Bankruptcy

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

All of the cases relating to bankruptcy law decided by the Fifth Circuit in 1980 arose under the old Bankruptcy Act.[1] The Bankruptcy Reform Act of 1978[2] applies to cases filed on or after October 1, 1979.[3] Many of these recent decisions may be of more than merely academic interest, however, since the Fifth Circuit's approach to the issues presented may shed some light on what can be expected in its interpretation of the new Code.

Three cases decided by the Fifth Circuit in 1980 illustrate pitfalls in appellate practice. In *Bad Bubba Racing Products, Inc. v. Huenefeld (In re Bad Bubba Racing Products, Inc.)*,[4] the issue was whether an appeal is perfected by merely mailing a notice of appeal. In a per curiam opinion, the court held that mailing was insufficient. Rules 801(a) and 802(a) of the Rules of Bankruptcy Procedure[5] require filing of the notice of appeal with the clerk within ten days of the entry of an order in order to perfect the appeal.

In *Schupak v. Dutch Inn of Orlando, Ltd. (In re Dutch Inn of Orlando, Ltd.)*,[6] the appellant sought specific performance of an alleged agreement by the Chapter XII debtor to sell real property. The debtor reneged and amended its plan to permit a sale to another purchaser. The

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* United States Bankruptcy Judge, Northern District of Georgia. Mercer University (B.A., 1954; LL.B., 1956). Member of the State Bar of Georgia. Coauthor of BANKRUPTCY PRACTICE FOR THE GENERAL PRACTITIONER (1980).

** Partner in the firm of Hurt, Richardson, Garner, Todd & Cadenhead, Atlanta, Georgia. Emory University (B.A., 1965); Columbia University (LL.B., 1968). Member of the State Bars of Georgia and New York.

1. 11 U.S.C. §§ 1-1255 (1966) (hereinafter referred to as the Bankruptcy Act or the Act).
2. 11 U.S.C. §§ 1-151326 (Supp. II 1978).
3. Pub. L. No. 95-598, § 402(a), 92 Stat. 2549 (1978).
4. 609 F.2d 815 (5th Cir. 1980).
5. 11 U.S.C., Rules of Bankruptcy Procedure, Rules 801(a), 802(a) (1976).
6. 614 F.2d 504 (5th Cir. 1980).

appellant failed to obtain a stay of that sale. The Fifth Circuit dismissed the appeal as moot, based upon the plain purpose and intent of rule 12-61(2) of the Rules of Bankruptcy Procedure.[7]

A similar problem confronted the appellant in *American Grain Association v. Lee-Vac, Ltd.*[8] In that case the Chapter XI debtor obtained an order approving the assignment of a sublease of real estate in connection with the sale of a grain elevator. The sublessor appealed that order but failed to obtain a stay. Thereafter, the debtor and the purchaser consummated the deal. The Fifth Circuit dismissed the appeal as moot, stating: "In the absence of a stay of a bankruptcy court's order affecting a debtor's property, a party appealing the order will not be heard to affect the rights of a third party who, pursuant to the order, acquired, in good faith, an option or lease on the property."[9]

Another frequent pitfall under the Act was the distinction between plenary and summary jurisdiction. In *First Arlington National Bank v. Barney's Boats of Chicago, Inc. (In re Barney's Boats of Chicago, Inc.)*,[10] the appellant-bank seized inventory of the debtor in which it claimed a security interest, despite knowledge that the debtor had filed a Chapter XI proceeding some months earlier. The debtor sued the bank in the bankruptcy court for conversion and sought punitive damages. The bank did not object to jurisdiction until four days prior to trial. The Fifth Circuit affirmed the holdings below that the appellant had waived its right to object to summary jurisdiction and affirmed an award of punitive damages against the bank.

Similarly, in *Roy v. Ellis Sarasota Bank and Trust Co. (In re Edgar)*,[11] the court held that the failure to object to summary jurisdiction in the initial answer constitutes a waiver of any objection to jurisdiction. Rule 915(a) of the Rules of Bankruptcy Procedure[12] clearly mandates that result.

In *Pacific Eastern Corp. v. Dinkins (In re Dinkins)*,[13] the appellant properly objected to summary jurisdiction, a step which ultimately proved to be critical. Dinkins, the Chapter XI debtor, had paid certain funds to an escrow agent pursuant to a construction contract. Upon the filing of the Chapter XI petition he commenced an adversary proceeding to recover those funds. The appellant intervened, contending that it was entitled to the funds, but it preserved its objection to the summary

7. 11 U.S.C., Rules of Bankruptcy Procedure, Rule 12-61(2) (1976).
8. 630 F.2d 245 (5th Cir. 1980).
9. *Id.* at 248 (footnote omitted).
10. 616 F.2d 164 (5th Cir. 1980).
11. 617 F.2d 1171 (5th Cir. 1980).
12. 11 U.S.C., Rules of Bankruptcy Procedure, Rule 915(a) (1976).
13. 610 F.2d 367 (5th Cir. 1980).

jurisdiction.

The bankruptcy court determined that the funds were property of the estate and then determined that the debtor had a superior claim to those funds. The district court affirmed. On appeal the Fifth Circuit agreed that the test for the exercise of summary jurisdiction is whether the property is the property of the debtor, rather than whether at the time of the filing of the petition the debtor was in actual or constructive possession of the property over which jurisdiction is sought.[14] However, the court found that the escrowed funds were not property of the debtor under the terms of the contract, though the debtor might have a claim to the funds. Since the appellant had objected to summary jurisdiction in its answer, there was no jurisdictional basis for the bankruptcy court to have considered the rights of the parties.

Two other 1980 decisions deal with the issue of what does or does not constitute property of the estate. The case of *Wallace v. Mercer (In re Mercer)*[15] raised an interesting question turning on Georgia law: whether the bankruptcy estate includes proceeds of a judgment for personal injury obtained by the bankrupt prior to filing when the judgment was appealed and not affirmed until after filing. Specifically, the trustee contended that the judgment constituted property of the estate under Section 70(a)(5) of the Act.[16] The trustee relied on Georgia Code Ann. Section 110-901[17] permitting the transfer of judgments. That statute does not, however, make any reference to the finality of a judgment. Rejecting the bankrupt's contention, the Fifth Circuit held that the judgment was sufficiently final, despite the appeal, to be transferrable under Georgia law.

In *Wisconsin v. Reese (In re Kennedy & Cohen, Inc.)*,[18] the appellants contended that unsegregated funds in the debtor's estate should be impressed with a constructive trust to pay claims of holders of appliance maintenance contracts sold shortly prior to the filing of the petition. The Fifth Circuit rejected this contention, holding that the inability of the appellants to identify specific funds in the hands of the trustee defeated those claims.

The interplay of the law of trusts and bankruptcy law arose in two other cases decided in 1980. In *Angelle v. Reed (In re Angelle)*,[19] the Fifth Circuit for the first time considered the meaning of the term "fiduciary" under Section 17a(4) of the Act.[20] A claim based upon the bank-

14. *Id.* at 370.
15. 631 F.2d 1197 (5th Cir. 1980).
16. 11 U.S.C. § 110(a)(5) (1976).
17. GA. CODE ANN. § 110-901 (1973).
18. 612 F.2d 963 (5th Cir. 1980).
19. 610 F.2d 1335 (5th Cir. 1980).
20. 11 U.S.C. § 35(a)(4) (1976).

rupt's fraud, embezzlement, misappropriation or defalcation while acting in a fiduciary capacity is not dischargeable. Angelle, a home contractor, failed to complete houses for owners who advanced funds for that purpose. Contending that Angelle was a fiduciary, five such owners objected to his discharge under section 17a(4); they relied on a Louisiana statute making misappropriation of funds by a contractor a criminal offense. There was no requirement in Louisiana, however, that a contractor in Angelle's position segregate funds, and the testimony indicated that he comingled advances received from various owners.

The cases were tried before different bankruptcy judges. In cases involving two of the owners, the court held that the claims were dischargeable. In the remaining cases the other bankruptcy judge held that the claims were not dischargeable. The district court decided that none of the claims were dischargeable. The Fifth Circuit reversed. It held that the fiduciary relationship referred to in section 17a(4) "is limited to a technical trust" and that the trust must have existed prior to the time of an alleged misappropriation.[21]

The bankrupt in *Carey Lumber Co. v. Bell,*[22] the second case to treat the interplay of trust law and bankruptcy law, was not as fortunate as the bankrupt in *Angelle.* In *Carey Lumber,* the Fifth Circuit affirmed a holding that debts of the bankrupt builder to a supplier were not discharged since, under Oklahoma law, the builder was specifically required by statute to hold the advanced funds in trust for the benefit of third parties.

Dischargeability of debts under section 17 of the Act[23] was the focal point of three other cases decided in 1980 by the Fifth Circuit. In *Koehler v. United States (In re Koehler),*[24] the issue was whether taxes, penalties and interest were dischargeable when assessments made within one year of the filing of the petition were based upon a disallowance of operating loss carrybacks. The taxes in question related to tax years 1964 and 1965. Returns for those years, filed in 1966, resulted in the assessment of taxes, penalties and interest which were later abated because of the tentative allowance of operating loss carrybacks for tax years 1966 and 1967. Subsequently, in 1969 those operating loss carrybacks were disallowed and the 1964 and 1965 taxes were again assessed. The petitions were filed in 1969, and the United States filed a proof of claim which was allowed a full priority. In 1971 the bankrupts received a discharge, and in 1974 they filed an application to reopen the case to determine the dischargeability of the tax debts. In 1978 the bankruptcy court held that the taxes, penalties and interest assessed for tax years 1964 and 1965 were discharged.

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21. 610 F.2d at 1341.
22. 615 F.2d 370 (5th Cir. 1980).
23. 11 U.S.C. § 35 (1976).
24. 619 F.2d 548 (5th Cir. 1980).

The issue raised by the appeal of the United States was whether the taxes in question were "assessed within one year preceding bankruptcy in any case in which the bankrupt failed to make a return required by law."[25] The Fifth Circuit affirmed on the basis of the district court's opinion that upheld the government's position. Despite the appellee's contention that the government had three years prior to the filing within which to collect the taxes, the district court pointed out that it was the appellees who chose to claim the tax benefits.

The second hurdle facing the government was the contention that there had been no failure to make a return required by law as provided in section 17a(1)(b). A majority of the panel agreed with the district judge that "the facts of this case indicate an unreasonable delay was present in the late filings of appellees' 1964 and 1965 tax returns."[26]

Judge Brown dissented from that portion of the opinion with respect to the 1965 return. He pointed out that that return was fully accurate, and that decisions relied upon by the majority involved returns filed several years late rather than just a few months late. The Fifth Circuit had recently decided that a return filed eleven days late was a "return required by law",[27] and Judge Brown found it impossible to reconcile that result with this case.

In *Alabama Department of Revenue v. Fox (In re Fox)*,[28] the state appealed lower court rulings discharging the bankrupt from liability for state sales taxes and penalties. The taxes and penalties in question related to tax years more than three years prior to the filing of the petition. Without more, that would have rendered the state's claim dischargeable. The state asserted, however, that the lower courts erred in failing to correctly apply section 17a(1)(d) and section 17a(1)(e).[29]

The Fifth Circuit rejected the state's position as to section 17a(1)(d). Although that section does provide that a discharge does not release a bankrupt from taxes with respect to which a false or fraudulent return has been filed, the court held that the term "false" is intended to cover deliberate fraud and not merely an incorrect return.

With respect to the interpretation of section 17a(1)(e), the Fifth Circuit agreed with the state that section 17a(1)(e) applies to sales taxes. Under Alabama law there is a mandatory duty on the seller to collect and remit those taxes, and those taxes have been held by the Alabama courts to be a burden on the purchaser, not the seller.

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25. 11 U.S.C. § 35(1)(b) (1976).

26. 619 F.2d at 553.

27. Harper v. District Director of Internal Revenue (*In re* Harper), 580 F.2d 165 (5th Cir. 1978).

28. 609 F.2d 178 (5th Cir. 1980).

29. 11 U.S.C. §§ 35(a)(1)(d), 35a(1)(e) (1976).

The last and most interesting question addressed by the court of appeals was resolved in the bankrupt's favor and relieved him from liability. As the bankrupt conceded, a debtor is obligated to pay sales taxes whether he actually collects them or not, but the court decided that the fundamental policies of the Act to provide rehabilitation and equitable distribution of assets would be circumvented if section 17a(1)(e) covered liabilities for taxes not actually collected.

> We conclude that the proper interpretation of § 17a(1)(e), consistent with the intent of the Bankruptcy Act and the legislative historicity [*sic*] of the section, prohibits discharge in bankruptcy only for sales taxes *actually* collected or withheld and not remitted. To the extent that the debtor merely failed to acquit a statutory duty and collect taxes he is discharged.[30]

The case of *Petty v. Dardar (In re Dardar)*[31] involved an interpretation of a rule of law that an aggressor has no claim for injuries inflicted by a party acting to repel that aggressor. The bankruptcy court found that Petty struck the Dardars with his automobile, and thereafter Mr. Dardar beat Petty. The bankruptcy court found that Dardar's actions were lawful, and the district court affirmed. The Fifth Circuit reversed, stating:

> The aggression doctrine is designed to permit a person to protect one's self from an act of violence from another person. It is not designed to permit an injured party to take the law into his or her own hands and retaliate against the initial agressor. Inasmuch as Petty was driving his car away from the scene of the initial tort, it cannot be said Dardar beat him to *repel* any aggression.[32]

Accordingly, the court indicated that the claims would be nondischargeable.

It is the duty of a trustee or debtor-in-possession to review secured claims to determine whether the security interest has been perfected. As a practical matter, trustees and debtors will sometimes overlook a possible objection to a secured claim early in a proceeding and concede the secured creditor's position. The court's decision in *Colorado Livestock Production Credit Association v. Schwab (In re Schwab)*[33] shows that secured creditors should not rely upon an initial characterization of a claim as secured or unsecured by either the debtor or the bankruptcy court. In that case, the Chapter XI debtor's petition conceded that the appellant's entire claim was secured. The bankruptcy court had also approved pay-

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30. 609 F.2d at 182 (footnote omitted).
31. 620 F.2d 39 (5th Cir. 1980).
32. *Id.*, at 41 (citations omitted).
33. 613 F.2d 1279 (5th Cir. 1980).

ments to the appellant on claims *properly classified as secured*, and the bankruptcy court had refused to allow the claim of the appellant as an unsecured creditor for voting purposes. After the confirmation of the debtor's plan, the debtor for the first time sought to defeat the security interest in certain collateral.

The Fifth Circuit rejected the appellant's contention, based upon section 369 of the Act,[34] that the bankruptcy court had lost jurisdiction. That section provides:

> The Court shall in any event retain jurisdiction until the final allowance or disallowance of all claims affected by the arrangement which have been filed within the limitations as to the time and amount prescribed by section 755A of this title but have not been allowed or disallowed prior to confirmation.[35]

The court noted that the Act mandates no formal procedure for the allowance of a claim. It determined that none of the references by the bankruptcy court in previous orders regarding the secured status constituted a judicial determination, and thus that court retained its jurisdiction.

In *Kittay v. Dutch Inn of Orlando, Ltd. (In re Dutch Inn of Orlando, Ltd.)*,[36] the Fifth Circuit held that limited partners have no standing to object to a sale by a Chapter XII debtor of its assets where the Chapter XII debtor is insolvent. The court stated: "Since the appellant limited partners did not qualify as creditors who hold a claim affected by the Dutch Inn's proposed plan of arrangement, they lack standing to object to the confirmation of the plan and the sale of Dutch Inn's assets under 11 U.S.C. § 861 (repealed 1979)."[37]

In *Durrett v. Washington National Insurance Co.*,[38] the Fifth Circuit reversed the district court's determination that a transfer of property made nine days prior to the filing of the Chapter XI petition was not voidable under section 67(d) of the Act.[39] That section renders "fraudulent" a transfer made within one year of the filing of the petition when the transfer was made without "fair consideration" by an insolvent debtor. It was undisputed that the property in this case had a fair market value of $200,000 and that the winning bid in at a foreclosure sale was $115,400, the outstanding indebtedness secured by the property. The court held that that sale price, which constituted only 57.7% of the fair

34. 11 U.S.C. § 769 (1976).
35. *Id.*
36. 614 F.2d 506 (5th Cir. 1980).
37. *Id.* at 508.
38. 621 F.2d 201 (5th Cir. 1980).
39. 11 U.S.C. § 107(d) (1976).

market value, was not a "fair equivalent" price within the meaning of section 67(d).

In the companion cases of *Rivercity v. Herpel (In re Jackson Brewing Co.)*[40] and *American Can Co. v. Herpel (In re Jackson Brewing Co.)*,[41] the Fifth Circuit considered objections to compromises of litigation in a Chapter X proceeding. The court stated that the bankruptcy judge must review all the necessary facts to evaluate the rewards and risks of the compromise and of continued litigation. Specifically, the bankruptcy judge must review the following:

> (1) The probability of success in the litigation, with due consideration for the uncertainty in fact and law,
> (2) The complexity and likely duration of the litigation and any attendant expense, inconvenience and delay, and
> (3) All other factors bearing on the wisdom of the compromise.[42]

In both of these cases, the Fifth Circuit held that the district court adequately evaluated the key considerations.

The Fifth Circuit rendered three decisions in 1980 in the *Multiponics, Inc.* Chapter X case. Its decision in *Machinery Rental, Inc. v. Herpel (In re Multiponics, Inc.)*[43] deals with the question of subordination of claims, which the court of appeals addressed most recently in *Benjamin v. Diamond (In re Mobile Steel Co.)*.[44] In *Machinery Rental,* the court upheld the subordination of a director's claim, which was based upon repayment of a loan that the director had guaranteed, when the transactions involving that and other loans were deemed inequitable and unfair. In addition, the court found that the debtor was undercapitalized from its inception and that, unlike *Mobile Steel,* the lack of capital "was a primary cause of the Company's failure."[45] In addition to the inequitable conduct, the court stated that either injury to creditors or advantage to the claimants sought to be subordinated must be shown. The record supported a finding of impairment of the position of creditors.

The court refused, however, to subordinate the claims of Machinery Rental, Inc., a company wholly owned by the same director. The trustee argued that the claimant was merely the alter ego of the director, but the court of appeals pointed out that there was a valid business purpose for the purchase of notes underlying the claim in question. The court found

40. 624 F.2d 599 (5th Cir. 1980).
41. 624 F.2d 605 (5th Cir. 1980).
42. *Id.* at 607, *quoting* Protective Committee for Independent Stockholders of TMT Trailer Ferry, Inc. v. Anderson ("TMT Trailer"), 390 U.S. 414, 424-25 (1968).
43. 622 F.2d 709 (5th Cir. 1980).
44. 563 F.2d 692 (5th Cir. 1977).
45. 622 F.2d at 720.

that there was no proof of sham or wrongdoing that would justify equitable subordination.

First National City Bank (Citibank) v. Herpel (In re Multiponics, Inc.),[46] involved an attempt by Citibank to set-off a debt. The issue was whether there was sufficient mutuality to permit set-off under section 68(a) of the Act.[47] The account in question had been created to cover interest payments on a loan, and it secured a revocable letter of credit for the amount of the interest. The account had been segregated from the bank's general funds. Because of the special purpose of the account and the circumstances surrounding Citibank's rights and duties with respect to the account, the court found no mutuality.

The last case in this trilogy, *Citibank, N.A. v. Multiponics, Inc. (In re Multiponics, Inc.)*,[48] involved an appeal of an award of attorneys' fees. Counsel for Citibank, as indenture trustee, had filed a fee application for over $600,000, but the attorneys were awarded only $30,000. After reviewing the factors to be considered in awarding fees in bankruptcy cases, the Fifth Circuit affirmed the lower court's order, despite the observation that the award "does appear to us to be rather restrained, particularly in light of the labor expended and professional abilities demonstrated by counsel here."[49] The essential defect in the fee application was the fact that most of the services rendered were not deemed beneficial to the estate, but were beneficial primarily to the debenture holders.

Attorneys who serve as trustees continue to have difficulty complying with the Fifth Circuit's interpretation of rule 219 of the Rules of Bankruptcy Procedure.[50] In *Braswell Motor Freight Lines, Inc. v. Crutcher, Burke & Newsom*,[51] a very successful Chapter XI proceeding, all creditor claims were paid under the plan and an acquiring company agreed to pay all the costs of bankruptcy administration. In addition, shareholders received compensation for their stock. One of the operating receivers served as his own attorney and submitted a fee application for $143,800. At a hearing he attempted to distinguish between his role as an operating receiver and his role as attorney. The bankruptcy judge awarded fees of $115,000 and based the reduction in the amount requested in part on the exclusion of non-compensable activities, but the debtor appealed. The district court affirmed. The Fifth Circuit reversed, despite the success of the case, stating: "In spite of the ten percent reduction for performing duties of the operating receiver, the record leads us to conclude that a

46. 622 F.2d 725 (5th Cir. 1980).
47. 11 U.S.C. § 108(a) (1976).
48. 622 F.2d 731 (5th Cir. 1980).
49. *Id.*, at 733.
50. 11 U.S.C., Rules of Bankruptcy Procedure, Rule 219 (1976).
51. 630 F.2d 348 (5th Cir. 1980).

portion of the award likely included services for non-professional services in violation of Bankruptcy Rule 219(c)(3)."[52] The record revealed that a substantial portion of the services rendered were not legal services.

There were two bright spots in the decision for bankruptcy practitioners. First, the Fifth Circuit held that it is an abuse of discretion to deny a reasonable fee for preparation of a fee application. Second, the court indicated that a fee of $100 per hour was not excessive under the circumstances of a favorable result.

In *Woods-Tucker Leasing Corp. of Georgia v. Hutcheson-Ingram Development Co.*,[53] the Fifth Circuit examined in some detail whether a transaction was a security arrangement or a true lease. The claimant had purchased equipment from the debtor and leased it back. The court of appeals affirmed the holding below that the transaction was a security arrangement and pointed to a number of facts supporting that result. First, the sale price of the equipment was substantially lower than its market value. Second, the payments were computed on the basis of the amount advanced by the "lessor" rather than the value of the property. Third, the initial contact between the parties had been for the purpose of a loan rather than a sale and leaseback. Fourth, the "lessor" had no inventory of equipment for lease. Last, the agreement required the "lessee" to pay all taxes and insurance.

52. *Id.* at 350.
53. 626 F.2d 401 (5th Cir. 1980.)