Bankruptcy

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The Fifth Circuit Court of Appeals rendered a number of decisions in 1978 of interest to the bankruptcy practitioner. This article considers the more important of those decisions in three sections: first, decisions interpreting substantive provisions of the Bankruptcy Act;[1] second, decisions interpreting state law applicable in a bankruptcy proceeding; and third, decisions involving procedural questions in a bankruptcy context.

I. Cases Interpreting Substantive Provisions Of The Bankruptcy Act

Attorneys who render legal services to a client who lies about his ability to pay will find no solace in the Fifth Circuit's decision in *Bailey v. Wright.*[2] In that case, the attorney as creditor sought to obtain an order denying the discharge of a debt for legal services. The issue was "whether the rendition of professional services evidenced by a bankrupt's promissory note and reduced to state court judgment constitutes 'property' within the meaning of Section 17a(2) of the Bankruptcy Act."[3] The lower courts had held that the indebtedness arose out of the rendition of legal services and that the rendition of professional services was not property which could be obtained by false pretenses or representations within the meaning of §17a(2).[4] The Fifth Circuit affirmed:

> The nature of the claim underlying the debt instrument is determinative of its dischargeability. Hence, though a promissory note allegedly induced by fraud was given to the plaintiff here, extrinsic evidence reveals that the nature and consideration for the promissory note was the rendering of legal services by the plaintiff. Such services are not "property" under § 17a(2) to which discharge can be excepted.[5]

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1. 11 U.S.C.A. §§1-1255 (1966). [References to the Bankruptcy Act hereinafter will be to the "Act"].
2. 584 F.2d 83 (5th Cir. 1978).
3. *Id.* at 84.
4. 11 U.S.C.A. §34a(2) (Supp. 1978).
5. 584 F.2d at 84.

In *Love v. Tower Loan of Mississippi, Inc.*[6] the Fifth Circuit held that a bankruptcy court, as a court of equity, has the power to award attorney's fees against a party who acts in bad faith, vexatiously, wantonly, or for oppressive reasons. The case arose out of a creditor's attempt to have a debt declared nondischargeable under §17 of the Act.[7] The lower courts had dealt at some length with the question of whether the bankrupts had willfully converted collateral in which the creditor claimed a security interest. The district judge had reversed the bankruptcy judge's finding that there had been no willful conversion. On appeal, the Fifth Circuit reversed, but on a different ground because the lower courts had missed the substantive issue in its entirety. Since the alleged conversion had occurred after the filing of the petition, there was no provable debt; hence §17 could not apply. Further, none of the acts alleged fell within any of the specified grounds for objecting to dischargeability under §17.

Being unsatisfied with the bankruptcy court's initial decision, the secured creditor appealed and obtained an order from the district judge requiring the bankrupt to assemble the collateral. Numerous hearings were held and at one point the bankruptcy judge became so exasperated that he sought to recuse himself, which the district judge refused to permit. In connection with continued hearings, the creditor took depositions and attempted to introduce new evidence on fraud and conversion without offering any explanation of why the evidence produced could not have been offered at the time of trial. In the course of the proceedings, the bankrupts had offered to reassume the debt, but the secured creditor turned down that request declaring that it simply wanted the collateral.

The Fifth Circuit was satisfied that the bankruptcy judge's findings of fact dealing with the conduct of the creditor were not clearly erroneous, and it reinstated an award of attorney's fees. The court said that the Supreme Court in *Alyeska Pipeline Service Co. v. Wilderness Society*[8] recognized an exception to the general rule that the prevailing party in litigation is not entitled to an award of attorney's fees. That exception is when a losing party has acted in bad faith, vexatiously, wantonly, or for oppressive reasons.

The issue in *Taylor v. Van Voorhis (In re Davis Transport & Rentals, Inc.)*[9] was whether the date of bankruptcy was November 8, 1973, the date on which a Chapter X petition was filed, or January 3, 1974, the date on which an involuntary straight bankruptcy petition was filed during the pendency of the Chapter X, or February 11, 1974, the date on which the bankrupt was adjudicated in the involuntary straight bankruptcy proceeding. The appellant was a landlord seeking a priority claim for rents due

6. 577 F.2d 344 (5th Cir. 1978).
7. 11 U.S.C.A. §34 (Supp. 1978).
8. 421 U.S. 240 (1975).
9. 585 F.2d 743 (5th Cir. 1978).

within three months of the date of the bankruptcy under §64a(5) of the Act.[10] The landlord had received rent for the three-month period prior to February 11, 1974 as administrative rent in the Chapter X. Hence, if the date of adjudication was the date of bankruptcy, as the bankruptcy judge had held, then the landlord had no priority claim for rent during the three-month period prior to November 8, 1973. The district court held that the date of the bankruptcy was the date on which the involuntary petition was filed, and the Fifth Circuit affirmed.

The date of the filing of the petition determines the date of bankruptcy.[11] The landlord argued that Rule 122 of the Rules of Bankruptcy Procedure[12] should apply since the involuntary proceeding followed an aborted Chapter X proceeding. The Rule provides in part that when a chapter proceeding is converted to ordinary bankruptcy, " . . . the case shall be deemed to have been commenced as of the date of the filing of the first petition initiating a case under this title and shall be conducted as far as possible as if no petition commencing a chapter case had been filed."[13] In this case, however, the Chapter X had not been converted to a straight bankruptcy. Instead, a separate case having a different case number had been filed. Therefore, no reference would be made to the dismissed Chapter X to determine the date of the filing of the involuntary proceeding.

May a Chapter XII trustee reject, then accept, and then terminate a lease? "Maybe" was the answer of the Fifth Circuit in the unusual case of *Commercial Trading Co. v. Weil (In re Garfinkle).*[14] Prior to the filing of a Chapter XII petition, the debtor had purchased a Miami hotel subject to a first mortgage. At the time of the purchase, she gave a second mortgage to the seller of the fee, purchased a lessee's interest in a 999-year lease on the property, and secured the purchase of the lease with a mortgage on the leasehold estate. Finally, the parties to these transactions agreed that the leasehold estate would not merge into the fee until the second mortgage on the fee was paid.

The Chapter XII trustee sought to terminate the lease and thereby end the status of the holder of the leasehold mortgage as a secured creditor. The bankruptcy judge held that the trustee could not reject the lease because it would be inequitable to do so. The Fifth Circuit reversed, but remanded to give the parties and the bankruptcy court an opportunity to consider further what the equities in fact were. The court suggested that the equities of the survival of the leasehold estate might depend on whether the secured party would be willing to assume the lease as a tenant and thereby benefit the other creditors of the estate.

10. 11 U.S.C.A. §104a(5) (Supp. 1978).
11. 11 U.S.C.A. §1(13) (1966).
12. 11 U.S.C.A., Rules of Bankruptcy Procedure, Rule 122 (1977).
13. *Id.*
14. 577 F.2d 901 (5th Cir. 1978).

The court analyzed the problem from the standpoint of a "split-personality" trustee and concluded that the actions of the trustee of the debtor-lessee did not bind the trustee of the debtor-lessor.

Under §70b of the Act,[15] a trustee may reject the lease of the real property except that a lease cannot be rejected by the trustee of a bankrupt lessor unless the lease expressly so provides. Further, §70b of the Act declares that a clause terminating the lease upon the bankruptcy of a specified party is enforceable against the trustee. The lease in this case contained such a clause giving the lessor the right to terminate upon the bankruptcy of the lessee.

The rejection of the lease by the trustee of the debtor-lessee did not terminate the lease but was in effect an abandonment of the lessee's interest in the leasehold estate. The lessee's interest then rested again with the debtor. The termination of the lease by the trustee of the debtor-lessor was a different matter, however. The court's analysis turned on the enforceability of the termination clause, and the court said that such clauses were enforceable unless enforcement conflicted with other provisions of the Act or was inequitable under the circumstances.

The holder of the leasehold mortgage argued that it was inequitable to enforce the clause since it was the affirmative act of the debtor-lessor in filing bankruptcy that gave rise to the opportunity to terminate the lease in the first place. In response, the court found merit in the counter argument: had the lessor and lessee been different persons and had the lessee been insolvent, the mortgagee would have lost its interest anyway; hence, the fortuitous circumstance that the lessor and lessee were the same person should not improve the mortgagee's position.

The court concluded that it did not have enough facts to balance the equities and suggested that the outcome might depend upon whether the mortgagee was willing to exercise a right that it might have in an amendment of the lease to cure the default. "In a bankruptcy context the justification for the continued existence of the leasehold mortgage is stronger if the mortgagee is willing to 'put something in the pot' for the rest of the creditors."[16]

In *Flournoy v. Century Finance Co. of Columbus (In re Henderson)*,[17] the court addressed the Chapter XIII Rules of Bankruptcy Procedure relating to examination of claims. Under Rule 13-307,[18] a claim filed in a Chapter XIII proceeding is deemed to be automatically allowed unless an objection is made by a party in interest. The Rule further authorizes objections to such claims even after disbursements have been made. In this case and

15. 11 U.S.C.A. §110b (Supp. 1978).

16. 577 F.2d at 906.

17. 577 F.2d 997 (5th Cir. 1978).

18. 11 U.S.C.A., Rules of Bankruptcy Procedure, Rule 13-307 (1977).

related cases, the Chapter XIII trustee had waited as long as seventeen months to file objections to creditors' claims. The bankruptcy court disallowed the claims under state usury law and the claimants appealed. The district court reversed, holding that the Chapter XIII trustee had been guilty of unreasonable delay in waiting up to seventeen months to review the claims in question. The claimants contended on appeal to the Fifth Circuit that Bankruptcy Rule 13-308[19] imposed a ten-day limitation on reconsideration of claims automatically allowed under Bankruptcy Rule 13-307. Since the Chapter XIII trustee did not review the claims within the ten-day period, the district court's ruling, the appellees asserted, was correct.

The Fifth Circuit reversed, holding that the scheme of the Rules was to permit a review of claims more than ten days after claims are automatically allowed under Bankruptcy Rule 13-307. The court stated:

> If the intent of the bankruptcy rules to facilitate early distribution of assets while providing the trustee an opportunity to carefully review each claim is to be effectuated, the trustee cannot be forced into a position of irreconcilably committing himself to the allowance of claims which he does not have adequate time to review.[20]

The Fifth Circuit further held that the district court erred in deciding that the trustee's objections were untimely. First, the court said that the doctrine of equitable estoppel had no application since the doctrine requires the demonstration of intentional deception or gross negligence amounting to constructive fraud. There had been no such showing. Second, the court observed that the district court had merely relied on unreasonable delay, but this was an affirmative defense requiring proof by the party asserting it. The court found that there was no proof sustaining the defense of laches:

> In none of the cases before us has the creditor met this burden. The pleadings and the record are barren of any evidence concerning the trustee's work load, the complexity of the proceedings, the number of claims to be examined, or the customary time period for evaluating claims in similar circumstances. Invocation of the word "laches" does not automatically lock the courthouse door. The defendants cannot make out the defense without offering the necessary evidence to hinge it upon.[21]

In *Bankers Trust Savings & Loan Ass'n v. Travis (In re Bankers Trust Co.)*,[22] the Fifth Circuit reversed a district court's order which had the effect of enjoining a proposed plan of reorganization of the bankrupt's wholly owned subsidiary, a state-chartered savings and loan association. The bankrupt, as a holding company, had the right to file a bankruptcy

19. 11 U.S.C.A., Rules of Bankruptcy Procedure, Rule 13-308 (1977).
20. 577 F.2d at 1001 (footnote omitted).
21. *Id.* at 1002.
22. 566 F.2d 1281 (5th Cir. 1978).

petition, while the subsidiary did not. The bankruptcy petition of the parent was filed on the eve of the reorganization of the subsidiary under state law. The trustee argued that because the reorganization of the subsidiary purported to affect the bankrupt's stock interest in the subsidiary, exclusive jurisdiction of the controversy should be in the bankruptcy court. The Fifth Circuit disagreed. "[T]he exercise of such jurisdiction would be inconsistent with other provisions of the Bankruptcy Act, especially those which explicitly excluded savings and loan associations from the Act."[23] The trustee also argued that the filing of a reclamation petition in the bankruptcy court by the subsidiary had subjected it to jurisdiction which would give the bankruptcy court power to interfere with the reorganization of the subsidiary. Again, the Fifth Circuit disagreed. "Although a reclamation petition does serve as consent to a bankruptcy court's jurisdiction, it does not amount to consent for the adjudication of totally unrelated counterclaims."[24]

In a per curiam decision, the Fifth Circuit held in *Sears, Roebuck & Co. v. Wood*[25] that there was no evidence in the case that the bankrupt did not intend to pay for goods that he had purchased using a credit card or that he had fraudulently concealed his financial condition. The court referred to several facts indicating that the bankrupt had simply overextended himself. For example, he had been current on his bills up to the time that he filed his bankruptcy petition and his current inability to meet bills was due to additional medical expenses. Thus, the court did not reach the issue discussed in *In re Boydston*[26] of whether the mere use of the credit card without explicit representations concerning financial condition may be the basis for a finding that there have been false representations within the meaning of §17a(2) of the Act.

II. Cases Interpreting State Law In Bankruptcy Proceedings

The most interesting case decided by the Fifth Circuit in 1978 was *Republic National Bank of Dallas v. Fitzgerald (In re E. A. Fretz Co.)*,[27] which presented an issue of first impression. The issue was whether, subsequent to the bankruptcy of the debtor, a secured party may take an assignment of claims against the debtor and thereby increase the secured party's claim against the collateral to the exclusion of a junior secured creditor and the bankruptcy trustee. Holding that the Uniform Commercial Code does not permit the use of "floating secured parties," the Fifth Circuit resolved this issue in favor of the bankruptcy trustee and the junior secured creditor.

23. *Id.* at 1288.
24. *Id.*
25. 571 F.2d 284 (5th Cir. 1978).
26. 520 F.2d 1098 (5th Cir. 1975).
27. 565 F.2d 366 (5th Cir. 1978).

The facts were rather simple. Security agreements between the Fretz Company as debtor and Revlon, Inc. as secured party granted a security interest in certain collateral to secure indebtedness not only to Revlon but also to affiliates of Revlon, and to secure debts of the debtor to others which Revlon might obtain by assignment or otherwise. The security agreements and the financing statements described the secured party as Revlon, Inc. with no mention of Revlon subsidiaries by name.

After Revlon filed its financing statement, Republic National Bank entered into a security agreement with the debtor covering the same collateral, and it also filed a financing statement. Approximately one year later, the debtor filed bankruptcy, and about one month after bankruptcy, subsidiaries of Revlon assigned their claims against the bankrupt to Revlon. The bankruptcy court held that this assignment was effective to increase Revlon's claim against the proceeds of the sale of the collateral and the district court affirmed. The result was that Republic and the bankruptcy trustee got nothing.

In a detailed analysis, the Fifth Circuit reversed. The court reasoned that the subsidiaries were not secured parties because they were not parties to the security agreement and their interests were not perfected since they had not signed or timely filed financing statements reflecting their status as secured parties. The court perceived the problem as one involving "floating secured parties."

> We believe that in a world of huge conglomerates a construction of the UCC's silence as to "floating secured parties" which would sanction such a weird device is clearly at odds with the "simple notice" requirements of § 9.402. Placing our imprimatur on floating secured parties would undercut "Article Nine's perfection requirement [which] reflects a Code policy against *secret* security." White & Summers, Uniform Commercial Code, § 24-3, p. 868 (1972) (emphasis added). Since the notice requirements are so simple to meet, the Revlon subsidiaries' failure to protect their interests in a timely fashion should not prejudice Republic.
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> Surely floating debt and floating collateral provide all the uncertainty any creditor should be required to suffer. When floating secured parties are wading in the wings, clairvoyance, not mere knowledge, would be essential. We are unwilling to impose on any junior secured creditor, with knowledge or without, the additional risk that, at a date subsequent to his perfection, any affiliate of the senior creditor or any stranger to it—unnamed as secured parties in a security agreement or a financing statement—could be metamorphosed into senior secured parties by virtue of an assignment "or otherwise", pre- or post-bankruptcy. We also decline to impose upon a junior secured creditor the burden of a frequent check to determine whether any unsecured parties have secretly assigned their claims to a senior secured party whose interest has been perfected. The risk and the burden would disrupt commercial transactions to an unwar-

ranted and unnecessary degree. No reasonable bank would ever make a loan in the wake of so much floating.[28]

Finally, the intervention of bankruptcy prevented "any possible transformation of unperfected, unsecured interests into perfected secured interests."[29] The court stated that the policy of the Bankruptcy Act to effect equitable distribution of the debtor's unpledged assets would be thwarted by the holdings below and that the possibility of fraud and collusion would be great.

Clearly, the holding of this case is correct. The intervention of bankruptcy mandates the result reached. Under §70c,[30] the bankruptcy trustee is given the status of a perfected lien creditor, and an analysis of the applicable sections of Article 9 of the Uniform Commercial Code[31] shows that Revlon's security interest was not perfected as to the claims of its subsidiaries on the date of the bankruptcy.

Under U.C.C. §9-301(3), a "lien creditor" is defined to include "a trustee in bankruptcy from the date of the filing of the petition." Under U.C.C. §9-301(1), an unperfected security interest is subordinate to the rights of "a person who becomes a lien creditor without knowledge of the security interest and before it is perfected." Section 9-303 of the Uniform Commercial Code states in part that a security interest is perfected when it attaches. Attachment occurs under U.C.C. §9-204(1) when there is an agreement that it attach, when value is given, and when the debtor has rights in the collateral.

In this case, Revlon certainly could have argued that the security interest had attached to the collateral by agreement and that value had been given—at least by the subsidiaries to the extent of their claims. The problem is that the debtor had no rights in the collateral at the time that the assignments occurred, since, as of the date of bankruptcy, title to the property passed to the trustee under §70 of the Act. Thus, an alternative ground for the holding in the *Republic* case is that perfection was an impossibility.

Insofar as the opinion dealt with the "floating secured party" problem in a non-bankruptcy context, it was dictum. Hence, one may profitably ask whether a court would come to the same conclusion without the intervention of bankruptcy. The policy basis for the Fifth Circuit's conclusion was its view that junior secured creditors would be subject to uncertainty and risks to an unwarranted and unnecessary degree if the senior secured creditor could acquire unsecured claims and convert those claims into secured

28. *Id.* at 371-372 (footnote omitted).

29. *Id.* at 374 (footnote omitted).

30. 11 U.S.C.A. §110c (Supp. 1978).

31. All citations to the Uniform Commercial Code [hereinafter referred to as "U.C.C."] are to the 1962 Official Text. The sections cited are not materially different from the 1972 Official Text.

claims. The court was also concerned with the possibility of secret liens.

The fact is, however, that a junior secured creditor is subjected to a great deal of uncertainty when a senior secured creditor may make future advances and when the security interest of that senior creditor includes after-acquired property. Even in the absence of collusion or fraud, a junior secured creditor's position may be substantially impaired through future advances. For example, the senior secured creditor may make a future advance in cash, and the cash may be used to prefer an unsecured creditor. If the preference occurs within four months of bankruptcy and is voidable, the trustee will be able to recover the funds under §60 of the Act,[32] but the junior secured creditor's position vis-à-vis the collateral will not be improved by that recovery.

The uncertainty argument is substantially answered by the fact that the junior creditor does not have to make a loan or advance credit in the first place if the senior secured creditor will not subordinate the portion of its claim arising out of the acquisition of unsecured debt. In the absence of subordination or in the absence of the obtaining of a purchase money security interest in particular collateral, the junior secured creditor would simply have to weigh the additional uncertainty prior to extending credit to the debtor. The observation of the Fifth Circuit that no reasonable bank would ever make a loan under these circumstances is an overstatement. Whether a junior creditor would make such a loan in the absence of a subordination agreement would obviously depend upon what safeguards that creditor could obtain from the debtor and upon the debtor's financial condition. In the court's view, a junior creditor should know precisely what and how many secured parties claim a prior interest in the same collateral, but that knowledge is no more important than knowing how large a particular secured creditor's claim will be.

It is the computation of the obligation—the amount of the senior secured creditor's claim—that is at the heart of this case and not whether the security agreement purports to create additional secured parties. Hence, the problem presented is more clearly addressed from the standpoint of whether the obligations secured by the collateral may include obligations acquired by a secured party from an unsecured creditor to the detriment of the position of a junior secured creditor. Nothing in Article 9 of the Uniform Commercial Code answers this question in the negative. Section 9-105(1)(i) of the Code defines a secured party as a "lender, seller or *other person* in whose favor there is a security interest, including a person to whom accounts, contract rights or chattel paper have been sold" (emphasis added). Thus, a secured party does not have to be a seller or a lender. An entity which purchases a claim from an unsecured creditor and then negotiates a security agreement with the debtor clearly falls within the

32. 11 U.S.C.A. §96 (1968).

definition of secured party. The fact that a creditor becomes a secured party without giving new value at the time the security interest is created is simply irrelevant in the context of this case. The term "security interest" is defined in U.C.C. §1-201(37) as "an interest in personal property or fixtures which secures payment or performance of an obligation." The term "obligation" is not defined in the Code. Under U.C.C. §9-204(5), obligations may include future advances or "other value." "Value" is very broadly defined in U.C.C. §1-201(44). Had the drafters of the U.C.C. determined that it was not permissible for an obligation covered by a security agreement to include debts acquired by a secured party from an unsecured creditor, surely U.C.C. §9-204(5) would have said so.

In *Marietta Baptist Tabernacle, Inc. v. Tomberlin Associates, Architects, Inc.*,[33] the Fifth Circuit affirmed the judgment of the district court that the filing of an architect's lien under Georgia law subsequent to the filing of a Chapter XI petition violated neither the automatic stay provisions of the Bankruptcy Rules nor a restraining order of the bankruptcy court, and that the lien was valid against the Chapter XI receiver even though the notice of lien was filed after the filing of the petition.

The architectural firm performed the services in question prior to the filing of the Chapter XI petition. Shortly after the filing, the bankruptcy court issued an order supplementary to Bankruptcy Rule 11-44[34] restraining creditors from endeavoring to foreclose or to take possession of assets of the debtor. Without obtaining leave of the bankruptcy court, the architectural firm filed a notice of lien within three months of the last services rendered pursuant to the provisions of Ga. Code Ann. §67-2002.[35] The bankruptcy court found the firm's lien to be null and void.

Two issues were presented on appeal. First, did the filing of the notice of lien violate the automatic stay provision of Bankruptcy Rule 11-44 or the restraining order? Second, was the lien valid when the notice was filed subsequent to the filing of the Chapter XI petition?

Relying on a number of Georgia cases interpreting Ga. Code Ann. §67-2002, the court of appeals held that the mere filing of a notice of a claim of lien is not an act to enforce a lien. That section requires the filing of the notice of lien as a condition precedent to the establishment of a lien and does not provide a means for the *enforcement* of a lien. Further, the court noted that the purpose of the automatic stay to prohibit harassment of the debtor was not violated by the filing of the lien.

The second issue nicely illustrates the interplay between §67c(1)(B)[36]

33. 576 F.2d 1237 (5th Cir. 1978).

34. 11 U.S.C.A., Rules of Bankruptcy Procedure, Rule 11-44 (1977).

35. GA. CODE ANN. §67-2002 (1967). The 1977 amendment to this section does not make any material change under the facts of this case.

36. 11 U.S.C.A. §107c(1)(B) (Supp. 1978).

and §70c(1).[37] Although the architects filed their notice of lien after the commencement of the Chapter XI proceeding, the lien was nonetheless valid against the Chapter XI receiver under those statutes. Section 70c(1) invalidates a lien which would be inferior to a judgment lien obtained on the date of bankruptcy by a hypothetical creditor. Thus, the key question before the court was upon what date the architect's lien was deemed perfected under Georgia law. The Court found that under Georgia law such liens relate back to the time the work under the contract *commenced,* provided that the lien is properly perfected. Thus, the receiver's hypothetical judgment lien, deemed obtained as of the date of the bankruptcy filing, was inferior to the architect's lien, since the latter was deemed perfected under Ga. Code Ann. §62-2002 long prior to the filing of the Chapter XI proceeding. Although the architect's lien was not technically perfected on the date of filing, §67c(1)(B) contains a saving clause permitting perfection subsequent to bankruptcy if state lien law requires the lien to be perfected in order to be valid against a subsequent bona fide purchaser. The court also rejected the receiver's argument that the lien was invalid under §67c(1)(B).

Fruehauf Corp. v. Revitz (In re Transystems, Inc.)[38] concerned an appeal from a determination by the bankruptcy court that advances by a parent to a bankrupt subsidiary were capital contributions rather than loans. In this case, the Fifth Circuit examined the "clearly erroneous" rule embodied in Rule 810 of the Bankruptcy Rules of Procedure.[39]

The factual setting was somewhat complicated. The parent corporation, Aero, Inc., acquired Transystems, Inc. in 1969 and at that time made a substantial capital contribution. In August, 1970, Aero advanced Transystems an additional $385,000.00 pursuant to promissory demand notes having no maturity dates. These notes were purportedly to be secured by Transystems' free assets.

The appellant, Fruehauf, was a major creditor of Transystems. When Transystems defaulted in September of 1970, Fruehauf agreed to an extension of the payment date in exchange for Aero's guaranty of Transystems' performance. To secure the guaranty, Aero pledged to Fruehauf collateral of Transystems that had already been pledged to Aero. The following year, Transystems was adjudicated a bankrupt and Aero defaulted on its obligation as a guarantor. In exchange for Fruehauf's agreement not to sue on the guaranty, Aero assigned Fruehauf the collateral pledged by Transystems to Aero pursuant to the alleged loan of $385,000.00. Fruehauf claimed to be a secured creditor of Transystems by virtue of that assignment. The district court affirmed the bankruptcy court's finding that the contributions were capital and not loans.

37. 11 U.S.C.A. §110c(1) (Supp. 1978).

38. 569 F.2d 1364 (5th Cir. 1978).

39. 11 U.S.C.A., Rules of Bankruptcy Procedure, Rule 810 (1977).

The Fifth Circuit held: (1) the "clearly erroneous" standard set forth in Rule 810 of the Bankruptcy Rules of Procedure was the correct standard for review; (2) the issue of whether the advances by Aero to Transystems were capital contributions or loans was a matter of state law; (3) under Florida law, it is the intent of the parties gathered from the facts that controls; and (4) the district court had correctly applied the "clearly erroneous" standard in affirming the bankruptcy court's decision that the advances were not loans.

The loan versus capital contribution conflict often arises in bankruptcy cases, and the *Fruehauf* opinion is a useful one in reviewing facts establishing the parties' intent. The notes were payable on demand without a maturity date; the parent was acutely aware of the subsidiary's poor financial condition at the time of the loans; and the parent became increasingly involved in management and operation of the subsidiary. These facts were considered strong evidence that the parties intended the advances to be capital contributions rather than loans because the parent had no reasonable prospect for repayment but rather put the advances at the risk of the venture.

In *Bill Swad Leasing Co. v. Stikes (In re Tillery)*,[40] the Fifth Circuit dealt with an issue frequently arising in litigation involving a bankruptcy trustee: whether a contract constituted a true lease or was in fact a lease intended for security. In that case, the creditor had leased an automobile to the bankrupt, but no U.C.C. financing statement was filed in Alabama where the bankrupt resided, nor had a lien been reserved on a title certificate in Ohio where the automobile had been leased. The court held that the lease was a security agreement. The most important feature of the agreement showing that it was intended for security was a provision that the "lessee" would receive any equity upon a sale of the vehicle and would be liable for any deficiency. In addition to the equity feature, the court observed that the lease provided for a sales tax, required the "lessee" to purchase insurance protecting the full value, required the "lessee" to pay all fees, required the "lessee" to pay a "termination value" of the vehicle in the event of loss or destruction, required the "lessee" to indemnify the "lessor" from and against any damage, loss, theft, or destruction of the vehicle, and required a security deposit of $1,000.00 which was, in the court's view, the equivalent of a down payment on the purchase price.

A significant fact in the case was that the lease agreement had no provision guaranteeing the "lessee" the right to purchase the vehicle at the end of the lease term and, indeed, provided that the "lessee" would not acquire any right, title, or interest in the vehicle. The court of appeals was not persuaded by these provisions:

40. 571 F.2d 1361 (5th Cir. 1978).

> F. Although the "Lease Agreement" provides that the "Lessee" shall not have or acquire any right, title or interest in or to the vehicle, the insertion of this provision is not controlling. . . .
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> Likewise, although the agreement does not specifically contain an option to purchase, such an omission is not controlling. Just as the *inclusion* of an option to purchase does not in and of itself make the lease one intended for security; so also, the *exclusion* of such an option does not ipso facto make it a "pure lease." The determination must be made upon consideration of all the factors involved in the contract.[41]

Ivey v. Transouth Financial Corp. (In re Clifford)[42] concerned a trustee's unsuccessful attempt to defeat the interest of the holder of a security deed deemed to be unrecorded under state law because of a defect in execution. The security deed, which had been executed outside of Georgia, did not have the notarial seal required for effective recording under Ga. Code Ann. §29-409.[43] The trustee asserted that his hypothetical judgment lien under §70c(3)[44] was superior to the lien of that security deed. The issue was: "as between the holder of a prior unrecorded security deed and a subsequent judgment lien creditor, who has priority under Georgia law?"[45] After carefully reviewing Georgia law from the ninteenth century to the present, the Fifth Circuit, citing numerous Georgia cases, held in favor of the holder of the unrecorded security deed.

In a per curiam opinion, the Fifth Circuit in *Gardner v. American Century Mortgage Investors*[46] affirmed a judgment denying the bankrupt's discharge. The court stated that the objecting creditor had proved all of the material elements for denying a discharge and that the bankruptcy judge's findings of fact would not be upset unless they were clearly erroneous. There was ample evidence supporting the denial of discharge, including the facts that in the bankrupt's financial statement he had placed a value of $1,750,000.00 on undeveloped property purchased for $85,000.00 and a value of $250,000.00 on a house purchased for $50,000.00, had listed properties that he did not own, and had omitted to list debts totaling $100,000.00. The Fifth Circuit had no problem in dealing with the bankrupt's argument that he was unaware of the misstatements:

> Gardner's signing of statements containing such inaccuracies is a sufficient reason for denying discharge since the Bankruptcy Act only requires that the bankrupt either had actual knowledge that the statement was incorrect or had reckless indifference to the actual facts.[47]

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41. *Id.* at 1366 (emphasis in the original).
42. 566 F.2d 1023 (5th Cir. 1978).
43. GA. CODE ANN. §29-409 (1969).
44. 11 U.S.C.A. §110c(3) (1978).
45. 566 F.2d at 1025.
46. 577 F.2d 928 (5th Cir. 1978).
47. *Id.* at 929. *See* Fidelity and Deposit Co. of Md. v. Browder, 291 F.2d 34 (5th Cir. 1961).

III. Cases Decided On Procedural Grounds

In *First Wisconsin National Bank of Milwaukee v. Grandlich Development Corp.*,[48] the appellants sought to amend or vacate an order which dismissed them as party defendants in an action and had the effect of dismissing a counterclaim filed by them. The appellants had been sued along with other defendants to foreclose certain mortgages and had counterclaimed against the plaintiff alleging that the plaintiff had charged usurious interest. When appellants filed petitions under Chapter XI of the Bankruptcy Act, the district court entered an order dismissing appellants from the foreclosure proceedings altogether and also dismissed their counterclaim. Appellants did not appeal. Subsequently, the statute of limitations ran on the allegations in their counterclaim, and recognizing this, appellants sought to revive the dismissed action through a motion under FED. R. CIV. P. 60(b).[49]

The Fifth Circuit held that Rule 11-44 of the Rules of Bankruptcy Procedure[50] did not deprive the district court of jurisdiction to dismiss appellants as parties and to dismiss the counterclaim, since the counterclaim was not a proceeding against the debtors. Although the opinion does not indicate when the original lawsuit and counterclaim were filed, it is apparent that a substantial amount of time passed between the dismissal of those proceedings and the making of the Rule 60(b) motion. Upon that basis, the Fifth Circuit found that the district court had not abused its discretion in denying the motion.

An interesting contrast to *First Wisconsin National Bank* is the case of *Willis v. Gladding Corp.*,[51] decided by the same panel. In that case, the district court dismissed a damage action against Gladding Corporation after Gladding filed a Chapter XI proceeding. The suit had been pending for more than a year, there had been substantial discovery, a summary judgment motion had been filed and ruled upon, and a pre-trial stipulation had been entered into by the parties.

The Fifth Circuit reversed the district court's dismissal, reasoning that "[d]ismissal of a foreign suit is not necessary to protect the debtor from harassment and adverse disposition of his property. A stay, backed by the bankruptcy court's contempt power, is adequate."[52] The dismissal of the suit would raise possible questions of the running of the statute of limitations, would nullify the expense of the plaintiff to prepare the case for trial and would put the plaintiff in the same position as creditors who had made no effort to pursue a judgment. Accordingly, because dismissal "could

48. 565 F.2d 879 (5th Cir. 1978).
49. 28 U.S.C.A., Federal Rules of Civil Procedure, Rule 60(b) (1970).
50. 11 U.S.C.A., Rules of Bankruptcy Procedure, Rule 11-44 (1977).
51. 567 F.2d 630 (5th Cir. 1978).
52. *Id.* at 631.

result in an expensive and time-consuming duplication of pretrial proceedings"[53] and because the plaintiff "is entitled to maintain his place on the district court calendar subject only to the stay permitted by statute," the court vacated the dismissal.[54]

The case of *Hunter v. Hicks (In re J.D. Jewell, Inc.)*[55] arose out of the issuance of an injunction preventing the sale of property by a bankruptcy trustee. The appellants, claiming an interest in certain property, moved for an order denying confirmation of the sale of the property. Though not requested to do so, the district court entered an order enjoining the potential purchaser from interfering with the property in question. The order further required the appellants to post a bond indemnifying the trustee and the estate from any loss. Apparently because of pending state court litigation, there was a delay of approximately two years before the amount of the bond was finally set. The adverse claimants never posted the bond, and in the meantime the property in dispute was stolen. The trustee obtained a judgment against the appellants on the theory that the entry of the injunction was the proximate cause of the loss of the property since the trustee could have sold the property to the purchaser had the injunction not been entered.

The Fifth Circuit declined to decide whether the appellants had an interest in the property superior to that of the trustee. Instead, it addressed the narrower issue of whether the failure of a party to post a bond as a condition of a temporary injunction, which that party had not requested, barred recovery by a party which had not been enjoined but which had claimed to have been injured by the issuance of that injunction.

The Fifth Circuit had no difficulty in reversing the judgment in favor of the trustee, stating that "unless a bond has been executed upon the granting of an injunction, the person enjoined can have no recovery against the moving party."[56] Even a party requesting a temporary injunction is free to refuse to post a bond and thereby let the temporary injunction lapse, and a suit for damages will not lie even if the temporary injunction was granted without justification. It followed that if there could be no recovery against the moving party by the person enjoined, there clearly could be no recovery by a party not enjoined against a party whose motion lead to the issuance of an injunction which the latter had not requested.

In *Ben Hyman & Co. v. Fulton National Bank*[57] the Fifth Circuit held that an order remanding the case to the bankruptcy court for a determination of whether a bank had a right of set-off in a bankruptcy proceeding was not an appealable order. The parties and the property were within the

53. *Id.* at 632.
54. *Id.*
55. 571 F.2d 928 (5th Cir. 1978).
56. *Id.* at 933.
57. 577 F.2d 966 (5th Cir. 1978).

summary jurisdiction of the bankruptcy court; and dispute was therefore a controversy arising in a proceeding for bankruptcy. Appeals to the court of appeals lie from interlocutory orders only in "proceedings in bankruptcy."[58] An order in a "controversy arising in proceedings in bankruptcy" is appealable only if the order is final.

58. 11 U.S.C.A. §47(a) (1953).