvencies are being administered in the federal courts.

#### CONCLUSION

This discussion is not intended to be the last word on the subject matter. Indeed, it is the author's belief that this topic does not lend itself to black letter rules. It is hoped, however, that the thoughts discussed herein may be of some assistance and serve as a guide for participation in proceedings under chapter 128 of the Wisconsin statutes.