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BANKRUPTCY — CHAPTER X PROCEEDINGS — SECURED CREDITOR'S RIGHT TO RECLAIM

Fruehauf Corp. v. Yale Express Sys., Inc., 370 F.2d 433 (2d Cir. 1966).

Bankruptcy courts have often been criticized for tenaciously adhering to a distinction between conditional sales agreements and chattel mortgage liens. Presently, the question is whether the distinction has general validity or whether it should affect the rights of a creditor only when his debtor is undergoing reorganization.

The Second Circuit, in *Fruehauf Corp. v. Yale Express Sys., Inc.*,[1] has recently answered this question. The creditor, Fruehauf, had sold several trucks and trailers to the debtor, Yale, on the basis of a false income statement. Upon discovering the error, the debtor notified the creditor, and, after some negotiation, it was agreed that the debtor was to have an opportunity to pay for the equipment on an installment plan rather than the original thirty-day cash basis. Further, the creditor took a chattel mortgage lien as security for the trucks and trailers. Approximately two months later, the debtor filed a petition for reorganization under Chapter X of the Bankruptcy Act.[2] After the debtor had refused to allow repossession, the creditor filed a petition for reclamation.

The district court stated that for the creditor to sustain his claim, he must show that the equipment was the "property of the debtor" and that "the distinction between a chattel mortgage and a conditional sale" had been abolished.[3] In so concluding, the court relied upon the leading case of *In re Lake's Laundry, Inc.*,[4] which stated that property sold under a conditional sales agreement would not be considered "property of the debtor" and thus would be subject to reclamation.[5] The court then determined that the agreement between the creditor and debtor was in the nature of a lien and thus title remained in the debtor, precluding the creditor's right to reclaim.[6]

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1 370 F.2d 433 (2d Cir. 1966).

2 Bankruptcy Act §§ 101-276, added by 52 Stat. 883 (1938), as amended, 11 U.S.C. §§ 501-676 (1964).

3 In the Matter of Yale Express Sys., Inc., 250 F. Supp. 249 (S.D.N.Y.), *rev'd and remanded*, 370 F.2d 433 (2d Cir. 1966).

4 79 F.2d 326 (2d Cir.), *cert. denied*, 296 U.S. 622 (1935).

5 *Ibid.*

6 In the Matter of Yale Express Sys., Inc., 250 F. Supp. 249, 254-55 (S.D.N.Y.), *rev'd and remanded*, 370 F.2d 433 (2d Cir. 1966).

On appeal, the Second Circuit abandoned the distinction created in the *Lake* case and relied upon the Uniform Commercial Code (UCC) for support of its position.[7] The court realized that *Lake* represented artificial distinctions and agreed with the dissent which stated:

> It seems to me a barren distinction, though indubitably true, that title does not pass upon a conditional sale; "title" is a formal word for a purely conceptual notion; I do not know what it means and I question whether anybody does, except perhaps legal historians. The relations resulting from conditional sales are practically the same as those resulting from mortgages; I would treat them as the same when we are dealing with the reorganization of the debtor's property.[8]

The court of appeals further felt that the *Lake* case could no longer serve as precedent since it was based upon state law which had since been replaced by the UCC.[9] The Code, it seems, was designed to modernize commercial laws, and reliance upon the *Lake* case could only "reestablish in new form limitations which reflect a passion for legal technicality over commercial reality."[10]

Thus, the *Yale* court resolved the problems created by the title distinctions by following the view adopted in the UCC. In concluding its discussion on this issue, the court said that "equitable considerations and the *substance* of the transaction should govern, regardless of the *form* of the security agreement."[11]

However, the court could not use the UCC to determine the rights of the individual with respect to reclamation. The UCC only voided any distinctions made on the basis of title; it did not guarantee the holder of a lien an absolute right of reclamation. Thus, it remained for the court to determine whether it should grant reclamation, stay the claim, or allow rentals to the lienholder. The

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[7] Fruehauf Corp. v. Yale Express Sys., Inc., 370 F.2d 433 (2d Cir. 1966). UNIFORM COMMERCIAL CODE § 9-202 [hereinafter cited as UCC] abandons the distinctions concerning possession of title. The UCC further evidences disagreement with the *Lake* case by stating: "[T]his Article adopts neither a "title" nor a "lien" theory of security interests . . . [therefore] the granting or denying of, for example, petitions of reclamation in bankruptcy proceedings should not be influenced by speculation as to whether the secured party had "title" to the collateral or "merely a lien." UCC § 9-507 comment 1.

[8] 79 F.2d at 328-29. This statement in Judge Hand's dissent has been cited in support of the abolition of the title distinction. See, *e.g.*, Fruehauf Corp. v. Yale Express Sys., Inc., 370 F.2d 433, 436 (2d Cir. 1966); 8 B.C. IND. & COM. L. REV. 101 (1966).

[9] 370 F.2d at 436-37. For a discussion of the *Lake* case and criticism of its basis, see 34 FORDHAM L. REV. 521 (1966).

[10] In the Matter of United Thrift Stores, Inc., 363 F.2d 11, 14 (3d Cir. 1966).

[11] 370 F.2d at 438. (Footnote omitted.)

nature of the problem can best be understood by examining each alternative.

It has been held that reclamation should not be granted where it would severely reduce or destroy the assets of the corporation undergoing reorganization.[12] This is in accordance with a main objective of bankruptcy courts, *i.e.*, to prohibit dissipation which would hinder the continuation of the debtor's business.[13]

In the *Yale* case, the appellate court was unable to determine if the district court refused reclamation on the basis of the aforementioned faulty title distinction or whether in fact there were equitable reasons for disallowing the creditor's claim.[14] The majority opinion agreed with the district court that if there were " 'cogent equitable reasons why . . . [the debtor] should not be forced to give up possession of this property at this time' " then reclamation should be denied.[15]

The power of the court to *stay* reclamation comes from section 116(4) of the Bankruptcy Act.[16] This power, however, is contrary to the generally accepted view, first expressed in *Northern Pac. Ry. v. Boyd*,[17] that the secured creditor has a protected position in a Chapter X reorganization.[18] This view, known as the "absolute priority rule,"[19] has been interpreted to mean that a plan of reorganization will not be "fair and equitable" unless secured claims are

[12] In the Matter of Flexton Corp., 143 F. Supp. 267, 269 (E.D. Pa. 1956). The reclamation proceeding is commenced by a petition of the claimant who invokes the summary jurisdiction of the reorganization court. The court is not strictly equitable but rather statutory in nature and is designed to administer the remedies offered by Congress in light of the equities of the debtor and creditor. MACLACHLAN, BANKRUPTCY § 325, at 387 (1956).

[13] 6 COLLIER, BANKRUPTCY § 3.05 (14th ed. 1966). It has been said that the purpose of reorganization under Chapter X of the Bankruptcy Act is to "avoid immediate liquidation of the properties involved, and to rehabilitate rather than liquidate." *In re* Greyling Realty Corp., 74 F.2d 734, 736 (2d Cir. 1935). See also NADLER, BANKRUPTCY § 899 (2d ed. 1965).

[14] 370 F.2d at 438.

[15] *Ibid.*

[16] Upon the approval of a petition, the judge may, in addition to the jurisdiction, powers, and duties . . . in this chapter conferred and imposed upon him and the court . . . enjoin or stay until final decree the commencement or continuation of a suit against the debtor or its trustee or any act or proceeding to enforce a lien upon the property of the debtor. Bankruptcy Act § 116, added by 52 Stat. 884 (1938), as amended, 11 U.S.C. § 513 (1964).

[17] 228 U.S. 482 (1913).

[18] Marine Harbor Properties, Inc. v. Manufactures Trust Co., 317 U.S. 78 (1942). This case brought the "absolute priority rule," as applied under section 77B of the original Bankruptcy Act, into line with Chapter X of the revised Bankruptcy Act. 48 Stat. 912 (1934).

[19] 6 COLLIER, *op. cit. supra* note 13, § 11.06.

recognized in relation to their priorities.[20] Thus, while the court may use its injunctive power and stay a claim, it must be careful not to impair the substantive rights of the secured creditor.[21]

In accordance with this reasoning, it has been suggested that if the court refuses to grant reclamation or stays the claim, it may be advisable for the court to explore alternative forms of relief.[22] In the *Yale* case the majority felt that since tractors and trucks depreciate, there should be some provision for *rentals*.[23] The dissent, however, maintained that there was no justification for allowing rentals when a petition for reclamation is denied,[24] contending that the debtor undergoing reorganization would be in no better position to pay rentals than to discharge the lien.[25]

Under the reasoning of the dissent, there would be no compensation for the creditor during the period of reorganization. Thus, this view places its emphasis upon the debtor, and the equities of the secured creditor, as advocated by the "absolute priority rule," are disregarded. The dissenting opinion relied on *In re Wis. Cent. Ry.*[26] to support the denial of rentals, since that case distinguished the allowance of rentals in conditional sales situations from possible allowances under a lien.[27] Because this distinction has been abolished,[28] it would now seem valid to infer that the rule should

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20 Under the original section 77B(f) of the Bankruptcy Act, it was said that "After hearing such objections as may be made to the plan, the judge shall confirm the plan if satisfied that (1) it is fair and equitable and does not discriminate unfairly in favor of any class of creditors or stockholders, and is feasible." 48 Stat. 912 (1934). This was later amended to say the plan must be fair and equal, but the language on discrimination was dismissed. Bankruptcy Act § 221(2), added by 52 Stat. 897 (1938), as amended, 11 U.S.C. § 621(2) (1964). However, the language of the section was interpreted in light of the "absolute priority rule." Case v. Los Angeles Lumber Prods. Co., 308 U.S. 106 (1939). This principle related to the old Bankruptcy Act and has been applied to Chapter X proceedings in Marine Harbor Properties, Inc. v. Manufactures Trust Co., 317 U.S. 78 (1942).

21 "Practical adjustments, rather than a rigid formula, are necessary. The method of effecting full compensation for senior claimants will vary from case to case. . . . [T]he appropriateness of the formula employed rests in the informed discretion of the court." Consolidated Rock Prods. Co. v. Du Bois, 312 U.S. 510, 529-30 (1941). See also Reconstruction Fin. Corp. v. Kaplan 185 F.2d 791, 796 (1st Cir. 1950); *In re* New York, N.H. & H.R.R., 147 F.2d 40, 48 (2d Cir. 1945).

22 370 F.2d at 439.

23 *Ibid.*

24 *Id.* at 440.

25 *Ibid.*

26 64 F. Supp. 251 (D. Minn. 1946). See Lincoln-Alliance Bank & Trust Co. v. Dye, 108 F.2d 38 (2d Cir. 1939) (per curiam); *In re* Maier Brewing Co., 38 F. Supp. 806 (S.D. Cal. 1941).

27 *In re* Wis. Cent. Ry., 64 F. Supp. 251 (D. Minn. 1946).

28 See text accompanying notes 7-11 *supra*.

be that an equitable determination will be made in the lien situation as to the granting of rentals.[29]

The rental allowances suggested by the majority in *Yale* seems to be the most equitable solution,[30] for the creditor will receive payments during the period of reorganization and thus will not have to sustain the loss caused by depreciation.[31] Yet, there remains the problem that the rights of the secured creditor who is entitled to preferential treatment may be distorted.[32]

The granting of rentals is not to be interpreted as a substitute for reclamation; it should only be used when the creditor is not entitled to reclamation. Further, courts should not be arbitrary in setting the amount of the rental. Rather, under the "absolute priority rule," it seems fair to say that rentals must be adequate to cover any expense the creditor suffers by not being allowed to recover his goods.

It is obvious from the *Yale* decision that the view of the UCC has been adopted and that therefore the demarcation which once existed between the treatment of the conditional vendor and the holder of a chattel mortgage has been abolished. Thus, in a reorganization under Chapter X of the Bankruptcy Act, the court must determine the merits of debtor's and creditor's claims on a case-by-case basis. If the claim is invalid, or if repossession of the goods will cause undue hardship to the debtor, reclamation should be denied. However, the denial should not be granted unless the secured creditor will receive adequate compensation in the form of rentals.

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29 It has been said that when the security of the conditional vendor "is depreciating in value . . . extended delay . . . may be in the interest of the general creditors, but their interest should not be pursued to the disadvantage of the conditional vendor and to the prejudice of its security." Power & Combustion, Inc. v. Wilson, 298 F.2d 937, 940 (4th Cir. 1962). This case was decided under Chapter XI and can thus be used only by analogy.

30 "It does not appear equitable to permit the debtor corporation to retain possession of the taxicabs, continue its business, while the taxicabs are depreciating, and fail to pay the balance due on the vehicles, shifting the risk of loss to the vendors." *In re* Sun Cab Co., 67 F. Supp. 137, 139 (D.D.C. 1946). The case implies that if reclamation was not allowed, rental payments may have been. See In the Matter of Newjer Contracting Co., 154 F. Supp. 567 (D.N.J. 1957).

31 *In re* Sun Cab Co., 67 F. Supp. 137, 139 (D.D.C. 1946).

32 See text accompanying notes 17-21 *supra*.