STRAIGHT BANKRUPTCY

By G. STANLEY JOSLIN*

The Fifth Circuit quote of the year in bankruptcy matters:

> This triggered a frantic scramble by automobile dealers, who descended upon the Mutual premises and physically took possession of any and all vehicles to which they felt they could assert any claim whatsoever.[1]

Of the bankruptcy cases decided by the Fifth Circuit this year (1971), the greatest number of them were concerned with fraudulent conveyances and preferences. The practice seems to be all too common for a person in financial difficulty, or threatened financial difficulty, to transfer assets to a wife or relative intending to isolate these assets from a later bankruptcy. Noting this too prevalent practice, the Bankruptcy Act provides in substance that any transfer made without fair consideration by a debtor who is or will be rendered insolvent is a fraudulent conveyance, without regard to his intent.[2] The spotting, proving and recovery of these fraudulent conveyances and preferences are duties put on the trustee in bankruptcy.[3] It may be that trustees are recognizing this duty and beginning to act upon it more frequently.

The preference situation is somewhat similar in that a person on the financial brink may begin to pay off certain of his favored creditors before his bankruptcy. This common practice is frowned upon by the preference law, which provides basically that payments made to a creditor within four months of bankruptcy, which would enable such creditor to get an advantage over other creditors, is voidable by the trustee.[4]

PREFERENCES

In the case of *In re Jack Kardow Plumbing Co.*[5] voidable preferences were established and the question was whether the preferred creditor was entitled to a set-off against the amount of the recoverable preference. Section 60(c) of the Bankruptcy Act provides that if a creditor has

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1. *In re* Mutual Leasing Corp., 449 F.2d 811, 814 (5th Cir. 1971).
2. Bankruptcy Act §§ 67(d)(2), 70(c)(1).
3. Bankruptcy Act §§ 47(a)(1), 70(a)(4), 70(e).
4. Bankruptcy Act §§ 60(a)(1), 60(b).
5. 451 F.2d 123 (5th Cir. 1971).

been preferred, and afterward in good faith gives the debtor further credit without security of any kind for property which becomes a part of the debtor's estate, the amount of such credit may be set off against the amount otherwise recoverable from him.

The Fifth Circuit held that the furnishing of plumbing supplies with the option later to obtain security by filing a mechanic's lien is not equivalent to being secured, but is the same as having no security at all and when the option is declined the creditor is without security as required in section 60(c) and thus entitled to the set-off.[6]

For a transfer to be voidable by the trustee as a preference, it must have been made within four months of the petition in bankruptcy.[7] In *In re Souder*,[8] the Fifth Circuit held that a voidable preference did not occur where a mortgage was given over nine months before the petition and the lien was transferred to the proceeds of the sale of the property within the four months period. However, the court went on to say that no diminution of the bankrupt's estate occurred as a result of the transfer of the lien from the property to the proceeds and, as this is another of the necessary elements for establishing a voidable preference,[9] what emphasis was placed upon the time element is not known.

It is clear that the giving of a security interest to secure a prior existing debt is a transfer on account of an antecedent debt within the voidable preference provisions of the Bankruptcy Act.[10] The time of giving the security interest is computed as of the time the security interest is perfected.[11] The Fifth Circuit held that as a security interest in after-acquired inventory was perfected before or at the time of extension of credit, the transfer was not on account of an antecedent debt and so not a voidable preference.[12] The importance of this case is the philosophy expressed by the court as follows:

> The Uniform Commercial Code . . . should be read in harmony with the Bankruptcy Act if at all possible . . . . There exists no legally valid reason, absent a contrary command in the Bankruptcy Act, why the disposition of creditors' claims in bankruptcy proceedings should not also be in accord with current business practice and understanding.
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> In keeping with this view, the bankruptcy courts must recognize the general validity of claims based on security interest created by

6. *Id.* at 139.
7. Bankruptcy Act § 60(a)(1).
8. 449 F.2d 284, 286 (5th Cir. 1971).
9. Bankruptcy Act § 60(a)(1); 3 COLLIER ON BANKRUPTCY 856, 862 (14th ed. 1971).
10. Bankruptcy Act § 60(a)(1); 3 COLLIER ON BANKRUPTCY § 60.19 (14th Ed. 1971).
11. Bankruptcy Act § 60(a)(2).
12. *In re* King-Porter Co., 446 F.2d 722 (5th Cir. 1971).

after-acquired property clauses . . . .

Nothing in the legislative history of the Bankruptcy Act reveals that claims created under the "floating lien" method of financing should invariably meet defeat in a bankruptcy court.[13]

PROPERTY OF ESTATE

As a pre-condition to a trustee's right to recover property transferred as a preference or fraudulent conveyance, the property must have been owned by the bankrupt at the time of the transfer.[14] The court will not find an equitable ownership which will sustain this right of recovery based only on recognition of agreements which have as their direct object the deceitful evasion and violation of a federal statute.[15]

The growing concern for the enforcement of causes of action against those who have wronged or injured a bankrupt is evidenced by the case, *Dallas Cabana, Inc. v. Hyatt Corp.*[16] Most causes of action reposing in a corporation pass to the trustee in bankruptcy. This includes rights of action resulting from a conspiracy to acquire assets of the bankrupt at a substantially lower price than its fair market value by fraudulently causing the bankruptcy.[17]

The Fifth Circuit quotes with approval the statement that:

> A trustee in bankruptcy . . . has title to all the assets of the bankrupt debtor, and represents all the creditors. It is his or its right to prosecute all causes of action which could have been prosecuted by the bankrupt . . . .[18]
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> The Act itself provides that the trustee takes title to all property of the bankrupt, including most rights of action, and puts a duty upon him to evaluate and prosecute these cause.[19]

SET-OFF

The Bankruptcy Act provides that in all cases of mutual debts or mutual credits between the estate of a bankrupt and a creditor one debt shall be set off against the other and the balance be paid.[20] The set-off

13. *Id.* at 732.
14. 449 F.2d at 811.
15. *Id.* at 815.
16. 441 F.2d 865 (5th Cir. 1971).
17. *Id.*
18. *Id.* at 868.
19. Bankruptcy Act § 70(a)(5) & (6).
20. Bankruptcy Act § 68(a).

rights of banks are specially developed to fit the current banking practices and are quite unique. A general deposit in a bank is treated as a debtor-ereditor relationship between the bank and a depositor,[21] and the bank has a right to set off the deposits as against obligations owed to it by the depositor.[22] In the case of *Mutual Leasing Corp. v. Miami National Bank*, the Court held that the bank was not entitled to set-off against deposits of the bankrupt, notes owed to it by the bankrupt.[23] It seems the court could well have been asserting its discretionary power based upon the fact that the notes were well secured.[24] It might be suggested as a warning that assertion of a right of set-off of secured claims might well waive the security.

JURISDICTION

Where an involuntary petition in bankruptcy was filed against a partnership and service was made on one of the alleged partners, and the court later decided that the bankrupt was the individual served and not a partnership, a creditor may not raise an objection to the jurisdiction of the court to proceed against the alleged partner as an individual.[25] The court was especially concerned over the devastating results which would follow as to preferences if creditors were permitted to object to jurisdiction.[26].

The filing of a claim in bankruptcy is very likely to submit the creditor to the summary jurisdiction of the court to much greater extent than the creditor desires or realizes.[27] Where a creditor filed a claim, stating in the claim that it did not consent to the summary jurisdiction of the court to determine preferences, the court held that by filing the creditor had submitted itself to the summary jurisdiction for the purpose of determining the preference issues, in spite of the disclaimer provision.[28]

The submission of a claim may also subject the creditor to the summary jurisdiction of the court in regard to counterclaims to much greater extent than the creditor realizes.[29] However, the filing of a claim for breach of a sales contract did not submit the claimant to the sum-

21. 4 COLLIER ON BANKRUPTCY ¶ 68.18 (14th ed. 1971).
22. 4 COLLIER ON BANKRUPTCY ¶ 68.16 at 918 (14th ed. 1971).
23. 449 F.2d at 811.
24. 4 COLLIER ON BANKRUPTCY ¶ 68.02 at 850 (14th ed. 1971). *See also* 449 F.2d at 816.
25. *In re* Kardow Plumbing Co., 451 F.2d 123 (1971).
26. *Id.* at 128.
27. Bankruptcy Act § 57(g).
28. 451 F.2d at 123.
29. 2 COLLIER ON BANKRUPTCY 554 (14th ed.).

mary jurisdiction of the court for the determination of a counterclaim to recover usurious interest paid by the bankrupt where the alleged usurious interest claim arose from other transactions.[30] The court stated that the matter of the counterclaim "should be inextricably interwoven with the subject matter of the claim" to be brought under the summary jurisdiction of the court.[31]

APPLICABLE LAW

Although the bankruptcy law is supreme over state law, in many instances it provides that state law will govern the initial determination of certain rights.[32] Although Louisiana law may be out of line with most other states, yet its law as to whether a creditor is a secured creditor is clear and that law will govern.[33] Whether a conditional sales contract was recorded so as to be binding on the trustee in bankruptcy is to be decided by the law of the state into which the property was brought.[34]

FILING PETITIONS

Although the Bankruptcy Act requires an involuntary petition in bankruptcy to be filed by three creditors if there are twelve or more creditors of the debtor,[35] it was held that although there were eighteen creditors, one petitioning creditor was sufficient where most held small, insignificant claims which consisted of consumer accounts.[36]

The claim of a petitioning creditor must not be contingent as to liability.[37] Within this, it was held that a judgment for fraudulent conversion which has reached the appellate level of a motion for rehearing in the Georgia Court of Appeals, is not so contingent as to bar the petitioner.[38]

There were several other cases presenting minor problems not sufficiently important to include here. However, the necessity for attorneys in bankruptcy proceedings to keep time sheets and to obtain authorization for acting for the trustee is emphasized.[39]

30. *In re* Behring & Behring, 445 F.2d 1096 (5th Cir. 1971).
31. *Id.* at 1098.
32. *E.g., see* Bankruptcy Act §§ 6, 70(e), 60(a)(4).
33. *In re* Hoover, 447 F.2d 195 (5th Cir. 1971).
34. *In re* Tuscaloosa Veneer Co., 439 F.2d 318 (5th Cir. 1971).
35. Bankruptcy Act § 59(b).
36. Denham v. Shellman Grain Elevator, Inc., 444 F.2d 1376 (5th Cir. 1971).
37. Bankruptcy Act § 59(b).
38. 444 F.2d at 1376.
39. *In re* Orbit Liquor Store, 439 F.2d 1351 (5th Cir. 1971).