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CREDITORS RIGHTS UNDER THE BANKRUPTCY ACT¹

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The Bankruptcy Act was materially revised by the Chandler Act which became effective on September 22, 1938. Decisions construing the Bankruptcy law as it existed prior to 1938 cannot safely be relied upon as being authoritative.

The Chandler Act modified the rights respectively of the bankrupt, the priority claim holders, secured claimants, and of the unsecured creditors, and in all cases reference should be made to the Chandler Act as amended.²

The theory of the Bankruptcy Act is to free honest debtors of their debts, and to distribute the bankrupt's assets equitably among the several classes of creditors. What is a fair and equitable distribution may be viewed in as many different aspects as there are interests seeking to participate in the debtor's assets.

The interests of creditors generally are adverse to the bankrupt's interests, and the interests of the several classes of creditors are adverse to each other to the extent that one class has priority or recognition over another class or classes of creditors.

The creditors, especially unsecured creditors, have an interest in seeing that bankrupts receive no exemptions to which they are not entitled, and also are interested in having the bankrupt's discharge denied if the facts warrant the denial thereof.

Creditors holding security have an interest in sustaining their liens. Unsecured creditors are interested in reducing or eliminating priority claims as well as to set aside secured claims in order to increase the dividend to unsecured creditors.³

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¹ This discussion is not intended to refer to the rights of creditors under Chapter X et seq. of the Bankruptcy Act. Also, references are to the sections of the Bankruptcy Act itself. The corresponding section may be found in the United States Code under Title 11. "COLLIER" means COLLIER, BANKRUPTCY 14th edition, JNARB means Journal of National Association of Referees in Bankruptcy.

² In re Tastyeast Co., 126 F.(2d) 879 (C.C.A. 3rd 1942).

³ See Streeter, 22(2) JNARB 35 (1948). This article does not treat of the priority or extent of tax liens, as an example of the importance of the question *see* In Reese, 131 F.(2d) 466 (C.C.A. 7th 1942), COLLIER, § 67.24 (1949 Supp.).

BANKRUPTS' RIGHTS AS AFFECTING CREDITORS' RIGHTS

Discharge of Debts

The bankrupt is entitled to a discharge from his debts if he has not committed one of the seven acts which are grounds for denying the discharge.⁴

Even though the discharge has been granted it will not discharge the debtor from six specific classes of debts.⁵

Bankrupts' Exemptions

The allowances to the bankrupt by way of exemption are reduced to the extent that no allowance shall be made out of the property which a bankrupt has transferred in fraud of creditors or has concealed and which is recovered for the benefit of the estate, unless the transfer was by way of security only and the amount recovered is in excess of the amount secured thereby, and in such event allowance may be made out of such excess.⁶

Bankrupts' Right to Satisfaction of Judgments

A valuable right given to the bankrupt by the 1943 Session of the Wisconsin Legislature is the compulsory satisfaction of a judgment against the bankrupt if the debt has been scheduled and is discharged in the bankruptcy proceedings.⁷

RIGHTS OF PRIORITY CREDITORS

Section 64 defines the classes of unsecured debts which have priority of payment. Since debts within the category defined by this section are entitled to payment in full, it is of fundamental importance to unsecured creditors that no priority claim be allowed which is not within the strict meaning of the statute. Wage claimants are limited in their priority both as to time and as to amount, whereas no such limitation applies as to taxes, with the result that estates may be virtually consumed by claims of taxing authorities, many of which are asserted for the first time after bankruptcy.

Prior to 1938 debts due to states and to subdivisions thereof were included among the claims entitled to priority of payment. The Chandler Act has eliminated such priorities and has confined such priorities to debts owing to any person including the United States, *who by the*

⁴ Sec. 14.

⁵ Sec. 17.

⁶ Sec. 6.

⁷ WIS. STAT. 270.91(2). This statute is most broad and may be a serious blow to a judgment creditor, since by its terms the satisfaction of a judgment may be compelled and thus destroy a lien years old, good as against the trustee, otherwise unassailable by the debtor. (The discharge in bankruptcy does not describe the debts which are discharged. General Orders in Bankruptcy (Form No. 45), see Supplement 305 U.S. effective February 13, 1939).

laws of the United States is entitled to priority, and rent owing to a landlord who by applicable state law is entitled to priority.⁸

RIGHTS OF LIEN CREDITORS

Congress has seen fit to define strictly the classes of debts which are entitled to priority of payment, but has left to state law to determine what constitutes a valid *lien*, excepting where the Chandler Act or federal law otherwise provides.⁹

Judicial Liens Obtained Within Four Months of Bankruptcy

Judicial liens obtained within four (4) months of the filing of a petition by or against a bankrupt are void if the bankrupt was insolvent at the time of the obtaining of the lien, or if it was sought or permitted in fraud of the provisions of the Act. Knowledge of insolvency on the part of the lienor is not important or material in order to determine the validity of the lien.¹⁰

Judicial Liens Obtained Prior to the Four Months Period

Such liens are not invalidated by the Bankruptcy Act and remain effective and include the following: Attachment,¹¹ Judgment,¹² Garnishment,¹³ Creditors' Bills,¹⁴ supplementary proceedings,¹⁵ and Execution Liens.¹⁶ Whether the lien must be perfected by judgment prior to the four (4) months period depends upon local law.¹⁷

Equitable Liens

Under rather limited circumstances an equitable lien may be valid under local law, and in that event such lien is valid under the Bankruptcy Act. Illustration: where an agreement fixes an immediate right to specific property and for the carrying out of such agreement equity will afford relief; as against a bona fide purchaser, suit lien would seem to be good under Section 67.¹⁸ An equitable *lien* may be

⁸ Sec. 64(a)5 (priority in a state court liquidation as compared with a bankruptcy proceeding); *In re Merrick Dairy Co.*, 249 Wis. 295, 24 N.W. (2d) 679 (1946).

⁹ Secs. 67(a)1, 67B; *Britton v. Western Iowa Co.*, 9 F.(2d) 488 (C.C.A. 8th 1925); COLLIER, § 67.02, 67.12, 70.70.

¹⁰ Sec. 67.

¹¹ COLLIER § 67.07.

¹² COLLIER § 67.08.

¹³ *Chadek v. Forest County*, 206 Wis. 85, 238 N.W. 850 (1931). *But cf In re Lincks Wire Forming Co.*, 60 F.(2d) 770 (C.C.A. 7th 1932) where the garnishment was void because the garnisheeing creditors were officers and directors attempting to collect their debt from an insolvent company in violation of their fiduciary responsibility to creditors.

¹⁴ COLLIER § 67.11.

¹⁵ *Alexander v. Wald*, 231 Wis. 550, 286 N.W. 6 (1930); COLLIER § 67.08.

¹⁶ COLLIER § 67.09.

¹⁷ Cases under notes 13 & 15, *supra*; COLLIER § 67.10.

¹⁸ COLLIER § 60.37 citing *Sexton v. Kessler*, 225 U.S. 90 (1912), *see Slack v. Gunerius*, 67 F.(2d) 852 (C.C.A. 7th 1933). Cases prior to 1938 should be carefully examined in the light of the amendments to sections 60, 67 and 70 of the Bankruptcy Act.

valid whereas an *equitable title* may be invalid as against the Trustee where delivery of possession or filing or recording is necessary in order that the lien or security be valid as against a bona fide purchaser for value.¹⁹

There is, of course, only one safe course to follow and that is to exercise all possible diligence in either filing, recording, or obtaining of possession as the case may be.

Statutory Liens

The Act provides that statutory liens in favor of employees, contractors, mechanics, landlords, or other classes of persons, and statutory liens for federal or state taxes including political subdivisions of States created or recognized by federal or state laws, may be valid against the Trustee even though arising or perfected while the debtor is insolvent and within four months of the bankruptcy²⁰ and may be perfected after the bankruptcy, subject to the limitation that statutory liens on personal property not accompanied by possession or enforced by sale before filing of the bankruptcy petition are postponed in favor of certain priority debts, i.e. administration expenses and wage claim priorities.²¹

Liens Created by Contract

In this category fall such liens as Chattel Mortgages,²² Real Estate Mortgages,²³ Conditional Sales Agreements,²⁴ Consignments,²⁵ Assignments of accounts receivable, etc.,²⁶ which under Wisconsin Law are permitted or required by law to be recorded or filed. In respect of each class of liens the law of the State of Wisconsin determines whether an unfiled or unrecorded lien is valid as to a particular class of persons and such law governs as to validity of a given lien when sought to be enforced in a bankruptcy proceeding.²⁷

¹⁹ In re Hutcherson, 133 F.(2d) 959 (C.C.A. 7th 1943).

²⁰ Sec. 67(b); COLLIER § 67.02.

²¹ Sec. 67(c).

²² Sec. 241.08.

²³ Sec. 235.49.

²⁴ Sec. 122.05.

²⁵ Sec. 241.26; Heller v. Journal Co., 172 F.(2d) 363 (C.C.A. 7th 1949).

²⁶ Sec. 241.28 (Assignee must not permit assignor to dispose of the same or apply the proceeds thereof for his own uses. Benedict v. Rattner, 268 U.S. 353 (1924); COLLIER § 70.77). The same rule has been applied to pledges as mortgages of shifting or changeable stocks of goods. COLLIER § 70.77 p. 1377. Refer to Corn Exchange Bank v. Klauder, 318 U.S. 434 (1943) for rule that where under local law the notification rule applies as to sale or assignment of accounts receivable; also Referee Weelands, *Sales and Accounts Receivable in Bankruptcy*, 23(2) JNARB 59 (1949); COLLIER § 70.70 p. 1347. Liens not invalidated by Bankruptcy Act remain valid if otherwise valid under state or federal law. Britton v. Western Iowa Co., 9 F.(2d) 488 (C.C.A. 8th 1925).

²⁷ Sec. 60(A), 67, 70(a), 70(c), 60(e) (1).

The local law must be consulted with respect to each such lien situation.²⁸

If under the state law the validity of a lien may be attacked by a judgment creditor, it may be attacked by the Trustee.²⁹

This power which may be exercised by the Trustee is quite generally referred to as the "strong arm" clause.³⁰

If filing or recording is required as a condition of validity as to a bona fide purchaser only, such liens may be good as against the Trustee's title under Section 70, but may constitute a preference if the other elements of a preference exist.³¹ Likewise, an unrecorded *deed* to real estate given more than four months prior to bankruptcy in payment of a debt, even though it is invalid only as to an innocent purchaser for value³² might nevertheless be preferential if it is unrecorded at the time of the bankruptcy or is recorded within four months of the bankruptcy.

RECLAMATION PROCEEDINGS

A reclamation proceeding is like a replevin action, and may be properly resorted to in order to obtain the surrender of property on which a valid lien exists. If the property is encumbered for more than its value and if there is no question of the validity of the lien, it is generally the rule to surrender the property. However, if there is a question of the validity of the lien or if there appears to be a surplus for the estate over and above the amount of the lien, the court may order the property sold free and clear of encumbrances,³³ and require the lien claimants to file their claims against the proceeds of the sale by a given time or be barred.³⁴

²⁸ *In re Hutcherson*, 133 F.(2d) 959 (C.C.A. 7th 1943); *In re Read-York*, 60 F.(2d) 951 (C.C.A. D.C. 1944) (Wisconsin as to unfiled liens). *In re Read-York*, 152 F.(2d) 313 (C.C.A. 7th 1945) reversed the District Court on the ground that the Wisconsin Statutes re filing are not binding on the United States Government. *Burnett County Abstract Co. v. Eau Claire C.L.&I. Co.*, 216 Wis. 35, 255 N.W. 890 (1934) (sustaining rights of a subsequent assignee of a subsequent sales contract against the owner of an unfiled alleged conditional sales agreement not accompanied by possession.)

²⁹ Secs. 70(c), 70(a)5, 70(e)(1); *In re Wayside Furniture Co.*, 65 F.(2d) 627 (C.C.A. 7th 1933); *In re Peacock Food Markets, Inc.*, 108 F.(2d) 453 (C.C.A. 7th 1939) (transfer must be given in good faith).

³⁰ Sec. 70(c); *Sparks v. Kuss*, 195 Wis. 378, 216 N.W. 929 (1928) (trustee is the "ideal creditor"); *cf In re Urban*, 136 F.(2d) 296 (C.C.A. 7th 1943); *In the Matter of Allee*, 55 F.(2d) 76 (C.C.A. 7th 1932); *Matter of Baumgartner*, 55 F.(2d) 1040 (C.C.A. 7th 1932); COLLIER § 70.48, 70.49.

³¹ Sec. 60(a); *Matter of Cox, Muncie Banking Co. v. Retherford*, 132 F.(2d) 881 (C.C.A. 7th 1943); *Matter of Hutcherson*, 133 F.(2d) 959 (C.C.A. 7th 1943).

³² *Bridgewater v. Schaefer*, 164 F.(2d) 447 (C.C.A. 5th 1947) (unrecorded deed given in payment of a debt).

³³ *In re Miller*, 95 F.(2d) 441 (C.C.A. 7th 1938).

³⁴ *In re Clark Supply Co. Inc.*; *Todd Bldg. Corporation v. Heller*, 172 F.(2d) 248 (C.C.A. 7th 1949); *In re Clark Supply Co. Inc.*; *Mercantile Discount Corporation v. Heller*, (C.C.A. 7th 1949), C.C.H. Bey #56,524.

Reclamation proceedings are available to recover property held by the bankrupt as trustee, to which the bankrupt has no title; property stolen or converted; and property fraudulently obtained by the bankrupt.³⁵

The property sought to be reclaimed must be traced into the hands of the receiver or trustee^{35a}

CLAIMS ENTITLED TO SHARE IN THE NET DISTRIBUTION

After the Trustee has reduced the estate to possession and has settled and discharged rights of the respective secured, lien, and priority claimants, there remains for determination the question of who are to be the ultimate beneficiaries of the net cash, if any, available for distribution. This involves the consideration of what claims are allowable in bankruptcy.

Provable and Allowable Claims

An allowable claim must be provable — Section 63 — and must be “proved” i.e. — filed within six months from the time of the first meeting of creditors — Section 57. The adjournment of the first meeting of creditors does not extend the time for filing claims.³⁶

There are ten classes of claims which may be “proved”,³⁷ but there are certain classes of claims which may or may not be entitled to share in the ultimate distribution³⁸ and if it is determined that these claims are not allowable, they then “shall not be deemed to be provable under this Act.”³⁹

It might be more accurate to say that unliquidated and contingent claims may be filed but unless they are liquidated in the manner provided by the Act⁴⁰ such claims are eventually established, for the purpose of *that* particular bankruptcy, not to be provable, and hence cannot be allowed.⁴¹

The consequences of liquidation or failure to liquidate a claim are important. All other unsecured creditors are interested in seeing that no unliquidated claims are allowed to participate in the dividend ultimately to be declared (Section 65); but the debtor (bankrupt) is interested in having all possible claims allowed or determined to be provable, since he is discharged from all *provable* debts (Section 17).⁴²

³⁵ COLLIER § 70.41 (reclamation where property obtained by fraud); COLLIER § 60.18 (return of property fraudulently obtained as constituting a preference).

^{35a} COLLIER § 70.25, 70.39.

³⁶ COLLIER, Vol. 3, § 57.27 p. 323.

³⁷ Secs. 63(a), 63(b).

³⁸ Sec. 57(d).

³⁹ Sec. 63(d).

⁴⁰ Sec. 57(d).

⁴¹ Secs. 63(d), 65.

⁴² Sec. 63(d).

Thus an unliquidated or contingent claim — even though initially provable⁴³—will not be *allowed* unless liquidated as provided in the Act, or the amount thereof estimated in the manner or within the time directed by the court. Such claims will not be allowed if the court shall determine that the claim is not capable of liquidation or of reasonable estimation, or that such liquidation or estimation would unduly delay the administration of the Act,⁴⁴ and the disallowed claim will therefore not receive any dividend since the claim for the purposes of the particular bankruptcy is not allowable. In short, every contingent or unliquidated claim must be liquidated in the particular bankruptcy so as to be entitled to share in the ultimate dividend and to be among the claims from which the bankrupt is to be discharged,^{44a} or the bankrupt will not be discharged of that particular claim.⁴⁵

THE ADVERSE INTERESTS OF THE RESPECTIVE CLASSES OF CREDITORS

The interests of secured and lien claimants are inherently adverse to unsecured creditors including priority claimants. The rights of unsecured non-priority creditors are adverse to all other classes of creditors, since non-priority unsecured creditors receive only the net available for distribution.

RIGHTS AND PROCEEDINGS FOR THE BENEFIT OF UNSECURED CREDITORS

The ultimate purpose of the Bankruptcy Act is to distribute the net residue after payment of all valid prior liens, debts and charges ratably among creditors whose claims are *allowed* and to that end the Bankruptcy Act gives the Trustee not only the title of the bankrupt but in addition thereto many rights and remedies not possessed by the bankrupt.⁴⁷

The Trustee's title includes powers which the bankrupt might have exercised for his own benefit, property transferred in fraud of creditors, property which might by any means have been transferred by the bankrupt, property which might have been levied upon by judicial process, rights of action on contract, contingent remainders, executory devises and limitations, rights of entry for condition broken, rights or possibilities of reverter and like interests in real estate, which were non-assignable prior to bankruptcy and which within six months there-

⁴³ Sec. 63(7) (8) (9).

⁴⁴ Sec. 57 D (C1.2).

^{44a} Sec. 65.

⁴⁵ Sec. 17.

⁴⁶ Sec. 65; Referee Wallace Streeter, *Attitudes and Prejudices of General Creditors and the Bankruptcy Fraternity Against Secured Creditors*, 22(2) JNARB 35 (1948).

⁴⁷ Sec. 70 (cross ref. sec. 67(d)—sec. 60); COLLIER § 70.01 et seq.

after became assignable interests or estates, or give rise to powers in the bankrupt to acquire assignable interests or estates.⁴⁸

The Chandler Act also provides that all property which vests in the bankrupt within six months after bankruptcy by bequest, devise or inheritance, vests in the trustee as of the date of the vesting in the bankrupt, including interests of the bankrupt in an estate or an interest by entirety which becomes transferable within six months of the filing of the petition and vests in the Trustee as of the date of bankruptcy.⁴⁹

The Trustee takes title to property transferred within four months of bankruptcy to an assignee for the benefit of creditors.⁵⁰

Trustee Rights Against Secured and Lien Claimants

As to property in the possession of the bankrupt or under his control at the time of the bankruptcy or otherwise coming into possession of the Bankruptcy Court, the Trustee is vested with all of the rights, remedies and powers of a creditor holding a lien thereon by legal or equitable proceedings, whether or not such creditor actually exists, and as to all other property the Trustee has the rights of a judgment creditor with an execution returned unsatisfied.⁵¹

Under this clause the Trustee may avoid any lien on property in the possession of the bankrupt which any creditor holding a lien thereon by legal or equitable proceedings⁵² might avoid.

Other Rights Exercisable by Trustee for Benefit of Creditors

The Chandler Act⁵³ enables the Trustee to avoid any transfer or obligation which under federal or state law is avoidable or fraudulent as to a creditor of a debtor.

The Bankruptcy Act has adopted the Uniform Fraudulent Conveyance Act⁵⁴ as part of the Bankruptcy Act, and the Trustee may exercise any right under that Act which any creditor might exercise.⁵⁵

Trustees' Right to Avoid Preferential Transfers

The Trustee may recover from a creditor any transfer of property made within four months of bankruptcy if the elements of a preference result.⁵⁶ This power may be exercised by the Trustee by a plenary suit

⁴⁸ Sec. 70(a) (7); refer generally, sec. 60 & 70(e); particularly secs. 70(a), 70(c), 70(e).

⁴⁹ Sec. 70(a) (8).

⁵⁰ Sec. 70(a) (8) (clause 3).

⁵¹ Sec. 70(c).

⁵² Sparks v. Kuss, 195 Wis. 378, 216 N.W. 929 (1928) and cases there cited under heading, "Liens Created by Contract."

⁵³ Secs. 70(c), 70E(1), 70(a) (3) (4) (5).

⁵⁴ Sec. 67(d); WIS. STAT. c.122.

⁵⁵ Sec. 70(e) (1).

⁵⁶ Sec. 60(b). Refer to sec. (1) of subsec. 30 for definition of "transfer".

if the transferee or the property is not within the jurisdiction of the court.

Equity Powers of a Court of Bankruptcy Over the Allowance of Claims

Under this power⁵⁷ the court has power to disallow claims which would be frauds on other creditors;⁵⁸ has power to subordinate claims of stockholders and officers of family and one man corporations;⁵⁹ and may exercise the power to limit the stipulated percentage for collection and attorney fees, and to disallow inequitable claims.⁶⁰

Important Rights of Unsecured Creditors

Since the unsecured creditor receives the full impact of the bankruptcy, which usually leaves only a small percentage remaining after satisfying secured and prior charges, the Act accords to the unsecured creditor an important role in the administration of the bankruptcy.

Unsecured creditors are the ones who may file an involuntary petition in bankruptcy,⁶¹ the unsecured creditors appoint the Trustee⁶² and the creditors' committee,⁶³ and the unsecured creditor alone has the right to vote at creditors' meetings.⁶⁴

Notices to Which Creditors are Entitled

Section 58 prescribes ten day notices to be given creditors by mail of eight specific phases of estate administration, and a thirty day notice of the date set for filing objections to the bankrupt's discharge.

However, if a creditors' committee has been appointed, then notice of: (a) examination of the bankrupt; (b) compromise of controversies; and (c) sales of property, shall be sent to the creditors' committee and to those creditors who have filed with the court a demand that all notices under the section be mailed to them.⁶⁵

The court may for good cause shown, shorten the time of sales or order an immediate sale without notice⁶⁶ and for good cause shown the Court may approve the compromise of a debt due the estate or permit the discharge of a lien upon property of the estate without notice.⁶⁷

⁵⁷ Sec. 2(a).

⁵⁸ *Petter v. Litton*, 308 U.S. 295 (1939).

⁵⁹ *In re Merrick Dairy Co.*, 249 Wis. 295, 24 N.W. (2d) 679 (1946).

⁶⁰ *In re Tasty yeast Inc.*, 126 F.(2d) 879 (C.C.A. 3rd 1941); COLLIER § 63.15, § 2.09 (Courts Equitable Power), § 63.03, § 63.06.

⁶¹ Sec. 59. The Chandler Act stiffened the requirements of a good petition for involuntary adjudication, and these requirements must be strictly complied with. *In re Garret & Co.*, 134 F.(2d) 227 (C.C.A. 7th 1943).

⁶² Sec. 44(a).

⁶³ Sec. 44(b).

⁶⁴ Sec. 56(b). A general unsecured claim may be allowed for the excess over the value of the security held by a secured creditor (sec. 57h).

⁶⁵ Sec. 58(a)(9).

⁶⁶ Sec. 58(a)(4) and General Orders in Bankruptcy No. 18.

⁶⁷ General Orders in Bankruptcy No. 28.

RESPONSIBILITY OF CREDITORS

The Chandler Act provides that a person shall be punished by imprisonment for a period of not to exceed five years, or by a fine of not more than \$5,000.00 or both, upon conviction of the offense of having knowingly fraudulently committed any one of eight acts, the fifth of which refers particularly to creditors. This subdivision applies to the receipt or attempt to obtain any money or property, remuneration, compensation, reward, advantage, or promise thereof from any person for acting or forbearing to act in any proceeding under the Act.⁶⁸ A typical violation of this subsection consists of an agreement to withhold filing of objections to the bankrupt's discharge for a consideration, such as a promise of payment of the debt, or perhaps actual payment of the debt.

⁶⁸ Sec. 29(b) (5)