a single Chapter VII. Additional muscle against secured creditors would be given in the area of offset and utilization by the debtor of collateral essential to the business.

Anyone active in the field of bankruptcy, reorganization, or the representation of institutional lenders would do well to study carefully the proposed Bankruptcy Act of 1973 to the end that their views may be made known to the subcommittees of the House and Senate Judiciary Committees, which will soon be conducting extensive hearings on the bills.

Survey

In a depressed economy, the fair administration of the bankruptcy laws becomes increasingly important. The cases decided by the Fifth Circuit during the compendium period, although overshadowed by the potential revision of the statutory law, are illustrative of the judiciary's application of the Act in light of its overriding purpose; to give relief to creditors and their debtors who are either unwilling or unable to pay their debts.[1]

I. DISCHARGE

Referring to the Bankruptcy Act as a "sturdy bridge over financially troubled waters," the Fifth Circuit affirmed the granting of a discharge in *In re Jones*.[2] The bankrupt's attorney had failed to complete a schedule of the dates certain debts were contracted. This failure served as the basis of the creditor's contention on appeal that the granting of discharge should be reversed.[3]

Writing for the majority, Judge Goldberg stated that although "[r]eliance on the Bankruptcy Act, chapter and verse, is to be applauded, . . . statutory detail should never obscure the relatively simple standards by which a Court of Appeals must evaluate this type of bankruptcy case."[4] Furthermore, the court viewed the

1. J. MACLACHLAN, HANDBOOK ON THE LAW OF BANKRUPTCY (1956).

2. 490 F.2d 452, 457 (5th Cir. Feb.,1974).

3. The creditor also objected to an oral amendment made in open court. *Id.* at 455.

4. *Id.* at 455. The court reasoned that section 14c-6 did not require denial of discharge for technical violations of a lawful order of the court and that discharge should be denied only for real and substantial reasons. *Id.* at 456.

Bankruptcy Act § 14(c)(6), 11 U.S.C. § 32(c)(6) (1970) provides that discharge shall be granted unless the bankrupt has,

> . . . in the course of a proceeding under this Act refused to obey any lawful order of, or to answer any material question approved by, the court; . . . .

statutory right to discharge as deserving of liberal construction in favor of the bankrupt and strict construction against the objecting creditor.[5] Thus, in weighing "the detriment to the proceedings and the dignity of the court against the potential harm to the debtor if the discharge [were] denied . . . ," the court found no abuse of discretion in the granting of discharge.[6] Judge Goldberg stated that the court would not make the Bankruptcy Act into "a treacherous tightrope on which the slightest misstep spells disaster and over which only the most accomplished acrobat can successfully pass."[7]

The conduct of a business bankrupt, as opposed to that of a mere wage earner, is measured by a higher standard of care. In *In re Goff*,[8] the bankrupt's business records were in sufficient disarray to prevent the preparation of tax returns. Putting aside the bankrupt's explanation for his failure in this regard, the court upheld the denial of discharge.[9]

In addition to denying discharge, the lower court in *In re Recile*[10] extended the time during which objections to the discharge could be filed. It appeared that 2 years after the deadline for filing objections to discharge, it was discovered that the bankrupt had withheld information relating to certain debts. Near the time of this discovery, the bankrupt, Sam Recile, sought discharge *nunc pro tunc*. The bankruptcy judge denied Recile's request and extended the time for filing objections to his discharge.[11] In affirming the lower court's decision, Judge Wisdom stated that the appropriate liberal construction of rule 404(c) allowed the lower court to extend the time for filing complaints objecting to discharge.[12]

---

5. *In re* Jones, 490 F.2d 452, 456 (5th Cir. Feb.,1974).

6. *Id.*, *citing In re* Kokoszka, 479 F.2d 990, 997-98 (2d Cir. 1973).

7. *In re* Jones, 490 F.2d 452, 457 (5th Cir. Feb.,1974). The court also found the oral amendments to be proper under the circumstances. *Id.*

8. 495 F.2d 199 (5th Cir. June,1974).

9. An experienced accountant could have produced a semblance of accuracy from the bankrupt's records in approximately 3 months and at a total cost of 2500 dollars. *Id.* at 200 n.3.

The Fifth Circuit remanded the case to the district court in order to allow the bankrupt to place his books and records in an adequate condition. *In re* Goff, 495 F.2d 199, 202 (5th Cir. June,1974).

10. 496 F.2d 675 (5th Cir. June,1974).

11. On appeal Recile argued that both the denial of discharge *nunc pro tunc* and the extension of time for filing objections after the time originally set had passed were reversible errors. *In re* Recile, 496 F.2d 675, 679-80 (5th Cir. June,1974).

12. *In re* Recile, 496 F.2d 675, 680 (5th Cir. June,1974). Bankruptcy Rule 404(c) provides:

> (c) Extension of Time. The court may for cause, on its own initiative or on application of any party in interest, extend the time for filing a complaint objecting to discharge.

II. Proof and Allowance of Claims

Claims represent liabilities of the bankruptcy estate. In order for those asserting claims to share in the dividends of the estate, however, the claimants must file and prove their claims. Additionally, certain claims are given priority treatment.[13]

A. The Right of Setoff

The common law right of setoff, as found in section 68 of the Bankruptcy Act, although historically applicable chiefly to banks, currently serves a myriad of purposes.[14] In upholding an employer's right of setoff against commissions owed to an employee, the Fifth Circuit in *Wiley v. Public Investors Life Insurance Co.*,[15] reasoned that only property belonging to the bankrupt passes into the bankruptcy estate.[16] Although section 70(a) of the Bankruptcy Act governs the passage of the bankrupt's property into the estate, state law defines the property of the bankrupt in the first instance.[17] In *Wiley* the court applied Louisiana state law, which sanctioned transfers of the right to future earnings.[18] The employee in *Wiley*, a life insurance salesman, had given his employer, as security for a salary advance, a lien on commissions owed to the employee. Upon the employee's bankruptcy, the trustee stepped into the employee's shoes, gaining no greater interest in the right to these future earnings than that of the employee.[19]

In *In re Diplomat Electric, Inc.*,[20] Westinghouse Electric Supply Company (WESCO) successfully set off a prior contract judgment against a subsequent intentional tort claim asserted by the bankrupt against WESCO for defamation.[21] Although noting that there were equitable policy considerations justifying denial of setoff when the intentional tort claim is conversion, the court distinguished defamation from conversion.[22]

---

13. *See* S. Riesenfeld, Creditors' Remedies and Debtors' Protection 564, 568 (1967).
14. *See* J. MacLachlan, Handbook on the Law of Bankruptcy 341-42 (1956).
15. 498 F.2d 101 (5th Cir. Aug.,1974).
16. *Id.* at 103. *See* Bankruptcy Act § 70(a), 11 U.S.C. § 110(a) (1970).
17. The court noted that while section 70(a) of the Bankruptcy Act governs the passage of the bankrupt's property into the estate, state law defines the property of the bankrupt. Wiley v. Public Investors Life Ins. Co., 498 F.2d 101, 103 (5th Cir. Aug.,1974).
18. Wiley v. Public Investors Life Ins. Co., 498 F.2d 101, 104 (5th Cir. Aug.,1974) *citing* Cox v. First Nat'l Bank, 126 La. 88, 52 So. 227 (1910).
19. Wiley v. Public Investors Life Ins. Co., 498 F.2d 101, 104 (5th Cir. Aug.,1974).
20. 499 F.2d 342 (5th Cir. Aug.,1974).
21. *Id.* at 344.
22. *Id.* at 346-47.

WESCO's original failure to include notice of its intention to exercise its claimed right of setoff at the time of filing its original proof of claim was not found dispositive.[23] The court held that WESCO's failure to assert this claim originally or to amend within 6 months, as provided by section 57(n) of the Bankruptcy Act, was not a waiver. The court noted that there can be no waiver in the absence of an "intentional relinquishment of a known right."[24] Judge Simpson found persuasive WESCO's argument that to have filed its claimed right of setoff at the time the defamation action was on appeal potentially would have been an admission adversely affecting its appeal.[25] The fact that WESCO was insured did not destroy the required mutuality between both the obligations and the obligors.[26]

The fact that the bankrupt's attorney in its defamation action was compensated on a contingent fee basis raised the question of the relative priority of attorney's charging liens vis-a-vis the right of setoff. The controlling state law was found in accord with the common law rule: Pre-existing judgments take priority. The common law right of setoff, therefore, takes priority over the attorney's charging lien.[27]

The Republic National Bank of Houston was allowed to exercise the right of setoff as to a payroll account of the bankrupt when the account was a general deposit, and the bank had no notice of the use of the monies as a special fund for withholding taxes of the bankrupt's employees. Although applying federal law, the Fifth Circuit in *In re Goodson Steel Corp.*[28] viewed the Texas rule with an "interested eye": When no special agreement exists between the bank and the depositor, the law will imply a general deposit, one that is subject to the bank's right of setoff.[29]

---

23. Judge Simpson noted that the right of setoff is within the sound discretion of the court. The basis of review, therefore, would be an abuse of discretion; clearly there was no such abuse here. *In re* Diplomat Elec., Inc., 499 F.2d 342, 347 (5th Cir. Aug.,1974).

24. *Id.* at 347. *See* Chassen v. United States, 207 F.2d 83 (2d Cir. 1953), *cert denied,* 346 U.S. 923 (1954). *See also* Bankruptcy Act § 57(n), 11 U.S.C. § 93(n) (1970).

25. *In re* Diplomat Elec., Inc., 499 F.2d 342, 347 (5th Cir. Aug.,1974).

26. Bankruptcy Act § 68(a), 11 U.S.C. § 108(a) (1970) provides

a. In all cases of mutual debts or mutual credits between the estate of a bankrupt and a creditor the amount shall be stated and one debt shall be set off against the other, and the balance only shall be allowed or paid.

In re Diplomat Elec., Inc., 499 F.2d 342, 348 (5th Cir. Aug.,1974).

27. *In re* Diplomat Elec., Inc., 499 F.2d 342, 349 (5th Cir. Aug.,1974).

28. 488 F.2d 776 (5th Cir. Jan.,1974).

29. *Id.* at 779-81. The court cited RESTATEMENT (SECOND) OF TRUSTS § 324(i) which states:

Banks, however, are not permitted to profit from a "misapplication of trust funds. . . ."[30] In *Kaufman v. First National Bank*,[31] Judge Godbold held in favor of the trustee in his plenary action attacking the bank's setoff as in fact a voidable preference. The deposits in question were C.O.D. and "escrow" accounts of a motor carrier. The bank, having knowledge of the true nature of the accounts, was deemed to hold the funds in the accounts not as general deposits, but rather in trust for a special purpose. No right of setoff exists against special accounts of this nature.[32]

B. Sufficiency of the Property Description

A secured creditor's rights in property possessed by the debtor are dependent upon proper perfection of a security interest under applicable state law. Most states require a filed financing statement that adequately describes the collateral, thereby diminishing the potential for disputes over what items, if any, serve as collateral.[33]

A secured creditor's interest withstood the trustee's allegation of an inadequate financing statement property description in *In re Turnage*.[34] The financing statement's reference to "consumer goods" was found sufficient to place third parties on notice that the particular item in question might be subject to a security interest and that further inquiry was required.[35]

C. Priority Claims

The Bankruptcy Act distinguishes "between liens and unsecured priority claims, postponing the latter to the former."[36] The trustee in *In re Crown Cabinets, Inc.*[37] unsuccessfully attempted to attack a fifth priority claim asserted by the Small Business Administration (SBA). Although the SBA's original proof of claim did not document fully the nature of its claim, full and sufficient documen-

---

(i)*Set-off of the trustee's personal indebtedness to the bank.* If a bank in which trust funds have been deposited has notice that funds deposited are trust funds, it cannot set off against its liability on the deposit a debt owing it from the trustee personally. . . .

30. Kaufman v. First Nat'l Bank, 493 F.2d 1070, 1072 (5th Cir. May,1974).

31. 493 F.2d 1070 (5th Cir. May,1974).

32. *Id.* at 1072, *citing In re* Goodson Steel Corp., 488 F.2d 776 (5th Cir. Jan.,1974).

33. *See generally* J. WHITE & R. SUMMERS, HANDBOOK OF THE LAW UNDER THE UNIFORM COMMERCIAL CODE 818-20 (1972).

34. 493 F.2d 505 (5th Cir. May,1974).

35. *Id.* at 506, *quoting* Associates Capital Corp. v. Bank of Huntsville, 49 Ala. App. 523, ___, 274 So. 2d 80, 83 (1973).

36. S. RIESENFELD, CREDITORS' REMEDIES AND DEBTORS' PROTECTION 567 n.32 (1967).

37. 488 F.2d 91 (5th Cir. Dec.,1973).

tation was offered in a second amended proof of claim filed outside the 6-month deadline provided by section 57(n).[38] The bankruptcy judge, sitting as a court of equity and being duty-bound to examine each claim to insure justice, ruled that the original claim was sufficient to place the bankruptcy court on notice of the claimed priority. In a per curiam opinion, the Fifth Circuit affirmed the bankruptcy judge's ruling that the SBA's fifth priority claim should be preserved.[39]

D. Review of Bankruptcy Orders

The bankrupt's attorney in *In re Simmons*[40] appealed from an order reducing the amount of his fee. The Fifth Circuit affirmed the lower court's holding that failure of the aggrieved party to file a petition for review with the bankruptcy judge within the 10-day limitation of section 39(c)[41] caused the order to become final. Judge Godbold ruled that the reduction order did not fit within the "administrative order" exception to section 39.[42]

III. VOIDABLE TRANSFERS

> [A]s a rule, some degree of cooperation between creditors is necessary. One creditor will be reluctant to withhold his hand, if he has reason to suspect that other creditors will rush in and seize the assets to his exclusion. An important factor promoting creditor

38. Bankruptcy Act § 57(n), 11 U.S.C. § 93(n) (1970). The SBA's fifth priority claim under Bankruptcy Act § 64 (5), 11 U.S.C. § 104(5) (1970), was based on 31 U.S.C. § 191 (1970) which provides:

> Whenever any person indebted to the United States is insolvent, or whenever the estate of any deceased debtor, in the hands of the executors or administrators, is insufficient to pay all the debts due from the deceased, the debts due to the United States shall be first satisfied; and the priority established shall extend as well to cases in which a debtor, not having sufficient property to pay all his debts, makes a voluntary assignment thereof, or in which the estate and effects of an absconding, concealed, or absent debtor are attached by process of law, as to cases in which an act of bankruptcy is committed.

In bankruptcy, 31 U.S.C. § 191 grants only a fifth priority to non-tax claims of the United States. *See* S. RIESENFELD, CREDITORS' REMEDIES AND DEBTORS' PROTECTION 567 n.33 and accompanying text.

39. The court distinguished three cases cited by the Trustee in which priorities were denied; the court noted that in the cited cases, the original claims were insufficient to put the bankruptcy judge on inquiry as to the "basis of the claim asserted in the later amendment." *In re* Crown Cabinets, Inc., 488 F.2d 91, 92 (5th Cir. Dec.,1973).

40. 493 F.2d 13 (5th Cir. Apr.,1974).

41. Bankruptcy Act § 39(c), 11 U.S.C. § 67(c) (1970).

42. *In re* Simmons, 493 F.2d 13, 14-15 (5th Cir. Apr.,1974).

> cooperation, however, is provision in the National Bankruptcy Act for setting aside liens and transfers where creditors pursuing aggressive collection methods attempt to get more than their share of the debtor's assets.[43]

The Fifth Circuit, in *Tankersley v. Creditor Executives Service Corp.*,[44] found voidable a transfer of funds by the bankrupt to a liquidator of insolvent estates. The transfer was made within 4 months of bankruptcy and with the knowledge that such liquidation would result in the bankrupt's father receiving a disproportionately large percentage of the estate.[45]

In *In re Wilco Forest Machinery, Inc.*,[46] the trustee sought to recover assets of the bankrupt in the hands of the bankrupt's supplier. The supplier asserted a security interest in the items in question. Wilco Forest Machinery, Inc. (WFM) was a large distributor of heavy logging machinery made by Timberjack Machines, Ltd., a subsidiary of Eaton Corporation (Eaton).[47] Eaton financed WFM's dealership operation. There were two types of accounts between WFM and Eaton, accounts payable and debenture notes payable in which a security interest had been perfected under Article 9 of the Uniform Commercial Code. The arrangement required WFM either to pay the accounts payable on a monthly basis or to transfer them to a secured debenture note account. Furthermore, the debenture notes were convertible into the common stock of WFM.[48]

WFM suffered a number of financial setbacks, and Eaton decided to exercise its conversion option. By converting the debentures into common stock, Eaton became the majority shareholder of WFM. After a proposed settlement with the unsecured creditors of WFM was rejected, the new Eaton management decided to place WFM into bankruptcy.[49]

---

43. J. MACLACHLAN, HANDBOOK OF THE LAW OF BANKRUPTCY 4 (1956).

44. 492 F.2d 1379 (5th Cir. Apr.,1974).

45. *Id.* at 1380. Bankruptcy Act § 60, 11 U.S.C. § 96 (1970).

46. 491 F.2d 1041 (5th Cir. Mar.,1974).

47. "Eaton" consists of several corporations. *See id.* at 1043 n.1.

48. Note that the Uniform Commercial Code has been adopted in Alabama and is codified in the ALA. CODE tit. 7A (1966).

49. Note that prior to filing the petition, the WFM officers, who were also officers of Eaton, organized Timberjack of Alabama, Inc. to repossess the collateral securing the debentures in question. Although the actual repossession took place on June 8, 1971, this new corporate entity was not actually formed until June 9, 1971. The trustee argued that the alleged secured party was not in existence at the time of the filing of its financing statement, and, therefore, the financing statement was insufficient. The court noted, however, that the purpose of the *Uniform Commercial Code* § 9-402 was to put inquiring creditors on notice of prior security interests. Judge Thornberry found that while it was true that Timberjack was

Eaton's repossession was alleged to be a voidable preference under section 60(a) and (b) of the Bankruptcy Act.[50] The Fifth Circuit, however, found that Eaton was a secured creditor, and, therefore, the transfer did not enable Eaton to "obtain a greater percentage of debt than some other creditor of the same class."[51] The trustee argued, however, that although a voidable preference may not have occurred as to the original debentures allowed by the corporate resolution of the original stockholders and directors of WFM, there was a preference as to an additional 617,000 dollars in debentures authorized by WFM's new management. The court, however, found that the action by the new stockholders and directors of WFM (the Eaton management) was not only proper, but was required by the terms of the dealer financing agreement between WFM and Eaton. The old stockholders and directors of WFM were without power in the first instance to have imposed a restriction on the number of convertible debentures that WFM could issue to Eaton.[52] The court also noted that the transfer in this case occurred, not when Eaton physically repossessed the assets of WFM, but rather when the security interest of Eaton "was so far perfected that no subsequent lien upon such property obtainable by legal or equitable proceedings on a simple contract could become superior to the rights of the transferee."[53] The fact that perfection, and thus transfer, occurred more than 1 year prior to bankruptcy negated both the possibility of a voidable preference and a fraudulent transfer.[54]

In *In re Ludlum Enterprises, Inc.*[55] the secured creditors perfected their security interest within 1 month of an original petition

---

not formally in existence at the time of the filing of the financing statement, the parent corporation's address listed thereon was the address for the Timberjack division of Eaton and "was the location of the records evidencing [Eaton's] security interest." *In re* Wilco Forest Mach., Inc., 491 F.2d 1041, 1044-45 (5th Cir. Mar.,1974).

50. *In re* Wilco Forest Mach., Inc., 491 F.2d 1041 (5th Cir. Mar.,1974). *See* Bankruptcy Act § 60, 11 U.S.C. § 96 (1970). The trustee also argued that he was denied a hearing before the district court. Judge Thornberry ruled, however, that the trustee had received a "fully adequate hearing." *In re* Wilco Forest Mach., Inc., 491 F.2d 1041, 1044-45 (5th Cir. Mar.,1974).

51. Bankruptcy Act § 60(a)(1), 11 U.S.C. § 96(a)(1) (1970).

52. *In re* Wilco Forest Mach., Inc., 491 F.2d 1041, 1046 (5th Cir. Mar.,1974).

53. Bankruptcy Act § 60(a)(2), U.S.C. § 96(a)(2) (1970).

54. *In re* Wilco Forest Mach., Inc., 491 F.2d 1041, 1047 (5th Cir. Mar.,1974). *See* Bankruptcy Act § 67(d), 11 U.S.C. § 107(d) (1970).

The court noted, however, the potential for overreachng by Eaton in its desire to salvage all possible assets from WFM and, therefore, affirmed the lower court's order for a full accounting of all assets recovered by Eaton between the date of the takeover of WFM and the date of bankruptcy. *In re* Wilco Forest Mach., Inc., 491 F.2d 1041, 1047 (5th Cir. Mar.,1974).

55. 493 F.2d 1345 (5th Cir. May,1974).

in bankruptcy, but without 4 months of an amended petition. Although the original petition was insufficient, adjudication of bankruptcy was obtained under the amended petition. The issue, therefore, was whether the amended petition related back to the original filing date. The Fifth Circuit found that the case should be remanded to the district court for a specific finding "with respect to the ground relied upon for the adjudication of bankruptcy . . ." under the amended petition.[56] Judge Simpson relied on the long-standing Fifth Circuit rule, announced in *Wynne v. Rochelle*,[57] that "amended petitions alleging already pleaded acts of bankruptcy in amplified or modified form relate back to the filing date of the original petition. Conversely, acts not previously alleged do not relate back, but date from the filing of the amended petition."[58]

IV. The Liquidation Sale

In *In re Hatfield Construction Co.*,[59] the Fifth Circuit held that the Georgia sales tax was applicable to a liquidation sale. The court found that " . . . property in the hands of a trustee in bankruptcy is not thereby exempt from state and local taxes . . . . Such an indirect economic detriment is not an impermissible burden . . . ."[60]

V. Conclusion

The Bankruptcy Law has evolved and changed radically over a period of years. Tracing its origin back to the Italian city-states, the Bankruptcy Law has been at times largely penal in character, and at other times has been of limited application only. Currently, we are looking forward to legislative revision and expansion of the present Bankruptcy Laws. During the interim prior to this needed change, the courts continue to construe the existing Bankruptcy Law in light of equitable principles which insure the fair administration of justice.

William B. Dawson

56. *Id.* at 1347-48.
57. 385 F.2d 789 (5th Cir. 1967).
58. *In re* Ludlum Enterprises, 493 F.2d 1345, 1347 (5th Cir. May,1974).
59. 494 F.2d 1179 (5th Cir. May,1974).
60. *Id.* at 1181.