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Bankruptcy--Bankrupt Retains Accrued Vacation Pay

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CASE COMMENTS

Bankruptcy—Bankrupt Retains Accrued Vacation Pay

The United States Supreme Court recently held that under section 70a (5) of the Bankruptcy Act, accrued vacation pay of bankrupt employees is not property which passes to a trustee in bankruptcy. Apparently the Court viewed the right to earn a living as an economic interest deserving special protection, perhaps because of its "humanistic" overtones. *Lines v. Fredrick,* 400 U.S. 18 (1970).

The respective trustees of the estates of appellants Fredrick and Harris had obtained turnover orders from the referee ordering each bankrupt to remit his accrued, but as yet unpaid, vacation pay to the trustee when it was received. The United States District Court for the Northern District of California affirmed the orders.

Both appellants had filed voluntary bankruptcy petitions. Their cases differed in the manner in which their employers handled vacations. Fredrick's employer shut down his plant and employees were given full pay during the shut-down. At the time of the petition, Fredrick had $121.68 of vacation pay to his credit Harris's employer used the common voluntary vacation plan. Harris had accumulated $144.14 vacation pay when he filed his petition of voluntary bankruptcy. In both cases the employee was not entitled to this pay until his vacation, unless the employment was terminated earlier.

The Court of Appeals for the Ninth Circuit reversed.[1] The court examined Section 70a (5) of the Bankruptcy Act[2] and stated that "vacation pay is 'property,' title to which vests in the trustee only if it is (1) non-exempt, (2) transferable or lienable, and (3) 'so little entangled with the bankrupt's ability to make an unencumbered fresh start' that it should be so regarded."[3] The court held that to transfer vacation pay to the trustee would inhibit the

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[1] Fredrick v. Lines, 425 F.2d 215 (9th. Cir. 1970).

[2] 11 U.S.C. § 110(a)(5) (1964).

> The 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, except insofar as it is to property which is held to be exempt, to all of the following kinds of property wherever located . . . (5) property, including Rights of Action, which prior to the filing of the petition he could by any means have transferred or which might have been levied upon and sold under judicial process against him, or otherwise seized, impounded, or sequestered. . . .

[3] 425 F.2d 215, 216-17 (9th. Cir. 1970).

bankrupt's ability to have this "fresh start." The Ninth Circuit cited *Segal v. Rochelle*,[4] which held that future wages of a bankrupt are not property which passes to the bankrupt's estate. The court stated that "[v]acation pay is analogous to future wages."[5] The trustee argued that those wages which were compensation for work done prior to the bankruptcy petition should be considered as accrued wages for the purpose of section 70a(5). The court rejected this, stating there was no similarity between wages earned which are paid at week's end, and vacation pay which has been credited to the employee, but which he cannot receive until his vacation or until he is laid off. Such credits, the court said, were as unobtainable as one's social security account before retirement.

The Supreme Court granted certiorari and, in affirming the decision of the Ninth Circuit Court of Appeals,[6] settled a conflict between the circuit courts on the matter.[7] A contrary result could easily be reached, for in *Segal v. Rochelle*,[8] cited in *Lines*,[9] the Court explained:

> [T]he main thrust of § 70a(5) is to secure for creditors everything of value the bankrupt may possess in alienable or leviable form when he files his petition. To this end the term "property" has been construed most generously and an interest is not outside its reach because it is novel or contingent or because enjoyment must be postponed.[10]

In *Segal* the taxpayer obtained a loss-carrybook tax refund under Internal Revenue Code section 172 (a)[11] after bankruptcy had been filed. The refund was from a period prior to bankruptcy, but the claim was contingent at the time the petition was filed. When he paid the initial tax, he had no thought of later receiving a return on it. The Court reasoned that to deny him the refund and declare it property to which the trustee was entitled would not lead to a loss of income which he had expected. The Court decided that the refund was "sufficiently rooted in the pre-bankruptcy

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[4] 382 U.S. 375 (1966).
[5] Fredrick v. Lines, 425 F.2d 215, 217 (9th Cir. 1970).
[6] Lines v. Fredrick, 400 U.S. 18 (1970).
[7] *See,* Kolb v. Berlin, 356 F.2d 269 (5th Cir. 1966).
[8] 382 U.S. 375 (1966).
[9] Lines v. Fredrick, 400 U.S. 18, 19 (1970).
[10] 382 U.S. 375, 379 (1966). *See also,* 35 Fordham L. Rev. 342 (1966).
[11] "There shall be allowed as a deduction for the taxable year an equal to the aggregate of (1) the net operating loss carryovers to such year, plus (2) the net operating loss carrybacks to such year." INT. REV. CODE of 1954, § 172 (a).

past and so little entangled with the bankrupt's ability to make an unemcumbered fresh start that it should be regarded as 'property' under § 70a (5)."[12]

As previously noted, prior to the court's opinion in *Lines* the circuit courts had been divided on whether accumulated vacation pay passed to the trustee in bankruptcy with the rest of his non-exempt property. The Sixth Circuit in *Tennessee Valley Authority v. Kinzer*[13] had previously reached the same conclusion as *Lines*. The court of appeals in that case reversed a decision which had held that sums accumulated toward a bankrupt employee's vacation and retirement were assets of the bankrupt's estate. The court held that at the time of bankruptcy the employee had no enforceable rights to these accumulated earnings; he could not transfer them nor could his creditors attach them. He acquired only a conditional right to this pay at a later date, contingent upon the fact that he remain in the employ of the company until time of payment; therefore, the accumulated vacation pay could not pass to the trustee.

However, in *Kolb v. Berlin*,[14] the Fifth Circuit affirmed an order requiring the bankrupt to turn over to the trustee in bankruptcy all accrued wages and annual leave pay. The court held these to be property within section 70a of the Bankruptcy Act. In that case, the bankrupt appellant relied on *Tennessee Valley Authorty v. Kinzer*[15] to support his argument that the accumulated sums were not property of the bankrupt's estate. The court distinguished *Tennessee Valley Authority*, pointing out that in that case the employee's right to accumulated vacation pay was contingent upon several factors, while in the case before the Fifth Circuit no contingencies were attached to the employee's right to the accumulated pay.[16]

In *Lines* the Supreme Court skirted the problem of when the right to vacation pay vests in the bankrupt employee. Instead the

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[12] Segal v. Rochelle, 382 U.S. 375, 380 (1966).
[13] 142 F.2d 833 (6th. Cir. 1944).
[14] 356 F.2d 269 (5th. Cir. (1966).
[15] 142 F.2d 833 (6th. Cir. (1944).
[16] In support of its decision the court cited *In re Kuether*, 203 F. Supp. 223 (N.D. Cal. 1962). In that case the district court vacated a ruling of the referee and awarded a turnover order to the trustee in bankruptcy of all vacation pay which had accumulated to the bankrupt at the time of the filing of the voluntary petition in bankruptcy. The *Kolb* court distinguished the case from *Tennessee Valley Authority v. Kinzer*, 142 F.2d 833 (6th Cir. 1944). stating that the reasons for the opposite result in that case were the contingen-

Court relied on the definition of the term "property" to reach its decision on whether vacation pay should be turned over to the trustee or whether a bankrupt employee should be allowed to retain it. The Court relied on *Local Loan Co. v. Hunt*,[17] in which it was pointed out that the primary purpose of the Bankruptcy Act is to allow the bankrupt to turn over all assets he possesses, and thereby settle all of his debts, giving him a chance to make a new start unemcumbered by his past debts. The Court said that whenever possible the provisions of the act should be interpreted with this purpose in mind. The Court also cited *Segal v. Rochelle*,[18] as precedent for not relying on the time of the filing of the petition as the sole factor in determining what property was to be turned over to the trustee. In *Segal* the Court found that the tax refund claim was "sufficiently rooted in the pre-bankruptcy past and so little entangled with the bankrupts' ability to make an unencumbered fresh start that it should be regarded as 'property' under section 70a (5)."[19]

However, in *Lines* the Court felt the accumulated vacation pay was to provide for the basic needs of the bankrupt and his family during the vacation or lay off. It concluded that to a force a bankrupt wage earner to endure such a period without wages would hardly be in keeping with the purpose of the act—to provide the bankrupt with a fresh start without the encumbrances of his old debts.

In reaching this result the court cited *Sniadach v. Family Finance Corp.*,[20] which held the freezing of wages without notice or prior hearing was a taking of property prohibited by the fourteenth amendment.[21] The Court in *Lines* stated that since vacation pay

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cies attached to the bankrupt's right to the accumulated vacation, which could have kept the employee from ever receiving the pay.

[17] 292 U.S. 234 (1934).

[18] 382 U.S. 375 (1966).

[19] *Id.*, at 380.

[20] 395 U.S. 337 (1969). *See*, Comment *Procedural Due Process Application to Pre-Judgement Garnishment*, 72 W. VA. L. REV. 165 (1969-70).

[21] For an expanded definition of "property" see Reich, *The New Property*, 73 YALE L.J. 733 (1964):

> The institution called property guards the troubled boundary between individual man and the state. It is not the only guardian; many other institutions, laws, and practices serve as well. But in a society that chiefly values material well-being, the power to control a particular portion of that well-being is the very foundation of individuality.

was a part of the worker's wages,[22] it was therefore entitled to the extra protection which *Sniadach*[23] held was due wages.

This decision should prompt new discussion of the property rights that receive special federal court protection. One may theorize about wages being a kind of property which might be given the same type federal court protection that non-property rights, often called "human rights", have been given in recent years. The interests which have been most vigorously guarded recently are free speech, civil and political rights, and privacy, none of which can be called a property right except perhaps privacy. *Sniadach* recognized that wages are of such importance as to be considered a "human right." Now the Court has this "humanistic right" into the term "property" in the Bankruptcy Act. The Court said that accumulated vacation pay is property, and therefore entitled to special protection; to accomplish this end it was necessary to find that accumulated vacation pay is not "property" within the meaning of the Bankruptcy Act.

In *Lines* the Supreme Court reached what is undoubtedly a fair result for the bankrupt wage earner. The result seems to follow a trend in which the Court has recognized basic needs of an individual and has sought to protect these needs. In *Bank of Marin v. England,*[24] the Supreme Court announced this policy, stating "that equitable principles govern the exercise of bankruptcy jurisdiction." Another example in which the Court seems to have ignored clear statutory language [§ 14c(5) of the Bankruptcy

[22] *See, In re Public Ledger,* 161 F.2d 762 (3rd Cir. 1947); *In re Wil-low Cafeterias, Inc.,* 111 F.2d (2nd Cir. 1940), holding that vacation pay is really extra wages.

[23] Sniadach v. Family Finance Corp., 395 U.S. 337 (1969).

[24] 385 U.S. 99, 103 (1966). Subsequent to the time of writing some checks, but prior to their being presented to the bank, a depositor filed a voluntary bankruptcy petition. The petitioner bank honored the checks of its depositor, being unaware of the bankruptcy proceeding. The trustee then sought a turnover order for the amount of the checks, and the referee held the bank and payee jointly liable for this amount. The district court affirmed the referee's order, and on appeal by the bank the court of appeals affirmed, relying on § 70a of the Bankruptcy Act. It held that upon the filing of the bankruptcy petition the bankrupt's checking account was frozen "by operation of law," the bankrupt's property vested with the trustee, and notice of this was unimportant. The Supreme Court granted certiorari and reversed. Section 70d (5) states that "no transfer by or in behalf of the bankrupt after the date of bankruptcy shall be valid against the trustee." It was argued that the drawing of the checks after the filing of bankruptcy constituted a "transfer" within the meaning of § 70d(5). The Court, however, said that there were overriding "equitable principles" which govern bankruptcy cases and held it would be inequitable to hold the bank liable for performing its contractual duty to pay checks of its depositors drawn prior to bankruptcy but presented after the filing of the petition, where the bank had no notice of the bankruptcy.

Act[25]] in favor of an equitable result was *Perry v. Commerce Loan Co.*[26]

In *Lines v. Fredrick*[27] the Supreme Court expanded the rights of a bankrupt. In doing this the Court added a new condition by holding that the meaning of "property" is also limited by the "basic purpose of the Bankruptcy Act to give the debtor a new opportunity in life and a clean field for future effort, unhampered by the pressure and discouragement of pre-existing debt."[28]

The Supreme Court has shown an increasing awareness of the needy and the destitute. The Court has moved to assure that these persons are not mistreated because of their financial problems. In *Shapiro v. Thompson*[29] the Court held statutory provisions which deny welfare assistance to otherwise eligible recipients solely on the ground that they have not resided in the state for one year create an invidious class discrimination. The Court noted that since such relief is a right and not a privilege,[30] the creation of such a class is a denial of equal protection under the fourteenth amendment. Again in *Goldberg v. Kelly*[31] the Court sought to assure that the impoverished individual's needs are not wrongfully denied him. The Court noted the dire dependence on this relief by the destitute, and reasoned that in order for a state to terminate this assistance the due process clause of the fourteenth amendment required a hearing prior to such termination.

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[25] 11 U.S.C. § 32(c) (1964).

> The court shall grant the discharge unless satisfied that the bankrupt has . . . . (5) in a proceeding under this Act commenced within six years prior to the date of the filing of the petition in bankruptcy . . . . has been granted a discharge, or had a composition or an arrangement by way of composition or a wage earner's plan by way of composition confirmed under this Act. . . .

[26] 283 U.S. 392 (1966). Plaintiff Perry sought an extension of time to pay his obligations pursuant to chapter XIII of the Bankruptcy Act. He offered to pay his debts in equal monthly installments of $60 from his wages of $265 a month for 28 months in order to pay his debts of $1,412. Within the preceeding six years Perry had filed a petition in straight bankruptcy and thereby had obtained a discharge of his debts. Upon motion the referee dismissed plaintiff's proposal, stating that pursuant to §14c(5) of the Act, the prior bankruptcy was a bar to this plan. The district court upheld the dismissal and was affirmed by the court of appeals. 340 F.2d 588 (6th Cir. 1965). Upon certiorari the Supreme Court held that § 14c(5) did not affect extension of debt payment plans, since such plans were developed subsequent to the enactment of the statute, and reversed the judgment below. *See also,* Reading Co. v. Brown, 391 U.S. 471 (1968).

[27] 400 U.S. 18 (1970).

[28] *Id.,* at 19.

[29] 394 U.S. 618 (1969).

[30] Shapiro v. Thompson, 394 U.S. 618, 627 n.6 (1968).

[31] 397 U.S. 254 (1970).

In *Lines* the Supreme Court has done what many feel is needed; the Court appears to have created a national exemption law under the Bankruptcy Act. Section 6 of the Bankruptcy Act[32] says that the bankrupt shall be entitled to the same ordinary exemption as he would pursuant to the laws of the state in which he is domiciled. West Virginia residents get only a two hundred dollar personal property exemption,[33] while in other states the exemption may be much higher. The Court has recognized the importance of wages in our society and has sought to protect them by recognizing a new property right—the right of an individual to earn a living. In so doing the Supreme Court has acted where Congress failed to act. It has created what amounts to a "federal common law" under the Bankruptcy Act. That a wage earner desperately needs the vacation pay he has accumlated is beyond question. He could not replace this money by another job during a lay-off or vacation period with anything comparable to what he would receive from this vacation pay.

The holding in *Lines* can logically be extended to all of a bankrupt's accrued but unpaid wages. This is an important extension because many employers "hold back" wages and pay employees for the pay period immediate preceding the one just completed. Bankrupt employees often have wages owed to them in excess of the statutory exemption. Thus a bankrupt would be without the funds necessary to provide for himself and his family if these wages were turned over to he trustee. Extending *Lines,* the bankrupt would be able to retain these wages in order to get a fresh start.

The requirement to give the bankrupt a fresh start could be extended beyond wages, to other necessities, such as a car required for the wage earner's job. However, one would expect the Court to reach a compromise here. Mr. Justice Harlan's dissent in *Lines v. Fredrick*[34] may provide some guidelines as to how far the court will go. He said that by giving the bankrupt this accumulated vacation pay the Court was not giving him a "fresh start", but instead a "head start" in that he was receiving assets. The Supreme Court probably would not say one needed a home for a fresh start; a

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[32] 11 U.S.C. § 24 (1964).

[33] W. VA. CODE ch. 38, art. 8 § 1 (Michie 1966):

> Any husband or parent residing in this State, or the widow, or the infant children of deceased parents, may set apart and hold personal property not exceeding two hundred dollars in value to be exempt from execution.

[34] 400 U.S. 18 (1970).

worker can rent. However, the bankrupt does need a job. The Court probably will not extend the doctrine very far, but will instead look to Congressional action in the area.

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Bankruptcy—New Approach To Dischargeability

On October 19, 1970, Congress enacted Public Law 91-467[1] which radically altered the existing practice concerning bankruptcy discharges.[2] In considering the full impact of this new law, it will be useful to consider some of the abuses it was meant to correct.

I. Introduction

Underlying the operation of bankruptcy discharge is the basic concept that in return for surrendering his non-exempt assets for the benefit of his creditors, the debtor will be discharged from all his provable debts, except for those debts which might be expressly excepted by statute from the operation of that discharge.[3] It can then generally be said that the bankruptcy law does equity both to the creditor, because he can more easily discover and recover the debtor's assets,[4] and to the debtor, because it is "in the interest of a sound public policy not to keep the debtor forever in bondage to his debts, but to restore his energies to the business community."[5]

Conceding that the policy of the bankruptcy law is to treat both the creditor and the debtor fairly, two major sources of abuse have existed in the past which allow the creditor to circumvent the discharge policy. These were: (1) once a bankruptcy court had granted a discharge, the actual effect of this on any individual creditor's claim would be determined in nonbankruptcy courts; and (2) even if the debtor could have pleaded his discharge in the non-

[1] 84 Stat. 990 (*U.S. Code Cong.* & Ad. News 4536 (1970)).

[2] Although enacted on Oct. 19, 1970 the new law will affect all cases filed on and after Dec. 19, 1970. 84 Stat. 990 (*U.S. Code Cong & Ad. News* 4536, 4540 (1970)).

[3] *In re* Anderson 1 F. Cas. 831 (No. 351) (E.D. 1974). *See generally* Beneficial Fin. Co. v. Collins, 150 W. Va. 655, 149 S.E.2d 221 (1966); Ruhl-Koblegard Co. v. Gillespie, 61 W. Va. 584, 56 S.E. 898 (1907).

[4] 7 H. REMINGTON, A TREATISE ON THE BANKRUPTCY OF THE UNITED STATES § 2993 (6th. ed. 1955).

[5] *Id.* The impracticality of such a bondage can be seen if it is remembered that many bankruptcies are the product of sincere, but inopportune, business decisions, rather than fraudulent manipulations.