Bankruptcy

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The Court of Appeals for the Fifth Circuit rendered several opinions in 1975 involving bankruptcy law and practice. This article highlights the most important of those decisions with a view toward their application by the practitioner.

I. JURISDICTION

A frequent pitfall for the general practitioner engaged in litigation in the bankruptcy court is the failure to recognize the distinction between summary and plenary jurisdiction. Summary jurisdiction encompasses the administration of the bankruptcy estate and the rights to property in the possession of the bankruptcy court, while plenary jurisdiction refers to the jurisdiction of the federal district court or other courts to determine the rights of third parties and the bankruptcy receiver or trustee in property not in possession of the bankruptcy court. A right to have a matter determined in a plenary action may be waived if objection to the exercise of summary jurisdiction is not raised prior to a hearing on the merits in the bankruptcy court. As any experienced litigator knows, the exercise of the right to a plenary trial may have decided procedural advantages for a defendant.

Objection to the exercise of summary jurisdiction by the bankruptcy court need not be raised in formal pleadings, according to the Fifth Circuit in In re Airmotive Suppliers, Inc. In Airmotive Suppliers the bankrupt, three months prior to filing a Chapter XI petition, delivered to the Internal Revenue Service three promissory notes having a face value of nearly $600,000.00 made by the National Airline of Ecuador. The bankrupt and the IRS had agreed that the notes were to secure the payment of past-due taxes, penalties and interest, and that the notes could be redeemed by tendering such taxes, penalties and interest. The assessment of penalties, however, would have left the estate with nothing out of the proceeds of the notes. The Government filed a proof of claim for only $253,000.00 for un-
paid taxes; no provision was made in the proof of claim for penalties.

The trustee brought this action to determine whether the IRS had any interest in the notes for the purpose of paying pre-petition or post-petition penalties against the bankrupt. The bankruptcy judge entered an order declaring that the Government had no interest in the notes or the proceeds of the notes for the payment of penalties, and the district court affirmed. The United States appealed, claiming that the bankruptcy judge lacked jurisdiction.

Section 2a(7) of the Bankruptcy Act4 provides in part that a party failing to object to summary jurisdiction by answer or motion filed before the expiration of the time prescribed by law or rule of court or fixed or extended by order of court for the filing of an answer to the petition, motion or other pleading to which he is adverse, he shall be deemed to have consented to such jurisdiction.5

In Airmotive Suppliers the Government had not raised its objection to summary jurisdiction in its answer or by motion. Nonetheless, the Fifth Circuit reversed the judgment of the court below, holding that since the Government intended to interpose such an objection and since its objection had been raised before the bankruptcy court, it had preserved its right to object. The trustee had conceded at the hearing before the bankruptcy court that the United States had objected to the exercise of summary jurisdiction, and the issue had been raised anew on appeal to the district court. The Fifth Circuit further held that the filing of a proof of claim by the Government for unpaid taxes without penalties did not confer summary jurisdiction on the bankruptcy court.

The fact that the Government had possession of the three promissory notes with something more than a colorable claim entitled the Government to a plenary action in the absence of consent. In so deciding, the court relied upon the recent case of Phelps v. United States.6 The Phelps case presented an almost identical issue on facts even more favorable to the fiduciary. There, funds had been paid into the hands of an assignee for the benefit of creditors and the IRS had levied upon those funds. The assignee claimed no interest in the fund. The receiver argued that the bankruptcy court had summary jurisdiction to enter a turnover order because the property was held by a person who made no claim to it. The Supreme Court rejected this argument, holding that the valid levy of the United States upon the fund gave the Government constructive possession. The Court rejected the argument that actual possession was necessary and held that the petitioner's reliance upon section 67c(3)7 of the Act was misplaced.

4. 11 U.S.C.A. §11a(7) (Rev. 1966). [References to the Bankruptcy Act hereinafter will be to the "Act."]
since the issue was not the priority of liens but rather the effect of a tax levy. In effect, the Court held that the notice of levy and demand were equivalent to seizure.

Assuming that the oral objection to jurisdiction in *Airmotive Suppliers* was in effect a motion, that case appears to be in accordance with decisions in other circuits. Nonetheless, the practitioner is cautioned that the raising of jurisdictional defenses is governed by Bankruptcy Rules 712 and 915, which require the objection to be made by timely motion or answer. What will be deemed timely may vary depending upon the facts of the case, but it is clear that an objection made after the entry of an order deciding the matter under consideration is too late.

II. DISCHARGE

In *In re McBee* the Fifth Circuit held that the bankruptcy court’s denial of a husband’s and wife’s discharge was justified where the bankrupts had failed to support adequately with records an alleged gambling loss of $14,000.00. The court rejected the bankrupt husband’s contention that gambling records were inherently impracticable to maintain. The only evidence of the alleged loss that the husband presented was airline ticket stubs and hotel receipts. The bankruptcy judge had held that these records were insufficient to constitute an explanation of the loss of assets within the meaning of section 14c(7) of the Act in spite of the fact that gambling records were by their very nature difficult to obtain. It was uncontroverted that the money in question belonged solely to the bankrupt’s wife, and on that basis the husband contended that since the money didn’t belong to him, he should not have to account for it. This argument was rejected by the court since the husband apparently had absolute control over his wife’s income and assets. The court also affirmed the denial of the wife’s discharge since the absence of records applied as evenly to her as it did to him. The court noted that although there was uncontradicted testimony that she did not know about her husband’s gambling spree, she did participate in a “stealthy handling” of the money, and in any event “collusion would be virtually impossible to prove.”

The case of *In re Boydston* involved an attempt by the bankrupt’s creditors to have certain debts declared non-dischargeable under section 17a(2) of the Act. The bankrupt and his wife had incurred indebtedness

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8. See *In re Los Angeles Trust Deed & Mortgage Exch.*, 464 F.2d 1136 (9th Cir. 1972) and *In re Perspectron, Inc.*, 422 F.2d 576 (7th Cir. 1970).
9. 2 Collier ¶23.08, at 548.
10. 512 F.2d 504 (5th Cir. 1975).
12. 512 F.2d at 506.
13. 520 F.2d 1098 (5th Cir. 1975).
of almost $32,000.00 in a five-month period prior to the filing of their petition. Most of the indebtedness was for non-essential personal expenses and had been charged on credit cards. The district court affirmed the bankruptcy judge's decision that the debts were dischargeable in that the creditors had not proven subjective intent not to pay for credit purchases. The Fifth Circuit likewise affirmed, finding that there was sufficient evidence in the record to sustain the original findings of fact, and that since those findings were not clearly erroneous they were binding upon the appellate court. By way of dictum the court stated that "[w]here hopeless insolvency at the time of purchase makes payment impossible, fraudulent intent may be inferred." The creditors, however, had failed to introduce any evidence concerning the bankrupt's solvency at the time the debts were incurred.

The Boydston case is notable for the court's indication that in a proper case it would overrule Davison-Paxon Co. v. Caldwell. In Davison-Paxon the Fifth Circuit had held that the phrase "obtaining property by false pretenses or false representations" contained in section 17a(2) did not encompass credit purchases with no intention of paying for them.

III. Procedure

In Windbrooke Development Corp. v. Environmental Enterprises, Inc. the Fifth Circuit considered the very narrow issue of whether the filing of an involuntary petition in bankruptcy tolls the four-month statutory period pertaining to preferential transfers where the summons is not issued until 24 days following the filing of the petition. The court affirmed the district court's decision and adopted the district court's opinion in full. The lower court had held that since the Bankruptcy Rules are similar to the Federal Rules of Civil Procedure, the settled interpretation of the latter rules should govern. Under Fed.R.Civ.P. 3, a civil action is commenced by the filing of a complaint, especially if there has been no lack of diligence in obtaining service of process. In Windbrooke the action had been properly commenced by the filing of an involuntary petition, and the failure to issue the summons immediately was not the fault of the petitioning creditors. Accordingly, the four-month statutory period was tolled; section 60a(1) of the Act measures the four-month period with respect to voidable preferences from the date of the filing of the petition.

The scope of appellate review of orders arising out of bankruptcy cases

15. 520 F.2d at 1101.
16. 115 F.2d 189 (5th Cir. 1940), cert. denied, 313 U.S. 564, 61 S.Ct. 841, 9 L.Ed.2d 748 (1941).
17. Id. at 191.
18. 524 F.2d 461 (5th Cir. 1975).
was the subject of In re Durensky. In that case, the bankrupt’s petition and schedules filed in 1972 listed the United States as a creditor with respect to income taxes alleged to be due for the years 1964 and 1965. Although the Government received notice of the bankruptcy, it never took any steps to perfect its claim and, in fact, never participated in any way in the proceedings. On May 25, 1972, the bankruptcy court entered an order discharging Durensky from his debts. Later that year, the Internal Revenue Service determined that Durensky did, in fact, owe approximately $90,000.00 in back taxes for the years 1964 and 1965, and served a “Final Notice Before Seizure” on him demanding payment. The bankrupt responded by filing in the bankruptcy court an application to determine the dischargeability of his tax liability under section 17c(1) of the Act. The bankruptcy court issued an order restraining the Government from seizing any of the bankrupt’s property and later denied the IRS’s motion to dismiss the application. The IRS appealed, arguing that the bankruptcy court had no subject-matter jurisdiction. The district court expressed the view that the bankruptcy court did have jurisdiction, and further held that the order denying the motion to dismiss for lack of jurisdiction was not appealable. The Fifth Circuit affirmed on the issue of appealability.

Section 24a of the Act refers to “proceedings in bankruptcy” and to “controversies arising in proceedings in bankruptcy.” That section provides that appeals as a matter of right may be taken from interlocutory or final orders in proceedings in bankruptcy, but only from final orders in controversies arising in proceedings in bankruptcy. The term “proceedings” relates to matters of administration of the bankrupt’s estate, while the term “controversies” refers to adversary proceedings involving the right and title to the bankrupt’s estate. The Fifth Circuit determined that the bankrupt’s application to determine the dischargeability of a claim was a “proceeding” rather than a “controversy” within the meaning of the statute. Nonetheless, the court found that the order was not appealable in that it did not dispose of any right or duty asserted by the parties and did not possess any “definitive operative finality.” The court was persuaded that the policy against piecemeal appeals and the policy of expeditious handling of bankruptcy matters outweighed any practical advantage of an immediate decision on the jurisdictional point.

Pennington v. Toyomenka, Inc., while not illustrating any principle of

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20. 519 F.2d 1024 (5th Cir. 1975).
22. In reliance on the district court’s dictum, two other circuits have ruled that bankruptcy courts have jurisdiction under §47(a) of the Act to determine the dischargeability of tax liability in similar circumstances. In re Bostwick, 521 F.2d 741 (8th Cir. 1975); In re Gwilliam, 519 F.2d 407 (9th Cir. 1975).
24. 519 F.2d at 1029.
25. 512 F.2d 1291 (5th Cir. 1975).
bankruptcy law, does emphasize the fact that bankruptcy trustees, in pursuing claims under the Act against creditors of the bankrupt or others in plenary actions, must comply with the rules governing plaintiffs generally. In Toyomenka the bankruptcy trustee had filed an action in the Northern District of Georgia to set aside an alleged voidable preference to Toyomenka in the amount of $99,524.00. Toyomenka, a New York corporation, was served in New York under the Georgia long-arm statute. The trustee commenced the action only two months prior to the expiration of the two-year statute of limitations. Toyomenka moved to dismiss the complaint on the ground that it did not transact business within Georgia and that it was therefore not subject to jurisdiction there. The Fifth Circuit affirmed the district court, holding that under Georgia case law Toyomenka had not transacted business in Georgia within the meaning of the long-arm statute. By the time the district court had rendered its decision, the statute of limitations had run, thus preventing the reinstatement of the lawsuit in New York.

IV. THE AVAILABILITY OF SET-OFF

In Rochelle v. United States, the Fifth Circuit in a very thorough opinion held that a third party indebted to a bankrupt partner may set off against that debt its claim against the bankrupt partnership. This case examines the relationship between sections 5g and 68 of the Act.

The plaintiff, trustee of the estate of a bankrupt partner, sued the United States to recover an income tax refund admittedly owed to the bankrupt. The bankrupt had formed a partnership with a corporation in New York to operate a pavilion at the 1964 New York World's Fair. The partnership, however, owed the United States withholding and other taxes for which the United States had filed claims against the bankrupt estates of both the partnership and the individual partner.

The trustee asserted that under section 5g the Government's claim against the estate of the partner was subordinated to the claims of other creditors of the individual partner, and, therefore, the set-off provisions of section 68 should not be available to the Government. The Government argued that the individual partner was liable for the partnership's tax debt, and, therefore, section 5g did not apply. In any event, the Government argued that it was entitled to claim a set-off.

Although the Fifth Circuit agreed that the Government had a claim against the individual partner, it pointed out that, with certain exceptions not material to this case, that claim was derived solely from the partner-

27. 521 F.2d 844 (5th Cir. 1975).
ship’s liability for partnership debts. Hence, creditors of a New York partnership must look to partnership assets before seeking to recover from individual partners. The court concluded that the Government’s claim was subordinated under section 5g:

It is clear that the term “individual debts” in section 5g refers to debts of the individual partner not imposed upon him derivatively as a result of partnership debts. Section 5g thus subordinates a partnership creditor—even though it is also an individual creditor in that it owns a claim against general partners imposed on the partners because of a partnership liability—to other kinds of individual creditors in the allocation of assets of the estates of the individual partners.  

Despite the Government’s subordinated position under section 5g with respect to any distribution, the court held that section 68 was available to permit set-off of the partnership’s debt to the Government against the Government’s debt to the individual partner. Thus, the subordination of a debt under section 5g is not a factor to be considered in applying section 68.

The court discussed at length the two basic fact patterns involving a partnership, a partner, and a third party which is a creditor of the one and a debtor of the other. In the first situation, the third party is indebted to the partnership but is a creditor of an individual partner. The third party or the individual partner might seek the benefit of a set-off. In either case, the other members of the partnership would lose the benefit of their claim against the third party without any corresponding benefit flowing to them. Hence, the court held that these debts are not mutual and that set-offs should not be permitted.

In the second basic factual pattern, an individual partner has a claim against a third party, which in turn has a claim against the partnership. In this situation, either the third party or a party sued on the partnership debt might seek to utilize a set-off. Section 68 is available to a partner who is a creditor of the third party and who is sued by the third party on a partnership debt, but only if the partners are jointly and severally liable for the partnership’s debts. In such case, the debts are clearly mutual.

On the other hand, a third party may seek to set off its claim against a partnership against a claim of one of the individual partners. This is the factual pattern of Rochelle in which the Fifth Circuit held that the debts are mutual within the meaning of section 68.

In Rochelle the court examined the relative positions of the parties with respect to the set-off to determine whether any party was losing any valuable benefit without a corresponding gain. In raising the defense of set-off, the third party loses a potential claim against the other partner in the partnership, but he does so at his own choosing. The individual partner

30. 521 F.2d at 850 (footnote omitted).
against whom the defense of set-off is raised has no complaint since the third party could, in any case, have sued him individually on the partnership debt. Finally, the remaining partner or partners of the partnership have no complaint since they are being relieved of the liability and are not giving up anything.

In addition to mutuality, a debt must be provable and allowable in order to be used for set-off under section 68. The Fifth Circuit noted that under section 63 of the Act, claims for taxes are provable despite the fact that taxes are not mentioned in that section: "The test is whether the claimant could have maintained an action against the bankrupt. Partnership claims are provable against the estates of the partners." As to allowability, the court noted that the claim of the Government was allowable and that section 57g of the Act, the only section arguably applicable to the facts of the case, was not helpful to plaintiff since the Government had not received a preference.

Finally, the court held that set-off was available to the Government despite the fact that its claim would otherwise have been subordinated under section 5g. In so holding, the court relied upon the judicial maxim of expressio unius est exclusio alterius. Section 68b specifically requires that claims be provable, but permits a set-off whether or not a claim is allowable unless the claim is not allowable under section 57g. Hence, the court reasoned: "If Congress intended a different result it would have drawn section 68 more narrowly than to permit set-off of all provable claims generally with but a single narrow exception . . . ." The court also noted that section 5g, requiring subordination with respect to distributions, was limited just to distribution and that Congress could have drawn that section more broadly. Further, not to permit the set-off in Rochelle would give rise to an incongruous interpretation of the Act: a subordinated claimant, who would be paid in full if there were sufficient assets, would not be entitled to benefits available to a claimant with a disallowed claim who would receive nothing even if there were sufficient assets to pay all claims in full.

V. PROPERTY PASSING TO THE TRUSTEE UNDER SECTION 70A(5)

In In re Nunnally, the Fifth Circuit dealt with the issue of dischargeability of a Texas divorce award, the issue of exemption of the cash surrender value of the life insurance policy under Texas law, and the issue of the trustee's interest in the bankrupt's retirement benefits. The first two issues
may be of some interest to Texas practitioners but will not be discussed here. The latter issue is of more general interest. In Nunnally the bankruptcy court and the district court held that the bankrupt's Navy retirement benefits did not constitute property under section 70a(5) of the Act and hence did not pass to the trustee in bankruptcy. Although it is not apparent on the face of the opinion whether either the appellant or cross-appellant challenged the correctness of this decision, the Fifth Circuit reviewed the decision below. The court held that retirement benefits clearly constituted property rights, that those rights were transferable, and that pension benefits therefore constitute the type of property that might pass to the trustee under section 70a(5) of the Act. The court concluded: "Even if the interest is contingent or subject to postponed enjoyment, it may pass to the trustee." The court found, however, that the benefits might well be paid when the bankrupt had no other source of income. Hence, the court affirmed, citing Kokoszka v. Belford. In Kokoszka the Supreme Court held that if an interest is a wage substitute for a future period such that the passing of the interest to the trustee would frustrate the bankrupt's attempt to make a new start in life, the property would not pass to the trustee.

Another interesting case involving the interpretation of section 70a(5) of the Act is McLoughlin v. Trust Co. of Georgia. In McLoughlin the bankrupt had a remainder interest in a trust created by his father's will. The trust instrument provided in part that upon the death or remarriage of the testator's wife, the trustee should divide the remaining property into as many equal shares as the testator then had children. The trustee was authorized to use the corpus of the trust in such amounts as it deemed necessary for the proper support and education of the testator's children. At the time that each child reached the age of 21, the trustee was directed to turn over to that child one-third of his share then held by the trustee; at age 25, the trustee was directed to turn over one-half of the remaining property; and, at age 35, the trustee was directed to turn over all of the remaining shares of the child still in the trustee's hands.

The testator and his wife had died in a common accident in 1962. One of their children had received his appropriate share at ages 21 and 25. At age 30, however, this child filed a voluntary bankruptcy petition. Therefore, the bankruptcy trustee sought to sell the bankrupt's remaining interest under the trust instrument. The bankrupt and the testamentary trustee objected on the ground that the interest in the corporate trust was not property within the meaning of section 70a(5). The bankruptcy court held that the bankrupt's interest in the trust funds passed to the trustee in

37. 506 F.2d at 1026.
39. 507 F.2d 177 (5th Cir. 1975).
bankruptcy and directed that no further payments be made to the bankrupt from the trust. On appeal, the district court reversed the prohibition against the bankrupt receiving any future discretionary payments but affirmed the remainder of the bankruptcy judge's judgment that the interest of the bankrupt passed to the trustee.

The trustee in bankruptcy and the testamentary trustee appealed. The Fifth Circuit affirmed. Section 70a(5) of the Act provides in part:

The trustee of the estate of a bankrupt and his successor or successors, if any, upon his or their appointment and qualification, shall in turn be vested by operation of law with the title of the bankrupt as of the date of the filing of the petition initiating a proceeding under this title, except insofar as it is to property which is held to be exempt, to all of the following kinds of property wherever located . . . (5) property, including rights of action, which prior to the filing of the petition he could by any means have transferred or which might have been levied upon and sold under judicial process against him, or otherwise seized, impounded, or sequestered . . . .

Thus, the "key issue" in McLoughlin was "whether the interest received by the bankrupt under his father's will was an interest which he could have transferred prior to or at the time the petition in bankruptcy was filed." 40

The transferability of such an interest is governed by state law, and under Georgia law, only a vested remainder is transferable. Whether the interest was vested or contingent depends upon the subjective intent of the testator. Looking to the terms of the will, the court rejected the argument of the testamentary trustee that the testator intended to make separate gifts as each child attained the ages of 21, 25 and 35.

A factor militating strongly in favor of finding that a gift is made presently with payment postponed is a provision that the recipient receive some present enjoyment in the property, even though a formal delivery will not be made until a later date. 41

In deciding that McLoughlin's father intended that his children receive vested remainders, the court relied heavily on Gillespie v. Ellis, 42 in which the Georgia Supreme Court found that a remainder interest was vested because the beneficiary was to receive income payments prior to the distribution of the corpus. The Fifth Circuit noted that the facts in McLoughlin even more strongly supported the finding of a vested interest; the will, in addition to providing for the payment of income to the children, also provided that the testamentary trustee could invade the corpus if necessary for the support and eduction of the testator's children. Indeed, the

41. 507 F.2d at 180.
42. 507 F.2d at 183.
43. 168 Ga. 790, 149 S.E. 221 (1929).
bankruptcy trustee's appeal floundered on this provision in the will.

The court stated that the provision for invasion of principal established a support trust and that rights to payments from such a trust had historically been held to be nontransferable and not subject to the claims of creditors. Thus, the Fifth Circuit affirmed the district court's holding that any rights which the bankrupt might receive under the support trust did not pass to the trustee in bankruptcy under section 70a(5) of the Act. The court supported this holding with citations to section 154 of the Second Restatement of Trusts\(^1\) and the early case of Barnett v. Montgomery & Co.\(^5\) in which the Georgia Supreme Court ruled that a support trust for a testator's wife is not subject to levy by creditors because otherwise the testator's intent would be frustrated.

VI. PROCEEDINGS UNDER CHAPTER X

In In re Fontainebleau Hotel Corp.\(^4\) the Fifth Circuit upheld the decision of a district court sitting in bankruptcy that had preserved the right of a Chapter X debtor to continue to use its telephone numbers. At the time the petition was filed, the debtor owed the telephone company approximately $9,000.00. The telephone company notified the debtor that it had two alternatives under the tariffs issued by the Louisiana Public Service Commission: it could either pay the outstanding pre-bankruptcy debt and continue with existing service, or begin new service with new telephone numbers. In either case, the telephone company demanded a substantial deposit. The Chapter X trustees sued to enjoin the interruption of service and the requirement of a deposit. The trustees argued, and the court below found, that the debtor's business would be substantially impaired without the use of existing numbers and that the company had spent substantial money advertising those numbers. The telephone company conceded that it had no business purpose in its demand that the numbers be changed other than coercing payment of the bill.

On appeal, the telephone company argued that the court below had improperly considered the issue in a summary rather than a plenary proceeding. The appellate court disagreed, holding that the hotel had "possession" of the telephone numbers and that the most important attribute of possession was the right of use of the numbers. The court declined to follow decisions in the Ninth and Second Circuits which had held that the right to use a telephone number did not constitute possession.\(^7\) In those cases, the courts had relied upon tariffs drafted by the telephone companies

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44. Restatement (Second) of Trusts §154 (1959).
45. 79 Ga. 726, 4 S.E. 874 (1888).
46. 508 F.2d 1066 (5th Cir. 1975).
47. In re Best Re-manufacturing Co., 453 F.2d 848 (9th Cir. 1971); Slenderella Systems of Berkeley, Inc. v. Pacific Tel. & Tel. Co., 286 F.2d 488 (2d Cir. 1961).
which stated that the subscriber acquired no property rights in the numbers.

On the merits, the court held that the Public Service Commission tariffs and other state laws did not compel the company, but only gave it a right, to demand a deposit and to change the telephone numbers of its customers upon the failure to pay a bill. Further, the court pointed out that whatever state law rights the company had, those rights were in direct conflict with federal bankruptcy law, which governs after the filing of a petition. The court held that the district court clearly had the power to enjoin interference with property in the debtor's possession and to enjoin acts, such as the demand for a deposit, that would frustrate attempts to formulate a plan of reorganization. The court further held that the application of Fed. R. Civ. P. 65(c), providing for the posting of a bond to indemnify a party wrongfully enjoined, had no application in summary bankruptcy proceedings and was inconsistent with the purposes of the Act.

Finally, the court rejected the telephone company's argument that it was entitled to priority under the "six months rule" on the ground that the "six months rule" did not create a right to payment of pre-bankruptcy debts prior to the adoption of a plan of reorganization.

The issue presented in In re Atlanta International Raceway, Inc. was the enforceability in a Chapter X proceeding of a lien for attorneys' fees asserted under Georgia Code section 20-506. The debtor, Atlanta International Raceway, Inc., had executed a promissory note to the predecessor in interest of Security National Bank in 1969, that note having been secured by the debtor's real property. The note provided that if any part of it should have to be collected by an attorney or by law, the holder would be entitled to collect 10% of the principal and interest and all costs of collection. On January 18, 1971, the debtor filed a petition under Chapter X of the Act, and the district court entered an order pursuant to section 148 of the Act prohibiting all creditors from prosecuting any suit or doing any act to enforce claims against the debtor. Approximately 18 months later, during the pendency of the Chapter X proceedings, attorneys for the

48. The provisions of Fed. R. Civ. P. 65(c) may apply in adversary proceedings, however. Bankruptcy Rule 765 provides in part that Fed.R.Civ.P. 65 applies in adversary proceedings "except that a temporary restraining order or preliminary injunction may be issued on application of a trustee, receiver, or bankrupt without compliance with subdivision (c) of that rule." Bankruptcy R. 765. Bankruptcy R. 765 is made applicable to Chapter X by Bankruptcy R. 10-701.

49. The six months rule is a judicially created priority granted in Chapter X proceedings to certain creditors of public and quasi-public enterprises providing essential services to the public. Those who extend credit to such enterprises within six months of the filing of a bankruptcy petition under Chapter X take priority over unsecured creditors. 508 F.2d at 1060.

50. 513 F.2d 546 (5th Cir. 1975).

51. GA. CODE ANN. §20-506 (Rev. 1971).

holder of the note sent the debtor and the Chapter X trustee a letter, written pursuant to Georgia Code section 20-506, declaring the note to be in default and demanding payment of principal and interest in full within 10 days in order to avoid the assessment of attorneys' fees. No payment was made on the debt, and the holder moved for summary judgment on its claim for attorneys' fees amounting to over $120,000.00. The bankruptcy judge in his Report to the District Judge distinguished Security Mortgage Co. v. Powers53 and National Acceptance Co. v. Zusmann,54 upon which the bank relied, and recommended that the bank's motion be denied.55 The district court, adopting the Bankruptcy Judge's Report, denied the motion, and the bank appealed.

The Fifth Circuit affirmed, holding that the enforcement of the attorneys' fee lien would frustrate the reorganization proceedings and would be inconsistent with the purposes of Chapter X. There was no way that the debtor or the Chapter X trustee could have provided for payment within the 10-day period in light of the statutory requirements of notice to other creditors. Further, the court pointed out that both the trustee and the district court had the responsibility of preserving assets essential to a plan for reorganization, and, therefore, they were required to hold in abeyance such demands for payment.

The bank argued that it had a right to make demand as a matter of substantive law. The court rejected that argument, relying in part upon In re Fontainebleau Hotel Corp.56

The court distinguished the Security Mortgage Co. case, in which a similar claim in a straight bankruptcy proceeding had been enforced. In Security Mortgage there had been no injunction against the enforcement of liens, and since it was a straight bankruptcy proceeding, there was no need to preserve assets to fund a plan of reorganization. The court pointed out that reorganization proceedings are sui generis, and that rules applicable in ordinary bankruptcy may be inapplicable in Chapter X proceedings. Even in Security Mortgage, the Supreme Court remanded with instructions for a hearing on several issues, including whether the trustee had received notice of the bank's demand for payment. The Fifth Circuit interpreted this portion of the Supreme Court's decision to mean that the entities or persons to whom such a demand is directed must have an opportunity to comply with the demand.

Recognizing that the validity of the lien in question depended upon Georgia law, the court cited Strickland v. Williams,57 for the proposition that an injunction prohibiting the sending of such a letter invalidated any

53. 278 U.S. 149, 49 S.Ct. 84, 73 L.Ed. 236 (1928).
54. 379 F.2d 351 (5th Cir. 1967).
56. 508 F.2d 1056 (5th Cir. 1975).
57. 215 Ga. 175, 109 S.E.2d 761 (1959).
alleged lien. For this reason, the practitioner desiring to attempt to enforce a provision for attorneys' fees against a potential Chapter X debtor would be well advised to make the demand at the earliest possible time.

The court also distinguished National Acceptance Corp. In that case, the demand letter had been sent five days prior to the filing of a petition for an arrangement under Chapter XI of the Act; however, no injunction had been entered prohibiting the enforcement of creditors' claims, and there was no automatic stay. Further, Chapter XI gives a court no power to alter the rights of secured creditors.

In the view of the authors, the adoption of the Bankruptcy Rules, and in particular the automatic stay provisions, may well result in the Fifth Circuit's extending this protection to Chapter XI and Chapter XII debtors as well. Indeed, the language of the automatic stay provisions could conceivably extend their application to straight bankruptcy proceedings.

VII. Conflict With Other Statutes

In Marvin Tragash Co. v. United States Department of Agriculture, a case of first impression in the Fifth Circuit, the court held that the imposition of penalties against a Chapter XI debtor under a federal statute was valid and enforceable despite an apparent conflict with the Bankruptcy Act. The petitioner, a licensee under the Perishable Agricultural Commodities Act, purchased several lots of fruits and vegetables in 1971 and early 1972 without paying for them, a violation of Section 261 of the Commodities Act. In April 1972, the petitioner filed a petition under Chapter XI of the Bankruptcy Act. Thereafter, it proposed a plan of arrangement providing for a settlement of debts of unsecured creditors at 15% of total debt. The plan was approved by its creditors, including the unpaid sellers of fruits and vegetables. The bankruptcy court enjoined any payment to creditors except through the provisions of the plan. In November 1972, the Secretary of Agriculture filed a complaint in an administrative proceeding under the Commodities Act. The administrative law judge found that the corporation's conduct in failing to pay the commodity sellers constituted flagrant violation of the Commodities Act.

The Fifth Circuit affirmed, relying in part upon the Second Circuit's decision in Zwick v. Freeman. In that case, the court noted a conflict between the Commodities Act and the Bankruptcy Act but held that the conflict was not so unconscionable or excessive as to prevent the imposition of penalties on a bankrupt. The decision in Zwick rested in part upon the

58. 524 F.2d 1255 (5th Cir. 1975).
60. 7 U.S.C.A. §499a et seq. (Rev. 1964) [hereinafter cited as the "Commodities Act."]
fact that there were references to the Bankruptcy Act in the Commodities Act. The court stated:

It is unlikely that Congress would include references to bankruptcy in some portions of the Commodities Act and omit them from the portions relevant to this case if Congress had intended that the provisions challenged here would be affected by the bankruptcy of persons subject to them.\(^3\)

The court also relied in part upon cases holding that state statutes imposing reasonable penalties on bankrupts were not invalid under the supremacy clause of the United States Constitution.\(^4\) There may be some question as to whether reliance was well founded, however. In *Perez v. Campbell*,\(^6\) the United States Supreme Court held that such state statutes were unconstitutional.

On this basis, the petitioner argued that the *Zwick* case had little value as precedent and that *Perez* required a reversal. The Fifth Circuit disagreed. The court pointed out that, in the first place, the supremacy clause has no bearing on a conflict between federal statutes. Secondly, the court noted that the holding in *Zwick* also rested upon an interpretation of Congressional intent. Since the Commodities Act contains references to the Bankruptcy Act, Congress would have specifically exempted bankrupts from the provision of the Commodities Act in question if it had intended to do so.

**VIII. Creditors' Rights In Bankruptcy Proceedings**

The case of *In re Manuel*\(^6\) may be of special interest to practitioners in the consumer bankruptcy field. The issue in that case was whether a purchase money security interest in consumer goods was perfected under the Georgia Uniform Commercial Code\(^7\) where the security agreement purported to secure a prior indebtedness with new collateral. The creditor had sold certain household furniture to the bankrupt in December 1972. On February 13, 1973, the creditor sold the bankrupt a television set pursuant to a security agreement providing for the consolidation of the entire debt. It was this attempt by the seller to make the television set security for debt other than its own price that the court regarded as fatal. The creditor had not filed any financing statement and had not taken possession of the property. It had relied instead upon the provisions of UCC sections 9-107

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63. 373 F.2d at 117.
64. U.S. Const. art. VI, §2.
66. 507 F.2d 990 (5th Cir. 1975).
and 9-302. Under those sections, no filing is required to perfect a purchase money security interest in consumer goods and a purchase money security interest exists to the extent that it is:

(a) taken or retained by the seller of the collateral to secure all or part of its price; or
(b) taken by a person who by making advances or incurring an obligation gives value to enable the debtor to acquire rights in or the use of collateral if such value is in fact so used.

The Fifth Circuit held:

A plain reading of the statutory requirements would indicate that they require the purchase money security interest to be in the item purchased, and that, as the judges below noted, the purchase money security interest cannot exceed the price of what is purchased in the transaction wherein the security interest is created, if the vendor is to be protected despite the absence of filing.

In this regard, the court approved the reliance of the court below on the case of In re Simpson, in which the secured party had failed in its attempt to create a purchase money security interest in farm machinery since the security agreement included a clause making the collateral security, not only for its own price, but also for future advances. The practitioner who on occasion acts as a bankruptcy court fiduciary may wish to keep the Manuel and Simpson cases in mind in reviewing the security agreements of consumer finance and similar companies.

The lengthiest, if not the most complicated, opinion handed down by the Fifth Circuit during 1975 in the area of bankruptcy and creditors' rights law was In re Samuels & Co. The essential issue in this case was the priority of interests in proceeds between a creditor having a perfected security interest in after-acquired property and the unpaid cash sellers of goods.

Samuels & Co., a meat packer, financed its operation on a weekly basis through CIT Corporation. Its obligations to CIT were secured with a perfected lien on all of its assets and inventory, including all after-acquired property. Appellants, cattle farmers, had delivered their cattle to Samuels & Co.'s slaughterhouse in mid-May, 1969. They subsequently received checks for the cattle delivered, but on May 23, 1969, before those checks were paid, CIT refused to advance any more funds to Samuels & Co. On the same day, Samuels & Co. filed a petition in bankruptcy. The checks

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70. 507 F.2d at 993.
72. 510 F.2d 139 (5th Cir. 1975).
issued to appellants were subsequently dishonored. Proceeds from the cattle sales were deposited with the trustee in bankruptcy pending the outcome of the litigation. At the trial level, the bankruptcy judge had held that the sellers had priority over the financing creditor. The district court reversed, and the sellers appealed. The Court of Appeals for the Fifth Circuit then reversed the district court, and the financing creditor appealed. The Supreme Court granted certiorari, reversed and remanded, holding that the Packers and Stockyards Act did not preclude the application of the Uniform Commercial Code.

On remand, the Fifth Circuit held that the selling cattle farmers had priority to the fund under the provisions of the Texas Uniform Commercial Code. After reviewing the historical concept of cash and credit sales with the accompanying concept of passing of title, the court noted that the UCC places little emphasis on the passage of title but nonetheless distinguishes between cash and credit sales, "at least with respect to the rights of the unpaid seller against the defaulting buyer." The remedies of a seller for credit are set forth in UCC section 2-702, dealing with the reclamation of goods from an insolvent buyer where the demand is made within ten days after receipt. UCC section 2-507 conditions the buyer's right to retain or sell goods upon payment where payment is due and demanded on delivery. The facts of the Samuels case established that the sale was one for cash.

The delay between delivery and payment was not credit, but rather was the result of a procedure mandated by the [Packers and Stockyards] Act and regulations that governed the relationship between the buyer and seller when cattle are sold on a grade and yield basis.

There is nothing in UCC section 2-507, however, that spells out a procedure for a seller's right to reclamation. The comment following that section "implicitly authorizes the seller's right to reclaim and simultaneously imposes a 10 day limit on that right when the buyer is insolvent." In the present case, the sellers failed to file a reclamation petition for almost one year. Nonetheless, the court held that the delay in filing a reclamation petition was not fatal since CIT Corporation had not been prejudiced.

The Code does not arbitrarily impose this limitation on the seller's rights, but does so in order to conform with the fundamental policies of the Code and the Bankruptcy Act. By imposing this limitation, a creditor is re-
quired to promptly disclose and identify his claim to property in the bankrupt’s estate so that other creditors will not prejudice themselves. Otherwise, a creditor might extend credit to the bankrupt subsequent to its filing a petition on the basis of a misapprehension that the bankrupt possesses unencumbered assets. Additionally, when all of the claims are properly disclosed, the objective of the Bankruptcy Act, equitable distribution of the bankrupt’s assets among its creditors, is more fully assured. The court noted that nothing in the record indicated that any creditors had been prejudiced, and that, in particular, CIT Corporation had an in-depth knowledge of the financial affairs of the bankrupt and hence was well aware of the claims of the sellers from the very beginning.

Ultimate reclamation itself would not prejudice creditors of the Bankrupt, since where “the sale is for cash, the merchandise belongs to the bankrupt’s estate only if the buyer pays for the goods.” By the same token, if a seller on credit commences a reclamation action within the 10 day limit imposed by UCC section 2-702, neither the bankrupt’s creditors nor secured creditors have any claim of prejudice since they obtain no greater rights in the goods than does the bankrupt.

CIT Corporation argued that under UCC section 2-401(a), any attempt to retain title is reduced to an unperfected security interest in goods, and hence its perfected security interest would have priority under its after-acquired property clause. The court neatly sidestepped this argument by drawing the distinction between cash sales and credit sales and holding that UCC section 2-401(a) has no application to cash sales.

The court then went one step further in holding that CIT’s rights in the collateral were, like the rights of the debtor, conditioned upon payment. Hence, even if the sellers had only an unperfected security interest in the proceeds, CIT Corporation still had no valid security interest in the cattle or the proceeds since its rights in the collateral were derived from those of the debtor and the debtor’s rights were conditioned upon payment.

Finally, the court held that CIT did not qualify as a good faith purchaser under UCC section 2-403. Under that section, the buyer of goods may convey to a good faith purchaser a greater right in the goods than the buyer itself had. The court held that CIT was not such a purchaser since its rights were no greater than those of the debtor. When the debtor failed to pay, its rights in the collateral terminated, and with that termination, the secured creditor’s rights terminated. Further, the court noted that CIT could not meet the requirements of good faith. The court held: “Implicit in the term ‘good faith’ is the requirement that CIT take its interest in the cattle

80. Id. at 147.
81. Id. at 148.
82. Practitioners having problems under UCC §§2-403 and 2-702 will be interested in the unpublished opinion of Judge W. Homer Drake, Jr. filed on August 15, 1974 in In re American Food Purveyors, Inc., Case No. 78172, United States District Court, Northern District of Georgia.
without notice of the outstanding claims of others." Since the secured creditor was completely aware of the operations of the bankrupt, it was on notice that checks issued to the sellers would be dishonored at the time the secured creditor refused to advance additional funds.

As against the trustee in bankruptcy, the court recognized that under section 70c of the Act, the trustee as a hypothetical lien creditor would defeat the rights of the sellers if they only held unperfected security interests. The court stated that the sellers did not merely have such an interest, but rather had the right to reclaim the cattle. Thus, the issue was whether the trustee's lien gave him a priority in the proceeds over the seller's right to reclaim. The court stated that under UCC section 2-507 and the comments thereto, the implicit right to reclaim was subordinated only to the rights of a good faith purchaser.

There is no mention of a subordination of the reclamation rights to the trustee in bankruptcy, nor is there any suggestion in this provision, the following comments, or otherwise that the drafters of the Code intended that the sellers' right to reclaim be so subordinated.

Lastly, citing Bank of Marin v. England, the court pointed out that the sellers had an overwhelming case in equity, and that equitable principles were the primary consideration governing the exercise of bankruptcy jurisdiction.

Judge Godbold filed a lengthy dissent. He took issue with the majority's "orientation" toward the sellers against a large corporate lender.

Doing what seems fair is heady stuff. But the next seller may be a tremendous corporate conglomerate engaged in the cattle feeding business, and the next lender a small town Texas bank. Today's heady draught may give the majority a euphoric feeling, but it can produce tomorrow's hangover.

Judge Godbold argued that UCC section 2-403 anticipated the precise facts in dispute in this case, i.e., the delivery by a cash seller to a buyer who pays by a subsequently dishonored check, and the transfer of title by the defaulting buyer to a good faith purchaser. Although the buyer lacks the "right" to transfer good title to goods, he nonetheless has the "power" to do so. The definition of "purchaser" under the Code includes not only one taking by sale, but also persons taking by voluntary mortgage pledge or lien, and therefore is broad enough to include a lender with a perfected security interest under Article 9 of the Code. Hence, Judge Godbold concluded that CIT Corporation was a purchaser under UCC section 2-403.

83. 510 F.2d at 151.
85. 510 F.2d at 152.
87. 510 F.2d at 154.
He then concluded that CIT's security interest attached to the goods because: (1) there was an agreement that the security interest attach; (2) the secured party had given value; and (3) the debtor had rights in the collateral sufficient to permit attachment. Since a purchaser can take from a defaulting cash buyer, and since lien creditors are purchasers, "the buyer's rights in the property, however marginal, must be sufficient to allow attachment of a lien."88

It would still be necessary under UCC section 2-403 for the secured party to have acted in good faith in order for its interest to be superior to that of an aggrieved seller, but the dissent had no problem with this point as a factual matter. Judge Godbold pointed out that there was no evidence that CIT had acted in bad faith, and in fact took issue with the majority's finding on the basis of the record before the court that CIT had an intimate knowledge of the debtor's obligation to third party creditors. Further, while lack of knowledge of outstanding claims is necessary to establish a common law bona fide purchaser for value and is similarly required in many provisions of the Code for purposes of determining the existence of a bona fide purchaser, the Code's definition of a "good faith purchaser" contains no element of lack of knowledge of third party claims. Hence, even if CIT knew of the claim of the sellers, Judge Godbold would hold that this would not prevent them from being good faith purchasers. Finally, the dissent notes that the sellers were not defenseless; they could have avoided any loss through the perfection of a security interest under Article 9 of the Code.

88. Id. at 155.