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BANKRUPTCY

INTRODUCTION

Sixteen bankruptcy cases resulted in published opinions by the Ninth Circuit during the past survey term.[1] The most significant cases decided by the court concerned the rights of a trustee in bankruptcy and a reclaiming seller under section 2-702(2) of the Uniform Commercial Code,[2] the question of appellate subject matter jurisdiction over a motion to transfer an adversary proceeding,[3] and the validity of a lien on corporate assets when the underlying note is unenforceable.[4]

1. On August 1, 1976, new Rules of Bankruptcy became effective. The areas covered by these rules include Chapter VIII, Bankruptcy Act §§ 75-77, 11 U.S.C. §§ 205-207 (1970) (section 77 railroad reorganization cases); Chapter IX, Bankruptcy Act §§ 81-84, 11 U.S.C. §§ 401-403 (1970) (municipal debt readjustment cases); Chapters I-VII, Bankruptcy Act §§ 1-72, 11 U.S.C. §§ 1-112 (1970) (straight bankruptcy); Chapter XI, Bankruptcy Act §§ 301-399, 11 U.S.C. §§ 701-799 (1970) (arrangements); and Chapter XIII, Bankruptcy Act §§ 601-686, 11 U.S.C. §§ 1001-1086 (1970) (wage earners' plans). These new rules have repealed much of the Bankruptcy Act, 11 U.S.C. §§ 1-1255 (1970), which is basically procedural in nature. The repeal has occurred pursuant to 28 U.S.C. § 2075 (1970), which authorizes the establishment of rules and provides that "[a]ll laws in conflict with such rules shall be of no further force or effect after such rules have taken effect."

Some of the newly adopted Bankruptcy Rules may be superseded by one of several new Bankruptcy Acts currently before Congress. In 1970, while the Bankruptcy Rules were being drafted, Congress created a Commission on the Bankruptcy Laws of the United States, which proposed a revision of the Bankruptcy Act that is currently pending as H.R. 31, 94th Cong., 1st Sess. (1975), and S. 236, 94th Cong., 1st Sess. (1975). In addition, The National Conference of Bankruptcy Judges has also submitted a bill which would completely revise the Bankruptcy Act. H.R. 32, 94th Cong., 1st Sess. (1975); S. 235, 94th Cong., 1st Sess. (1975). For further information regarding these pending revisions see Anderson, *A Digest of Broader Perspectives for Bankruptcy Court Reforms*, 81 COM. L.J. 240 (1976); Herzog, *The Proposed Amendments to the Rules of Bankruptcy Procedure*, 50 AM. BANKR. L.J. 283 (1976); Lee, *A Critical Comparison of the Commission Bill and the Judges' Bill for the Amendment of the Bankruptcy Act*, 49 AM. BANKR. L.J. 1 (1975); Rochelle, *Fifth Circuit Survey–Bankruptcy*, 6 TEX. TECH. L. REV. 455 (1975); Note, *The Proposed Bankruptcy Acts–Chapter IV, Part 6: Reshaping the Trustee's Sword*, 61 CORNELL L. REV. 257 (1976). These proposed revisions are a result of a widely accepted belief that the present bankruptcy system is inadequate. *See, e.g.*, D. STANLEY & M. GIRTH, BANKRUPTCY: PROBLEM, PROCESS, REFORM 4 (1971); Giles, *Is Bankruptcy Really Necessary? Potential Causes of Action Lost Upon Filing*, 25 DRAKE L. REV. 411 (1976).

2. *See* Lewis, Inc. v. Holzman (*In re* Telemart Enterprises, Inc.), 524 F.2d 761 (9th Cir. Sept., 1975) (per Choy, J.), *cert. denied*, 424 U.S. 969 (1976).

3. *See* Young Properties Corp. v. United Equity Corp. (*In re* Young Properties Corp.), 534 F.2d 847 (9th Cir. Apr., 1976) (per Carter, J.), *dismissing appeal from* 394 F. Supp. 1243 (S.D. Cal. 1975), *cert. denied*, 45 U.S.L.W. 3220 (U.S. Oct. 4, 1976).

4. *See* Walsh v. Paterna (*In re* National Tile & Terrazzo Co.), 537 F.2d 329 (9th Cir. Aug., 1976) (per Choy, J.).

In other areas of bankruptcy law, panels of the Ninth Circuit considered the standards applied by bankruptcy referees to review of expenses of administration,[5] the federal subject matter jurisdiction for controversies arising in reorganization proceedings[6] and suspension of the statute of limitations on collection of taxes during bankruptcy proceedings.[7]

I. OVERVIEW

A. Awards of Expenses of Administration

The Ninth Circuit has recently taken steps to clarify the standards applicable to a bankruptcy referee's determination of expenses of administration that may be awarded under the Bankruptcy Act. In *Whitten Management Corp. v. Wetzel (In re Ranchero Motor Inn, Inc.)*,[8] a Ninth Circuit panel declared that the policies underlying the Bankruptcy Act should set the standard for a bankruptcy referee's[9] review of expenses awarded to a company which had been engaged to manage a bankrupt business.[10] *Whitten* concerned a management company which sought review of the bankruptcy referee's decision that the company could not be reimbursed for certain expenses it incurred while managing the bankrupt business as a result of its willful gross negligence in rendering accountings of the business to the trustee.[11]

The district court upheld the referee's decision not to reimburse the company for some of its expenses and, on appeal, the Ninth Circuit affirmed. The *Whitten* court stated that a review of expenses to be awarded should not be limited to a considera-

5. *See* Whitten Management Corp. v. Wetzel (*In re* Ranchero Motor Inn, Inc.), 527 F.2d 1044 (9th Cir. Dec., 1975) (per Chambers, J.).

6. *See* Rochelle v. Marine Midland Grace Trust Co., 535 F.2d 523 (9th Cir. May, 1976) (per Hufstedler, J.).

7. *See* McAuley v. United States, 525 F.2d 1108 (9th Cir. Nov., 1975) (per Plummer, D.J.).

8. 527 F.2d 1044 (9th Cir. Dec., 1975) (per Chambers, J.). For a general discussion of the awarding of fees to attorneys and other persons who render services to a bankruptcy estate see Pickels, *Attorneys' Fees in Bankruptcy Proceedings*, 54 Tex. L. Rev. 762 (1976).

9. At the time of the events referred to in *Whitten*, a bankruptcy judge was known as a referee.

10. 527 F.2d at 1047. Bankruptcy Act § 62a(1), 11 U.S.C. § 102(a)(1) (1970) provides for the award of expenses incurred by persons who administer a bankruptcy estate:

> The actual and necessary costs and expenses incurred by officers . . . in the administration of estates shall . . . be . . . examined and approved or disapproved by the court . . . .

Bankruptcy Act § 1(9), 11 U.S.C. § 1(9) (1970), defines "court" as the judge or referee of the court of bankruptcy where the bankruptcy proceedings are pending.

11. 532 F.2d at 1046.

tion of the contract between the management company and the trustee and whether the expenses were necessary and actually incurred by the firm. Instead, the *Whitten* court engaged in an examination of the management company's actions and questioned whether the expenses incurred by the company were designed to further its own interest as a potential future owner of the business or were incurred simply to preserve the ongoing value of the business.[12] The Ninth Circuit found that the management company's furnishing of misleading accounting and financial information to the trustee justified the referee's decision not to reimburse it for some expenses. *Whitten* stated that improper conduct by those who render services to a bankruptcy estate could properly be penalized by the referee by withholding reimbursement for expenses incurred by the guilty party. In this case, the Ninth Circuit concluded that the referee's actions were proper, and the judgment of the district court was affirmed.[13]

Whitten is significant for its recognition that a bankruptcy referee must be allowed great discretion in determining the extent to which parties who have rendered services to a bankruptcy estate may be reimbursed. The decision in *Whitten* indicates that the Ninth Circuit will give great weight to a referee's determinations of the penalties to be imposed on service-rendering parties for their misconduct.[14]

B. Subject Matter Jurisdiction

Rochelle v. Marine Midland Grace Trust Co.[15] involved a reorganization trustee's suit against the former officers and directors

12. *Id.*

13. *Id.* at 1048.

14. For a discussion of the policies underlying the award of fees to parties who render services to a bankruptcy estate see S. Nadler & M. Nadler, The Law of Bankruptcy §§ 1-19 (1972).

In a related area, the Ninth Circuit considered standards applicable to the award of a reorganization trustee's fees in a corporate reorganization under Chapter X, Bankruptcy Act §§ 101-276, 11 U.S.C. §§ 501-676 (1970), in York Int'l Bldg., Inc. v. Chaney (*In re* York Int'l Bldg., Inc.), 527 F.2d 1061 (9th Cir. Oct., 1975) (per Kilkenny, J.). The Ninth Circuit focused primarily on three areas: (1) the success or failure of the reorganization proceeding; (2) the time spent on the proceeding including an estimate of efficiency, the accuracy of record-keeping and whether other interested parties contributed services; and (3) the hourly rate claimed by the trustee compared to rates paid other public officials, particularly that of the district judge passing on the award of the fees. A recent Ninth Circuit decision cited the *York* case and emphasized the third standard of the hourly rate claimed. Moshein v. Beverly Crest Convalescent Hosp., Inc. (*In re* Beverly Crest Convalescent Hosp., Inc.), No. 75-1047 (9th Cir., Dec., 1976).

15. 535 F.2d 523 (9th Cir. May, 1976) (per Hufstedler, J.).

of a debtor corporation and an independent certified public accountant. The trustee, Rochelle, sought relief for the defendants' violations of federal securities laws and for common law deceit and negligence. The district court dismissed the trustee's federal securities claims for failure to state a claim upon which relief may be granted. The district court also held that it did not have jurisdiction to hear Rochelle's common law claims, assuming that federal jurisdiction over these claims rested solely on pendent jurisdiction over the federal claims.[16]

The Ninth Circuit upheld the district court's dismissal of Rochelle's securities laws claims.[17] As to the common law claims, however, the court noted that a federal district court acting as a Bankruptcy Court does have jurisdiction to hear plenary suits brought by a reorganization trustee[18] even though "diversity or

16. Pendent jurisdiction has been defined as a "nonfederal claim which is so allied and the facts so interwoven with a federal claim that the court will accept jurisdiction over the subject matter even though it could not hear the claim if presented as a separate action." Ferguson, *Pendent Personal Jurisdiction in the Federal Courts*, 11 U. ILL. L. REV. 56, 57 n.4 (1965). Pendent jurisdiction had its origin in the Supreme Court decision in Osborn v. Bank of the United States, 22 U.S. (9 Wheat.) 738 (1824). Subsequent decisions of the Court have also recognized the doctrine. *See* Aldinger v. Howard, 96 S. Ct. 2413 (1976); Philbrook v. Glodgett, 421 U.S. 707 (1975); Moor v. County of Alameda, 411 U.S. 693 (1973); UMW v. Gibbs, 383 U.S. 715 (1966); Hurn v. Oursler, 289 U.S. 238 (1933); Siler v. Louisville & N.R.R., 213 U.S. 175 (1909). For other commentary on pendent jurisdiction see Lowenfels, *Pendent Jurisdiction and the Federal Securities Act*, 67 COLUM. L. REV. 474 (1967); Note, *Pendent Jurisdiction: An Expanding Concept in Federal Court Jurisdiction*, 51 IOWA L. REV. 151 (1965); Annot., 5 A.L.R.3d 1040.

17. Trustee Rochelle had asserted claims founded on section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78(b) (1970), and rule 10b-5, 17 C.F.R. § 240.10b-5 (1975). Rochelle alleged that the financial statements issued by the debtor corporation were "seriously misleading" and that the officers and directors participated in producing these misrepresentations. 535 F.2d at 529. Subsequently, the corporation issued debentures. While the Ninth Circuit recognized that the alleged misrepresentations and mismanagement did "taint the purity of the marketing of these debentures," *id.*, it stated the corporation itself lost no money as a result of their issuance:

> [The corporation] could not successfully sue because it lost nothing in its capacity as an investor on the issuance of the debentures. It received full value for the securities; that the directors later frittered away the funds on losing real estate ventures does not mean that the [corporation] suffered a loss compensable under the federal securities fraud laws.

Id. (footnote omitted). Since the causal nexus between the securities transaction and the alleged losses due to mismanagement was too attenuated, the *Rochelle* court concluded that the district court correctly dismissed the trustee's federal securities laws claims.

18. Bankruptcy Act § 2a(7), 11 U.S.C. § 11(a)(7) (1970), provides in part that bankruptcy courts are vested with original jurisdiction over proceedings under the Bankruptcy Act and over controversy determination relating to bankruptcy estates. Section 23 of the Bankruptcy Act, 11 U.S.C. § 46 (1970), however, has the effect of restricting jurisdiction for controversies to those courts where the bankrupt might have brought such actions had bankruptcy proceedings not been instituted. Thus, a separate basis for

other usual grounds for federal jurisdiction is lacking."[19] Consequently, the *Rochelle* court remanded the trustee's common law claims to the district court for further consideration.[20]

The Ninth Circuit's decision in *Rochelle* is important for its recognition of an alternative basis of federal jurisdiction for common law claims of corporate mismanagement in corporate reorganization. Prior to *Rochelle*, meritorious claims against corporate managements would often not be litigated in the federal courts because diversity of citizenship was lacking between the parties. Practitioners in the Ninth Circuit should become familiar with *Rochelle*'s recognition of an often overlooked basis for federal jurisdiction.

C. Suspension of Tax Statute of Limitations on Collection During Bankruptcy Proceedings

The question of when the statute of limitations for the collection of taxes is suspended during bankruptcy proceedings was presented in *McAuley v. United States*.[21] In *McAuley*, assessments for unpaid taxes were made by the government both shortly before and after bankruptcy petitions were filed by the plaintiffs. Just prior to the end of the nine-year proceedings, the government sought to collect the unpaid assessed taxes. The district court granted judgment to the government for the unpaid taxes.[22] On appeal, the plaintiffs contended that the six-year statute of limitations on the collection of assessed taxes had run.[23] In response, the government contended that the statute of limitations had been stayed during the entire time the bankruptcy estate had been open, so that the usual six-year limitation period had been extended.

Section 6503(b) of the Internal Revenue Code, relied upon by

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federal jurisdiction becomes necessary for federal determination of controversies in bankruptcy. In the case of reorganization proceedings, however, Congress saw fit to remove the section 23 restriction on federal jurisdiction over controversy determination by Bankruptcy Act § 102, 11 U.S.C. § 502 (1970). This elimination of the section 23 limitation has the effect of reviving the section 2a(7) broad grant of federal jurisdiction to include the determination of controversies in reorganization proceedings.

19. 535 F.2d at 531, *quoting* Williams v. Austrian, 331 U.S. 642 (1947).

20. 535 F.2d at 531.

21. 525 F.2d 1108 (9th Cir. Nov., 1975) (per Plummer, D.J.).

22. *Id.* at 1109-10. In *McAuley*, the taxpayers paid the employee taxes assessed against the partnership and subsequently brought this suit for a refund of taxes paid. The government then counterclaimed for the additional assessed, but unpaid, taxes.

23. I.R.C. § 6502(a)(1) provides for a six-year limitation on the collection of taxes after assessment.

the government in *McAuley*, provides that the statute of limitations on collection of taxes after assessment "shall be suspended for the period the assets of the taxpayer . . . are in the control or custody of the court in any proceeding before any court of the United States . . . and for 6 months thereafter.[24]

The Ninth Circuit rejected the government's contention that section 6503(b) stayed the statute of limitations as a matter of law. The court indicated that Congress did not intend that a court make a factual determination of when a taxpayer's assets were under its control in order to stay the running of a statute of limitations.[25] Thus, the Ninth Circuit concluded that section 6503(b) should not be interpreted to require unnecessarily difficult factual determinations.[26]

Instead, the *McAuley* court followed the position of the Fifth Circuit that the running of the statute of limitations is suspended only during the time that collection efforts by the government could possibly be hindered.[27] The court expressly rejected the government's contention, adopted by a district court in the Second Circuit,[28] that the period of limitations on collections is sus-

24. *Id.* § 6503(b).

25. 525 F.2d at 1110. Int. Rev. Code of 1954, ch. 66, § 6503(c), 68A Stat. 806 (amended 1966) provided that the statute of limitations for the collection of taxes was suspended when collection of the tax was hindered because the assets of a taxpayer were outside the United States. However, section 6503(c) was amended in 1966 to suspend the period of limitations during the time when the taxpayer, not his or her assets, was outside the country. *See* Federal Tax Lien Act of 1966, Pub. L. No. 89-719, §106, 80 Stat. 1139-40 (codified at I.R.C. § 6503(c)). By amending section 6503(c) in this manner, Congress hoped to avoid the difficult factual determination of when the assets were outside the country, as required under the original section. *See* S. REP. No. 1708, 89th Cong., 2d Sess. 3722, 3746 (1966). The *McAuley* court utilized the foregoing as evidence of a general congressional policy against introducing difficult factual determinations into statute of limitations questions in the tax collection area.

26. 525 F.2d at 1112.

27. *See* United States v. Verlinsky, 459 F.2d 1085 (5th Cir. 1972). In *Verlinsky*, the Court of Appeals for the Fifth Circuit interpreted the suspension of the statute of limitations set by section 6503(b) as ending when the taxpayer is discharged as bankrupt. *Id.* at 1088. *Verlinsky* clearly rejected the government's contention that the statute of limitations on collection was suspended from the time the bankruptcy estate is opened to the time until it is closed. The court focused on the bankrupt's right to "start afresh," and to divorce himself or herself from former holdings and debts. *Id. Contra*, United States v. Malkin, 317 F. Supp. 612 (E.D.N.Y. 1970). In *Malkin*, which involved a different partner but the same partnership as *Verlinsky*, the court concluded that the "in the control" and "in the custody" language of section 6503(b) referred to the time at which the bankruptcy referee signed an order closing the bankruptcy estate. Thus, the statute of limitations for collection would be stayed from the time of opening to the time of closing of the bankruptcy estate. This position was adopted by the government in *McAuley*, but was rejected by the Ninth Circuit.

28. *See* United States v. Malkin, 317 F. Supp. 612 (E.D.N.Y. 1970), discussed at note

pended from the time the bankruptcy estate is opened until the time it is closed. *McAuley* stated that the major hindrance on the collection rights of the government was the "confusion caused by the dividing of the bankrupt's property into exempt and nonexempt estates and the filing of creditors' claims against the estate."[29] Because such claims must be filed within six months of the first creditors' meeting,[30] the *McAuley* court reasoned that suspending the statute of limitations during this time allowed the government to fairly evaluate its rights as compared to those of other creditors. Thus, the court held that the statute of limitations was suspended until six months after the date of the first creditors' meeting, and for an additional six months thereafter as provided for in section 6503(b).[31]

Under the court's construction of the statute, the assets of the taxpayer are deemed to be in the control of the Bankruptcy Court only until the time for filing claims in bankruptcy proceedings has passed. In this respect, the Ninth Circuit differs from the position taken by the Fifth Circuit, which has held that assets in the bankruptcy estate cease to be assets of the taxpayer only at the time of discharge.[32] The Ninth Circuit's position on this issue appears to be the better view because it suspends the statute of limitations until the government has the information necessary to determine whether its claim can be satisfied from the estate or whether claim satisfaction will require proceeding against exempt or after-acquired property. The time difference between these two positions is ordinarily small.[33] However, even though the taxpayer has effectively given up all claim to the assets at the end of the claim filing period, the assets themselves remain "in the control

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27 *supra*.

29. 525 F.2d at 1113.

30. *See* note 33 *infra*.

31. 525 F.2d at 1115.

32. *See* note 27 *supra*. The government did not file a petition for certiorari in *McAuley* for two reasons: (1) I.R.C. § 6503(b) is rarely litigated in tax-bankruptcy cases; and (2) the actual difference in the time that the statute of limitations is suspended under either the *McAuley* rule or the *Verlinsky* rule is slight, consequently the government carries an equal burden of collection under either rule. Telephone interview with staff members of the U.S. Dep't of Justice, Washington, D.C. (Aug. 20, 1976).

33. The first meeting of creditors must be held sometime between ten and thirty days after the filing of the petition in individual voluntary bankruptcies. Bankruptcy Act § 55a, 11 U.S.C. § 91(a) (1970). Both the time of discharge and the time for filing claims are calculated from the time of the first creditors' meeting. Discharge is granted upon expiration of the time for filing objections to discharge which is fixed by the court at sometime between thirty and ninety days after the first creditors' meeting. Bankruptcy Act § 14b(1), 11 U.S.C. § 32(b)(1) (1970). The time for filing claims ends six months after the first creditors' meeting. Bankruptcy Act § 57n, 11 U.S.C. § 93n (1970). Provisions for

or custody of the court'' for a substantial period thereafter. Both circuit positions differ significantly from earlier interpretations of the language of section 6503(b) and from the position adopted by the government. Legislative clarification of the section should be sought to bring the statute into conformance with the *McAuley* decision.

II. RIGHT OF A RECLAIMING SELLER

A. INTRODUCTION

Alfred M. Lewis, Inc. v. Holzman (In re Telemart Enterprises, Inc.)[1] dealt with the relative rights of the reclaiming seller and the trustee in bankruptcy to the bankrupt's property under Uniform Commercial Code (U.C.C.) section 2-702(2).[2] The *Telemart* court held that since the state-created right of the reclaiming seller was neither a lien nor a priority, it should prevail over the trustee.[3] Shortly after beginning business as a corporation engaged in the selling and delivering of groceries, Telemart Enterprises, Inc. (Telemart) encountered operational difficulties and sought protection under the chapter XI Bankruptcy Act provisions for arrangements.[4] Alfred M. Lewis, Inc. had sold and delivered products on credit to Telemart for a period of twenty-nine days which ended four days prior to Telemart's filing for an arrangement. On the day following the filing of the petition, the seller learned of the proceedings and demanded return of the $61,000 in goods under the terms of U.C.C. section 2-702(2).[5] The bankruptcy judge de-

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extensions of time exist both for discharge and for the end-of-the-claim filing period. In most cases, however, the *McAuley* end-of-the-claim filing period will occur after the *Verlinsky* time-of-discharge choice.

1. 524 F.2d 761 (9th Cir. Sept., 1975) (per Choy, J.), *cert. denied*, 424 U.S. 969 (1976).

2. The *Telemart* court applied the California version of U.C.C. § 2-702(2) which is identical to the parallel section of the official amended U.C.C. *See* CAL. COMM. CODE § 2702(2) (West 1964), the text of which may be found in note 5 *infra*.

3. 524 F.2d at 765. A debt which is determined to be a priority is paid out of a bankruptcy estate before any payment is made to unsecured creditors. Priorities are limited to those created by Bankruptcy Act § 64, 11 U.S.C. § 104 (1970).

4. Bankruptcy Act §§ 301-399, 11 U.S.C. §§ 701-799 (1970).

5. CAL. COMM. CODE § 2702(2) (West 1964) provides:

> Where the seller discovers that the buyer has received goods on credit while insolvent he may reclaim the goods upon demand made within 10 days after the receipt, but if misrepresentation of solvency has been made to the particular seller in writing within three months before delivery the 10-day limitation does not apply. Except as provided in this division the seller may not base a right to reclaim goods on the buyer's fraudulent or innocent misrepresentation of solvency

nied the seller's claim on the basis of the fact that the seller had failed to prove the bankrupt's insolvency at any time prior to the filing of the petition. The district court affirmed without opinion, but on appeal, a Ninth Circuit panel reversed and remanded. The Ninth Circuit determined that the seller's right to reclaim was based on a rescission of the contract due to fraud and was therefore a valid defense against the bankruptcy trustee. In reaching this result, the court responded to two major arguments of the trustee.

B. Statutory Liens

First, the trustee asserted that the seller's reclaiming right under U.C.C. section 2-702(2) was invalid because it was a statutory lien which first became effective upon insolvency of the debtor and thus was invalidated by section 67c(1)(A) of the Bankruptcy Act.[6] The court rejected this argument and stated that Congress did not intend to reach the right of reclaiming sellers when section 67c(1)(A) was enacted in 1966.[7]

Section 60 of the Bankruptcy Act operates to invalidate attempts to prefer one creditor over another by voiding transfers "on account of an antecedent debt . . . by [a] debtor while insolvent and within four months [of the date of bankruptcy]. . . ."[8] The 1938 Chandler Act[9] incorporated liens into the definition of transfers, but at the same time it expressly excepted statutory liens from invalidation under section 60.[10] In addition to validating statutory liens, the Chandler Act eliminated previously allowed state priorities by introducing a federal scheme of priorities.[11]

Those creditors who had enjoyed state priorities prior to their elimination by the Chandler Act immediately sought to regain that special status by pressuring state legislatures to categorize

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or of intent to pay.

6. Bankruptcy Act § 67c(1), 11 U.S.C. § 107(c)(1) 1970, provides in pertinent part: "The following liens shall be invalid against the trustee: (A) every statutory lien which first becomes effective upon the insolvency of the debtor. . . ."

7. 524 F.2d at 764.

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

9. Act of June 22, 1938, ch. 575, § 1, 52 Stat. 842 (codified at 11 U.S.C. §§ 1-1255 (1970)). The Chandler Act amendments constituted a major revision to the Bankruptcy Act. For further discussion of the Chandler Act see *Legislation, Liens and Fraudulent Transfers Under the Chandler Act*, 87 U. Pa. L. Rev. 317 (1939).

10. Bankruptcy Act § 67b, 11 U.S.C. § 107(b) (1970).

11. Bankruptcy Act § 64, 11 U.S.C. § 104 (1970).

their priorities as statutory liens. In 1966, section 67c(1)(A)[12] was enacted to invalidate those state statutory liens which had been enacted since the Chandler Act and which were merely disguised state priorities.[13]

The *Telemart* court rejected the trustee's contention that U.C.C. section 2-702(2) since the "lien" involved did not *first* tory lien to escape the effect of the Chandler Act. The Ninth Circuit noted that a debtor's receipt of goods on credit while insolvent is deemed a fraud on the creditor under section 2-702(2), and thus the sale of goods is clearly defective from its inception.[14] Any "lien" involved in the transaction attached at the instant the debt between seller and buyer was created; no transfer on account of an antecedent debt has occurred in this transaction. Thus, the court concluded section 67c(1)(A) could not be used to invalidate U.C.C. section 2-702(2) since the "lien" involved did not *first* become effective on the insolvency of the debtor, as required by section 67c(1)(A).

C. State Priorities

The second assertion made by the trustee was that the right of the reclaiming seller was an attempt by the state to give a particular class of creditors, sellers of goods, a priority in bankruptcy. Since a state priority is in conflict with the exclusivity of the federal scheme of priorities established by section 64 of the Bankruptcy Act,[15] the trustee maintained that the state "priority" favoring the reclaiming seller should fail. The *Telemart* court, however, held that "a state confers a priority repugnant to section

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12. The text of section 67c(1)(A) may be found at note 6 *supra*.

13. *See* S. Rep. No. 1159, 89th Cong., 2d Sess. 2-7 (1966), *reprinted in* [1966] U.S. Code Cong. & Ad. News 2456. The enactment of this statute was a congressional attempt to strike a proper balance between two conflicting interests under the Bankruptcy Act: (1) the equitable distribution of the bankrupt's assets among all of his or her creditors; and (2) the congressional policy of recognizing state established property interests (liens). 524 F.2d at 764. For a discussion of the equities of the reclaiming seller see Note, *Commercial Law—UCC Section 2-702 Held Invalid Against Trustee in Bankruptcy*, 50 Tul. L. Rev. 961 (1976). For a presentation of the many theories under which trustees have claimed rights superior to those of the reclaiming seller see Bjornstad, *Reclamation of Goods by Unsecured Sellers in Bankruptcy Proceedings*, 24 Drake L. Rev. 357 (1975).

14. For a discussion of the seller's right of reclamation see Henson, *Reclamation Rights of Sellers Under Section 2-702*, 21 N.Y.L.F. 41 (1975).

15. 11 U.S.C. § 104 (1970).

64 only when it attempts to direct the disposition of assets to which the bankrupt has received a nondefeasible title."[16]

In support of its conclusion, the court reasoned that a priority could not have been accorded a seller by U.C.C. section 2-702(2), because the title transferred to the debtor was only a voidable title. The title was voidable, according to the court, because a debtor's receipt of goods on credit while insolvent is deemed a fraud on the creditor, rendering the sale voidable. The *Telemart* court considered the reclaiming right to be the "exact equivalent of the common law remedy of rescission . . . ,"[17] which allows the voiding of a contract because of fraud or misrepresentation. Upon exercise of the reclaiming seller's right, the title, along with the transaction, would be voided. Since the debtor had never possessed the full powers of ownership, the state was not establishing a priority over the unsecured creditors by allowing the seller to reclaim the merchandise.

D. Conclusion

The arguments employed by the *Telemart* court establish the reclaiming seller's right as beyond the reach of the statutory language prohibiting (1) preferences; (2) statutory liens which first arise on insolvency; and (3) state priorities. The right is not a preference as it is not granted on account of antecedent debt and it merely returns to the creditor the goods that equitably are his or hers. While the reclaiming right might initially seem to fall within the prohibition against statutory liens first arising on insolvency, *Telemart* emphasizes that the right arises when the debtor is already insolvent, that is, the insolvency precedes the right. The right is not a state priority, but is merely a preservation of a legitimate state defined property interest. More importantly, *Telemart* advances a fundamental purpose of the Bankruptcy Act by insuring the equitable distribution of the bankrupt's assets. Although other courts have not adopted the Ninth Circuit position,[18] the decision establishes valid standards for upholding the legitimate, equitably–sound and state–sanctioned right of the re-

16. 524 F.2d at 765-66.

17. *Id.* at 765.

18. *See In re* Federal's, Inc., 402 F. Supp. 1357 (E.D. Mich. 1975); *In re* Good Deal Supermarkets Inc., 384 F. Supp. 887 (D.N.J. 1974), (held U.C.C. § 2-702(2) is a statutory lien which is invalidated by section 67c(1)(A)). The *Federal's* court reviewed the order of a Bankruptcy Court which denied the seller's right to recover merchandise against a

claiming seller over the bankruptcy trustee. From a commercial point of view, it is not practicable for small sellers to perfect liens

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buyer's receiver. The merchandise had been sold and delivered on credit to the buyer just before the filing of the petition for an arrangement. *Federal's* initially held that Michigan law itself would have found the receiver had rights superior to those of a reclaiming seller. The *Federal's* court then went on to examine the conclusions of the Bankruptcy Court. First, the court found that MICH. COMP. LAWS ANN. § 440.2702(2) (1967) (U.C.C. § 2-702(2)) was a state-created priority in conflict with section 64 of the Bankruptcy Act. 402 F.2d at 1367. The court concluded that the right to reclaim under section 2-702(2) is a statutory lien which attaches only upon the insolvency of the debtor and is, therefore, invalid as against the trustee or receiver in bankruptcy by virtue of section 67c(1)(A) of the Bankruptcy Act. *Id.* at 1367. In light of these conclusions, the district court affirmed the decision of the Bankruptcy Court.

The *Federal's* court based its analysis on a Michigan statute which is an old version of current U.C.C. § 2-702(3). The old version of section 2-702(3) subordinated the rights of a reclaiming seller to those of a lien creditor. Since the bankruptcy trustee was considered to be a lien creditor in *Federal's*, the reclaiming seller was subordinated to the rights of the bankruptcy trustee. This analysis is inapplicable to *Telemart* because the current U.C.C. § 2-702(3), adopted by California, eliminates the subordination of the rights of the reclaiming seller to a lien creditor.

The current version of U.C.C. section 2-702(3) was enacted largely in response to the holding in *In re* Kravitz, 278 F.2d 820 (3d Cir. 1960). After determining that the right of the reclaiming seller was expressly made subject to a lien creditor by section 2-702(3) and that U.C.C. section 9-301(3) included a bankruptcy trustee within the scope of a lien creditor, the *Kravitz* court looked to Pennsylvania law for a determination of the relative priorities of the reclaiming seller and the lien creditor. Pre-U.C.C. Pennsylvania law adopted the minority position which subordinated the right of a reclaiming defrauded seller to the right of a lien creditor. The *Kravitz* case has been construed by some commentators as authority for giving the trustee in bankruptcy priority over the reclaiming seller's right to rescind the contract in all cases. *See* Kennedy, *The Interest of a Reclaiming Seller under Article 2 of the Code*, 30 BUS. LAW., 833, 841 (1975). To date, only 13 states, including California, have adopted the current version of U.C.C. § 2-702(3). *See* 3A BENDER'S UNIFORM COMMERCIAL CODE SERVICE § 13-03[4][iii] (1976).

For a decision involving a seller's cash sale (as opposed to a credit sale) to an insolvent buyer see Stowers v. Mahon (*In re* Samuels & Co.), 526 F.2d 1238 (5th Cir. 1976), *cert. denied*, 97 S. Ct. 98 (1977). *Samuels* is discussed in Burke, *Secured Transactions*, 31 BUS. LAW. 1583, 1598-99 (1976).

In re Mel Golde Shoes, Inc., 403 F.2d 658 (6th Cir. 1968), involved a demand for reclamation which was made before bankruptcy, but the demand was made after the intervention of two actual lien creditors. Since the right of the reclaiming seller was not a security interest, the court looked to state law for determination of their relative rights. The court held that the reclaiming seller prevailed over the actual intervening lien creditors. *Id.* at 661. However, the issue of whether a bankruptcy trustee is a lien creditor was not presented. Therefore, possible conflicts between the U.C.C. and the Bankruptcy Act were not resolved.

In Ray-O-Vac v. Daylin, Inc. (*In re* Daylin, Inc.), No. 02958 (C.D. Cal., Aug. 14, 1975), *noted* in 50 AM. BANKR. L.J. 87, 187-88 (1976), the bankruptcy judge held that the U.C.C. section 2-702(2) right of a reclaiming seller was invalid against the trustee as a statutory lien under both section 67c(1)(A) and section 67c(1)(B). The latter section invalidates a statutory lien not perfected or enforceable at the date of bankruptcy as against one acquiring the rights of a bona fide purchaser from the debtor on that date.

on what are anticipated to be short-term credit sales.[19] *Telemart* retains for such sellers the long established common law right to rescind when defrauded.[20]

III. APPEALABILITY OF MOTIONS TO TRANSFER

A. INTRODUCTION

The subject matter jurisdiction of the courts of appeals in bankruptcy cases is governed by section 24a of the Bankruptcy Act.[1] Section 24a has uniformly been interpreted, by courts and commentators, as permitting appeals of (1) either interlocutory or final orders from proceedings in bankruptcy; and (2) final orders from controversies arising in proceedings.[2] Thus, any time a fed-

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The bankrupt did business in six states, two of which had adopted the current version of U.C.C. § 2-702(3), which deletes the subordination of a reclaiming seller to a lien creditor. Therefore, it is unclear on which version of U.C.C. § 2-702(3) the court actually based its decision.

19. For a discussion of how U.C.C. section 2-702(2) might be modified to eliminate an "unwarranted" protection for the imprudent reclaiming seller who fails to follow otherwise required procedures to obtain a secured interest in the goods sold see Note, *Bankruptcy—Reclamation Right of Seller Under Section 2-702(2) of the Uniform Commercial Code Is Valid Against Trustee in Bankruptcy*, 7 TEX. TECH. L. REV. 702, 707-08 (1976). *See also* Staff Letter No. 1066 of the Federal Reserve Board Truth in Lending Staff Letters, June 4, 1976, *reprinted in* [1976] 5 CONS. CREDIT GUIDE (CCH) ¶ 31,406, which interprets the seller's right of reclamation granted by section 2-702(2) as a right other than a security interest. The staff letter states that this position is in conformance with the fact that the right is not considered a security interest under the Code itself.

20. Invalidating the right of the reclaiming seller against the trustee in bankruptcy is contrary to pre-Code law. *See, e.g.*, 4A W. COLLIER, BANKRUPTCY ¶ 70.41(1) (14th rev. ed. 1975). U.C.C. section 2-702(2) does not change pre-Code law which allows a defrauded seller to rescind. It merely eases the burden on the seller by establishing a presumption of fraud by the buyer in accepting goods while insolvent. U.C.C. § 2-702(2) Comment 2.

1. Bankruptcy Act § 24a, 11 U.S.C. § 47a (1970) provides:

> The United States courts of appeals . . . are . . . invested with appellate jurisdiction from the several courts of bankruptcy in their respective jurisdictions in proceedings in bankruptcy, either interlocutory or final, and in controversies arising in proceedings in bankruptcy, to review, affirm, revise, or reverse, both in matters of law and in matters of fact. . . .

2. *See In re* Durensky, 519 F.2d 1024, 1027 (5th Cir. 1975); Diamond Door Co. v. Lane-Stanton Lumber Co., 505 F.2d 1199, 1202-03 n.4 (9th Cir. 1974); *In re* Merle's Inc., 481 F.2d 1016, 1017 (9th Cir. 1973); Trieber v. England, 237 F.2d 117, 118 (9th Cir. 1973); 2 W. COLLIER, BANKRUPTCY ¶ 24.27[2], at 762 (14th rev. ed. 1976); 9 MOORE'S FEDERAL PRACTICE ¶ 110.19[5], at 222 (2d rev. ed. 1975).

Conflicting uses of the terms controversies and proceedings in federal statutes and court decisions have often led to confusion over their precise meaning. Bankruptcy Act §§ 2a(7), 23a, 11 U.S.C. §§ 11(a)(7), 46(a) (1970), contain references to "controversies" in

eral court of appeals is faced with the question of whether an order in a bankruptcy case is appealable, it must determine whether the order involved is final or interlocutory and whether the order arises from a controversy or a proceeding in bankruptcy.

In *Young Properties Corp. v. United Equity Corp. (In re Young Properties Corp.)*,[3] a Ninth Circuit panel considered, as a question of first impression, whether an order denying a motion to transfer an adversary proceeding in bankruptcy constituted an interlocutory or a final order. The court was required to determine whether the denial was appealable. The court also resolved the proceedings-controversy question as it applied to this case. In *Young*, a petition had been filed for an arrangement under chapter XI of the Bankruptcy Act.[4] The Bankruptcy Court authorized Young Properties Corporation to continue conducting its business as a debtor in possession with the title and powers of a trustee in bankruptcy under section 342 of the Bankruptcy Act.[5] Subsequently, the debtor in possession filed a complaint seeking damages against the defendant, United Equity Corporation, for breach of contract. A timely motion under Bankruptcy Rule 782[6] was filed by the defendant to transfer the adversary proceeding[7] to

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various contexts, while Bankruptcy Act §§ 23a, 24a, 11 U.S.C. §§ 46(a), 47(a) (1970) refer to "proceedings" in different contexts. For a general discussion of the distinction between "proceedings" and "controversies" see 2 W. COLLIER, *supra* ¶ 24.08.

3. 534 F.2d 847 (9th Cir. Apr., 1976) (per Carter, J.), *cert. denied*, 45 U.S.L.W. 3220 (U.S. Oct. 4, 1976).

4. 11 U.S.C. §§ 301-399 (1970).

5. *Id.* § 742.

6. BANKR. R. 782 reads:

> Upon notice and hearing afforded the parties, any adversary proceeding may, in the interest of justice and for the convenience of the parties, be transferred by the court to any other district and shall thereafter continue as if originally filed in such district. An adversary proceeding transferred under this rule shall be referred to a referee by the clerk of the court to which it has been transferred.

The district court indicated that there were no published decisions dealing with rule 782 prior to this case. Young Properties Corp. v. United Equity Corp., 394 F. Supp. 1243, 1244 (S.D. Cal. 1975).

7. "Adversary proceeding" is defined in BANKR. R. 701 as follows:

> The rules of this Part VII govern any proceeding instituted by a party before a bankruptcy judge to (1) recover money or property, other than a proceeding under Rule 220 [examination of bankrupt's transactions with his or her attorney] or Rule 604 [accounting by custodian of property of estate prior to proceedings], (2) determine the validity, priority, or extent

the federal district court where its principal place of business was located. The Bankruptcy Court denied the motion and the district court affirmed the denial. The Ninth Circuit dismissed the subsequent appeal as a result of lack of subject matter jurisdiction.

B. Interlocutory Orders and Proceedings or Controversies in Bankruptcy

The *Young* court stated that since the court of appeals is a court of limited jurisdiction, an affirmative grant of authority is always required to constitute a basis for jurisdiction. To determine whether a denial of a motion to transfer under rule 782 is interlocutory or final for purposes of appellate jurisdiction, the court examined analogous provisions of the Bankruptcy Act. The court determined that the provisions most like rule 782 in nature are Bankruptcy Rule 116[8] and sections 1404[9] and 1406[10] of the Judicial Code. These statutes are essentially rules of venue, as is rule 782, and orders under these statutes have generally been held to be interlocutory.[11] Based on the similarity of the statutes, the court held that an order denying a transfer under rule 782 was interlocutory in nature.[12]

> of a lien or other interest in property, (3) sell property free of a lien or other interest for which the holder can be compelled to take a money satisfaction, (4) object to or revoke a discharge, (5) obtain an injunction, (6) obtain relief from a stay as provided in Rule 401 or 601, or (7) determine the dischargeability of a debt. Such a proceeding shall be known as an adversary proceeding.

8. Bankr. R. 116 revises and extends Bankruptcy Act § 32, 11 U.S.C. § 55 (1970). Its net effect is to permit the Bankruptcy Court to transfer the entire bankruptcy proceeding. Bankruptcy Rules are prescribed by the Supreme Court and, like the Federal Rules of Evidence and Procedure, Bankruptcy Rules supersede all laws with which they conflict, but may not abridge, enlarge, or modify any substantive right. *See* 28 U.S.C. § 2075 (1970).

9. 28 U.S.C. § 1404(a) provides in pertinent part: "For the convenience of parties and witnesses, in the interest of justice, a district court may transfer any civil action to any other district or division where it might have been brought."

10. *Id.* § 1406(a) (1970) provides in pertinent part: "The district court of a district in which is filed a case laying venue in the wrong division or district shall dismiss, or if it be in the interest of justice, transfer such case to any district or division in which it could have been brought."

11. In *Young*, the court stated that "[t]he Ninth Circuit, along with other circuits, has continued to hold that orders respecting venue entered under section 1404(a) and section 1406(a) are interlocutory in nature." 534 F.2d at 852. *See, e.g.*, Pacific Car & Foundry Co. v. Pence, 403 F.2d 949, 951 (9th Cir. 1968); Shapiro v. Bonanza Hotel Co., 185 F.2d 777, 778-79 (9th Cir. 1950).

12. 534 F.2d at 852.

The panel considered next the proceedings-controversy problem. Proceedings is the term generally used to refer to the administrative procedures utilized in the liquidation and distribution of a bankrupt's estate.[13] On the other hand, the term controversy is used to describe the situation where a third party asserts some right hostile either to the title of the trustee or to the right of the court to administer the particular bankruptcy estate; not where a third party asserts a claim under the administration of the bankrupt's estate.[14] In *Young*, the defendants intended to assert a right hostile to the title of the debtor-trustee, namely, a denial of liability for breach of contract.[15]

The court cited *Goldie v. Carr*[16] as a similar factual situation which was characterized as a controversy arising in bankruptcy proceedings.[17] In *Goldie*, an action was initiated to enforce performance of a contract and to recover money allegedly due and payable to the bankruptcy estate. The *Young* court found that the case before it presented a fact situation similar to that involved in *Goldie* since the debtor-trustee was suing on a breach of contract claim which sought damages that would be included in the bankruptcy estate. The Ninth Circuit thus concluded that the *Young*

13. *See In re* National Fin. & Mortgage Corp., 96 F.2d 74, 75 (9th Cir. 1938).

14. One court has clearly distinguished "a controversy arising in proceedings in bankruptcy" from a "proceeding in bankruptcy":

> A controversy arising in proceedings in bankruptcy has generally been held to embrace disputes between the trustee and adverse claimants concerning the right and title to the bankrupt estate. Proceedings in bankruptcy, on the other hand, refer to matters affecting merely the administration and distribution of the estate.

In re Imperial "400" Nat'l, Inc., 391 F.2d 163, 167 (3d Cir. 1968), *quoting In re* Christ's Church of the Golden Rule, 172 F.2d 523, 524 (9th Cir. 1949).

15. Controversies affect only the size of the estate which will ultimately be distributed among the unsecured creditors. 2 W. COLLIER, *supra* note 2, ¶ 24.28.

16. 116 F.2d 335 (9th Cir. 1940).

17. For examples of additional fact situations involving the categorizing of "proceedings" and "controversies" see PRACTISING LAW INSTITUTE, LITIGATION WITH THE BANKRUPTCY AND REORGANIZATION RECEIVER AND TRUSTEE 109, 110 (1975). A recent case is helpful in distinguishing between proceedings, controversies and "cases." In an unreported opinion, Danning v. Loeffler, No. 3294 (9th Cir., Nov. 19, 1975), *cert. denied*, 44 U.S.L.W. 3593 (U.S. Apr. 19, 1976), the Ninth Circuit dismissed an appeal for lack of subject matter jurisdiction. The court's decision was based on the fact that the interlocutory order for submitting the bankrupt's reorganization plan to the Securities and Exchange Commission for its examination and a report (pursuant to Bankruptcy Act § 172, 11 U.S.C. § 572 (1970)) did not arise in a "proceeding" but rather in a "controversy arising in bankruptcy." Thus, the interlocutory order was held not to be appealable under Bankruptcy Act § 24a, 11 U.S.C. § 47(a) (1970).

facts involved a controversy, and not a proceeding, in bankruptcy.[18]

C. Conclusion

In light of its conclusions, the *Young* court held that section 24 of the Bankruptcy Act did not confer subject matter jurisdiction in this instance because (1) the order denying the motion to transfer the adversary proceeding was interlocutory; and (2) the case was a controversy, rather than a proceeding.[19] Courts have had much difficulty in the past distinguishing controversies from proceedings and interlocutory orders from final orders. Factual situations have required determination on a case-by-case basis. Aside from *Goldie*, no previous case seems to have dealt with a contractual issue such as the *Young* facts presented. Thus, the *Young* case provides a useful precedent for a contract issue in the bankruptcy proceeding-controversy context. The Ninth Circuit has also rendered a service to bankruptcy practitioners by clarifying the considerations necessary for application of Bankruptcy Rule 782,[20] and it is felt that other circuits would be well advised to follow the *Young* court's approach in this area.

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18. 534 F.2d at 853.

19. *Id.* The *Young* court considered the Advisory Committee's Note to Bankr. R. 782 and found it to be in conflict with Bankruptcy Act § 24a, 11 U.S.C. § 47(a) (1970). Therefore, the note was disregarded by the court. For the text of the note see Bankruptcy Act and Rules, Part 2, at 961 (Collier pam. ed. 1976). The Advisory Committee Note states that an order transferring or retaining an adversary proceeding under Bankr. R. 782 should be reviewable on appeal in the same manner as an order transferring or retaining a bankruptcy case under Bankruptcy Act § 32, 11 U.S.C. § 55 (1970). Both rule 782 and section 32 authorize transfers of cases with regard to venue. However, bankruptcy jurisdiction is awarded to circuit courts under section 24a only for interlocutory orders which arise in a proceeding, not for interlocutory orders arising in a controversy. Since section 32 interlocutory orders arise only in bankruptcy cases, which are proceedings, such orders are therefore appealable. On the other hand, rule 782 interlocutory orders arise in adversary proceedings which may be either proceedings or controversies. *See* Bankr. R. 701, *supra* note 7, for the definition of adversary proceedings. Therefore, the *Young* court found that the Advisory Committee Note was too broad in scope because it stated that interlocutory orders arising in controversies as well as proceedings could be appealed. 534 F.2d at 854.

20. The Ninth Circuit interpreted another new rule in Wood v. Richmond (*In re* Branding Iron Steak House), 536 F.2d 299 (9th Cir. May, 1976) (per Ely, J.). Bankr. R. 802(a)(3) lengthens the otherwise firm ten-day limit under Bankruptcy Act § 39c, 11 U.S.C. § 67(c) (1970), for appeal of Bankruptcy Court decisions to the district court. *Wood* held that the filing of a motion to reconsider acted as a motion under Bankruptcy Rule 923 to alter or amend the judgment. A motion under rule 923 is one of the exceptions listed in rule 802(b) that extends the time limit on appeal. The *Wood* court based its decision on the waste of judicial resources which would result if an appeal were required to be filed while a motion to reconsider was still pending approval or denial.

IV. STOCK REPURCHASE AGREEMENTS

The validity of stock repurchase agreements executed prior to the time of corporate insolvency is a complex question that arises most often in the context of bankruptcy, especially when the terms of the repurchase agreement call for payment in installments under a promissory note secured by a mortgage on corporate assets. *Walsh v. Paterna (In re National Tile & Terrazzo Co.)*[1] dealt with the question of the validity of a lien on corporate assets when the underlying note was made unenforceable by state law, a question of first impression under California law.[2]

In *National*, a shareholder sold her entire equity interest back to the corporation. In exchange, she received a cash downpayment and a promissory note payable over six years. The note was secured by a deed of trust on corporate real property. The corporation made the installment payments to the former shareholder for three and one-half years, but shortly thereafter the corporation filed a voluntary petition in bankruptcy. When the former shareholder filed a lien claim in the bankruptcy proceedings, the claim was denied by the bankruptcy judge, a decision subsequently affirmed by the district court. On appeal, the Ninth Circuit reversed.

A. Enforceability of the Lien

The *National* court first found that the note received by the shareholder was unenforceable under California law which prohibited a corporation's purchase of shares previously issued unless the shares were acquired out of earned surplus.[3] However,

1. 537 F.2d 329 (9th Cir. Apr., 1976) (per Choy, J.).

2. The court stated: "In interpreting and applying state law we ordinarily defer to the judgment of the district court, located in that state. [But California] precedents appear to us to be inadequate to answer the immediate question. . . . We must, therefore, express our own view. . . ." *Id.* at 331.

3. Cal. Corp. Code § 1707(c) (West 1955) (repealed 1977). One commentator has noted that a proper interpretation of the law in force at the time of *National* might have called for a finding that the note was enforceable. 10 Loyola L.A.L. Rev. 254, 261 (1976). However, the point is now moot as the new California Corporations Code, which became effective January 1, 1977, makes an installment note, given as payment for repurchased stock, unenforceable if there are inadequate retained earnings (formerly earned surplus) or if the payment would make the corporation insolvent at the time of *any* of the installment payments. This rule looks to the time of payment for measurement of retained earnings, despite an earlier contract execution date. Law of Sept. 12, 1975, ch. 682, § 7, 1975 Cal. Stats. —, *as amended*, Law of Aug. 27, 1976, ch. 641. 1976 Cal. Stats. §§ 166, 500, 501.

the shareholder argued that she still had a valid claim against the bankruptcy estate based on her deed of trust. Although *National* recognized that past California decisions contained language to the effect that such a lien could not be effective if the underlying debt were invalid,[4] it distinguished these decisions on the ground that the underlying debts involved were invalid from their inception. The Ninth Circuit noted that other California decisions had held that a lien does not lose its validity where an initially valid debt, not discharged by the creditor, has become unenforceable because the statute of limitations has run.[5]

B. Purpose of the Law

The *National* court was aware that a similar factual situation had not been previously dealt with in California decisions. Consequently, the court looked to the purpose behind the enactment of the California law in order to determine whether the lien was valid. The Ninth Circuit found that the California law was "enacted for the benefit of the corporation as a whole, its creditors and stockholders other than the participating stockholder."[6] In view of the purpose of the statute, the *National* court reasoned that holding a shareholder lien ineffective would be disadvantageous to the corporation and to its shareholders. If the shareholders selling stock back to a corporation cannot rely upon a lien to insure payment of the amounts owed to them, they would most probably demand complete payment from the corporation at the time of sale. This would compel the corporation to borrow funds from an outside lender to enable it to complete the repurchase of stock and would most likely expend a portion of the corporation's line of credit.[7] The Ninth Circuit rejected the argument that protection of the corporation's creditors requires such a limitation on corporate operations.

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4. *See* Coon v. Shry, 209 Cal. 612, 615, 289 P. 815, 816 (1930); Fleming v. Kagan, 189 Cal. App. 2d 791, 796, 11 Cal. Rptr. 737, 740 (2d Dist. 1961).

5. 537 F.2d at 331. *See* Puckhaber v. Henry, 152 Cal. 419, 423-24, 93 P. 114, 116 (1907); Howell v. Dowling, 52 Cal. App. 2d 487, 496, 126 P.2d 630, 635 (1942).

6. 537 F.2d at 332, *quoting* Tiedje v. Aluminum Taper Milling Co., 46 Cal. 2d 450, 455, 296 P.2d 554, 557 (1956). Judge Goodwin, dissenting in *National*, was not satisfied that the policy reasons enunciated by the majority were not outweighed by equally valid policy reasons underlying Cal. Corp. Code § 1707 (West 1955) (repealed 1977), namely, the protection of creditors of small, closely-held, corporations. 537 F.2d at 333.

7. It would seem, however, that corporate borrowing from a selling shareholder (by repurchasing shares and paying for them with a promissory note) would have the same effect as borrowing from an outside lender. The corporation can expect to pay interest

The *National* court reasoned that the real property lien involved had to be recorded in order to be enforced, thus giving subsequent creditors constructive notice of an outstanding corporate encumbrance.[8] Furthermore, the court noted that if the corporation had chosen to pay the shareholder in cash at the time of the purchase agreement and, in so doing, had borrowed funds from an outside lender mortgaging the same property, then the lien would be valid, but its effect would be equally detrimental to corporate creditors. Since the interests of the corporation, other shareholders and creditors are adequately protected without invalidation of the lien, the *National* court held that the shareholder's deed of trust was enforceable in bankruptcy.[9] This holding, the court noted, is consistent with the purposes of the California statutes which control the transactions that had occurred in *National*. The court relied on a Minnesota Supreme Court decision, *Tracy v. Perkins-Tracy Printing Co.*,[10] to support its holding.

C. Conclusion

It appears that the Ninth Circuit was strongly moved by the equities of the factual situation involved in *National*, and therefore may have based part of its decision on equitable principles alone,[11] although the court never explicitly acknowledged this.

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to its selling shareholders, and the same asset is pledged as the outside lender would require for security. Moreover, the potential credit line is equally as consumed by the promissory note to the selling shareholder as it would be if the note were given to the outside lender to finance the purchase of the shares.

8. The subject of notice to subsequent creditors has been discussed by another court:

> In contrast to the normal valid commercial transactions for which U.C.C.'s innovation of notice filing was devised, a repurchase of stock depletes a corporation's assets without any consideration of value to creditors moving to the corporation in return. Such cases as there are reflect a recognition of the unusual character of such transactions and hence suggest a distinction between the notice required to prevent subsequent creditors from challenging a security created in connection with an obligation that was and remains valid and the notice required to subordinate subsequent creditors to a lien securing an obligation that is no longer enforceable against the corporation.

Gold v. Lippman (*In re* Flying Mailmen Serv., Inc.), 539 F.2d 866, 870-71 (2d Cir. 1976).

9. 537 F.2d at 332.

10. 278 Minn. 159, 153 N.W.2d 241 (1967).

11. For a useful discussion of the equity powers of bankruptcy courts see *In re* Elkins-Dell Mfg. Co., 253 F. Supp. 864 (E.D. Penn. 1966); *In re* DeMoise, 87 F. Supp. 474 (N.D. Ohio 1949).

Consequently, the precedential effect of the court's decision may be limited. This conclusion is supported by the fact that the court itself emphasized "two significant factual circumstances"[12] which influenced its conclusions. First, the corporation involved in *National* possessed sufficient earned surplus when it made the purchase agreement with the shareholder and thus could have legally paid the whole amount due at that time. Second, the court made it clear that it believed that no fraud had occurred in the transaction between the shareholder and the corporation. The Ninth Circuit's special emphasis on the factual circumstances involved in *National* may provide subsequent courts with the opportunity to restrict the decision to its facts.[13]

Helen Coyne-Hoerle

12. 537 F.2d at 331.

13. In Gold v. Lippman (*In re* Flying Mailmen Serv., Inc.), 539 F.2d 866 (2d Cir. 1976), the Second Circuit recently applied New York law to subordinate a former shareholder's lien on corporate assets to the claims of subsequent creditors. The court indicated that installment payments may not be made in New York on a repurchase agreement by an insolvent corporation even though the agreement itself may have been made when the corporation had a surplus sufficient to cover the entire purchase price. *Id.* at 867. However, the Second Circuit stated that if subsequent creditors of the corporation had notice of the shareholder's lien, the lien could be enforced. *See* Cross v. Beguelin, 252 N.Y. 262, 265-66, 169 N.E. 378, 379 (1929). On the facts before it, the *Gold* court found that the shareholder's filing of a financing statement covering the stock repurchase agreement and perfecting his security interest in the corporation's property did not provide the requisite degree of notice to corporate creditors. *Id.* at 870.