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Bankruptcy: Effect of State Statutes of Limitation

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RECENT DECISIONS

Bankruptcy—Effect of State Statutes of Limitation—A Virginia corporation filed on February 23, 1942, in the Federal District Court of Virginia, a petition for reorganization under Chapter X of the Bankruptcy Act. Subsequent investigation resulted in suit by the trustee in a federal district court of New York against the corporation's majority stockholder—Williams—and one of its directors, charging breach of fiduciary duty in some thirteen transactions which occurred in 1927 and 1929. The trustee alleged that Williams had retained his dominant status for fifteen years, thus concealing the breach of fiduciary duty until the trustee took over in 1942. Against a defense that the statute of limitations as interpreted in New York had run, the trustee contended that the suit having been brought in the federal courts, the federal equitable interpretation as to when a state statute of limitations began to run should control. *Held:* For the defendants. Where a federal court has jurisdiction by virtue of a federal statute directing it to apply state law as well as federal law, the statute must be interpreted in accordance with congressional intent and state-created rights adjudicated with respect to appropriate state law, including the interpretation of state statutes by state courts. Judge Clark dissented. *Austrian v. Williams, 198 F.2d 697 (1952) Cert. denied 73 S.Ct. 328 (1952).*

The problem of what law is applicable to suits brought in the federal courts regarding state-created rights has long confronted the American lawyer. Judicial decision seems to have established three general principles regarding suits brought in the federal courts. First, where the jurisdiction of a federal court is based upon federally-created rights or federal questions, both federal substantive and procedural law are to be applied.[1] Second, where federal jurisdiction is based upon diversity of citizenship and state-created rights are at issue, federal procedural law and the state substantive law of the forum are to be applied.[2] Third, where federal jurisdiction is based upon a federal statute creating the right to sue in the federal courts upon a state-created right, but the

[1] Clearfield Trust Co. v. United States, 318 U.S. 363 (1943); National Metropolitan Bank v. United States, 323 U.S. 454 (1945); Holmberg v. Armbrecht, 327 U.S. 392 (1946); United States v. Standard Oil, 332 U.S. 301 (1947); Steela v. Kaiser, 81 F.Supp. 807 (1947).

[2] Erie v. Tompkins, 304 U.S. 64 (1938); Guarantee Trust Co. v. York, 326 U.S. 99 (1945); D'Oench, Duhme & Co. v. F.D.I.C., 315 U.S. 447 (1942). In commenting upon the intent behind the *Erie v. Tompkins* decision, Justice Jackson remarked that it was the intent of the court, "to secure in the federal court in diversity cases the application of the same substantive law as would control if the suit were brought in the courts of the state wherein the federal court sits." Thus federal modification of state law in diversity cases is precluded.

statute directs that state law is to be applied in particular instances, the federal statute is to be construed in accordance with congressional intent and state law is to be applied only in the manner and instances so specified.[3] While this principle or rule has been recognized, the difficulties that have arisen therefrom have been concerned with determining "congressional intent" in the particular statute involved.

The problem of determining congressional intent in respect to Section 11 e[4]—covering statutes of limitations in bankruptcy proceedings—has been particularly perplexing. Prior and subsequent to its adoption in 1938, there has been, with the exception of a brief paraphrasing of the section, a complete absence of congressional comment upon 11 e.[5] However, from the wording of the statute—occasioned by the dispute[6] over the interpretation of its predecessor 11 d[7]—as well as judicial decision,[8] one thing is clear. The statute very definitely provides the trustee an extension of time within which to bring suit. If a cause of action has not expired at the time of the filing of the bankruptcy petition the trustee is given a two year period in which to bring suit. Despite the fact that the applicable statute of limitations may run out within that two year period, the period is nevertheless extended two years from the filing of the petition. If the particular state or federal law which

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[3] Though no particular case contains an exact statement of the rule, this statement of the rule may be derived from (1) the reluctance of the court in D'Oench, Duhme & Co. v. F.D.I.C., 315 U.S. 447 (1942) to lay down a general rule as to the possibility or the extent of federal modification of state law when state-created rights are heard under a non-diversity jurisdiction; (2) the confinement of the Erie rule to diversity cases. D'Oench, Duhme & Co. v. F.D.I.C., 315 U.S. 447 (1942); (3) the well established principle that "the intent of the legislature, when properly ascertained, must govern in the construction of every statute." Pollard v. Bailey, 20 Wall. 520 (U.S. 1874).

[4] 52 STAT. 849 (1938), 11 U.S.C.A. §29 e (1952). "A receiver or trustee may, within two years subsequent to the date of adjudication or within such further period of time as the Federal or State law may permit, institute proceedings in behalf of the estate upon any claim against which the period of limitations fixed by Federal or State law had not expired at the time of the filing of the petition in bankruptcy."

[5] Except for a brief paraphrasing of the section the Senate and House reports at the time of its enactment make no reference to 11 e. H.R. REP. 1409, 75th Cong. 1st Sess. 20, 22 (1937); SEN. REP. 1916, 75th Cong. 3rd Sess. 14 (1938).

[6] State and lower federal courts explicitly and uniformly held that its two year limitation applied to all actions brought under the Bankruptcy Act itself but did not supersede limitations on derivative actions arising under state law. Davis v. Wiley, 273 Fed. 397 (9th Cir. 1921); Meilke v. Drain, 69 F.2d 290 (9th Cir. 1934). Other courts ruled that it was a superseding statute applying to all actions brought by the trustee under state or federal law. Isaacs v. Neece, 75 F.2d 566 (5th Cir. 1935); Callaghan v. Bailey, 293 N.Y. 396, 57 N.E. 2d 729 (1944). Other courts held that it did not supersede the state statutes in adding any time to the period of limitation but rather, merely prohibited actions by or against a trustee after the two year period. Narin v. McCarthy, 120 F.2d 910 (7th Cir. 1941); *Cf.* Harrigan v. Bergdoll, 270 U.S. 560 (1926).

[7] 30 STAT. L. 549 (1898) "Suits shall not be brought by or against a trustee subsequent to two years after the estate has been closed."

[8] Dabney v. Levy, 92 F.Supp. 551 (1950), *aff'd.*, 191 F.2d 201 (1951), *cert. den.*, 342 U.S. 887 (1951) *rehearing den.*, 342 U.S. 911 (1951).

gives rise to the cause of action provides a longer period in which to bring suit, the longer period prevails and the period prescribed by the state statute is not limited by the two year regulation.[9]

Thus it appears evident that, while granting an extension of time for bringing suit if the cause of action exists at the filing of the bankruptcy petition, it is not the intent of Congress to allow suit on expired causes of action.[10] However, in determining whether a cause of action exists at the filing, the statute is not clear as to the meaning or application of the term "state law."

The court in the instant case—applying 11 e—assumes that the term "state law" means not only statutory law but also state decisional interpretation and modification thereof. It further assumes that a federal court is required to follow such interpretation. Thus the court, considering itself bound to apply the New York rather than the federal equitable interpretation[11] of the statute of limitation, decided that the statute began to run at the time of the wrongful act in 1927, rather than at its discovery in 1942, and held for the defendants.

At first glance, the present interpretation[12] of the Rules of Decision Act[13]—compelled by *Erie v. Tompkins*[14]—would make such an interpretation a reasonable one. But to establish that interpretation of the term "state law" as that intended by Congress in its adoption of 11 e would be to disregard (1) the policy considerations motivating the adoption of the section, and (2) its history.

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[9] The majority of cases decided under 11 e seem to bear out this statement of the rule. See in particular, Herget v. National Bank & Trust Co. of Peoria, 141 F.2d 150 (7th Cir. 1944), *aff'd.*, 324 U.S. 4 (1945) "... The meaning of the statute seems quite simple—that when a cause of action has not already expired at the time of the filing of the petition in bankruptcy, a receiver may sue within whichever is the longer of two periods, two years, or that provided by the statute permitting or creating the cause." McBride v. Farrington, 60 F.Supp. 92 (Ore.D. 1945). "The new Sec. 11, Sub e, was obviously a compromise and extended the limitations laid down by the state statute . . . to a fixed period of two years beyond the date of adjudication. It will be noticed, however, that if the state statute provided for a term of limitation which did not lapse until two years after adjudication that no change was effected where the doctrines previously announced . . . continue in effect. The purpose of the new act seems unquestionably to be to extend to the trustee a fixed period within which he might file all suits which he has inherited from the debtor unless that it were the policy of the particular state to give him even a longer time."

[10] *Supra,* notes 4 and 9.

[11] Bailey v. Glover, 21 Wall. 342 (U.S. 1875).

[12] D'Oench, Duhme & Co. v. F.D.I.C., *supra,* note 2, "Thus the Rules of Decision Act as now interpreted require federal courts to use state law whether declared by the legislature or by the courts as rules of decision 'in cases where they apply' except where federal laws shall otherwise require or provide."

[13] 62 STAT. 944 (1948), 28 U.S.C.A. 1652 (1952), "The laws of the several states, except where the Constitution or treaties of the United States or Acts of Congress otherwise require or provide, shall be regarded as rules of decision in civil actions in the courts of the United States, in cases where they shall apply."

[14] Erie v. Tompkins, *supra,* note 2.

From a policy viewpoint two factors are noteworthy. First, after the courts had exhibited considerable difficulty[15] in agreeing upon the interpretation of the negatively phrased 11 d[16]—which on its face limited all actions by the trustee to a two year period following the closing of the estate—Congress completely revamped the phraseology of the section to provide in the positively phrased 11 e,[17] a two year extension of the period in which to bring suit. Though there has been no congressional indication as to the motives behind the change[18] it may be safe to assume that it was occasioned by the realization that to efficiently carry out his duties, a trustee—at his appointment, unfamiliar with the situation—requires greater time in which to discover and bring suit on causes of action in favor of the bankrupt. From the fact that the present 11 e extends the period for bringing suit where as its predecessor 11 d sought to limit it, may be inferred the adoption of a policy of allowing the trustee all possible opportunity for discovering and prosecuting causes of action in favor of the bankrupt.

Secondly, the general policy of the Bankruptcy Act as regards the powers of a trustee in a Chapter X reorganization proceeding,[19] seem to indicate the feasibility of an interpretation of 11 e other than that advanced in the instant case. While the ordinary trustee in bankruptcy receives only those causes of action existing in favor of the bankrupt or his creditors prior to the bankruptcy proceedings, a trustee in certain instances may be given rights greater than those of the bankrupt or his creditors in order to further particular policies.[20] Thus the trustee in reorganization is given broad investigatory powers for the purpose of discovering causes of action which have, up to the time of the bankruptcy proceedings, been successfully concealed. There is evidence that at the time of the adoption of 11 e Congress was particularly concerned about uncovering corporate management abuses—like those in the instant case which are unlikely to be uncovered prior to reorganization.[21] Thus, the fact that Congress has given the trustee in reorganization broad investigatory powers as well as a duty to prosecute all discovered causes of action indicate a congressional policy of aiding in the exposure of corporate management abuses.

However, the result in the instant case under the present interpre-

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15 *Supra*, note 6.
16 *Supra*, note 7.
17 *Supra*, note 4.
18 *Supra*, note 5.
19 BANKRUPTCY ACT, §167, 52 STAT. 890 (1938), 11 U.S.C.A. §567 (1952).
20 *See* D'Oench, Duhme & Co. v. F.D.I.C., *supra*, note 2; Board of Trade of Chicago v. Johnson, 264 U.S. 1 (1924); Prudence Realization Corp. v. Geist, 316 U.S. 89 (1942); Vanston Bondholders Protective Committee v. Green, 329 U.S. 156 (1946).
21 See *Hearings Before Committee on the Judiciary* in H.R. 6439 and H.R. 8046, 75th Cong. 1st Sess. 163-4, 175-6 (1937); H.R. REP. No. 1409, 75th Cong., 1st Sess. 42-4 (1937); SEN. REP. No. 1916, 75th Cong., 3d Sess. 21 (1938).

tation of 11 e seems to be inconsistent with both the above mentioned policies. First, in that the interpretation of the state statute of limitation under the federal equitable doctrine would generally give the trustee greater time to discover and prosecute any cause of action found in favor of the bankrupt than would the state interpretation, a refusal to follow the equitable interpretation seems inconsistent with the general policy of 11 e. Second, in that the federal equitable interpretation would toll the statute of limitation until discovery of the wrongful act, whereas the New York state interpretation would not, a refusal to adopt the federal equitable interpretation would be inconsistent with the grant of wide investigatory powers to a trustee in reorganization. While the trustee could still uncover corporate management abuses—by their very nature so well hidden as to prevent discovery until the trustee's investigation—the court's inability to apply the federal equitable interpretation tolling the statute of limitation until such discovery—would lessen the likelihood that such abuses would be remedied.

Section 11 e was passed by the House of Representatives in 1937[22] before the *Erie v. Tompkins* decision,[23] and by the Senate in 1938 shortly after the decision was handed down.[24] At the time the section was proposed and passed by the House, the federal courts, following the rationale of *Swift v. Tyson,*[25] interpreted the Rules of Decision Act to mean that while federal courts must apply state law where required, state law meant that only the statutory law and not the non-statutory law as contained in the judicial decisions of the state courts. Thus, the federal courts, not being required to follow state decisional law, were granted complete freedom to apply federal equitable doctrines where a state's interpretation of a state statutory provision differed from the federal equitable interpretation.

In the absence of any contrary expression of intent, we may reasonably conclude that in using the term "state law" in 11 e, Congress intended that the term as then interpreted (1938) should apply and that the federal courts are free to apply federal equitable interpretations to state statutes of limitations in bankruptcy proceedings.

The policies which have extended the period for discovering and bringing suit and which have been aimed at exposing corporate abuses would seem to warrant that, if at all possible, any interpretation of the statute of limitations which would extend a trustee's time for bringing suit, should not be followed. There being no expression of congressional intent that the federal courts should not be allowed to modify state

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[22] The Act passed the House on Aug. 10, 1937. 81 CONG. REC. 8649 (1937).
[23] Erie v. Tompkins, *supra,* note 22, (decided April 25, 1938).
[24] The Act passed the Senate on June 10, 1938. 83 CONG. REC. 8729 (1938).
[25] Swift v. Tyson, 16 Pet. 1 (U.S. 1842); Kirby v. Lake Shore & Mich. S.R.R., 120 U.S. 130 (1887).

statutes of limitation, policy considerations would seem to warrant allowing the federal courts in bankruptcy proceedings to impose federal equitable interpretations upon state statutes of limitations.

The Supreme Court's recent denial of certiorari seems unfortunate inasmuch as the *Austrian* decision cannot be justified on the grounds that the interpretation of 11 e which formed the basis of the decision was that intended by Congress. In addition thereto, the general policy of the Bankruptcy Act aimed at extending the period in which to bring suit would seem to warrant a contrary interpretation of 11 e.

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Partnerships—The Nature of the Partnership before the Law— In 1946 two persons formed a partnership to operate a Ford sales and service agency. Two years later the same persons formed a second partnership to sell and service tractors. Each partnership had its own building, books, employees and bank account. All they had in common were the two owners, the partners. The Ford agency employed enough men to make it subject to the Michigan employment security act, but the tractor agency did not. However, acting under advice from appellant, the partners included the employment of both firms on the same report. By 1949, because of the good employment record of the two firms, the partners' contribution rate for employment insurance was only one per cent of the wages paid. At that time appellee purchased the Ford agency from the partners, retaining the same employees. Appellant raised the contribution rate of the Ford agency to three per cent on the ground that the two partnerships had legally been but a single firm because they were composed of the identical partners; that appellee therefore was not a successor to the firm that had the one per cent contribution rate, but to a distinct firm. Appellee won on an appeal to a referee. This decision was affirmed by the appeal board and by the circuit court, but the commission appealed. *Held:* Affirmed. A partnership is a legal entity distinct from the individuals composing it. Consequently, two partnerships with the same members are not a single employing unit but must be considered separately. *Michigan Employment Security Commission v. Crane et al. 334 Mich. 411, 54 N.W. 2d 616 (1952).*

The decision of the principal case, that a partnership has a legal existence distinct from its members, follows what is generally known as the entity theory of partnerships. The contention of the appellant—a partnership is not a distinct legal entity but an association of individuals—is known as the aggregate theory.[1] Whether a partnership is

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[1] Crane, *The Uniform Partnership Act—A Criticism,* 28 HARV. L. REV. 762 at 763 (1915).