Bankruptcy

By W. Homer Drake, Jr.* and James E. Massey**

The Court of Appeals for the Fifth Circuit decided few cases involving the Bankruptcy Act[1] in 1976. Of these, only nine merit special attention.

The right to file a bankruptcy petition without being fired was the subject of *McLellan v. Mississippi Power & Light Co.*[2] Nothing in the U.S. Constitution or the Bankruptcy Act prohibits an employer from firing an employee who files a voluntary bankruptcy petition. The *McLellan* case, however, held that a plaintiff states a claim for relief under the Civil Rights Act of 1861[3] by alleging that his employer deprived him of his civil rights by firing him after he filed a voluntary bankruptcy petition.

Affirming the district court, the Fifth Circuit held that the amended complaint in *McLellan* failed to state a claim under 42 U.S.C.A. §1983, since that section requires state action. "A private corporate utility company is not brought within the purview of state action merely because it is state regulated," the Court of Appeals said.[4] But it reversed the balance of the district court's opinion. The district court had dismissed the plaintiff's amended complaint, which added a union as a defendant, on the ground that leave of court had not been obtained but was required for the amendment under Rule 21 of the Federal Rules of Civil Procedure. The case thus presented a conflict between Rule 15(a), which provides that a complaint may be amended at any time before a responsive pleading is served, and Rule 21, which requires leave of court to add or drop a party. The Fifth Circuit held that Rule 15 takes precedence, since "pleadings are not an end in themselves, but are only a means to the proper presentation of the case."[5]

Having determined that the added party was a proper defendant, the Fifth Circuit next turned to whether a claim had been stated under

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* Partner in the law firm of Swift, Currie, McGhee & Hiers, Atlanta, Georgia. United States Bankruptcy Judge, Northern District of Georgia (1964-1976); Adjunct Professor of Law, Emory University. A.B., Mercer University (1954); LL.B., Mercer University (1956). Member of the Georgia Bar.

** Associate with the law firm of Redfern, Butler & Morgan, Atlanta, Georgia. A.B., Emory University (1965); LL.B., Columbia University (1968). Member of the Georgia and New York Bars.

1. U.S.C.A. tit. 11 (1966).
2. 526 F.2d 870 (5th Cir. 1976).
3. 42 U.S.C.A. §1985 (1974).
4. 526 F.2d at 872.
5. *Id.* at 873, *quoting* 3 J. MOORE, FEDERAL PRACTICE §15.02[1] at 813 (2d ed. 1974).

§1985(3).[6] The four elements necessary to state a claim under that section are:

> (1) There must be a conspiracy by the defendants;
> (2) Its purpose must be to deprive, either directly or indirectly, a person or class of persons of "equal protection of the laws, or of equal privileges and immunities under the law;"
> (3) One or more of the conspirators must do something to further the conspiracy; and
> (4) As a consequence of that act, another person must be "injured in his personal property" or "deprived of having and exercising any right or privilege of a citizen of the United States."

The U.S. Supreme Court had decided in *Griffin v. Breckenridge*[7] that a private conspiracy was sufficient to state a claim under the Civil Rights Act of 1861 and that the prerequisite of intent to deprive a person of "equal" protection or "equal" privileges and immunities means that there must be some invidious discrimination in the conspirators' action. The Supreme Court had, however, stopped short of determining whether a conspiracy motivated by factors other than race could form the basis for a claim under §1985(3). The *McLellan* case is significant because it answered that question. It held that allegations of nonracial, class-based, invidiously discriminatory conduct can form the basis of a §1985(3) claim:

> The language of §1985(3) gives no indication that racial discrimination is a requisite element of a cause of action thereunder. To engraft such a limitation would bring the statute into anomalous contrast with comparable Reconstruction civil rights legislation, under which a wide variety of nonracial classes have won relief from discriminatory treatment. We therefore hold that in order to come within §1985(3), it is unnecessary for plaintiff to be the subject of racial discrimination.[8]

The Fifth Circuit had no problem finding that the plaintiff's complaint in *McLellan* met the §1985(3) prerequisite that the discrimination be class-based. The allegation that all employees filing bankruptcy petitions would be discharged as a matter of policy would subject a class which is "neither imaginary nor uncertain" to discrimination.[9] Section 1985(3) further says that a class must have a particular right that gives it a reason for protection. The Fifth Circuit found such a right in the overriding federal concern, embodied in the Bankruptcy Act and articulated by the Supreme Court, that debtors be given "'a new opportunity in life and a clear field for future effort unhampered by the pressure and discouragement of pre-existing

6. 42 U.S.C.A. §1985(3) (1974).
7. 403 U.S. 88 (1971).
8. 526 F.2d at 876 (footnote omitted).
9. *Id.* at 878.

debt.'"[10] The court noted that in recent years the Supreme Court had offered special protection to persons discriminated against because of their distressed financial condition. That trend supports the result in *McLellan,* said the court, even though there was no need to decide "to what extent the impoverished are a class deserving of a high level of protection under the equal protection clause."[11]

Lastly, the court held that the discriminatory intent necessary for §1985(3) liability must be "invidious." Thus, the burden would be on the plaintiff "to show that the policy of discharging employees who file voluntary bankruptcy petitions is not justifiable in light of the necessities of [Mississippi Power & Light's] business, or that it is irrational. The defendants, in turn, will be entitled to present evidence that the policy serves the interest of its business sufficiently to outweigh the injury inflicted upon the plaintiff."[12]

The remainder of the court's opinion in *McLellan* deals with the constitutionality of the Civil Rights Act of 1861 as applied by the Supreme Court. The court found that the application of the statute was constitutional. It noted that Congress had the authority to establish the bankruptcy laws and that, under the Necessary and Proper Clause of the U.S. Constitution,[13] "the bankruptcy power manifestly vests Congress with the power, via civil remedies, to discourage people from conspiring to interfere with efforts of individuals to obtain discharges in bankruptcy."[14]

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Reversing the decision of the panel in *In re Samuels & Co.,*[15] the court of appeals sitting en banc adopted as its opinion the earlier dissenting opinion of Judge Godbold.[16] This case raised the question whether the interest of an unpaid cash seller in goods already delivered to a buyer is superior to the interest of a holder of a perfected security interest in after-acquired property. Judge Godbold said the perfected security interest is "unquestionably superior" to the interest of the seller.[17] This opinion was discussed in some detail in last year's survey.[18]

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In *RIDC Industrial Development Fund v. Snyder,*[19] the Fifth Circuit held that the participation of a creditor, both as a secured and unsecured

10. *Id., quoting* Perez v. Campbell, 402 U.S. 637, 648 (1971) (citations omitted).
11. 526 F.2d at 879.
12. *Id.*
13. U.S. CONST. art. 1, §8.
14. 526 F.2d at 880 (footnote omitted).
15. 526 F.2d 1238 (5th Cir. 1976).
16. 510 F.2d 139, 154 (5th Cir. 1975).
17. *Id.* at 154.
18. Drake & Massey, *Bankruptcy, 1975 Fifth Circuit Survey,* 27 MER. L. REV. 867, 882-886 (1976).
19. 539 F.2d 487 (5th Cir. 1976).

creditor in Chapter XI proceedings, did not affect the liability of a guarantor of the debtor's obligation to that creditor. Snyder had guaranteed the debt of the Chapter XI debtor, Sunny Hill Research and Manufacturing Company, to RIDC. The indebtedness was secured by certain equipment and inventory. The guarantor as well as RIDC consented to a six-month moratorium on Sunny Hill's obligation and to the sale of certain assets subject to RIDC's security interest. In June, 1968, Sunny Hill filed a Chapter XI petition. The plan of arrangement provided for a payment schedule and further provided that "'any indebtedness . . . remaining unpaid after the last of the distributions . . . shall be cancelled, discharged and extinguished.'"[20]

The district court held that RIDC as a secured creditor was outside the jurisdiction of the bankruptcy court and that because the balance of the debt was discharged, the guarantor had no liability on the balance of the unpaid debt. That court further held that §16 of the Bankruptcy Act,[21] providing that liability of the guarantor is unaffected by discharge, was inapplicable because the bankruptcy court lacked jurisdiction to discharge a secured debt. The creditor's acceptance of the plan, however, was held to be a contractual agreement that could effect such a discharge.

The Fifth Circuit held that the bankruptcy courts may have jurisdiction over secured creditors in Chapter XI proceedings at least insofar as those creditors are partially unsecured. In that connection, the court limited the dicta in the case of *In re Texas Consumer Finance Corp.*,[22] in which the court had said, "No provision of the Act permits an arrangement proposed under Chapter XI to deal with the rights of the secured creditors or with the rights of stockholders."[23] Obviously, to the extent that a secured creditor is unsecured, a bankruptcy court may deal with its claim. The court also limited dicta in the *Texas Consumer* case relating to the ability of the court to restrain secured creditors in Chapter XI proceedings. A secured creditor does not jeopardize its claim by participating as an unsecured creditor to the extent that the amount of the debt exceeds the value of the collateral. "While it is clear that a bankruptcy court lacks jurisdiction under Chapter XI to *compel* a secured creditor to participate in an arrangement that alters his security interest," the court said, "the present case raises the question of whether the Court has jurisdiction to *allow* him to participate without sacrificing other legal rights."[24] Since permitting voluntary participation would serve the purpose of increasing the value of the debtor's estate and of allowing the debtor to continue in business, the court concluded that "[a]llowing a secured creditor to voluntarily join in

20. *Id.* at 490 (footnote omitted).
21. 11 U.S.C.A. §34 (1953).
22. 480 F.2d 1261 (5th Cir. 1973).
23. *Id.* at 1265.
24. 539 F.2d at 493.

an arrangement may facilitate completion of the Chapter XI process by allowing compromise among the interested parties on [the] issues [of the validity of a lien or the extent to which the lien covers the property]."[25] The court's reasoning is unassailable:

> To limit the secured creditors to foreclosure followed by filing of a claim for the unsecured balance or surrender of the security followed by filing for the whole claim as an unsecured creditor would undermine the Chapter XI purpose of maintaining a viable business, when feasible, to benefit all creditors and the debtor. If the business is worth more as a going concern than it would bring in liquidation, then it is also to the guarantor's advantage to allow this option since more of the debt will be paid by the debtor.[26]

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The case of *Moureau v. Leaseamatic, Inc.*[27] illustrates the danger of a common error of bankruptcy practitioners in filing schedules of creditors. Leaseamatic, the creditor, obtained an order from the bankruptcy court declaring the indebtedness of Moureau to be non-dischargeable under §17a(3) of the Bankruptcy Act,[28] which provides: "A discharge in bankruptcy shall release a bankrupt from all of his provable debts, whether allowable in full or in part, except such as . . . (3) have not been duly scheduled in time for proof and allowance, with the name of the creditor, if known to the bankrupt, unless such creditor has notice or actual knowledge of the proceedings in bankruptcy . . . ." Moreau had been sued by Leaseamatic in a state court in late 1973, although service of process was not obtained until April 16, 1974. On March 4, 1974, Moreau filed a voluntary bankruptcy petition. Although Leaseamatic had made formal demand for payment numerous times, Moureau failed to disclose on his bankruptcy schedules the indebtedness or the fact that he had leased certain equipment from Leaseamatic or the fact that there was a pending state court proceeding. On April 25, 1974, Moreau received the discharge, and the following day he filed an answer in the state court proceeding reciting the issuance of a stay order in the bankruptcy proceedings as a defense. The answer, however, did not disclose the discharge. On June 25, 1974, he amended his answer to disclose the discharge and alleged it as a bar to the recovery. The following month Leaseamatic filed its complaint to determine the dischargeability of the debt, and the bankruptcy court held that the debt was non-dischargeable. The district court and the court of appeals affirmed. The bankrupt argued that since the time for filing proofs of claim had not expired, he should receive a discharge. The court of appeals dis-

25. *Id.* at 494 (footnote omitted).
26. *Id.* (footnotes omitted).
27. 542 F.2d 251 (5th Cir. 1976).
28. 11 U.S.C.A. §35a(3) (Supp. 1976).

agreed. It held that a creditor must receive actual notice "in ample time fully to protect his rights."[29] Thus, it is not simply the ability to file a proof of claim that is controlling. Rather, the debtor must carefully schedule his creditors so that they can participate throughout the proceedings.

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Baum v. Anderson[30] held that a Chapter XI debtor is not entitled to the dismissal of a state court foreclosure proceeding but merely to a stay of those proceedings. The defendant in *Baum* filed the foreclosure proceedings after the filing of the debtor's Chapter XI petition. Although there was conflicting testimony, the courts below held that the foreclosure action was filed in good faith without knowledge of those proceedings. Nonetheless, the debtor contended that the state court proceedings should be dismissed and a sanction should be levied against the creditor. In a well-reasoned opinion, the court of appeals held that the policy underlying §11a of the Act,[31] on which the various stay provisions of the Bankruptcy Rules of Procedure are based, is to protect the bankrupt from harrassment. Since the Bankruptcy Rules provide for an automatic stay, the debtor had obtained protection equivalent to that which he would have obtained had the state court action been dismissed. Accordingly, the court of appeals ruled that dismissal was not mandatory. The court did direct the entry of a formal order for the benefit of state officers, who would, without the issuance of a formal stay, be required under state law to take certain actions.

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The teaching of *Pyramid Mobile Homes, Inc. v. Speake*[32] is that the Bankruptcy Rules relating to appeals may not be ignored with impunity. Pyramid had been adjudged a bankrupt on April 14, 1973, after a trial. It filed a notice of appeal to the district court nine days later, but it was some two months later before the bankrupt ordered a transcript. The court reporter, who was owed approximately $1,000, requested a payment before commencing the transcription. There was no further contact between the court reporter and the bankrupt's counsel for two months. On September 9, 1975, the receiver moved to dismiss the appeal for lack of prosecution, and the district court entered a "conditional order of dismissal" giving the bankrupt until September 18, 1975, to file the record. On September 25, that order was amended extending the time to October 21. On October 21, Pyramid requested an additional twenty days on the ground that only one-third of the transcript had been prepared. The district court granted the motion to dismiss the appeal. Affirming, the Fifth Circuit took pains to point out that even the notice of appeal to it was not filed until the very last day. The court said Bankruptcy Rule 806 requires that the transcript

29. 542 F.2d at 253.
30. 541 F.2d 1166 (5th Cir. 1976).
31. 11 U.S.C.A. §29a (1966).
32. 531 F.2d 743 (5th Cir. 1976).

be ordered immediately and that the appellant make satisfactory arrangements for paying the cost of the transcript, and allows extensions of time to be granted only if good cause is shown. Good cause is not shown, according to the court, if there is a "gross lack of diligence or dilatory maneuvering."[33] The court summarized the policy underlying the need for dispatch as follows: "Precisely because the filing of a notice of appeal is such a simple matter, and because of the inherent prejudice to creditors when the estate of a bankrupt is subject to dissipation by expenses incurred each additional day, some device is necessary to insure that appeals taken are diligently prosecuted."[34]

Recognizing that the conduct of appellant's counsel might punish an innocent client, the court pointed out that the dismissal was discretionary and that a district court might consider "the prejudicial effect of delay on the appellee and the bona fides of the appellant" in deciding such a motion.[35]

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Mioton v. Mulla[36] is of only passing interest, except perhaps to Louisiana lawyers. In that case, certain assets subject to a usufruct under Louisiana law at the time of the bankrupt's adjudication vested a few years later. The bankrupt petitioned the bankruptcy court to reopen his case to determine the status of the assets and in that petition contended that the trustee had abandoned the property by his failure to administer it. The Fifth Circuit held that while the property could not be sold until the usufruct ended and the assets were distributed to the bankrupt, the assets remained in his estate and the trustee did all that he could under the circumstances, which was simply to wait. Thus, the court concluded that the trustee had not abandoned the property.

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In Murphy v. IRS,[37] the Fifth Circuit affirmed a determination that a tax penalty under 26 U.S.C.A. §6672 was a nondischargeable debt. The court held that liability under §6672 is a nondischargeable debt governed by 11 U.S.C.A. §35(a) rather than a dischargeable penalty governed by 11 U.S.C.A. §93(j). The court also held that a bankruptcy court has jurisdiction, upon the application of a bankrupt, to determine the dischargeability of a tax assessment.[38]

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33. *Id.* at 745.
34. *Id.*
35. *Id.* at 746.
36. 526 F.2d 968 (5th Cir. 1976).
37. 533 F.2d 940 (5th Cir. 1976).
38. The court cited *In re* Durensky, 519 F.2d 1024 (5th Cir. 1975), discussed in last year's survey: Drake & Massey, *Bankruptcy, 1975 Fifth Circuit Survey*, 27 MER. L. REV. 867, 870 (1976).

In *Federal National Mortgage Ass'n v. Delaney*,[39] the Fifth Circuit held that Chapter XIII of the Bankruptcy Act[40] gives a bankruptcy court jurisdiction to permit enforcement of a lien securing payment of attorney fees provided for in a mortgage contract; whether such a lien should be enforced is a matter left to the court's discretion. In *Delaney*, the debtor had been operating under a Chapter XIII plan and had been making mortgage payments for some time. In 1974, the debtor stopped making payments, so the mortgagee sought a lifting of the stay. The bankruptcy court denied that relief but only on the condition that the arrearages be paid within ninety days. The arrearages were paid, but the mortgagee then sought attorney fees as provided in the mortgage contract. The bankruptcy court denied the application on the ground that the indebtedness for attorney fees had not existed at the time the petition was filed. On appeal, the mortgagee contended that the bankruptcy court had no jurisdiction to modify the terms of the contract, since debts secured by real property are not affected by Chapter XIII.

The Fifth Circuit agreed with the mortgagee that the bankruptcy court could not modify the mortgage contract. The only power relevant, the Fifth Circuit said, was the bankruptcy court's power over the debtor's property. Hence, the court concluded, the bankruptcy court had discretion only to permit foreclosure or to stay foreclosure. The "usual rule that bankruptcy proceedings suspend the rights and obligations between a creditor and his debtors"[41] does not apply in Chapter XIII proceedings, since a creditor secured by real property has no right to participate in the proceedings and, indeed, gets no notice of it. The court remanded the case to the bankruptcy court to determine whether it would exercise its discretion to permit the mortgagee to show the amount due for attorney fees and to permit foreclosure. If the bankruptcy court should decide to forbid foreclosure, the court pointed out, the mortgagee would have to wait until the Chapter XIII proceedings are concluded to enforce its rights in the absence of a contractual right to attorney fees under state law.

39. 534 F.2d 645 (5th Cir. 1976).
40. 11 U.S.C.A. §§1001-1086 (1970).
41. 534 F.2d at 647.