Chicago-Kent Law Review

Volume 52
Issue 2 *Seventh Circuit Review*

Article 3

October 1975

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Recommended Citation
Ronald R. Peterson & Ronald R. Peterson, *Bankruptcy* , 52 Chi.-Kent L. Rev. 229 (1975).
Available at: https://scholarship.kentlaw.iit.edu/cklawreview/vol52/iss2/3

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BANKRUPTCY

RONALD R. PETERSON*

In the past year there have been many new developments in the bankruptcy area for lawyers who practice in the Seventh Circuit. Bankruptcies and reorganizations filed in the Seventh Circuit have increased almost 25 percent in the past year and 70 percent since 1973. Whether this is a result of the economy, the energy crisis, or merely an increase in the public awareness and acceptance of bankruptcy remains uncertain, but the trend, despite the "recovery", continues.

With the filing of more complex cases under Chapter XI, the entire proceeding has continued to evolve from a procedure designed for debtors with large unsecured debt but insignificant secured debt to a procedure whereby debtors with large secured debt but minor unsecured debt can ingeniously hold secured creditors, landlords and equipment lessors in line and persuade them to accept something less than that to which they might feel they are entitled. In addition, in the last six months there have been more Chapter XII cases filed than since the days of the depression.

In answer to this turbulent setting the bankruptcy bar has adapted itself to the new Chapter XI rules, effective July 1, 1974, and the newer Chapters X and XII rules, effective August 1, 1975. During the same time the Seventh Circuit has been busy handing down many important bankruptcy decisions addressing the thorny problems which confront the bankruptcy bar. While this article will not review every Seventh Circuit decision, it will focus on the more important decisions involving reclamation, attorneys' and accountants' fees, and creditors' standing in the bankruptcy court.

RECLAMATION

The Illinois Uniform Commercial Code, section 2-702,[1] gives the seller a right to reclaim goods he sold the bankrupt buyer when the seller discovers that the buyer had received goods on credit while insolvent.[2] The demand for the return of the goods, however, must be made within ten days of the buyer's receipt of said goods. Too many times the hapless seller's credit

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1. ILL. REV. STAT. ch. 26, § 2-702 (1973).
2. *Id.* Section 2-702(2) states:

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 receipts . . . .

manager does not hear of the buyer's financial embarrassment until long after the ten-day period has elapsed. Subsection (2) of section 2-702 also provides that if written misrepresentations of solvency have been made to the seller by the buyer within three months of delivery of the goods the ten-day limitation does not apply.[3]

The Seventh Circuit took a hard look at the seller's right to reclaim after the ten-day period expired in the matter in *In Re Creative Buildings, Inc.*[4] In that case, the seller had transacted business with the buyer since June, 1969. In late 1971 the buyer gave the seller two checks, one for $47,859.23 dated November 19, 1971, and the other for $9,900.76 dated December 1, 1971. Both checks were returned to the seller stamped not sufficient funds (N.S.F.). The first check was paid when re-presented, however, and the seller subsequently redeposited the second check. On January 5, 1972, the seller, based upon (1) the payment of the first check and assumed payment of the second check, (2) the oral assurances of the buyer, and (3) a promise by the buyer that a solvent third party would pay for the goods, shipped additional goods to the buyer on credit. The seller did not know that the second check had again failed to clear the bank. It was subsequently returned N.S.F. at the end of the month. On January 28, 1972, the buyer filed for an arrangement under Chapter XI of the Bankruptcy Act. The seller did not file a demand for reclamation of the goods until March 9, 1972. Since the ten-day period had expired, the seller contended that when the debtor had given it an N.S.F. check in November and December, 1971, it had "ceased to pay its debts in the ordinary course of business" and had demonstrated that it would not pay its debts as they became due, and thus was insolvent.[5]

The seller also alleged that the debtor was insolvent under the Bankruptcy Act definition.[6] The court found there was no evidence that the debtor was insolvent in the bankruptcy sense, but it struggled with the question of whether it should accept a strict literal meaning of the UCC definition of insolvency and hold that when a debtor has one of its checks returned to the payee marked N.S.F. it has ceased to pay its debts in the regular course per se. The court objected to the application of the strict

3. [B]ut if misrepresentation of solvency has been made to the particular seller in writing within 3 months before delivery the 10-day limitation does not apply. Except as provided in this subsection the seller may not base a right to reclaim goods on the buyer's fraudulent or innocent misrepresentations of solvency or of intent to pay.

ILL. REV. STAT. ch. 26, § 2-702(2) (1973).

4. 498 F.2d 1 (7th Cir. 1974).

5. ILL. REV. STAT. ch. 26, § 1-201(23) (1973) states:

A person is "insolvent" who either has ceased to pay his debts in the ordinary course of business or cannot pay his debts as they become due or is insolvent within the meaning of the federal bankruptcy law.

6. 11 U.S.C. § 1(19) (1970) states:

A person shall be deemed insolvent within the provisions of this Act whenever

literal meaning of the words of the Code.[7] It found that there are a variety of business transactions in which for one reason or another N.S.F. checks issue either through mistake, miscalculation, good faith reliance by the drawer on anticipated income, or other more or less innocent circumstances.[8] Although the court could have concluded that checks and other negotiable instruments could never be representations of solvency, it backed away from such a strong conclusion and presented a test under which a check or note could be considered a representaiton of solvency. In so doing, the court looked to section 2-702 which on its face requires (1) a written (2) misrepresentation of solvency (3) made within three months of delivery (4) to the particular creditor who is attempting to rescind the contract.[9]

There was no doubt that the check was a writing, nor was there any question that the seller satisfied the last two requirements. The key issue of the case was whether a check is a representation of solvency. Some courts have held that a check is an implicit representation that the seller is solvent and that the check will be paid.[10] The official comments to the Illinois Uniform Commercial Code state that any acceptance of goods by the buyer on credit is a tacit representation of solvency.[11] Thus, when a writing is received in conjuction with a receipt of goods, the check stands all the more as a representation of solvency. In considering its opinion, the Seventh Circuit looked to the law of Illinois as interpreted by the Illinois Appellate Court in *Hamm Brewing Co. v. First Trust & Savings Bank.*[12] The appellate court had stated:

> Although [section] 2-702(2) does not so prescribe in express terms, an implicit requirement of the section is that the particular writing be treated as a representation by the seller. While the check can comply with the literal requirements of a writing, i.e., in writing, addressed to the particular seller and dated within three months of the delivery, unless the writing is treated by the seller as a representation, he should not be accorded the benefit of the section.

the aggregate of his property, exclusive of any property which he may have conveyed, transferred, concealed, removed, or permitted to be concealed or removed, with intent to defraud, hinder, or delay his creditors, shall not at a fair valuation be sufficient in amount to pay his debts.

7. 498 F.2d at 2.

8. 498 F.2d at 3. *See also* Hamm Brewing Co. v. First Trust & Savings Bank, 103 Ill. App. 2d 190, 195, 242 N.E.2d 911, 914 (1968).

9. 498 F.2d at 3; *see In re* Bel Air Carpets, Inc., 452 F.2d 1210 (9th Cir. 1971).

10. Amoco Pipeline Co. v. Admiral Crude Oil Corp., 490 F.2d 114, 117 (10th Cir. 1974); Guy Martin Buick, Inc. v. Colorado Springs Nat'l Bank, 32 Colo. App. 235, 511 P.2d 912, 914 (1973) (dissenting opinion); Hamm Brewing Co. v. First Trust & Sav. Bank, 103 Ill. App. 2d 190, 195, 242 N.E.2d 911, 914 (1968).

11. The Official Comment to section 2-202 states that subsection (2) takes as its base line the proposition that any receipt of goods on credit by an insolvent buyer amounts to a tacit business misrepresentation of solvency and therefore is fraudulent as against the particular seller.

12. 103 Ill. App. 2d 190, 242 N.E.2d 911 (1968).

> At least one indication of treatment of a writing as a representation is whether the seller relied upon the writing as an element in determining its course of dealing with the buyer. Sec[tion] 2-702(2) does not specifically require reliance; however, the concept is present by implication. In reasonable commercial expectation, the seller does not expect his buyer to be insolvent, and relies on this expectation.
>
> Official Comments indicate that any receipt of goods on credit is a tacit representation of solvency. Thus if reliance was not relevant in any case, the presence of a writing as a determinative factor would be meaningless. Cases decided in Illinois involving misrepresentation in commercial transactions are of guidance here, and can properly be considered, as above noted.[13]

The appellate court further noted, in determining whether a party had a right to rely on false representations, that the representation had to be viewed in light of the facts of which the injured party had or could have had knowledge of through the exercise of ordinary prudence.[14]

If treatment by the seller of the writing as a representation and reliance by the seller were not necessary, section 2-702(2) could be utilized to protect a seller who knows full well that his buyer is insolvent but continues to sell to him and then reclaims the property when the buyer does not pay as promised or when another party appears on the scene.[15] Section 1-203 of the UCC requires dealing in good faith. This requirement would not be met by the conduct just described and would seem to require that a seller not be able to profit by such a course of conduct.[16]

The Seventh Circuit found that if the payment of the first check by the buyer upon representment induced the seller to release the goods on credit, then the requisite standard of reliance would have been satisfied. But, the court also found that the seller had relied on oral representation, especially upon the statement that a solvent third party was to pay for the goods. Thus, it concluded that there was no reliance by the seller upon the check.

The court further noted that the very fact that the checks had been returned N.S.F. the first time should have been a "red flag" in front of the seller's face that the buyer was on a shaky footing. For the buyer to have proceeded the way he did was an act of foolhardiness.

Thus the Seventh Circuit established a test that the seller must have relied principally on the writing and that the reliance was in good faith and in the exercise of prudent and knowledgeable business judgment. Where a

13. *Id.* at 195, 242 N.E.2d at 915. *See also* American Merchant's Union Exp. Co. v. Willsie, 79 Ill. 92 (1875); Schweizer v. Tracy, 76 Ill. 345 (1875).

14. 103 Ill. App. 2d at 195, 242 N.E.2d at 915, *citing* Moral v. Masalski, 333 Ill. 41, 164 N.E. 205 (1928).

15. 103 Ill. App. 2d at 196, 242 N.E.2d at 915.

16. *Id.*; ILL. REV. STAT. ch. 26, § 1-203 (1973).

seller can make out the rather formidable burden of proof, the Seventh Circuit holds that he would be entitled to reclamation.[17]

The court took a realistic approach to the commercial world. First, few, if any, credit managers exclusively consider the issuance of a check to be prima facie proof of solvency. Credit managers often look to a number of other written and oral representations: credit bureau reports, past experience, and the plain desire to gamble to make money. To hold that the decisions of credit managers hinge on the issuance of a check by the buyer borders on fantasy.

Second, the court protected section 2-702 from complete subversion by the ambitious sellers with a heads, seller wins, tails, buyer loses, philosophy. If the mere issuance of an N.S.F. were to be considered a written representation of solvency upon which reclamation could be ordered under section 2-702, then the ten-day rule would never be of any use in N.S.F. check transactions.

The decision is consistent with that of other contemporary courts. The court left the door open to the reasonable interpretation that if the seller can meet the burden of proof he is entitled to reclamation.[18] Thus, the Seventh Circuit's restriction of the meaning of section 2-702 was appropriate.

CREDITOR'S STANDING

Although creditors normally are given the opportunity to appear in bankruptcy court to participate in the proceedings and to object to the adjudication of the bankrupt or the jurisdiction of the bankruptcy court, an involuntary petition of bankruptcy places the creditor on a different footing. In *Carlson Plywood Co. v. Vytex Plastics Corp.*[19] the Seventh Circuit opined that a creditor has absolutely no right to challenge an involuntary petition either directly or indirectly.

In that case the bankrupt, Vytex, filed a petition in the state court praying for an order of liquidation and the appointment of a state court receiver. Subsequently, three of Vytex's creditors filed an involuntary petition and Vytex consented to being adjudicated a bankrupt. Carlson, one of the non-petitioning creditors of Vytex, filed an action in the federal district court to enjoin the bankrupt from proceeding in the bankruptcy court and to dismiss the bankruptcy petition. The basis for Carlson's collateral attack was that the bankruptcy court lacked jurisdiction to grant the petition

17. One seller did just that in Amoco Pipeline Co. v. Admiral Crude Oil Corp., 490 F.2d 114 (10th cir. 1974).

18. Amoco Pipeline Co. v. Admiral Crude Oil Corp., 490 F.2d 114 (10th Cir. 1974); *In re* Bar-wood, Inc., 73-334-BK-WM-H, 15 UCC REP. SERV. 828 (S.D. Fla. 1974); *In re* Fairfield Elevator Co., Inc., BK 0-22-72, 14 UCC REP. SERV. 96 (S.D. Ia. 1973).

19. 519 F.2d 556 (7th Cir. 1975).

and that Vytex could not consent to the involuntary petition because of the appointment of the state court receiver.

The federal district court rejected Carlson's claim on the grounds that it should have objected to the petition in the bankruptcy court rather than proceeding with a collateral attack. The Seventh Circuit affirmed, but for a different and more fundamental reason: Carlson lacked standing to challenge the adjudication both in the district court and in the bankruptcy court. In reaching this result, the court looked to the history of the Bankruptcy Act and the decisions of other circuits that have dealt with this issue.

The filing and adjudication of the bankrupt is governed by section 18b of the Bankruptcy Act.[20] As originally enacted in 1898, the Act provided that "[t]he [b]ankrupt or any creditor [could] appear and plead to the petition within five days after the return day or within such further time as the court may allow."[21] In 1938, however, the words "or any creditor" were deleted by the Chandler Act.

In re Carden[22] was the first post-Chandler Act case to consider this question. The court held:

> Since there is no longer any express statutory right given creditors to contest an adjudication upon the involuntary petition in bankruptcy, the right, if any, of creditors to make such a contest must rest upon general principles of equity applicable in bankruptcy proceedings. It is true that such principles will govern action in the bankruptcy court when not in conflict with the statute. But where there has been an amendment to the statute whereby such right formerly existing has been withdrawn, there has been the equivalent of a statutory denial of the right and any action under general principles of equity contrary thereto would be contrary to the statute and so erroneous. Consequently the appellant was without standing to question the sufficiency of the petition.[23]

The reasons for the change were stated in the House Report.

> The right of creditors to file an answer and oppose the petition has been eliminated in the amendment of section 18b and section 59f has been changed to correspond with this amendment. A creditor should not be permitted to oppose an adjudication; invariably, the motive of such a creditor is to protect a preference or to retain some other undue advantage at the expense of the other creditors,

20. 11 U.S.C. § 41(b) (1970):
The Bankrupt and, in the case of a petition against a partnership, any general partner or, in the case of a petition in behalf of a partnership, any general partner not joining therein, may appear and plead to the petition within five days after the return day or within such further time as the court may allow.

21. Bankruptcy Act of 1898, § 18b. *See also* 2 COLLIER ON BANKRUPTCY ¶ 18.33 [1] at 106 (14th ed. 1975) [hereinafter cited as COLLIER].

22. 118 F.2d 677 (2d Cir. 1941).

23. *Id.* at 679 (citation omitted).

> contrary to the fundamental purpose of the Act—an equitable distribution among all creditors.[24]

Subsequently, other circuits followed *Carden* in denying the creditor the right to appear in bankruptcy court to plead or object to the adjudication.[25]

Thus, the Seventh Circuit concluded that if Carlson had proceeded initially in the bankruptcy court it would have been without standing. The second question was whether Carlson could do indirectly what it could not do directly.

The court acknowledged that creditors cannot oppose an involuntary adjudication of bankruptcy, either during the proceedings before the bankruptcy court or after completion of these proceedings through a motion to set aside the adjudication.[26] The troublesome point of this opinion is that if Carlson's point was correct, the court was utterly without jurisdiction. Several schools of thought have considered what rights the creditor may have to object to the jurisdiction of the bankruptcy court.

In both *In re Jack Kardow Plumbing Co.*[27] and *In re Highley*,[28] the Fifth and Ninth Circuits denied the creditor any standing to challenge the jurisdiction of the court by motion to vacate after adjudication on the grounds that the intent of Congress was to prevent a post-adjudication challenge as well as a pre-adjudication challenge.[29]

Professor Collier takes the position that if the defects of the involuntary petition are patently jurisdictional, the bankruptcy court may raise the objection on its own motion and accordingly permit a creditor to appear, not as a qualified party in interest, but as amicus curiae.[30] The Seventh Circuit stated that it was expressing no opinion as to whether Carlson could have, short of setting aside the adjudication, objected to the discharge of the bankrupt under section 14 of the Act, thus, accomplishing the same end.[31]

24. H. REP. No. 1409 on H.R. 8046, 75th Cong., 1st Sess. 17 (1937). *See also* 3A COLLIER, *supra* note 21, ¶ 18.33 at 106. Other grounds may exist, though, for a creditor to object to an involuntary proceeding, including the exhausting administrative costs and the protracted time for receiving dividends.

25. *In re* Gold Metal Packing Corp., 470 F.2d 186 (2d Cir. 1972); *In re* Highley, 459 F.2d 554 (9th Cir. 1972); *In re* Jack Kardow Plumbing Co., 451 F.2d 123 (5th Cir. 1971); Commercial Credit Corp. v. Skutt, 341 F.2d 177 (8th Cir. 1965).

26. Carlson Plywood Co. v. Vytex Plastics Corp., 519 F.2d 556, 558 (7th Cir. 1975). *See also In re* Highley, 459 F.2d 554, 556 (9th Cir. 1972).

27. 451 F.2d 123, 130 (5th Cir. 1971).

28. 459 F.2d 554, 556 (9th Cir. 1972).

29. *But see In re* T.J. Ronan Co., 114 F. Supp. 299 (S.D.N.Y. 1953), which implies that the circuitous route to bypass the problem should be used as it would be in the voluntary proceedings. *Cf. In re* Federman, 119 F.2d 754 (2d Cir. 1941).

30. 2 COLLIER, *supra* note 21, ¶ 18:47 [3] at 188.

31.
> The thrust of the complaint is to put a halt to the bankruptcy proceedings. This would, in turn, involve setting aside the adjudication. While we have determined that Carlson, as a creditor, is without standing to make an attack, we express no opinion as to whether Carlson in the bankruptcy proceedings may be in a position to have grounds to oppose a discharge.

519 F.2d at 558 n.1 (citation omitted).

Although the policy of the 1938 Chandler Act amendments is clear, some remedy must exist to protect creditors from the costly effects of an involuntary petition when that petition lacks the requisite jurisdictional requirements. The policy of the Act was to prevent creditors from delaying the involuntary adjudication until after the four-month preference period in section 60 had expired.[32] But when that period is tolled by an adjudication, it would seem that the creditor at that point should have the right to object to the jurisdiction of the court. Professor Collier's comment that he could file an amicus curiae brief merely skirts the issue. Allowing the creditor to object to discharge perhaps allows the creditor the right to terminate the proceedings, if the court is patently without jurisdiction, without the problem of exhausting the four-month rule protecting his preference. This would be a proper result. After all, a creditor in a voluntary proceeding has the right after adjudication to object to discharge and challenge the jurisdiction of the court. It would be an anomaly to deny the creditor in an involuntary situation the same right if the problem of preferences can be overcome. Thus, the court's lack of guidance as to how a creditor in an involuntary proceeding may proceed if he cannot set aside the adjudication was disappointing, but the door was left wide open for a future creditor to raise such an objection.

ATTORNEYS' AND CREDITORS' FEES

One of the most taxing problems facing bankruptcy judges and one of the most often litigated areas of bankruptcy law is the amount and fairness of attorneys' and accountants' fees. The Seventh Circuit addressed itself to this problem in *In re Brooks & Woodington, Inc.*[33] The case started as a Chapter XI arrangement which was soon aborted. The trustee in bankruptcy petitioned the court for permission to hire an accounting firm so that the trustee might have and use a full and comprehensive report on the assets and liabilities of the bankrupt. The court was given an estimate by the accountants of $7,500 as the total cost of the project and the court approved a set of hourly schedules. But the bankruptcy court also extended the scope of the review to include auditing all of the bankrupt's subsidiaries. The bankrupt's affairs were hopelessly confused and intertwined with that of its subsidiaries. Innumerable security interests further clouded the financial picture. The accountants submitted regular bills and periodical payments were made to the accountants totalling $34,000. The bankruptcy court never restricted the right of the accountants to continue their work although they had far exceeded their own estimates.

When all of the work had been completed the accountants claimed an additional $23,000 although they had recovered over $700,000 for secured

32. 11 U.S.C. § 96 (1970).
33. 505 F.2d 794 (7th Cir. 1974).

creditors. The bankruptcy court found that if the fees were paid, the unsecured creditors would not receive a dividend, but if the fees were denied, a generous 3.61 percent dividend would be paid to the unsecured creditors. Thus, the court concluded that the accountant's fees should be denied.

In considering the appeal, the Seventh Circuit first paid homage to the doctrine that the bankruptcy judge's discretion should not be disturbed unless clearly in error as to law and fact.[34] The court found, however, that the judge had in fact made an error in both his interpretation of the Bankruptcy Act and his understanding of the facts.

The first issue considered by the court was whether the accountants were under an obligation to obtain an order from the bankruptcy court if the accountants knew that their work would exceed the estimate.[35] In answering in the negative, the court found that the estimate was not based on the additional work covered in the order. The bankruptcy judge knew at all times of the activities of the accountants, their billing rate and the accumulated time. The bankruptcy judge could have stopped the proceedings at any time. The court therefore concluded that the application by the accountants for authority to proceed was not necessary.[36]

The court also found that as a matter of law the bankruptcy judge's conclusion was erroneous. The Eighth Circuit in *Killoren v. Boyd, Cronk & Co.*[37] considered an almost identical factual situation and held: "He [the trustee] should not have permitted the firm [accountants] to continue rendering services which he knew, or ought to have known, were being performed with the expectation that they would be paid for at the rate fixed by the court."[38] The court concluded that even though *Killoren* involved a

34. The bankruptcy court has the power to decide whether or not to allow compensation and reimbursement out of the estate to a trustee's accountant or attorney. It is an attribute of the court's exclusive and nondelegable control over the administration of an estate in its possession. In the normal course of proceedings the referee's discretion and judgment, if free from error of law and sufficiently supported by the facts, is entitled to great weight. Prior to the Chandler Act of 1938 an appeal from the bankruptcy judge's order would have been very difficult and limited in scope. The appeal required the approval of the appellate court, and was limited to the bankruptcy judge's errors in law. Section 24 of the Chandler Act authorizes an appeal as of right from a compensation order in bankruptcy provided that where the order involves less than $500 the appeal may be taken upon the allowance of the reviewing court. In addition the reviewing court may examine not only errors in law but may question the bankruptcy judge's analysis of the facts. *See* 2 COLLIER, *supra* note 21, ¶ 24.41[2] at 807.

35. Order No. 45, General Orders in Bankruptcy, abrogated by General Order 49, provided in relevant part: "No . . . accountant shall be employed by a . . . trustee . . . except upon an order of the court expressly fixing the amount of the compensation or the rate of measure thereof . . . ." *See also* Bankruptcy Rule 215; Chapter X Rule 10-206; Chapter XI Rule 11-29(b); Chapter XII Rule 12-12; Chapter XIII Rule 13-207.

36. 505 F.2d at 797-98.

37. 119 F.2d 1 (8th Cir. 1941).

38. *Id.* at 3.

reorganization (resurrection of the debtor), the same rule would apply in a liquidation (burial of the debtor) as well.

The next issue in the case was whether the fact that there would be no dividend to unsecured creditors should be a determinative factor in denying the additional fees. The court found that it must weigh two important considerations: the spirit of economy demanded by the Supreme Court for the administration of estates[39] versus the court's desire to attract competent lawyers and accountants to the bankruptcy bar by paying them a fair compensation.

The Seventh Circuit was correct in finding that economy is not equivalent to parsimony when under all circumstances and conditions the fee was fair and equitable.[40] The court found that the work done by the accountants was necessary to the estate, had caused the recovery of $700,000, and was done in an efficient manner. As stated by the Ninth Circuit in *Jacobowitz v. Double Seven Corp.*,[41] "[W]e think that the economical spirit of the Bankruptcy Act does not require nor justify reducing a requested fee where as here by all other proper standards it is fair and a reasonable one."[42]

Although the court had to consider as equally important the fact that the unsecured creditors would be deprived of a dividend, the court concluded, "[W]e hold as a matter of law that the desire for some dividend to creditors, if that dividend is only of a token nature, should not override the commitment lawfully made with those employed on specific terms by the bankruptcy court."[43] Thus while the decision does not present a controlling rule, the court makes it clear that it will consider each case on the basis of its own facts. The court makes it clear that the economic spirit of the Bankruptcy Act is a balancing procedure in which the amount of the dividend is weighed against the results and efficiency of the accountant's work product.

COST OF CREDITORS' RIGHTS

Not infrequently, particularly in a reorganization proceeding, the estate requires the services of accountants, lawyers and other professionals. As a rule, the only attorneys entitled to compensation are the attorneys for the debtor-in-possession, the receiver, and the attorneys for the statutory creditor's committee.[44]

39. Realty Associates Sec. Corp. v. O'Connor, 295 U.S. 295 (1934).

40. 3A COLLIER, *supra* note 21, ¶ 62.12 [5] at 1485: "In determining the reasonable values of services rendered the following elements are to be considered: the time spent, the intricacy of the problems involved, the size of the estate, the opposition met, the results achieved all subject to the economical spirit of the Bankruptcy Act."

41. 378 F.2d 405 (9th Cir. 1967).

42. *Id.* at 408.

43. 505 F.2d at 799.

44. Chapter X Rule 10-206; Chapter XI Rules 11-22 and 11-27(b); Chapter XII Rule 12-28; Chapter XIII Rule 13-209.

From time to time, either because one of the above enumerated counsel does not, would not or could not act, an attorney, usually for one of the creditors, volunteers to act for the benefit of the estate. The contributions of such attorneys are in many cases the sole reason for additional monetary recovery for the estate or the protection of valuable creditor's rights. The tautologous question always follows: are the volunteers who serve for the benefit of the creditors or the estate, but without court order or sanction to act, entitled to compensation?

The most troubling case of the last term was *In re Peerless Manufacturing Co.*[45] It raised two important questions concerning fees: (1) When the appointment of a trustee is successfully challenged because his election violated the Bankruptcy Act, whether the estate (creditors) must pay for his attorney's fees in defending the challenge, and (2) whether the attorney for the challenging creditors who vindicates the creditor's rights is entitled to fees from the estate.

Peerless I

Peerless, like many cases, started as a Chapter XI proceeding which was soon aborted and adjudicated as a straight bankruptcy. Edward Limperis was appointed receiver and he retained Louis I. Kessler, an experienced bankruptcy attorney, as his counsel. At the subsequent first meeting of creditors, thirteen creditors, whose claims totaled a majority of the bankrupt's total indebtedness, nominated Sherwin L. Ehrlich as trustee and one other creditor nominated Limperis.[46] Without a vote on the nominations, the bankruptcy judge appointed Limperis, who in turn hired Kessler as his counsel.[47]

The thirteen creditors involved, represented by another bankruptcy lawyer, Joseph Stein, objected to the so-called election of a trustee and filed an appeal. The district court affirmed, but the Seventh Circuit reversed.[48]

45. *In re* Peerless Mfg. Co., 523 F.2d 110 (7th Cir. 1975) [hereinafter referred to as *Peerless II*]. *Peerless I* is reported at 416 F.2d 57 (7th Cir. 1969).

46. Alex H. Dolnick, an attorney representing Lee Gollub, a creditor, shareholder and director of the bankrupt, nominated Limperis as trustee. Lee Gollub as director of the bankrupt was precluded by statute from making any nomination. Harold Lansing, an attorney representing the only other creditor participating in the meeting and who had a claim of $1,012 joined in the nomination of Limperis. Kessler, conceding he had no voice in the election of the trustee, nevertheless objected to the nomination of Ehrlich and took an active part in supporting the nomination of Limperis.

Brief and Argument for Appellees at 4, *In re* Peerless Mfg. Co., 523 F.2d 110 (7th Cir. 1975) (citations omitted).

47. The court found among other reasons for rejecting Ehrlich's nomination that Stein had failed to file affidavits as required in and by rule 10a of the Local Bankruptcy Rules and Limperis had considerable experience in the bankruptcy field while Ehrlich had no experience. The court also concluded that Gollub's nomination was valid in light of its confirmation by Lansing. Bankruptcy Judge McCormick's order of April 29, 1968, Nos. 74-1585, 75-1586.

48. 416 F.2d 57 (7th Cir. 1969).

Circuit Judge Cummings noted that section 44 of the Bankruptcy Act provides:

> The creditors of a bankruptcy . . . where the bankrupt is a corporation . . . shall, at the first meeting of creditors after the adjudication . . . appoint a trustee . . . for such estate. If the creditors do not appoint a trustee, or if the trustee so appointed fails to qualify . . . the court [the referee] shall make the appointment.[49]

The court summarily swept aside the bankruptcy judge's technical objections and concluded, "One of *the highest acts of the creditors* is the choice of a trustee, and . . . section 44a of the Bankruptcy Act clearly confers that choice upon them."[50]

> The choice by a bankrupt's creditors of a trustee, although subject to the approval of the court, should be approved unless good reason exists for disapproving. If any question exists in the court's [referee's] mind as to whether the choice of the creditors should be approved, it may hold a hearing for that purpose . . . .[51]

The court decided that the appointment of Limperis had deprived the creditors of their right to vote. As the court noted, "such preemptory disregard for the desire of the creditors was a *plain* violation of [s]ection 44a as it has long been constructed."[52] Upon the remand by the Seventh Circuit, Ehrlich was elected trustee by the creditors of the bankrupt, and Stein was appointed attorney for Ehrlich as trustee.

Peerless II

After Ehrlich and Stein were appointed they began an investigation into claims which had been filed and allowed by the referee upon concurrence with the trustee. They learned that claims submitted by Gollub and another officer, director and shareholder of the bankrupt had not been contested by Limperis and Kessler and orders had been entered approving their claims as filed. Erhlich and Stein petitioned to have the orders allowing the claims vacated and, after contested hearings, the orders allowing the claims were vacated and the claims were denied. The estate thereby saved $29,527. Another claim of Gollub in the sum of $19,027 was subordinated to the claims of the general creditors.[53] Thus, through Ehrlich and Stein's work the amount of claims against the estate was reduced by $57,710, allowing a larger dividend to unsecured creditors.

Upon the conclusion of the proceedings, Stein and Ehrlich petitioned for fees, but the bankruptcy judge denied the bulk of the claim. Kessler and

49. 11 U.S.C. § 72(a) (1970).
50. 416 F.2d at 60 (emphasis added).
51. *Id., citing In re* Thomas, 263 F.2d 287, 290 (7th Cir. 1959).
52. *Id.* (citations omitted).
53. Brief of Stein at 11-12.

Limperis also applied for fees and the application was granted by the bankruptcy judge.[54] The federal district court, in an opinion issued by District Judge Frank J. McGarr, remanded Stein's fees to the bankruptcy court for further proceedings, but denied that Stein was entitled to his fees in prosecuting his action in favor of the creditors.[55] Judge McGarr also reversed the award of all fees to Limeris and Kessler on the grounds that their appointment was void, ab initio.[56]

Kessler's Fees

Stein advanced four grounds for affirming the district court's conclusion: (1) The protection of the rights of creditors required that fees to Limperis and Kessler be denied; (2) the order appointing Limperis and Kessler was void ab initio and thus service rendered under such order could not be compensated; (3) the services of Limperis and Kessler did not benefit the estate; and (4) the denial of fees was a proper exercise of discretion.[57] Kessler responded by arguing that his services had benefited the estate and that as Professor Collier suggests, "In fact, denial of compensation or reimbursement is a sanction distinctly punitive in character and should be reserved to cases warranting a moral censure."[58]

The Seventh Circuit had long held that when a decree is reversed it is no longer of any force or effect and the parties are in exactly the same situation as though no decree had been entered.[59] Despite the court's previous position Judge Swygert held that vacation of the 1968 order appointing Limperis as trustee did not mean that his and Kessler's appointments were invalid in the sense that they should receive no compensation.[60]

Instead of taking the position that for all purposes except fees Kessler's appointment was void, the court should have taken the position enunciated

54. Ehrlich, as successor trustee, petitioned for fees and expenses in the amount of $2,412.50 and Stein petitioned for fees of $25,000 plus expenses of $2,225.39. Stein's petition for fees indicated that he had performed approximately 480¼ hours of services, of which 233 hours of Stein's time was spent in the effort to reverse the bankruptcy's judge's original order. The bankruptcy judge entered his order allowing fees of $500 to Ehrlich and $8,000 plus costs and expenses to Stein. Kessler applied to the court for fees of $4,500 and $128.54 in costs and expenses, as attorney for the trustee, of which the bankruptcy judge allowed $4,000. Of the 151 hours billed by Kessler, approximately 50 hours were for defending the appeal by Stein. Brief of Stein at 4-7.

55. Memorandum Opinion and Order of Federal District Court Judge Frank J. McGarr of April 24, 1974, Nos. 74-1585, 74-1586.

56. *Id.*

57. Brief of Stein at 8-19.

58. Brief of Kessler at 9, *citing* 3A COLLIER, *supra* note 21, at 1472.

59. Kaplan v. Joseph, 125 F.2d 602 (7th Cir. 1942). *See also* Quinn v. Gardner, 32 F.2d 772 (8th Cir. 1929); Willet Co. v. Carpentier, 4 Ill. 2d 407, 123 N.E.2d 308 (1954).

60. 523 F.2d at 112.

in *In re Stolkin,*[61] and argued that there were substantial equitable considerations in allowing fees for Kessler although his appointment was not technically valid at the time he performed the services. The great majority of Kessler's work was not related to the litigation over the election of the trustee, but directly and significantly benefited the estate. Thus, the court was correct when it concluded that to deny all of Kessler's fees would have been too harsh a result.

But the court argued, in justifying the awarding of Kessler's fees for defending the appeal, that to deny Kessler the cost of the appeal would be too great a disincentive for able attorneys such as Kessler to accept such appointments. The court stated that the attorney has no duty to investigate the validity of his own appointment, especially when the court calls the invalidity of the appointment plain and obvious.[62] A much better policy would be to create an incentive for the trustee's attorney as an officer of the court to report to the court cases of plain error in order that the rights of creditors be protected. While the court concerned itself with the public policy ramifications of not compelling attorneys to check the validity of their own appointments, the court expects that creditors should stand up for their rights even though head or tails they lose because they have to pay the losing trustee's attorney's fees.

After the court's decision in *In re Brooks & Woodington, Inc.*,[63] it is surprising that the Seventh Circuit completely overlooked the criteria it and other courts have established for determining whether the bankruptcy judge and the district court judge have abused their discretion in denying fees. The court should have concluded that the 50 hours Kessler spent defending Limperis's illegal election did nothing to benefit the estate but, on the contrary, caused increased administrative expenses, lengthened the time of administration, and contributed to the frustration of what the Seventh Circuit called one of the most sacrosanct rights of a creditor, his right to elect a trustee.[64]

Thus, the reading of *Peerless I* leaves a contradictory result in the policy of the Seventh Circuit. While the allowance of the bulk of Kessler's fees were overwhelmingly justified, the policy enunciated in *Peerless II* chills any incentive creditors have to protect their rights.

The Appeal of Stein

Stein advanced two theories to justify the award of compensation to an attorney who does not serve with an order of court,[65] the doctrines of

61. 472 F.2d 222 (7th Cir. 1973).
62. 523 F.2d at 112.
63. 505 F.2d 794 (7th Cir. 1974).
64. 472 F.2d at 60.
65. General Order 44 of the Bankruptcy Rules, abrogated by General Order 49,

Randolph v. Scruggs[66] and *In re New York Investers.*[67] Stein initially argued that the rule of *Randolph* justified his compensation. *Randolph* considered the compensation of an attorney as a common law receiver prior to bankruptcy and the appointment of a trustee. Collier summarizes the rule of *Randolph* as follows:

> (1) Persons who rendered service that proved beneficial to the estate will not be precluded from claiming reimbursement because they are not, at the time, officers of the bankruptcy court or because their services were rendered prior to bankruptcy; (2) their claim will be measured exclusively by the benefit they conferred on the estate by preserving it intact for the uses and purposes of a trustee when elected.[68]

Although the *Randolph* case and others[69] provide justification for awarding attorneys' fees when no trustee is appointed, the rule, as described later, does not justify the award of compensation when a trustee is appointed and serving. However, the implied premise of Stein's argument was that since Limperis's appointment was reversed and the order appointing him vacated, there was no trustee. Thus, Stein by analogy would meet the requirements of a common law receiver in the *Randolph* mode if the court had considered Limperis's appointment void. The court was therefore correct in rejecting this argument if it were also rejecting Stein's argument in the Limperis appeal that Limperis, despite the reversal, was until the time of a new election the legal trustee.

The theory of *New York Investors* is the culmination of a constant evolution of bankruptcy law. Courts have long held that the trustee must perform all of the services required for the administration of an estate and that compensation could not be awarded from the estate to others (third party volunteers) unless (1) services by the volunteer benefited the estate; (2) the trustee refused to act; and (3) formal authorization was procured from the bankruptcy court to proceed in the trustee's stead.[70]

read in pertinent part:

> No attorney for a receiver, trustee or debtor in possession shall be appointed except upon the order of the court, which shall be granted only upon the verified petition of the receiver, trustee or debtor in possession, stating the name of the counsel whom he wishes to employ, the reasons for his selection, the professional services he is to render, the necessity for employing counsel at all, and to the best of the petitioner's knowledge all of the attorney's connections with the bankrupt or debtor, the creditors or any other party in interest, and their respective attorneys. If satisfied that the attorney represents no interest adverse to the receiver, the trustee, or the estate in the matters upon which he is to be engaged, and that his employment would be to the best interests of the estate, the court may authorize his employment, and such employment shall be for specific purposes unless the court is satisfied that the case is one justifying a general retainer. . . .

66. 190 U.S. 533 (1903).
67. 130 F.2d 90 (2d Cir. 1942).
68. 3A COLLIER, *supra* note 21, ¶ 62.03 at 1411-13.
69. *E.g., In re* New York Investors, 130 F.2d 90, 92 (2d Cir. 1942).
70. *Id.*

The cautious procedures of requiring a preliminary order from the court as a condition of later applying for payment for service at the expense of the estate was adopted in order to mitigate, if not completely avoid, the harrassing importunities of numerous claimants for allowance out of the estate of the insolvent debtors. It was also adopted to relieve bankruptcy courts from the embarrassment of passing upon the merits of claims for compensation after all the services had been performed instead of determining initially whether the services were such as the trustees or their attorneys were bound to perform.[71] Thus, bankruptcy courts have been reluctant to allow third parties to undertake any action which a trustee could do unless the trustee refused to act.

New York Investors considered a set of circumstances where the court was willing to dispose of the final requirement of prior court approval. The exception was based on the premise that compensation for opposing allowances to trustees and their counsel stands on a different footing from compensation for opposing allowances to third parties. "Trustees cannot be expected to take appeals from their own allowances. They are scarcely in a better position to appeal from allowances to their counsel who would certainly be unlikely to advise such appeals."[72] The Second Circuit dismissed the necessity of obtaining an order by stating:

> But it seems to us that the efficient administration of the estate would have been but little promoted by such a step, even though it might have been better practice to seek a preliminary order. It is true that several creditors may seek compensation for opposing allowances to trustees and their attorneys, and then the very difficulties may arise which an initial order was designed to prevent. But denial of all compensation in a situation like the present entails *great hardship to the applicant and brings few advantages to offset this hardship.*[73]

Thus, the Second Circuit established the test that if the question involved is the trustee's own fees or fees for his counsel, then the attorney for the creditor who undertook to save the estate money by challenging such fees would be entitled to compensation.

In response to the compelling language of the Second Circuit, the Seventh Circuit apparently rejected the equitable consideration brought forth in *New York Investors*. But rather than rationalize its rejection of *New York Investors*, the court attempted to distinguish the facts in *New York Investors* from those in *Peerless II*.[74]

> *In re New York Investors* involved a situation in which the benefit to all the creditors was a monetary increase in the amount of the

71. *Id.*
72. *Id.*
73. *Id.* (emphasis added).
74. 523 F.2d at 111.

> bankrupt's estate. After the allowance of additional attorney's fees each of the creditors still received a larger award than they would have had there been no challenge. Our situation is different. The only direct benefit to the creditors was a vindication of the right to vote in the election for trustee. Although this is a valuable right, no actual increase in the amount of the bankrupt's estate resulted solely from the appellants' successful challenge.[75]

Both the court's major premise that a pecuniary increase in the estate is a condition precedent to compensation and the minor premise that the estate was not benefited must be questioned. First, the court asserted that only a pecuniary benefit can justify compensation. It is hard to believe that this is the same court which enthusiastically asserted that the creditor's right to elect a trustee is sacrosanct. The court's answer that the creditors right to elect a trustee is valuable, but cannot be quantified, is a mind-boggling exercise in double thinking. The court is saying the disfranchisement of creditors is not as important as collecting a few dollars for the estate.

Neither did the court address itself to one of the important facts of the case. Stein and Ehrlich upon their appointments as officers of the court had succeeded, just as the attorneys in *New York Investors,* in reducing the claims filed against the estate and challenging the trustees. In dollars and cents the claims against the estate were reduced by $57,000. Because Gollub had nominated and supported Limperis, it is highly unlikely that but for the successful fight of Stein and Ehrlich on behalf of the creditors, those claims would have ever been challenged and removed.[76] Yet, despite both the protection of sacrosanct creditors' rights, and the monetary benefit accruing to the estate, the court concluded that equity did not dictate an award of fees.

Considering the first appeal of Limperis and Kessler in *Peerless I,* the court spoke of the strong public policy in favor of giving lawyers and trustees incentive to serve in bankrupt estates. Yet, in *Peerless II,* the court was unwilling to give any incentive to creditors to vindicate their rights in bankruptcy even where such a vindication has monetary benefit. There is no doubt that the court has left only to the very rich the burden of defending the democratic and monetary rights of creditors in bankruptcy. The court should have remanded Stein's application for fees to the bankruptcy court for a determination of their fairness in light of the benefits accrued under the doctrine of *New York Investors.* Instead, *Peerless II* stands for the proposition that even where a creditor's attorney vindicates the rights of all creditors and minimizes the claims against the estate, the creditor's attorney will be left unpaid by the estate he protected, but the creditors will have to pay the fees of the trustee and his attorney who deprived them of their rights and allowed the invalid claims.

75. 523 F.2d at 113.

76. Limperis had failed to object to the claims initially and the court had allowed them.