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BANKRUPTCY

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In reviewing the bankruptcy developments in the Seventh Circuit Court of Appeals, this article will discuss noteworthy cases involving discharge, set-off and railroad reorganization. With some discomfort is anything written on bankruptcy law at present, for the Congress continues to consider reform of the bankruptcy law. Except as noted, however, this survey of recent decisions in the Seventh Circuit foresees no change in the matters discussed here by the Congress in the near future.

DISCHARGE

In the past year, the Court of Appeals for the Seventh Circuit decided several cases in the discharge area.[1] The most interesting of the discharge cases is *In re Sotelo*[2] in which the Seventh Circuit departed from precedent set in other circuits.[3] In that case, the Seventh Circuit construed section 6672 of the Internal Revenue Code,[4] and held dischargeable a liability arising out of the bankrupt's failure to account to the United States for withholding taxes of employees of the corporation of which the bankrupt was chief executive officer.[5]

In *Sotelo*, the bankrupt conceded liability pursuant to the provision of section 6672 of the Code,[6] but argued that this liability is dischargeable despite the Bankruptcy Act's limited exception from discharge of tax liabili-

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1. *In re* Sotelo, 551 F.2d 1090 (7th Cir.), *cert. granted*, 98 S. Ct. 54 (1977); *In re* Jones, 560 F.2d 775 (7th Cir. 1977); *In re* Woods, 561 F.2d 27 (7th Cir. 1977).
2. 551 F.2d 1090 (7th Cir.), *cert. granted*, 98 S. Ct. 54 (1977).
3. *See In re* Murphy, 533 F.2d 941 (5th Cir. 1976); Westenberg v. United States, 285 F. Supp. 915 (D. Ariz. 1968); Lynn v. Scanlon, 234 F. Supp. 140 (E.D.N.Y. 1964); Sherwood v. United States, 228 F. Supp. 247 (E.D.N.Y. 1964).
4. I.R.C. § 6672.
5. 551 F.2d at 1092.
6. I.R.C. § 6672 provides that:

> Any person required to collect, truthfully account for, and pay over any tax imposed by this title who wilfully fails to collect such tax, or truthfully account for and pay over such tax, or wilfully attempts in any manner to evade or defeat any such tax or the payment therefore, shall, in addition to other penalties provided by law, *be liable to a penalty* equal to the total amount of the tax evaded, or not collected, or not accounted for and paid over. No penalty shall be imposed under section 6653 for any offense to which this section is applicable. (emphasis added).

ty.[7] The court agreed with the bankrupt's contention, and found this liability dischargeable by construing the term "tax" as used in the Bankruptcy Act more narrowly than it is construed by other courts within the context of the Internal Revenue Code.[8] The court rejected decisions from other jurisdictions which had taken the view that liability under section 6672 of the Code is in the nature of a tax rather than a penalty which would be dischargeable,[9] characterizing these decisions as lacking sufficient analysis to override Congress' denomination of the section 6672 liability as a "penalty."[10] Moreover, and of probably more importance to the decision of *Sotelo*, the court recognized the policy implication of a failure to discharge this debt. The court felt that the policy of the Bankruptcy Act in favor of a fresh start, noticed as "basic," should not be overcome by a liability under the tax law which lacks any nexus with the bankrupt's personal tax affairs absent a clear congressional intent.[11]

Thus, *Sotelo* presented the narrow statutory interpretation issue, that is, whether section 6672 liability is nondischargeable for purposes of section 17 of the Bankruptcy Act, as well as the broad issue of policy favoring fresh economic start, for which an affirmative response to the narrow issue would tend to be frustrating. Despite the clearly contrary case law which seemed to this court to rest on narrow analogy without due regard for the fresh start policy, *Sotelo* does give the questions raised fuller treatment and a more convincing resolution.

The Seventh Circuit also faced an interesting procedural question with respect to discharge practice in the case of *In re Jones*.[12] The Bankruptcy Rules provide that cause must be shown for the bankruptcy court to hear an untimely application for an exception to discharge regardless of whether the application be formally made by a creditor or on the court's own motion.[13] In *Jones*, the court overlooked the new Bankruptcy Rules practice change on untimely requests for exceptions to a grant or discharge,[14] and held that the bankruptcy judge may hear an untimely application for exception under section 17a(4) of the Bankruptcy Act in the court's discretion and apparently even if cause has not been shown.[15] That this had been the court's preroga-

7. *See* Bankruptcy Act § 17a(1), 11 U.S.C. § 35(a)(1) (1970).
8. 551 F.2d at 1092.
9. *See* cases cited at note 3 *supra*.
10. 551 F.2d at 1092. *See* the emphasized language of section 6672 of the IRC cited at note 6 *supra*.
11. 551 F.2d at 1092-93.
12. 560 F.2d 775 (7th Cir. 1977).
13. Bankruptcy Rules 409(a)(2), 404(c), 906(b), 11 U.S.C.A. app. R. 409(a)(2), 404(c), 906(b) (1977).
14. *See* text accompanying notes 18-20 *infra*.
15. 560 F.2d 775 (7th Cir. 1977).

tive prior to the new Rules seems clear;[16] that this discretion now may not be exercised without cause seems likewise clear.[17]

The importance of the procedural issue in *Jones* stems from recent changes in the dischargeability law. Prior to 1970, the bankruptcy court primarily concerned itself with granting discharges. The question of exception from discharge grants was largely left to the determination of other courts, usually when the bankrupt debtor pleaded his discharge grant as a bar to the creditor's suit for the debt.[18] Substantial dissatisfaction in several areas led the Congress to amend section 17 in 1970 to provide that a creditor with an exception under section 17a(2), (4) or (8) must litigate his exception before the bankruptcy court lest the debt be discharged under the bankruptcy court's order of discharge.[19] Thus, a creditor who fails to satisfy the timeliness rules in tendering his claimed exception under these provisions risks loss of his exception.[20]

The procedure in the bankruptcy court for the hearing of applications for exceptions from discharge under section 17a of the Bankruptcy Act is governed both by the Act and its Rules. Under the Act, the bankruptcy court shall make an order fixing the time for the filing of applications for exceptions from discharge, which shall not be less than thirty nor more than ninety days after the first meeting of creditors.[21] Notice of this order is to be given to all creditors.[22] The Act then provides the language relied on in *Jones*: "The Court may, upon its own motion or, for cause shown, upon motion of any party in interest, extend the time or times for filing such . . . applications."[23] In *Jones*, the circuit court deemed the bankruptcy judge to have extended the time on his own motion since that judge had entertained the exception beyond the time provided in his order and had not considered the timeliness issue, at least as shown in the record.[24]

In conflict with both the quoted sentence of the Bankruptcy Act and the *Jones* court's application is Bankruptcy Rule 409(a)(2), which authorizes

16. Bankruptcy Act § 17c(2), 11 U.S.C. § 35(c)(2) (1970) which provides that "unless an application is timely filed, the debt shall be discharged" must be read in conjunction with the last sentence of Bankruptcy Act § 14b(1), 11 U.S.C. § 32(b)(1) (1970), which provides that "[t]he Court may, upon its own motion or, for cause shown, upon motion of any party in interest, extend the time . . . ."

17. *See* the Bankruptcy Rules cited at note 13 *supra* and text accompanying note 25 *infra*.

18. Exceptionally, the bankruptcy court could determine the dischargeability of a particular debt upon the application of a bankrupt. *See* Local Loan Co. v. Hunt, 292 U.S. 234 (1934). For an excellent in-depth recitation of the pre-1970 situation and the legislative history of the 1970 amendments to the dischargeability law cited at note 19 *infra*, *see* 1 BANKRUPTCY ACT AND RULES, 58-63 (Collier pamphlet ed. 1975).

19. *See generally* Bankruptcy Act § 17c, 11 U.S.C. § 35(c) (1970).

20. Bankruptcy Act § 17c(2), 11 U.S.C. § 35(c)(2) (1970).

21. Bankruptcy Act § 14b(1), 11 U.S.C. § 32(b)(1) (1970).

22. *Id.*

23. *Id.*

24. 560 F.2d at 777-78.

extensions for filing a complaint to determine the dischargeability of a debt for cause only, whether the extension issue arises by party motion or sua sponte.[25] Under the Rules' enabling statute, such a conflict between the Act and the Rules on a procedural matter is controlled by the Rules.[26] Regrettably, however, the court ignored the rule requiring cause to be shown, though one might assume, as the court may have, that the bankruptcy court had found cause for its extension of time.[27]

Finally, in the area of discharge the Seventh Circuit considered again the plight of the divorced person whose former spouse attempts in bankruptcy to obtain a discharge of a debt created in a divorce property settlement.[28] The Bankruptcy Act bars discharge of debts "for alimony due or to become due, or for maintenance or support of wife or child."[29] In *In re Woods*,[30] the court adhered to settled cases[31] in distinguishing debt created by property settlement proximate to divorce from alimony or support obligations under the exception statute. As some commentators have noted,[32] the Proposed Bankruptcy Act of the Bankruptcy Commission would eliminate this distinction.[33] However, it should be noted that the version of the Bankruptcy Act approved by the United States House of Representatives during the First Session of the Ninety-fifth Congress speaks without substantive change to this particular dischargeability issue; section 523(a)(5) of that version regards debt "to a spouse, former spouse, or child of the debtor, for alimony to, maintenance for, or support of, such spouse or child" as nondischargeable.[34] Lamentably, as matters have stood, divorce settlements made without expert planning in light of the likelihood of a bankruptcy discharge continue to be treacherous.

SET-OFF UNDER SECTION 68A

In what would seem to have been a pat case, the court in *Pabst v. Harris Truck & Trailer Sales, Inc.* (*In re Griswold*)[35] denied a partially

25. *See also* Bankruptcy Rules 404(c), 906(b), 11 U.S.C.A. app. R. 404(c), 906(b) (1977).
26. 28 U.S.C. § 2075 (1970) provides that the rules may not "abridge, enlarge, or modify any substantive right" and is understood to thereby authorize procedural and practice changes such as the time extension issue under discussion.
27. *Jones* suggests no ground for concluding otherwise than that the bankruptcy judge exercised proper discretion for cause apparent or shown.
28. *In re* Woods, 561 F.2d 27 (7th Cir. 1977).
29. Bankruptcy Act § 17a(7), 11 U.S.C. § 35(a)(7) (1970). *But see In re* Wasserman, 46 U.S.L.W. 2073 (D.R.I. 1977) (holding section 17a(7) exception from discharge of alimony for "wife" unconstitutional sex discrimination under the fifth amendment).
30. 561 F.2d 27 (7th Cir. 1977).
31. *See, e.g.*, Nichols v. Hensler, 528 F.2d 304 (7th Cir. 1976).
32. *See* Ginsberg, *Bankruptcy*, 53 CHI.-KENT L. REV. 231 & n.265 (1976).
33. REPORT OF THE COMMISSION ON BANKRUPTCY LAWS OF THE UNITED STATES, Pt. II, § 4-506(a)(6) (Proposed Law) (1975).
34. H.R. 8200, 95th Cong., 1st Sess. § 523(a)(5) (1977).
35. 559 F.2d 451 (7th Cir. 1977).

secured creditor the privilege of section 68a[36] set-off because the court found the creditor to have obtained a voidable preference under the Bankruptcy Act.[37] The court reasoned that since section 68b(1)[38] denied set-off to a creditor who had received a preference from the debtor's estate, the creditor at bar, in having received a preference, was precluded by a limitation on set-off under section 68.[39] In that view the appeal appears untroublesome. However, the case seems noteworthy in that although a sound result is reached, the reasoning of the court is interesting and not arguably unquestionable. After examining the court's rationale under the apparent facts of the case, an alternative rationale will be examined which may offer guidance on the general question of the availability of this set-off to the partially secured creditor.[40]

In *Pabst*, the creditor held security interests in several vehicles of the debtor-bankrupt which had been appropriately perfected well before bankruptcy. Although the security interests were several, no consolidation of these debts was agreed to by the parties. Due to the debtor's default, the creditor commenced repossession (apparently by self-help) shortly before the filing of the bankruptcy petition and concluded these repossessions shortly after the filing.[41] As is not unusual, when the creditor concluded liquidation of its collateral it found that on some vehicles foreclosure sale brought less than the debt secured, and on others sale brought more than the debt secured. In the resultant position of obtaining by foreclosure less than the aggregate of debt owed, the creditor thus faced a net loss; and its position was ostensibly worsened by the filing of the bankruptcy trustee's petition for an accounting and turnover of funds obtained by the collateral sales in excess of the security interest on each vehicle. Perhaps distressed by this petition but not undaunted, the creditor countered with a claim against

36. Bankruptcy Act § 68a, 11 U.S.C. § 108(a) (1970) provides: "In all cases of mutual debts or mutual credits between the estate of a bankrupt and a creditor the account shall be stated and one debt shall be set off against the other, and the balance only shall be allowed or paid." This section is not to be confused with another so-called set-off provision found under section 60 of the Act, which is entirely distinct (Bankruptcy Act § 60, 11 U.S.C. § 96 (1970)).

37. Bankruptcy Act § 60, 11 U.S.C. § 96 (1970).

38. Bankruptcy Act § 68b(1), 11 U.S.C. § 108(b)(1) (1970) provides: "A set-off or counterclaim shall not be allowed in favor of any debtor [creditor] of the bankrupt which (1) is not provable against the estate and allowable under subdivision g of section 93 [section 57] of this title [Act]". (For purposes of clarification, bracketed material indicates variance in language found in the Statutes at Large).

39. 559 F.2d at 454.

40. *See* text accompanying notes 53-54 *infra*.

41. As noted in the text accompanying note 50 *infra*, such post-petition repossession and sale of the collateral, assuming the collateral to have passed in legal contemplation to the trustee, seems clearly to be wrongful against the trustee. *See, e.g.*, Arkansas Fuel Oil Co. v. Leisk, 133 F.2d 79 (5th Cir. 1943). The appropriate procedure to reclaim the collateral by the secured party is to file a reclamation petition with the bankruptcy court. *See generally* 2 W. COLLIER, COLLIER ON BANKRUPTCY ¶ 23.11 (14th ed. 1976) [hereinafter cited as COLLIER]; S. & M. NADLER, LAW OF BANKRUPTCY § 658 (2d ed. 1972).

the bankrupt estate in the amount of the difference between the total debt of the bankrupt to this creditor and the total proceeds from the sale of the collateral.

Thus, the creditor responded in a superficially attractive manner to the trustee's seemingly correct petition to recover proceeds realized from the "profitable" sales, that is, the surplus above the security interest held. In looking at the transactions between creditor and debtor as a whole, it appears that the creditor has suffered substantial loss even though the credit extensions were properly secured. The Bankruptcy Act provides a creditor so positioned with equity through the set-off of section 68a, which entitles a creditor to set-off "in all cases mutual debts or mutual credits between the estate of a bankrupt and a creditor."[42] Thus, the creditor concludes that it should be able to set-off gains and losses from the collateral sales, with the negative balance standing as its claim as an unsecured creditor of the estate.[43] Another view, submitted to be correct, holds that this set-off would result in preferential treatment of the creditor relative to the other creditors of the estate who have unsecured claims. Instead of sharing the surplus obtained from the profitable sales, that is, the excess over the security interest, with similarly positioned unsecured creditors, this creditor would retain the surplus, set-off that amount against the proceeds from sales which obtained less than the security interest held, and share with other creditors the net loss out of other assets of the estate as well.

The Seventh Circuit's resolution of the argument took an interesting turn. Without scrutiny of whether a creditor so positioned is entitled to set-off under section 68a, the court looked to section 68b(1)[44] to deny the claim

42. *See* note 36 *supra*.

43. The secured creditor's theory in *Pabst* results in dividends being paid it as a general creditor in excess of its prorated general claim against the estate. Using hypothetical figures for convenience, the creditor files a claim against the estate for $10,000 representing a debt owed on two notes that had been secured by two pieces of equipment. On sales of the equipment for net prices of $6000 and $4000 (where each secured the notes promising each $5000), the creditor contends that his gain of $1000 on one note is offset by his loss of $1000 on the other note. This contention, however, cannot be supported since the creditor had a security interest in each piece of equipment of only $5000. Allowing this sort of set-off deprives the other estate claimants of their prorated share of the $1000 derived from the sale of the one piece of equipment that produced a $1000 surplus.

A secured creditor has a provable and allowable prima facie claim against the bankruptcy estate for a deficiency, to which that creditor is no more nor less deserving of priority over other unsecured creditors, where a second secured claim held by the same creditor happens fortuitously to produce a surplus on sale. Extraordinarily, the bankruptcy court may in a limited way jump up the creditor if, for example, the creditor's production of this surplus is especially meritorious under the rules provided by Bankruptcy Act § 64a(1), 11 U.S.C. § 104(a)(1) (1970). However, that section has no apparent application to *Pabst* since it limits the promotion of the deserving creditor to costs and expenses of the recovery of property. Likewise, demotion through disallowance under section 57g may be ordered by the bankruptcy court should the creditor have committed one of the proscribed acts thereunder and yet hold a deficiency claim. Bankruptcy Act § 57g, 11 U.S.C. § 93(g) (1970).

44. *See* note 38 *supra*.

and find for the trustee. That subsection bars use of set-off to any creditor who would under section 57g[45] have a claim against the estate disallowed for various reasons, including receipt of a preference. Finding here that creditor had received a preference, it followed that sections 68b(1) per 57g barred the set-off. This circuitous rationale bypasses the initial issue of whether creditor fell within section 68a set-off. Moreover, the analysis given by the court may be doubtful since it assumes that the creditor did obtain a preference.[46]

The preference section of the Act limits what is a preferential transfer to those transfers occurring "within four months *before* bankruptcy,"[47] and in *Pabst* all but one repossession occurred after the bankruptcy.[48] In the absence of disclosure in *Pabst* as to whether the sole pre-bankruptcy repossession resulted in proceeds on sale greater than the security interest held on that vehicle, one cannot determine whether a preferential transfer did occur. Nonetheless, the absence of a preference would not disturb the court's rationale under section 68b(1) since that subsection's incorporation of the grounds for disallowance found in section 57g includes the receipt of *any* void or voidable transfer, not only a preference.[49] Since the post-bankruptcy petition repossessions and resales seem conversions[50] of property that in legal contemplation had passed to the trustee of the bankruptcy estate[51] and into the constructive possession and jurisdiction of the bankruptcy court,[52]

45. Bankruptcy Act § 57g, 11 U.S.C. § 93(g) (1970) provides: "The claims of creditors who have received or acquired preferences, liens, conveyances, transfers, assignments, or encumbrances, void or voidable under this title [Act], shall not be allowed unless such creditors shall surrender such preferences . . . ."

46. The *Pabst* court found a preference only because the secured creditor sold seven of the vehicles for amounts in excess of the security interests. 559 F.2d at 454.

47. Bankruptcy Act § 60a(1), 11 U.S.C. § 96(a)(1) (1970) (emphasis added).

48. Technically, if only the pre-bankruptcy repossession and sale obtained less than the applicable security interest amount, under the court's reasoning no voidable preference had been obtained. Importantly, section 57g disallowance requires a void or voidable preference, not only an actual preference. No argument hereby, however, follows that the secured party has a right to retain the surplus of his foreclosure because no void or voidable preference arose thereby. *See* text accompanying notes 48-49 *infra*; *see generally* 3 COLLIER, *supra* note 41, at ¶ 57.19.

49. *See* note 45 *supra* for the text of section 57g.

50. Conversion on the theory that title has passed to the trustee under Bankruptcy Act § 70a, 11 U.S.C. § 110(a) (1970), and the repossession and resale thereafter of collateral constitutes a violation of the trustee's property interest as well as the automatic stay against lien enforcement now provided by Bankruptcy Rule 601, 11 U.S.C.A. app. R. 601 (1977). As noted in the Advisory Committee's Notes accompanying the Rules, whether post-petition lien enforcement against the property in the court's jurisdiction is void has split the authorities. *See* Bankruptcy Rule 601, 11 U.S.C.A. app. R. 601 (1977) and accompanying Advisory Committee's Notes; COLLIER, *supra* note 41, at ¶2.62(1), (2). The Advisory Committee expressed a preference for the "void" view. *See* Bankruptcy Rule 601, 11 U.S.C.A. app. R. 601 (1977) and accompanying Advisory Committee's Notes.

51. *See* Bankruptcy Act § 70a, 11 U.S.C. § 110(a) (1970); 4 A COLLIER, *supra* note 41, at ¶ 70.18.

52. The bankruptcy court has constructive possession of all non-exempt property of the

this misconduct would justify disallowance and bar the set-off as well.

The question that the *Pabst* court left untouched concerns whether, absent commission of conduct that would bar set-off by section 68b(1), a creditor in the same position as the creditor in *Pabst* may set-off gains against losses. It is submitted that generally the proper answer is no, since this set-off is generally available only for a creditor with whom the bankrupt held an open account under which the statutory requisite mutual credits or mutual debts is satisfied.[53] A creditor who holds security for one debt, or more, whose security is more than sufficient to satisfy the debt or debts secured, may not retain or obtain the surplus of sale of the security to satisfy another debt wholly unsecured or only partially secured when bankruptcy ensues.[54]

bankrupt held by the bankrupt at the filing of the petition. *See* 2 COLLIER, *supra* note 41, at ¶ 23.05.

53. Early Supreme Court opinions denied the set-off of section 68a (Bankruptcy Act § 68a, 11 U.S.C. § 108(a) (1970)) to creditors who tried to credit the bankrupt's debt by retention of property which had come into their possession and was properly includible in the bankrupt's estate. In Libby v. Hopkins, 104 U.S. 303 (1881), the Court held the property in the creditor's control not to be a "mutual credit or mutual debt" within the statute. *Id.* at 306-07. The Court noted, and a line of subsequent decisions continues, that the creditor merely holds such property as "trustee" for the benefit of the debtor or the estate. *Id.* at 309. *Accord*, Western Tie & Timber Co. v. Brown, 196 U.S. 502 (1904); Brunswick Corp. v. Clements, 424 F.2d 673 (6th Cir. 1970), *cert. denied*, 400 U.S. 1010 (1971); Arkansas Fuel Oil Co. v. Leisk, 133 F.2d 79 (5th Cir. 1943); Lehigh Valley Coal Sales Co. v. Maguire, 251 F. 581 (7th Cir. 1918); Continental & Commercial Trust & Sav. Bank v. Chicago Title & Trust Co., 199 F. 581 (7th Cir. 1912), *rev'd*, 229 U.S. 435 (1913); *In re* Gravure Paper & Board Corp., 150 F. Supp. 613 (D.N.J. 1957); *In re* Lykens Hosiery Mills, 141 F. Supp. 891 (S.D.N.Y. 1956); *In re* Sandy's Novelty Corp., 116 F. Supp. 132 (S.D.N.Y. 1946). *See also* Ivanhoe Bldg. Ass'n. v. Orr, 295 U.S. 243 (1935).

54. This proposition knows abundant authority, but only arguable unanimity. The cases of Brust v. Sturr, 128 F. Supp. 188 (S.D.N.Y. 1955), and *In re* Autler, 23 F. Supp. 756 (S.D.N.Y. 1938) provide unequivocal support. In his book on the law of bankruptcy, Professor James A. MacLachlan makes the point that distinguishes Gibson v. Central Nat'l Bank, 171 F.2d 398 (5th Cir. 1948), the main case appearing to hold contrarily (and rejected in *Brust* on the authority of *Autler*). MacLachlan appreciates the fact that a creditor may have an understanding with his debtor that the creditor is secured by the collateral on more than one debt owed by the debtor even though the legal relationship may be cloudy with respect to the securing of the second debt. To the extent that understanding may be properly shown and accepted by the court, no section 68a set-off issue arises since no surplus is presented should the foreclosure of the creditor produce more proceeds than necessary to cover the first debt. Rather, one finds fully-used-up collateral as it is devoted, hypothetically, to both debts' satisfaction. J. MACLACHLAN, THE LAW OF BANKRUPTCY § 288 (1956).

In *Gibson*, the foregoing explains the court's conclusion to allow set-off from the proceeds of the collateral sale against additional debt of the bankrupt to the foreclosing creditor. The court held that since the collateral in *Gibson* had been given to secure a running indebtedness, that would seem to have included the additional debt for which the creditor sought to devote the proceeds. 171 F.2d at 400. Although the court did resolve the appeal in *Gibson* in favor of the creditor by citing the set-off provision, that case should be understood to stand, along with Wolf v. Aero Factors Corp., 221 F.2d 291 (2d Cir. 1955) and Brislin v. Killanna Holding Corp., 85 F.2d 667 (2d Cir. 1936), for the proposition that proceeds from the collateral foreclosure are not surplus proceeds where the parties have agreed to secure several debts or a continuing indebtedness by the same piece of collateral. It may well be true that parties in the position of the *Pabst* case do so intend. In that situation, however, the issue is not set-off of surplus security but no surplus at all.

RAILROAD REORGANIZATION

The troublesome area of railroad reorganization[55] presented an important issue for the Seventh Circuit's resolution in the case of *In re*

In re Searles, 200 F. 893 (E.D.N.Y. 1912), which later was disapproved of in *In re* Autler, 23 F. Supp. 756 (S.D.N.Y. 1938), seems contrary to the position taken here and in *Gibson, Wolf,* and *Brislin*. *Searles* presented a case in which the creditor held two notes of the bankrupt, of which one was secured. Foreclosure produced a surplus with which the creditor sought to pay off his other note. As in *Pabst*, the trustee sought the surplus and creditor argued set-off. The court denied the trustee's turnover motion and amended the creditor's claim against the estate by the amount of the surplus. It is submitted that *Searles* is explained by examination of the incorrect argument upon which the trustee heavily depended. The trustee contended that since the creditor had filed and proved a claim against the estate for the full amount of the unsecured note, and since the creditor was thereafter shown to have security for the note (the surplus proceeds), the creditor should be estopped from set-off because of a failure to note in his claim the security he held for the note on which claim was made. The court notes in reaching its decision that no estoppel is made out on such facts by the trustee, since no other creditors had changed position in reliance on the representation made in the creditor's filed claim. 200 F. at 894. This estoppel argument of the trustee was thus as bad on the facts of that case as it is on the law since the court thereby seems genuinely uninformed on the set-off provision which received no substantive discussion in the opinion. On this view, then, *Searles* stands only for the estoppel argument considered and lacks precedential weight on the issue of when section 68a set-off may be allowed.

55. The whole area of railroad reorganization is sometimes needlessly troublesome. For example, the recent case of National R.R. Passenger Corp. v. Blanchette, 551 F.2d 127 (7th Cir. 1977), put a noteworthy series of events before the court which led to a ruling that is without special significance to the law on reorganization court jurisdiction. Pursuant to Bankruptcy Act § 77a, 11 U.S.C. § 205 (1970), the reorganization court has exclusive jurisdiction over matters of reorganization. In this decision the Seventh Circuit reversed the District Court of Northern Indiana on the ground that matters on which the district court had ruled fell within the exclusive jurisdiction of the Pennsylvania reorganization court of the Penn Central railroad.

Amtrak and the Penn Central trustees had agreed (with the approval of the reorganization court) to arbitrate certain disputes that could arise under the so-called National Passenger Corporation Agreement of April 16, 1971 (the "basic agreement") which was mandated by the Rail Passenger Service Act of 1970, 45 U.S.C. §§ 501, 561(a) (1970). The agreement provided, *inter alia*, that Penn Central would maintain certain lines, about which a dispute arose that ultimately was decided by the arbitration clause in the basic agreement. However, though the basic agreement provided that judgment might be entered in any federal district court on any arbitration award, the reorganization court's approval of the basic agreement was premised on the submission to that court for its approval any arbitration award agreement before the debtor or trustees would become finally bound by it.

An award was rendered in the favor of Amtrak and eventually Amtrak took the award to the Indiana district court for confirmation. The flight to Indiana for the confirmation saw no resistance then by the trustees since Amtrak counsel, by memorandum of record in the reorganization court, assured that "any judgment entered by the Indianapolis District Court upon Amtrak's Petition to Confirm will not . . . [become] finally binding upon the Trustees." 551 F.2d at 132. Amtrak's then declared motive seemed only to liquidate its claim for purposes of provability aqainst the estate before the reorganization court. The trustees thereby claim to have consented to the Indiana judgment confirming the award in March 1976.

Next, Amtrak petitioned the reorganization court for enforcement of its confirmed award. When the trustees answered this petition by claiming that the award could not be enforced since the disputed lines had been conveyed to ConRail under the Regional Rail Reorganization Act of 1973, 45 U.S.C. §§ 701-793 (Supp. IV 1974), and thereby Penn Central's obligation had terminated, Amtrak returned again to the Indiana court in May 1976 and sought there a declaratory judgment to provide a show cause order on Penn Central why a quarterly schedule for the restoration of track had not been submitted to Amtrak as required by the confirmation order of March.

Chicago, Rock Island & Pacific Railroad.[56] The issue in *Rock Island* concerned the appropriate findings by which the reorganization court may authorize the trustee's issuance of certificates to raise funds for the repair, rehabilitation and maintenance of a railroad, as well as funds for long-term locomotive leases.[57] The issuance of certificates for these purposes in the reorganization of the Chicago, Rock Island and Pacific Railroad, prior to the development of a reorganization plan, has the legal effect of granting priority to the holders of the certificates as a first lien on all of the property of the debtor railroad.[58] Not surprisingly, in such circumstances, the creditors of the railroad will object to the proposal of the trustee since their priority rank legally lessens and their collateral potentially diminishes.[59]

Over the past decade, through railroad reorganization litigation largely involving the Penn Central railroad,[60] the Third Circuit Court of Appeals has set forth two tests[61] by which the reorganization court may determine whether the pre-plan funding proposal of the trustee protects the equitable, statutory and, ultimately, the constitutional rights of pre-reorganization creditors.[62] These Third Circuit decisions apply a strict standard, the *Third Avenue* test,[63] to the expenditure of funds for operations, as compared to the

The Indiana court ordered that its March confirmation judgment was res judicata on the arbitral issues including the question of the effect of the ConRail transfer of the following month, which not merely had yet to come about, but about which the trustees made no argument or objection in the Indiana court pursuant to the Amtrak memorandum noted above. This Indiana sally by Amtrak was met by a late thrust in the reorganization court whereby the trustees obtained an injunction against Amtrak's judicially trafficking elsewhere on the matter with an appeal to the Seventh Circuit of the latest Indiana ruling expressly excepted. 551 F.2d at 133.

In what seems to be the only reasonable choice in the case, the Seventh Circuit reversed the later Indiana order, including its recitation of its res judicata effects, on the ground that the matter was properly justiciable in the reorganization court. *Id.* at 136. Of course, the comings and goings of counsel for and against the Penn Central will come eventually to be recorded in more colorful detail where hopefully one may finally learn which plane Amtrak counsel took to Indiana.

56. 545 F.2d 1087 (7th Cir. 1976) [hereinafter referred to in text as *Rock Island*].

57. Bankruptcy Act § 77c(3), 11 U.S.C. § 205(c)(3) (1970).

58. *Id.*

59. The economic effect is nicely described by the court in one of the Penn Central appeals to the Third Circuit, *In re* Penn Central Transp. Co. (Columbus Option), 494 F.2d 270, 277-78 (3rd Cir.), *cert. denied*, 419 U.S. 883 (1974) [hereinafter cited as *Columbus Option*].

60. The leading cases arising out of the various Third Circuit decisions involving the reorganization of Penn Central are *Columbus Option*, *supra* note 59; *In re* Penn Central Transp. Co. (Selkirk Yard), 474 F.2d 832 (3d Cir. 1973) [hereinafter cited as *Selkirk Yard*]; *In re* Penn Central Transp. Co. (Mortgage Releases), 468 F.2d 1222 (3d Cir. 1972); Central R.R. of N.J. v. Manufacturers Hanover Trust Co., 421 F. 2d 604 (3d Cir.), *cert. denied*, 398 U.S. 949 (1970). *See generally In re* Third Ave. Transit Corp., 198 F.2d 703 (2d Cir. 1952). *See also In re* Boston and Maine Corp., 484 F.2d 369 (1st Cir. 1973); *In re* Bermec Corp., 445 F.2d 367 (2d Cir. 1971); *In re* Yale Express System, Inc., 384 F.2d 990 (2d Cir. 1967).

61. Hereinafter referred to in the text and footnotes as the *Third Avenue* test and the *Jersey Central* test. *See* notes 63 and 64 *infra*.

62. As discussed in text accompanying notes 68-71 *infra*, it is not clear whether the Third Circuit views these tests as constitutionally required or as simply meeting the constitutional standard.

63. Of great influence to the present position of the Third Circuit has been the opinion of

expenditure of funds for additions or betterments to capital assets, to which a less strict *Jersey Central* test applies.[64]

The Third Circuit emphasizes the *use* and not the *source* of the funds sought in determining whether the *Third Avenue* or *Jersey Central* test applies in the particular trustee proposal.[65] The use analysis assumes that the economic effect on extant creditors is more drastic where the funds are to be used for operations[66] whereas the use of funds to better or add to assets of the railroad, on the other hand, requires a lesser standard because the expenditure more likely expands the railroad's assets that are potentially available to satisfy creditor claims.[67]

Rock Island construes the Third Circuit developments as having elevated the *Third Avenue* test to a constitutional requirement, necessitated, in the Third Circuit's judgment, by the fifth amendment to avoid unconstitutional diminishment of creditor collateral.[68] With directness, the Seventh Circuit disagreed that the amendment requires so strict a test, stating that

Judge Jerome Frank in Third Ave. Transit Corp., 198 F.2d 703 (2d Cir. 1952), in which Judge Frank reversed a reorganization court's authorization of trustees to take half a million dollars from a fund of the first mortgagees containing proceeds from the disposal of mortgaged properties. The trustees in *Third Avenue* believed that trustee certificates would have been more costly and funds were required for working capital. Judge Frank indicated that seizure of the debtor's property in the hands of a mortgagee could be permitted, but the necessary proof of a most extraordinary circumstance would be necessary. Specifically, the court held there must be findings both of a "high degree of likelihood (a) that the debtor can be reorganized . . . within a reasonable time, and (b) that the secured creditors whose security is being compulsorily loaned will not be injured." *Id.* at 706-07. The court remanded *Third Avenue* as no findings had been made consistent with these standards. Of interest also was the court's note of the looming fifth amendment issue, should reorganization courts overstep their authority in affecting creditors. *Id.* at 707.

64. The *Jersey Central* test, first seen in Central R.R. of N.J. v. Manufacturers Hanover Trust Co., 421 F.2d 604 (3d Cir. 1970), provides a lesser standard for the trustee to satisfy in seeking certain financing goals. Where the trustee seeks funds by which to make additions to, or betterment of, the mortgaged property, he may convert capital assets to cash if the funds are unavailable otherwise, reorganization is probably feasible, the money obtained will materially contribute to possibility of a successful reorganization and to continuation as a going concern, and if thereby the interests of bondholders will not be prejudiced. *Id.* at 606. *See Selkirk Yard, supra* note 60, and *Columbus Option, supra* note 59.

65. By "use" is meant for what purpose the trustee proposes acquiring the funds; by "source," from where the funds will come.

66. *Columbus Option, supra* note 59, at 284, applied the stricter *Third Avenue* test where the sources proposed included only property theretofore unencumbered by pre-reorganization creditors, and proposed to be used for operational financing.

67. *Selkirk Yard, supra* note 60, at 836, applied the less strict *Jersey Central* test where the source was to be mortgaged property or its proceeds and the use was additions or betterment to road property and not operational.

68. The theory is that to the extent priority is lost to new holders of claims against the estate with a higher legal priority than existing creditors (through issuance of trustee certificates under the Bankruptcy Act § 77c(3), 11 U.S.C. § 205(c)(3) (1970)), previous creditors have suffered a taking of their property under the fifth amendment without due process of law. Supreme Court cases make clear that Congress' power to make bankruptcy law is limited by the fifth amendment, although the precise extent of creditor protection in circumstances as in the instant cases is not at all clear. *See, e.g.*, Regional Rail Reorganization Act Cases, 419 U.S. 102 (1974); Continental Ill. Nat'l Bank & Trust Co. v. Chicago, R.I. & P. Ry., 294 U.S. 648 (1935).

"the Fifth Amendment . . . is not violated by anything less than actual impairment of a creditor's security."[69] Though one must grant that the Third Circuit's opinion in *In re Penn Central Transportation Co. (Columbus Option)*[70] may be so read, another plausible reading of both *Columbus Option* and its antecedent, *Third Avenue*, leads one to conclude that these courts prescribed a strongly creditor-protectionist test to satisfy the statutory and equitable rights of creditors even if something less could have satisfied constitutional rights.[71] Moreover, one may err in assuming that the difference of opinion between these circuit courts, even if on constitutional and not statutory/equitable grounds, is of broad range. The analysis below suggests that the disagreement exhibited in *Rock Island* may be less than is apparent since these cases are substantially distinguishable.

As noted, the Third Circuit emphasized the *use* to which the reorganization trustee proposed putting the funds sought and seems to have treated the *source* as effectively immaterial.[72] Specifically, the court applied the more rigorous *Third Avenue*[73] test in *Columbus Option*,[74] wherein the property to be used to attract funds had not previously been subjected to the claims of creditors who were opposing the trustee proposal.[75] Only one year earlier the same court applied the less strict *Jersey Central* test[76] in the case of *In re Penn Central Transportation Co. (Selkirk Yard)*,[77] wherein the property to be used to obtain funds for additions and betterment of the yard was proceeds of the disposal of mortgaged property of the creditors who opposed the proposal. *Selkirk Yard* followed the decision of the earlier Third Circuit case of *In re Penn Central Transportation Co. (Mortgage Releases)*[78] under the same use and source facts.

69. 545 F.2d at 1090.

70. 494 F.2d 270 (3d Cir.), *cert. denied*, 419 U.S. 883 (1974) [hereinafter referred to in text as *Columbus Option*].

71. Again, resolution of the holdings of *Rock Island* and the Third Circuit cases does not require decision of constitutional scope. Creditor protection, notably secured credit protection, arises not only from the fifth amendment, but also from the statutory scheme of the bankruptcy law as well as antecedent equitable receivership law out of which the reorganization law came. The statutory/equitable test of creditor protection need not be co-extensive with the outer limit of the amendment. There may even be a greater protection afforded by the former, as is implicit in the *Rock Island* opinion. The seminal *Third Avenue* opinion of Judge Jerome Frank only notes the possible clash with the amendment. Even *Columbus Option* seems better read as imposing *Third Avenue's* strict test "to insure that the reorganization court is not engaged in an intentional uncompensated taking." 494 F.2d at 279. *Third Avenue* seems compelled by prudence and not by the Constitution.

72. *See* text accompanying notes 65-67 *supra*.

73. *See* note 63 *supra*.

74. *See* notes 59 and 60 *supra*.

75. However, the subject property secured the lien of the trustee certificates. *See* notes 59, 65 and 66 *supra*.

76. *See* note 64 *supra*.

77. 474 F.2d 832 (3d Cir. 1973) [hereinafter referred to in the text as *Selkirk Yard*].

78. 468 F.2d 1222 (3d Cir. 1972).

Rock Island presented a proposal of the trustee which contemplated both operational and capital uses of the funds whose source was unlike any of the Third Circuit precedents, where the use proposed had been *either* operational *or* capital. In addition, unlike all of the Third Circuit precedents, save arguably *Columbus Option*,[79] the source of the *Rock Island* funds was issuance of trustee certificates and not disposal of mortgaged property or proceeds thereof. One should consider whether the Seventh Circuit's disregard in reaching its decision,[80] of the *use* to which the funds would be put, in favor of its cryptic dictum about the constitutional protection extending simply to "actual impairment of a creditor's security,"[81] leaves open to that court alternatives far closer to the strict *Third Avenue* test than might appear. Where mortgaged property is proposed to fund either operational or capital expenditure, nothing inconsistent nor incoherent would appear from the Seventh Circuit's adoption of a test even stricter than *Third Avenue*.[82] Before one assumes the difference of opinion gratuitously presented by *Rock Island* on the constitutional issue really marks substantially divergent opinion on the statutory or equitable protection of creditors, consideration must be accorded the distinguishing factors among these cases on the extent of protection each accords creditors.

The extent of the difference in analysis between these cases lies in the focus of the Third Circuit on *use* and the arguable focus of the Seventh Circuit on *source*. Construing the Seventh Circuit's constitutional dictum as its decision to bar invasion of mortgaged property or its proceeds—a construction concededly conjectural, unless strongly optimistic findings favoring successful reorganization are offered in support—one finds little if any disagreement of principle or analysis from the Third Circuit decisions. Examination of the Third Circuit decisions reveals that *Rock Island* substantially presents different factors. The Third Circuit cases hold that where the use proposed is capital, and the source proposed is mortgaged property or proceeds, the less strict *Jersey Central* test applies; where the use proposed is operational, and the source proposed is unmortgaged property, the stricter *Third Avenue* test applies. Thus, one may securely infer that the stricter test, *Third Avenue*, applies where the proposed use is operational and the

79. *Columbus Option* proposed financing from several sources all encumbered already by trustee certificate issue.

80. By "disregard" it is meant only that *Rock Island* is read as holding the use to be immaterial to the result explicitly. The court did recite the proposed use and, of course, would disapprove outlandish uses, but it entertained no contention of such a use in the case presented.

81. 545 F.2d at 1090. The court's cryptic dictum may mean different things to different people. *See, e.g.*, note 82 *infra*.

82. That is, the dictum may mean that the protection of *Third Avenue* does not pass constitutional analysis because use of the mortgaged property is an "actual impairment of a creditor's security." *Id.*

proposed source is mortgaged property. However, one also may securely infer that the less strict test applies where the proposed use is capital and the proposed source is unmortgaged property. When *Rock Island* proposes both operational and capital uses out of the same source, that is, trustee certificates and not (legally) mortgaged property, the only Third Circuit *precedent* on point is *Columbus Option*, and that bears only on the operational part of the *Rock Island* case.

Yet, even as to the part of the use proposed in *Rock Island* for which arguably *Columbus Option* stands as precedent, an important distinction between the two cases obtains. The unencumbered source property in *Columbus Option* was at the time unencumbered only in the respect that the opposed creditors held no liens thereon, but it is inaccurate to say that the source was unencumbered, since by then trustee certificate issues had placed a first lien on the property in favor of the United States, who argued in favor of the trustee's proposal.[83] Contrariwise, in *Rock Island*, the trustee certificates proposed to attract funding were not preceded by an earlier encumbrance.[84] Without doubt, this last distinction *need* not have been crucial to the actual economic erosion of the Rock Island creditor interests in either case,[85] though in neither circuit has actual economic erosion become the controlling consideration.[86] However, when coupled with the other plainly relevant factors, including prospects of successful reorganization, alternative sources of funds, timing of the proposal and the public interest effect, the actual economic effect may be quite an overwhelming consideration completely separating the *Columbus Option* case from the *Rock Island*. The prejudicial effect on creditors of the *Columbus Option* proposal to fund operational use through a previously tapped and encumbered source seems distinctly stronger than the effect on creditors of the *Rock Island* proposal to fund both capital and operational uses out of a previously untapped source. For courts to have applied a stricter test in the former and a lesser in the latter seems proper under the statutory and equitable protection enjoyed by creditors.

For these reasons it seems premature to suppose that any real difference of agreement obtains between these circuit courts besides the problematical but unnecessary disagreement about whether the stricter *Third Avenue* test is constitutionally required.[87] This conclusion is borne out even more strongly by the findings of the *Rock Island* reorganization court with which the Seventh Circuit supported its conclusion that the reorganization court had not abused its discretion in authorizing the trustee's proposal,[88] as these

83. *Columbus Option, supra* note 59, at 275.
84. 545 F.2d at 1088.
85. *See* the discussion of economic effect in *Columbus Option, supra* note 59.
86. *Id.*
87. *See* note 71 *supra*.
88. 545 F.2d at 1090-91.

findings sufficiently mirror the standards provided by the Third Circuit's less strict *Jersey Central* test. The reorganization court found that "reorganization is not clearly impossible:"[89] that the proposal was "essential to the continued operations of the road;" and that these expenditures would have a "direct beneficial effect on profitability."[90] Given additionally that alternative funding was practically impossible,[91] these findings seem quite sufficient under *Jersey Central* since the only missing *Jersey Central* factor of whether thereby the creditors would be prejudiced, seems likewise satisfied here if the invasion of mortgaged property in *Selkirk Yard* could have been sanctioned by the Third Circuit.[92]

89. *Id.*
90. *Id.*
91. *Id.* at 1088 & n.2.
92. The "thereby prejudice creditors" element seems only to be conclusory from the other elements of the *Jersey Central* test. But, possibly it means that if the source of the funds be mortgaged property, prejudice to creditors arises and then *Third Avenue* needs to be satisfied, although as the text points out *Selkirk Yard* convincingly suggests otherwise.