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Recent Developments in Bankruptcy

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Although bankruptcy deals primarily with the interpretation and application of the Bankruptcy Act, which was enacted in 1898, significant new developments continue to occur which are of importance both to the bankruptcy specialist and to the general practitioner. This results from the interplay of repeated amendments to the Act by Congress, new authoritative decisions on points of previous uncertainty in the interpretation of the Act, and the steady evolution of new commercial forms and new factual situations. This article will review several of the more important recent developments which illustrate each of these factors.

I. Procedural Matters
   A. Summary Jurisdiction

One of the more troublesome problems in bankruptcy practice is whether the trustee may proceed by a summary proceeding in the bankruptcy court or must proceed by a plenary action in a court of general jurisdiction in seeking to recover property for the estate or in litigating with parties other than the bankrupt. Summary jurisdiction is ordinarily available only in certain specific cases. In all other instances a plenary action is necessary. The advantages to the trustee of a summary proceeding in terms

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1. 30 Stat. 544-66 (1898), 11 U.S.C. §§ 1-1255 (1964). The short title was added by 64 Stat. 1113 (1950). References to the Bankruptcy Act in this article will be by section number only, viz.: Section 57g. Section numbers used are those given in the Bankruptcy Act rather than those in Title 11 of United States Code.

2. Substantial amendments were made in 1903, 1910, 1926, and 1952. The Chandler Act in 1938 effected the only major revision of the entire Act. Significant amendments were made in 1917, 1922, 1950, and 1956. Some change has been made in nearly every session of Congress in the last 35 years.

3. This article reviews bankruptcy legislation enacted by the 89th Congress and selected cases reported in the Supreme Court Reporter, volume 86 and volume 87, pp. 1-338; Federal Reporter, 2d Series, volumes 352 through 365; and Federal Supplement, volumes 253 through 257.

4. The principal areas in which the bankruptcy court has summary jurisdiction are (a) administrative matters in the course of the bankruptcy proceeding itself, (b) power to order the bankrupt or those holding for him to surrender property for bankruptcy administration, (c) controversies between third parties and the trustee regarding property in the custody of the court, (d) controversies involving third parties who have consented to the court's jurisdiction, and (e) certain areas in which the Act specially grants summary jurisdiction as in Sections 67a(4) and 70a(8). See MacLachlan, Bankruptcy 200-15 (1956).
of a more expeditious and economical adjudication of the issues by a court with greater experience in bankruptcy matters may be considerable and, in some cases, may be determinative of whether the claim is worth pursuing at all.\(^5\)

(1) **Summary Jurisdiction Based on Consent.** While jurisdiction cannot ordinarily be conferred on a court by consent of the parties, two provisions in the Bankruptcy Act make it clear that if the party entitled to insist on a plenary action consents to the summary jurisdiction of the bankruptcy court, the court acquires jurisdiction of the controversy and may validly proceed with a summary adjudication of it.\(^6\) Of particular concern to bankruptcy litigants is the fact that such consent to summary jurisdiction may arise by implication of conduct—even from the inadvertent failure to make a timely objection to a summary proceeding.\(^7\)

*Vidricksen v. Grover*\(^8\) illustrates the extremely broad scope of issues that may be determined by the bankruptcy court in a summary proceeding based on implied consent. Dr. Vidricksen had mistakenly believed he was a limited partner with the bankrupt. Six months after he had learned of his error he filed a document renouncing his interest in the profits of the firm in the pending bankruptcy proceeding.\(^9\) The referee in a summary proceeding determined that this renunciation had not been made “promptly” as required by statute and, hence, Dr. Vidricksen was liable as a general partner. In affirming this ruling the court of appeals pointed out that, while determination of the issue of limited partnership status was unusual for the bankruptcy court in a summary proceeding, Dr. Vidricksen had impliedly consented to summary jurisdiction and objected only to the result reached.

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5. It is not suggested that the summary procedure is in any respect one-sided or unfair or that referees tend to favor the trustees position. But in the summary proceeding the trustee may litigate locally with short time limits and expeditious procedures similar to those characteristic of a hearing before the court without the problems involved in trying issues to a jury. In contrast, the plenary action may require litigation elsewhere under the more formal procedures and possible delays of ordinary civil trials and may involve jury submission. Hence, a questionable claim by the trustee to property worth \$500, for example, turning on construction of a transaction under Section 60, might be worth testing in a summary proceeding but not worth the expense, even if successful, if a plenary action is required.

6. Section 2a(7) principally, and cf. Section 23b.

7. Section 2a(7) provides, in part, that by failure to make timely objection generally in his first answer a party against whom the trustee has proceeded is “deemed to have consented” to summary jurisdiction.

8. 363 F.2d 372 (9th Cir. 1966).

9. The renunciation attempted was pursuant to section 11 of the California enactment of the *Uniform Limited Partnership Act* providing that a person mistakenly believing he is a limited partner may obtain limited liability if, on learning his error, “he promptly renounces his interest in the profits of the business.” It is unclear from the opinion whether the partnership had been adjudicated bankrupt also. Cf. Section 5.
The extent to which a creditor may be submitting to the summary jurisdiction of the bankruptcy court by filing a proof of claim has been a matter of uncertainty and concern to many creditors with dischargeable claims against an estate of dubious worth, Section 57g provides:

The claims of creditors who have received or acquired preferences, liens, conveyances, transfers, assignments or encumbrances, void or voidable under this Act, shall not be allowed unless such creditors shall surrender such preferences, liens, conveyances, transfers, assignments or encumbrances.

Clearly, if the claim is filed and the trustee objects to its allowance on the ground that the creditor received a voidable transfer, the bankruptcy court would have summary jurisdiction to determine the allowability of the claim. This would necessarily include a determination of whether the creditor did receive the alleged voidable transfer. But if the court finds for the trustee on this issue, does its power extend merely to disallowance of the claim until the transfer is surrendered by the creditor, or may it go further and affirmatively order the creditor to surrender the property to the trustee? The significance of the distinction is even more sharply delineated in cases where either the voidable transfer is materially larger than the creditor's claim or the claim is disallowed on other grounds.

Most circuits had concluded that the referee did have summary jurisdiction to enter an affirmative order in favor of the trustee for return of the property, but at least one circuit had held to the contrary. The United States Supreme Court in Katchen v. Landy has authoritatively resolved this issue, holding that under Section 57g the bankruptcy court has summary jurisdiction both to determine the issue of the alleged voidable transfer and to enter an affirmative order requiring the creditor to deliver the property received to the trustee.

The Court reasons that by filing a claim the creditor has clearly con-
sent to the summary jurisdiction of the bankruptcy court to determine objections by the trustee under Section 57g and that a determination in favor of the trustee on the alleged voidable transfer would in any event operate as res judicata or collateral estoppel on the issue in a subsequent plenary action by the trustee to recover the property transferred. Thus, to require such subsequent plenary action would only add to the delay and expense of the bankruptcy, contrary to the general purpose of Congress in providing for summary proceedings in bankruptcy. The Court therefore concludes that Section 57g should be interpreted as vesting sufficient power in the bankruptcy court to order return of the property determined to have been improperly transferred.\textsuperscript{13}

\textit{Katchen v. Landy} is thus in accord with the general trend of decisions in recent years toward enlargement of bankruptcy summary jurisdiction based on implied consent.\textsuperscript{14} It had been suggested that, if this interpretation of Section 57g did prevail, it should be qualified to limit the summary jurisdiction of the bankruptcy court to ordering the return of only those transfers involved in the same transaction or occurrence which gives rise to the creditor's claim.\textsuperscript{15} However, the Court did not include this qualification in its holding, and the language of Section 57g would not seem to require it. Apparently, therefore, once a creditor files a proof of claim, the bankruptcy court under Section 57g has summary jurisdiction to adjudicate and order return of all voidable transfers alleged by the trustee to have been received by the creditor, whether or not related to the claim filed.

(2) \textit{Summary Jurisdiction Based on Possession of Property.} Under Section 2a(7) the bankruptcy court is given jurisdiction to determine controversies with reference to the property comprising the bankruptcy estate. This provision is interpreted as giving the bankruptcy court summary jurisdiction to determine controversies relating to all property in its custody,

\textsuperscript{13} The Court also rejects the contention that this result denies the right to jury trial under the Seventh Amendment on the ground that, bankruptcy proceedings being inherently equitable, there is no right to jury trial, notwithstanding the seeming presence of issues of purely legal cognizance. Justices Black and Douglas dissent without opinion. For an excellent analysis of the problems remaining in this area, see Rochelle & King, \textit{Summary Jurisdiction in Bankruptcy: Katchen v. Landy and Questions Left Unanswered}, 1966 \textit{Duke L.J.} 669 (1966).

\textsuperscript{14} See \textit{MacLachlan}, op. cit. supra note 4, § 196.

\textsuperscript{15} See Daniel v. Guaranty Trust Co., 285 U.S. 154 (1932); Peters v. Lines, supra note 10; \textit{In re Majestic Radio \& Television Corp.}, supra note 10; \textit{In re Solar Mfg. Corp.}, supra note 10; Conway v. Union Bank of Switzerland, 204 F.2d 603 (2d Cir. 1953). The court of appeals in Katchen v. Landy, 336 F.2d 535 (10th Cir. 1964) had rejected this limitation but held that summary jurisdiction under Section 57g did not extend to unrelated counterclaims not involving a preference, set-off, voidable lien, or fraudulent transfer.
which is in turn construed to mean all property in the possession of the bankrupt on the date of bankruptcy.\(^{16}\) Hence, many controversies over whether summary jurisdiction exists turn on whether the property in question was in the possession of the bankrupt on the date of bankruptcy.

Three recent decisions are illustrative. In *Kyle v. Stewart*\(^{17}\) the Fifth Circuit held that the referee in bankruptcy had summary jurisdiction to order turnover of the proceeds of property of the corporate bankrupt which was in the possession of a corporate officer on the date of bankruptcy. The officer had possession in order to liquidate the property and distribute the proceeds to corporate creditors. The court held that since the officer's possession of the property was for the bankrupt, the property was constructively in the possession of the bankrupt on the date of bankruptcy.\(^{18}\)

Conversely, in *In re Consolidated Carriers, Inc.*\(^{19}\) a creditor of the bankrupt, pending suit on his own claim, levied on the bankrupt's bank account more than four months prior to bankruptcy but did not take judgment foreclosing the lien of the levy until after bankruptcy. The court held that the bankruptcy court did not have summary jurisdiction over the account because the levy had validly removed possession of the account from the bankrupt, even though on the date of bankruptcy the creditor's lien was contingent on recovery of judgment.\(^{20}\)

An unusual extension of summary jurisdiction occurred in *In re Wiltse Bros. Corp.*\(^{21}\) On the date of bankruptcy the bankrupt had possession of partially fabricated items it was making for sale to *R*, using supplies purchased from *W* which had not been paid for. The referee authorized the bankruptcy receiver to sell these items to *R* free and clear of liens, which were then transferred to the proceeds of the sale. The Sixth Circuit held that the summary jurisdiction of the bankruptcy court to authorize this sale free and clear of liens, based on the bankrupt's possession of the items on the date of bankruptcy, necessarily included summary jurisdiction to

\(^{16}\) Section 1(13) provides that "date of bankruptcy" means the date the petition is filed.

\(^{17}\) 360 F.2d 753 (5th Cir. 1966).

\(^{18}\) Cf. Section 70a(8) expressly granting summary jurisdiction for recovery of property from an assignee for the benefit of creditors under an assignment which constituted an act of bankruptcy.


\(^{20}\) The opinion tends to confuse the issue of validity of the attachment under Section 67a with that of possession of the account to support summary jurisdiction. Obviously there is a relation; if invalid, the attachment did not change possession. But if the controversy is validity under Section 67a, paragraph (4) of that Section expressly grants summary jurisdiction. If the issue is validity apart from Section 67a, possession is material to jurisdiction, but Section 67a is not involved.

\(^{21}\) 361 F.2d 295 (6th Cir. 1966).
enjoin \( W \) from pursuing its mechanic's lien rights against \( R \)'s realty in another jurisdiction. Otherwise, reasoned the court, the referee could not effectively authorize a sale free and clear of all liens.

B. Discovery

As in any litigation, discovery may be of critical importance in bankruptcy. With slight modification, the Federal Rules of Civil Procedure generally,\(^{22}\) and the discovery procedures of those rules specifically,\(^{23}\) are applicable to bankruptcy proceedings. In addition, the Bankruptcy Act and the General Orders provide several sources of highly valuable information by requiring the bankrupt to file extensive schedules of assets and liabilities\(^{24}\) and a statement of affairs\(^{25}\) and to submit to oral examinations pertaining to his affairs.\(^{26}\)

Petitioning creditors in involuntary proceedings often face a particularly difficult problem of proof if the act of bankruptcy on which they are relying requires proof of the insolvency of the debtor.\(^{27}\) Since this fact usually depends on information peculiarly within the knowledge, custody, and control of the debtor who, not having yet been adjudicated, has not filed his schedules and statement of affairs, Section 3c provides that the debtor has the burden of proving his solvency at the time of the petition as a defense to the first act of bankruptcy.\(^{28}\) And when the petition is based on the second, third, or fifth act of bankruptcy, Section 3d provides that if the debtor denies his alleged insolvency, he shall appear in court "with his books, papers, and accounts, and submit to an examination and give testimony" relating to the solvency issue, and that on his failure to do so, the burden of proving his solvency shall rest on him.\(^{29}\)

In Berg v. Hoppe\(^{30}\) the Ninth Circuit held that Section 3d did not authorize the referee in an involuntary proceeding, prior to adjudication, to order the debtors to file their schedules and statements of affairs under Section 7a, which imposed such duty only after adjudication as bankrupts. The court pointed out that the petitioning creditors had available to them all of the usual discovery procedures under the Federal Rules of

\(^{23}\) Section 21k and cf. Section 21, paras. b and c.
\(^{24}\) Section 7a(8); cf. Official Form 1, Schedules A and B, 11 U.S.C. App.
\(^{25}\) Section 7a(9); cf. Official Forms 2 and 3, 11 U.S.C. App.
\(^{26}\) See Sections 55b and 21a.
\(^{27}\) Cf. Section 3a. Of the six acts of bankruptcy the first, second, third and fifth involve the issue of insolvency.
\(^{28}\) See Section 3c.
\(^{29}\) See Section 3d.
\(^{30}\) 352 F.2d 776 (9th Cir. 1965).
Civil Procedure and the special provisions of Section 3d which adequately enabled the creditors to obtain the information they needed without resort to this unwarranted device.

In an unusual situation the Second Circuit in *Ansbacher & Co. v. Klebanow* held that limited partners of the bankrupt, whose claims as such were inferior to claims filed by ten banks as general creditors, were not entitled in their own right to serve interrogatories on the banks preparatory to objecting to their claims because they were not "adverse parties" to the banks, both being only general creditors. The court held, however, that the limited partners might in this case serve the interrogatories on behalf of the trustee, who had failed thus far to investigate the banks' claims and had a complex estate to administer. Since the banks' claims, if allowed as filed, would consume the entire estate, leaving nothing for the limited partners, the court's ruling that the limited partners, not being in the position of secured creditors, were not sufficiently "adverse" to the banks to be entitled to discovery seems debatable. Arguably the limited partners could properly be treated as adverse parties as much as could secured creditors. In each case there is a direct clash of economic interest which perhaps should be sufficient to justify the availability of discovery.

C. Qualification as a Petitioning Creditor

In order to qualify as a petitioning creditor in an involuntary proceeding the creditor must have a provable claim "not contingent as to liability," and "if unliquidated [the claim] shall not be counted . . . if the court determines that the claim or claims cannot be readily determined or estimated to be sufficient, together with the claims of the other creditors, to aggregate $500.00, without unduly delaying the decision upon the adjudication." The latter provision, added in a 1962 amendment to Section 59b, was construed in *In re Coldiron & Peeples*.

31. 362 F.2d 569 (2d Cir. 1966).
32. This grew out of the involved bankruptcy of Ira Haupt & Co., which has produced several related controversies. See *In re Ira Haupt & Co.*, 361 F.2d 164 (2d Cir. 1966), discussed in the text accompanying note 82 infra; *In re Ira Haupt & Co.*, 343 F.2d 726 (2d Cir. 1965), cert. denied, 382 U.S. 890 (1965). Cf. *Ira Haupt & Co. v. Seligson*, 361 F.2d 164 (2d Cir. 1966).
33. Section 59b. The 1898 enactment required only that the claims be "prov-able." The Chandler Act in 1938 materially enlarged the scope of "provable claims," and thus Section 59b was also modified to restrict petitioning creditors to provable claims "fixed as to liability and liquidated as to amount." "Fixed" was changed to "not contingent" by the Act of July 7, 1952, 66 Stat. 420-38, and the quoted provision regarding liquidity was introduced by the Act of Sept. 25, 1962, 76 Stat. 570, at 571.
Oil Co.\textsuperscript{34} There the sole petitioning creditor's claim was based on a disputed right to subrogation under thirteen bilateral contracts, the amount due on which was also disputed. The referee dismissed the petition, concluding that the claim could not be readily determined or estimated to be sufficient to aggregate $500.00 without unduly delaying the decision on the adjudication. The court of appeals affirmed, holding that the issue was properly within the discretion of the trial court to prevent unreasonable delay in involuntary proceedings while collateral issues were litigated, and that the referee had not abused his discretion here.

D. Review of Pre-Bankruptcy Liquidations

Section 2a(21) of the Act gives the bankruptcy court jurisdiction to require pre-bankruptcy receivers and assignees for the benefit of creditors to surrender all property of the bankrupt to the bankruptcy court and to account to the bankruptcy court regarding disbursements out of the property, if the bankruptcy occurs within four months. The court is further empowered to surcharge the receiver or assignee "the amount of any disbursement deemed by the court to have been improper or excessive."\textsuperscript{35} Two recent cases have interpreted the standard which the bankruptcy court is to apply in reviewing the propriety of such disbursements.

In \textit{Flaxman v. Gardners}\textsuperscript{36} the Ninth Circuit held that, in passing on whether the disbursement was "improper," the court was to determine whether the bankruptcy trustee would have had to obtain an audit concerning certain transactions suspected of being fraudulent if the pre-bankruptcy assignee for the benefit of creditors had not already done so, rather than deciding the question on the limited value to the estate of the information produced by the audit, which disclosed no fraud. The court also held that this issue of propriety must be separated from the issue of whether the cost of the audit was "excessive," which should be measured by the reasonableness of the charge for the type of services rendered. Here the referee had improperly confused the two issues and in deciding the issue of propriety had looked only at the limited value of the information produced rather than the need for the audit, when

\textsuperscript{34} 356 F.2d 266 (9th Cir. 1966).
\textsuperscript{35} Section 2a(21) was added in 1938 and amended in 1952 codifying and expanding the doctrine of Taylor v. Sternberg, 293 U.S. 470 (1935) and Gross v. Irving Trust Co., 289 U.S. 342 (1933). Cf. Section 69d.
\textsuperscript{36} 353 F.2d 764 (9th Cir. 1966).
he surcharged the pre-bankruptcy assignee part of the cost of the audit.

The court in *In re Garrett Road Corp.*, 37 citing the *Flaxman* case, affirmed the referee's allowance of $18,000 as fee to the pre-bankruptcy receiver plus $5,000 for the receiver's attorneys fees. In this case the pre-bankruptcy receivership triggered an involuntary petition in bankruptcy within four months, but the question of adjudication was not ruled on until two years later. Meanwhile the state court receiver and his attorney had handled the debtor's estate ably, filing numerous reports and submitting accounts to the referee and getting the referee's approval on several suggestions. The court held that the referee in such circumstances was not restricted to the amounts allowable under Section 48 to bankruptcy receivers for fees and expenses and had not abused his discretion in this case.

**E. Procedural Amendments**

Two amendments relating to procedural matters which were enacted by the 89th Congress based on recommendations of the Judicial Conference of the United States should be noted. First, Section 39b was amended expressly to prohibit both full-time referees and part-time referees from acting as trustee or receiver in any bankruptcy proceeding.38 This was to avoid the possibility of any conflict of interest, especially with reference to part-time referees, "as a matter of ethics, policy and good practice."39

Second, in order to reduce mailing expense, Sections 14b and 14c were amended to enable a single, combined mailing to include both the notice of the first meeting of creditors and the notice of the time fixed by the referee for filing objections to the bankrupt's discharge.40 It was estimated that savings from reduced mailing costs would be between $150,000 and $200,000 per year.41 In order to guarantee the payment of filing fees, the amendment prevents the granting of the discharge until the filing fees have been paid. This is done by adding as an eighth ground for objection to the discharge that the bankrupt shall be denied discharge if he "(8) has failed to pay the filing fees required to be paid by the Act in full."42

40. 79 Stat. 646 (1965).
42. 79 Stat. 646 (1965). The key change is deletion of the opening phrase in Section 14b which prevented mailing the notice of time for objections to discharge until all filing fees were paid in full, which might not have occurred by the time notice of the first meeting of creditors was required. Cf. Section 55a.
While priority claims are of particular concern to those asserting them, they necessarily concern the general creditors also, who will share only so much as is left in the estate after the priority claims are paid. Not infrequently the major portion or all of a smaller estate may be consumed by priority claims. It is, of course, necessary to keep clearly in mind the basic distinction between priority claims in bankruptcy, which are determined solely by Section 64aa, and priority of liens on certain property in the estate, which is ordinarily governed by state law or other non-bankruptcy law. The two are apt to be more easily confused in the case of priority claims which are also secured by statutory liens on assets of the bankrupt and, in that respect, also concerned with lien priority in those assets.

The recent decision in *In re Travis Bros. Body Works, Inc.* illustrates this problem. The controversy was between the state, claiming sales taxes secured by three tax liens, and the United States, claiming withholding taxes secured by two tax liens. Both claims obviously shared the fourth priority as claims, but the real question was the relative priority of the several liens on assets inadequate to satisfy all of them. Although the opinion tends to confuse the issue of lien priority with that of claim priority, the decision reached correctly deals with the question as one of lien priority and allocates priorities among the competing liens under the principle that the first in time is first in right.

A. The Federal Tax Lien

Due to its scope, both as to the amounts often secured and as to the property reached by the lien, the federal tax lien is of considerable importance in bankruptcy. This lien attaches to "all property and rights to property, whether real or personal, belonging to" the bankrupt and arises "at the time the assessment is made" but, subject to limited exceptions, has for many years been declared to be invalid "as against any mortgagee, pledgee, purchaser, or judgment creditor until notice thereof has been filed"

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43. Section 64a lists five categories of claims given priority in the order listed in the general assets of the estate apart from any question of liens. The list is generally exclusive and only recognizes priorities under non-bankruptcy law in the limited cases covered by the fifth priority, relating to priorities granted by federal law and landlord's claims for rent if given priority by state law.

44. Cf. Sections 67b and 67c regarding statutory liens.


46. See Section 64a(4) which covers claims for taxes generally.

47. INT. REV. CODE OF 1954, §§ 6321-23.


49. INT. REV. CODE OF 1954, § 6322.
Whether the trustee in bankruptcy under the "strong-arm clause" of Section 70c of the Bankruptcy Act could defeat an unrecorded federal tax lien has been a question of considerable concern. The Second, Third, and Ninth Circuits, relying on language in *United States v. Gilbert Associates, Inc.* to the effect that the term "judgment creditor" was used in Section 6323 of the Internal Revenue Code only in the conventional sense of a judgment of a court of record, had held that the trustee under Section 70c did not become a "judgment creditor" in that sense and thus could not defeat an unrecorded federal tax lien. The Sixth Circuit had held to the contrary.

In a decision of major importance resolving all uncertainty on this point the United States Supreme Court in *United States v. Speers* recently held that the trustee in bankruptcy under Section 70c was entitled to the protection of Internal Revenue Code Section 6323 and thus could defeat the unrecorded tax lien. The Court pointed out that *United States v. Gilbert Associates, Inc.* did not involve Section 70c of the Bankruptcy Act and that the legislative history of both Section 70c and Section 6323 clearly indicated that Congress intended the trustee in bankruptcy to have sufficient standing to defeat an unrecorded federal tax lien.

In part, the uncertainty on this point and the decisions in the Second, Third, and Ninth Circuits stemmed from the fact that Section 70c, in strengthening the trustee's position, did not explicitly give him the rights of a "judgment creditor." Contemporaneously with the decision in *United

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50. INT. REV. CODE OF 1954, § 6323. In the Federal Tax Lien Act of 1966, Pub. L. No. 89-719, 89th Cong., 2d Sess. (Nov. 2, 1966), the quoted portion of § 6323 was amended to read "as against any purchaser, holder of a security interest, mechanic's lienor, or judgment lien creditor until notice thereof . . . has been filed . . . ." This change in language, intended to harmonize with the Uniform Commercial Code, and to eliminate certain inequities to secured creditors, does not appear to alter the result reached in United States v. Speers, *infra* note 54, or the result intended in the 1966 amendment to Section 70c, *infra* note 58.


53. *In re Kurtz Roofing Co.*, 335 F.2d 311 (6th Cir. 1964), *aff'd* sub nom. United States v. Speers, 382 U.S. 266 (1965); *but cf.* *In re Taylorcraft Aviation Corp.*, 168 F.2d 808 (6th Cir. 1948).

54. 382 U.S. 266 (1965).

55. The relevant portion of Section 70c reads: The trustee, as to all property . . . upon which a creditor of the bankrupt could have obtained a lien by legal or equitable proceedings at the date of bankruptcy, shall be deemed vested as of such date with all the rights, remedies, and powers of a creditor then holding a lien thereon by such proceedings, whether or not such a creditor actually exists.
States v. Speers an amendment to Section 70c, which would resolve any doubt on this question, was pending before Congress in a bill which had first been introduced in February, 1957, based on proposals by the National Bankruptcy Conference, and which had been before Congress in each subsequent session. Within months after the Speers decision this amendment was enacted.

The changes effected in Section 70c by this amendment are intended to carry out the original purpose of the "strong-arm clause" which had been obscured by several misinterpretations. First, the trustee is now explicitly given the rights of a "judgment creditor," and the rule established by United States v. Speers is given an even clearer footing in the language of Section 70c. Secondly, the trustee's rights are more clearly stated as being those of a hypothetical creditor as of the date of bankruptcy who on that date obtains a lien by legal or equitable proceedings. This is intended to avoid both the misinterpretation that the trustee might also hypothesize that the credit had been extended at some previous "ideal" point in time and the opposite misinterpretation that only the obtaining of a judicial lien by an existing creditor entitled to do so, and not the existence of the creditor, could be hypothesized. Finally, a transaction partially valid against the hypothetical creditor is valid against the trustee to the same extent.

58. United States v. Speers was decided December 13, 1965. The amendment to Section 70c was approved July 5, 1966.
extent, and the "chameleon clause" enables the trustee to assume different and inconsistent positions in different contexts.

B. Statutory Liens

The treatment of statutory liens in Sections 67b and 67c of the Bankruptcy Act has been one of the more perplexing and obscure areas of the Act. This has resulted from a policy adopted in 1938 not to recognize most priorities granted by state common law but to allow statutory liens in bankruptcy. This policy was countered in many states by efforts to convert former priorities into statutory liens. Consequently, Section 67c was amended in 1952 to invalidate certain statutory liens while retaining the provision postponing and limiting others. The resulting overlap and confusion between the two parts of Section 67c and Section 67b has created several problems. There has been no definition of the term "statutory lien," and an inevitable but unsolved circuity of liens problem has been created by postponing some liens without providing for the effect on liens junior to those postponed.

In an effort to resolve these problems Congress has recently enacted a major revision of these portions of the Act, adopting for the most part the recommendations of the National Bankruptcy Conference first presented to Congress in 1957 and resubmitted in subsequent years. Section 67c has been completely rewritten, and a new paragraph (29a) has been

Pacific Finance Corp. v. Edwards, 304 F.2d 224 (9th Cir. 1962), held that Section 70c permitted the trustee to hypothesize only the obtaining of a lien on the date of bankruptcy by an actual creditor entitled to do so, not the existence of the creditor himself.

60. Compare Section 64a, which does not recognize state law priorities generally (with a limited exception for a claim for rent), with Sections 67b and 67c, recognizing statutory liens subject to several limitations. See S. Rep. No. 1159, 89th Cong., 2d Sess. (1966).


64. As revised Section 67c reads:

C. (1) The following liens shall be invalid against the trustee:

(A) every statutory lien which first becomes effective upon the insolvency of the debtor, or upon distribution or liquidation of his property, or upon execution against his property levied at the instance of one other than the lienor;

(B) every statutory lien which is not perfected or enforceable at the date of bankruptcy against one acquiring the rights of a bona fide
added to Section 1 of the Act providing a definition of the term "statutory lien" to make it clear that this term includes only liens arising solely by force of statute and not contractual liens aided, enforced by, or parallel to a statute.

The approach of the revised Section 67c is to invalidate generally, rather than postpone, the purely statutory lien. Thus the lien circuitry prob-

purchaser from the debtor on that date, whether or not such purchaser exists: Provided, That where a statutory lien is not invalid at the date of bankruptcy against the trustee under subdivision c of section 70 of this Act and is required by applicable lien law to be perfected in order to be valid against a subsequent bona fide purchaser, such a lien may nevertheless be valid under this subdivision if perfected within the time permitted by and in accordance with the requirements of such law: And provided further, That if applicable lien law requires a lien valid against the trustee under section 70, subdivision c, to be perfected by the seizure of property, it shall instead be perfected as permitted by this subdivision c of section 67 by filing notice thereof with the court;

(C) every statutory lien for rent and every lien of distress for rent, whether statutory or not. A right of distress for rent which creates a security interest in property shall be deemed a lien for the purposes of this subdivision c.

(2) The court may, on due notice, order any of the aforesaid liens invalidated against the trustee to be preserved for the benefit of the estate and in that event the lien shall pass to the trustee. A lien not preserved for the benefit of the estate but invalidated against the trustee shall be invalid as against all liens indefeasible in bankruptcy, so as to have the effect of promoting liens indefeasible in bankruptcy which would otherwise be subordinate to such invalidated lien. Claims for wages, taxes and rent secured by liens hereby invalidated or preserved shall be respectively allowable with priority and restricted as are debts therefor entitled to priority under clauses (2), (4), and (5) of subdivision a of section 64 of this Act, even though not otherwise granted priority.

(3) Every tax lien on personal property not accompanied by possession shall be postponed in payment to the debts specified in clauses (1) and (2) of subdivision a of section 64 of this Act. Where such a tax lien is prior in right to liens indefeasible in bankruptcy, the court shall order payment from the proceeds derived from the sale of the personal property to which the tax lien attaches, less the actual cost of that sale, of an amount not in excess of the tax lien, to the debts specified in clauses (1) and (2) of subdivision a of section 64 of this Act. If the amount realized from the sale exceeds the total of such debts, after allowing for prior indefeasible liens and the cost of the sale, the excess up to the amount of the difference between the total paid to the debts specified in clauses (1) and (2) of subdivision a of section 64 of this Act and the amount of the tax lien, is to be paid to the holder of the tax lien.

(4) Where a penalty not allowable under subdivision j of section 57 is secured by a lien, the portion of the lien securing such penalty shall not be eligible for preservation under this subdivision c.

(5) This subdivision c shall not apply to liens enforced by sale before the filing of the petition, nor to liens against property set aside to the bankrupt as exempt, nor to liens against property abandoned by the trustee or unadministered in bankruptcy for any reason and shall not apply in proceedings under section 77 of this Act, nor in proceedings under chapter X of this Act unless an order has been entered directing that bankruptcy be proceeded with.
Developments in Bankruptcy

The lien is eliminated with one exception. Section 67c(3) postpones tax liens on personal property not accompanied by possession to the payment of first and second priority claims. Provision is made, however, for the lien circuity problem that would result in order to prevent a valid lien junior to the postponed tax lien from suffering the adverse effect of the postponement of the tax lien. This is done by allowing the junior lien to participate in the proceeds of the sale of the security immediately after the amount that would ordinarily go toward the prior tax lien has been applied as far as it goes toward the first and second priorities and the tax lien. Thus only the postponed tax lien suffers the effect of the postponement. Section 67c(3) is intended to be applied only to those tax liens which are not invalidated under Section 67c(1).

Minor changes were made in Sections 67b and 64a(5) to harmonize them with the revision of Section 67c and to eliminate overlap regarding priority for taxes between Sections 64a(4) and 64a(5). Taxes are now given priority only under Section 64a(4).

C. Priority and Dischargeability of Taxes

The fact that tax claims have enjoyed unlimited priority in bankruptcy and have not been subject to discharge has long been opposed to the two basic policies of the Bankruptcy Act to preserve equitable distribution of the estate and to rehabilitate the debtor. With the steady increase in recent years in the amount of most taxes, this has had an undesirable effect in many bankruptcies. Often, due to the presence of substantial claims for taxes, there may be nothing left for distribution to unsecured creditors, and there may still be unpaid taxes which continue to be owing by the discharged bankrupt who is attempting to make a new start. In the latter respect the bankrupt corporation has had an advantage since the corporation may become defunct and render continued tax liability meaningless. The individual debtor is not so fortunate.

In order to remedy these inequities and again following the recommendations of the National Bankruptcy Conference, Congress has amended Sections 17a(1) and 64a(4) to provide first, that taxes which became legally due and owing more than three years prior to bankruptcy are subject to the bankruptcy discharge, and second, that only those taxes not subject to discharge (that is, those which became legally due and owing within three years prior to bankruptcy) are to have priority in bank-

66. 80 Stat. 268 (U.S. Code Cong. & Ad. News 1807 (July 5, 1966)).
It was felt that this qualification of the non-dischargeability of taxes and of priority allowed taxes in bankruptcy was reasonable and consistent with treatment of taxes in other commercial nations and treatment of other priority claims in the Bankruptcy Act. This amendment also added a new paragraph (2A) to Section 2a, expressly giving the bankruptcy court jurisdiction to resolve tax disputes, if not adjudicated or pending at the time of bankruptcy, in lieu of a similar provision formerly in Section 64a(4).

D. Other Governmental Claims

Ordinarily the accrual of interest on all claims is stopped on the date of bankruptcy. But there has been conflict in the decisions on whether interest on tax liabilities incurred during an arrangement proceeding under Chapter XI will continue to accrue during a subsequent straight bankruptcy liquidation and will share in the first priority as an expense of administration. This has now been authoritatively resolved by the Supreme Court in Nicholas v. United States to the effect that interest on taxes incurred by the debtor in possession during the arrangement stops on the date the petition for straight bankruptcy liquidation is filed. Since returns on the taxes incurred were not due in this case until after the straight bankruptcy had begun, the Court held that no interest accrued on the taxes. But the Court also held that it was the duty of the bankruptcy trustee to file the returns and that penalties for his failure to do so, plus interest on the penalties, were valid claims in the bankruptcy and were entitled to first priority as administrative expenses.

Dealing with the treatment to be given priority claims in wage-earner's plan proceedings under Chapter XIII, the Sixth Circuit in In re

67. 80 Stat. 270 (U.S. CODE CONG. & AD. NEWS 1810 (July 5, 1966)).
69. 80 Stat. 270 (U.S. CODE CONG. & AD. NEWS 1810 (July 5, 1966). The new Section 2a (2A) replaces the second proviso of Section 64a(4) which is deleted. The first proviso of Section 64a(4), which limits property taxes, has become the second proviso. See In re Nussbaum, 257 F. Supp. 498 (S.D. Tex. 1966) applying this provision.
71. In United States v. Kalishman, 346 F.2d 514 (8th Cir. 1965), interest was allowed to continue to accrue. Contra, United States v. Nicholas, 346 F.2d 32 (5th Cir. 1965).
73. See 28 U.S.C. § 960 (1964) and Boteler v. Ingels, 308 U.S. 57 (1939), regarding liability of the trustee for taxes and penalties. In the Nicholas case Mr. Justice Harlan dissented on the first holding but concurred in the second. Justices White, Douglas, and Fortas concurred on the first holding but dissenting on the second.
Belkin held that, notwithstanding the permissive provisions of Section 646 regarding contents of a proposed plan, Section 659(6) requires that all priority claims under Section 64a first be paid in full before distribution to general creditors. The Court also held that the Chapter XIII petition, by which the debtor, while insolvent, submitted his non-exempt property and future earnings to the jurisdiction of the bankruptcy court, was sufficient to invoke the priority of the United States under section 3466 of the Revised Statutes (1875) and Section 64a(5). The claim granted priority in that case was based on a debt insured by the United States under Title I of the National Housing Act which had been assigned to the United States by the lending bank the day before the debtor petitioned under Chapter XIII. Unfortunately, the court does not deal with the troublesome problem of whether this is the type of debt properly entitled to the benefits of section 3466.

E. Attorneys' Fees

Attorneys' fees incurred by the debtor in contemplation of a bankruptcy petition or by the trustee may be entitled to share in the first priority, but in either event will be subject to review by the court as to reasonableness. Two recent cases tend to restrict the value of the claim of the debtor's attorney.

In Davis v. Negin the debtor, prior to bankruptcy, paid his attorney $683.52 and gave him a note for $650.00 "for legal services, to be rendered following bankruptcy, in enabling [the debtor] to be re-established in business." The Sixth Circuit affirmed the decision of the referee, finding $450.00 to be a reasonable fee and ordering the attorney to pay over $182.52 and to cancel a portion of the $650.00 note. While Section 60d empowers the court to cancel a portion of an indebtedness to the attorney for future services, presumably this refers to future services related to the bankruptcy proceedings rather than other matters, and thus the decision in this respect seems questionable.

Similarly, the debtor's attorney in In re Tariffville Mfg. Co. with

74. 358 F.2d 378 (6th Cir. 1966).
78. Sections 64a(1) and 60d. Cf. General Orders 42 and 44, 11 U.S.C. App.
79. 357 F.2d 154 (6th Cir. 1966).
80. Id. at 155.
the court's approval, spent considerable effort in preparing and obtaining the necessary acceptances by creditors of a plan for an arrangement under Chapter XI, which was not confirmed because the debtor could not make the required deposit. Nevertheless, the court denied the attorney any recovery from the estate for these services on the ground that Chapter XI did not authorize such allowance where the plan was not confirmed. The desirability of this result is questionable since it may tend to discourage attempts to develop a satisfactory "workout" plan in close cases where the attorney can be sure of a reasonable fee for preparing a voluntary petition in straight bankruptcy.

With respect to the trustee's attorney, two recent decisions have dealt with the difficult problem of the propriety of selection of the particular attorney. The Second Circuit in In re Ira Haupt & Co.\(^8\) was faced with a motion by limited partners of the bankrupt for an order directing the trustee to disassociate the firm of attorneys previously retained with court approval. The request was based on the ground that the trustee was a partner in the firm and, as such, would share in the fees paid to the firm as attorneys and would share his fees as trustee with his partners. After a close analysis of Sections 72 and 62c and General Order 42 the court concluded that the Act contained no clear answer to the problem of fee sharing in this context and that, in any event, the practice of retaining the trustee's own firm as attorneys is not desirable and should be discouraged, especially in large estates where independent advice is needed. However, the Court held that in this case, where the firm had made considerable investigation and was receiving outside help, more harm than good would result from requiring the trustee to change attorneys at this point. Thus, while the court declined to hold that the practice of appointing the trustee's firm as his attorneys violates the Act, the opinion weighs heavily in that direction.

This should be compared with In re Itemlab, Inc.,\(^9\) in which the attorney who represented a secured creditor was approved as special counsel for the trustee to sue for invalidation of a prior lien against the property subject to the lien of the attorney's client. The court held that the attorney did not represent conflicting interests between the secured creditor and the trustee within the meaning of General Order 44 in seeking to invalidate the prior lien, since the interests of both clients were parallel

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or common at that point. Any conflict of interest arose only after the prior lien was invalidated, when both clients would assert rights in the property thus recovered. The court also stated as dictum that in any event there was probably adequate disclosure here of the attorney's representation of the secured creditor from his having filed the secured claim.

III. THE ESTATE IN BANKRUPTCY

Under Section 70a the bankruptcy trustee is "vested by operation of law with the title of the bankrupt as of the date of the filing of the petition"\(^4\) in most of the non-exempt property of the bankrupt. Several recent decisions deal with problems related to the estate thus succeeded to by the trustee or recoverable by him through use of his various avoiding powers.

A. Section 70a(5)

Section 70a(5) broadly vests in the trustee the title of the bankrupt as of the date the petition is filed in all property transferable by him or subject to levy against him. This includes "rights of action," even though contingent, if sufficiently vested to be property in any way transferable or subject to levy. There has been uncertainty as to whether the trustee succeeds to a claim for refund of federal income taxes, based on net operating losses which were incurred in the year during which the bankruptcy petition is filed and applied against income earned, and on which tax was paid by the bankrupt in prior years. The courts of appeals have differed on the question.\(^8\)

There are two problems. First, the claim for refund does not technically come into existence until the end of the year in which the bankruptcy petition is filed. Second, 31 U.S.C. Section 203 prohibits transfers of claims against the United States until allowed or settled as to amount.

The Supreme Court in *Segal v. Rochelle*\(^8\) has now authoritatively resolved the issue in favor of the trustee. It held first that, although the claim for refund did not technically arise until the close of the year, it was based in this case on losses which had occurred prior to bankruptcy and was therefore "property" within the broad language of Section 70a(5). Second, the claim was at that time sufficiently transferable to pass under Section

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84. Section 70a.
85. Fournier v. Rosenblum, 318 F.2d 525 (1st Cir. 1963) and *In re Sussman*, 289 F.2d 76 (3d Cir. 1961) held in favor of the bankrupt, but *Segal v. Rochelle*, 336 F.2d 298 (5th Cir. 1964) held for the trustee.
86. 382 U.S. 375 (1966).
70a(5), notwithstanding 31 U.S.C. section 203, because this statute is solely for the protection of the government. As between the transferror and transferree, the local courts would protect the rights of an assignee of such property in equity. Thus, the Court states, the bankruptcy estate properly gets the benefit of the refund predicated both on taxes paid and losses incurred prior to bankruptcy which may have contributed to the bankruptcy itself.87

In contrast, the Second Circuit in Klebanoff v. Mutual Life Ins. Co. of New York88 held that the wife's interest as beneficiary of ten life insurance policies on the husband's life subject to the husband's right to change the beneficiary did not pass to her trustee in bankruptcy under Section 70a(5) where the insured husband died less than three months after the wife's bankruptcy. Even though local law treated the wife's interest as "vested subject to divestment" and a creditor had obtained a temporary injunction against change of the beneficiary prior to bankruptcy, the court held that the wife's interest was not sufficiently vested on the date of bankruptcy.89

B. Equitable Subordination

Three recent decisions deal with the uncertain limits of the bankruptcy court's equitable power to subordinate certain claims against the estate which the court deems unconscionable under the doctrine of Pepper v. Litton.90 As in Pepper v. Litton, this power is usually invoked with respect to claims by corporate insiders against the bankrupt corporation. Thus, in Braddy v. Randolph91 the Fourth Circuit held that the corporate president's claim and deed of trust were properly subordinated to claims of creditors on the basis of substantial evidence of initial under-capitalization and mismanagement of the corporation. But the Eighth Circuit in Kennalley v. Standard Electronics Corp.92 held that the secured claim of

87. In this case there were three bankrupts—two partners and the partnership they had operated which had incurred the losses. The court does not discuss whether the estates of the partners or that of the partnership gets the refund. Since prior taxes being refunded had been paid by the partners, they were asserting the claim. But it is not clear whether creditors of the partnership estate might not claim priority over separate creditors since the refund depends in part on losses incurred by the partnership. Cf. Section 5.
88. 362 F.2d 975 (2d Cir. 1966).
89. The court also rejects an argument based on the clause in Section 70a vesting in the trustee property which vests in the bankrupt within six months after bankruptcy "by bequest, devise or inheritance." The court held that the receipt of insurance proceeds did not constitute either bequest, devise, or inheritance as commonly understood.
91. 352 F.2d 80 (4th Cir. 1965).
92. 364 F.2d 642 (8th Cir. 1966).
Standard, which had effective control of the bankrupt corporation, should not be subordinated, since there was no evidence of actual fraud or unfairness by Standard. However, in an unusual and questionable application of this principle it was held in *In re Elkins-Dell Mfg. Co.*\(^{93}\) that security agreements held by a non-insider creditor might be invalidated if the referee found as a fact that the extreme protection and remedies these agreements gave the creditor made them unconscionable in equity.

C. Trust Funds

Ordinarily funds held by the bankrupt in trust for another are subject to reclamation by the beneficial owner, if the trust is valid and the funds are segregated from the bankrupt's own funds or can be traced into specific identifiable assets. Three recent cases illustrate the many possible uses of the trust form in commercial transactions. *Elliott v. Bumb*\(^ {94}\) involved proceeds of money order sales held by the bankrupt in trust for the issuer who brought reclamation proceedings. The Ninth Circuit held that a valid trust had been created as to the segregated part of the proceeds, which could therefore be reclaimed. But the court held that the co-mingled part of the proceeds could only be reclaimed if traced into specific present assets, and that a statutory trust on the bankrupt's general assets imposed by California law\(^ {95}\) for such proceeds was unenforceable. Similarly, in *Sonnenschein v. Reliance Ins. Co.*\(^ {96}\) where an insurance agent had used collected premiums, which under New York law were held in trust for the insurers as collateral for his personal loans from the bankrupt, the Second Circuit held that co-mingling of the funds by the bankrupt placed the burden on the insurers to trace them into specific present assets of the bankrupt in order to have reclamation. *In re Lord's, Inc.*\(^ {97}\) involved a reclamation petition by the lessee of the shoe department in the bankrupt's department store for the net proceeds of shoe sales held by the bankrupt for the lessee under a provision that the proceeds were to be held in trust but might be co-mingled and used to pay expenses. The court denied reclamation, holding that the bankrupt's freedom to use and co-mingle the alleged trust funds prevented the creation of an actual trust relationship merely from the use of the words "trust" and "trust funds" in the lease.

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94. 356 F.2d 749 (9th Cir. 1966).
95. CAL. FIN. CODE § 12300.3.
96. 353 F.2d 935 (2d Cir. 1965).
97. 356 F.2d 456 (7th Cir. 1965).
D. Post-bankruptcy Transfers

Since the trustee's title under Section 70a vests "by operation of law" and dates from the filing of the petition, the rights of innocent transferees for value from the bankrupt after that date have long been a problem as a result of which Section 70d was added to the Act in 1938. But except for a clause protecting generally "the negotiability of negotiable instruments," the protection granted by Section 70d is limited to good faith transfers prior to adjudication or possession of the property by a receiver. In 1959 Congress amended Section 18f to make adjudication automatic on the filing of a voluntary petition, but it did not revise Section 70d. This apparent oversight recently resulted in the unfortunate decision of the Ninth Circuit in Bank of Marin v. England.

In that case checks properly drawn by the bankrupt payable to a creditor shortly before filing a voluntary petition were presented for payment and paid by the drawee bank in due course six days after the petition had been filed, the bank having no actual notice of the bankruptcy. The Ninth Circuit held that both the bank and the payee of the checks were jointly liable to the trustee for the amount of the checks. The court reasoned that the filing of the petition automatically (a) revoked the outstanding checks, (b) vested title to the bank account in the trustee, and (c) was constructive notice of the bankruptcy to all the world. The Court concluded that only Section 70d protected post-bankruptcy transferees, but did not help the bank here because (a) payment of the checks occurred after adjudication and (b) was not technically a negotiation and thus not within the "negotiability" proviso.

On certiorari the Supreme Court reversed the Ninth Circuit with respect to the bank's liability. The basic holding of the Court is that

101. Bank of Marin v. England, 87 Sup. Ct. 274 (1966). Mr. Justice Fortas dissented on the ground that the issue was moot since the payee had paid the amount of the checks to the trustee. The Court held that the issue of costs and

http://scholarship.law.missouri.edu/mlr/vol32/iss1/7
under Section 70a the trustee succeeds only to such title in the bank account as the bankrupt had, which in this case was subject to the bank's right and duty under the deposit contract to honor validly issued checks on presentment unless given reasonable notice to the contrary in time to stop payment. The Court rejected both the idea that the filing of the petition automatically revoked outstanding checks and the idea that the mere filing of the petition was sufficient notice to the bank to stop payment. These holdings are eminently sound and rectify a clear injustice.

But on the difficult problem of construing the language of Section 70d the Court's opinion is less clear and relies essentially on the equitable powers of the bankruptcy court under Pepper v. Litton\(^{102}\) to prevent an inequitable result. At this point Mr. Justice Harlan dissented vigorously on the ground that equitable powers under Pepper v. Litton should not be invoked where the Act is clear, as Section 70d is here, and that in this decision the Court is opening the door to judicially created exceptions with no definite limits, which Section 70d was intended to preclude. The cogency of this argument and the equity of the Court's decision point to the need for a clarifying amendment to the Act.

E. Preferences

Two cases illustrate the fact that, while the trustee has a potent ability to recover assets for the bankruptcy estate under Section 60 by avoiding preferences, this power is limited in several important respects. Once the trustee has established that a preference occurred within four months prior to bankruptcy under the complex definitions of Section 60a, he still must prove under Section 60b that the creditor receiving the preference has, "at the time the transfer is made, reasonable cause to believe that the debtor is insolvent" in order to set it aside.\(^{103}\)

The Fifth Circuit in International Minerals & Chem. Corp. v. Moore\(^{104}\) held that the term "reasonable cause" means actual knowledge of facts which would induce a reasonable belief of insolvency or which would prompt an inquiry which would disclose insolvency and that this knowledge must exist at the time the preference is received. The court held that in the case before it the creditor's mere anxiety about collectibility of its debt more than two years prior to receipt of the preferential payment in ques-

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the fact that the payee was asserting a claim for contribution from the bank overcame the mootness problem.

102. 308 U.S. 295 (1939).
103. Section 60b.
104. 361 F.2d 849 (5th Cir. 1966).
tion was not shown to have been of this character or to have continued to the time of the preferential transfer.

Four days later the same court in Shaw v. United States Rubber Co.\textsuperscript{105} held that the creditor did not have "reasonable cause" to believe the debtor was insolvent, notwithstanding the fact that an earlier certified balance sheet based on book values less depreciation resulting in a net deficit had been replaced on inquiry by the creditor by an uncertified balance sheet using appraisal values resulting in a surplus, and the fact that the check received by the creditor constituting the preferential payment in question had previously been returned for insufficient funds, but was paid on second presentment with a plausible explanation by the debtor.

IV. THE BANKRUPTCY DISCHARGE

Economic rehabilitation of the bankrupt is one of the principal policies of the Bankruptcy Act and is achieved primarily through discharge of most existing indebtedness. However, the discharge may be denied on any one of the eight grounds listed in Section 14c,\textsuperscript{106} and if granted, the discharge does not release the several types of debts enumerated in Section 17a.

A. Denial of Discharge—Section 14c

Three recent cases have dealt with denials of discharge to the bankrupt under Section 14c. The court in In re Simard\textsuperscript{107} held that the referee properly denied discharge under Section 14c(3) where the bankrupt had borrowed over $21,000 on the security of fictitious invoices and schedules evidencing non-existent accounts receivable. The Court held that the invoices and schedules in this context were "false statement(s) in writing respecting his financial condition" within the meaning of Section 14c(3), though not financial statements in the usual sense. And the Second Circuit in In re Melnick\textsuperscript{108} held that the referee had not acted unreasonably in denying discharge under Section 14c(1), which incorporates 18 U.S.C. Section 152, where the bankrupt had failed to disclose in his statement of affairs, filed under Section 7a(9), that within the year prior to bankruptcy he and his wife had realized $273.72 net proceeds from the sale of their home held as tenants by the entirety which they had used to pay moving expenses.

\textsuperscript{105} 361 F.2d 679 (5th Cir. 1966).
\textsuperscript{106} The eighth ground was added by 79 Stat. 646 (1965) and is discussed in text accompanying note 42 supra.
\textsuperscript{108} 360 F.2d 918 (2d Cir. 1966).
Evidently the bankrupt in *Baum v. Millikin*\(^{109}\) was on the horns of a dilemma. Having successfully defended the validity of a financial statement given 21 months before bankruptcy, which showed his net worth as \$309,359.00, against the trustee's objection under Section 14c(3), the bankrupt was only able to explain his subsequent loss of \$366,740.26 by vague and disjointed testimony regarding "shrinkage" of values and transactions between closely held corporations. The Seventh Circuit held that the referee's denial of discharge under Section 14c(7) was not improper, since this was less than a "satisfactory" explanation of the loss.

### B. Wage Earner's Plans

Under Section 14c(5) discharge may be denied a bankrupt if he has received a bankruptcy discharge within the preceding six years. In a proceeding under Chapter XIII the court is to deny confirmation of the wage earner's plan under Section 656a(3) if the debtor has "been guilty of any of the acts or failed to perform any of the duties" which would bar a discharge. While this would seem to incorporate all of the grounds listed in Section 14c as bars to confirmation of a wage earner's plan, it has been urged that a prior discharge within six years should not prevent confirmation of a plan providing only for extension of time in which to pay existing indebtedness out of future wages, as distinguished from a plan for composition or partial payments.\(^{110}\)

In a recent decision of major importance the United States Supreme Court in *Perry v. Commerce Loan Co.*\(^{111}\) has now interpreted Section 656a(3) as not preventing confirmation of a wage earner's plan for an extension only where the debtor has received a discharge within the preceding six years. The Court, recognizing the basic distinction between the extension plan and the composition plan, points out that the policy behind the six-year rule was to prevent repeated escape from debt through bankruptcy discharge, but that in contrast, Congress, in enacting Chapter XIII in 1938, intended to provide a means by which a wage earner could repay indebtedness out of future earnings as a preferable alternative to straight bankruptcy liquidation of present assets. The Court observes further that statistics indicate it has been used principally for extension

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\(^{109}\) 359 F.2d 811 (7th Cir. 1966).


rather than composition plans. The Court reasons that Section 656a(3), in referring only to "guilty acts" and failures of duty, might reasonably be interpreted as incorporating only those grounds in Section 14c involving fault or wrongdoing (which would not include the six-year rule), but that it is at least sufficiently ambiguous to permit the Court to construe it in harmony with the intent of Congress in enacting Chapter XIII. Hence, the Court concludes that Section 656a(3) does not prevent confirmation of an extension plan on the grounds that there has been a prior discharge within six years.

The Court carefully qualifies its decision as being applicable only to Chapter XIII and not Chapter XI and only to the extension plan rather than a plan involving any element of composition. Further, the Court comments that, if an extension plan is not completed within three years and discharge is sought under Section 661, objection might then be made on the grounds of a prior discharge within six years and that the bankruptcy court might invoke its equitable powers to prevent abuse of Chapter XIII through repeated filing of extension plans with unreasonable frequency.

This latter dictum was invoked by the court in In re Webb to affirm the referee's dismissal of a wage earner's extension plan filed in February, 1966, on the grounds that another extension plan, which had been confirmed in November, 1964, was still pending before the court and that the debtor had filed petitions in April and June, 1964, for extension plans, which had been dismissed, and had received a bankruptcy discharge in September, 1963.

While it is generally agreed that the result reached in Perry is desirable, it is difficult to reconcile with the language of the sections involved. As ably pointed out by Mr. Justice Harlan in his dissent, several of the arguments advanced by the Court's opinion are on questionable footing historically. Since the result seems desirable, but the Court, in order to strengthen this decision, has virtually precluded the same treatment from obtaining for an extension plan under Chapter XI, it is to be hoped that Congress will buttress this decision with remedial legislation and will extend the same treatment to other extension plans. Similarly, several related situations should be dealt with on a consistent basis.

112. Administrative Office of the United States Courts, Tables of Bankruptcy Statistics, Table F 11 (1964) indicates that 95% of funds paid to creditors in Chapter XIII proceedings are from extensions rather than compositions.
114. Confirmation of an extension plan may precede within six years a straight bankruptcy, a composition plan under either Chapter XI or Chapter XIII, or an extension plan under either Chapter XI or Chapter XIII. A parallel set of possi-
In the converse situation where the bankrupt obtained confirmation of a Chapter XIII extension plan in 1960 and filed a voluntary petition in bankruptcy in 1964, the Seventh Circuit in *Barnes v. Maley*,\(^{115}\) relying almost exclusively on *Perry v. Commerce Loan Co.*, reversed the denial of discharge to the bankrupt under Section 14c(5). The court interpreted *Perry* as stating a basic principle governing treatment of Chapter XIII extension plan confirmations equally applicable in the converse situation. While the court reaches a proper result in this case, the opinion fails to observe that Section 14c(5) itself, more clearly than *Perry*, draws the distinction between extension and composition plan relevant to this situation by providing only that the discharge shall be denied when the bankrupt has received a discharge or had a composition plan under Chapter XI or Chapter XIII confirmed within the preceding six years. No reference is made in Section 14c(5) to prior confirmation of an extension plan.

**C. Scope of the Discharge—Section 17a**

Several specific types of debts of the bankrupt are excepted from the effect of the discharge by Section 17a. Since the enforcement of the discharge itself is ordinarily left to the bankrupt, who must assert it as a defense to a subsequent suit on the debt,\(^{116}\) the issue of whether the debt sued on is excepted from the discharge under Section 17a is usually also decided in the subsequent suit. Hence, the interpretation of Section 17a falls largely to the state courts rather than the bankruptcy courts.

Two recent decisions in this area should be noted by Missouri lawyers. In *United States v. Syros*,\(^{117}\) the District Court for the Eastern District of Missouri held that under Section 17a(2) the burden was on the plaintiff (in this case the United States suing on home improvement notes it had insured through FHA) to prove that the defendant was motivated by actual, willful fraud and an intent to deceive in failing to disclose outstanding FHA obligations in the loan application. The court concluded that,
since the defendant's explanation that he had not understood what was called for and that due to his inability to read English well a bank officer had actually completed the form for him was credible, the plaintiff had failed to prove this degree of culpability and thus had not established that its debt was excepted under Section 17a(2) from the defendant's bankruptcy discharge.

In Behymer Corp. v. Steffe the St. Louis Court of Appeals held that the plaintiff's claim based on a judgment recovered prior to the defendant's bankruptcy was excepted from the discharge under Section 17a(3) because the defendant failed to include the plaintiff's correct address in listing his claim in the schedules filed under Section 7a(8). It was clear from the evidence that the correct address, if not known to the defendant, was readily ascertainable from the local telephone directory. The defendant had listed an address from which plaintiff had moved two years earlier, evidently obtained from old invoices. The court held that the defendant's responsibility to schedule the creditor properly under Section 7a(8) included, at least, the obligation to check for a change of address where the information was at hand. In addition, the court held that it was not shown that the plaintiff had notice or actual knowledge of the bankruptcy proceedings in time to protect its rights merely from a recitation in the sheriff's return on an earlier writ of execution on plaintiff's judgment that defendant had filed bankruptcy.

V. Conclusion

Thus Congress and the courts have recently effected several material changes and new interpretations in important areas of bankruptcy law and practice within the general framework of the Bankruptcy Act. Consistent with past experience, it appears that several of the new developments pose problems which call for still further amendment of the Act by Congress and interpretation of it by the courts.

118. 400 S.W.2d 457 (St. L. Mo. App. 1966).