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li. Bankruptcy

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courts concur, however, that determining admiralty jurisdiction on the basis of locality alone is inconsistent with the purpose of the jurisdictional grant.⁵⁵

The Fourth Circuit holding in *Moore* is consistent with the Supreme Court's holding in *Executive Jet*⁵⁶ and is in harmony with the purpose behind the Constitution's grant of admiralty jurisdiction.⁵⁷ The framers of the jurisdictional grant in the Constitution, recognizing that conflicting and changing state laws would detract from the smooth flow of interstate and international maritime commerce,⁵⁸ sought to protect the domestic shipping industry through the development and application of a uniform and specialized body of law by neutral federal courts.⁵⁹ Before *Executive Jet*, some courts sustained admiralty jurisdiction in cases that bore no relationship to the type of activity that the jurisdictional grant was created to serve.⁶⁰ In *Executive Jet*, the Supreme Court recognized this divergence from the framer's intent and required that the wrong bear a significant relationship to traditional maritime activity.⁶¹ The Fourth Circuit's decision in *Moore* reflects the *Executive Jet* philosophy.

SCOTT A. STOREY

II. BANKRUPTCY

One of the primary objectives of the law of bankruptcy is to provide a method of collecting a debtor's assets so that they may be used to satisfy

mishap on dam-obstructed water lacks relationship to maritime commerce) with *Kelly v. United States*, 531 F.2d 1144 (9th Cir. 1975) (failure of United States Coast Guard to rescue drowning victim whose sailboat had capsized; relationship held to exist); *St. Hilaire Moye v. Henderson*, 496 F.2d 973 (8th Cir. 1975) (boating accident on Arkansas River held to fulfill maritime nexus requirement); and *Kelly v. Smith*, 485 F.2d 520 (5th Cir. 1973) (boat-to-shore gun battle on Mississippi River held to fulfill requirement of maritime relationship).

⁵⁴ See note 53 *supra*. The disunity is especially notable in the area of pleasure boat torts. See Note, *Admiralty Jurisdiction Over Pleasure Craft Torts*, 36 MD. L. REV. 212 (1976); Comment, *Torts On Inland Waters—Admiralty Jurisdiction*, 39 MO. L. REV. 28 (1974); Note, *Pleasure Boat Torts In Admiralty Jurisdiction: Satisfying The Maritime Nexus Standard*, 34 WASH. & LEE L. REV. 121 (1977).

⁵⁵ *E.g.*, *Kelly v. United States*, 531 F.2d 1144, 1146 (9th Cir. 1975); *Adams v. Montana Power Co.*, 528 F.2d 437, 439 (9th Cir. 1975); *St. Hilaire Moye v. Henderson*, 496 F.2d 973, 976 (8th Cir. 1974); *Kelly v. Smith*, 485 F.2d 520, 523-24 (5th Cir. 1973).

⁵⁶ See note 7 *supra*.

⁵⁷ See text accompanying note 5 *supra*.

⁵⁸ Putnam, *supra* note 1, at 469; 48 IND. L. J. 87, 87-88 (1972).

⁵⁹ *Adams v. Montana Power Co.*, 528 F.2d 437, 439 (9th Cir. 1975); *Crosson v. Vance*, 484 F.2d 840 (4th Cir. 1973); *Deutsch*, *supra* note 3, at 118; 48 IND. L.J. 87, 87-88 (1972).

⁶⁰ *Executive Jet Aviation, Inc. v. City of Cleveland*, 409 U.S. at 255-66 (1972), *citing*, *Davis v. City of Jacksonville Beach*, 251 F. Supp. 327 (M.D. Fla. 1965) (injury to swimmer by surfboard); *King v. Testerman*, 214 F. Supp. 355 (E.D. Tenn. 1963) (injury to water skier).

⁶¹ 409 U.S. at 268.

the claims of creditors.¹ When bankruptcy is initiated² the assets of the debtor immediately come within the jurisdiction of the bankruptcy court and vest in the possession and control of the bankruptcy trustee upon his appointment.³ The trustee's duty is to collect the assets of the debtor's estate⁴ and liquidate them as quickly as possible.⁵ The trustee distributes these proceeds to the creditors and closes up the debtor's estate.⁶

A recent Fourth Circuit decision involved the distribution of the assets of a debtor's estate. *Jackson Park Realty Co. v. Williams* (In re *O'Neill Enterprises*)⁷ dealt with whether an insurance policy was abandoned by the bankruptcy trustee during the distribution of the assets of the estate. The Fourth Circuit held that the insurance policy owned by the corporate debtor was not abandoned property, but remained under the control of the bankruptcy trustee.

O'Neill Enterprises had entered into a loan agreement with its financiers, Fidelity Bankers Life Insurance Co. and Philadelphia Life Insurance

¹ *Kothe v. R.C. Taylor Trust*, 280 U.S. 224, 227 (1930); see *Kuehner v. Irving Trust Co.*, 299 U.S. 445, 452 (1937); 4A W. COLLIER ON BANKRUPTCY ¶ 70.42 (14th ed. 1976) [hereinafter cited as COLLIER]; J. MACLACHLAN, HANDBOOK OF THE LAW OF BANKRUPTCY § 18 (1956) [hereinafter cited as MACLACHLAN]; FULLERTON, *Katchen v. Landy—Its Practical Significance*, 27 FED. B. J. 140 (1967); Note, *Abandonment of Assets by a Trustee in Bankruptcy*, 53 Colum. L. Rev. 415, 426 (1953) [hereinafter cited as *Abandonment*].

² A straight bankruptcy case is commenced with filing a petition in the appropriate court. FED. BANKR. R. 101. The filing under Bankruptcy Rule 103 may be a voluntary petition in bankruptcy by any person seeking the benefits of the Bankruptcy Act, or an involuntary petition by the creditors of a person owing more than \$1,000 under Bankruptcy Rule 104. Bankruptcy Act § 4a, b, 11 U.S.C. § 22(a), (b) (1970); see Bankruptcy Act § 3b, 11 U.S.C. § 21(b) (1970). See generally MACLACHLAN, *supra* note 1, at §§ 34-51.

³ Bankruptcy Act § 70a, 11 U.S.C. § 110(a) (1970) provides: "[t]he trustee of the estate of a bankrupt and his successor or successors, if any, upon his or their appointment and qualification, shall in turn be vested by operation of law with the title of the bankrupt as of the date of the filing of the petition initiating a proceeding under this title . . ." See *Isaacs v. Hobbs Tie & Timber Co.*, 282 U.S. 734, 737 (1931); FED. BANKR. R. 218(1); 4A COLLIER, *supra* note 1, at ¶ 70.05; MACLACHLAN, *supra* note 1, at § 169.

⁴ Assets of the bankrupt include all of the real and personal property, debts, and causes of action involving property and contract owned by the bankrupt. *Wilson v. National Bank*, 3 F. 391, 393 (W.D. Mo. 1880) quoting Rev. St. § 5067; see *Scharmer v. Carrollton Mfg. Co.*, 525 F.2d 95 (6th Cir. 1975) (bankrupt's estate includes causes of action); *Feldman v. Philadelphia Nat'l Bank*, 408 F. Supp. 24 (E.D. Pa. 1976) (bankrupt's estate includes personal property); *In re Polumbo*, 271 F. Supp. 640 (W.D. Va. 1967) (bankrupt's estate includes real property). Life insurance policies that are not exempt from bankruptcy proceedings under state law and payable to the bankrupt are assets of the bankrupt's estate. As such, the policies pass to the trustee for administration. *Mutual Trust Life Ins. Co. v. Wemyss*, 309 F.Supp. 1221 (D. Me. 1970); *Joslin, Life Insurance in Bankruptcy: A Review*, 76 COM. L. J. 59 (1971); see D. EPSTEIN, DEBTOR-CREDITOR LAW 149 (1973) [hereinafter cited as EPSTEIN]; cf. *In re Insulation & Acoustical Specialities, Inc.*, 311 F. Supp. 1209 (W.D. Mo. 1969), *aff'd*, 426 F.2d 1189 (8th Cir. 1970) (policy on life of president of bankrupt corporation is asset of bankrupt's estate).

⁵ Bankruptcy Act § 47, 11 U.S.C. § 75 (1970); MACLACHLAN, *supra* note 1, at § 127. See generally MacLachlan, *Protection and Collection of Property of Bankrupt Estates*, 39 MINN. L. REV. 626 (1955).

⁶ Bankruptcy Act § 2a(7), 11 U.S.C. § 11(a)(7) (1970).

⁷ 547 F.2d 812 (4th Cir. 1977).

Co.⁸ The financiers received as security for the loan a first deed of trust⁹ on real estate owned by O'Neill Enterprises, and an assignment of rents from the real estate conditioned on default on the loan payments. The financiers received as additional collateral, life insurance policies in the amount of \$1,000,000.¹⁰ Approximately five years after the original loan agreement, O'Neill Enterprises was declared bankrupt after an involuntary petition in bankruptcy was filed by its creditors.¹¹ The insurance policies were listed as assets of the bankrupt on the asset schedule¹² with the note that they were thought to have no cash surrender value.¹³ After the bankruptcy petition had been filed, Fidelity and Philadelphia surrendered the policies to the issuers and collected their cash value¹⁴ without the knowledge of the bankruptcy trustee. The trustee abandoned the real estate secured by the insurance policies¹⁵ after an effort to sell the real estate failed to bring a bid sufficient to produce any equity for the estate.¹⁶

⁸ O'Neill Enterprises received a \$750,000 loan from Fidelity and Philadelphia for which it executed two \$375,000 notes. The loan was used to finance construction of a building in Charlottesville, Virginia. *Id.* at 813.

⁹ O'Neill Enterprises later executed a second deed of trust on the same property to secure a \$100,000 loan by Jackson Park Realty Co. *Id.*

¹⁰ The \$1,000,000 in life insurance policies insured the lives of Frank A. O'Neill, the president and the sole stockholder of O'Neill Enterprises, and his wife and children. The policy at issue in *Jackson Park* was the \$250,000 policy on Mr. O'Neill's life. *Id.* at 813. The policy had a cash surrender value of \$25,715.70. For a definition of cash surrender value see note 14 *infra*. The proceeds of the insurance policies were to be applied to the debt of O'Neill Enterprises only if the sale price of the real estate under the first deed of trust would not satisfy the corporation's indebtedness to the financiers. 547 F.2d at 814.

¹¹ An involuntary bankruptcy proceeding is initiated by a creditor filing a petition in the bankruptcy court. The creditor petitions the court on behalf of at least two other creditors whose claims aggregate to \$500. Bankruptcy Act § 59b, 11 U.S.C. § 95(b) (1970); see MACLACHLAN, *supra* note 1, at § 40. The creditor's claim must be a provable or definite claim against the bankrupt's estate. Bankruptcy Act § 59b, 11 U.S.C. § 95 (b) (1970). For a definition of provable claims see note 69 *infra*.

¹² A bankrupt has the duty under the Bankruptcy Act to prepare a schedule of assets. The schedule must show the amount and kind of property, the location of the property, and its monetary value. See Bankruptcy Act § 7a(8), 11 U.S.C. § 25(a)(8) (1970); FED. BANKR. R. 108, 402; MACLACHLAN, *supra* note 1, at § 44. See generally *Berg v. Hoppe*, 352 F.2d 776 (9th Cir. 1965).

¹³ The court's opinion indicates that Mr. O'Neill noted on the schedule of assets that the policies had no cash value. 547 F.2d at 813.

¹⁴ The cash surrender value of an insurance policy is the policy's cash value if the insurance contract was cancelled by the owner. *In re Welling*, 113 F. 189, 192 (7th Cir. 1902); see 7 G. COUCH, CYCLOPEDIA OF INSURANCE LAW § 32.220 (2d ed. 1961); EPSTEIN, *supra* note 4, at 152.

¹⁵ Fidelity, Philadelphia and Jackson Park entered into an agreement, outside of the bankruptcy proceeding, in which Jackson Park would be allowed to foreclose on the real estate. If, at the foreclosure sale, Jackson Park purchased the real estate subject to the first mortgage, Fidelity and Philadelphia promised to transfer their right to the rents and insurance policies to Jackson Park. This plan was followed and Jackson Park purchased the real estate at the foreclosure sale. 547 F.2d at 814.

¹⁶ FED. BANKR. R. 608 provides: "[t]he court may . . . approve the abandonment of any property If a case is closed without administration of property of the estate that has been scheduled, the property shall be deemed to have been abandoned with the approval of

The bankruptcy court's order of abandonment referred to the abandonment of the real estate, but failed to mention the insurance policies.¹⁷ After the foreclosure sale of the real estate under the second deed of trust, the trustee filed a petition in the bankruptcy court to recover the cash value of the insurance policies from Fidelity and Philadelphia.¹⁸ The financiers contested the petition,¹⁹ arguing that the trustee had abandoned the policies when the real estate was abandoned.²⁰ The bankruptcy court held that the policies remained as assets of the bankrupt's estate. The district court and the Fourth Circuit affirmed.²¹

The Fourth Circuit held that Fidelity and Philadelphia had no defense to the trustee's claim to the insurance policies.²² The court found that the title to the insurance policies vested in the trustee by operation of law, subject to the security interest of Fidelity and Philadelphia.²³ Under the terms of the loan agreement²⁴ the policies were to be applied to O'Neill Enterprises' debt only upon the contingency that the sale price of the real estate did not satisfy the debt. The court held, however, that the sale of the real estate under the second deed of trust brought a price sufficient to satisfy O'Neill Enterprises' debt to Fidelity and Philadelphia.²⁵ Therefore, the Fourth Circuit ruled that the satisfaction of the debt owed the financiers discharged Fidelity's and Philadelphia's security interests in the insurance policies.²⁶ This discharge terminated the financiers' power to assert claims against the policies.²⁷

The Fourth Circuit rejected the financiers' argument that the security was abandoned when the trustee abandoned the encumbered real estate. An inference that the security had been abandoned could not be drawn merely from the real estate abandonment because neither the petition for abandonment nor the resulting court order referred to the insurance poli-

the court . . ."; see *Brown v. O'Keefe*, 300 U.S. 598, 602 (1937); *First Nat'l Bank v. Lasater*, 196 U.S. 115, 118-19 (1905); *MacLachlan*, *supra* note 1, at § 128; *Abandonment*, *supra* note 1, at 415.

¹⁷ 547 F.2d at 814.

¹⁸ After property has been abandoned by the trustee, title to the property reverts in the bankrupt subject to any valid security interests. *In re Wattlely*, 62 F.2d 828, 829 (2d Cir. 1933); *Webb v. Raleigh Hardware Co.*, 54 F.2d 1065, 1067 (4th Cir. 1932); 4A *COLLIER*, *supra* note 1, at ¶ 70.42[4].

¹⁹ The petition was an adversary proceeding under Bankruptcy Rule 703 to recover money retained by creditors of the bankrupt. See *FED. BANKR. R.* 701(1).

²⁰ 547 F.2d at 815.

²¹ *Id.* at 814.

²² See *Id.* at 816.

²³ *Id.* at 815. The basis of the trustee's title is set forth in note 3 *supra*.

²⁴ The terms of the loan agreement are set forth in note 15 *supra*.

²⁵ 547 F.2d at 814. Jackson Park purchased the property subject to the first deed of trust and thus assumed the debt held by Fidelity and Philadelphia. *Id.*

²⁶ *Id.* at 815.

²⁷ *Id.* The agreement with Fidelity and Philadelphia limited Jackson Park's interest in the insurance policies to that of the financiers. As the financiers' interest was discharged by the sale of the real estate, Jackson Park's interest in the policies was also extinguished. 547 F.2d at 814.

cies.²⁸ The court reasoned further that because the trustee was not aware of the value of the policies at the time of abandonment and because the abandonment decision might have been affected had the trustee known of the value of the policies,²⁹ the trustee had not intended to abandon the collateral insurance policies when the real estate was abandoned.

While abandonment is a method through which a bankruptcy trustee disposes of encumbered property that has no value to the bankrupt's estate,³⁰ the preferred abandonment procedure requires a trustee to obtain a court order authorizing abandonment before he abandons the property.³¹ Approval by the bankruptcy court is not mandatory, however, and several courts have held that obtaining a court order is only one indication of whether the property actually has been abandoned.³² These courts indicate that evidence of the trustee's intent concerning disposition of the property³³ and his knowledge of the asset³⁴ should be considered in determining whether a specific piece of property was abandoned by the trustee.³⁵

In asset abandonment cases where there is not an order of abandonment and where the trustee's knowledge of the existence of the asset is not an issue, the trustee's intent is a decisive element. Many courts draw inferences of an intent to abandon from the failure of the trustee to either assert a claim to the asset or formally request abandonment of the asset

²⁸ *Id.*

²⁹ The Fourth Circuit's opinion indicates that had the trustee known the value of the policies, the trustee would have applied that value to the first lien indebtedness and accepted one of the offered bids at the trustee sale. *Id.* at 814.

³⁰ A trustee has no duty to accept encumbered property from the bankrupt's estate. *First Nat'l Bank v. Lasater*, 196 U.S. 115, 118-19 (1905); *Hanover Ins. Co. v. Tyco Indus., Inc.*, 500 F.2d 654, 657 (3d Cir. 1974); 4A COLLIER, *supra* note 1, at ¶ 70.42. In deciding whether a specific piece of property should be abandoned, the trustee must exercise practical business and administrative judgment in concluding that the interests of the estate will be furthered by abandonment. *Abandonment*, *supra* note 1, at 418.

³¹ Bankruptcy Rule 608 codifies the preferred practice for asset abandonment under the Bankruptcy Act. Advisory Committee's Note, FED. BANKR. R. 608; 4A COLLIER, *supra* note 1, at ¶ 70.42[3]. Under the rule, however, assets can be abandoned without a court order. *See* note 16 *supra*.

³² *Pierson v. Paris (In re Humeson)*, 83 F.2d 187 (2d Cir. 1936); *Wood v. Lowe*, 39 Cal. App. 3d 296, 114 Cal.Rptr. 69, 72 (Ct. App. 1974).

³³ *See, e.g., Hanover Ins. Co. v. Tyco Indus., Inc.*, 500 F.2d 654, 657 (3d Cir. 1974) (intent not shown by abandonment of related asset); *Webb v. Raleigh Hardware Co.*, 54 F.2d 1065, 1067 (4th Cir. 1932) (intent manifested in abandonment order); *In re Yalden*, 109 F. Supp. 603, 604 (D. Mass. 1953) (intent shown by trustee's words).

³⁴ *See, e.g., First Nat'l Bank v. Lasater*, 196 U.S. 115, 119 (1905) (abandonment does not occur if trustee is unaware of existence of asset); *Webb v. Raleigh Hardware Co.*, 54 F.2d 1065, 1067 (4th Cir. 1932) (abandonment occurred where bankrupt had revealed asset to trustee); *Moore v. Slonim*, 426 F. Supp. 524, 527 (D. Conn. 1977) (abandonment precluded by failure to schedule asset); *In re Yalden*, 109 F. Supp. 603, 604 (D. Mass. 1953) (abandonment occurred where trustee expressly intended to abandon); *In re Malcom*, 48 F. Supp. 675, 679 (E.D. Ill. 1943) (abandonment occurred where trustee knew of asset).

³⁵ *Wood v. Lowe*, 39 Cal.App.3d 296, 114 Cal. Rptr. 69, 72 (Ct. App. 1974) (abandonment involves elements of knowledge, intent, and existence of order).

by the bankruptcy court.³⁶ At least one court has questioned whether an inference can be drawn from the trustee's disposition of related assets.³⁷ The Third Circuit has held that a trustee does not evidence an intent to abandon a claim to a chattel insurance fund by abandoning a defense to a state court action for the price of the chattel.³⁸ The court found that such an intent could not be inferred from the defense abandonment by the trustee because the bankrupt's liability in the related action was in no way linked to its interest in the proceeds of the insurance fund.³⁹

Many courts, in the absence of an abandonment order explicitly covering the asset in question, examine the extent of the trustee's knowledge of the existence and value of the asset in determining whether the trustee abandoned the asset. The Sixth Circuit has ruled⁴⁰ that a bankrupt's claim was not abandoned by the trustee because the bankrupt had failed to schedule the claim as an asset of its estate.⁴¹ The court held that the claim remained in the trustee's possession⁴² because the doctrine of abandonment had no application to a bankrupt's unscheduled assets of which the trustee had no knowledge.⁴³

³⁶ Mere inaction by the trustee is insufficient to prove abandonment. Inaction, however, coupled with probative evidence of an intent to abandon may be sufficient to prove abandonment. *Webb v. Raleigh Hardware Co.*, 54 F.2d 1065, 1067 (4th Cir. 1932); *In re Yalden*, 109 F. Supp. 603, 604 (D. Mass. 1953); ABANDONMENT, *supra* note 1, at 424.

³⁷ See *Hanover Ins. Co. v. Tyco Indus., Inc.*, 500 F.2d 654 (3d Cir. 1974). *Tyco* involved a shipment of goods left at a buyer's warehouse which were stolen before the buyer took actual possession. The buyer refused to pay for the goods and asserted a defense of ineffective delivery to the seller's state court action for the price of the goods. Before the suit was decided, the buyer was adjudicated a bankrupt. The trustee decided to abandon the defense of the suit, and invited the goods' theft insurer to defend the action. After the seller obtained judgment, he sued the insurance company for the proceeds of the policy on the theory that the trustee abandoned the insurance fund when he abandoned the defense to the state court action. The insurer filed an interpleader action in federal court to resolve ownership of the insurance proceeds. *Id.* at 656.

³⁸ *Id.* at 657.

³⁹ *Id.* at 658. Two unrelated contracts were involved; one contract was between the buyer and the seller on the sales agreement; the other was between the buyer and the insurer on the insurance policy. *Id.*

⁴⁰ *Scharmer v. Carrollton Mfg. Co.*, 525 F.2d 95 (6th Cir. 1975). *Scharmer* involved an assignment by a bankrupt corporation to one of its directors of all property interests, choses in action, and things of value. After the bankruptcy proceeding ended, the director attempted to assert the bankrupt's claims against a third party by alleging abandonment even though the claims were not scheduled. The Sixth Circuit affirmed the dismissal of the action, holding that unscheduled assets of a bankrupt cannot be abandoned. *Id.* at 98. The court directed the assignee to petition the bankruptcy court to reopen the proceedings and allow the trustee to decide whether to abandon the claims. *Id.*

⁴¹ *Id.*

⁴² *Id.*

⁴³ *Id.*; see *First Nat'l Bank v. Lasater*, 196 U.S. 115 (1905). *Lasater* involved a bankrupt's attempt to bring a post-discharge action to seek damages on an unscheduled usury claim. The Court held that a trustee abandons property only when he knows of the existence of the asset and then elects not to accept the property. *Id.* at 119. The bankrupt regains title only if he schedules the asset and the trustee does not use the asset to satisfy the creditors' claims.

The common element in both the Third Circuit's and the Sixth Circuit's abandonment approach is the attempt to guard against inadvertent abandonment of assets outside of the court order procedure by requiring that effective asset abandonment be the product of a knowing and intentional act by the trustee.⁴⁴ The Third Circuit refused to infer an intent to abandon from the abandonment of a related asset and the Sixth Circuit ruled that a trustee must have an adequate knowledge of an asset before it can be abandoned. While *Jackson Park* is factually distinguishable from the Sixth Circuit's decision, because the O'Neill life insurance policy was scheduled as an asset, the reason supporting a denial of abandonment in unscheduled asset cases applies in *Jackson Park* as well. The duty to apply the assets to satisfy the creditors' claims implies that the trustee should only abandon assets in circumstances where a knowledgeable decision that the assets have no value to the estate has been made.⁴⁵ A lack of knowledge of the value of the asset prevents the trustee from balancing the factors involved and reaching a decision in the creditors' best interests.

The Fourth Circuit's analysis in *Jackson Park* was more analogous to the Third Circuit's position on the intent element of abandonment. Both courts held that the abandonment of a related asset, without other indicia of intent, failed to prove an abandonment of anything other than the specified asset.⁴⁶ The same duty of the trustee to apply the assets to satisfy the creditors' claims requires that any abandonment be the result of an intentional disposition of the asset by the trustee, not the result of an intent incorrectly inferred from a related action.

The holding of *Jackson Park* that the trustee had not abandoned insurance policies of the bankrupt when real estate was abandoned is not only consistent with the purposes of the Bankruptcy Act, but apparently consistent with the terms of the original agreement in *Jackson Park*.⁴⁷ At the conclusion of the dealings between the parties to the loan agreement, the financiers had received full compensation for the loan. The financiers stood as secured creditors to the extent of O'Neill Enterprises' collateral and would have received an amount beyond that intended by the parties⁴⁸ had

The Supreme Court concluded that the bankrupt had no claim for usury because the trustee had not abandoned the asset. *Id.*

⁴⁴ See *Webb v. Raleigh Hardware Co.*, 54 F.2d 1065 (4th Cir. 1932). The Fourth Circuit allowed the bankrupt in *Webb* to assert a pre-bankruptcy usury defense to a post-bankruptcy mortgage foreclosure. The court held that the trustee surrendered the claim to the bankrupt through inaction because the record reflected that the bankrupt had not concealed the asset from the trustee and, in fact, was active in aiding the trustee whenever possible. *Id.* at 1067. The trustee was assumed to have knowingly and intentionally abandoned the cause of action. *Id.* at 1068.

⁴⁵ See generally *Scharmer v. Carrollton Mfg., Co.*, 525 F.2d 95 (6th Cir. 1975).

⁴⁶ *Jackson Park Realty Co. v. Williams (In re O'Neill Enterprises)*, 547 F.2d 812, 813 (4th Cir. 1977); *Hanover Ins. Co. v. Tyco Indus., Inc.*, 500 F.2d 654, 659 (3d Cir. 1974).

⁴⁷ 547 F.2d at 815.

⁴⁸ *Id.* at 813. The proceeds of the insurance policies were to be applied by the financiers only if the sale price of the real estate would not satisfy the corporation's indebtedness. *Id.*

they retained the cash surrender value of the insurance policies as a result of abandonment.

Jackson Park does not alter the requirements of abandonment in the Fourth Circuit. Mere inaction remains insufficient to establish abandonment unless the inaction is strongly probative of the trustee's intent.⁴⁹ Abandonment must be a knowing and intentional act of the trustee.⁵⁰ The most effective way for a trustee or other party to a bankruptcy proceeding to clarify whether abandonment has occurred is to obtain a court order which authorizes abandonment and specifically designates the assets to be abandoned.⁵¹

Assets not abandoned by the trustee are applied to satisfy the claims of the bankrupt's creditors. These assets may include real or personal property, causes of action, or claims against debtors for unpaid debts.⁵² The bankrupt may, however, owe a debt in turn to his debtor or possess a similar claim against his creditor. In such circumstances, section 68 of the Bankruptcy Act allows the bankrupt to set-off claims against his creditor, and the debtor to set-off debts owed him by the bankrupt.⁵³ Consequently, the creditor may file a claim only for the amount by which his claim exceeds the amount he owes the bankrupt. Conversely, the debtor may be required to pay into the bankrupt's estate only the amount by which the bankrupt's claim exceeds the debt owed the debtor.

To be set-off, debts or credits must be both provable⁵⁴ and mutual.⁵⁵ Normally an unsecured creditor must await distribution of the bankrupt's assets for satisfaction of any claim and in turn risk partial payment of his claim.⁵⁶ A set-off under section 68, however, allows an unsecured debtor-

at 814. The financiers attempted to claim the policies after the debt was satisfied and they had obtained their full compensation under the loan. *Id.* at 815-16.

⁴⁹ See cases cited in note 36 *supra*.

⁵⁰ 547 F.2d at 815.

⁵¹ FED. BANKR. R. 608.

⁵² For a discussion of the administration of the bankrupt's assets see note 4 *supra*.

⁵³ Bankruptcy Act § 68, 11 U.S.C. § 108 (1970), provides:

(a) 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 setoff against the other, and the balance only shall be allowed or paid.

(b) A set-off or counterclaim shall not be allowed in favor of any debtor of the bankrupt which (1) is not provable . . . or (2) was purchased by or transferred to him after the filing . . . with a view to such use and with knowledge or notice that such bankrupt was insolvent or had committed an act of bankruptcy.

See also Morton, *Creditor Set-Offs in Business Reorganization and Relief Cases under the Bankruptcy Act*, 50 AM. BANKR. J. 373 (1976).

⁵⁴ For a definition of provable debts or claims see note 69 *infra*.

⁵⁵ For a definition of mutual debts or claims see note 67 *infra*.

⁵⁶ Unsecured creditors normally must await final settlement of all outstanding titles and liens to the bankrupt's property before the assets can be distributed to satisfy their claims. Bankruptcy Act § 65a, 11 U.S.C. § 105(a) (1970). Therefore, if the assets are insufficient to pay all claims, the general creditors are paid pro rata out of the asset fund. *Id.*; see MACLACHLAN, *supra* note 1, at § 301.

creditor⁵⁷ to avoid this risk by receiving full value for his claim in relationship to the debt which he owes the bankrupt.

In the recent case of *Goldstein v. McLean Bank* (In re *Johnson*),⁵⁸ the Fourth Circuit held that a creditor's counterclaim was properly asserted as a set-off to a bankruptcy receiver's claim.⁵⁹ In *Goldstein*, McLean Bank made a number of loans to investors in a wine import business owned by Robert Johnson.⁶⁰ The bank held notes guaranteed by Johnson and payable to the investors as security for the loans.⁶¹ Immediately before an involuntary petition in bankruptcy was filed against Johnson, he converted some of his assets into a cashier's check issued by the bank.⁶² After the petition was filed, Johnson indorsed the check to his attorney who in turn indorsed the check over to the receiver in bankruptcy.⁶³ When the receiver presented the check for payment, the bank refused to accept the check and asserted a right of set-off based on claims transferred to the bank by assignment from the investors after the bankruptcy proceedings had started.⁶⁴ The receiver brought a federal court action to collect on the cashier's check⁶⁵ and the bank asserted a counterclaim⁶⁶ to set-off the receiver's claim. The district court allowed the set-off and the court of appeals affirmed.

The respective claims of the bankrupt and the bank were recognized as mutual⁶⁷ because the bank stood as a debtor on the cashier's check, and

⁵⁷ For the purpose of this article the term "debtor-creditor" refers to a party who owes the bankrupt a debt and who also has a claim against the bankrupt's estate.

⁵⁸ 552 F.2d 1072 (4th Cir. 1977).

⁵⁹ *Id.* at 1078.

⁶⁰ *Id.* at 1075.

⁶¹ The bank's loan agreement with Johnson's investors provided that if and when the bank had reason to fear that the collateral was unsound, the bank had the right to ask the investors to substitute new collateral or repay the loans. *Id.*

⁶² Johnson was involved in a multi-million dollar fraud through his import business. He converted his assets at the bank into the cashier's check with the apparent intent to abscond with the money and avoid his creditors. *Id.* His attempted concealment was an act of bankruptcy which allowed his creditors to initiate involuntary bankruptcy proceedings against him. Bankruptcy Act §§ 3a(1), b, 11 U.S.C. § 21 (a)(1), (b) (1970).

⁶³ A receiver supervises the bankrupt's estate until a trustee is elected. Bankruptcy Act § 2a(3), 11 U.S.C. § 11(a)(3) (1970). The receiver has powers to protect the creditors' interests and, upon application, to conduct the bankrupt's business as well as to litigate any matter which concerns the bankrupt's estate. *Id.*; FED. BANKR. R. 201; 1 COLLIER, *supra* note 1, at ¶ 2.24; Hanna, *The Receiver in Bankruptcy; An Introduction to Bankruptcy Reform* 3 S. CAL. L. REV. 241 (1930).

⁶⁴ 552 F.2d at 1075.

⁶⁵ This action was independent of the Johnson bankruptcy proceeding and in furtherance of the receiver's duty to collect all of the bankrupt's assets. *See* note 63 *supra*.

⁶⁶ 552 F.2d at 1075. The bank's counterclaim was based on an agreement made between the bank and Johnson's investors after the bankruptcy proceedings had begun. The agreement provided that the bank would retain full ownership of Johnson's notes while the investors were credited with the full face value of the notes on their indebtedness to the bank.

⁶⁷ Mutual debts or credits are claims between the same parties each having claims against the other. *In re Phoenix Hotel Co.*, 20 F. Supp. 240, 241 (E.D. Ky. 1937); *see, e.g., Western Tie & Timber Co. v. Brown*, 196 U.S. 502 (1905) (set-off improper because creditor asserted claim arising from individual corporate capacity while debt owed in fiduciary capac-

as a creditor of the bankrupt on the transferred claims.⁶⁸ The court then held that the bank's claims against the bankrupt's estate were provable⁶⁹ even though the claims had not yet matured. While the bank had no defense⁷⁰ to the cashier's check, it asserted the transferred claims as a counterclaim against the receiver to set-off and negate the bank's debt on the check.⁷¹ The Fourth Circuit held that the bank had a right under the terms of section 68 to assert a set-off against the receiver.⁷²

The set-off provision utilized by the bank in *Goldstein* is restricted by the terms of section 68b to prevent abuse by unsecured creditors.⁷³ The restriction requires that a claim may be asserted as a set-off only if it was not obtained by the creditor with the view to use it as such after the debtor's insolvency became apparent.⁷⁴ The Fourth Circuit failed to deal with this safeguard in its treatment of the set-off in *Goldstein*. The resulting analysis and decision conflicts with the terms of section 68 and allows

ity); *Western Dealer Management, Inc. v. England (In re Bob Richards Chrysler-Plymouth Corp.)*, 473 F.2d 262 (9th Cir. 1973)(claims not mutual because credit held in fiduciary capacity); *Bayliss v. Rood (In re W. Va. Indus. Dev. Corp.)*, 424 F.2d 142 (4th Cir. 1970)(set-off improper where claim arose from fiduciary duty); 4 COLLIER, *supra* note 1, at ¶ 68.04[2.1].

⁶⁸ 552 F.2d at 1076. The Fourth Circuit applied substantive state law to determine the bank's rights against Johnson on the notes. *Id.*; see *Erie R.R. v. Tompkins*, 304 U.S. 64 (1938). Even though the claims were transferred after Johnson was adjudicated bankrupt, the Fourth Circuit reasoned that the bank as transferee took whatever rights the previous holders had in the notes. 552 F.2d at 1076; see VA. CODE § 8.3-201 (1965).

⁶⁹ Provable debts are debts of the bankrupt's estate including debts of fixed liability, debts arising from express or implied contracts, and contingent debts. Bankruptcy Act § 63a, 11 U.S.C. § 103(a) (1970); FED. BANKR. R. 301; see 3A COLLIER, *supra* note 1, at ¶ 63.01[2.1]; MACLACHLAN, *supra* note 1, at §§ 133-149.

The Fourth Circuit evaluated the claims' provability in terms of their liquidity. See 3 COLLIER, *supra* note 1, at ¶ 57.15 at 253. See also 4 COLLIER, *supra* note 1, at ¶ 68.11. Because the claims were for a fixed amount and personally guaranteed by the bankrupt they were liquid. 552 F.2d at 1077. A personal guarantee of payment establishes the guarantor's liability on the instrument to the same extent as if he were a comaker. VA. CODE § 8.3-416(1) (1965), Official Comment.

⁷⁰ The receiver argued that the bank's defenses to the cashier's check were limited by VA. CODE §§ 8.3-305(2), 306(c) (1965). The statutory defenses are the real defenses ascertainable against the holder in due course of an instrument and the personal defenses of failure of consideration, nonperformance or nondelivery which are ascertainable against a holder who is not a holder in due course. The bank conceded that it had no defense to its obligation under the check but argued that the set-off doctrine still applied. 552 F.2d at 1077.

⁷¹ *Id.* at 1077-78.

⁷² See note 53 *supra*.

⁷³ Set-offs must be provable, mutual debts or credits that were not transferred to the creditor after or within four months of bankruptcy with the purpose of the creditor using the claim as a set-off and with knowledge of the bankrupt's insolvency. Bankruptcy Act § 68, 11 U.S.C. § 108 (1970). For a definition of provable debts or credits see note 69 *supra*. For a definition of mutual debts or credits see note 67 *supra*. In this manner, the debtors of the bankrupt are prevented from using claims as set-offs to avoid the equitable distribution of assets from the bankrupt's estate. See *Continental & Commercial Trust & Savings Bank v. Chicago Title & Trust Co.*, 229 U.S. 435, 444 (1913); *United States v. Columbia Erection Corp.*, 134 F. Supp. 305, 306 (W.D. Mo. 1955); *Becker v. Crabb's Trustee*, 21 S.W.2d 438, 439 (Ky. 1929).

⁷⁴ Bankruptcy Act § 68b(2), 11 U.S.C. § 108(b)(2) (1970).

a debtor of the bankrupt to obtain an advantageous position over other unsecured creditors.⁷⁵

Section 68b(2)⁷⁶ defines a group of debtor-creditors who are specifically denied set-offs in bankruptcy proceedings. That group includes transferees who obtained their claims with the intent to use the claim as a set-off to a debt already owed the bankrupt after the bankruptcy proceedings were initiated. The term "transfer" is defined in the Bankruptcy Act as including a sale, assignment, pledge, or any mode of disposing of an interest in property.⁷⁷ *Goldstein* involved claims assigned by Johnson's investors⁷⁸ to the bank after the bankruptcy proceedings were started. Thus, the *Goldstein* transfer was clearly to a transferee⁷⁹ which obtained the claim after the bankruptcy proceeding had started. Although the Fourth Circuit never questioned the bank's motives⁸⁰ in the transfer, the most likely reason for the bank's accepting the collateral at face value would seem to be to enable the bank to set-off the investors' claims against the cashier's check.⁸¹

In deciding whether the debtor-creditor obtained his claim after bankruptcy to use it as a set-off against an existing debt, many courts use the existence of a prior underlying obligation between the debtor-creditor and the bankrupt to determine the debtor-creditor's intent.⁸² The Ninth Circuit

⁷⁵ For the advantages of the set-off doctrine to an unsecured creditor see note 56 and accompanying text *supra*.

⁷⁶ Bankruptcy Act § 68b(2), 11 U.S.C. § 108(b)(2) (1970). For the text of this section see note 53 *supra*.

⁷⁷ Bankruptcy Act § 1(30), 11 U.S.C. § 1(30) (1970); see *Pirie v. Chicago Title & Trust Co.*, 182 U.S. 438 (1901) ("transfer" used in most comprehensive sense in Bankruptcy Act); *Allan v. Archer-Daniels-Midland Co. (In re Commodity Merchants, Inc.)*, 538 F.2d 1260 (7th Cir. 1976) ("transfer" under Bankruptcy Act is relinquishment of valuable property).

⁷⁸ 552 F.2d at 1075. The individuals who borrowed money from McLean Bank to invest in the Johnson business received full face value for the Johnson guaranteed collateral. *Id.*

⁷⁹ The Fourth Circuit considered the bank to be "at the very least, a transferee of the . . . instruments which Johnson . . . had personally guaranteed." *Id.* at 1076.

⁸⁰ In discussing the applicability of § 68b to the case, the Fourth Circuit did not inquire into the bank's motives for procuring the investors' claims. *Id.* See generally Brief for Appellee at 57 (appendix), *Goldstein v. McLean Bank (In re Johnson)*, 552 F.2d 1072 (4th Cir. 1977).

⁸¹ Cf. *Coyle v. Morrisdale Coal Co.*, 289 F. 429 (2d Cir. 1923) (set-off denied where debtor purchased claim to extinguish debt owed bankrupt); *United States v. Columbia Erection Corp.*, 134 F. Supp. 305 (W.D. Mo. 1955) (set-off denied to debtor who purchased claims after bankruptcy to negate debt owed bankrupt's estate).

⁸² See *Bel Marin Driwall, Inc. v. Grover*, 470 F.2d 932 (9th Cir. 1972) (direct payments by bankrupt's debtor to bankrupt's creditor made under obligation imposed by California law was proper set-off); *Tucson House Constr. Co. v. Fulford*, 378 F.2d 734 (9th Cir. 1967) (set-off of payments upon which debtor was only contingently liable made to bankrupt's creditors denied); *Coyle v. Morrisdale Coal Co.*, 289 F. 429 (2d Cir. 1923) (denying set-off to debtor who had purchased claim against bankrupt to extinguish debt); *In re Agostini Constr. Co.*, BANKR. L. REP. (CCH) ¶ 64,280 (D.R.I. 1970) (payments made by bankrupt's guarantor were properly asserted as set-off to debts owed bankrupt's estate); *United States v. Columbia Erection Corp.*, 134 F. Supp. 305 (W.D. Mo. 1955) (denying set-off to debtor of claims purchased after bankruptcy and intended by debtor to negate debt owed bankrupt's estate); *Lowenthal v. Block*, 175 Misc. 472, 22 N.Y.S.2d 736 (Cir. Ct. N.Y. 1940) (guarantor allowed set-off of payments made in regular course of business).

has allowed a set-off of claims acquired after the filing of the bankruptcy petition where state law obligates the debtor-creditor to assume a portion of the bankrupt's debts.⁸³ Because the payments were required by law, the court held that they were not made by the debtor-creditor with an intent to later use the payments as a setoff.⁸⁴ In another case, however, the Ninth Circuit denied a set-off to a debtor-creditor who had voluntarily assumed a bankrupt's debt to a third party creditor.⁸⁵ Since the debtor-creditor purchased the claim within four months of bankruptcy and because the debtor-creditor was only contingently liable on the debt owed the third party, the court denied set-off. The Ninth Circuit refused to permit a set-off when the claim was deliberately obtained for set-off purposes.⁸⁶

The Fourth Circuit failed to examine the bank's counterclaim in light of the section 68b(2) set-off criteria after the court determined that the bank obtained the transferred claims subsequent to the start of the bankruptcy proceedings. If the bank had obtained the claims to reduce its obligation on the cashier's check, application of the set-off doctrine would violate the terms of section 68b. The bank's set-off would unlawfully negate, to the detriment of the other bankruptcy creditors,⁸⁷ the receiver's claim on the cashier's check. The Fourth Circuit's decision, by permitting a debtor outside of the bankruptcy proceedings to assume an unsecured creditor's claim and use the claim as a set-off, prevents the bankruptcy receiver from collecting debts owed the bankrupt's estate and allows the unsecured creditor to receive full value for his claim.⁸⁸ This result virtually

⁸³ *Bel Marin Driwall, Inc. v. Grover*, 470 F.2d 932 (9th Cir. 1972). Under CAL. CIVIL PRO. CODE § 1185.1(c) (repealed 1971), a general contractor was liable to any subcontractor's unpaid materialmen or suppliers who were involved in the construction project. In *Bel Marin* the bankrupt's debtor, a general contractor, made direct payments to a creditor supplier after an involuntary petition was filed against the subcontractor. The general contractor sought to assert such payments as a set-off against a claim for the bankrupt's work on the construction project. The Ninth Circuit held that while the debtor had acquired the claim within the prohibited period, he had not done so with a view to use the claim as a set-off but only to be in compliance with state law. 470 F.2d at 935-36.

⁸⁴ 470 F.2d at 936; see *In re Agostini Constr. Co.*, BANKR. L. REP. (CCH) ¶ 64,280 (D.R.I. 1970); *Lowenthal v. Block*, 175 Misc. 472, 22 N.Y.S.2d 736 (Cir. Ct. N.Y. 1940).

⁸⁵ *Tucson House Constr. Co. v. Fulford*, 378 F.2d 734 (9th Cir. 1967). *Tucson* involved a construction contract under which the general contractor was liable for all unpaid claims for labor and materials furnished on the job. The general contractor, in turn, required the subcontractor to post a surety bond for any obligations under the subcontract. After the subcontractor filed a voluntary petition, the general contractor paid some of the outstanding bills owing the subcontractor's laborers and materialmen, and then asserted the payments as a set-off against a claim for the bankrupt's work on the project. The Ninth Circuit denied the set-off because the general contractor was only contingently liable for the bills in the unlikely event that the bankrupt's surety could not pay the outstanding claims. *Id.* at 736.

⁸⁶ *Id.* at 738; see *Coyle v. Morrisdale Coal Co.*, 289 F. 429 (2d Cir. 1923); *United States v. Columbia Erection Corp.*, 134 F. Supp. 305 (W.D. Mo. 1955).

⁸⁷ *United States v. Columbia Erection Corp.*, 134 F. Supp. 305, 306 (W.D. Mo. 1955) (the use of claim purchased after bankruptcy as set-off to existing debt would treat other creditors of same class unfairly).

⁸⁸ Unsecured creditors must normally await distribution of the bankrupt's estate and may only then receive partial payment of their claims. See note 56 *supra*.

eliminates the exception contained in section 68b(2) from the set-off provision.

Straight bankruptcy generally requires the distribution of a debtor's assets to satisfy creditors' claims and allows the debtor to rehabilitate himself without the burden of his prior indebtedness.⁸⁹ The Bankruptcy Act, however, also provides other means for debtor rehabilitation. A debtor may petition a bankruptcy court for a Chapter XI arrangement,⁹⁰ which is a plan under which the claims of his unsecured creditors will be satisfied.⁹¹ Such plans usually allow a debtor to retain control of his assets and to establish a schedule for the satisfaction of his unsecured creditors' claims from the earnings, under which the terms of payment are adjusted.

A confirmed arrangement may be revoked or modified by a party if confirmation was procured by fraud and if the party was unaware of the fraud at the time of the confirmation.⁹² Upon motion, the bankruptcy court may reopen the case and conduct a hearing on the allegation of fraud.⁹³ If the confirmation is then revoked the court has the option to set aside or modify the tainted arrangement. Alternatively, the party is allowed to obtain the same relief from the confirmation as a party in an action under the Federal Rules of Civil Procedure.

⁸⁹ *Wright v. Union Central Life Ins. Co.*, 304 U.S. 502 (1938).

⁹⁰ An arrangement proceeding in bankruptcy is a voluntary action initiated by the debtor in a competent court through the filing of a petition stating that the debtor is insolvent and setting forth the provisions of a plan to pay unsecured debts. Bankruptcy Act §§ 306(1), 322, 323, 11 U.S.C. §§ 706(1), 722, 723 (1970); FED. BANKR. R. 11-3; see MACLACHLAN, *supra* note 1, § 311. With his petition, the debtor must include a schedule of debts and a statement of his financial affairs. Bankruptcy Act § 324, 11 U.S.C. § 724 (1970); FED. BANKR. R. 11-11. The plan may provide for equal treatment of unsecured creditors, or it may group individual debts into classes with treatment according to the class. The plan may also allow the debtor to engage in specific undertakings or continue his business during the time for the plan. Bankruptcy Act § 357, 11 U.S.C. § 757 (1970). The bankruptcy court must call for the first meeting of the creditors within twenty-five to forty days after the petition is filed. Bankruptcy Act § 334, 11 U.S.C. § 734 (1970); FED. BANKR. R. 11-25. At the meeting, a vote is taken of those creditors who accept the proposed plan. Bankruptcy Act § 336, 11 U.S.C. § 736 (1970); FED. BANKR. R. 11-37. If the arrangement plan is accepted by the creditors and confirmed by the bankruptcy court, the plan binds the debtor and all creditors whether they accepted the plan or not. Bankruptcy Act § 367, 11 U.S.C. § 767 (1970); see MACLACHLAN, *supra* note 1, at §§ 317, 320.

⁹¹ Bankruptcy Act § 323, 11 U.S.C. § 723 (1970).

⁹² A bankruptcy court may set aside or modify an arrangement if, upon the application of the parties in interest filed within six months after an arrangement has been confirmed, it appears that the arrangement was fraudulently procured and that the petitioner had no knowledge of such fraud at the time of confirmation. Bankruptcy Act § 386, 11 U.S.C. § 786 (1970); FED. BANKR. R. 11-41; see *In re 20546 Corp.*, 408 F. Supp. 959 (S.D.N.Y. 1976); 9 COLLIER, *supra* note 1, at ¶ 11.01.

⁹³ Bankruptcy Act § 386, 11 U.S.C. § 786 (1970); FED. BANKR. R. 11-41.

⁹⁴ Relief in bankruptcy cases is coextensive with that granted in civil actions. Bankruptcy Act § 21k provides that "[i]n all proceedings under this Act, the parties in interest shall be entitled to all rights and remedies granted by the Rules of Civil Procedure . . ." 11 U.S.C. § 44(k) (1970); General Order in Bankruptcy 37; MACLACHLAN, *supra* note 1, at § 24. See also 7 MOORE'S FEDERAL PROCEDURE ¶ 60.18[7] (2d ed. 1975) [hereinafter cited as MOORE'S];

Recently, the Fourth Circuit determined whether the availability of relief under Bankruptcy Act procedures bars relief to parties in an independent action in equity to remedy fraud. The court decided in *Bizzell v. Hemingway*⁹⁵ that the separate means of relief available under the Bankruptcy Act and the Federal Rules of Civil Procedure were alternative, non-exclusive remedies and a party may choose which remedy to pursue. In *Bizzell*, a creditor of the bankrupt was fraudulently induced by another creditor to approve a Chapter XI arrangement.⁹⁶ After the arrangement was confirmed⁹⁷ by the bankruptcy court and the fraud was discovered,⁹⁸ the creditor initiated an action, independent of the bankruptcy proceedings, to recover for securities fraud and breach of contract.⁹⁹

The Fourth Circuit ruled that the creditor stood as a judgment bound party after the arrangement was confirmed by the bankruptcy court.¹⁰⁰ Thus, the court reasoned, the creditor could be granted relief if the facts surrounding the arrangement would warrant equitable relief from a final judgment.¹⁰¹ The court held that where an attorney's fraud prevents the creditor from protecting his own interests in the arrangement proceedings because the attorney's interests are in direct conflict with his own,¹⁰² a creditor can rely on Federal Rule of Civil Procedure 60(b)¹⁰³ as a basis for

Kratovil & Werner, *Appeals in Bankruptcy: Traps For the Unwary*, 8 J. MAR. J. PRAC. PROC. 1 (1974); Yarkwich, *The Impact of the Federal Rules of Civil Procedure on Bankruptcy*, 29 REF. J. 75 (1955).

⁹⁵ 548 F.2d 505 (4th Cir. 1977). *Bizzell* involved the plaintiff's claims against, and the bankruptcy arrangement of, Fairco Drugs, Inc. Plaintiff Bizzell, for the sale of his drugstore to Fairco, received Fairco debentures and a five year employment contract with Fairco. Fairco subsequently petitioned for an arrangement under Chapter XI of the Bankruptcy Act. *Id.* at 507.

⁹⁶ *Id.* at 506. During the course of the arrangement proceedings Bizzell and another creditor, defendant Hemingway, were represented by the same attorney. Between themselves, Hemingway and the attorney agreed to support the arrangement plan with the intention that after reorganization Hemingway would control Fairco and Bizzell would be excluded. Bizzell's support of the arrangement plan was crucial to Hemingway's gaining control of Fairco. Thus, Bizzell's attorney, in collusion with Hemingway and without revealing the conflict of interest, convinced Bizzell to agree to the arrangement by incorrectly advising Bizzell that the arrangement was his sole means of seeking redress. *Id.* at 507.

⁹⁷ After confirmation until the final decree is entered the bankruptcy court retains jurisdiction over the arrangement to allow or disallow late claims and to supervise the estate. Bankruptcy Act §§ 369, 372, 11 U.S.C. §§ 769, 772; 9 COLLIER, *supra* note 1, at ¶ 9.34.

⁹⁸ After Bizzell discovered the conspiracy, he obtained independent counsel. 548 F.2d at 507.

⁹⁹ *Id.* at 506.

¹⁰⁰ *Id.* at 507; *see* *Levy v. Cohen*, 199 Cal.2d 165, 172, 561 P.2d 252, 256, 137 Cal. Rptr. 162, 166 (1977)(confirmed arrangement has effect of judgment); MACLACHLAN, *supra* note 1, at § 330.

¹⁰¹ *Accord*, *Pepper v. Litton*, 308 U.S. 295 (1939)(equitable relief necessary to counter planned and fraudulent scheme); *Crosby v. Mills*, 413 F.2d 1273 (10th Cir. 1969)(equitable relief in a Chapter XII arrangement is proper only in unusual and exceptional circumstances).

¹⁰² 548 F.2d at 507. Bizzell could have sued Fairco on the securities fraud cause of action with permission of the bankruptcy court while the arrangement proceeding was pending. *Id.*; *see* RESTATEMENT OF JUDGMENTS § 122 (1942).

¹⁰³ Rule 60(b) provides for relief of a party from a judgment induced through fraud, and

filing an independent action to remedy the fraud.¹⁰⁴ The Fourth Circuit concluded that while Bankruptcy Act procedure should normally be followed in bankruptcy cases involving fraud, the procedure is not an exclusive remedy.¹⁰⁵

The Fourth Circuit relied on *United States v. Throckmorton*¹⁰⁶ as support for the grant of equitable relief from the bankruptcy arrangement.¹⁰⁷ In *Throckmorton* the Supreme Court granted equitable relief from a twenty year old land confirmation suit which was based on a fraudulently antedated land grant prepared by the prevailing party in the action. The original judgment was reversed because the Court concluded that fraud had prevented the unsuccessful party from fully litigating the case.¹⁰⁸ Application of the *Throckmorton* rationale in *Bizzell* resulted in the finding that the involvement of the creditor's attorney in a scheme to gain control of the bankrupt had prevented the creditor from representation in the confirmation proceedings.¹⁰⁹ The court, thus, allowed independent action to grant the creditor relief.¹¹⁰

While an independent action in equity under Federal Rule 60(b) is a proper remedy to a judgment obtained through fraud on the court,¹¹¹ this remedy may be applied only in situations where equity normally grants relief.¹¹² Rule 60(b) relief may be obtained only in extraordinary circumstances¹¹³ where the "delicate balance between the sanctity of final judg-

mistake or because of newly discovered evidence. FED. R. CIV. PRO. 60(b).

¹⁰⁴ 548 F.2d at 507.

¹⁰⁵ *Id.*

¹⁰⁶ 98 U.S. 61 (1878).

¹⁰⁷ The Fourth Circuit relied on *Throckmorton* in granting equitable relief from a bankruptcy proceeding procured by fraud on the court. 548 F.2d at 507. The Supreme Court, however, had noted that *Throckmorton* did not involve fraud on the court. 98 U.S. at 62.

¹⁰⁸ *Id.* at 65-66.

¹⁰⁹ An attorney's position as an officer of the court broadens the fraud's effect beyond injury to a single person to an injury which encompasses the entire court. See *Hazel-Atlas Glass Co. v. Hartford-Empire Co.*, 322 U.S. 238 (1944) (circuit courts have power to vacate judgments when evidence of scheme to defraud court is shown); 11 C. WRIGHT & A. MILLER, FEDERAL PRACTICE AND PROCEDURE § 2870 (1973) [hereinafter cited as WRIGHT & MILLER]; Moore & Rodgers, *Federal Relief from Civil Judgments*, 55 YALE L. J. 623, 679 (1946).

¹¹⁰ 548 F.2d at 508.

¹¹¹ *S & E Contractors, Inc. v. United States*, 406 U.S. 1 (1972); *Hazel-Atlas Glass Co. v. Hartford-Empire Co.*, 322 U.S. 239 (1944); FED. R. CIV. P. 60(b); Note, *Attacking Fraudulently Obtained Judgments in the Federal Courts*, 48 IOWA L. REV. 398, 399 (1963). Fraud on the court is "a scheme to interfere with the judicial machinery performing the task of impartial adjudication . . ." *Pfizer, Inc. v. International Rectifier Corp.*, 538 F.2d 180, 195 (8th Cir. 1976).

¹¹² The indispensable elements of an independent action to gain equitable relief from a prior judgment are a valid defense to the original cause of action, fraud, accident or mistake which negated the benefit of the valid defense, a resulting unjust judgment, the absence of wrongdoing on the part of the party seeking relief, and the absence of an adequate remedy at law. *National Surety Co. v. State Bank*, 120 F. 593, 599 (8th Cir. 1903); see *Bankers Mortgage Co. v. United States*, 423 F.2d 73, 79 (5th Cir. 1970).

¹¹³ See, e.g., *Horace v. St. Louis Sw. R.R.*, 489 F.2d 632 (8th Cir. 1974) (alleged error in instruction not exceptional circumstance for purposes of granting equitable relief); *Crosby v. Mills*, 413 F.2d 1273 (10th Cir. 1969) (determination whether exceptional circumstances ex-

ments, expressed in the doctrine of res judicata, and the incessant command of the court's conscience that justice be done¹¹⁴ will be preserved. Accordingly, most courts refuse to disturb this balance where the aggrieved party petitions equity to rectify matters remediable at law.¹¹⁵ In such circumstances, needless collateral litigation and expense are avoided by forcing the burdened party to fully litigate the matter in a single forum before resorting to equitable relief. Courts have adopted this rule in order to avoid repeated litigation between the same parties on the same facts.¹¹⁶

The rule discouraging the grant of equitable relief to parties with adequate remedies at law is followed in bankruptcy proceedings. The Tenth Circuit dealt with such a situation involving a Chapter XII bankruptcy arrangement.¹¹⁷ When confronted with the decision whether an independent action to void a referee's order was proper in lieu of an opportunity to appeal the order through the Bankruptcy Act provisions, the court ruled that the better practice was to appeal the order through the Act.¹¹⁸ The Tenth Circuit held that substituting an independent action for an appeal could only be allowed in unusual and exceptional cases.¹¹⁹ The Tenth Circuit's decision does not totally deny relief to an aggrieved party, but discourages, however, repeated litigation of the same issues in different forums by restricting the substitution of an independent action for a direct appeal.¹²⁰

The Fourth Circuit's decision in *Bizzell*, however, allowed the creditor

isted deferred to trial court); *Stewart Sec. Corp. v. Guaranty Trust Co.*, 71 F.R.D. 32 (W.D. Okla. 1976)(failure to take appeal not an exceptional circumstance); *WRIGHT & MILLER*, *supra* note 109, at § 2868.

¹¹⁴ *Bankers Mortgage Co. v. United States*, 423 F.2d 73, 77 (5th Cir. 1970).

¹¹⁵ See, e.g., *Winfield Assoc. v. W. L. Stonecipher*, 429 F.2d 1087 (10th Cir. 1970); *Bankers Mortgage Co. v. United States*, 423 F.2d 73 (5th Cir. 1970); *Taft v. Donellan Jerome, Inc.*, 407 F.2d 807 (7th Cir. 1969); *National Surety Co. v. State Bank*, 120 F. 593 (8th Cir. 1903); *RESTATEMENT OF JUDGMENTS* § 128 (1942).

¹¹⁶ See *FED. R. CIV. P.* 60(b), Advisory Committee's Comments; *Rule 60(b); Survey and Proposal for General Reform*, 60 CAL. L. REV. 531, 533 (1972); Note, *The Final Judgment Rule in the Federal Courts*, 47 COLUM. L. REV. 239 (1947); see, e.g., *United States v. Throckmorton*, 98 U.S. 61, 65 (1878).

¹¹⁷ *Crosby v. Mills*, 413 F.2d 1273 (10th Cir. 1969). A Chapter XII arrangement is a real property arrangement by persons other than corporations. See *MACLACHLAN*, *supra* note 1, at § 310. In *Crosby* the Tenth Circuit reversed the district court and held that a federal court has ancillary jurisdiction over a Rule 60(b) independent action for relief from orders rendered in a bankruptcy proceeding. 413 F.2d at 1276. An independent action could not, however, be substituted for the review by petition provided by the Bankruptcy Act in other than exceptional circumstances. *Id.* The court of appeals remanded the case to the district court for a finding of any special circumstances in light of the need for a prompt and effective determination of the bankrupt's estate. *Id.* at 1277.

¹¹⁸ *Id.* at 1275.

¹¹⁹ *Id.* at 1276.

¹²⁰ See, e.g., *Stewart Sec. Corp. v. Guaranty Trust Co.*, 71 F.R.D. 32 (W.D. Okla. 1976)(equitable relief improper where party failed to appeal); *McCormack v. Schlinder (In re Orbitec Corp.)*, 392 F. Supp. 633 (S.D.N.Y. 1975)(denied the simultaneous use of direct appeal and an independent action for relief from bankruptcy judge's ruling); Note, 4 VAND. L. REV. 338, 339 (1951).

to maintain an independent action to gain affirmative relief from the parties who had defrauded him in connection with the arrangement proceedings¹²¹ although he had not exhausted all of his legal remedies. The bankruptcy court retained power under the Bankruptcy Act to allow the creditor to modify the arrangement to achieve a fair plan.¹²² This remedy would have been limited in that the aggrieved party could not have litigated the securities fraud claim against the bankrupt or the fraud claim against the fellow creditor in the bankruptcy court.¹²³ The Fourth Circuit must have intended to avoid this limitation by allowing Bizzell equitable relief in which his claims could be satisfied in a single action. Because both equitable relief and litigation of outside claims involve an action independent of the bankruptcy proceedings, Bizzell would not have been significantly prejudiced had he obtained leave of the bankruptcy court before seeking independent relief. Thus, the creditor's situation in *Bizzell* cannot be characterized as the exceptional case required in the Tenth Circuit's test before an independent action is properly asserted.

The departure in *Bizzell* from the equitable rule discouraging repeated litigation was unnecessary because Bizzell could have obtained relief without resorting to an independent equitable action.¹²⁴ While the Fourth Circuit's holding may be limited to cases of fraud on the court, *Bizzell* indicates that the court will no longer place emphasis on the lack of an adequate remedy at law in allowing equitable relief from bankruptcy proceedings.

The Fourth Circuit's recent decisions in bankruptcy cases indicate a trend toward a flexible application of the provisions of the Bankruptcy Act. The court in both *Goldstein* and *Bizzell* liberally construed the provisions of the Act. In *Goldstein* the court allowed a debtor-creditor set-off in direct conflict with a provision of the Act, and *Bizzell*, similarly, a creditor independent equitable relief although a legal remedy was available. In *O'Neill*, however, the court determined that the claims of creditors had already been satisfied. Thus, the recent bankruptcy decisions of the Fourth Circuit indicate that the court will construe provisions of the Bankruptcy Act broadly in favor of creditors, but will do so only when necessary to protect creditors' rights and insure satisfaction of their claims.

J. PETER RICHARDSON

¹²¹ 548 F.2d at 508.

¹²² A bankruptcy court may set aside or modify an arrangement if it appears that the arrangement was fraudulently procured and that the petitioner had no knowledge of such fraud at the time of confirmation. Bankruptcy Act § 386, 11 U.S.C. § 786 (1970); FED. BANKR. R. 11-41.

¹²³ The Fourth Circuit ruled that the action against Hemingway was proper because Fairco's arrangement in the bankruptcy court had no effect on Hemingway's liability to Bizzell. 548 F.2d at 507.

¹²⁴ Had Bizzell sought relief under the Bankruptcy Act provisions, he could have petitioned the bankruptcy court for modification of the arrangement under § 386 and for leave to litigate the securities fraud claim outside of the arrangement proceedings. Bizzell could then have sued both Fairco and Hemingway in the same forum.