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SEQUESTRATION FOR THE BENEFIT OF CREDITORS

L. L. RIESELBACH

INTRODUCTION

The liquidation of the estates of debtors demands the attention of commercial interests at any period of financial stringency. The collapse of 1929 and the vastly changed conditions thereafter emphasized the inadequacy of existing regulations. Proposals for the amendment of the system of bankruptcy flooded Congress during the Hoover administration and thereafter, culminating in the enactment of the so-called Chandler amendments effective in September, 1938. In administration for a distribution under the state forum there were no changes proposed or enacted during the comparable period until July, 1937, when the new Chapter 128 of the Wisconsin Statutes became operative.

At common law there existed no reason why one creditor should not satisfy a debtor's obligation to him even though at the expense of other creditors. The vigilant, aggressive or favored creditor, with or without the cooperation of his debtor, might obtain a preference leaving no redress to other creditors. In juxtaposition to this theory is the principle of equitable distribution as repeated from time to time in the application of bankruptcy laws, creditors' bills and representative suits. Statutes embodying the maxim that equality is equity have been devised and enacted from time to time to meet changing circumstances.

Chapter 128 of the Wisconsin Statutes is that portion of the section of the statutes devoted to regulation of trade which is identified as "Creditors' Actions." Its enactment in 1937 was the outgrowth of feeling of attorneys handling liquidations that legislative correction was needed to eliminate the inconsistencies and glaring inadequacies of the then existing state law.

At that time Chapter 128 related solely to voluntary assignments. It was a development of two portions of the Wisconsin Statutes. One was a part of the section under "Regulation of Trade" and entitled "Voluntary Assignments," and the other a separate chapter which provided for the obtaining of a discharge by the debtor from his debts and obligations. These two chapters were wedded in the old Chapter 128. The Wisconsin Supreme Court In the Matter of the Voluntary Assignment of Tarnowski decided that the sections were mismated and declared the discharge feature to be unconstitutional as contravening rights delegated exclusively to the federal Congress.

1 191 Wis. 279, 210 N.W. 836 (1926).
The remainder of the statute was regarded by most attorneys as impractical. Few assignments were placed under the supervision of the circuit courts as intended by the law. Most of them were handled arbitrarily by an assignee selected by the debtor or insisted upon by his creditors. The game was often played without rules or limited solely by the terms of the instrument of assignment itself and subjected to numerous obvious inequities and abuses. The old statute contained some provisions for involuntary control of assets but the procedure was seldom used.

In addition to voluntary assignment the estate of a debtor could have been sequestered, where such debtor was a corporation, by a petition to the court either as a separate action or supplemental to a circuit court judgment after an execution upon such judgment was returned unsatisfied. The courts held that the creditors were entitled to this remedy as a matter of right. This proceeding, however, although the subject of the equivalent of a textbook in Harrington v. Gilchrist, left the administration almost entirely to the discretion of the receiver subject to the remote control of the Court.

A scrutiny of the law prior to the enactment of the 1937 version of Chapter 128 disclosed the following deficiencies which it was believed should be corrected.

1. The old Chapter 128 contained useless or unconstitutional provisions.

2. The title, power and authority of the receiver and assignee were too limited.

3. There existed no right of recovery by the receiver of property transferred as a preference; and in the case of an assignee, the right was too closely restricted as to time.

4. Liens void under the national Bankruptcy Act were valid in state court proceedings.

5. Distribution under state court proceedings upon the appointment of a receiver varied from the distribution upon a voluntary assignment, and both placed the wage earner under a disadvantage in comparison with the federal bankruptcy system.

6. Secured creditors were not required to offset their security in order to determine the amount upon which they could obtain a dividend, but they were entitled to a dividend upon the full amount of their claim.

The financial debacle of 1929 focused attention on these several handicaps. As a result legislation was repeatedly suggested and ulti-

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3 121 Wis. 127, 99 N.W. 909 (1904).
mately fostered to eliminate the objections and to give to a state court functionary, whether receiver or assignee, weapons to prevent preferences to or grabbing by aggressive creditors.

**After Amendment**

The law was amended to furnish the mechanics to accomplish the efficient collection, administration and equitable distribution to creditors entitled to share in them of the assets of the debtor. No attempt was made to provide him a discharge from his obligations or to permit the composition, scaling down by reorganization, or otherwise reducing the claims of creditors against the debtor. It does attempt to facilitate gathering the assets and distributing them.

There is little in the law itself that is new. The better and more practical features of the old Chapter 128 were re-enacted. For the balance of the chapter, the national Bankruptcy Act was taken as a guide and where it was practicable, the language of the Bankruptcy Act was embodied in the chapter. In most cases arising under the act, precedents will be found either in decisions under the old Chapter 128 or under the Bankruptcy Act. Any attempt to determine the intent of the present chapter will be simplified by comparison with the parallel section in the Bankruptcy Act. There are in most cases ample annotations and authority for interpretation and application.

**Involuntary Proceedings**

In all cases except where the proceeding is supplementary to a Circuit Court judgment, the proceedings are begun by the issuance of a summons. The petition serves as the bill of complaint in equity. The statutory requirements should be pleaded to give the court jurisdiction. It is customary to issue an order at the same time requiring the debtor to show cause why a receiver should not be appointed forthwith, so that the assets of the debtor will not be dissipated during the time for answer. Where there is no contest, the order upon the proceeding to show cause is often accepted as an adequate and proper course of administration. The recommended practice is to obtain a further sufficient order after the expiration of the statutory time for answer.

After the appointment of a receiver or the designation of an assignee for the benefit of creditors in voluntary proceedings, the course of the liquidation becomes uniform. The former distinctions as to title (with one possible exception⁶), rights and distribution have been eliminated.

Under Chapter 128.06,⁷ a petition may be filed against an insolvent debtor whenever the debtor shall have (1) Conveyed, transferred, or

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⁶ Wis. Stat. (1937) § 128.19(1,b).
removed his property with intent to hinder, delay or defraud his creditors, (2) Made a transfer with intent to prefer creditors, or (3) Permitted or suffered, while insolvent, any creditor to obtain a preference through legal proceedings. Instead of the bankruptcy requirement of three creditors having claims totaling $500.00, the state law requires that there need be but two creditors with claims totaling not less than $200.00. There is no minimum requirement as to the total indebtedness of the debtor as is required by the Bankruptcy Act. Under this procedure, the claim need not be reduced to judgment. The validity of the claims must be determined as challenged in the involuntary proceeding. Subsection (2) of 128.06 Wis. Stat. (1937) requires the debtor, where he denies the insolvency or opposes the petition, to appear in Court at the time set for hearing with his books and records. Upon his failure to produce such records as will make the information available to the petitioners, there falls upon him the burden of proving himself solvent. Subsection (3) provides for a prompt hearing and permits the intervention of other creditors.

Note should be made of Subsection (4). Formerly, where an assignment was made by the debtor, it was often the practice for the assignee to execute his trust without any court supervision. The method of requiring the filing of the assignment and the supervision of the court has been simplified by this section. Any one creditor may, upon proof of the making of the assignment, require the assignor to file the assignment and comply with the provisions of this chapter as to both procedure and distribution. It has been the practice in some localities to create preferences in the assignment so that distribution under the deed of trust would be different from that provided for in the chapter. Upon filing of the assignment, either voluntary or upon petition, it is believed the provisions of the chapter as to distribution will govern despite provisions in the contract of assignment to the contrary.

Where the debtor is a corporation, in addition to the proceedings by petition referred to above, Section 128.08 provides that one creditor, who has reduced his claim to judgment and issued an execution which has been returned unsatisfied, can, upon a showing of the facts, obtain appointment of a receiver to sequester and liquidate the assets of the corporation. This may be done by the commencement of a separate proceeding or, if the judgment is a Circuit Court judgment, by a bill supplementary to judgment. This section incorporates the provision of

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what was, in 1935, Chapter 268.16(7) of the Wisconsin Statutes, and prior to that time Chapter 286.10. The Wisconsin Supreme Court in *Hazelwood v. Third & Wells Company*\(^{12}\) held that courts of equity have the inherent power to appoint receivers for insolvent corporations and that this power was not suspended by the Bankruptcy Act.

**Liens and Title of Trustee**

Upon the appointment of a receiver in involuntary proceedings or upon the filing of an assignment in voluntary proceedings, Section 128.19 provides that the assignee or trustee, as the case may be, takes the title of the debtor except to exempt property including the following:

A. Property transferred in fraud of his creditors.

B. Property which, prior to the filing of the petition, he could by any means have transferred or which might have been levied upon or sold under judicial process against him,\(^{13}\) as well as

C. Rights of action upon contract for damages.\(^{14}\)

These provisions are taken from the federal Bankruptcy Act, Section 70a. Although the reference in both the Bankruptcy Act and the state act is to the title of the debtor, the additional provisions constitute a substantial enlargement of the debtor's title. The various subsections have been the subject of numerous decisions of the federal and state courts interpreting the bankruptcy sections. Such decisions will probably control as to the interpretation of the state act.

Prior to the enactment of this statute, the title of the receiver or assignee was limited strictly to the title of the debtor. As a consequence, unrecorded liens or liens on which the period of record expired were valid as against the receiver and other creditors, although prior to the commencement of liquidation proceedings other creditors might have levied or attached. This was the holding in the case of *Milwaukee Tank Works v. Sadlier*,\(^{15}\) in which the Court said, "The possession of the receiver is only that of the Court whose officer he is, and adds nothing to the previously existing title of the mortgagor."

It should be noted that the additional title of an assignee under voluntary proceedings is vested at the time of the filing of the assignment, not as of the time of the making of the assignment.\(^{16}\) It is felt that despite provisions of Section 128.02, which permit the Court to amend any assignment so as to obtain a fair and equitable distribution, the voluntary assignee may be taking considerable risk in not filing

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\(^{12}\) 205 Wis. 85, 236 N.W. 591 (1931).

\(^{13}\) Bankruptcy Act § 70a(5), 11 U.S.C.A. § 110.

\(^{14}\) Bankruptcy Act § 70a(6), 11 U.S.C.A. § 110.

\(^{15}\) 191 Wis. 233, 210 N.W. 694 (1926).

\(^{16}\) Wis. Stat. (1937) § 128.19(1,b).
his assignment promptly. In other words this section, apparently, permits the possibility of a creditor perfecting a lien otherwise rendered invalid between the time of appointment and time of the filing of the assignment if that filing is delayed.

The title of the receiver or assignee is further enlarged by subsection (2) of Section 128.19. This places the receiver in the position of the most favored creditor and is taken almost verbatim from Section 70e of the Bankruptcy Act. It permits the receiver or assignee to avoid any transfer by the debtor of his property which any creditor might have avoided. The bankruptcy provision from which this has been adapted has been passed on by the Wisconsin Supreme Court in the case of *Sparks v. Kuss,* and by the Circuit Court of Appeals for the 7th Circuit in the case of *In re Baumgartner* arising out of the Eastern District of Wisconsin.

Section 128.19 should be read in conjunction with Section 128.18 covering the validity of liens. The latter provides at Subdivision (1) that liens which, for want of record or for other reasons, would not have been valid liens against creditors of the debtor armed with process, shall not be liens against the estate. It was intended that the phrase "armed with process" be interpreted to mean armed with process by virtue of which property has been seized. This was based upon definitions given in *Graham v. Perry,* and certain Federal decisions cited therein. Since, apparently, the courts are having difficulty with the interpretation of the section, it might be well to amend the phrase to state plainly "armed with process by which the property has been seized."

In addition thereto, the receiver or assignee is again placed in the position of the most favored creditor in being subrogated to the rights of any creditor who is prevented from enforcing his rights as against a lien created or attempted to be created by the debtor. The phraseology was drawn from Section 67b of the Bankruptcy Act and should be read in conjunction with Section 47a (2) of the Bankruptcy Act.

Section 128.18 also permits the receiver or assignee to set aside liens which would create a preference or were given to hinder, delay or defraud creditors. It preserves the rights of creditors who obtained liens in good faith and for an adequate, valuable consideration.

Transfers made or given within four months prior to the proceedings while the debtor is insolvent, for a pre-existing indebtedness, are declared void as preferential. Much of the language is that of the old

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18 195 Wis. 378, 216 N.W. 929 (1928).
19 55 F. (2d) 1041 (1931).
20 200 Wis. 211, 228 N.W. 135 (1929).
21 In re Baumgartner, 55 F. (2d) 1041 (1931).
22 Fairbanks Steam Shovel Co. v. Wills, 240 U.S. 642, 36 Sup. Ct. 466, 60 L.Ed. 841 (1916).
Bankruptcy Act. Cases decided under Section 67 of the Act are regarded as controlling for the most part. It should be noted, however, that the state act goes farther than the Bankruptcy Act in that where a lien is proven to be preferential, it does not require that the creditors have reasonable causes to believe that the transferor was insolvent.

The sections on the title of the receiver and on liens and preferences are intended to give to the receiver or assignee all of the property rights which a trustee in bankruptcy receives. This should successfully prevent an inequitable disposition of assets where bankruptcy is not available to the creditors. It will enable creditors to recover without entailing a duplicate expense by filing a petition in bankruptcy where the debtor has made a voluntary assignment or a receiver has been appointed in Circuit Court.

The provisions as to the setting aside of the preferences are under the section on liens. This is deemed proper since a preference is always an attempted transfer of title which the recipient endeavors to set up as against other creditors.

**Administration**

After a receiver has been appointed or an assignee been designated, an efficient and expeditious administration has been provided for. The debtor is required by Statute to file a statement of assets and a list of creditors comparable to schedules in bankruptcy. The receiver is then required to send a notice of the pendency of the proceedings to all creditors to permit them to file their claims. He is also required to publish notice of the pendency of the proceedings.

The time for filing claims under the state law has been reduced to three months. It was felt that under the modern system of commercial practice ample time was given by those provisions, and that the bankruptcy provisions permitting six months for filing of claims was a vestige of an earlier day when the speed of communications was much more limited. Thus, the period of administration is curtailed and distribution is made possible within a period of time three months shorter than through bankruptcy proceedings.

Provisions are made for the proof of claims and the objections thereto either by the receiver or by creditors.

Creditors have repeatedly complained that the administration of any liquidation takes far too long. In order to expedite such administration, every receiver or assignee is required by Section 128.20 to file with the Court, within six months after the time limited for filing claims, a full

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accounting. If any receiver or assignee neglects to apply promptly for a settlement of his account, the Court may, upon the request of any creditor, compel the making of a final account, and the receiver or assignee may be denied compensation.

The trustee or assignee is compelled to collect and liquidate the assets during this limited period. If litigation is pending when the time has elapsed he is permitted to obtain an extension of his administration. If he believes that assets have been concealed or transferred in violation of the provisions of Chapter 128 or Chapters 240 to 242 applying to fraudulent transfers, he may compel the debtor to submit to examination as provided for in Section 128.16, and to disclose the circumstances surrounding the disposition of his property and the consideration therefor. All officers, agents or stockholders of a corporation, and all persons to whom it is alleged that a transfer has been made, may be compelled to testify.

**Distribution**

The question of distribution left much to be desired prior to the enactment of Chapter 128. In cases of voluntary assignment, there might have been preferences or priorities granted by the contract establishing the trust. The legislature had previously attempted to establish some sort of a priority for wages. Under a voluntary assignment, however, there was one provision, and under the receivership section, Chapter 268, a different provision was applicable. Under Chapter 286 dealing with the sequestration of insolvent corporations, a third provision existed. In all three instances the payment of wages was formerly subordinated to the payment of taxes, both federal and state.

The Bankruptcy Act, on the other hand, established wages as prior to taxes. For the sake of uniformity, Section 128.17 adopts the same order of distribution and provides for the payment of wages earned within three months prior to the commencement of the proceedings, and not to exceed $600.00, to a claimant immediately after the payment of the necessary costs of preserving the estate and the cost of the administration. Taxes, both state and federal, constitute the next group of priorities.

A peculiar situation may have arisen by the enactment of this provision for distribution. Federal tax legislation gives priority to taxes due to the United States over everything except the cost of administration. The system of bankruptcy, however, places wages ahead of taxes. The provision in a state system of distribution may be unconstitutional in attempting to abrogate the priority given by federal tax legislation even though it copies, word for word, the federal Bankruptcy Act.

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Whether this legislation is unconstitutional or not, no cases have been noted where the federal government has attempted to claim a priority over wages.

In the provision on taxes, taxes and assessments due the United States and the state are included in the same subdivision. The federal government insists that it is entitled to a priority over the various state taxing agencies, and this contention has been upheld in our Circuit Court.

Formerly, attorneys representing judgment creditors against corporations sometimes availed themselves of the statute providing for sequestration for the sole purpose of obtaining payment of the judgment plus costs, and including, if allowed, an attorney's fee. They would issue summons and complaint and an order to show cause and obtain the designation of a receiver. Upon being paid off, no further steps would be taken in the sequestration proceedings, or the action would be dismissed. The use of the proceedings merely as a club is limited by Section 128.12, which provides that after the designation of a receiver or custodian, proceedings cannot be dismissed for want of prosecution or by consent until after notice has been sent all creditors. The Court, before considering an application for dismissal, requires the debtor to file a list of creditors to whom such notices are sent advising the date for the hearing of the petition for dismissal. In other words, this section will not permit the use of the chapter's provisions to circumvent its purpose and to allow one creditor to obtain a preference.

**Advantages of the State Act**

It is believed that the system of administration provided affords a more facile means of liquidation in some instances than the bankruptcy proceedings. The terms of Chapter 128 probably are more flexible than the Bankruptcy Act. A creditor who has failed to file a claim within the time limited may for cause shown be permitted at a subsequent time to present his proof and to participate in the dividend. A sale of the property can be held in a shorter time. The receiver or assignee may, by Court order, be permitted to operate the business until the time of sale, filling orders on hand, completing contracts or taking advantage of opportunities to increase the net proceeds.

Under the practice prevailing in the United States District Court for this district, a receiver or trustee is not permitted to operate the business of the bankrupt. It was felt that this at times worked a hardship upon the creditors, for by operation during the limited time required for the sending of notice of sale there could be obtained a higher price for the assets as a going business. The uninterrupted operation
in a great many cases has carried with it a goodwill value which increases the proceeds to creditors.

As we have noted before, a simple unlitigated matter can be closed in about half the time of the federal minimum.

**Constitutionality**

The question of the constitutionality of the entire legislation has been raised from time to time upon the accepted theory that only the federal government may establish, maintain and enforce a system of bankruptcy. The answer to this broad objection is simply that no effort has been made to create or maintain a bankruptcy or insolvency law. Its primary purpose is to permit liquidation for the benefit of creditors under state jurisdiction. It affords no discharge to the debtor of his obligations and no voluntary proceeding by the debtor is effective to alter the debtor-creditor relationship without the consent of the creditors. The Wisconsin Supreme Court has intimated that no matter what the nature of the proceeding provided for, a statute will not be held to be an insolvency law unless it provides for the discharge of the debtor. The following quotation is from *In re Tarnowski*: 29

"The winding up and a fair and equal distribution of the estate of insolvent debtors may arise in various ways, but where such a proceeding does not result in the discharge of the insolvent debtor, state statutes regulating such proceedings do not conflict in any manner with the bankruptcy law."

The sole purpose of the state act is the administration of assets belonging to or which should properly belong to the debtor. In other words, it is not sought to affect the creditor's rights against his debtor or to afford the debtor any privilege of disposing of his debts in the absence of a contract with his creditors by which they consent to discharge him of his obligations. The chapter operates upon the res and not upon the status of the parties.

The right to make a voluntary assignment of assets for the benefit of creditors is a common law one. It has been repeatedly upheld by the United States Supreme Court. One of the leading cases on the subject is *Porbreslo v. Boyd Co.*, 30 which includes a comprehensive discussion and citation of authority. The right of the state to regulate liquidation after a voluntary assignment is supported by the United States Supreme Court in the affirming opinion. The state court in its decision followed its own line of cases, prominent in which is the case

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29 191 Wis. 279, 285, 210 N.W. 836, 838 (1926).
of Mayfield Woolen Mills v. Goodrich & Martineau. The case of Johnson v. Star, and Pobreslo v. Boyd both decided in 1933, hold that the United States Supreme Court will follow the state court's interpretation of its own statutes.

The leading case declaring a state system of insolvency as unconstitutional is International Choe Co. v. Pinkus, in which Justices Brandeis, McReynolds and Sanford dissent. It seems that this case is clearly distinguishable and that the rule set forth in Stellwagen v. Clum is more likely to be applied if the act is tested. The Court there said:

"It is only state laws which conflict with the bankruptcy laws of Congress that are suspended; those which are in aid of the Bankruptcy Act can stand."

This was quoted with approval in In re McElwain.

The right of a state to regulate generally the disposition of assets of a corporation of its creation has not been successfully challenged. It is believed that as a general plan of liquidation, the chapter is constitutional. There is an interesting article dealing with the constitutionality of the chapter in the Wisconsin Law Review. In the final analysis, since the equity jurisdiction of the courts under a creditors' bill is conceded, the enactment of regulatory provisions is not an unwarranted enlargement of that jurisdiction.

CHANDLER ACT

When the bill for liquidations and distribution through the state courts was being drawn, it was known that recommendations to Congress had been made from time to time for the amendment of the Bankruptcy Act. Other than emergency legislation in the field of reorganization, amendments had been few and it was thought best not to wait for any amendment of the Bankruptcy Act. The unexpected, however, happened and the Chandler Act was passed effective September, 1938, giving the federal system a thorough and needed revision. The substance of the old Bankruptcy Act has been changed in some respects but most of the provisions of the state act still conform to the federal law. An interesting example of what has happened, however, can be stated briefly. The provisions of the Bankruptcy Act prescribed the duties of the Trustees at Section 47a (2), and the trustee was there directed to reduce to possession assets of the estate. In order to do so, he was given the power of a creditor holding a lien by legal proceed-
ings. It was felt in drawing the state act that this properly belonged under the section of liens which is Section 67 of the Bankruptcy Act. The sponsors of the Bankruptcy Act in drawing the Chandler bill felt that this should properly be included under Section 70, for it deals with the title of the trustee. Since the interpretation of the provision has been the subject of a great many decisions, it is felt that the purpose of the provision is now clear regardless of whether it is included in the section of liens or that of title.

Upon the suggestion of Dean Garrison of the Wisconsin Law School, there was added to the bill as it was originally proposed by the Committee on Bankruptcies and Receiverships, the section for the amortization of the debts of wage earners. This provides in brief for a plan of payment whereby the debts of a wage earner may be paid in full over a period of two years during which time his wages will be free from garnishment and his assets from levy. A plan of this nature has subsequently been enacted as Chapter XIII of the Chandler Act and is now a part of the bankruptcy system of the United States.

CONCLUSION

The new Chapter 128 has been in operation a little more than a year. During that time, a great many interesting questions have arisen as to the title of the Trustee, the jurisdiction of the Court to entertain questions of liens in summary proceedings, the priorities of taxes, and the interpretation of the lien section as to present and fair consideration. In most instances the courts have followed the precedents established by the Bankruptcy Act and the obvious intent of the state bill. This purpose of course is to obtain an equitable distribution of the assets of any insolvent debtor, and to prevent any creditor, by reason of vigilance, inside information or the friendship of the debtor, from obtaining the lion's share.

There are many changes which may or should be made to clear up ambiguities or inconsistencies. For the most part, it is submitted that the law serves its purpose of furnishing to creditors a fair, workable, expeditious method of collection and distribution of a debtor's available assets.