

AN APPROACH TO UNCONSCIONABILITY IN
THE FEDERAL BANKRUPTCY COURTS

In re Elkins-Dell Mfg. Co., 253 F. Supp. 864 (E.D. Pa. 1966)

In re Elkins-Dell Manufacturing Company,¹ indicates that at least one federal district will use bankruptcy's broad equity powers to enable its referees to nullify a security agreement when "the sum total of its provisions drives too hard a bargain for a court of conscience to assist."²

The bankrupt and Fidelity America Financial Corporation entered into an agreement whereby the latter would finance the former against an assignment of accounts receivable. The agreement stipulated that the assignor would pay about 16% interest (or a minimum of \$500 a month) on the loans,³ and that Fidelity would lend 75% of the face amount of the accounts that it might choose. Elkins-Dell was allowed to borrow only from Fidelity, who could have the former's mail sent directly to it for disposition as it wished. The borrower agreed not to file a voluntary petition in bankruptcy without the written consent of Fidelity. Substantial amounts were loaned and collections were made against the advances. When the involuntary petition was filed against Elkins-Dell, about \$14,000 was still owing;

1. 253 F. Supp. 864 (E.D. Pa. 1966).

2. *Id.* at 867, quoting *Campbell Soup Co. v. Wentz*, 172 F.2d 80, 84 (3d Cir. 1948). In the companion case, *In re Dorset Steel Equip. Co., Inc.*, 253 F. Supp. 864 (E.D. Pa. 1966) (hereinafter cited as *Dorset Steel*), the court reached a similar result on only slightly different facts.

3. In *Dorset Steel*, the security agreements were essentially the same, except the interest rate was about 18% and the minimum interest per month was \$250. At the date of adjudication there was still an unpaid balance due Fidelity of over \$11,000, and Fidelity filed as a secured creditor for this amount. The referee disallowed the security, but allowed Fidelity to file as an unsecured creditor, and ordered it to refund to the trustee all interest in excess of 6% already collected. The referee further declared that the unconscionability provisions of the UNIFORM COMMERCIAL CODE § 2-302 (1962) were not limited to sales contracts (also suggested in 5 A. CORBIN, CONTRACTS § 1164 (Supp. 1962)) and were directly applicable here to nullify the security agreement. The code section states:

(1) If the court as a matter of law finds the contract or any clause of the contract to have been unconscionable at the time it was made the court may refuse to enforce the contract, or it may enforce the remainder of the contract without the unconscionable clause, or it may so limit the application of any unconscionable clause as to avoid any unconscionable result.

(2) When it is claimed or appears to the court that the contract or any clause thereof may be unconscionable the parties shall be afforded a reasonable opportunity to present evidence as to its commercial setting, purpose and effect to aid the court in making the determination.

Compare these "criteria" with the suggestions of the court in the principal case for determining unconscionability. *In re Elkins-Dell Mfg. Co.*, 253 F. Supp. 864, 873-74, (E.D. Pa. 1966).

however, continued collections created a credit balance of \$2,000 within a month. By the date of adjudication, the credit balance was as high as \$10,678. Between the filing and the adjudication, the trustee demanded an accounting; it was rendered and exceptions were taken. Drawing on *Campbell Soup Co. v. Wentz*,⁴ the referee declared the security agreement unconscionable,⁵ and ordered Fidelity to turn over to the estate the money collected on the accounts after the petition was filed,⁶ the advance on the minimum interest paid by the bankrupt, and all interest in excess of 6% since the first loan was made.⁷

In support of the referee's basic premise that the inherent equity powers of a bankruptcy court entitle it to declare a security agreement unconscionable, the *Elkins-Dell* court indicated that bankruptcy powers extend not only to the issuance of orders and the granting of the relief sought, but also to an examination of the circumstances surrounding any claim to see that injustice or unfairness is not done in administering the estate.⁸ Emphasizing that the federal courts of bankruptcy are "essentially courts of equity, and their proceedings inherently proceedings in equity,"⁹ the district court remanded solely because of the criteria used by the referee for the determination of unconscionability.

Noting a possible conflict with an earlier Supreme Court decision, the district court distinguished *Manufacturer's Finance Co. v. McKey*¹⁰ whose salient facts varied little from the case at bar. In *McKey*, the lower court affirmed a referee's order adjusting the effective interest rate on the assignment of the accounts receivable of the bankrupt to the creditor finance company. When a receiver was appointed for the then solvent debtor, the creditor attempted to force the receiver to comply with the terms of the

4. 172 F.2d 80 (3d Cir. 1948).

5. 39 REF. J. 115 (1965).

6. If the security agreement is void *ab initio* for unconscionability, it is curious that the referee did *not* order Fidelity to turn over payments within four months of bankruptcy, which payments would have constituted a preference. Presumably, Fidelity was aware of the borrower's financial straits, and the payments were for an antecedent debt (prior loans), thereby satisfying the requirements of a preference. Bankruptcy Act § 60, 11 U.S.C. § 96 (1964).

7. "The interest rate would have been usurious, except for the Pennsylvania statute [PA. STAT. ANN. tit. 15, § 1313 (1967)] which precludes a corporation from raising the defense of usury." *In re Elkins-Dell Mfg. Co.*, 253 F. Supp. 864, 866 (E.D. Pa. 1966).

8. *Id.* at 867-68, citing *Pepper v. Litton*, 308 U.S. 295, 307-08 (1939); *accord*, *Central States Corp. v. Luther*, 215 F.2d 38 (10th Cir. 1954), *cert. denied*, 348 U.S. 951 (1955).

9. *Local Loan Co. v. Hunt*, 292 U.S. 234, 240, (1934).

10. 294 U.S. 442 (1935).

contract insofar as they affected the accounts already assigned. The debt outstanding at the time of receivership had been paid, but the "service charge" or interest had not, and the receiver, as well as the circuit court,¹¹ refused to allow the creditor's claim in excess of the rate of 7%, or only about one-third the amount claimed. The Supreme Court reversed, noting that the parties dealt at arm's length, that there was no fraud in the contract, and that the creditor arrived in a federal court of equity asserting what would otherwise have been only a *legal* right.¹²

The mere fact that a party is obliged to go into a federal court of equity to enforce an essentially legal right arising upon a contract valid and unassailable under controlling state law does not authorize that court to modify or ignore the terms of the legal obligation upon the claim, or because the court thinks that these terms are harsh or oppressive or unreasonable. A party may stand upon the terms of a valid contract in a court of equity as he may in a court of law. "If he asks no favors, he need grant none."¹³

Interestingly, the *McKey* court continued:

"But if he calls upon a court of chancery to put forth its extraordinary powers and grant him purely equitable relief, he may with propriety be required to submit to the operation of a rule which always applies in such cases, and do equity in order to get equity."¹⁴

Thus, legal rights stand as strong in chancery as in a court of law, no matter what the appeal to the conscience of the chancellor.¹⁵ Unless the plaintiff enters a court of equity seeking equitable relief,¹⁶ a court of equity is powerless to change the terms of a contract, in the absence of fraud, accident or mistake.¹⁷

The pronouncements in *McKey* seem dispositive of the issues in *Elkins-Dell*, but the Eastern District of Pennsylvania was far from satisfied, noting

11. *Manufacturers' Fin. Co. v. McKey*, 72 F.2d 471 (7th Cir. 1934), *rev'd*, 294 U.S. 442 (1935).

12. *Manufacturers' Fin. Co. v. McKey*, 294 U.S. 442, 448 (1935).

13. *Id.* at 448-49.

14. *Id.*, quoting *Fosdick v. Schall*, 99 U.S. 235, 253 (1898).

15. *Colonial Trust Co. v. Central Trust Co.*, 243 Pa. 268, 276, 90 Atl 189, 191 (1914).

16. As was the situation in *Campbell Soup Co. v. Wentz*, 172 F.2d 80 (3d Cir. 1948).

17. *Hedges v. Dixon County*, 150 U.S. 182, 189 (1893). *But see* Leff, *Unconscionability and the Code—The Emperor's New Clause*, 115 U. PA. L. REV. 485, 534 (1967) wherein the author suggests that "there is nothing in an 'equitable' doctrine as such that particularly makes it unfitted for importation into an action which would historically have been an action 'at law.'"

significant dissimilarities between the cases. In contrast to the lender's situation in *McKey*, Fidelity, as creditor in *Elkins-Dell*, "relies on its security" and is "asking a favor" of the bankruptcy court."¹⁸ Apparently, this refers to the fact that Fidelity continued to collect on the security after the petition was filed, "a course which requires the approval of the bankruptcy court."¹⁹ The court does not tell us how the collections were made prior to bankruptcy, but it is nearly certain that payments by customers of the bankrupt were made directly to Fidelity all along. If this is so, it is difficult to see how the continuation of this practice turns the proceeding into one of equity. The manner of collection during the bankruptcy proceedings was undoubtedly a matter of convenience, of which the referee was fully aware. His rubber-stamp approval of this technique hardly seems reason to deny Fidelity the relief requested, notwithstanding any technical distinctions between "equity" and "law" drawn by either the *Elkins-Dell* or the *McKey* courts.²⁰ However, the *Elkins-Dell* court insisted that as to both debtors, Fidelity "asked for the affirmative aid of the bankruptcy court to secure its preferred position in the bankruptcy. That aid having been invoked, equitable scrutiny attaches."²¹ The alleged distinction between this situation and *McKey* is that in the principle case, the creditor was seeking equitable relief whereas in the *McKey* case, the creditor was "obliged to submit the determination of his strictly legal rights to a chancery court because it has plenary control of the remedy."²² The distinction is dubious, because regardless of the forum, both creditors were merely attempting to be reimbursed for loans made under a security agreement.

The further distinction is made by the court in *Elkins-Dell* that state law is no longer controlling.²³ The *McKey* court had relied heavily on the enforceability of the agreement to pay usurious interest rates under the controlling state law. Similar rules apply under the laws of Pennsylvania, the state in which Fidelity made its loan agreements. But, "the validity of the claim under state law would be no bar to disallowing it in bankruptcy because the bankruptcy court must exercise [the] authority granted by Congress to determine how and what claims shall be allowed under equitable

18. *In re Elkins-Dell Mfg. Co.*, 253 F. Supp. 864, 869 (E.D. Pa. 1966).

19. *Id.*

20. See quote in note 17, *supra*.

21. *In re Elkins-Dell Mfg. Co.*, 253 F. Supp. 864, 869 (E.D. Pa. 1966). In *Dorset Steel*, the court reasoned similarly when Fidelity filed a secured claim under its security agreement.

22. *Manufacturers' Fin. Co. v. McKey*, 294 U.S. 442, 451 (1935).

23. See *Heiser v. Woodruff*, 327 U.S. 726 (1945).

principles.'²⁴ Although appealing at first glance, this argument of the *Elkins-Dell* court is incomplete, for it suggests no compelling federal law to the contrary which insists that the court nullify the security agreement. If, indeed, the contract is unconscionable, the issue is still whether *equitable* principles (be they federal *or* state) apply, or do *legal* principles apply? The court's reasoning insufficiently establishes that a federal bankruptcy court need impose equitable doctrines in this situation.

Finally, the *Elkins-Dell* court points out that Fidelity could seek relief only in the bankruptcy court, whereas Campbell Soup Co. could have sought damages in a court of law.²⁵ The *McKey* decision indicates that the exclusiveness of the remedy in the equity court should not jeopardize plaintiff's rights.²⁶ While obliged to submit the determination of his strictly legal rights to a chancellor only because the latter has plenary control of the remedy, a plaintiff should not be penalized, even though an otherwise valid contract which he is asserting drives a hard bargain for the other party.²⁷ In *McKey*, the court states that if a plaintiff has *no other forum* in which to press his claim but an equity court, then that court should not conjure up equitable maxims and refuse to enforce that claim.²⁸ But the *Elkins-Dell* court implies that Fidelity should not be able to avail itself of this reasoning. There was some indication that the harshness of Fidelity's bargain may have precipitated the bankruptcies, and that if the bankruptcy court is the only forum in which Fidelity could press its claim, this is a situation of its own making. But this distinction from *McKey* also leaves much to be desired, for as this court admits, it rests on implications not sufficiently supported by the record.²⁹ The distinctions between this case and *McKey* drawn by the *Elkins-Dell* court are tenuous and unconvincing, and it seems that this court is subtly sidestepping the mandates of the decision in *McKey*.

Although the distinctions drawn between the *McKey* case and *Elkins-*

24. *In re Elkins-Dell Mfg. Co.*, 253 F. Supp. 864, 869 (E.D. Pa. 1966) (citation omitted).

25. *Id.* at 870.

26. Whether or not plaintiff's rights will in fact be jeopardized is a matter of conjecture. See Leff, *supra* note 17, at 541 n.237.

27. *Manufacturers' Fin. Co. v. McKey*, 294 U.S. 442, 451 (1935).

28. *C.f.*, *Campbell Soup Co. v. Wentz*, 172 F.2d 80, 83 (3d Cir. 1948).

29. A finding that Fidelity itself bargained away its choice of remedies by making the bankruptcy more certain—that it is, loosely speaking, estopped from complaining of the scrutiny which equity gives its claims—would have to be predicated on more than speculation about the effect the contracts had on the bankrupt's businesses. *In re Elkins-Dell Mfg. Co.*, 253 F. Supp. 864, 870 n.2 (E.D. Pa. 1966).

Dell are somewhat oblique, the district court may have been justified in attempting to side-step the mandate laid down in the ancient Supreme Court decision, for there exists a continuing line of decisions applying equitable doctrines. That bankruptcy courts attempt to "do equity" is not a novel idea.³⁰ Section 2(a) of the Bankruptcy Act invests these courts with "jurisdiction . . . in equity."³¹ Within the confines of the Act itself, and under special rules of practice prescribed by the Supreme Court, the proceedings are to be administered in accord with the general principles of equity.³² New remedies may be contrived where those at law are inadequate,³³ but the equitable powers of the court are to be exercised within the limits of the Act³⁴ and subject to its dictates.³⁵ The court has summary jurisdiction to determine all claims against the property of the bankrupt estate,³⁶ but this jurisdiction does not extend to conducting plenary suits to settle claims having no proper relation to the business with which the court is entrusted.³⁷ On the other hand, bankruptcy and related courts have extended relief such as making distributions to junior lien-holders,³⁸ striking down vague and ambiguous subordination provisions of debentures and putting the holders thereof into the class of general creditors along with note holders who had not relied on the subordination provisions,³⁹ granting an injunction against a railroad for the sale of pledged collateral,⁴⁰ returning

30. *See* *Prudence Realization Corp. v. Geist*, 316 U.S. 89 (1942); *SEC v. United States Realty & Improvement Co.*, 310 U.S. 434 (1940); *Pepper v. Litton*, 308 U.S. 295 (1939). For a breakdown of equity powers exercised by the court, see 1 W. COLLIER, *BANKRUPTCY* § 2.09 n.1 (14th ed. 1966).

31. 11 U.S.C. § 11 (1964).

32. *In re Lustron Corp.*, 184 F.2d 789 (7th Cir.), *cert. denied*, 340 U.S. 946 (1950).

33. *See* *Tyler v. Marine Midland Trust Co.*, 128 F.2d 927 (2d Cir. 1942); *Scottsville Nat'l Bank v. Gilmer*, 37 F.2d 227 (4th Cir. 1930); *In re Franklin Brewing Co.*, 254 Fed. 910 (E.D.N.Y. 1918). And a bankruptcy court may adopt remedies that a local state court would apply. *In re Gunning*, 124 F.2d 7 (9th Cir. 1941).

34. *SEC v. United States Realty & Improvement Co.*, 310 U.S. 434 (1940).

35. *Id.* at 455. *See also*, *Pepper v. Litton*, 308 U.S. 295 (1939). Some courts have thought the *Pepper* case sanctions almost any use of equitable power in a bankruptcy court. *In re Bender Body Co.*, 47 F. Supp. 867 (N.D. Ohio), *aff'd*, 139 F.2d 128 (6th Cir. 1942); *In re Credit Service, Inc.*, 45 F. Supp. 890 (D. Md. 1942). The suit itself is not a "suit in equity" either by statutory or common-sense definition of that term. *Columbia Gas & Elec. Corp. v. American Fuel & Power Co.*, 322 U.S. 379 (1944).

36. 11 U.S.C. § 46a (1964).

37. *Smith v. Chase Nat'l Bank*, 84 F.2d 608 (8th Cir. 1936); *c.f.*, *Katchen v. Landy*, 382 U.S. 323 (1966). However, if the administration of the estate cannot properly proceed without the settlement of the controversy, the bankruptcy court will assume jurisdiction, *In re Burton Coal Co.*, 126 F.2d 447 (7th Cir. 1942), or will stay proceedings until the matter is decided by the appropriate court.

38. *In re Evergreen Memorial Park Ass'n*, 308 F.2d 65 (3d Cir. 1962).

39. *In re Joe Newcomer Fin. Co.*, 226 F. Supp. 387 (D. Colo. 1964).

any surplus to the bankrupt after the creditors are paid in full,⁴¹ appointing special masters (before the advent of the Federal Rules of Civil Procedure),⁴² declaring a deed to be a mortgage,⁴³ reopening an order of dismissal,⁴⁴ requiring refunds of unauthorized payments as a condition to the allowance of claims,⁴⁵ imposing equitable conditions upon the granting of a reclamation petition,⁴⁶ applying the equitable doctrine of laches,⁴⁷ and reforming a chattel mortgage on fixtures and merchandise to eliminate the provisions covering merchandise if the court is convinced that they were inserted through mutual mistake of fact.⁴⁸ The full list of equity relief granted by the bankruptcy court is long, the situations varied, and the relief given extensive. The courts have simply adapted the traditions of equity to meet the circumstances at hand. And if unconscionability is a worthwhile legal doctrine, there is little reason for stopping short of it in bankruptcy, if it is applied cautiously and with due regard for the rights of the creditor who is asserting his claim, be it legal or equitable, under an allegedly unconscionable agreement. The distinction in *McKey* between seeking legal and equitable relief seem spurious in terms of modern judicial reasoning, and perhaps that case should be overruled, so that lower courts like the *Elkins-Dell* court would not have to draw doubtful distinctions between its decisions and that of *McKey*. Perhaps the exceptions to the limitations on the power of the equity courts to change a contract should now include unconscionability. As Corbin suggests:

It is difficult to believe, however, that the judges of today, practically all of them "chancellors" as well as "judges," can fail to be influenced by equitable doctrines in the granting of any of the remedies that are available. There is sufficient flexibility in the concepts of fraud, duress, misrepresentation, and undue influence, not to mention differences in bargaining power, to enable the courts to avoid enforcement of a bargain that is shown to be unconscionable. . . .⁴⁹

40. *Continental Illinois Nat'l Bank & Trust Co. v. Chicago, Rock Is. & Pac. Ry. Co.*, 294 U.S. 648 (1935) (a railroad reorganization case).

41. *In re Lennox*, 2 F.2d 92, 93 (W.D. Pa. 1924).

42. *Berl v. Crutcher*, 60 F.2d 440 (5th Cir. 1932), *cert. denied*, 287 U.S. 670 (1933).

43. *In re Euclid Doan Co.*, 104 F.2d 712 (6th Cir. 1939).

44. *Kroell v. New York Ambassador, Inc.*, 108 F.2d 294 (2d Cir. 1939).

45. *In re Wil-Low Cafeterias, Inc.*, 35 F. Supp. 965 (S.D.N.Y. 1940).

46. *In re Detroit Macaroni Co.*, 46 F. Supp. 284 (E.D. Mich. 1942).

47. *Continental Can Co., Inc. v. Graham*, 220 F.2d 420 (6th Cir. 1955).

48. *In re Traymore Shoe Shops, Inc.*, 300 Fed. 245 (S.D.N.Y. 1923) (dictum); *In re Brenner*, 190 Fed. 209 (D. Pa. 1911).

49. 1 A. CORBIN, *CONTRACTS* § 128 (1950).

If bankruptcy courts are indeed courts of equity, whose intention is to protect all of the creditors of the debtor, as well as the debtor himself, there would seem to be no reason not to extend the relief as Corbin proposes.

Moreover, it is difficult to avoid the conclusion that the result reached in the principal case was both sensible and desirable. The contract therein seemed one-sided and there was some inference that it was the base of the troubles that drove Elkins-Dell under.⁵⁰ If a factor has forced an unreasonable contract upon a relatively defenseless company in a strictly sellers' market, then for the sake of the other creditors of a bankrupt, there ought to be (at least) a modification of the contract in order to make it more equitable to all concerned.⁵¹ Although the bankruptcy court would not be allowed to charge a penalty against the factor for driving so hard a bargain,⁵² it still must enforce the purposes of the Bankruptcy Act by securing an equitable distribution of an insolvent debtor's estate.⁵³ The differences between "law" and "equity" are age-old. However, the necessity of retaining the distinction in such a situation in a court whose essential duty is to protect a large number of creditors as well as the debtor may be dubious. At any rate, perhaps the application of the doctrine of unconscionability should no longer depend on the kind of relief initially sought by the claimant, as suggested by the *McKey* court, but rather on the appropriateness of the situation and the proposed remedy.

Finally, once it is accepted that unconscionability is applicable when appropriate in bankruptcy proceedings, the exercise of caution is essential to maintain the balance of fairness sought in a court of equity.⁵⁴ Indicative of such caution are the elaborate instructions⁵⁵ issued by the court on re-

50. Note 29, *supra*.

51. As one author points out, the harshness in *Campbell Soup* which would arise from enforcing the contract was not directed at the unfairness complained of and found to exist. Leff, *supra* note 17, at 538. In the case of *Elkins-Dell*, however, the harshness of enforcing the bargain directly related to the unfairness complained of.

52. *In re Black Ranches, Inc.*, 362 F.2d 8 (8th Cir. 1966); *In re Tastycast, Inc.*, 126 F.2d 879 (3d Cir. 1942).

53. *In re Laskin*, 316 F.2d 70, 72 (3d Cir. 1963).

54. If the security agreements between Fidelity and the bankrupts were indeed unconscionable, the factor will be allowed to prove its claims as an unsecured creditor. *In re Elkins-Dell Mfg. Co.*, 253 F. Supp. 864, 874 (E.D. Pa. 1966); see 3 W. COLLIER, BANKRUPTCY § 57.20[4] (14th ed. 1966).

55. The criteria for determining the conscionability of an agreement are set down by the court as follows: (a) financial positions of the bankrupts when the contracts were made; (b) extent to which agreements like this are customary among lenders like Fidelity; (c) extent to which Fidelity's contracts vary with and reflect anticipated risks; (d) availability of other credit to the bankrupts, both at the time and after they en-

mand to the referee. The care exercised by the district court is explicable in light of its unique position leaving it in conflict with an antiquated Supreme Court decision.

tered into the agreements; (e) ability to secure other funds; (f) amount of facilitation of commerce by making new funds available; (g) effect of holding these contracts enforceable on such future agreements. A further discussion of the *Elkins-Dell* criteria is contained in 40 S. CAL. L. REV. 165 (1967).

The UCC also indicates some factors to help in the determination of conscionability. Note 3, *supra*. At least one source feels that these criteria, if they can be called such, are inadequate to inform the court of precisely what the framers of the Code intended when they included section 2-302. Leff, *supra* note 17. Perhaps "unconscionability" is comparable to Justice Stewart's "definition" of obscenity, when he said:

I shall not today attempt further to define the kinds of material I understand to be embraced within that shorthand description; and perhaps I could never succeed in intelligibly doing so. But I know it when I see it, . . . *Jacobellis v. Ohio*, 378 U.S. 184, 197 (1964) (concurring opinion).

Unconscionability is no less elusive a doctrine to define and to spot, and one wonders about the type of testimony to be given on remand before the referees in *Elkins-Dell* and *Dorset Steel*. *C.f.*, Leff, *supra* note 17, at 544-45. Whether or not this problem will seriously interfere with the application of the doctrine in bankruptcy cases, or for that matter, in any situation where unconscionability need be applied, is a matter yet to be determined.